Testimony of the Honorable Dallas P. Tonsager
Board Chairman and Chief Executive Officer
Farm Credit Administration
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Committee on Agriculture
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Introduction

Chairman Conaway, Ranking Member Peterson, and Members of the Committee, I am Dallas P. Tonsager, board chairman and CEO of the Farm Credit Administration. On behalf of my colleagues on the FCA board, Jeffery S. Hall of Kentucky and Kenneth A. Spearman of California, and all the dedicated men and women of the agency, I am pleased to provide this testimony.

FCA is an independent agency responsible for examining and regulating the banks, associations, and related entities of the Farm Credit System (FCS or System), including the Federal Agricultural Mortgage Corporation (Farmer Mac).

The FCS is a government-sponsored enterprise (GSE) created by Congress in 1916 to provide American agriculture with a dependable source of credit. The System's banks and associations form a nationwide network of cooperatively organized lending institutions that are owned and controlled by their borrowers, serving all 50 states and Puerto Rico.

FCA mission

As directed by Congress, FCA's mission is to ensure a safe, sound, and dependable source of credit and related services for all creditworthy and eligible persons in agriculture and rural America. We accomplish this mission in two important ways.

First, we protect the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and we ensure that they comply with applicable laws 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 ensure that it serves 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 take appropriate corrective action.

Second, we develop policies and regulations that govern how System institutions conduct their business and interact with customers. Our policies and regulations protect the System's safety and soundness; implement the Farm Credit Act; provide minimum requirements for lending, related services, investments, capital, and mission; and ensure adequate financial disclosure and governance. We approve the corporate charter changes of System institutions, System debt issuance, and other financial and operational matters.

Through the oversight and leadership of the House and Senate Agriculture Committees, many important reforms were made to the Farm Credit Administration and the FCS as a result of the agricultural credit crisis of the 1980s. This included restructuring FCA as an independent arm's-length regulator with formal enforcement powers, providing borrower rights to System borrowers with distressed loans, and establishing the Farm Credit Insurance Fund to protect System investors.

Since then, the Farm Credit System has restored its financial health and the public trust. Using our authority as an arm's-length regulator, we have contributed to the System's success by ensuring that System institutions adhered to safety and soundness standards. The Insurance Fund also helped to restore investor confidence.

Both the System and FCA learned much during the crisis of the 1980s, and those lessons helped build a much stronger Farm Credit System, as well as a stronger regulator. We 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, we recognize that FCS institutions must have the appropriate culture, governance, policies, procedures, and management controls to effectively identify and manage risks. Today the System is a dependable provider of credit to agriculture and rural America as intended by Congress.

Farm Credit System mission

According to the Farm Credit Act of 1971, Congress created the System 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 necessary for efficient farm operations."

In fulfilling this mission, the System provides credit and other services to agricultural producers, aquatic producers or harvesters, and farmer-owned cooperatives. It also makes loans for agricultural processing and marketing activities, rural housing, farm-related businesses, rural utilities, and foreign and domestic companies involved in international agricultural trade. In addition, the System provides funding and discounting services to certain "other financing institutions" and forms partnerships with commercial banks to provide credit to agriculture and rural America through participations and syndications.

As a regulator, we pay careful attention to the System's congressional mandate to serve the needs of young, beginning, and small farmers and ranchers. By offering competitive interest rates, flexible underwriting standards, and their expertise in the agricultural industry, System institutions make it possible for more people to enter farming and to stay in it. This is good for producers, as well as for the rural communities in which they live.

The System has successfully fulfilled its mission for more than 100 years. It adds value to agriculture and rural America at all times, but it really proves its worth in difficult times. In early 2008, when commodity prices soared, operators of grain elevators could not find the financing they needed to operate, so System institutions stepped in to meet that need. If the System had not been there, those operators would have faced a financial crisis.

This was a classic example of a GSE doing exactly what Congress intended it to do. And I'm confident that the System will again prove its value by meeting the credit needs of farmers and ranchers during the current downturn in the farm economy.

The farm economy and agricultural credit

After years of historic highs, farm income reached a peak in 2013, and it has been dropping every year since then. USDA expects this trend to continue in 2017, falling another 9 percent to $62.3 billion. That would be just half of the $123.7 billion in net farm income recorded for 2013.

Crop and livestock sales and cash production expenses are expected to stay flat this year. At the same time, government payments, which rose 20 percent in 2016, are expected to fall 4 percent.

As a result of the growing stress in the farm economy, many farmers and ranchers are now having difficulty covering their costs, and this is beginning to reduce the quality of agricultural loans. While farm lenders, including the Farm Service Agency, continue to report that overall loan quality remains good, many loan performance indicators are now weaker.

Nonaccrual rates for System farm mortgages stood at 0.76 percent as of September 30, 2016, up from 0.69 percent a year earlier. And nonaccrual rates for farm production loans were at 1.04 percent, up from 0.80 percent a year earlier.

Federal Reserve Bank surveys of commercial bankers in the fourth quarter of 2016 also suggest a worsening credit climate. According to the surveys, repayment rates on agricultural production loans have declined, and the number of renewals and extensions has increased.

Although lenders expect an increase in loan delinquencies in 2017, they do not expect a *large* increase in problematic loans. With expectations for tight profit margins to continue through 2017, more farmers are likely to rebalance their farm balance sheets or change their operating structures to lower their production costs.

The condition of the farm economy also depends in part on interest rate policy. Currently, interest rates on farm loans remain historically low, but an improving economy and labor market is prompting the Federal Reserve to make incremental interest rate increases. The average interest rate on all System loans held nearly steady at about 4 percent during 2016.

Condition of the FCS

Despite conditions in the farm economy, the FCS remains fundamentally safe and sound and is well positioned to manage this downturn. The depth and duration of market weakness is unknown, but it will continue to present challenges for the System until markets rebound.

While the current credit stress level in the System's loan portfolio is well within its risk-bearing capacity, asset quality is expected to decline modestly in 2017 from relatively strong levels in 2016. Moderate loan growth, adequate capital, and reliable access to debt capital markets are supporting the overall condition of the FCS.

The System continues to grow at a moderate pace. As of September 30, 2016, gross loans totaled $242.1 billion, up $15.3 billion or 6.7 percent from September 30, 2015. Real estate mortgage lending was up $9.5 billion or 9.2 percent as demand for cropland continued in 2016. Overall, real estate mortgage loans represent 46.7 percent of the System's loan portfolio. Production and intermediate-term lending increased by $0.2 billion or 0.3 percent from the year before, and agribusiness lending increased by $2.6 billion or 7.7 percent.

The System also continues to enhance its capital base, which strengthens its financial position as low or negative farm returns increase financial stress on borrowers. As of September 30, 2016, System total capital equaled $52.4 billion, up from $48.9 billion the year before. The System's total capital-to-assets ratio was 16.7 percent as compared with 16.8 percent a year earlier. Moreover, 82 percent of total capital is in the form of earned surplus.

The increase in total capital is due in large part to the System's strong earnings performance. For the first nine months of calendar year 2016, the System reported net income of $3.6 billion compared with $3.5 billion for the same period the previous year.

Credit quality in the System's loan portfolio continues to be strong. Relative to total capital, nonperforming assets represented 3.9 percent as of September 30, 2016. For historical comparison, nonperforming assets represented 11.6 percent of capital at year-end 2010.

The System continues to have reliable access to the debt capital markets. Investor demand for all System debt products has been positive, allowing the System to continue to issue debt on a wide maturity spectrum at very competitive rates. Risk spreads and pricing on System debt securities remained favorable relative to corresponding U.S. Treasuries.

Another factor that makes System debt attractive to investors is the Farm Credit Insurance Fund, which has a balance of over $4.4 billion. Administered by the Farm Credit System Insurance Corporation, this fund protects investors in Systemwide consolidated debt obligations. System banks also maintain liquidity reserves to ensure they can withstand market disruptions. As of September 30, 2016, the System's liquidity position equaled 177 days, significantly above the 90-day regulatory minimum required for each FCS bank.

As required by law, System borrowers own stock or participation certificates in System institutions. The FCS had approximately 1.3 million loans and 513,000 stockholders in 2016. Of these stockholders, 86 percent were farmers or cooperatives with voting stock. The remaining 14 percent were nonvoting stockholders, including rural homeowners and other financing institutions that borrow from the System. USDA's latest data (as of December 31, 2015) show that the System's market share of farm debt was 41 percent, compared with 43 percent for commercial banks.

Examination Programs for FCS Banks and Associations

To help ensure the safety and soundness of FCS institutions, FCA uses examination and supervision processes to address material and emerging risks at the institution level and across the System. We base our examination and supervision strategies on institution size, existing and prospective risk exposure, and the scope and nature of each institution's business model.

We monitor agricultural, financial, and economic risks that may affect groups of institutions or the entire System. Given the increasing complexity and risk in the System and human capital challenges at FCA, we continue to implement initiatives to improve operations, increase examination effectiveness, and enhance staff expertise in key examination areas.

The frequency and depth of examination activities vary based on risk, but each institution is examined at least once every 18 months and receives a summary of examination activities and a report on its overall condition. FCS institutions are required to have effective loan underwriting and loan administration processes to properly manage assets and liabilities, to establish high standards for governance, and to provide transparent disclosures to shareholders.

Our examination and supervision program promotes accountability in FCS institutions by working to ensure institutions identify and manage risks. Currently, we are closely watching real estate values because lower grain prices and a rise in long-term interest rates are pushing land prices down in certain sections of the country. When necessary, we use our enforcement powers to require institutions to change their policies and practices to correct unsafe or unsound conditions or violations of law or regulations.

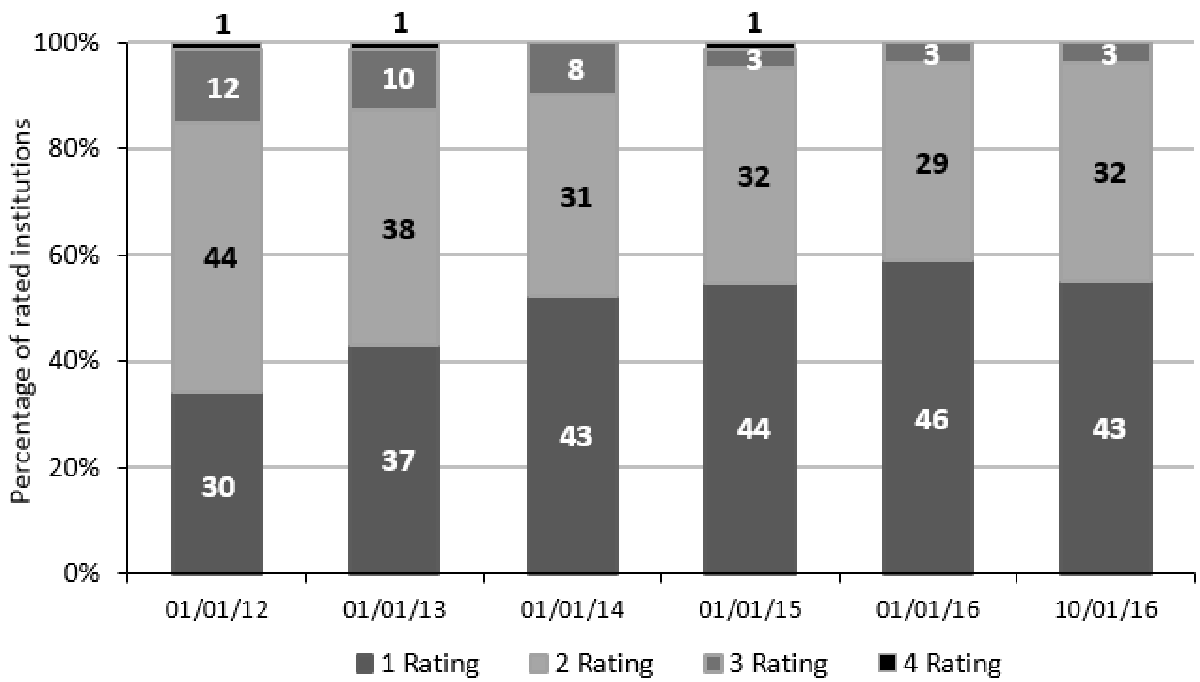
To assess the safety and soundness of each FCS institution, we use our Financial Institution Rating System (FIRS). This system provides a framework of ratings to help examiners evaluate significant financial, asset quality, and management factors. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail.

As the chart below indicates, the System remains financially strong overall. Institutions are well capitalized, and the FCS does not pose material risk to investors in FCS debt, the Farm Credit System Insurance Corporation, or to FCS institution stockholders.

Although the System's condition and performance remain satisfactory overall, several institutions are experiencing enough stress to require special supervision. Factors causing the stress include weaknesses in the nation's economy and credit markets and a rapidly changing risk environment in certain agricultural segments. Also, in some cases, System institutions experience stress because their management fails to respond effectively to these risks and operational challenges.

As of December 31, 2016, three System institutions were operating under a higher level of FCA supervisory oversight. While these institutions do not materially affect the System's consolidated performance, they require significantly greater time and agency resources to examine and oversee. No FCS institutions were under formal enforcement actions, in conservatorship, or in receivership.

Farm Credit System Financial Institution Rating System (FIRS) composite ratings



Source: FCA's FIRS Ratings Database.

Note: This chart reflects ratings for only the System's banks and direct-lending associations; it does not include ratings for the System's service corporations, Farmer Mac, or the Federal Farm Credit Banks Funding Corporation. Also, the numbers in the bars indicate the number of institutions by FIRS rating.

Federal Agricultural Mortgage Corporation

Congress established Farmer Mac in 1988 to create a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac has authority to create and guarantee securities and other secondary market products that are backed by agricultural real estate mortgages and rural home loans, USDA-guaranteed farm and rural development loans, and rural utility cooperative loans.

Farmer Mac is committed to enhancing the availability of reasonably priced credit to agriculture and rural America through its secondary market activities. Under specific circumstances defined by statute, Farmer Mac may issue obligations to the U.S. Treasury Department, not to exceed $1.5 billion, to fulfill the guarantee obligations on Farmer Mac guaranteed securities.

As measured using generally accepted accounting principles (GAAP), net income in FY 2016 (ended September 30) was up 12.8 percent from FY 2015 to $53.7 million. The increase was due primarily to unusual costs in the prior year associated with the redemption of $250 million of Farmer Mac II preferred stock. That redemption resulted in an $8.1 million one-time, after-tax loss recorded in the first quarter of FY 2015. Despite a slight drop in net effective spread in FY 2016, earnings were up because of higher program loan volume, as well as higher guarantee and commitment fees.

As of September 30, 2016, Farmer Mac's core capital totaled $587.1 million, which exceeded its statutory requirement of $474.8 million by $112.3 million. The total portfolio of loans, guarantees, and commitments grew 10.4 percent to $17.2 billion.

Regulatory and corporate activities

Regulatory Activities — Congress has given the FCA board statutory authority to establish policy, prescribe regulations, and issue guidance to ensure that FCS institutions comply with the law and operate in a safe and sound manner. We are committed to developing balanced, flexible, and legally sound regulations. Current regulatory and policy projects include the following:

- Revising regulations on eligibility and creditworthiness of FCS institution investments
- Clarifying and strengthening standards-of-conduct regulations
- Clarifying or changing the amortization limits for agricultural credit associations and production credit associations
- Revising regulations on eligibility and creditworthiness of Farmer Mac investments
- Revising the criteria in the regulations for reinstating nonaccrual loans
- Reviewing stress testing done by System institutions
- Reviewing cybersecurity requirements for System institutions
- Clarifying the disclosure and servicing requirements in the borrower rights regulations
- Evaluating regulations to reduce regulatory burden

Corporate Activities — Because of mergers, the number of FCS institutions has declined over the years, but their size and complexity have increased, placing greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in more cost-efficient and better-capitalized institutions with broader, more diversified asset bases, both by geography and commodity. As of January 1, 2017, the System had 73 direct-lender associations, 4 banks, 5 service corporations, and 2 special-purpose entities. Since December 31, 2010, these System institutions have increased their staff by approximately 2,100 employees to 14,140 at December 31, 2016.

Serving young, beginning, and small farmers and ranchers

As part of their mission to serve all eligible, creditworthy borrowers, System institutions are required to develop programs and make special efforts to serve young, beginning, and small (YBS) farmers and ranchers.

In 2015, the pace of new lending to YBS farmers generally exceeded the pace of overall System lending to farmers. The number of loans made in 2015 to young, beginning, and small farmers increased by 5.1 percent, 7.5 percent, and 6.7 percent, respectively, from 2014.

Since the total number of farm loans made by the System was up by only 3.7 percent, the share of total System farm loans made to all three YBS categories rose from that of 2014. These results are encouraging given the high costs of starting a farm, the declining number of people entering agriculture, and the rising average age of farmers.

To help YBS farmers qualify for credit in 2015, FCS associations offered differentiated loan underwriting standards for YBS borrowers or made exceptions to their regular standards. More than a third of associations provided concessionary loan fees, and more than half offered lower interest rate programs for YBS borrowers. Many associations partnered with state and federal programs to provide interest rate reductions, guarantees, or loan participations for YBS borrowers.

Working with financially stressed borrowers

Risk is an inherent part of agriculture, and the causes of risk are many: bad weather, changes in government programs, international trade issues, high interest rates, etc. These risks can sometimes make it difficult for borrowers to repay loans.

To provide some protection from these risks, the Farm Credit Act gives System borrowers certain rights when they apply for loans and when they have trouble repaying loans. For example, the act requires FCS institutions to notify borrowers of the right to seek restructuring of loans before the institutions begin foreclosure. When a System institution acquires agricultural property through liquidation, the Farm Credit Act also provides borrowers the first opportunity to buy or lease back their former properties.

FCA enforces the borrower rights provisions of the Farm Credit Act and examines institutions to make sure they are complying with these provisions. We also receive and review complaints from borrowers who believe their rights have been denied.

This year, because of the additional stress in the farm economy, we are emphasizing the need for System institutions to do everything they can within the bounds of safety and soundness to help borrowers in difficulty. We encourage them to seek the best possible outcome for every borrower.

System institutions can use their vast agricultural, financial, and business expertise to help borrowers develop strategies to weather the storm. We are encouraging System institutions to monitor their portfolios carefully for early signs of borrower stress. When they identify struggling borrowers, we urge the institutions to reach out to them before their situations become dire — while they still have options. In doing so, System institutions can successfully fulfill their congressional mission of meeting the credit needs of our farmers and ranchers even in challenging times like these.

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. While we are proud of our record and accomplishments, we remain committed to excellence, effectiveness, and cost efficiency, and we will remain focused on our mission of ensuring a safe, sound, and dependable source of credit for agriculture and rural America. This concludes my statement. On behalf of my colleagues on the FCA board and at the agency, I thank you for the opportunity to share this information.