Remarks by
The Honorable Kenneth A. Spearman
Farm Credit West Planning Meeting
Santa Barbara, California
July 26, 2012

Mr. Spearman begins with brief introductory remarks and expresses his gratitude for the invitation to speak. The following text contains the body of his speech.

I've been asked to provide you with an update on some areas of FCA concern, which I'm happy to do. First off, however, I want to note that while FCA takes action upon the collective vote, its three Board Members—each FCA Board Member appointed by the President—acts independently. This means, among other things, that any opinions I happen to express during my time here are my own and not necessarily official Agency views.

As I'm sure most of you know, I am one of three presidentially appointed members of the FCA Board, along with Chairman Lee Strom and fellow Board Member Jill Long Thompson. As most of you also may know, Lee Strom's term as a Board Member comes to an end this October, at which time the President will designate one of the remaining Board Members to be Chairman of the Agency. He also must nominate a new Board Member—who will need the approval of the Senate—to take Lee's seat and serve a six-year term on the FCA Board.

As some of you may not know, in addition to my role as FCA Board Member, I also serve as Chairman of the Farm Credit System Insurance Corporation, which has the same three Board Members as FCA. I have enjoyed working with the very diligent and professional staff members of the Insurance Corporation, who constantly monitor the Insurance Fund to ensure its safety and soundness. Over the past year, the Insurance Corporation has studied, reviewed, and revised its policies and procedures to ensure its readiness for resolving a seriously troubled or impaired institution and has extensively studied and provided input on important issues facing the System, particularly involving capital and liquidity.

Also, significantly for the System, in April 2012 the Insurance Corporation was able to refund over $221 million to the System in excess funds, the second time in the past three years we were able to provide the System with a significant refund. Our ability to provide these timely refunds was a result of statutory changes made by Congress in 2008. While we always seek to collect only the necessary amount of premiums, the new process has worked to allow us to provide timely refunds when we end the year with excess amounts. The fact that we are able to refund this money also reflects positively on the stability of the System and the determination that the fund will not need to be used in the near future.

FCA ISSUES—Importance of a Strong Regulator

The first broad issue I want to mention relates to the role of FCA. Congress has continued to put off any serious debate about what to do with Fannie Mae and Freddie Mac—the big housing

Government-sponsored enterprises—but at some point it will have to address this situation. Up to this point the Farm Credit System—the nation's first GSE—has not really been brought into this debate, but there is no guarantee that will continue.

Note that the failure of the biggest GSEs was also a failure of their regulatory agency and a failure of Congress to protect the independence of the regulator. We saw Fannie and Freddie use their lobbying strength to undermine their regulator's ability to effectively regulate. So far, the System has managed to avoid the most onerous provisions of the Dodd-Frank Reform Act and to stay out of the debate on GSE reform, in part because of its regulator and in part because of its differences from the housing GSEs, including its cooperative structure and agricultural focus. I believe it is critical for the future of the System to have a strong, independent regulator so that the System may differentiate itself from its GSE cousins and maintain its GSE status for the long-term.

So while I believe that open communication and interaction with regulated parties—like what we are doing here today—is absolutely vital in order to be an effective regulator, I always try to be mindful of my role as an arm's-length regulator and representative of the United States Government.

Business Planning Rule

The second item I want to mention is the business planning rule adopted by the FCA Board this past April, which requires institutions to incorporate concepts of diversity and inclusion into their human capital and marketing plans.

I view the marketing component of this rule to be central to fully achieving the statutory mission of the Farm Credit System to serve the credit needs of *all* potential customers, specifically including young, beginning, and small farmers in order to help make sure there will be a next generation of American farmers.

Therefore, I think it's important for the System, and for FCA, to take a broader view of System lending and to look at how the System is serving "*all types of agricultural producers"* in *all* segments of the agricultural marketplace. This marketplace includes minorities, women, and new entrants to agriculture, as well as producers seeking to capitalize on consumer demand for organic and local foods.

The marketing component of the business planning rule is significant because—as a GSE with a public mission to serve all of agriculture—it really isn't enough for an association to just open its doors and serve those who walk in. I've heard numerous stories about different kinds of agricultural producers who've never heard of Farm Credit. I think it's important for the System to be widely known as an inclusive organization.

Many of the commenters on our business planning rule were concerned that we were looking for quotas or some other easily quantifiable result. That was not our intent. We are not trying to dictate particular outcomes.

Instead, the rule is focused on *qualitative* outreach efforts. Association boards and management can't control or guarantee results; however, they can control the quality of outreach and other efforts made by their associations.

We do recognize, for example, that agriculture in California is different from agriculture in New York or Iowa. That's why the new rule rejects a one-size-fits-all philosophy. Each association faces different sorts of challenges, and each association needs to take different steps in order to best serve its particular market.

I believe that it is a shared responsibility of everyone in the System to ensure that the System meets its mission of serving the credit needs of all potential customers. This is why I sought, as part of FCA's approval of the merger of CoBank and U.S. AgBank, a condition that required CoBank to assist its associations in meeting their mission of serving all potential borrowers.

While the associations are responsible for retail lending to farmers and ranchers, CoBank, with its vast resources and national presence, is uniquely situated to coordinate, support, and assist in local efforts. Therefore, I am very pleased to see CoBank step up and take a leadership role with its "Growing Rural America" initiative. I also look forward to other System banks taking a role in supporting their associations' efforts to meet the System's mission.

FCA's new rule—putting concepts of diversity and inclusion into our regulations—is a good first step. I recognize, however, that it is only a first step. In order to be effective, this cannot become a check-the-box sort of regulatory compliance issue. FCA can't effectively dictate to the System in this area. Instead, this has to be something that the System embraces and effectively incorporates into its own culture. While some System institutions may be more forward thinking, this culture change will likely not come easily in many parts of the country. Hopefully, leaders in the System will view this as an important issue for the System as a whole and work together to share best practices and strategies.

While FCA's eligibility rules for financing agricultural producers are broad, we are continuing to review FCA rules and guidance to see if there are any impediments we need to remove or additional guidance we need to provide that will enhance the ability of the System to finance emerging farmers or local food producers.

Another important question in this area is how we look at the issue of creditworthiness. The risk profile for a YBS or other unconventional borrower is going to be very different from that of a commodity producer with crop insurance and Government support programs. However, that doesn't necessarily mean that they aren't creditworthy and won't be able to repay debts. While institutions often categorize YBS loans as higher risk, from what we can tell, the default rates on these loans don't appear greater than for other loans.

I'm not suggesting System lenders lend money to people who won't be able to pay it back. I recognize that many small producers are not creditworthy under any reasonable standard and are not able to service any significant level of debt. The System is not the lender of last resort. However, I am suggesting that we make the effort to look differently at these types of farmers in making creditworthiness decisions. I am also suggesting that lending to these borrowers is the type of risks, effectively managed, that a System institution should be prepared to take in order to fulfill its mission.

In addition to the *obligation* to serve all types of agricultural producers, the significant consumer demand for organic and locally produced foods indicates that there are also viable *business* opportunities—and viable customers—out there for the System to cultivate. To maintain its long-term relevance, I think the System needs to continue to keep its focus closely on agriculture and ensure that the next generation of farmers—whoever they are and however they operate—is served by Farm Credit.

It may be just as important for the System's long-term relevance for Congress and the public to understand the important role that Farm Credit plays in ensuring credit for *all* agricultural producers—in other words, that Farm Credit is needed and continues to support an important public purpose.

Note that local food systems frequently include farmers operating in or near—or directly supplying—urban and suburban areas. These are areas in which Farm Credit historically doesn't have much of a presence. Therefore, being active in this market is an opportunity to create more people who understand—and care about—Farm Credit, something that will clearly pay long-term dividends for the System.

Safety and Soundness

While ensuring that the System fulfills its public mission is vitally important, the primary job of FCA is to ensure the continuing safety and soundness of the System—so that it has the ability to meet its mission. FCA staff is very focused on identifying and monitoring risks in the System, both at the micro level at every institution and on a Systemwide macro level.

With regard to Systemwide oversight, improved data collection has been a long-term goal of the Agency, and we are stepping up our efforts in working with the System in achieving this goal. We intend to enhance the Agency's use of institution and Systemwide loan level data in examination and policymaking, with emphasis on improving the capacity to measure and monitor shared-asset and other Systemwide risks. We also intend to leverage improved data through investments in technology, modernized examination tools, and enhanced staff skills to advance the Agency's examination and policymaking roles.

I know that this goal of improved data collection to enhance Systemwide risk assessment is also an important priority of Tracy McCabe, the new head of the Funding Corporation—just as it was for Jamie Stewart, the recently retired CEO. We look forward to continuing our work with the System and the Funding Corporation to achieve these common goals.

Safety and Soundness Rulemaking

Most of our upcoming regulatory agenda is focused on ensuring the continuing safety and soundness of the System. We have issued proposed rules related to liquidity, funding, and investments and will likely be looking at revising our capital rules within the next year.
As a whole, the System has acted prudently and done a good job of insulating itself from the financial problems encountered by other types of financial institutions since 2008; however, because of the unique nature of the System, we believe it's important for FCA to have appropriate rules in place in order to avoid future problems.

One thing we are cognizant of is that—unlike commercial banks—the System has no recognized "lender of last resort." This means that the System needs to be able to rely on its liquidity and capital in the event of a market disruption. We are also cognizant of the fact that the System is currently funding itself at incredibly low rates, continuously calling debt to improve interest margins. This remarkable situation presumably can't last forever, so we need to take steps today to be prepared to deal with a more historically normal interest rate environment.

Compensation Rule/Corporate Governance

One final pending rule I should probably mention is our proposed rule, adopted by the FCA Board last December, intended to enhance disclosure of senior officer compensation. The proposed rule would also provide a nonbinding mechanism for a shareholder "say on pay" vote if certain events occur. Judging from the comment letters we received, System folks don't seem to like this proposal very much.

Because this is still a pending proposed rule, I can't really get into a dialogue with you on the particulars of this rule because of legal restrictions related to Federal agency rulemaking. However, please be assured that FCA staff and board carefully review and consider all comments we receive before taking action on a final rule and I appreciate when people take the time to write an individual letter explaining their views. The Board will likely consider a final rule early this fall.

I do want to note, as a general matter, that I strongly believe in transparency of corporate operations—particularly for a member-owned co-op. I also believe that corporate governance is an important safety and soundness issue that FCA should be concerned with.

As you may know, my background is primarily in the financial and accounting field, including 28 years working for large cooperatives in the citrus industry in Florida. As you may also know, prior to being appointed to the FCA Board by President Obama, I served as an outside appointed director for AgFirst Farm Credit Bank for approximately four years, serving on board compensation and governance committees. I came away from my experience on the AgFirst board with a deep appreciation for the knowledge and dedication of my fellow board members. I also came away with an understanding of the crucial need for an effective board of directors for each System institution.

Unfortunately, good economic times sometimes hide management and corporate governance problems in institutions. We've seen an illustration of that over the last few years; many of the System associations that have gotten into significant financial trouble are also institutions where FCA examiners have identified significant corporate governance problems—including circumstances where the board has not exercised effective oversight over the management and operations of the association. We've also been concerned about certain compensation situations that have occurred in the System over the past several years.

The governance of all corporations is vested in its board of directors. This role is even more vital in a cooperative—such as a System association—where, for most board members, it truly is *your* institution: you own it and you borrow from it. Part of being a co-op director is also finding ways to ensure that the membership is engaged, informed, and feels a vested interest in the organization.

Conclusion

I'd like to thank you for the opportunity to visit with you today and share some of my thoughts on FCA and the Farm Credit System. While there are many challenges facing FCA and the Farm Credit System, I want you to know that I appreciate the dedication, knowledge, and expertise of the people of the Farm Credit System and FCA. I very much look forward to working with you over the coming years during my term on the FCA Board.