Testimony of Gary Weirauch

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FCA Public Hearing on OFIs & FCS Relationships

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Good morning everyone. My name is Gary Weirauch. I'm President of Citizen's State Bank of Loyal, in Loyal, Wisconsin. We appreciate the FCA's initiative in setting up this meeting today.

One of my colleagues here with me today is Bill Knox from the great state of Washington. Bill's President is also on ICBA's Agriculture-Rural America committee. Our committee is meeting in exactly one week and I would be happy to pass along any points that should be further discussed with our committee to provide feed back. We hope there can be an opportunity for ongoing dialogue on this issue by interested parties.

My bank is quite involved in agricultural lending, primarily to dairy farmers. We set up an OFI five years ago because, like many community banks, we were concerned about liquidity issues and whether we would have the funding necessary to meet our loan demand.

We have found the OFI program can work but it is a very difficult program to make work. That is why you only have a couple dozen OFIs around the entire nation while the Federal Home Loan Bank has several thousand bank members.

I don't think it really has to be that way. The legislative statute is not nearly as burdensome and complex as the regulations. So my suggestion in general today would be for FCA to consider redesigning the program so it can be a much more streamlined and straightforward, using the FHLB program as a model for example. If you want a successful program, copy what has been successful in the past.

The issues can be categorized fairly simply, I believe.

- **The program needs to be easy to get into.** To accomplish that, FCA should develop a standard application form. District funding banks should be required to uniformly apply a well known set of FCA standards for establishing an OFI because not all district Farm Credit banks have embraced the OFI program or make it easy to participate.

- **The program needs to be cost efficient**. The issue today in the world of ag financing is not whether funding is available to rural America. Rather the issue is "at what cost is funding available"? The OFI program, as I'll discuss more in a moment, has significant entrance fees that make its costs often outweigh the benefits of participating for most bankers. The market is telling you that by the lack of use of the program.

- **OFIs Should be placed on a more level playing field** with FCS associations in terms of benefits and costs of funding. OFIs should not be given less representation and less service by Farm Credit banks than is given to FCS associations. And, finally,

- **FCA needs to work with the FCS district funding banks and interested bank trade associations and other groups to promote and market the program**. Obviously, you need to have a good product if you're going to be successful marketing it. But, let's face it, the effort to promote the OFI program has been pretty non-existent. And how many countless applicants have been discouraged from pursuing an OFI because of the "word of mouth" effect where bankers have told other bankers not to waste their time applying.

Impediments To OFI Participation

As I mentioned, **cost is a key issue**. Our FCS funding bank imposes what it calls a "Capital Equalization Factor". This is currently a 137 BP up-charge to the interest rate for new OFI's. Obviously, this makes it hard to be competitive in making loans.

This charge declines over five years but it only reduces based on a **predetermined,** total capital pay-in amount and not a set percentage. The full equalization factor is then **reinstated** on any growth over 25% at any time including after the initial five-year period. So if an OFI currently borrows $10 million, but wanted to increase their borrowings above $12.5 million, the OFI gets charged 137 basis points on the borrowings above $12.5 million, in other words, on any growth above 25%.

The legislative statute does not require this type of scenario. It should not exist and as it is inflexible, costly and discourages participation.

It must also then be asked, "How does a district bank come up with this specific charge?" Initially, we were told we'd have a charge of 100 basis points, which would be reduced by 20 percent each year over five years (to 80 bp; 60 bp; 40 bp, 20 bp, and finally 0 bp). What ended up happening is the funding bank decided on a predetermined amount they wanted from our OFI and then applied a rate to get that number. My point is that there are no measurable, objective standards being set by FCA and this needs to be changed so that everyone all over the country understands what the rules of being an OFI are.

This capital equalization factor payment requires us to pay for **over-capitalization** because our Farm Credit funding bank has a 16% equity level. Equity is being substituted for appropriate risk avoidance policies and this approach has not allowed an ROE above single digits. By comparison, the return on equity at most ag banks is around 12 percent.

We do have 1% of our outstanding loan balance in participation certificates as non-voting stock and we receive a dividend based on our Farm Credit funding bank's cost of funds. But here is **a key problem** -- we provide system capital through participation certificates and capital equalization assessments but have no ability to vote for board representation – hence no voice. This amounts to **"Taxation without Representation"** and this implies there are no advocates for the OFI program within the Farm Credit funding bank.

If FCS funding banks want the OFI to provide capital, then the level shouldn't be in excess of normal risk guidelines, as I mentioned, specifically the FDIC guideline of 8 percent. In exchange for that capital, the OFI should get stock in the FCS and some board representation on the FCS funding bank's board. This request is not, obviously, some disguised attempt to control the actions of the FCS funding bank by OFIs. Rather, it is an attempt to gain some measure of fair treatment of OFIs within the FCS and allow OFIs to have a voice for any needed change as part of the funding bank with which the OFI has a borrowing relationship.

We have received a patronage dividend over the past three years. It has risen from only 10 basis points a couple years ago to 35 basis points last year. However, this is not a return of the capital equalization factor. **We should have a stock or participation certificate capital account equal to the capital we paid. Dividends should be based on this equity account, not the 1% participation balance**. For example, Farm Credit Associations can show equity in Agribank on their balance sheets – where is the equity our OFI paid for? We paid it in, but unlike FCS associations, we cannot get it back. This is unfair.

My OFI should be getting a dividend on the capital I have paid in, not just the amount that I have borrowed. And the high "capital equalization fees" should either be eliminated or drastically reduced. If they are reduced, there should also be an end in sight. Blatant fees imposed on growth are only an impediment to improving financing in rural America.

Lending Limit

The OFI per customer lending limit had been 50% of capital, which was quite high. This was subsequently reduced to 25%. The Agribank Board is now looking at reducing this to 15-20%. Our state bank level is 20%. Our OFI would be comfortable staying at 25% as a proper lending limit that doesn't overtax capital.

A question I have is why don't the Farm Credit funding banks participate individual loans which exceed the OFI's lending limit to enhance participation and the flow of funds to rural America? For example, if I have a $1 million loan that I want to move into the OFI, then AgriBank should become a participating lender in the loan. This would allow an increase in the per customer lending limit because AgriBank, based on their higher lending limit, would assume the overline. That would be one option. This arrangement could also allow OFIs to participate loans with other lenders of their choice. This would help increase the flow of funds to rural America.

Leverage Ratio

We are currently forced to capitalize at a 9:1 ratio or 11% equity which is well above banking industry standards and well above the 8% the FDIC considers "well capitalized". In other words, $1 million of capital in the OFI allows the OFI to borrow $9 million from AgriBank. FHLB, by contrast, has a 20 to 1 ratio, requiring a bank to only provide 5% capital. Credit quality should also be allowed to determine some of the capital requirements and lending limit.

I believe the statute allows a 10:1 ratio. This is still insufficient. But again, OFIs should be allowed the maximum ratio in the law and this should not be left up to the various funding banks to establish differing ratios. FCA needs to set maximum allowable standards so the rules are the same on all OFIs.

<u>Borrower Rights Regulation</u>

FCA's most recent regulations extended borrower rights provisions to OFI's if they originate the loan. **Legislation is silent when speaking on OFI's and borrower rights but it is not silent on borrow rights and FCS associations**. In addition, banks must already comply with CRA. Imposing borrow rights is a regulatory burden and is inconsistent with FCA's often stated philosophy of removing regulations not required by law and that are unnecessary for safety and soundness reasons. The Bank OFI is an extension of the bank, which again complies with CRA. The bank OFI is not an extension of an FCS association's retail lending activities. So borrow rights provisions for bank OFIs should be removed. I personally would be supportive of removing the borrow rights provisions for FCS institutions especially if OFIs could receive the changes we are suggesting today.

<u>Cost of Funding / Rate Differential / Lending Rates</u>

PCA's and OFI's under $100,000,000 pay a 25 BP spread to AgriBank based on size. The average ACA pays 15-17 BP with some larger associations paying even less. This is risk weighted only for size and not for asset quality. The risk weighting needs to be based on asset quality, not size – just the opposite of what is occurring. Otherwise, there is "size discrimination", for lack of better terminology, based on asset size, which should not exist and is not based on actual safety and soundness considerations. This is a negative factor that discourages smaller banks from applying for an OFI.

Currently all term products offered are pre-payable. We should be offered term advances that are also pre-payable with yield maintenance, in other words a penalty, if we want to choose that option, so the rate could be reduced further. This would help reduce the discount rate for the OFI based on the risk management mix that is best for their organization. In other words, the OFI would have the option of paying a penalty if they made a mistake in exchange for the option to get their advances for less. Thus, the OFI should be allowed both pre-payable and non pre-payable advances. Let us do more asset-liability management.

<u>PCA Only Authority</u>

OFIs should be allowed to discount ag real estate loans. Currently, OFIs can discount such loans only when the real estate has buildings on it. This means, for example, that a farmer can't get a loan from an OFI to buy 80 acres of farmland from their neighbor unless there are buildings on the land. This should be changed and OFIs should have authority to lend on real estate just as an Ag Credit Association (ACA) can do.

FCA should consider an OFI to be like an ACA and not a PCA. We are currently restricted to 15 year amortization with 10 year balloons. And, again, OFI loans are not permitted to finance bare land.

Comparable term rates on 7-20-01

	Agribank	FHLB-Chicago	Farmer Mac
1 year	4.15%	4.06%	4.68%
2 year	5.20%	5.01%	5.77%
5 year	5.85%	5.68%	6.31%
10 year	6.55%	6.36%	6.91%

Farmer Mac & FHLB Authorities

The Farmer Mac Ag-Vantage program has been grossly over-priced and not competitive. This makes the Agribank-OFI funding relationship more critical.

I want to comment also on the recent expansion of the FHLB lending to supposedly provide better access for community banks to small business and agricultural borrowings. In applying the new regulations to my bank's portfolio, it appears the FHLB has established the regulations in a way that make the use of this program not very meaningful in their current form. It appears to me that the FHLB doesn't want to really be a lender to agriculture and rural America. This means there are opportunities for the FCA and the FCS to promote a restructured OFI program so we can all work together for the betterment of our nation's farmers and ranchers.

Conclusion

If a better OFI program leads to more competition in rural America, then the farmer should get the benefit of better service. The customer will win, but obviously lenders should be on a level playing field. My suggestions for change isn't just self-motivated even though changes are necessary. But I believe an improved OFI program would be for the good of the agricultural credit industry as a whole, not just for commercial bankers.

In concluding, let me just say that we appreciate and welcome these discussions. I do think it would be worthwhile to have a brainstorming session among the OFIs themselves to come up with some formalized proposals. These proposals could then be discussed in a followup meeting to this one that would again include interested FCS funding banks. I also want to associate myself with the comments of Bill Knox that I was not able to address today due to time constraints. Again, I'm sure the ICBA would be willing to help the FCA in further exploring OFI related issues if the result can lead to a better and more widespread use of the program. Thank you.