Comments of Jim Caspary
President, First National Bank of Clifton (IL)
On Behalf of the Independent Community Bankers of America
At the FCA Public Meeting on Scope and Eligibility
June 26, 2003

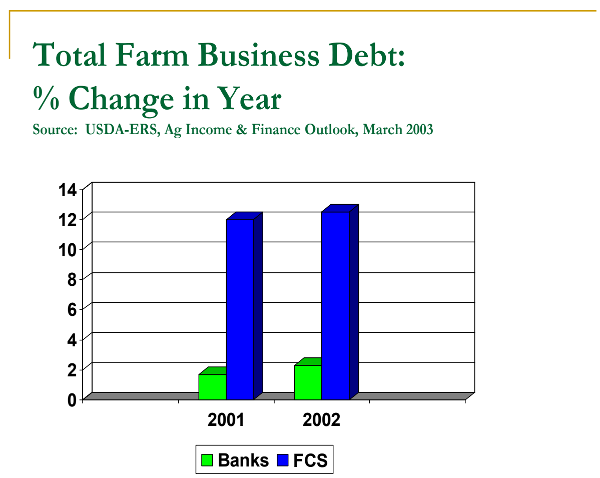
Good morning everyone. Mike, Doug and Nancy thanks for holding this public hearing today. My name is James Caspary. I am the President of the First National Bank of Clifton, in Clifton Illinois. I'm also Chairman of ICBA's Agriculture-Rural America Committee.

First National Bank of Clifton is a small Midwestern agricultural bank with $25 million in assets that has been serving the community of Clifton since 1902. It is located in the north central part of Illinois where the primary agricultural commodities are corn and soybeans.

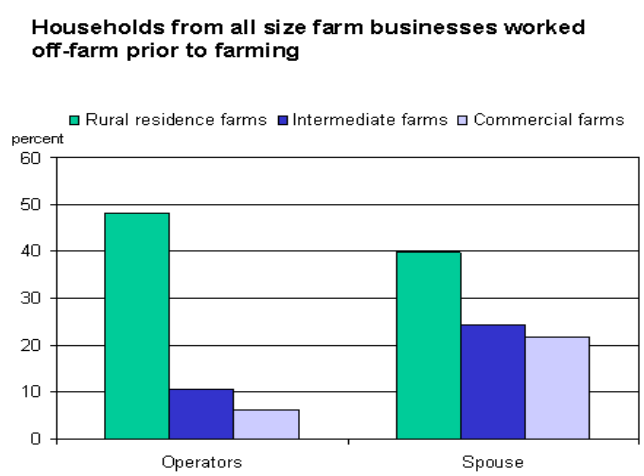
At the outset let me say that I find the request by the two FCS institutions to drop your current regulations as being totally unnecessary and I find their rationale to be faulty.

Further Relaxation of FCA Scope & Eligibility is Unnecessary

We're not discussing a Farm Credit System here that is on the ropes. To the contrary, the System comes to you asking for quite a dramatic expansion at a time when they are as healthy as they've ever been and are growing rapidly. FCS is growing agricultural market share at a time when banks are losing market share. FCS loan volume is growing rapidly. FCS is growing dramatically in institution size. FCS net profits have been large and growing reaching almost $1.8 billion last year. Let's look at the specific numbers:



- As of last September, gross loan volume was up approximately 10 percent to $88 billion.
- About 70 FCS associations had double-digit loan volume growth.
- The System made $1.77 billion in net income last year.
- Long-term real estate loans were up by over 12 & ½ percent last year.
- Short-and-intermediate term loans were up almost 10 percent.
- The FCS's total farm debt has increased 72 percent in the last 10 years while total farm debt has risen by only 42 percent.



- According to data from FCA's Financial Institution Rating System (FIRS), as of September 30, 2002 – more than 99 percent – of FCS institutions had received a 1 or 2 rating, while only one institution had received a 3 rating.
- Importantly and contrary to what the System says is the reason we're here today, their customer base grew three percent during the past year.
- During the previous year, FCS had also increased its customer base by three percent!
- In fact, according to the FCA's most recent annual report—the fastest growing components of FCS lending is for "other" farm-related business lending and marketing and processing loans.
- Since 1996, when FCA last considered this proposal, according to FCA, the FCS loan volumes have grown by over 50 percent!

So I ask, what is the need for this proposal? My response is, clearly, there is no need.

In fact, I suggest that much of the basis for this public meeting today is based on a false pretext concerning off-farm income. So I want to address that issue next.

Need to Look Rationally at Off-Farm Income

Considerable hay is being made by FCS petitioners who are throwing out various statistics on off-farm income. They suggest that because many individuals have farm assets, but earn off-farm income, FCS should be able to lend to these individuals <u>on an unrestricted basis</u> – <u>for non agricultural purposes</u> – even when these individuals are not bona fide farmers; even when people have retired from farming; even when people already have access to farm related business financing in other FCA regulations that are not part of today's discussion; and even when the lending industry is awash in liquidity and there is an abundant supply of credit to meet the needs of rural borrowers.

Non-farm income is very important to many family farmers and for some it is a necessity to remain on the farm. For many others, it provides access to health care, which would otherwise be very expensive.
Many people with agricultural assets may be retired or may have a career away from farming. Many farmers have passive, unearned, non-farm income. The list of what non-farm income is used for is a substantial one.

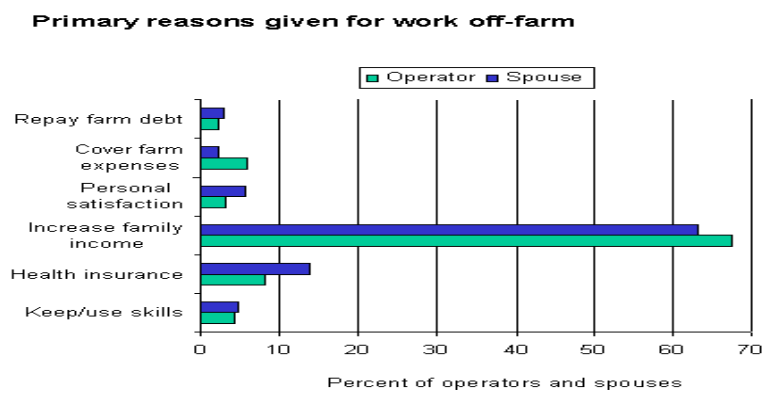
My point is we cannot just assume that the only reason somebody has non-farm income is to remain on the farm. But this seems to be the System's argument and it has little, if any, merit to justify allowing the System to lend <u>on an unrestricted basis</u> – <u>for nonagricultural purposes</u> – to anybody who may receive income that is unrelated to their agricultural assets or work.

USDA data indicates there are several categories of farm types with off-farm income and USDA points out that many people with land or farm related assets do not list farming as their bona fide or primary occupation.

Here are several key facts from USDA:

- System officials suggest they need to finance non-farm activities so that farmers can remain on the farm. However, USDA states that "Covering farm expenses or repaying farm debt ranked low for both farmers and their spouses as the primary reason for working off-farm." In fact, this reason ranked lower than any other! (See Chart)

- According to USDA, the principal reason for off-farm work reported by both operators and spouses was to increase family income and to access health insurance and for personal satisfaction.



- FCS Officials suggest they need to finance non-farm activities to help family farmers remain on the farm. However, that explanation is again contradicted by USDA, which states, "Of the 956,000 farm operators who indicated that their primary job was off-farm work, 725,000 said that off-farm work was their career choice." (emphasis added)

- USDA states, "A long-held belief was that farmers and family members take off-farm work to support the farm business. National survey results show that as many as one-third of operators worked off-farm prior to becoming a farmer!" (emphasis added)

- USDA reports that while 70 percent of one of its four categories – rural residential farms – report off-farm jobs, 90 percent of these work 35 hours a week. USDA then states, "This suggests that individuals who likely do not consider farming as their primary occupation run many of these small operations (emphasis added).

- "In fact, only 4 percent of operators of rural residential farms reported farming as their primary occupation." (emphasis added)

- Nearly 500,000 spouses reported an off-farm occupation, with 80 percent indicating that off-farm work was their career choice.

- "Further, approximately 32 percent of limited resource operators and 46 percent of low-sales farmers are age 65 or more."

- USDA says that another of its four categories of farmers, retirement farms, "obtain most of their off-farm income from unearned income (net income from land rentals, interest, dividends, social security and other public programs, and other passive sources)."

When one looks at statistics for commercial farmers, you find most commercial farmers earn a majority of their income from farming.

- USDA's Economic Research Service (ERS) states: "on average, farming made the largest contribution to household income for groups with sales of $100,000 or more."

- "Households operating very large farms, with average incomes of $214,000 receive only 15 percent of their income from off-farm sources and 69 percent of this group relies on farming for at least half of their income."

- "Average farm operator household income for 2003 is forecast at $65,795 per household, up 7 percent from last year. Increases in crop and livestock receipts and government payments are causing the farm income component of total household income to recover from the year-ago low."

- "Commercial farms, which rely more heavily on the farm for income, are expected to realize the largest increases in household income (in 2003). For these farms, income from farming is expected to increase by 26 percent."

- "Households operating the remaining (categories of USDA) family farms—farming occupation/higher sales . . .farms on average have positive earnings from farming."

These facts raise a multitude of questions that time does not permit us to even ask, yet alone answer. But some of them would be:

- Why should FCS be allowed to make non-farm loans, especially on an unrestricted basis, to people who don't consider farming to be their "bona fide" occupation, since this would contradict the law?

- Why should FCS be making non-farm loans, especially on an unrestricted basis, to limited-resource farmers or small farmers who report they primarily have a non-farm occupation, or retirement as their major occupation?

- Why should FCS be making non-farm loans, especially on an unrestricted basis, to retired farmers who no longer plan to be involved in production agriculture as their livelihood?

- Why should FCS be engaged in non-farm lending, especially on an unrestricted basis, when USDA data suggests that only a small percent of off-farm income is actually used to repay farm debt?

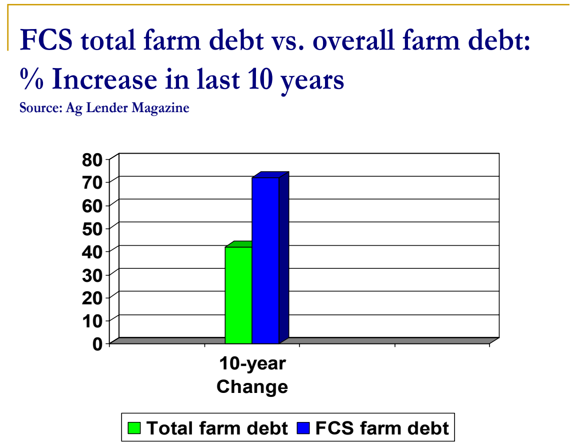
- Why should FCS further relax current regulations lending to bona fide farmers, which are already extremely liberal, when other FCA regulations allow FCS to make non-farm business loans if these businesses receive a majority of income from farm related sales?

- Why doesn't FCA tighten up these extremely liberalized regulations and close existing loopholes?

- Why should FCA reward FCS by expanding scope and eligibility when examinations of FCS institutions revealed a number of "illegal" lending activities?

The list of questions goes on, but for the sake of time let's get to your questions.

FCA Questions



First question—do you think FCA should change or retain your current definition of bona fide farmer? If you favor changing this definition, please offer specific recommendations.

Your current definition is already very liberal under a close reading of the law, which states loans are to be to "bona fide" farmers. Whether FCS should be lending to part-time farmers —especially for non-farm credit needs — is questionable at best.

Bona fide farmers should be individuals who actually produce a commodity rather than anyone who owns potentially productive land. So I believe your choices are to either retain the existing regulation or tighten it up so the FCS serves bona find farmers—real, authentic farmers.

This generous allowance in existing regulations raises the question again – what is the need for this proposal? Current regulations already seem exceedingly generous and IF changes are made, we strongly recommend tightening this loophole.

IF changes are made to existing regulations, we recommend:

- FCA Criteria should require loan applicants to file a schedule F tax return within two years of their initial loan application or be automatically ineligible.
- A majority of the farmer's income come should come from farming.
- The applicant should make a significant contribution of their personal time, labor, capital and management skills to the farm operation.
- The loan should be primarily agricultural in nature, as is required by existing regulations.

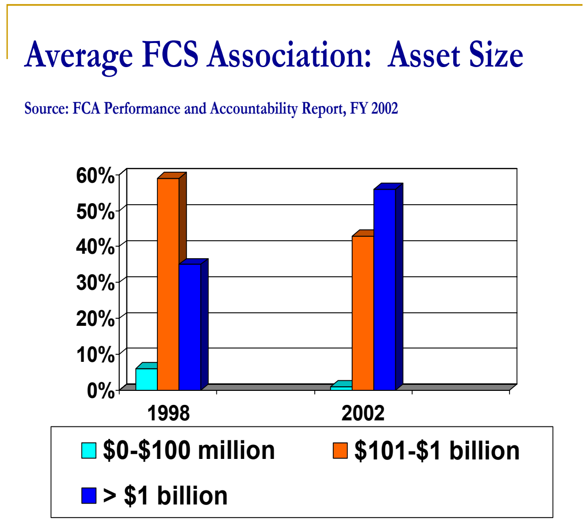
We believe these four criteria should all be required to verify the individual is a bona fide farmer.

FCA regulations are also very lenient on another issue – loans to part-time farmers. FCA regulations allow FCS to make loans to part-time farmers, including those who have career pursuits other than farming, and allow these farmers to essentially be treated as full-time farmers if they're trying to earn a living from farming. FCA's regulations say the overall credit should remain primarily an agricultural loan, and we do agree with this because its in keeping with congressional intent. This is also necessary because the scope and eligibility mission statement of the "Act" as laid out in the "Objective" section states FCS financing needs to be for the purpose of maintaining an efficient farm operation.

Second question— what limits, if any, should FCA regulations place on lending for farmers' other credit needs?

A plain reading of the Act is that the other credit needs are to be directly related to producers' farming operations.

FCA regulations already state that part-time farmers "shall have availability of credit for mortgages, other agricultural purposes, and family needs in the preferred position along with full-time farmers." This is already a very generous interpretation of the Act for people who earn off-farm income but are not full-time farmers or may have careers other than farming.



Third question — how should we regulate access to the other credit needs of eligible farmers who derive most of their income from off-farm sources? Do you favor retaining the current regulatory distinction between full-time and part-time farmers? If not, what would be a better approach?

We believe it is imperative that the current regulatory approach be maintained, that the "total credit results in being primarily an agricultural loan." This interpretation is generous while keeping the FCS focused on making agricultural loans.

We strongly believe there should be no further relaxation of the current regulatory approach that "Loans to farmers shall be on an increasingly conservative basis as the emphasis moves away from the full-time bona fide farmer to the point where agricultural needs only will be financed for the applicant whose business is essentially other than farming." After all, the statute says credit is to be provided:

1) To "bona fide" farmers;
2) For the purpose of maintaining an efficient farming operation; and
3) Directly related to the farming operation.

We prefer that FCS finance only full-time "bona fide" farmers. Obviously we favor keeping the distinction between full-time and part-time farmers as one way to regulate and scrutinize lending to this group where FCS has questionable lending authority.

"Other credit needs" in the context of the Act is always accompanied by the wording "directly related to their farming operations". This is not a license to be a general purpose lender. Congress knows how to write statute and they specify in the opening stanzas of the Act that credit is for maintaining efficient farming operations. Seeking to get into general purpose, non-farm lending is a complete distortion of what the Act says and what Congress intended.

If FCS lenders want to lend for "other credit needs"—non-farm lending—then are they willing to lend only to full-time farmers, meaning the ones whose primary business and vocation is farming and cut out their lending to part-time farmers, or at least those who basically have non-farm careers? My deduction is they won't since the System never wants to retreat from an authority once granted.

The regulations already have ample flexibility, are already excessively lenient and if anything, need to be tightened down, especially by eliminating the allowance to lend to landowners who don't produce agricultural commodities and have no agricultural sales.

Fourth question — should FCA change the definition of "moderately priced" rural housing?

We suggest either of two options: If regulations are changed, it would be best to tighten the criteria by requiring that independent data used to determine rural home valuations be based on rural communities in the local area, preferably those less than 2,500, rather than on data that reflects the values of ALL housing, including in other regions which may not reflect local conditions. FCS is limited to rural communities of less than 2,500.

We believe the two approaches FCA currently uses are more than adequate and the definition of "moderately priced" is more than ample. FCA liberalized these allowances in recent years. Further liberalization would cause FCS to focus on the very high end home owners and ignore the lower-income homebuyers.

The statute allows FCS to sell mortgages into the secondary market based on $100,000 adjusted for inflation since 1987. Using the CPI, our calculations show this would allow FCS to make loans up to about $158,000. So we believe complaints about Farmer Mac levels are NOT warranted at all. The Farmer Mac numbers are consistent with what the statute says.

The reality is that these numbers are actually quite high for the median values of rural home loans. We also point out that a couple months ago Farmer Mac changed its housing appreciation indicator from the CPI to the Fannie Mae formula, which also has increased their valuations. Any further changes at this time would be completely unwarranted and inappropriate.

We believe it is appropriate to use the "median" value since that is a common way to state home values.

We do not agree that FCS should be able to use "special studies" based solely on new home construction values. As a government sponsored enterprise, the FCS should be focusing on the lower valued houses where there might be a legitimate credit gap. The very high-end homes already have ample access to private sector mortgages.

FCS petitioners have also stated that some statistics show average home prices increased between 30 - 36% over the past five years, and this supposedly is a basis for their complaint that they should have even higher valuations for FCS lending. We point out that the FCS lenders are supposed to be making home loans in communities of 2,500 or less and therefore using national or regional numbers may inflate what the local home values actually are. Using housing values that do not reflect local conditions can lead to much higher home values than would be warranted in the local area.

For example, here are the five-year home price appreciation numbers for several of the states that were mentioned by the FCS petitioners.

- Ohio -- According to OFHEO, the five-year increase for house prices (period ended March 31, 2003) was 22.86%.
- In Tennessee, the five-year increase for house price appreciation was 20%.
- In Indiana the five-year period saw a 19.87% increase.
- In Illinois the five-year period witnessed a 20.09% increase

Keep in mind these numbers include ALL metro areas as well as non-metro. Rural areas near large metropolitan areas or near suburbs will tend to have higher priced homes than remotely located rural areas.
Rural areas in the West with scenic amenities or areas in close proximity to tourist and recreational areas also tend to have higher home values than remotely located rural areas.

We need to keep in mind when looking at national statistics—that some regions have higher home values due to extremely high home price appreciations for some states such as California (67.61%), New York (52.97%), Washington, D.C. (77.93%), Massachusetts (73.05%), and New Hampshire (68.87%).

We also question some of the counties used as examples by the FCS petitioners. For example:

- Williamson County, Tennessee, one of the counties cited, according to the 2000 Census, experienced a phenomenal 56.3% growth rate in the past decade, making it the fastest growing county in Tennessee. That's not your typical rural county.

- There are 16 institutions of higher learning in the Nashville Metro area within 30 minutes of Williamson County. The colleges and universities closest are Vanderbilt University, Belmont University, MTSU and TSU.

- Williamson County is within 500 miles of half the business markets in the United States

- Williamson County is one of eight counties in the Nashville Metropolitan Statistical Area (MSA) and is ranked third in the United States for economic growth potential.

- In terms of quality of life criteria (schools, recreation, access times, etc.) Williamson County is Tennessee's most preferred location.

- Several if not all of the other counties mentioned were in near proximity to large metropolitan areas and therefore, are not representative of your typical rural areas.

Therefore, we would oppose increasing the 75th percentile qualification as some have suggested. Rather, we propose:

- That FCA should require the data used for the 75th percentile criteria be based on rural home loans from the local and surrounding area that are reflective of the community's rural home valuations. Preferably the statistics should reflect rural home loans in rural communities of less than 2,500, which is where FCS can lend.

- FCA provide the public with specific data on the valuations of the home loans that are being made by FCS institutions by state so the public can better gauge how FCS is fulfilling its home lending mission.

- FCA provide the above requested information to be consistent with the Department of Housing and Urban Development's (HUD) recent announcement that the public will now have access to Fannie Mae's and Freddie Mac's mortgage activities later this summer when the agency will reclassify data from these GSEs, making this data public rather than treating it as proprietary.

When you look at the facts, it's plain to see FCA housing parameters for FCS valuations are already lenient and more than adequate to allow FCS to serve legitimate rural housing needs.

Conclusion
In summary, our conclusions are that, at the very least, IF CHANGES ARE MADE to the current regulations, they should be along these lines:

- FCS lending should only be to "bona fide" farmers and ranchers.

- Bona fide farmers should be required to actually produce ag commodities within two years of an application or become automatically ineligible as evidenced on their schedule F tax form.

- Bona fide farmers should be considered to be those who receive a majority of their income from production agriculture.

- Bona fide farmers should contribute significant personal time, labor, capital and management to the farming operation.

- Do not allow FCS lenders to finance the non-farm needs of either full-time or part-time farmers that are not necessary for maintenance of the farm. Keep FCS financing focused solely on agricultural lending and any other lending should be directly related to the farming operation. Loans should be restricted as borrowers move away from agriculture.

- The FCA housing regulations are already too liberal and should be tightened so that FCS uses only rural housing data reflective of the local and surrounding area.

- FCA should provide the public with specific details on FCS housing loans by state to have adequate information to accurately gauge what FCS is doing in their housing financing. We ask that this information be made a part of this hearing record.

- We also request FCA make available to the public as part of this meeting record the statistics on FCS lending to businesses that have farm-related activities. This information should describe whether businesses' farm related sales represent a majority or minority of the businesses' total income and the proportional degree of FCS financing. This authority has not been discussed in context of this latest FCS push for new customers and unrestricted lending, even though it has played a role in the growth of the FCS customer base and FCS's disproportionate gain in market share relative to commercial banks.

  I want to thank the FCA board for the opportunity to make these comments.