

LaDue, Eddy L.

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## Some Thoughts on a Bailout of the Farm Credit System

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Some Thoughts on a Bailout of  
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by  
Eddy L. LaDue

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Department of Agricultural Economics  
Cornell University Agricultural Experiment Station  
New York State College of Agriculture and Life Sciences  
A Statutory College of the State University  
Cornell University, Ithaca, New York, 14853

# Some Thoughts on a Bailout of the Farm Credit System

by  
Eddy L. LaDue

Any bailout of the Farm Credit System should be designed to provide a long lasting solution to the System's problems. It is in no one's best interest to develop another stop-gap measure, like RAP accounting, that puts the problem off for another year, but results in the need for another "Farm Credit Bill" next year, and next year, and next year. Such a long lasting solution must recognize several facts and issues.

1. The problems the System faces are primarily due to the severe and largely unanticipated downturn in the prices and incomes received by farmers. Between 1981 and 1986 the price farmers received for corn, wheat and soybeans dropped by \$0.96, \$1.17 and \$1.92 per bushel, representing declines of 33, 30 and 19 percent, respectively. A large portion of this decline occurred between 1981 and 1982. During that same period the price of milk, (including assessments) declined by \$1.58 per hundredweight.<sup>1</sup> 1987 crop prices are even lower. Further, 1986-87 prices are viewed by most as the "new normal" rather than a temporary low from which we can soon expect to recover. These price declines have resulted in cash flow problems for many farmers, particularly those who are highly leveraged.

The lower price and income expectations have resulted in a large drop in farm asset values. Between 1981 and 1986 average land values fell 29 percent with values in some states dropping as much as 59 percent.<sup>2</sup> The price of livestock and machinery also declined with milk cows falling from \$1,203 to \$821 (32 percent). Declining asset values have turned many well secured loans into unsecured or poorly secured loans.

2. Other lenders are also experiencing losses. Farm loan losses by commercial banks have been larger in both absolute value and as a percent of loan volume than those experienced by the Farm Credit System (Table 1). Commercial banks have been able to sustain the loss because of the broad loan portfolio base, they loan to more than just farmers, and because bank regulators, and society, have been willing to allow bank failures (as long as they are small banks!). Some banks in agricultural areas have experienced as much or more stress from farm loans as the Farm Credit System.

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<sup>1</sup> USDA, ERS. Agricultural Prices.

<sup>2</sup> USDA, ERS. Agricultural Resources, Agricultural Land Values and Markets, Situation and Outlook Report. AR2-June 1986.

Table 1. Net Farm Loan Charge-Offs  
Commercial Banks and Farm Credit System, 1984-86

Year	Commercial Banks <sup>a</sup>		Farm Credit System <sup>b</sup>	
	Estimated Amount	% of Loans Beg. of Year	Estimated Amount	% of Loans Beg. of Year
1984	900	2.3	427	0.5
1985	1,300	3.3	1,105	1.6
1986	1,200	3.4	1,352	1.9

<sup>a</sup> Melichar, Emanuel. Farm Credit Developments and the Financial Condition of Agricultural Banks, A preliminary report for the National Agricultural Credit Committee. Board of Governors of the Federal Reserve System, Washington DC. March 16, 1987.

<sup>b</sup> Federal Farm Credit Banks Funding Corporation. Farm Credit System Annual Information Statement - 1986. New York, NY. March 6, 1987.

Insurance company farm loan portfolios have also suffered significant losses and have high delinquency rates. Farmers Home Administration delinquency rates on farm loans have been at record high levels during the 1984-86 period.<sup>3</sup>

3. The evidence does not support the contention that the System's problems are the result of widespread mismanagement. Given 20-20 hindsight, many managers and loan officers would have made different decisions. However, at the time that those decisions were being made no one, farmer, lender, professor, regulator or politician, stood up with a clear voice and predicted the decline in the farm economy that has occurred.

The System has had, and likely still has, some poor managers. This is true for most large organizations and correction likely should occur on a case by case basis. Every financial institution has its horror stories about missing collateral and inaccurate or incomplete security filings. These tend to come to light in times of financial stress when farmers are going bankrupt and lenders have to fall back on their security for loan repayment.

Both noninterest expense and net interest income for the System have historically been much below similar values for agricultural banks (Table 2). Net interest income indicates

<sup>3</sup> USDA, FmHA. Active Borrowers Delinquent Report, code 616.

the amount of money that the institution uses to cover loan losses, operating expenses, taxes and profit. Banks can, of course, argue that their net interest income must be higher because a larger part of their cost of obtaining funds is made up of the salaries, computer expenses, etc. used in handling CD's, savings and other accounts. Some may argue that agricultural banks do not represent an appropriate comparison because they tend to be smaller banks with smaller loans and numerous small depositors. However, net interest income as a percent of total assets has been over two percent for money center banks and over three percent for banks with over \$1 billion in assets for the last 10 years.<sup>4</sup>

Noninterest expense includes costs for wages and salaries, occupancy and equipment expense and miscellaneous expenses, and thus, indicates operating efficiency. By this measure the System has been operating more efficiently than agricultural banks.

Table 2. Comparison of Net Interest Income and Noninterest Expense for the Farm Credit System and Agricultural Banks

Year	Agricultural Banks <sup>a</sup>	Farm Credit System <sup>b</sup>
---net interest income as % of total assets---		
1984	3.7	1.8
1985	3.8	1.7
1986	3.6	1.2
--noninterest expense as % of total assets <sup>c</sup> --		
1984	2.6	1.0
1985	2.7	1.1
1986	2.7	1.1

<sup>a</sup> Melichar, Emanuel. Farm Credit Developments and the Financial Condition of Agricultural Banks, A Preliminary Report for the National Agricultural Credit Committee. Board of Governors of the Federal Reserve System, Washington DC. March 16, 1987. Noninterest income is excluded in calculation of net interest income.

<sup>b</sup> Farm Credit Banks Report To Investors for 1984 and 1985. Report To Investors of the Farm Credit System 1986.

<sup>c</sup> Excludes provision for loan losses (banks and FCS) and losses on other property owned (FCS).

<sup>4</sup> Federal Reserve Bank of New York. Recent Trends in Commercial Bank Profitability: A Staff Study. September 1986.

4. The Farm Credit System's problems cannot be solved by reductions in operating costs. Noninterest expenses (excluding loan losses) of the System have been relatively modest during the last three years (Table 3). Some gains can be achieved by putting PCA's and FLBA's together in Districts where they are separate entities. Also, some efficiencies can be achieved by redrawing association boundaries to make them consistent with today's agriculture. They were originally drawn when farms were smaller and transportation more difficult. They also need to reflect the downsizing of the System that is taking place. However, given the modest operating cost of the System, those savings will not amount to more than a few basis points. Combining associations only saves a few higher level management personnel. At the loan officer level, combining PCA's and FLBA's should improve service but only modestly improve operating efficiency.

Table 3. Noninterest Expense and Loan Losses  
Farm Credit System, 1984-86

Year	Noninterest Expense	Loan Losses
---as percent of average loans outstanding---		
1984	1.1	0.4
1985	1.2	4.3
1986	1.2	3.2

Source: Federal Farm Credit Banks Funding Corporation. Farm Credit System Annual Information Statement - 1986. New York, NY. March 6, 1987.

5. The rationale for a Federal Board like that used for Chrysler is underwhelming. We do not have a company that produces a low quality product at high cost that needs to be whipped into shape.

The System has two basic problems: loss loans and high interest costs. The most pressing problem is how to handle the large volume of loss loans that currently exist. Unless there is a further major decline in farm incomes or asset prices, most FCS loss loans have likely been identified. The Capital Corporation has been established to handle the existing loss loan problem. Possibly the board for FCSCC should be modified rather than creating a Federal Board.

The loan evaluation process likely needs to be modified in some districts. However, if changes are made, the effect of those changes will not be known for years and may not

really be tested with conditions like the early 1980's for another 30 or 40 years. There is little reason to believe that a centrally determined loan evaluation process would leave the System better able to compete and less likely to suffer severe losses, should conditions like the early 1980's reappear, than would result from individual District action with the current Farm Credit Administration (FCA) and Farm Credit Corporation of America (FCCA).

It is unlikely that the System's loan loss problems could be solved in anything like the 18 months that the Chrysler board served. A long lasting board could result in very cumbersome management of the system.

The second major problem faced by FCS, that might be approached from a national level, is a rationalization of their funding approach and its relation to the lending function. In the past, funding has been designed to achieve low rates over the long run. This has involved some mix of short and moderately long term funding. With their variable rate loans they, thus, have short term assets with long term funding. As long as interest rates were relatively constant or generally rising, as they were during the last few decades, this procedure worked very well. However, when interest rates were rising during the early 1980's savings banks, and to a lesser degree commercial banks, experienced severe problems with long term assets and short term funding. It is not surprising that the System, with its short term assets and long term funding, would experience interest rate stress during times of declining interest rates. Unfortunately this stress occurred at a time when farmers were experiencing poor cash flows and could not afford to pay the average cost interest rates that Farm Credit would be required to charge in order to average-cost-price during the declining part of the interest rate cycle. Further, cost conscious farmers would have little incentive to stay with Farm Credit, when its rates were high during the declining portion of the rate cycle, any more than they did with commercial banks which had higher rates when market rates were rising. Procedures must be instituted for handling their interest rate risk. Those who believe interest rates can only rise from current levels argue that Farm Credit should be lengthening rather than shortening their bond maturities. However, the economics profession's record at predicting interest rates argues for development of a risk management strategy.

6. There is some rationale for the healthy parts of the System to contribute funds to those parts of the System that are experiencing losses. There are at least three factors contributing to the current condition of healthy banks: (1) less severe economic conditions, (2) a low cost source of capital, and (3) good management. Between 1981 and 1987 land values in the three healthiest districts; Springfield, Texas and Baltimore, changed by +5.5, +0.1 and -3.4 percent,

respectively, while land values in the other districts declined by 9.9 to 46.4 percent.<sup>5</sup> Declining land values mean that lenders have two problems with farm loans; lack of cash flow caused by declining farm incomes, and unsecured loans caused by declining land values (which are the result of lower income expectations), while the healthy districts have had to deal with only the cash flow problems. Declining livestock and machinery prices have caused problems in all Districts. However, the consequences have been less severe.

All districts have benefited from Agency status and the access to national money markets that a large organization with significant credit needs can command. The System, as a whole, is large enough that the financial markets could believe that the Government would not let the System fail, even without a direct government guarantee, when it would not allow Continental Bank or Chrysler to fail. The large size also allows for liquidity in the secondary market for its bonds that would not be possible for individual banks, and particularly individual associations, of the System.

There are, undoubtedly, differences in the management capacity of different System entities. For example, the Springfield Banks experienced some problems in a few associations in the mid 1970's that caused them to sharpen their management style and procedures. However, separating the effects of management from the other factors is difficult.

To the degree that healthy bank profits have been generated by the first two listed factors it makes sense that healthy banks should share their past profits (current capital) with less healthy banks. The level of sharing, however, should not be so high as to threaten the financial stability of the contributing banks. It makes little sense to make 12 unhealthy banks out of three healthy and nine less healthy banks. Past contributions to the banks that first encountered financial difficulty, such as Omaha and Spokane, undoubtedly hastened the decline of some of the currently unhealthy banks.

7. FCS Banks must be allowed to charge competitive interest rates. If banks with currently high interest costs are forced to charge rates that allow coverage of those costs, loan losses and operating expenses, they will soon have portfolios containing only farmers who cannot borrow money any place else. The flight of good borrowers will reduce the loan volume over which losses must be spread which will create a snowball effect of higher rates, lower loan volumes and increasingly unhealthy banks.

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<sup>5</sup> Guebert, Steven R. Agricultural Situation Report. Farm Credit Administration. April 10, 1987.



8. Since the System sells bonds to the public and makes loans to a diverse population of individuals and small businesses, annual, quarterly and other financial statements should be made available to the public on a timely basis. This would allow individuals, universities and others with interest, to analyze these statements and provide evaluations of the operation and performance of the System. In the past some units of the System have limited the availability of statement to stockholders. Many stockholders are unprepared to understand the statements or evaluate the performance of an individual association or bank.

9. Any bailout of the System must leave the operating units of the System in a condition that allows them to be competitive in the agricultural lending market. This will likely involve removing loss loans and high cost bonds from a number of units of the System. Both the loss loans and the high cost bond problem must be addressed in order for any bailout to provide a real solution to the System's problems.

Any real solution will cost a significant amount of money. The total cost will depend on the path of interest rates over the next few years and the amount of recovery achieved on the existing loss loans. An increase in interest rates would allow the System to raise rates and, thus, reduce the burden of the existing high cost bonds. Farm loans have historically had a high recovery rate. A rational approach to handling loss loan borrowers would likely limit losses. For these reasons the total cost of any bailout cannot be known with any certainty at this time. A rational approach will require setting up a procedure for handling the System's problems, and for investment of federal funds, that will allow a draw on federal funds as needed.

The Capital Corporation could serve as the vehicle for handling the infusion of federal funds. It could buy the loss loans from troubled institutions and buy down the bond costs of Banks requiring such assistance to be competitive. It could also collect funds from the System, after it gets back on its feet, to repay the federal funds.