REVIEW OF THE FEDERAL AGRICULTURAL MORTGAGE CORPORATION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

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REVIEW THE FEDERAL AGRICULTURAL MORTGAGE CORPORATION

WEDNESDAY, JUNE 2, 2004

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., in room 1300 of the Longworth House Office Building, Hon. Bob Goodlatte (chairman of the committee) presiding.

Present: Representatives: Boehner, Pombo, Smith, Lucas, Moran, Jenkins, Gutknecht, Ose, Osborne, Pence, Graves, Burns, Rogers, King, Musgrave, Neugebauer, Stenholm, Peterson, Dooley, Holden, Etheridge, Baca, Alexander, Marshall, Pomeroy, Thompson, and Udall.

Staff present: Dave Ebersole, Ryan Weston, Jen Daulby, Callista Gingrich, clerk; and Teresa Thompson, Howard Conley, and Russell Middleton.

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

The CHAIRMAN. Good morning. This hearing of the House Committee on Agriculture to review the Federal Agricultural Mortgage Corporation will come to order.

This morning the committee meets to examine the programs and financial products of the Federal Agricultural Mortgage Corporation, better known as Farmer Mac. Today's hearing will focus on an October 2003 report of the General Accounting Office entitled, "Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed." In this report, the GAO makes important observations about Farmer Mac's operations, and, as the title suggests, points to several issues this committee should be aware of in terms of Farmer Mac's mission and management.

As witnesses pointed out during a 1995 hearing before the Credit Subcommittee, Farmer Mac's reason to exist is to provide a secondary market for agricultural real estate mortgages that will translate into long-term, fixed-rate loans for farmers and ranchers. As envisioned when Congress adopted the Agricultural Credit Act of 1987, that market would be created by Farmer Mac's development of a marketable financial instrument known as an agricultural mortgage-backed security, or AMBS.

As it turns out, more than 8 years after the Congress freed Farmer Mac from many of the original operational constraints put in place as prudential policies of safety and soundness, the GAO reports that Farmer Mac holds most of the AMBS in its own portfolio, apparently for reasons of profits over the public policy requirements of its charter.

In addition to the GAO, we will hear from the Farm Credit Administration, which has increased over the last several months its examination and supervision of Farmer Mac's management and board activities as well as its portfolio of agricultural real estate loans and acquired property.

The committee has asked the Treasury Department for its views on Farmer Mac's ability to issue obligations to the Treasury should Farmer Mac need taxpayer assistance to satisfy its guarantee obligations for the timely payment of principal and interest on AMBS held in the Farmer Mac portfolio. A 1997 Treasury Department letter to FCA held then that Farmer Mac's statutory $1.5 billion line of credit at Treasury was available only for AMBS held by private investors. As I noted a few moments ago, few among the investing public holds Farmer Mac's AMBS.

Finally, the committee will hear from Farmer Mac's board chairman and its president, both of whom, we expect, will offer a balancing view of Farmer Mac's activities and current financial status.

With that, I will turn to my colleague from Texas, the ranking Democrat, Mr. Stenholm.

OPENING STATEMENT OF HON. CHARLES W. STENHOLM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. STENHOLM. Thank you, Mr. Chairman, and thank you for holding this oversight hearing today regarding Farmer Mac.

News articles and a recent report by the General Accounting Office have raised questions about Farmer Mac's operations. Therefore, this oversight hearing is particularly timely and will give us an opportunity to review Farmer Mac's mission. I think it is important that the committee get a better understanding of some of the issues that have been raised. As you know, Farmer Mac was established as a result of the Agricultural Credit Act of 1987. At that time, the entire agricultural credit system was under severe stress, and I am proud to say that we were able to devise a relief package that strengthened the overall system at little expense to the taxpayer. Farmer Mac was an integral part of that relief package and was designed to provide a secondary market for agricultural real estate mortgages. It was also designed to increase the availability of long-term credit to farmers and ranchers at stable interest rates.

Then, as now, I strongly support the need for that legislation and the additional dimension that it brings to agricultural lending. The Farm Credit System, community bankers, and other lenders, compete to provide farmers and ranchers with the credit needs necessary to produce the food and fiber that feeds our Nation and much of the world. Agricultural lending is no small enterprise, however, and there is currently $116 billion outstanding in agricultural lending in the United States. Farmer Mac helps in this endeavor by providing greater liquidity and lending capacity to system institutions and community banks for that purpose. Over the years, we have provided Farmer Mac with additional authorities and broadened its mandate. Farmer Mac has come under scrutiny in the last few years, however, as have almost all government-sponsored enterprises, including the Farm Credit System. This committee is responsible to the American taxpayer, and therefore, we must ensure that Farmer Mac, in this instance, is operating in an effective and prudent manner without undue Federal exposure.

I am particularly interested in hearing the views of today's witnesses on the recommendations made by the GAO with regard to legislative changes to the statute governing Farmer Mac. We must ensure that the Farm Credit Administration, Farmer Mac's regulator, has sufficient regulatory authority and is exercising that authority to ensure Farmer Mac's safety and soundness. Today's hearing will allow us to review the operations of Farmer Mac so that any necessary and appropriate action can be taken.

Again, thank you, Mr. Chairman. I look forward to the upcoming testimony.

The CHAIRMAN. I thank the gentleman.

Any other Members with opening statements, those statements will be made a part of the record.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you Chairman Goodlatte and Ranking Member Stenholm for holding this important oversight hearing on the Federal Agricultural Mortgage Corporation.

Farmer Mac (one of five Government Sponsored Enterprises, GSE's) is the secondary market for agricultural loans and is part of the Farm Credit System. By purchasing loans from agricultural lenders, Farmer Mac allows lenders to provide additional loans to borrowers. For example, if a lender makes a 30-year loan, the lender can sell the loan to Farmer Mac and use proceeds from the sale to make another loan, rather than have its funds tied up in the 30-year loan.

Both FCS and Farmer Mac are regulated under the Farm Credit Administration, which is led by a three-member board appointed by the President. Farmer Mac, created by Congress in 1987 as a result of the farm crisis in the mid-1980s, is a federally chartered and privately operated corporation that is publicly traded on the New York Stock Exchange.

To relieve structural impediments that had limited Farmer Mac's ability to function efficiently, Congress passed the Farm Credit System Reform Act of 1996, which significantly revised Farmer Mac's statutory authority and had significant impact on Farmer Mac's operations. Farmer Mac's net income has steadily increased from $4.6 million in 1997 to $22.8 million in 2002, for a total increase of 392 percent. On- and off-balance sheet program activity is now $5.8 billion. Non-program investments of nearly $1.7 billion resulted in Farmer Mac managing or guaranteeing assets of $7.5 billion at December 31, 2003.

During 2002, negative publicity about financial accounting and corporate governance within Farmer Mac generated congressional interest about the institution's safety and soundness and its mission as a GSE. As I understand it, the problem was that Farmer Mac was holding most of its loans it purchased from system institutions, instead of selling them as securities to investors. While this strategy is potentially more profitable, it is also more risky.

An October 2003 GAO report recommended that Congress consider legislation that would establish clearer, measurable mission goals for Farmer Mac. GAO also found concerns with risk management practices (Farmer Mac's impaired loans increased from zero in 1997 to $75.3 million at the end of 2002), lack of secondary market development, and lack of independence in Farmer Mac's board of directors. I am concerned about measurable accomplishments and the fact that most of the activity is in the Western United States.

However, since the 2003 GAO report, I believe that Farmer Mac has taken some of the necessary steps to enhance its risk management practices.

I look forward to the testimony.

The CHAIRMAN. We will now proceed to our first witnesses.

I would like to welcome our first panel: Ms. Davi D'Agostino, Director of Financial Markets and Community Investments, and Ms. Jeanette Franzel, Director of Financial Management and Assurance, both of the U.S. General Accounting Office; the Honorable Nancy C. Pellett, Chairman and Chief Executive Officer of the Farm Credit Administration, McLean, VA; and Mr. Gregory Zerzan, Deputy Assistant Secretary for Financial Institutions Policy, Department of the Treasury, also Washington, DC.

Ms. D'Agostino, we will start with you. I will advise all members of the panel that their complete statement will be made a part of the record, and we would ask that you limit your remarks to 5 minutes. Welcome.

STATEMENT OF DAVI M. D'AGOSTINO, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GENERAL ACCOUNTING OFFICE

Ms. D'AGOSTINO. Thank you, Mr. Chairman.

Mr. Chairman, Mr. Ranking Member, and members of the committee, we are pleased to be here with you today to discuss the results of GAO's work on Farmer Mac and the report we issued in October of 2003.

First, I will provide an overview of Farmer Mac, its mission, and portfolio. And second, I will provide our report findings on certain aspects of Farmer Mac's financial risks and its line of credit with Treasury, mission-related activities, board structure, and oversight provided by FCA, or the Farm Credit Administration.

First, Farmer Mac is a government-sponsored enterprise, or GSE, that is to provide a secondary market for agricultural real estate and rural housing loans, and to increase the availability of agricultural mortgage credit. Farmer Mac is also an independent entity within the Farm Credit System, or FCS, which is another government-sponsored enterprise. Farmer Mac is subject to the FCA's regulatory authority and examination. Farmer Mac's statute allows it to borrow up to $1.5 billion from the U.S. Treasury in extreme circumstances. Farmer Mac buys agricultural mortgages from lenders and securitizes these loans into guaranteed securities, or AMBS. For profitability reasons, Farmer Mac has held most of the AMBS in its own portfolio rather than selling them in the capital markets to generate cash and instead issues debt to raise money.

Currently, Farmer Mac holds about $1.5 billion worth of these securities on its balance sheet. Farmer Mac also issues long-term standby purchase commitments and similar agreements—to date, all with FCS institutions—comprising $3.1 billion of its total $5.8 billion in program assets. These loans are not on Farmer Mac's balance sheet, because Farmer Mac currently does not own them. Farmer Mac and the FCS institutions involved in these agreements are also required to hold less capital against the loans underlying the agreements than those that are kept on the balance sheet—$66 million instead of $215 million if standbys did not exist.

Farmer Mac is committed to buy the loans under these agreements when the lender wants to sell them to Farmer Mac and when the loans become delinquent for more than 120 days. In fact, under these agreements, the worse things get, the less negotiating power Farmer Mac has over the price of the loans when buying them. We raise concerns about how Farmer Mac managed the increased risk that has accompanied its rapid growth in these standby and related agreements. For example, in a severe agricultural economic downturn, Farmer Mac could be required to purchase a large portion of delinquent or defaulted loans under the standby program, causing unexpected demand for funding or liquidity. We call this liquidity risk. During such conditions, it could be difficult for Farmer Mac to raise additional funds through either issuing debt or selling AMBS to the capital markets.

Now let us turn to the disagreement between Treasury and Farmer Mac about what Treasury's $1.5 billion line of credit covers if Farmer Mac exhausts its reserves against losses and the line of credit is needed to fulfill Farmer Mac's obligations under any of its agreements. Treasury has serious questions about whether it is required to purchase AMBS held by Farmer Mac or its affiliates where Farmer Mac's guarantee essentially runs to Farmer Mac itself. Farmer Mac's outside counsel, however, argues that Treasury would have to buy the debt obligations regardless of who holds them.

On mission, we reported that Farmer Mac had increased its mission-related activity since our 1999 report. However, Farmer Mac's statute lacks specific or measurable mission goals, so it is difficult to meaningfully assess whether the increased activities are having a positive impact on the agricultural real estate market. In addition, Farmer Mac's loan activities have been largely concentrated in a small number of financial institutions. During 2003, 80.8 percent of Farmer Mac I loan activities were with 10 institutions, and its loan activities are further concentrated in the western United States.

Therefore, we concluded that Farmer Mac had increased its mission activities, but we also concluded that the public benefits derived from them were not clear. We suggested that Congress consider establishing more specific, clearer mission goals for Farmer Mac. And also, because of Farmer Mac's strategy of keeping its issued securities in its own portfolio for profitability reasons, we concluded that the depth and liquidity of the secondary market for AMBS is unknown. We recommended that Farmer Mac reevaluate its current strategy of holding the AMBS in portfolio and issuing debt to get funding.

Regarding corporate governance, we found that Farmer Mac's board structure, set in law, may make it difficult to ensure that the board fully represents the interests of all shareholders. This structure could also hamper Farmer Mac's efforts to comply with the independence requirements of the New York Stock Exchange's listing standards. Also, Farmer Mac's board structure, which contains elements of both a cooperative and an investor-owned publicly traded company, may need to be updated to reflect today's market environment. For example, two-thirds of board members are elected by entities that do business with Farmer Mac and hold the only voting stock, while the common stockholders have no vote. We suggested, among other things, that Congress consider legislative changes to amend the structure of Farmer Mac's board and the structure of the Farmer Mac class C nonvoting common stock.

Finally, regarding FCA's oversight of Farmer Mac, we reported that FCA had improved its oversight and strengthened its examination approach, but noted that more needed to be done to enhance the assessment of risk-based capital and Farmer Mac's accomplishment of its mission. This enhanced focus is especially important given Farmer Mac's increasing risk profile, its concentration of business with few business partners and in the west, and its holdings of non-mission-related assets. Since the law does not include any measurable goals or requirements to assess Farmer Mac's progress in furthering its mission, FCA lacks criteria and procedures to effectively oversee this aspect of Farmer Mac.

We made several recommendations to FCA to enhance the effectiveness of its oversight. To further assist FCA, we also suggested that Congress consider legislative change that would give FCA more flexibility in setting minimum capital requirements for Farmer Mac. Since our October report, Farmer Mac and FCA have taken some action to address certain recommendations or are in the process of implementing several others, but since most of these actions will not be fully completed for some time, it is too early for us to tell how effective they are.

In conclusion, our 2003 review showed that Farmer Mac's income, mission activities, and risks have all increased since we last reported in 1999. However, its risk management practices did not keep pace with its growing complexity and risks. We concluded that Farmer Mac, FCA, and the Congress could each take actions to ensure that Farmer Mac continues to operate in a safe and sound manner while fulfilling a clear public policy mission. We believe it is important that Farmer Mac and FCA both devote sufficient resources and continued attention to the matters that we reported. If Congress wishes to retain its public sponsorship of Farmer Mac through its line of credit with the Treasury and its other benefits, we suggest that Congress consider making change to ensure that Farmer Mac's public benefits can be measured and evaluated and that FCA has the necessary tools and flexibilities to carry out its oversight responsibilities.

Mr. Chairman, that concludes our prepared statement.

[The prepared statement of Ms. D'Agostino appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Ms. D'Agostino.

Ms. Franzel, do you have additional comments?

Ms. FRANZEL. No, Mr. Chairman, but I will assist in answering questions at the end of the presentations.

The CHAIRMAN. Great. Thank you.

We will turn, then, to Ms. Pellett. We are pleased to have you with us as well. And I might add, congratulations on your new appointment as chairman of the FCA.

STATEMENT OF NANCY C. PELLETT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FARM CREDIT ASSOCIATION

Ms. PELLETT. Thank you very much. Thank you, and good morning. Mr. Chairman, members of the committee, I am Nancy Pellett, Chairman and Chief Executive Officer of the Farm Credit Administration. On behalf of my board colleagues, Doug Flory and Michael Reyna, I am pleased to be here this morning to discuss FCA's oversight of the Federal Agricultural Mortgage Corporation, generally known as Farmer Mac.

The mission of the Farm Credit Administration is to ensure a safe, sound, and dependable source of credit for farmers, ranchers, aquatic producers, farmer-owned cooperatives, and rural homeowners. To achieve our mission, we oversee the operations of two government-sponsored enterprises devoted to agriculture and rural America, the banks and direct lending associations of the Farm Credit System, and Farmer Mac.

Farmer Mac is a privately owned and publicly traded government-sponsored enterprise that we regulate through our office of Secondary Market Oversight, which we refer to ask OSMO. As a publicly traded corporation, Farmer Mac must also comply with New York Stock Exchange listing standards and requirements. And, unlike other GSEs, Farmer Mac, by statute, must comply with Federal securities laws.

In response to the farm credit crisis of the mid–1980's, Congress, in 1987, established Farmer Mac to develop a liquidity source similar to that provided for residential mortgages by the housing GSEs Fannie Mae and Freddie Mac. The 1996 amendments to Farmer Mac's authorizing legislation have allowed it to grow its business and achieve economic viability, which by no means was assured during the first years of its existence.

In our regulatory oversight role, we issue regulations and conduct an annual examination to ensure the safe and sound operation of Farmer Mac. The examination combines on-site and off-site activities that result in a report of examination to the Farmer Mac Board. We have regulatory enforcement powers that are similar to those of other Federal financial regulators, though somewhat broader in the area of receivership authorities.

FCA oversight activities of Farmer Mac have increased significantly during the past several years due to Farmer Mac's rapid growth and a changing risk profile. For safety and soundness reasons and to be consistent with our past practices, FCA does not comment on any institution-specific examination findings and recommendations. Therefore, I hope that you will appreciate that I may not be able to respond to certain questions in open session that relate to our examination of Farmer Mac.

We agree with the recommendations in the recent GAO report on Farmer Mac and have taken action in several areas. In April, the FCA board approved a proposed rule on non-program investments and liquidity that addresses issues about Farmer Mac liquidity planning and mission focus. The rule, when finalized, would set limits on the amount and type of non-program liquidity investments that Farmer Mac would be permitted to hold.

Additionally, FCA is developing a proposed rule to revise numerous aspects of the risk-based capital stress test and is analyzing additional regulatory requirements that Farmer Mac should consider in its overall capital adequacy planning. Further, we have made several revisions to Farmer Mac reporting requirements that will enhance our off-site monitoring efforts of Farmer Mac.

FCA is also analyzing the approaches taken by other regulators to require their regulated entities to obtain credit ratings. Their analysis will help the FCA board decide whether a formal rule is needed in this area.

And lastly, in response to the GAO report, we are developing a plan that will consider different approaches for assessing Farmer Mac's impact on the agricultural real estate market. In addition to the actions we have taken, FCA supports the suggestions GAO made to Congress. In particular, we support greater flexibility for the regulator to set capital standards as Farmer Mac grows and its risk characteristics continue to change.

In conclusion, Mr. Chairman, FCA is committed to Farmer Mac's success and the achievement of its statutory mission to serve agriculture and rural America. We continue to enhance our regulatory oversight of Farmer Mac, and I believe we are well positioned to ensure Farmer Mac has the capability to succeed in the future.

Thank you for the opportunity to appear before you today, and I or Tom McKenzie, our director of OSMO who has accompanied me today, stand ready to answer any questions you or the members of the committee might have.

[The prepared statement of Ms. Pellett appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Ms. Pellett. And I would also like to note that you are joined by another Farm Credit Administration board member, Mr. Doug Florry, seated behind you, who is from my district in Virginia. Doug, we are pleased to have you with us as well.

I would also now like to give a special welcome to Mr. Zerzan, who is a former associate counsel of this committee. He served under Chairman Bob Smith of Oregon and has moved on to other important work serving the interests of our country's financial institutions and the American taxpayer. Mr. Zerzan, welcome.

STATEMENT OF GREGORY ZERZAN, DEPUTY ASSISTANT SECRETARY, FINANCIAL INSTITUTIONS POLICY, DEPARTMENT OF THE TREASURY

Mr. ZERZAN. Thank you, Mr. Chairman. It is a privilege to be before the committee again. Thank you, Chairman Goodlatte, Ranking Member Stenholm, and members of the committee for the opportunity to testify today on the Federal Agricultural Mortgage Corporation.

Farmer Mac poses a number of questions for policy makers to consider. In particular, today I would like to focus on three such issues: Farmer Mac's mission achievement, regulatory issues associated with Farmer Mac, and the Treasury Department's perspective on Farmer Mac's line of credit.

One useful way to evaluate Farmer Mac's broad, statutory purpose is to consider whether Farmer Mac has contributed to the development of an active secondary market in agricultural real estate mortgages, much like the secondary market that exists for residential housing mortgages. The secondary market for residential housing mortgages is characterized by a wide array of investors who, on any given day, are buyers and sellers of mortgage-backed securities.

Similarly liquid markets for AMBS do not yet exist. Absent a more aggressive effort by Farmer Mac to sell its AMBS to outside investors, it is difficult to perceive of an active secondary market for AMBS developing.

The Farm Credit Administration is the regulator of Farmer Mac. The Treasury Department does not have any direct regulatory oversight responsibilities with respect to that entity. However, in December 1995, the House and Senate Agriculture Committees asked the Treasury to jointly monitor Farmer Mac's financial condition with the FCA throughout the capital deferral period and beyond, if necessary. We have appreciated the close working relationship we have had with FCA in conducting the joint monitoring requested by Congress, but at this time, with the capital deferral period long over, there will be no continued formal relationship with FCA on the joint monitoring of Farmer Mac. Having FCA provide an advanced copy of the report for Treasury to review or having Farmer Mac or FCA continue to reference a joint monitoring arrangement with Treasury may inadvertently provide the false impression that Treasury exercises some form of oversight of or responsibility for Farmer Mac. Treasury plays no such role.

As noted by GAO, there appears to be some confusion over how and under what terms Farmer Mac would have access to its line of credit with Treasury. A Treasury letter to the FCA described Treasury's position regarding Farmer Mac's line of credit as follows, in part: "We have serious questions as to whether the Treasury would be obligated to make advances to Farmer Mac to allow it to perform on its guarantee with respect to the securities held in its own portfolio, that is, where Farmer Mac's guarantee essentially runs to Farmer Mac itself."

Treasury has not changed its position on this issue since that 1997 letter. Investors in Farmer Mac securities should rely on the underlying credit quality of Farmer Mac when making investment decisions and not on any potential access to a line of credit with the Treasury.

In conclusion, Mr. Chairman, our Nation's interest in maintaining strong agricultural credit markets that serve the needs of farmers and ranchers remains strong. Farmer Mac has improved its business prospects since it was granted new powers by Congress in 1996, and its capital position has improved over the years. While Farmer Mac's role in agricultural mortgage markets has increased, whether Farmer Mac's increased business activity contributes to achieving a significant public purpose remains an issue that Congress should continue to evaluate.

Thank you very much.

[The prepared statement of Mr. Zerzan appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Zerzan.

I would like to start with a question that gets to the heart of the issue that is at the table today, and that is the capitalization of Farmer Mac, and I will ask the same question of the president and chairman when they are up in a minute. But I would like to ask each of you if you believe Farmer Mac is sufficiently capitalized and positioned in the capital markets to withstand a downturn in the agricultural economy, similar to that experience in the mid–1980's when commodity prices fell through the floor and land values followed shortly thereafter.

Ms. D'Agostino?

Ms. D'AGOSTINO. I will defer to Jeanette Franzel for that.

Ms. FRANZEL. The scenario similar to the early 1980's and the test of Farmer Mac's current capital, that has simply not been tested. In general, since 1997, Farmer Mac has been operating in good economic times where land values have been rising and interest rates have been relatively low. So in this environment, Farmer Mac has really experienced relatively low credit losses, and they have not had negative net bottom line losses as would happen in a depressed agricultural real estate market. So capital has not been stressed, and therefore we really don't know if capital could absorb this type of a scenario.

Furthermore, exacerbating the issue, Farmer Mac's loan loss and economic modeling does not adequately measure the potential impact of depressed agricultural conditions, such as falling land values. So again, we were unable to determine how well Farmer Mac could withstand such a downturn because of its reliance on this model and because Farmer Mac does not really have experience with this type of scenario.

The CHAIRMAN. Thank you.

Chairman Pellett has requested that she be joined by Tom McKenzie, the Director of the FCA's Office of Secondary Market Oversight, to assist in fielding Members' questions. So Ms. Pellett, you or Mr. McKenzie, or both, can answer that question.

Ms. PELLETT. Thank you very much.

Mr. Chairman, I am a farmer, and I am a producer from Iowa, and I lived through that time of the 1980's. And heaven forbid if that ever happened again. That was a time that was very stressful for producers, their lenders, and also a regulator. And right now, our Director of OSMO is working with Farmer Mac management and with the Farmer Mac Board to get their risk management systems in place during these good times so that when, and if, anything like that should happen again, they would be prepared to weather that storm.

The CHAIRMAN. Thank you.

Mr. McKenzie, do you want to add anything to that?

Mr. MCKENZIE. No, sir. I think Ms. Pellett covered that quite adequately.

The CHAIRMAN. Very good.

Mr. Zerzan?

Mr. ZERZAN. Thank you, Mr. Chairman. I would demur on whether or not they could withstand such a stress, because I am not sure that any of us know that. I would note, as we note in our testimony, that the failure to develop an active secondary market for the AMBS and their retention of the AMBS within portfolio certainly does call into question what the GAO noted as their strategy for dealing with times of high stress which is going to market with AMBS because they have not allowed a secondary market to develop heretofore, and as the GAO notes in its report, it would be difficult to understand what the demand for such a product would be. But I would defer on the question of how exactly they would withstand such a crisis.

The CHAIRMAN. Thank you.

Ms. D'Agostino and Ms. Franzel, you work has focused a great deal on the Long-Term Standby Commitment to Purchase, or LTSCP program, that has been used extensively by institutions of the Farm Credit System. What is the GAO's view of that program, and is Farmer Mac able to monitor that portfolio since those loans are retained on the originator's books?

Ms. FRANZEL. This program is a little different from some of Farmer Mac's other programs, because these agreements are off balance sheet, and there are variations on the agreement. So currently, Farmer Mac holds $3.1 billion in standby and related agreements, the related agreements are essentially securitized loans that are under standby agreements, and Farmer Mac would be required to purchase these loans whenever a lender wants to sell them to Farmer Mac or when the loan becomes 120 days delinquent. If Farmer Mac is buying a performing loan, it can negotiate the price, but if the loan is 120 delinquent, Farmer Mac must purchase the entire loan and any unpaid interest due to the financial institution. So this really does change and increase the risk profile of Farmer Mac. Buying a distressed loan is essentially like buying the entire farm when it is in financial distress. And so in a distressed agricultural economy, Farmer Mac could be required to use substantial amounts of cash to purchase these loans. And then once Farmer Mac purchases the loans, some sort of mechanism would need to be put in place to recover some value from those loans and really resolve the issues, sell the underlying assets. And our experience in previous financial institution crises has shown that this is a very lengthy and expensive process.

So under these agreements, Farmer Mac would need large amounts of cash up front potentially to purchase the underlying loans and then incur substantial amounts of time and expense to sell and resolve the underlying assets. So it really does raise the risk profile and complexity of Farmer Mac.

The CHAIRMAN. Thank you, Ms. Franzel.

Mr. Zerzan, finally, let me ask you. Assuming that Farmer Mac needed to come to Treasury for assistance and assuming there is a continuing dispute about the availability of that assistance for AMBS held in Farmer Mac's portfolio, what would you guess to be the likely outcome of that dispute and the time that it would take to resolve it, and should Congress clarify this matter now?

Mr. ZERZAN. Thank you, Mr. Chairman.

I think it is difficult to speculate how long it would take to resolve such a dispute. We believe, in the Treasury, it would be anomalous for Congress to have granted a publicly traded corporation a line of credit with the taxpayers for a guarantee that runs solely to itself. To the extent that clarification of that congressional intent is necessary, then certainly I think the Treasury Department, in general, is in favor of clarity. So that would certainly not be unwelcome.

The CHAIRMAN. Thank you.

Mr. Stenholm.

Mr. STENHOLM. Ms. Pellett, in your estimation, does FCA have sufficient authority to regulate Farmer Mac?

Ms. PELLETT. Congressman Stenholm, presently, yes; FCA does have enough authority to regulate Farmer Mac. We do have authorities that are very comparable to other regulatory agencies of the financial institutions. However, we do support GAO's recommendation to Congress that enhancements are needed in the future. We especially support greater flexibility for FCA as the regulator to set minimum and regulatory capital requirements for Farmer Mac.

Mr. STENHOLM. Have your auditors and examiners found Farmer Mac's board and executive management helpful during examinations?

Ms. PELLETT. I think I should let our Director of OSMO respond to that, please.

Mr. MCKENZIE. Congressman, I appreciate being here this morning and also the opportunity to work with Farmer Mac over the last 12 to 15 months.

Any time that the examiners of the financial institutions conduct examinations of institutions, management culture, adequacy of systems, and the ability to respond to the substantial amount of requests from examiners is stressful at times. So to say that it is easy on both sides would not be totally accurate, but I would say yes, the Farmer Mac Board and Farmer Mac management have increasingly been responsive to the regulator, and over the last several months, have had increasingly positive relationships, and progress is being made from the Farmer Mac Board in oversight of the institution.

We appreciate that very much and look forward to continuing our relationship with them.

Mr. STENHOLM. Thank you.

Mr. Zerzan, would you go a little bit further in your conclusion, the last statement in which you raised a question for Congress, whether Farmer Mac's increased business activity contributes to achieving a significant public purpose? You say it remains an issue that Congress should continue to evaluate. Would you go a little bit further to help Congress?

Mr. ZERZAN. Yes, sir.

The point that I am trying to illustrate in this testimony is that to the extent Congress established Farmer Mac to create a liquid secondary market for agricultural mortgage-backed securities, similarly to the markets that exist for residential housing mortgages, that has not been achieved. It has not been achieved largely because Farmer Mac has chosen to retain AMBS largely in portfolio. Certainly they do provide some benefit and some credit to the agricultural market as a whole by purchasing loans which are made by other lenders, but in that respect, they are not acting in a capacity significantly different from other specialized agricultural lenders.

I think it is a question that needs to be continually followed and considered whether or not another specialized agricultural lender is what Congress intended to create when it created Farmer Mac or if, in fact, the goal was to enhance the liquidity of the secondary market for agricultural mortgage-backed securities.

Mr. STENHOLM. Ms. D'Agostino, just a summation, I guess, of your testimony, are you satisfied that Farmer Mac is making progress regarding the recommendations that were made in the GAO report, especially those dealing with lowering its risk profile?

Ms. D'AGOSTINO. It is a little too early for us to be able to evaluate the actions. We met with them recently to discuss their actions. A lot of the things that they said were planning to do or are in the process of doing are at such early stages it is really hard for us to tell at this point whether they fully responded to our recommendations. As you know, we continue to do recommendation follow-up and circle back with entities that we have reviewed and see where they stand on implementing our recommendations. We will continue to do that. And if the committee would like us to look even further, we would be happy to do that additionally, at request. But it is a little too early for us to tell how much progress they're making in some of the activities that they are doing now.

Mr. STENHOLM. Thank you.

The CHAIRMAN. Thank you.

The Chair is now pleased to recognize the vice chair of the committee, the gentleman from Ohio, Mr. Boehner.

Mr. BOEHNER. Thank you, Mr. Chairman.

I would like to ask Mr. Zerzan and Ms. Pellett to comment on this question. In formulating its policy position on a new independent regulator for the housing GSEs, the administration made an affirmative decision that this regulator should be solely and exclusively focused on secondary market activities and not combined with one of the existing regulators of the primary lending market to avoid a conflict of interest in the regulatory mission. Does this issue need to be reviewed and reconsidered with respect to the FCA since the agency regulates primary lenders in the Farm Credit System as well as Farmer Mac, which was mandated by Congress to establish and maintain a secondary market for agricultural mortgage loans? Mr. Zerzan, I will let you go first.

Mr. ZERZAN. Thank you, Congressman Boehner.

As I note in my testimony, there is a concern over the possibility that the dual regulatory role of the FCA over both the Farm Credit System and by Farmer Mac, which is largely owned by Farm Credit System members, could pose issues with respect to conflicts of interest. In particular, in my testimony, I note that this is true in the long-term standby purchase commitment agreements. It is certainly worth monitoring and considering whether or not the current system is created in such a way that in a time of future difficulties the FCA might not be conflicted by virtue of it being a dual regulator.

Mr. BOEHNER. Ms. Pellett?

Ms. PELLETT. Thank you, Congressman.

We do recognize that there could be a potential conflict of interest here in our oversight of both the Farm Credit System and Farmer Mac. However, I would like to note that GAO found no actual evidence where our two oversight responsibilities were not properly balanced. In our response to GAO, we stated that FCA is committed to the very highest standard of financial institution supervision possible. And I vow and I pledge to this committee that this is true now and it will continue to be true. Congress originated the Office of Secondary Market Oversight as an independent office within the Farm Credit Administration. The FCA board and the FCA staff respects that commitment and the original intent and the independence of the Office of Secondary Market Oversight.

Mr. BOEHNER. Well, that is part of my concern is that do you have the capability of separating the two missions: one of regulating the primary lending institutions and then separately and independently being able to regulate Farmer Mac as a secondary lending organization?

Ms. PELLETT. Congressman, yes; we do have that capability because of the independence of this office. And maybe Mr. McKenzie could comment on that as well. But again, I want to vow to you that we do hold high that standard, a very high standard of financial institution supervision and whether it be whichever hat we do have on, we do honor that.

Mr. BOEHNER. Mr. McKenzie, do you want to comment?

Mr. MCKENZIE. Yes, sir. Thank you, Congressman.

I would say, going back to Chairman Pellett's opening comments, my observation, and I have worked on both sides of regulating Farm Credit System institutions and now recently regulating Farmer Mac, is that the FCA board and the agency, as a whole, is committed to providing an adequate, dependable source of credit through both GSEs, the Farm Credit banks and associations, and Farmer Mac. They both have a role to play. And the FCA board, in my observation over several administrations, is that they are, indeed, committed to the success of both GSEs. There is, indeed, separation, and I should share with you my personal view that the FCA board has been very supportive of the Office of Secondary Market Oversight's independence, its resource requests, and its support as we have been engaged in that office over the last 15 months.

Mr. BOEHNER. Mr. McKenzie, do you have any concerns that the top ten clients of Farmer Mac constitute 80 percent of the loan volume?

Mr. MCKENZIE. From Farmer Mac's perspective and our regulation of oversight, there is—from the development of business, Farmer Mac is a developing entity, a developing GSE. And so it is, no doubt, trying to fulfill its mission and provide a liquidity source from whatever available demand that there is from those institutions. We support that accomplishment from the agency standpoint. We also look at it from a concentration standpoint, both from risk posed geographically as well as the development, and that the business could go away, so to speak, from too many single sources. But I would share with you, at this point, we have no major issues from the regulation of this side of our business of FCA with regard to concentration of sources of business in meeting Farmer Mac's mission at this development stage.

Mr. BOEHNER. Just a final comment. The reason I bring up the question is that with an agency, such as FCA, having a dual role, in terms of regulating both the banks that originate the loans and the secondary market, is that we don't want to be regulating Farmer Mac, the secondary market, in a way that is similar to the originating banks. And there seems to be at least some concern that we are seeing a mission from the banking side applied to Farmer Mac. And the concern is inhibiting their ability to truly act as a secondary market.

Mr. MCKENZIE. If I get the gist of your point, Congressman, I think what I would say in response is that we do examine and regulate Farmer Mac based upon the risks that it faces: agricultural credit risk, interest rate risk, liquidity risk, and operations risk. I think we have some of the best agricultural credit risk examiners in the country. I personally would place them against any other regulator in assessing that risk. I think we have adequate skills to address all the risks that Farmer Mac faces. Mr. Zerzan indicated in his own statement that the risk profiles are changing and are similar to other specialized lenders while capital requirements of Farmer Mac are still based upon the secondary market structure. Management of risk, when you have a secondary market capital structure that is relatively highly leveraged compared to other retail lenders, management systems, as I have shared with others, must be pristine. There is minimal room for error. We apply risk-based examinations to approach that regardless of whether it is a secondary market or whether it is a primary. And, we base it upon risk and capital levels to absorb that risk.

Mr. BOEHNER. Yes, but my point is they are not a retail lender.

Mr. MCKENZIE. Granted, but the risks, I would say, Congressman, must be also addressed in the same fashion at the core.

The CHAIRMAN. I thank the gentleman.

The gentleman from California, Mr. Dooley.

Mr. DOOLEY. Thank you, Mr. Chairman.

Ms. D'Agostino and Ms. Franzel, in the GAO report where you spent considerable time talking about the standby agreements, which when you look at the portfolio of Farmer Mac, it constitutes a significant, in fact, a majority of their portfolio. I guess, not having the level of expertise I would like to have on this, it almost seems like we have created an incentive with different capital requirements there, from the 0.75 to the 2.5 or whatever it is, is that we have a significant incentive for Farmer Mac to enter into these standby agreements. Is that consistent with the capital requirements that we put in place that provide, obviously, some protection to the taxpayers and their interests here? Are we providing an adequate level of protection there?

Ms. FRANZEL. Your point, Congressman, is right on target. The standby agreements do result in reduced capital throughout the system really without any corresponding change in the substance of the underlying loans or transactions. So, for instance, once these loans are put under the standby agreements, the capital requirement, which would have been 7 percent, if they had been loans, get reduced. The institutions hold 1.4 and Farmer Mac holds 0.75, so really, it is a combined requirement of 2.17 in capital versus 7 percent, which would have been required if the loans were not under the agreement. So yes, there is significant incentive for these agreements so that capital can be reduced by the institutions. And that results in less capital being held in the system as a whole as protection in the event of difficult economic times.

Ms. D'AGOSTINO. And in addition, yet at the same time, by entering into standbys, the lenders who do enter into them do free up capital to then lend more. And in addition, Farmer Mac does make a significant amount of income from the fees off of the standby agreements. So you have this tension and issue going on here where on the one hand stanbys generate fees for Farmer Mac and on the other hand, they lower the capital held by the FCS and

Farmer Mac and it makes it difficult. This is why we recommend that FCA get more flexibility in setting capital requirements so that they can risk weight specific products for the specific facts and circumstances they are dealing with and the risks posed thereby.

Mr. DOOLEY. So is the actual capital requirement then is where the Farmer Mac, in their testimony, contend that they have capital that is six times what their risk-based amount would need to be, but is that figure most likely based on their portfolio that is not in the standby account, or have we structured this so that the capital requirements are also weighted based on the standby versus the mortgages that they are holding?

Ms. D'AGOSTINO. In one respect, the statutory capital requirements were set long before standby agreements ever existed. So the statutory requirements never envisioned products like this coming to be. This is one of the reasons, again, why it is better not to have a static statutory number there and to allow the regulator to adjust capital over time, with various products and their complexities and risks to adjust the capital so that FGA can better assure adequate capital. And it is true that Farmer Mac exceeds the current capital requirements. But to date, it is not totally clear, and it hasn't been demonstrated that it is adequate to withstand a severe economic downturn. And so what we have recommended is that Farmer Mac do come up with a capital adequacy plan. We have asked the Farm Credit Administration to adjust how it stresses the risk-based capital. And all of that was kind of pointed at this fundamental problem with the capital requirements. And it is interesting that Farmer Mac points out in each one of its 10-Ks how much more it could increase its program assets because it exceeds its capital requirements by so much rather than saying we really think we have adequate capital to cover our risks. It is an interesting contrast in perspective.

Mr. DOOLEY. Ms. Pellett, did you want to comment on this, I mean, in terms of the FCA's approach to this in terms of evaluating the potential risk that is emerging because of the standby agreements?

Ms. PELLETT. Mr. McKenzie, please.

Mr. MCKENZIE. Thank you, Congressman.

Capital is always a very, very important issue to a regulator. And when we are talking about, again, the secondary market capital structure that is relatively highly leveraged compared to other lenders, it makes it doubly important.

First of all, let us recognize what we are talking about as far as the standby required capital level. They are similar to the AMBSs that would be sold. In particular, they would be treated the same for under the statutory minimum capital requirement, which is three-quarters of 1 percent capital required. Currently, that is the amount that Farmer Mac would have to hold for any of the standbys that it would be providing or guaranteeing on the loan amounts, because the risk-based capital, which you also referred to, is substantially predicting less capital than the statutory required levels in total. So whether 0.75 percent capital required for agricultural credit is sufficient in the statute, I think, we fully support GAO's recommendation that the regulator be given greater flexibility to address those capital issues.

Furthermore, I might add that in response to not only the GAO recommendation but our own initiative to review the risk-based capital regulatory requirements that are required by statute that we are aggressively looking into those issues recommended by GAO as well as our own issues, some of which were caused by the long-term standby. And, we hope to have before the FCA board a proposed rule with some revisions later this year to address them.

The CHAIRMAN. I thank the gentleman.

The gentleman from Michigan, Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman.

With your leave, I would like to briefly introduce my new agriculture LA, and that is Lee Van Aken. Lee did his undergraduate and his masters at the University of Wisconsin, got his doctor's degree in Montana State, worked for a year as a science fellow with Representative Gutknecht, so Lee, welcome.

I guess it seems to me that our goal is to have credit availability to farmers and ranchers. I mean, that is the goal. That is why, in 1987, we made this decision to expand the secondary market in hopes of facilitating that goal. And I guess my first question would be if there wasn't any Farmer Mac and you were advising this committee today whether or not we should establish a Farmer Mac, would you recommend that we establish a Farmer Mac? In other words, is credit availability otherwise provided by other institutions adequate today without Farmer Mac? And I guess I would go to you, Ms. Pellett, for, maybe, your first reaction.

Ms. PELLETT. Thank you, Congressman.

Each entity that services rural agriculture, the farmers and ranchers that make it up, has its own place. And that is true for the commercial independent bankers, Farmer Mac, as well as the Farm Credit System. Farmer Mac has made it possible for a steady flow of credit from the institutions that use it to the farmers and ranchers. And for that reason, I would say that there is a place for each one of them, and yes; I would recommend it.

Mr. SMITH. So you are saying that credit availability today for farmers and ranchers is such that without Farmer Mac, it would be lacking? Is that what you are saying?

Ms. PELLETT. No, no. It just makes it smoother and makes it more available. No, it would not be lacking.

Mr. SMITH. Help me understand. With the other efforts for farm loans in FSA, in our rural development both in USDA, what is the involvement of Farmer Mac now in terms of underwriting some of the FSA farm loans? Do they take a very small portion or a significant portion of that underwriting? Do you know that, or shall I save that for the next panel?

Ms. PELLETT. I think that Mr. McKenzie probably does.

Mr. MCKENZIE. I don't have the precise number, Congressman, but they have, indeed, a special program for these loans. They have two programs. One is Farmer Mac I and the second is Farmer Mac II. And Farmer Mac II is devoted exclusively to USDA guaranteed loans. It is my recollection, and you could ask Farmer Mac the precise numbers in the later discussion with them, but I believe they have somewhere in the neighborhood of $750 million, three-quarters of a billion dollars under Farmer Mac II out of the $5.8 billion total. So it would be somewhere around 10 to 12 percent, if you look at overall program activity. That is to the best of my recollection.

Mr. SMITH. Thank you.

And a question to GAO. In your report, you concentrated somewhat on the Farmer Mac's board structure. And maybe in 1987, the makeup of that board structure might have been adequate. Would you recommend a change in how the board is made up, such as possible presidential nominees, especially when the class C stockholders don't seem to have board representation now?

Ms. D'AGOSTINO. Yes, Congressman. We recommended that the Congress restructure the board to take both feet and put them squarely either into a cooperative structure with the class A and class B stockholders electing the board of directors and not issuing any class C stock, don't have it a publicly-traded company, or place both feet squarely in the publicly-traded, investor-owned corporation world, which is now governed by Sarbanes-Oxley Act, and by NYSE listing standards. And at this time, the structure that is set in the statute is seemingly misaligned with today's market environment and other statute and principles in corporate governance that prevail today.

Mr. SMITH. Secretary Zerzan, or maybe anybody, do we know, is there somehow an accounting or record keeping of how much rural, farm, or ranch loans are underwritten or have a secondary market from Freddie Mac or Fannie Mae or other underwriting secondary institutions? Do we know how much they are doing?

Mr. ZERZAN. Thank you, Congressman Smith.

I don't know that information off of the top of my head, but I will be sure to see if we can find that and get it to you after this hearing.

[Mr. Zerzan responded for the record:]

Fannie Mae and Freddie Mac do not purchase loans like farm and ranch loans. They do buy and guarantee rural housing loans. The Department of Housing and Urban Development tracks this measure as part of collecting data on Fannie Mae's and Freddie Mac's housing goals. According to HUD's proposed rule on the GSE's housing goals (69 FR 24228), Fannie Mae and Freddie Mac purchased 1.2 million mortgages for single family homes in "non-metropolitan" counties in 2002, see attached table B.11 of proposed rule. HUD derived this number from loan level data provided by the GSE's using 2000 census data assuming metropolitan statistical area (MSA) boundaries used prior to June 2003.

Table B.11

Loan and Borrower Characteristics of Single-Family Mortgages Purchased by the GSEs In Nonmetropolitan Counties, 2002

Loan and Borrower Characteristics	Fannie Mae		Freddie Mac		Total	
	Served	Underserved	Served	Underserved	Served	Underserv
Number of Loans	368,835	262,120	352,928	222,616	721,763	484,736
Loan Purpose						
Home Purchase	28.7 %	35.5 %	24.4 %	26.8 %	26.6 %	31.5
Refinancing	71.3	64.5	75.6	73.2	73.4	68.5
Origination Year						
Current Year	82.8 %	74.9 %	82.9 %	80.3 %	82.9 %	77.4
Prior Years	17.2	25.1	17.1	19.7	17.1	22.6
Loan-to-Value Ratio						
Over 95%	3.0 %	3.4 %	1.1 %	1.3 %	2.0 %	2.4
91-95%	7.2	11.9	7.4	8.7	7.3	10.4
81-90%	12.3	16.7	11.5	13.7	11.9	15.3
61-80%	54.4	50.2	56.0	55.4	55.2	52.6
60% or Less	23.2	17.8	24.1	20.9	23.6	19.2
Income of Borrower(s)						
60% of Area Median or Below	11.3 %	10.8 %	10.4 %	9.4 %	10.9 %	10.2
61-100% of Median	27.4	25.1	26.5	23.5	27.0	24.3
Below Area Median	38.7	35.9	36.9	32.8	37.8	34.5
Over 100% of Median	61.3	64.1	63.1	67.2	62.2	65.5
Total	100.0	100.0	100.0	100.0	100.0	100.0
First-time Home Buyer	5.6 %	5.8 %	4.7 %	5.1 %	5.2 %	5.5
Race/National Origin of Borrower						
White	95.5 %	88.1 %	95.1 %	87.3 %	95.3 %	87.7
African American	0.9	5.3	0.7	1.6	0.8	3.6
Hispanic	1.7	3.5	1.4	7.5	1.5	5.3
Asian or Pacific Islander	0.6	1.4	0.6	0.9	0.6	1.2
American Indian or Alaskan Native	0.4	0.8	0.3	0.4	0.4	0.6
Other	0.8	0.9	2.0	2.3	1.4	1.5
Age of Borrower						
Under 30	9.9	10.1	9.1	9.1	9.5	9.6
30-39	27.8	26.4	26.7	25.1	27.3	25.8
40 and Over	62.3	63.6	64.2	65.8	63.2	64.6
Gender of Borrower(s)						
All Male	20.0	21.6	17.9	19.0	19.0	20.4
All Female	15.1	16.1	13.0	13.5	14.1	15.0
Male and Female	64.9	62.3	69.1	67.5	67.0	64.6

Source: HUD analysis of GSEs' loan-level data on mortgages on owner-occupied one-unit properties. In computing the percentages, missing data are excluded.

PROGRAM: RULE95. PROGRAMS(GOAL9697)- SPECIAL, RUN ON 05JAN2004.

Mr. SMITH. Mr. Chairman, I don't have any other questions, except I would like to compliment GAO on that kind of effort that allows us to review the service of this organization.

Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

My first question goes to our GAO friends. I can see, obviously, where the long-term standby commitment program is a benefit to the Farm Credit System since each institution has a guarantee on a sizable amount of its assets, and they are able to maintain less capital in that portfolio. But is there a particular reason or a series of reasons as to why the rest of the commercial banking companies or other agricultural lenders have not used this program, that you could tell or determine?

Ms. D'AGOSTINO. Yes, sir. We attempted to address this in our work that we did in the 2003 report. What we found was that between 1996 and the end of 2002, commercial banks participation in Farmer Mac I dropped from 80 percent to 22 percent. It is quite precipitous, and it is quite large. Also, the commercial lenders that do do business with Farmer Mac are very few and very concentrated in between two and four commercial lenders.

In the meantime, the FCS institutions participation went from 2 percent to more than 55 percent. So as you can see, whereas I think the vision was the commercial lenders would really use the Farmer Mac facility and then free up a lot of commercial lending credit availability, what has happened is fewer commercial lenders are using it and more FCS institutions are using it, who already have GSE status. It was difficult for us to find a reason why this was happening, why commercial lenders weren't using Farmer Mac's facility more. And Farmer Mac's latest 10-K', points out that historically the commercial lenders have preferred to keep their agricultural mortgage loans in their portfolio rather than use the secondary market for these loans. I have no further explanation, just noting the trends that have occurred. We did try to find out, but it is very hard to get at something like that from our perspective.

Mr. LUCAS. Any opinions from the rest of the panel, perhaps, on this issue?

Mr. MCKENZIE. I think that would be a good question, again, that you may want to ask Farmer Mac, but from our perspective, we would note that the Farm Credit System obviously is a source of mortgages and a primary source of mortgages, which is a legitimate source of business for Farmer Mac. Ms. D'Agostino mentioned disclosure and SEC filings. I think also reported there is Farmer Mac's recognition that the commercial banks and lenders have adequate liquidity present and have adequate cash funds on hand. And, so there is a difference between availability of secondary market demand during high demand periods and low deposit periods. So, I think that may have contributed as well.

Mr. LUCAS. And before I would direct my last question to the panel, I would note that there have been several comments made about the challenges in the early 1980's. And having lived through that period, also, it is kind of unique in my part of Oklahoma in that we faced both the collapse of agricultural prices, the collapse of energy prices, high inflation, and a deregulated interest market for the first time since the 1930's. So the early 1980's can only be compared to the deepest, darkest part of the early 1930's. And if we gauge everything by that absolute worst case scenario, well, that is a challenge.

So let me ask my last question. Based on the comments and testimony and written testimony of everyone on the panel, on this first panel, is it fair to say that there are no major immediate short-term problems with Farmer Mac? Is that a fair statement to say in the immediate short-term nature? Major problems? And whoever would care to be brave enough to answer that.

Ms. FRANZEL. OK. I hate to go first on this. That is a very good question. Our report did point out areas of risk. We did make a number of recommendations of areas that we thought needed to be addressed now in good times and difficult public policy issues that are easier to consider in good times rather than in bad times. And we did point out some limitations of the credit modeling at Farmer Mac as well as liquidity planning, again, which are very important to address, because even if we don't get to an early 1980's scenario, some depressed conditions in the agricultural economy could put a strain on Farmer Mac in terms of credit losses as well as liquidity needs. So we do see those as issues that should be addressed now rather than later.

Ms. PELLETT. Excuse me. I can not comment on specific issues as far as examination is concerned, but what I would like to say is that we continue to work with the Farmer Mac Board and executive management as they address their risk profile, as they continue to grow. Also, we do not see any immediate threat to the financial condition of Farmer Mac to its viability or to its access to the GSE debt market.

Mr. ZERZAN. Thank you, Congressman.

As Treasury does not regulate Farmer Mac, I would defer to the FCA's opinion on this.

Mr. LUCAS. So the barn doors may be a little creaky and the roof may need some patching, but it is not on fire yet, I believe, Mr. Chairman.

Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from Colorado is departing, so we will turn, then, to the gentleman from Minnesota, Mr. Gutknecht.

Mr. GUTKNECHT. Thank you, Mr. Chairman, and thank you for having this hearing.

And I come at this issue maybe different than most people. I have spent a lot of time in Mr. Lucas' District back in the 1980's as an auctioneer and a real estate broker, and we sold an awful lot of real estate. And who would have guessed 50,000 people in the State of Oklahoma turned the keys to their houses back to their lenders, because everything went upside down. Now Ms. Franzel, you come from a little farm. You grew up on a farm between Owatonna and Bigsby, Minnesota.

Ms. FRANZEL. That is correct.

Mr. GUTKNECHT. And let me just ask you, having grown up on that farm, a little bit about farm values. And I want to go back and visit, because I think we are setting ourselves up for the same kind of problem we had in the 1980's. And the reason I say that is I think the fundamental problem was we were involved in asset-based lending, OK, not cash flow based lending, which everybody said now we are going to move to cash flow based lending. Is there any way that you can afford to pay $3,000 an acre for land in southern Steele County, Minnesota and make it work, even at $8 beans?

Ms. FRANZEL. I am not up on all of the cash flows on farming, but certainly if the loan goes upside down, so, for instance, the farmer has more debt on the land than the land is even worth, and usually that happens when farm prices are low, you have got a very bad scenario on your hands. I would defer to Farm Credit Administration and Farmer Mac to discuss underwriting standards, which are key up front to helping ensure that quality loans are made.

Mr. GUTKNECHT. Well, I want to just come back to the point. Maybe I am wrong, but I don't see any way in the world that you can make it work. Now Ms. Pellett, you are from Iowa. What county are you from?

Ms. PELLETT. Cass County, southwest Iowa.

Mr. GUTKNECHT. OK. I don't know what land values are down there, but I mean, how did land values get so high?

Ms. PELLETT. Congressman, they are rising, and——

Mr. GUTKNECHT. But no, I understand they are rising, but how did they start rising? What is driving the price up?

Ms. PELLETT. I, in my opinion, this is not an official FCA opinion, but I——

Mr. GUTKNECHT. Well, if people can't get a loan, how can they possibly buy land for $3,000 an acre?

Ms. PELLETT. There are several factors. One is that there are very nice government subsidies, and they are making that land rise. And they are——

Mr. GUTKNECHT. But even with government subsidies, you can't make those numbers work.

Ms. PELLETT. Interest rates, again, are very low. Congressman, as we go about examining the institutions that we regulate, we look very closely at those risk management factors and rising land——

Mr. GUTKNECHT. But are you doing cash flow analysis of some of these deals? I mean, somebody ought to be paying attention. Here is the deal. Here is what happened in the 1980's. Who took the haircut at the end of the day in the 1980's? It was the American taxpayer that took the haircut, and it was to the tune of billions of dollars. And I am not blaming Farm Credit System or Farmer Mac or any of those things. I mean, it was all of those Federal guarantee programs, and basically it was the American taxpayer who lost billions and billions and billions of dollars, because people were making loans that they probably shouldn't have made because liquidity. Gee, if we don't make the loan, somebody else will. And that is what is happening again today. I mean, I do not see that much difference between today and 1982.

Ms. PELLETT. Congressman, I would agree. The indicators are there. As we go into these institutions that we regulate and we examine them once every 18 months, we are looking at just the things that you are talking about. They have to have and we have to ensure that their risk management practices are in place so that they can weather this and that they have done appropriate measures now during the good times to keep from happening what happened in the 1980's. Their underwriting standards are very conservative.

Mr. GUTKNECHT. How can you say that? I mean, how can you say when they are loaning money for $3,000 for an acre of land, how can you say they are conservative?

Mr. MCKENZIE. Congressman, are you referring to Farmer Mac or lenders in general?

Mr. GUTKNECHT. Well, ultimately, you buy those loans. I mean, they make the loan, they are off of the hook, right?

Mr. MCKENZIE. The lenders?

Mr. GUTKNECHT. Right. If they sell the loan to you, how much skin have they got in the game now?

Mr. MCKENZIE. Certainly, with lenders and cash flow, I will go back to what Chairman Pellett said in our examination of institutions we do the examination and ensure that there is not collateralized lending as you indicated there. We want to make sure that the risk management systems in all institutions that we regulate, and Farmer Mac in particular with its capital structure, are adequate. I will let Farmer Mac address its underwriting standards. It does have an underwriting standard program. It does do due diligence on all loans that it buys. And those factors are factored into even the risk-based capital model that the statute requires us to address. From the examination perspective, I would share with you that we do do a thorough analysis of risk and cash flow. I personally share with you some of the concerns about agricultural prices in general. I grew up on a small farm myself, and the market is driving the prices. And there are a lot of investors. And obviously farmers that are buying it is doing that.

Mr. GUTKNECHT. But none of that could happen if you didn't have pretty loose credit.

Mr. MCKENZIE. And I would say to you, in FCA, we are looking for good examiners. And you might be a good source. I would appreciate any help that we could have from you.

Mr. GUTKNECHT. Well, I may be an auctioneer back in a couple of years, and I don't want to see that happen again. But I think we are setting ourselves up for the same situation, because we have got land values way ahead of what they could possibly cash flow. And the greatest farm economist that ever lived is a guy by the name of Johnny Cash. And he said it best when he said, "Everything changes as well it should. The bad ain't forever, and the good ain't for good." And I just think we are set up, once again, with land values that can not be cash flowed, and sooner or later, when the market begins to turn, we are going to wind up with a whole lot of that coming back, and then the auctioneers will reset the values of that, and it will be set at what people can really afford to pay for it. And it will be a lot lower than it is today. And everybody loses. And I just think we are not doing enough today to make certain that that doesn't happen.

I yield back.

Ms. Pellett?

Ms. PELLETT. Congressman, we appreciate your comments and respect them. And may I assure you that we are taking means to keep these things from happening and will continue to. Thank you.

The CHAIRMAN. I thank the gentleman.

Before we turn to the gentleman from Nebraska, I yield to the gentleman from Texas for a brief comment.

Mr. STENHOLM. Yes. The gentleman from Wisconsin was asking some very good questions as it pertained to current and future questions, but I think the inference was left that the taxpayers took a haircut in the 1980's as a result of the appreciation of land values. I believe, if you examine the record, taxpayers have not been out one penny to the Farm Credit System. We provided in the legislation of 1987 loans that have been paid back, capital is adequate today in the Farm Credit System to pay back in its entirety, should they choose to do so, pay back that which was lent to the Farm Credit System. We also created an insurance system that is self-financed. Now there were some haircuts, as the gentleman said, that were taken, but it was usually with stockholders and various PCAs and land banks, et cetera, all part of the system that, for various mismanagement or misjudgment, as the gentleman is correctly pointing out the question how can you pay this much, these are legitimate questions. But I did not want the record to show that the taxpayers of America have been out any money on the Farm Credit System thanks to good management taking the legislation that was passed in 1987 and doing with it what Congress intended, we have a system today that in today's terms are in good financial condition. Not to say that the gentleman from Wisconsin's questions are not ones that all of us in agriculture need to be looking at. And also, from the standpoint of GAO and on the risk management of Farmer Mac, et cetera, these are all things that we have got to pay a little bit more attention to. But the folks that gave the taxpayers the haircut, as it was termed, was the savings and loans. And that was some of the most gross mismanagement that you could possibly see. And the taxpayer was out a bunch. But the taxpayer was not out one penny on the Farm Credit System.

The CHAIRMAN. I thank the gentleman. And I am sure the gentleman from Minnesota appreciates those comments, but I also appreciate the observations from the gentleman from Minnesota. There are some concerns here that need be addressed.

The gentleman from Nebraska, Mr. Osborne.

Mr. OSBORNE. Thank you, Mr. Chairman.

I have a question for Ms. D'Agostino. And I read in your testimony you said that government does not guarantee Farmer Mac obligations and that the perception in the agricultural community is that the government does guarantee those obligations. And I think the fact that this perception is out there, you also said in your testimony, allows Farmer Mac to have some advantages in terms of rates and ability to borrow. Now it seems to me that this isn't quite consistent with a fair way of doing business if, in fact, all we are dealing with here is a perception and, in reality, the government does not stand behind these loans. It would seem that maybe we should have some specific language where either it does or it doesn't. And also whether we should put these people in a position where they can achieve lower interest rates than the banks and other people who are in a lending situation. I just would appreciate your comment on that and your willingness to flesh out your original testimony.

Ms. D'AGOSTINO. Sure. I think, to clarify one thing, what we have said is that not that they don't have the Treasury line of credit, but that the Treasury line of credit, according to Treasury's view, is extendible only in cases where the guarantees aren't running to Farmer Mac itself, in other words where Farmer Mac has kept its own securities in its own portfolio. Where Farmer Mac has securitized and sold to investors the capital markets, then that guarantee would run, I believe, under the Treasury position. And of course, this is a disputed issue between Treasury and Farmer Mac whose outside counsel totally disagrees that Treasury's line of credit could apply only in certain given instances, that it would apply in all instances. So what we pointed out was this dispute is ongoing. And the lack of certainty and the lack of clarity about this point does allow a perception to continue, as you pointed out, in the markets that everything of Farmer Mac's has the full faith and credit guarantee backing of the U.S. Government; whereas the Treasury line of credit is $1.5 billion and there is this question out there about to what it covers, not under what conditions, but what it covers.

Mr. OSBORNE. I am assuming that it would be advisable to get this clarified, is that correct?

Ms. D'AGOSTINO. That is one of the options that Congress has——

Mr. OSBORNE. All right.

Ms. D'AGOSTINO [continuing]. is providing more clarity to the line of credit. And I think the Treasury witness also welcomed that.

Mr. OSBORNE. Well, let me press on with one other question for you. You also stated that legislation is not specific and it does not provide mission-related criteria that allows for a meaningful assessment of Farmer Mac's progress in meeting policy goals. I am thinking about where does this committee come in. And it seems to me that that is somewhat in our area of jurisdiction to provide specific language. And again, I guess what you are saying is that the language isn't tight enough, because it is not clear enough, and therefore, your job of assessing is difficult.

Ms. D'AGOSTINO. It was very difficult. And I think Treasury's statement amplified the difficulty even further of trying to go from the broad statutory mission statement to figure out what Farmer Mac really is contributing in terms of interest rates, in terms of coverage, in terms of the agricultural real estate market as a whole. This is true particularly given the concentration and the number and the location of lenders that use Farmer Mac. It would seem that to be fulfilling a public purpose, you would want a very broad and nicely spread out benefit from Farmer Mac to the Nation as a whole. And we would be happy to work with the committee on trying to improve the language. Some of the things that we have thought about include being informed by what the housing GSEs have in terms of their goals. There may be targeted populations you want to cover. I know in the FCS statute, there are provisions for young beginning and small farmers to get some attention from the institutions. I think there are a lot of options for you to consider and paths that you can take.

Mr. OSBORNE. Thank you. And my time has expired. I yield back, Mr. Chairman.

Mr. LUCAS [presiding]. Thank you.

Mr. King.

Mr. KING. Thank you, Mr. Chairman, and I would like to thank the chairman for the hearing here today and the testimony of all of you.

As I listen to this, most of the questions have been answered, and I think they have been good questions and good answers. The three questions, really, that stand out about this hearing for me are the question about capitalization, the question then about the board structure, and then the third question is about the mission statement and is the mission being fulfilled. I would look back on a couple of things. The long litany of things that were wrong in 1982 given by the gentleman from Minnesota is really right on the mark. I would say there is a little bit of a difference between today and then, though. And the exception that I would point out is that today we have markets. Today, at least in our part of the country, we have gotten some rain, and I am grateful for that. And so that makes a big difference to have markets have productivity and some rain to support that. And I hope that comes to the western part of the country as well. So that is a distinction.

But I would also point out that the taxpayers did take a haircut in the 1980's. And I remember a headline that said $26 billion dumped into the farm program. That came out of the taxpayers, and that was specifically to bring agriculture out of the toughest hit that it had taken at least since the 1930's. It was part of all of the things that Mr. Stenholm pointed out and Mr. Gutknecht and a number of others, but we also, as taxpayers, did take a hit. And so what is interesting to me is Chairman Goodlatte's initial question intrigued me from the beginning and that was replay the scenario of the 1980's and advise the committee on what that impact might be if we went back to that scenario again. And that has recurred from Mr. Lucas and Mr. Gutknecht. And so it was also interesting to me that that question asked of Ms. D'Agostino that was passed off to Ms. Franzel. It is interesting to know that you are from Minnesota and your water runs down to us, and you had a prepared answer to that question, which boiled down to we don't know. I understand that, but don't we have any kind of model that can look at this capitalization? I mean, don't we know that underlying all of these loans are land values and cash flows together, not exclusive from each other, but together? And can't we do some kind of analysis of that so that we can better predict what condition we are in here, because that is the central question here? The very purpose of setting up Farmer Mac was in reaction to the farm crisis in the 1980's. So why don't we know more? And can we find out more? And I direct that, then, to Ms. D'Agostino.

Ms. D'AGOSTINO. OK. You have really hit this right on the money in that, and this is one of what we feel is a major and important issue to address now. It was to address the modeling problems that we found at Farmer Mac and some at Farm Credit. Basically, the models that Farmer Mac uses are using old loans from FCB Texas.

They are using old loans and assumptions that don't bear any resemblance to the loans currently in portfolio. There are different conditions. There are different prepayment risks and terms. And what we recommended was to include current data on farm loan, payment delinquency, and valuation, one of the issues you pointed out, for the loans included in the estimation models so that this process reflects current loan and economic conditions. We had several other recommendations. I won't bore you and read them to you, but not being a modeler, we had modelers looking at their models, and this is where our recommendations came from. The modeling has serious limitations and weaknesses, and that is why we can't answer your question. Their model has major problems.

Mr. KING. But does anyone have a model that lays this all out? I mean, I envision an interrelational spreadsheet that plays with some of these scenarios, which is part of our land values are prompted by the farm program, some by low interest rates, some by strong markets, some because it is in good hands and we have people that have their farms paid for and they can afford to pay a high dollar for 80 acres. But can we plug that into our loans and play with those scenarios that maybe see land values drop by 10 percent? And then what does that do to the cash flow capitalization and——

Ms. D'AGOSTINO. You should be able to, but this model that they have doesn't do that.

Mr. KING. Can you put that together?

Ms. D'AGOSTINO. No, we normally don't. I mean, are you willing to augment our appropriations?

Mr. KING. I mean, you are making recommendations here, and I'm giving an opinion, so I am suggesting that it needs to be far more important.

Ms. D'AGOSTINO. No, I agree. Really, we don't see it as our job to create the model for them. We have recommended that they do so. There are other models out there that they could use to inform themselves to adjust and make the correct type of model that would adequately consider changes in land values and interest rates. It would be relatively awkward for GAO to offer to create the model for them and then go review it the next time you ask us.

Mr. KING. So in summary, you can either endorse or offer recommendations?

Ms. D'AGOSTINO. Yes.

Mr. KING. And I will accept that answer, and I would ask the chairman for unanimous consent for an extra couple of minutes, please.

Mr. LUCAS. Seeing no objection.

Mr. KING. Thank you, Mr. Chairman. And I would just pass the question that question along to Ms. Pellett or Mr. McKenzie. With regard to models, I think the modeling part of this may be the way this question gets answered for us. Would you care to speak to that?

Ms. PELLETT. OSMO has been working on this, and I will pass to Mr. McKenzie.

Mr. MCKENZIE. Congressman, I think you have gone to the core of the issue. I would respond this way. There is a multitude of people out there in risk management that are attempting to do exactly what you are requesting. I will say this—this is one reason that the regulator we support the recommendation to have greater flexibility so that we can adjust over time. Indeed, the statute prescribes a certain risk model now. This is the regulatory minimum risk-based capital stress test, that it is known as, that it tries to predict just what you said. But the model and the data availability has limitations. So you end up with a multitude of assumptions that build into those issues. And whether your assumption is correct or the regulator is correct, or the Congressman from Minnesota's predictions are correct is all a matter of opinion. And it is very difficult to have one model that addresses the minimum capital levels of financial institutions. For example, in our regulation of Farm Credit institutions, we have at least four minimum capital levels that we address by regulation. Most of the financial institutions regulators have multiple ratios that they look at and capital. They look at it from different ways. And we do support the additional flexibility. I will assure you that we are looking at the existing statutory provisions and the existing risk-based model to improve the existing regulatory requirements for Farmer Mac.

Mr. KING. Would it, Mr. McKenzie, be a reasonable statement that if this Congress is to provide for any changes in the capitalization structure of Farmer Mac or Farm Credit Administration in its entirety that we have the opportunity to hear from the people who are managing the models so that we can listen to those types of scenarios that you described?

Mr. MCKENZIE. Correct. Actually, we prescribe the regulation that Farmer Mac actually submit quarterly submissions of its risk-based model result, and we will be reviewing those as a matter of off-site processes and as a part of our examination. And as I have indicated, also, we have a regulatory project that will be looking at revisions for the regulatory provisions as well.

Mr. KING. And I would be interested at some point if there is a red line scenario there to get a sense of where that might be. I think that would be an operative question.

I want to thank you for your responses to these questions, and I thank the chairman for the additional time.

Mr. LUCAS. Thank you.

Mr. Peterson.

Mr. PETERSON. Thank you, Mr. Chairman. And I missed part of this hearing, because I had an Intelligence committee meeting. I hope this hasn't been addressed. In the GAO testimony, risk control and management are one of their underlying concerns. And Farmer Mac, I guess, argued that the hypothetical situation that they have raised is too implausible that something like what they are looking at would never happen. And I guess I am kind of wondering, we have got a couple of things going on. One is that the people are continually taking shots at us and talking about eliminating government programs and supports in the future. We are in the middle of the round where we are trying to give away all of our support for agriculture.

I am not sure that that is going to happen, but say that it did happen. Say that we pulled out the supports completely either because of the trade agreements or because the Congress decided they finally wanted to balance the budget, what would happen? It seems to me that the farm bill that we passed had a significant effect of increasing land values. And the land values are going up. I think the main reason is because of the farm bill, at least in my part of the world. So what would happen if we accomplish these things and all of a sudden the support wasn't there and that land values fell in half, for example? What kind of a situation does that put you in?

Ms. PELLETT. I would like to respond to that, Congressman. That would be a very, very challenging time for both the institutions that we regulate and for all lending institutions that give agricultural credit. That is why during these very good times in agriculture we are doing everything possible to see that our institutions are safe and sound and that the risk management tools are in place to handle a time that is not as good as we are experiencing right now.

Mr. PETERSON. And so you have those tools in place so that if we saw a 50 percent collapse in land values you wouldn't have a problem?

Ms. PELLETT. It would be very challenging, Congressman, but we are working to see that they are in place in the institutions that we regulate.

Mr. PETERSON. From 1998 to 2001 we put in $26 billion of additional assistance. What would have happened during that period of time if we wouldn't have done that? Have you looked at that?

Ms. PELLETT. Congressman, I am a farmer, and I lived during those times, and they were very difficult times for all entities involved: the farmers, the lenders, and now, as I am looking at it from the regulator standpoint, it would have been a very difficult time for the regulator. And like I said, we are working hard and diligently every day to make sure that those risk management tools are in place.

Mr. PETERSON. Yes, maybe I just don't have enough background in this area, but I am a CPA and I get involved and am somewhat used to in my practice that I had the Fannie Mae and those folks up talking to me because of the spotlight that has been put on them. And I have to tell you, after talking to them for 2 hours trying to understand what in the heck this is about, I still couldn't figure it out. You get into all of these derivatives and all of this other stuff that supposedly is risk management is mystifying to me. I hear what you are saying that you are trying to do something about this, but I come away from this conversation like I did with that one with those other agencies and that is that I don't quite get it. So maybe if there is some way you could put this into some simpler language that an old farm boy CPA could understand, it would be helpful.

Ms. PELLETT. Congressman, we would be pleased to do that, and our staff would be pleased to put something in writing and/or meet with you personally.

Mr. LUCAS. Thank you, Mr. Peterson.

Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

My understanding of the GAO report is that there are standby commitments of $3.1 billion.

Ms. D'AGOSTINO. Standby and similar agreements.

Mr. OSE. Is Farmer Mac compensated for taking those standby positions?

Ms. D'AGOSTINO. Yes, they generate fee income for Farmer Mac.

Mr. OSE. What does the fee income equate to, in terms of basis points?

Ms. D'AGOSTINO. We have the balance sheet.

Ms. FRANZEL. The guarantee and commitment fees for 2003 were $20.7 million. They have been growing steadily each year as the amount of these commitments increased. For instance, in 2001, the amount of guarantee and commitment fees was $15.8 million.

Mr. OSE. Now I also understand that Farmer Mac's total portfolio is around $4.5 billion.

Ms. D'AGOSTINO. It is $5.8 billion, including on and off balance sheet assests and guarantees.

Mr. OSE. And if I read your report correctly, the income for the period ending December 31, 2003 for Farmer Mac was $27.3 million? It is on page eight of your report.

Ms. FRANZEL. Yes, net income before cumulative changes of accounting principles would be $27.2 million.

Mr. OSE. So if I take the $27.3 million and I subtract the $20.7 million, I come up with $6.6 million of income from continuing operations under GAAP?

Ms. FRANZEL. That is correct. You would also want to calculate in the tax effect, so the effect would not be that dramatic, but your point is that those guarantee and commitment fees are making up a large part of the bottom line.

Mr. OSE. Well, my point is that the margin between profit and loss on the underlying $5.8 billion portfolio is one basis point, essentially? $6.6 million on $5.8 billion?

Ms. FRANZEL. That is approximate, yes.

Mr. OSE. Is it supposed to be run on a basis of a break-even status? Is that what the statute calls for?

Ms. FRANZEL. No, but there is a number of components of income. You can also segregate out the income on their retained securities, which is also very significant.

Mr. OSE. Well, I notice that the mortgage-backed security thing has not been effectively marketed or marketized.

Ms. FRANZEL. Right.

Mr. OSE. Marketized? Is that a word?

Ms. D'AGOSTINO. It hasn't been put out——

Mr. OSE. Securitized, but it hasn't been marketized?

Ms. D'AGOSTINO. Right.

Mr. OSE. That is a new word.

Ms. D'AGOSTINO. That is a good one.

Mr. OSE. We make a lot of things up around here. So I am curious whether you have any information as to whether or not those mortgage-backed securities would trade at face value, at a premium, or a discount?

Ms. D'AGOSTINO. That is the big, unanswered question.

Mr. OSE. So you have an organization running a margin on a year-to-year basis of about one basis point, owning $5.8 billion worth of mortgages with an in-house traded, mortgage-backed security portfolio of—I am unclear on what that amount is, some amount, with over $3 billion of contentious liabilities and what can only be called a special purpose entity under GAAP's provisions. Am I correct on that?

Ms. FRANZEL. That is correct. Yes. And that is really the heart of the mission and non-mission question here. Our Farmer Mac is holding a number of investments, which are kicking off a fair amount of income, which contributes to the bottom line, and a number of——

Mr. OSE. But the liabilities associated with that income are not reflected on their balance sheet?

Ms. FRANZEL. Correct, although that would be part of the program assets. Yes, the underlying assets are off balance sheet, because Farmer Mac does not own them, however, Farmer Mac does have potential future obligations, and Farmer Mac does collect annual income related to those standby agreements. So it is very complicated.

Mr. OSE. In your study, if Farmer Mac, on a continuing operation basis, is operating on a margin of one basis point, how does that compare with, say, Fannie Mae or Freddie Mac? Do you have any information about that?

Ms. FRANZEL. We do have, in our October report, some comparisons of Farmer Mac's net income or return on assets to the other institutions. I don't have that at my fingertips, but we can certainly get back to you with that. We have some analysis on that.

Mr. OSE. But what I am interested in is if you take out the special purpose entity income and you come down to what is euphemistically called as income from continuing operations. I would like to compare that as a function and basis point margin with that of, say, Fannie Mae or Freddie Mac.

Ms. FRANZEL. Yes, we could slice and dice the income for you and give you some analysis, if you would like.

Mr. OSE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Ose.

A couple of questions from the Chair. Chairman Pellett, your statement is a very straightforward accounting of your regulatory program overseeing Farmer Mac and provides a great deal of very useful information. And I noted on page five in the last full paragraph, you discuss the increased regulatory presence over Farmer Mac. You do mention the GAO report as being an impetus for stepping up these examinations, however, what role did the allegations that Farmer Mac may be operating in an unsafe manner have in your increased activity?

Ms. PELLETT. The increased activity was a result of the rapid growth that Farmer Mac had experienced. And there was a very steep rise after 1999. And that raised their whole risk profile, and that triggered our increased examination, which has taken place over the last couple of years.

Mr. LUCAS. You also mention that FCA staff is looking at a requirement for Farmer Mac to obtain a credit rating. Does FCA have sufficient authority to require Farmer Mac to get a credit rating?

Ms. PELLETT. That may be questionable, however, we are studying to see how the other regulators have gone about seeing that the institutions that they regulate have gotten credit ratings. A credit rating is usually driven by the marketplace. But we are doing that study, and we may have some findings from that very soon.

Mr. LUCAS. OK.

The Chair turns to the ranking member, Mr. Stenholm.

Mr. STENHOLM. Thank you. I thank the panel for your input today in this Farmer Mac hearing. And again, going back to 1987 and remembering how we got there, it is fascinating to me. And Ms. D'Agostino, you said you couldn't answer the question, but one of the questions that I have in my mind that I hope someone will be able to answer for this committee's satisfaction soon is when we passed this in 1987, we had strong support from the banking community, but we had almost downright opposition from the Farm Credit System. And today, we find that the Farm Credit System is using it, but we have seen a decline in the bankers in using it. And that is the question. Why? What is it that is happening today that is causing that, because the whole purpose of Farmer Mac was to provide agricultural borrowers with the cheapest interest that we could, compared to Fannie Mae, et cetera? And the theory still works, but for some reason, we have not been able to fully utilize it to this point. Well, admitting that Farmer Mac is a baby in this area, I think that that perhaps is part of the answer, but I think that there are some other questions that you can't answer and I think, perhaps, even Farmer Mac can't answer, but it is something that I hope, Mr. Chairman, this committee will continue to pursue, because I think that is a valid question.

Just regarding the haircut, and my friend from Iowa pointed out the $26 billion. That was disaster assistance. That was trying to bail out agriculture. And of course lenders get bailed out when you bail out producers. But I remember very distinctly, because it is still today, the Rolling Plains Production Credit Association that was my original financier and still is. They have changed names about three times now as they have adjusted to meet the challenges of modern day agriculture, but they refused, during the 1980's when so many experts in agriculture were recommending leverage: "Take whatever dollars you have, borrow, buy land. It is never going down again." Well, the folks that did lost big. I also observed with great sadness many producers who received SBA disaster loans at 3 percent interest and didn't use that to pay off their debt but used that to leverage into continuing to enlarge their operations and ended up losing everything.

The questions that you have been asked by many of my colleagues today regarding standards and how we look at this whole question of agriculture, the question Mr. Peterson asked regarding WTO and regarding the constant pressure to eliminate agricultural subsidies, if we were to do that, there will be an adjustment that will affect lenders of all shapes, sizes, and proportions. I can't help but remember when we were doing the hearings on what became the 2002 farm bill. We had 10 hearings, 20 witnesses at each hearing, 200 witnesses, 1 of which suggested the total elimination of all subsidies and doing it immediately, because that would be the best way to get us to the adjustment that sooner or later we are going to be at anyway. 199 said, "No, that is not the best suggestion and solution for us." But the questions that you have been asked today and your answers and the emphasis on risk is something that we have to continue to look at and continue to do so in a way that is complementary to the industry in which we serve and you have been here today to testify on behalf of one element, Farmer Mac, which I still believe, as I did in 1987, has a significant role to play in the future of agriculture.

Thank you very much for your attendance today. We may have some additional questions to submit to you in writing for the record.

The CHAIRMAN. I thank the gentleman.

Yes, we do have some additional questions we will submit in writing for the record, and I want to thank you for your very extensive and very helpful testimony. The committee has some valuable information and some good recommendations that we need to look at very closely and see where we go from here. And we also look forward to hearing from the representatives of Farmer Mac on the next panel. So we thank you all and move on to them.

We will invite our second panel to the table: the Honorable Frederick Dailey, Chairman of the Federal Agricultural Mortgage Corporation of Washington, DC; and Mr. Henry Edelman, president and chief executive officer of the Federal Agricultural Mortgage Corporation.

Mr. Dailey, we welcome you and advise you that your full statement will be made a part of the record and ask that you limit your comments to 5 minutes. And you may proceed.

STATEMENT OF FREDERICK L. DAILEY, CHAIRMAN, FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Mr. DAILEY. Thank you, Mr. Chairman and members of the committee. My name is Fred Dailey. I am Chairman of the Federal Agricultural Mortgage Corporation. I also happen to be a farmer, and, in another lifetime, also the director of the Ohio Department of Agriculture.

I appreciate the opportunity you have given us today to appear before you and to speak about our mission successes, our safety and soundness, and our corporate governance policies. As the chairman of Farmer Mac, I feel a great sense of duty to exercise my shared responsibilities in such a manner as to ensure the fulfillment of our congressional mission in a safe and sound way for the benefit of farmers, ranchers, home owners, the lenders who serve them, and the stockholders who have capitalized this enterprise.

By statute, as you have heard, Farmer Mac is made up of five appointees of the President of the United States, five representatives of the Farm Credit System, and five representatives of commercial banks, insurance companies, and other financial institutions. Our board works together as an alliance that is unique in agricultural finance to accomplish Farmer Mac's important congressional mission.

Every day, Farmer Mac seeks new ways to fulfill the important socioeconomic mission Congress has given us in a safe and sound manner and to create ongoing value for our stockholders. As you are aware, agriculture has become a very capital-intensive industry, and Farmer Mac has made great strides in accomplishing its congressional mission of increasing the availability of long-term mortgage credit to farmers and ranchers at stable interest rates by providing greater liquidity and lending capacity to agricultural lenders in our role as a secondary market for agricultural mortgages.

Since the 1996 revision to our charter, we have helped farmers, ranchers, and rural homeowners throughout all 50 states by acquiring or committing to acquire over 33,500 loans. Here is a fact that encapsulates why we were created and how we are fulfilling our mission. On average, interest rates offered by lenders using the Farmer Mac I program are almost a full percentage point lower, actually 85 basis points lower, than rates on comparable loans as reported to U.S. Federal Reserve banks by member banks in agricultural lending states. We also, through our Farmer Mac II program, are reaching out to help small and family farmers who would not otherwise be able to obtain financing and to help finance the development of business and infrastructure in the Nation's rural communities.

I am especially proud of the strides we have made in corporate governance. At my very first board meeting in October of 2002, we instituted a policy of executive sessions at all board and committee meetings. Farmer Mac's board and committee membership meet the independence requirements of the SEC rules and the New York Stock Exchange listing requirements. In distinction to other secondary market GSEs and most other private sector corporations, Farmer Mac has a board of directors composed entirely of outside directors. No members of management serve on the board. The chairman of the Farmer Mac Board is not the chief executive officer as its president serves in that latter capacity. Since the fall of last year, Farmer Mac's board has adopted a code of business conduct and ethics. We have adopted new board committee charters. We participated in director training, hired an outside, nationally recognized consultant for corporate governance. And we have also brought our board in for one day of special training put on by the National Association of Corporate Directors. We have also revised our committee structure by eliminating the executive committee and transferring those responsibilities to our corporate governance committee. And we have a split our program development committee in to a credit committee and marketing committee to avoid any appearance of conflict of interest.

Farmer Mac is operating safely and soundly and in full compliance with current corporate governance standards. Since the inception of its business, Farmer Mac has been required to comply with the rules and regulations of both the FCA, SEC, and New York Stock Exchange listing rules. Farmer Mac has been an SEC reporting company for security law purposes since its initial public offering of stock in 1988 and publicly offered Farmer Mac guaranteed agricultural mortgage-backed securities have always been required to be registered with the SEC. Farmer Mac files quarterly call reports with the FCA as well as periodic financial reports and quarterly reports on form 10-Q and annual reports on 10-K with the SEC. Farmer Mac continues to build its capital strength through efficient and profitable operations, linited credit losses, and retention of earnings.

Farmer Mac is receptive and responsive to comments and recommendations from Congress and GAO and its regulators, such as

FCA and the SEC, agricultural lenders, capital market debt, equity investors, and most importantly, farmers, ranchers, and rural homeowners. We at Farmer Mac welcome this hearing as an opportunity to explain how we attempt to satisfy each of these constituencies.

Thank you, Mr. Chairman, and members of the committee, for your attention and for your support of Farmer Mac.

[The prepared statement of Mr. Dailey appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Dailey.

Mr. Edelman, welcome.

STATEMENT OF HENRY D. EDELMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Mr. EDELMAN. Thank you, Mr. Chairman.

Mr. Chairman, distinguished members of the committee, my name is Henry Edelman. I am president of Farmer Mac, and I am pleased to be here today reporting to your committee on Farmer Mac's progress and the fulfillment of its congressional mission. I share Chairman Dailey's appreciation for the opportunity you have given us to appear before you today.

Having been at Farmer Mac since it started business in 1989, I am proud of the advances we have made, and I look forward to the opportunities that stand before us to benefit rural America. Most of our recent progress has been through the development of the well-considered changes you have made to our statute in 1996. Our guarantees and commitments on securities and agricultural loans held by lenders enable those lenders to make more loans without increasing their equity. Farmer Mac's guarantee or commitment decreases to one-fifth the amount of equity the lenders must maintain in support for those loans. This provides lenders with five times as much capacity to make loans based on the same equity.

Farmer Mac has purchased or provided guarantees and commitments on $10.7 billion of agricultural mortgage loans to farmers, ranchers, and rural homeowners throughout America. In addition, Farmer Mac purchases loans to recharge lenders' funding. This creates new liquidity and gives them the ability to make additional loans. As a secondary market, Farmer Mac maintains a ready and consistent daily offer to purchase or guarantee loans that conform to Farmer Mac standards based on our access to the capital markets.

A credit delivery system that relies solely upon primary lenders, whose funding may ebb and flow according to economic cycles or other factors, would put rural borrowers at risk of uncertain funding availability. Farmer Mac, as a capital market based secondary market, has demonstrated its ability to provide a consistent and reliable source of funding for rural America. This is evidenced by Farmer Mac's purchases of $4.5 billion of agricultural loans to date.

Farmer Mac is operating safely and soundly, consistent with its enabling legislation. As disclosed in our quarterly SEC filings, Farmer Mac administers its risks conservatively. Our regulatory capital is almost six times the level required by the statutory risk-based capital test. And its regulatory capital is 1⅔ times the required statutory minimum capital level. Farmer Mac's 90-day delinquencies at the end of 2003 had trended down to 0.6 percent, lower than the average experience of comparable agricultural mortgage lenders. This represented a reduction from $58 million at the end of the preceding year to $30 million during the preceding year.

As an SEC reporting company, our reserve for losses meets GAAP requirements. I will just mention on losses, when you consider that we have done $9.2 billion of business in Farmer Mac I and our total losses have been approximately $11 million on loans while we continue to be profitable on our bottom line, that represents a 13 basis point historical loss over the life of Farmer Mac's business.

Farmer Mac's assets and liabilities are closely matched with the low sensitivity to shifts and interest, which enables us to hold AMBS on our books with little risk, and there is no requirement in the statute that we sell AMBS. We have certainly done so. We have sold $940 million of AMBS. We have sold them as recently as last month at a profit, and we consistently, over time, on a hedge basis sold at a profit, so I am really appalled to hear people talking about the risk vetted in those AMBS when they are helping farmers and ranchers.

While Farmer Mac is similar to other secondary market GSEs, it has been able to succeed with many qualifications on its ability to do business that distinguish it from Fannie Mae and Freddie Mac. And while we have made great progress, we have always recognized that growth is going to bring new challenges. We are ready to meet those challenges. We have taken many steps consistent with the findings and recommendations in the GAO report to enhance our risk management practices, and we have specified those in our testimony. And contrary to the GAO testimony, we have completed many of those.

These and other enhancements have strengthened Farmer Mac so that, in summary, we believe we have made great progress in the safe and sound accomplishment of the very important congressional mission you have given us for the benefit of the Nation's farmers and ranchers. A great deal of work certainly lies ahead, but so do also many promising opportunities. We are confident that Farmer Mac will make an ever-greater difference for rural America. We look forward to working with this committee in bringing our potential to fruition.

Thank you, sir.

[The information appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you very much.

At the outset, I said that I would give you the opportunity to answer the same question I asked the first panel, and that is, with Farmer Mac's sizable loan portfolio, how confident are you that the company could withstand a downturn in the agricultural economy that was seen in the mid–1980's?

Mr. EDELMAN. Thank you, sir.

The CHAIRMAN. Are you confident that Farmer Mac can maintain the liquidity to sustain itself through such a recession?

Mr. EDELMAN. Yes, we are very confident. Let me describe a few things. First of all, Farmer Mac's underwriting standards, in response to a question that Mr. Gutknecht raised, are based not only on collateral, but also on cash flow. And therefore, when we look at cash flow, that includes the income from farming that is earned by a farmer. And when you consider that and also further consider the fact that our appraisal standards include the income method, that gives due consideration to the present value of the future economic flows from the highest and best agricultural use of the property, and when the example was made about a $3,000 per acre farm, we would probably only see a $1,500 per acre loan on that farm. Now if you put this into the context of the 1980's, the statutory risk-based capital model that was devised by Congress for Farmer Mac and developed by the FCA actually was implemented by FCA at approximately a 50 percent higher level than was required by the statute. This is because they used worst case data from Texas in the Farm Credit Bank in the mid–1980's, and that would have resulted in a 2.73 percent loss rate for the two worst years in the mid–1980's. They then looked at the loss severity in other States, Iowa, Illinois, Minnesota, and raised the number from 2.73 to 4.18 percent. So they went beyond any historical information about a specific time and place in formulating that risk-based capital model. Having done so, they generated a model, which was designed and validated by outside experts at the University of Illinois Urbana, and that model showed that Farmer Mac needed different amounts of equity at different times. Currently, Farmer Mac's equity is, for modeling purposes—which includes reserves—approximately $245 million, and that is more than five times the risk-based capital requirement. So if you use data from the mid–1980's, you see that Farmer Mac, based upon a model, which contrary to GAO's testimony about their uncertainties, was, indeed, based not only on loans from the mid–1980's, but loans that were specifically selected out of the total database for their conformity to Farmer Mac's underwriting standards, appraisal standards, and documentation standards that were submitted to this committee for review on September 13, 1989.

And when you consider those factors, I think that Farmer Mac could easily withstand a similar cataclysm to what was seen in the 1980's because of our underwriting standards, because of the effectiveness of the risk-based capital model, and because of our careful administration of loans.

The CHAIRMAN. Mr. Dailey, anything you want to add to that?

Mr. DAILEY. The only thing I want to add to that is that that was during a very stressful time. We have tried to take the worst case scenarios and use to underwrite our risk assessment programs. We have been encouraged by GAO and by FCA to use more of our own data, our own historical data, but it comes from a good time in agriculture. If we use our own historical data, it requires us to have less reserves instead of more reserves, but we operate very conservatively.

The CHAIRMAN. OK. Let me ask another question to you, Mr. Edelman. You currently hold a sizable portion of the agricultural mortgage-backed securities in your portfolio even though the GAO reported in March of 1998 that you expected, within 2 to 3 years, your presence in the capital markets would be well established and AMBS would be a marketable asset. Do you have a view as to why the market interest in Farmer Mac securities has not worked out as anticipated?

Mr. EDELMAN. I would say that was a mistatement, sir. There is a lot of interest in Farmer Mac securities. We have, nevertheless, retained AMBS while we have sold Farmer Mac debt. Since 1998, that is a very important date, the collapse of long-term capital resulted in a widening of spreads throughout the bond market such that the profitability of retaining AMBS in portfolio, very closely and carefully funded under Farmer Mac's asset and liability management standards, which are very high standards, as reflected in the half-month duration gap, has proven to be a benefit to farmers and ranchers, because we have been able to use lower rates and been able to deliver the 85 basis point advantage for farmers and ranchers in their potential borrowing from Farmer Mac lenders.

At the same time, we have recently sold AMBS at a profit, and we see no impediment to selling AMBS at a profit. However, we question the real wisdom of doing so when retention of these on our books with the carefully managed ALM that we have engaged in also creates a diversification of our sources of income so that, in other words, part of our income is from spread on those assets. Asset and liability management can produce a positive spread, and that is another source beyond the assumption of credit risk, so that the combination of those two sources makes Farmer Mac safer and sounder and, at the same time, provides a benefit to farmers. There is nothing in the Farmer Mac statute that requires us to sell AMBS into the secondary market. It says make a secondary market for agricultural mortgages. We make a vibrant secondary market for agricultural mortgages and, to the extent that it benefits farmers and ranchers, we will sell AMBS, but if it benefits them better for us to hold AMBS on the books, we would expect to do that as long as it was safe and sound.

The CHAIRMAN. Well, now it has been reported that Farmer Mac, just within the last few days, may have sold AMBS to an outside investor or investors. Is this correct?

Mr. EDELMAN. That is correct.

The CHAIRMAN. And if that is the case, please describe that sale and include the amount of AMBS sold and the number of investors involved.

Mr. EDELMAN. Mr. Chairman, we would be happy to submit that to you in writing, but inasmuch as it is not public information, and we are a publicly traded company, we would prefer not to do so in a public forum.

The CHAIRMAN. All right. Well, we will accept that.

Mr. Dailey, when are the normally scheduled meetings of the Farmer Mac Board, and how often do you meet without the managing officers?

Mr. DAILEY. Mr. Chairman, members of the committee, we meet at least six times a year. During the last year, we probably met about eight or nine times. We are changing our meeting schedule, having meetings on a quarterly basis with two additional meetings, this is so that we can track our quarterly reports better that we will be implementing that new schedule next year. We will still have six meetings, but there will be four meetings corresponding with the end of each quarter.

The CHAIRMAN. And how often do you meet without the managing officers?

Mr. DAILEY. We have met—as I indicated, we have executive sessions at every meeting.

The CHAIRMAN. Are the managing officers excluded from the executive sessions?

Mr. DAILEY. They are. They are. It is strictly board members.

The CHAIRMAN. What number of board members constitutes a quorum? And do all board members attend regularly scheduled board meetings?

Mr. DAILEY. The quorum, I believe, is 10. Is that right? It is eight, but very seldom do we have anybody miss one of our board meetings. Our attendance is usually the total 15. Occasionally, we will lose one or two.

The CHAIRMAN. Good. Thank you very much.

The gentleman from Texas, Mr. Stenholm.

Mr. STENHOLM. Welcome, gentlemen.

A question that I want to ask you is what we have talked about here, and that is I remember when legislation passed in 1987. We had strong support from the independent banking area and, if not opposition, reluctance from the Farm Credit System. Today, we find the Farm Credit System participating at a growing rate and a declining rate of participation from independent banking.

Mr. EDELMAN. That was the manipulation of numbers, sir. What in fact has happened is not that there has been a decline in volume but rather a decline in share. That is, when people referred to the participation of bankers falling from 80 to 22 percent, that is simply what size of the pie their volume represented at Farmer Mac.

Mr. STENHOLM. It is still a decline.

Mr. EDELMAN. That is only because of the corresponding growth of the Farm Credit System. The bankers didn't pull away so much as the Farm Credit System came in, which made the volume that the bankers were doing with us look like a smaller percentage of the total. But the Farm Credit System sort of went from 0 to 60 in 3 years, sir. What happened is that the Farm Credit System did more and more business with Farmer Mac and became approximately 50 percent of our total book of business, and so there wasn't so much a decline and a rise as simply a normalization of what you probably expected, in 1987, which is that there has been more or less equal use by the Farm Credit System and the bankers. So those moving percentages belie the actual dollars, which show consistent growth and more or less equilibration of Farm Credit and the bankers' use of Farmer Mac.

Mr. STENHOLM. On a similar light, then, Farmer Mac's Long-Term Standby Commitment to Purchase program has been used exclusively by institutions of the Farm Credit System. Why haven't commercial bankers used the LTSCP program?

Mr. EDELMAN. There are several reasons, sir. First of all, there is some notion out there that long-term standby is something mysterious and different, and nothing could be farther from the truth. Long-term standby is simply a pure mutation of a swap. And that is in a swap transaction, Farmer Mac acquires mortgages from a lending institution and gives them back a mortgage-backed security backed by the same mortgages with Farmer Mac's guarantee.

And we have done that type of business with a number of banks throughout the United States, and insurance companies as well, I should add. And a standby is a slightly different arrangement where we provide Farmer Mac credit enhancement to a designated pool of mortgages on the books of a Farm Credit institution. And it is a closed pool that gets the same credit underwriting and appraisal review that the loans going into a swap would get. And in turn, we stand ready to absorb the losses in the same manner, that is to buy the loans out of the pool, whether it is a pool backing a mortgage-backed security or a standby. The specific reason that the Farm Credit System uses standby is because they prefer to hold assets on their books for two important reasons. One, as another GSE, their funding is very comparable to Farmer Mac's, and so coming to Farmer Mac for the funding is not very important to them. However, as a co-op, they have limited access to new equity, and what Farmer Mac does is it provides its guarantee for a select sub-group of loans on their portfolio that allows them more lending capacity as intended by the statute.

The other consideration for those Farm Credit institutions, I beg your indulgence, is the fact that statutory borrower rights are a very important consideration for Farm Credit institutions, and those are not provided for customers at commercial banks and insurance companies. In order for us to allow Farm Credit institutions to interact with their borrowers consistent with the borrower rights, what Farmer Mac has done is left the loans on the books of the Farm Credit institution for the benefit of those borrowers, and at the same time, assumed the credit risk so that the Farm Credit institutions could have more lending capacity and be more competitive in their lending area.

Mr. STENHOLM. It is that practice that GAO warned, or had real concerns about your policy as you have just described it. And in fact, there is a little—I have got a little—let me ask it this way. The last page of your own testimony regarding the forward-looking statements appears to have been copied from SEC 10-K filing. It lists a number of uncertainties. For example, substantial changes in interest rates of the general economy could materially alter Farmer Mac's expectations and actual results. Yet on page 12 of your own testimony, you dismiss GAO's concern as too implausible to deserve serious consideration. Please explain why you believe GAO's concerns are too implausible and therefore unwarranted.

Mr. EDELMAN. Yes, sir. First of all, I would note that you are correct that this forward-looking statement warning is taken from our 10-K. Other factors that are included in that disclosure, for the sake of completeness, are changes in the weather and possible establishment of another secondary market and the rate and direction of the market itself. So I think that there are many different issues that have to be taken into account in full and fair disclosure to investors. Turning, however, to the assumptions that were made by GAO in their report, in my testimony I noted the fact that in order to get to the conclusion that they got to, they made several leaping assumptions.

First, they assumed defaults far beyond the 13.8 percent default rate peak that was reached in the 1980's for all agricultural loans, including non-mortgage loans and mortgage loans that didn't meet

Farmer Mac standards, in other words, uncollateralized loans and sub-standard loans all generated a 13.8 percent default rate. Nevertheless, GAO went beyond that for these loans which had to meet the underwriting standards that were reviewed by Congress in 1989. The made a completely fallacious assumption that the default rate in a mid–1980's scenario on the loans that we are talking about at Farmer Mac would be worse than the entire gamut of loans out there.

The second error in their analysis was they disregarded the loan-to-value ratio of the portfolio at Farmer Mac. The loan-to-value ratio at origination on a weighted average basis at Farmer Mac is under 50 percent. And again, Congressman Gutknecht mentioned the losses in Iowa. Iowa was the worst state in the mid–1980's, in terms of losses of land values, and those were 50 percent. And Farmer Mac does not assume that the entire United States would suffer a 50 percent loss. However, when you consider the fact that on a weighted average basis, 50 percent of our portfolio of mortgages represents only borrower equity and less than 50 percent represents Farmer Mac's mortgage exposure—or rather our portfolio of real estate backed by mortgages, we have a very high level of support.

Another inconsistency in the GAO's analysis was their concern that even in this case, which I dismiss as being farfetched, that Farmer Mac would have to buy back those mortgages. Those mortgages represent a balance of approximately $2.5 billion on Farmer Mac's books. Farmer Mac currently issues approximately $100 billion a year in debt securities. For us to absorb another $2.5 billion of issuance is a relatively minor consideration. And so I think that when I look at all of the different considerations that they had to get through in order to reach the conclusion that they did, I think they went beyond reason.

The CHAIRMAN. Thank you.

We do have some votes. The gentleman from Minnesota, I think, can get some questions in. We will come back after the votes, though and——

Mr. GUTKNECHT. Well, Mr. Chairman, I thank you, and I will be very brief, because, Mr. Edelman, you have shared something here that I apologize, I did not understand. That $3,000 land that is selling in my District, you are only loaning, or not you, but ultimately Farmer Mac is only taking loans for $1,500, and it is a 50 percent equity deal?

Mr. EDELMAN. Let me elucidate on that, if I may. I know you——

Mr. GUTKNECHT. Well, I would prefer just a yes or a no.

Mr. EDELMAN. The answer is maybe, sir.

Mr. GUTKNECHT. OK.

Mr. EDELMAN. Because sometimes it could be $1,500, sometimes it could be less or more. It depends on the cash flow.

Mr. GUTKNECHT. Well, I am not concerned about the less. I am concerned about the more.

Mr. EDELMAN. It depends on cash flow.

Mr. GUTKNECHT. Right.

Mr. EDELMAN. And Farmer Mac looks at the present value of the future profit stream from the highest and best agricultural use of that land. So to the extent that the price was bid up, speculatively, that would not necessarily cover the income. So first of all, we are capped at 70 percent LTV in our lending programs normally, so you would normally see a maximum of $2,100 an acre on that land. But even below that maximum, we look to see the property cash flow, because under the underwriting standards at Farmer Mac, we expect to see it cash flow, and we expect to see a surplus above what is necessary to meet the mortgage on a 1.25 times what is necessary to meet the mortgage. So on that basis, I would find it very remarkable to see the loan above $1,500 unless you told me that it was a very profitable and efficient operation.

Mr. GUTKNECHT. Thank you.

The CHAIRMAN. We have five votes, and so rather than keep you all waiting while we do that, we will recess the committee until one o'clock or as soon thereafter as the votes are completed, that way if you want to go downstairs to the cafeteria and get something to eat or something, we can assure you that we won't start without you, at least not until one o'clock.

Mr. EDELMAN. Thank you.

Mr. DAILEY. Thank you.

[Recess.]

The CHAIRMAN. The committee will reconvene.

And at this time, it is the Chair's pleasure to recognize the gentleman from California, Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

Mr. Dailey, I want to understand something here. If I am correctly informed, the way I understand Farmer Mac to work is that Farmer Mac buys pools of loans from its member or correspondent banks across the country that are based in agriculture. In other words, some bank out here might make a loan, and then they will turn to Farmer Mac and, either in the form of a pool or with the standby guarantee, basically ensure that that loan is liquidatable, that is not the right word, but you can liquidate that loan if circumstances require it. Am I correct in that understanding?

Mr. DAILEY. Yes, sir.

Mr. EDELMAN. Yes, you are.

Mr. OSE. OK. So now the loans come from different areas of the country?

Mr. EDELMAN. Yes.

Mr. OSE. So is there a geographic concentration, or do you spread your risk, in a sense, by only buying X percent from each region?

Mr. EDELMAN. We limit our risks in several ways. First, we buy loans, and I think we should more broadly talk about Farmer Mac assumes credit risk, because whether we purchase a mortgage and put it into a security or whether we guarantee a security or whether we issue a standby commitment, we are still assuming the credit risk. So I think that if you look at Farmer Mac's total book of business, you should look at a consolidated book of credit risks that we assume through different transaction types.

Mr. OSE. And you and I had a brief conversation about the characteristics of the loans that are either directly purchased or otherwise existent under the standby situation.

Mr. EDELMAN. Yes.

Mr. OSE. And if I recall correctly, your comment to me was that the credit characteristics, whether it is in this pool or that, whether it is the actual loan itself or the standby commitment, the credit characteristics underlying each loan are the same?

Mr. EDELMAN. Yes, the credit standards for whether we accept the loan or not would be the same.

Mr. OSE. So when these pools of loans are put to you or offered to you, more accurately, if there are loans—let us say someone offers to sell or asks Farmer Mac to liquidate from this third party's portfolio a group of ten loans, do you go through each of those loans and examine their credit?

Mr. EDELMAN. We do.

Mr. OSE. All right.

Mr. EDELMAN. What happens is, if I may, there are three different types of transactions that put us in a position where we have assumed credit risk. First of all, if we purchase mortgages and then securitize them, that is form a pool of mortgages and create a mortgage-backed security backed by that pool of mortgages, we can either hold that security on our books or sell it into the capital markets. But in any event, if we guarantee the AMBS, we have assumed the credit risk.

The second type of transaction is a swap transaction. And in a swap, what we do is we exchange Farmer Mac guaranteed mortgage-backed securities for mortgages. And of course, those mortgage-backed securities are backed by the same mortgages that were proffered in the transaction. There again, the result is a mortgage-backed security, called an AMBS, Agricultural Mortgage-Backed Security with a Farmer Mac guarantee on it.

The third type of transaction is a long-term standby commitment where someone comes to us with a group of mortgages and instead of asking us to purchase them, they ask us to assume the credit risk by performing the same due diligence we would perform in evaluating the loans for inclusion in the pool that we would have used for an AMBS, but in this case, we evaluate them and consent to their being placed in a closed pool at that lending institution. And they pay us a commitment fee, which is of the same magnitude as the guarantee fee, and we assume the same credit risk. That is we would buy a defaulted mortgage out of an AMBS the same way we would buy it out of a long-term standby closed pool. And the economic risk to Farmer Mac is statistically the same because we perform the same due diligence. We get the same fees, whether it is a guarantee fee or a commitment fee, and at the end of the day, we have assumed the same credit risk, because we have underwritten to the same credit underwriting and appraisal standards.

Mr. OSE. Are you saying you comb through those loans offered to you and sort out the ones that do meet your standards and the ones that don't meet your standards?

Mr. EDELMAN. That is correct.

Mr. OSE. And you force the tenderer to replace the ones that don't meet your standards?

Mr. EDELMAN. We would give them the choice of either replacing them with loans that did meet our standards or doing a smaller pool.

Mr. OSE. OK. Now, on the—Mr. Chairman, I see my red light is blinking. May I have—if it would be satisfactory to you and the ranking member, may I have some extra time?

The CHAIRMAN. Without objection, the gentleman may proceed.

Mr. OSE. All right.

If I understand correctly, you have sold $940 million worth of mortgage-backed securities to date?

Mr. EDELMAN. That is correct.

Mr. OSE. OK. Now you have retained an additional amount of mortgage-backed securities?

Mr. EDELMAN. Yes.

Mr. OSE. And I think your testimony regarding the $940 million was that you had sold them profitably?

Mr. EDELMAN. Yes.

Mr. OSE. Most recently, last month?

Mr. EDELMAN. Yes.

Mr. OSE. On those loans that have been securitized, do you offer the buyer the same guarantee that would come in the form of a standby commitment to purchase back anything that might default?

Mr. EDELMAN. Yes, it is embedded in the security. Yes.

Mr. OSE. OK. So there is little, if any, risk of a buyer of a mortgage-backed security from Farmer Mac?

Mr. EDELMAN. If I could phrase it another way, sir. There is no difference in risk to the buyer of an AMBS than to the holder of a standby commitment. It is the same risk. That is, Farmer Mac's credit, our equity, and the Treasury backstop.

Mr. OSE. All right. Now would you characterize United States' farm economy today as in good shape, in medium shape, in bad shape? How would you characterize it?

Mr. EDELMAN. I think the farm economy is in good shape.

Mr. OSE. All right. I had a conversation with the lady from the GAO, and you were kind enough to come up here and tell me that my numbers were a little bit wrong, and I appreciate that. I want to step through the calculation that I did that mistakenly said the margin was one basis point. We have a $5.8 billion portfolio. We have annual income reported as of December 31 of 2003 of $27.3 million, and we have $20.6 million of that, according to the testimony from GAO, attributable to the standby fees on the off balance sheet commitments you have.

Mr. EDELMAN. I don't believe that that is a correct number.

Mr. OSE. OK. Then we need to correct that, for the record.

Mr. EDELMAN. In fact, sir, GAO was incorrect. If you were to look at our financials, you would see guarantee and commitment fees, that is all guarantee fees on that $5.8 billion and all commitment fees added up to $20.7 million. And so it was not on just the standbys. It is on all guarantees.

Mr. OSE. OK. Do you break that out between the standbys versus balance?

Mr. EDELMAN. Between what, I am sorry?

Mr. OSE. You have income from standby commitment fees and then you have income from the loans you actually——

Mr. EDELMAN. Yes. And part of the income from the loans held on our books is, in fact, guarantee fees.

Mr. OSE. OK. How much from the $20.7 comes from the fees on your books, the loans on your books?

Mr. EDELMAN. On books?

Mr. OSE. Yes.

Mr. EDELMAN. That would be approximately 50 times $4.5 billion times one-half, $11.25 million.

Mr. OSE. So it would be 50 basis points times $4.5 billion?

Mr. EDELMAN. Partly. It works out to $11.25 million.

Mr. OSE. OK. So you have got about $9 million in fees from standby situations?

Mr. EDELMAN. Well, it is about 11 from standby. The thing that complicates this is that under financial accounting statement 140, if you put mortgages or mortgage-backed securities on your books post April 1, 2001, the guarantee fee income has to be treated as interest income for financial statement purposes so that the guarantee fees on that are somewhat understated in the vernacular, because it includes that.

Mr. OSE. The $20.7 million is an understatement?

Mr. EDELMAN. It is an understatement of what we are receiving for assuming credit risk, because there is a recharacterization under FAS–140 of guarantee fee income into interest income for new on books assets after April 1, 2001.

Mr. OSE. For the purposes of the committee, in terms of basis points, contrary to what GAO might have testified, on the $5.8 billion portfolio, you are making about $11 million in standby fees?

Mr. EDELMAN. That is about correct, yes.

Mr. OSE. Which is, by my math, about 20 basis points?

Mr. EDELMAN. Approximately.

Mr. OSE. OK. Now there is one other thing on here that I didn't understand. I have the semi-annual report dated December 31, 2003. And on page 13, there is a chart. Now the testimony has been, from previous witnesses, that there are about $3.1 billion worth of off balance sheet commitments or obligations. And I must be missing something. But I look at page 13 on this chart put together by Farm Credit Administration, so it is not your chart, it shows on balance sheet assets, as of December 31, of $4.3 billion and plus off balance sheet program assets and obligations of about $5.8 billion, which is $1.5 billion.

Mr. EDELMAN. Part of the on balance sheet assets, Congressman, include our non-program investments of approximately $1.5 billion. So if you back the $1.5 billion out of the $4.3 billion, you get back down into the ballpark.

Mr. OSE. I am trying to find the difference between the $3.1 billion that has been testified to by GAO and the $1.5 billion that is reflected in this chart. That is the thing I don't quite understand right now.

Mr. EDELMAN. I don't understand the question very well without the chart in front of me. However, there is one point I would make, sir, which is the number you were referring to as a margin of one basis point is, in fact, 47 basis points. That is, when you take our net income and divide it by guarantees and commitments, what you see is a 47 basis point margin.

Mr. OSE. That would be the $27.3 million number?

Mr. EDELMAN. Yes. Correct. When I look at the document here, what I see in the FCA table is they show on balance sheet assets of $4.3 billion, and of that $4.3 billion, approximately $1.5 billion is investments. So if you back that out, that is $2.8 of on books program assets as opposed to non-program.

Mr. OSE. OK. So then you add the $2.8 plus the $3.1 and you come up with that $5.8-odd that is in that chart?

Mr. EDELMAN. That is right.

Mr. OSE. OK. I misread that. All right. That makes it consistent. All right. So the mortgage-backed securities that you have sold again have the buyer's protection have been able to put back a loan or default to you. In other words, they are protected from any decline in principal?

Mr. EDELMAN. Yes, sir.

Mr. OSE. The mortgage-backed securities that Farmer Mac has put to market contain provisions to protect the buyer from a default or a loss of principal by basically protecting the income stream in such a case. And the way Farmer Mac has protected itself on those cases is that the quality of the loans within those pools have met the standards that are otherwise laid out by the organization as a whole?

Mr. EDELMAN. That is correct.

Mr. OSE. All right.

Mr. EDELMAN. In particular, those standards include the fact that every single loan has to meet a property debt coverage ratio.

Mr. OSE. 1.25. Actually, that is the cash flow.

Mr. EDELMAN. That is the total debt coverage, TDC, of 1.25.

Mr. OSE. Which is an 80 percent loan-to-value ratio.

Mr. EDELMAN. And a one-to-one coverage ratio for property itself. So where the property is less than the total package of debt on a farm. So——

Mr. OSE. Run through that again.

Mr. EDELMAN. Sure.

Mr. OSE. Start at the 1.25 again, please.

Mr. EDELMAN. OK. 1.25 is total debt coverage. One-to-one is property debt coverage, so if there is a farm that has multiple parcels, incremental parcels can be added at one-to-one, however, the total debt coverage of the enterprise must be 1.25 to 1, because it is conceded that certain parcels may be less profitable than others, but the aggregate for a borrower has to be 1.25.

Mr. OSE. Let me reverse that to you. Are you saying that the loan-to-value ratio in the aggregate for the enterprise——

Mr. EDELMAN. OK. This is not loan-to-value ratio, sir. This is the cash flow coverage. That is the ability——

Mr. OSE. I understand. I understand what that is, too. That was my next question.

Mr. EDELMAN. Right.

Mr. OSE. All right. So the cash flow in the aggregate from the enterprise must be 125 percent of the debt service under any of the loans that you are otherwise holding or financing?

Mr. EDELMAN. That is right.

Mr. OSE. OK.

Mr. EDELMAN. The loan-to-value ratio is statutorily capped at 80 percent, but, in fact, operationally, we have capped it at 70 percent for full-time farm loans. And as a practical matter, the loan-to-value percentage at origination on a weighted average basis is only 49 percent in our total exposure.

Mr. OSE. Loan-to-value ratio is 49 percent?

Mr. EDELMAN. Weighted average at origination. Yes. So in other words, a $490,000 loan on $1 million property creates a 49 percent loan-to-value.

Mr. OSE. Why do you have the caveat at—I don't understand the at origination caveat.

Mr. EDELMAN. We can't track it on an ongoing basis without conducting new appraisals each year.

Mr. OSE. All right.

Mr. EDELMAN. So there are two countervailing forces. One is amortization of the debt, because each payment of principal reduces debt outstanding, also appreciation in land values decreases LTV. Conversely, the other force is depreciation of land values would increase the LTV.

Mr. OSE. Mr. Chairman, I thank you for your indulgence on this line of questioning.

The CHAIRMAN. I thank the gentleman.

We will have another round.

Mr. Edelman, earlier when you were commenting on the ability to cover your loans during a very difficult situation like the mid–1980's that we have all talked about, you commented on the conservative nature of your underwriting standards, which you again reiterated with Mr. Ose. Does that apply to purchasing loans through your cash window or when packaging loans for the Long-Term Standby Program? I understand that there are exceptions made to those underwriting standards.

Mr. EDELMAN. The answer to your first question is no. The answer to your second question is also no.

The CHAIRMAN. You never have any exceptions to the underwriting standards?

Mr. EDELMAN. Let me clarify that, sir. We have several underwriting standards. I believe there are nine or ten of them in all. One of them is what we refer to as standard nine, which says that a loan that does not meet all of the ratios in the preceding standards, but which is, nevertheless, a loan that is of high quality because of compensating strengths, that is being stronger on one particular ratio would compensate for a certain amount of weakness in another, but not loan-to-value. We don't let loan-to-value be compensated. And in the instance there is a loan that still meets our underwriting standards it simply meets them through standard nine instead of through other ratios because of compensating strength. And statistically, we have shown that those loans have consistently performed as well as or better than loans that met the list of ratios, because indeed they are loans made to borrowers who had a profile, although it didn't meet the one-size-fits-all profile of ratios, nevertheless were loans to farmers who represented the profile of a strong borrower in their segment of agriculture.

The CHAIRMAN. So are you saying that there are no loans through the cash window or the guarantee program that are purchased even though the loans do not meet Farmer Mac's loan underwriting standards?

Mr. EDELMAN. Including standard nine, that is correct.

The CHAIRMAN. And standard nine is the ratio?

Mr. EDELMAN. Standard nine is the compensating strengths.

The CHAIRMAN. Well, but how would one looking at that evaluate that? Is that documented in such a way that someone can evaluate those compensating strengths when they are giving up something else on the other standards?

Mr. EDELMAN. Yes. We have internal documentation that acts as a guideline for that, and we keep internal documentation of how we reach the conclusions and also how the loans perform.

The CHAIRMAN. In the March 1998 report, the GAO indicates your debt issuance and retained portfolio strategy would make funds available to recruit new mortgage originators to the Farmer Mac program. How many originators now participate, and how many have been added to your operation since 1998?

Mr. EDELMAN. I would have to provide you with the exact numbers in writing after the hearing, Mr. Chairman, however, if I could give you a rough estimate, we have about 300 or 400, closer to 400, lenders. However, that number is not entirely illuminating, because that would include a community bank that had, say, one office, and it would also include a large, multi-state bank that had 500 lending branches in many states. So to count the number of institutions does not necessarily give you a fair sense of how many outlets there are offering loans that would go into Farmer Mac guaranteed securities. You were asking, also, how many have been added since 1998. I would estimate about on-third, but again, I would like to provide you with detailed information.

The CHAIRMAN. Please, we would like to have that.

Could you describe how a group of loans are pooled and securitized?

Mr. EDELMAN. Yes.

[Mr. Edelman responded for the record as follows:]

There are a total of 948 lenders participating in Farmer Mac's programs, including 160 Farmer Mac I approved sellers; 667 Farmer Mac II participants to date, and 121 lenders who have participated indirectly through two networks established by larger approved sellers.

As of December 31, 1998 (the closing date of the referenced GAO Report), there were 6,261enders participating in Farmer Mac's programs, with a similar break-out as above; thus, the number of participating lenders has increased by 322 or 51 percent since the referenced GAO Report.

The CHAIRMAN. What are the pieces of this information, and how much does each piece cost Farmer Mac?

Mr. EDELMAN. Let me see if I can answer that. First, the pooling process, let me give you a hypothetical. It is probably easier to answer your question. If a lending institution came to us with a pool of $120 million worth of loans and asked us if we would purchase those loans so that we could place them in a security. What we would do is have a group of underwriters from Farmer Mac review each of the loan files and also review, in that process, the credit underwriting, the original application, the appraisal, the documentation to ascertain that the loans met our underwriting and appraisal standards and documentation standards. In addition, we obtain a database printout from the lender containing the relevant ratios on each loan in the pool, and they represent and warrant to us, legally, that the data in the loan files conforms to the database.

We analyze all of those loans, and using both the database and actual file review, determine which loans meet our underwriting, appraisal, and documentation standards. Based on that, we might exclude, in my hypothetical, $20 million worth of loans, so it became a $100 million portfolio. We would purchase the $100 million of loans and place that into a trust and issue a mortgage-backed security backed by that trust, which we would either hold or sell, or in some cases, deliver back to the lender, if it were a swap. The costs of that will vary, depending on the travel costs, the time involved, the complexity of the loans. And those are our up front fixed costs.

In addition, if we sell into the capital markets, we will pay SEC registration fees on the AMBS. We will also pay attorney fees working on the registration statement for that offering. And in any event, we will pay attorney fees in connection with the formation of the trust and the documentation of the security even if we hold it on our books or swap it. And then the ongoing costs involved are ongoing monitoring of the credit quality of the underlying mortgages from year to year. And again, that will be a function of how the mortgages perform, because if they all perform well, it is relatively less expensive. We also contract out to central servicers, who perform the billing and collection function, and to field servicers, who perform the local monitoring function and borrower contact function. And we also pay fees to an agent, who is the transfer agent on the securities, and we, in addition, incur costs that are regulatory costs, because those are really associated with those securities.

I hope I have answered your question.

The CHAIRMAN. Yes, well, I have a follow-up.

Mr. EDELMAN. Please.

The CHAIRMAN. What if you would compare that arrangement, which I suppose could be described as your usual business, compare that arrangement in terms of its costs versus benefits with the Long-Term Standby Commitment to Purchase and the swap programs.

Mr. EDELMAN. It is substantially the same, except for the SEC fees and the securitization costs, because we don't have to form a mortgage-backed security in the case study of standby commitment. Even though we have taken the same economic risk and we have contracted to receive the same economic benefits through a commitment fee instead of a guarantee fee, at the end of the day, the only difference between the two is the fact that when you form a security, there are a few more costs associated with securitization and SEC registration if we sell, but otherwise, the costs are substantially the same because of the due diligence and the monitoring.

The CHAIRMAN. Would you describe the AgVantage program and provide us with some insight as to why that program has not been attractive to lenders?

Mr. EDELMAN. Well, that program was instituted at the specific request of the ICBA a number of years ago. That program, to describe it very simply, is a program in which we purchase securities backed by mortgages, which are debt instruments issued by lending institutions and collateralized by Farmer Mac conforming mortgages on their books. And the effective rate is comparable to rates that those entities might have achieved with residential mortgages and with the debt securities they would issue to the home loan banks. In fact, we have patterned our documentation after home loan bank documentation.

The CHAIRMAN. And how have you marketed this program compared with the Long-Term Standby Commitment to Purchase program?

Mr. EDELMAN. We have sent out mailings, and we have sent out people as salespeople to call on individual lending institutions and to make presentations at lender conventions and other meetings to promote that program.

The CHAIRMAN. And I think Mr. Stenholm asked this in a little different way earlier, but in your view, why haven't commercial bankers used the LTSCP?

Mr. EDELMAN. Well, because, first of all, they could easily do swaps, which would give them a liquid security that would be pledgable at the Fed, and if I ran a community bank, for example, I would much prefer to do a swap, which is essentially the same as a standby, if I were not impeded by borrower rights consideration statutory that are unique to the Farm Credit System. So under those circumstances, getting a pledgable security is a liquidity advantage for a small institution that is not a requirement for a Farm Credit institution that can fund itself through the Farm Credit Funding Corporation.

The CHAIRMAN. And what is your view of the Treasury Department's position on the $1.5 billion line of credit?

Mr. EDELMAN. Well, I think that your question is their concern about the question of Farmer Mac being able to invoke the Treasury backstop as to a security held on its own books.

The CHAIRMAN. Right.

Mr. EDELMAN. The law of guaranty specifically provides, as our counsel has advised us, that a guarantor who acquires his own paper might potentially lose the guarantee, however, in the event that it is the subsidiary corporation that acquires the guaranteed security, it is not extinguished. And based upon that, we believe that we have a reasoned legal opinion from outside counsel that supports our interpretation, and as much as we respect the United States Treasury and all of the importance they have for Farmer Mac, I have yet to hear of or see one page of reasoned legal opinion, but rather I have heard a lot of polemic.

Now turning, if I may, to the polemic, it is a question of how many angels could dance on the head of a pin. It is all well and good to talk about whether Farmer Mac would have access to the Treasury backstop as to securities that are held on its books, but as a practical matter, if Farmer Mac were under pressure—let me give you an example, if I may. If we had $2.5 billion of mortgage-backed securities on our books and we had $2.5 billion of debt, the logical thing for us to do would be—to get more liquidity if we needed it to pay on guarantees—to sell those mortgage-backed securities into the capital markets to investors whose recourse to Treasury backstop of our guarantee is unassailable. We would do that for liquidity reasons long before it came down to a crunch where we had to go to Treasury. There is no earthly reason that Farmer Mac would want to hold those securities and have valuable assets on its books as well as matching liabilities and go to the Treasury and concede the authority over its business to Treasury at a time when it had liquid assets. So Farmer Mac would sell those assets. Once we sold the assets, this legal quibble about whether the guarantee is backed by Treasury or not becomes irrelevant. And therefore, although I think it is a fascinating topic and I would love to see Treasury's legal opinion on it, in the end, as a practical matter, no one would get to use either of our legal opinions.

The CHAIRMAN. Do you think the Congress should clarify this matter?

Mr. EDELMAN. I think that Farmer Mac works at a certain disadvantage to the other GSEs, and you have to decide whether you want to perpetuate that disadvantage, sir. The disadvantage is that Fannie Mae and Freddie Mac are covered by the Treasury backstop for all of their securities, both their mortgage-backed securities and their debt securities. This gives them a certain amount of latitude in how they operate and how they provide value to residential borrowers. Farmer Mac, on the other hand, is limited, and by the way, I want to emphasize the fact that all of our debt securities are emblazoned with the statement that there is no Treasury support behind them. And if Farmer Mac is going to operate at a disadvantage such as this, I would like to see Congress consider clarifying for Treasury the fact that the backstop should apply to guaranteed securities on our books or alternatively give Farmer Mac the same status as Fannie and Freddie, that is, to extend the Treasury backstop to include our debt securities, however, tha latter would put us on a more equal footing with the residential market. But to not do the latter and to question the backstop on our on books assets would create an economic disadvantage even beyond that which we now endure.

The CHAIRMAN. Thank you.

I have got some questions for Mr. Dailey. Perhaps Mr. Stenholm wants to ask some questions before I do that.

Mr. STENHOLM. Thank you, Mr. Chairman.

No, I will submit additional questions in writing. Thank you very much.

The CHAIRMAN. All right.

Mr. Dailey, as you probably know, the GAO has observed that Farmer Mac and, by extension, its board have characteristics of a cooperative in that banks and other financial institutions and the Farm Credit System are required to own shares and have a legally mandated membership. What benefits does this structure bring to the Farmer Mac Board, or conversely, what liabilities?

Mr. DAILEY. Well, Mr. Chairman, I believe the advantage that you have there is that you have people on the board working with the agricultural credit system, and it is an opportunity for them to learn more about our programs, learn more about marketing opportunities. I don't see the conflict of interest if we have one institution that sells a lot of product. The determination will be made whether they are independent or not. So I see advantages to that simply by tying us closer, letting those banks, financial institutions, and insurance companies, know more about our programs and have some degree of representation on our board.

The CHAIRMAN. Well, does that explain the concentration of your business? I mean, would you agree or disagree with this statement as it pertains to Farmer Mac? Farmer Mac is a relatively small company doing a relatively substantial business with a very few business partners that are concentrated geographically.

Mr. DAILEY. Well, once again, the concentration, as was mentioned earlier, is with some banks that have many, many branches. The concentration that I have been more concerned about, quite frankly, has been geographical concentration. We have talked a lot today about risk. We have talked about the agricultural economy and where it stands. Quite frankly, even though the agricultural economy, generally, is considered to be good today, there are always segments of the agricultural economy that are stressed. The areas that we focused a lot of attention in the past year or so has been the apple industry up in Washington. So one of the concerns I have is more geographical distribution of the loans that we have. As the company was set up——

The CHAIRMAN. Is there a history of these loans being geographically concentrated in other parts of the country?

Mr. DAILEY. Well, we probably have more concentration on the northwest and the southwest. Part of that is because——

The CHAIRMAN. Right, but I mean, I think that has historically been true, has it not?

Mr. DAILEY. It has historically been true, but——

The CHAIRMAN. How would you explain why you are not loaning in my part of the country or in the Midwest and——

Mr. DAILEY. Well, we are loaning in those parts of the country, we are just not doing as much. And coming from the Midwest myself, it is an area of particular concern to me.

The CHAIRMAN. OK. But what would be your explanation for why that is occurring?

Mr. DAILEY. Well, part of that has to do with unit banking laws that some states, such as Iowa, might have that encourages banks to hold more of their portfolio themselves rather than to sell it. Part of it, I think, is the nature of the industry. You have smaller family farmers. We don't have agriculture capitalized to such the extent that you might see in some other areas. And but once again, I think there is opportunities for us to provide more penetration into that Midwest market. And we are going to focus more of our attention there.

Mr. EDELMAN. Mr. Chairman, may I add to that?

The CHAIRMAN. Sure. Sure.

Mr. EDELMAN. The concentration, which is somewhat of a concentration, in the western United States, is attributable to several things. First of all, the higher value of land in that part of the country on a per acre basis tends to make each loan a higher dollar amount. And therefore, when Farmer Mac thinks about its congressional mission of serving borrowers, we try to look at this on a per capita basis. How many borrowers are we serving, not how much is the value of their particular farm? Overall, the average amount of a Farmer Mac loan is $275,000, and 75 percent of the loans are under $300,000. But nevertheless, what that means is that there are a number of farmers in the western United States, which already produces one-third of the value of agricultural output who have more expensive farms, and therefore taking one loan from one of them gives us a higher number than a loan from one farmer in, say, Virginia.

The CHAIRMAN. So how would the dollar distribution occur, then, between different regions of the country? You are saying that the number of farms served is not as disparate.

Mr. EDELMAN. That is correct.

The CHAIRMAN. But what about the dollar amount?

Mr. EDELMAN. The dollars, clearly, are concentrated more in the western United States where two factors are at work: the higher value of land and the greater level of competition among agricultural lenders.

The CHAIRMAN. All right.

Mr. Dailey, should class C stockholders, which do not now enjoy voting rights in the company, have a voice in the operations of Farmer Mac?

Mr. DAILEY. Mr. Chairman, that was a recommendation that GAO wanted Congress to take a look at. I don't have a strong opinion on that. We don't want anybody to be disenfranchised.

The CHAIRMAN. Well, that is my next question. If we were to do it, how would we reconstitute the board to allow for doing it?

Mr. DAILEY. Well, that is a decision that you, in Congress, would have to make.

The CHAIRMAN. Do you have any advice for us?

Mr. DAILEY. Well, I know from——

The CHAIRMAN. You are there every day every time you meet. The board a little better than I do.

Mr. DAILEY. Well, we will have our annual board meeting tomorrow, and there will be an opportunity for all of the class C stockholders to make any kind of statements that they would like to at that meeting.

The CHAIRMAN. Do they traditionally do that?

Mr. DAILEY. They occasionally do it. But let me say something about the presidential appointments, because I think maybe you are going there as well. And that is that we don't come in with as strong a financial background as our president has or the other 10 Board members. Yet we do come to the board with a strong and abiding interest in America's agricultural industry. We are ranchers and farmers. Our focus is agriculture. You have heard me talk about the concentration. It is easy and natural to pick the low-hanging fruit first, but our focus is going to be on the mission, whether we are accomplishing the mission, whether we are making Farmer Mac succeed, whether we are providing more competitive advantages for our farmers. And if we look to the future, where we may see more financial stress, it is all the more important in a capital-intensive industry, such as agriculture, to be as competitive as we can and lower the costs that farmers have for borrowing money.

The CHAIRMAN. Thank you. Your statement indicates that the Farmer Mac Board meets all of the New York Stock Exchange listing requirements, but your 2004 proxy statement indicates that two board members will be replaced. I wonder if you could explain that.

Mr. DAILEY. Mr. Chairman, as Sarbanes-Oxley was passed and implemented, we worked with our outside counsel and others to determine whether our board members were independent. As a result of some of the business that two of the board members did, they were determined not to be independent, which meant that they could still serve on the board, but they couldn't serve on the audit committee, the compensation committee, or the corporate governance committee. In one particular case, the board member decided to not seek renomination to the board. In another case, the board member is still with us, but doesn't serve on those committees and is making very useful contributions to our organization.

The CHAIRMAN. When you say they were determined to be not independent, that means they have a substantial amount of dealings with——

Mr. DAILEY. That means not that they personally do, but the banks or the financial institution, the Farm Credit System institution with which they are affiliated is selling loans to us, and that is what makes the determination of whether they are independent or not. When it reaches a certain threshold, I think it is 2 percent of their income.

The CHAIRMAN. And what about the percentage of Farmer Mac's transactions? Is that a measure as well?

Mr. DAILEY. Of the amount of transactions that we do with them?

The CHAIRMAN. Right.

Mr. DAILEY. I think it is based more on the 2 percent rule, but I would defer to Mr. Edelman.

Mr. EDELMAN. It is not. Their independence is based on the amount of their revenue they derive from us.

The CHAIRMAN. All right. And do you have a figure of the total amount of the transactions of Farmer Mac that are done with board members? What percentage of your overall business? Of the institutions represented by board members, put it that way.

Mr. EDELMAN. Mr. Chairman, that is set forth in our proxy statement in great detail. I would be happy to provide you with a copy of the proxy statement.

The CHAIRMAN. I believe we already have that.

Mr. EDELMAN. The related party activity, as of December 31, 2003, included transactions with Zions National Bank, which is no longer represented on our board. And there are a variety of different types of transactions there. We purchased loans from them of about $75 million, representing 38 percent of the volume in that particular segment of our program. We purchased six USDA guaranteed portions from them for $1.7 million. We sold approximately $75.8 million of Farmer Mac guaranteed securities to them. We entered into interest rate swap transactions with Zions with an aggregate notional principal amount of $28.6 million. All interest rate swaps between Farmer Mac and Zions added to $307.6 million. Farmer Mac received approximately $1.4 million in guarantee fees on Farmer Mac guaranteed securities from Zions. Farmer Mac paid Zions $48,000 in underwriting and loan file review fees. Zions received approximately $1.3 million in servicing fees for acting as a central servicer. In addition, they received $225,500 in fees for acting as an agent with respect to $154.7 million of Farmer Mac medium-term notes. And they received approximately $18,000 in commissions for acting as a dealer in $189 million of Farmer Mac discount notes. We also had transactions with AgFirst Farm Credit Bank, which is a major holder of class B voting stock. We purchased four loans with an aggregate principal amount of $900,000 from them, representing one-half of 1 percent of that program's volume for the year. We extended standby commitments on 1,016 loans with an aggregate principal amount of $172.5 million to AgFirst. We guaranteed approximately $393 million of Farmer Mac guaranteed securities backed by rural housing loans under which Farmer Mac is a second loss guarantor. Farmer Mac received $400,000 in guarantee fees from AgFirst and approximately $2.1 million in commitment fees on standbys. AgFirst received approximately $107,000 in servicing fees for acting as a central servicer. And as of December 31, 2003, Farmer Mac owned $88 million of preferred stock of AgFirst. In addition, Farm Credit West, which is also represented on our board, did business with us so that we extended standbys on 287,000 loans.

The CHAIRMAN. Let me interrupt for a second. Are these the two directors that are referenced on the proxy statement?

Mr. EDELMAN. The two directors referenced on the proxy statement, Mr. Chairman, the first one was from Zions Bank.

The CHAIRMAN. Right.

Mr. EDELMAN. The second one——

The CHAIRMAN. But you just listed in there—is the second one you are about to——

Mr. EDELMAN. No, it is not. The second one who resigned from our board was the former vice chairman of Greenpoint Savings Bank. The member of our board referenced in respect to AgFirst Farm Credit was not previously mentioned. And the member who I was just about to describe at Farm Credit West was the second of the two who were deemed not independent for SEC purposes. And the reason in that case, Farm Credit West, was that the percent of their revenues was slightly over 2 percent. I think it was approaching 3 percent.

The CHAIRMAN. I see. But in terms of the overall percentage of the transactions or dollar value of the transactions of your organization, you do not have a figure of what percentage of that is undertaken by institutions that are represented on your board?

Mr. EDELMAN. There are many different types of transactions, sir. There are mortgage-backed securities. There is discount note——

The CHAIRMAN. Certainly, but you could break those down into each category.

Mr. EDELMAN. I could certainly break all of those down. I would be happy to provide you with that information.

[Mr. Edelman responded for the record as follows:]

Farmer Mac's business with related parties during 2003 was as follows:

a. 54.9 percent of Farmer Mac I and II program volume in 2003 was transacted with related parties

i. 39.1 percent, or $75 million, of Farmer Mac I loan purchases in 2003 were from related parties in 2003, with the preponderance of that volume coming from one entity (no longer represented on the Farmer Mac Board as of June 3, 2004) that networks more than 100 unrelated lenders.

ii. 77.1 percent of Farmer Mac Long- Term Standby Purchase Commitments were with related parties in 2003. That percentage reflects the facts that the LTSPC structure was established at the request of the Farm Credit System and, by statute, that the FCS has five seats on the Farmer Mac Board that have been distributed among the five district banks.

iii. 3.8 percent of Farmer Mac II guaranteed portion purchases were from related parties in 2003.

b. With respect to debt transactions:

i. 0.26 percent, or $189 million, of the discount notes Farmer Mac issued in 2003 were issued through a related party .

ii. 42 percent, or $155 million, of the medium-term notes Farmer Mac issued in 2003 were issued through a related party .

c. With respect to hedging transactions:

i. 10.6 percent, or $29 million notional amount, of the long-term interest rate swaps Farmer Mac entered into in 2003 were entered into with a related party.

ii. 62 percent, or $553 million notional amount, of the short-term hedging transaction volume Farmer Mac conducted in 2003 was conducted with a related party .

The CHAIRMAN. We would appreciate it if you would do that. Let me ask you one more thing. Do you have enough employees to carry out the complex business that you operate?

Mr. EDELMAN. I believe that we do, sir.

The CHAIRMAN. Has the Farm Credit Administration made any recommendations about those levels?

Mr. EDELMAN. They have made recommendations to us about various functions, and although I am not at liberty to describe all of the details of the FCA examination report, I would say that Farmer Mac is very receptive to their recommendations. And we take them seriously, and we always try to carry them out to the extent that we can.

The CHAIRMAN. But at this point, you have not carried them out?

Mr. EDELMAN. Oh, we have. We have added a number of employees over the last year, both at our own instance and at that of the FCA.

The CHAIRMAN. Great. Thank you.

Well, gentlemen, I thank you very much. You have handled a great many detailed questions. And I will ask the gentleman from California if he has anything else he wants to ask.

Mr. OSE. Mr. Chairman, I just want to make sure I convey this. We have spent a lot of time. Members of Congress serve on a number of different committees, and the chairman serves on Judiciary. I serve on Financial Services. And the thing that just gives me pause, Mr. Chairman, is the off balance sheet obligation. And if I could convey one very real concern of Members collectively, Mr. Dailey and Mr. Edelman, it would be that those off balance sheet commitments will get an undue amount of attention from those of us in Congress. It is not that your credit quality standards aren't satisfactory. It is that we have had to deal with all sorts of "special purpose entities" to the detriment of the economy and at significant loss to the American public. So I would just urge you, to any degree you can, to go in a direction other than off balance commitments, regardless of the protections you set in place. They are just a red flag.

Mr. EDELMAN. May I make one brief comment on that?

Mr. OSE. Certainly.

Mr. EDELMAN. I respect what you are saying completely. There is a little bit of a tension here that I want to just highlight, if I might. That is we have been asked, at times, to sell our AMBS. If we took all of our existing AMBS and sold them into the capital markets, they would be off balance sheet liabilities.

Mr. OSE. Because of the guarantees.

Mr. EDELMAN. That is right. The same as long-term standbys today. Conversely, if we sold no AMBS and went to all of the institutions with whom we had standbys and persuaded them, somehow, to sell us the underlying mortgages so that we could create AMBS and put them on our books, then we would have no off balance sheet liabilities. So it is all a question of where Congress wants us to go. We want to be responsive, but there is an inconsistency between telling us to sell AMBS and move these assets into the status of off balance sheet liabilities and telling us to get rid of off balance sheet liabilities and hold them on the books and then not sell AMBS. And whatever guidance you could give us, I would be grateful.

Mr. OSE. One of the things we struggle with here is that oftentimes the people we deal with immediately are exceptional operatives. They know what they are doing and how to do it and how to protect themselves, but next week, they might be gone. And I haven't figured out how to solve that. I just reiterate my concern about off balance sheet issues as they relate to government-sponsored enterprises. This is a hornet's nest that, in my judgment, holds more risk than reward.

Mr. DAILEY. Mr. Chairman, thank you for this opportunity.

The CHAIRMAN. I thank you, Mr. Dailey. I thank you, Mr. Edelman.

Mr. EDELMAN. We appreciate it.

The CHAIRMAN. I thank all of the members of our audience, who I understand includes a number of members of the board of your organization, and we welcome their presence as well. I thank the gentleman from California.

Without objection, the record of today's hearing will remain open for 10 days to receive additional material and supplementary written responses from witnesses to any question posed by a member of the panel. This hearing of the House Committee on Agriculture is adjourned.

[Whereupon, at 2:13 p.m., the committee was adjourned.]

[Material submitted for inclusion in the record follows:]

GAO
Accountability-Integrity-Reliability

Highlights

Highlights of GAO-04-827T, a testimony to the Committee on Agriculture, House of Representatives

Why GAO Did This Study

This testimony is based on GAO's October 2003 report, *Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed* (GAO-04-116). GAO's testimony presents a brief overview of Farmer Mac and discusses issues raised in its 2003 report, including Farmer Mac's risk management practices and line of credit with Treasury, mission-related activities, board structure, and oversight, which is provided by the Farm Credit Administration (FCA).

What GAO Recommends

GAO's 2003 report found that Farmer Mac, FCA, and Congress could all take actions to help improve Farmer Mac's safety and soundness and ability to carry out its public policy mission. GAO recommended that Farmer Mac strengthen its risk management and corporate governance and reevaluate some operational strategies. GAO also recommended that FCA enhance its oversight tools for Farmer Mac and that Congress consider establishing measurable goals to help FCA assess how well Farmer Mac is meeting its mission.

www.gao.gov/cgi-bin/getrpt?GAO-04-827T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Davi M. D'Agostino at (202) 512-8678 or dagostinod@gao.gov.

June 2, 2004

FARMER MAC

Greater Attention to Risk Management, Mission, Public Purpose, and Corporate Governance Is Needed

What GAO Found

Farmer Mac, a government-sponsored enterprise (GSE), was established to provide a secondary market for agricultural real estate and rural housing loans and to increase agricultural mortgage credit. In 2003, GAO reported that several aspects of Farmer Mac's financial risk management practices had not kept pace with its increasing risk profile. First, Farmer Mac had $3.1 billion in off-balance-sheet commitments and other agreements that could obligate it to buy the underlying loans or cover related losses under certain conditions. Farmer Mac and the Farm Credit System institutions that participate in the agreements are required to hold far less capital than is otherwise required. Because Farmer Mac's loan activities are concentrated in a small number of financial institutions and in the West, the risk is not reduced while less capital is required to be held. Under stressful agricultural economic conditions, Farmer Mac could be required to purchase large amounts of impaired or defaulted loans if large amounts of the commitments were exercised. Second, the coverage of Farmer Mac's $1.5 billion line of credit with the U.S. Treasury was controversial, as the entities disagreed on whether the securities it has issued and kept in its portfolio would be eligible. Third, GAO reported that while Farmer Mac had increased its mission-related activities since its 1999 report, their impact on the agricultural real estate market was unclear. The effects were difficult to measure partly because Farmer Mac's statute lacks specific mission goals. For this and other reasons, GAO concluded that the public benefits derived from Farmer Mac's activities are not clear. Finally, for profitability reasons, Farmer Mac had a strategy of holding securities it issued in its portfolio instead of selling them to investors in the capital markets. As a result, the depth and liquidity of the market for Farmer Mac's securities is unknown.

Farmer Mac's board structure, set in federal law, may make it difficult to ensure that the board fully represents the interests of all shareholders and meets independence and other requirements. The board structure contains elements of both a cooperative and an investor-owned publicly traded company. For example, two-thirds of the board members do business with Farmer Mac and hold the only voting stock, while the common stock holders have no vote. GAO also identified challenges FCA faced in its oversight of Farmer Mac, including a lack of specific criteria for measuring how well it was achieving its mission. Although FCA had taken steps to improve its safety and soundness oversight, more needs to be done to improve its off-site monitoring and assessment of risk-based capital.

Farmer Mac and FCA have efforts underway to address many of GAO's recommendations and it was too early to assess them.

Mr. Chairman, Mr. Ranking Member, and Members of the Committee:

We are pleased to be here today to discuss the results of GAO's work on the Federal Agricultural Mortgage Corporation, commonly referred to as Farmer Mac. Our testimony is based on the report we issued on October 16, 2003, at the request of the Senate Committee on Agriculture, Nutrition, and Forestry: *Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed*, GAO-04-116 (Washington, D.C.: October16, 2003). Our overall objective today is to provide the committee with information and perspectives to consider as it continues to oversee Farmer Mac. My remarks are divided into two sections. First, I will provide an overview of Farmer Mac, its mission and portfolio, and potential risks to taxpayers. Second, I will provide our report findings on a variety of items associated with Farmer Mac, including its risk management practices and its line of credit with Treasury, mission-related activities, board structure, and oversight provided by the Farm Credit Administration (FCA). Throughout my statement, I will comment on Farmer Mac's and FCA's responses to the findings and recommendations in our report. Information discussed in our report was gathered from August 2002 to May 2003 from reviews of documents and interviews we had with representatives from Farmer Mac, FCA, other market participants, and individuals with expertise in the agricultural real estate market. We also reviewed FCA's examinations of Farmer Mac and consultants' studies related to Farmer Mac. To update our report for this testimony, we obtained more recent financial data on Farmer Mac and Farmer Mac's and FCA's responses to our recommendations. We conducted our work in accordance with generally accepted government auditing standards.

In summary, I will first give a brief overview of Farmer Mac. Farmer Mac is a government-sponsored enterprise or GSE[1] established by Congress to create a secondary market in agricultural real estate and rural housing loans, and to improve the availability of agricultural mortgage credit. FCA, through its Office of Secondary Market Oversight (OSMO), regulates Farmer Mac. In extreme circumstances, Farmer Mac may borrow up to $1.5 billion from the U.S. Treasury. Among its program activities, Farmer Mac purchases agricultural mortgages from lenders and periodically

[1]As used in this testimony, a GSE is a federally chartered, privately owned corporation established by Congress to provide a continuing source of credit nationwide to a specific economic sector.

securitizes these loans into guaranteed securities or agricultural mortgage-backed securities (AMBS). During the last 2 years, Farmer Mac sold AMBS principally to related parties.

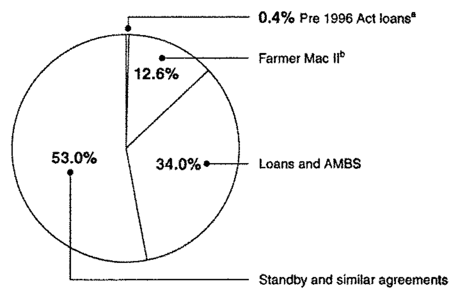
Farmer Mac also issues long-term standby purchase commitments or standby agreements for eligible loans. To date, all of these commitments are with institutions in the Farm Credit System (FCS), which is also a GSE. As of December 31, 2003, loans underlying standby and similar agreements[2] totaled $3.1 billion and represent 53 percent of the book value of total loans included in Farmer Mac's programs (see fig. 1). These agreements are held off balance sheet because Farmer Mac does not own the loans underlying these agreements and is conditionally obligated to purchase them. In the case of the $722.3 million of standby agreements that was converted into a Farmer Mac I Guaranteed Security, Farmer Mac may, at its discretion, repurchase the defaulted loans or choose to pay the associated losses under the guarantee without purchasing the loan. Although the underlying loans have been performing better than its on-balance sheet loans, the standby agreements include provisions that commit Farmer Mac to purchasing the loans under specific conditions—for example, when they become 120-day delinquent.

Farmer Mac also faces potential liquidity risk as a result of these standby and similar agreements, which can create unexpected demands for additional funding. In other words, at a time when either the agricultural sector is severely depressed or interest rates are falling, Farmer Mac could be required to purchase large amounts of impaired or defaulted loans under the agreements, thus subjecting Farmer Mac to increased funding liquidity risks and the potential for reduced earnings. Notwithstanding the risk these standby and similar agreements could generate for Farmer Mac under stressful economic conditions, their off-balance sheet status allows Farmer Mac to hold less capital against the loans placed under them

[2]During third quarter 2003, at the request of Farm Credit West, A.C.A., of which one of Farmer Mac's directors is President, Farmer Mac converted a $722.3 million standby agreements that had been established prior to January 1, 2003 into a Farmer Mac I Guaranteed Security. To achieve this result, the program participant transferred a pool of agricultural loans to Farmer Mac, Farmer Mac transferred the loans to a trust, and the trust issued Farmer Mac I Guaranteed Securities that were transferred by Farmer Mac to the program participant. Because Farmer Mac received no proceeds other than the beneficial interests in the transferred assets, the transfer between Farmer Mac and the trust does not qualify as either a sale or a financing; therefore, no gain or loss was recognized in Farmer Mac's financial statements. Additionally, because the trust is a special purpose entity, it was not included in Farmer Mac's financial statements.

compared with its own on-balance sheet loans. These agreements also allow the FCS institutions to hold less capital against the loans placed under them. Further, the amount of capital that Farmer Mac would be required to hold against these underlying loans if required to buy them is less than what the FCS institutions are required to hold against the loans. The result of Farmer Mac's $3.1 billion in standby and similar agreements is to significantly reduce the amount of capital held against these loans in the FCS as a whole without correspondingly reducing risk because of its geographic and lender concentration.

Figure 1: Percentage of Outstanding Balance of Loans, AMBS and Standby Agreements of December 31, 2003



Source: GAO analysis of data from Farmer Mac 2003 SEC 10-K filing.

Note:

[a] These are loans purchased by Farmer Mac prior to the change in its statutory charter in 1996.

[b] Farmer Mac loan programs are divided into two main groups, Farmer Mac I and Farmer Mac II. Farmer Mac I consists of agricultural and rural housing mortgage loans that do not have federally provided primary mortgage insurance. Farmer Mac II consists of agricultural mortgage loans with primary mortgage insurance provided by the U.S. Department of Agriculture.

Second, we looked at a number of issues associated with Farmer Mac. For instance, our findings showed that Farmer Mac's income had increased since 1999 and that its capital continued to exceed required levels. At the same time, however, the rapid growth in Farmer Mac's standby agreements presents additional risk. We also identified trends indicating certain aspects of Farmer Mac's risk management systems have not kept pace with its increasingly complex portfolio. We made recommendations to Farmer Mac to enhance its risk management practices. Our study also pointed out that Farmer Mac faces some uncertainty involving its $1.5 billion line of credit with the U.S. Treasury (Treasury). In particular, while the legal opinion of Farmer Mac's outside counsel disagrees, Treasury has taken the position that it is not obligated to cover losses on the AMBS held in Farmer Mac's portfolio because the Treasury line of credit is not for the purpose of protecting Farmer Mac shareholders or general creditors. AMBS totaled $1.5 billion and made up 35 percent of Farmer Mac's total assets as of December 31, 2003.

We found that Farmer Mac has increased its mission-related activities since we last reported on them in 1999.[3] However, Farmer Mac's statute lacks specific or measurable mission goals beyond providing a secondary market and stable long-term financing. Without specific mission goals, it is difficult to meaningfully assess whether the increased activities are having the desired impact on the agricultural real estate market. In addition, Farmer Mac's loan activities have been largely concentrated in a small number of financial institutions—during 2003, 80.8 percent of Farmer Mac I loan activities were with ten institutions—and its loan portfolio is concentrated in the West. Therefore, we concluded that Farmer Mac has increased its mission-related activities, but the public benefits derived from these activities are not clear. We suggested that Congress consider legislative changes to establish clearer mission goals for Farmer Mac. Further, because Farmer Mac has elected to retain nearly all its AMBS in its portfolio instead of selling them to investors in the capital markets, we could not ascertain the depth and liquidity of the secondary market for AMBS, which is unknown even in good market conditions. We made recommendations to Farmer Mac to reevaluate its current strategy of holding AMBS in its portfolio and issuing debt to obtain funding.

Next, we found that Farmer Mac's board structure may make it difficult to ensure that the board fully represents the interests of all shareholders and could hamper Farmer Mac's efforts to comply with the independence requirements of the New York Stock Exchange's (NYSE) listing standards. As a GSE, Farmer Mac has a board set by statute that contains elements of both a cooperative and an investor-owned publicly traded company. In

[3]U.S. General Accounting Office, *Farmer Mac: Revised Charter Enhances Secondary Market Activity, but Growth Depends on Various Factors*, GAO/GGD-99-85 (Washington, D.C.: May 21, 1999).

most respects, Farmer Mac's board policies and processes appear reasonable, but we found that some processes could be further developed and formalized and made recommendations to Farmer Mac to make them more transparent and consistent. We further suggested that Congress consider legislative changes to amend the structure of the Farmer Mac board and the structure of Farmer Mac's Class C nonvoting common stock.

Finally, we found that FCA had improved its oversight of Farmer Mac and strengthened its examination approach but that more needs to be done to enhance the assessment of risk-based capital and Farmer Mac's accomplishment of its mission. This enhanced focus is especially important given Farmer Mac's increasing risk profile, its concentration of business with few business partners in the West, and its holdings of non-mission related assets. Since the law does not include any measurable goals or requirements to assess Farmer Mac's progress in furthering its mission, FCA lacks criteria and procedures to effectively oversee this aspect of Farmer Mac. We made several recommendations to FCA to enhance the effectiveness of its oversight. To further assist FCA's with its oversight effort, we also suggested that Congress consider a legislative change to allow FCA more flexibility in setting minimum capital requirements for Farmer Mac.

To update our information for this testimony, we met with representatives from Farmer Mac and FCA to discuss the status of our recommendations. We found that Farmer Mac has either taken actions to address or is in the process of implementing most of our recommendations. FCA is also engaged in efforts to address and implement our recommendations. FCA staff told us they considered and decided not to adopt certain elements of our recommendation to enhance the risk-based capital model for Farmer Mac, including a "run-off" approach, the effect of yield maintenance penalties, and the use of land value declines as the independent variable in loan loss regression. Since most of the actions undertaken by Farmer Mac and FCA will not be fully completed for some time, it is too early for us to evaluate their effectiveness.

Farmer Mac Provides a Secondary Market for Agricultural Real Estate but Entails Certain Risks

Farmer Mac is a government-sponsored enterprise or GSE that was chartered by Congress in 1987.[4] It is a federally chartered and privately operated corporation that is publicly traded on the New York Stock Exchange. Farmer Mac is also an independent entity within the Farm Credit System or FCS, which is another GSE. As an FCS institution, Farmer Mac is subject to FCA's regulatory authority. FCA, through OSMO, has general regulatory and enforcement authority over Farmer Mac. According to the 1987 Act, Farmer Mac, in extreme circumstances, may borrow up to $1.5 billion from the U.S. Treasury to guarantee timely payment of any guarantee obligations of the corporation.[5] Congress established Farmer Mac with a mission to create a secondary market—a financial market for buying and selling loans, individually or by securitizing them—in agricultural real estate and rural housing loans, and improve the availability of agricultural mortgage credit. When loans are securitized, they are repackaged into a "pool" by a trust in order to be sold to investors in the capital markets to generate liquidity. Generally, to carry out its mission, Farmer Mac purchases mortgages or bonds directly from lenders using cash generated by issuing debt obligations. It also issues standby agreements for eligible loans whereby Farmer Mac is committed to purchase eligible loans from financial institutions at an undetermined future date when a specific event occurs. The intent for these activities is to provide real estate credit to farmers at rates or conditions more favorable than those that would be available in the absence of Farmer Mac. Farmer Mac also securitizes the mortgages it purchases and issues AMBS and guarantees the timely payment of interest and principal on these securities. However, instead of selling the AMBS in the capital markets to generate cash, Farmer Mac holds most of the AMBS that it issues in its retained portfolio.

Farmer Mac Faces a Variety of Risks

Farmer Mac faces potential losses primarily from four sources:

- Credit risk, or the possibility of financial loss resulting from default by borrowers on farming assets that have lost value;

[4] Pub.L. No. 100-233. The Farm Credit Act of 1971, as amended by the Agricultural Credit Act of 1987 (the 1987 Act).

[5] Id.

- Liquidity risk, or the chance that Farmer Mac will be unable to meet its obligations as they come due;
- Interest rate risk, or possible fluctuations in interest rates that negatively impact earnings or the balance sheet; and
- Operations risk, or the potential that inadequate or failed internal processes, people and systems, or external events will affect financial condition.

Although the federal government explicitly does not guarantee Farmer Mac's obligations, it is generally assumed in financial markets that the government will not allow the GSE to default on its debt and AMBS obligations. In fact, during the 1980s the federal government provided financial assistance to both Fannie Mae and the Farm Credit System when they experienced difficulties due to sharply rising interest rates and declining agricultural land values, respectively. Because the markets perceive that there is an implied federal guarantee on Farmer Mac's obligations, Farmer Mac can borrow money at interest rates that are lower than those generally available to comparably creditworthy private corporations and thus can extend credit and other forms of liquidity to financial institutions at favorable rates.

The Size and Composition of Farmer Mac's Portfolio

The assets associated with Farmer Mac's activities can generally be divided into program assets and nonmission investments. Program assets are agricultural mortgage loans held by Farmer Mac, the guaranteed securities backed by agricultural loans, and loans underlying Farmer Mac's standby agreements. As of December 31, 2003, Farmer Mac's loan and guarantee portfolio and standby agreements totaled about $5.8 billion. Of that total, nearly $3.1 billion was in off-balance sheet standby and similar agreements. Standby agreements represent a potential obligation of Farmer Mac that does not have to be funded until such time as Farmer Mac is required to purchase a loan. As such, these commitments are not on Farmer Mac's balance sheet and are subject to a statutory minimum requirement of 0.75 percent capital instead of 2.75 percent for on-balance sheet assets. Let me point out that whenever Farmer Mac is obligated under a standby agreement to purchase a delinquent loan, it must also increase the capital held against the loan from 0.75 to 2.75 percent, nearly a 270 percent increase. Farmer Mac funds its loan purchases and other activities primarily by issuing debt obligations of various maturities. As of December 31, 2003, Farmer Mac had $2.8 billion of payable notes due within one year and $1.1billion of payable notes due after one year outstanding. At the same time, Farmer Mac held approximately $1.1 billion in nonmission investments.

Farmer Mac's Income and Risk Levels Have Increased

Farmer Mac's net income increased from $4.6 million in 1997 to $27.3 million in 2003, for a total increase of 493 percent. Farmer Mac's two primary revenue sources are (1) interest income earned on its loan portfolio, guaranteed securities, and nonmission investments, and (2) commitment fees earned on standby agreements. In recent years, Farmer Mac's earnings growth has principally been driven by fees generated by its off-balance sheet standby and similar agreements, which grew rapidly from zero in 1998 to $3.1 billion as of December 31, 2003.

Farmer Mac's risk levels have increased along with its income. First, increased risk is apparent in the growing number of impaired loans, real estate owned, and write-offs of bad loans, as well as in the rapid growth in its on- and off-balance sheet loans, guarantees, and standby agreements. Impaired loans totaled $69.96 million at December 31, 2003, compared to zero at December 31, 1997. Part of our concern about the increased credit risk involves Farmer Mac's loan loss model, which is based on loans that differ from those held in the corporation's own portfolios and those covered under its standby agreements in terms of geographic distribution and interest rate terms. This lack of comparability and other limitations of the model may affect the reasonableness and accuracy of Farmer Mac's estimated losses from credit risk either upward or downward. A complicating factor is that notwithstanding the quality of the loans underlying standby agreements, which have been performing better than the loans on Farmer Mac's balance sheet, Farmer Mac lacks the historical experience with standby agreements that is needed to accurately estimate the type and amount of loans it may ultimately be obligated to purchase and any associated losses.

Farmer Mac also faces potential liquidity risk as a result of these standby and similar agreements, which can create unexpected demands for additional funding. In other words, at a time when either the agricultural sector is severely depressed or interest rates are falling, Farmer Mac could be required to purchase large amounts of impaired or defaulted loans under the agreements, thus subjecting Farmer Mac to increased funding liquidity risks and the potential for reduced earnings. Although our study found that Farmer Mac has maintained sufficient liquidity to support its loan purchase and guarantee activity, Farmer Mac's liquidity may not be adequate to cover its obligations under its standby or similar agreements. We did not have the necessary historical information to project the number of covered loans that Farmer Mac might need to purchase in the future. Thus, we could not determine the extent of the liquidity risk Farmer Mac might face. At the same time, Farmer Mac management did not have the quantitative data it needed to make accurate risk management and other operating decisions.

As noted earlier, we made recommendations to Farmer Mac to enhance its risk management practices. We would like to report that Farmer Mac has responded to our recommendations but it is too early for us to assess the actions taken to implement them. Farmer Mac management recently showed us a loan classification system that will be completed in 2005 that is based on Farmer Mac's loan loss experience. Staff are also now documenting the supporting underwriting decisions for loans that Farmer Mac management approved by overriding one or more specific criteria based on the compensating strengths of those loans. Farmer Mac has also adopted a formal contingency funding and liquidity plan but this plan does not address our concerns about providing for liquidity if a large amount of standby and similar agreement loans were put to Farmer Mac unexpectedly. Farmer Mac representatives told us they are also developing a capital adequacy model. In addition, Farmer Mac management said that they are working with an outside consultant to develop a prepayment model to ensure accurate interest rate risk measurements.

Disagreements about the Extent of Coverage of Treasury's Line of Credit Could Generate Uncertainty

Now I want to focus on an issue involving Farmer Mac's $1.5 billion line of credit with Treasury that could impact the corporation's long-term financial condition. This issue is significant because it centers around the AMBS in Farmer Mac's retained portfolio, which as we have seen, makes up 35 percent of its total on-balance sheet assets of $4.3 billion and 26% percent of Farmer Mac's total program assets of $5.8 billion—including off-balance sheet loans underlying the standby and other agreements. Treasury has expressed serious questions about whether it is required to purchase Farmer Mac obligations to meet Farmer Mac-guaranteed liabilities on AMBS that Farmer Mac or its affiliates hold.[6] On the other hand, a legal opinion from Farmer Mac's outside counsel states that Treasury would be required to purchase the debt obligations whether the obligations are held by a subsidiary of Farmer Mac or by an unrelated third

[6]Both Treasury and Farmer Mac are in agreement that the authority of Treasury to purchase obligations to enable Farmer Mac to fulfill its guarantee obligations does not extend to the standby agreements because they do not involve Farmer Mac's guarantee liabilities.

party. This disagreement could create uncertainty as to whether Treasury would purchase obligations held in Farmer Mac's portfolio in times of economic stress. This uncertainty also relates to statements made by Farmer Mac to investors concerning Treasury's obligation to Farmer Mac, which in turn, could affect Farmer Mac's ability to issue debt at favorable rates. Ultimately, this uncertainty could impact its long-term financial condition.

Farmer Mac's subsidiary, Farmer Mac Mortgage Securities Corporation, holds the majority of AMBS that Farmer Mac issued. Farmer Mac's charter (the 1987 Act) gives it the authority to issue obligations to the Secretary of the Treasury to fulfill its guarantee obligations. According to the 1987 Act, the Secretary of the Treasury may purchase Farmer Mac's obligations only if Farmer Mac certifies that (1) its reserves against losses arising out of its guarantee activities have been exhausted and (2) the proceeds of the obligations are needed to fulfill Farmer Mac's obligations under any of its guarantees.[7] In addition, Treasury is required to purchase obligations issued by Farmer Mac in an amount determined by Farmer Mac to be sufficient to meet its guarantee liabilities not later than 10 business days after receipt of the certification. However, Treasury has indicated that the requirement to purchase Farmer Mac obligations may extend only to those obligations issued and sold to outside investors.

In a comment letter dated June 13, 1997, and submitted to FCA in connection with a proposed regulation on conservatorship and receivership for Farmer Mac (1997 Treasury letter),[8] Treasury stated "...we have 'serious questions' as to whether the Treasury would be obligated to make advances to Farmer Mac to allow it to perform on its guarantee with respect to securities held in its own portfolio—that is, where the Farmer Mac guarantee essentially runs to Farmer Mac itself." The 1997 Treasury letter indicated that if the purchase of obligations extended to guaranteed securities held by Farmer Mac this would belie the fact that the securities are not backed by the full faith and credit of the United States, since a loan to Farmer Mac to fulfill the guarantee would benefit holders of Farmer Mac's general debt obligations. The 1997 Treasury letter stated "Treasury's obligation extends to Farmer Mac only in the prescribed circumstances, and is not a blanket guarantee protecting Farmer Mac's guaranteed

[7] 12 U.S.C.2279aa-13.

[8] Letter dated April 13, 1997, from then-Under Secretary for Domestic Finance, John D. Hawke, Jr., to Marsha P. Martin, then-Chairman of the Farm Credit Administration.

securities holders from loss. Nor is the purpose of the Treasury's obligation to protect Farmer Mac shareholders or general creditors." According to Treasury, the 1997 letter remains its position concerning Farmer Mac's line of credit.

Meanwhile, the legal opinion of Farmer Mac's outside counsel is that the guarantee is enforceable whether AMBS are held by a subsidiary of Farmer Mac or by an unrelated third party. Farmer Mac's legal opinion also states that Treasury could not decline to purchase the debt obligations issued by Farmer Mac merely because the proceeds of the obligations are to be used to satisfy Farmer Mac's guarantee with respect to AMBS held by a subsidiary. According to Farmer Mac, if the conditions set forth in the 1987 Act are met—required certification and a limitation on the amount of obligations of $1.5 billion—then there is no exception in the 1997 Act that authorizes Treasury to decline to purchase the obligations. Farmer Mac states that discriminating among Farmer Mac guaranteed securities based on the identity of the holder in determining whether Farmer Mac could fulfill its guarantee obligations would lead to an anomalous situation in the marketplace and thereby hinder the achievement of Congress' mandate to establish a secondary market for agricultural loans.

Mission-related Activities Have Increased, but the Impact of Activities on Agricultural Real Estate Market Is Unclear

Before I go into whether Farmer Mac's activities have had an impact on the agricultural real estate loan market, I want to point out that the enabling legislation contains only broad statements of the corporation's mission and purpose. The legislation is not specific and does not provide measurable mission-related criteria that would allow for a meaningful assessment of Farmer Mac's progress in meeting its public policy goals. Our attempt to determine the extent to which Farmer Mac had met its public policy mission led us to conclude that although Farmer Mac has increased its mission-related activities since our previous review, the public benefits derived from these activities are not clear.

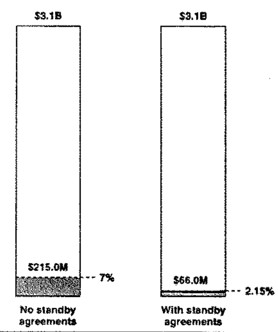
Farmer Mac's Strategy of Retaining AMBS Has Limited the Development of a Liquid Secondary Market for AMBS

In trying to assess whether Farmer Mac had made long-term credit available to farmers and ranchers at stable interest rates, we found that from 2001 to 2002, its long-term fixed interest rates on Farmer Mac I loans were similar to the rates offered by commercial banks and FCS institutions. We also found that since 1998, Farmer Mac had been operating under a strategy of retaining the loans it purchased and securitized as AMBS in its portfolio. Farmer Mac stated that this strategy would lower funding costs and increase profitability but as a result, the depth and liquidity of the secondary market for AMBS is unknown. In our report, we recommended that Farmer Mac reevaluate this strategy. Recently, Farmer Mac management said that the corporation had reevaluated its strategy for holding AMBS but determined to continue holding them for economic reasons. However, Farmer Mac management also indicated that the corporation was committed to selling newly issued AMBS periodically, when the conditions of the capital markets and the size of loan pool made such transactions efficient.

Standby Agreements Reduced Total Capital Required To Be Held in FCS

As I mentioned earlier, Farmer Mac has increased its mission-related activities, primarily by developing the standby agreement program. As of December 31, 2003, all of Farmer Mac's standby agreements are with FCS institutions and 3 FCS institutions represented 51 percent of the standby agreement program. While standby agreements provide greater lending capacity for those institutions, they also lower the amount of capital lending institutions are required to hold against their loans. Fig. 2 shows the effect of standby agreements on the total capital required to be held against the underlying loans in the entire FCS.

Figure 2: Impact of Standby and Similar Agreements on Total Required Capital Of Farm Credit System and Farmer Mac



	No standby agreements	With standby agreements	
Current amount of FCS loans	$3.1B	$3.1B	
Minimum capital levels			
FCS	$215.0M(7.00%)	$43.0M (1.40%)	(on balance sheet)
Farmer Mac	N/A	$23.0M (0.75%)	(off balance sheet)

Sources: GAO analysis of Farmer Mac and FCS data.

Our concern is that standby and similar agreements reduce the sum of capital required to be held by the Farm Credit System and Farmer Mac. Generally, institutions can help mitigate the risks associated with lower capital by maintaining a relatively large number of participating lenders and a geographically diverse portfolio. However, Farmer Mac's business activities are concentrated among a small number of business partners and its portfolio is concentrated largely in the western United States.

Farmer Mac's Board of Directors May Not Reflect All Shareholder Interests, Be Fully Independent, or Use Clear and Transparent Processes

Before discussing governance issues at Farmer Mac, I want to describe how Farmer Mac's board of directors is structured in federal law. Farmer Mac's 15-member board of directors includes 5 members elected by Class A stockholders, which include banks, insurance companies, and other financial institutions that do business with Farmer Mac; 5 members elected by Class B stockholders, which are FCS institutions that do business with Farmer Mac; and 5 members appointed by the President of the United States. Farmer Mac also issues nonvoting Class C stock to the general public. Class A and Class B shareholders are concerned with the use of Farmer Mac services, while Class C shareholders are generally investors concerned with maximizing their profits.

According to statements made at the time Farmer Mac's enabling legislation was being considered, this structure was intended to protect the interests of both FCS and commercial lenders by providing for equal representation by FCS, commercial lenders, and the public sector. Under this structure, Farmer Mac resembles a cooperative. At the same time, however, it is a publicly traded company, because its Class A and C stock are traded on the NYSE. But unlike most other publicly traded corporations, Farmer Mac is controlled by institutions with which it has a business relationship. For this reason, the board may face difficulties representing the interests of all shareholders. Good corporate governance requires that the incentives and loyalties of the board of directors of publicly traded companies reflect the fact that the directors are to serve the interests of all the shareholders. However, we found that the statutory structure of Farmer Mac's board and the voting structure of its common stock hamper Farmer Mac's ability to have such a focus.

Farmer Mac is subject to NYSE listing standards on corporate governance, as well as statutory and regulatory requirements such as the Sarbanes-Oxley Act of 2002. Collectively, these standards and provisions require that a majority of the board be independent and that key committees (audit, nominating or corporate governance, and compensation) consist entirely of independent directors. During our review, the listing standards were being revised and criteria for independence had not been finalized.[9] Based on the proposed standards, our assessment was that business relationships between Farmer Mac and the directors of its board may have prevented these individuals from meeting the standards of independence under NYSE rules. In updating our information for this testimony, we

[9]SEC approved NYSE listing standards SEC on November 4, 2003.

noted that Farmer Mac's 2004 annual proxy statements had identified 2 of 15 directors as not meeting the independence standards. One of the 2 directors is not a nominee for re-election. The other director has decided to withdraw as a member of the corporate governance committee if elected as a director at 2004 annual meeting.

We found that Farmer Mac's board nomination process, director training, and management succession planning were not as concise, formal, or well documented as best practices would suggest. We also found that Farmer Mac's stock option vesting program appears generous compared to general industry practices. We made recommendations to Farmer Mac's board to improve the transparency and disclosure of these processes and to reevaluate stock option levels and vesting period. Since our 2003 report, according to Farmer Mac management, the board has reviewed and confirmed that all board members fully understand the nomination process and that it has established a formal executive management succession plan. Further, the board has initiated a formal training program for its members that included external training and briefings on subjects relevant to the operations of Farmer Mac. Finally, the board had extended the vesting period of the corporation's stock options.

FCA Has Continued to Take Steps to Enhance Its Oversight of Farmer Mac

The final area of our 2003 review involved regulatory oversight of Farmer Mac. We reported that since 2002 FCA had taken several steps to enhance supervisory oversight of Farmer Mac but it faced significant challenges that could limit its regulatory effectiveness. We made several recommendations to FCA designed to enhance the risk-based capital model, improve off-site monitoring of Farmer Mac, and help assess and report how well Farmer Mac is achieving its mission. In updating our information for this testimony, we found that FCA had taken or planned to take a number of actions to further address many of our concerns and recommendations.

FCA Has Taken Steps to Enhance Oversight of Farmer Mac, but Faces Challenges That Could Limit the Effectiveness of Its Oversight

During our 2003 review, we noted that FCA had begun strengthening its oversight of Farmer Mac by doing a more comprehensive safety and soundness examination and undertaking initiatives to expand its regulatory framework. These initiatives included developing regulations to limit the level and quality of Farmer Mac's nonmission investments and issue specific liquidity standards, and studying the implications of regulatory capital arbitrage between FCS institutions and Farmer Mac. However, we found that FCA continued to face significant challenges in sustaining and improving its oversight and more remained to be done to improve its off-site monitoring, assessment of risk-based capital, and mission oversight. For example, FCA had not been updating and reformatting Farmer Mac's call report schedules and corresponding instructions to fully conform to FCA regulations and to reflect recent accounting changes. We also identified a number of issues related to the data used in and structure of FCA's risk-based capital model, but the overall impact these issues have on the estimate of risk-based capital for Farmer Mac's credit risk is uncertain. Some concerns, such as the potential undercounting of loans which experienced credit losses, or greater prepayment of the loans in the database used to build FCA's credit risk model relative to the kinds of loans that Farmer Mac now purchases, may result in the FCA credit risk model underestimating the credit risk capital requirement. Other issues, such as lacking a variable to track land price changes for any but the year with the most economic stresses, may cause the model to overestimate the credit risk capital requirement. Augmented data and more analysis could better determine the relative magnitudes of these effects.

Our study found that FCA's oversight of Farmer Mac had typically focused on safety and soundness and that FCA lacked criteria and procedures to effectively oversee how well Farmer Mac achieves its mission. At the same time, Farmer Mac's enabling legislation is broadly stated and does not include any measurable goals or requirements to assess progress toward meeting its mission. More explicit mission goals or requirements would help FCA in improving its oversight of Farmer Mac.

Since our 2003 report, FCA has continued to make a concerted effort to further enhance its oversight of Farmer Mac. First, FCA staff are drafting regulatory revisions to the risk-based capital model that covers a range of issues. They plan to present a proposed rule to the FCA board for consideration in the fall of 2004. According to FCA officials, they are engaged in efforts to address the issues related to the risk-based model raised in our report but there are certain elements of our recommendation they have considered and decided not to adopt, including a "run-off" approach, the effect of yield maintenance penalties, and the use of land value declines as the independent variable in loan loss regression. Second, FCA has made some revisions to the Farmer Mac quarterly call reports, and is in process of making additional revisions. These initial revisions included adjustments to call report schedules that were identified during our 2003 review. FCA has a number of capital-related projects in progress that, taken collectively, may address the issue of capital arbitrage within the Farm Credit System. In addition, FCA has a number of ongoing projects that may address our recommendation related to requiring

Farmer Mac to obtain a credit rating. Finally, FCA has begun planning for a project that will consider different approaches for assessing the impact Farmer Mac's activities have on the agricultural real estate lending market.

Conclusions

Our 2003 review showed that Farmer Mac's income, mission-related activities and risks have all increased since we last reported in 1999. At the same time, we found that Farmer Mac, FCA, and Congress could each take actions to ensure that Farmer Mac operates in a safe and sound manner while fulfilling its public policy mission. We recommended in our report that Farmer Mac strengthen its risk management and corporate governance practices and reevaluate its strategies to carry out its mission. Our report also recommended that FCA make several enhancements to its oversight tools to more effectively oversee both the safety and soundness and mission of Farmer Mac. Farmer Mac and FCA agreed with several of our report's findings and conclusions. During our recent discussions with Farmer Mac and FCA, both entities demonstrated that they are taking steps to implement many of our recommendations. Finally, our report suggested that Congress consider making legislative changes to ensure that Farmer Mac's public benefits can be measured and FCA has the necessary flexibilities to carry out its oversight responsibilities.

Mr. Chairman, this concludes our prepared statement. We would be happy to respond to any questions you or other members of the Committee may have at this time.

GAO Contacts and Staff Acknowledgements

For information about this testimony, contact Davi D'Agostino, Director, Financial Markets and Community Investment, at (202) 512-8678, or Jeanette Franzel, Director at (202) 512-9471. In addition to the individuals named above, Rachel DeMarcus, Debra Johnson, Austin Kelly, Paul Kinney, Bettye Massenburg, Kimberley McGatlin, John Treanor, and Karen Tremba made key contributions to this testimony.

GAO ANSWERS TO SUBMITTED QUESTIONS

The GAO report encourages Congress to consider the make up of the Farmer Mac Board structure by either making it a true cooperative entity and rescind Farmer Mac's authority to issue class C stock, or by amending its board structure to ensure its independence and including a one share, one vote principle to its class C common stock. I'm curious to know what you found in your review of Farmer Mac's board structure for making this recommendation. For example, did you find conflict of interest issues because class A and class B board members do business with Farmer Mac?

Our recommendation was made in the context of comparing Farmer Mac's statutory board structure to sound corporate governance practices found in today's business environment. Under this board structure, Farmer Mac resembles a cooperative that is owned and controlled by the institutions that use its services. At the same time, Farmer Mac is also a publicly traded company and therefore subject to requirements of the market on corporate governance, which requires an independent board and fully independent key committees such as the Audit Committee, Nominating Committee and Compensation Committee. However, because two-thirds of Farmer Mac's board of directors are elected by class A and class B shareholders who do business with Farmer Mac, the board may give the appearance that it lacks independence and that the directors will be protecting or pursuing the interests of those shareholders with respect to Farmer Mac. For example, conflict of interest could arise where Farmer Mac ends up serving the most influential shareholders instead of carrying out its broader public mission. During our 2003 review, we were concerned that some of Farmer Mac's board members may not meet the independence standards. In 2003, Farmer Mac board's corporate governance consultant opined that 3 out of the 15 directors were not "independent". Similarly, in its 2004 proxy, Farmer Mac noted that one class A board member did not meet the standards by virtue of his executive management positions at the financial institution that does business with Farmer Mac and a class B board member exceeded the material relationship (dollar standards) requirements for independence. With this board structure, it may become more and more difficult each year to fill these key committees with independent class A and class B directors as these entities' business with Farmer Mac could exceed the dollar limits. In addition, good corporate governance dictates that the interests and loyalties of directors of publicly traded companies should be clearly focused on serving the interests of all shareholders. Without voting rights, holders of class C stock cannot voice their opinion on governance and management issues.

Are you satisfied that Farmer Mac is making progress regarding recommendations made in the GAO report especially those dealing with lowering its risk profile?

As mentioned in our statement, Farmer Mac has demonstrated that it is taking steps to implement our recommendations, including those intended to lower its risk profile. However, in many cases, it is too early for us to assess the actions taken. In response to our recommendation, Farmer Mac staff are developing a loan classification system that will be completed in 2005 that is based on Farmer Mac's loan loss experience. Staff are also now documenting the supporting underwriting decisions for loans that Farmer Mac management approved by overriding one or more specific criteria based on the compensating strengths of those loans. Farmer Mac management told us that they are developing a capital adequacy model and they are working with an outside consultant to develop a prepayment model to ensure accurate interest rate risk measurements. Farmer Mac has also adopted a formal contingency funding and liquidity plan but this plan does not address our concerns about providing for liquidity if a large amount of standby and similar agreement loans were put to Farmer Mac unexpectedly.

Based on your review do you believe Farmer Mac has achieved its statutory mission of creating a secondary market for agricultural real estate mortgages?

Farmer Mac's enabling legislation contains a broad mission statement that refers to Farmer Mac providing a secondary marketing arrangement for agricultural real estate mortgages that would generally improve the credit availability to farmers and ranchers. The lack of specific or measurable mission-related criteria in the legislation does not allow for a meaningful assessment of whether Farmer Mac had achieved its public policy goals. Nevertheless, we evaluated Farmer Mac's contribution to the secondary market in four ways. First, we tried to assess whether Farmer Mac has made long-term credit available to farmers and ranchers at stable interest rates. We found that from 2001 to 2002, its long-term fixed interest rates on Farmer Mac I loans were similar to the rates offered by commercial banks and FCS institutions but whether the terms and condition were improved was difficult to determine. Second, we considered whether Farmer Mac has contributed to the development of a secondary market in agricultural real estate mortgages through the sale of agricultural mortgage backed securities (AMBS) to outside investors. We found that Farmer Mac has been operating under a retained portfolio strategy; therefore, the depth and liquidity of the AMBS market is unknown. Third, we compared lending institutions' market share in the agricultural real estate market with their percentage of participation in Farmer Mac's programs. We found that FCS institutions accounted for more than 55 percent of Farmer Mac I loans in December 2002, a significant increase from 2 percent in 1996. In contrast, commercial banks participation rate has dropped from 80 percent in 1996 to 22 percent as of December 2002. As of 2002, FCS institutions held 36 percent and commercial banks held 32 percent of nationwide farm-related real estate debt. It is interesting to note that while commercial banks' relative share of Farmer Mac's business has been falling, bank-held farm mortgage volume has doubled since Farmer Mac was created—a time when commercial banks viewed Farmer Mac as a new source of competitively priced funding. It remains questionable whether Farmer Mac has truly developed a secondary market and whether a need exists for such a market if (1) it is only meeting the needs of FCS institutions and (2) other financial institutions such as commercial banks are not using its programs and services. Finally, we analyzed Farmer Mac's nonmission investment portfolio in relation to Farmer Mac's business needs. Although we found that the proportion of nonmission investments has declined, we still have concerns about the composition and potential growth of this portfolio. Holding relatively high proportions of nonmission investments could potentially lead to charges that Farmer Mac is misusing its status as a GSE to generate arbitrage profits.

Based on your analysis, do you believe the Farm Credit Administration (FCA) is fulfilling its regulatory role in regard to Farmer Mac?

As discussed in our report and testimony, in the past two years, FCA has continued to strengthen its oversight of Farmer Mac by doing a more comprehensive safety and soundness examination and undertaking initiatives to expand its regulatory framework. However, we found that FCA continued to face challenges in sustaining and improving its oversight and more remained to be done to improve its off-site monitoring, assessment of risk-based capital, and mission oversight.

The GAO report made a number of recommendations directed at FCA to improve its oversight role. How has FCA responded to those recommendations?

Since our 2003 report, FCA has continued to further enhance its oversight of Farmer Mac, including implementing our recommendations, but again, it is too early for us to assess their actions. FCA staff have drafted regulatory revisions to the risk-based capital model that covers a range of issues in addition to our recommended changes. They plan to present a proposed rule to the FCA board for consideration in the fall of 2004. In response to our recommendation, FCA has made some revisions to the Farmer Mac quarterly call reports. FCA is also undertaking a number of projects to address our recommendations about (1) capital arbitrage within the Farm Credit System, (2) requiring Farmer Mac to obtain a credit rating, and (3) assessing the impact Farmer Mac's activities have on the agricultural real estate lending market.

Do you believe FCA's role as regulator for both the Farm Credit System and Farmer Mac impairs its ability to effectively and fairly fulfill its oversight responsibility?

In our report, we pointed out that because the FCS institutions and Farmer Mac are subject to oversight by the same FCA board and reviewed by some of the same FCA examiners and analysts, FCA could be subject to potential conflicts of interest. In our discussions with FCA officials, they said they were aware of the need to maintain the proper balance in their oversight roles to avoid such potential conflicts. Conversely, we have recently observed that this arrangement could enhance FCA's ability to effectively oversee both the FCS institutions and Farmer Mac. For example, FCA has recently issued an information memorandum to the FCS institutions suggesting that their boards consider whether the institutions should engage in transactions only with counterparties that have been assigned one of the highest two credit ratings. Since some of the FCS institutions conduct business with Farmer

Mac, this could be one way for FCA to provide an incentive for Farmer Mac to obtain a credit rating.

Testimony
of
Mr. Larry Doyle, CEO
Farm Credit Bank of Texas

Before the
House Agriculture Committee
Washington, D.C.
June 2, 2004

Thank you Mr. Chairman and members of the Committee.

My name is Larry Doyle. I am the CEO of the Farm Credit Bank of Texas, which provides wholesale funding and related services to 21 retail Farm Credit associations in Texas, New Mexico, Louisiana, Mississippi and Alabama. Within this territory, we have approximately $7 billion in loans to approximately 60,000 borrowers.

In recent years, Farm Credit associations in our territory have seen increased loan growth attributed to the competitive pricing inherent in the System's cooperative structure, solid demand for real estate property in most areas of our territory, and increased marketing and customer service efforts. As a result of this increased loan volume, our associations were exceeding target levels in their capital plans, thereby putting pressure on their capital adequacy ratios and causing them "put on the brakes" in their lending activity.

Our associations had a few options in addressing this challenge: 1) increase capital, 2) continue to reduce lending activity, or 3) a combination of the two. Unfortunately, the second option is never a good one because when a financial institution puts the brakes on its lending activity, it takes many years and a tremendous marketing campaign to regain standing in the marketplace. The adverse consequences are long lasting and difficult to overcome. The business strategy, therefore, ultimately involved a combination of options designed to increase capital and avoid having to do what is inherently illogical to a banker – that is, not lend money.

One aspect of that strategy involved Farmer Mac. Congress created the Federal Agriculture Mortgage Corporation (Farmer Mac) to serve as a secondary market for first mortgage agricultural real estate loans and that's exactly the role they play in our business. They do so by guaranteeing qualified loans for our associations, thereby increasing the associations' capital adequacy ratios.

The Bank helps facilitate this process by acting as a Pooler of these loans on behalf of the associations and by coordinating this process with Farmer Mac. Specifically, we utilize Farmer Mac's Long-Term Standby Commitment. This program allows us to place only our highest quality loans in the pool – loans that meet a very strict and conservative credit standard.

Through this process, our associations are freed up to respond to the local credit needs and grow with the local marketplace. As the associations grow, the Bank's direct loans to these associations grow – thereby reducing our overall operating costs as a percentage of overall loan volume. This results in a lower cost of funding from the Bank to the local associations – a cost that is ultimately passed on to farmers and ranchers who do business with those associations.

Additionally, because we can partner with Farmer Mac in this way, our retail associations can avoid having a portfolio that is too heavily concentrated in a specific commodity or geographic location. By guaranteeing these credits, Farmer Mac allows our local institutions to greatly reduce the credit-risk weighting of these loans on their balance sheets and thereby better manage the inherent risks of being a single-industry lender with a limited territorial charter.

In this way, Farmer Mac is adding value to our local Farm Credit institutions, our funding Bank and to the overall mission of the Farm Credit System.

As the chart below explains, Farmer Mac's standby guarantee allows Farm Credit institutions to more fully leverage their capital and provide needed financing to more agricultural producers.

Farmer Mac Standby Benefits

- Capital Leverage
  - Risk weighting reduced from 100% to 20%
  - Example using $30 million loan portfolio
    - Risk weighting at 100% (without standby guarantee)
    - Current capital at 14% = $4.2 million
    - Under standby guarantee, risk weight becomes $6 million
    - New capital at 7% = $420,000
    - Freed-up capital = $3.78 million

Overall, Farmer Mac serves as an important partner with Farm Credit and other lenders in improving the availability of mortgage credit to America's farmers, ranchers and agribusinesses. We greatly appreciate Congress' foresight in establishing Farmer Mac and encourage your continued support of this important player in today's financial marketplace.

JOINT STATEMENT OF FRED L. DAILEY AND HENRY D. EDELMAN

Mr. Chairman, distinguished members of the committee, our names are Fred Dailey and Henry Edelman; we are, respectively, the Chairman of the Board and the president and CEO of Farmer Mac, the Federal Agricultural Mortgage Corporation. We appreciate the opportunity you have given Farmer Mac to appear before you today to review the business and corporate activities and financial products of Farmer Mac, particularly as reflected in the October 2003 Government Accounting Office report on Farmer Mac (GAO–04–116).

It has been some time since Farmer Mac last testified before this Committee, and we are pleased to be here today to update you on the forward strides this Corporation has taken in the accomplishment of its mission in a safe and sound manner since Congress expanded its authorities in the Farm Credit Reform Act of 1996.

OVERVIEW

Farmer Mac is accomplishing its congressional mission of increasing the availability of long-term mortgage credit to farmers and ranchers at stable interest rates by providing greater liquidity and lending capacity to agricultural lenders through a secondary marketing arrangement for qualified mortgages. Since the 1996 revision to its charter, Farmer Mac's $10.7billion of credit enhancements and purchases have covered more than 33,500 loans that have helped farmers, ranchers and rural homeowners throughout all 50 states. On average, interest rates offered by lenders through the Farmer Mac I program are almost a full percentage point lower than rates on comparable loans, as reported to U.S. Federal Reserve Banks by member banks in agricultural lending states. Through its Farmer Mac II program, Farmer Mac is reaching out to help small and family farmers who would not otherwise be able to obtain financing, and to help finance development of businesses and infrastructure in the Nation's rural communities.

Farmer Mac is operating safely and soundly, consistent with its enabling legislation and in full compliance with current corporate governance standards. Since the inception of its business, Farmer Mac has been required to comply with the rules and regulations of both the Farm Credit Administration (FCA) and the U.S. Securities and Exchange Commission (SEC). Farmer Mac has been a reporting company for Securities Exchange Act purposes since its initial public offering of stock in 1988, and publicly offered Farmer Mac-guaranteed agricultural mortgage-backed securities (AMBS) have always been required to be registered with the SEC. Farmer Mac files quarterly call reports with the FCA, as well as periodic financial statements in quarterly reports on Form 10-Q and annual reports on Form 10-K with the SEC. The United States Treasury backstop line of credit that supports Farmer Mac's mission-related activities is limited to support of Farmer Mac's guarantees of AMBS and does not extend to the Corporation's debt.

By conventional measures of financial management, Farmer Mac administers its risks conservatively:

- As of March 31, 2004, Farmer Mac's regulatory capital of $245.7 million was almost six times the level required by the Congressionally mandated risk-based capital stress test, and its regulatory core capital was one and two-thirds times the required statutory minimum capital level.
- As of March 31, 2004, Farmer Mac's 90day delinquencies have trended down to 1.17 percent of the principal balance of all post–1996 Act Farmer Mac I program loans, slightly lower than the average experience of agricultural mortgage lenders for 2003, as reported by the USDA.
- Farmer Mac's reserve for losses meets the accounting requirement under U.S. Generally Accepted Accounting Principles (GAAP) of a provision for "probable and reasonably estimable losses."
- The Corporation's assets and liabilities were closely matched, with a low sensitivity to shifts in interest rates. Farmer Mac has maintained effective internal controls and conservative risk management, while always working to improve and enhance its risk management practices and tools. Accordingly, as will be explained in detail later in this testimony, the Corporation has generally adopted the recommendations contained in the GAO Report.

While Farmer Mac is similar to other secondary market GSEs, many qualifications upon its ability to do business distinguish Farmer Mac from them. Unlike Fannie Mae and Freddie Mac, public offerings of Farmer Mac guaranteed securities must be registered with the Securities and Exchange Commission; every loan brought into the Farmer Mac program must meet various statutorily mandated credit underwriting and collateral appraisal requirements; and Farmer Mac must comply with numerous other requirements that have distinguished its operating structure from those of the other GSEs.

In further distinction to other secondary market GSEs and most other private sector corporations, Farmer Mac has a Board of Directors composed entirely of outside directors; no member of management serves on the Board. Likewise, the Chairman of the Farmer Mac Board is not the chief executive officer of the Corporation; its president serves in that latter capacity. The Corporation's board and committee membership meet the independence requirements of the SEC rules and NYSE Listing Requirements.

DISCUSSION

Background. The need for Farmer Mac is best explained in the context of the circumstances that gave rise to the creation of this secondary market. In 1987, the U.S. agricultural lending community had just gone through its most serious financial credit crisis since the Great Depression of the 1930's. This prompted concern in Congress that farmers, ranchers and rural homeowners might someday be without stable sources of long-term credit. At the end of 1987, in response to those concerns, Congress passed legislation to facilitate the creation of a secondary market for mortgages backed by agricultural real estate and rural housing that meet rigorous underwriting standards. In the preamble to Farmer Mac's charter, Congress stated its purposes in creating the new secondary market:

- to increase the availability of long-term credit at stable interest rates;
- to provide greater liquidity and lending capacity to lenders who extend credit to farmers and ranchers; and
- to provide for new long-term lending to agriculture with new sources of funding provided through the capital markets, including at fixed rates of interest.

Farmer Mac thus became one of a small group of congressionally chartered institutions owned by private-sector investors but charged with carrying out specific public policy objectives, subject to Congressional oversight and Federal agency regulation and contingently backed by the Federal Government. Farmer Mac was capitalized initially through the sale of $21 million of common stock, primarily to commercial banks, insurance companies and institutions of the Farm Credit System. No Federal funds were invested in Farmer Mac and no Federal funds have ever been provided to Farmer Mac to support the Corporation's operations. In fact, Farmer Mac has paid increasingly-sizable annual assessments to the FCA to cover the entire cost to the government of regulating and supervising the Corporation for safety and soundness, an assessment currently equal to one-third of Farmer Mac's total personnel costs.

To relieve structural impediments that had limited Farmer Mac's ability to function efficiently, Congress passed the Farm Credit System Reform Act of 1996 (the 1996 Act), which significantly revised Farmer Mac's statutory authority and significantly improved Farmer Mac's ability to serve rural America. Among other things, the 1996 Act allowed Farmer Mac to: (1) purchase agricultural mortgage loans directly from lenders, pool the loans, and create securities that are backed by these pools, for retention or sale; and (2) eliminate the mandatory requirement for loan originators and poolers to retain ten percent, first-loss subordinated interests in each securitized loan pool.

ACCOMPLISHMENTS IN FULFILLMENT OF CONGRESSIONAL MISSION UNDER THE REVISED CHARTER.

Since the 1996 revision to Farmer Mac's charter, the Corporation has maintained a ready and consistent daily offer to provide agricultural lenders with a variety of credit enhancements based on capital markets rates and terms. Through those activities, Farmer Mac has provided credit enhancements on agricultural mortgages for farmers, ranchers and rural homeowners throughout America aggregating $9.2 billion through its Farmer Mac I program and an additional $1.5 billion through its Farmer Mac II program. This market presence, in turn, has created new liquidity and lending capacity for participating lenders. As of March 31, 2004, Farmer Mac's total guarantees and standby commitments outstanding were $5.7 billion, resulting in at least $5.0 billion of new lending capacity for agricultural lenders. As of that the same date, Farmer Mac's outstanding purchases of agricultural mortgages stood at $3.3 billion, reflecting an increase in agricultural lenders' liquidity of a like amount.

Through the sale of AMBS or the issuance of its debt, Farmer Mac has used the capital markets as a funding source and as the basis for the interest rates and terms in its loan purchases, guarantees and commitments. Those funding sources afford Farmer Mac the ability to further its mission of providing a secondary market for agricultural mortgage loans.

Farmer Mac's programs have influenced lenders to offer more attractive loan rates and terms when they use Farmer Mac I, as reflected in comparisons of interest rates offered by lenders through the Farmer Mac I program to rates on comparable loans, as reported to U.S. Federal Reserve Banks by member banks in agricultural lending states. It is further evidenced by analyses of rates and spreads in Farmer Mac II loans compared to rates and spreads on U.S. Department of Agriculture (USDA)-guaranteed loans made before the advent of Farmer Mac II. Farmer Mac's programs have also had a positive influence on agricultural mortgage lending through the standardization of agricultural mortgage loan terms offered by lenders across the country, which has contributed to prospective liquidity for the lenders, whether they currently use Farmer Mac or not.

FARMER MAC'S PROGRAMS

Farmer Mac loan programs are divided into two main groups referred to as Farmer Mac I and Farmer Mac II. Farmer Mac I consists of agricultural and rural housing mortgage loans that do not contain federally provided primary mortgage insurance. For loans underlying pre–1996 Act Farmer Mac I AMBS, ten percent first-loss subordinated interests mitigate Farmer Mac's credit risk exposure. Before Farmer Mac incurs a credit loss on those AMBS, losses are first absorbed by the poolers' or originators' subordinated interest. As of March 31, 2004, Farmer Mac had not experienced any credit losses related to the pre–1996 Act Farmer Mac I AMBS, and the first-loss subordinated interests are expected to exceed the estimated credit losses on those loans. Current risks in Farmer Mac's loan and guarantee portfolio, such as those discussed later in this testimony, are generated primarily by post–1996 guaranteed securities and loans. Farmer Mac receives an annual guarantee fee from the third party or trust involved based on the outstanding balance of the Farmer Mac I post–1996 AMBS.

With particular regard to the availability of long-term credit, Farmer Mac has, since 1996, operated a "cash window" program in which it offers daily rate locks on long-term mortgage loans, including fixed rates. Through the cash window, Farmer Mac purchases mortgages directly from lenders for cash and purchases mortgage-backed bonds from agricultural lenders. Periodically, Farmer Mac transfers its purchased loans into trusts that it uses as vehicles for the securitization of those loans. Securitization is the transfer of assets (in this case, loans) to a third party or trust. In turn, the third party or trust issues certificates to investors. Farmer Mac refers to such certificates as "guaranteed securities" or as agricultural mortgage-backed securities (AMBS). The cash flow from the transferred loans supports repayment of the AMBS. Farmer Mac guarantees timely payments to investors holding the certificates, regardless of whether the trust has actually received such scheduled loan payments.

Farmer Mac's long-term standby purchase commitments (standby agreements), introduced in 1999, represent a commitment by Farmer Mac to purchase eligible loans from financial institutions at an undetermined future date if a specific event occurs. The specific events or circumstances that would require Farmer Mac to purchase loans under a standby agreement include when: (1) an institution determines to sell at mark-to-market prices some or all of the loans that are not then more than 120 days delinquent under the agreement to Farmer Mac; or (2) a borrower fails to make installment payments for 120 days on a loan covered by a standby agreement. Upon entering into a standby agreement with Farmer Mac, financial institutions effectively transfer the credit risk on the loans covered by a standby agreement to Farmer Mac over the life of the agreement. Consequently, these institutions' regulatory capital requirements and loss reserve requirements would then be reduced. To date, Farm Credit System (FCS) institutions have been the only participants in standby agreements, though they are available to all agricultural lenders. In exchange for Farmer Mac's commitment under the standby agreement, Farmer Mac receives an annual commitment fee from institutions entering into these agreements, based on the outstanding balance of the loans covered by the standby agreement. Any standby agreement party may, at any time, require that Farmer Mac issue to it, in exchange for the loans covered by the standby, a guaranteed security backed by those loans.

Farmer Mac II is Farmer Mac's program for acquisition of USDA-guaranteed portions of farm ownership, farm operating, business and industry and community facilities loans to enable lenders to fund more of those loans at lower rates. Those USDA-guaranteed loans are backed by the full faith and credit of the United States. Similar to the pre–1996 Act securities, Farmer Mac has experienced no credit losses in the Farmer Mac II program and does not expect to incur any such losses in the future.

Farmer Mac is the single largest purchaser of USDA-guaranteed loans. Since the inception of the Farmer Mac II program in 1991, Farmer Mac has purchased approximately $1.5 billion in guaranteed portions, representing over 6,500 loans to small and family farmers and rural businesses and communities, of which $723 million were outstanding as of March 31, 2004 (reflecting an annual growth rate of 13 percent). As of March 31, 2004, 660 sellers from 45 states had participated in the Farmer Mac II program. The core group of active sellers (defined as sellers who have sold loans into the Farmer Mac II program since January 1, 2002) total 217 USDA-guaranteed loan originators (selling 1,718 loans totaling $491 million), most of which are small to mid-size community banks; the group also includes mortgage companies and credit unions, as well as FCS institutions.

• Farmer Mac II program volume in 2003 was a record-setting $271 million, compared to $173 million in the prior year. This growth represented a $98 million or 56 percent increase, in which:

• 78 percent (or $210 million) of 2003 Farmer Mac II volume was from the purchase of USDA- guaranteed farmer program loans.

• 22 percent (or $61 million) of 2003 Farmer Mac II volume was from the purchase of USDA- guaranteed community facility and business and industry loans.

Benefits to Agricultural Borrowers

Rates available on real estate loans purchased in the Farmer Mac I program are typically 85/100ths of a percentage point lower than the average rate on such loans made by commercial banks, as published by the Federal Reserve. According to the United States Department of Agriculture, there is approximately $111 billion of agricultural real estate debt outstanding today, of which we estimate about $45 billion is eligible for Farmer Mac loans. Farmer Mac currently provides credit enhancement and, in many cases, funding for approximately 20,800 loans to borrowers in all 50 states. Today, Farmer Mac's guarantees and commitments outstanding equal $5.7 billion, nearly 13 percent penetration of the eligible market. On the basis of the current Farmer Mac-eligible market, the current potential savings to agricultural borrowers from Farmer Mac can be estimated between $25 million and $60 million per annum, depending on the extent to which portfolio lenders pass back to borrowers the advantages of past transactions with Farmer Mac in their future lending activities. If half of the eligible market were covered by Farmer Mac guarantees, analogous to the market penetration of other secondary market GSEs, the savings to farmers could be as great as $225 million per year.

In addition to those monetary savings, Farmer Mac is a primary source of fixed-rate mortgage financing that offers the advantage of stable rates that do not fluctuate with short-term interest rates. This stability is of particular importance to agricultural borrowers when farmers stand to profit from higher commodity prices in an inflationary economy. Affected borrowers with short-term adjustable interest rate loans may give up a significant portion of those profits in higher interest payments. A viable entity such as Farmer Mac can provide stable, long-term fixed rates of interest when rates rise under inflationary pressures, resulting in a consistently available benefit to agriculture.

In its Farmer Mac I program, Farmer Mac is reaching small and family farmers, as reflected by the average loan size of $275,000 in that program, with 75 percent of the loans under $300,000.

Of the $210 million of USDA-guaranteed farmer program loans purchased in Farmer Mac II in 2003, $177 million were made to borrowers who locked in intermediate- or long-term (5- to 25-year) fixed interest rates. Furthermore, 40 percent (or $84 million) of that farmer program loan volume was specifically tied to the 5-year reset Farmer Mac II Cost of Funds Index. During 2003, Farmer Mac II allowed lenders to offer borrowers fixed rates of interest on intermediate term loans at historically low levels, less than one point above the prevailing Prime Rate typically used for short-term floating rate loans.

Through its Farmer Mac II program, Farmer Mac works closely with not only the lenders in our selling group, but also with state and county USDA field offices. The Farm Service Agency's farmer program guaranteed loans are available only to small and family farmers and ranchers who cannot obtain direct commercial credit from a local agricultural lender. USDA business and industry loans, which do not have a test for credit, encourage the financing of rural businesses, thereby creating and saving rural jobs as well as improving the economic climate of rural communities. With both of these important USDA programs, Farmer Mac adds significant value by serving as a constant, dependable source of liquidity and interest rate risk management for participating lenders. As previously mentioned, Farmer Mac has assisted in the financing of more than 6,500 USDA guaranteed loans to date, totaling approximately $1.5 billion.

BENEFITS TO AGRICULTURAL LENDERS

In the preamble to Farmer Mac's statutory charter, it is stated that the Corporation was formed to: increase the availability of long-term credit to farmers and ranchers at stable interest rates; and provide greater liquidity and lending capacity in extending credit to farmers and ranchers through a secondary marketing arrangement for qualified mortgages with new sources of funding provided through the capital markets.

a. Liquidity—Loan purchases by Farmer Mac recharge the lenders' funds available to make additional loans, thereby creating new liquidity. Farmer Mac has always maintained a ready and consistent daily offer to purchase or guarantee loans conforming to Farmer Mac's credit and appraisal standards, based on the Corporation's access to the capital markets. Farmer Mac has purchased $4.5 billion of agricultural loans in Farmer Mac I and Farmer Mac II to date; the balance of loans purchased as of March 31, 2004 was $3.3 billion.

b. Lending Capacity—In addition to its loan purchases, Farmer Mac's guarantees and commitments on securities and agricultural loans held by lenders enable those lenders to make more loans without increasing their equity. The Farmer Mac guarantee or commitment decreases to one-fifth the amount of equity that lenders must maintain to support those loans, giving them five times as much capacity to make loans based on the same equity. Since the 1996 revision to Farmer Mac's charter, Farmer Mac has purchased or provided guarantees and commitments on $10.7 billion of agricultural mortgage loans to farmers, ranchers and rural homeowners throughout America. As of March 31, 2004, the balance of loans purchased, guarantees and commitments outstanding was $5.7 billion.

Farmer Mac's Congressional mission clearly states the legislative intent that it should increase lending capacity, i.e., enable lenders to make more loans without increasing their equity, as we have described. The justification for the resulting higher leverage is the higher quality of the loans which, as required by Farmer Mac's charter, must be first mortgages on agricultural real property that meet appraisal, underwriting and documentation standards established by Farmer Mac's Board of Directors. Federal banking regulators and FCA set uniform regulatory capital levels for primary lenders that encompass not only first mortgage loans (except residential loans), but also a wide spectrum of riskier loans, including second mortgage loans, personal property loans, signature loans, and credit card receivables. Only agricultural first mortgage loans that meet Farmer Mac's standards are eligible for a Farmer Mac guarantee or commitment.

Critics of Farmer Mac have claimed that its secondary market activities undermine capital support of mortgage loans on the books of regulated entities. Those critics use the term "capital arbitrage" to disparage the legitimate process by which Congress enabled lenders to make more agricultural mortgage loans without increasing the regulatory capital they hold to support those mortgages. This is accomplished through the regulatory assignment of a lower capital requirement (risk weight) to mortgages supported by a Farmer Mac guarantee or commitment. Criticism of that process of increasing the lending capacity of agricultural lenders through the judicious use of Farmer Mac as a secondary market GSE is inconsistent with the intent of Congress expressed in the preamble to Farmer Mac's charter. Nothing else could have been meant by the phrase "provide greater. . . lending capacity" in 12 U.S.C. ◆2279aa (note)(3)(B). The 20 percent regulatory risk weight assigned to mortgages and AMBS that are credit enhanced by Farmer Mac is consistent with the intent of Congress that Farmer Mac should, by increasing the lending capacity of agricultural lenders, generate sizable economic benefits for the farmers, ranchers and rural homeowners of this Nation.

ADEQUACY OF FARMER MAC'S CAPITAL

Farmer Mac's core capital as of March 31, 2004 totaled $223.7 million and exceeded its statutory minimum capital requirement of $132.2 million by $91.5 million. Farmer Mac is also required to meet the capital standards of the risk-based capital stress test promulgated by FCA (RBC test). The RBC test is a worst-case scenario based on industry loan loss data from the experience of the Farm Credit Bank of Texas in the mid–1980's (FCBT data). The RBC test determines the amount of regulatory capital Farmer Mac would need to maintain a positive capital position during a ten-year stress period of extraordinary credit losses and interest rate volatility.

The RBC test then increases the capital requirement by an additional thirty percent to cover operational risks.

As of March 31, 2004, the RBC test generated a capital requirement of $42.0 million. Farmer Mac's regulatory capital of $245.7 million exceeded that capital requirement by $203.7 million.

Credit. As of March 31, 2004, Farmer Mac's 90day delinquencies were trending downward at $57.4 million, or 1.17 percent of the outstanding portfolio, slightly lower than the average experience of agricultural mortgage lenders for 2003, as reported by the USDA. This also compared favorably to Farmer Mac's 90day delinquencies of $76.2 million (1.58 percent) a year earlier.

As part of the loss mitigation process, Farmer Mac may acquire the real estate securing its loans. When a property is acquired in the loss mitigation process, Farmer Mac develops a liquidation strategy that results in either an immediate sale or retention pending later sale. Farmer Mac evaluates these and other alternatives based upon the economics of the transactions and the requirements of local law. As of March 31, 2004, Farmer Mac owned $12.3 million of such collateral, compared to $15.5 million as of December 31, 2003 and $8.2 million as of March 31, 2003.

Since its inception, Farmer Mac I has accepted the credit risk on $9.2 billion of agricultural mortgage loans and has incurred an aggregate of just $11.8 million of credit losses, about one-eighth of one percent. Coupled with the recent downward trend in delinquencies, Farmer Mac believes that this history evidences its prudent credit risk management practices. Additionally, Farmer Mac provides an allowance for losses in conformity with GAAP as a reserve to cover "probable and reasonably estimable losses" as required by Statement of Financial Accounting Standards No. 5, Accounting for Contingencies. As of March 31, 2004, that represented a reserve for further losses of $22.2 million.

Interest Rate Risk. Farmer Mac measures its interest rate risk through several tests, including the sensitivity of its Market Value of Equity (MVE) and Net Interest Income (NII) to uniform or "parallel" yield curve shocks. As of March 31, 2004, a parallel increase of 100 basis points across the entire U.S. Treasury yield curve would have increased MVE by 0.5 percent, while a parallel decrease of 100 basis points would have decreased MVE by 0.8 percent. As of March 31, 2004, a parallel increase of 100 basis points would have increased Farmer Mac's NII, a shorter-term measure of interest rate risk, by 2.8 percent, while a parallel decrease of 100 basis points would have decreased NII by 4.3 percent. Farmer Mac's duration gap, another measure of interest rate risk, was only minus 0.5 months as of March 31, 2004.

The goal of Farmer Mac's interest rate risk management is to create and maintain a portfolio that generates stable earnings and value across a variety of interest rate environments. Farmer Mac's primary strategy for managing interest rate risk is to fund asset purchases with liabilities that have similar durations so that they will perform similarly as interest rates change. To achieve this match, Farmer Mac issues discount notes and both callable and non-callable medium-term notes across a spectrum of maturities. Farmer Mac issues callable debt to offset the prepayment risk associated with its mortgage assets. By using a blend of liabilities that includes callable debt, the interest rate sensitivities of the liabilities tend to increase or decrease as interest rates change in a manner similar to changes in the interest rate sensitivities of the assets.

Taking into consideration the prepayment provisions and the default probabilities associated with its mortgage assets, Farmer Mac uses prepayment models to project and value cash flows associated with these assets. Because borrowers' behavior in various interest rate environments may change over time, Farmer Mac periodically evaluates the effectiveness of these models compared to actual prepayment experience and adjusts and refines the models as necessary to improve the precision of subsequent prepayment forecasts. In addition, Farmer Mac consults with independent prepayment experts as part of the model evaluation process. Regular back-testing of existing proxy prepayment models (comparing forecast to actual prepayment experience) has consistently demonstrated the predictive accuracy of existing models for prepayment experience in Farmer Mac's portfolio of program assets, thereby ensuring accurate interest rate risk measurement.

Farmer Mac also uses financial derivatives to alter the duration of its assets and liabilities to better match their durations, thereby further reducing overall interest rate sensitivity. Farmer Mac uses those instruments solely for hedging risk, not for speculative purposes. All of Farmer Mac's financial derivative transactions are conducted through standard, collateralized agreements that limit Farmer Mac's potential credit exposure to any counterparty. As of March 31, 2004, Farmer Mac had no uncollateralized net exposure to any counterparty.

Comments on GAO Report. Farmer Mac has previously received and reviewed the October 16, 2003 General Accounting Office (GAO) Report on Farmer Mac (No. GAO–04–116) titled, Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission and Corporate Governance Needed, addressing topics in the June 2002 request letter from the Senate Committee on Agriculture, Nutrition and Forestry to GAO. It was gratifying to note that, after the third examination and review of Farmer Mac by GAO over the course of the past six years, no serious deficiencies in the implementation of Farmer Mac's programs or mission were identified; recommendations were made for enhancing risk management procedures in light of the Corporation's continuing growth; and a number of positive findings were made about the safety and soundness of Farmer Mac's operations and about its progress in establishing the secondary market for agricultural mortgages.

In its previous report on Farmer Mac, dated May 21, 1999, GAO had concluded that "Farmer Mac's future viability depends on its growth potential in the secondary market for agricultural mortgages and the prospects for realizing that potential are unclear. . . . if FCS institutions or other lenders increase participation in Farmer Mac programs, Farmer Mac's financial condition could improve." Working with agricultural lenders throughout the Nation, Farmer Mac's Board and management have resolved favorably the uncertainties raised in that earlier report, reflected in dramatic increases in participation in Farmer Mac's programs. Thus, Farmer Mac is pleased with the most recent Report's recognition of Farmer Mac's progress in the four intervening years, in terms of both its financial strength and the growth of its mission-related activities. At the same time, Farmer Mac shares GAO's view, expressed in the Report, that Farmer Mac should continue to enhance its risk management, because the efficiency of our operations will be a key factor in the accomplishment of our mission and the overall success of Farmer Mac. Farmer Mac has already implemented several enhancements to risk management procedures since the issuance of GAO Report, and is in the process of implementing others, as will be explained later in this testimony.

The chairman and ranking member of the United States Senate Committee on Agriculture, Nutrition, and Forestry, in their letter request of June 26, 2002, sought GAO's assistance "to ensure that Farmer Mac's mission continues to be met in a financially sound manner." As to the six specific topics GAO was asked to address in that letter, the GAO Report: found no current financial instability at Farmer Mac, noting that: independent accountants issued Farmer Mac a "clean, unqualified audit opinion; an outside forensic accounting firm concurred with Farmer Mac's methodology for estimating loan loss allowance under GAAP; Farmer Mac effectively managed its interest rate risk through asset/liability matching and yield maintenance protection against prepayment risk; and Farmer Mac's controls over credit risks were generally sound, but could be improved in light of recent and expected future growth. Since the date of the GAO Report, Farmer Mac's independent accountants issued Farmer Mac a clean, unqualified audit opinion on the Corporation's 2003 financial statements.

Found no significant shortcomings in corporate governance; acknowledged that Farmer Mac was taking actions to ensure that it complies with recent Sarbanes-Oxley Act and NYSE listing requirements, as they become effective; and noted areas in which Farmer Mac (like other private sector corporations) might have to update its corporate governance, including expanded director training. Since the date of the GAO Report: Farmer Mac's Board adopted a Code of Business Conduct and Ethics; adopted new Board committee charters; participated in director training with outside counsel and the National Association of Corporate Directors; received advice of outside counsel that it is in full compliance with Sarbanes-Oxley requirements currently in effect; nominated a certified public accountant from a firm not associated with the Corporation for election as a director at the 2004 Annual Meeting of Stockholders; revised its committee structure to eliminate its Executive Committee, transferring those responsibilities to the Corporate Governance Committee; and will tomorrow bifurcate its Program Development Committee into separate Credit and Marketing Committees.

Found executive compensation was in line with the recommendations of two independent consultants, but recommended that the timing of vesting of stock options be extended, which the Farmer Mac Board has done. Since the date of the GAO Report, the Compensation Committee directed its outside consultant to perform a zero-based analysis of executive compensation and to advise on incentive compensation alternatives to stock options for directors and officers.

Found no irregularities in Farmer Mac's investment practices or strategy and that non-mission investments have been reduced as a percentage of mission-related assets. recommended that Congress reconsider the non-voting status of Farmer Mac class C common stock.

Noted that Farmer Mac has increased its congressional mission-related activities (loan purchases, guarantees and commitments) since GAO's 1999 report, and recommended that Congress consider establishing more specific criteria for measurement of Farmer Mac's mission accomplishment. Since the date of the GAO Report, the Public Policy Committee has adopted a requirement for regular monitoring of mission accomplishment.

In addition, the Report raised several hypothetical or problematic issues. For simplicity, those issues are paraphrased in italics below, with Farmer Mac's observations following them.

As Farmer Mac's Long-Term Standby Purchase Commitments (LTSPCs) continue to grow, if risks were not closely managed and there were massive defaults on those loans far beyond the worst levels experienced in U.S. agricultural economic history, the Corporation could be required to acquire a high proportion of the outstanding loans covered by LTSPCs, resulting in a possible future funding risk. This hypothetical relies upon words "if," "and," "far beyond, "could," and "possible" to such a degree as to render its premise too implausible to deserve serious consideration. To hypothesize circumstances in which Farmer Mac would face a "possible future funding risk," the GAO Report had to posit: (1) unchecked mismanagement of risks at Farmer Mac (despite close management, Board, FCA monitoring and securities law disclosure of the components of those risks); (2) loan defaults far beyond the 13.8 percent default rate peak for all agricultural loans (including non-mortgage loans) within a concentrated geographic region in the Farm Credit System in 1986, the worst period in recorded U.S. agricultural economic history; (3) significant impairment of the value of the collateral behind those loans, for which the weighted average loan-to-value ratio at origination was less than 50 percent; (4) nearly simultaneous default among a group of thousands of Farmer Mac loans diversified by commodity and geography, and (5) an inability on Farmer Mac's part to issue $2.5 billion of new short-term debt, a small amount relative to its current annual issuance rate of over $100 billion of such instruments. Without discussing Farmer Mac's 90-day delinquency rate on the LTSPCs referenced in the GAO Report at 0.1 percent, Farmer Mac notes that, while the hypothetical is incredibly remote, the additional funding required would not be inconsistent with Farmer Mac's demonstrated level of access to the capital markets.

With respect to guaranteed AMBS held by Farmer Mac, the U.S. Treasury has questioned whether it would be required to allow Farmer Mac to draw upon its Treasury line of credit to support those guarantees.

No issue has been raised as to the availability of Farmer Mac's statutory Treasury line of credit relative to AMBS held by parties other than Farmer Mac and, if Farmer Mac were coming under pressure to fund its guarantee obligations, it would sell to third parties any AMBS it held long before it needed to access the Farmer Mac Treasury line of credit.

Farmer Mac recognizes that there are a number of areas in its business that will continue to evolve and need attention. Independent of, but consistent with the findings and recommendations in the GAO Report, Farmer Mac has taken a number of steps to enhance its risk management practices. With respect to the recommendations for Farmer Mac itemized on pages 57 and 58 of the GAO Report, the Corporation has taken the following actions:

The GAO Report cites the conclusion of a prominent agricultural economic consultant to Farmer Mac's Federal regulator, the FCA, that the FCBT data was the "best available" data for the purpose of building a model to estimate Farmer Mac's credit risk, but it nevertheless concludes that it would be better if Farmer Mac were using its own historical data. Since the date of the GAO Report, Farmer Mac has taken great strides toward the development of a model based on its own historical data to estimate the credit risk in its portfolio and ultimately establish loss reserves. Farmer Mac is currently testing that model and expects to migrate to the model by 2005, and will continue to use the FCBT data in a manner consistent with GAAP until that migration is completed. Farmer Mac has enhanced its loan classification system as a critical step in the process of migrating our loss allowance and reserve process to a methodology based on Farmer Mac's loan loss experience rather than the FCBT data. Farmer Mac also uses its loan classification system as the basis for its internally developed capital adequacy model. Farmer Mac measures its capital adequacy against this model, in addition to the statutory minimum capital levels established by Congress and risk-based capital levels established by FCA.

Farmer Mac has continued to gather documentation supporting underwriting decisions based on compensating strengths of loans to be used in supporting future underwriting decisions and considered in the enhancement of Farmer Mac's loan classification system. With respect to loans resulting from those underwriting decisions, the Corporation has enhanced its documentation procedures; its tracking of the subsequent performance of those loans; and conformed its loan loss reserve methodology and procedures.

During 2004, Farmer Mac has marketed and sold on-books AMBS at prices similar to those of comparable GSE securities. The Corporation will continue to market and sell AMBS on a periodic basis in the future.

Farmer Mac has formalized a contingency funding plan. Farmer Mac has formalized the Corporation's long-standing liquidity contingency funding plan, with Board action confirming the new plan, adopted in August 2003. Farmer Mac completed two significant floating rate medium-term note (MTN) issuances totaling $280 million during first quarter 2004 to enhance its balance sheet liquidity and reduce its exposure to discount refunding needs. The Corporation has conducted regular fixed-rate MTN issuances, in lieu of floating-to-fixed interest rate swaps, according to its MTN needs supporting program purchases. During 2003 and 2004 to-date, Farmer Mac issued a total of $749 million of MTNs at rates similar to those of comparable GSE securities. A comprehensive analysis of Farmer Mac liquidity needs is has been performed, based on the Sound Practices for Managing Liquidity in Banking Organizations issued by the Basel committee on Banking and Supervision in 2000. Farmer Mac maintained an average of 92 days' liquidity during first quarter 2004. Farmer Mac's Board adopted a new liquidity policy in April 2004, with a 60-day minimum liquidity requirement and a 90-day liquidity target.

Farmer Mac has been consulting with a nationally-recognized prepayment expert to ensure the continued accuracy of its current prepayment model and to develop a proprietary prepayment model based on its own portfolio agricultural mortgage prepayment data. The prepayment models used by Farmer Mac to date have been consistent with models used by other agricultural mortgage lenders. Since no publicly available agricultural mortgage prepayment database exists, Farmer Mac has used several residential prepayment models, adjusted to reflect the differences in the behavior of agricultural and residential mortgage borrowers, with validation by a recognized outside expert on prepayment modeling; and the accuracy of Farmer Mac's model has been confirmed through "back-testing," i.e., verifying model forecasts against actual outcomes. Regular back-testing of adjusted proxy prepayment models has consistently demonstrated the predictive accuracy of those models for prepayment experience in Farmer Mac's portfolio of program assets, thereby ensuring accurate interest rate risk measurement. Since the date of the GAO Report the design of a prototype Farmer Mac agricultural mortgage prepayment model has been completed by the prepayment consultant and is expected to be available for Farmer Mac's use in its interest rate risk management during the latter part of 2004.

Independent of its statutory and regulatory capital requirements, Farmer Mac has developed a capital adequacy model for internal use in its capital planning.

Farmer Mac's Board has extended the vesting period of new grants of stock options on Farmer Mac's class C non-voting common stock, effective January 2004.

Farmer Mac is working with its corporate governance advisors to assure that the Board nomination process continues to comply with all applicable laws and regulations. Farmer Mac's Board has reviewed, and confirmed by unanimous resolution, that all of its members understand the nomination process and they consider it to be "transparent." Moreover, Farmer Mac and its counsel believe the nomination process is fully and fairly disclosed in its Proxy Statement issued in connection with its 2004 Annual Meeting of Stockholders.

Farmer Mac's Board formalized the Corporation's management succession plan in June 2003, and will do so annually each year at its June meeting. Farmer Mac has initiated a formal training program for its Board of Directors, including consultation and participation with the National Association of Corporate Directors. In fact, in December 2003, in conjunction with the Board's meeting, the members participated in an eight hour training program on Director Professionalism presented by the NACD. The Board intends to participate in at least one "outsider provided" training program each year, generally in conjunction with its December meeting and receives more detailed briefings on specific Farmer Mac-related subjects on a regular basis from the Farm Credit Administration and management. Three examples of management briefings included reviews of: (1) Farmer Mac debt issuance and investment strategy; (2) Farmer Mac interest rate risks and asset and liability management strategy; and (3) Farmer Mac's use of derivatives and the advantages and disadvantages of such instruments.

Farmer Mac has fully considered GAO's recommendations and is continuing to enhance its operations consistent with them. These and other enhancements have further strengthened Farmer Mac as it continues to carry out its mission in a safe and sound manner for the benefit of the Nation's farmers and ranchers.

The Board of Directors of Farmer Mac statutorily mandated to be composed of five appointees of the President of the United States, five representatives of Farm Credit System institutions and five representatives of commercial banks, insurance companies and other financial institutions works together as an alliance unique in agricultural finance to accomplish Farmer Mac's important Congressional mission. Farmer Mac is receptive and responsive to criticism and recommendations from Congress and GAO as its investigative arm, regulators such as FCA and the SEC, agricultural lenders, capital markets debt and equity investors, and, most important, farmers, ranchers and rural homeowners. Every day, Farmer Mac seeks new ways to satisfy all of those important constituencies in furtherance of its Congressional mission, safe and sound operation, and creation of stockholder value. Farmer Mac welcomes this hearing as an opportunity to explain how we attempt to satisfy each of those interests.

Thank you for the opportunity you have generously provided Farmer Mac to give testimony on this matter of great importance to American agriculture. We would be pleased to answer any questions you may have at this time.

NOTE ON FORWARD LOOKING STATEMENTS

In addition to historical information, this testimony includes forward-looking statements that reflect management's current expectations for Farmer Mac's future financial results, business prospects and business developments. Management's expectations for Farmer Mac's future necessarily involve a number of assumptions and estimates and the evaluation of risks and uncertainties. Various factors could cause Farmer Mac's actual results or events to differ materially from the expectations as expressed or implied by the forward-looking statements, including uncertainties regarding: (1) the rate and direction of development of the secondary market for agricultural mortgage loans; (2) the possible establishment of additional statutory or regulatory restrictions or constraints on Farmer Mac that could hamper its growth or diminish its profitability; (3) legislative or regulatory developments or interpretations of Farmer Mac's statutory charter that could adversely affect Farmer Mac or the ability or motivation of certain lenders to participate in its programs or the terms of any such participation, or increase the cost of regulation and related corporate activities; (4) possible reaction in the financial markets to events involving government-sponsored enterprises other than Farmer Mac; (5) Farmer Mac's access to the debt markets at favorable rates and terms; (6) the possible effect of the risk-based capital requirement, which could, under certain circumstances, be in excess of the statutory minimum capital requirement; (7) the rate of growth in agricultural mortgage indebtedness; (8) lender interest in Farmer Mac credit products and the Farmer Mac secondary market; (9) borrower preferences for fixed-rate agricultural mortgage indebtedness; (10) competitive pressures in the purchase of agricultural mortgage loans and the sale of agricultural mortgage backed and debt securities; (11) substantial changes in interest rates, agricultural land values, commodity prices, export demand for U.S. agricultural products and the general economy; (12) protracted adverse weather, market or other conditions affecting particular geographic regions or particular commodities related to agricultural mortgage loans backing Farmer Mac I Guaranteed Securities or under LTSPCs; (13) the willingness of investors to invest in agricultural mortgage-backed securities; or (14) the effects on the agricultural economy or the value of agricultural real estate of any changes in Federal assistance for agriculture. Other factors are discussed in Farmer Mac's Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 15, 2004, and its Quarterly Report on Form 10-Q for the quarter ended March 31, 2004, as filed with the SEC on May 10, 2004. The forward-looking statements contained in this testimony represent management's expectations as of the date of this testimony. Farmer Mac undertakes no obligation to release publicly the results of revisions to any forward-looking statements included in this testimony to reflect any future events or circumstances, except as otherwise mandated by the SEC. Both of the referenced filings are available on Farmer Mac's website at *www.farmermac.com.*

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June 15, 2004

The Honorable Robert Goodlatte, Chairman
House Committee on Agriculture
House of Representatives
1300 Longworth House Office Building
Washington, DC

Re: Follow-up to June 2, 2004 Oversight Hearing on Farmer Mac

Dear Chairman Goodlatte:

We appreciated the opportunity to testify before you on June 2, 2004 to discuss Farmer Mac's accomplishments to date and the progress we are making in fulfilling our important Congressional mission in accordance with the authorities granted us by Congress. During that hearing, the Committee requested that Farmer Mac provide certain follow-up information. The questions asked, and our responses, are as follows:

1. *Q. What is the number of lenders participating in Farmer Mac's programs?*

   A. There are a total of 948 lenders participating in Farmer Mac's programs, including 160 Farmer Mac I approved sellers; 667 Farmer Mac II participants to date, and 121 lenders who have participated indirectly through two networks established by larger approved sellers.

2. *Q. What has been the change in the number of lenders participating since the last GAO report on Farmer Mac, in 1999?*

   A. As of December 31, 1998 (the closing date of the referenced GAO Report), there were 626 lenders participating in Farmer Mac's programs, with a similar break-out as above; thus, the number of participating lenders has increased by 322 or 51% since the referenced GAO Report.

3. *Q. What percent of Farmer Mac's business is conducted with related parties?*

   A. Farmer Mac's program volume with related parties during 2003 was as follows:
   a. 54.9 percent of Farmer Mac I and II program volume in 2003 was transacted with related parties
      i. 39.1 percent, or $75 million, of Farmer Mac I loan purchases in 2003 were from related parties in 2003, with the preponderance of that volume coming from one

The Honorable Robert Goodlatte, Chairman
House Committee on Agriculture
House of Representatives
June 15, 2004
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entity (no longer represented on the Farmer Mac Board as of June 3, 2004) that networks more than 100 unrelated lenders.

ii. 77.1 percent of Farmer Mac Long-Term Standby Purchase Commitments were with related parties in 2003. That percentage reflects the facts that the LTSPC structure was established at the request of the Farm Credit System and, by statute, that the FCS has five seats on the Farmer Mac Board that have been distributed among the five district banks.

iii. 3.8 percent of Farmer Mac II guaranteed portion purchases were from related parties in 2003.

4. *Q. What percent of Farmer Mac's business is conducted with lenders represented on Farmer Mac's Board?*

   A. All program volume with related parties in 2003 was with lenders represented on Farmer Mac's Board. Accordingly, please refer to response to Question 3, above.

5. *Q. Please state the amount of AMBS sold in the most recent transaction and the number of investors involved.*

   A. In May 2004, Farmer Mac solicited bids from multiple potential investors and sold $26.9 million of AMBS to one investor, a related party, in an SEC-registered transaction, on terms comparable to those that would have pertained to a mortgage-backed security transaction with a residential mortgage secondary market GSE.

If you have any further questions, please do not hesitate to contact us.

For the record, we wish respectfully to note that all statements contained in our written and oral testimony before the Committee, and the contents of this letter, reflect the opinions of Farmer Mac solely, and do not necessarily reflect the opinions of any other person or entity including, but not limited to, the United States Treasury, the General Accounting Office, or the Farm Credit Administration.

We appreciate your, and the Committee's, continuing interest in Farmer Mac and the diligent and responsible fulfillment of our Congressional mission.

Very truly yours,

Henry D. Edelman
President

cc: Mr. David Ebersole

Responses to questions for inclusion in the hearing record:

Questions from Chairman Goodlatte:

1. As you may have read in yesterday's (June 1, 2004) Washington Post, there is an apparent agreement to stop diverting the Owens Valley water in California to the City of Los Angeles. In your analysis of the credit risk associated with your Long-Term Standby Commitment to Purchase agreements or other guarantees with lenders in California and elsewhere in the western U.S., have you estimated the impact of agreements, either by private contract or judicial decrees, that may make it difficult for farmers to get the water to farm efficiently and repay their loans?

Before Farmer Mac assumes credit risk on an agricultural mortgage loan, whether through direct purchase of the loan or inclusion of the loan in a pool that is subject to an LTSPC or guaranteed by Farmer Mac, the loan must meet Farmer Mac's credit underwriting, appraisal and documentation standards. During the underwriting process, Farmer Mac closely scrutinizes the economic support for a loan, including water rights and entitlements, particularly when the related security property does not have well-established and secure supplementary irrigation water sources. If the presence of irrigation water has a significant effect on the total value of a property securing a loan, Farmer Mac's standards require an appraiser to identify and analyze the property's irrigation equipment and irrigation water based upon an examination of all permits, agreements and other information pertinent to the delivery of water, its use, and its drainage. Any such analysis must include a discussion of the sources, adequacy, stability, quality, timing of delivery, cost, and drainage capacity of irrigation water and an evaluation of the adequacy of the borrower's future legal and physical access to the irrigation water. If the property securing a loan is irrigated, Farmer Mac requires the water supply rights to have a remaining economic life at least equal to the amortization period of the loan and to have sufficient quality and volume to sustain and economically produce crops typically grown in the area. Furthermore, with respect to each loan for which Farmer Mac assumes credit risk, sellers represent and warrant to Farmer Mac that a security interest has been properly perfected in any water rights and entitlements associated with the collateral property and that documentation has been obtained, as may be necessary, to ensure the delivery of that water to the collateral property.

In addition to the analysis of water rights on a loan-by-loan basis during the collateral valuation and underwriting processes, Farmer Mac carefully monitors water rights issues on a regional basis and uses the information in loan underwriting and loan servicing decisions. As a result of that monitoring, Farmer Mac has on occasion limited its activities with respect to loans from certain areas. For example, Farmer Mac suspended purchases of loans secured by property located in the drainage-affected area of California's Westlands Water District in May 2003. Farmer Mac also modified its core lending standards when lending in the Klamath Basin in Oregon and California due to ongoing water disputes that may adversely affect farmers in that area.

It was not clear from the question whether the Committee had a particular interest in mortgage loans secured by property located in the Owens Valley, which is in Inyo County California. For the Committee's information, Farmer Mac does not currently own, or guarantee a pool including, any loan secured by property located in Inyo County. Under its LTSPC program, Farmer Mac has assumed credit risk on two loans secured by property located in Inyo County in the cumulative amount of approximately $210,000, but neither property is located in the Owens Valley.

2. You recently have used a participation swap agreement that converts loans from the Long-Term Standby Commitment to Purchase program to a guarantee of these loans on different terms. Could you please walk us through this transaction and describe the benefits and any interest rate or credit risks to Farmer Mac of the transaction? How many of these swap transactions has Farmer Mac completed? Did Farmer Mac market these swaps as a transaction that would result in a Farm Credit System institution avoiding payment of premium to the Farm Credit System Insurance Corporation?

During third quarter 2003, Farm Credit West, ACA ("FCW")[1] exercised the conversion feature incorporated in all existing LTSPCs and, accordingly, Farmer Mac converted that participant's $722.3 million LTSPC into a Farmer Mac Guaranteed Agricultural Mortgage-Backed Security ("AMBS") in a swap transaction. Under this "participation swap" alternative to the LTSPC program, FCW assigned to Farmer Mac's wholly-owned subsidiary, Farmer Mac Mortgage Securities Corporation ("FMMSC"), interests in $722.3 million of agricultural mortgage loans consisting of: (1) the right to receive principal and interest on the loans and FCW's interest in the collateral securing the loans; and (2) participation interests in all of the cash flows and other interests of FCW relating to the loans other than servicing rights and obligations related to the loans and legal title of the loans, which remained with FCW. FMMSC then deposited the interests in a trust, which issued AMBS guaranteed by Farmer Mac with a pass-through rate equal to the weighted average net interest rate of the loans. The AMBS were then transferred to FCW. Under this structure, FCW holds legal title to the loans and is obligated to service the loans under Farmer Mac standards and to give effect to all applicable statutory borrower rights.

The benefit to FCW of this participation swap transaction is that the AMBS it now holds is a security that has more liquidity than the related pool of individual mortgage loans, as demonstrated by FCW's sale of part of its AMBS to another Farm Credit System institution in April 2004. The AMBS structure provides the holder with a guarantee that is supported directly by Farmer Mac's $1.5 billion U.S. Treasury backstop line of credit in the unlikely event of Farmer Mac's inability to perform under its guarantee obligations. In addition, as a security, the AMBS is not subject to a FCSIC premium.

While providing benefits to FCW, the participation swap transaction with FCW did not create any additional risk to Farmer Mac. Farmer Mac had already assumed 100 percent of the credit risk on the loans underlying the AMBS through the LTSPC program, and the conversion from LTSPC to AMBS did not increase that risk. Interest rate risk was never an issue with respect to these loans, under either the LTSPC or AMBS transaction type, because the loans have never been funded by Farmer Mac. In the participation swap securitization process, no gain or loss was recognized in Farmer Mac's financial statements, the trust was not consolidated into

[1] Kenneth A. Graff, CEO of FCW, is also a member of the Board of Directors of Farmer Mac.

Farmer Mac's financial statements, and there was no reduction in Farmer Mac's total allowance for losses.

While the referenced transaction with FCW described above is the only LTSPC conversion transaction that has been completed by Farmer Mac, it is important to note that, before LTSPCs became the transaction of choice for Farm Credit System institutions, Farmer Mac completed four swap transactions with FCW's predecessor, Central Coast Farm Credit, aggregating $264 million in the 1998-99 time period, with the same effect on the FCSIC premium, with no adverse comments by FCA.

The derivation of the participation swap transaction structure was unrelated to the payment of premiums to the Farm Credit System Insurance Corporation ("FCSIC"). Farmer Mac created the participation swap transaction structure in August 2002 in response to questions raised regarding various aspects of the LTSPC program, including LTSPC holders' access to U.S. Treasury support of Farmer Mac's guarantees of mortgage-backed securities. At that time, the FCSIC premium rate applied to loans was 0% (zero). Subsequently, when the FCSIC premium rate on loans was increased to 0.12% (12 basis points), Farmer Mac's marketing materials for Farm Credit System institutions were modified to note that AMBS were not subject to FCSIC premiums.

3. When you acquire farm property through your operations, how long do you normally hold it before disposal? How do you market these properties for sale? Are they generally sold as whole farm units? If some farms are divided and sold in parcels, what is the percentage of those sales compared to the real estate owned portfolio and is there any part of the country where parcel sales are conducted more frequently?

When Farmer Mac acquires a farm property as a result of a borrower default (commonly referred to as a "real estate owned property" or "REO"), it begins marketing the property for resale as soon as possible, subject to any restrictions under applicable law. The most common legal restriction is the "redemption period" after a foreclosure sale that allows a borrower an opportunity to repurchase the REO property at any time prior to the expiration of the redemption period, which can be as long as 12 months in some states. It is usually impossible for Farmer Mac to sell any such property until after the expiration date, unless Farmer Mac obtains from the borrower and other creditors a waiver of those redemption rights.

In the agricultural lending sector, a marketing period ranging from 6 to 12 months is considered to be normal for the sale of REOs. Exclusive of the redemption period, the average marketing period for Farmer Mac REOs has been approximately 7 months. The marketing timeframe for each REO can be affected greatly by a number of factors, including: the time of year the property was acquired; the condition of the property and or its improvements/facilities; the crop or commodity produced on the property; the condition of the crop or commodity; the need to harvest a crop; and whether an eviction from the property must take place.

Farmer Mac generally markets REOs through a local broker familiar with that particular type of agricultural property. Marketing proposals are requested from several area brokers and reviewed by the Central Servicer and Farmer Mac to determine with whom to list the property. In some cases, a Central Servicer has internal personnel with the background, experience and relevant contacts in the agricultural community to offer the property for sale without involving a broker.

REO properties typically are sold in the same parcel configuration as when the parcel was offered as collateral for the Farmer Mac loan, which sometimes are "whole farm units," but more typically are "sub-farm units," i.e., tracts of land that are operated as separate parcels but comprise a total farm or ranch operation. Farmer Mac has not subdivided collateral for sale in parcels if it had not been operated as separate parcels by the borrower. The buyers of the REO properties are nearly always local farmers or ranchers who are adding to their current operations. Whether an REO property is marketed in smaller tracts or not depends on local market conditions and is subject to the input of the broker(s) who market of the property.

There is no particular part of the country in which collateral is sold in parcels more frequently than any other area. Of the 24% of Farmer Mac REO properties that have been sold as parcels, one was located in North Carolina, two were located in Idaho, one was located in Montana, three were located in Washington, and one was located in California.

4. What is the extent of your servicing arrangements and with whom do you currently have such arrangements?

Farmer Mac generally does not directly service the agricultural mortgage loans for which it has assumed credit risk. Instead, Farmer Mac has chosen to outsource the majority of the servicing function for two reasons: (1) to access the expertise and specialized knowledge of several industry-recognized third-party servicers throughout the country; and (2) to obtain servicing economics that more closely correlate to the marginal cost of servicing than to the fixed-plus-marginal cost of servicing that would be incurred if Farmer Mac performed that function in-house. Farmer Mac actively supervises and monitors the performance of loan servicers and may assume direct servicing for certain loans.

Farmer Mac I loans held by Farmer Mac or underlying AMBS are serviced only by Farmer Mac-approved entities designated as "central servicers" that have entered into central servicing contracts with Farmer Mac. In addition, sellers of mortgage loans sold into the Farmer Mac I program have a right to retain certain "field servicing" functions (typically direct borrower contacts) and may enter into contracts with Farmer Mac's central servicers that specify such servicing functions. Farmer Mac currently has central servicing contracts with five entities that handle backroom accounting, reporting, billing, lock box, collection and other normal loan servicing activities with respect to designated loans held by Farmer Mac or underlying AMBS (other than the Participation Swap AMBS): (1) AgFirst Farm Credit Bank (both full-time farm and part-time farm loans); (2) CGB Agrifinancial Services, Inc. (part-time farm loans only); (3) MONY Life Insurance Company (full-time farm loans only), whose servicing rights are currently in the process of being transferred to AgStar Financial Services, ACA; (4) Rabo Agrifinance, Inc. (full-time farm loans only); and (5) Zions First National Bank (full-time farm loans only). Farmer Mac currently has 175 field servicers across the country that provide the direct line loan servicing for each loan and report to the designated central servicer on all delinquent loan and other servicing activities.

Farmer Mac I loans subject to LTSPCs are retained on the books of the LTSPC participant and serviced by the participant in accordance with its own servicing procedures, which have been reviewed in the past by the Farm Credit Administration, as all current LTSPC participants are Farm Credit System institutions. The LTSPC participants pay Farmer Mac a commitment fee for assuming the credit risk on the loans and service the loans at no cost to Farmer Mac. LTSPC participants have the option of selling to Farmer Mac any loan in the LTSPC pool that becomes 120 or more days past due. If the participant sells a loan to Farmer Mac pursuant to the terms of an LTSPC, the participant is then required to become a central servicer and follow Farmer Mac's servicing procedures with respect to the loan in exchange for a servicing fee. Farmer Mac currently has 20 LTSPC participants (all Farm Credit System institutions) that service the loans subject to LTSPCs. Consistent with other structural aspects that parallel LTSPCs, the loans underlying the Participation Swap AMBS are serviced by the originator of those loans.

Farmer Mac believes that the combined expertise of its central servicers, field servicers, LTSPC servicers and its own internal staff provides the Corporation with access to adequate resources for performing the necessary servicing functions.

<u>Questions from Mr. Stenholm</u>:

1. The statutory capital ratio for Farmer Mac's off-balance sheet activities, such as the more than $3 billion in long term loan standby purchase commitments, is 75 basis points, three-quarters of one percent. This ratio is similar to those of other GSEs that purchase housing loans. Geographic diversification mitigates risk in home mortgages. Housing prices in one part of the country do not necessarily affect housing prices in another part. I must ask, is the risk profile facing Farmer Mac sufficiently similar to the risk profile in housing loans? Loans related to agriculture are somewhat different, however, because farm values and the incomes that determine the repayment ability are linked nationally by commodity markets. Homes in Spokane, Washington, and homes in Topeka, Kansas, may have little relationship in their values to one another, but wheat farms in eastern Washington and eastern Kansas have quite a strong relationship. What assurances can you provide that Farmer Mac is adequately capitalized, especially in the standby loan agreements, given this difference?

Farmer Mac's statutory minimum capital ratio for off-balance sheet activities (75 basis points) is 66 percent higher than the comparable required ratios for the housing GSEs (45 basis points).

Nationwide geographic and commodity diversification mitigates Farmer Mac's vulnerability to local or commodity specific problems. The risk profile of agricultural real estate loans is significantly different than that of housing loans in terms of geographic diversification and is also significantly affected by commodity diversification, which has no obvious corollary in the evaluation of risk in housing loans. While it is generally true that housing prices in one part of the country do not necessary impact housing prices in another area, as this is determined by local economics, this is not always true during times of national economic problems. In such cases, geographic diversification does not afford protection from this type of risk. An agricultural loan portfolio that is diversified by commodity, however, is less susceptible to both national economic problems and local economic problems. For example, if the U.S. economy was in recession and many local economies were having unemployment issues as a result, several different types of agriculture could be affected, each with its own set of market risk attributes. Agricultural commodities are generally affected by national and world markets for the particular commodity, and most will not be affected by national and local economic and unemployment issues. When one commodity industry is having difficulties (e.g., tree fruit), other industries (e.g., dairy and almonds) may be having exceptional years, regardless of where the properties producing the commodities are located geographically.

Farmer Mac has commodity diversification standards for individual sub-groups (e.g., dairy, vineyards, feed grain, and food grains) and major commodity groups (permanent plantings, crops, livestock and part-time farms) that ensure diversification of Farmer Mac's loan portfolio against significant and adverse concentration. As shown in the table below, Farmer Mac's loan portfolio is quite diversified in terms of commodity concentrations, with the largest commodity concentration in feed grains at an 11 percent concentration.

Farmer Mac's Loan Portfolio
by Commodity Groups
March 31, 2004
(individual percentages may not add to totals due to rounding)

Commodity Group	**Percentage**
Cotton/Tobacco	3%
Feed Grains	11%
Food Grains	7%
Oilseeds	7%
Potatoes, Tomatoes, and Other Vegetables	7%
Sugarbeets, Cane and Other Crops	8%
Total Crops	**44%**
Cattle and Calves	8%
Dairy	10%
Eggs	0%
Hogs	1%
Poultry	1%
Sheep, Lambs and Other Livestock	1%
Total Livestock	**21%**

Apples and Pears	1%
Citrus	3%
Grapes	10%
Greenhouse/ Nursery	3%
Nuts	3%
Other Fruit	3%
Stone Fruit	1%
Timber	1%
Total Permanent Plantings	**26%**
Total Part-Time Farms	**6%**
Total Not Specified	**1%**

The academically recognized Herfindahl-Hirschman Index ("HHI") is a commonly used measure of relative market concentration that can be applied to loan portfolio concentration. The HHI is calculated by squaring the portfolio or regional share of each commodity group and then summing the results. For example, for a portfolio or region with four commodities with shares of thirty, thirty, twenty and twenty percent, the HHI is 2600 ($30^2+30^2+20^2+20^2 = 2600$). A lower HHI indicates more diversification. Farmer Mac's loan portfolio is more diversified by commodity than U.S. agriculture in general, as reflected by the 689 HHI of Farmer Mac's loan portfolio compared to the 1049 HHI of U.S. agriculture's taken as a whole.

Farmer Mac's geographic loan volume in the Southwest increases its commodity diversification. The Southwest is the most diversified U.S. geographic region in terms of commodities with an HHI of 1190, which is almost as diverse as U.S. agriculture taken as a whole. Similarly, the loan volume in the Southwest is not particularly dependent on government support, being based on the domestic and international supply and demand of the commodities.

With respect to the adequacy of its capital, Farmer Mac believes that the risk-based capital ("RBC") model legislated by Congress and implemented by FCA (beyond the statutory historical data requirement) applies the "ultimate" stress to Farmer Mac's portfolio – a 10-year depression scenario of unprecedented severity. The RBC model applies loan loss rates from the worst period in agricultural history to the entire portfolio for a ten-year period. As of March 31, 2004, the RBC model produced a $42.1 million RBC requirement for Farmer Mac, more than half of which was covered by solely by the Corporation's total allowance for losses ($22.2 million). Farmer Mac's regulatory capital of $245.7 million as of March 31, 2004 was nearly six times the RBC requirement.

2. The capital ratios are compared to other GSEs that engage in buying mortgages, securitizing them and selling those securities to investors in a secondary market. Yet, a significant part of Farmer Mac's business appears to be insuring the credit risk of these loans for which it provides a standby purchase commitment. How would Farmer Mac's balance sheet and reserves compare to private firms that insure loans, such as mortgage insurer, PMI, Inc., or municipal bond insurer, MBIA?

Farmer Mac's contingent liability for the credit of loans underlying its off-balance sheet LTSPCs is the same as the liability it would have if the loans were supporting off-balance sheet AMBS that it guaranteed or on-balance sheet AMBS that it held. All such liabilities are fully and fairly disclosed in Farmer Mac's financial statements, as filed with the SEC and distributed to investors and other interested parties.

By issuing a guarantee on AMBS, Farmer Mac "insures the credit risk" of the underlying loans. This is also true for other secondary market GSEs that buy mortgages and either hold them in portfolio or securitize and sell them to investors. In both cases, the GSE retains (insures) the credit risk of the underlying loans. Other GSEs also issue LTSPCs, which result in the same contingent liability. Farmer Mac's capital ratios and those of the other secondary market GSEs reflect their status as GSEs, with the lower capital ratios than the primary lenders they serve being the fundamental means by which secondary market GSEs are able to provide value to the primary lenders and ultimately the borrowers.

The PMI Group, Inc. and MBIA, Inc. are publicly-traded private sector corporations with no GSE status. MBIA is engaged in various types of credit insurance, largely second-loss credit guarantees on unsecured bonds issued by single entities, ranging from small municipalities to corporations and high risk collateral. PMI is principally a provider of credit enhancement on high LTV (i.e., greater than 80%) residential mortgages. Notwithstanding those notable distinctions from Farmer Mac, we have highlighted in the table below certain attributes of the businesses in which Farmer Mac, PMI and MBIA participate.

Attribute	**Farmer Mac**	**The PMI Group, Inc**	**MBIA, Inc**
Primary Business	Provider of liquidity to the agricultural mortgage market; primary guarantor of agricultural mortgage credit	Provider of mortgage insurance	Financial guarantor of bonds; financial guarantee insurance
Primary Risk Underwritten	Agricultural mortgage credit	Home mortgage default on loans with LTV ratio greater than 80%	General obligation bonds of municipalities
Loss Position	Primary loss position	Secondary loss position	Primary loss position

Collateral	1st lien on agricultural real estate	None – 1st lien on property is held by lender, not PMI. To the extent that, upon foreclosure and sale, the value of the property does not make the lender "whole" PMI must compensate the holder of the mortgage insurance policy.	None – guarantee covers general obligation bonds of municipalities
Average Loan to Value	Approximately 55%	N/A – PMI is not making loans; therefore LTV is not specifically applicable for PMI in this comparison. However, the LTV on the loans that PMI insures are generally over 80%.	N/A – MBIA is not acting as a lender and does not have a collateralized position, therefore LTV is not applicable.
Funding Risk	By committing to purchase loans at specific interest rates from its network of sellers, Farmer Mac accepts funding or interest rate risk. To manage this risk, Farmer Mac hedges all loan purchase commitments.	PMI does not fund the mortgages it insures and therefore is not directly impacted by daily interest rate movements.	MBIA does not fund the bonds it insures and therefore is not directly impacted by daily interest rate movements.

The capital structures of MBIA and PMI reflect the varied nature of the obligations they guarantee and their distinct regulatory requirements. A comparison of the three companies' balance sheets highlights the dissimilarities between the entities' businesses and the unique accounting requirements promulgated for insurance companies under GAAP. One such difference is the capitalization of policy acquisition costs by insurance companies. Other differences include:

- Farmer Mac's recognition of the liability for its "Guarantee and commitment obligation";
- MBIA's recordation of the asset "Goodwill"; and
- PMI's recognition of the asset "Investments in unconsolidated subsidiaries."

Notwithstanding these and other differences, certain comparative information is shown below.

	Farmer Mac	The PMI Group, Inc.	MBIA, Inc.
	December 31, 2003		
		(in thousands)	
Total Assets	$4,299,650	$4,794,829	$30,268,000
Stockholders' Equity	$213,254	$2,784,029	$6,259,000
Guarantees and Commitments:			
Farmer Mac Loans Underlying AMBS and LTSPCs	$5,796,186		
Direct Primary Insurance in Force		$105,241,000	$835,800,000
Equity, as a Percent of Guarantees and Commitments	3.7%	2.7%	0.8%
Reserve for Losses	$22,053	$346,939	$559,510

Further analysis of the capital ratios above would require in-depth consideration of the nature of the insurance or guarantees provided by PMI and MBIA, which within each entity includes multiple, varied business lines and risk profiles. In particular, an analysis of reserves directed toward quantifying the ability of a business to absorb future losses would be fundamentally flawed because, under GAAP,[2] reserves are established to quantify losses that have already "occurred," not to cover future losses. The analysis of an entity's ability to absorb future losses that have not already "occurred" (i.e., are not covered by reserves) should be predicated upon the measurement of capital relative to that risk.

[2] Financial Accounting Standard No. 5.

3. In a May 28, 2002, NY Times article, Mr. Dailey is quoted as saying, "If there is a problem, Congress is going to hold me and the other appointees on the board responsible. We're not going to be able to stand up and say it was the management team or somebody else." You are absolutely correct. As you know, the board has been the subject of criticism, in fact, the NY Times article charged that there was "an inversion of good corporate governance: a board that serves management, rather than the other way around. . ." What steps have you and the current board taken to address these past criticisms of the Farmer Mac Board?

Farmer Mac disagrees with the corporate governance criticisms levied by the May 28, 2002 article in the New York Times, most of which were based on events that were claimed to have occurred more than six years before the publication of an article written by a reporter admittedly coached by short sellers of Farmer Mac common stock.[3]

Farmer Mac has been a Securities and Exchange Commission-reporting company since its charter was enacted in 1987, complies with all of the corporate governance standards adopted by Congress, the SEC and the New York Stock Exchange, and will continue to be in complete compliance with the various provisions of the Sarbanes-Oxley Act of 2002 as they become effective. Examples of Farmer Mac's high corporate governance standards include:

- Farmer Mac's Board and committee membership meet the independence requirements of the SEC rules and NYSE Listing Requirements.
- Farmer Mac's Board is composed entirely of outside directors; no member of management has ever served on the Board.
- The Chairman of the Farmer Mac Board is not, and never has been, the Chief Executive Officer of the Corporation; Farmer Mac's President serves in that latter capacity.
- The Board considers nominations for directors from Board members and stockholders without regard to whether or not any current directors are seeking renomination.
- Board training is conducted on a regular basis and is incorporated into Farmer Mac's annual Business Plan.
- All elected directors are evaluated annually through a process conducted by the Board's Corporate Governance Committee and a Board self-evaluation is conducted once per year.
- The President does not serve as secretary to the Corporate Governance or Compensation Committees of the Board.
- Farmer Mac's Board has adopted a Code of Business Conduct and Ethics, Corporate Governance Guidelines, and charters for its Audit, Corporate Governance and Compensation Committees, all in compliance with the Sarbanes-Oxley Act of 2002 and NYSE Listing Standards.
- Executive sessions without management present are conducted at each meeting of the Board and each Board Committee.

[3] *See* Henny Sender, "Gotham Partners' Heavy Research Raised Questions, and the Fund Made Sure Everybody Listened," *The Wall Street Journal*, April 11, 2003, page C1, a copy of which is included with this submission.

- The Chairman of the Compensation Committee of the Board directly engages Farmer Mac's compensation consultant for the review of management compensation.
- The Board has instructed the Corporate Secretary to ensure that Board and Committee minutes reflect appropriate disclosures with respect to conflicts of interest and to report any undisclosed conflicts to the Chairman of the Board.
- Farmer Mac reports all transactions, programs, and contractual arrangements involving Farmer Mac and institutions associated with its directors in a footnote to the Consolidated Financial Statements in its Form 10-K and Proxy Statement filed with the SEC.

Question from Mr. Smith:

Is Farmer Mac working to reduce prepayment penalties in their loan products? If so, what types of specific actions have been taken?

Farmer Mac has worked to develop products that provide the loan applicant with choices that don't have yield maintenance attached. In March 2004, Farmer Mac began offering long term fixed rate mortgages with no yield maintenance, i.e., the ability to prepay a loan in full at any time without penalty. For the past several years, Farmer Mac has offered partial open prepayment products; it expanded those offerings at more favorable rates during 2004.

It should be noted that loans with yield maintenance provisions had been an industry standard in agricultural and, indeed, commercial lending long before Farmer Mac came into existence. Yield maintenance provisions allow borrowers to benefit from lenders' "zero prepayment speed" assumptions that result in lower-cost funding of the loans, generally facilitating lower rates for borrowers relative to prevailing rates at the time the loans are made.

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Hedge Funds: Reward & Risk: Behind an Attack on Farmer Mac

Gotham Partners' Heavy Research Raised Questions, and the Fund Made Sure Everybody Listened

By Henny Sender

[Fourth in a Series]

ONE YEAR AGO, Gotham Partners Management Co. partner William Ackman began to make bearish bets on Federal Agricultural Mortgage Corp., an obscure government-sponsored agency whose mandate is to create a vibrant market for farm loans.

Mr. Ackman didn't stop there. He hired a publicist to press his case to financial journalists. He retained a Washington lobbyist to promote his views to relevant congressional oversight committees. He wrote a critical 48-page research report that he posted on his Web site and sent to media organizations and the Securities and Exchange Commission.

The comprehensive effort had one aim: to bring down the share price of the agency, better known as Farmer Mac.

There's nothing necessarily improper about that, of course. Yet Mr. Ackman's far-flung and public effort to make his Farmer Mac case demonstrates just how far some hedge funds go to buttress their trading positions. Moreover, Gotham's trumpeting of its research report showed a new zeal among hedge funds to press their views, a strategy more familiar among those who try to make stocks go up rather than down -- particularly Wall Street's now-discredited sell-side analysts.

Farmer Mac executives howled at the Gotham attacks. New York State Attorney General Eliot Spitzer is investigating the firm's Farmer Mac campaign in response to complaints from the company. But lost amid the rancor is an important question: Was Gotham's research correct?

Since Gotham, which had $500 million at its peak, began focusing on Farmer Mac in April 2002, that company twice has announced quarterly net-income results below expectations. The company's stock, which rose 88 cents to $23.47 in 4 p.m. New

York Stock Exchange composite trading yesterday, is down 44% since April 26, 2002, just before the campaign began in earnest, while the Standard & Poor's 500-stock index is off 20%.

While these developments may support the underlying premise of the bearish research, Gotham's most important conclusions don't hold up very well under scrutiny.

The main prediction -- that Farmer Mac would face a cash crunch that would cripple it -- hasn't happened and doesn't look likely anytime soon. A spokesman for Gotham says the firm stands by its research. Gotham Partners has no relationship with Gotham Capital LLC. Gotham Partners, faced with massive redemption requests from investors, is in the process of winding down its two principal funds.

The first salvo against Farmer Mac came the old-fashioned way: via the media. Money managers, including hedge funds, usually prefer to make their investments quietly. Subsequently, they sometimes try to publicize the ideas that led them to go long or short a certain stock in order to encourage other investors to follow in their footsteps. The best way to get the word out is to make their case to a journalist in hopes of persuading him or her to write about the issue. Sometimes a money manager will make the case on television. Or the idea will appear in a newspaper or magazine article. Hedge-fund managers frequently approach Wall Street Journal reporters with suggestions for articles.

In the Farmer Mac case, Gotham's Mr. Ackman approached the New York Times, according to a Gotham spokesman. On Friday, April 26, 2002, the newspaper had a small preview of the Sunday business section. It promised a corporate focus on Farmer Mac. That Friday, trading in Farmer Mac shares soared to the third-highest level ever, and the stock slumped as word circulated that the Times article wouldn't be kind. A Times spokeswoman declined to comment on the matter yesterday.

On Sunday, April 28, 2002, the Times published an article with the headline "Big City Paydays at Farmer Mac." The article focused on high executive compensation at the government-sponsored agency. More important for Gotham, the article reported that Farmer Mac had inadequate reserves in the face of rising problems in its portfolios, as well as a serious timing mismatch between its loan portfolio and its debt.

There isn't a reference to Gotham in the article. Mr. Ackman, however, spent "hours" walking a Times reporter through his investment case, the Gotham spokesman says. And Mr. Ackman did appear in a subsequent Times article about Farmer Mac.

Not content with the Times' coverage of the Farmer Mac case, Mr. Ackman on May 23 posted on the Gotham Web site what was the first of his three reports on Farmer Mac, repeating the Times' reporting. The report was meant to document Gotham's claim that Farmer Mac was "overvalued and in a precarious financial situation" as a result of inadequate reserves against bad loans, growing customer-loan delinquencies, misleading disclosure about the way it manages possible mismatch between its long-term loans and short-term borrowings, potential vulnerability to rising interest rates and excessive reliance on the short-term debt market, among other factors. The report also raised corporate-governance issues.

The last section of report asked: "small enough to fail?" The conclusion: Farmer Mac would unravel very rapidly.

But that hasn't happened. While Farmer Mac's results in recent quarters do show gradual deterioration, it doesn't reach the near-cataclysmic levels Gotham predicted.

Some fund managers say they weren't unduly rattled by Gotham's research. "I am not greatly concerned," says Mark Mulholland of Matthew 25 Fund, a small portfolio in Jenkintown, Pa. Farmer Mac has been a big position in recent months, and Mr. Mulholland recently added shares. "I am very pumped up about the long-term potential of Farmer Mac. Their losses are low and they are a monopoly." Jack Smiley, a portfolio manager with Eaton Vance Management in Boston, adds: "We paid attention to Gotham's report but we didn't take action. We felt it was not objective." Recently, the firm sold its holdings of Farmer Mac for reasons that were unrelated to the report, he adds.

While Gotham won't say if it made money on its short bet, here is an assessment of Gotham's main research points.

-- A FUNDING CRISIS? Gotham devoted a lot of space in its first report to a possible funding crisis, noting that Farmer Mac borrows money every week, or more recently every two weeks, to finance its operations. "A disruption in the market could lead to a potentially fatal liquidity crisis for the company," the report warned.

The report also suggested that investors are paid badly for holding Farmer Mac notes and do so partly because they are under the incorrect impression that Farmer Mac carries a triple-A rating as do its larger peers, Fannie Mae and Freddie Mac. In fact, Farmer Mac isn't rated. In a Farmer Mac conference call with analysts May 31, Mr. Ackman returned to this point. He noted that in the fledgling credit-derivatives market, where investors can buy and sell protection against bond defaults, the cost for $10 million of protection against a Farmer Mac default had soared to $200,000 from $37,000 in a matter of weeks, implying that the market regarded the unrated agency as noninvestment grade.

For a short period, Gotham's report appeared prescient. In its second-quarter filing Aug. 14, Farmer Mac warned the price it was paying to get "wary" investors to buy its debt had risen marginally. In retrospect, it is clear that the rise was temporary and no more extraordinary than it was for other companies at a time when investors were generally uncertain. Today, Farmer Mac has no trouble accessing the capital markets.

As for the steep rise in the price of the credit-default protection, as it turns out Gotham itself had purchased a massive amount of protection. Now, one of the matters that Mr. Spitzer is looking into is whether, by buying protection in the thin, lightly regulated market, Gotham had found a relatively inexpensive way to make it appear that Farmer Mac was under great financial pressure at a time when investors were already nervous, according to people familiar with the matter. A Gotham spokesman says the firm's investments in the credit-default protection and certain other positions would allow it to "profit only if its analysis was proven correct. It has been."

-- MOUNTING DELINQUENCIES? As Gotham rightly pointed out, the absolute level of delinquencies is growing. At the end of last year, Farmer Mac reported account delinquencies of $74 million on a $4.8 billion book of business, a 27% increase from the $60 million of delinquencies registered the year before.

At the same time, because the total book of loans by Farmer Mac and guarantees it had made on other farm lenders' loans swelled 37%, the percentage of loans on which borrowers delayed making payments dropped to 1.54% from 1.7%.

Gotham said that, in addition to rapid growth of the loan and guarantee book, Farmer Mac's performance looked deceptively healthy because Farmer Mac buys old loans from other banks and puts them in its portfolio to dilute the percentage of problem loans from earlier years.

But some other fund managers see it differently. "As long as the trend is for delinquencies to get smaller as a percentage, I am not worried," says John Behre, a senior analyst for Trusco Capital Management Inc. in Atlanta, whose STI Classic Small Cap Fund is a large holder of Farmer Mac.

-- INADEQUATE RESERVES? Mr. Ackman's report contended that, if Farmer Mac's reserves for losses on the loan book were adjusted to more appropriate levels, most of the company's book value, or asset minus liabilities, would be wiped out and the company would be out of compliance with the rules on regulatory capital, "making it subject to receivership and/or bankruptcy."

Gotham also maintained that Farmer Mac's reserves are less than those of comparable farm lenders. That may be true. For example, At Midstates Bank, in Missouri Valley, Iowa, reserves recently have been raised from 1.25% of the loan book to 1.5%, according to Michael Kenealy, its chief. That's more than three times the level at Farmer Mac.

Henry Edelman, Farmer Mac's chief executive, says that other institutions have more concentrated risk portfolios and therefore Farmer Mac is justified in carrying lower reserves.

Also, while Farmer Mac's reserving policy may be aggressive, it isn't evident that establishing bigger reserves would produce a bankruptcy-court filing anytime soon, some Wall Street analysts note.

-- RISING CHARGE-OFFS? Gotham predicted in its first report that Farmer Mac's charge-offs inevitably would rise. In the conference call following the release of first-quarter earnings in 2002, Mr. Edelman said quarterly charge-offs amounted to some $850,000 and he expected they would remain at that level in coming quarters. But by the third quarter, net charge-offs were up nearly 50%, to $1.2 million. In the fourth quarter, charge-offs amounted to $1.3 million.

Technically, Gotham was correct: Charge-offs rose. But the increase doesn't demonstrate the sort of financial stress the report predicted.

---- INDEX REFERENCES ----

COMPANY (TICKER): Federal Agricultural Mortgage Corp. (CL C); Federal Agricultural Mortgage Corp. (CL A) (AGM AGMA)

NEWS SUBJECT: Mutual Funds; Fund Markets; Newspapers' Section Fronts; Hedge Fund News; Securities Regulations; Regulation/Government Policy; Special Reports; Stock News; Wall Street Journal; English language content; Personal Finance; Corporate/Industrial News; Commodity/Financial Market News; Political/General News (FND M16 FRT HGF RGU C13 RPT STK WSJ ENGL GPERSF CCAT MCAT GCAT)

MARKET SECTOR: Financial; Newswire End Code (FIN NND)

INDUSTRY: Diversified Financial Services; Securities (FIS SCR)

PRODUCT: Banking; Investment Services (DBK DIS)

REGION: District of Columbia; United States - District of Columbia; North America; United States; United States; Northeast U.S.; North American Countries (DC USDC NME US USA USE NAMZ)

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STATEMENT OF WILLIAM (BILL) R. CLAYTON

AgFirst Farm Credit Bank (AgFirst) provides service to over 85,000 borrowers through twenty-three local cooperative associations whose members include full-time and part-time farmers as well as rural homeowners in fifteen states and Puerto Rico. As one of five Farm Credit System Banks, AgFirst is located in Columbia, South Carolina.

AgFirst and its affiliated associations, each of which is locally owned and operated, serve a broad mission. This mission is to help maintain the quality of life in rural America and on the farm through a constant commitment to competitive lending, expert financial services and advice, and a feeling of partnership with our customers.

As one of the largest financial cooperatives in the country, our key goal is to reward our borrowing entities with value added through patronage dividends and other returns on capital invested. In fact, our institutions have distributed to our owner/users nearly $1.9 billion in the past 15 years.

In continuing to meet our mission goals, we likewise look to partner with other entities whose missions are compatible. The Federal Agricultural Mortgage Corporation (Farmer Mac) is one of the institutions with which we are proudly associated. Our partnership with Farmer Mac has provided AgFirst with certain statutory authorities which assists us in the delivery of value to our stockholders as well as providing the member associations a secondary market for certain agricultural and rural home loans.

The mission of Farmer Mac has evolved over its history as it has adapted itself to the changing needs of U.S. farmers and the financial institutions that serve them. This ability was enhanced when Congress passed the Farm Credit Reform Act of 1996 (the 1996 Act), which revised Farmer Mac's statutory authority resulting in an improved ability to fulfill its public policy mission to serve rural America.

From our perspective, as both a stockholder of Farmer Mac and a customer, we strongly believe it is fulfilling its mission, while likewise, helping us fulfill our own.

For example, Farm Credit System institutions, geographically constrained by regulation, build up natural credit concentrations in certain crop or livestock enterprises. Farmer Mac, by purchasing loans or guaranteeing credits, enables those FCS institutions to transfer credit risks on loans that meet its conservative underwriting standards to an external, nationwide pool, and so allows them to continue to expand their service to local farm borrowers without undue concentration concern. The additional benefit achieved is the supplement to capital brought to the retail lending institutions servicing their respective territories. The 20 percent risk weight of loans under Farmer Mac credit enhancement (Long Term Standby Purchase Commitments) allows a potential five-times increase in our associations' service to agricultural mortgage borrowers, with the risk transferred largely from our farmer-stockholders to the private sector investors who have capitalized Farmer Mac.

In this latter regard, we note that there has been some criticism of the so-called capital arbitrage created by Farmer Mac, referencing the lower capital requirements for loans covered by it guarantees and commitments compared to other loans. We believe it was part of the intent of Congress in creating and revising Farmer Mac's authorities that it should provide agricultural mortgage lenders the benefits of a GSE secondary market, particularly more efficient use of capital through safe leveraging. This is accomplished through the regulatory assignment of a lower capital requirement (risk weight) to mortgages supported by a Farmer Mac guarantee or commitment, and is particularly important for Farm Credit Institutions, whose access to equity is only through borrower stock purchases and retention of earnings. We think the prudent use of Farmer Mac as a secondary market GSE is consistent with the intent of Congress in the preamble to Farmer Mac's charter, seeking to create an entity that would provide greater. . . lending capacity in 12 U.S.C. §2279aa (note)(3)(B).

The resulting benefits for the farmers, ranchers and rural homeowners of this Nation have already been proven, not least by our own affiliated associations' having placed over $400 million under Farmer Mac's stand-by in portfolio guarantees, working through AgFirst, which services these loans on a centralized basis.

Our conclusion is that Farmer Mac is meeting its congressionally mandated mission. It is vital to our meeting and expanding our current and future stockholders' expectations for a competitive return on their investment in AgFirst.

Likewise, our view of Farmer Mac's risk management is that our equity investment is well protected. Farmer Mac's underwriting standards, appraisal guidelines, and other risk assessment and control factors involved in lending decisions are conservative and market tested. The company's comparatively low historical credit loss rate attests to this, as reported in Farmer Mac's 2003 annual report.

In its service to rural America, Farmer Mac plays a critical role in the financing of qualified rural residences. Through its programs, it purchases or guarantees loans on homes to rural homeowners or part-time farmers. In the U.S., over 55 million people live in communities of less than 2500 population or unincorporated areas. Many of these in the areas served are minorities, elderly, and/or young, small or beginning farmers whose family needs include adequate, affordable housing.

AgFirst and many associations and Farmer Mac, in tandem, serve this growing market. The local associations through their loan originations and Farmer Mac through its guarantees on single family home loans are fulfilling a growing need often not filled by traditional residential mortgage lenders. Interest rates on these long-term mortgage loans are competitive nationally through the pooling of credit risk and efficiencies created by the secondary mortgage market program. Rate benefits are passed through to the borrower giving them advantages not only of availability of credit but also access to conventional home mortgage rates as well.

Farmer Mac has supported territorial service objectives of Farm Credit System institutions in serving the part-time farmer needs with over $375 million in part-time farm loans. Of these, over $150 million in part-time farm loans are serviced by AgFirst.

Of the GSEs serving agriculture and rural America, Farmer Mac is unique in that its shares are publicly traded. Its governance and management policies and practices are open to public scrutiny. Its regulation by the Farm Credit Administration, should be progressive and market oriented, not burdensome, as the changing financial regulatory landscape is viewed today.

The House Committee on Agriculture has an important responsibility for oversight of GSE's serving agriculture and rural America. This is to assure a regulatory regime is in place to balance financial safety and soundness on one hand and the public policy mission fulfillment on the other.

Farmer Mac is important to AgFirst. AgFirst became a Farmer Mac lender/servicer in 1992 to take advantage of Title VIII lending authority. This authority afforded the bank the opportunity to establish a nationwide program to enhance residential financing in rural America. This authority gives us the ability to purchase qualified residential mortgage loans from any Farm Credit System association or Non-Farm Credit System mortgage lender. Non-Farm Credit System mortgage lenders include small rural community banks and traditional residential mortgage companies. We at AgFirst are servicing 11,750 loans which total $1.56 billion. Without Farmer Mac, this rural housing program would be significantly curtailed. AgFirst is proud to be known nationally as the rural housing expert. AgFirst and Farmer Mac are accomplishing the public policy mission mandated by Congress.

AgFirst is grateful to have an opportunity to express to the House Committee on Agriculture our views on the positive and continuing contributions of Farmer Mac to the people of rural America and to the Nation's food and fiber production.

Representing the member/stockholders of the AgFirst district within the Farm Credit System, we are grateful to Congress for the establishment of Farmer Mac and the significant revisions to its statutory authority via the 1996 Act. Farmer Mac is accomplishing its mission by providing liquidity, lending capacity and stable mortgage rates to the loan markets serving agriculture and rural America.

STATEMENT OF JOHN EVANS, JR.

Thank you Chairman Goodlatte and Ranking Member Stenholm for holding this hearing on Farmer Mac and for the opportunity to provide this statement for the record. I am John Evans, Jr., CEO of D.L. Evans Bank in Burley, ID and also the chairman of ICBA's Agriculture-Rural America Committee.

ICBA represents the largest constituency of community banks in the Nation and is dedicated exclusively to protecting the interests of the community banking industry. Seventy-five percent of ICBA's members are located in communities with a population of 20,000 or less and our members are heavily involved in financing agriculture and rural development across the country. Commercial banks continue to provide approximately 40 percent of the financing for farmers and ranchers, more than any other lender group.

We appreciate the Committee holding this hearing. As you know, Farmer Mac is a government- sponsored enterprise (GSE) within the Farm Credit System (FCS) with a mission to provide a secondary market for agricultural mortgages. Although the purpose of this oversight hearing is to review the recent General Accounting Office (GAO) report on Farmer Mac, we would also like to offer our suggestions for additional oversight activities by the Committee pertaining to GSE's.

As you know, the housing GSE's have been under considerable scrutiny by their Congressional Committees of jurisdiction and the Administration in recent months. We believe the larger agricultural GSE, the FCS, should not be exempt from close scrutiny. We are particularly concerned about the FCA's board structure and the FCA's predilection to facilitate the FCS's expansion agenda through regulatory changes. Therefore, we believe additional hearings would provide the opportunity to build upon the Committee's oversight function by focusing attention on the broader GSE, the FCS, in addition to just looking at Farmer Mac.

Furthermore, as the numbers show, the use of the Farmer Mac I program by commercial banks has decreased significantly over time. In light of this, we believe there is a need for further program enhancements that would improve the usefulness of Farmer Mac for community banks. The use of the Farmer Mac II program by banks continues to be significant.

We have several recommendations for improving the Farmer Mac I program that we believe would allow banks to more fully utilize this secondary market for agricultural real estate loans.

GREATER GSE OVERSIGHT

The Senate Banking, Housing, and Urban Affairs Committee has held seven hearings on GSE's in the 108th Congress and the House Financial Services Committee has held three such hearings this Congress. Given that Farmer Mac is part of the FCS, a GSE, and the Administration's recent concerns over the housing GSE's and its efforts to enact new legislation establishing a stronger regulator, we believe it would be appropriate for the Committee to hold a hearing focusing on the role the FCA plays as the regulator of the FCS, of which Farmer Mac is an independent entity.

Even though the FCS is regulated by the FCA, which is charged with regulating and examining all FCS institutions, it is important to point out that the FCA board has no mandated participation by members that are objectively and primarily concerned about protecting the general public's interests. It is possible, for example, for all three members of the FCA board to have previously been employed by the FCS and/or have direct ties to the FCS.

Here are some recent examples of the FCS expansionist agenda, which are described in more detail below.

- Allowance of illegal activities by institutions if using excess capacity in good faith.
- Scope and Eligibility proposal that would allow unlimited lending to anyone for non-agricultural purposes even if the borrower has only a tangential involvement in agriculture.
- Development of broad new lending programs under the guise of investment authorities.

Illegal Activities. The FCA allows FCS institutions to engage in illegal activities if it is proven that the institution is operating with so-called "excess capacity and good faith". This has the effect of encouraging more FCS institutions to seek the same exemptions for illegal activities and to build up excess capacity for this purpose. We believe such decisions have dubious legal underpinnings and should cause the Committee major concerns given the FCA's role as a regulator to prohibit any illegal activities by FCS institutions. The fact that a regulator would continuously allow illegal activities to take place under the guise of "excess capacity and good faith" certainly calls into question its objectivity and the level of independence the regulatory agency and its general counsel has regarding the industry it is mandated to regulate.

Scope and Eligibility

This proposal would allow the FCS to go far beyond its traditional GSE mission of serving bona fide farmers as required by statute and allow the System to make an unlimited amount of loans virtually unrelated to agriculture to borrowers that have little or no real involvement in farming. This proposal is currently pending within the FCA.

INVESTMENTS AS LOANS

The FCA board recently directed staff to prepare a proposed rule allowing FCS institutions to offer retail lending for business and consumer loans for items completely unrelated to agriculture. This Farmers Notes proposal would allow the FCA to take a minor statutory authority to regulate FCS investments and turn it into broad retail and consumer-lending programs. We believe this is an abuse of FCA's authorities and was never envisioned by Congress.

It is important to point out that such actions by the FCA have a direct bearing, not only on FCS institutions, but also on all lenders involved in the rural credit markets, including thousands of community banks across the country. According to the Federal Reserve, there were 2,600 agricultural banks as of June 30, 2002 and thousands of other banks lend in rural areas. Further expansion of what is supposed to be a limited purpose GSE to one that competes against the private sector by providing retail lending products and services to all rural residents will diminish the ability of community banks to serve agriculture and rural communities, resulting in fewer credit choices for rural residents.

To begin addressing some of these issues, we offer the following recommendations:

- Increase the FCA board from 3 members to 5 members, adding board members who are objective and required to be principally concerned with protecting the public interest. This would help diminish criticism of the FCA as an advocate for the FCS and allow it to be considered an arms-length, objective, world-class regulator, on par with the housing GSE regulator that the Senate Banking Committee and House Committee on Financial Services are working to establish.
- Prohibit the FCA from using the so-called excess capacity and good faith loophole and require the FCA to publish all instances of illegal activities by FCS institutions.
- Prohibit the FCS from using their so-called investment authority as a facade for expanded lending activities.
- Require the FCA to monitor and report on below-market, predatory pricing practices of FCS lenders.
- Reduce or eliminate FCA's exemptions under the Freedom of Information Act, as it appears the agency is creating a lack of transparency and accountability to the public, by using closed board meetings to consider important policy matters.

Banks Use of Farmer Mac I. Community banks were a strong advocate for the creation of a secondary market for agricultural real estate loans when Farmer Mac was chartered in 1987. However, the participation of banks in the Farmer Mac I program has decreased from 80 percent of program loans in 1996 to 22 percent in 2002, according to the 2003 GAO report on Farmer Mac. The FCS now accounts for about 55 percent of Farmer Mac I loans. For comparison, commercial banks held 34 percent of the nationwide agricultural real estate debt in 2003, while the FCS held 36 percent. As can be seen from these numbers, commercial banks have not been able to utilize the Farmer Mac I program on a level comparable with their agricultural real estate lending volume because the program has not been user friendly for community banks and small lenders.

To give a personal perspective, my bank was the 6th largest originator of Farmer Mac I loans in 1999 and this year we haven't originated a single loan with Farmer Mac. We have dropped from originating $11–12 million in loans four years ago to $0 this year in the Farmer Mac I program. This tells me there are some issues that need to be resolved so that community banks can resume the level of activity that once existed.

New Farmer Mac Products

In 1999, Farmer Mac introduced a long-term standby purchase commitment (LTSPC) product, which is a commitment by Farmer Mac to purchase eligible loans from financial institutions at a future date if the loan deteriorates or the holder chooses to sell the loan. This program allows lenders to transfer the credit risk of loans to Farmer Mac, while maintaining the loan in their portfolio. In exchange for this agreement, the lender must pay Farmer Mac an annual commitment fee based on the outstanding balance of the loans covered by the LTSPC. Commercial banks have not participated in the LTSPC program to date; only FCS institutions have been participants in the LTSPC, which now represents approximately 40 percent of Farmer Mac's loan and guarantee portfolio. As of year-end 2003, there were $2.3 billion of LTSPC with Farmer Mac.

We will be exploring the LTSPC program further with commercial bank lenders to ascertain whether Farmer Mac is marketing the program equally aggressively to banks as to FCS associations.

In a positive move, Farmer Mac is planning to eliminate some of the pre-payment penalties on their products, which should be a help for lenders who have not used Farmer Mac because of the potential costs of such penalties if borrowers decide to pay off the loan earlier than anticipated.

Recommendations for Farmer Mac

The GAO report on Farmer Mac in 2003, "Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance is Needed" out-lines a number of recommendations for Farmer Mac and its board to undertake as well as recommendations for the FCA and Congress. GAO urged the FCA to assess and report on the impact Farmer Mac activities have on the agricultural real estate lending market.

But, Farmer Mac also needs to focus on further developing and enhancing its offerings to the thousands of community banks in rural America. There may be some external issues that have contributed to the reduced level of participation by community banks in Farmer Mac programs. However, we believe there are significant internal issues that need to be addressed that would allow banks to better utilize the Farmer Mac I program. We would recommend the following:

- Offer more competitive interest rate options so Farmer Mac loans are competitive with the FCS.
- Ensure consistency in the application of underwriting standards across loans.
- Provide for electronic submission of loan packages and ensure an efficient approval process (days, not weeks or months as has been the case).
- Ensure all users of Farmer Mac, both large and small, are treated equally.
- Greater outreach and communications by Farmer Mac to community banks and promote products without bias to the types and size of lenders.
- Require Farmer Mac to engage in four to six well-publicized listening sessions with agricultural lenders in different regions of the U.S. to gather input and ideas on how to streamline and enhance their products.
- Consider eventually altering the makeup of the Farmer Mac board by reducing the board size. This would include reducing the number of seats allotted to the FCS representatives, since this is supposed to be an independent entity within FCS, and placing a cap on the total number at eleven members instead of the fifteen members now on the board.

FARMER MAC II

While commercial banks' use of the Farmer Mac I program has been on the decrease, the smaller Farmer Mac II program, which buys the guaranteed portion of USDA loans, continues to be used primarily by banks. In 2003, 650 lenders participated in the Farmer Mac II program, about 95 percent of which were commercial banks. The 2003 loan volume was approximately $270 million with a total loan portfolio of $1.5 billion.

In short, Farmer Mac was to provide a simple mechanism for lenders to securitize pools of long-term agricultural real estate loans at a low overhead cost, freeing up additional capital to lend to farmers. At this point, we believe Farmer Mac still has room for improvement if it is to reach the expectations that were envisioned when it was created. In particular, if Farmer Mac is to ever achieve the success once envisioned, it must offer a better array of competitively priced products tailored to the needs of community banks. It does not now offer products that allow community banks to compete with FCS lenders. This reality is inconsistent with lowering the cost of credit to farmers. Congress should ask "Why"? Why are the Farmer Mac interest rates uncompetitive with those of the FCS? And, why is its cost of funds in the AgVantage program uncompetitive with the other sources of funds?

Again, we thank the Committee for holding this hearing and for the opportunity to provide this input. We urge the Committee to hold additional hearings in the future on the impact of both agriculturally oriented GSE's. If the housing GSE's and their regulatory structure are going to receive intense scrutiny by Congress, the Agriculture Committees would be remiss to avoid similar scrutiny over the GSE's under their oversight particularly the Farm Credit System.

ICBA would welcome the opportunity to assist in the implementation of any recommendations that will improve Farmer Mac programs in a way that is beneficial to community banks.

STATEMENT OF NANCY C. PELLETT

Mr. Chairman, members of the committee, I am Nancy C. Pellett, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or agency). On behalf of my colleagues on the FCA Board, Doug Flory and Michael Reyna, I am pleased to be here this morning to discuss FCA's oversight of the Federal Agricultural Mortgage Corporation, often referred to as Farmer Mac. Farmer Mac is one of two government-sponsored enterprises (or GSEs), which the FCA regulates, examines, and supervises.

Farmer Mac and the Farm Credit banks and associations are devoted to providing credit and financial services to agriculture and rural America. Our mission at FCA, through these two GSEs, is to ensure that a safe, sound and dependable source of credit is readily available at all times for farmers, ranchers, farmer-owned cooperatives, rural homeowners, and rural America.

This morning I would like to share with you information about FCA and, specifically, its role in the oversight and supervision of Farmer Mac. I will provide you with a brief overview of the organizations, Farmer Mac's current financial condition and risk profile,and recent regulatory and oversight activity affecting Farmer Mac.

THE FARM CREDIT SYSTEM

To add perspective on our regulatory oversight of Farmer Mac, I would like to give you a very brief overview of our role overseeing the Farm Credit System banks and associations (FCS or System). The System has played a prominent role in financing American agriculture and rural America since Congress created the System's first part, the Federal Land Banks, in 1916. The System is the oldest financial GSE in America, and is the only GSE that engages in retail lending. The 108 institutions of the FCS serve all 50 states and the Commonwealth of Puerto Rico. As of December 31, 2003, the System consisted of four Farm Credit Banks and one agricultural credit bank, 97 association lenders, and six subsidiary service corporations. The FCS banks also provide credit to 29 non-System financing institutions, known as OFIs, which include commercial and community banks and their affiliates. At year-end 2003, FCS banks and associations provided services to nearly 450,000 borrowers and held assets of just under $117 billion.

FARMER MAC

Our focus today, however, is on FCA's oversight role of Farmer Mac. Farmer Mac is regulated by FCA through the Office of Secondary Market Oversight (OSMO), which was established in 1992 as required by the Farm Credit Act, as amended. OSMO provides for the examination and general supervision of Farmer Mac's safe and sound performance of its powers, functions, and duties prescribed by the statute. The statute requires that OSMO constitute a separate office within the agency, reporting to the FCA Board and that its activities, to the extent practicable, be carried out by individuals not responsible for the supervision of the banks and associations of the System.

Farmer Mac was created in response to the farm credit crisis of the mid–1980's and subsequent calls from commercial rural bankers for a liquidity source similar to that provided for residential mortgages by the so-called housing GSEs, Fannie Mae and Freddie Mac. Amendments in 1996 to Farmer Mac's authorizing legislation have allowed this GSE to grow its business and achieve economic viability, which was by no means certain in the first few years of its operation. To illustrate that point, the new authorities provided in the Farm Credit System Reform Act of 1996 (1996 Act), helped launch Farmer Mac's first year of positive earnings in that year, when net income was $777,000. Net income generally has risen as rapidly as program growth since then andreached $25 million at year-end 2003, representing a 5-year average annual growth rate of 35 percent while program growth averaged 37 percent over the same period.

Farmer Mac is a stockholder-owned, federally chartered GSE established by Congress to provide a secondary market for agricultural real estate and rural home mortgages. Farmer Mac operates through a network of agricultural lenders, originators, and sellers, among them commercial banks, FCS banks and associations, life insurance companies and mortgage companies. Farmer Mac conducts its business primarily through two core programs, known as Farmer Mac I and Farmer Mac II. Under Farmer Mac I, FarmerMac purchases, or commits to purchase, qualified loans, or obligations backed by qualified loans, that are not guaranteed by any instrumentality or agency of the United States. Under Farmer Mac II, Farmer Mac purchases the guaranteed portions of farm ownership and farm operating loans, rural business and community development loans, and certain other loans guaranteed by USDA.

Farmer Mac has three classes of common stock: class A Voting Common Stock which may only be held by banks, insurance companies, and other financial institutions that are not institutions of the FCS. By statute, no owner of class A stock may hold more than 33 percent of the outstanding shares of class A stock. At year-end 2003, one class A stockholder, Zions Bancorporation, held over 31 percent (2 percentage points under the statutory limit). There are just over one million shares of class A common stock outstanding.

2. Class B Voting Common Stock which may only be held by institutions of the FCS and are not exchange-traded. There are no restrictions on the maximum purchase or holdings of class B stock. Major class B common stockholders of the FCS

include: AgriBank, FCB, St. Paul, MN, (40 percent); U.S. AgBank, FCB, Wichita, KS, (20 percent), and AgFirst Farm Credit Bank, Columbia, SC, (17 percent). There are just over 500,000 class B shares issued and outstanding.

3. Class C Non-Voting Common Stock which has no ownership restrictions. The top holders of class C non-voting stock is Zions Bancorporation (14.6 percent) as of April 9, 2004, the record date for Farmer Mac's most recent notice of annual meeting. Together, all Farmer Mac directors and executive officers owned 26.9 percent of class C shares. Outstanding shares of class C common stock were just over 10.5 million at year-end.

Class A and class C common stock are traded on the New York Stock Exchange (NYSE) under the symbols "AGMa" for class A and "AGM" for class C shares.

The Farmer Mac Board of Directors (Board) is comprised of 15 members according to the statute. Five are elected by class A common stock shareholders. Five are elected by holders of class B common stock. The President of the United States appoints the remaining five, and one of these is appointed by the President as chairman. The Board has organized several standing committees and appoints other adhoc committees, which oversee Farmer Mac's management and operations.

The recent General Accounting Office (GAO) report noted the potential difficultyFarmer Mac could have complying with the independence requirements in NYSE listingstandards. Notably, in response to this, the Farmer Mac Board and, in particular, the Audit Committee have increased their activity in the areas of independent review and reporting processes in recent months.

Farmer Mac's daily operations are led by its President and Chief Executive Officer (CEO) and a core team of five vice-presidents made up of the Chief Financial Officer, General Counsel, Controller, Vice President of Agricultural Finance (primarily a marketing/business development position), and the recently created position of Vice-President of Mortgage Servicing. The Corporation employs 36 people and all but one are located at the Washington, D.C. headquarters.

FINANCIAL HIGHLIGHTS

For the year ended December 31, 2003, Farmer Mac's net worth increased 16 percent to $213 million, up from $183.5 million at year-end 2002. Capital available to meet minimum and regulatory requirements were well above levels prescribed by the statute and FCA regulations. The minimum core capital required by statute was $142 million. Core capital available to meet this requirement was $216 million. Risk-based regulatory capital required at year-end 2003 was $39 million. Regulatory capital available to meet this requirement was $238 million.

Operations and Program Portfolio. Net income for the year was $25 million, an 18 percent increase over 2002. However, core earnings were relatively flat.

Loan purchase and credit guarantee activity grew just under 5 percent to $5.8 billion from $5.5 billion at year-end 2002. Liquidity investments were $1.7 billion, up nearly 9 percent from a year earlier.

Farmer Mac's Long-term Standby Purchase Commitment (Standby) program has become a significant part of its operations. Standby's essentially are a guarantee of loans that are not purchased by Farmer Mac unless a specific event, such as a default of the loans, trigger such a response. Standby volume outstanding totaled $2.3 billion at the end of December 2003 and now represents over 40 percent of all (off- and on-balance sheet) Farmer Mac program activity.

PORTFOLIO RISK

Nonperforming asset volume at year-end 2003 amounted to 1.39 percent of post–1996 program volume outstanding, compared to 1.56 percent at December 31, 2002. These assets are measured against post–1996 activity because of the negligible risk in loans underlying assets acquired before the 1996 legislative changes. The downward trend in nonperforming loans and delinquencies appears to be continuing in 2004.

The allowance for losses, the first buffer to Farmer Mac's capital from loan losses, was $22.1 million at year-end 2003, compared to $20.0 million as of December 31,2002. Charge-offs on loans and real estate-owned during 2003 were $5.2 million, up from $4.1 million in 2002 and $2.2 million in 2001. In contrast, there were no charge-offs in 2000. Working with Farmer Mac and Farmer Mac's outside accounting firm, FCA monitors charge-off activity.

REGULATORY ACTIVITY

FCA examines and supervises Farmer Mac through authorities granted by Title VIII of the Farm Credit Act of 1971, as amended. As part of FCA's oversight program, the agency requires Farmer Mac to report quarterly on financial performance consistent with regulatory requirements that are similar to the quarterly Call Reports required by other Federal financial regulators. The agency promulgates regulations, examines all books and records, and ensures safe and sound operations of Farmer Mac through regulatory enforcement powers that are comparable with other Federal financial regulators, though somewhat broader in the area of receivership authority than that of our counterpart, the Office of Federal Housing Enterprise Oversight (OFHEO). FCA, in contrast to OFHEO, has clear statutory authority to establish receivership regulations for the institutions it regulates, including Farmer Mac. The FCA has had receivership regulations in place for Farmer Mac since 1997. The statute provides the FCA Board broad enforcement powers.These powers are comparable to other Federal financial regulators such as the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

Unlike Fannie Mae and Freddie Mac, by statute, Farmer Mac must register with the Securities and Exchange Commission (SEC) and as a publicly traded corporation, also must comply with NYSE listing standards and requirements. As a publicly traded entity and SEC registrant, regulatory reporting and disclosure requirements are significant matters demanding constant vigilance for compliance by Farmer Mac's compliance officer, executive management, and Board.

EXAMINATION AND SUPERVISION

The statute requires FCA to examine Farmer Mac's operations once each year. In practice, FCA monitors activities and requires reports from all institutions it regulates on an on-going basis, including Farmer Mac. We combine our offsite review and follow-up activities with onsite testing and verification procedures and produce an annual report of examination. OSMO and FCA examiners regularly meet with the Farmer Mac Board and executive management to discuss and resolve examination findings and recommendations and to ensure required regulatory reporting is accurate and appropriate.

Consistent with past practice and for safety and soundness reasons, FCA does not make public (1) institution-specific examination findings and recommendations, nor (2) enforcement actions taken against institutions it supervises. Therefore, I may not be able to fully address certain questions in open session that would pertain to examination findings or FCA's supervisory activities resulting from the examination. Ongoing monitoring and oversight activities resulting from examination findings and recommendations are conducted through OSMO and are independent and separate from the oversight activities affecting other institutions of the Farm Credit System.

The FCA has increased examination and oversight activities of Farmer Mac over the past 2 years. Numerous meetings and follow-up discussions have occurred with the Farmer Mac Board and management during 2003 as results from the 2002 examination were being addressed and as the 2003 examination was conducted. Examination scopes, both breadth and depth, were expanded significantly. Examiner resources applied to Farmer Mac's oversight more than tripled from FY 2001 to those used during FY 2003. Use of outside consultants to assist OSMO in the examination and oversight of Farmer Mac also increased, including securing an outside accounting firm to advise and assist FCA examiners as the 2003 examination was completed.

Throughout 2003, agency offsite monitoring and follow-up activities with Farmer Mac's Board and management increased significantly over prior years. FCA's increased examination and oversight activities respond specifically to the GAO report recommendations. Additional permanent budgeted resources also were increased for OSMO. In October 2002, a full-time Senior Policy Analyst was added to OSMO's staff, and an Associate Director for Examination and Supervision is planned for FY 2004.

The most recent examination was concluded in December 2003. The examination was comprehensive, risk-based, and focused on what is referred to by Federal financial regulators as a "CAMELS" assessment. A CAMELS assessment includes an in-depth analysis of the institution's Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risks. The 2003 examination also included an in-depth evaluation of Farmer Mac's information technology, internal controls, and accounting treatmentfor nonperforming loans and real estate owned. We presented the agency's 2003 Report of Examination to the Farmer Mac Board at its February 2004 meeting and OSMO actively continues to follow-up with the Board, the Board's Audit Committee,and executive management.

CHALLENGES FOR THE FUTURE

The GAO Report issued in October 2003 included five recommendations for enhanced oversight of Farmer Mac by FCA. In addition to activities that were already underway while the GAO was conducting their study, the agency has taken action on several fronts in response to the GAO report, among which are the following:

Non-Program Investment and Liquidity Proposed Rule. This proposed rule was approved by the FCA Board on April 22, 2004. Publication in the Federal Register is expected in June with a comment period of 90 days. The proposed rule would set limits, both minimum and maximum, on the amount and type of non-program liquidity investments that Farmer Mac would be permitted to hold. While GAO had no specific recommendations for FCA regarding Farmer Mac's liquidity, we believe the proposed rule will help address the issues raised in the report with regard to liquidity planning and mission focus by Farmer Mac.

2. Revised Risk-Based Capital Standards. We have a workgroup actively engaged in the development of a second proposed rule, which we expect will revise numerous aspects of the Risk-based Capital (RBC) Stress Test. The RBC stress test is required by statute and is used to calculate the amount of minimum regulatory capital required by Farmer Mac. By this fall, we expect the workgroup to provide recommendations to the FCA Board regarding any additional regulatory requirements for Farmer Mac to consider in the application of the RBC test and capital adequacy planning. I would also note that we are giving full consideration to the recommendations by GAO for the RBC stress test.

3. Offsite Monitoring and Reporting Requirements Initial revisions to the Farmer Mac quarterly call reports (Call Reports) were implemented in March 2004,including conversion from hardcopy to electronic submission format, as well as numerous adjustments to Call Report schedules, some of which were specifically recommended by GAO in their comments regarding offsite monitoring of Farmer Mac. We are also evaluating the need for additional revisions or expansion of schedules, which will be implemented in 2005. Other reporting requirements have been implemented also. For example, OSMO recently required a detailed position-level report on Farmer Mac's debt issuances, derivatives, and liquidity investments that are received on a more frequent schedule than the quarterly Call Reports. We believe these enhanced reporting requirements are necessary for the on-going oversight of Farmer Mac's operations and go beyond the recommendations provided by the GAO report.

4. Credit Rating Requirement for Farmer Mac. FCA has initiated work and committed resources for an analysis and evaluation of different approachesused by other GSE regulators that require their regulated entities to obtain credit ratings. We have asked staff to present options and recommendations to the FCA Board regarding GAO's recommendation on this matter. We have alsorequested staff to consider other activities currently underway at the agencyand at Farmer Mac that may affect the need for the agency to promulgate formalrules in this area.

5. Assessment of Farmer Mac's Impact on the Real Estate Market. The GAO report recommended we conduct an assessment of Farmer Mac's impact on the agricultural real estate market. The GAO report also suggested Congress clarify the statute with regard to Farmer Mac's mission. Staff has begun planning for this recommendation and will consider different approaches for conducting this assessment. Meanwhile, OSMO is developing a special "Mission Call Report"to help track Farmer Mac's success in achieving its mission as currently defined in statute.

I would like to note that FCA supports the suggestions to Congress made in the GAO report. In particular, we support greater flexibility for the regulator to design and set minimum and regulatory capital standards in addition to those established by the Risk-Based Capital Stress Test. This would be consistent with authority granted to other financial institution regulators and our own authority to regulate capital needed by the Farm Credit System banks and associations.

Farmer Mac has made progress since the 1996 legislative changes. Capital has increased to $213 million at year-end 2003 from $47 million at year-end 1996. Program growth has been robust impacting Farmer Mac's risk profile and challenging management, operational systems, and internal controls. Both Farmer Mac and FCA are actively working to ensure these challenges are met.

In conclusion, Mr. Chairman, let me say that we are committed to Farmer Mac's success and the achievement of its statutory purpose as a Congressionally-chartered GSE serving agriculture and rural America. It must be safe and sound at all times to do so. FCA continues to enhance its regulatory oversight of Farmer Mac, and I believe we are well positioned to address any challenges to ensure Farmer Mac has the capability to remain successful in the future. We remain committed to that goal and the achievement of our mission, "to ensure a safe, sound and dependable source of credit for agriculture and rural America."

Thank you for the opportunity to be here today and for your continued support of FCA and our mission of service to agriculture and rural America. I will be pleased at this time to answer any questions.

RESPONSE TO SUPPLEMENTAL QUESTIONS PERTAINING TO FARMER MAC HEARING OF JUNE 2, 2004

Questions from Mr. Stenholm:

1. The statutory capital ratio for Farmer Mac's off-balance sheet activities, such as the more than $3 billion in long-term loan standby purchase commitments, is 75 basis points, three-quarters of one percent. This ratio is similar to those of other GSEs that purchase housing loans.

   I must ask if the risk profile facing Farmer Mac is sufficiently similar to the risk profile in housing loans. Geographic diversification mitigates risk in home mortgages. Housing prices in one part of the country do not necessarily affect housing prices in another part.

   Loans related to agriculture are somewhat different, however, because farm values and the incomes that determine the repayment ability are linked nationally by commodity markets. Homes in Spokane, Washington, and homes in Topeka, Kansas, may have little relationship in their values to one another, but wheat farms in eastern Washington and eastern Kansas have quite a strong relationship.

   What assurances can you provide that Farmer Mac is adequately capitalized, especially in its standby loan agreements, given this difference?

Response:

FCA's conclusion on capital adequacy is a central element of our examination on any institution we regulate. As a matter of practice, we do not comment publicly on examination findings. Should the Committee desire further information on Farmer Mac's condition, we will provide the information in an appropriate forum.

The risk of housing loans vis-à-vis farm loans is different as you imply. This is an issue of discussion between FCA and Farmer Mac. While geographic diversity is important for agricultural mortgages, diversification of the income stream stemming from various commodity and farm programs is just as important for Farmer Mac. Accordingly, we believe providing the regulator increased flexibility to set appropriate capital levels for the unique risk associated with agricultural mortgages would help address your concern.

With regard to the 75 basis point statutory minimum capital requirement that you referenced, we would note the following. Farmer Mac faces two principal types of risk in its loan portfolio, credit risk and interest rate risk. Since Farmer Mac faces only credit risk on its off-balance sheet loan portfolio, this implies the statute's 75 basis point requirement is intended to cover credit risk. Farmer Mac faces both credit and interest rate risk on its retained loan portfolio for which the statute requires it to hold 275 basis points in capital. The implication is that 200 basis points of capital are required to cover the interest rate risk on loans held on-balance sheet. We believe that opportunities exist to improve the balance of on- and off-balance sheet minimum capital requirements in the statute. This is one of the reasons FCA supports GAO's suggestion to Congress to consider providing increased flexibility for FCA to set minimum capital standards. We would be pleased to work with the Committee should it decide to reconsider the balance between these two statutory minimum requirements.

2. The capital ratios are compared to other GSEs that engage in buying mortgages, securitizing them and selling those securities to investors in a secondary market. Yet, a significant part of Farmer Mac's business appears to be insuring the credit risk of these loans for which it provides a standby purchase commitment.

How would Farmer Mac's balance sheet and reserves compare to private firms that insure loans, such as mortgage insurer PMI inc., or municipal bond insurer MBIA?

Response:

Such comparisons are difficult because PMI and MBIA underwrite diverse lines of business and emphasize the residential mortgage insurance markets rather than agricultural mortgage markets. Risks posed by agricultural mortgages are substantially different than housing loans. Also, the current capital required under the international Basel Capital Accord for housing loans is 50 percent of that required for farm loans.

Below, we have reproduced the table from page 13 of FCA's December 2003 Semiannual Report to Congress. While neither Fannie Mae nor the Farm Credit System provide a perfect "apples-to-apples" comparison with Farmer Mac, we believe the table is a useful tool to gain perspective on such comparisons.

Table 2

Farmer Mac Capital Leverage Ratio Trend and Comparisons

($000,000 except percentages)

	Farmer Mac			December 31, 2003	
	31-Dec-01	**31-Dec-02**	**31-Dec-03**	**Fannie Mae**	**Farm Credit System**
Capital (GAAP Equity)	134.4	183.6	213.3	22,373	18,923
On-Balance Sheet Assets	3,417	4,223	4,300	1,009,569	116,894
On- & Off-Balance Sheet Program Assets and Obligations	4,187	5,528	5,796	2,198,604	116,894
Capital/On-balance Sheet Assets Ratio	3.9%	4.3%	5.0%	2.2%	16.2%
Capital/Program Assets and Obligations Ratio	3.2%	3.3%	3.7%	1.0%	16.2%

Source for Fannie Mae: Quarterly Press Release and SEC Form 10-K.
Source for Farm Credit System: Quarterly Press Release, note that FCS Capital includes $1.9 billion in Farm Credit Insurance Fund.

The table illustrates that Farmer Mac's capital as a percent of program assets and obligations is more than three times that of Fannie Mae (an extremely large GSE, which focuses exclusively on housing loans). Farmer Mac also is much smaller than the other single-sector agricultural GSE, the Farm Credit System. Users of this table should bear in mind certain factors that make the comparisons imperfect such as the cooperative structure of the Farm Credit System versus Farmer Mac's public ownership. Additionally, Farmer Mac's portfolio is made up exclusively of long-term first mortgage loans, usually underwritten with conservative loan to value ratios, while the Farm Credit System contains a much broader base of commercial and short- and intermediate-term loans.

3. Risk control and management is the underlying concern of the GAO testimony. Farmer Mac argues that GAO's hypothetical situation for concern is "too implausible," but notes that "additional funding required would not be inconsistent with Farmer Mac's demonstrated level of access to the capital markets."

   Yet, Farmer Mac testimony also qualifies its forward looking statements for future financial results. Among the factors that could affect these results are "substantial changes in interest rates, agricultural land values, commodity prices and export demand for US agricultural products" and "effects on the agricultural economy or the value of agricultural real estate of any changes in federal assistance for agriculture."

   These are the very uncertainties that raise concern. It appears that the US economy, while recovering, is off the bottom of an interest rate cycle with future increases ahead as economic activity continues to pick up.

Even more important, the prospect for reduction in US assistance to agriculture is very real. Many of us think Congressional efforts to reduce the federal deficit, with attendant reductions in agriculture programs, is likely in the near future.

In addition, the Administration is pursuing wide-ranging reductions in farm programs in the Doha Round of the WTO. This could result in a 40 to 50% reduction in domestic commodity income and price support programs as well as opening US markets to non-supported commodities. Opening markets in other countries and reduced export and internal subsidies is expected to improve commodity prices, but it will expose the US farm economy to more variability.

A. How will Farmer Mac manage these risks in the future? What changes might be necessary?

   Response:

   Farmer Mac must manage these risks both strategically and on a daily basis. GAO findings and recommendations concerning risk management systems are consistent with FCA's views on improvements that must be made. Assessing risk management systems and capital sufficiency to absorb risks are routinely covered in FCA examinations. We will provide the Committee additional appropriate and private briefings on our most recent examination and our ongoing follow-up activities with the Farmer Mac Board and management as requested.

B. A less hypothetical question to ask is how would Farmer Mac have managed its risk during the 1998 and 2001 period had not Congress supplied $26 billion in emergence assistance to farmers and ranchers?

   Response:

   A significant drop in farm income and government payments would have placed considerable stress on institutions holding large volumes of farm loans, including Farmer Mac. The statutorily required Risk-based Capital Stress Test (RBC model) estimates the level of capital Farmer Mac would need to maintain non-negative capital levels in an historical worst-case scenario. While Farmer Mac currently has capital well in excess of that calculated amount, FCA believes certain statutory provisions on the design of the RBC model could constrain the model's ability to predict the appropriate minimum capital level needed by Farmer Mac. FCA would be pleased to work with Committee staff to explore opportunities to enhance the RBC model through changes in its authorizing legislation.

1. In FCA's recent audit, what is your overall view of Farmer Mac's current situation? What is the current status of Farmer Mac and its safety and soundness?

   Response:

   FCA does not comment on specifics arising from our examination and supervision of the institutions we regulate. However, we agree with GAO that progress has been made, though rapid growth has affected Farmer Mac's risk profile and pressured its management systems. Farmer Mac's capital structure creates a highly leveraged financial institution. This puts pressure on Farmer Mac to maintain high quality risk management systems and internal controls.

   We agree with GAO's assessment that risk management systems need improvement. However, we see no immediate threat to Farmer Mac's financial condition, its viability, or its access to the GSE debt markets. We are working closely with the Farmer Mac Board and management to ensure risk management systems and internal controls are appropriate for its changing risk profile.

   For more specifics on Farmer Mac's situation, we would be pleased to provide the Committee additional private briefings at your request.

2. Does FCA have sufficient authority to regulate Farmer Mac?

   Response:

   We believe FCA has sufficient authority to regulate Farmer Mac's safety and soundness. However, opportunities exist to improve our authority, particularly in the areas related to minimum capital standards and the clarity of Farmer Mac's mission. FCA would welcome the opportunity to assist the Committee in considering any legislative changes.

3. Have your auditors/examiners found Farmer Mac's Board and Executive Management helpful during examinations?

   Response:

   We have experienced an improved, constructive relationship with Farmer Mac officials. Board governance and oversight of management have been strengthened. FCA's Office of Secondary Market Oversight (OSMO) works closely with the Board to ensure appropriate follow-up actions occur in response to our examination activities. The Farmer Mac Board's response to examination findings has been constructive, respectful, and positive results are being achieved. While more work remains to be done, we are actively engaged with the Board and executive management to ensure agreed upon efforts are completed and positive results achieved. We would be pleased to provide follow-up briefings for you and the Committee's staff in this area.

4. It is my understanding that FCA's examination instructed Farmer Mac to make a number of corrective actions. Is Farmer Mac complying with those corrective actions?

   Response:

   As stated previously, FCA does not comment publicly on examination findings, but we will provide the Committee such information in an appropriate forum at their request.

5. GAO's recent report raised concern about potential regulatory conflict of interest due to FCA's role as regulator of Farmer Mac and Farm Credit System institutions. Do you believe a conflict of interest exists and, if so, what is being done to strike the proper balance in your oversight responsibilities?

   Response:

   While we recognize that there could be a potential conflict, we note that GAO has not found any actual evidence that indicates FCA has acted inappropriately.

   GAO also noted there are offsetting benefits inherent in the current regulatory oversight arrangement. These include FCA's ability to leverage expertise in the examination and supervision of agricultural lenders in the oversight of Farmer Mac. We carefully preserve the independence of the Office of Secondary Market Oversight and feel confident the arrangement is creating synergies that enhance our ability to oversee both GSEs.

6. GAO's report recommends Congress consider allowing "FCA more flexibility in establishing minimum capital standards that are commensurate with Farmer Mac's changing risk profile and in setting minimum capital requirements." Currently, these capital standards are set in statute. What is your opinion of GAO's recommendation?

   Response:

   FCA strongly supports this recommendation and is ready to work with the Committee to explore potential opportunities to enhance our authorities. We also support GAO's suggestion that Congress clarify Farmer Mac's mission goals.

Questions from Mr. Jenkins:

1. A *New York Times* article written by Alison Leigh Cowan, dated June 20, 2002, illustrated a point of some concern for me. The article detailed a confidential internal memo within the Farm Credit Administration (FCA) that urged an "acceleration of a scheduled examination of Farmer Mac," as well as requiring a

list of 33 questions about Farmer Mac's business practices be answered. My concern is that a journalist obtained a copy of this confidential internal memo. I would like to know whether the then-Chairman or other Board Members initiated an internal investigation, how the decision was made, and if there was an investigation, what was the outcome.

Response:

That the *New York Times* apparently had access to the May 28 document was extremely troubling to FCA. As a Federal financial regulatory agency, FCA is always mindful of its policy to maintain the confidentiality of all information relative to Farm Credit System institutions or FCA that is not normally of a public nature. The then FCA Board Chairman and the Director of the Office of Secondary Market Oversight, during the period in question, held discussions with those who had access to the document. No one was able to account for how the *New York Times* came into possession of the May 28 document. The only other Board member during the period is no longer a member of the FCA Board.

The then Chairman and Chief Executive Officer approached the Office of the Inspector General (OIG), regarding the feasibility of a formal investigation into the matter. The OIG commenced a preliminary investigation which included an examination of outgoing telephone and FAX transmissions from the agency to the *New York Times*. There were no transmissions that were not fully documented, explained, or justified. Lacking any factual evidence linking agency personnel to the disclosure, the OIG informed the Chairman that there was insufficient evidence to proceed with a formal inquiry.

The internal memorandum in question was dated May 28, 2002 from the then Chairman asking the Director of the Office of Secondary Market Oversight, to evaluate numerous allegations raised by external publications beginning with the April 28, 2002 *New York Times* article regarding the condition and practices of Farmer Mac. While our prior annual examinations had evaluated the areas in question, as the safety and soundness regulatory agency we consider all sources of information and perspectives involving risks. Therefore, we felt it necessary to follow up on the allegations contained in the article.

The inappropriate disclosure of the internal FCA document to the *New York Times* resulted in heightened attention to the control of all information within FCA particularly that related to Farmer Mac. The Office of Secondary Market Oversight, in particular, ensured that all confidential documents related to Farmer Mac were secured when not in use and that the internal distribution of information related to Farmer Mac was limited to those on a need-to-know basis.

Additionally, on June 26, 2002, the then Chairman reminded all FCA employees via an email of the confidentiality of internal agency documents and the fact that FCA employees may not disclose them outside the agency. Employees were further reminded of the potential for administrative discipline, including dismissal, for the unauthorized disclosure of confidential information.

Subsequent to these steps, there have been no unauthorized disclosures of information related to Farmer Mac.

As the current Chairman and Chief Executive Officer of FCA, I can assure you that the agency remains keenly aware of its responsibilities to safeguard all information related to the agency and institutions of the Farm Credit System that are proprietary, confidential, or otherwise not for public release.

2. As you know, a hedge fund, Gotham Partners Management Co., LLC, and one of its principals, William A. Ackman, alleged during 2002 that Farmer Mac's operations were risky, and it was undercapitalized. These allegations appeared at the same time as Gotham Partners and Ackman acknowledged they were shorting Farmer Mac stock and were reported in a series of stories that appeared in *The New York Times*. Because the Farm Credit Administration is the safety and soundness regulator of Farmer Mac, I assume the FCA Board and staff would have been aware of these allegations and stories during the time they appeared in 2002.

Did any FCA Board Member or staff have contact, directly or indirectly, with any of the following persons or organizations during 2001 or 2002?

Alison Leigh Cowan	--	*The New York Times*
Guy Spier	--	Aquamarine LLC
Whitney R. Tilson	--	Tilson Capital
William Ackman	--	Gotham Partners
David Berkowitz	--	Gotham Partners
David Cowan	--	Bessemer Venture Partners
Richard Shapiro	--	Brunswick Group
Thomas Quinn		-- Venable LLP
Aaron Marcu		
Greenlight Capital		

Response:

Other than contacts received or initiated by FCA's Office of Congressional and Public Affairs, within the normal course and scope of their duties and responsibilities, we have not been able to identify any contacts by members of the FCA Board or FCA staff, occupying positions having access to Farmer Mac examination information, with any of the parties specified above with respect to Farmer Mac during 2001.

Publicity surrounding Farmer Mac began with the first article on Farmer Mac by the *New York Times* on April 28, 2002. This was followed by other articles in the *New York Times* and other publications, including those by Gotham Partners. As a result of this public interest, we have identified the following contacts in 2002 by members of the FCA Board and/or FCA staff with the above specified parties as follows:

June 18, 2002 – In response to multiple requests for interviews and statements, at the direction of the FCA Board Chairman, the then Office of Secondary Market Oversight Director, the head of the Office of Congressional and Public Affairs, an Associate General Counsel, and a staff member of the Office of Congressional and Public Affairs, participated in a telephone conference call with Alison Leigh Cowan of the *New York Times* to respond as appropriate to her questions regarding Farmer Mac. The call lasted approximately 1.5 hours. This conference call resulted in another article in the *New York Times* dated June 20, 2002.

Other than as referenced above, no other material and substantive contacts by FCA Board Members or FCA staff has occurred with the above parties during 2002.

As a matter of procedure, all contact with outside parties regarding institutions of the Farm Credit System or FCA were at the time handled by the Office of Congressional and Public Affairs and continue to be handled by offices within the agency designated to coordinate and communicate with Congress, the media, or the public.

Statement of Greg Zerzan

Thank you Chairman Goodlatte, Ranking Member Stenholm and members of the Committee for this opportunity to testify today on the Federal Agricultural Mortgage Corporation (commonly know as Farmer Mac). Our Nation's interest in maintaining strong agricultural credit markets that serve the needs of farmers and ranchers remains strong. The Federal Government has established a number of programs or entities that seek to supplement the private sector's efforts in meeting the credit needs of Rural America. Farmer Mac is one such entity, a government sponsored enterprise (GSE) established by Congress in 1987 to address perceived inefficiencies in the allocation of mortgage credit to agricultural real estate. Publicly traded GSEs such as Farmer Mac are not backed by the full faith and credit of the United States, nor do they receive funding from the United States. However, such GSEs do enjoy a limited set of benefits not generally available to other financial institutions.

Farmer Mac was created in the aftermath of the farm financial crisis of the mid–1980's, which many observers linked to the predominance of variable rate mortgages. Farmer Mac was envisioned to operate along the lines of the successful secondary markets for residential mortgages and improve the opportunities for farmers and ranchers to obtain long-term fixed rate mortgages. The idea was that farm real estate mortgages would be originated by participating lenders, pooled by third party financial institutions, guaranteed by Farmer Mac, and sold to investors in the form of securities. Originators would use the proceeds from the sale of loans to make new loans, enhancing the competitiveness of agricultural real estate mortgage markets, and expanding the supply of long-term credit available for farmers and ranchers.

The initial structure of Farmer Mac, however, proved unsuccessful and by 1995 Farmer Mac had low business volume, its capital was depleted, and the anticipated secondary market in agricultural real estate mortgages had not developed. Congress decided to act the following year to significantly alter Farmer Mac's structure with the Farm Credit System Reform Act of 1996 (the 1996 Act). The 1996 Act permitted Farmer Mac to directly act as pooler of agricultural real estate mortgages and it eliminated the requirement that loan originators and poolers retain a 10 percent subordinated participation interest in each securitized loan pool.

Since 1996, Farmer Mac's business operations have improved. Total assets have increased from $512 million at the end of 1995 to $4.3 billion at the end of 2003. Farmer Mac had its first profitable year in 1996, and Farmer Mac's net income totaled $27 million in 2003.

Despite Farmer Mac's improving financial results, as the General Accounting Office (GAO) noted in its November 2003 report, Farmer Mac poses a number of questions for policy makers to consider. In particular, today I would like to focus on three such issues: Farmer Mac's mission achievement; regulatory issues associated with Farmer Mac, including the perception of the Treasury Department's oversight role; and the Treasury Department's perspective on Farmer Mac's line of credit.

Farmer Mac's Mission Achievement

To evaluate the mission of a GSE like Farmer Mac, it is important to understand the reason why Congress created such an entity and what powers Congress provided the entity to accomplish its purpose. Unlike some of the other GSEs, Farmer Mac's enabling legislation does not contain an explicit, prescriptive mission; instead, its broad mission statement refers to Farmer Mac providing a secondary marketing arrangement for agricultural real estate mortgages that would generally improve the credit availability to farmers and ranchers.

One useful way to evaluate Farmer Mac's broad statutory purpose is to consider whether Farmer Mac has contributed to the development of an active secondary market in agricultural real estate mortgages, much like the secondary market that exists for residential housing mortgages. The secondary market for residential housing mortgages is characterized by a wide array of investors who on any given day are buyers and sellers of mortgage-backed securities. GSEs such as Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System have roles in this market, as does a wholly-owned government corporation, Ginnie Mae; but other institutions, such as commercial banks, thrifts, credit unions, mutual funds, insurance companies, and pension funds also have significant investments in mortgage-backed securities.

Similarly liquid markets for agricultural mortgage backed securities (AMBS) do not yet exist. Farmer Mac operates two main AMBS programs. Under the Farmer Mac I program, Farmer Mac purchases agricultural mortgages that meet Farmer Mac's underwriting, appraisal, and documentation standards. Then Farmer Mac issues and guarantees the timely payment of principal and interest on AMBS backed by such mortgages. Under the Farmer Mac II program, Farmer Mac purchases the guaranteed portions of loans guaranteed by the United States Department of Agriculture and guarantees the AMBS backed by those USDA-guaranteed portions. Farmer Mac may retain its guaranteed securities in its portfolio or sell them to third parties.

The amount of AMBS held by outside investors fell dramatically between 1998 and 2002 from about $600 million to about $367 million. As a portion of total AMBS outstanding, the amount of AMBS held by outside investors declined from 52 percent in 1998 to 19 percent in 2002. As noted by GAO, because Farmer Mac holds so much of its own guaranteed securities as investments, no active secondary market has developed. In 2003, the amount of AMBS held by outside investors did increase to about $1 billion, or 40 percent of all Farmer Mac AMBS outstanding; however, this increase was due to a loan participation swap that Farmer Mac entered into with a Farm Credit System institution in 2003. Under this loan participation swap, Farmer Mac replaces loans guaranteed under its Long Term Standby Purchase Commitment (LTSPC) program with an AMBS. Thus, while the participation swap transaction increased AMBS held by outside investors, it did not increase the outstanding credit guarantees of Farmer Mac. Even with this substantial increase in AMBS outstanding, Farmer Mac continues to hold more than twice as many loans and AMBS in portfolio as it sells to investors. Absent a more aggressive effort by Farmer Mac to sell its AMBS to outside investors, it is difficult to perceive of an active secondary market for AMBS developing.

Another way to consider Farmer Mac's mission achievement is to determine if it is broadly providing support for agricultural credit that is not being provided by other credit providers. There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. Farmer Mac supplements these institutions' activities by issuing debt in capital markets and purchasing agricultural real estate mortgages or AMBS. In that sense, Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another. If the goal of creating Farmer Mac was to create another specialized agricultural lender, as opposed to developing a viable secondary market for AMBS, then Farmer Mac has been more successful in achieving its mission. Whether such an activity constitutes a meaningful public mission is one that Congress should carefully consider.

Another mission evaluation issue is Farmer Mac's investments in non-mission-related assets (i.e., non-agricultural assets). Farmer Mac continues to maintain the highest percentage of non-mission investments among all the GSEs. As of year-end 2003, Farmer Mac's investment portfolio accounted for 25 percent of Farmer Mac's total assets with the majority of Farmer Mac's remaining assets being its own AMBS. Farmer Mac's investment portfolio has increased from $150 million as of year-end 1996 to $1.7 billion as of year-end 2003. In 2003, 22 percent of Farmer Mac's interest income was generated from its investment portfolio.

Holding relatively high proportions of non-mission investments invites speculation that GSE status is being used to generate what amount to arbitrage profits. Farmer Mac initially justified its build-up of investments in the latter part of 1990's on the grounds that the corresponding increase in debt issuance would improve capital market recognition of Farmer Mac and the pricing of its securities. It was then argued that improved pricing on Farmer Mac debt securities would be passed on to farmers in the form of lower mortgage rates. Non-mission investments have also been viewed by some as providing a source of liquidity. All financial institutions should maintain a prudent amount of liquidity. The question of how much non-mission investments are necessary for Farmer Mac's liquidity purposes has been the source of debate over several years. We understand that the Farm Credit Administration is about to issue a proposed rule on this issue, and we look forward to following the progress of that rulemaking.

REGULATORY OVERSIGHT OF FARMER MAC

The Farm Credit Administration (FCA) is the regulator of Farmer Mac. The Treasury Department does not have any direct regulatory oversight responsibilities with respect to Farmer Mac. However, on December 22, 1995, the House and Senate Agriculture Committees asked the Treasury to jointly monitor Farmer Mac's financial condition with FCA throughout the capital deferral period and beyond if necessary. The capital deferral period was established as part of the Farm Credit System Reform Act of 1996 and effectively prohibited FCA from implementing a risk-based capital rule for Farmer Mac prior to February 10, 1999. The FCA Board approved a final Farmer Mac risk-based capital rule on February 21, 2001, the final rule became effective on May 23, 2001, and Farmer Mac was required to be in compliance after a 1-year trial period that ended on May 23, 2002.

Treasury's role under the joint monitoring request has consisted of reviewing the semi-annual report that FCA sends to Congress, periodically discussing Farmer Mac's progress with FCA officials, and on a few occasions submitting comments to FCA that focused on broader policy issues associated with Farmer Mac. We have appreciated the close working relationship we have had with FCA in conducting the joint monitoring requested by Congress, but at this time, with the capital deferral period long over, there will be no continued formal relationship with FCA on the joint monitoring of Farmer Mac. FCA has developed a useful semi-annual report, which, as we understand, it will continue to provide to Congress. It would be useful for Treasury also to receive a copy of the final report. However, having FCA provide an advance copy of the report for Treasury to review, or having Farmer Mac or FCA continue to reference a joint monitoring arrangement with Treasury, may inadvertently provide the false impression that Treasury exercises some form of oversight of, or responsibility for, Farmer Mac. Treasury plays no such role.

While Treasury does not have any regulatory supervision responsibilities with respect to Farmer Mac, just as Treasury does not have with the other financial institutions (including the other GSEs), Treasury has an interest in monitoring the activities of Farmer Mac and the FCA. An issue that has periodically come up in FCA rulemaking, which the GAO report raised and we have also raised in the past, is Farmer Mac's relationship under certain transactions with members of the Farm Credit System. In particular, under the LTSPC program, Farmer Mac effectively acts as an insurer of mortgages held by Farm Credit System institutions. LTSPC transactions create regulatory capital arbitrage opportunities for Farm Credit institutions. Under this arrangement, a Farm Credit institution can carry its agricultural mortgages at a 20 percent risk weight, rather than 100 percent, which in turn lowers its regulatory capital requirement for these loans from 7 percent to 1.4 percent. Farmer Mac must hold 0.75 percent in capital against these loans under its minimum capital requirement (which appears to be the binding requirement at this time). Thus, the combined regulatory capital for these loans is just over 2 percent compared to the Farm Credit institution's 7 percent capital requirement on these loans prior to the transaction. This may raise some particular concerns because Farmer Mac is partially owned by Farm Credit institutions.

Outstanding LTSPC guarantees have increased from $575 million as of year-end 1999 to $2.3 billion as year-end 2003. The GAO also noted concerns with the LTSPC program regarding Farmer Mac's liquidity and concentration risk. Over the last few years, FCA Board members have indicated an awareness of the potential for capital arbitrage with the LTSPC program and they have taken some recent actions to address concentration risk within the Farm Credit System.

FARMER MAC'S LINE OF CREDIT WITH TREASURY

As noted by GAO, there appears to be some confusion over how and under what terms Farmer Mac would have access to its line of credit with Treasury. This issue was brought to the forefront in 1997 when Treasury submitted comments to FCA on a proposed regulation that would govern any future conservatorship or receivership for Farmer Mac. That letter described Treasury's position regarding Farmer Mac's line of credit as follows:

The Farm Credit Act specifies the circumstances allowing Farmer Mac to request the Treasury Secretary to purchase Farmer Mac obligations. Farmer Mac must certify that the proceeds from issuing obligations to the Treasury are necessary to fulfill Farmer Mac's guarantee obligations, and it must have exhausted its reserves. Treasury's obligation extends to Farmer Mac only in the prescribed circumstances, and is not a blanket guarantee protecting Farmer Mac's guaranteed securities holders from loss. Nor is the purpose of the Treasury's obligation to protect Farmer Mac shareholders or general creditors. Thus, we have serious questions as to whether the Treasury would be obligated to make advances to Farmer Mac to allow it to perform on its guarantee with respect to the securities held in its own portfolio—that is, where Farmer Mac's guarantee essentially runs to Farmer Mac itself. Indeed, Farmer Mac's guaranteed securities must, by statute, carry a disclaimer stating that these securities are not guaranteed by the Federal Government.

Treasury has not changed its position on this issue. Investors in Farmer Mac securities should rely on the underlying credit quality of Farmer Mac when making investment decisions, not on any potential access to a line of credit with the Treasury.

Our Nation's interest in maintaining strong agricultural credit markets that serve the needs of farmers and ranchers remains strong. Farmer Mac has improved its business prospects since it was granted new powers by Congress in 1996, and its capital position has improved over the years. FCA completed its implementation of Farmer Mac's risk-based capital standards and has been considering other issues associated with risk concentration within the Farm Credit System and Farmer Mac's non-mission investments. While Farmer Mac's role in agricultural mortgage markets has increased, whether Farmer Mac's increased business activity contributes to achieving a significant public purpose remains an issue that Congress should continue to evaluate.