



Regulatory Burden Comment Period Closes

The comment period for reducing regulatory burden on Farm Credit System (FCS or System) institutions ended January 19. Of the 30 comment letters received, nearly all were from FCS institutions and FCA staff. Within the 30 letters, more than 325 separate comments were identified.

Last August, FCA published a notice in the *Federal Register* asking commenters to identify regulations and policies that duplicate other governmental requirements, are ineffective, or impose burdens that are greater than the benefits received. Our earlier regulatory burden and rulemaking projects resulted in eliminating or streamlining many regulatory requirements and repealing several FCA prior-approval requirements.

"We initiated this most recent project to continue improving the regulatory framework for the FCS," said Thomas McKenzie, director, Office of Policy and Analysis. "Such projects help us maintain the most effective regulations for the System in the face of continually changing agricultural credit markets," he added.

According to McKenzie, the greatest number of comments focused on borrower rights/servicing requirements, loan purchases and sales, and disclosure of loan information. Other regulatory areas receiving a significant number of comments were member insurance and related services, and eligibility and scope of financing issues.

"We are currently in the process of analyzing all the comments and will make recommendations to the FCA Board in the coming months," McKenzie noted.

McKenzie explained that the Board may take several approaches to address the comments as it considers FCA staff recommendations. The Board could:

- Modify or delete regulations for non-complex issues through a fast-track action such as an Interim Final Rule or a Direct Final Rule;
- Initiate a comprehensive regulation project to modify complex regulations and seek public comments;
- Retain the existing regulation but provide further guidance through FCA Board Policy Statements or Bookletters; or
- Retain existing regulations without change because of statutory requirements or safety and soundness concerns.

He expects the Board to take its first action resulting from the project this summer.

"We are committed to continually updating our regulations and policies so they remain useful to the FCS. However, most importantly, they must maintain the System's safety and soundness and meet the requirements of the Farm Credit Act of 1971," McKenzie said.

Copies of all comment letters received are available for review by the public within certain legal and procedural guidelines. To learn more about these guidelines, contact Patsy DiMuzio, Director, Regulation and Policy Division, at 1501 Farm Credit Drive, McLean, Virginia, 22102-5090, by telephone at (703) 883-4498, or by e-mail at dimuziop@fca.gov.

FCA Assists Small Business Administration with Examinations

FCA's Office of Examination (OE) is "lending a hand" to the Small Business Administration (SBA) this year by performing examinations of 14 Small Business Lending Companies (SBLCs).

Just how did this arrangement between FCA and SBA come about? FCA is an associate member of the Federal Financial Institutions Examination Council (FFIEC). The FFIEC is a formal interagency body established by the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The law restricts membership to include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

During a meeting with FFIEC, SBA asked for help in conducting examinations of the SBLCs, which are licensed by SBA to make guaranteed loans to small businesses. SBA is responsible for supervising, examining, and regulating the SBLCs, many of which are subsidiaries of major corporations such as GE Capital, First Union, and Transamerica.

In response to SBA's request for help, FCA entered into an agreement with SBA to examine the 14 SBLCs during a one-year period. This period may be extended if both FCA and SBA are satisfied with the arrangement. The exams are conducted on a full cost recovery basis. Every dollar we receive from SBA is returned to the FCS, which will result in a net reduction of approximately \$950,000 to FCA's assessment of the FCS.

"We don't perform full-scope examinations like we do with FCS institutions," said Tom Holland, director of the Special Examination and Supervision Division. "We focus on risk by evaluating asset quality, credit administration, and compliance with the SBA capital regulation," he said. "We also look at how the SBLC is addressing Year 2000 problems."

Holland said the examinations are staffed with examiners from all FCA field offices as well as FCA's Office of Policy and Analysis. This arrangement has given examiners the opportunity to broaden their experience through exposure to a different lending environment. Holland added that examiners are enjoying their participation in this new venture. "In this respect, it is a win-win situation," he said.

While FCA has a contractual agreement with SBA, there is an escape clause. "If we need to, we can terminate the program by providing SBA with 60 days of notice," Holland said. He added that SBA can also terminate the program by providing the same amount of notice.

FCSIC Board Announces Increases in Insurance Premium Rates

Citing substantial growth in System volume, the Farm Credit System Insurance Corporation Board of Directors announced an increase in the rate of insurance premiums charged on accruing loans held by Farm Credit System institutions.

The Corporation raised the rate from 3 basis points to 9 basis points on accruing loans for the period January 1 through June 30, 1999. The premium rate on nonaccrual loans remains at 25 basis points and zero on government-guaranteed loans.

"The growth in insured debt, 9 percent in 1998, was greater than the growth of the Insurance Fund and well beyond the growth originally estimated by System banks," said Corporation Chairman Michael Reyna. "The growth resulted in the Insurance Fund dropping below the statutory 2 percent secure base amount," he added. Reyna explained the secure base amount is a "moving target" affected by growth in System debt outstanding. At yearend, the Insurance Fund balance was \$1.26 billion, and total System loans were \$67.9 billion.

"Increasing the premiums should provide for reaching the secure base again and also may allow a small cushion for additional growth in insured debt for 1999," Reyna said. He noted the Board believes the System may continue to grow in 1999 at a rate that is equal to or greater than the 6 percent average growth for the last four years.

Reyna also said that during the latter half of 1998, several institutions experienced increases in nonperforming loans. He noted the System's nonperforming assets compared to total loans and other property owned increased to 2.1 percent at yearend 1998 from 1.4 percent at yearend 1997. Reyna added that other institutions expect deterioration later this year due to continued low commodity prices and poor export markets for System borrowers.

"The Corporation will review premium rates again shortly after mid-year," Reyna said. He noted the policy statement on adjustments to the insurance premiums provides for a review to be conducted at least semiannually and sets out five factors the Board will consider in determining whether to adjust premiums. The five factors are the level of the Insurance Fund relative to outstanding insured debt obligations, any projected losses to the Insurance Fund, the condition of the Farm Credit System, the health of the agricultural economy, and any risks in the financial environment.

Following release of the announcement on the increase in premiums, some FCS institutions expressed concern about the increase being retroactive to January 1, 1999. In response to these concerns, Reyna promised to consider revising the timing of the review to better mesh with the budget cycle used by System institutions.

USDA Forecasts Continued Stress in Agriculture

U.S. Department of Agriculture (USDA) Secretary Dan Glickman was pessimistic about the prospects for a quick turnaround in the current adverse conditions for agriculture when he spoke at the USDA's Agricultural Outlook Conference February 22 and 23.

"We are in the middle of a crisis that shows no signs of abating for producers. We are losing farmers at an alarming rate," said Glickman. He noted three major factors contributing to the current situation: (1) harsh weather conditions, (2) increased world production, and (3) a global economic slump. The near-term outlook is for continued large surpluses and weak demand.

Staff members of the Risk Analysis Division attended the conference and provided the following highlights:

- The USDA expects farm income to decline over the 1998-2000 period due to lower commodity receipts, but then, starting in 2001, gradually to increase through 2007.
- Supplies of wheat, corn, soybeans, cotton, and rice are the highest in years, while prices for these commodities are the lowest in years. For 1999, USDA analysts project income for these crops will be 27 percent below the previous 5-year average. Commodity prices are expected to remain low for the next several years. The outlook for soybeans is especially grim as domestic acreage is expected to continue expanding while foreign producers, especially in South America, do likewise.
- Livestock markets for both cattle and hogs will be stronger in 1999, with prices for these two commodities averaging about 7 percent higher than last year.
- Using entirely new regional designations that do not follow state boundaries, the USDA expects the brunt of financial difficulties for 1999 to fall mainly in three regions—the Heartland, Mississippi Portal, and the Northern Crescent regions. One in four farms in the Heartland region is not expected to earn enough to cover expenses in 1999.
- Many differences separate today's conditions from those of the 1980s. Today's agriculture sector is financially better able to withstand adversity and is also less likely to be as dramatically tested. This is due to greater domestic economic stability, a less pronounced agricultural expansion, and more conservative use of credit by farmers.
- Secretary Glickman explained that a new and improved risk management safety net is needed for agriculture, with crop insurance as the foundation of that system. Massive Federal assistance can not be relied on in the future. The crop insurance program needs to be more affordable, cover multi-year losses, offer revenue insurance, and include livestock coverage. In addition, a simplified farm credit application process is needed, as well as incentives to establish on-farm storage facilities.

Overall, agriculture will continue to face stress in the short-term. But as noted during the conference, agricultural lenders, including the Farm Credit System, are financially stronger and more able to withstand these down cycles than in previous years.

FCA Explains Approval Process for Related Services Programs

The Farm Credit Administration has received questions from the Farm Credit System about the prior approval process for “related services” and whether all proposed new services require prior approval from FCA.

In 1995, the FCA Board adopted the final regulation on related services. This regulation replaced the previous prior approval requirement with a post-review process, significantly reducing the time and resources needed for an FCS institution to begin offering most services.

FCA defines “related service” as any activity provided by an FCS institution that is appropriate to the recipient's on-farm, aquatic, or cooperative operation, including control of related financial matters. This definition includes activities previously referred to as financially related services, technical assistance, and financial assistance. The regulation also includes insurance in the definition of “related services.”

Currently, FCA communicates to all FCS institutions those services the Agency has approved through a “Related Services List,” which identifies any institutional restrictions or special conditions that apply to each service. For any service on that list, an FCS institution can develop a program and offer the service without any prior regulatory review.

New services that have never been approved by FCA must be submitted for review. Action is taken generally within 60 days. FCA determines whether the proposed new service meets the definition of related service and evaluates the risks associated with the service. In some cases, to better evaluate the risks in particularly complex or controversial services, FCA may ask for public comment on certain new services.

The *FCA Newsline* is a publication of the Farm Credit Administration. Suggestions, comments or questions should be sent to: Editor; Office of Congressional and Public Affairs; Farm Credit Administration; 1501 Farm Credit Drive; McLean, VA 22102-5090; Phone: 703-883-4056; Fax: 703-790-3260; E-mail: info-line@fca.gov; Web site <http://www.fca.gov>.

Chairman and CEO, Marsha Pyle Martin; Board Members, Ann Jorgensen and Michael M. Reyna.

The Farm Credit Administration is the Federal agency responsible for the regulation and examination of the Farm Credit System, a nationwide network of cooperatively owned agricultural lending institutions and their service organizations.

The approved related services are: estate planning; fee appraisal; record keeping (including Agrifax™); tax planning and preparation; farm business consulting; cooperative business consulting; foreign currency exchange; and financial risk management for customers.

Approved insurance services are: credit life insurance; mortgage life insurance; mortgage accidental death insurance; term life insurance; credit disability; accident insurance; mortgage disability insurance; hospital income insurance; multiple-peril crop insurance (including insurance provided by the Federal Crop Insurance Corporation); crop hail insurance; hay (or other crop) fire insurance; and title insurance.

Visit FCA's Web site to find more about any institutional restrictions or special conditions that apply to each service. The address is: <http://www.fca.gov/handbook.nsf>. Click on the link **FCA Board Policy Statements**. Click on the link **Related Services List** at the bottom of the page to view the complete list.

Proposed Bill May Expand Use of Subchapter S by Commercial Banks

Recently introduced legislation could reduce the amount of Federal tax paid by banks and financial institutions other than FCS entities. If enacted, the Small Business and Financial Institutions Tax Relief Act of 1999 (H.R. 242) would increase the opportunity for small banks to convert to S corporations, thus decreasing significantly the amount of taxes they pay annually. The proposed bill would double the Subchapter S eligibility determination from 75 to 150 stockholders (family members and trust organizations would continue to count as a single stockholder).

Historically, commercial banks have claimed FCS institutions have a tax advantage. In recent years, however, more commercial banks have taken advantage of the Small Business Job Protection Act of 1996, which allows certain financial institutions to convert to Subchapter S corporations, thereby eliminating the double taxation associated with corporations and their stockholders.

As cooperatives, FCS institutions fall into three tax filing categories: (1) tax-exempt; (2) C corporations under Chapter 1, Subchapter A, of the Internal Revenue (IR) code; or (3) cooperatives under Subchapter T of the IR code. FCS institutions are fairly evenly divided among the three categories.

Of 203 FCS associations in 1997, 32 percent paid corporate taxes as C corporation filers. A C corporation is an entity separate from its owners, providing a stable organizational structure that can outlive its owners as well as provide them with a legal liability protection. Corporate income tax rates generally range from 15 to 35 percent, with the higher rates applied to taxable income brackets of more than \$100,000. Corporation profits distributed to stockholders as dividends are included in their gross income. Consequently, corporation profits are subject to taxation at the corporate level and again at the shareholder level when distributed as dividends. In 1997, only one of 10 businesses in the United States operated as a C corporation.

Thirty percent of FCS associations took advantage of Subchapter T rules in 1997 to pass earnings and tax liability through to shareholders as patronage dividends. A total of 61 System institutions elected to file under Subchapter T of the IR Code. Thirty-eight percent of FCS entities are tax exempt. In 1998, FCS institutions recorded \$180 million in provisions for state and Federal income taxes, approximately 13.6 percent of its income earned before taxes.

To reduce taxes and increase after-tax earnings, much like the Subchapter T option, commercial banks are converting to Subchapter S corporations at a rapid pace, according to Linda Sherman and Robert Andros of FCA's Risk Analysis Division. They co-authored "Federal Income Tax Options Available to FCSIs and Their Competitors," which appeared in the *FCA 1998 Mid-Year Report*. They explain that a Subchapter S corporation, like a partnership, is not subject to Federal income tax at the corporate level, passing its income and expenses through to its shareholders in proportion to their stock ownership.

According to the Federal Deposit Insurance Corporation, 58 commercial banks filed Subchapter S tax returns for tax year 1995. By 1997, that number had jumped to 585, saving an estimated \$190 million in taxes.

By March 15, 1999, the number of Subchapter S converted commercial banks was 1,042. These ranged in assets from \$12 million to more than \$1 billion. Minnesota and Texas led the nation in banks filing under Subchapter S last year, with 148 and 145, respectively. Many of these commercial banks are small rural banks that pass their tax savings on to their owners and customers, increasing the competition for FCS institutions that compete for some of the same loans.

If enacted, H.R. 242 would make it easier for small banks to convert to S corporations and make them more competitive with FCS institutions. Approximately 25 percent of small commercial banks—those with assets less than \$150 million—have converted to S corporations. About 3,000 potential candidates remain.