

November 2004



The Main Street ———
Economist
Commentary on the rural economy

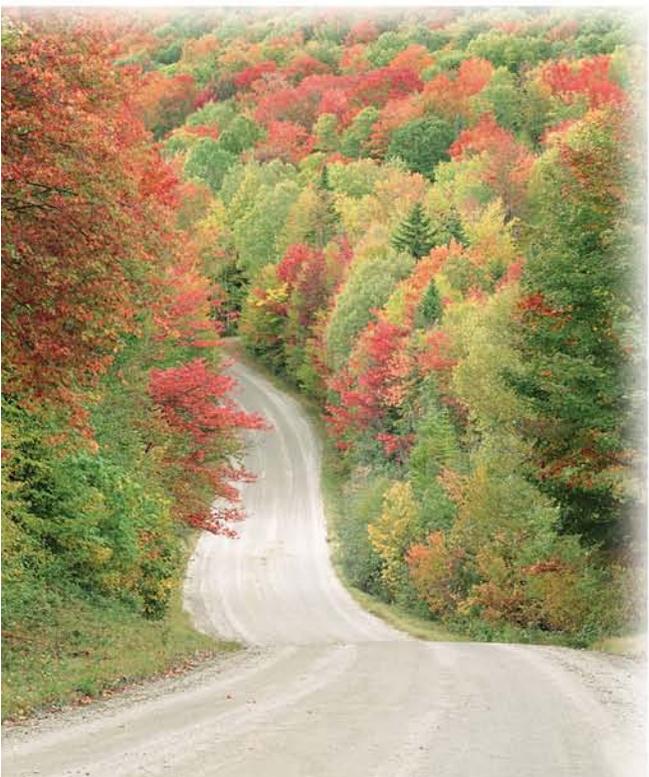


Termination of the Rabobank and Farm Credit Services of America Sale

Nancy Novack
Associate Economist

Jason Henderson
Economist

Center for the Study of Rural America



In October, Farm Credit Services of America (FCSAmerica), terminated its summer 2004 agreement to sell itself to Rabobank Group, a Dutch-based lending cooperative. The termination appears to have ended three months of controversy in U.S. agricultural lending markets. The purchase offer attracted widespread attention in the agricultural community. The wide-ranging views of the proposed sale culminated in a congressional hearing in September with calls for more public scrutiny. The sale will not happen now. But the questions raised about the role of the Farm Credit System (FCS) and the competitive landscape in agricultural lending are likely to linger.

This article discusses some frequently asked questions concerning the proposed deal. The FAQs focus on three areas: What happened? What issues did the offer raise? And what are the impacts on the agricultural lending environment?

The Rabobank purchase offer of FCSAmerica

The agricultural lending market was roiled in the summer of 2004 as one of the largest institutions in the FCS, FCSAmerica, received a purchase offer from Rabobank. The Rabobank offer was unprecedented in that it was the first attempt by a private entity to purchase an institution with the status of a government-sponsored enterprise (GSE). Following the announcement of the purchase agreement, AgStar Financial Services (AgStar), another FCS institution, submitted a proposal to merge with FCSAmerica.

On July 30, 2004, the board of directors of FCSAmerica initially accepted a Rabobank purchase offer that included a \$600 million distribution of cash to FCSAmerica stockholders and an \$800 million exit fee to the Farm Credit System Insurance Corporation. (The exit fee was required by legislation passed in 1987, which bailed out the then struggling FCS.) Rabobank later increased their cash distribution offer to \$750 million. Following the initial Rabobank purchase agreement, AgStar submitted a proposal to merge with FCSAmerica that would have paid a \$650 million cash distribution to FCSAmerica stockholders. But on October 21, 2004, FCSAmerica terminated their agreement with Rabobank and rejected the AgStar offer as well, ending a summer of controversy in U.S. agricultural financial markets.

What is the Farm Credit System?

The Farm Credit System is a GSE serving agricultural lending needs through a national network of borrower-owned financial

institutions. The FCS was established in 1916 to address the lack of adequate agricultural credit, especially long-term credit, available to the nation's farmers and ranchers. The FCS currently comprises four Farm Credit Banks that fund loans to farmers and one Agricultural Credit Bank that funds loans to farmers and their cooperatives (Map 1). In turn, the banks provide funds to "associations," the retail arm of the FCS. Agricultural Credit Associations (ACAs) make short-, intermediate-, and long-term loans, while Federal Land Credit Associations (FLCAs) make only long-term loans. There are 86 ACAs and 11 FLCAs in the FCS. The FCS is regulated by the Farm Credit Administration, an independent federal agency in McLean, Virginia.

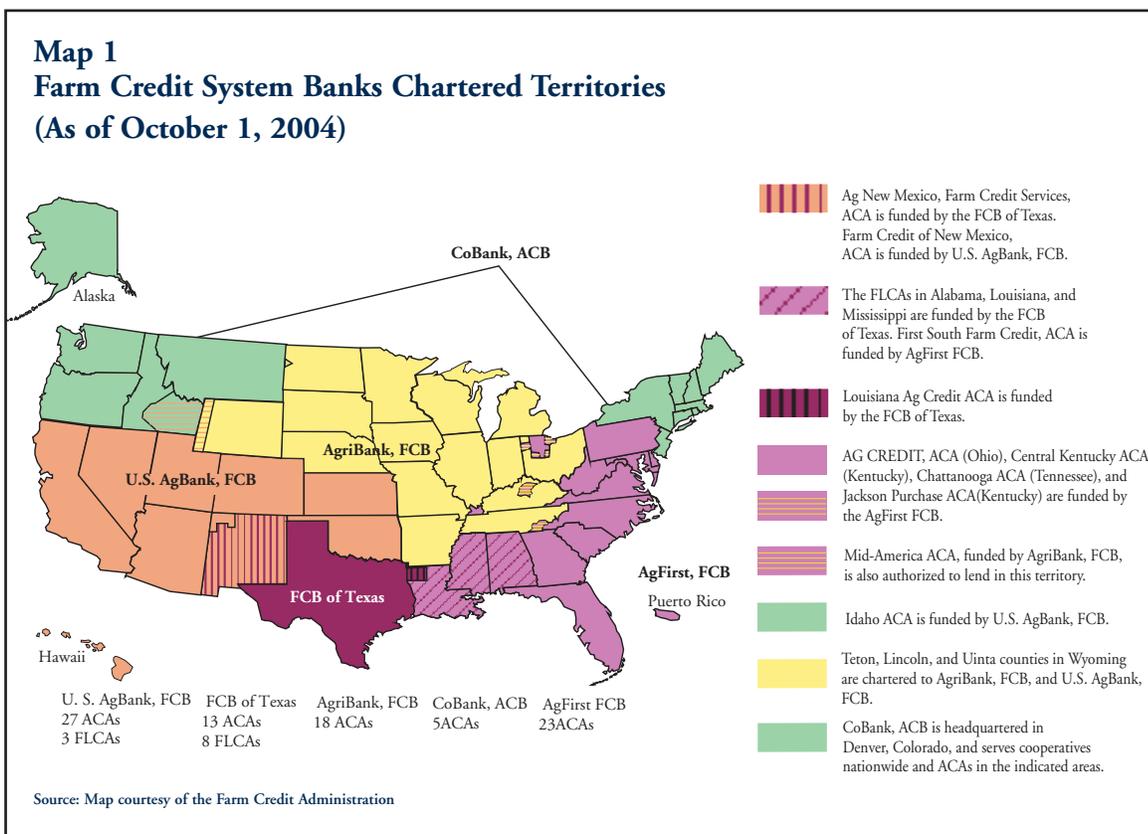
Farm Credit banks and associations do not accept deposits. Funds are generated by selling Farm Credit Debt Securities. These securities have been assigned very favorable credit ratings for several reasons, including: (1) the FCS's GSE status, (2) the "joint and several" liability clause requiring FCS banks to make debt payments should a bank

primarily liable for the payments default, (3) traditionally strong government support of agriculture, and (4) the perception among investors that there is an implicit government guarantee. In addition, recent strong financial performance has contributed to favorable credit ratings that have allowed FCS institutions to borrow funds at relatively low rates. Farm Credit Banks and associations have also been given certain tax exemptions. The favorable tax treatment and access to relatively inexpensive funds create benefits that are passed on to FCS customers.

Who is Farm Credit Services of America?

Farm Credit Services of America is an Agricultural Credit Association in the Farm Credit System. FCSAmerica is a \$7.6 billion lender headquartered in Omaha, Nebraska. Owned by more than 50,000 stockholders/customers, it operates as a cooperative, lending to farmers and ranchers in Nebraska, Iowa, South Dakota, and Wyoming. It is governed by a 17-member board of directors—15 are elected by the stockholders and two are appointed by the

**Map 1
Farm Credit System Banks Chartered Territories
(As of October 1, 2004)**



board members. FCSAmerica provides a range of financial services, including operating and real estate loans, financing and educational benefits, risk management products, and customized financial products for livestock producers. The \$7.1 billion loan portfolio of FCSAmerica is mostly farm real estate loans (70 percent as of December 2003). Agricultural production loans account for 29 percent.

Who is Rabobank?

Rabobank is a \$315 billion lending cooperative based in the Netherlands with subsidiaries in 35 countries serving 9 million customers (Table 1). Rabobank is owned by 328 independent local cooperative banks in the Netherlands. The banks comprise more than 1.3 million members, from which the Rabobank supervisory board members are selected. Membership is open to all customers of the cooperative banks in the Netherlands. Rabobank does not pay dividends to the local Dutch banks and retains all profits in the company.

Rabobank's ties to agricultural lending date back more than 100 years to their founding in the Netherlands. Rabobank entered the international market 25 years ago. It remains the leading agricultural lender in the Netherlands but has expanded its scope to small- and medium-sized businesses as well as consumer banking. *The Banker* ranks Rabobank as the 15th largest bank worldwide in tier one capital and 24th in total assets. Rabobank offers a full range of financial services and has a AAA credit rating by Moody's and Standard & Poor's. *Global Finance* ranks Rabobank as the 7th safest bank in the world (Citigroup is ranked 24th and Wells Fargo is ranked 38th).

Who is AgStar Financial Services?

AgStar Financial Services is another Agricultural Credit Association in the Farm Credit System. AgStar is headquartered in Mankato, Minnesota, and serves farmers and ranchers in southern and eastern Minnesota and northwest Wisconsin. The AgStar cooperative is owned by approximately 19,000 stockholders/customers. Service offerings are similar to those of FCSAmerica. AgStar and FCSAmerica differ in two important ways: First, AgStar's loan portfolio is less concen-

Table 1
Selected Financial Indicators, December 31, 2003

	Rabobank	FCSAmerica	AgStar
Loans (thousand \$)	\$315,928,981	\$7,084,015	\$2,370,705
Agricultural Loan Share	16%	100%	100%
Assets	\$508,043,309	\$7,633,606	\$2,537,140
Net Worth	\$29,711,284	\$1,293,436	\$340,314
Net Income	\$1,767,359	\$114,070	\$38,160
Return on Avg. Equity ¹	9.4%	9.6%	11.9%

Sources: Annual Reports, 2003.

¹The return on average equity calculations are as follows: Rabobank is return on average equity reserves; FCSAmerica is return on average total capital; and AgStar is return on average members' equity.

trated in real estate loans. Second, AgStar has a patronage dividend program that distributes profits to stockholders.

Why did Rabobank make the offer?

The proposed purchase of Farm Credit Services of America was a way for Rabobank to increase its share of the U.S. agricultural lending market by pursuing a country banking strategy. Rabobank's roots lie in agricultural lending, and its leading goal in the international market is to be the world's food and agri bank. In the Netherlands, its services have focused on all segments of agriculture, from small farms to large agribusiness, and beyond. When Rabobank entered the international market nearly 25 years ago, they focused only on serving large farms and agribusiness companies. Recently, however, Rabobank has adopted a strategy of offering services to smaller agricultural clients internationally.

To be the food and agri bank of the world, however, Rabobank recognized it must service all of the needs of producers, including their nonfarm banking needs. Therefore, the strategy also sets out to provide services to small- and medium-sized businesses and individuals in nonmetropolitan areas of selected countries. The strategy extends Rabobank's expertise in retail banking to the international market. The brand given to this strategy of providing retail activities in the international markets is "country banking." Central to the strategy is acquiring financial institutions involved in the target markets.

The country banking strategy has already proven successful in Australia, New Zealand,

and Ireland, where Rabobank offers retail banking services to farmers, rural businesses, and individuals. Three recent acquisitions over the last three years illustrate Rabobank's country banking initiative in the United States: (1) Valley Independent Bank, a community bank in California, 2002, (2) Lend Lease Agribusiness, a national mortgage lender in St. Louis, 2003, and (3) Ag Services of America, a provider of operating credit in Cedar Falls, Iowa, 2004. These acquisitions have enabled Rabobank to offer a full range of financial services to agricultural clients in the United States, and the Valley Independent Bank acquisition immediately extended their reach beyond agriculture.

Purchasing FCSAmerica would have allowed Rabobank to expand in the Midwestern agricultural lending market. FCSAmerica accounts for about 3.5 percent of the total U.S. agricultural loan portfolio and has an extensive customer list. By purchasing FCSAmerica, Rabobank would have acquired an existing customer base to market their real estate and agricultural production loan products, as well as their retail banking and insurance products.

Why did the FCSAmerica board initially accept the Rabobank offer?

Several reasons may have been behind the initial acceptance of Rabobank's offer. One may have been access to Rabobank's products and knowledge of international markets. Farm Credit System institutions are limited in their financial activities. Becoming a Rabobank subsidiary would have removed those restrictions. A second motivation may have been a desire to cash out retained earnings that were

never paid in patronage dividends. Similar to many other Farm Credit institutions, FCSAmerica had not paid dividends to shareholders despite retained earnings in excess of 6 percent of total assets. The large amount of retained earnings held in cash made FCSAmerica attractive to potential buyers, such as Rabobank.

Why did the FCSAmerica board terminate the Rabobank agreement?

From the time of FCSAmerica's original acceptance of the Rabobank offer to final termination, several groups publicly opposed the acquisition. Chief among them was a group of existing stakeholders and some former FCSAmerica board members, and the Farm Credit Council, the lobbying arm of the Farm Credit System. Others rallying against the sale were farm groups and some politicians in farm states.

Opponents raised several issues. A primary concern was the distribution of capital contributed by past borrowers to current shareholders. Under the proposal, past borrowers that had paid off their loans would not have received a cash distribution, even though their past borrowing had contributed to FCSAmerica's earnings. In addition, some current stockholders felt the sale price was too low. A consulting firm, commissioned by the group of stockholders, calculated the fair price at \$2.7 billion—compared to the final Rabobank offer of a \$750 million cash distribution and the \$800 million exit fee.

Another concern was the future of the FCS and the availability of credit in good and bad times. If the sale started a run on other system institutions, the Rabobank acquisition could have paved the way for further purchases of FCS associations by private institutions, possibly leading to the end of the FCS. The loss of the FCS, opponents feared, could lead to the loss of agricultural credit in good and bad times, especially for small and beginning farmers.

Objections were also raised about the sale setting an unwanted precedent for privatizing a government-sponsored enterprise. If the FCS were privatized, some wanted a coordinated process, not a piecemeal sale of

system institutions. Some U.S. Senators wanted to change the approval process by extending the current 60-day FCA review process and holding public meetings in each state in FCSAmerica territory (Iowa, Nebraska, South Dakota, Wyoming).

Impacts on ag lending institutions

Although FCSAmerica terminated its agreement with Rabobank, questions for agricultural lenders will linger.

What is the impact on the GSE status of the Farm Credit System?

The GSE status of the Farm Credit System will receive increased scrutiny. The FCS was created early in the 20th century to deal with the shortage of dependable credit for agriculture. Today, the FCS has a public mission to provide competitive agricultural credit and services to producers and related businesses. They also have a special mandate to service young, beginning, and small farmers. Commercial banks have long criticized the GSE status of FCS institutions and the benefits they receive by being a government-sponsored financial institution. The proposed buyout of FCSAmerica is raising fresh questions about the need for GSEs and the implicit subsidy for agricultural lending when private companies appear willing to fulfill the market. If the U.S. follows a global trend in reducing subsidies for agriculture and agricultural lending, questions about the GSE status of FCS will again be raised. If U.S. policymakers determine GSE status is not needed, what is the process for privatizing the FCS? This is a big question with no answers at the present time.

What is the impact on the FCS mission?

The proposal may also lead policymakers to revisit the mission of the FCS. Nancy Pellet, Chairman and CEO of FCA, has stated that the purchase offer indicates the need to review the Farm Credit Act and the need to expand the FCS mission. FCS would like to expand their lending activities beyond farm and agribusiness lending to rural business lending (FCS institutions already engage in rural housing lending). Commercial banks adamantly oppose any

expansion of the FCS mission, claiming the supply of credit available to America is already abundant.

What is the potential impact on the agricultural lending environment?

The agricultural lending environment is likely to become more competitive in the period ahead. The offer tendered by Rabobank for FCSAmerica is a clear signal that it intends to become a major player in U.S. agricultural lending as part of its quest to be the world's food and agri bank. It has already purchased GSEs in Australia, New Zealand, and Ireland. In addition to short- and long-term loans to the agricultural sector and small- and medium-sized enterprises (SMEs), Rabobank intends to offer leasing, insurance, wealth management, and a broad range of retail banking products to rural retail lending markets as part of its country banking strategy. Acquisitions have been the preferred strategy of Rabobank to achieve its country banking goals. For example, after being purchased by Rabobank in 2002, Valley Independent Bank substantially expanded its activities in California's agricultural lending market. After the termination announcement, several Rabobank officials confirmed their desire to expand in the U.S. agricultural lending market.

In summary, an offer by Rabobank to purchase FCSAmerica spurred much debate in the agricultural lending community earlier this year. While the offer was ultimately rejected, the proposed sale has brought important issues to the table in discussions about the role of the FCS and the competitive forces in agricultural lending. The proposed sale has forced FCS institutions to re-evaluate their patronage policies to redistribute earnings to stakeholders. The GSE status of the FCS has long been scrutinized but will receive renewed attention in light of these events. The mission of the FCS may be re-examined. Agricultural lending, and rural banking in general, could become more competitive if Rabobank pursues other avenues to widen their operations into Midwestern agricultural lending markets.