Testimony of the Honorable Leland A. Strom
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Farm Credit Administration
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Credit, Energy, and Research
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Mr. 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 colleague on the FCA Board, Nancy Pellett of Iowa, and all the dedicated men and women of the Agency, I am pleased to participate in this important hearing today.

FCA is an independent agency responsible for examining and regulating the banks, associations, and related entities in the Farm Credit System (FCS or System), including the Federal Agricultural Mortgage Corporation (Farmer Mac). The FCS is a nationwide network of borrower-owned financial institutions that provide credit to farmers, ranchers, residents of rural communities, agricultural and rural utility cooperatives, and other eligible borrowers.

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 ensures that FCS institutions, including Farmer Mac, operate in a safe and sound manner and 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. We evaluate the ability of management and board to direct operations in each institution. We also evaluate each institution's compliance with laws and regulations to serve all eligible borrowers, including young, beginning, and small (YBS) 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, and capital; 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.

As the arm's length regulator of the FCS, the Agency will continue to focus on ensuring that the System remains safe and sound by promulgating regulations, providing appropriate guidance, and maintaining strong and proactive examination and supervisory programs. With the dynamics and risks in the agricultural and financial sectors today, FCA recognizes that FCS institutions must have the appropriate culture, governance, policies, procedures, and management controls to effectively identify and manage risks.

It is in times such as these that the System, as a Government-sponsored enterprise (GSE) devoted to agriculture and rural America, must maintain its critical presence in the agricultural marketplace to provide competitive credit for creditworthy farmers, ranchers, and agricultural cooperatives. In fact, the System did much during the past year to help producers and rural America. When commodity prices soared in early 2008, System institutions stepped forward to meet the critical financing needs of the grain elevator industry. They met increased demands for financing machinery and higher input costs for producers. The FCS also helped Midwest borrowers affected by floods, worked with livestock producers as they made difficult decisions, and made critical infrastructure projects possible for rural America through innovative bond financing, such as a critical care facility in St. James, Minnesota, and similar needed community facilities in the Midwest, Southeast, and Northwest.

CONDITION OF THE FARM CREDIT SYSTEM

I am pleased to report that 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. The System finances more than 35 percent of all U.S. farm business debt, providing credit to more than 450,000 eligible agricultural borrowers through a nationwide framework of 5 banks and 90 local retail associations. In addition, the FCS finances cooperatives, agribusinesses, rural utilities, and rural residents. As of March 31, 2009, total assets were $215 billion and loans exceeded $161 billion.

During 2008, the FCS experienced another year of solid earnings and continued strong asset growth. Gross loans grew by 13.0 percent in 2008 compared with 15.8 percent the previous year. However, we anticipate overall 2009 loan growth to moderate from these historically high levels because of less demand, a riskier credit environment, and the System's decision to more carefully manage growth in fulfillment of its mission. In fact, the System's loan growth slowed to just 0.6 percent in the first quarter of 2009, which reflects normal seasonal repayments on agricultural production loans and a modest 2 percent growth in all other lending types.

While the System continues to have good credit quality and adequate capital, it and its borrowers face a number of risks, including volatile farm commodity and farm input prices; stress to specific agricultural sectors, including ethanol, cattle, hogs, poultry, and dairy; and reduced debt servicing ability by many farm families and rural residents because of the rising level of unemployment and less non-farm income. System asset quality has deteriorated recently because of this challenging economic environment and, in particular, because of large credits in the poultry and ethanol industries that have become stressed. With the continuation of the adverse effects emanating from the general economy and the rising risks in the agricultural economy, we anticipate further deterioration in the System's portfolio, as well as in portfolios of other agricultural lenders throughout 2009.

Going forward, agricultural producers are facing greater financial challenges from lower farm income, volatile commodity prices, higher input costs, and potentially changing government support priorities. As a result, lenders are naturally becoming more cautious and conservative on the extension of credit to farmers, ranchers, and other agricultural producers. While creditworthy farmers and ranchers still have access to credit, the cost of credit is rising, underwriting requirements are more carefully scrutinized, and fixed-rate term loans are more difficult to obtain. To avoid excessive risk, lenders are increasingly lowering portfolio hold limits on various segments of the agricultural industry experiencing stress and conserving their capital resources. From FCA's perspective, the potential for increased risks in the agricultural industry will make credit a continuing area of concern. While creditworthy borrowers will still have access to credit, rising risks in various agricultural sectors means lenders will be cautious about increasing portfolio exposures.

Importantly, however, the System's capital position, solid financial condition, and experienced management will help it remain a viable, dependable, and competitive lender during these difficult times. Total capital was $27.8 billion (including the Farm Credit Insurance Fund) at March 31, 2009, with more than 85 percent of total capital in the form of earned surplus, the most stable form of capital. The ratio of total capital to total assets was 12.9 percent as of March 31, 2009, compared with 13.6 percent the year before. The decline occurred because System assets grew at a faster pace than capital and because the fair value of certain System investments changed. We note that the Agency's efforts and encouragement for the System to build its capital proved beneficial last year when commodity price volatility led to huge margin calls and other credit demands that the FCS was able to fund.

System earnings in 2008 remained strong, with $2.9 billion in net income, a 7.9 percent increase over 2007. As cooperative institutions, the FCS banks and associations passed a portion of their earnings on to their borrower-owners as patronage distributions—33 percent of Systemwide net income in 2008. Return on assets (ROA) remained favorable at 1.44 percent. In fact, during an unprecedented turbulent and challenging year for all financial institutions, an ROA of nearly 1.5 percent is considered very strong when compared with the ROA of other lenders. During the first quarter of 2009, the System earned $615 million, 19 percent less than a year earlier. The decline in earnings resulted primarily from increased loan charge-offs and the need to replenish loan loss reserves because of rising risk in the loan portfolio, in particular for large credits in the ethanol and livestock/poultry industries.

Despite declines from historic high levels over the past few years, credit quality remained good overall with less than 4 percent of all loans classified adversely as of March 31, 2009. Another credit quality indicator is the level of nonperforming loans. Nonperforming assets and nonaccrual loans increased from historically low levels. Nonperforming loans increased $500 million from December 31, 2008, to nearly $3 billion on March 31, 2009. This represents 1.8 percent of total loans, up from 1.5 percent at year-end 2008. Importantly, as increased stress is beginning to surface in FCS portfolios, we at FCA recognize that System senior management is well experienced and seasoned. Many gained experience during the agricultural credit crisis of the 1980s, and we believe appropriate actions, in general, are being taken by FCS boards and management.

In addition to the System's management experience and board direction, as well as FCA's oversight, the Farm Credit System Insurance Corporation (FCSIC) further protected investors in more than $175 billion in Systemwide consolidated debt obligations. It holds $3 billion in its Insurance Fund. In response to an FCSIC proposal, Congress amended the Farm Credit Act through the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill) to authorize a broader range of FCSIC premiums on the System's insured debt obligations. The implementation of these legislative changes in June 2008 for the second half of the calendar year increased the amount of premiums that FCSIC collected in 2008 and will ensure the fund's continued growth as needed into the future.

The FCS has been able to maintain financial strength and serve its mission despite the economic and financial market turmoil. During the past year, negative economic developments in the financial markets have created a high level of uncertainty about the repayment capacity of global financial institutions. These conditions greatly reduced both the level of credit available and investor willingness to purchase debt securities of financial institutions. As a result, the System's ability to issue debt with preferred maturities and structures was extremely challenging. Because of the strong condition of the FCS and its status as a GSE, it has been able to issue short-term debt securities, even though the issuance of longer-term debt became much more difficult. The current financial environment also negatively impacted the System's cost of funding, as spreads relative to Treasuries have increased significantly. For instance, the spread to comparable Treasuries for two-year FCS debt peaked at 230 basis points compared with typical levels before the financial market crisis, ranging from 20 to 30 basis points. Most recently spreads have been about double the pre-crisis level. System institutions are responding to these funding challenges appropriately by increasing liquidity and the quality of its investment portfolio and, as necessary, increasing borrowing rates to customers.

During this period of extreme market volatility, many non-System banks and financial institutions have been able to access funds through various programs created or recently expanded by the U.S. Government in response to the current financial crisis. The System does not have access to these programs or to any other U.S. Government-backed liquidity credit line. While this situation has not prevented the System from obtaining funds, continued volatility within the GSE debt market makes the outlook for the availability and pricing of future funding less certain. This is an area meriting close monitoring by the FCS, its regulator, and Congress.

For our part, we have taken actions to provide the System appropriate regulatory flexibility during this difficult period. For example, we increased the System's discount note ceiling to $60 billion from $40 billion to allow it to raise funds if financial markets are not open to term debt. The FCA Board also adopted a Market Emergency Standby Resolution that would go into effect only in the event of a serious market disruption. It would temporarily allow Farm Credit banks to fund their assets with short-term liabilities, even if doing so would cause the liquidity reserve of one or more System banks to drop below the regulatory minimum requirement of 90 days. We continue to consider other measures to enhance System liquidity, capital levels, and earnings.

EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

The Agency'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 on-site presence and oversight of FCS institutions in response to the changing and riskier environment we face today.

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 in every respect to 5 for an institution that is likely to fail. Our most recent FIRS ratings continued to reflect the sound financial condition of the FCS, although conditions in the System are beginning to show increased stress.

The global recession is having a serious impact on the agricultural economy and the risk environment faced by agricultural lenders. Lower global demand for most commodities since mid-2008 has led to a rapid decline in crop prices. The decline in farm input costs in recent months should mitigate some of the effects of declining commodity prices, but for most crop producers prices have declined much more than input costs, resulting in tighter margins. Volatile feed prices and falling demand, especially in international markets, have also led to lower livestock margins. Significantly higher unemployment rates are expected to result in lower off-farm income, which is an important source of loan repayment for many System borrowers. Overcapacity in the biofuels industry and much lower dairy prices have added to System risk.

The recent H1N1 outbreak has sparked import bans on U.S. pork, which may continue to depress hog prices. In February, the U.S. Department of Agriculture forecast a decline in 2009 net cash farm income of 17 percent from the record 2008 level. These factors are expected to lead to a continued decline in asset quality at System institutions.

The combined effect of these factors increased the risk environment and contributed to FIRS ratings downgrades for several institutions in the fourth quarter of 2008 and again in the first quarter of 2009. Currently, none of the 95 FCS institutions are under formal enforcement action and no FCS institution is in conservatorship or receivership. However, we maintain an aggressive oversight and special supervision program to address risk in FCS institutions promptly and proactively. For example, we have increased examination and supervisory actions on the ten institutions rated 3 or worse. It is important to note that these 10 institutions do not pose material risks to the System overall and the System remains financially strong and adequately capitalized.

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 on-site presence and placing special emphasis on testing and evaluating the following:

- Internal audit and credit review programs to ensure that they are adequate and that they reflect each institution's risks in a timely manner
- Portfolio management and stress testing functions to ensure that they are appropriate for the institution
- Large loans held by multiple institutions to ensure that 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
- Adequacy and quality of liquidity at System banks

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, including certain USDA guaranteed loans. 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.

Farmer Mac is a separate GSE devoted to agriculture and rural America. 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. The Insurance Fund does not back Farmer Mac's securities, and the System is not liable for any Farmer Mac obligations.

Farmer Mac's total program volume exceeded $10 billion at year-end, including both direct loan volume and guarantees. For the year ending 2008, Farmer Mac experienced a large net loss. Specifically, nonprogram investment losses occurred because Farmer Mac held $50 million of Fannie Mae floating rate preferred stock and $60 million of Lehman Brothers senior debt securities. Events in September 2008 caused Farmer Mac to recognize a total of $106 million in other-than-temporary impairment charges on investment holdings. The full year 2008 net loss to common stockholders was $154 million, including the above-mentioned investment losses and losses related to fair value changes in financial derivatives and provisions for loan exposures to the ethanol sector. These losses were not the result of significant negative developments in Farmer Mac's program loan portfolio, although stress in Farmer Mac's ethanol portfolio has developed during the past two quarters and pushed delinquencies and nonperforming loans higher from recent historically low levels.

Despite the difficulties in 2008, Farmer Mac continued to have access to the debt markets to fund its program assets. Farmer Mac raised $124 million in net new capital through preferred stock offerings in the third and fourth quarters of 2008. As a result of the issuance of new equity, Farmer Mac's core capital exceeded the statutory minimum capital requirement at year-end 2008. The Farmer Mac Board of Directors replaced the Chief Executive Officer and Chief Financial Officer during the fourth quarter.

During the first quarter of 2009, Farmer Mac reported net income of $33.5 million, compared with a net loss in the fourth quarter of 2008 of $61.1 million. First quarter 2009 net income was primarily driven by gains on the values of financial derivatives and trading assets, offset somewhat by further provisions for losses principally related to the ethanol sector. Capital surplus exceeded the minimum requirement by $67 million at March 31, 2009. During the first quarter of 2009, Farmer Mac improved its capital position by raising equity in conjunction with new business, selling loans and thereby shrinking assets, and recognizing gains on the values of financial derivatives and trading assets since fourth quarter 2008. Farmer Mac is continuing to work to improve its balance sheet, strengthen its capital position, and provide secondary market opportunities for agriculture mortgages and rural utility loans.

Farmer Mac had positive developments for its business in late 2008 and improvements continue in 2009. As mentioned above, the 2008 Farm Bill expanded Farmer Mac's program authorities in guarantee securities backed by eligible rural utility loans made by cooperative lenders. As of the quarter ending March 31, 2009, Farmer Mac guaranteed rural utility securities totaling $1.3 billion. Since then, Farmer Mac has agreed to purchase or guarantee additional rural utility loans from one cooperative lending partner.

Working with Young, Beginning, and Small Farmers

The System is required to develop programs and make special efforts to serve young, beginning, and small farmers and ranchers. In 2008, lending by the System to YBS producers continued to show solid gains. Nevertheless, YBS results as a percentage of total loans have either dipped a few points or remained relatively flat over the past several years. However, since the percentage of young and small farmers is decreasing in general, the System's YBS dollar results are noteworthy because institutions have managed to expand loan volume. FCS institutions may use a variety of tools to fulfill their commitment to YBS lending. Many associations revised their YBS policies and procedures in the past year, or reported plans to do so in 2009. The changes were in response to guidance issued in an August 2007 FCA Bookletter, which allowed for more flexibility in lending to YBS borrowers and encouraged use of credit enhancements so YBS borrowers could qualify for credit. This indicates that FCA's oversight activities are accomplishing the goal of helping institutions' management and boards stay focused on this important mission area.

Working with Financially Stressed Borrowers

Agriculture involves significant inherent risks and volatility because of many factors, including adverse weather, changes in Government programs, international trade issues, fluctuations in commodity prices, and crop and livestock diseases. The significant risks in agriculture can sometimes make it difficult for borrowers to repay loans. The System (under provisions of the Farm Credit Act) provides borrowers certain rights when they apply for loans and when they have difficulty repaying loans. For example, the 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, the Farm Credit Act and implementing regulations provide borrowers who qualify 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 this value.

FCA enforces the borrower rights provisions of the Farm Credit Act and examines institutions to make sure that they are complying with these provisions. It also receives and reviews complaints from borrowers regarding their rights as borrowers. Through these efforts, FCA ensures compliance with the law and helps FCS institutions continue to provide sound and constructive credit and related services to eligible farmers and ranchers. As the economy has deteriorated and affected FCS borrowers, FCA has received an increase in the number of borrower complaints. Generally, borrowers who contact FCA with complaints are seeking clarification, additional information, and options to redress their concerns. To the extent there are potential violations of law and regulations, FCA requires corrective actions by the institutions.

CONCLUSION

The lending environment for the FCS going forward will be more challenging than the System has faced for many years. As agriculture and rural America contend with the challenges of these difficult and uncertain times, we are mindful that the System was designed to be a dependable lender to agriculture and rural communities in both good times and bad. FCA remains committed to ensuring that the System can fulfill its public policy mandate to both current and future generations of farmers and ranchers and the rural areas in which they live.