Remarks by
The Honorable Leland A. Strom
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Thank you for that very nice introduction, and good morning to all of you. I appreciate the opportunity to join you here in this beautiful city.

What tremendous changes we have seen in the financial industry over the past couple of years and what challenging times our nation has faced. Today, the United States is slowly recovering from a deep global recession. The unemployment rate remains high at 10 percent, and agriculture continues to face a difficult economic environment.

There is still much uncertainty about the recovery and whether there could be another downturn. This morning I'd like to share with you my thoughts on the economic environment, the stress in the Farm Credit System, FCA activities over the past year, and my objectives and challenges for the future.

2009 was another interesting year. Early in the year, the System faced increased funding costs, limited access for term funding, and extreme market turmoil. However, because of the strong condition of the System and its status as a Government-sponsored enterprise, it was able to continue to issue short-term debt securities. As the year progressed, market access for term financing steadily improved, and, despite relatively wider spreads to Treasury, interest rates were generally low. By the end of the year, the improved economic and financial market conditions afforded the System good access to funding across the yield curve, with narrower spreads than we saw at the beginning of the year. System banks have added high-quality liquid assets to their investment portfolios to ensure sufficient liquidity in the event of another market disruption. I applaud the Farm Credit banks' boards and management for making this decision.

2009 was also noteworthy as we saw several years of double-digit growth by the System come to an end. Growth was basically flat during 2009. Not only was loan demand down, but System institutions further controlled and managed loan growth by focusing their lending activities in their local service areas and by adjusting loan structure, payment terms, and pricing to better reflect risk and market conditions. All of this, coupled with improvements in funding, helped the System maintain good earnings in 2009. In fact, the Funding Corporation recently reported that the System had combined net income of $2.85 billion for the year. That was a significant accomplishment during a challenging environment and reflects the System's effectiveness in managing some difficult credit situations, particularly in poultry and ethanol. The System also maintained appropriate asset/liability management practices while continuing to strengthen its capital position. Its capital as a percentage of assets grew from 12.7 percent at December 31, 2008, to 13.9 percent at the end of 2009.

However, the financial market turmoil, prolonged economic weaknesses and deterioration in the agricultural economy, poses significant management challenges for borrowers, System institutions, and FCA. High unemployment and the domestic and global recession have reduced demand for U.S. farm products, causing commodity prices to decline and weakening the agricultural economy. USDA's most recent forecast estimates 2009 farmers' net cash income at $70.8 billion, down $26.7 billion, or about 28 percent from the record set in 2008. On a brighter note, USDA forecasts 2010 farmers' net cash income to increase to $76.3 billion, a $5.5 billion increase from 2009, and $3.4 billion above the 10-year average.

Nevertheless, System borrowers face increased risk from volatile commodity prices, soft farm product demand, higher input prices, and uncertain weather conditions. Sectors showing the most stress are hogs, dairy, forestry, ethanol, and poultry, and together these sectors represent more than 20 percent of the System's portfolio.

Increased unemployment has also adversely impacted many rural communities. The potentially slow economic recovery and uncertain housing recovery suggest that 2010 may be another difficult year for many agricultural producers. These uncertainties will present challenges to lenders and regulators alike.

The System's capital position and sound financial condition will help it weather these difficult times. Another benefit to the System is the experience of its senior management. Also, a number of you in this room were directors of System institutions during the 1980s, as I was, when we learned just how quickly and extensively credit conditions could deteriorate. You now have the opportunity to apply the lessons you learned during that difficult period to help navigate your institutions through the current difficulties.

And there *are* some similarities between the 1980s and the current environment. Just like in the 1980s, we've had rapidly rising land values and volatile commodity prices. Fortunately, there's one significant difference between then and now: Interest rates are much lower today. And although it's unclear how seriously the current economic downturn will impact agriculture, I'm happy to say that I do not expect anything like the agricultural crisis of the 1980s.

While it appears the worst of the economic and financial turmoil may be over, the System and FCA must remain vigilant and proactive. For many financial institutions, the past year was characterized by declining credit quality and increased loan losses. Some of the System's key performance measures are weakening because of the difficult economic environment and management issues in a few institutions. To address these instances, FCA has increased its supervisory activities and enforcement actions. We now have 15 institutions under special supervision or enforcement actions. Also, the Financial Institution ratings for many institutions have slipped.

The current environment poses particular challenges for institutions that participate in large, complex, and shared loans. System institutions must monitor these loans closely, making sure they maintain appropriate information and fully report risk exposures. We also recognize the need to improve our own information, and we have continued to enhance our information and analysis capabilities, including the development of a consolidated loan database.

We are continuing to focus the resources necessary to intensify oversight, take proactive measures to safeguard institutions, and identify emerging risks across institutions. Our Office of Examination developed a National Oversight Plan to ensure that all examinations have consistent priorities and focus squarely on material and emerging risks. For example, examiners are giving added attention to loan portfolio management; large, complex, and shared assets; collateral risk management; and liquidity risk and balance sheet management.

In communicating the Oversight Plan to System Boards, Chief Examiner Tom McKenzie made a request, which I strongly support, that each System board take decisive actions to ensure its institution is well prepared to manage current risks. System institutions must exercise caution at all levels—from making individual loans to ensuring that portfolio risk management policies are adequate.

To assist you in this regard, we have increased our communications to the System on safety and soundness issues. For example, we issued an Informational Memorandum on "Confronting the Increased Risk Environment" and provided other guidance addressing such issues as executive compensation, responding to local financial institution failures, and financing land in transition. We issued an Informational Memorandum on "Consumer and Borrower Rights Compliance Requirements."

During the past year, we conducted special studies on distressed agricultural industries to assess emerging risks that may impact the System. The studies identified concentrations within institutions, trends, and recent structural changes in these industries. They also provided an update on the current industry economic conditions, credit situation, and outlook. Agency staff held a series of conference calls with certain System institutions that have large loan concentrations in these distressed industries.

But we are not only coordinating and communicating with the System. We are also working with USDA. I met with Secretary Vilsack last June as we were beginning these special studies. I plan to meet with him again soon.

In addition, we coordinated with other agencies, particularly the Treasury Department, regarding the Consumer Financial Protection Agency Act of 2009 and the Financial Stability Improvement Act of 2009. We had productive meetings with key staff on the House and Senate Agriculture Committees to discuss how the proposed bills would affect the Farm Credit System, Farmer Mac, and FCA. Through the leadership of Chairman Peterson, the Committee worked to exempt the System and Farmer Mac from the provisions of the financial reform legislation. Now we are dealing with these same issues on the Senate side in the Dodd Bill.

These are a few of the specific actions and activities we've undertaken this past year. I'd now like to discuss the three FCA-related objectives I see as key to meeting the challenges of the future.

First, the Agency's overriding objective must continue to be the safety and soundness of the Farm Credit System. By ensuring safety and soundness, we help the System serve the ultimate purpose for which it was created—to ensure market access and competitive credit for farmers, ranchers, and their cooperatives. However, we must continue to prepare for the increasingly complex nature of financing agriculture and rural America in response to the changing and riskier environment we face today.

To ensure that we can provide the proper supervision and oversight of the System and Farmer Mac, we are continuing to increase our examination staffing levels. These additional resources are necessary, especially because of the higher risk environment and the impending retirement bubble we face.

As we did this past year, we will be providing additional guidance to you during 2010 to address safety and soundness, as well as other important issues. For example, Chief Examiner McKenzie recently sent an Informational Memorandum further outlining our stress testing expectations for all System institutions. We believe an important goal of stress testing is to enhance the understanding by both management and the board of the institution's portfolio risk under a range of operating environments. This is valuable in providing information for use in key decisions such as setting capital goals, formulating underwriting standards, pricing loans, and establishing concentration parameters. Stress testing also enables an institution to identify vulnerabilities by exposing it to plausible stress scenarios. We also recognize our own need to do work in this area, and we have begun a project to stress test capital and earnings capacity for all System associations and banks.

The Agency's second objective is to focus on establishing the right level of regulatory capital for Farm Credit System institutions. In 2008 we conducted a series of informational meetings as part of the advance notice of proposed rulemaking (ANPR) on possible regulatory changes to the System's capital rules. We continued our work on this project during 2009. Now, staff is developing a second ANPR that would consider new capital standards consistent with the capital tiers delineated in the Basel Capital Accord. Our goal is to enhance the System's capital framework and more closely align minimum capital requirements to risks taken by System institutions. We also are focused on making our regulatory capital requirements more transparent and understandable to those outside the System and active in the broader market. We hope to accomplish this by revising the framework to match the requirements applied to other financial institutions.

Our third objective is to ensure that the System continues to meet its public policy purpose and mission-related responsibilities. We must always remember that was why Congress created the Farm Credit System in the first place. With our current concern and focus on confronting the higher risk environment, it may be easy to overlook this important goal. But while we address the pressing problems, we must also keep an eye to the future.

And, looking to the future requires us to think more strategically. I recently communicated to you my views on association mergers in economically challenging times. I noted that in stressful times, boards of directors may need to pursue and make merger decisions quickly. I believe that it is important for each association to strategically and proactively consider different merger scenarios long before a merger is imminent.

I challenge System leadership to proactively prepare for potential corporate restructurings by having an open, thoughtful, and meaningful internal dialogue about structure and the types of mergers that best position the System for its safe and sound long-term success.

Farm Credit institutions should plan for the future of an agricultural industry that continues to change. Consumers are now interested in knowing how, where, and by whom their food is produced. This interest has generated a surge in the local foods sector, creating opportunities for producers. The next generation of farmers is watching this development closely. They recognize that meeting the demand for sustainably produced local foods allows them to diversify their farming operations, which in turn helps revitalize rural communities. This was a major theme at the USDA Outlook Forum last month.

The growth in local food systems presents an opportunity for the Farm Credit System as well. Your institutions can play an essential role in supplying capital and expertise to create localized food supply chains. At the same time, this will also demonstrate Farm Credit's dedication to our young, beginning, and small farmer mission.

My own son Tyler is an example of this change. He obtained a degree in agriculture business and international studies from Iowa State University. But instead of coming back to the farm in Illinois or entering the work force, he followed his desire to better understand the global issues of the agricultural industry. For example, he wants to understand how environmental challenges and demands for sustainability will affect the future of agriculture. He is about to finish a two-year international master's program overseas. As part of this program, he has been studying these issues with individuals from 27 countries. Tyler realizes the importance of establishing an era of working together with people who will be leaders around the world to solve these emerging problems.

We are now in the decade that will mark the 100th anniversary of the creation of the Farm Credit System. As we approach this milestone, we all have a responsibility to think about how the System must continue to evolve to successfully finance agriculture and the rural areas of this nation in the future.

I'll conclude this morning by commending the Texas District for providing a tremendous service to agriculture through these difficult times. And I'll leave you with one piece of advice: Be proactive in preparing for the challenges ahead. As I have learned over the years—first as a farmer, then as a System board member, and now as FCA Chairman—there is so much uncertainty, especially in the agricultural sector. The best remedy is to be prepared for the unexpected.

Again, I appreciate the opportunity to be here with you today at your Annual Meeting, and I look forward to working with you over the coming year.