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Restructuring of the Ag Lending Markets: The FCS Dilemma

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The recent initiative by Rabobank to expand their business in agricultural production lending in the United States through the acquisition of Farm Credit Services of America surfaced considerable debate about the appropriateness and desirability of that acquisition. But in reality, the question is much more fundamental: Given the dramatic restructuring of the agricultural capital markets with respect to both the changing customer base and the changing competitors, how can the cooperative Farm Credit System (FCS) maintain its competitive position?

The Changing Customer Base

Farm and agribusiness firms are becoming increasingly complex in their size, structure, organization, and interdependent relationships. The financing needs and uses of funds by these more complex agribusinesses are challenging traditional lenders to consider new lending policies and procedures.

For example, many farms operate farming businesses not only in different counties than their home base, but even in different states or different countries. This broader geographic domain challenges the delivery system of a funding organization that does not match that domain. Likewise, more farmers are entering value-added businesses and new ventures beyond the farm gate. Some of these new ventures include such business arrangements as value-added production systems in the livestock industry, ethanol and biodiesel plants, and other downstream activity. Farmers are also acquiring assets in the input supply sector of the agricultural industry and even in nonagricultural sectors. This increased scope of business activity by farmers challenges a lender who has limited capacity to offer financial products and services in other industries. Farmers are also increasing their financial product/service demands, including cash management services, asset management services, risk management services, payroll services, and so forth; a lender must offer a broader product/service bundle to serve this increasingly demanding customer base.

An additional change in the agricultural credit market is how farmers may access their lender. Increasingly, food companies and processors are developing qualified supplier or franchise grower arrangements with a limited number of preferred producers. These processors are serving as value chain coordinators and in many cases are facilitating their franchise growers' acquisition of price discounts and preferred customer relationships in the feed, chemical, and equipment businesses. It is not illogical that similar arrangements would be developed with credit or financial providers. Thus, a value chain coordinator may facilitate access on the part of their franchise growers to a national or global lender who can provide the broader set of products and services their growers need. In essence, the traditional lenders to agriculture—commercial banks and the Farm Credit System—may need to compete and collaborate with value chain integrators to provide total systems solutions including inputs, product merchandising, risk management, and financial products and services to growers participating in vertically aligned value chains.

In essence, the farm customer base is changing profoundly in terms of the traditional domain and boundaries with respect to geography, line of business, product/service needs, business model, asset control, and utilization and buying behavior.

The Changing Competitor Landscape

The US agricultural credit market has been dominated in the past by domestic commercial banks and the Cooperative Farm Credit System, but that dominance is increasingly being challenged in a number of important dimensions. The recent entry of Rabobank into the US farm production lending market has resulted in a global ag

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lender that is one of the highest credit-rated banks in the world challenging US-based agricultural lenders. Agriculture has suddenly become a sector attracting global and international bankers and is no longer the exclusive domain of US-based lending institutions.

Noninstitutional lenders are also important to the farm sector, accounting for almost 25% of the non-real estate and real estate credit in agriculture (Ryan & Koenig, 1999). Captive finance companies, in particular, have become much more permanent in recent years with loan volumes growing rapidly; it is estimated that manufacturers and dealers now have a 25% market share of the intermediate-term non-real estate debt market for commercial farmers (Dodson, 1997). The recent expansion of captive finance companies appears to be driven more by perceived profit opportunities in finance rather than marketing strategies to sell excess inventories, suggesting that these companies are more likely to be permanent participants in the market than in the past.

Financial leasing arrangements are also growing rapidly—estimates are that one fifth of commercial crop farmers lease machinery and equipment (Dodson, 1997). In the machinery, equipment, and facility market in particular, leasing companies affiliated with manufacturers (as well as independent leasing companies) are expanding volume at double-digit rates. The unique financing that captive financing and leasing companies emphasize—along with relatively efficient origination, servicing, and collection procedures—frequently enables them to provide credit services at an equal or lower cost and with more convenience than traditional institutional lenders.

The FCS Challenges

The aforementioned changes in the customer base and competitors present challenges to lenders who can not or do not respond in maintaining their market position and presence. It is essential for any lender to anticipate and respond to changing customer needs and expectations, to offer products and services that are preferred in pricing, service, and other features to that of the expanded offerings of their competitors, and to deliver that product/service efficiently and effectively. Regulations or business policies that limit a lender's responses to changes in the marketplace clearly put it at a competitive disadvantage.

The Regulatory/Policy Challenge

A fundamental challenge that will be faced by the Farm Credit System is that of the regulatory and policy regime that shapes its business focus and activities. This challenge in reality involves two interrelated issues: (a) regulations that define the domain of the Farm Credit System with respect to customer and line of business focus, geographic boundaries, and product/service offering; and (b) Government Sponsored Enterprise (GSE) status.

The first issue of focus and domain of the Farm Credit System is possibly the most straightforward to assess. If the characteristics of both the customers and the competitors evolve as discussed earlier, the Farm Credit System will be increasingly at a competitive disadvantage in serving that changing customer base. Deregulation with respect to a broader set of loan products and financial services that would be attractive to both current and future grower and agribusiness customers, as well as other businesses in rural communities, would allow the Farm Credit System to serve its current and prospective future customers more effectively. Furthermore, as will be discussed shortly, a more diversified customer base would allow the system to more efficiently allocate its risk capital, thus increasing its competitiveness with other global financial institutions.

However, broadening the scope of lending and provision of financial services does not come without a cost. First, one of the benefits of being a specialized lender is that of understanding the industry and tailoring the product/service offering to that industry. If broadening the focus of the Farm Credit System results in less effective and efficient delivery of credit and other financial products to its current customer base, FCS will not be fulfilling its legislatively mandated mission, and the cost may offset the benefits. Furthermore, attempts to expand lending authority of the Farm Credit System will likely be met with resistance from other lenders—commercial bankers in particular. It is highly likely that the quid pro quo required by commercial bankers, if the Farm Credit System were to obtain expanded lending and financial service authority, would be the elimination of GSE status and favorable tax treatment received by certain Farm Credit System entities.

The critical issue, then, is how much the cost of sourcing funds would increase without GSE status compared to the cost reduction that would occur if FCS were a more diversified lender due to reduced equity capital requirements per dollar of loan funds. The costs and benefits of GSE status can not be adequately analyzed without taking into account the prospects of a more risk-efficient use of capital if the portfolio were more diversified.

The Capital Market Challenge

An increasingly important challenge that must be faced by all financial institutions (including the Farm Credit System) is that imposed by the capital markets to efficiently allocate and utilize risk capital. This challenge will be intensified with the phased-in implementation of the New Basel Accord concerning allocation of risk capital for all financial institutions worldwide. The increasingly competitive market conditions all institutions (including cooperatives) will face in sourcing equity capital and compensating providers of equity capital at competitive rates of return on their investment will require financial firms to be more prudent with the use of their equity capital.

A fundamental tenet of risk management and efficient equity capital allocation in any financial institution is that of diversification: Risk can be mitigated and equity capital most efficiently allocated when the institution has a diversified (in contrast to a specialized) portfolio of assets. This tenet is in direct conflict with the specialized focus of FCS lending that, as a function of regulatory policy and business practice, has very explicit boundaries concerning its geographic, line of business, product/service offering, and market segment domains. In essence, the Farm Credit System has been and continues to be a specialized lender that cannot take advantage of diversification to manage risk. System members are thus forced to maintain a higher equity capital position to manage that risk compared to a more diversified financial institution. The system may need to maintain its current high level of equity capital—almost double that of other financial institutions—if it remains as a specialized agricultural lender that cannot diversify. However, it is clearly overcapitalized compared to a diversified lender like Rabobank that can loan to many different industries in many geographic locations in the world. Moreover, from the perspective of current borrowers, this equity capital is "locked up," and consequently has limited current value.

The "excess" equity capital concern is very fundamental—one could argue that if the Farm Credit System operated without current geographic, line of business, product/service offering, and customer segmentation boundaries, the equity capital required would be reduced without increasing the financial risk and potential loss exposure of the system. This concern was in fact acknowledged by FCS of America when the board reconsidered and rejected the Rabobank offer, indicating it would implement policies to more rapidly redeem or repay its patron retains, thus allocating retained equity capital back to the shareholders.

But, a partial redemption of the equity capital may not solve the fundamental problem of efficient risk capital utilization—a specialized lender by definition must maintain a higher equity capital position to manage the higher level of risk it faces. Even further consolidation of the current FCS entities would not generate the risk mitigation advantages of more line of business diversification. Over time, if capital market investors, including those who provide equity capital to financial cooperatives such as the Farm Credit System, recognize that they are not and can not receive a competitive return on that capital as long as the institution maintains its specialized focus, they will move their capital elsewhere or support the transition to more diversification, unless that institution is clearly providing other benefits not available in the market place.

With the significant changes in customers and competitors noted earlier, it is likely to become increasingly difficult for the Farm Credit System to maintain its competitive position under the current regulatory environment that limits its scope. An expanded scope could provide for a system that is more responsive to today's competitive environment. In addition, a broader scope for the system may allow for a more risk efficient allocation of equity capital that would continue to attract investors. However, an increase in scope would require substantial changes in the current regulatory environment of the system, which may lead to the loss of GSE status. In addition, a broadening of scope and reduction in regulatory requirements may lead to further consolidation of the system. These costs will need to be weighed against the benefits of broader scope as the system determines its competitive strategy moving forward.

For More Information

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