

# CRS Report for Congress

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## Farm Credit System

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### Summary

The Farm Credit System (FCS) is a nationwide financial cooperative lending to agricultural and aquatic producers, rural homeowners, and certain agriculture-related businesses and cooperatives. Established in 1916, this government-sponsored enterprise (GSE) has a statutory mandate to serve agriculture. Farmer Mac is a related but separate secondary market for agricultural loans. Federal oversight provides for the safety and soundness of FCS institutions. The FCS would like to expand its lending authorities for rural housing and non-farm businesses, as highlighted in its 2006 "Horizons" report, but commercial banks oppose this effort. This report will be updated.

### What Is the Farm Credit System?

**A Rural Lender.** The Farm Credit System (FCS) was created to provide a permanent, reliable source of credit to American agriculture. When Congress enacted the Federal Farm Loan Act in 1916, credit was frequently unavailable or unaffordable in rural areas. Many lenders avoided such loans due to the inherent risks of agriculture. Statutory authority is in the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*). The most comprehensive recent changes were enacted in the Agricultural Credit Act of 1987.

The FCS is authorized to lend to farmers, ranchers, and harvesters of aquatic products. Loans may also be made to finance the processing and marketing activities of these borrowers, for home ownership in rural areas, certain farm- or ranch-related businesses, and agricultural, aquatic and public utility cooperatives.

As of June 2006, FCS had \$113 billion in loans outstanding, of which about 51% was in long-term agricultural real estate loans, 28% in short- and intermediate-term agricultural loans, 16% in loans to cooperatives, 2% in export financing, and 3% in rural home loans. The System holds about 31% of the farm sector's total debt (second to the 40% share of commercial banks) and has the largest share of farm real estate loans (38%).

**A Government-Sponsored Enterprise (GSE).** As a GSE, FCS is a privately owned, federally chartered cooperative designed to provide credit nationwide, and limited to serving agriculture. Each GSE is given certain benefits such as implicit federal

guarantees or tax exemptions, presumably to overcome barriers faced by purely private markets.<sup>1</sup> FCS is a direct lender, unlike the housing GSEs, which are secondary markets.

**A Cooperative Business Organization.** FCS associations are owned by the borrowers who purchase stock, typically as part of their loan. FCS stockholders elect the boards of directors for banks and associations. Each has one vote, regardless of the loan size. Most directors are members, but federal law requires at least one from outside.

If an association is profitable, the directors may choose to retain the profits to increase lending capital, or distribute some of the net income through dividends or **patronage refunds**, which are proportional to the size of loan. Patronage refunds effectively reduce the cost of borrowing. Some associations tend to regularly pay patronage while others prefer to retain their earnings or charge lower interest rates.

**A National System of Banks and Associations.** FCS is composed of 5 regional banks that provide funds and support services to 96 smaller Agricultural Credit Associations (ACAs), Federal Land Credit Associations (FLCAs), and Production Credit Associations (PCAs). These associations in turn, provide loans to eligible borrowers. The most common operating structure (due to favorable tax and regulatory rules) is a “parent ACA” with FLCA and PCA subsidiaries. FLCA subsidiaries are exempt from federal income taxes (12 U.S.C. 2098). There are 86 ACAs and 10 stand-alone FLCAs.<sup>2</sup>

One of the regional banks, CoBank, has a nationwide charter to finance farmer-owned cooperatives and rural utilities. It finances agricultural exports and provides international services for farmer-owned cooperatives through three international offices.

**Capitalized with Bonds and Stock, not the U.S. Treasury.** The Federal Farm Credit Banks Funding Corporation (<http://www.farmcredit-ffcb.com>) uses capital markets to sell FCS bonds and notes. These debts become the joint and several liability of all FCS banks. The funding corporation allocates capital to the banks, which provide funds to associations, which lend to borrowers. Profits from loans are used to repay bondholders.

FCS also raises capital through two other methods. Borrowers are required to pay the lesser of \$1,000 or 2% of the loan amount and become a cooperative stockholder. FCS also retains profits that are not returned as patronage to borrowers.

With the exception of seed money that was repaid by the 1950s and a temporary U.S. Treasury line of credit in the 1980s,<sup>3</sup> FCS operates without any direct federal money. FCS banks and associations do not take deposits like commercial banks.

<sup>1</sup> There are five GSEs: Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), Federal Home Loan Bank System, Federal Agricultural Mortgage Corporation (Farmer Mac), and FCS. For more on GSEs, see CRS Report RL30533, *The Quasi Government: Hybrid Organizations with Government and Private Characteristics*.

<sup>2</sup> For a directory of institutions in the Farm Credit System, and a map of the five regional banks, see the Farm Credit Administration website at <http://www.fca.gov/apps/instit.nsf>.

<sup>3</sup> The Financial Assistance Corporation (FAC) borrowed \$1.26 billion from Treasury following the farm financial crisis of the 1980s. On June 10, 2005, the last of these bonds was repaid on schedule, and interest was repaid to the U.S. Treasury. The FAC will be dissolved by June 2007.

## What the Farm Credit System Is Not

FCS is not a government agency and its debt instruments and loans are not explicitly guaranteed by the U.S. government.<sup>4</sup> FCS is a GSE with certain tax benefits and a mandate to serve agriculture. FCS is not a lender of last resort. FCS is a commercial, for-profit lender. Borrowers must meet creditworthiness requirements similar to those of a commercial lender. (The USDA Farm Service Agency (FSA) is a lender of last resort for borrowers who are unable to get a loan from another lender.<sup>5</sup>)

## Types of Loans and Borrowers

FCS provides three types of loans: (1) operating loans for the short-term financing of consumables such as feed, seed, fertilizer, or fuel; (2) installment loans for intermediate-term financing of durables such as equipment or breeding livestock; and (3) real estate loans for long-term financing (up to 40 years) of land, buildings, and homes.

Since FCS has a statutory mandate to serve agriculture and rural America, borrowers must meet certain eligibility requirements in addition to creditworthiness. Eligible borrowers and their scope of their financing can be grouped into four categories.

- **Full-time farmers.** For individuals with over 50% of their assets and income from agriculture, FCS can lend for all agricultural, family, and non-agricultural needs (including vehicles, education, home improvements, and vacation expenses).
- **Part-time farmers.** For individuals who own farmland or produce agricultural products but earn less than 50% of their income from agriculture, FCS can lend for all agricultural and family needs. However, non-agricultural lending is limited.
- **Farming-related businesses.** FCS can lend to businesses that **process** or **market** farm, ranch or aquatic products if more than 50% of the business is owned by farmers who provide at least some of the “throughput.” FCS also can lend to businesses that **provide services** to farmers and ranchers (but not aquatic producers), such as crop spraying and cotton ginning. The extent of financing is based on the amount of the business’ farm-related income.
- **Rural homeowners.** FCS can lend for the purchase, construction, improvement, or refinancing of single family dwellings in rural areas with populations of 2,500 or less.

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<sup>4</sup> Because of the significant role of GSEs in the U.S. economy, most investors feel the federal government will not allow a GSE to fail. Thus, an implicit, albeit not statutory, guarantee exists.

<sup>5</sup> For more information about other agricultural lenders, see CRS Report RS21977, *Agricultural Credit: Institutions and Issues*, by Jim Monke.

## Consolidation

The number of banks and associations has been declining for decades through mergers and reorganizations. This consolidation accelerated, however, in 1999 when the Farm Credit Administration (FCA), the system's regulator, approved the "parent ACA" structure and the Internal Revenue Service declared FLCA subsidiaries tax-exempt. In the mid-1940s, there were over 2,000 lending associations, nearly 900 in 1983, fewer than 400 by 1987, 200 in 1998, and only 96 in 2006. The system operated with 12 districts into the 1980s, 8 districts in 1998, and 5 regional banks (districts) since 2004.

Twenty years ago, the typical FCS association covered several counties and specialized either in land or farm production loans. Today, the typical FCS association covers a much larger region, delivers a wide range of farm and rural credit programs and services, and has an extensive loan portfolio. FCS benefits when consolidation creates more diversified portfolios. Customers may benefit if greater institutional efficiency is passed along through lower interest rates. However, consolidation may weaken the original cooperative concept of local borrower control and close many local offices at which farmers had established relationships.

## Charter Territories

Each association within FCS has a specific "charter territory." If an association wants to lend outside its charter territory, it first must obtain approval from the other territory's association. For example, associations within U.S. AgBank's region (the southern Plains and West) can compete for loans, but associations in the AgFirst region (the East and Southeast) cannot. Charter territories help ensure that borrowers are served locally and maintain local control of the association. Charter territories and any changes must be approved by FCA.

In 2001, FCA proposed allowing national charters so that associations would not be restricted by geographical boundaries. The FCA board later dropped the idea after opponents raised concerns that national charters would weaken FCS's mission by pitting associations against each other for prime loans and reducing commitments to local areas.

## Federal Regulation

**Congressional Oversight.** Congressional oversight of FCS is provided by the House and Senate Agriculture Committees. Most recently, the House held hearings on Farmer Mac on June 2, 2004, and over the proposed sale of an FCS association on September 29, 2004.

**Farm Credit Administration (FCA).** The FCA (<http://www.fca.gov>) is an independent agency and the federal regulator responsible for examining and ensuring the safety and soundness of all FCS institutions. Regulations are published in 12 C.F.R. 600 *et seq.* FCA's operating expenses are paid through assessments on FCS banks and associations. Even though FCA does not receive an appropriation from Congress, the annual agriculture appropriations act in recent years has put a limit on FCA's administrative expenses (\$44.25 million in FY2006).

FCA is directed by a three-member board nominated by the President and confirmed by the Senate. Board members serve a six-year term and may not be reappointed after serving a full term or more than three years of a previous member's term. The President designates one member as Chairman, who serves until the end of that member's term.<sup>6</sup>

## Other FCS Entities

**Federal Agricultural Mortgage Company (Farmer Mac).** Farmer Mac (<http://www.farmermac.com>) was established in the Agricultural Credit Act of 1987 to serve as a secondary market for agricultural loans — purchasing and pooling qualified loans, then selling them as securities to investors. However, Farmer Mac continues to hold most of the loans it purchases, a potentially more profitable activity for the company, but also more risky. Farmer Mac increases the capacity for agricultural lenders to make more loans; for example, if a lender makes a 30-year loan and sells it to Farmer Mac, the proceeds can be used to make another loan.

Although Farmer Mac is part of FCS and regulated by FCA, it has no liability for the debt of any other FCS institution, and the other FCS institutions have no liability for Farmer Mac debt. Farmer Mac is organized as an investor-owned corporation, not a member-owned cooperative. Voting stock may be owned by commercial banks, insurance companies, other financial organizations, and FCS institutions. Nonvoting stock may be owned by any investor. The Board of Directors has 15 members: five elected from the FCS, five elected from commercial banks, and five appointed from the public at-large.

Farmer Mac operates two programs: **Farmer Mac I** (loans not guaranteed by USDA) and **Farmer Mac II** (USDA-guaranteed loans).

- A majority of **Farmer Mac I** volume comes from the sale of “long-term standby purchase agreements” (LTSPC). Farmer Mac promises to purchase specific agricultural mortgages, thus guaranteeing the loans against default risk while the participating lender retains interest rate risk.
- Under **Farmer Mac II**, the company purchases the portion of individual loans that are guaranteed by USDA. On these purchases, Farmer Mac accepts the interest rate risk but carries no default risk.

**Farm Credit System Insurance Corporation.** The Insurance Corporation (<http://www.fcsic.gov>) was established by statute in 1988 to ensure timely payment of principal and interest on FCS debt securities. The FCA Board comprises its board of directors. Annual premiums are paid by each bank through an assessment based on loan volume until the secure base amount of 2% of total outstanding loans is reached.

**Farm Credit Council.** The Farm Credit Council (<http://www.fccouncil.com>) is the national trade association of FCS. FCC has offices in Washington, DC, and Denver, CO, and lobbies on behalf of FCS. FCC also provides support services.

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<sup>6</sup> FCA board members are Nancy C. Pellett (chairman since May 22, 2004), appointed in 2002 for a term that ends in May 2008; Douglas L. Flory, appointed in 2002 for a term that ends in October 2006; and Dallas Tonsager, appointed in 2004 for a term that ends in May 2010.

## Policy Issues for Congress

**Farm Credit System Authority.** In recent years, the FCS sought to expand its lending authorities beyond traditional farm loans and into rural housing and non-farm businesses. FCS also generally desires to update the Farm Credit Act of 1971, which was last amended comprehensively in 1987. In early 2006, the FCS released a report titled “Horizons,” which highlights perceived needs for greater lending authority.<sup>7</sup> Some see Horizons as a precursor to legislative action, possibly in the 2007 farm bill debate.

Commercial banks oppose expanding FCS lending authority, saying that commercial credit in rural areas is not constrained and that FCS’s government-sponsored enterprise (GSE) status provides an unfair competitive advantage. FCS responds to this debate by asserting its statutory mandate to serve agriculture (and by extension, rural areas) through good times and bad, unlike commercial lenders without such a mandate.

**Termination/Buyout of FCS Associations.** The controversy over GSE status and lending authority was highlighted in 2004 when a private bank, Netherlands-based Rabobank, tried to purchase an FCS association. The board of directors of Omaha-based Farm Credit Services of America initially voted for the sale, indicating to some that FCS may no longer need government sponsorship. Although Congress had no direct statutory role in the buyout process, the House held hearings on the implications,<sup>8</sup> and Senators Daschle and Johnson introduced S. 2851 in the 108<sup>th</sup> Congress to require public hearings and a longer approval process.

In 2004, FCS asked Congress to eliminate the provision (12 U.S.C. 2279d) allowing institutions to leave the system. Commercial bankers say that institutions should be allowed to leave FCS if they want more lending authorities than are currently allowed. It is not clear whether Congress, in 1987, intended the provision to be used by outside companies to purchase parts of the FCS.

In July 2006, the Farm Credit Administration, the federal regulator of FCS, amended the rules governing how an FCS bank or association may terminate its charter (71 FR 44409, August 4, 2006). The changes allow more time for FCA to review the request, more communication, and more shareholder involvement. For further background, see CRS Report RS21919, *Farm Credit Services of America Ends Attempt to Leave the Farm Credit System*, by Jim Monke.

**Farmer Mac Risk Exposure.** In 2003, the Government Accountability Office recommended that Congress establish clearer goals for Farmer Mac (GAO-04-116). GAO was concerned with risk management practices (including geographic concentration), lack of secondary market development, and corporate governance. On June 2, 2004, the House Agriculture Committee held a hearing. Questions have also arisen whether a certain type of swaps are reducing insurance premiums paid to the insurance corporation without any reduction in risk exposure.

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<sup>7</sup> The Horizons report is available at [<http://www.fchorizons.com>].

<sup>8</sup> House Agriculture Committee, “Review the Farm Credit System and its Provisions for Associations to Exit the System” [<http://agriculture.house.gov/hearings/108/10838.pdf>].