Remarks by
The Honorable Kenneth A. Spearman
Board Chairman and CEO, Farm Credit Administration
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I am pleased to report that the condition of the Farm Credit System is strong. Its net income was $4.72 billion in 2014, up 1.8 percent from 2013. The System also maintained a strong capital position in 2014, with total capital at $45.7 billion at the end of 2014, up more than $3 billion from the year before.

In general, the quality of System loans remains very good. Credit quality for livestock, dairy, and poultry producers improved in 2014 because lower feed costs and favorable pricing led to strong profits.

And the AgFirst district is an important part of the overall System's success. Your total loan volume increased 5 percent in 2014.

Since your portfolio of loans to protein producers is generally higher than the overall System, your district benefited from the higher prices and lower feed costs that protein producers enjoyed in 2014. This has contributed to the improvement in your credit quality.

At year-end 2014, almost 94 percent of the combined association district portfolio was classified as acceptable, compared with 92 percent last year, and up substantially from several years ago. So I would like to congratulate you on the success of this past year.

As a regulator, we work very hard to anticipate challenges that the System may face in the years ahead, so I'd like to spend a few moments sharing with you the five greatest risks that we foresee for the System as a whole.

The **first risk** I'll mention is the possibility of a substantial correction in farm real estate values. Real estate mortgage loans accounted for about 45 percent of the System's total loan portfolio on December 31, 2014, and farm real estate serves as the primary collateral for these loans.

As we're all aware, farmland values have risen dramatically over the past few years. When land values are high and demand for credit is great, credit risks may not be as apparent. I am pleased to note that System institutions have generally been restrained in their farm real estate lending during this period of rising land values, and this conservatism will help mitigate any financial fallout from a drop in land prices. I encourage you to continue to pay close attention to collateral risk in the loans you make.

The **second risk** I'll mention is the risk of a protracted period of low grain and soybean prices. As a result of more plentiful world supplies and weaker demand, many analysts are now projecting an extended period of lower grain and soybean prices. Although many producers are well positioned to survive a few lean years, some are not. And cash grain farms account for about 18 percent of the System's total loan portfolio, making it the largest commodity risk for the System.

In general, the AgFirst district is well diversified, but a few associations have higher concentrations of loans to grain producers. These associations may need to monitor this risk closely.

The **third risk** is the rapid rise in interest rates. The Federal Reserve appears likely to raise short-term rates before the end of the year, and higher long-term rates are likely as the economy strengthens and expectations for inflation rise.

A steep, rapid rise in interest rates could cause assets, such as farmland or housing, to lose value quickly. The dollar would also strengthen against other currencies, putting U.S. farm exports at a disadvantage. A rapid rise in interest rates could produce a spike in credit problems because of falling collateral values and higher debt servicing costs. It could also lead to slower economic growth, choking off the demand for higher-valued farm products.

We recognize that interest rates will eventually rise, and as your regulator, we will continue to monitor developments in the Fed's interest rate policy and its impact on the System.

The **fourth risk** to the System as a whole is a continuation of California's drought for several more years. The drought is already in its fourth year, and it is likely to go into a fifth year. Some experts suggest that the state's drought could extend for many more years.

If that happens, many current borrowers may be deemed uncreditworthy because of limited water access. This would likely lead to loan losses for the System. Nearly 10 percent of the System's total loan portfolio consists of loans made in California.

And the **fifth risk** to the System is a weakening in export demand. The value of U.S. agricultural trade has more than doubled since the mid-2000s, making trade very important to our farm economy. And last year was a record year for U.S. farm exports. So a drop in demand could be a real challenge to farmers and therefore to farm lenders.

Economists do, in fact, expect to see a decline in exports in 2015—for several reasons. First, some of the fast-growing economies to which U.S. producers sell farm products are slowing down. They're still growing, just not as fast. Second, the dollar has gotten stronger, which makes our products less competitive. Another factor that can drive down exports is a change in government trade policy. Take Russia, for example. In response to international sanctions levied against it, Russia has banned products from the countries imposing the sanctions. All of these factors can weaken export demand, reducing farm income and the ability of farmers to repay their loans.

Those are the top five risks that we see facing the System. There are many other risks, including crop and livestock diseases. Your district has been dealing with the effects of citrus greening for several years now, and I am aware that the industry is searching for solutions. Fortunately, the porcine epidemic diarrhea virus, which affected some of the swine operations in your district, is now under control, but the avian flu could take its place. The most recent outbreak of this virus was detected in Oregon seven months ago. Since then, it has spread to 14 more states. So far, the virus has not appeared in the AgFirst district. But since your district portfolio includes a sizeable poultry segment, I do encourage you to take measures to mitigate this risk.

Over the past several years, FCA has emphasized the importance of sound loan portfolio management. I would like to commend your district for your responsiveness to the guidance we've provided in this area. In late 2012, you established a Collateral Risk Focus Group, with representatives from all district associations. This group has focused on data enhancements, policy and procedure recommendations, collateral evaluations, and land trend analysis. These efforts have significantly strengthened your district's collateral risk management.

I would also like to recognize your district's leadership in serving young, beginning, small, and minority farmers. Six years ago you sponsored Ag Biz Planner, a curriculum designed to teach members of these groups how to successfully manage and grow their operations. Already, the curriculum has had 500 enrollments, and this number is likely to grow substantially as more System institutions take advantage of it.

I am aware that the AgFirst Farm Credit Bank continues to review its operating expenses, and I commend you for doing this. As I understand, AgFirst associations may be able to achieve greater efficiency by utilizing existing information technologies more fully. I encourage you to take advantage of these opportunities to improve efficiency across the district.

FCA is also working hard to leverage technology for greater efficiency. In May we created a separate Agency-level division called the Office of Technology, and we are currently recruiting for the right person to lead this office.

In the few remaining minutes, I'd like to share some thoughts about the work we are doing at FCA. I just mentioned our efforts to use technology to improve efficiency. We are also using it to improve our effectiveness. The Farm Credit System Loans database project is a good example. With this new database, we can obtain more timely, comprehensive information about the loans that System institutions are making and how these loans are interrelated. That will enable us to detect risks earlier and to see their effects not only on individual institutions but the System as a whole.

Of course, technology comes with risks, as well as opportunities. I'm sure you've all heard about the cyber security breach at the Office of Personnel Management. Incidents like this are a threat to every organization, public or private, and we are constantly on guard against this threat.

As the System regulator, we are also concerned with cyber security threats to your institutions. I was recently asked to join the Financial and Banking Information Infrastructure Committee. Chartered under the President's Working Group on Financial Markets, this committee is charged with improving coordination and communication among financial regulators. As a member, I will work with others from regulatory agencies to coordinate efforts to improve network reliability and information security.

On the regulatory front, we recently reopened the comment period on the proposed capital rule. This will give the two new Board members additional time to consider this complex rule. Since the end of the original comment period, we have been reviewing the input we received, and we will carefully consider these additional comments as well. This rule is very important because it will update the System's foundation for safety and soundness, and it will help ensure that the System remains well-capitalized.

On the examination front, we are stressing the importance of strong internal controls. Our Office of Examination has developed new draft guidance for our examiners to use in evaluating institutions' internal controls. In the near future, we plan to provide guidance on best practices that we want you to consider. We may also develop other guidance, including a proposed rule, to strengthen this area.

But you don’t have to wait for this guidance. I encourage you to take the initiative now to perform a self-assessment. What are your weaknesses? And what business practices could you adopt to address them? You know best where your weaknesses may lie and how to address them. I understand the value that strong internal controls can bring to an organization. Having them in place can save many headaches down the road. So I urge you and your audit committees to make sure your institution’s internal controls are functioning effectively.

I’d also like to share a few thoughts on diversity. In 2012, I was proud to support a new rule requiring System institutions to increase their outreach to minority groups in their territories. The purpose of the rule is to increase diversity—both in the customer base and the workforce of System institutions. I would like to commend your district for your responsiveness to this rule. I understand that you have reworked your YBS policy and procedures to include minority farmers. I also hear that you have supported events focused on nontraditional audiences, such as organic farmers and women farmers. And I understand that you have expanded your efforts through your farmers market program. These are exactly the kinds of initiatives that we had in mind when we issued the diversity rule.

Diversity is especially important in the Farm Credit System because it’s a Government-sponsored enterprise. It has a public mission to serve all eligible, creditworthy individuals.

We’re focusing on diversity at FCA as well. In our recruiting for new employees, we are making concerted efforts to attract qualified individuals from diverse backgrounds. I support diversity because I believe it’s the right thing to do. At FCA, we expect ethical behavior of every individual in every activity—from hiring, to conducting exams, to writing regulations. We have a strong ethics program, which includes mandatory annual training for every employee. I believe that integrity is critical to the success of any organization.

In addition to emphasizing diversity and ethics at FCA, we are also looking for ways to make the working environment more positive for all employees. When morale is high, employees are more efficient and effective.

Now I’ll leave you with a few final thoughts. In my early career as an accountant in private industry, my focus was on the numbers and how they affected my organization.

But when I entered the agriculture industry about 30 years ago as an accountant in an ag cooperative, my perspective broadened. I am proud to be part of an industry that meets one of humanity’s basic needs.

I am also proud today to play a role in ensuring the safety, soundness, and mission achievement of the Farm Credit System because I am keenly aware of the role the System has played over the past century to create the vibrant farm economy we have here in the United States. And although I am bound by ethical standards to maintain an arm’s length distance from the System, I understand that we cannot be an effective regulator without open communication with the institutions that we regulate.

The System truly is the best-kept secret to the success of the American farm economy. For the System to continue to play this important role, however, it can’t stay a secret, not in today’s political environment. The System needs to tell its story—to Congress, to the public, and to its detractors. —Don’t let others define you.—

Another crucial factor in the System's continued success is its focus on mission. The System must stick close to its congressional mandate to serve agriculture and rural America. And we, as the regulator, will do our job to ensure the System's safety and soundness so that you may fulfill your mission to provide credit for farmers and ranchers for generations to come.

Thank you.