

The Farm Credit System: Looking for "the proper balance"

George D. Irwin

The Farm Credit System (FCS) was devised by Congress to enable agricultural borrowers nationwide to participate in the management of a credit system serving their unique needs. The FCS has traditionally been a strong and reliable source for agricultural loans; however, the current economic stress in farming has affected its loan portfolio and its operations. The FCS has responded in part by adjusting some current programs and by focusing attention on proposed structural changes as well.

FCS structure

The Farm Credit System is composed of 12 Federal Land Banks and more than 400 Federal Land Bank Associations, 12 Federal Intermediate Credit Banks and 370 Production Credit Associations, and 13 Banks for Cooperatives, supported by several service organizations (Figure 1).¹

The twelve farm credit districts cover the United States and Puerto Rico (Figure 2): Each district includes a district Farm Credit Board, a Federal Land Bank (FLB) and its Federal Land Bank Administration (FLBA), a Federal Intermediate Credit Bank (FICB) and its affiliated Production Credit Associations (PCAs), and a Bank For Cooperatives (BC). The districts are designated by numbers and by the names of headquartering cities.²

The Federal Land Banks are a major source of mortgage loans, accounting for about 40 percent of the farm mortgage loan volume. The policies of each bank are determined by its Farm Credit Board, which is authorized to exercise all powers necessary to carry out bank business. The banks, once owned by the government, are now wholly owned by the federally chartered, affiliated FLBAs, which are in turn owned by the borrowers in the district

(borrowers are required to buy capital or participation certificates, which are retired when their loans are paid in full). The FLBAs originate business and are the point of contact with the public.³

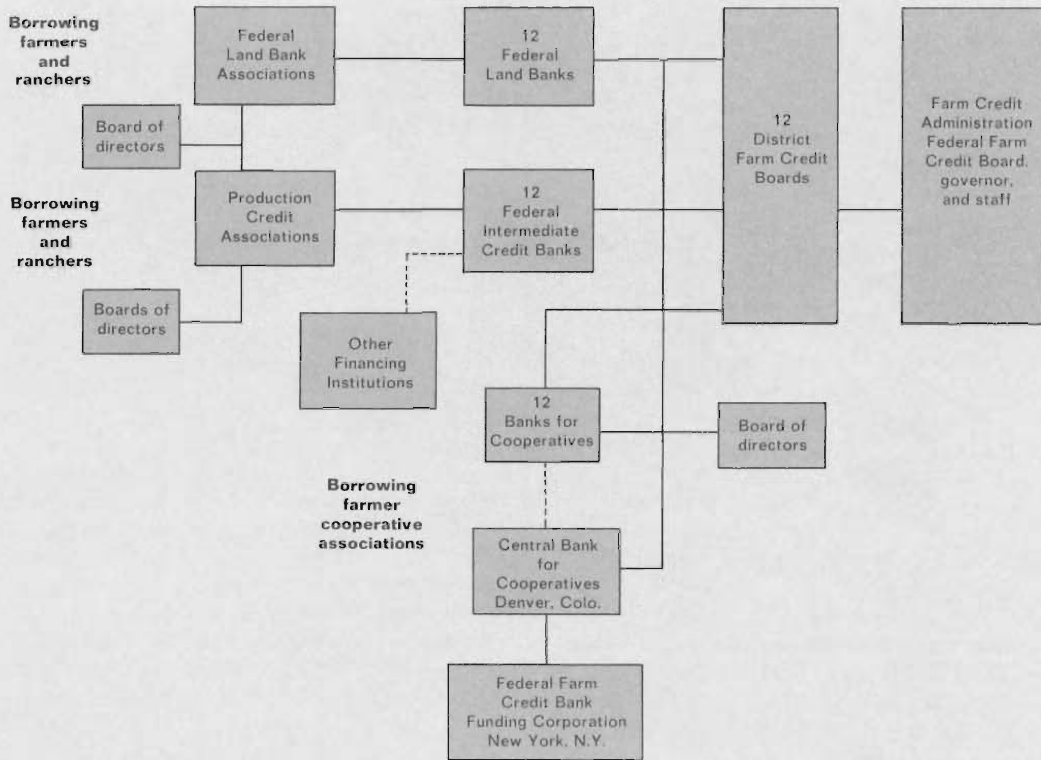
The production credit associations provide eligible applicants with short- and intermediate-term loans. PCAs may make both secured and unsecured loans to agricultural producers for any reason. FICBs make loans to the PCAs, over which they have some supervisory responsibility, and to commercial banks and other financing institutions.⁴ The FICBs are owned by the PCAs and other financing institutions with which they do business. PCAs are owned by their borrowers who are required to purchase stock in them as a provision to obtaining loans. PCAs provide about 20 percent of all non-real estate farm debt.

The Banks for Cooperatives provide more than 60 percent of the funds borrowed by U.S. farm cooperatives. Like the other components of the system, BCs are owned by the borrowers in the district, in this case cooperatives. They provide loans to allow a cooperative to establish and maintain an efficient operation to carry on the business of its members.⁵

The FCS obtains capital through retained earnings, and through the requirement that borrowers own stock in the associations from which they borrow. Most of its funds for loans come from the sale of Federal Farm Credit Banks Consolidated Systemwide Bonds in the national financial markets. These bonds are the joint obligation of the 37 Farm Credit

George D. Irwin is associate deputy governor and chief economist of the Farm Credit Administration. This paper is adapted from a talk delivered on May 2, 1985, at the Federal Reserve Bank of Chicago's Conference on Bank Structure and Competition. The views are those of the author, and do not necessarily reflect those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

Figure 1
Farm credit system



Banks; capital, however, is actually dispersed among the 37 banks and 802 associations. While these securities have no government guarantee, they have long been regarded as a quality investment.

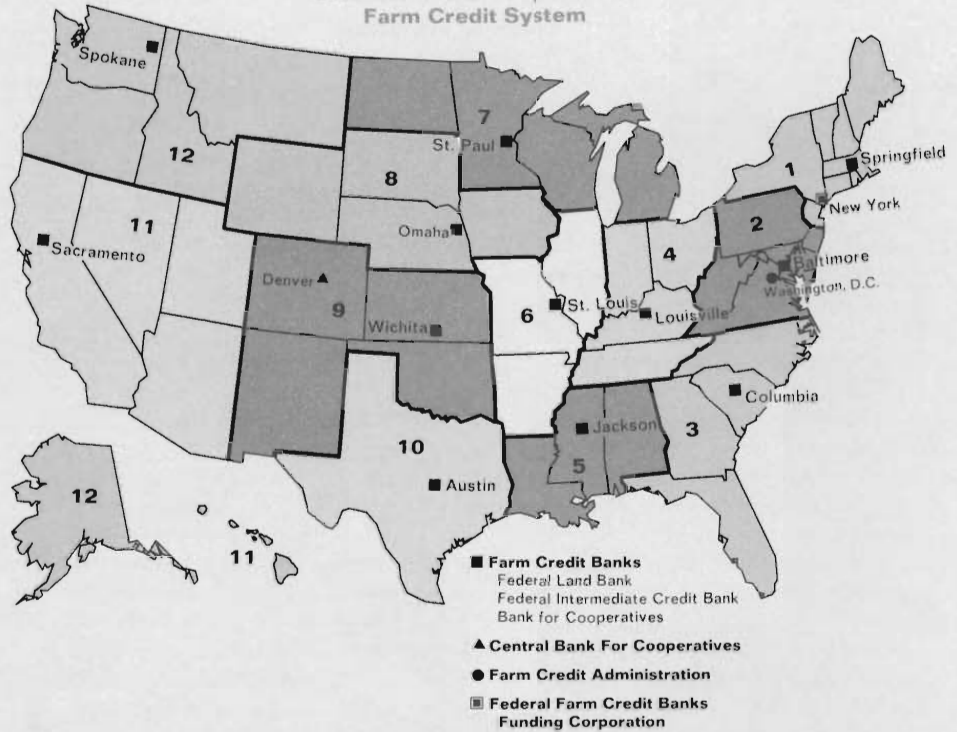
Reflections of financial stress

Although the cooperative FCS is conservatively leveraged, it inevitably is reflecting the current problems in the farm sector. Systemwide loan losses reached \$261 million in 1983 and \$428 million in 1984. Eleven PCAs have been liquidated in the past two years, and over 50 were merged. At year-end 1984, \$1.8 billion of

the \$80.6 billion in loans outstanding was not accruing interest, and another \$5.1 billion was otherwise nonperforming. Some \$542 million in acquired property was being held by the FCS.

Several concerns have arisen in light of these figures. The first is the optimal degree of centralization versus decentralization in the FCS. Loan stress has tended to be geographically concentrated in areas that experienced the greatest gain in asset values during the demand boom of the 1970s and in areas experiencing several successive years of adverse weather conditions. Consequently, the FCS institutions

Figure 2
Districts of the Cooperative
Farm Credit System



in those areas have been weakened and some have failed. This problem is related to the conflict between the need for capital mobility within the system and the local nature of the ownership of stock. Despite their effort to ensure local autonomy in lending, lender-borrowers in the individual districts have become especially aware that, because of the structure of the system, they lack risk control over lenders in other districts with whom they are jointly liable. With many separate pools of capital, but with joint bank liability to protect systemwide securities, conflict develops in trying to provide assistance to distressed financial institutions. This is illustrated by the objections of some farmers and bankers to the recent proposal for rescuing the ailing Federal Intermediate Credit Bank of Omaha, a plan that would be fi-

nanced largely by funds from the system's other banks.⁶

Another area of concern is competitive pricing. When nonperforming loans must be carried by higher overall interest rates, PCAs lose their ability to compete with the more liquid commercial banking sector. The passthrough of costs of nonperforming loans leads to noncompetitive loan pricing and the loss of the most desirable customers.

Since 1972, most lending has been done on a variable interest rate, which transfers risk from the system to borrowers. However, this too leads to problems in competition, because as the level of interest rates has increased, so has customer demand for implementation of rate caps, fixed rate programs, or other options available from competing institutions.

In addition, although lower new money costs would ordinarily lead to a drop in the billing rate, average cost pricing produces only a partial reflection of changes in new money cost. At the same time, because of the absence of a Federal guarantee, investors in the system must be reassured that their earnings, after provision for losses, are stable, reliable, and growing. The proper balance between the long-term need for access to investors' funds and the immediate relief of borrower stress is a major management problem.

Finally, borrowers may leave for a reason that has never before been tested—the risk of loss of their equity investment in association stock should the association fail.

As the period of economic stress continues, the FCS must contend as well with a third concern, the cross-payment phenomenon. In the beginning years of economic adversity, borrowers may make payments to the short-term lender by refinancing against mortgage security, or the mortgage lender's payments may be included in the operating line of credit. Both procedures keep loans in performing status and delay recognition of or response to problems. In time, the capacity to market cross-payments runs out, and the financial statistics deteriorate rapidly.

A final consideration is that the system could suffer as a result of adverse rumors. The underlying liquidity of the FCS has resulted from its high financial rating and its agency status in financial markets, which enables it to issue securities whenever funds are needed to support loan volume. In order to maintain public confidence, the FCS may need to incur the cost of additional liquidity.

Coping with the stress

A few steps have been taken recently as a result of the difficulties created by the transition from the expansionist 1970s to the relatively austere 1980s. For example, in the past year we have seen a significant number of association mergers. Joint management of banks now exists or is

planned in 11 of the 12 districts. A number of districts have plans for or are involved in joint management of short-term and real estate lending at the association level. The system has also developed a joint services corporation called Farmbank Services, a jointly owned Farm Credit Leasing Services Corporation, and a central organization to lobby Congress, called the Farm Credit Council. A centralized mechanism for management of capital, liquidity, lending risk, planning and other functions has been established. It is called the Farm Credit Corporation of America.

Other considered changes would require changes in the law, including the ability to merge institutions where now only joint management is permitted. Though in recent years the FCA has clearly taken a hands-off regulatory posture, proposed legislation would also permit the FCA to exercise powers like those of other financial regulators.

The immediate concern of the FCS relates to managing the current difficulties and to correcting any practices that may have contributed to them, rather than to the system's fundamental financial soundness. While the structural problems of the Farm Credit System will always be different from those of commercial banking, the effects of the recent financial stress in agriculture demonstrate that there is a growing degree of commonality. Indeed, they are affected by the same forces, and there is certainly substantial interdependence. The measures outlined above will contribute to the FCA's efforts to balance the interests of healthy borrowers, troubled borrowers, investors, and the Farm Credit institutions, to ensure that agriculture continues to have in the FCS a reliable source of financing and financial services.

¹Warren F. Lee and others, *Agricultural Finance* (The Iowa State University Press, 1980).

²*Ibid.*

³*Ibid.*

⁴*Ibid.*

⁵*Ibid.*

⁶*Ibid.*

⁶"Rescue Planned for Farm Bank by Loan Agency," *Wall Street Journal*, July 15, 1985.