Remarks by
The Honorable Kenneth A. Spearman
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Thank you for your warm welcome. I appreciate the opportunity to come to Kansas City and visit with you today at the audit and appraisal conference. As some of you may know, my experience in the financial arena includes an extensive background in auditing. However, for today, I'll leave the technical issues to the experts and instead provide you with my perspective on some of the important issues facing FCA and the Farm Credit System. Please note that the views I will be expressing today are my own based on my charge as an independent FCA Board member. I've been a member of the FCA Board for a little more than 10 months now and as I continue to learn new things on the job, I look forward to gaining a bevy of new insights throughout my term as a board member. I certainly appreciate the support and assistance from FCA staff, as well as System representatives, in helping me with this endeavor.

The arrival of Jill Long Thompson, a former congressperson and USDA under secretary, on the FCA Board this spring, has, I believe, rounded out FCA with an excellent mix of political, agricultural and financial expertise on the board. I plan on working closely with my fellow board members to ensure the continued health and vitality of the Farm Credit System.

Role of FCA

As previously noted, I come from a financial background and have knowledge of the System from my tenure as an appointed outside director of AgFirst Farm Credit Bank. I believe my primary job at FCA is to ensure that the Farm Credit System operates in a safe and sound manner so that the System can continue to serve its vital public mission of providing affordable credit to America's farmers and ranchers.

I recognize that the health and continued viability of the Farm Credit System requires FCA to be a strong, competent independent regulator. In order to do that, I think FCA needs to follow some basic principles.

First and foremost, I think FCA needs to be credible in the eyes of Congress, investors in System debt, and the public. Interested parties need to believe that FCA is truly independent and capable of handling the job of regulating the System. I think a crucial aspect of being credible is maintaining transparency of FCA's operations so that the public can clearly see and understand what we are doing.

Second, I think FCA needs to keep good lines of communication open with the System—as well as with Congress and other interested parties. I believe it's important as an FCA Board member to regularly meet with System representatives in order to maintain a sense of what is going on with the entities we regulate. Visiting institutions and visiting with System borrowers allows us to have a greater feel for the impact of our actions. However, as an FCA Board member, I'm always cognizant of my role as an arm's length independent regulator; FCA is a Government agency and we ultimately answer to the American public. Therefore, I think it's also important for board members to maintain some healthy skepticism and to listen to and consider outside views.

Third, I think FCA needs to consider creative ways of furthering policy goals—but to apply the law as written when the law is clear. Part of that is respecting Congress' role in changing the law. Having worked on the Horizons project while with the District Bank, I certainly recognize the difficulty in achieving legislative change. However, while parts of the Farm Credit Act may be deemed outdated or no longer meaningful, FCA is just not authorized to ignore or change congressional policy.

Fourth, FCA needs to keep its primary focus on regulating the safety and soundness of the System. This means effectively monitoring System operations and acting swiftly when we find problems or troublesome risks in the System. A big part of fulfilling this key task is hiring, training and retaining high-quality staff at FCA. During my brief time with the Agency I've been impressed with the dedication and professionalism of the staff, and I think it's important going forward to ensure that FCA staff has the necessary resources to effectively regulate the System.

Economic Situation

With regard to the continued safety and soundness of the System, I want to say just a few words about the current economic situation faced by the System. It's no secret that these continue to be challenging times for System lenders. Tomorrow, you'll hear a detailed update from Tom McKenzie, FCA's Chief Examiner, on economic conditions and the health of the Farm Credit System.

As an aside, some of you may know that Tom McKenzie will be retiring this October after more than 30 years of service to the Farm Credit Administration. Tom has been a loyal and diligent public servant for many years and we at FCA certainly appreciate his service. Please be sure to wish Tom the best when you see him. Note also that we are currently in the process of hiring a new Chief Examiner; we've had many excellent applicants for the position and expect to have someone on the job before Tom leaves the Agency in order to ensure a smooth transition takes place.

Tomorrow, Tom will provide greater detail, but it's clear that the general economy has a ways to go before a full recovery. Certain agricultural sectors are continuing to cause problems. The result on the System has been sobering; in December 2007, fully 82 percent of all System institutions had the highest FIRS rating of 1; in March 2010, only 28 percent of all institutions received this top rating.

While the Farm Credit System remains fundamentally sound and adequately capitalized, five associations remain under enforcement actions and a number of institutions are under special supervision. However, unlike commercial banks, no Farm Credit System institution has failed or been placed under receivership during the financial crisis.

We have seen some necessary mergers of weaker institutions into stronger ones and FCA's Office of Examination has been extremely diligent in identifying and requiring corrective action when troubles are found. I fully support the efforts of FCA's Office of Examination as well as the FCA Chairman's leadership to ensure that the Agency keeps its focus on the continued safety and soundness of the System and remains vigilant about monitoring looming risks.

FCA Agenda

In addition to our examination focus, FCA's regulatory agenda for the coming year is also primarily focused on safety and soundness issues. We recently issued a proposed rule on lowering lending and leasing limits and request your comment on that. Earlier this summer FCA issued an important bookletter on loan pricing to address risk. We will be looking at issuing a rule or other guidance on liquidity and funding issues—with the System already implementing important changes to improve liquidity—as well as investment management practices to ensure prudent practices are being followed in the management investment portfolios. This may also entail looking at our eligible investment and divestiture rules more broadly.

This summer FCA also issued an advance notice of proposed rulemaking on capital adequacy, requesting comment on a potential revision to FCA rules to provide for greater uniformity with other financial institutions under the Basel framework. However, as the entire capital landscape in the commercial banking world is in flux, we will proceed cautiously in this area to ensure that FCA retains robust and effective capital rules.

Next month, the FCA Board will adopt a Unified Agenda that discloses the regulatory actions the Agency intends to pursue in the coming year. While this agenda is not set in stone, it does provide a general roadmap for the public on what the Agency is working on and therefore I recommend taking a look at it if you are interested in following what the Agency is planning for.

System Responsibility

While FCA will be following an active policy and examination agenda, FCA can't be everywhere at all times. Instead, we expect the board and management of each institution to proactively monitor and scrutinize every aspect of its own operations when it comes to dealing with risk and safety and soundness issues. Many System institutions have done an excellent and innovative job of monitoring risk; in fact, many of our recent safety and soundness policy actions, including our proposed rule lowering lending and leasing limits and bookletter guidance on loan pricing, are informed by, and partially based on, best practices followed in the System already. As you know, FCA's minimum capital and other safety and soundness limits are just that, minimums; we continue to encourage and expect each System institution to set internal institution-specific safety and soundness limits and safeguards appropriate to protect the institution against undue risk.

Additionally, to remain safe and sound during this turbulent period I think the System should primarily stick to the basics; keep the focus on the core business of lending to creditworthy farmers and ranchers and ensure that good underwriting and lending practices are followed and that effective internal controls are in place.

Board Oversight and Governance

While the economic conditions have caused distress in System institutions, they have also, in a number of cases, exposed a more fundamental problem: lack of sufficient board oversight and governance. I spent four years as an appointed outside director for AgFirst Farm Credit Bank, serving on board compensation and governance committees. I came away from my experience with a deep appreciation for the knowledge and dedication of my fellow board members. I also came away with an understanding of the crucial need for an effective board of directors for each System institution. While boards should certainly be able to rely on good management, ultimately they are responsible for the operation of the institution, and strong oversight is essential.

Good corporate governance starts with recruiting good candidates for the board. Good governance also requires that board members stay informed about important matters affecting their institution and receive the training and support necessary to effectively do their jobs. Additionally, I think good governance includes having a manageable board size that allows the institution to be effectively governed. I think that establishing strong committee structures, allowing a smaller group of board members to fully delve into particular issues, is also important.

Getting good people on the board may mean looking beyond the usual suspects and making greater efforts to get new people involved. There is significant value in having diverse backgrounds and experiences on boards. Notably, the appointed outside director position provides an important opportunity to add expertise and a truly independent viewpoint that might otherwise be overlooked. Additionally, some institutions are using an appointed shareholder director to gain some diversity on their boards; for example, one institution has appointed a YBS farmer-borrower to its board, with very positive results, while another has used the appointed position to gain commodity diversity on its board.

FCS Mission to Serve All Farmers

As you know, the agricultural industry is continuing to evolve and consolidate. We are rapidly moving towards a situation in which 10 percent of farmers produce 90 percent of American agricultural output. Certainly the System needs to keep up with these changes, making sure it can continue—including by working together with other lenders when necessary—to serve these larger entities.

However, Congress established the System as a Government-sponsored enterprise with a specific mission to “meet the credit needs of *all* types of agricultural producers having a basis for credit. . . .” Congress also included a specific mandate to serve young, beginning and small farmers in order to help make sure there will be a next generation of American farmers. Therefore, I think it’s important for the System, and for FCA, to take a broader view and look at how the System is serving *all* segments of the agricultural marketplace. This marketplace includes minorities, it includes women, it includes truly new farmers without family ties to farming, and it includes nontraditional farmers seeking to capitalize on consumer demand for organic and local foods. So the real question is, is the System meeting its mission of serving the needs of *all* potential creditworthy agricultural borrowers? Part of the answer may also be that it isn’t enough to only “serve” farmers who walk in the door and ask for credit; arguably the System has an affirmative obligation to seek out underserved potential borrowers, which also makes good business sense in the long term by cultivating a new generation of customers loyal to Farm Credit.

This fall, FCA is going to begin systematically looking at these issues, considering whether we need to enhance our existing guidance to ensure that System institution operating and strategic business plans adequately address service and outreach to creditworthy borrowers in all marketplace segments, as well as addressing diversity in the workforce and the marketplace. We at FCA certainly recognize the significant efforts made by a number of System institutions in this area; I applaud those institutions for their genuine efforts and look forward to other institutions emulating their example so that the System as a whole may be viewed as embracing best practices in this important area.

Reputation Risk—Ethical Conduct

I think achieving Systemwide gains in reputation and ethical conduct is particularly important. As you know, the Farm Credit System is unique in that it is considered a single Government-sponsored enterprise that consists of numerous privately owned institutions. While the joint and several liability of the Farm Credit Banks certainly binds them together, there are varying viewpoints and interests among System institutions. There are even many areas of the country where association territories overlap, resulting in direct competition for customers. This "separateness" of System institutions is something policymakers in Washington and the public at large do not necessarily understand. Because of this, the System is often viewed by the public as a single entity. Therefore, success and failure of various System efforts is often viewed on a broader scale.

This view of the System also means that we all need to recognize that the failure of one System institution, or even just the questionable behavior by one institution, reflects negatively on the entire System, and impacts the System's ability to fulfill its mission.

This fall, the FCA Board is going to consider changes to our standards of conduct rules in order to clarify and strengthen those rules. I believe that maintaining a very high ethical standard in each System institution is vital for insuring against reputation risk issues that potentially affect the entire System. Additionally, as an examination matter, FCA has not hesitated to require institutions to address internal controls, governance policies and take other corrective actions to ensure that System institutions adhere to the highest standards of integrity and legal compliance.

GSE Status

I think that adhering to the highest ethical standards is part of the duty that comes along with System's continued GSE status. As you know, Congress has continued to delay addressing the future of the biggest GSEs, Fannie Mae and Freddie Mac. I don't think there is any imminent danger of the System losing its GSE status or of FCA being merged into a "super-regulator." Notably, FCA's continued status as an effective, independent regulator is an extremely important factor for the System's continued independent GSE status. It was also an important factor in Congress exempting the System from the reach of many of the provisions of the recent financial regulatory reform legislation.

However, while there may be no imminent direct threat, the recent financial crisis and proposed and adopted legislative fixes have shown that there may be unintended consequences that will affect the System. For example, the fall 2008 shutdown of financial markets and the subsequent Federal Reserve action to guarantee commercial bank debt threatened the System's ability to fund itself. Similarly, any action taken to reform Fannie and Freddie that significantly alters the overall agency debt market may have a significant adverse impact on the market for Systemwide debt. So, as with the recent financial reform legislation, we will continue to closely monitor legislative action to try to ensure that the System is not inadvertently affected in a negative way by legislation aimed at other entities.

System Consolidation

Just as agriculture is continuing to consolidate, we are continuing to see consolidation in the Farm Credit System. From over 1,000 institutions some 40 years ago, we are down to around 100 today, including only 5 banks. It's also no secret that there may be additional bank mergers in the near future.

This past July, the FCA Board adopted a bookletter requesting that any banks seeking to merge address certain risks in their application. These include size concentration risk, business model compatibility risk and intra-System operational risk. This bookletter does not affect the banks' legal authority to seek a merger and is not intended to signal FCA's view on future mergers. Instead, as stated in the bookletter, we are necessarily concerned with these issues and expect those to be addressed by the parties to a merger.

As Chairman Strom has described it, with fewer pieces on the chessboard, each move has greater significance. Congress established a limited number of Farm Credit banks and authorized those banks to merge with each other. However, Congress didn't tell us when the banks should *stop* merging.

Congress also gave FCA authority to approve mergers on a case-by-case basis upon application by the parties. I think it's certainly appropriate for FCA to consider all risks, including risks to the System and to the Insurance Fund posed by a much larger bank, in the context of a particular merger. As with any merger, there must be a demonstration that the benefits outweigh the costs and risks.

Additionally, as associations grow larger and larger, FCA also needs to consider risks posed by size concentration in association mergers. However, I don't think that it's appropriate for FCA, as an arm's length safety and soundness regulator, to dictate the long-term structural organization of the System. This is why the Board has challenged the System to come together to address these long-term structural issues. While we recognize that there is no binding governing body for the System and that FCA can't force System leaders to come together, we do believe that System coordination prior to large-scale changes in the structure of the Farm Credit System is in the best interests of System stakeholders and the public as a whole.

FCSIC

Finally, in addition to my role as FCA Board member, I am the Chairman of the Farm Credit System Insurance Corporation board. As you probably know, the Insurance Corporation is essentially a separate Government agency, with its own management and staff but with the same board members as FCA.

One of the primary roles of the Insurance Corporation is to assess insurance premiums to maintain the Insurance Fund at 2 percent of adjusted insured debt. The Insurance Corporation board sets premiums in advance based on growth projections gathered from the System. Growth was flat in 2009 and below expectations in 2010.

Therefore, the Insurance Corporation board of directors voted in January to reduce the insurance premium assessment rate for the Farm Credit banks on their adjusted insured debt from 20 basis points in 2009 to 10 basis points in 2010. In June, we revisited this decision and voted to reduce the assessment to 5 basis points for 2010 because the Insurance Fund was $193 million above the 2 percent secure base amount at that time.

Insurance Corporation staff is presently contacting System institutions to get their estimates on growth so that we may provide guidance on anticipated rates for 2011 at the Insurance Corporation's September board meeting.

Additionally, because the Insurance Fund finished 2009 above the secure base amount, in January we were also in a position to distribute approximately $40 million held in the Allocated Insurance Reserves Accounts to the Farm Credit banks and to the remaining Financial Assistance Corporation stockholders—which are the banks and the AgFirst associations.

Then in March, because of the excess amounts in the Insurance Fund, we were able to distribute an additional $165.4 million to System institutions. These distributions are made in accordance with the 2008 statutory revisions to the Insurance Corporation's authorities and are working as intended by Congress. I think we need to be conservative in setting rates to ensure the Insurance Fund is always at the 2 percent target amount; however, as we've shown, we will act quickly to return excess amounts to System institutions. I am pleased that the process is working well, and I note that these distributions have had a positive impact on System earnings for 2010.

Closing

In closing, I'd like to again thank you for the opportunity to address you today and share some of my thoughts on FCA and the Farm Credit System. While there are many challenges facing FCA and the Farm Credit System, I appreciate the knowledge and expertise of the System credit, audit and appraisal professionals represented here today and have confidence that the future of the Farm Credit System is in good hands. So thank you again for inviting me and I look forward to working with you over the coming years during my term on the FCA Board. THANK YOU and have a good afternoon!