Testimony of the Honorable Leland A. Strom
Chairman and Chief Executive Officer
Farm Credit Administration
Before the Subcommittee on Agriculture,
Rural Development, Food and Drug Administration, and Related Agencies
U.S. Senate Committee on Appropriations
April 30, 2009

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 colleagues on the FCA Board, Dallas Tonsager of South Dakota and Nancy Pellett of Iowa, and all the dedicated men and women of the Agency, I am pleased to provide this testimony.

Before I discuss the Agency's role, responsibilities, and budget request, I would like to thank the Subcommittee staff for its assistance during the budget process. Also, I would respectfully bring to the Subcommittee's attention that the funds used by the FCA to pay its administrative expenses are assessed and collected annually from the Farm Credit System (FCS or System) institutions we regulate and examine — the FCS banks, associations, and service corporations, and the Federal Agricultural Mortgage Corporation (Farmer Mac). FCA does not receive a Federal appropriation.

Earlier this fiscal year, the Agency submitted a proposed total budget request of $54,828,569 for FY 2010. FCA's proposed budget for FY 2010 includes funding from current and prior assessments of $54,500,000 on System institutions, including Farmer Mac. Almost all this amount (approximately 82 percent) goes for salaries, benefits, and related costs.

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, 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, as well as on the ability of its board and management to direct its operations. We also evaluate each institution's compliance with laws and regulations to serve all eligible borrowers, including young, beginning, and small 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, capital, and mission, 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.

EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

The Agency's highest priority is to maintain appropriate risk-based oversight and examination programs. These 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.

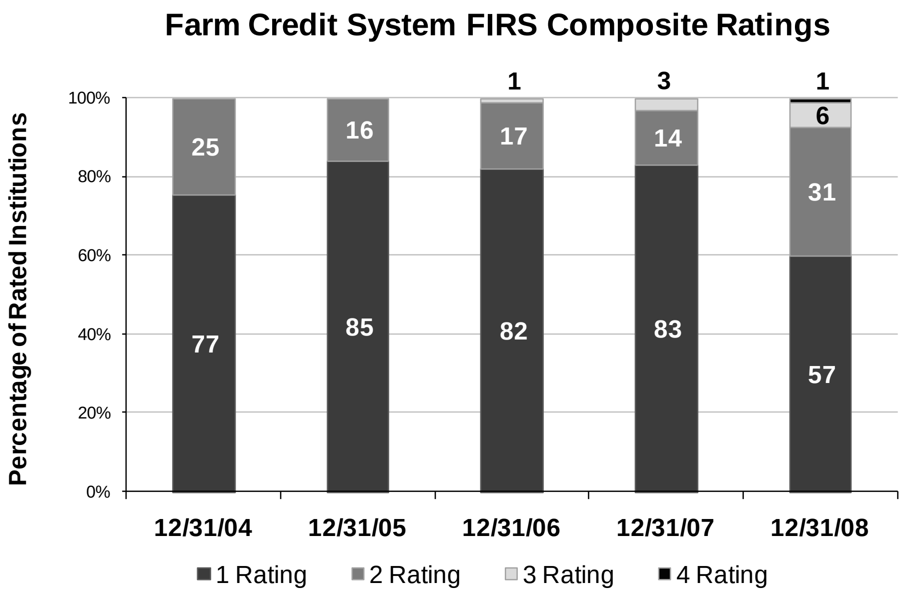
With the changes in the System and human capital challenges within our Agency (pending retirements, normal attrition of staff, and the ever-increasing need for more sophisticated skills in the financial sector), we have undertaken a number of initiatives to enhance our skills and expertise in key examination functions. 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.

The scope and frequency of each examination is based on our assessment of an institution's internal controls and the ability of its board and management to manage risks. FCS institutions are required to have prudent loan underwriting and loan administration processes, to maintain adequate asset-liability management capabilities, and to establish high standards for governance and transparent shareholder disclosures. The frequency and depth of our examinations may vary, but each institution is provided a summary of our activities and a report on its overall condition at least every 18 months. Most issues are resolved through corrective actions established in the Report of Examination or other communication. In extreme cases, FCA will use its enforcement powers to effect changes in the institution's policies and practices to correct unsafe or unsound conditions or violations of law or regulations.

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 to 5 for an institution that is likely to fail. As of December 31, 2008, FIRS ratings as a whole continued to reflect the sound financial condition of the FCS, although conditions in the System are beginning to indicate that stress is increasing.

The global recession is having a serious impact on the agricultural economy and the risk environment of the FCS in 2009. 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, has 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 flu epidemic has sparked import bans on U.S. pork, which may continue to depress hog prices. Overall, the U.S. Department of Agriculture forecast, in February 2009, 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.

FIRS ratings were downgraded in several institutions in the fourth quarter of 2008, and we have increased supervisory oversight. The following chart summarizes the change in ratings over the past five years. Currently, no 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 seven institutions rated 3 or worse. These seven institutions do not pose material risks to the System overall and the System remains financially strong and adequately capitalized. Additionally, the FCS does not pose material risk to investors in FCS debt, the Farm Credit System Insurance Corporation (FCSIC), or FCS institution stockholders.



Source: FCA's FIRS Ratings Database. The above chart does not include the Farm Credit Leasing Services Corporation. The figures in the bars reflect the number of insitiutions by FIRS rating.

REGULATORY AND CORPORATE ACTIVITIES

Congress has given the FCA Board statutory authority to establish policy, prescribe regulations, and issue other guidance necessary to ensure that FCS institutions comply with the law and operate in a safe and sound manner. The Agency's regulatory philosophy focuses our efforts on developing balanced, flexible, and legally sound regulations. For fiscal years 2008 and 2009, a significant focus of our regulatory and policy projects was on ensuring FCS safety and soundness. The FCA Board approved a final rule in April 2008 that revised FCA regulations governing the Risk-Based Capital Stress Test for Farmer Mac, which calculates the minimum amount of regulatory capital that Farmer Mac is required to hold. The Agency also issued guidance to System institutions to clarify areas of concern regarding collateral appraisals, valuations, and association review programs; to discuss System growth, emerging risks in agriculture and best practices for fast-growing institutions; and to provide System institutions guidance on determining regulatory capital requirements for certain off-balance-sheet exposures. Additionally, the FCA Board adopted a Market Emergency Standby Resolution, which would only go into effect in the event of a serious market disruption. It would temporarily allow FCS banks to fund their assets with short-term liabilities, known as discount notes, even if doing so would cause the liquidity reserve of one or more FCS banks to drop below the regulatory minimum.

Other regulatory and policy projects the Agency is working on now include projects on capital adequacy to (1) revise our regulatory capital definitions to more closely resemble those used by the Basel Accords and the Federal banking agencies; (2) create a transparent and effective early intervention process; and (3) revise other parts of our regulatory capital framework as needed to more closely align it with the Basel II standardized approach. Additionally, we are reviewing FCA regulations and policies on loan pricing, terms, and conditions to ensure that System practices and procedures reflect sensitivity to market conditions and safety and soundness. We are developing regulations with the Federal banking agencies to implement the Secure and Fair Enforcement for Mortgage Licensing Act of 2008. We are reviewing FCA regulations relating to investment assets to ensure that prudent practices are in place for the safe and sound management of investment portfolios. We also will review conditions for divestiture of investment assets.

Corporate Activities — The pace of System restructuring increased in FY 2008. Eight corporate applications were submitted for FCA Board approval during FY 2008, compared with one application the prior year. As of January 1, 2009, the System had 90 direct-lender associations and five banks for a total of 95 institutions. Seven service corporations and special-purpose entities brought the total number of FCS institutions to 102 entities. While the number of FCS institutions has declined, their complexity has increased, which has resulted in greater demands on both examination staff resources and expertise.

CONDITION OF THE FARM CREDIT SYSTEM

The System's overall condition and performance remained safe and sound throughout 2008. Its strong capital position will help it remain a viable, dependable, and competitive lender during any near-term downturns in the agricultural economy. Total capital was $27.1 billion at December 31, 2008, with more than 85 percent of capital in the form of earned surplus, the most stable form of capital. The ratio of total capital to total assets was 12.7 percent at year-end 2008, compared with 14.2 percent the year before. The decline was due to fair value changes of certain System investments and System assets growing at a faster pace than capital in order to meet borrower needs. We note that the Agency's efforts for the System to build its capital paid dividends last year when commodity price volatility led to huge margin calls that the FCS was able to fund.

Asset quality remained high and loan volume increased in 2008. While loan volume growth is expected to continue in 2009, we anticipate that the rate of growth will slow. Gross loans grew by 13.0 percent in 2008, compared with 15.8 percent the previous year. Nonperforming loans increased by $1.795 billion to $2.416 billion as of December 31, 2008, and represented 8.91 percent of total capital by the end of 2008, up from 2.35 percent at the end of 2007.

FCS senior management is generally experienced and seasoned. Many gained experience during the agricultural crisis of the 1980s. Ninety-four percent of FCS institutions had a 1 or 2 management FIRS rating in the most recent quarter. In 2008, the System earned $2.9 billion, a 7.9-percent increase from 2007. The return on assets was favorable at 1.44 percent. The System increased its liquidity position to 177 days at December 31, 2008, up from 122 days a year earlier and well in excess of the 90-day regulatory liquidity reserve requirement. The additional liquidity provides System banks a cushion in view of the uncertainty in the U.S. and global markets.

Further strengthening the System's financial condition is the Farm Credit Insurance Fund (Insurance Fund), which has grown to more than $3 billion. The Insurance Fund protects investors in Systemwide consolidated debt obligations. The Farm Credit System Insurance Corporation administers the Insurance Fund. In response to a 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.

Despite the economic and financial market turmoil, the System was able to maintain its financial strength, serve its mission, and build the Insurance Fund in 2008. However, even though it is a Government Sponsored Enterprise (GSE) with solid financial performance, the System has experienced increasing challenges accessing the financial markets, its primary source of liquidity. Specifically, the financial markets crisis has resulted in an increased spread over Treasuries for System debt issuances for longer-term securities. For instance, prior to the financial crisis, all GSE debt tended to trade at the same basis-point spreads relative to comparable Treasury securities. After the crisis surfaced and related Government actions were taken, the System has seen its relative spreads for three-year debt instruments widen by 46 basis points on average when compared with other GSEs. Nevertheless, Government actions to stabilize the financial markets and funding for other GSEs have provided some ancillary benefit to System funding. While the System has been able to endure the financial market uncertainties, continuing weaknesses in the financial markets and potential related government actions will likely make 2010 another challenging year for System debt issuance.

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. 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.

Like the FCS, Farmer Mac is a GSE devoted to agriculture and rural America. Farmer Mac is not subject to any intra-System agreements or the joint and several liability of the FCS banks. Also, the Insurance Fund does not back Farmer Mac's securities. However, 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.

Farmer Mac experienced a large net loss for the 12 months ended December 31, 2008. Specifically, nonprogram investment losses came from Farmer Mac holding $50 million of Fannie Mae floating rate preferred stock and $60 million of Lehman Brothers senior debt securities. Events in September 2008 led to Farmer Mac recognizing a total of $106 million in other-than-temporary impairment charges on these investment holdings.

Farmer Mac has now discontinued entering into certain interest rate swap derivatives that led to the 2008 losses related to fair value changes in the financial derivatives portfolio. Over time, this change will lead to a reduction in the volatility in earnings from the fair value changes and the resulting reductions to capital. As such, the reductions are expected to be restored to capital over time as the interest rate swap derivatives mature. The large losses discussed above 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.

Farmer Mac continues to have access to the debt markets to fund its program assets. It raised $124 million in capital through preferred stock offerings during the third and fourth quarters of 2008 to remain compliant with regulatory capital requirements. Finally, the Farmer Mac Board of Directors replaced members of the executive management team and has moved aggressively to continue to strengthen its capital position.

CONCLUSION

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System and Farmer Mac remain financially sound and focused on serving agriculture and rural America. It is our intent to stay within the constraints of our FY 2010 budget as presented, and we continue our efforts to be good stewards of the resources entrusted to us in order to meet our responsibilities. While we are proud of our record and accomplishments, I assure you that the Agency will continue its commitment to excellence, effectiveness, and cost efficiency and will remain focused on our mission of ensuring a safe, sound, and dependable source of credit for agriculture and rural America. On behalf of my colleagues on the FCA Board and at the Agency, this concludes my statement and I thank you for the opportunity to share this information.