Bert Ely's

Farm Credit Watch

Shedding Light on the Farm Credit System, America's Least Known GSE

Stockholder Discipline in the FCS is a Bad Joke

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by Bert Ely

(Editor's Note: Bert Ely's Farm Credit Watch *is a monthly report that is available in the "Members Only" section on the ABA Web Site (www.aba.com). The following two articles are the most recent installments.*

To keep Journal of Agricultural Lending *readers up to date on Mr. Ely's comments, we will publish all his columns that appear between publication dates. Mr. Ely welcomes information about the Farm Credit System in your area and can be reached at (703) 836-4101 or by e-mail at* ***bert@ely-co.com.)***

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In the July issue of Farm Credit Watch, I reported on a dramatic shift in philosophy adopted by the Farm Credit Administration (FCA) on July 14. Briefly, the FCA Board stated that it intends to promote competition among Farm Credit System (FCS) institutions, a sharp break with its general practice over eight decades of authorizing exclusive lending territories for FCS lenders. The FCA refuses to post the statement of its controversial new philosophy on its Web site, so I have posted it at my Web site at http://www.ely-co.com/fca-ps73.pdf. I encourage you to read it.

Increased competition among FCS associations, which will certainly lead to further consolidation within the FCS, should heighten concerns regarding financial oversight within the FCS since FCS institutions, as enterprises sponsored by the federal government, ultimately are playing with taxpayer dollars. Specifically, who can ensure that FCS institutions, in trying to beat each other's brains out, will not take undue risk with taxpayer funds? What type of data would one rely upon in monitoring FCS associations? As I discuss below, monitoring financial conditions within the FCS, as distinguished from the FCS as a whole, is extremely difficult because of insufficient public information and the substantial amount of cross-ownership that exists within the FCS. In effect, at the association level, the FCS is much less transparent than the commercial banking industry is at the individual bank level. It is this lack of transparency at the association level which creates a serious public policy concern.

In genuine stockholder-owned businesses, such as commercial banks, there is true stockholder discipline. Specifically, bank stock can be bought and sold in the secondary market so that individual stockholders can sell an ownership position or, alternatively, accumulate a large ownership position, and the votes that go with it, in order to take control of a bank. FCS institutions, however, are cooperatives; as such, one becomes a stockholder only by also borrowing from the institution. Since each stockholder/borrower has just one nontransferable vote, there effectively is no market for the control of an FCS institution.

FCS borrowers supposedly have a financial incentive to monitor their institution since they must "invest" in the FCS institution from which they borrow the *lesser* of a percentage of the amount borrowed, generally the statutory minimum of 2 percent, or a fixed sum, often just $1,000. Further, this "investment" is deducted from the loan proceeds and therefore does not require a cash outlay. For example, a farmer borrowing $200,000 will receive cash proceeds of as much as $199,000. Consequently, losing $1,000 if a borrower's FCS institution goes bust will effectively raise the interest rate on a 15-year real estate loan by 8 basis points over the life of the loan. That is hardly an interest rate differential to get excited about, which is why the notion of borrower/stockholder discipline within the FCS is a bad joke.

Directors of an FCS institution presumably have a greater incentive to monitor its health since they usually receive a director's fee. However, as FCS institutions consolidate, thereby operating over increasingly larger territories, the ability of part-time directors to oversee an aggressive management team becomes increasingly questionable, particularly since there is no significant reward for being a diligent director or borrower/stockholder.

Presumably the financial markets, which currently are lending about $63 billion to the FCS, should provide critical oversight for the FCS, but because FCS borrowings are joint and several obligations of the eight FCS banks, the financial markets do not have much incentive to monitor the financial health of the individual FCS banks or the associations borrowing from the banks. The financial markets also take comfort in the implicit federal guarantee of FCS debt, which the 1987 bailout of the FCS vividly demonstrated, and in the AAA-rating that both Moody's and S&P have assigned to FCS debt. Unfortunately, as history has shown, AAA ratings cannot always be relied upon since the rating agencies are sometimes slow to detect a decline in the creditworthiness of an organization.

Even if market analysts wanted to probe the financial condition of individual FCS lenders, they would find it a very difficult task. Despite the availability of quarterly call report information on the individual associations, the call report data provide no breakdown of total loans and non-performing loans by type of loan (real estate, non-real estate, lease, etc.) or the lender's commodity concentrations (corn, cattle, potatoes, etc.). The FCA collects this information through its Loan Account Reporting System (LARS), but does not make it publicly available.

Further complicating the ability of outsiders to evaluate the financial condition of an FCS lender is the double counting of capital which exists within the FCS. This double counting occurs for two reasons. First, FCS associations buy stock in the FCS bank from which they obtain funding. Second, when an association participates in a loan originated by another association, the originating association buys stock in the association buying the loan participation. In both cases, capital is counted twice, once by the investing institution and again by the institution receiving the investment.

The double-counting of capital within the FCS is not insignificant — it totaled $2.9 billion at the end of 1997, almost 22 percent of the total capital reported by FCS banks and associations. When I asked the FCA how to eliminate this double count when evaluating the financial condition of individual FCS lenders, I was told that the elimination process is too complex to be based on call report data. Once again, the FCS is a black box to all but a few insiders who do not necessarily have the taxpayers' interest in mind.

Due to the joint-and-several liability of its eight banks, the FCS is often viewed as one entity; that certainly is the thrust of its financial reporting. Yet the FCS is composed of widely varied lenders who are on the verge of becoming competitors, and bigger ones at that, if the FCA sticks to its new philosophy. As FCS lenders consolidate and begin to claw away at each other, it will become increasingly important for outsiders to monitor the financial health of these lenders since history teaches that the FCA cannot be relied upon to do that job. jal