Restructuring the Farm Credit System – why now and how to do it

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The Farm Credit System (FCS), America's least known government sponsored enterprise, or GSE, is both the oldest GSE and the only GSE with an excessively complex and increasingly obsolete organizational structure. This paper will explain what the FCS is, why the FCS structure needs to be simplified, and how that can be accomplished.

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What is the Farm Credit System?

The FCS, one of five federally chartered GSEs, was created by Congress to lend to farmers, ranchers, and agriculturally related businesses. The other currently active GSEs are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), both of which guarantee mortgage-backed securities; the Federal Home Loan Bank System, a network of eleven regional banks extending loans (called advances) to banks, thrifts, credit unions, and insurance companies that are primarily collateralized by residential mortgages; and the Federal Agriculture Mortgage Corporation (Farmer Mac), which owns and securitizes farm and ranch mortgages. A one-time GSE, the Student Loan Marketing Association, or Sallie Mae, completed a privatization process at the end of 2004.

As a GSE, the FCS enjoys certain congressionally bequeathed privileges, and therefore competitive advantages over its private-sector competitors, notably commercial banks engaged in agricultural finance as well as life insurance companies and captive finance companies owned by farm equipment manufacturers and suppliers of seed, fertilizer, and other agricultural inputs. Importantly, the profits FCS banks and associations earn on their real estate loans are exempt from any taxation while profits earned on non-real estate lending are largely exempt from state income taxation.

The FCS also can borrow at lower rates of interest than its private-sector competitors by virtue of its implied taxpayer support as a GSE; the FCS's lower funding costs give it a material funding-cost, and therefore competitive advantage, over its private-sector competitors. That implied support was reinforced by the 1987 taxpayer bailout of the FCS discussed below and more recently by the ongoing federal conservatorship of Fannie Mae and Freddie Mac.

The federal taxpayer backing of the FCS was further enhanced when the U.S. Treasury Department, without any congressional authorization, in September 2013 extended a $10 billion line-of-credit from the Federal Financing Bank to the Farm Credit System Insurance Corporation (FCSIC), which guarantees the timely payment of the principal and interest on debt issued on behalf of the FCS by the Federal Farm Credit Banks Funding Corporation. That line-of-credit has since been renewed annually.

The history and structure of the FCS

The origins of the FCS date to 1916, when Congress established the Federal Land Bank System, which consisted of twelve regional Federal Land Banks (FLBs) that provided real estate financing to farmers and ranchers at a time when commercial banks were barred from making real estate loans or were too small to finance farm real estate. FLB loans were originated by local Federal Land Banks Associations (FLBAs), which were lending cooperatives owned by their borrowers.

The Farm Credit Act of 1933 authorized the creation of Production Credit Associations, or PCAs, which were borrower-owned cooperatives extending short-term loans to farmers and ranchers, as well as twelve regional cooperative banks and a Central Bank for Cooperatives to lend to agricultural and rural utility cooperatives. The assigned territories for the PCAs often coincided with FLBA territories but they operated independently of each other.

The FLBA/PCA overlap led to the creation of local Agricultural Credit Associations (ACAs), which provided both real estate and non-real estate credit to farmers and ranchers. ACAs then began to restructure themselves as "parent ACAs," each with a PCA subsidiary as well as a Federal Land Credit Association (FLCA), which not only had the lending powers of an FLBA, but could then own the real estate loans it originated, thereby retaining for each ACA the real-estate tax exemption the FCS has long enjoyed.

The FCS functioned reasonably well until the 1971 Farm Credit Act[1] greatly liberalized the collateral requirement for farm real estate loans made by the FLBAs as farmland prices soared. That farmland bubble started to deflate in 1980 when interest rates reached record highs. On an inflation-adjusted basis, the average acre of farmland then lost over one-third of its market value, leading to thousands of farm bankruptcies, the failure of several hundred agricultural banks, and such severe losses among FCS institutions that Congress had to bail out the FCS in 1987.[2]

The 1987 bailout of the FCS led to significant consolidation within the FCS, with the overall number of FCS entities shrinking from 845 at the end of 1984 (37 banks and the rest associations lending directly to farmers and ranchers) to 196 on July 1, 1999, including the consolation of the regional cooperative banks into CoBank, which today has the exclusive authority within the FCS to lend to cooperatively owned agricultural businesses and rural utilities.[3]

The FCS today

Today, the FCS has just four regional banks, including CoBank, and 69 associations. The last FCS bank merger occurred on January 1, 2012, when U.S. AgBank merged into CoBank. Here is the link to a map of the territories served by the four banks (https://www.fca.gov/bank-oversight/fcs-directory-map)

The principal function of the FCS banks, other than CoBank, is to act as funding intermediaries between the Funding Corporation, which raises funds by selling in the capital markets notes and bonds known as the Systemwide Debt Securities. That is the debt guaranteed by the FCSIC.

The Funding Corporation lends those funds to the four banks, with each bank in turn relending funds to the associations that are members of that bank. By being the dominant creditor of the associations it has lent to, each bank provides some financial oversight of those associations. That oversight supposedly complements the regulatory oversight and periodic safety-and-soundness examinations carried out by the FCS's regulator, the Farm Credit Administration (FCA).

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[1] The Farm Credit Act is codified as 12 USC. Sec. 2001-Sec. 2279g.

[2] Ely, Bert, and Vicki Vanderhoff; *The Farm Credit System: Reckless Lender to Rural America,* American Bankers Association, 1990, pp. 7-28.

[3] Ely, Bert, *The Farm Credit System: Reckless Past, Doubtful Future*, American Bankers Association, 1999, pg. 8.

Despite that duplicative oversight, or perhaps because of it, two FCS associations experienced significant financial difficulties in recent years. Farm Credit Services Southwest (FCSSW), which was funded by CoBank, stated in its 2014 Annual Report that it had had to restate its financial statements back to 2009 due to a sudden increase in delinquent loans resulting from potential fraud and "material weaknesses in internal controls related to credit origination, administration, and servicing procedures.[4]" FCSSW subsequently merged into another FCS association, Farm Credit West, most likely at the insistence of the FCA.

In August 2017, Lone Star Ag Credit, headquartered in Fort Worth, Texas, and funded and overseen by the Farm Credit Bank of Texas, issued a "Notification of Non-Reliance on Previously Issued Financial Statements" for 2016 and the first quarter of 2017 due to just-discovered "appraisal and accounting irregularities.[5]" Unlike FCSSW, Long Star was not forced into a merger (as of the publication of this paper).

The diagram on page 5 of the 2018 annual information statement issued by the Funding Corporation[6] shows the relationship of the various types of FCS institutions with each other while the diagram on page 6 illustrates the flow of funds from investors in Systemwide Debt Securities issued by the Funding Corporation to FCS borrowers and the ultimate repayment of those funds to investors resulting from loan repayments by FCS borrowers.

This map (https://www.fca.gov/template-fca/bank/20180101InstitutionTerritoryMap.pdf) shows the territories served by the 69 associations now in operation.[7] The tremendous variation in the size of the areas served parallels the enormous asset-size differential among FCS associations. As of March 31, 2019, the associations ranged from total assets of $29.88 billion (Farm Credit Services of America, which serves four states) and $23.71 billion (Farm Credit Mid-America, which serves all or portions of four states) to Delta ACA, which serves just five counties in southeast Arkansas, with $49 million of assets.

The combined assets of all FCS institutions have grown steadily, rising from $214 billion at the end of 2008 to $261 billion at the end of 2013 to $349 billion on March 31, 2019, about the size as Bank of New York Mellon, the United States' eleventh largest financial holding company.

Despite the tremendous degree of consolidation within the FCS over the last 30 years, the FCS has retained its two-tier structure, with the four banks funding a declining number of associations, from 78 at the beginning of 2014 to 69 today.

Further consolidation among the remaining four FCS banks is unlikely because of a little-known feature of FCS debt issued by the Funding Corporation – each additional bank merger would further weaken the joint-and-several liability the remaining banks would have for the Systemwide Debt Securities issued by the Funding Corporation. That is, if an FCS bank cannot pay the interest due on the funds it has borrowed from the Funding Corporation or repay the borrowed funds when due and the FCSIC lacks the funds to pay what is due, then the other three banks are jointly liable for that debt.[8]

[4] https://www.fcssw.com/~/media/Financial%20Statements/2014%20Annual%20Report2.ashx, pg. 5
[5] https://sitebridge.farmcreditbank.com/f/other/38/Notification-of-Non-Reliance-on-Prev-Issued-Financial-Stmts-FINAL.pdf
[6] https://www.farmcreditfunding.com/ffcb_live/serve/public/pressre/finin/report.pdf?assetId=371190
[7] https://www.fca.gov/template-fca/about/NumberBanksAssocs18.pdf
[8] https://www.farmcreditfunding.com/ffcb_live/serve/public/pressre/finin/report.pdf?assetId=371190, pages 22 and 79.

The next FCS bank merger, should it occur, would further weaken the joint-and-severally-liable feature now backing FCS debt by reducing to two the number of other banks liable for a troubled bank's obligations if that bank could not meet its debt obligations in a timely manner. Each of the remaining banks would have to shoulder a larger portion of the defaulting bank's debt, thereby increasing the likelihood that the other banks would default – all the dominoes would quickly topple.

Most interestingly, the joint-and-several liability feature backstopping debt issued by the Funding Corporation does *not* extend to the FCS associations. While each bank "is authorized, under certain circumstances, to require its affiliated Associations and certain other equity holders to purchase additional Bank equity subject to certain limits and conditions . . . only the banks, and not the Associations, are jointly and severally liable for the repayment of Systemwide Debt Securities.[9]"

The time has come to simplify the structure of the FCS

As the FCS associations continue to consolidate while the number of banks has shrunk to an irreducible number, the time has come to authorize each association to borrow directly from the Funding Corporation, which in turn would assume the association oversight functions now performed – not always that effectively – by the four banks. That is, the functions of three of the banks – all but CoBank – would simply be assumed by the Funding Corporation and the banks liquidated. The equity capital in each bank would then be transferred to the associations that belonged to that bank, thereby strengthening the capital position of those associations.

Most importantly, the joint-and-several obligation now residing with the four banks would then shift to the much larger number of FCS associations as they began borrowing directly from the Funding Corporation. That shift would greatly strengthen the joint-and-several liability feature of FCS debt, which in turn would reduce the taxpayer risk posed by the FCS, a risk that became a reality in 1987. It might then be possible for the Treasury Department to cancel the $10 billion line-of-credit it extended to the FCSIC in 2013.

As extreme as this proposal may seem, the late Dallas Tonsager, the former board chairman and CEO of the FCA, on at least three occasions, most recently in a January 30, 2018, speech,[10] implored the FCS to study its present structure and to suggest how the FCS should be restructured, stating that:

> System Structure: Some folks think I kicked a hornet's nest last year by suggesting we have a year of dialogue around the topic. This is not a new issue, but it is an important one. The System has been in a constant state of renewal since its inception in 1916. As it continues to evolve, we must evaluate how any proposed change could impact the integrity and cooperative structure of the System. We must look at the operational, managerial, and reputational risks that might result from the change. And we must consider how the change might affect the relationship between the funding bank and its associations. Bottom-line, your members and stakeholders must have confidence that structural changes are in the best long-term interest of the System and those it serves.

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[9] Ibid., page 79.

[10] https://www.fca.gov/template-fca/download/Speeches/Tonsager/Tonsager30Jan2018.pdf, pg.4; see also https://www.fca.gov/template-fca/download/Speeches/Tonsager/Tonsager7Mar2017.pdf, pg. 4, and https://www.fca.gov/template-fca/download/Speeches/Tonsager/Tonsager1Feb2017.pdf, pg. 4.

Unfortunately, former Chairman Tonsager did not invite the public to participate in that discussion nor has his plea stirred any public dialogue. Hopefully this paper will help to stimulate *public* involvement in that much needed discussion.

Simplifying the structure of the FCS would improve its operating efficiency, which presumably would benefit its member/borrowers, while strengthening the FCA's safety-and-soundness regulation of the FCS. Perhaps the FCA would then begin publishing its enforcement orders, as the bank regulators have done for many years.

Where CoBank fits into this proposal

In addition to funding 22 associations, CoBank has three nationwide lending authorities unique to it.[11] Therefore, special consideration needs to be given to the scope of its so-called Title III authorities under the Farm Credit Act in a restructured FCS. Interestingly, in its 2017 annual report, CoBank acknowledged that "the FCS has experienced many of the same challenges facing its commercial competitors, including . . . persistent pressure to consolidate. How will the [FCS] evolve to ensure it is optimally configured to serve customers and fulfill its vital mission going forward?[12]"

Listed below are CoBank's unique lending authorities; that is, other FCS entities cannot lend to these types of entities or for these purposes, except with CoBank's consent or by purchasing a participation in a loan to a cooperative originated by CoBank:

- Cooperatively owned rural utilities, specifically telephone; electricity production, transmission, and distribution; and water systems and waste disposal facilities;
- Cooperatively owned businesses engaged in activities related to agriculture;
- Financing agricultural exports, some of which are guaranteed by the federal government.

That CoBank has these exclusive lending authorities reflects the evolution of the FCS; there is no rational reason for barring FCS associations from lending directly to agricultural and rural-utility cooperatives under Title III of the Farm Credit Act.

As noted above, CoBank sells participations in many of its loans to cooperatives such that as of March 31, 2019, 26 percent of the amount the FCS had lent to rural utilities and 21 percent of the amount lent to agricultural cooperatives in fact had been loaned by FCS institutions other than CoBank.[13] Given the knowledge FCS associations have gained in lending to agricultural and rural utility cooperatives by virtue of buying participations in loans to those businesses, there is no reason why FCS associations should not be able to originate loans to cooperatives operating in the territories the associations serve.

Authorizing FCS associations to lend directly to cooperatives also would have the beneficial effect of shrinking the size of CoBank relative to the FCS as a whole, thereby reducing the risk it poses to the solvency of the FCS and therefore the risk the FCS poses to taxpayers. That is, CoBank would continue to exist, but as a vastly shrunken, specialized lender within the FCS.

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[11] CoBank is chartered under Title III, Part A, of the Farm Credit Act of 1971, 12 U.S.C. Sec. 2121 to Sec. 2134.

[12] https://www.cobank.com/-/media/files/financials/2017/2017-cobank-annual-report.pdf?la=en&hash=76B1C361851F746162B7A34D866DA306D53C602F, pp. 10-11.

[13] Calculated from call reports submitted to the FCA by FCS banks and associations.

CoBank owns 100 percent of the stock of the Farm Credit Leasing Services Corporation, which specializes in leasing on a nationwide basis a broad range of equipment, machinery, vehicles, and facilities. Possibly this leasing activity should be spun off into an independent entity that could borrow directly from the Funding Corporation or FCS associations could engage directly in leasing activities now conducted by CoBank's leasing subsidiary.

Conclusion

Over its 103-year existence, the FCS has undergone several major structural changes as it has grown into a major source of financing for agriculture and agriculturally related activities. Yet it now has an increasingly outdated structure that does not reflect the extent of consolidation that has taken place within the FCS and in agriculture nor does its structure reflect the impact technology has had on the delivery of credit and other financial services to borrowers. Empowering FCS associations to borrow directly from the Funding Corporation while shifting other FCS bank functions to the Funding Corporation and the FCA would improve the operating efficiency of the FCS while reducing the substantial insolvency risk it now poses to taxpayers.