Testimony of the Honorable Leland A. Strom
Chairman and Chief Executive Officer
Farm Credit Administration
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Committee on Agriculture
Subcommittee on Department Operations, Oversight, and Credit
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INTRODUCTION

Chairman Fortenberry, Ranking Member Fudge, 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, Kenneth Spearman of Florida, Jill Long Thompson of Indiana, and all the dedicated men and women of the Agency, I am pleased to participate in this important hearing today.

FCA is an independent agency responsible for examining and regulating the banks, associations, and related entities in the Farm Credit System (FCS or System), including the Federal Agricultural Mortgage Corporation (Farmer Mac). The FCS is a nationwide network of borrower-owned financial institutions that provide credit to farmers, ranchers, residents of rural communities, agricultural and rural utility cooperatives, and other eligible borrowers.

FCA MISSION

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 protects the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and ensures that the institutions 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, 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.

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 (Insurance Fund) to protect System investors.

Over the ensuing two decades, the Farm Credit System, which FCA regulates, has restored its financial health and the trust of its borrowers. With its authority as an arm's length regulator, FCA has been able to ensure that System institutions adhered to safety and soundness standards. The Insurance Fund also helped by restoring 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. As the arm's length regulator of the FCS, the Agency 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, FCA recognizes 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

The FCS is a Government-sponsored enterprise (GSE) created by Congress in 1916 to provide American agriculture with a dependable source of credit. It is a nationwide network of cooperatively organized banks and associations that are owned and controlled by their borrowers, serving all 50 States and the Commonwealth of Puerto Rico. The System provides credit and other services to agricultural producers and farmer-owned agricultural and aquatic 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 service to certain "other financing institutions" and forms partnerships with commercial banks to provide credit to agriculture and rural America through participations and syndications.

As required by law, System borrowers own stock or participation certificates in System institutions. The FCS had nearly 880,000 loans and approximately 488,000 stockholders in 2010. Approximately 85 percent of the stockholders were farmers or cooperatives with voting stock. The remaining 15 percent were nonvoting stockholders, including rural homeowners and other financing institutions that borrow from the System. The U.S. Department of Agriculture's latest data show that the System's market share of farm debt was 40 percent, second only to the 44 percent share held by commercial banks.

One of FCA's oversight roles is to ensure that the System, with its mission devoted to agriculture and rural America, maintains its presence in the agricultural marketplace to provide competitive and dependable credit for all eligible and creditworthy farmers, ranchers, and agricultural cooperatives. In fact, the System has maintained its mission service during the difficult markets of the past three years to help producers and rural America. When commodity prices soared in early 2008, System institutions stepped forward to meet the critical financing needs of the grain elevator industry. They met increased demands for financing machinery and higher input costs for producers. The FCS also helped Midwest borrowers affected by floods and worked with livestock producers, especially dairy and hog producers, as they made difficult decisions during stressful market conditions. The System also provided funding for critical infrastructure projects in rural America through innovative bond financing, such as a critical-care facility in St. James, Minnesota, and similar needed community facilities in the Midwest, Southeast, and Northwest. Overall the System continued to have access to funds and was able to increase its lending to agriculture and rural America during a financial crisis and severe recession.

CONDITION OF THE FCS

Farm income is expected to be very strong in 2011. The U.S. Department of Agriculture forecasts $98.6 billion in farm net cash income—the highest since 1974, after adjusting for inflation. The high prices that grain, soybean, and cotton farmers will receive for their products will largely account for this increase. High feed costs, however, will present challenges for livestock producers. Already tight supplies of corn and soybeans in the United States could lead to significantly higher feed costs in 2011 and 2012 if growing conditions are unfavorable. High grain prices combined with extremely low interest rates are also propelling farmland values to record highs in parts of the Midwest.

We are carefully watching factors such as higher interest rates that could cause a reversal in the factors that have contributed to a strong farm economy and land values. We are also watching carefully how higher oil prices may influence the global economy and undermine the demand for farm products. Although grain producers are doing well at this time, their input costs are rising rapidly. For example, fuel and fertilizer prices, which account for about a third of the non-land costs of a Central Illinois corn farm, have increased 22 percent and 31 percent, respectively, since August 2010. Consequently, crop farmers could face declining profit margins if grain prices retreat from current levels.

The System remained fundamentally safe and sound in 2010 and is well positioned to withstand the continuing challenges affecting the general economy and agriculture. Total capital increased to $33.3 billion at December 31, 2010, up from $30.0 billion a year earlier. In addition, more than 81 percent of total capital is in the form of earned surplus, the most stable form of capital. The ratio of total capital to total assets increased to 14.5 percent at year-end 2010, compared with 13.9 percent the year before, as strong earnings allowed the System to continue to grow its capital base.

Loan growth picked up in 2010, especially in the second half of the year when commodity prices increased sharply. In total, loans grew by 6.4 percent in 2010 compared with 2.1 percent in 2009. The greatest contributors to the System’s loan growth last year were loans to cooperatives and real estate mortgage loans, as they increased $5.7 billion and $2.7 billion, respectively. Credit has been available to eligible creditworthy borrowers. Outstanding loans to producers of most major commodities increased in 2010 compared with the prior year. However, loans outstanding did decline in 2010 for forestry, poultry and eggs, hogs, and biofuels industries that have struggled recently.

Nonperforming loans decreased modestly to $3.4 billion as of December 31, 2010, and represented 10.2 percent of total capital at the end of 2010, down from 11.8 percent at the end of 2009. Two of the most troubled industries in 2009, hogs and ethanol, experienced a substantial improvement in 2010 because of much stronger prices for their products. Other sectors that have had difficulties over the past few years, such as cattle, dairy, and forestry, recorded relatively small changes in their nonaccrual rates in 2010. Dairy improved slightly, while cattle and forestry registered somewhat higher nonaccrual rates. Although credit quality is satisfactory overall, the volatility in commodity prices and weaknesses in the general economy have increased risks to some agricultural operators, creating the potential for future declines in asset quality.

The System reported significantly higher earnings in 2010, with a combined net income of $3.5 billion, up 22.6 percent from 2009. Return on assets remained favorable at 1.60 percent. System institutions, as cooperatives, distributed 29 percent of their earnings in patronage to their borrower-owners in 2010.

Further strengthening the System’s financial condition is the Insurance Fund, which holds more than $3.2 billion. Administered by the Farm Credit System Insurance Corporation (Insurance Corporation), this fund protects investors in Systemwide consolidated debt obligations.

The System’s access to capital markets returned to normal during 2010, which helped the System further augment its solid overall financial strength, serve its mission, and maintain the Insurance Fund. As a GSE with solid financial performance, the System benefitted from monetary policy actions that helped to foster historically low domestic interest rate levels. Tepid investor demand for longer-term Systemwide debt securities in 2009 improved appreciably in 2010, particularly for those with maturities of more than five years. While the System expects to have continued reliable access to the debt capital markets to support its credit mission in 2011, it has also taken steps to enhance the liquidity of its investment portfolio to provide flexibility in the event of restricted market access. The System’s overall liquidity position equaled 173 days at December 31, 2010, well in excess of the 90-day regulatory minimum.

RISING FARMLAND VALUES

We are in an optimistic period for U.S. agriculture, as rising world and domestic demand for commodities has been coupled with very low interest rates. Not surprisingly, profitability and expectations for further growth in returns are being bid into the value of U.S. farmland. Farmland values rose in 2010, especially in the latter half of the year, with much of the Midwest showing strong double-digit annual gains. While data for this past winter are incomplete, anecdotal evidence suggests that farmland values continued to rise this past winter, especially in the major corn and soybean producing regions. The importance of farmland values to the agricultural economy and to agricultural credit markets cannot be overstated, as farmland accounts for the overwhelming majority of the $2 trillion in farm equity that USDA is projecting for the end of this year.

History has shown that substantial downward adjustments to the value of farmland can occur. The severe correction in the 1980s reshaped farming and agricultural lending alike. We studied the land markets of both periods, and while there are some similarities, there are also some important differences. The most significant difference is that the level of debt or leverage used to purchase farmland today is much less than it was in the 1980s. Nonetheless, FCA is closely monitoring the situation because FCS associations are the largest supplier of farm mortgages in the United States, with a market share estimated by USDA of about 43 percent.

Although the current economy generally supports today's average land prices, some factors, such as higher interest rates, geopolitical developments that could undermine global demand for farm products, and an unexpected decline in grain prices because of a global supply response, could lead to a sharp drop in the value of farm real estate. Indeed, farm commodity markets have become more volatile in the past five years. The volatility is no more evident than in corn, the single biggest U.S. crop. Just since last summer the spot price of corn has more than doubled in value, helping to drive the latest surge in cropland prices.

To address the risks associated with rising farmland values, FCA has issued guidance on collateral risks to FCS lenders through a series of Informational Memorandums. FCS institutions are improving underwriting standards, implementing appraisal guidelines, and capping the amount per acre they will lend on the basis of sustainable agricultural value analysis. They are also improving efforts to identify portfolio risk through land value studies and the stress testing of land value changes.

To further address the issue of rising farmland values, FCA recently organized a meeting with the other Federal financial regulators to discuss concerns and observations regarding agricultural land values and associated risks to loan collateral. Our intent also was to foster a broad-based interchange on the appropriate regulator response to these risks and to develop a productive working relationship among banking regulators. We plan to hold additional meetings to continue our focus on topics important to agriculture.

EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

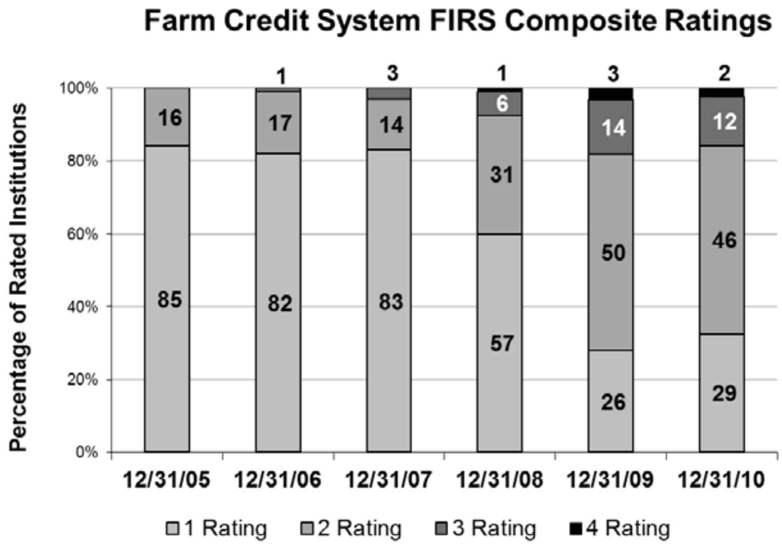
The Agency's highest priority is to maintain appropriate risk-based oversight and examination programs to ensure the safety and soundness of FCS institutions. Given the increasing complexity and risk in the System and human capital challenges at FCA, we have undertaken a number of initiatives to improve operations, increase examination effectiveness, and enhance staff expertise in key examination areas. The Agency bases its examination and supervision strategies on institution size, existing and prospective risk exposure, and the scope and nature of each institution's business model. FCA also performs nationally focused examinations of specific issues and operational areas to monitor the condition and operations of the System as a whole. On a national level, we actively monitor risks that may affect groups of System institutions or the entire System, including risks from the agricultural, financial, and economic environment. There are several key risk areas on which the Agency is focusing in 2011. They include loan portfolio management; large, complex, and shared assets; collateral risk management; and compensation programs and corporate governance.

The frequency and depth of examination activities vary based on risk, but each institution receives a summary of examination activities and a report on its overall condition at least every 18 months. FCS institutions are required to have effective loan underwriting and loan administration processes to maintain adequate asset-liability management capabilities, and to establish high standards for governance and transparent disclosures for shareholder oversight. Because of the recent increased volatility in the agricultural and credit sectors, FCA has increased its on-site examination presence. Also, FCA is closely watching rapidly rising real estate values in certain sections of the country to ensure that FCS lending practices remain prudent.

In certain 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. The Agency uses the Financial Institution Rating System (FIRS) as a key method to assess the safety and soundness of each FCS institution (see chart on next page). The FIRS provides a general framework for evaluating significant financial, asset quality, and management factors to assign component and composite ratings. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail. Overall, the System remains financially strong and adequately capitalized. The FCS does not pose material risk to investors in FCS debt, the Insurance Corporation, or to FCS institution stockholders.

Although the System's condition and performance remain satisfactory overall, a number of FCS institutions are experiencing stress and now require special supervision and enforcement actions. These actions reflect the weaknesses in the Nation's economy and credit markets, a rapidly changing risk environment in certain agricultural segments, and, in certain cases, management's ineffectiveness in responding to these risks. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to those 14 institutions rated 3 or worse. Although these 14 institutions represent less than 4 percent of System assets and do not meaningfully impact the System's consolidated performance, they require significantly greater Agency resources to oversee. Currently, seven FCS institutions are under formal enforcement action, but no FCS institutions are in conservatorship or receivership.

The chart below includes only the five System banks and their affiliated direct-lender associations. The figures in the bars reflect the number of institutions by FIRS rating.



Source: FCA's FIRS Ratings Database.

REGULATORY ACTIVITIES

Congress has given the FCA Board statutory authority to establish policy, prescribe regulations, and issue other guidance to ensure that FCS institutions comply with the law and operate in a safe and sound manner. The Agency is committed to developing balanced, flexible, and legally sound regulations.

Some of the Agency's current regulatory and policy projects include the following:

- Revising regulations to implement the requirements of the Dodd-Frank Act with respect to imposing margin requirements on non-cleared derivatives transactions and removing references to credit ratings.
- Revising regulations to ensure that FCS funding and liquidity requirements are appropriate and to ensure that the discounts applied to investments reflect their marketability.
- Revising regulations to require that each FCS institution's business plan includes strategies and actions to serve all creditworthy and eligible persons in the institution's territory. In addition, the regulation will encourage serving nontraditional customers, such as women and minorities, who often operate within local food systems by producing organic or specialty crops on small farms. The regulation will also seek to achieve diversity and inclusion in the workforce of System institutions.
- Enhancing our risk-based capital adequacy framework to more closely align it with that of other Federal banking agencies and the Basel Accord. We published an advance notice of proposed rulemaking to solicit comments on amending FCA's regulations to replace the current core and total surplus capital standards with a "Tier 1/Tier 2" capital framework.

- Revising lending- and leasing-limit regulations to ensure that FCS institutions maintain effective policies to measure and manage exposure to single counterparties, industries, and market segments, and to large complex loans.
- Revising regulations to allow System institutions to purchase eligible agricultural loans from the Federal Deposit Insurance Corporation.
- Revising regulations to enhance System disclosures of senior officer compensation and supplemental benefit programs. We published an advance notice of proposed rulemaking to solicit comments on ways to clarify and enhance rules related to the disclosure of senior officer compensation, and the responsibilities and authorities of System institution compensation and audit committees.
- Strengthening investment-management regulations to ensure that prudent practices are in place for the safe and sound management of FCS investment portfolios.

CORPORATE ACTIVTIES

While the number of FCS institutions has declined over the years as a result of mergers, their complexity has increased, which has placed greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in larger, more cost-efficient, and better-capitalized institutions with a broad, diversified asset base, both by geography and commodity. Thus far in FY 2011, two mergers of associations have become effective. In addition, two banks, U.S. AgBank, FCB, and CoBank, ACB, have submitted a plan of merger for FCA Board consideration. As of January 1, 2011, the System had 84 direct-lender associations, five banks, five service corporations, and two special-purpose entities.

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, including certain USDA guaranteed loans. 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.

Farmer Mac is a separate GSE devoted to agriculture and rural America. By statute, in extraordinary 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. The Insurance Fund does not back Farmer Mac’s securities, and the System is not liable for any Farmer Mac obligations.

From Farmer Mac’s creation, Congress included strong statutory underwriting, security appraisal, and repayment standards for qualified loans, with Farmer Mac’s activities regulated and supervised by FCA. In addition to its statutory minimum requirements, Farmer Mac was required to develop sound underwriting standards for loans to qualify for its programs. To date, these standards and regulations have prevented any investor credit losses in Farmer Mac securities. However, Farmer Mac was impacted by the spillover of the economic stress and recession stemming from the 2008 financial crisis. Losses on certain investments required Farmer Mac to raise additional capital during the fall of 2008, and management changes were made by its board of directors. Farmer Mac continues to restructure its balance sheet and further strengthen its operations and risk-bearing capacity to focus on fulfilling its mission.

Notably, in January 2010, Farmer Mac raised $250 million in capital from a private offering of shares of noncumulative perpetual preferred stock of Farmer Mac II LLC, an operating subsidiary in which Farmer Mac owns all of the common equity. The new preferred stock has a lower net effective cost than the retired capital and has increased its capacity to purchase and guarantee qualified loans and to provide liquidity to rural markets. As of December 31, 2010, Farmer Mac's core capital totaled $460.6 million, which exceeded its statutory requirement of $301.0. As a result, capital surplus grew to $159.6 million, up from $120.2 million as of December 31, 2009. The total portfolio of loans, guarantees, and commitments grew 14 percent to $12.2 billion.

Farmer Mac's program-business portfolio shows continued stress in certain subsectors but remains manageable. Stress in the ethanol industry, as well as certain crop and permanent planting segments, contributed to an increase in the nonperforming loan rate to 1.90 percent at December 31, 2010, compared with 1.41 percent at December 31, 2009. Loans more than 90 days delinquent increased from 1.13 percent at December 31, 2009, to 1.63 percent at December 31, 2010.

Farmer Mac continues to enjoy reliable access to the debt capital markets to support its mission of providing financing and liquidity to agriculture and rural markets. Over the past two years, Farmer Mac has taken significant measures to increase the quality and liquidity of its $1.76 billion investment portfolio in order to improve its financial flexibility in the event of a financial or market disruption.

WORKING WITH YOUNG, BEGINNING, AND SMALL BORROWERS

System institutions are required to develop programs and make special efforts to serve young, beginning, and small (YBS) farmers and ranchers. In 2010, lending by the System to YBS producers continued to show gains in loan dollars outstanding. Nevertheless, YBS results as a percentage of total loans have either dipped or remained relatively flat over the past several years. However, the System's YBS dollar results are noteworthy because institutions have managed to expand loan volume in spite of generally downward demographic trends for these groups of farmers.

FCS institutions may use a variety of tools to fulfill their commitment to YBS lending, including lower rates or fees for YBS borrowers, differential underwriting standards, USDA guarantees, and special training programs and other financial services. Many associations have revised their YBS policies and procedures in the past three years. The changes are in response to guidance issued in our August 2007 FCA Bookletter, which allowed for more flexibility in lending to YBS borrowers and encouraged use of credit enhancements so YBS borrowers could qualify for credit. The changes are an indication that FCA's oversight activities are accomplishing the goal of helping institutions' management and boards stay focused on this important mission area.

WORKING WITH FINANCIALLY STRESSED BORROWERS

Agriculture involves significant inherent risks and volatility because of many factors, including adverse weather, changes in Government programs, international trade issues, fluctuations in commodity prices, and crop and livestock diseases. The significant risks in agriculture can sometimes make it difficult for borrowers to repay loans. The System, under provisions of the Farm Credit Act of 1971, as amended (Act), provides borrowers certain rights when they apply for loans and when they have difficulty repaying loans. For example, the Act requires FCS institutions to consider restructuring a distressed agricultural loan before initiating foreclosure. It also provides borrowers an opportunity to seek review of certain credit and restructuring decisions. If a borrower's loan goes through foreclosure, the Act and implementing regulations provide qualifying borrowers the opportunity to buy back their property at the appraised fair market value or to make an offer to buy the property back at less than this value. These rights are unique when compared with other financial institutions that operate under Federal law.

FCA enforces the borrower rights provisions of the Farm Credit Act and examines institutions to make sure that they are complying with these provisions. It also receives and reviews complaints from borrowers regarding their rights as borrowers. Through these efforts, FCA ensures compliance with the law and helps FCS institutions continue to provide sound and constructive credit and related services to eligible farmers and ranchers. In 2009 and 2011, FCA issued Frequently Asked Questions (FAQs) to clarify its borrower rights regulations. These FAQs help guide System institutions and their borrowers through many of the situations encountered.

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, 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. 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.