

**Where is the
Farm Credit System
Going?**

by Bert Ely

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The Farm Credit System (FCS) has changed dramatically since Congress chartered 12 regional federal land banks in 1916. But the FCS is sailing a course that could change it more over the next five years than it has over the last 84 years. This new course, into uncharted waters, is being enabled by the Farm Credit Administration (FCA), the FCS's regulator, without any congressional direction or oversight. The time has come for Congress, bankers, and all who care about rural America to ask a fundamental question: Where is the FCS going?

The roots of today's FCS were planted in the mid-1980s when Congress first tried to reform the System in the aftermath of the collapse of the farmland bubble in the early 1980s. That bubble was largely inflated by reckless FCS lending in the 1970s. The reform legislation of 1985 and 1986 was not enough, though, to save the FCS, forcing Congress in 1997 to enact a \$4 billion taxpayer bailout of the FCS. However, the reforms did trigger major consolidation within the System. The number of FCS institutions dropped from 845 at the end of 1984 to 165 on July 1, 2000, with the consolidation pace accelerating in the year ended July 1, 2000, as the number of FCS institutions declined by 29, or 15%. Despite this institutional shrinkage, the FCS's total assets continue to grow, reaching \$88.9 billion on June 30, 2000.

Not only has consolidation been evident among local FCS associations, which lend directly to farmers and ranchers, but the twelve Farm Credit Banks (FCBs), which fund the associations, have shrunk to six. A seventh bank, CoBank, doubles as the FCS bank serving the Northeast and the FCS's nationwide lender to farm cooperatives. The six FCBs and CoBank obtain their funds from the Federal Farm Credit Banks Funding Corporation, which raises funds for the FCS from Wall Street. In addition to funding the FCS associations located in their territories, the FCBs also provide some safety-and-soundness oversight over the associations they lend to.

As consolidation has proceeded within the FCS, the character of the system has changed subtly, but significantly. No longer is it the FCS of a generation ago. Fewer and fewer FCS associations are small, local lenders genuinely controlled by a board of farmer-borrowers who know the local agricultural marketplace and are dedicated to meeting the financing needs of a broad range of farmers. Increasingly, the FCS is characterized by large, multi-state associations, headquartered in distant cities, which focus on serving larger, older, and wealthier farmers, the very individuals who least need the FCS's taxpayer-subsidized financing. That subsidy, in the form of tax exemptions and borrowings implicitly backed by the federal government, now exceeds \$1 billion annually.

The road map

The FCA launched the FCS into uncharted waters in July 1998 with the publication of a Policy Statement (FCA-PS-73) titled "Philosophy on Intra-System Competition." Although little publicized, this one-page statement is revolutionizing the FCS without any congressional inquiry or assent. Stating that it "believes that unrestricted intra-System competition is beneficial for the customer and the long-term relevancy of the Farm Credit System" and stating that it seeks to provide "a flexible regulatory environment," the FCA's three-member board stated that it supported the following:

"Flexibility for associations to choose their source of funding.

"Initiatives . . . which will allow [FCS] institutions to become more efficient.

"Removal of geographical boundaries of System entities.

"Movement towards institutional structures which have broad-based lending authorities encompassing [the full range of FCS lending powers].

"Broad interpretation of existing statutes which will enable FCS institutions to become more competitive."

The Policy Statement closed with this warning: "This statement presents the FCA Board's philosophical framework for the Agency's chartering, policy development, and regulatory activities . . . The FCA Board will facilitate an orderly plan to phase in this philosophy." What is most interesting about this statement is what it does not say.

The statement makes no reference to congressional hearings, new legislation, or any signal whatsoever that Congress endorses or even condones the FCA's new "philosophical framework." The FCA Board acted as if Congress does not exist and that it is a law unto itself.

The statement cites no public purpose for unleashing competition within the FCS, it provides no evidence of unfulfilled agricultural credit needs which will be better met through FCS restructuring and consolidation, and it ignores the impact of fostering increased taxpayer-subsidized lending in rural America.

The statement is silent about the safety-and-soundness implications of unleashing competition within the FCS, permitting FCS institutions to lend wherever they want, and granting FCS lenders the broadest possible lending powers that the FCA can interpret under existing law. It is as if insolvency and failure are of no concern to the FCA.

Although not discussed openly, this FCA philosophy clearly was shaped by those individuals and institutions within the FCS who have chafed at the traditional structure of the FCS and the restraints imposed on government-sponsored enterprises (GSEs), and

particularly on the FCS in the aftermath of its 1987 bailout. The FCA, captured by the System's aggressive elements, has become the willing enabler of their ambitions.

Plunging ahead

The FCA wasted little time implementing its new philosophy. In the fall of 1998, it published for comment a new "lender's choice" regulation which would permit any FCS institution to lend anywhere it wanted to within the United States. Had it been adopted, this regulation would have implemented the "removal of geographical boundaries of System entities." However, a storm of protest arose from within the System, with as many FCS associations opposing the proposed regulation as supporting it. After an extended, seven-month comment period, the FCA simply let it die, helped along by a few concerns expressed on Capitol Hill.

But the FCA was unbowed. After a hiatus during the fall and winter of 1999 and the transition to a new FCA chairman, Michael Reyna, the FCA relaunched its effort to knock down geographical barriers within the FCS by releasing its "national chartering" proposal. As would have been true under "lender's choice," an FCS association, starting in January 2001, can lend anywhere it wants to within the United States, after first notifying the FCA. In a unique twist to sidestepping public comment, and objections, to nationwide chartering, the FCA announced its intent to adopt a national chartering policy in a 12-page booklet instead of a proposed regulation.

Not only was FCA trying again to unleash its ambitious lenders, but it tried to break new ground in the field of administrative law through "regulation by booklet." However, apart from one critical letter from House Banking Committee Chairman Jim Leach, Congress has been silent about this bold departure from the well-established principles of U.S. administrative law. Although Mr. Reyna rejected Mr. Leach's request that FCA publish its national chartering initiative as a proposed regulation, the FCA did publish the proposal in the Federal Register, soliciting comments on it. Almost 1,000 comment letters were filed with the FCA, more than five times as many comments as were filed on the "lender's choice" proposal. While many of the comment letters were "inspired" by the advocates of national chartering, almost two-thirds of the FCS institutions did not bother to comment, perhaps because they felt it would be a waste of time. Of greater importance, the Texas Farm Credit Bank as well as fifteen associations offered numerous sound reasons why national chartering should not be authorized.

On the heels of "national chartering," in July 2000 the FCA dropped another shoe by proposing a 100% loan "participation" rule. This regulation would permit FCS institutions to purchase 100% of a loan originated by a non-FCS institution, regardless of where the borrower was located. Effectively, this rule represents national chartering by another name. More importantly, it would enable ambitious associations to quickly expand the geographical scope of their lending by simply purchasing loans originated by others rather than going through the more expensive and time-consuming process of setting up loan production offices in new markets or hiring lending officers in those markets. However, a borrower under a loan purchased by an FCS association will not become a member of that association, breaking with another tradition, that FCS associations are

controlled by their borrowers. Increasingly, FCS associations will be lead by managements accountable only to subservient boards of directors.

The pell-mell expansion of FCS lenders that the FCA is unleashing through national chartering and the 100% loan participation rule have grave safety-and-soundness implications, for surely expensive lending mistakes will be made since agricultural markets do differ significantly across the country. But the FCA is not done. If it sticks to its current "regulatory performance plan," it will soon issue a proposed "mission-related investments" regulation that would authorize FCS associations to make venture capital investments of an equity-like nature. The regulation will give all FCS institutions what CoBank failed to obtain in its aborted attempt in 1999 to take over the USDA's failed venture capital enterprise, the Alternative Agricultural Research and Commercialization Corporation, or AARCC. If adopted, the venture capital regulation will draw FCS associations into a new class of risks for which they have no experience or congressional mandate. It would then be logical for these associations to begin offering investment banking services to farm-related organizations, an entirely inappropriate activity for a GSE. The implications of mission-related investment authority for FCS institutions are quite troubling.

Where does this lead?

Although the 1998 Policy Statement is not yet fully implemented, the shape of the new FCS is rapidly taking form. The consolidation pace has picked up even though it does not seem to be producing the efficiencies claimed for it. Much like the pioneers who lined up for the Oklahoma land rush, ambitious FCS institutions almost certainly are preparing to begin lending out of their existing chartered territories under national chartering. Obviously, they will try to cherry-pick loans to larger borrowers now served by other FCS institutions.

This intra-System competition will trigger predatory price competition among FCS lenders, something new to the FCS and something that will quickly destroy the traditional cooperative nature of the FCS, just as competition among credit unions has undermined the cooperative tradition of those institutions. Commercial banks, already competing against taxpayer-subsidized FCS lenders, will face even more aggressive competition as FCS associations begin battling each other.

As the aggressive FCS institutions spread their wings, smaller and less aggressive associations will feel intense pressure to merge with other associations. The consolidation pace within the FCS will accelerate, with the number of associations shrinking to fifty, or fewer. This shrinkage will call into question the present two-tier structure of the FCS. At some point in time, the larger associations, having grown through mergers and out-of-territory lending, will seek to deal directly with the Funding Corporation, making the regional FCBs obsolete. The FCS will steadily transform itself into a handful of large, and largely unaccountable, taxpayer-subsidized lenders who will focus on serving larger farmers and ranchers as well as agribusinesses, with the FCA the handmaiden to this congressionally unsanctioned process.

By transforming itself in this manner, the FCS will not only abandon its roots, but despite FCA policy statements to the contrary, the FCS will no longer serve the very farmers and ranchers -- young, beginning, small, minority, and women farmers -- that justify its existence in the first place. If the FCS no longer serves these farmers, then why should the FCS continue to exist as a GSE? Congress needs to address this question as it examines the implications and consequences of the FCA's headlong rush to implement its July 1998 Policy Statement.

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