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FARMER MAC

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

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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.

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.: October 16, 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 GSE¹ 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

¹As 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.

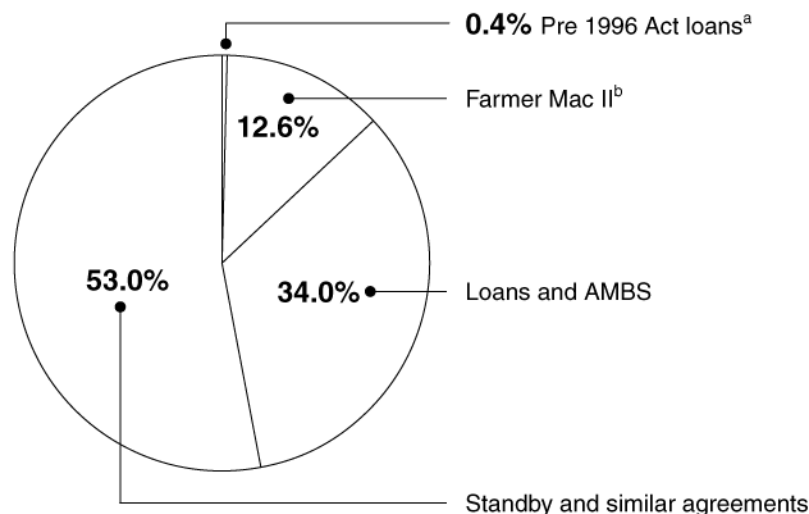
Farmer Mac also issues long-term standby purchase commitments or standby agreements for eligible loans. To date, all of these commitments are with institutions in the Farm Credit System (FCS), which is also a GSE. As of December 31, 2003, loans underlying standby and similar agreements² totaled \$3.1 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

²During 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:

^aThese are loans purchased by Farmer Mac prior to the change in its statutory charter in 1996.

^bFarmer 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

³U.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;

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

⁵Id.

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- 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 \$1.1 billion 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

⁶Both 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

⁷12 U.S.C.2279aa-13.

⁸Letter 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

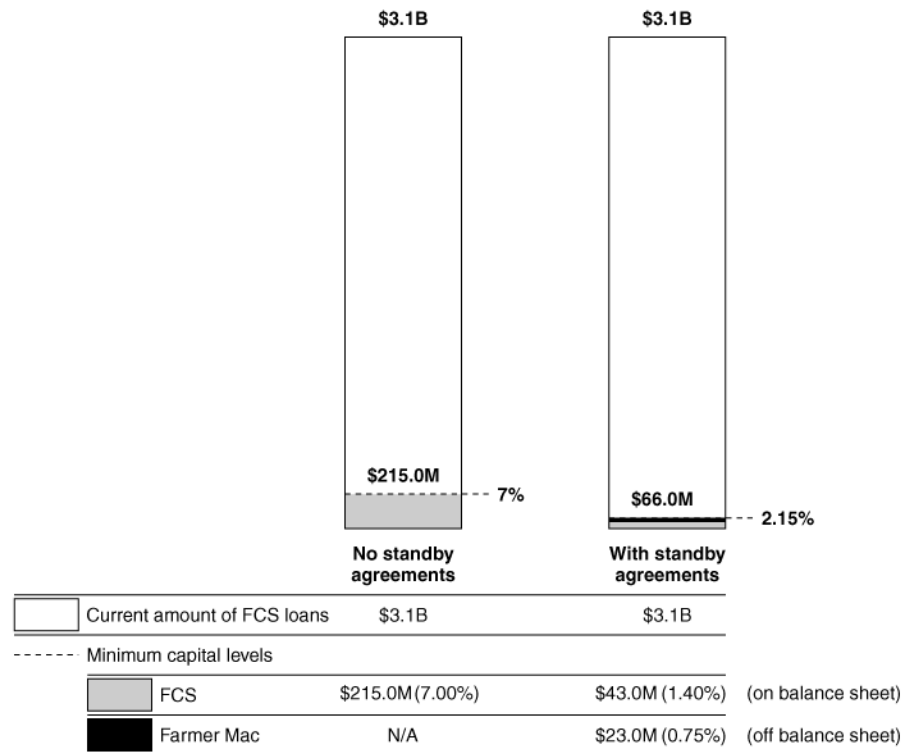
In trying to assess whether Farmer Mac had made long-term credit available to farmers and ranchers at stable interest rates, we found that from 2001 to 2002, its long-term fixed interest rates on Farmer Mac I loans were similar to the rates offered by commercial banks and FCS institutions. We also found 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



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

⁹SEC 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

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