

55113

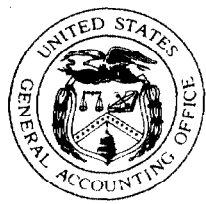
GAO

Briefing Report to Various Members of Congress

December 1985

FARM CREDIT SYSTEM

GAO's Analysis of the System's Third Quarter Financial Condition



7



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

December 23, 1985

B-220507

To Various Members of Congress

In response to Members of Congress that have requested us to monitor the financial condition of Farm Credit System (System) we are providing an assessment of its financial condition as of September 30, 1985. The Congress has passed legislation that would enable the System to obtain federal assistance subject to the appropriation process, if its own resources were not adequate to solve its financial problems.

This report updates the data contained in our October 4, 1985, report Preliminary Analysis of the Financial Condition of The Farm Credit System (GAO/GGD-86-13BR). Our analysis is prepared from data reported by System district banks to the Farm Credit Administration. We have certain concerns about the accuracy of reported System data. In our October report we extrapolated past trends to indicate what the System's financial condition might be on June 30, 1986. We have not revised those extrapolations because we are not sure whether the changes in the System's financial condition revealed by the third quarter data reflect actual third quarter experience or a recognition of problems that existed in prior periods.

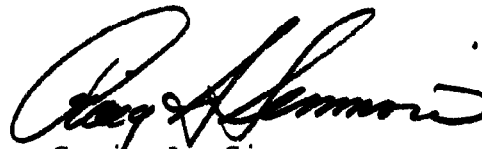
In general, the material contained in this briefing report indicates a significant deterioration in the financial condition of the System. The long-term viability of the System depends on whether the trends of growing loan losses and nonearning assets can be reversed over the relatively near term, and there is little to indicate that this will occur.

This briefing report was reviewed by officials of the Farm Credit Administration. In general, the officials did not disagree with the validity of our depiction of the System's

condition as of September 30, 1985, nor did they disagree with our projection of loans in nonaccrual status as of June 30, 1986. As they stated in their comments on our October 4, 1985, report, they were concerned about potential misinterpretations of the significance of the assumptions underlying our projections of loan reserve establishment scenarios. They believe that misinterpretation could have an adverse impact on the System's ability to fund its operations. We agree with the concerns expressed and emphasize the importance of a careful review of this briefing report.

Copies of this briefing report are being sent to the Governor of the Farm Credit Administration, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. We will also make copies available to other interested parties upon request.

If there are any questions regarding the contents of this briefing report, please call me on (202) 275-8678.

A handwritten signature in black ink, appearing to read "Craig A. Simmons". The signature is fluid and cursive, with a large initial "C" and "S".

Craig A. Simmons
Associate Director

C o n t e n t s

	<u>Page</u>
GAO'S ANALYSIS OF THE SYSTEM'S THIRD QUARTER FINANCIAL CONDITION	i
OVERVIEW	iii
Table 1: Selected consolidated financial data for the Farm Credit System	iv
PROFITABILITY	1
Figures 1-2: Return on assets	2-3
Figure 3: System provision for loan losses to average assets	5
Figures 4-5: System net operating income to average assets	7-8
Figures 6-7: System net interest margin to average assets	10-11
Figures 8-9: System operating expenses to average assets	13-14
LOAN QUALITY	15
Figure 10: Weighted System adversely classified loans and nonaccruals to average assets	16
Figure 11: Weighted System adversely classified and nonaccruals \$billions	17
ADJUSTED CAPITAL	18
Figures 12-13: System adjusted capital to average assets	19-20
Figures 14-15: System adjusted capital \$billions	22-23
Figures 16-17: System loan losses to average gross loans	25-26
Figures 18-19: System allowance for loan losses to gross loans	28-29
Figures 20-21: System allowance for loan losses to loan losses	30-31
Figures 22-23: System net operating income to loan losses	33-34
Table 2: Adjusted capital to nonaccrual loans	35
AVAILABILITY OF FUNDS	36
Table 3: Comparison of FCS and U.S. Treasury intermediate and long-term bond yield rates	37-38
Table 4: Comparison of FCS and U.S. Treasury short-term bond yield rates	39
Table 5: Farm Credit System funding	40
CUSTOMER BASE	41
Figures 24-25: System gross loans \$billions	42-43



GAO'S ANALYSIS OF THE SYSTEM'S THIRD QUARTER
FINANCIAL CONDITION

This document supplements and updates the data contained in our October 4, 1985, report, Preliminary Analysis of the Financial Condition of the Farm Credit System (GAO/GGD-86-13BR). In that report, we portrayed trends in the financial condition of the Farm Credit System (System) from January 1, 1979, to June 30, 1985, analyzed the financial condition of the System as of June 30, 1985, and projected what the condition of the System might be on June 30, 1986, if the past trends continue.

In this document we analyze the System's third quarter financial performance and show how that performance relates to our previous projections of the System's June 30, 1986, condition. In our October report we pointed out the limitations of our extrapolations and our concerns about the quality of data being reported to the Farm Credit Administration. We have not revised the June 30, 1986, projections to reflect third quarter figures because we can not tell from the data whether there was a significant change in the System's condition from June 30, 1985, to September 30, 1985, or whether the data reflect a more accurate reporting of the System's financial condition prior to June 30, 1985.

For purposes of assessing the overall financial condition of the System, we have combined the financial data for the banks and associations that comprise the entire System.¹ We have made adjustments for inter-system accounts. Our analysis assumes that the individual banks and associations are, in effect, one large consolidated institution and that funds can be applied where needed. This assumption is based in part on regulations, which were approved on September 4, 1985, that enable the Governor of the Farm Credit Administration (FCA) to transfer funds among System institutions to assist troubled System institutions.

¹Federal land bank associations do not report financial data to the Farm Credit Administration (FCA) on a quarterly basis. To construct third quarter consolidated financial data for the System, we have included estimated data on the federal land bank associations for the 12 months ending September 30, 1985. We estimated the data by using historical relationships and inter-system items that appear on the federal land bank balance sheet or income statement. We have, however, made one major adjustment to these data. In some districts the federal land banks and their associations share in the chargeoffs of bad loans. We, therefore, extrapolated what the associations' chargeoffs and allowance for loan losses would be at September 30, 1985 based on the ratios that existed at June 30, 1985 between the banks and their associations.

Consistent with the methodology in our October 4, 1985, report, to facilitate comparative analysis, all income and expense data have been annualized unless otherwise stated. This means that the income and expense data shown for the second and third quarters are for the 12-month periods ending June 30, 1985, and September 30, 1985, respectively.

OVERVIEW

The third quarter financial data reflect a significant decline in the profitability of the System and a significant deterioration in the quality of its loan portfolio since June 30, 1985. However, it is not clear whether the data accurately reflect the current rate of deterioration or whether recognition of past reporting inaccuracies are distorting the results. If the reported data accurately reflect the third quarter experience of the System, the trends raise concerns for the future viability of the System.

The fundamental change that occurred during the third quarter, as reflected in the reported financial data, is the level of deterioration in the quality of the loan portfolio. On June 30, 1985, nonaccrual² and weighted adversely classified loans³ were 3.2 and 7.5 percent of total loans, respectively. By September 30, 1985, nonaccrual and weighted adversely classified loans had increased to 5.6 and 9.3 percent of total loans, respectively. The amount of bad loans charged off during the 12-month period ending June 30, 1985, was \$0.7 billion compared to \$0.9 billion for the 12-month period ending September 30, 1985.

The deterioration in loan quality appears to have been a major factor in the System's having a \$0.8 billion loss for the 12-month period ending September 30, 1985. While several factors influenced third quarter earnings, the large provision for loan losses had the greatest effect. The large chargeoff of bad loans combined with the net operating loss resulted in the System's earned surplus decreasing by nearly \$1 billion in the 3-month period. Moreover, the System's net losses and reduction in earned surplus would have been larger had the institutions maintained the allowance for loan losses account at the same level as the ratio of allowance to nonaccrual loans that existed at June 30, 1985.

To a lesser extent, the System's profitability was adversely affected by the loss of interest income associated with the increased amount of nonaccrual loans and by the increased risk premium that investors are now requiring on System securities.

²Nonaccrual loans are those on which interest accruals are no longer being recorded because they are not considered fully collectible.

³Loans that are not fully acceptable are adversely classified into three different categories depending on the severity of the weaknesses in the loan. We weighted the adversely classified loans as follows: 20 percent of problem loans, 50 percent of vulnerable loss, and 100 percent of loss loans.

In table 1 we present some selected consolidated financial data for the System.

Table 1: Selected Consolidated Financial
Data for the Farm Credit System

Gross Loans	(Billions)
December 31, 1984 (actual)	\$83.5
June 30, 1985 (actual)	80.4
September 30, 1985 (actual)	77.6
June 30, 1986 (extrapolated)	75.2
Nonaccrual Loans	
December 31, 1984 (actual)	1.8
June 30, 1985 (actual)	2.6
September 30, 1985 (actual)	4.3
June 30, 1986 (extrapolated)	6.1
Allowance for Loan Losses	
December 31, 1984 (actual)	1.3
June 30, 1985 (actual)	1.2
September 30, 1985 (actual)	1.7
June 30, 1986 (extrapolated based on FCA data) ^a	3.1
June 30, 1986 (extrapolated based on commercial bank ratios) ^b	6.7 ^c
Loan Losses	
For the 12 months ending June 30, 1985 (actual)	0.7
For the 12 months ending September 30, 1985 (actual)	0.9
For the 12 months ending June 30, 1986 (extrapolated)	1.1
Earnings	
For the 12 months ending June 30, 1985 (actual)	0.2
For the 12 months ending September 30, 1985 (actual)	-0.8
For the 12 months ending June 30, 1986 (extrapolated based on FCA data)	-2.6
For the 12 months ending June 30, 1986 (extrapolated based on commercial bank ratios)	-7.4 ^b
Earned Surplus	
December 31, 1984 (actual)	6.2
June 30, 1985 (actual)	6.3
September 30, 1985 (actual)	5.4
June 30, 1986 (extrapolated based on FCA data)	3.7
June 30, 1986 (extrapolated based on commercial bank ratios)	0 ^b

^aExtrapolated balance based on the ratio of allowance for loan losses to nonaccrual loans for the Farm Credit System as of June 30, 1985.

^bExtrapolated balance based on the ratio of allowance for loan losses to nonaccrual loans for all commercial banks as of March 31, 1985.

^cAn allowance for loan losses based on the ratio of nonaccrual loans to the allowances maintained by commercial banks would result in a System allowance level of \$7.9 billion. The System's earned surplus was only sufficient to establish an allowance level of \$6.7 billion, leaving a shortfall in the allowance account of \$1.2 billion.

The following sections discuss in more detail our analyses of the profitability of the System, the quality of its loans, the adequacy of capital, the availability of funds to finance the System's lending activities, and the retention of the customer base. The ratios used in our analyses are commonly used by regulators of financial institutions, researchers, and academia to analyze the financial condition of institutions and banking systems.

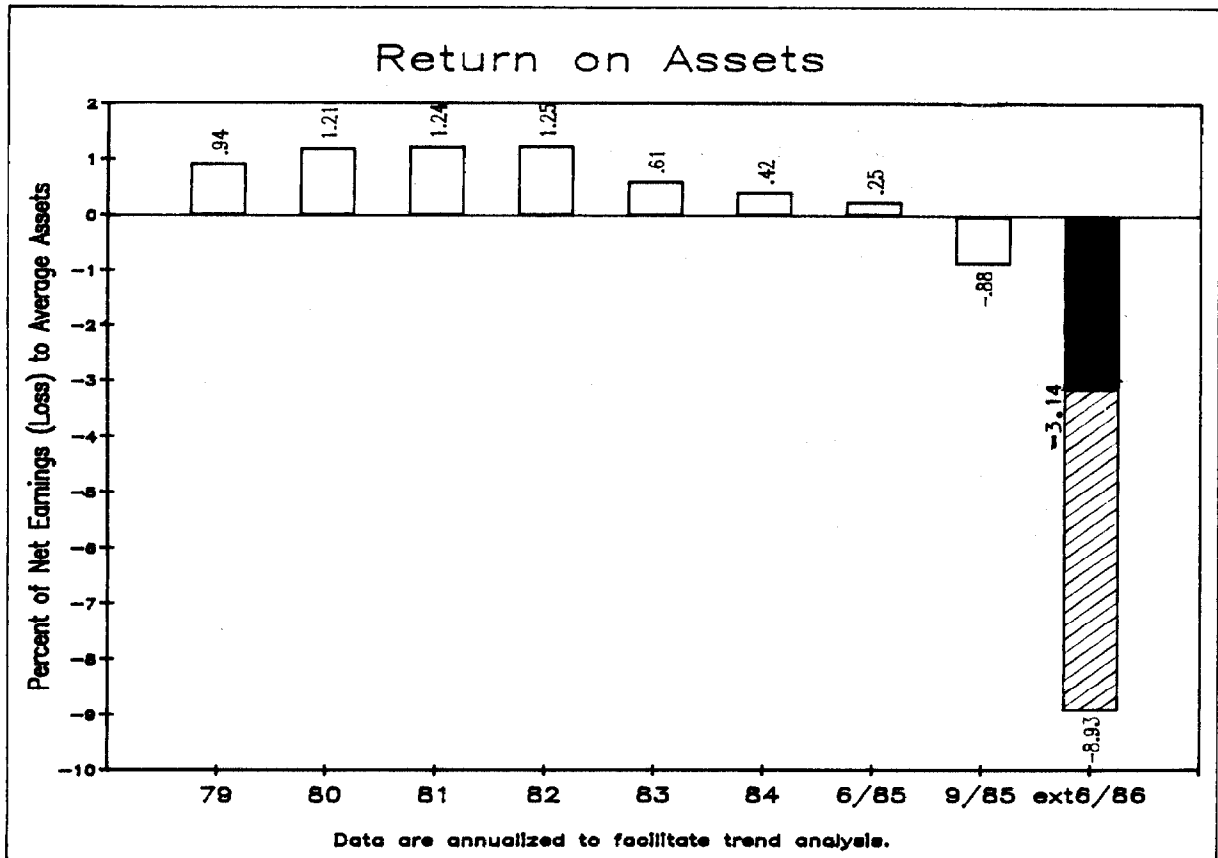
PROFITABILITY

A firm's return on assets is a widely accepted measure of its overall profitability. Under current conditions, the profitability of the System is adversely affected by the need to absorb large loan losses as well as by an increased volume of loans on which interest is no longer earned because the loans are not considered fully collectible.

During the third quarter, the System's return on assets declined from 0.25 percent for the 12 months ending June 30, 1985, to a minus 0.88 percent for the 12 months ending September 30, 1985. Because data are annualized for the respective 12-month periods, the 452 percent decrease reflects the difference in operating results for the third quarter 1984 and the third quarter 1985. (See figures 1 and 2.)

Figure 1 shows the historical trend and the extrapolated June 30, 1986, data. Figure 1 distorts the trend relationship between June 1985 and June 1986. Because of this, we have included figure 2 which shows the return on assets in appropriate relationship to time between June 30, 1985, September 30, 1985, and extrapolated June 30, 1986. We have provided a second figure to correct the distortion of the trend for several of the financial ratios we have computed and used in this report.

Figure 1



Actual

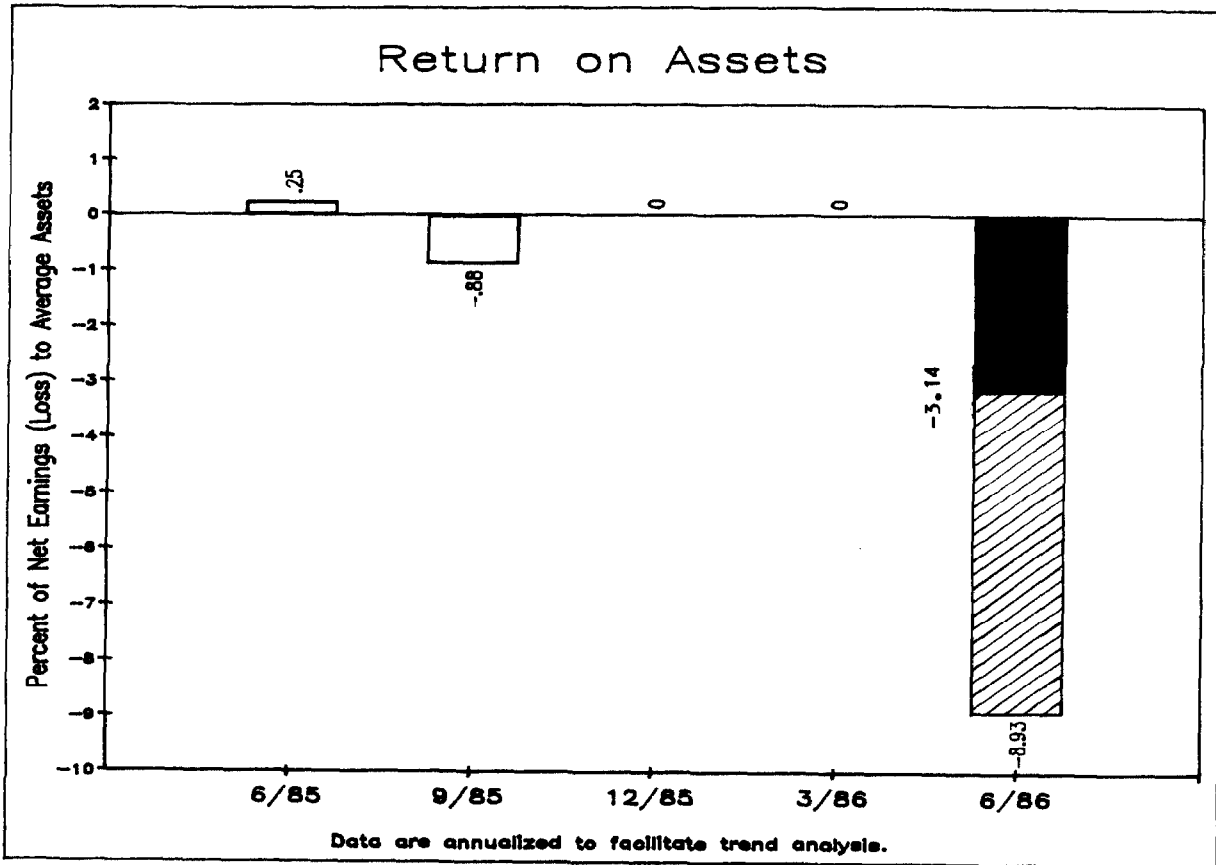


Extrapolated on basis of FCS's ratio of nonaccrual loans to allowance for loan losses at June 30, 1985



Extrapolated on basis of commercial bank's ratio of nonaccrual loans to allowance for loan losses at March 31, 1985

Figure 2



Actual



Extrapolated on basis of FCS's ratio of nonaccrual loans to allowance for loan losses at June 30, 1985

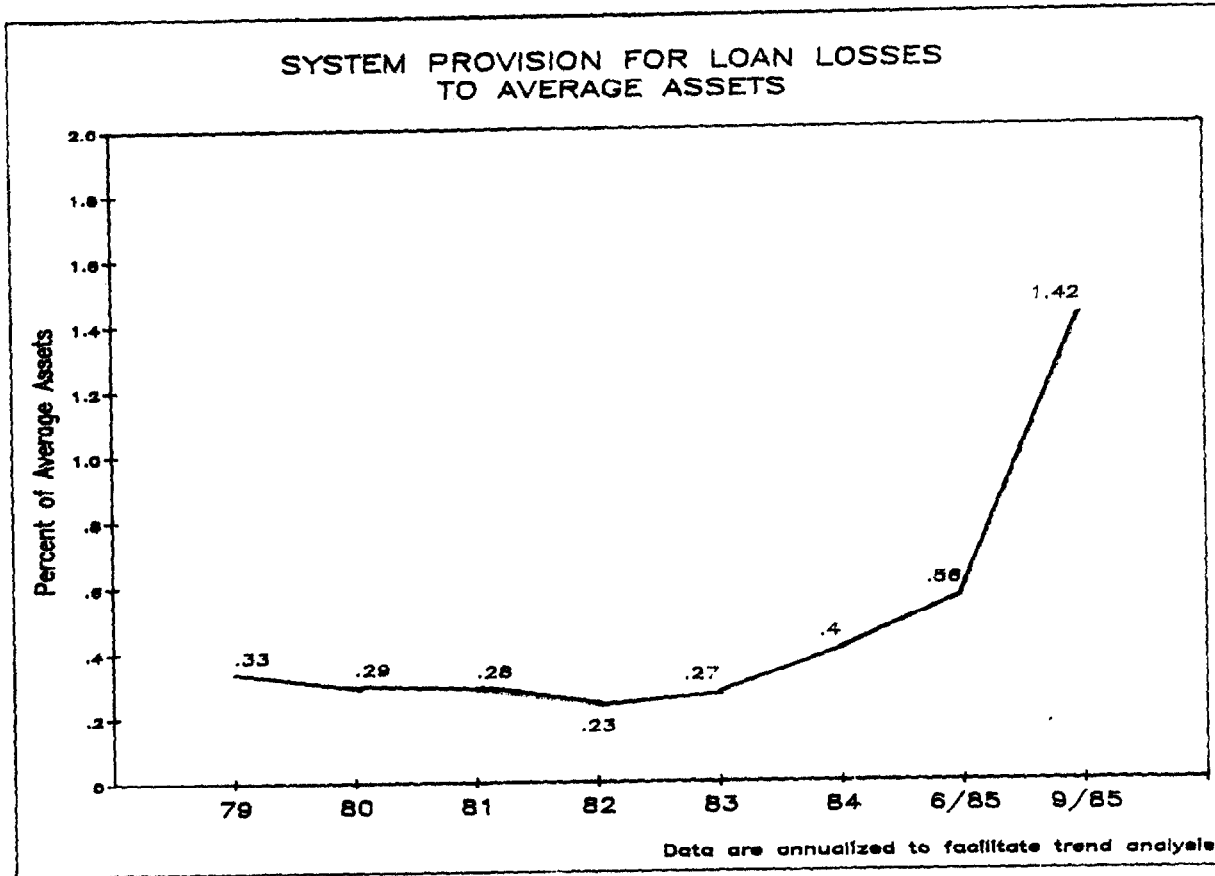


Extrapolated on basis of commercial bank's ratio of nonaccrual loans to allowance for loan losses at March 31, 1985

The net loss in the third quarter was largely due to a sharp increase in the provision for loan losses from 0.56 to 1.42 percent of average assets (see figure 3). As discussed on pages 19 through 21, the allowance for loan losses to gross loans increased from 1.52 percent at June 30, 1985, to 2.17 percent at September 30, 1985. We have concerns regarding the adequacy of this allowance. Despite the increase in the allowance for loan losses account, the ratio of allowance for loan losses to nonaccrual loans fell from 47.7 percent at June 30, 1985, to 39.0 percent at September 30, 1985.

Nonaccrual loans as a percentage of average assets increased 70.2 percent from 2.92 percent at June 30, 1985, to 4.97 percent at September 30, 1985. (See page 16.) Had the System maintained the same ratio of allowance for loan losses to nonaccrual loans as that of June 30, 1985, an additional \$378 million provision for loan losses would have been required. From the available data we cannot determine whether the rapid increase in nonaccruals, and thereby the need for increased provision for loan losses, is a result of an accelerated deterioration in loan quality or a recognition of nonaccrual loans from prior periods. However, should the downward trend continue, the negative return on assets will exceed our projection based on the System's ratio of nonaccrual loans to average assets at June 30, 1985.

Figure 3



The ratio of net operating income before the provision for loan loss to average assets declined 33.3 percent from 0.81 percent at June 30, 1985 to 0.54 percent for the 12 months ending September 30, 1985. (See figure 4.) The change, in this one quarter, represents 87.0 percent of our projected decline for the year ending June 30, 1986, and indicates a far sharper deterioration in earnings before provision for loan losses than projected in our October 4, 1985 report. (See figure 5.)

Figure 4

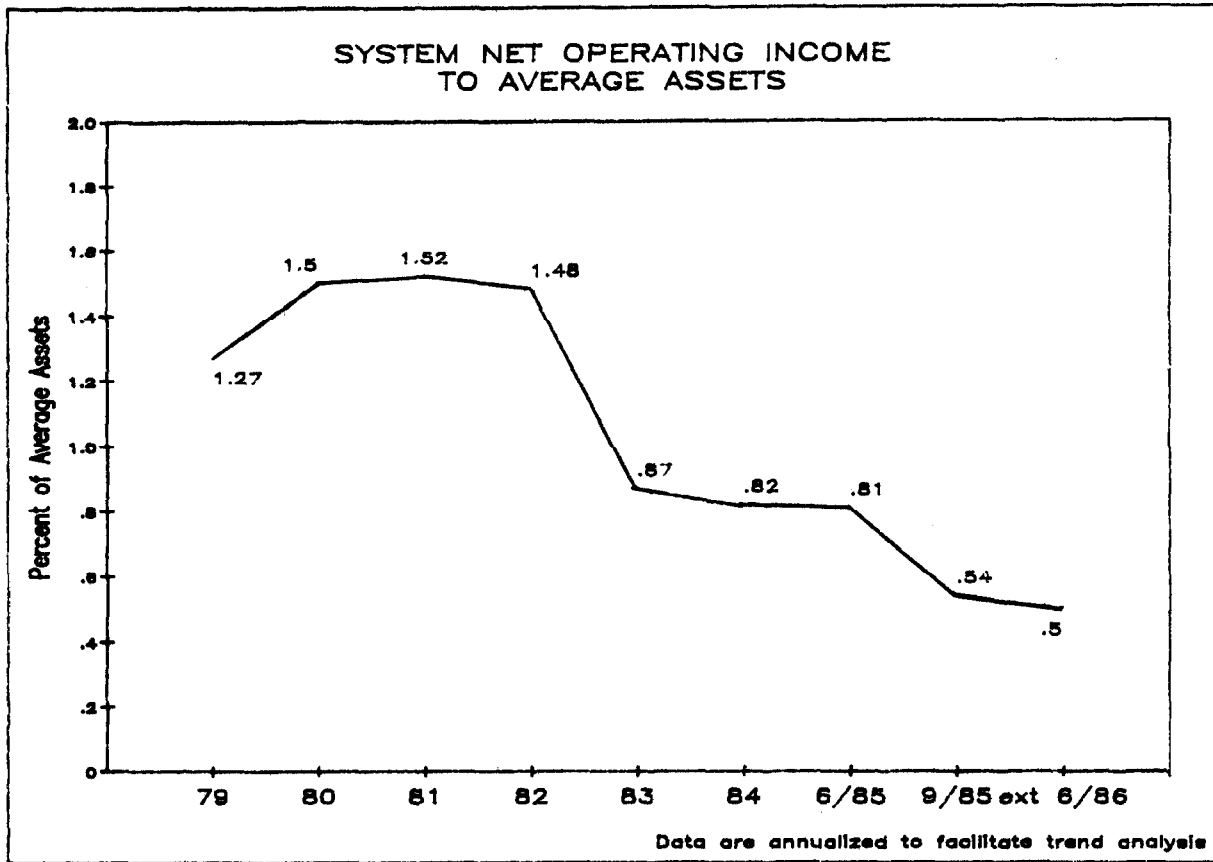
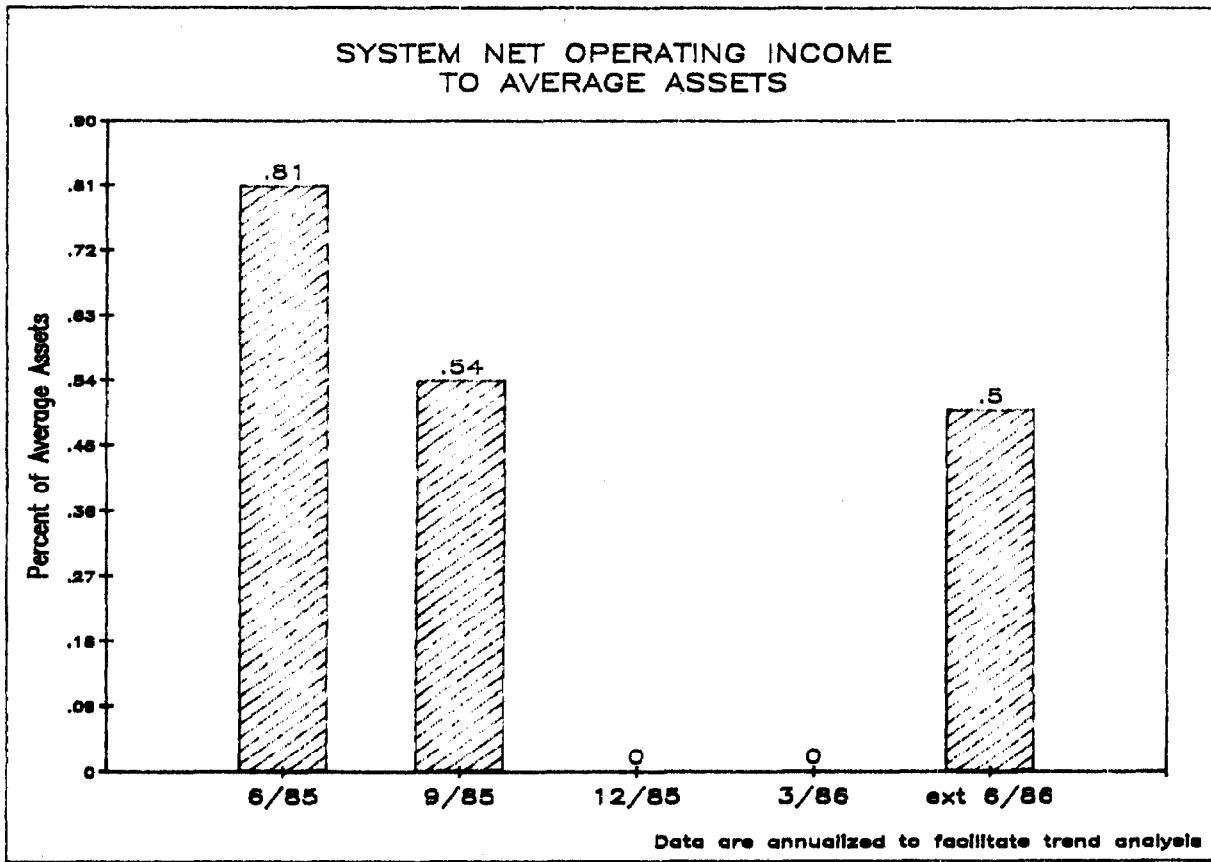


Figure 5



The decline in the net interest margin (the difference between interest income and interest expense) was the major factor contributing to the decline in net operating income. (See figures 6 and 7.) Several factors affected the net interest margin. Since June 30, 1985, a \$2.76 billion decline in gross loans together with a \$1.76 billion increase in nonaccruals resulted in a \$4.52 billion decline in interest-bearing loans. The increase in nonaccruals has a significant effect on interest income because not only does the System lose the interest that would have been accrued during the quarter but also any interest previously accrued during the current year and now deemed uncollectible would be subtracted from earnings.

Partially offsetting the loss of interest income was a reduction in interest expense attributable to reduced System outstanding debt. (See page 40.) The net effect of these changes in interest income and expense was a reduction in the ratio of net interest margin to average assets from 1.39 percent for the 12-month period ending June 30, 1985, to 1.17 percent for the 12-month period ending September 30, 1985. This is lower than the projected figure for the period ending June 30, 1986, and may indicate either a more severe decline in interest income than indicated by our earlier trend analysis or a recognition of losses which should have been reported in prior periods.

Figure 6

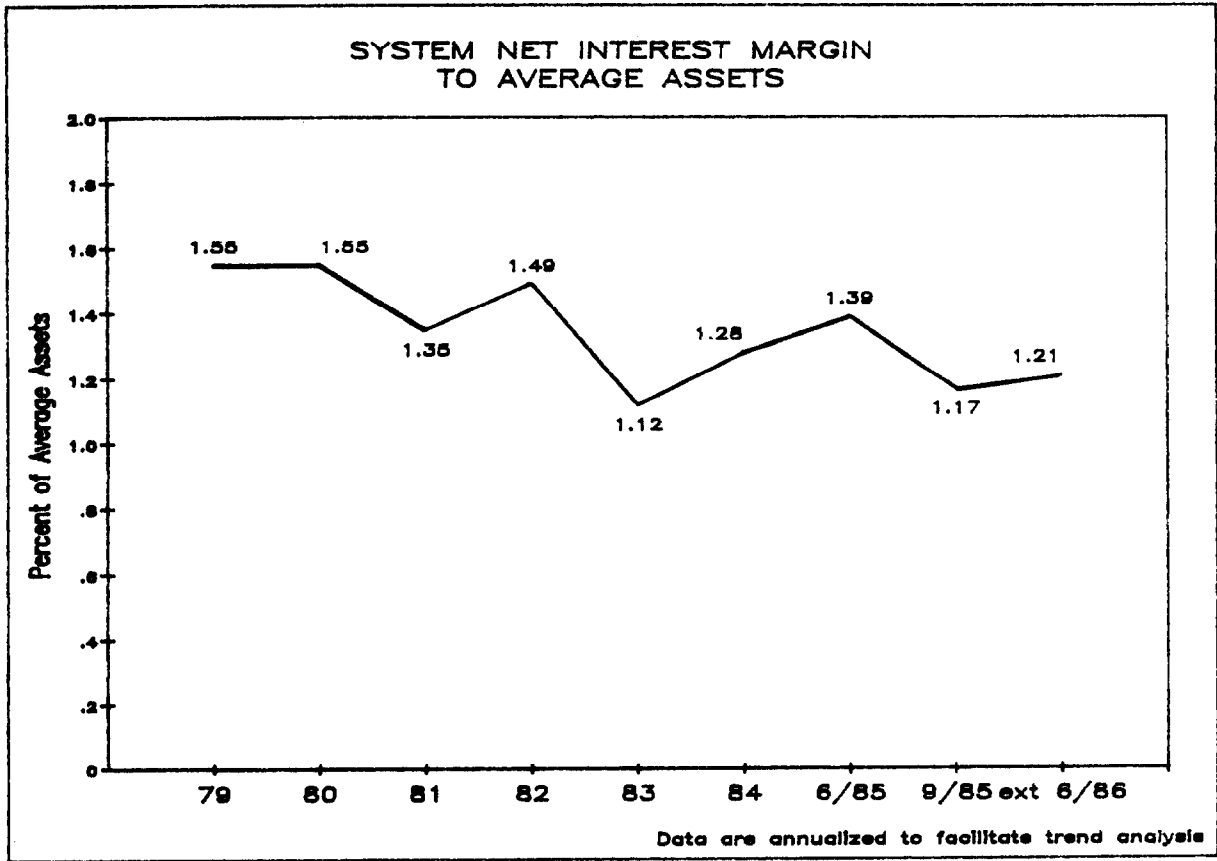
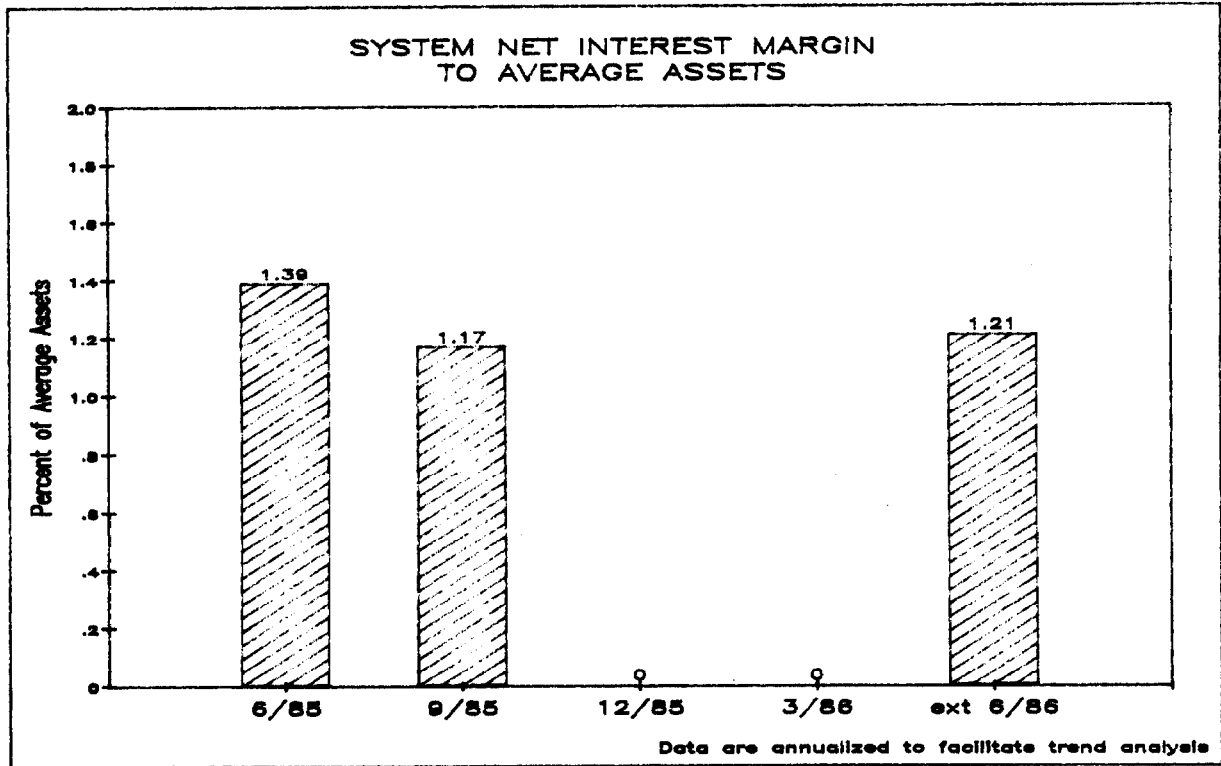


Figure 7



Although earnings decreased sharply, operating expenses as a percentage of average assets (see figures 8 and 9) did not change, remaining at 0.94 percent of average assets for the 12-month periods ending June 30 and September 30, 1985.

Figure 8

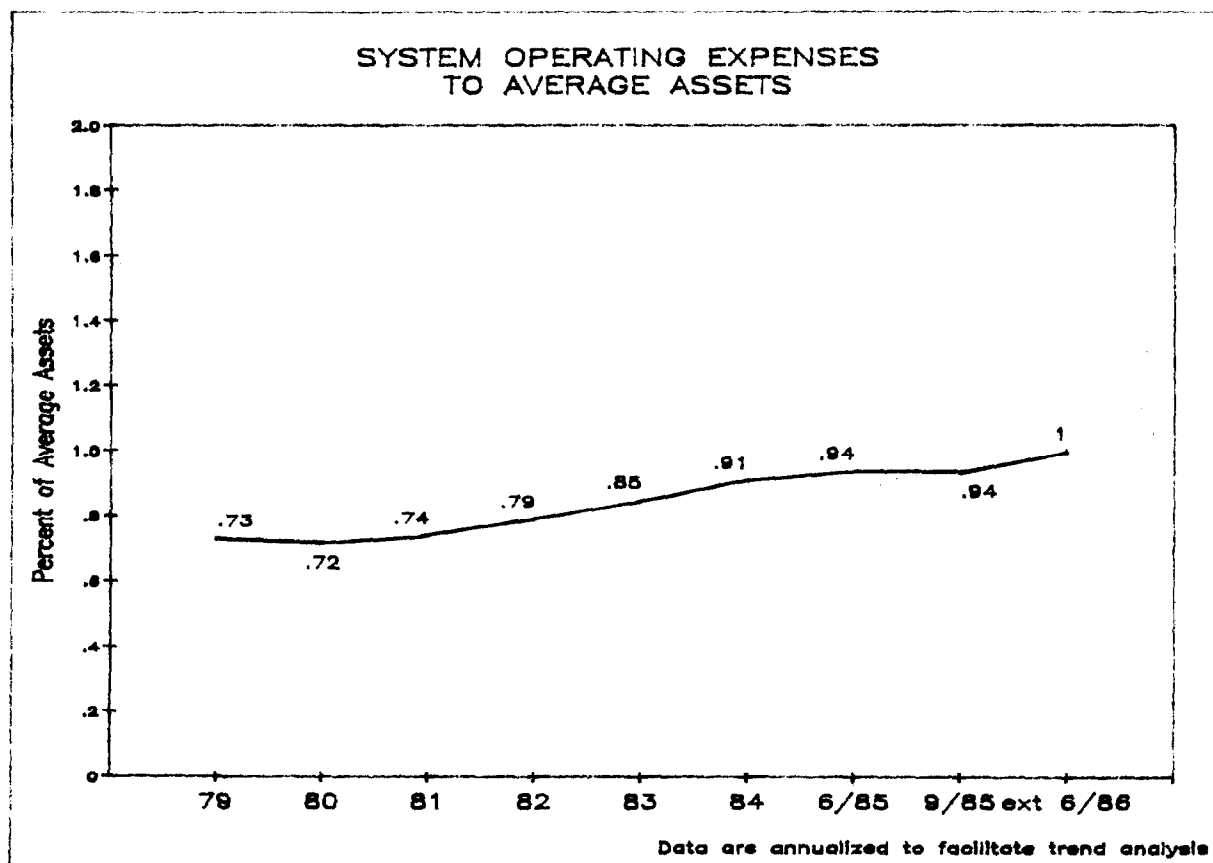
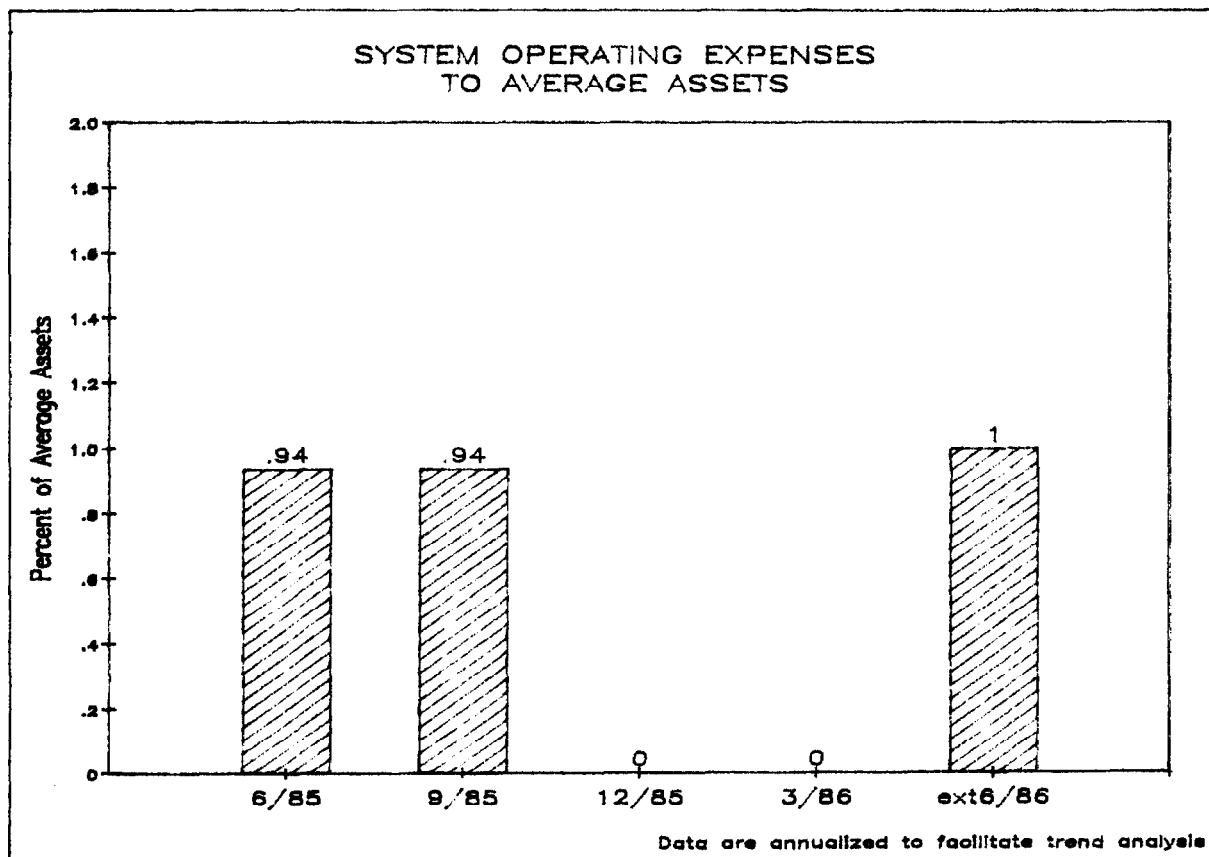


Figure 9



LOAN QUALITY

The financial condition of the Farm Credit System is critically dependent on the quality of its loan portfolio. The System employs various measurement systems to depict the quality of its loans. We have used the acceptable, problem, vulnerable, or loss classification system used by the System because this is the only measurement device that has been consistently used over the years included in our analysis.⁴

We attached a weight to each of the adverse classifications to determine the relative severity of weaknesses in the loan portfolio.⁵ While our analysis shows a continuous deterioration in loan quality, it shows a dramatic deterioration during the third quarter of 1985. (See figures 10 and 11.) Figure 10 shows that between June 1985 and September 1985 weighted adversely classified loans as a percentage of average assets increased from 6.85 to 8.3 percent and that nonaccruals to average assets increased from 2.92 to 4.97 percent. Because a time lag generally exists between when a loan is adversely classified and when a loss, if any, is recognized and charged against the allowance account, it follows that loan losses will significantly increase during the next 12 months.

Figure 11 shows that nonaccrual loans increased from \$2.56 to \$4.32 billion during the quarter, an increase of 68 percent, and weighted adversely classified loans increased from \$6.01 billion in June 1985 to \$7.22 billion in September 1985.

⁴Acceptable loans--loans of highest quality, ranging down to and including those having significant credit weaknesses.

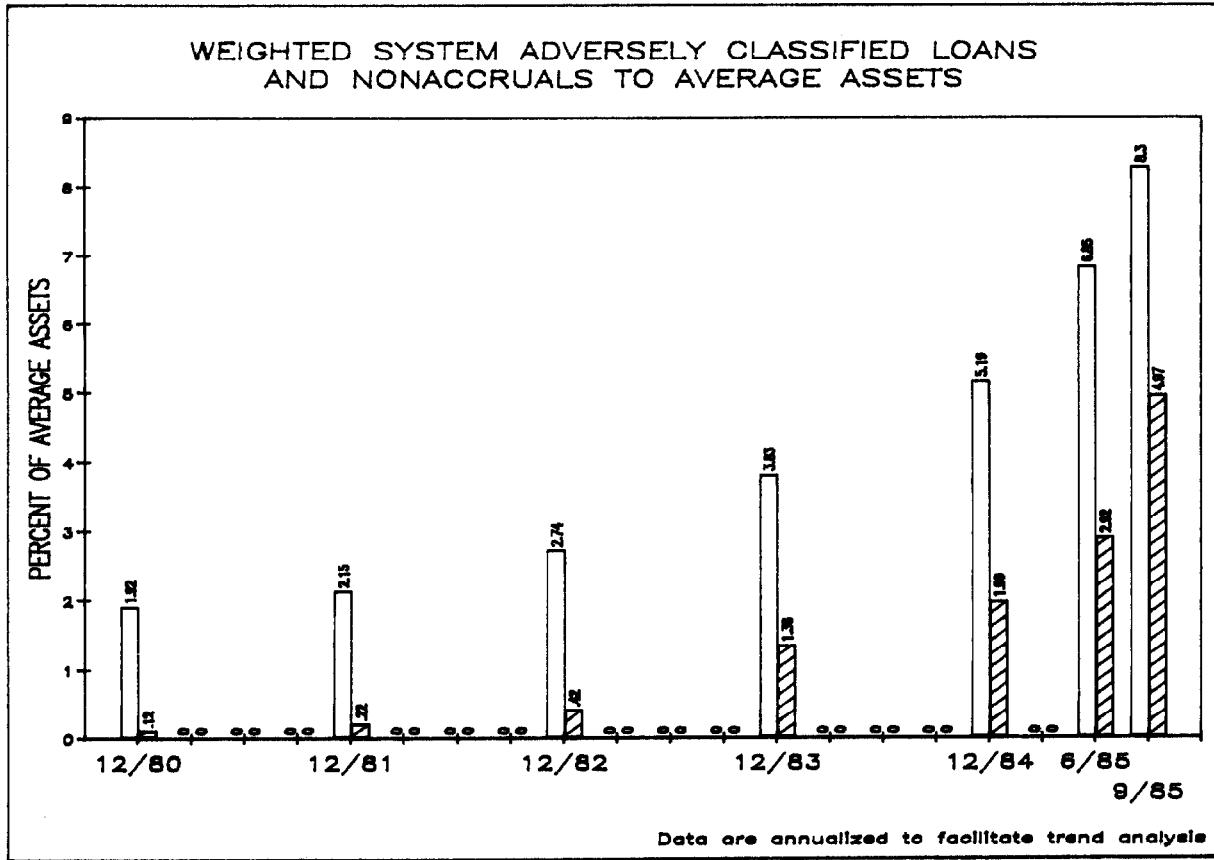
Problem loans--loans having serious credit weaknesses requiring more than normal supervision but believed to be collectible in full.

Vulnerable loans--high risk loans still considered collectible but involving probability of loss in the event that repayment from available sources does not materialize.

Loss loans--loans deemed uncollectible, either in part or in full.

⁵We weighted the adversely classified loans as follows:
20 percent of problem loans, 50 percent of vulnerable loans,
and 100 percent of loss loans.

Figure 10

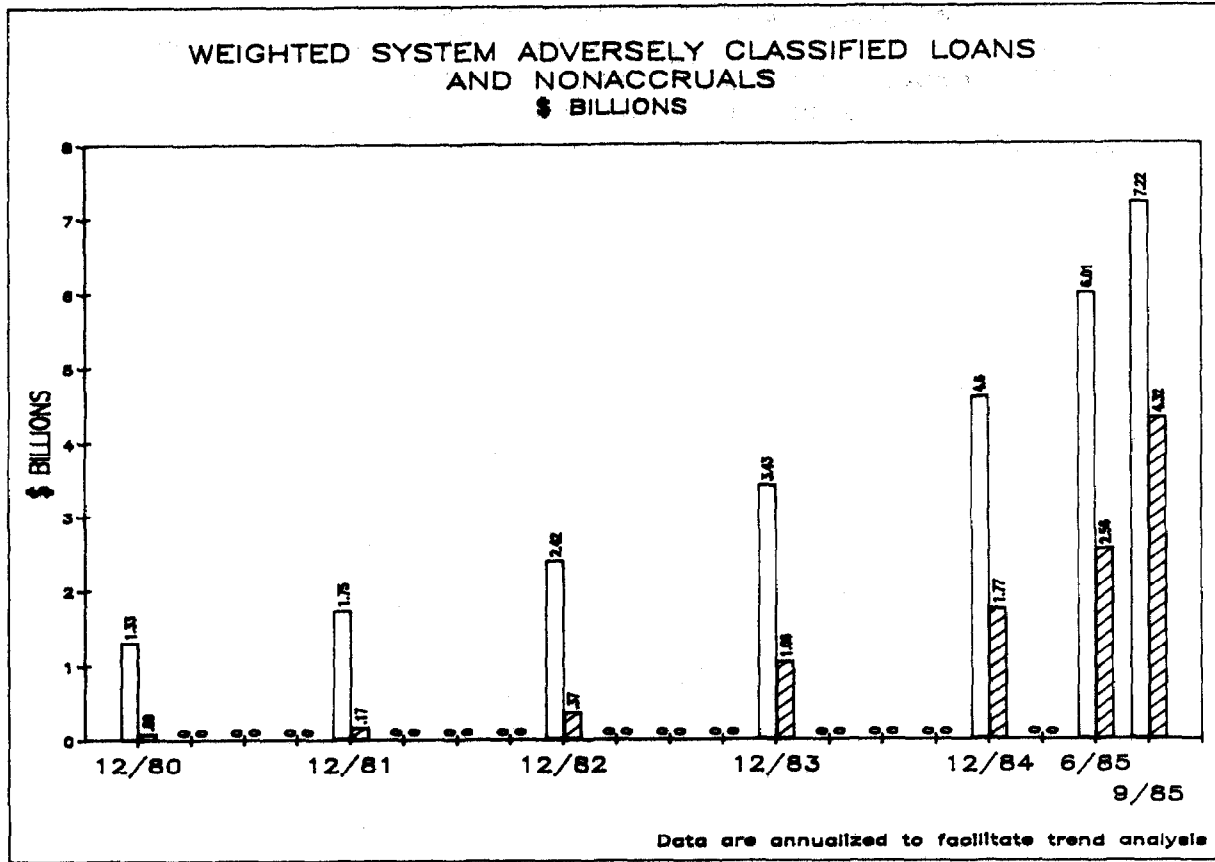


□ ADVERSELY CLASSIFIED

▨ NON ACCRUALS

Note: Prior to 1984 data are for loans in process of liquidation

Figure 11



□ ADVERSELY CLASSIFIED

▨ NON ACCRUALS

Note: Prior to 1984 data are for loans in process of liquidation

ADJUSTED CAPITAL

Figures 12 and 13 show that the System's adjusted capital⁶ to average assets declined from 8.62 percent on June 30, 1985, to 8.13 percent on September 30, 1985. Our projection of the June 30, 1986, System's condition indicated a decline in adjusted capital that has already been exceeded during the third quarter. We had projected that the adjusted capital would be 8.26 percent of average assets on June 30, 1986. If the third quarter 1985 experience continues, adjusted capital to average assets will be considerably less than originally projected for June 30, 1986.

⁶Adjusted capital is defined as total earned net worth plus allowance for loan losses.

Figure 12

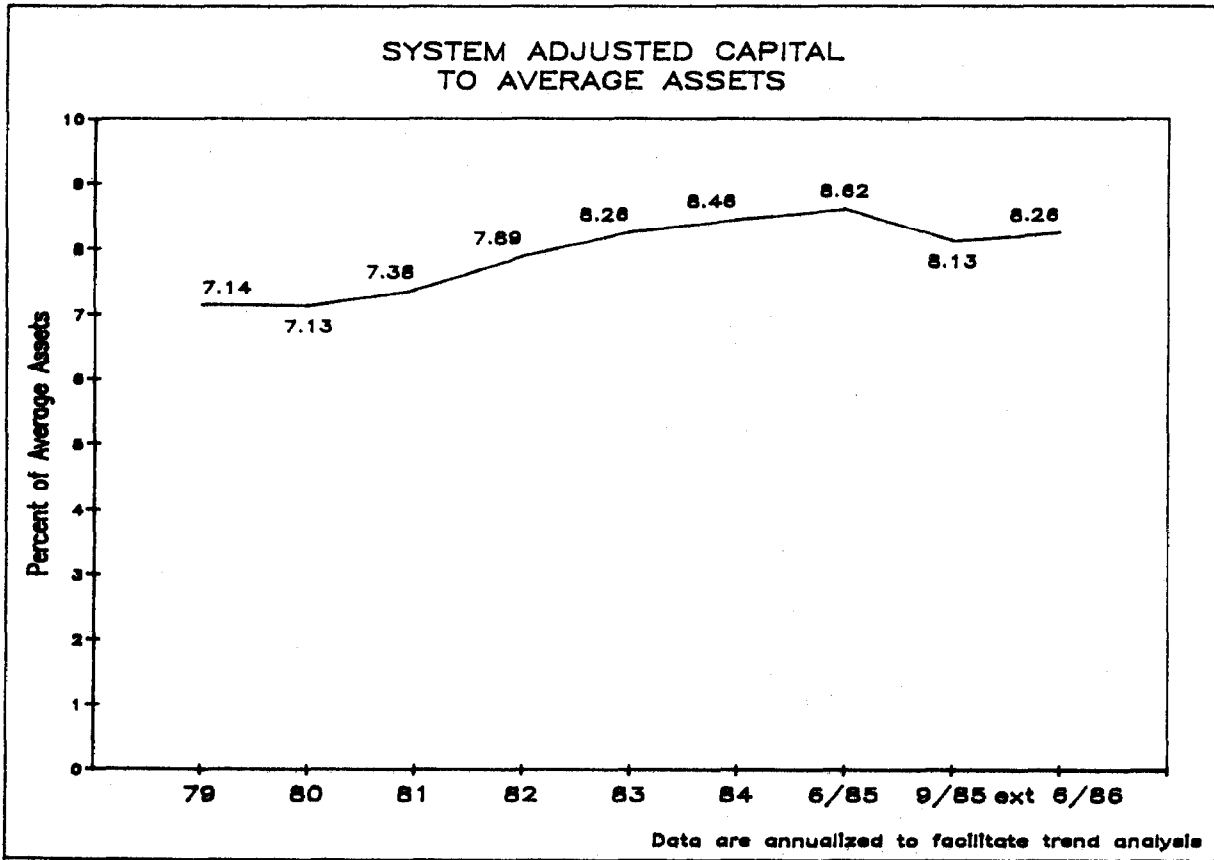


Figure 13

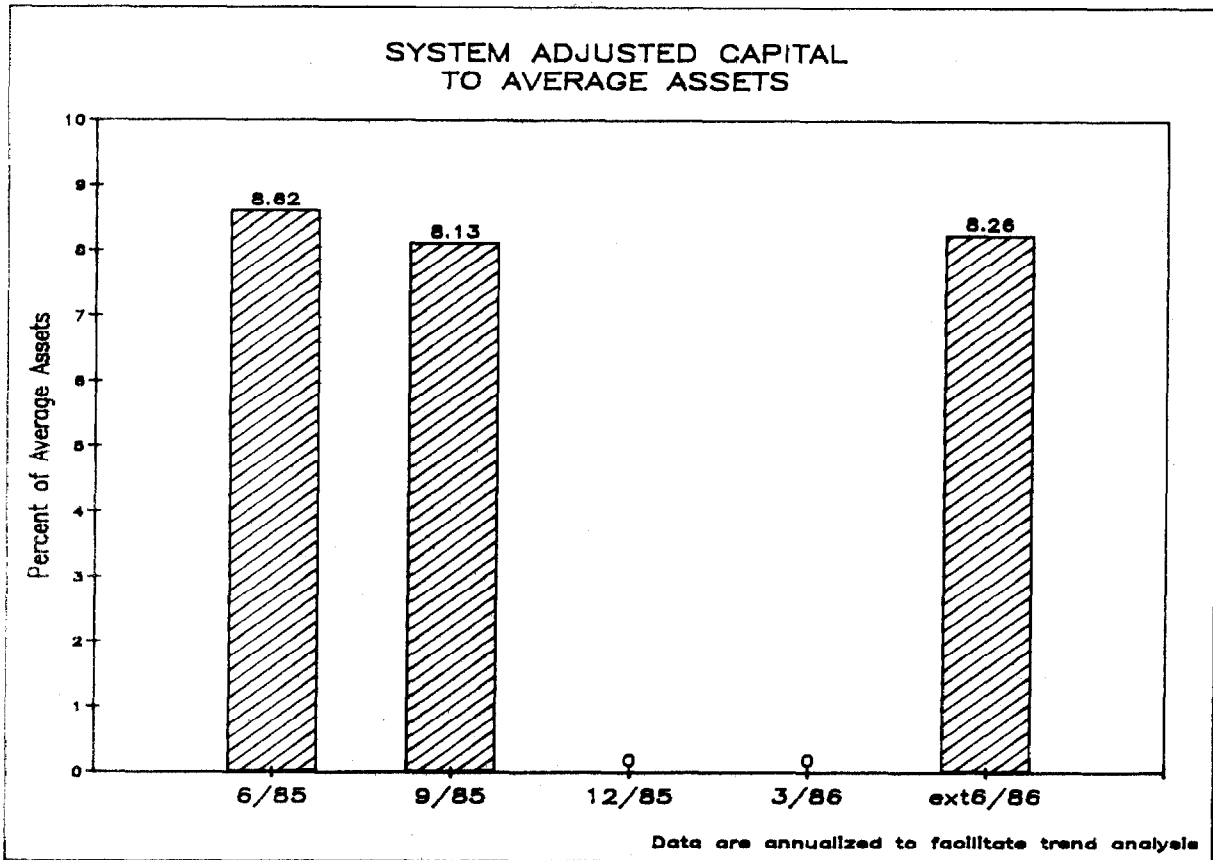


Figure 14 shows a comparison of the trend in the dollar amount of adjusted capital. Figure 15 compares the third quarter data with the projections that we previously made based on June 30, 1985, data. In our analysis of capital we have included the System's earned net worth accounts and allowance account but excluded capital stock accounts. Stock in System institutions is different than it is in most companies. Capital in most companies serves as a cushion against future losses. System stock, however, is generally not available to absorb losses. An FCS association's or bank's stock is impaired if its value is less than its par or stated value. If FCA finds that an association's or bank's stock is impaired, it may either place that institution under special operating conditions or consider liquidating the institution.

Figure 14

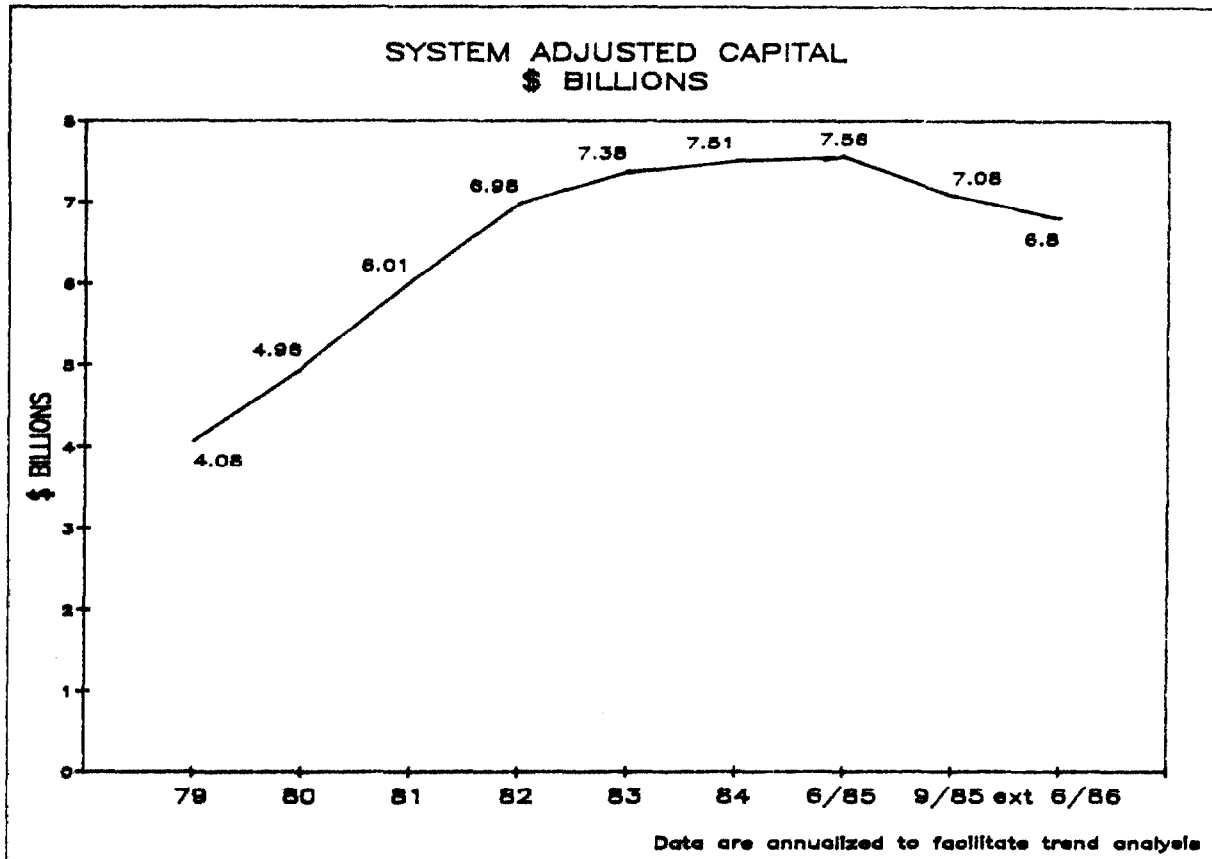
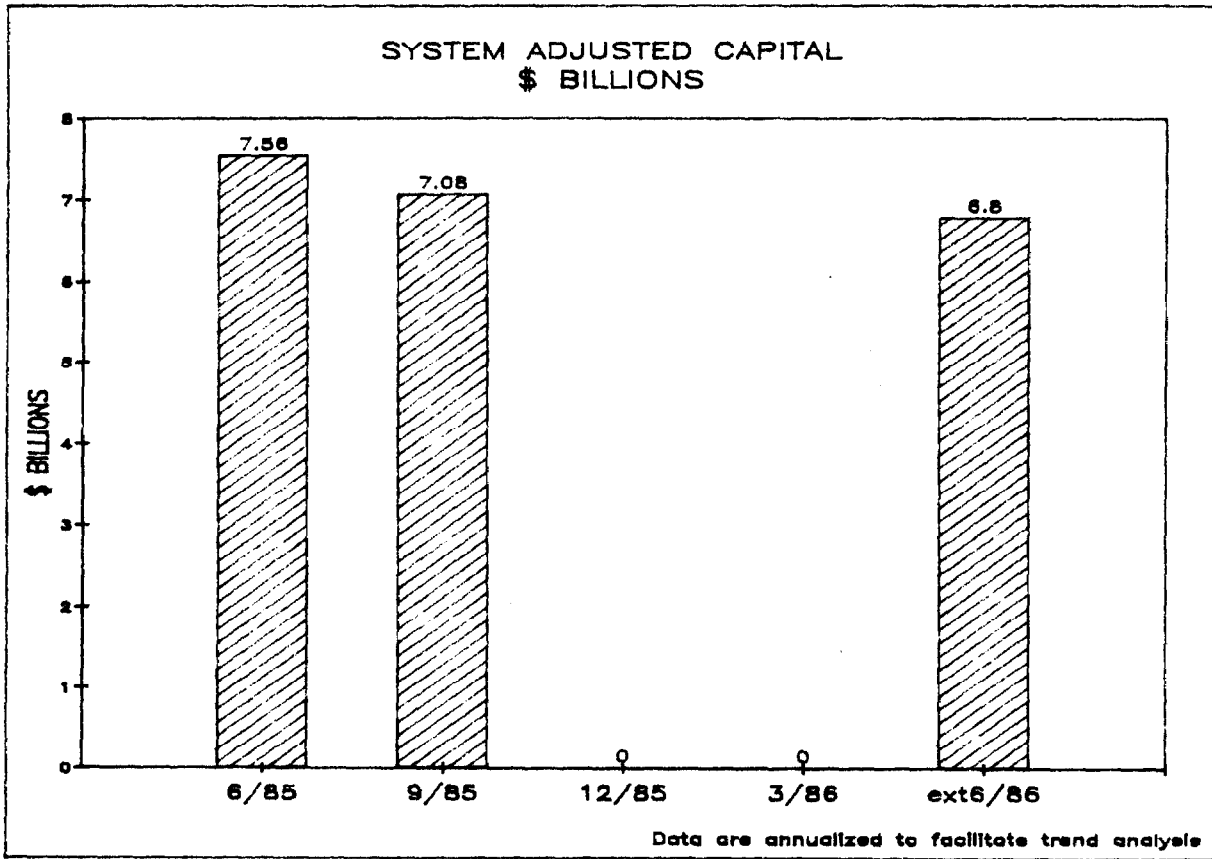


Figure 15



The decline in adjusted capital occurred because of the bad loans that were charged off during the third quarter and the lack of earnings to cover those chargeoffs. Chargeoffs for the 12 months ending September 30, 1985, were \$0.9 billion or about 1.13 percent of average gross loans. The annualized increase in chargeoffs for the third quarter was significantly higher than the expected amount based on our estimate, with over 50 percent of the expected change occurring in that quarter. (See figures 16 and 17.)

Figure 16

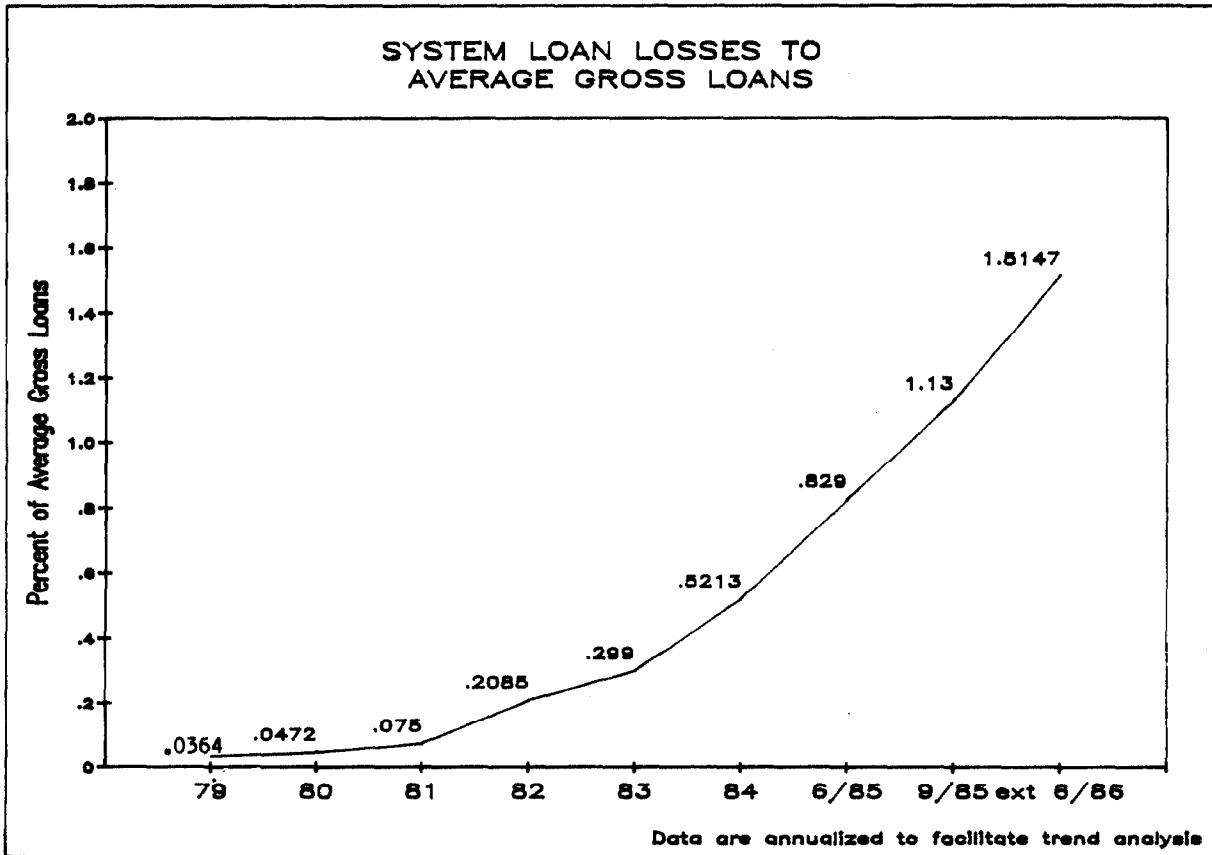
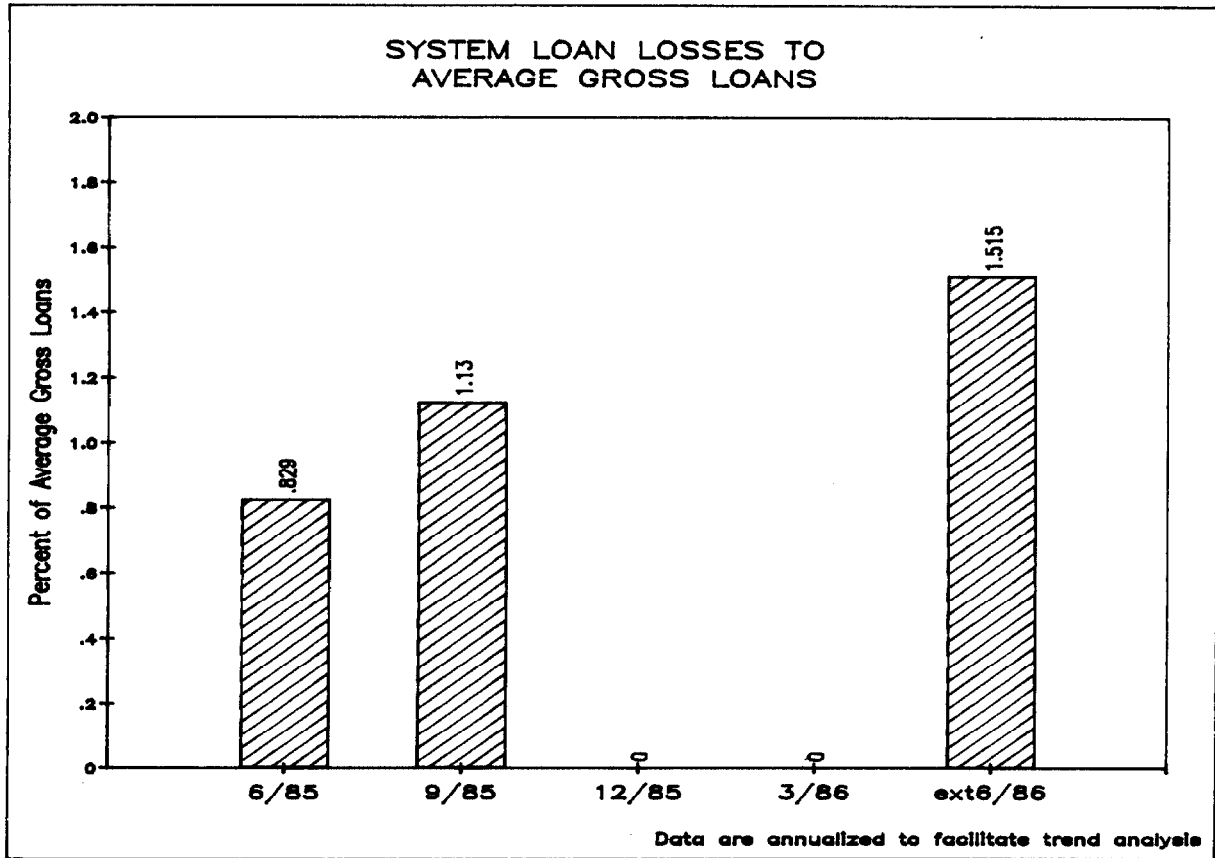


Figure 17

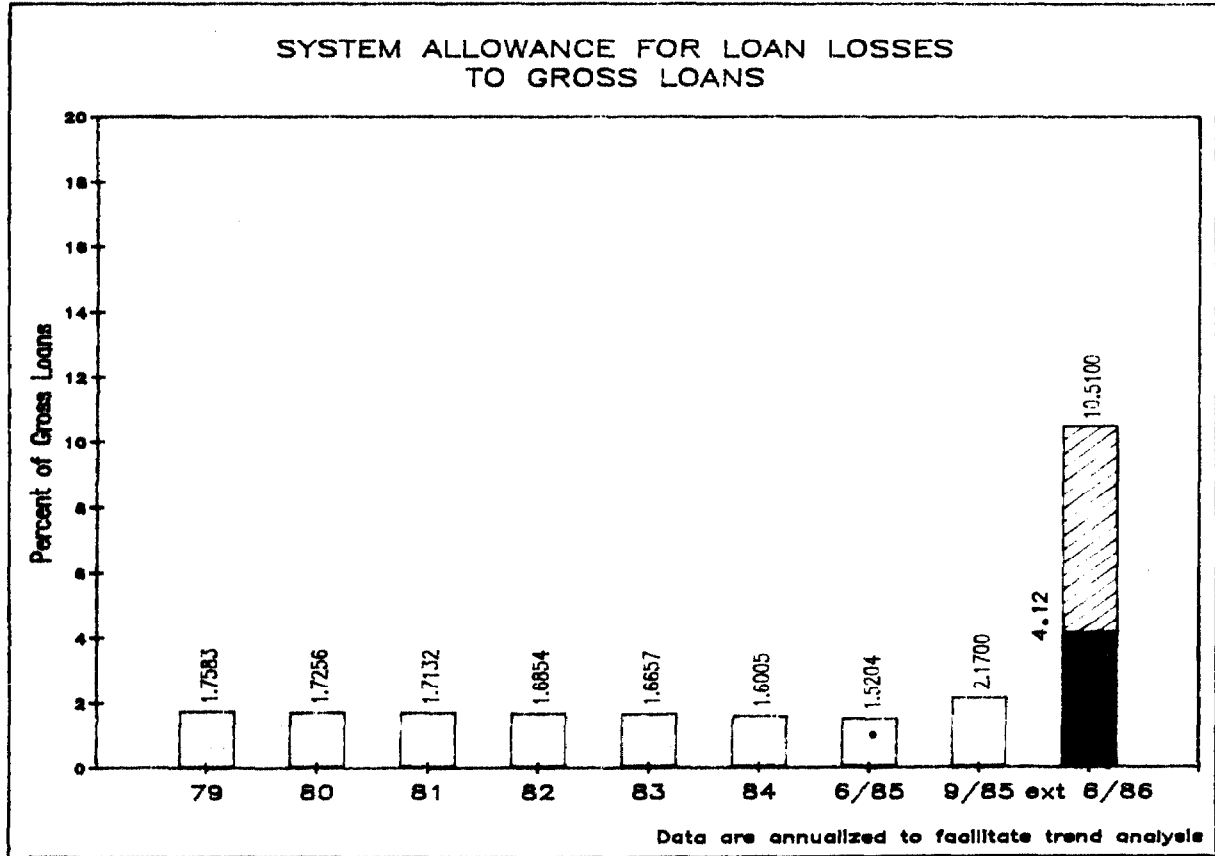


As shown in figures 18 and 19, the ratio of allowance for loan losses to gross loans rose by about one third during the third quarter. However, the amount of nonaccrual loans increased by 68 percent, and the percentage of allowance for loan losses to nonaccrual loans decreased, which indicates that the allowance for loan losses may not be adequate to cover future losses.

As shown by figures 20 and 21, the allowance for loan losses at September 30, 1985, was 1.82 times the chargeoffs for the prior 12 months. The amount of allowance for loan losses maintained by commercial banks is generally 3 to 4 times the annual chargeoffs.

When we made our projections based on June 30, 1985, data, we had concerns about the allowance level maintained by the System. To give some range of possible future levels that would be appropriate for the System, we made projections on two different bases. The first basis was to extrapolate the System's reserve level to projected nonaccrual loans at June 30, 1986, and to apply that ratio to the projected nonaccrual loans at June 30, 1986. The computation for the System resulted in a ratio of 4.12 percent. The second basis for projecting the allowance level was to use the ratio of allowance for loan losses to nonaccrual loans as reported by all commercial banks as of March 31, 1985, and to apply that ratio to the projected nonaccrual System loans for June 30, 1986. The computation for commercial banks resulted in a ratio of 10.51 percent. In commenting on our October 4, 1985, report, both FCA and System officials said that the reserves at June 30, 1986, should fall somewhere between these two extremes. Had the System maintained a reserve at the lower of the two levels used in our projections, the September 30, 1985, allowance would have been \$378 million more than the actual level.

Figure 18



Actual

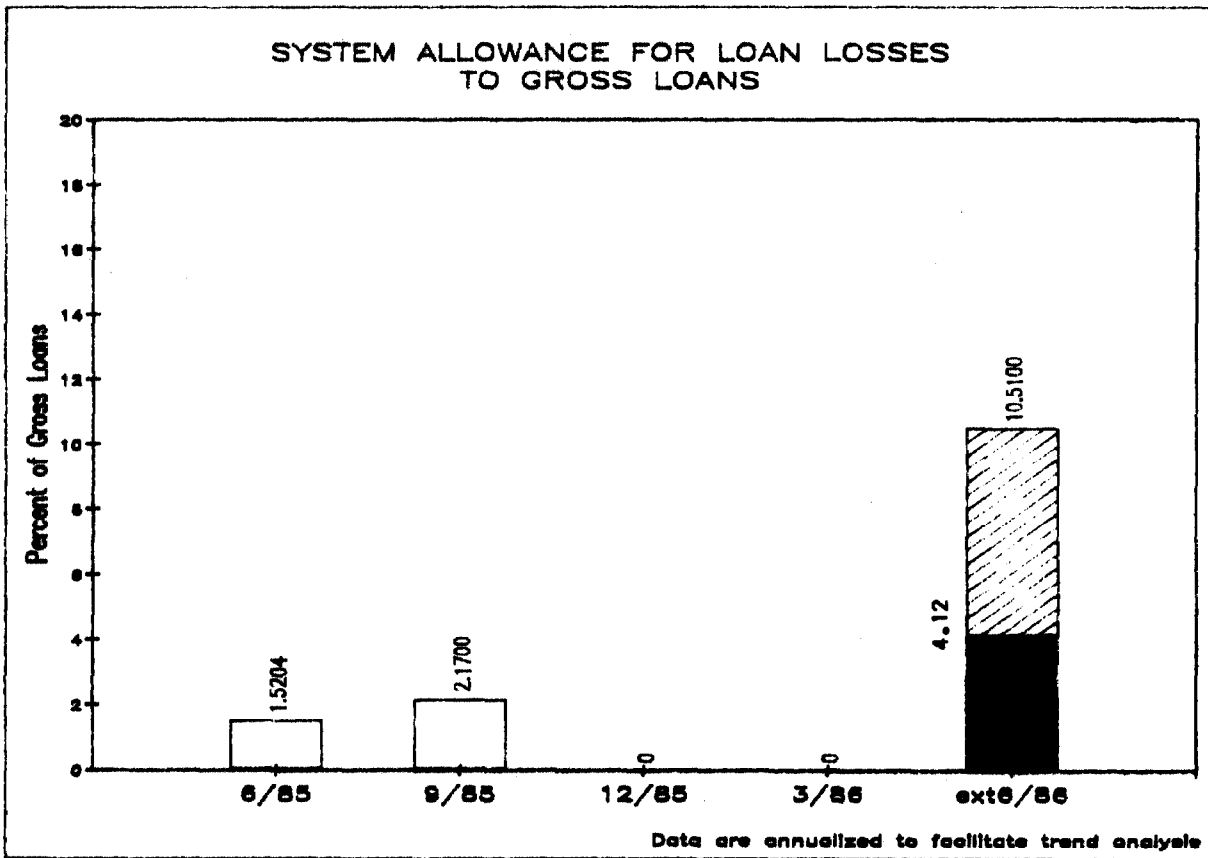


Extrapolated on basis of FCS's ratio of nonaccrual loans to allowance for loan losses at June 30, 1985



Extrapolated on basis of commercial bank's ratio of nonaccrual loans to allowance for loan losses at March 31, 1985

Figure 19



Actual

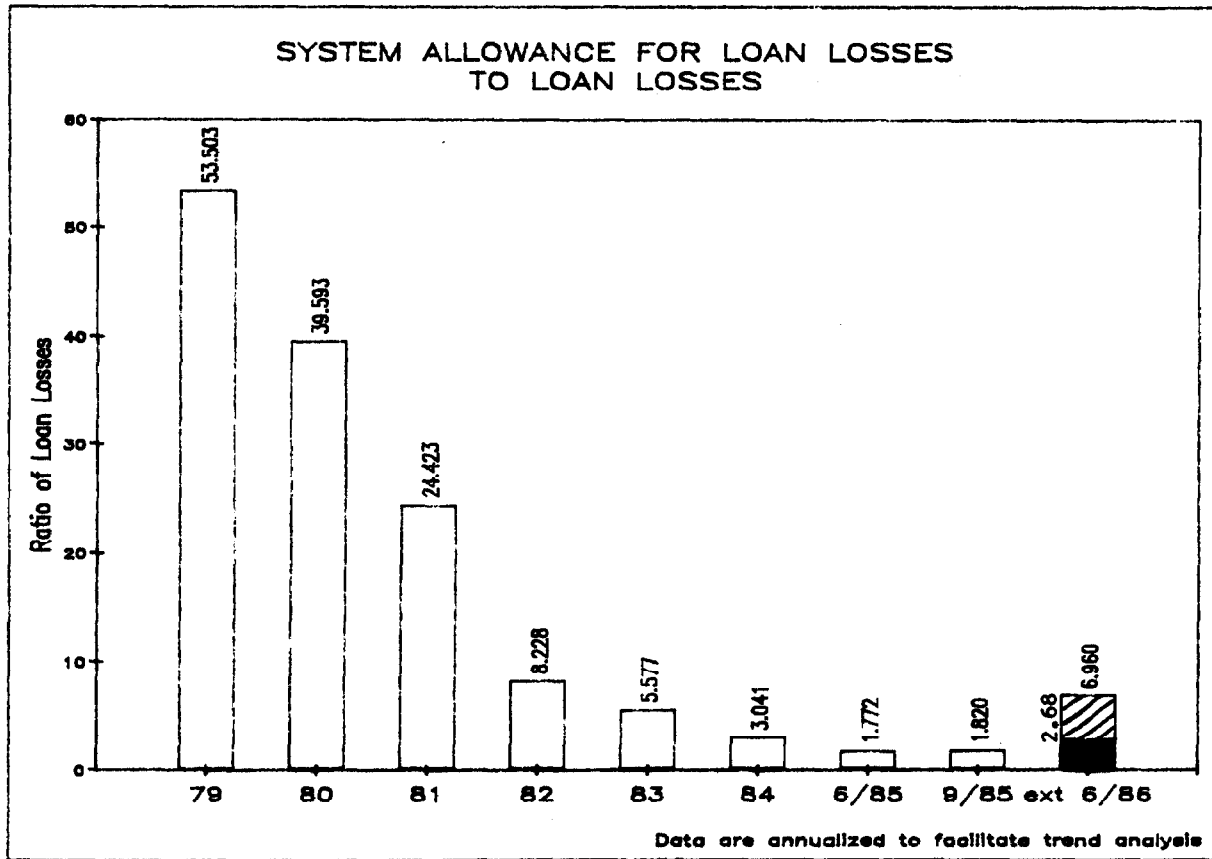


Extrapolated on basis of FCS's ratio of nonaccrual loans to allowance for loan losses at June 30, 1985



Extrapolated on basis of commercial bank's ratio of nonaccrual loans to allowance for loan losses at March 31, 1985

Figure 20



Actual

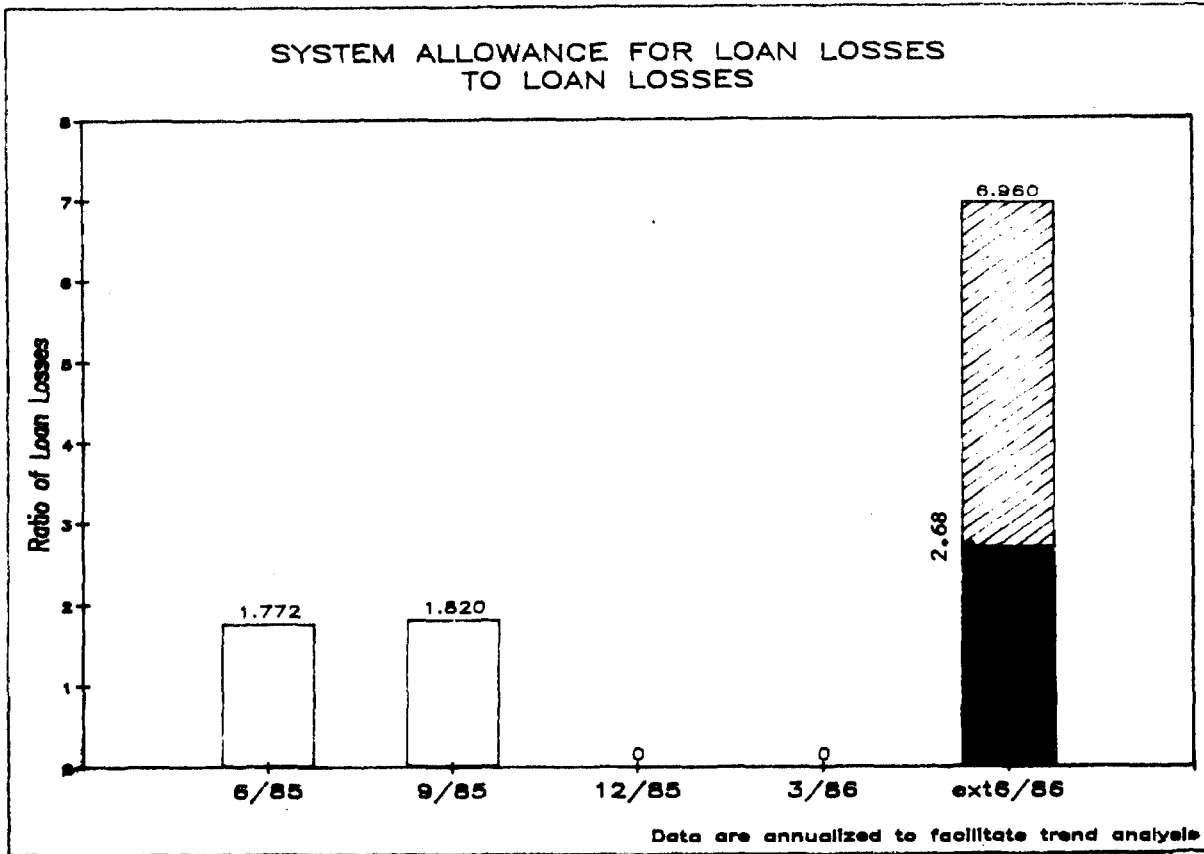



Extrapolated on basis of FCS's ratio of nonaccrual loans to allowance for loan losses at June 30, 1985





Extrapolated on basis of commercial bank's ratio of nonaccrual loans to allowance for loan losses at March 31, 1985

Figure 21



 Actual

 Extrapolated on basis of FCS's ratio of nonaccrual loans to allowance for loan losses at June 30, 1985

 Extrapolated on basis of commercial bank's ratio of nonaccrual loans to allowance for loan losses at March 31, 1985

Figures 22 and 23 show that while the net operating income for the 12-month period ending June 30, 1985, was adequate to cover the bad loans that were charged off against the allowance account, by September 30, 1985, the net operating income was only adequate to cover one-half of the chargeoffs for the year. As a result, the earned surplus had to be reduced to cover the chargeoffs.

Figure 22

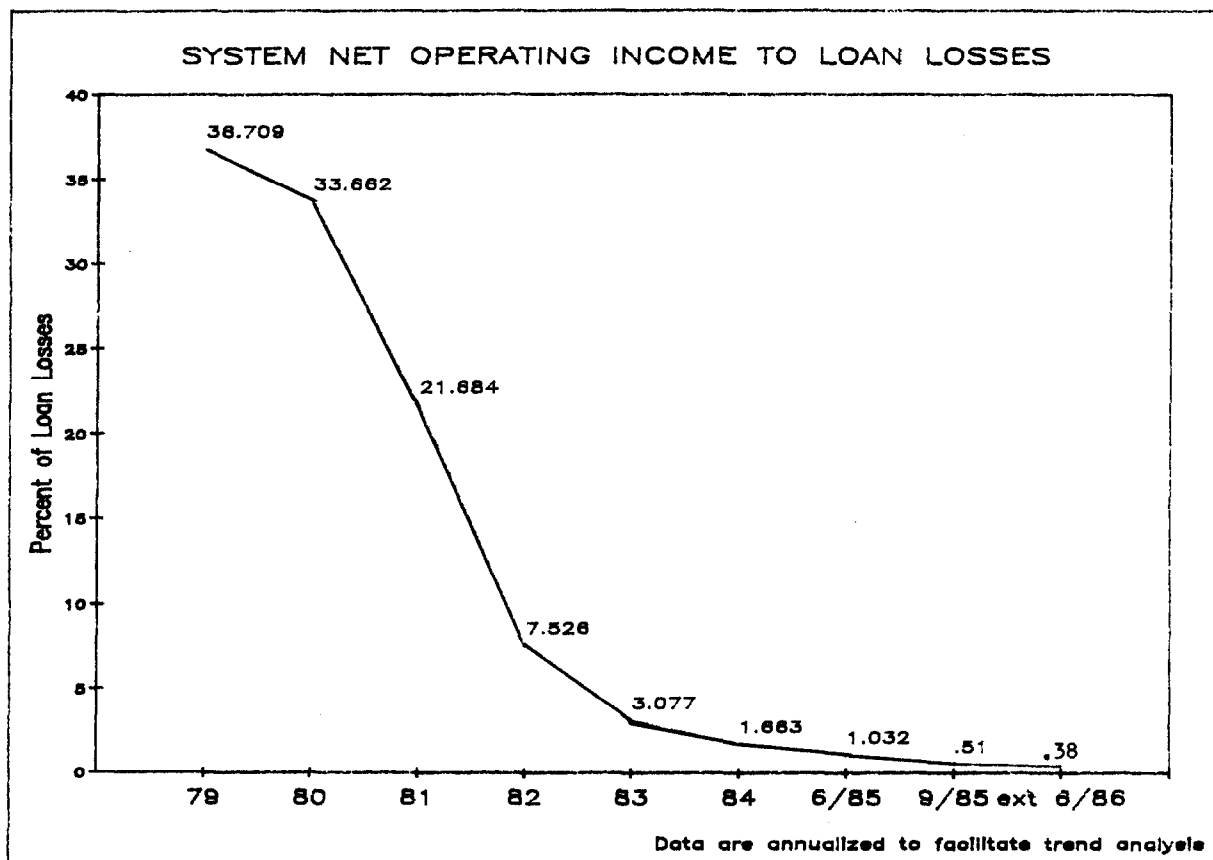
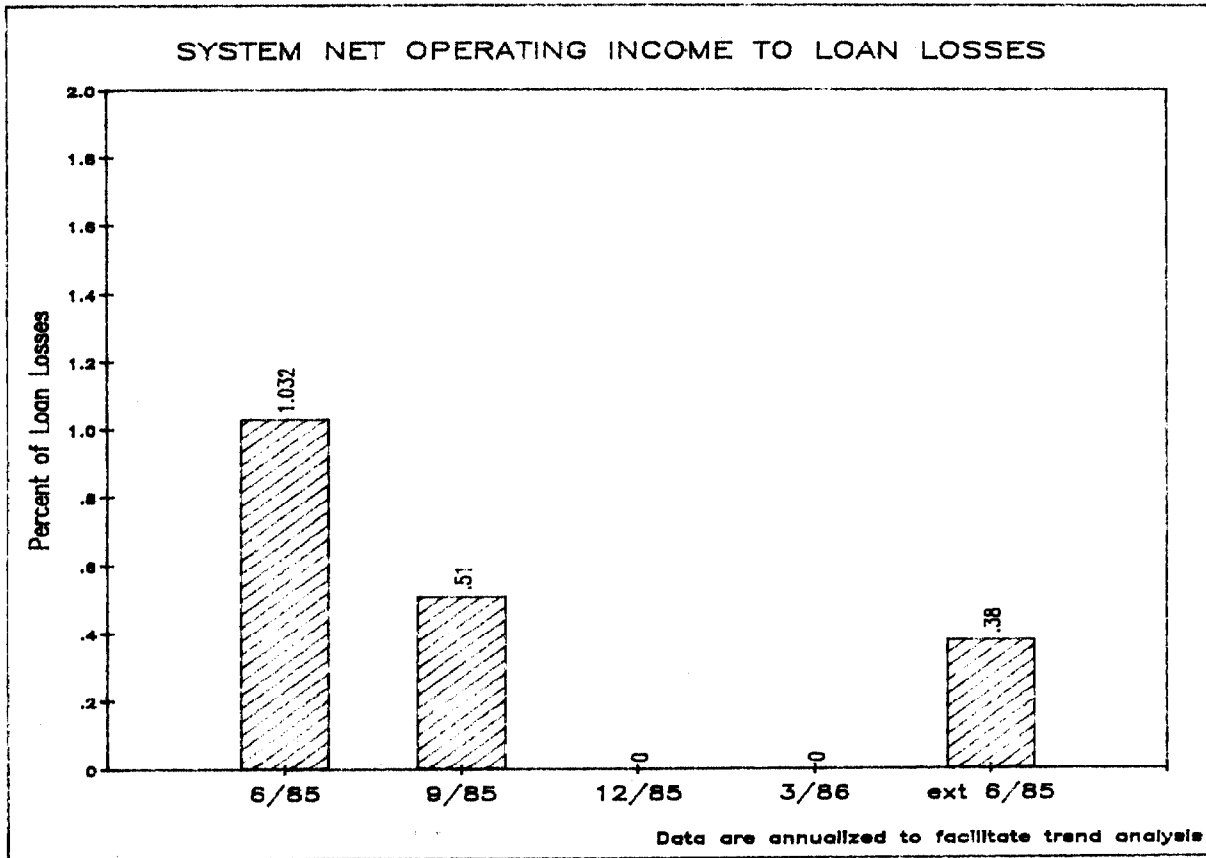


Figure 23



One important indicator of the adequacy of adjusted capital to absorb potential losses is its relationship to nonaccrual loans, i.e., those loans most likely to incur significant losses. As can be seen in table 2, the coverage of nonaccrual loans by adjusted capital declined steadily since the System began recording nonaccruals in 1984. Between June 30, 1985, and September 30, 1985, this coverage ratio decreased from 2.92 to 1.65, a decrease of 43.5 percent. This decrease was caused mainly by a 68 percent increase in nonaccrual loans and points to a decreased capacity to absorb already identified risk in the System loan portfolio.

Table 2: Adjusted Capital to Nonaccrual Loans

	<u>Adjusted capital</u> --- (\$ billions) --	<u>Nonaccrual loans</u>	<u>Coverage ratio</u>
December 31, 1984	\$7.5	\$1.8	4.2
June 30, 1985	7.6	2.6	2.92
September 30, 1985	7.1	4.3	1.65

AVAILABILITY OF FUNDS

The Farm Credit System's liabilities mature faster than its assets. Therefore, the System must frequently go to the financial market for additional funds for its activities. These funds must be obtained at competitive rates. Our analysis of this component of the System compared the rates at which System bonds were sold with those of comparable Treasury instruments. During the period from December 31, 1981, to June 30, 1985, we found no material changes in the spread between the interest rates on System bonds and comparable Treasury bonds. However, beginning in July 1985 and to a greater extent during September 1985, investors began requiring a premium on System securities to compensate for the risk that they perceived in the System's ability to pay its debt. That trend continued during October and November. (See tables 3 and 4).

Table 3: Comparison of FCS and U.S. Treasury
Intermediate and Long-Term Bond Yield Rates

<u>Farm Credit System</u>		<u>U.S. Treasury</u>		<u>Basis point</u>
<u>Maturity</u>	<u>Yield</u>	<u>Maturity</u>	<u>Yield</u>	<u>spread</u>
Pricing - December 31, 1981				
7/85	9.69	8/85	9.61	08
4/86	10.46	3/86	10.10	36
6/87	10.27	8/87	10.46	-19
Pricing - June 25, 1982				
4/85	14.74	3/85	14.91	-17
4/86	14.98	3/86	14.87	11
6/90	15.24	8/90	14.48	76
Pricing - December 27, 1982				
4/86	10.48	3/86	10.22	26
6/87	10.42	8/87	10.54	-12
10/90	10.76	11/90	10.84	-08
Pricing - June 24, 1983				
12/87	10.84	1/88	10.83	01
2/90	10.93	1/90	10.88	05
10/91	11.12	11/91	11.28	-16
Pricing - December 28, 1983				
12/87	11.49	1/88	11.39	10
1/87	11.10	12/86	10.96	14
7/88	11.57	8/88	11.50	07
Pricing - June 26, 1984				
3/87	13.34	2/87	13.26	08
4/89	13.78	4/89	13.69	09
10/91	13.94	11/91	13.72	22
Pricing - July 30, 1985				
1/88	9.70	1/88	9.35	35
4/90	10.55	4/90	10.13	42
1/92	10.91	1/92	10.58	33
Pricing - August 13, 1985				
1/88	9.38	1/88	9.17	21
4/90	10.29	4/90	10.00	29
1/92	10.61	1/92	10.40	21

Table 3: Comparison of FCS and U.S. Treasury
Intermediate and Long-Term Bond Yield Rates

<u>Farm Credit System</u>		<u>U.S. Treasury</u>		<u>Basis point spread</u>
<u>Maturity</u>	<u>Yield</u>	<u>Maturity</u>	<u>Yield</u>	
Pricing - August 28, 1985				
1/88	9.17	1/88	8.99	18
4/90	10.05	4/90	9.71	34
1/92	10.31	1/92	10.06	25
Pricing - September 10, 1985				
1/88	10.10	1/88	9.23	87
4/90	10.97	4/90	10.04	93
1/92	11.20	1/92	10.41	79
Pricing - September 25, 1985				
1/88	9.85	1/88	8.85	1.00
4/90	10.54	4/90	9.69	85
1/92	10.84	1/92	10.14	70
Pricing - October 9, 1985				
1/88	10.09	1/88	9.06	1.03
4/90	10.87	4/90	9.89	98
1/92	11.17	1/92	10.31	86
Pricing - October 30, 1985				
1/88	9.69	1/88	8.74	95
4/90	10.47	4/90	9.53	94
1/92	10.68	1/92	9.92	76
Pricing - November 12, 1985				
4/88	9.58	4/88	8.69	89
7/90	9.98	7/90	9.28	70
1/92	10.40	1/92	9.57	83
Pricing - November 26, 1985				
4/88	9.45	4/88	8.67	78
7/90	9.95	7/90	9.26	69
1/92	10.35	1/92	9.57	78

Source: FCA Money and Credit Market Reports for 1981, 1982, 1983, 1984, and 1985. (Random selection of FCS long-term bonds offered on the same date as U.S. Treasury long-term bonds but with slightly differing maturity dates.) Yields reflect pricing of bonds in the secondary market.

Table 4: Comparison of FCS AND U.S. Treasury
Short-Term Bond Yield Rates

<u>Date</u>	<u>6-Month Treasury bills</u>	<u>6-Month FCS securities</u>	<u>Basis point spread</u>
June 25, 1981	15.20	15.80	60
December 24, 1981	12.77	12.90	13
June 25, 1982	14.14	14.48	34
December 23, 1982	8.57	8.31	-26
June 24, 1983	9.61	9.09	-52
December 28, 1983	9.74	9.61	-13
June 27, 1984	11.23	11.29	06
December 27, 1984	8.50	8.40	-10
June 12, 1985	7.74	7.80	06
July 10, 1985	7.36	7.30	-06
July 30, 1985	7.79	8.05	26
August 13, 1985	7.75	7.82	07
August 28, 1985	7.59	7.70	11
September 10, 1985	7.78	8.30	52
September 25, 1985	7.41	8.30	89
October 9, 1985	7.71	8.42	71
October 30, 1985	7.76	8.50	74
November 12, 1985	7.61	8.30	69
November 26, 1985	7.64	8.45	81

Source: FCA Money and Credit Market Reports 1981, 1982, 1983, 1984, and 1985.

To partially offset the effect of investors' requiring a greater risk premium, the System has increased its use of discount notes. The System's discount notes had an average maturity of about 50 days as of September 30, 1985. Table 5 shows the System's increased reliance on discount notes. The advantage of using discount notes is that the System is not locked in to the current premiums that investors are requiring. The primary disadvantages are that the System has significantly increased its vulnerability to interest rate fluctuations and increased the frequency with which the debt must be rolled over.

Table 5: Farm Credit System Funding

<u>Date</u>	Total outstanding <u>debt</u> ---- (billions)	<u>Bonds</u> ---	Percent of <u>total</u>	Discount <u>notes</u> (billions)	Percent of <u>total</u>
9-82	\$74.5	\$72.6	97.4	\$1.9	2.6
9-83	73.2	68.8	94.0	4.4	6.0
12-84	71.8	67.0	93.3	4.8	6.7
3-85	70.1	65.2	93.0	4.9	7.0
6-85	69.6	63.7	91.5	5.9	8.5
9-85	68.1	60.7	89.1	7.4	10.9

CUSTOMER BASE

The decline in gross loans from June 30, 1985 to September 30, 1985, was \$2.8 billion. The decline in gross loans during the quarter has occurred at over twice that which we projected for the June 1985 through June 1986 period.

Since December 31, 1984, the System's gross loans have declined about \$6 billion or 7 percent. (See figures 24 and 25.) Of this decrease, \$0.7 billion is the result of charging off bad loans. The remaining decline could be a result of several factors, such as good borrowers' leaving the System for other sources of credit or less creditworthy borrowers' leaving the System for programs available from such sources as the Farmers Home Administration (FmHA). We do not know the extent to which the decline in loan volume is caused by good or bad borrowers' leaving the System.

If good borrowers leave the System, it increases the percentage of risky loans in the loan portfolio and therefore, causes less creditworthy borrowers to carry the burden of the high risk borrowers. If less creditworthy borrowers leave the System to obtain loans from FmHA, the quality of the System's loan portfolio improves. As these borrowers obtain financing from FmHA, they may either paydown or payoff their debt to the System. However, even if neither a paydown nor a payoff occurs, the System may be better off than otherwise would have been the case. Had the borrower not obtained funds from FmHA, the System would have been forced either to make a risky loan or to foreclose, neither of which is an attractive alternative.

Figure 24

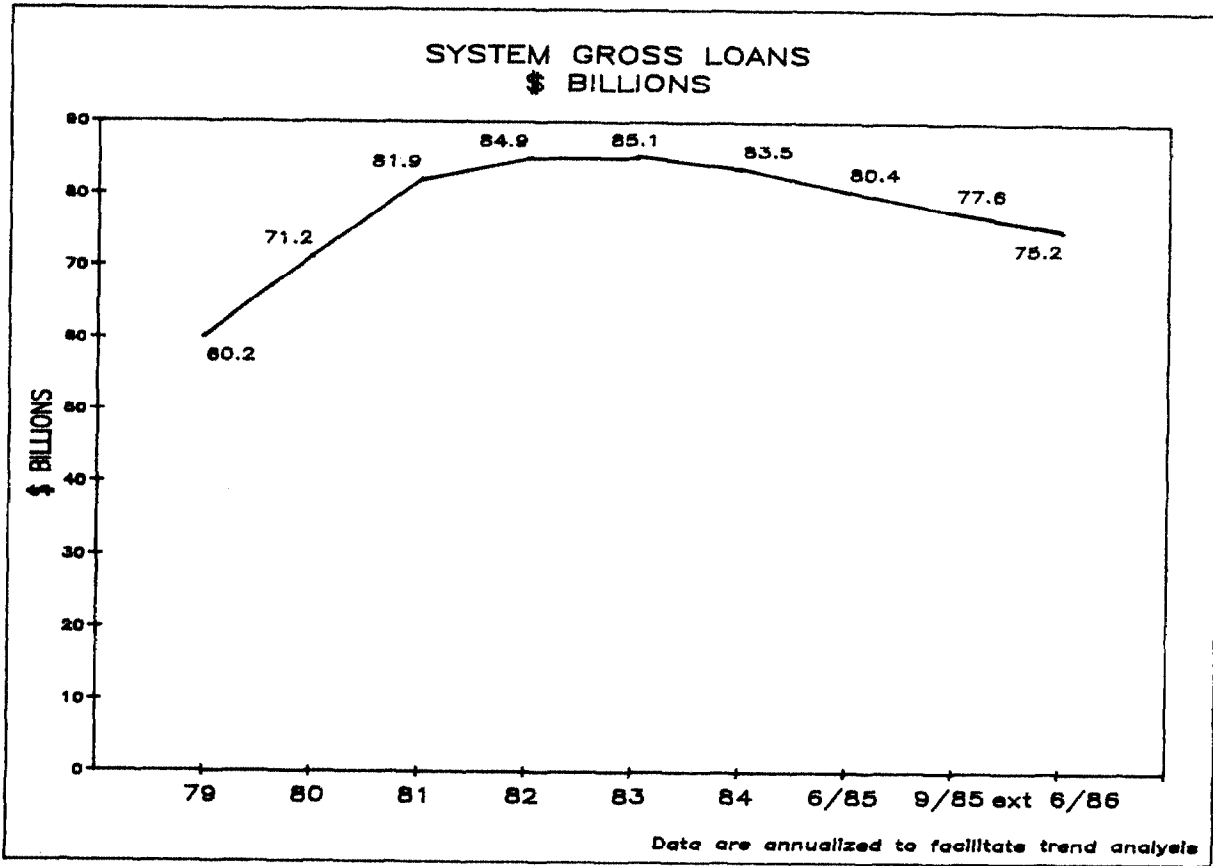
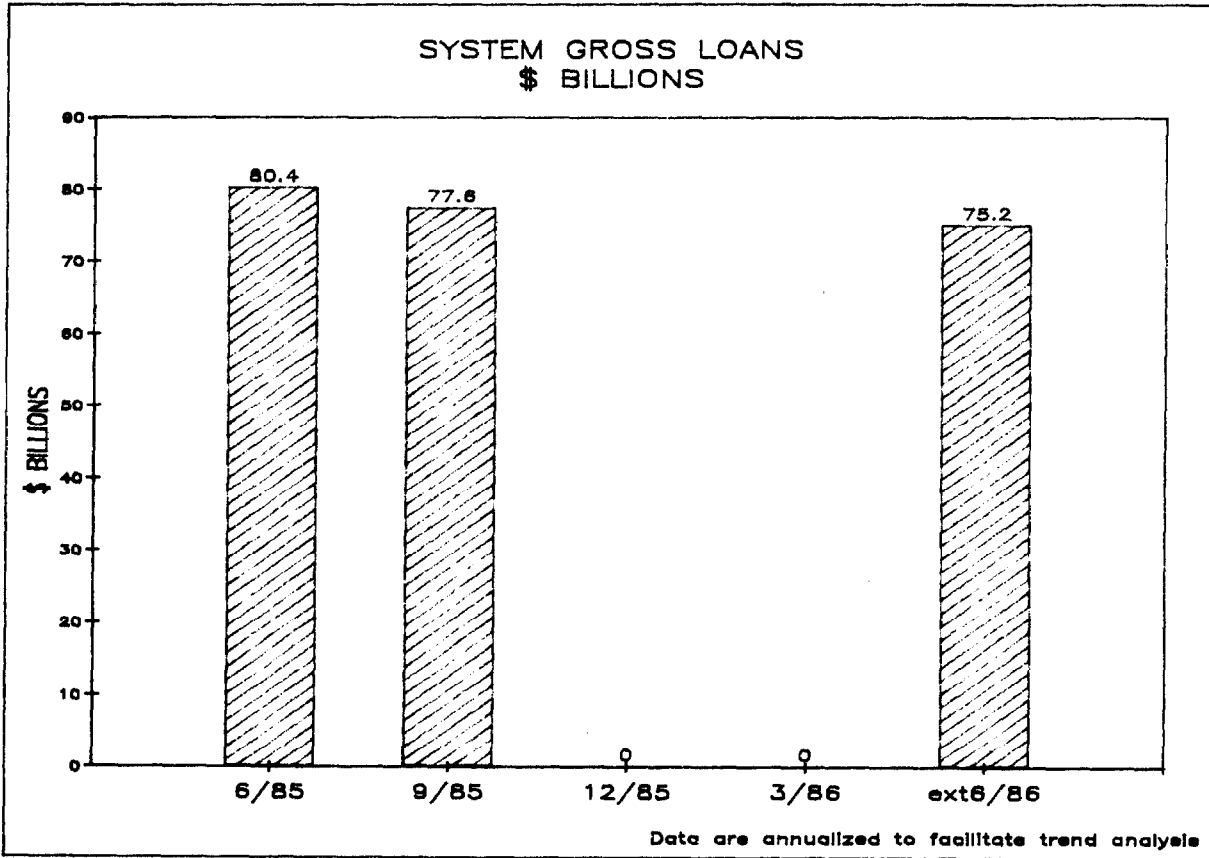
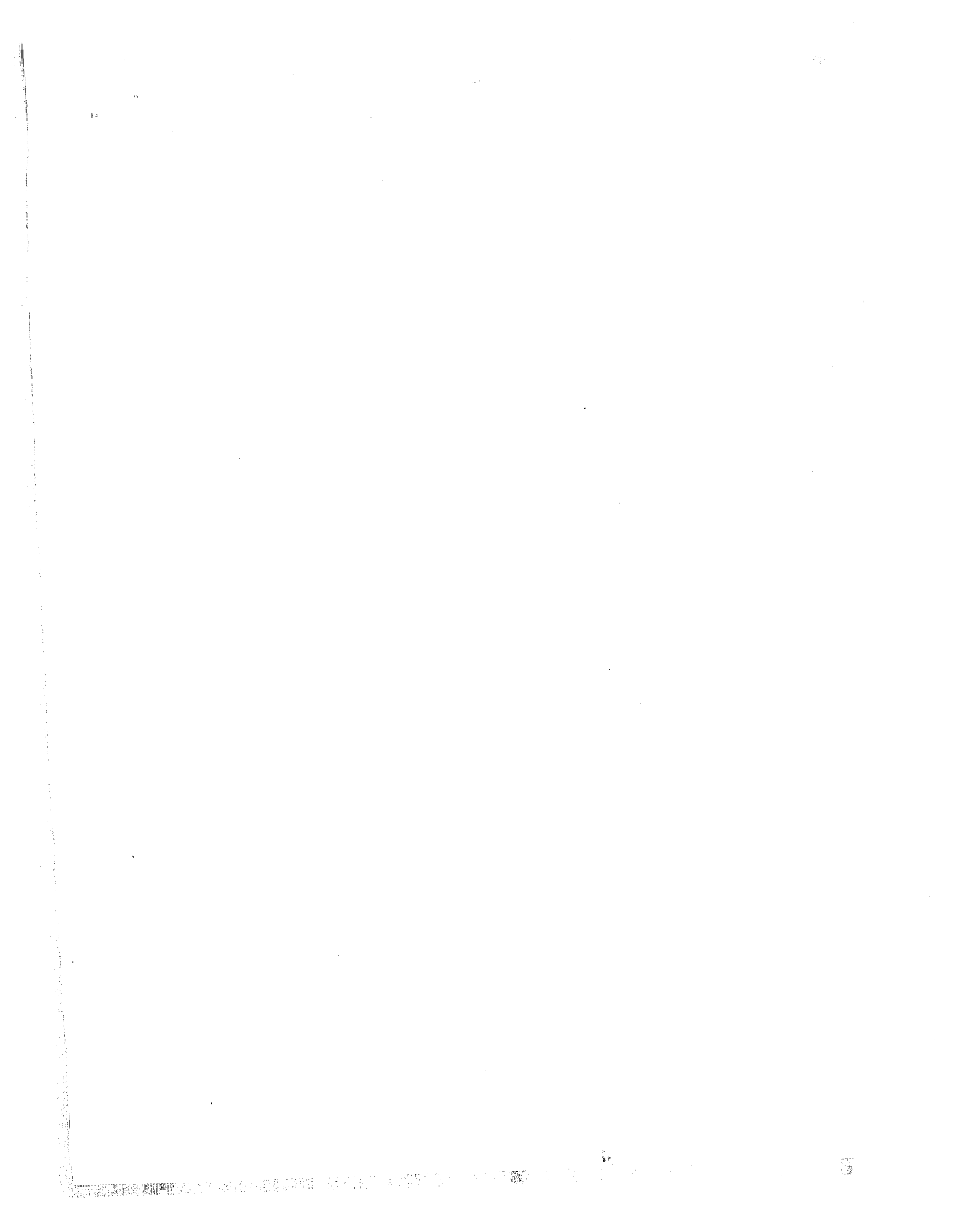


Figure 25









Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are \$2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

33193

United States
General Accounting Office
Washington, D.C. 20548

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use, \$300