Heavy Going Ahead for the Farm Credit System?

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by Bert Ely

The Farm Credit System reported a 27 percent increase in nonperforming loans in the third quarter of 1998 and suggested that more bad news is on the way.

A Nov. 10, 1998, news release issued by the Federal Farm Credit Banks Funding Corporation, FCS's funding arm, stated that "Results going forward may be impacted by certain adverse conditions currently being experienced in the agricultural economy." While the FCS obviously is going to be impacted by the tough times many farmers and ranchers have experienced last year, as will commercial banks, FCS may soon begin eating the bitter fruit of its increasingly aggressive loan pricing.

Interestingly, FCS's increase in nonperforming loans in the third quarter of 1998 was not attributable to farmers and ranchers, but to an increase in nonaccrual loans "principally attributable to the deterioration in the credit quality of loans to a limited number of processing and marketing cooperatives." Although I have not been able to obtain an official confirmation, this problem may be a recurrence of the "hedge to arrive" problem which some grain elevator operators experienced in 1997 that caused problems at the St. Paul Bank for Cooperatives. This problem, in turn, may have been one reason why the Farm Credit Administration (FCA) issued a Cease and Desist (C&D) Order against the St. Paul Bank on Aug. 27, 1997, which required the bank to "take various remedial actions in connection with credit quality, capital adequacy, and internal processes and controls." No one at the St. Paul Bank or the FCA will tell me whether or not this C&D order is still in force, but perhaps the existence of this order is an underlying reason why the St. Paul Bank is merging into the much larger and financially stronger CoBank, the other cooperative bank within the FCS.

In anticipation of a future rise in problem loans, FCS institutions almost doubled their loan loss provision in the third quarter of last year after cutting their loss provisioning by half for the second half of 1997 and the first half of 1998. The FCS continues to be well-reserved for future loan losses, with an allowance for loan losses equal to 173 percent of its nonperforming assets (nonperforming loans plus other property owned) as of Sept. 30, 1998. However, as the FCS's Funding Corporation noted in its news release, "a continuation or worsening of existing pressures on commodity prices or adverse weather conditions could result in increased [loss] provisions in future periods and could cause a deterioration in the System's credit quality."

The news release also should have stated that increasingly aggressive lending by certain FCS lenders may add materially to future FCS loan losses. Now is the time when bankers must be especially quick to blow the whistle on reckless FCS lending, for their own sake as well as for rural America's financial health. Bankers should continue faxing or e-mailing to me concrete examples of FCS institutions lending at below-market rates.

Is the FCS's Below-Market Pricing Legal?

As bankers know all too well, aggressive FCS lenders are pricing at below-market interest rates, particularly on real estate loans where the FCS enjoys significant tax breaks. As I reported in the Fall 1998 issue of the *Journal of Agricultural Lending*, these tax breaks totaled $430 million in 1997. Several bankers have asked if this aggressive price competition is legal because the Farm Credit Act clearly states that FCS institutions shall not lend "below competitive market rates." Specifically, the last portion of the first section of the Farm Credit Act states:

> *Provided*, that in no case is any borrower to be charged a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent creditworthiness and access to alternative credit.

In an Oct. 26, 1998, letter to Jean Noonan, the FCA's general counsel, I posed questions designed to clarify the FCA's interpretation of words and phrases in this statutory language, including what is meant by "competitive market rates." I have been promised a reply and will report on it in a future issue of *FCW*. **jal**