HEARING TO REVIEW CREDIT CONDITIONS IN RURAL AMERICA

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, ENERGY, AND RESEARCH

OF THE

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HEARING TO REVIEW CREDIT CONDITIONS IN RURAL AMERICA

THURSDAY, JUNE 11, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSERVATION, CREDIT, ENERGY, AND RESEARCH,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 1302, Longworth House Office Building, Hon. Tim Holden [Chairman of the Subcommittee] presiding.

Members present: Representatives Holden, Herseth Sandlin, Halvorson, Dahlkemper, Markey, Schauer, Kissell, McIntyre, Costa, Ellsworth, Massa, Bright, Murphy, Minnick, Pomeroy, Peterson (*ex officio*), Goodlatte, Moran, King, Smith, Latta, Luetkemeyer, and Thompson.

Staff present: Nona Darrell, Adam Durand, Scott Kuschmider, Merrick Munday, John Riley, Anne Simmons, Debbie Smith, Kevin Kramp, Josh Maxwell, and Jamie Mitchell.

OPENING STATEMENT OF HON. TIM HOLDEN, A REPRESENTATIVE IN CONGRESS FROM PENNSYLVANIA

The CHAIRMAN. This hearing of the Subcommittee on Conservation, Credit, Energy, and Research to review the credit conditions in rural America will come to order.

I would like to welcome our witnesses and guests to today's hearing. We will review the status of credit conditions in rural America.

Agriculture is not the risky business as it once was perceived in the early part of the last century, when credit was often unavailable or unaffordable in rural areas. Credit opportunities for farmers have greatly increased in the last 100 years, and even in the last 20 years.

The current financial crisis that has affected so many other markets has not hit the agriculture sector quite as hard, but farmers are still feeling the effect. For example, dairy farmers in my home State of Pennsylvania, and across the nation, have been negatively affected by a drop in prices received for their products.

Given the current state of the economy, some farmers are finding it harder to repay their loans. Even producers who are doing better than others are having difficulty in obtaining new credit.

Lenders have to tighten their purses as they find it harder to access capital or sell bonds. Lenders are seeing a small uptick in the number of non-performing or delinquent loans, yet it is not anywhere near as serious a situation as back in the last recession of the 1980s.

The Department of Agriculture's Farm Service Agency, as a lender of last resort for those who cannot obtain credit from the market, has experienced a large influx of producers who are not finding loans in the private sector. Congress recently provided, in the stimulus bill, extra funding for this higher demand, but now even those funds are running short.

I hope we will hear today how we can assist our agriculture producers and rural residents in obtaining credit and creating opportunity for development.

I look forward to hearing from our witnesses today and now recognize the Ranking Member of the Subcommittee, the gentleman from Virginia, Mr. Goodlatte.

OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM VIRGINIA

Mr. GOODLATTE. Thank you, Mr. Chairman. I appreciate you holding today's hearing to review credit conditions in rural America.

The financial crisis has taken longer to reach rural America, but our farmers and ranchers are starting to feel the effects and face challenges in accessing credit. Crop prices are down from historical highs, land values are decreasing, and there is rising unemployment throughout rural America. The USDA predicts that average farm income will decrease by 20 percent in 2009.

Agriculture lenders state that credit is still available for eligible borrowers. However, FSA, the lender of last resort, has reported a 200 percent increase in demand for guaranteed assistance for operating loans. FSA continues to face backlogs in their oversubscribed lending programs, even after the addition of supplemental appropriations.

The Farm Credit System reports a reduction in growth and a small rise in delinquencies, though it should be noted these trends come off of historic lows in delinquencies. I believe that, due to the actions of the Congress in the 1980s, the Farm Credit System remains strong and continues to be a source of credit to farmers and ranchers during these tough economic times. Also, because the people in the Farm Credit System didn't lose sight of their underwriting standards and requirements, the Farm Credit System is still able to provide loans for creditworthy projects. I congratulate the farm credit banks like AgFirst in Virginia for staying true to its mission.

With current economic conditions, I am stunned that Congress is attempting to pass a cap-and-trade—some of us refer to it as "cap-and-tax bill"—that will result in a massive national energy tax. The effects of this national energy tax will be far-reaching to business, consumers, and even more so to rural America. A national energy tax will cause producers to pay more for seed, equipment, machinery, steel and other supplies needed for agricultural operations. This will ultimately increase the need for larger operating loans during a time when credit is already becoming more difficult to obtain.

Today, I hope to hear more from our witnesses on current credit conditions and how rural America will be affected in the future if the current economic environment continues.

Thank you, Mr. Chairman.

The CHAIRMAN. The chair thanks the Ranking Member and would ask all other Members of the Subcommittee to submit any opening statements for the record.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you Mr. Chairman. I appreciate your calling this hearing today. I look forward to hearing from both panels of witnesses this morning and get their thoughts about the credit conditions in rural America, particularly the obstacles that farmers and ranchers face in securing financing for their operations in these tough economic times.

While most people have focused on the failures of large banks on Wall Street and the resulting credit crisis, the balance sheets of rural America, including farmers and agricultural lenders, are starting to be affected.

There are some economic signs in rural America that are of concern. Farm income is on the decline this year; non-performing loans are on the rise; and the chief asset of many rural Americans, their home and land, is declining in value in some regions. Because of these and other factors, tighter credit is expected for the remainder of the year. These economic factors could continue to cause hardships among some farmers and ranchers when it comes to paying back loans or trying to sustain their operations.

Conditions are such that applications for financing through the Farm Service Agency's credit programs have increased dramatically. Congress has had to respond with two rounds of funding, one in the stimulus bill and another one pending in the supplemental appropriations bill.

Some communities have felt the brunt of the credit crunch worse than others. In particular, the dairy and pork sectors have experienced some very hard times due to low milk and pork prices. And the failure of New Frontier Bank, a large farm lender in eastern Colorado, has caused severe problems for farmers and ranchers in a major ag-producing area of our country. This has directly affected many of the constituents of one of our Committee Members, Ms. Betsy Markey, who has worked to help find a solution for those who are scrambling to find new lenders for their operating loans.

The availability of credit is of concern to this Committee because there are still a lot of opportunities for rural America and American agriculture.

Farmers and ranchers are eager to meet the public demand for locally-grown crops, organics, and other value-added products. Farm-based renewable energy has the potential to be a great economic engine for rural America. It is the job of policymakers and administrators to help them access all the tools that are available to them to ride out the tough times.

I have long said that farmers take the kinds of financial risks most people wouldn't even think about taking. And they don't do it for the dream of striking it rich, but rather to provide themselves and their neighbors with the food, fiber and fuel that supports our economy. Whether they are getting started, or whether they need a bridge during downturns, folks need accessible credit at reasonable rates, and a network that can assist them when they need it. Having these financial tools will quite often determine whether or not they can succeed.

I hope this Subcommittee will gain some good information today about the credit conditions in rural America. Thank you again, Chairman Holden, for calling this hearing today, and I yield back my time.

The CHAIRMAN. We would like to welcome our first panel of witnesses today: Mr. Doug Caruso, Administrator for the Farm Service Agency for the United States Department of Agriculture; and Mr. Leland Strom, Chairman and CEO of Farm Credit Administration.

Mr. Caruso, you may begin when you ready.

STATEMENT OF DOUG CARUSO, ADMINISTRATOR, FARM SERVICE AGENCY, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, D.C.

Mr. CARUSO. Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to appear before you to discuss credit conditions in rural America, focusing on the current status and operations of the farm loan programs at the Farm Service Agency.

I want to address the issue of credit availability first. Activity at FSA's farm loan program certainly indicates that less commercial credit is available to farmers at the present time. Loan volume in farm loan programs is usually countercyclical to the general farm economy. This makes sense, since the basic requirement to qualify for the programs is to be unable to meet the criteria for commercial credit.

When the farm economy is strong, farm loan program activity is flat, even declining. During times of financial stress in the farm economy, we see increased demands for FSA farm loans.

This year, the programs are experiencing demand levels that have not been seen in over 20 years. As of May 30, demand for direct operating loans was up by 81 percent; demand for direct ownership loans was up 132 percent and demand for guaranteed operating loans has increased by 31 percent.

And just to look at the numbers quickly, as of June 10, we had obligated $848 million in direct operating loans and have another backlog of approved, but unfunded, loans to the tune of $96 million. And in direct farm ownership we have obligated $198 million and have a backlog of $277 million of approved, but unfunded loans, for a total backlog of approved but unfunded loans, direct loans, of $373 million. That is a total of about 3,000 loans that we have approved, but are unable to fund due to lack of funds.

Perhaps the most telling is the number of new applicants this year. As of May 26, 45 percent of the direct operating loans approved for this fiscal year were for customers who did not have existing FSA operating loans; that is, they are new to our System. Normally that number is about 20 percent. The fact that an unusually high number of direct operating loan applications are for new customers this year is a clear indication that more farmers are having trouble getting the credit they need.

When farmers need credit, they need it timely. We continue to emphasize the importance of processing applications rapidly. Between 2001 and 2008, farm loan programs reduced direct application processing time-frames by 13 days, or 30 percent, and reduced the guaranteed loan processing time-frames by 5 days or 28 percent.

As of May 30, the average time for applications from receipt to final decision was 27.7 days for direct loans and only 8.5 days for guaranteed loans. It is remarkable that even though loan demand has surged, there has been no deterioration in application processing time, and this is a testament to the dedication of FSA field staff and the effectiveness of the IT solutions that the farm loan programs has deployed.

I want to take a moment to touch on an issue that is of critical importance, civil rights at FSA. Secretary Vilsack has made extremely clear that improper and inequitable treatment of those that USDA and FSA serve will not be tolerated. I and all members of the FSA management team remain fully committed to equal access and opportunity for all those that FSA serves. I will closely monitor the operations of farm loan programs, and all other FSA programs, to assure that our producers, program applicants and employees receive fair and equitable treatment.

I want to update you on a few key activities in this critical area. As you may know, Section 14002(b)(1) of the Food, Conservation, and Energy Act of 2008 required the USDA Office of Inspector General to conduct a review of FSA foreclosure cases of socially disadvantaged farmers and ranchers to determine whether the Agency followed the applicable laws and regulations governing foreclosures.

Of course, foreclosure is never the outcome we want. When an account ends with foreclosure, we and the borrower have both failed. However, I am glad to report that the OIG review found no instances of inconsistency or improper treatment of any borrowers in that unfortunate circumstance.

I believe it is important to point out that FSA does not reach—does reach many socially disadvantaged farmers and ranchers more often than given credit for. A look at statistics shows that FSA provides assistance to socially disadvantaged farmers in greater proportions than their demographic percentage of the total farming population.

In the 2008 Farm Bill, Congress reaffirmed the focus for FSA programs on beginning farmers and ranchers. FSA continues to strive to reach more beginners and has increased the amount of loan funds provided to beginning farmers and ranchers. The FSA direct loan beginning farmer caseload increased from about 3,500 in 1995 to almost 17,000 in 2008, and the guaranteed beginning farmer caseload increased from about 3,600 in 1997 to over 8,600 in 2008.

Given the difficult conditions in today's credit environment, borrower term limits pose a major challenge to the Agency and to borrowers alike. The statute presently limits a borrower to direct operating loans in each of 7 years with an additional one-time 2 year waiver on an individual basis. There are more than 4,800 FSA borrowers who can only receive direct operating loan assistance 1 more year from the Agency, and there are more than 7,800 FSA borrowers who can only receive direct operating loan assistance 2 more years from the Agency.

Without FSA direct loan assistance, many of these borrowers will be forced out of farming, as they may not have access to the capital necessary for them to conduct their farming operations. Under the current credit environment, it is unlikely that many of these borrowers, reaching their term limits with us, will be able to obtain conventional financing. They will be left with nowhere to turn.

It does not seem fair that these borrowers may be forced out of business because they reached their term limits at a time when credit is scarce.

More challenges lie ahead. Government resources are increasingly limited and the agricultural production landscape is changing. We are experiencing unique conditions in the credit and banking sectors and, to a large extent, in agriculture. These changes pose significant barriers and challenges to the groups that FSA farm loan programs are intended to assist.

These issues create major challenges for us as well, since the success of the program depends on the farmers and ranchers we are here to serve. To keep pace with these changes, we will modernize the efforts to change the delivery system and refine and adjust program requirements and operations to maximize the opportunities for our nation's small, beginning and socially disadvantaged farmers and ranchers.

We look forward to working with you, Mr. Chairman, and the Committee Members to address the challenges we face in accomplishing this worthwhile mission to strengthen family farmers in rural America.

[The prepared statement of Mr. Caruso follows:]

PREPARED STATEMENT OF DOUG CARUSO, ADMINISTRATOR, FARM SERVICE AGENCY, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, D.C.

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear before you to discuss credit conditions in rural America, focusing on the current status and operations of the farm loan programs at the Farm Service Agency (FSA).

Credit Conditions

Reports from the Federal Reserve and other sources indicate there is a tightening of credit for farmers and ranchers around the country. A combination of limited or negative returns in much of the livestock industry, reduced profit margins in crop production, and increased sensitivity to credit risk has caused many farm lenders to raise their credit standards, reduce the amount they are willing to lend in agriculture, or both. Many lenders report that increased scrutiny from regulators has caused them to raise credit standards significantly.

Activity in FSA's farm loan programs certainly indicates that less commercial credit is available to farmers at the present time. Farm Loan programs demand is usually countercyclical to the general farm economy; when the farm economy is strong, farm loan activity is flat. During times of financial stress in the farm economy, demand for farm loan program loans increases. This makes sense, since a basic requirement to qualify for the programs is to be unable to meet the criteria for commercial credit. This year, the programs are experiencing demand levels that have not been seen in over 20 years. As of May 30, 2009, demand for direct operating loans was up by 81 percent, demand for direct ownership loans was up 132 percent, and demand for guaranteed operating loans has increased by 31 percent An unusually high number of direct operating loan applications are from new customers this year. As of May 26, 45 percent of the direct operating loans approved in FY 2009 were for customers who did not have existing FSA operating loans. Normally, that number is about 20 percent.

Performance and Portfolio Condition

Farm loan programs continue to emphasize the importance of processing applications in a timely manner. Between FY 2001 and FY 2008, farm loan programs reduced its direct loan application processing time-frames by thirteen days (30 percent), and reduced guaranteed loan processing time-frames by 5 days (28 percent). As of May 30, the average time from applications receipt to final decision for direct loans was 27.7 days, and for guaranteed loans, 8.55 days. It is remarkable that even though loan demand has surged, there has been no deterioration in application processing time. This is a testament to the dedication of FSA field staff and the effectiveness of the IT solutions farm loan programs has deployed.

The quality of our portfolio has continued to improve, due in large part to our modernization efforts, better customer service and the dedication of FSA employees, as well as the much improved farm financial environment of the past 7 years. At the same time, we realize that given the increased financial stress the agriculture economy and the increased workload resulting from a larger case load, portfolio performance is likely to somewhat deteriorate in the future. We are committed to using all the authorities available to assist borrowers and will strive to minimize any deterioration in portfolio performance.

Loss Rates. In FY 2008, losses in the direct loan program fell to their lowest level since 1986—just 1.7 percent (*Chart 1*).

Losses for FY 2008 in the guaranteed loan program were 0.3 percent, the lowest rate since we began monitoring this trend in 1985 (*Chart 2*).

Delinquency Rates. As with losses, the direct loan delinquency rates are at historic lows at 6.5 percent for FY 2008 (*Chart 3*). This is the result of steady and dramatic decreases from a 23.8 percent delinquency rate in FY 1995. The decrease was facilitated by expanded authority, since 1996, to offset Federal payments, salaries and income tax refunds to delinquent borrowers.

In the guaranteed program, the FY 2008 delinquency rate was 1.18 percent, the lowest since 1995 (*Chart 4*).

Foreclosures. Foreclosure rates continue to be very low in the direct loan program. In 2008, FSA participated in 169 foreclosures, including cases initiated by other lenders against individuals who also had loans with FSA. This is compared to 311 foreclosures the agency participated during 2003. This represents less than ¼ of 1 percent of the agency's direct loan caseload.

Inventory Properties. Inventory farm properties—those that have come into government ownership through voluntary conveyance or foreclosure—are also at historic lows with just 79 farms covering 9,600 acres in FY 2008. In 1995, FSA held nearly 1,800 farms covering 598,000 acres. Many of those inventory properties were sold to established and beginning farmers, providing those individuals with prime opportunities to expand or create new operations.

Graduation Rates. Federal law requires FSA to "graduate" its borrowers to commercial credit when they have made sufficient progress to be able to qualify for loans from other lenders. They are assisted by the agency in refinancing their direct loans with FSA guaranteed loans from commercial lenders. Some 2,918 direct loan borrowers were able to graduate in FY 2008, which is consistent with graduation rates over the past 5 years.

Equitable treatment and participation

Secretary Vilsack has been extremely clear that improper and inequitable treatment of those that USDA and FSA serve will not be tolerated. On April 21, 2009, he announced several actions in a comprehensive approach to ensure fair treatment of USDA employees and constituents. These actions included an initiation of several improvements in processing civil rights complaints, requesting an external analysis of program delivery by USDA service center agencies, and 90 day suspension of FSA farm foreclosures, which has provided us time to review these files to ensure that all producers have received their statutory protections. I, and all the members of the FSA management team remain fully committed to equal access and opportunity for all those FSA serves. I will closely monitor the operations of farm loan programs and all other FSA programs to assure our producers, program applicants, and employees receive fair, equitable treatment. I want to update you on a few key activities dealing with these important issues.

Foreclosure review

As you know, section 14002(b)(1) of the Food, Conservation, and Energy Act of 2008 (the 2008 Farm Bill) required the USDA Office of Inspector General (OIG) to conduct a review to determine whether foreclosure proceedings, with respect to farm loans made to socially disadvantaged farmer and ranchers, were consistent and in conformity with the applicable laws and regulations governing foreclosures. Foreclosure is never a desired outcome. When an account ends with foreclosure, both the agency and the borrower have failed. However, I am glad to report that the OIG review found no instances of inconsistency or improper treatment of any borrowers in that unfortunate circumstance. These results speak to the commitment of farm loan program managers and field staff to assure that all applicants and borrowers are treated fairly and equitably. I am committed to maintaining, and where possible further improving performance in this area.

Program participation

An examination of the composition of FSA's loan portfolio indicates that FSA finances minority farmers at a much higher rate than those groups' proportion of the farm population (*Chart 5*). For example, while the 2007 Census of Agriculture indicates that 1.40 percent of farm operators are Black or African American, this group makes up 3.42 percent of FSA's direct loan portfolio, almost 2.5 times the proportion in the total farm population.

FSA has significantly increased the amount of loan funds provided to socially disadvantaged applicants. Between 1995 and 2008, the FSA direct SDA caseload increased from 3,260 to 14,068. Between 1997 and 2008, the FSA guaranteed socially disadvantaged caseload increased from 1,730 to 3,014.

In the 2008 Farm Bill, Congress re-affirmed the focus for FSA programs on beginning farmers and ranchers. FSA continues to strive to reach more beginning farmers and has increased the amount of loan funds provided to beginning farmers and ranchers. The FSA direct loan beginning farmer caseload increased from 3,474 in 1995 to 18,785 in 2008. Guaranteed caseloads for beginning farmers and ranchers were first reported in 1997. The FSA guaranteed beginning farmer caseload increased from 3,617 in 1997 to 8,648 in 2008.

IT Modernization

FSA has made significant strides in modernizing the IT systems used in farm loan programs delivery and management. Performance in delivery and operations this year illustrates the high level of performance and functionality of farm loan programs IT systems. So far, in FY 2009, FSA has processed 41 percent more loan requests than in FY 2008, but service levels have not declined. Average processing times for direct and guaranteed loan applications have been fairly steady. This is a tribute to the dedication and diligence of farm loan programs field staff, but without the modern IT systems they could not have maintained an acceptable level of service. For example, Business plans for FSA borrowers are now processed through a Web based state of the art system. This off-the-shelf IT solution provides access to "real time" data on our portfolio while sharing data among our automated systems. This system also provides a reporting option. This system has allowed our loan officers to conduct more extensive and meaningful financial analysis of our borrower's farm businesses reducing risk to the government while enhancing their opportunities for success and graduation to commercial lending. FSA loan officers now order applicant credit reports from the three major reporting companies through this system as well, which also expedites processing.

Farm loan programs has also implemented modern, web-based systems to manage the loan application, approval, and funding process. This system provides real-time management data on application activity and allows the Agency to better cope with funding problems and act quickly when necessary. For example, when the Agency received supplemental funding in the American Revitalization and Recovery Act, over 2,000 farmers were waiting for desperately needed direct operating loans to pay 2009 planting and other farming expenses. When funds were made available to FSA, the agency was able to process obligations over night, and funds began flowing into farmers' bank accounts only 3 days later. I am proud to say that FSA was one of the first agencies in the government to get stimulus funding flowing to those who desperately needed it. The modern, web-based IT systems in place for farm loan programs were a key factor in our ability to provide such timely service.

Currently, we are in the last phase of moving all of our automated farm loan programs systems to the Web. When the project is completed we will eliminate duplicate data collection and farm loan services will be delivered even more efficiently. Our employees will be able to conduct USDA business from any location where there is broadband, WiFi or dial-up Internet access. This will allow us to conduct business with producers at locations and times convenient to them. Additionally, this information will be stored on a centralized server allowing employees to quickly access portfolio information and provide real time management reports. However, there is still additional work to be done. We will continue working to improve our accounting systems to improve their capabilities to capture data and be more easily modified to cope with program changes. These improvements will enhance our capabilities in portfolio management.

Ongoing Challenges

As we look ahead in the ever-changing environment, FSA will face significant and ongoing challenges in the years to come. Some of the most prominent are staffing constraints, term limits, and maintaining program performance and success rates through these difficult times.

Staffing Challenges. We project that approximately 35 percent of FSA's current loan officers will be eligible to retire by the year 2012 and 45 percent can retire by 2014. This potential loss of experienced, seasoned credit experts comes at exactly the wrong time considering the increased workload from this year's influx of new borrowers; and creates the potential for major staffing challenges in the next few years.

FSA farm loan programs has an excellent employee recruitment and training program, but appropriations limit the number of new hires that can be brought into the system at any given time. On average, it requires about 2 years to hire and train a loan officer in order to provide the level of effective supervision, expertise and customer service needed to maximize every opportunity for success for FSA borrowers. The 2 year training window for new loan officers complicates an already cloudy staffing forecast.

FSA's portfolio and borrowers could be exposed to financial risk if retirement attrition projections for loan officers are even marginally accurate. A large percentage of FSA borrowers are either beginning farmers or financially stressed borrowers who need financial supervision, especially in these challenging times. FSA loan officers provide this supervised credit which requires a complete knowledge of FSA programs, finances, and agriculture enterprises.

Term Limits. The statute presently limits a borrower to direct operating loans in each of 7 years, with an additional one-time, 2 year waiver on an individual case basis:

- There are more than 4,800 FSA borrowers who can only receive direct operating loan assistance one more year from the agency; and
- There are more than 7,800 FSA borrowers who can only receive direct operating loan assistance 2 more years from the agency.

Without FSA direct loan assistance, many of these borrowers may be forced out of farming as they may not have access to the capital necessary for them to conduct their farming operations. Under the current credit environment, it is unlikely that many borrowers reaching their term limits will be able to obtain conventional financing. They will be left with nowhere to turn. It will be unfortunate if these borrowers are forced out of business because they reached their term limits during a period of unprecedented upheaval and uncertainty in the banking and financial sectors.

The statute presently limits borrowers with guaranteed operating loans to 15 years of eligibility, with receipt of a direct operating loan also counting as a year of eligibility for guaranteed operating loans. This provision has been suspended on several occasions; most recently the 2008 Farm Bill extended the suspension through December 31, 2010. How problematic this limit will be when the suspension ends depends on the agricultural economy and availability of conventional credit at that time. As of June 1, 2009, over 3,800 guaranteed loan borrowers would not qualify for additional loan guarantees if the limits were in effect.

Farm loan programs performance over the past few years has been outstanding, with delinquencies and losses near all-time lows. Under the challenging economic and financial environments agriculture faces, it is almost inevitable that program delinquency and loss rates will increase. However, we are committed to use all available options to minimize any increases in program delinquencies and losses.

We are fortunate to have many tools at hand to service accounts and assist borrowers through difficult times. The automated systems I have mentioned will assist us in timely farm planning and exploring many different possibilities to assist borrowers in finding a viable operating plan if that is possible. We have a wide array of loan servicing options available to include restructuring or deferring payments, and even to reduce debts in exchange for conservation contracts in some cases. We expect that our ability to manage our portfolio will only improve as we move forward with IT modernization. However, limited staffing and administrative resources combined with departures of experienced staff will limit FSA's ability to respond to this challenge, particularly if demand for new loans continues at a higher than normal level.

Conclusions

Through modernization efforts, maintaining focus on program objectives, and the hard work and dedication of FSA employees, FSA farm loan programs has made great strides in improving program performance. Loan failures and losses have declined which is a strong indication that the program mission of helping farmers become successful is being accomplished. At the same time, increased assistance to small, beginning, and minority farmers, reflects remarkable success as well.

However, more challenges lie ahead. Government resources are increasingly limited and the agriculture production landscape is changing. We are experiencing unique conditions in the credit and banking sectors, and to a large extent, in agriculture. These changes pose significant barriers and challenges to the groups that FSA farm loan programs are intended to assist. These issues create major challenges for the agency as well, since the success of the program depends on those whom the programs are intended to serve. To keep pace with these changes, we will continue efforts to modernize the delivery system, and to refine and adjust program requirements and operations to maximize the opportunities for our nation's small, beginning, and socially disadvantaged farmers and ranchers.

Because of our rural delivery system and experienced loan officers, the FSA farm loan programs staff is well positioned to continue the high quality delivery of existing programs and new initiatives to assist small, beginning, and minority family farmers. We look forward to working with this Subcommittee to address the challenges we face in accomplishing this worthwhile mission to strengthen family farmers and rural America.

Thank you for allowing me to share our Department of Agriculture perspective as you address this important issue. I am available to answer your questions now or at any time in the future.

ATTACHMENT

Chart 1

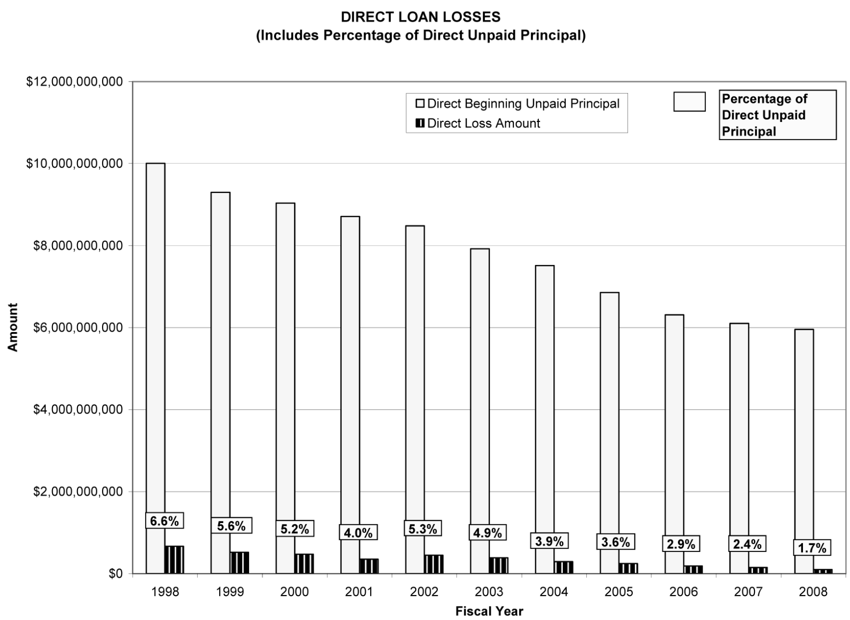


Chart 2

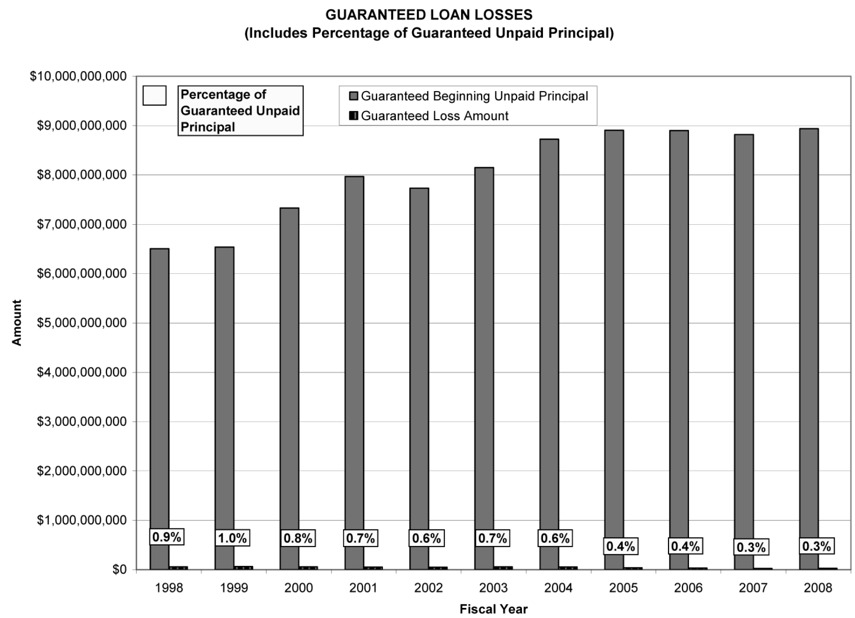


Chart 3

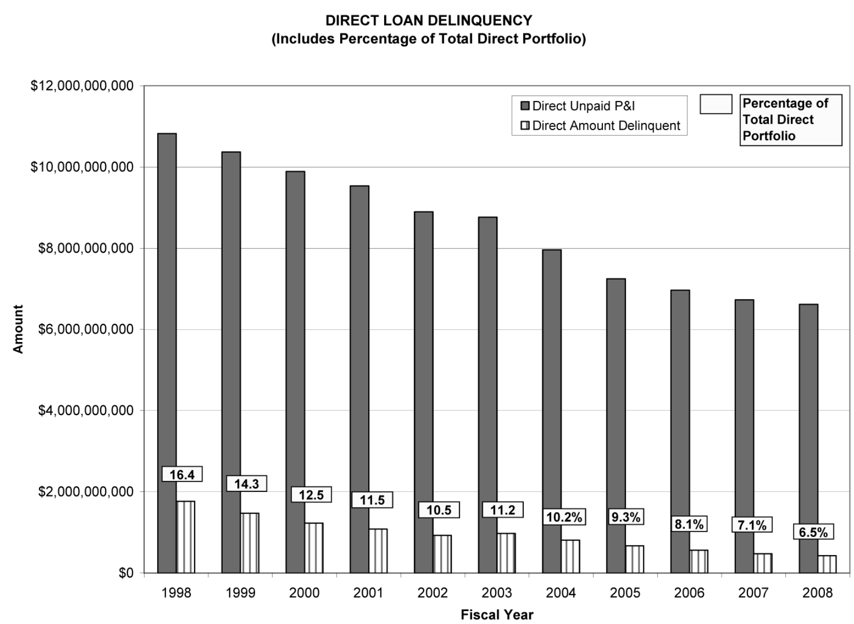


Chart 4

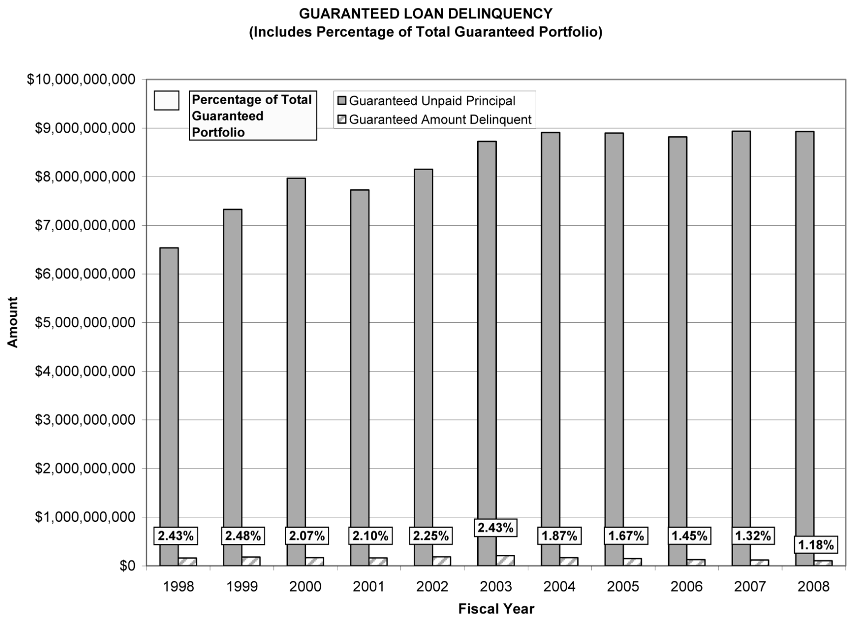


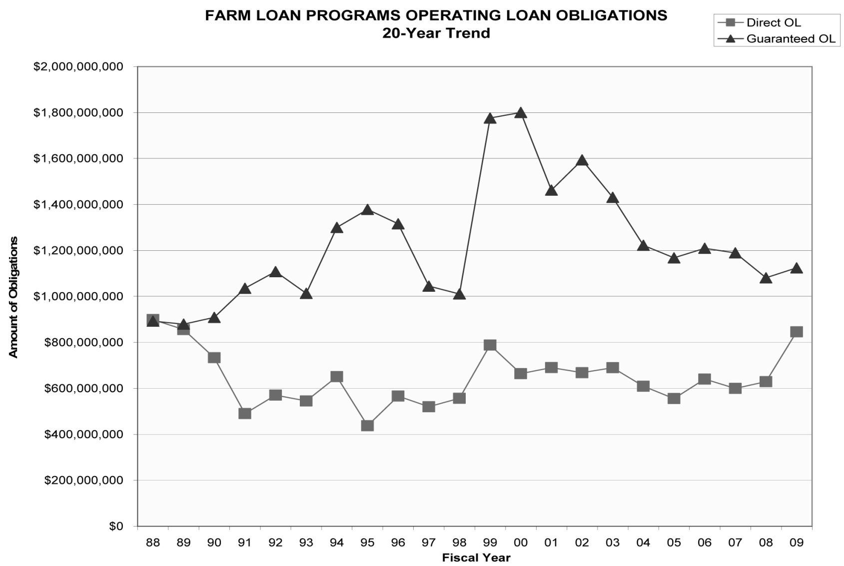
Chart 5

FY 2008 BORROWER CASELOAD BY RACE
(As Compared to 2007 Ag Census Data)

	Percent of 2007 Census Population	Percentage of FY 2008 Direct Caseload	Percent of Population being served by FSA Direct Farm Loans	Percentage of FY 2008 Guaranteed Caseload	Percent of Population being served by FSA Guaranteed Farm Loans
White	96.45	88.59	2.85	95.22	1.51
Black	1.40	3.42	7.60	0.60	0.65
Asian/Hawaiin	0.57	0.90	4.86	2.34	6.27
Amer Ind/Al Nat	1.58	3.29	6.44	1.58	1.53
* Hispanic	N/A	3.68	N/A	0.19	N/A
Other	N/A	0.12	N/A	0.07	N/A

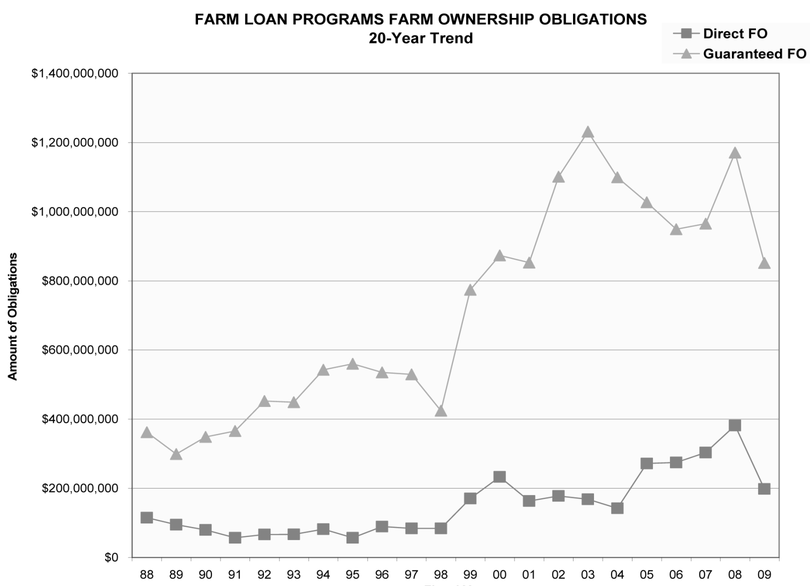
* Hispanic Americans are not a separate category within the 2007 Census of Agriculture; therefore, no reliable comparison can be established.

Chart 6



Note: FY 2009 data through 5/30/09

Chart 7



Note: FY 2009 data through 5/30/09

The CHAIRMAN. Thank you, Mr. Caruso.

It is my understanding that you have additional information that you did not submit previously that you want to make part of the record?

Mr. CARUSO. I do, sir. I have a table here that shows historic participation in our programs and the significant spike that we have experienced in the current fiscal year.

The CHAIRMAN. Without objection, it will be made part of the record. Thank you.

[The information is located on p. 13.]

The CHAIRMAN. Mr. Strom.

STATEMENT OF HON. LELAND E. STROM, CHAIRMAN AND CEO, FARM CREDIT ADMINISTRATION, McLEAN, VA

Mr. STROM. Mr. Chairman, Ranking Member Goodlatte, Members of the Subcommittee, I am Leland Strom, Chairman and CEO of the Farm Credit Administration. I serve on the FCA board with my colleague, Nancy Pellett.

FCA is an independent, arm's-length agency responsible for examining and regulating the Farm Credit System. The FCS is a network of borrower-owned financial institutions that provide credit to farmers, ranchers, rural residents, agriculture and rural utility cooperatives and other eligible borrowers.

I am pleased to report that the overall condition and performance of the System remains safe and sound. During 2008, the FCS experienced another year of solid earnings and continued strong asset growth. Significantly, the System continues to have good credit quality and adequate capital. However, stresses from the general economy, the financial and credit crises and shocks in commodity prices have increased risks.

The global recession is having a serious impact on the agricultural economy and the risk environment faced by agricultural lenders. In fact, System asset quality has deteriorated from the challenging economic environment that stressed large credits in the poultry and ethanol industries. As a result, during the fourth quarter of 2008, and in the first quarter of 2009, we downgraded our risk ratings of several Farm Credit System institutions and increased our supervisory oversight.

It is times such as these that the System, as a government-sponsored enterprise devoted to agriculture and rural America, must maintain its presence in the marketplace to provide dependable credit for creditworthy farmers ranchers and agricultural cooperatives.

In fact, the System did much in the past year to help producers in rural America. When commodity prices soared in early 2008, System institutions met the critical financing needs of the grain elevator industry and the high demand for financing of machinery and increased input costs for producers. The FCS also helped borrowers affected by floods, worked with livestock producers as they made difficult decisions, and made critical infrastructure projects possible for rural America.

The System also continued its unique mission to serve young, beginning and small farmers and ranchers. In 2008, the System's lending and service to YBS producers continued to show solid results. As a result of the economic and financial market turmoil, the System's ability to issue debt with preferred maturities was extremely challenging.

Due to its strong financial condition and investors' demand short-term high quality securities, the System was able to maintain continuous access to short-term funding. However, System access to longer-term debt market became much more difficult. The current economic environment also increased the System's funding cost as spreads relative to U.S. Treasuries increased and remained well above historic levels.

For our part, we have provided the System appropriate regulatory flexibility. For example, we increased the System's discount note ceiling and adopted a market emergency standby resolution to allow the System to raise short-term funds if financial markets are not open to term debt.

Going forward, we will focus on continuing to ensure that the System remains safe and sound while serving its mission by providing appropriate and proactive guidance, examination and supervisory programs.

FCA also oversees Farmer Mac, a separate GSC established by Congress to provide secondary market services for agricultural mortgages, rural home loans and rural utility loans made by cooperatives. Despite nonprogram investment losses this past year, Farmer Mac continued to have access to the debt markets to fund its program assets. Among other actions, it raised new capital through preferred stock offerings in the third and fourth quarters of last year to replace investment losses.

Farmer Mac continues to work to improve its balance sheet and to provide options to financial institutions that lend to agriculture, rural utilities and rural America.

In conclusion, as agriculture contends with the challenges of these uncertain times, we are mindful that the System was designed to be a dependable lender to agriculture and rural communities. Farm Credit Administration remains committed to ensuring that the System can fulfill its mandate to both current and future generations of farmers and ranchers and the rural areas in which they live.

Mr. Chairman, this concludes my statement. I would be happy to take your questions.

[The prepared statement of Mr. Strom follows:]

PREPARED STATEMENT OF HON. LELAND A. STROM, CHAIRMAN AND CEO, FARM CREDIT ADMINISTRATION, MCLEAN, VA

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 colleague on the FCA Board, Nancy Pellett of Iowa, 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.

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, operate in a safe and sound manner and 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. We evaluate the ability of management and board to direct operations in each institution. We also evaluate each institution's compliance with laws and regulations to serve all eligible borrowers, including young, beginning, and small (YBS) 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, and capital; 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.

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.

It is in times such as these that the System, as a government-sponsored enterprise (GSE) devoted to agriculture and rural America, must maintain its critical presence in the agricultural marketplace to provide competitive credit for creditworthy farmers, ranchers, and agricultural cooperatives. In fact, the System did much during the past year 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, worked with livestock producers as they made difficult decisions, and made critical infrastructure projects possible for 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.

Condition of the Farm Credit System

I am pleased to report that despite the unprecedented instability in the U.S. and global financial markets and a recessionary world economy, the overall condition and performance of the System remains fundamentally safe and sound. The System finances more than 35 percent of all U.S. farm business debt, providing credit to more than 450,000 eligible agricultural borrowers through a nationwide framework of five banks and 90 local retail associations. In addition, the FCS finances cooperatives, agribusinesses, rural utilities, and rural residents. As of March 31, 2009, total assets were $215 billion and loans exceeded $161 billion.

During 2008, the FCS experienced another year of solid earnings and continued strong asset growth. Gross loans grew by 13.0 percent in 2008 compared with 15.8 percent the previous year. However, we anticipate overall 2009 loan growth to moderate from these historically high levels because of less demand, a riskier credit environment, and the System's decision to more carefully manage growth in fulfillment of its mission. In fact, the System's loan growth slowed to just 0.6 percent in the first quarter of 2009, which reflects normal seasonal repayments on agricultural production loans and a modest two percent growth in all other lending types.

While the System continues to have good credit quality and adequate capital, it and its borrowers face a number of risks, including volatile farm commodity and farm input prices; stress to specific agricultural sectors, including ethanol, cattle, hogs, poultry, and dairy; and reduced debt servicing ability by many farm families and rural residents because of the rising level of unemployment and less non-farm income. System asset quality has deteriorated recently because of this challenging economic environment and, in particular, because of large credits in the poultry and ethanol industries that have become stressed. With the continuation of the adverse effects emanating from the general economy and the rising risks in the agricultural economy, we anticipate further deterioration in the System's portfolio, as well as in portfolios of other agricultural lenders throughout 2009.

Going forward, agricultural producers are facing greater financial challenges from lower farm income, volatile commodity prices, higher input costs, and potentially changing government support priorities. As a result, lenders are naturally becoming more cautious and conservative on the extension of credit to farmers, ranchers, and other agricultural producers. While creditworthy farmers and ranchers still have access to credit, the cost of credit is rising, underwriting requirements are more carefully scrutinized, and fixed-rate term loans are more difficult to obtain. To avoid excessive risk, lenders are increasingly lowering portfolio hold limits on various segments of the agricultural industry experiencing stress and conserving their capital resources. From FCA's perspective, the potential for increased risks in the agricultural industry will make credit a continuing area of concern. While creditworthy borrowers will still have access to credit, rising risks in various agricultural sectors means lenders will be cautious about increasing portfolio exposures.

Importantly, however, the System's capital position, solid financial condition, and experienced management will help it remain a viable, dependable, and competitive lender during these difficult times. Total capital was $27.8 billion (including the Farm Credit Insurance Fund) at March 31, 2009, with more than 85 percent of total capital in the form of earned surplus, the most stable form of capital. The ratio of total capital to total assets was 12.9 percent as of March 31, 2009, compared with 13.6 percent the year before. The decline occurred because System assets grew at a faster pace than capital and because the fair value of certain System investments changed. We note that the Agency's efforts and encouragement for the System to build its capital proved beneficial last year when commodity price volatility led to huge margin calls and other credit demands that the FCS was able to fund.

System earnings in 2008 remained strong, with $2.9 billion in net income, a 7.9 percent increase over 2007. As cooperative institutions, the FCS banks and associations passed a portion of their earnings on to their borrower-owners as patronage distributions—33 percent of Systemwide net income in 2008. Return on assets (ROA) remained favorable at 1.44 percent. In fact, during an unprecedented turbulent and challenging year for all financial institutions, an ROA of nearly 1.5 percent is considered very strong when compared with the ROA of other lenders. During the first quarter of 2009, the System earned $615 million, 19 percent less than a year earlier. The decline in earnings resulted primarily from increased loan charge-offs and the need to replenish loan loss reserves because of rising risk in the loan portfolio, in particular for large credits in the ethanol and livestock/poultry industries.

Despite declines from historic high levels over the past few years, credit quality remained good overall with less than four percent of all loans classified adversely as of March 31, 2009. Another credit quality indicator is the level of non-performing loans. Non-performing assets and nonaccrual loans increased from historically low levels. Non-performing loans increased $500 million from December 31, 2008, to nearly $3 billion on March 31, 2009. This represents 1.8 percent of total loans, up from 1.5 percent at year-end 2008. Importantly, as increased stress is beginning to surface in FCS portfolios, we at FCA recognize that System senior management is well experienced and seasoned. Many gained experience during the agricultural credit crisis of the 1980s, and we believe appropriate actions, in general, are being taken by FCS boards and management.

In addition to the System's management experience and board direction, as well as FCA's oversight, the Farm Credit System Insurance Corporation (FCSIC) further protected investors in more than $175 billion in Systemwide consolidated debt obligations. It holds $3 billion in its Insurance Fund. In response to an 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.

The FCS has been able to maintain financial strength and serve its mission despite the economic and financial market turmoil. During the past year, negative economic developments in the financial markets have created a high level of uncertainty about the repayment capacity of global financial institutions. These conditions greatly reduced both the level of credit available and investor willingness to purchase debt securities of financial institutions. As a result, the System's ability to issue debt with preferred maturities and structures was extremely challenging. Because of the strong condition of the FCS and its status as a GSE, it has been able to issue short-term debt securities, even though the issuance of longer-term debt became much more difficult. The current financial environment also negatively impacted the System's cost of funding, as spreads relative to Treasuries have increased significantly. For instance, the spread to comparable Treasuries for 2 year FCS debt peaked at 230 basis points compared with typical levels before the financial market crisis, ranging from 20 to 30 basis points. Most recently spreads have been about double the pre-crisis level. System institutions are responding to these funding challenges appropriately by increasing liquidity and the quality of its investment portfolio and, as necessary, increasing borrowing rates to customers.

During this period of extreme market volatility, many non-System banks and financial institutions have been able to access funds through various programs created or recently expanded by the U.S. Government in response to the current financial crisis. The System does not have access to these programs or to any other U.S. Government-backed liquidity credit line. While this situation has not prevented the System from obtaining funds, continued volatility within the GSE debt market makes the outlook for the availability and pricing of future funding less certain. This is an area meriting close monitoring by the FCS, its regulator, and Congress.

For our part, we have taken actions to provide the System appropriate regulatory flexibility during this difficult period. For example, we increased the System's discount note ceiling to $60 billion from $40 billion to allow it to raise funds if financial markets are not open to term debt. The FCA Board also adopted a Market Emergency Standby Resolution that would go into effect only in the event of a serious market disruption. It would temporarily allow Farm Credit banks to fund their assets with short-term liabilities, even if doing so would cause the liquidity reserve of one or more System banks to drop below the regulatory minimum requirement of 90 days. We continue to consider other measures to enhance System liquidity, capital levels, and earnings.

Examination Programs for FCS Banks and Associations

The Agency's highest priority is to maintain appropriate risk-based oversight and examination programs. FCA's 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. We are hiring more examiners and increasing on-site presence and oversight of FCS institutions in response to the changing and riskier environment we face today.

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 one for a sound institution in every respect to five for an institution that is likely to fail. Our most recent FIRS ratings continued to reflect the sound financial condition of the FCS, although conditions in the System are beginning to show increased stress.

The global recession is having a serious impact on the agricultural economy and the risk environment faced by agricultural lenders. 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, have 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 outbreak has sparked import bans on U.S. pork, which may continue to depress hog prices. In February, the U.S. Department of Agriculture forecast 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.

The combined effect of these factors increased the risk environment and contributed to FIRS ratings downgrades for several institutions in the fourth quarter of 2008 and again in the first quarter of 2009. Currently, none of the 95 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 ten institutions rated three or worse. It is important to note that these ten institutions do not pose material risks to the System overall and the System remains financially strong and adequately capitalized.

FCA Actions to Mitigate Risk

To address the heightened risk environment facing the System, we have told FCS boards and management that solid portfolio management and underwriting are paramount in these uncertain times and have emphasized the importance of portfolio stress testing. The Agency's examiners are increasing on-site presence and placing special emphasis on testing and evaluating the following:

- Internal audit and credit review programs to ensure that they are adequate and that they reflect each institution's risks in a timely manner.
- Portfolio management and stress testing functions to ensure that they are appropriate for the institution.
- Large loans held by multiple institutions to ensure that underwriting, servicing, and independent credit decisions are made by purchasing FCS institutions and that representations and warranties of the FCS originating lender are appropriate.
- Adequacy of the Allowance for Loan Losses and loan loss provisions.
- Capital adequacy and capital management.
- Adequacy and quality of liquidity at System banks.

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 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. The Insurance Fund does not back Farmer Mac's securities, and the System is not liable for any Farmer Mac obligations.

Farmer Mac's total program volume exceeded $10 billion at year-end, including both direct loan volume and guarantees. For the year ending 2008, Farmer Mac experienced a large net loss. Specifically, nonprogram investment losses occurred because Farmer Mac held $50 million of Fannie Mae floating rate preferred stock and $60 million of Lehman Brothers senior debt securities. Events in September 2008 caused Farmer Mac to recognize a total of $106 million in other-than-temporary impairment charges on investment holdings. The full year 2008 net loss to common stockholders was $154 million, including the above-mentioned investment losses and losses related to fair value changes in financial derivatives and provisions for loan exposures to the ethanol sector. These losses 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 and pushed delinquencies and non-performing loans higher from recent historically low levels.

Despite the difficulties in 2008, Farmer Mac continued to have access to the debt markets to fund its program assets. Farmer Mac raised $124 million in net new capital through preferred stock offerings in the third and fourth quarters of 2008. As a result of the issuance of new equity, Farmer Mac's core capital exceeded the statutory minimum capital requirement at year-end 2008. The Farmer Mac Board of Directors replaced the Chief Executive Officer and Chief Financial Officer during the fourth quarter.

During the first quarter of 2009, Farmer Mac reported net income of $33.5 million, compared with a net loss in the fourth quarter of 2008 of $61.1 million. First quarter 2009 net income was primarily driven by gains on the values of financial derivatives and trading assets, offset somewhat by further provisions for losses principally related to the ethanol sector. Capital surplus exceeded the minimum requirement by $67 million at March 31, 2009. During the first quarter of 2009, Farmer Mac improved its capital position by raising equity in conjunction with new business, selling loans and thereby shrinking assets, and recognizing gains on the values of financial derivatives and trading assets since fourth quarter 2008. Farmer Mac is continuing to work to improve its balance sheet, strengthen its capital position, and provide secondary market opportunities for agriculture mortgages and rural utility loans.

Farmer Mac had positive developments for its business in late 2008 and improvements continue in 2009. As mentioned above, the 2008 Farm Bill expanded Farmer Mac's program authorities in guarantee securities backed by eligible rural utility loans made by cooperative lenders. As of the quarter ending March 31, 2009, Farmer Mac guaranteed rural utility securities totaling $1.3 billion. Since then, Farmer Mac has agreed to purchase or guarantee additional rural utility loans from one cooperative lending partner.

Working With Young, Beginning, and Small Farmers

The System is required to develop programs and make special efforts to serve young, beginning, and small farmers and ranchers. In 2008, lending by the System to YBS producers continued to show solid gains. Nevertheless, YBS results as a percentage of total loans have either dipped a few points or remained relatively flat over the past several years. However, since the percentage of young and small farmers is decreasing in general, the System's YBS dollar results are noteworthy because institutions have managed to expand loan volume. FCS institutions may use a variety of tools to fulfill their commitment to YBS lending. Many associations revised their YBS policies and procedures in the past year, or reported plans to do so in 2009. The changes were in response to guidance issued in an 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. This indicates 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) 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 Farm Credit Act and implementing regulations provide borrowers who qualify 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.

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. As the economy has deteriorated and affected FCS borrowers, FCA has received an increase in the number of borrower complaints. Generally, borrowers who contact FCA with complaints are seeking clarification, additional information, and options to redress their concerns. To the extent there are potential violations of law and regulations, FCA requires corrective actions by the institutions.

Conclusion

The lending environment for the FCS going forward will be more challenging than the System has faced for many years. As agriculture and rural America contend with the challenges of these difficult and uncertain times, we are mindful that the System was designed to be a dependable lender to agriculture and rural communities in both good times and bad. FCA remains committed to ensuring that the System can fulfill its public policy mandate to both current and future generations of farmers and ranchers and the rural areas in which they live.

The CHAIRMAN. Thank you, Mr. Strom.

Members are reminded that they will be recognized in order of seniority as long as they were here at the beginning of the hearing. If not, they will recognized based on their time of arrival.

Mr. Caruso, you talked about the backlog that you are facing. Can you just repeat those numbers one more time? And how many states have run out of money?

Mr. CARUSO. The backlog itself in the Direct Operating Loan Program, we have 1,440 approved loans that are not funded to the tune of $96 million, and in the Direct Farm Ownership Program we have 1,566 approved loans that are unfunded at this time to the tune of $277 million.

We also have approximately 3,000 loan applications on hand that are being processed and have not yet been processed and acted on, which could obviously, as those become approved or meet our standards, would add to the demand for funds that we do not currently have the funds for.

The CHAIRMAN. How about the states? How many states are out of money?

Mr. CARUSO. That might take just a moment—all of them.

The CHAIRMAN. I thought she said that.

I mentioned in my opening statement the troubles we are facing in Pennsylvania and, really, across the country, with dairy farmers. How much of that backlog are dairy farmers? Can you tell me that?

And also are the MILC checks getting to the mailbox on time?

Mr. CARUSO. Let me answer the second question first and then seek some help on the first one.

On MILC, the MILC payments, we put out $404 million thus far for production in the months of February, March and April, so about $130 million a month. And that will continue at some uncertain rate, depending on market prices, until markets recover.

Additionally, in dairy, we purchased about 240 million pounds of nonfat dry milk under the Price Support Program. Over 200 million of that has been moved into Domestic Feeding Programs, getting it out of the commercial market. And we have also been involved with the Food and Nutrition Service in bartering some of our nonfat dry milk for cheese that the School Lunch Program can use on pizza, and in other ways so that our school children will consume it.

In terms of the backlog, whether we know its relevance to specific sectors, I am going to look to our Director of Farm Loan Programs, Carolyn Cooksie.

Ms. COOKSIE. No, we don't.

Mr. CARUSO. We don't have that broken down, but I will say that the livestock sector, dairy in particular, being as stressed as it is by low prices is an area of incredible demand, because it makes it obviously very difficult for traditional producers to get credit.

The CHAIRMAN. Mr. Strom, given the situation at Farmer Mac last year, do you believe there was enough oversight into their investment decisions? And what have you learned from that situation?

Mr. STROM. Mr. Chairman, you are referring to the losses that Farmer Mac incurred in their investment holdings in Lehman and in Fannie Mae?

The CHAIRMAN. Correct.

Mr. STROM. Those investments were made much earlier, and in the process, as they looked at that, they came to the Agency, and they had the authority to make those investments.

At the time those investments were made, obviously unbeknownst to everyone, Fannie Mae and Lehman were still solid. As the deterioration of last September occurred and they took the losses on that, they were able to take some actions to raise capital through some preferred stock offerings.

The investment decisions—obviously hindsight is always 20/20 on these, and as you look back, for liquidity purposes they seem to be solid investments. I think in our oversight, going forward, we as an agency will apply appropriate examination and scrutiny on those types of investments.

The CHAIRMAN. Thank you.

The chair recognizes the Ranking Member.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Gentlemen, welcome.

Mr. Caruso, you mentioned dairy farmers, and they seem to be facing tough times all across the country with high feed costs and low prices. Virginia dairymen have let me know that they have sought loans through the FSA, but the money is just not there.

Is this the case of oversubscribed programs, or are the carve-outs in place for the loan programs keeping some producers from accessing loan funds?

Mr. CARUSO. I would say it is largely a case of oversubscription. It is pretty much across the board.

The carve-outs that we have for certain targeted borrowers are a minor amount in the entire context. And we believe, based upon the trends that we are seeing, that those will be used up and perhaps turned into backlogs as well.

We have done what we can———

Mr. GOODLATTE. But they have not been used up thus far; is that correct?

Mr. CARUSO. Not totally. But based upon the trend lines we see, they will be used up within the fiscal year.

We have done what we can, basically, in terms of interfund transfers to try and meet the demand, but the demand is just exponentially high, based on sort of a perfect storm of conditions we have out there.

Mr. GOODLATTE. Do you have any feel for what percentage of farmers in the carve-out categories are receiving loans?

Obviously, so far, all of them have—if you haven't used up the backlogs yet—relative to what percentage of other farmers are receiving funds?

Mr. CARUSO. We have—we have obligated $848 million in direct operating loans, and we have $11 million remaining unobligated. That would be the carve-out funds. So that gives you some sense of what a small portion of the total it is.

We have $11 million in unobligated that is carved out, $96 million in approved but unfunded loans. In direct FO—direct farm ownership, excuse me—the carve-out is $1.4 million. We have funded $200 million. We have a backlog of $277 million. We are still sitting on $1.4 million.

So it is just a minuscule amount, and we do anticipate that those amounts will be needed by those targeted constituents.

Mr. GOODLATTE. So—I am not quite sure I follow you.

Is it less than ½ of what non-carve-out farmers have applied for that they have received?

Mr. CARUSO. We have an approved unfunded for farm ownership of $277 million, and we are sitting on $1.4 million.

Mr. GOODLATTE. Got you. But how much have you loaned to those farmers, non-carve-out?

Mr. CARUSO. About half of the amount that we have approved and funded has gone to targeted constituencies.

Mr. GOODLATTE. Half has gone to targeted and they have been pretty much fully met.

The half that has gone to nontargeted farms, what percentage of the subscription is that? Have they received half of what they have applied for or is it less than that?

Mr. CARUSO. All of the backlog would be those that don't meet the standards for the targeted funds.

Mr. GOODLATTE. I think maybe we need to sit down and look at some numbers together. So we will work with you afterwards.

Mr. CARUSO. I would be happy to make Ms. Cooksie and her staff available to you and your staff to get to the basics.

Mr. GOODLATTE. Thank you.

Mr. Strom, your testimony focuses on the Farm Credit System's ability to meet increased demands due to higher farm input costs. How is this System preparing for the imposition, or the possible imposition, of the Waxman-Markey cap-and-tax climate change bill?

Analysis of that bill shows that input costs will go up as much as 115 percent. Given the current limit on credit availability, do you think your System can provide the liquidity needed to get farmers through this?

Mr. STROM. Congressman Goodlatte, obviously, as that climate change legislation is addressed and the impact on agriculture, which could be significant—and you referenced the added input costs; agriculture producers are already stressed due to the volatility of this past year, year and a half, with their input costs, as you are well aware. Farm Credit System institutions stand ready to serve good, constructive, sound credit decisions in rural America for these agriculture producers.

The System has built a strong capital base and has grown significantly in the last 5 years. The System now has over $200 billion in assets, about $160 million outstanding loans in agriculture. And cognizant of the fact that this type of consideration, if there is impact for producers, could be significant to the producers' bottom line, we will still encourage System institutions to do what they can to work with producers to make safe, sound, dependable credit available to agriculture.

Mr. GOODLATTE. But this could put—we have already seen from Mr. Caruso's testimony that what is available through USDA is oversubscribed already. If this change in the law regarding climate control were put into effect, the demands on both systems would be dramatically increased, and the creditworthiness of some of those seeking to borrow, given the dramatic increase in input costs, could also be called into question, could it not?

Mr. STROM. Well, yes. And when you are talking about credit underwriting standards, obviously the System is going to look at the loans of the producers, make sure that they are safe, sound, dependable credits for those producers.

But, yes, when you look at the System itself, the System in the last 5 years has experienced, on an annual basis, double-digit loan growth in the last 5 years.

Now we are seeing a slowdown of growth in the first few months of this year. The first quarter, the loan growth was a little less than one percent in the System when we had double-digits in previous years.

But we are—we are not using that as a base and an assumption to say that is where that is going to stay. We assume that there will be credit needs coming forth; especially as the ag industry faces some of the stresses that are going on in the various industries from poultry to hogs, and dairy to ethanol, that there will be credit needs and demands. And the System will still be ready to meet those demands where they make good credit decisions.

Mr. GOODLATTE. Thank you.

Thanks, Mr. Chairman.

The CHAIRMAN. The chair thanks the Ranking Member and recognizes the gentleman from North Carolina, Mr. Kissell.

Mr. KISSELL. Thank you, Mr. Chairman.

Mr. Strom, any idea of how many clients have come forth to have their loans refinanced and in what ways are you working towards refinancing?

Mr. STROM. Are you referring, Congressman, to distressed borrowers that need refinancing?

Mr. KISSELL. Yes. Yes.

Mr. STROM. The System, as part of Congress' foresight 20 years ago in the amendments to the Farm Credit Act, put in place borrower rights provisions. So the first step for borrowers is, if they face difficult times, go in and sit down with their lender, go in and look at what can be done working with the lender, working with restructuring the loans.

If the situation gets to the point where the borrower is seriously distressed, there are, again, these borrower rights provisions that require the System institution to look at the least-cost restructuring method for this producer.

And so we encourage in our oversight and have—I sent out a communication recently to the System institutions to refamiliarize themselves with all of the borrower rights provisions of the Farm Credit Act, so that they appropriately address the needs of and the situations as these develop for agricultural producers.

Mr. KISSELL. Any idea, in terms of foreclosures, are we seeing an increase there, and how does it compare to the recent past?

Mr. STROM. I can't speak specifically to statistics for foreclosures, I simply see what some of the headlines and press are reading—are saying also.

I think as far as System institutions are concerned, we are not seeing the deterioration to that point yet. There are stresses going on in the portfolio.

Unfortunately, we are seeing in some of the—outside of Farm Credit System lending institutions in the commercial banking sector, some failures of commercial banks. FDIC has closed a number of banks; some have agricultural portfolios. And those producers that may be in that situation, which may be looking for a lender, we are making sure that Farm Credit System institutions are open to talking to any of those displaced borrowers from those types of situations.

Mr. KISSELL. Thank you, sir.

Mr. Caruso, I congratulate you on the reduction in the turnaround time on being able to get back and respond to the individuals as they ask for help.

We were talking about the concerns in the dairy industry. Any other aspect, in particular in agriculture, a portion that is maybe feeling more stressed than others, or any particular part of the country where we are seeing more stress than in other parts?

Mr. CARUSO. Well, I think relative to where we were a year ago on commodity prices, everybody is feeling the downturn. But I would say, anecdotally, my observation is, it is in the livestock sector in particular, and dairy in particular within that, that my office gets the most phone calls.

Mr. KISSELL. Thank you, gentlemen, for being here today. I forgot to mention that to begin with.

Thank you, Mr. Chairman.

The CHAIRMAN. The chair thanks the gentleman and recognizes the gentleman from Kansas, Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you for very much.

Gentlemen, thank you for being with us.

Mr. Chairman, Chairman Strom, explain to me, please, the nature, the substantive difference between farm credit as a GSE and other GSEs such as Fannie Mae and Farmer Mac?

Mr. STROM. Congressman Moran, probably the biggest difference is—first of all, the Farm Credit System is the oldest of the GSEs. But there are strong differentiations between that, I mean, the issues around Fannie and Freddie and their securitization business.

The Farm Credit System institutions are different in that they hold their loans on their books. This is a cooperatively owned System where the borrowers, the farmers and ranchers who go into those offices and get loans, then some of them end up on the boards of directors elected by the others who use the System. And so they are the governing bodies of these institutions, these 90 associations and five banks of the Farm Credit System nationwide.

So that cooperative structure—Congressman Goodlatte had mentioned in his opening comments, the strength of the past of the System under the guidance, again, of Congress—the System has set about in the last 20 years building a good, strong capital base and has been able to service agriculture in the last 2 decades with significant growth, as I mentioned, in the last 5 years.

But I would say that is primarily the difference. I mean, this is a cooperatively based lender that holds its loans on its books and is well capitalized.

Mr. MORAN. The taxpayers of this country have contributed significant resources to other GSEs, to Freddie Mac and to Fannie Mae. My impression is that there is unintended—perhaps unintended consequences.

There are consequences that occur, that accrue as a result of that taxpayer support, that taxpayer support for the other GSEs. And that consequence is the cost of lending, therefore, the cost of borrowing money to farmers in Kansas and across the country who use the Farm Credit System, has and will increase as a result of the Federal support for the other GSEs. My assumption is that means that it is more likely that capital investment flows into the other GSEs faster than it will into farm credit.

Is that true and would you explain that to me? And if you are able to quantify, several of us have criticized—many of us have criticized the role that government is taking in regard to the private sector, in this case in these other two GSEs. But, are my farmers going to pay a price for this at higher interest rates; is that true?

Mr. STROM. Absolutely, Congressman. The issues, again, of the GSEs, there has always been the implied backing of the Farm Credit System by the Federal Government. It is not explicit; it is implied.

The events of last fall, as they unfolded with the financial and banking crisis, caused, in the lack of confidence issue, as investors worldwide backed away from investments in debt offerings, predominantly in the long end of the maturity.

The Farm Credit System relies on its ability through the consolidated debt obligations of these System institutions, through their funding operations in New York, to be able to access those debt markets.

The unintended consequence that you mentioned was that as some of the remedies that were put forth—for instance, as an example, FDIC's 100 percent guarantee of new bank debt issuance—caused investors to look to those types of things where there was a more explicit backing and caused even more dislocation for the Farm Credit System.

How did that relate to cost? We saw the cost of spreads of U.S. Treasuries, as I mentioned in my opening statement, which had typically run 20 to 30 basis points over U.S. Treasuries, spike to over 160 basis points, almost a full 1½ percent more interest cost for the System to be able to issue long-term debt.

It has been able to continue to issue on the short-term basis, the short-term maturities, but that is risky for it to do that in a long-term mode. So those costs ultimately get passed on to the producers.

Now, we have seen a little bit of an easing in that where the long-term costs have eased off to about 100 basis points in that area right now, but still significantly above because of this dislocation. And the farmers and ranchers on these boards of directors around the country and those farmers and ranchers that are served say, "Hey, the Farm Credit System has done a good job in the last 20 years of building capital, it is a strong organization, and it has just been unfortunate, these unintended consequences and the relating costs."

Mr. MORAN. Thank you very much. My time has expired.

Mr. Caruso, I won't ask you any questions about credit, but maybe I will follow up with you.

But I would encourage you in your capacity at FSA to develop a long-term plan in regard to the Conservation Reserve Program. We need answers earlier, rather than later, as farmers are making decisions. What you do in regard to extensions and to new general sign-up needs to be known as quickly as possible.

Thank you, Mr. Chairman.

The CHAIRMAN. The chair thanks the gentleman and recognizes the gentleman from Alabama, Mr. Bright.

Mr. BRIGHT. Mr. Chairman, thank you very much. Let me commend and thank the panelists for being here today.

Mr. Caruso, I believe we have heard this morning that there has been a steep rise in the loan applications. Can you describe who these applicants may be and why they are turning to FSA at this point in time? Do you have an opinion?

Mr. CARUSO. I don't have specific data on it, but I think it is generally across the board. We have seen a downturn in agricultural prices, in agricultural income as a result. At the same time we have seen a tightening of credit standards due to the credit markets in general.

We would normally expect an uptick with the downturn in farm prices. Combined with tighter standards for commercial credit, which is a prerequisite to coming to our programs, I think it is largely across the board; I don't know that there is any particular sector. I think everyone is looking in our direction, which is why we have such a huge increase in first-time participants in our farm loan programs.

Mr. BRIGHT. Thank you, sir.

Mr. Strom, just one question for you, how would you compare the state of agricultural credit to that of the rest of the economy in conjunction with the credit availability, and in terms of the safety and the soundness?

Mr. STROM. Congressman, I guess I would characterize it as, there is still credit available to agriculture. It comes, as I mentioned in my previous comments, at a higher cost for agriculture.

We have seen interest rates stay at a relatively high level, even though there have been these proposed remedies for the housing market in an effort to get housing mortgage rates down.

But I would say there is still credit availability. The Farm Credit System is still out lending to agriculture, again, on a safe and sound basis. That is our job as a regulator, to ensure that the System institutions are doing the right thing with their borrowers and making that credit available.

Mr. BRIGHT. Thank you very much.

Just one last statement that I would like to make as a Congressman from a heavily rural, very agricultural dependent district, I want you to continue working with the farmers. Because as far as I am concerned our farming industry and agriculture industry is so key to our—similar to our military as far as our national defense is concerned. Once we lose our food chain, we lose that bit of security that we have here and that sovereignty that we so much enjoy here in America.

So thank you very much for what you do in continuing to support our agriculture industry.

Thank you, Mr. Chairman. I yield back my time.

The CHAIRMAN. The chair thanks the gentleman and recognizes the gentleman from Pennsylvania, Mr. Thompson.

Mr. THOMPSON. Well, I thank the Chairman and Ranking Member for this hearing today. I appreciate it.

And thanks to the panelists that are here.

Chairman Strom, despite increases from historic low default rates, do you see similarities in today's agricultural markets—credit markets, to what we saw in the mid-1980s? And what has the System done to make sure we don't have a repeat of the 1980s in rural America?

Mr. STROM. Congressman, let me just reference where we were at in that situation, and then address where we are at.

We have seen some increasing in the nonaccrual loans and some of those loans that we classify adversely in the Farm Credit System. The amount of that, adversely, has gone back to more historic levels, if you look back over the last 20 years. The last few years' credit quality was the best in the history of the Farm Credit System, and it is reflective of a strong agricultural industry in the last decade or 2.

Yes, there have been issues in particular pockets of agriculture; but by and large, land prices have risen, and that is the key asset in agriculture, and they are still remaining relatively stable.

And as you asked the question about what we see down the road, that, yes, there is going to be, and I think anyone would expect that in this financial, banking, and economic climate that the country is in right now that you would see and expect some deterioration, some stresses. We are monitoring closely, as I mentioned earlier, the larger ones, the keys on our radar screen in the livestock industry, all the livestock sectors, because of the increase in their input cost and feed costs.

We are looking at issues around the ethanol industry. The Farm Credit System is the largest provider of credit to that, to the ethanol industry, with about $3 billion outstanding.

But I would characterize, as you ask the question of, is this characteristic of something that would lead us into a 1980s-type situation—I am a farmer back in Illinois also. I lived through the 1980s. I was a Director on Farm Credit System institutions at that time, as we set about trying to do the right things, we had to make some changes.

I don't see this being that type, or scope, of an agricultural—of a looming agricultural crisis. But there are issues, as referenced with some other potential changes, that could happen. If changes in climate change legislation did add significant cost to agriculture producers, the bottom lines of these producers is what makes the solid base for agriculture, going forward.

Mr. THOMPSON. Now, kind of sticking with the theme that you raised there in a little different light with climate change, your testimony highlights and compliments the authority this Committee provided in the farm bill, allowing Farmer Mac to do business with the National Rural Utilities Cooperative Finance Corporation. And it is my understanding that business largely involves financing of coal-fired rural electric cooperatives that faithfully serve the majority of our constituents—I know my constituents.

How is Farmer Mac preparing for the—what I see as the devastating impact that the Waxman-Markey "cap-and-tax" climate change bill will have on rural electric cooperatives?

Mr. STROM. Congressman, again, in our job as a regulator of Farmer Mac and making sure that they are doing the right things over at Farmer Mac—and, yes, they are in rural utility lending. In the changes in the 2007 Farm Bill, it did provide them additional authorities and, in fact, they have about $1.3 billion of guaranteed rural utility securities at the current time, and an agreement to purchase an additional $1 billion in rural utility loans.

As far as preparation for change, I think is what you are asking, we simply are wanting to ensure that Farmer Mac, in its loan program business and in the volume that it securitizes, and puts on its books, is good, solid, constructive credit. If you look at what potential risks are down the road, obviously we all need to be cognizant of how change like you referenced can impact segments of the industry.

I guess I would also ask—I have my Director of our Office of Secondary Market Oversight here present with me, who heads up our oversight of Farmer Mac. I don't know if he would have any additional reference for me.

But, in a preparation mode, we are simply trying to do the right things, making sure Farmer Mac puts on good, solid program businesses.

Mr. THOMPSON. I yield back, Mr. Chairman.

The CHAIRMAN. The chair thanks the gentleman and recognizes the gentleman from Indiana, Mr. Ellsworth.

Mr. ELLSWORTH. Thank you, Mr. Chairman.

Thank you, gentlemen, for being here. I will try to be brief.

Mr. Caruso, I believe in your testimony you said that there weren't—you weren't seeing any delays and the staff at FSA was keeping up with the increased applications. If you could delve into that, how that is occurring, is it just the dedicated workforce that is working extra hours; are you adding staff, and how you are accomplishing that.

And then I would like you to touch on the status of the computer system.

Since I took this office, going back to farmers and the FSA offices, I continue to hear about the rather antiquated system and not talking—and I would like you to just touch on that for me. What the status is and what the future plans are on the computer system, so it works and is modernized and is the most efficient it can be.

Mr. CARUSO. Certainly, Congressman.

We have not added staff. It has been the existing staff that has largely handled this. And the ability to meet this demand has largely been because of the improvement in the IT systems for loan-making.

In that area, within our FSA IT infrastructure, we are way ahead of everything else. Our farm loan folks and the IT people who work with them are ahead of the rest of FSA in the loan-making area.

The one part of our farm loan side that we are not yet up to where we would like to be in IT is in loan servicing. And at this point we haven't gotten into a great demand for loan servicing. But if this downturn in the ag economy pervades for an extended period, we may see some increase in demand for servicing of loans as farmers struggle. That is the remaining piece for IT for farm loans.

The IT system for our farm programs, our Title I crops, for example, is another beast. That is the one that we commonly hear about where we have some serious, serious challenges. And some fairly costly solutions are being suggested. And I, being new in my position, am being asked to look at that entire area in terms of trying to bring it forward into the current century, and make it as effective and efficient and as producer friendly as is our farm loan-making IT system.

Mr. ELLSWORTH. Thank you. Anything I can do to work with you on that, like you said, bring it up to modern times, or at least semi-modern times, would be greatly appreciated.

Mr. CARUSO. Thank you. You could talk to your colleagues on the Appropriations Committee.

Mr. ELLSWORTH. Okay, will do.

Mr. Chairman, I yield back.

The CHAIRMAN. I recognize the gentleman from Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Just very briefly, Mr. Strom, many pieces of testimony today have focused on the System's inability to sell long-term debt; 3 years is the longest the market is interested in right now.

Have you seen any change in who is buying long-term debt from us?

Mr. STROM. Congressman, I believe we have seen a little change in that. Prior to last year's, last fall's events, roughly 30 percent of System debt issuance was purchased by foreign interests. Foreign central banks had a fairly good appetite for Farm Credit System securities.

We have seen them basically exit the market. So there is no—virtually, at this time, no investment from outside the U.S. in that. So that is the biggest piece I can speak to.

I think, otherwise, this still—there are still institutional investors in the United States here that are the buyers of debt. But, again, it is extremely difficult to issue beyond 5 years. The System is still relying on much shorter-term maturities.

Mr. LUETKEMEYER. I have a lot of biodiesel and ethanol plants in my district, and I know you have been a major financier of those. Would you discuss just for a few minutes a little about your continued efforts along that line to continue to finance ethanol plants, biodiesel plants, and where you think it is going to go; if we are solid there yet or if we are struggling, or how much you compare to public finance—other types of private financing?

Mr. STROM. Congressman, as I mentioned, the Farm Credit System has probably been the most significant financier of the growth in the ethanol industry. Of the 158 operational ethanol plants, the Farm Credit System participates in financing of approximately 60 percent of that, about $3 billion outstanding, another $1 billion in commitments yet.

The ethanol industry, as we are all aware, has been facing a stressful time here recently. And System lenders—and whether it is System or the other commercial lenders that are involved in ethanol—don't have much of an appetite right now to add additional ethanol exposure with the uncertainty swirling around a variety of issues, and then just the dynamics of volatility of commodity prices and the bottom line for those ethanol producers.

I think, as we are very aware of this situation, and in our role as a safety and soundness regulator of these institutions—and I should mention that there are four lead lenders in the Farm Credit System that have the expertise and work directly with the financing of these plants, and that $3 billion is then participated out across System institutions to minimize concentration risk for specific farm credit institutions.

But we are active in the process of looking at this. As the examiner of the farm credit institutions, obviously our job is to maintain the safety and soundness of these institutions that have risk in this portfolio. And I should mention that I had a visit last week with Secretary Vilsack last Tuesday—last Thursday morning, and we talked about this issue and a variety of other issues. And I am well aware of USDA's efforts in this issue also.

Mr. LUETKEMEYER. Thank you.

I yield back my time, Mr. Chairman.

The CHAIRMAN. The chair thanks the gentleman, and recognizes the gentlewoman from Pennsylvania, Mrs. Dahlkemper.

Mrs. DAHLKEMPER. I thank you, Mr. Chairman. I thank the Ranking Member, and I thank the gentlemen for coming today and speaking in front of us.

Mr. Strom, I wanted to ask you about a proposed rule that the FCS is currently limited to just lending to farmers and ranchers with few exceptions, but there is an expansion to this that is proposed. I want to ask you where is this at in terms of the timeline for approval or for dropping this proposed rule?

Mr. STROM. Congresswoman, I believe you are referring to our Rural Community Investment Rule that was put out last year and that was open for a comment period. And in that comment period we received over 10,000 comment letters. Currently, we are in the process, yet, of review of all of those comment letters.

But let me just express that in this, this is the program for Rural Community Investment, mission-related types of investments that allow System institutions to make investments in rural America. And let me just mention that currently there are 52 institutions—this was at the end of 2008—52 institutions held mission-related investments across the System totaling almost $5 billion, with commitments for additional projects totaling about $51 million.

The proposed rule has been backed up by a 4½ year pilot program that we have that has granted the authority, or given the structure, to this program.

There are three points, I guess, I would just like to comment with you on this, that the Farm Credit Act of 1971 gives the investment authority to the System to do these types of investments. FCA, our role as a regulator, is to ensure that this is done in the safe—in a safe and sound manner.

And as we now review the comments that came in, we are going to do the right thing, going forward, on this. Because it is good for farmers and ranchers and the communities that they live in to have access to these types of investments.

I can reference one particular item in St. James, Minnesota, where a Critical Access Hospital was funded by a group of nine Farm Credit System institutions, totaling $16.3 million in a—again, a Critical Access Hospital unit.

These are the types of examples that, again, we are reviewing, making sure that it works. I believe our job is to make sure that System institutions have the capacity and the capability under these types of programs to do these types of things for rural America.

Mrs. DAHLKEMPER. But you are moving forward in approval of that?

Mr. STROM. Well, we have not made that decision yet. We are still in the process of reviewing the comment letters.

Mrs. DAHLKEMPER. Thank you. I yield back.

The CHAIRMAN. I thank the gentlewoman and recognize the gentlewoman from Colorado, Ms. Markey.

Ms. MARKEY. Yes, thank you very much, Mr. Chairman, and panel members.

Thank you, Chairman Strom, it was very good to meet with you the other day. Mountain Plains Farm Credit does an excellent job in my district, particularly in Greeley, Colorado, particularly with the failure of one of our large commercial ag lending institutions, New Frontier Bank. I know that they are doing everything they can to help mitigate that situation.

But apparently ten percent of the associations are considered—I guess they are published ratings—FSA associations are published, and ten percent have a troubled rating of three or four.

Can you talk a little bit about what is the source of that problem? Are there delinquencies, poor management in some of these associations? And can you tell me what percentage of FCS loans are at these troubled associations? Are they more or less than ten percent? And what kind of enforcement is taking place right now?

Mr. STROM. Congresswoman, you are referencing the internal rating system we have at Farm Credit Administration that we employ as we rate the health of the associations and the banks of the Farm Credit System. It is called our FIRS rating, Financial Institution Rating System.

We have seen a decline. As I mentioned in my opening statement, we are seeing some stresses and decline in the ratings of some of the System institutions. Most recent numbers show that we now have about ten institutions that are rated three or four in our System.

But let me characterize, these are typically smaller associations than the Farm Credit System. So when you reference ten percent of the Farm Credit System, it is actually a much smaller percentage of the volume of the System that are in these farm credit institutions.

Now, not all of their portfolio is rated poorly. So, I mean, only—I would say, the volume of these institutions is less than three percent of the System volume that is comprised in these ten institutions. So it is a small, much smaller percentage.

As a—again, I mentioned that we are seeing an increase, though, in some of our—stresses in loans, some non-performing loan numbers are up and what we would quantify as "adverse credits."

Ms. MARKEY. I appreciate that clarification.

Mr. STROM. Let me mention, Systemwide the System is still in a very strong position, again, with good capital.

Ms. MARKEY. I have one question for Mr. Caruso. Right now there seems to be more emphasis on guaranteed loans *versus* direct loans at USDA. I know it keeps business flowing at commercial banks. But there is more of a demand right now for direct loans as compared to guaranteed loans. Can you comment on the significance of this change?

Mr. CARUSO. Well, I think that there also is an uptick in demand for guaranteed loans as well. So we are seeing it in general. But the direct loan program is the program for those producers who are unable to even obtain a commercial loan with one of our guarantees behind it. And so it is sort of the entry point into our Federal loan programs.

Our goal is to graduate our borrowers from direct loans that we fund with tax dollars to commercial credit backed by our guarantee, and eventually to commercial credit without any government backing. But we are seeing an uptick across the board in loan demand.

Ms. MARKEY. Thank you, Mr. Chairman.

I yield back.

The CHAIRMAN. The chair thanks the gentlewoman, and recognizes the gentleman from North Dakota, Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. Our background material from the Congressional Research Service indicates that debt-to-asset ratio is less than ten percent, which is historically low. It indicates healthy circumstances relative to leverage. Land prices have generally held. Yet, a couple of things warrant, at least, questions.

The increase in direct loans, the substantial increase in direct loan demand, about a doubling of last year, and an increase in nonperforming loans, the highest in about 10 years, *albeit* a very low rate—how do we look at that? Are these indications in this larger troubled economy of something that ought to cause alarm, or just points to note indicating a period of extraordinary good times has come to an end, and we are back to more business as usual.

Each of your thoughts on that.

Mr. CARUSO. I don't know that I have a quantifiable answer to your question. I think it is a very good one. I guess a personal observation is that agriculture and producers seeking credit are facing a small piece of what is going on, in a larger sense, in our economy and in the credit markets. But I don't have data to support that. That is just a personal observation.

Mr. STROM. Congressman, I guess I would characterize in that as we have seen some deterioration, obviously there are specific stresses that have caused good portions of this. The poultry situation of the last year, which has been very difficult. You have the recent impact of the H1N1 on the hog industry. And we all know, as the Chairman referenced, the dairy industry. Fluid milk prices are half of what they were a year ago.

There are significant stresses going on within certain sectors within agriculture. But then you look to the producers all across rural America. The financial crisis of the last year and the resulting impact on small businesses—more businesses going out of business, and some of those are located in rural America. Job opportunities for farm families off-farm income-type of things aren't there also.

So there are a series of compounding factors here. And you ask about is this something that—I don't know if I use the term "systemic possibility" in agriculture, but there are pieces we can put together here that, taken in the whole, could be considered somewhat troublesome.

Mr. POMEROY. A larger economy aside, looking at the extraordinary volatility in ag prices over the last couple of years—period, that kind of price weighing doesn't do anybody any good. We all like the extraordinary upside moment, but the downdraft is very disturbing.

Is it a fair statement that through this cycle, which occurred in a relatively short period of time, the profit-taking went into debt reduction as opposed to leveraging based on economics of prices that were unlikely to continue. So, in the end, we went through the up and now we are back more to normal pricing levels without a considerable disruption in the underlying financial underpinnings of farm operations?

Mr. STROM. Yes, Congressman. As I see the numbers, there was significant paydown. I mean farmers are going into this period, by and large—again, I realize there are segments that are significantly stressed now, but on the whole producers are going into this with a fairly strong balance sheet of agriculture. They can weather a fair amount because they did good practices in recent years of managing their risk, of paying down debt, and those types of actions.

Let me just, if I might; you also referenced the commodity volatility. Let me just mention this as an important factor of last year and where the Farm Credit System played a role. When commodity prices reached unprecedented levels at this time a year ago, the Farm Credit System, predominantly CoBank, headquartered in Denver, Colorado, stepped forward and was able to provide financing. And our calculations are somewhere north of $6 billion of financing went in, on a very short notice, to keep the grain industry liquid so that it wasn't a fracturing of that industry. That is one example of what the Farm Credit System is capable of doing, given the need.

Mr. POMEROY. Thank you, Mr. Chairman.

The CHAIRMAN. The chair thanks the gentleman and recognizes the gentleman from New York, Mr. Massa.

Mr. MASSA. Thank you, Mr. Chair. Mr. Strom, just a quick question for you, and my apologies for my arriving late. We have multiple hearings ongoing.

I know there has been some discussion already, alluding to current dairy issues. Is there anything that you can bring to the table from your position—and I fear not to use the word "emergency" but, frankly, in many of the dairy farms that I have visited in the past 2 months, it is an appropriate characterization—that will help.

We are viewing a catastrophic meltdown of smaller family dairy farms in my district, and I would extrapolate that out of my area as well. I turn to you for ideas as a farm expert on some extraordinary partnership that you may be able to forge under your leadership.

Mr. STROM. Congressman, as a regulator of the Farm Credit institutions, our duty and responsibility is to maintain safety and soundness of these institutions. Those cooperatively loaned institutions where farmers sit on those boards of directors make decisions and guide that management team in the policies of those institutions.

And I understand the dairy industry is being beset by unprecedented issues. Our encouragement—and I have sent out communication to encourage System institutions to refamiliarize themselves with the issues about borrower rights that were afforded under the amendments of 1987 in the Farm Credit Act, so that the System institutions is required to look at least-cost loan restructuring options for producers.

Now, the Farm Credit System is not the lender of last resort. It works alongside the commercial and independent banking community to provide agriculture credit. We also encourage, though, our System institutions, if a borrower is significantly stressed, to recommend that borrower turn to and look to FSA. When you go on FSA's website and you look under the loan programs, it says: If farmers can't get loans from commercial banks or the Farm Credit System, they can turn to the Farm Service Agency as an option.

But, as we heard the gentleman at the table here alongside me say, I mean, they are stretched now significantly, too, with some funding issues on loans there. But we encourage System institutions to work with borrowers as best as possible, but to maintain safety and soundness and make proper underwriting decisions and loan decisions in their institutions.

Mr. MASSA. I certainly respect and appreciate that. In fact, your solvency and strength is a testament to those very good banking practices, and I would in no way encourage deviating from that, except under the following category. I might recommend that perhaps, literally, a financing summit of all stakeholders take place to look at if your leadership across the three organizations you just mentioned could somehow look at some sort of emergency high-risk program that is a gated or a fenced set-aside for these extraordinary times and this extraordinary sector.

I believe that men and women of good intention, both those in need and those as potential who can solve it, might be able to come up with a solution if we view this as the true national emergency that it is. And I am, again, not asking you to destroy underwriting practices. I am not asking you to go down such that 10 years from now we have a collapse that we need to deal with. But if there is a one or two percent margin of difference that we can come to concurrence on, that will get us through the next year, that may be an investment in the short term that would be worthwhile. And I commend you to consider this possibility.

Mr. STROM. I appreciate your comments. Let me just reference also so that you are aware that the Farm Credit System has a significant portion of debt into the dairy industry—and I am looking for the number. I thought I saw it earlier. I apologize for not having it. The Farm Credit System has about $11 billion, almost $12 billion of financing into the dairy industry. So it is important.

Mr. MASSA. It is very significant. I appreciate that. And I know that you guys are very focused on this. I just add my voice as a note of urgency. Thank you very much.

I yield back my time.

The CHAIRMAN. The chair thanks the gentleman and also thanks our witnesses for their testimony today and their participation in the hearing.

I would like to call upon our second panel. Mr. Bob Frazee, President, MidAtlantic Farm Credit, Westminster, Maryland; Mr. Michael Gerber, President and Chief Executive Officer, Farmer Mac, Washington, D.C.; Mr. Fred Bauer, President/Chief Executive Officer, Farmers Bank, Ault, Colorado; Dr. Mark Drabenstott, Director and Research Professor, Truman School of Public Affairs, University of Missouri, Kansas City, Missouri; Mr. Patrick Sullivan, Economic Development Specialist and Agriculture Mediation Program Project Leader, New Mexico State University.

When everyone is seated, you may begin.

STATEMENT OF J. ROBERT FRAZEE, PRESIDENT AND CEO, MIDATLANTIC FARM CREDIT, WESTMINSTER, MD

Mr. FRAZEE. Mr. Chairman, Ranking Member, Members of the Subcommittee, my name is Bob Frazee. I am President and CEO of MidAtlantic Farm Credit. As a part of the Farm Credit System, we are cooperatively owned by more than 10,500 farmers in the States of Maryland, Delaware, West Virginia, Virginia, and Pennsylvania. Our cooperative structure keeps us focused on the needs of our farmer-members and it means that we share our profits with them.

Over the past 4 years, MidAtlantic has returned over $110 million to our member-borrowers. The Farm Credit System returned some $2.6 billion to its owners during the same period. That money stays in agriculture and contributes to our members' success.

The Farm Credit System remains very strong. The first quarter of 2009 combined net income was $615 million. Total loans outstanding were $162.3 billion. The System provided almost $1 million in new credit to agriculture during the first quarter of this year.

The Farm Credit Administration is our safety and soundness regulator, and because Farm Credit's mission, ownership, structure, and authorizing legislation is unique, it would be a mistake to include the Farm Credit Administration in any effort to consolidate Federal financial institution regulation. And we urge this Committee to resist such a proposal.

Now, let me share some highlights of significant credit issues and challenges in the territory that my association serves. Poultry, cash grain, and dairy are the major commodity types that are prevalent in our territory. Poultry represents 21 percent of our portfolio. And in 2008, the poultry industry had high production costs plus high levels of inventory. This resulted in significant losses for the integrators who reduced production and conserved cash and ultimately impacted our contract growers.

We have been working with individual borrowers all up and down the stream, contract growers and integrators, to help maintain their cash flows during these times. We are hopeful that the industry is going to return to profitability in the near future. There are some encouraging signs there.

Cash grains represents 19 percent of our portfolio. And demand for local grain continues to be good, but is highly dependent upon poultry production. Pressures from development and environmental concerns will continue to challenge our producers.

Dairy is 11 percent of our portfolio. We have already talked today about the impact on the dairy industry. Certainly low milk prices and high input costs through 2008 have resulted in numerous herd liquidations within the industry. We have contacted all of our dairy borrowers, individually, to explore the options for working with their businesses. And we hope that some positive signs of milk futures will mean that there will be higher prices in the coming months.

Our Start Right program helps young and beginning farmers during these times—a farmer like Jeremy Larimore, highlighted in my submitted testimony. His story of buying a farm in his twenties is just one of many successes. Overall, the Farm Credit System provided almost $12 billion in new loans and commitments to beginning farmers in 2008.

Now, how do we work with farmers to ensure that we are there for them in good times and in bad? We deal with each customer on a case-by-case basis. We use Farm Service Agency loan guarantees to help us serve higher risk credits. We see crop insurance as an important tool for farmers in managing risk in their operations.

Our farmer-borrowers have specific borrower rights that are outlined in my written testimony, including the right to have adverse credit decisions appealed to a credit review committee of its board. We restructure loans when it is the right economic decision for the borrower and the lender.

Today's financial environment has brought new challenges to us in serving our members. Because we issue debt in the national financial markets, their problems have been disruptive for us. There is decreased access to longer-term debt and increasing pricing volatility. This means farmers have less access to longer-term fixed rate loans at current low rates. And while we have not denied a single member-borrower credit because we could not access the nation's money markets, last fall's financial market turmoil signaled that our ability to access funding could be put at risk through no fault of our own.

Unlike other lenders, Farm Credit has no Federal guarantees, no capital support, no explicit borrowing line with the Treasury, and no Federal backstop for our insurance fund.

In summary, the Farm Credit System remains strong. We continue to make credit available to all segments of agriculture. Access to the national markets across all terms would help improve credit availability.

Agriculture should not be disadvantaged by Federal efforts to revive the home mortgage market. And FSA loan guarantees should continue to have adequate funding.

Mr. Chairman, thank you for the opportunity to testify, and I will be pleased to respond to your questions.

[The prepared statement of Mr. Frazee follows:]

PREPARED STATEMENT OF J. ROBERT FRAZEE, PRESIDENT AND CEO, MIDATLANTIC FARM CREDIT, WESTMINSTER, MD

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Farm Credit System. My name is Bob Frazee, and I am President and CEO of MidAtlantic Farm Credit. MidAtlantic is a part of the nationwide Farm Credit System. My remarks today will provide some background on the Farm Credit System, comments on current credit conditions and the impact of recent financial market disruptions, and discuss how we are working to meet the credit needs of agriculture in the geographic area served by my institution.

Background on the Farm Credit System

Established in 1916, the Farm Credit System is a unique set of 95 private institutions, including five funding banks (four Farm Credit Banks and one Agricultural Credit Bank) and direct-lending associations, all of which are cooperatively owned by farmers, ranchers, agricultural cooperatives, rural utilities and others in rural America. We are chartered by the Federal Government to provide credit and other related financial services to our owners and others consistent with the eligibility criteria set out in the Farm Credit Act.

MidAtlantic is one of these 95 Farm Credit cooperatives. We are owned by more than 10,500 farmers that borrow from us in the states of Maryland, Delaware, and parts of West Virginia, Virginia, and Pennsylvania. As President and CEO, I report to a 23 member Board of Directors. Twenty-one of these directors are farmers elected by the members of the cooperative. MidAtlantic is required to have at least one appointed outside director that has financial experience, and we have chosen to have two. In no case are employees allowed to serve as directors.

There are 90 independently operated Farm Credit associations like MidAtlantic serving agriculture throughout the United States and Puerto Rico. Every Farm Credit association is organized as a cooperative that is owned and governed by its farmer-members. Our Board of Directors is responsible for establishing our institution's capitalization plan consistent with Federal regulations and for ensuring that management makes available loan products and financially related services appropriate to the unique needs of agriculture in the geographic territory that we serve.

Each Farm Credit association obtains funds for our lending programs from one of five wholesale Farm Credit banks. At MidAtlantic, we get our funding from AgFirst Farm Credit Bank (headquartered in Columbia, SC), which is cooperatively owned by twenty-two local associations. The five System banks own the Federal Farm Credit Banks Funding Corporation (located in Jersey City, NJ), which, as agents for the banks, markets to the investing public the Systemwide debt securities that are used to fund the operations of all Farm Credit System institutions. Unlike commercial banks, Farm Credit institutions do not have access to insured deposits guaranteed by the FDIC and backed by the U.S. Treasury as a source of funding for our operations.

Regulatory Oversight by the Farm Credit Administration

All Farm Credit institutions are regulated by the Farm Credit Administration (FCA), which was created by Congress and is subject to this Committee's oversight. The Farm Credit Administration is an arm's-length, independent safety and soundness regulator. FCA's three board members are nominated by the President and confirmed by the Senate. The FCA has all of the oversight and enforcement powers that every other Federal financial regulatory institution has to ensure that Farm Credit institutions operate in a safe and sound manner. In some instances, FCA has more authority than other comparable Federal regulators.

I compliment this Committee for its instrumental role in reconfiguring the FCA in the mid-eighties. The decisions made by this Committee shaped the System's regulator, providing a regulatory framework second to none among Federal financial institution regulators. Should this Congress move forward with reforms for other financial regulators, we ask that you vigorously resist any proposal to include FCA in those efforts. I strongly believe the Agriculture Committees have done an excellent job providing the appropriate statutory framework and ongoing oversight of FCA. Including FCA in a financial institution regulatory reform effort likely would cause serious repercussions for agriculture in what already is a difficult and stressful environment. Simply put, let's not fix what isn't broken.

The Farm Credit System's mission, ownership structure and authorizing legislation is unique among financial institutions. For farmers, ranchers and the cooperatives that they rely on, it is critically important that our safety and soundness regulator understands our unique mission and what it takes to be successful in accomplishing it. Changing this would threaten our ability to accomplish the mission set out for us by this Committee in the Farm Credit Act.

Fulfilling Farm Credit's Mission of Serving Agriculture and Rural America

MidAtlantic Farm Credit, like all Farm Credit System institutions, focuses on accomplishing the mission established for us by Congress: to serve agriculture and rural America. We do not take our Congressional charge lightly. Our cooperative structure and governance is designed specifically to ensure that our lending and financially related service activities are driven by the needs of our farmer-members and to ensure that there is a reliable and competitive credit source available to agriculture that farmers own and control. Our practice is to engage our customers in a consultative lending relationship, using our accumulated expertise and knowledge of agriculture and finance to craft long term lending relationships that are often delivered across the farmer's kitchen table

We understand that farming isn't a short-term investment for our member-borrowers. Our cooperative structure allows us to work with our farmer-owners with an approach that is not focused on achieving quarterly returns to impress investing stockholders. We know that when we work with our customer-owners to help them achieve success in their business, our business will succeed as well. Our lending relationship with our member-borrowers is based on constructive credit over the long haul—we do not enter and exit agricultural lending as farm profitability waxes and wanes.

Distributing Profits to Farmers Through Patronage

Our commitment to our farmer-members' business success is demonstrated further by the fact that we share our profits directly through patronage dividends with the farmers that borrow from us. Each year, the MidAtlantic board of directors makes a determination based on our profitability and financial strength as to what portion of our net earnings will be returned directly to the farmer-members that own our institution.

In just the past 4 years, MidAtlantic has sent back over $110 million in earnings as patronage dividends to the member-borrowers of our cooperative. During the same period, the Farm Credit System in total has returned some $2.6 billion to our customer-owners. That is money that stays in agriculture and rural America and helps our members be successful.

Farm Credit's Financial Strength

I am pleased to report that the Farm Credit System remains very strong financially. At the end of April, the Federal Farm Credit Banks Funding Corporation reported the System's combined financial results for the first quarter of 2009. Net income earned was $615 million with total loans of about $162.3 billion. The System provided almost $1 billion in new credit to agriculture during the first 3 months of this year. Reflective of the overall economy and growing stress in certain segments of the farm economy, we are seeing demand for credit decline as farmers become wary of expanding operations, purchasing new equipment, or taking on additional risk at this time of economic weakness.

Current Conditions in Agriculture

I also am pleased to report to you that MidAtlantic Farm Credit has not changed its lending standards in response to the current financial and economic disruption. This is particularly important to farmers in that there are now fewer choices of agricultural lenders available.

Let me give you some highlights regarding what we are seeing in MidAtlantic's territory when it comes to the local farm economy and credit conditions.

Poultry represents 21% of our portfolio. For several years, the industry has been increasing production. In 2008, it found itself in a position of high production costs plus high levels of inventory. This resulted in significant cash flow losses for the integrators, who reduced production and conserved cash. We have been working with individual borrowers to help maintain their cash flow during these times of lower prices. We expect the industry will work through the current distressed environment and return to profitability.

Cash Grains represents 19% of our portfolio. Demand for local grain continues to be good, but is highly dependent on poultry production. Demand for grain continues to keep land in production, but pressures from development and environmental concerns will continue to challenge producers.

Dairy is 11% of our portfolio. Low milk prices and high input costs throughout 2008 have resulted in numerous herd sales within our territory. We have contacted all of our dairy borrowers individually (most recently in April) explaining the options for sustaining their business. Milk prices will be determined by cow numbers, total milk production and dairy exports. Slaughter for the year is 12% above last year and we hope that the positive signs in milk futures will mean higher prices in the next 6 months.

In addition to the key sectors mentioned above, we also serve operations that produce fruit, vegetables, livestock, as well as those involved in timber and forestry, nursery and greenhouse, and equine operations. Where operations touch the housing industry, we expect to see some stress occurring.

A Commitment to Serving Young, Beginning, and Small Farmers

The Farm Credit System's commitment to agriculture not only extends to these typical farming operations, but also to those young, beginning, and small farmers who may need some assistance as they start out in agriculture. Every Farm Credit association has programs in place targeted specifically at meeting the needs of three special categories of borrowers, those that are young, those that are just beginning in farming, and those that are small farmers. At MidAtlantic Farm Credit, we call ours the "Start Right" Young, Beginning, Small, and Minority Farmer program.

The Start Right program offers lower interest rates, while maintaining our credit standards. In fact, since last April, we've written over $45 million of new loans to Young, Beginning, Small and Minority Borrowers in our territory. In addition, we are now piloting a national online business-planning course targeted at young, beginning, and small farmers. This is part of our commitment to training future farmers the good credit habits and skills that will help make them successful business people in the future. This program encourages skill attainment by integrating training with access to lower rates.

One of these farmers is 27 year old Jeremy Larimore, who now owns a small poultry farm on Maryland's Eastern Shore, along with 30 acres of grain and soybeans. Jeremy didn't grow up on a farm, but he worked on farms owned by his uncles, and he realized early that that's what he wanted to do. Seven years ago, when he was twenty, Jeremy wanted to buy a used combine so that he could do some custom harvesting for his neighbors, bringing him closer to his dream. Farm Credit helped him finance the combine.

Jeremy's Farm Credit loan officer was impressed with Jeremy's drive and business sense. The two stayed in touch for years, talking about how Jeremy could purchase his own farm. In 2005, when Jeremy was just 24, the opportunity arose for him to purchase 33 acres with four poultry houses on it. Jeremy has said that without Farm Credit, he would still be dreaming of buying that farm.

Today, Jeremy leases an additional 100 acres, for a total of 133, and his four poultry houses account for about 90,000 chickens per flock. He's currently talking to his loan officer about opportunities for buying more land.

When it comes to serving the needs of small farmers, the Farm Credit System stands out. Recently, the American Bankers Association released its report on "farm bank" performance in 2008. They indicated that the 2,247 banks that met their definition of a "farm bank" had some $32.8 billion in credit outstanding in small farm loans (those with an original loan size of less than or equal to $500,000). In comparison, the 90 associations of the Farm Credit System had slightly more than $58 billion of similar sized loans outstanding at the end of 2008.

Even if we are to look just at the new credit extended in 2008, the System clearly continues to demonstrate its commitment to the next generation of farmers. Farm Credit institutions provided new loans and commitments totaling almost $12 billion to beginning farmers last year (those with 10 or fewer years experience). USDA's FSA beginning farmer loan programs totaled $1.24 billion in Fiscal Year 2008. Unfortunately, there is no comparable data available from commercial banks since they are not required to collect this same data.

USDA Programs and Farmer Mac Help Farm Credit Serve Agriculture

At MidAtlantic we make significant use of USDA's Farm Service Agency (FSA) loan guarantees to support our lending. We are pleased that our experience and excellent credit management practices have allowed us to be recognized as an FSA preferred lender. At the end of May, we had over $74 million in our portfolio that had FSA guarantees. We believe about 60% of all System associations are FSA preferred lenders.

The guarantees available through FSA are an important tool that allows us to serve higher risk credits that might not otherwise meet our underwriting standards. The Farm Credit Act requires that we focus our resources on meeting the needs of credit worthy borrowers. The FSA guarantees permit us to reach some individuals that we might not otherwise be able to serve. In fact, in the story I just mentioned about Jeremy Larimore, we used both FSA direct money, as well as an FSA guarantee to make the loan work.

Another USDA program which benefits our farmer-members is the Risk Management Agency's (RMA) crop insurance program. Crop insurance is an important tool for our farmer-members to use in mitigating the risk in their operations. MidAtlantic writes almost 25% of the crop insurance policies in Maryland. Last year, we paid out $10.3 million in claims.

These two programs are very important tools in ensuring that we can stay with borrowers in stressful times—especially those who are just getting started and likely have inadequate equity, as well as those that have experienced losses due to adverse weather or economic conditions.

One other tool that this Committee has made available to agricultural lenders is the Federal Agricultural Mortgage Corporation or Farmer Mac. At MidAtlantic we have used Farmer Mac to help us manage the risk of portfolio concentration in certain agricultural sectors and to help manage our capital position. At the end of 2008, we had almost $16 million in loans in Farmer Mac's long-term standby program, all of which are 100% guaranteed. Farmer Mac serves an important function for our institution, and we look forward to continuing to utilize it in the future.

In addition to the tools mentioned above, Farm Credit institutions also work with many commercial banks of all sizes. When your focus is on meeting the needs of the customer, reaching out to a competitor easily morphs into finding partnerships that work for the customer. These relationships allow us to better manage risk and permit us to provide the customer with what they need to succeed. When there are services that our borrowers need that they can't get from us it makes sense for us to partner with others who can provide those services. We have worked with local commercial banks on loan participations. We have both bought these participations, and sold them. This allows us to diversify our portfolio, manage our risk, and continue to serve our marketplace.

Farm Credit institutions also work with many commercial banks as we participate in the pilot program established by the Farm Credit Administration that permits System institutions to make mission-related investments. Many of our borrowers, especially the young ones, depend on off-farm employment to help pay the bills as they get started in agriculture. Permitting Farm Credit institutions to help rural communities by making mission-related investments just makes good sense especially now when so many other sources of investment funds have evaporated.

Serving the Vital Needs of Rural Communities and Global Markets

Lending to companies that serve the needs of rural communities in the energy, communications, and water industries is a growing part of Farm Credit's overall business. Customers in these industries include rural electric generation and transmission cooperatives, electric distribution cooperatives, independent power producers, rural local exchange carriers, wireless provides, cable television system, and water and waste water companies. Farm Credit loans to these customers increased to $14.2 billion at the end of the first quarter this year from $10.8 billion at the end of 2007.

Much of the loan growth to these customers came as the broader debt capital markets contracted as part of the overall financial market crisis. The Farm Credit System, primarily through CoBank (the one Farm Credit bank that operates as an Agricultural Credit Bank) has increased its lending to these customers ensuring that a continued flow of competitively priced credit is available to them. The System's ability to expand financing to these customers has been critical as many of them, electric co-ops especially, have been forced to modernize facilities and expand operations as demand for electricity has boomed across rural areas.

Similarly, as global credit markets contracted, demand for credit around the world to purchase U.S. agricultural export products increased. Loans made by CoBank to facilitate the export of U.S. farm products increased from $2.1 billion at the end of 2007 to $4.5 billion at March 31, 2009.

Impact of Financial Market Disruptions

Because the Farm Credit System relies on our access to the financial markets for the funds we need to make credit available to our borrowers, a disruption in the efficient operation of those markets can adversely impact agriculture. Over the last year the nation's financial markets have changed dramatically and this has impacted not only our cost of funds but also the term of the funds that are available.

At this time last year of our nation's grain marketing cooperatives were faced with the need to meet unprecedented levels of margin requirements due to the volatility of commodity prices. They turned to the Farm Credit System because they knew we could access the capital markets to get them the credit they needed at a moment's notice. Farm Credit increased its borrowing from the market by $21 billion through the first half of 2008 just to meet these and other needs. The market understood our financial strength and our unique status as agriculture's GSE. Margin calls were met and what could have been a disastrous situation was averted because of that access to the financial markets.

The dynamic of the financial markets changed quickly late last summer in some very unusual ways. While the Federal conservatorship of Fannie Mae and Freddie Mac had disastrous impacts on their equity holders, it positioned them in the debt markets as having greater links to the Federal Government, and ironically created the perception in the eyes of investors that they are a less risky credit. This was underscored further when the Treasury made available a direct line of credit for Freddie Mac and Fannie Mae as well as their sister housing GSE the Federal Home Loan Bank System.

Then utilizing direct backing through the FDIC, the Federal Government provided commercial banks the ability to issue debt that essentially has a direct Federal guarantee standing behind it. These same banks also have Treasury's backing of the FDIC to facilitate them generating loanable funds through bank deposits. And this Federal FDIC backstop has just been expanded substantially.

Complicating the national and international debt markets even further has been the heavy issuance of U.S. Treasury securities to finance our nation's deficit and the substantial increase in foreign government backed debt hitting the markets and competing for investors. We have seen the investment banking sector collapse that we had relied on to facilitate transactions between sellers and buyers of debt. The severe economic stress also has resulted in very few investors being interested in term debt that exceeds 3 years in maturity.

While we continue to access the funding we need to serve our marketplace, the changes and disruptions in the national financial markets have markedly changed the landscape for us. Decreased access to longer-term debt and pricing volatility has presented a challenge. While the environment has settled since the beginning of 2009, it would be a mistake to conclude that we are back to normal. The Farm Credit securities margin spread over 5 year U.S. Treasury bonds makes the point:

Pre-2007 norm	32 basis points	0.32%
Fall 2008 peak	215 basis points	2.15%
April 2009	92 basis points	0.92%

The result is that farmers seeking to reduce the volatility of their interest expense by locking in longer-term, fixed rate loans at low rates do not have options that are available to the average homeowner. Low cost home mortgage rates are available to homeowners because of direct government intervention targeted at helping them. The Federal Reserve action to purchase mortgage-backed securities has improved pricing in the home mortgage market, but similar action is not being taken to address the needs of agriculture.

To summarize, commercial banks have been extended a direct Federal guarantee on their debt issuance and access to Federal capital support. The housing GSEs have enhanced support from the Treasury to facilitate their access to the debt markets. Actions are being taken to facilitate the liquidity of mortgage-backed securities. Farm Credit institutions have no such guarantee, no access to capital support, no explicit borrowing line with Treasury and no Federal backstop for our insurance fund.

Despite the fact that we have had no assistance from the government throughout these times of extreme stress in the financial markets, we are very proud to report to you that we have not had to deny a single farmer, cooperative or other eligible borrower access to credit because we could not access the nation's money markets. This is testament to the financial strength that the System has carefully built up during good times through cautious lending and the accumulation of appropriate capital reserves.

Trust has been built with our investors, who know that the Farm Credit System has never failed to meet its obligations. They are secure in the knowledge that System management and directors are intent on preserving this fine organization to ensure that farmers will continue to own and govern their credit source through their cooperative in the future. However, Farm Credit's operational prudence notwithstanding, last fall's financial market turmoil demonstrated to us that our ability to access the necessary funding to meet our mission to agriculture and rural America may be at risk if circumstances beyond our control disrupt our market access.

Loan Restructuring Available for Farm Credit's Farmer-Owners

As economic stress increases in agriculture we stand ready to work with our customers as they deal with their individual challenges. Farm Credit System institutions have operated with specific "borrower rights" requirements for over twenty years. We are required to follow "least cost" restructuring requirements for farmers that can't meet the terms of their loans. In addition, if a farmer that applies for a loan or one that has a loan with us is faced with a credit decision they believe is adverse to them, they have a specific right to appeal that decision before a credit review committee that must involve a local elected farmer-director from the board of their institution.

You have probably heard us say that Farm Credit serves agriculture in good times and in bad. Borrower rights are one of the ways that we serve our marketplace when the environment is more bad than good.

I'll give you a recent example of this: for years, MidAtlantic has had a lending relationship with a customer whose business is sensitive to the general economy and in particular the housing industry. Although this business was well managed, it began to experience the financial stresses that came with the downturn in the housing industry in 2006. As you might imagine, those stresses have continued and grown.

In response, MidAtlantic has worked with this borrower by employing a variety of tools from our borrower's rights guidelines: we have advanced additional monies during this time, provided principal forbearance, and relaxed the financial covenants that had been placed on the account. Our goal in taking these actions has been to help this account return to profitability.

As recently as last month, we completely reworked the credit, advancing more new money for the purchase of equipment, and working with the borrower to help them secure funds from the Pennsylvania Machinery and Equipment Loan Fund (MELF), as well as a USDA Business and Industry Guarantee.

We assume, and we hope, that the housing industry will turn around. In the interim, what we've done for the borrower—and what the borrower has done for themselves—has given them an opportunity to stay in business during an extremely challenging down cycle. This company has a strong management team, they have implemented efficiencies that are serving them well now and will serve them even better when things do improve.

At Farm Credit, we know that the economy, markets and commodity prices are cyclical. That comes with 93 years of experience. When we say we're there in good times and in bad times, we mean it.

Conclusion

The Farm Credit System is financially stable, economically vital, and serving its mission for agriculture and rural America well. We continue to make credit available to all segments of agriculture including commercial producers as well as young, beginning and small farmers. We have stepped up our lending to vital rural infrastructure companies. There is no taxpayer support of the Farm Credit System. There are no Federal dollars invested in the Farm Credit System. We even pay for the expense of being regulated by the Federal Government through an assessment on all Farm Credit System institutions.

As a network of agricultural and rural lending cooperatives owned by the farmers, cooperatives, and rural utilities that borrow from us, we have the built in oversight mechanism of our owners holding our feet to the fire to keep service quality high. We understand that Farm Credit's success depends on our customers' success. To continue serving our mission, we must have continued, effective access across all terms to the national debt markets and an independent, arm's-length regulator that comprehends the unique requirements of agriculture.

I am testifying to you as a leader of a nationwide lending institution in a climate of lapsed supervision by regulators and mistrust of institutional intent. But it should not surprise you that I am reporting on our successes and service to mission. The Agriculture Committee understands why the Farm Credit System exists, and our continued success is due in part to the fact that this Committee had the foresight to change our structure more than 20 years ago while strengthening our regulatory oversight to ensure our safety and soundness.

We are proud of our commitment to rural America. We have maintained our focus and continually work to meet our mission. Certain parts of agriculture are facing some challenging economic times that may test the resolve of many. We urge that you continue to monitor this situation closely and continue to provide both FSA and Rural Development at USDA with the funding resources and flexibility they need so that an adequate guaranteed loan program remains available. And we urge that you continue to monitor the Federal programs that are being put in place to address the upheaval among commercial banks and the disruption of the money markets to ensure that agriculture is not disadvantaged in its access to the nation's money markets

Mr. Chairman, thank you again for the opportunity to testify today on behalf of MidAtlantic Farm Credit and the Farm Credit System. I will be pleased to respond to your questions.

The CHAIRMAN. Thank you, Mr. Frazee.

Our witnesses seem to have thrown us a little curve ball here. We generally go left to right. But we will be flexible and go down the line right to left.

Dr. Drabenstott.

STATEMENT OF MARK DRABENSTOTT, PH.D., DIRECTOR, (RURAL POLICY RESEARCH INSTITUTE) RUPRI CENTER FOR REGIONAL COMPETITIVENESS; RESEARCH PROFESSOR, HARRY S TRUMAN SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF MISSOURI, KANSAS CITY, MO

Dr. DRABENSTOTT. Chairman Holden, Ranking Member Goodlatte, and Members of the Subcommittee, it is an honor to appear before this important hearing. I commend your ongoing leadership in ensuring that rural America has access to the capital it needs to thrive in today's economy.

I am Mark Drabenstott, Director of the RUPRI Center for Regional Competitiveness. My Center helps rural areas think and act regionally to compete globally.

This Committee is rightly concerned about current agricultural credit conditions. Conditions have deteriorated over the past 9 months, reflecting a softening farm economy and turbulent financial markets. These developments are cause for concern, but they do not yet translate into alarm.

This Committee must also keep its sights on a critical set of longer-term rural capital issues. Indeed, how the nation's financial architecture is refashioned in the months and years ahead will likely have a far bigger impact on the rural economy than today's concerns about agricultural credit.

What steps should Washington take to assure effective rural financial markets in the future? I offer four views on this important question. First, how has the financial crisis affected rural financial markets?

The debate on financial reform now unfolding in Washington must take into account the unique financial needs of rural businesses. Simply put, financial policy must aim for a 21st century rural economy instead of the one now passed. It will not be easy to assemble the knowledge base Congress will need to design new rural financial markets.

Number two, how have rural capital needs changed over time? The rural economic landscape continues to evolve. Agriculture remains a key sector, but its role has declined sharply. Meanwhile, manufacturing still supplies 20 percent of rural income.

Rural capital needs have also changed. Rural businesses have grown bigger, but are relying more on retained earnings to fund their growth, raising questions about the ability of rural lenders to keep pace. In recent years, rural businesses have also built more equity into their balance sheets, yet with limited access to equity capital providers. This reliance on retained earnings will be much more difficult in today's economy.

Number three, what principles should guide rural financial policy? The principles to guide public policy for rural financial markets are well established, and they still ring true. The cornerstone principle is that rural businesses should have comparable access to capital as urban businesses, in competitive markets at market rates.

There are two big issues I believe will augment this list of principles in the period ahead.

Number one, the cost of bailing out housing-related GSEs in the wake of the financial crisis may bring fresh oversight scrutiny to all such enterprises, including the Farm Credit System. It will be important to weigh each GSE on its own merits.

Second, principles in the past have focused almost exclusively on rural credit markets, with a heavy emphasis on agriculture. In a more entrepreneurial, innovation-driven economy, equity capital has risen in importance relative to debt, and this remains mostly a new frontier in rural areas.

Fourth, how can we bring better information to your decisions? To put rural into the financial reform calculus, policymakers must engage a fresh set of questions most likely to shape rural America's business and economic future. These include the following. As banks consolidate and rebuild their capital base, what will be the impact on available rural credit; how can public policy encourage the emergence of a stronger network of rural equity capital institutions; what changes in regulation can help rural lenders match the growing size and regional scope of larger rural businesses; and, what unique role do rural financial institutions play in the emerging framework of a regional economic development, and what can be done to encourage their participation and leadership?

Answering these questions will require a better base of information than is currently available, and filling this information gap will be a tough challenge. Databases that shed light on rural business conditions are few, and some of them are even being retired.

Apart from data limitations, much of the research and analysis on rural financial markets is still heavily oriented on agricultural finance, not rural finance. A national panel of experts on rural finance would help in assembling better data and in spurring research. And this panel could be modeled after RUPRI's highly successful rural health panel.

Thank you very much, Mr. Chairman. I look forward to answering your questions.

[The prepared statement of Dr. Drabenstott follows:]

PREPARED STATEMENT OF MARK DRABENSTOTT, PH.D., DIRECTOR, (RURAL POLICY RESEARCH INSTITUTE) RUPRI CENTER FOR REGIONAL COMPETITIVENESS; RESEARCH PROFESSOR, HARRY S TRUMAN SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF MISSOURI, KANSAS CITY, MO

Chairman Holden, Ranking Member Goodlatte, and Members of the Subcommittee, it is an honor to appear before this important hearing. I commend your ongoing leadership in ensuring that rural America has access to the capital it needs to help rural businesses compete in today's economy. As you know, capital is the lifeblood for businesses, not only to survive in today's troubled times but also to create the jobs and wealth that sustain the rural economy in the long run.

I am Mark Drabenstott, Director of the RUPRI Center for Regional Competitiveness. My Center helps rural areas think and act regionally to compete globally. We provide the tools and technical assistance rural regions need to identify their competitive advantage, strengthen regional partnerships, and prioritize investments. RUPRI provides objective analysis and facilitates dialogue on the impacts of public policy on rural people and places.

This Committee is rightly concerned about current agricultural credit conditions. Conditions have deteriorated over the past 9 months, reflecting a softening farm economy and turbulent financial markets. The most notable change has been a sharp increase in lender credit standards. Lenders are requiring more collateral to offset rising credit risks. At the same time, farmland values appear to have stalled, after one of the biggest booms on record. Last, farm income is projected to tumble more than a fifth this year due to a sharp fall in commodity prices from last year's peaks.

These developments are cause for concern, but they do not yet translate into alarm. Farm borrowers and their lenders are both coming off a period of strong profits, leaving them with solid capital cushions. Nevertheless, in a small number of cases, that cushion may be tested this year.

All of these issues merit monitoring, but this Committee must also keep in its sights on a set of longer term rural capital issues. The financial crisis has grabbed headlines and the attention of nearly everyone in Washington. Most of that attention has focused on markets and institutions far-removed from Main Street. How Washington responds to today's financial crisis, however, will have profound implications for future capital availability on Main Street. Indeed, how the nation's financial architecture is re-fashioned in the months and years ahead will likely have a far bigger impact on the rural economy than any current concerns about agricultural credit.

In my testimony today, therefore, I will focus on this question: *What steps should Washington take to assure effective rural financial markets in the future?* To frame this question, I will address four subsidiary questions:

- How has the financial crisis affected rural financial markets?
- How have rural America's capital needs changed over time?
- What principles can guide future Federal responses to rural capital markets?
- How can we build a stronger information base for Federal decisions in this area?

The first section of my testimony discusses how the financial crisis poses major implications for the future of rural financial markets. The second section reviews how capital needs have changed in rural America. The third section identifies some key principles that can guide Federal policy in rural capital markets. The final section describes some recommended steps in improving the knowledge base for Federal action.

The financial crisis and rural financial markets

Global financial markets have been rocked the past 9 months. A wave of losses triggered by collapsing housing derivatives has brought low some of the world's best known banks. The same wave brought an end to one of the landmarks of U.S. financial prowess—investment banks. The turmoil in financial markets resulted in a nearly total freeze in bank lending. In response, the United States and many other nations launched special measures to lubricate credit channels and shore up bank balance sheets. Lending channels have begun to thaw, but the effects of the financial crisis still linger throughout the nation.

No one is sure what U.S. and global financial markets will look like when all the dust settles from the current crisis. Two observations are warranted, though. First, financial markets will operate differently than they did before the crisis, and in ways that cannot be fully anticipated now. Second, financial market regulations will be dramatically reformed. Policymakers will take a hard look at a wide range of regulations with the goal of avoiding in the future the very problems that brought about the current crisis.

What does all this mean for *rural* financial markets? Rural capital markets have not been the front lines in this financial crisis, but the impacts clearly extend to Main Street. The global economic downturn is dragging down important elements of the rural economy. In particular, manufacturing-dependent rural areas have experienced some of the biggest job losses in the downturn. (Jobs in manufacturing-dependent rural counties have fallen 3.9 percent over the past year, compared with 2.9 percent in all rural counties and 3.5 percent in the nation.) Finally, credit standards have risen for rural borrowers as losses have piled up for lenders.

That said, it should also be noted that while rural financial markets are part of national and international financial markets, they also retain important distinct features. In rural areas, there are generally fewer lenders than in metro areas, raising ongoing questions about whether rural borrowers enjoy the same benefits of competitive markets that urban borrowers enjoy. Lack of access to equity capital is an even greater issue for rural areas, forcing rural businesses to look longer and harder to assemble the equity base that powers new businesses.

A whole new architecture for financial market regulation is likely to emerge in weeks and months to come. The issues in that dialogue obviously have broad implication for the U.S. economy, including its vital rural areas. Nevertheless, for this regulatory and policy debate to be successful, it must take into account the unique needs of rural businesses and the powerful forces that have swept across the rural economic landscape. Put simply, financial policy must aim for a 21st century rural economy instead of the one that is now past.

It is not a simple task to assemble the knowledge base your Committee and others in Congress will need to design new rural financial markets. First, rural capital markets have not been studied extensively. To give but one example, the last major study done by the Federal Government on rural capital markets is now more than a decade old (ERS, 1997). Second, the databases on which analysis can be performed are comparatively scant. Washington has always viewed rural financial markets mainly through the lens of agriculture. As a result, much more is known about the finances of farm businesses than non-farm businesses, even though the non-farm businesses now provide the lion's share of rural jobs and income. Finally, no expert panels have been created to frame and evaluate rural financial market policy issues. This is ironic since President Teddy Roosevelt's *Country Life Commission* provided the landmark report in 1908 that ultimately resulted in one of the most significant policy interventions in rural financial markets—the Farm Credit System. A lot has changed in the past century, so the time may be right for a new commission.

The shifting economic & business landscape in rural America

The rural economic landscape has undergone dramatic changes in recent decades—shifts RUPRI has closely watched and chronicled. Three trends are especially notable. Agriculture remains an important sector, but its role has declined sharply. Commodity production continues to consolidate (farms getting fewer and bigger). This shift has not been offset fully by new efforts to add more value to farm production. As one indicator of agriculture's changing role, 82 percent of farm family income now comes from sources *off* the farm. Meanwhile, manufacturing still supplies almost 20 percent of rural income, but global pressures and technological advance are reducing the number of factory jobs. And, as noted above, rural factories are especially hard-hit in the current downturn. Finally, the service sector is taking root in rural areas, although activity appears concentrated in exurban and scenic areas. In addition, rural areas have not participated fully in the growth of many high-earning service industries.

Against the backdrop of these long-term trends, the global economic downturn will lead to some significant short-term economic shifts. Agricultural incomes will drop after a sharp boom. Rural factories will be under enormous cost pressures, especially in the troubled auto industry. Rural service businesses will struggle as corporate customers cut back and tourism declines.

The shifts in the rural business landscape are difficult to pinpoint due to limited data on the businesses in rural America. One rich source of data is the Federal Reserve Board's *Survey of Small Business Finance* (Federal Reserve Board, 2008). This survey is conducted every 5 years, and captures information from more than six million small businesses, defined as firms with fewer than 500 employees. Roughly a quarter of the businesses in the sample are in rural areas. The data is robust, but it becomes available only after a long lag. The 2003 data are the most recent available.

A comparison of data from the 1998 and 2003 surveys points to some important shifts in the rural business landscape (*Table 1*). First, the typical rural business was getting bigger and generally more profitable. In 2003, the typical rural small business had total sales of $915,000 and profits of around $167,000. This sales figure was still smaller than the metro counterpart, but the gap had closed (82 percent of metro, compared with 64 percent 5 years ago). Rural businesses earned profits roughly on par with metro businesses in 2003; by comparison rural profits were 23 percent below metro 5 years ago.

The balance sheet reflects more interesting differences. The typical metro small business was far more leveraged in 2003 than its rural counterpart (debt/asset ratio of 1.56 *versus* 0.70). Viewed another way, the typical rural small business grew its sales nearly 40 percent in 5 years, but had to rely almost entirely on retained earnings to do so. As a result, liabilities grew only modestly for the typical rural business. Moreover, a separate question on the Survey suggests that very few rural businesses obtained equity capital from sources other than the owner (*Table 2*).

Both urban and rural businesses raise equity from individuals, but rural businesses rely mostly on their own capital reserves, whereas urban businesses turn to angels, employees, and others with much greater frequency.

The picture that emerges of rural small business finances is sketchy, but poses some big questions in this critical period of decision for rural financial markets. First, rural businesses have grown bigger, but appear to be relying more on retained earnings to fund their growth. This poses fresh questions about whether lending standards are tighter or the supply of credit is less than in urban areas. It also raises questions about whether rural lenders are keeping up with the increasing scale of at least some rural businesses. Second, rural businesses have built more equity in their balance sheets, but they appear to have more limited access to equity capital. The retained earnings approach was possible during a time when the national economy was growing; such an approach will be much more difficult in the economic period through which we are passing today.

Principles for policy intervention in rural financial markets

The principles that can guide public policy for rural financial markets are well-established. These principles still ring true, although the practical implication of them has likely changed as the rural economy and the financial needs of rural businesses have shifted. Looking back over a century of government oversight and policy involvement in rural capital markets, a handful of principles have been present throughout:

- Rural businesses should have comparable access to capital as urban businesses.
- Policy should aim to encourage competitive markets that yield a steady supply of credit at market rates.
- Where credit markets fail, government policy should encourage the creation of new lenders that fill critical market gaps, but limit the role of such institutions to those market segments.
- Government should be a lender of last resort for segments of rural borrowers who cannot obtain any credit in rural financial markets. In the main, this should be a short-term credit facility.
- Government should provide credit and loan guarantees to ensure that rural areas have adequate access to housing, utilities, and basic infrastructure. This should be a long-term commitment given the fundamental nature of these investments.

This list is still relevant in the current period. That said, other considerations may lead to some adjustment in the application of these principles in the future. These include:

- The cost of bailing out housing-related government sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, in the current crisis may bring fresh oversight scrutiny to all such enterprises, including the Farm Credit System. It will be important to weigh each GSE on its own merits.
- Principles in the past have focused almost exclusively on rural *credit* markets, with a heavy emphasis on agriculture. In a more entrepreneurial, innovation-driven economy, *equity* capital has risen in importance relative to debt. There have been several isolated forays by public policy into this arena, but it remains mostly a new frontier in rural areas (Freshwater and others, 2001).

Building a stronger framework for policy decisions

Experts, rural businesses, and policy officials alike would agree that the nation is entering a critical period of decision regarding the financial policies and rules that will govern rural financial markets for the next several years. However, rural America will only benefit from the new financial market architecture if the dramatic shifts in the rural economic landscape and the unique needs of rural businesses are taken into account.

To put *rural* into the policy calculus, policymakers must engage a fresh set of questions most likely to shape rural America's business and economic future. Answering these questions, however, probably demands a better base of information than is currently available.

The questions at the heart of the upcoming dialogue will span many dimensions of rural financial markets:

- In a period when banks are actively rebuilding their capital base, what will be the impact on the credit available to rural businesses?

- In a period of significant consolidation among commercial banks, what will be the impact on the credit available and the interest rates charged to rural borrowers?
- As more rural businesses shift from products to services, what provisions are necessary to help rural lenders underwrite loans increasingly backed by "knowledge assets"?
- How can public policy encourage the emergence of a stronger network of rural equity capital institutions?
- What changes in regulations may be important in helping rural lenders match the growing size and regional scope of larger rural businesses?
- How can rural financial institutions better meet the widening financial service requirements of rural businesses increasingly engaged with customers all around the world?
- What unique role do rural financial institutions play in the emerging framework of regional economic development, and what can be done to encourage their participation and leadership?

These questions cannot be answered with the available base of rural financial information. Filling this information gap will be a difficult challenge. Databases that shed light on rural business conditions are few, and some of them are even being retired. For instance, the Federal Reserve Board has indicated it will no longer conduct the survey on small business finance, even though it is widely regarded as a benchmark set of financial data. Apart from data limitations, much of the research and analysis on rural financial markets is still heavily oriented on agricultural finance, not *rural* finance.

A national panel of experts on rural finance would help in assembling better data and in spurring new research on rural financial markets. This panel might bring together national experts, policy advisors, and capital providers to supply an objective, ongoing source of information, analysis, and policy insight on rural financial market issues. The panel could be modeled after RUPRI's highly successful Rural Health Panel. It could issue policy briefs on rural financial market issues, including recommendations for shoring up the information base for public decision. It could encourage rural finance research and strengthen the network of rural finance researchers. Finally, it could provide a valuable sounding board for regulators and policy officials in current and future policy dialogues.

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ATTACHMENT

Table 1. Financial Characteristics of Metro and Rural Small Businesses.

Income Statement	2003		1998	
	Metro	Rural	Metro	Rural
Total sales	$ 1,112,514	$ 915,570	$ 1,064,664	$ 664,088
After Tax Profit	$ 167,117	$ 167,384	$ 116,685	$ 90,235
Balance Sheet	**2003**		**1998**	
	Metro	Rural	Metro	Rural
Total Assets	$ 560,272	$ 524,426	$ 426,706	$ 356,708
Total Liabilities	$ 341,409	$ 215,136	$ 261,455	$ 194,198
Owners Equity	$ 218,866	$ 309,293	$ 165,253	$ 162,512
n=	4.6 m	1.7m	4.2m	1.1m

Source: Federal Reserve Board *Survey of Small Business Finance.*

Table 2. Sources of Equity Capital for Incorporated Rural and metro Small Businesses, 2003.

Question: Did the firm obtain any new equity from new or existing shareholders, exlcuding retained earnings?

	Metro	Rural
Yes	6.2%	5.1%
No	93.8%	94.9%

Question: Of those answering yes, did the firm raise equity from…

	Metro	Rural
Individuals investors	94.2%	85.2%
Venture capital firms	0.7%	0.0%
Public equity	0.3%	0%
Other	5.3%	14.7%

Question: Of those obtaining new equity from individual investors, did the firm raise equity from…

	Metro	Rural
Original founders	78.6%	97.1%
"Angel" capitalists	8.5%	0.6%
Employees	1.9%	0.0%
Someone else	15.7%	2.2%

Source: Federal Reserve Board *Survey of Small Business Finance.*

The CHAIRMAN. Thank you, Doctor.
Mr. Bauer.

STATEMENT OF FRED J. BAUER, PRESIDENT AND CEO, FARMERS BANK, AULT, CO; ON BEHALF OF INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. BAUER. Thank you, Mr. Chairman, thank you for the opportunity to testify. My name is Fred Bauer, I am the President and Chief Executive Officer of Farmers Bank in Ault, Colorado. For those of you that don't know the geography, that is about 50 miles north of Denver. It is a 103 year old community bank with over 40 percent of our loans in agriculture. I am testifying on behalf of the Independent Community Bankers of America.

Many have wondered about the impact of the financial crisis on agriculture. Community banks did not cause the financial crisis, and have been quite upset at the bailout of Wall Street investment firms and our nation's largest banks considered too big to fail. Dozens of community banks have been allowed to fail the last 2 years. A large majority of the 8,000 community banks are in rural areas, and form an extensive credit delivery system serving rural America.

Even in the financial crisis, 40 percent of community banks increased their loan origination volumes during the past year. While the largest banks saw a 3.2 percent decrease in 2008 net loans and leases, banks less than $1 billion grew by 5½ percent. For farm loans, over 6,000 banks under $1 billion in assets made over 60 percent of all farm loans from the banking sector, while holding only 12 percent of all banking assets.

Commercial banks extend 53 percent of all farm operating loans and 38 percent of farm real estate loans. The banking sector increased ag lending by $8 billion for the period ending March 31, 2009 *versus* March 2008.

Economists state there is ample credit for creditworthy farm borrowers and point out that, despite increasing risk, credit is being supplied to agriculture at historically low interest rates. ICBA received input recently from its Ag Rural America Committee, made up of 25 bankers across the country. Several bankers stated they had no classified ag loans, in part due to some areas having excellent crops in the past 2 years. Some bankers have had a significant increase in farm loans and little deterioration in portfolios, but are concerned about high input costs and lower farm income. Some banks picked up farm loans as larger banks cut back on their lines of credit.

Land loans have remained steady for the highly productive farmland, but sales have slowed and less productive farmland has fallen five to ten percent.

Dairy cattle, feed, hogs, poultry, and cow/calf sectors are experiencing stress due to lower prices and higher feed costs. Several states have been impacted by drought or severe weather.

Some bankers are under pressure to decrease loan-to-deposit ratios. Regulators question some banks' use of Federal Home Loan Bank advances, an important funding source for community banks. Community banks remain very well capitalized. The ag portfolios of rural banks are a strong contributor to banks' overall income and stability.

My testimony discusses the recent failure of a $2 billion bank in northern Colorado. Banks are reviewing which farm loans they can acquire from that bank.

A very small percentage of all community banks receive TARP funds. A number of banks would like to get TARP funds. Banks receiving TARP funds do pay dearly with the tax-effected dividend cost as high as 7.7 percent for the first 5 years, then rising to 13½ percent. They are not bailout funds, and are repaid with interest.

My written testimony covers several surveys and references a few of the many competitive advantages Farm Credit has over community banks. First, keep the farm safety net intact without budget cuts. Actually, there are six recommendations.

First, keep the safety net intact, without budget cuts.

Second, provide more funds for USDA direct and guaranteed loans.

Third, enhance USDA's B&I loan program, limiting fees to one percent; increasing guarantee on loans under $5 million to 90 percent, or even 95 percent; and, keep the low-doc application for USDA loans.

Fourth, ensure FCA does not proceed with this rural community investment proposal. The proposal, not authorized by Congress, allows FCS to shift credit away from agriculture, contrary to their mission, for manufacturing, commercial buildings and businesses, restaurants, dentists' offices, apartment complexes, *et cetera*, taking loans from community banks, which also hurt rural America.

Fifth, ensure regulators don't restrict lending by community banks.

Sixth, avoid unintended consequences for bank customers by imposing new requirements on the community banking sector.

In conclusion, community banks have increased lending in a time of economic contraction by providing loans to farmers at historically low interest rates. ICBA urges the Subcommittee to adopt our proposals, and we look forward to working with you.

Again, thank you for the opportunity to testify.

[The prepared statement of Mr. Bauer follows:]

PREPARED STATEMENT OF FRED J. BAUER, PRESIDENT AND CEO, FARMERS BANK, AULT, CO; ON BEHALF OF INDEPENDENT COMMUNITY BANKERS OF AMERICA

Introduction

Mr. Chairman and Members of the Subcommittee, thank you very much for the opportunity to testify today on a topic of great interest to this Committee, our nation's farmers and ranchers, and the thousands of community banks in rural America.

My name is Fred Bauer and I am the President and CEO of Farmers Bank in Ault, Colorado. I am testifying on behalf of the Independent Community Bankers of America and I serve on ICBA's [1] Agriculture-Rural America Committee. I am also Chairman of the Independent Bankers of Colorado. I am pleased to present ICBA's views on credit conditions in rural America.

Farmers Bank of Ault has been in existence for 103 years. The present ownership has owned the bank since 2001. We branched to Ft. Collins 2 years ago. Ours has

[1] ICBA represents 5,000 community banks throughout the country. Community banks are typically independently owned and operated and are characterized by personal attention to customer service and are proud to support their local communities and the nation's economic growth by supplying capital to farmers and ranchers, small businesses, and consumers.

always been an "ag" bank, but we have diversified over the last 10 years given the opportunities in our trade area, which is the north front range of Colorado. Agricultural lending still accounts for 40 percent or more of our business.

As an agricultural lender, we are very diversified serving dairies, feedlots (cattle and sheep), ranchers, beet, onion, carrot, wheat, alfalfa, dry bean, and corn farmers. Our community has approximately 1,500 people, but there are approximately 300,000 people within 20 miles of our bank. Additionally, we service small business customers, consumers and real estate interests (land holding, development and construction).

This morning I will briefly provide the community bank perspective on credit conditions in rural America and offer recommendations for the Members of this Subcommittee to consider in order to ensure the viability of our farms and ranches and rural economies.

The Financial Crisis

As the financial crisis spread and deepened last fall many people wondered what the impact of the worst economic recession since the Great Depression would be on the agricultural sector. At the outset, let me emphasize that community banks played no part in causing the financial crisis and have been quite upset at the bailout of the Wall Street investment firms and our nation's largest banks that have been considered "too big to fail."

Dozens of community banks have been allowed to fail during the past 2 years while the largest banks have been prevented from failing due to governmental intervention.

Community banks did not cause the current financial crisis, which was fueled by exotic lending products, subprime loans, and complex and highly leveraged investments that went terribly awry. The sharp decline in the U.S. housing markets and the distressed credit markets triggered a ripple effect throughout the entire nation that continues to strain households and impact our economy.

Community Banks Role in the Rural Economy

Community banks play an important role in the nation's economy. There are approximately 8,000 community banks in the U.S. and the vast majority of these are located in communities of 50,000 or fewer residents. Thousands of community banks are in small rural communities.

Community banks have only 12 percent of all bank assets but make 20 percent of all small business loans. This is important since small businesses represent a whopping 99 percent of all employer firms and employ ½ of the private sector workforce. Small businesses are important in rural America since many farmers and/or their spouses have off-farm jobs. In addition, the more than 26 million small businesses in the U.S. have created 70 percent of the net new jobs over the past decade. Community banks are small businesses themselves and specialize in small business relationship lending.

Community banks under $1 billion in assets make over 60 percent of all agricultural loans extended by the commercial banking sector. Even more astounding, community banks under $500 million in assets extend over 50 percent of all agricultural credit from the banking sector. Commercial banks extend approximately 53 percent of non-real estate loans to the farm sector and 38 percent of the real estate credit.

Aite Study

The Aite Group LLC released a study,[2] conducted with the assistance of the ICBA, in March on the impact of the financial crisis on community banks. The study drew several conclusions that are informative regarding the ability of community banks to continue serving their customers during the financial crisis.

Although the current financial crisis is impacting all financial institutions, most community banks are well positioned to overcome new challenges, take advantage of new opportunities, and reclaim some of the deposits lost to larger institutions over the last decade.

Despite most community banks' lack of participation in subprime lending, the implications of larger bank activities have begun to trickle down. Of the 773 community banks surveyed, 73 percent stated they have seen an increase in their traditionally low loan delinquencies and charge-offs since the start of the crisis. The significant growth in quarterly net charge-offs for the industry is being driven primarily by the largest banks.

[2] *Impact of the Financial Crisis on U.S. Community Banks, New Opportunities in Difficult Times,* March 2009, Christine Barry and Judy Fishman, Aite Group LLC, Boston, MA. 773 community banks were surveyed in February 2009, for this study.

Fifty-five percent of bankers stated they have seen an increase in deposits as a result of new customer acquisition. Only 17 percent are challenged by customers withdrawing deposits from their institutions.

Community banks are still lending and 40 percent have seen an increase in loan origination volumes over the last year while 11 percent believe the financial crisis has "significantly curtailed" their lending ability. In several cases, decreases in community bank lending activity, when it has occurred, is not the result of a lack of funds or financial instability, but rather part of a reaction to mixed messages coming from the U.S. Government. While these banks hear the government's requests for them to lend money, they also feel the government is dissuading them from lending by putting them through overzealous regulatory exams. Moreover, an economic contraction, by definition, means fewer loans will be originated; leading to bank's curtailed ability to lend.

While some community banks are faced with new lending challenges, they are still lending, especially when compared to larger banks. In fact, while the largest banks saw a 3.23 percent decrease in 2008 net loans and leases, institutions with less than $1 billion in assets experienced a 5.53 percent growth.

The financial crisis and new documentation requirements are also causing some banks to change processes and re-evaluate their credit evaluation practices. While most community banks have not strayed from traditional prudent lending and underwriting practices, 81 percent have tightened their credit standards since the start of the crisis. Of banks surveyed, 20 percent described this tightening as significant. Banks with more than $100 million in assets have been the most likely to tighten their credit standards, while only 15 percent of banks with less than $100 million in assets have done so. In most cases, tighter standards often means focusing greater attention on risk management and requiring more borrower information prior to making lending decisions.

The Agricultural Sector—Farm Income

Many rural lenders have been quite concerned that a global recession would lead to fewer exports of U.S. agricultural products, thereby reducing markets and income for American farmers, and causing a ripple effect up and down Main Street. The agricultural sector was fortunate that at the outset of this severe recession, in which unemployment figures continue to march toward double digit levels, U.S. net farm income had reached a record high of nearly $90 billion for 2008.

This followed the $87 billion level reached in 2007 and a 10 year average (1999–2008) of $65 billion. However, production expenses also increased dramatically during the past 2 years, and although expenses are projected to be approximately nine percent lower this year, net cash income is also projected to fall to $71 billion. While still above the 10 year average, 2009 net farm income will be 18 percent less than last year's record level, according to USDA's Economic Research Service.

Perspective on Agricultural Credit

We agree with various economists who have noted there is an ample amount of credit available to the agricultural sector for creditworthy borrowers. However, we also point out that there are several problem areas of concern that warrant continued monitoring. For example, the dairy industry has been hard hit by lower prices and high feed costs which have also impacted the livestock sector. In addition, there are several states where farmers have been impacted by drought conditions that will threaten yields and farm income.

As was recently pointed out to another Subcommittee in April, despite some increasing risks in agriculture, ample credit appears available at historically low interest rates.[3] In addition, the FDIC's recent data indicates that farm loans (non-real estate) and farm real estate loans increased collectively by $8 billion for the period ending March 31, 2009 compared to March 31, 2008.

ICBA's Agriculture-Rural America Committee Input

ICBA conducted a conference call last week with its Agriculture-Rural America Committee to further assess credit conditions. This Committee consists of twenty-five agricultural bankers from every region of the U.S. representing virtually every agricultural commodity grown in the country.

A number of these bankers stated they had no classified agricultural loans. This is in part due to several areas of the country having excellent crops during the past 2 years, allowing farmers to increase their cash reserves or pay down their lines of credit. Some bankers have seen a significant increase in agricultural loans and

[3] Jason Henderson, Federal Reserve Bank of Kansas City before the Subcommittee on General Farm Commodities and Risk Management, April 1, 2009, page 2.

have seen little deterioration in their agricultural portfolios but are concerned that higher input costs will reduce farm income. Some community banks have picked up agricultural loans as larger banks have cut back their lines of credit. Land values have remained steady for highly productive farm land although sales have slowed considerably.

Land values for less productive farmland have fallen five to ten percent in some areas. Some banks have tightened underwriting standards, including taking a stronger collateral position, slightly shortening loan maturities, or requiring greater documentation from borrowers. The dairy, cattle feeding and cow/calf sectors are areas experiencing stress.

Several bankers stated they are concerned with the potential for their regulators to second-guess their desire to make additional loans and some bankers are under pressure from their regulators to decrease their loan-to-deposit ratios. In addition, several bankers stated their regulators do not want them to utilize Federal Home Loan Bank (FHLB) advances as a means of funding their loans. The regulators are suggesting that FHLB advances are not as "stable" as core deposits. Bankers disagree, noting that it is quite easy for depositors to withdraw funds in search of higher yields in the stock market, which has risen rapidly in recent months, or in shopping for higher rate CDs at other institutions.

The real issue, bankers believe, is that regulators do not want to be in a secondary security position behind the FHLB if there are widespread bank failures. FHLB advances have become an important source of funding for community banks that must be allowed to continue.

A number of bankers also complain about a very harsh examination environment from field examiners and believe there is a disconnect between the public statements from agencies in Washington, D.C. and the treatment of local banks during examinations.

At least one banker relayed that when he called to inquire about receiving TARP funds he was questioned on why he needed the money. When he explained he wanted to supplement his capital position and also make more loans, the regulator told him the agency didn't want banks making more loans in this environment. This type of attitude has led many community banks to conclude there is a reluctance to extending TARP money to community banks and that the program was primarily designed to assist large, troubled banks. Community banks in danger of failing would not be eligible for TARP funds.

In addition, many banks have concluded that TARP funds are an expensive source of capital both in terms of the dividend cost as well as the administrative costs.[4] There is also the threat that requirements will be changed after banks receive funding and new conditions will be imposed.

Generally, the bankers' assessment is that ample credit is available for credit worthy borrowers; they would like to make more loans; and they're concerned about heavy-handedness from their regulators going forward. Community banks remain very well capitalized and are in a good position to assist with new borrowing needs as the economy strengthens.

There are some sectors of agriculture that are struggling, but the agricultural portfolios of many rural banks are currently a very strong contributor to the bank's overall income and stability.

New Frontier Bank Failure

Recently, a $2 billion bank with heavy involvement in agriculture, and located in northern Colorado, failed. The bank apparently took a lot of risks in its effort to grow quickly, achieving all of its growth in the past 10 years. As Chairman of the Independent Bankers of Colorado, I facilitated a meeting a few weeks ago between the local bank presidents, the State Division of Banking, representatives of the Federal Reserve, and the local representatives of the FDIC in charge at New Frontier, providing a venue to exchange information about what everyone could expect over the next few months. The meeting was also an opportunity to voice concerns over what would or could happen to an already struggling local economy given New Frontier's demise. One concern was the potential negative impact upon existing farmers and ranchers if there was a large and sudden glut of real estate for sale due to a number of foreclosed properties. Also of concern was dealing with the many customers seeking new credit relationships.

We agreed to meet again after the dust had settled. Many of the banks are reviewing New Frontier's loan portfolio to determine if there are bankable loans that

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[4] The cost of TARP funds includes a five percent dividend payment for the first 5 years increasing to nine percent after 5 years. On an after tax basis, ICBA estimates the cost would be 7.5 percent the first 5 years and 13.5 percent after the first 5 years.

they could add to their own portfolio. Bankers of course want to be sure that the borrowers are capable of repaying their loans if they extend them credit. Regulators also expect banks to lend to borrowers that can repay. Our bank looked at a number of these loans and will acquire at least four in our trade area.

One limiting issue is that regulators recently decided to require community banks to increase their capital levels once again. Previously, regulators increased our capital level from eight percent to ten percent. Now the regulator requires banks to have a 12 percent capital level for all banks that have commercial real estate loan volumes three times their level of capital (*e.g.,* $30 million in commercial loans and $10 million of capital). Obviously, the regulators believe that commercial real estate loans are more vulnerable in the current economic climate. Many banks in northern Colorado exceed this threshold due to the region's fast growth in recent years. However, since capital is leveraged approximately ten times for new lending, a $2 million required increase in capital reduces the amount of lending the bank is able to provide by $20 million. Many bankers in our area believe this new requirement is unnecessarily restrictive.

Federal Reserve Agricultural Surveys

Several of the Federal Reserve District banks (Kansas City, Dallas, Chicago, Minnesota, and Richmond) conduct quarterly agricultural surveys of bankers in their regions. A summary of these surveys follows.

The Federal Reserve Bank of Kansas City [5] notes that the average return on assets (ROA) and equity (ROE) at agricultural banks steadily declined in 2008. ROE at ag banks last September declined to 7.6 percent and ROA declined to 0.8 percent. Yet, these returns were much stronger than returns at other commercial banks. Contributing to the decline in ag bank profits were lower interest rates which have dropped significantly below 2006 levels. At smaller banks, delinquency rates on agricultural loans actually declined. Delinquency rates and net charge-offs on agricultural loans remain well below other types of loans and help explain the relative strength of agricultural banks. The delinquency rate on all types of loans and leases in the third quarter of 2008 was almost triple the rate on agricultural loans. Ag banks report ample funds for operating loans.

Banks have tightened lending standards to preserve capital and manage risk arising from the economic downturn. Collateral requirements rose almost 20 percent above year-ago levels but this increase does not appear to have severely restricted loan activity as farm real estate accounted for approximately 17 percent of the collateral used for the nation's farm operating loans. Bankers report deteriorating loan quality as livestock profits were elusive and margins declined for the crop sector. Carry-over debt appears to be rising as more ag banks report an increase in operating loan renewals and extensions during the fourth quarter. In response to rising risks, banks reduced the length of operating loans to approximately 12 months.

Rising job losses from the recession pose a risk to deposit growth because people could lose their income stream and tap savings for household needs. Ag banks are increasing their use of USDA guaranteed farm loans.

Continued deterioration in the ag economy could further erode the creditworthiness of ag borrowers. Farmland values edged down in the fourth quarter.

The Federal Reserve Bank of Minneapolis [6] reports that farm income, capital expenditures and household spending decreased in the first quarter. Loan demand was flat and collateral requirements increased. Banks reported no shortage of funds and interest rates decreased from the fourth quarter of 2008. Survey respondents expect decreases in income and capital expenditures during the second quarter. Dairy producers are hard hit as the price of milk has fallen to below break-even levels. Most respondents from Wisconsin report below average income for their borrowers. One quarter of Minnesota respondents reported above average income, but 49 percent reported below average income. Producers are responding to lower spending by reducing capital equipment spending. Approximately 25 percent of respondents reported lower levels of loan repayments and 19 percent reported higher levels. Twenty-five percent saw higher renewals or extensions and only eight percent saw lower levels.

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[5] The Kansas City region, the Tenth Federal Reserve District, includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico and the western third of Missouri.

[6] The Minneapolis Fed, serves the six states of the Ninth Federal Reserve District: Minnesota, Montana, North and South Dakota, 26 counties in northwestern Wisconsin and the Upper Peninsula of Michigan.

The Federal Reserve Bank of Dallas[7] includes the states of Texas and portions of New Mexico and Louisiana, a region which has been impacted by a severe drought. Many ranchers are unable to reach a break-even point, forcing livestock liquidations. The dairy industry is suffering from large losses. The outlook for crop production, due to the lack of moisture, remains bleak. Eighty-four percent of bankers report that loan demand remains unchanged or has decreased compared to last quarter.

The Federal Reserve Bank of Chicago[8] reports sale of farms were below the levels of the prior year. Bankers anticipate declines in land values during the second quarter. For the second quarter of 2009, respondents expect higher loan demand for operating loans and USDA guaranteed loans. As of April 1, District interest rates had reached historically low levels with the level for operating loans at the lowest since the early 1970s. The average loan-to-deposit ratio was 76 percent, or four percent below the desired level. As land values have stalled, cash rental rates for farmland increased seven percent for 2009. Twenty-one percent of bankers reported that more funds for lending were available than a year ago and nine percent reported that fewer funds were available.

Bankers expect the volume of non-real estate farm loans to grow during the second quarter compared to year ago levels and expect higher FSA guaranteed loan demand. They expect farm machinery, grain storage construction, feeder cattle and dairy loan volumes to decrease.

The Federal Reserve Bank of Richmond's[9] fourth quarter 2008 survey reported the demand for farm loans was little changed from its sharp drop off in the third quarter, which bankers attributed to variations in commodity prices and production costs. Lenders expressed concern about escalated feed costs which had reduced profits for livestock production. Requests for loan renewals or extensions increased at a quicker pace. Agricultural lenders reported that farm loan availability turned positive, and collateral requirements eased slightly from third quarter levels. Reports also indicated that interest rates for agricultural loans moved lower across all categories. Compared to third quarter levels, rates for intermediate-term loans decreased 34 basis points and rates for operating loans moved down 28 basis points. In other categories, interest rates for long-term real estate loans fell 19 basis points, and interest rates for feeder cattle loans dropped ten basis points.

In the fourth quarter, 75 percent of lenders reported that they had actively sought new farm loans, up slightly from last quarter's reading of 73 percent. Fourth quarter land prices were slightly below the previous quarter and considerably lower than year ago levels. Bankers expected farm loan volumes in the first quarter of 2009 to continue a downward trend led by further weakness in the demand for dairy and feeder cattle loans.

National Ag Risk Education Library Survey

In an effort to better understand what is happening in the agricultural economy, a survey[10] was conducted in January 2009 by the Extension Risk Management Education Regional Centers and the Center for Farm Financial Management at the University of Minnesota, funded through the USDA CSREES Risk Management Education Program. Twenty-three hundred agricultural professionals responded to the survey, whose respondents represented various agricultural disciplines: Lenders—21 percent; educators—43 percent; crop insurance representatives—7 percent; consultants—6 percent—elevators, cooperatives, marketing brokers and nonprofits 22.5 percent.

Currently, 63 percent of respondents stated that ten percent or less of the producers they work with are experiencing financial stress, with 15 percent indicating that less than two percent of the producers they work with are currently experiencing financial stress.

In the next 3 years, however, more than 28 percent of respondents expect at least 30 percent of their agricultural clients will experience financial stress. Seventy-five percent of respondents expect 11 percent or more of producers will experience financial stress in the next 3 years.

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[7] The Federal Reserve Bank of Dallas covers the Eleventh Federal Reserve District, which includes Texas, northern Louisiana and southern New Mexico.

[8] The Chicago Fed serves the Seventh Federal Reserve District, a region that includes all of Iowa and most of Illinois, Indiana, Michigan and Wisconsin.

[9] The Federal Reserve Bank of Richmond, (Fifth district) comprises Maryland, the District of Columbia, Virginia, North Carolina, South Carolina, and most of West Virginia.

[10] This survey can be accessed at: *http://www.agrisk.umn.edu/Library/Display.aspx?RecID=3971.*

Twenty-six percent of lenders think the probability is very high that producers will experience financial stress in the next 3 years. Fifty-four percent of lenders expect the probability of financial stress to be "high."

It is particularly interesting to note the reasons stated for expected financial stress in agriculture over the next 3 years. The first five reasons given were: Price/input cost margins; price volatility; negative cash flows; inadequate business planning; and lack of financial planning skills. Tightening credit availability was sixth on the list of thirteen reasons and was cited as having "moderate" impact. The lowest rated factors expected to have an impact on farm financial stress were rising interest rates and declining land values.

Farm Credit System Considerations

The Farm Credit System (FCS) is a government sponsored enterprise (GSE) that is unique in that, unlike other GSEs, it competes with private sector lenders at the retail level. The financial crisis has proven that not only do GSEs have the *implicit* backing of the Federal Government; they also have the *explicit* backing of the Federal Government. Just like the nation's largest banks, they would not be allowed to fail in times of financial difficulty. The FCS, as a competitor of community banks, also has unique advantages—it can typically raise funds cheaply in the government debt markets and FCS institutions have numerous tax advantages enabling them to offer lower rates than commercial bank competitors.

This has led to FCS entities cherry picking prime farm loans from community banks as FCS institutions seek the very best customers from bank portfolios. Allowing this practice, unintended by Congress, can discourage community bank involvement in the agricultural sector, reducing the amount of resources and institutions available to farmers.

The performance numbers of the FCS indicates this as well. Compared to commercial ag banks' ROE of 7.6 percent and ROA of 0.8 percent for September 2008, FCS associations' ROE for the same time period was 10.85 percent and associations' ROA was 1.70 percent.

Community banks serving agriculture should receive the same tax benefits as FCS associations. In this century, it no longer makes sense to provide billion-dollar and multi-billion dollar FCS institutions tax advantages over much smaller commercial lenders to compete for the same customers. The benefit of equalizing the playing field will accrue to the end-user, the farmers and ranchers.

ICBA Recommendations to Congress

While it is difficult to predict accurately what will happen in American agriculture 2 or 3 years down the road, we believe that Congress can have a positive influence by making wise decisions now on a number of key policy choices. Our recommendations are as follows:

1. Keep the farm safety net intact without budget cuts. The 2008 Farm Bill was difficult to enact but represented an important investment in rural America's future. As such, the funding commitments should be kept in place because many lenders and farmers have made long term planning decisions based on the farm bill's safety net. ICBA has joined over three dozen other interested organizations in recent letter(s) [11] to Congress explaining the rationale for requesting no further cuts to the farm bill.

2. Provide additional funding for USDA direct and guaranteed farm loans. Appropriations bills in both the House and Senate contain significant new money to meet recent projections for increased demand for direct and guaranteed farm loans. It is our understanding that the dollar numbers in the House bill are closer to meeting expected demand for direct operating loans. The House Agriculture Appropriations bill would provide $400 million of direct operating loans, $300 million in direct ownership loans and $50 million in guaranteed operating loans. However, it appears that approximately $150 million in guaranteed operating loans will be needed to meet demand so more money should be added for guaranteed operating loans. These programs assist borrowers who cannot obtain credit elsewhere and are an important backstop for farmers who need temporary assistance until they are able to graduate to commercial credit.

3. Enhance USDA's Business and Industry (B&I) loan program. Congress added significant new money for USDA's rural development efforts as part of the recently enacted economic stimulus package (P.L. 111–5). The new funding would allow an additional $3 billion of business and industry loans in addition to $1 billion of loans provided as part of USDA's regular budget. However, the funds to provide

[11] Letter to Chairman DeLauro and Ranking Member Kingston, June 4, 2009 from 41 organizations.

$3 billion in new B&I loans will expire October 1, 2010. It will be important for USDA to aggressively market the program to lenders and provide adequate information in order to utilize these new funds.

Even more importantly, we believe the B&I program needs to be enhanced (at least for the new funding) by: (A) implementing no more than a one percent origination fee; (B) increasing guarantees on loans under $5 million from the current 80 percent level to 90 percent—perhaps even 95 percent on smaller loans; and (C) not eliminating the low doc application as USDA appears to be on the verge of doing for smaller loans.

These changes would help ensure the program is attractive enough for lenders and their customers and will ensure that Main Street rural America has the resources necessary to ride out any storms on the horizon that could result from stress in the agricultural sector.

4. Ensure that the FCA does not proceed with its Rural Community Investments Proposal. This proposal poses significant new risks to the FCS and its borrowers and should not be adopted. The proposal appears to be illegal and was never considered or authorized by Congress. It allows FCS to extend credit, mislabeled "investments," for a vast array of purposes never intended by Congress. These purposes include extending credit for non-farm business financing, apartment complexes, construction projects and virtually any other purpose. This wide non-farm reach of FCS institutions will move FCS lenders further away from serving farmers and ranchers—the specific reason it was created and granted GSE tax and funding privileges.

5. Ensure that regulators not unduly restrict lending by community banks. Regulators can have a major impact on the ability of lenders to extend credit particularly if they engage in unduly harsh examinations at the local level. Many community banks believe this is occurring. Members of Congress should interact with regulatory agencies and stress the need to allow the banking sector to work with farm customers during difficult financial times that may lie ahead. Such regulatory flexibility allowed many farmers to survive the turbulent times of the 1980's farm crisis but was the result of clear and strong messages sent by Congress.

6. Avoid unintended consequences resulting from imposing new requirements on the banking sector. In recent months there have been various proposals aimed at bank recipients of TARP funds that would impose unnecessary costs and regulatory burdens on banks. Such proposals have included requiring commercial banks to write down principal and interest on troubled loans as the first option to consider when restructuring loans. Bankers already work with their customers and utilize a wide variety of options to keep customers in business. Seeking to dictate from Washington formulaic regulatory regimens will only add to the costs and complexity of working with borrowers and is unnecessary.

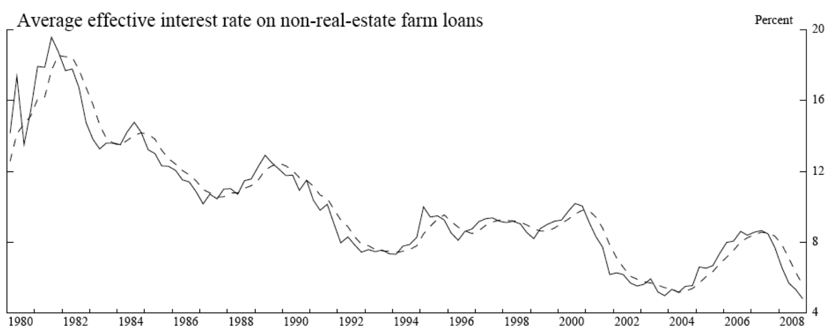
Conclusion

Thank you, Mr. Chairman, for the opportunity to testify today. Clearly, community banks did not cause the problems that resulted in the financial crisis but have done their part to work with borrowers and have even increased their lending during a period of economic contraction. In addition, thousands of community banks are providing loans to farmers and ranchers at historically low interest rates. ICBA urges the Subcommittee to adopt the recommendations provided in our testimony to enable the community banking sector to do even more to serve American agriculture and our rural communities. We look forward to working with you and the Members of this Subcommittee and full Committee.

ATTACHMENT

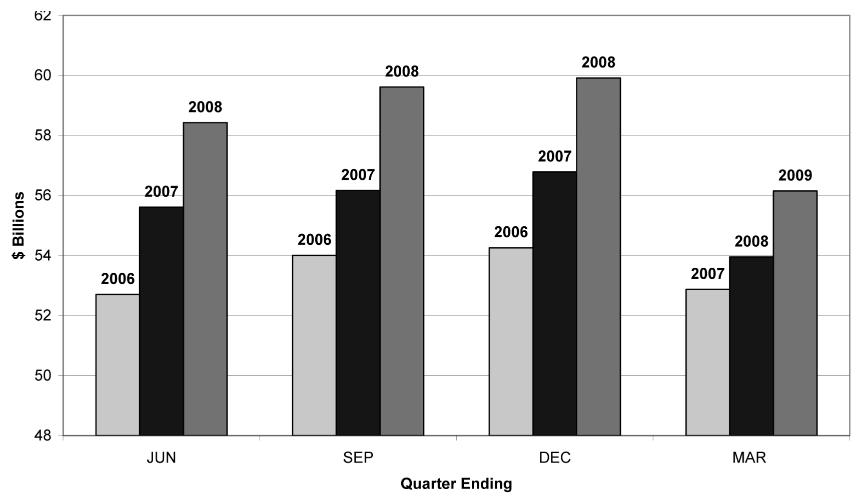
Asset Size ($ Million)	Percent of Ag Loans at Commercial Banks	Number of Banks
Less than $100	16.09%	2,507
100-500	33.96%	2,677
500-1,000	10.44%	474
1,000-10,000	17.85%	347
Greater than 10,0000	21.66%	66

Source: Illinois Farm Economics Update, *Financial Markets in Agriculture,* Ellinger and Sherrick, October 15, 2008, p. 3.



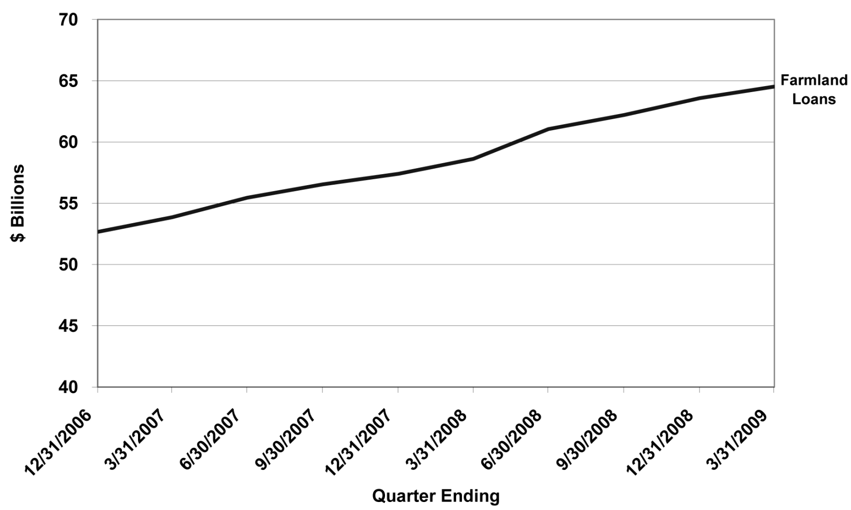
Source: Federal Reserve's Agricultural Finance Databook, Dec. 2008.

U.S. Commercial Banks: Total Non-Real Estate Farm Loans



Source: FDIC.

U.S. Commercial Banks: Total Farmland Loans



Source: FDIC.

The CHAIRMAN. Thank you, Mr. Bauer.
Mr. Gerber.

STATEMENT OF MICHAEL A. GERBER, PRESIDENT AND CEO, FEDERAL AGRICULTURAL MORTGAGE CORP. (FARMER MAC), WASHINGTON, D.C.

Mr. GERBER. Chairman Holden, Ranking Member Goodlatte, and Members of the Subcommittee, thank you for inviting Farmer Mac to testify here today.

I am Mike Gerber. I am the President and CEO of Farmer Mac. Farmer Mac was created by Congress in 1987 to provide lenders in rural America with enhanced liquidity and lending capacity. We do this by providing a secondary market for agriculture real estate lines, rural housing mortgage loans, and rural utility credits. As a result, lenders are able to offer agricultural and rural borrowers loan products that provide longer-term funding at stable rates.

Farmer Mac is not a direct lender. Instead, we work through the network of commercial banks, insurance companies, Farm Credit institutions, rural utilities, lenders, and others who work directly with agricultural and rural borrowers.

In addition to providing a secondary market for real estate and rural utilities loan assets in rural America, Farmer Mac is also an active purchaser of USDA-guaranteed loans. All of these loans can be pooled and those securities can then be sold to investors in the capital markets, retained on the lenders' books, or retained by Farmer Mac as part of its portfolio.

Loans in our portfolio grew to a record $10.1 billion in 2008. Portfolios performed well, with the notable exception of ethanol loans. Delinquencies on non-ethanol loans as of March 31 remained near historically low levels at .67 percent.

Farmer Mac funds its purchases of eligible loans by issuing debt. While our access to the debt markets has been uninterrupted, the recent turmoil in the financial markets has presented challenges to that access. In particular, placing medium-term notes for terms longer than 5 years continues to be a challenge. It is crucial that we have access to the medium-term note market at reasonable cost if we are to provide lenders a full range of competitive projects.

Farmer Mac maintains a liquidity portfolio also in compliance with governing regulation. That portfolio allows us to manage our short-term funding needs, as well as to protect us in the event of an interruption in our funding sources.

In September of 2008, Farmer Mac suffered losses totaling $106.2 million on two investments: Fannie Mae Preferred Stock and Lehman Brothers Senior Debt Securities. Without additional capital, Farmer Mac would have been below regulatory minimum and out of capital compliance with a key safety and soundness measure. To offset those losses and to ensure compliance, we raised over $124 million in additional capital through the preferred stock offerings, with investors representing all segments of our business partners: A commercial bank, the Farm Credit System, the National Rural Utilities Cooperative Finance Corporation, and an institutional investor. We appreciate this strong display of support from our business partners.

As of March 31, our capital access above the regulatory minimum was above $67 million. That private capital assistance was necessary because Farmer Mac does not receive appropriated funds, and has not received any government assistance through Treasury programs.

The combination of the investment losses and market disruption necessitated quick action on the part of the board of directors to ensure the financial health of Farmer Mac. They removed the CEO and CFO, and I was asked to step in as the CEO and President on an acting basis and was hired as a permanent CEO replacement in March of this year.

Our focus since that time has been on assuring the stability of our business, mitigating the risk on our balance sheet, enhancing our capital position, and continuing to look for ways to provide financial products for our customers.

While we still have some work to do, we have made progress. We have taken no more losses in our investment portfolio. We have been able to place debt every day in the marketplace to fund our new business and replace maturing debt.

Delinquencies and charge-offs remain within manageable levels. We generated $33.5 million worth of net book earnings in the first quarter of 2009, even with allowance charges for ethanol.

We do believe there will continue to be opportunities to grow our business and meet the needs of lenders who serve rural America.

Today, we have loans purchased from over 370 different lending institutions. We continue to grow our partnership with the ABA. We have a partnership with the Independent Community Bankers of America. We continue our relationships with many Farm Credit institutions. We now have the opportunity to work with the National Rural Utilities Cooperative Finance Corporation. We look forward to working with these entities to serve rural America.

Our Congressional mission is clear and our focus is on rural America. We believe Farmer Mac has a unique opportunity and is in a unique position to help serve rural America.

Thank you.

[The prepared statement of Mr. Gerber follows:]

Prepared Statement of Michael A. Gerber, President and CEO, Federal Agricultural Mortgage Corp. (Farmer Mac), Washington, D.C.

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear today to testify on behalf of the Federal Agricultural Mortgage Corporation known as Farmer Mac. My name is Michael Gerber and I am the President and Chief Executive Officer of Farmer Mac, headquartered here in Washington, D.C.

Farmer Mac provides a secondary market for agricultural real estate, rural housing mortgage loans and some rural utilities loans. This secondary market increases the availability of long-term credit at stable interest rates to America's rural communities, including farmers, ranchers and rural residents, and provides those borrowers with the benefits of capital markets pricing and product innovation. Farmer Mac is a stockholder-owned, federally chartered instrumentality of the United States and part of the Farm Credit System.

Created by Congress in the aftermath of the agricultural credit crisis of the 1980's when land values fell, credit policies tightened and there was a wave of farm foreclosures, Farmer Mac helps ensure liquidity and lending capacity for agricultural lenders. Every day Farmer Mac interacts with all types of rural lenders (banks, Farm Credit System members and insurance companies) throughout the country. We serve as a bridge between institutional investment pools of capital and main street Rural America.

Farmer Mac maintains a portfolio of investments to manage risk, liquidity and short term surplus funds. Last fall, when the global credit crisis adversely affected the values of many securities, Farmer Mac's portfolio of investments, which at the time included Fannie Mae preferred stock and Lehman Brothers senior debt securities, was dramatically impacted. Reflecting primarily the severe market declines in these two securities in September, Farmer Mac recognized a total loss of $106 million during 2008, necessitating quick action on the part of its Board of Directors to assure the financial health of the organization and its capabilities to fulfill its ongoing mission to Rural America. The Board responded by replacing the CEO and beginning a process to revaluate the business model. In the last 8 months management has raised over $124 million of capital to assure it is in capital compliance. Though challenges exist in the ethanol segment of our loan portfolio, the other segments are performing very well. As a result, despite the difficult economic times generally, Farmer Mac has continued to provide access to our programs for banks, Farm Credit System members and other agricultural lenders in a sound manner.

Farmer Mac Programs

Farmer Mac accomplishes its Congressional mission of providing liquidity and lending capacity to agricultural and rural utilities lenders by:

- purchasing eligible loans directly from lenders;
- guaranteeing securities representing interests in, or obligations secured by, pools of eligible loans; and
- providing credit enhancements that enable lenders to transfer risk and enhance their capital position.

Farmer Mac conducts these activities through three programs—Farmer Mac I, Farmer Mac II and Rural Utilities. Farmer Mac offers loan products designed to increase the liquidity of agricultural real estate mortgage loans and the lending capacity of financial institutions that originate those loans. As of December 31, 2008, the total volume in all of Farmer Mac's programs was $10.1 billion.

Under the Farmer Mac I program, Farmer Mac purchases or commits to purchase eligible agricultural mortgage loans or securities backed by eligible loans. Loans must meet credit underwriting, collateral valuation, documentation and other specified standards. Small farms account for 65% of Farmer Mac guarantees and commitments and the average outstanding loan balance for Farmer Mac I loans is $279,000.

Under the Farmer Mac II program, Farmer Mac purchases the guaranteed portions of loans guaranteed by the U.S. Department of Agriculture. Eligible USDA-guaranteed portions include Farm Service Agency Guaranteed Farm Ownership and Term Operating Loans and Rural Development Business and Industry and Community Facility Guaranteed Loans.

In May 2008, Congress expanded Farmer Mac's charter to authorize the Corporation to purchase, and to guarantee securities backed by, loans made by cooperative lenders to cooperative borrowers who have received or are eligible to receive loans under the Rural Electrification Act of 1936 (REA). These loans are for the financing of electrification and telecommunications systems in rural areas. This expansion has been very successful, with Farmer Mac working with National Rural Utilities Cooperative Finance Corporation to provide nearly $1.8 billion of funding for electric coops to date. Last month we created a structure that could provide an additional $1 billion in funding, bringing the potential total of the program up to nearly $3 billion. We are grateful to the support from Congress in approving this farm bill provision.

After buying a loan, Farmer Mac can pool the loans together, securitize them, and guarantee the timely payment of interest and principal. Securities Farmer Mac guarantees are sold to investors in the capital markets, swapped in exchange for the loans and retained by the seller of the loans or held by Farmer Mac.

Farmer Mac funds its purchases of Farmer Mac Guaranteed Securities and eligible loans primarily by issuing debt obligations of various maturities in the capital markets. Farmer Mac's regular debt issuance and non-program investment assets support its access to the capital markets. While Farmer Mac's access to the debt markets has been consistent and uninterrupted, the recent turmoil in the financial markets has caused such access to be more challenging. As lenders seek Farmer Mac's products and services, favorable loan terms ultimately depend on Farmer Mac's access to the capital markets. In the face of these challenges, Farmer Mac has worked to develop new products to meet customer demand. Further, financial institutions that Farmer Mac currently conducts business with face a host of challenges beyond their agricultural lending product lines. Farmer Mac aspires to position itself as a critical element in delivering solutions to lenders that meet all of the financing needs of Rural America.

Strong Statute and Oversight

When Congress created Farmer Mac in the aftermath of the collapse of the agricultural credit delivery system, the legislators added requirements not previously included in any of the statutes establishing other Government-Sponsored Enterprises (GSEs).

Unlike the other existing GSEs at the time, the initial 1987 legislation required Farmer Mac to be regulated by a separate office (Office of Secondary Market Oversight) of an independent regulator, the Farm Credit Administration, for safety and soundness. The statute creating Farmer Mac expressly required that qualified loans meet minimum credit and appraisal standards that represent sound loans to profitable farm businesses. Farmer Mac's statutory charter (Title VIII of the Farm Credit Act of 1971 as amended), requires offerings of Farmer Mac Guaranteed Securities to be registered under the Securities Act of 1933 unless an exemption for an offering is available. This provision leads to the requirement that Farmer Mac comply with the periodic reporting requirements of the Securities Exchange Act of 1934, including quarterly reports on the financial status of the Corporation and reports when there are significant developments. This also put Farmer Mac under the regulatory authority of the Securities and Exchange Commission.

As required by its statutory charter, Farmer Mac has established underwriting, appraisal, and repayment standards for eligible loans taking into account the nature, risk profile, and other differences between different categories of qualified loans. These standards for agricultural real estate mortgage loans under the Farmer Mac I program at a minimum are intended to:

- provide that no loan with a loan-to-value ratio ("LTV") in excess of 80 percent be eligible;
- require each borrower to demonstrate sufficient cash-flow to provide adequate debt service on the loan; and
- protect the integrity of the appraisal process with respect to any loan.

Farmer Mac is required to set aside in a segregated account a portion of the fees it receives from its guarantee activities. This segregated account must be exhausted before Farmer Mac may issue U.S. Treasury obligations against the $1.5 billion that it is statutorily authorized to borrow in order to fulfill its guarantee obligations. That borrowing authority is not intended to be a routine funding source and has never been used.

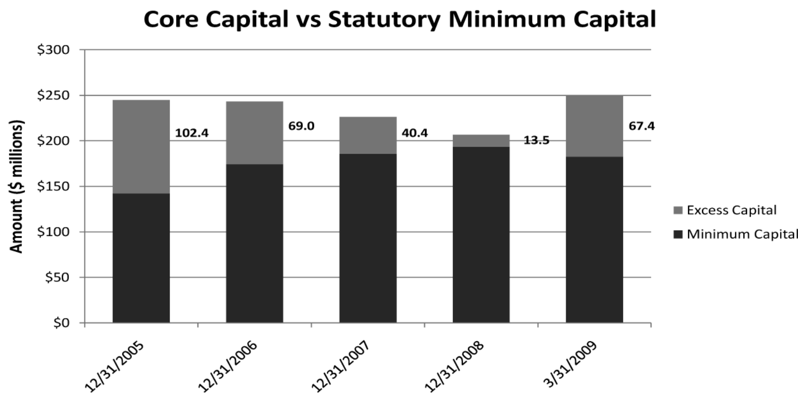
Focus on Minimizing Financial Market Volatility, Capital Strength, and Access to Debt Markets

As a result of the amount of losses in 2008 on its Fannie Mae and Lehman holdings, Farmer Mac conducted an extensive review of its investment policies and operations with a view to strengthening policies, procedures and oversight of its investment portfolio and related funding strategies. Farmer Mac is implementing initiatives and controls recommended as a result of this review, with the goals of minimizing the Corporation's exposure to financial market volatility, preserving capital and supporting the Corporation's access to the debt markets.

Maintenance of Regulatory Capital Levels

The Farm Credit Act established capital requirements for Farmer Mac. Farmer Mac must comply with the higher of the minimum capital or risk-based capital requirement. Its level of excess capital was $102.4 million at the end of 2005, $69 million in 2006, $40.4 million in 2007, $13.5 million in December of 2008 and $67 million as of March 31, 2009.

- **Core Capital meets regulatory requirements**



The Farm Credit Act directs the Farm Credit Administration to classify Farmer Mac within one of four enforcement levels for purposes of determining compliance with capital standards. As of March 31, 2009, Farmer Mac was classified as within level I—the highest compliance level.

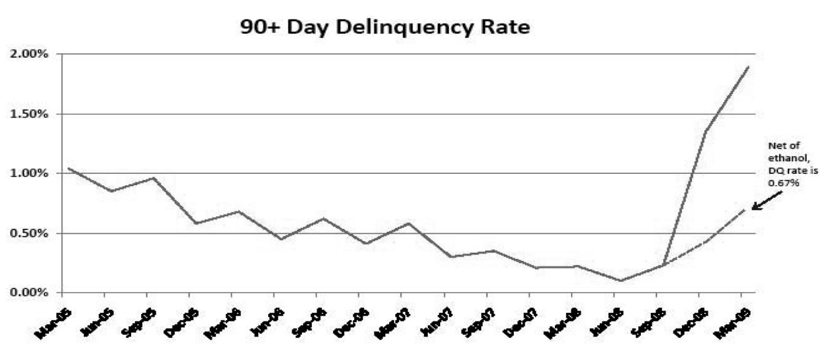
Since September of last year, Farmer Mac has been able to raise over $124 million in additional capital through preferred stock offerings with investors representing all segments of our partners—a commercial bank, Farm Credit System institutions, the National Rural Utilities Cooperative Finance Corporation and an institutional investor. Farmer Mac does not receive appropriated funds and has not received any government assistance through Treasury programs.

To ensure that it has adequate regulatory capital to support new business, in fourth quarter 2008 Farmer Mac began to require that lenders who place pools of loans in excess of $20 million into a Farmer Mac program purchase an equity interest in Farmer Mac in the form of Farmer Mac preferred stock.

Current Credit Conditions

As of March 31, 2009 Farmer Mac's ethanol portfolio consisted of loan participations with a cumulative unpaid principal amount of $293.3 million, with exposure to 29 different plants in 11 states. At the end of 2008 adverse developments in its ethanol portfolio caused a substantial increase in Farmer Mac's delinquencies and non-performing assets. However, other than the delinquent ethanol loans, the vast majority of loans underlying the Corporation's guarantees and commitments continue to perform well, with delinquencies on non-ethanol loans remaining near historically low levels consistent with the strength of the U.S. agricultural economy through the end of the year. Agriculture is a cyclical, weather driven business. At this time, the segment of the loan portfolio we are watching most closely is dairy. In addition, we are focused on non-irrigated loans in the west that continue to be pressured by water supply issues exacerbated by drought conditions.

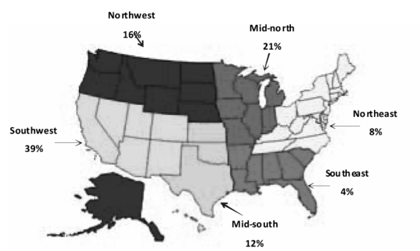
- **Absent ethanol, delinquencies remain low**



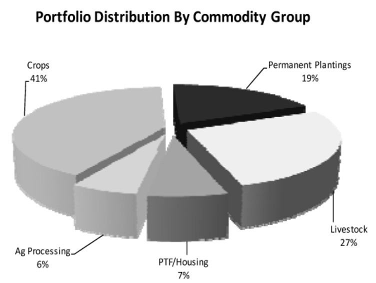
Commodity/Geographic Diversity

It is Farmer Mac's policy to diversify its portfolio of loans held and loans underlying Farmer Mac I products, both geographically and by agricultural commodity/product. Farmer Mac directs its marketing efforts toward agricultural lenders throughout the nation to achieve commodity/product and geographic diversification in its exposure to credit risk. Farmer Mac evaluates its credit exposure in particular geographic regions and commodities/products, adjusted for the credit quality of the loans in those particular geographic regions or commodity/product groups relative to the total principal amount of all outstanding loans held and loans underlying Farmer Mac I products.

Geographic Diversification



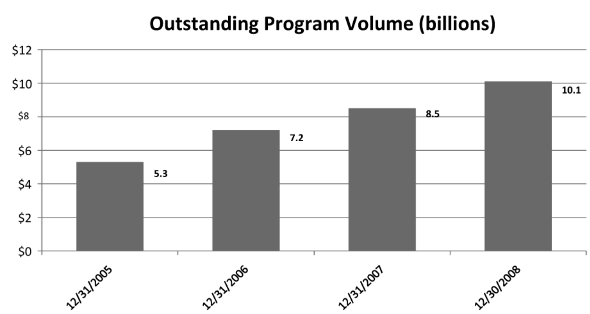
Industry Diversification.



Program Growth

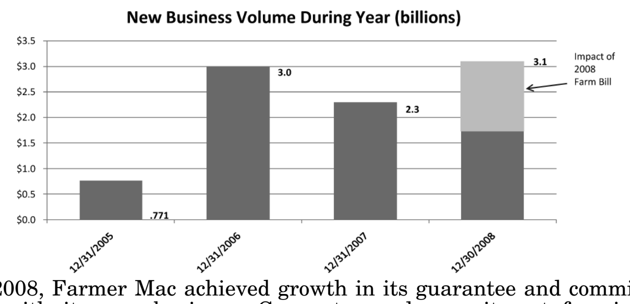
Farmer Mac's business experienced positive developments during 2008. Farmer Mac added a record $3.1 billion of new program volume, compared to $2.3 billion in 2007. Farmer Mac's total outstanding program volume as of December 31, 2008 was $10.1 billion, compared to $8.5 billion as of December 31, 2007 and $7.2 billion as of December 31, 2006.

- **2008 Program volume set new record**



The farm bill, which expanded Farmer Mac's authority to include providing a secondary market for rural electric and telecommunications loans made by cooperative lenders to cooperative borrowers, resulted in $1.8 billion of new program volume for Farmer Mac to date. This volume contributed greatly to the record level of $3.1 billion in new growth in 2008 and contributed additional diversification when compared with the agricultural loans in Farmer Mac's portfolio.

- **New Loan Business increased in 2008**



During 2008, Farmer Mac achieved growth in its guarantee and commitment fees associated with its core business. Guarantee and commitment fees increased to $28.4 million for 2008. Farmer Mac also maintained access to the capital markets at favorable rates throughout 2008, as the Corporation's short-term borrowing costs were significantly lower than historical levels. Consequently, Farmer Mac's net interest income was significantly higher during 2008 than in previous years. For 2008, net interest income including (expense)/income related to financial derivatives was $61.7 million.

Relationships

As of December 31, 2008, more than 370 lenders were participating in one or both of the Farmer Mac I or Farmer Mac II programs. Farmer Mac has initiated partnerships with the American Bankers Association and the Independent Community Bankers of America to increase participation by banks. We have continued our long standing relationships with many Farm Credit System institutions and our ongoing relationship with National Rural Utilities Cooperative Finance Corporation is providing new products to help rural electric cooperatives improve their financing. Our business partners are the conduits to providing the benefits of Farmer Mac programs to farmers, ranchers, rural utilities and rural residents and we will continue our efforts to expand these relationships.

Conclusion

Our focus since last fall has been on assuring the strength of our business, mitigating the risk on our balance sheet and enhancing our capital position. We are succeeding in our efforts, and we are beginning to realize the benefits.

While lenders in both the agricultural and rural utilities sectors continue to face both capital markets and challenges brought on by these economic times, Farmer Mac is continuing to work with its partners to provide products to respond to their needs. As evidenced through our commitment to meet the challenge Congress put before us just last year in the form of expanded authority for rural utilities lending, we stand ready to support additional expectations.

We thank you for the opportunity to present Farmer Mac to you today. We look forward to working with Members of Congress and our partners to fulfill our mission of bringing liquidity and the benefits of the secondary market to Rural America.

The CHAIRMAN. Thank you, Mr. Gerber.
Mr. Sullivan.

STATEMENT OF PATRICK SULLIVAN, ECONOMIC DEVELOPMENT SPECIALIST AND LEADER, AGRICULTURAL MEDIATION PROGRAM PROJECT, NEW MEXICO STATE UNIVERSITY, LAS CRUCES, NEW MEXICO, LAS CRUCES, NM; ON BEHALF OF COALITION OF AGRICULTURAL MEDIATION PROGRAMS (CAMP)

Mr. SULLIVAN. Mr. Chairman and distinguished Members of the Subcommittee, thank you for the opportunity to testify before you today. My name is Patrick Sullivan. I am with Mexico State University. And I am here today testifying on behalf of the 34 state

Coalition of Agricultural Mediation Programs that are scattered across the United States.

The Coalition of Mediation Programs, or CAMP, is a clearinghouse; basically a forum for sharing ideas, information, and commonalities amongst the various state programs.

These programs originated back in the late 1980s as a result of the ag credit crisis. They were actually authorized under the 1987 Farm Credit Act at that time to try to work with borrowers and lenders that were suffering from financial distress at that time.

Since the inception of this program, what we have tried to do is provide a neutral forum to discuss complex agricultural issues. Furthermore, the nature of this process provides stability and diversity that allows farmers, ranchers, and agricultural producers a forum to work out their own agreements with lenders and suppliers of credit for these operations.

Today, the state-certified mediation programs assist agriculture producers and creditors from various USDA agencies to address loan problems and USDA adverse decisions as a result of the Reorganization Act of 1994. These mediation processes, as I said, allow people to develop their own solution based on the uniqueness of their situation.

I would like to reference, Mr. Chairman, a recent survey that was put out by the University of Minnesota, along with the Centers for Risk Management, whereby they surveyed 2,300 respondents from different agriculture professions—ag creditors, educators, crop insurance representatives, consultants, and other people—and based on the results of that survey, 84 percent of the respondents expected the probability that producers will experience some kind of financial distress in the next 3 years was rated as high to very high.

When this was broken down by lenders only, that was still 54 percent of the lenders believed that the likelihood that agriculture producers would experience financial stress is high. And 20 percent of the agriculture lenders in this survey thought that it would be very high.

In this same survey, when questioned about factors contributing to farm financial stress, the respondents to the survey ranked the price and input cost margins and price volatility as having the highest impact on agricultural producers.

The survey respondents also were asked about changes in the amount of documentation required by lenders for loans. In response to that, 26 percent of the respondents indicated that they had seen, or yet to see, any change in documentation; 56 percent indicated a slight increase in the amount of documentation; and only 17 percent indicated that they had seen substantial increases in the amount of loan documentation.

Perhaps the most interesting element of this survey, though, was the respondents were asked how well they thought producers were equipped in terms of financial management skills to deal with business through these tough financial and economic times. And the response indicated that 74 percent thought that most farmers were moderately well prepared or equipped to deal with this, and that only eight percent were very well equipped to do this.

I am going to provide some regional responses that we received from the different states, real quick: many of the things we have hit on today, some of the factors that we are seeing the most, as far as financial disputes, is in the dairy industry. We see that basically from coast to coast. The poultry integrators have suffered a multitude of financial problems. Again, most of it is related to the high cost of their inputs and the feed cost that they are having to bear at this time.

By and large, most states indicate that they haven't seen huge or large number of increases in the type of agricultural cases that we mediate across the country. There have been some pockets in the Midwest that have seen substantial increases, particularly in areas like Kansas and Minnesota, but by and large most of the states have reported that their ag credit cases have remained consistent, although they do anticipate that they will see increases later.

The largest single element that we are seeing right now is the unfunded or under-funded FSA loans, which has forced a number of borrowers in the interim to try to have to bridge this through credit cards and other means of credit. But by and large, like I stated, we haven't seen a real falter or problem with people being able to get credit for those that are creditworthy.

This concludes my testimony.

[The prepared statement of Mr. Sullivan follows:]

PREPARED STATEMENT OF PATRICK SULLIVAN,[1] ECONOMIC DEVELOPMENT SPECIALIST AND LEADER, AGRICULTURAL MEDIATION PROGRAM PROJECT, NEW MEXICO STATE UNIVERSITY, LAS CRUCES, NEW MEXICO, LAS CRUCES, NM; ON BEHALF OF COALITION OF AGRICULTURAL MEDIATION PROGRAMS (CAMP)

Mr. Chairman and distinguished Members of the Subcommittee, thank you for the opportunity to testify on the credit conditions in rural America. I am here today representing the USDA state certified 34 state Coalition of Agricultural Mediation Programs (CAMP). The purpose of CAMP is to serve as a presence and voice for the use of mediation in rural disputes. CAMP serves as a clearinghouse and forum for sharing ideas; examining commonalties and differences; and for enhancing decisions about the conduct of rural mediation programs.

State certified agricultural mediation programs were originally authorized by Congress in 1988 as a result of the 1980's agricultural credit crises. In 1988 Congress authorized USDA to develop and participate in State Certified Farm Mediation Programs under the USDA Farm Loan Mediation program as part of the Agricultural Credit Act of 1987.

At their inception, these programs functioned as Federal-state partnerships to provide a confidential, neutral forum to discuss and resolve complex agricultural credit issues. These programs facilitated rapid decision making by the involved parties and streamlined government involvement. Furthermore, because of the nature of the process, stability and diversity was supported in rural economies. Allowing states the flexibility to develop their own programs based on the needs of their state has proven to be a key element in the success and popularity of the programs.

In 1994, Congress expanded the program beyond agricultural credit under the USDA Reorganization Act. This Act authorized USDA to offer mediation as an option as part of the formal appeals process with respect to adverse decisions on USDA farm program issues.

Today, USDA state certified mediation programs continue to assist agricultural producers, their creditors and various USDA agencies to address loan problems, USDA adverse decisions and other disputes. The programs do this in a confidential and non-adversarial setting outside the traditional legal process of foreclosure,

[1] Economic Development Specialist and Agricultural Mediation Program Project Leader, New Mexico State University, Las Cruces, New Mexico.

bankruptcy, appeals and litigation. The mediation process allows people to develop their own solutions based on the uniqueness of their situations.

Outlook

A survey conducted by the University of Minnesota Center for Financial Management in conjunction with the regional Centers for Risk Management Education on "Agricultural Financial Conditions 2009" resulted in 2,300 responses from agricultural professionals across all 50 states. The distribution of the respondents to this survey is as follows:

Ag Lenders	21.1%
Educators	42.8%
Crop insurance	7.3%
Consultants	6.3%
Other (Elevators, Cooperatives, Marketing brokers, Nonprofits	22.5%

Based on the results of this survey, 84 percent of the respondents expect the probability that producers will experience financial stress in the next 3 years is high or very high. Lender only responses showed that 54 percent of the lenders believe that the likelihood that agricultural producers will experience financial stress in 2009 is high and 26 percent believe the likelihood is very high.

In this same survey, 63 percent of the respondents indicated that ten percent or less of the agricultural producers they work with are currently experiencing financial stress. However, 28 percent of the respondents indicated that they expect at least 30 percent of the producers will experience financial stress in the next 3 years.

When questioned about the factors contributing to farm financial stress, the respondents to the survey ranked price/input cost margins and price volatility as having the highest impact. These were followed by negative cash flows, inadequate business planning, lack of financial management skills, and tightening credit availability.

Survey respondents were also asked about changes in the documentation required of agricultural producers requesting financing from lenders in recent months. In regard to this question, 26 percent of the respondents indicated no change, 56 percent indicated a slight increase, and 17 percent indicated a substantial increase.

Perhaps the most interesting element of this survey was the response to "How well are producers equipped in terms of financial management skills to manage their business through a period of financial stress?" The responses indicated that 74 percent are moderately equipped and that eight percent are well equipped. The survey results indicated that only 18 percent are poorly equipped.

CAMP Observations

As previously stated, there are 34 USDA state-certified agricultural mediation programs. Participating states include: Alabama, Arizona, Arkansas, California, Colorado, Florida, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, and Wyoming.

While not all states have a USDA state-certified program, those that do, represent a broad cross section of agriculture in the United States. Furthermore, while there is some commonality of the agricultural credit issues affecting each of these states, many more are regional in nature. Therefore, for the purpose of this testimony, I will make observations based on three separate geographic regions of East, Midwest, and West.

East

CAMP states in eastern United States have indicated that overall, agricultural credit is available. However, the consensus is that there are challenges related to obtaining credit/financing that have not existed in the past. Most of these challenges are risk related in that lenders are more closely reviewing credit worthiness. Ultimately, because of overall economic instability, lenders are following good lending policies and practices and are being disciplined in their credit principals. Concern exists in several states that there is not sufficient funding for Farm Service Agency direct loans to meet the current demand.

All CAMP states indicated high input costs and low prices were the primary concern of most producers and that margins appear to be tight across the board. However, states in the East and particularly in the Northeast are reporting dire conditions for both conventional and organic dairy farmers. Many if not most dairy farms are unable to cash flow under the current conditions and their equity positions have eroded. As a result, several states have indicated that some dairy farmers are now using personal credit in an attempt to meet short-term farm credit needs.

Overall, the major issue appears not to be the availability of credit but rather the time it takes to secure credit. This is particularly true in situations where the producer has had to find a "new" agricultural lender or obtain credit through the Farm Service Agency.

As a result of these conditions, eastern states indicated an increase in stress for both the borrower and the lender. Mediation is proving effective in resolving agricultural credit disputes quickly and efficiently through the use of a neutral third party. By bringing the parties to the mediation table, the process has allowed for farmers to determine how or if they will continue farming while working with their lenders to explore and develop options.

Midwest

Most of the mid-western state programs echoed the observations made by the eastern states regarding the agricultural credit situation. The majority of states indicate a reasonably stable agricultural credit market. However, several states indicate that there as been a substantial increase in demand for both direct and guaranteed Farm Service Agency loans and while many of these loans have been approved, many loans remain unfunded. Also, several states indicate substantial increases in financial stress calls and an increase in complexity when compared to last year.

Several states indicate an anticipated increase in the value of farm production. However, this anticipated increase is being outstripped by the increase in production costs. States with dairy continue to see an economic decline in the industry. Also, poultry integrators, pork producers, cow/calf and feeder cattle operations are experiencing profit losses as a result of high input cost and low prices. The poultry industry has experienced closed facilities, reduced flock placements, and a reduction in grower contracts.

Isolated bank failures have resulted in farmers having a short time period to find financing and when financing can be found, collateral requirements are more stringent. Also, bank mergers and decentralization have resulted in changes in the way farmers have traditionally been financed. On longer can a farmer amortize a loss year over several years but rather the farmer is forced to obtain outside financing.

As interest rates increase, farmers that are dependent on financing will continue to see downward pressure on profitability and their ability to cash flow. Lenders are more closely scrutinizing cash flow and the value of collateral. Because of increased credit restrictions, more and more farmers may be forced to use credit cards to finance their operations.

USDA state-certified mediation programs in the Midwest are utilizing mediation to empower individuals to resolve difficult financial situations by providing them with confidence and the ability in a neutral setting to make and consider objective, business-based solutions. This allows producers and their creditors to mediate and resolve the situation rather than being subjected to a decision imposed by a court.

Several Midwest state programs provide free financial counseling prior to mediation. Ono-on-one intensive counseling allows the producer to consider the feasibility of restructuring. Ultimately, this assists both the borrower and the lender to negotiate objectively and effectively in the course of mediation.

Mediation has a substantial impact on rural communities. Helping one farmer restructure their operation to stay in business has an impact on: fuel dealers, seed and input suppliers, agricultural lenders, commodity storage facilities, schools, local businesses, extended family members involved in the operation, and many others. In Kansas, statistics indicate that one in five individual's occupations relate to agriculture. From the standpoint of the multiplier effect, it is estimated that for every dollar of farm income, $2.38 are generated in other income throughout the state.

West

Generally, the overall crop situation in the West is strong. Adequate sources of credit are available to strong borrowers with fewer sources available to moderate or weak agricultural borrowers. Not unlike other parts of the country, high input prices have taken a toll on profitability. Also, the low milk prices and high feed costs have adversely affected dairy producers throughout the West.

Conditions are worse in Colorado as a result of the FDIC takeover of New Frontier Bank, the largest agricultural lender in the state. Again, dairy producers, particularly those that were financed at New Frontier Bank are suffering from the current credit situation. Many dairy producers are finding it extremely difficult to find new financing.

Cattle feeders throughout the West are exercising extreme caution as a result of reduced profitability. Also, many input suppliers have constrained their credit policies such that all but the most creditworthy are COD and those with strong credit are net 30.

While traditional sources of agricultural credit for small and medium sized operations remain stable, agricultural credit for very large and/or specialized operations seems to be more limited or at least less time sensitive. Also, there are states in the West where Farm Service Agency lacked sufficient funding to fund all direct loan requests. As a result, there are producers midway through the production cycle that have loans approved that have not yet received the loan proceeds.

USDA state-certified mediation programs continue to utilize mediation and financial counseling to assist both borrowers and lenders in resolving agricultural credit disputes. The mediation process promotes calm and rational discussion by the parties to identify goals and options and to construct a plan that will benefit both the borrower and the creditor. Also, early intervention and counseling has proved effective in avoiding potential crisis that would otherwise lead to court ordered actions.

Summary

Overall, agricultural producers and agribusinesses that depend heavily on credit could be constrained. This is especially true with respect to dairy, poultry, cattle feeding and pork production. Farmers that are closely tied to local rural banks tend to have secure long-term relationships that should mitigate much of the economic crisis's effect on farm loans. However, without adequate funding for Farm Service Agency direct loans, many producers that have weak to moderately weak credit could find it difficult to secure adequate financing.

The CHAIRMAN. Thank you, Mr. Sullivan.

Mr. Frazee, Mr. Strom testified that the dairy portfolio for the entire System was about $12 billion. I think you said that reflected about 60 percent. What are the numbers at MidAtlantic?

Mr. FRAZEE. We are at about 12 percent of our portfolio. That would be something in the neighborhood of $250 million.

The CHAIRMAN. You also raised concerns that this Committee should keep sole jurisdiction over the farm system. I think that is an opinion all of us on this Subcommittee and Committee share. But would you care to elaborate why that is so important?

Mr. FRAZEE. We have been charged with the unique mission of providing a steady and reliable source of credit to agriculture; with that goes good times and bad. That means in lending institutions it is important that we dig deeper and understand the particular risks of agriculture, and they are unique. We have heard about the volatility that our producers are experiencing today. And we have all experienced that.

My fear is that if we get under a regulatory regime that covers all financial systems, given that agriculture is a comparatively small part of the overall banking system, that we might get lost in that. We won't have the unique expertise from a regulatory side that is necessary to provide the oversight that this Committee expects of the lender who is going to be there in good times and bad.

The CHAIRMAN. Mr. Gerber, beside higher review, can you elaborate what changes Farmer Mac made after the experience that you faced last year with Fannie Mae and Lehman Brothers?

Mr. GERBER. Sure. We have done a number of things: tightening hold positions; tightening our structures around buying and selling of pieces within our investment portfolio. We have looked at hold positions on the credit side of our business to make sure that we were managing the risks in the business. We have relooked at our policies and structures around all of the operations and are in the implementation phase of those things now.

In addition, we have looked at funding structures and reestablished or established some processes around which to do that. All of that was made available, or made possible, by the ability to raise capital. We did that twice in the last quarter, if you will; once in September and once in December. In addition, we raised new capital as part of a process as new business comes on the books.

The CHAIRMAN. For anyone on the panel—about access to the bond market. How has it changed since the event of last fall? How much more difficult is it? Anyone care to elaborate?

Mr. GERBER. From our perspective on the debt side of things, funding is tighter across the board and, as one of the panelists said earlier, it was a struggle as a result of, especially in the longer-term maturities, very challenging—anything over 5 years—to really place any debt.

The CHAIRMAN. Anyone else care to comment?

Mr. FRAZEE. I just echo that we saw those same challenges as well. It resulted in about a 150 basis point spike in rates last fall that either compressed our margins or were passed on to borrowers.

The second piece is that I have had borrowers say to me, "I have a loan now that is priced at 3 to 5 years, but what about over the long term?"

So it does raise questions in terms of what is going to be there for the longer term.

Mr. BAUER. The shorter term is actually at a historical low. Just the opposite of the curve on the long term. Right now, wholesale funding is at less than one percent for one year CDs. I have been a banker for 40 years and I have never seen that part that low.

The CHAIRMAN. Thank you.

The chair recognizes the Ranking Member, Mr. Goodlatte.

Mr. GOODLATTE. Thank you, Mr. Chairman. I would like to ask all of the panelists about the poor performance of the ethanol and biofuels loans due to the overcapacity in the biofuel sector. A number of you testified about that.

Why was the Farm Credit System so eager to finance this overcapacity? Anybody want to jump in on that? Mr. Gerber?

Mr. GERBER. Well, from Farmer Mac's perspective, our mission says we are to provide liquidity to rural America, and as financial institutions finance businesses, we provide that liquidity in whatever it is they are financing.

That said, ethanol, biofuels, the alternative fuel structure certainly is a part of rural America. It is a part of the business of agriculture. And we believe there is a role for Farmer Mac in that.

Mr. GOODLATTE. Do you think that the RFS standard and other artificial government mandates encourage the System to finance this overcapacity? I will ask you and Mr. Bauer and others as well.

Mr. GERBER. I wouldn't want to speak for the System. I guess I would let others do that.

Mr. BAUER. I don't participate in any ethanol financing, so I wouldn't have a good answer for you. But I am sure Mark Scanlon from ICBA can provide information on that.

Mr. GOODLATTE. Do any of you have any direct financing of ethanol or have an opinion about this?

Mr. FRAZEE. My association has no direct financing of ethanol, but we will be happy to get information to you for the record.

Mr. GOODLATTE. I am concerned that part of the problem that we find ourselves in is that there was a lot of over-promising built around the hope that somehow government could lead the way, and the ethanol sector overbuilt, and now the government is being asked to step in again and come to its rescue again.

I would predict that the industry is in difficulty unless the government does step in. I think that that is simply digging an already deep hole even deeper. If there isn't additional policy interference, is the domestic ethanol industry viable?

Any of you have an opinion on that?

Mr. GERBER. I would say I believe the ethanol industry continues to change. It continues in the stage of changes in the technology and the understanding of how to do that. We believe the industry is here to stay in some form. That may change. And, as I said, we believe it to be part of that rural America structure. So, as lenders look at those, Farmer Mac has the opportunity and the responsibility to look at if we can underwrite those in a safe and sound manner to provide that liquidity where possible.

Mr. GOODLATTE. Thank you.

Dr. DRABENSTOTT. Congressman, if I could just add. While, you are correct that there are some financial concerns that surround the ethanol industry as we have known it, we have been involved in a major regional development project in southern Minnesota that I think speaks in part to this issue. And it is very encouraging to see the high level of interest in the private sector to look beyond corn-based ethanol. And there is a very active pursuit of biomass-related ethanol technologies.

Mr. GOODLATTE. I fully agree with that. And I don't object to the government even helping to do some of the research and incentivize the startup of cellulosic ethanol, because clearly that is a source of energy that is less in friction with our food and feed supply production, which causes a number of us to chafe at the idea that the government ought to be favoring one group of customers for corn products over other such customers.

That is a different avenue than the ongoing desire to increase the mandates on how much ethanol needs to be used in automobiles and the continued tariff barriers on bringing in ethanol from elsewhere, when we are concerned about high energy costs and the mandate that I have already referred to, and the tax credit, the Blenders Tax Credit.

It is a concern to me that the industry, instead of finding its footing to sustain itself, is finding a greater and greater need for government support because of the fact that there was an overextension of credit and an over-construction of capacity in that area that couldn't be sustained without that government support, and may not be sustained even with it, with the existing level.

Mr. Chairman, I would like to ask Mr. Frazee about an entirely different subject.

MidAtlantic's status as a USDA preferred lender, what does that mean and what does that mean for your farmer borrowers?

Mr. FRAZEE. It means quicker turnaround, quicker service. As a preferred lender, basically I would agree with the FSA, that they will use our loan documents and our underwriting and empower us to make decisions on the spot. That comes with oversight.

We have an annual review by FSA of our portfolio and our credit administration practices, and, then on an annual basis situation, a decision is made whether we continue to have that kind of authority. Ultimately, what that allows us to do is to be able to respond much more quickly to our farmers' needs and structuring the packages they need to be successful.

Mr. GOODLATTE. Do you require your farm loan applicants to have crop insurance?

Mr. FRAZEE. We look at those on a case-by-case basis. Depends on the risk in the individual operation and the capacity of that individual borrower to bear risk.

Mr. GOODLATTE. Do you consider direct payments when calculating collateral?

Mr. FRAZEE. If you are referring to our evaluation repayment capacity.

Mr. GOODLATTE. Yes.

Mr. FRAZEE. We do look at direct payments and give consideration to that. We look at any source of repayment and have to make an assessment of the likelihood of those continuing. So we give some factoring to that as we look at our sensitivity analyses.

Mr. GOODLATTE. Has your definition of a *creditworthy* or *eligible borrower* changed since 2007?

Mr. FRAZEE. It has not. It has not changed since 2000 when we were formed. We did not loosen our underwriting standards and we have not tightened them.

Mr. GOODLATTE. I commend you on the stability that has benefited farmers in the Mid-Atlantic region, which includes Virginia, and hope that we will continue to see that kind of stability in the area of Farm Credit for agriculture which, as we have obviously discussed today, is a major concern, but has weathered this very difficult financial crisis better than some other sectors.

The CHAIRMAN. The chair thanks the Ranking Member and recognizes the gentleman from Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

For Mr. Bauer, have you seen a situation or have you endured recent regulatory examinations or folks in your area that have caused you, as a result of the examinations, to restrict credit or take a second look at processes and procedures, as a result, that impact the credit availability to farmers?

Mr. BAUER. Mr. Congressman, we have. In addition to being about 40 percent agriculture, about 40 percent of our loans in our bank are classified CRE, or commercial real estate. And along with that classification there has been a new definition of *well capitalized* that has come from the examiners.

Years ago, eight percent tiered to a risk-based capital was well-capitalized. That was raised to ten percent a number of years ago. And if you have levels above the supervisory-recommended levels of 300 percent of capital for defined loans, or 100 percent of capital for other defined CRE loans, the new rule of thumb is 12 percent capital.

What that means is I have to have 20 percent more capital to stay the same size if I am going to stay well-capitalized. So that limits my ability to make more loans, whether they be in the real estate sector or in the ag sector.

I am at about 117 percent risk-based capital, so that means I stay the same, shrink, or grow my capital through profits. So when somebody like the bank in Greeley, a $2 billion, probably 50 percent ag bank, folds up, it limits what I can do to absorb any of those ag customers. We have probably looked at about 60 ag customers in the last 90 days from that bank. We have made very few loans. We didn't even look at the larger ones, simply because we had no ability to grow the bank and take on customers in the $2, $3, or $4 million category.

So, yes, to answer your question, we were examined in October. And I have been a banker for 40 years, and that was the most unpleasant situation I have ever been through.

Mr. LEUTKEMEYER. Well, yours is not an uncommon story. I hear from a lot of my constituents in the banking community especially, independent communities bankers. They are kind of the backbone of rural America, yet they seem to be taking the brunt of the regulatory outcry instead of the big banks, which obviously one in your neighborhood failed as well.

Most of the smaller banks seem to be well-capitalized and seem to be run fairly efficiently, but yet they seem to be bearing the brunt of the regulatory angst or what is going on.

Do you know of other banks in your area that are facing that same problem—restricting credit?

Mr. BAUER. How many would you like to talk to?

Mr. LEUTKEMEYER. That is what I needed to know.

Mr. BAUER. Not one that I have talked to that—well, up and down the front range, you have to remember that is a lot of growth in northern Colorado, and so it involves a lot of CRE lending. And every one of them is singing the same song.

Mr. LEUTKEMEYER. It seems as though there is a disconnect between what is going on here in D.C. When you talk to the folks in D.C., they will tell you, We haven't changed standards, we haven't changed the way we looked at loans or bank capitalization. Yet, when you go out to the field and talk to the folks who are dealing with examiners who are there in their banks, it is a whole different story.

There is a disconnect there. I think that is something we need to take a look at at some point. I have had some discussions with the FDIC folks and the Federal Reserve folks, and it doesn't seem like—they have a hard time recognizing that fact. But I appreciate your testimony today because that tells me that, again, there is not just one area of the country, it is similar to everybody out there. So, thank you very much.

With regards to, Mr. Sullivan, very quickly, one of the things that you talked about in your testimony was some free counseling for the mediation for some folks who have some difficulties. Have you seen that go up? Do a lot of people take advantage of this? And what is the result of the credit counseling that people take advantage of?

Mr. SULLIVAN. Not all states offer counseling. Some programs do and some don't. Those programs that do have seen an increase in their credit counseling. Particularly states like Minnesota and Kansas have seen a larger number of credit counseling cases come on.

Also, of course, it is important to note that there was recently an article in the *Denver Post* where they talked about the number of crisis calls that have come in over the last I believe 4 years, or something like that, and a doubling of the number of suicides of agricultural producers.

Again, I don't think we are anywhere close to where we were back in the eighties in the ag credit crisis of that time, but we are seeing a steady incline. Not that overnight emergency-type situation that we were seeing back in the 1980s, but we are seeing more and more people that are calling, coming to us, asking questions, trying to figure out how they are going to resolve this.

Again, a lot of it reverts back to borrowers that were forced for the very first time to go to FSA for direct operating loans, only to be told that they were approved, but there was not funding for those types of loans. Of course, the credit counseling comes in handy at that time because it is a mechanism to try to help those people bridge that gap in the short term and try to work with their suppliers, their feed dealers, their fuel suppliers, people like that, to get them across that gap until, hopefully, we have adequate funding for those loans.

Mr. LUETKEMEYER. Thank you very much. I see my time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. I recognize the gentleman from Nebraska, Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman. My questions have been answered.

The CHAIRMAN. The chair would like to thank our witnesses for the participation in the hearing today. Thank you very much.

Under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplementary written responses from the witnesses to any questions posed by a Member.

This hearing of the Subcommittee on Conservation, Credit, Energy, and Research is adjourned.

[Whereupon, at 12:00 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) is pleased to submit this testimony for the record to the Subcommittee on Conservation, Credit, Energy, and Research of the House Agriculture Committee. We greatly appreciate the opportunity to provide information to the Subcommittee about agricultural credit conditions. The topic is extremely important and timely. Our nation is certainly facing difficult economic conditions which are affecting all businesses, including banks. The core business of banking is lending. That is what banks do. Banks will continue to be the source of financial strength in their communities by meeting the financial needs of businesses and individuals. Banks in every state in the country are actively looking for good farm and ranch loan opportunities.

Banks currently provide over $123.5 billion in loans to farmers and ranchers, which is more credit to farmers and ranchers than any other industry. We are pleased to report that the overwhelming majority of banks are highly capitalized, sound, and fully engaged in doing what they do best—making the widest range of credit and related financial services available to all Americans to keep our economy strong, growing, and vibrant.

The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than $125 million in assets—represent over 95 percent of the industry's $13.9 trillion in assets and employ over two million men and women.

Since the Start of the Economic Crisis the American Bankers Association has Increased Communications to Farm and Ranch Customers.

Since the beginning of the financial crisis, the American Bankers Association has ramped up communications to farmers, ranchers and all rural Americans about the availability of credit. ABA staff, our affiliated state bankers associations, and hundreds of volunteer bankers nationwide have actively communicated to their customers and communities that banks have adequate resources to make loans, that banks have a desire to make agricultural loans at competitive rates and terms, and that banks believe that agriculture is a good business to lend to.

At the same time, we have pointed out to our customers that economic conditions have changed and that agricultural producers (along with all other business borrowers) must recognize that the economic disruptions we have experienced has changed the nature of lending in general. We have pointed out that customers have to improve their firm's business risk profile. Bankers are asking their farm and ranch customers to provide more detailed information about their farm's financial performance, more details about their assets and liabilities, and have requested more information about their farm and ranch marketing plans. Our industry has increased credit underwriting scrutiny because there is a need for bankers to clearly demonstrate to their shareholders and to their regulators that prudent credit decisions are being made and that risks are being properly managed. Farm and ranch customers understand this as they too have had to request more information about the financial strength of their suppliers, buyers and others they do business with on a daily basis. To help farm and ranch customers meet the challenges they face in this harsher business climate, ABA has published numerous tip sheets for farmers and ranchers to help them increase their financial management skills. All of the tip sheets are available to the public on our web site, *www.aba.com.*

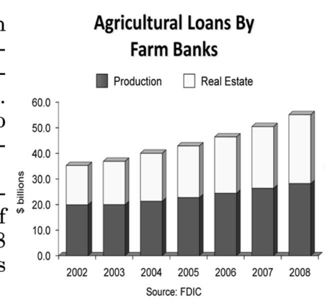
For the past 10 years, U.S. agriculture has enjoyed one of the longest periods of financial prosperity in history. Financially, American agriculture has never been stronger. In 2007 and 2008, American farmers and ranchers enjoyed some of their most profitable years ever. The balance sheet for U.S. agriculture at the end of 2008 (according to USDA) is the strongest it has ever been with a debt to asset ratio of less than ten percent. USDA projects that at year end 2009 farm and ranch net worth will be $2.171 trillion. This unprecedented high net worth is due in part to a robust increase in farm asset values (mainly farm real estate), but is equally due to solid *earned* net worth as farmers used their excess cash profits to retire debt and to acquire new plant and equipment. As a result, farmers and ranchers in 2009 have the capacity to tap their equity should there be a significant decline in farm profitability resulting in diminished cash flows. While no farmer or rancher wants to take on additional debt, the strength of the U.S. farm and ranch balance sheet gives producers options to do so if the need arises.

While the past 10 years may be looked back upon by historians as a "golden era" of farm prosperity, not all sectors of the farm economy are doing well in 2009. The livestock sector is under considerable financial pressure. Dairy prices have dropped to below break-even levels for many producers as demand has declined and dairy production continues to increase. The cattle feeding business has lost money for over twenty-four months. Poultry producers have been hurt by lower prices and by the collapse of the largest poultry integrator in the country in 2008. The hog industry, which was poised to recover from low prices in 2008, has been badly hurt by misguided fears of the H1N1 virus and the subsequent closure of some key export markets. Bankers are working closely with their customers who have been impacted by these developments. Bankers are restructuring, rescheduling, and re-amortizing debt to help their customers weather tough economic conditions. Most of these negative conditions can be clearly traced to the economic conditions that exist on a world-wide basis and will not completely turn around until the global economy improves.

ABA's Annual Survey of Farm Bank Performance Indicates that Farm Banks are Strong and Well Positioned to Lend.

For the last twenty plus years, the American Bankers Association has reviewed the performance of banks that we define as "farm banks". These are banks that specialize in making agricultural loans and that have a concentration of agricultural loans on their books. The data we analyze annually is generated by reports from the Federal Deposit Insurance Corporation (FDIC). Some of the highlights from our recently released report about 2008 farm bank performance (the entire report is available at *www.aba.com*):

- With strong farm income, farm banks [1] posted solid performance in 2008.
- Banks are a major source of credit to small farmers. The banking industry reported holding approximately $69.1 billion in small farm loans with almost $26.0 billion in micro-small farm loans on the books.[2] The number of small farm loans on the books of banks surpassed 1.2 million with the vast majority—almost 1.0 million loans—under $100,000.
- The demand for farm credit rose in 2008 and banks have met the challenge by increasing loans. Agricultural loans for farm real estate and production at farm banks increased almost 9.2 percent to $55.1 billion in 2008 from $50.5 billion in 2007.
- Almost $1 in every $3 lent by a farm bank in 2008 was an agricultural loan. Fueled by appreciating land values, outstanding farm real estate loans grew 11.7 percent to $26.9 billion. Loans to finance agricultural production also advanced, growing at an annual rate of 7.0 percent to $28.2 billion in 2008.
- Almost 93 percent of all farm banks were profitable in 2008 and approximately 39 percent of farm banks reported an increase in their 2008 profitability compared to a year earlier, as measured by return on average assets.



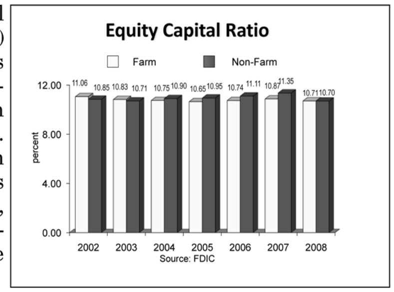
- During the last decade, farm real estate loans have become a larger share of the overall farm loan portfolio. In 2001, approximately 42 percent of farm loans held by farm banks were farmland loans. As of the end of 2008, 48.8 percent of farm loans were to finance farm real estate.

[1] Farm banks are defined by the American Bankers Association as banks with assets less than $1 billion whose ratio of domestic farm loans to total domestic loans greater than or equal to 14.20 percent for 2008. Twenty-one banks with more than $1 billion in assets had a ratio of farm loans to domestic loans greater than or equal to 14.20 percent.

[2] A small farm loan is defined as a loan with an original value of $500,000 or under. A micro-small farm loan is a loan with an original value of $100,000 or less.

- Moreover, farm banks are meeting the credit needs of small farmers.

Small farm loans (loans with an original amount equalto or less than $500,000) from farm banks totaled $32.8 billion as of the end of June 2008. Farm banks reported holding $9.8 billion in loans with an original value of $100,000 or smaller. In fact, about 23 percent or 517 farm banks only make farm loans that are less than or equal to $100,000. Additionally, farm banks held an additional $11.6 billion in farm loans with an original value between $100,000 and $250,000.



- Equity capital, a key measurement of bank financial strength, increased 6.5 percent to $26.6 billion in 2008 and core capital increased by almost $1.3 billion to $24.9 billion. Farm bank equity capital-to-average asset ratio was 10.71 percent at year end 2008.
- The loan-to-deposit ratio at farm banks remained high by historical standards. The ratio increased to almost 80.3 percent in 2008—up from 73.1 percent in 2001. However, the overwhelming majority of farm banks reported no shortage of funds in meeting the credit needs of their farm customers.

While Challenges May Lie Ahead for Agriculture, the Banking Industry is Well Positioned to Meet Their Customer's Needs

Since the collapse of the agricultural economy in the 1980s, the banking industry has provided the majority of agricultural credit to farmers and ranchers. While other lenders greatly shrank their portfolios of agricultural loans or exited the business altogether, banks expanded their agricultural lending. Bankers saw opportunity where others did not. Farmers and ranchers remember who helped them when the chips were down. This solid foundation of trust that was built during great the last period of great economic uncertainty is what the banking industry continues to build upon.

Thank you for the opportunity to submit this statement for the record.

SUBMITTED QUESTIONS *

Questions Submitted By Hon. Stephanie Herseth Sandlin, a Representative in Congress from South Dakota

Responses from Doug Caruso, Administrator, Farm Service Agency, U.S. Department of Agriculture, Washington, D.C.

Question 1. Is the FSA seeing an increase in young and beginning farmers applying for credit as a lender of last resort?

Question 2. What impact have the loan guarantees or programs for young and beginning farmers authorized in the farm bill helped to ease the situation, if at all?

Question 3. One of the largest hits to most ag loan portfolios across the banking system appears to have been from the volatility in the ethanol industry. Are you still making new loans for ethanol operating costs or facilities, or has lending to this industry stopped or dramatically slowed?

Responses from Hon. Leland A. Strom, Chairman and CEO, Farm Credit Administration

Question 1. Are Farm Credit System (FCS) institutions still able to provide credit to young and beginning farmers and ranchers, or are increased underwriting standards you mention in your testimony making it harder for these producers to obtain necessary credit?

Question 2. Do you know what percentage of loans made by FCS institutions that are non-performing come from young and beginning farmers or ranchers?

* There was no response from the witnesses by the time this hearing went to press.

Responses from J. Robert Frazee; Mark Drabenstott, Ph.D.; Fred J. Bauer; Michael A. Gerber; Patrick Sullivan

Question 1. Have certain regions of the country been more hardly hit by the changes in agricultural lending and increased production costs?

Question 2. What are some of the more effective tools or resources producers, agricultural lenders, and grain elevators can use to mitigate the impact of the economic downturn in their region and ensure that they will have access to credit despite increased caution now being exercised by most lenders, both commercial and through FCS institutions?

Questions Submitted By Hon. Timothy J. Walz, a Representative in Congress from Minnesota

Response from Hon. Leland A. Strom, Chairman and CEO, Farm Credit Administration

Question. Mr. Strom, as you probably know the rural communities that seem to be most successful at attracting employers are the ones that find ways to ensure that the essential community facility needs in their towns are met, such as in the area of healthcare facilities; good schools, reliable utilities. I know that Farm Credit can play a role in helping our rural communities have access to the capital required to put needed community facilities in place. Often this program brings together Farm Credit, commercial banks and USDA's rural development programs to make a project work.

I encourage this sort of activity and want to know what we can do to make sure that it continues to help other rural communities.

Responses from Mark Drabenstott, Ph.D., Director, (Rural Policy Research Institute) RUPRI Center for Regional Competitiveness; Research Professor, Harry S Truman School of Public Affairs, University of Missouri

Question 1. How does the Southern MN Regional Competitiveness Project point to the kinds of financial market needs for rural communities in the future?

Question 2. Can rural America benefit from having greater access to debt or equity markets for these types of projects?

Question 3. How can public policy help rural communities prioritize their investment needs?

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