ucts. The phasing out of domestic price supports that now raise U.S. prices above world price levels is an important first step in achieving a more open economy and in increasing exports of U.S. farm products.

The United States should phase out price supports forthwith and independently of GATT negotiations to reduce trade barriers. Price supports not only are inimical to trade. They are also ineffective in attaining their primary objective of increasing the long-run profitability of farming.

Two developments are creating additional pressures on the United States, at long last, to make our domestic agricultural policies more consistent with the objectives of GATT.

First, there is growing concern about the cost of farm programs. The U.S. Treasury cost of price and income stabilization programs alone increased from $4 billion in 1980 to some $18 billion in 1985. Second, rising global farm productivity coupled with slow economic growth of many countries has meant lower international farm product prices. These lower prices increase the budget cost of maintaining domestic price support programs.

Thus, increasing competition in markets for U.S. farm products and budget pressures may force U.S. policy makers to do what they heretofore have been unable to do—modify our domestic farm policies to make them compatible with the GATT objective of liberalized trade. C

Gregory Gajewski and Ronald Meekhof on Band-Aids for Banks

Bankers Dream While Regulators Adjust the Rules

The income and equity of commercial banks specializing in farm lending are declining with the farm economy. In 1985, almost 1300 agricultural banks had loan losses of 2.5 percent or more of loans outstanding—a level high enough to wipe out net income at the typical farm bank. Since 1983, returns to agricultural bank equity have been halved. The number of farm bank failures has jumped almost tenfold, and the number of "problem" agricultural banks has quadrupled. The poorest prospects are for farm banks in Iowa, Kansas, Nebraska, Minnesota, and Missouri.

Agricultural banks and their organizations are pressing for Federal assistance. Proponents point to the Farm Credit System (FCS) rescue package, the net worth certificate program for troubled savings and loans, and the 1984 Continental Illinois bailout to justify their case. The relief movement has found support in the Senate among Republicans from farm states. Senators, especially those facing reelection, are concerned about the impact of reduced banking services on rural economies and, in turn, the effects on the elections this fall.

In contrast, the Federal bank regulators—the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Fed), and the Comptroller of the Currency—have been reluctant to provide aggressive relief to farm banks. They emphasize the potential damage Federal assistance to agricultural banks could have on the safety and soundness of the nation's banking system.

Recent hearings held by the Senate Committee on Banking, Housing, and Urban Affairs and chaired by Jake Garn (R-UT) provided a unique opportunity to clarify the different positions held by the banking industry and the institutions that regulate the banks. There is a great diversity of opinion as to whether relief is needed, and if so, the most effective approach.

The most widely discussed relief measures include:

—Extending the net worth certificate program to agricultural banks;

—Allowing agricultural banks to spread their farm losses over a number of years;

—Subsidizing acquisition of failed banks by healthy banks;

—Implementing various accounting reforms.

The hearings pointed out that, in the extreme, the choice facing policy makers is between: (1) a bank bailout, and (2) faith in market forces. The first would increase risks to the safety and soundness of the banking system while the second could curtail credit for farm and other rural businesses. The challenge is to find a middle ground that facilitates the recovery of banks that are fundamentally viable but experiencing temporary adverse economic adjustments.

System Not Threatened

Even without a relief program, the national commercial banking system can weather the agricultural crisis. However, there remains a remote possibility that confidence in the system could be shaken by failing agricultural banks. These kinds of developments are highly unlikely because institutional safeguards, provided by the FDIC and the Fed—protect the banking system from any runs on rural banks.

Though the nation's banking system is not really at risk, the availability of credit and financial services in rural areas is at issue. Also at issue is: the extent to which bank owners should be held responsible for their lending decisions, the eligibility of troubled banks servicing other sectors for a legislative or regulatory remedy, and the structure and stability of the banking system.

The issues also relate to fairness. Why protect assets of bank owners when farmers have lost a quarter trillion dollars in asset values and tens of thousands have experienced foreclosures and liquidations?

The response is that farm bank aid will ease the transition for farmers. The aim, some say, is to help farmers through their banks, even if it means saving bank owners.

Problem of Overcorrection

Some analysts argue that when mar-

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kets adjust to dramatic changes in underlying conditions, they overshoot their long-term equilibrium. For today's agricultural sector, this means declines in commodity prices and land values below their long-term, market-clearing levels. As a result, payments on bank loans slow. Farm and agricultural-related business failures rise. These conditions all lead to increases in farm bank failures.

Commercial banks in the regions most affected by these abrupt declines in farm prices and land values may make the situation worse by unduly restricting credit. In an atmosphere of rising farm loan defaults, bankruptcies, and bank failures, some agricultural banks, especially those with substantial net worth, limit the number of farm and related loans (i.e., ration credit) so as to improve their liquidity positions. A properly constructed farm bank relief program could alleviate this problem.

In contrast, many opponents of aid for agricultural banks believe that market discipline is necessary to bring about an efficient allocation of resources. Communities deprived of banking services, as one cost of volatile agricultural markets, are merely experiencing short-term difficulties. Areas with enough activity to support a bank will find replacements to fill the void, according to this view.

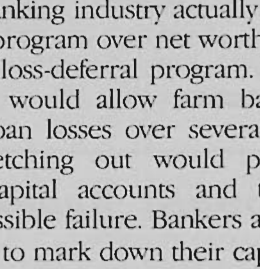
Others contend that bank deregulation has not gone far enough to fully apply market discipline. This is especially important for agricultural banks. Heartland States have a long history of restrictive banking laws; many are unit banking states that prohibit bank branching and some also restrict multibank holding company growth. Such restrictions may have prevented banks in these states from growing to a size where they can effectively compete in the new deregulated environment, the argument goes.

The Bankers' Dream

The banking industry has proposed a net worth certificate program for agricultural banks. Their proposal to Senator Garn is similar to what was created for the nation's troubled savings and loans. If their proposal was accepted, qualifying banks with capital insufficient for regulatory standards could apply to the FDIC to receive certificates which would be counted as capital by the bank. These certificates would help boost the banks' capital accounts in order to meet the regulatory standard that banks' capital must be at least 6 percent of the banks' assets (for example loans outstanding). Banks would have several years to replace the certificates with their own funds. Redemption periods ranging from 3 to 30 years have been proposed. The program would give banks with large agricultural loan losses time to recover, if bank examiners think they have good earnings prospects.

The banking industry actually prefers another program over net worth certificates—a loss-deferral program. Such a program would allow farm banks to spread loan losses over several years. This stretching out would preserve banks' capital accounts and thereby avoid possible failure. Bankers are now required to mark down their capital accounts in the year the loan losses occur.

Either program, however, as generally



proposed, could reduce public confidence in the banking system and could lead to confusion about a bank's real performance. Because both proposed programs depart from Generally Accepted Accounting Principles (GAAP), financial statements would not be comparable to those of non-participating banks. More important, banks receiving assistance under either program would report capital levels above what would be normally reported. Moreover, reported net income of banks using the loan loss deferral program would be inflated, giving a false impression of improved performance.

In theory, the accounting could be structured so that a loan loss deferral or a net worth certificate program did not distort the reported true financial condition of participating banks. The specific proposals under serious consideration, however, do not call for this kind of accounting.

Critics also fear that benefiting banks, with little or no owners equity left to lose, would take extreme risks. Bank owners would have an incentive to finance inordinately speculative ventures in the hope of large returns but with little risk to themselves. In effect, the bank owners would say to FDIC, "Heads we win, tails you lose." If the speculative venture succeeds, the bank owners pocket the profits. If the venture fails, the FDIC is responsible for the bank's deposits, not the owners.

The ultimate cost to the government of either option might be quite high. If farm conditions remain depressed for several more years, most banks in either program would probably not return to profitability. This is true regardless of a bank's attitude toward risk, because neither program addresses underlying financial problems.

The Regulators Respond

In response to Congressional pressure, the regulators adopted a three-part relief program of their own for farm banks. Their program has blunted Congressional agitation for either a loan loss deferral or net worth certificate program. Farm banks and their trade organizations have adopted a "wait and see" attitude before determining if the regulator's program is adequate.

This program, constructed by the FDIC, the Fed, and the Comptroller has three elements: (1) a reduction in the penalty banks bear when they renegotiate troubled loans with their borrowers, (2) an improvement in the way in which successfully renegotiated loans are reported, and (3) formal capital "forbearance" for banks with low net worth but good future prospects. The first two are already in place. As of this writing in late March, the details of the third, capital forbearance, are still being worked out.

The first element relies on a change in accounting practices which should encourage bankers to renegotiate problem loans on terms more favorable to the troubled borrowers. The regulators now say that the term of the loan may be extended, and interest and principal payments reduced, provided that the entire original principal amount is scheduled to be repaid eventually. Any loss on the loan is thus accounted for as foregone interest income, so the bank's net income is lower than expected. But, unlike regulator-sanctioned accounting practices in the past, banks need not record a loan loss, and therefore no reduction in bank capital is necessary.

There is one catch. Accounting standards require and regulatory practices will enforce limiting application of this element to loans that have a reasonable prospect of being repaid under the renegotiated terms. The individual banker will be making this judgment, subject to examiner approval. This element is similar to a loan loss deferral in that it protects the bank's capital from write-offs.

However, it is also more restrictive because it is limited to loans with a reasonable prospect of repayment after renegotiation.

The second element in the regulator's program also provides all banks, including farm banks, with an incentive to redo the loans of their cash-strapped borrowers. It relies on a change in the procedure a bank uses to report successfully renegotiated loans.

Up to now, all renegotiated loans have been counted as nonperforming (i.e. "problem") bank assets. If a bank has many problem assets, the public's confidence in the bank is reduced. As a result, some bankers have been reluctant to renegotiate the loans of their delinquent borrowers. Not only would they incur a loss through renegotiation under the old rules, but the renegotiated loans would still be reported as nonperforming.

The regulators now say that, as of June 30, 1986, all (including farm) loans successfully renegotiated will be reported as "renegotiated loans" but "performing according to modified terms." Thus, a bank would improve its performance both in the eyes of the public and the regulators by renegotiating the loans of its problem borrowers.

The third element of the bank regulators' program is the capital forbearance policy. When implemented, it will permit agricultural banks to operate with substandard levels of capital if the thinly capitalized farm banks have, in the regulators' judgment, the potential to return to profitability.

This program was initially designed to aid agricultural banks. However, many in Congress pushed to extend the plan to banks burdened by questionable energy and real estate loans. Most energy banks are in Texas and Oklahoma, areas also characterized by weak real estate markets. In response, the Federal bank regulators extended the renegotiated debt accounting rule changes to these and all banks. Yet, testimony at Senator Garn's hearings indicate that capital forbearance may be limited to banks serving ailing farm borrowers.

The Pros and Cons

The regulators' program has two advantages over the bankers' proposals. First, legislation is not required to implement the program, so aid is being made available quickly, perhaps even in time for the current planting season.

Second, relief provided to needy banks will not violate GAAP standards, thus maintaining public confidence in the integrity of the commercial banking system. Along with all banks, those availing themselves of the program's benefits must nevertheless make clear their current income and capital positions to the public, potential customers, and the regulators.

Dangers in Any Plan

All relief packages expose the nation's banking system to additional risk. The bankers' proposals, and to a lesser extent the regulators' program, open the door to aid for specialty banks involved with other sectors of the economy. In fact, the first two elements of the regulators' program have already been extended to all banks. This increases regulators' potential losses. It also sets a dangerous precedent in relieving banks of their responsibility to manage risk through diversification.

The financial community fears that banks will now feel more secure in concentrating their loans in a particular sector, knowing that they can expect a bailout if the sector should experience a contraction. The most critical consideration relates to allowing banks to operate with little or no equity of their own on the line. Such arrangements encourage bank managers to try to gamble their way to prosperity.

Even banks that are prudently managed, but in weak financial shape, may incur increasing losses if agricultural markets do not improve. Postponing bank failure in these cases increases the ultimate cost to the FDIC insurance fund and, possibly, the taxpayers.

Longer Range Solutions

Numerous policy actions can promote the health of agricultural banks over the long term. Almost all require legislative reform on the part of Congress or the states, and once in place would take several years to aid farm banks. Nonetheless, they could be important to agricultural banks, farmers, and their communities in the 1990's. Some specific proposed actions are:

—Change state laws that restrict the length of time that state-chartered banks may hold foreclosed land to match the 10-year federal limit for nationally chartered banks.

—Relax the interstate and intrastate restrictions on acquiring failed and failing banks in order to stem the drain of local banking services associated with bank failures in rural communities.

—Enable small farm banks to participate in large loans not sensitive to local economic developments.

—Develop a secondary market for farm mortgages through an organization similar to the Federal National Mortgage Association (Fannie Mae) with initial capital put up by the Federal government.

—Loosen or remove restrictions on branching and holding company growth to open new markets for rural banks.

Diversification is the key to bank stability. And most of these proposals aim to make diversification easier for farm banks. A bank with a diversified loan portfolio can better serve its community and will not be under as much pressure to ration credit—deny loans to farmers—when the sector is hit by hard times.

The farm sector is in the process of making the necessary economic adjustments to a contraction in demand. While Federal agencies should provide enough relief to farm banks to prevent credit rationing, they must be careful that the assistance does not overwhelm the gains from deregulation. The salutary benefits of these adjustments in both sectors need not be blunted if relief is provided sparingly. C

More Information

If you are interested in more details, you will want to write your Senator and ask for the record of the March 6 and 11, 1986 hearing before the Senate Committee on Banking, Housing, and Urban Affairs. It includes statements by the chairman of the FDIC, William Seidman; the Comptroller of the Currency, Robert L. Clarke; the Vice Chairman of the Board of Governors of the Fed, Preston Martin; and the President of the Independent Bankers Association of America, B.F. Backlund.

For information more generally related to farm credit conditions write to the Information Division of the Economic Research Service, USDA, Room 228, 1301 New York Avenue, N.W., Washington, D.C. 20005-4788 and ask for the most recent *Agricultural Finance Outlook and Situation Report* (AFO-26). There is no cost.

You may also want to ask your Senator for a copy of the hearings before the U.S. Senate, Banking, Housing, and Urban Affairs Committee last year, that focused on farm credit. Ask for the Farm Credit Relief Act of 1985, (S. Hrg. 99-308).