Remarks by
The Honorable Leland A. Strom
to the FCS Coordinating Committee
McLean, Virginia
September 29, 2010

Good afternoon and we appreciate your interest in meeting with us today as follow-up to our recent Bookletter on Farm Credit System Bank Merger Applications.

I support the role of this new System Coordinating Committee and commend each of you as leaders of the Farm Credit System for your role and work on this Committee.

The period 2008–2010 marks the most significant period of financial stress on our economy and banking system since the Great Depression. The crisis demonstrated that risks to the financial system can emerge from varying segments of financial markets and any financial institution.

Much has been and will continue to be said and written about the financial crisis. In the period prior to 2008, there was considerable growth of large interconnected firms. There became a standard belief that they had become "too big to fail."

The financial crisis resulted partly from deficiencies in the formulation and execution of U.S. regulatory policies. In particular, according to the U.S. Treasury, "regulators did not take into account the harm that large, interconnected, and highly leveraged institutions could inflict on the economy if they failed." A key part of the "too-big-to-fail" scenario was the inability of regulators to sufficiently monitor emerging concentrations of risk within the financial system. More properly put, regulators could not constrain risk they could not see.

The crisis resulted in the 2,300-page Wall Street Reform and Consumer Protection Act, which was signed into law this past July. The law will help ensure that risks taken by banks and financial institutions do not threaten the wellbeing of our economy as a whole. The largest banks and financial firms will be required to build up capital and liquidity buffers, better control risks in financial activities, and constrain their relative size. The Act will also bring better transparency to the overall banking system. The reforms also create a means for the government to resolve failing financial firms without risk to the taxpayers. An underlying premise is that, from now on, Congress has expressed its intent that no bank or financial firm can be "too big to fail." It provides for clear, strong, and accountable regulation and supervision of any bank or financial firm whose combination of size, interconnectedness, or leverage could pose a serious threat to the overall financial stability of the financial system if it were to fail.

Altogether, the new reforms will provide incentives for banks and financial firms to reduce their complexity, leverage, size and interconnectedness.

The financial crisis also showed that a too narrow supervisory focus on safety and soundness can result in an inability to detect emerging threats to overall stability across interconnected firms or have significant systemic risk implication.

What does this mean for the Farm Credit System?

We are all very well aware that being a lender involves risk, especially in a single-sector industry such as agriculture. No one can ever fully identify all of the risks or guarantee that plans and expectations will be accurate. But our role as the regulator is to assess and address the potential risks we see to make sure the System remains safe and sound.

As you've all heard me say before, looking to the future requires thinking more strategically. That's why at the Farm Credit Council Annual Meeting last January I challenged System leadership to proactively prepare for potential corporate restructurings by having an open, thoughtful, and meaningful dialogue about structure and the types of mergers that best position the System for its safe and sound long-term success.

Nearly a year ago, I sent a letter to the System providing my thoughts on association mergers in economically challenging times. This letter addressed my concerns regarding shareholder representation, geographic structure, over-chartering, and safety and soundness.

We then issued an Informational Memorandum last January distributing revised guidelines on submission of proposals to merge or consolidate associations. That guidance required significantly more funding bank analysis to support its approval or disapproval of an association merger application, including a requirement to address specific questions regarding the impact of the merger on other institutions, the risk profile of the bank, and any unique issues arising from the potential merger.

This past July the FCA Board approved a Bookletter on Farm Credit System bank mergers. In that Bookletter, we noted that mergers of System banks may provide benefits and create risks for the merging banks, bank shareholders, the System as a whole and all eligible borrowers. Benefits of a bank merger may include portfolio and geographic diversification, improved risk-bearing capacity, management capability, and operational efficiencies. However, a bank merger may increase risk by creating a larger, more complex and difficult-to-manage institution. Such a bank may present broad risks to other System institutions. Therefore, when evaluating a bank merger application, FCA will carefully consider the long-term impact on the safety and soundness at the institution, district, and System levels, including size concentration risk, business model compatibility, and intra-System operational risk. Of particular importance are the implications these risks may have on the System's long-term service to eligible borrowers and its continued ability to fulfill its mission as a government-sponsored enterprise.

In addition to the Bookletter, the agency issued a follow-up Informational Memorandum distributing the guidelines for the submission of proposals to merge banks. That guidance specifically requires bank merger applications to include an analysis of size concentration risk and business model compatibility issues. It also requires applications to assess and address the impact of the merger on various System-wide decision-making and coordinating bodies, as well as identify needed enhancements to result in long-term cooperation across the System.

I recognize some actions have already been taken by the System to address FCA concerns and issues related to this important subject. For example, the System has

1. established this Coordinating Committee and initiated projects to address systemic risk and System GSE Risk Assessment, which includes structure issues;
2. discussed FCA's expectations at PPC meetings and initiated a shared assets repository project under the purview of the PPC Risk Committee;
3. enhanced bank analysis of association merger applications; and
4. requested to meet with FCA to understand expectations and concerns – the purpose of our meeting today.

But I would encourage you to do more. My desire is for the Farm Credit System to engage in a national dialogue to identify and address systemic and structure risk issues in a systematic, consistent, and coordinated manner. I'm concerned that the System's historical ad hoc approach to addressing such risk issues will not be sufficient in the future. My particular concern is the impact of continuing structure changes on the System as a result of bank and association mergers. I believe there has not been an adequate effort to approach mergers from a System-wide structure perspective in a cooperative and collaborative manner. My desire is that mergers support the long-term success of the entire System in serving agriculture and rural America.

I'm also concerned that continued mergers may now condense risk in fewer entities, thereby presenting a broader risk to the System as a whole. Therefore, as we've communicated in the Bookletter, going forward we will specifically evaluate size concentration risk, business model compatibility, and operational risk posed by a bank merger.

When evaluating future merger requests, FCA will ensure that the proposed merger would result in a safe and sound institution. Importantly, the agency will evaluate if it needs to set prudential capital and other requirements in connection with a merger to address the potential risks posed by a larger interconnected institution within the Farm Credit System. And just as importantly, FCA will evaluate whether the proposed merger enhances service to eligible customers and contributes to the overall long-term mission achievement of the System.