

# Farm Credit Administration

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Bookletter – BL-063

July 8, 2010

To: Chairman, Board of Directors  
Each Farm Credit System Institution

Chief Executive Officer  
Each Farm Credit System Institution

From: Leland A. Strom  
Chairman and Chief Executive Officer

A handwritten signature in black ink that reads 'Leland A. Strom'. The signature is written in a cursive style with a large initial 'L'.

Subject: Farm Credit System Bank Merger Applications

This booklet has been approved by the Farm Credit Administration (FCA or Agency) Board and communicates the Agency's expectations for the submission of proposals to merge Farm Credit System (FCS or System) banks.<sup>1</sup> The FCA Board recognizes that merger decisions primarily rest with System stockholders. However, given the complexity of issues that may result from bank mergers, the FCA Board also wants to ensure that merger applications identify and comprehensively address all the broad implications for the System and its institutions.

Mergers of FCS banks<sup>2</sup> may provide benefits and create risks for the merging banks, bank shareholders, the System as a whole and all eligible borrowers. Benefits of a bank merger may include portfolio and geographic diversification, improved risk-bearing capacity, management capability, and operational efficiencies. However, a bank merger may increase risk by creating a larger, more complex and difficult-to-manage institution. Such a bank may present broad risks to other System institutions. As discussed more fully below, when evaluating a bank merger application, the FCA will carefully consider the long-term impact on the safety and soundness at the institution, district, and System levels, including size concentration risk, business model compatibility, and intra-System operational risk. Of particular importance are the implications

<sup>1</sup> Section 611.1020 of FCA's regulations states:

Where two or more banks plan to merge or consolidate, the banks shall jointly submit to the Farm Credit Administration the documents itemized in §§ 611.1122(a)(1) through (4), (6), (7), 611.1122(e) and 611.1123. In interpreting those sections, the word "bank" shall be read for the word "association."

Section 611.1122(a)(7) requires that banks include in their merger applications any information or documents requested by the FCA in addition to the documents and information specified in the regulations.

<sup>2</sup> Subject to the FCA's approval, FCS bank mergers are authorized under sections 7.0 and 7.12 of the Farm Credit Act of 1971, as amended (Act).

these risks may have on the System's long-term service to eligible borrowers and its continued ability to fulfill its mission as a government-sponsored enterprise (GSE). Therefore, the FCA expects bank merger applications to clearly and fully address:

- The risks that the larger bank would create for the continuing bank's shareholders and System as a whole, including the impact on the System's repayment of joint and several debt obligations and protections available to investors in System debt.
- How the resulting bank and the System would be structurally safe and sound for the long-term, including the long-term compatibility of the shareholder associations with the business philosophy of the bank.
- How the proposed merger furthers intra-System collaboration and coordination on intra-System operations, furthers the System's GSE mission, including service to eligible borrowers, and safeguards the American taxpayer in the financial performance and mission service of the System as a GSE.

### **Size Concentration Risk**

During the 1980s and 1990s, with dramatic changes in the financial landscape, the System evaluated and implemented various alternative organizational structures to better position System institutions for providing financial products and services to agriculture. The various mergers, territorial realignments, transfers of direct lending authorities, and other organizational changes have resulted in a complex array of differently sized entities, overlapping territories and different business models. At the bank level alone, the number of institutions went from 37 in 1988 to 5 today, with 2 bank districts accounting for over 62 percent of total System assets. Future bank mergers would further concentrate System assets.

Size concentration risk is a significant safety and soundness issue that must be addressed in any bank merger application. The bank merger application must include an analysis of the size concentration risk being borne by the other banks, the System as a whole, and by investors in Systemwide debt obligations. For instance, concentrating assets and funding in a single bank's business model may unduly stress the Insurance Fund and the statutory joint and several liability of the remaining banks. To address size concentration risk, merger applications must identify needed risk mitigating controls such as stronger financial performance requirements, enhanced standards and obligations in intra-System agreements and, possibly, equalization through association re-affiliations, territorial adjustments, or other structural or financial approaches that could occur contemporaneous with the merger. As part of the analysis of size concentration risk, it is important that the merging banks consult with other banks on appropriate and acceptable risk mitigating actions and controls.

### **Business Model Compatibility**

Bank mergers succeed or struggle based on the level of business model, cooperative philosophy, and operating practice compatibilities between the bank and its shareholder associations. Therefore, it is important for a bank and its affiliated associations to share business model compatibility in order to achieve long-term success. This compatibility is essential whether the bank is a limited-service, full-service, or mixed retail-wholesale bank. Successful integration into a cohesive bank district requires the long-term support of the resulting bank's affiliated associations and their respective boards and management teams. Given the risks posed by business model incompatibilities to the long-term financial and operating success of a bank, merger applications must identify and analyze the risks and provide practical approaches for addressing them. These approaches may include providing associations that have different philosophies the opportunity to re-affiliate contemporaneous

with the merger. Alternatively, the bank may consider refining its business practices or governance structure to result in greater compatibility with the district business model, cooperative philosophy, and operating practices.

### **Intra-System Operational Risk**

Associations' ability to serve eligible borrowers depends on the System's collaboration and coordination on various intra-System operational matters. For instance, associations rely, to varying degrees, on their funding bank, including bank support for needed loan products and related services, skill in obtaining cost-efficient funding, ability to limit interest-rate risk, and success in managing liquidity risk. Similarly, all banks work together to access the financial markets, coordinate on loan products and services, and on other matters.

A bank merger may concentrate significant influence, management decision making, and authority in the resulting bank. Therefore, bank merger applications must include: (1) an assessment of the impact that the merger will have on representation in various Systemwide decision-making and coordination bodies; and (2) identify any needed enhancements or new measures that ensure long-term cooperation across the System. Within the bounds of safety and soundness, the FCA wants to ensure that coordination and cooperation across the System continues to facilitate individual institutions fulfilling and furthering their statutory mission as GSEs. The FCA expects the merging banks to use a cooperative and collegial approach in addressing this issue by communicating with their respective shareholders and all System banks and associations in the process.

### **Conclusion**

Open communication with the merging banks' respective shareholders and comprehensive disclosure are essential to fully identify and address these broad issues. Similarly, discussion and coordination with other System banks and their shareholders will be important in analyzing and addressing potential issues that may impact the System. FCA expects early and ongoing communication when banks are considering a possible merger, including an early review of the many potential agreements or arrangements needed to facilitate the process.

As we have done for association merger applications, the FCA intends to issue bank merger guidelines that describe the bank merger application process and list the specific information and documents that a bank merger application must contain. These bank merger guidelines will help facilitate comprehensive and complete bank merger applications.

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