

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
February 4, 2013

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. The funds used by FCA to pay its administrative expenses are assessed and collected annually from the Farm Credit System (FCS or System) institutions we regulate and examine—the FCS banks, associations, and service corporations, and the Federal Agricultural Mortgage Corporation (Farmer Mac). Also, as the Subcommittee knows, FCA does not receive a Federal appropriation.

The Agency is submitting a proposed total budget request of \$64,100,000 for fiscal year (FY) 2014. FCA's proposed budget for FY 2014 includes funding from current and prior-year assessments of \$63,300,000 on System institutions, including Farmer Mac, and \$800,000 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 2014 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. This past year, on January 1, 2012, two System banks merged, representing the largest merger in the history of the FCS. As System institutions continue to merge and grow larger and more complex, the Agency must dedicate more resources to examining and overseeing these institutions. The funding we have requested for FY 2014 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 take appropriate corrective action. 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

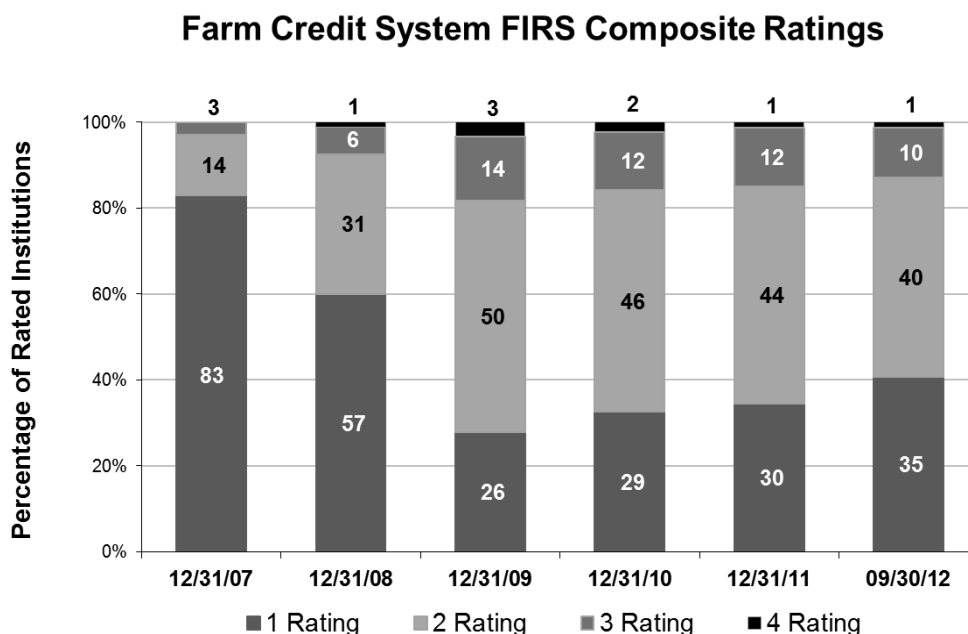
disclosure and governance. The policy development program includes approval of corporate charter changes, System debt issuance, and other financial and operational matters.

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 rapidly rising real estate values 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 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.



Source: FCA's FIRS Ratings Database. The above chart includes only the System banks and their affiliated direct-lender associations. The figures in the bars indicate the number of institutions by FIRS rating.

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. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to the 11 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 December 31, 2012, seven 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 the capital regulations to make them consistent with Basel III and the proposals of other U.S. financial regulators, 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 regulations to ensure that FCS funding and liquidity requirements are appropriate and to ensure that the discounts applied to investments reflect their marketability
- Revising the investment eligibility regulations for FCS institutions and Farmer Mac
- Revising regulations to provide the parameters under which an FCS institution may organize or invest in limited liability companies, limited liability partnerships, and other unincorporated business entities
- Clarifying and strengthening standards-of-conduct regulations
- Revising regulations to replace outdated references to GAAP
- Revising regulations related to FCS bank and association mergers and consolidations
- Revising regulations related to liquidity investment operations for Farmer Mac
- Revising the capital planning requirements for Farmer Mac
- Developing FCA's minimum data needs for evaluating shared-asset risk in FCS loan portfolios

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, 2013, the System had 82 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 2012 and is well positioned to withstand the continuing challenges affecting the general economy and agriculture. Total GAAP capital increased to \$38.5 billion at September 30, 2012, up from \$35.9 billion a year earlier. The ratio of total capital to total assets increased to 16.1 percent at September 30, 2012, compared with

15.8 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 almost \$3.3 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 protect investors in Systemwide consolidated debt obligations.

In a year of severe drought during much of the growing season in many parts of the country, the System experienced moderate loan growth. There was a 5.4 percent increase in the System's outstanding real estate loans from December 2011 to September 2012 due primarily to rising farmland values. Production loans increased 2.4 percent during the same period. In total, gross loans grew by 8.7 percent over the 12-month period ended September 30, 2012, compared with 1.3 percent during the previous period. Nonperforming loans decreased modestly to \$2.8 billion at the end of FY 2012, representing 7.4 percent of total capital, down from 9.2 percent a year earlier. However, although credit quality has been improving and is satisfactory overall, volatility in commodity prices, rising input prices, and weaknesses in the general economy pose continued risks to some agricultural operators, creating the potential for a reversal of this trend.

The FCS earned \$3.2 billion in the first nine months of 2012, a 5.5 percent increase from the same period in 2011. Return on assets remained favorable at 1.3 percent. The System's liquidity position decreased from 200 days as of September 30, 2011, to 183 days a year later, remaining significantly above the 90-day regulatory minimum. The quality of the System's liquidity reserves also improved in 2012.

The drought of 2012 was the worst since 1956, leading to sharp reductions in the production of corn, soybeans, and other crops, which sent livestock-feed costs to record highs. Many livestock operations and ethanol plants faced significant stress. Despite the drought, USDA is expecting reports to show record levels of farm income in 2012, as gains in corn and soybean prices and large increases in crop insurance payments offset reduced crop yields. Gains by crop producers are expected to offset livestock farmers' losses caused by record feed expenses and heat stress on animals.

The weather will be a key factor in determining the System's operating environment in 2013. Supplies of feed grains and soybeans will be very tight going into the 2013 growing season. If weather is favorable, large crops will likely be harvested in the fall, reducing crop prices substantially. This will provide livestock, dairy, and ethanol producers considerable relief and set the stage for improved profitability. However, another year of adverse growing conditions would likely lead to severe financial stress for many livestock, dairy, and ethanol producers.

As a Government-sponsored enterprise (GSE), 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 2013, the System expects that 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 creates and guarantees 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 loans made by cooperative lenders. 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 a GSE 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 2012. GAAP net income was up from 2011, and core earnings, a measure based more on cash flow, were up by 37 percent. As of September 30, 2012, Farmer Mac's core capital totaled \$508.5 million, which exceeded its statutory requirement of \$368.4 million. The total portfolio of loans, guarantees, and commitments grew 5.3 percent to \$12.5 billion.

Farmer Mac's program-business portfolio shows stress in certain sectors, such as dairy, but credit risk remains manageable. As of September 30, 2012, impaired loans were 2.51 percent of total direct credit exposure, compared with 2.02 percent a year earlier. Nonaccrual loans remained low at 1.13 percent, and loans more than 90 days delinquent declined to 0.93 percent from 1.53 percent the year prior.

This year's drought conditions have had no measurable impact on the credit quality as of September 30, 2012. The majority of grain producers used risk management strategies including crop insurance, and most grain producers entered this period in a position of strength after a period of high profitability. Farmer Mac reports that it does not expect to recognize additional probable losses in the portfolio because it remained well collateralized on its exposures in drought areas. Both we and Farmer Mac continue to closely monitor the effects of the 2012 drought.

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 2014 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 other 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. While we are proud of our record and accomplishments, 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.