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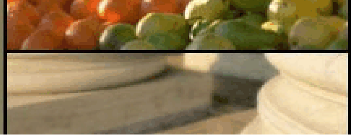

University of Arkansas
System Division of Agriculture
NatAgLaw@uark.edu | (479) 575-7646

An Agricultural Law Research Article

Policy Considerations Related to Further Intervention in the Farm Credit System

by

Neil E. Harl

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Invited Papers

Policy Considerations Related to Further Intervention in the Farm Credit System

Neil E. Harl

The Farm Credit System is a major participant in extending credit to and brokering losses from the agricultural sector during the current adjustment process. This article focuses on the problems faced by the system as a cooperative lender with relatively little diversity in its loan portfolio. Assistance to the system should be accompanied by organizational and structural changes that address the fundamental reasons for its vulnerability. Conditions suggest three basic choices: (1) preservation of the system in recognizable form, (2) decentralization to the district level, or (3) a shift toward a wholesaling function. One realistic alternative would involve a combination of these approaches.

The nature of the debt crisis in agriculture, one of the two major problems facing the sector (Harl 1986b), ensures that the near-term financial travail cannot be solved by farm commodity programs alone, even if price support programs are continued at present levels. Additional programs, on a targeted basis, will be necessary if agriculture is to be made stable in the near term. Relative stability for agriculture slows the adjustment process to levels at which land and machinery transfers can be realistically absorbed by the markets. Time and income buoyancy are needed for the necessary debt and asset adjustment to be carried out in a rational manner.

The Farm Credit System, as a cooperative lender, is a major participant in the delicate but vital process of extending credit to and brokering losses from the agricultural sector enduring this massive adjustment process. This article focuses attention on the problems faced by the Farm Credit System as a cooperative lender with relatively little diversity in its loan portfolio.

Scope of the Problem

Fundamental to an understanding of the farm debt phenomenon is that it is a systems problem, not merely a problem of borrower instability. The

Neil E. Harl is Charles F. Curtiss Distinguished Professor in Agriculture and professor of economics, Iowa State University. He is a member of the Iowa Bar.

problem is one of lender instability, vendor instability, and even instability of rural communities (see U.S. Congress; U.S. Department of Agriculture 1986b). Thus the proper characterization of the sector in the 1980s has been one of substantial economic stress. For the Farm Credit System, the relevant challenges are: (1) near-term survival and (2) longer-term restructuring to reduce the risk of system difficulty during the next period of comparable economic stress.

The data make it abundantly clear that enough assets and debt are held by farmers who are unstable economically to ensure that further weakness in land and machinery values (below 1987 levels) may occur if: (1) farm incomes fall significantly, (2) real interest rates for agricultural lending rise significantly, or (3) major public sector intervention efforts are not implemented to stabilize the agricultural sector.

The impact of debtor distress on lenders has been substantial. In 1985, the Farm Credit System incurred a $2.7 billion loss, the largest one-year loss of any U.S. financial institution. The loss in 1986 was $1.9 billion. A total of 68 agricultural banks failed in 1986, out of a total of 138 failed banks. The concentration of debt among the most heavily indebted farmers indicates further deterioration of financial condition of lenders is likely. As shown in table 1, a total of almost $38 billion of debt is held by farm operators with debt-to-asset ratios above 70 percent. For operators with debt-to-asset ratios above 40 percent, the figure is more than $75 billion (U.S. Department of Agriculture 1986b, table 10).

- Commercial banks hold about 27 percent of operator debt (table 2), but almost 61 percent of those loans are held by operators above a 40 percent debt-to-asset ratio. Just under 14 percent of their debt is owed by insolvent farmers (those with debt-to-asset ratios over 100 percent).

Table 1.—Debt Owed by Farm Operators, January 1, 1986

Lender	Debt-to-Asset Ratio				
	0–40%	41–70%	71–100%	Over 100%	Total
	Million Dollars				
Commercial Banks	12,007	10,508	4,284	4,263	31,062
Federal Land Banks	8,164	8,936	5,380	2,663	25,142
Farmers Home Administration	2,626	4,833	3,538	6,035	17,082
Production Credit Associations	3,704	2,951	1,116	1,037	8,807
Commodity Credit Corporation	2,652	2,988	1,467	1,146	8,253
Merchants and Dealers	766	446	317	330	1,860
Other Farmers	386	258	410	364	1,419
Other Individuals	5,042	3,950	2,092	1,544	12,628
Others	2,847	2,378	1,089	823	7,136
All Farms	38,195	37,248	19,692	18,205	113,389[a]

Source: U.S. Department of Agriculture 1986b, table 10, p. 22.
[a]This figure is about $92 billion less than published in the U.S. Department of Agriculture farm sector balance sheet, with about $39 billion in "unexplained differences" (pp. 31–33).

Table 2.—Distribution of Debt Owed by Farm Operators, January 1, 1986

Lender	Share of Total Operator Loans	Share of Loan Portfolio Owed by Operators With Debt-to-Asset Ratios Over 40%	Share of Loan Portfolio Owed by Operators With Debt-to-Asset Ratios Over 100%
		Percent	
Commercial Banks	27	61	14
Federal Land Banks	22	68	11
Farmers Home Administration	15	84	35
Production Credit Associations	8	58	12
Commodity Credit Corporation	7	68	14
Merchants and Dealers	2	59	18
Others Farmers	1	73	26
Other Individuals	11	60	12
Others	6	60	12

Source: Computed from table 1.

- Federal Land Banks, with 22 percent of operator debt, have 68 percent held by operators above the 40 percent line. About 11 percent of their debt is owed by insolvent farmers.
- The Farmers Home Administration (FmHA), holding 15 percent of the debt, has 84 percent concentrated in the hands of operators with debt-to-asset ratios above 40 percent. More than 35 percent of the debt held by FmHA is owed by insolvent farmers.
- For Production Credit Associations (PCAs), with 8 percent of the operator debt, 58 percent is held by operators with debt-to-asset ratios above 40 percent. Just under 12 percent of their debt is owed by insolvent farmers.

As loan losses have mounted, farm lenders, in their role as brokers of funds, have "socialized" the costs involved by maintaining interest rates for farm loans above normal equilibrium rates. This has been made possible by the diminished competition in rural areas among lenders as loan losses have risen. As a consequence, borrowers not in financial difficulty are paying a substantial part of the costs of those unable to pay principal and interest when due.[1]

A policy of no further intervention would have substantial negative effects. A March 1986 report of the U.S. General Accounting Office estimates that with no further intervention 21 percent of farm assets would have to be sold for restructuring purposes, 57 percent of the debt would have to be liquidated, 25 percent of farm operations would go out of business, and another 23 percent of the operators would need to sell some assets to remain in business.[2] About 7 percent of the debt would be written off.

Condition of the Farm Credit System

By 1983, when outstanding farm debt totaled $216 billion, the Farm Credit System had become the dominant farm lender. The system held nearly 32 percent of total farm debt in 1983, with Federal Land Banks holding more than 43 percent of farm real estate debt. PCAs held almost 23 percent of non–real estate debt before experiencing a decline in 1982 (Amols and Kaiser, tables 1-3). By the end of 1985, these figures had decreased substantially. PCAs held 7.5 percent of non–real estate debt while the Federal Land Banks' share of real estate lending had declined to 21 percent (U.S. Department of Agriculture 1986a, table 12).[3] At the same time, reserves of the Farm Credit System, including farmer-owned stock, had declined from $11.8 billion in 1984 (of which $6.2 billion was surplus) to $5.64 billion at the end of 1986, with system surplus totaling only $1.45 billion on December 31, 1986 (Farm Credit System).

With the weakening of the Farm Credit System, Congress responded with remedial legislation. The Farm Credit Amendments Act of 1985[4] was directed principally at reorganizing the Farm Credit Administration into the role of effective regulator, providing for the pooling of reserves within the Farm Credit System, and opening a line of credit at the U.S. Treasury. Under the legislation, the secretary of treasury is authorized to purchase Farm Credit System Capital Corporation obligations with funds appropriated for that purpose by Congress as a means of providing additional funds for the Farm Credit System when the system is unable, through its own resources and the Capital Corporation, to furnish adequate funds to provide credit for its borrowers.[5] Before the secretary of treasury may purchase Capital Corporation obligations, the Farm Credit Administration must certify to the secretary of treasury and Congress that: (1) the Farm Credit System needs financial assistance, (2) the system has committed its available capital surplus and reserves, (3) salaries and benefits of senior officers of the system (except associations) are frozen for the earlier of five years or until the secretary no longer holds Capital Corporation securities, and (4) the system has used its capital to the extent that further contributions from or losses by the system would preclude its institutions from making credit available to eligible borrowers on reasonable terms.[6]

In terms of stabilizing agriculture, the legislation was believed by its backers at the time of enactment to be sufficient to keep the Farm Credit System afloat but afforded little hope of significant trickle-down benefits to borrowers. Had the act been generous enough to benefit borrowers directly, it would have created serious problems of whipsawing agricultural lending by providing benefits for one group of borrowers over another group similarly situated except for the identity of their lender. Such an outcome would, over time, be expected to shift agricultural lending into the hands of lenders with access to the program of intervention and away from lenders denied that access.

Additional legislation enacted late in the 1986 congressional session provided authority for the Farm Credit System to spread losses over as much as 20 years. That was designed to give the system more time before federal assistance would be required. Under the legislation, with the approval of the Farm Credit Administration, beginning July 1, 1986, and running through December 31, 1988, the institutions of the Farm Credit

System may annually capitalize their losses in excess of 0.5 percent of loans outstanding and amortize the amount over a period not to exceed 20 years.[7] In addition, through December 31, 1988, the banks of the Farm Credit System may spread the costs involved in refinancing high-interest noncallable obligations over a maximum of 20 years.[8] In the same legislation, the required approval of the Farm Credit Administration of interest rates charged by the system was terminated.[9]

Possible Federal Intervention

Continued massive losses in the Farm Credit System through the first quarter of 1987 and the strong likelihood of losses continuing at a high rate make additional federal intervention inevitable. Some time during 1987, the system is expected to approach the end of capital reserves and reach the point of system instability. Assistance before the end of 1987 will be needed if system failure is to be avoided. Joint and several liability for obligations of the system, which have been issued on a consolidated systemwide basis, has ensured that the system would respond in support of weaker districts.[10] However, a 1987 U.S. District Court decision has held invalid regulations requiring stronger districts to respond with financial contributions to weaker districts.[11]

Need for Structural Change

Assistance rendered to the Farm Credit System should be accompanied by organizational and structural changes that address the fundamental reasons for vulnerability of the system. Unless inherent system vulnerability is addressed, problems of system instability will recur.

Concern about system vulnerability is not new. A 1952 report prepared by a committee chaired by a former governor of the Farm Credit Administration focused on the problem of PCAs sharing the risks of losses on large loans (Hill et al.).[12] The governor of the Farm Credit Administration, who had appointed the committee, had tried unsuccessfully to win support for changes to better enable the PCAs to weather economic adversity. In its report, the committee stated that

> aside from the Government revolving fund, the production credit associations have no way of sharing risks nor recourse to any comparable assistance in times of stress. Under the present structure, each production credit association stands alone with respect to the risks of outstanding loans; there is no way now of spreading an association's risks beyond the limits of its territory. Because of the possibility of conditions which may be beyond the control of the borrowers or the association arising in a particular territory, it is evident that individual associations could find themselves in an adverse financial condition beyond their ability to cope with. (p. ii)

In a letter to committee member W. G. Murray, the governor, I. W. Duggan, who by that time had left the Farm Credit Administration, stated, "Your very nice letter brought forcibly to my mind the fact that I had completely failed in making any progress in developing a program for operating the risks among PCA's. In fact, I even failed to convince those in

the Production Credit System that they had any problems. *Possibly, they will have to go through a wringing out process before they realize the situation* [emphasis added]. . . ."[13] In 1966, the Federal Farm Credit Board approved risk-sharing plans in eight farm credit districts (Hoag, p. 159).

If the Farm Credit System is to survive in recognizable form with both a wholesaling and retailing function in farm credit, four problem areas should be addressed. Unless the system is reconfigured to reflect solutions to the four problems, financial difficulties will almost inevitably recur.

Diversity of Loan Portfolio

One of the most important reasons, if not the most important reason, for the financial difficulties encountered by the Farm Credit System in the 1980s is lack of diversity in the system's loan portfolio. Except for loans to farmer cooperatives, the system lends principally for agricultural purposes and takes as collateral principally agricultural property. Moreover, loans to farmer cooperatives add relatively little diversity inasmuch as the fortunes of farmer cooperatives tend to parallel the fortunes of their farmer members. Diversity can be achieved in various ways:

Geographical Diversity

Diversity based on geography has existed since the Farm Credit System was established[14] and is particularly important in terms of withstanding economic adversity related to weather, other natural disasters, and localized price and income phenomena. In the 1980s, geographical diversity was initially helpful in enabling the system to withstand the effects of the general economic downturn, the epicenter of which was in the Upper Midwest (U.S. Department of Agriculture 1986b, appendix tables 8 and 12). As shown in table 3, the financial problems of borrowers have been most severe in the Corn Belt, Lake States, and Northern Plains.

Horizontal Diversity

Diversity could be achieved by lending to borrowers whose economic fortunes are unrelated to agriculture. Moving to such diversity would alter the basic nature of the Farm Credit System and would make the system virtually indistinguishable in mission from other large, diversified lenders.

Utilizing a secondary market for agricultural loans would be another dimension of horizontal diversity. Under the assumption that investors in a secondary market are unlikely to shoulder losses very long before withdrawing from the market, a question is raised, however, about the extent to which a secondary market can be counted upon to absorb losses when the agricultural sector is under severe financial pressure as at present. Clearly an effective secondary market would require government guarantees, capital reserves, or both to ensure that investor losses were consistent with investor expectations.

Vertical Diversity

Diversity could be achieved by lending to greater segments of the input supplying and output processing components of the agricultural sector.

Table 3.—Distribution of Farms and Debt by Debt-to-Asset Ratio for Regions of the United States, January 1, 1986

	Debt-to-Asset Ratio					
	41–70%		71–100%		Over 100%	
Region	Farms	Debt	Farms	Debt	Farms	Debt
			Percent			
Northeast	9.3	27.3	3.3	23.3	1.4	9.1
Lake States	19.1	35.2	7.3	37.8	6.4	18.9
Corn Belt	15.6	35.7	5.6	37.1	5.1	16.7
Northern Plains	17.6	34.0	8.8	40.1	6.8	19.8
Appalachia	6.7	23.0	1.1	25.6	1.5	13.7
Southeast	9.8	37.8	3.4	28.7	2.6	15.3
Delta States	7.7	29.0	3.0	41.8	5.8	28.6
Southern Plains	9.0	25.4	3.2	26.8	3.0	15.9
Mountain States	16.0	36.4	4.9	24.6	2.9	9.8
Pacific States	10.5	31.8	4.0	30.2	2.1	10.7
United States	12.7	[a]	4.6	[a]	4.0	[a]

Source: U.S. Department of Agriculture 1986b, appendix tables 8 and 12, pp. 41 and 44.
[a]Not applicable.

Such diversity would be less valuable than horizontal diversity because of the tendency for some segments of input supply and output processing to move in tandem with farming in terms of economic health. To a degree, the Farm Credit System has a measure of vertical diversity with loans to farm input supplying and output processing firms. The relatively more favorable performance levels of the Banks for Cooperatives in the 1980s compared with Federal Land Banks and Federal Intermediate Credit Banks attest to the value of diversity, even vertical diversity.

Functional Diversity

Broadening the system's line of products beyond loans would add functional diversity. Diversification into insurance, real estate, brokerage, and other financial services could provide such diversity. Long-range plans developed by the Farm Credit System earlier in this decade would have brought a modicum of functional diversity. A relevant question to ask is whether there is adequate justification for governmentally assisted creation of another large financial conglomerate.

Time Diversity

Diversity over time could be achieved by building capital reserves in good economic times with the realization that the reserves will be utilized in times of economic adversity for borrowers. This is essentially the diversity option used by the system through the mid-1980s, but without sufficient reserves to enable the system to survive the unusually severe downturn.

Accordingly, the system was obliged to arrange for external assistance from the federal government in late 1985.[15]

If time diversity is once again relied upon in the decades following the 1980s, a greater premium will need to be exacted from borrowers in good economic times than was exacted in the period before the 1980s. This of course creates a competitive disadvantage compared with lenders able to achieve diversity of loan portfolio other than on a time basis. A mandatory lender indemnity program funded by all agricultural borrowers would resolve the problem of competitive effect. If not imposed on all lenders, the question is whether the unique features of the Farm Credit System, notably agency status, provide a sufficiently large advantage to offset the competitive disadvantage inherent in accumulating additional capital reserves during favorable economic times.

Protection for Bonds

With most lenders highly leveraged, the onset of economic or financial adversity means that those supplying funds to troubled lenders are likely to become increasingly reluctant to provide capital on a continuing basis. For commercial banks, Federal Deposit Insurance Corporation (FDIC) protection for depositors acts to ease depositor concerns and prevent "runs" on banks that were common before enactment of legislation creating the FDIC in 1933.[16]

For the Farm Credit System, agency status (Hoag, chap. 6) has enabled the system to weather minor crises and obtain funds near the cost of U.S. Treasury borrowing [17] but was ineffective in allaying investor concerns in late 1985 before enactment of legislation ensuring a procedure for seeking direct federal assistance if needed.[18] The cost of system borrowing soared to some 150 basis points above U.S. Treasury borrowings in contrast to the usual 8 to 10 point spread.

If the Farm Credit System is to survive with funds obtained in the money markets, attention should be given to providing protection for bondholders. Consideration should be given to creating FDIC-type coverage for the system in any package of measures for restructuring the Farm Credit System for survival. The experience of the 1980s has demonstrated conclusively that a plan of accumulating reserve funds throughout the system but with later levy on those reserves held by the stronger banks to assist those who are less strong is a certain prescription for strong dissent. Accumulating funds under an FDIC-type arrangement, perhaps as a small proportion of funds obtained through the placement of securities by the fiscal agency, would seem to be a superior solution. The role of an FDIC-type fund for the Farm Credit System, as with the role of the FDIC, would be to provide protection to the financial system by maintaining investor losses within the range of investor expectations rather than to provide protection for the contributors of equity capital.

Adequacy of Capital

It is axiomatic that any lender needs an adequate capital base to withstand loan losses. The Farm Credit System has functioned with an unusual capital arrangement. Borrowers from the Farm Credit System have been

required to purchase stock in the system equal to 5 or 10 percent of the loan. The borrower thus received 90 to 95 percent of the loan with the other 5 to 10 percent retained as stock in the system. By contrast, the Banks for Cooperatives have functioned with real money capital, adjusted each year with cash paid into the bank by borrowers to maintain the required stock base.

Plans for a reconfigured Farm Credit System must give attention to a capital base adequate for the risks and economic shocks likely to be inflicted upon the system. A system of capital generated by farmer loans is simply too fragile to endure in times of extreme economic adversity.

One possibility, of course, is to downplay the importance of a capital base with loan losses absorbed through higher interest rates or lower levels of net worth (or greater levels of negative net worth) in periods of adversity. A disciplined approach to lending and financial institution management would suggest that a system based on capital at risk by decision makers is superior to a system where the shocks of adversity are transmitted directly to taxpayers generally.

Monitoring of Borrower Condition

A major reason why the Farm Credit System was blindsided by the economic problems of the 1980s was lack of awareness of the economic difficulties faced by its borrowers. This was particularly true of the Federal Land Banks. Relatively little attention was given to the changing economic condition of its member-borrowers. Thus the system was both unprepared and unbelieving when adversity surfaced in the 1980s.

Fundamental as it may seem, an important part of effective loan management is monitoring the changing economic condition of borrowers. The system should be far more aggressive in maintaining that level of surveillance and more responsive in developing strategies to deal with borrower travail. In the economic downturn of the 1980s, the Farm Credit System initially gained the dubious distinction of being the least responsive of major lenders in terms of willingness to restructure loans.

Intervention Alternatives

The roots of member-borrower control of the Farm Credit System run deep. The Federal Farm Loan Act of 1916 provided for member-borrower control of local National Farm Loan Associations and the election of members of boards of directors of the Federal Land Banks by the representatives of the farmers—local boards of directors.[19] The concept of farmer control continued through subsequent legislation, including the Farm Credit Act of 1971.[20] Control of the Farm Credit System is in the hands of its member-borrowers—farmers and ranchers. Member-borrowers elect local boards of directors to make policies for their cooperative and to choose and guide management and monitor its effectiveness. The local directors selected by member-borrowers also act as their representatives in choosing directors for the district Farm Credit banks.

Member-borrower control is not viewed as a major reason for system difficulties in the 1980s. Moreover, member-borrower control is not viewed as inconsistent with professional-style management at the various levels.

As a nontrivial aggregation of capital, the Farm Credit System must be managed with a high level of skill if the system is to survive.

Basic Choices

The condition of the Farm Credit System, the magnitude of the system, the relationship of units within the system, and the nature of the objectives being served suggest three basic choices in terms of remedial action: (1) preservation of the system in recognizable form, (2) decentralization of the system to the district level, or (3) a shift toward a wholesaling function for the Farm Credit System. A fourth alternative, centralization to a single decision-making unit, seems unattainable politically and practically.

System Preservation

Preservation of the system would be the most likely to meet the expectations of system borrowers and also would be the most likely to protect borrower stock in the system in the near term. Preservation of the system would ensure a competitive presence in agricultural lending and could be carried out in a manner that would strengthen borrower control. To preserve the Farm Credit System in recognizable form, massive infusions of capital or loan guarantees by the federal government would be required. The cost, in the face of continuing borrower instability, is expected to total $8 to $10 billion.

A policy issue of critical importance is whether expenditures to preserve the Farm Credit System would be the best use of public funds. In light of (1) excess lending capacity in agriculture under current conditions, (2) the likelihood of further substantial reductions in agricultural loans, (3) the weakened condition of the Farm Credit System, and (4) the central importance of borrower stability to sectoral stability, a question is raised as to other possible strategies for public intervention.

Decentralization of the System

Another alternative would be to decentralize the system to the district level with each district expected, at least in the long run, to maintain viability. Such a move would address the concerns held by some districts that assistance to weaker banks threatens their economic future. However, a district-level system would mean even less geographical diversity than at present.

To effect decentralization, it would be necessary to provide sufficient funding or guarantees to ensure that holders of system bonds were not jeopardized. Joint and several liability would be modified as to new security issues. Some districts would require external assistance in the near term or the banks in those districts would be in danger of failing. Mergers of banks and of districts would be one possible outcome, with banks permitted to operate beyond district boundaries. With this approach, each district would be left to wrestle with market forces and develop an appropriate strategy for survival and eventual rebuilding of capital.

A Wholesaling Function

As a third alternative, the Farm Credit System could be restructured into a wholesaler of credit with gradual disappearance of the retail function. The most valuable features of the system would be retained with loan guarantees used where necessary to move loans into the hands of other lenders.

Preserving the Unique Features of the System

Clearly the Farm Credit System possesses two unique and highly valuable features: (1) a long-term land lending capability[21] and (2) a highly efficient mechanism for obtaining funds in the central money markets. A convincing argument could be made for a transition of the Farm Credit System toward: (1) a central land bank serving the entire country, (2) a central bank for cooperatives, and (3) a wholesaling function for other credit needs, with funds for production credit and land loans channeled through commercial banks. With this approach, the system would recede from retail lending operations, with outstanding loans moved into the hands of commercial banks and federal loan guarantees where necessary to make the loans marketable.

Serving a function of wholesaling credit is not a new experience for the Farm Credit System. When Congress established the Federal Intermediate Credit Banks in 1923, it provided that these banks could discount farmers' notes financed by agricultural credit corporations, livestock loan companies, and commercial banks as well as make loans to cooperatives on warehouse receipts.[22]

In the Farm Credit Act of 1971,[23] Congress gave PCAs the authority to participate with local commercial banks in their larger farm and range loans. The commercial bank/Farm Credit System participation loan program is similar to an overline arrangement between a commercial bank and one of its regional correspondent banks. An agreement is signed specifying terms for the PCA to purchase a portion of larger agricultural loans from the commercial banks, normally representing amounts in excess of lending limits for individual borrowers. The primary lender continues its role, servicing the complete line of credit.

Since the Agricultural Credits Act of 1923,[24] the Farm Credit System has had authority to provide funds to commercial banks and other financial institutions. To qualify for discounting privileges, an institution must show that: (1) it is primarily engaged in the business of extending short- and intermediate-term credit to farmers, ranchers, and/or producers or harvesters of aquatic products; (2) at least 15 percent of its total loan volume is in agricultural loans at the seasonal peak; (3) it has had a gross loan-to-deposit ratio of at least 60 percent at the seasonal peak for the last three consecutive years; (4) it has limited access to national or regional money markets as an alternative source of funds and is fully utilizing locally generated funds to finance local needs; and (5) it would continue to use at least the same proportion of its resources for agricultural or aquatic lending.[25]

A transition to a wholesaling function for the Farm Credit System would mean less competition in agricultural lending and greater difficulty in

ensuring borrower control. Limitations on access of funds could be implemented by the system as a wholesaler of funds. Borrower control would be effected principally by controlling the conditions of access to funding from the Farm Credit System. One realistic approach to restructuring the system would involve a combination of approaches as discussed in the next section.

An Integrated Approach to Restructuring the Farm Credit System[26]

The rapidly deteriorating condition of the Farm Credit System ensures that assistance will be needed in 1987 if the system is to avoid financial instability. The amount, type, and timing of assistance are all critical variables in terms of the influence on long-term configuration of the system and the extent to which the problems of heavily stressed farm borrowers are addressed. To the extent that assistance is funded from amounts diverted from price and income support programs, an additional segment of borrowers is placed at risk as farm incomes decline, thus creating the need for targeted programs of intervention for borrowers. Various patterns are possible and feasible for providing assistance to the Farm Credit System. This paper discusses one set of alternatives as outlined in figure 1.

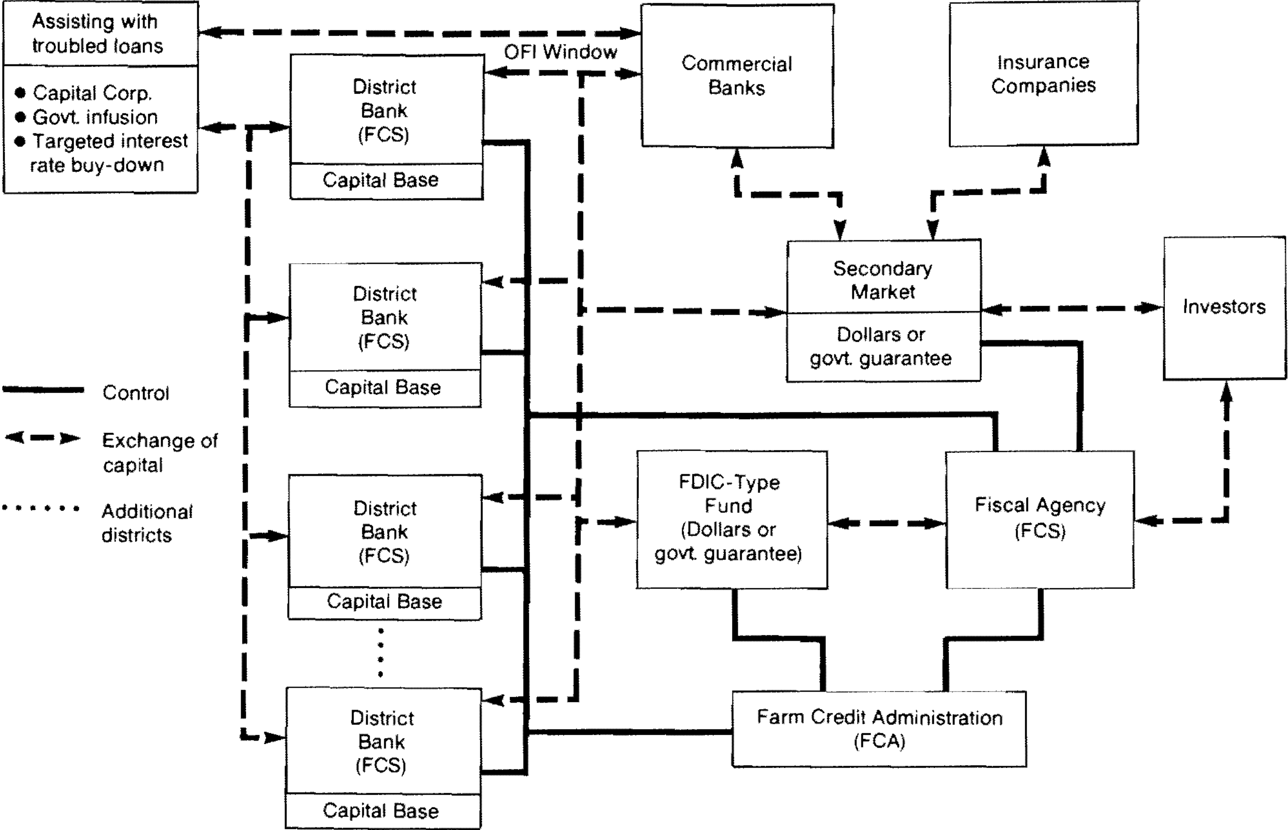
Secondary Market

The concept of a secondary market for mortgage-backed farm real estate loans would provide a number of important advantages in connecting primary mortgage lenders with final investors. Eventually a secondary market could embrace properly backed non–real estate loans as well. It is anticipated that originating lenders would retain at least a significant interest in the loan and would continue to service the loan account. It is envisioned that the secondary market would be operated within the Farm Credit System to take advantage of the system's agency status, perhaps as a subsidiary of that organization. The market would be accessible by units of the Farm Credit System, commercial banks, insurance companies, and other regulated farm lenders.

The greatest concern about the secondary market is in handling loan losses. While the strong collateral requirements for loans (with loans limited to 50 to 60 percent of collateral value) and the retained ownership of the loan by the originating lender would provide substantial assurance that investors would not suffer losses, it is almost certain that losses in periods of cyclic downturns in agriculture (similar to the 1930s and 1980s) would exceed margins. For that reason, a reserve fund should be maintained as a credit enhancer. Initially the reserve fund could be secured by an explicit government guarantee, which would be phased out as capital reserves are accumulated, based on a modest percentage of the value of loans sold in the secondary market.

To ensure responsiveness of secondary market operations to the needs of agriculture for a dependable source of credit at reasonable cost, it would be important to have farmer involvement in the control of the secondary market operation. A secondary market could fit with any configuration of a restructured Farm Credit System.

Figure 1.—Organization Chart for Proposed Restructured Farm Credit System



Decentralization of the Farm Credit System

The experience of the 1980s, as the Farm Credit System was overwhelmed with a deteriorating loan portfolio, has been that stronger districts respond in support of districts weakened by loan losses only grudgingly and with substantial resistance. Stronger districts have mounted legal challenges to the pooling of capital systemwide. It seems unwise to continue such a procedure for responding to adversity.

One feasible approach would be to decentralize the system with greater autonomy at the level of district banks. Each district bank would be viewed as a profit-and-loss and control center and would be free to expand business operations outside present district boundaries. Each district bank would be expected to rebuild and maintain an adequate capital base for bank operations.

To implement a decentralized approach, it would be necessary to modify joint and several liability for consolidated systemwide bonds and notes. In addition, ongoing assurances would be needed to ensure that investors in bonds and notes would be paid interest and principal on schedule. To handle both functions, it is envisioned that an FDIC-type fund would be created to provide such assurance. The fund would respond after district bank capital had been reduced to specified minimum levels. Initially the fund would be backed by government guarantees that would be phased out as reserve amounts (based on a percentage of loans made by district banks) reached an adequate level.

Assistance with Troubled Loans

For weaker district banks to have a reasonable opportunity to rebuild capital and to ensure farm borrowers an opportunity to become financially and economically stable, assistance in some form will be needed: (1) to lenders in restructuring farm loans or (2) to borrowers in servicing loan obligations. Indications are that the cost would be approximately the same in either case.

Three alternatives for providing the assistance seem feasible: (1) provide sufficient funding to the Capital Corporation such that troubled loans could be purchased from district banks and other farm lenders, (2) provide an infusion of limited amounts of capital from the U.S. Treasury directly to district banks as needed, or (3) implement a targeted interest buy-down program for borrowers with several times more funding than provided in the Food Security Act of 1985. The objective of the latter type of program would be to reduce the interest rate for borrowers with good management skills to approximately the rate of return on farm assets (Harl 1986a, 1986c).

Any intervention effort, whether available to lenders or borrowers, must at some point provide for determinations of which farm operations are to be liquidated, which farm operations are to be restructured, and which farm operations are to be ineligible for intervention benefits. In all instances, an "upside" eligibility test is necessary to identify operations that are capable of being or becoming economically stable without intervention assistance and a "downsize" eligibility test to identify operations incapable of becoming economically stable even with intervention assistance (Harl 1986a, 1986c).

Expanded OFI Window

To ensure adequate credit in all areas on a dependable basis at reasonable cost, it seems highly advisable to provide for unimpeded access to the "Other Financial Institutions" (OFI) window of the Farm Credit System. In all instances, commercial banks would be assured access to loanable funds as needed through issuance of Farm Credit System bonds and notes. Competition among lenders in rural areas should be enhanced as a result.

In areas where district banks were unable to rebuild capital and maintain a viable presence in agricultural lending, the Farm Credit System would become essentially a wholesaler of credit with both production credit and land loans made by commercial banks in accordance with regulations governing lenders acquiring funds through the Farm Credit System.

Long-Term Objectives

The policy considerations of paramount importance relate to the features of the agricultural lending system that will provide the sector with a dependable and stable source of reasonably priced credit over the next several decades. Certainly the institutional instability currently in evidence poses an opportunity to recast agricultural lending in a mold to better fit the realities of the next century. With very rapid growth in agricultural productivity occuring in recent years outside the United States, and with further growth in prospect, agricultural lending in the United States will likely go through a downsizing process over the next several years. With a clear prospect of substantial excess capacity in agricultural lending, the restructuring of the Farm Credit System should be carried out in a manner consistent with the realities of credit needs for agriculture.

Notes

1. Some commentators focusing only on the macro side of the farm debt crisis seem to have ignored this response by those suffering losses. See Gabriel and Prentice.
2. More recent data indicate these figures may be low. See Jolly, Doye, and Choat.
3. Preliminary figures for the end of 1986 show Federal Land Bank loans dropping to 18 percent of real estate loans outstanding.
4. Pub. L. 99-205, 99 Stat. 1678 (1985).
5. 12 U.S.C. § 2216(j), added by Pub. L. 99-205, Sec. 103, 99 Stat. 1686 (1985).
6. *Id.*, § 2216(i)(a).
7. Farm Credit Act Amendments of 1986, Sec. 1037, amending 12 U.S.C. § 2254 (b).
8. *Id.*, Sec. 1034, amending 12 U.S.C. § 2259.
9. *Id.*, Sec. 1033, amending 12 U.S.C. §§ 2015, 2075, 2131(a).
10. See 12 C.F.R. § 615.5100 (1986).
11. Federal Land Bank of Springfield v. Farm Credit Administration, Civ. 86-0214, ____ F. Supp. ____ (D. Mass. 1987).
12. The committee consisted of F. F. Hill, chair; G. H. Aull; E. L. Butz; A. R. Gaus; W. G. Murray; and R. J. Saulnier.
13. Letter dated July 22, 1953, from I. W. Duggan to William G. Murray (copy in author's files).
14. There is some evidence that the original 12 land bank districts were established to avoid "one-crop" districts (Hoag, p. 215; Wright, pp. 80–81).

15. See note 4 *supra*.
16. Banking Act of 1933, Pub. L. 73-66, 48 Stat. 162, 168 (1933).
17. Among earlier crises was the insolvency of the Spokane Federal Land Bank in 1925, with assistance provided by the other federal land banks (Sparks, p. 135). Several joint-stock land banks also failed (Sparks, pp. 163–64).
18. See note 4 *supra* and accompanying text.
19. Pub. L. 64-158, 39 Stat. 360, 362-63 (1916) (For Federal Land Banks, six of nine directors must be local directors "chosen by and . . . representative of national farm loan associations.").
20. Pub. L. 92-181, 85 Stat. 583 *et seq.* (1971), 12 U.S.C. §§ 2001-2259 ("Each Federal Land Bank association shall elect from its voting shareholders a board of directors . . . as may be required by its bylaws.").
21. The Federal Farm Loan Act of 1916, Pub. L. 64-158, 39 Stat. 360 (1916), provided for two types of banks: (1) the cooperative Federal Land Banks and (2) individual joint-stock land banks organized by private individuals for profit. The stated purposes to be served were "to provide capital for agricultural development, to create standard forms of investment based upon farm mortgages, [and] to equalize rates of interest upon farm loans. . . ." Pub. L. 64-158, 39 Stat. 360, Ch. 245 (1916).
22. Agricultural Credits Act of 1923, Pub. L. 67-503, 42 Stat. 1454 (1923).
23. Pub. L. 92-181, 85 Stat. 583 (1971).
24. Pub. L. 67-503, Sec. 1, 42 Stat. 1454 (1923).
25. 12 C.F.R. § 614.4550(a) (1986).
26. This section is drawn from testimony presented on March 26, 1987, to the Committee on Agriculture, Nutrition, and Forestry, Subcommittee on Agricultural Credit, U.S. Senate, Washington, D.C. Helpful comments from members of the Farm Credit Task Force, National Pork Producers' Council, are gratefully acknowledged.

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