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Testimony of the Honorable Dallas P. Tonsager
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Before the Subcommittee on Agriculture, Rural Development,
Food and Drug Administration, and Related Agencies
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Mr. Chairman and Members of the Subcommittee, I am Dallas P. Tonsager, board chairman and CEO of the Farm Credit Administration (FCA or agency). On behalf of my colleagues on the FCA board, Jeffery S. Hall of Kentucky and Glen R. Smith of Iowa, and all the dedicated men and women of the agency, I am pleased to provide this testimony. Mr. Hall also serves as chairman of the board of directors of the Farm Credit System Insurance Corporation (FCSIC).

In my testimony today, I will discuss the agency's responsibilities, the current state of the farm economy, and the conditions of the Farm Credit System (FCS or System). I would also like to take a moment to thank the subcommittee members and staff for their assistance during the most recent budget process. The resources included in the FY 2019 budget will be critical for recruiting and training highly qualified staff to maintain the safety and soundness of the System.

FCA's responsibilities

FCA is an independent agency responsible for examining and regulating the banks, associations, and the related entities of the System. The FCS is a government-sponsored enterprise (GSE) created by Congress in 1916 to provide American agriculture with a dependable source of credit. The System's banks and associations form a nationwide network of cooperatively organized lending institutions that are owned and controlled by their borrowers, serving all 50 states and Puerto Rico. The System is currently made up of 4 banks, 69 associations, 5 service corporations, the Federal Farm Credit Banks Funding Corporation, and the Federal Agricultural Mortgage Corporation (Farmer Mac).

As directed by Congress, FCA's mission is to ensure that System institutions and Farmer Mac are safe, sound, and dependable sources of credit and related services for all creditworthy and eligible persons in agriculture and rural America. We accomplish this mission in two important ways.

First, we protect the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and we ensure that they comply with applicable laws and regulations. Our examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risk, as well as on the ability of its board and management to direct its operations. We also evaluate each institution's compliance with laws and regulations to ensure that it serves all eligible borrowers. If a System institution violates a law or regulation or operates in an unsafe or unsound manner, we use our supervisory and enforcement authorities to take appropriate corrective action.

Second, we develop policies and regulations that govern how System institutions conduct their business and interact with customers. Our policies and regulations protect System safety and soundness; implement the Farm Credit Act; provide minimum requirements for lending, related services, investments, capital, and mission; and ensure adequate financial disclosure and governance. We approve the corporate charter changes of System institutions, System debt issuance, and other financial and operational matters.

Current state of the farm economy

U.S. farmers and ranchers are facing challenging economic conditions. After several years of robust times, many farmers and ranchers have encountered declining financial conditions amid large commodity supplies and weak prices for crops and livestock products. Higher operating costs for labor, farm inputs, and other expenses are putting stress on farm cash flows and liquidity levels. Abundant commodity supplies, resulting in part from favorable weather and continued gains in agricultural productivity, have collided head-on with changes in trade policy.

For decades, lower tariffs and improved access to foreign markets have benefited U.S. agriculture. The sector is now in the crosshairs of retaliatory tariffs as the administration pursues larger policy objectives. As a result, price risk has increased for agriculture and affected key commodities, including soybeans, pork, dairy, almonds, and citrus. During the last quarter of 2018, U.S. agricultural exports declined 9 percent from the same period in 2017.

We await a speedy resolution to the United States–Mexico–Canada Agreement and trade issues with China and other countries so that longer-term damage to U.S. agricultural export demand can be avoided. Farmers want to fully share our nation's abundance with the rest of the world, and exports are at the core of a healthy farm sector. This statement is as true today as it was in 1976 when I started my career as a dairy farmer.

U.S. farm income stabilizes

As spring planting gets underway, generally favorable conditions continue for both the U.S. and global economies, underpinning domestic and foreign demand for agricultural products. Global gross domestic product on a per capita basis is expected to continue near 2 percent in 2019 for the third consecutive year. U.S. unemployment is low, and consumer wages and income are growing. This supports consumer spending, which powers the economy. Off-farm income is a significant source of loan repayment, and many farmers are relying on it more than ever.

Several concerns are apparent, though. Labor availability and costs are straining some sectors, including farm commodity sectors, such as specialty crops and dairy, that use significant amounts of labor. The U.S. Department of Agriculture is forecasting a somewhat better net cash farm income situation for 2019 ($95.7 billion), but this is still well below the level achieved five years ago.

In the past year, a lot of attention has been focused on farm price pressures, but cash receipts were mostly steady to higher in 2018 because the higher quantities sold boosted farm revenue. Instead, the main driver of lower income last year was higher production expenses. The income drop-off in 2018 was moderated by USDA trade-related payments to farmers, most of which went to soybean producers.

At current price levels, many farmers will remain under financial pressure in 2019 despite the projected increase in farm income. For example, profitability for corn and soybean enterprises remains well below levels reported earlier in the decade. Adjusting production costs to meet expected commodity prices will challenge many producers.

Outlook for agricultural commodities

Corn and soybean producers represent the largest group of crop producers financed by System institutions, particularly those serving the Midwest. The soybean market weakened considerably last summer, a result of a record U.S. crop and implementation of China’s 25 percent tariff. U.S. exports to other countries have increased, but not enough to prevent a significant stock pileup of soybeans. For the current marketing year ending this August, stocks relative to use are forecast to be the highest in more than three decades. Some producers in regions with a very weak basis and/or poor yields are facing negative returns. However, farmers with good yields likely turned a profit because they received a payment of $1.65 per bushel under the Market Facilitation Program. For the 2019 crop, profit margins are expected to turn negative due to weak pricing and higher costs.

The corn market has not broken out of its four-year sideways price trend because there are plenty of stocks globally, no serious threats to production, and no big run-up in demand. Still, both domestic and export demand is helping to cut burdensome supplies. Given a sharp drop in prices for the 2013 through 2016 crop years, the profitability picture for corn producers was negative during those four years. For 2017 and 2018, though, profitability improved to near or slightly above breakeven levels for producers with good yields. But those with lower yields and/or a higher cost structure are feeling significant financial pain. No improvements are expected for the crop harvested this fall if trend yields and current price levels remain the same.

Dairy producers are also experiencing stress. Milk prices in 2018 were 8 percent below the previous year due to increases in milk productivity, excess supplies, and weakening cheese export demand from additional tariffs by Mexico and China. Higher feed costs squeezed dairy returns even further. A long period of poor margins is driving some small dairy producers into liquidation. While these supply adjustments are starting to lift milk prices slightly and improve returns marginally in 2019, dairy profits will likely remain under pressure. As authorized in the 2018 Farm Bill, the Dairy Margin Coverage program will provide improved and more affordable protection against low margins, especially for dairy farmers with small herds. Program payments could help slow the exit of dairy operations.

Another significant commodity financed by System institutions is cattle. Cow/calf producers have seen moderate profits in the past two years, and the same is expected for 2019. Fortunately, beef supplies appear to be well balanced with demand. Even with large U.S. beef and other meat supplies, the relatively strong domestic and export demand for beef is supporting prices. From a lender’s standpoint, in the grain-producing areas, producers with both cattle and grain are doing much better than those with grain alone.

Tree nut production has been expanding in recent years, with California almonds leading the expansion after heavy acreage investment. The industry has done well to develop both domestic and export demand, yet farm prices have been near $2.50 per pound in recent years, down from a record $4 in 2014. As with other agricultural commodities, the question is whether demand can keep up with future supplies. The increased tariffs by China affect between 10 and 15 percent of the California crop, so restoring the previous trade situation is also critical for these producers.

Weather is, of course, an ever-present risk for farmers and ranchers. Last year, Hurricanes Florence and Michael severely damaged poultry, cotton, and other farms in parts of the Southeast. In the West, wildfires damaged California vineyards and wineries, as well as rangeland and some cropland. Most recently, the mid-March "bomb cyclone" dropped heavy rain and triggered massive snowmelt, which led to widespread flooding in the Midwest, particularly in Nebraska and Iowa. Damages include loss of livestock, production facilities, and grain in storage. Also, saturated soil is adversely affecting preparations for spring planting. Federal agricultural disaster and crop insurance programs are expected to cover some of the losses.

FCA has provided policy guidance to System institutions to address actions they should consider in the face of natural and man-made disasters. My fellow board members and I continue to support this policy and encourage System institutions to continue to work with their borrowers when these disasters strike by extending the terms of loan repayments, restructuring borrowers' debt obligations, and easing some loan documentation or credit-extension terms for new loans to certain borrowers. In addition, we inform System institutions that if disasters impair their ability to comply in a timely way with regulatory reporting and publishing requirements, the institution should contact FCA if relief from specific regulatory or reporting requirements is needed.

Land value stability

About 46 percent of the System's loan volume at the end of 2018 was for real estate mortgages. The System is the largest source of credit for farm- and ranchland. Farmland value trends across major production regions were mixed in 2018 and early 2019. Some local markets and land types continued to be strong while others experienced modest price declines on waning demand. The volume of land for sale continues to be relatively modest and balanced with demand in many land markets. In general, farmer and investor demand for high-quality land is stronger than for lower-quality land.

Surveys of lenders and real estate professionals indicate these experts foresee stable to somewhat lower cropland prices for the balance of 2019. Higher interest rates and lower commodity prices have been negatively impacting farmland valuations over the past few years. Further rate increases in 2019, coupled with even a modest decline in major commodity prices, could lead to much sharper declines in valuations going forward. For 2019, it is unclear how small changes in volume might affect pricing and whether demand for good-quality land remains intact.

Farm liquidity and farm-level adjustments

As has been the case for the past several years, farm liquidity has been declining as low or negative returns deplete producers' financial reserves (their working capital). An individual farm's liquidity level depends in part on its level of debt.

The University of Illinois published 2017 data that point to the serious challenge facing some Illinois grain producers. Farms with high and very high debt have current ratios at or below 1.0 — meaning their current assets are equal to or less than their current liabilities. These farms, which are either in or approaching the danger zone, account for about 12 percent of total grain farms. For the remaining 88 percent, the current ratio is considerably better, and some producers may have improved their financial position in 2018 because of high yields, pre-harvest hedging, and receipt of trade-related USDA payments. The concern is that, if returns again drop below the breakeven point in 2019, there will be further deterioration.

As of early March, USDA forecasts call for farm equity in 2019 to rise slightly because of a small rise in farm real estate values. However, when adjusted for inflation, farm assets and equity would decline slightly. Total farm debt is forecast to rise 4 percent because of a rise in farm real estate debt, in part from increased debt restructuring by farmers. Farm sector solvency ratios will be weaker in 2019, with the debt-to-asset ratio rising to 13.9 percent from 13.5 percent in 2018. Working capital is forecast to decline almost 25 percent from 2018, while the current ratio for the farm sector is forecast to decline from 1.43 in 2018 to 1.31 in 2019.

Many farmers are working through this difficult period by finding ways to reduce costs, improve their marketing strategies, take advantage of risk management programs, reduce living expenses, and work with their lenders. Farmers who own their land have options for dealing with cash flow problems by restructuring debt, while those with a significant portion of rented land have fewer options and are more vulnerable during periods of weak or negative returns.

Farm programs offer support, but the support levels are generally not enough to help operations with higher total costs. As previously mentioned, the Market Facilitation Program payments issued in 2018 and 2019, particularly for soybean producers, likely helped extend the viability of some operations into 2019.

Some farmers are deciding to voluntarily exit the business while they still have equity in their operations. Farm bankruptcy rates, while rising somewhat, remain low, but this could change, depending on how crop and livestock markets develop this summer and fall.

Condition of the FCS

The System is in a strong position to carry out its mission and to support its membership, which extends directly to farm families, farm businesses, and rural communities that depend on agricultural credit. Overall, the System is safe and financially sound. For calendar year 2018, the System reported strong earnings that continued to support capital growth. While overall portfolio credit quality has declined from last year, System institutions have strong risk-bearing ability and are well-positioned for the challenges facing agriculture.

The System also continues to benefit from a strong capital base, which enhances its risk-bearing capacity at a time when System borrowers in certain agricultural sectors face significant financial stress. As of December 31, 2018, total System capital equaled $58.4 billion, up from $55.4 billion a year before. The System's total capital-to-assets ratio at year-end 2018 was 16.7 percent as compared with 16.8 percent for 2017. Overall, almost 80 percent of total capital is in the form of retained earnings. The increase in total capital is due in large part to the System's strong earnings performance. For 2018, the System reported net income of $5.3 billion, up from $5.2 billion in 2017. Net interest margin was 2.46 percent compared with 2.48 percent for 2017.

The System continued to grow in 2018. Gross loans totaled $271.9 billion at year-end, up $13.2 billion or 5.0 percent from 2017. Real estate mortgage lending was up $5.4 billion or 4.5 percent because of continued demand for cropland from new and existing customers. Overall, real estate mortgage loans represent almost 46 percent of the System's loan portfolio. Production and intermediate-term lending increased by $1.7 billion or 3.3 percent from the year before, and agribusiness lending for processing and marketing increased by $3.3 billion or 15.1 percent.

Credit quality in the System's loan portfolio continues to be good. Nonperforming assets totaled $2.3 billion, or just 0.84 percent of loans and other property owned at the end of 2018. While nonperforming assets were up from $2 billion at the end of 2017, or 0.78 percent, the System's loan portfolio continues to perform well. Comparatively, the System's allowance for loan losses was equal to 75 percent of the System's nonperforming assets.

The System continues to have reliable access to the debt capital markets. Investor demand for all System debt products remains positive, allowing the System to continue to issue debt on a wide maturity spectrum at competitive rates. Risk spreads and pricing on System debt securities remain favorable relative to corresponding U.S. Treasuries.

With a balance of $5 billion at year-end 2018, the Farm Credit Insurance Fund further enhances the financial integrity of the System. Administered by the FCSIC, this fund protects investors in Systemwide consolidated debt obligations. System banks also maintain liquidity reserves to ensure they can withstand market disruptions. As of December 31, 2018, the System's liquidity position equaled 182 days, significantly above the 90-day regulatory minimum required for each FCS bank.

Young, beginning, and small farmers and ranchers

Consistent with the mission of the FCS to provide sound, adequate, and constructive credit for all farmers and ranchers, Congress requires each association to have a program to provide credit and related services to young, beginning, and small (YBS) farmers and ranchers. In the late 1990s, FCA established a system to monitor the associations' YBS programs and activities and to receive reports regarding the associations' YBS lending. We compile data from these reports into our annual reports to Congress.

Using some of the increased resources recently approved by Congress, we have examined the System's data on YBS farmers and ranchers in a more sophisticated manner and have found potential areas for improvement in data collection, quality, and granularity. The current approach for reporting allows a farmer's or rancher's loan to be reported in each of the categories for which it qualifies — young, beginning, or small. In addition, more than one institution may be participating in the financing of an individual YBS farmer; since each participation interest is counted, further duplication occurs when the institutions' numbers are consolidated. As a result, for certain purposes, reconciling and analyzing the data can be difficult. Separately, the definitions of who is a YBS farmer or rancher have not been updated since the 1990s and may be out of date.

With the goal of improving the quality and usefulness of the System's YBS data by taking advantage of new tools and resources as well as 20 years of experience, we decided to begin a transparent process of reevaluating the YBS data collection process and definitions. On February 21, 2019, we published an advance notice of proposed rulemaking to seek public comment on ways to improve the YBS data collection process and definitions. We believe that with better data we can improve service to YBS farmers and ranchers. We are looking forward to reviewing the comments that we receive from the advance notice.

Condition of Farmer Mac

Congress established Farmer Mac in 1988 to create a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac has authority to create and guarantee securities and other secondary market products that are backed by agricultural real estate mortgages and rural home loans, USDA-guaranteed farm and rural development loans, and rural utility cooperative loans. As mandated by statute, we have a separate office — the Office of Secondary Market Oversight — through which we regulate, examine, and supervise Farmer Mac's operations.

Farmer Mac is committed to enhancing the availability of reasonably priced credit to agriculture and rural America through its secondary market activities. Under specific circumstances defined by statute, Farmer Mac may issue obligations to the U.S. Treasury Department, not to exceed $1.5 billion, to fulfill the guarantee obligations on Farmer Mac guaranteed securities. Farmer Mac is not subject to any intra-System agreements and, unlike System banks, is not jointly and severally liable for Systemwide debt obligations. Moreover, the Farm Credit Insurance Fund does not back Farmer Mac's securities.

As measured using generally accepted accounting principles (GAAP), net income available to common stockholders in FY 2018 (ended September 30) was up 15.0 percent from FY 2017 to $92.0 million.[1] The increase was due to an increase of $3 million in after-tax net interest income; a $5 million gain in fair values of financial derivatives; and the lower federal corporate income tax rate, which resulted in a $4.5 million decrease in income tax. The increases were partially offset by deferred tax asset remeasurements and adjustments to the allowance for losses.

Core earnings, a non-GAAP measure based more on cash flow, were up by 30.3 percent over FY 2017 to $81.5 million. Core earnings differ from net income by excluding infrequent or unusual transactions that are not indicative of future operating results, leading to a clearer depiction of the financial performance of Farmer Mac. The increase was primarily driven by the decrease in income tax expense

[1] All references to time periods and fiscal years refer to the federal government's fiscal year, not Farmer Mac's fiscal year, which corresponds to the calendar year.

relating to the lower federal corporate income tax rate, in addition to a $6.7 million increase in net effective spread. The increase was partially offset by increases in operating expenses related to technology and business infrastructure investments, increased staffing, and new leases on office space. Net effective spread in FY 2018 increased to 93 basis points, up from 92 basis points 12 months earlier. Earnings were also up due to growth in program volume, as well as continued improvements in LIBOR-based short-term funding costs for floating-rate assets indexed to LIBOR.

Farmer Mac’s healthy earnings led to an increase in its core capital through retained earnings. As of September 30, 2018, Farmer Mac’s core capital totaled $713.6 million, which exceeded its statutory requirement of $539.8 million. This compares to $653.4 million in core capital as of September 30, 2017. The increase in core capital helped support business volume growth. The total portfolio of loans, guarantees, and commitments grew 4.8 percent to $19.5 billion.

Credit quality trends remained favorable, and credit quality in all program business lines remained satisfactory. Credit risk was manageable, and adversely classified volume remained stable. As of September 30, 2018, substandard loans were 3.1 percent of total direct credit exposure, down 0.2 percent from a year earlier. Loans more than 90 days delinquent decreased to 0.53 percent compared with 1.01 percent in the prior year.

Conclusion

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System, including Farmer Mac, remains financially sound and focused on serving agriculture and rural America. We will continue our commitment to excellence, effectiveness, and cost efficiency and will remain focused on our mission of ensuring that System institutions and Farmer Mac are safe, sound, and dependable sources of credit for agriculture and rural America.