They're Different; Solutions Should Be, Too

by Paul T. Prentice

The Federal Savings and Loan Insurance Corporation (FSIC), 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 FSIC.

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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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.

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?

We May Not Need Them Anymore

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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-
...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