Marvin Duncan has been on the front lines throughout the Farm Credit System (FCS) crisis and observed first-hand the causes, the effects, and the steps taken to cope with this crisis. These experiences provided him with a unique vantage point to observe U.S. financial institutions during the past years. We are pleased to include his comments as a followup to the *CHOICES* debate between Paul Prentice and Greg Gajewski

Observations From the Front Lines

by Marvin Duncan

Paul Prentice's and Gregory Gajewski's analyses are both perceptive and, in part, flawed.

Source of the Problem

There were essentially four factors outside of the farm economy that were major contributors to the problems of Farm Credit institutions:

- enhanced lending authorities,
- unsound pricing policies,
- inadequate regulation, and
- blurred lines of responsibilities and accountabilities.

Many observers have argued that these same factors contributed to problems in the thrift industry.

Areas of Agreement

Prentice is dead on target when he identifies the "incestuous and revolving door relationships" between the regulator and the regulated as an important source of the Farm Credit institutions' problems. Prentice is also correct in identifying the critical importance of the implied Federal guarantee that the financial market attaches to agency issue paper. In the absence of such a market perception, the Farm Credit banks would have been in the junk bond business and have experienced interest rate spreads attendant to that business. Finally, Prentice also seems to recognize the need for a strong, independent, and effective financial regulator to ensure recovery and future financial stability for Farm Credit institutions.

Gajewski correctly identifies the skewed risk profile that single industry lenders face and by implication raises, I believe, valid questions about the long-term stability of such lenders. Gajewski is also correct when he identifies the fixation on growth in loan volume that permeated most Farm Credit institutions' policymaking and management. Unfortunately, with a government assistance package now in place, evidence of that same attitude is emerging again in some quarters.

Finally, valid questions are raised about the need for special purpose lenders in an increasingly integrated and competitive financial marketplace. However, the final test of need for a special purpose lender is likely to be found in the marketplace itself. Will the Farm Credit institutions be able to grow and prosper given a level regulatory playing field with its competitors? There should be no inherent reason why the Farm Credit institutions cannot meet the marketplace challenge, if they have the will and the discipline to do so.

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Areas of Disagreement

Sources of the Problem—Prentice asserts the problems of the Farm Credit institutions arose primarily from the impact of outside forces, unlike the thrift industry's problems that were the result of internal factors. Prentice makes the analogy that the FCS boat was leaking, but once patched was capable of safe navigation. I believe that this view is incorrect. Internal policy and management lapses of the institutions along with much complacency and in some cases default on responsibilities by regulators were the primary causes of problems in each case. The Farm Credit institutions required major changes as did the Federal Savings and Loan institutions. The corrective legislation for both the Farm Credit Administration and the Farm Credit institutions is being implemented quite effectively, thus far.

The Mission of the Farm Credit Administration—The major disagreement with Gajewski goes to his assertion that "It's up to the Farm Credit Administration (FCA), the regulator, to make sure the Farm Credit institutions grow enough to repay the aid, but not so fast as to touch off another runup in land prices that will not be supported by future returns." This assertion reflects a lack of understanding of the respective authorities and responsibilities of the FCA and the Farm Credit institutions.

The Federal bailout legislation both confirmed and enhanced the Farm Credit Administration role as an independent Federal financial regulatory agency with statutory responsibilities to examine and regulate the Farm Credit institutions for compliance with laws and regulations. The FCA is also responsible for promoting the safety and soundness of the privately owned credit cooperatives that comprise the Farm Credit System. The FCA does not establish policy for, nor does it manage these cooperatives.

The cooperatives' duly elected board members and their management teams are charged with the responsibility for setting the policy and managing the business affairs of the cooperatives. Whether those cooperatives are well run or poorly run is clearly their responsibility. The boards of directors of the Farm Credit insitutions have an important fiduciary duty to the cooperatives' stockholders and to the investors who purchase Farm Credit bank securities.

The clear separation of responsibility and accountability that I have outlined is fundamental to the reemergence of a financially stable, well run and successful group of cooperatives. To blur or to confuse the responsibilities and accountabilities of the regulator with those of the cooperatives' policy directors and managers would be the height of foolishness. Indeed, that confusion of responsibility and accountability was a major factor in setting the stage for the Farm Credit institutions' plunge into crisis during the early 1980s. To our chagrin, we found that where responsibility and accountability were unclear or uncertain, no one adequately tended the store, neither in the Farm Credit institutions nor in the Farm Credit Administration. The high cost to farmers and taxpayers alike of the Farm Credit institutions' financial problems need not be repeated. Mr. Gajewski's prescription would, however, ensure such a repetition.

Staying the Course

The regulations resulting from the legislation rescuing the Farm Credit institutions, create a strong regulatory environment to protect stockholders and investors who buy farm credit securities. These changes will be successful only if the FCA stays the course of sound and prudent examination and regulation of the Farm Credit institutions. The managers and directors of Farm Credit institutions must continue to recognize their business problems and take responsible steps to correct them. While this is now happening, it will take 3 to 5 years of a highly disciplined approach to the credit business to rebuild the financial strength of Farm Credit institutions. That rebuilding is absolutely critical, however if these institutions are to survive. Farmers have shown little support for, or patience with, financially sick or failing cooperatives. Indeed, the lesson we have learned is that financially able farmers quickly abandon failing credit cooperatives.

If all goes according to plan, however, the Farm Credit System rescue that was a few years ago called one of the biggest sector bailouts in history will wind up with only relatively little cost to the taxpayers. Staying the course should ensure that the rescue is a real success story for everyone concerned, including both the farmer and the taxpayer.

Gajewski Responds

Marvin Duncan's view that the Farm Credit Administration (FCA) should not watch over how fast Farm Credit System banks grow is unsettling. This policy, if followed by the FCA, could lead to a repeat of the 1970s-1980s boom-bust cycle. I agree with Duncan that the FCA should not set policy for or manage individual banks. However, this statement misses the core issue. If an institution boosts loan growth over a reasonable rate, the FCA should carefully examine if the bank is being run in a "safe and sound" manner.

If the bank is encouraging farmer borrowers to expand and take on more debt than they can be expected to repay based on their long-term future returns, then land values could go into another speculative "boom" phase. This is what happened in the 1970s. The inevitable crunch that would follow could again push FCS banks into insolvency.

Let us assume that the FCA would act as a strong regulator and close banks as they became insolvent. The stockholders would lose their investment, and the bondholders would be protected by the newly established Farm Credit Insurance Fund. But just because a bank is closed would not stop the losses since the insurance fund would be holding the defunct bank's assets—mostly farm land. If collateral values (i.e., land values) continued to fall, the losses to the insurance fund would keep rising. Should the insurance fund go broke trying to cover these losses, taxpayers would probably end up footing the bill again.

The FCA is charged with promoting the safety and soundness of the FCS. So, I believe that it is critical for the FCA to carefully watch how fast the banks grow, and that the FCA should step in and halt unreasonable growth to protect the System's viability. Indeed, if the FCA properly enforces the new risk-based capital standards, such growth will be limited.

In a different world, where taxpayers could not be called on to cover financial debacles, the FCA would not need to make sure that FCS bank managers practiced prudent growth policies. But then the bondholders would supply the needed discipline by refusing to finance excessive growth.

Also, in contrast to Duncan, I believe that FCS institutions probably will not be able to meet the challenges of today's financial markets because FCS institutions are confined to farm lending. FCS banks must be free to diversify outside of farming to increase their odds of remaining financially viable over the long term. Without this freedom, the banks will have to be extremely conservative during farming's good times in order to avoid going broke during the bad times.

Prentice Responds

Many thanks to Marvin Duncan for his insightful comments on the similarities and differences between the Farm Credit System crisis and the Savings and Loan crisis. Thanks also to Greg Gajewski for his earlier comments. And thanks to *CHOICES* Magazine for airing the debate.

The original disagreement was about whether the financial crises were caused primarily by external economic forces or internal institutional forces. While recognizing that both sets of factors played a major role, I placed a higher weight on the external forces while Gajewski placed a higher weight on the internal ones. If the main negative forces were external, then a "temporary bailout" policy response would work.

But Gajewski took the issue to a deeper level. He continued on to question the very desirability, as well as the viability, of single-sector lenders in today's modern financial system. Given his perspective, and his belief that the main negative forces were internal, his policy response would include massive structural change to the institutions involved.

Now Duncan's article has caused me to re-think the issue in some depth. He takes Gajewski's view on the internal forces, and now I agree with them. All financial institutions faced the same difficult external economic environment in the early 1980s. But only those with inflexible lending policies, restrictive markets, or access (explicit or otherwise) to the Federal trough actually fell into crisis. Therefore, the primary cause must have been internal—an institutional crisis, not an economic crisis.

I don't like to admit it, and I don't like to change my mind. But I am a scientist, and deductive logic must prevail. Sometimes our elegant economic training abstracts too far from the reality of the individuals and institutions that actually make our markets work. Perhaps our profession needs fewer equations and models. Perhaps it needs more worldly philosophers and hands-on businessmen in order to put itself back in touch with reality.

To this end, I am encouraged by Duncan's hard-nosed approach to regulating the FCS. But I am also discouraged by his note that evidence of the same institutional management policies that created the crisis was emerging again after the bailout. I hope he is right that staying the course under the Farm Credit Assistance Act of 1987 will both protect FCS investors and repay the public's investment.

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