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Report to Congressional Requesters

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FARM CREDIT SYSTEM

Analysis and Comment on Possible New Insurance Corporation Powers

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The Honorable Richard G. Lugar
Chairman
The Honorable Patrick J. Leahy
Ranking Minority Member
Committee on Agriculture, Nutrition,
and Forestry
United States Senate

The Honorable Pat Roberts
Chairman
The Honorable E (Kika) de la Garza
Ranking Minority Member
Committee on Agriculture
House of Representatives

The Farm Credit System (the System) is a government-sponsored enterprise that was chartered by Congress to ensure a stable supply of credit to agriculture. The Farm Credit System Insurance Corporation (FCSIC) maintains the Insurance Fund, which insures the prompt payment of most of the debt obligations of the System's eight banks.

The Farm Credit Banks and Associations Safety and Soundness Act of 1992 (the 1992 Act) required us to review and evaluate the feasibility and appropriateness of three possible increases in FCSIC's powers. The System's regulator, the Farm Credit Administration (FCA), had recommended each of these changes to Congress in 1991. Briefly, these powers, which are intended to strengthen the Insurance Fund in a time of stress, would authorize FCSIC to

- assess the capital of the 228 System associations that have ownership interest in the banks that fund them;[1]
- charge supplemental insurance premiums to the banks; and
- base the premiums it charges banks on the relative riskiness of each bank.

The objective of this report is to briefly describe our understanding of each of these possible powers, FCA's stated reasons for requesting them in 1991, and the major advantages and disadvantages we anticipate were Congress to authorize them. In addition, we reviewed unimplemented

[1]An assessment of an association's capital could be accomplished, for example, by a transaction that transfers certain association assets without compensation.

recommendations regarding the Insurance Fund that we made in a 1994 report to see whether they were still valid.

Background

The System is a government-sponsored enterprise consisting of a nationwide network of privately owned cooperative banks and their related associations that provide billions of dollars of credit and services to eligible farmers, ranchers, producers, cooperatives, and others in rural America. The System, like other government-sponsored enterprises, raises funds in the capital markets at a relatively low cost because of the strength of its ties to the federal government. Most System borrowing is done through the issuance of System-wide debt obligations that are the joint and several liabilities of all eight System banks. This means that, in the event one or more banks are unable to repay their respective obligations, the FCA can require the remaining banks to repay the total amount of the obligations. However, the 228 System associations, which are the cooperative owners of the banks in their respective geographical districts, are not liable for the repayment of the banks' debts.

The System nearly collapsed in the mid-1980s, and as a result, investors began to lose confidence in the System's debt obligations. As we noted in a 1994 report, the System's problems were partly caused by weak credit standards, ill-advised loan pricing, and excessively risky financing policies that resulted in a costly mismatch in the maturities of its liabilities compared to its assets.[2] Under these circumstances, the System was unable to weather the deflation of commodity and land values and the extreme volatility in market interest rates in the early to mid-1980s. At this point, Congress decided to intervene before the System failed.

In 1985, Congress began to devise a long-term plan to rescue the System and prevent recurrence of the problems that led to its near failure. Up to that time, FCA had functioned as a part of the System, with limited powers for dealing with financially troubled institutions. The Farm Credit Amendments Act of 1985[3] reconstituted FCA as an arm's-length regulator with enforcement powers that essentially parallel those of regulators of other federally insured financial institutions. Under this legislation, FCA was authorized for the first time to issue cease and desist orders to banks and to remove bank management.

[2]Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems (GAO/GGD-94-14, Jan. 7, 1994).

[3]P.L. 99-205, 99 Stat. 1678.

FCSIC was established under the Agricultural Credit Act of 1987[4] (the 1987 Act) as part of a recovery plan involving federal assistance. The initial capitalization of the FCSIC Insurance Fund was provided by a $260 million transfer in 1989 of government funds that were in a revolving fund and thus available to assist the System.[5] Since that time, the reserves of the Insurance Fund have increased through premiums paid by the System banks and by income earned on its own investments. FCSIC is authorized to assist troubled System banks or the direct lender associations. It is also required to act as conservator or receiver if a System institution fails.

The Insurance Fund is not the last source of investor and taxpayer protection because of the banks' joint and several obligation to repay the insured debt. However, that obligation cannot be invoked until the Insurance Fund has first been depleted. As of December 31, 1995, the amount of outstanding insured debt issued by System banks was $58.5 billion. The Insurance Fund equity balance was $902 million, or about 1.6 percent of the insured debt.

The System's financial condition improved significantly between year-ends 1990 and 1995. Total System capital (excluding Insurance Fund equity) increased from $5.4 billion to $8.8 billion during that period. Combined annual System earnings rose from $0.61 billion in 1990 to $1.2 billion in 1995. The growth of net loans outstanding has been gradual: at year-end 1990, loans were $49.7 billion, increasing to $56.9 billion at year-end 1995.

FCSIC has experienced no significant losses in its regular insurance operations. FCSIC officials have indicated that none of the eight banks is financially threatened at this time, and therefore the Insurance Fund shows no additional provision for other losses. The Insurance Fund balance, which was $298 million in 1990, rose to $902 million as of December 31, 1995. During this period, the ratio of this balance to insured System debt rose from about 0.6 percent to 1.6 percent. The Insurance Fund's year-end 1995 financial statement also reflects a special one-time liability to repay debts that were incurred in 1990 in connection with the federal rescue.[6] As of December 1995, this liability was estimated to be $121 million.

[4]P.L. 100-233, 101 Stat. 1568.

[5]Unlike other federal assistance provided to the System under the 1987 Act, which must be repaid, there is no provision for repaying this amount.

[6]The details of the plan to repay federal assistance were explained in our 1994 report Farm Credit System: Repayment of Federal Assistance and Competitive Position (GAO/GGD-94-39, Mar. 10, 1994).

The 1987 Act requires that FCSIC assess premiums until the Insurance Fund balance exceeds 2 percent of the insured obligations, or such other percentage of the insured obligations as FCSIC in its sole discretion determines is "actuarially sound."[7] This level is referred to as the Secure Base Amount. When the Fund balance, less estimated expenses for the year, exceeds the Secure Base Amount, FCSIC must reduce premiums to an amount sufficient to maintain the Insurance Fund at the Secure Base Amount. FCSIC has projected that the Insurance Fund will reach the Secure Base Amount as early as 1998, assuming that no major losses will occur. However, despite the provisions that could reduce premiums, the Fund is expected to continue to grow because of its investment income.

Prior to 1996, FCSIC had no authority to limit this growth of the Insurance Fund. The Farm Credit System Reform Act of 1996[8] (the 1996 Act) will, in effect, constrain the amount of these excess Fund balances by authorizing FCSIC to make partial distributions of the excess balance each year. These distributions can begin at any point beyond 8 years after the Insurance Fund attains the Secure Base Amount, but not before 2005.

Results in Brief

In 1991, FCA recommended to Congress that FCSIC be authorized to assess the capital of associations, if needed, in order to restore financial soundness to the Fund or a troubled bank. Authorizing FCSIC to assess association capital would, in the short term, provide additional protection to the Insurance Fund, investors in System debt, and ultimately the taxpayers. However, the concerns that formed the basis for this recommendation, such as the limited size of the Fund or the adequacy of capital in System banks, have diminished over time. Moreover, if FCSIC had this authority and tried to implement it during a period of financial stress, there is some risk that the result would be the withdrawal of a significant number of individual member/borrowers from their associations. The System and the Insurance Fund could thus suffer some degree of destabilization instead of benefiting from the additional protection that capital assessments were intended to provide.

Currently, FCSIC premiums are established in law and cannot be increased by FCSIC. FCA also recommended that FCSIC be authorized to charge supplemental premiums to banks in case the Insurance Fund appeared

[7]For the purpose of calculating the amount of insured obligations, FCSIC is required to reduce the actual amount outstanding by a percentage of the System's loans that are guaranteed by the federal government or state governments.

[8]P.L. 104-105, 110 Stat. 162.

inadequate to meet projected needs. While such premiums might appear to be justified if the Insurance Fund experienced major losses, the size of such premiums would likely be limited by adverse industry conditions and competitive considerations at such a time.

The Insurance Fund has completed its start-up phase and is expected to reach the target amount as early as 1998, so that ordinary premiums will likely no longer be assessed. Even so, the Fund is expected to continue growing for several years thereafter because of its investment income. The 1996 Act was designed, in part, to limit the growth of the Fund. However, if the reserves do accumulate as expected, the probability that FCSIC might need to charge supplemental premiums would correspondingly decrease. As a result, authorizing FCSIC to charge supplemental insurance premiums has the potential to be counterproductive in a crisis and does not appear necessary.

Finally, FCA recommended that FCSIC be authorized to incorporate additional risk factors into its premium structure to require higher risk banks to pay higher premium rates. FCSIC premiums are already based in part on credit risk but not on other forms of risk, such as interest rate risk. Giving FCSIC the authority to charge premiums that are more fully based on all risks than at present could create additional incentives for banks to manage risk prudently, because banks that were judged to be riskier would be expected to pay higher premiums. Used in this way, risk-based premiums could be a useful complement to the FCA's risk-based capital requirements.

In our March 1994 report, we recommended that FCSIC be required to repay $260 million in government funds that had been transferred to the Insurance Fund as its initial capitalization. This recommendation is consistent with the overall policy of the 1987 Act that federal assistance to the System be repaid. In recent years, both the growth of the Insurance Fund and the System's recovery have supported the view that these funds are no longer needed. Moreover, because FCSIC pays no interest on the unpaid balance of these funds, it in effect receives a continuing federal subsidy.

Objectives, Scope, and Methodology

Section 204 of the 1992 Act mandated our study of two specific aspects of the Farm Credit System and of FCSIC.[9] First, we were to study the impact on the System of a growing trend toward mergers and consolidations of

[9]Farm Credit Banks and Associations Safety and Soundness Act of 1992, P.L. 102-552, 106 Stat. 4102.

the banks. This trend was described in our 1994 report Farm Credit System: Potential Impacts of FCB Mergers on Farmer and Rancher Borrowers (GAO/GGD-95-19, Dec. 2, 1994). Second, the act required us to study the feasibility and appropriateness of three specific options to increase FCSIC's powers to (1) directly or indirectly assess association capital, (2) assess supplemental insurance premiums, and (3) establish a risk-based insurance premium system. The primary purpose of this report is to fulfill this second part of the 1992 Act's mandate.

To address these issues, we reviewed the statutes and legislative history of FCSIC, our previous reports, and records of pertinent congressional hearings. We identified and reviewed three of FCA's 1991 legislative recommendations that were related to the issues in our mandate. We had numerous discussions with FCSIC and FCA staff and reviewed relevant correspondence, memoranda, legal opinions, and financial statements of the System and of the FCSIC Insurance Fund over the past 6 years. We did not audit or verify these financial data, all of which were provided to us by FCSIC and FCA officials. We reviewed the basis for FCA's 1991 legislative recommendations pertaining to increased powers for FCSIC. We also reviewed a report done by a System task force that presented its response to these FCA recommendations. In addition, we reviewed our previous recommendations from a 1994 report regarding the Insurance Fund to determine whether any that had not yet been adopted should be further considered at this time.[10]

We did our work between June 1994 and March 1996 at FCSIC and FCA headquarters, which are both located in McLean, Virginia, in accordance with generally accepted government auditing standards.

We obtained written comments from FCSIC, FCA, and the System on a draft of this report. We have reprinted their letters in appendixes I through III. The comments are summarized and evaluated at the end of this report.

[10]Farm Credit System: Repayment of Federal Assistance and Competitive Position (GAO/GGD-94-39, Mar. 10, 1994).

FCSIC Access to Association Capital Could Both Provide Some Protection and Cause System Instability

If the Insurance Fund were to be depleted, the next layer of protection against losses for investors in Systemwide debt and for taxpayers is represented by the capital of the eight Farm Credit Banks. In 1991, FCA was concerned that the association capital did not also stand behind this FCSIC-insured debt. For that reason, FCA recommended to Congress in 1991 that association capital be exposed to this debt by authorizing FCSIC to assess the capital of associations, if needed, in order to restore financial soundness to the Insurance Fund or a troubled bank.[11] FCA's concern was that, after 1987, banks had no means of requiring associations to contribute capital to the Insurance Fund.

FCA cited three additional issues in support of its recommendation. Two of these issues have diminished since 1991. First, uncertainty about the System's return to financial health, noted by FCA at the time, is no longer a major concern because the System has recovered significantly. Second, the Insurance Fund, which was very small in 1991, is now approaching the Secure Base Amount. The third concern of FCA was that bank capital had been declining as a percentage of total System capital. This issue could be addressed simply by requiring that the banks maintain, as FCA believes they now do, an acceptable level of capital. However, even if these additional issues are no longer of serious concern, this does not settle the basic question of whether drawing upon the associations' capital is an acceptable way to support the Insurance Fund and the banks, should the need arise.

While the concept of assessing associations to support the Insurance Fund, back up the insured debt, and prevent losses to taxpayers may appear reasonable, it could be difficult and perhaps impractical to implement for three reasons. First, the System structure is such that a System bank does not have the power to require financial support from its member associations, because it does not own them.[12] The situation is additionally complicated by the fact that each of the 228 associations is an independent entity. Association stock is owned solely by its member borrowers, and each association is governed by a board of directors elected from its own membership.

Second, a FCSIC program to assess the capital of associations could result in assessments on well-managed and well-capitalized associations that

[11]As of December 31, 1995, total System capital was $8.8 billion. This comprised $3.2 billion in bank capital and $5.6 billion in association capital.

[12]Banks do have the power to assess member associations for their prorated share of FCSIC premiums. However, revenue from this source would not provide significant support to a troubled bank.

were not responsible for the problems experienced by the less solvent associations. Granting FCSIC the power to distribute capital assessments among the associations would raise difficult questions of equity. More importantly, depending on how it was implemented, this power could create various incentives for behavior that might ultimately diminish investor protection. For example, knowing that their capital might be assessed at some future time, associations would have a disincentive to accumulate any more capital than the regulatory minimum.

Third, the threat of a capital assessment against associations could destabilize even the strongest of them and thus aggravate the condition of an already troubled System. For example, destabilization could result if an association's most creditworthy borrowers—those who were able to obtain credit elsewhere at an equal or lower interest rate—were to prepay loans. These prepayments could reduce the capital of the association through the redemption of these members' stock. In addition, because only the strongest borrowers would likely be able to prepay, the transactions would result in lowering the average quality of the remaining loan portfolio. At that point, to maintain or restore fiscal soundness, the association's loan rates could be expected to rise and its dividends to members fall, making new farm loans difficult to attract. Many associations experienced these problems in the 1980s. While we cannot estimate the probability of this happening again, we regard this potential risk as a major disadvantage of the FCA proposal.

There is also the question of how a capital transfer would be accomplished. In this mandated review, we were asked to comment on a specific type of transaction that might be considered a capital transfer—that is, an association's purchase of additional bank stock, paid for by borrowing under the association's line of credit at the bank. This transaction would transfer capital to the bank. However, the ability of associations to pay the note and remain competitive is questionable. To repay the note, the association would need to increase its earnings—probably by raising rates on loans and reducing dividends to members. If the association proved unable to repay the note, the bank capital that was created by the association's purchase of stock would be decreased.

As an alternative, the association could contribute to its bank certain association assets, such as a portion of its seasoned portfolio of loans with an established record of satisfactory performance. However, several factors might constrain the amount of association capital that could be transferred in this way. These factors include FCA's minimum capital requirements for associations, the minimum amount of assets that associations must have to collateralize their regular borrowings, and the impact of the contribution on the association's future profitability. FCSIC's implementation of assessments that could be paid in this way would require difficult judgments, and would be subject to these constraints.

In summary, the reasons for asking for this power to transfer association capital have decreased in importance with the improvement in the financial condition of both the System and the Insurance Fund since 1991. Both the potential and actual exercise of this power could raise concerns about System stability. Additionally, in our view, it is especially important that FCA set adequate capital standards for the banks and that any problems be promptly identified and resolved to minimize threats to the Insurance Fund. Moreover, it is essential that the associations have adequate capital and be well supervised, because the financial strength of each bank is largely dependent on the health of its member associations.

The Need for Supplemental Premium Authority Has Not Been Demonstrated

FCSIC premiums are established by statute and cannot be increased, regardless of any adverse condition experienced by the Insurance Fund. In 1991, FCA recommended that FCSIC be authorized to charge supplemental premiums to the banks. Such premiums could help the Fund recover more rapidly if large losses were to occur. FCA believed that a major bank failure might result in costs that would overwhelm the Insurance Fund, and that an immediate and possibly very large supplemental premium might be needed to restore Fund soundness. However, in 1995, FCA officials indicated to us that they no longer supported this recommendation. FCSIC officials concurred that supplemental premium authority was not necessary.

We believe FCSIC's position is acceptable for two reasons:

- The cost of a major supplementary premium would have to be passed along to the System's member/borrowers, and this could impair the System's ability to compete or increase its potential for instability.
- The ability of banks to pay supplemental premiums is likely to be diminished at the very time the Fund would be most in need of them, because of the tendency of unfavorable conditions to affect most or all of the banks.

In addition to these factors, the System's recovery and the growth of the Insurance Fund diminish the likelihood that supplementary premium authority is justified. The Insurance Fund balance is now approaching the Secure Base Amount set by the statute, a condition that did not exist several years ago. As of year-end 1995, the balance was $902 million, or about 1.6 percent of the $58.5 billion in FCSIC-insured obligations. In April 1996, FCSIC projected that, if no major losses occur, the Fund will reach the Secure Base Amount as early as 1998. When the Fund exceeds the Secure Base Amount, FCSIC must reduce its annual premiums to an amount sufficient to maintain the Insurance Fund at the Secure Base Amount.

If the System avoids major losses in the next several years and the Insurance Fund reaches the Secure Base Amount, the Fund should continue to grow gradually because of its investment income, even though no premiums are assessed. For example, the Fund had investment income of about $54.7 million in 1995, while administrative operating expenses were relatively minor at $1.4 million.

The 1996 Act provides a mechanism which will, in effect, constrain the future growth of the Insurance Fund. For each year that the Fund balance exceeds the Secure Base Amount, the amount of the excess, after subtracting projected FCSIC operating expenses and insurance obligations for the next year, will be credited to a group of Allocated Insurance Reserves Accounts (reserve accounts) established for each bank. These accounts are still part of the Insurance Fund and available to FCSIC. According to a FCSIC official, the amounts to be credited will be recalculated each year and will replace—rather than be added to—the amounts allocated in the preceding year. The amount of funds in the allocated reserve accounts each year will likely fluctuate, depending upon the annual calculation of the Secure Base Amount and any excess Insurance Fund balance.

Before the 1996 Act was passed, FCSIC had no authority to repay to the banks any balance in the Insurance Fund that exceeded the Secure Base Amount. The 1996 Act authorizes FCSIC to make such repayments to the banks from their respective reserve accounts, beginning at any point beyond 8 years after the date when the Secure Base Amount is first reached, but not earlier than January 2005.[13] In the meantime, FCSIC

[13]The 1996 Act provides for a one-time initial payment that includes, in addition to the regular annual payment, the amounts that would have been payable for each of the preceding 3 years, with interest accrued to the payment date.

projects that the Insurance Fund could continue to grow beyond the Secure Base Amount and that by 2006 the excess balance might be in the range of $250 million to $400 million, or between 0.35 percent and 0.75 percent of insured obligations.

If and when annual payments do begin, they are to include 20 percent of the excess year-end Fund balance, subject to certain conditions and adjustments. Therefore, the Fund should continue to hold more resources than the Secure Base Amount if no major insurance losses occur. Assuming favorable industry conditions continue, these reserves will provide additional protection to investors and are to be allocated at a time when the banks are no longer paying premiums and the industry is doing well. To that extent, such additions are preferable to supplemental premiums that FCSIC might attempt to assess during troubled times.

The need to charge supplemental premiums—like the need to assess the capital of the associations—can best be avoided by strong capital standards and timely and effective supervision of all System institutions. Moreover, the joint and several liability of the banks remains as the final layer of protection to System investors and taxpayers.

Premiums Are Not Based on All Bank Risks

FCSIC already charges risk premiums according to a formula that takes some account of the credit risk in System loans. The annual statutory premium paid by each bank is higher for nonperforming loans (0.25 percent) than it is for performing loans (0.15 percent).[14] In 1991, FCA recommended that FCSIC be authorized to further differentiate the premium structure. FCA recognized that FCSIC could not change the premiums it charged individual banks, although the relative risk to the Insurance Fund could vary by bank. For example, FCA cited interest rate risk, which could result from mismatched maturities of assets and liabilities, as a factor that could expose a bank to major losses if market interest rates changed.

If FCSIC were to charge premiums based on differences in the various banks' capital-to-assets ratio, it would also have a risk-based premium system. This would be similar to the arrangement that the Federal Deposit Insurance Corporation uses to charge deposit insurance premiums to insured thrifts and commercial banks, with the institutions posing the greatest threat to the Insurance Fund—those with the lowest level of

[14]For the purpose of calculating premiums, nonperforming loans are measured at the retail level of individual borrowers rather than at the level of the banks' wholesale loans to its member associations. Premium rates are substantially reduced for performing loans that carry federal or state guarantees.

risk-adjusted capital—generally paying more for their insurance. Under this arrangement, the riskier institutions have a financial incentive to reduce their high premium expenses; they can do this either by maintaining a high level of capital to compensate for the risks they take or by reducing their riskiness. It follows that FCSIC's implementation of risk-based premiums could compensate FCSIC for these non-credit risks where they exist and provide incentives for the banks to properly manage their risks.

There may be a concern that such an arrangement could be used to raise average premiums and thus serve as a back door approach to supplemental premiums. However, if higher premiums were not the goal, the authorization for FCSIC could specify that the total estimated premium revenue raised by the new procedure must not exceed the estimated revenue that would have been raised under the existing premium structure. This would result in increased premiums at higher risk banks and lower premiums at lower risk banks than under the current premium system.

Federal Subsidy of FCSIC Should Be Terminated

In our previously cited March 1994 report regarding the System's repayment of federal assistance,[15] we noted that a $260 million payment of government funds was made to start up the Insurance Fund in 1989. We recommended that Congress require that the funds be repaid to the Treasury. As of April 1996, no action had been taken regarding this recommendation.

This payment of government funds, which represented the Insurance Fund's initial capital, came at a time when the System's capacity to support the Insurance Fund's commitments was in doubt. The payment came from federal revolving funds. The funds were available to FCA to make temporary capital stock investments in System institutions.[16]

The $260 million, together with the investment income that FCSIC earns on it, represents a continuing federal subsidy of the System. Repayment of these funds to the general fund of the Treasury—and not to the former revolving funds—would be consistent with the overall policy of the Agricultural Credit Act of 1987 that the System repay federal aid. Congress

[15]GAO/GGD-94-14.

[16]The federal government provided such start-up capital for System institutions beginning in 1929. All such investments were fully repaid by 1968. Thereafter, the revolving funds were available to FCA until their transfer to the Insurance Fund in 1989.

employed this principle with previous industry-financed insurance funds in the 1950s and in the more recent reform of commercial bank deposit insurance.[17] Moreover, the substantial recovery of the System and growth of the Insurance Fund have made this an opportune time to consider how and when the subsidy should be repaid.

Assuming that a repayment program might extend over a period of years, FCSIC could reduce the federal subsidy by paying interest to the Treasury on the unpaid balance. The Insurance Fund's investments are in U.S. Treasury obligations. A FCSIC official reported to us that the Fund earned approximately $154.8 million in investment income from the time of the federal payment on May 5, 1989, through December 31, 1995. While we do not suggest that these past earnings should also be paid to the Treasury, future investment income will represent a significant continuing annual federal subsidy unless the Insurance Fund begins to pay interest on the $260 million.

Conclusions

From our review of the three specific options for increasing FCSIC's powers recommended to Congress by FCA in 1991, we determined that the first two are not currently needed, but that the third could be useful. Specifically, the first option of authorizing FCSIC to assess the capital of the Farm Credit associations could provide additional short-term protection to the Insurance Fund, investors in System debt, and taxpayers. However, implementing this option could also result in unacceptable destabilization of the System.

The second option, authorizing FCSIC to charge supplemental premiums, does not appear attractive because the amount of revenue that could be raised would likely be limited by adverse industry conditions and competitive considerations. The probable need for such premiums has also been diminished now that the Insurance Fund has completed its start-up phase.

Finally, the third option, authorizing FCSIC to charge premiums that are more fully based on risk, would be a useful complement to FCA's risk-based capital requirements.

In addition, we believe our 1994 recommendation—that FCSIC repay the $260 million in government funds used to start up the Insurance Fund—remains valid. The investment income earned by FCSIC on this

[17]The Federal Deposit Insurance Corporation Improvement Act of 1991, P.L. 102-242, 105 Stat. 2236.

$260 million, or any unpaid balance, represents a continuing federal subsidy, because FCSIC is not required to pay interest to the government. Thus, we also believe that, regardless of whether FCSIC repays the entire $260 million or any part of that amount, paying interest on the unpaid balance would reimburse the government for the use of its funds.

Recommendation to Congress

While we continue to believe that FCSIC should be required to repay the entire amount of government funds, we also recommend that, until this occurs, Congress require FCSIC to pay interest to the government on the unpaid balance of the original $260 million that was transferred to it in 1989.

Agency Comments and Our Evaluation

FCSIC, FCA, and the System (through the Farm Credit Council) provided written comments on a draft of this report. Their comments are reprinted in appendixes I through III. Additional technical comments were provided and have been incorporated throughout the report as appropriate.

All three organizations generally agreed with our conclusions that the options of authorizing FCSIC to assess the capital of associations and to charge supplemental premiums are not needed at this time. However, FCA and FCSIC commented that, under certain circumstances, Congress might want to revisit these issues in the future. These circumstances could include significant deterioration in the System's financial condition or substantial System structural changes, including a continuation of the trend of bank consolidation and mergers.[18] If the number of banks fell substantially, relatively few banks might remain that were subject to the joint and several liability provisions and thus available to share in System losses.

If the System and the Insurance Fund were to experience a financial emergency that called for congressional attention, the issues of capital assessment and supplemental insurance premiums could be raised. The nature of the solution would depend upon the nature of the emergency, and is therefore difficult to predict. While these particular solutions could be a part of the recovery plan that Congress developed, they would be subject to the difficulties we discussed in the report.

[18]See our report Farm Credit System: Potential Impacts of FCB Mergers on Farmer and Rancher Borrowers (GAO/GGD-95-19, Dec. 2, 1994), on System bank mergers.

FCSIC and FCA generally agreed with our conclusion that FCSIC should have the authority to charge risk-based premiums. However, they noted that it would be difficult to develop a premium structure that fully addressed all the risks to which a bank is subject. The System stated its view that the existing risk-based premium structure was not in need of revision. It noted that any alternative to the current premium structure would have to be carefully scrutinized to determine whether it would create specific and appropriate incentives and disincentives for System institutions. Additionally, the System pointed out that, with the anticipated achievement of the Secure Base Amount within the next few years and the resulting suspension of premiums, there would be little benefit gained from the revision of the premium structure at this time. This limitation could be overcome, however, by amending FCSIC's current statutory authority to collect premiums. For example, rather than requiring FCSIC to reduce or possibly suspend premiums when the Insurance Fund reaches the Secure Base Amount, FCSIC could be authorized to assess premiums on banks that posed greater than average risk to the insurance fund, provided that an equal amount were paid to banks posing less than average risk. In that case, while there would be no net premiums charged to the System, relative premiums would be related to relative riskiness.

FCSIC, FCA, and the System expressed concerns about our recommendation to Congress that FCSIC repay the $260 million in government funds used to initially capitalize the Insurance Fund. While neither FCSIC nor FCA disagreed with our recommendation, they both stated that consideration should be given to how the repayment of the $260 million could affect FCSIC's ability to protect investors in System debt. FCSIC also expressed the concern that the immediate payment of the entire $260 million could potentially undermine investor confidence in the Insurance Fund's ability to protect them. We agree that repayment of these funds should be scheduled so that the Insurance Fund is not significantly affected. Thus, repayment could be expected to take several years. Because of the time value of these funds, we believe that the Treasury should receive interest on the outstanding balance. Further, the interest rate should be related to the investment income earned on FCSIC's investment portfolio.

FCSIC stated its belief that the System, rather than the Insurance Fund, was the recipient of the federal subsidy represented by the $260 million in government funds. In our view, the original transfer to the Insurance Fund provided FCSIC liquid resources to assist or close troubled institutions. FCSIC's immediate credibility to investors in Systemwide debt should have been enhanced by this transfer. FCSIC staff has estimated that, from the initial transfer through year-end 1995, the Insurance Fund earned approximately $154.8 million of investment income on these funds. The initial transfer plus this investment income accounts for about $414.8 million, or about 46 percent of the Fund balance at year-end 1995.

In the long run, the System is the primary beneficiary of the transfer, because potential major insurance losses would be paid for in part by funds that the System had not provided. In addition, the Insurance Fund could reach the Secure Base Amount several years earlier than would be true if the transfer had not been received, thus saving the System a significant amount of future premium expense. Investors in insured System debt have also benefitted from the accelerated growth of the Insurance Fund that resulted from the transfer.

The System disagreed with our recommendation, stating that its views had not changed from the time we initially made our recommendation. The System continues to believe that using the $260 million in former FCA revolving funds is consistent with their historical use and does not reduce the industry-financed nature of the Insurance Fund. However, as we noted in our earlier report, the amounts in the revolving fund were not originally supplied by System institutions, but rather by taxpayers in general. Thus, this portion of the Insurance Fund cannot be said to have been industry-financed.

We are sending copies of this report to the Chairman of FCSIC and the Chairman of FCA, as well as to the Farm Credit System's Presidents' Planning Committee. We will also make copies available to others upon request.

Major contributors to this report were Charles M. Roberts, Senior Evaluator, and Edward S. Wroblewski, Senior Evaluator. If you or any of your staff have any questions or comments on this report, please call me on (202) 512-8678.

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Abbreviations

FCA	Farm Credit Administration
FCSIC	Farm Credit System Insurance Corporation

Comments From the Farm Credit Insurance Corporation

Farm Credit System Insurance Corporation

June 13, 1996

Mr. James L. Bothwell, Director
Financial Institutions and Markets
Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bothwell:

Thank you for providing the Farm Credit System Insurance Corporation (Corporation) the opportunity to comment on the draft GAO report entitled Farm Credit System: Comments on Proposed New Insurance Corporation Powers. Our views on the GAO recommendations are outlined below.

GAO Conclusions and Recommendations

See p. 14.

1. *GAO concludes that new Insurance Corporation authority to access the capital of the Farm Credit System (System) associations who own and borrow from the System's banks is not necessary at this time.*

   We agree with your conclusion and share your belief that such authority could create disincentives to building and retaining capital above regulatory minimums at the System's associations. We also share your view that the Insurance Fund can best be protected by establishing and maintaining adequate regulatory capital levels for the System's institutions. However, if the structure of the Farm Credit System changes substantially, the Congress may wish to revisit this recommendation.

See p. 14.

2. *GAO concludes that new Insurance Corporation authority to charge supplemental insurance premiums to the System's banks is not necessary at this time.*

   We agree with your conclusion for the reasons articulated in the draft report.

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See pp. 14 and 15.

3. *GAO concludes that new Insurance Corporation authority to base insurance premiums it charges the System's banks on the relative riskiness of each bank would be a useful complement to the Farm Credit Administration's risk-based capital requirements.*

The GAO report recognizes that the current insurance premium formula incorporates limited risk-based components for differentiating insurance premiums based on credit risk. Providing the Corporation with the authority to base insurance premiums charged to System banks more fully on their level of risk as reflected by their various capital-to-asset ratios could create incentives to modify risky behavior. For example, a bank that was experiencing rapid growth or deteriorating asset quality and not accumulating or retaining adequate capital, might be charged higher insurance premiums than other banks with higher capital-to-asset levels using the approach suggested in the GAO draft report. Since an individual bank's capital represents the first line of defense to any draw on the Insurance Fund, it seems appropriate to charge higher insurance premium rates to those institutions that operate with lower levels of capital (and higher risk profiles) to reflect their greater risk to the Insurance Fund.

Use of the capital-to-asset ratio which the GAO report suggests as a criteria for charging risk based premiums however, might not fully address all of the risks to which a bank is subject. Other risks such as interest rate or market risk, asset concentration risk or operational risk would be difficult to incorporate. For example, other banking regulators have been seeking a common approach to measuring interest rate risk for inclusion in their capital standards for some time with no successful result. Use of the capital-to-asset ratio for risk based premiums might need to be supplemented by some type of a more subjective measure which incorporates these risk factors.

See pp. 15 and 16.

4. *GAO restates a recommendation it made in 1994 that Congress require the Corporation to reimburse the Treasury for its initial capital infusion of $260 million within a reasonable time, taking the financial condition of the System and the Insurance Fund into consideration. The GAO recommendation was expanded to include a requirement for the Corporation to begin to pay interest to the government on the unpaid balance of the $260 million.*

As we commented in our response to this recommendation in the 1994 GAO report, we believe additional research needs to be conducted to determine the effect on the Farm Credit System prior to implementation of any such recommendation. Too short a repayment schedule for the large amounts reflected in your recommendation could have a negative impact on the System and the Insurance Fund and should be considered carefully. Repayment of the $260 million would have constituted 29 percent of the Insurance Fund balance at December 31, 1995. The purpose of the Insurance Fund is to protect investors. An immediate requirement for lump sum repayment could undermine investor confidence, causing an increase in funding costs to the System's borrowers. We note that the FDIC became operational in 1933 and completed its repayment by the early 1950's. The gradual repayment of its initial government capital began when the Bank Insurance Fund exceeded $1 billion.

The discussion regarding the $260 million capitalization on pages 9 and 22 through 24, references at different times that the FCSIC is the recipient of a continuing Federal subsidy

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and that the System is the recipient of this subsidy. We suggest that the report language be consistent and we request that to the extent that the GAO views the initial capitalization as a "subsidy", it is the Farm Credit System that is the beneficiary. We are troubled by the suggestion on page 25 that FCSIC has an "incentive" to hold onto rather than repay this "subsidy." As your report notes on page 4, the initial capital was transferred, pursuant to the Agricultural Credit Act of 1987 (1987 Act), from an FCA revolving fund to the Corporation. The 1987 Act which created the Insurance Fund did not authorize the Corporation to repay these funds to the general Treasury. With the funds came a mandate to reach and then maintain the secure base amount so that the taxpayer would not be required to rescue the Farm Credit System again, as it had been in the mid-eighties.

When these funds were in an FCA revolving fund they were available for emergency assistance, if the Farm Credit System needed it. We believe that the Corporation should also have some type of borrowing capability from the Treasury to serve as a back-up source of funds for liquidity or working capital needs if necessary. The other Federal insurers, the Federal Deposit Insurance Corporation and the National Credit Union Share Insurance Fund have this type of emergency borrowing capability. We would suggest that this authority be based on a specified percentage of insured debt obligations outstanding.

Other Comment

Now on p. 10.

On page 18, the reference to FCSIC projecting that the Fund will reach the secure base amount in 1998 should be revised to "as early as 1998". Recently the Farm Credit System has experienced significant growth in the level of insured debt outstanding to finance increased loan demand. For the 12 months ending May 1, 1996, System insured debt increased 13.5 percent to $61.4 billion from $54.1 billion a year earlier. As the level of insured debt outstanding increases, so does the secure base amount, since it is a percent of the level of debt outstanding. The Corporation has updated its projections over the past year to include multiple scenarios where different growth assumptions are used in doing projections for attainment of the secure base amount. Considering the significant growth over the past year and the higher secure base amount, 1998 is the earliest we currently project attainment. If this growth were to continue, attainment could occur later.

If you have any questions, please contact me at (703) 883-4380.

Sincerely,

Doyle L. Cook

Doyle L. Cook
Chairman

Comments From the Farm Credit Administration

Farm Credit Administration

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FCA
FARM CREDIT ADMINISTRATION

June 17, 1996

Mr. Thomas J. McCool, Associate Director
Financial Institutions and Markets Issues
United States General Accounting Office
1730 Pennsylvania Avenue, NW
Washington, DC 20429

Dear Mr. McCool:

Thank you for the opportunity to provide the U.S. General Accounting Office (GAO) with our response to the GAO's draft Report, "FARM CREDIT SYSTEM: Comments on Proposed New Insurance Corporation Powers" (Report).

See p. 14.

The Farm Credit Administration's (FCA) position is that events occurring since 1991 have significantly diminished the probability that authorities for accessing association capital and charging supplemental premiums would be needed to protect the Insurance Fund and investors in Farm Credit securities. Such events include significantly increased capital levels due to earnings, the voluntary implementation by the Farm Credit System (FCS) of agreements and controls designed to monitor and maintain the adequacy of capital quantity and quality, and substantial progress toward the secure base amount. Although the FCA no longer believes that legislation is needed to implement its 1991 recommendations related to supplemental insurance premiums and access to association capital, the FCA believes that in the event financial conditions deteriorate significantly or the structure of the FCS changes substantially, Congress may wish to revisit these recommendations.

See pp. 14 and 15.

The FCA agrees with the third recommendation that authority to incorporate additional risk factors into the Farm Credit System Insurance Corporation's (FCSIC) premium structure could be a useful complement to the FCA's risk-based capital requirements. However, developing an approach which fully addresses all of the risks to which a bank is subject would be difficult.

See pp. 15 and 16.

With respect to GAO's recommendation that FCSIC repay $260 million to the U.S. Treasury, this is, of course, a decision for Congress. However, we note that the transfer of the $260 million to the Insurance Fund from the FCA Revolving Fund in 1989 was consistent with the purpose for which these funds had been designated since they had been returned from the FCS in 1968, to provide assistance to Farm Credit institutions when needed. The revolving fund served a purpose that is now served by the Insurance Fund. Before Congress decides that these funds are no longer needed, we would urge that the effect on the FCS and its ability to perform its statutory mission be carefully considered.

A listing of suggested technical changes to the Report has been provided to and discussed with members of your staff. Should you have questions or wish to discuss these matters, please contact me or Terry Stevens at (703) 883-4447.

Sincerely,

Marsha Pyle Martin
Chairman and Chief Executive Officer

Comments From the Farm Credit System

THE FARM CREDIT COUNCIL

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June 3, 1996

Mr. Thomas J. McCool
Associate Director, Financial Institutions
and Market Issues
General Government Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. McCool:

On behalf of the Presidents Planning Committee of the Farm Credit System, we are submitting comments on your draft report entitled FARM CREDIT SYSTEM: Comments on Proposed New Insurance Corporation Powers. We would note that your report acknowledges the comments regarding the subject matter of this report previously submitted by the System in May, 1993. We continue to support the thrust of those comments and note that several of your conclusions are consistent with those comments.

See pp. 15 and 16.

In general, we concur with the conclusions of the draft report with two notable exceptions -- it is our view that (1) the existing risk-based premium structure of the Farm Credit Insurance Fund (Insurance Fund) is not in need of revision, and (2) the original capitalization provided the Insurance Fund should be maintained without change.

See pp. 14 and 15.

First, regarding changes to the existing risk-based insurance premium structure, the report notes that the current structure is too rigid, only permitting adjustments to premiums based on whether loans are performing or nonperforming and whether they carry a state or federal guarantee. It is suggested that Farm Credit System Insurance Corporation (FCSIC) be given the flexibility to charge premiums "... based on differences in the various banks'capital-to-assets ratio."

See pp. 14 and 15.

In establishing the existing premium structure, Congress sought to establish a mechanism which would accomplish the following two goals: 1) gather the amount of funds necessary to capitalize the fund while permitting System institutions to remain competitive, and 2) impose some risk-based discipline on System institutions. To impose the discipline, the Congress chose a risk measure that was already captured in System information and which would not be continually open to interpretation and change. While we appreciate the recognition that the existing premium structure does not take into consideration all possible risk factors, we believe that any alternative would have to be carefully scrutinized to determine whether it would create specific and appropriate incentives and disincentives for System institutions. With the anticipated

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See pp. 15 and 16.

achievement of the secure base amount within two years and the resulting mandatory suspension of premiums, there would be little benefit gained from the revision of the premium structure at this time.

Second, the draft report recommends that funds used to initially capitalize the Insurance Fund be repaid to the Treasury. This issue was originally discussed in your report FARM CREDIT SYSTEM: Repayment of Federal Assistance and Competitive Position (GAO/GGD-94-39). In our comments to that report published at pages 100-120, we indicated that "GAO should be satisfied that Congress knew what it was doing when it found that utilizing the revolving funds as a part of the Insurance Fund was consistent with their historical use and did not reduce the 'industry-financed' nature of the Insurance Fund." Our views have not changed.

Since the time of your original report in 1994, Congress has reviewed the operation of the Insurance Fund and made appropriate adjustments in P.L. 104-105, the Farm Credit System Reform Act of 1996. We supported the revisions made in the Insurance Fund even though they will result in a Fund that has available to it assets significantly in excess of the original 2% secure base amount. These excess funds, in addition to the original capitalization, will continue to stand as protection against the need for any future taxpayer assistance to Farm Credit institutions. The Congress has addressed the relevant issues surrounding the Insurance Fund. No further adjustments are appropriate at this time.

We appreciate having this opportunity to respond to the draft report, and we would be pleased to meet with you and your staff to discuss any or all of the comments contained herein.

Very truly yours,

Jerold L. Harris

Jerold L. Harris, Chairman
Presidents Planning Committee

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