CBO TESTIMONY

Statement of
Robert S. Seiler, Jr.
Congressional Budget Office

before the
Committee on Agriculture,
Nutrition, and Forestry
United States Senate

May 21, 1991

NOTICE

This statement is not available for public release until it is delivered at 2:30 p.m. (EDT), Tuesday, May 21, 1991.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, I appreciate the opportunity to appear before this Committee to discuss the Congressional Budget Office's (CBO's) report, *Controlling the Risks of Government-Sponsored Enterprises*. My testimony will focus on CBO's analysis of the risk posed by the Farm Credit System (FCS)--including the Federal Agricultural Mortgage Corporation--federal supervision of the safety and soundness of the system, and several policy options that could limit the government's exposure to risk.

The FCS has recently been through a period of wrenching financial difficulties and significant and continuing institutional change. CBO's analysis of the system suggests that the institutional changes, which resulted largely from legislation that provided federal financial assistance, have greatly reduced the risk that the FCS poses to the federal government. Nonetheless, portions of the system remain in weak financial condition. The weaker Farm Credit Banks could seriously threaten the financial integrity of the entire system if the farm economy were to suffer a serious downturn during the next few years. The likelihood of such a downturn is not high, in CBO's view. Nevertheless, the FCS continues to pose more risk to the government than any other GSE, even though it has fewer assets than all the other enterprises except the Student Loan Marketing Association (Sallie Mae). Its financial condition, therefore, will merit close scrutiny in the next three to five years.

IMPLICATIONS OF THE AGRICULTURAL CREDIT ACT OF 1987

After the FCS lost $4.6 billion over the 1985 to 1987 period, the Agricultural Credit Act of 1987 provided federal financial assistance and made major changes in the system's institutional structure and its relationship to the government. These changes, although not yet fully carried out, have significantly reduced the government's exposure to risk.

The 1987 act established the Farm Credit System Financial Assistance Corporation (FAC) to provide up to $4 billion in financial assistance to the system by late 1992, to be financed with debt backed by an explicit federal guarantee. To date, $1.3 billion of FAC bonds has been sold, including $0.4 billion to pay back capital preservation agreements executed among the system's institutions before 1987. Current CBO projections indicate that total sales should be less than $2.5 billion by the time the FAC's borrowing authority expires at the end of fiscal year 1992.

The Farm Credit System Insurance Corporation, headed by a board consisting of the members of the board of the Farm Credit Administration (FCA), was created to collect premiums from FCS institutions and build up a fund that would be available, beginning in 1993, to assure the timely repayment of borrowing by the system, to cover defaults on bonds issued by the FAC, and to ensure the retirement of the protected borrower stock of all banks and associations in the system. The legislation established a target minimum balance for the fund, known as the secure base amount, equal to 2 percent of outstanding liabilities of the system or whatever amount the Insurance Corporation might deem necessary to ensure the actuarial soundness of the fund. At the end of 1990, $438 million had accrued in the fund, an amount equal to slightly more than three-quarters of 1 percent of the FCS's liabilities.

The legislation provided for some consolidation of the FCS. The Farm Credit Banks were created in 11 districts by merging the Federal Land Banks and the Federal Intermediate Credit Banks. The local Production Credit Associations and Federal Land Bank Associations were permitted to merge and to form Agricultural Credit Associations, which make both short- and long-term direct loans. The local Federal Land Bank Associations were allowed to convert to Federal Land Credit Associations, which only have direct lending authority for real estate loans. The Central Bank for Cooperatives and the district banks for cooperatives were also permitted to merge, so that there now are three banks for cooperatives with authority to lend on a nationwide basis. Finally, the act urged the system to explore the possibility of reducing the number of districts through mergers. Although a number of mergers have been discussed, none has taken place.

The 1987 act also required the Farm Credit Administration, the federal agency that supervises the safety and soundness of the FCS, to set interim and final minimum capital standards for each institution. The FCA has set the minimum permanent standard at 7 percent of each institution's risk-weighted assets. Protected borrower stock is excluded from the definition of permanent capital. The final capital standard will be phased in over time, with full compliance to be achieved by the beginning of 1993. As of September 1990, all but 11 of the FCS institutions, which then numbered 305, had achieved risk-adjusted capital levels of 7 percent or more, and only one Farm Credit Bank, the Spokane bank, was not in compliance with the FCA's interim capital standard. The members of the Spokane bank have since taken steps to increase its capitalization and comply with the interim standard. The FCA may require an institution to maintain a greater percentage if the agency believes it is necessary to assure safety and soundness.

Finally, the statute created the Federal Agricultural Mortgage Corporation (Farmer Mac) to increase agricultural lenders' access to capital markets by guaranteeing securities backed by pools of loans for agricultural real estate and rural housing. The act sought to minimize Farmer Mac's exposure to credit risk by requiring that it guarantee securities representing no more than 90 percent of the principal balance of the loans in each pool. Farmer Mac was also recently given authority to issue and guarantee securities backed by loans guaranteed by the Farmers Home Administration (FmHA). Last month the first such securities were issued.

RECENT PERFORMANCE AND CURRENT EXPOSURE TO RISK

The FCS has been profitable in each of the last three years. The most important reason for the system's turnaround has been the improvement in the general farm economy, which has made borrowers better able to service their debt, reduced the amount of loans that are nonaccruing, and enabled the FCS to lower its reserves for loan losses. The system's interest expenses have dropped significantly, and its operating costs have also declined somewhat. In addition, the FCS has disposed of a large inventory of acquired property and stopped its loan portfolio from shrinking.

Despite the improved performance of the FCS as a whole, data reported in CBO's study indicate that portions of the system continue to be quite vulnerable financially. For example, measures of the performance of loans made by FCS institutions reveal that a large number of districts continue to have significant problems with the credit quality of their loans. Many of the districts that have the lowest ratios of loan loss reserves to high-risk loans (an indicator of the ability to cope with an increase in defaults) also have portfolios of the poorest quality. The FCA's rating system indicates that the overall financial condition of banks and associations has improved on average in the last few years, but that the agency's examiners continue to have concerns about the well-being of a large percentage of institutions.

The FCS and the FCA currently have a number of procedures, some of them developed in recent years, to reduce the credit risk of the system's lending. The district banks have agreements with member associations about minimum levels of acceptable financial performance, which the banks could use to restrict new borrowing by associations that perform poorly. Most FCS institutions use credit-scoring techniques and have loan review committees, and most associations employ differential loan pricing, so that loan rates reflect, at least partially, the relative credit risk of borrowers. Because the associations retain significant autonomy in making lending decisions, however, FCA examinations play a critical role in managing and controlling the credit risk of institutions in the system.

Since the 1987 act, the **FCS** has also improved its internal mechanisms for controlling its exposure to interest rate risk. System institutions have the ability to change the interest rates on variable-rate loans as their cost of funds rises and falls with market interest rates. Their success in using this method of shifting the cost of changing rates to borrowers is still somewhat uncertain, however. The banks more closely monitor their portfolios and those of local associations to spot mismatches between the terms of loans and the bonds issued to finance them. Portions of the system are also using sophisticated financial techniques to manage their exposure.

CAPITAL ADEQUACY AND THE FEDERAL GOVERNMENTS EXPOSURE TO RISK

The **FCS** will eventually have several tiers of capital or capital-like funds on which to draw when another agricultural downturn occurs. After collateral pledged to back the system's obligations and earnings, each institution's loan loss reserves and capital will be the first funds available to absorb losses. If internal resources are insufficient, the banks will be able to seek assistance from the insurance fund, which has a target level of at least 2 percent of the FCS's insured liabilities. If neither source is sufficient, the district banks are jointly and severally liable for all of the system's obligations. Joint and several liability means that financially healthy portions of the FCS would be called on to assure timely payment on borrowings by institutions in the system that could not meet their obligations.

The FCA's minimum risk-based capital standards, however, will not be fully in place, and the insurance fund will not be available to absorb losses, until 1993. Because portions of the system continue to be financially weak as they recover from the losses of the 1980s, CBO has concluded that the system's financial condition and capital adequacy merit close scrutiny over the next three to five years.

As a partial test of the ability of the FCA's minimum capital standards and the insurance fund to handle potential financial difficulties in the FCS in the near term, CBO analyzed a simple scenario, which assumed a downturn in the farm economy beginning in 1991 that would be somewhat less severe than the one that occurred in the mid-1980s. The analysis, which is reported in more detail in our report, assumed that the system would suffer a decline in loan volume and high loan losses, but would not incur losses from changes in interest rates, during the downturn. CBO projected that seven districts within the system might be unable to maintain their minimum capital standards throughout the 1991-1996 period. The shortfalls in three of the districts were large and persistent, and the insurance fund was not sufficiently large to offset them. CBO projected, however, that the fund would have sufficient balances to absorb the insolvencies in those three districts.

CBO's analysis assumed that the bank and associations in each district operate as a single entity. In particular, CBO assumed that all at-risk capital within each district, whether held at the bank or association level, would be available to the district bank to absorb losses. In a future economic downturn, the behavior of component parts of the system might not be consistent with these assumptions. Consequently, specific districts could have greater difficulty dealing with losses than CBO's analysis suggests. Further, even if a district fared well as a whole, the hardships suffered by individual farmers and their local associations could be severe, and the aggregate amount of insolvencies at the system's institutions could be greater than suggested by our analysis. If the FCS suffered losses from changes in interest rates during a downturn, capital shortfalls and insolvencies could also be greater than CBO projected.

FEDERAL SUPERVISION OF SAFETY AND SOUNDNESS

CBO's report analyzed federal supervision of the safety and soundness of each GSE in terms of the institutional capacity, statutory mandate, and statutory authority of the federal supervisory agencies. Institutional capacity includes the ability to hire, train, and retain a competent and professional staff that can understand the activities of the enterprise and directly represent the government in litigation. The statutory mandate of a supervisory agency is a clear statement of the agency's responsibility to protect the government from risk of loss. The agency's statutory authority may include the ability to require financial disclosure and reporting, perform examinations, set binding capital requirements, enforce those requirements and other restrictions on risk, and take action when an enterprise is failing.

CBO concluded that the institutional capacity, statutory mandate, and statutory authority of the Farm Credit Administration are quite similar to those of the bank and thrift regulatory agencies and are generally adequate to assure the safety and soundness of FCS institutions. Because the system consists of several hundred institutions--most of which lend directly to borrowers--and makes many different types of loans, the FCA conducts detailed examinations that focus principally on the credit quality of assets.

The FCA examines each institution once a year, except Federal Land Bank Associations, which are examined at least once every three years. To correct inadequacies in the operations of FCS institutions, the FCA employs a hierarchy of informal and formal enforcement actions. The agency may also appoint a conservator or receiver for failing FCS institutions. Because the FCA has not been truly independent of the system or possessed all its current powers for very long, however, its ability to ensure the safety and soundness of the FCS over the long term cannot be assessed.

The FCA also has authority to examine Farmer Mac and to provide for the general supervision of its safety and soundness. This supervision may include the use of enforcement powers. The legislative history is clear that the agency is authorized to use its rule-making authority to address the specific issues of examination and reporting of Farmer Mac's financial condition. The FCA would also seem to have access to the usual supervisory process, including the ability to issue cease and desist orders, to enforce capital standards after the fact.

However, the Congress has not given the FCA general rule-making authority over Farmer Mac. The FCA's authority to define in advance unsafe and unsound business practices for Farmer Mac is ambiguous. Also, it is not clear that the agency could use the rule-making process to promulgate capital standards prospectively for Farmer Mac. Finally, it is unclear that the FCA could rely on its general supervisory authority to appoint a conservator or receiver for Farmer Mac if the corporation got into financial difficulty. These are possible areas for legislative action should the Subcommittee wish to revisit the issue of the FCA's authority over Fanner Mac.

POLICY OPTIONS

CBO examined three broad policy options that could affect the risk that the **FCS** poses to the government: eliminating joint and several liability, eliminating or consolidating the district banks, and authorizing the Insurance Corporation to change the target size and rate of growth of the system's insurance fund. Each option addresses an important issue but might compromise the financial viability of the **FCS.** Assessing the relative costs and benefits of these options is difficult, because the recent institutional changes in the system limit the value of using historical data to predict systemwide effects. A fourth option examined by CBO concerns possible changes in the FCA's statutory authority over Farmer Mac. Finally, our report discussed the advantages and disadvantages of moving supervision of the **FCS**, including Farmer Mac, to a new agency created to supervise the safety and soundness of all the GSEs.

Eliminate Joint and Several Liability

All districts currently share the liability for the bonds issued by any **FCS** district. Increasingly, however, the lending that exposes the **FCS** to risk occurs at the local association level. Joint and several liability can give institutions in some districts an incentive to take excessive risk, since each reaps the benefits of lending, but shares the responsibility for repayment of their obligations with institutions in other districts. Further, when a bank needs capital in order to absorb losses that it or its associations have incurred, sound associations within its district or other banks may feel that their continued viability would be endangered by the withdrawal of capital. In the mid-1980s, when many districts and associations faced just such a dilemma, intrasystem capital transfers, though substantial, were insufficient to cope with the problem and generated extensive litigation.

Eliminating joint and several liability would address these concerns but could have drawbacks. For example, the districts or banks that issued bonds in the future would lack the geographic diversity of the whole system. Investors might infer a reduced federal commitment to the system and an increased willingness of the government to allow portions of the FCS to default on their obligations. The liquidity of the debt could also decrease. All three factors could increase the borrowing costs of FCS institutions and their borrowers. Of course, to the extent that borrowing costs reflected risk more closely, institutions would have a greater incentive to employ sound business practices, which could reduce the government's exposure to risk.

Perhaps the most powerful argument for retaining joint and several liability is that, under the emerging institutional structure, the likely costs associated with it decline while its benefits are undiminished. Specifically, if the minimum capital standards and insurance fund function as planned, the likelihood of having to activate joint and several liability is diminished. At the same time, the economies of scale and the benefits of a diverse geographic lending base that are generated by joint and several liability are still relevant.

Eliminate or Consolidate District Banks

District banks have provided oversight and coordination of the activities of local associations. With lending authority being increasingly placed at the local level and with improvements in communications and transportation, some analysts feel that FCS district banks could be eliminated or reduced in number. The primary benefit would be to reduce the system's operating costs. Replacing the district banks with additional national-level institutions, however, could undermine local control of the system, at least in perception. One of the stumbling blocks to the mergers suggested by the 1987 Agricultural Credit Act has reportedly been a reluctance on the part of members of a district to risk a change in their operating procedures that might result from a merger. In addition, the practicality of reducing the number of banks is diminished by the lack of an acceptable means of dealing with their nonaccruing assets.

Change the Insurance Fund

The board of the Farm Credit System Insurance Corporation could be given additional authority to modify the structure of the fund to help protect the government against loss in the period of heightened vulnerability that the system faces in the next few years. The Insurance Corporation's board could change the premium rates or the target fund level to respond to changes in the system's financial situation or conditions within agriculture.

One can advance two arguments for requiring the fund to be somewhat greater than 2 percent, at least in the near term. First, having a larger fund would allow the recapitalization of the three districts that CBO's analysis projected to have relatively significant capital shortfalls in a serious downturn. Second, some districts may have difficulty meeting their obligations to repay FAC debt beginning in the year 2003. It might be wise to have enough money in the insurance fund to enable them to cover their obligations without falling out of compliance with the FCA's capital standards or defaulting.

Increasing the target size of the fund or rapidly increasing the premium rates might, however, imperil the financial condition of the more vulnerable portions of the system or increase the costs to borrowers. Also, there is little evidence to suggest what the appropriate premium structure ought to be to give institutions a proper incentive to avoid unnecessarily risky lending.

The recent report submitted by the Treasury Department advocates another possible change in the powers of the board of the Insurance Corporation. If the insurance fund was tapped to assist an ailing district bank, the corporation would have access to capital at associations within the district to cover at least some of the cost of the assistance. The amount of an association's capital that could be tapped would be proportionate to the amount that the institution had borrowed from the district bank in recent years. The argument for this proposal is that each local association benefits from the ability to borrow through the district bank and, therefore, should share in the responsibility for absorbing losses for which the bank is liable. The change would help to resolve the contradiction between moving the responsibility for lending decisions and the accumulation of earnings to the local level, as the 1987 act and the FCS's capital regulations encourage, while retaining liability for losses at the district level. A possible objection to the option is that increasing effective risk-sharing within districts that have associations whose financial condition varies greatly would impose significant additional risk on the healthier institutions.

Increase the FCA's Authority over Farmer Mac

Finally, the FCA could be given the same clear authority to define unsafe and unsound practices in advance, to set capital standards, or to appoint a conservator or receiver for Farmer Mac that it possesses for banks and associations of the FCS. The Treasury's recent report advocates this option. Although the FCA could use such authority to restrict Farmer Mac's freedom, the corporation would probably continue to function. An alternative approach would be to require the FCA to report promptly to the Congress on any practices of Farmer Mac that posed an unreasonable risk to the government.

Move Supervision of the System to a Centralized Agency

One strategy for reforming federal regulation of GSEs would be to create a new agency and give it responsibility for supervising the safety and soundness of all the enterprises. The FCA and the FCS Insurance Corporation would be moved into this new agency, their boards would be abolished, and the responsibility for making decisions about regulation of the FCS, including Farmer Mac, and disbursement of funds from the insurance fund would be lodged in the board of the new agency. Supervision of Farmer Mac would reside in a division of the agency that would handle all GSE secondary market operations. Because the FCS consists of primary lenders, supervision of the system's institutions would be in a separate division.

A centralized supervisor for all GSEs would have greater responsibility, would be accountable to a broader range of interests, and could be more visible than are the existing agencies that supervise the enterprises, including the FCA. These factors probably would reduce the possibility that one or more of the GSEs could dominate the decisions of, or capture, the new agency's board. Several questions can be raised about applying this option to the FCS, however. CBO's analysis suggests that the government is exposed to significant risk principally because the system is a single-sector lender and is recovering from substantial losses suffered in the 1980s, and because the institutional changes begun in 1987 have not been fully implemented, rather than because federal supervision by the FCA is inadequate. Also, a new agency probably could not achieve economies of scale by monitoring and examining FCS institutions in the same way it would other GSEs. Finally, a centralized agency might be more likely than the FCA to take steps that would reduce the government's exposure to risk at the expense of making the system less competitive.

CONCLUSION

In conclusion, Mr. Chairman, I will reiterate the major points of my testimony. First, CBO's analysis of the Farm Credit System suggests that the institutional changes that have been made since 1987 have significantly reduced the risk that the **FCS** poses to the federal government. Second, the analysis also indicates that portions of the system remain in weak financial condition and could seriously threaten the safety and soundness of the entire FCS if agriculture suffered a serious downturn during the next few years. Although CBO does not think such a downturn is likely, the Congress will want to pay close attention to the system's financial condition in the next three to five years. Third, the substantial changes to the structure of the FCS that CBO **considered--eliminating** joint and several liability, eliminating or consolidating the district banks, and changing the structure of the insurance **fund--would** address important policy issues, but would entail risks in terms of the financial viability of the system. Assessing the relative costs and benefits of these changes is difficult, because the recent institutional changes in the FCS limit our ability to use the historical record to assess the likely effects on the system as a whole.