L's in Crisis

We May Not Need Them Anymore

by Gregory R. Gajewski

Paul Prentice comes to a comforting conclusion for supporters of the Farm Credit System (FCS) and of farming interests generally. To me, however, the differences between the S&L and the FCS crises seem to be of magnitude, degree, and timing — not of substance. While we can debate about using the 1987 Farm Credit Assistance Act as a model for restructuring the S&L industry, Prentice is missing the forest for the trees. The real question is: Does it make sense for the United States to subsidize single-sector lenders, or are such lenders obsolete?

Both S&L's and the FCS were set up to serve a sector that, in the early part of this century, could not secure enough credit. Back then, the costs of collecting information about small farmers and homeowners were so high as to warrant specialized lenders.

Does the U.S. really need, and can it afford, to subsidize credit for farmers and homeowners by subsidizing the FCS and S&L's?

Now, information costs have fallen so much due to the revolution in computers and communications that the Nation may not need such lenders. Multinational banks can access a farmer's credit history via computer at little cost, and probably make a sound lending decision, even though the farm is a continent away. The decision to keep specialized lenders means that taxpayers may have to rescue them every 50 years or so, and certainly requires better (and more costly) supervision to avoid even more frequent rescues.

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Moreover, the FCS today, with numerous weak institutions and many restructured loans, could be similar to the S&L's nearly a decade back, when many were already in deep trouble.

To operate effectively in an unstable macroeconomic environment, financial institutions must be free to choose their mix of short- and long-term assets and funding sources, plus be free to diversify across all sectors of the economy. Regulators must be vigilant and stay at arms-length.

Even if they survive the next decade, both S&L's and the FCS will continue to pose a threat to taxpayers. Both remain single-sector lenders that cannot easily diversify risk away from their primary sector. Even with new powers, S&L's must still use at least 60 percent of their assets to support housing, or they lose tax and regulatory benefits. The FCS is prohibited from going beyond making loans for farming and farm-related businesses, although it is lobbying for expanded powers.

Farmers get federal support through the commodity programs, and homeowners get federal support through the income-tax code. Does the U.S. really need, and can it afford, to subsidize credit for farmers and homeowners by subsidizing the FCS and S&L's?

S&L Crisis Arose From Both Internal and External Factors

External factors were at least as important, if not more important, in creating the S&L crisis as they were for the FCS crisis. The inflationary 1970s followed by the deflationary 1980s induced big swings in interest rates, farmland values, and non-

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farm land values in the oil patch that caused major problems for both the S&L's and the FCS. These events were outside the lenders' control. But the S&L's and the FCS made things worse for themselves through aggressive lending that bet on ever-rising asset values.

In the mid- to late-1970s when interest rates surged, S&L's suffered from two problems: disintermediation and misintermediation. Disintermediation occurred when deposits flowed out of S&L's to earn higher rates in the money markets. Misintermediation occurred when the S&L's were stuck with long-term low-rate mortgages funded by liabilities (i.e., deposits) that were costing more than what the S&L's earned on the mortgages. Liability and asset term structures were "mis-" matched.

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Congress responded by removing Regulation Q, which had kept the S&L's from offering market interest rates. That solved the disintermediation problem, but made the misintermediation problem worse; the S&L's were still stuck with those long-term low-rate mortgages as the costs of their deposits skyrocketed.

As a result, some estimate that at least a third of all S&L's were insolvent as early as 1980-81. Without federal deposit insurance or the power to issue agency-status bonds, insolvent institutions are almost always forced into bankruptcy.

The Federal Home Loan Bank Board (FHLBB, the S&L's federal regulator) needed more cash back then to clean up the mess. Instead, the FHLBB only moved against some of the insolvent S&L's and sold them to people willing to put up a little new capital. Situations like this attract risk-takers, "high fliers," who jacked up rates, pulled in deposits, and made high-risk loans and investments. These new owners had little of their own money on the line, and had a strong incentive to gamble for a recovery. Here is where the massive frauds and insider abuses entered the picture.

Had the FHLBB been more aggressive in shutting down S&L's when they first became insolvent, and more selective in who could buy a failed S&L, the problem would have been largely solved. But the FHLBB would have needed federal funds, and Congress would have resisted refinancing FSLIC in 1982, much as they have resisted in recent years. And closing a third of the S&L's would have called into question the federal commitment to support homeownership.

In the early 1980s, Congress did give the S&L's the power to diversify away from home mortgage lending, hoping the new powers would promote diversification and lead to a more stable industry. But the powers were used by the insolvent or nearly insolvent

S&L's to get into even higher-risk situations. And the regulators were ill-equipped to police the deregulated S&L's.

...As Did The FCS Crisis

The FCS was also shaped by the inflationary 1970s and the contractionary early 1980s. There was talk in the 1970s about a world food crisis, and commodity prices were going through the roof. With U.S. farm exports growing at an inflation-adjusted rate of over 10 percent annually, many believed that the farm real estate market was a sure bet.

But Prentice makes it sound as if the FCS was a hapless victim of external events; I strongly disagree. The pickle the FCS landed in was in large part due to its rapid loan growth during the 1970s. Some research shows that over four-fifths of farm-output growth during the 1970s was financed by new credit, not farmers' savings. As the then-largest farm lender, the FCS's loan growth probably was responsible for much of the run up in farmland prices.

Even during boom times, lenders must exercise caution in extending new credit lest conditions unexpectedly sour. If the lenders fail to exercise caution, the institutions' creditors (i.e., bondholders) can enforce the needed restraint.

But the FCS bonds have quasi-agency status, meaning that bond buyers view the bonds as being implicitly guaranteed by the federal government. With such a guarantee, bondholders are likely to prefer a high-risk growth strategy, because the risk of bondholder losses is almost nonexistent. For S&L's, federal deposit insurance works the same way.

Aside from the rapid growth, the FCS made a big interest-rate gamble in the early 1980s. Back when interest rates were in the high teens and near their peak, the FCS issued long-term, high-rate bonds to finance more growth in farm mortgages. Here, the FCS was gambling that interest rates would go even higher during the following 20 years, when in fact interest rates fell. Research suggests that the FCS could have survived the farm crisis without federal assistance if it had not taken on the burden of this high-cost debt.

Will The FCS Bailout Work?

The FCS bailout seems to be working now because, as Prentice points out, the farm sector has rebounded. But what if the sector enters another cost-price squeeze, or endures another contraction?

Even if the farm sector does well, it is too early to tell if the bailout will work. The FCS has to pay back much of the Federal aid over the next 15 years, creating a drain on profits. Moreover, many FCS lenders have vowed to regain their market share by jacking up loan volume. Such a high-growth strategy could work, but it could also help fuel another land boom, and eventually backfire if the farm sector recovery falters. It's up to the Farm Credit Administration (FCA), the FCS regulator, to make sure the FCS institutions grow enough to repay the aid, but not so fast as to

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