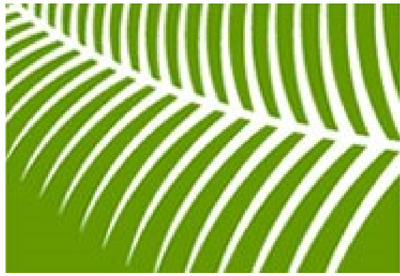

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Farm Credit Performance 1997

by Keith Leggett

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The Farm Credit System has rebounded from its credit problems of the 1980s to become a major competitor of banks in supplying credit to rural America. Because of the continuing relatively high loan-to-deposit ratios at agricultural banks, Farm Credit System lenders had the opportunity to further leverage their government-sponsored funding advantage to increase their loan volumes during 1997. The U.S. Department of Agriculture (USDA) reported that the Farm Credit System (FCS) accounted for more than a quarter of the increase in farm lending in 1997, maintaining its share of total farm credit at slightly less than 26 percent. In 1994, the FCS held a 24 percent market share.[1] This paper provides a brief overview of the Farm Credit System and the trends in its financial performance.

Overview of the Farm Credit System

The Farm Credit System is the only Government-Sponsored Enterprise (GSE) with direct access to retail markets. Created in 1916, the FCS was intended to raise funds in capital markets and to make loans to eligible farmers, ranchers, producers, cooperatives, and others in rural America. FCS debt instruments are not backed by the full faith and credit of the United States, but because of the System's GSE status, investors assume that the government will protect them in the event of financial difficulty. This enables the FCS to raise funds at rates close to Treasury secu-

[1]Economic Research Service. *Agricultural Income and Finance: Situation and Outlook Report*. United States Department of Agriculture: February 1998.

rities – a substantial competitive advantage over any private sector firm offering similar services. The funds raised by the System are channeled to a network of 211 Farm Credit lending institutions.

The Farm Credit System consists of the following entities:

• **The Farm Credit Administration**, the federal regulator which examines and supervises all System institutions;

• **The Farm Credit System Insurance Corporation**, which insures the principal and interest on System-wide debt securities;

• **Federal Farm Credit Banks Funding Corporation**, which manages the sale of System-wide debt securities;

• **Lending Institutions (211 Farm Credit System Banks)**

- Six Farm Credit Banks and their 203 local associates (comprised of 48 Federal Land Bank Associations, 64 Production Credit Associations, 60 Agricultural Credit Associations, and 31 Federal Land Credit Associations);

- Bank for Cooperatives (St. Paul Bank), which offers lines of credit and related financial services nationwide to agricultural cooperatives and other eligible borrowers; and

- Agricultural Credit Bank (CoBank), which finances cooperatives and agricultural businesses nationally;

• **Farm Credit Leasing**, owned by System lending institutions, which provides equipment leasing services; and

• **The Farm Credit Council**, a national trade association for the FCS.

Since the beginning of the decade, the Farm Credit System has undergone significant structural changes due to consolidation. Between January 1991 and December 1997, the number of organizations within the System declined 34 percent to 211. Moreover, the number of Farm Credit System Bank "districts" declined from 12 to 6. While these mergers have associated restructuring costs in the short run, they are likely to have long-term benefits including greater portfolio diversification and lower operating expenses. Additionally, two Farm Credit Banks (AgAmerica FCB and Western FCB) have entered a joint management agreement beginning March 1, 1997, while keeping separate boards of directors.

Consolidated Farm Credit System Performance

The consolidated financial performance of the FCS has been strong the last several years.The FCS reported a profit of $1.3 billion in 1997 — an increase of $66 million over 1996. The return on average assets (ROA) was

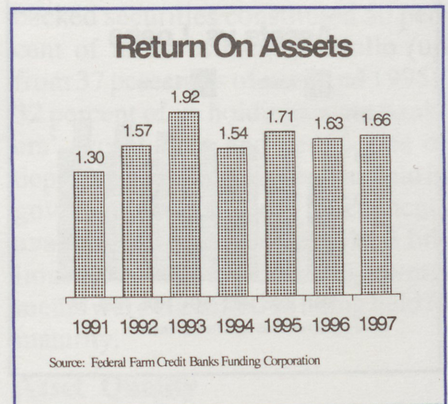

Figure 1

1.66 percent in 1997, an increase from 1.63 percent from 1996 (see Figure 1). The increase in return on average assets is attributable to the growth of net interest income result-

ing from higher loan volumes and reductions in provisions for loan losses.

Since the beginning of 1994, net interest margins for the Farm Credit System have narrowed because of intense competitive pressures in the pricing of loans and an increase in the cost of funds. Net interest margins have narrowed from 3.17 percent in 1993 to 2.95 percent in 1997. Net interest margins declined 4 basis points between 1996 and 1997 because of an increase in the cost of funds. However, the reduction in net income from the squeeze in net interest margins in 1997 was more than offset by an increase in loan volume and increased use of capital stock and surplus to fund earning assets.

Consolidated Balance Sheet

Assets

As of year-end 1997, the FCS had total assets of $78.1 billion – an increase of 4.3 percent, or $3.2 billion, over year-end 1996 assets. The System's asset growth continues to be primarily driven by growth in loan volume. Figure 2 shows the relationship between total assets and total loans of the FCS over the last 7 years.

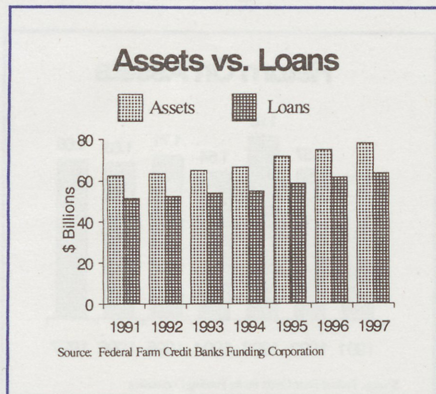

Figure 2

Loan volume for the FCS increased 3.7 percent in 1997 and compares favorably to the 2 percent average growth rate for the years of 1992 through 1994. On the other hand, commercial banks' farm debt grew at an estimated annual rate of 4.1 percent in 1997.[2]

"The increase in the System's loan volume reflects System's institutions' effort to maintain and increase their market share ... through various marketing, business development and operating strategies."[3] For example, in December, the FCS inaugurated AgSmart, its first nationwide credit product.[4]

Five of the six district Farm Credit Banks and the Agricultural Credit Bank (CoBank) reported increased loan growth. Only the Bank for Cooperatives (St. Paul Bank) and AgAmerica reported a decrease in lending over the 12-month period ending September 1997. The Wichita FCB reported the strongest loan growth at 8.9 percent.

Loan Portfolio

The composition of the loan portfolio has changed since the beginning of the decade (see Figure 3). The percentage of the portfolio held in long-term real estate loans dropped to 48 percent in 1997 from 56 percent in 1991. However, during 1997, the dollar volume of long-term real estate

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[2] Ibid.

[3] Farm Credit System. Annual Information Statement – 1997.

[4] AgSmart is a point-of-sale trade credit program.

[5] Preliminary estimates indicate that the interest rates charged by FCS lenders are on average 105 basis points lower than the average interest rates charged by commercial banks on agricultural real estate loans, according to the USDA.

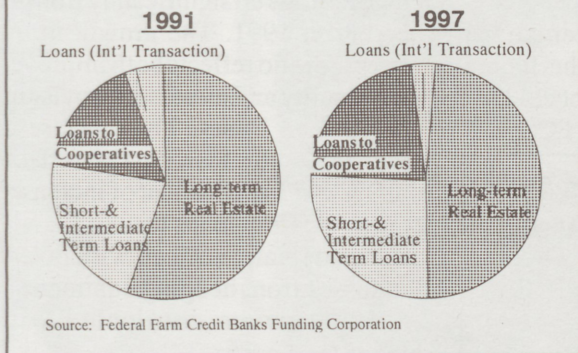

Figure 3

loans increased 3.6 percent.[5]

Short- and intermediate-term loans to agricultural producers increased from 22 percent of loan portfolio in 1991 to 26 percent of the total loan portfolio in 1997. This category grew by $1.5 billion, or 10.1 percent, in 1997. The growth in short- and intermediate-term loans resulted from enhancement of market share through competitive loan pricing and improved marketing efforts.

Domestic loans to cooperatives remained relatively stable during 1997 and currently account for 23 percent of the total loan portfolio. While loans to rural utilities increased in 1997, this was offset by reductions in agribusiness loans to cooperatives. The reduction in agribusiness loans resulted from financial restructuring by large borrowers and the reduced need for working capital by the grain industry. In 1991, loans to cooperatives represented 17 percent of the loan portfolio.

At year-end 1997, the FCS had a significant number of outstanding commitments to extend credit. The notional (contractual) amount of commitments and standby letters of credit extended by the Farm Credit System institutions was $21.6 billion – an increase of $3.2 billion at year-end 1996.

Investments and Liquidity Balances

Total balances held for liquidity – investments, cash, and federal funds – equaled $13 billion at year-end 1997. According to Farm Credit Administration regulations, institutions within the FCS can hold eligible investments to maintain liquidity reserves, to manage excess short-term funds, and to control interest rate risk.

The Farm Credit System's investments grew by approximately $500 million to $10.8 billion in 1997. At year-end 1997, 36.5 percent of FCS's investment portfolio had maturities of less than one year, and 80 percent of its investments were scheduled to reprice within one year. Mortgage-backed securities constituted 50 percent of its investment portfolio (up from 37 percent as of year-end 1995), 32 percent of its holdings were bankers' acceptances and certificates of deposit, and the remainder was held in government securities. Investments available for sale equaled $10.3 billion. Less than 5 percent of investments were classified as being held to maturity.

Asset Quality

Credit quality for the Farm Credit System continued to be favorable in 1997. Improvements in FCS asset quality can be attributed to:

• net farm cash income approaching record levels;

• programs to reduce or restruc-

ture non-performing assets; and

• enhanced underwriting practices by FCS lenders.[6]

Additionally, most international loans are guaranteed by the federal government, which also acts to limit the credit exposure of the FCS.[7]

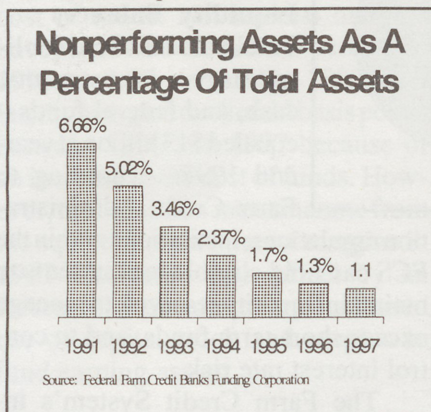

Figure 4

The dollar volume of non-performing assets declined by 12 percent in 1996 to $859 million. As of year-end 1997, non-performing assets stood at 1.1 percent of total assets. Figure 4 shows the continual improvement in asset quality as the ratio of non-performing assets to total assets declined over the first half of the decade.

Another sign of improving asset quality is that restructured loans declined by $46 million to $200 million in 1997. However, accruing loans 90 days or more past due increased by $8 million to $36 million in 1997.

Allowances for loan losses reached 222 percent of non-performing loans at year-end 1997. This "coverage ratio" is up significantly from 41 percent in 1991. The growth in the coverage ratio reflects both improved asset quality and increased provisioning for loan losses. The increase in allowances for loan losses reflects the System's assessment of increased credit risk from loans to:

• cooperatives faced with potential losses from hedging contracts;

• borrowers confronted with higher feed costs;

• borrowers faced with lower livestock prices; and

• borrowers adversely affected by weather-related problems.

At the System level, only loans to borrowers producing grain or raising livestock exceeded 10 percent of the System's total assets. As of December 1997, loan concentration ratios to grain and livestock borrowers were 14 percent and 12 percent, respectively.

While asset quality improved for the System as a whole, St. Paul BC, CoBank, and the Texas FCB posted increases in nonaccrual loans during the year ending Sept. 30, 1997.

Funding Sources

Debt Securities

The Farm Credit System is not permitted by law to take *deposit* liabilities. However, due to its GSE status, the FCS enjoys significantly lower borrowing costs than other lenders. For example, the average difference in the borrowing cost of the FCS vis-à-vis AAA-rated corporate bonds was 138 basis points in 1997. The Farm Credit System is funded primarily through the sale of System-wide Debt Securities, for which all the System

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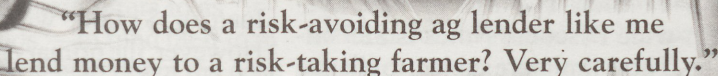
[6] Farm Credit System. Annual Information Statement – 1997.

[7] Eighty-eight percent of the loans for international transactions are guaranteed by either the United States Department of Agriculture's Commodity Credit Corporation or the Export-Import Bank of the United States.



Steve Hatz, Ag lender
US Bank
Omaha, Nebraska

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banks (6 Farm Credit Banks, Agricultural Credit Bank, and Bank for Cooperatives) have joint and several liability. Total System-wide Debt Securities outstanding as of year-end 1997 was $63.2 billion – 81 percent of total assets.

In 1997, the FCS increased the level of outstanding System-wide Medium-Term Notes by 13 percent[8] to $30.9 billion, or 49 percent, of its debt obligations. System-wide Bonds constitute 27 percent of the debt outstanding, and Discount Notes represent 22 percent of the debt outstanding. The remainder of the debt obligations is comprised of Consolidated Bank Debt Securities and Other Bonds. The average maturity structure of its debt obligations outstanding is 1.6 years, with an average interest rate of 5.89 percent.

The current maximum permissible amount of FCS System-wide Medium-Term Notes was increased to $40 billion. The limitation for System-wide Discount Notes is $25 billion. These limits are subject to change by the Funding Corporation with the approval of the Farm Credit Administration.

In 1997, the aggregate issuance of debt was nearly $247 billion – a $15 billion decrease over 1996 issuances. The majority of debt issuances (almost $193 billion) was in the form of System-wide Discount Notes. The average maturity structure of system discount notes was 27 days.

This heavy reliance on discount notes reflects an aggressive financing strategy on the part of the FCS. This financing strategy has increased the exposure of the Farm Credit System to interest rate risk and liquidity risk.

Capital

Since the beginning of the decade, the FCS has steadily built its capital. Between 1991 and 1997, the accumulated combined capital of the FCS has grown at an annualized rate of more than 12 percent. In 1997, the FCS added $1 billion to its capital, pushing its capital-to-asset ratio to 14.8 percent as compared to 14.1 percent as of year-end 1996.

There are two ways for FCS lenders to raise capital: mandated capital investments by borrowers and retained earnings. By law, borrowers are required to invest in capital stock or participation certificates of the local Associations, the Agricultural Credit Bank, or the Bank for Cooperatives through which the loan is originated. The minimum capital investment required is 2 percent of the loan or $1,000, whichever is less. However, the primary means of building capital has been through retained earnings of the System. As of December 1997, surplus as a percentage of total FCS capital equaled 72 percent compared to 68 percent as of year-end 1995.

All FCS institutions were in compliance with the regulatory capital standards except for one Bank and one Association, which did not meet the minimum core surplus ratio requirement.[9] The capital-to-asset ratio for the Farm Credit Banks was 8.3 percent, while the local credit associations' capital ratio stood at 18.2 percent.

Asset/Liability Management

As of year-end 1996, the gap position

[8] This follows increases of 22 percent and 48 percent in 1996 and 1995, respectively.

[9] The core surplus ratio is 3.5 percent of risk adjusted assets.

(difference in the repricing interval between earning assets and interest-bearing liabilities) was positive for all repricing intervals except for 6 months to 1 year. The cumulative gap position was a positive $11.8 billion, or 15 percent, of all earning assets. Typically, a positive gap position will favorably affect earnings in a rising interest rate environment and will negatively affect earnings in a declining interest rate environment. To limit its interest rate risk exposure, the FCS uses derivatives – primarily interest rate swaps.

Consolidated Income Statement

Net Interest Income

Despite tight interest rate spreads in 1997, net interest income of the Farm Credit System increased by $29 million in 1996 to $2.2 billion. This growth was the result of an increase in the volume of interest earning assets and the greater use of capital – which the Farm Credit System refers to as "interest-free funds" – to fund their loan portfolios, which held down the cost of funds. Between 1996 and 1997, increased earning assets added $93 million to net interest income, while narrower spreads reduced net interest income by $64 million. The use of "interest-free funds" (capital) increased from $7.7 billion in 1993 to $11.2 billion in 1997.

Non-interest Income

Non-interest income grew over $38 million from $203 million at year-end 1996 to $241 million at year-end 1997. The increase in non-interest income stems from increases in (1) loan related fee income, (2) gains from the sale of Farmer Mac stock by FCBs, and (3) income earned on Farm Credit System Insurance Fund investments.[10]

Operating Expenses

Operating expenses increased 5.4 percent to $892 million as of year-end 1997. The increase in operating costs was associated with strategic initiatives to improve the development, marketing and delivery of financial services and credit products; and growth in employee benefits and salaries. The efficiency ratio was 37 percent in 1997, compared to 36 percent for 1996.

Income Taxes

The FCS does pay state, local, and federal income taxes. The FCS provision for state, local, and federal income taxes was $186 million for the year ending Dec. 31, 1997. The level of provision for income taxes increased $12 million compared to Dec. 31, 1996, levels. Provisions for income taxes were $174 million and $137 million for 1996 and 1995, respectively.

The effective income tax rate – combined local, state, and federal income taxes divided by earnings before taxes – has increased from 10.4 percent for 1995 to 12.8 percent for 1997.

Production Credit Associations of the FCS contend that, as federal instrumentalities, their income is exempt from taxation at the state and local levels. The Eighth U.S. Circuit Court agreed. The case was appealed to the Supreme Court of the United States, which reversed the lower court.

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[10] The growth in Insurance Fund investment earnings is attributable to the increased level of assets in the Insurance Fund.

Conclusion

The Farm Credit System has rebounded from its credit problems of the 1980s. Its Government-Sponsored Enterprise status, which allows it to access funds at near-Treasury rates, and its tax status give it a tremendous advantage over private sector direct retail lending institutions. The financial health and funding advantage has prompted an aggressive grab at market share by the Farm Credit System, and the System is well-positioned to continue its advantageous expansion of credit to rural America. jal

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