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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The Farm Credit System: Some Opportunities For Improvement

The Farm Credit System provides credit to farmers and ranchers through three separate banking systems. If these systems were consolidated, unneeded competition and overlapping responsibilities and services would be eliminated and costs could potentially be reduced.

The System has been providing credit and services for some purposes which go beyond agricultural needs, such as for marginal farming operations, obtaining tax advantages, and recreational purposes. But in many cases, farm income alone is not sufficient to make the loan installments.

This report recommends that the Congress require the Federal Farm Credit Board to determine how best to consolidate the three banking systems and to prepare legislation to accomplish such a consolidation. The report also recommends that the Federal Farm Credit Board and the Governor of the Farm Credit Administration improve lending operations and supervision.

UNITED STATES GENERAL ACCOUNTING OFFICE

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives CW00001

This report reviews the operations of the Farm Credit Administration and the banks and associations which make up the Farm Credit System. It discusses consolidation, questionable loans, and effectiveness of supervision. This is our first review of the Farm Credit Administration's management of the Farm Credit System. Because the last of the Government capital was repaid in 1968 and the Farm Credit System now holds about one-third of the Nation's total farm debt, we made this review as part of our overall evaluation of Federal farm credit programs. AGC00345 IO

We are sending copies of this report to the Federal Farm Credit Board; the Governor of the Farm Credit Administration; and the Director, Office of Management and Budget.

Elmer B. Staats
Comptroller General
of the United States

FFCB DLG03763

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE FARM CREDIT SYSTEM: SOME OPPORTUNITIES FOR IMPROVEMENT

D I G E S T

The Farm Credit Administration (FCA), an independent Federal Government agency, provides credit to ranchers, rural homeowners, and farm-related businesses through three separate banking systems. GAO believes these systems should be consolidated and should make only agricultural-oriented loans. GAO also believes that FCA should get legislative authority to take over a bank's operation when supervisory efforts fail.

The Farm Credit Act of 1971 gives FCA authority over 37 banks and almost 1,000 associations. During 1978, the System made loans totaling \$44.9 billion and had \$47.4 billion in loans outstanding at the end of the year.

The System primarily obtains its funds through the sale of bonds and discount notes. During 1978, it issued \$50.9 billion in securities and had \$41.7 billion outstanding at the end of the year. The System's net worth was \$6.2 billion at December 31, 1978. The borrowers/owners pay all expenses necessary to operate the System. In addition, the System enjoys some benefits not available to other financial institutions, such as usury and income tax law exemptions. (See pp. 1 and 2.)

FCA's FUTURE IS ONE CONSOLIDATED BANK

The three banking systems which make up the System have overlapping authority and provide similar credit needs. Every county is served by both a Federal Land Bank Association and a Production Credit Association. In many cases, both have offices in the same town and sometimes the offices are in the same or in an adjacent building, yet each operates as a separate entity and competes for a share of the loan market.

The Federal Farm Credit Board, the policy-making body for FCA, has recognized that the activities and policies of the three banking systems should be closely coordinated to best serve agricultural credit needs. However, coordination among associations has been less than optimum. Gradually, a sense of competition developed which has not always benefited the member/borrower.

Generally, the opinion throughout the System is that the borrower's interests are best served under the one-stop credit service concept. The borrower needs a lender's help in planning a total financial package. Yet under the current system, the borrower must go to one lender for short-term operating needs and another for long-term real estate needs. A borrower could be obtaining credit from more than one bank, with each bank concerned only with a specific type of credit and not the borrower's total credit needs.

The Federal Farm Credit Board has promoted coordination by emphasizing one-stop credit centers. However, due to legislative constraints and System structure, the Board has provided only limited help in correcting the overlapping services offered by the three banking systems. The System structure, with the legal requirement for a separate "body corporate" for each district bank, has limited the incentive for coordinated activities which would ultimately benefit the member/borrower.

Before the System can adequately support and provide the farmer with a total financial package and become more cost effective, new legislation would have to be enacted allowing banks and associations within a district to consolidate. FCA could then develop and implement a consolidated banking plan. (See pp. 11-15.)

Movement toward one banking system can include many steps, such as moving into adjacent or jointly housed offices, joint management, or merging different systems into one system. However, little progress has been made in establishing one banking system. FCA has not studied the feasibility of one system or established it as a long-range goal.

Although FCA discussion papers have shown the need for closer coordination over a 10-year period, GAO believes that now is the time for one banking system to replace the current three systems. What form or structure the one banking system should take in order to be most effective is not known. However, one system could better serve the borrower's total credit needs, could provide overall cost savings, and could correct other problems regarding advance payment funds, income tax law exemptions, and lines of credit. (See pp. 29-30.)

AGENCY COMMENTS

FCA disagreed with GAO's recommendation that the Congress should require the Federal Farm Credit Board to review how best to consolidate or merge the three banking systems and to prepare legislation to accomplish such a consolidation or merger. It said the recommendation was based on the unsupported conclusions that further consolidation is needed, that a one-bank system is best, and that further consolidation of banks and associations should be forced on the borrowers.

GAO concludes that further consolidation is needed because under the present system the banks' goals and services overlap, creating a certain amount of competition. Also, coordination of credit services has been limited. The most complete and desirable form of consolidation is a single banking system. Since consolidation, irrespective of the form it takes, does not happen over night, the System should be establishing it as a long-range goal now. (See pp. 30-31.)

RECOMMENDATION TO THE CONGRESS

The Congress should require the Federal Farm Credit Board to review how best to consolidate or merge the three banking systems and to prepare legislation to accomplish it. (See p. 31.)

THE SYSTEM MAKES LOANS FOR QUESTIONABLE FARMING OPERATIONS

The Farm Credit Act of 1971 authorizes the System to make rural housing loans to non-farmers. As of June 30, 1979, it had made over $1.5 billion in rural housing loans.

Although the System may be fulfilling a need for rural housing credit in some areas of the country, many rural housing loans are being made in counties that have large metropolitan areas. These loans cost more to service than farm loans. Since most Federal Land Banks charge the same interest rate for farming loans and rural housing loans, the farmer shares in these additional costs.

Recognizing the importance of off-farm income, especially for small farming operations, the System makes loans to part-time farmers. However, some loans are being made for recreational or pleasure farming where the agricultural benefit is questionable. (See pp. 34-40.)

The System also makes nonagricultural investor-oriented loans for which the System was not established. (See pp. 40-42.)

AGENCY COMMENTS

FCA did not agree with GAO's recommendations. It said GAO did not demonstrate that rural housing loans were significantly more costly to make and administer. It also said its regulations provide for full credit to bona fide farmers and for increasingly conservative credit as the emphasis moves away from the full-time farmer, to the point where agriculture needs only will be financed for the applicant whose business is essentially other than farming.

GAO agrees with FCA that GAO did not determine the cost differences involved in processing rural housing loans and agricultural loans. Instead GAO pointed to two features of rural housing loans that make them more costly to service than agricultural loans. GAO also believes that certain part-time farmer and investor-oriented loans are made for nonagricultural and questionable farming operations. In these instances, there was no evidence that FCA applied its own regulations to restrict credit as the emphasis moves away from the full-time farmer. (See pp. 42 and 43.)

RECOMMENDATIONS TO THE FEDERAL FARM CREDIT BOARD

The Federal Farm Credit Board should:

--Issue regulations to the district banks requiring them to charge nonfarmers interest rates which reflect the additional costs of making rural housing loans.

--Clarify FCA's regulations to insure that loans are being made to individuals who are bona fide part-time farmers or ranchers and that loans are primarily agricultural loans.

--Amend FCA's regulations to preclude the System from making nonagricultural loans to investor-oriented individuals. (See pp. 43 and 44.)

FCA's SUPERVISORY EFFORTS ARE NOT ALWAYS SUCCESSFUL

The Farm Credit Act of 1971 gave FCA broad supervisory authority over the System. FCA's basic supervisory functions are

--identifying a bank's problems or weaknesses,

--identifying the causes of such problems or weaknesses,

--determining the significance and interdependence of the causes,

--determining how to eliminate the causes and who should take these actions, and

--designing a program to determine the degree to which the causes and problems are being addressed.

FCA's primary supervisory method is its power of persuasion through formal and informal communication with a bank's board of directors and executive officers. This communication ranges from offering advice and counsel to bank staff and officers to the annual supervisory report to the bank's board of directors. If these methods do not bring about improvement, the Farm Credit Act of 1971 provides for more drastic supervisory actions, including FCA approval of bank loans; FCA approval of the bank president's salary; and, according to FCA's interpretation, authority to take over a bank's operations. (See pp. 45 and 46.)

AGENCY COMMENTS

FCA questions GAO's recommendation that the Governor of FCA seek legislation to amend the Farm Credit Act of 1971 to specifically provide FCA authority to take over the operation of a district board and/or bank when normal supervisory efforts fail to obtain needed corrective action. It maintains it has not had a need for such specific additional legislative authority.

GAO disagrees with FCA's assessment of its need for stronger tools to deal with problem situations in banks. Stronger supervisory action by FCA in the Louisville banks could have turned that situation around.

FCA, at the time of GAO's review, was considering the most drastic action it had ever taken. This included taking over the operation of one or both Louisville district banks. FCA thought this authority was implied in the Farm Credit Act of 1971. GAO believes there should be no room for doubt when such authority has to be used to deal with Louisville-type situations. (See p. 55.)

RECOMMENDATION TO THE GOVERNOR OF FCA

The Governor of FCA should request that the Congress amend the Farm Credit Act of 1971 to specifically provide FCA authority to take over the operation of a district board and/or bank when normal supervisory efforts fail to obtain needed corrective action. (See p. 55.)

Contents

ABBREVIATIONS

BC	Bank for Cooperatives
FCA	Farm Credit Administration
FFCB	Federal Farm Credit Board
FICB	Federal Intermediate Credit Bank
FLB	Federal Land Bank
FLBA	Federal Land Bank Association
GAO	General Accounting Office
PCA	Production Credit Association

CHAPTER 1

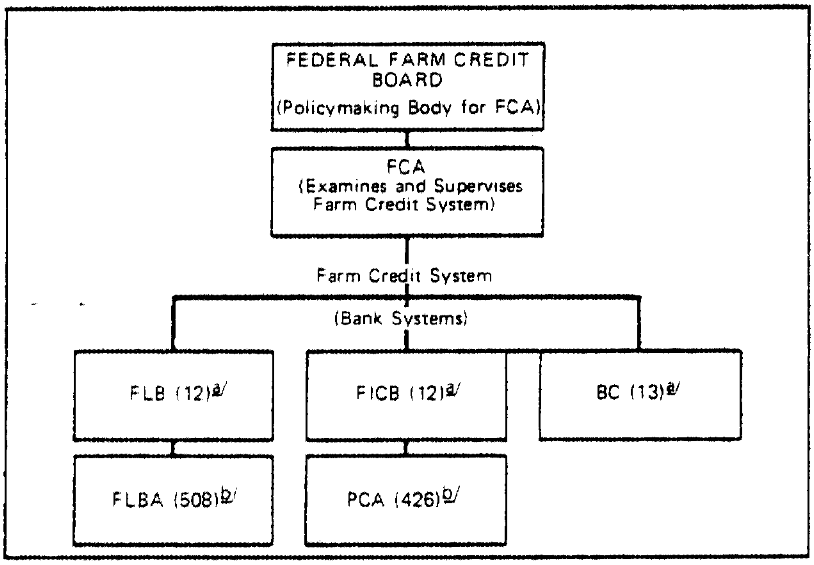
INTRODUCTION

The Farm Credit Administration (FCA), an independent Federal Government agency, supervises and regulates the activities of the member-owned Farm Credit System. The Farm Credit Act of 1971 (Public Law 92-181, 85 Stat. 583) gives FCA broad authority over the banks and associations which make up the Farm Credit System.

The System, holding about one-third of the Nation's total farm debt, provides credit and related services to farmers, ranchers, producers and harvesters of aquatic products, agricultural and aquatic cooperatives, rural homeowners, and certain businesses which provide farmers and ranchers with services essential to their onfarm operating needs. Credit and services are provided through three separate banking systems--Federal Land Banks (FLBs), Federal Intermediate Credit Banks (FICBs), and Banks for Cooperatives (BCs). During 1978, the System made loans totaling $44.9 billion and had $47.4 billion in loans outstanding at the end of the year. This represented increases over 1977 of 15.5 and 13.6 percent, respectively.

The System obtains its loan funds primarily through the sale of bonds and discount notes. During 1978, it issued $50.9 billion in securities and at the end of the year had $41.7 billion in securities outstanding. Total net worth was $6.2 billion at December 31, 1978, an increase of 14.2 percent over 1977. These figures illustrate the self-supporting nature of the System. The borrowers/owners pay for the borrowed funds and all the expenses to operate the System. In addition, it is exempt from State usury laws and certain components are exempt from Federal, State, and local income tax laws.

The following organizational chart shows the relationship between FCA and the System.



a/Number of banks

b/Number of associations

DEVELOPMENT OF THE FARM CREDIT SYSTEM

The System had its beginning with the passage of the Federal Farm Loan Act in 1916 (Public Law 64-158, 39 Stat. 360) which authorized 12 FLBs. The act also authorized local National Farm Loan Associations, now called Federal Land Bank Associations (FLBAs). FLBs were established to fill the need for a permanent and dependable source of long-term agricultural credit. FLBAs service FLB loans.

The depression of the 1920s led to the passage of the Agricultural Credits Act in 1923 (Public Law 67-503, 42 Stat. 1454) which authorized 12 district FICBs. FICBs were set up to make loans to farmer cooperatives and to discount farmers' short- and intermediate-term notes which had been given to other financial institutions. However, these other financial institutions did not use FICB services to the extent expected and a credit gap remained. To help close the gap, the Congress passed the Farm Credit Act of 1933 (Public Law 73-75, 48 Stat. 257) which authorized local Production Credit Associations (PCAs). PCAs could discount farmers' short- and intermediate-term notes. In effect, they became retail outlets for wholesale credit available from FICBs.

The Farm Credit Act of 1933 also authorized 13 BCs to provide complete loan services for farmers' marketing, supply, and business service cooperatives. Twelve BCs serve the needs of cooperatives in their respective districts. The thirteenth, a central BC, helps the other 12 on larger loans. Also, in March 1933, an Executive order created FCA and placed all System institutions under its supervision.

FLBs, FICBs, and BCs were initially capitalized by the Federal Government and remained largely owned by the Government until the Congress passed the Farm Credit Act of 1953 (Public Law 83-202, 67 Stat. 390). This act, which farmers and cooperatives endorsed, provided System users a means of controlling the System and allowed for the ultimate retirement of all Government capital invested in it. Additional legislation enacted in 1955, 1966, and 1968 further emphasized user ownership, a goal which was fully realized on December 31, 1968, when the last of the Government capital was repaid.

The Farm Credit Act of 1971 recodified all the prior laws governing the System, modernized its functions, broadened its lending authority, and brought decisionmaking closer to the borrowers. The act provides the authority for the present activities of the System banks and associations.

ORGANIZATION OF BANKS AND ASSOCIATIONS

The United States is divided into 12 farm credit districts. An FLB, FICB, and BC are at the same location in each district. FLBAs and PCAs are located throughout the districts to serve borrowers. The central BC is located in Denver, Colorado.

Each district is managed by a seven-member board of directors. The board includes six elected members--two each from an FLBA, PCA, and BC--and one member appointed by the Governor of FCA. FLBAs and PCAs can be organized by any group of 10 or more persons. Associations are managed, as are banks, by a board of directors elected from their members. The banks and associations are federally chartered instrumentalities.

FLBs make loans with terms ranging from 5 to 40 years through 508 FLBAs. All loans must be secured by first liens on interests in farm or rural real estate and first liens on rural housing. Loans are made to purchase farm property, rural homes, and real estate needed for farm-related businesses; to purchase equipment, machinery, and livestock; to refinance existing mortgages and pay other debts; and to finance other borrower needs. Total credit extended to one borrower is limited to 85 percent of the market value of the property used to secure the loan. Each bank is limited in rural home lending to 15 percent of its total loan volume outstanding.

FICBs provide loan funds to 426 PCAs and discount agricultural producers' notes which have been given to certain other financial institutions. They also participate with PCAs, commercial banks, and each other in making loans. PCAs make loans with terms up to 7 years to farmers, ranchers, rural homeowners, and certain farm-related businesses. They also make loans with terms up to 15 years to producers and harvesters of aquatic products. Loans are made for various purposes related to production of agricultural products; production and harvesting of aquatic products; purchase, repair, or maintenance of rural homes; and other borrower needs. The total amount of credit extended to a rural homeowner may not exceed 85 percent of the property's appraised value. Each PCA is limited in rural home lending to 15 percent of its total loan volume outstanding at the end of its preceding fiscal year. In addition, all such loans in a district cannot exceed 15 percent of the outstanding loans for all PCAs in that district at the end of the preceding fiscal year.

BCs serve marketing, supply, and business service cooperatives whose headquarters are located within their respective districts. To qualify for a loan, at least 80 percent of the cooperative's voting control must be vested with farmers, ranchers, producers or harvesters of aquatic products, or federations of cooperatives. For rural electric, telephone, or public utility cooperatives, 70 percent of the voting control must be held as described above. The cooperative must also do 50 percent of its business with its members. Excepted from this requirement are business done with the Federal Government and services or supplies furnished by the cooperative as a public utility. BCs provide complete credit service to cooperatives to fulfill their specialized needs. The central BC participates with the other BCs in loans that exceed their individual lending limits.

ORGANIZATION OF FCA

The Federal Farm Credit Board (FFCB) is the policymaking body responsible for guiding FCA and the System. The Board prescribes the rules and regulations necessary for implementing the Farm Credit Act of 1971 and directs FCA, which in turn examines and supervises System institutions. Board members are appointed by the President of the United States and are subject to Senate confirmation. The members serve part time and meet six or more times a year. One member is appointed from each of the 12 farm credit districts. These 12 members serve 6-year terms and are not eligible for reappointment. One additional member is appointed by the Secretary of Agriculture. In making appointments to the Board, the President considers a list of persons nominated by the boards of directors of FLBAs and PCAs and by cooperatives holding stock in the district BCs.

The Board appoints the Governor of FCA who carries out pertinent laws, administers rules and regulations, and implements Board policies. The Governor, under the Board's direction, is responsible for managing FCA in its supervision, regulation, and examination of the System.

The FCA organization includes five major offices. The offices and their primary responsibilities follow:

--Office of Supervision. Responsible for supervising banks in all areas except funding, personnel, information, and examination or audit.

--Office of Examination. Responsible for the general supervision and coordination of the examination of banks, associations, and other offices within the System.

--Office of Finance. Responsible for participating in System funding at the national and individual bank level, facilitating the Governor's approval of the sale of securities, and supervising System funding and financial management.

--Office of Administration. Responsible for providing all internal administrative support services and supervising System personnel, communications, and research programs.

--Office of General Counsel. Responsible for performing legal services for the Board, the Governor of FCA, and the FCA staff.

FINANCING THE FARM CREDIT SYSTEM

The System provides approximately one-third of all agricultural credit in the United States and obtains most of its funds to provide this credit by selling securities--bonds and discount notes. Security sales, which totaled $50.9 billion in calendar year 1978, are handled by a fiscal agent who is jointly employed by the 37 banks belonging to the System. Selling securities has been a highly effective way to obtain funds.

The System also obtains some funds by accepting advance payments from borrowers to apply against future loan installments and by requiring borrowers to purchase stock as a condition to obtain a loan. In addition, it has access to revolving funds which are maintained in the U.S. Treasury.

Securities

The Farm Credit Act of 1971 authorizes the System banks to obtain funds by borrowing money and by issuing bonds, notes, and other obligations. The act restricts the total bond and note issues to 20 times the capital and surplus of the banks primarily liable for the issues. To issue securities, the banks must maintain collateral equal to the total amount of securities outstanding. The collateral must be in the form of (1) loans made under the act, (2) Federal Government or agency obligations, (3) readily marketable securities, or (4) cash.

According to the act, the Federal Government is not liable for securities issued by System banks. Each bank is liable for its own obligations and for any portion of systemwide obligations issued on its behalf. It is also liable for payment of any additional sums which another bank cannot pay.

The act also established (1) a finance committee, composed of the presidents of each bank, to determine for each obligation issue the amount, maturity, rate of interest, and participation by the banks and (2) a fiscal agency to handle obligation issuance and marketing.

The System sells 6- and 9-month bonds with a face value of $5,000 and 13-month or longer duration bonds with a face value of $1,000. Before September 1977, each FLB, FICB, and BC issued its own bonds. FLBs issued 13-month or longer duration bonds four times a year; FICBs issued 9-month bonds and BCs issued 6-month bonds, both on the first day of each month.

Beginning in September 1977, the System experimented with a consolidated, systemwide bond representing the joint and several obligations of all 37 banks. With this type bond, all the banks can issue bonds on any of the individual bond dates, or 16 times a year. They can also choose from all types of bond maturities, from the short-term BC bonds to the long-term FLB bonds.

The System has also issued consolidated, systemwide discount notes since January 1975. These discount notes are sold in denominations of $50,000, $100,000, and $1,000,000, with maturities ranging from 5 to 270 days. The purpose of the discount note is to complement commercial bank borrowings, to provide interim financing between bond issues, and to increase flexibility in making adjustments to seasonal changes.

Advance payments

The Farm Credit Act of 1971 permits FLBs to accept advance and/or future payments from borrowers. The payments are for application against future loan installments. As of December 31, 1978, FLBs held $129.2 million in future payments funds and $143.7 million in advance payments and other trust accounts.

Stock purchases

The Farm Credit Act of 1971 restricts System banks from borrowing more than 20 times their capital and surplus. FCA regulations further restrict borrowing by stating that a PCA cannot make additional loans if liabilities exceed 10 times its capital and surplus. The System's capital is provided by association borrowers, but the methods of obtaining the capital vary by bank.

Each FLB/FLBA borrower must, as a loan condition, purchase stock in the FLBA equal to at least 5 percent and no more than 10 percent of the loan amount. In turn, the FLBA is required to purchase a similar amount of stock in the FLB. The borrower's stock is retired when the loan is paid.

Like FLB borrowers, each FICB/PCA borrower must purchase stock in the PCA equal to at least 5 percent of the loan amount. On payment, the stock is not retired, unless permitted by local PCA bylaws. The borrower's stock is converted from voting to nonvoting stock within 2 years after the loan is retired. The nonvoting stock is eligible for dividends if paid by the PCA. The PCA must purchase stock in the FICB in amounts required by each district bank. The FICB can return a portion of its yearly earnings to the PCAs in the form of additional stock.

BCs require borrowers at the time of the loan to own at least one share of $100 par value voting stock. Also, borrowers must purchase additional voting or nonvoting stock up to 10 percent of the loan amount. The amount of capital stock of each bank is determined by the board of directors and approved by FCA.

Revolving funds

The Farm Credit Act of 1971 includes two provisions allowing the Federal Government to make temporary investments in System banks to meet borrowers' emergency credit needs. For example, section 4.0 states that FLBs, FICBs, BCs, and under certain circumstances, PCAs may issue stock which the

Governor of FCA may purchase for the Federal Government. The purchase would be a temporary stock investment to help one or several banks or associations.

Section 4.1 states that revolving funds, established under Public Laws 87-343 and 87-494, shall be available at the request of the Governor of FCA for temporary investment in the stock of any FICB, PCA, or BC. Further, the Secretary of the Treasury may, at the Governor of FCA's request, deposit up to $6 million for the temporary use of any FLB, out of any money in the Treasury not otherwise appropriated. According to the Farm Credit Banks' 1978 report to investors, the revolving funds totaled $112 million for FICBs and $149 million for BCs.

FARM CREDIT SYSTEM ADVANTAGES

The System is exempt from State usury laws and certain of its components are exempt from Federal, State, and local income tax laws. The extent of any of the System's advantages, as a result of these exemptions, varies from State to State and is difficult to determine on an overall basis. The Congress provided the System with competitive advantages as part of an overall program to insure the success of a system that would provide an adequate flow of money to farmers and ranchers.

State usury law exemptions

Exemptions from State usury laws give the System advantages not provided certain other financial institutions. However, the advantages really apply only when the interest rate exceeds the maximum allowable rate established by each State. When this occurs, certain other financial institutions are prohibited from making loans above the maximum allowable rate; however, the System may continue making loans above the maximum allowable rate. Various State laws exempt certain loans and institutions from the usury laws, therefore mitigating the effect of the System's advantage.

Income tax law exemptions

Exemptions from income tax laws provide FLBs, FLBAs, and FICBs advantages not provided other lending institutions. The advantages result in higher profits and ultimately lower interest rates. PCAs and BCs are not entitled to this exemption but have other options available to eliminate or reduce their taxes.

The Farm Credit Act of 1971 (sections 1.21 and 2.8) states that every FLB, FLBA, and FICB and their capital, reserves and surplus and the income derived from these sources is exempt from Federal, State, municipal, and local taxation. For PCAs and BCs, the act (sections 2.17 and 3.13) states that the same exemption only applies in a year in which the Governor of FCA holds stock in the association or bank. As with usury law exemptions, the Congress provided these exemptions as part of an overall program to insure success of a system that would provide an adequate flow of money to farmers and ranchers.

FCA officials do not know the basis for excluding PCAs and BCs from the income tax exemption. However, both PCAs and BCs can reduce their taxes by excluding from earnings amounts set aside as reserves for losses on loans. For example, at the end of each fiscal year, PCAs can add an amount equal to 1/2 percent of loans outstanding until the reserve equals 3-1/2 percent of the loans outstanding. In addition, both PCAs and BCs can reduce their income tax liability by returning some of their earnings to their borrowers/owners in the form of patronage refunds. The tax liability, therefore, passes to the members.

According to the American Bankers Association, PCAs can set aside more in reserve for bad debt accounts prior to computing income taxes than can commercial banks. They maintain that commercial banks presently are permitted to make additions to the reserve for bad debt account until the account equals 1.2 percent of eligible loans. This amount is only one-third of the amount that PCAs can set aside.

SCOPE OF REVIEW

We reviewed selected activities of FCA and the banks and associations which make up the System. This review was our first detailed management audit of the System and includes a review of usury and income tax exemptions, financing, loans, supervision, and coordination.

We performed our work at FCA in Washington, D.C., and at the FLB and the FICB in the fourth (Louisville, Kentucky), sixth (St. Louis, Missouri), and eighth (Omaha, Nebraska) farm credit districts. We also visited five FLBAs and five PCAs within those districts. In addition, we interviewed bank and association officials in the second (Baltimore, Maryland) farm credit district, the System fiscal agent, American Bankers Association officials, commercial bankers, and individual farmers.

We examined legislation, regulations, management systems, bylaws, and examination and supervisory reports. We also selected some loan files for review at each FLBA and PCA we visited. We excluded BCs from the detailed review because our focus was on the individual farmer and not on cooperatives.

CHAPTER 2

THE FARM CREDIT SYSTEM'S FUTURE

IS ONE CONSOLIDATED BANK

The System consists of three separate banking systems, each of which has overlapping authority and provides similar credit needs. Under such conditions, coordination is necessary, and the Board has recognized that the activities and policies of the three systems should be closely coordinated to best serve agricultural credit needs. However, coordination at times has fallen short. As a result, the members/borrowers' credit needs are not always fully met. For example, a member/borrower cannot satisfy his or her total credit needs through one system. Instead, he or she must go to one system for short-term credit needs and another system for long-term credit needs. One consolidated bank would overcome this inconsistency by allowing the lender to provide the borrower with a total financial package. For the most part, the opinion throughout the System is that borrowers' interests are best served under a "one-stop" credit service concept where their total credit needs can be considered.

The System is moving toward consolidation, but more needs to be done. For instance, legislative constraints and the System's structure hinder consolidation. Therefore, new legislation would have to be enacted allowing banks and associations within a district to consolidate. Then consolidated banking plans could be developed and implemented.

LEGISLATIVE CONSTRAINTS AND SYSTEM STRUCTURE DO NOT ENCOURAGE CONSOLIDATION

The Farm Credit Act of 1971 provides for three distinct banking systems, each of which is designed to serve different needs of members/borrowers. The act does not allow mergers of unlike banks and associations, such as an FICB with a BC or an FLBA with a PCA. The act also requires that each district bank and each association be federally chartered, making each a separate and distinct legal entity. These provisions do not encourage or allow consolidation. Therefore, new legislation and a new structure are required to better serve members/borrowers' total credit needs.

The fact that the Farm Credit Act of 1971 has to be amended and that system structure has to change in order to allow consolidation is quite clear. However, any attempt to change legislation or the System's structure could be affected by the attitudes and philosophies of bank and association boards of directors and management. The slow progress in achieving consolidation through one-stop credit service, for example, has been due in part to these attitudes and philosophies. For example, since each district bank and association is a federally chartered legal entity, each must approve or agree to change. In one district, the three bank presidents visited each association in the district to discuss an implementation plan for a more coordinated type of credit service, to assure everyone that they were not going to lose their jobs, and to explain the benefits coordination could bring to the System. The presidents were told at several locations that if the district board went ahead with the plan, the associations would elect a new board. At the time of our review, three new members had been elected to the district board.

Another example which illustrates the independence of banks and associations and the fact that they must agree to change involved the planned joint housing of an FLBA and a PCA in one district. Initially, the PCA planned to build a new building to house its central office and one branch, with room for a branch of the FLBA. The district coordinator, however, met with the managers of both associations to plan a building that would house both associations' central offices and one branch office of each association. Both association managers agreed to form a building planning committee. However, the district coordinator and the FLBA manager heard nothing further about the building until they were informed that the PCA had let the contract for the building as it had initially planned. In addition, the rent the PCA was going to charge the FLBA for the branch office space was going to be much higher than originally agreed. The building was completed in early 1979. As a result, the FLBA kept its rented branch office but had to rent additional space for its central office.

Another factor which officials told us limits the System involves the structure of the System itself. For example, the district bank is required to supervise and regulate the associations. However, the associations elect the bank's board of directors, who in turn appoint the bank managers. Therefore, if the association managers feel they are being oversupervised and/or over-regulated, they can elect new supervisors or regulators.

We believe that it is obvious that legislative changes are needed to allow a consolidated approach to farm credit lending provided by the System. We also believe that consolidation will have to overcome the structural impediments currently inherent in the present system as illustrated in the above examples.

THE BANKS' FUNDAMENTAL GOALS AND SERVICES OVERLAP

The fundamental goal of all three banks is to raise and improve the income and well-being of its borrowers by extending sound credit. Each is authorized to make loans to individuals or legal entities relating to agricultural needs and products. At times, this authority overlaps, causing competition among the System's banks and associations.

FLBs are authorized to make real estate loans through FLBAs ranging from 5 to 40 years secured by a first lien on real estate. PCAs, on the other hand, borrow from FICBs and are authorized to make operating loans with terms up to 7 and, in some cases, 10 years. BCs make both short- and long-term loans to farmers' cooperatives for any credit needs necessary to perform their marketing, supply, or business service function.

The most competition exists between FLBAs and PCAs, which make loans to farmers and ranchers. However, competition can also extend to BCs which primarily make loans to cooperatives formed by farmers and ranchers. Every county is served by both an FLBA and a PCA. In many cases, both have offices in the same town and sometimes the offices are in the same or adjacent buildings. However, each operates as a separate entity and competes for a share of the loan market.

FLBAs and PCAs make loans to the same borrowers for the same purposes. The loans can be for any agricultural purpose or for other requirements of the borrower, such as real estate purchases, building new structures, improvements and remodeling, equipment and operating funds, and other personal needs. BCs also make loans to purchase real estate, build new structures, remodel, purchase equipment, and for working capital. In addition, both FLBAs and PCAs make rural housing loans and farm-related business loans. BCs also make farm-related business loans to cooperatives.

Overlapping authority results in different System elements providing credit to the same borrowers for the same purpose

Because the banks and associations have overlapping authority, they provide credit to the same borrowers for the same purposes. In addition, borrowers can choose the banking system they wish to do business with, especially for farm-related business and rural housing loans.

Our review disclosed examples which point out the overlapping authority within the System and support the need for a more coordinated banking system.

--A borrower received a PCA loan of $19,000 for a downpayment on the purchase of 160 acres of land costing $50,000. The balance of the land cost was financed by the FLBA. A PCA official said that the FLBA would not make the loan unless the borrower had a downpayment. If there was only one bank, only one loan package would have to be negotiated.

--An applicant received an interim PCA rural home loan of about $49,000 which was to mature in 2 years. The loan file stated that repayment would be made with FLBA refinancing. In another case, an applicant received an interim PCA farm loan for about $326,000 which was to mature in 1 year. An FLBA also provided about $172,000 for a portion of the same loan. The PCA loan file stated that an FLBA could finance the repayment on its loan.

--In January 1978, a PCA approved a loan which included $215,500 for operating expenses. The loan file showed that this included $93,300, or 43 percent, to an FLBA loan for real estate and interest.

--In August 1977, an FLBA approved a loan of $51,500, which included $5,000 for operating expenses to be applied against the borrower's PCA loan. Another FLBA loan, approved in February 1978, was to refinance the borrower's non-real estate debts including a PCA short-term loan of $61,000 and a PCA intermediate-term loan of $42,000.

We believe that the above examples illustrate the need for a single banking system which could result in better services to borrowers by satisfying their total credit needs. Two banks, competing with each other and financing the same needs, seem inefficient. One bank could eliminate certain operating costs, such as the cost of processing two loan applications instead of one.

COORDINATION OF CREDIT SERVICES HAS BEEN LIMITED

Both the FFCB and FCA have recognized that the activities and policies of the three banking systems should be closely coordinated in order to best serve the credit needs of agriculture and borrowers. Policy positions on coordination have been issued and reaffirmed; however, little progress has been made or can be made under the present legislative constraints and System structure.

The FFCB has promoted coordination by emphasizing one-stop credit centers. However, implementation of such a system has been slow with few major breakthroughs on a systemwide basis. One-stop credit can work in several ways. It can mean that an eligible borrower may secure both short- and long-term credit at one location as a result of adjacent or jointly housed FLBA and PCA offices. Each association retains its own entity, and normally the offices are separated by physical barriers. Each office has its own manager and loan officer. One-stop credit can also mean that FLBA and PCA share housing and personnel, including management. However, records and loan data would be maintained separately for each association. Finally, one-stop credit can mean one consolidated bank with branches or associations.

Joint or adjacent housing

The Board has supported and encouraged the districts to move toward one-stop service for several years but has never forced it. On June 3, 1959, the Board directed FCA to study one-stop service. The primary objective of the study was to provide a means of short-, intermediate-, and long-term credit services that would be most convenient and effective from the farmers' viewpoint and practical from the standpoint of cost and management considerations. On December 7, 1960, the Board adopted the following study report conclusions as policy.

--One-stop credit service should be expanded as rapidly as possible in all districts where it is not available.

--Joint or adjacent housing with separate managers is generally the most workable method of providing one-stop service.

--Joint management provides effective one-stop service under favorable conditions.

--To make conditions more favorable for one-stop service, cooperating PCAs and FLBAs should serve the same areas whenever possible.

Due to a lack of progress in implementing one-stop service, the Board has reaffirmed its policy several times since

1960. For example, on June 4, 1974, the Board adopted a resolution reaffirming and emphasizing its 1960 policy and requested

- --FCA to study and develop information on the results of joint and adjacent housing to serve as a basis for improving services to borrowers;

- --district boards to review, analyze, and strengthen policies to expedite joint and adjacent housing; and

- --district boards to recommend to FCA how the System could make greater progress in implementing one-stop service.

A December 1974 FCA report on one-stop credit provides a good overview of the problem that existed at the time and which still exists today. The report said:

- --The move toward one-stop credit facilities has been slow with no major breakthroughs on a systemwide basis.

- --Policies, persuasions, and inducements accomplish little until people, directors, and managers decide to pursue one-stop credit service and to expect favorable results.

- --One-stop credit service requires leadership by district boards and bank management.

The report pointed out that the attitude and personality of association management greatly influences their receptiveness to joint or adjacent facilities. These attitudes often are reflected in the association board of directors. If the philosophy of management and directors is for separate facilities and limited cooperation among associations, it is extremely difficult to develop one-stop credit service without personnel changes regardless of other advantages. The report also noted that new and dynamic approaches to the task of encouraging one-stop credit service in the FLBA/PCA system do not spontaneously occur when relying on the natural course of events. District boards and bank management are in the best position to set the stage, atmosphere, and example for encouraging the development of one-stop credit service among the associations. The natural course of events will require a long-term period for the system to complete the development of one-stop credit service because of the overriding influence of personal opinions and self interests of association directors and management.

The FCA report, however, did show that one-stop service works. For example, the Worthington, Minnesota, PCA and FLBA became jointly housed in 1966. When this occurred, both association managers further developed relationships that assured successful one-stop credit service. Their experiences, both on operating costs and on service, verified that the move produced those improvements that were sought.

In another instance, the Douglas, Georgia, PCA and FLBA became jointly housed in 1971; in 1972 they elected to operate under joint management. The PCA and FLBA members requested these changes and the association boards of directors actively sought to provide one-stop credit service. They said that under this arrangement the associations could provide better credit service by (1) reducing the time required to provide financing because of improved borrower information and education, (2) making lending more flexible by better balancing and scheduling of long- and short-term debt, (3) enabling the association to compete better with commercial banks for unexpected short-term financing, and (4) establishing a more efficient recordkeeping system since records would be retained in branch offices, thus reducing travel. Initially, association operating costs increased, mostly due to training needs, but later fell below the previous levels of the two associations.

In August 1975, a consulting firm completed a feasibility study of one-stop service centers for the System in the Louisville district. The study recommended a number of alternatives, including a system of 39 association networks set up as a supervisory body to manage groups of branches. The branches would become one-stop credit outlets to serve an immediate market area. According to the study, annual cost savings would be $230,000. The proposal was to be implemented by 1985.

While this proposal includes the concept of joint or adjacent housing or one-stop credit service, it also introduces a different structure of association networks and branches in the district. We did not evaluate the structure's feasibility or the cost savings involved; however, we do endorse the joint or adjacent housing concept because it is one step closer to consolidation. Some of the firm's major findings include:

--Eighty-nine percent of the farmers supported one-stop credit service.

--Seventy-seven percent of the FLBA managers and 89 percent of the PCA presidents favored one-stop credit service.

--PCA presidents had three major objections to one-stop credit service:

1. Some were concerned about their image as a result of being associated with an FLBA, which they felt was not as aggressive or as committed to quick service.

2. PCA presidents and directors anticipated the loss of profitable portions of their portfolios, which currently permit them to extend a high level of services and market coverage.

3. Some PCA presidents, directors, and others suggested that FLB and FLBA operating procedures may be extended to PCAs.

--FLBA managers had two major objections to one-stop credit service:

1. PCAs are more aggressive than FLBAs, and managers were concerned that FLBAs would be dominated or absorbed by PCAs.

2. FLBAs are more conservative in extending credit and in making appraisals, and managers believe this may be compromised by the more aggressive PCAs.

The three districts we visited did not have any associations jointly managed but did have several colocated associations providing one-stop credit service. The table below shows the percentage of offices that were colocated (jointly or adjacently housed) as of December 31, 1978, in the three districts.

	Percent of FLBAs colocated	Percent of PCAs colocated
Louisville	59	33
St. Louis	67	59
Omaha	54	51

FCA's most recent estimate was that systemwide only 42 to 55 percent of the offices are colocated and providing one-stop credit. Two of the smaller districts are 100 percent colocated and jointly managed.

Officials that we contacted generally favored one-stop credit service, citing better service to the borrowers, cost savings, and improved coordination. We noted that each district had adopted, to different degrees, a coordination policy; some were very supportive and others were only a matter of record.

Joint management

Once joint or adjacent housing is achieved, joint management should come easily. Presently, the Springfield, Massachusetts, and Baltimore, Maryland, districts have implemented one-stop service and joint management at the bank and association level. The Columbia, South Carolina, and Sacramento, California, districts are working toward joint management.

The Baltimore district started working on territory alignments and one-stop credit service in the 1930s before the Board adopted the policy systemwide. Baltimore officials told us that the district adopted joint management because too many small associations with limited potential for agricultural growth existed and that by combining some of these associations, more efficient operations could be achieved. Similar conditions exist in other districts. For example, the Louisville district has 26 associations that serve three or fewer counties and several that serve only four counties. Many are classified as metropolitan areas.

Baltimore district officials cited several things that must be accomplished before instituting joint management. These include territory alignments, joint housing, attitude changes, and removing impediments such as different loan approval authorities. They said the major advantages of joint management are better credit service to the borrower and lower costs to the association. The disadvantages mentioned were the cost of additional training for loan officers and the difficulty of allocating costs between three legally separate systems. However, the Baltimore district officials said the advantages outweighed the disadvantages.

One banking system

After achieving joint housing and joint management, the next step is to establish one banking system. Baltimore district officials stated that they were as close to one banking system as legislative constraints would allow and they would favor further consolidation. They said the advantages would include better service to the borrower, increased control and managerial effectiveness, increased System identification, and overall consolidation of operations. The officials could not identify any major disadvantages. They said that before the three banks could merge, there would have to be legislative changes allowing the merger and differences such as taxation, reserves, and stock ownership would have to be worked out.

FCA has not studied the feasibility of one banking system or established any long-range goals to achieve such a system. However, the system and organization has been changing. In some instances, the System is already geared toward one rather than three systems as follows:

--FCA is directed and supervised by one Board.

--FCA is organized to supervise and regulate one organization and not three.

--The three bank systems use a consolidated system bond to obtain funding.

--The three bank systems have stock purchase requirements for borrowers.

--Each district has a joint board of directors which establishes policy for the three bank systems.

--District banks are located in one building, and many share personnel and training offices.

--Each district has a single retirement, benefit, and salary program.

--FLBAs and PCAs use the same credit factors in making loan decisions.

--PCAs and FLBAs use the same basic procedures in conducting real estate appraisals, and sometimes PCAs use the FLBA real estate appraisal report.

An FCA official told us that the most obvious concept within the System would be the consolidation of the three present banking systems into one. Other officials also favored a single banking system which they believed would benefit the borrowers and the System. However, some of these officials said that the rate of change will depend on how the legislative constraints and system politics are overcome. The major legislative constraint is that the Farm Credit Act of 1971 does not allow mergers of different banks and associations, such as an FLB with an FICB or a BC and an FLBA with a PCA. The political realities are that since each

System element--three banks and two associations--is a separate entity, most boards of directors and executive officers do not want to relinquish any authority or prestige.

Examples of cost savings under a single banking system

A single banking system could potentially be more cost effective. While we did not specifically address cost increases or decreases, we have identified a few areas which we believe could provide some savings. These include combining and reducing the number of association boards of directors, reducing dual and parallel positions, eliminating facilities and equipment, and reducing operating costs. These are discussed below.

Each of the almost 1,000 associations which make up the System has a board of directors. During 1978 the total board of director costs in the three districts we reviewed amounted to $2.4 million. If these districts are representative of all 12 districts, total board of director costs could be as high as $9.6 million. By consolidating the present System into a single banking system, some or all of these costs could be eliminated. This would depend on the form the single banking system takes--a bank in each district with branches or associations.

The elimination of dual and parallel positions is another example where cost savings can be achieved under a single banking system. Each of the three district banks has a president, an executive vice president, and various senior vice presidents. With one bank in each district, two-thirds of these positions would be eliminated. Even though consolidation may create more secondary roles, an overall reduction in salary costs should result.

Another example whereby dual and parallel positions can be eliminated is the use of FLB and FICB credit reviewers and financial auditors. Each performs individual reviews even if FLBAs and PCAs are located in the same place. With one bank there would only be one branch to review and one review team, which would reduce operating costs. On the other hand, the bank could make more frequent reviews if necessary, hopefully resulting in more efficient and economical branch offices. Even FCA would be affected by a consolidation. The Office of Examination currently must audit 37 banks and about 1,000 associations. Also, the Office of Supervision must supervise the same number of banks. Consolidation into one banking system should reduce FCA's travel costs and expenses for the System. For fiscal year 1979, FCA travel costs were budgeted at approximately $875,000 for the Office of Examination and $286,000 for the Office of Supervision.

Other savings involved in a consolidated system include advertising and public relations expenses. For example, each of the three banking systems advertises its own services and the services of the System as a whole. During 1978 advertising costs in the three districts totaled $3.3 million. One bank should reduce these expenses. Also, each bank and association currently has stockholders meetings and other membership-related activities. These costs for 1978 amounted to $3.2 million in the three districts. Again, with one bank these expenses should be reduced. These are just some areas where cost savings can be realized by consolidating the present three systems into one.

FCA discussion paper on long-range planning for improved coordination

In October 1978, FCA officials prepared a discussion paper on long-range planning for improved coordination in the System. It was prepared for a Board planning conference in November 1978. The paper concluded that it could serve as a framework from which to begin design and implementation of a long-range planning effort for an improved climate of coordination. It noted that considerable coordination could be achieved within the present corporate structure, but legislative changes should occur to provide the best possible coordination and services to borrowers. The paper did not identify ultimate goals or deadlines for systemwide bank consolidation but said that further study would be required before specific timetables could be developed.

The paper said that coordination in the System is a controversial subject and that those who oppose it are either independent or feel their jobs are threatened by it. However, coordination has always been recognized as being important to best serve agricultural credit needs and some progress has been made. However, due to past operating practices, board makeup, organizational identity, and financial strength of individual system entities, coordination between PCAs and FLBAs has at times been less than optimum. As a result, a certain amount of competition has developed which has not always been to the member/borrower's long-range benefit, even though the increasing interdependence of system portfolios suggests the need for improved coordination.

The paper used the following examples to point out the need for more coordination which was found to be limited in many districts.

--The relationship between BC and PCA borrowers points out the need for coordination. PCAs sometimes finance cooperative membership. Failure of the marketing cooperatives directly affects the financing PCA and indirectly affects them if the PCA borrowers cannot get competitive prices for their crops.

--The relationship between FLBA and PCA borrowers points out the need for coordination. Rapid rises in land values have allowed some FLBA borrowers to refinance their FLBA loans to help meet short-term loan payments to their PCAs. The rising importance of land in the farmer's debt and equity structure suggests that a separation of long- and short-term lending may not be logical either for the farmer or the banker.

--The farmer's more sophisticated approach to debt suggests a need for coordination. Borrowers need lenders to help them plan a total financial package instead of having to go to one lender for short-term needs and another for long-term needs.

--The greater volatility of agricultural prices and incomes suggests a need for coordination. New technologies have led to more highly specialized production and to greater vulnerability to price fluctuations. Steady growth in grain exports and shifts to a floating exchange rate have rapidly translated worldwide changes in growing conditions, overseas trade policy, or production decisions into changes in farm income. Finally, the greater use of debt by farmers has increased their vulnerability to fluctuations in cash flow.

The paper noted that the Board has always recognized opportunities for coordination. However, due to legislative constraints and structure of the System, the Board has provided limited direction to correct the proliferation and duplication of services offered by the three banking systems. The paper said that the structure of the System itself, with the legal requirement for a separate "body corporate" for each district bank, has limited the incentive for coordinated activities that can be of ultimate benefit to the user borrower. However, the paper concluded that coordination could be improved, in spite of structural and political difficulties. It stated some improvements could be initiated at once through Board policy and FCA supervisory actions. Other improvements, mostly dependent on legislative changes, could be initiated in 3 to 5 years; in 5 to 10 years, legislation could be enacted aimed at consolidating units of the System.

According to the paper, the following items could be considered for immediate action:

--Encourage the development of standardized core information to be obtained on all PCA documents that can be integrated with the FLB system. Also, encourage techniques for uniform storage and retrieval mechanisms for this data within the System.

--Encourage the development of a centralized data base for core data on BC borrower profiles.

--Encourage sharing specialized expertise among similar and dissimilar banks in the System.

--Encourage exchange of personnel and contracting of services among unlike associations when needed to service a territory.

--Consolidate credit-related services into one systemwide and/or districtwide corporation or similar operating activity. Also, encourage and further develop the use of joint personnel to provide credit-related services among unlike banks and associations.

--Place stronger emphasis on the use of joint housing, joint or single management, and identical territories for PCAs and FLBAs. Also, FCA should provide stronger direction to the supervisory banks and they, in turn, to the associations.

The paper said the following items could be considered within the next 3 to 5 years.

--Legislation should be enacted to allow participation in loans among two or more unlike banks within and among districts.

--Legislation should be enacted requiring a commitment of resources of each Farm Credit Institution by requiring financial assistance in the following order: (1) among like associations within a district, (2) among a bank and related associations within a district, (3) among like banks, including a certain level of related associations' resources, and (4) among all banks, including a certain level of all associations' resources.

--Legislation should be enacted, without changing corporate identities, which will stipulate that the financial statements of like associations and banks will be combined to reflect the System's financial strengths to the public as collateral for systemwide financing.

--Boards and management at all levels should support a commitment to develop and project a "Farm Credit System" image for credit at the borrower level, just as is projected at the funding level to potential investors. Individual corporate entities would continue to exist but would not be emphasized to the individual borrower.

The final long-range issues to be considered in the next 5 to 10 years are as follows:

--Examine the applicable sections of the Farm Credit Act relating to the independent operation of each institution and revise the act to convey that

> "the financial and other resources of unlike banking groups may be combined or consolidated whenever it is determined that borrower service and efficiency of operation can be improved by doing so."

--Legislation should be enacted to allow consolidation of two or more banks within a district or like banking institutions within two or more districts and to allow consolidation of unlike entities at the association level following consolidation at the bank level.

--Encourage consolidation of district BCs into more efficient sizes but retain existing district BCs to serve as branch offices.

--Legislation should be enacted to allow creation of new central banks for FICBs or FLBs or to allow expansion of authority in the existing central BC to serve each banking system in supplying overlines of credit and credit-related services.

--Encourage the use of one label (such as Farm Credit loans) for all types of loans following consolidation of two or more banks within a district.

--Encourage the System to develop its own mechanism for handling the role of spokesperson for the System.

We believe FCA's discussion paper points to a need for improved coordination including consolidating the three banking systems into one banking system. Throughout the paper, there are indications that competition has replaced coordination within the System and that this hurts rather than helps the member/borrower. The paper also points to changing conditions within agriculture which almost demand coordination. The suggested plan for achieving improved coordination and consolidation is a good one. However, at the time of our review, FCA had not studied the feasibility of one banking system or established any long-range goals to achieve such a system.

CONSOLIDATION CAN RESOLVE OTHER PROBLEMS

Consolidation of the three banking systems into one would help correct other problems which we noted during our review. For example, inconsistent application of advance payment funds, income tax law exemptions for portions of the System, and costly lines of credit could all be improved under a consolidated banking system.

Advance/future payment funds inconsistently used

The Farm Credit Act of 1971 permits FLBs to accept advance payments from borrowers. The payments are for application against future loan installments. FCA regulations allow borrowers to make withdrawals from their advance/future payment funds for purposes for which the bank would make a loan. In addition, FLBs pay interest on advance payment funds. According to FCA, banks are not allowed to accept deposits other than advance payments. Because guidelines on borrower withdrawals are too general, the potential exists for banks to abuse these funds, turning them into little more than high-interest savings accounts.

FCA established two separate advance payment accounts--advance payments and future payments. According to an FLB official, the accounts are similar. With a future payment fund, the bank does not deduct an installment payment from the borrower's account until the loan has become delinquent. Thus, as long as the borrower makes payments on time, no funds are ever deducted. With an advance payment fund, however, the installment is automatically deducted from the borrower's advance payment account at the due date. The banks pay interest on these funds, usually at current loan rates.

Before 1972, FLBs used only the future payment fund. As of December 1978, 6 of the 12 FLBs were using the advance payment fund exclusively, including the St. Louis and Louisville banks. Omaha continues to use the future payment fund. As of December 31, 1978, FLBs held $129.2 million in future payment funds and $143.7 million in advance payments and other trust accounts.

FCA has set forth few criteria for using advance/future payment funds. Thus, each bank is free to set its own terms and conditions and consequently they vary from bank to bank. Differences in bank implementation of advance/future payment accounts may result in unequal treatment of borrowers using these funds. For example, the St. Louis FLB limits the amount borrowers may deposit in the fund to 2 years' worth of installments; Omaha limits the amount to 4 years' installments; Louisville limits the amount to the total outstanding loan balance and encourages limiting the total to 3 years' installments.

The St. Louis, Omaha, and Louisville FLBs will not normally let borrowers withdraw their advance/future payment funds. Only in cases of emergency, with bank approval, can the funds be withdrawn. Louisville officials estimated emergency withdrawals occur only about 6 times a year; St. Louis and Omaha officials each estimated no more than 12 times a year. In any event, FCA regulations are too general in that withdrawals are allowed for purposes for which the bank would make a loan. In our opinion, this in itself does not necessarily constitute an emergency.

While fund withdrawals were minimal, we believe the lack of specific guidelines on advance/future payment fund withdrawals opens the door for potential abuse, turning the funds into little more than high-interest savings accounts. In addition, borrowers could be receiving unequal treatment since banks implement the funds differently. We believe many of these inconsistencies could be resolved by increased coordination and consolidation within the System.

Income tax law exemptions are not uniform

The Farm Credit Act of 1971 exempts FLBs, FLBAs, and FICBs from paying Federal, State, and local income taxes, an advantage not provided other lending institutions. The exemptions, however, do not apply to PCAs and BCs, which have other options available to them to eliminate or reduce their taxes. FCA officials did not know why PCAs and BCs were excluded from the income tax exemption. However, both PCAs and BCs can reduce their taxes by excluding from earnings amounts set aside as reserves for losses on loans and amounts returned to their borrowers/owners as patronage refunds.

As a result of the income tax law exemption, FLBs, FLBAs, and FICBs paid no income taxes during 1978 on net earnings of $318 million. Some FCA officials said the exemption was needed to keep the System viable and to meet its mandate to extend credit to all eligible borrowers. They said the exemption keeps borrowing costs lower than that of other lenders. Another FCA official said the exemption provided some advantage but was not that essential.

We believe that the System probably does not need the income tax law exemption to remain viable and meet its mandate to extend credit to all eligible borrowers. If the tax exemption were that crucial to its viability, then it would seem that it would also apply to PCAs and BCs. Also, the System's net earnings for calendar year 1978 were $424 million, another indication that the tax exemption is not necessary today. In any event, consolidation of the three banking systems into one should eliminate the inconsistent application of income tax exemptions in the System.

Are costly lines of credit really needed?

FCA requires each bank to maintain lines of credit with commercial banks or other financial institutions equal to at least one-third of its outstanding discount notes. As of June 30, 1979, System banks had lines of credit with approximately 85 institutions totaling $1.9 billion. The cost of maintaining these lines of credit varies from bank to bank. Usually, System banks must deposit funds in a non-interest-bearing account or pay a fee to the institution furnishing the line of credit. In a few cases, the lines of credit are free. Generally, the required deposit averages between 3 and 7 percent of the line of credit. Based on the total lines of credit available at June 30, 1979, System banks could have maintained deposits bearing no interest from $57 million to $133 million. Assuming the banks could have loaned these funds at 9 percent, the cost to the banks could be between $5.1 million and $11.9 million annually.

FCA officials maintain that they need the lines of credit to make the discount notes more marketable and to provide liquidity. The fiscal agent stated that the line of credit is a normal requirement for issuing corporate commercial paper, which is similar to the System's discount note. FCA regards the lines of credit as a form of insurance and, therefore, a first step for providing self-help if and when financial problems occur. Other System officials, including the presidents of the St. Louis FLB and FICB, said discount notes could be marketed adequately without any lines of credit, pointing to the excellent reputation of the System's securities in the Nation's money markets. On the other hand, the System has never activated the lines of credit for discount note purposes.

We believe FCA should consider less restrictive line of credit requirements for discount note purposes, such as reducing the size of the line of credit. Also, in our opinion, one cost-saving alternative to the commercial bank line of credit would be for the System to use Federal revolving funds to which it has access. District and FCA officials stated that they have never used the Federal revolving funds and do not consider them in their financial planning. A St. Louis FLB official was uncertain if the bank had any access to the revolving funds. FCA and district bank officials stated that the banks would be extremely reluctant to request revolving fund moneys because of consequent Federal involvement.

FCA officials see several other drawbacks to using revolving funds in place of lines of credit. They said the amount in the revolving funds, $267 million, is too small and too difficult to obtain and their purpose is to provide capital, not operating funds. We do not know whether or not these are in fact drawbacks or whether or not they can be overcome. However, we still believe their use has merit and should be explored. Also, we believe that consolidation of the System could provide added backing to the discount note program making it more marketable without obtaining lines of credit.

CONCLUSIONS

The System was created at different points in time and today consists of three separate banking systems. The three systems provide credit and related services to farmers, ranchers, and their cooperatives. To best serve the needs of agriculture, such credit and service should be closely coordinated. However, coordination has been less than optimum. As a result, different banks are providing credit to the same borrowers for the same purposes, hindering consideration of the borrowers' total credit needs. Such a system also is more costly to operate. A single banking system would work better.

Movement toward one banking system can include many steps, such as moving into adjacent or jointly housed offices, joint management, and merging different systems into one system. However, little progress has been made in establishing one banking system. FCA has not studied the feasibility of one system or established it as a long-range goal.

Although FCA discussion papers have shown the need for closer coordination over a 10-year period, we believe that this is the time for one banking system to replace the current three systems. We do not know what form or structure the one banking system should take in order to be most effective. However, one banking system could better serve the borrowers' total credit needs and could provide overall cost savings. Such a system could also correct other problems which we noted during our review dealing with advance payment funds, income tax law exemptions, and lines of credit.

AGENCY COMMENTS

FCA disagreed with our recommendation that the Congress require the Board to review how best to consolidate or merge the three banking systems and to prepare legislation to accomplish such a consolidation or merger. It said the recommendation was based on the unsupported conclusions that further consolidation is needed, that a one-bank system is best, and that further consolidation of banks and associations should be forced on the borrowers. It said FCA would support a recommendation to study whether, how, and when further consolidation of the banks should be undertaken and then seek legislation, if needed, to make further consolidation possible.

Our conclusion that further consolidation is needed is well-documented and supported. We based our position on two issues. The first was that banks' fundamental goals and services overlapped and resulted in a certain amount of competition when the borrowers' total credit needs should have been of utmost concern. Our examples demonstrated that the borrowers' total credit needs had to be met by both an FLBA and a PCA and raised questions about whether one association would have made the loan if the other would not participate. Consolidation would eliminate overlapping services. The second issue was that coordination of credit services had been limited. The Board has never forced this issue but has promoted one-stop credit service. Yet, only about half the associations are colocated to provide one-stop credit service even though both the Board and FCA have recognized that the activities and policies should be closely coordinated to best serve the credit needs of agriculture and borrowers. Consolidation would provide coordinated credit services.

Our conclusion that a one-bank system is best is based on discussions with both System and FCA officials. These officials said that the most obvious concept within the System would be the consolidation of the three banking systems into one, thereby benefiting both the borrowers and the system. In addition to the positions of the System and FCA officials, we identified some areas where costs could potentially be reduced. Finally, we noted that consolidation would resolve the inconsistent application of advance payment funds and income tax exemptions and reduce the need for lines of credit to support the discount note program.

Finally, FCA's interpretation that we concluded that further consolidation of banks and associations should be forced on the borrowers is erroneous. We concluded that a single banking system would work better and that now was the time for one system to replace the current three systems. We pointed out that we did not know what form or structure the one system should take in order to be most effective. The point here is not forced consolidation because, for the most part, everyone agrees that consolidation results in better service to the system borrowers. We concluded that the most complete and desirable form of consolidation is a single banking system. Consolidation, irrespective of the form it takes, does not happen overnight. Therefore, the System should be establishing it as a long-range goal now.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress require the Federal Farm Credit Board to review how best to consolidate or merge the three banking systems and to prepare legislation to accomplish such a consolidation or merger.

CHAPTER 3

THE FARM CREDIT SYSTEM MAKES LOANS

FOR QUESTIONABLE FARMING OPERATIONS

The System is increasingly serving nonagricultural needs. The Farm Credit Act of 1971 authorizes FLBs to make loans to bona fide farmers and ranchers for any agricultural purpose. However, some part-time farmer and investor-oriented loans are for nonagricultural and questionable farming operations. Also, rural housing loans, which are authorized by the act, are not directly related to farming operations and are more costly to service.

ACTIONS AFFECTING FLB LOANS

The authority for making FLB loans originated in the Federal Farm Loan Act of 1916. This legislation was updated by the present Farm Credit Act of 1971 based on a 1969-70 study of agricultural credit needs.

Federal Farm Loan Act of 1916

The Federal Farm Loan Act of 1916 restricted FLBs to making loans for the following purposes:

- --Purchasing land for agricultural uses.
- --Purchasing equipment, fertilizers, and livestock necessary for the proper and reasonable operation of the mortgaged farm.
- --Building on and improving of farmlands.
- --Liquidating the borrower's existing debt.

No loan was to be made to any person who was not about to become engaged in cultivating a mortgaged farm. Also, loans had to be secured by first mortgages on farmland.

As of January 1971, before the Farm Credit Act was enacted, the 1916 act's restrictions were for the most part still in effect. FLB lending was restricted to those engaged in or about to become engaged in farming or to those whose income was primarily from farming.

The Commission on Agricultural Credit's report

In May 1969, the Board formed a Commission on Agricultural Credit to study agriculture's credit needs. On March 26, 1970, the Commission submitted its report to the Board. One goal the Commission supported was to extend adequate credit to farmers to meet their total needs where a sound basis for such credit existed. The Commission made the following recommendations to achieve this goal:

--The term "farmer" should include anyone owning farmland or producing farm products, including part-time farmers with only limited farm income.

--In providing farm credit, the System should limit financing to individual farmers and other legal entities whose business is predominantly farming.

--The System should serve the farm and family credit needs of the part-time farmer, but such farmers should not be entitled to unlimited financing for other purposes.

--Since the System is designed to be an agricultural lender, administrative measures should be taken to assure that lending for other than agricultural purposes does not jeopardize its ability to extend agricultural credit.

--Collateral should not be the determining factor in establishing the amount of credit which may be extended to a borrower.

The Commission did not believe that part-time farmers should be entitled to unlimited financing for nonfarm purposes because providing credit to individuals who may engage in part-time farming only to obtain System services is not in the best interest of farmers or the System.

Farm Credit Act of 1971

The Farm Credit Act of 1971 authorizes FLBs to make long-term real estate mortgage loans to persons who are (1) bona fide farmers and ranchers, (2) furnishing to farmers and ranchers farm-related services directly related to their onfarm operating needs, or (3) rural homeowners. Loans made to farmers and ranchers may be for any agricultural purpose or other credit needs. The act makes similar provisions for PCAs. The act incorporated many of the Commission on Agricultural Credit's ideas but did not include the earlier restrictions that loans could not be made unless the borrower was engaged or about to become engaged in farming operations or the borrower's income was principally derived from farming.

FCA regulations

While the 1971 act specifically says that loans are to be made to bona fide farmers and ranchers, FCA's definition of a bona fide farmer and rancher is broad enough to include individuals who are not bona fide farmers and ranchers. FCA defines bona fide farmer or rancher as a person owning agricultural land, or engaged in producing agricultural products. We believe that merely owning agricultural land should not qualify a person as a farmer for the purpose of unlimited access to System credit.

FCA has established lending objectives whereby full-time, bona fide farmers receive full credit and part-time farmers receive conservative credit for agricultural purposes and restrictive credit for other purposes.

FCA position on part-time farmer and rural home loans

An FCA official told us that in accordance with the above lending objectives, FCA provides full credit, including risky loans, to bona fide farmers and more conservative loans to part-time and investment farmers. The official said, however, that the only type of loan that might not qualify would be one for agricultural land located close to a large city.

The official told us that FCA supported rural housing and farm-related business loans for nonfarmers because it opened the door on loans for part-time farmers. The official said he could foresee the System making more types of loans to a broader range of eligible applicants but did not contemplate it becoming similar to a commercial banking system or savings and loan institution.

RURAL HOUSING LOANS MADE TO NONFARMERS

The Farm Credit Act of 1971, for the first time, authorized the System to make loans to nonfarmers to purchase rural housing. Under the current act, FLBAs and PCAs are authorized to make rural housing loans without any restrictions as to whether or not the applicant is a farmer. Prior to this act, the System was authorized to make housing loans only to the population they were designed to serve--farmers.

Rural housing loan criteria

FCA, for purposes of nonfarm lending, defines rural resident as an individual residing in a rural area and defines rural residence as a single-family, moderate-priced dwelling, including appropriate appurtenances, which the applicant uses or will use as a permanent home and which is located in a rural area. According to FCA, a rural area is open country which may include any city or village with a population not exceeding 2,500 persons. Also, rural areas do not include cities, subdivisions, or villages associated with a larger population center.

Loans may be made to rural residents to buy, build, remodel, improve, and repair rural residences and to refinance existing debts on such loans. Loans cannot be made to purchase or construct a rural residence for rental or resale purposes. The total amount of credit that may be extended cannot exceed 85 percent of the residence's appraised value. According to FCA, if the System's loan funds were curtailed, agricultural loans would receive priority over rural home loans.

Rural housing loan volume

Since the act's passage, the System has made more than $1.5 billion in rural housing loans, as shown in the following table.

	FLBAs				PCAs	
	Loans made		Loans outstanding		Loans made	Loans outstanding
Year ended	Number	Amount	Number	Amount	Amount	Amount
	------(\$000 omitted)------				(000 omitted)	
6/30/72	12	$ 232	12	$ 232	$ -	$ -
6/30/73	2,081	40,658	2,059	39,942	1,705	1,473
6/30/74	8,430	192,570	10,151	223,451	4,384	4,780
6/30/75	12,702	303,631	21,783	497,139	7,242	8,096
6/30/76	5,738	133,370	25,478	574,659	5,569	10,320
6/30/77	4,957	122,124	27,858	627,652	8,187	13,372
6/30/78	6,597	188,332	31,350	733,380	11,968	18,236
6/30/79	15,886	545,579	44,457	1,198,289	16,875	24,994
Total	56,403	$1,526,496			$55,930	

Rural housing loans are made near large metropolitan areas

Although the System may be fulfilling a need for rural housing credit in some areas, it was also making numerous rural housing loans in counties having large metropolitan areas. For example, during 1978, Story County, Iowa, had the largest number of System rural housing loans in the State. The 30-mile corridor between Ames (population approximately 44,000) and Des Moines, Iowa (population approximately 250,000) is located in Story County and is highly developed. Likewise, the four Iowa counties having the next largest number of rural housing loans included metropolitan areas with populations of 54,000, 60,000, 124,000, and 127,000.

In the St. Louis district, associations with the largest numbers of rural housing loans were located near the large metropolitan areas of Little Rock, Arkansas; Memphis, Tennessee; Chicago, Illinois; St. Louis, Kansas City, and Springfield, Missouri.

We agree that making rural housing loans near large metropolitan areas is perfectly acceptable as long as the loans meet the criteria spelled out in the Farm Credit Act of 1971. On the other hand, we believe that rural housing loans made near large metropolitan areas could provide a source of credit for developers of agricultural land. This is the point opponents raised during House and Senate debates on the 1971 act; namely that credit would be diverted from farming to country houses for present city dwellers.

Rural housing loans are more costly than farm loans

Rural housing loans are more costly to service than farm loans. The higher cost occurs because of: (1) the monthly repayment plan versus the annual repayment plan normally used by farmers and (2) the additional requirements on construction loans.

FLB procedures provide for monthly, semiannual, or annual loan repayment plans. Because most rural housing loans are made to wage earners receiving weekly, biweekly, or monthly salaries, most rural housing loan repayment plans are correspondingly on the shorter monthly basis, whereas most farm loans are on an annual repayment plan to correspond with the farmers' sale of crops and/or livestock. FLB billings and the time and paperwork involved in processing monthly loan payments is greater than when the repayment is made annually.

When the loan is for constructing a rural house, some district procedures require periodic inspections to insure that the construction is in accordance with planned requirements. In addition to more inspections, most builders require periodic payments during the construction, which involve additional processing time and paperwork.

These added costs are combined with other operating costs and the cost of obtaining money in computing interest rates. Most FLBs charge rural home owners the same interest rate that they charge farmers. Thus, the farmers are also sharing the additional costs.

Not only are these nonfarmers not paying their share of the costs, they are also benefiting from reduced interest rates on their loan because FLBs are exempt from paying local, State, and Federal income taxes.

LOANS TO PART-TIME FARMERS FOR MARGINAL FARMING OPERATIONS

Recognizing the importance of off-farm income, especially to small farming operations, the System makes loans to part-time farmers. However, its loans are also made for recreational or hobby farming, where the agricultural benefit is questionable and/or marginal.

The gross annual agricultural income needed to qualify as a part-time farmer varies by district. For example, to qualify in the Omaha and St. Louis districts, $1,000 is generally required, whereas in the Louisville district, $500 is necessary. The System realizes that these figures do not represent the major portion of a typical part-time operator's income, and that such operators often locate near cities or towns which offer nonagricultural employment.

For many FLB loans classified as going to part-time farmers, the applicants' agricultural income is very small in proportion to total income. For the year ended December 31, 1978, in about 67 percent of all such loans, the operator's agricultural income was 10 percent or less of the total net income, as shown in the following table.

Percent of income from farming	Number of loans made	Percent of total loans made
-	799	6.4
0 - 10	7,506	60.4
11 - 20	1,485	11.9
21 - 30	756	6.1
31 - 40	467	3.8
41 - 50	335	2.7
51 - 60	205	1.6
61 - 70	161	1.3
71 - 80	145	1.2
81 - 90	151	1.2
91 - 100	428	3.4
Total	12,438	100.0

The following table shows details of some loans made to part-time farmers during 1978 for which the applicant had little or no farm income:

Loan amount	Number of acres operated	Net income		Percent of net income from farming
		Farm	Nonfarm	
$ 73,900	40	$300	$40,000	0.7
32,000	7	100	45,500	0.2
56,100	10	200	34,700	0.6
53,500	1	150	33,000	0.5
25,000	20	10	22,000	0.04
26,400	8	-	13,800	0.00
116,000	36	-375	59,700	0.00
100,000	20	200	38,000	0.5
37,500	5	150	41,000	0.4
113,500	13	500	60,000	0.8

We believe that part-time farming operations in which the operator has little or no farm income and operates on a very small tract of land are of marginal, if any, benefit to agriculture. These operators produce few, if any, farm products, apparently devote much of their time to nonfarming employment, and their production is restricted by the amount of land they farm. As shown on the previous page, one FLBA loan for $53,500 was for 1 acre of land and is producing $150 in net farm income. This individual can produce very little on 1 acre and, due to the size of the tract, cannot expand operations to pay off the debt.

Further examples of five loans made to part-time farmers during 1978 follow:

--An FLBA approved a loan of about $100,000 to purchase 5 acres, including 3 acres of pasture and about 2 acres for buildings. FLBA appraised a house on the property at $100,000. The applicant and his spouse were employed in nonfarming occupations and had a combined annual salary of about $45,000. The applicants' net farm income was $500, and they used the pasture for nonagricultural purposes. The loan file indicated that the applicant was going to feed some cattle on the property, thereby meeting the requirement for income from the property. The property is located approximately 8 miles from a large city. FLBA rated the property very high due to its condition and its closeness to a large metropolitan area.

--An FLBA approved a loan of about $100,000 to refinance a loan for approximately 90 acres of land. The applicant rents the cropland and does some pleasure farming. His projected annual agricultural gross income is over $7,500, with net income of only $500. This net farm income is not sufficient to make the annual payment.

--An FLBA approved a loan for about $100,000 to refinance a loan for over 30 acres of land, which included the applicant's house, a tenant house, a summer cottage, and three barns. The applicant has a nonagricultural job at an annual salary of $32,000. The applicant and his spouse raise horses and rent land which provides them an annual income of about $10,500. FLBA records showed that "knowing this is high risk business and loan, plus last 2 years 1040's showed a loss, I still have approved this loan." The annual payment exceeded $9,500.

--An FLBA approved a loan for about $25,000 to purchase 165 acres of land. The property had no house. The applicant works in private industry at an annual salary of $36,500. He lives and works in a large metropolitan area in a neighboring State about 75 miles from the farm. His projected net agricultural income is less than $1,500 and is not sufficient to make the annual loan payment.

--An FLBA approved a loan for about $20,000 to refinance a previous FLBA loan and to build a new barn. The applicant works in private industry and the spouse works outside of agriculture. Their combined annual salary is about $25,000. The applicant lives on 7 acres which is producing $250 gross farm income. The loan files show the principal farm product as cattle, yet the applicant shows no cattle listed in his financial statements. The farm income is not sufficient to make the annual loan payment.

INVESTOR-ORIENTED LOANS FOR NONAGRICULTURAL PURPOSES

The System makes loans classified as investor-oriented loans for nonagricultural purposes. Investor-oriented farmers and ranchers are defined in some district regulations as individuals or entities whose primary occupation involves nonagricultural ventures. Although the System does not maintain statistics on the volume of investor-oriented loans, we found examples of such loans as follows:

--An FLBA approved a loan for over $300,000 to refinance an earlier FLBA loan and to make improvements. The applicant is co-owner, with his wife, of a business. Their annual income from the business and from dividends and interest was about $75,000. The loan file showed that the applicants operate an animal farm with hired labor. Further, the file showed that the "entire farming and livestock enterprises generate substantial losses which are used to offset high nonfarm income." The loan records also showed that in 1976 they had a gross farm income of about $8,000 and total expenses of $73,000. FLBA classified this loan as an "investor managing operation."

--An FLBA approved a loan for about $60,000 to purchase 80 acres of land. The applicant is retired and receives an annual pension of $42,000. He lives in another State, which is over 1,000 miles from the farm and is employed as a consultant. His annual income from salary, interest, and dividends is over $70,000. The applicant's net farm income represented .3 percent of his total income. The farm he purchased is handled by a farm management firm. FLBA classified this as an investor loan.

--During September 1978, an FLBA approved a loan for over $42,000 to purchase a rental property in a large metropolitan area. The security was 160 acres of inherited land in another State, located over 200 miles from the applicant's place of business and home. The applicant rents the 160 acres for over $5,000 a year. The applicant works in private industry with an annual salary of almost $16,000. The loan file showed that the purpose of the loan was to purchase house rental property, and FLBA classified the applicant as a "#1 investor." In November 1978, FLBA approved another loan to this same individual to purchase a commercial building near the metropolitan area, consisting of a cafe and warehouse. Again the applicant used the inherited 160 acres as security and again FLBA classified him as a "#1 investor."

System district policy provides two classes of investor-oriented loans: number 1 investor-oriented loans are made to farmers and ranchers actively involved in the day-to-day farm management, and number 2 investor-oriented loans are made to farmers and ranchers passively involved in managing and operating agricultural enterprises. We believe that since the applicant is living and working over 200 miles from the security property and rents the land for others to farm, he qualifies as a number 2 investor rather than number 1. Number 2 investor loans, however, are contrary to this district's policy, which provides that loan funds may be used only for agricultural purposes.

--An FLBA approved a loan for about $4,500 to purchase a store in a town of over 12,000 inhabitants. The FLBA president stated that the loan was secured by 80 acres of land. The applicant's wife wanted to buy into an existing partnership in the store. According to the loan file, she did not plan to sell products produced on their existing farm. The loan officer put the following statement in the loan file: "I gave no consideration to income from (store) as I feel it is strictly a risk venture and counseled applicant accordingly." The loan file stated that this was a 5-year, semiannual decreasing payment plan because it was for nonfarm purposes, and it fit the applicants' cash flow.

Since the applicant is actively involved in farming operations, this loan qualified as a number 1 investor-oriented loan. System district policy provides that such loan proceeds shall be used primarily for agricultural purposes. The proceeds from this loan were not used for agricultural purposes.

--An FLBA approved a loan for about $55,000 to purchase a new home in a large eastern metropolitan area. The applicant, a government employee, used his midwestern farmland as security for the loan. The loan file showed that this was an investor-oriented loan.

CONCLUSIONS

The System was established to serve agriculture but is increasingly serving nonagricultural needs. Some part-time farmer and investor-oriented loans are for nonagricultural and questionable farming operations. Also, rural housing loans, which are authorized by the act, are not directly related to farming operations, are more costly to service, and have the potential to provide credit to develop agricultural land for nonagricultural purposes. Processing and administering these types of loans add to the operating costs of the System. These added costs are reflected in the interest rates which bona fide farmers must pay to obtain credit.

AGENCY COMMENTS

FCA did not agree with our recommendation that the Board (1) issue regulations to the district banks requiring them to charge nonfarmers interest rates which cover the additional costs of making rural housing loans, (2) clarify FCA's regulations to insure that loans are made to individuals who are bona fide farmers or ranchers and that the loan is primarily an agricultural loan, and (3) amend FCA's regulations to preclude the System from making nonagricultural loans to investor-oriented individuals.

Regarding the first recommendation, FCA said we did not demonstrate that rural housing loans were significantly more costly to make and administer. It is true that we did not determine the cost difference involved in processing rural housing loans as opposed to agricultural loans. Instead, we pointed to two administrative differences involved with servicing rural housing loans that usually are not involved with servicing agricultural loans. We said these differences--monthly repayment plans and construction inspections--make rural housing loans more costly to service than agricultural loans. FCA pointed out that some banks already do charge different rates for rural housing loans; however, at the time of our review, only 5 of the 12 banks were doing so. The point to keep in mind here is that rural housing loans were authorized to benefit nonfarmers for nonfarming operations, even though the System was established to serve agriculture. Therefore, we believe that the interest rates for rural housing loans should reflect the added servicing costs.

The second and third recommendations were also not agreeable to FCA. It said its regulations provide for full credit to bona fide farmers and for increasingly conservative credit as the emphasis moves away from the full-time farmer, to the point where agriculture needs only will be financed for the applicant whose business is essentially other than farming. FCA said that its regulations indicate that credit is not to be extended where investment in agriculture is primarily for speculation. FCA further says that our report does not recognize the important changes that are occurring in agriculture as regards the importance of the part-time farmer and the absentee farmowner and "appears to conclude that 'eligibility' should be decided solely on the 'purpose' of the loan."

We do not concur with FCA's overall assessment. We agree that the part-time farmer and the absentee farmowner are important in agriculture today. We did not conclude that eligibility should be decided solely on the purpose of the loan. We believe that eligibility should also be based on whether or not applicants are or are not bona fide farmers, irrespective of whether or not they farm on a full-time or part-time basis. We also agree with FCA's regulations which allow full credit for bona fide farmers, conservative credit as the emphasis moves away from the full-time farmer, and credit for agricultural needs only for the applicant whose business is essentially other than farming.

In our opinion, the examples we use in the report raise two very basic questions. One question is whether or not the loan applicant was really a bona fide farmer. The second question is whether or not the loan was really an agricultural loan. In our examples, we believe the part-time farmer and investor-oriented loans were for nonagricultural and questionable farming operations. While the applicants met FCA's very broad definition of a bona fide farmer, there was no evidence that FCA applied its own regulations of providing conservative credit as the emphasis moves away from the full-time farmer and credit for agricultural needs only for the applicant whose business is essentially other than farming.

RECOMMENDATIONS TO THE FEDERAL FARM CREDIT BOARD

We recommend that the Federal Farm Credit Board:

--Issue regulations to the district banks requiring them to charge nonfarmers interest rates which reflect the additional costs of making rural housing loans.

--Clarify FCA's regulations to insure that loans are made to individuals who are bona fide farmers or ranchers and that loans are primarily for agricultural purposes.

--Amend FCA's regulations to preclude the System from making nonagricultural loans to investor-oriented individuals.

CHAPTER 4

FCA'S SUPERVISORY EFFORTS

ARE NOT ALWAYS SUCCESSFUL

FCA is responsible for seeing that System banks and associations are operated and managed in accordance with sound business practices. FCA's supervisory efforts, except in the Louisville district, have generally resulted in improved bank operations. While it is difficult to quantify the effectiveness of FCA's efforts, we believe that they were a motivating force in correcting problems in the Omaha and St. Louis FICBs. FCA considered these banks "high" concern banks, requiring maximum supervision. At the request of the respective district boards, FCA conducted special reviews to identify bank problems and reported its findings to the boards. In both cases, the district boards, working with bank management, improved the situation.

In the Louisville district, however, a different situation existed. FCA had identified the same problems over the last three annual examinations in both the FLB and FICB. Yet, FCA's efforts to correct these problems had been unsuccessful and it believed that the situation was deteriorating even further. As in Omaha and St. Louis, FCA conducted a special review of the banks and presented its findings to the district board. The board, however, had not moved management to implement any changes. FCA had planned stronger supervisory action to improve the banks, including a complete takeover of the banks' operations. However, FCA abandoned that action because it believes the situation has improved.

FCA'S SUPERVISION PHILOSOPHY

The Farm Credit Act of 1971 gave FCA broad supervisory authority over the System. FCA's objective is to have the directors and executive officers of the System's institutions use sound business practices for operating a decentralized credit system. Supervision is provided to protect the investing and borrowing public. FCA's basic supervisory functions are

--identifying a bank's problems or weaknesses,

--identifying the causes of the problems or weaknesses,

--determining the significance and interdependence of the causes,

--determining how to eliminate the causes and who should act--bank executive officers or the board of directors, and

--designing a program to determine the degree to which the causes and problems are being addressed.

FCA holds the board of directors and executive officers in each bank accountable for satisfactory bank operations, including the supervision of associations. The board must direct bank management in general business practices and the banks must supervise and maintain accountability over the associations.

Supervising the System is the combined responsibility of all FCA offices. The Office of Supervision, however, is responsible for supervising bank operations in most areas. Supervision consists of (1) monitoring System operations--through the FCA Office of Examination's annual report, formal and informal communications, and visits to the banks--to evaluate performance, (2) documenting all findings in a composite resource file, and (3) supervising as necessary to achieve and maintain improvements. Under the System, supervisory efforts are primarily directed at the institutions with the greatest weaknesses.

FCA's primary supervisory method is its power of persuasion through formal and informal communication with a bank's executive officers and board of directors. This communication ranges from FCA supervisory personnel offering advice and counsel to bank staff and officers to the annual supervisory report to the bank's board of directors. This supervisory report evaluates the bank's strengths and weaknesses, providing a balanced overview of the operations. The report also designates whether the bank requires high-, medium-, or low-level supervision during the next year. This is a subjective rating based on FCA's review and experience. This rating lets the district board of directors know FCA's opinion on the bank's effectiveness and the level of effort FCA will exert to improve the bank's condition.

The Farm Credit Act of 1971 provides for more drastic supervisory actions if they become necessary. These actions include FCA approval of bank loans; FCA approval of the bank president's salary; and, according to FCA's interpretation, FCA authority to take over a bank's operations. According to FCA, this type of strategy brings attention to the problem and strong bank resistance and should be considered only as a last resort. The most successful supervision is that which accomplishes the desired aims with the least amount of bitterness and exposure.

SUPERVISORY EFFORTS AT SIX SYSTEM BANKS

Our review of FCA's supervisory efforts in the FICBs and FLBs in the Omaha, St. Louis, and Louisville districts showed that FCA's normal supervisory methods can either be effective and result in corrections or unsuccessful and result in little or no improvement. In the latter case, FCA needs to use stronger supervisory methods. FCA's supervision of these six banks is described below.

Omaha FLB

According to FCA, the Omaha FLB has been a well-run bank. The last three FCA supervisory reports have classified it as a low-concern bank requiring only minimal FCA supervision. FCA found the bank's credit quality, credit administration, and association supervision over the last 3 years to be satisfactory. FCA noted several minor areas where improvements could be made, but found no major problems.

As of December 31, 1978, the Omaha FLB was the largest land bank in the System with outstanding loans of about $3.1 billion. During the past 6 years, its outstanding loan volume has tripled. It supervises 40 FLBAs serving Nebraska, Iowa, South Dakota, and Wyoming.

According to FCA, the bank's effective operation is due to (1) adequate overall policy, direction, and philosophy provided by the district board of directors and (2) bank executive officers and staff effectively working together and administering board policies. FCA stated that the bank is constantly looking for ways to improve and it welcomes FCA's suggestions.

Omaha FICB

In 1978, FCA removed the Omaha FICB from the high-concern category and reclassified it a medium-concern bank. According to FCA, the bank had allowed PCAs to operate so independently that they were beyond the bank's supervision. The bank's lack of effective PCA supervision resulted in ineffective bank personnel and no real leadership or discipline. The PCA's liberal lending philosophy and deteriorating credit practices resulted in heavy losses in 1974 and 1975. Now, however, improvements are being made in the bank's operation.

As of December 31, 1978, the Omaha FICB had outstanding loans of $1.4 billion with PCAs and $86 million with other financial institutions. The Omaha FICB supervises 40 PCAs in the same four States as the Omaha FLB.

FCA made a special management review in May 1975 and reported its findings to the bank president and the district board of directors. FCA pointed out several problems including (1) ineffective supervision of associations, (2) poor communication between bank management and the board, (3) unsound credit practices, and (4) too much independence for associations. FCA made recommendations to the bank president that would enable these problems to be corrected.

The examination and supervisory reports for 1976, 1977, and 1978--all completed after FCA's special review--again discussed many of these same problems. In the 1976 report, only two-thirds of the loan volume was considered to be of acceptable quality. The bank was continuing to incur large loan losses and its supervision of PCAs continued to be weak. The bank was classified a high-concern bank at that time.

The 1977 reports indicated that the same problems were still evident. Overall credit quality continued to deteriorate and credit administration was still poor. Supervision of PCAs, however, appeared to improve. The bank was still considered a high-concern bank.

The 1978 reports, however, indicated that progress had been made. Credit quality, while not improving significantly, had stabilized. Credit administration and supervision of PCAs showed improvement with more improvement still needed. FCA changed the bank's classification from high to medium concern, citing the substantial effort and many improvements made in board direction, management response, and improved administration and organization throughout the district. FCA emphasized, however, that supervision efforts and PCA credit standards and/or lending practices still needed improvement.

St. Louis FLB

According to FCA, the St. Louis FLB has been a well-run bank. FCA classified it as a low-concern bank for all 3 years we reviewed. It kept this low-concern rating in the 1979 supervisory report. Credit quality, credit administration, and association supervision during this period were all satisfactory.

As of December 31, 1978, the bank had outstanding loans of $2.7 billion. The bank experienced an 18.6-percent increase in loan volume from 1977. The bank supervises 41 FLBAs in Illinois, Missouri, and Arkansas.

In its 1978 supervisory program for the bank, FCA pointed out some areas in the bank's internal operations that needed improvement, but generally found that sound and effective management existed. FCA concluded in its 1979 supervisory report to the bank's board of directors that, based on the strong leadership provided by the bank president and the bank's overall performance, only a minimum level of FCA supervision was necessary.

St. Louis FICB

The St. Louis FICB has been experiencing problems. Through the combined efforts of FCA, the district board, and bank management, however, the bank's operation is beginning to improve.

As of December 31, 1978, the St. Louis FICB had outstanding loans totaling $1 billion with PCAs, $17 million with other financial institutions, and $3 million in participation loans with PCAs. The St. Louis FICB supervises 44 PCAs in Arkansas, Missouri, and Illinois.

For several years, FCA's supervisory reports to the district board expressed concern about the bank's lack of a comprehensive PCA supervision program. FCA, in its 1976 supervisory report, found that credit quality and credit administration had deteriorated. Following this, the board requested that FCA further review the bank's administration. FCA concluded in its special August 1976 report that the bank had failed to supervise the PCAs properly and top bank management either did not perceive the supervisory problems within the district or did not have the management capacity to face the responsibility which supervisory discipline imposes. FCA recommended in its report that the district board employ a chief executive officer with the management capacity and administrative objectivity to provide PCA supervision and bank leadership. It also recommended that the board reevaluate its policy regarding supervision to insure full support for a positive association supervision program. At about the same time that FCA presented its report to the district board, the bank president resigned.

FCA objected to the board's choice of a new bank president. This led to a confrontation between the district board and FCA. FCA did not believe the bank's candidate was suited for the position and refused to approve his salary. In effect, FCA disapproved the board's selection. However, after several months, FCA acquiesced and in January 1978 approved the salary with the stipulation that the board and FCA would monitor and evaluate the president's and bank's progress during the year and at the end of the year, decide if the president should continue.

Although FCA's 1978 supervisory report classified the bank a high-concern bank, it indicated that bank operations were improving. The report found that credit quality was unfavorable in some PCAs but was improved districtwide and found that weaknesses still existed in credit administration. As a result, the bank created a new department responsible for supervising PCAs. Although it was too early to evaluate its effectiveness, the report stated that "early signs are encouraging." The supervisory plan for 1978 concentrated on monitoring further bank progress in PCA supervision and credit administration.

Louisville FLB

Presently, the Louisville FLB, along with the Louisville FICB, probably offers the greatest challenge to FCA. The land bank has severe problems with deteriorating credit quality, weak credit administration, and ineffective supervision of FLBAs. To date, FCA's efforts have failed to correct these problems.

As of December 31, 1978, the FLB had outstanding loans of $2.8 billion, an 18-percent increase over the previous year. The bank supervises 66 FLBAs in Indiana, Kentucky, Ohio, and Tennessee.

In January 1979, FCA presented a report to the Louisville district board of directors outlining the major problems which had to be addressed. The report stated that:

--No clear understanding existed as to the responsibilities of the bank board, the bank's chief executive officer, the senior officers, association boards, and association management.

--Credit administration was weak because bank personnel lacked the technical and managerial capability needed in a decentralized operation. Credit quality was deteriorating.

--Supervision of FLBAs was ineffective, causing major bank weaknesses.

--Personnel problems existed because bank management and staff did not understand the role of bank supervision in the district.

The report also pointed out that FCA efforts had failed to produce improvements.

We believe FCA misjudged the seriousness of the bank's problems. In late 1976, the FLB president requested FCA to conduct an overall review of bank management and operations. In May 1977, FCA reported its findings to the president which, for the most part, were the same as those mentioned in the 1979 report. Just before the management audit report findings, FCA, in its February 1977 report to the district board of directors, had classified this a low-concern bank. However, in the following supervisory report submitted to the board on March 15, 1978, after the management audit, the bank was designated as a high-concern bank.

FCA met with the district board on March 29, 1978. At that time, FCA informed the board that until it established appropriate policy direction and acted to insure that management carried out that policy direction, FCA could do little to bring about any change in the bank's operation. Thus, FCA's 1978 supervisory program was to do nothing unless the problems multiplied, necessitating a conservator role.

The 1979 supervisory report to the district board stated that bank operations had not improved over the previous year. The board, however, had dismissed the bank president in January 1979.

At the time of our review, FCA was considering the strongest supervisory action it had ever taken--taking over bank operations. FCA had never attempted such a supervisory action and said a court test could result of whether it has the authority to take such action.

Louisville FICB

The Louisville FICB has serious problems and requires a high degree of FCA supervision and attention. This bank has many of the same problems as the FLB--deteriorating credit quality, weak credit administration, and poor supervision of the PCAs. Here again, FCA supervision has not resulted in improvement.

The Louisville district is the largest in the FICB system in terms of loan volume. As of December 31, 1978, the Louisville FICB had $2.5 billion in outstanding loans with PCAs and $9 million in outstanding loans with other financial institutions. The bank supervises 39 PCAs in Indiana, Kentucky, Ohio, and Tennessee.

The 1979 FCA report to the Louisville district board discussed the following FICB problems.

--Although credit quality was still at an acceptable level, adverse trends in several areas could seriously affect the quality of credit service to borrowers.

--Serious weaknesses existed in credit administration including (1) inadequate financial information, (2) inadequate analysis of financial information, and (3) inadequate controls over amount of credit extended.

--Loans were being made which represented willful disregard of legislative intent by lending to individuals who are substantially less than full-time farmers for clearly speculative purposes and by using an individual's minimal involvement in agriculture as a basis for financing nonagricultural business ventures.

--Supervision of associations over the past several years has been ineffective.

--Lack of capable key bank officers, the inability to change philosophical direction, and political infighting within the bank have and will continue to hamper improvement.

These problems were not new to FCA or the bank. Most of them had been identified in a 1976 management audit report or in previous FCA examinations. FCA, in its 1976 supervisory report had classified the Louisville FICB as a medium-concern bank. The 1977 supervisory report, prepared after the management audit, reclassified the bank as a high-concern bank due to (1) an unsatisfactory administrative structure and management system, (2) lack of a cohesive bank/PCA relationship, (3) a new bank president, and (4) the adverse trend in credit quality. In the 1978 supervisory report the high-concern classification was continued. FCA cited the board's failure to provide the leadership, direction, and support demanded by the conditions within the district; growing inadequacies in association credit and administrative operations; and inability of the board and management to address association supervisory problems constructively.

FCA's efforts for 1978 were designed to help the bank develop a monitoring and supervisory process that (1) properly identified performance of associations, (2) compared that performance with district policies and standards, (3) communicated that performance to the associations and the district board, and (4) constructed and implemented plans for improving the PCAs. At the time of our review, not much progress had been made and FCA was considering stronger supervisory action--taking over this bank along with the Louisville FLB.

FCA actions in Louisville

FCA, in April 1979, presented to the Board two options designed to halt further deterioration and initiate corrective action in the Louisville district. The options under consideration were as follows.

--If the district board has not accepted the seriousness of the situation and thus does not intend to take any action, or if the board has accepted the seriousness of the situation but believes it has longer to act than it actually does, FCA will assume direct control over certain authorities of the district board and bank management. FCA would in effect be running and making policy for the banks.

--If the board has accepted the seriousness of the situation but does not know how to correct the problems, FCA may enter into a memorandum of understanding with the board which would grant to FCA all authorities normally granted to a bank president. The board would retain policy approval authority and authority to remove an association's board of directors. However, should the district board default on any provision of this agreement, full FCA authority to take over district operations could be exercised.

Unless the district took positive action before the Board meeting in June 1979, one of the options was to be implemented. The length of the FCA commitment in the district would depend on the district board. The board had to demonstrate a commitment to change; the employment of new bank presidents and a significant restaffing in both banks was required before authorities assumed by FCA would be restored.

After the Board meeting in June 1979, FCA informally agreed to give the FLB and the FICB up to 4 months and 12 months, respectively, to hire new executive officers. The effect of this agreement was to postpone the two options until the 4 months and 12 months were up or until FCA revoked the agreement. In October 1979, FCA told us that it no longer had the two options under consideration. It said that changes which have taken place or which are in process of taking place with regard to top FLB and FICB bank management are the major reasons for this change in their position.

CONCLUSIONS

Our review showed that FCA's supervisory efforts are not always successful. Successful supervision of System banks depends on various factors. Supervision is more likely to be successful where FCA is dealing with capable bank executive officers and staff and/or with effective boards of directors which are receptive to constructive criticism and will implement needed changes. Even if only one of these factors is present, FCA supervision can be successful in getting improvements. If, however, both factors are missing, the traditional FCA supervisory methods of persuasion and interaction with the board and management are much less effective.

Our review of FCA's supervisory efforts showed that the St. Louis and Omaha FLBs were traditionally well-run banks and required minimum supervision. The St. Louis and Omaha FICBs had or were having serious problems. These banks, under FCA's normal procedures--persuasion and working with bank management and the district board--have improved significantly. While determining the effect of FCA's effort is difficult, we believe that FCA supervision was in part responsible for these improvements.

In the Louisville FLB and FICB, however, FCA supervisory efforts have not been successful. According to FCA, both banks suffered from weak bank management and staff and the district board of directors' inability or unwillingness to provide effective guidance and leadership to the banks. We believe, however, that FCA is also at fault for the situation in the Louisville district. FCA misjudged the seriousness of the problems in this district. As a result, supervisory action was not taken as soon as it should have been. The problems that existed in Louisville at the time of our review were basically the same ones that existed 3 or 4 years ago. They intensified to the point, however, that FCA considered more drastic supervisory measures--taking over the operation of one or both of the banks. However, FCA now believes the situation in Louisville has improved.

We believe that any improvement in the Louisville FLB and FICB could be attributed to FCA's plan to take over the operation of those banks. While FCA believes such authority is implied in the Farm Credit Act of 1971, it also thought such an action could be challenged in court, thereby further delaying corrective action in System banks. We believe this authority should be specifically included in the Farm Credit Act of 1971.

AGENCY COMMENTS

FCA questions our recommendation that the Governor of FCA seek legislation to amend the Farm Credit Act of 1971 to specifically provide FCA authority to take over the operation of a district board and/or bank when normal supervisory efforts fail to obtain needed corrective action. It maintains it has not had a need for such specific additional legislative authority.

We disagree with FCA's assessment of its need for stronger tools to deal with problem situations in banks. Stronger supervisory action on the part of FCA in the Louisville banks could have turned that situation around. Instead the last three annual examinations of those banks have identified the same problems. FCA also believed that this situation was deteriorating further.

FCA pointed out that at no time were the banks in financial difficulty and were always able to meet the credit needs of their borrowers. Yet, in its supervisory reports, FCA stated that the FLB and FICB had severe problems with deteriorating credit quality, weak credit administration, and ineffective supervision of associations. We believe all three problems, if left uncorrected for long periods of time, could lead to financial difficulty for the banks.

FCA, at the time of our review, was considering the most drastic action it had ever taken. This included taking over the operation of one or both district banks. FCA thought this authority was implied in the Farm Credit Act of 1971. We believe there should be no room for doubt when such authority has to be used to deal with Louisville-type situations. Therefore, such authority should be specifically included in amendments to the Farm Credit Act of 1971.

RECOMMENDATION TO THE GOVERNOR OF FCA

We recommend that the Governor of FCA request that the Congress amend the Farm Credit Act of 1971 to specifically provide FCA authority to take over the operation of a district board and/or bank when normal supervisory efforts fail to obtain needed corrective action.

Farm Credit Administration

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(202) 755-2195

October 12, 1979

Mr. Henry Eschwege, Director
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

We appreciate the opportunity to comment on the draft report entitled "The Farm Credit System: Some Opportunities for Improvement."

We have concern that the report in some respects does not give evidence of a good understanding of the functioning of the cooperative Farm Credit System. We are also concerned that some of the conclusions are not supported by appropriate study or by the discussions in the report. The basis for these concerns is evident in our comments on the report.

Our comments on some of the significant GAO conclusions and on the recommendations follow. To keep this letter brief, our other significant comments are in an attachment which we request be considered a part of our overall comments and included along with this letter as an appendix to the final report. Numerous other detailed comments previously provided in writing to the GAO staff are not repeated in this letter or in the attachment, but are also still applicable.

Corporate Consolidation

The GAO conclusion that the "FCS Future is One Consolidated Bank" does not fully consider how the three banking Systems evolved; does not recognize the grassroot support for decentralized operating entities that are responsive to the specialized needs of agriculture; and seems to ignore the cooperative nature of the business whereby individual farmers and their cooperatives support the local banks and associations through the mutual interest of its active members. If a forced "one consolidated bank" were imposed upon the membership with, as GAO suggests, elimination of the local association boards who are elected by the borrowers, much of the local support would diminish.

FCA acknowledges that whenever cost efficiencies and improved service are apparent, merger of associations or territorial adjustments should be made to effect better services to the agricultural community. This is substantiated by the fact that 22 PCAs and 118 FLBAs have been merged with like associatons in the past 10 years. FCA and the supervisory banks are constantly screening associations' operating costs and field patterns to determine how the individual farmers can be better served. In addition, as your report states, joint bank and association operations are used when cost savings can be accomplished.

FCA does not dispute the premise that further consolidation of the banks and associations may be in the best interests of System borrowers. However, we believe that past progress should be recognized in the report as well as the need for the support of the member-owners to further combine the System entities in the future. The members will, we believe, support further consolidation if significant advantages to them become obvious. The GAO report does not make such advantages obvious. The consolidation advantages claimed by GAO concerning advance loan payments, taxes, and lines of credit are not advantages at all.

FCA disagrees with the GAO conclusions that the "FCS Future Is One Consolidated Bank" and that "this is the time" for such consolidation because GAO has not documented this as a workable or viable alternative to the present organizational structure. FCA agrees, however, that the System and FCA should continue to review the System structure and seek consolidation when improved service to farmers is possible.

The GAO chapter 2 recommendation regarding consolidation is not agreeable to FCA because it is based on the unsupported conclusions that further consolidation is needed, that a one bank system is best, and that futher consolidation of banks and associations should be forced on the borrowers. FCA would support a recommendation that it study whether, how and when further consolidation of the banks should be undertaken and then seek legislation, if needed to make further consolidation possible.

FCS *Lending Objectives*

The GAO report states that rural housing loans are being made in counties having large metropolitan areas. The Farm Credit Act of 1971 authorized the Farm Credit System to make rural housing loans on a single-family, owner-occupied, moderately priced dwellings. This new authority limited the financing of rural housing to open areas which are undeveloped for housing and still devoted to agricultural use. Applicants for rural housing loans rely upon dependable employment and, therefore, the demand for these types of loans is greater near the stable employment centers.

The GAO report states that "rural housing loans are administratively more costly to service than farm loans," because of the monthly repayment schedules involved and the additional requirements on construction loans. While most rural housing loans are on a monthly or quarterly repayment basis, many agricultural loans have similar repayment schedules. This is particularly true where the farmer's income flow is realized throughout the year, such as on dairy and poultry operations and on thoses where a member of the family has off-farm income. System rural housing loans are made for the construction or remodeling of dwellings, but so are many farm loans made for construction or improvement programs, such as farm dwellings, barns, dairy buildings, land levelings, and for irrigation pipelines and wells. Therefore, the administrative costs for rural housing and farm construction type loans have similarities and the differences in costs, if any, may not be significant.

FCA does not agree with GAO's first recommendation in chapter 3, that FCA Regulations be issued to require district banks to charge nonfarmers interest rates which cover the additional costs of making rural housing loans. As discussed above, GAO has not demonstrated that rural housing loans are significantly more costly to make and administer. Also, the banks can charge and some already do charge differential rates for rural housing loans. The farmer member/borrowers can, if they wish, bring about differential rates for rural housing in the banks through their bank's board of directors whom they elect.

FCA also does not agree with GAO's second and third recommendations in chapter 3, to clarify regulations pertaining to bona fide farmers and to prevent nonagricultural loans to investor-oriented individuals. The FCA regulations (Reg. 613.3020 and 614.4160) already prevent nonagricultural loans to investor-oriented individuals and the regulations pertaining to less than full-time farmers are clear and adequate.

The regulations provide for full credit to bona fide farmers (farming is a primary vocation) and for increasingly conservative credit as the emphasis moves away from the full-time farmer, to the point where agriculture needs only will be financed for the applicant whose business is essentially other than farming.

Regulations indicate that credit is not to be extended where investment in agricultural assets is primarily for speculation. Under the decentralized operations of the System it is recognized that a few loans might be made that are not within the intent of the System's lending objectives. That is a risk of decentralized operations. We believe our monitoring and accountability systems keep the risk within reasonable bounds.

The GAO report does not recognize the important changes that are occurring in agriculture, particularly the role and extent of absentee farm owners and the importance of part-time farmers. For example, at least 44 percent of all principal farm operators have employment off the farm, and in 1974 part owners and tenant farmers with sales of agricultural products of $2,500 or more produced 62 percent of the total sales of farm products from commercial farms. The Farm Credit Act of 1955 specifically authorized the making of loans to part-time farmers, and this authority carried forward to the Farm Credit Act of 1971.

The GAO report appears to conclude that "eligibility" should be decided solely on the "purpose" of the loan. If this is true, we disagree. Farmers whose livelihood is primarily agriculture should receive full consideration for all reasonable credit needs. Conversely, less than full-time farmers should be able to use equity in agriculture assets for credit needs other than agricultural.

Supervision of the System

The report concludes that FCA's supervisory efforts are not always successful and discusses the "successful" supervisory efforts in several banks and the as yet unsuccessful efforts in two banks -- the Federal Land Bank of Louisville and the Federal Intermediate Credit Bank of Louisville. We agree that supervisory efforts have not been fully successful in the two Louisville district banks, but the report should note that substantial progress had been made to improve the personnel in high management positions in those two banks and to make the district board more aware of its responsibility to bring about the improvements needed in the banks. The report also fails to recognize the important facts that the Louisville district banks were not and are not in any way in financial difficulty and that the banks and associations have met and are meeting the credit needs of their borrowers. The weaknesses were in management.

GAO recommends that the Governor of FCA seek legislation to amend the Farm Credit Act of 1971 to specifically provide FCA authority to take over the operation of a district board and/or bank when normal supervisory efforts fail to obtain needed corrective action. To date, FCA has not had a need for such specific additional legislative authority. A more appropriate GAO conclusion would be that an appropriate study should be made of existing legislative authorities to determine their adequacy.

Sincerely,

Donald E Wilkinson

Donald E. Wilkinson
Governor

Attachment

ADDITIONAL COMMENTS ON GAO REPORT

Consolidation Needed Because of Overlapping Authority (pp. 11-14)

The report is incorrect when it says (p. 14) that borrowers' total needs aren't being satisfied and implies (p. 14) that only consolidation will achieve better coordination. The report does not give support for these conclusions. The report also does not clarify why in some instances competition is not consistent with meeting the objectives of the 1971 Act. Competition can result in inefficiency through wasted efforts, but it can also be a factor in helping ensure that agriculture credit needs are met. The report needs to recognize these factors. It also needs to give recognition to the fact that credit structuring and tailoring is a reason PCAs and FLBAs have made loans for the same purpose. The FLBA lien requirements and PCA collateral requirements and the loan terms and repayments may be quite different even though the purpose of the loan is the same. The report should further note that a one-bank concept would not prevent FCS borrowers from wanting to get loan funds from commercial banks, life insurance companies and other lenders.

[GAO COMMENT: The report on page 14 states that a single banking system could result in better services to the borrower by satisfying his or her total credit needs. It goes on to state that two banks competing with each other and financing the same needs seems inefficient. The examples demonstrate that the applicants' financing had to come from an FLBA and a PCA. One consolidated bank could provide total financing and eliminate these inefficiencies. We believe the report is correct on these matters.]

FCA Officials Don't Know The Tax Exemption Bases For FCS Institutions

The statement (p. 9) should be deleted because it does not pertain to the discussion in the rest of the paragraph and is not correct. The tax exemption applies to the FLBs, FLBAs and FICBs because, unlike other institutional lenders, these institutions were conducting a Federal program operating under certain legal obligations and restrictions imposed by the Congress to ensure adequate credit to eligible borrowers. The statute requires 50 percent of FLB earnings and 10 percent of FLBA earning to be permanently retained in the capital structure. They are not available to stockholders, therefore, they are similar to a tax burden on System earnings. These matters were discussed in a letter from the Governor of FCA to a congressional committee.

[GAO COMMENT: The report on page 9 states that FCA officials do not know the basis for excluding PCAs and BCs from the income tax law exemption. The FCA goes to great lengths to explain the basis for exempting FLBs, FLBAs, and FICBs but does not explain why these institutions are exempt and PCAs and BCs are not.]

President Not Reappointed

The example on page 12 of a bank president who was not reappointed is not a good example. The president of the bank referred to was not reappointed by the board because his overall management of the bank and its supervision of the associations was not at an acceptable professional level. His departure can not be tied to the new type credit service. The example should be deleted.

[GAO COMMENT: We concur and have deleted the statement, "The new board, in turn, did not reappoint one of the presidents who had been very supportive of implementing this new type credit service."]

Joint or Adjacent Housing

The extensive discussion of this subject (pp. 15-19) implies that there is or may be disagreement on the advantages generally available from joint housing. FCA does not disagree. Also, there is no connection between one-stop service and GAO's opinion that bank branches can replace associations and there is nothing in the report to explain why branches might be better. Suggest cutting the report discussion back to 2-3 paragraphs to avoid false inferences and to save the reader from having to read all the detail.

It is GAO's opinion that little progress has been made in joint housing. FCA believes that progress has been made but the job is clearly not complete.

[GAO COMMENT: We believe the discussion does not imply that there is or may be disagreement on the advantages generally available from joint housing. On the contrary, the discussion points out the advantages of such an arrangement. The reference to branches in this section results from a consulting firm's recommendation to establish a system of association networks to manage groups of branches. We did change the sentence immediately preceding this section so as not to imply that branches should be substituted for associations.

Finally, we believe that 42 to 55 percent of the offices being colocated do not represent progress in implementing a policy in effect since 1960.]

Joint Management (p. 19)

It is GAO's opinion that joint management will come easily after joint housing. There is no linkage that would make joint management easy just because everyone is housed in the same building.

[GAO COMMENT: We did not say that joint management will come easily after joint housing. What we said was that once joint or adjacent housing is achieved, joint management "should" come easily.]

Progression to a One-Bank System (p. 19)

It is GAO's opinion that a one-bank system is the next step after joint management. The report does not contain any indepth study or analysis to show this is the best alternative. The report should clearly point out that the Baltimore banks are not typical of the System in size or growth and that joint management in Baltimore under their circumstances was much easier than it would be for some other banks.

[GAO COMMENT: What we are attempting to demonstrate here is that normally one banking system would follow quite closely after achieving joint housing and joint management. As we pointed out, Baltimore district officials said they were as close to one banking system as legislative constraints would allow. We take issue with the comment that we did not show that this is the best alternative. That is the message of chapter 2.]

Eliminating Association Boards (p. 21)

Elimination of association boards of directors should not be referred to in the report because that idea is contrary to the cooperative concept, is contrary to decentralization and is not acceptable to FCA, the Federal Board, or to any other known group in the System.

[GAO COMMENT: The report on page 21 never states that association boards of directors should be eliminated in total. On page 21, we talk about reducing the number of association boards of directors and eliminating some or all board of director costs. This is based on having one banking system instead of three. Obviously, with one system the need for as many boards of directors will not be as great as with three systems.]

Consolidation Savings (p. 21)

Contrary to what the report says, consolidation of the three district banks into one probably would not decrease top management costs. In any case, GAO has not done any research to determine whether there might be savings or whether any savings wuld be significant. The report should state that only a study and analysis would indicate how and whether there would be savings.

[GAO COMMENT: We do not know to what extent savings, if any, could be achieved under a consolidated banking system. We agree with FCA's statement that we have not done any research to determine whether there might be savings or whether any savings would be significant. In fact, the report states that we did not specifically address cost increases or decreases. We simply identified a few obvious areas where we believe savings could be achieved.]

Coordination Discussion Paper (pp. 22-26)

Reference to the October 1978 discussion paper prepared by two staff members should be deleted because it has and had no official recognition within FCA or the Federal Board. Its sole purpose was to create discussion of coordination in a planning context. It was not intended to represent FCA staff views, not even the writers', and it was never intended the Federal Board accept, reject, or take action on its conclusions. It did not get the customary internal reviews within FCA as would any paper that was intended to have high credibility and acceptability.

[GAO COMMENT: We presented the discussion paper in its proper context and pointed out that the suggested plan for achieving improved coordination and consolidation is a good one. We find it difficult to believe that the paper does not represent anyone's views.]

Advance Payments (pp. 26-27)

The report should point out that advance payments are a service to borrowers. If prepayments directly reduced loan balances, borrowers would incur loan closing costs when they would have to process another loan. The abuse potential referred to by GAO is insignificant because FCA reviews each bank's policy, because proposed guidelines prevent banks from paying more interest on advances than borrowers pay on their loans, and because the total amount of advances is insignificant (.75 percent of outstanding FLB loans). A reason the banks aren't alike in their handling of advance payments is because of their concern to keep it under control. There is nothing to suggest it is out of control. Also, GAO does not give any reason to believe that consolidation into a one-bank system would change anyone's concern about advance payments. The entire discussion of advance payments should be deleted from the report or else revised to recognize the above facts.

[GAO COMMENT: We agree with FCA that the total amount of advances is insignificant and we recognized that in the report. In three districts we visited, officials told us that they will allow borrowers to withdraw advance/future payment funds only in an emergency and with bank approval. Yet, FCA, in its comment, starts off its argument by saying this is a service to borrowers and that borrowers save loan closing costs by withdrawing from these funds instead of processing a new loan. This is exactly where we believe the potential for abuse exists. System banks are not allowed to accept deposits, except advance/future payments. As stated in the report, more specific guidelines and increased coordination and consolidation could improve this situation.]

Interest on Advance Payments (p 27)

The phrase "high-interest savings accounts" is misleading. The report should explain that the banks can't pay any more to the borrower than the borrower pays on loans.

[GAO COMMENT: We do state in this section of the report that the banks pay interest on advance payment funds at the current loan rates. We do not know of any financial institutions that pay 9 percent interest on savings accounts; therefore, we believe "high-interest savings accounts" is an accurate description.]

Income Tax Exemptions are not Uniform (pp. 27-28)

The report does not give any analytical support for the GAO opinion that the tax exemptions are not necessary. The report also does not discuss any support for the implied conclusion that a one-bank system would, by eliminating tax differences, be of benefit to farmers and ranchers. FCA does not believe that eliminating tax differences should be a reason to favor a consolidated one-bank system unless it can be shown that eliminating the tax differences will, in effect, help meet the objectives of the 1971 Act.

[GAO COMMENT: We believe that eliminating tax differences is not in itself a reason to favor a single banking system. However, as the report points out, consolidation should eliminate the inconsistent application of income tax exemptions. Our arguments regarding the need for the income tax exemption center around two points. First, if the exemption is not crucial, then it should also apply to PCAs and BCs. Second, the System is very successful and this success is reflected in its net earnings.]

Bank Earnings (p. 28)

The fact that earnings were $424 million tells nothing about return on assets, capital needs, patronage refunds, and other factors which together might indicate whether the tax exemption is necessary. The $424 million doesn't indicate anything about tax paying ability.

[GAO COMMENT: The only reason we mention the bank earnings is to demonstrate the success of the System.]

Lines of Credit (pp. 28-29)

The discussion of lines of credit does not lead to the opinion of GAO: that consolidation would make lines of credit unnecessary. The System follows the industry in recognizing the advantages of having lines of credit, one of which is to ensure liquidity sufficient to meet the demands of short-term securities.

The report does not refute FCA's reasons for not using revolving funds: they are too small in amount and cannot be used as operating funds. Also, without the back-up lines, the service and borrowing costs of the frequent short-term credit needs of FCS banks would undoubtedly be increased by commercial banks.

The $1.6 billion total lines of credit referred to in the report consists of two types. $400 million exists to compensate commercial banks for their services. The remaining $1.2 billion represents a combination of compensation for services and back-up lines. Therefore, GAO's estimated costs of having back-up lines is probably overstated.

[GAO COMMENT: FCA said the lines of credit were needed for two reasons--to make the discount notes more marketable and to provide liquidity. Regarding discount note marketability, we said consolidation of the System could provide added backing to the program without obtaining lines of credit. This position only dealt with the lines of credit for marketing purposes and not for liquidity purposes.

FCA's reasons for not using the revolving funds are not valid because FCA has never explored their use. We believe FCA's real reason for not wanting to consider using revolving funds is because of eventual Federal involvement.

The estimated costs of the lines of credit are based on FCA's data--not ours--that the required deposits average between 3 and 7 percent of the line of credit.]

Less Restrictive Loans (p. 32)

The implication tht prior to the 1971 Act the types of FLB loans being made were more restrictive is not correct. Except for rural housing, FLBs were making the same kinds of loans as today. Part-time farmers were specifically covered in 1955 and loans for other borrower requirements were being made prior to 1971.

[GAO COMMENT: We do not imply that prior to the 1971 act the types of FLB loans being made were more restrictive. In fact, we do not talk about types of loans. The report deals more with the loans' purpose and the occupation of the applicant. What we say is that FLB lending was restricted to those engaged in or about to become engaged in farming or to those whose income was primarily from farming. All the report says is that these restrictions were for the most part still in effect in January 1971.]

FCA Position on Part-Time Farmer Loans (p. 34)

The report should quote Regulation 4160 directly rather than an FCA official.

[GAO COMMENT: The report does acknowledge that the officials' statement is based on FCA's lending objective, which we discussed in the preceding section of the report. We see no need to quote the regulation involved.]

Rural Home Loans and Part-Time Farming (p. 34)

Loans for less than full-time farmers have been made for many years. There is no linkage between getting rural housing loans and qualifying for loans as a part-time farmer as the report suggests.

[GAO COMMENT: The report does not establish any linkage between rural housing loans and part-time farmer loans.]

Rural Housing Loans Near Metropolitan Areas (pp. 35-36)

It is GAO's opinion that loans could be made to develop real estate near large metropolitan areas. Nothing is in the report to suggest that this has or even might happen to any significant degree. The reference to "one" farmer's opinion on this subject weakens rather than strengthens the GAO conclusion. The paragraph should be deleted.

[GAO COMMENT: The point we are making here is to show one of the pitfalls of rural housing loans. These pitfalls were raised during House and Senate debates on the 1971 act. We still believe they are applicable today.]

Loans for Marginal Farming Operations to Less than Full-Time Farmers (p. 39)

Some of the examples of loans to less than full-time farmers (2nd, 3rd, and 4th) based on the limited information given, may be acceptable loans. More information is needed on the other two examples before a decision can be made. Even if the loans had not been advisable, presentation of some examples doesn not lead logically to a conclusion that no loans to less than full-time farmers should be made.

[GAO COMMENT: The examples we used demonstrate that System loans are made for recreational or hobby farming where the agricultural benefit is questionable or marginal. We do not conclude that loans should not be made to less than full-time farmers.]

Investor-Oriented Loans (pp. 40-42)

At least four (1st, 2nd, 4th, 5th) of the examples of "investor-oriented" loans may have been acceptable as meeting the "other credit needs of the borrower". More information is needed before a different conclusion can be reached.

[GAO COMMENT: The examples we used demonstrate that investor-oriented loans are used for non-agricultural purposes. According to FCA on page 3 of its comments, its regulations prevent nonagricultural loans to investor-oriented individuals.]

Press Release (Cover Summary)

The sentence "In many cases, farm income is not sufficient to make loan installments" is misleading unless the discussion clarifies that nonfarm income is used to help meet the loan repayments. Unless this is stated, the reader will assume the loan is not repaid.

[GAO COMMENT: We agree with FCA and have added the word "alone" to the sentence.]

GAO note: Page references were changed to correspond to page numbers in the final report.

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