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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, AND

RURAL DEVELOPMENT,

OF THE

COMMITTEE ON AGRICULTURE,

HOUSE OF REPRESENTATIVES

ON

THE FARM CREDIT SYSTEM

ANALYSIS OF FINANCIAL CONDITION

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Mr. Chairman and Members of the Subcommittee:

I am pleased to appear today to issue our report on the current and future financial condition of the Farm Credit System. I would like to briefly summarize the findings contained in the report and discuss their implications for the future.

The Farm Credit System began to experience significant difficulties in its loan portfolio in mid-1983. During 1985, the deterioration in the System's financial condition accelerated and the System suffered an operating loss of $2.8 billion. This loss and certain other accounting adjustments reduced the System's combined surplus from $6.2 billion to $3.2 billion by year's end. If these loan problems continue, we project that the System could incur an operating loss of $2.9 billion for 1986. This result would effectively eliminate the System's remaining surplus and thus pave the way for seeking Federal financial assistance.

Our projections are judgmental in nature and because of this, legitimate differences of opinion exist between us, the System and the Farm Credit Administration over their validity. The primary reason for the different opinions is that in 1986, like 1985, System financial performance will be determined to a large extent by judgments regarding the amount to set aside to cover expected future losses on loans in the System's portfolio.

During the first half of 1986 high risk loans in the System's portfolio increased by 32 percent from $9.3 billion to $12.3 billion. In light of this development the question becomes what is an appropriate level of reserves to set aside to cover eventual losses on these and other loans in the System's portfolio. While there is little difference of opinion regarding the likely condition of the System's loan portfolio by year's end, there is currently a considerable difference of opinion over the adjustment needed to bring the allowance for loan losses to an appropriate level. The System is currently projecting a 1986 allowance for loan losses of about $3.5 billion (an 8 percent increase over the 1985 allowance), while we are projecting an allowance of about $4.6 billion which represents a 43 percent increase over the 1985 level. (See Table 1.) The System believes that a considerably smaller adjustment to the allowance than the one we have made is appropriate because of the large addition to the allowance that was made by the System at the end of 1985. The System's smaller adjustment results in a smaller System estimate of losses during 1986 than we project.

I do not want to emphasize the differences of opinion that exist on this matter too heavily. Regardless of whether we are a billion dollars too high in our estimate, or the System is a billion dollars too low, there is general agreement that the losses experienced during 1985 and expected during 1986 will continue into the foreseeable future unless there is a dramatic reversal in the condition of the agricultural sector or the current trend in interest rates.

INDICATORS OF SYSTEM FINANCIAL STRESS

I would like at this point to highlight several of the key indicators of financial stress on the System.

-- In addition to the almost $3 billion operating loss in 1985, the System through June of this year reported an additional $1 billion in losses. We project that losses by year end could be about $2.9 billion if the System establishes the year end allowance on the same basis as occurred at the end of 1985.

-- At December 31, 1985, the System had about $1 billion in farm property acquired through foreclosure. The inventory of acquired assets is expected to increase this year.

-- The System has high debt servicing costs because a significant portion of its borrowings consist of long-term bonds that were sold in an earlier high interest rate environment. The after shock of this condition on the System's ability to compete with other lenders and on its borrowers' financial conditions will continue to be felt for some time to come. (See Table 2.)

-- The System's gross loans outstanding stood at $82 billion at the end of 1984. We project that this will decline to about $64 billion by the end of 1986. After taking into account the problems in the loan portfolio, we project that loans earning interest will stand at about $56 billion by year's end. This decline in loans outstanding has had a significant negative impact on revenues. Some System officials believe that at least part of this decline in loan volume is due to the exodus of more creditworthy borrowers who have found more favorable lending rates offered by the System's competitors.

CAUSES OF SYSTEM FINANCIAL STRESS

The growing stress being experienced by the System results from two main causes: weakness in the agricultural sector and questionable System policies for funding its debt and pricing its loans.

Triggered by weakness in the agricultural economy and falling land values, the System's loan portfolio contains a record-breaking volume of problem loans. Many of the problem loans are not being repaid according to terms, and in some cases these loans must be liquidated. Many loans are also not fully collateralized. This condition has resulted in and will continue to result in losses when the loans are liquidated. Loans, not yet liquidated, on which interest is no longer being paid, are costly to the System because such loans are funded primarily with interest-bearing debt. Because the System's loan portfolio is dependent on the condition of the agricultural economy, there is little hope of relief for the System's loan portfolio problems until the fortunes of the agricultural sector are reversed.

The System has exposed itself to fluctuations in interest rates by funding a significant amount of its variable rate loans with long-term fixed-rate bonds. The System reprices its loans on the basis of its average cost of borrowing. Because of this, when market interest rates are rising, rates on its loans are lower than current market interest rates and when market rates are falling, rates on its loans are high relative to current market rates. During the past 8 years long-term market interest rates rose from about 9 percent in 1978 to about 15 percent in 1981 and then returned to 1978 levels in 1986. In the 1980-1982 period, the System adopted a strategy of growth, which it

achieved by charging relatively low rates for variable rate loans during periods of rising interest rates. This growth was financed in part by long-term fixed-rate bonds. This has exposed the System to losses in the event that interest rates should rapidly decline, because its average borrowing costs could not be competitively passed through to borrowers in a lower interest rate environment. While a funding strategy that resulted in pricing at current rates during the 1980-1982 period might have increased repayment problems for existing borrowers, such a practice might also have discouraged some of the System's current borrowers from borrowing funds which they cannot now repay. Had the System used alternative debt instruments that allowed it to match the repricing of the debt which it sold to that of its variable rate loans, it would in all likelihood now be generating additional net interest revenue and/or be in a position to reduce the interest rates that it charges its borrowers. Assuming no future change in the level of interest rates or loan prices, the high rates on these bonds will continue to depress earnings for several years.

The combined effects of problem loans and high borrowing costs and the strong likelihood that these conditions will persist for some time to come raise serious questions about the viability of the System. Barring a dramatic turnaround in the agricultural economy and/or a dramatic reversal in market interest rates that would allow the System to borrow and lend at more competitive rates, it would appear that the trends we have

observed in the System's financial condition will continue for at least the near future. These trends may be slowed by effective management actions but it is very doubtful that the trends can be reversed by such actions.

There is nevertheless one area that must be attended to immediately by the System's management. We are recommending in our report that the System's management undertake an aggressive program to reduce further exposure to interest rate risk. Such a program could involve a combination of decreasing the frequency for adjusting interest rates on all new loans, making more fixed-rate loans, issuing new long-term securities with a call provision or with floating interest rates, and issuing more debt with short-term maturities. The Farm Credit System has indicated that it has proposals for dealing with this problem, but to our knowledge none of them have been implemented.

CONCLUSION

Our projection of the System's 1986 performance indicates that externally supplied capital may be needed in the relatively near future. It is not possible to determine how large an infusion of capital will ultimately be necessary, but it would be needed until the conditions in agriculture improve markedly and until the adverse effect of the System's high-cost, long-term debt on its average cost of funds is sharply reduced. Because our extrapolations involve a combination of judgments regarding the condition of the System's portfolio as well as

appropriate levels of reserves to cover expected future loan losses, we cannot be certain about the precise time at which the System's surplus will be effectively exhausted. Our analysis indicates that this could happen in early 1987. Unofficial projections by the System indicate that the surplus may not be exhausted that quickly and may be sufficient to carry the System until 1988. (See Table 3.) As I indicated, the exact time at which the System's surplus will be exhausted is not so important as the inevitability of the event.

The provisions of the 1985 Farm Credit Amendments Act provide that the System will be eligible to qualify for federal assistance when the System exhausts its surplus. We believe it is important that careful thought be given to the design of such an assistance program in advance of the exhaustion of System surplus rather than waiting until the last dollar of past earnings is drained out of the System. While the System would not be technically insolvent even after exhaustion of its surplus, it would effectively be unable to absorb any future losses in its loan portfolio or the adverse revenue effects of its past funding decisions. If no action is taken to develop an approach for a program of federal assistance prior to the exhaustion of the surplus, the uncertainty about federal involvement and the way it will work could create a crisis of confidence among the System's borrowers because of concerns over potential impairment of their stock and, among the System's investors whose continued participation in System bond offerings

is essential to its continued functioning. Actions taken in a crisis atmosphere frequently do not reflect the full range of possibilities for design of an effective and efficient federal assistance program. We believe that it is not too soon to begin thinking about the likely financial needs of the Farm Credit System over the next few years and ways to provide for those needs that maximize the chances of its attaining long range viability as a self sustaining entity.

Mr. Chairman, that concludes my prepared statement. My colleagues and I would be happy to answer any questions the subcommittee has at this time.

Table 1

Farm Credit System
Loan Losses
($ billions)

1. Balance sheet items at year end

		Projected 1986	
	1985	GAO	System
Nonaccrual loans	5.1[a]	7.5	7.7
Reserve allowance for loan losses	3.2	4.6	3.5
Allowance as a percent of nonaccrual loans	63%	62%	45%
2. Annual expense provision for losses	3.0	3.1	1.8

[a]Does not include "other high risk" loans estimated by the System to have been $4.0 billion and by FCA to have been $5.0 billion as of December 31, 1985.

APPENDIX I

Table 2

Farm Credit System
Unallocated Surplus at December 31
($ billions)

		Projected		
Organization	1985	1986	1987	1988
GAO	3.2	0.4	a	a
System	3.4	1.7	0.6	(0.1)
FCA	3.2	1.5	0.2	(0.9)

[a]No projection was made by GAO.

APPENDIX I

Table 3

Farm Credit System
Bonded Debt
at June 30, 1986
($ billions)

Maturity	Amount	Average interest rate	U.S. Treasury interest rates
6 months or less	12.6	9.4%	6.1%
Over 6 to 12 months	7.5	10.6%	6.4%
1 to 5 years	24.9	10.9%	7.0%
Over 5 years	8.8	11.8%	7.4%