The Farm Credit System
America's Least Known GSE

12-1999

A Brief History of the Farm Credit System

The Farm Credit System (FCS) is America's first Government Sponsored Enterprise (GSE). It was created in 1916 when Congress chartered 12 regional farm credit banks. Congress wanted to increase the ability of farmers to obtain credit to finance the purchase of farms and ranches. In 1923 Congress created 12 regional Federal Intermediate Credit Banks (FICBs) to try to provide farmers and ranchers with short and intermediate term credit. The FICBs were authorized to lend to commercial banks that in turn would provide credit to farmers and ranchers. With the onset of the Depression, and the resulting turmoil in the banking industry, the idea did not work. In 1933 Congress authorized the creation of Production Credit Associations to lend money directly to farmers and ranchers. The FCS remains the only GSE that has direct, retail lending authorities.

Over the years the FCS has received additional authorities, most notably in 1971 when lending to farm businesses was authorized. Significant changes to FCS lending practices were also authorized by the 1971 legislation, including a major liberalization of its real estate lending limit, raising the limit from 65% of *normal, income producing value* to 85% of *current market value*.

The FCS was a major player in the agricultural credit market of the 1970s and 1980s. From 1971 to 1980 FCS farm and ranch lending quadrupled, rising from $13.2 billion in 1971 to $53 billion by the end of 1980. By 1982 the FCS had over $64.5 billion in loans outstanding to American farmers and ranchers (34% of the total agricultural credit market). Farmers and ranchers took advantage of low real interest rates and borrowed heavily from all lenders. The FCS offered the lowest rates in town because the interest rates it charged averaged in the lower cost debt it had sold in the 1960s. When interest rates jumped in the early 1980s, farm real estate values crashed and the FCS found itself burdened by a high number of non-performing loans and an interest cost structure that could not be sustained. Congress responded by passing emergency legislation in 1985 and 1986 to help but both attempts failed to restore the FCS to financial health.

During this period the FCS was tearing itself apart, because each FCS institution was (and continues to be) jointly and severally liable for the losses of the other FCS institutions. This system of interlocking liability quickly broke down as healthy FCS institutions balked at sending their capital to bailout another, ailing FCS institution. It began to appear that the FCS would default on its GSE debt. Since the beginning of the FCS, farmers and ranchers that borrowed from the system had to buy FCS stock in amounts up to 10% of their total borrowings. They became worried that they would lose their stock investment. Finally, in 1987, Congress authorized a $4 billion cash infusion rescue package for the FCS. Specifically, the FCS was authorized to sell up to $4 billion in taxpayer-backed bonds to assist troubled FCS institutions.

The 1987 legislation established two new precedents about how the federal government responds to the financial collapse of a GSE. First, the legislation protected all of the bondholders by making what had been an implied federal warranty on Farm Credit bonds an explicit federal

guaranty since the Treasury now backed them with a $4 billion commitment. Second, the legislation protected all of the FCS stockholder/borrowers from any loss on FCS stock. In addition, the legislation reduced the required stock purchase that FCS borrowers had to make from 10% (or more in some cases) to the lesser of $1,000 or 2% of the amount borrowed.

Ultimately, the Farm Credit System Financial Assistance Corporation sold $1.26 billion in Treasury backed bonds. The FCS is on track to repay all of the emergency borrowings. The 1987 legislation also required the FCS to establish an insurance fund to guard against future losses, and today that fund has an uncommitted balance of $1.35 billion. In addition, minimum capital guidelines for FCS institutions were established. During this period of wrenching restructuring, the FCS shrank its farm loans by nearly $30 billion over 9 years. The organization contracted rapidly with thirteen banks for cooperatives consolidating into one and twelve farm credit banks consolidating into six. At the retail lending level, there has been massive consolidation as well with some 750 associations in 1987 consolidating to less than 190 in 1999.

The Farm Credit System Today

At the end of 1998 the Farm Credit System was an $84.1 billion entity with approximately $48.5 billion in loans to farmers and ranchers, $9.9 billion in loans to domestic cooperatives, $2.3 billion in loans for international transactions, $4.8 billion in loans to rural utilities, $1.4 billion in rural home mortgages and $895 million in undefined other loans. The FCS reported a net profit of $1.25 billion in 1998.

The Farm Credit System is made up of six Farm Credit Banks and one Agricultural Credit Bank. Although each of the seven serves a defined region of the country, there is some regional overlap among them.

The seven banks obtain their funding through the Federal Farm Credit Banks Funding Corporation. The organization raises funds by selling debt instruments of varying maturities in the capital markets to institutional investors. The seven institutions provide funding to 187 retail lending associations and provide some safety and soundness oversight for these associations.

CoBank, the one agricultural credit bank, is headquartered in Denver; as of July 1999 it had $23 billion in assets. CoBank is the exclusive FCS lender to farming related cooperatives, makes loans to rural utilities, finances international agricultural commodities transactions, and serves as the FCB for New England, New York and New Jersey. CoBank also owns 82 percent of Farm Credit Leasing Services Corporation, which is a nationwide equipment and fixed asset lessor.

The Farm Credit System Enjoys Unfair Advantages in a Crowded Agricultural Credit Market

Since the 1987 bailout legislation and the subsequent recovery of the agricultural economy, the Farm Credit System has emerged as a powerful competitor in the rural credit market. During the

1990s bankers and other private sector lenders have become alarmed as the Farm Credit System re-emerged as a competitor that exploits its GSE status to the fullest. Specifically the FCS has:

- Used below market pricing to regain market share. During the 1990s bankers and other private sector lenders have filed numerous complaints with the Farm Credit Administration (FCA) the system's regulator, about below market pricing. The FCA has ignored nearly all of their complaints.
- Used the regulator to advance the business interests of the FCS at the expense of safety and soundness. The FCA has used its regulatory authority to allow the FCS to expand into lines of business that the Congress never intended the FCS to be in, as the ABA lawsuit demonstrated.
- Targeted larger, older and wealthier farmers. According to several studies by USDA economists, the FCS loan portfolio is heavily concentrated among larger, wealthier farmer borrowers.
- Ignored many small and economically disadvantaged farmers. The FCS serves fewer small, economically disadvantaged or beginning farmers than the banking industry according to USDA economists.
- Lost active stockholder discipline. With the changes in borrower stock purchases brought about by the 1987 legislation, governance of the FCS has been ceded to management.
- Continued to consolidate; eventually the cooperative lender could have 50 or fewer retail FCS lenders. These larger lenders will become even more removed from the farmer/owner that FCS was chartered to serve.

The Farm Credit Administration

The Farm Credit Administration (FCA) is the regulator of the Farm Credit System and the Federal Agricultural Mortgage Corporation (Farmer Mac). The FCA is made up of a three-member board that is appointed by the President. The board oversees 300 employees and has an annual budget of approximately $39 million.

In recent years FCA has worked aggressively to "modernize" the FCS through regulatory action. In 1996 the agency undertook a comprehensive review of the 1971 Farm Credit Act and proposed a new series of interpretations of the act. The most controversial of these was the "Scope and Eligibility" rule that led to the ABA and the IBAA filing a lawsuit against the FCA in U.S. Federal District Court. The banking associations lost in court, but succeeded in partially reversing the rule on appeal in 1998.

More recently, the agency proposed another controversial rule, titled "Customer Choice". Under the proposed rule, any FCS lender would be able to lend to any eligible FCS customer anywhere in the country. At present, the system is not engaged in direct competition with itself; with some minor exceptions, FCS institutions serve defined geographic territories. After receiving many letters in opposition to the rule from the banking community and from FCS institutions, the FCA postponed publication of a final rule. Final disposition of the rule is unclear but could occur in early 2000.

The FCA board also is the governing board of the Farm Credit System Insurance Fund, a fund that was mandated by Congress as part of the 1987 FCS bailout legislation. FCS lenders pay an assessment to the fund; at present the fund has approximately $1.35 billion in it. The insurance fund is supposed to be the FCS's first line of defense against widespread credit problems among its borrowers.

The Farm Credit System's Unique Tax Treatment

The Farm Credit System enjoys two major tax breaks that together exceed $400 million annually. First, the FCS's real estate or Title I lenders are exempt from all corporate income taxes; this tax break costs the federal government and the states approximately $350 million annually. These lenders include the six farm credit banks, 32 federal land bank associations, and 40 federal land credit associations. The FCS's 63 production credit associations and 52 agricultural credit associations are subject to corporate income taxation. However, some of these associations distribute a portion of their income as tax-deductible patronage refunds, thereby reducing their income tax
liability as a percentage of their income before taxes and patronage refunds. For the calendar years 1996-98, the income tax liability for the FCS as a whole fell in the range of 12.6% to 12.8%. However, for the first nine months of 1999, this percentage dropped to 11.2%.

FCS's second tax break is the exemption of interest paid on FCS obligations from state and local income taxation; this break is estimated to have reduced the tax burden on the FCS debt being used to fund loans to farmers by at least $80 million annually.

CoBank is a taxable entity. Therefore, it is subject to federal income tax liability. However, according to its 1998 annual report, CoBank is seeking tax refunds from many states "owing to its status as a federal instrumentality." In recent years, CoBank has distributed approximately half of its pre-tax income in the form of tax-deductible patronage refunds. Hence, CoBank substantially reduced its corporate tax liability. For the years 1996, 1997, and 1998, CoBank's corporate tax liability, as a percentage of its pre-tax, pre-refund income, was, respectively, 16.9%, 19.0%, and 20.6%. This percentage rose as its patronage refunds declined as a percent of pre-tax, pre-refund income. For the first nine months of 1999, CoBank's tax liability dropped to 17.2% of its pre-tax, pre-refund income. These data exclude the financial results of the four New York, New England, and New Jersey ACAs for which CoBank serves as their farm credit bank.

CoBank's Attempt to Receive Venture Capital Authority

Late in the last congressional session, a proposal emerged that would have given CoBank the authority to make venture capital investments. CoBank sought to have the authority granted to it through the appropriations process. The House and Senate Agricultural Committees, the committees that have jurisdiction over the FCS, did not originate the proposal or hold any public hearings on it.

What the CoBank Proposal Would Have Authorized

The CoBank proposal would have transferred the authority of an obscure USDA agency, the Alternative Agricultural Research and Commercialization Corporation (AARC) to CoBank. AARC's mission is to help start-up companies bring new, non-food, non-feed products to market by investing in them. Since 1990, AARC has been involved with a wide range of small companies that have tried to find successful commercial uses for agricultural and forestry by-products. AARC's success rate has been spotty at best. However, what the proposal actually did is to greatly expand the authority of CoBank in several important ways. The proposal would have:

- Allowed CoBank to create a subsidiary that could make equity capital investments in entities eligible to use the services of CoBank. This authority would have allowed this subsidiary to become an investor in, or even the owner of, any entity that could do business with CoBank. CoBank could have been in the unique position of being a creditor to companies its subsidiary owned.

- Allowed CoBank to invest up to 10 percent of its capital to the new subsidiary. With its present balance sheet, CoBank could have committed up to $165 million of its capital to the new subsidiary.

- Authorized the new investment subsidiary to raise additional capital, without limit, to fund its activities. There would have been no limit placed on the size or sources of funding for the subsidiary.

- The subsidiary was not prohibited from borrowing in order to make equity capital investments. CoBank sought to portray the investment of 10% of its capital as a way to minimize its risk. However, since the proposal did not explicitly prohibit borrowing by the new subsidiary, CoBank could have become a major creditor to the subsidiary. The initial equity investment of $165 million could have become highly leveraged, greatly increasing CoBank's exposure to venture capital deals (see attached chart).

Finally, the Farm Credit Administration, the safety and soundness regulator of the Farm Credit System, would have been given the responsibility to regulate the subsidiary, although the language in the proposal did not explicitly give FCA that regulatory authority.

On December 2, 1999 the USDA Inspector General released a highly critical audit report on the AARC Corporation that found that AARC had only minimal assurance that taxpayers' monies had been properly expended. For the full text of the Inspector General's report, please access the following: http://www.usda.gov/oig/auditrpt/auditrpt.htm.

The report on the AARC Corporation is the first file listed. You need Adobe to be able to open the file.

How CoBank Might Have Used New Venture Capital Authority To Leverage Initial Capital Investment and How CoBank Could Become an Owner of Companies it Loaned To