## Number of People Undernourished

| Regions | Total Population | Millions Undernourished |
|---|---|---|
| | 1980 | 1979-81 |
| Africa | 376 | 70 to 99 |
| Far East | 1,232 | 210 to 313 |
| Latin America | 357 | 38 to 56 |
| Near East | 210 | 16 to 25 |
| Total developing market economies (98 countries) | 2,179 | 335 to 494 |

number of undernourished people, especially given the lack of adequate food consumption data and the lack of a consensus on how to estimate minimal energy requirements. Nonetheless, statistics on or estimates of the "number of hungry people" receives the most attention because they are most effective in rallying public opinion in support of the needed efforts to eradicate hunger and poverty from the developing world.

### For More Information:

*A limited number of copies of the Fifth World Food Survey are available by writing to Dennis Bridges, Executive Officer, North American Liaison Office, 1001 22nd Street NW, Suite 300, Washington, DC 20437.*

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# *RAPPING* The Farm Credit System:

## *Spreading Costs to the Future*

**By Delmar K. Banner and Peter J. Barry**

Loan losses, high interest rates on bonds, and the flight of high-quality borrowers have pushed farm credit banks toward insolvency. Even as Congress scrambled to enact legislation in 1987, several of these banks already would have failed without the benefit of emergency legislation passed late in 1986. The 1986 legislation allowed those banks to keep the doors open through "regulatory accounting practices" (RAP).

Called "Magical Accounting" by some observers and "Blue Smoke and Mirrors" by others, RAP is used to escape the effects of regulations that otherwise would force system institutions into insolvency and receivership. RAP is *not* to prepare financial reports that go to farmer stockholders or to the investing public.

RAP has two major provisions. Under the first, banks may amortize for up to 20 years the additions to their loss reserves — money set aside now to cover expected loan losses in the future. Under the second provision, the banks may likewise capitalize and amortize current interest expenses in excess of the "current cost" of borrowing by the farm credit banks. For purposes of RAP, "current cost" was pegged on October 21, 1986, the date of enactment of the 1986 law. The second provision is available only after the first is fully utilized.

Originally set to expire at the end of 1988, RAP was extended by assistance legislation enacted late in 1987. RAP will now remain available to Farm Credit banks and associations through 1992 as long as book value of their stock is worth at least 75 percent of par. Failing that, those institutions must then turn to a newly created Assistance Board for financial assistance under the 1987 law.

RAP can have a substantial effect on a bank's income and net worth as considered for some regulatory purposes, but not for financial reporting to stockholders or the investing public. The easiest way to visualize the effect of the RAP provisions is to work through an example.

Suppose a farm credit bank has $600 million of loans outstanding. In addition to stock valued at par, the bank's capital includes $3 million of surplus (earnings saved from previous years) at the beginning of the year. During the year the bank receives interest income from its borrowers of $70 million, and pays interest expenses to bond holders of $65 million as shown in the table.

The critical number in the first column of the table is the $20 million provision for loan losses. This is the reduction in loan assets that the bank feels it needs to reflect accurately its anticipated loan losses. This amount is shown on the bank's earnings statements as a charge against current earnings.

We assume other income is $1 million and other expenses $8 million, giving a net income of negative $22 million and an ending surplus of negative $19 million. Said differently, the aggregate book value of the borrowers' stock would be worth $19 million less than par. Without the provisions of RAP, the institution would be unable to retire borrower stock at par, and the bank would be placed in receivership under regulations of the Farm Credit Administration (FCA).

To avoid this result, the bank can refigure its bottom line, "ending net worth," if FCA approves the use of RAP. Applying the first provision of RAP, only $3 million (0.5 percent of loan volume) in provision for losses is charged against current year earnings. This is shown in the middle column of the table. The remaining $17 million is spread over the next 19 years. Applying the RAP loss deferral provision, ending "regulatory net worth" is improved from the actual negative $19 million. But

**"Farmers used to live poor and die rich... That's sure been fixed!"** Cartoon courtesy of Robert Aukes

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still, the bank is "impaired" by negative $2 million.

The bank may then turn to the excess interest deferral provision of RAP. Here, we assume the bank's $65 million in interest expense is substantially more than it would have been had its total debt been priced on October 21, 1986. RAP permits deferral of that excess to the extent necessary to eliminate the $2 million impairment remaining after the RAP loan loss deferral has been applied. The third column of the example shows $2 million "RAP deferral" of interest expense.

For regulatory purposes, the result is zero surplus and borrower stock is worth 100 cents on the dollar. Having avoided regulatory insolvency, the bank continues to do business, and borrower-stock is retired at par.

## RAP Avoids Regulatory Insolvency

| | No RAP | Loss deferral | Loss & interest deferral |
|---|---|---|---|
| | | *Million dollars* | |
| Beginning Surplus* | $3 | $3 | $3 |
| Earnings for the year** | | | |
| Interest income | 70 | 70 | 70 |
| Interest expense | 65 | 65 | 65 |
| Less RAP deferral | - | - | (2) |
| Net interest expense | - | - | 63 |
| Net interest income | 5 | 5 | 7 |
| Provision for loan losses | 20 | 20 | 20 |
| Less RAP deferral | | 17 | 17 |
| Net provision for losses | | 3 | 3 |
| Net interest income after provision for loan losses | (15) | 2 | 4 |
| Other: | | | |
| Income | 1 | 1 | 1 |
| Expenses | 8 | 8 | 8 |
| Net other | (7) | (7) | (7) |
| Net income (Loss) | (22) | (5) | (3) |
| Ending surplus* | (19) | (2) | 0 |

*Total net worth less par value of borrower stock.
**Assumed outstanding loans of $600,000,000.

The bank's loan losses and interest expenses are not reduced; rather, they are artificially reallocated over time and must be paid from future years' earnings if the banks are to avoid insolvency in those years. In this way, RAP permits the banks to mortgage their future. For some farm credit banks, RAP will only postpone their day of reckoning. For other banks, whose problems are less severe, it may be a life saver.

The 1986 Legislation sent a strong message to system stockholders concerning the safety of their stock investment: "It will be protected, even if Congress has to rewrite the law to get the job done." That message was made even louder and clearer by the legislation enacted late in 1987 which explicitly guarantees the ability of current stockholders to redeem their stock at par.

By authorizing RAP, the Congress took a timely and imaginative step to keep the doors of troubled farm credit banks open and to avert a crisis of borrower/stockholder confidence if banks were unable to retire stock fully at par. The effects of RAP, including its continuing costs, will be felt by the Farm Credit banks for years to come.

# The Farm Credit System:

## *It Has A New Lease on Life, But...*

**By J. Bruce Bullock and Charles Dodson**

The Farm Credit System has a new lease on life. The recent legislation provides interest-free use of $4 billion for five years. This financial assistance gives the System an opportunity to focus on positioning itself for the future rather than trying to survive from month to month with inadequate capital resources. The legislation does not guarantee the long-run viability of the Farm Credit System, however.

The System will have to partially service $4 billion of new debt during years 6-10 and fully service that debt after 10 years. These costs will substantially increase required margins for the System. In addition, the so-called borrower rights provisions of the legislation will tend to increase the cost of servicing the System's loan portfolio and will likely reduce the quality of that portfolio. It is not at all certain that the Farm Credit System will be able to repay the $4 billion in new debts it acquired through the legislation. It it cannot, the U.S. taxpayer will be left holding the bag for what will have become a lending institution similar to the Farmers Home Administration.

As expected, Congress attached several strings to the financial assistance provided to the Farm Credit System. The three major strings relate to (1) borrower rights, (2) the System's structure, and (3) a secondary market for farm mortgages.

### Borrower Rights

The new legislation restricts how the System deals with borrowers who have non performing loans. These restrictions are similar to long standing restrictions on the Farmers Home Administration.

The borrower rights legislation is restricted to borrowers of the Farm Credit System and FmHA. Apparently other agricultural borrowers do not need their rights protected, or do not warrant such protection.

The net effects of the borrower rights being imposed on the Farm Credit System will:

- Increase the System's operating costs relative to other lenders,
- Reduce the quality of the System's loan portfolio as non performing loans remain in the portfolio for a longer time and other loans become non performing as borrowers seek loan write downs, and
- Attract lower credit quality borrowers concerned about borrower rights to the System's portfolio while quality business borrowers willing to forego generous borrower rights in return for lower interest rates will obtain credit from commercial lending sources.

In combination, these effects will mean a smaller income stream generated by the System's loan portfolio.

### Mandatory Changes in System Structure

The legislation requires that the Banks for Cooperatives vote on whether to combine their banks into a single bank. Most observers agree this is a good idea and that the consolidation will likely occur. The new legislation also requires that the Fed-

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