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REPORT BY THE U.S.

General Accounting Office

Farm Credit Administration's Liquidation of Production Credit Associations

Eight Members of Congress asked GAO to review the liquidation of insolvent borrower-owned cooperatives within the Farm Credit System that provide short- and intermediate-term credit to farmers and ranchers. In examining four associations during 1983 and 1984, GAO found that

--the Farm Credit Administration's criteria for determining whether an association is insolvent and should be liquidated were based on its ability to comply with the terms of its financial obligations with its federal intermediate credit banks,

--the liquidation procedures used were consistent with those used by other financial regulators,

--although some delays occurred in granting new loans to customers residing in the service area of the associations in liquidation, loans were available from adjoining associations, and

--the Farm Credit Administration's decision not to use a revolving fund to assist the insolvent associations was a proper decision.

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

GENERAL GOVERNMENT DIVISION

B-114806

The Honorable Mark O. Hatfield
United States Senate

The Honorable James A. McClure
United States Senate

The Honorable Bob Packwood
United States Senate

The Honorable Les AuCoin
House of Representatives

The Honorable Mike Lowry
House of Representatives

The Honorable Denny Smith
House of Representatives

The Honorable Robert F. Smith
House of Representatives

The Honorable Al Swift
House of Representatives

As you requested, this report discusses various issues relating to the Farm Credit Administration's actions and procedures to liquidate production credit associations. During 1983 and 1984, 11 production credit associations ceased to do business and were placed in the hands of a receiver or conservator who began the process of selling assets and converting them to cash, discharging all debts and obligations, and distributing the remaining assets to the associations' stockholders. Before 1983, only one production credit association had been liquidated in the previous 45 years.

Copies of this report will be sent to the Governor of the Farm Credit Administration, the Director of the Office of Management and Budget, and interested committees of the Congress.

W. J. Anderson

William J. Anderson,
Director

The Farm Credit Administration (FCA), an independent federal agency, is responsible for regulating and supervising more than 800 banks and associations that make up the farmer-owned, cooperative Farm Credit System (System). The principal objective of the System is to provide sound, adequate, and constructive credit that will serve the unique credit needs of farmers, producers and harvesters of aquatic products, agricultural cooperatives, and rural home owners. When FCA took actions in 1983 to force or allow five production credit associations to begin liquidation, GAO was requested by eight Members of Congress to examine the various actions relating to these associations' liquidations.

As agreed with the requesters, GAO looked at (1) the criteria and procedures used to liquidate production credit associations; (2) whether FCA was meeting the credit needs of creditworthy borrowers formerly served by the associations in liquidation; and (3) the appropriateness and implications of using funds from an FCA revolving fund to assist financially production credit associations.

BACKGROUND

Production credit associations make short- and intermediate-term loans for any need in the production of agricultural or aquatic products; the purchase, repair, or maintenance of rural homes; and other needs of farmers and ranchers. Each association is an independent, borrower-owned, private institution. A production credit association obtains its loanable funds from its district federal intermediate credit bank. Associations are subject primarily to federal intermediate credit bank supervision. FCA supervisory efforts are primarily devoted to activities of the 37 district banks that are in the Farm Credit System; however, it also retains some oversight responsibility of associations.

FCA carries out involuntary liquidations of associations, and its procedures allow intermediate credit banks to carry out voluntary liquidations. FCA's liquidation procedures are the same for an association that is forced into liquidation as those for an association that voluntarily enters liquidation.

FCA has a revolving fund that is available for investment in the stock of production credit associations and intermediate credit banks. FCA has taken the position that the fund was intended to supplement the capital base of viable associations, not failing ones.

GAO visited four of the five associations in liquidation. The fifth association's liquidation was being litigated at the time of GAO's review. FCA believed that the four associations that GAO visited failed because they did not adhere to proper credit extension procedures and did not receive adequate or effective supervision, and their borrowers were exposed to adverse economic and climatic conditions. FCA found that while intermediate credit banks repeatedly identified deficiencies during their annual credit reviews of the associations, the banks did not stress the importance and effect of these deficiencies and did not immediately undertake the supervisory and enforcement actions necessary to overcome the poor loan decisions made by the troubled associations.

Since the liquidation of the five associations that GAO was requested to review, a number of other associations have failed or have been merged with other associations, and the financial condition of the Farm Credit System has deteriorated. Proposals have begun to surface to provide various forms of financial assistance to the System. GAO does not analyze these developments in this report.

RESULTS IN BRIEF

GAO found that FCA had general criteria for determining whether a production credit association should be liquidated but that application of the criteria involved substantial

subjective judgments; the liquidation procedures used by FCA were similar to those used by other financial regulators; the sound credit needs of those who had used the services of the failed associations were being adequately met by adjacent associations; and not using the revolving fund to rescue the associations was proper.

PRINCIPAL FINDINGS

Liquidation Criteria and Procedures

FCA determined that the production credit associations included in GAO's review had defaulted on their obligations and either agreed to allow the associations to enter liquidation or forced the associations into liquidation. Default and insolvency findings leading to a determination to liquidate a production credit association are subjective determinations that are based on an association's ability to comply with its loan agreement with its intermediate credit bank and its ability to meet its financial responsibilities under the terms of the agreement. For example, if an association does not adequately protect its loan collateral the association is in default of its financial obligations with the intermediate credit bank. The determination of what is adequate is subjective. Even if FCA decides that an association is in default, FCA can use its judgment as to whether the association should be liquidated. In general, FCA's liquidation procedures, revised in the fall of 1983, are similar to those used by other financial regulators. Also, with the notable exception of not involving the courts or court appointed creditor committees, FCA procedures are generally similar to the procedures used to liquidate any business. (See pp. 13 to 30.)

Meeting credit needs

Credit service to creditworthy farmers continued with minimal disruption, although some farmers experienced delays in receiving loan approvals. FCA arranged for the transfer of creditworthy loan accounts of liquidating associations to adjoining associations. Credit was available at all times to both current association members and prospective members. (See pp. 31 to 36.)

Revolving fund

GAO found that FCA's decision not to use the "Short Term Credit Investment Fund" to provide aid to failing associations was proper under the circumstances. GAO cites the availability of numerous forms of self-financed and nonfinancial assistance that may be used and were used in the cases it reviewed; the minimal disruption of credit services that resulted in the areas served by the failing associations; the doubtful financial viability of the associations; and the undesirable incentives that might be created if the fund were used to rescue poorly managed institutions or institutions that engage in excessively risky ventures. (See pp. 37 to 48.)

AGENCY COMMENTS

The Farm Credit Administration stated that the report accurately assesses the liquidations of production credit associations. (See p. 69.)

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ABBREVIATIONS

FCA	Farm Credit Administration
FDIC	Federal Deposit Insurance Corporation
FHLBB	Federal Home Loan Bank Board
FRB	Board of Governors of the Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency

CHAPTER 1

INTRODUCTION

In the summer and early fall of 1983, the Farm Credit Administration (FCA) took actions to force or allow five production credit associations to begin liquidation[1] because the associations had defaulted on the terms of their loans from their federal intermediate credit banks. Production credit associations are borrower-owned cooperatives within the Farm Credit System that provide short- and intermediate-term credit to farmers. Federal intermediate credit banks supervise and are the primary source of loan funds used by production credit associations to meet the credit needs of eligible borrowers. FCA is responsible for chartering both institutions and both are subject to FCA supervision. FCA's actions eventually resulted in closing the Southern Idaho, Southern Oregon, Puget Sound, and Willamette[2] Production Credit Associations in the Spokane Farm Credit District and the Mammoth Cave Production Credit Association in the Louisville Farm Credit District. Before their closing, these five associations had about 6,300 outstanding loans totaling over $450 million.

In three of the above five cases, FCA requested each association's board of directors to enter voluntary liquidation or be forced into liquidation involuntarily by FCA. Three associations chose to enter liquidation voluntarily. The other two associations--Puget Sound and Southern Oregon--were involuntarily liquidated.

In the previous 45 years, one production credit association in the entire Farm Credit System had been liquidated. This occurred in 1972 when a Texas association entered liquidation.

In November and December 1983, several senators and representatives asked us to review the actions taken by FCA and by federal intermediate credit banks to liquidate production credit associations. These members were concerned about the propriety of FCA's actions and whether alternative sources were available to finance the credit needs of farmers served by the associations in liquidation.

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[1]Liquidation is the process of terminating a business. The liquidation process includes converting assets into cash by sale of the business or by piecemeal sale of individual assets or groups of assets, disposing of liabilities, and distributing any remaining cash to stockholders. This process can take years to complete.

[2]The Willamette Production Credit Association had obtained a preliminary injunction on October 26, 1983, preventing its liquidation but in May 1984 agreed to voluntarily enter liquidation.

OVERVIEW OF THE FARM CREDIT SYSTEM

The Farm Credit System (System) is regulated, supervised, and examined by FCA, an independent federal agency. The System provides credit to farmers, ranchers, producers and harvesters of aquatic products, agricultural and aquatic cooperatives, and rural home owners. The System is composed of 12 districts covering the United States and Puerto Rico and is organized as a borrower-owned cooperative.

Included within the overall structure of the System are the federal intermediate credit banks and their constituent local production credit associations. Providing short- and intermediate-term credit is a function of the federal intermediate credit banks and local production credit associations. Production credit associations may make loans for up to 10 years to farmers for seasonal operating purposes and to finance capital expenditures for such items as seed, fertilizer, equipment, fuel, repair or maintenance of rural housing, and other agricultural needs such as storage facilities; and, for up to 15 years to producers or harvesters of aquatic products.[3] Intermediate credit banks provide production credit associations with loan funds under a General Financing Agreement. According to the agreement, the intermediate credit bank agrees to purchase production credit association loans which the association has made to borrowers.

The following chart depicts the organization of the entire Farm Credit System and FCA. All Farm Credit institutions became privately owned in 1968 when the last of the intermediate credit banks and production credit associations and the Banks for Cooperatives in which the government owned stock retired that stock. The Federal Land Banks and Federal Land Bank Associations had retired the government's investment some years earlier.

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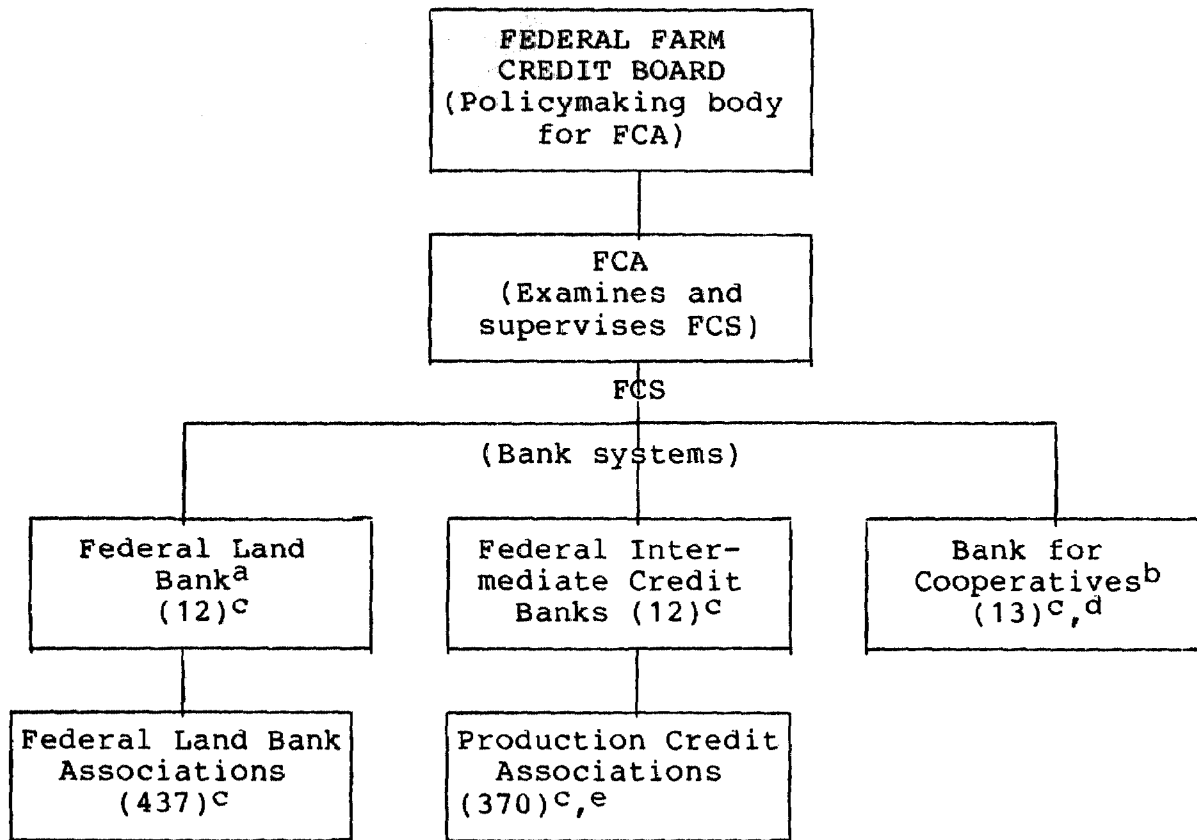
[3]These borrowers are defined as those engaged in the production or harvesting of fish and other marine life where (1) no element of husbandry of the product is involved prior to harvesting and (2) the borrower and general public have equal access to the product, such as in open seas.



[a]Federal land banks offer long-term first mortgage loans, secured by real estate, which are made through local federal land bank associations.

[b]Banks for cooperatives offer financing services to agricultural, aquatic, and public utility cooperatives.

[c]Number of banks or associations as of January 31, 1985.

[d]Includes the Central Bank for Cooperatives and 12 regional banks for cooperatives.

[e]Of the 370 production credit associations, 11 are in liquidation.

The System's institutions currently operate on a self-sustaining basis without any expenditure of taxpayers' dollars. Loanable funds are primarily obtained through the sale of System securities in the nation's financial markets. FCA expenses are borne solely by the System through an assessment of the various farm credit banks. Each institution in the System is a separate, privately owned corporation. Each district's board of directors constitutes the board of directors of each

district bank, and each association has its own board of directors to establish policy, provide direction to management, and hold management accountable for satisfactory performance. This structure permits the banks and associations to function in a manner that recognizes local credit needs.

The System is the largest single supplier of agricultural credit. Borrowers bear the interest costs through variable interest rate loans that are adjusted whenever necessary to cover administrative and System borrowing costs. In 1984, the System made loans totaling about $66 billion. Loans made in 1984, however, were 0.5 percent above the 1983 level. Total loans outstanding on December 31, 1984, amounted to about $80 billion.

The legislation establishing the System requires each production credit association borrower to invest in the capital structure of the association, thereby making the borrowers owners. The law requires that, at a minimum, a borrower must purchase stock at $5 a share equal to 5 percent of the borrower's outstanding loan. An association may require its borrowers to purchase more than the required 5 percent stock investment but not more than 10 percent of the borrowers' outstanding loans. The amount above the required 5 percent is determined by the capital requirements at each production credit association. When the loan is repaid, the association may redeem the stock at its par value of $5 per share or apply the stock to the last portion of the debt. However, an association's stock is risk capital, and, if an association enters liquidation, retirement of stock stops.[4] As the owners of the association, the borrowers are expected to assume any losses up to their stock investment value if the association's debts exceed its assets.

The federal intermediate credit banks provide loan funds to 370 production credit associations nationwide and to "other financing institutions" under the terms of financing agreements which, subject to limitations, provided for an open-end revolving line of credit. The loans to the associations are collateralized by a pledge of substantially all of the assets of the associations. Discounted financial papers purchased by the federal intermediate credit banks from the "other financing institutions" is purchased on a recourse basis and is generally further secured by pledges of certain general assets of the institutions. "Other financing institutions" include commercial banks, trust companies, agricultural credit corporations, incorporated livestock loan companies, and other institutions involved in making loans for agricultural purposes. As of

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[4]Retirement of stock may be stopped at times other than an association's liquidation, such as when its stock is impaired or near impairment.

December 31, 1984, of the System's $80 billion in outstanding loans, federal intermediate credit banks' loans totaling $16.4 billion were outstanding to production credit associations and $887 million were outstanding to "other financial institutions."

FCA SUPERVISES AND EXAMINES INTERMEDIATE CREDIT BANKS

FCA is responsible for the examination and supervision of all System institutions. The Farm Credit Act of 1971 sets forth the statutory framework for FCA examination and supervisory activities. FCA examination and supervision efforts focus on maintaining financially viable, well-managed, and well-directed institutions.

FCA practices a concept of supervision which concentrates supervisory efforts in areas it believes have the greatest need or areas of weaknesses or deficiencies. Intermediate credit banks have adopted FCA's concept of supervision and apply it to their associations. FCA believes that supervising in this manner will create and maintain System lending operations that offer the highest quality of service with a minimum of outside interference.

Annual programs of examination and supervision of each intermediate credit bank by FCA and of each production credit association by the intermediate credit banks help FCA to meet its responsibilities. At a minimum each annual examination of intermediate credit banks by FCA consists of the following:

1. An audit of the bank's financial records in accordance with generally accepted audit standards.

2. Such tests as deemed necessary to evaluate the quality of performance by bank boards and management.

3. Evaluation of major program areas for compliance with the law, FCA regulations, and good business practices.

These annual financial and management reviews consider internal and external factors affecting the current and future operations of the respective FCA institutions. Emphasis is placed on assessing the effectiveness of boards of directors and management of the institutions and how they are responding to current conditions at the bank and within the associations. FCA also emphasizes verifying the accuracy of bank financial reporting, testing the quality of loan assets, and ensuring that borrowers' credit and credit-related needs are met.

FCA examination and supervisory staff prepare an annual written report to the board of directors and management of each intermediate credit bank. These reports contain the examination findings, FCA conclusions resulting from the examination, and any recommendations for improving bank performance. The evaluation contained in these reports, together with the bank board and management responses, determines the level of supervision that the bank will receive.

INTERMEDIATE CREDIT BANKS SUPERVISE AND EXAMINE PRODUCTION CREDIT ASSOCIATIONS

Within the bounds of FCA regulations, each federal intermediate credit bank establishes its own policies and bank procedures designed to regulate, control, and review the extension of credit within the district. Intermediate credit bank policies and procedures include guidelines for lending and guidelines limiting lending in specialized or high risk areas. The banks have responsibility for supervising production credit associations' credit operations, monitoring their performance, and initiating corrective action when deficiencies are found. The banks also supervise and assist associations in training lending officers and employees.

On an annual basis, each intermediate credit bank performs a "credit review" of each production credit association in its district. These reviews classify loans and evaluate credit administration, loan servicing, and the operational effectiveness of each association. These reviews are a primary method of identifying association problems and initiating steps to correct problems that may surface during the review.

FCA typically reviews two to five associations in each district concurrently with the intermediate credit bank's annual examination, to assess the adequacy of the bank's reviews and particularly the credit classifications assigned to the association's loan portfolio. Some of FCA's reviews have been targeted toward associations FCA believed to be having financial, credit, or other problems.

PRODUCTION CREDIT ASSOCIATIONS ARE ACCOUNTABLE AND RESPONSIBLE FOR LOANS

Providing sound, constructive credit to eligible borrowers is the primary function of production credit associations. In particular, associations must negotiate loan contracts with eligible borrowers that constructively (that is, without adversely affecting the borrower's financial position) ensure

repayment. Should a borrower fail to comply with loan terms or fail to repay a loan, the association is responsible for working with the borrower to arrange new terms that will result in collection or to take other actions to collect the loan--including foreclosure and sale of collateral. The production credit associations' board of directors and management must ensure that association policies and operations comply with FCA and intermediate credit bank policies and procedures.

OBJECTIVES, SCOPE, AND METHODOLOGY

In November 1983, Senator Hatfield requested that we examine various actions relating to the liquidation of the Willamette Production Credit Association. By mid-December 1983, Senators McClure and Packwood and Representatives AuCoin, Lowry, Denny Smith, Robert F. Smith, and Swift had expressed interest in FCA liquidation activities at Willamette or other associations. We met with Congressman Denny Smith and representatives of the other congressional requesters on December 21, 1983, to reach a consensus on issues that should be addressed to satisfy their concerns about FCA liquidation activities.

At that meeting agreement was reached to examine FCA activities at the five associations previously mentioned and to report on

- --the decision criteria for liquidating a production credit association, the procedures used to liquidate production credit associations, and whether the liquidation procedures were documented;
- --whether FCA is meeting the credit needs of creditworthy borrowers in areas formerly served by production credit associations in liquidation; and
- --whether FCA could and should have used its "Short-term Credit Investment Fund"[5] to assist financially troubled production credit associations and the implications of using the fund.

Also, it was agreed that we would not examine the decisions to terminate the associations.

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[5]This is a public enterprise revolving fund. These types of funds are authorized by the Congress with the provision that repayments to the fund may be used again for the earmarked purpose, to finance a specific, continuing, business-type operation.

After the December 21, 1983, meeting, we independently decided to include two additional topics in this review. We added an explanation of how FCA values collateral because understanding the valuation of collateral is necessary to discuss the liquidation issue. We also included a discussion of other aid that was available to financially troubled production credit associations because the availability of other assistance is important to our discussion of the implications of using the revolving fund.

We did not examine FCA or intermediate credit bank activities associated with the Willamette Production Credit Association because those activities were in litigation. We do, however, discuss certain actions taken by FCA and the supervising intermediate credit bank in dealing with the Willamette situation prior to its litigation activities.

Our analysis of FCA's current liquidation procedures and related issues required examining the procedures and discussing the procedures with various FCA and intermediate credit bank officials. We also discussed these procedures with the receivers and other people responsible for liquidating the four associations we visited:

--Mammoth Cave Production Credit Association, Glasgow, Kentucky;

--Southern Oregon Production Credit Association, Coos Bay, Oregon;

--Southern Idaho Production Credit Association, Twin Falls, Idaho; and

--Puget Sound Production Credit Association, Seattle, Washington.

At the time we did the field work for this review (April through September 1984), these were the only associations that were in liquidation other than the Willamette Production Credit Association.[6] We also reviewed various FCA, intermediate credit bank, and/or production credit association correspondence, reports, plans, and analyses and have included their contents when appropriate but did not audit the information contained in these sources. These data sources, in general, covered the period 1978 through 1984. We updated some of the data in this report in May 1985. This review was conducted in accordance with generally accepted government auditing standards.

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[6]After completing our field work, six other production credit associations entered voluntary liquidation.

FCA officials informed us that when they recognized that the problems being experienced by several production credit associations might ultimately require their being liquidated, they discovered that FCA liquidation procedures were relics of the 1930s and were out of date. Therefore, between midsummer and December 1983 FCA completely revised and documented its liquidation procedures in its PCA Receivership Manual.[7]

To determine if FCA liquidation procedures were reasonable, we compared them to the procedures used by other liquidators of financial institutions. We obtained copies of the procedures used by the

--Federal Deposit Insurance Corporation (FDIC) to liquidate banks,

--Federal Savings and Loan Insurance Corporation (FSLIC) to liquidate savings and loans associations, and

--National Credit Union Administration (NCUA) to liquidate credit unions.

We also discussed these procedures with officials at the various agencies to obtain a better understanding of the reasons various procedures exist.

We met with other officials at the FDIC, Federal Home Loan Bank Board (the Bank Board), and Office of the Comptroller of the Currency (OCC) to discuss the methods they use in their examinations of bank lending activities to evaluate collateral which borrowers have pledged as security for the repayment of loans. We compared the System's method of valuing collateral with these regulators' methods to determine the reasonableness of the System's method.

To determine the feasibility and implications of using FCA revolving fund (the Short Term Credit Investment Fund) to rescue financially troubled production credit associations, we first examined the legislative history of the various acts that created, changed, or continued the fund. We then discussed the use of the fund with FCA officials.

AGENCY COMMENTS

FCA reviewed this report and stated that it believes the report accurately assesses the liquidations of production credit associations. A copy of their comments is contained in appendix III.

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[7]FCA officials were not aware of any decisions to make additions, deletions, changes, or revisions to the procedures because of court criticism which arose from the Willamette Production Credit Association suit.

CHAPTER 2

PROBLEMS OF FAILED ASSOCIATIONS

Voluntary liquidation of two of the associations we visited was actively sought by their intermediate credit bank and FCA. The Mammoth Cave and Southern Idaho Production Credit Associations entered voluntary liquidations. However, if these two associations had not entered liquidation voluntarily, FCA officials stated that they would have declared them insolvent and forced their liquidation. In the case of the Puget Sound and Southern Oregon Production Credit Associations, FCA did not request voluntary liquidation. The basic reason that all these associations entered liquidation was that the borrowers were not repaying their loans. The remainder of this chapter is based on information in FCA, intermediate credit banks, and production credit association reports. These are the sources of our discussion of the problems experienced at the associations and in the supervision of the associations by their intermediate credit banks.

Mammoth Cave, Southern Idaho, Puget Sound, and Southern Oregon Production Credit Associations were plagued by common uncontrollable external factors that contributed to their being liquidated. Each association also shared similar internal problems. External factors such as economically depressed farming and fishing industries, declining property values, and adverse weather conditions, were beyond the control of these production credit associations. However, examinations found two common internal problems that led to the financial difficulties and subsequent failure of all four production credit associations--poor association management practices and, to a lesser extent, weak oversight of the associations by their respective intermediate credit bank. (Appendix I contains additional details on why these production credit associations failed.)

POOR MANAGEMENT PRACTICES AT THE ASSOCIATIONS

Studies of commercial bank failures have shown that banks that are poorly managed become especially vulnerable during periods of economic stress.[1] Intermediate credit bank

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[1]See Sinkey, Problems and Failed Institutions in Commercial Banking Industry, (Greenwich, Connecticut: JAI Press Inc.), p. 268. Meyer and Pifer, "Prediction of Bank Failure," Journal of Finance, 25 (September 1970), pp. 854-856. Korobow, Stuhr, and Martin, "A National Test of Early Warning Research in Banking," Federal Reserve Bank of New York Quarterly Review (Autumn 1977), pp. 39-40.

examinations of the failed associations revealed many incidents of bad management practices and a reluctance by the associations to correct these practices after they had been identified.

Examinations of the Mammoth Cave Production Credit Association cited poor credit administration, improper real estate loans, conflict of interest problems, and liberal lending practices. However, association management did not take action to correct these problems. When Mammoth Cave entered voluntary liquidation in August 1983, it had about $51 million in loans outstanding (a decline from $120 million in 1978); its acceptable[2] outstanding loans totaled 54.5 percent compared to the national average for all production credit associations of 72.4 percent; and it had written off almost $5 million in bad loans in less than a year but had sufficient reserves to cover the write-offs.

Examinations of the Puget Sound Production Credit Association cited poor credit administration, understated amounts of loan losses, overstated security as collateral for loans, and a concentration of loans in the depressed fishing industry. As Puget Sound's credit quality eroded, the Spokane Intermediate Credit Bank attempted to correct the problems but these attempts did not result in significant changes. When FCA assumed control of Puget Sound[3] in August 1983, Puget Sound had about $83.6 million in loans outstanding, its acceptable outstanding loans totaled 46.1 percent, and it had $7.6 million in estimated loan losses in its loan portfolio with $1.7 million in its reserve for bad debts to cover estimated losses.[4] Puget Sound was declared insolvent and its liquidation began in October 1983.

Examinations of the Southern Oregon Production Credit Association disclosed that its lending practices were deficient resulting in violations of both association and district credit policies, weaknesses in borrower selection, inadequately

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[2]Intermediate Credit Bank examiners annually evaluate the quality of the loan portfolio of each production credit association and classify loans as acceptable, problem, vulnerable, or loss. Acceptable loans are loans of the highest quality ranging down to and including loans having significant credit weaknesses.

[3]That is, FCA removed the association's Management and Board of Directors authorities to act without FCA approval. See chapter 4 page 6 for more detail.

[4]A production credit association should have a sufficient amount in its reserve for bad debts to cover estimated losses.

collateralized loans, a concentration of aquatic loans (a depressed industry), a decline in earnings, and a deterioration in loan quality. FCA assumed control of Southern Oregon in August 1983. As of June 1983, Southern Oregon's outstanding loans totaled $58.8 million, 46.4 percent were rated as acceptable, and it had $8 million of estimated loan losses in its loan portfolio with $65,131 in its reserve account to cover estimated losses. Southern Oregon was declared insolvent and its liquidation began in October 1983.

Examinations of the Southern Idaho Production Credit Association cited inadequate credit extension practices, inadequate collateral verification procedures, poor loan decisions, extensive loan losses, and ineffective supervision by the Spokane Intermediate Credit Bank. At the direction of FCA and the Spokane bank, Southern Idaho made some changes in management and credit extension procedures. Loan losses continued despite the changes, and Southern Idaho voluntarily agreed to liquidate in November 1983. After FCA's examination of Southern Idaho, in July 1983, 50.3 percent of Southern Idaho's loans were rated as acceptable, its outstanding loans totaled $136 million, estimated losses totaled $11.5 million, and it had a negative balance of $79,834 in its loan loss reserve account.

CHAPTER 3

FCA LIQUIDATION PROCEDURES SIMILAR TO OTHER REGULATORS'

FCA's liquidation authority is broad and comprehensive. As a result, various procedures may be used to liquidate associations depending on the particular circumstances existing in a district or at a production credit association. In this chapter, we discuss factors considered by FCA and the intermediate credit banks in determining whether an association should be liquidated and the procedures used by FCA to liquidate four production credit associations. We found FCA's liquidation criteria to be based on an association's insolvency and/or default on its loan agreement with the intermediate credit bank. We found these procedures to be similar to the procedures used by other financial institution regulators that liquidate banks, savings and loans, and credit unions. This chapter also discusses some differences in the way liquidations were handled in the Louisville and Spokane Intermediate Credit Bank districts. These differences relate primarily to the manner in which debt was compromised and stock was retired.

LIQUIDATION CRITERIA

FCA regulation 1130 (C.F.R. 611.1130), which implements Section 412 of the Farm Credit Act of 1971, authorizes both voluntary and forced liquidation of associations. Associations may voluntarily enter liquidation if FCA and the association's intermediate credit bank agree with the proposed liquidation. If an association defaults on any obligation (debt), the Governor of FCA may force liquidation by declaring the association insolvent and replacing the association's board of directors and management with a conservator or receiver.

An association is considered in default if any of the following events occur:[1]

(a) The association fails to pay when due according to its terms or at any accelerated maturity date duly fixed by the bank, the principal or interest on any note, draft, or other such obligation upon which the association is liable to the bank as maker, endorser, guarantor, or otherwise.

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[1]The General Financing Agreement between an association and an intermediate credit bank from which this information was taken is the note which the association signed with the intermediate credit bank.

(b) The association fails to keep or perform any of the terms and conditions of its General Financing Agreement with the intermediate credit bank or of any agreement in connection with any indebtedness or obligation to the bank.

(c) The association enters liquidation.

(d) The association is declared insolvent and placed in the hands of a receiver by the Governor of the FCA.

(e) The collateral pledged to the bank at any time is deemed unacceptable or insufficient by the bank and the association does not deposit additional approved collateral acceptable to the bank within 5 days from the date of the demand for additional collateral, or reduce its indebtedness or obligations to the bank in such amount as the bank may require.

(f) The association fails to do all things necessary to preserve and maintain the value and collectibility of any obligation discounted or purchased by the bank or of any collateral pledged to the bank.

(g) The association fails, during the life of the General Financing Agreement with the intermediate credit bank, to maintain in a manner acceptable to the bank sound management and control of association affairs.

According to the General Financing Agreement between a bank and its associations, at the option of the bank and without demand or notice, all or any part of an association's indebtedness to the intermediate credit bank shall immediately become due and payable upon default, irrespective of any agreed maturity.

Even if an association defaults, the language of FCA Regulation 1130 allows the Governor of FCA to decide against liquidating the troubled association. FCA officials told us that, in most instances, FCA would prefer rescuing an association over liquidating it. FCA has broad authority over possible liquidation, and its criteria for declaring an association insolvent versus initiating a rescue effort are important issues in the liquidation process.

How FCA reaches a finding of insolvency

A production credit association is considered insolvent when immediately converting assets into cash would be insufficient to discharge its debts. FCA has the authority to liquidate any association it declares to be insolvent.

Determinations of insolvency are subject more to FCA judgments regarding asset values than debt values. Determining the value of an association's debts is not difficult because over 95 percent of an association's debt consists of loans from its intermediate credit bank. On the other hand, the value of an association's principal assets--its outstanding loans--is often uncertain because the loans may never be repaid and the prevailing cash value of the collateral which secures these loans can only be estimated. At least 85 to 90 percent of an association's assets consists of its outstanding loans. If the assets securing the association's outstanding loans are valued at less than the borrower's outstanding debt, the association will generally be required to write off the difference as a loss if the loans are not considered collectible. If, after valuing outstanding loans and collateral and making other appropriate adjustments to the association's asset values, their total is less than the association's liabilities, the association is deemed insolvent.

How FCA estimates collateral values

Collateral values represent the estimated amount of money which the association would obtain if it became necessary to sell an asset to repay a loan. Using various means, FCA estimates the recovery value or collateral value of equipment, supplies, crops, etc. securing association loans. For example, FCA uses the values in the Official Farm Equipment Guide Book, a book similar to the "Blue Book" for cars, as an acceptable estimate of the value of farm equipment. Each association is also required to track the local farm equipment market. Very large and expensive items or specialized items of equipment may be adjusted to reflect local selling conditions. For example, a tractor that, when new, cost $100,000 may only realize half of the guide book amount when resold as used in some areas, and its collateral[2] value would reflect lower selling prices based on local auctions and other sales.

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[2]Collateral values should not be confused with "loan-to-value" ratios; i.e., the amount that an association will loan based on the borrower's ownership in the collateral offered to secure the loan. Loan-to-value ratios are established by each intermediate credit bank. For example, the Federal Intermediate Credit Bank of Spokane allows its associations to loan up to 75 percent of the market value of crops or cattle, 60 percent of the market value of machinery and equipment, and 85 percent of the market value of real estate. Collateral values fluctuate depending on the market, whereas the loan-to-value ratios are fixed.

The FCA allows the System to use either one of two long-standing procedures for estimating the value of an association loan secured or collateralized by real estate. One method of estimating the collateral value of real estate could be characterized as an evaluative method and the other as a computed method. The examiner responsible for the review decides which method to use on an association-by-association basis.

Both methods are based on the appraised value of the real estate. Examiners must first accept or establish a market or appraised value for the real estate. To accomplish this, examiners must verify that the associations' recorded values for the real estate are realistic. Each association is required to maintain a sales register of real estate sold in its area. The examiner will compare the association's recorded values of real estate collateral with sale prices of similar property as recorded in the association's sales register, the Federal Land Bank Association sales register, or the values obtained from other sources, such as local professional appraisers. The objective of the verification procedure is to provide the examiner with some assurance that real estate is reasonably valued. If the real estate is not reasonably valued, the examiner would adjust its value to reflect the amount believed to be reasonable based on the sale prices of similar properties.

In the evaluative method, the examiner deducts certain items from the appraised value of the real estate collateralizing a loan. All prior liens[3] are deducted from the appraised value. In addition, 10 percent of the appraised value may be deducted to reflect that there may be some neglect of the property and that the sale will be under distressed conditions. If an association found it necessary to take the property as payment or partial loan payment, some time would be required to sell the property. Therefore, generally 2 years' worth of interest on prior liens and estimated taxes, and 1 year's worth of insurance are deducted, as are estimated attorneys' fees and costs. After making these adjustments, the value determined is compared with the association's mortgage or borrower's outstanding debt and the smallest figure is recorded as the value of the asset. If the asset is valued at less than the outstanding debt, the association will generally be required to write off the difference as a loss, if the loan is nonperforming.[4]

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[3]Money owed to others that would be paid before the association would be paid if the real estate was sold.

[4]Nonperforming loans are loans which are classified as either loss or vulnerable. Vulnerable loans are high risk loans that are still considered collectible but involve probability of loss in the event repayment from available sources does not materialize. Loss loans are loans which all, or any portion, is deemed uncollectible.

The alternative method of valuing real estate collateral--the computed method--is more straightforward than the evaluative method. The examiner's computation is based on the quality of the loan. Depending on the quality of the loan, either 10 or 25 percent of the appraised property value is deducted. The appraised value of real estate for loans considered to be fully collectible (on which no loss is expected) would be reduced by 10 percent, and 25 percent would be deducted from the appraised property value of other loans. This deduction, plus deductions of any prior liens, will provide the collateral value attributed to the real estate. As was the case in the first method, the value obtained is compared with the association's mortgage and/or the borrower's outstanding debt, whichever is less, and the loan is valued at the smallest of the three figures. If the real estate is less than the debt, the association will generally be required to write off the difference as a loss if the loan is nonperforming.

The second method of valuing real estate collateral discussed above was the subject of considerable controversy when its use resulted in a finding that the Willamette Production Credit Association's stock was impaired, that is, worth less than the legislatively established price of $5 a share. FCA officials told us that the real estate values in the June audit (using the computed appraisal) were within 1 percent of the values in the November audit (using the evaluative appraisal). While recognizing that there were both positive and negative factors affecting real estate values during the period, FCA officials believe that these results validated the use of either method of appraisal as a realistic method of valuing the likely proceeds from the sale of property securing loans. Therefore, FCA will continue to accept either method as appropriate for valuing the collateral securing intermediate credit bank loans as well as the value of the association's loan assets secured by real estate.

How other regulators value collateral

FCA's procedures are similar to procedures used by other financial institution regulators to evaluate loan collateral. We talked with several financial institution regulators about their methods of valuing collateral. A Bank Board official told us that the agency allows its examiners to accept the appraised value of real estate as long as the appraisal was based on one of its approved appraisal methods. However, the Bank Board does not estimate the cost of acquiring, holding, or selling the asset. We were also told that the Bank Board has no studies that would indicate an average amount realized from disposing of various assets as compared to their appraised value.

An FDIC official told us that FDIC establishes an appraised value for an asset based on the average of two or more professional appraisals. From this amount, 15 percent will be deducted to establish a sale price. The FDIC does not estimate the costs it will incur to acquire, hold, and sell the asset because costs change depending on the asset and the holding period. However, this official stated that realtors' fees for selling property will range from 6 to 10 percent of the selling price.

An OCC official told us that its examiners estimate collateral values based on the assets' merits, if the business is solvent. If the business is likely to be liquidated, OCC will seek the advice of professional appraisers that deal with the assets to be liquidated. An OCC official noted that the value of an asset usually changes drastically in liquidation. For example, the liquidation of a hardware store will usually produce only 25 percent of its book value, and a restaurant will usually realize only 10 percent of its book value in a liquidation sale.

How FCA reaches its liquidation decisions

FCA officials told us that many combinations of indicators and conditions can exist that would cause FCA to consider liquidating an association. However, an insolvency finding, a stock impairment,[5] and a debt-to-capital ratio exceeding ten-to-one[6] are three indicators or conditions that may exist at an association that would cause FCA to consider liquidating the association.

FCA officials told us that hard and fast rules cannot be established for whether to liquidate or rescue an association. A clear understanding of the association's problems and the causes of those problems is paramount before selecting a solution. Many factors will influence the supervising intermediate credit bank and the FCA decision to liquidate an

[5]An 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 place that institution under special operating conditions (see ch. 4, p.6).

[6]Under the law, when a production credit association's debt-to-capital ratio exceeds ten-to-one the intermediate credit bank can no longer provide it with loan funds.

association or to use various assistance alternatives. (See ch. 5 for a discussion of assistance alternatives.) Some of these factors include the seriousness of the association's problem, the financial condition of the troubled association and other associations in the same district, and the effect each alternative will have on the intermediate credit bank and its borrowers. The main consideration is which alternative is most likely to provide a dependable source of funds to creditworthy borrowers at a reasonable cost.

FCA must approve an intermediate credit bank's plan to assist a troubled association. The FCA also has responsibility for overseeing the intermediate credit bank's planning and implementation of corrective actions. In the approval process, FCA will evaluate the intermediate credit bank's decision and justification for the assistance. FCA will evaluate the assistance plan to assure that the proposal is legal, is within the financial resources of the bank, and is likely to return the association to viability. In making its decision, FCA has the option of approving the bank's proposal, suggesting or selecting another alternative, or liquidating the association.

With the exception of Regulation 1130 cited on page 13, there are no established criteria or guidance for deciding when to liquidate an association. Many factors will affect that decision.

When faced with the decision of whether to liquidate a troubled association, intermediate credit bank and FCA officials will examine such issues as:

--How can quality of service be restored or maintained?

--How can costs be minimized?

--How can association and bank assets best be protected?

--How can member investment best be protected?

Answers to these questions lie in the analysis of the conditions existing at the association and the necessary corrective actions that would be required to rescue the association. Not only will the causes of an association's problems be analyzed but the potential effects of the solution (rescue or liquidation) on its intermediate credit bank must also be considered.

The troubled association is analyzed by FCA and the intermediate credit bank to determine how long it will take and how much it will cost to correct the association's problems and

if the intermediate credit bank can afford a rescue undertaking without affecting its other borrowers. FCA and the bank then will decide if the association's losses can be contained in the future or if they will continue to increase. If large losses are expected to continue to occur, the bank and FCA may decide to liquidate while some value remains. The ability of the intermediate credit bank to deal with the association's problem but still remain responsive to and supervise its other associations is also considered.

Another important question that FCA and the intermediate credit bank address is the potential for growth in loan volume. Can the association's current borrowers be retained, new ones found, and former borrowers returned? Prudent, creditworthy borrowers tend to borrow on the best terms available. Therefore, the association's expected future credit terms must be competitive with other lenders in the area. The production credit association may find that it cannot work itself out of its problems because the interest rate it must charge borrowers to counter loan losses must be higher than those of competitors.

FCA relies heavily on the intermediate credit bank's and its own financial projections to determine if an association's lending rate will be competitive in its market and remain within FCA's regulatory rate ceiling of no more than 4 percent above the association's cost of funds. FCA views a competitive interest rate as a key factor in deciding whether to liquidate a production credit association. FCA officials advised us that a financially troubled association cannot become viable unless it can charge an interest rate that will attract and keep creditworthy borrowers.

While there are no established criteria for determining what is unacceptable, FCA and the intermediate credit banks will also consider such factors as

--the potential for surrounding associations to assume the responsibility for providing credit to the borrowers by expanding their territory and loan volume;

--the amount of nonfinancial assistance needed to rescue the troubled association;

--the ability of the troubled association to adequately capitalize itself and generate risk funds--an association's allowance for losses and net worth surplus accounts--i.e., withstand future losses; and

--the ability of the association to generate loanable funds--the difference between the association's outstanding loans and its debt to the intermediate credit bank.

LIQUIDATION PROCEDURES

Liquidating a production credit association is similar to liquidating any business. The objective of the liquidation is to convert the association's assets into cash, pay creditors, and return any surplus funds to the owners of the association. To accomplish this, a disinterested party, known as a receiver or liquidator, is appointed.

The procedures FCA uses are fairly typical of the procedures used by other regulators that liquidate financial institutions, such as the FDIC, FSLIC, or NCUA. The other regulators' procedures include notifying corresponding banks or creditors that the affected entity is in liquidation, taking control of the affected entity, verifying the financial records of the affected entity, and initiating payment or collection of the entity's liabilities and assets. We did not find any material differences in the procedures used by other regulators as compared to FCA.

FCA liquidations are also similar to corporate liquidations which are governed by Public Law 95-578 except that for FCA liquidations, there is no court involvement and no creditor committee is formed to work with the court-appointed trustee. The lack of a creditor committee is understandable since the intermediate credit bank holds between 95 to 99 percent of an association's debt. The bankruptcy code, as do FCA procedures, provides for a liquidation plan; an inventory of assets, recordkeeping, and availability of professional services such as lawyers and appraisers; use of the debtor's property to transact the liquidation; the ability to stop contracts not in keeping with liquidating the business; distribution of liquidation proceeds based on predetermined priority; and a final accounting of liquidation proceeds.

Two types of liquidations exist at FCA: voluntary and forced or involuntary. If an association voluntarily enters liquidation, the association's board of directors will adopt a resolution requesting the Governor of FCA to place the association in voluntary liquidation. Before an association can enter voluntary liquidation both the intermediate credit bank and FCA must concur with the resolution. FCA procedures provide that the supervising bank is responsible for appointing and overseeing the receiver in voluntary liquidation cases. The intermediate credit bank, in turn, is responsible to the FCA. Also, FCA may be responsible for approving selected actions of the intermediate credit bank during the liquidation process.

FCA is responsible for initiating involuntary liquidations of failing associations. If an association is declared insolvent by FCA and is involuntarily liquidated, the FCA is

responsible for responsible for appointing and overseeing the receiver. The association's board of directors does not adopt a resolution of liquidation and may challenge the FCA action in the courts. At the two associations included in our review that FCA declared insolvent and is liquidating, FCA hired a liquidator/receiver to liquidate the associations.

Receiver's responsibilities

The responsibilities of an FCA or intermediate credit bank receiver are typical of the responsibilities of any court-appointed or other receiver. The receiver is responsible for closing the association and starting the liquidation process. From the time the receiver assumes control of the association, the old association is out of business. In effect, the association in liquidation is a different institution. The receiver becomes responsible for all debts that may arise while the receiver controls the association. The receiver becomes totally responsible for the association's operations. During liquidation, an association's operations include meeting the association's existing credit commitments to borrowers as well as receivership responsibilities, subject to the constraints placed upon the receiver by either FCA or the intermediate credit bank. The receiver, in effect, becomes the chief executive officer and the board of directors of the association responsible only to FCA or the intermediate credit bank.

A receiver has many specific tasks to perform. The receiver will

--take physical control of the association's records and ensure that they are safeguarded;

--provide notice to banks, businesses, association stockholders, and government agencies, etc., post notices on all production credit association places of business that the association is in liquidation, and advertise the association's liquidation in local newspapers;

--verify and control all cash and negotiable items;

--take control of documents that support the association's rights to collateral for loans outstanding to its borrowers;

--physically inventory all association assets, verify that all recorded assets exist (including furniture, fixtures, and property), and assess each asset's condition;

--inventory all liabilities to determine which creditors are eligible for payment and whether liabilities of the association were legally incurred;

--request bank statements and close all association bank accounts;

--review all loans to ensure that all debtors are identified;

--hire and pay employees to liquidate the association as well as establish employees' salaries and duties;

--phase out the former employees of the association;

--stop transactions that the association may have initiated prior to the receiver assuming control of the association which would not be in keeping with the association's liquidation, such as contracting for a new computer;

--determine which goods and services are necessary for continued operation of the receivership and advise those companies that the receivership wishes to continue the service and will be responsible for all subsequent charges; and

--stop services not necessary to continue association operations during liquidation.

The more important tasks of the receiver are discussed below.

Borrower notification and options

Once the receiver has taken possession of an association, the receiver will notify stockholders and participation certificate[7] holders, all of whom are borrowers or former

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[7]Participation certificates are issued to "other financial institutions" that participate with the association in lending to farmers. Those institutions are not eligible to own stock in the associations; therefore, the participation certificate is the evidence that the institution has invested in the association. The participation certificate holders have all the rights and obligations of stockholders except the right to vote in the affairs of the association.

borrowers of the association, that the association is in liquidation. In either this notice, or in a subsequent notice, the receiver will inform the borrowers of the

--number of shares the shareholder owns,

--responsibility of the borrowers to continue payment to the receiver,

--terms and conditions of the borrowers' outstanding loans,

--options available regarding the payment or transfer of loans,

--services available during the association's liquidation, and

--other matters the receiver may deem appropriate.

Association borrowers will be informed that alternative sources of financing must be found in the future. Creditworthy borrowers have three options. The first borrower option is to continue financing with the association chartered to serve the territory previously served by the association in receivership. Both intermediate credit banks associated with the associations in liquidation helped borrowers make the transition from the association in liquidation to the acquiring association. These intermediate credit banks provided interest-free loans to borrowers choosing to finance with the acquiring association. Each loan was equal to the capital stock that the acquiring association required of a member. This assistance enables association members to continue a line of credit while their stock is frozen. The second borrower option is to refinance with a nonfarm credit institution lender. The third borrower option is to remain with a receiver until the borrower's next debt maturity or until the receivership sells its interest in the loan.

Disposition of loan assets

A formidable task of the receiver is the disposition of the association's loan assets. Disposition of loan assets takes two forms. The first task is bulk sale of loan assets. The second is individually working out repayment schedules with borrowers or foreclosing on those properties.

Sale of loans

FCA and intermediate credit banks worked with surrounding production credit associations and the receiver to arrange the sale of loan assets to the associations that assumed

responsibility for serving the area formerly served by the associations in liquidation. At the four associations we visited, the receiver sold acceptable and problem loans to the associations acquiring the territory formerly served by the association in liquidation. These sales were bulk sales at the book value of the loans transferred. The sale agreements provided the acquiring association time to examine the loans purchased and required the receiver to repurchase any loans not meeting the acquiring association's credit criteria. The repurchase options ran for up to 180 days and in some cases, these agreements were extended. Once an acquiring association accepted a loan or extended credit to the borrower, it became responsible for servicing the loan and for any loan profit or loss. The FCA or intermediate credit bank approved the terms of these sales agreements. Loans to borrowers who elected to stay with the associations in liquidation as well as loans which were of unacceptable quality were not part of the bulk sales.

Remaining loans

Loans that remained with the receivers after the bulk sale of loans had a range of loan quality. Some fully creditworthy borrowers elected to remain with the associations in liquidation. These borrowers were provided with additional credit if the association's receiver determined that such financing was necessary to continue the farm or aquatic business or to protect the collateral position of the association. However, only essential financing was provided. As the loans mature, borrowers in this category must refinance with another lender.

Borrowers whose financial condition would not permit them to obtain credit elsewhere but who had potential for recovery--by voluntary reduction in their businesses--through increased earnings were provided with only essential operating and capital financing. These borrowers had to meet certain conditions that the receiver prescribed and are required at each loan maturity date to submit evidence that credit could not be obtained elsewhere.

Some borrowers were not able to obtain credit elsewhere and did not offer the potential for recovery through improved earnings. These borrowers were only provided with financing necessary to protect the association's collateral position. Arrangements were made with some of these borrowers to compromise their loan.

Loan compromise

Loan compromise is the process by which the original terms and conditions (i.e., interest rate, maturity, or principal) of a loan are adjusted because the borrower is not able to meet the original terms and conditions. The objective of a loan compromise, also referred to as loan work out, is to obtain the

highest practical return for the association in liquidation. In return for granting the borrower one or more of these concessions, the receiver expects to enhance the association's recovered amount. Typically, the receiver will obtain additional collateral to ensure a greater return should foreclosure subsequently become necessary to collect the debt.

Loan compromises are justified on the grounds that the new loan arrangements will provide the borrower with a better chance at recovery. They also provide the association in liquidation a higher return than under a foreclosure. A loan compromise will usually result in some financial loss for the association when compared to the original terms of the loan agreement. In some loan compromises, the receivership may even incur a loss on the loan principal. The receiver must obtain FCA or intermediate credit bank approval to implement a loan compromise that exceeds a predetermined dollar amount of losses.

By their very nature, loan compromises can cause at least two types of problems. FCA and the intermediate credit banks responsible for liquidating associations try to preserve an association's stock value and prevent stock from becoming impaired or further impaired during the liquidation process. Each loan that the receiver compromises may become part of a stockholder's suit alleging that the stock would not have been impaired had the concession not been made. A second problem can arise because loan compromises can increase the difficulty of collecting debts.

In the farm and fishing communities involved in our review, word travels quickly among association members when a borrower's debt is compromised. In the cases we reviewed, the receivers told us that as word spread that some loan compromises were being made by the associations in liquidation, some borrowers assumed the associations were having a "debt sale" to get out of business as soon as possible. We were told that many borrowers, acting on less than full, if not incorrect, information and limited knowledge of loan compromise criteria, sought compromises similar to what they had heard other borrowers had received.[8] The receivers told us that they were not compromising debts unless the compromise was in the economic interest of the association. Nonetheless, dealing with borrowers seeking to compromise their debt is a time-consuming process.

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[8]In the opinion of one receiver we talked with, some borrowers threatened suits alleging various types of improprieties on the part of the association in an attempt to obtain a better bargaining position in the compromise. The receivers we spoke to told us that threats of borrower suits alleging association improprieties had no effect on their decisions regarding debt compromises.

The Spokane and Louisville Intermediate Credit Banks reacted differently to opportunities to compromise debts. Debt compromise was more prevalent in the Spokane district. Very few borrowers' debts were compromised at Louisville's Mammoth Cave Production Credit Association. Several factors caused this difference.

The Louisville district had experienced more diversion of collateral than the Spokane bank.[9] Neither the Louisville receiver nor the Spokane receivers were willing to offer a compromise to any borrower that diverted the association's assets. Also, the Louisville receiver were concerned that a loan compromise might lead to stock impairment, and subsequent law suits. The Spokane receivers were not concerned about suits resulting from stock impairment because the Spokane Intermediate Credit Bank made a business decision to retire all stockholders' stock at its par value of $5 a share. FCA concurred with the decision. This decision was made because the intermediate credit bank was not sure that it had adequately informed borrowers that their investment in stock was an investment at risk--that it could be lost. This bank has since instituted revised procedures for informing borrowers that their stock purchase is at risk.

Sale of acquired assets

In any lending operation, it is inevitable that some borrowers will default on their obligations and foreclosure will become necessary. In those cases where the receiver determines that the best interests of the association in liquidation are served by obtaining a borrower's property and selling it, the receiver must foreclose. Receivers for the four associations we examined did foreclose on some properties. Before selling the asset, according to FCA procedures, the receiver must obtain an appraisal if the asset is believed to be worth more than a specified amount--$100,000 and $250,000 at the associations we visited. In cases of assets worth less than the specified amount, the receiver may use the best estimate of the asset's value based on comparable sales in the area or some other authoritative source for valuing the asset. At the associations we visited, the receivers told us that they generally obtained appraisals on land and boats that were to be sold, even though their value may have been less than the specified amount.

Once the receiver has an estimated asset value, the receiver must determine an acceptable price for disposing of the asset. Usually, the receiver may sell assets without FCA

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[9]Diversion of collateral is the term used to describe the unauthorized sale of collateral, such as land or cattle, without applying the proceeds toward the repayment of a debt.

approval if the sale price is at least 80 percent of the asset's estimated value. FCA allows the receiver to use brokers, auctioneers, or other means to sell association assets. It is incumbent upon the receiver to obtain the best price available for property sold. Therefore, property may be held for a period of time in anticipation of receiving better purchase offers. FCA-appointed receivers work under contract to FCA. Intermediate credit bank appointed receivers are employees of the bank. However, the interests of association members, intermediate credit banks, and FCA are the same--that of protecting their investment in the association. The receivers we contacted told us that they were attempting to get the best price possible for the assets that the association had acquired through foreclosure or other means. For example, because Spokane is a fishing community, the market for fishing boats is depressed there. The receiver for two associations has sought to sell boats to foreign countries by advertising the boats internationally and has made one overseas trip to present the available boats to prospective buyers.

Payment of association debt

The receiver is responsible for preparing a plan for paying creditors. To prepare such a plan the receiver must determine which creditors' claims are allowable. FCA has established classes of creditors and the priority in which each class will be paid. The payment priority is similar to that used in section 7 of bankruptcy proceedings under Public Law 95-598. Liquidation expenses are paid first, and taxes are paid second. FCA priorities differ from payment priorities of a section 7 bankruptcy proceeding under Public Law 95-598 for the third and fourth priorities. Claims or expenses that an association incurred while operating under FCA regulation 1140--the period of time between declaring an association insolvent and deciding that it should be liquidated--are paid next. Fourth in priority are claims for wages and salaries incurred during the 90 days prior to restricting the association's activities by imposing regulation 1140. In all four production credit associations' liquidations we examined, expenses associated with these first four priorities were paid.

Fifth in priority are claims of creditors which are secured or have liens on assets or property of an association (these expenses are being paid at the associations we visited). Sixth in priority are all claims by the intermediate credit bank; the extent to which these claims will be paid is questionable. Seventh in priority are payments to general creditors. In the case of these associations, general creditors typically consist of suppliers of paper and office supplies, telephones and utilities, and office equipment. Because the amount of general creditors' claims were relatively small, FCA and both intermediate credit banks allowed the associations we

visited to pay general creditors regardless of their priority. Eighth, and final, in priority are all claims of stockholders and holders of participating certificates in accordance with the number of shares they hold plus any funds that may remain after paying the par value of the stock or participating certificates and all other debts.

All claims in a class of creditors must be paid before the next lowest class of creditors will be paid, unless FCA authorizes deviation from the established priorities. If funds are insufficient to pay an entire class of creditors, pro rata payments are made to that class of creditors, and the remaining creditor class claims lower in priority are not paid.

Final distribution of assets

After an association's loans or assets have been sold or retired and its liabilities have been paid, which may take several years, the stockholders and holders of participation certificates will be paid if funds remain. If funds remain after priority seven and the liquidation has been completed, FCA's general rule establishes the following order of payment:

1. Retire any Class C preferred stock[10] investment owned by the FCA Governor or others.

2. Retire any Class A stock[11] owned by the intermediate credit bank, FCA Governor or investors.

3. Retire at par value ($5 a share) Class B stock[12] and participation certificates and after deducting the amount necessary to retire any Class D stock investment, return any remaining fund to Class B stock and participation certificate holders.

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[10]Nonvoting preferred stock may be issued to the Governor and to investors when authorized by a majority vote of Class A stockholders, a majority vote of Class B stockholders, and a majority vote of Class C stockholders, and with prior approval of the bank and the Farm Credit Administration.

[11]Class A nonvoting stock may be issued to the Governor, to the bank, and to investors in such amounts and to such persons as may be permitted under a plan adopted by the board of directors and approved by the bank. At the end of a 2-year period following the repayment of a borrower's indebtedness to an association, the borrower's Class B stocks, if not redeemed, are also converted to Class A stock.

[12]Class B stock and participation certificates are issued to eligible borrowers in an amount equal to at least $5 per $100, or a fraction thereof, of the amount of the loan.

4. Retire any Class D stock owned by the intermediate credit bank.[13]

Mammoth Cave Production Credit Association's liquidation plan follows the above procedures except that the accrued interest on the association's debt to the intermediate credit bank will be paid after retirement of Class A stock to the extent that the payment would not impair the borrowers' Class B stock. Likewise, if funds remain in the Southern Idaho, Southern Oregon, or Puget Sound Production Credit Associations, we were told those funds will be used in a manner similar to the Mammoth Cave Production Credit Association liquidation. As we noted earlier, the Spokane Intermediate Credit Bank has retired shareholder and participation certificate holder equities (step 3) at par. Therefore, a difference exists between the way funds will be disposed of between the two intermediate credit banks liquidating production credit associations. FCA officials told us that in the future they will probably not permit borrower stock to be retired before liquidation activity has reached or is near conclusion. Therefore, borrower stock will remain at risk.

CONCLUSIONS

FCA has broad authority to liquidate production credit associations. FCA's criteria for whether to liquidate an association--default and insolvency--are subjectively determined based on an association's compliance with the terms and conditions of its loan agreement with its intermediate credit bank. If an association defaults on its obligation to its intermediate credit bank, the association may be declared insolvent and liquidated. Once an association has voluntarily entered liquidation or FCA has declared the association insolvent and forced its liquidation, FCA's procedures for liquidating production credit associations are consistent with procedures used by other lending regulators.

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[13]Class D stock has been used by some intermediate credit banks to assist troubled associations.

CHAPTER 4

ASSOCIATION LIQUIDATIONS

DID NOT DISRUPT CREDIT FLOW

In this chapter we describe the steps that FCA takes in assuring that credit supplied by the liquidated associations continues to flow on an uninterrupted basis. FCA tries to avoid material interruption of credit service to farmers while liquidating an association and was successful in this effort at the four associations we visited.

LOANS WERE TRANSFERRED AND CREDIT NEEDS MET

In keeping with FCA's general rule, the liquidation plans we examined called for the association in liquidation to continue servicing existing loans, to honor commitments for new loans made before the liquidation date, and to forward loan requests submitted after the liquidation began to an adjoining association. In addition, FCA arranged for surrounding production credit associations to purchase the viable loan accounts of the production credit associations in liquidation. The intermediate credit banks aided the transition of loans from the association in liquidation to the association acquiring the loan by providing transferring members with an interest-free loan to purchase stock in the association assuming their loan.[1] In three out of four cases, the assuming associations were charging a lower interest rate than the liquidating production credit association. According to FCA officials, the one association in liquidation whose members' interest rate increased had material misstatements in its financial statements. These misstatements led the association to charge its borrowers a lower interest rate than normally would be expected.

The Mammoth Cave Production Credit Association voluntarily agreed to liquidate on August 10, 1983. As its liquidation plan stated, it continued to service existing loans and honor previous commitments for new loans. Loan applications submitted after August 10, 1983, were forwarded to surrounding

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[1]Borrowers are required to purchase between 5 and 10 percent of their outstanding loan in stock, at $5 per share, from the association providing the loan. When an association is in liquidation it cannot retire the borrowers' stock as is the normal practice when borrowers repay their loans. The borrowers/owners are expected to assume any losses up to their investment in the stock of an association being liquidated if the association's debts exceed its assets.

associations. FCA reapportioned Mammoth Cave's territory to the West Kentucky, Nolin, Springfield, and Cumberland Production Credit Associations. These associations subsequently purchased the viable Mammoth Cave loans at book value. An average borrower transferring out of Mammoth Cave initially received an interest rate reduction of 1.19 percent. By means of an interest-free loan, the Louisville Intermediate Credit Bank agreed to buy stock on the borrower's behalf in the association to which the borrower's loan was transferred. This offer was limited to the borrower's ownership of stock in Mammoth Cave. Mammoth Cave's stock will be retired when liquidation is completed. The receiver at Mammoth Cave did not believe that the borrower's stock would be impaired but this will be determined by events subsequent to this report. Between August 10, 1983, and December 31, 1983, about $42.3 million of Mammoth Cave's $51 million outstanding loan balance was transferred to other associations and 90 percent of its 2,567 former members transferred to other associations.

FCA took control of the Southern Oregon Production Credit Association on August 10, 1983. On the day liquidation began at Southern Oregon, October 19, 1983, loans to creditworthy borrowers were purchased and transferred to either Klamath or Northwest Livestock Production Credit Association. The Klamath Production Credit Association provided financing to creditworthy agricultural borrowers initially at an average yearly effective interest rate of about 1.5 percent lower than Southern Oregon; Northwest Livestock initially provided financing to creditworthy aquatic borrowers at an average yearly effective interest rate 1 percent lower than Southern Oregon. The Spokane Intermediate Credit Bank also arranged interest-free loans for borrowers to purchase stock in either Klamath or Northwest Livestock in an amount equal to the par value of its class B stock in Southern Oregon. (Subsequently, the class B stock in Southern Oregon was retired.) Between October 19, 1983, and December 31, 1983, about $33 million of Southern Oregon's beginning outstanding loan balance of $53.2 million had transferred to Klamath or Northwest Livestock Production Credit Associations.

The FCA took control of the Puget Sound Production Credit Association on August 10, 1983, and on this date requested the Southwest Washington Production Credit Association to accept applications from eligible applicants not then indebted to Puget Sound. Liquidation of Puget Sound began on October 7, 1983. Loans to creditworthy agricultural borrowers were purchased and transferred immediately to the Southwest Washington Production Credit Association, while loans to creditworthy aquatic borrowers were purchased and transferred immediately to the Northwest Livestock Production Credit Association. As in Southern Oregon's case, the Spokane bank provided each borrower that transferred an interest-free loan to purchase stock in either the Southwest Washington (agricultural borrowers) or

Northwest Livestock Production Credit Association (aquatic borrowers) in an amount equal to the par value of its class B stock in Puget Sound. (As with Southern Oregon, the class B stock in Puget Sound has been retired or is in the process of retirement.) The average yearly effective interest rate charged by Northwest Livestock and Southwest Washington Production Credit Associations initially was about 0.2 percent lower and 1 percent higher, respectively, than Puget Sound's. However, material misstatements found by FCA in the Puget Sound financial statements make interest rate comparisons not meaningful. Between October 7, 1983, and December 31, 1983, approximately $54.6 million of Puget Sound's $78.9 million outstanding loans were transferred to other associations.

FCA assumed control of the Southern Idaho Production Credit Association on September 14, 1983. Two months before placing Southern Idaho into receivership, FCA requested the Eastern Idaho Production Credit Association to accept loan applications from eligible borrowers not indebted to Southern Idaho. Southern Idaho continued to service existing loans and to meet previous commitments for loans. Southern Idaho entered liquidation on November 18, 1983. Southern Idaho transferred $104.1 million of its $136.2 million beginning outstanding loan balance to the Eastern Idaho Production Credit Association on December 12, 1983 (this represented 93 percent of its 1,381 members). Class B stock in Southern Idaho was retired so that members could purchase an equivalent amount of stock in Eastern Idaho. Eastern Idaho initially charged an average yearly effective interest rate 0.5 percent lower than Southern Idaho.

LIQUIDATION CREATED SOME UNCERTAINTY FOR BORROWERS

Servicing the credit needs of borrowers involved two phases: servicing borrowers' existing loans and providing for future credit needs. FCA used its Regulation 1140 (12 C.F.R. 611.1140) to suspend the authority of the associations that are in liquidation in the Spokane district.[2] Regulation 1140 provides that

> "Upon determination by its board of directors, by a supervising bank, or by the Farm Credit Administration, that the capital stock, participation certificates, equity reserves, or allocated equities of any bank or association have a book value less than par or stated value, or the

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[2]FCA did not use the 1140 procedures before the Mammoth Cave Production Credit Association entered liquidation because the association's stock was not impaired.

> bank or association is insolvent, further operations of the bank or the association shall be subject to procedures approved by the Farm Credit Administration. In the case of associations, the procedure may be established by the supervising bank subject to approval by the Farm Credit Administration."

The period between FCA invoking Regulation 1140 to assume control of these associations (1140 associations) and the ultimate decision to liquidate them was a period of uncertainty for association member/borrowers. This was the period during which FCA and the Spokane Intermediate Credit Bank assessed the various rescue options and their potential usefulness at each association. (See ch. 5 for a discussion of various assistance alternatives.) The receivers told us that members were concerned about whether their association would survive and how their credit needs would be met if the association was liquidated.

When FCA assumed control of the four associations in the Spokane district, the associations' activities were partially frozen. Basically, the following occurred at each association:

- --Bylaws and regulatory provisions under which the associations operated were suspended.
- --All board of directors' actions became subject to the prior approval of FCA.
- --Approval of loans or commitments on existing loans or disbursements on outstanding commitments became subject to FCA approval.
- --Retirement and issuance of all stock, transfer of Class B to Class A stock, and application of any stock to loans stopped.
- --FCA approval was required before collection efforts on loans through foreclosure, compromise of indebtedness, transfer of assets or other methods not provided in the normal repayment schedule for loans occurred.
- --FCA approval was required to record loan charge-offs, to transfer loans to loans in process of liquidation, and to stop interest accrual on nonperforming assets.
- --The authority of the associations to purchase or sell any asset, including fixtures; hire or discharge any officer or employee; pay any

obligation or indebtedness; make any verbal or written agreement, commitment, or obligation for the purchase or sale of any services or property, both real and personal, were all suspended.

The member/borrowers were notified of FCA actions by FCA press releases, mail, and at special stockholder's meetings.

While these 1140 associations were controlled by FCA, the credit needs of creditworthy farmers and fishermen were met. However, additional approval by FCA's site representative was required before existing lines of credit and commitments were met. FCA officials told us that FCA approval added 1 to 2 days to the approval process.

Loan requests from prospective members and requests for new loans from current members were accepted by the FCA-controlled 1140 associations; however, the authority to approve and make these loan requests was given to neighboring associations. This meant that each borrower's loan request needed to be completely researched and information verified using the credit extension process in effect at the association making the loan. Because control over credit extension had been lax for a number of years at the 1140 associations, the neighboring associations took longer to approve or disapprove the loan requests than borrowers had come to expect when requesting loans from their association. Furthermore, the receivers told us that neighboring associations initially may not have been adequately staffed to meet the increased credit requests, and that a lack of full coordination, understanding, and appreciation of what was happening may have contributed to the uncertainty experienced by borrowers.

In the process of loaning funds to borrowers, the 1140 associations and neighboring associations explained the loan terms and conditions to borrowers. These terms and conditions were not always the same as those that borrowers had previously experienced. For example, if a borrower signed a 1-year note on November 1, 1983, borrowers were told the note would be due November 1, 1984, and if it was not paid, penalties would be assessed. According to intermediate credit bank officials, the receivers, and former association loan officers, borrowers were accustomed to controlling their loan repayments. Before, if borrowers had signed a 1-year note and chosen not to repay on the due date, the association might not have charged the borrower a penalty. The officials we interviewed said that these borrowers believed the association making the loans would not be willing to work out problems with an individual borrower and perceived the more rigorous procedures to be new. They also said that many borrowers were upset because the associations making loans were examining the borrower's ability to repay and

because the associations making loans were asserting control over the loan. Consequently, some borrowers sought and found credit from commercial banks and other non-System sources.

CONCLUSIONS

Although some delays occurred, credit service to creditworthy farmers continued uninterrupted in the liquidations of Mammoth Cave, Southern Oregon, Puget Sound, and Southern Idaho Production Credit Associations. The FCA adequately arranged for the transfer of viable loan accounts from liquidating associations to adjoining associations. New financing was available at all times to both association members and prospective members. In three of the four cases, interest rates charged borrowers were lower at the adjoining associations than at the liquidating associations. FCA sufficiently arranged to meet the new credit needs of the farming and fishing communities in the areas formerly served by the associations in liquidation.

CHAPTER 5

RESCUING FINANCIALLY TROUBLED ASSOCIATIONS

WITH THE REVOLVING FUND MAY NOT HAVE BEEN DESIRABLE

Rescuing a financially troubled association is an option to forcing or allowing its liquidation. In our opinion, fundamental to a rescue attempt are the necessary resources and the belief that an association can, within some desired costs and time, become a self-sustaining, viable operation. When an association experiences financial difficulty, many actions can be taken to deal with the problem. Among the available remedies are merger or consolidation, and more direct financial assistance, such as is available under loss-sharing or capital infusion programs. The specific action taken depends on the probable future financial viability of the association, the strength of the intermediate credit bank, and the effect that specific actions will have on the availability and quality of service to borrowers in the affected area.

We were asked to explore the implications of rescuing the four financially troubled associations we examined by using FCA's Short Term Credit Investment Fund.[1] FCA's Short Term Credit Investment Fund is available to FCA's Governor for temporary investment in the stock of any intermediate credit bank or any production credit association to meet the emergency credit needs of borrowers. The revolving fund represents a contingent liability of the Treasury; i.e., there is no money maintained in the fund and if the fund were used it would require an outlay from the general funds of the Treasury. FCA has opted not to use the revolving fund to provide financial aid to failing associations. Based on our analysis of the circumstances surrounding the four failed associations we visited, we agree with FCA's decision to not use the revolving fund to rescue the associations. There are four basic reasons underlying this judgment:

--The limited legislative history associated with the statutes, while not dispositive of the issue, lends support to FCA's decision not to use the revolving fund in the cases we reviewed.

--The provision of credit to borrowers was not disrupted as a result of the liquidation actions taken by the FCA.

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[1]FCA has two investment revolving funds. One is designated for investment in banks for cooperatives. The other is commonly referred to as the "Short Term Credit Investment Fund," and is designated for short-term investment in intermediate credit banks and production credit associations.

--There are numerous options available to FCA to aid financially troubled associations that do not make use of the revolving fund. In the specific cases we reviewed, it became clear after employing various assistance devices that the viability of the associations could not be sustained even after considering the effect of a federally financed cash infusion.

--The revolving fund was not necessary to preserve the flow of credit to borrowers and its use could create incentives for System institutions to engage in excessively risky lending and management practices.

In the previous chapter we discussed the question of whether the liquidation of the associations we reviewed disrupted the availability of credit for borrowers. In the remainder of this chapter, we discuss the remaining three reasons underlying our judgment.

FCA'S INTERPRETATION OF THE STATUTE AND LEGISLATIVE HISTORY IS REASONABLE

Neither the face of the statute nor its limited legislative history addresses whether the revolving fund can be used to rescue failing production credit associations.

With regard to investment by FCA in System institutions, 12 U.S.C. §2151(a) provides:

> "The Federal land banks, the Federal intermediate credit banks, the banks for cooperatives, and, subject to section 2094(d) of this title, the production credit associations may issue stock which may be purchased by the Governor of the Farm Credit Administration . . . as a temporary investment in the stock of the institution to help one or several of the banks or associations to meet emergency credit needs of borrowers. . . ."

The FCA Governor is authorized by 12 U.S.C. §2152(a) to use the revolving fund established by Public Law 87-343, as amended, for such investments in intermediate credit banks or production credit associations as provided in 12 U.S.C. §2151 quoted in part above.

The Congress originally created two separate revolving funds, one for investment in the stock of production credit associations (see 12 U.S.C. §1131i(a) (1970)), and one for investment in the stock of intermediate credit banks (see 12 U.S.C. §1131i(e) (1970)). Public Law 87-343, 75 Stat. 758 (1961), combined the two funds to make the total amount

available for investment in either institution. (See appendix II for more details on the fund's origin.) The legislative history of Public Law 87-343 gives some indication of the circumstances under which the Congress contemplated that FCA would use the revolving fund. In explaining the use of the then-separate revolving funds, the House Report states:

> "Out of one of the revolving funds the Governor of the Farm Credit Administration currently subscribes to capital stock in a production credit association. . . when. . . further capital is needed because of adverse conditions or rapidly increasing loan volume to enable the association to serve the sound credit needs of farmers and ranchers in its territory. . . .
>
> "Out of the other revolving fund the Governor currently subscribes to capital stock in the Federal intermediate credit banks . . . when it is necessary because of substantial increases in their business. . . ."[2]

A similar explanation of the use of the revolving fund is provided in a Senate report[3] and in an explanatory statement submitted on the Senate floor.[4] There is no further elaboration on the circumstances under which the revolving funds were to be used or the combined fund is to be used to aid financially troubled intermediate credit banks or production credit associations in the legislative history of either the 1933 Farm Credit Act and its relevant amendments, or the Farm Credit Act of 1971.

The FCA has taken the position that its authority to make short-term investments in production credit associations was intended to be used to supplement the capital base of viable associations, not failing ones. For example, in FCA's view, it would be appropriate to invest in a production credit association using the revolving fund when, as a result of a natural disaster affecting farmers, such as a drought, or of the departure of a large commercial lender, there is increased demand for loans to be made by the association. In these circumstances, the FCA investment would enable the association to increase the number of loans it makes by increasing its capital base. (A production credit association cannot borrow if

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[2]House Report No. 1112, 87th Cong., 1st Sess. 15 (1961).

[3]Senate Report No. 747, 87th Cong., 1st Sess. 8-9 (1961).

[4]107 Cong. Rec. 16457-16458 (1961) (statement of Senator Holland).

its debt to capital ratio is greater than 10 to 1.) In FCA's view, the government investment was not intended to be used solely for the purpose of rescuing a failing association.

Although the legislative history on using the revolving fund is limited, it lends support to FCA's interpretation. As FCA maintains, the Congress appears to have contemplated that the funds would be used to supplement the capital base of intermediate credit banks or production credit associations in response to increased loan demand, rather than to rescue failing institutions. FCA's position also is supported by the language of the statute, in that it authorizes investment by FCA only to meet "emergency credit needs" of qualified borrowers. Thus, in our view, FCA's position represents a reasonable legal interpretation of its statutory authority.

ALTERNATIVE ASSISTANCE MECHANISMS EXIST AND WERE USED UNTIL THERE WAS NO PROSPECT OF RECOVERY

Although FCA has no financial resources of its own except the revolving fund, numerous System self-financed and non-financial assistance alternatives exist. These alternatives were used to aid institutions experiencing financial difficulty.

FCA's and intermediate credit banks' financial or non-financial assistance programs are tailored to provide troubled associations with an opportunity to correct identified or potential financial problems as well as their causes. Usually, assistance allows an association to continue providing financial services to its owner-borrowers and offers the association a chance to avoid liquidation. These actions include supervision, loss-sharing programs, and capital assistance as well as merger, consolidation, and realignment of territories. We evaluated the use of these devices, with emphasis on their use in the liquidated association cases we were asked to review.

Supervisory actions

Supervisory actions are FCA's first line of assistance. Basically, supervision consists of: (1) monitoring operations to evaluate performance, (2) documenting all findings through examinations and examination reports, (3) recommending corrective actions, and (4) providing guidance through directives on how to implement various regulations. Most supervisory actions are nonfinancial methods of obtaining improvements or correcting unsafe and unsound practices. FCA or an intermediate credit bank can influence the financial well-being of an association without infusing funds by using supervisory means, such as requiring an association to obtain approval prior to making loans to certain borrowers. As

indicated in appendix I, FCA believed that the intermediate credit banks in its Spokane and Louisville districts had provided weak supervision to the associations included in this review.

Another of FCA's supervisory actions--that of allowing an association to exceed its direct loan limit--is the same as an intermediate credit bank providing financial assistance because it allows the association to continue to finance the sound credit needs of borrowers. This action was taken in the cases we reviewed.

An association's direct loan limit is the amount of money that an association can borrow from its supervising intermediate credit bank. This amount is limited by FCA regulations. FCA considers an association approaching or exceeding its direct loan limit as a warning sign that corrective action is needed. An association's direct loan limit is based on the quality of the association's outstanding loans. Section 4190 of FCA regulations requires FCA approval before an intermediate credit bank can discount loans for an association in excess of the association's direct loan limit. Both the intermediate credit banks and FCA have formulas for calculating and establishing an association's limit. The intermediate credit banks' formulas are typically more restrictive than FCA's formula.

In reaching a decision to allow an association to exceed its direct loan limit, FCA considers such matters as the future solvency of the association, its management's performance and capability, its loan growth potential, and its interest rate competitiveness. FCA believes these factors will indicate an association's prospects for recovery. Also, the association and its intermediate credit bank must develop a plan that will describe how the association will go about improving its financial condition. If these matters appear positive or have potential, FCA will allow an association to exceed its direct loan limit. FCA will also closely monitor the corrective actions taken by the association and its intermediate credit bank and the results they produce.

On September 15, 1983, the Spokane Intermediate Credit Bank listed 13 associations which exceeded the district's direct loan limit using its formula and 4 associations which exceeded both the district's and FCA's direct loan limit using the FCA formula. The four associations that exceeded both the intermediate credit bank and FCA direct loan limits were Southern Idaho, Puget Sound, Southern Oregon, and Willamette--all now in liquidation. The Mammoth Cave association, also in liquidation, exceeded both the Louisville Intermediate Credit Bank and FCA direct loan limit. All five associations were given approval to exceed both the intermediate credit bank and the FCA direct loan limit to provide time for the FCA and the bank to consider appropriate actions to correct their financial problems.

Loss-sharing programs

Associations have protected themselves against operating losses through the use of district loss-sharing programs since 1970. Each district's loss-sharing program is designed as a form of mutual, limited insurance to protect the capital base of a district's associations. Loss-sharing assistance need not be repaid, unless an association recovers on the losses which made it eligible for assistance. The maximum annual contribution required from an association that elects to participate in the program is limited to one-half of 1 percent of its outstanding loans at the end of the previous year. An association is not required to contribute if doing so would cause it to impair its stock or become eligible for assistance. This limit establishes the amount that may be required from an association and the total amount available in a district to assist a troubled association.

Only associations that participate in a district's loss-sharing program are eligible to receive loss-sharing assistance. In the two districts we visited, all associations participated in the district program. To qualify for financial assistance, an association must incur loan losses during the calendar year which exceed the association's provision for loan losses, current year earnings, and 10 percent of its beginning of the year unallocated reserves. Currently, loss-sharing is generally available to all participating associations regardless of an association's future viability. FCA, however, has requested the intermediate banks to add a viability test to the agreement.

Since the program's inception, 28 associations have received loss-sharing assistance nationwide. In 1983, 13 associations received assistance; in 1984, 4 associations received assistance. The amounts of assistance received in 1983 ranged from a low of $107,000 to a high of $7,448,000.

The Southern Oregon and Willamette associations received assistance in 1982 based on 1982 reviews of their operations. However, in 1983, the Spokane district's resources available to provide loss-sharing were limited because district associations generally performed poorly and because the magnitude of the financial problems of the associations that were ultimately liquidated was large. Under the terms of district loss-sharing agreements, the amount of assistance is to be shared among the associations qualifying for assistance based on their share of qualified losses. Under the terms of the Spokane District loss-sharing program, the bank may prevent an association from receiving loss-sharing assistance, if the assistance would be insufficient to provide the potential for the association to remain viable. After analysis, the Spokane Intermediate Credit Bank concluded that the pro rata amounts would be insufficient to alleviate the financial problems of even one of the four

associations that subsequently failed. Mammoth Cave in the Louisville district did not receive assistance in 1983 because it was in liquidation, thereby automatically waiving its right to loss-sharing under the Louisville district loss-sharing program.

Capital assistance

Since 1968, intermediate credit banks, with FCA approval, have been able to invest in an association's capital either by purchasing non-voting stock or by contributing to the paid-in surplus of an association. Of the 20 associations which have received capital assistance since 1968, 10 were provided assistance in 1983. The amount of assistance averaged about $5 million an association. Intermediate credit banks invested $22 million and $8.3 million in two associations in 1982. Stock purchased by an intermediate credit bank provides temporary emergency capital to an association which has suffered unusually large loan losses.

This type of capital infusion is, in effect, an interest-free loan from an intermediate credit bank to an association. A capital infusion will reduce the association's direct loan from its intermediate credit bank, thereby reducing its liabilities and improving its debt-to-capital ratio. The capital infusion generally is to be repaid when the association's financial status improves.

Certain conditions are generally required before FCA will allow an intermediate credit bank to invest in an association. These conditions are loss-sharing utilized, detailed financial projections prepared, an analysis of an association's long-term viability prepared, an intermediate credit bank supervisory plan indicating the association's prospects for correcting the deficiencies necessitating the capital investment, and, if appropriate, the replacement of an association's management or board of directors.

Financial projections or viability studies were prepared for the Mammoth Cave, Puget Sound, Southern Idaho, and Willamette associations in 1983. None of these projections indicated that capital assistance at a level that the intermediate credit bank could afford would enable the associations to become viable, self-sustaining associations. Southern Oregon received $6 million in capital assistance in early 1983 after having received loss-sharing assistance in 1982. However, a second set of financial projections for Southern Oregon indicated that additional financial assistance would not have kept the association viable.

Merger, consolidation, and realignment of territory

To continue financial services in a particular location, FCA may merge, consolidate, or realign a territory or an association. A merger may occur when the assets and liabilities of one association (selling association) are transferred to, and absorbed by, a second association (buying association); the selling association will disappear as a separate association. A consolidation occurs when two or more associations are combined to form an entirely new association. Territories may be realigned as part of a merger or consolidation agreement.

The merging or consolidating of associations may involve financial assistance. If the intermediate credit bank determines that it is necessary to provide financial assistance, it may offer such assistance as the purchase of high risk assets, a guarantee by the bank to absorb future losses on certain assets, a capital infusion, or other types of assistance.

Section 2.10 of the Farm Credit Act of 1971 provides FCA with the authority to reassign association territories or to charter new associations. Financial assistance may be provided in territory reassignments. Under this authority, the FCA Governor directed that the territories formerly served by the Mammoth Cave, Puget Sound, Southern Idaho, and Southern Oregon associations be reassigned to currently operating associations located within the same district. Also under this authority, a new association was organized to serve Willamette's old territory.

PROS AND CONS OF USING THE REVOLVING FUND

This section discusses the pros and cons of using the revolving fund and focuses attention on the undesirable incentives that using the fund to rescue poorly managed, financially troubled associations could have; on the difference between using taxpayer versus System-generated funds to assist the associations we visited; on "saving institutions" versus "maintaining the flow of credit"; and on the costs that using the fund would have avoided.

Use of the revolving fund in these cases could have created undesirable incentives for associations

The previous section of this chapter indicated that there are many self-financed and nonfinancial assistance alternatives that can and have been used by the System. In the cases we

reviewed, using the revolving fund would have represented a significant departure from traditional assistance devices because it would have involved using taxpayer funds by a System that has operated on a self-sustaining basis for a number of years.

Using federal funds to assist financially troubled associations may encourage associations to take greater risks and thus create the wrong kind of incentives for association management. For example, knowing that the Governor of FCA will inject capital into an association if the association needs additional financing could eliminate the incentive for the associations to build up their equity beyond the legal minimum requirements. The incentive created in such a case would be for associations to maximize their leverage and their profits with risky ventures. In the event that decisions proved correct, all of the gains would accrue to the associations. If the decisions resulted in losses, those losses would be borne by the federal government. Clearly, if losses did occur and were financed by the federal government, the institutions would likely experience heavy government control of their operations; but this would occur after the fact.

Using the revolving fund to rescue failing associations would transfer risk taking from association management as well as the System itself to the general public. The Farm Credit System has been established as an autonomous operation where responsibility has been granted to each association and bank board of directors and management. Poor association management could be perpetuated if federal assistance were available in time of impending failure. On the other hand, if a poorly managed association is liquidated, it may be assumed that the acquiring association would review very carefully the qualifications of any management of the failed association that it might consider employing.

<u>Liquidations were not costless in these cases</u>

In these cases, the decision not to use the revolving fund did impose costs on certain individuals and institutions. In addition to the effects of liquidation on a failed institution's management, the borrower-owners of the associations being liquidated, the borrower-owners of the remaining production credit associations in the district, and the district intermediate credit bank would be affected. For the associations in liquidation in the Spokane district, the intermediate credit bank prevented the associations' owners' investment from being harmed by purchasing the borrower-owned stock at its par value of $5 a share. However, the Louisville Intermediate Credit Bank did not provide protection. The extent of loss, if any, on borrower-owned stock will not be determined

until the liquidation is completed, which may take several years. Therefore, the capital investment of the borrower-owners of this association is at risk.

An intermediate credit bank is adversely affected by insolvencies because (1) its associations may lose some customers, (2) it will not be able to collect on all the poor quality loans the association in liquidation made, (3) it loses the interest that it would have received on a portion of the association's outstanding debt to the bank, and (4) it will suffer some loss of "good will" throughout the district because of the adverse publicity. Since the intermediate credit bank is adversely affected, the other district associations are also adversely affected because they ultimately pay the costs of any loss. For example, the Louisville Intermediate Credit Bank estimated that it will cost (i.e., either actual losses or lost income) the district between $9 and $12 million to liquidate the Mammoth Cave Production Credit Association or the equivalent of about $300,000 for each district association or about $100 for each of the district's production credit association members.

Preservation of the flow of credit is more important than preservation of poorly managed institutions

Clearly, any liquidation may be expected to produce certain adverse effects on those involved. However, in evaluating the significance of the effects, it is important to distinguish between meeting the sound credit needs of farmers and fishermen and meeting the credit needs of a production credit association. A production credit association is only a vehicle through which farmers' and fishermens' credit needs are met. And, as discussed in chapter 4 of this report, the liquidation of the associations did not disrupt the availability of agricultural credit in the areas being served by the failed associations nor did it force repayments or adversely affect existing loan commitments. Our review of various financial and non-financial alternatives used by the System indicated that once it was clear that their continued use would not save the institutions, the System adequately met the sound credit needs of member farmers and fishermen of failed associations by making the resources of other production credit associations available to borrowers.

FCA's substitution of stronger associations to meet the credit needs of borrowers from failed associations is similar to the actions of bank regulators. The concern of both FCA and other bank regulators has traditionally been with the continuation of financial services within a given community, not with whether a particular bank or association remains in

business. Assistance that preserves a bank's operations has only occurred when such action was essential to the provision of financial services to the community.

LEGAL CONSEQUENCES OF USING THE REVOLVING FUND

In addition to the effects of using the revolving fund that have been emphasized above, other effects which are required by law are:

--The System's Governor would be appointed by and subject to removal by the President of the United States rather than FCA's Board of Directors.

--An investment in an intermediate credit bank would subject it to audit by the GAO every 3 years under the provisions of the Government Corporation Control Act.

--An investment in an intermediate credit bank would strictly limit its dividends payments to associations to stock distribution.

--An investment in an intermediate credit bank would require it to pay a franchise tax representing the lower of either 25 percent of net earnings or the average rate of interest on outstanding public debt applied to the amount of the fund during the period used.

--An investment in a production credit association would cause it to be exempt from federal income tax.

--An investment in a production credit association would restrict cash dividends to association members to 20 percent of total dividends and dividends would also be payable to the Governor on the stock taken in exchange for the revolving fund cash infusion.[5]

CONCLUSIONS

Based on our examination of the limited legislative history associated with the revolving fund, FCA's decision not to use the revolving fund for these failing associations represents a

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[5]The statute establishing the franchise tax for banks receiving a revolving fund investment may also require that associations receiving a revolving fund investment pay a franchise tax. FCA has not taken a position on whether the franchise tax would be applied to associations.

reasonable interpretation of its statutory authority. The circumstances faced by the associations included in our review and the actions taken to preserve the flow of credit from these associations suggest that FCA's decision not to use the revolving fund to aid the failing associations was a proper response. This is not to suggest that at some future time under different circumstances a different decision could not be reached.

We found that the assistance alternatives used by the intermediate credit banks and FCA ensured that eligible association members' sound credit needs were met, regardless of the status of the association. We found that the intermediate credit banks used various assistance means, such as the capital infusion program and the associations' loss-sharing program to assist the financially troubled associations that were eventually liquidated. And, of fundamental importance, these assistance programs were used only as long as FCA believed there was a reasonable prospect for recovery of the benefitting associations.

Liquidating associations may have adverse financial effects on the equity positions of associations' borrower-members and on other district associations because they will ultimately share any losses of the district intermediate credit bank. Despite the adverse effects on individuals and institutions involved, we believe that if liquidating poorly managed associations can be achieved without significant adverse effects on the provision of credit to farmers and fishermen and without prompting a loss of confidence in the System, liquidations should occur. The cost of isolated failures may be small when compared to the costs of potential increases in inefficient and risky bank practices that might be encouraged by providing federal aid to nonviable production credit associations at times when the System is financially sound.

Since we conducted our review of the circumstances associated with the liquidation of the associations covered in the report, the financial condition of the Farm Credit System has deteriorated. An additional six production credit associations have failed and many more have been merged with other associations. Proposals to provide various forms of financial assistance to the System are being developed and proposed. We did not analyze these developments in this report.

ASSOCIATION PROBLEMS IDENTIFIED AS CAUSING THEIR LIQUIDATION

Why did the Mammoth Cave, Puget Sound, Southern Idaho, Southern Oregon, and Willamette Production Credit Associations go into liquidation? The simple answer is that the borrowers were not repaying their loans. This appendix discusses the problems that contributed to each association's failure. This appendix is based on information contained in official FCA, intermediate credit bank, and production credit association reports, which we did not verify.

Internal problems affected these associations in the following way. Each experienced excessive loan growth and poor lending practices during the late 1970s. However, because the economy was thriving and high inflation existed, borrower credit problems could be dealt with through refinancing, renewal, and substantial real estate sales activities by the borrower. In the past 3 or 4 years, however, the farm economy has not been conducive to easily working out problem situations. Therefore, financial problems at these associations became pronounced.

One of the most important internal and controllable factors contributing to the liquidated associations' financial problems was their failure to adhere to safe and sound credit extension procedures. Credit extension is the basis of any lending organization's financial operations and encompasses the entire process of lending and servicing loans to borrowers. All credit extension procedures are based on the credit policies and rules established by intermediate credit banks and FCA's rules, policies, and procedures. Each association then develops its own credit extension procedures which must be approved by its supervising intermediate credit bank.

Another important, internal, and controllable contributing factor was inadequate or ineffective supervision. Supervision involves the responsibility of identifying problems and correcting them as well as designing and implementing effective programs to prevent future problems. Supervision of associations within the System is both an independent and interdependent responsibility and is a primary mechanism for evaluating how well associations comply with System rules, policies, and regulations. The authority and responsibility of the intermediate credit banks to supervise the operations of associations is stated explicitly and by implication in both law and the regulations under which the System operates.

Beyond internal and controllable factors, external factors contributed to the associations' financial problems; i.e., adverse economic and climatic conditions. To one extent or another all associations were subject to these adverse economic and climatic conditions. These factors were uncontrollable.

LOUISVILLE INTERMEDIATE CREDIT BANK ENCOUNTERED PROBLEMS

The Federal Intermediate Credit Bank of Louisville serves the System's Fourth Credit District which encompasses the states of Ohio, Indiana, Kentucky, and Tennessee. Associations in this district serve farmers who produce a variety of agricultural crops, commodities, and dairy products. The Louisville bank currently supervises 38 active production credit associations. Liquidation of one association in this district began in August 1983.

Although the Louisville bank and its associations had serious problems for a number of years, problems recently escalated. Real estate values have been declining since 1981 with equity in more recently purchased real estate nearly evaporated. Grain production in 1982 was excellent, but cash grain prices remained low in relation to production costs. Generally, strong production for most commodities in 1982 created downward pressure on farm prices. As a result, associations experienced a dramatic increase in loan defaults and bankruptcy filings in 1982. Poor growing conditions during 1983 exacerbated these problems. The bank regards many of its associations as requiring a high degree of supervision.

Credit administration

Within the System's structure, credit reviews (an evaluation of how well an association has performed its lending responsibilities) are a major source of information on which supervisory actions are initiated. FCA allows banks to use three types of credit review: full, comprehensive, and limited. Credit reviews are done at least annually but may be done more frequently if an association's condition indicates a need for closer supervision. The range of these reviews includes a minimum sampling or limited review for strong associations, a larger sampling or comprehensive review for weaker associations, and an all-inclusive or full review at critically weak associations. However, all associations are subject to a comprehensive review at least once every 3 years. These credit reviews verify the condition and the classification of association loan portfolios by looking at individual loan files.

FCA approved the current Louisville district association credit review policy in December 1982. Before implementing the review program, bank management documented policies and procedures in a bank credit review manual. These policies and procedures established the accountability and responsibility of the personnel who administer loans. The credit manual includes such material as (1) district board policies, (2) credit review policies, procedures, and guidelines, and (3) a glossary of terms to assist personnel in understanding and discharging their duties.

Association supervision

The Louisville bank, like the System, utilizes the differential supervisory approach. Associations' performances are characterized in three separate supervisory levels of concern. The characteristics which determine the concern level or degree of supervision are as follows:

Minimum Supervision - Association exhibits strong self-monitoring, self-supervising, and self-correcting action. Performance is consistently within the parameters of desired standards. Association requires only normal supervision and preventive guidance.

Moderate Supervision - Association exhibits self-monitoring, self-supervising, and self-correcting action. Performance is sometimes less than satisfactory and frequently does not meet one or more of the desired standards. Association requires more than normal supervision and preventive guidance.

Maximum Supervision - Association fails to exhibit self-monitoring, self-supervising, and self-correcting actions. Performance is clearly inferior in one or more of the standards. Association requires extraordinary supervision, control, and corrective action.

Twenty-three of Louisville's 39 associations, as of March 1983, required maximum supervision.

FCA concluded in a September 1983 report that, although the bank's supervisory effectiveness had improved relative to prior years, continuing problems in associations' credit quality, credit administration, financial operations, and management and board of directors leadership indicated a need for further improvement. FCA believed that the bank needed to practice more preventive supervision (anticipate and correct potential

association problems) and to take more timely corrective actions. FCA noted that the Louisville intermediate credit bank frequently had not taken firm supervisory action until an association's problems had almost reached an unmanageable level or until substantial deterioration had occurred in credit, financial, or management operations.

Credit quality

The Louisville district's average credit quality dropped from 84.8 percent acceptable loans in 1978 to 68.7 percent acceptable loans in 1982. The overall credit quality declined in 36 of the district's 39 associations from 1981 to 1982. Significant declines in credit quality of 10 percent or greater occurred in 19 associations during this same period. Of the 10 associations on which the Louisville bank performed credit reviews during the first 3 months of 1983, the average credit quality declined to 62.4 percent.

PROBLEMS AT MAMMOTH CAVE PRODUCTION CREDIT ASSOCIATION

Mammoth Cave Production Credit Association, supervised by the Louisville district bank, served the central Kentucky area. Its main office was located in Glasgow with a field office in each of the nine counties it served. The principal farm products in this area are tobacco, cattle, milk, corn, soybeans, hogs, hay, and wheat.

Weather conditions and the economy had exacerbated the problems of association members during 1980, 1981, and 1982. The 1980 drought and 1981 low commodity prices caused serious problems for a large portion of association members. Weather conditions were more favorable during the 1982 season enabling average to above-average crop yields. However, low grain prices and higher production costs resulted in narrow profit margins. Information was not available to indicate the effect of 1983 economic and climatic conditions on the association members' operations because the association entered liquidation in August 1983.

Mammoth Cave was characterized by exceptionally rapid growth in loan volume during the late 1960s through the mid-1970s which resulted from the association's aggressive and liberal lending philosophy and stated desire to be the largest production credit association in the nation. Numerous violations of real estate financing, eligibility, scope of financing (i.e., it financed items it should not have), and territorial lending policies (it lent to borrowers outside of its territory) contributed to the problems associated with

Mammoth Cave's growth in loan volume. The association's liberal credit decisions, along with unfavorable economic and climatic conditions, led to a severe deterioration in credit quality and related financial weaknesses. These problems ultimately resulted in acceptable loan volume or credit quality declining during its last years of operation.

Credit quality and credit administration

Since 1979, Mammoth Cave's credit quality deteriorated steadily from 76.7 percent acceptable outstanding loans to 54.5 percent acceptable outstanding loans in June 1983. The averages for acceptable outstanding loans for all production credit associations in the System in 1979 and 1983 were 87.8 percent and 72.4 percent, respectively. The System measures the quality of an association's loans by the percentage of its loans rated acceptable. Large loans--$100,000 or more--accounted for more than 49 percent of the association's total loan volume, and the credit quality of these large loans was 42.7 percent as of June 1983. From 1979 to 1983, Mammoth Cave's loan-related assets (assets obtained in lieu of loan payment) increased from $2.4 million to over $14.1 million. Its loans outstanding declined from $120.9 million in 1978 to $57.5 million in 1983 because Mammoth Cave's borrowers left the association. Losses accumulated since the association was organized increased from $2.8 million in 1979 to $6.8 million through 1982, an increase of $4 million. As of November 1982, Mammoth Cave had an additional $3.9 million of estimated losses remaining in its portfolio but had only $1.6 million in its reserve for bad debts to cover estimated losses. In June 1983, an additional $5.1 million in loan losses were identified and charged off.

Association supervision

Mammoth Cave's problems had been known by the Louisville district bank and FCA since 1979. In a 1979 examination, FCA indicated that Mammoth Cave's operations were substandard. The Louisville bank concurred with FCA's opinion. The areas of concern noted in the examination included credit administration, improper administration of real estate loans, and possible conflicts of interest in employee activities. A 1981 FCA examination report said that the degree of substandard performance in these and other areas brought into question the adequacy of supervision provided by both Mammoth Cave's directors and officers and the Louisville bank.

From 1979 until it entered liquidation, Mammoth Cave was classified as needing maximum supervisory attention. The bank's November 1982 credit review rated the association as needing

maximum supervision in the areas of credit quality, credit and loan administration, compliance with laws and regulations, credit management, and overall credit operations.

The Louisville bank attributed the association's credit and financial weaknesses to the failure of the association's board and management to lead the association in a responsible manner. The board and management had a liberal lending philosophy, low credit standards, and weak collection practices. Although the association's senior management eventually recognized the seriousness of the association's weaknesses, the association's board of directors did not acknowledge or accept responsibility for these weaknesses until after the association's financial condition materially deteriorated. Because the association's board of directors did not take proper corrective actions, the Louisville bank, in February 1982, requested and received the resignation of the association's board of directors.

Extensive corrective measures were eventually taken by the association. During 1982, in response to previous criticism, the association's lending policies were changed to reflect district standards, and operational costs were reduced. The association sold its boat, plane, and motor home that had been used in its aggressive marketing program, and some employees were identified as having performed poorly and were dismissed.

A November 1982 Louisville district bank credit review on Mammoth Cave reported

> "The association's previous liberal lending philosophy and disregard of sound business practices had a far greater impact on its credit quality and loss exposure than low profit margins and the economic recession. . . ."

A June 1983 FCA examination indicated that Mammoth Cave's loan quality was still deteriorating, loan losses were still increasing, and non-financial problems continuing, such as lack of member support and public distrust. The association voluntarily agreed to liquidate in August 1983. At that time, Mammoth Cave had about $51.0 million in outstanding loans (a decline from $120.9 million in 1978) and was serving about 2,600 members.

SPOKANE INTERMEDIATE CREDIT BANK ENCOUNTERED PROBLEMS

The Federal Intermediate Credit Bank of Spokane serves the System's Twelfth District, which encompasses the states of Alaska, Idaho, Montana, Oregon, and Washington. The primary farm products of the district are wheat, barley, cattle, dairy,

fruit, and commercial fishing. As of December 31, 1983, the Spokane district bank supervised 26 active production credit associations. Steps toward liquidation began at four associations in 1983. As of January 31, 1985, four other associations in the Spokane district had entered liquidation. We did not review liquidation activities associated with the Willamette Production Credit Association because those activities were in litigation. The reasons for liquidating the Puget Sound, Southern Idaho, and Southern Oregon Production Credit Associations are discussed later in this section.

The Spokane bank and its associations have been faced with serious problems for the last several years. Loan losses have adversely affected the financial condition of several associations. Severe problems in the aquatic industry have contributed to association losses and were the primary cause for the decline in the financial position of two associations.

During the past several years, rising operating costs and declining prices also had a significant effect on association members' enterprises. Farmers incurred higher production costs but received stagnant or lower prices for their commodities. The commercial fishing industry was also depressed. Fruit orchards were only marginally profitable. Dairy farming was profitable but profit margins were declining. Producers of specialty crops were generally unprofitable. Many smaller borrowers, dependent on off-farm income, lost their non-farm jobs. The depressed real estate market caused problems for many highly leveraged operators. These economic conditions warranted strong supervision which the bank did not provide in a timely manner. In 1983, FCA reported that the bank's demonstrated lack of leadership, direction, and control cast doubt as to whether the bank could solve the problems of its associations.

Credit administration

The Spokane bank has generally provided its associations with adequate policies, procedures, and reasonable credit standards for extending sound, dependable, and constructive credit. Spokane's credit review and credit administration procedures are generally similar to Louisville's procedures discussed on page 50, as these procedures are based on FCA approval policies.

The Spokane bank's credit manual outlines standards for a borrower's financial position and repayment capacity. The bank encourages each association to establish its own guidelines along with other lending policies for the region it serves. Associations have documented loan policies and procedures that have been approved by the bank.

Margin requirements (the amount of borrower equity required before making loans) among the Spokane district associations vary widely. In an attempt to compensate for this, the Spokane district bank issues position letters from time to time urging credit restrictions in response to prevailing farm product and economic conditions. During the latter half of 1983, the bank reoriented its loan approval process by requiring better compliance with established bank procedures and implemented additional procedures to improve accountability and control in the credit approval process.

Though procedures were specified, it is clear that they were not followed. A May 1983 FCA examination report concluded that the Spokane bank's 1982 and 1983 credit reviews seriously overstated district credit quality and understated loan losses. Factors affecting the accuracy of the credit reviews included (1) inaccurate association loan information on loan repayment sources and loan collateral, (2) associations' collateral values were overstated because they did not reflect current market conditions and income projections were overstated, and (3) acceptance of inaccurate, unverified, or incomplete borrower financial information. As a result, FCA did not consider the reviews reliable.

Furthermore, FCA believed that the bank's reviews failed to adequately address the full extent of credit management and credit administration deficiencies in several associations. FCA reached these conclusions even though the bank's association credit reviews in 1983 specifically cited such association weaknesses as: overextension of credit in relation to borrowers' financial position and ability to repay, lending based on inflated collateral, lack of proper association loan servicing, and inadequate association analysis and investigation of borrower's financial position. The FCA report indicated that weak association and bank credit administration compounded by a depressed agricultural economy were the major causes of associations' credit problems. The bank has hired new management which is addressing the bank's problems.

Association supervision

In a 1983 report, FCA stated that bank supervision had been ineffective in correcting problems in several associations and noted several district associations as having extremely serious credit problems. Twenty associations were considered by the bank to require more than normal credit supervision as well as more than normal overall supervision. For a time in 1983, FCA suspended the bank's credit review authority.

In response to this criticism and FCA's action, the Spokane bank developed relatively short-range supervisory plans for all associations. The bank plans addressed the two basic areas of supervision that affected loan risk: (1) loan quality and (2) deficiencies in credit administration. In addition, the plans addressed other pertinent areas of financial risk and each association's future viability: credit policies and procedures, the internal review process, management, staff evaluations, and planning.

The bank plans were also designed to correct each identified administrative weakness within a specified time. The bank required that certain credit administration deficiencies, such as real estate security perfection and evaluation, be corrected within 3 months. Associations were required to provide staff training and establish monitoring procedures and staff accountability.

The Spokane bank presented each supervisory plan to the affected association's board of directors concurrently with the credit review results. Through this procedure, the bank attempted to make the association's board of directors accountable and responsible for the association and the association's management accountable and responsible for creating and implementing plans designed to correct association weaknesses.

The Spokane bank management also communicated its supervisory posture and expectations to its staff and association boards and management by issuing standards of performance for the Twelfth District associations effective January 1, 1984. Standards of performance were established in the areas of operations including organization, credit, finance, credit-related services, personnel and management control. While these standards were not new, it was the first time they had been written and assembled in one document. This document should provide the bank and the associations an improved basis for evaluating associations and for effecting corrective action. Use of these standards should allow the bank to furnish association boards better counsel and guidance during the evaluation process.

Credit quality

The Spokane district's credit quality based on acceptable loan volume has deteriorated substantially in recent years. The district's average credit quality dropped from 88.2 percent acceptable loans in 1979 to 66.1 percent acceptable loans in 1983. In 1982, 20 of the district's associations did not meet the bank's goal of 80 percent acceptable loan volume; 10 of

these 20 associations were below 70 percent credit quality. By the time each of the associations in liquidation entered liquidation, acceptable loans were less than 51 percent.

PROBLEMS AT PUGET SOUND PRODUCTION CREDIT ASSOCIATION

The Puget Sound Production Credit Association, supervised by the Spokane bank, encompassed nine counties in northwest Washington state. The association's central office was located in Mount Vernon with field offices in Ballard and Lynden. The association members were primarily fishermen, dairymen, and crop farmers.

Economic conditions contributed to the need to close this association, but the association's concentration of loans in the fishing industry and the association's weak credit administration were significant factors contributing to its failure. The combined effect of Puget Sound's losses and non-earning assets on the interest rates it charged on loans made the association noncompetitive in attracting new creditworthy members.

Puget Sound had extremely rapid loan growth between 1978 and 1983. Outstanding loans grew from $13.1 million in December 1978 to over $83.5 million as of June 1983, with most of this loan growth in large aquatic loans. By 1983, the association had concentrated over 86.6 percent of its loan volume in aquatic loans. The decline in the prices and quantity of fish caused a dramatic decline in the commercial fishing industry. This decline caused the association to suffer because loan payments were not made. The decline in the aquatic industry also eroded members' equity and the value of fishing vessels used as collateral.

Credit quality and credit administration

After 1980, Puget Sound's credit quality deteriorated dramatically--from 97.8 percent acceptable outstanding loans to 46.1 percent acceptable outstanding loans in 1983. As of June 1983, noninterest-bearing, loan-related assets acquired in lieu of loan payments totaled $16.2 million. Also, as of June 1983, Puget Sound had $7.6 million of estimated losses remaining in its loan portfolio but had only $1.7 million in its reserve for bad debts to cover estimated losses.

According to FCA reviews, the Spokane bank's annual credit reviews did not adequately identify or evaluate loan portfolio and association conditions. Therefore, credit reviews could not

provide the necessary early warning of developing problems. The bank's 1983 credit review did not accurately portray credit quality because it understated the amount of loan losses and overstated the value of vessel security used as collateral for aquatic loans, according to FCA.

The Spokane bank estimated $1.95 million in losses should have been charged off for aquatic loans as of March 1983. FCA was unable to categorize the quality of the association's loans or to enumerate the weaknesses in the association's credit administration because the Spokane bank credit review reports were inadequate not only for this association but for most associations in the district. FCA believed that the lack of bank specificity in the credit administration comments reflected the lack of a set of minimum documentation and analysis standards. Without such standards, it was difficult for the bank and FCA to measure the performance of the association and individual association loan administration personnel. This lack of specificity also prohibited meaningful guidance to the association on how to correct credit administration deficiencies and inhibited the bank's supervisory officials' preparation of association evaluations and supervisory plans.

These problems caused FCA, several months later, to perform a limited review of the same aquatic loans that the intermediate credit bank had reviewed in March. FCA estimated the losses, based on the then-current condition, to be $7 million. FCA believed that the loss estimates could increase substantially if the extremely weak operating position of many borrowers did not improve and if further deterioration of loan collateral, land values, and commodity prices occurred.

Association supervision

FCA concluded that bank supervision was ineffective in correcting the weaknesses identified in bank credit review reports. Weaknesses reported as early as the 1979-80 review could be directly linked, FCA believed, to the subsequent serious portfolio deterioration. Two of these weaknesses: (1) failure to improve the followup procedures on past-due, term loan payments and operating loans and (2) inadequate or incomplete loan analyses were identified in each subsequent review.

Although Spokane bank officers believed the association did a reasonably good job of screening applicants, the loans made during the 1980-83 period contained credit weaknesses whose effects might have been less severe if proper credit extension techniques had been used. The association revised its policies and procedures, but the revisions were not approved by the Spokane bank until the fall of 1981, after a majority of the

aquatic loans were on the association's books. Even with the new policy in place, the association continued to aggressively pursue aquatic loans.

Following a 1981 examination, FCA indicated that the Spokane bank was concerned about the growing concentration of loan volume among some of its associations in the aquatic industry. However, this concern was not identified or emphasized as such in the bank's credit reports. Puget Sound not only disagreed with the bank's concern about loan concentration but viewed its ability to provide loans to the Seattle-based Alaskan fishing fleet as an opportunity to capitalize on a rapidly expanding market. The association's rapid move toward a heavy concentration of loan volume (more than 86 percent) in the capital-intensive fishing industry could, in part, be attributed to the bank's lack of a firm supervisory stance because the bank could have replaced the management and board of directors of the association.

As Puget Sound's credit quality eroded, the bank's supervisory efforts intensified. Numerous meetings were held with the association's board of directors, president, and credit personnel. These meetings included a training workshop and other supervisory visits. In addition, many letters and memoranda were exchanged and a special servicing agreement was approved in October 1982.

FCA acknowledged that the Spokane bank made numerous attempts to supervise Puget Sound but these attempts did not result in significant change. Factors contributing to the association's deterioration included: the bank's low key, persuasive approach to supervision; the association's refusal to take corrective actions; the association board's commitment to serve all members as long as considered reasonably prudent (FCA and the intermediate credit bank substantially disagreed with the board on what was reasonably prudent); the bank's failure to analyze and report credit administration deficiencies in credit reviews; and the bank's lack of ongoing monitoring systems to provide a warning of developing problems. However, the main reasons the association failed were because of its heavy loan concentration in the aquatic industry--an industry that is no longer as profitable as it was when the loans were made--and its poor credit administration.

In October 1983, FCA declared the association insolvent, citing a continued decline in loan quality, rising loan losses, and other financial and nonfinancial problems. At this time, Puget Sound had 499 members with outstanding loans amounting to $83.6 million.

PROBLEMS AT SOUTHERN IDAHO PRODUCTION CREDIT ASSOCIATION

The Southern Idaho Production Credit Association, also supervised by the Spokane bank, was once the Twelfth District's largest association. This association encompassed eight counties located in the southern portion of the state of Idaho. The association's central office was in Twin Falls and it had several field offices. The area's primary farm products are cereal grains, potatoes, edible beans and peas, cow-calf operations, cattle feeding, sheep raising, hay production, and a few trout operations.

Adverse weather conditions during the past few years throughout the association's territory increased production costs. Several years of low commodity prices plagued most farmers and ranchers. Real estate prices were depressed. Additionally, long-term lenders were reluctant to refinance most operations because of existing heavy debts and inadequate cash flow for repayment.

Inadequate credit extension practices and collateral verification procedures were major causes in the deterioration of the association's financial position. Extensive loan losses further contributed to the closing of the Southern Idaho association. Weather conditions and a depressed agricultural economy were not only factors contributing to the financial condition of the association but were also factors that amplified the effects of the association's past credit extension deficiencies.

Credit quality and credit administration

Southern Idaho's quality of credit deteriorated steadily from 86.6 percent acceptable loans in 1979 to 50.3 percent acceptable in 1983. During this same period of time, Southern Idaho's volume of adversely classified loans increased from $27.9 million to $62.5 million. As of July 1983, Southern Idaho had estimated losses of $11.5 million remaining in its loan portfolio with a negative balance of $79,834 in its loan loss reserve account. The association had a significant increase in high risk accounts, an increase in the amount of recommended charge-offs, but very few recoveries. Between December 31, 1982, and July 21, 1983, the association charged off $81,234 but recovered only $1,400.

FCA was concerned about the quality of the Spokane district bank's credit reviews. Therefore, FCA chose to examine several associations that it believed were having financial or other

problems. FCA's July 1983 report on the Southern Idaho association stated that the association's decline in credit quality and increase in recommended charge-offs were primarily the result of the association's (1) failure to identify repayment capacity, (2) over extension of financing based on asset or collateral values, (3) use of asset values that were not realistic in the current economic environment, and (4) failure to adequately consider the current agricultural conditions on the operating margins necessary to improve loan repayment performance for many association members.

An FCA report stated that Southern Idaho's liberal lending practices and its hesitancy to collect high-risk accounts once they became uncorrectable or uncollectible through normal collection procedures were the primary causes for the association's deteriorated loan portfolio. Deficient credit extension procedures added to the problems of the association by compounding already bad loan decisions. These procedures extended financing beyond prudent levels for borrowers. More importantly, the association failed to adhere to its own and the district's policies when extending credit. For example, contrary to policy, the association did not independently verify the value of collateral.

A 1983 FCA report stated that the association's management failed to provide adequate direction to staff and failed to establish programs and procedures to analyze, control, service, and collect high-risk accounts. The board of directors was heavily involved in credit extension decisions, and its liberal philosophies and inconsistent approach to credit substantially contributed to the excessive risk on the loan portfolio. The association's board of directors did not give adequate direction to management and did not hold management accountable for maintaining the loan portfolio, particularly the high-risk accounts. FCA concluded that weak credit administration over a period of years placed Southern Idaho's loan portfolio in a serious state of deterioration.

Association supervision

FCA concluded in a 1983 report that the Spokane bank's supervision of Southern Idaho had been ineffective. Furthermore, the bank's supervisory objectives for Southern Idaho were stated in general and ambiguous terms that were not measurable.

The Spokane bank's 1981 credit review of Southern Idaho's operations disclosed six significant credit extension procedural weaknesses and noted a serious deterioration in credit quality. However, the bank rated the association as meeting standards and

did not institute corrective actions to address the credit review weaknesses. Instead, the suggested actions called for the association to institute corrective action or collect on all adversely classified loans. The bank did not effectively address the credit extension procedural deficiencies documented in the credit review because the same credit deficiencies were identified in the bank's 1982 review. The association still had not corrected the problem at the time of FCA's July 1983 review. The bank's supervisory stance contributed to the association's failure to institute corrective actions because the bank did not ensure corrective actions were instituted.

FCA believes the Spokane bank did not properly classify Southern Idaho's loans and did not adequately verify the collateral for these loans. In a May 1983 report, FCA stated

> "It is evident that gross errors in classification and estimates of loan losses have occurred in both 1982 and 1983. Proper identification of losses in 1982 could have activated the mutual loss-sharing plan. If these classification standards are applied consistently by the FICB reviews in other PCAs, district loan classifications are inaccurate. This would result in a serious misrepresentation of loan quality and understatement of loan losses in the district."

At the direction of FCA and the Spokane bank, Southern Idaho made some management changes. As a result, there was some improvement in the association's operations, even though the association's board did not always cooperate with association management.

Despite efforts to correct weaknesses and deficiencies, loan losses continued to increase. Southern Idaho voluntarily agreed to liquidate in November 1983. At this time, the association had 1,381 members with outstanding loans amounting to $136.0 million.

PROBLEMS AT SOUTHERN OREGON PRODUCTION CREDIT ASSOCIATION

The Southern Oregon Production Credit Association, also supervised by the Spokane bank, encompassed the counties of Coos, Curry, Douglas, Jackson, and Josephine. The association's central office was located in Medford with branch offices in Coos Bay, Roseburg, Coquille, and Brookings. Commercial fishing, beef, sheep, dairy farming, fruit orchards, and grain products were the major income-producing activities for association members.

Economic conditions in this association's territory had been poor since 1981. Drastic cutbacks in employment in the timber industry, high unemployment in general, poor aquatic production, high interest rates, and increasing costs had a serious economic effect on the association's membership. Poor weather conditions have caused further worsening of economic conditions.

Primarily because of conditions affecting the aquatic industry, the association was placed in a very difficult financial position. Loan losses were heavy and triggered the district's Mutual Loss Sharing Agreement in 1982. Earnings continued to be inadequate, and the Spokane bank invested $6 million in the association in 1983. The association's aggressive, liberal lending policy toward aquatic borrowers substantially contributed to the association's failure.

Credit quality and credit administration

Southern Oregon's credit quality based on acceptable loan volume declined dramatically--from 91.0 percent in 1980 to 46.4 percent in June 1983. The 1980 credit review reported about $6 million in adversely classified loans. By 1983, the amount of adversely classified loans had risen to $30.5 million, or more than half of the association's total outstanding loans. Southern Oregon's loan portfolio was equally divided among aquatic and agricultural loans, but more aquatic loans were adversely classified than agricultural loans because of the depressed fishing industries. By June 1983, Southern Oregon had $8.0 million of estimated losses in its loan portfolio, while having $65,131 in its reserve for bad debts to cover estimated losses.

FCA considered Southern Oregon's credit administration ineffective because the association violated both its own and the district's policies in extending credit to many of its members. For example, the association's extension of credit in relation to security was excessive. Loan decisions were poor in many cases and insufficient emphasis was given to the member's total debt service obligations. After the association had made many bad loan decisions that eventually resulted in loans of less than acceptable performance, the association failed to follow up on: (1) scheduled repayment; (2) conditions in the loan agreement; and (3) past due and delinquent loans.

A FCA study stated that the association's expansion into aquatic loans occurred about the same time as the fishing industry began to decline. The association's support of member ventures into some nontraditional fisheries also came at a time

of poorly established markets and declining disposable income. The recession had a severe impact on many of the association's members who were heavily involved in the livestock industry or employed in the timber industries. Since many of the association's members relied heavily on the timber and livestock industries to supplement other farm or fishing income, adverse conditions in these industries were directly reflected in many of the association's less-than-acceptable loans.

Association supervision

In a 1979 credit review, the Spokane bank identified weaknesses in Southern Oregon's credit extension practices and made recommendations for the prevention and correction of potential and identified problems and deficiencies. The bank recommended (1) strengthening loan documentation, (2) establishing followup procedures on scheduled repayments, and (3) establishing a well-defined written loan program for the more difficult lines of credit. These same weaknesses and recommendations were stated in the bank's 1980, 1981, and 1982 credit review reports.

The Spokane bank indicated in 1981 that economic conditions had a serious effect on the association's loans, particularly its aquatic loans, and that deviations from sound lending practice during the years 1977 through 1980 exacerbated the association's financial problems. In addition, association and district aquatic policies were violated and numerous loans appeared to be made without adequate borrower equity. These actions resulted in debts that aquatic borrowers could not repay because of the subsequent decline in fish harvest and prices. The bank also indicated that some unqualified individuals became borrowers and the fishing fleet was overexpanded.

During an April 1981 credit review, the Spokane bank found that the association had exceeded its direct loan limit. The association was asked to develop a special servicing plan that would improve credit quality and relieve the deficit. The review also identified weaknesses in borrower selection, poor loan administration and inadequate collection, and violations of association and district lending policies. Steps were taken by the association and the bank to correct these weaknesses, but the weaknesses were mentioned again in 1982 and 1983 credit reviews.

The association and the Spokane bank had problems in correcting these weaknesses. The association was unable to correct its loan collection procedures. In addition, the association had problems collecting past due loans because some borrowers abandoned their vessels, and an excess supply of

vessels caused a general decline in vessel values which prevented the association from recovering the full amount of the loans outstanding when it acquired vessels in lieu of loan repayment. Also, during this period, the association's earnings were sharply reduced by the reduction in loan volume and repayments and an increase in noninterest-bearing assets (loans in process of liquidation).

A comprehensive review of Southern Oregon was performed jointly by FCA and the Spokane bank in June 1983. The deviations, weaknesses, and deficiencies mentioned in the previous credit reviews were again identified along with the continued deterioration in loan quality and increases in loan-related assets. Because of these insurmountable problems, FCA subsequently declared the association insolvent and began its liquidation in October 1983. At that time, the association had 929 members with outstanding loans amounting to $56.9 million.

THE COMPOSITION OF FCA'S REVOLVING FUND

FCA's Short Term Credit Investment Fund is available to FCA's Governor for temporary investment in the stock of any intermediate credit bank or any production credit association to meet the emergency credit needs of borrowers. This revolving fund evolved from a combination of two funds.

One fund was originally established to increase the capital base of the now nonexistent Production Credit Corporations directly and the production credit associations indirectly. The Congress originally established Production Credit Corporations in each district, where a Federal Intermediate Credit Bank was located, to oversee and provide funding for production credit associations. The other fund was originally established to increase the capital base of the intermediate credit banks. The two funds were combined in 1961.

An amendment to the Farm Credit Act of 1933 enacted in 1961, (Public Law 87-343 75 Stat. 758) combined the $60 million production credit association revolving fund with the up-to-$70 million intermediate credit bank fund. The 1956 Farm Credit Act authorized the latter fund's increase from $40 to $70 million but stipulated that the additional $30 million was to come from the retirement of the last of the government owned stock in intermediate credit banks. Assuming the entire $30 million from the retirement of the government owned intermediate credit bank stock was obtained, the combined fund was authorized to reach $130 million.

From 1961 until the System retired all government-held stock in 1968, the combined fund was used to facilitate the provision of credit to borrowers. The money in the revolving fund was mostly invested in intermediate credit banks. The intermediate credit banks, in turn, used this money, along with money they obtained by selling bonds, to invest in association loans or to invest in income producing government bonds. Almost all funds in the revolving fund were invested in the intermediate credit banks at the time the government's stock was retired.

Although its current balance is $111,707,505, there are no actual funds in the revolving fund account. The intermediate credit banks retired all government capital ahead of schedule. A discount of $18,292,495 was allowed for early retirement of the stock. Thus, the combined revolving fund never reached the maximum of $130 million. If the Governor were to request these funds, the Department of Treasury would use general Treasury funds to accommodate the request. Since these funds are

available to FCA only if the Governor requests them, FCA does not control or otherwise have use of these funds at other times. FCA does not collect interest or receive any benefit from the fund. Even though all government stock in the Farm Credit System had been retired 3 years earlier, the Farm Credit Act of 1971 continued the availability of the combined revolving fund.

Farm Credit Administration

1501 Farm Credit Drive
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(703) 883-4000

July 30, 1985

Mr. William J. Anderson
Director, General Government Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

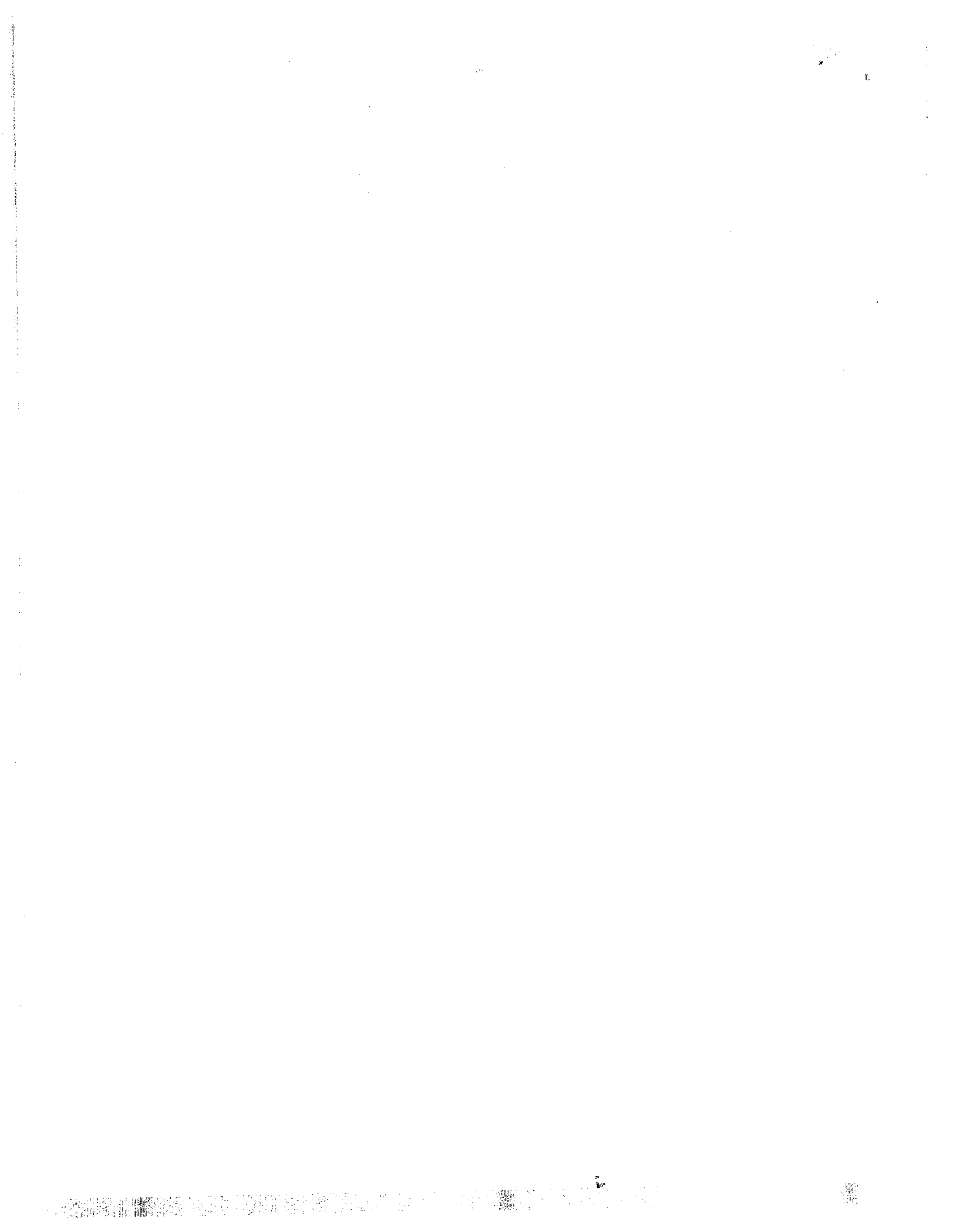
Thank you for the opportunity to comment on the GAO draft report entitled "Farm Credit Administration's Liquidation of Production Credit Associations" as requested in your letter of July 1, 1985. The Farm Credit Administration has reviewed the draft report and believes the report accurately assesses the liquidation of production credit associations and, therefore, has no comments.

Should you have any questions regarding this response, please feel free to contact us.

Sincerely,

Donald E. Wilkinson
Governor

(233115)



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