



The Farm Credit System:

Reinvented and
Mission-Challenged

How a Fortunate Few
Receive a Benefit from
the Farm Credit System
that Congress Never
Intended or Envisioned

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Executive Summary

The Farm Credit System (FCS) was created in 1916 and expanded in 1933 to meet an agricultural financing need that no longer exists. Where once commercial banks were barred from providing the full range of financing that farmers and ranchers needed or, as was the case in 1933, thousands of rural banks had been closed, now the countryside is populated with banks and other private-sector lenders competing aggressively to meet all of rural America's financing needs.

Like any government bureaucracy threatened with extinction, the FCS has tried to reinvent itself, but has done so in a manner that Congress never intended or envisioned. This reinvention has accelerated since Congress bailed out the FCS in 1987 following the bursting of a farmland bubble largely inflated by the FCS's reckless lending in the 1970s.

The FCS's reinvention is evident in three respects. First, it has experienced tremendous consolidation, shrinking from more than 800 local lending associations in 1984 to just 104 much larger associations in October 2002. Quite possibly the FCS will shrink to as few as 20 associations by 2010. As the FCS has consolidated, FCS associations have reduced their income tax burden by reorganizing as Agricultural Credit Associations. As a result, the FCS paid no federal income taxes in 2001. Second, the FCS increasingly lends for non-agricultural purposes, to rural businesses not closely related to agricultural production and to finance a rural lifestyle of country estates, weekend getaways, and hunting preserves. Third, as the FCS has consolidated, almost all of its loan growth in recent years has flowed to larger, wealthier, and older borrowers, making a mockery of the FCS's legal obligation to serve young, beginning, and small (YBS) farmers.

Lending trends within the FCS are difficult to decipher because of a lack of data — transparency is not an FCS virtue. Fortunately, the Farm Credit Administration (FCA), the FCS's regulator, has initiated efforts to collect more lending data and to make it available on the FCA website, but much remains to be done. Not only must the FCA collect and publish more detailed FCS lending data, but it must also mandate that individual FCS institutions do the same.

These actions, however, are insufficient, for they will not eliminate the FCS's unfair, taxpayer-subsidized competition against commercial banks and other private-sector lenders nor will they eliminate the FCS's bias toward providing taxpayer-subsidized credit to wealthy rural residents and well-heeled farmers and ranchers. Only complete privatization of the FCS, coupled with recasting the delivery mechanism for the agricultural financing subsidy it now delivers, will solve the problem. That subsidy is approximately \$1 billion annually. Until privatization occurs, the FCA should move aggressively to increase FCS transparency, create a more effective system for receiving and responding to complaints about inappropriate FCS activities, and initiate more aggressive enforcement of the spirit as well as the letter of the Farm Credit Act, the FCS's governing law.

Introduction

The Farm Credit System (FCS) has recovered fully from the financial problems that triggered a taxpayer bailout in 1987. Since then, it has produced stunning profits as it has restored its capital strength. Yet the FCS's original mission no longer exists — it has become mission challenged. Lacking a legitimate mission, it now provides a fortunate few in rural America with taxpayer-subsidized credit.

Chartered in 1916 as the first government-sponsored enterprise (GSE), the FCS was designed to supply credit to farmers and ranchers where branching and lending restrictions prevented commercial banks from fully meeting agriculture's credit needs. Like all GSEs, the FCS was given tax exemptions and other privileges plus the ability to borrow at lower interest rates than private-sector financial firms in return for providing credit to underserved areas of rural America. Since its 1987 bailout, though, the FCS has moved dramatically away from its intended purpose. Increasingly, the FCS focuses on serving larger, wealthier, and older farmers and ranchers and select non-farm borrowers — rural America's fortunate few.

This report will address the changes that have taken place within the FCS and outline what should be done to rectify the FCS problem. The first chapter summarizes the history of the FCS since the 1987 bailout, drawing in part on reports on the FCS the author published in 1990 and 1999. The second chapter explains and quantifies how the FCS is drifting away from its original mission as its member associations have consolidated and grown. Fewer and fewer FCS associations are locally owned and managed. The biggest associations are multibillion-dollar institutions serving several states. That increasingly will become the case as consolidation eventually shrinks the FCS to 20 or fewer associations and just one or two Farm Credit Banks (FCB) serving those associations. The far more numerous commercial banks have become the primary source of credit for smaller farming and ranching operations as the FCS uses its tax and credit cost advantages to compete unfairly against all private-sector lenders for larger rural customers.

The third chapter concludes by outlining what can be done to fix the FCS problem. The long-term solution is to fully privatize the FCS. The first section of this chapter summarizes a detailed privatization proposal set out in the author's 1999 report on the FCS. The second section presents three initiatives the FCS's regulator, the Farm Credit Administration (FCA), should take to increase the FCS's financial transparency, respond more effectively to complaints about the FCS's abuse of its special privileges, and enforce more aggressively the spirit as well as the letter of the FCS's chartering legislation, the Farm Credit Act.

Table 1: Farm Credit System Condensed Combined Balance Sheet**Farm Credit System
Condensed Combined Balance Sheet**

As of June 30, 2002 (unaudited)

(in millions of dollars)

ASSETS	
Cash	\$ 189
Federal funds sold, repurchase agreements	1,486
Investments:	
Available-for-sale, carried at fair value	13,770
Held-to-maturity, at amortized cost	760
Loans	86,155
Less: allowance for loan losses	<u>(2,019)</u>
Net loans	<u>84,136</u>
Accrued interest receivable on loans	1,101
Premises, equipment, and other assets	1,560
Restricted assets, held by the FCS Insurance Corporation	<u>1,775</u>
Total assets	\$ <u><u>104,777</u></u>
LIABILITIES AND CAPITAL	
Systemwide bonds and master notes	\$ 55,318
Systemwide medium-term notes	8,752
Systemwide discount notes	20,532
Farm Credit investment bonds (issued by FCBs)	469
Financial Assistance Corporation bonds	775
Other liabilities	<u>1,978</u>
Total liabilities	<u>87,824</u>
Protected borrower capital (protected by 1987 legislation)	39
Mandatorily redeemable preferred stock	226
Capital:	
Preferred stock	300
Capital stock and participation certificates	1,492
Restricted capital attributable to the FCS Insurance Corp.	1,775
Accumulated other comprehensive income	19
Surplus, largely unallocated	<u>13,102</u>
Total capital	<u>16,688</u>
Total liabilities and capital	\$ <u><u>104,777</u></u>

1

The Recent History of the Farm Credit System

Although Congress created the FCS in 1916, when it chartered 12 regional federal land banks, the FCS's modern history commenced in 1987 when Congress bailed it out.¹ This bailout saved the FCS as many farmers defaulted on their loans following the bursting of a farmland bubble that the FCS itself had inflated in the 1970s through excessively low interest rates and reckless lending practices.²

The 1987 bailout legislation created the Farm Credit System Financial Assistance Corporation. It was authorized to issue up to \$4 billion of *taxpayer-backed* bonds to provide capital assistance to FCS institutions financially weakened by losses arising from collapsing farmland prices. Bonds totaling \$1.261 billion were issued, with 15-year maturities. At the end of 2001, \$775 million of these bonds were still outstanding; they will mature in 2003 and 2005. FCS institutions are responsible for paying off the bonds and the interest on them, including interest the U.S. Treasury advanced during the first 10 years the bonds were outstanding. However, the FCS is not obligated to pay interest to the Treasury on the interest advances it made — that cost has been borne by taxpayers.

Growth and consolidation trends within the FCS

The 1987 bailout stabilized the FCS sufficiently enough to enable it to slowly regain its financial health. Today, the FCS is strong financially — as **Table 1** (*opposite page*) shows, the FCS had \$16.7 billion of capital on June 30, 2002, giving it a 15.9 percent capital ratio. It reported pre-tax profits of almost \$1 billion during the first half of 2002. This strength has enabled the FCS to use its tax and borrowing-cost advantages to regain some of the market share that it lost during the 1980s. That subsidy is approximately \$1 billion annually — \$400 million in taxes the FCS's real-estate lenders do not pay and an estimated \$600 million in reduced funding costs by virtue of the FCS's GSE status.³

Figure 1 (*see page 8*) shows market share trends in farm credit since 1970, while **Figure 2** (*see page 8*) plots the growth of FCS loans and its capital ratio. **Figure 3** (*see page 9*) shows the steady

¹ The Agricultural Credit Act of 1987 was signed into law on January 6, 1988.

² The FCS's pre-1988 history is discussed in depth in two earlier reports by the author: *The Farm Credit System: Reckless Past, Doubtful Future* (1999) and *The Farm Credit System: Reckless Lender to Rural America* (1990, with Vicki Vanderhoff).

³ FCS borrowings averaged \$79 billion in 2001. Assuming a .75 percent funding-cost advantage, the FCS funded its balance sheet in 2001 for \$590 million less than a comparable private-sector financial firm could have funded itself.

growth in the FCS's pre-tax earnings and the recent decline in its effective tax rate. Much less well known than its financial recovery and market-share growth is the tremendous consolidation and restructuring that has taken place within the FCS since the 1987 bailout. **Figure 4** (*see page 9*) plots the decline in the total number of associations since the 1987 bailout. Since then, the FCS has largely transformed itself into a set of Agricultural Credit Associations (ACA) that combine the long-term mortgage lending activities of Federal Land Credit Associations (FLCA) and Federal Land Bank Associations (FLBA) with the short- and medium-term lending of Production Credit Associations (PCA). FCS associations of all types borrow funds to lend from the regional FCB to which they belong. FCBs also exercise some lending oversight over their member associations.

The ACA has rapidly emerged as the organizational model of choice within the FCS because of the superior tax advantage this model recently gained when the IRS blessed the ACA "parent" form of organization. Under this model, an ACA owns a tax-exempt FLCA and a taxable PCA. All of the association's personnel and operating activities are located in the parent ACA, but its loans are owned by the subsidiary FLCA and PCA. The ACA then directs any lending secured by real estate, including even short-term loans formerly made by PCAs, into the FLCA while the ACA's remaining lending goes to the PCA. Not surprisingly, the FCS's tax liability, as a percentage of income, has dropped dramatically in recent years as the ACAs minimize the taxable income of their subsidiary PCAs. The solid line in **Figure 3** illustrates this phenomenon. As the FCS's Quarterly Information Statement for June 30, 2002, noted on page 9, "lower effective tax rates [for the first half of 2002] reflected the restructurings of ACAs [into parent ACAs], which have resulted in a lower level of income earned at taxable [FCS] institutions." Adding insult to injury, the ACAs successfully sought refunds on past taxes paid, plus interest, totaling at least \$363 million. The net result — the FCS paid no income tax in 2001.

Where the FCS is headed

Consolidation within the FCS will continue rapidly as the ACA becomes the sole type of FCS association. By June 30, 2002, ACAs already held 93 percent of the total assets of FCS associations. The number of FCS associations dropped from 203 at the end of 1997 to 133 at the end of 2000 and to 104 in October 2002. The average and median sizes of FCS associations have tripled since the end of 1997.

On June 30, 2002, the average asset size of an FCS association was \$605 million and the median asset size was \$324 million. The 14 largest FCS associations, each with assets exceeding \$1 billion, collectively held 53 percent of all FCS association assets. The average size of the 14 associations was \$2.45 billion. In contrast, the average size of the 7,834 commercial banks with less than \$10 billion of assets on that date was \$250 million and the median size of those banks was \$86 million.

The salaries of FCS association and FCB presidents have kept pace with the growth of FCS institutions. For the first time in 2001, a president's salary topped \$1 million, reaching \$1,054,000. Another bank president broke the \$500,000 mark while the salaries of a third bank president and four association presidents fell in the \$400,000 to \$500,000 range. For 16 presidents who were among the 20 highest-paid FCS presidents in 2000 and 2001, their 2001 compensation was 14.4 percent higher than their 2000 compensation, a far greater increase than the rate of inflation.

The total number of associations could drop to 50 or fewer by the end of 2005 and to 20 or fewer by 2010. Most would exceed \$1 billion in assets and some could approach \$10 billion in assets. No longer will the typical FCS association be a local institution run by farmer-directors with intimate knowledge of local agricultural conditions. Instead, it will serve all of one state or even several states and will be run by professional managers headquartered some distance from the markets they serve. Even today, three associations (FCS of America, FCS of Mid-America and Northwest FCS) serve all or part of 15 states. The quaint notion that the FCS consists of locally owned associations run by a board of farmers and ranchers has become a fiction.

The consolidation of the FCS at the association level has led to consolidation among the FCBs. The 1987 bailout legislation created 12 FCBs that by the end of 1995 had consolidated into seven FCBs, including CoBank which serves eight Northeastern states as an FCB in addition to serving as the exclusive FCS lender to agricultural cooperatives throughout the United States. That number will soon shrink to five and could dwindle to one or two by 2010.

Figure 1

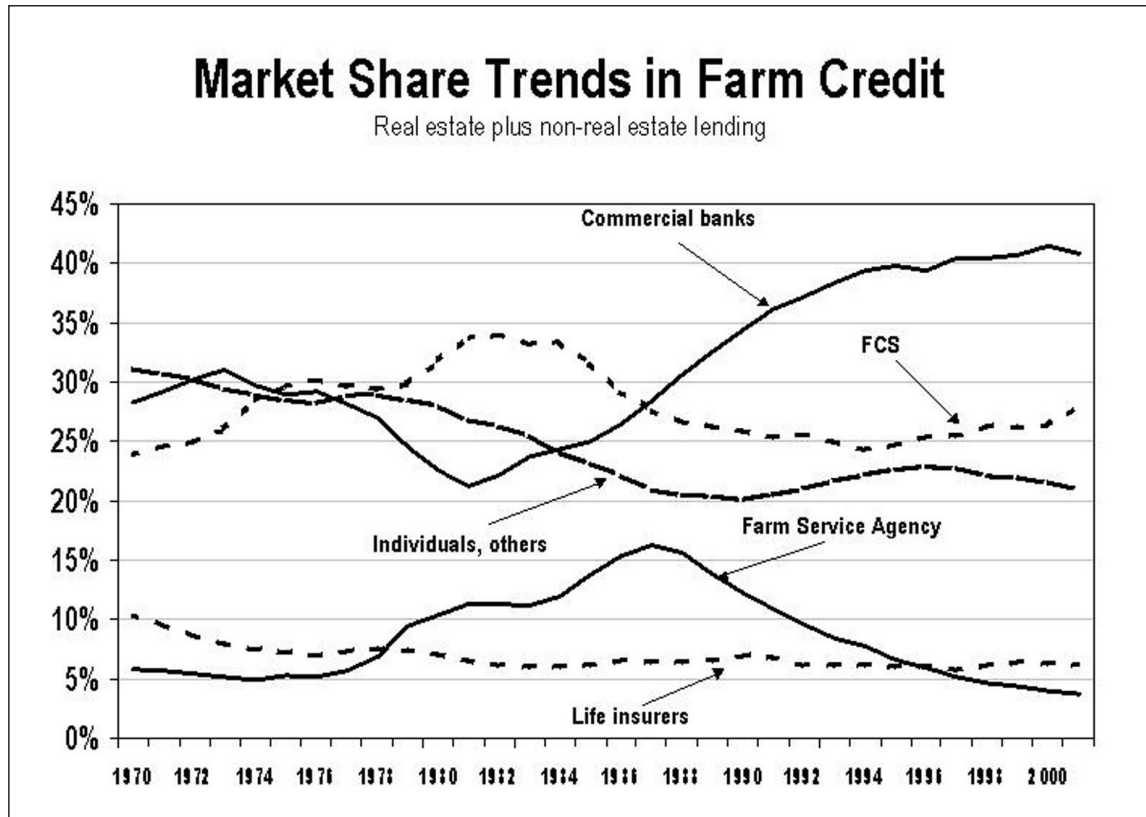


Figure 2

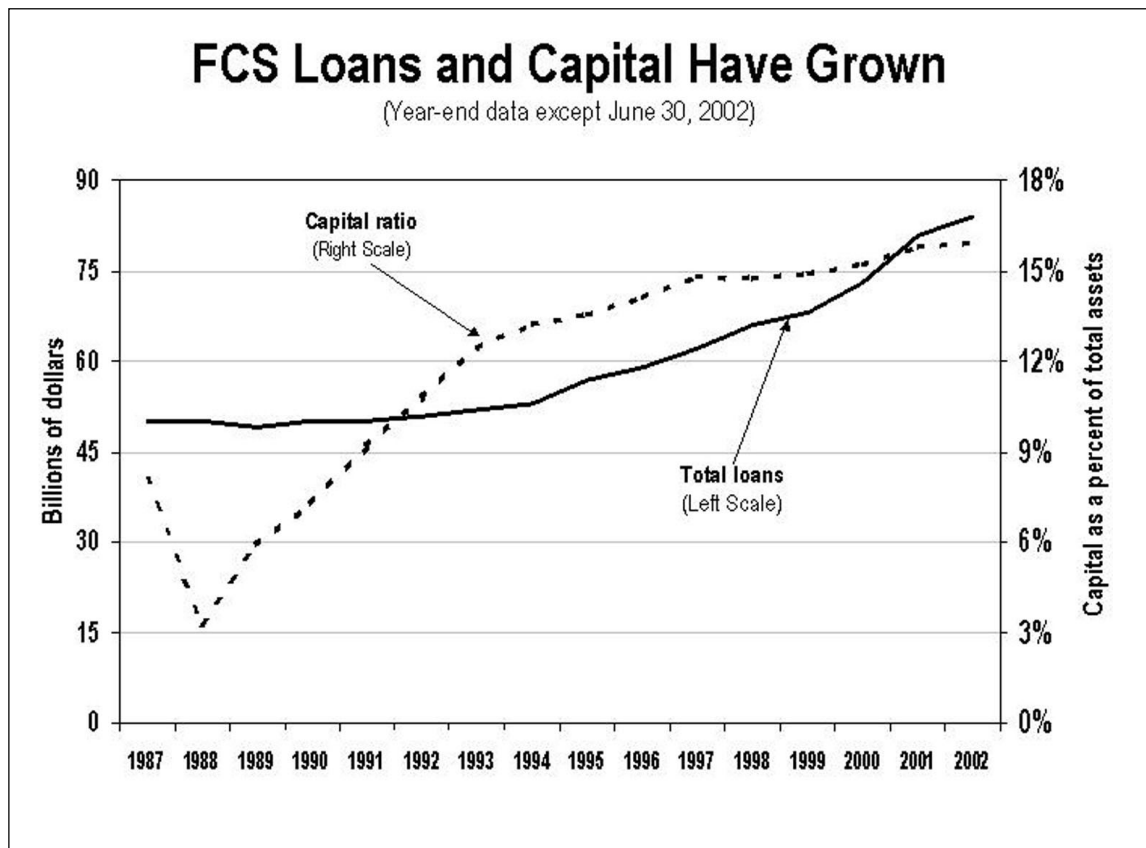


Figure 3

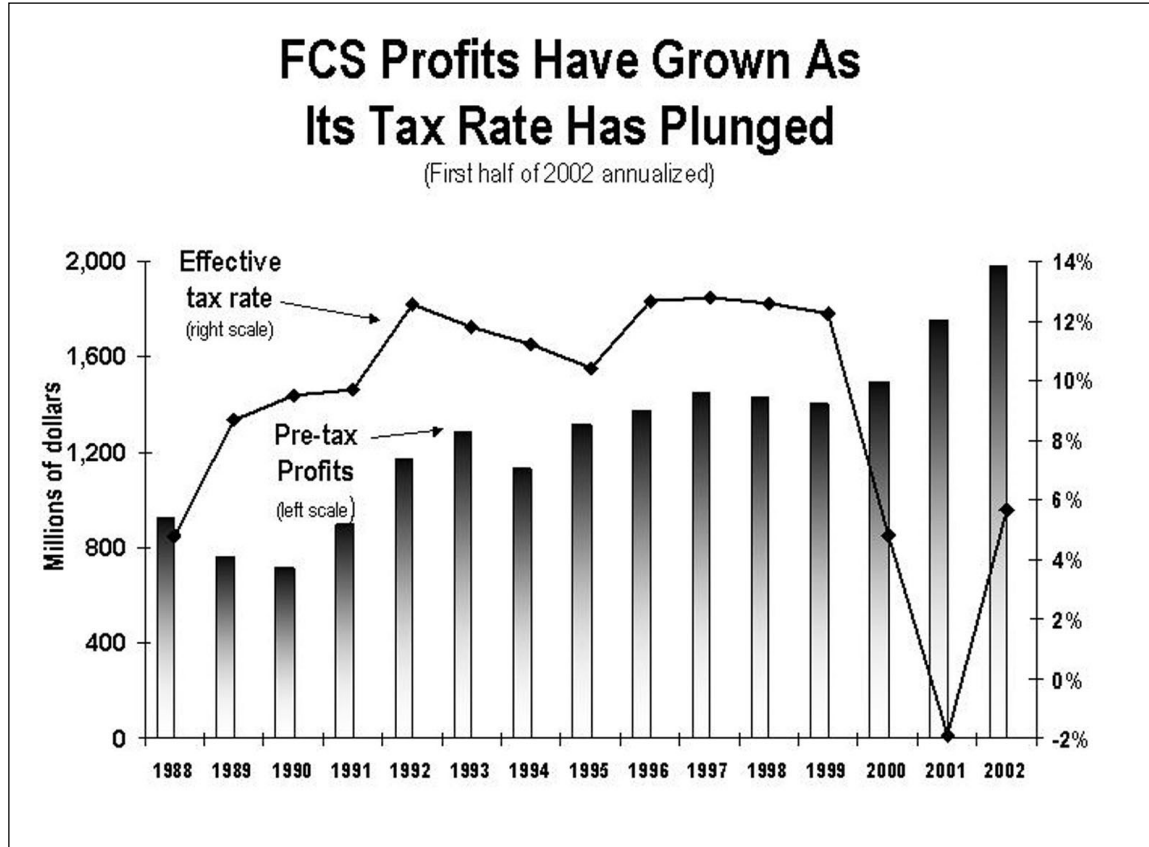
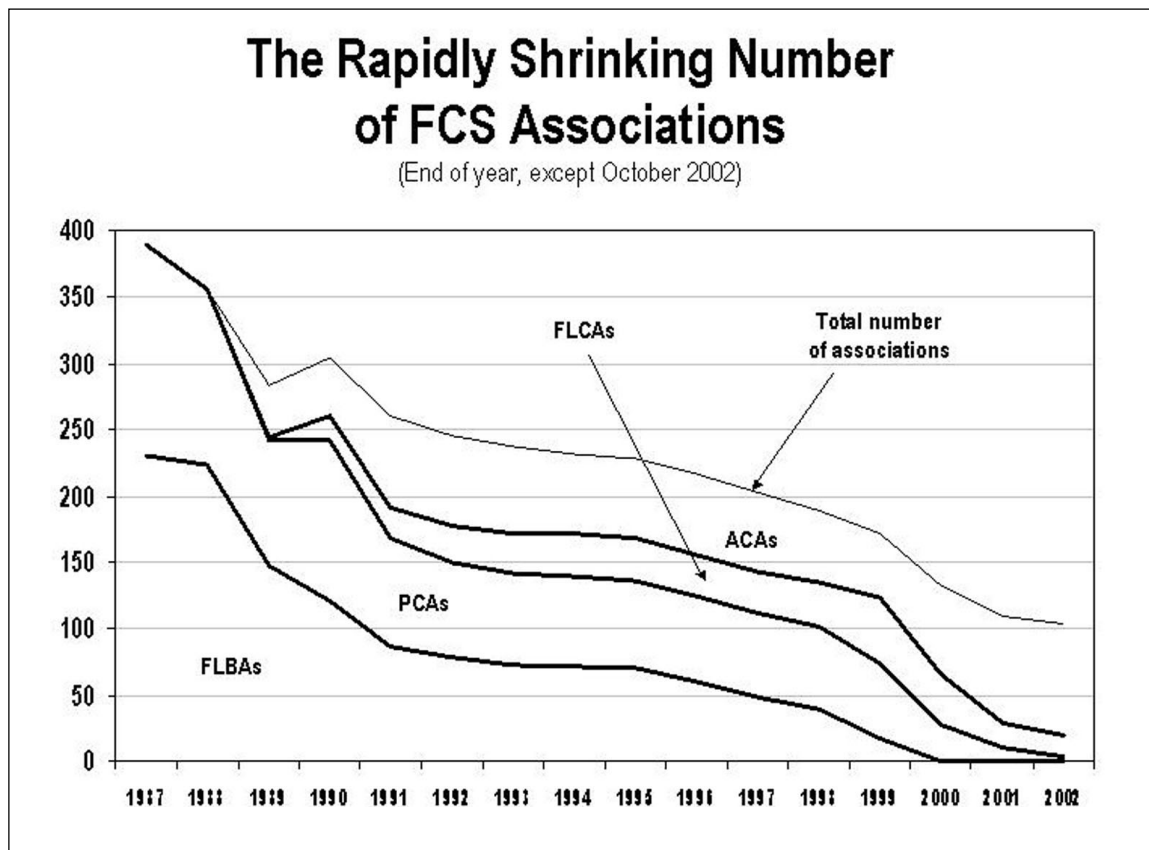


Figure 4



2

The Farm Credit System Has Abandoned Its Mission as It Consolidates and Grows

The FCS has abandoned its mission as it consolidates into larger associations headquartered scores or hundreds of miles from the farmers and ranchers they serve. As FCS associations grow, the traditional notion of a cooperative that is member-run for the benefit of members gives way to one administered by hired managers intent on building GSE empires. Empire building has led to mission abandonment and a focus on larger borrowers, at the expense of serving YBS farmers, the little guys of American agriculture.

How consolidation triggers mission abandonment

As FCS associations consolidate, the now larger associations direct more of their marketing efforts toward making bigger, more profitable loans to larger farming and ranching operations. Larger customers can be served efficiently from more distant offices, enabling the association to close smaller offices better positioned to serve smaller farming operations. In this way, the FCS is steadily moving away from serving those it was designed to serve — farmers and ranchers operating in areas not served by commercial banks and other private-sector lenders. Fortunately, the far more numerous commercial banks stand ready to meet those credit needs, using Farm Service Agency loan guarantees when appropriate.

The FCS's Annual Information Statement for 2001, on page 36, illustrates the FCS commitment to large borrowers. At the end of 2001, just 2.8 percent of the FCS loans then outstanding — all over \$500,000 in size — accounted for 51.3 percent of total FCS lending. Assuming all FCS loans to cooperatives and to finance international trade were over \$1 million, then 25 percent of the balance of FCS loans outstanding exceeded \$1 million. The FCS's focus on larger borrowers would be even more evident if its loans were aggregated by borrower, a point discussed below.

Abandoning the little guy — America's YBS farmers and ranchers

FCA annual reports have long touted the FCS's commitment to serve young, beginning, and small (YBS) farmers. Actually, this is a commitment Congress imposed on the FCS in 1980 (see 12 U.S.C. Sec. 2207). Each FCS association is required to "prepare a program for furnishing sound and constructive credit and related services to young, beginning, and small farmers and ranchers." In 1998, the FCA launched a three-year program to implement new YBS reporting requirements "to obtain data that better represents [FCS] service to YBS borrowers."⁴

⁴ Farm Credit Administration, "Accountability Report Fiscal Year 1999," pg. 35.

The new reporting system is flawed in two fundamental respects. First, loans and loan commitments are not aggregated by borrower. For example, a borrower who has four separate FCS loans and loan commitments outstanding is counted four times, not once. Second, a small farmer (one who generates less than \$250,000 annually in gross agricultural sales) who is under 36 (35 is the cutoff age for young farmers) and who has been farming or ranching for 10 years or less (the definition of beginning farmer) gets counted three times — once under each of the three categories. Hence, FCS data seriously overstate the FCS's volume of YBS lending.

Because it took three years to implement the new reporting system, it is difficult to compare the FCS's YBS lending in recent years. Nonetheless, a comparison of YBS lending data as of December 31, 1998, with that of December 31, 2001, reveals some interesting insights, particularly after taking into account the fact that the 1998 data, to use the FCA's wording, "likely underrepresent [FCS] YBS lending."⁵ The reported growth in lending to young farmers (39.3 percent over the three years) and beginning farmers (39.9 percent over the three years) may seem impressive. However, due to the likely underreporting of YBS data in 1998, the growth of lending to young and beginning farmers over that three-year period may not have matched the 32.8 percent growth in overall FCS lending to farmers and ranchers over that period.

Large farmers and large loans account for almost all FCS loan growth since 1998

Many young and beginning farmers are also small farmers. Hence, these farmers are being double- and triple-counted in the FCS reporting system — as young **and** beginning **and** small farmers. It is doubtful that the FCS's genuine YBS lending increased significantly from the end of 1998 to the end of 2001, since total lending to small farmers increased just 4.6 percent over that three-year period. That increase accounted for just 5.2 percent of the total increase in FCS loans and loan commitments to farmers and ranchers over that period. In other words, large farmers (those with annual sales over \$250,000) accounted for 94.8 percent of the total FCS loan growth from 1998 to 2001. The claimed increase in YBS lending is further overstated to the extent that a young, beginning, and/or small farmer has the financial backing of an older, well-established farmer, such as a parent or in-law, is in partnership with an older, well-established farmer or rancher, or has a government-guaranteed loan.

Other data for this three-year period show the FCS's decided shift away from YBS lending as the FCS has consolidated into larger associations with fewer offices:

- While the number of reported loans to small farmers was unchanged from the end of 1998 to the end of 2001 (and probably declined due to underreporting in 1998), the number of loans over \$250,000 to non-YBS farmers grew 29 percent.
- More startling, loans and loan commitments over \$250,000 to non-YBS farmers grew from 37 percent of total FCS lending to farmers at the end of 1998 to 50 percent three years later. That loan growth accounted for 89 percent of the total growth in FCS lending to farmers and ranchers over that three-year period. This clearly shows a pattern of lending to large farmers, not small farmers.

⁵ Farm Credit Administration, "Report on the Financial Condition and Performance of the Farm Credit System 1998," pg. 16.

- During the 1998-2001 period, 98.8 percent of the increased amount of loans over \$250,000 went to large farmers; only 1.2 percent of the increase went to “small” farmers.
- The average size loan/loan commitment to non-YBS farmers in the over-\$250,000 category grew from an average of \$662,000 at the end of 1998 to \$915,000 at the end of 2001, a 38 percent growth in average loan size.

If FCS lending was aggregated by borrower, the FCS’s growing emphasis on lending to larger and better capitalized farmers and ranchers would become even more evident.

General Accounting Office knocks YBS lending programs

The General Accounting Office (GAO), Congress’s investigative arm, confirmed the FCS’s disregard for YBS lending in a report, the title of which said it all: *Farm Credit Administration: Oversight of Special Mission to Serve Young, Beginning, and Small Farmers Needs to Be Improved* (GAO-02-304, March 8, 2002). Key conclusions drawn from the GAO report were:

- Slightly less than half of the FCS institutions (14 out of the 30 the GAO reviewed) did not have “some type of specific program or service in place to serve” YBS farmers and ranchers.
- More than two-thirds of the institutions (21 out of 30) did not have “measurable goals for their service to YBS.” Also, goals were not comparable across the institutions with goals.
- Half of the institutions had not made “YBS marketing and outreach efforts.” More than one-third of the institutions (11) “had no formal marketing or outreach efforts to YBS.”
- Most of the 30 institutions “were not conducting demographic studies” to identify potential YBS borrowers.
- Some FCS institutions “did not use any special loan underwriting standards, risk parameters, or risk pools for extending credit to YBS.”

To its credit, in September 2002 the FCA launched a comprehensive review of its YBS loan policies and operations, publishing for a 90-day comment period an “advance notice of proposed rulemaking” regarding its YBS regulations. Not only can the public submit written comments to the FCA, but the FCA plans to hold public hearings around the country to solicit additional public input on the FCS’s YBS activities. One can hope that the FCA will not only receive extensive comments, but will act upon them to improve the FCS’s YBS lending and the transparency of those lending activities.

The types of borrowers the FCS increasingly favors

As the preceding data demonstrates, the FCS is rapidly abandoning its mission to serve the credit-deprived to focus on lending to larger farming operations as well as for non-farm purposes. Many FCS associations are pursuing two types of lending that certainly violate the spirit of the Farm Credit Act, if not the letter of the law. One category of lending encompasses “farm-related” businesses; the other, rural “lifestyle” lending.

The Farm Credit Act authorizes lending to farmers, ranchers, and producers or harvesters of aquatic products, including financing for “basic processing and marketing directly related” to the borrower’s operations and the operations of other “eligible” farmers and ranchers. The Act also authorizes the FCS to lend to “persons furnishing farm-related services to farmers and ranchers directly related to their on-farm operating needs” (see 12 U.S.C. Sec. 2019). What is troubling, in light of the present law, is the degree to which the definition of “farm-related” has been stretched in some recent FCA legal opinions:⁶

- An association can enter “into an alliance with a business that sells financial planning and insurance products and services. The association, which plans to provide [an Internet] hyperlink on its website to connect its visitors to the other business, will earn a small fee for each referral.” The association “will also permit the other business to conduct sales seminars on association premises from time to time” and “will compensate the association for the use of its office space and staff.” (Issued June 12, 2002)
- An FCS association can lend to a publicly owned restaurant chain that “plans to produce, process, and market all the meat and potatoes that it sells in restaurants” and use the remaining loan proceeds to take the company private. (Issued February 14, 2000)
- An association was authorized to “contract with a buying service that enables its farmer members to buy material farm inputs such as fuel, fertilizer, and herbicide at a discount. The association would receive compensation based on the quantity of goods purchased.” The FCA concluded that “a contractual arrangement with a buying service that helps the association’s farmer members reduce their farm expenses is within the authorized consulting services that FCA permits as related services.” (Issued December 23, 1999)
- The FCA told an association that “a trucking firm that hauls farmer-owned and elevator-owned grain under a contract with a grain elevator is a ‘farm-related business’ eligible to receive financing from the association” even though “that business has no direct contractual link to farmers or does not serve farmers and ranchers exclusively.” (Issued October 12, 1999)
- An association asked if it “could finance a business that offers various farm-related services, including custom blending and spreading of fertilizer.” A portion of the loan “would refinance an expense [sic] related to a subsidiary that provides raw material for

⁶ A summary of FCA legal opinions can be found on the FCA website at <http://www.fca.gov/apps/legalopn.nsf>.

the custom-blended fertilizer.” The FCA “concluded that the association could finance all of the customer’s operations . . . even those related to selling goods, because the customer derived more than half of its income from providing farm related services that are directly related to the agricultural production of farmers and ranchers.” (Issued September 10, 1999)

Rural “lifestyle” lending has become an increasingly important source of business for FCS associations, particularly in areas where agriculture has declined and higher-income individuals are purchasing weekend homes, rural getaways, and hunting preserves. Several associations now aggressively advertise that they finance “country homes” to signal that they willing to lend to the rural well-to-do. Not only do FCS loans to finance a rural lifestyle violate the spirit of the Farm Credit Act, but they clearly violate FCA regulations in two regards. The lending objective regulation (12 CFR Sec. 613.3005) states:

It is the objective of [FCS associations] to provide full credit, to the extent of creditworthiness to the full-time bona fide farmer (one whose business is farming, ranching, or producing or harvesting aquatic products); and conservative credit to less than full-time farmers . . . as long as the total credit results in being primarily an agricultural loan. . . . Loans to farmers shall be on an increasingly conservative basis as the emphasis moves away from the full-time bona fide farmer to the point where agricultural needs only will be financed for the applicant whose business is essentially other than farming. Credit shall not be extended where investment in agricultural assets for speculative appreciation is a primary factor. [emphasis supplied]

According to the rural home financing regulation (12 CFR Sec. 613.3030):

Rural homeowner means an individual who resides in a rural area and is not a bona fide farmer, rancher, or producer or harvester of aquatic products. Rural home means a single-family moderately priced dwelling located in a rural area that will be . . . the occupant’s principal residence. Rural area means open country . . . which may include a town or village that has a population of not more than 2,500 persons. . . . Housing values at or below the 75th percentile of values [in the rural area] will be deemed moderately priced.

In 2001, the author researched FCS rural-lifestyle lending in Fauquier County, Virginia, about 50 miles west of Washington, D.C. Fauquier is the center of Washington’s fabled horse country, where the only noise is the roar of Jeeps and Land Rovers carrying Washington’s monied elite to their weekend getaways. Listed below are six loans that do not pass muster under the FCA regulations cited above. The homes on these properties certainly far exceed the value of moderately priced housing in Fauquier County.

Based on a conversation the author had with one FCS officer, the loans on these properties were based on the notion that they had the “potential” to be working farms. Leaving aside the question of that potential, the FCA regulations clearly do not authorize lending on properties that have a potential for agricultural production — “full credit” is to be provided only to “full-time bona fide” farmers and to the extent that “agricultural needs only will be financed.”

- A lovely 50-acre wooded hillside estate, with scant evidence of agricultural activity, whose purchase in 2001 was financed with an \$840,000 first mortgage from the FCS. The property's land value was assessed for tax purposes at \$264,000 while its improvements, principally a fieldstone manse, were valued at \$604,000. In Virginia, property tax assessments are supposed to reasonably approximate market values.
- A 337-acre estate located in a tony area of the county on which a \$1.1 million mortgage was placed in the 1997. The land was assessed for tax purposes at \$265,000 and its improvements for \$671,000. Since FCS loans cannot exceed 85 percent of the appraised value of the real estate, the market value of this estate undoubtedly is much higher. Some of the property lies behind a low ridge, hiding the manor house, but not much agricultural activity was evident.
- A more modest 49-acre estate with several cattle grazing against the backdrop of a barn and a country home. The land carried a \$243,000 tax valuation while its improvements were valued at \$252,000; a \$200,000 FCS mortgage was placed on the property in 1997. From all appearances the house on the property appears to be much more substantial than the moderately priced single-family rural homes Congress has authorized the FCS to finance.
- A 130-acre commercial agricultural operation that appears to focus on horses. The land carried a \$756,000 tax appraisal while the improvements (principally barns and silos) were valued for tax purposes at \$459,000. FCS granted a \$455,000 mortgage on this property in 1997. Interestingly, the owners of this horse farm live nearby on a hidden estate, with a very impressive entrance, that is valued for tax purposes at \$1.28 million. Arguably this operation qualifies as an agricultural activity, but its owners obviously are quite wealthy, which does not conform with the spirit of the Farm Credit Act.
- A 121-acre cornfield purchased in 2001 by a local property developer. Financed with a \$153,000 FCS loan, the property carried a \$331,000 tax value on its land and a \$43,000 valuation on a dilapidated farmhouse. Given the relatively new homes already standing on the edge of this property and its location adjacent to a lovely county park, this land almost certainly is slated for development as a residential subdivision. If the purchaser of this land intends to subdivide it, then the FCS loan clearly violates the prohibition on FCS lending for speculative purposes.
- A 41-acre property on which the FCS granted a \$285,000 mortgage in 1997. The land carried a \$183,000 tax valuation and \$224,000 on its improvements, which appeared to consist of a large single-family residence. The house hardly appeared to be the "moderate-priced" dwelling the FCS is authorized to finance.

Two particularly egregious FCS loans have surfaced recently that illustrate how far the FCS has lost its way. According to a lawsuit filed in October 2002, several FCS associations participated in a \$499 million loan to Bernie Ebbers, of WorldCom fame, to finance his 1999 purchase of 460,000 acres of timberland in Alabama, Tennessee, and Mississippi.⁷ *Forbes* magazine estimated Ebbers' net worth in 1999 at \$1.4 billion. Reportedly the FCS associations funded \$30 million of the Ebbers loan. By no stretch of the imagination did Congress create the FCS to provide taxpayer-subsidized credit to billionaires.

⁷ *The Washington Post*, October 15, 2002; *Bloomberg News*, October 15, 2002.

In April 2002, Carolina Farm Credit, ACA, lent \$4.5 million to Fox Den Development Company, L.L.C. The loan is secured by 400 acres near Statesville, North Carolina, consisting of “an exciting 18-hole championship golf course” and contiguous, developable land. According to the Fox Den website, “luxurious, but surprisingly affordable homes” will be built on this property. The deed of trust for this loan provides that this property can collateralize up to \$8 million in loans to Fox Den. This loan clearly violates the Farm Credit Act and the FCA’s lending regulations. Hopefully, the FCA will investigate the propriety of this loan.

In the almost five years that the author has been researching and reporting regularly on the FCS, he has received scores of calls, letters, and emails from bankers across the country reporting on FCS lending that contravenes the Farm Credit Act. These questionable loans have financed hunting preserves, weekend getaways such those in Fauquier County, golf courses, large lumber tracts owned by billionaires and nationals of another country, motels, apartments, trucks not used in farming operations, and businesses not closely related to farming or ranching. Clearly, Congress never intended nor envisioned that the FCS would provide this type of financing.

3

What to Do about the Farm Credit System

The circumstances that led Congress to create 12 regional federal land banks in 1916 and to authorize PCAs in 1933 disappeared long ago. No longer are commercial banks barred by branching laws and lending restrictions from meeting the full range of farmers' and ranchers' credit needs. America's 9,500 banks and thrifts compete aggressively in meeting the credit and banking needs of non-farm residents and businesses throughout rural America. Numerous non-bank lenders, some operating on a national basis, complement commercial bank lending in rural America. Federal loan and loan guarantee programs enable bankers to provide credit to borrowers that FCS associations increasingly ignore. There is no shortage today of reasonably priced credit in rural America. The competition among lenders to provide credit in rural America is robust. Why should a "fortunate few" borrowers, many of whom are quite well off, receive government-subsidized credit?

The permanent solution to the FCS problem — full privatization

The author's 1999 report on the FCS explains how the FCS could be privatized while redirecting the farm finance subsidy it now delivers. Three primary forces drive privatization. First, the farm finance subsidy delivered through the FCS increasingly goes to larger, older, wealthier farmers and ranchers, the very people who should *not* be subsidized. Second, as the FCS continues to consolidate, the FCA may lack the regulatory vigor to regulate the largest FCS institutions, just as the Office of Federal Housing Enterprise Oversight has experienced great difficulty regulating Fannie Mae and Freddie Mac. Third, it has been decades since the FCS has met farm finance needs that otherwise would go unmet. There simply is no need for an FCS today, given the varied size of commercial banks and the intense competition among banks and other private-sector lenders. American agriculture and rural America would be better off without the FCS.

The author's 1999 FCS report proposed that the \$1 billion-plus annual farm finance subsidy now delivered through the FCS be targeted toward those farmers — the struggling middle — most in need. The most efficient way to deliver this subsidy would be through a tax credit that eligible farmers would receive **regardless of whether they borrow from the FCS, a bank, insurance company, or another source of credit**. Those farmers eligible to receive the subsidy could claim it as a credit against their individual income tax liability. (The report provided a detailed illustration of the operation of this tax credit.)

The 1999 report also outlined three legislative changes that would encourage individual FCS associations to privatize themselves once they no longer delivered the farm finance subsidy:

- Amend the Farm Credit Act to permit an FCS association terminating its FCS status to retain all of its capital.
- Permit a departing institution to retain its existing GSE-status borrowings until they mature.

- Permit FCS managers and directors to share in the ownership allocation of the substantial retained earnings or surplus that most FCS lenders have accumulated.

In effect, FCS lenders would undergo mutual-to-stock conversions comparable to the conversions that hundreds of mutually owned S&Ls and savings banks have undertaken successfully.

Transition to privatization: focus on mission

Until the FCS is fully privatized, there is much the FCA can do to refocus the FCS on its mission while also reducing the unfair, taxpayer-subsidized competition in which the FCS now engages. FCA actions should fall into three categories:

Require FCS institutions to disclose much more data on their websites. Sunlight is a powerful antiseptic, which is why Congress has just required publicly held corporations to disclose more information about their finances and operations, in a timelier manner.⁸ Because of the tax and funding-cost advantages Congress has bestowed on GSEs, they must be subject to even more stringent disclosure standards. Treasury Under Secretary Peter Fisher recently recommended, in testimony before a congressional committee, that all GSEs, including the FCS, meet the financial statement filing requirements the Securities and Exchange Commission now requires of publicly held companies.⁹

Publicly available financial disclosures by FCS institutions should include call reports filed with the FCA, quarterly financial reports distributed to member-borrowers, and their Association Annual Meeting Information Statements, which are comparable to proxy statements. Because the Internet has quickly become a powerful, efficient tool for disseminating financial and business information of all types, these disclosures should be posted on an institution's website the day they are sent to the FCA or to members. Most FCS associations and all of the FCBs already have websites, and those that do not could easily set them up. Therefore, it would be quite reasonable for the FCA to mandate that FCS associations and FCBs post a wide variety of financial and operational data on the publicly accessible portions of their websites.

In light of the FCS lending abuses discussed in the previous chapter, each association should post on its website quarterly detailed information about its outstanding loans and new loans that can be reconciled with its call report. Presently, FCS associations provide no breakdown of the types of loans they make in the publicly available call reports they file with the FCA. This lack of lending data contrasts sharply with commercial banks, which report their loans across 21 categories.

The FCA's Loan Account Reporting System, or LARS, is now used to collect 29 data items on every loan FCS associations make. Unfortunately, LARS data is reported only once a year in association and FCB annual reports that are not readily available to the public. LARS should be expanded to provide for a readily available, detailed categorization of an association's lending

⁸ The Sarbanes-Oxley Act of 2002.

⁹ Testimony of Peter R. Fisher, Under Secretary for Domestic Finance, U.S. Department of the Treasury, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, July 16, 2002.

activities, particularly loans made to businesses and to individuals who are not “bona fide” farmers and ranchers. LARS also should have the capability to aggregate all loans to one borrower to present a more accurate picture of FCS lending by the amount lent. Presently, LARS overstates the breadth of FCS lending by not grouping loans by borrower. The FCA could protect borrower identities by not providing LARS data to the public if the requested data would encompass just one or two borrowers.¹⁰ To ensure accuracy, FCA examiners should always review the accuracy of LARS data during association examinations.

Create a more effective system for receiving and responding to complaints about inappropriate FCS activities. A major difficulty in ensuring public oversight of FCS lending activities has been the lack of a centralized, uniform basis for registering complaints with the FCA. On August 6, 2002, the FCA announced that it would study creating an ombudsman position within the FCA to serve as a single point of contact for public inquiries and complaints. The FCA should create an ombudsman position, or something quite similar to it, for just that purpose. The public should be able to file complaints by all means possible — letter mail, email, over the Internet, or by telephone. Of course, a complaint center will serve its purpose well only if it sheds plenty of light on valid complaints. Complaints that have been substantiated through an investigation should be posted on the FCA website, along with a statement as to how the complaint was resolved.

Initiate more aggressive enforcement of the spirit as well as the letter of the Farm Credit Act. Laws are only as strong as their enforcement. Too often the FCA Board and staff have been far too lenient in enforcing the spirit as well as the letter of the Farm Credit Act. This reflects the classic problem of “regulatory capture,” where the regulator caters more to the concerns of those it regulates than to its public obligations. This condition reflects, to some extent, the fact that many FCA board members and staff have come to the FCA from within the FCS. It is understandable that the FCA would draw upon the FCS to meet some of its staffing needs. However, those joining the FCA must rigorously set aside their former loyalties and embrace wholeheartedly the FCA’s obligation to ensure that the FCS fulfills its public mission, rather than aggrandizing it.

The time is now

Congress did not create the FCS to serve wealthier farmers and better-off rural residents with little, if any, connection to agriculture — that was not Congress’s “original intent” for the FCS. And yet that is how the FCS has evolved, particularly as it has consolidated into larger associations focused on serving larger, wealthier customers. Whatever their size, the FCA should force FCS associations to focus on meeting their congressionally mandated mission, specifically in serving YBS farmers. Perhaps the FCA could reinforce this message by turning down some association mergers and breaking up some of the mega-associations into smaller associations. That would help to return the FCS to its roots.

If the FCA fails to act now, the FCS will continue its unrestricted growth into more and more non-farm lending, more country estate financing, and activities that could endanger the safety-

¹⁰ The IRS and the Bureau of the Census use this technique even as they provide highly detailed tax and census data to the public.

and-soundness of the FCS. The current practice of showering a rural elite with taxpayer-subsidized credit must be stopped. To these ends, the FCA should revise its lending regulations, specifically the “lending objective” and “rural home financing” regulations cited above to more clearly restrict FCS lending to the financing of agricultural land actually in production and housing that truly is moderately priced. No longer should the FCS finance real estate that has the “potential” to be farmed or ranched or properties that generate just a few thousand dollars annually in gross agricultural sales. At the same time, the definition of a “farm related business” should be narrowed.

Conclusion

The FCS no longer serves a valid mission. Since its 1987 taxpayer bailout, the FCS has strayed further and further from a mission that has shriveled as rural residents everywhere have gained great access to private-sector credit from many sources. As the FCS strays, it increasingly distorts competition within the agricultural credit markets, to no one's benefit except that of highly paid FCS managers and larger, wealthier borrowers blessed with FCS financing.

The time has come for Congress and the American public to recognize that the FCS now exists only for the "fortunate few." Since that was never Congress's intent, nor in the best interest of the public, the FCS should be privatized. Given that this will take time, the FCA should move quickly and aggressively to improve the FCS's financial transparency, respond more effectively to the FCS's abuse of its special privileges, and enforce more aggressively the spirit as well as the letter of the Farm Credit Act.

Glossary of Terms

Agricultural Credit Association (ACA) ACAs are FCS associations that enjoy the full range of FCS lending powers — short-, medium- and long-term lending secured by real estate or non-real estate assets or made on an unsecured basis — except lending to agricultural cooperatives and to finance international trade. ACAs are subject to federal income taxation.

ACA “parent” association An ACA “parent” association is an ACA that has chartered a subsidiary PCA, which is taxable, and a subsidiary FLCA, which is not subject to federal income taxation. This structure permits the ACA to minimize its tax liabilities.

Call report A call report is a financial report every FCS association and bank files quarterly with the FCA. Each report provides an income statement, balance sheet, and supporting financial schedules. Individual call reports can be downloaded from the FCA website, at <http://reports.fca.gov/CRS/InstitutionDataIntro.asp>.

Farm Credit Administration (FCA) The FCA is the regulator of the FCS as well as another GSE, Farmer Mac (officially the Federal Agricultural Mortgage Association). The FCA is an independent agency within the federal government run by a three-member board appointed by the President and confirmed by the U.S. Senate.

Farm Credit Bank (FCB) FCBs provide funding and some safety-and-soundness oversight over member FCS associations. There presently are seven FCBs, but that number will shrink to five during 2003. One of the FCBs is CoBank (technically an Agricultural Credit Bank), which has the exclusive right within the FCS to lend to agricultural cooperatives and to finance U.S. agricultural exports. FCBs obtain their funding from the Federal Farm Credit Banks Funding Corporation, which raises its funds on Wall Street.

Farm Credit System (FCS) The FCS consists of the FCS associations and FCBs. Farmer Mac also is a component of the FCS.

Federal Land Bank Association (FLBA) FLBAs were agents making long-term real estate loans on behalf of the FCB to which they belonged. All FLBAs have been converted into FLCAs.

Federal Land Credit Association (FLCA) FLCAs make long-term real estate loans and carry those loans as an asset on their own balance sheets.

General Accounting Office (GAO) The GAO is the auditing and investigative arm of the U.S. Congress. Individual members of Congress as well as congressional committees routinely ask the GAO to investigate the programs and activities of federal agencies such as the FCS and the FCA.

Government Sponsored Enterprise (GSE) A GSE is a lending enterprise chartered by Congress to meet a specific credit need. In addition to the FCS and Farmer Mac, there are three housing GSEs — Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System — and Sallie Mae, the Student Loan Marketing Association. Sallie Mae is in the process of being privatized.

Loan Account Reporting System (LARS) LARS is a data-collection system within the FCS that gathers information on every FCS loan. While LARS data is aggregated for certain financial reporting purposes, LARS data is not available to the general public.

Production Credit Association (PCA) Congress authorized PCAs in 1933 to provide short- and medium-term credit to farmers and ranchers to finance seasonal operating needs, such as buying seed and fertilizer, and farm equipment. The last two stand-alone PCAs will be merged out of existence on January 1, 2003.

Young, Beginning, and Small (YBS) farmers and ranchers Congress mandated that the FCS make a special effort to meet the credit needs of YBS farmers and ranchers. The FCA has defined a young farmer as someone 35 or younger, a beginning farmer as someone with no more than 10 years of farming experience, and a small farmer as someone with less than \$250,000 in annual gross agricultural sales.

About the Author

Bert Ely has specialized in deposit insurance and banking structure issues since 1981. As the S&L situation worsened, in 1986 he became one of the first persons to publicly predict a taxpayer bailout of the FSLIC. In 1991, Mr. Ely was the first person to correctly predict the non-crisis in commercial banking. In 1990, he issued his report on the 1980s' ag crisis, *The Farm Credit System: Reckless Lender to Rural America*. The sequel to that report, *The Farm Credit System: Reckless Past, Doubtful Future*, was published in 1999.

On an ongoing basis, Mr. Ely monitors conditions in the banking and S&L industries, the politics of the credit allocation process, and monetary policy. He also writes the monthly *Farm Credit Watch*, which is distributed by the American Bankers Association. He has helped to draft legislation to enact the cross-guarantee concept for privatizing banking regulation and its related deposit insurance risk. Mr. Ely has testified on numerous occasions before congressional committees on banking issues and he often speaks on these matters to bankers and others.

Mr. Ely first established his consulting practice in 1972. Before that, he was the chief financial officer of a public company, a consultant with Touche, Ross & Company, and an auditor with Ernst & Ernst. He received his MBA from the Harvard Business School in 1968 and his Bachelor's degree in economics in 1964 from Case Western Reserve University.