Testimony of the Honorable Leland A. Strom
Chairman and Chief Executive Officer
Farm Credit Administration
Before the Subcommittee on Agriculture,
Rural Development, Food and Drug Administration, and Related Agencies
U.S. House of Representatives Committee on Appropriations
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Madam Chairman, Members of the Subcommittee, I am Leland A. Strom, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). On behalf of my colleagues on the FCA Board, Kenneth Spearman of Florida and Nancy Pellett of Iowa, 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, I would like to thank the Subcommittee staff for its assistance during the budget process. Also, I would respectfully bring to the Subcommittee's attention that 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). FCA does not receive a Federal appropriation.

Earlier this fiscal year, the Agency submitted a proposed total budget request of $59,537,346 for fiscal year (FY) 2011. FCA's proposed budget for FY 2011 includes funding from current and prior assessments of $59,400,000 on System institutions, including Farmer Mac. Almost all this amount (approximately 83 percent) goes for salaries, benefits, and related costs.

The FY 2011 proposed budget is driven largely by two factors: (1) stress on the System caused by conditions in the agricultural and the general economy and (2) the large number of retirements that FCA anticipates in the coming five years. Although the System remains safe and sound overall, risks have increased across the System, and conditions in several institutions have deteriorated. As a result, we are hiring additional staff members to provide more intensive examination and oversight. We are also hiring employees to fill the positions of those who will be retiring soon. The funding we've requested for FY 2011 will allow us to provide the additional supervision and oversight required in challenging economic times and to ensure that we maintain a staff with the skills necessary to properly examine, oversee, and regulate the System.

MISSION OF THE FARM CREDIT ADMINISTRATION

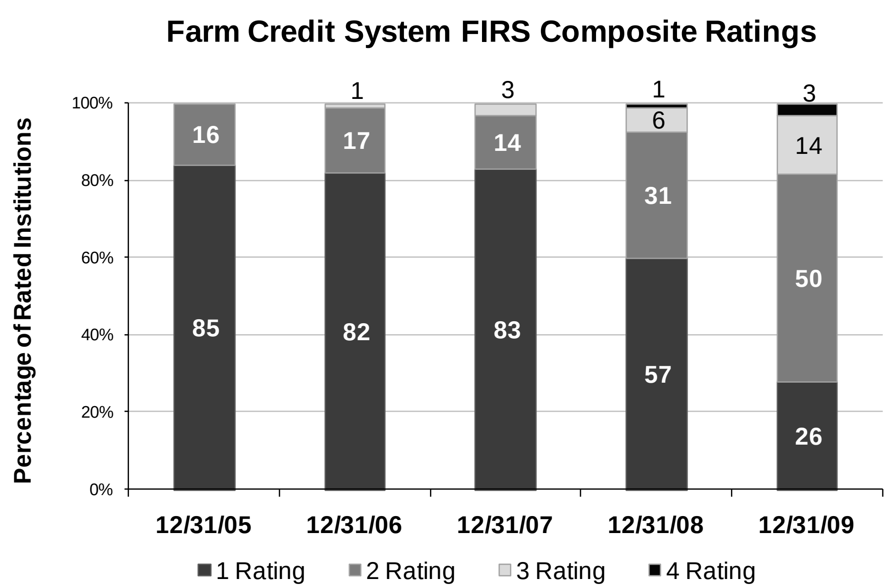
As directed by Congress, FCA's mission is to ensure a safe, sound, and dependable source of credit and related services for agriculture and rural America. The Agency accomplishes its mission in two important ways. First, FCA protects the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and ensures that the institutions comply with applicable law and regulations. Our examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risk, 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 to serve 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. 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

The Agency's highest priority is to maintain appropriate risk-based oversight and examination programs. With changes in the System and human capital challenges within our Agency (pending retirements, normal attrition of staff, and the ever-increasing need for more sophisticated skills in the financial sector), we have undertaken a number of initiatives to enhance our skills and expertise in key examination functions. On a national level, we actively monitor risks that may affect groups of System institutions or the entire System, including risks that may arise from the agricultural, financial, and economic environment in which the System institutions operate.

The scope and frequency of each examination is based on our assessment of an institution's internal controls and the ability of its board and management to manage risks. FCS institutions are required to have prudent loan underwriting and loan administration processes, to maintain adequate asset-liability management, to establish high standards for governance, and to issue transparent shareholder disclosures. Furthermore, we also are requiring institutions to complete stress tests to determine their ability to withstand increased risk and to develop appropriate contingency plans. The frequency and depth of our examinations may vary, but each institution is provided a summary of our activities and a report on its overall condition at least every 18 months. Most issues are resolved through corrective actions established in the Report of Examination or other communication. In certain cases, FCA will use its enforcement powers to effect changes in the institution's policies and practices to correct unsafe or unsound conditions or violations of law or regulations.

We evaluate each institution's risk profile on a regular basis. The Financial Institution Rating System (FIRS) is the primary risk categorization and rating tool used by examiners to indicate the safety and soundness of an institution. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail. As of December 31, 2009, FIRS ratings as a whole continued to reflect the sound financial condition of the FCS, although some individual institutions are showing stress from conditions in agriculture and the general economy.



Source: FCA's FIRS Ratings database. The above chart includes only the five System Banks and their affiliated direct-lender assocations. The figures in the bars reflect the number of insitiutions by FIRS rating.

As shown in the preceding chart, FIRS ratings were downgraded in several institutions in 2009, continuing a declining trend over recent years. In addition, at December 31, 2009, two FCS institutions were under a formal enforcement action and two others were placed under enforcement actions shortly after the first of the year. There are no FCS institutions in conservatorship or receivership. As a result of declining ratings, we have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to those 17 institutions rated 3 or worse. Although these 17 institutions represent only 4 percent of System assets and do not threaten the System's consolidated performance, they require significantly greater Agency resources to oversee.

Overall the System remains financially strong and adequately capitalized. Additionally, the FCS does not pose material risk to investors in FCS debt, to the Farm Credit System Insurance Corporation, or to FCS institution stockholders.

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's regulatory philosophy focuses our efforts on developing balanced, flexible, and legally sound regulations. Some of the Agency's current regulatory and policy projects include the following:

- Enhancing our risk-based capital adequacy framework for the FCS to more closely align it with that of the Federal banking agencies and the Basel II standardized approach
- Revising lending and leasing-limit regulations to ensure that FCS institutions maintain effective policies to measure and manage exposure to single counterparties, industries, and market segments, and to large complex loans
- Reviewing regulations and policies on loan pricing, terms, and conditions to ensure that System practices and procedures are safe and sound and reflect sensitivity to market conditions
- Developing regulations with the Federal banking agencies to implement the Secure and Fair Enforcement for Mortgage Licensing Act of 2008
- Revising regulations to enhance System disclosures of senior officer compensation and supplemental benefit programs and issuing guidance for System compensation policies and best practices
- Strengthening investment-management and liquidity regulations to ensure prudent practices are in place for the safe and sound management of FCS investment portfolios

Corporate Activities—While FCS institutions have declined in number over the years, their complexity has increased, which has resulted in greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in larger, more cost-efficient, and better capitalized institutions with a broad, diversified asset base, both by geography and commodity. As of January 1, 2010, the System had 88 direct-lender associations, five banks, five service corporations, and two special-purpose entities. Thus far in FY 2010, we have received and approved six restructuring applications.

CONDITION OF THE FCS

Agricultural economic conditions and the System's operating environment continue to be unsettled. In February 2010, USDA forecast a 7.8 percent increase in net cash farm income for 2010 largely because of an approximate 10 percent increase in cash receipts from livestock and related products. Improved demand for livestock and dairy products, combined with lower production, has improved prices and profitability in these sectors. However, many of these producers remain financially vulnerable because of a substantial reduction in equity over the past couple years. Also, the USDA report forecast weakening in other sectors. Profit margins for some crop producers could be lower in 2010 since commodity prices are generally lower than a year ago and input prices are higher. Crop cash receipts are expected to decline about 4 percent. Profitability in the ethanol industry improved in the fall of last year although ample ethanol supplies pressured margins in early 2010. Uncertainty has increased in the global economy in part because of fiscal difficulties in several European countries and elevated unemployment rates in the United States. This uncertainty will likely lead to a somewhat tepid economic recovery and to a challenging operating environment for the FCS in 2010.

Despite a very challenging year affecting the credit markets, the System's overall condition and performance remained sound in 2009. The System is well positioned to withstand the continuing challenges coming from the general economy and stress in some sectors of the agricultural economy. Total capital increased to $30.0 billion at December 31, 2009, up from $27.1 billion a year earlier. Also, more than 82 percent of total capital is in the form of earned surplus, the most stable form of capital. The ratio of total capital to total assets increased to 13.9 percent at year-end 2009, compared with 12.7 percent the year before as asset growth slowed considerably and the System continued to grow its capital base.

Gross loans grew by a modest 2.1 percent in 2009, compared with double-digit growth for several years. System borrowers were negatively impacted by the overall stress in the general economy and certain sectors of the agricultural economy. Credit quality declined but remained satisfactory overall. Nonperforming loans increased by $1.1 billion to $3.5 billion as of December 31, 2009, and represented 11.8 percent of total capital at the end of 2009, up from 8.9 percent at the end of 2008.

In 2009, the System earned $2.9 billion, a 2.2 percent decrease from 2008. The return on assets remained at the very favorable level of 1.33 percent. The System's liquidity position equaled 178 days at December 31, 2009, essentially unchanged from a year earlier and well in excess of the 90-day regulatory minimum.

Further strengthening the System's financial condition is the Farm Credit Insurance Fund (Insurance Fund), which has grown to more than $3.2 billion. The Insurance Fund protects investors in Systemwide consolidated debt obligations. The Farm Credit System Insurance Corporation administers the Insurance Fund.

The economic and financial market turmoil in 2008 dissipated somewhat in 2009, and certain sectors of the capital markets began to function more normally. This helped the System to maintain its overall financial strength, serve its mission, and build the Insurance Fund in 2009. Even though the System is a Government-sponsored enterprise (GSE) with solid financial performance, not all of the liquidity has returned to the financial markets. Investor demand for longer-term Systemwide debt securities, particularly those with maturities over five years, remained moderate, and long-term funding costs, while declining, remained volatile. Government actions to stabilize the financial markets and funding for other GSEs have provided some ancillary benefit to System funding, which helped support solid System earnings performance in 2009. Also, the System has enhanced its domestic marketing and internal liquidity reserve requirements. For 2010, the System expects debt markets to remain accessible.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Congress established Farmer Mac in 1988 to provide secondary market arrangements for agricultural mortgage and rural home loans. Farmer Mac creates and guarantees securities and other secondary market products that are backed by mortgages on farms and rural homes. The 2008 Farm Bill expanded Farmer Mac's program authorities by allowing it to purchase and guarantee securities backed by eligible rural utility loans made by cooperative lenders. Through a separate office required by statute (Office of Secondary Market Oversight), the Agency examines, regulates, and monitors Farmer Mac's operations.

Like the FCS, Farmer Mac is a GSE devoted to agriculture and rural America. Farmer Mac is not subject to any intra-System agreements or the joint and several liability of the FCS banks. Also, the Insurance Fund does not back Farmer Mac's securities. However, by statute, in extreme circumstances Farmer Mac may issue obligations to the U.S. Treasury Department, not to exceed $1.5 billion, to fulfill the guarantee obligations of Farmer Mac Guaranteed Securities.

Farmer Mac made significant financial progress during 2009 compared with 2008. Net income for the year ending December 31, 2009, was $82.3 million, compared with a net loss to common stockholders of $154.1 million in 2008. At year-end 2009, capital surplus had grown to $120.2 million, up significantly from $13 million as of December 31, 2008. The total portfolio of loans, guarantees, and commitments grew to $10.7 billion. Farmer Mac continues to have access to the debt markets to fund its program assets.

In January of 2010, Farmer Mac raised $250 million in capital from a private offering of shares of noncumulative perpetual preferred stock of Farmer Mac II LLC, a recently formed operating subsidiary in which Farmer Mac owns all of the common equity. Farmer Mac used the proceeds to repurchase and retire $150 million of Farmer Mac's outstanding Series B preferred stock, with additional proceeds available for other corporate purposes. The new preferred stock has a lower net effective cost than the recently retired capital and will improve Farmer Mac's ability to generate new capital through earnings.

Farmer Mac's program loan portfolio shows stress in certain subsectors such as ethanol; however, risk in the portfolio remains manageable. Improvements related to the ethanol industry reduced the nonperforming loan rate to 1.41 percent at December 31, 2009, compared with 1.61 percent at December 31, 2008. Loans more than 90 days delinquent decreased from 1.35 percent at December 31, 2008, to 1.13 percent at December 31, 2009.

Regulatory activity for 2010 includes plans to issue an Advance Notice of Proposed Rulemaking to consider modifying regulations governing nonprogram investments and liquidity at Farmer Mac. Additionally, FCA plans to finalize a rule this year governing the Risk-Based Capital Stress Test that would update the model to address Farmer Mac's new rural utility financing authority and certain other technical changes in parts of the stress test.

CONCLUSION

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System and Farmer Mac remain financially sound and focused on serving agriculture and rural America. It is our intent to stay within the constraints of our FY 2011 budget as presented, and we continue our efforts to be good stewards of the resources entrusted to us. 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.