FCS of America’s Organizational Choices: Sale to Rabobank, Merger with AgStar, or Status Quo?

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September 1, 2004

Executive Summary

During the summer of 2004, one of the largest lending associations of the farmer-owned U.S. Farm Credit System received two competing sale and merger offers. The target of these offers is Farm Credit Services of America, the farm credit association serving agricultural borrowers and rural customers in Iowa, Nebraska, South Dakota, and Wyoming. On July 30, the association’s board of directors voted to accept Rabobank’s purchase offer. Soon thereafter, AgStar, a neighboring association serving parts of Minnesota and Wisconsin, made its second proposal of the summer for merger between the two associations. Both the sale and merger offers include \$600 to \$650 million cash distributions of capital to FCS of America stockholders of record as of a yet to be determined date. The sale alternative would also require FCS of America to transfer capital in excess of 6% of assets, estimated to be approximately \$800 million, to the government-owned Farmer Credit System Insurance Corporation for exiting the Farm Credit System.

The purchase offer from Rabobank is unprecedented in the history of the Farm Credit System. It has raised many questions and concerns about the motivations for the transaction, the equitability of the purchase price, and whether a sale of a Government Sponsored Enterprise is in the public interest. In contrast the merger offer by AgStar follows the path of numerous prior mergers and consolidations among System institutions over the last two decades.

FCS of America views the sale as providing its stockholder/borrowers with access to Rabobank’s national and international lending markets, and to its extensive menu of products and services. Such prospects seem brighter than a continuation of concentration in a mature farm real estate lending market and a highly competitive non real estate farm lending within the four state territory. More effective deployment of the association’s relatively strong, unallocated capital position is also sought. Interestingly, however, much of the same goals can be achieved by remaining a merged member of the Farm Credit System and utilizing the available tools, programs, and authorizations.

Rabobank sees the FCS of America purchase as a profitable way to further penetrate the U.S. agricultural finance market and to achieve high rates of return. High profitability (e.g. 15 to 20% return on equity) arises from the \$800 million exit fee. One effect of this requirement is to reduce the purchase price to \$600 million and boost the rate of return. Rabobank is a Dutch-based, triple A rated, internationally active bank with a solid history of U.S. operations. Its

interest in buying part of the U.S. Farm Credit System is understandable in light of the favorable profit prospects.

AgStar's merger proposal would combine the two neighboring associations, diversify the types of loans and farming regions, increase operating efficiencies and size economies, distribute $650 million to FCS of America's stockholders, and provide access to an on-going capital and patronage allocation program to stockholders. The merger would also continue the consolidation trends among the Farm Credit System institutions.

Public policy perspectives are also important to consider. The Farm Credit System has a nearly 90 year history of service to the agricultural sector. Despite extensive modernization, the System remains a farmer-owned, federated system of banks and associations, organized as cooperatives, with loan funds obtained from bond and other security sales in the financial markets. The "agency status" of these securities offsets part of the risks of having a single industry focus. A 25% to 30% share of total farm debt (around 50% for farm real estate debt), the added competition to rural financial markets, the System's capacity to absorb agricultural credit risks, and its public mandate to serve young, beginning, and small farmers speak to the value of the System's contributions. In moving forward, both the Farm Credit Act of 1971, as amended, and the FCA capital and territorial regulations should be examined to determine whether they have inadvertently fostered the proposed sale of FCS of America to Rabobank.

Finally, GSEs in general have come under periodic scrutiny, regarding their continued need, the subsidies they provide to external investors, and the contingent liability they bring to the Federal government. Only one GSE—the Student Loan Marketing Association (Sallie Mae)—has sought and received permission from Congress to relinquish its GSE status. A 12-year wind-down period between 1996 to 2008 was established in this case, although the company anticipates being ready for privatization two years ahead of this date.

The web of factors cited above and discussed in this report suggests that the proposed merger between AgStar and FCS of America has considerable merit. It would avoid the ad hoc sale of a large lending association that could bring a run on other Farm Credit System institutions. It will also meet most of the needs expressed by the FCS of America's board of directors, and avoid the need to recreate a new delivery system by the Farm Credit System in meeting the financing needs of farmers in the four state territory. If privatization of the System were to eventually occur, an orderly process of relinquishing GSE status is preferable to an opportunistic departure in serving the public interest, continuing reliable credit services to U.S. agriculture, and adapting to changing financial market conditions.

FCS of America's Organizational Choices:
Sale to Rabobank or Merger with AgStar

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During the summer of 2004, two competing offers to sell or merge have been received by one of the largest lending associations in the farmer-owned U. S. Farm Credit System. The target of these offers is Farm Credit Services of America, serving agricultural and rural customers in Iowa, Nebraska, South Dakota, and Wyoming. On July 30, the association's board of directors voted to accept Rabobank's purchase offer. Soon after, AgStar, a neighboring association serving parts of Minnesota and Wisconsin, made a second proposal for merger between the two associations. Both offers include $600 million to $650 million cash distributions of capital to FCS of America stockholders of record as of a yet to be determined time period.

Mergers and consolidations among FCS institutions have been common, beginning in the 1980s, but the sale of a System institution to outside investors is unprecedented. A sale would require FCS of America to exit the Farm Credit System following a detailed set of steps overseen by the Farm Credit Administration, the U.S. government agency that regulates System institutions. Approval by FCS of America stockholders will be one of the crucial steps, as will approval by the Farm Credit Administration. An association exiting the System must also pay a fee to the government-owned Farm Credit System Insurance Corporation equal to the amount of capital above 6% of the association's total assets—an estimated $800 million in this case. No such fee is required in the event of a merger.

The two proposals have significantly different impacts on the farmer members of FCS of America, the rest of the Farm Credit System, and on the roles of Government Sponsored Enterprises (of which the Farm Credit System is one) in the nation's public credit polices. One sale could begat another, ultimately dissolving the System and ending its role as a dedicated source of credit for U.S. farmers, ranchers, and their cooperatives during good and bad economic times. A merger with AgStar would keep the merged entity in the System, continue the past pattern of consolidation, and avoid creating the costs of re-establishing Farm Credit System services in the four-state territory (Appendix A summarizes the Farm Credit System's organizational characteristics and capitalization practices).

The Two Proposals

AgStar's merger proposal has the following features

- A cash distribution of $650 million to FCS of America stockholders as well as a special capital allocation to current AgStar stockholders to equalize the capital positions.
- Extension of AgStar's current capital allocation policy to members of the merged entity, including equity allocations to members and revolving cash distributions.
- Continued ownership and control by stockholder/members of the merged institutions

- Retaining membership in the Farm Credit System.

- Focus on continued service to mid-western U.S. states, by the current office locations and lending personnel of the two associations.

- A re-named association "AgStar Financial Services", headquartered in Omaha, Nebraska with leadership by AgStar's CEO and an executive team appointed from the current management of AgStar and FCS of America.

Rabobank's purchase proposal is featured by:

- A $600 million purchase price disbursed in cash to stockholders who borrowed from FCS of America during the past five years (precise allocation rules and stockholder eligibility remain to be defined).

- Exit of FCS of America from the Farm Credit System, pending stockholder and FCA approval. FCA would grant access to the four state territory to other yet to be determined FCS institutions or allow charter of a new lending association.

- Likely conversion of FCS of America to an agricultural credit corporation chartered in Nebraska, subject to regulation by Nebraska banking authorities

- Expansion of credit services to the entire U.S. market and to global markets served by Rabobank, as well as access to Rabobank's multiple products and services.

- Payment to the U.S. government-owned Farm Credit System Insurance Corporation of approximately $800 million as an exit fee for leaving the Farm Credit System. The payment would result in a substantial increase in the assets of the insurance fund, likely reducing for a time the insurance premiums paid by other System institutions.

- Both proposals would have similar income tax effects on the stockholders of FCS of America, with income tax obligations created on the cash distribution. Whether the income is considered a corporate dividend or a patronage distribution is unclear. The tax consequences of the exit payment have also not been determined.

Rabobank's Perspective

Rabobank is a banking institution created in the 1890s and currently owned by nearly 400 Dutch cooperative banks. Its $500+ billion of assets places it in the top 15 of commercial banks world-wide. About 16% of its loans are to food and agribusiness firms, again world-wide. U.S. operations are conducted by a subsidiary, Rabobank International, headquartered in New York, with several regional offices staffed mostly by Americans. Rabobank began its U.S. operations in the 1980s by focusing heavily on agribusiness financing largely in the form of loan participations and syndications with other financial institutions, including some of the banks of the Farm Credit System.

Rabobank's earnings have yielded returns on equity of about 10% in recent years, a modest level for financial institutions (annual report). The average ROE for 9,192 FDIC insured commercial banks in the U.S. was 15.03% during 2003, with a 16.31% ROE for 110 banks having more than $10 billion of total assets. Purchase of FCS of America, however, will yield an estimated ROE for Rabobank of about 15.4% based on the $600 million purchase price (Appendix C). The high ROE in part reflects the reduction of FCS of America's capital by the $800 million exit fee. Ironically, the exit fee, established in part as a disincentive for exiting the System, now provides a strong incentive for outside investors to acquire Farm Credit System institutions, as long as the associations hold capital well above the 6% level -- as is generally the case.

FCS of America's Perspective

FCS of America has capital holdings that are high relative to those of other lending associations in the System. Moreover, none of the capital has been allocated or distributed to its members. Thus, FCS of America is likely seeking ways of more effectively deploying the capital, although the association could likely make a sizable allocation/distribution to its members at this time.

In addition, the FCS of America sale announcement touts the new entity's ability to leverage and utilize Rabobank's deep resources, large size, and world-wide reach. This would provide access to financing for those borrowers who seek to expand beyond the four state territory in the U.S. or beyond the U.S. borders. Such expansions, however, are also currently possible through existing System arrangements and lending authorities. Loan participations among the System institutions are a commonly used tool for spreading risks and pooling funds. While overseas lending is not permitted, funds for international expansion can be mobilized through System relationships with commercial banks, other lenders, and foreign institutions including Rabobank.

The number of FCS of America's approximately 50,000 members realistically interested in expanding internationally is likely few in number, although they would be large in size, strong in financial performance, and among the more profitable borrowers for lenders to finance. The 2002 Census of Agriculture indicates that Iowa and Nebraska have heavy concentrations of hogs and beef, respectively. Contract hog production and custom cattle feedlots can be large enterprises with substantial financing needs. Beyond these factors, the four state territory has a size distribution of producers comparable to those of other mid-western states.

FCS of America's high concentration in farm real estate lending (about 70% of their loan portfolio) suggests that much of its lending occurs in a mature market in which the demand for other credit-related services may be smaller than for non real estate loans. The four state territory also is characterized by strong, long standing competition in non real estate lending by other lenders, especially commercial banks. At year end 2002, for example, commercial banks held 64.5% and 64.4% of non real estate farm loans in Iowa and Nebraska, while Farm Credit System market shares were 10.4% and 9.3%, respectively. These banking shares reflect the history of strong community bank lending in the respective states. The Farm Credit System shares are considerably higher in other regions of the U.S. where larger banking organizations have a weaker history of agricultural lending.

While the sale announcement reports that Rabobank anticipates retaining the same personnel and office locations in Iowa, Nebraska, South Dakota, and Wyoming, the longer term post-sale decisions will be Rabobank's responsibilities.

AgStar's Perspective

The AgStar merger proposal is consistent with the extensive consolidation of System institutions over the last 25 years. Since the early 1980s, the number of Farm Credit System banks has fallen from 37 to 5, while the number of lending associations has declined from over 1,000 to less than 100.

The territorial and asset sizes of lending associations differ considerably across the U.S., ranging from several large, multi-state entities to numerous multi-association states. FCS of America is one of the larger associations while AgStar's total assets place it in the top 10% of all associations. Similar to other System mergers, AgStar's interests are to achieve operating efficiencies and size economies, more extensive diversification of risks, and to deepen service offerings to member/customers of the merged entity.

Unlike other System mergers, AgStar's proposal creates a clear choice regarding the value stockholders place on ownership and control of a lending institution with a public mission to serve agriculture. If FCS of America stockholders choose to "cash out" the equity in their cooperative, farmers in neighboring states would in effect be asked to recapitalize a farm credit presence in Iowa, Nebraska, South Dakota, and Wyoming.

Association Profiles and Merger Effects

Several key differences between the two associations influence potential benefits of merging, as summarized in Appendix B. AgStar shows a considerably higher share of non real estate (operating and term) loans in its portfolio than does FCS of America which has a high concentration in farm real estate loans. AgStar's extensive involvement in financing dairy, swine and grain producers in Minnesota and Wisconsin along with other local enterprises, the adjacent geographic location and a favorable pattern of weather conditions also complement those of FCS of America. Swine and grain would continue to be major enterprises in a merged association.

AgStar has relied on a combination of allocated and unallocated capital in its capital management, while FCS of America has made no capital allocations to its members (neither have the other associations in the Agribank district). These patronage allocations of capital by AgStar are to be followed by revolving cash distributions. They reflect the cooperative principles of keeping current capital and voting involvement in the hands of current borrower/members.

Other non financial agricultural cooperatives have long followed capital allocation and distribution practices in managing cooperative capital. Prior to the farm credit legislation of the 1980s FCS institutions relied on stock purchases required of farm borrowers as the dominant source of capital, with stock redemptions when loans were fully repaid(stock rollovers were common on the renewals of operating loans).

Since the 1980s, however, the emphasis has shifted to "at risk" retained earnings as the primary source of capital. Rebuilding depleted capital levels and repaying federal assistance were major goals for System institutions following the farm financial problems of the 1980s. Patronage allocations and cash distributions were on the back burner. This is no longer the case. Capital levels have been restored and strengthened. The FCS banks have been distributing capital to the associations that own the banks and some associations (especially in the south-eastern AgFirst district) now have established patronage allocation programs to their members. In the AgriBank district, however, AgStar's patronage allocation program begun in 1998 is unique.

AgStar's cost and revenue structure also differs from that of FCS of America. Greater reliance by AgStar on smaller operating and term loans increases operating costs per dollar of loan relative to costs per unit of real estate loans. However, greater reliance on non real estate loans also increases the opportunity to offer related services (e.g. crop insurance, record keeping, tax accounting, financial counseling, and others) to borrowers, thereby expanding non interest earnings. As a result, the combined net cost structure for AgStar and FCS of America are about the same.

The merged institutions' compliance with minimum regulatory capital requirements could also be achieved through the use of available capital management tools to offset the effects of a $650 million cash distribution to stockholders. Examples include the sale of loan participations to other System institutions, issuance of preferred stock, stand-by purchase arrangements, and loan securitization. To illustrate, consider a simplified representation of the merger impacts, including $100 million of preferred stock and a $1.5 billion of loan participation sales to other System institutions (Table 1).

Table 1. Summary Financial Effects of a Merger Between AgStar and FCS of America, December 31, 2003 Data

	AgStar	FCS of America	Merged Institutions
		Millions	
Net loans	$2,371	$7,084	$7,955
Total assets	$2,537	$7,634	$8,671[1]
Total liabilities	$2,197	$6,340	$7,587[2]
Net worth	$340	$1,293	$1,084[3]
Capital ratios			
Capital/Total assets	13.41%	16.94%	12.50%[4]

[1]AgStar plus FCSA assets minus $1.5 billion loan sale.
Total assets (merged) = 2,537 + 7,634 – 1,500 = 8,671
[2]AgStar plus FCSA liabilities plus $650 distribution minus $1,500 loan sale and preferred stock
Total liabilities (merged) = 2,197 + 6,340 + 650 – 1,500 – 100 = 7,587
[3]Total asset minus total liabilities
Net Worth (merged) = 8,671 – 7,587 = 1,084
[4]Capital/Total assets = 1,084/8,671 = .1250

The total net merged assets after the participation ($8,671 million) are the sum of AgStar's assets ($2,371 million) plus FCS of America ($7,634 million) assets minus $1.5 billion of loan sales. Total liabilities ($7,587 million) are the sum of the two associations' merged liabilities plus $650 million needed for the cash distribution minus $1.5 billion of debt retirement for the loan portfolio and the $100 million preferred stock. The restructured balance sheet results in a total capital to assets ratio of 12.50%, slightly less than AgStar's stand-alone capital ratio of 13.41% at year end 2003. One time merger costs are excluded from this illustration, and it is assumed that other FCS institutions would have the capacity to engage in purchases of preferred stock and loan participations. The relatively strong capital positions System-wide together with recent growth in loan participations and preferred stock support the plausibility of these assumptions.

A more extensive modeling analysis and the consideration of tax implications would add validation and adjustments to these calculations. Projections over time would also validate the capacity of a merged association to competitively meet the credit needs of borrowers, sustain loan growth, and counter risk, while also conducting a patronage program of capital allocation and revolving cash distributions. Past experiences of several associations with patronage programs, the positive results of past System mergers, continued evolution of credit risk assessment and underwriting practices, and the long standing experiences of other agricultural cooperatives suggest that these are feasible goals to attain.

FCA Regulatory Perspectives

The Farm Credit Administration will engage extensively in overseeing the steps of an orderly exit process for FCS of America or a merger between AgStar and FCS of America. These steps are set forth in the Farm Credit Act of 1971, as amended, and in the Agency's regulations for System institutions. The unprecedented nature of the potential exit, however, raises several issues about regulatory changes in the future.

Current regulations specify minimum capital requirements for FCS institutions regarding safety and soundness and institutional compliance with the provisions of the Farm Credit Act of 1971, as amended. The institutions are examined regularly to ensure institutional compliance and to foster management practices consistent with the FCA regulations. In addition, FCA regulations require institutions to consider optimal capital levels over and above the minimum requirements. The FCS banks generally have determined quantitative parameters for optimal capital. Associations, however, rely more on qualitative and judgmental considerations in addressing optimal capital. Following the stress times of the 1980s, capital restoration was a primary goal with what might be informally characterized as a "more is better" philosophy. While FCA never articulated such a policy or philosophy, it may be fair to say that higher levels of capital were seldom discouraged. Thus, capital levels of associations are currently at relatively strong levels. As a result, most believe that adoption of modern economic capital management concepts would lead to modest reductions in overall capital holdings.

FCS institutions have also been less consistent than non-financial agricultural cooperatives in their use of formal patronage allocation and distribution practices. Thus, capital holdings of many associations are unallocated, obscuring identification of institutional ownership and hampering determination of the costs of equity capital as occurs in non cooperative, corporate businesses. In the future, FCA could consider placing greater emphasis on capital allocation issues as a part of overall capital management.

Related to the above discussion is the connection between capital regulations and the actual levels of credit, market and operational risks carried by the FCS institutions. The current version of risk-based capital employed by FCA has become antiquated in light of best-practices employed by the leading financial institutions world-wide. The recently published New Basel Accord, which recommends guidelines for capital regulations of financial institutions, sets forth a variety of options that range from a few risk weight categories to use of the institution's own internal risk rating systems to determine probabilities of default, loss given default, expected losses, and capital needed to backstop potential losses. In contrast, FCA capital requirements use several risk weight categories even though nearly all of the loans held by the FCS associations are in the 100% risk weight class. The result is no meaningful quantitative distinction between higher and lower risks in addressing required or optimal capital holdings. The adoption of more contemporary approaches to risk-based capital would allow closer calibration of capital to differences in associations' risk conditions.

Competition among Farm Credit System institutions occurs in some instances, and FCA gave recent consideration to the availability of national charters for those institutions that would apply and demonstrate strong prospects for successful expansion. CoBank currently has a national charter, internet lending capabilities are increasing, and the recent growth in loan participations across territorial lines has represented a form of territorial expansions. The FCS of America proposals and the continued interest in more broadly based competition suggest further consideration of re-chartering and mobilizing the System's lending and service capacities.

The Agricultural Policy Perspective

Policy considerations affecting the Farm Credit System occur at two levels. One involves the mission of a Government Sponsored Enterprise in agricultural finance. The other involves the general role of GSEs in the U.S. economy. The Farm Credit System was developed by Congress in the early 1900s to first provide a dedicated source of farm real estate credit for farmers which were expanded in the 1930s to include non real estate credit. A prior century of credit problems for farmers was highlighted by short 3- to 5-year maturities on farm mortgage loans, the absence of amortized repayment programs, farmers' uncertainties about the availability of credit to refinance maturing loans, and whether or not the same institution still existed.

Congress recognized that a specialized, dedicated financial institution for agriculture had little opportunity to further diversify risks. Back-up, thus, was provided through the concept of a Government Sponsored Enterprise. The FCS began with government seed money (subsequently repaid) which aided funds acquisition though bond sales in the national financial markets. System institutions were also to follow a cooperative structure to allow farmer ownership and control. Also allowed were certain regulatory preferences and exemptions on bond sales and a perception of implied government backing if bond repayment obligations could not be met. As a result, the bonds have carried "agency status" allowing them to be issued at interest rates that normally are 10 to 50 basis points above those of U.S. Treasury securities of comparable maturity.

The general description above is still applicable today despite a host of major changes in the Farm Credit System over the past 90 years. The public purpose remains one of providing dedicated, competitive credit and related services to the agricultural community, broadly defined. A 25% to 30% total market share of farm debt over time speaks to the high value attributed to the System's services. Also important is the degree of effective competition, especially in farm real estate lending, the System has brought to the market. Its delivery system provides a localized presence for delivering funds from the national and international financial markets to rural communities and farmers. These credit sources combine with those of commercial banks, agribusiness lenders and others to expand farmers and ranchers competitive choices in financing their operations. Moreover, statutory oversight by the agricultural committees of the House and Senate together with a specialized regulatory agency provides for close monitoring and periodic adaptation of the System's role in financing agriculture.

The Farm Credit System also plays an important role in agricultural policy through its involvement in agricultural risk management. The equity capital and reserves position of the FCS institutions are a farmer-owned reserve for backstopping credit risk in agriculture. They join government payments, federal crop insurance, and other government credit programs as the policy menu for agricultural risk management. At year end 2000, the Farm Credit System reserves consisted of $18.9 billion of equity capital and assets in the FCS Insurance Corporation. In addition, borrower/stockholders paid about $37 million for the safety and soundness functions of the Farm Credit Administration.

The GSE Policy Perspective

Other GSE financial institutions have been patterned after the successful experiences of the Farm Credit System. Fannie Mae and Freddie Mac have achieved extraordinarily large size by providing secondary market services for the residential housing market. Sallie Mae has provided a similar function for university student loans. The Federal Home Loan Bank System gives commercial banks and other institutions access to GSE funds on terms comparable to those of the FCS. Farmer Mac provides a secondary market capability for farm real estate loans originated by other lenders, and has provided stand-by purchase commitments on farm real estate loans made by several FCS institutions.

GSEs in general have come under periodic, yet growing public scrutiny due to the contingent liability they bring to the federal government, the size and recipients of the subsidies they provide, their political power, and claims that other providers of credit services can successfully and equitably fill the GSE mission. Subsidies primarily arise from the funding cost advantages of agency securities and the mandated availability of credit to eligible borrowers through good and bad economic times. Estimated annual subsidies for Fannie Mae, Freddie Mac and the Federal Home Loan Banks, for example, fall in the $13 billion to $16 billion range. About half the subsidy goes to mortgage borrowers and the other half to the institution's owners. Because the Farm Credit Systems owners are farmers, the subsidies are captured by the intended recipients. It is unclear, however, why external investors in other GSEs should profit from federal subsidies.

Given these combined attributes of the GSEs, it is also unclear why their mission and resources should be sold off in a piecemeal fashion. As a retail- wholesale lender the FCS has invested heavily in an extensive delivery system to provide access to all U.S. farmers, consistent with its public mission. Having to recreate or duplicate this delivery system to ensure FCS credit services in a territory exited by an FCS institution has its shortcomings.

Privatization of a GSE is not without precedent. Sallie Mae, formerly the Student Loan Marketing Association, determined it could better meet its goals by relinquishing its GSE status. They brought their case to Congress and received authorization in 1996 to wind down their GSE operations over a 12-year period. Sallie Mae, now called SLM Corporation, is ahead of schedule, anticipating full privatization by the end of 2006. In the meantime, the institution conducts its operations in GSE and non GSE divisions, with the latter increasing in relative size over time. The privatization issue was publicly debated, thoroughly analyzed, and accepted by the parties involved. The result has been an orderly process of privatization.

Concluding Comments

The web of factors cited above and discussed in this report suggests that the proposed merger between AgStar and FCS of America has considerable merit. It would avoid the ad hoc sale of a large lending association that could bring a run on other Farm Credit System institutions. It will also meet most of the needs expressed by the FCS of America's board of directors, and avoid the need to recreate a new delivery system by the Farm Credit System in meeting the financing needs of farmers in the four state territory. If privatization of the System were to eventually occur, an orderly process of relinquishing GSE status is preferable to an opportunistic departure in serving the public interest, continuing reliable credit services to U.S. agriculture, and adapting to changing financial market conditions.

Appendix A

The Farm Credit System: Organizational Characteristics and Capitalization Practices

The Farm Credit System is a system of federally chartered, privately owned lending associations, banks, and service units organized as cooperatives for the purpose of providing credit and related services to agricultural producers, their cooperatives, and rural homeowners in the United States, The System's goals, expressed in the Farm Credit Act of 1971, as amended, are to improve the income and well-being of U.S. farmers by furnishing sound, adequate, and constructive credit to credit worthy borrowers, and to provide these services through favorable and unfavorable economic times. By virtue of the cooperative organization, the agricultural borrowers become the System's owners and holders of equity capital, and they are represented by elected boards of directors. The associations and banks of the System are regulated and examined by the Farm Credit Administration, an independent agency in the Executive Branch of the U.S. Government.

The capital or net worth components of the System institutions reflect a combination of their cooperative and taxation status. These components have their own terminology and typically include

1. Capital stock, participation certificates, and paid-in surplus.
2. Earned surplus which may be

   Allocated surplus—allocated to members and either paid in cash or retained by the institution, and

   Unallocated retained earnings

3. Accumulated other comprehensive income.

Patronage distributions of equity capital generally occur when unallocated capital is allocated to members through either qualified or non qualified allocations. Non qualified allocations such as those allocated by AgStar and as defined by IRS are not deductible for the cooperative and are not subject to federal income taxation for stockholders at the time of allocation. Qualified distributions require at least 20% of the allocation to be distributed in cash. Both the cash and non cash portions of a qualified allocation are taxable to the recipient in the year of allocation.

Regulatory capital held to meet minimum capital requirements of the Farm Credit Administration must be at least 7% of risk weighted assets.

Appendix B

Table B.1. Selected Business and Financial Characteristics for AgStar and FCS of America, December 31, 2003 Data

	AgStar	*FCS of America*
1. Business and Lending Characteristics		
1.1 Number of borrowers		
Voting	12,363	42,920
Non-voting	3,708	3,702
1.2 Number of loans outstanding		
Within territory	133,490	210,906
	680	267
2. Financial Characteristics		
2.1 Balance sheet		
Net loan, $ million	2,370,705	7,084,015
Total assets, $ million	2,537,140	7,633,606
Total liabilities	2,196,826	6,340,170
Net worth	340,314	1,293,436
Capital stock, participation, certificates, paid surplus	11,060	47,819
Earned surplus	329,254	1,245,617
Unallocated	255,625	1,245,617
Ratios, %		
Total capital to assets	13.41	16.94
Permanent capital/risk adjusted assets	12.03	14.64
Core surplus ratio	10.53	13.28
Total surplus ratio	11.60	14.19
Unallocated capital to total assets	10.08	16.32

2.2 Income Composition, % of Average Earning Assets, 2003

	AgStar	*FCS of America*
	%	
Average earning assets/average total assets	94.07	95.67
% average earning assets		
Interest income	5.87	5.55
Interest expense	2.80	2.64
Net Interest Margin	3.07	2.90
Non interest income	0.94	0.61
Non interest expense (operating cost)	1.87	1.68
Net operating expense	.93	1.07
Provision for loss	0.18	0.07
Income taxes	0.30	.09
Net Income	1.66	1.67
Return on Avg. Earning Assets	1.66	1.67
Return on avg. assets	1.56	1.60
Return on equity	11.64	9.44
Patronage distribution/net income	0.60	0.00

Table B.2. Composition of Loan Portfolios by Type of Loan, December 31, 2003[1]

AgStar		FCS of America	
Long-term agricultural mortgage	40.7%	Farm real estate	69.7%
Production	13.3%	Agricultural production	28.5%
Intermediate term	18.1%	Farm-related businesses	0.7%
Finance leases	3.9%	Leases	0.3%
Rural home	1.3%	Rural residence	0.8%
Participation purchased (mostly agri-business)	22.7%		
Total	100%		100%

[1]Source: Annual reports, 2003. Differences in reporting formats and possible definitions of loan types hamper comparisons. For example, FCS of America reports participations sold (excluded here) but does not report their loan types.

Appendix C

Table C.1. Income Impacts for Rabobank from FCS of America Investments

Assumptions and Estimates

- Based on 2003 performance of FCS of America from 2003 Annual Report.
- Steady-state conditions in the future.
- Revenue reductions for Agribank payments for dividend equalization and patronage allocation.
- Cost reduction for FCSIC premiums and Financial Assistantship Corporation payments.
- Adjustment for income taxation of real estate loans, 20% of net
- Estimated income transaction costs, 2.5% of net purchase price

FCSA 2003 net income	
Before tax	$120,751
Tax provision	6,681
After tax	114,070
Post acquisition revenue reductions	
Divided equalization, Agribank	2,548
Patronage distribution, Agribank	14,227
Total	(16,775)
Post acquisition cost reductions	
FCSIC premium	8,386
Financial Assistance Corporation	5,789
Total	14,175
Adjusted net income	118,151
Income taxes	23,630
Net income	94,521

Return on Equity (ROE): $\dfrac{\text{Net income}}{\text{Purchase price plus transaction cost}}$

$$ROE = \frac{94{,}521}{615{,}000} = .154 \text{ or } 15.4\%$$