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FARM CREDIT SYSTEM

Potential Impacts of FCB Mergers on Farmer and Rancher Borrowers

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This report discusses the potential impact of mergers of the Farm Credit Banks on Farm Credit System borrowers. This report is in response to the mandate in the Banks and Associations Safety and Soundness Act of 1992 (P.L. 102-552, 106 Stat. 4102) that required that GAO study how certain factors related to the Farm Credit System would be affected by Farm Credit Bank mergers.

We are sending copies of this report to other interested congressional committees, Farm Credit System officials, Farm Credit Administration Officials, and Farm Credit System Insurance Corporation officials. Copies of this report will also be made available upon request.

Please contact me on (202) 512-8678 if you or your staff have any questions. Major contributors to this report are listed in appendix IX.

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Executive Summary

Purpose

The Farm Credit System is a congressionally chartered nationwide network of cooperatively owned banks and their related associations that provides billions of dollars of credit and services to eligible farmers, ranchers, producers, cooperatives, and others in rural America. As a result of unprecedented consolidation between 1974 and 1994, the total number of banks and associations in the System decreased from more than 1,000 to fewer than 250, with 97 percent of this decrease resulting from association mergers. As of April 1, 1994, over half of the Farm Credit Banks (FCB) had merged since 1992.

The Farm Credit Banks and Associations Safety and Soundness Act of 1992 mandated that GAO study the potential benefits to System borrowers of merging the existing FCBs to form fewer regional banks. GAO focused on the mergers that took place or were planned since 1992. GAO's principal objectives in this report were to determine the potential effects of bank mergers on System member-borrowers by assessing several factors, including (1) economies of scale, (2) the level of services offered by associations, (3) the System's operation as a cooperative, and (4) the bank-association relationship.

Background

The System's original structure included 12 districts, each of which contained 3 types of banks supported by 2 types of local associations. The Agricultural Credit Act of 1987, among other things, required the merging of certain types of district banks to create FCBs. Between May 1992 and April 1994, several FCBs voluntarily merged; as a result, the number of FCBs has decreased from 11 to 8.

FCBs generally make loans either to or through their district associations. Most lend to direct lending associations, which in turn lend to member-borrowers. Others make retail loans to member-borrowers through agent associations that originate and service loans for the bank. The bank-association relationship is shaped not only by the lending arrangement but also by FCB oversight of its associations and the support services FCBs provide to those associations.

The System operates on several basic cooperative principles: democratic control, ownership by member-borrowers, member-borrower financing according to use (stock purchase requirement based on loan amount), limited return on borrower stock (borrower stock is generally retired at face value), and service at cost (no pure profit motive per se). Application of these principles has evolved with several statutory and regulatory changes. Another characteristic considered by many System officials as fundamental to the System's cooperative nature is local control, which involves giving member-borrowers a voice in the operation of their associations through the election of directors to the associations' boards.

GAO focused on associations in lieu of member-borrowers in analyzing the potential effects of mergers because FCBs primarily provide funds and services to associations rather than directly to member-borrowers. GAO interviewed various System officials, surveyed bank and association officials by questionnaire, reviewed merger and consolidation plans, and studied the short-term effects of the first voluntary merger—the consolidation of the St. Louis and St. Paul FCBs to form AgriBank, which had been merged only 8 months in 1992. Long-term effects could not be studied in this case, because the merged bank had been operating less than 2 years at the conclusion of GAO's review. This case study should not be generalized to other actual and potential mergers due to the variations in district and bank structures and operations.

Results in Brief

The merged FCBs anticipated that the mergers would create economies of scale resulting in lower operating costs due to the elimination of overlapping and duplicative functions. If the merged banks are able to achieve cost savings, some associations and in turn their member-borrowers may receive slightly lower interest rates on their loans or higher dividends on their stock. However, achieving noticeable district-level savings from FCB mergers may be difficult, since most district operating costs are incurred at the association level.

Associations in merged districts generally have offered or are expected to offer the same or more services; however, services offered depend on local demand. More services could result if the FCB approves new borrower services and the associations decide to offer those services to their customers. On the other hand, the bank could withdraw its approval for an existing service, thus forcing associations to offer fewer services to their borrowers.

Generally, FCB mergers cannot change the System's cooperative nature, which is grounded in statute and regulation; however, mergers between certain FCBs may affect certain cooperative features, such as dividend policies. Although mergers result in larger FCBs, local control is maintained since local borrowers continue to serve as directors on the boards of their associations and merged banks. However, association officials expressed concerns over local control being diminished by mergers. FCB mergers do result in diluted association voting strength and, in some districts, the election of proportionately fewer bank directors per association.

FCB mergers could significantly change some bank-association relationships by bringing together banks with varying oversight practices and levels of association support services; however, these changes may not necessarily have a direct effect on member-borrowers. Although there is a general trend toward wholesale lending among FCBS, most banks share similar funding relationships with their associations, which should not be affected by mergers. Finally, mergers between banks that offer different levels of support services to their associations may change the number and availability of such services for some associations.

GAO's Analysis

Merger-Related Economies of Scale Could Result in Operating Cost Savings

Merged FCBS anticipated reduced operating costs by achieving economies of scale through the elimination of duplication and overlap, particularly in staffing. The range of anticipated bank-only operating cost savings was $5 million to $20 million annually. If such cost savings were achieved and passed along in the form of lower rates, the associations' cost of funds could decrease 6 to 32 basis points. A 6 basis point decrease would lower a 6-percent rate to 5.94 percent. (See pp. 25-31.)

From the district perspective, savings in FCB operations may produce only limited effects, because districtwide costs are predominantly incurred at the association level. In 1992, association operating costs averaged 71 percent of total district operating costs, ranging from 52 to 88 percent per district. Therefore, from a borrower's perspective, operating cost savings realized through reductions in FCB costs could be obscured by increases in association costs. In the case GAO reviewed, although the AgriBank merger did not become effective until May 1992, its ongoing bank-only operating costs decreased $9.3 million from the 1991 level. However, AgriBank's net operating costs decreased $5.3 million after the merger while district association operating costs increased $5.9 million which resulted in a $.60 million overall increase in districtwide costs in 1992. (Although some of the increased costs at the association level may have been related to the merger, associations throughout the System experienced similar overall increases in their operating costs.) (See pp. 31-32.)

Member-Borrowers Are Generally to Be Offered the Same or Wider Variety of Services

According to bank and association officials and merger plans, associations in merged districts generally have offered or planned to offer member-borrowers the same or a wider variety of services. Officials of the merged banks generally expected little change in the level of services provided to member-borrowers. The types of services associations offered member-borrowers most frequently in 1993 included credit life and crop insurance, leasing, fee appraisal, and tax record keeping. (See pp. 34-36.)

In the case GAO studied, the merged FCB authorized all services that had been provided in each district before the merger. Some associations chose to offer newly authorized services to their member-borrowers. However, other associations chose not to offer borrower-members any of the newly authorized services. (See p. 36.)

FCB Mergers Should Not Adversely Affect the System's Cooperative Nature

The cooperative principles that govern the System, which are grounded in statute and regulation, have not been fundamentally changed by mergers. Following mergers, member-borrowers continued to elect directors to association boards, which in turn elected bank directors. As before, bank and association borrowers were required to purchase minimum amounts of stock as a condition of borrowing—in keeping with the cooperative principles of member-borrower ownership and "financing according to use." Also, return on borrower stock in the System remained generally limited, with stock retired at par or face value. The System still retains some aspects of "service at cost," although interest rates charged reflect the institutions' need to retain earnings and to build capital sufficient to meet the 7 percent regulatory minimum. (See pp. 37-39.)

Although numerous FCBs have merged, creating fewer larger banks covering larger geographic territories, two trends have been occurring in the System that tend to promote local control. First, banks' supervision of their associations has generally been declining. Second, the proportion of agent associations in the System has dropped from 56 percent in 1974 to 30 percent in 1994. As agent associations become direct lenders, they generally assume more autonomy in their operations. Citing loss of association voting strength and larger districts, 53 percent of association officials surveyed believed FCB mergers would negatively affect local control (percentage excludes AgriBank). However, the general trend toward less bank supervision among FCBs and the proliferation of direct lender associations may help promote local control and greater association autonomy. Provided these trends continue, FCB mergers should not negatively affect local control even if mergers create larger districts and result in loss of individual association voting strength. (See p. 40.)

FCB mergers dilute individual association voting strength as an increasing number of associations own the merged FCB. Mergers also resulted in some associations electing proportionately fewer bank directors. Merged banks had fewer elected directors than their combined totals before the mergers. However, all existing FCB mergers have been approved by their stockholders, the associations. (See pp. 40-41.)

FCB Mergers Could Significantly Affect the Bank-Association Relationship

Most banks that merged had operational similarities but nonetheless differed in certain aspects of their relationships with their respective associations. For example, AgAmerica FCB was formed from the merger of the Omaha and Spokane FCBs. The Omaha FCB had provided its jointly managed districtwide Production Credit Association and Federal Land Credit Association with numerous support services ranging from data processing to setting interest rates on loan products. In contrast, the Spokane FCB had provided its districtwide association with few support services, basically data processing, benefits administration, and asset-liability management. To fulfill its philosophy of promoting autonomous and self-sufficient associations, AgAmerica planned not to provide numerous support services unless the associations requested them. The former Omaha associations thus were expected to provide many of their own support services after the merger. (See pp. 44, 47-48.)

Although all FCBs are authorized to supervise certain aspects of association operations, GAO found differences in oversight. Some banks were closely involved in association operations. Others were much less so. For example, some FCBs set association interest rates and approved association business plans. Others primarily monitored association performance. According to bank and association officials, many FCBs have changed their supervisory practices in recent years. For example, in 1993, AgriBank initiated plans to change its relationship with associations and promote a partnership to clarify associations' accountability for their performance and financial condition. (See pp. 44-46.)

As of September 1993, officials at over 60 percent of the associations that had not been involved in an FCB merger believed that mergers would have some effect on the bank-association relationship. Twice as many of these officials, without having experienced an FCB merger, expected the effect would be negative rather than positive. However, AgriBank associations surveyed were evenly divided about whether the St. Paul-St. Louis merger had a positive or negative impact on the bank-association relationship. Bank officials were also split on whether FCB mergers would negatively or positively affect the bank-association relationship. Like the association officials, some said there would be little or no impact, and others had no opinion. (See apps. I-III.)

Recommendations

GAO is making no recommendations in this report.

Agency Comments

GAO requested comments on a draft of this report from the Farm Credit System's Presidents' Planning Committee, Farm Credit Administration, and Farm Credit System Insurance Corporation. None of these three disagreed with GAO's observations or conclusions. Their written comments are presented and evaluated in chapter 1 and are reprinted in appendixes VI through VIII. Additional technical comments were provided and have been incorporated throughout the report as appropriate.

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Abbreviations

ACA	Agricultural Credit Association
ACB	Agricultural Credit Bank
ALM	asset/liability management
BC	Banks for Cooperatives
CAMEL	Capital, Assets, Management, Earnings, and Liquidity
CEO	chief executive officer
FAC	Farm Credit System Financial Assistance Corporation
FCA	Farm Credit Administration
FCB	Farm Credit Bank
FCC	Farm Credit Council
FCCA	Farm Credit Corporation of America
FCL	Farm Credit System Leasing Corporation
FCS	Farm Credit System
FCSIC	Farm Credit System Insurance Corporation
FICB	Federal Intermediate Credit Bank
FLB	Federal Land Bank
FLBA	Federal Land Bank Association
FLCA	Federal Land Credit Association
GFA	general financing agreement
GSE	government-sponsored enterprise
MIS	management information system
PCA	Production Credit Association
PPC	Presidents Planning Committee
RAU	risk asset unit

Introduction

The Farm Credit System is a congressionally chartered enterprise that provides credit and services to agriculture. Divided into regional districts, this nationwide network of cooperatively owned banks and associations with almost $65 billion in assets provides credit to member-borrowers, including eligible farmers, ranchers, producers of aquatic products (fish farms), cooperatives, and certain farm-related businesses. One of the types of banks in the System is called a Farm Credit Bank (FCB). FCBs primarily provide loans to district associations, which in turn lend to their member-borrowers, primarily eligible farmers and ranchers. Congress required us in the Farm Credit Banks and Associations Safety and Soundness Act of 1992 (P.L. 102-552) to study how farmer and rancher member-borrowers of the Farm Credit System institutions might benefit if the 10 district Farm Credit Banks (and the Federal Intermediate Credit Bank of Jackson) merged into fewer regional Farm Credit Banks.

Background

The System is a government-sponsored enterprise (GSE).[1] System institutions are privately owned, but Congress chartered the System to serve the public purpose of facilitating the flow of funds to agriculture. As table 1.1 illustrates, Congress established the System in several stages to supply credit needs associated with agriculture.

Table 1.1: Creation of the Farm Credit System (Prior to the Implementation of the Agricultural Credit Act of 1987)

Date	Lending institution	Purpose
1916, authorized	Federal Land Banks (FLB)	Provide long-term agricultural credit.
1923, established	Federal Intermediate Credit Banks (FICB)	Provide short-term agricultural credit.
1933, established	Banks for Cooperatives (BC)	Provide credit for agricultural, aquatic, and rural cooperatives.
1933, authorized	Production Credit Associations (PCA)	Provide short- and intermediate-term loans to farmers.
1951, established	Federal Land Bank Associations (FLBA)	Serve as agents of the FLBs in providing long-term mortgage loans.

The System is regulated by the Farm Credit Administration (FCA), which has enforcement authorities similar to other federal financial regulators. It issues regulations and examines System institutions for compliance with

[1]The System is not a single legal entity, but it is often referred to as "a GSE" for convenience, as we do in this report. Other GSEs include the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Banks (Freddie Mac), and Student Loan Marketing Association (Sallie Mae).

applicable laws, regulations, and safe and sound banking practices. In 1993, the Farm Credit System Insurance Corporation (FCSIC) became fully operational with certain limited oversight responsibilities that are closely coordinated with FCA. However, its primary purpose is to ensure the timely payment of principal and interest on all System-wide debt and, if needed, to assist System banks in the future. FCSIC controls the System's Insurance Fund which is funded with premiums paid by banks and associations.

The 1987 Act Resulted in Significant Changes to the System's Structure

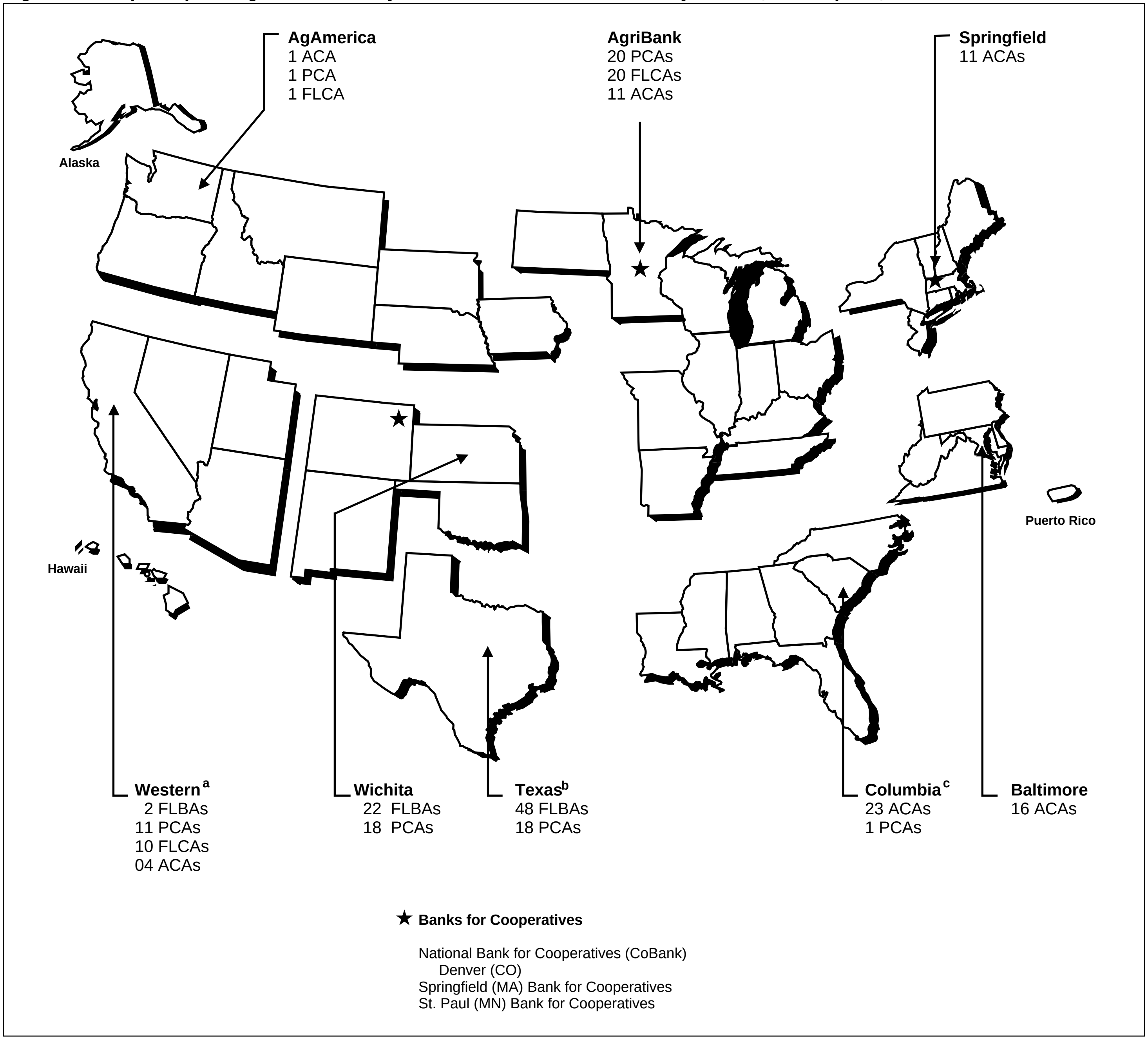
The Agricultural Credit Act of 1987 significantly changed the structure of the System. Before the 1987 act, the System was organized into 12 districts, each with 3 types of banks supported by 2 types of associations. However, the 1987 act mandated certain structural changes and encouraged others, as shown in table 1.2. As a result of these mandated and voluntary changes, district structures within the System ranged, as of April 1994, from 1 bank and 3 associations to 1 bank and 66 associations. The System included 8 districts; the number of states in each district ranged from 1 to 11, as shown in figure 1.1. Table 1.3 provides a comparison of districts by assets, as of December 31, 1993.

Table 1.2: Selected Provisions of the Agricultural Credit Act of 1987

Statutory provision	Impact on System's structure
Required that each FLB and FICB in a district merge.	Resulted in the formation of 11 FCBs and 1 FICB.
Authorized mergers among the BCs.	Resulted in three remaining BCs, all of which have national charters.
Authorized the merger of BCs and FCBs to form Agricultural Credit Banks (ACB).	None existed as of April 1994, but negotiations were underway.
Authorized the merger of PCAs and FLBAs to form Agricultural Credit Associations (ACA).	Several districts have all ACA structures.
Authorized the transfer of long-term real estate lending from the FCBs to FLBAs to create Federal Land Credit Associations (FLCA) and ACAs.	Several FCBs transferred their mortgage lending authority.
Authorized associations to be reassigned to adjoining districts with proper approval for 12 months following the act's effective date.	Several associations transferred to new districts.

Note: The act also commissioned a special committee to develop a proposal for merging the newly created FCBs into no fewer than six viable banks. However, the committee was unable to develop a proposal due to ongoing association mergers, financial assistance issues, and structural differences. Within 4 years, FCBs began to merge voluntarily.

Figure 1.1: Map of Operating Farm Credit System Banks and Associations by District, as of April 1, 1994



[a]The Western FCB also funds an ACA in eastern Idaho.

[b]The Texas FCB makes long-term loans in Alabama, Louisiana, and Mississippi. It also funds a PCA in northwest Louisiana and certain PCAs in New Mexico.

[c]The Columbia FCB funds certain ACAs in Kentucky, Ohio, and Tennessee.

Source: FCA data.

Table 1.3: Asset Size for Districts and Banks for Cooperatives as of December 31, 1993

Dollars in thousands

System districts	District assets	Bank-only assets
District		
Springfield[a]	$2,128,193	$1,913,394
Baltimore[b]	3,641,576	3,226,600
Columbia[b,c]	5,607,714	5,026,512
Louisville[d]	4,235,330	3,808,796
AgriBank[d]	10,669,639	9,920,353
Omaha[e]	4,289,855	4,199,123
Wichita	3,896,441	3,768,657
Texas	4,368,470	4,189,028
Western	5,329,313	4,881,679
Spokane[e]	2,948,193	2,891,381
Banks for Cooperatives		
Springfield BC[a]	227,892	
St. Paul BC	2,044,740	
National Bank for Cooperatives (CoBank)[a]	14,407,592	

[a]The FCB and BC of Springfield plan to merge with CoBank on January 1, 1995. The merged CoBank would have assets of approximately $16.5 billion.

[b]In August 1994, the Columbia and Baltimore FCBs announced plans to merge in 1995. If merged, the resulting bank would have district assets of $9.2 million and bank-only assets of $8.2 million.

[c]The Columbia FCB and Jackson FICB merged on October 1, 1993. As of September 30, 1993, Jackson FICB/PCA had assets of approximately $689 million.

[d]The Louisville FCB merged with AgriBank on January 1, 1994, but four associations with $541 million in assets reaffiliated to the Columbia FCB. After the merger, AgriBank's assets were approximately $13.2 billion (bank-only).

[e]The Omaha and Spokane FCBs merged on April 1, 1994; combined FCB assets were approximately $7.1 billion (bank-only).

Source: 1993 FCB annual reports.

System Consolidation Resulted in Fewer Banks and Associations

Between 1974 and 1994, the number of banks and associations in the System decreased from more than 1,000 to less than 250. (See table 1.4.) Over 85 percent of this consolidation occurred during the System's financial crisis in the 1980s, when associations merged primarily to facilitate the movement of capital and eliminate inefficiencies. Following the 1987 act, the number of banks decreased from 37 to 15 as a result of mandated mergers between FLBS and FICBS in each district to form FCBS and a voluntary merger among BCS.[2] Between April 1992 and April 1994, 8 banks voluntarily merged or consolidated,[3] decreasing the number of operating banks in the System to 11. As of August 1, 1994, two additional mergers were being negotiated. Reasons commonly cited for the recent mergers included opportunities for competitive cost structures (reduced costs), higher quality of management, improved risk management and diversification, and improved financial condition. Some officials also cited opportunities to better serve the needs of their borrowers.

Table 1.4: Comparison of the Number of Active System Banks and Associations in 1974 and 1994

Type of institution	December 31, 1974	April 1, 1994
Federal Land Banks	12	0
Federal Intermediate Credit Banks	12	0
Banks for Cooperatives	13	3
Farm Credit Banks	0	8
Federal Land Bank Associations	552	72
Production Credit Associations	433	69
Agricultural Credit Associations	0	66
Federal Land Credit Associations	0	31
Total	**1,022**	**249**

Source: FCA data.

The first voluntary FCB merger occurred in May 1992, when the St. Paul and St. Louis FCBS consolidated to form AgriBank, FCB. On October 1, 1993, the Jackson FICB merged with the Columbia FCB.[4] On January 1, 1994, the

[2]The Jackson FICB was left without a merger partner when the Jackson FLB was placed into receivership. Additionally, 10 of the 12 BCs and the Central Bank for Cooperatives voluntarily merged in 1989 to form the National Bank for Cooperatives (CoBank).

[3]Consolidation is the creation of a new organization from two or more similar organizations, while a merger is simply combining two or more similar organizations into another similar organization. However, for convenience, we often refer to both consolidations and mergers as “mergers” throughout this report.

[4]The Farm Credit Banks and Associations Safety and Soundness Act of 1992 required the FICB of Jackson to find an FCB merger partner before a specified date or be forced to enter into arbitration to merge with the Texas FCB.

Louisville FCB merged with AgriBank.[5] On April 1, 1994, the Spokane and Omaha FCBS consolidated to form AgAmerica, FCB. Also, on March 15, 1994, the FCB and BC of Springfield and CoBank signed a letter of intent to pursue a merger. This consolidation would create the System's first ACB, named CoBank ACB, which could offer credit and services to eligible farmers, ranchers, producers, and cooperatives.[6] The proposed merger would become effective January 1, 1995. The Baltimore and Columbia FCBS also announced plans to merge in 1995. However, as with all voluntary mergers, both mergers are subject to board, stockholder, and FCA approval.

FCBs and Associations Operate as Part of a Cooperative System

The System operates on the following basic cooperative principles:[7]

- Democratic control. Each member-borrower has a vote in the election of his/her association's board of directors. Also, each association board of directors has a vote in the election of the bank's board of directors, which generally consists of member-borrowers.
- Ownership by member-borrowers. Borrowers must purchase stock or participation certificates (nonvoting) as a condition of borrowing.
- Member financing according to use. Historically, borrowers purchased stock in the amount of 5 to 10 percent of the loan amount. The 1987 act and subsequent regulations reduced the minimum stock purchase requirement to 2 percent of the loan amount or $1,000, whichever is less.
- Limited return on capital (borrower stock). Stock is normally retired at par or face value. Dividends or patronage refunds[8] may be paid occasionally. The amount of earnings paid out as dividends or patronage refunds depends on an institution's need to retain earnings and build capital.
- Service at cost. The cooperative principle of service at cost generally involves setting interest rates to cover costs of ongoing operations, which include retained earnings, building capital, and meeting the 7-percent minimum permanent capital requirement. The System, like other GSEs, enjoys relatively easy access to the national capital market on the strength of its ties to the government. Rather than operating to generate the largest

[5]Four of Louisville's five associations, with assets totaling $451 million, chose not to become part of the AgriBank district and changed their affiliation to the Columbia district.

[6]Like FCBs, ACBs will continue to provide funding to associations, which in turn directly provide the credit and servicing needs of eligible borrowers. Similarly, cooperatives would continue to be serviced as they had been by the bank for cooperatives.

[7]We identified several basic cooperative principles that have been built into the System; see Farm Credit: Actions Needed on Major Management Issues (GAO/GGD-87-51, Apr. 1, 1987).

[8]Patronage refunds are excess earnings that are distributed to borrowers in the form of cash or stock.

possible profits, the System generally operates for the benefit of its member-borrowers and has no pure profit motive. As a result, banks have historically charged the lowest possible rates consistent with safe and sound operations. In the mid-1980s, however, statutory changes concerning how interest rates were established led some banks and associations to offer more market-driven rates.

While certain operating philosophies, such as capitalization, specific dividend policies, and supervision of association operations, may affect whether borrowers perceive banks and associations as cooperatives, the System's cooperative structure is grounded in statute and regulation.

System Funding

Each bank in the System raises funds for its lending operations by issuing System-wide debt securities through the Farm Credit System Funding Corporation. Like other GSEs, the System raises funds on the national capital markets at a relatively low cost on the strength of its ties to the federal government. All System debt is ultimately the joint and several obligation of all System banks. This means that each FCB and BC may be called upon by the FCA to make payments on System debt regardless of whether it is primarily responsible for the liability or not. The System produces combined financial statements to reflect the interdependence of the banks and the joint and several nature of System obligations.

FCBs Provide Funding to Their Local Associations

FCBs make loans to and through their local associations. FCBs make wholesale loans[9] to PCAs, ACAs, and FLCAs—also known as direct lending associations—which in turn make retail loans to eligible borrowers.[10] Some FCBs are strictly wholesale lending banks, because all of their associations are direct lenders. Other FCBs make not only wholesale loans but also long-term (mortgage) retail loans through FLBAs, which act as agents for the bank in originating and servicing those loans.

Objectives, Scope, and Methodology

The 1992 act required that we study the potential benefits to System farmer and rancher borrowers of merging the existing regional banks into fewer regional banks. In conducting this study, we were asked to consider the impact of FCB mergers on the following factors: (1) any economy of scale benefits, (2) the level of services provided, (3) the cooperative nature

[9]A wholesale loan is a loan made to a direct lending association.

[10]FCBs also make loans to other eligible financial institutions and join associations and other banks in loan participation.

of the System, (4) the issuance of System-wide bonds, (5) the bank-association relationship, and (6) jointly provided services. We also assessed other related factors that emerged as potentially significant in the course of our work.

Since we initiated this study in March 1993, seven FCBs and one FICB have merged or consolidated; two additional merger discussions were underway as of August 1994. We focused on the short-term impact of these existing and planned mergers on affected associations and their farmer and rancher borrowers. To gauge the potential impacts, we reviewed the plans for merging the St. Paul and St. Louis FCBs, the Columbia FCB and Jackson FICB, the AgriBank and Louisville FCBs, and the Omaha and Spokane FCBs.

To gain a historical perspective on the debate concerning the System's structure, we reviewed various studies conducted by the System, the special committee commissioned by the 1987 act, and industry consultants on the System's structure. Building on a recently completed report,[11] we collected additional data on all FCBs and associations. We reviewed the philosophies, policies, strategic plans, annual reports, board minutes, and FCA examinations of the FCBs to obtain information on differences and similarities among the FCBs and districts. In some cases, this information was supplemented by interviews with bank and association officials.

Although Congress asked us to determine the impact of mergers on farmer and rancher borrowers, we focused on associations as proxies for member-borrowers because FCBs provide funding and services to or through associations rather than directly to farmer and rancher member-borrowers. The associations, in turn, provide services and funding to the member-borrowers. The impact of FCB mergers on farmer and rancher borrowers primarily depends on how their associations are affected. Because all of the FCB mergers have occurred since 1992 (most since 1993), our analysis is of short-term impacts and not potential long-term outcomes.

Our work focused on the six factors we were asked to consider. To provide balanced views, we met with over 75 bank and association officials. We mailed survey questionnaires to the chief executive officer (CEO) or president of every association and faxed surveys to each FCB CEO or president to obtain their opinions on FCB mergers. Eighty-eight percent

[11] Farm Credit System: FCA Effectively Addresses Identified Problems (GAO/GGD-94-14, Jan. 7, 1994).

of the association officials and 100 percent of bank officials responded.[12] Because we surveyed every association and FCB in the System for which we had a record, and because we did not project the results to any larger population, our results were not subject to any sampling error. Nevertheless, all survey data are subject to various types and amounts of nonsampling error, such as the error that could result (1) if nonrespondents differ from respondents on some attribute measured by the survey or (2) from omissions and erroneous answers made by respondents. We are unsure of the exact magnitude of such errors but have no reason to believe that they were significant in this survey. Our survey results are presented in appendixes I, II, and III.[13]

In addition, we met with officials from FCA, FCSIC, the Funding Corporation, the Department of the Treasury, the Farm Credit Council (FCC), and the Economic Research Service of the Department of Agriculture.

To determine potential economies of scale or cost savings, we relied on the audited financial data in the FCBs' annual reports and unaudited operating cost data generated by the Funding Corporation when no comparable audited FCB data were available. For additional data on AgriBank and its associations, we relied on unaudited bank-generated financial data. However, we reviewed AgriBank's 1993 FCA examination report to ensure that no material internal control and reporting problems were identified. We also reviewed estimated cost savings expected from the mergers provided in bank disclosure documents. We did not independently analyze the projections; however, FCA, the System's regulator, found them to be generally reasonable and achievable. To determine the potential impact of mergers on the level of services provided by associations, we gathered information from associations on the level of services offered as of September 1993. We also reviewed merger plans to determine expectations, if any, of disruptions in the level of services or types of loan products available to borrowers.

To determine the impact of mergers on the cooperative nature of the System, we gathered the opinions of bank and association officials. We also conducted an analysis of other cooperative systems and organizations to determine whether consolidation had affected their cooperative nature.

[12]PCAs and FLBAs/FLCAs in similar territories often share management. In such cases, we surveyed association officials only once.

[13]We mailed or faxed three separate surveys to System officials. We sent a general survey to associations that had not experienced an FCB merger as of September 1993. (See app. I.) We sent AgriBank associations a generally comparable survey that focused on their recent FCB merger experience. (See app. II.) Finally, we sent the FCBs another survey that focused on mergers from the bank's perspective. (See app. III.)

We reviewed various academic articles to supplement our knowledge of the history of cooperatives. We performed similar work for the evaluation of the impact on System-wide bond issuance.

To determine the potential impact on the bank-association relationship, we examined the current relationship in each district. For FCBs already in merger negotiations, we determined some of the potential impacts of the merger on the bank-association relationship as it relates to supervision, funding, and existing support services. To make this determination, we reviewed bank merger disclosure documents, policies and procedures, and bank and association survey data. We obtained information on supervision and existing support services from FCBs and associations. We also used data collected for our January 1994 report cited earlier (GAO/GGD-94-14), which included a review of the supervision and oversight provided by five selected FCBs (Omaha, Spokane, St. Paul, Western, and Columbia).

We also gathered information on services that are jointly provided in the System. This included reviewing the history of several organizations that provide or have provided various types of services. These organizations included FarmBank Services, the Funding Corporation, Farm Credit Leasing Services Corporation (FCL), the Farm Credit Corporation of America (FCCA), and the Farm Credit Council (FCC). We met with officials from the existing organizations to determine the types of services being jointly provided and collected related documentation. We also discussed options to further utilize this authority and potential benefits to borrowers.

We selected the oldest voluntary FCB merger, the May 1992 consolidation of the St. Louis and St. Paul FCBs to form AgriBank, as a case study to illustrate some of the possible short-term effects of mergers on associations and their borrowers. However, we did not attempt to draw conclusions about the long-term impact of this merger because we reviewed bank operations after its first 8 months and subsequent year of consolidation. This case study should not be generalized to other actual and potential mergers due to differences in district and bank structure and operation. We integrated our observations on this merger in chapters 2 through 4 as appropriate. Our work at AgriBank included observing operations during its 20 months of consolidation. We compared the resulting operations to AgriBank's plans and projections, and we monitored actual savings to determine where and how savings were achieved. To obtain additional information, we interviewed bank officials and requested supporting documentation. We also interviewed FCA officials knowledgeable about the merger and AgriBank operations. Appendix IV provides the case study of the St. Paul/St. Louis merger.

Our study was done between March 1993 and April 1994 at FCA headquarters in McLean, VA; the FCA field office in Bloomington, MN; AgriBank in St. Paul; and FCL in Minneapolis. Our work was done in accordance with generally accepted government auditing standards.

Agency Comments

We received written comments on a draft of this report from the Farm Credit System, through the Presidents Planning Committee (PPC), FCA, and FCSIC. In general the PPC, FCA, and FCSIC agreed with our conclusions and found the draft to be factually accurate. The full text of each entity's comments and our responses are provided in appendixes VI through VIII. In addition, the PPC and FCA provided technical comments that have been incorporated throughout the report as appropriate.

FCBs Projected Bank-Level Savings as a Result of Mergers

FCBs involved in mergers cited cost savings as one of the goals of merging. If FCB operations can be effectively consolidated or merged, the merged FCB may be able to reduce its operating costs by eliminating duplicative functions, thereby achieving economies of scale. The four merged FCBs projected bank-level cost savings of $5.1 million to $20 million annually per merger.[1] Under certain conditions, the realization of the anticipated bank-level savings may eventually result in slightly lower interest rates for farmers and ranchers.

Although the projected savings per FCB may appear substantial, the amounts for each FCB represented only a small fraction of total district operating costs (see table 2.1.), because most district operating costs are incurred at the association level. In terms of overall district operating costs, slight increases in association costs could easily offset projected merger-related savings at the FCB level. The overall (districtwide) cost-reducing effect of mergers may also be limited, in that bank mergers do not directly reduce the costs of the local lending network (associations and their branches).

[1]The St. Paul and St. Louis FCBs projected annual merger-related savings from ongoing operations that would be achieved without shifting costs to associations. The same was true for the subsequent Louisville and AgriBank merger. However, the Omaha and Spokane FCBs anticipated association costs to increase $13 million, offsetting their $20 million projected bank-level savings following the creation of AgAmerica, which resulted in the $7.7 million savings represented to shareholders in the disclosure materials. Similarly, the Columbia FCB and Jackson FICB estimated a $1.1 million increase in the expenses of Jackson's one association, First South PCA, after the merger. However, the merger also eliminated Jackson FICB expenses primarily paid by First South.

Table 2.1: FCB/FICB and Association Asset Size and Operating Costs by District, as of December 31, 1992

Dollars in thousands

District	Asset size	Operating costs
Springfield	$2,162,403	$43,428
Baltimore	3,842,989	61,688
Columbia	5,199,242	83,895
Louisville	4,242,204	65,048
Jackson[a]	496,463	19,036
AgriBank	10,324,687	173,892
Omaha	4,658,053	63,858
Wichita	3,971,720	66,916
Texas	4,359,792	68,468
Western	5,575,334	87,756
Spokane	2,913,453	45,040

Note 1: All asset figures come from the banks' 1992 Annual Reports.

Note 2: The operating costs categories include: salaries and benefits, occupancy and equipment, other operating expenses, and FCSIC premiums. We calculated operating costs from Funding Corporation and annual report data. We compared data from both sources and found only 5 of the 44 figures used to calculate operating costs varied. In two cases the annual report data were used when differences were noted in the "salaries and expenses" category. In the other three cases, Funding Corporation data were used when no comparable "other operating expenses" data were available in the annual report.

[a]Jackson FICB was left without a merger partner when the Jackson FLB was placed into receivership. Thus this district's asset figure and operating costs include only the FICB and two PCAs.

Source: 1992 FCB annual reports and the Funding Corporation's Summary Report of Condition and Performance (Dec. 31, 1992).

Operating Expense Rates Varied Among the Districts

To provide a measure of the overall operating efficiency of the districts (banks and associations), we calculated operating rates—operating expenses per $100 of gross loans—between 1990 and 1993 and found that they varied somewhat throughout the System. (See table 2.2.) Although 1993 district rates ranged from $1.72 to $2.95, excluding the high and low rates, 8 of 10 were between $2.05 and $1.78. Some of this $.27 variation in operating expenses may have resulted from various organizational, structural, operational, and philosophical differences among the districts.

Table 2.2: Districtwide Operating Expense Rates

Dollars per $100 gross loans

District[a]	1990	1991	1992	1993
Springfield	$2.30	$2.39	$2.49	$2.95
Baltimore	1.71	1.73	1.80	$2.00
Columbia	1.96	2.09	1.99	$2.05
Louisville	1.89	1.88	1.70	$1.78
Jackson[b]	3.85	4.21	4.70	N.A.
AgriBank[c]	1.84	1.93	1.95	$2.05
Omaha	1.48	1.57	1.70	$1.72
Wichita	1.94	2.00	1.93	$1.87
Texas	1.74	1.97	1.93	$1.98
Western	1.58	1.69	1.84	$1.91
Spokane	1.68	1.83	1.82	$1.88

Note: The operating expenses were calculated using data obtained from FCB annual reports and Funding Corporation reports. We relied most heavily upon audited annual report data; however, when comparable data were not available, we relied on the data prepared by the Funding Corporation.

N.A. = not applicable.

[a]We calculated district rates because retail borrower interest rates include both bank and association operating costs. Since district structures varied, bank-only operating rate calculations yielded inconclusive results when we tried to gauge the impact on the retail borrower. Therefore, we decided it was more appropriate to measure the efficiency of the entire district. The operating cost rate was calculated using districtwide gross operating expenses (including insurance premiums, excluding compensation paid to associations and merger implementation costs) divided by gross loan volume. The combined district's rate was calculated using operating expenses net of intradistrict transactions.

[b]Jackson FICB's operating expenses were out of line with other costs because it had a much smaller volume of loans supporting its operations. It was unable to merge with the Jackson FLB in 1988 because the FLB was placed into receivership in 1988, leaving the FICB without a merger partner. Jackson merged with the Columbia district in 1993.

[c]AgriBank's 1990 and 1991 rates reflect combined St. Paul and St. Louis data.

Source: 1993 and 1992 FCB annual reports and Funding Corporation's Summary Report of Condition and Performance (Dec. 31, 1990-1993).

We found that no one type of district structure or operating philosophy appeared to be consistently more efficient than another. For example, while Omaha and Louisville had the lowest operating cost rate in 1992 and 1993, they operated quite differently. The Omaha FCB provided its jointly managed districtwide FLBA/PCA with numerous support services and essentially operated as a single entity. On the other hand, the Louisville FCB operated as a strictly wholesale lender, providing few support services to its five ACAs (one had $2.5 billion in assets, the remaining four had combined assets of $.54 billion). Other wholesale FCBs, such as Springfield, Baltimore, and Columbia, had higher rates.[2]

If banks that belong to districts with different district operating rates merge, the rate for the merged district may be higher or lower depending on the characteristics of the districts. For example, premerger operating cost rates for the St. Paul and St. Louis districts were $1.91 and $1.96 respectively. AgriBank's restated 1991 rate was $1.93. Thus, the new rate was higher than St. Paul's but lower than St. Louis'. Following the merger in May 1992, the AgriBank rate increased slightly, in part because of higher association operating costs. In 1993, the district's operating rate increased further to $2.05. For additional information on operating costs following the St. Paul/St. Louis merger, see appendix IV.

Merged Banks Projected Bank-Level Annual Cost Savings Between $5.1 Million and $20 Million

The eight banks that merged between 1992 and 1994 projected bank-level annual ongoing merger-related cost savings between $5.1 million and $20 million.[3] We did not independently verify the reasonableness of these projections; however, FCA found them to be generally reasonable and achievable. The merged banks expected to achieve most of their savings through staff reductions, office consolidation, more efficient use of technology, and a general reduction in other costs due to fewer employees. Projected savings net of any anticipated increases in association costs represented only 3 to 7 percent of total district premerger operating costs. However, it is often difficult to project and realize any merger-related cost savings because (1) projections are based on economic assumptions; (2) success depends on management's ability to actually lower costs; and (3) there are many uncontrollable factors, such as inflation.

Fifty-nine percent of association and bank officials surveyed believed bank mergers would lead to economies of scale. Another 24 percent believed they would negatively affect economies of scale.[4] If economies of scale were achieved, we calculated that projected bank-only operating cost savings for each of the four mergers could translate to a 6 to 32 basis point

[2]While these FCBs had wholesale structures, they differed in operating philosophies and number of associations.

[3]Projected merger implementation costs ranged from $2.8 million to $27.6 million. While these costs are generally expensed once, usually on the effective date of the merger, they may actually be incurred over a number of years.

[4]The remaining 17 percent believed that mergers would have little or no impact on economies of scale.

savings for associations in those districts.[5] A 32 basis point decrease in an association's wholesale loan rate would be equivalent to a 6-percent rate being decreased to 5.68 percent. For borrowers, the impact of bank-level savings would depend on costs at the association level as well. For example, if a merged bank were able to lower its rates to associations by 32 basis points but association operating costs increased an equivalent of 19 basis points, the association could pass only 13 basis points of savings on to farmer and rancher borrowers provided all other operating goals remained constant. Under this scenario, a farmer or rancher borrower's loan rate would decline 13 basis points. On a $70,000 loan, he or she would save $91 in interest costs on the loan annually. However, a bank may use any merger-related savings to cover other costs rather than lower rates. According to AgriBank officials, AgriBank used its savings to repay financial assistance and fund early redemptions of Assistance Preferred Stock.[6]

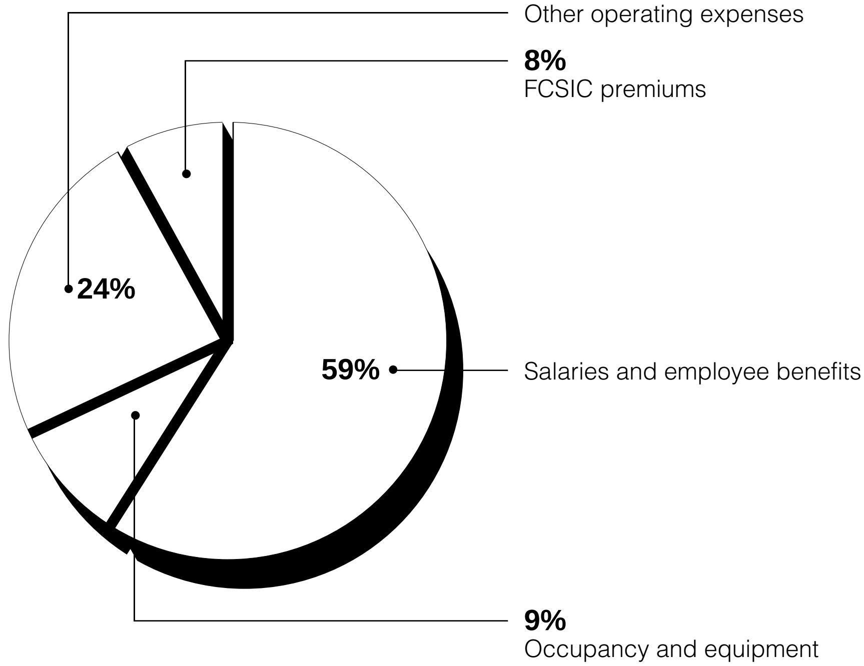
FCBs Projected a Substantial Portion of Savings Would Come From Staff Reductions

A significant amount of the merger-related savings was expected to come from staff reductions. As figure 2.1 illustrates, salaries and employee benefits accounted for the largest segment of System-wide FCB and association operating expenses in 1992. Likewise, salaries and benefits represented the largest operating expense category in each district. Depending on the district, these costs ranged from 52 to 65 percent of total operating expenses.

[5]Basis points—which equal one one-hundredth of a percentage point—were calculated as dollar savings divided by 1993 accruing loan volume.

[6]Prior to merging with the St. Louis FCB to create AgriBank, the St. Paul FCB was one of four banks authorized by the Farm Credit System Assistance Board to issue preferred stock to the Farm Credit System Assistance Corporation. See Farm Credit System: Repayment of Federal Assistance and Competitive Position (GAO/GGD-94-39, Mar. 10, 1994).

Figure 2.1: Farm Credit System Combined FCB and Association Operating Costs, 1992



Source: Funding Corporation data.

Generally, the merged FCBs projected that a substantial portion of their operating savings would come from reductions in staff achieved by consolidating duplicative staff positions. For example, documents related to the 1992 St. Paul/St.Louis merger showed that 70 percent of the projected $10 million in cost savings would come from eliminating 142 employees. As of April 1993, AgriBank had reduced its staff by a total of 111.[7] For a detailed discussion of bank-level staffing changes resulting from the St. Paul/St. Louis merger, see appendix IV. Other merged FCBs projected staff reductions of 50 to 90 employees, representing reductions in the range of 16 to 45 percent of the premerger staff.

Although bank mergers are expected to result in lower staff levels, banks may delegate certain functions to their associations if the merged FCB

[7]Following the merger, AgriBank staff levels declined by 187. Decentralization of the appraisal function to associations accounted for 52 of the 187. However, AgriBank also centralized its risk asset unit (RAU) following the merger, and this centralization increased staff by 76. Therefore, the net decline was 111.

chooses not to provide those functions. For this reason, associations in some merged districts expected to increase staff to perform services once provided by the FCB. For example, Farm Credit Services of the Midlands PCA/FLCA—the jointly managed associations in the old Omaha district—planned to hire additional staff following their FCB's merger to provide certain services and functions formerly provided by their FCB. Conversely, AgriBank anticipated that centralization of the risk asset unit (RAU) at the bank level would result in a corresponding decline in association staffing. However, no decline occurred because the resources were used to staff expansion of other functions delegated to the associations.

Most District Costs Are Incurred at the Association Level

Although the initial FCB mergers focused on bank-level operating cost savings, association costs comprise most of the districts' operating costs. The FCBs serve generally exclusive territories through their local associations.[8] In many districts, associations commonly had local branches serving relatively small territories of the associations. In 1992, the number of branches per association ranged from 1 to 173. Also, total association operating expenses as a percent of total district operating expenses averaged 71 percent in 1992.[9]

FCB mergers consolidate FCB headquarters offices but not association facilities. Since FCBs generally do not compete with other FCBs in a given geographic region, mergers would not lead to substantial savings in "bricks and mortar" commonly associated with in-market mergers in commercial banking.[10] Thus, a two-bank merger eliminates the need for one building; it does not reduce the number of associations or association branch offices. Some association officials believed that FCB mergers would result in more association mergers and larger associations able to function with less FCB support. Some mergers did result in associations having to provide certain services and functions previously provided by their FCB. However, we did not find a substantial increase in association mergers

[8]FCBs generally serve exclusive territories, meaning they generally do not compete with other FCBs in a given geographic region. However, there is at least one example of two FCBs providing funding to associations serving the same territory.

[9]Total association operating expenses ranged from 52 to 88 percent of total district operating expenses in 1992.

[10]An in-market merger, which involves the merger of banks competing in the same market, enables consolidation of offices and the closure of redundant branches. FCB mergers are more comparable to market extension mergers, in which commercial banks participate to gain access to a new market.

following the St. Paul/St.Louis merger.[11] As of December 31, 1993, AgriBank had 50 associations, only 3 fewer than the 53 St. Paul and St. Louis had at the time of the 1992 merger.

The St. Paul/St. Louis Merger Resulted in a Decline in Bank-Level But Not Districtwide Expenses

According to AgriBank documents, bank-only gross operating expenses declined $8.2 million (13 percent) in 1992.[12] AgriBank projected it would achieve cost savings primarily by reducing staff and spreading other costs over a larger asset portfolio, not by shifting costs to associations.[13] In 1992, AgriBank experienced a decline in every major operating expense category except “occupancy and equipment.” In 1993, each cost category experienced an increase over 1992 levels but the 1993 costs were still lower than 1991 levels. However, because a majority (71 percent in 1992) of the district’s costs are incurred at the association level, increases in association operating costs contributed to an overall increase in district operating costs.[14] Since associations in other districts experienced similar increases, we believe the increase in association costs experienced in the AgriBank district is not necessarily attributable to the merger. The effect of association costs on districtwide costs in this instance illustrates the influence that association operating costs can have on district costs. (See app. IV for additional details.)

Conclusions

Mergers may lead to greater economies of scale at the bank level through the elimination of duplicative functions and if achieved, potentially lower funding costs for their associations. Whether member-borrowers obtain similar savings depends on districtwide operating costs. The merged banks projected between $5.1 million and $20 million of bank-level operating cost savings per merger, which could translate to 6 to 32 basis points of

[11]A few AgriBank association officials believed there was pressure from the bank to merge.

[12]AgriBank projected annual savings from ongoing operations (excludes costs associated with the risk asset unit) of $10 million in 1991 dollars. If costs associated with the risk asset unit are excluded, the costs of ongoing bank operations decreased $9.3 million between 1991 and 1992.

Net bank-only operating expenses declined $5.3 million between 1991 and 1992. This figure is net of revenues that the bank received from associations for vendor support services.

[13]While a larger portion of FCSIC premiums—payments made to FCSIC, which ensures the timely payment of principal and interest on insured System obligations—was paid by associations, it had no impact on the district’s overall operating costs, since the association increase corresponded with the bank’s decline. Overall FCSIC premiums paid by the district declined in 1992 due to improving loan quality.

[14]The district’s operating costs increased annually between 1991 and 1993. Between 1991 and 1992, operating costs increased at a rate lower than other districts experiencing similar increases while four districts experienced declines over the same period. Between 1992 and 1993, Agribank had the third highest rate of increase while only one district experienced a decline in their operating costs.

savings for their associations if the savings were passed along in the form of lower interest rates. However, some merged banks expected increases in association costs following the merger, which could affect the amount of savings passed on to member-borrowers.

Projecting and achieving cost savings through mergers are often difficult due to various uncontrollable factors. The System's localized lending structure, which consists of local associations, often with numerous branches, goes largely unaffected after FCB mergers. Therefore, member-borrowers may not see substantially lower operating costs following mergers. Following the creation of AgriBank, while bank-only operating costs declined in 1992, the district's overall costs increased slightly.

Impacts on System's Borrower Services, Cooperative Nature, and Bond Issuances

The existing FCB mergers generally had little impact on the number of borrower services, the cooperative nature of the System, and System-wide bond issuances. However, mergers between certain banks could affect services to member-borrowers and the manner in which some cooperative principles are applied by FCBs. Before associations may offer financially related and technical services to member-borrowers, they must seek FCA and FCB approval to provide those services. FCB mergers could affect the level of services provided by associations if the merged bank authorized levels of service different from those that were available before the merger. Officials of merged FCBs generally expected their associations to offer the same or a wider variety of services to borrowers. None of the merged banks expected reductions in the level of services provided to borrowers. System banks and associations are cooperatives; they are owned by member-borrowers who must buy stock as a prerequisite for borrowing. Although we found no evidence that FCB mergers would affect the System's cooperative nature, mergers could change the way certain cooperative principles are applied. Finally, since the banks issue System-wide debt securities collectively through the Funding Corporation, FCB mergers should have little impact on the issuance of System-wide bonds.

Banks Expected No Adverse Impact on Level of Borrower Services in General

We found that newly merged banks generally expected little or no change in the level of services provided to borrowers. At least one merger resulted in a wider variety of services and loan products being offered after the FCB merger. Generally, FCB mergers would affect the level of services an association provided its member-borrowers only if the FCB—which has the authority to approve or disapprove services its district associations may want to provide—forced the association to change the services offered before the merger. If the merged banks choose to increase the services and loan products offered in each district before the merger, some associations could enjoy greater flexibility in servicing their borrowers' needs. However, if the merged FCBs force a reduction in an association's level of services, the merger could negatively affect farmers and ranchers who formerly relied upon the discontinued services (if they were not able to obtain the same level of service from another provider). We found no evidence that banks planned to restrict association-provided borrower services after mergers.

Selected FCB-conducted surveys of member-borrowers indicated that while most borrowers considered available services when choosing a lending institution, such services were not a primary consideration in their selections. Some associations have been able to generate significant fee income by effectively marketing and promoting their services.

Most Services Varied by District

While most associations offered basic services, such as insurance, leasing, and fee appraisals, others offered a greater number and variety of services, as shown in table 3.1. According to bank documents, associations provide services on the basis of borrower demand. We found that FCBs generally authorized the services their associations wanted to offer. However, 27 percent of all association respondents surveyed noted that they would like to offer services that they were not yet authorized by their district FCBs to offer.[1] These services included estate planning and System-wide bond purchasing programs.

Table 3.1: Level of Services Provided by Associations to Farmers and Rancher Borrowers by District, as of September 30, 1993

	Districts										
Services	**1**	**2**	**3**	**4[a]**	**5[b]**	**7**	**8[c]**	**9**	**10**	**11**	**12**
Insurance	x	x	x	x	x	x	x	x	x	x	x
Tax preparation	x	x				x				x	
Record keeping	x	x		x		x		x			
Tax record keeping	x	x		x		x		x		x	
Estate management	x					x			x		
FCL leasing	x	x	x	x		x	x	x	x	x	x
Non-FCL leasing				x		x		x	x		
Fee appraisals	x	x	x	x		x	x	x	x	x	
Other	x	x	x	x		x		x	x	x	

Legend: District 1 is Springfield; 2, Baltimore; 3, Columbia; 4, Jackson; 5, Louisville; 7, AgriBank; 8, Omaha; 9, Wichita; 10, Texas; 11, Western; and 12, Spokane.

Note: Not all associations in a given district could provide the service.

[a]The FICB in this district, Jackson, merged into the FCB in District 3, Columbia, on October 1, 1993.

[b]Louisville and AgriBank merged January 1, 1994.

[c]Omaha and Spokane merged on April 1, 1994.

Source: GAO association survey data.

[1]We found examples of associations that were not authorized to provide services provided by other associations in the same district. Banks may disallow certain associations from providing specific services for many reasons. Reasons commonly cited included: not cost-effective, lack of need, and/or an expected adverse impact on bank and/or association operations.

Although a bank may authorize a variety of services in a district, not all associations may choose to offer those services. For example, AgriBank associations from the former St. Louis district continued to offer fewer services than did associations from the former St. Paul district, although AgriBank had authorized the same services for each group of associations. (See table 3.2.) Seven of the 10 associations from the former St. Louis district indicated no additional services that they would like to offer. However, other associations listed additional services they would like to provide but that had yet to be approved by AgriBank.

Table 3.2: Comparison of Services Provided by Associations in the Former St. Paul and St. Louis Districts, as of September 30, 1993

Services offered to borrowers	Former St. Louis associations	Former St. Paul associations
Insurance	x	x
Tax preparation		x
Farm record keeping		x
Tax record keeping		x
Estate management		x
FCL leasing	x	x
Non-FCL leasing		x
Fee appraisal	x	x
Other		x

Note: Not every association in the AgriBank district may provide the indicated service.

Source: AgriBank association survey data.

Merger of St. Paul and St. Louis FCBs Resulted in More Service Options

The merger of the St. Paul and St. Louis FCBs increased the number of services their respective associations could offer borrowers. The merged bank generally allowed its associations to offer any service that had been approved in either of the districts before the merger, thus making some services that had been available in only one district before the merger available districtwide. For example, before the consolidation, St. Paul associations were not authorized to offer title and aquatic facilities/equipment insurance, all of which were authorized by the St. Louis FCB. Conversely, St. Louis associations were not authorized to provide financial management services and could not independently offer leasing services to borrowers. These services were authorized in the St. Paul district.

FCB Mergers Should Not Adversely Affect the System's Cooperative Nature

We found that the fundamental cooperative principles were still operative in the System and among the merged FCBs although they had evolved over time with changes in statutes and regulations. Because most of the cooperative principles are grounded in statute and regulation, additional mergers should not adversely affect the System's cooperative nature. Related to the System's cooperative nature is its tradition of local control, which refers to associations making lending, credit, and operational decisions with member-borrowers having an active voice in decision-making through their election of peers to serve as directors on association and bank boards. Although the amount of local control exercised in the System varies, changes in bank supervision and increased delegation of authorities as associations become direct lenders have generally promoted greater local control in many districts. Although we do not expect mergers to adversely affect the System's cooperative nature or local control, past FCB mergers have resulted in the dilution of association voting strength as more associations shared in the ownership of each merged FCB. Additionally, some associations elected proportionately fewer bank directors following the mergers. However, each FCB merger has been approved by its stockholders, the associations, which are required to approve voluntary mergers.

Consolidation Has Not Been Uncommon Among Cooperatives

The trend of consolidation is not unique to the System; it has also occurred, for example, among the European Cooperative Banks, which share some similarities with the System. According to a 1984 System study, the number of European Cooperative Banks had declined due to consolidation. The study noted that while ownership and control were exercised from the bottom up, regional bank management was characterized by strong leadership that influenced the strategic direction from the top down. Like the European Cooperative Banks, the System has experienced substantial consolidation while maintaining cooperative ownership and local control through the trend toward wholesale lending and establishment of more direct lending associations.

Democratic Control Remained a Guiding Principle

Democratic control, a guiding principle of the System, is not fundamentally changed by FCB mergers. Each member-borrower has a vote in the election of members to the association's board of directors.[2] Also, each association, as owner of the FCB, elects directors to the bank's board, with its vote weighted in proportion to the number of voting stockholders

[2]Each stockholder has a single vote regardless of the number of shares held or number of loans outstanding. However, cumulative voting is authorized.

in the association. In addition, all of the merged FCBs require that their elected directors be voting stockholders of an association. The directors of both associations and banks are responsible for the management and operation of their respective institutions.

Ownership by Member-Borrowers Continues After Mergers

Regardless of mergers, System borrowers are required to purchase stock or participation certificates (nonvoting) as a condition of borrowing. As a result of this stock ownership requirement, borrowers own their local associations, which in turn own the FCBs. As owners of the banks, associations, through their directors, vote to approve or disapprove any voluntary FCB merger proposals. Thus, borrowers of the System continue to indirectly own the merged FCBs through their associations.

"Financing According to Use" Remained After Mergers

Following mergers, financing for member-borrowers continues to be guided by the policy of "financing according to use." This means that the amount of stock that a member-borrower is required to purchase is determined by the size of the member-borrower's loan. Historically, the amount has been 5 to 10 percent of the loan amount. The 1987 act and subsequent regulations reduced the minimum stock requirement to 2 percent of the loan amount or $1,000, whichever is less. However, banks and associations may set stock requirement levels above the statutory minimum. In 1992, for example, AgriBank and its associations required initial investments that ranged from the statutory minimum to a maximum of 10 percent.

Return on Borrower Stock Remains Generally Limited

Limited return on borrower stock remains an operating principle of the System as FCBs merge. That is, stock continues to be retired at par (face value), and dividends and patronage refunds continue to be paid occasionally. In the past, borrower stock was automatically redeemed when the loan was repaid. However, under 1987 act provisions, member-borrowers may be required to retain their stock for some period,[3] whether or not they receive dividends or patronage refunds. After mergers, as before, banks and associations may periodically distribute earnings through dividends and/or patronage refunds. The amount paid out depends in part on an institution's need to retain earnings and build capital in order to meet the regulatory minimum. In 1993, banks and associations paid combined cash dividends and/or patronage refunds

[3]Although such stock is generally retireable at the sole discretion of an institution's board of directors, no retirement can be made unless the institution meets certain minimum capital adequacy standards.

varying from 0 to 33 percent of net income per district.[4] This illustrates that mergers between certain banks could affect the amount of earnings returned to associations and member-borrowers.

FCB mergers may affect the amount of dividends paid if merging banks have different financial conditions and/or dividend policies. Following the merger of the financially weaker Jackson FICB with the Columbia FCB, the merged FCB expected to pay significantly higher dividends to First South PCA[5] than Jackson had paid. However, merger disclosure documents cautioned that there was no guarantee that such dividends would be paid. Other merged banks noted similar changes. For example, AgriBank's dividend policy was different from the former St. Louis bank's and would result in higher dividends for those associations. If the FCB paid higher dividends, associations may also be able to pay out higher dividends or lower their interest rates to member-borrowers.

"Service at Cost" Remains but Has Evolved

The notion of "service at cost" continued to guide the operation of many FCBs (and associations) after mergers, although the tradition has evolved as the result of statutory changes. Statutory changes in the mid-1980s concerning the manner in which interest rates were established resulted in some banks and associations offering more competitive or market-driven rates.[6] Additionally, the 1987 act authorized FCA to establish minimum capital standards for all System institutions. While some banks still offer lower rates in lieu of higher earnings and greater dividends ("service at cost"), others prefer to charge rates that are more comparable to rates charged by other lenders and pay greater dividends.[7] In 1993, System earnings exceeded $1 billion for the first time since 1982.

[4]FCBs may pay dividends or patronage to their associations, which may in turn provide dividends and patronage to their farmer and rancher borrowers.

[5]First South was the Jackson PCA that joined the Columbia district following the merger.

[6]In 1986 amendments to the Farm Credit Act, Congress authorized the System, rather than FCA, to set loan rates, thereby allowing rates to become more market-oriented. The amended policy section of the Farm Credit Act also noted that farmers' needs are best served if System institutions provide "equitable and competitive" rates. For additional information on System loan pricing practices, see GAO/GGD-94-39.

[7]As GAO/GGD-94-39 explains, System institutions can benefit their member-borrowers by earning profits to pay dividends or offering lower loan rates as an indirect dividend payment. Mergers of FCBs with conflicting policies would primarily affect borrowers if they preferred one policy over the other.

Mergers' Impact on Local Control Depends on Merging Banks

The principle of local control dates back to 1916 and has been reinforced over the years. In fact, the 1971 Farm Credit Act, as amended, encourages farmer and rancher member-borrowers to participate in management and control of the System. Local control of the System is ensured most directly by the power of member-borrowers to elect the directors of their associations and, in turn, these association boards elect directors of their FCB.

An important factor in determining how FCB mergers will affect local control is the general trend in the System toward more independent associations as more associations become direct lenders.[8] As part of this trend, many banks have begun to make their associations more accountable for their financial well-being by delegating many responsibilities to them. FCB mergers would enhance local control if the merged banks promoted association autonomy and encouraged borrower involvement. A variety of factors[9] are likely to affect the amount of association autonomy that evolves in districts. Each district, newly merged or otherwise, would have to reconcile the FCB's need to oversee its associations and the interests of the shareholders if differences exist between the FCB and shareholders. Merged banks may also experience local differences in merged districts.

Although 53 percent of general association survey respondents believed FCB mergers would negatively affect local control, only 28 percent (8 of 29) of AgriBank survey respondents believed the St. Paul/St. Louis merger actually had a negative impact on local control. Four of 10 bank officials responding to our survey believed mergers would negatively affect local control. Some bank and association officials focused on the loss of representation to a larger bank board (addressed in the following section), while others expressed concerns about potentially increased direction from the merged FCB.

Mergers Have an Impact on Association Voting Strength and Number of Elected Bank Directors

An FCB merger increases the number of associations affiliated with a single bank and dilutes individual association voting strength.[10] For example, an association with 90,000 voting shareholders in a district with 100,000 voting shareholders would control 90 percent of the weighted vote. If that

[8]None of the merged banks have remaining agent associations; all are direct lenders.

[9]Factors include asset size, financial condition, management philosophy, and whether it is a direct lending or agent association.

[10]Each association is entitled to one vote that is assigned a weight proportional to the number of its voting shareholders.

association's FCB merged with an FCB in a district that had 150,000 voting shareholders, the number of shareholders or weighted votes in the merged district would be 250,000 (100,000 plus 150,000), thus diluting the association's voting strength to 36 percent of the weighted vote.

In addition to diluting voting strength, mergers also caused some associations to elect proportionately fewer bank directors. As table 3.3 shows, the total number of elected bank directors in a merged district was lower than the total number of bank directors the associations elected before the merger. In merged FCBs, each elected FCB director may be the only resident of his/her state elected to the bank board.

Table 3.3: Comparison of the Number of Elected Bank Directors Pre- and Postmerger

Premerger		Postmerger	
Premerger banks (no. of elected directors)	Total number of directors	Merged bank	Total number of directors
St. Paul FCB (4) St. Louis FCB (6)	10	AgriBank FCB	8[a]
Columbia FCB (8) Jackson FICB (7)	15	Columbia FCB	11[b]
AgriBank FCB (8) Louisville FCB (6)	14	AgriBank FCB	12[c]
Omaha FCB (6) Spokane FCB (6)	12	AgAmerica FCB	8[d]

[a]Four of the eight elected directors come from each former district, one from each of the four states in the former St. Paul district and one from each state of the three states in the former St. Louis district, plus one from any of the three states.

[b]Eight of the 11 elected directors come from the former Columbia district (2 from each state) and 1 from each of the 3 states in the former Jackson district.

[c]Eight of the 12 directors come from the former AgriBank district and 1 is elected from each of the 4 states in the former Louisville district.

[d]The merged bank initially is to have 12 elected directors. However, four directorships (two from each premerger district) are to be eliminated over a 2-year period. One director is to come from each of the four states in each former district.

Source: FCB merger disclosure documents.

FCB Mergers Likely to Have Little or No Impact on System-Wide Bond Issuances

FCB mergers are likely to have little or no impact on the issuance of System-wide bonds for several reasons.[11] Although the System is a collection of institutions, investors essentially view the System as a single entity. This perception is reinforced by the joint and several nature of System-wide obligations, which ultimately makes all banks liable for System-wide and consolidated debt. From an investment perspective, joint and several liability removes much of the credit risk of individual district financial problems.

The System also presents combined financial data to the investment community through the Funding Corporation. Additionally, investors rely on the strength of the System's ties to the federal government because of the System's GSE status. As of February 1994, Moody's rated the System's debt "Aaa," the highest available rating. According to a Funding Corporation official, mergers would bolster the System's safety if mergers resulted in larger, more financially stable institutions.[12] Most bank officials surveyed agreed that mergers would not negatively affect System-wide debt security issuances.

Some bank officials indicated that FCB mergers could enable some merged FCBs to utilize more favorable financing options. For example, one bank official noted that the merged bank was able to privately place its debt issuances following a merger, thus simplifying the issuance process.[13] In managing their assets and liabilities, individual FCBs also use financing options such as interest rate swaps. For these types of transactions, the increased size and financial strength that result from mergers may offer the individual banks some advantages.

Conclusions

We found that merged FCBs generally expected mergers to have no adverse impact on the number of services associations provide to borrowers. Some AgriBank associations were even able to offer additional services and loan products. Because the System's cooperative nature is grounded in statute and regulation, FCB mergers are not likely to affect it. FCB mergers may

[11]As of February 1994, System-wide bonds were the only bonds publicly issued by the banks through the Funding Corporation. In addition to general System-wide bonds, the banks also can use System-wide medium-term and discount notes for their funding needs.

[12]We also recognize that mergers may increase the operating risk of the merged institution as a greater portion of System assets are managed by fewer people. Larger institutions also pose a relatively greater risk to the System than smaller ones if they were to fail. However, merging banks contend that larger institutions are able to attract and retain higher caliber managers.

[13]Private placement means that the Funding Corporation was able to sell the bond issuance directly to an investor.

affect an individual association's voting strength and board representation. Although our survey revealed that many association officials were concerned that mergers would negatively affect local control, as of April 1, 1994, all voluntary mergers had been overwhelmingly approved by their stockholders. Additionally, most banks are moving toward wholesale lending relationships with their associations, which should promote greater association autonomy and local control. However, merged banks would still have to balance local needs and bank objectives.

We also found no evidence that FCB mergers would have an adverse effect on the issuance of System-wide bonds because the investment community views the System as a single GSE entity, and all System banks are ultimately jointly and severally liable for debt issued by the System. Some System officials indicated that larger FCBs may have greater flexibility in asset/liability management because these transactions are based on each bank's individual financial strength, and size is a factor.

FCB Mergers Could Significantly Affect How Banks and Associations Relate

Of all the factors covered by our study, the bank-association relationship is likely to be most affected by FCB mergers. An FCB merger may alter the dynamics of the existing bank-association relationship in various ways. The degree of alteration is likely to depend upon the similarities and differences in the philosophies of the merging districts and the philosophy adopted by the merged institution. We identified three basic ways the FCBs and associations relate to each other. First, banks oversee or supervise the activities of their owner-associations based on existing statutes, regulations, and contractual duties. Second, banks and associations have a quasi-debtor-creditor relationship because FCBs are the primary funding sources for their district associations. Third, banks provide numerous operational support services to associations.

FCB Mergers Could Change Supervision of Some Associations

The bank-association supervisory relationship is unique and complicated because ownership and supervision flow in opposite directions: associations own the banks, but banks have various authorities over association operations. FCB authorities emanate from statute, FCA regulation, and contractual arrangements between FCBs and their associations. FCBs exercise these authorities to varying degrees throughout the System. Some banks closely monitor association operations and are actively involved in association management; others are much less involved.[1] The level of bank involvement often depends upon the association's financial condition and whether it lends directly to member-borrowers (acts as a direct lender) or facilitates loans between member borrowers and the FCB (acts as an agent association). According to association officials we contacted, banks generally oversee various aspects of their operations, focusing on credit and other areas, such as strategic planning, policy reviews, and CEO salary approval. FCB statutory authorities over associations include powers to

- approve the appointment and compensation of chief executive officer and salary scale of staff,
- delegate power to associations,
- establish lending standards for associations,
- supervise associations,
- approve alternative funding sources,
- approve association investments,
- approve merger plans,
- approve service charges,
- approve loss-sharing agreements, and

[1]This issue is addressed in detail in GAO/GGD-94-14.

- prescribe amounts held as surplus by associations.

If the FCBs involved in a merger have different supervision or oversight practices, the resulting consolidation will affect the bank-association relationship of at least some associations and possibly their member-borrowers.[2] However, many associations throughout the System indicated that their FCBs were generally less involved in their operations than they were a few years ago. Many attributed the change to their becoming direct lending associations. Given this general trend, FCB mergers are not likely to adversely affect association autonomy.

Since all voluntary FCB mergers are subject to association approval, association boards have options available if they believe a merger would adversely affect their operation. An association could use its voting authority and elect not to approve the proposed merger. However, unless the association held a majority of the votes, the outcome would depend on whether other associations shared its view. An association, with the proper approvals, could also reaffiliate with another district with a structure more compatible with its needs. For example, the four smaller former Louisville associations with $451 million in assets chose to reaffiliate with the Columbia district rather than become part of the AgriBank district. Among other issues, they cited greater compatibility with the Columbia district than the merged AgriBank district.

Association Opinions Varied on Whether The St. Paul/St. Louis Merger Affected FCB Supervision

Although AgriBank has the same powers and responsibilities to supervise associations as did the St. Louis and St. Paul FCBs, 19 of 29 association officials responding to our survey indicated some change in FCB supervision and/or oversight following the merger. Both premerger banks shared similar supervisory policies; AgriBank's policy is a combination of the two. Responses varied as to whether the merger actually led to more or less bank supervision. This variation may indicate that the FCB's relationship with each association is unique because the level of supervision depends on the condition and performance of the association. Seven of the remaining 10 officials responded that there was no change in the supervision provided after the merger.[3]

AgriBank Planned to Promote Bank/Association Partnership

In 1993, AgriBank drafted plans to change its supervision policy and forge a partnership with its associations. Noting the debate over how much

[2]For example, some banks approve association policies that deal with lending practices and loan administration, which affects member-borrowers.

[3]Three had no response.

control an FCB should exert versus the ability, opportunity, and prerogatives of associations to fulfill their missions, the bank drafted plans to change its operations. According to bank documents, AgriBank planned to stop trying to improve association business performance through such methods as "coaching" and "threatening." Instead, the bank planned to use an incentive program to achieve and maintain association success. AgriBank planned to continue to provide feedback to association boards and management concerning association performance; it would, however, no longer offer recommendations for remedying weaknesses unless requested by the association. If the collection of an association's loan was placed in jeopardy, AgriBank still intended to take the necessary steps to remedy the situation and avoid any adverse impact on the rest of the district. This course of action appears consistent with the general FCB trend toward less supervision and oversight.[4]

FCB Mergers Not Likely to Change the FCB and Association Funding Relationship

Merged FCBs continue to serve as the primary funding source for direct lending associations. Unlike independently negotiated debtor/creditor relationships, the FCBs and associations share a mandated funding relationship or quasi-debtor-creditor relationship.[5] This funding relationship is governed by a general financing agreement (GFA) that establishes the terms and conditions of the associations' funding. Associations have the authority to borrow from their district FCBs and must have the FCB's approval to obtain funding elsewhere. Similarly, FCA requires FCBs to notify it at least 60 days before they take any action that would lead to the liquidation of an association.

Unlike direct lending associations that originate, service, and own their loans, agent associations originate and service loans on behalf of the FCB. The service agreements that FCBs negotiate with their agent associations are similar to GFAs direct lenders have with the FCBs. FCBs may also establish service agreements with direct lending associations that service loans on behalf of the bank. These agreements outline performance targets, services provided by the association, and compensation to be paid by the bank.

[4]Many officials noted that FCBs were moving away from extensive oversight of association operations. This was spurred in part by movement toward more direct lending associations and statutory changes that required FCA to examine each bank and direct lending association at least once annually (FLBAs must be examined at least once every 3 years).

[5]Associations have the option to change their bank affiliation by territorial transfers and amendments to bank charters, subject to required approvals. Several associations have used this option to establish affiliations with different banks.

General Trend Toward Wholesale Lending

Most FCBs—merged and unmerged—are moving toward wholesale lending relationships with their associations. (See app. V.) FCBs have been encouraged to become wholesale lenders by efficiency and operational issues and by several changes related to capital accumulation and the status of borrower stock.[6] Banks become wholesale lenders as they transfer their long-term lending authority to FLBAS (which then become FLCAS) or as FLBAS merge with PCAS to form ACAS.[7] The Springfield, Baltimore, Columbia, and Louisville FCBS became strictly wholesale lenders through the creation of ACAS. These banks also sold or transferred all of their mortgage retail loans to their newly created ACAS. Although the Omaha and Spokane FCBS had only direct lending associations by the end of 1993, both still had large volumes of retail loans in their loan portfolios.[8] The AgriBank and Western FCBS were still moving toward wholesale lending structures in 1993. In 1994, AgriBank transferred its direct long-term real estate lending authority to its remaining FLBA (making it an FLCA). Like Omaha and Spokane, however, a substantial amount (40 percent as of September 1993) of AgriBank's retail loan volume remained at the bank level. The Wichita and Texas FCBS maintained traditional PCA/FLBA district structures with retail mortgage loans made through their agent associations (FLBAS).

Mergers Could Change Support Services to Associations

Another component of the bank-association relationship is the support services FCBS provide to their associations. While these services may facilitate an association's ability to serve its borrowers, they are generally invisible to the borrower. These services often include data processing, marketing, training, and asset/liability management, as detailed in appendix V. On the basis of our analysis, we found the level of support services provided to an association depended in part on the association's asset size and whether it was an agent or direct lender. Some FCBS provided many support services for their associations; others provided few.

Because banks offer varying levels of support services to their associations, a merger may result in a change in the number of services

[6]The 1987 act changed the way borrower stock issued after October 1988 can be accounted for in computing permanent capital. In addition, regulations further changed the way capital is to be accounted for in achieving the regulatory minimum. For a more detailed discussion of these changes see chapter 1 (p. 24) of GAO/GGD-94-14.

[7]Banks also may sell retail loans in their portfolios to their associations.

[8]While Omaha planned to sell or transfer a portion of its remaining retail loans to its FLCA, Spokane had no such plans for its retail loans. Thus, AgAmerica—the result of the April 1, 1994, merger between the Omaha and Spokane FCBs—will continue to have retail loans on its books.

available to some associations. For example, the Louisville FCB provided very few support services to its associations before merging with the AgriBank FCB. AgriBank provided dozens of services to its associations and planned to extend these services to the Louisville association. Similarly, the Spokane and Omaha FCBs offered different levels of support services to their respective associations before consolidating to form AgAmerica. AgAmerica did not plan to provide most of the support services formerly provided by the Omaha FCB. Therefore, Omaha's jointly managed PCA/FLCA planned to provide many of those services for themselves or buy them elsewhere. However, Northwest Farm Credit Services, ACA, in the Spokane district was not affected because the Spokane FCB had provided few support services before the merger. Since support services provided by the banks facilitate association operations, there may be some indirect impact on member-borrowers.

All of the banks provided their associations with data processing or information systems. According to disclosure documents and bank officials, merged FCBs try to achieve economies of scale by integrating their associations through use of a common system. During the integration, member-borrowers may encounter disruptions in the level and quality of association-provided services in areas such as billing and loan origination. A few associations in the AgriBank district said this was an issue following the merger. However, if the implementation is adequately planned and executed, such disruptions should be only temporary. In every merger to date, one merger partner's associations adopted the other's accounting, data processing, and information systems. AgriBank primarily adopted St. Louis' system, Jackson adopted Columbia's, and Louisville was adopting AgriBank's. Spokane and Omaha planned to implement a joint management information system (MIS) venture with CoBank.

Support Services Provided to AgriBank Associations Were Similar to Premerger Services

AgriBank provided various support services to associations upon request. The bank's 1993 vendor services catalog listed 37 support services including a variety of accounting, human resources, legal, marketing, and MIS services. If a particular offering was not used by associations, the bank generally discontinued the service. For example, AgriBank eliminated its sales management services and related staff resources due to low association usage. Although most services were optional, AgriBank required all associations to subscribe to key accounting and MIS services to achieve operating efficiencies across the district.

MIS Conversion Was a Critical Implementation Issue

The most significant implementation issue for AgriBank was the development and implementation of a common MIS. AgriBank adopted St. Louis' core lending system, loan origination system, and computer hardware. The bank also retained some features of the St. Paul system. St. Paul associations were trained and converted to the St. Louis system. Agribank completed association personnel training and conversion in October 1993. On the basis of AgriBank associations' responses to our September 1993 survey, we believe the conversion created some dissatisfaction about the merger. Associations in the former St. Paul district had problems with the MIS technology provided by AgriBank. Although the number of loan products and pricing options increased following the merger, some officials believed they lost some flexibility in customizing loan documents because of standardization required by the new system.[9] A few former St. Louis association officials noted poorer service quality and less support for existing MIS services from the merged bank. It should be noted that our survey was conducted during the conversion process, and AgriBank officials expected associations to experience certain adjustment problems and disruptions during this period.

Conclusions

FCB and association relationships vary throughout the System; therefore, certain FCB mergers could affect some bank-association relationships. Although all FCBs share the same supervisory authorities over association activities, most FCBs exercise these authorities to varying degrees throughout the System. How this relationship is managed affects association operations and how associations in turn relate to their member-borrowers.

Since FCBs and associations share a mandated funding relationship, FCB mergers are not likely to change this arrangement. However, many FCBs are moving toward wholesale lending relationships with their associations. As of April 1, 1994, all merged FCBs had wholesale lending structures.

In addition to funding, banks also provide numerous support services to associations to facilitate their ability to serve member-borrowers. While all FCBs provided certain basic services, such as data processing and information systems, many FCBs provided a variety of other support services to their associations. If banks that provide different levels of support merge, associations in one or both districts may be affected. One

[9]We did not attempt to address the merits of such complaints. Although some may appear to go beyond conversion issues, it is important to note that as the associations become more comfortable with the new system, they may find fewer problems with it.

of the mergers resulted in an association having additional support services available to it, while another merger resulted in some associations providing support services (formerly provided by their bank) in-house or purchasing them elsewhere.

FCB Mergers May Spur Additional Jointly Provided Services

FCBs throughout the System have consolidated certain duplicative functions and services to achieve economies of scale and/or reduce costs without merging. Banks own various entities that provide services to themselves, their associations, and their member-borrowers System-wide. Jointly provided services include System-wide and individual arrangements between or among banks to buy or sell specific services. According to System officials, district differences and a large number of banks made certain past System-wide joint efforts problematic.[1] Bank mergers may ease efforts to achieve System-wide economies of scale because they tend to reduce the number of banks and districts that have to be accommodated in such efforts.

The System Has Established Organizations to Provide Common Services

In the past 20 years, System banks have established several organizations to provide common support and coordination services for the benefit of System banks, associations, and their borrowers. For example, the banks established a fiscal agent responsible for issuing bonds to fund the banks; this evolved into the existing statutorily based Funding Corporation. The 1971 Farm Credit Act authorized banks to provide joint services to themselves, their associations, and borrowers. The banks subsequently established FarmBank Services in 1975 to reduce costs and increase efficiencies by providing various support services System-wide. Also, the Farm Credit Council (FCC) was established in 1983 as the System's trade association to provide governmental affairs support. Also in 1983, the System banks established the Farm Credit Leasing Services Corporation (FCL) to provide expanded leasing services to borrowers.[2] In 1985, the Farm Credit Corporation of America (FCCA) was established to provide strategic leadership and planning for the System. FarmBank Services was merged into FCCA at that time. When FCCA dissolved in 1990, the Funding Corporation assumed its financial reporting responsibilities, and the service functions, including the responsibilities to assist in the development of consensus on System-wide issues, were transferred to FCC.

Common and Jointly Provided Services Are Available to Banks, Associations, and Member-Borrowers

The Farm Credit Act of 1971, as amended, provides, in general, that any System bank, or two or more banks acting together, may organize a corporation or corporations for the purpose of performing certain functions and services for or on behalf of the organizing bank or banks. Given the duplication of various functions throughout the System, opportunities exist for FCBs to jointly provide additional support functions,

[1]There were 37 banks in existence in the mid-1980s; as of August 1, 1994, there were 11.

[2]The Springfield FCB and BC do not share in the ownership of FCL.

such as data processing, MIS, and administration, to reduce their overall operating costs.

Within the System, a number of services are provided on a joint or System-wide basis to banks, associations, and member-borrowers. An example of a jointly provided service for banks is the data processing service that the Columbia FCB provided in 1993 to the Springfield FCB. System-wide bank services include those provided by FCC, the System's trade association. In addition to its governmental and public affairs activities, through a wholly owned subsidiary (Farm Credit Council Services, Inc.), FCC provides many support services on a voluntary fee basis, including risk management, joint purchasing contracts, review and internal audit services, and human resource services. FCC estimates that it saves the System about $10 million annually as a result of the services it provides directly and/or manages for System institutions.[3]

Banks also own FCL, which provides leasing and related services primarily to eligible borrowers but also to banks and, in some cases, associations.[4] According to an FCL official, its operations result in economies of scale and leasing expertise that would not be possible if leasing activities were decentralized at the district level. As owners of FCL, FCBs may also receive dividends from its operations.[5] While some associations opt to independently provide leasing services, FCL is an example of the System using its authority to create a service organization to provide a service to borrowers.

According to The Leasing and Financial Services Monitor, a trade publication, FCL posted the largest percentage increase in its lease portfolio among large independent leasing companies in 1992. Although FCL has sales offices throughout the country, it utilizes the existing association structure through a lease origination program that enables associations to originate leases for a fee. Seventy-seven percent of associations responding to our survey participated in the FCL lease origination program. FCL has leases available for various types of agricultural and nonagricultural items, from tractors and kiwi-defuzzers to office equipment and automobiles.

[3]This savings estimate was calculated in 1993 for 1990 costs, but FCC expected the estimated savings for subsequent years to be comparable. The estimate compares joint purchasing costs to similar costs as if they were purchased individually. We did not independently verify these estimates.

[4]All banks share in the ownership of FCL except the Springfield FCB and BC.

[5]A dividend was declared in 1991, but not in 1992.

FCB Mergers May Facilitate Development of Additional Common or Jointly Provided Services

According to System officials, past efforts to integrate certain services were unsuccessful because of differences in district bank operations. For example, in the late 1970s through early 1980s, several banks tried to integrate data processing, but the effort was aborted because no effective common approach could be developed. Because mergers result in fewer districts and banks with specific needs that a System-wide service would have to accommodate, mergers may facilitate the development and acceptance of System-wide services.

In late 1993, CoBank and the Omaha and Spokane FCBs (now AgAmerica) began pursuing a joint venture to consolidate their data processing functions through the creation of a service corporation. In February 1994, FCA received an application for a service corporation charter stemming from this joint venture. In May 1994, FCA's Board approved the request to form AgCo Services Corporation.[6] This corporation is to provide CoBank and AgAmerica and their associations with all their MIS and electronic data processing services. AgCo is also to have the capacity to provide similar services to other FCS institutions.

Conclusions

Mergers, which result in fewer banks and districts, may increase opportunities for the banks to jointly provide additional services on a System-wide basis and lower operating costs. While many joint efforts indirectly benefit member-borrowers through lower operating costs, FCL provides leasing and related services directly to member-borrowers. According to FCL officials, FCL is able to achieve a level of leasing expertise that would not be available through district-based individual leasing programs.

Fewer FCBs may facilitate other joint projects since there would be fewer banks to accommodate. The latest joint venture, AgCo, illustrates this possibility. Joint efforts could benefit borrowers if they helped control operating costs through greater economies of scale.

[6]The FCA Board approved issuance of the charter once certain conditions have been met.

General Association Survey Results

United States General Accounting Office

Survey on Farm Credit System Bank Mergers

INTRODUCTION

The U.S. General Accounting Office (GAO), an independent agency of Congress, has been asked to evaluate the potential impact on farmer and rancher borrowers of the Farm Credit System institutions of merging the 10 district Farm Credit Banks (FCB's), and the Jackson FICB, into fewer regional FCB's.

Your assistance in answering the following questions will help us determine the types of services the FCB provides to you, obtain your opinions on the role of the FCB, and will give you the opportunity to contribute your views on a number of issues Congress asked us to consider, including:

- the potential reduction in services from mergers,
- the potential benefits of jointly providing services,
- the potential impact on the cooperative nature of the Farm Credit system,
- the potential impact on bank and association relationships, and
- the potential impact on System-wide bond issuances.

Although your participation in this survey is completely voluntary, your frank and honest answers are essential to our review. The questionnaire should take less than 30 minutes to complete.

If you have any questions, please call Ms. Orice Williams at (703) 883-4290. Please return the completed questionnaire in the enclosed preaddressed, prepaid envelope *within 5 working days of receipt.* In the event the envelope is misplaced, our return address is:

U.S. General Accounting Office
Ms. Orice Williams
441 G Street, NW, Room 3660
Washington, D.C. 20548

Thank you for your cooperation and assistance.

I. INSTRUCTIONS

This questionnaire should be filled out by the current president or chief executive officer of this association, or by someone authorized to provide the information requested and to state the positions of this association.

Please provide the following information so that we may contact you if we need to clarify a response:

Name of primary respondent: ____________________

Title: ____________________

Association name: ____________________

Address (if different from mailing label): ____________________

____

____

Telephone: (   ) ______ -- ______

1

1. For each of the following services, please indicate whether or not your district's FCB actually performs any part of that service for your association, aside from simply providing guidance or support in that area.

(For each row, check "Yes" if your district's FCB performs any part of the service for you. If the FCB does not offer any form of the service, or if your association does not use a service which is offered by the FCB, check "No." Also check "No" if the FCB provides only guidance or support in that particular area.)

Services:	**Does the FCB perform this service for you?**		
	Yes (1)	No (2)	Don't know (3)
Administration:			
1. Data processing N=146	98%	1%	1%
2. Marketing, advertising N=145	66	34	
3. Financial statement preparation (not only guidance or support) N=146	60	40	
4. Call report preparation N=145	47	53	
5. Other N=15	80	20	
Human Resources:			
6. Salary administration N=147	45	55	
7. Hiring N=146	7	93	
8. Benefits administration N=146	97	3	
9. Staff (not CEO) performance evaluation N=147	1	99	
10. Training for management N=145	66	34	

(Continued on next page)

2

1. (Continued.)

Please indicate whether your district's FCB performs the following services for your association:

Services:		Does the FCB perform this service for you? Yes (1)	No (2)	Don't Know (3)
Human Resources:				
11. Training for other staff	N=146	83	17	
12. Other	N=13	77	23	
Funding/Liquidity:				
13. Asset/liability management	N=142	69	31	
14. Other	N=15	73	27	
Audit/Internal Controls:				
15. Internal credit reviews (See FCA 618.8430; do not include credit review FCB performs as part of annual review.)	N=145	10	90	
16. Internal audits	N=143	32	66	1
17. Other	N=13	100	0	
Credit:				
18. Setting of interest rates on loan products[1]	N=147	45	52	
19. Special (troubled) asset management	N=147	21	79	
20. Asset appraisals	N=147	18	82	
21. Policies and procedures (consider as a service)	N=146	47	52	1
22. Other	N=10	90	10	

[1]Three percent of the jointly managed associations indicated that the bank provides the service for the FLBA but not the PCA.

3

2. Please describe the current oversight or supervision performed by your district's FCB over your association. *(List the major oversight or supervision functions the FCB performs.)* N=329[2]

Policies and Procedures - 9%
Planning/Budgeting - 6
Prior Approvals - 11
Salary Administration - 4
GFA Oversight - 13
Reviews - 28
Ratings - 2
Other - 26

3. Has the oversight or supervision of your district's FCB over your association changed in any way since the implementation of the 1987 Farm Credit Act? *(Check only one box.)* N=147

1. Yes - 69% ⇨ *Continue with Question 4.*

2. No - 22

3. Don't know - 8

} *Skip to Question 5.*

4. IF YOU ANSWERED "YES" TO THE PREVIOUS QUESTION:
Please describe how the oversight or supervision of your district's FCB over your association has changed. *(List changes below.)* N=134[2]

Bank is less involved in association - 48%
Bank no longer prior approves association polices - 2
Increased lending limits - 2
Fewer support services - 2
More general guidance - 2
Debtor/Creditor relationship - 16
Other - 28

[2]Respondents were allowed multiple responses. GAO categorized the responses into several broad categories, such as policies/procedures, reviews, and ratings.

4

III. SERVICES YOUR ASSOCIATION PROVIDES TO ITS CUSTOMERS

5. Does your association offer any of the following types of services, in any form, to its customers?

(Check only one box in each row.)

Association Services:	Yes, offers (1)	No, does not offer (2)	Don't know (3)
1. Insurance N=148	96	4	
2. Tax preparation N=146	10	90	
3. Farm record keeping N=146	12	88	
4. Tax record keeping N=146	11	89	
5. Estate management N=144	3	96	1
6. FCL* leasing N=148	78	22	
7. Non-FCL leasing N=137	3	97	
8. Fee appraisal N=146	36	64	
9. Other N=23	91	9	

* Farm Credit Leasing Services Corporation

5

6. Are there any services that you would like your association to provide, but that have not been approved by the FCB in this district?

(Check only one box.) N=143

1. Yes - 24% *Continue with Question 7.*

2. No - 66
3. Don't know - 9

Skip to Question 8.

7. IF YOU ANSWERED "YES" TO THE PREVIOUS QUESTION:
Please describe those services that your association would like to provide but which have not been approved by the FCB in this district.

(List up to four services in the boxes below.) N=34

	Services[3]
Service 1	Debit Cards
Service 2	Fee Appraisals
Service 3	Estate Management
Service 4	Consulting

[3]These are samples of services that were listed.

6

IV. FCB MERGER ISSUES[4]

8. In general, would mergers have positive or negative impacts on the following issues:

a) The level of services provided to borrowers? *(Check only one box.)* N=148

1. Very positive impact - 9%
2. Generally positive impact - 14
3. Little or no impact - 41
4. Generally negative impact - 11
5. Very negative impact - 12

----

6. Don't know - 13

Please explain why you feel that mergers would have this impact on the level of services provided to borrowers:

"Most customers have very little contact with the district bank."

"Mergers ... will effect services negatively by taking local control away from banks and associations."

"A larger FCB would be able to justify the personnel needed to support additional Financially Related Services."
"Slower response time on requests."

"The Association is responsible for the level of service provided to the customers."

"Depends on what services the 'merged' bank decided to approve."

"Mergers usually impact the cost of services but not the level of services."

"Lower cost of funds."

b) Customer satisfaction? N=148

1. Very positive impact - 5%
2. Generally positive impact - 14
3. Little or no impact - 38
4. Generally negative impact - 19
5. Very negative impact - 14

----

6. Don't know - 10

Please explain:

"Services provided by the FCB are transparent to the customer."

"Generally the bigger the bank the less responsive they are to customer needs."

c) Economies of scale? N=146

1. Very positive impact - 23%
2. Generally positive impact - 34
3. Little or no impact - 16
4. Generally negative impact - 8
5. Very negative impact - 6

----

6. Don't know - 12

Please explain:

"...should reduce costs to individual associations."

"Operating expenses should be reduced."

"Mergers have proven not to save the customer money."

"It has been my experience and observation that large mergers become inefficient and bureaucratic."

[4] Many respondents provided narrative answers; the ones provided are generally representative of the responses received. All views are represented on a proportional basis.

7

In general, would mergers have a positive or negative impact on:

d) The relationships between associations and banks? N=148

1. Very positive impact - 5%
2. Generally positive impact - 16
3. Little or no impact - 17
4. Generally negative impact - 28
5. Very negative impact - 12
----
6. Don't know - 22

Please explain:

"Depends on the attitudes of management."

"Greater emphasis placed at the point of delivery, which is the Association."

"Would make associations more independent."

"[Mergers] would reduce the bank[']s sensibility and responsiveness to individual association needs."

e) The cooperative nature of the Farm Credit System? N=148

1. Very positive impact - 4%
2. Generally positive impact - 9
3. Little or no impact - 41
4. Generally negative impact - 20
5. Very negative impact - 16
----
6. Don't know - 9

Please explain:

"...less local control as a result."

"Associations are key to the cooperative nature, not the FCBs."

"...larger organizations tend to contribute to more destruction of cooperative spirit."

"We are primarily only a cooperative in name today..."

f) Local control? N=148

1. Very positive impact - 9%
2. Generally positive impact - 10
3. Little or no impact - 22
4. Generally negative impact - 32
5. Very negative impact - 21
----
6. Don't know - 5

Please explain:

"All local control would be lost if merger was with the wrong district."

"Directorship would represent a larger geographic area."

"If mergers are approved by stockholders then local control would not be diminished."

"Local director and management would become the critical ingredient to success."

g) The issuance of system-wide bonds? N=147

1. Very positive impact - 13%
2. Generally positive impact - 31
3. Little or no impact - 33
4. Generally negative impact - 4
5. Very negative impact - 3
----
6. Don't know - 16

Please explain:

"All FCBs are now jointly liable for all system-wide bonds."

"[I] don't think the bond market would be any different."

"Greater public perception of System unity and financial strength."

"The System would be more profitable, more competitive, and the financial strength of the FCBs would be consolidated into one financial statement."

8

9. Are there any other <u>positive</u> impacts mergers would have?

(List below, or write "none" or "don't know")

"The only real benefit a merger between districts should accomplish would be to reduce the interest rate to the borrower."

"Greater diversification."

"Would increase loan limits."

"Improve FCS image with Congress - did what was asked to streamline the System."

"FCA would be able to reduce its size and overhead which would directly reduce the cost to our customers."

"FCB mergers will drive ACA mergers--into larger, more efficient, well-run organizations with less risk..."

"Could help to standardize policies and procedures across large geographical areas."

"Commodity diversity."

"Lower cost of funds."

"Would help in handling distress conditions with better access to capital."

10. Are there any other <u>negative</u> impacts mergers would have?

(List below, or write "none" or "don't know")

"Much more difficult to resolve operational problems."

"Could increase overall risks to the System since fewer people would have more control."

"Loss of accountability."

"Tends to ignore the small family farm operation."

"Less district employees, thereby creating less jobs and more unemployment."

"...[less] concern about customers on a regional basis due to differences in credit needs, products demands, etc.."

"Less flexibility..."

"Increased travel by employees and Board members."

"More distance between district activities and grassroots."

"Small ACAs will lose their political clout."

9

11. Overall, would you support or oppose an FCB-level merger for your district?

N=147

(Check only one box.)

1. Strongly support - 23%
2. Generally support - 23
3. Neither support nor oppose - 15
4. Generally oppose - 14
5. Strongly oppose - 15

----

6. Don’t know - 10

Please explain your answer if necessary:

"Depends on the situation and perceived benefits or disadvantages to borrowers."

"This would depend on who the merger partner was..."

"It would benefit the customer and improve the long-term viability of the System."

"Association Boards have asked the District Board to more aggressively pursue [a] merger."

"Support would depend on the make-up of districts being merged."

"I am not convinced that there are sufficient gains possible to overcome the negatives."

"Have a good relationship and don’t want it destroyed."

"Would oppose mandated merger. Would support voluntary merger if best for the district and if supported by local boards."

"Time is running out to improve our competitiveness and service orientation to our customer."

"The decision should be left entirely up to the stockholders of the district."

12. Overall, would you support or oppose a policy mandating FCB mergers throughout the Farm Credit System?

N=148

(Check only one box.)

1. Strongly support - 11%
2. Generally support - 9
3. Neither support nor oppose - 2
4. Generally oppose - 23
5. Strongly oppose - 53

----

6. Don’t know - 2

Please explain your answer if necessary:

"Mergers should be decided on their own merit."

"A mandated merger would create a merger that would be unsupported and would cause tremendous inefficiency."

"Mergers should be a matter of choice by the stockholders and should not be mandated by anyone."

"Stockholders own the System!"

"...the mandatory merger of [FLBs] and [FICBs] was successful, so this could be too."

"Politics of the System moves too slowly."

"Several mergers during the past couple of years indicates that the System is moving in the right direction."

"This would completely negate the concept of local control in this System."

10

13. In your opinion, will the FCB in your district merge in the near future (in the next 3 years, for example)?
N=147

(Check only one box.)

1. Definitely will merge - 8%
2. Probably will merge - 24
3. As likely to merge as not - 22
4. Probably will not merge - 33
5. Definitely will not merge - 3
----
6. No basis to judge - 9

Please explain your answer if necessary:

"Merger activity is in 'Vogue' at present. Talks are taking place with neighboring FCBs as we respond to this survey."

"Fear of loss of jobs and directorships."

"Not much confidence movement will occur..."

14. In your opinion, what is the largest barrier, if any, to FCB mergers today?

(Describe below, or write "none" or "don't know")

"Accounting Systems that are not compatible."

"Politics, egos, 'turf' issues, economic loss to stronger entities, lack of 'grassroots' support, [and] lack of perceived need or benefit."

"Association structure in the various districts."

"Perception of loss of management positions and director positions."

"No real advantage to the customer/borrower."

V. COMMENTS

15. If you have any comments on this questionnaire, or the issues raised in it, please use the space provided below, and attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire. Please return it in the envelope provided, or mail it to the address shown on the front within 5 working days.

GGD/CR/9-93/233404

11

AgriBank Association Survey

United States General Accounting Office

Survey on Farm Credit System Bank Mergers

INTRODUCTION

The U.S. General Accounting Office (GAO), an independent agency of Congress, has been asked to evaluate the potential impact on farmer and rancher borrowers of the Farm Credit System institutions of merging the 10 district Farm Credit Banks (FCB's), and the Jackson FICB, into fewer regional FCB's. Because of your district's recent merger, your answers are particularly important to us.

Your assistance in answering the following questions will help us determine the types of services the FCB provides to you, obtain your opinions on the role of the FCB, and will give you the opportunity to contribute your views on a number of issues Congress asked us to consider, including:

- the potential reduction in services from mergers,
- the potential benefits of jointly providing services,
- the potential impact on the cooperative nature of the Farm Credit system,
- the potential impact on bank and association relationships, and
- the potential impact on System-wide bond issuances.

Although your participation in this survey is completely voluntary, your frank and honest answers are essential to our review. The questionnaire should take less than 30 minutes to complete.

If you have any questions, please call Ms. Orice Williams at (703) 883-4290. Please return the completed questionnaire in the enclosed preaddressed, prepaid envelope *within 5 working days of receipt*. In the event the envelope is misplaced, our return address is:

U.S. General Accounting Office
Ms. Orice Williams
441 G Street, NW, Room 3660
Washington, D.C. 20548

Thank you for your cooperation and assistance.

I. INSTRUCTIONS

This questionnaire should be filled out by the current president or chief executive officer of this association, or by someone authorized to provide the information requested and to state the positions of this association.

Please provide the following information so that we may contact you if we need to clarify a response:

Name of primary respondent: ______________________

Title: ______________________

Association name: ______________________

Address (if different from mailing label): ______________________
____
____

Telephone: (   ) _____ - ______

1

1. **For each of the following services, please indicate whether or not AgriBank actually performs any part of that service for your association, aside from simply providing guidance or support in that area.**

(For each row, check "Yes" if AgriBank performs any part of the service for you. If the bank does not offer any form of the service, or if your association does not use a service which is offered by the bank, check "No." Also check "No" if the bank provides only guidance or support in that particular area.)

Services:	Does AgriBank perform this service for you?		
	Yes (1)	No (2)	Don't know (3)
Administration:			
1. Data processing	28	1	
2. Marketing, advertising	19	10	
3. Financial statement preparation (not only guidance or support)	20	9	
4. Call report preparation	21	6	
5. Other	6	1	
Human Resources:			
6. Salary administration	14	15	
7. Hiring	3	26	
8. Benefits administration	28	1	
9. Staff (not CEO) performance evaluation	1	28	
10. Training for management	20	8	

(Continued on next page)

1. (Continued.)

Please indicate whether or not AgriBank performs the following services for your association:

Services:	Does AgriBank perform this service for you? Yes (1)	No (2)	Don't Know (3)
Human Resources:			
11. Training for other staff	27	2	
12. Other		1	
Funding/Liquidity:			
13. Asset/liability management	18	11	
14. Other	1	1	
Audit/Internal Controls:			
15. Internal credit reviews (See FCA 618.8430; do not include credit review FCB performs as part of annual review.)	1	28	
16. Internal audits	10	19	
17. Other	1	1	
Credit:			
18. Setting of interest rates on loan products		29	
19. Special (troubled) asset management	21	8	
20. Asset appraisals	1	28	
21. Policies and procedures (consider as a service)	12	17	
22. Other	5	1	

2. Please describe the current oversight or supervision performed by AgriBank over your association:

(List the major oversight or supervision functions AgriBank performs.[1])

Policies and procedures - 5

Planning/budgeting - 12

Prior approvals - 6

Salary administration - 3

GFA oversight - 5

Reviews - 17

Ratings - 11

Other - 19

3. Please describe how AgriBank's oversight or supervision over your association is different now from what was performed by the St. Louis or St. Paul FCB before the merger.

(Describe below, or write "none" or "don't know")

More supervision - 6

Less supervision - 4

Same as before the merger - 7

Supervision has changed - 9

No response - 3

[1] Respondents were able to provide multiple reponses.

III. SERVICES YOUR ASSOCIATION PROVIDES TO ITS CUSTOMERS

4. Does your association offer any of the following types of services, in any form, to its customers?

(Check only one box in each row.)

Association Services:	Yes, offers (1)	No, does not offer (2)	Don't know (3)
1. Insurance	29		
2. Tax preparation	17	12	
3. Farm record keeping	17	12	
4. Tax record keeping	13	13	
5. Estate management	7	17	
6. FCL* leasing	19	6	
7. Non-FCL leasing	7	19	
8. Fee appraisal	20	9	
9. Other	3	1	

* Farm Credit Leasing Services Corporation

5. Are there any services that you would like your association to provide, but that have not been approved by AgriBank?

(Check only one box.)

1. Yes - 12 ⇨ *Continue with Question 6.*

2. No - 14

3. Don't know - 1

} *Skip to Question 7.*

No Response - 2

6. IF YOU ANSWERED "YES" TO THE PREVIOUS QUESTION:
Please describe those services that your association would like to provide but which have not been approved by AgriBank?

(List up to four services in the boxes below.)

	Services**
Service 1	FCS bond purchases
Service 2	Secondary management loan pooling
Service 3	Commodity brokerage & marketing services
Service 4	Health insurance to members

**Not all services may be allowed under statute.

IV. FCB MERGER ISSUES[2]

7. In general, did the AgriBank merger have a positive or negative impact on the following issues :

a) The level of services provided to borrowers? *(Check only one box.)*

1. Very positive impact - 2
2. Generally positive impact - 4
3. Little or no impact - 15
4. Generally negative impact - 8
5. Very negative impact - 0

----

6. Don't know - 0

Please explain why you feel that the AgriBank merger had this impact on the level of services provided to borrowers:

"Merger created a larger "critical mass" and helped reduce costs of programs."

"Changing systems, policies and procedures impacts all our associations to one extent or another."

"Services continue to be provided by association local offices."

"Bank cut staff too thin."

"For the most part, merger was transparent[.] Borrowers deal with association[,] not bank."

"The merger did not affect our ability to serve our borrowers."

"Lower cost of funds."

"No material changes in services that are available."

"New loan origination system is less flexible in providing options to borrowers."

b) Customer satisfaction?

1. Very positive impact - 1
2. Generally positive impact - 5
3. Little or no impact - 16
4. Generally negative impact - 5
5. Very negative impact - 0

----

6. Don't know - 2

Please explain:

"Merger was fairly transparent to our customer in terms of service."

"The majority of our customers believed that there was greater strength and stability in a larger [bank]..."

"Conversion of loan accounting systems did not go well. Customer billing errors."

"Implementation of new technology systems...caused slightly negative reaction from this change."

c) Economies of scale?

1. Very positive impact - 8
2. Generally positive impact - 12
3. Little or no impact - 5
4. Generally negative impact - 3
5. Very negative impact - 0

----

6. Don't know - 1

Please explain:

"We feel the cost to the association is somewhat greater due to the merger."

"There have been reductions in overhead at the district bank level."

"...lowered our cost of funds."

[2] The narrative responses presented are generally representative of responses received.

d) The relationship between your association and the bank?

1. Very positive impact - 1
2. Generally positive impact - 9
3. Little or no impact - 8
4. Generally negative impact - 10
5. Very negative impact - 0
----
6. Don't know - 0 Mixed - 1

Please explain:

"We supported 'the partnership' between [the] bank and associations and are committed to district definition of success."

"FCB services deteriorated."

"We detect little or no change in our relationship with the bank since the merger."

"Slightly negative. AgriBank appears less willing to accept association differences and unique needs."

"Began to establish a more business-like relationship."

e) The cooperative nature of the Farm Credit System?

1. Very positive impact - 0
2. Generally positive impact - 3
3. Little or no impact - 19
4. Generally negative impact - 6
5. Very negative impact - 0
----
6. Don't know - 1

Please explain:

"The merger had a very little impact on the true cooperative nature of Farm Credit which is at the association[,] not bank level."

"local input and responsiveness becomes diluted."

f) Local control?

1. Very positive impact - 1
2. Generally positive impact - 7
3. Little or no impact - 13
4. Generally negative impact - 6
5. Very negative impact - 2
----
6. Don't know - 0

Please explain:

"Less emphasis placed on controlling FCS activities."

"No change in local control."

"Little impact since association was already a direct lender."

"Perceived by association directors as less willing to be responsive to local needs."

"Hard to measure but with any merger, this always an early concern."

g) The issuance of system-wide bonds?

1. Very positive impact - 3
2. Generally positive impact - 9
3. Little or no impact - 8
4. Generally negative impact - 0
5. Very negative impact - 0
----
6. Don't know - 8
Other - 1

Please explain:

"I would expect that the strengthening of the bank income statement and balance sheet would be positive."

"We don't believe this has had much impact on investors."

"Early repayment of FAC debt."

"Cost cutting is a positive influence on investors."

8. Are there any other positive impacts the AgriBank merger had?

(List below, or write "none" or "don't know")

"Kept cost of funds from increasing."

"Capitalization level of the FCB was reduced."

"...improved communication and consistency between associations and bank as well as among associations within the district."

"larger base and critical mass"

"Focus more on portfolio management and control - less loan specific."

"Appear to be moving toward a results oriented environment rather than process oriented."

"Change in FCB management philosophy."

"Diversification of enterprise."

"Better asset/liability management."

"Focused district bank attention to systems, funding, and leadership and rely on associations for retail customer responsibilities."

"Working partnership with AgriBank."

9. Are there any other negative impacts the AgriBank merger had?

(List below, or write "none" or "don't know")

"More control over the association through the CAMEL control system."

"Start-up problems have reduced the level of effectiveness and quality of service to associations."

"...AgriBank can no longer support individualized or customized services to a small number of small associations on a cost-effective basis."

"Strategic direction primarily reflects AgriBank's best interest not necessarily that of the association."

"...consensus building is more difficult."

"Level of services was not negatively impacted, but support for services is reduced."

"Increased pressure by AgriBank for association mergers."

"More standardization and less flexibility."

"...no local market sensitivity, implies the association must only seek the few mega-credits--that is not consistent with Congress' direction."

"Additional costs are now being billed to the association."

9

10. Overall, did the AgriBank merger have a positive or negative impact on your association?

(Check only one box.)

1. Very positive impact - 4
2. Generally positive impact - 14
3. Little or no impact - 4
4. Generally negative impact - 4
5. Very negative impact - 1

----

6. Don't know - 2

Please explain your answer if necessary:

"Other than the costs of borrowed funds, the pain seems to have exceeded the gain."

"Strategic leadership and cost of funds reduction."

"Increased earnings due to lower wholesale interest rates."

"The full impact of the merger is not yet known."

"The positive impact was from generally improving availability of more professional services at constant or slightly reduced cost of Agribank."

"...we feel start-up problems have had a short-term negative impact on the association, but that the merger was needed and will ultimately provide benefits to farmers-members through reduced operating costs."

"Lower cost of funds."

11. Overall, would you support or oppose a policy mandating FCB mergers throughout the Farm Credit System?

(Check only one box.)

1. Strongly support - 5
2. Generally support - 9
3. Neither support nor oppose - 3
4. Generally oppose - 3
5. Strongly oppose - 7

----

6. Don't know - 2

Please explain your answer if necessary:

"System does not require 10 district banks in today's financial environment."

"One or at most 3 could easily provide the funds, oversight, & services."

"Consolidation based on economics is preferred--but consolidation has many benefits and should be encouraged."

"Would be inappropriate to 'mandate.' Stockholders must see and desire the benifits of any proposed merger."

"Districts are moving in that direction - no need to mandate."

"I would have to see more positive results from St. Paul/St.Louis before I would endorse mandating further mergers."

10

12. In your opinion, what is the largest barrier, if any, to FCB mergers today?

(Describe below, or write "none" or "don't know")

"Intersystem politics and turf protection."

"The unwillingness to trade some measure of control for the benefit of reduced cost[s] and common leadership and direction."

"A recognition of the need to change and a sense of urgency to do so at all levels of the organization."

"... the widely divergent capital structures of association[s] and FCB[s] as well as the regulatory environment which hampers the effective merger of FCBs."

"A small group of FCB CEOs want to be top dog in the pound!"

"Lack of clear-cut financial gains."

"...loss of local director/member control."

"Lack of a common vision for the Farm Credit System and its future."

V. COMMENTS

13. If you have any comments on this questionnaire, or the issues raised in it, please use the space provided below, and attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire. Please return it in the envelope provided, or mail it to the address shown on the front within 5 working days.

GGD/CR/9-93/233404

Farm Credit Bank Survey Results

United States General Accounting Office

Survey on Farm Credit System Bank Mergers

INTRODUCTION

The U.S. General Accounting Office (GAO), an independent agency of Congress, has been asked to evaluate the potential impact on farmer and rancher borrowers of the Farm Credit System institutions of merging the 10 district Farm Credit Banks (FCB's), and the Jackson FICB, into fewer regional FCB's.

Your assistance in answering the following questions will help us determine the types of services the FCB provides to you, obtain your opinions on the role of the FCB, and will give you the opportunity to contribute your views on a number of issues Congress asked us to consider, including:

- the potential reduction in services from mergers,
- the potential benefits of jointly providing services,
- the potential impact on the cooperative nature of the Farm Credit system,
- the potential impact on bank and association relationships, and
- the potential impact on System-wide bond issuances.

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U.S. General Accounting Office
Ms. Orice Williams
441 G Street, NW, Room 3660
Washington, D.C. 20548

Thank you for your cooperation and assistance.

I. INSTRUCTIONS

This questionnaire should be filled out by the current president or chief executive officer of this association, or by someone authorized to provide the information requested and to state the positions of this association.

Please provide the following information so that we may contact you if we need to clarify a response:

Name of primary respondent: ______________________

Title: ______________________

Association name: ______________________

Address (if different from mailing label): ______________________
____
____

Telephone: (   ) _______ -- _________

1

II. SERVICES YOUR BANK PERFORMS FOR YOUR ASSOCIATION

1. For each of the following services, please indicate whether or not your bank actually performs any part of that service for any associations in your district, aside from simply providing guidance or support in that area.

(For each row, check boxes as applicable to indicate that your FCB performs any part of the service for those types of associations. If you do not offer any form of the service, or if there is no such association using that service, leave the box blank. Also leave the box blank if the FCB provides only guidance or support in that particular area.)

N=10

	Does your FCB perform this service for:			
Services:	FLBA	PCA	ACA	FLCA
Administration:				
1. Data processing	4	6	7	3
2. Marketing, advertising	4	6	5	3
3. Financial statement preparation (not only guidance or support)	3	4	3	2
4. Call report preparation	3	4	3	2
5. Other	1	3	1	
Human Resources:				
6. Salary administration	3	5	4	2
7. Hiring	2	2	2	1
8. Benefits administration	4	6	7	3
9. Staff (not CEO) performance evaluation			1	
10. Training for management	4	6	5	3

(Continued on next page)

1. (Continued.)

Please indicate whether your FCB performs the following services for each type of association in this district:

Services:	Does your FCB perform this service for: FLBA	PCA	ACA	FLCA
Human Resources:				
11. Training for other staff	4	6	5	3
12. Other	2	3	1	
Funding/Liquidity:				
13. Asset/liability management	3	5	6	3
14. Other	2	2	1	
Audit/Internal Controls:				
15. Internal credit reviews (See FCA 618.8430; do not include credit review FCB performs as part of annual review.)	1	2		1
16. Internal audits	2	3	3	2
17. Other:	1	2	2	
Credit:				
18. Setting of interest rates on loan products	2	2	1	1
19. Special (troubled) asset management	3	2	2	3
20. Asset appraisals	3	5	2	2
21. Policies and procedures (consider as a service)	2	3	2	1
22. Other	2	3	2	

3

2. Please describe the current oversight or supervision performed by your FCB over associations in this district. *(List the major oversight or supervision functions your FCB performs.)*

GFA administration

Overall performance monitoring

CEO evaluation

Credit and appraisal reviews

Internal audits

Accounting oversight

Training

Legal reviews

Monitoring compliance with laws, regulations, and general financing agreement

Approval and monitoring of business plans and policies

CAMEL based ratings

Credit, underwriting standards, and delegated authorities

Approve CEO salary

Approve financially related services

Review policies

4

3. Has the oversight or supervision your FCB performs changed in any material way since the implementation of the 1987 Farm Credit Act?

(For banks that have merged, please answer in terms of whether oversight or supervision has changed since the merger. Check only one box.)

1. Yes - 9 ⇒ *Continue with Question 4.*

2. No - 1
3. Don't know

} *Skip to Question 5.*

4. IF YOU ANSWERED "YES" TO THE PREVIOUS QUESTION:
Please describe how the oversight or supervision your FCB performs has changed.
(List changes below.)

More focus on the general financing agreement

More opportunity for each association to develop its own operating practices and procedures

ACAs have more authority over their business

Role of the bank has changed to a support function

More delegated authorities

Monitors effectiveness in achieving desired targets

Less regulatory compliance review, internal credit review, and internal audit function

Less involvement with policy development

Local accountability for performance has increased significantly

Changed from "hands-on" to "results-oriented"

Moving towards differential supervision program

Development of arms-length relationship through comprehensive changes in policies

5

III. **FCB MERGER ISSUES** [1]

5. In general, would a merger of your FCB have a positive or negative impact on the following issues: *(If your FCB has already merged, please answer in terms of what the merger's impact has been on the following issues:)*

a) The level of services provided to farmer/rancher borrowers?
(Check only one box.)
1. Very positive impact
2. Generally positive impact - 1
3. Little or no impact - 7
4. Generally negative impact
5. Very negative impact
----
6. Don't know - 2

Please explain why you feel that a merger would have (has had) this impact on the level of services provided to farmer/rancher borrowers:

"No impact if successor bank would support the same borrower services available today. If not, merger would have a very negative impact."

"Should result in no material change to the customer if handled properly."

"It would depend on financial soundness of merger relative to [the] bank's stockholder group."

"...the bank is virtually transparent to the farmer-borrower."

"Critical mass allows for [a] broader array of products and services."

"The level of services provided is more closely related to the unique characteristics of associations than to the bank."

b) Customer satisfaction?
1. Very positive impact
2. Generally positive impact - 1
3. Little or no impact - 7
4. Generally negative impact
5. Very negative impact
----
6. Don't know - 2

Please explain:

"Results would depend on [the] effectiveness of management and support services post-merger."

"Bank customers are the associations."

"Primarily a function of [the] association relationship with borrowers."

c) Economies of scale?

1. Very positive impact - 1
2. Generally positive impact - 5
3. Little or no impact - 2
4. Generally negative impact - 1
5. Very negative impact
----
6. Don't know - 1

Please explain:

"Any merger should produce lower operating costs per $100 of loan volume for [our] associations."

"Bank mergers would spread overhead over larger base."

"Would depend on the financial dynamics of the specific terms and conditions of [the] merger."

Due to past consolidation of banks, further reductions will have little impact as to economies of scale.

[1] Narrative responses are generally representative.

6

In general, would a merger of your FCB have (or has a merger had) a positive or negative impact on:

d) The relationships between associations and banks?

1. Very positive impact
2. Generally positive impact - 3
3. Little or no impact - 2
4. Generally negative impact - 3
5. Very negative impact
----
6. Don’t know - 2

Please explain:

"May or may not depending on post merger implementation."

"...less opportunity to share service through the bank and would have to support more of what they want on their own."

"Reduced bank overhead expense would have positive impact."

e) The cooperative nature of the Farm Credit System?

1. Very positive impact - 1
2. Generally positive impact - 1
3. Little or no impact - 5
4. Generally negative impact - 2
5. Very negative impact
----
6. Don’t know - 1

Please explain:

"This would depend on the ’cooperative nature’ is defined. Should be negligible in theory."

"Mergers should result in no material change to cutomer if handled properly."

"Customers have a voice in direction and policies of Farm Credit institutions."

f) Local control?

1. Very positive impact
2. Generally positive impact
3. Little or no impact - 4
4. Generally negative impact - 3
5. Very negative impact - 1
----
6. Don’t know - 2

Please explain:

"...associations would lose control of their bank."

"The larger district bank with less support to ACAs will cause ACA mergers into larger units. The local control will be diluted."

"Associations are the point of contact with customers."

"Customer relationship with Association will not change."

"Depends on the operating style of the bank."

g) The issuance of system-wide bonds?

1. Very positive impact - 1
2. Generally positive impact - 3
3. Little or no impact - 5
4. Generally negative impact - 1
5. Very negative impact
----
6. Don’t know

Please explain:

"System investors would tend to view System consolidation positively..."

"Financial markets already perceive the [System] as a unit."

"Due to joint and several liability, mergers would not improve this. If one bank became too large and ended up with financial problems, management, etc., it could negatively affect the issuance of System bonds."

7

6. Are there any other positive impacts a merger involving your FCB would have (or has had)?

(List below, or write "none" or "don't know")

"A larger district bank would provide a strategic position to offset non-solicited offers to finance ACAs by other districts."

"May have cost benefits to member-associations depending on how [the] merger is structured."

"Competitive cost structure."

"Portfolio risk lessened..."

7. Are there any other negative impacts a merger involving your FCB would have (or has had)?

(List below, or write "none" or "don't know")

"Mergers usually cause a dip in operational performance as a result of confusion and employee turnover."

"May reduce ratio of board representation and level of influence by some associations."

"Implementation costs."

"Risk concentrated under more narrow managerial and board span of control."

8

8. Overall, would you support or oppose an FCB-level merger for <u>your district</u>?

   (Check only one box.)

   1. Strongly support - 5
   2. Generally support - 1
   3. Neither support nor oppose - 2
   4. Generally oppose
   5. Strongly oppose
   ----
   6. Don't know - 2

   Please explain your answer if necessary:

   "The bank needs to merge to reduce operating expenses to association borrowers, but the terms of the merger cannot otherwise disadvantage those same borrowers by reducing service or increasing risk."

   "Provided there are strategic and economic benefits."

   "Would generally support if financial feasibility reflected advantages to stockholders of the bank."

   "Merger for the sake of merger is not supportable from a business standpoint."

9. Overall, would you support or oppose a policy mandating FCB mergers throughout the Farm Credit System?

   (Check only one box.)

   1. Strongly support
   2. Generally support
   3. Neither support nor oppose - 2
   4. Generally oppose - 2
   5. Strongly oppose - 6
   ----
   6. Don't know

   Please explain your answer if necessary:

   "Mergers should occur where they will be to the advantage of cooperative borrowers."

   "The owners should control their destiny on mergers."

   "Stockholders should vote on mergers."

9

10. In your opinion, will your FCB merge in the near future (in the next 3 years, for example, if it has not already merged)? *(Check only one box.)*

    1. Definitely will merge - 3
    2. Probably will merge - 2
    3. As likely to merge as not - 2
    4. Probably will not merge - 1
    5. Definitely will not merge
    ----
    6. No basis to judge/already merged - 2

    Please explain your answer if necessary:

    "We are evaluating opportunities with several other banks."

    "We are a financially strong institution. [We] will not merge unless a merger opportunity provides a strategic advantage to the bank's stockholders."

11. If your bank has not yet merged, or is not currently involved in a merger, what conditions would cause your bank to initiate a merger?

    (Describe below, or write "none" or "don't know")

    "We are engaged in merger discussions."

    "Currently involved in a merger study."

    "Major increase in returns to stockholders."

    "Stockholder desires."

12. In your opinion, what is the largest barrier, if any, to FCB mergers today?

    (Describe below, or write "none" or "don't know")

    "personal issues"

    "concern for loss of autonomy"

    "Loss of franchise, local control, and a lower level of bank support."

    "Lack of financial reward..."

    "...the status quo is difficult to change in times of good financial performance."

    "...lack of similarity among district..."

13. Overall, how favorable or unfavorable are you towards the current trend of consolidation in the Farm Credit System?

    1. Very favorable - 2
    2. Generally favorable - 3
    3. Neither favorable/unfavorable - 5
    4. Generally unfavorable
    5. Very unfavorable
    ----
    6. Don't know

14. How many Farm Credit System banks do you envision in 1998?
    (Enter number and/or describe your answer below.)

    "Should be no more than 1 or 2, but there will probably still be 4 or 5 due to management and director interests and concerns."

    "5 (East, West, Middle, South, CoBank)"

    "2-3 BCs and 3-5 FCBs"

    "2-4"

10

IV. REQUEST FOR ADDITIONAL INFORMATION

Please enclose with this questionnaire, or send under separate cover, the following documents:

15. A copy of current bank policies concerning association supervision, delegation of authorities, loan pricing, and credit administration/underwriting.

16. A copy of the most recent customer satisfaction survey for the bank and/or district, if any.

17. Copies of any merger-related analysis or due diligence reports conducted by the bank in the last two years to examine the potential for a merger.

18. Documentation of the total number of employees for the district (please indicate the split between the bank and the associations).

19. Please provide criteria used to determine whether associations in your district may provide a requested service to their members/borrowers.

V. COMMENTS

20. If you have any comments on this questionnaire, or the issues raised in it, please use the space provided below, and attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire. Please return it in the envelope provided, or mail it to the address shown on the front within 5 working days.

GGD/CR/12-93/233404

11

Short-Term Effects of the Consolidation of the St. Louis and St. Paul FCBs

This appendix summarizes our review of the effects on associations and their borrowers of the May 1992 consolidation of the St. Louis and St. Paul FCBs, the first voluntary FCB merger. We focused on three of the factors we were originally asked to consider: (1) economies of scale, (2) the number of services provided to farmers and ranchers, and (3) the relationship between the FCB and its associations. At the time of our review, we did not attempt to assess the actual long-term effects of the consolidation because the consolidated FCB, AgriBank, had been operating for less than 2 years. The results of this case study cannot be generalized to other mergers due to significant differences among districts, associations, and FCB structures and operations.

According to association officials, the consolidation had both positive and negative effects on associations and their members in the short term. The merger achieved some cost savings at the bank level from economies of scale. Economies of scale were achieved primarily through reductions in FCB staffing and by spreading certain fixed costs over a larger asset base. While more than half of the district associations cited a lower cost of funds as a benefit of the merger, lower funding costs were also experienced throughout the System. The number of services that associations could offer to farmer and rancher borrowers increased after the merger; this may benefit borrowers if associations eligible to offer the newly available services do so.

Many association officials reported actual and anticipated changes in the level of supervision provided by AgriBank. Generally, support services provided by AgriBank were comparable to those provided by the former FCBs. However, some associations reported negative experiences with the districtwide conversion to a common MIS support system.

Background

The St. Louis and St. Paul FCBs consolidated operations on May 1, 1992, to form AgriBank, FCB. The merger created a district covering 7 states (the combined territories of the premerger districts) and affected about 112,000 retail borrowers. At year-end 1993, the associations included 10 ACAs, 19 FLCAs, 20 PCAs, and 1 FLBA.[1] AgriBank and its associations had combined total assets of $10.7 billion. According to the bank's 1992 annual report, the merger provided AgriBank with capital sufficient to prepay St. Paul's

[1]Substantially all PCAs share management and facilities with the FLCA or FLBA serving the same territory. Effective April 1, 1994, the remaining FLBA became an FLCA.

$133 million in financial assistance (not scheduled to be redeemed until 2003).[2]

The two FCBs decided to merge for several reasons. First, they believed they had compatible business and operating philosophies. For example, their supervisory philosophies were similar. For both FCBs, bank supervision included reviewing various aspects of association operations and monitoring compliance with the general financing agreement, rating association financial strength and performance, and providing strategic leadership and direction to associations. Each evaluated their associations' performance using similar CAMEL[3] rating systems to assign differential interest rates to association wholesale loans. For example, if an association's CAMEL score weakened, the FCBs would increase that association's interest differential.

The FCBs also agreed that the consolidated FCB should become a wholesale lender and expected consolidation to achieve operating cost reductions as well as economies of scale at the FCB level. These achievements were expected to provide a competitive cost structure for the FCB and thus a reduced wholesale loan spread for the St. Paul associations and potentially lower interest rates on association wholesale loans. Finally, both FCBs expected the merger to reduce capital requirements for district associations and increase the geographic and commodity diversification of the loan portfolio.

Some Economy-of-Scale Benefits Achieved After Merger

According to bank documents, the bank experienced some economy-of-scale benefits after the merger, which contributed to the $8.2 million (about 13 percent) decline in bank-only gross operating costs.[4] Most of the decline was achieved by reducing staff in regular bank operations and some costs being spread over a larger asset base. (Regular ongoing bank operations included AgriBank functions, such as credit, legal, and human resources.) Another factor contributing to AgriBank's lower operating costs was a 32-percent decline in FCSIC premiums paid by the bank. Although bank-level savings were achieved, operating costs for

[2]AgriBank prepaid its assistance in December 1992, becoming the second FCB to repay its assistance early; the Omaha FCB repaid its assistance earlier in 1992.

[3]CAMEL is an acronym for the factors evaluated under this system—capital, assets, management, earnings, and liquidity.

[4]Bank-only gross operating expenses exclude compensation paid to associations and merger implementation costs.

the district increased, primarily because of higher association operating expenses.

Bank-Only Costs Decline Following the Merger

While bank-only gross operating costs declined by $8.2 million in 1992, the savings from consolidating regular ongoing bank operations resulted in a $9.3 million decline. However, costs associated with the bank's Risk Assets Unit (RAU), which centrally manages the district's high-risk loan portfolio, increased by $1.1 million following the merger. Thus, the bank's overall savings was $8.2 million. In 1993, regular ongoing operations declined an additional $2.2 million but RAU costs increased by an additional $2.5 million over 1992 costs.[5] According to AgriBank's annual report, 1993 RAU expenses reflect full staffing and the annual report also notes a reduction in total risk loans in the portfolio which is consistent with favorable borrower financial conditions and repayment trends.

As anticipated, the most significant savings were achieved through combining duplicative bank functions, thereby reducing staff. As of December 1991, St. Louis and St. Paul FCBs' combined staff numbered 551. By April 1, 1993, Agribank staff numbered 440—111 fewer people, or a 20-percent reduction. Regular bank staff decreased by 135 people (33 percent), with the greatest drop in the administrative services and executive and finance functions. (Table IV.1 shows these staff changes by bank department.) AgriBank also decentralized its appraisal function to the association level, resulting in a further staff reduction of 52 at the bank level. However, according to a bank official, AgriBank had to increase its RAU staff by 76 people (87 percent) after the merger to manage the high-risk loan portfolio of the combined districts, because in the former St. Paul district this function was generally decentralized among St. Paul associations. After the merger, 60 percent of the RAU staff hired came from St. Paul associations, which enabled continuity in borrower relations and asset servicing.[6] AgriBank expects the number of people needed in the RAU to diminish as high-risk loans improve or are repaid over the next several years.

[5]Although AgriBank's operating expenses increased from 1992 to 1993, 1993 operating costs for the total bank and regular operations were still less than premerger levels.

[6]Before the merger, St. Louis had a centralized high-risk assets management group, while St. Paul was in the process of developing such a centralized function.

Table IV.1: Merger-Related Staff Changes by Bank Department

Bank department	Premerger staff[a]	Postmerger staff[b]	Percent change in staff
Regular operations			
Administrative services	40	13	–68%
Executive	13	5	–62
Finance[c]	96	49	–49
Legal	31	19	–39
Marketing	27	18	–33
Credit	29	21	–28
Human resources	25	20	–20
Audit and review	47	39	–17
Systems and technology	94	82	–13
Field operations	8	9	+13
Total regular operations	**410**	**275**	**–33**
Risk assets unit	87	163	+87
Appraisal operations[d]	54	2	–96
Total	**551**	**440**	**–20**

[a]Premerger staffing data as of December 1991.

[b]Postmerger staffing data as of April 1, 1993.

[c]The Finance department includes the treasury and accounting functions. Treasury staff decreased from 15 to 8 (47 percent), while Accounting staff decreased from 81 to 41 (49 percent).

[d]AgriBank decentralized the appraisal function to the association level after the merger. A majority of the former bank appraisers were hired by the associations.

Source: AgriBank, FCB.

Although the bank's regular ongoing operations declined $9.3 million in 1992 (representing 8 months of merged operations) and $2.2 million in 1993 due in part to greater economies of scale, over 30 percent of the reductions in ongoing operations resulted from lower FCSIC premiums in both years.[7] The decline for the overall district (regular ongoing and RAU) was $8.2 million in 1992, 35 percent of which consisted of FCSIC premiums. In 1993, operating costs increased overall. If FCSIC premiums are excluded from the analysis, savings from ongoing operations achieved between 1991 and 1992 equal $6.5 million, and between 1991 and 1993, the savings equal $6.8 million.

[7]Overall, the amount of FCSIC premiums declined as the district's loan quality improved. However, the bank also shifted ownership of loans to some of its associations, thereby increasing the portion of FCSIC premiums paid by the associations. While this reduced the bank's operating costs, it had no impact on the district's operating costs.

Merger Implementation Costs

Actual merger implementation costs of $28.2 million were close to estimated levels of $27.6 million.[8] AgriBank accrued the estimated implementation costs on the effective date of the merger. However, the costs were to be actually paid out over about a 3-year period. The bank accrued an additional $1.8 million expense in connection with the disposal of the St. Louis bank building in 1992; however, as of December 31, 1993, all expenses had been incurred, and the remaining accrual of $1.2 million was reversed.

Districtwide Operating Expenses Increased Slightly in 1992

Although the merger resulted in some bank-level savings, operating costs for the district increased slightly in 1992 due in part to higher association operating costs. The district's operating cost rate per $100 of gross loans increased from $1.93 to $1.95 between 1991 and 1992.[9] Although bank-only costs declined (lowering the bank-only operating rate), association-level costs increased (contributing to the increase in the district's rate). In 1993, the district's operating cost rate increased even further to $2.05 per $100 of gross loans due primarily to higher bank (RAU) and association expenses.

Associations throughout the System experienced increased operating costs in 1992 and 1993; therefore, association expenses would probably have increased whether the banks merged or not. Likewise, the St. Paul FCB had been selling or transferring its retail loans to its associations prior to the merger, thus increasing the portion of FCSIC premiums paid by some associations. While increased FCSIC premiums accounted for 36 percent of the overall increase in AgriBank association costs, this increase had no impact on the district's expenses because there was an offsetting decline at the bank level.

Merger May Have Contributed to Lower Cost of Funds for Many Associations

Bank management projected that merger-related operating cost savings would reduce the wholesale loan spread for St. Paul associations and potentially lower interest rates on direct loans to associations.[10] As anticipated, AgriBank's spread was significantly lower than St. Paul's. While former St. Paul associations enjoyed a lower spread on funds

[8]Implementation costs fell into four categories: severance, retention, relocation, and pension-related costs; implementation staffing; loss on the disposal of the St. Louis building and surplus office furniture and equipment; and other implementation costs.

[9]Before the merger, the St. Paul and St. Louis districts had operating cost rates of $1.91 and $1.96 per $100 of gross loans, respectively.

[10]The wholesale spread is assessed across all direct loans to associations to compensate the bank for its wholesale functions.

obtained from the bank, former St. Louis associations generally saw no change after the merger. As of December 1993, AgriBank's wholesale spread had been at 40 basis points since the May 1992 merger compared to 40 basis points for St. Louis and an average of 80 basis points for St. Paul before the merger.[11] AgriBank's wholesale spread decreased to 35 basis points after the merger with Louisville on January 1, 1994.

Respondents to our survey commonly cited a lower cost of funds as a benefit of the merger. These respondents included 2 of 10 former St. Louis associations and 16 of 19 former St. Paul associations. However, the cost of funds System-wide generally declined due largely to the declining interest rate environment in 1992 and 1993. Other factors, such as the termination of the assistance agreement due to the repayment of St. Paul's FAC debt and operational policy changes, may also have contributed to AgriBank's lower rates.

Merger Increased the Number of Service Options Available to Associations

The number of services that former St. Louis and St. Paul associations could offer to farmer and rancher member-borrowers increased as a result of the merger. Borrowers could benefit if eligible associations choose to offer the newly available services. Generally, AgriBank associations were able to offer insurance, financial management, appraisal, and leasing services. AgriBank allowed all associations to offer any services that were authorized by either of the premerger banks, with prior bank approval.[12] Following the merger, some services formerly available in only one of the premerger districts were available to associations throughout the new 7th District. The services newly available to former St. Paul associations included title insurance and aquatic facilities/equipment insurance. Financial management and leasing services were made newly available to former St. Louis associations.

Although AgriBank associations could offer a wide variety of services, our September 1993 association survey indicated that former St. Louis associations had continued to offer only a fraction of the services offered by most associations in the former St. Paul district. Some associations had

[11]According to a bank official, St. Paul's wholesale spread was higher than St. Louis' for three reasons. First, St. Paul had financial assistance-related expenses, while St. Louis did not. Second, St. Paul had to pay higher FCSIC insurance premiums because it had more nonaccrual loans, i.e., loans that were uncollectible, classified "loss," or severely past due and not adequately secured. Third, St. Paul passed on the cost of its high-cost debt to associations via the spread, while St. Louis directly expensed these costs to associations. The St. Paul FCB also indirectly passed on costs for support services via the wholesale spread; however, AgriBank now expenses support services directly to the associations.

[12]This excludes St. Paul's pilot System-wide investment bond program. AgriBank has discontinued this service due to lack of borrower demand.

chosen not to offer available services, while others had not yet received bank approval to provide new services. Appendix II provides survey responses of AgriBank associations.

Merger Widened Loan Products and Pricing Options Available to Associations

The merger also generally increased the number of loan products and pricing options available to associations. Farmer and rancher borrowers may benefit if associations elect to offer the newly available products and pricing options. According to bank officials, AgriBank could offer a broader array of loan products than either St. Louis or St. Paul could offer separately because the merger resulted in an FCB with greater assets. AgriBank was responsible for approving and standardizing all loan products and pricing options offered to borrowers. Associations could choose not to offer certain loan products and pricing options on the basis of borrower demand.

The merger did not change the main loan products that the St. Louis and St. Paul associations had offered before the merger—operating, intermediate-term, real estate, and rural residence loans. AgriBank retained all but one of the other specific loan products offered in the premerger districts. Following the merger, former St. Louis associations could offer loan products that had previously been available only in the St. Paul district. Table IV.2 compares the other loan products available in each district before and after the merger. We did not determine whether former St. Louis associations were offering borrowers the new products.

Table IV.2: Comparison of Other Loan Products Available Before and After the Merger, as of December 31, 1993

Other loan products	St. Louis	St. Paul	AgriBank
Small loan package for operating and intermediate-term loans[a]	x	x	x
Point-of-sale program for equipment financing		x	x
Operating loans originated through suppliers[b]		x	
Adjustable rate real estate products indexed to U.S. Treasury bonds with interest rate caps		x	x
Draft product allowing access to operating loan funds using a draft check	x	x	x
Federal National Mortgage Association (Fannie Mae) conforming rural residence loans[c]		x	x

[a]Before the merger, St. Louis and St. Paul established maximum loan size under this program as $50,000 and $25,000, respectively. After the merger, associations were allowed to determine maximum loan size from $50,000 to $100,000.

[b]AgriBank dropped this product because of very low borrower demand and because it was offered by only four associations.

[c]Fannie Mae rural residence loans are originated by associations and then sold to Fannie Mae poolers.

Source: AgriBank, FCB.

AgriBank associations could offer almost all of the pricing options that were offered in the premerger districts. Only four options were discontinued due to historically low borrower demand. Pricing options for operating loans were not affected by the merger. Certain pricing options available in the St. Louis district before the merger were not available in the St. Paul district and vice versa. Table IV.3 compares the intermediate-term, real estate, and rural residence loan pricing options available before and after the merger. We did not determine whether associations were offering the new pricing options to their borrowers.

Table IV.3: Comparison of Intermediate-Term, Real Estate, and Rural Residence Loan Pricing Options Available Before and After the Merger

Pricing option	St. Louis	St. Paul	AgriBank
Intermediate-term loans			
Variable rate	x	x	x
Adjustable rate[a]			
1 year	x		x
2 year			x
3 year	x		x
5 year	x		x
Fixed rate			
1 year	x	x	x
2 year		x	x
3 year	x	x	x
4 year	x	x	x
5 year	x	x	x
6 year[b]	x		
7 year	x	x	x
10 year	x	x	x
Real estate loans			
Variable rate	x	x	x
Adjustable rate (not indexed)[a]			
1 year	x	x	x
2 year		x	x
3 year	x	x	x
4 year[b]		x	
5 year	x	x	x
7 year		x	x
10 year	x	x	x
15 year		x	x
Adjustable rate (indexed)[a]			
1 year		x	x
3 year		x	x
5 year		x	x
Fixed rate			
5 year	x		x
10 year	x	x	x
15 year	x	x	x
20 year	x	x	x
30 year	x		x
Rural residence loans			

(continued)

Pricing option	St. Louis	St. Paul	AgriBank
Adjustable rate (indexed)[a]			
1 year	x	x	x
3 year	x	x	x
5 year[b]		x	
7 year	x		x
Fixed rate			
10 year[b]		x	
15 year	x	x	x
20 year	x	x	x
30 year	x		x
Originate for Fannie Mae		x	x

[a]Adjustable rate pricing options indicate the frequency of interest rate adjustments, not the total term of the loan.

[b]Pricing option was dropped by AgriBank due to very low historic usage by borrowers.

Source: AgriBank, FCB.

Associations Observed Differences in Bank/Association Relationship After Merger

Most of the 29 association officials who responded to our survey believed that the merger had some impact on their relationship with AgriBank. Ten officials felt the impact was positive; another 10 felt it was negative. A smaller number (8 of 29) indicated that the merger had no impact. One official noted mixed results, citing positive changes in some areas and negative changes in others. AgriBank, like most FCBs, related to its associations through its oversight of association operations, funding practices, and the provision of support services.

Merger Had Some Effect on Oversight of Associations

Of the 29 association officials responding to our survey, 19 (about 66 percent) indicated some change in FCB supervision after the merger, 7 (about 24 percent) noted no change, and 3 (about 10 percent) did not respond to the question. Opinions varied on whether the merger resulted in more or less bank supervision, which may reflect the fact that the level of FCB supervision of an association generally depends on the association's condition and performance. After the merger, some associations may also have experienced differences in the timing of FCB reviews and methods of evaluation compared to premerger practices.

Association Reviews and Rating Procedures Changed to Reflect Postmerger Policies

In 1992, AgriBank audited the financial, operational, and appraisal performance of its associations and verified the independence and effectiveness of the associations' internal credit review programs. The results of these annual reviews were generally reported and quantified through the CAMEL rating system. Though each of the premerger FCBs had evaluated the same factors and used the CAMEL system, they measured the factors differently and weighted some differently in determining the composite CAMEL score. In addition, they assigned different interest rate differentials on the basis of the CAMEL scores. Also, while St. Paul assigned CAMEL ratings on an annual basis, St. Louis reserved the right to change an association's CAMEL rating up to four times per calendar year.

AgriBank's Strategic Planning Process Varied Slightly From That of the Former Banks

AgriBank associations previously in the St. Paul District may also have experienced some differences in the annual business planning session—meetings the FCB conducts with associations to provide strategic direction and leadership. The former St. Louis and St. Paul FCBs had done this somewhat differently, with St. Paul tending to be less involved than St. Louis in association business planning and goal setting. AgriBank adopted St. Louis' strategic planning process, including the use of 10 measures of success and a district strategic planning team. The measures of success (which included, among others, permanent capital ratio, return on assets, and market share) provided common standards for bank and association performance across the district.

AgriBank Implements Formal Internal Credit Review Program

AgriBank required all associations to implement a formal internal credit review program to perform loan reviews and evaluate internal credit controls. Although St. Louis associations already had such programs in place, St. Paul associations had only informal programs. Citing greater lending responsibilities and accompanying credit risk, AgriBank required all associations to establish formal programs after the merger. According to a bank official, associations accepted these programs easily and established them without difficulty.

According to AgriBank officials, the internal credit review program will eventually be expanded to include financial, operational, and appraisal reviews. However, in 1993 these reviews were still the responsibility of the bank. According to bank officials, the bank continued to perform these reviews because most associations in the district were not large enough to warrant full-time audit departments.

AgriBank Plans to Forge New Partnership With Associations

AgriBank officials reported plans to change its oversight practices by replacing techniques such as "coaching" and "threatening" to improve association business performance with an association incentive compensation program linked to funding. Under this program, AgriBank would assign differential interest rates on wholesale loans to ensure that associations achieve and maintain success. This program would replace the existing CAMEL rating system, but it would evaluate almost all of the same factors; it would also emphasize aspects of association marketplace performance—for example, customer satisfaction and market penetration.

AgriBank Moves Toward Wholesale Lending Structure

The conversion of AgriBank's final FLBA to an FLCA moves closer to a wholesale lending structure; however, it still has a substantial amount of retail loans on its books. Although St. Louis had been operating as a wholesale lender since 1991, at the time of the merger St. Paul was just starting to move toward a wholesale lending structure by transferring long-term mortgage lending authority to agent associations and selling or downloading existing retail loans in its portfolio to associations.[13] After the merger, all new and refinanced retail loans were owned at the association level.

As before the merger, these direct lender associations generally were fully responsible for administering policies and procedures for both the lending and servicing functions and had full authority, responsibility, and accountability to manage their loan portfolios, cost structures, and the repayment of wholesale funds to the bank. Associations generally set the interest rates on retail loans within their chartered territories.

Merger Did Not Significantly Affect Availability of Support Services

In general, the services provided by the newly formed AgriBank were similar to those offered by St. Louis and St. Paul before the merger. AgriBank offered a variety of services, including accounting, human resources, legal, and credit services in addition to MIS services. The bank reserved the right to eliminate any service not used by the associations. In 1993, AgriBank eliminated its sales management services and related staff resources due to low association usage.

MIS Conversion Was an Important Merger Implementation Issue

The most significant merger implementation issue was the development and implementation of a common MIS system, one of the support services AgriBank provided to associations. Although most support services were optional, AgriBank required association subscription to key accounting and MIS services for the sake of districtwide operating efficiencies. AgriBank adopted St. Louis' core lending system, loan origination system,

[13]AgriBank has not initiated any new asset download programs since the merger.

and computer hardware, retaining only some features of St. Paul's. Former St. Paul associations expressed some dissatisfaction with system implementation and use, saying that it had increased the number of forms, slowed response time, and reduced flexibility. Other problems with the system noted in survey responses included disruptions in the level and quality of billing and loan origination services, less flexibility in customizing loan documents, and poor service quality. Bank officials said that they expected some adjustment problems and disruptions at the association level during the conversion that was completed in October 1993.

FCB District Profile

The purpose of this appendix is to present structural, operational, and policy differences among the FCBs. This profile includes all FCBs in existence as of October 1, 1993. Asset figures are as of September 30, 1993, while branch numbers reflect December 31, 1993, data. We generally rely on survey information provided by the banks and associations regarding supervision and support services provided. Although every association in each district may not rely on its FCB for all available support services, the support services listed include any support service provided to at least one association. We independently verified the oversight provided by the Columbia, St. Paul, Omaha, Western, and Spokane FCBs in a previous report.[1] However, we relied in part on FCA and association survey data for the others and did not independently verify their accuracy.

District 1

FCB: Springfield.

Lending structure: wholesale.

Association structure: 11 ACAs.

Number of association branches in the district: 47.

District Assets: $2.1 billion.

FAC[2] Assistance Status: nonassisted.

Support services provided: data processing, marketing, financial statement preparation, call report preparation, salary administration, hiring, benefits administration, staff evaluation guidance, training (management and staff), asset/liability management (ALM), internal audits, and policy and procedures models.

Description of supervision or oversight provided by the FCB: The bank periodically reviewed various aspects of association operation, including management and operations, credit and collateral, and compliance with the general financing agreement. The bank was also involved in certain

[1]Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems (GAO/GGD-94-14, Jan. 7, 1994).

[2]Congress created the Farm Credit System Financial Assistance Corporation (FAC) to raise funds for assisting System banks. FAC was authorized to issue, with Farm Credit System Assistance Board approval, up to $4 billion in Treasury-guaranteed, 15-year bonds. It actually issued $1.26 billion in bonds. See our report entitled Farm Credit System: Repayment of Federal Assistance and Competitive Position (GAO/GGD-94-39, Mar. 10, 1994).

aspects of planning and worked with the association boards on various issues.

District 2

FCB: Baltimore.

Lending structure: wholesale.

Association structure: 16 ACAS.

Number of association branches in the district: 95.

District assets: $3.7 billion.

FAC assistance status: nonassisted.

Support services provided: data processing, marketing, salary administration, benefits administration, training (management and staff), ALM, loan development, internal audits, loan development, policies and procedures, and large loan servicing.

Description of supervision or oversight provided by the FCB: The bank periodically reviewed areas, such as credit, allowance for loan losses, financial reports, and operations. The bank ensured compliance with statutes, FCA regulations, district policies, and the general financing agreement. Oversight was differentially based depending on the associations' condition established through the general financing agreement.

District 3[3]

FCB: Columbia.

Lending structure: wholesale.

Association structure: 19 ACAS and 1 PCA.

Number of association branches in the district: 222.

District assets: $5.7 billion.

[3] Jackson FICB merged with the Columbia FCB effective October 1, 1993. On January 1, 1994, four ACAs from the Louisville district became affiliated with the Columbia district rather than join AgriBank.

Assistance: nonassisted.

Support services provided: data processing, marketing, financial statement preparation, call report preparation, salary administration, benefits administration, training (staff and management), recruiting, ALM, establishment of interest rates, and appraisal reviews.

Description of supervision or oversight provided by the FCB: The oversight was described as a debtor/creditor relationship guided by the general financing agreement. Supervision was based on association performance. Bank used standards established by the Contractual Interbank Performance Agreement to rate association financial condition. It also periodically reviewed the associations' internal credit review function, credit administration, general condition and performance, and management policies. The bank regularly monitored the associations electronically. The bank was also involved in policy approvals and provided ongoing financial and operational coaching and counseling.

District 4[4]

FCB: Louisville.

Lending structure: wholesale.

Association structure: five ACAs.

Number of association branches in the district: 209.

District assets: $4.3 billion.

Assistance status: Received $90 million in federal financial assistance in 1988. Assistance was repaid in 1994 following its merger with AgriBank.

Support services provided: data processing, benefits administration, and ALM.

Description of supervision or oversight provided by the FCB: The lender-borrowers relationship was guided by a general financing agreement that covered all aspects of association operations and provided penalties for default. Association performance was also gauged against its business plan. Bank oversight included monitoring compliance with FCA

[4] The Louisville FCB merged with AgriBank on January 1, 1994. However, only one of its five associations with $3.5 billion in loan volume opted to join AgriBank. The other four associations with $451 million are now part of the Columbia district.

and FCB policies and CIPA and CAMEL ratings. The bank also annually tested the reliability of association internal controls. The amount of supervision was determined by the reliability of those controls.

District 7[5]

FCB: AgriBank.

Lending structure: mixed wholesale and moving toward wholesale.

Association structure: 10 ACAs, 20 PCAs, 19 FLCAs, and 1 FLBA; the FLBA expects to convert to an FLCA.

Number of association branches in the district: 260.

District assets: $10.8 billion.

Assistance status: The St. Paul FCB received $133 million in federal financial assistance in 1988. AgriBank repaid St. Paul's FAC assistance in 1992.

Support services provided: data processing, marketing, financial statement preparation, call report preparation, legal documentation, salary administration, benefits administration, training (management and staff), ALM, internal audits, special asset management, policies and procedures, collateral custodianship, tax preparation, staff evaluation, and acquired property management.

Description of supervision or oversight provided by the FCB: bank supervision included reviews, monitoring, and guidance. The bank periodically reviewed various aspects of bank operations, including credit, internal controls, and operations. The bank also monitored the associations' compliance with the general financing agreements. The extent of oversight was based on association performance. The bank also monitored association performance through a CAMEL rating system.

The bank was in the process of changing its supervision of associations. In the future, the bank planned to offer advice and guidance only when asked, opposed to coaching and counseling. However, the bank still planned to take any actions necessary to protect the district from associations that were in threat of defaulting on their obligations. The

[5] AgriBank was created when the FCBs of St. Paul and St. Louis merged in 1992. On January 1, 1994, AgriBank merged with the Louisville FCB.

bank planned to continue to annually review association operations and assess the reliability of association formal credit review programs.

Characteristics of former FCBS: The St. Paul FCB had a mixed association structure with all types of associations operating in the district. The bank's supervision was characterized by close bank supervision in the form of periodic reviews and general guidance. The St. Louis FCB was a wholesale lender providing funding for its nine ACAS. Supervision included reviews, direction, and support.

District 8[6]

FCB: Omaha.

Lending structure: wholesale (bank had high volume of retail loans remaining in its portfolio).

Associations structure: one PCA and one FLCA.

Number of association branches in the district: 84.

District assets: $4.3 billion.

Assistance status: The Omaha FCB received $107 million in federal financial assistance in 1988. The assistance was repaid in 1992.

Support service provided: data processing, marketing/advertising, financial statement preparation, call report preparation, salary administration, benefits administration, staff and management training, ALM, internal credit reviews, internal audits, establishment of interest rates, special asset management, asset appraisals, and policies and procedures.

Description of supervision or oversight provided by the FCB: Omaha was a wholesale lender with jointly managed associations. Its FLBA converted to an FLCA in late 1993, but a high volume of retail loans remained on the bank's books. The bank and the associations were operated closely, essentially functioning as a single entity. The bank performed annual credit and internal audit reviews, approved the associations' strategic plans and business plans (included monitoring), and administered and enforced the general financing agreement. Similarly, the bank approved and monitored all policies and related programs.

[6] Effective April 1, 1994, the Omaha and Spokane FCBs merged to form AgAmerica.

District 9

FCB: Wichita.

Lending structure: traditional PCA and FLBA.

Association structure: 18 PCAS and 22 FLBAS.

Number of association branches in the district: 64.

District assets: $3.9 billion.

Assistance status: nonassisted.

Support services provided: data processing, marketing/advertising, product development and research, financial statement preparation, call report preparation, purchasing services, collateral custodian services, salary administration, hiring, benefits administration, training (management and staff), ALM, special pricing and modeling, internal credit reviews, internal audits, legal services, setting interest rates, asset appraisals, and policies and procedures.

Description of supervision or oversight provided by the FCB: The bank periodically reviewed the internal operations, credit, appraisal, and management. The bank also provided assistance in budgeting. Likewise, it ensured compliance with regulations and GFAS and servicing agreements. The bank also provided coaching and counseling and provided input into association CEO evaluations and approved CEO appointments. The level of supervision was determined by compliance with the general financing agreement.

District 10[7]

FCB: Texas.

Lending structure: traditional PCA and FLBA.

Association structure: 18 PCAS and 48 FLBAS.

Number of association branches in the district: 142.

District assets: $4.4 billion.

[7] The Northwest Louisiana PCA transferred and reaffiliated from the Jackson FICB to the Texas FCB effective September 30, 1993.

Assistance status: nonassisted.

Support services provided: data processing, marketing, financial statement preparation, call report preparation, salary administration, benefits administration, training (management and staff), ALM, internal audits, establishment of interest rates, special asset management, asset appraisals, policies and procedures, internal audits, and internal credit reviews.

Description of supervision or oversight provided by the FCB: The bank reviewed credit, overall performance, and the internal audit function. The bank was involved in budgeting and loan servicing. The bank monitored compliance with laws and regulations and district policies and procedures. The bank conducted a CAMEL rating and approved certain association policies.

District 11

FCB: Western.

Lending structure: mixed wholesale and retail moving toward wholesale lending.

Association structure: 4 ACAS, 10 FLCAS, 12 PCAS, and 3 FLBAS.

Number of association branches in the district: 76.

District assets: $5.3 billion.

Assistance status: nonassisted.

Support services provided: data processing, marketing, benefits administration, training (staff and management), ALM, legal counsel, salary administration, legislation and regulations monitoring, establishment of loan pricing and products, and asset appraisals.

Description of supervision or oversight provided by the FCB: The level of supervision was determined by association ratings. The bank approved and monitored compliance with the general financing agreement. It also provided policies and procedures and reviewed compliance with them. The bank reviewed association business plans and approved association CEO salaries. The bank also periodically visited the associations and reviewed internal review reports, allowance for loan loss reports, appraisals, and credit. The bank also preapproved any interest rate actions.

District 12

FCB: Spokane.

Lending structure: wholesale (bank had high volume of retail loans remaining in its portfolio).

Association structure: one ACA.

Number of association branches in the district: 52.

District assets: $3.0 billion.

FAC assistance status: Spokane received $88.6 million in federal financial assistance in 1990. Spokane plans to repay its assistance in 1994.

Support services provided: data processing, benefits administration, and ALM.

Description of supervision or oversight to be provided by the FCB: Spokane focused its oversight on the approval of policies, reviews of procedures, and compliance with key result areas. The bank also reviewed the association's credit review program.

Comments From the Farm Credit System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

We did not reproduce the Farm Credit System's technical comments.

THE FARM CREDIT BANK OF COLUMBIA

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803/799-5000

MAXEY D. LOVE, JR.
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CHAIRMAN, EXECUTIVE COMMITTEE

August 8, 1994

Ms. Helen H. Hsing
Associate Director,
Financial Institutions and Market Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Hsing:

Thank you for providing us with the opportunity to comment on the draft report entitled Farm Credit System: Potential Impacts of FCB Mergers on Farmer and Rancher Borrowers. As you know, since the Congress directed GAO to undertake this report, the Farm Credit System has undergone significant structural change voluntarily. These changes have been made with the full concurrence of the stockholders of the effected institutions, preserving the cooperative decision making process Congress envisioned when it authorized the System.

In general, we find the report to be accurate in its description and conclusions. This letter includes two attachments. The first highlights specific issues regarding the draft report which require some explanation. The second contains issues of a more technical or typographical nature which do not require any explanation.

We hope these comments are of assistance to you in your final review of the report. If you have any questions regarding them, please do not hesitate to let me know.

Sincerely,

Maxey D. Love, Jr.
Chairman
Presidents Planning Committee

Attachments

THE FARM CREDIT SYSTEM

Attachment 1

Now on pp. 5 and 32.
See comment 1.

1) On page 8 of the report, it is stated that "...Agribank's net operating costs declined $5.3 million after the merger, but association costs increased $5.9 million, resulting in a $.60 million increase in districtwide costs in 1992." First, GAO has used a very broad definition of net operating expenses, including insurance fund premiums and federal assistance repayment expense. Second, the selection of 1992 as the year to analyze reflects only eight months of operation for Agribank since the consolidation was effective May 1, 1992. Footnote 11 on page 48 does provide an accurate evaluation of Agribank's targeted and actual cost savings for the first year of operation.

Now on p. 15.
See comment 2.

2) The second column of the second row of Table 1.2 on page 21 of should be revised to reflect that all three Banks for Cooperatives have national charters. None are "district" BCs.

Now on p. 18-19.
See comment 3.

3) The top of page 26 characterizes the activities assumed to be conducted by an Agricultural Credit Bank (ACB) as being "one-stop shopping" to eligible borrowers. It should be clarified that the ACB will continue to serve the associations which are providing credit and other services to eligible borrowers directly, while cooperatives will continue to be serviced as they have been by the bank for cooperatives.

Now on pp. 19-20.
See comment 4.

4) On page 27, the second paragraph needs to be clarified. It can be read to infer that System institutions may pay dividends to borrowers by "...offering a discount on loan rates." It is against Farm Credit Administration regulations to pay a dividend by charging less than competitive rates.

Now on p. 25.
See comment 5.

5) On page 36, the portion of the footnote relating to the Columbia/Jackson merger is misleading. It is true that First South's operating expenses went up, but it is also true that several million dollars of FICB of Jackson expenses paid primarily by First South were eliminated.

Now on p. 26.
See comment 6.

6) On page 39, some explanation is provided of the variation in operating expenses between districts. It may be useful to also mention that some districts offer a significant array of fee services which, when the costs of providing those services are added to operating expenses per $100 of loan volume, will result in distortion when compared to districts which do not offer fee services.

Now on pp. 5, 28-29,
and 32-33.
See comment 7.

7) On pages 43 and 44 (and elsewhere), the report relates merger cost savings to reduced customer/member loan rates in terms of basis points. In reality, a significant portion of Agribank's

merger cost savings have been and are being used to repay financial assistance without having to increase loan rates to associations or to customer members. In Agribank's case, portions of the cost savings were also used to fund early redemptions of the Assistance Preferred Stock.

Now on pp. 51-52.
See comment 8.

8) Page 80 of the report purportedly cites Farm Credit Administration regulations as they relate to System institutions coordinating administrative functions. The regulation cited only applies to financially related services provided to eligible borrowers and not administrative functions. However, banks and associations may, under general corporate powers, agree to share/contract for such functions.

Now on p. 90.
See comment 9.

9) On page 122 in Appendix IV, a statement is made regarding the ongoing Agribank cost savings being offset by increases in the Risk Assets Unit's costs. While the statement is technically correct, it would seem that a more balanced perspective could be added by including information about the results of the Risk Assets Unit's efforts.

Now on p. 91.
See comment 10.

10) On page 125 in Appendix IV, GAO attributes 35 percent of the cost savings to reductions in FCSIC premiums. There is no doubt the premiums have been reducing as retail loans come off Agribank's books and go on to association books with a like increase in premium expense. However, a more correct analysis of the $10 million merger cost savings targeted and achieved is found in a narrower definition of management controllable expenses. Had there been a merger or not, the premiums and Risk Assets Unit's expenses would have behaved in the same fashion.

Now on p. 103.
See comment 11.

11) Footnote 4 on page 142 regarding the Louisville reaffiliation could be misleading. It might be clearer to report that $3.5 billion of the loan volume and one association from the Louisville district went to Agribank and $450 million from the other four associations went to Columbia.

The following are GAO's comments on the Farm Credit System's August 8, 1994, letter.

GAO Comments

1. Our definition of district total net operating expenses is broad and does include all operating costs associated with the district. However, we also provide a narrower analysis based on the bank's ongoing operating expenses. We believed it was important to determine postmerger savings at the bank and district levels to determine any potential benefits to farmer and rancher borrowers since their interest rates include costs associated with the entire district. Although we included 1993 results in our overall analysis, we focused on 1992 operating cost results since 1992 results were readily available during the period of our study. However, the text has been expanded to include 1993 AgriBank results where appropriate. As noted throughout the draft and this report, our AgriBank analysis is based on short-term results and should not be used to draw conclusions about the long-term impact of this merger. We also point out throughout the report that AgriBank was consolidated for only 8 months of 1992.

2. Text modified.

3. Text modified.

4. Text modified.

5. Text modified.

6. The text has been expanded to include operational issues, which would include varying levels of fee services that may also affect operating cost rate variations in the System.

7. Since the focus of the report was potential impacts on borrowers, we calculated potential basis point savings that farmers and ranchers could experience based on targeted savings if savings were achieved and passed on to borrowers in the form of lower interest rates. While we believe that a basis point calculation is a useful way to evaluate potential savings from a borrower's perspective, we are also aware that there is no guarantee that savings will be passed along in the form of lower rates. As pointed out in the draft and on pages 4, 28, and 29, savings may be passed along. This apparently was the case with AgriBank, which opted to use its savings in ways other than lowering borrower interest rates. We have expanded the

AgriBank discussion to include how achieved savings were used following the St. Paul/St. Louis merger.

8. Text modified.

9. The results of AgriBank's RAU have been added where appropriate.

10. Operating costs, as defined this report, are salaries and benefits, occupancy and equipment, other operating expenses, and FCSIC premiums. Financial assistance is not included. This definition is consistent with that used by AgriBank in various bank documents, including its annual report and monthly operating expense reports. Our analysis of AgriBank's overall operating expense does include costs from ongoing operations and risk asset unit. However, we also noted in this report that AgriBank's projected savings in ongoing operations equalled \$9.3 million compared to the \$10 million targeted. In comment 1, the System found our evaluation of AgriBank's targeted and actual cost savings of \$9.3 million for the first year of operation accurate. However, FCSIC premiums were included in the analysis. If we exclude FCSIC premiums from our analysis, AgriBank's gross ongoing operating expenses for 1991-1993 decline to \$50.0 million, \$43.5 million, and \$43.2 million, respectively. Likewise, the resulting postmerger savings equal \$6.5 million and \$7.8 million between 1991-1992 and 1991-1993.

11. Text modified.

Comments From the Farm Credit Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

FCA
FARM CREDIT ADMINISTRATION

August 11, 1994

Mr. William J. Kruvant
Assistant Director
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Kruvant:

Thank you for providing the Farm Credit Administration (FCA) with the opportunity to comment on the General Accounting Office's (GAO) draft report entitled FARM CREDIT SYSTEM: Potential Impacts of FCB Mergers on Farmer and Rancher Borrowers. The following comments highlight some significant areas to consider in your report. Attached are additional comments for your consideration.

As stated in the report, GAO's focus for this study was on the potential benefits to System borrowers of merging the existing FCBs to form fewer regional banks. Given the cooperative nature of the Farm Credit System, several options exist for providing potential benefits to its member-borrowers. For instance, as outlined in the report, lower loan rates may be offered. Additionally, given the borrowers' ownership of institution stock, they realize a benefit when institutions retain earnings to protect their stock investment. Accordingly, when savings realized from a merger are retained at the institution in the form of greater capital strength, the borrowers' ownership in a permanent system of credit is enhanced. Also, further benefits in the form of patronage payments and dividends may be made. The extent to which any or all of these options are utilized may increase over time as the savings from the mergers become more accurately determinable.

See comment 1.

Now pp. 19 and 38.

In this regard, the report omits mention of the institutions' need to retain earnings, build capital, and meet the 7-percent minimum permanent capital requirement. We respectfully request that a discussion of these points be included under Limited Return on Capital (Borrower Stock), and Service at Cost on page 27; and under Conclusions on page 49, as they are key components of the Farm Credit Act of 1971, as amended.

See p. 45.
See comment 2.

In Chapter 4, the report omits discussion of the choices available to associations during a merger if they envision the merger creating operating incompatibility between the association and the resulting bank. The choices, of course, have to take the form of alternative merger proposals that would be subject to member-borrower approval and acceptance by the FCA. For example, four Louisville District associations chose not to become affiliated with the AgriBank FCB when the

FCA provided additional technical comments and changes were made throughout the report as appropriate.

Louisville and AgriBank FCBs merged, opting instead to affiliate with the Columbia FCB. As stated in their Territorial Transfer Proposal, ". . . the current structure of the Third Farm Credit District is more compatible with the structure of our associations than the structure of the district that would result from Louisville's merger in AgriBank." Further, they stated, ". . . The net cost of funds to us is expected to be less with Columbia than with AgriBank." On the basis of these arguments and other factors, the FCA approved the transfer request.

Our comments were directed toward the text of your report and we conducted no validation procedures over the data in the report and its appendices.

Thank you again for the opportunity to comment on the report. If you would like to discuss these comments or desire more clarification, please contact Mark Connelly of my staff at (703) 883-4107.

Sincerely,

Dorothy L. Nichols

Dorothy L. Nichols
Chief Operating Officer

Attachment

The following are GAO's comments on the Farm Credit Administration's August 11, 1994, letter.

GAO's Comments

1. Although the draft listed capitalization as one of the reasons that some districts had varying dividend payouts, the text has been expanded to include a discussion of capital standards and retained earnings. We recognize that an institution must make dividend and patronage refund decisions based on the need to retain earnings and build capital in order to maintain the 7-percent minimum capital requirement.

2. We agree that associations have certain options if they believe a proposed merger would adversely affect their operation. The text of the report has been modified to clarify that options exist, what the options are, and how associations have used them.

Comments From the Farm Credit System Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Farm Credit System Insurance Corporation

August 11, 1994

Ms. Helen H. Hsing
Associate Director
Financial Institutions and
Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Hsing:

Thank you for the opportunity to provide comments on the General Accounting Office's (GAO) draft report entitled Farm Credit System: Potential Impacts of FCB Mergers on Farmer and Rancher Borrowers.

Now on pp. 14-15.

We have one comment regarding the discussion of the authorities of the Farm Credit System Insurance Corporation (Corporation) on pages 19 and 20 of the draft report. The draft report suggests that the Corporation has authority similar to the Farm Credit Administration (FCA) to issue regulations and examine institutions for compliance with applicable laws, regulations and safe and sound banking practices.

It is true that section 5.58 (10) of the Farm Credit Act of 1971 as amended (the Act) gives the Corporation authority to issue rules and regulations necessary to carry out Part E of Title V of the Act. However, section 5.58 (10) excepts any authority to issue regulations that has been expressly and exclusively granted to any other regulatory agency. This exception limits the Corporation's power to issue regulations. We note, for example, that the Act gives FCA, not the Corporation, the authority to issue regulations regarding safety and soundness issues.

Section 5.59 (b) grants authority to the Corporation to examine certain System institutions using FCA examiners and to use the reports of examination and other information compiled by the FCA. The Corporation may, however, appoint other examiners only if the FCA informs the Corporation that the FCA is unable to comply with an examination request. We believe that these limitations on the Corporation's authority to issue regulations or conduct examinations should be clarified in any discussion of Corporation authorities in the final GAO report.

If you have any questions or would like to discuss the issue further, please contact me or Mary A. Creedon, Chief Operating Officer of the Corporation, at (703) 883-4380.

Sincerely,

Gary C. Byrne

Gary C. Byrne
Chairman

McLean, Virginia 22102-0826
703/883-4380

The following are GAO's comments on the Farm Credit System Insurance Corporation's August 11, 1994, letter.

GAO's Comments

The text was modified to clarify the role of FCSIC. Specifically, information was deleted about the authority of FCSIC to examine and regulate System institutions. The report now notes the coordination between FCA and FCSIC and more clearly defines the role of FCSIC, which is to manage the Insurance Fund.

Major Contributors to This Report

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