



Selling a Piece of the Farm Credit System

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On July 30, 2004, the Directors of Farm Credit Services of America (FCSA), an association of the farmer-owned cooperative Farm Credit System (FCS), announced that they had agreed to a purchase offer from Rabobank, an international financial services company headquartered in the Netherlands. This announcement set off howls of protest from within the FCS and from some FCSA members and public officials. It was also greeted with restrained glee by some bankers and other FCSA members. Three months later, the FCSA Board terminated the sale negotiation. Shortly thereafter, their CEO resigned and the board followed up with several full-page ads in local newspapers pledging their (and management's) commitment to members and to the principles of cooperation. In demonstration of their renewed commitment, the Board recently announced patronage programs for 2004 and 2005—the first ever by this association.

Unexpected and unprecedented events are generally interesting in their own right. But they also give us an opportunity to examine long-held views and plumb what lies beneath the surface in markets, institutions and public policy. The Rabobank/FCSA deal is one of those seismic events.

The Players in Brief

Sometimes you do need a scorecard to tell the players apart. Here are thumbnail sketches of the major players involved in the Rabobank/FCSA deal.

The Farm Credit System (FCS) is a nationwide farmer-owned and -governed financial cooperative. It currently provides \$95 billion in short- and long-term loans to farmers, ranchers, fishermen, rural home owners, agricultural processing and marketing operations, farm-related businesses, farmer-owned cooperatives, rural utilities, and certain foreign and domestic entities engaged in international agricultural trade. Loans are funded not by deposits but rather through the sale of FCS securities in global money markets. The FCS was chartered and initially capi-

talized by the federal government following passage of the Federal Farm Loan Act in 1916. The motivation for creating the FCS was to provide a source of credit for agricultural mortgages at rates and terms that banks would not or could not meet—whether due to cost or inadequate competition. Although the FCS now provides a wide range of financial services to its designated customer base, slightly more than 50% of its business still comes from agricultural real estate lending. Since the FCS is a creation of the federal government, it is both a business and an instrument of public policy. It is privately owned (all public equity had been repaid by the 1960s) and governed by its members. But it is considered an instrumentality of the federal government when it sells securities. All income from agricultural real estate loans is tax-exempt. The size of the FCS, its collective liability for its debt, and its historical ties to the federal government result in an “implied guarantee” on its securities if the assets of the Farm Credit System Insurance Corporation were to be exhausted. This permits the FCS to borrow funds at a cost only slightly above the federal government. In exchange for these benefits, the FCS is required to serve exclusively rural and agricultural credit markets. The rationale for this bargain has been to ensure that credit is available to rural markets that might be abandoned by banks or other commercial lenders.

The FCS is organized into five regional banks. The regional banks fund a variety of associations serving smaller geographic markets. Farm Credit Services of America is an association of the FCS. It is funded by Agribank, FCB, located in St. Paul, Minnesota. FCSA provides approximately \$7.7 billion in loans to farmers and rural home owners in Iowa, Nebraska, South Dakota, and Wyoming. The FCSA is owned and governed by about 53,000 members. (45,000 have voting rights.) The members are represented by a 17-member board. Following cooperative principles, FCSA is owned by those who use it and is governed on a one member, one vote basis.

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Rabobank Group is a century-old member-owned bank based in the Netherlands. Its historical roots resemble those of the Farm Credit System. It was started in response to rural credit problems in the Netherlands. Farm and agribusiness lending constitute a long-standing core competency. Rabobank operates in 38 countries with an asset base (at the end of 2003) of approximately \$500 billion. Rabobank has operated in the United States for the past 23 years specializing in agribusiness lending. However, in 2002 Rabobank began to implement their “country banking” strategy with a broader focus on production agriculture and rural credit markets. In fairly rapid succession, they acquired Valley Independent Bank in California, Lendlease Agribusiness Division in Missouri, and Ag Services of America in Iowa. These acquisitions gave them toeholds in rural community banking, agricultural real estate, and agricultural input financing, respectively. Rabobank’s country banking strategy has been successfully implemented in a number of countries. For example, in 1994 Rabobank acquired the Primary Industry Bank of Australia (PIBA), an established lender with a comfortable loan portfolio. Since acquisition, Rabobank has significantly expanded its lending activities more broadly throughout the country and the agricultural and agribusiness sector. Rabobank continues to finance food and agribusiness firms in Australia as well. A similar pattern of acquisition and growth in rural, food, and agribusiness financial markets has been implemented recently in New Zealand and Ireland. Rabobank has fostered a reputation as a committed agricultural lender with exceptional safety and soundness ratings.

The Farm Credit Administration (FCA) is the regulatory agency for the FCS. Its primary role in overseeing the Rabobank/FCSA transaction was to ensure adherence to the legal process required for an FCS bank or association to leave the FCS and to approve or disapprove the proposal. If approved by FCA, the proposal would then be submitted to the FCSA stockholders for vote.

The Offer

So, here is the deal. Initially, Rabobank offered current FCSA members a \$600 million cash buyout for the assets of the association—loans, personnel, customer base, and facilities. The payment would be allocated based on current patronage or outstanding loan balances. This cash offer was eventually increased to \$750 million. An exit fee of approximately \$800 million would be paid to the FCS Insurance Corporation from FCSA surplus. The calculation of the exit fee is specified in the 1987 Farm Credit Act and is based on an association’s capital relative to its assets. It can be viewed as a payment for the benefits received by the association for being part of the system. In addition, Rabobank would need to pay off the \$6.2 billion credit line from Agribank funding FCSA’s existing loan portfolio.

Good Deal or Not?

At the time the deal was announced, the directors identified a number of benefits for FCSA members:

- a broader set of financial services, including access to international markets;
- competitive cost of funds due to Rabobank’s AAA credit rating and size;
- a cash payout from FCSA capital surplus; and

- an opportunity to slip the bonds of the FCS and to serve a broader array of rural households and businesses.

Opponents to the sale also expressed concern that:

- Most of the financial services that Rabobank could offer were or could be offered by FCSA.
- The FCSA could develop a patronage program—as most FCS associations have already done. Patronage programs would serve as an alternative means for member/borrowers to share in the earnings of their cooperative.
- The cash offer was too low, given FCSA’s assets and earnings.
- The current members would obtain the cash from the sale, but because it wasn’t clear how much of the cooperative’s capital was due to the patronage of former members, the former members would be out of luck.
- The exiting association would leave a significant hole in the FCS that the FCA would be required to fill either by expanding the territory of existing associations or chartering a new association. Resources for either option might have to partially come from equity contributions of other FCS banks and associations.
- If FCSA were allowed to secede, a mass exodus of other associations could follow.
- Rabobank, although ostensibly committed to agriculture, would be free to follow profit opportunities in any market. This commitment to rural finance would be much more flexible than the legislation governing the FCS.
- Finally, many FCSA members were concerned about the loss of control over an organization that

they had built and relied on for nearly 80 years.

Why Sell When You Can Merge?

Shortly after the Rabobank/FCSA deal was announced, AgStar, another Agricultural Credit Association serving parts of Minnesota and Wisconsin, presented the FCSA directors with a merger proposal. The merger offer included a cash payout to FCSA members of \$650 million and consolidation of administrative offices. Further, because this was a merger and not an exit, the exit fee would be avoided. However, the FCSA board rejected the AgStar offer at the same time as the termination proposal.

What Were They Thinking?

The Rabobank and FCSA folks are no dummies. Yet, this deal is vaguely reminiscent of the introduction of New Coke. The negative reaction from many members, as well as parts of the agricultural community, was quick and strong and seemed to catch the proponents of the sale off guard. Rabobank's stated objective in purchasing the FCSA was to enter a new rural credit market. This strategy of enter, transform, and expand has played out reasonably well in other markets. In singling out the FCSA, was Rabobank attracted to the market? The firm? Or was it an opportunity for a bargain? The answer, it seems, is all of the above.

Figure 1 traces the current value of farm operator assets and debt in the FCSA trade area. Note that since the end of the 1980s, nominal credit volume has grown steadily but slowly—around 3% annually. Also note that outstanding non-real estate debt is nearly equal to real estate debt in this market. And because the value of farm assets has increased at a much greater rate than debt, nominal net

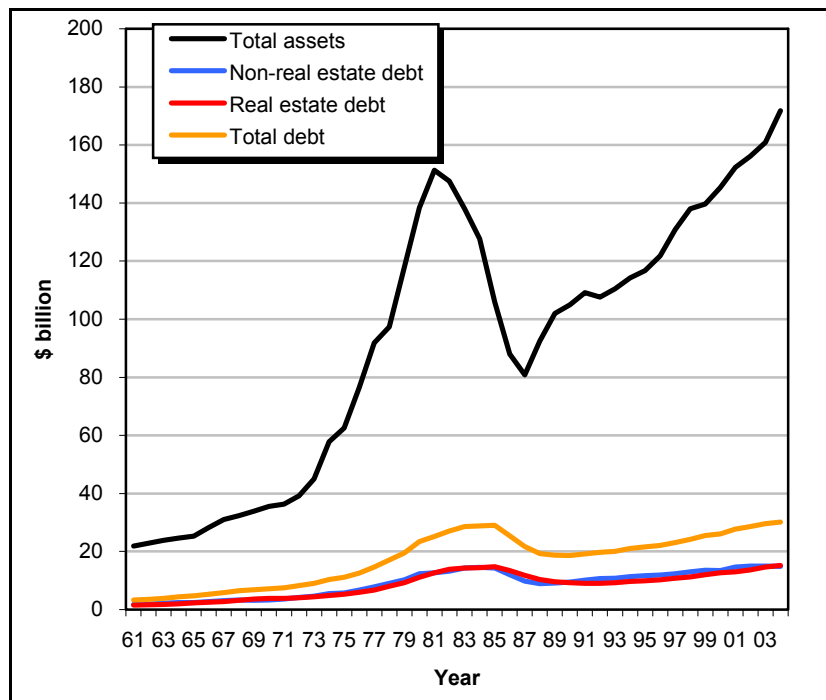


Figure 1. FCSA trade area farm assets and liabilities—1961–2004.

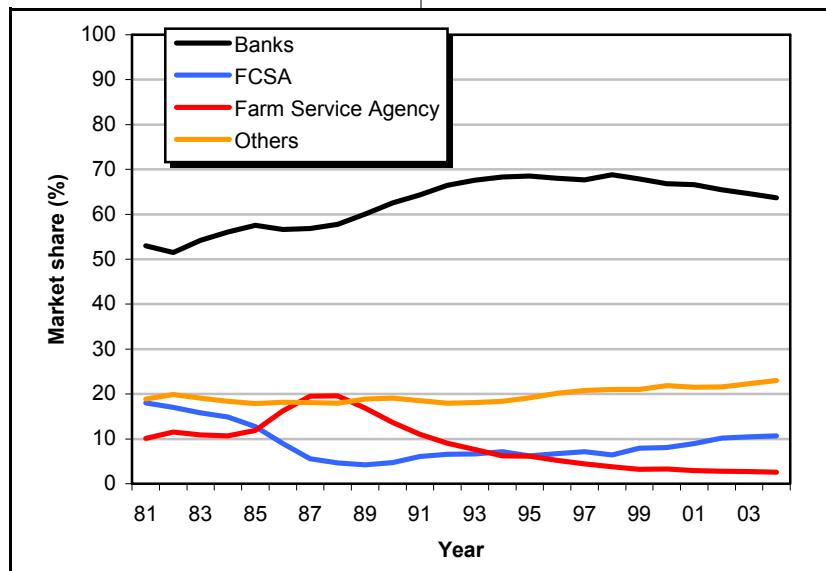


Figure 2. FCSA trade area non-real estate farm debt market share by lender—1981–2004.

worth (and hence potential collateral) has grown significantly.

Figures 2 and 3 show the changes in market share for major lenders serving the short- and long-term markets in the FCSA trade area. Commercial banks are clearly the dominant non-real estate lender. The FCS and other (mostly nontradition-

al) lenders have made some inroads in recent years. One of the most striking features of the real estate market is the gain in market share achieved by commercial banks—from dead last in the early 1980s to the top of the heap 15 years later.

A quick perusal of this information reveals a mature market—slow

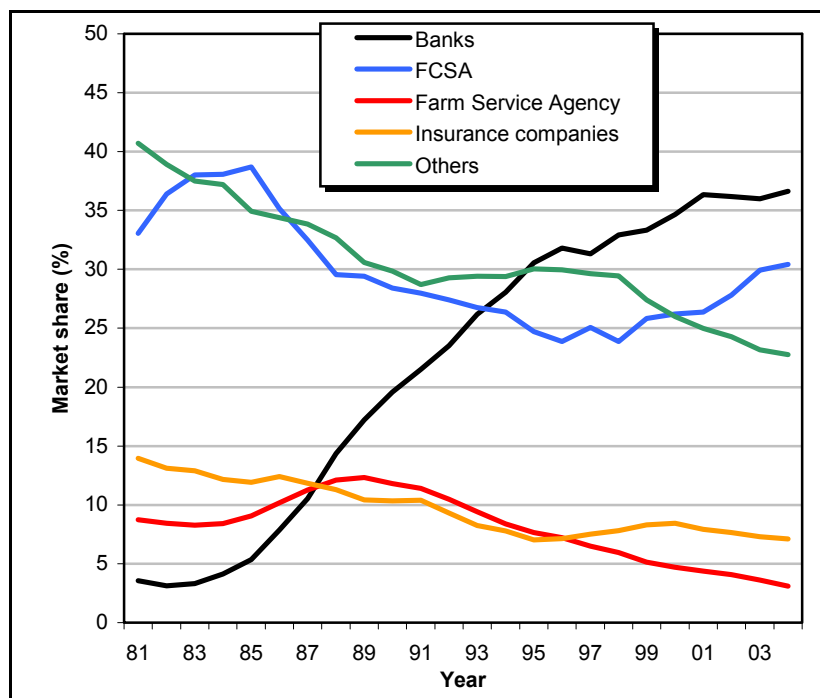


Figure 3. FCSA trade area real estate farm debt market share by lender—1981–2004.

growth in credit volume with existing firms battling for market share. The apparent winners of this zero-sum game are the banks. FCSA’s total farm debt market penetration is relatively low—less than 22% in the four-state area compared with about 50% for banks in 2004. This contrasts with FCS penetration nationally of 30% and more than 40% in some markets such as Michigan or Ohio. Keep in mind, too, that many of the commercial banks serving this market are small closely held businesses. Small size imparts higher costs, loan limits, and a reliance on local deposits—hardly strategic assets for a mature market.

Was FCSA a plum to be picked? In Table 1 we compare financial characteristics of FCSA with two other associations. Farm Credit Services of Mid-America serves farmers in the eastern Corn Belt and is roughly the same size as FCSA. Ag-Star is smaller, but has had a patronage program in place for the past few

years. Again, a quick look suggests that FCSA’s performance measures are generally weaker than the other two associations. In particular, note that FCSA earned a lower return on its assets and member capital. The lower charge-off rates, while admirable for being low, may indicate a rather conservative lending philosophy. This is supported by the fact that FCSA tended to favor real estate lending. Non-interest expense is higher, despite the fact that real estate lending is usually a lower cost business compared to short-term lending. And, FCSA is certainly sitting on a pile of capital.

Finally, FCSA could have been attractive because it was offered at a favorable price. Space doesn’t permit a complete discussion of this topic. However, capitalizing earnings can suggest a value. In Table 2 we show capitalized values for a range of incomes and required rates of return. As a reference point, we use \$115 million (the average income for

Table 1. Average financial measures, 2001–2003 for selected farm credit associations.

	FCS America	FCS Mid-America	AgStar
Average assets (\$ billion)	\$6.99	\$7.26	\$2.23
Return on average assets	1.77%	2.07%	2.20%
Return on average total capital	10.78%	12.78%	16.30%
Net interest income/earning assets	2.83%	2.27%	3.07%
Net charge-offs/average loans	0.09%	0.20%	0.17%
Real estate loans/total loans	70.2%	35.2%	40.7%
Average loan interest rate	6.06%	6.28%	6.25%
Permanent capital ratio	14.23%	14.90%	12.63%
Retained earnings/assets	16.10%	15.08%	10.68%
Non-interest income/assets	0.74%	0.47%	0.47%
Non-interest expense/assets	1.60%	0.62%	1.06%
Wages/assets	0.85%	0.39%	1.14%

FCSA for the past three years) and a nominal return of 12%. The analysis is very simple—but it does suggest that a \$600 or \$750 million offer might have been a tad low.

Seismology

There is no question that the Rabobank/FCSA deal shook up farmers, lenders, and public officials. A number of questions stemming from this transaction merit consideration and answers:

If FCSA is attractive to a private firm, are the various legislative and tax preferences granted to the FCS justified? Or have changes in farm

Table 2. Estimated bank value (\$ million).

Required rate of return (%)		Income (\$ million)		
Nominal	Real	110	115	120
9	5.8	1,897	1,983	2,069
12	8.7	1,264	1,322	1,379
15	11.6	948	991	1,034

structure and information technology moved us to a point where the traditional problems of rural credit markets—distance and information—no longer require unique institutions or policies? The same questions arise simply from the growth in real estate backed lending by banks. If deposit-based lenders can profitably make agricultural land loans, is government-sponsored enterprise still needed for the FCS?

Do rural credit markets need increased competition? Most lenders, particularly community bankers, would argue that they have to work hard enough as it is to attract deposits and originate loans. Nonetheless, agricultural lending remains a fragmented industry, and fragmented industries frequently leave money on the table. Rabobank's interest in this market suggests there could be some gains from further consolidation.

Organizations generally don't spend much time working on procedures for events that they don't think will occur. The FCA regulations and the FCSA's bylaws that govern exit from the FCS appear to be incomplete. Two major stumbling blocks arose as a result of the FCSA purchase. The statutorily required exit fee did not appear to reflect the full value of the benefits an association derives from being part of the FCS. And, because the association had not had an earnings patronage program in the past, there was no way to link

property rights of former members to the capital surplus and the earning potential of the association.

Some financial cooperatives such as the FCS (or credit unions, for that matter) do not pay patronage (two thirds of FCS associations do pay patronage). The benefits to members in lieu of patronage may appear in other forms—lower loan rates, more office locations, or better-trained personnel, for example. But an unwillingness to pay patronage dividends can create an unaccountable cash flow that may result in expense preferences and other managerial mischief. In fairness, following the 1987 bailout of the FCS, a growing capital surplus was a goal of the system so that government assistance could be repaid and the FCA could be assured that none would be required in the future. If some capital is good, perhaps more is better. However, patronage allocation of at least some earnings can be accomplished along with goals for capital growth. It is clear that management of FCS capital and patronage needs a careful look.

Effective governance is critical in both cooperatives and investor-owned firms—as the stockholders of Enron will surely attest. When directors and their hired managers take actions that produce an uproar on the part of members or investors, both the governance process, as well as its performance, need to be carefully reviewed and strengthened. Cooperative boards, in particular, must work to overcome an inherent conflict of interest, because they are members who represent members.

Finally, perhaps the time has come to take FCS off its leash. The FCS might trade off its tax preferences and instrumentality status for the freedom to seek opportunities in a broader market. The FCS is unique because it is a financially strong co-

operative with a national infrastructure and reach, 80 years of rural lending experience, and an enviable ability to source loanable funds. With those assets and a rural credit market that appears to offer some opportunities, the FCS may be ideally suited to compete on a leveled playing field to the benefit of rural America. Such a bold stroke, however, should only be considered if the historical mission that underlies the creation of the FCS could be assured—the dependable and permanent supply of credit for all segments of the agricultural sector.

Links

- Farm Credit Services: <http://www.farmcredit.com>
- Farm Credit Services of America: <http://www.fcsamerica.com>
- Rabobank: <http://www.rabobank.com>
- AgStar: <http://www.agstar.com>
- AgriBank: <http://www.agribank.com>
- Farm Credit Services of Mid-America: <http://www.e-farmcredit.com/Default.aspx?2-18>
- Farm Credit Administration: <http://www.fca.gov/FCA-HomePage.htm>

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For More Information

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