Specialized Credit Institutions and New Institutions: Discussion

Warren F. Lee

Proceedings of
Regional Research Committee NC-161

FINANCING AGRICULTURE IN A CHANGING ENVIRONMENT: MACRO, MARKET, POLICY AND MANAGEMENT ISSUES

Denver, Colorado
October 6-7
1987

Department of Agricultural and Applied Economics
University of Minnesota
St. Paul, MN 55108
March 1988

Specialized Credit Institutions and New Institutions: Discussion

by

Warren F. Lee

Historical Perspective

Specialized farm lending institutions have played a prominent role in the U.S. credit markets throughout much of this century. The Cooperative Farm Credit System (FCS) evolved over a 17 year period beginning with the Federal Land Bank (FLB) System in 1916, the Federal Intermediate Credit Banks (FICB's) in 1923 and the Production Credit Associations (PCA's) and Banks for Cooperatives in 1933.

Another specialized farm lender, the Farmers Home Administration (FmHA) has its roots in the depression. The Resettlement Administration was established in 1935 and was renamed the Farm Security Administration (FSA) in 1937. The FSA was replaced by the FmHA in 1946. The Commodity Credit Corporation (CCC) also has its roots in the depression of the 1930's.

These specialized farm lending institutions and programs share two common characteristics:

1) They evolved during periods of widespread farm financial stress, or, in the case of the FLB's, to provide services (long-term loans) that were not being furnished by private sector lenders.

2) They were originally created with government funding, and they relied on government funding for some time after their inception. (The FmHA is still a government agency and the FCS repaid the last of its government capital in 1968).

During the first 30 or so years of their existence, the FmHA and the FCS played comparatively minor roles in the farm credit markets. The Federal Land Bank's share of total farm real estate debt outstanding dropped from 42 percent in 1940 to 16% in 1950 and then grew slowly to 24% in 1970. The PCA's share of non-real estate debt outstanding increased gradually from 5% in 1940 to 23% in 1970. Throughout this same period, FmHA's market share never exceeded 8% of farm real estate debt or 12% of non real estate farm debt. After 1970, these

Warren F. Lee is Professor of Agricultural Economics, The Ohio State University.

specialized lenders experienced a decade of phenomenal growth in market share, followed by a decade of severe stress that forced a return to government funding for the FCS.

The Risks of Specialization

The experiences of FCS, FmHA, and agricultural banks since 1980 offer clear evidence of the hazards of specialized lending. The sharp reversal in farm incomes and farm asset values had immediate and widespread repercussions on the FCS which entered this period with a strong capital position and a high quality loan portfolio. Total loan volume declined by nearly 30%, from a peak of $82 billion in 1983 to $58 billion in 1986. During the same period delinquent loans increased from $1.3 to $7.1 billion, i.e. from 1.6% to 12% of total loan volume. The system reported losses of $2.7 billion in 1985 and $1.9 in 1986.

The FmHA also has serious problems. By year-end 1986, nearly 30 percent of their borrowers, representing 43 percent of their loan volume were delinquent, compared to 5% of their borrowers, and 23% of their loan volume in 1980.

Farm loan delinquencies in the nation's 4700 agricultural banks also reached 8% of loans outstanding in 1986. About 400 of these banks are vulnerable and nearly 200 agricultural banks have failed since 1985. These failed banks, however represent an insignificant proportion of total banking system assets, and most banks, including most of those heavily involved in farm lending, remain solvent and profitable, due largely to their diversified portfolios.

The FCS institutions, especially the FLB's, also experienced problems with their specialized source of funding -- they are nearly totally dependent on the agency bond and discount note markets. The FLB's borrowed heavily in the early 1980's to fund a growing volume of loans. They paid double digit interest rates, and maturities on much of that debt stretched out into the early 1990's. By 1986, when the cost of new money was below 7%, the FLB's still had an average cost of funds above 10%. The resultant uncompetitive lending rates contributed to a large paydown by high quality borrowers.

Despite the hazards, specialization in lending does offer potential operational efficiencies. Loan officers who specialize in farm lending are more efficient in analyzing and servicing loans. LaDue reports that non interest expenses were 1.1% of total assets for the FCS and 2.7% of total assets for agricultural banks in 1985-86. Thus, a case for preserving the FCS as a specialized farm credit delivery system can probably be justified on the grounds of operational efficiency; however, any bailout should result in a financial institution that is capable of withstanding shocks such as the ones we have experienced in the 1980's. Some suggestions include:

1) Require borrower-owners to provide "hard" rather than "soft" equity capital, and as Jones and Barry suggest, be prepared to vary the capitalization program with changing economic conditions.

2) Diversify the asset portfolio to include primary and secondary reserves much like those held by commercial banks. For example, why not require the FCS institutions to hold a specified fraction of their assets in treasury securities. Diversification does not necessarily have to involve lending to all sectors of the economy.

3) Increase the geographic diversification of the loan portfolio. Barry and Barnard have estimated the potential gains from pooling lending risks beyond local associations.

4) Diversify the source of funding beyond the government agency market, and perhaps eventually wean the system away from this market entirely.

5) Establish and maintain a "war chest" of surplus capital and loan loss reserves that is large enough to avoid the need for future infusions of government funds.

Options for the FmHA are less clear. The USDA estimates that potential FmHA loan losses will be $2.7 billion. In addition, there is the continuing debate about its role and mission. Critics argue that it is overly politicized and that it should be substantially downsized or eliminated entirely. Nevertheless, credit programs are politically popular and several state credit programs have been put in place over the last three years in response to the farm financial crisis. These programs include low-interest loans, foreclosure moratoria, credit mediation and others concessionary programs initiated to assist financially pressed farmers.

The recent growth in specialized federal and state government credit programs is distressing given the overwhelming evidence that they offer insignificant benefits for highly indebted operators and that the benefits generally go to those who can easily survive without concessional credit. (Barry, Ellinger and Eidman; Froerer, Adams and Lee; Batte, Farr and Lee). Recent experience again suggests that specialized government institutions and programs should play a very limited and closely monitored role in the farm credit markets.

New Institutions

A number of new institutions have been proposed or implemented in recent years. As noted previously, several state farm credit programs/institutions have emerged. There have been proposals for institutions that would acquire distressed farm assets and/or loans -- for example, the Agricultural Credit Corporation (Harl) and The Agricultural Conservation Corporation (Farm Credit Council). The 1985 Farm Credit Amendments Act created the Farm Credit System Capital Corporation to handle loan workouts. House Bill H.R. 3030 calls for the creation of a new FCS Temporary Assistance Corporation, a Farm Credit Insurance Corporation and a Farm Mortgage Corporation. This same legislation would revoke the charter of the Capital Corporation.

Clearly, there is no shortage of new institutions. What is lacking is analytical research on these institutions. There has been some useful work on FCS capitalization (Jones and Barry), impacts of an FCS bailout on lending rates (Barry) and on the impacts of deregulation (Barnard and Barry). Similar work needs to be done on "Farmer Mac", and other new institutions coming on stream.

A Research Agenda

With some exceptions, there has been little research on financial institutions and changes since the survey of ag finance literature by Brake and Melichar was published more than ten years ago. As they observed,

> "There has been a great deal of descriptive research on how various credit institutions operate, but much less evaluative and analytical research has been done on these institutions..."
>
> "A number of institutional changes deserve research. Given what appears to be a continually rising need for capital and credit by American agriculture, can existing institutions meet future farm credit needs? What reorganization or changes might be useful? For example, should the relatively small rural banks be provided with new ways to obtain funds? By what means, such as pooling arrangements, might they increase their farm loans and at the same time keep their risks at acceptable levels? Would new financial institutions be useful -- perhaps a counterpart of the Federal National Mortgage Association to insure farm loans? For many of these questions, modeling and simulation of intermediary institutions and systems serving the farming sector would be a useful approach."

With existing specialized farm credit institutions in a state of disarray, and a number of new institutions coming on stream, we need to give added research emphasis to this area. The pace of institutional change has outpaced the research agenda. For example, we are in the process of creating a secondary market for agricultural loans with little or no basic information on the potential size of the market or on the costs of establishing and operating the program. Do we really need a "Farmer Mac", or might the comparatively small volume of secondary market farm mortgages be absorbed by existing institutions?

There is also a proposal to consolidate the 37 FLS banks into six combined FLB/FICB units and one B.C. Why six? Why not four? Or eight? Or one?

In addition to research on credit institutions, we need to redo previous work on forecasting the demand for farm credit. Total outstanding farm debt has already declined by one fourth -- from $210 to less than $160 billion. Where will it bottom out and once it does, how rapidly will it grow over the next decade? It seems obvious that the institutional structure needed to service a declining or stagnant farm credit/market would be quite different from the one we envisioned at the beginning of this decade when farm credit volume was growing at double-digit annual rates.

REFERENCES

Barnard, Freddie L. and Peter J. Barry. "Interest Rate Deregulation and Agricultural Banking: A Risk Programming Analysis." Agric. Finance Review. Vol. 45 (1985) 100-112.

Barry, Peter J. "Needed Changes in Farmers Home Administration Lending Programs." AJAE. 167:2 (May 1985) 341-44.

Barry, Peter J. "Financial Stress for the Farm Credit Banks: Impacts of Future Loan Rates for Borrowers." Agric. Finance Rev. Vol. 46 (1986) 27-36.

Barry, Peter J. and Freddie L. Barnard. "Interaction Effects on Rural Financial Intermediaries of Financial Stress and Deregulation." AJAE. 67:5 (December 1985) 1191-95.

Barry, Peter J., Paul N. Ellinger and Vernon R. Eidman. "Farm Level Adjustments to Financial Stress." Agri. Finance Rev. Vol. 47 (1987), 72-99.

Barry, Peter J. and Warren F. Lee. "Financial Stress in Agriculture: Implications for Agricultural Lenders." AJAE. 65:5 (Dec., 1983) 945-52.

Batte, Marvin T., Terry J. Farr and Warren F. Lee. "Effects of Selected Credit Policies on Farm Financial Survival." Selected Paper, AAEA Annual Meeting. East Lansing, MI. August 1987. 12 p.

Brake, John R. "Financial Crisis in Agriculture: Discussion." AJAE. 65:5 (December 1983) 953-54.

Brake, John R. and Emanual Melichar. "Agricultural Finance and Capital Markets" A Survey of Agricultural Economics Literature. Minneapolis, University of Minnesota Press. 1977.

Drabenstott, Mark. "Financial Crisis in Agriculture: Discussion." AJAE. 65:5 (December 1983) 955-57.

Farm Credit Administration. Agricultural and Credit Outlook, 1987. Office of Analysis and Supervision, Economic Analysis Division. February 1987.

Farm Credit Administration. Annual Report, 1986. McLean, VA. March, 1987.

Farm Credit Council. Proposed Agricultural Credit Corporation. Washington D.C. April 1985.

Froerer, Landell S., Dale W. Adams and Warren F. Lee. "Assisting Farmers Through Concessionary Loans: Insights from Ohio's Linked-Deposit Program. N.C.J.A.E. (forthcoming).

Harl, Neil E. "New Initiatives for Farm Debt Problems." AgriFinance, February, 1985, 20-22.

Jones, Bruce L. and Peter J. Barry. "Impacts of Production Credit Association Capitalization Policies on Borrowers' Costs." Agric. Finance Rev. Vol. 46, (1986) 15-26.

LaDue, Eddy L. "Needed Changes in Farmers Home Administration Lending Programs: Discussion." AJAE. 67:2 (May 1985) 352-53.

LaDue, Eddy L. "Some Thoughts on a Bailout of the Farm Credit System." Cornell Agr. Econ. Staff Paper. 87-91. (May, 1987) 7p.

Lins, David A., Mark Drabenstott, and John R. Brake. "Programs to Alter Lender Risks." Agric. Finance Rev. Vol. 47, (1987) 138-47.

Melichar, Emanual and George D. Irwin. "Condition of Rural Financial Intermediaries." AJAE. 67:5 (December 1985) 1178-83.

Melichar, Emanuel. "Turning the Corner on Troubled Farm Debt." Federal Reserve Bulletin. 73:7 (July 1987) 523-36.

Norris, Kim. "The Farmers Home Administration: Where is it Headed?" Economic Review. 71:9 (November 1986) Federal Reserve Bank of Kansas City. 21-32.

U.S.D.A., ERS. Agricultural Finance: Situation and Outlook Report. AFO-27, March, 1987.

U.S.D.A., ERS. "Agricultural Debt at Risk: How Much do Farm Lenders Stand to Lose?" Agricultural Outlook. April 1987. 8p.

U.S. General Accounting Office. Farm Finance: Secondary Markets for Agricultural Real Estate Loans. Washington D.C., Resources, Community and Economic Development Div. GAO/RCED-87-149BR, July, 1987.