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Report to Congressional Requesters

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FARM CREDIT

Basis for Decision Not to Assist Jackson Federal Land Bank

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The Honorable Mike Espy
House of Representatives

The Honorable Claude Harris
House of Representatives

The Honorable Jerry Huckaby
House of Representatives

At your request, we reviewed the process used by the Farm Credit System Assistance Board that led to the appointment of a receiver for the Federal Land Bank of Jackson, Mississippi.

Copies of this report are being provided to the Farm Credit System Assistance Board, the Farm Credit Administration, the Office of Management and Budget, and other interested parties.

Please contact me at 275-8678 if you have any questions concerning the report. Other major contributors to this report are listed in appendix IV.

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

Within 5 months after legislation was enacted to provide up to $4 billion to financially troubled Farm Credit System institutions, the Farm Credit System Assistance Board denied financial assistance to return the Federal Land Bank in Jackson, Mississippi, to a viable position and recommended it be placed in receivership. Because of uncertainties about (1) why assistance was denied, (2) the cost of receivership, and (3) the extent of communication between the Bank and Board, Representatives Jerry Huckaby, Mike Espy, and Claude Harris requested that GAO examine the procedures followed by the Board in deciding not to assist the Bank back to economic viability. GAO's objectives were to determine

- the basis for the Board's decision to deny financial assistance,
- whether the Board's analysis showed that receivership was the least costly option for resolving the Bank's problems and whether the analysis provided a reliable basis for the decision, and
- the extent to which good communication and cooperation existed between the Board and the Bank during the decision process.

Background

The Agricultural Credit Act of 1987, enacted on January 6, 1988, established the Board to provide up to $4 billion of financial assistance to troubled Farm Credit System institutions. As a condition for providing assistance, the Board may require an institution to change its management and operating policies and practices. Alternatively, the Board can deny the request for assistance if, for example, estimated assistance costs exceed the estimated cost of liquidating the institution. On denying a request, the Board may ask that the Farm Credit Administration appoint a receiver to liquidate the institution. (See pp. 9 to 11.)

Results in Brief

The Board decided on receivership rather than providing assistance to make the Bank financially viable. In deciding on receivership, Board officials considered several factors and concluded that assistance would be more expensive than receivership and that receivership would effectively eliminate the Bank's management problems and restore credit to the district.

The Board's cost estimates did not provide a reliable basis for deciding whether receivership or assistance would be the less expensive alternative. While GAO did not do an independent cost analysis, it found that the cost estimates used in the Board's final decision were based on an analysis that omitted millions of dollars in receivership interest costs, relied on unsupported or inappropriate economic assumptions, and compared alternatives on the basis of cash costs rather than present value costs.

GAO also found that interaction between Board and Bank officials was strained and characterized by misunderstandings over their respective roles and responsibilities and over assistance request requirements. In GAO's opinion, the confusion that existed could have been avoided and the decisionmaking process enhanced with better guidance from the Board.

GAO's Analysis

Management Concerns

The Bank's financial condition had deteriorated to the point that insolvency was preventing it from making new loans to meet the needs of district borrowers. The Board needed to act. Board officials believed existing management had contributed to the Bank's failure through deficient credit policies and practices and high overhead and operating expenses. Furthermore, an inability to develop a plan acceptable to the Board for resolving the Bank's problems and paying its debts provided additional evidence that existing management may not have been able to solve its problems. (See pp. 16 to 19.)

Cost Comparison Was Unreliable

Board officials underestimated receivership costs by excluding interest costs for money needed to pay the shortfall between receivership revenues and expenses. However, the Board's cost estimates for assisting the Bank included millions of dollars in interest costs on the money needed to provide such assistance. If interest had been included for the receivership shortfall at the same 8-percent rate used in the viability estimate, receivership cash costs would have increased by over $470 million to $869 million. As a result, the cost estimate for receivership would have been significantly higher than viability assistance, which ranged from $384 million, assuming new Bank management and other favorable assumptions such as a stable economy, to $636 million, assuming existing management and other unfavorable assumptions such as a deteriorating economy. (See pp. 21 and 22.)

Additionally, certain assumptions used in the Board's analysis were unsupported by economic analysis or relied on inappropriate support. For example, the Board used cash flows to project Bank losses during the first 5 years but then used an official's judgment rather than an economic analysis to assume that the Bank would lose between $120 million and $400 million over the last 10 years of the 15-year assistance period. Also, the Board used an 8-percent interest rate to calculate the cost of 15-year bonds sold to provide assistance. However, at the time the analysis was done, the prevailing rate was 9 percent. Using the prevailing rate would have affected the Board's assistance cost estimates by several million dollars. (See pp. 22 to 24.)

To support its final decision to resolve the Bank's insolvency, the Board compared costs on the basis of cash expenditures rather than on the basis of present value costs. However, the options involved considerable differences in timing of revenues and expenses. Present value comparisons eliminate the effect of these timing differences. Despite this, the Board did not base its final decision on present value analysis because (1) its officials felt present value analysis was confusing and (2) the timing of cash flows was uncertain. (See pp. 24 and 25.)

GAO did not develop estimates independently to determine whether assistance or receivership would have been less expensive. To determine the effect of the flaws it identified, GAO adjusted the Board's analysis by including omitted interest costs and by making other needed adjustments. The adjustments were sufficient to question the results of the Board's analysis. Therefore, GAO does not believe the Board's analysis was sufficiently reliable to make an informed decision on the basis of costs. (See pp. 25 and 26.)

Communication and Cooperation Problems

Board officials and Bank management operated under different assumptions about their respective roles and responsibilities during the process, leading to the decision not to provide viability assistance. Bank management assumed the Board would have a cooperative, consultative role in formulating the assistance request. By contrast, Board officials viewed themselves as arm's-length reviewers of the requests and, consequently, provided only limited guidance and feedback. (See pp. 28 and 29.)

These different expectations remained throughout the process and contributed to additional misunderstandings. For example, Board officials had concerns with the Bank's approach for improving its financial condition and said they relayed these concerns to Bank management. However, Bank managers continued developing their approach and said they first learned of the Board's disapproval of this approach at the time the Bank was placed in receivership. (See p. 30.)

Another misunderstanding involved deadlines. Bank managers believed they had until the end of June 1988 to obtain approval for their final plan and arrange for its implementation by July 6, 1988. But on April 1, 1988, the Assistance Board informed the Bank it had until April 8, 1988, to develop an acceptable plan. The Board did not explain to the Bank why the plan had to be completed by April 8. The Bank submitted a plan within that time frame and continued revising it, still believing they had until the end of June. The Board denied viability assistance on the basis of its review of the April plan. (See pp. 29 and 30.)

Recommendations

Although future assistance requests may be unique (i.e., institutions may need assistance to resolve different types of financial problems), costs should be estimated on the basis of a complete and well-supported analysis. Therefore, GAO recommends that the Board use a cost analysis that (1) includes all relevant costs for each option; (2) provides that data used in the analysis and key assumptions, such as interest rates, be supported by current and generally accepted economic sources; and (3) compares costs on a present value basis. (See p. 26.)

GAO also recommends that the Board issue guidance to help avoid the misunderstandings and confusion that existed with the Jackson Bank's request for assistance. (See p. 31.)

Agency Comments

GAO sent the draft report to the Farm Credit Administration and Board. In oral discussions, FCA and Board officials provided technical clarifications and additional information which GAO incorporated in the report.

In addition, Board officials reaffirmed their position that receivership cash costs should only include the receivership shortfall and not the interest costs for funding that shortfall. GAO believes that both costs should be considered for the receivership option given that (1) the Board's method for estimating the cash costs of assistance includes interest costs and (2) the System and/or government would pay both the shortfall principal and interest for a receivership. (See pp. 26 and 27.)

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Abbreviations

Assistance Board	Farm Credit System Assistance Board
Bank	Federal Land Bank of Jackson, Mississippi
CEO	Chief Executive Officer
FAC	Farm Credit System Financial Assistance Corporation
FCA	Farm Credit Administration
OMB	Office of Management and Budget
System	Farm Credit System

Introduction

On April 18, 1988, the Farm Credit System Assistance Board (Assistance Board) requested that the Farm Credit Administration (FCA) initiate actions to appoint a receiver to take control of the Federal Land Bank of Jackson, Mississippi (Bank). The Assistance Board took this action after deciding not to provide the Bank, which was insolvent, with viability assistance—financial assistance sufficient to restore it to a sound financial condition. On May 20, 1988, FCA placed the Bank in receivership,[1] the first time in the history of the Farm Credit System (System) that a federal land bank was placed in receivership. This report discusses how the Assistance Board dealt with the Bank and why it decided receivership was the best option for the Bank.

Farm Credit System

The System is a nationwide network of banks and associations that lend money to farmers and farm-related businesses (1) to purchase land, (2) buy equipment, (3) pay operating expenses, and (4) for other related purposes. Before July 1988, the System was divided into 12 districts, each having a Federal Land Bank and a Federal Intermediate Credit Bank. Each of these banks had related associations that made loans to farmers.

The Agricultural Credit Act of 1987, enacted on January 6, 1988, restructured the System. In July 1988, the Federal Land Banks and Federal Intermediate Credit Banks in all districts except the Jackson district merged to form 11 Farm Credit Banks. Because the Jackson Federal Land Bank was in receivership and no longer providing credit to its former customers, in February 1989 FCA gave the Farm Credit Bank of Texas responsibility for providing credit to the area formally served by the Jackson Bank. To fulfill the act's restructuring requirements, in April 1989 FCA also directed the Jackson Federal Intermediate Credit Bank to merge with the Farm Credit Bank of Texas but this is being contested in litigation. If merged, this would in effect consolidate the Jackson and Texas districts.

As of December 31, 1988, System institutions held about $9 billion in cash and investments and $51 billion in agricultural loans. To fund these assets, the System sold bonds and notes to the public totaling about $55 billion. Each System bank is primarily liable for repaying the part of this debt it receives. However, all System banks are liable for ensuring that funds are available to redeem the debt at maturity if the bank primarily

[1] FCA appointed a receiver to liquidate the Bank's assets and liabilities.

liable cannot repay it—a mechanism known as joint and several liability.

FCA, an independent federal agency, regulates and examines the operations of System institutions. To ensure that institutions operate in a safe and sound manner and comply with applicable laws and regulations, FCA is required to examine the books, policies, and operations of each System institution at least once a year, except federal land bank associations which are examined at least once every 3 years. FCA's enforcement powers include removal of management, cease and desist orders, and the ability to place institutions into receivership or conservatorship.

Financial Assistance Under the Agricultural Credit Act of 1987

During the 1980s, adverse economic conditions, volatile interest rates, and poor management practices led to severe financial difficulties in many System institutions. In the 1970s, System institutions decided to seek a larger share of the farm credit market through high-risk funding and lending policies. When interest rates dropped sharply in the early 1980s, after they had been rising since 1977, some System institutions were prevented from lowering their lending rates because of high debt costs and, thus, lost some creditworthy borrowers. Also in the early 1980s, international demand for U.S. agricultural products declined significantly, leading to a drop in commodity prices, farm income, and land values. As a result, the quality of the System's loan portfolio significantly declined and the System experienced record losses.[2]

In response to the System's deteriorating fiscal condition, Congress passed the 1987 act which, among other things, provided up to $4 billion in assistance to System institutions. To allocate and oversee the use of assistance, the act established the Assistance Board for 5 years. To raise funds used to provide financial assistance, the act established the Farm Credit System Financial Assistance Corporation (FAC) with authority to sell $4 billion of 15-year bonds.

The Assistance Board operates as an independent federally chartered instrumentality of the United States. It is managed by a three-member Board of Directors that includes the Secretaries of the Treasury and Agriculture and one agricultural producer with financial experience who is appointed by the President and confirmed by the Senate. The Board of Directors appoints a chief executive officer (CEO) who is responsible for

[2]See GAO's report Farm Credit—Actions Needed on Major Management Issues (GAO/GGD-87-51, Apr. 1987) for a more detailed discussion.

the Assistance Board's daily operations. The Assistance Board has 20 employees, including managers, financial analysts, attorneys, and clerical staff.[3] Its fiscal year 1988 and 1989 budgets were approximately $1 million and $2 million, respectively.

The act established broad guidelines governing when and how the Assistance Board may provide financial assistance. The act permits a System institution to apply for financial assistance whenever the book value (on the basis of generally accepted accounting principles) of its stock falls below par—set at $5 dollars for each share. An institution must apply for assistance when its stock falls below 75 percent of par. Upon application, the Assistance Board may certify an institution to sell preferred stock to FAC. The act authorizes the Assistance Board to certify the sale of preferred stock to (1) restore an institution to a viable position, (2) help an institution retire high-cost debt, or (3) facilitate a merger. The Assistance Board may also provide assistance by other methods that it determines appropriate. In addition to assisting open institutions, the act requires the Assistance Board to direct FAC to provide sufficient financial assistance to enable a receiver to retire eligible borrower stock at par value.

The act established a mechanism by which the System is to repay the 15-year bonds used to fund the financial assistance. Both the System and U.S. Treasury will contribute to the interest costs. Treasury pays all the interest during the first 5 years after the bonds are sold. Treasury and the System share the interest costs during the second 5 years. The System pays all the interest during the final 5 years. After the bonds are retired, the FCA must determine a schedule under which the System will reimburse Treasury for interest payments it made. The act stipulates that each institution should pay a portion of the interest costs equal to its share of the System's total volume of performing loans (loans that are being repaid on time).

The procedure the System uses to repay the principal depends on how the Assistance Board uses the bond proceeds. If the Assistance Board certifies an institution to issue preferred stock, that institution is responsible for redeeming its preferred stock. If an institution does not redeem its stock, first the Farm Credit System Insurance Fund, also established by the act, and then Treasury are responsible for repaying the assistance. If the Assistance Board uses FAC bond proceeds to (1) facilitate a mandatory

[3] During early 1988, when the Assistance Board was considering whether to provide viability assistance to the Bank, it had 14 permanent and 2 temporary employees.

merger, (2) enable a receiver to retire eligible borrower's stock, or (3) cover Assistance Board expenses, the act provides for System-wide repayment under which each institution would repay a portion of the proceeds equal to its average share of the System's total performing loan volume over the 15-year term of the bonds.

The Assistance Board has broad authority to supervise the affairs of each institution requesting financial assistance. It may approve (1) business, operating, and investment plans and policies; (2) terms and conditions of debt issues; (3) credit standards for making loans; (4) loan interest rates; and (5) management changes and policies. The Assistance Board may also impose other terms and conditions, such as those that require an institution to change its management and operating policies and practices to (1) improve the institution's financial condition, (2) improve service to agricultural borrowers, or (3) ensure efficient use of assistance funds.

The Assistance Board may use methods other than providing money to deal with a troubled System institution. For example, it may request that FCA approve a merger of the troubled institution with another System institution, subject to the approval of both institutions' stockholders. It may direct FCA to appoint a conservator to manage the open institution while long-term solutions to the institution's problems are considered. Also, it may request that FCA exercise any of its enforcement powers or initiate action to appoint a receiver to close the institution and dispose of its assets and liabilities.

The Bank Was Required to Seek Assistance

Because of loan delinquencies, borrower bankruptcies, foreclosures, and high-cost debt, the Jackson Bank's financial condition went from one of prosperity to one that, by the end of 1987, could no longer conduct business. In 1984, the Bank's loan volume was $3 billion and its net worth was $364 million. However, its net worth declined by $370 million between December 31, 1984, and December 31, 1987, giving it a negative net worth. Because the Bank was insolvent, it could no longer provide loans or borrow money. On January 15, 1988, FCA informed the Bank that it was required by the act to seek assistance from the Assistance Board.

Objectives, Scope, and Methodology

Representatives Jerry Huckaby, Claude Harris, and Mike Espy asked us to review the procedures followed by the Assistance Board in making its decision to recommend the Jackson Bank be placed in receivership rather than to provide it with viability assistance. In response, as agreed with the requesters, we

(1) gathered information concerning the Assistance Board's decision process and the basis for its decision;

(2) determined whether the Assistance Board's analysis showed that receivership was the least costly alternative for resolving the Bank's financial problems and whether the analysis provided a reliable basis for the decision;

(3) determined whether the coordination and communication between the Assistance Board and Bank were conducive to an informed, cooperative decision process; and

(4) determined whether the act authorized the Assistance Board to make separate financial assistance decisions for preventing institutions from defaulting on debt and returning institutions to economic viability.

We obtained details about the decision process by reviewing the Assistance Board's internal documents and by interviewing its officials and former Bank managers and directors that were involved in the process. To determine how the Assistance Board's Directors were involved in the decision process, we contacted the lead individuals at the Departments of Agriculture and the Treasury who considered the matter for their individual Board members. At the time of the decision, the third Board member had not been appointed.

To determine how the Assistance Board analyzed its options, we reviewed the cash flows and assumptions used for estimating receivership and assistance costs. We did not attempt to develop estimates independently to determine which alternative would be the least expensive. However, we tested key aspects of the Assistance Board's methodology to form an opinion on whether the results were reliable. We checked key assumptions, such as interest rates, by comparing them with generally accepted sources such as The Wall Street Journal. We compared key variables in the cost models used by the Assistance Board with source documents. We replicated the Assistance Board's computer models to calculate the effect of adjusting the key assumptions.

To obtain information on the level of coordination and communication between the Bank and Assistance Board, we spoke with officials involved in the process from both organizations and reviewed correspondence between them.

To evaluate whether the Assistance Board's decisions, first to provide financial assistance to prevent the Bank from defaulting on its debt but then not to provide viability assistance, were authorized by the act, we checked the act's language, legislative history, and an opinion by the Assistance Board's legal division.

GAO sent a draft of this report to FCA and the Assistance Board for comment. In its written response, FCA had no comments on this report. The Assistance Board chose not to provide written comments. In oral discussions, FCA and Assistance Board officials suggested some technical clarifications and additional information which were incorporated in the report. The Assistance Board disagreed with our point concerning interest costs of the receivership. We discuss its position and our response at the end of chapter 3. The work was done between July 1988 and June 1989 using generally accepted government auditing standards.

The Assistance Board Chose Receivership Because of Cost and Management Considerations

On April 18, 1988, the Assistance Board's Board of Directors decided to recommend receivership rather than one of the various options considered for assisting the Jackson Bank back to a financially viable position.[1] The Board of Directors recommended receivership because (1) its staff's analysis showed that the estimated cost of receivership would be more certain and generally less than assistance to make the Bank viable and (2) it believed receivership would restore reasonably priced credit to the district's farmers and would effectively eliminate problems, such as deficient credit policies and practices, high overhead, high operating expenses, and management's inability to submit an acceptable business plan for resolving its problems. Furthermore, Assistance Board officials felt that another advantage of receivership was that a message would be sent to other System institutions that the cost of mismanagement was receivership, including removal of officers and directors. The deterrent effect of this message would be to reduce the amount of assistance needed by the entire System and the ultimate cost to the taxpayer. This chapter discusses the process used to consider the various options for handling the Bank's long-term problems.

The Process Leading to the Assistance Board's Decision

The Assistance Board considered the Bank's financial condition and resolution options from January 21, 1988, to April 18, 1988. Two decisions needed to be made. First, the Assistance Board needed to decide what to do about the Bank's debt obligations maturing in the short-term. Second, the Assistance Board needed to decide whether to provide long-term assistance to return the Bank to viability or recommend that FCA place it in receivership or conservatorship. The Assistance Board gave the Bank sufficient financial assistance to fund refinancing of its maturing debt to (1) avoid triggering joint and several liability—a mechanism whereby the System as a whole has to pay debt obligations that the System bank with primary liability cannot pay—and (2) provide additional time to analyze the options available to the Assistance Board. It then chose to recommend receivership rather than provide additional funding to meet the Bank's long-term viability needs. Table 2.1 describes the process and events leading to the Assistance Board's decision.

[1] Assistance Board officials would consider the Bank to be financially viable if it had (1) more interest-earning assets than interest-paying liabilities, (2) adequate capital, (3) positive retained earnings, and (4) the ability to generate a profit after paying back the assistance.

Table 2.1: Chronology of the Process

Date	Event
January 15, 1988	The FCA Chairman, acting for the Assistance Board, directed the Bank to apply for assistance and to submit a business plan by January 29, 1988.
January 21, 1988	FCA chartered the Assistance Board.
February 1, 1988	The Bank requested $55 million in collateral and capital to cover operating expenses as a fully operational lending institution through June 1988. The Bank also submitted an outline of a business plan and market assumptions it planned to use in a future request for viability assistance.
February 11, 1988	Bank officers briefed Assistance Board officials on the Bank's financial operations from 1982 through 1987 and on the Bank's financial and management plans for 1988 and 1989. The Bank's preliminary plan was for FCA to liquidate the Bank's problem assets and charter a new land bank that would merge with the Jackson Federal Intermediate Credit Bank.
February 17, 1988	The Bank increased its short-term assistance request to $57 million in collateral and informed the Assistance Board that its basic plan would be to charter a new bank and liquidate the old Bank.
February 23, 1988	Assistance Board officials asked by February 29, 1988, for additional information to analyze the Bank's assistance request, including a business plan and any other information the Bank considered necessary to complete its assistance application.
February 26, 1988	The Assistance Board certified the Bank to issue $25 million of preferred stock assistance to prevent the Bank from defaulting on its debt. The Bank provided most of the information the Assistance Board had requested on February 23 including parts of a business plan.
March 8, 1988	Assistance Board officials requested that the Bank provide financial projections, assuming new Bank management and stable economic conditions that would result in what the officials considered to be favorable results of future Bank operations (favorable scenario). The Bank provided the requested data.
March 16, 1988	Assistance Board officials requested that the Bank provide financial projections, assuming existing management and deteriorating economic conditions that would result in what the officials considered to be unfavorable results of future Bank operations (unfavorable scenario). The Bank provided the requested data.
March 31, 1988	Bank managers and directors met with Assistance Board officials to discuss the Bank's long-term viability assistance needs.
April 1, 1988	Assistance Board officials directed the Bank to provide a business plan for long-term viability assistance by April 8, 1988, and instructed the Bank on what had to be included in the plan.
April 11, 1988	The Bank provided the Assistance Board with a business plan that had been approved in concept by the district Board of Directors. In an April 14 letter, the district Board notified the Assistance Board that it endorsed the plan and on April 21 the district Board approved the plan.
April 18, 1988	Assistance Board Directors, on the basis of the recommendations of the Assistance Board's staff, decided not to assist the Bank to economic viability and requested that FCA initiate action to appoint a receiver for the Bank.
May 2, 1988	The Assistance Board certified the Bank to issue an additional $5

(continued)

Date	Event
	million of preferred stock to meet its short-term maturing debt needs.
May 17, 1988	The Assistance Board confirmed for FCA that it was requesting that FCA initiate actions to appoint a receiver for the Bank and that it was denying assistance to make the Bank economically viable. FCA's Board unanimously voted to appoint a receiver for the Bank.
May 20, 1988	The receiver took control of the Bank.

Assistance Board Considered Five Options

Assistance Board officials considered five options for resolving the Bank's long-term problems: (1) assistance to viability including a merger with the Jackson Federal Intermediate Credit Bank, (2) assistance to viability without the merger, (3) a Bank plan to reorganize the farm credit district into a "good" bank and "bad" bank system, (4) liquidating receivership, and (5) conservatorship. In deliberating on each option, Assistance Board officials considered several factors, including cost and Bank management's ability and plans for resolving the problems that led to the Bank's deteriorating financial condition and repaying the Bank's debt. Regarding existing Bank management, the Assistance Board's CEO said that he did not have confidence in them because they did simple things wrong, like understating collateral needs and not developing an acceptable business plan. He also said that FCA examinations had shown that Bank managers had initiated actions intended to improve the Bank's deteriorating financial condition that were ineffective and, in some instances, contributed to further declines.

Viability Assistance After Merger Option

The first option involved providing viability assistance to a new Farm Credit Bank after a merger of the Jackson Federal Intermediate Credit Bank with the Bank. The act would have required that such a merger take place by July 6, 1988, had the Bank not been in receivership. Under this option, the Intermediate Credit Bank's assets and $24 million in surplus capital[2] would have been used to improve the combined Farm Credit Bank's financial condition and reduce the amount of assistance needed. Since the two banks had the same senior management but different stockholders, the merger may not have affected overall management policies and practices but could have affected ownership claims to the surplus capital.

[2]Surplus capital is the amount of stockholders' equity remaining after subtracting total liabilities and the par value of capital stock from total assets.

A senior Assistance Board official said that the Assistance Board chose not to provide assistance to a merged Farm Credit Bank because it would not necessarily have resolved the Bank's management problems and may have resulted in litigation. The Assistance Board's cost estimate showed that this option would have cost significantly more than receivership under its unfavorable assumptions and slightly less than receivership under its favorable assumptions. The official also said that because the most serious financial problems were in the Bank, which was four times larger than the Intermediate Bank, merger may have postponed insolvency but would have had little long-term positive effect. Consequently, merger could ultimately have resulted in the insolvency of the new Farm Credit Bank. In addition, the Bank provided the Assistance Board with information indicating that the Intermediate Bank would probably object to a merger in court because, since the Bank was solvent, it was opposed to any merger that did not protect its stockholders' capital.

Viability Assistance Before Merger Option

The second option was to provide viability assistance to the Bank before a merger. The Assistance Board did not choose this option because it believed it would have been the most expensive solution. The Assistance Board's cost estimate showed that this option would have cost significantly more than receivership under its unfavorable assumptions and slightly more than receivership under its favorable assumptions. Also, Assistance Board documents said that this option potentially committed too large a percentage of the total funds available to the Assistance Board and was highly dependent upon excellent Bank management. Assistance Board officials said they did not believe existing management would be successful in making the changes necessary for this option to work.

Bank's Reorganization Option

The third option involved supporting the Bank's reorganization plan to place the Bank's unacceptable assets and high-cost debt in receivership. Its remaining assets were to be transferred to a newly chartered federal land bank in Jackson. The new land bank, as a viable institution, was to merge with the Jackson Federal Intermediate Credit Bank no later than July 6, 1988, as required by the act. For the Bank's plan to work, the Assistance Board would have had to provide assistance to the receiver to cover liquidation losses, and FCA would have had to charter a new federal land bank. A senior FCA official said that he told the Bank's CEO that, because the plan required assistance to be successful, FCA would not consider the Bank's plan without having first obtained a commitment of financial assistance from the Assistance Board. Because, under the Bank's plan, the assistance would have been provided to the receivership and not to the new bank, both principal and interest would have been borne by the System as a whole, with the Jackson district paying only its proportionate share. If assistance is provided to a System institution, that institution is responsible for repaying the principal, and the whole System is responsible for the interest expense.

The Assistance Board had several concerns with the Bank's reorganization plan. The Assistance Board's cost estimates showed that receivership for the whole Bank was less expensive than the Bank's plan. Also, Assistance Board documents said that because the System would have to repay both principal and interest on the assistance, and the Jackson District would only have to repay its proportionate share, other System institutions may have brought litigation objecting to the plan. The documents said that the Bank plan offered no evidence that management weaknesses would be corrected and, thus, in future years, more assistance would be required. Furthermore, Assistance Board officials said that the Assistance Board could not have accepted the plan because its authority extended only to providing financial assistance and not to the chartering of a new bank. Also, they said that a decision on providing assistance to a receiver for the Bank's bad assets and liabilities was premature because only the receiver could request assistance and a receiver had not been appointed.

Receivership Option

The fourth option involved recommending that FCA appoint a liquidating receiver for the entire Bank. The receiver would take control of the Bank, wind down its business operations, liquidate its assets, and pay its creditors. The Assistance Board selected this option because its cost estimate showed it would be the least expensive solution with the least risk of future losses. Assistance Board officials also said they were concerned with (1) quickly restoring credit at competitive and reasonable interest rates to the district's farmers and ranchers and (2) protecting borrower stock. The officials said that receivership accomplished these objectives. Additionally, Assistance Board officials believed that by eliminating the Bank's management and Board of Directors, the receivership option provided a strong disincentive for other System institutions to mismanage their affairs. Furthermore, its officials said that this option reduced the number of System banks in accordance with what they considered the general congressional intent. They also said that the Bank itself planned for its problem assets to be liquidated through a receivership.

Conservatorship Option

The fifth option involved directing FCA to appoint a conservator. A conservator would have taken control of the Bank to continue its ongoing operations, conserve its assets, and protect its stockholders until the Assistance Board and FCA decided whether to liquidate the Bank or return it to normal operations.

Assistance Board officials said that a conservatorship might have resolved concerns about management, but they chose not to require a conservator because it would not have been a permanent solution to the Bank's problems. They said that the additional time that a conservatorship would have allowed them for analysis was unnecessary because they had all the information needed to make their decision.

Cost Analysis Was Unreliable

As discussed in chapter 2, cost was a major factor in the decision to recommend that the Bank be placed in receivership rather than assisting it back to a viable position. The Assistance Board's estimates showed that placing the Bank in receivership would generally be less costly than the other options. Our analysis showed that the Assistance Board's analysis (1) omitted interest costs associated with the receivership option, (2) relied on certain key assumptions and data that were not supported by economic analysis, and (3) compared costs and revenues on the basis of cash rather than present value in the final decision. While we are not rendering an opinion on which alternative was more expensive, these estimating flaws were significant enough, in our judgment, to render the cost estimates unreliable as a basis for the Assistance Board's decision.

Assistance Board's Cost Analysis

Assistance Board officials used one procedure to estimate assistance costs, a second to estimate receivership costs, and a third to estimate the cost of the Bank's plan. Each procedure had its own set of assumptions and cost variables. Estimates for the assistance options were computed in ranges to reflect what the officials considered to be favorable and unfavorable assumptions of future economic conditions and management changes. The favorable scenario assumed a stable economic environment and management changes that would be successful in resolving the Bank's problems. The unfavorable scenario assumed a moderately deteriorating economic environment and existing management that would be less successful in resolving the Bank's problems—would not reduce operating expenses and would restructure bad loans and liquidate acquired property more slowly. Appendix II contains the specific assumptions for the favorable and unfavorable scenarios.

The estimated costs showed that receivership would be less expensive than viability assistance without merger, less than the Bank's reorganization plan, and within the cost range for viability assistance with merger. Table 3.1 shows the Assistance Board's estimate for each option. Appendix I describes the procedure used by the Assistance Board to arrive at each estimate.

Table 3.1: Cost of Options to Resolve the Bank's Problems

Dollars in millions

Option	Assistance Board Estimated Cost
Assist to viability with merger	$384 to $606
Assist to viability without merger	$396 to $636
Bank's plan	$442[a]
Receivership	$395[a]

[a]Assistance Board officials considered the Bank's plan to be another form of receivership. They also considered receivership cost to be more certain than viability assistance and, therefore, did not estimate a range.
Source: Assistance Board

Flaws in the Assistance Board's Cost Estimates

The Assistance Board's cost estimates for the viability and receivership options were flawed and, thus, were unreliable to use as a basis for deciding among the options. Specifically, the analysis

- omitted interest costs for the receivership option, understating receivership costs compared to other options;
- used assumptions to estimate certain key costs that were unsupported by economic analysis; and
- used cash rather than present value to compare viability and receivership options for the final decision, showing that the options were not compared on an equal basis.

Interest Costs Excluded for the Receivership Estimate

Assistance Board officials excluded interest costs for the receivership cash cost estimate. However, a receiver would need to pay the interest on the Bank's debt until it matures, thus increasing the shortfall between revenues and expenses. Moreover, the System would ultimately need to pay interest costs for funds borrowed to pay for that shortfall.

A Senior Assistance Board official said that he chose not to include interest costs as part of the cash cost of receivership because a decision had not been made on how the Bank's debt or receivership shortfall would be funded. The Assistance Board's documents showed five possible ways for funding the Bank's debt to avoid triggering joint and several liability. The documents say that joint and several liability is a highly undesirable outcome adversely affecting all banks of the System and that Congress clearly intended for the Assistance Board to avoid it. Although the method of funding the shortfall may affect the rate and timing of the interest costs, significant funding costs would have to be paid under any alternative. For example, the receiver could issue new debt or swap debt with other System institutions and continue paying interest costs.

The documents say that to pay for the receivership shortfall and avoid triggering joint and several liability, the receiver must obtain funds from FAC, the same source used for the viability assistance options. Had interest on FAC bonds for the $395 million shortfall been included at the 8-percent rate used to estimate viability assistance costs, the Assistance Board's cash estimate for the receivership option would have increased by $474 million to $869 million. As a result, the cash cost estimate for receivership would have been significantly higher than for viability assistance, which was between $384 million and $636 million.

Unsupported and Inconsistent Assumptions

Any analysis of future costs is uncertain and affected by the reliability of assumptions and data used in the analysis. To make meaningful comparisons, assumptions should be consistent for all options and should be based on recent and accurate information. However, the Assistance Board used different methodologies, assumptions, and data to estimate the costs of the various options.

Assistance Board officials first estimated the cost of both viability assistance and receivership on the basis of December 31, 1987, financial data. It then updated the cost of receivership on the basis of March 31, 1988, data but not the cost of viability assistance. The updated receivership cost declined by $23 million, mostly because of improvements in the Bank's loan portfolio. An Assistance Board official said that viability assistance cost estimates were not updated because they were driven by economic conditions that did not change as much over time. However, in our opinion, as the Bank's problem assets declined, the cost for viability assistance should also have declined because the model used to estimate future Bank losses, which was the basis for estimating assistance costs, started with the Bank's initial financial condition.

In addition, the Assistance Board's estimates for the costs of viability assistance did not precisely satisfy its viability criteria. For example, the Assistance Board's analysis showed that $320 million was needed under the favorable scenario for the viability with merger option. We ran the Assistance Board's cost model and found that $305 million in assistance would have satisfied the Assistance Board's criteria—more interest-earning assets than interest-paying liabilities, positive retained earnings, a capital level of 5 percent of assets, and the ability to generate a profit after paying back the assistance. This change would have decreased the Assistance Board's cost estimate for this option from $384 million to $366 million. Documentation also showed that $530 million was needed under the unfavorable scenario for the viability without merger option. We ran the model and found that it would have taken $558 million in assistance to satisfy the viability criteria. This change would have increased the Assistance Board's cost estimate for this option from $636 million to $669 million.[1]

Moreover, to make the cost estimates, Assistance Board officials used certain assumptions that were unsupported by economic analysis or relied on inappropriate support. For example, the Assistance Board used an 8-percent interest rate to calculate the cost of bonds sold to provide viability assistance. The workpapers did not show the basis for the 8-percent rate. In discussing the draft report, Assistance Board officials said they used Office of Management and Budget (OMB) budget projections of interest rates for FAC bonds for fiscal year 1988 and they provided an excerpt from an undated OMB document to support their assumption. These OMB estimates were outdated. We checked the prevailing yield for 15-year Treasury securities shown in The Wall Street Journal on March 31, 1988, the date of the financial data used in the analysis. This generally accepted source reported a higher rate of 9 percent. In our opinion, the most current interest rate should have been used.

The Assistance Board's cost estimate for viability assistance was also based on the Bank investing the assistance money and obtaining an 8-percent rate of return on that investment. The return from this investment was to be used to cover the Bank's losses and return the Bank to a viable position. The Assistance Board's documentation did not indicate how the money would be invested or how the 8-percent rate was determined. As mentioned above, the prevailing rate on Treasury securities was about 9 percent. Thus, without incurring additional risk, the Bank could have earned about 9 percent by investing in Treasury securities, 1 percent more than assumed by the Assistance Board.

Using a 9-percent rate has two effects on the Assistance Board's analysis. It decreases the amount of assistance needed to meet the Assistance Board's viability criteria but increases the interest rate on the bonds used to provide that assistance. Because the higher interest rate affects cash flows

[1]In discussing our draft report, Assistance Board officials said they used a 6 percent capital level instead of 5 percent as they previously stated. Using 6 percent in the cost model results in cost estimates that differed from the Assistance Board's estimates for three of the four assistance estimates. Two were within $6 million of the Assistance Board's estimate but the third was off by $33 million.

needed to meet the viability criteria differently under the Assistance Board's favorable and unfavorable economic and management assumptions, the net effect is to increase the cost estimate for the favorable scenario and decrease the cost estimate for the unfavorable scenario. Instead of the Assistance Board's range of $384 million to $636 million for viability assistance, the range, using a 9-percent interest rate, would have been $398 million to $601 million.

In addition, the Assistance Board used a weak analytical basis for the assumption that, without assistance, the Bank would lose between $120 million and $400 million over the last 10 years of the 15-year assistance period. The Assistance Board's documents showed that cash flows were used to project losses for the first 5 years, but no economic basis was shown for the last 10 years. An official said that he considered the trend in the first 5 years and the Bank's position at the end of 5 years to estimate an amount of losses that would then be held constant over the last 10 years. He said that the losses were based mostly on his judgment that most of the improvements in Bank earnings would occur during the first 5 years, and those improvements would be insufficient for the Bank to earn a profit for the next 10 years. Since this assumption was important in determining the amount of viability assistance needed, we believe that it is reasonable to expect it to be based on economic analysis.

Cash Rather Than Present Value Analysis

In making its final decision, the Assistance Board compared costs based on cash expenditures rather than on a present value analysis. As a result, cash flows of different magnitudes occurring at different times under the various options were not adjusted to the same point in time so that they could be compared on an equal basis.

Present value analysis was needed because assistance options involved interest costs over 15 years, and the receivership option involved revenues from asset sales and receivership expenses over 5 years (in calculating receivership expenses, the Assistance Board assumed a 5-year receivership) and interest costs to pay for the receivership shortfall over 15 years, assuming FAC bonds were used to pay costs. Present value comparisons adjust for the reality that money has earning power over time and, thus, the same dollar amount is worth less in the future than at present. For example, workpapers prepared by Assistance Board staff and presented to its Board of Directors for their consideration contained a present value estimate for assistance without merger that showed the present value cost ranged from $226 million to $363 million, rather than the cash cost of $396 million to $636 million. The workpapers did not contain present value estimates for the other assistance options. The workpapers showed a receivership cost of $418 million on the basis of both cash and present value. In our opinion, this assumption does not reflect the timing differences that would occur in paying liabilities and expenses, selling assets, and paying the final shortfall, all of which are inherent in making a present value estimate.

According to the Assistance Board's CEO, present value estimates were not used as a basis for the Assistance Board's decision because these estimates were more confusing than comparing costs and revenues using a cash basis. He added that timing of asset sales for the receivership option and interest rate assumptions, which are an integral part of present value calculations, were uncertain. A senior Assistance Board official said that the Assistance Board was aware of the value of present value analysis. However, he agreed that present value estimates were not used to decide among the options because they were more confusing and dependent on timing assumptions. We agree that these assumptions are uncertain, but interest rates were an integral part of the viability assistance analysis and timing of receipts from asset sales in the receivership was no more uncertain than recovery rates from asset sales that were used in the receivership analysis. Furthermore, methodologies were available for developing timing assumptions for asset sales, such as the method used by the Federal Deposit Insurance Corporation.

Adjusted Cost Estimates for Viability and Receivership Options

We adjusted the Assistance Board's estimated costs for the viability and receivership options to determine the net effect of the estimating flaws we identified. As shown in table 3.2, after we (1) added omitted interest for the receivership shortfall, (2) adjusted financial data to match source documents, (3) used a 9-percent interest rate, (4) calculated present value using Assistance Board assumptions, and (5) used the least amount of assistance needed to meet the viability criteria, the adjusted estimates showed that the cost for the receivership option was significantly higher than the costs for the viability assistance options.

Table 3.2: Comparison of Costs for Assistance and Receivership After GAO Adjustments

Dollars in millions

Option	Present Value			Cash		
	Favorable		Unfavorable	Favorable		Unfavorable
Viability without merger	$218	to	$326	$405	to	$607
Viability with merger	$214	to	$302	$398	to	$562
Receivership[a]	$391			$920		

[a]Excludes costs associated with timing differences between expenses and revenues and interest costs for the Bank's debt, which would be paid by the receiver. To reliably estimate the cash and present value costs, assumptions for the timing of paying liabilities, selling assets, and paying the final receivership shortfall must be developed. The Assistance Board did not develop such assumptions.

Source: GAO analysis of Assistance Board's data.

Conclusion

The Assistance Board's cost estimates did not provide a reliable basis for deciding between viability and receivership options for the Bank. They were based on an analysis that was flawed and sometimes unsupported. The flaws, including omitted receivership costs, inconsistent assumptions, and the use of cash rather than present value analysis, sufficiently affected the estimates to question the results of the Assistance Board's analysis. Therefore, while we are not rendering an opinion on which alternative was more expensive, we do not believe the Assistance Board's analysis was sufficiently reliable to make an informed decision on the basis of cost.

Recommendation

Although future assistance requests may be unique (i.e., institutions may need assistance to resolve different types of financial problems), costs should be estimated on the basis of a complete and well-supported analysis. Therefore, we recommend that the Assistance Board's Board of Directors direct its officials to use an analysis that (1) includes all relevant costs for each option; (2) provides that data used in the analysis and key assumptions, such as interest rates, be supported by current, generally accepted economic sources; and (3) compares cost on a present value basis.

Agency Comments

In discussing this report, Assistance Board officials reaffirmed their position that receivership costs should be limited to the amount of the receivership shortfall and should not include interest costs on the money needed to pay that shortfall. They viewed the principal amount of the shortfall as the primary cost that is comparable to the primary cost of viability assistance, which they viewed as interest on the money needed to pay the assistance principal.

To be consistent with the Assistance Board's criteria for assistance costs as being costs borne by the System and/or government, we believe the interest on the receivership shortfall principal should be included in the cash cost of receivership. For the assistance options, the Assistance Board defined cost as interest on FAC bonds and not the principal amount of assistance because the Bank would be responsible for paying the assistance principal and the System and government would only have to pay the interest on that principal. However, under receivership, both the receivership shortfall and the interest costs associated with paying that shortfall would be paid by the System and/or government. Therefore, we believe that both of these costs should have been included.

Misunderstandings Between the Assistance Board and the Bank

The Assistance Board provided the Bank with some guidance during the decisionmaking process, but differing expectations were not reconciled and interactions were strained. The interaction between the Assistance Board and the Bank involved confusion, misunderstandings, and, after the Bank submitted a reorganization plan, a complete lack of communication on that plan. The Assistance Board is authorized, but not required, to issue regulations and guidelines detailing the assistance process and application requirements but has not done so. Assistance Board officials said that they do not believe such regulations or guidelines are necessary because each assistance request is considered to be unique and, therefore, formal criteria cannot be established to cover every request. Nevertheless, because no regulations or guidelines on the assistance process existed, we believe that unnecessary confusion concerning respective responsibilities and assistance request requirements occurred between Assistance Board officials and Bank managers. Eliminating that confusion and the misunderstandings would, in our opinion, enhance the decisionmaking process.

Initial Guidance Was Contradictory

In a January 15, 1988, letter, FCA, acting for the Assistance Board, asked Bank management for a detailed business plan showing the amount of assistance needed and how the assistance would be used to make the Bank viable. The Assistance Board's CEO said that he had no discussions with Bank managers on the content of the Bank's initial request for assistance. He said that he assumed the Bank would submit a detailed request. However, Bank managers said that they were told by a former senior Assistance Board official that the initial request only needed to be a preliminary viability plan that included the Bank's first impression of how much assistance it would need to become viable. The Bank provided a preliminary plan and cost estimate but was criticized by the Assistance Board's CEO for not providing more details on its cost estimate and projected financial condition.

Misunderstandings Over Guidance and Feedback

Misunderstandings occurred between Assistance Board officials and Bank managers concerning their respective roles and responsibilities during the decision process. Bank managers believed that they would be able to work with Assistance Board officials in developing a business plan and assistance request. Assistance Board officials said that they believed their role was limited to evaluating the Bank's assistance request, not to providing the Bank with guidance or assistance in developing a plan for resolving its problems. Throughout most of the decisionmaking process until March 31, 1988, the Assistance Board never told the Bank that its role was restricted to passing judgment on the Bank's request.

Statements in a February 23, 1988, Assistance Board letter requesting additional information further demonstrated the confusion that existed. The Assistance Board described the initial Bank request as "purporting to be a business plan designed to correct the Bank's deteriorating financial condition is a mere outline." Actually, the Bank's request explained that it was providing a plan outline because its president had recently commissioned a planning team to develop a detailed business plan that would show how much assistance was needed and how the assistance would be used to return the bank to a sound financial condition. In addition, the Assistance Board's letter described the Bank's analysis of the estimated amount of financial assistance needed as "too simplistic" and as showing a lack of understanding or effort in its preparation. Actually, the Bank itself described its analysis as preliminary and as using a "simplistic budgetary model." To improve the analysis, the Bank requested that the Assistance Board provide guidance in clarifying parts of the act, such as how principal and interest on the assistance would be paid.

Confusion Over Time Frames

In their initial request, Bank managers requested short-term assistance to cover operating expenses through June 1988. Bank officials said that they intended to work with the Assistance Board and FCA during February through June to finalize a long-term business plan and have everything in place so all required actions, including a merger with the Federal Intermediate Credit Bank, could be accomplished by July 6, 1988. Assistance Board officials said they were unaware of the June time frame and, therefore, did not question it in correspondence with the Bank.

The Bank's initial request showed that the request was for assistance through June 30, at which time a long-term plan was to be completed and the merger of the Bank and Intermediate Bank accomplished. In an April 1, 1988, letter Assistance Board officials requested a comprehensive business plan by April 8 that was to include (1) a detailed description of how Bank operations were to be managed, (2) how operating expenses would be reduced, and (3) how field offices would be consolidated if viability assistance were provided. The letter provided no indication of why the plan was needed by April 8. The Assistance Board's CEO said that the Assistance Board had made it clear in a March 31, 1988, meeting that the final plan had to be submitted by April 8. He also said that the plan was required in 7 days because the Bank had had sufficient time to develop an acceptable plan, and the Assistance Board needed time to evaluate it before part of the Bank's debt was due on May 1, 1988.

Bank managers submitted a business plan on April 11 but continued revising the plan, still believing they had until the end of June. As it turned out, after the Bank provided the business plan, the Assistance Board ended all communication with the Bank concerning viability assistance.

Confusion Over Assistance Board Concerns With the Bank's Reorganization Plan

In mid-February 1988, the Bank informed the Assistance Board that its basic business plan would be to reorganize the district by chartering a new bank for the good assets and by using the original bank to liquidate the problem assets. Assistance Board officials said at that time, that they informed Bank management of significant problems with the Bank's basic plan. However, Bank managers said that Assistance Board officials never expressed such concerns to them. The Bank continued for the next 3 months developing its plan in greater detail. While subsequent correspondence between the Assistance Board and Bank showed that the Bank continued to develop its plan, we found nothing from the Assistance Board expressing any concerns about that plan. Bank managers said that the first time the Bank learned the approach was unacceptable was on May 20, 1988, when FCA placed the Bank in receivership.

Confusion Over Appointment of a New CEO

On May 5, 1988, subject to the Assistance Board's approval, the Jackson district board appointed a new CEO to carry out all duties and responsibilities of the Bank and Federal Intermediate Credit Bank, such as finalizing the business plan to reorganize district institutions. The district board notified the Assistance Board of the action in a May 5, 1988, letter. The district board thought it was requesting the Assistance Board's approval of the management change by including, both in the letter and the attached board resolution, statements that it was requesting approval. However, Assistance Board officials misunderstood the letter and informed the district chairman that its consent was needed before replacing the previous CEO. Assistance Board officials said that they were confused because the resolution was not signed and the letter was written on stationery that still reflected the old management.

Conclusion

The process of deciding whether the Bank would receive viability assistance or be placed in receivership was very confusing to both Bank and Assistance Board officials. The Assistance Board and the Bank operated under different assumptions throughout the process. The resulting unnecessary confusion and misunderstandings may have been avoided to some extent if the Bank had a clearer understanding of the Assistance Board's role, assistance request requirements, time frames, and concerns throughout the process. The Assistance Board has not issued policy statements or other guidance concerning the process of deciding between viability assistance and receivership.

Recommendation

To help avoid misunderstandings between affected parties in possible future requests, we recommend that the Assistance Board's Board of Directors direct its officials to issue guidance detailing (1) the requirements for requesting assistance and (2) the Assistance Board's role in helping institutions request assistance.

Assistance Certifications Were Consistent With Legislation

While the Assistance Board was weighing viability and receivership options to resolve the Bank's problems, it certified the Bank to issue preferred stock of $25 million on February 26, 1988, and $5 million on May 2, 1988, to prevent the Bank from defaulting on its debts. We believe these actions were consistent with the Agricultural Credit Act of 1987. The act authorized the Assistance Board to provide assistance to the Bank to retire its maturing debt obligations. Unique circumstances justified the Assistance Board's decision to assist the Bank on a temporary basis rather than to return it to viability.

The act authorized the Assistance Board to provide assistance that would prevent the Bank from defaulting on its maturing debt. Although section 6.5(a) of the act does not specifically enumerate this as a purpose for which assistance is authorized, the fourth paragraph gives the Assistance Board broad authority to provide assistance for any purpose it deems appropriate. Furthermore, a discussion of section 6.5 in the Senate report accompanying the act, indicates that Congress intended that the Assistance Board provide assistance for purposes other than those specifically enumerated in the act.[1]

The Senate report provides five examples of purposes for which the Assistance Board may authorize assistance. Because only two of these are specifically listed in paragraphs (1) through (3) of section 6.5(a), authority for the other three must flow from paragraph (4).

Unique circumstances justified the Assistance Board's decision to provide temporary assistance. The 1987 act anticipated that if the Assistance Board decided not to provide a troubled bank sufficient assistance to return it to viability, FCA would place the bank in receivership or conservatorship before it had exhausted its capital account. The Bank, however, was already insolvent when the act became law and required assistance before the Assistance Board could make an informed decision whether to place it in receivership or conservatorship. By providing assistance to enable the Bank to pay its maturing debt obligations, the Assistance Board prevented the triggering of joint and several liability, which could have spread the Bank's financial troubles to other System institutions.

[1]Senate Report No. 230, 100th Cong., 1st Sess. 23 (1987). The Conference Committee adopted the Senate version of this provision. H. Conf. Rep. No. 100-490, 100th Cong., Sess. 185 (1987).

Procedures Used by the Assistance Board to Estimate Costs

Assistance Board officials used three different procedures to estimate costs of the options it considered. These procedures are described in this appendix.

Estimated Cost of Viability Assistance

To determine how much assistance would be needed to make the Bank viable with or without a merger, Assistance Board officials used a three-step process of (1) projecting operating losses for 15 years without assistance, (2) estimating the amount of assistance needed to cover these losses and make the Bank viable, and (3) estimating the interest cost of providing this assistance.

Assistance Board officials first provided the Bank with various assumptions for changes in economic variables and in the Bank's assets, liabilities, and operating expenses. The officials then asked the Bank to use the assumptions to project operating losses for 5 years without any assistance. The Bank used a computer forecasting model and the Assistance Board's assumptions to project cash flows and losses from operations for 5 years. Under both favorable and unfavorable economic scenarios that are described in appendix II, operating losses declined over the 5 years but remained substantial. Assistance Board officials did not have the Bank project cash flows on losses beyond 5 years. Instead it assumed losses would remain constant over years 6 through 15. Table I.1 shows the projected operating losses under the favorable and unfavorable scenarios for the 15 years.

Table I.1: Projected Bank Net Losses Without Assistance

Dollars in millions

	Year					
Without merger	**1**	**2**	**3**	**4**	**5**	**6 through 15**
Favorable	$89	$69	$52	$41	$34	$15 each year
Unfavorable	$104	$73	$61	$53	$50	$40 each year
With merger						
Favorable	$87	$67	$49	$38	$31	$12 each year
Unfavorable	$103	$71	$58	$50	$47	$36 each year

Source: Assistance Board.

Assistance Board officials then used the projected operating losses to estimate the amount of assistance needed to make the Bank viable. It used trial and error to determine the least amount of assistance needed for the Bank to cover operating losses and meet its viability criteria of (1) more interest- earning assets than interest-paying liabilities, (2) a capital-to-asset ratio of 5 percent,[1] (3) positive retained earnings, and (4) the ability to generate a profit after paying back the assistance. It decided that the most appropriate way to make the Bank economically viable, if it chose to do so, was to provide enough assistance up front to allow the Bank to meet the four viability criteria. Assistance Board officials assumed that the Bank would (1) invest the assistance at an 8-percent rate of return; (2) use the interest income to pay for projected operating losses and improve its financial condition over the 15-year period; and (3) at the end of the 15th year, use the investment principal to repay the assistance. A senior Assistance Board official said that this method was more practical and would have allowed the Bank to realize more benefits than providing assistance as needed each year, because it allowed the Bank to obtain the maximum amount of interest income.

Finally, Assistance Board officials estimated the cost of the assistance by calculating the interest cost to provide the assistance. Under the act, FAC provides assistance by selling bonds to the public and then purchasing preferred stock from the Bank. The interest on the bonds was considered the cost of the assistance because, initially, it would be paid by the government and, ultimately, by the System as a whole. Because the Bank was responsible for repaying the assistance principal, it was not considered a cost. Table I.2 shows the Assistance Board's estimated costs for viability assistance with and without merger for the favorable and unfavorable scenarios.

Table I.2: Assistance Board's Estimated Viability Cost

Dollars in millions

Without merger	Assistance required	Annual expense[a]	Cost[b]
Favorable	$330	$26.4	$396
Unfavorable	$530	$42.4	$636
With merger			
Favorable	$320	$25.6	$384
Unfavorable	$505	$40.4	$606

[a]The Assistance Board assumed the interest rate would be 8 percent for the 15-year bonds used to fund the assistance.

[b]Expressed on a cash basis.

Source: Assistance Board.

[1]In discussing our draft report, Assistance Board officials said they used a 6 percent capital level instead of the 5 percent they previously stated.

Estimated Cost of Receivership

Assistance Board officials estimated the cost of placing the Bank in receivership by projecting losses on the sale of the Bank's assets and by adding those losses to expected receivership costs, including paying liabilities, guaranteeing the par value of stock, and paying expenses. To estimate asset losses, the officials made various assumptions about the amount of money that would be recovered from the sale of assets over the term of the receivership. It assumed a 100-percent recovery rate for good loans, an 85-percent recovery rate for loans still accruing interest but considered substandard, and a 50-percent recovery rate on the book value of acquired property and loans that were not accruing interest. For other assets such as buildings, no recovery was assumed. To estimate the receivership expenses, it assumed the receivership would cover 5 years.

Assistance Board officials assumed the Bank's debt would be (1) assumed by other System institutions in exchange for assets, (2) exchanged for other institutions' debt, or (3) retired by the receiver using funds from the sale of FAC bonds. In any case, the officials assumed the receiver would have to pay a premium to deal with the Bank's high-cost debt. The Farm Credit System Funding Corporation provided the Assistance Board with the amount this premium would have been at the time the analysis was done. Table I.3 shows the Assistance Board's receivership cost estimate.

Table I.3: Assistance Board's Estimated Receivership Cost

Dollars in millions

Asset Type	Beginning balance	Assumed loss (percent)	Estimated cost
Acceptable loans	$960	0	$0
Substandard loans	278	15	42
Nonaccrual loans	330	50	165
Acquired property	68	50	34
Other assets	13	100	13
Subtotal:			**254**
Expenses Incurred			
Premium for the bank's debt			87
Guaranteeing stock			115
Receivership expense			27a
Allowance for loan losses			(88)
Subtotal:			**141**
Total estimated receivership cost			**$395[b]**

[a]Receivership expenses include the receiver's fees, legal expenses, cost of terminating pension and other benefit programs, and severance payments.

[b]Based on Bank's March 31, 1988, financial statements.

Source: Assistance Board.

Estimated Cost of the Bank's Reorganization Plan

The Bank estimated that its April 11, 1988, plan to reorganize the Farm Credit district by creating a new bank for the good assets and by placing the problem assets into a receivership would cost $309 million. The cost estimate was based on 5-year cash flow projections of the results of the receivership's efforts to (1) restructure or liquidate problem loans, (2) sell acquired property, and (3) retire debt. The projections were based on various assumptions the Bank developed concerning (1) future land values, (2) the farm economy, (3) interest rates, and (4) the return from selling acquired property. These assumptions were more optimistic than those used in the Assistance Board's whole bank receivership option. For example, the Bank assumed a higher return on assets sold and greater success in restructuring loans.

The Bank's projections showed that because of losses on the disposal of assets and other costs, the receivership part of this option would start with a negative net worth of $61 million and end with a negative net worth of $309 million after the fifth year. The Bank then redid its cash flows to determine the amount of assistance needed to cover the negative net worth. It assumed the assistance would be provided in July 1988 and the receiver would invest the assistance in short-term securities. Both the assistance principal and interest income were to be used over the 5-year period to bring the receivership's net worth to zero. With zero net worth, the Bank assumed that any assets, stocks, and liabilities remaining in the receivership at the end of the 5 years would be transferred to the new bank. On the basis of these projections, the Bank estimated that $190 million in assistance would be needed to cover the shortfall. Assistance Board officials did not do their own analysis to estimate the cost of the Bank's plan. However, they increased the Bank's estimate from $309 million to $442 million by adding costs they felt were omitted, such as costs of disposing of assets remaining in the receivership at the end of the fifth year and the cost of guaranteeing the par value of stock as required by the act.

Assistance Board's Assumptions for Favorable and Unfavorable Scenarios

Assistance Board officials estimated the cost of returning the Bank to economic viability under favorable and unfavorable scenarios of future economic and management influences on the Bank's earnings. It used these assumptions as a baseline to determine how much assistance the Bank would require to become economically viable.

Favorable Scenario

The favorable scenario assumed a stable economic environment and that new management would be successful at resolving the Bank's problems. Specifically, it was assumed that:

- Management would aggressively restructure nonaccrual loans and liquidate acquired property. Nonaccrual loans would be reduced to $26 million by the end of 1992 (a 93-percent reduction from 1987). Acquired property would decline to $55.6 million by the end of 1992 from $83.7 million in 1987.
- Management would be able to reduce bank operating expenses by 10 percent in 1988 and 1989 by closing unnecessary branch offices, reducing compensation to advisory directors, and reducing personnel.
- Land values would not decline, loan volume would remain relatively stable over the first 5 years, and interest rates on loans and new debt obligations would remain at current levels.
- For the assistance option without merger, the Bank would sustain operating losses from 1993 through 2002 of $15 million for each year.
- For the assistance option with merger, the Bank would sustain operating losses from 1993 through 2002 of $12 million for each year.

Unfavorable Scenario

The unfavorable scenario assumed a moderately deteriorating economic environment and that existing management would be less successful at resolving the Bank's problems. Specifically, it was assumed that:

- Management would restructure nonaccrual loans and liquidate acquired property but at a rate slower than in the favorable scenario. Nonaccrual loans would be reduced to $70 million by the end of 1992 (an 82-percent reduction from 1987). Acquired property would decline to $55.6 million by the end of 1992, down from $83.7 million in 1987. The Bank would sustain slightly less in losses from charge-offs on restructuring loans and disposing of acquired property than in the favorable scenario since fewer troubled accounts were to be resolved.
- Bank management would be unable to reduce operating expenses from their 1987 levels.

- Outstanding loan volume would decline $50 million per year over the first 5 years. As a result, proportionately higher allowances for loan losses would be needed. Interest rates on loans and new debt obligations would remain at current levels.
- For the assistance option without merger the Bank would sustain operating losses from 1993 through 2002 of $40 million for each year.
- For the assistance option with merger the Bank would sustain operating losses from 1993 through 2002 of $36 million for each year.

Comments From the Farm Credit Administration

Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

September 14, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

The Farm Credit Administration (FCA) appreciated the opportunity to review and comment on the GAO draft report entitled Farm Credit: Basis for Decision not to Assist the Jackson Federal Land Bank.

This is to inform you that after thorough review, the FCA has no comments to offer on the draft report. Enclosed are the five copies of the draft report that were provided the agency.

Sincerely,

Marvin Duncan

Marvin Duncan
Acting Chairman

Enclosures - 5

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