Remarks by
The Honorable Leland A. Strom
AgFirst Farm Credit Bank Annual Meeting
July 12, 2011

Good morning and thank you for the kind introduction and invitation to be with you at your annual meeting. It is always good to have the opportunity to travel to different regions of the country and hear first-hand from farmers and ranchers regarding issues that affect them every day.

Let me begin this morning by giving you an update on the conditions in the Farm Credit System (FCS). The FCS continues to remain safe and sound. Weather has been a significant factor affecting most regions of the country, ranging from drought in the Southwest to excess moisture and flooding in the Upper Midwest and Mississippi delta. Farm Credit System assets are more than $230 billion, and earnings exceeded $1 billion for the quarter ending March 31. Capital has also increased to an average of 14.7 percent of assets. Loan quality is relatively good, with almost 91 percent classified as acceptable. Composite FIRS ratings were unchanged for the quarter, with the 75 institutions rated 1 or 2 holding a substantial majority of the combined FCS assets. Of the remaining institutions, 12 were rated 3, and two rated 4. There are currently seven institutions under enforcement actions by the Agency.

The Office of Examination has been addressing risks in the FCS. We have provided guidance and are encouraging institutions to identify shocks that could impair their capital through stress testing and to take steps to manage or mitigate those risks. Examiners have also provided guidance and asked institutions to shore up their loan portfolio management practices appropriate to the risk and complexity in their loan portfolios. We continue to emphasize the importance of identifying and managing collateral risks that have been aggravated by the recent recession and declining values in housing, especially certain industries and properties most affected in the depressed housing market. Of course, in the Midwest we are seeing land values rise to high levels driven by commodity prices and historically low interest rates, but we do not expect the worldwide crop shortages to sustain those prices indefinitely. And we recognize the adverse impact the high prices have had on livestock producers and the poultry industry in the AgFirst district. I am sure everyone here has heard of the recent discussions within Congress on the ethanol front, with some test votes that have already been taken which indicate ethanol subsidies may soon be changed. Even though the blend mandate will still be in effect and the impact somewhat muted, clearly this is an example of the types of changes that will influence the agriculture industry in the future.

The FCA Board recently completed our work on the Agency's five-year strategic plan. We have posted it on our website, and I invite you to give it a read. While not substantially different in strategic direction than the plan it replaces, it certainly reflects the philosophies of this board and the strategies and actions that we feel are needed to continue to ensure the Agency is prepared for an ever-changing and volatile agricultural operating environment.

We continue to be proactive in addressing the issue of rising farmland values. Earlier in the year we hosted a Regulator Roundtable, with several of the other Federal regulators in attendance. We are planning an informal follow-up meeting with those regulators, following the Kansas City Fed's Ag Symposium in Kansas City, in order to maintain those lines of communication on this issue that were developed at our Roundtable.

Staff recently provided the FCA Board with an analysis of the System's young, beginning and small farmer lending statistics. We were pleased to see year-to-year increases in both the number and the volume of loans to young, beginning, and small farmers. I encourage you to continue your education and outreach efforts with these groups of farmers, and the extension of constructive credit.

Proposed Merger of CoBank, ACB, and U.S. AgBank, FCB

On June 22, 2011, the FCA Board granted preliminary approval of the proposed plan of merger by and between CoBank, ACB, and U.S. AgBank, FCB. FCA's preliminary approval is subject to certain conditions of approval and supervisory conditions of approval, which must be accepted by the banks' boards of directors. Each constituent bank's board approved the conditions, by resolution, on June 28, 2011. After FCA receives the certified board resolutions and reviews the revised disclosure, it will confirm the FCA Board's preliminary approval of the plan of merger. In order to receive final approval, the plan of merger must also be approved by the voting stockholders of both banks. The effective date of the merger will be no later than January 1, 2012, with CoBank, ACB, and its wholly owned subsidiary, CoBank, FCB, as the continuing entities.

Recently Adopted Final Rules

We recently adopted a final rule to lower the limit on loans and leases to a single borrower or lessee from the current limit of 25 percent of an institution's lending and leasing limit base to no more than 15 percent of the base. The revised limit applies to Farm Credit System (FCS, or System) institutions with title I (long-term) and title II (short- and intermediate-term) lending authorities under the Farm Credit Act of 1971, as amended.

The rule also requires System institutions to adopt written policies to measure, limit, and monitor exposures to concentration risks caused by the institutions' lending and leasing activities. This requirement applies to title I and II System institutions, as well as to title III institutions.

As a result of comments received, we delayed the effective date of the final rule until July 1, 2012, to give title I and II institutions approximately 12 months to comply with the 15 percent lending and leasing limit, and to give title I, II, and III institutions approximately 12 months to adopt loan and lease concentration risk mitigation policies.

We also recently adopted a final rule permitting FCS institutions with direct-lending authority to purchase agricultural and cooperative loans from the FDIC that meet eligibility requirements for System financing. The purpose of the rule is to allow System institutions to provide credit and

liquidity to rural areas affected by commercial bank failures. It was developed in response to questions by the FDIC, System institutions, and others as to whether System institutions could provide a source of liquidity to borrowers whose operations are financed with agricultural or cooperative loans affected by commercial bank failures.

Recently Proposed Rules

Proposed rule on operating and strategic business planning: The proposed rule would amend FCA's regulations to require the operational and strategic business plan of each FCS institution to include a human capital plan. The plan is to include strategies to achieve diversity and inclusion within the institution's workforce, management, and governance structure, as well as an assessment of the progress the institution has made in achieving greater diversity. The proposed rule would also require each human capital plan to contain an assessment of the strengths and weaknesses of the institution's workforce, management, and governance structure, and a description of the institution's workforce and management succession programs.

The proposed rule would also require each System institution to implement a marketing plan that describes the institution's chartered territory by geographic region, types of agriculture practiced, and market segment. The marketing plan is to contain strategies for providing the institution's products and services to all creditworthy and eligible persons, with specific attention toward diversity and inclusion within each market segment, as well as an assessment of the progress the institution has made in achieving greater diversity.

The comment period for this rule ends on July 25, 2011. So far, we have received approximately 90 comment letters. Many of the commenters address the need for more outreach to local and regional food producers.

Let me now mention a few rulemakings under consideration. Staff is currently reviewing the 99 comment letters we received as a result of an advance notice of proposed rulemaking (ANPR) on System compensation and retirement programs. The ANPR requested public comment on possible regulatory changes to enhance the disclosure of senior officer compensation, to clarify the responsibilities and authorities of System institution compensation committees, and to give audit committees greater authority to access external resources. The ANPR also requested comment on whether and to what extent FCA should regulate (1) a separate, nonbinding, advisory vote by shareholders on senior officer compensation, (2) current reporting by System institutions between required reporting periods, and (3) certain payments to System institution boards of directors. The next step for this project is to determine the areas we may want to address in a proposed rule.

Staff is working on a proposed rule that would define the parameters under which a System institution could invest in limited liability companies, limited liability partnerships, and similar entities. As many of you may know, we have issued a Bookletter that allows System institutions to invest in these types of entities under limited circumstances, that is, holding acquired properties, and subject to certain conditions.

We are also considering the issuance of a proposed rule to revise our regulations on the requirements for the merger of banks and of associations.

We received more than 10,000 comment letters on our Rural Community Investments' proposed rule that would allow System institutions to make investments in rural community essential facilities and infrastructure projects in collaboration with Federal and State agencies and other rural lenders. Currently, the Agency's planned action for a final rule is listed as undetermined in our spring 2011 unified agenda.

Other Projects

FCA staff has been providing assistance to USDA's Rural Development staff in developing regulations for the operations of nonleveraged Rural Business Investment Companies. Nonleveraged RBICs will not receive government funding, but will be authorized to fund capital investments in rural businesses. This authority was established by the 2008 Farm Bill, which also authorized System institutions to invest in RBICs. This investment opportunity may provide an additional avenue for System institutions to meet the capital needs of businesses in rural America.

I wanted to call to your attention an important initiative the Agency has undertaken cooperatively with the Farm Credit System to address reporting and disclosure needs on a Systemwide basis. This Loan Database Project is designed to commonly identify and collect important data elements in a way that supports both the Farm Credit System and the Farm Credit Administration in timely assessment and reporting of risks. Each district and some associations maintain vital information through their individual loan databases that they use to meet public disclosure requirements in an accurate and timely fashion. The current limitation is that there is no universal data dictionary that allows aggregation. The ability to perform Systemwide risk assessments is of increasing importance to investors and to the Agency. The database will allow us to respond to questions about the soundness and extent of exposures to industries, individual borrowers, and loan performance that directly affect the cost of debt and borrower interest rates. There are certainly some front-end costs to implement these changes; but the database will facilitate complete and accurate information, as is expected from a Government-sponsored enterprise with the size and exposure of the Farm Credit System. The loan database project is designed to collect and store critical data elements in a consistent format so the Agency can assess risk and provide timely reporting. We have made significant progress in the past six months, and I want to recognize our associates in the AgFirst district for their commitment to this project.

In regard to legislative and Hill activities, in 2009 the House Agriculture Committee requested that the Agency develop a list of technical corrections and regulatory enhancements to the Farm Credit Act. A product was delivered to the House and Senate Agriculture Committees in March of 2009. There has been no further activity on the list of items or plans to pursue it. On the other hand, the Farm Credit System Insurance Corporation does plan to pursue legislation in the next

Farm Bill that would update its conservator/receiver authorities to reflect recent modification at other financial regulatory agencies.

Farmer Mac is pursuing an expansion of its authorities. Among other things, the proposal would make additional rural lending eligible for Farmer Mac to include in its program business. We are monitoring this issue and may seek enhanced authorities to ensure that we can capture and examine for any added risk associated with these new authorities.

The House and Senate Agriculture Committees are conducting hearings in preparation for the 2012 Farm Bill. Of course, a budget agreement that includes significant spending reductions in agricultural programs could preempt the 2012 Farm Bill process.

You've heard recently that the major credit rating agencies have warned that the failure of Congress to take timely action to increase the national debt ceiling would have negative implications for the AAA ratings of U.S. sovereign debt. It's also important to remember that the AAA credit ratings of Government-sponsored enterprises, including the Farm Credit System, are linked to the implied support of the U.S. Government. If the U.S. Government's debt is perceived as being less secure, then the ratings of the Government-sponsored enterprises would be negatively affected and the cost of their debt issues would rise. Thus, the risk of lack of action on the U.S. debt limit also poses a risk for higher interest rates for System customers. The same is not necessarily true for the debt of other financial institutions where links to Treasury support are much weaker. However, the implications of a technical default in U.S. Treasuries, even if only for a very short period, would likely cause serious disruptions across the financial markets.

Standard & Poor's, in an April 21, 2011, ratings report, said that it had revised its outlooks on the debt issues of Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, and the Farm Credit System banks to negative from stable. The changes reflected their revision of the outlook on U.S. debt to negative from stable. They also noted they would not raise their outlook and ratings on these entities above those of the U.S. Government as long as the ratings and outlook on the U.S. remain unchanged.

Regulatory Capital

FCA's regulatory capital regime uses the basic risk-based capital framework first adopted in the late 1980s (Basel I). That basic framework has been adapted to reflect the requirements of the Farm Credit Act and in recognition of the unique issues posed by the cooperative nature of the Farm Credit System, specifically its revolvement/retirement of borrower-owned equity and its inverted holding company structure. For instance, in our rules we define "core surplus" and "total surplus" as measures of capital rather than using the "Tier 1" and "Tier 2" measures that are used in rules issued by bank regulators. In many ways, however, the FCA rules are similar to those issued by bank regulators.

Beginning in the mid-1990s, shortcomings in the original Basel I regime became widely recognized. Examples of these shortcomings were the overly broad risk categories and the

incentives to hold riskier assets on balance sheet and securitize safer assets. A revised regulatory capital regime, known as Basel II, was developed by the Basel Committee on Banking Supervision (BCBS), proposed in 1999, and adopted by the BCBS in 2006. The Basel II regime or framework provided a range of options for consideration by national banking supervisors (such as the Federal Reserve Board or the FDIC). The Basel II framework provided guidance, based on bank size and complexity, for capital, supervision, and disclosure. Stated simply, the largest banks would be required to use internal capital models approved by their supervisor (the advanced approach), while smaller banks would be allowed to use a simpler framework similar to Basel I (the standardized approach). U.S. banking regulators adopted the advanced approach in 2007 for the largest banks. U.S. banking regulators have not adopted final rules implementing the standardized approach for the remaining banks.

As the financial crisis unfolded, it became clear that the Basel II regime was inadequate. The BCBS began work on a revised capital framework that has come to be known as Basel III. The Basel III framework builds on Basel II but strengthens it. Capital levels are higher, and new requirements have been added for liquidity, stress testing, and other matters. The new framework was approved in December 2010, and minor revisions were made as recently as June 2011. The new framework is to be implemented by national supervisors over the next eight years. It appears that the U.S. bank regulators may issue a proposed rule for at least some aspects of Basel III this year.

Since 1988, FCA has adopted numerous revisions and enhancements to its capital rules. Most recently, we published an ANPR in July 2010 that was designed to solicit comments about implementing a Tier 1/Tier 2 capital scheme similar to the standardized approach proposed by the bank regulators. Once the other bank regulators issue their proposed rules, FCA intends to propose revisions to its regulatory capital rules. Staff expects to be able to initiate policy discussions within a few weeks after publication of the bank regulator proposals. Formal proposals will follow within a few months.

In addition to capital, FCA staff members are working on several related financial regulations. We have held three meetings with System staff to discuss potential changes to our regulations, including any changes necessary to address a provision in the Dodd-Frank Act that requires each Federal agency to review and modify regulations that refer to or require reliance on credit ratings. Staff plans to present a proposed investment management rule to the FCA Board at the July Board meeting.

Staff is also drafting a proposed rule on liquidity that would update and revise existing regulations, and expects to bring the rule to the Board in August or September.

So in conclusion, you can see that the FCA Board and staff remain quite busy on a number of fronts to ensure the continued safe and sound operation of the Farm Credit System.

Thank you again for this opportunity to be with you today.