

OFI LENDING

Statement of

Jeff Plagge

On Behalf of

The American Bankers Association



Farm Credit Administration

Public Meeting

Des Moines, Iowa

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Chairman Reyna and Board Member Jorgensen, I am pleased to be here on behalf of the American Bankers Association (“ABA”) to participate in this meeting to examine ways to increase the availability of credit to agriculture and rural communities. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership-- which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks -- makes ABA the largest banking trade association in the country. The ABA wishes to commend you for holding this meeting to explore additional ways that farmers and ranchers can have easier access to safe and sound, competitive, and dependable credit.

I am Jeff Plagge, President of the First National Bank in Waverly, Iowa, a \$140 million community bank with branches in Waverly and Plainfield. Over the years I have served a number of roles in the American Bankers Association. I have been chairman of the ABA’s Agricultural and Rural Bankers Committee, chairman of the ABA Rural Economic Development Task Force, and a member of the Board of Directors of the Association. At present, I serve on the ABA’s Government Relations Council and I chair the Iowa Bankers Association’s Legislative Committee.

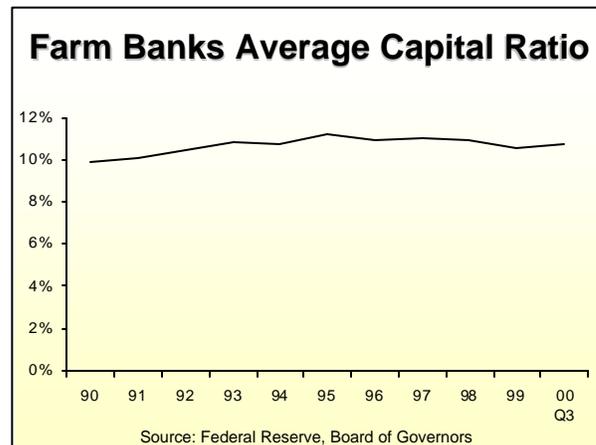
During my 23 yearlong career in finance, I worked for the Farm Credit System (“FCS” or “System”) in western and central Iowa for 6 years, then became an Executive Vice President and department head at a bank in north central Iowa, and became President of the First National Bank of Waverly in 1994. My personal experience as a rural banker and as a leader and member of various ABA committees has given me some unique insights into the issues we are discussing today.

I think that before we discuss the immediate issue, it is important that we review the agricultural economy and the agricultural credit business. American agriculture continues to face an uncertain future. The banking industry shares the concerns of producers about the future economic viability of agriculture. Our industry provides the vital credit that farmers and ranchers need to be successful. At the end of 2000 banks had nearly \$75 billion in loans outstanding to farmers and ranchers- - an increase of 3.3% over the previous year. In 2000, the banking industry surpassed all other lenders in loans secured by real estate and non-real estate secured loans. More farmers and ranchers borrow more money from the banking industry than from any other source. For every dollar of agricultural credit outstanding, 41 cents is loaned by the banking industry.

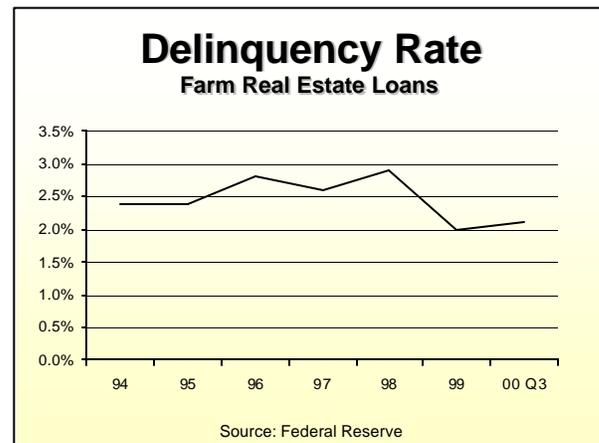
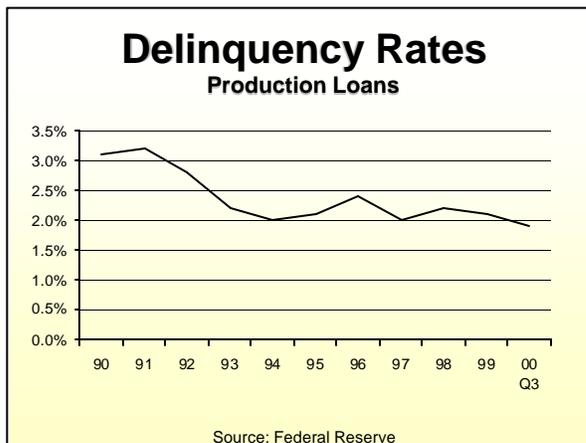
Despite A Difficult Agricultural Economy, Agricultural Banks Remain Strong

Despite low commodity prices for key agricultural commodities and regional weather and disease problems, widespread negative effects on banks’ farm loan portfolios have not materialized. The sound state of farm banks today is the result of the strong non-farm economy, improved credit underwriting standards and high levels of government assistance in 1998, 1999, and 2000 that enabled farmers to meet their debt obligations.

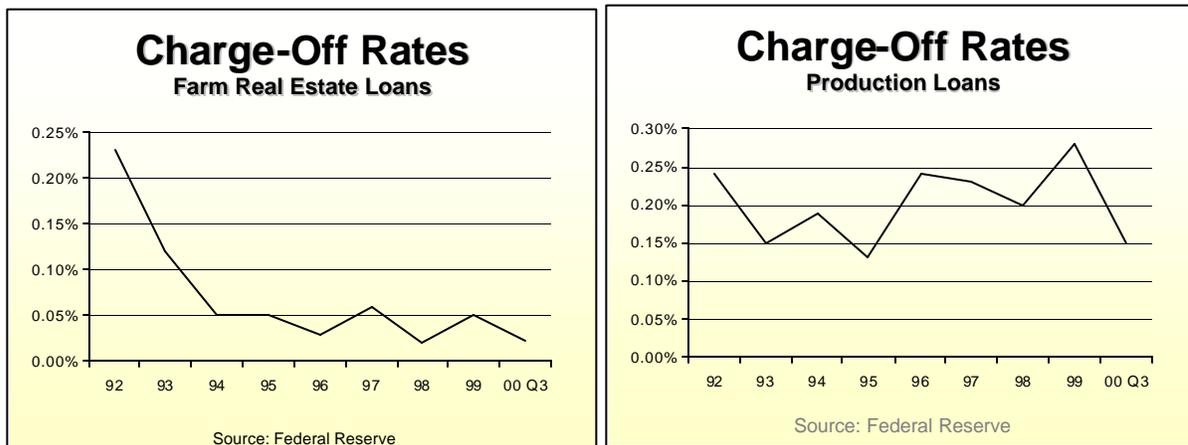
Agricultural banks tend to be better capitalized than other small banks. The average capital ratio at an agricultural bank stood at 10.7 percent as of the third quarter of 2000. As of September 2000 almost all agricultural banks met the regulatory definition of being “adequately” capitalized and more than 98 percent of all agricultural banks meet the definition of being “well” capitalized. Farm banks were able to build capital during the 1990s because they have been profitable.



Loan quality remains strong for agricultural banks. As of September 2000, in aggregate farm banks reported \$0.9 billion in farm production loans as delinquent (30 days or more past due) or 1.9 percent of the outstandings. Non-performing farm production loans (past due 90 days accruing interest and non-accruals) were 1.2 percent. Additionally, \$700 million in farm real estate loans were delinquent as of the third quarter 2000. As a percent of the portfolio, delinquent farm real estate loans stood at 2.1 percent. This compares favorably to the previous year’s ratio of 2.3 percent.



Further evidence of the strength of farm bank portfolios is reflected in the relatively low charge-off rates for both farm real estate and production loans. The charge-off rate for farm real estate loans stood at .02 percent – below the charge-off rate reported in 1999. For farm production loans, the charge-off rate was slightly lower than the rate reported in the last several years at .15 percent.



Despite the positives that I have reported to you about the agricultural credit portfolio and the financial performance of agricultural banks, continued low commodity prices and the uncertain nature of future federal assistance to agriculture have raised our concerns about our farm and ranch customers. The uncertainty in agriculture has also had a negative impact on farm supply and Main Street businesses in my community and across all rural America.

ABA Center for Agricultural and Rural Banking

Our growing concern about the health of the agricultural economy and the role that our member banks play in the health of rural America led to the creation of the ABA Center for Agricultural and Rural Banking in 1999. The center is focused on the unique challenges faced by banks in rural America, and provides information, training, education, and advocacy for this unique constituency.

Farm Bill Listening Sessions Conducted in 2001

From early January to early May 2001, staff of the ABA Center for Agricultural and Rural Banking conducted 19 farm bill listening sessions in 14 states. Nearly 1,000 bankers, producers, businesspeople, state legislators, local federal officials and other stakeholders participated in the sessions held around the country.

The sessions covered a wide range of topics from federal support for agriculture to trade to USDA program delivery to expectations and recommendations for the next farm bill. At nearly every session, bankers wanted to discuss the FCS. I would like to share with you some general findings from the sessions:

- There was near unanimous agreement that the federal payments made available to producers in 1998, 1999, and 2000 made the difference whether their customers had adequate cash flow. Further, participants agreed that, if economic conditions

remain the same, federal support consistent with what was made available in 2000 would be needed in 2001.

- In many commodities, farmers are receiving the lowest prices they have received in 20 or 30 years. Low commodity prices are universal and nation-wide. We spent a lot of time discussing the causes and consequences of this very negative economic situation.
- Bankers have worked with their customers to continue to find ways to help them continue their operations another year. Fortunately, farming was very profitable for much of the 1990s and farmers were able to build equity. That equity reserve is what has allowed banks to continue to term out debt so that farmers can get operating credit another year. Many bankers noted that ongoing cash losses will deplete equity reserves to the point that financing options will become much more limited.
- Crops that depend heavily on export markets have been hard hit; this is especially true for cotton. Participants in the listening sessions urged our staff to communicate to you that the future of American agriculture is dependent upon policies that support free and open trade.
- High-energy costs, increased prices for inputs, and scarce water for irrigation in the Pacific Northwest in 2001 are new, dark clouds on the horizon.
- There was a great deal of discussion about the current federal payment structure. The planting flexibility afforded by the 1996 legislation was seen as a major positive change by the participants. The dependence upon the Loan Deficiency Payments (LDP) as a de facto price support mechanism was less universally praised. LDP is only an effective price support mechanism when a farmer has a normal to above normal yield. When drought or other factors hurt yields, the LDP is reduced and the farmer suffers a diminished cash flow. In many areas of the country, LDP payments have been large because farmers have experienced above average yields. Other areas that we visited, Texas and Kansas for example, have had extensive drought, and farmers there are faced with greatly reduced cash flows because their LDP payments were negligible. Many bankers concluded that they are uncomfortable with a price assistance program that works best only when there is an average to above average crop yield.
- We discussed the FCS at nearly every meeting. Since you are the regulator of the System, I think it is important that I share some of the comments we heard at the sessions.

Banks View the Farm Credit System as a Government Sponsored Lender that Unfairly Targets Big Deals

Bankers complained about persistent low ball pricing, the System's relentless targeting of the largest and most profitable deals, the System's lack of interest in beginning and low income farmers, their involvement in loans that appear to be well outside of providing credit to farm and ranch customers, and the System's growing appetite to solicit deposits under the guise of an "Advance Payment Program".

What we heard during the listening sessions was further confirmed by several recent surveys conducted by the ABA and the Nebraska Bankers Association ("NBA").

In the ABA survey, conducted between October 2000 and December 2000, we asked bankers to respond to the following:

- Does the FCS target larger, wealthier farm customers? More than 60% agreed.
- Is the FCS interested in lending to small farmers? Nearly 60% said they were not.
- Does FCS offer below market interest rates to attract new business? Nearly 90% agreed that FCS offers below market interest rates.
- Does FCS offer services at below market rates to attract new business? More than 50% of the respondents agreed that they do.

The NBA has conducted an annual survey of bankers in Nebraska since the 1980s. In their April, 2001 report, 58% of Nebraska bankers responded that the FCS does not provide lending services to individuals across the financial spectrum. Additional comments from the bankers in Nebraska indicated that the FCS is interested in larger, wealthier farmers. One survey respondent noted, "FCS in our area habitually targets the high volume/low risk borrower." Another noted that, "[the FCS] is not out to help beginning farmers or small farms."

I have reviewed this data because I, and many of my colleagues in banking are concerned about where the FCS is going. Further, I believe the business practices of the Farm Credit System since the late 1980s have had a direct impact on the Other Financial Institution program ("OFI"). While the FCA may be trying to foster a climate that encourages System and non-System lending institutions to form partnerships, the reality is that the System has not been interested in working with the banking community on a program like OFI and has not been interested since the federal bailout of the System in 1987.

The Other Financial Institution Program Was Once Important to the Agricultural Credit Industry

At one time, the OFI program was an important component of the agricultural credit delivery system in America. At its peak in 1981-82, there were 327 OFIs with nearly \$1 billion outstanding. Since that time, the number of OFIs has declined to less than 25. In what was the territory of the former Omaha Farm Credit Bank, which included the state of Iowa, there were 46 OFIs in 1982-83. Most, if not all, are gone today.

In preparing this statement, we talked to many individuals about how the program worked back then, what happened to it, and what the prospects are for the program.

Since we conducted our research in the states served by the former Omaha Farm Credit Bank, our comments will be based on that research. However, we believe that the experiences in the Omaha territory reflect what happened in the rest of the country.

- Most of the OFIs were subsidiaries of commercial banks and were capitalized in a variety of ways. The optimism of the founders of these OFIs was reflected in the names they picked for their new corporations. Some of the more creative included, “Agricultural Business Credit Corporation,” “Farmers Credit Corporation,” and “Packers Agricultural Credit Corporation.”
- ABA literature at the time reflected the growing concern among bankers about sources of funding for future growth in their agricultural credit portfolios. Several articles in banking publications recommended that banks create credit corporations and apply to their local FCB for OFI funding.
- The agricultural credit market was quickly expanding in the late 1970s and early 1980s- - there seemed to be no end in sight for agricultural credit and there seemed to be room for everyone to participate. Bank and FCS market share for the period from 1974-1980 remained close with each holding about 30% of total agricultural credit. In 1974 total agricultural debt was \$75 billion. By 1984, just 10 years later, total agricultural debt had grown to \$190 billion and FCS market share had grown to 33% of the total market while bank share had declined to 24%.
- Bank owned OFIs were typically used to fund agricultural credits that were in excess of the bank’s ability to fund. They acted as an over line source of funding. Other banks used their credit corporations to expand and complement their agricultural lending programs.
- To accommodate the demand for OFI funding, FCBs had staffs of professionals who actively marketed their programs and that traveled the country to do due diligence on the OFIs. Omaha FCB was one of the most aggressive in creating OFIs.
- When the agricultural economy began to weaken in the 1980s and ultimately collapsed, many banks closed their OFIs. Some exhausted the capital in their OFI and ceased doing business, some voluntarily liquidated their holdings, and some were liquidated by the FCB or by the FDIC.
- The System, struggling with a large portfolio of bad loans, began to restrict the capital of the associations and the OFIs. In the Omaha district, OFIs lost all or most of their earned co-op equity, as did the associations. For some OFIs, which had been in business many years, this was a considerable loss. The loss of earned equity soured many against the program. Bankers, who had acted responsibly in underwriting their credits and supervising their portfolios, felt they had been burned by irresponsible lending by Production Credit Associations and Federal Land Banks. It was, to say the least, not the best cooperative experience for many OFI owners.
- The period of OFI liquidations in the Omaha district concluded around 1989. By that time, the OFIs had lost their capital, their earned equity in the System, and many of their customers. Nationwide, the agricultural credit market contracted and the need for liquidity subsided.

- With the changing market conditions, the need for OFIs became less urgent. Priorities changed and banks and System lenders went about restructuring their portfolios.

Fundamental Changes in the Farm Credit System following 1987 Pushed the OFI Program Further into Dormancy

The resulting mergers of the Production Credit Associations with the Federal Land Banks following the 1987 bailout altered the tone of the relationship banks had with the System. Suddenly, banks found themselves confronted with a “one stop shop” Farm Credit lender. The old relationship between the long term lending of the Federal Land Banks and intermediate term lending by commercial banks ended. In addition, rural banks and the FCS became more liquid as they worked out of agricultural credits and restricted new credit exposure. OFIs, a tool for liquidity and over line lending, were simply not needed at the time. As the agricultural credit market contracted, a new obstacle emerged.

Following the 1987 bailout, the System embarked on a new lending policy of seeking high volume, high quality/low risk credits (this activity has been well documented by the ABA, the NBA and USDA economists). As the competition for deals in a shrinking credit market heated up, the local associations were less comfortable with their FCB financing the competition. Since the associations “own” the FCBs, they put pressure the FCBs to create more restrictive policies for OFIs. This competitive situation has had a direct impact on the OFI program and will greatly restrict future program growth. We understand, for example, that the successor FCB to Omaha no longer has anyone on staff working to encourage OFI lending.

ABA Proposed an Enhanced OFI Program to the Farm Credit System in 1994 and Was Rebuffed

By 1993 the banking industry had been the lead lender to agriculture for 6 years. The System, which had been the lead lender to agriculture for many years, was focused on liquidating their portfolio of problem loans and trying to find new, large credits to replace their lost volume. As a result, they were shrinking.

Some of us saw an impending liquidity issue for rural banks. Our small town populations were shrinking. Our citizens were aging. Other investment opportunities for individuals became available. We could see that rural banks, that were funding their loan portfolios with traditional deposits, were facing a dilemma. The banking industry was leading the recapitalization of American agriculture and rural America. But, in order to continue, it was becoming clear to us that we needed a new source of funding. The traditional dependence, by banks, upon deposits for loan funds was not going to be adequate to meet the credit needs of rural America.

In response, the leadership of ABA created the Rural Economic Development Task Force (“Task Force”) in 1993 and appointed me chairman. Our mission was to find new ways to help spur economic development in rural America. Very early on, we began to focus

on how rural banks could secure a dependable source of lendable funds that would enable us to offer all rural Americans the same credit opportunities that their urban and suburban counterparts enjoyed.

We looked at the FCS as a potential partner with the banking industry. As a Government Sponsored Enterprise (“GSE”) with a unique rural mandate, the FCS appeared to us to be a natural source of lendable funds for the rural banking industry. It was clear to us that the OFI relationship of the past was not adequate to meet the new, bold outlook that members of our task force had for the future of their rural communities.

At the same time that we were focusing on our future, the FCS was also looking toward their future. It appeared to us that, increasingly, the FCS was attempting to define their future on a “go it alone” basis. In 1994, legislation was introduced in the US House of Representatives that would have expanded the authorities of the FCS into broad new areas of business that were being well served by our members. We thought the time was right to try to form a partnership with the System that would have expanded opportunities for both banks and the FCS.

To that end, representatives of the ABA task force and the System met a total of 6 times over the next 36 months. Had we been successful in our discussions, I doubt that this meeting would be held today. Unfortunately, we were not able to reach an agreement outside of meeting. This period was a valuable learning experience for all of us. I would like to review with you some of the more critical events from that time.

I believed then, and I believe today, that a monumental business opportunity for the System was tossed away, and that the failure of the representatives of the System, at that time, to see the future in anything other than “go it alone” has implications for the System well into the future.

As I stated earlier, the ABA task force was chartered by ABA in late 1993. By the spring of 1995, we had developed a two-page concept that we optimistically titled, “*The Rural Economic Development Partnership*”, a copy of which is attached.

The Rural Economic Development Partnership Proposal

We proposed that rural banks, with a large infrastructure of delivery outlets, should gain access to FCS funding. We proposed that the FCS would deliver funds through two channels: the FCS associations and rural banks that had at least 10% of their assets in agricultural and rural lending.

Further, we proposed that the FCBs would be governed by a twelve-member board, ***with at least one board member elected or appointed from a state or national bank.*** We proposed that banks, seeking funding from the FCBs, would be required to purchase stock in the FCB, and would have to maintain a capital investment in the FCB equal to 5% of outstanding advances.

If you carefully examine our 1995 proposal you will find that, it was essentially an enhanced OFI proposal. The only real enhancement over the existing OFI program is that we called for one banker to be elected or appointed to the board of each FCB. Ironically, the System's response to the proposal, and a suggestion made by a representative of the FCS drove us to pursue other opportunities for funding.

In the spring of 1995, ABA testified before the House Subcommittee on Resource Conservation, Research, and Forestry. We discussed the Rural Economic Development Partnership proposal. The witness for the System reacted very negatively to the proposal, and stated that it amounted to a "banker take-over of the Farm Credit System." One member of Congress asked the System representative where banks should go for funding, and he replied, "they should go to the Federal Home Loan Bank System."

While we met with FCS on a couple of other occasions after that hearing, we decided that further discussions would be unproductive. From that point, we focused our attention on the Federal Home Loan Bank System ("FHLB"). Many banks were already members of the FHLB System. As members, they owned stock in the banks, were represented on the boards of directors, and had a real say in the governance of the FHLB System. The Farm Credit System representative was correct; the FHLB did offer the banking industry a solution to their funding needs, *all we had to do was to get the eligible collateral broadened* to help rural banks use their agricultural, agribusiness, and small business loans as eligible collateral. We felt that if we accomplished this, we would create a powerful funding tool for rural America. After our experience with the FCS, we were surprised to find the FHLB anxious to work with us and was very willing to do more in rural America.

The rest is history. When President Clinton signed the Gramm-Leach-Bliley Act into law on November 12, 1999 the FHLB System was authorized to accept loans to small farms, small agribusinesses, and small businesses as collateral for advances. While this lending activity is restricted to banks with assets of \$500 million or less, we believe that a significant milestone was achieved.

The irony in all of this is that we went to the Farm Credit System four years before the passage of Gramm-Leach-Bliley and asked for the exact same thing. Had the FCS been more receptive to the idea, rural America would have had a new funding source years before the legislation, and System would be a larger, more robust institution.

The Farm Credit System Let Their Exclusive Franchise to Deliver GSE Funding to Rural Banks Slip Away

Had the System been more receptive to the proposal we put forth in 1995, the System may have been able to preserve its exclusive franchise to provide GSE funding to rural banks. Now, the FHLB has professional staff actively calling on banks to provide them with the funding products that they need to meet their rural customer's needs. In addition, since governance of the FHLB System includes the banks that are stockholders and borrowers, bankers are very receptive.

We attempted to find funding solutions with the FCS that involved some power sharing. We felt that would be in the best interests of all parties. The unequal nature of the OFI structure has consigned it to the dormant state it is in today. In the final analysis, the OFI program is flawed from the top down.

Today, many banks have invested in the FHLB System- nearly 5,000 banks are members. In the ABA agricultural credit survey that I mentioned earlier, 71.3% of the respondents identified the Federal Home Loan Bank System as their primary source of non-deposit liquidity.

Frankly, I do not know how the FCA can revitalize the OFI concept. The resistance of the associations to allow “their” FCBs to fund what they perceive as the competition has led to restrictive loan policies that our members find unattractive. There is no longer staff at the FCBs dedicated to expanding the OFI program. The fundamentally undemocratic nature of the OFI lender-borrower relationship, when compared to the relationship that exists between the FHLB System and banks, is a real impediment.

Recent policy changes and proposals made by the FCA will also serve to further consign the OFI program to an interesting footnote in the history of the agricultural credit industry. These initiatives include:

- Loan participations. FCA now allows System institutions to participate, up to 100%, in eligible loans originated by non-System lenders. Some commercial banks have found this to be a satisfactory way to handle loans that exceed their legal lending limit. Other banks have been able to create a working relationship with System lenders to enable them to fund additional loan growth by doing loan participations.
- The National Charters proposal (which the ABA strongly opposes) will, if enacted, lead to a rapid consolidation of FCBs and FCS associations. We believe that the more consolidated the FCS becomes, the more ingrained will become the “go it alone” philosophy.

Summary

The OFI program once played a role in the delivery of credit to rural America. The FCS failed to capitalize on an opportunity presented by the banking industry. The System’s refusal to consider that old paradigms were changing may well have cost them an opportunity that could have ensured them a place in the 21st century. The ability for the System to catch up to other GSEs that are providing funding to banks is doubtful, and, I believe, the System’s interest in playing a role in this business is non-existent.

Thank you for your interest in this issue and for holding this meeting. I am happy to answer any questions you may have at this time.