

PERSPECTIVES

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Perspectives

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FEDERAL RESERVE BANK of KANSAS CITY

Lending Competition of Community Banks and the Farm Credit System

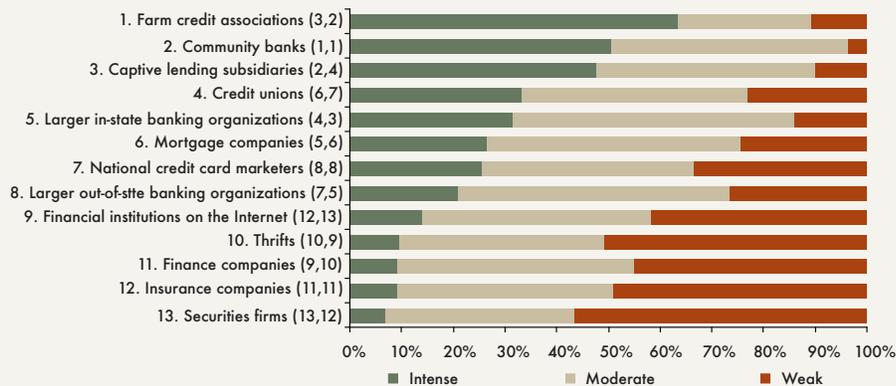
ERIC ROBBINS

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Community banks have always faced loan competition from many sources. But the nature of their competitive environment has changed over the years, as regulations were altered that previously limited bank branching or the activities of other competitors, like thrifts and credit unions, or nonbanks, including government-sponsored enterprises (GSEs) such as Farm Credit Associations. In addition, consolidation in the financial services industry has introduced added competition from larger financial institutions.

For community banks located in non metropolitan areas, loan competitors are often other community banks. However, the Farm Credit System (FCS) and farm credit associations (FCAs) are attracting increasing attention from many community banks as significant loan competitors. In the 2008 Survey of Community Banks in the Tenth Federal Reserve District, 63 percent of community bank respondents said they expect intense loan competition from Farm Credit Associations in the next five years. (Most of these banks, 76 percent, are located in rural areas with less than 10,000 residents). Their responses put FCAs above other community bank competitors as the top loan competitor for the first time since the community bank survey began in the late 1980s (Chart 1).

Chart 1
Expected Level of Future Loan Competition during the Next Five Years



Note: Numbers in parentheses represent rankings in the 2004 and 2001 surveys, respectively.
 Source: 2008 Survey of Community Banks in the Tenth Federal Reserve District

Concern about competition from FCS organizations was also apparent in written comments from survey respondents. These comments illustrate some of the potential causes of bankers' concerns. For example, many bankers claim that FCS participants have a competitive advantage that allows FCAs to offer better loan rates. One banker described this by saying, "We have great concerns regarding Farm Credit and credit unions in regard to their tax-free status. We believe the playing field should be equal. 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)."

Other bankers expressed concern about the growth of Farm Credit. As one banker noted, "When the FCS has more loans in a given county than all other banks combined, we are in for big trouble. Their momentum is growing, and because their rates are lower, (and) they pay no taxes and no filing fees, we will not be able to compete."

Another worry of bankers is related to the perceived mission creep of the FCS. Some claim that the FCS has moved beyond its original intent and is entering new lines of business. According to one respondent, "Farm Credit has continued to be a big

competitor for loans that aren't truly farm loans."

Are community bankers' anxieties about the FCS warranted? What aspects of the FCS structure or strategies may be exacerbating these worries? Is this so-called competitive advantage reflected in differences in how FCS participants are performing relative to banks? And what may be the future impact of these issues for community banks?

This article seeks to answer these questions by describing the characteristics of the FCS and how it has evolved; by analyzing the performance of FCS vis-à-vis community banks in general and agricultural banks in particular; and by exploring what these factors mean for the future competitive environment.

THE EVOLUTION OF THE FARM CREDIT SYSTEM

The Farm Credit System has evolved over time after first being established as a government-sponsored enterprise (GSE) in 1916. At that time, Congress responded to farmers' complaints about the lack of affordable long-term financing by passing the Federal Farm Loan Act. This lack of affordable financing may have been due to constraints on commercial banks and other lenders on the amount and terms of agriculture lending.¹ The new law resulted in the chartering of twelve Federal Land Banks that provided funding to hundreds of National Farm Loan Associations. The National Farm Loan Associations were cooperatives in that they were owned by member farmers, who were required to buy stock in the associations in order to be eligible for long-term land loans.

Subsequent congressional actions imple-

mented structural changes to the system of Farm Credit entities. These actions were taken to address un-met needs of farmers or in response to economic crises that induced government intervention to recapitalize FCS organizations. For example, in response to increasing defaults on farm debts during the Great Depression, Congress passed the Emergency Farm Mortgage Act of 1933, which extended repayment periods for delinquent borrowers and allocated new government financing. The 1933 Farm Credit Act simultaneously created new entities to provide not only long-term land loans, but also short- and intermediate-term loans for land and operations. Later, during the 1980s agricultural crisis, Congress passed the Agricultural Credit Act of 1987, providing federal assistance to FCS organizations that faced financial problems and establishing the Farm Credit System Insurance Corporation and the Federal Agricultural Mortgage Corporation, or Farmer Mac.

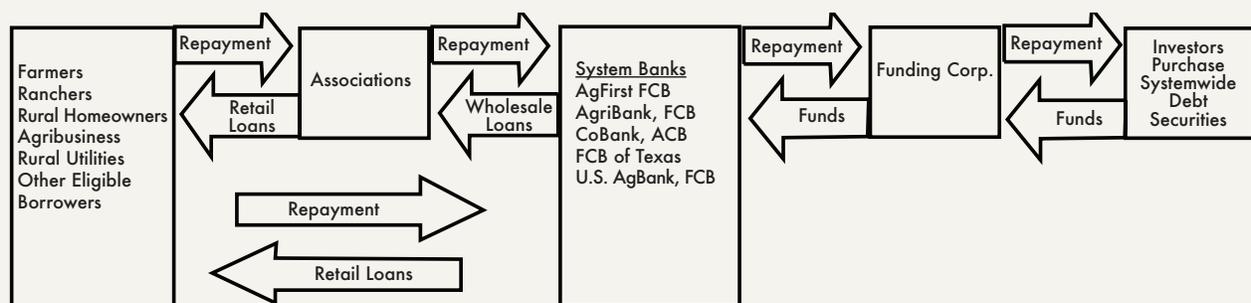
Today's Farm Credit System receives its structure and regulatory framework from the Farm Credit Act of 1971, which superseded all prior authorizing legislation. The FCS is organized into four Farm Credit Banks and one Agricultural Credit Bank, CoBank, which are chartered by their regulator, the Farm Credit Administration (Chart 2). In addition, the Federal Farm Credit Banks Funding Corporation (FFCB Funding

Corp.) is authorized to issue debt obligations in the form of bonds on behalf of the five banks. The banks, in turn, lend the proceeds of these debt issuances to the so-called Agricultural Credit Associations (ACAs) and Federal Land Credit Associations (FLCAs), together referred to as Farm Credit Associations.

The Farm Credit Associations provide loans to agricultural and aquatic producers, businesses that provide services to these producers, and mortgage loans to homebuyers located in rural areas. In the case of ACAs, these loans may be short-, medium-, or long-term loans, whereas the FLCAs only provide long-term funding. The associations can leverage their lending authority by selling these loans to Farmer Mac—another GSE created by Congress as a result of the Agricultural Credit Act of 1987. Farmer Mac is authorized to purchase agricultural real estate and rural home mortgages, which it pools as mortgage-backed securities that carry a government guarantee of repayment.

While the Farm Credit Act of 1971 provides the authorizing legislation for the FCS, the Act also provides guidance on the policy objectives that Congress is attempting to realize through the creation of the FCS. The law stipulates that it is the policy of the Congress that the “farmer-owned cooperative Farm Credit System be designed to accomplish the objective of improving the income and well-being of American farmers and ranch-

Chart 2
Funding Flow of the Farm Credit System



Source: FCS Annual Information Statement, February 27, 2009.

ers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related business necessary for efficient farm operations” (Farm Credit Act of 1971 Section 1.1.a).

The same section stipulates that “the credit needs of farmers, ranchers, and their cooperatives are best served if the institutions of the Farm Credit System provide equitable and competitive interest rates to eligible borrowers.” However, later amendments qualified this policy statement to require that “in no case is any borrower to be charged a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent creditworthiness and access to alternative credit” (Farm Credit Act of 1971, Section 1.1.c).

In addition to providing the policy and objectives of the U.S. Congress, the Act also gives FCS organizations flexibility in lending to production agriculture and authorizes lending to commercial fishermen and rural homeowners. More specifically, the Act allows FCS lenders to provide home mortgages to any resident of a rural area, defined as cities with fewer than 2,500 residents, as long as the total of all such rural housing loans does not exceed 15 percent of the FCS lenders’ total bank loans. The Act was also amended in 1980 to encourage FCS lending to so-called young, beginning and small farmers.

Overall, these policy objectives as stated do not support the concerns of our survey respondents, who believe that Farm Credit Associations are offering below-market interest rates and providing loans to entities beyond their intended mission. However, as the Act has been amended to increase FCS lending authority and broaden its focus beyond providing credit to farmers, the FCS is potentially coming into more direct competition with community banks in rural areas. This may be one reason community banks express concern about loan competition from FCAs.

New initiatives of the FCS and recent actions of the Farm Credit Administration are also likely fueling these worries. In 2004, the FCS spon-

sored an initiative called the HORIZONS Project to “identify and document the evolving financial needs and business trends of farmers, rural businesses, and rural communities.” One of their eight key findings published in a 2006 report argued that “ongoing access to debt and equity capital is paramount to the future prosperity of U.S. agriculture and rural America.” The report concludes by noting four financial needs that are essential to the future success of rural America (see box).

This list of financial needs raises some questions regarding the future role of the FCS. First, the proposition that producers and rural entrepreneurs require specialized lenders could be viewed as suggesting that the FCS is such a lender. If so, the implication could be that the FCS should not

HORIZONS Project – Four Essential Financial Needs

1. Producers and rural entrepreneurs of all types require access to a dedicated, specialized lender to meet their complete credit needs.
2. A broad range of processing, marketing and other agriculturally related businesses on which farmers depend requires ongoing access to reliable, flexible financial products and services to compete in a rapidly changing business environment.
3. Rural America and agriculture need investors and financial/business partners to meet the growing requirements of rural entrepreneurs and to fuel economic growth in rural communities.
4. Rural residents and producers living in increasingly diverse communities throughout the nation require access to full service residential mortgage products and the ability to leverage real estate equity for other family needs and obligations.

Source: “21st Century Rural America: New Horizons for U.S. Agriculture”

be limited to serving only farmers, agriculturally related business and rural homeowners, but also should be serving entrepreneurs. The third point introduces the need for equity financing, whereas the current public policy framework provides for debt financing that is supported through GSEs like the FCS, Farmer Mac and the Federal Home Loan Banks.

Just as the FCS is exploring broadening its services and its customer base, its federal regulator, the Farm Credit Administration, has also proposed changing its regulatory policies to allow these new services. In June 2008, the Farm Credit Administration proposed a new rule that would allow FCS organizations to invest in debt securities and make equity investments in venture capital funds that support projects or programs in rural communities. And this effort has the potential to broaden the communities eligible for such investments by defining “rural community” as any town or city with less than 50,000 residents. This is in stark contrast to the FCA’s current definition of a rural community that allows mortgage lending to rural homeowners in towns with less than 2,500 residents.²

In response to this proposal, the financial services industry and Congress expressed growing concern about the FCA’s expansion of lending authority.³ Congressional committees sent letters to the FCA requesting that the agency withdraw the proposed rule.⁴ In its letter, the House of Representatives’ Financial Services Committee stated that the “proposed rule would allow the Farm Credit System to exceed its legislative mandate by funding activities and businesses with few or no ties to the agricultural sector.”⁵ The committee tied this effort to the FCS Horizons project by noting that “during the consideration of the 2008 Farm Bill Congress rejected certain provisions developed in connection with the Farm Credit Council’s Horizons Project...it

is disturbing that the Farm Credit Administration is now championing similar or greater expansion of the Farm Credit System through this proposed rule and others.” To date, the FCA has not finalized the rule.

THE CHANGING FARM CREDIT SYSTEM LOAN PORTFOLIO

Although the FCS is exploring new areas of loan growth, its loan portfolio remains dominated by farm real estate and agricultural production and intermediate-term loans.⁶ As of December 2008, 44 percent of the FCS loan portfolio was concentrated in agricultural real estate mortgage loans, with an additional 23 percent dedicated to production and intermediate-terms loans (Chart 3), equaling \$72 billion in ag real estate loans and \$37.5 billion in production and intermediate-term loans at year-end 2008 (Table 1). The third-largest lending category is agribusiness loans. As shown in Table 2, these include loans to cooperatives; processing and marketing loans; and farm-related business loans. (Prior to 2004, these loans were not reported individually.)

The overall growth of the FCS loan portfolio

Chart 3
FCS Loan Portfolio

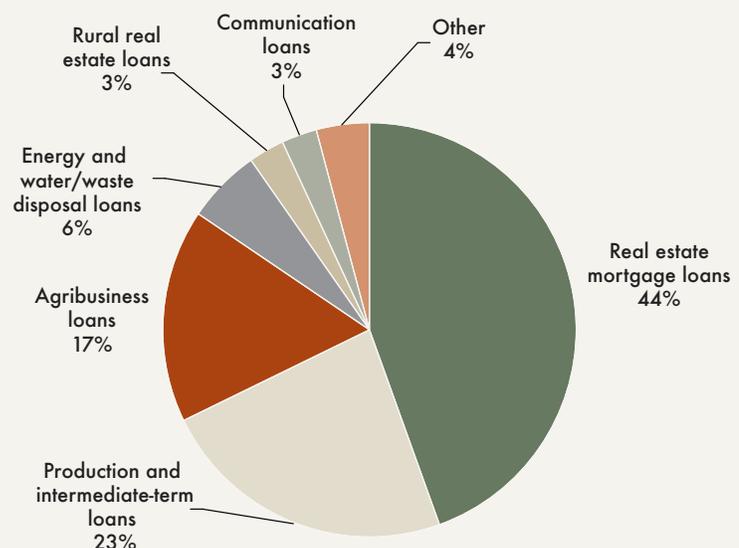


Table 1
Farm Credit System Loan Portfolio, in millions

	2008	2007	2006	2005	2004
Real estate mortgage loans	\$71,892	\$63,458	\$56,489	\$51,690	\$47,695
Production and intermediate-term loans	37,468	32,267	28,731	24,935	22,789
Agribusiness loans:					
Loans to cooperatives	12,213	15,855	12,222	8,778	7,627
Processing and marketing loans	12,160	9,772	6,781	4,083	2,678
Farm-related business loans	2,528	2,464	2,138	1,812	1,748
Energy and water/waste disposal loans	9,387	7,496	6,279	5,458	4,811
Rural residential real estate loans	4,611	3,965	3,408	2,950	2,482
Communication loans	4,544	3,350	3,290	2,605	2,389
International loans	4,077	2,135	2,183	2,277	2,624
Lease receivables	1,952	1,708	1,489	1,290	1,168
Loans to other financing institutions	591	436	426	394	356
Total loans	\$161,423	\$142,906	\$123,436	\$106,272	\$96,367

Source: FCS Annual Information Statements

has been very rapid the last four years. In fact, since the 2001 recession, the FCS loan portfolio more than doubled—increasing from \$75.2 billion in 2000 to \$161.4 billion in 2008. But growth among some of the individual loan components is much more volatile. Some loan types, such as real estate mortgage loans, production and intermediate-term loans, energy and water/waste disposal loans, and rural residential real estate loans, have had consistently high growth rates since 2004 (Table 2). Processing and marketing loans grew even more rapidly during this same period.

MARKET SHARE OF FARM DEBT

Community banks may see this rapid loan growth as an indication of the potential for even greater future competition from the FCS. In addition, the growth in loans not directly related to agriculture, such as energy and water/waste related loans, rural residential real estate loans, and communication loans,

may be contributing to bankers' worries as well. Understanding whether these concerns are warranted requires a more in-depth look at FCS and commercial bank lending as a share of total agricultural lending.⁷

Table 2
Growth in FCS Lending Portfolio by Category

	2008	2007	2006	2005	2004
Real estate mortgage loans	13.3%	12.3%	9.3%	8.4%	2.6%
Production and intermediate-term loans	16.1%	12.3%	15.2%	9.4%	8.2%
Agribusiness loans:					-0.3%
Loans to cooperatives	-23.0%	29.7%	39.2%	15.1%	
Processing and marketing loans	24.4%	44.1%	66.1%	52.5%	
Farm-related business loans	2.6%	15.2%	18.0%	3.7%	
Energy and water/waste disposal loans	25.2%	19.4%	15.0%	13.4%	23.6%
Rural residential real estate loans	16.3%	16.3%	15.5%	18.9%	9.0%
Communication loans	35.6%	1.8%	26.3%	9.0%	-6.6%
International loans	91.0%	-2.2%	-4.1%	-13.2%	-6.1%
Lease receivables	14.3%	14.7%	15.4%	10.4%	-11.7%
Loans to other financing institutions	35.6%	2.3%	8.1%	10.7%	14.5%
Total loans	13.0%	15.8%	16.2%	10.3%	3.9%

Source: FCS Annual Information Statements

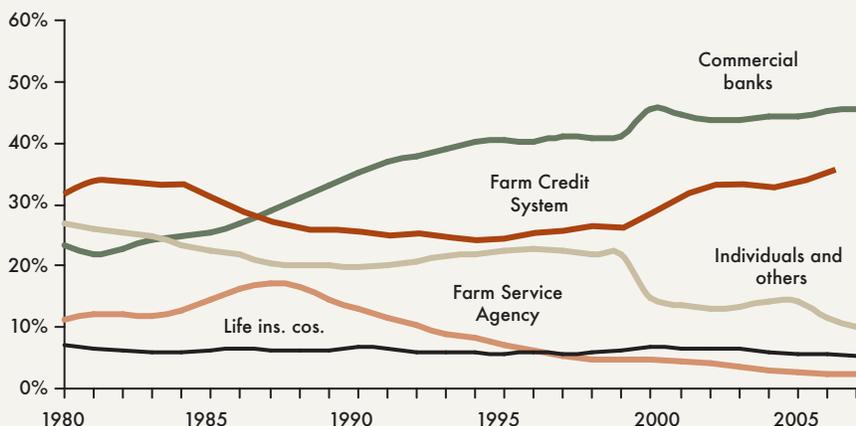
FCS and Commercial Banks' Share of Farm Debt

Community banks compete with larger commercial banks, as well as the FCS, for agricultural loans. While community banks' concern about competition was focused on the FCS, commercial banks as a group actually have the greatest share of farm debt at 45.5 percent (Chart 4). Commercial banks' share of farm debt appears to have been stable since 2000. However, prior to the mid 1980s, the Farm Credit System had a larger share of farm lending until it suffered heavy losses and required a federal government bailout. Congress imposed

higher capital requirements and imposed other limits as a result of this bailout. As Chart 4 shows, banks took on more ag lending since then, although their share of total farm debt has remained flat since 2000. And although the FCS share of farm debt is lower at 36.7 percent, its share has been growing as other lenders' shares decline.

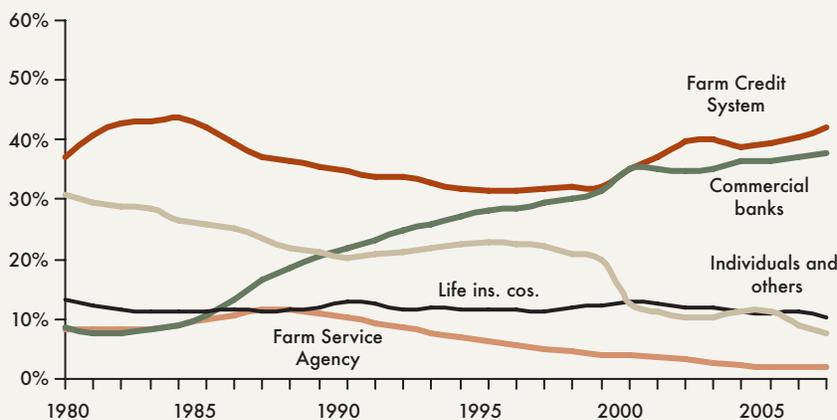
Disaggregating total farm debt into real estate debt and non-real estate debt reveals a more complex story. For the most part, the FCS has maintained the highest percentage share of farm real estate debt for the last three decades (Chart 5). However, banks have steadily increased their farm real estate lending, and other lenders have declined in importance. Commercial banks have dominated non-real estate farm lending, but the FCS share has been increasing (Chart 6). This trend is consistent with the growth rates shown earlier in Table 2, where production and intermediate-term FCS loans have grown more rapidly compared to real estate mortgage loans since 2003.

Chart 4
Share of Farm Debt by Lender



Source: USDA Economic Research Service, 2009

Chart 5
Share of Farm Real Estate Debt – by Lender



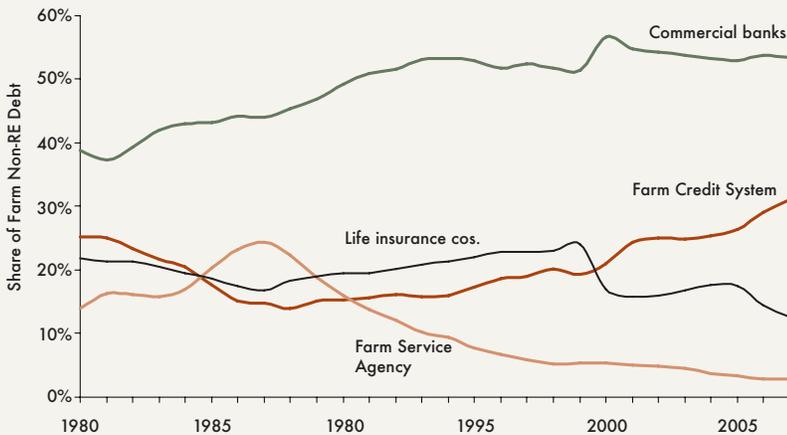
Source: USDA Economic Research Service, 2009

Ag Banks' Share of Farm Debt

If commercial banks' share of total farm debt exceeds that of the FCS, why are community banks troubled by the FCS? It turns out, when using an alternative data source to focus on smaller banks' share of agricultural lending, that so-called ag banks are losing market share and are not ex-

Chart 6

Share of Farm Debt not Related to Real Estate – by Lender



Source: USDA Economic Research Service, 2009

perencing the same loan growth as FCS lenders and larger banks. These financial reports of commercial banks, referred to as reports of condition and income, help explain what is happening with respect to lending competition. To explore this issue, we reviewed data for banks that specialize in agricultural 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.

By comparing ag banks' balance sheets with FCS lenders, one observes FCS dominance in farm real estate lending, consistent with the Economic Research Service (ERS) data (Chart 7). But the data also reveal that ag banks' share of this lending has declined compared to FCS and other, mostly larger banks. For example, in 2001, ag banks held \$12.3 billion in farm real estate loans compared to the FCS's \$37.7 billion and other commercial banks' \$23.2 billion balance. By 2008,

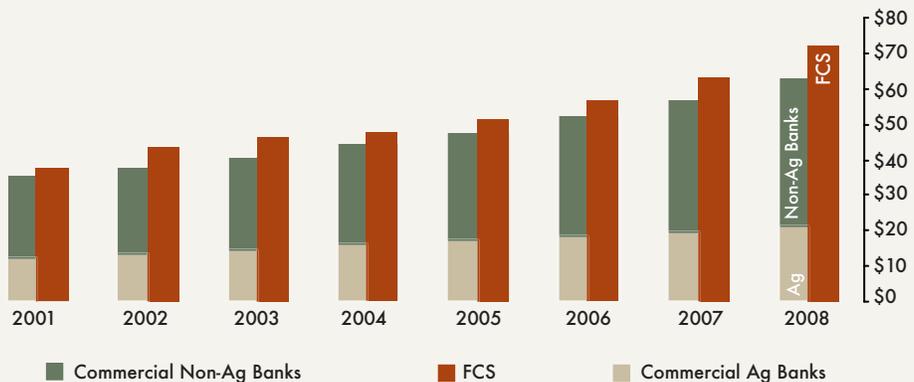
ag banks' level of farm real estate loans increased by 74 percent to \$21.4 billion, while FCS farm real estate loans increased by 91 percent to \$71.9 billion, and non-ag specialized banks increased their farm real estate lending by 80 percent to \$41.8 billion.

One factor that may contribute to this growth-rate difference is ag banks' declining share of industry assets. In 1998, ag banks held 2.3 percent of commercial bank assets, compared to 1.4 percent in 2008. The number of ag banks as a percentage of all commercial banks declined as well, from 26 percent of banks in 1998 to 22 percent by 2008. Despite these differences, farm real estate lending has increased rapidly across all lenders as farm land prices have escalated.

Ag banks' share of non-real-estate farm loans has also declined compared to FCS and other commercial banks. Back in 2001, ag banks held \$19 billion in non-real-estate farm loans, while the FCS held slightly more, at \$20 billion, and non-ag commercial banks held \$29 billion in these loans (Chart 8). By 2008, the FCS increased its level of non-real-estate ag lending by 87 percent to \$37.5

Chart 7

Farm Real Estate Loans by Lender, in billions



Source: FCS Annual Information Statements and FDIC Statistics on Depository Institutions

billion; ag banks increased their non-real-estate ag loans by just 29 percent to \$24.5 billion; and non-ag commercial banks increased their level of these loans by even less—25 percent to \$35.2 billion.

Overall, these charts reflect a declining share of real estate and non-real-estate agricultural lending by smaller commercial banks that specialize in agricultural lending. Whether or not this trend will continue will likely depend on the strength of loan demand from farm and agricultural producers. In recent years, demand for real estate mortgages from agricultural producers supported

land prices have increased significantly in recent years until slowing down in 2008 (See Appendix for charts reflecting crop and land price changes).

PERFORMANCE OF THE FARM CREDIT SYSTEM AND COMMERCIAL AG BANKS

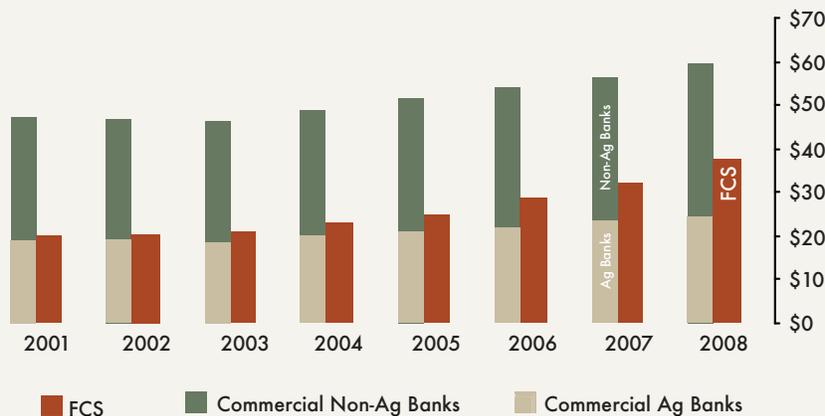
While rising crop and land prices may have contributed to strong loan demand and asset growth, they do not explain why FCS lenders are experiencing more rapid growth than ag banks. Do FCS participants have an advantage that allows

them to offer more competitive rates on loans? If so, does this competitive advantage show up in greater earnings or other financial factors? The following section will attempt to explore this issue by comparing the financial performance of the Farm Credit System with commercial banks that specialize in agricultural lending. As discussed later, one caveat to this approach relates to differing structures and business models of commercial banks and the Farm Credit System. Thus, any comparison must be considered in light of

these differences.

One indicator of how much financial institutions earn, in return for lending or investing their funds, is their yield on earning assets. This ratio includes the total amount of interest earned divided by average earning assets. These earning assets include not only loans for which the financial institution is charging interest, but also interest earned on other investments. As shown in Table 3, agricultural banks consistently obtain higher yields on earning assets when compared with the FCS and the lending arm of the FCS—the agricultural credit associations (ACAs). The ACA yields are a bit higher than the FCS as a whole, likely due to the nature of the FCS struc-

Chart 8
Non-Real-Estate Farm Loans by Lender, in billions



Source: FCS Annual Information Statements and FDIC Statistics on Depository Institutions

strong growth of FCS balance sheets. And as the dominant provider of farm real estate financing, FCS asset growth has outpaced commercial banks, especially commercial ag banks. During the last decade, the FCS experienced a compound annual growth rate of 9.8 percent, compared to 8.5 percent for commercial banks as a whole and only 3.0 percent for ag banks.

Several factors probably influenced this heightened demand for real estate and agricultural production loans. For instance, agricultural commodity prices have been very strong in recent years, leading to more farm income to support higher farm and ranchland values. And indeed, the Federal Reserve Bank of Kansas City's Agricultural Credit Survey shows that Tenth District

Table 3
Yield on Earning Assets

	2008	2007	2006	2005	2004
Ag Banks	6.37	7.14	6.83	6.10	5.68
FCS	5.55	6.84	6.65	5.66	4.63
ACAs	6.05	7.01	6.79	5.99	5.23

Source: FCS Annual Information Statements, FCA, and FDIC Statistics on Depository Institutions

ture. The FCS ratio also includes the Farm Credit Banks (FCBs), whose yields on earning assets are generally lower and whose primary role is to downstream the proceeds of FCS bond issuances to the ACAs to fund loans.

When considering the yield on farm loans, a greater disparity is found—and in this instance the disparity is to the benefit of FCS loan customers. While it is difficult to make a straight-forward comparison of bank and FCS balance sheet assets, data sources indicate that FCS lenders are generally providing non-real-estate farm loans and farm real estate loans at slightly lower rates compared to banks. For example, survey data in the Federal Reserve's Agricultural Finance Databook notes the average effective interest rates banks are charging on non-real-estate farm loans (Table 4). FCS reports also provide the average interest rate earned on similar loans, including production and intermediate-term and agribusiness loans. The spread between bank and FCS non-real-estate farm loans had been about 100 basis points throughout most of 2006 and 2007. More recently, as interest rates have plummeted, banks' average interest rates have declined—likely because the majority of farm loans are variable-rate loans.⁸

When it comes to farm real estate loans, FCS lenders may be offering even more competitive rates. In 2006 and 2007, the spread between FCS farm real estate loans and bank's real estate loans varied from 108 to 138 basis points (Table 5). In this instance, we are comparing FCS average interest rates on real estate mortgage loans with the rates that Tenth District banks reportedly charge on farm real estate loans. Again, banks' interest charges on farm real estate loans have declined

Table 4
Average Interest Rate Earned on Non-Real Estate Farm Loans

		Banks ⁹	FCS	Spread
2006	Q2	8.10	7.25	0.85
	Q3	8.60	7.66	0.94
	Q4	8.40	7.39	1.01
2007	Q1	8.50	7.47	1.03
	Q2	8.60	7.60	1.00
	Q3	8.50	7.70	0.80
	Q4	7.70	7.49	0.21
2008	Q1	6.50	6.20	0.30
	Q2	5.70	5.48	0.22
	Q3	5.30	5.52	-0.22
	Q4	4.80	5.63	-0.83
2009	Q1	5.1	4.28	0.82

Source: Federal Reserve Agricultural Finance Databook Table A.5 and Federal Farm Credit Banks Funding Corporation Quarterly and Annual Information Statements

Table 5
Average Interest Rates on Farm Real Estate Mortgage Loans

		Tenth District Banks	FCS	Spread
2006	Q2	8.4	7.02	1.38
	Q3	8.5	7.16	1.36
	Q4	8.4	7.04	1.36
2007	Q1	8.4	7.19	1.23
	Q2	8.3	7.23	1.09
	Q3	8.3	7.24	1.08
	Q4	7.9	7.21	0.66
2008	Q1	7.0	6.87	0.14
	Q2	7.0	6.23	0.74
	Q3	7.0	6.15	0.83
	Q4	6.8	6.39	0.36
2009	Q1	6.6	5.9	0.69

Source: Federal Reserve Bank of Kansas City Quarterly Agricultural Credit Survey and FCS Quarterly and Annual Information Statements

recently as market interest rates have dropped—making them slightly more competitive with FCS lenders. But Tenth District banks appear still to be at a disadvantage.

Lower yields on FCS loans could legitimately occur for several reasons. They could be due to

differences in the terms or length of the loans, or differences in the creditworthiness of borrowers. In addition, borrowers from the FCS are required to make equity investments in the FCS by investing in capital stock or participation certificates of the association or farm credit bank providing the loan. The actual amount required by FCS banks and associations can vary, but the statutory minimum investment is the lesser of 2 percent of the loan amount or \$1,000. It could be argued that FCS borrowers are buying down the interest rate, assuming they are not receiving a dividend payment in return for their investment that fully compensates their required investment.

In addition to these factors, the FCS could be accepting lower yields on their earning assets because their funding costs are lower than those of banks. Yet this appears not to be the case. Financial reports from ag banks indicate that their funding costs, or total interest paid to fund their earning assets, were lower than the funding costs of the FCS as a whole and the ACAs (Table 6). As noted earlier, the FCS funds its loans to agricultural producers and farmers by issuing bonds, whereas agricultural banks fund their lending activities primarily by using bank deposits. These deposits normally pay a much lower interest rate compared to what the FCS would pay bondholders, although the slow rate of deposit growth would inhibit significant increases in lending. In the last ten years, core bank deposits at ag banks have grown at a compound annual rate of just 1.8 percent. For the FCS, the result of higher funding costs causes their net interest margins to also be lower than ag banks' margins. In fact, the ACAs' margins are almost 150 basis points lower than ag banks' (Table 7).

Despite these tighter net interest margins for FCS entities, they still achieve higher net income compared to banks, resulting in more favorable return-on-average-asset ratios (ROAA). The return-on-average-asset ratio reflects net income divided by average assets (Table 8). The table shows that ACAs, the primary lending arm of the FCS, consistently achieve a 50 basis point higher

Table 6
Funding Costs to Earning Assets

	2008	2007	2006	2005	2004
Ag Banks	2.48	3.18	2.79	1.99	1.61
FCS	3.14	4.41	4.17	3.07	2.07
ACAs	3.56	4.44	4.17	3.29	2.51

Source: FCS Annual Information Statements, FCA, and FDIC Statistics on Depository Institutions

Table 7
Net Interest Margin

	2008	2007	2006	2005	2004
Ag Banks	3.90	3.96	4.04	4.11	4.07
FCS	2.41	2.43	2.48	2.58	2.56
ACAs	2.50	2.57	2.62	2.70	2.72

Source: FCS Annual Information Statements, FCA, and FDIC Statistics on Depository Institutions

Table 8
Return on Average Assets

	2008	2007	2006	2005	2004
Ag Banks	1.00	1.20	1.23	1.27	1.22
FCS	1.44	1.56	1.59	1.61	1.52
ACAs	1.62	1.82	1.80	1.90	3.11

Source: FCS Annual Information Statements, FCA, and FDIC Statistics on Depository Institutions

ROAA compared to ag banks, even in the face of higher funding costs.

Several factors likely influence these higher ROAAs for FCS organizations. Whereas the net interest margin takes into account the interest cost of funding these assets, it does not take into account non-interest costs, such as operating expenses. As it turns out, ag banks' operating expenses are double those of ACAs, equaling 2.9 percent of average assets at year-end 2008, compared to 1.4 percent of average assets for ACAs (see Appendix for operating expense ratios). This is likely due to differences in their business models as well as the types of services they offer. Unlike commercial banks, the FCS does not provide banking services, such as transaction services and deposit accounts. Thus, they do not face the costs associated with such services. Ag banks, like other commercial banks, offer non- or low-interest transaction accounts, but incur costs associated with these accounts, so their net inter-

est margins are higher, but non-interest expenses reduce banks' return on assets. In addition, the two parties operate on very different scales. At year-end 2008, 1,559 commercial banks were considered agriculturally specialized banks by the FDIC. In contrast, the FCS includes only 95 separate entities; thus, its personnel and other non-interest expenses are spread out over much larger organizations.

Taken as a whole, the contributions to earnings of interest income versus non-interest income can be depicted graphically to demonstrate the competitive positions of FCS and ag bank lenders. In Chart 9, net interest income as a percent of average assets, also called margin income, is shown on the top half of the graph, while the bottom of the graph reflects the negative impact on earnings of non-interest expenses by illustrating net non-interest income as a percentage of average assets. Ag banks' higher margins are clearly shown by the tan bars in the top portion of the graph. Meanwhile, their higher non-interest expenses, as reflected by the shaded olive bars in the bottom portion of the graph, drag down total return on assets. In stark contrast, FCS lenders' net non-interest expense ratio is much lower, which helps compensate for their lower yields on assets and also explains their superior return on average assets.

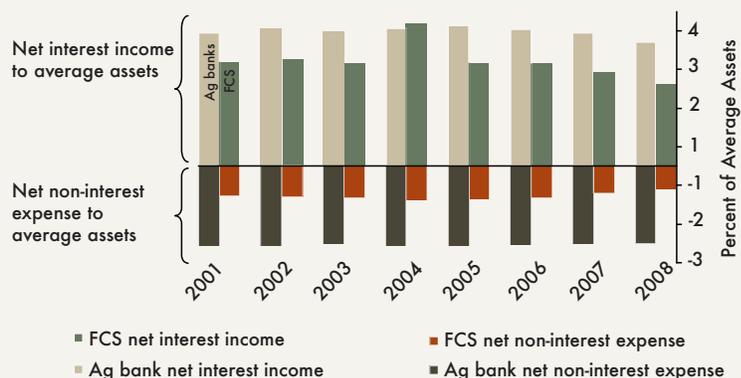
Another factor that affects the overall profitability of agricultural banks in comparison to FCS entities is the impact of taxes. As government-sponsored enterprises that are organized as

cooperatives, most participants in the FCS are exempt from taxation. According to the Annual Information Statement of the FCS, "certain Associations...are exempt from federal and other income taxes as provided in the Farm Credit Act. CoBank, certain other Associations and service organizations are not exempt from federal and certain other income taxes."¹⁰ Thus, some FCS entities are subject to taxation. To determine the extent to which taxes impact ROAA of ag banks versus the FCS and ACAs, pretax earnings can be used to develop a pretax ROAA (Table 9). For ag banks, their pretax ROAA is 18 basis points higher than after-tax ROAA, while ACAs pretax ROAA is 8 basis points higher and the FCS's pretax ROAA is 9 basis points higher.

Although some argue that the tax exempt status of cooperatives and GSEs provides an unfair advantage, a good number of commercial banks achieve a similar, although not identical status by choosing to be organized as Subchapter S Corporations. Subchapter S Corporations do not pay taxes at the corporate level; rather the income of the bank is taxed at the shareholder level. Among the 1,559 agricultural banks at year-end 2008, 53 percent were Subchapter S filers.

Considering the prospect that favorable economic conditions have contributed to the performance of FCS and ag lenders, two additional performance ratios are helpful in considering whether they are prepared for worsening conditions. These variables include the percentage of noncurrent loans and the lenders' capital ratios. These ratios also help address several other questions. For example, the variance in interest rates charged by FCS and ag lenders could be due to differences in the creditworthiness of their borrowers. Community banks have claimed that the FCS is capturing the best borrowers. One way to examine whether the FCS and ag banks are competing for and serving similar customers and whether the FCS is lending

Chart 9
Components Contributing to Return on Average Assets



to more creditworthy borrowers is to review the credit quality of their loan portfolios. In addition, by reviewing capital levels, one may ascertain whether the institutions have the ability to absorb losses and the likelihood that FCS's rapid lending growth, which could increase its risk exposure, is supported by strong capital levels.

As shown earlier, land and crop prices are declining from recent peaks, potentially leading to rapidly increasing noncurrent loans in both ag banks and FCS lenders. This is true especial-

Table 9
Pretax Return on Average Assets

	2008	2007	2006	2005	2004
Ag Banks	1.18	1.44	1.49	1.56	1.49
FCS	1.53	1.74	1.86	1.81	2.80
ACAs	1.65	1.86	1.81	1.93	3.29

Source: FCS Annual Information Statements, FCA, and FDIC Statistics on Depository Institutions

ly among FCS organizations, whose noncurrent loans almost tripled in 2008 to \$2.4 billion (Table 10). The FCS made a loan loss provision of \$408 million in 2008, compared to a 2007 provision of \$81 million. According to the FCS, the "significant increase in the 2008 provision for loan losses primarily resulted from credit deterioration due to exceptional volatility in commodity prices, which adversely impacted the livestock/poultry and ethanol sectors and, to a lesser extent, a decline in the condition of the overall economy."¹¹ Ag banks are suffering from similar conditions, although their loan portfolios are less concentrated in ag lending compared to the FCS. In 2008, ag banks made provisions of \$576 million compared to a provision of \$225 million in 2007.

Table 10
Noncurrent Loans as Percent of Total Loans

	2008	2007	2006	2005	2004
Ag Banks	1.43	1.05	0.87	0.82	0.92
FCS	1.50	0.43	0.50	0.56	0.77

Source: FCS Annual Information Statements and FDIC Statistics on Depository Institutions

Increasing provisions and charge-offs could cause financial institutions' capital levels to decline as their net income is reduced. Indeed, ag banks and the FCS are experiencing declines in capital ratios, but their capital levels remain fairly healthy (Table 11). In fact, ag banks' capital levels are relatively stable, while FCS capital levels are fluctuating to a greater degree. Again, according to the FCS annual information statement, the FCS capital levels "declined to 12.7% at December 31, 2008 from 14.2% at December 31, 2007 due principally to the growth in loans and investments and increases in accumulated other comprehensive losses." At year-end 2008, accumulated other comprehensive losses totaled \$2.1 billion.

It is important to note that capital is needed to support additional growth and serve as a buffer in the face of losses. This buffer could be impacted

Table 11
Capital to Total Assets

	2008	2007	2006	2005	2004
Ag Banks	11.00	11.17	10.73	10.55	10.78
FCS	12.65	14.17	15.00	16.28	17.13

Source: FCS Annual Information Statements and FDIC Statistics on Depository Institutions

by the performance of FCS institutions because the farm credit banks are jointly and severally liable for the repayment of FCS issued bonds. And the farm credit banks are dependent on the repayment from the farm credit associations of loans made by the FCBs to support association lending to farmers. Thus, deteriorating economic conditions that impact the agriculture industry can pass through to the FCBs, undermining their ability to repay FCS bonds. However, the FCS maintains an insurance fund that would be utilized to repay these bonds before the capital of FCBs came into play. In addition, FCS capital levels are well above the more stringent capital requirements Congress put in place following previous industry downturns (See appendix for FCS capital adequacy data).

THE FUTURE COMPETITIVE MARKET OF AGRICULTURAL FINANCE

At first glance, financial performance data seems to suggest that banks' concerns about unfair lending competition from the FCS could be overstated. However, the differences in yield on earning assets and comparisons of their respective interest rates indicate that FCS lenders are lending at slightly more competitive rates compared to ag banks, although these differences could be due to several legitimate factors. When it comes to overall profitability though, performance data indicates that FCS's lower operating costs are a bigger contributing factor.

In addition to differences in overall profitability, ag banks are not experiencing the same loan growth as FCS organizations. More rapid growth of FCS lending could be aided by its structure—especially with respect to its access to funding. As noted earlier, small banks have access to inexpensive consumer and business deposits, but these funding sources are growing slowly among banks. In addition to deposit funding, banks are also able to borrow from other sources, such as the Federal Home Loan Banks; however, these funds can be more expensive and require that banks provide collateral. In contrast, the FCS can issue bonds to provide liquidity to fund more lending. And these bonds are attractive to investors seeking safe returns because their repayment is guaranteed by the FCS insurance fund. In addition, despite FCS statements to the contrary, investors likely believe the bonds will be repaid by the federal government if the FCS requires a bailout. This access to capital markets has probably facilitated the rapid asset growth of the FCS, which has grown three times faster than ag bank assets.

Another factor that will probably lead to heightened competition is related to the scale of the FCS compared to ag banks. The FCS has very low operating costs as a percent of assets, partly because FCS organizations are much larger and can spread their costs over a larger asset base. Ag banks are much smaller, with an average asset size of \$108 million. This small size probably limits their ability to provide large real estate and operating loans to medium and large agricultural businesses. As discussed previously, banks also have higher operating costs because they offer transaction accounts, which require much more attention.

Finally, as the FCS pursues new avenues of lending, such as lending to non-agriculturally related businesses and infrastructure projects, community banks will likely continue to voice concern. These concerns will likely grow if the FCA pursues regulatory changes that allow equity investment in entrepreneurial and venture capital activities. At present, the Farm Credit Administration has not yet finalized its proposed rule to allow equity investments in venture capital and entrepreneurial activities. Nonetheless, its policy of allowing exceptions on a case-by-case basis means that these activities may continue without a system-wide policy and without the approval of Congress.

The future agricultural finance market will likely continue to be very competitive. As noted in this article, community banks face many challenges in competing for ag loans. Their smaller scale, operating structure and retail banking activities drive overhead costs much higher than government-sponsored enterprises. For community banks that specialize in agricultural finance, their competitive environment for ag lending will likely be intense as they compete with FCS lenders and larger banks—both of whom have access to capital market funding enabling more rapid growth.

Endnotes

¹Webb, Kerry, "The Farm Credit System," Federal Reserve Bank of Kansas City, Economic Review, June 1980.

²Federal Register citation, 73 FR 33931, 06/16/2008

³Public comments on the proposed rule are available on the FCA website: <http://www.fca.gov/apps/regproj.nsf/>

⁴<http://www.americanbanker.com/media/pdfs/081208Dodd-ShelbyLetter.pdf>

⁵http://www.americanbanker.com/media/pdfs/LetterFCA_7_10_08.pdf

⁶These production loans are likely used by agricultural producers to fund operating costs prior to an eventual harvest that will repay the loans. This category would also include farm machinery loans.

⁷The U.S. Department of Agriculture's Economic Research Service (ERS) compiles data from a number of sources to develop a consolidated balance sheet of farm debt. The ERS makes adjustments to these datasets to remove nonfarm lending and loans for operator dwellings.

⁸Table A.6 of the Federal Reserve Agricultural Finance Databook indicates that since 2001, more than 70 percent of non-real estate bank loans made to farmers were variable rate loans.

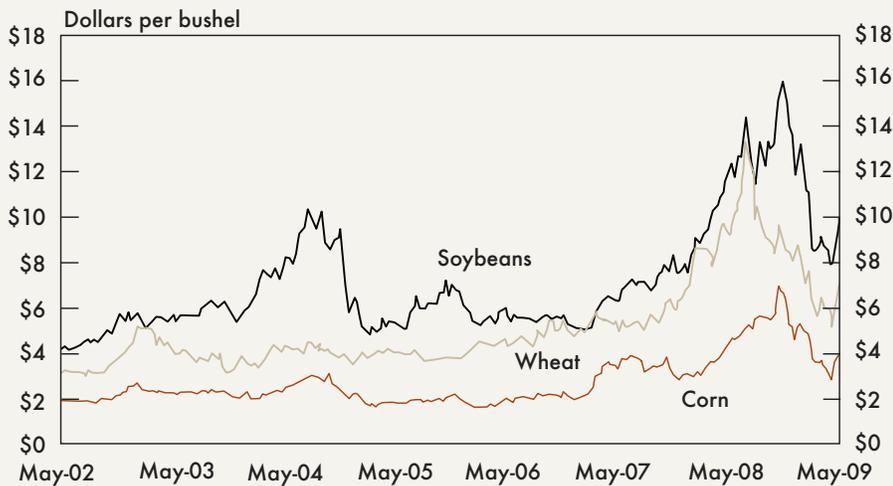
⁹Data are estimates from the Federal Reserve System's Survey of the Terms of Bank Lending to Farmers. Effective (compounded) interest rates are calculated from the stated rate and other terms of the loans and weighted by loan size.

¹⁰The Farm Credit Banks, certain Associations, and the income related to the Insurance Fund are exempt from federal and other income taxes as provided in the Farm Credit Act. CoBank, certain other Associations and service organizations are not exempt from federal and certain other income taxes. Taxable institutions are eligible to operate as cooperatives that qualify for tax treatment under Subchapter T of the Internal Revenue Code. Under specified conditions, these cooperatives can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds, FCS 2008 Annual Information Statement, p. F-12.

¹¹FCS 2008 Annual Financial Statement, p. 35.

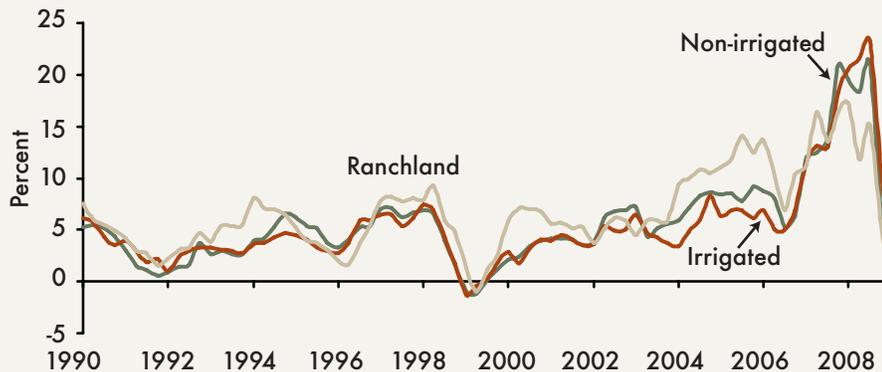
APPENDIX

U.S. CROP PRICES, DOLLAR PER BUSHEL



Source: Commodity Research Bureau

LAND VALUES, SAMPLE PERCENT CHANGE YEAR-OVER-YEAR



Source: Federal Reserve Bank of Kansas City Agricultural Credit Survey

APPENDIX (CONTINUED)

OPERATING EXPENSE TO AVERAGE EARNING ASSETS

	2008	2007	2006	2005	2004	2003	2002	2001
Ag Banks	2.90	2.94	2.97	3.00	3.02	2.98	2.97	2.96
FCS	0.88	0.96	1.04	1.12	1.14	1.11	1.14	1.17
ACAs	1.41	1.41	1.49	1.48	1.57	1.59	1.50	1.44

Source: FCS Annual Information Statements, FCA, and FDIC Statistics on Depository Institutions

FCS CAPITAL ADEQUACY IN COMPARISON TO CAPITAL REQUIREMENTS

<u>System Institutions</u>	<u>Permanent Capital Ratio</u>	<u>Total Surplus Ratio</u>	<u>Core Surplus Ratio**</u>	<u>Net Collateral Ratio</u>
Banks*	13.3%–17.1%	10.1%–15.9%	5.3%–9.1%	104.8%–107.6%
Associations	10.6%–27.7%	10.0%–27.3%	8.5%–25.0%	Not Applicable
Regulatory minimum required	7.0%	7.0%	3.5%	103%***

* See Note 13 for each bank's permanent capital ratio and net collateral ratio at March 31, 2009 and December 31, 2008.

** The Farm Credit Administration determined that one bank may include a significant portion of its capital stock and participation certificates in its core surplus, subject to certain conditions, on a temporary basis that would likely continue until the earlier of December 31, 2012, or when the Farm Credit Administration promulgates a final capital rule that would be inconsistent with this treatment. As part of this determination, the Farm Credit Administration also imposed a requirement that the core surplus ratio be calculated excluding capital stock and participation certificates and established a 3.0% minimum for this ratio.

*** In connection with preferred stock and subordinated debt offerings, certain banks are required by the Farm Credit Administration to maintain a minimum net collateral ratio of 104%.