

Comments by Andrew D. Jacob
Director of the Office of Regulatory Policy
Farm Credit Administration
at the
Commodity Futures Trading Commission's Agricultural Forum
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I am Andrew D. Jacob, the Director of the Office of Regulatory Policy, at the Farm Credit Administration. I want to thank Acting Chairman Walter Lukken for inviting me to speak with you today on the topic of agricultural credit from a financial regulator's perspective. Today, I will briefly provide comments about the Farm Credit Administration, the Farm Credit System, and agricultural credit conditions.

Farm Credit Administration

The Farm Credit Administration is the independent safety and soundness regulatory agency for the Farm Credit System and the Federal Agricultural Mortgage Corporation, also known as Farmer Mac. The Farm Credit System and Farmer Mac are Government Sponsored Enterprises. The Farm Credit Administration has broad regulatory and enforcement authorities under the Farm Credit Act of 1971, as amended. The Agency's examination and policy development programs are directed by a full-time, three-person Board. Board Members are appointed by the President of the United States with the advice and consent of the Senate.

As the safety and soundness regulator of the Farm Credit System, we strive to be proactive in our examination and regulatory actions considering trends in the agricultural credit marketplace. We understand that the current environment of high commodity price volatility and input costs includes risks that must be appropriately and prudently identified, monitored, and managed. As a result, we are closely watching the changing dynamics in the commodity markets and the potential attendant risks to lenders that provide credit to the agricultural industry.

We also continue to monitor the general agricultural economy. The agricultural economy has experienced several favorable years with strong net earnings at the producer level. Earnings were supported, in part, by high commodity prices and strong exports. Exports, in turn, were helped by a declining U.S. dollar and strong foreign demand. However, a weakening general economy, growing bio-fuels industry, rising

input costs, increasing feed costs, changing farmland values, and evolving Government farm and trade policies are contributing to potential future uncertainties in the agricultural economy. These uncertainties have been noted with agricultural producers across the board experiencing increases in operating costs. Increases have been particularly significant for livestock producers.

Farm Credit System

The Farm Credit System is a network of 103 borrower-owned cooperative financial institutions and affiliated service organizations serving all 50 States and the Commonwealth of Puerto Rico. It is established under the authority of the Farm Credit Act to provide credit and financially related services to farmers, ranchers, residents of rural communities, and agricultural and rural utility cooperatives. Entities that can borrow from the Farm Credit System include creditworthy grain elevators and other processing and marketing entities that meet statutory and regulatory eligibility requirements.

The Farm Credit System is a \$186 billion lender to U.S. agriculture and rural America. At year-end, it had total loans outstanding of \$143 billion. Lending to cooperatives and processing and marketing entities totaled about \$26 billion, which was diversified among various types of entities. While the Farm Credit System is a significant lender to the grain industry, loan portfolio concentration in all grains and cotton was only around 13 percent of the total lending portfolio due to commodity diversification.

The Farm Credit System is fundamentally safe and sound with adequate capital, strong credit quality, good agricultural loan portfolio diversification, proven and seasoned management and governance structure, strong earnings, and good liquidity provided through access to the Agency debt market. For 2007, the Farm Credit System again posted strong operating performance. As a result, it has the ability and willingness, given its statutory mission, to meet the financing needs of creditworthy and eligible customers.

General Agricultural Credit Conditions

As a financial regulator, the Farm Credit Administration considers the current commodity markets and agricultural economic situation from the perspective of its safety and soundness oversight responsibilities for the Farm Credit System. Looking back over the first quarter of 2008, we have seen a significant increase in credit provided to elevators and other processing and marketing entities. They have drawn down existing loan commitments or expanded credit lines to cover the margin requirements from using commodity futures to hedge their positions.

As you know, margin requirements have increased significantly as a result of higher commodity prices and changes imposed by the commodity exchanges. The Farm Credit System has met the increased credit demand of eligible elevators and other processing and marketing entities. It did so by obtaining funds through the sale of securities in the Agency debt markets. Debt securities outstanding increased by about \$10 billion over the first quarter of 2008, or 6 percent. Debt outstanding fluctuates based on seasonal credit demand factors. This year we are seeing seasonal credit demand increasing to a new level in light of higher commodity and input prices. Along with increased credit demand, we observed that the Farm Credit System did not materially change its underwriting standards. It has prudently stepped up risk management and credit controls to closely monitor and perform due diligence on borrowers' assets that collateralize their loans. As part of their underwriting and credit practices, we expect the Farm Credit System to carefully evaluate the risk management capabilities of customers, particularly in light of recent commodity price volatility.

Looking forward, we expect that the Farm Credit System will continue to see strong credit demand. From the regulator's perspective, we presently believe that the System is well-positioned to continue to meet the credit needs of elevators and other processing and marketing customers. However, given the dynamic commodity market situation, customers are closely evaluating their future borrowing needs. Faced with significant demand on working capital, we have heard that some elevators and other processing and marketing entities may be modifying their marketing options offered to agricultural producers. It appears that the entities making changes are doing so to manage financial risks, borrowing costs, counterparty exposures, and leverage given their specific circumstances and management objectives. Therefore, some entities may not be offering producers the same longer-term forward sales and hedge-to-arrive contracts. As a result, this situation may lead them to make changes in risk management and marketing practices. These changes might include, among others, using option-based hedging, requiring revenue crop insurance, and increased equity capitalization. These changes may further result in risk transference to individual agricultural producers, who may increasingly need to manage the risks of commodity price volatility by hedging directly in the futures markets and obtaining funding for this activity. We further recognize the importance of risk management practice at the producer level and the importance of the industry responding to the dynamic marketplace environment.

The Farm Credit Administration continues to ensure that the Farm Credit System appropriately maintains internal controls, financial capacity, expertise, and underwriting requirements. We have stepped up our examination and systemic risk analysis activities to remain proactive in our oversight of the Farm Credit System. We also continue to provide the Farm Credit System the flexibility for balance sheet and capital

management. Flexibility is needed so that lending capacity remains available and risk exposures stay within the Farm Credit System's risk-bearing capacity. Examples include raising capital through third-party sources, managing loan exposures through participations within the Farm Credit System and with other lenders, increasing Systemwide coordination efforts, and working with agricultural producers as they adjust their risk management strategies.

In conclusion, competition in agricultural lending markets remains robust with the Farm Credit System, commercial banks, and other lenders providing liquidity to the agricultural industry. As a significant financier of the agricultural industry, the Farm Credit System has met, and we believe will continue to meet, the increased credit demand resulting from higher commodity prices, input prices, and farmland values. From our perspective, the Farm Credit System has the financial strength, industry expertise, and mission focus to play a significant role in meeting the agricultural industry's credit needs going forward.

Thank you for the opportunity to address the Commodity Futures Trading Commission's Agricultural Forum.