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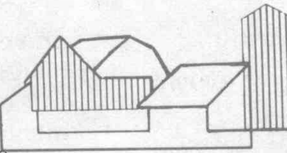

AGRICULTURAL LETTER

FEDERAL RESERVE BANK OF CHICAGO
March 11, 1988 Number 1729

The Agricultural Credit Act of 1987

The Agricultural Credit Act of 1987 was passed by Congress in December and signed into law by President Reagan on January 6. The Act provides for up to $4 billion in federal financial assistance to troubled institutions within the Farm Credit System (FCS). It also outlines a number of provisions for recapitalizing and restructuring the FCS and implements several features that expand the rights of FCS borrowers and reduce the risks to investors in FCS obligations. The following discussion of these provisions draws heavily from summaries of the legislation prepared by the Farm Credit Administration. The legislation also implements a secondary market for eligible farm and rural home mortgages, the provisions for which will be discussed in a future issue of the *Agricultural Letter*.

To provide for federal financial assistance, the Act requires the creation of the Farm Credit Assistance Board and the Farm Credit Financial Assistance Corporation. Both entities were chartered in January.[1] The 3-member Assistance Board is comprised of the Secretaries of Agriculture and Treasury and one agricultural producer yet to be appointed by the President. The Board of Directors for the Financial Assistance Corporation is comprised of the same 10 members who serve as the Board of Directors for the System's Funding Corporation. The Act provides for a onetime purchase of Assistance Corporation stock by each system institution. In general, each bank is required to purchase stock in an amount equal to its unallocated retained earnings in excess of 5 percent of its assets at the end of 1986. For each association, the purchase requirement is equal to its unallocated earnings in excess of 13 percent of assets.[2] The monies from the onetime sale of stock are to be held in a separate Trust Fund by the Assistance Corporation.

In general, the Assistance Board has the authority to determine whether a requesting system institution shall receive financial assistance and to exercise considerable authority over the credit, investment, and management plans of those institutions that apply for, or receive, assistance. An institution may apply for assistance when its stock falls below par value, and must apply when its stock is below 75 percent of par value, based on generally accepted accounting principles. The Board can certify that an applying institution is eligible for a certain amount of financial assistance from the Financial Assistance Corporation. Or, if it determines that other actions would be less costly and still ensure the availability of credit services in the applicant's area, the Board can take other actions, such as requesting that the applicant institution be liquidated or merged with other FCS institutions.

A certification by the Board that an applicant is eligible for a certain amount of assistance from the Assistance Corporation permits the applicant to issue a special class of preferred stock to the Corporation in exchange for the assistance. As a minimum, any such certification must permit the applicant institution to receive an amount of assistance sufficient to maintain the value of the applicant's equity stock at no less than 75 percent of par and make the applicant economically viable and capable of delivering credit at competitive interest rates.

To fund any assistance provided, the Assistance Corporation is authorized to issue (through September 1992, and with the Assistance Board's approval) 15-year, uncollateralized bonds[3] that are to be fully guaranteed by the U.S. Treasury. The Act permits up to $2.8 billion in such bond issues this year, and thereafter an additional amount of up to $1.2 billion, provided proper notification and verification of the additional need has been conveyed to Congress.

The Act contains detailed and complex provisions as to the entities responsible for the payment of interest and principal on the bonds issued by the Assistance Corporation. But in general, the Act stipulates that the principal of a maturing bond is to be paid by the institution(s) that received financial assistance from the bond sale proceeds. Such payment is to be affected by redeeming, at par, the preferred stock issued by the institution(s) that received assistance. With respect to the interest obligations on the bonds, the Act requires the U.S. Treasury to cover initially all interest payments during the first five years after the issuance of an Assistance Corporation bond and up to half of the interest payments during the second five-year period after issuance. All other interest payments are to be shared equitably among all FCS institutions, with each institution's share to be set equal to the ratio of its performing loans to all performing loans in the FCS. After the bond matures, all interest payments initially made by the U.S. Treasury become reimbursable

through an equitable assessment on all FCS institutions.

The complexity of the bond principal and interest payment responsibilities stems mostly from the possibility of defaults by some system institutions in meeting those responsibilities. The Act stipulates that no FCS institution can be forced to meet its shared interest payment obligation or, if an assisted institution, to redeem its preferred stock to meet a principal payment obligation if such a payment or redemption would threaten that institution's economic viability. In view of the possibility that some FCS institutions may default, the Act stipulates that such defaulted interest and principle payment obligations are to be covered initially by the Trust Fund (from the onetime purchase of Assistance Corporation stock), thereafter by the FCS Insurance Fund (see discussion below), and ultimately, if necessary, by the guarantee provided by the U.S. Treasury.

With regards to restructuring the FCS, the Act mandates that by June of this year the Federal Land Bank and the Federal Intermediate Credit Bank in each Farm Credit District must merge into a single Farm Credit Bank. If necessary to protect the merged stockholder equity, the Assistance Board shall direct the Assistance Corporation to provide financial assistance for the merger. Within six months of a district bank merger, each PCA and FLBA that shares similar geographical territory within that district must submit an FCA-approved plan for merging the two associations to a vote of its stockholders. If approved by a majority of those voting, the resulting association would become a direct lender to individual borrowers and obtain its funds from the district Farm Credit Bank in much the same manner as PCAs presently operate as a direct lender with funds obtained from an FICB.

In addition, the Act sets up an 18-month schedule for the development and consideration of a plan to consolidate the existing twelve Farm Credit Districts into no fewer than 6 districts. Prior to being submitted in mid-1989 to a vote of the stockholders of involved Farm Credit Banks, the plan must be approved by the FCA, the Assistance Board, and a special committee whose members represent the affected districts.

With respect to the 12 Banks for Cooperatives and the Central Bank for Cooperatives, the Act requires the formation of a special committee to formulate an FCA-approved plan to merge all such banks. The plan is to be submitted to a majority vote of the stockholders of each BC by mid year. If approved by BC stockholders from 8 or more districts, those BCs and the Central BC will merge into the National Bank of Cooperatives. The service area for both the resulting National Bank and any district BC that does not approve the merger will become nationwide. If the merger plan is approved by the Central BC and by 1 to 7 of the district BCs, the approving institutions will merge into a United Bank for Cooperatives and have a service area comprising that held by the merging banks prior to the merger. Service areas for BCs that do not merge with the United Bank will continue to be limited to their own district.

To help insure the timely payment of principal and interest on FCS bonds, notes, and other obligations, the Act calls for the creation of the Farm Credit Insurance Fund to be managed by the Farm Credit Insurance Corporation. The management of the Insurance Corporation will constitute the same 3-member Board that serves as the Farm Credit Administration Board, but someone other than the FCA Board Chairmen is to be appointed Chairman of the Insurance Corporation. The Insurance Fund will be capitalized initially by the revolving fund now held by the FCA. Each system bank will begin making premium payments to the Fund in early 1990. Until the money in the Insurance Fund reaches an amount equal to 2 percent of the outstanding debt obligations of all system banks, (or any other percentage determined by the Insurance Corporation to be actuarially sound) the annual premium to be paid by each bank is to be the sum of 0.15 percent of its accruing loans plus 0.25 percent of its nonaccrual loans.

The Insurance Fund will begin insuring FCS obligations in January 1993. At that time, the joint and several liability that presently backstops system bank obligations will be maintained, but triggered only if all monies in the Insurance Fund are exhausted. In addition to insuring the payment of interest and principal on FCS obligations, the money in the Insurance Fund beginning in 1993 must be made available, if necessary, to cover system institution defaults on principal and interest payments on obligations issued by the Financial Assistance Corporation and to ensure the retirement of system borrowers stock at par. In addition, the Insurance Corporation may use the Insurance Fund monies to make loans, purchase the assets of, assume the liabilities of, or make contributions to any system bank if such action is necessary to prevent placing the bank in receivership, restore it to normal operations, or to reduce the risk of one stressed bank threatening the stability of other system banks.

For purposes of developing new capitalization structures for the FCS, the Act stipulates that the Farm Credit Administration must develop and issue in May regulations to establish minimum permanent capital adequacy standards for system institutions. In general, permanent capital is defined to include current-year retained earnings, surplus (net of allowances for losses) and stock, <u>excluding</u> stock that may be retired upon

the repayment of a holder's loan. The standards are to be set in terms of fixed minimum percentages that represent the ratio of permanent capital of an institution to its assets and are to be phased in over a 5-year period ending in early 1993. During the phase-in period, the FCA will be precluded from taking any enforcement action against an institution that fails to meet the capital adequacy standards, if such institution has been certified by the Assistance Board to receive assistance from the Assistance Corporation.

The Act requires each system bank and association to develop and adopt new capitalization bylaws to meet the capital adequacy standards to be set by FCA. The Act permits considerable flexibility in developing new classes of stock and capitalization structures. Among other things, the bylaws could permit the charging of loan origination fees, the ownership of nonvoting stock by persons who are not borrowers of the institution, and the retirement of stock at the discretion of adequately capitalized institutions. In addition, the Act requires that stock must be transferable. Countering these attributes, however, the Act also stipulates that stock with voting rights can only be issued to, and held by, system borrowers. With regards to the stock-purchase requirement for an individual borrower, the Act stipulates that the new bylaws need only to impose a minimum requirement of the lesser of $1,000 or two percent of the loan obtained by the borrower.

To discourage the flight of borrowers from the FCS, the Act incorporates a broad range of borrower rights and imposes a guarantee on borrower stock. The guarantee requires that all stock outstanding as of the date of enactment, all new stock issued to borrowers 9 months after enactment (or, if sooner, prior to the adoption of new capital bylaws), and the stock of PCAs placed in liquidation since the start of 1983 must be retired at par. If necessary, funds to meet the stock guarantee are to be provided by the Assistance Corporation upon the approval of the Assistance Board. With respect to the borrower rights provisions, the Act requires FCS institutions to restructure distressed loans if the borrower acts in good faith and if restructuring would be less costly than foreclosure. Also, lenders must notify borrowers that their loans may be eligible for restructuring at least 45 days prior to starting foreclosure proceedings. Among lenders certified (by the Assistance Board) eligible for financial assistance, there is to be established, at both the district level and the national level, a special asset group that will monitor the foreclosure determinations of those lenders, and where warranted by the restructuring policies, reverse those determinations if necessary to be in compliance.

The Act also requires FCS institutions to make extensive disclosures to borrowers regarding loan terms and options, effective interest rates, and the borrower's rights. It also gives loan applicants, whose loan request has been denied, the right to appeal, with legal counsel, that decision, the right to have a copy of the lenders appraisal of the applicant's assets, and the right to submit an independent appraisal of the collateral offered to support the requested loan. The Act also contains extensive provisions granting to previous owners rights of first refusal (to buy or lease) property foreclosed upon by a FCS institution. In general, the provisions preclude a FCS institution from selling or leasing such property to a third party under terms not already turned down by the previous owner.

In view of the multitude of problems facing the FCS, the 1987 Act still leaves many uncertainties. The Act promises a more effective means of providing assistance to components of the FCS that are financially weak and/or facing collateral shortages. Yet the pending lawsuits over the onetime stock purchase requirement to initially capitalize the Assistance Corporation could prove disruption. The problem of borrower flight may be eased somewhat by the stock guarantee and the new borrower rights. And the Insurance Fund will likely enhance the longer term reliability of normal funding operations. But with respect to the System's high overhead costs, the implications of the Act are unclear. The mandated mergers in the Act will not provide much savings and the bulk of the cost-effective mergers must still await the uncertainty of stockholder approvals. Moreover, several provisions in the Act will add to the system's cost of providing credit services. These include the borrowers rights provisions, the premiums to be paid to the Insurance Fund, and the shared cost of paying interest on Assistance Corporation bonds. Also, there are numerous uncertainties with respect to the new capitalization base that will emerge for FCS institutions. It is hard to envision a workable capital base that will restrict voting rights to the stock held by borrower-stockholders and simultaneously preclude stock that can be retired upon loan repayment from serving as part of the permanent capital base. It may be difficult (or costly) to get nonborrowing investors interested in owning stock that doesn't carry voting rights.

Gary L. Benjamin

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[1] Upon the chartering of the Assistance Board, the charter for the FCS Capital Corporation (the entity created by 1985 legislation to provide financial assistance) was terminated. The Assistance Board assumed the assets and obligations of the Capital Corporation and made a refund to system institutions that held any debt or equity obligations of the Capital Cor-

poration. In a related matter, the legislation stipulates that any contributions made by system banks through loss-sharing arrangements activated in the third quarter of 1986 are (through aid from the Assistance Corporation) to be refunded by the receiving banks and that any such contributions still payable on the books of the contributing banks are to be cancelled and assumed as an obligation of the Assistance Corporation.

[2] Legal actions have already been implemented by some FCS institutions that seek an injunction barring them from having to purchase stock in the Assistance Corporation.

[3] These bonds will be distinctly different obligations than the consolidated bonds and notes that will continue to be issued by the FCS as part of its normal funding operations.

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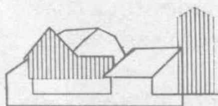
Selected Agricultural Economic Indicators

	Latest period	Value	Percent change from: Prior period	Year ago	Two years ago
Interest rates on farm loans *(percent)*					
7th District agricultural banks					
Operating loans	January 1	11.29	0.0†	2	-11
Real estate loans	January 1	10.70	0.1†	2	-13
Commodity Credit Corporation	March	6.75	-5.3	15	-11
Agricultural exports *($ millions)*	December	2,959	4.7	8	12
Corn *(mil. bu.)*	December	79	-25.3	16	-9
Soybeans *(mil. bu.)*	December	77	-21.9	-14	-19
Wheat *(mil. bu.)*	December	118	50.3	104	65
Farm machinery salesP *(units)*					
Tractors, over 40 HP	February	3,167	-26.6	83	-3
40 to 139 HP	February	2,441	-15.4	70	1
140 HP or more	February	726	-49.1	145	-15
Combines	Februray	220	-63.5	206	-5

†Prior period is three months earlier.
PPreliminary



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