

Competitive Pricing And The Farm Credit System

What rules apply to Farm Credit System institutions in setting interest rates to customers?

- The Farm Credit Act (Act) provides that “it shall be the objective” of System lenders to set interest rates and other charges “at the lowest reasonable cost on a sound business basis” taking into consideration the lender’s cost of funds, necessary reserves and the cost of providing services to its members. *See* sections 1.8(b), 2.4(c)(2), and 3.10(a).
- FCA regulations require System institution boards to approve interest rates and adopt policies on differential interest rates. *See generally* §§ 614.4150, 614.4155, and 614.4160.

Does the Act prohibit System lenders from charging interest rates below other lenders’ rates?

- Generally, no. Section 1.1(c) sets forth Congress' policy to prohibit a System institution using special regulatory accounting practices (RAP) per from charging below competitive market rates. No System institution now uses RAP.
- Section 1.1(c) and the RAP provisions were added to the Act in 1986. In response to the worsening crisis in agricultural debt, Congress amended the Act in order to enable System institutions to charge borrowers lower rates of interest.
- The 1986 Amendments authorized System institutions to use RAP to capitalize interest costs and amortize loan losses over a 20-year period. *See* sections 4.8(b) and 5.19(b) of the Act.
- Congress also amended section 1.1, the “policy and objectives” section of the Act, to say that when an institution took action in accordance with the 1986 Amendments (*i.e.*, used RAP), it should not charge a rate of interest below competitive market rates for borrowers of equivalent creditworthiness. The System’s authority to use RAP expired in 1992.

Does FCA expect System lenders to take competitive market rates into consideration when they set interest rates?

Yes. Appropriate loan pricing is critical to the safety and soundness of System lenders. We expect institutions to consider their cost of funds, reserve needs, and capital requirements and to support loan pricing decisions with documentation of their competitive environment. Most often that documentation should include surveys of competitors' rates.

How does FCA respond to complaints about unfair competition?

- In reviewing allegations of unfair pricing, typically we will contact the System institution in question and discuss the nature of the complaint. Without specifically identifying the commercial bank, we ask the institution to respond to the allegations. We also obtain information regarding the System institution's loan pricing and loan policies and conduct other interviews, as necessary.
- We review the specifics of the allegation to evaluate whether the loan pricing is consistent with the institution's loan pricing policy and whether there are any safety and soundness concerns. We will generally determine whether the institution's loan pricing is sufficient to cover the institution's costs and provide for sufficient capital and review the institution's analysis of competitive market rates.
- In all cases, we make a determination as to whether the loan or loan program in question is in compliance with the law, regulations, and the loan policies of the institution, and we provide an appropriate response.

Has there been an independent review of the System's loan pricing practices?

Yes.

- In early 1990, Congress held a hearing on "Predatory Pricing and the Farm Credit System." *Hearing before the Subcomm. on Policy Research and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. (1990). Subsequently, in the 1990 Farm Bill, Congress mandated a General Accounting Office (GAO) study of the extent and fairness of competition between Farm Credit institutions and commercial banks. The GAO published its study in 1994.
- The GAO concluded that the System was not an unfair competitor. On average, rates on System loans were lower than those offered by small commercial banks, higher than rates at large banks, and about the same as rates available from insurance companies.
- The GAO also reviewed all the complaints of "predatory pricing" made to FCA between 1989 and 1991 and, based on that review, supported FCA's view that none of the complaints was justified. *See General Accounting Office, Farm Credit System: Repayment of Federal Assistance and Competitive Position*, GAO/GGD-94-39 at 139 (1994).

Did the GAO address commercial bankers' charges that System institutions were prohibited from offering loan rates below competitive market rates?

Yes. The GAO rejected the commercial bankers' interpretation of the 1986 Amendments. The GAO said that section 1.1(c) was intended to address concerns over possible dissipation of System capital that might result from charging below market rates (*e.g.*, rates set using average-cost pricing during the late 1970s and early 1980s). The GAO further stated that section 1.1(c)

was not a provision of "positive law" and did not constitute a formula for the determination of loan rates.

How do System lenders obtain accurate information about competitors' rates?

It is difficult for financial institutions—commercial banks as well as System lenders—to obtain exact information about competitors' actual loan rates and terms or loan practices. Pricing surveys, whether performed in-house or by an independent third party, give a valuable picture of the trends and ranges of loan prices but must be used as only a general indicator of the market. Advertised loan rates provide some data, but institutions often adjust advertised rates to reflect the risk profile of a specific borrower. Some information is also provided by prospective customers, but that information may not be entirely accurate.

It is important to keep in mind that, today, many types of creditors provide agricultural financing. The agricultural credit market includes not only System lenders and rural commercial banks, but also large commercial banks, finance companies, and manufacturers and suppliers providing trade credit. Many of these large, highly-efficient competitors can offer farmers better rates than the traditional agricultural lenders. In addition, the credit market is increasingly national, and even international, instead of local. As a result, agricultural credit customers have more choices than ever before.

Is it important for System institutions to be able to charge their borrowers competitive interest rates?

As stated above, the Act intends System lenders to set interest rates "at the lowest reasonable cost on a sound business basis." As a response to the agricultural crisis of the mid-1980s, Congress enacted the 1986 Amendments to "permit the moderation of interest rates FCS institutions charge." A year later, in order to make sure that the relief provided by the Agricultural Credit Act of 1987 was effective, Congress required the Farm Credit System Assistance Board to report on "the extent to which System institutions translate the savings in the cost of the operations of such institutions due to the Federal assistance provided to the System under this title into lower interest rates charged to System borrowers" *See* section 6.6(d) of the Act. Today, with farmers facing economic challenges on many fronts, it is as important as ever for them to have access to credit at competitive rates.