THE AGRICULTURAL CREDIT SITUATION

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George Irwin was unable to attend the NC-161 Seminar. Edward Harshbarger substituted for Dr. Irwin but did not prepare a written paper. The following paper is included in these proceedings, with the author's permission to represent the viewpoint of the Farm Credit Administration.

Remarks of Dr. George Irwin, Associate Deputy Governor
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OVERVIEW

We all know that the problems facing American agriculture are deep and widespread. They affect borrowers, lenders, rural businesses, and rural communities throughout the country.

Agriculture is undergoing a major secular adjustment -- we are not just on the back side of an economic cycle. This means that significant changes are taking place in structure. Neither farmers nor their lenders can prevent these changes from occuring. Nor can government. But government can and should provide some cushion to the adjustment process to smooth it out.

Such help is particularly appropriate in addressing the farm land market and its impact on farm mortgage lenders. This past week, the Congress considered a specific piece of farm credit legislation which focuses on part of the problem. I will return to some of the specifics later in my presentation. But let me reiterate that no affordable set of Federal programs is going to stop adjustments from taking place. It will only cushion the impact.

The current crisis in agriculture was precipitated by three national forces.

1. The expansion of international trade in the early 1970s, followed by the contraction of the 1980's.

2. Inflation of the 1970's and the incentives for expansion which it created.

3. The combination of monetary and fiscal policy used to control inflation which made the adjustment occur more rapidly.

On top of these, long range forces we were entering the recessionary phase of the world economic cycle. Agriculture's problem was worsened because we were all slow to realize what had happened and to make the needed financial adjustments to the long range forces. We saw only the economic cycle downturn. Forbearance was prescribed to deal with what was thought to be only a temporary cyclic situation, when the longer range part of the problem called for more major changes. This delayed doing what was necessary, and made the problem worse.

We will complete recovery from the cyclic part in the near future. Indeed, the value of the dollar has dropped nearly 20 percent this year, and economic recovery of trading partners is creating some new demand growth. But we are not going to see "recovery" from abundance to scarcity for the rest of this century. Supply capacity is expanded, nations which were considered hopeless a decade ago are now food exporters, and the part of the 1970's demand growth which was based on debt expansion cannot be turned around.

As a result, Agriculture is going through the most wrenching financial adjustment in a half-century. Although farm cash returns have held up well, it has been only at major government program costs and these face the prospect of future budget cutting efforts. Interest costs have shot upward, eroding net returns. Most importantly, land values have dropped at an unprecedented rate. Over the four years ending April 1, farm real estate values have fallen $180 billion in 10 of the 12 Farm Credit Districts across the country. The Cornbelt States have seen values drop 40-50 percent. Another 10 percent drop may be seen this year and the adjustment is probably not yet completed.

IMPACTS

This enormous writedown in equity has been compounded by the additional pressures caused by the load of servicing debt at record high *real* interest rates. The result is pressures on farmers, on farm lenders, and on government. Let's look briefly at each.

Farmers

Early in this period of financial stress, farmers absorbed most of the loss in land values through erosion of their equities. The most recent data find that 70 percent of commercial sized farmers are in stable financial condition, while the other 30 percent are facing financial adjustments. About two-thirds of the agricultural assets are held by operators in sound financial condition and one-third by those in a stressed condition. And finally the outstanding agricultural debt is split about 50/50 between those in good financial conditions and those in difficulty.

Lenders

More recently, with the equity of some farmers depleted, losses in the sector are being borne very directly by agricultural lenders.

And financial structure was already under pressure to change as a result of financial deregulation in the 1970's. The process has been speeded up for commercial banks having problem agricultural loans. As of December 1, 103 commercial banks had failed. Over half of them were classified as agricultural banks.

During the first half of the year insured commercial banks charged off $520 million in loans, 1.3 percent of the total. Charge-offs for the year will probably exceed $1 billion, compared to $800 million in 1984. Loan delinquencies at agricultural banks also continue to rise, indicating that charge-off rates are likely to remain high. At the end of the second quarter, their non-performing loans were 7.3 percent of the total portfolio. Non-accrual loans, the most seriously delinquent in the non-performing category, were 5.2 percent of all loans.

The institutions of the Farm Credit System are almost totally focused on agricultural lending and thus are being hit even harder than their commercial bank counterparts.

Some direct comparisons of Production Credit Associations (PCAs) to commercial banks are appropriate, since both are short- and intermediate-term lenders to farmers. PCAs have a bit less than half of the loan volume that commercial banks have to agriculture, and they have had about half as much in loan chargeoffs. This suggests that any charges of credit mismanagement must logically be levied at both or at neither!

PCA chargeoffs in the first half of 1985 were $139 million, or 0.8 percent of loan principal outstanding. PCA chargeoffs were $286 million for all of 1984, or 1.6 percent of the loan principal outstanding. On June 30, 11.7 percent of total loans outstanding were non-performing which included the 4.0 percent in a non-accrual status.

The really unique problem of the Farm Credit System is with the land mortgages, where the bulk of the land price decline hits home. It is in this area that the System is unique from commercial banks. And it is in this area that problems have grown very rapidly in the past two quarters hand have created the need for outside help.

On September 30, the Federal Land Banks had non-performing loans totaling 12.4 percent of outstandings which includes the 6.7 percent in non-accrual status. And they charged off $140.3 million in loans during the quarter.

Financial pressures on lenders produce a severe squeeze. One half of the pincers is the need to increase earnings to makeup lost income from non-performing assets and loan losses. The other pincer is the desire to keep interest rates down for customers who are making payments or who may be driven off to competitors. A fairness factor is also involved. That is -- how much can you "tax" sound borrowers in the name of forbearance to stressed borrowers.

Like commercial banking, the Farm Credit System is also undergoing some structural changes; some are underway and some are being contemplated. All call for some sort of consolidation of management and capital.

There are some distinct plusses in what is happening. On the PCA side, the most obvious is the consolidation of capital. In those districts where like associations have been consolidated, but PCAs and FLBAs remain separately managed, operating efficiencies are possible. But perhaps more important, from the view point of the System, is the development of strong management centers, able to employ specific expertise that would not have been possible without consolidation. From the borrower view point, joint management provides some advantages such as being able to provide a borrower with a wider range of credit and related services.

It should also provide improvement in quality of the credit service by better coordination. One of the lessons we should have learned in the last two years is the inadequate sharing of information between short- and long-term lenders caused some problems. Too often the Federal Land Bank Associations (FLBAs) weren't aware of a loan problem early because the banker or PCA had included the mortgage payment in the short-term credit package. From the other direction, too often inadequate operating earnings were masked by borrowing against land appreciation. Waiting too long to recognize a problem and do something about it can be disasterous in a long term economic adjustment period as we are now seeing. While looking at the credit package as a whole can't make response to an economic change easier, it can help provide better financial management to deal with changes when they are forecast.

The perceived minus of consolidation in the minds of some is the "local control" issue. Fewer people will serve as corporate directors with policy making authority. However, those that do serve will still be elected by and from among the borrowers. In some instances, local advisory boards will provide grass roots thinking to aid in the decision making process. On the other hand it could be argued that a System with one director for every 4.25 employees may be a bit top heavy. It should also be noted that loss of local control, to the extent that it occurs, is partly offset by a gain in a different form of local control. This occurs in two ways. First, some control is gained over excessive practices of <u>other</u> banks and associations. With joint liability, that is important. Second, we may see some increase in the control exercised by local stockholders in dealing with local directors. FCA has published for comment a series of regulations which increase the rights of stockholders to have information to hold their elected directors accountable. In this way, the grass roots input can become more effective from all stockholders, not just those serving as directors. These general principles are also incorporated in the recent Farm Credit Act amendments, to which I now turn.

Government

FCA concluded last Fall that these structural changes, while providing help, are not enough to stabilize the Farm Credit System against current and projected losses. Thus, final steps are being taken to have a third party share the load of adjustment -- the general public, through the Federal government.

FCA announced last September that the System would require Federal financial assistance within the next 18 to 24 months. We reiterated that need in testimony before committees of the Congress and have proposed it in legislation, and both the House and the Senate have now acted.

The bill is in four parts, (1) more enforcement authorities for FCA to help maintain sound institutions, (2) better mechanisms for the System to use its own capital in dealing with stress, (3) a means for Federal assistance, and (4) rights of borrowers and stockholders.

The first part, enhanced enforcement authorities to the Farm Credit Administration, is essential if we are to properly carry our our role as a Federal financial regulator. This will complete a transition from serving the "head office" function which has been underway for the past half dozen years. In the future, FCA expects to operate solely as a regulator.

These enforcement authorities include:

1. The power to issue cease and desist orders to prevent unsafe or unsound practices or violations of the law or regulations;

2. The power to levy civil money penalties against those who violate the law, regulations, or the provisions of final orders; and

3. The power to remove or suspend officers or directors of Farm Credit System institutions for cause.

All of these actions, of course, would be subject to a hearing and a judicial review in a Federal court.

We also intend to reassume direct examination and regulation of Production Credit Associations and Federal Land Bank Associations, an authority that had been delegated to the district banks under provisions in the 1971 Farm Credit act.

There are also provisions for revising the organization of the Farm Credit Administration by replacing the current Federal Farm Credit Board with a three person presidentially appointed fulltime board which would include a chairman who will also act as the chief executive officer for the agency.

The second part provides for the system to make full use of its own resources in dealing with losses. This is a precondition of the Administration, the Congress, and FCA to any Federal assistance. Such assistance would be provided through statutory authorities broadening the role of the current Farm Credit System Capital Corporation. This corporation was created earlier this year to handle troubled loans and acquired properties in two System banks receiving assistance from the rest of the Farm Credit System.

The corporation will purchase non-performing loans and acquired properties from all system entities. It will assess other system institutions and require stock investment from them to fund and support its workout efforts. This assessment authority is necessary to enforce the joint liability on Farm Credit Securities.

The capital corporation will have significantly more staying power in workout situations which could convert into a broader base of options for a troubled farm operator.

Every effort would be made on the basis of sound business decisions to work out the loans through restructuring, reamortization, and other loan servicing treatments to turn non-performing loans into performing loans. The total liquidation of a loan will be a last resort. But economic circumstances assure that a portion of troubled accounts will have no other option.

Having workout specialists deal with these non-performing assets on a case-by-case basis should improve prospects for keeping property in the hands of farmers and would tend to bring some stability to farm real estate values and other farm assets. And, stabilization of the rate of liquidation into land markets will enable the System to deal with problem loans and assets in a more orderly manner than they otherwise could.

The third legislative part is a backup revolving line of credit to be made available to the Chairman of the Farm Credit Administration. This credit line would become available only when the system had fully mobilized its own earned equity and loss reserves. It is expected that these Federal funds would flow through the Capital Corporation. The head of FCA will certify the need to the Secretary of the Treasury, who would make the decision, which would be subject to availability of a specific appropriation of funds by the Congress.

The fourth area is clarification of rights of both borrowers and stockholders. Borrowers will be assured by law that they have access to documents signed in the loan transaction and to disclosure of the impacts of variable interest rate loans. Stockholders are assured the right to association bylaws, informative annual reports, and appropriate information on candidates for election as directors. While most of these were followed as good business practices already, they will now have a statuatory basis.

We believe this assistance package is responsive to the real needs of the Farm Credit System. It is also responsive to congressional concerns about the Federal budget deficit. Most importantly, it is responsive to the needs of agricultural producers. Given the enormity of the problem, we believe it is relatively austere. It demands considerable discipline and a high level of performance on the part of the system.

THE STAKE IN THE FUTURE

Farmers and virtually everyone else involved in rural America have an enormous stake in the future of the Farm Credit System and in the unique set of services it offers. The system provides more than 40 percent of all the farm real estate debt outstanding in the United States and nearly 20 percent of outstanding non-real estate debt. I want to emphasize that this includes the commercial banks.

The unique role of the Land Bank in mortgage finance, and in stability of agricultural land markets, is a major concern for both PCAs and commercial bankers. Thus stabilization of the farm mortgage function of the FLBAs is and must remain an important priority for agriculture.

This point emphasizes the fact that the benefits of this legislation accrues primarily to farmers and rural communities, even though the actions flow through the Farm Credit System. Assistance in stabilizing the mortgage lending function especially benefits the 70 percent of farmers not in distress and those farmers in the margin of survival.

The current farm financial problems are very large for farmers and lenders alike, as the U.S. agricultural sector passes through a major period of adjustment. But there are some bright spots. The opportunity to enter farming is likely to become the best in two decades or more based on the earning capacity of ag assets. The weakening dollar and cyclic recovery in the world economies causes a modest hope for increased demand. The experience of the past few years will change some bad financial habits that contributed to inflation and should help in providing public support for budget actions intended at heading off future inflation. With that there is some hope for relief from the stressful high <u>real</u> interest rates we now have. And agriculture may be heard a bit more in evaluation of macroeconomic policies.

With constructive cooperation among agricultural lenders and their farm customers -- and with some Federal assistance -- American agriculture can work through its current crisis. There will be no way to avoid major adjustments. But we should all work to see that the end result can be a stronger, more viable sector than before.

Thank you.