Bert Ely's

Farm Credit Watch

Shedding Light on the Farm Credit System, America's Least Known GSE

ABA Court Victory Highlights Fundamental FCS Threat (January 1999)

by Bert Ely

Editor's Note: Bert Ely's Farm Credit Watch *is a monthly report that is available in the "Members Only" section on the ABA Web site (**www.aba.com**). The following articles are the most recent installments.*

To keep Journal of Agricultural Lending *readers up to date on Mr. Ely's comments, we will publish all his columns that appear between publication dates. Mr. Ely welcomes information about the Farm Credit System in your area and can be reached at (703) 836-4101 or by e-mail at* ***bert@ely-co.com.***

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The banking industry won a significant victory against the Farm Credit System on Jan. 19 when a U.S. Court of Appeals voided a Farm Credit Administration (FCA) regulation which authorized FCS institutions to lend to homebuyers who are not rural residents (i.e., living in communities with fewer than 2,500 inhabitants).

In effect, FCS institutions are now restricted to making housing loans on owner-occupied homes located in rural communities. No longer can the FCS fund vacation homes, hunting lodges, investment properties and rural weekend retreats for Big City fat cats. The court also barred farm credit banks (FCBs) from making short-term loans to non-farm rural businesses. Instead, FCBs can only lend to non-farm businesses (technically, "farm-related businesses") for "necessary sites, capital structures, equipment and initial working capital."

This victory culminates a long, hard-fought battle that began on Sept. 11, 1995, when the FCA issued a draft regulation which would broaden the ability of FCS institutions to lend to borrowers other than farmers and ranchers. Although the FCA received almost 2,000 comment letters, mostly negative, about its proposed rule and even though the FCA issued a revised draft regulation after eight U.S. senators complained about the original draft, the FCA still issued a defective regulation in January 1997.

The ABA and the IBAA then jointly

sued the FCA. After losing on a motion for summary judgment in the U.S. District Court, the two associations appealed to the Court of Appeals, which overturned a portion of the FCA regulation.

Unfortunately, the appeals court did not void that portion of the FCA regulation which extends FCS lending powers to non-farm businesses except for the restriction on FCB lending noted above. Hence, production credit associations (PCAs) and agricultural credit associations (ACAs) can now lend to non-farm businesses that only incidently serve farmers and ranchers.

Also, FCA lending is no longer limited to non-farm businesses providing services, such as custom-type work, which farmers could otherwise perform themselves. Now, as a result of the FCA regulation, businesses providing services which farmers *cannot* perform themselves can borrow from PCAs and ACAs. This expansion covers almost anything a farmer or rancher might buy.

The court also let stand that portion of the regulation liberalizing FCS lending to farmer-controlled enterprises which process and market agricultural output. Hence, the taxpayer-subsidized FCS can compete more broadly than ever against commercial banks even though documents I have just obtained from the FCA under the Freedom of Information Act demonstrate more clearly than ever that the FCA is not making FCS lenders follow the law when competing against banks and other private-sector firms.

As I reported in the winter issue of *TheJournal of Ag Lending*, the last portion of the first section of the Farm Credit Act (codified as 12 U.S.C. §2001) states:

> *Provided, 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.*

This language is unequivocable – FCS borrowers shall never be charged a rate of interest below what a private-sector lender would charge. In other words, FCS lenders are barred by law from competing based on the price of credit. Instead, the tax breaks and government-backed borrowing FCS enjoys are supposed to pay for improved delivery of FCS credit, particularly to young, beginning, small and otherwise disadvantaged farmers and to build sufficient capital to absorb losses from reckless FCS lending. Clearly, the FCS's tax and credit subsidy is not to be reflected in below-market interest rates.

Given this explicit statutory mandate, one would expect the FCA, as the government regulator of the FCS, to enforce this law. Sadly, that is not the case, as is clearly evident from the FCA documents I reviewed. True, the FCA Examination Manual supplied to me states that "because allegations of pricing below market rates and the competition could signal the existence of significant pricing problems," examiners should "ensure the [FCS] institution's analysis of competitor rates adequately documents the competitive environment and provides support for the institution's pric-

ing decisions." However, this section of the Examination Manual does not instruct the examiner that below-market pricing by FCS institutions is illegal and should be subject to a cease-and-desist order. One wonders how many FCA examiners even understand that below-market pricing is unlawful.

Further evidence of FCA indifference to, if not contempt for, its statutory obligation to prevent FCS institutions from setting below-market rates flows from reviewing complaints bankers have registered with the FCA. First, the volume of complaints rose dramatically in 1998 from previous years. Second, many of these complaints were directed against Farm Credit Services of the Midlands, which serves the states of Iowa, Nebraska, South Dakota and Wyoming. Third, several of these letters referenced the statutory language cited above.

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The FCA responses to these complaints were quite interesting. First, the FCA did not explicitly acknowledge the statutory bar against below-market pricing even when bankers referenced that bar. Second, it admitted that "FCS of the Midlands developed for a limited time, a special [loan] program." That is tantamount to admitting that Midlands, contrary to the law, was offering below-market loan rates. Third, again with regard to FCS of the Midlands, it refused to make public pricing surveys conducted for it by an independent contractor, stating instead that Midlands' fixed-rate loans "were within the ranges of the rates offered by the association's competitors." It did not say who those competitors were or the size of the range of rates, yet that information is crucial to determining whether an FCS lender is conforming with the law. FCS pricing surveys should be a matter of public record.

Clearly, the FCA, increasingly a promoter rather than the regulator of the FCS, is ignoring its obligation to enforce 12 U.S.C. §2001. The recent Court of Appeals decision, while partially helpful, nonetheless does not stop the potential for below-market FCS pricing. **jal**