

**The Farm Credit Administration's  
National Charter Initiative**

**Oral Statement by**

**Bert Ely**

**to the**

**House Committee on Banking and Financial Services**

**October 3, 2000**

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**Presented by  
Bert Ely  
Ely & Company, Inc.  
Alexandria, Virginia  
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**The Farm Credit Administration's National Charter Initiative**

Mr. Chairman and members of the Committee, I am pleased to testify today on the Farm Credit Administration's (FCA) national charter initiative. Appended to my statement is a paper I have written, titled "Where is the Farm Credit System Going?" and a report I wrote last year, titled "The Farm Credit System: Reckless Past, Doubtful Future." I request that this material be included in the record of this hearing. While the American Bankers Association is a client of mine, my statements will reflect views that I hold personally, and quite strongly.

Mr. Chairman, I commend you for holding this hearing, for the FCA's national charter initiative is a train that is about to rush from the station and onto a weakened bridge that will quickly collapse into a deep chasm, with catastrophic consequences. In the ten years that I have been following the Farm Credit System (FCS),<sup>1</sup> no FCA proposal has concerned me more than its national charter initiative. Hopefully, after this hearing, the FCA will take off its blinders, slam on the brakes, and put this initiative on hold until the next Congress has not only considered the future, if any, for the FCS, but also enacted the appropriate legislation. National charters should not be an element of the FCS's future.

The numerous implications of national charters for the FCS, for agriculture, and for rural America are quite troubling. More specifically, national charters will accelerate consolidation within the FCS. From the end of 1984 to July 1, 1999, the FCS shrank from 845 largely local lending institutions to 187 increasingly regionalized lenders. As of last week, the number of FCS lenders had shrunk further, to 158. Given the joint management of many production credit associations and federal land credit associations, the actual number of FCS management teams today is just 117. Pending mergers will shrink that number further this year. Clearly, the FCS today is not the FCS of twenty years ago, or even ten years ago.

Once upon a time, the typical FCS institution served a relatively small area, often just a few counties, and was run by a board of directors of local farmer/borrowers. Increasingly, FCS associations cover vast territories, in one case serving five states, and have as much as \$5 billion in assets. Consequently, these organizations are run by

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<sup>1</sup> In 1990, I co-authored, with Vicki Vanderhoff, a report for the American Bankers Association titled "The Farm Credit System: Reckless Lender to Rural America."

professional managers distantly removed from the markets they serve. Instead of genuine cooperatives, they have become large, mutually owned financial institutions, with the attendant lack of stockholder accountability common to all large mutually owned organizations. Consolidation within the FCS is gravely changing its nature. National charters will worsen this situation, in four regards.

First, in a dramatic break with its 84-year history, national charters will pit FCS lenders against each other in the pursuit of loans outside of previously exclusive territories. Aggressive FCS lenders will use their taxpayer subsidized funding and tax exemptions, which now exceed \$1 billion annually,<sup>2</sup> not only to compete even more aggressively against banks and other private-sector lenders, but also against each other. For the first time, we will witness GSEs competing against each other at the retail level, for each FCS association is a GSE in its own right. Predatory FCS lenders will cut interest rates, take greater credit risks, and lure lending officers away from other FCS lenders with bigger paychecks and the hope of capturing their customers. Despite cries to the contrary, expansionist FCS institutions will not fill unmet credit needs. Instead, they will be chasing after the most desirable agri-business customers. Therefore, no public purpose will be served by national charters for FCS lenders.

Second, national charters will accelerate the pace of consolidation within the FCS. Smaller FCS lenders, specifically those with less than \$100 million of assets, will be forced by loan cherry-picking by bigger, out-of-territory associations to merge into larger organizations. I can easily foresee less than 50 and perhaps as few as 20 FCS lenders within a few years, each competing aggressively outside of its assigned territory.

Third, bigger FCS organizations will increasingly focus their lending on larger farms and ranches as well as agribusinesses, the very enterprises which neither need nor deserve the \$1 billion-plus financing subsidy the FCS now delivers to American agriculture. Simple economics will force the larger lenders to trim their lending to small, beginning, young, minority and women farmers and ranchers, the very individuals a GSE should serve. Fortunately, unsubsidized commercial banks will be there to meet those credit needs.

Finally, and perhaps most troubling, national charters will create the potential for another FCS-induced agricultural credit crisis, and a second taxpayer bailout of the FCS. This potential will arise as aggressive FCS institutions overlend again on agricultural real estate, as occurred in the 1970s, inflating a bubble in farmland values that inevitably will collapse, with tragic results for rural America. Many members of this Committee may

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<sup>2</sup> Ely, Bert, "The Farm Credit System: Reckless Past, Doubtful Future," American Bankers Association, November 1999, pg. 17.

remember 1987, when Congress had to toss the FCS a \$4 billion life ring. Just as the FCA of the 1970s could not prevent that bubble from erupting, a regulator who has become a cheerleader and facilitator of the empire builders within the FCS is hardly equipped to rein in their appetites.

In closing, I will address two other points. First, since I am not a lawyer, I cannot opine on whether the FCA has the statutory authority to issue national charters. But even if it did, it should not issue them until after Congress has explicitly considered their merits. Second, I encourage members of the Committee to read the comment letters that 16 FCS institutions opposed to national charters filed with the FCA. Set out below is a list of those institutions. These FCS insiders can attest far better than I can to the dangers and downsides posed by national charters.

Mr. Chairman and members of the Committee, I thank you for your time. I welcome your questions.

Comment letters filed by FCS institutions opposed to national charters:

Federal Land Bank Association of Kingsburg, FLCA, Kingsburg, California  
Farm Credit Services Southwest, Tempe, Arizona  
Northern California Farm Credit, Chico, California  
Colusa-Glenn Farm Credit Association (FLCA and PCA), Colusa, California  
Idaho Agricultural Credit Association, Blackfoot, Idaho  
Central Coast Farm Credit (FLCA and PCA), Arroyo Grande, California  
Ag Credit of California, Stockton, California  
Texas Farm Credit Bank, Austin, Texas, on behalf of itself  
and six FCS associations

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

**by Bert Ely**

**September 2000**

# Where is the Farm Credit System Going?

by Bert Ely  
Ely & Company, Inc.

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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