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BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON CONSERVATION, CREDIT, ENERGY, AND RESEARCH
MARCH 27, 2007

Chairman Holden, Ranking Member Lucas, and Members of the Subcommittee, I am Nancy Pellett, Chairman and CEO of the Farm Credit Administration (FCA or Agency). On behalf of my Board colleagues, Dallas Tonsager and Leland Strom, I am pleased to be here this morning to participate in this important hearing.

MISSION OF THE FARM CREDIT ADMINISTRATION

The FCA is an independent arm's-length safety and soundness regulator established by Congress to oversee the operations of the Farm Credit System (FCS or System). Specifically, we are responsible for approving regulations and examining the institutions of the Farm Credit System, the Government-sponsored enterprise (GSE) that Congress established to improve the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses. We also regulate and examine Farmer Mac, which provides a secondary market operation for agricultural mortgage loans. The Agency accomplishes its mission in two important ways — through examination and regulations.

EXAMINATION

First, FCA ensures that the System and Farmer Mac remain safe and sound and comply with the applicable law and regulations. Specifically, our risk-based examinations and oversight strategies focus on an institution's financial condition and material risk exposures, as well as its board's and management's abilities to direct its operations. Our oversight and examination strategies also evaluate each institution's efforts to serve all eligible borrowers, including young, beginning, and small farmers and ranchers.

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. Our job is not to forecast specific events, but to understand the environment so we can take steps in advance to help System institutions take preemptive actions before adverse conditions result.

Examiners use a risk-based examination and supervision program to differentiate the risks and develop individualized oversight plans for each FCS institution. We set the scope and frequency of each examination based on the level of risk in the institution. In addition, we continuously identify, evaluate, and proactively address risks within each institution. Examiners scope their oversight and examination activities on their assessment of an institution's internal control environment and the institution's board and management's ability to manage risks, both present and future. When needed, we direct institutions to implement appropriate corrective actions to address weaknesses examiners identify.

Risks are inherent in lending, and managing risks associated with a single sector of the economy, such as agriculture, can be particularly challenging for lenders. If FCA discovers unwarranted risks, we work with an institution's board and management to establish a plan of action to mitigate or eliminate those risks. Appropriate actions may include reducing risk exposures, diversifying its portfolio of risks, increasing capital, or strengthening risk management practices. In those cases where the board and management are unable or unwilling to take appropriate action, the Agency has broad authority under the Farm Credit Act to take a variety of enforcement actions including supervisory letters, written agreements, and cease and desist orders. We also have authority to issue capital directives when necessary to maintain an institution's financial viability. In extreme cases, we can remove or suspend management, issue civil money penalties, and/or liquidate the institution.

REGULATORY ACTIVITY

The second way FCA accomplishes its mission is through regulatory activity. The FCA approves corporate charter changes and adopts regulations, policies, and other guidelines that govern how System institutions conduct their business and interact with their customers. Congress has given the FCA Board statutory authority to establish policy and prescribe regulations necessary to ensure that FCS institutions comply with the law and operate in a safe and sound manner. The Agency's regulatory philosophy is to establish a flexible regulatory environment that enables the System, consistent with statutory authority, to offer high-quality, competitively priced credit to farmers and ranchers, their cooperatives, rural residents, and other entities on which farming operations depend. This translates into developing balanced, well-reasoned, flexible, and legally sound regulations. We strive to ensure that the benefits of regulations outweigh the costs of implementation; maintain the System's relevance in the marketplace and in rural America; and ensure that FCA's policy actions encourage member-borrowers to participate in the management, control, and ownership of their GSE institutions.

I would like to give the committee a brief status report on a few of our notable regulatory projects this past year. In 2006 we completed a final rule on governance that established governance standards throughout the FCS — strengthening the independence of System institution boards, fostering the increased involvement of member-borrowers in System governance, and improving transparency in public disclosures. Our governance rule is consistent with the best practices found in the financial marketplace today, balanced to reflect the unique cooperative structure of the Farm Credit System. We believe the provisions of the governance rule are among the most comprehensive of all GSE financial regulators. The Agency also completed a final rule on disclosure and reporting requirements for FCS institutions that will improve the transparency of published disclosures, strengthen board and management accountability and auditor independence, and increase shareholder and investor confidence in the System.

The FCA Board also approved revisions to the Farmer Mac Risk-Based Capital Stress Test (RBC model). We adopted a final regulation this past November to ensure a more accurate reflection of the risk in Farmer Mac's operations. We completed these amendments in response to changing financial markets, new business practices and the evolution of the loan portfolio at Farmer Mac, as well as continued development of industry best practices among leading financial institutions. The Agency is also studying the possibility of further revising the Farmer Mac Risk-Based Capital Stress Test to better accommodate the evolving terms and structure of certain program business underwritten by Farmer Mac.

The Agency also issued a proposed rule last fall on processing and marketing that is focused on allowing agricultural producers to capture more of the value-added dollar. The rule recognizes the evolving sophisticated legal structures that farmers now use when engaging in processing and marketing business activities. The rule does not involve expanding the System's authority to lend to businesses that only have a tangential relationship to agricultural or producers operations. Instead, the proposal is focused on assisting, through System financing, only those agricultural or producer processing and marketing entities that are truly integrated and are a logical extension of bona fide farmer and rancher operations. We will carefully examine all the comments submitted, and our Board will likely vote on a final rule later this year.

CONDITION OF THE SYSTEM AND FARMER MAC

Mr. Chairman, now let me turn briefly to the condition of the Farm Credit System. The System is a nationwide network of borrower-owned *cooperative* lending institutions and affiliated service entities that lend to agricultural and to rural America. I would like to highlight several of the underlying fundamentals of the System's cooperative business structure that are important to keep in mind.

1. Cooperatives are organizations that are *owned* and *controlled* by their members who benefit from the use of the cooperative's products, supplies, or services.

2. Boards of System lending institutions include elected directors from the voting membership of each institution, and a limited number of outside directors to supplement specific experience. Accordingly, the directors of System lending institutions are elected by their owner-users. Management does not sit on any boards of System lending institutions.

3. System lending institutions, as cooperatives, generally pay a portion of profits in patronage to their member-owners based on use of the cooperative's services. In contrast, owners of investor-owned businesses are typically not the users and dividends are paid to the owner based on stock ownership.

4. For the year ending 2006, 86 of 100 System institutions declared a total of $718 million in patronage to its member-owners. This amount represented 30 percent of 2006 combined net income of all System institutions.

The System comprises five banks and 95 associations that are the direct lenders to farmers and ranchers. I am pleased to report that the System's overall condition and performance remained strong throughout 2006. As the regulator, we take our job very seriously, and I am proud to say that FCA has played a major role in bringing the System back from the tough times of the 1980s to its present extremely healthy condition. Also distinguishing the FCS from other GSEs is the Farm Credit Insurance Fund. The Insurance Fund provides added protection for investors in Systemwide securities. The FCS is the only GSE afforded this level of protection.

The FCS is fundamentally sound in all material respects, and it continues to be a financially strong, reliable source of affordable credit to agriculture and to rural America. The quality of loan assets, risk-bearing capacity, stable earnings, and capital levels collectively reflect a healthy Farm Credit System. Capital levels continued to be strong, especially when compared with the System's risk profile. Asset quality remained high, loan volume growth was strong, and favorable credit conditions enabled the System to achieve nearly $2.4 billion in earnings for the 12 months ended December 31, 2006.

The Farm Credit System has earned more than $1 billion per year consistently beginning in 1993 and more than $2 billion per year beginning in 2004. As a result capital remains strong and is made up largely of earned surplus, the most stable form of capital. The System also continues to enjoy strong credit ratings from the rating agencies.

Farmer Mac is a stockholder-owned, federally chartered instrumentality established in 1988 to create a secondary market for agricultural real estate and rural housing mortgage loans. It provides secondary market services through a network of agricultural lenders and intermediaries that includes commercial banks, FCS banks and associations, life insurance companies, and mortgage companies. As of December 31, 2006, Farmer Mac's portfolio of loans, guarantees, and standbys totaled $7.3 billion. During 2006, Farmer Mac experienced significant growth in its outstanding portfolio of program assets.

One of the Agency's highest priorities continues to be the development and implementation of examination and oversight programs that meet the high standards and expectations of the Congress; investors in System debt obligations; the farmers, ranchers, and cooperatives that own System banks and associations; and the public at large. Our programs and practices have worked well over the years and have contributed to the present safe and sound overall condition of the System and Farmer Mac, yet we will continue to challenge our staff to evolve and meet the challenge of regulating and examining the increasingly complex nature of agricultural and rural America lending and financing.

CREDIT OUTLOOK AND OPPORTUNITIES FOR THE FCS

The System loan volume reflects the System’s activities in meeting its public policy purpose of providing for the credit needs of agricultural producers and rural America. Overall, agriculture has experienced several years of strong financial performance, which has resulted in high credit-quality agricultural loan portfolios, stable lender returns on agricultural loans, and increased competition for creditworthy agricultural producers. The underlying agricultural economic environment that supports this favorable financial performance is due to higher commodity prices, increasing land values, and for the 40 percent of farmers that receive them, the safety-net provided by government farm support programs. Of course, farm incomes vary a great deal by farm size, geographic location, and commodity specialties.

It is also important to note that economic growth in the off-farm rural economy is an increasingly important part of farm family income and helps make total incomes less vulnerable to the cyclical nature of the agricultural economy. Farmers rely on the income from off-farm employment and from their own off-farm business enterprises to stabilize their income stream and help with repayment of their business debt. In fact, smaller and intermediate farms obtain more than 80 percent of household income from nonfarm sources. Even for commercial farms, USDA estimates that off-farm income represents between 20 and 40 percent of farm household income.

Based on the underlying economic factors, including higher production input costs over the past few years, we have seen considerable growth in the Farm Credit System’s loans outstanding. USDA projects an increase in the System's overall market share of farm business debt to 32.6 percent in 2006 from 31.7 percent a year earlier. I note that the share of this debt held by commercial banks also increased last year to about 42 percent. The System's share is increasing because of enhanced marketing efforts and new business development, competitively priced credit to the System's borrow-owners, increased distribution of patronage refunds, new products, and collaborative efforts with commercial banks, especially through loan participation and syndication activity. The System's three largest lending segments continue to be real estate mortgage loans at 45.8 percent, production and intermediate-term loans at 23.3 percent, and agribusiness lending at 17.1 percent of the portfolio. Overall, System loan volume grew by 16.2 percent in 2006 compared with 10.3 percent in 2005, reflecting strong growth in all three of these business segments.

We believe that agriculture and rural areas will continue recent favorable financial trends and will demonstrate a growing need for competitive credit and financially related services. Rapidly rising input costs including feed, fertilizer, fuel, and capital equipment; the rising cost of farm land; and the needs of related industries in rural areas will keep the demand for debt rising. It will take the financial resources and expertise of all rural lenders to provide this credit, in many cases working together, as commercial lenders and System institutions have been doing for some of the larger loans. In addition, the FCA, through our examination and regulatory programs, will continue to strongly encourage the System to make its best effort to provide credit and services to young, beginning, and small farmers as well as work with USDA's Farm Service Agency in making guaranteed loans to these farmers.

As the landscape of agriculture and rural America continues to change, the Agency is continually studying and endeavoring to understand how these changes will affect the System's safe and sound mission achievement. For example, with the new emphasis on renewable fuels, specifically ethanol, various System institutions have responded by providing financing for this emerging market. Just a few weeks ago in this Subcommittee you heard from a System representative regarding its commitment to funding renewable fuel projects. As the regulator, FCA will be supportive of these important projects while continuing to ensure the System's safety and soundness.

Just to add a word of caution, however, history has taught us that we cannot expect the favorable financial conditions that have existed in the agricultural sector for several years to continue. Uncertainties such as high and volatile energy prices, the longevity of the ethanol boom and its impacts throughout the agricultural economy, a new farm bill, international trade agreements, and the usual weather and production risks are some of the factors that will affect the longevity of the current conditions. As identified by other regulators, there are signs in other lending segments, like housing and commercial real estate, of potential future credit weaknesses and general economic risks. These regulators point to concentration issues, an easing of underwriting standards, and systemic liquidity exposure. Agriculture and rural America are affected by some of the same general economic risks impacting other lending segments, including economic growth here and abroad, the value of the dollar, the global trading environment, inflation, interest rates, and employment opportunities, while also being exposed to the risks noted above. Through our oversight effort, we remind System institutions to maintain constructive underwriting standards, solid credit administration and effective portfolio risk management practices, all of which help to mitigate the potential economic risks in agricultural lending. This is important, given the System needs to be a reliable source of credit to agricultural producers not only in good economic times, but also when economic times turn stressful and other lenders constrict credit or other sources of liquidity to agricultural producers and rural America.

Mr. Chairman, as you well know, the health of rural America is so crucial to the future of agriculture and our country. If we continue to encourage young people and new entrants to get involved in agriculture, then rural America must offer the basic infrastructure and amenities that will bring them back to the rural areas. We believe the System has a Congressional mandate to assist in providing credit and capital for these important projects and must play a meaningful role going forward in strengthening rural America. Directly linked to this is the importance of serving young, beginning, and small farmers. The System continues to increase its service to these important groups, and FCA will continue to closely examine that service to ensure that these important groups are served in a constructive, safe, and sound manner.

One of the ways we have encouraged System institutions to continue their service to underserved groups and rural communities is to use the broad investment authority provided in the Farm Credit Act. FCA issued guidance in January 2005 that gave System institutions a provisional opportunity to make mission-related investments through pilot programs supporting investments in rural America. Many of the investments are made in the form of a bond or other security instrument. The pilot programs are intended to strengthen the System's mission to provide for an adequate and flexible flow of funds, under specified conditions, to agriculture and to rural communities across the country. Further, the pilot investment programs are intended to provide FCS institutions with greater flexibility to partner with Government agencies and with other agricultural and rural lenders in fulfilling their mission objectives. Through these programs, the Agency is looking to gain a better understanding of the diverse financing needs of agriculture and rural communities and how FCS institution investments could help increase the availability and efficiency of funds to these markets.

These investments include rural housing mortgage securities; bonds that provide funding for economic development; infrastructure; essential community facilities; and revitalization and stabilization projects. One program that I was particularly pleased to see is aimed at helping starter farmers or cooperatives obtain greater access to funds needed to begin or continue operations. Through a subordinated debt arrangement, the program provides investments for working capital purposes of up to $50,000 for young and/or beginning farmers for terms of up to five years. Thus far, the program has funded a goat cheese operation, an apple orchard, and a vegetable operation. While we believe these programs are important for agriculture and rural America, I do want to make it clear that FCA is cognizant that safety and soundness must come first. We place appropriate conditions on each pilot program to limit risk exposures, and we can revise our approval any time safety or soundness becomes an issue.

Before I close, Mr. Chairman, I would like to provide you with a few thoughts and proposals as the Subcommittee and later the full Committee looks toward crafting a credit title for the next farm bill. First and foremost, the FCA is the safety and soundness regulator of the System. Most of our time and certainly the majority of our resources are dedicated to the examination function by our Office of Examination. Similar to the Office of the Comptroller of the Currency, you should know that the Farm Credit Act provides the Agency with all the regulatory, enforcement, and supervisory tools that we need to carry out our responsibilities in this regard. The regulatory framework established by the Agency has resulted in a strong cooperative federation of agricultural lenders that are well capitalized and operate in a safe and sound manner.

Along with safety and soundness, the Agency also has a responsibility to monitor and address how well the System is carrying out its mission as established by Congress. Overall, we believe that the System does a very good job of using the authorities provided under the Farm Credit Act to meet the needs of farmers and ranchers and other authorized borrowers across the country. There are, though, two areas where we think the Subcommittee should consider changes in law.

First, we see a need to clarify the System's ability to use two existing USDA programs to serve farmers and others in rural America. I am suggesting that the Subcommittee make a technical review of the Rural Business Investment Company program so that changes can be made to allow System institutions to participate in the program as originally intended. Briefly, the 2002 Farm Bill (section 6029) created a rural business investment program that was designed to promote economic development and create wealth and job opportunities among individuals living in rural areas and help meet the equity capital investment needs primarily of smaller enterprises located in rural areas. The law envisioned two types of rural business investment companies (RBIC), one that would leverage its own capital with a grant of Government funds, and one that would not receive Government funding (nonleveraged). System institutions were made specifically eligible to participate, and would like to be part of a nonleveraged program or RBIC. USDA regulations do not provide for the creation or certification of nonleveraged RBICs. This issue was also discussed at the Subcommittee's hearing last March.

Second, along with a review of the RBIC, a technical change to the loan-to-value requirements of the Farm Credit Act (section 1.10) would assist farmers and other rural Americans of modest means to take advantage of the guarantee programs of the USDA and perhaps other Government agencies. Under current law, if a loan is guaranteed by Federal, State, or other Government agency, a System institution may lend up to 97 percent of the appraised value of real estate held as security. This limitation does not serve a useful safety or soundness purpose in the case of guaranteed loans. In particular, we are aware of a USDA program that guarantees 100 percent, in some cases slightly greater than 100 percent, of the appraised value of the real estate. These programs are designed to assist moderate- and lower-income individuals and families to acquire or retain real estate in rural areas. Specifically, I would suggest that the statute be amended to allow the FCA to provide, through regulations, that the loan-to-value requirement may exceed 97 percent in the case of guaranteed loans.

Additionally, the Farm Credit System Insurance Corporation (FCSIC) will be suggesting technical changes to the statute that would allow its premium authority to match premium assessments to the Farm Credit System debt it ensures. The changes would enhance investor protection by increasing the amount FCSIC can collect to recapitalize the Insurance Fund. Board Member Leland Strom, in his role as Chairman of the FCSIC, has submitted a letter to the Committee that further explains the issue and would be pleased to visit with you or your staff to discuss it.

As you consider these possible changes, we would be pleased to provide you with draft legislative language at the appropriate time if that meets the needs of the Subcommittee.

CLOSING

In closing, as we continue to see major changes in agriculture and in rural America that will continue to change the lending landscape, the FCA is committed to maintaining our excellence in examination and being the strong, arm's-length regulator that Congress intended. We will also continue to craft thoughtful and sound regulations that will ultimately benefit the all-important end users whom we must always keep in the forefront of our minds — the farmers and ranchers in rural America. Mr. Chairman, thank you for allowing me to testify today. This concludes my statement and I will be happy to answer any questions.