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STATEMENT OF
CRAIG A. SIMMONS
ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ON
THE FINANCIAL CONDITION OF THE FARM CREDIT SYSTEM
AND
GUIDELINES FOR CONSIDERING A RESCUE PACKAGE



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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to participate in your deliberations on the Farm Credit System. The U.S. agricultural economy continues to experience severe economic difficulties two years after the end of our last economic recession. Generally, the fortunes of financial institutions mirror the fortunes of their borrowers. This is particularly true today of the Farm Credit System which lends exclusively to the agricultural sector. As a result of recent developments, the System and the Farm Credit Administration have requested federal financial assistance to restore farmer and investor confidence in the System and to permit it to carry out its mandate to provide a dependable credit source for U.S. agriculture.

In the first part of my testimony, I would like to summarize our perspective on the financial condition of the System that was issued in early October in our Preliminary Analysis of the Financial Condition of the Farm Credit System (GAO/GGD-86-13BR.) I would also like to update the information in that report through September 30, 1985. In the second part of my testimony I suggest that in considering solutions to the System's problems there are lessons that can be learned from the large scale federal financial rescues of the Penn/Central Railroad, the Lockheed Corporation, New York City and the Chrysler Corporation. The Continental Illinois National Bank rescue of 1984 also provides some lessons.

Before proceeding, I would like to emphasize that we are not taking a position supporting or rejecting the notion of

federal assistance for the System. Our purpose is simply to help advance thinking about whether to provide federal assistance and, if so, how it might be structured, implemented, and overseen.

THE FINANCIAL CONDITION
OF THE SYSTEM

Last month we issued our briefing report on the mid-1985 financial condition of the Farm Credit System to various Members of Congress. In that report we also projected the financial experience that might be expected between June 30, 1985 and June 30, 1986, if the deterioration in financial condition continues at its historical rate.

The financial difficulties now facing the Farm Credit System stem from the deterioration in the quality of its loan portfolio. The decline in loan quality was first felt by the production credit associations during 1982. By June 30, 1985 thirty percent of the production credit associations' loans were adversely classified. The quality of the federal land banks' loans, however, did not begin to show signs of major deterioration until early 1985. By June 30, 1985, seventeen percent of the federal land banks' loan portfolio was adversely classified. At the same time, consolidated System records showed that the amount of nonaccrual loans, i.e. loans no longer considered fully collectible and on which interest is no longer being accrued, had reached \$2.7 billion.

The deterioration in loan quality has adversely affected System profitability in two ways. First, as loan quality

deteriorated, nonearning assets increased, depriving the System of income from these assets. Second, as the risk of loss from bad loans increased, the System was forced to set aside a larger portion of its earnings to cover future charge-offs of bad loans. Largely because of these two factors, the System's net earnings declined from \$1 billion in 1983 to \$200 million for the 12 months ending June 30, 1985.

The deterioration in loan quality and its effect on earnings have caused two further problems: First, the System increased the interest rates it charges to reverse the decline in income. These rate increases together with the risk of loss of the borrowers' investment in association stock and the fact that interest rates elsewhere are declining, may be influencing the more creditworthy borrowers to leave the System. The System's outstanding loans decreased by \$3.1 billion, or about 4 percent during the first 6 months of this year. We do not know precisely how much of the decline in loan volume is due to charge-offs of bad loans versus loss of good borrowers. But System officials have expressed concern about the competitiveness of the System's interest rates and the effect that these rates have had on its better borrowers. The loss of the more creditworthy borrowers would materially hurt the System's ability to generate income to absorb continued losses.

Second, in July, 1985, investors began to require a premium on System securities. By the end of September, the System's securities were priced about one percentage point higher than comparable Treasury securities. In October, this trend

continued and the System encountered some resistance to marketing long term securities. During the next five months the System estimates that it will need to market \$8.4 billion to replace maturing bonds and it will increase its discount notes from \$9.9 billion to \$10.7 billion. If the premium attached to these securities continues to increase, it will be difficult to pass this cost on to existing borrowers.

Despite these negative financial indicators, as of June 30, 1985, the System had \$7.5 billion in earned surplus and reserves available to absorb losses. A major concern, however, is the rate at which the System appears to be deteriorating, and its ability to reverse these trends.

Based on these trends we extrapolated, in our report, that nonaccrual loans would reach \$6.1 billion by June 30, 1986. The loss of earnings and provision for loan losses would have devastating effects on the System's profitability. To set up an appropriate reserve for loan losses by June 30, 1986, we projected that at least half and possibly all of the earned surplus built up from prior year's earnings would be needed. While the System would still be solvent, its ability to absorb future losses would be materially reduced.

PRELIMINARY RESULTS
FOR THE THIRD QUARTER

We have not completed our analysis of third quarter System results because financial data from all reporting institutions was not furnished to the Farm Credit Administration until this week.

Nevertheless, there are several things that are obvious at this point. Key indicators of financial condition show a continuing deterioration in the System. During the third quarter

- Gross loans declined by 5.5 percent from \$80.4 billion to \$76 billion.
- Nonaccrual loans increased by 63 percent from \$2.7 billion to \$4.4 billion or 5.8 percent of gross loans.
- Most of the increase in nonaccrual loans occurred in the federal land banks. During the three-month period their nonaccrual loans increased by 78 percent.
- Short term debt increased by 25 percent from \$5.9 billion to \$7.4 billion or 10.9 percent of the total debt increasing the System's vulnerability to interest rate swings.
- Earned surplus declined by 12.7 percent from \$6.3 billion to \$ 5.5 billion.

The figures that I have just cited seem to indicate that the System is deteriorating at a faster rate than we projected based on our extrapolation of the trends as of June 1985. However, because we have concerns about the quality of data reported to the Farm Credit Administration, we are not certain whether the System is actually deteriorating at a faster rate or whether the data reflects a recognition at this time of problems that existed in prior periods.

With no reversal in current rates of deterioration in the quality of the System's loans, capital will eventually be wiped out. No one is sure how long it will take for this to occur.

Nevertheless, even though the depletion of capital, by itself may not cause an immediate financial crisis, it could result in a loss of investor confidence in System securities at any time, causing a funding crisis.

WHAT OUR EXPERIENCE WITH
PAST FINANCIAL RESCUES SUGGESTS
ABOUT POSSIBLE APPROACHES TO
RESOLVING FARM CREDIT SYSTEM PROBLEMS

At this point I will turn to the second part of my testimony. In March of last year GAO published its report entitled Guidelines For Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34). This report assessed the experience with the government's rescue of the Penn/Central Railroad (later Conrail), the Lockheed and Chrysler Corporations, and New York City. Each assistance program had a different justification and each was structured somewhat differently from the others. Although each program was unique, together they taught us much about appropriate responses to requests for federal financial assistance. Also, last December, GAO submitted testimony to the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance which, in part, assessed the rescue of the Continental Illinois National Bank in the context of the guidelines.

It strikes us that these guidelines provide an appropriate framework within which to think about a financial rescue of the Farm Credit System.

CRUCIAL CONSIDERATIONS

Past experience has taught us that there are four essential areas to be explored when considering a rescue of the Farm Credit System.

- First, the problem to be solved must be clearly defined as quickly as possible. What are the precise causes of the System's problems? If we do not define the problems correctly, the rescue package we design may fail to address root causes and thereby provide only a temporary solution.
- Second, the national interest must be clearly established. Why is preserving one particular private sector institution --the Farm Credit System-- important to our agricultural and national economies? How does the cost of saving it compare with the cost of letting it fail?
- Third, the goals and objectives associated with the response should be clear and non-conflicting. Are we more worried about the health of the System's borrowers or the fortunes of its lenders? There may be an inherent conflict between the goal of providing farmers with a ready source of credit at the lowest reasonable cost and the goal of maintaining a safe and sound credit system. Trying to accomplish both goals in one program could prove counterproductive by preventing our achieving either.
- Fourth, the government's financial interests must be adequately protected and to the extent it is practical, all parties with an interest in seeing the Farm Credit System survive must have appropriate incentives to contribute to the program's success. Who has a financial interest in the System's survival? Are there incentives for them to share in the cost of the rescue package? What types of collateral are available to secure the government's investment in the System? What form of risk compensation should the government receive for the aid it provides?

Let me discuss in a bit more detail our preliminary thoughts on how these four guidelines relate to potential program designs for solving the problems of the Farm Credit System.

Defining the Problem

While there has been much discussion of the nature of the problems facing the Farm Credit System there is still one fundamental unanswered question. Precisely how much of the System's problems are its alone and how much are due to the larger problem facing the agriculture sector? Clearly, some of its problems are due to poor internal management and oversight practices. An assistance package could be an effective vehicle for obtaining needed internal reform. In this regard, we note that the Farm Credit Administration is proposing a considerable strengthening of its supervisory and enforcement powers over the System's institutions as well as actions to pool the System institutions' capital and reserves as a prerequisite to obtaining a borrowing line with the Treasury.

It is equally clear that many of the farm Credit System's problems mirror broader problems in the agriculture sector. The System is likely to continue to experience stress if farmers remain highly leveraged and their incomes and land values continue to decline.

Unlike the problems experienced by Chrysler which were due, in part, to recessionary forces which were temporary in nature, it is difficult to see exactly how and when the agricultural sector's current problems will end. Nonetheless, federal aid to the System structured without regard to the longer term adjustments necessary to restore the health of the agriculture sector may provide only a temporary solution for the System.

Determining the
National Interest

Fundamental to the issue of whether providing aid to the Farm Credit System is in the national interest and how such aid should be structured are two basic sets of questions.

--Does the System continue to provide unique sources of financing to the agricultural sector or can it reasonably be expected that if it were shrunken in a controlled manner over a number of years its activities would be picked up by other financial institutions?

--How much would a rescue package cost and how do these costs compare with those that would result if federal aid was not provided?

It makes little sense to consider the specifics of a rescue package until we have answers to these questions. If Congress decides, for example, that the role now played by the Farm Credit System can be played by other private sector institutions, then it may need to legislate a program to achieve an orderly winding down of the System's operations. The structure of an assistance package to wind down operations would differ from the structure of a rescue package designed to ensure the System's continuance.

With regard to the second question, we need to learn more about how seriously a default on the System's bonds would jeopardize the financial viability of its lenders, what the implications of a default would be for the System's borrowers, and how serious the spillover effects throughout the economy would be. In the Continental Illinois case there was concern that the spillover effects on smaller banks, which had a

business relationship with Continental, and on larger banks were too severe to let the bank fail. In Chrysler's case, adverse effects of its failure on suppliers and others having a business relationship with the company as well as social costs such as lost employment were believed to be larger than the amount of aid being contemplated. Can the same be said for the consequences of a default of the Farm Credit System? Although we have not done a detailed analysis ourselves it seems clear that should an unexpected default occur the effects would reach beyond the System itself and could be very serious.

In addition to these considerations, we also need to consider the effect that saving the System might have on its competitors. Aiding the System will weaken market discipline if a perception is created that government aid will be available to rescue firms that get into financial difficulty as a result of their business decisions. This has been a concern in all past programs. It was dealt with in past programs by imposing requirements on the aid recipient that were sufficiently stringent that other potential recipients would view federal aid only as a last resort measure to be avoided if at all possible.

Clear and Nonconflicting Program Goals

While it may seem obvious that as a matter of principle, the objectives of an aid program should be clear and nonconflicting, this has not always been the case in past large scale financial rescues. For example, was the major

intent of the Conrail program to save jobs, preserve rail service or restore profitability? For a number of years the answer to this question was unresolved and it caused problems. Without knowing the primary objective of an aid program, problems can be perpetuated, it will be difficult to decide what program design features are necessary, and it will be hard to judge whether the program is succeeding. Should a program for the Farm Credit System be designed to save farming operations, restore a sound, prudently managed System, protect investors, or preserve the existing System institutions? These objectives probably cannot be mutually satisfied.

Protecting the
Government's Interest

If we decide to aid the Farm Credit System because

--saving it is an important component of a broader policy for dealing with the Farm Sector's problems,

--it will continue to provide a unique source of financing to agriculture,

--it is unlikely that the System, on its own, can save itself, or

--the financial repercussions of a failure exceed the costs of providing assistance

the government's financial interests should be protected to the maximum extent possible.

The Farm Credit System is a private organization.

Therefore, a rescue program should be designed to provide as much assurance as possible that the assistance will be repaid.

If this prospect is not good, then nationalization is one

alternative. I noted earlier that the Farm Credit Administration has proposed an increase in its supervisory and examination powers and a mechanism for pooling its capital. There are additional ways to increase the prospect of repayment that have been used in past programs that may be useable in a program for the Farm Credit System.

Concessions from those
with a financial stake
in the entity

In the Chrysler, Lockheed, and New York City situations, the government required concessions from those with a financial stake in the resolution of each entity's respective problems as a prerequisite to providing Federal assistance. Such concessions reduce the federal government's risk exposure, help the program appear fair, and create appropriate incentives. But, we emphasize in our report that affected parties will cooperate only if the program offers a better alternative than restructuring or liquidation. We should not expect investors, for example, to make concessions that will cost them more than they expect to lose through eliminating their relationship with the firm on their own, or through restructuring or liquidation.

In the case of a financial entity, concessions may be more difficult to obtain or prove to be of less significance than in the case of a major manufacturing firm or municipality. In Continental's case, for example, depositors had no incentive to maintain their relationship with the bank once its problems became known. It was virtually costless for them to transfer

balances to another institution. In the System's case, it is not clear what incentives there might be for investors to sacrifice something of value but it is an area worth exploring. However, even if investors were willing to go along with such a program it could change investor's perception of other "agency" status debt; potentially raising interest costs on that debt.

Others that might be asked to participate in a program of concessions are the System's employees. While employee concessions were a major factor in saving the Chrysler Corporation, in the case of a financial entity these types of concessions cannot be expected to provide a major source of assistance. Nevertheless, they should be required because of their symbolic value. State and local governments are another possibility for participation in a plan to revitalize the System. Finally, elimination of management perquisites, as occurred in Chrysler case, is another important symbolic concession.

Controls over management

The Congress should protect the government's interest by creating a mechanism through which the assistance program will be administered and overseen. It is essential that the System develop operating and financing plans which show how it intends to maintain viability and that these plans be independently reviewed and approved as a condition of assistance. These plans are important because they will guide the System's operations and, thus, its future financial condition. Therefore, they must

be subject to governmental review and approval. It is also important that major contracts or other important structural changes in operations be reviewed and approved by the government.

This element has been a central feature of all large scale federal financial rescues and we see no reason why it should not be incorporated into any rescue proposal for the Farm Credit System. It provides a source of objective outside discipline. This requirement along with increases in examination and supervisory responsibilities for the Farm Credit Administration, pooling of capital resources, loss of management perquisites, and, presumably, the power to remove officers result in a significant loss of management autonomy. And, this loss of autonomy is an important concession that the government can require of System management and its constituent institutions.

Collateralization of federal investment

In our report we also indicate that the government should require, when feasible, that the assisted entity maintain adequate collateral and that all other lenders subordinate their claims to the government's. In the New York City case, requiring collateral was not feasible; but in the Chrysler and, initially in the Continental case the government's investment was fully collateralized. Whether this can be done in the case of the Farm Credit System is uncertain at this

time. Its feasibility depends on whether the System's investors would be willing to relinquish first claim on the System's loans and on what premium such investors might require for doing so.

Risk compensation

Finally, as in past programs, the government should receive risk compensation in return for federal aid, particularly if the program succeeds in restoring financial health. Fees are one possibility worth considering but they should not be set at a level representing full risk compensation. Fees set at that level, if passed through to the borrowers as higher interest rates, could be counterproductive. For this reason, some form of equity participation by the government in the gains of the System if the program proves successful would seem most appropriate. This form of risk compensation was used in the Chrysler case and was also an important part of the rescue package for the Continental Illinois National Bank.

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I would like to conclude by emphasizing the following points:

- We can never be certain that a particular rescue program will succeed, but past experiences have taught us how to design those programs in a way that gives us the greatest assurance of success.
- The strings attached to any rescue program should not be so onerous as to impede success. On the other hand, they need to be stringent enough to discourage other private firms and institutions from seeking federal aid.

--Finally, we may find that there are, for example, few opportunities for significant risk sharing. We may also find it is impossible to settle on a single objective or mutually compatible objectives for a rescue program. Thus, past experience may not prove completely relevant to the problem we are discussing today. But the Farm Credit System is a private organization, and good public policy dictates that we make a concerted attempt to seek answers to the questions that have been addressed in past rescues of major failing entities. If we do not do this, and simply provide cash infusion to the System with no definition of what we hope to ultimately accomplish or avoid, or if we do not explore possibilities for contributions by financially interested parties and protection of the government's interest, we run the risk of setting a dangerous precedent which, over the long term, could prove very costly.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions that you or other committee members might have.

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