FRBSF WEEKLY LETTER

October 16, 1987

FCS: At The Crossroad, Again

The Farm Credit System (FCS) is at yet another critical juncture. The System faced an earlier crisis in the fall of 1985, when public disclosure of grave financial problems raised concern over the riskiness of the debt issued by this key agricultural lender. (See *Weekly Letter*, Dec. 20, 1985.) This concern was not eased until the passage of the 1985 Farm Bill, which provided for Congressional consideration of direct federal aid to the FCS.

Today, the sense of urgency surrounding the FCS "crisis" stems mostly from a desire to protect the System's member/borrowers. The FCS already has taken a number of steps to protect member capital. Many of these steps were made possible by legislative changes. This year, the Farm Credit Administration (FCA), the federal regulator of the FCS, is seeking further federal legislative assistance. Most prominent among the measures sought by the FCA is a line of credit from the Treasury to the Farm Credit System.

In this *Letter*, we discuss whether a line of credit with the Treasury, as well as some other steps already taken by the FCS, addresses the fundamental problems plaguing the FCS.

The FCS

The Farm Credit System is a cooperatively owned organization of banks and associations that provides credit and related services to farmers and agricultural cooperatives. The System holds about one-fourth of total farm debt in the U.S. and is organized into 12 districts. Each district has three bank groups serving different purposes. The Federal Land Bank in a district makes long-term real estate and equipment loans to producers through the local Federal Land Bank Associations. The Federal Intermediate Credit Bank primarily makes funds available to the local Production Credit Associations to finance demand for short-term production loans. The 13 Banks for Cooperatives, including one Central Bank for Cooperatives, are sources of funds for agricultural and rural cooperatives. The loans extended by the FCS generally have floating rates, so the effective maturities of most of the System's loans are relatively short.

The FCS obtains most of its funds by selling its own securities in the federal agency market. The System's status as a federally sponsored agency offers it certain advantages, the major one being the market's perception of an implicit federal guarantee of agency debt. For the FCS, this perception was bolstered by the 1985 Farm Bill, which provides the groundwork for opening a Treasury line of credit to the FCS.

As a cooperative, the FCS obtains capital from its members. Farmers borrowing from the System are required to purchase capital. When the loan is repaid, the borrower can redeem his capital at book value or par value, whichever is less.

Sources of the problem

The depressed condition of the agricultural economy has affected all farm lenders, including the FCS. The effects of the poor quality of FCS assets are evident in net charge-offs of $2.9 billion and the $2.1 billion increase in loan loss reserves since 1984. As the chart shows, heavy losses for the FCS have depleted most of the System's surplus capital (earned surplus), leaving only a small buffer against member capital.

The threat to member capital compounds the FCS problems by effectively reducing the competitiveness of the FCS relative to the other major agricultural lenders, such as commercial banks and life insurance companies. As the book-value of member capital has fallen relative to its par or face value, those members of the FCS with higher credit ratings, and therefore better access to other borrowing sources, have the incentive to withdraw from the System. Moreover, as some members withdraw their capital the greater possible losses for the remaining members, as well as for borrowers taking out new loans with the FCS, could make the true cost of borrowing higher than the stated interest rate on an FCS loan.

To make matters worse, even the stated rates at many of the FCS banks have become less competitive. The average cost of the FCS debt has remained high because of its high-yielding, longer-term debt issued in the early 1980s. This, coupled with the FCS's practice of setting loan rates on the basis of the average cost of funds, rather than on the cost of newly issued securities, as most other lenders do, has made the System's loan rates less attractive.

Buying time

In an attempt to slow the departure of higher quality borrowers, the FCS has instituted a system of loan rates that are more competitive with those of banks and other lenders. First, the FCS is shifting away from average cost pricing. Second, borrowers are divided into several tiers depending on their credit standing. The highest quality borrowers are offered the lowest rate of the bottom tier while riskier borrowers are offered higher rates in the upper tiers.

Although a flexible pricing structure will help retain some members and have some long-run benefits for the FCS, it does not address the immediate problems of losses due to the high average cost of funds and poor quality assets and the resulting threat to member capital. In an attempt to deal with these problems, the 1986 amendments to the Farm Credit Act permitted the FCS to account for losses using Regulatory Accounting Practices (RAP). Unlike Generally Accepted Accounting Principles, which require that losses be booked in the same period that they are realized, RAP allows the FCS to amortize losses over a 20-year period. Such techniques are designed to prevent the impairment of member capital stock on an accounting basis — that is, to keep the book value equal to the par value. Unfortunately these accounting techniques are cosmetic. They may buy time, but they do not improve the underlying financial condition of the FCS.

Treasury line of credit

The financial problems of the FCS require more substantive solutions. The most often mentioned possibility, and one supported by the FCA, is to activate a line of credit for the FCS with the Treasury. One potentially important weakness of this option is the adverse effect it would have on the federal budget deficit.

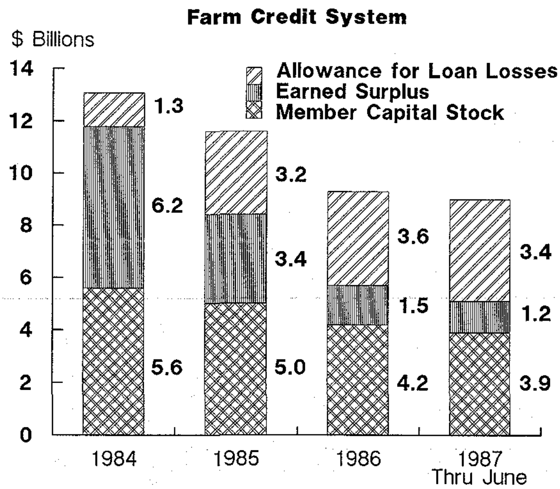
But budget issue aside, how would a line of credit help the FCS? If Treasury assistance took the form of a conventional line of credit, the one tangible effect would be some reduction in the interest costs of the FCS. As of early September 1987, rates on FCS debt were around 30 to 40 basis points over those of comparable Treasury securities. Such a line of credit, however, would not give the FCS a new way around the high cost of its outstanding debt. If the FCS were to use the Treasury funds to retire some of the high-cost debt outstanding, the System would have to pay a premium to retire that debt even at current market interest rates. Also, a straight line of credit would do nothing to reduce the losses from exposure to problem loans.

What the FCS really could use is additional capital. Then, why is the FCA so interested in a line of credit? The answer lies in the unusual terms likely to be attached to the Treasury loans. Current legislation being debated by the Congress would allow the Treasury to make a long-term loan to the FCS, which over part of its life would be interest-free.

Such an interest-free loan is equivalent to a capital infusion. The effective size of that infusion is equal to the present value of the interest payments foregone by the Treasury. The longer the interest-free period, the larger the capital contribution from the Treasury (taxpayers). For example, the FCS is currently requesting a $6 billion dollar line of credit. Assuming a full takedown of the line of credit, an interest rate of 10 percent, no repayment of principal for 5 years, and an interest-free period of 5 years, the present value of the transfer would be approximately $2¼ billion. If the interest-free period were increased to 10 years, the transfer would increase to approximately $3¾ billion.

Even though the effective capital infusion from the Treasury could be quite substantial, it would take time for it to be reflected fully on the balance sheets of FCS banks. This lag presents a problem to those FCS banks and associations that have fully depleted their earned surplus.

An FCS proposal embodied in Senate Bill S.1219 would allow Treasury assistance to make an impact on the book value capital of the FCS more quickly. The proposal would establish a Federal Farm Credit Assistance Board that would have the ability not only to lend to FCS banks but also to make "capital" infusions into individual banks. According to an FCS report, as much as half of the $6 billion dollars being requested would be needed to meet deficiencies in surplus capital in eight of the twelve FCS Districts. Such use of the Treasury borrowings would allow the individual entities within the FCS to maintain book-value capital above mem-



ber contributions, until the favorable effects of the interest free loans were reflected on the System's balance sheet.

Recapitalization?

The proposal to recapitalize the FCS with debt has certain parallels with the plan enacted earlier this year to provide additional funds to the Federal Savings and Loan Insurance Corporation (FSLIC). The legislation to recapitalize the FSLIC authorizes a new federally sponsored agency that would issue its own securities and pass the funds on to the insurance fund as a capital contribution.

A distinguishing feature of the plan for the FSLIC, however, is that the interest on the debt will be paid from the insurance fund's resources, not from taxes. In particular, the interest on the debt issued would be paid out of the insurance premiums assessed the insured savings institutions. The rationale for using debt to recapitalize the FSLIC reflects the recognition that the FSLIC has more resources — namely, the authority to assess insurance premiums — to handle problem savings institutions than what is shown on the insurance fund's current balance sheet.

A similar situation does not hold for the FCS. Moreover, it is likely that, on a true or market value basis, the FCS is in worse shape than its current balance sheet indicates. The FCA's own outlook for the System supports this view. Without federal aid, the FCA projects that the Farm Credit System as a whole would show net losses each year through at least 1994. It appears that the Treasury line of credit to the FCS would provide for interest-free loans, at least for some period, because the FCS simply would not be able to met both interest payments to the Treasury *and* its obligations to other debtors, without impairing member capital.

Conclusion

Heavy FCS losses and the depletion of its earned surplus have left little or no buffer for member capital at many FCS banks and associations. To protect FCS member capital legislation has been proposed that would give the System a line of credit with the Treasury. Since a conventional line of credit would be of little help, plans for Treasury assistance currently being considered by the Congress provide for interest-free loans. For the FCS, such interest-free lending would represent a needed infusion of capital, funded by the taxpayers.

The size of the capital infusion ultimately required by the FCS is uncertain. For example, if the farm sector itself were to perform better over the next few years than is currently expected, a higher proportion of the FCS's problem loans could be repaid. This would exert a favorable effect on earned surplus and reduce the period for which Treasury loans would have to be interest-free. To limit the transfer of taxpayer funds to the FCS to the minimum amount required, the interest-free period initially should be relatively short, should be reviewed periodically, and extended based on the prospective financial condition of the FCS.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/23/87	Change from 9/16/87	Change from 9/24/86 Dollar	Change from 9/24/86 Percent[7]
Loans, Leases and Investments[1] [2]	206,325	– 439	2,750	1.3
Loans and Leases[1] [6]	182,383	– 543	– 1,229	– 0.6
Commercial and Industrial	51,148	333	1,072	2.1
Real estate	69,897	– 9	2,448	3.6
Loans to Individuals	37,096	– 13	– 4,276	– 10.3
Leases	5,401	16	– 265	– 4.6
U.S. Treasury and Agency Securities[2]	17,001	100	5,240	44.5
Other Securities[2]	6,941	3	– 1,262	– 15.3
Total Deposits	202,413	– 4,713	– 1,741	– 0.8
Demand Deposits	49,077	– 3,893	– 1,414	– 2.8
Demand Deposits Adjusted[3]	34,530	– 1,282	– 11,784	– 25.4
Other Transaction Balances[4]	19,456	– 754	2,454	14.4
Total Non-Transaction Balances[6]	133,880	– 65	– 2,781	– 2.0
Money Market Deposit Accounts—Total	44,373	– 320	– 1,969	– 4.2
Time Deposits in Amounts of $100,000 or more	31,158	208	– 3,482	– 10.0
Other Liabilities for Borrowed Money[5]	26,603	– 757	– 305	– 1.1

Two Week Averages of Daily Figures	Period ended 9/21/87	Period ended 9/7/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	27	45
Borrowings	91	6
Net free reserves (+)/Net borrowed(–)	– 63	39

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change