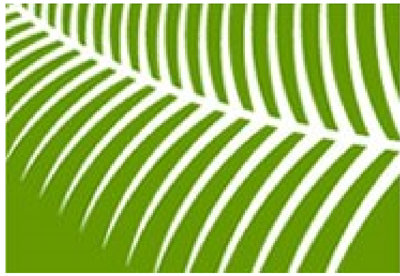


*The World's Largest Open Access Agricultural & Applied Economics Digital Library*

**This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.**

**Help ensure our sustainability.**

Give to AgEcon Search

AgEcon Search
http://ageconsearch.umn.edu
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

*No endorsement of AgEcon Search or its fundraising activities by the author(s) of the following work or their employer(s) is intended or implied.*

MO

#1987-3

# SUGGESTED RESTRUCTURING OF THE FARM CREDIT SYSTEM

J. Bruce Bullock

AEWP 1987-3

Working papers generally have not been reviewed by anyone other than the author. They are published as part of the process of obtaining from readers comments and suggestions for the author to use in subsequent revisions of the paper. Working papers should not be quoted or cited as a reference without approval of the author.

University of Missouri - Columbia
Department of Ag. Economics

GIANNINI FOUNDATION OF AGRICULTURAL ECONOMICS LIBRARY
WITHDRAWN
JUN 23 1988

# SUGGESTED RESTRUCTURING OF THE FARM CREDIT SYSTEM*

J. Bruce Bullock

This paper makes some specific suggestions for restructuring the currently bankrupt Farm Credit System. However, before outlining those suggestions, I want to provide you with first, a brief summary of my assessment of the financial problem of U.S. agriculture and of the financial problem of the Farm Credit System in particular and, second, a statement of the value judgments that cause me to arrive at the suggested restructuring of the Farm Credit System.

The financial problem facing U.S. agriculture is excess debt. There is twenty to thirty billion dollars of farm debt that cannot be repaid from the combined farm and non farm income of the farm families that owe the debt [1 and 2].[1] This excess debt was incurred during the latter half of the 1970s.

Collateral lending and borrowing practices allowed the excess debt to be placed on the books of all agricultural lenders. During the decade of the 1970s agricultural debt increased at the same rate as increases in agricultural asset values rather than at a rate constrained by growth in repayment capacity of borrowers. The value of farm assets increased 220 percent while the amount of debt increased 228 percent during the decade of the 1970s. Farm income, debt repayment capacity, increased only 50 percent during the same period. Unfortunately, repayment capacity never existed for a substantial portion of the debt placed on the books during the 1970s.

When inflation was brought under control in 1981, the wealth illusion that lenders and farmers had operated under during the 1970s disappeared. Debt could no longer be rolled over against ever increasing land values. The day of reckoning arrived.

*Presented to American Farm Bureau Farm Credit Committee March 5, 1987, Chicago, Illinois.

[1]Refers to references at end of paper.

The 30 to 50 percent decline in land values since 1981 have dumped the financial problems of farmers squarely in the laps of their lenders. Since land acquired as a result of loan foreclosures cannot be sold at prices required to recover the outstanding loan balance, farm failures have been increasingly translated into lender failure.

The bankruptcy of the Farm Credit System was inevitable as soon as land prices fell sharply in 1981. The System was not, and could not have been, capitalized at a level to withstand the consequences of holding 100% of its loan assets in agricultural loans a third of which have both inadequate repayment capacity and are under collateralized.

Lending standards for FLB and PCA loans were no lower than for other lending institutions. Thus, we see that the Farm Credit System share of loans with excess debt is about the same as its share of total agricultural debt. The difference is that the Farm Credit System has 100 percent of its loans in agriculture and the FCS made loans with borrowed capital rather than equity capital.

## Value Judgments Shaping Proposed Restructuring

(1) Agricultural producers should be expected to pay competitive interest rates on both real estate and non real restate debt.

(2) The long term economic viability of the restructured Farm Credit System should be determined by agricultural credit market forces.

(3) The Farm Credit System should not be salvaged at the expense of current member borrowers.

(4) A major portion of the benefits of salvaging the Farm Credit System should accrue directly to member borrowers.

(5) The economic viability of the restructured Farm Credit System should be determined by GAAP, not RAP.

(6) Government injection of capital should be in the form of equity capital with a plan to rotate out government stock over a 20 year period.

(7) Individual Farm Credit Banks should have to prove and maintain their economic viability within their own territories, and individual banks should be allowed to fail without dragging down other banks.

(8) The restructured Farm Credit System should not become a government lending agency like FmHA. One FmHA is quite enough.

## Proposed Restructuring

(1) Merge existing 13 banks for cooperatives into a single National Bank for Cooperatives located in Denver and managed by CBC management team. Two outside directors immediately added to CBC Board of Directors.

(2) Merge FLB and FICB in each district into a single Farm Credit Bank.

(3) All FLBA and PCA stock converted into FCB stock at par value or GAP determined book value, whichever is higher. FCB stock issued at $100 per share par value.

(4) All FCB stock is "at risk." Stock is redeemable at owners option only after stockholder has had no loans with FCB for five consecutive years.

(5) Shares of stock will be redeemed at GAAP book value in three equal annual payments beginning at end of fifth year after borrower has repaid all FCB loans. Stock is not transferrable between stock holders.

(6) All borrowers required to own an amount of FCB stock equal in value to 5% of the loan at the time the loan is obtained. Stock owned in excess of this requirement will be referred to as the stockholder's surplus stock. The FCB will pay interest on surplus stock equal to the current Farm Credit Bond rate on five year bonds.

(7) Stock can be purchased by existing stockholders, prospective borrowers, and by interested investors. All stock is subject to the five year ownership rules specified above.

(8) Stock purchase and redemption rules would be the same for the NBC as for FCB stock.

(9) Each FCB and the NCB will be organized as a stockholder owned cooperative and treated as a cooperative for state and federal tax purposes. Exclusive loan making territories for FCBs will be recognized as current 12 districts of the FICB and FLB.

(10) Create the Agricultural Finance Corporation (AFC) to purchase stock in the FCBs in amounts defined below. AFC stock offered for public sale at $100 per share. The U.S. Government will subscribe to all stock not sold to the public.

(11) Each FCB will specify the credit standards and lending practices for real estate and non real estate lending to be used in making loans.

(12) Each loan currently in the portfolio of each FCB will be evaluated relative to the lending standards established by the bank and placed into one of three categories:

    (A) All standards met -- acceptable quality performing loan.

    (B) Loan involves X dollars of excess debt. If X dollars of debt is written off, the loan would qualify as a category A loan.

    (C) Farm business owing debt is beyond salvage point even with 100% debt write off.

(13) Loans in category C would be written off and claims against the assets of borrowers would be withdrawn. The AFC would purchase an amount of preferred, non voting stock in the FCB equal to 40% of the amount written off for each category C loan when the write off occurs.

(14) The preferred stock purchased by AFC will be non interest bearing for the first five years. After the first five years, the stock will earn an interest rate equal to the short term treasury bonds. This preferred stock can be repurchased by the FCB at any time at par value.

(15) Loans in category B would be written down by the X dollar amount required to convert them to performing assets. The AFC would purchase stock in the FCB equal to 75% of the value of the X dollar write down.

(16) The AFC purchases of stock discussed above will be applicable <u>only</u> for loans in the portfolio as of January 1, 1987. FCB will absorb all losses on loans made after January 1, 1987.

(17) Each FCB now is left with a portfolio of category A loans and has had an injection of equity capital to partially offset the losses associated with cleaning up the portfolio.

(18) The Farm Credit Administration will define the capital standards by which banks will be placed in each of the three classes defined below. These standards will include defining the maximum percent of total bank capital that can be accounted for by preferred stock owned by AFC. This would be a decreasing amount and be at zero level after 20 years.

Class I - All capital standards exceeded.

Class II - Medium Risk - Some standards not met. Bank generally in sound condition but changes in balance sheet needed.

Class III - High risk - standards not met - bank must be liquidated.

(19) All class III banks would be closed and liquidated by FCA. Loan assets and trade territory will be first offered for purchase by Class I and Class II FCBs. If a satisfactory purchase arrangement cannot be made, the assets and trade territory will be offered to other lenders.

(20 The Agricultural Finance Corporation would assume responsibility for all Farm Credit Bonds and lending to the FCBs and NBC. The AFC would also be a source of funds for other agricultural lenders. The AFC would sell FCB bonds and NBC bonds.

(21) The AFC will sell bonds with a declining degree of agency status over the next 20 years.

Years 1-5 100% agency status; i.e., government guarantees 100% bonds.

Years 6-10 75% guaranteed.

Years 10-15 50% guaranteed.

Years 16-20 25% agency status.

Years 21 and beyond No government guarantee.

(22) The government guarantee would gradually be replaced by an Agricultural Finance Corporation Insurance Fund (AFCIF). This fund would be accumulated by insurance premiums paid by FCB and NBC on funds borrowed from the AFC.

FCB, NBC and other agricultural lenders would borrow funds from the AFC at the current cost of AFC bond sales, plus an insurance premium.

Class I 50 basis points

Class II 100 basis points

This insurance fund would be invested in government securities and would be used to cover AFC losses associated with closings of a FCB and to replace the government guarantee on AFC bonds.

(23) Each FCB would be assigned exclusive territory -- the nature of the credit delivery system would vary by district. It is conceivable that local banks could be agents for making loans.

(24) Bank Boards of Directors would consist of nine members. Six board members will be elected by stockholders. The other three members of the FCB

board will be "outside" members of the Board. The three outside members of the board will be appointed by FCA from a list of seven nominations submitted by the elected members of the Board. Board members will be elected or appointed for a period of three years with 1/3 of the Board up for re-election/reappointment each year. Members can be reelected/or reappointed for a maximum of three consecutive terms.

(25) Create a secondary market for real estate loans secured by first mortgage on land. FCB free to buy and sell in that market.

(26) Commercial agricultural banks (over 25% of portfolio in agricultural loans) holding category B loans for farms with gross farm sales over $100,000 can take advantage of AFC by transferring those loans to FCB as follows:

The FCB will purchase the loans at a price equal to the loan repayment capacity of the borrower plus 50 percent of the difference between the amount of the loan outstanding and the loan repayment capacity of the borrower. The AFC would then purchase stock in the FCB equal to 75 percent of the premium paid by the FCB for the note. Each FCB would be required to purchase all such loans in its territory offered for sale by commercial lenders within the first six months of operation. This transfer would be available only for commercial loans of record January 1, 1987.

## Impacts of Proposed Restructuring

The financial position of the Farm Credit System is illustrated by the example in Table 1. The first two columns reflect a $100,000 loan made against $125,000 in collateral that now has a recoverable value of $67,500. The Bank now holds a $112,000 non performing assets and owes $112,000 of bonds on which interest must be paid. If the loan is foreclosed on (Column 3), the FCB is left

holding $39,500 of bonds that were originally purchased for the closed out loan but which were not repaid by the foreclosure process. Moreover, the farm business that originally borrowed the money is no longer in operation.

If the non performing asset is sold to the AFC at 75% of loan value, the total loss and effect on the farmer-borrower are the same (Column 1). The AFC has a non recoverable loss and the FCB still owes $23,000 bonds that cannot be repaid from income on a non existent asset.

The final column of Table 1 illustrates the solution to the financial problem of the farm business and the Farm Credit Bank using the approach proposed in this paper.

A similar loan purchased by the FCB under terms defined in (26) would have the following impact on the FCB portfolio. FCB would pay bank $80,000 + ½ ($32,000) = $96,000 for loan. Bank thus has a $16,000 loan loss rather than $32,000 or larger. The FCB pays for the loan by using .80(16,000) = $12,800 of cash received from AFC stock purchase and sale of $83,200 of FCB bonds. Thus, the FCB now holds an $80,000 asset against what it owes $83,000, about the same as for the loan that was already in the portfolio.

The discounts and stock purchase requirements used in all the above discussion were selected arbitrarily for illustrative purposes.

Analysis and evaluation are needed to explore the feasibility of alternative levels of these variables. There are many details of the program to be worked out.

It is entirely possible -- probably even desirable -- that at the end of the first round of restructuring that some of the FCBs would be classified as a Class III bank and thus have to be liquidated. However, that liquidation would not cause the downfall of other banks and should even strengthen their financial position.

Table 1. Illustration of Financial Problems of Farm Credit System and Impacts of Alternative Methods of Correcting These Problems.

| | Financial Position of Each Participant | | | | |
|---|---|---|---|---|---|
| | When Loan Originated | Now | After Fore-closure by FCB | FCB Sells Loan to AFC at 75% of OLB | Loan Write Off with AFC Pur-chase of FCB Stock |
| Borrower | | | | | |
| Market Value of Land Used as Collateral | $125,000 | $ 75,000 | --- | --- | $75,000 |
| FCB Stock | 5,000 | 5,000 | --- | --- | 5,000 |
| FCB Loan | 100,000 | 112,000 | --- | --- | 80,000 |
| Debt Service Capacity | 80,000 | 80,000 | --- | --- | 80,000 |
| Farm Credit Bank | | | | | |
| Borrower Loan | 100,000 | 112,000 | --- | --- | 80,000 |
| Borrower Stock Owed | 5,000 | 5,000 | --- | --- | 5,000 |
| AFC Stock Owed | --- | --- | --- | --- | 24,000 |
| Cash | 5,000 | 5,000 | --- | --- | --- |
| Bonds Owed | 100,000 | 112,000 | $39,500 | $23,000 | 83,000 |
| Agr. Finance Corp | | | | | |
| Direct Loss | | | | 16,500 | |
| FCB Stock Purchase | | | | | 24,000* |

*75 percent of the $32,000 debt write off.

## REFERENCES


1. Bullock, J. Bruce, Farm Credit Situation: Implications for Agricultural Policy, FAPRI #4-85. Department of Agricultural Economics, University of Missouri-Columbia, March 1985.

2. Dodson, Charles and J. Bruce Bullock, The Farm Finance Situation 1986 vs. 1984. Forthcoming, University of Missouri, Department of Agricultural Economics.

3. Bullock, J. Bruce, Policy Issues in Farm Credit, Paper presented at Commodity Round Table Session, St. Louis, December 1986.