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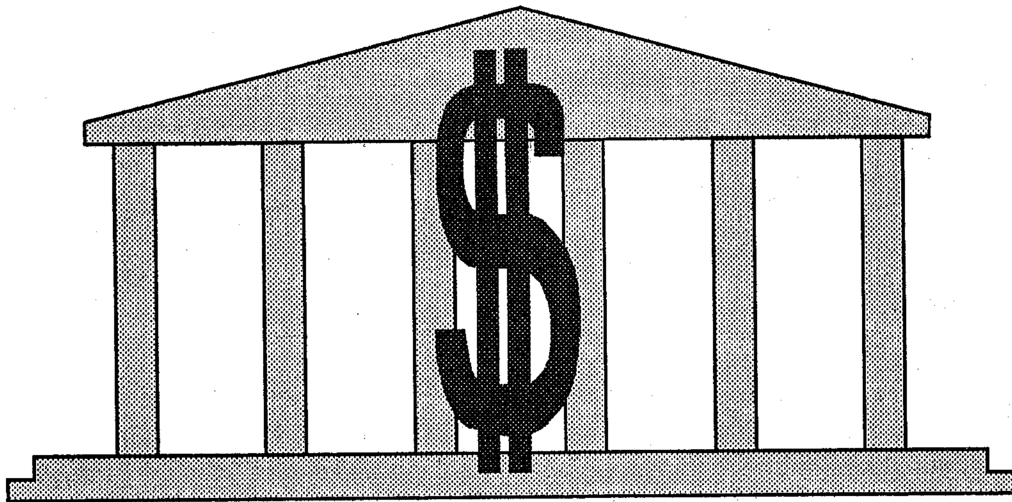
Reforming the Farm Credit System

Analysis of the Agricultural Credit Act of 1987

Cole R. Gustafson



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Highlights

Various external economic factors and internal management practices contributed to the need for federal legislation to recapitalize and reform the operating practices of the Farm Credit System. The Agricultural Credit Act of 1987 not only provides direct assistance to the system, but also benefits financially stressed farmers by protecting the value of FCS stock, providing borrowers with additional rights and debt restructuring opportunities. To maintain competitive equilibrium in agricultural capital markets, the legislation aids other agricultural lenders by creating an opportunity for them to originate farm real estate loans via a secondary market.

REFORMING THE FARM CREDIT SYSTEM - ANALYSIS OF THE AGRICULTURAL CREDIT ACT OF 1987

For the third consecutive year, Congress is considering legislation to aid the financially troubled Farm Credit System (FCS). Past efforts were designed to provide FCS with the flexibility to solve its problems alone. Direct financial assistance from the federal government was only a last resort. However, as the financial performance of the agricultural sector continued to deteriorate and legal challenges to the legislative provisions of FCS self-help began to mount, the need for direct financial assistance and more aggressive reform of FCS's organization became evident.

The Agriculture Credit Act of 1987 (ACA'87) not only provides direct financial assistance to FCS but also benefits farmers by protecting the value of FCS stock they hold, providing borrowers with additional rights and debt restructuring opportunities. Finally, to maintain a competitive equilibrium in agricultural capital markets, the act aids other agricultural lenders by creating an opportunity for them to originate farm real estate mortgage loans via a secondary market.

The first two sections of this report discuss the history of FCS and examine the factors and management decisions that lead to the need for this legislation. The report's third section summarizes provisions of the act, while the final section discusses implications for the price and availability of agriculture credit in the future.

History of the Farm Credit System

The Federal Farm Loan Act of 1916 chartered the original Federal Land Bank (FLB) organization — a predecessor to the current FCS. It was an era when capital markets in general were undeveloped. Chronic shortages of capital existed in rural areas of the agricultural sector. As a response, the government organized the FLB system as a member owned cooperative. Initial capitalization of the FLB occurred with federal capital, although Congress intended that the equity would eventually be replaced by stock which farmers would be required to purchase if they obtained a loan from FLB.

Goals of FLB have remained unchanged -- to provide capital to farmers, ranchers, firms engaged in aquaculture and persons willing to develop homesites in remote regions of the country. Cooperative borrowers of FLB were granted considerable authority to manage FLB so that the system could respond quickly to environmental change.

In 1923, Congress established the Federal Intermediate Credit Banks (FICB) which provide funds to local Production Credit Associations (PCA) to meet the shorter term (10 years or less) financing needs of farmers. The Bank for Cooperatives (BC), created in 1933, finance the marketing and supply operations of agricultural and rural cooperatives. The three different banks, FLB, FICB/PCA, and BC jointly compose the Farm Credit System.

By 1968, FCS paid off all of the federal government's original capital infusion. The Farm Credit Act of 1971 granted additional means by which capital needs could be provided within the system in the unlikely event economic conditions deteriorated. The system continued to grow and prosper until the mid-1980s. Consideration was even being given to the idea of removing the agency status or federal backing of FCS bonds.

Farmers in general had very high regard for FCS. The system offered farmers many new financial services such as record-keeping, insurance and tax management strategies. Nationwide, FCS helped both beginning and established farmers expand the scope and efficiency of their farm businesses.

Genesis of the FCS Problem

The financial strength of FCS quickly changed in the mid-1980s. Various external economic factors and internal management practices contributed to FCS's financial stress. International demand for U.S. agricultural products declined significantly in the 1980s, leading to a drop in commodity prices, farm income, and land values. At the same time, market interest rates declined sharply by 1985. Rates charged by competitors fell below FCS lending rates. As a consequence, creditworthy borrowers left FCS, while borrowers in weaker financial positions remained with the system and compounded its problems.

At the same time economic influences were adversely affecting FCS's fiscal posture, management of the system made a series of decisions that contributed to the problem (General Accounting Office). These decisions, which assumed a set of optimistic economic conditions that later failed to materialize, promoted high risk funding and lending policies. Moreover, a thrust to centralize the system's organizational structure made it increasingly difficult for FCS to respond to environmental change. Examples of these decisions include:

Rapid Expansion of Loan Portfolio

FCS aggressively sought to increase its market share of farm real estate debt with the use of liberal lending practices (Figure 1). Implementation of average cost rather than marginal cost pricing and variable rate loans allowed FCS to offer below market interest rates relative to the risks associated with agricultural lending.[1] Implicit subsidies connected with FCS loans have been shown to be as much as $352 million annually (Hughes and Osborne). In addition, FCS obtained limited collateral as it financed assets up to 85 percent of market value. Once

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[1]Under average cost pricing, FCS charge borrowers an interest rate based on the average cost of both new and existing debt in their portfolio. In contrast, farmers are charged the full cost of new borrowing under marginal cost pricing.

loans were originated, very little monitoring occurred afterward. FCS management placed emphasis on loan volume, not loan quality.

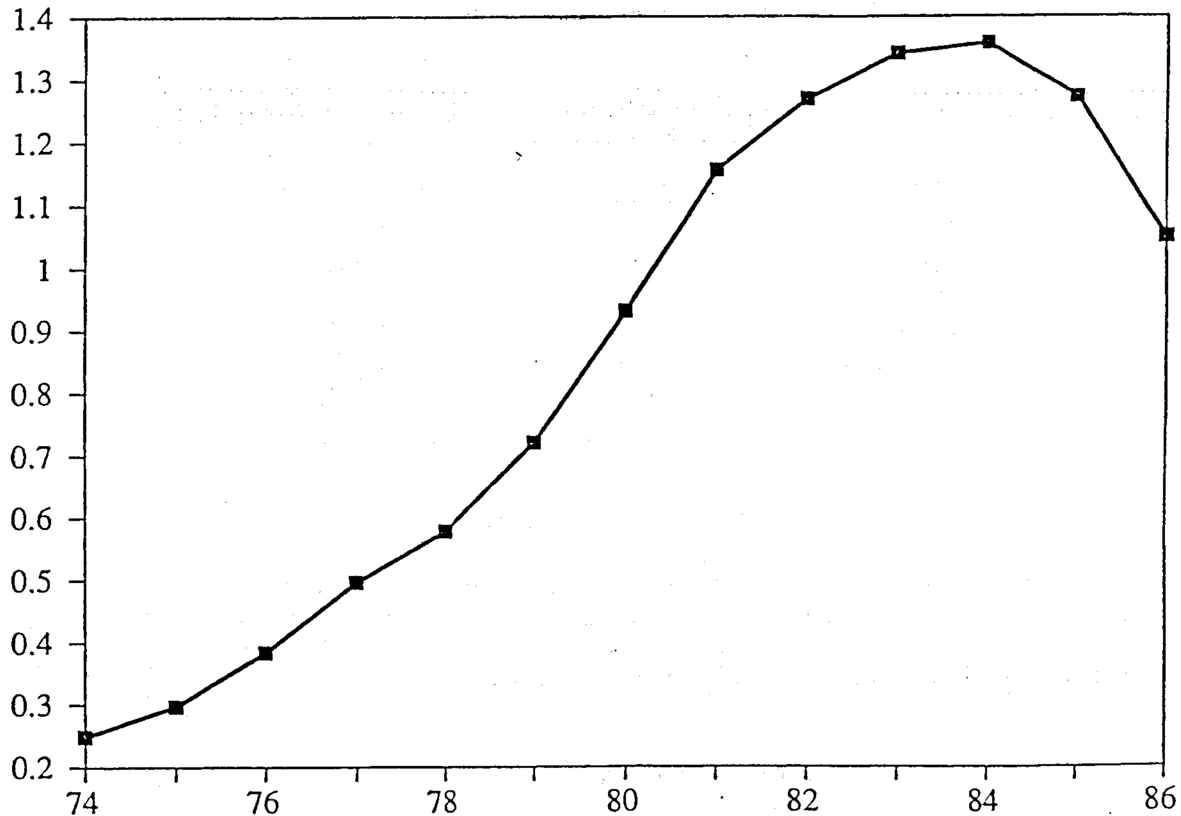

Figure 1. North Dakota FCS Real Estate Loan Volume.

Limited Diversification

FCS obtained loanable funds from a single source and lent them to a single sector of the economy — agriculture. Unlike other lenders who diversified, FCS exposed itself to significant risk as a result of high concentrations in both assets or liabilities. The effects of limited diversification are similar to leverage. When financial conditions in agriculture deteriorated, FCS profitability rapidly declined.

Unfortunate Timing of Bond Sales

During an era of high interest rates in the late 1970s, FCS issued a significant volume of fixed rate, noncallable term debt at maturities substantially longer than those of its loans (Table 1). When rates dropped in the mid-1980s, FCS experienced severe prepayment risk as their loans to farmers were variable rate and contained no prepayment penalties.

TABLE 1. MATURITY OF FARM CREDIT SYSTEM TERM BOND DEBT, AS OF DEC. 31, 1986

Year	Proportion of Term Debt	Average Rate
	---------- percent	----------
1987	33	11.06
1988	16	11.05
1989	17	11.20
1990	13	11.21
1991-2007	21	11.72
	100	11.24

Poor Management Information

Management did not recognize the weaknesses of their credit operations in a timely manner because FCS did not consolidate its financial statements prior to 1985 nor hire an independent outside auditor. Yet, all districts were jointly and severally liable for any losses.

Inaction on Nonaccrual Loans

With the exception of the St. Paul district, FCS failed to resolve problems surrounding its inventory of nonaccrual loans. At the end of 1987, nonaccrual FCS loans totaled $6.0 billion, while another $4.5 billion were considered high risk (Congressional Budget Office). Nonperforming loans are costly to a financial institution because both reduced revenue and increased administrative and overhead expenses lead to lower net income (Gustafson et al.).

In summary, both changes in the general economy and internal management mistakes contributed to FCS's severe financial trouble. Failure of the system would adversely affect the agricultural sector and could potentially affect other government sponsored capital markets. Hence, Congress attempted to rescue FCS and enacted ACA'87.

Bail-Out of FCS

The ACA'87 has four goals. Paramount is the recapitalization of FCS. In order to participate in systemwide bond offerings, each district must have positive equity, where equity consists of earned surplus and borrower capital. At the end of 1987, three district-level institutions within the system nearly exhausted their equity. Banks with negative equity have been

able to continue operations only because more liberal Regulated Accounting Practices allowed them to postpone recognition of certain expenses.

A second goal of ACA'87 is to provide FCS with greater institutional flexibility. The nation's capital markets have been greatly deregulated in the past decade. Lenders are now very competitive in terms of offering high rates of return on deposits, low interest rates on loans, and increased financial services including stock brokerage, insurance, tax, and trust management activities. At the same time, FCS has become more complex and integrated in its organizational structure. Thus, the system is becoming more structured but being asked to operate in a setting of change.

The third goal of ACA'87 relates to budget concerns. Competition for available spending funds is intense from the perspective of both agricultural and general interest groups. In addition, the sheer size of the federal budget deficit, possibility of sequestration under the Balanced Budget Act and the growth of the agricultural budget all combined to minimize the budgetary impact of the act. Alternative forms of legislation ranged from simple guarantees of FCS stock (which move expenses associated with the bail-out off the budget), to outright injection of federal funds into the system.

Congress has enacted legislation designed to help FCS deal with its financial problems in each of the past two years. Hence, a final goal of ACA'87 is to reduce the likelihood that federal assistance packages will be needed in future years. This involves a tradeoff -- increasing FCS's survival chances requires a larger capital infusion and greater budget exposure.

The means by which ACA'87 accomplishes these goals are discussed in the following sections according to financial assistance, system reorganization, FCS borrower rights, FmHA borrower rights, and long-term capital market issues.

Financial Assistance

The actual injection of capital into FCS is administered by a new entity referred to as the Assistance Board. ACA'87 dissolves the Farm Credit Capital Corporation which previously supervised the operations of troubled FCS institutions. Purposes of the board are to protect the value borrower stock and restore FCS to economic viability.

Organization of the board is similar to those that oversaw the restructuring of Chrysler Corporation and Continental Illinois. Board membership includes the Secretary of Treasury, Secretary of Agriculture and a farmer representative appointed by the president.

The board has a large degree of oversight and power. It has authority to 1) approve an insolvent bank's reorganization plan, 2) force an insolvent bank to price loans based on principles of marginal cost, 3) remove bank

management and employees, and 4) merge troubled banks and associations as deemed necessary.

Through the board, FCS is eligible to receive up to $4.0 billion dollars of assistance. This capital infusion is in the form of a loan -- not just a guarantee of FCS bonds. In 1988, FCS can obtain $2.8 billion and $1.2 billion during 1989. A district must apply for assistance when the book value of stock is less than face value.

Recently released quarterly financial reports from the St. Paul district show generation of a profit totalling $32 million. If this trend continues, it is unlikely that the district will have to apply for assistance. However, if the agricultural sector in the region deteriorates, the district may have to eventually apply for aid, as equity reserves are minimal.

Repayment of the assistance is as follows: The federal government pays all accruing interest on the assistance loan for the first five years. During years 5-10, FCS and the government are each responsible for paying one-half of the interest. After 10 years, FCS must pay all interest. By year 15, FCS is expected to repay the entire loan principal. If any district applies for assistance, all districts are obligated to help repay, as FCS districts are considered jointly and severally liable. Each district's share is determined by its relative proportion of loan volume.

This capital infusion is designed to protect FCS borrower stock values for a period of five years, if a borrower's payments of interest and principal on the loan are current. Costless redemption of borrower stock is a necessity if FCS expects to retain existing customers and attract new borrowers. Each of the House and Senate bills had provisions repealing the mandatory stock purchase. If stock purchases were voluntary, borrowers could choose whether or not they want to be investors in FCS and bear the subsequent risks of ownership. However, the proposal was eliminated during conference negotiations as many of the benefits enjoyed by FCS accrue because of its cooperative characteristics.

As part of the assistance package, all districts must obtain updated financial statements every three years from every borrower. Previously, FCS did not have a uniform policy of loan documentation. Some associations only obtained borrower financial statements at the time of loan origination -- with no followup over the maturity of the loan. The new policy is still more lenient than those of competing lenders who usually demand new financial statements annually.

In an effort to strengthen its loan portfolio, ACA'87 also stipulates that FCS can not originate new real estate loans for greater than 85 percent of an asset's appraised value or 75 percent of an asset's market value. Below market collateral requirements is one factor that resulted in greater FCS market share and compounded the system's financial troubles when economic conditions in the agricultural sector deteriorated.

System Reorganization

Even though ACA'87 is often popularly referred to as bail-out legislation, it truly is a package of reform, because FCS must implement specific reorganization plans in order to be eligible for assistance. When drafting the legislation, Congress expressed concern about insufficient local input into decisionmaking, the efficiency of the system and the long-term viability of FCS. At the end of 1987, there existed $800-900 million worth of duplication of overhead and administrative expenses within the system (Congressional Budget Office). Shown in Table 2 are relative changes in FCS expenses since 1981. As the data indicate, most expense components rose while aggregate loan volume and profits were declining due to deteriorating conditions in the agricultural sector. The only expense component reduced was training. Perhaps increases in this area could have aided FCS's recovery and customer goodwill.

TABLE 2. FARM CREDIT SYSTEM OPERATING COSTS

Account	1981	1985	Change
	dollars in thousands		percent
Directors' expense	14,274	17,053	20
Salaries & benefits	387,257	534,387	38
Purchased services	12,528	30,539	144
Occupancy expense	51,828	86,530	67
Comm. & EDP	38,020	54,873	44
Travel	32,257	33,462	4
Ads & member relas.	30,109	30.387	1
Supervision (FCA)	14,760	24,041	63
Farmbank (FCCA)	1,850	3,586	94
Training	9,279	7,604	-18
Other expenses	28,731	60,007	209
Total	620,893	882,469	42

To reduce overhead, FCS must consider merging various system entities. Presently, three organizational tiers exist within FLB and PCA systems -- the national, district and local association offices. Reorganization proposals ranged from vertical compression, which essentially eliminated district offices, to horizontal mergers of like institutions. The latter proposal was eventually adopted. At the end of 1987, FCS consisted of 250 Federal Land Bank (FLB), 150 Production Credit Associations (PCA), 12 district BCs and Central BC in Denver. ACA'87 forces FCS to combine adjoining FLB and PCA associations into a single local office by July 6, 1988. ACA'87 also commissions a six month study to investigate the possibility and cost savings of reducing FCS to no fewer than six district offices. Prior to passage of ACA'87, the St. Paul and Omaha district offices were considering merger. If district banks agree to merger, the

Assistance Board must provide sufficient capital so that the book value of the new institution exceeds 75 percent of par value.

An interesting amendment to ACA'87 permits local associations along a district boundary to join neighboring FCS district offices. For example, local associations in North Dakota are permitted to join FCS Spokane or Omaha districts if desired.

Banks for Cooperatives (BC) must also consider merger. If less than eight vote for merger, the new entity will be referred to as the United Bank for Cooperatives. If eight or more agree, their new title will be the National Bank for Cooperatives.

Local control is still sufficiently strong within the FCS organization. Congress felt this structure would enable FCS to quickly respond to changing conditions in agricultural credit markets.

FCS Borrower Rights

The ACA'87 directly addresses the problems of financially stressed farmers in the agricultural sector -- many of whom are FCS borrowers. Unlike the Food Security Act of 1985 which dealt with the profitability of all farms regardless of indebtedness, ACA'87 places relatively strict limits on the actions of FCS and Farmers Home Administration (FmHA) toward borrowers in financial difficultly. These limits are referred to as borrowers' rights. Because financial markets in agriculture are highly competitive, other lenders may ultimately have to offer similar rights to their troubled borrowers.

Granting borrowers additional rights raises a number of equity issues. These rights enable a borrower to renegotiate the terms of a loan. The ability to do so is contingent upon being delinquent or at high risk of default. Hence, some marginal borrowers may be induced to become delinquent and take advantage of these provisions. Therefore, an equity issue arises because borrowers who remained financially sound are penalized and financially stressed borrowers rewarded, in a relative sense.

Debt Restructuring

The main focus of borrowers' rights is on debt restructuring. If a borrower resides in a district that receives financial assistance, FCS is required to review the loans of all borrowers in the district to determine if they are eligible for restructuring. In other districts, borrowers must apply for restructuring. The St. Paul district office has temporarily suspended all foreclosure actions to determine if loans in legal proceedings qualify for restructuring.

To qualify for restructuring, a borrower must have a "distressed loan," which by definition is a loan on which the borrower does not have the capacity to pay, is not in foreclosure or bankruptcy and one of the four following conditions exist: 1) the loan is delinquent, 2) the borrower

demonstrates adverse repayment trends, 3) the loan is inadequately collateralized, or 4) there appears to be a high probability of loss to the lender if restructuring is not undertaken.

If a loan is a candidate for restructuring, FCS must notify the borrower 45 days prior to foreclosure and tell them of their restructuring rights. If restructuring is denied, the borrower must be provided with a written explanation. Further, the borrower has the right to appeal any decision.

When deciding whether or not to restructure, FCS must determine if 1) loan is equal to or greater than the cost of foreclosure, 2) the borrower is applying all income above family living and operating expenses to payment of the financial obligation (i.e. dealing in good faith), 3)the borrower has the capacity to protect collateral, and 4) the borrower can establish a viable operation and repay the loan after it is restructured.

Obviously a trade-off exists between insuring the viability of a borrower and reducing the costs of restructuring from the perspective of FCS which increases chances of system survival. Further, necessary income to remain a viable farm operation is difficult to specify and varies by region according to living standards.

In the past, ad hoc procedures were employed to calculate the value of restructuring and costs of foreclosure. The ACA'87 specifically defines uniform procedures for determining both. The value of restructuring includes the present value of interest and principal foregone and reasonable (necessary) administrative expenses to finalize a restructuring plan. To determine these values, the distressed borrower must provide complete financial statement and submit a restructuring plan and cashflow analysis that takes into account all sources of income and assets (farm and nonfarm sources together).

Costs of foreclosure on the other hand include 1) the difference between the outstanding balance of the loan and value of collateral, 2) cost of maintaining the loan as a nonperforming asset, and 3) cost of administrative and legal actions to foreclose and maintain the property afterward. As above, the calculation must be based on all sources of the borrower's income and assets.

If two plans are available, FCS has the right to choose the least cost plan. Congress also urged FCS to participate in various FmHA and state programs of restructuring to the greatest extent possible in order to reduce overall restructuring costs to the system. Borrowers whose debts are restructured lose a proportion of their FCS stock in an amount equal to the percentage of debt written off.

By March 6, 1988, all districts were to have developed a debt restructuring policy. For the preceding 18 months, the St. Paul district has had such a policy, and it is very similar to that required by ACA'87.

Right of First Refusal

If a borrower fails to qualify for restructuring and FCS ultimately forecloses on the property, the original owner has the first right of refusal to purchase or lease the property conveyed to FCS. After deciding to sell or lease a piece of acquired property, FCS must notify previous owners of their decision within 15 days. The owner then has another 15 days from notification to either pay appraised value or make an offer on the property. If the borrower pays appraised value, FCS must accept the offer within 30 days. In situations were an offer is made, FCS must make a decision within 15 days. If the property is sold, FCS is not obligated to provide financing.

The right of first refusal does not diminish the rights of a borrower under statutory law. For instance, North Dakota provides borrowers with a one year right-of-redemption. This one year provision begins after the time the previous owner refuses the right to purchase the property in question.

Other Rights

In addition to debt restructuring and right of first refusal, ACA'87 affords FCS borrowers numerous other rights. Protection of borrower stock was discussed earlier. FCS must also disclose certain documents and information to their borrowers. FCS must conform to the standards set forth by Truth in Lending and disclose to borrowers information on total interest costs and the mechanisms by which interest rates on variable rate loans are adjusted. Borrowers are guaranteed access to loan documents they have signed and the right to appear in person before a review committee. Further, they can obtain independent appraisals of any property if valuation is disputed.

Rights of Nondelinquent Borrowers

Additional protection is also offered to borrowers who are not distressed. First, FCS may not foreclose a loan because the borrower fails to post additional collateral, if the borrower is current on interest, principal, and penalties. Second, if a district offers more than one interest rate to its borrowers, FCS must 1) review all loans to determine if the proper rate is being charged, 2) explain to the borrowers the basis for an interest rate differential, and 3) explain to the borrowers how they can qualify for a lower interest rate on their loan.

Funding of state mediation programs is also insured by ACA'87. The secretary of agriculture will reimburse states up to 50 percent ($500,000 maximum) of the cost of operating mediation programs. Lenders cannot force borrowers to waive their rights when a loan is either originated or restructured.

FmHA Borrower Rights

ACA'87 contains a number of provisions applying directly to distressed FmHA borrowers. If an FmHA borrower is over 180 days delinquent, FmHA must notify the borrower of available options. Borrowers are now permitted to use county or statewide average crop yields in their reorganization plans if a local crop failure was the cause of their distress. The secretary of agriculture must establish a National Appeals Division within FmHA. The new division has the authority to review all state and county decisions.

Debt Restructuring

A formal debt restructuring procedure will apply to FmHA borrowers as well as those of FCS. The policy is similar to that of FCS with the following exceptions. Costs of restructuring also include repairs and upkeep expenses, taxes, depreciation and the annual change in the value of the property and interest calculated for each type of property. In addition, when determining the present value of foregone principal and interest, the 90-day treasury bill interest rate must be employed. Finally, if an FmHA borrower's loan is restructured, the borrower must agree to a shared appreciation mortgage whereby the property is reappraised after ten years. If the property increases in value during that time, the borrower must share part of the increase with FmHA.

If the value of restructuring is less than the cost of foreclosure and the borrower can obtain third party financing to purchase the property, the borrower is liable for a portion of the debt written off if the property is sold for a greater value within two years after purchase.

Homestead Protection

FmHA borrowers are still guaranteed protection of their homesteads. ACA'87 expands current law to include a reasonable number of outbuildings and up to 10 acres of land. The homestead protection exists for a maximum of five years, and to be eligible, borrowers must have derived at least 60 percent of their income from farming sources in the last two of six years. FmHA must also release sufficient income for family living and operating expenses.

Acquired Property

If FmHA desires to sell or lease property that was conveyed voluntarily to them or obtained by foreclosure, it cannot sell or lease the acquired property to entities larger than family farms. Also, preference must be given to borrowers with the greatest need for additional income.

Long-term Capital Market Issues

The cost of borrower rights granted to FCS borrowers and operating losses for the previous two years may deplete most of the system's equity. Low levels of equity make it difficult for the system to survive cyclical downturns in agricultural prosperity. Hence, Congress was concerned about the system's viability and credit supplies to agriculture over the long run.

ACA'87 deals with these concerns in two contradictory ways. First, the act strengthens FCS's ability to withstand adverse conditions by strengthening capital requirements and creating an insurance fund. But, the act also enhances the supply of credit to agriculture by providing a secondary market for agricultural mortgages. Such a market would compete directly with FCS for profitable real estate loans and make recovery of FCS more difficult.

FCS Viability

Farm Credit Administration, the chief regulator of FCS, must develop new capital standards that insure long term survivability. These standards are specific ratios of equity capital to loans -- and they must be adjusted to reflect the riskiness of each lender's portfolio. FCS will now be subject to the same capital standards as imposed by the Federal Deposit Insurance Corporation on commercial banks.

FCS already has an implicit insurance fund -- the joint and several liability clause in the system's cooperative charter. If a district bank adopts a risky lending strategy that eventually leads to insolvency, other district banks must absorb the loss in order to participate in systemwide bond offerings. This concept is not sufficiently strong, because more aggressive banks do not face higher insurance premiums reflecting their added risk. Hence, a freerider problem exists with all districts seeking risky investments.

To resolve this problem, a Farm Credit Insurance Fund was created by ACA'87 to protect system banks during future financial crises. The fund is created by assessing each district, those with riskier loans contributing more to the fund. Congress hopes that the capital standards and insurance fund will eventually, once again, lead to removal of FCS's agency status. However, similar efforts to decouple the Federal Savings and Loan Insurance Corp. have failed to materialize.

Secondary Market for Agricultural Loans

A secondary market for agricultural real estate mortgages is diagrammed in Figure 2. A farmer would contact either a farm audit system lender, commercial bank, savings and loan association, insurance company, credit union, or any other participating financial institution and apply for a real estate loan in the usual fashion. The participating lender, referred to as the <u>originator</u>, writes the mortgage and retains responsibility for 10

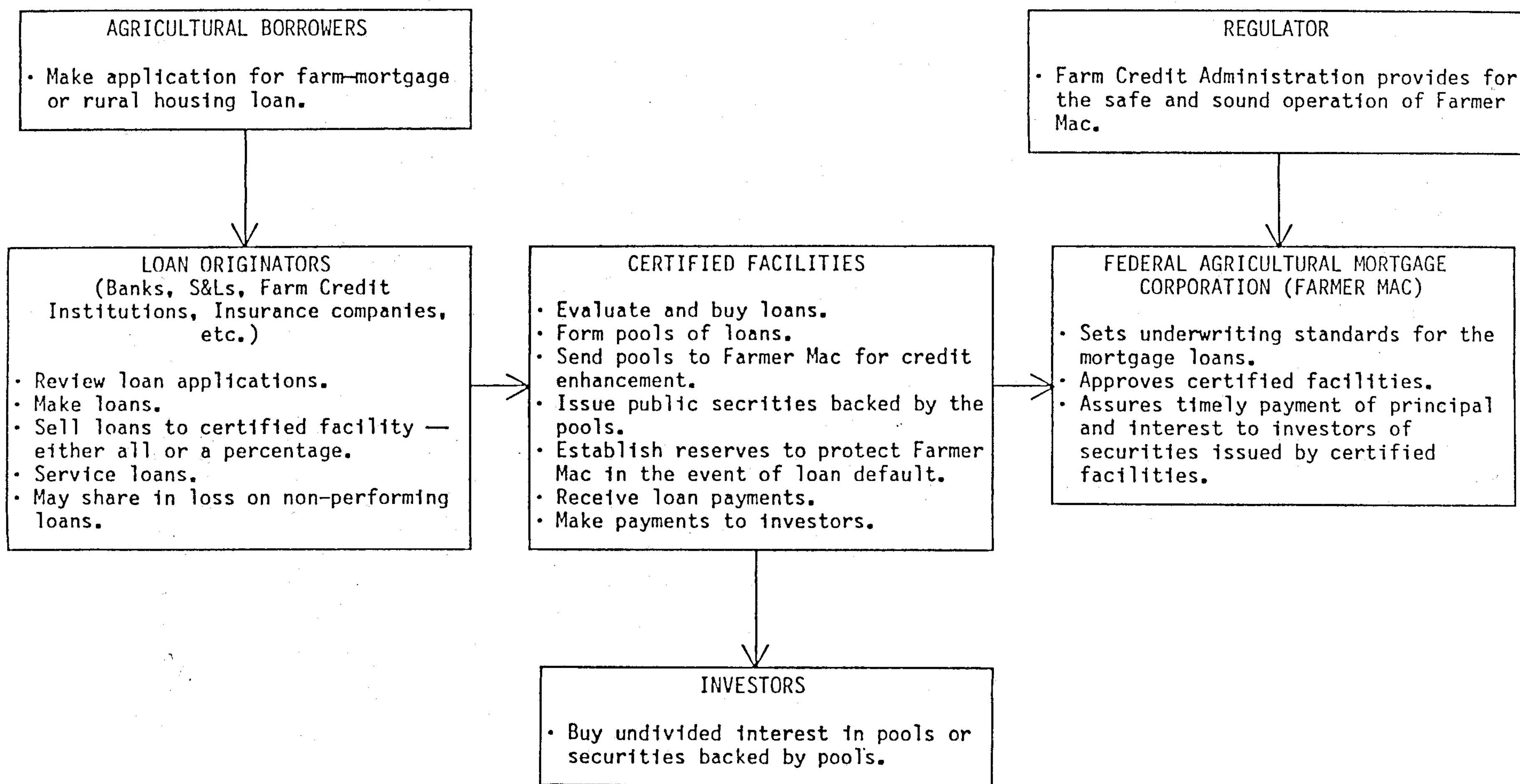

Figure 2. Elements of the Secondary Market for Agricultural Loans

percent of the loan so the lender is still at risk and does not have the incentive to make poor loans. The remaining 90 percent of the loan is sold to a certified facility whose responsibilities are to bundle groups of loans into pools. There must be at least 50 loans in a pool with no one loan exceeding 3.5 percent of the total, valued over $1.2 million, or representing more than 1,000 acres of land.

Once the certified facility bundles a package of loans, it applies to Farmer Mac for credit enhancement, which is the assurance that interest and principal will be paid. Farmer Mac has the responsibility for developing uniform underwriting standards, creating and overseeing the operation of the certified facilities and guaranteeing payments of principal and interest to investors. Farmer Mac is considered part of FCS, but FCS is not liable for Farmer Mac. Ultimately, Farmer Mac will consist of a 15 member panel of five FCS representatives, five non-FCS members who intend to originate secondary loans and five members appointed by the President. To capitalize Farmer Mac, each certified facility will be required to purchase capital stock in Farmer Mac.

Having obtained credit enhancement, the certified facility sells the pool of loans to investors in the nation's capital markets. The certified facility reduces transaction costs associated with the sale of bonds backing the pool of mortgages. Fees charged for this service are the spread between interest rates charged by the originator and those on the secondary market. The originator retains responsibility for servicing the loan.

There are numerous concerns surrounding a secondary market. First, large, frequent and regular bond offerings are required for successful operation of a secondary market. An agricultural secondary market may not possess all of these fundamental characteristics. Interest on the part of farmers is uncertain because if they elect to have their loan sent to the secondary market (which presumably would result in lower borrowing costs), they must agree to waive most of their borrower rights, including the eligibility of debt restructuring at some future date and the right of first refusal.

Further, the relative volatility and riskiness of agriculture implies that a secondary market will only function with fairly high levels of government support. This guarantee affects the flow of capital among sectors of the economy. More capital could flow into agriculture than is merited on strictly economic grounds. Excess capital is one of the factors that contributed to the agricultural sector's financial crisis of the 1980s. Also, a successful secondary market competes directly with FCS for profitable loans and hamper recovery of the system.

Implications

The Agricultural Credit Act has significant implications for interest rates and credit availability to agriculture in the foreseeable future.

Interest rates

Although it is difficult to predict the general trend of interest rates, three factors suggest FCS lending rates will be higher than those of competitors in both the short and long run. First, higher risk premiums are being attached to FCS systemwide bonds relative to U.S. treasury bill rates. Prior to September 1985 when FCS announced its financial difficulties, risk premiums were generally less than 5 basis points. Subsequently, whenever uncertainties mount, the risk premium widens (as great as 140 basis points) and remains high for nearly six to nine months afterward. Hence, short-term rates will continue to be high until investor confidence is restored.

Long-term rates will also remain high because the system issued a relatively large percentage of high cost noncallable bonds in the early 1980s. As discussed earlier, the system will not pay off those bonds until the year 2007. A second factor contributing to higher rates will be the repayment of interest and principal on funds received from the Assistance Board. It is estimated that FCS will have to raise interest rates 200 basis points to generate sufficient reserves for repayment of the capital infusion (Barry). Finally, costs associated with expanded borrower rights and debt restructuring lead to increased rates (Gustafson et al.). This latter factor will have less impact on rates in the St. Paul district because FCS has already restructured over $1.0 billion of debt for 7,000 farmers.

An offsetting factor leading to lower rates will be the economies realized through restructuring and reorganization. FCS now has the justification and need to change its operating practices. Chrysler and Continental Illinois were very successful in their corporate reorganizations -- so much so that they are now acquiring their former competitors. FCS has a dissimilar operating structure, but the same opportunity to once again attain financial stability.

Credit Availability

A successful secondary market for agricultural mortgages will have a dramatic effect on credit availability. Farmers will have additional sources of financing beyond FCS and FmHA. Other lenders, particularly commercial banks, could not consistently offer real estate loans because they had to rely on local deposits for investment capital and could not diversify their agricultural loan portfolio geographically.

Benefits to farms of a secondary market include lower borrowing rates and more certain credit availability. Once again, farmers will be able to obtain fixed rate long-term financing. Further, farmers will know precisely what credit standards exist and what characteristics are necessary to qualify for a mortgage. However, these strict standards will make it difficult for lenders to tailor loan terms to meet the needs of individual borrowers.

Conclusion

Many complex and diverse factors contributed to the financial problems of the Farm Credit System. The legislation which attempts to rescue FCS is also complex. The package is not a quick-fix but a serious attempt to reform the structure and operating practices of the nation's largest agricultural lender. Congress intends for the FCS to function as a commercial entity -- not a social institution which indirectly channels federal funds to the agricultural sector. In addition, the act offers significant protection to selected financially stressed farm borrowers, those who are also commercially viable over the long run.

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