**Remarks of the Honorable Leland A. Strom**
**Chairman and Chief Executive Officer**
**Farm Credit Administration**
**At the Federal Reserve Bank of Chicago's Conference on**
**"Perspectives on the Future of Agriculture in the Midwest"**
**December 1, 2009**

Good afternoon and thank you for that nice introduction. I also want to thank David Oppedahl for the invitation to speak at this conference today. It is especially a pleasure to be back here with you because I very much appreciated and enjoyed the opportunity I had to serve for several years on the Federal Reserve Bank of Chicago's Advisory Council on Agriculture, Labor and Small Business.

As I address you today, I'm not far from the small dairy farm on which I was raised in Kane County. In the late 1800's, by grandparents settled in the rolling hills of the Fox River Valley, about 40 miles west of Chicago. At that time, it was a good day's journey from the city. Today, the city has reached our farm, and my small community is faced with the challenges that population growth brings.

Besides being a farmer, I have had the honor and pleasure over the years of serving the agriculture industry in a variety of ways, from being a board member of our local farm service cooperative and organizations such as the Farm Bureau, to serving on the boards of a Farm Credit System bank and association, as well as the Agriculture Advisory Council here at the Chicago Fed that I've already mentioned. These various roles and experiences have provided me a special appreciation for the agricultural industry, and specifically the crucial role of commercial banks and the Farm Credit System in financing agriculture.

Being a farmer and a Farm Credit association board member during the farm crisis of the 1980's taught me a lot about the agricultural credit industry and just how quickly we can go from the best of times to the worst of times. I personally saw and experienced the extreme challenges those times presented – both in my own farming operation, and in serving on the board of my local Production Credit Association and dealing with the credit problems of many other producers.

## RECENT DETERIORATON IN THE ECONOMIC ENVIRONMENT

The United States is slowly recovering from a severe global recession. The economic downturn began in late 2007; it worsened in 2008 from significant financial market instability; then it extended into 2009 with increased unemployment, lost consumer confidence, and continued housing sector weaknesses. General economic weaknesses, high unemployment, and stress in several sectors of the agricultural economy, mostly livestock, are affecting net cash farm income, which the USDA forecasts at $68 billion for 2009, down 30% from 2008's record level. The 2009 forecast is the lowest since 2002 and is below the 10-year average; $71 billion. However, prior to 2009, farmers had 6 years of record net cash farm income.

Among the hardest hit industries in 2009 are dairy farmers and hog producers. Lower demand, especially in the export markets due to the recession, and excess production have been the key factors causing today's lower prices. USDA projects the average net 2009 cash farm business income to drop 94% for dairy and 73% for hogs versus 2008. Total expenses are forecast to decline for the first time since 2002. But we need to put that into perspective. The 2007 and 2008 increases in farm expenses were so large that even with the $9.2 billion decline in expenses projected for 2009, farm expenses would still be 5% higher than in 2007.

Due to the higher level of most commodity prices relative to support prices – milk and cotton are the exceptions – government payments are forecast to be up only slightly in 2009, remaining near their lowest level since 1997, and off 27 percent from the prior 10 year average.

However, fiscal stimulus programs should benefit agriculture in 2009 and 2010 both directly and indirectly: directly, by providing tax credits and new spending on alternative fuels and infrastructure projects; and indirectly, by generating jobs and new off-farm income opportunities. Financial outcomes likely will vary widely by region, by enterprise type, and by size as producers wrestle with volatile commodity prices, mounting labor and water supply issues, new Government policies, and a host of other variables. These conditions will complicate risk management strategies for farmers and increase the challenges for agricultural lenders.

**What is the availability of credit for agricultural producers?**

Ag lending growth has significantly slowed, for both FCS and commercial bank lenders, but it's important to note that both System and commercial banks continued to grow their farm lending portfolio, even during this recession year when lenders are generally less willing to take on new risks. Growth has slowed compared to recent years due both to less demand from farmers as well as generally tighter underwriting practices. Low interest rates are a big benefit to the borrower in the agricultural credit market today, but rates are expected to rise.

In this environment of higher credit risk, agricultural lenders are more cautious about their underwriting practices, and there are fewer exceptions to underwriting standards. While bank failures are on the rise, few have been agricultural banks or attributable to agricultural portfolios.

**What is going on with agricultural land values?**

After almost tripling since 1980, the latest survey shows that 2008 farmland values fell by 3 percent, the first time values declined in 22 years. The Fed 2009 surveys indicate year-to-year mixed results as of second quarter: down 3% in the Chicago Fed District; up 2% in the Kansas City Fed District. Recreational, marginal and land-in-transition real estate have been hit the hardest. Limited water also plays a role where relevant.

Two factors make land markets unusual this year: Markets are thin – thus harder to know what the trends are – and it's also harder than normal to determine collateral values. A high level of uncertainty and lack of confidence in the economy has generally held back the number of sales and made pricing difficult. However, a limited supply of land has probably helped keep prices from falling further. Also, farmers are the bigger players in the markets today, with a diminished role for investors.

**Challenges for agriculture going forward**

One challenge for the future is that traditional agriculture is being forced to change to fit the agenda of others. Two examples are Cap and Trade and Animal Confinement.

Cap and Trade Legislation: In general, the current climate proposals would not require greenhouse gas emission reductions in the agriculture and forestry sectors. However, if enacted, provisions in these bills could potentially raise farm input costs for fossil fuels, fertilizers, energy, and other production inputs. These higher costs could potentially be offset by possible farm revenue increases should farmers participate in carbon offset and renewable energy provisions that are part of this legislation. Livestock producers are not likely see any of these benefits.

Regarding animal confinement, there is a significant diversity of views. A reasonable approach is needed to work through these contrasting views. For instance, Ohio recently enacted legislation to form a state animal protection committee made up of representatives from all groups. This may be the approach for the future. The important point here is that agriculture needs to be listening carefully to be prepared and willing to work to form creative solutions, some of which may require changes in traditional practices. Otherwise, those who do not understand agriculture will define and limit it.

The future for the livestock industry is changing as a result of alternative energy and changing demand factors. Clearly, enough can be produced to meet both needs. However, in the longer term, livestock producers can expect higher feed costs due to growth of the bio fuels industry. Those that do not grow a portion of their own feed will be more susceptible to profit swings as commodity prices fluctuate. Limited government support also complicates risk management for the livestock sector. Livestock producers are also more likely to be affected by regulatory costs, especially environmental, and particularly for confinement operations. We can also expect even more diversity in operating efficiencies between livestock producers. The end result may be a smaller livestock sector going forward as those who cannot reduce their costs move out of the industry.

Alternative energy will be a critical issue for agriculture going forward, both in providing opportunities and challenges. We can produce enough agricultural products to meet both food and energy needs. Currently, the ethanol industry is under stress, but given the importance of alternative energy, that sector should stabilize. Ethanol plants depend greatly on financing, and they are having difficulty getting the needed credit. Wall Street and most commercial banks have turned away from financing new ethanol plants, which may make it difficult for second generation cellulosic plants to get financing. Government actions will have a big impact on the industry; including setting a higher blend rate and increasing production of E85 vehicles.

Risk management practices, while always important, will be a critical issue going forward. Increased volatility in both output and input prices, and the global nature of agriculture will contribute to volatility. Even some of the best producers are having problems because they did not properly handle the volatility in 2008 and 2009. Also, traditional intermediaries like grain elevators or other agricultural-related businesses are reducing their risks by pushing that risk down to the producer level.

The rising production costs increase the level of risk for farming. At the same time, budget restrictions make it more likely that the government farm safety net will provide less risk protection than in the past. Lenders need to do a good job of understanding risk management tools, especially government subsidized tools such as revenue insurance and the new Average Crop Revenue Election (ACRE) program, as well as knowing when to recommend the use of such tools to help borrowers reduce risk.

One of the biggest future challenges will be the Federal deficit. For agriculture, this means the concerns about money for farm programs are heightened. The 2008 Farm Bill made changes in the Federal safety net for agriculture. Although the new bill leaves loan rates and target prices mostly unchanged, the safety net for the program crops is actually lower today because support prices were not adjusted to reflect recent increases in farm cost structures. In essence, the focus of farm policy is shifting toward revenue protection and away from higher target prices. The 2008 act also shifts the spending priorities toward nutrition, renewable fuels, conservation, and rural development. Farmers are expected to manage their own risk through the use of government subsidized risk management programs and revenue crop insurance rather than rely on price supports or disaster payments. We can also expect the budget deficit issue to be in the forefront when the next farm bill is debated in the months leading up to 2013.

Another major challenge going forward is finding the next generation of farmers. As the percentage of retirement-age farmers continues to rise, the role of agricultural lenders becomes more important in helping young and beginning farmers finance the purchase of agricultural assets sold by those who are exiting the business. USDA's 2007 Census of Agriculture found that almost 30 percent of principal operators are 65 or older, compared with about 21 percent in 1987. The census also reported a continuing sharp decline in the percentage of young operators. Principal operators under the age of 35 declined from 13.3 percent in 1987 to 5.4 percent in 2007. In this area, the Farm Credit System has a special mission to have programs and make efforts to serve young, beginning, and small farmers and ranchers.

Also important are open markets that support foreign trade and are so essential to the future of agriculture. Exports are a critical part of the farm income picture because our domestic markets cannot absorb all that is produced each year. Foreign sales often account for a fourth of all agricultural sales in a given year. In fiscal year 2008, farm exports were more than $115 billion, up $33 billion from fiscal 2007, easily making it a new record. It is also a phenomenal achievement when viewed from a historical perspective because, as recently as 2004–05, exports were about $60 billion per year. Because of this expansion in foreign sales – more volume and sharply higher prices – the net surplus from agricultural trade, after shrinking over several years to almost zero, is once more solidly in the black.

Unfortunately, our export prospects could dim further if the global recession takes stronger root and potentially moves countries toward protectionist policies. Such a scenario would further depress farm prices and increase credit risk for agricultural lenders. In addition, the fear of human- or animal-borne disease can suddenly reduce the demand for U.S. farm products, as we saw last spring when fears about the spread of the H1N1 flu virus affected the export of pork.

**Three Observations in Going Forward**

1. The Farm Credit System and other lenders to agriculture will have adequate funds available to meet the needs of agricultural producers, but all lenders will be more cautious in granting credit. While creditworthy farmers and ranchers still have access to credit, the cost of credit is rising. Underwriting requirements are now more carefully scrutinized, and more collateral is often required. Because of the recent term funding difficulties, fixed-rate term loans are now more difficult to obtain and more costly where available. To avoid excessive risk, lenders are increasingly lowering portfolio limits on various segments of the agricultural industry experiencing stress, and thus conserving their capital resources.

2. Consistent with the weakening of the commodity markets and the general economy, agricultural land prices have started to decline. Federal Reserve banker surveys show land price stability as of the first quarter of 2009, at least in the Nation's mid-section, after showing a declining trend in the fourth quarter of 2008. However, the Chicago Fed district was the significant exception with an overall decline of 6% for the latest quarter, the largest quarterly decline since 1985. Iowa land values declined by 7%. We also know that land prices have declined further in many areas adjacent to urban development. For example, 1031 exchanges have greatly diminished as a factor pumping up farm land

values in the path of residential or commercial development. The recession and a decline in investment portfolios have also reduced the non-farmer demand for recreational properties and investment properties. However, we do not expect a significant decline in land values because of the longer term favorable predictions for farm income. Nevertheless, farm land prices have doubled in the last 5 years, rising faster than farm income. Current conditions suggest we will see some more decline. We will be watching this area carefully since 45 percent of the System's portfolio is collateralized by first liens on farm land and more than 80% of the farm sector's net worth is tied to the value of farm land.

3. We are concerned about margins in the livestock sector. Volatile feed prices and falling demand, especially in international markets, have led to negative livestock margins, especially for dairy and hog producers. Overcapacity exists in both industries and will have to be addressed before prices can rise enough to provide positive margins.

After many years of good times, agriculture is again experiencing some significant stress. Just how serious that stress becomes is still to be determined. While there are some similarities to the 1980s, such as rapidly rising land values and volatile commodity prices, I don't think we will experience anything like the agricultural crisis of the 1980s. Unlike that period, the Farm Credit System is in much stronger financial condition today. Despite the unprecedented instability in the U.S. and global financial markets and a recessionary world economy, the overall condition and performance of the System remains fundamentally safe and sound.

After growing rapidly for a few years, the Farm Credit System's loan growth slowed markedly during the first 9 months of 2009 --only 0.5 percent compared to about 10 and ½ percent for the same period last year. Capital levels relative to risk are adequate at most institutions. Asset quality remains overall satisfactory, although deterioration occurred in 2009, with a significant increase in adverse assets and nonaccrual loans from the extremely low levels seen in 2008. System earnings, which set a record in 2008, are lower this year, reflecting a rise in nonaccrual volume and larger provisions for loan losses. While the System has maintained adequate access to short term funding and the term funding situation improved, some segments of the marketable investment portfolio remained weak with continued downgrades of certain types of securities.

FCA also examines and regulates the Federal Agricultural Mortgage Corporation (Farmer Mac). Farmer Mac is a separate GSE that provides a secondary market arrangement for agricultural real estate, Government-guaranteed portions of certain loans, rural housing mortgage loans, and rural utility loans. Farmer Mac's net income and capital surplus improved during the first 9 months of 2009. Its levels of nonperforming assets and delinquencies as of September 30, 2009 decreased from earlier dates in the year reflecting sales of acquired property previously owned.

Farmer Mac was also impacted last year by the financial system stress. Losses on certain investments required Farmer Mac to raise additional capital during 2008 and management changes were made by its Board of Directors. Farmer Mac continues to restructure its balance sheet and further strengthen its operations and risk bearing capacity to focus on fulfilling its mission.

## EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

The Farm Credit Administration's highest priority is to maintain appropriate risk-based oversight and examination programs. FCA's programs have worked well over the years and have contributed to the present overall safe and sound condition of the System, but we must continue to evolve and prepare for the increasingly complex nature of financing agriculture and rural America. We are hiring more examiners and increasing onsite presence and oversight of FCS institutions in response to the changing and more risky environment we face today.

### FCA Actions to Mitigate Risk

To address the heightened risk environment facing the System, we have told FCS boards and management that solid portfolio management and underwriting are paramount in these uncertain times and have emphasized the importance of portfolio stress testing. The Agency's examiners are increasing onsite presence and placing special emphasis on testing and evaluating:

- Internal audit and credit review programs to ensure they are adequate and timely reflect each institution's risks;
- Portfolio management and stress testing functions to ensure they are appropriate for the institution;
- Large loans held by multiple institutions to ensure underwriting, servicing, and independent credit decisions are made by purchasing FCS institutions and that representations and warranties of the FCS originating lender are appropriate;
- Adequacy of the Allowance for Loan Losses and loan loss provisions;
- Capital adequacy and capital management; and,
- Adequacy and quality of liquidity at System banks.

### Other issues we see as regulator of the FCS

**Importance of Borrower Rights**: Declining economic conditions lead to borrower repayment problems. The System by law must provide borrowers certain rights when they apply for loans and when they have difficulty repaying loans. For example, the Farm Credit Act requires FCS institutions to consider restructuring a distressed agricultural loan before initiating foreclosure. It also provides borrowers an opportunity to seek review of certain credit and restructuring decisions. If a borrower's loan goes through foreclosure, FCS borrowers who qualify have the opportunity to buy back their property at the appraised fair market value or to make an offer to buy the property back at less than appraised value. FCA enforces the borrower rights provisions of the Act and examines institutions to make sure that they are complying with these provisions.

**Strong Governance Practices**: Good governance practices will be necessary to effectively compete. Compensation and conflict of interest policies will be more closely watched, and director experience and training will be more important. For the cooperative FCS, an important feature of good governance is maintaining good borrower representation and service regardless of the size or geographic complexity of the cooperative lending association.

**Staffing**: It's a challenge to get quality staff to handle the credit needs of the complex businesses characteristic of today's more specialized agriculture. On the positive side, at entry levels, high unemployment provides more excellent applicants to choose from. But getting them to stay after they are trained is a problem for System lenders.

In short, we are seeing increased stress, and the lending environment for agriculture going forward will be more challenging than we have faced in many years. It's certainly not "business as usual" anymore, and it probably won't be for quite some time.

Again, I appreciated the opportunity to meet with you today, and I extend you my best wishes as we finish up the year for 2009 and prepare for the next decade of the $21^{st}$ century.