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**THE FARM CREDIT SYSTEM'S STRUCTURAL CHANGE AND
COMPETITIVENESS**

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THE FARM CREDIT SYSTEM'S STRUCTURAL CHANGE AND COMPETITIVENESS

C.T. Fredrickson

My assignment this morning is to talk briefly about the Farm Credit System's structural changes and competitiveness. My premise will be that the structure of the system has developed until very recently much more in response to political, to some degree to bureaucratic forces, than to market or customer orientation and that the evolving market forces in agriculture over the past couple of decades, given especially acute focus in the middle 1980s, present a very special challenge to Farm Credit, far beyond the financial challenge that came out of those years.

Any of you who have ever attempted, as some of us have been burdened throughout our careers, to explain the structure of Farm Credit in an understandable, comprehensible fashion know that complex is an inadequate word. It goes far beyond that. It is becoming a little more comprehensible, though perhaps not yet understandable. But it is simpler than it was.

It was, before 1984 or 1985, a three-element system: the Federal Land Banks and their associations, some 550 in number; the Federal Intermediate Credit Banks and their associated PCAs, some 450; and 13 Banks for Cooperatives. That structure was created by trial and error because it arose at different periods in time. The Land Banks were created prior to World War I in response to a felt need for much longer term capital availability in agriculture. The onset of the agricultural depression following the First World War gave rise to the FICBs; and with the Great Depression of the early '30s, the BCs and PCAs came into existence. Each time there was some sort of crisis or felt need, Congress responded by creating more associated institutions. The economic purpose generally was the same: to provide the capital needs of an increasingly capital-intensive agriculture, but always in a political environment. The resulting structure, which began in government, slowly migrated away and out from government but remained heavily bureaucratic in its nature. Inherent in Farm Credit's structure was a very great potential for high operating costs. Twelve quite independent districts were created and then divided into hundreds of more-or-less independent lending associations, each a corporate entity with its own management, boards of directors and, by reason of its organization and operation, filtering business decisions through its own internal political structures. This system built up a huge market share and a great deal of financial strength over many years. An advantage, yes; but it was also a great disincentive to change. If there ever was an example of the verity of the old saying that the most dangerous time in a hog's life is when it gets fat, this was it.

As we look at the competitive factors that have evolved in the last decade and more sharply in the last five or six years, I think a retrospective view suggests that the development of American agriculture into the commercial engine in the global marketplace has really become the pivotal competitive factor challenging Farm Credit. This, I think, has led, along with many other forces, to the increasingly bimodal distribution that we see in production agriculture; at the one end, fewer larger commercial farming operations that account for the lion's share has been the increasing disappearance of that group in the middle. And that traditional "family farm" operation was the staple for Farm Credit.

Farm Credit built its entire delivery system and much of its operating philosophy around serving that middle group. And with the built-in inertia and disincentives to change, it has responded very slowly to the changes that have been occurring in production agriculture. That might well have continued, in my view, had it not been for the financial crisis in the early and middle '80s.

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That crisis really crystallized the issues for Farm Credit in several ways. First of all, in my judgment, it accelerated the disappearance of the small- to middle-sized commercially non-competitive production unit, the traditional family farm. Secondly, it has left Farm Credit with a mountain of bad debt, a radically depleted market share and no resources in the traditional structure to cope with the challenge. The recovery that we have seen in agriculture in the last three years that was largely fueled by the '85 farm bill leaves these larger, commercial operators stronger than ever as a group and, more importantly, focuses Farm Credit's competitors on them as a sector, probably the sector, of the ag economy that has long-term potential for profitable lending.

Now Farm Credit, as you all know, in part in response to the crisis of the '80s, had to turn to Congress. Congress passed three pieces of legislation in successive years beginning in 1985. The most important of these by far is the Farm Credit Act of 1987. This bill gives the Farm Credit System time to make structural changes, the kinds of changes that are essential to its remaining a major player. But very importantly and most cruelly, the bill does not make those changes. It leaves that in the hands of Farm Credit to do or to fail to do.

The legislation provides a period of time for Farm Credit to adjust. It provides a line of credit, a total of up to \$4 billion, to work out our bad debt and, to some degree, make structural adjustments. The system, in total, anticipated in 1985 that it would be necessary to work through about \$15 billion of bad debt. That will prove to be a reasonably accurate estimate. In St. Louis, we estimated that we would have to deal with \$1.25 billion of that \$15 billion, and again that estimate will prove to be most accurate. The losses involved in dealing with that bad debt have proven, frankly, to be substantially less than estimated. In part, and I think honesty compels me to say in lesser part, that is so because the system responded well in dealing with the problem. A much more significant element in lessening that loss was the enactment of the 1985 farm bill and the fact that the public sector pumped huge amounts of money into farmers' hands. That's largely responsible for the fact that the system has returned to profitability much earlier than anyone had anticipated and at least, to date, in a much stronger fashion.

While the '87 act provides what is sometimes called a bailout, it also provides that any money received must be repaid. That cost of repayment we estimate to be somewhere between 40 and 50 basis points for all system institutions over 15 years on the roughly \$1.5 billion that we now expect to have to use out of that \$4 billion. But, those 50 basis points, half of one percent, over the next 15 years, will require a very, very substantial, some would call radical, restructuring of Farm Credit operations, a restructuring that would, at the same time, better position us a contender in the competitive marketplace. The act gives the Farm Credit System the means to reform its structure. It provides the authorities for very extensive merger and consolidation of corporate entities. As you know, the Land Banks and Production Credit Banks in each district have been consolidated, except in the Jackson, Mississippi, district where the Land Bank is in liquidation. So, instead of Land Banks and Credit Banks, we now have Farm Credit Banks in all the other 11 districts.

The '87 act also provided the authority for the first time for Federal Land Bank Associations and PCAs to merge to form agricultural credit associations. There has been extensive consolidation at the association level. There are now just over 250 associations nationwide. That compares with about 1,000 in 1984. It also provided for the creation of the National Bank for Cooperatives, headquartered in Denver. It is an amalgamation of the Central Bank and ten of the pre-existing district Banks for Cooperatives. The '87 act also provided for a reduction of the borrower's stock requirement. Most districts have implemented that stock purchase reduction and thereby eliminated a further competitive drag.

Clearly, there are further efficiencies available. There is, in my judgement, very little need or justification on an economic basis for 11 Farm Credit Banks. I say that with obviously very little concern for career considerations, since I am one of those who would likely be most immediately affected; but there simply is, on an operating and economic basis, no justification in this day and time for #3 and #4 billion district banks. There has been some discussion, some tentative moves, toward district bank mergers, but thus far they have not borne any fruit; and quite frankly, I think it will be probably another couple of years before

there really is much progress.

The remaining challenge, however, is even more critical - that of recapturing lost market share. Our success in this area is going to depend on our ability to rediscover the customer (a strange admission for a borrower-owned institution to make). We will have to restructure our operations to serve our customers efficiently. We will have to drive our cost structure down to achieve both the assistance payback and market leader position. I am going to leave largely to Chris Gaia the details of how we are beginning to recapture lost market share, but let me summarize some of our leading challenges.

Customers themselves define those challenges. They tell us precisely the values they seek in a lender, and they are not hesitant at all to do it. They tell us in no uncertain term in our service quality surveys and our focus group meetings just where they find us deficient. The basic message that we are hearing from farmers in these three states I could capture fairly succinctly. Managing agricultural production and marketing risks is tough enough in a global market. Farmers should be able to count on their lender to provide efficient tools either to eliminate or to control interest rate risk in their operations.

This leads to the logical question: How are those of you in the bank going to do to earn your keep? A question they frequently ask. We will provide them funds. We will be wholesale bank. We will lend them money. We will do the asset-liability management for the consortium. We will provide them services, but they will be the direct lenders. They will be very much freestanding financial institutions. That is a key element in our getting back in touch with our customers. The associations are closer to customers. They are closer to the markets. We cannot manage those relationships effectively from St. Louis. We simply cannot be responsive to all of them. We would either price too high or leave money on the table. Products that work in some areas of the district do not work well in other. We are, therefore, in the process of decentralizing those decisions.