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FCS and S&

They're Different; Solutions Should Be, Too

by Paul T. Prentice

The Federal Savings and Loan Insurance Corporation (FSLIC), the public insurer of private S&L deposits, faces enormous losses. Indeed, the entire system is bankrupt. These losses have been estimated at anywhere from $75 billion to a staggering $150 billion, and a few credible analysts put the final cost over $200 billion.

With some form of publicly funded bailout now a certainty, many look to the 1988 bailout of the Farm Credit System (FCS) for guidance. This is a big mistake.

Though there are a few similarities between the S&L crisis and the Farm Credit System (FCS) crisis, the differences are so fundamental as to preclude the use of the Farm Credit Assistance Act as a model for rescuing FSLIC.

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The Similarities

- Both the S&L's and the FCS were originally chartered to meet certain perceived needs and market niches. The S&L's became the predominant home mortgage lender, while the FCS became the predominant farm mortgage lender.

At first, the S&L's were restricted to home mortgage lending in contrast to FCS charter authority to lend for short-term farm production expenses and to lend to farmer cooperatives in addition to mortgage lending for farm land purchases. Eventually, however, deregulation allowed the S&L's to lend to commercial business, home builders and developers, in addition to its home mortgage business.

- Both the S&L's and the FCS are private institutions regulated by public or quasi-public agencies. The Federal Home Loan Bank Board regulates S&L's, the Farm Credit Administration the Farm Credit System. But both regulators suffered from an incestuous and revolving door relationship with those they regulate. This practice was not the direct cause of either crisis, but it led to costly delays in recognizing the problems, and implementing solutions. The lesson here is an ancient one: Don't allow people to mark their own report cards.
- Finally, both the S&L's and the FCS, while private institutions, depend to some extent on federal guarantees—explicit or implicit. The S&L's were covered at both ends; FSLIC insured their deposits, and Fannie Mae, Ginnie Mae, and Freddie Mac provided a secure secondary market for their loans. The FCS was covered to the extent that the financial markets perceived their paper as having agency status, backed by the full faith and credit of the federal government. Though FCS had no such guarantee, perception, it would seem, is reality.

The strength of the implicit guarantee was affirmed when the full extent of likely FCS losses became evident in 1987. Even at their darkest hour, FCS bonds traded at only a 120 basis point (bp) premium over comparable Treasuries—just 100 bp more than their typical risk premium of around 20 bp. Considering that even high-grade BAA corporate bonds typically trade at a 200-300 bp premium to Treasuries, it is clear that the marketplace assumed an FCS

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bailout would occur. And the market was right.

These then, are the main similarities between the S&L crisis and the FCS crisis. To recap, (1) both were chartered to meet specialized market niches; (2) both were private institutions with cozy relationships with their regulators; and (3) both depended, to one degree or another, on federal guarantees. Undoubtedly, there are other similarities. But these are the major ones.

Critical Differences

- The S&L crisis was brought on by events largely *internal* to the industry, the FCS crisis by *external* events.

Difficulties in the S&L's were fueled in large part by deregulation and plain old-fashioned fraud and mismanagement. Financial deregulation in the late 1970s and early 1980s opened a Pandora's Box of potential abuse in the S&L's. First, interest rate ceilings on deposits were lifted allowing S&L's to pay whatever rate they needed to attract new deposits. Then the Congress raised the ceiling on insured deposits several-fold, to $100,000. Finally, S&L's were allowed to branch out from their traditional base of stable homeowner lending into riskier commercial real estate and business ventures. S&L losses could be passed easily to the government. FCS losses were not as easily passed on to the government.

The regulators' implicit signal to S&L's was pay high interest rates in order to attract and make risky loans without fear. But don't worry, be happy, depositors' deposits are insured if losses should occur. Is there any wonder that underwriting standards deteriorated as fast-money artists flocked to the industry to fleece FSLIC?

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In contrast to the internal causal events of the S&L crisis, the FCS crisis was brought about by events that were mostly *external* to the industry, namely high real interest rates caused farmland values to plunge as the (related) soaring dollar caused farm exports to dry up.

This is not to say that there was not some fraud and mismanagement within the FCS—there certainly was—but it was not the same major causal factor as it was with the S&L's. By the same token, the volatile external macroeconomic environment (inflation and interest rates) was an impetus for deregulation of the S&L's. The crises of both institutions, therefore, involved both external forces and internal practices. But my point is that external conditions were the driving forces causing the FCS crisis while the S&L crisis was caused primarily by internal practices and conditions. It is a matter of emphasis and degree, no doubt, but a critical one nonetheless.

In contrast to the S&L's, the FCS was not able to pass losses on to the federal government as easily. The FCS is a cooperative lending system and farmers taking out loans are required to hold stock in the system. Each of the system's 12 district banks are held jointly and severally liable for FCS bonds. This arrangement provided some degree of internal restraint. In the end, however, Congress' bailout of the FCS made joint and several liability a moot issue.

As the farmland market unraveled, FCS got caught because they had succumbed to the temptation to tie their loan amounts to asset "market values" rather than cash flows generated by the assets.

However, private lenders, such as life insurance companies, were even more aggressive in tying the amounts of their loans to asset values than were FCS banks. Nonetheless, everyone learned a valuable lesson on the merits of basing loan amounts on cash flows rather than market value of assets.

- FCS was able to stem the losses. The losses for S&L's con-

tinue. For the FCS, once the losses were recognized, the failing regional banks either received a capital infusion or, in the case of the Jackson FLB, were closed down. These steps stemmed the system-wide losses and profitability was restored—for the time being at least.

Not so for the S&L's. Failing S&L's have been allowed to operate for many months (in some cases, years), while their losses were compounded by attracting even higher-priced deposits and making ever riskier loans. Troubled S&L's found themselves on a treadmill—the bigger their losses, the higher the interest rates they paid to attract deposits; these higher rates on deposits required even riskier loan ventures which in turn led to even greater defaults and losses. Not quite a Ponzi scheme, but close. And all fully sanctioned and backed by the full faith and credit of the federal government—i.e., you and I. The price of this delay in solving the S&L crisis is enormous—$1-$2 billion per month.

This third point of difference is the critical one for policymakers. The FCS situation improved once aid was obtained and farmland prices turned around; but the S&L crisis just gets worse and worse even though the residential housing market remains strong.

Two years ago, about 300 S&L's were in trouble to the tune of $25-$50 billion. One year ago, 500 S&L's required $75-$100 billion of assistance. Today, there are at least 800 S&L's in trouble requiring $150-$200 billion.

And nothing has been done to prevent the S&L crisis from happening again. It stemmed not so much from deregulation as from misregulation.

The Cures

These differences in the causes of the crises have important implications for selection of the cure for each. Because the triggering events were largely external for FCS, a stronger moral case can be made for assistance to FCS than to S&L's. Furthermore, declines in real interest rates and devaluation of the dollar suggested that there was "light at the end of the tunnel" for the FCS. Assistance could be temporary and selective, like patching a leaky boat until it arrives at a safe harbor.

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For the FCS, the *price* for the bailout was the creation of a secondary market for farmland mortgages. For years, the FCS had a monopoly on a defacto secondary market. Now it has to face competition from other lenders. In the end this competitive pressure will ultimately enhance the system's operations. Survival now requires tighter "ships" and better managed ones.

There are, of course, some drawbacks to the FCS "cure." However, FCS has faced up to the new reality and some FCS banks plan to become active poolers in the new Farmer Mac. It remains to be seen if the farm sector financial recovery will continue (we think it will), and if the FCS can restore longer-term profitability while paying back the bailout (something we are less confident will happen).

For the S&L's, however, a capital infusion similar to the FCS infusion and higher deposit insurance fees will not suffice. A major overhaul of the regulatory environment is necessary if the current S&L crisis is to be corrected and future crises avoided.

So there are some similarities between the FCS and the S&L crises. The problems are similar—bad loans and failing financial institutions.

There are other similarities—both were chartered to meet specific needs in society, both are private institutions regulated by public or quasi-public agencies and both have depended on explicit/implicit federal guarantees.

But the differences in the causes of the S&L's crisis as compared to the FCS crisis—internal mismanagement and fraud as opposed to external forces, losses easily passed to the federal government as opposed to difficulty and uncertainty about passing these losses to the government, and continued losses as opposed to restored prosperity—argue for different solutions. An FCS type capital infusion into the S&L's without changes in the regulatory environment to root out fraud and mismanagement will merely set the stage for more crises in the future. C