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Options For Dealing With Farm Credit System Problems

Statement of
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Before the
Subcommittee on Conservation, Credit, and
Rural Development
Committee on Agriculture
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our thoughts on rescuing the Farm Credit System. Last September you asked us to report on how a federal rescue of the System might be structured. We have considered a number of alternatives and are presenting today our suggested approach to stabilizing the System in the short-run while allowing time to develop long-term policies on the System's future role in financing American agriculture.

The General Accounting Office was involved in the large scale financial rescues of the 1970s involving the Penn Central Railroad (later Conrail), the Lockheed and Chrysler Corporations as well as New York City. Based on our experiences with these situations, in 1984 we published Guidelines For Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34) in which we outlined those elements that in our judgment should be considered when federal assistance is used in attempting to restore the financial health of such entities.

As for the Farm Credit System itself, we have now completed a broad review of its structure and management and published our report: Farm Credit: Actions Needed On Major Management Issues (GAO/GGD-87-51). In addition, we continue to monitor the System's financial condition and have been reporting periodically on our assessment of the situation. We also reviewed the independent audit of the System's 1985 financial statements which was performed by the accounting firm of Price Waterhouse and have seen the results of their 1986 audit. As you are probably aware, that audit resulted in a "qualified" opinion, expressing reservations about the System's ability to continue as a going concern in the absence of assistance. This body of work, coupled with knowledge gained in our other work on agriculture programs, and on financial institutions generally, is the basis for the views expressed in this statement.

The Farm Credit System was created to facilitate a reasonably stable flow of credit to farmers and ranchers. That objective should remain at the center of discussions about the future of the System. A "solution" which preserves the System while sacrificing its ability to perform the mission for which it was created is no solution at all.

At the same time, our immediate concern must be that the System's problems may lead to a default on its debt. Our assessment is that an outright failure and default on the System's obligations either in the near term or in the more distant future would seriously disrupt the flow of credit to the agricultural sector. It would also have adverse spillover effects on agency debt issued by other government sponsored instrumentalities such as Fannie Mae and Freddie Mac. Failure would also pose significant risks to major investors in System obligations, including many commercial banks and other lending institutions.

CURRENT SITUATION AND OUTLOOK

By almost any measure, the System's situation has continued to deteriorate since September, when we last reported to you our assessment of the System's condition.

- -- Substantial operating losses continue;
- -- Some district banks are at the point of impairment of the par value of their stock, and some banks may have reached a point at which borrowings are not fully collateralized;
- -- Intrasystem litigation is impeding the flow of funds from the strong System banks to assist the weak ones;
- -- Significant numbers of System customers (we are told the most creditworthy ones) are leaving; and
- -- The System's creditors are charging a higher premium over Treasury rates than in the past.

Our estimates of the financial condition of the Farm Credit System have, in the past, been somewhat more pessimistic than those of the System or its regulator. However, on March 12, 1987, a member of the Farm Credit Administration Board characterized the current situation in the following way:

> According to figures compiled by FCA, on a GAAP Basis, it is estimated that member stock will be invaded by over $1.6 billion as of December 31, 1987. Even using RAP accounting, made possible because of the 1986 amendments, five federal land banks and two federal intermediate credit banks will be impaired by $202 million. Currently, System entities are losing $1 billion in business each month. Twenty-four percent of the System's portfolio is in non-accrual or high risk assets, an increase of 10 percent since December 31, 1985. In addition, the System is rapidly depleting its capital at a rate of at least $400 million per quarter and, in my estimation, this will increase during the next two quarters. This is a tremendous burden for the sound System entities and the quality borrowers to bear.

There are many factors that have contributed to the current condition of the System. As we point out in our recently issued report on its structure and management, economic influences have clearly damaged the System's fiscal posture. But in our judgment, System bank management as well as the basic structure of the Farm Credit System also contributed in a significant way to the current problem. Management decisions, which were made against the backdrop of optimistic economic expectations that later failed to materialize, set the System on a path of high risk funding and lending policies. Loan decisions appear to have been made with an expectation that land prices would continue to rise and too many funding decisions appear to have been made with an expectation that interest rates would remain high. Moreover the System's decentralized organizational structure made it difficult to adjust policies in a rapidly changing environment and to confront emerging Systemwide management problems.

Serious challenges lie before policymakers in overcoming these problems. It is essential that:

-- an organizational structure be developed that establishes management accountability and responsibility for Systemwide actions,

-- loans be made at competitive interest rates,

-- funding be done in a manner that minimizes exposure to interest rate fluctuations,

-- an effective credit management process be created, and

-- investor and borrower support be retained.

There is little evidence that the Farm Credit System is capable of solving its own problems or agreeing on or implementing a cooperative strategy for lessening the rate of its current deterioration. Relatively well-off districts are litigating loss sharing arrangements made by the Farm Credit System Capital Corporation and the Farm Credit Administration, and there is no end in sight to resolving loss sharing issues. Furthermore, despite the fact that we have known for months that a time was rapidly approaching when the System would no longer be able to collateralize its borrowings, a solution has yet to be developed. In our view the System's decision-making processes are paralyzed because of litigation and confusion, and because the views of the individual System entities do not currently seem reconcilable with overall System interests or those of its investors.

These events indicate that some immediate action is needed to assure continued investor confidence in the System's debts and to prevent further erosion in the System's customer base. These immediate actions as well as those that will continue to be needed over the longer term may cost billions of dollars. But money alone will not prove sufficient to resolve the causes of the System's problems. Permanent structural reforms are also necessary to assure that the problems the System currently faces are dealt with adequately, and also to minimize the chance that similar problems will develop in the future.

OPTIONS FOR
STRUCTURING ASSISTANCE

There are a number of approaches that could, in theory, be taken to deal with the problems of the Farm Credit System. For example, we could attempt to structure a long-term solution now. Another approach would be to take a very tough-minded workout approach to arranging a financial restructuring of the System. In this case financial sacrifices would be obtained from all of those with a stake in the outcome. Finally, an outright bailout of the System could be done with an unconditional commitment of federal funds.

We have thought about all three of these approaches and have doubts about their wisdom and/or achievability. We believe that action is needed before a crisis exists, and we do not believe there is enough time to construct carefully thought out long-term solutions. There are very difficult issues to be resolved. We need to decide how the functions of the Farm Credit System along with those performed by other agricultural lenders might be equitably and efficiently organized to assure a reasonable flow of credit to the agricultural sector in the future. We also need to reconcile the System's current cooperative structure with the need for mechanisms to greatly enhance accountability and control of financial risks.

As for the second approach, there do not appear to be opportunities for obtaining the types of concessions from System participants that have occurred in past federal financial rescues, such as the Chrysler situation. The Farm Credit System is a financial intermediary and, like the Continental Illinois case, possibilities for sacrifice on the part of those with a business relationship with the System are limited.

Finally, in our view, there simply has to be a better alternative than an unconditional cash grant designed to keep the System afloat. This was the approach taken in the Conrail situation, at least during the first six years of the program. No management or other types of reform were required as a condition for federal assistance, and the program wound up costing taxpayers about $7 billion.

In light of the continuing erosion of the System's financial condition, the seeming inability of the System itself to reverse the situation, and the disadvantages in the various approaches that we just mentioned, we would like to offer a different way of coming to grips with the System's current problems and resolving the longer term structural issues.

CREATE A FEDERAL CONTROL BOARD WITH EXTENSIVE POWERS

The 1985 Amendments to the Farm Credit Act of 1971 provide a means for channelling assistance to districts and institutions experiencing difficulty. The Treasury Department, upon certification of need by the Farm Credit Administration, is authorized to assist the System through the Farm Credit System Capital Corporation, subject to congressional appropriations.

We do not believe that the Farm Credit Administration or the Capital Corporation can: (1) provide the leadership necessary to assure that the assistance would be used effectively to stabilize the situation; (2) reform the System's management structure and practices; and (3) enforce needed changes in policies and practices during what will be a very difficult workout period.

In place of the mechanism contemplated in the 1985 Amendments and, in return for providing assistance to the System, we believe that control over decisionmaking and certain management practices should be placed with a federal control board consisting of high level officials of federal agencies with either a programmatic or financial interest in the outcome of a federal rescue. We believe such a control board, modelled in many ways on the successful example of the Chrysler Loan Guarantee Board, could provide an effective means for stabilizing the current situation and instituting the management controls necessary to protect the government's financial interests. It would also provide a mechanism for developing a consensus about the longer-term structural reforms necessary to assure the continued flow of credit to American agriculture on an equitable and efficient basis.

During its first 18 months of operation, the board should have the power to approve or reject:

-- all System business and operating plans;

-- the terms and conditions of all debt issuances as well as strategies for management of asset and liability maturities;

-- all System plans for management structure changes;

-- the design of System management information and accounting systems as well as any variances from generally accepted accounting principles in financial reporting;

-- all determinations and plans formulated by the Capital Corporation for asset and entity liquidations;

-- the hiring and levels of compensation for the System's senior officials, as well as decisions regarding the continued employment of System officials; and

-- all System capital investment plans.

Under this structure we would envision the federal board overseeing the affairs of the System through a subordinate and accountable:

-- Farm Credit Administration, which would be responsible for examination and supervision of System entities;

-- Capital Corporation, which would be responsible for asset and entity restructuring and liquidations; and

-- Farm Credit System Funding Corporation, which would be responsible for raising funds for the System in the money and capital markets.

Management of the program would be enhanced if the System agreed to the creation of a System Chief Executive Officer position, with authority over the district banks analogous to those of the CEO of large holding company. The Farm Credit System's highly decentralized structure is a principal source of its management difficulties, particularly when coupled with the lack of an effective mechanism for achieving consensus on System policies and for assuring that those policies are properly implemented. We believe it would be an improvement if a position of Chief Executive Officer were established to facilitate the development of policies and plans serving the interests of the System as a whole and to assure that the operations of the district banks and, through them, the local associations, conformed to those policies. Creation of the position would reduce substantially the extent to which the board and its staff would otherwise have to involve itself directly in the day-to-day management of the System.

The board should be supported by a small staff to be provided on detail by the Farm Credit Administration, Treasury and other appropriate federal agencies, and led by an executive director. The board staff would review the various submissions by the System, the regulator, the Funding Corporation, and the Capital Corporation for their compliance with the broad objectives, policies and procedures specified by the board.

To assure effective oversight of the board's actions, the board should provide quarterly reports on its actions and plans and on the outlook for the System to the President and Congress. In addition, at the end of the 18-month period, the board should submit a plan along with appropriate implementing legislation to conduct an effective workout of the Farm Credit System's problems. This plan should take into account how the functions which the System performs fit into the existing and likely future structure of the agricultural credit delivery network.

Oversight of the board would be facilitated by granting GAO access to the books and records of the board and all components of the Farm Credit System. GAO should review and comment periodically on the quarterly reports and the workout plan submitted to the Congress. If Congress and the board considered it desirable, we would be pleased to provide whatever assistance we could to the board in the form of advice and consultation.

Stabilize the Sources of Funding and Loan Volume

In our view, certain additional steps need to be taken in concert with the creation of the board to enable it to operate in a non-crisis environment and to help assure that the current erosion in the System's financial condition is checked to the greatest extent possible.

Stabilize the Customer Base

Aside from the threat of investor flight from the System, the most important current concern is with the loss of loan volume. The Farm Credit Administration has indicated that the Federal Land Banks have lost 143,000 accounts and the production credit associations 110,000 accounts since 1984 and that the System is currently losing more than 13,000 additional accounts each month. We are not certain how much the phenomena represent a loss of high quality customers but we have been told by System officials and others that some of the loss of business and account volume represents the flight of good customers.

It is our understanding that the loss of business is a result of two factors. First, earlier losses of customers were due to the high interest rates the System was charging to cover its high average borrowing costs. We have been told that the System has lowered its lending rates in order to more closely align them with the competition. It is crucial that competitive interest rates be achieved and maintained in order to retain the System's customer base and attract new customers. Second, much of the current customer flight is attributed to growing concerns over the safety of the borrower's stock. To the extent that fears over stock impairments are not allayed or are, in fact realized, there will be a continued exodus of borrowers and the System will find it difficult if not impossible to attract new creditworthy customers.

The loss of loan volume is having serious effects on System revenues. Furthermore, no workout strategy can succeed in the long term if the System loses its most creditworthy borrowers to other suppliers of credit, leaving the System to serve only high risk and marginal borrowers. Thus, the issues of maintaining competitive rates and of protecting the value of the borrowers' stock are important to the System as well as its customers.

Arguments in favor of protection of borrower stock include its effect on customer flight, as well as the fact that the 1985 amendments give a statutory basis for borrowers believing that such protection would be provided. In addition, while borrower stock is in the form of a capital investment, it is required to be purchased as a condition of the loan, and is not transferrable. Thus, it may be analogous more to a compensating balance (five to ten percent of loan proceeds) than to common stock. In effect, the only choice faced by System borrowers is to stay with the System and risk losses as stockholders or get out.

On the other hand, the stock does represent the ownership of the System and is its principal form of capital. In other federal rescues of private entities, it has been usual to insist that the owners bear some portion of the costs of the rescue.

All things considered, we believe it will be very difficult not to assure repayment of the par value of stock upon its retirement. However, in the longer-term, alternatives to the current stock arrangement for raising capital need to be considered.

Stabilize the Investor Base

The interest rate spread between System offerings and

Treasury securities has widened at various times over the past several years on announcements of System difficulties. The loss sharing arrangements and availability of a line of credit with the Treasury called for in the 1985 Amendments to the Farm Credit Act were, among other things, designed to shore up confidence in the System's obligations. However, the loss sharing arrangements are being litigated and some in the System are questioning the whole concept of the Capital Corporation. These developments could, in the near future have a serious effect on continued investor interest in the System's debt securities.

To preserve investor confidence, a reserve needs to be established to assure repayment of debt and to underwrite losses experienced by the System in both its operations as well as in any workouts of assets and problem entities. And, depending on the perceived need to assure repayment of borrower stock, the fund might also be available for that purpose.

This reserve should be maintained by the Capital Corporation, and should be funded by the proceeds of an annual risk premium of perhaps ten to fifty basis points on the outstanding assets of each System entity, augmented when necessary by a line of credit with Treasury. The board should have the authority to approve draws on the line of credit that would be requested by the Capital Corporation. The 1985 Amendments require that assistance from the Treasury be subject to the appropriations process. To further help assure continued provision of funding by the System's investors, we believe the needed appropriations approval should be sought immediately after creation of the board rather than waiting until the need is urgent.

Take the Time Necessary to Resolve Complex Issues in a Non-crisis Atmosphere

The Farm Credit System is an extremely complex organization because of its cooperative structure. And, it is operating in a distressed agricultural economy. It is not possible at this time to predict what the ultimate organization of the functions of the Farm Credit System will or should be. Nor is it possible to be certain which of the System's functions will be self sustaining and which will need continuing federal assistance, if deemed in the national interest. It is also not possible at this time to be certain about what the best means might be in the longer run for delivering agricultural credit to farmers.

For these reasons, we believe the board should, in addition to instituting the management controls spend its first 18 months reviewing carefully the various options available for restructuring the System, and then report its recommendations to the Congress. Input from all groups associated with the delivery of agricultural credit should be sought to determine whether the functions performed by the System should be configured the way they currently are or whether alternative borrowing and credit delivery structures might prove more efficient. There are a number of key issues that need resolution. These include:

-- The approach to be taken to asset and entity workouts.

-- The approach to lending terms that serves the best interests of farmers and the System.

-- Whether alterations in current ownership arrangements might be necessary.

-- Whether ultimate reorganization of the System is necessary and, if so, settling on the alternative which best fits in with the ultimate configuration of an efficient agricultural credit delivery network.

-- The effects of a federal rescue on the System's competitors and those steps that might be necessary to assure that by virtue of federal aid the System does not enjoy an undue competitive advantage.

Let me turn briefly to a discussion of each of these issues.

Approach to Workouts

One of the important factors that will affect the costs of the program borne by the government as well as the reception the program receives by the System's constituencies is the means by which problems of troubled associations and borrowers are resolved. There are two considerations associated with this issue: organization of the effort and decision criteria to be used in working problem assets.

With regard to the first consideration, there seems to be a choice between managing all problem assets centrally as part of the Capital Corporation's portfolio or managing such assets at the local level. Having a centralized workout facility has advantages and disadvantages. Specialization in this field generally yields beneficial results. However, totally centralized loan restructuring is liable to be less sensitive to local conditions and opportunities.

The second point involves the decision criteria to be used when deciding whether to foreclose or restructure a loan or for that matter, an institution. There are any number of decision rules that could be adopted. Should a loan be foreclosed if its expected value in liquidation exceeds the repayment stream resulting from restructuring? Or should the approach be to err on the side of forbearance in the hope that conditions in the agricultural sector affecting specific borrowers or institutions will improve? These types of decisions could have significant effects on the federal government's exposure. It is therefore desirable that the approach to troubled assets or institutions be settled on as quickly as possible by the board.

Approach to Lending Terms

In the 1970s the System began making variable rate loans. However, when interest rates rose to unprecedented levels during the early 1980s and then reversed themselves, the System's variable rate loans continued to carry relatively high rates. In turn, this has generated a great deal of discontent among the borrowers and calls are increasingly heard for a return to fixed rate lending. Regardless of whether variable rate lending is continued or fixed rate loans are made with increasing frequency, either the borrower or the lender bears the risk of losses that result from movements in interest rates. The board may wish to consider how much of this risk should be borne by the System's borrowers and how much should be borne by its various lending associations.

We indicated that the Board should exercise control over the terms and conditions of debt issuances as well as strategies for management of asset and liability maturities. In our opinion, if variable rate lending is to continue, then funding must be designed to assure that changes in interest rates on the System's liabilities coincide to the greatest extent possible with changes in interest rates on loans. If there is a desire to share the risks of variable rate lending between the borrower and the association, the board might consider requiring the placement of some sort of cap on the magnitude of interest rate adjustments on loans over specified intervals of time. If it is decided that more fixed rate lending should be done, then System borrowing should occur in maturity ranges that reflect the expected repayment cycles on such loans. And, if risk sharing between borrower and lender is desired for fixed rate loans, the board might consider requiring the imposition of prepayment penalties on borrowers in order to partially compensate for the costs to the associations' having to continue to service outstanding long-term debts. Alternatively, long-term debt could be floated with a call provision, which typically carries an interest rate premium, and the costs of that premium could be shared between the lending association and the borrower. This would give the lender partial protection against the cost of loan prepayments in a period of falling market interest rates because the related System debt could also be called in and prepaid. Finally, the initiative for development of a secondary market, which I discuss briefly later in my testimony offers the potential for an expansion of fixed rate lending on terms and conditions that may be beneficial to both the borrower and lender.

Ownership Structure

A principal factor contributing to the poor performance of the Farm Credit System is the fact that local borrower/owner controlled boards of directors determine the terms and conditions of lending. Such terms can reflect borrower interests which are not necessarily consistent with the interests of all the other borrowers in a local association, other associations within a district, the System itself, or investors in the System's securities. With regard to funding policy, a further problem may lie in the limited experience and expertise of those making choices about the funding of loan portfolios. The environment of volatile interest rates since the late 1970s has posed a special challenge for all financial intermediaries, including the Farm Credit System. The need to understand the behavior of financial markets has become a great deal more important and the risks of guessing wrong are much greater than in earlier periods. This puts a premium on a type of expertise which one would not necessarily expect to find on a local board of directors consisting exclusively of farmers and ranchers.

Decisions regarding cooperative ownership arrangements are crucial to a number of other issues the board must come to grips with in developing its plan and recommendations. For example, decisions need to be made in the following areas:

-- adjustments to control arrangements that would be needed to assure adherence to sound credit standards, pricing policies, and debt management strategies in a System or in parts of a System free of federal control, if that ultimately proves feasible.

-- the desirability and feasibility of the sale of ownership interests to outside private investors who have no self-interest in particular loan decisions, but who would have a strong interest in the viability of the entity in which they had invested. Alternatively, the feasibility of attracting hard, at-risk capital investments by the borrower/owners themselves should be explored if the cooperative principle is to be continued.

-- whether private ownership would facilitate or hinder the System's providing credit to the agricultural sector in reasonable quantities over the course of the business cycle, assuming that it is deemed in the public interest to do so.

<u>Restructuring Alternatives</u>

There are a number of decisions that need to be made regarding restructuring. And there are at least two ways to think about restructuring options. At one level, restructuring can be thought of in terms of reorganizing the System itself. At another level, however, thought needs to be given to how the <u>functions</u> currently performed by the Farm Credit System should be preserved, restructured, or enhanced to make the most efficient contribution to the delivery of agricultural credit in the United States. Resolution of these issues is, in our judgment, the most crucial responsibility of the board.

There are two general alternatives that have been discussed for restructuring the System itself. Both are designed to resolve the seeming contradiction between joint and several liability for System obligations and the concept of local ownership and control. One option, decentralization, would eliminate joint liability for System debt and preserve locally controlled, completely autonomous lending outlets that would fund themselves in the money and capital markets. The other option, centralization, would maintain joint and several liability, and eliminate local control of operations. There are pros and cons to each option that the board must evaluate, in the context both of the System itself and of a completely reorganized agricultural credit delivery network, if that is what the nation needs.

With regard to a complete reorganization of agricultural lending, there is a great deal of current interest in the concept of a secondary market in agricultural loans. Under this arrangement, loans originated by agricultural lenders could be sold, either individually or in packaged lots, to a facility that would finance its acquisitions by borrowing from or reselling the loans to the money and capital markets. Several proposals for secondary market arrangements are currently being studied. Some proposals seem to be designed to facilitate the financing of long-term agricultural lending by the System's competitors; others would use the System's current funding capabilities as the means by which to develop a secondary market for the System itself as well as for its competitors. Benefits claimed to flow from this arrangement include increased credit availability, increased lender liquidity, increased farmland values, and the potential for lower interest rates to agricultural borrowers. However, there are legitimate concerns about the feasibility of achieving a large volume secondary market as well as the feasibility of potential benefits without some form of federal support. Decisions about the ultimate configuration of a secondary market need to be reconciled with decisions regarding the long-term future of the Farm Credit System and _vice versa_.

There are other aspects of the restructuring issue that need to be resolved.

-- Certain of the System's entities are currently profitable and do not appear to need federal assistance. The board needs to decide whether these entities should be kept within the System or be "spun off" or otherwise disengaged from board control. One of the considerations in this regard is whether the government should engage in a classic partitioning of the "bad company" and the "good company" that occurs in many workouts or whether it is in the best interests of the government, given its risk exposure, to rely on the total resources of the System to help fund the losses.

-- A second consideration involves which functions of the System need to be preserved. The board should explore the desirability of winding up, in an orderly fashion, those functions that can be performed equally well or perhaps better by others. The potential development of a secondary market in agricultural loans may have an important bearing on this issue.

Effect on System Competitors

We recognize that it is not desirable public policy to create a program of federal assistance that gives a competitive advantage to the beneficiary. We also recognize that any rescue will be perceived to and in fact probably will confer at least some temporary competitive benefits to the Farm Credit System. The board will have to avoid, to the greatest extent possible, taking actions which treat the System's competitors unfairly.

The assistance provided to the System should not enable it to solve its problems painlessly or more rapidly than its competitors, who are experiencing similar difficulties, could hope to do.

CONCLUSIONS

At this point, I would like to conclude with the following remarks.

Since we last appeared before this Subcommittee the condition of the System has continued to deteriorate. In order to eliminate the current confusion and conflict within the System that is contributing to its financial erosion and so that the government is in a position to protect its financial interests, a takeover of the System through a federal control board appears to be necessary. In the short run, a series of actions are necessary to prevent the situation from becoming much worse due to the flight of creditworthy borrowers and a growing unease about the situation by its investors. Over the long run, numerous decisions need to be made by the Congress and the board that will balance the needs of the System with those of other agricultural lenders to assure the continuation of credit to meet the legitimate financing needs of the agricultural sector.

We believe that our approach will lessen the rate of deterioration in the Farm Credit System and offers the time and flexibility to address the longer term issues in a non-crisis atmosphere.

That concludes my prepared statement. My colleagues and I will be happy to respond to questions at this time.