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Farm Credit System Performance 1998

by Keith Leggett

Despite extremely low commodity prices and increased financial stress to the farm sector, the Farm Credit System (FCS) posted a strong performance in 1998. The Farm Credit System remains profitable and has strong capital adequacy. A few specific FCS institutions reported an erosion in credit quality, but overall, the numbers are not troubling. The system accounted for 32.5 percent of all new farm lending in 1998 and had a market share of almost 26 percent, according to the United States Department of Agriculture.

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. Even though FCS debt instruments are not backed by the full faith and credit of the United States, investors assume that the government will protect them in the event of financial difficulty because of the System's GSE status. This enables the FCS to raise funds at rates close to Treasury securities – a substantial competitive advantage over any private sector firm. The funds raised by the System are channeled to a network of 197 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 In-*

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surance 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 (197 Farm Credit System Banks)*

– Six Farm Credit Banks and their 189 local associates (comprised of 39 Federal Land Bank Associations, 63 Production Credit Associations, 54 Agricultural Credit Associations, and 33 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 borrow ers; 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 1998, the number of organizations within the System declined by almost 42 percent, and 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.

Farm Credit System lenders have historically been restricted to lending to a specific geographic territory – thereby limiting geographic competition among FCS institutions. In July 1998, the board of directors of the FCA adopted a philosophy statement supporting intra-System competition. The FCA board believes that unrestricted competition among System institutions will benefit eligible farm borrowers.

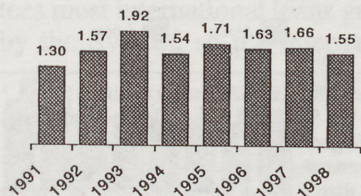
In November 1998, the FCA published a proposed rule to implement the policy change with respect to chartered territories of FCS lenders. Eligible borrowers will be allowed to obtain credit and financial services from FCS lenders of their choice – effectively eliminating territorial restrictions.

This change in philosophy will likely accelerate the consolidation of the System – creating fewer, but larger, lenders.

Consolidated Farm Credit System Performance

The FCS reported a profit of $1.25 billion in 1998 – a decrease of $16 million from 1997. The return on average assets (ROA) was 1.55 percent in 1998, a decrease from 1.66 percent

Figure 1



Source: Federal Farm Credit Banks Funding Corporation

from 1997 (see Figure 1). This decline in ROA was due to strong growth in average assets, while higher non-interest expenses and increased provisioning for loan losses kept income constant.

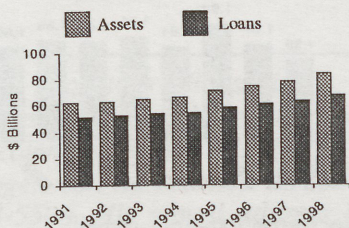
Since the beginning of 1994, net interest margins for the Farm Credit System have narrowed. The decline in net interest margins in 1998 is due to intense competitive pressures in the pricing of loans and decreased interest income recognized on non-accrual loans. Net interest margins have fallen from 3.17 percent in 1993 to 2.87 percent in 1998. Net interest margins declined 8 basis points between year-end 1997 and year-end 1998.

Consolidated Balance Sheet

Assets

As of year-end 1998, the FCS had total assets of $84.1 billion – an increase of 7.7 percent, or $6 billion, over year-end 1997 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 eight years.

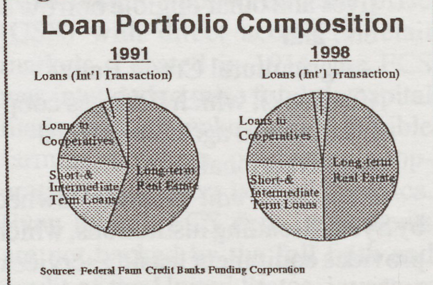
Loan volume for the FCS increased 7 percent in 1998, compared to a 2 percent average growth rate for



the years of 1992 through 1994.

The increase in the System's loan volume reflects System's institutions' improved financial conditions and ability to extend competitively priced credit. The System continues "to implement a number of measures including competitive loan programs and fixed rate pricing plans, designed to retain ... and to attract new loan volume."[1]

All six district Farm Credit Banks reported increased loan growth. Only the Bank for Cooperatives (St. Paul Bank) and CoBank, ACB reported a decrease in lending over the 12-month period ending September 1998. AgAmerica FCB reported the strongest loan growth at 11.1 percent for



the 12-month period ending September 1998.

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 49 percent in 1998 from 56 percent in 1991. However, during 1998, the dollar volume of long-term real estate loans increased 7.6 percent.

Short-and intermediate-term loans to agricultural producers increased

[1] Farm Credit System. Annual Information Statement – 1998.

from 22 percent of the total loan portfolio in 1991 to 26 percent in 1998. This category grew by $1.2 billion, or 7.2 percent, in 1998. The growth in short- and intermediate-term loans resulted from competitive loan pricing and improved marketing efforts.

Domestic loans to cooperatives grew $700 million during 1998 and currently account for 22 percent of the total loan portfolio. The growth in loan volume reflects increased lending to rural utilities in 1998. In 1991, loans to cooperatives represented 17 percent of the loan portfolio.

At year-end 1998, the notional (contractual) amount of commitments and standby letters of credit extended by Farm Credit System institutions was $24.6 billion – an increase of $3 billion from year-end 1997.

Investments and Liquidity Balances

Total balances held for liquidity – investments, cash and federal funds – equaled $14.4 billion at year-end 1998. 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.

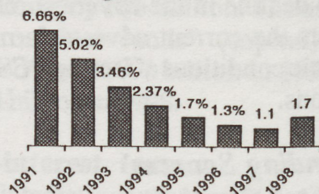
The Farm Credit System's investments grew by approximately $1.9 billion to $12.7 billion in 1998. The fact that investments grew significantly faster than loans indicates that FCS borrowed more than was necessary to support loan growth. Because of their GSE status, this means that, intended or not, the System is engaging in arbitrage.

At year-end 1998, 28.1 percent of FCS's investment portfolio had maturities of less than one year, and 77 percent of its investments were scheduled to reprice within one year. Mortgage-backed securities constituted 55 percent of its investment portfolio (up from 37 percent as of year-end 1995), 23 percent of its holdings were bankers' acceptances and certificates of deposit, 12 percent in other asset backed securities, and the remainder was held in government securities. Investments available for sale equaled $12.1 billion. Less than 5 percent of investments were classified as being held to maturity.

Asset Quality

Credit quality for the Farm Credit System decreased during 1998, but the current level does not raise concerns. The decline in FCS asset quality stems primarily from problem loans to a limited number of processing and marketing cooperatives and certain loans to the hog industry.[2]

Figure 4



The federal government guarantees most international loans granted by the System, so the international

[2] Farm Credit System. Annual Information Statement – 1998.

[3] Eighty-seven percent of the loans for international transactions are guaranteed by either the USDA's Commodity Credit Corporation or the Export-Import Bank of the United States.

credit exposure of the FCS is limited.[3]

The dollar volume of non-performing assets increased 66 percent in 1998 to $1.4 billion. As of year-end 1998, non-performing assets stood at 1.7 percent of total assets – reversing the trend of continual improvement in asset quality (see Figure 4).

Another sign of declining asset quality is the 103 percent increase in non-accrual loans in 1998 after a decline of 8 percent in 1997. Most of the erosion in credit quality came from FCS institutions with large lending exposures to cooperatives – St. Paul BC and CoBank, ACB. Both of these FCS institutions experienced a triple-digit percentage increase in non-accrual loans. In fact, the deterioration of asset quality was a major factor in the planned merger between St. Paul BC and CoBank, ACB.

Despite an increase in allowances for loan losses in 1998, the level of loan loss reserves as a percent of non-performing loans fell to 137 percent from 222 percent as of year-end 1997. The decline in the coverage ratio reflects the current adverse farm economic conditions affecting FCS institutions.

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 118 basis points in 1998. The Farm Credit System is funded primarily through the sale of System-wide Debt Securities, for which all the System banks (six 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 1998 was $68.6 billion – 81.6 percent of total assets.

In 1998, the FCS increased the level of outstanding System-wide Medium-term Notes to $33.8 billion, or 49.3 percent of its debt obligations. System-wide Bonds constitute 23.2 percent of the debt outstanding, and Discount Notes represent 26.1 percent of the debt outstanding. The remainder of the debt obligations is comprised of uninsured debt. The average maturity structure of its debt obligations outstanding is 1.8 years with an average interest rate of 5.34 percent.

The current maximum permissible amount of FCS System-wide Medium-term Notes is $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 1998, the aggregate issuance of debt was nearly $302.6 billion – a $55.7 billion increase over 1997 issuances. The majority of debt issuances (almost $241.5 billion) was in the form of System-wide Discount Notes. The average maturity structure of system discount notes was 25 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 1998, the accumulated combined capital of the FCS has grown at an annualized rate of almost 12 percent. In 1998, the FCS added $861 million to its capital. Its capital-to-asset ratio of 14.8 percent was unchanged from year-end 1997.

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 1998, surplus as a percentage of total FCS capital equaled 74 percent compared with 68 percent as of year-end 1995.

All FCS institutions were in compliance with the regulatory capital standards with the exception of one Bank and one Association, which did not meet the minimum core surplus ratio requirement. The capital-to-asset ratio for the Farm Credit Banks was 7.8 percent, while the local credit associations' capital ratio stood at 18.2 percent.

Asset/Liability Management

As of year-end 1998, the gap position (difference in the repricing interval between earning assets and interest-bearing liabilities) was positive or "asset sensitive" for all repricing intervals except for 6 months to 1 year. The cumulative gap position was a positive $12.4 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 tighter interest rate spreads in 1998, net interest income of the Farm Credit System increased by $53 million to $2.24 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 1997 and 1998, increased earning assets added $119 million to net interest income, while narrower spreads reduced net interest income by $66 million. The use of "interest-free funds" (capital) increased from $7.7 billion in 1993 to $12.4 billion in 1998.

Non-interest Income

Non-interest income grew $64 million from $241 million at year-end 1997 to $305 million at year-end 1998. The increase in non-interest income stems from increases in (1) loan related fee income, (2) one-time gain on the sales of Financial Assistance Corporation investment, (3) commissions on the sales of insurance, and (4) income earned on Farm Credit System Insurance Fund investments.[4]

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

Operating Expenses

Operating expenses increased 7 percent to $954 million as of year-end 1998. The increase in operating costs arose from the hiring and training expenditures for strategic alliances for customer research and development efforts, for the support and management of loan growth, and for upgrades in information technology systems.The efficiency ratio was 37.4 percent in 1998, compared with 36 percent for 1996.

Income Taxes

The FCS does pay local, state and federal income taxes. The FCS provision for income taxes was $180 million 1998, $6 million less than in 1997. The effective income tax rate – combined local, state, and federal income taxes divided by earnings before taxes – increased from 10.4 percent in 1995 to 13.6 percent in 1998.

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, gives the FCS a tremendous advantage over private sector direct retail lending institutions. The System's current financial health and its GSE funding advantage make it a formidable competitor to private lenders in rural America. jal