Conditions in the Farm Credit System

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Over a decade ago, U.S. Agriculture was in the middle of its worst financial crisis since the Great Depression. And it seemed that the Farm Credit System (System or FCS) was particularly impacted because of weak lending and financial management practices, and because its single purpose charter prevented diversification into less risky industries. More than $8 billion in capital surplus that had been accumulated for over 50 years in the Farm Credit System was gone. Three separate pieces of Federal legislation were required to help resolve the problems that threatened the System. Since then, Farm Credit System institutions have been recovering from that crisis. In particular, the FCS has been rebuilding its capital strength; it has become more efficient; and it has improved risk management practices.

Statistics ($ in millions)	1997*	1990*	% Change
Capital	**11,585**	**4,599**	**151.9** ⇑
Nonperforming loans	**828**	**4,660**	**(82.2)** ⇓
Nonaccrual loans	**592**	**2,627**	**(77.5)** ⇓
Allowance as a % of nonaccrual	**310.0**	**57.7**	**437.3** ⇑
Allowance as a % of nonperforming	**221.6**	**32.5**	**581.8** ⇑

* Data are as of December 31.
Source: "Report to Investors of the Farm Credit System," Federal Farm Credit Banks Funding Corporation.

We should particularly note they have improved the management of credit risk and the delivery of credit. This is evident in the risk profiles (adverse loans to risk funds) of direct lender associations. For the first time since we have been tracking this risk measurement, all direct lender associations reflect risk profiles at December 31, 1997, that we would consider acceptable … their adverse loans as compared to their risk funds were less than 50 percent for almost all associations.

While these statistics reflect that FCS institutions have significantly improved their credit risk management practices, they also reflect the generally favorable operating environment over the past 5 years. Implementation of formally documented loan underwriting standards, improved internal controls, and risk identification practices have enabled System institutions to re-position themselves to better serve agriculture and rural America and to withstand potential risks on the horizon. I believe the risk profiles of most System institutions are currently satisfactory and they have the where-with-all to ensure a dependable source of credit for America's farmers, ranchers, and cooperatives.

Some could argue the strong financial condition of the System is due primarily to the overall improvements of the general economy. Others would argue that it is due to actions on the part of System institutions to change their methods of operations and to undergo a restructuring in order to gain the needed efficiencies to continue to effectively serve agriculture. The truth is, it's a combination of both.

Farm Credit System — Deliberate Restructuring Program

A major restructuring and overhaul of the Farm Credit System over the last decade, both structurally and financially, has re-positioned institutions in the System. Some of these changes may have been driven by changes in the Farm Credit Act, while others were clearly based on strategic decisions by institutions to take the needed steps to ensure a viable Farm Credit System.

In 1983, there were 932 Farm Credit System institutions and today there are only 210. This decline of over 75 percent (721 institutions) reflects the commitment of the System institutions to re-position themselves to better serve agriculture and rural America. In some districts, all associations consolidated into one institution. Also during that time, the Agricultural Credit Associations (ACAs) were formed as a result of mergers of Production Credit Associations and Federal Land Bank Associations. The ACAs were formed with the objective of better serving the funding needs of eligible borrowers.
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The mergers/consolidations generally eliminated small associations that had operated inefficiently because their high overhead costs hindered their ability to competitively price their products. Those institutions that were inefficient were often unable to effectively meet the needs of borrowers in the most cost efficient manner.

Restructuring into large associations also enabled them to compete more effectively in the agriculture credit arena and provide eligible borrowers a full array of loan products. Through such structuring, those institutions improved financially, their operating efficiencies improved, and they became better able to withstand the risk of their operating environment.

Banks

In addition to the major consolidations of the associations, System banks also consolidated. In late January 1988, there were 37 banks; today there are only 8. You may recall one of the most significant changes was the merger of 12 of the former Banks for Cooperatives to form the National Bank for Cooperatives. Subsequent merger resulted in the formation of CoBank, ACB. Today this bank and the St. Paul Bank for Cooperatives provide financing to cooperatives owned by farmers and ranchers — many of which are also financed by associations. Restructuring of this component of the System to a large extent has also facilitated the expansion of foreign markets and international trade. Financing international trade involves many risks that are uncommon in typical lending to agriculture. It takes a lot of capital and involves very thin margins that discourage most financial institutions from entering this market. In order to provide for the risk associated with this type of lending, Government guarantees are frequently used. As a result, U.S. agriculture exports were enhanced to the benefit of all farmers and ranchers.

The other Farm Credit banks (Federal Intermediate Credit Banks and Federal Land Banks), you may recall, also went through a series of consolidations to form the 6 Farm Credit Banks that presently exist. Those institutions have made significant strides to operate more efficiently and ensure a reliable and reasonable source of funds is available to Farm Credit associations and other financial institutions.

Because of these initiatives taken in the past 15 years (although some were statutorily driven), and as unfortunate as the problems caused by the Farm Crisis of the 1980s were, the System survived, it has rebounded, and it is in a **much stronger position** to serve farmers, ranchers, and cooperatives in America to ensure that a dependable source of credit is available to produce the food and fiber necessary to feed, clothe, and house the public.

Risks on the Horizon

While the FCS institutions have rebuilt their financial strength and re-positioned themselves to better serve agriculture and rural America, we must be mindful of the **potential risks on the horizon** that confront not only lenders in the Farm Credit System but all lenders that operate in the farm credit arena.

Government Programs

The phase-out of Government support programs by the year 2002 could significantly alter the dynamics of agriculture. We are starting to see the impact of this deregulation. A recent article in the May 5, 1998, *Wall Street Journal* tells the story of how some wheat growers in the upper Midwest are quitting farming and seeking other employment. It says that thousands who have made their living from growing wheat are quitting. In North Dakota, state officials received a Federal grant last month to re-train hundreds of wheat growers for other jobs. Roger Johnson, North Dakota Commissioner of Agriculture, was quoted as saying, “I’ve never seen it as bad as this.” This clearly reflects the changing dynamics of agriculture and reflects risks that need to be addressed.

Rising Farm Real Estate Values

The increase in the value of farm real estate is a concern to me. Although increases to real estate values improve the financial position of farmers, they do not necessarily improve their cash flow or repayment capacity. This could potentially increase lenders’ risk if borrowers and lenders alike do not prudently manage credit risk. I am concerned about the increasing values because we are seeing values significantly outstripping the repayment capacity of the farm in some instances. There is an increase in collateral risk for all lenders, not just the Farm Credit System. Lending money on the market value of farm land versus repayment capacity of the land can involve a lot of risk (this I don’t like). Lending money to borrowers based on repayment capacity mitigates risk (this I like).

Actions Taken to Deal with This Risk

Fortunately, I believe institutions in the Farm Credit System learned valuable lessons from the flawed collateral lending practices of the 1980s. They now focus their lending programs on the borrower's capacity to repay debt. As you know, I have a basic philosophy that I believe is fundamental to sound lending and that is … "If the borrower cannot repay the debt, it is best not to lend the money."

Our examiners continue to examine this in all institutions by evaluating underwriting standards and lending practices.

Rising Interest Rates

Some believe there is a real potential that interest rates will rise. This is a customary dynamic of lending that lenders must factor into their operations. My concern with interest rates is twofold: (1) institutions must price loans in accordance with the risk inherent in loans and (2) institutions must manage their interest rate risk exposures. While the prospect of rising rates will affect the cost of operations for virtually all segments of agriculture, our concern is how well Farm Credit System institutions manage their **interest rate risk** with **effective asset liability management** (ALM) programs. Inadequate ALM programs and practices were a major contributing factor to the financial crisis of the 1980s, and both the System and the Agency have taken steps to deal with this issue to prevent a recurrence of the problem.

Later today, special commissions will be awarded to certain examiners because they have completed our 3-year Capital Markets Specialist training and certification program and have developed the skills necessary to examine the complex capital markets area. They are **our Agency's Capital Markets Experts**. We are pleased to report that these examiners and others lead initiatives in examining capital markets activity and other asset liability management practices in Farm Credit System institutions. These special commissions did not exist 10 years ago, and they reflect our commitment to ensure that risk in this critical aspect of FCS institutions is appropriately managed.

Through emphasis placed on capital markets and asset liability management practices in Farm Credit System institutions, examinations have found that System institutions are acutely aware of interest rate risks and have significantly enhanced their controls to manage this critical component of their operations.

Year 2000

Another emerging risk that I'm sure you have all heard about touches virtually all segments of our society, that is the problem associated with the year 2000. This simple problem, the inability for systems to distinguish between years, is a major **business problem**. Please note that I did not say **computer** problem.

The Agency has devoted significant resources to information systems issues over the years. Today, special commissions will be awarded to Information Systems Examiners who are technical experts in this area.

As you know, we have devoted a lot of resources in reminding institutions of potential problems that could emerge and we believe the System is listening. We have seen the System's awareness of the year 2000 issue significantly improve in the last 6 months. All institutions are looking at these issues and as you can appreciate, we will be monitoring institutions very carefully in our oversight of this critical issue.

Enforcement Actions

I would like to speak briefly on our initiatives over the past decade or so to seek and obtain corrective action in the Farm Credit System institutions.

You might recall that in the second quarter of 1991, we had 82 enforcement actions in place with FCS institutions. At that time, 83.2 percent of the System's assets of $61.4 billion were under enforcement actions. These actions were largely due to problems that emerged from the farm crisis of the 1980s.

Since the second quarter of 1991, enforcement actions have declined substantially to the extent that there are only two formal enforcement actions in place today. It is interesting to note that these two actions were due to recent problems that had no correlation to the farm crisis of the 1980s. The most significant point here is that there are no "leftover" enforcement actions or problems associated with the 1980s, as the last one was lifted in the first quarter of 1998.

We must recognize that the farm crisis of the 1980s took a significant toll on the Farm Credit System. The recovery from that era was long, a recovery that is worthy of announcement. Accordingly, I now state, as the Chief Examiner of the Farm Credit Administration, that the Farm Credit System has recovered from the farm crisis of the 1980s. There are now no institutions under any supervision requirements due to the farm crisis of the 1980s.

Although the Farm Credit System has officially recovered from the farm crisis of the past decade, I am mindful that concentrated lending to a single industry has tremendous risk. Unlike commercial banks, FCS institutions cannot diversify out of agriculture because agriculture is their principal market. Therefore, a prolonged downturn in the agricultural economy that might or could occur from world surpluses, the phasing out of Government support programs, rising interest rates, or other conditions that might impact the profitability of agriculture, could quickly dissipate the present capital strength of System institutions. As you can appreciate, this would increase risk and threaten the safety and soundness of the institutions that we are charged to regulate.