The Agricultural Credit Act of 1987: Problems Solved and Created For The Cooperative Farm Credit System

by

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When they passed the Agricultural Credit Act of 1987 (the Act), Congress restructured and redesigned the Farm Credit System (FCS), and they gave FCS owners and management very explicit directions on how to run their business. The Act is a far reaching attempt to repair a broken down system, and redesign it to minimize the chances of another breakdown. Congress also sent a clear signal that if the FCS does break down again, it probably will not be repaired.

The organizers of this symposium asked me to identify problems solved and problems created. I added a third category-- problems unresolved.

Problems Solved

1. Financial Assistance

The $4 billion financial assistance package simultaneously addresses a number of problems. Cash infusions into financially troubled FCS entities will restore solvency and liquidity, guarantee borrower stock, offset some of the interest payments on high cost debt, and restore investor confidence. By restoring borrower confidence and reducing interest expenses, they should be able to slow the exodus of high quality borrowers, and be in a better position to compete for new business. The impact of the $90 million assistance package on the Louisville FLB illustrates these effects. The value of stock worth $3.03 under GAAP was restored to its $5 par value, and average debt cost was reduced from 11.1% to 9.7%. However, the availability of financial assistance does not guarantee that all FCS institutions will survive. As the Jackson FLB experience has demonstrated, the Act gives the FCA the power to close FCS institutions when liquidation costs less than financial assistance.

2. Fewer Nonaccrual Loans.

Restructuring of distressed loans will convert some nonaccruing loans into earning assets which should increase net interest income. In addition, loan restructuring negotiated directly by lenders and borrowers should be less costly for both parties than Chapter 12 bankruptcies. The long term effects of mandatory loan restructuring are uncertain. Restrucutured loans

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essentially leave those borrowers with 100 percent debt financing, so longterm prospects for recovery are questionable. Also, only part of any gains from loan restructuring can be attributed to the Act because several troubled banks were aggressively restructuring loans and liquidating acquired property long before the Act was passed.

3. Organizational Restructuring

In 1982, the FCS had enough bricks and mortar to handle a loan portfolio that was $85 billion, and growing. By 1987 it was $50 billion, and still shrinking. At year-end 1987 there were 37 banks. Now there are 16--11 Farm Credit Banks, 4 regional BC's and 1 National BC. (These numbers are based on the assumption that without a merger partner, the Jackson FICB will merge with a neighbor).

The primary benefit from restructuring will be improved service to borrowers and better credit evaluations from packaging long and short term loans. The cost savings from bank mergers will be small because all 36 FLB/FICB/BC regional banks were operated as 12 jointly managed units before the Act was passed; hence, potential overhead reductions from mergers had already been largely realized. In fact, it could be argued that the Act increased the number of FCS banks from 13 to 16! Reducing the number of entities will not result in a proportionate reduction in staff, and any cost savings may well be offset by increases in travel and communication expenses.

4. Regulatory Authority

The 1987 Act reaffirmed the regulatory powers of the FCA provided in the 1985 Farm Credit Amendments Act. The extent to which the FCS's problems can be attributed to inadequate supervision is debatable; however the FCA should now be able to enforce timely corrective action when necessary. The surprise closing of the Jackson FLB indicates that the FCA does have the will to make difficult decisions.

Problems Created

There are several provisions of the Act that will increase FCS lending costs and give competitors greater lending authority.

1. Borrower's Rights

Restructuring, reviews, appeals, right of first refusal, federal funding of mediation, etc. have significantly reduced FCS's flexibility in managing delinquent loans and acquired property. In addition to their immediate impacts on existing distressed loans, the borrowers rights provisions convey implicit messages to all present and future borrowers: good borrowers are subsidizing delinquent ones and the consequences of defaulting on a FCS loan are not particularly serious. Thus, FCS lenders will also experience higher loan screening costs because there are clear incentives for weak borrowers to go to FCS and for good ones to go elsewhere. It appears that Congress overreacted to a few legitimate cases of unfair treatment of FCS borrowers, and in doing so they may have created another FmHA.

2. Increased Lending Costs

Despite efforts to streamline the FCS, most provisions of the Act will adversely affect their lending costs well into the 21st century. The $4 billion assistance package and RAP accounting may solve immediate problems; however, the Act stipulates that the FCS must eventually repay all government aid, with interest. In addition, there will be insurance fees of .0015 (.0025) X accruing (nonaccruing) loans. The new capitalization methods and higher capital requirements will also have to be passed on to borrowers in the form of loan origination fees and/or higher interest rates.

In the short run, organizational restructuring will be disruptive and costly. Fewer offices will require new credit delivery systems. An expanded FCA and new entities such as the Financial Assistance and Insurance Corporations will increase overhead that may have to be spread over a declining volume of loans. Some of these added costs will be offset by lower funding costs resulting from restored investor confidence.

Precise estimates of these cost increases cannot be predicted. Barry's analysis suggests that repaying $4 billion over 10 years will add 130 basis points to lending cost. When other costs and RAP deferred expenses are included, the total effect may well be 200 basis points. Reduced funding costs may reduce the net effect to 150 basis points. Overall, the loan pricing advantage that the FCS historically enjoyed has likely been eliminated.

3. More Competition in Real Estate Lending

If the secondary market authorized by the Act does evolve, the FCS will continue to lose market share in real estate lending. It is not clear whether the FCS should participate in a secondary market or compete with it. They may be forced to use it to avoid the high costs of capital requirements and borrower rights on loans held in their own portfolios.

Prospects for a viable secondary market appear questionable. Origination and pooling fees, payments into reserve funds and compliance with eligibility standards will be expensive, especially in the early stages. The long list of restrictions on eligibility for inclusion in a pool will also make it difficult to process loan applications in a timely manner. It may be nearly impossible to find a pool of loans that fulfill all of the parameters on loan size, geographic and commodity diversity, etc. The size of the market may be the biggest constraint. Prentice estimates that $500 million to $2 billion of farm mortgages will go into the secondary market each year. With nearly $300 billion in residential mortgages to choose from each year, it will be difficult to generate much investor enthusiasm for Farmer Mac offerings.

Problems Not Resolved

1. Single Sector Lending Authority

The Act does nothing to allow or encourage the FCS to diversify beyond lending to farmers, farmer owned cooperatives, and rural home buyers. Splitting off the BC's from the Farm Credit Banks may have worsened the specialization problem.

2. Lack of Coordination/Cooperation

A spirit of cooperation within FCS has been noticeably absent throughout their traumatic years as evidenced by their tendency to sue each other instead of sharing losses. Although the Act suspended Capital Preservation Agreements, it does nothing to encourage or force system entities to come together when the need arises. As an example, $12.3 million of the $16.4 million FAC assessment on Fourth District PCA's was paid by the five small associations that stayed outside of the district-wide merger in 1986, and they are going to court to try to get their money back.

3. Management Issues

The Act does little to address management problems that contributed to the FCS's problems. As Klinefelter notes, not all troubled FCS entities were poorly managed, and some FCS management problems are common in all lending institutions. My own assessment is that FCS owners have been reluctant to pay what it takes to attract the calibre of people needed to effectively manage a large, complex financial institution. The FCS can no longer hide its management shortcomings behind the veil of low cost agency market funding. Unfortunately, increased bureaucratic overhead and reduced managerial flexibility resulting from the Act will make it even more difficult to attract qualified management in the future.