

Range *of*  
options



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## Community banks, Farm Credit System vie for same customers

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**J**ohn Gross sees both sides. As president and CEO of his family-owned Farmers State Bank in Pine Bluffs, Wyo., Gross goes head-to-head with the Farm Credit System when it comes to making agricultural loans. The Farm Credit System, which is one of the country's largest farm lenders, often wins, he says, and he can see why. When the other family business, Gross Wilkinson Ranch, needed a multimillion-dollar line of credit, Gross's family became a customer of their bank's biggest competitor.

"We had to," Gross says, explaining a community bank like his was too small to make such a large loan to the ranch and a larger bank couldn't beat the Farm Credit System's rate.

"As a banker, I'm discouraged," he says. "As a rancher, I like the interest rates."

His dichotomy with the Farm Credit System sums up the frustration of many community bankers and the appeal to a lot of loan customers. In the past, rural community banks' stiffest loan competitors were other community banks. But more recently, the

Farm Credit System and its associations are being viewed as significant loan competition—more so than any other source, say regional community bankers.

The Farm Credit System is a federally regulated, federally chartered network of five banks and 90 borrower-owned associations. It differs from banks in that it doesn't offer traditional banking services, such as checking accounts or other deposit services, but rather ag-related loans. This brings it into direct competition with many rural community banks that specialize in ag lending (defined as banks with agricultural production loans plus real estate loans secured by farmland in excess of 25 percent of total loans and leases).

In the 2008 Survey of Community Banks conducted by the Federal Reserve Bank of Kansas City, 63 percent of respondents said they expect intense loan competition from Farm Credit associations in the next five years. Seventy-six percent of the respondent banks are in rural areas with less than 10,000 residents.

Eric Robbins, a policy economist at the Kansas City Fed who co-authored the survey,

has since researched further the issue of rural lending competition. He says community bankers' concerns with Farm Credit generally fall into three areas:

- **Competitive advantage:** Many community bankers say the Farm Credit System is able to offer better loan rates because of its tax-free status and therefore has a competitive advantage. One banker wrote in the survey, "If we didn't have to pay federal and state income taxes, our loan rates could be lower (more competitive with Farm Credit) and our deposit rates could be higher (more competitive with credit unions)."

- **Growth:** The overall loan portfolio of the Farm Credit System has nearly doubled since 2001—significantly more growth than community banks have seen. A banker survey respondent wrote that Farm Credit's "momentum is growing. And because their rates are lower, they pay no taxes, and no filing fees, we will not be able to compete."

- **Expanded mission:** Other community bankers say the Farm Credit System has moved beyond its original intent of farm lending and is entering new lines of business, including offering loans not related to agriculture. A banker survey respondent wrote: "Farm Credit has continued to be a big competitor for loans that aren't truly farm loans."

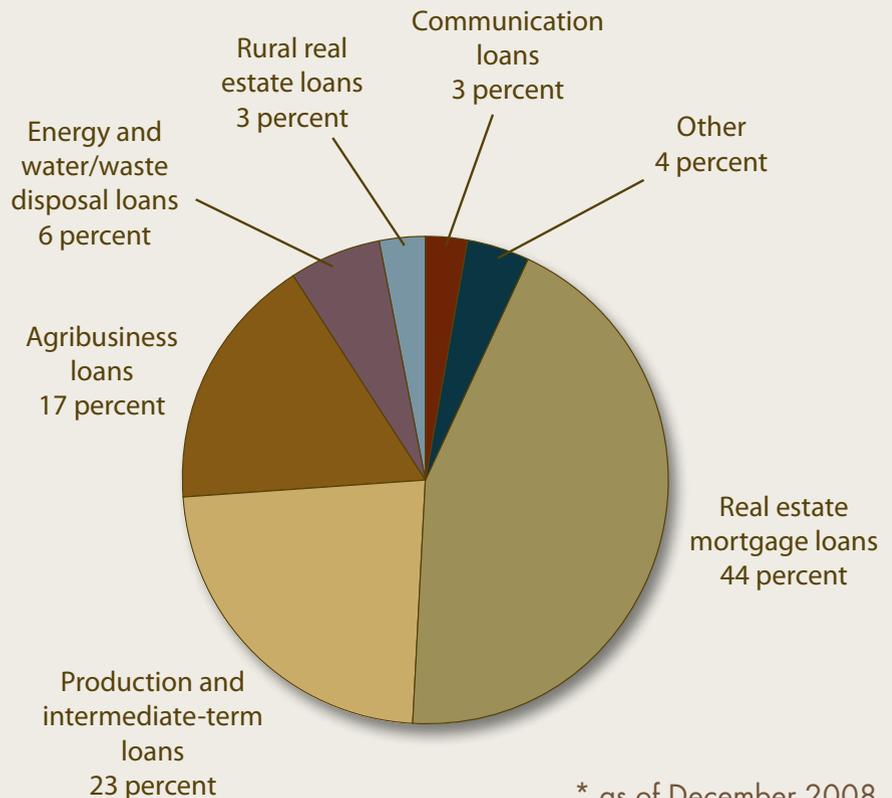
Ken Auer, president and CEO of the Farm Credit Council, a trade association that represents the Farm Credit System, says, "The simple answer (to these three areas of concern) is no, no and no."

Auer says community banks' negative perception about the Farm Credit System stems from the loan competition between the two entities.

"I've never heard anyone say fewer competitors are better for farmers," Auer says. "Community banks serve as a competitor for us, and we serve as a competitor for them. It works out better for the rural economy."

## Farm Credit System Loan Portfolio\*

The overall growth of the Farm Credit System loan portfolio has been rapid in recent years. Since the 2001 recession, the loan portfolio has almost doubled, increasing from \$82.6 billion to \$161.4 billion. The Farm Credit System's portfolio remains dominated by farm real estate and agricultural production and intermediate-term loans.



\* as of December 2008

## From the beginning

The Farm Credit System was established by Congress in 1916 as a government-sponsored enterprise in response to complaints about a lack of affordable ag financing. The Farm Credit System banks lend to Farm Credit associations in respective geographic territories. Each association then provides loans to agricultural producers, commercial fisherman and businesses that offer related services. They also provide mortgages to rural homebuyers as long as the total of all rural housing loans isn't more than 15 percent of total bank loans. Additionally, the Farm Credit Act states borrowers can't be charged an interest rate less than the competitive market rate for similar loans made by private lenders to equivalent borrowers.

"However, there have been amendments to the Act that increase the Farm Credit System's lending authority as well as new initiatives that would broaden its focus to include a larger customer base," Robbins says. "So, the Farm Credit System is potentially coming into more direct competition with rural community bankers, as many mentioned in our survey last year."

Auer says the Farm Credit System doesn't want to expand its mission beyond agriculture, but rather is working to further support that mission as established by Congress. The Farm Credit System is a "competitive force to ensure agriculture has the credit it needs," he says.

## Financial performance

"Comparing their financial performance suggests that maybe banks' concerns about unfair lending competition from the Farm Credit System could be overstated," Robbins says. "However, looking at the data does show that Farm Credit System associations are lending at slightly more competitive rates than ag banks and that ag banks aren't growing like Farm Credit organizations are."

A comparison of total ag lending (real estate, operational, equipment loans and the



PHOTO BY JOSHUA LAWTON

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**COMMUNITY BANKERS SAY LOAN COMPETITION** in rural America, like in the small town of Pine Bluffs, Wyo., is increasing, especially from the Farm Credit System. The Farm Credit System says more options benefit customers, but bankers say the System has an unfair advantage.

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like) shows commercial banks have the greatest share of farm debt at 45.5 percent while the Farm Credit System's share of farm debt is 36.7 percent, and growing.

The Farm Credit System's portfolio is predominately made up of farm real estate, agricultural production (funding for operating costs and farm machinery) and intermediate-term loans. Meanwhile, growth of the overall loan portfolio has been significant during the last few years—almost doubling since the 2001 recession to \$161.4 billion today.

"Community banks may see this rapid loan growth as an indication of the potential for even greater future competition from



PHOTO BY BOB GREENSPAN

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RURAL AMERICA WAS NOT LEFT UNSCATHED by the most recent global recession, and as a result, margins have been reduced for the entire financial sector. Meanwhile, loan competition may grow for community banks, which face the Farm Credit System, banks of all sizes, credit unions and others. “Small banks will probably continue to voice concerns,” says policy economist Eric Robbins.

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the Farm Credit System for lending in rural markets,” Robbins says.

Robbins’ research shows a comparison of the financial performance of the Farm Credit System in comparison to ag banks, including yield on earning assets, average interest rate earned on farm real estate and non-real estate farm loans, funding costs as percent of earning assets, net interest margin, return on average assets, operating expense to average earning assets, and capital to total assets.

In comparing ag banks’ balance sheets with Farm Credit System lenders’, the latter dominates in farm real estate lending while banks’ share has declined. In 2008, ag banks’ level of farm real estate loans increased by 74 percent to \$21.4 billion, and Farm Credit System farm real estate loans increased by 91 percent to \$71.9 billion. (Farm real estate lending has increased significantly across all lenders as farm land prices have soared.) Ag banks’ share of non-real estate farm loans also

has declined compared to the Farm Credit System’s and other commercial banks’.

Auer says a comparison of community banks’ and the Farm Credit System’s performance data shows “it doesn’t appear that they (ag banks) are being harmed at all by the Farm Credit System being there.”

### **Competitive advantage**

Though the ag lending environment has been positive the past couple of years, an “economic tsunami” struck last summer as the global recession hit rural America, says Daryl Oldvader, president and CEO of FCS Financial, a member of the Farm Credit System. This means margins have been greatly reduced for the entire sector. Still, FCS Financial hasn’t seen any major changes in competition—community banks have the majority of the market share in Missouri, where he operates, and continue to be its most significant competition, he says.

FCS Financial's average real estate and operating loans are about \$100,000 and \$45,000, respectively, and its typical customer is a part-time producer with a small amount of acreage.

"They (ag banks) are vying for that same type of customer," Oldvader says, but he sees this as positive. "We've been a good checks and balances for each other.

"Competition is good for the customer. It provides an opportunity to meet the needs of the customer, and it's a good opportunity for me as a lender to be better," Oldvader says.

Ag banks say the Farm Credit System has competitive advantages in terms of its structure, access to funding and lower operating costs.

Community banks' operating structures, diverse lending and retail banking services mean costs will remain higher than government-sponsored entities, Robbins says. While lower operating costs likely are giving the Farm Credit System a competitive advantage that enables faster growth, its greater advantage is more likely its structure, especially its access to funding and scale, Robbins says.

Smaller banks have access to inexpensive consumer and business deposits, but these deposits have a slow rate of growth. Banks also are able to borrow from other funding sources, such as the Federal Home Loan Banks, but these funds can be more expensive and require collateral. The Farm Credit System, however, can issue bonds to investors, which are guaranteed by its insurance fund. This likely contributed to the Farm Credit System's rapid asset growth, which has been three times faster than ag banks' asset growth, Robbins says.

Another factor contributing to the difference in operating costs is their respective size and scale. By the end of 2008, there were 1,559 ag banks and 95 Farm Credit System entities. Because the Farm Credit System is more concentrated, it can spread costs over a larger asset base, while ag banks' smaller individual size limits their ability to provide large loans to large- and medium-sized agricultural businesses, like Gross Wilkinson Ranch in Wyoming.

"We have no advantages over them except as a depository," Gross says of his family's bank, adding that banks have "far more regulations," which is the biggest disadvantage compared to the Farm Credit System.

As a member of the Farm Credit System, Oldvader says he thinks one of the System's biggest advantages is its niche—staff has an ag background and experience in ag cycles, which appeals to customers.

"We're a mirror of our marketplace," Oldvader says.

## Future

"Looking ahead, the agricultural finance market probably will be very competitive," Robbins says. "Community banks face many challenges."

Other competitors include other banks both small and large, credit unions, and others. But the competitive environment for ag lending in particular will be intense as they compete with the Farm Credit System lenders, he says.

"As the Farm Credit System pursues new avenues of lending to non-agriculturally related businesses and infrastructure projects," Robbins says, "small banks will probably continue to voice concerns."

Ultimately, though, rural America will benefit, Oldvader says.

"We all have the interests of our customers in mind."



BY BRYE STEEVES, SENIOR WRITER

## FURTHER RESOURCES

### "RURAL LENDING COMPETITION OF COMMUNITY BANKS AND THE FARM CREDIT SYSTEM"

By Eric Robbins  
[KansasCityFed.org/TEN](http://KansasCityFed.org/TEN)

COMMENTS/QUESTIONS are welcome and should be sent to [teneditors@kc.frb.org](mailto:teneditors@kc.frb.org).