Testimony of the Honorable Jill Long Thompson
Chair and Chief Executive Officer
Farm Credit Administration
Before the Subcommittee on Agriculture,
Rural Development, Food and Drug Administration, and Related Agencies
U.S. Senate Committee on Appropriations
March 4, 2014

Mr. Chairman and Members of the Subcommittee, I am Jill Long Thompson, Board Chair and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). On behalf of my colleagues on the FCA Board, Kenneth A. Spearman of Florida and Leland A. Strom of Illinois, and all the dedicated men and women of the Agency, I am pleased to provide this testimony.

Before I discuss the Agency's role, responsibilities, and budget request, it is my privilege to thank the Subcommittee staff for its assistance during the budget process. As the Subcommittee knows, FCA does not receive a Federal appropriation. The funds used by FCA to pay its administrative expenses are assessed and collected annually from the Government-sponsored enterprises we regulate and examine—the Farm Credit System (FCS or System) made up of banks, associations, and service corporations, and the Federal Agricultural Mortgage Corporation (Farmer Mac).

The Agency is submitting a proposed total budget request of $65,600,000 for fiscal year (FY) 2015. FCA's proposed budget for FY 2015 includes funding from current and prior-year assessments of $65,100,000 on System institutions, including Farmer Mac, and $500,000 from anticipated reimbursable work for the Farm Credit System Insurance Corporation, the U.S. Department of Agriculture, and the National Consumer Cooperative Bank. Almost all this amount (approximately 83 percent) goes for salaries, benefits, and related personnel costs.

A key factor driving the FY 2015 budget is the Agency's need to hire and train qualified individuals to replace the many employees—especially examiners—who have begun to retire. We must ensure that our staff has the skills it needs to address changes in the agricultural industry and the complexities of agricultural finance. Also, changes in the organization and structure of the System itself are presenting challenges. As System institutions continue to merge and grow larger and more complex, the Agency must dedicate more resources and skilled staff to examining and overseeing these institutions. The funding we have requested for FY 2015 will allow us to hire and train the people we need to continue to properly examine, oversee, and regulate the System.

MISSION OF THE FARM CREDIT ADMINISTRATION

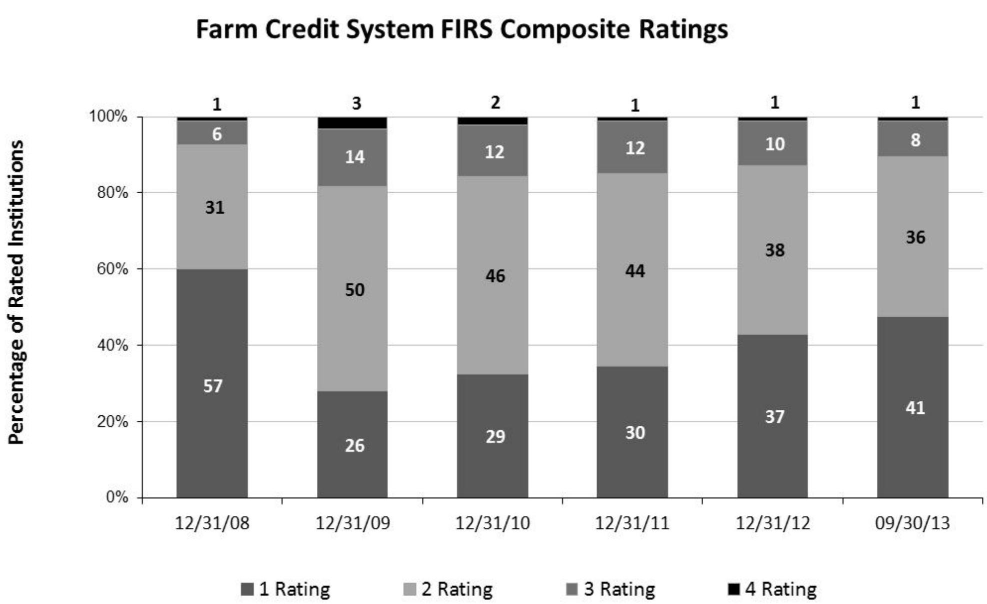
As directed by Congress, FCA's mission is to ensure a safe, sound, and dependable source of credit and related services for all creditworthy, eligible persons in agriculture and rural America. The Agency accomplishes its mission in two important ways. First, FCA protects the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and ensures that the institutions comply with applicable laws and regulations. Our examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risks, as well as on the ability of its board and management to direct its operations. We also evaluate each institution's compliance with laws and regulations and evaluate whether it serves all eligible borrowers, including young, beginning, and small farmers and ranchers. If a System institution violates a law or regulation or operates in an unsafe or unsound manner, we use our supervisory and enforcement authorities to ensure appropriate corrective action is taken. Second, FCA develops policies and regulations that govern how System institutions conduct their business and interact with customers. FCA's policy and regulation development focuses on protecting System safety and soundness; implementing the Farm Credit Act; providing minimum requirements for lending, related services, investments, capital, and mission; and ensuring adequate financial disclosure and governance. The policy development program includes approval of corporate charter changes, System debt issuance, and other financial and operational matters.

EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

To help ensure the safety and soundness of FCS institutions, FCA uses examination and supervision processes to address material and emerging risks at the institution level and across the System. The Agency bases its examination and supervision strategies on institution size, existing and prospective risk exposure, and the scope and nature of each institution's business model. We monitor agricultural, financial, and economic risks that may affect groups of institutions or the entire System. Given the increasing complexity and risk in the System and human capital challenges at FCA, we continue to implement a number of initiatives to improve operations, increase examination effectiveness, and enhance staff expertise in key examination areas.

The frequency and depth of examination activities vary based on risk, but each institution is examined at least once every 18 months and receives a summary of examination activities and a report on its overall condition. FCS institutions are required to have effective loan underwriting and loan administration processes, to properly manage assets and liabilities, to establish high standards for governance, and to provide transparent disclosures to shareholders. FCA's examination and supervision program promotes accountability in FCS institutions by providing a framework to help institutions identify and manage risks. In addition, FCA is closely watching real estate values that have risen rapidly in certain sections of the country to ensure that FCS lending practices remain prudent. FCA may use its enforcement powers to effect changes in an institution's policies and practices to correct unsafe or unsound conditions or violations of law or regulations.

The Agency uses its Financial Institution Rating System (FIRS) to assess the safety and soundness of each FCS institution. The system provides a framework of component and composite ratings to help examiners evaluate significant financial, asset quality, and management factors. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail. As the chart below indicates, the System remains financially strong overall. At the present time, institutions are well



Source: FCA's FIRS Ratings Database. The above chart includes only the System banks and their affiliated direct-lender associations. It does not include Farmer Mac. The figures in the bars indicate the number of institutions by FIRS rating.

capitalized, and the FCS does not pose material risk to investors in FCS debt, the Farm Credit System Insurance Corporation, or to FCS institution stockholders.

Although the System's condition and performance remain satisfactory overall, several institutions are experiencing stress that requires special supervision and, in some cases, enforcement actions. Factors causing the stress include weaknesses in the Nation's economy and credit markets, a rapidly changing risk environment in certain agricultural segments, and, at times, management's ineffective response to these risks or other operational challenges. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to the nine institutions rated 3 or worse. Although these institutions represent about 2 percent of System assets and do not materially affect the System's consolidated performance, they require significantly greater Agency resources to oversee. As of September 30, 2013, eight FCS institutions were under formal enforcement actions, but no FCS institutions are in conservatorship or receivership.

REGULATORY AND CORPORATE ACTIVITIES

Regulatory Activities—Congress has given the FCA Board statutory authority to establish policy, prescribe regulations, and issue other guidance to ensure that FCS institutions comply with the law and operate in a safe and sound manner. The Agency is committed to developing balanced, flexible, and legally sound regulations. Current regulatory and policy projects include the following:

- Revising regulations on flood insurance to conform to the Biggert-Waters Flood Insurance Reform Act of 2012
- Revising the capital regulations to make them consistent with Basel III, as appropriate
- Revising regulations to implement requirements of the Dodd-Frank Act by adding margin and capital requirements for FCS institutions that engage in noncleared swaps and noncleared security-based swaps, and removing references to credit ratings in our regulations
- Revising the investment eligibility regulations for FCS institutions
- Clarifying and strengthening standards-of-conduct regulations
- Clarifying and enhancing voting procedures related to tabulating votes, using teller committees, and distributing and handling ballots
- Revising regulations related to FCS bank and association mergers and consolidations
- Revising regulations related to investment eligibility and creditworthiness for Farmer Mac
- Revising the corporate governance requirements for Farmer Mac
- Revising regulations based on the solicited public input we received regarding regulations that may duplicate other requirements, are not effective in achieving stated objectives, are not based on law, or impose burdens that are greater than the benefits received

Corporate Activities—Because of mergers, the number of FCS institutions has declined over the years, but their complexity has increased, placing greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in more cost-efficient and better-capitalized institutions with broader, more diversified asset bases, both by geography and commodity. As of January 1, 2014, the System had 78 direct-lender associations, four banks, five service corporations, and two special-purpose entities.

CONDITION OF THE FCS

The System remained fundamentally safe and sound in 2013 and is well positioned to withstand the continuing challenges affecting the general economy and agriculture. Total Generally Accepted Accounting Principles (GAAP) capital increased to $41.7 billion at September 30, 2013, up from $38.5 billion a year earlier. The ratio of total capital to total assets increased to 16.5 percent at September 30, 2013, compared with 16.1 percent the year before, as strong earnings allowed the System to continue to grow its capital base. Total GAAP capital includes the Farm Credit Insurance Fund of about $3.4 billion, which is restricted capital. The Fund is administered by the Farm Credit System Insurance Corporation, which is an independent Government-controlled corporation established by Congress to insure the timely payment of principal and interest on Systemwide and consolidated debt obligations.

The System experienced moderate loan growth this year. There was a 4.8 percent increase in the System's outstanding real estate loans from December 2012 to September 2013 due primarily to rising farmland values. Production loans declined 1.6 percent during the same period. In total, gross loans grew by 4.7 percent over the 12-month period ended September 30, 2013, compared with 8.7 percent during the previous period. Nonperforming loans decreased modestly to $2.2 billion at the end of FY 2013, representing 5.4 percent of total capital, down from 7.4 percent a year earlier. However, although credit quality has been improving and is satisfactory overall, volatility in commodity prices, declining profit margins for grain producers, and the potential for a correction in farmland prices pose continued risks to some agricultural operators, creating the potential for a reversal of this trend.

The FCS earned $3.5 billion in the first nine months of 2013, a 10.8 percent increase from the same period in 2012. Return on assets remained favorable at 1.4 percent during this period. The System's liquidity position increased to 202 days as of September 30, 2013, from 183 days a year later, remaining significantly above the 90-day regulatory minimum. The quality of the System's liquidity reserves also improved in 2013.

Weather conditions in 2013 were mixed, resulting in a significant level of uncertainty throughout the growing season. A very wet spring led to delayed planting in the western Corn Belt. This was followed by abnormally dry to moderate drought conditions in parts of the Corn Belt. However, the 2013 corn harvest reached a record high, and the soybean crop was also among the largest on record. Grain and soybean prices have declined substantially as a result, providing needed relief to the protein, dairy, and ethanol sectors. After struggling with high input costs the past several years, these industries are now looking forward to a favorable profitability outlook. Grain and soybean producers, however, are expected to face thinner profit margins in 2014 and this will likely put pressure on farmland prices in the Midwest and Plains states going forward.

USDA is expecting the data will show another year of strong farm income in 2013. Cash receipts in the crop sector are projected to be down about 3 percent while the livestock sector is expected to see a 6 percent gain. Another large crop in 2014 would put considerable pressure on producers of grain and soybeans and could lead to weakening farmland values.

The System has benefited from the monetary policies that have helped foster historically low interest rates. Investor demand for System debt has remained favorable across the yield curve. Because of low interest rates, as well as very low risk premiums on newly issued System debt, the System was able to exercise the options on significant quantities of callable bonds to further reduce the cost of funds for the majority of FY 2013. However, the final quarter of FY 2013 saw a significant increase in interest rates for newly issued debt instruments with maturities of 1 year and longer. This fact greatly reduced the volume of exercised options on callable bonds and portends to be the case for FY 2014 and probably beyond. Despite this development, the System fully expects the capital markets will continue to meet its financing needs.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Congress established Farmer Mac in 1988 to create a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac has authority to create and guarantee securities and other secondary market products that are backed by agricultural real estate mortgages and rural home loans, USDA-guaranteed farm and rural development loans, and rural utility cooperative loans. Through a separate office mandated by statute (Office of Secondary Market Oversight), the Agency regulates, examines, and supervises Farmer Mac's operations.

Farmer Mac is devoted to making funds available to agriculture and rural America through its secondary market activities. Under specific circumstances defined by statute, Farmer Mac may issue obligations to the U.S. Treasury Department, not to exceed $1.5 billion, to fulfill the guarantee obligations on Farmer Mac guaranteed securities. Farmer Mac is not subject to any intra-System agreements and is not jointly and severally liable for Systemwide debt obligations. Moreover, the Farm Credit Insurance Fund does not back Farmer Mac's securities.

Farmer Mac made financial progress during FY 2013. GAAP net income was up from 2012, and core earnings, a measure based more on cash flow, were up by 1.2 percent to $51.2 million. As of September 30, 2013, Farmer Mac's core capital totaled $578.4 million, which exceeded its statutory requirement of $389.5 million. The total portfolio of loans, guarantees, and commitments grew 10.6 percent to $13.8 billion.

Farmer Mac's program-business portfolio shows stress in certain sectors, such as dairy, but credit risk remains manageable. As of September 30, 2013, substandard loans were 3.8 percent of total direct credit exposure, compared with 4.4 percent a year earlier. Loans more than 90 days delinquent remained low, declining to 0.66 percent from 0.93 percent the year prior.

CONCLUSION

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System, including Farmer Mac, remains financially sound and focused on serving agriculture and rural America. It is our intent to stay within the constraints of our FY 2015 budget as presented, and we continue our efforts to be good stewards of the resources entrusted to us. In addition, we have met all of the requirements of the GPRA Modernization Act that apply to our Agency. Our budget proposal identifies our goals and the performance measures we have developed to help ensure that we use our resources efficiently and effectively. We are proud of our record and accomplishments; and I assure you that the Agency will continue its commitment to excellence, effectiveness, and cost efficiency and will remain focused on our mission of ensuring a safe, sound, and dependable source of credit for agriculture and rural America. This concludes my statement. On behalf of my colleagues on the FCA Board and at the Agency, I thank you for the opportunity to share this information.