

**Testimony of Bert Ely, President  
Ely & Company, Inc.  
Before the FCA Public Meeting on  
Eligibility and Scope of Financing  
June 26, 2003**

Mr. Chairman and members of the Board of the Farm Credit Administration (FCA), I am Bert Ely and I am here today to offer some comments on the eligibility and scope of financing provided by Farm Credit System (FCS) institutions. As you know, I am a long-time observer of the FCS, having published three reports on the FCS since 1990. Also, since 1998 I have written a monthly newsletter, the Farm Credit Watch (FCW), commenting on FCS lending practices. Although the American Bankers Association is a client of mine, I am speaking today solely for myself.

The notice for today's Public Meeting posed four questions regarding the eligibility and scope of financing provided by FCS institutions. Before addressing these most important questions, I would like first to frame the FCS lending issue, offer a proposed revision to the lending objective regulation, 12 C.F.R. '613.3005, and then illustrate the need for this proposed revision with a few examples of highly inappropriate FCS lending.

### **Framing the FCS lending issue**

It is clear from reading the Farm Credit Act, the existing FCA regulations, and histories of the FCS that Congress has always intended that the FCS provide credit to agriculture and not to rural America, per se. There is one exception to this congressional intent, which I will discuss later -- FCS financing of rural housing.

Very sound reasoning underlies this congressional intent -- when Congress created the FCS, various federal and state laws prevented commercial banks from meeting all of agriculture's credit needs. When the federal land banks were created in 1916, national banks and many state-chartered banks were barred from making real estate loans. Further, branching restrictions had prevented the emergence of larger, multi-branch banks with the capital and geographical diversity to finance farm real estate.

The failure of 9,000 mostly small, single-office rural banks in the 1930-33 period led to congressional authorization of production credit associations in 1933. Had branch banking been permitted prior to that time, there would have been adequate bank credit available to farmers during the Great Depression. Had there not been artificial, government-imposed constraints on banking, the FCS would never have been created. Today, those constraints are long gone. Commercial banks and other private-sector lenders have the capacity to provide ample credit to farmers and ranchers as well as to non-agricultural borrowers living or operating within rural America.

### **Meeting the credit needs of part-time farmers versus full-time farmers**

As we all know, agriculture has changed dramatically in recent decades. The drop in the total number of farms and ranches, from 6.8 million in 1935 to 2.1 million in 2001, has masked an even sharper drop in full-time farmers and ranchers. In 2001, America had just 313,000 farmers with annual farm sales exceeding \$100,000, 147,000 of which had annual farm sales exceeding \$250,000. Clearly, the 1.8 million other farmers, who usually are less-than-full-time farmers, have credit needs as do the substantial number of non-farmers living in rural America and the non-farm businesses operating in rural America. However, the thousands of commercial banks operating in

rural America, as well as other private-sector lenders, are fully capable of meeting rural America's non-agricultural credit needs and in fact are meeting the majority of those credit needs every day. More importantly, Congress never intended that the FCS meet the non-agricultural credit needs of rural America -- the FCS was created solely to finance agriculture. The FCA's regulations should not expand upon that intent.

Congress's later authorization of FCS loans to finance rural housing did not authorize FCS lending for other non-agricultural purposes. In fact, the reference to "owners of rural homes" in the eligibility section of the Farm Credit Act (12 U.S.C. '2017) clearly expresses the congressional intent that FCS institutions not lend for non-agricultural purposes, except to finance rural housing. Note also the FCS's authorization to lend for "basic [agricultural] processing and marketing operations" and for "farm-related service businesses" -- the emphasis is on agriculturally related businesses, not all rural businesses. If Congress wanted FCS to lend for any purpose to any person living in or any business operating in a rural area, it would have so stated in the Farm Credit Act. It has not done so.

The sharp distinction the Farm Credit Act draws between agricultural and non-agricultural credit underlies a key issue facing the FCA -- how to differentiate the agricultural credit needs of part-time farmers and ranchers from their non-agricultural credit needs. Some would argue that if someone dabbles even a tiny bit in agriculture -- for example, raising and selling a few cows annually -- the FCS should be able to finance all of that person's credit needs. That credit might include the mortgage on a 20-acre parcel on which the cows graze, but which also is graced by a \$1.5 million mansion with an attached garage housing three Mercedes financed with installment loans and credit cards. FCS financing of all of that person's credit needs clearly would violate congressional intent, as reflected in the Farm Credit Act.

The FCA has addressed this conundrum in the present lending objective regulation with the word "conservative." Here the word does not have a safety-and-soundness connotation. Rather, it means that credit shall be supplied only to finance agricultural needs, not mansions and Mercedes. For example, the third sentence of the regulation states 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" [emphasis supplied].

#### **A proposed revision of the lending objective regulation, '613.3005**

The intent of the third sentence in '613.3005 is laudable, but it is not objective and quantifiable. That lack of an objective and quantifiable manner in which to define "agricultural needs" makes it extremely difficult for the FCA to enforce congressional intent upon FCS lenders who are willing to violate that intent. I am here today to propose a revision to the lending objective regulation to establish a quantifiable measure for limiting the amount of credit that the FCS can provide to a less-than-full-time farmer. The intent of this proposed revision is to put the farm back into Farm Credit. The first and fourth sentences of the existing regulation would remain as they are. The middle two sentences would be replaced by three new sentences, which I have underlined.

It is the objective of each bank and association, except for banks for cooperatives, to provide full credit, to the extent of creditworthiness, to the full-time bona fide farmer (one whose primary business and vocation is farming, ranching, or producing or harvesting aquatic products); and conservative credit to less than full-time farmers for agricultural enterprises, and more restricted credit for other credit requirements as needed to ensure

a sound credit package or to accommodate a borrower's needs as long as the total credit results in being primarily an agricultural loan. In order to provide an objective measure of credit supplied by a Farm Credit institution or institutions to a farmer, the maximum amount of credit provided at any one time shall not exceed five times the farmer's average farm sales over the previous three calendar years, as evidenced by the farmer's federal tax returns, or projected farm sales over the following two calendar years. Should the amount borrowed exceed five times actual farm sales over the period of projected sales, as evidenced by the farmer's federal tax returns, then the loan shall be sold promptly to a non-Farm Credit institution. FCA examiners shall review new credit extensions to farmers during the course of their safety and soundness examinations to ensure compliance with this regulation. Credit shall not be extended where investment in agricultural assets for speculative appreciation is a primary factor.

Three examples will illustrate the operation of a five-times-annual-farm-sales rule. In the first case, a part-time farmer has annual farm sales of \$40,000. Under this regulation, he could borrow up to \$200,000 at any one time from the FCS to finance his farming activities. In the second case, the hobby farmer with the \$1.5 million mansion, three Mercedes, and \$5,000 in annual farm sales would be able to borrow only \$25,000 from the FCS. That is an entirely appropriate limit since this "farmer" obviously has substantial non-farm income. In the third case, a beginning farmer reasonably projects that her farm sales in the second calendar after the year in which she obtains an FCS loan would reach \$150,000. She would be eligible to borrow up to \$750,000 under this regulation. However, she should not be lent more than she can safely manage, which might be much less than \$750,000.

The five-times-annual-farm-sales limit is not an arbitrary number. Rather, it is a very generous limit on the amount of credit that can be serviced by an agricultural activity. That is, any credit provided to a borrower which exceeds five times her annual farm sales simply cannot be serviced by those farm sales, after taking into account the cost of the farm inputs and labor it would take to produce those sales. The five-times-sales multiplier would ensure that FCS credit was financing only agricultural activities, the clear intent of the Farm Credit Act.

### **A response to the Board's first three questions**

Having presented my proposal, I will address the first three questions posed by the Board:

Question 1 -- Current '613.3000(a)(1)) defines a bona fide farmer, rancher, or aquatic producer as a person who either owns agricultural land, or is engaging in the production of agricultural products. Do you think the FCA should retain this definition or change this definition? If you favor changing this definition, please offer specific recommendations.

Answer: It is not necessary to change the related regulation if the FCA adopts the five-times-annual-farm-sales limit I have just proposed. A bona fide farmer today is one who sells at least some portion of what she produces. Therefore, the amount of annual farm sales or farm rental income a farmer or rancher reports on Schedule F or another federal tax return form should be the basis for determining the maximum amount the farmer can borrow from the FCS.

Question 2 -- What limits, if any, should FCA regulations place on lending for farmers' other credit needs?

Answer: The Farm Credit Act clearly indicates that except for financing rural housing, the FCS should not finance any individual's non-agricultural credit needs.

Question 3 -- 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?

Answer: The present regulatory distinction between full-time and part-time farmers is too vague and can never be drawn with sufficient precision in words. Some part-time farmers are very part-time, i.e., taking just a few hours a year to lease some farmland they own to a farmer, while others spend 1,000 hours, or more, actually farming. Therefore, the FCA should adopt a quantitative measure -- annual farm sales -- to limit the amount a farmer or rancher can borrow from the FCS so as to avoid the impossible task of drawing a semantical distinction between a full-time farmer and a part-time farmer.

### **Examples of highly inappropriate FCS lending that the revised regulation would bar**

I will briefly cite three outrageous FCS loans that I have reported in ECW that apparently have been classified as loans to "farmers" under the present lending objective regulation. My proposed revision to the regulation clearly would have barred these loans as well as many other FCS lending abuses that I have reported in ECW.

Minnesota gravel pit: The current (June 2003) issue of ECW reported on a loan Grand Forks ACA made to the owner of a gravel pit, refinancing an existing \$1.04 million loan that had been made by the Ultima Bank Minnesota. Reportedly, the loan also refinanced some gravel hauling equipment and the pit owner's lake home. Mining a gravel pit is a legitimate rural activity, but there is nothing agricultural about mining. Further, this loan reportedly was solicited by Grand Forks ACA, not the gravel pit owner. Obviously, Grand Forks ACA make this loan only because it could offer the borrower a lower, taxpayer-subsidized interest rate. That is not why the FCS was created. My proposed rewrite of '613.3005 would bar this type of loan.

Fox Den Development: The October 2002 ECW reported that Carolina Farm Credit, ACA, lent \$4.5 million in April 2002 to Fox Den Development Company, L.L.C. The loan was secured by approximately 400 acres near Statesville, North Carolina, consisting of "an exciting 18-hole championship golf course" and contiguous, developable land. According to the Fox Den website, "luxurious, but surprisingly affordable homes" will be built on this property. The open-ended deed of trust for this loan provided that this property can collateralize up to \$8 million of FCS loans to Fox Den that are outstanding at any one time. This loan clearly violates the Farm Credit Act and the FCA's lending regulations. In particular, the regulations state that loans shall be made to bona fide farmers and shall not be made "where investment in agricultural assets for speculative appreciation is a primary factor." Growing homes is not an agricultural activity, but clearly property appreciation is a primary goal of property developers. My proposed rewrite of '613.3005 would bar this type of loan.

50-acre estate in Fauquier County, Virginia: The November 2001 ECW reported the purchase of a lovely 50-acre wooded, hillside estate, with scant evidence of agricultural activity, that was financed with an \$840,000 first mortgage provided by Farm Credit of the Virginias, ACA. The property's land value was assessed for tax purposes at \$264,000 while its improvements, principally a fieldstone manse, were valued at \$604,000. In Virginia, property tax assessments are supposed to reasonably approximate market values. Therefore, it appears that Farm Credit of the Virginias financed most of the purchase price of this property, which at best has farm sales of just a few thousand dollars annually. Farm Credit of the Virginias justified this loan by stating that the property had the "potential" for agricultural. Apart from the fact that this property has very little agricultural potential, due to its hilly nature, the purpose of the FCS is to lend to active farmers and ranchers and to those, such as young, beginning, and small (YBS) farmers, who have viable business plans for entering agriculture or expanding an existing farming operation. My proposed rewrite of '613.3005 would have barred this loan and thousands of similar loans the FCS has made in recent years to finance rural estates, weekend getaways, and hunting preserves, none of which are even remotely related to agriculture.

### **The rural housing issue**

Question 4 -- Should we change our definition of "moderately priced" rural housing in Section 613.3030(a)(4)? If you favor changing the definition, please offer specific recommendations.

I wish to endorse the position taken by another witness today, Mr. Mike Firestine, regarding how the FCA should approach the issue of FCS financing of moderately priced housing. Clearly, though, FCS institutions increasingly are financing rural housing that can hardly be called "moderately priced." The upper end of the local market would be a much better description of these cases.

Mr. Chairman and members of the Board, I have appreciated the opportunity to testify today on these most important issues. I welcome your questions.

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