FRBSF Weekly Letter

December 20, 1985

Farm Credit System

Severe financial stress in sectors of the economy often is accompanied by calls for protective government intervention. We have heard those calls in the cases of Chrysler Corporation and Continental Illinois Bank. More recently, attention has focused on the Farm Credit System, which is reeling from depressed conditions in agriculture.

Representatives from the Farm Credit Administration have proposed a number of "self-help" measures as well as legislative changes calling for greater centralization of decisionmaking in the Farm Credit System and more flexibility in the system's ability to redistribute its capital. The measure that has generated considerable debate within the Congress and the Administration is the request for a line of credit with the Treasury for the Farm Credit Administration. In this *Letter*, we provide some background on the Farm Credit System and its financial problems, and discuss the implications of Treasury aid.

A brief sketch

The Farm Credit System (FCS) is an elaborate cooperative, borrower-owned network of farm lending banks under the supervision, examination and coordination of the Farm Credit Administration (FCA), an independent federal agency. Administratively, the FCS is composed of 12 regional farm credit districts. As of September 1985, FCS loans outstanding totalled $70.7 billion.

The 12 Federal Land Banks (one in each district) account for most of the loans in the system, or about 68 percent. These Land Banks make long-term mortgage loans through the more than 400 Federal Land Bank Associations. Twelve Federal Intermediary Credit Banks account for about 22 percent of the system's loans and comprise the main source of funds for the Production Credit Associations (PCAs). Some 370 PCAs make primarily short-term production loans to their members. Thirteen Banks for Cooperatives (there is one central bank for cooperatives) are important sources of funds for agricultural and aquatic cooperatives. The loans extended by the Farm Credit System generally have floating rates. Most loan rates are adjusted only with the approval of the FCA and a few loans are linked by contract to market rates.

Since 1979, the FCS has funded its loans and other assets primarily through the issuance of system-wide consolidated obligations. Prior to that date, individual components of the Farm Credit System raised funds independently. The liabilities of the Farm Credit System consist mainly of 6- and 9-month securities and intermediate term coupon instruments (mostly securities with maturities in the range of 2 to 5 years). The system also issues short-term discount notes on a more or less continuous basis (currently about $10 billion outstanding).

Dimensions of the problem

The financial fate of the Farm Credit System is tied in large part to the health of its members — the farmers. In the 1970s, prospects for farmers, as reflected in the sharp rise of farm land values, were quite good. In the early 1980s, inflation expectations dropped sharply and brought down the rapid appreciation of real estate in general. At the same time, the farmers were hit by the effects of a strong dollar and a high volume of agricultural production worldwide. The FCS (as well as other agricultural lenders) found itself facing borrowers with heavy debt obligations, weakening incomes, and declining land values — the latter representing collateral for much of its loans.

With the deterioration in farm incomes and land prices, outstanding FCS loans have contracted by about $7 billion from the peak level reached in 1982-83. The contraction in loans by the FCS, however, has done little to protect the system from a deterioration in the quality of its assets. At the 37 FCS banks, loans reported as not accruing interest rose from $2.0 billion in June 1985 to $3.5 billion in September, but even this higher figure understates the problem. Representatives of the FCS have indicated that over the next couple of years, assets in the system not accruing interest (real estate and loans) could rise to $13 billion.

The total value of "problem assets" of the Farm Credit System, of course, is not at risk because many loans are collateralized to some extent. Nevertheless, Farm Credit System losses are expected to rise sharply in the near future. By its own estimate, the Farm Credit System expects to lose as much as $3 billion over the 1985-87 period.

Critical to the FCS' capacity to handle these problems is the strength of its capital position. As of September 1985, the book value of the capital, surplus and reserves of the 37 banks in the FCS was about $9.6 billion. On the surface at least, given the projected losses in capital position, the FCS would appear able to handle the current scope of its problems. These problems, however, involve more than the capacity of the FCS' current level of capital to absorb losses.

Complications

The problems of the Farm Credit System are complicated by the uneven distribution of financial strains in agriculture. "Nonperforming loans" as a percent of total loans vary considerably among the units of the Farm Credit System. Even in June of this year, before market concern over the financial condition of the FCS intensified, the percentage was quite high at some individual units, particularly the Spokane and Omaha intermediate credit banks, both of which have required special assistance.

Because of the uneven distribution of problems, the Farm Credit System has had to take steps to redistribute net worth internally. The problems at the Spokane bank were handled through the purchase of bad loans by the newly formed Farm Credit Capital Corporation. Other banks in the FCS helped the Omaha bank by buying bad loans and sharing their capital.

However, there has been some reluctance among the stronger units in the Farm Credit System to redistribute capital. As a result, the FCA has asked the Congress for more centralized authority to set the criteria under which the Farm Credit Capital Corporation can make assessments on individual units or require system institutions to purchase Capital Corporation stock.

Another source of concern for the Farm Credit System is the withdrawal of capital by its members. The FCS is a cooperative system in which capital is obtained from the members; farmers borrowing from the system simultaneously subscribe to capital. For example, a borrower of $100,000 typically must also purchase between $5,000 and $10,000 in capital.

However, as the quality of the FCS loan portfolio has deteriorated, there has been a flight of some good borrowers. They have paid off their loans and left the system in order to recover the value of their invested capital. Members of the FCS have the incentive to do this since capital contributions can be withdrawn at par value. In extreme cases, some FCS banks are attempting to prohibit the withdrawal of capital when a member pays off loans, but such action has not been undertaken on a systemwide basis.

The problem of adverse selection of borrowers in the Farm Credit System is further exacerbated by the system's approach to pricing loans. The FCS generally prices loans by employing the average cost of the system's liabilities. As a consequence, when market rates were rising sharply in the 1970s, the Farm Credit System was making loans available at rates considerably below market rates since much of the outstanding debt had been issued at lower rates.

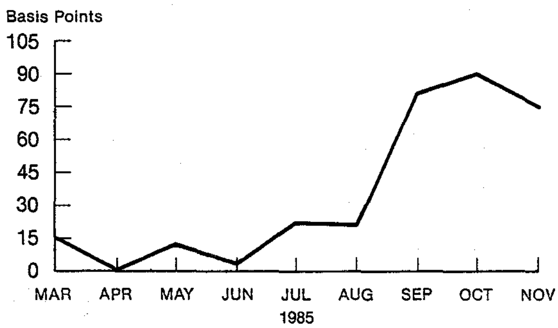
More recently, average cost pricing has tended to hold up FCS rates as market rates have fallen from peak levels. Moreover, when pricing loans, units in the FCS must take into account the need for reserves, expenses and capital requirements, which, in the current environment, also would add to loan rates. For example, the large volume of nonperforming loans must be carried by higher overall interest rates on FCS loans.

Cost of funds

Interest rates on loans from the FCS also are affected by what the system's financial problems have done to its cost of funds. Historically, securities of the FCS as well as other agencies have traded with yields slightly above those on comparable Treasury securities. In part, the relatively low cost of funds for the federally sponsored agencies has been related to special factors such as the exemption of interest income from state and local taxes, as well as the financial soundness of the agencies. But, the narrow spread between yields on FCS and Treasury securities has been viewed mainly as an indication of the market's belief that the agency's securities are implicitly guaranteed by the federal government.

Over the past several months, the market's concern over the quality of the FCS loan portfolio has offset at least some of the funding advantages afforded the FCS as a sponsored agency. The chart shows the spread in yields on FCS debt maturing in 6 months over those for comparable Treasury

Interest Rate Spreads on FCS Securities*



* Estimated spreads on Farm Credit System (FCS) securities over Treasury securities maturing in six months. Estimates are based on data for the last five business days of each month.

securities. As the chart indicates, yields on FCS debt ballooned in September. The figures reflect data for the last week of the month, but concern in the market was apparent in secondary market trading earlier in September. The higher spreads on FCS debt persisted through late November.

Treasury assistance

In part because of the market's reaction to its problems, the FCA asked the Congress for assistance in the form of a line of credit with the Treasury. In early December, the full Senate and the House Agriculture Committee voted to authorize the Treasury to lend to the FCS as a backstop source of liquidity. (The Senate and House versions of the bill also provide for greater regulatory powers for the FCA and centralization of the process for pooling FCS resources to help troubled units in the system.)

The financial assistance that the Congress would give the FCS does stop short of formally guaranteeing the system's securities. However, formal backing of FCS debt may not be required to reassure the market, at least as far as FCS security holders are concerned. We note that, to the extent Treasury lending to the FCS facilitates the repayment of private holders of the system's debt, the assistance plan would provide some protection for the system's current security holders.

Perhaps even more relevant, it is not clear that the market's reaction up to this point has been due primarily to worries that the FCS would be allowed to default on its debt. The "risk premia" on the FCS debt may reflect the concerns about liquidity risk should short-term cash flow problems delay disbursements more than default risk *per se*. (Such a situation is similar to that observed in 1984 during the Continental Illinois crisis when, even with the FDIC's guarantee of all of the bank's deposits, the market demanded substantial interest rate premia on large CDs issued by Continental compared with those of other money center banks.)

From the point of view of the FCS, the reassurance of its bondholders would be beneficial since it could reduce the system's interest costs. Also, the willingness of the Treasury to provide funds to the FCS could allow for a more orderly disposal of assets by the system that could, in turn, dampen the FCS' losses.

Nevertheless, Treasury lending is by no means a cure-all for the FCS. The measures as they stand do not address the system's fundamental problem — the quality of its loans and the potential for sizeable permanent losses from bad loans. Financial aid will not turn bad loans into good loans. If Treasury aid is limited strictly to the provision of liquidity, members (capital holders) of the Farm Credit System still are at risk.

Summary

The depressed condition in the farm sector has taken its toll on farm lenders. The problem is particularly acute for the FCS since it specializes in lending to support agriculture. The FCS not only must face the problem of managing an existing portfolio of problem loans, but also the threat that better quality borrowers will leave the system and thereby reduce its level of capital.

The Congress has acted on requests for a greater centralization of decisionmaking in the Farm Credit System, including giving the system more authority to redistribute its net worth as well as financial assistance in the form of a line of credit with the Treasury. The potential for backstop lending by the Treasury is intended to reassure FCS securities holders. Such reassurance would benefit the system, in part, by reducing its cost of funds. Even with such aid, the FCS expects to incur sizeable losses because of the rising volume of nonperforming loans.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/27/85	Change from 11/20/85	Change from 11/28/84 Dollar	Change from 11/28/84 Percent[7]
Loans, Leases and Investments[1] [2]	198,473	1,255	11,680	6.2
Loans and Leases[1] [6]	179,804	952	11,612	6.9
Commercial and Industrial	51,803	554	– 774	– 1.4
Real estate	65,669	29	4,125	6.7
Loans to Individuals	38,044	240	7,036	22.6
Leases	5,427	11	376	7.4
U.S. Treasury and Agency Securities[2]	11,342	215	– 300	– 2.5
Other Securities[2]	7,327	88	369	5.3
Total Deposits	203,961	3,160	14,839	7.8
Demand Deposits	51,824	3,060	9,007	21.0
Demand Deposits Adjusted[3]	33,081	368	4,689	16.5
Other Transaction Balances[4]	14,338	86	2,134	17.4
Total Non-Transaction Balances[6]	137,799	14	3,697	2.7
Money Market Deposit Accounts—Total	45,737	– 67	5,703	14.2
Time Deposits in Amounts of $100,000 or more	38,465	125	– 2,119	– 5.2
Other Liabilities for Borrowed Money[5]	26,117	1,620	4,213	19.2

Two Week Averages of Daily Figures	Period ended 11/18/85	Period ended 11/4/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	40	25
Borrowings	19	17
Net free reserves (+)/Net borrowed(–)	21	8

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