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FARM CREDIT SYSTEM

Repayment of Federal Assistance and Competitive Position

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The Honorable Richard G. Lugar
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Subcommittee on Environment,
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Committee on Agriculture
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The Honorable Thomas A. Daschle
United States Senate

This report discusses the Farm Credit System's repayment of the federal financial assistance provided in the late 1980s and its current and future competitive position. This report completes GAO's response to the mandate in the Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624, 104 Stat. 3359) that required GAO to study certain matters related to the cost and availability of credit in rural America.

We are sending copies of this report to other appropriate congressional committees and executive branch agencies, including the Office of Management and Budget; the U.S. Department of Agriculture; the Department of the Treasury; and the Farm Credit System; and to other interested parties, such as the American Bankers Association. Copies of this report will also be made available upon request.

Please contact me on (202) 512-8678 or William J. Kruvant, Assistant Director, on (202) 728-5847 if you or your staff have any questions. Major contributors to this report are listed in appendix VII.

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Executive Summary

Purpose

The Food, Agriculture, Conservation, and Trade Act of 1990 mandated a GAO study of rural credit cost and availability. The mandate included 10 questions; this report addresses 8 of them. The remaining two questions, concerning the availability of rural credit, were addressed in another recent GAO report.[1]

GAO distilled the eight questions into three objectives for the study: (1) whether and how the federal financial assistance granted to the Farm Credit System (System) will be repaid, (2) the extent and fairness of competition between System institutions and commercial banks, and (3) whether the System's charter should be changed to permit diversification.

Background

The System is a government-sponsored enterprise (GSE). A GSE is a private institution chartered by Congress to serve the public purpose of facilitating the flow of funds to a particular sector of the economy, in this case agriculture. The 14 banks and about 250 related local lending associations that the System comprises are cooperatively owned by their member-borrowers. On December 31, 1992, the System reported $63.2 billion in assets, including over $50 billion in outstanding loans. It holds one-fourth of the total U.S. farm debt.

Farmers and their lenders experienced severe financial stress in the mid-1980s. Congress passed the Agricultural Credit Act of 1987 in response to the impact of this stress on the System. It authorized up to $4 billion in federal financial assistance to the System and required extensive structural and operational reforms. The 1987 act also set up the Farm Credit System Insurance Corporation (FCSIC) to insure System debt and to assist System institutions in the future, if needed. FCSIC became fully operational on January 1, 1993.

Results in Brief

The reforms required by the 1987 act and an improving agricultural economy have strengthened the System, whose business is now profitable and stable. Barring another unexpected crisis in agriculture, the System should be able to repay the $1.261 billion in federal financial assistance it received when due early in the next century.

[1]See Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992).

Recent legislation clarified how System banks should accumulate funds for repayment of the 1987 act assistance. However, this legislation continues certain kinds of accounting and regulatory relief. Because of these statutory provisions, neither the public nor the Farm Credit Administration (FCA), the System's regulator, has completely accurate information on System banks' progress toward financial recovery. GAO believes that ending these types of relief would make System banks' true financial position clearer and improve regulatory oversight. GAO found that, as of December 31, 1992, all System banks could still meet minimum regulatory capital standards if these actions were taken.

The 1987 act required the Department of the Treasury to advance the System interest-free funds to pay some of the interest on the bonds issued to raise money for assistance. GAO believes that accounting adjustments are needed to recognize this benefit—estimated to be over $200 million—to System banks. These adjustments, if made, would reduce the System's reported liabilities and, thus, increase its combined capital.

The 1987 act also granted an initial capital infusion of $260 million in taxpayer money to FCSIC. GAO believes that this money can and should be returned to the Treasury so that FCSIC is entirely financed by premiums collected from the System. Congress recently reaffirmed this policy of "industry financing" of federal insurance for commercial banks.

FCSIC's Insurance Fund is counted as a System asset and as System capital in the System's combined financial statements. GAO believes the System should remove FCSIC's Insurance Fund from its combined balance sheet because FCSIC is a federal entity created to assist the System. Since FCSIC is a government agency, its funds are part of the government's budget and should not be counted as System capital. GAO's analysis of relevant accounting rules showed that exclusion of the Insurance Fund from the System's combined financial statements is better supported by generally accepted accounting principles (GAAP) than the current treatment. GAO found that removing FCSIC's Insurance Fund from the System's balance sheet would leave the System with a combined capital ratio of about 10 percent as of December 31, 1992, well above the 7-percent regulatory requirement. Removing the Insurance Fund would have no impact on the financial reports of any individual System bank.

GAO's economic analysis did not reveal evidence of unfair competition by the System. While some System institutions have been lending aggressively, FCA found that such lending was legitimate competition in nearly all cases. GAO examined how FCA investigates complaints of unfair competition and found that the investigations provide a reasonable basis for FCA's conclusions. The System has some cost advantages over small commercial banks. These advantages, however, are the result of the System's GSE status, not unfair competitive practices.

As a GSE, the System's charter is limited to ensure that it fulfills its public policy purpose of serving agriculture. GAO found that the System does not need to diversify beyond agriculture to remain viable in the near term. However, as rural America's financial needs evolve, the System's charter may need to be updated.

GAO's Analysis

System Should Be Able to Repay 1987 Act Assistance

The System used $1.261 billion of the $4 billion in assistance authorized by Congress under the 1987 act. A temporary organization created by the 1987 act, the Farm Credit System Financial Assistance Corporation, raised the funds used for assistance by issuing Treasury-guaranteed 15-year bonds. The money went to aid four Farm Credit Banks, liquidate the Jackson Federal Land Bank, fund certain obligations between banks incurred before the 1987 act, and for miscellaneous authorized purposes. In addition, the Treasury must advance an estimated $444 million to $580 million to pay as much as one-third of the interest on the bonds issued to finance the assistance package. System banks must reimburse the Treasury for these advances in 2005, but are not required to pay interest on these funds. This interest-free loan benefits the System by reducing the burden of assistance repayment on System banks by over $200 million, which is made up by taxpayers.

GAO's analysis of the System's financial condition indicates that System banks can record their assistance obligations as liabilities on their balance sheets and still meet new regulatory capital requirements. In fact, two assisted Farm Credit Banks have paid off their direct aid early. (See pp. 37 and 38.)

New Legislation Continues Accounting and Regulatory Relief for Assistance Repayment

By specifying how System banks should meet their assistance repayment obligations, the Farm Credit Banks and Associations Safety and Soundness Act of 1992 addresses one weakness of the 1987 act. The 1987 act was silent on mechanisms for accumulating funds to repay assistance.

The new law, however, continues to provide both accounting and regulatory relief to the banks. (See pp. 36 to 40.)

System banks are not required to record liabilities for all of their assistance repayment obligations. Since System banks do not record liabilities for all obligations, their reported capital is greater than their actual available capital.

For regulatory purposes, current law allows System banks to count some of the annual assessments deposited with the Financial Assistance Corporation toward assistance repayment as permanent capital until shortly before repayment is required. The banks may also delay making some of these payments to avoid falling below the regulatory minimum for capital. Those that received direct aid can continue to count both this assistance and the amounts they set aside to repay it toward this minimum. These provisions allow the banks to overstate their regulatory capital ratios. Thus, effective regulatory oversight could be compromised.

GAO believes that continuing the accounting and regulatory relief for assistance repayment is inappropriate and unnecessary. GAO's analysis of the impact of eliminating it showed that no System bank would incur serious financial stress or fail to meet regulatory minimum capital requirements as of December 31, 1992.

FCSIC's Initial Governmental Capital Infusion Should Be Repaid

FCSIC has been charging premiums to System banks since 1989. As of December 31, 1992, its insurance fund had a net balance of $488 million after subtracting FCSIC's obligation to pay some of the costs of liquidating the Jackson Federal Land Bank.

The 1987 act transferred $260 million from the Treasury to FCSIC as initial capital for the insurance fund with no requirement for repayment. GAO believes that such insurance funds should be financed from industry sources, not by the government, if at all possible. Nonrepayment of the $260 million is inconsistent with past practice and current policy for federal deposit insurance, which requires insured commercial banks to take responsibility for this protection. In addition, GAO notes that this nonrepayment is a departure from the overall policy of the 1987 act that the System repay federal aid. (See pp. 46 to 48.)

GAO examined what effect repaying the $260 million would have on FCSIC. GAO's projections show that repayment would have only modest effects—postponing achieving the goal for the size of the insurance fund by 3 years (to 2001 instead of 1998).

Insurance Fund Is Inappropriately Counted as a System Asset

The System's combined financial statements include FCSIC's Insurance Fund as an asset and as capital. GAO, the Office of Management and Budget, and FCSIC agree that this is not appropriate. GAO's reasoning is that FCSIC is a federal entity created to provide assistance to the System. In addition, GAO does not believe including FCSIC's Insurance Fund as an asset and as capital in the System's combined financial statements is the most appropriate treatment under GAAP. FCA had agreed with this position, but in December 1993 it accepted a System proposal for additional disclosure on the Insurance Fund in the notes to the System's combined financial statements that, according to FCA, resolves its concerns.

By counting the Insurance Fund as an asset, the System is not well positioned to benefit from future FCSIC assistance should the need for such aid arise. This is because the replacement capital available in the Insurance Fund is, under the System's current accounting treatment, already counted as part of the System's combined capital.

As of December 31, 1992, removing FCSIC's Insurance Fund from the balance sheet would have left the System with combined capital of over $6 billion. This translates to a capital ratio of about 10 percent, compared to about 11 percent if the Insurance Fund is included. The adjustment will become larger if action is delayed because the Insurance Fund will grow. Excluding the fund would have no impact on the financial reports of any individual System bank. (See pp. 48 to 51.)

Is the System an Unfair Competitor?

Congress instructed the System to make loans at equitable and competitive interest rates. The System's GSE status gives it cost advantages. Thus, it has been able to offer loans at rates below those charged by small rural banks (but not by large ones). However, that does not mean that the System is an unfair competitor. According to economic theory, an unfair competitor is one that sets prices below its own cost and prevailing market rates in an effort to damage its competition (often called "predatory pricing"). (See pp. 53 to 59.)

FCA scrutinizes System lenders' loan pricing during annual examinations and investigates complaints of predatory pricing. GAO reviewed all complaints of predatory pricing made to FCA between 1989 and 1991. GAO's review of the files supports FCA's view that none of these complaints was justified. FCA did identify one case of predatory pricing in a 1990 annual examination that did not arise because of a complaint.

The Farm Credit System Assistance Board also monitored unfair competition complaints against the banks it assisted. It did not find examples of unfair competition by these banks.

System and Commercial Bank Interest Rates

GAO compared System and commercial bank interest rates to see if the System consistently offered loans at lower rates. (See pp. 62 to 67.) GAO found that the following interest rates were offered during 1991.

- National average rates on operating loans varied from 8.1 percent at large banks to 10.7 percent at small banks. System operating loans were priced at 9.9 percent on average, fairly near the middle of this range.
- For real estate loans, large banks averaged 9.1 percent and small banks 10.3 percent. System real estate loans averaged 9.5 percent.

Nationwide averages conceal much of the variation in local pricing. This is important because rural banks and local System institutions may compete in fairly small areas. Indeed, unfair competition complaints have come mostly from agricultural banks in the Midwest. GAO did two analyses of rates charged by banks and System institutions in local midwestern markets. The first, for 10 local market areas, showed that most of the System institutions charged less on operating loans at least some of the time in 1991, and none charged higher rates. The second analysis was a statistical test covering a broader midwestern area. This test showed that the System charged an average of 0.59 percentage points less on operating loans and 0.99 percentage points less on real estate loans than small midwestern banks.

Does the System Need to Diversify?

The System's charter is generally limited to serving agriculture. There have been proposals to expand the System's charter to diversify its loan portfolio to increase safety and reduce risk. There have been small expansions of the System's powers, but in no case have the actual or proposed changes been major ones. (See pp. 68 to 71.)

The System's current stability suggests that it does not need expanded powers to promote safety and soundness in the near term. However, rural America's economy is changing. It is shifting away from relying on agriculture and other natural resource industries. At some point, the System's charter may also need to be updated and, if judged desirable in the context of the nation's rural development agenda, expanded to reflect these changes.

Recommendations

GAO recommends that Congress

- require that System institutions record all categories of assistance granted under the 1987 act using the GAAP that best reflects the economic substance of this federal aid;
- provide FCA statutory authority to recognize all categories of 1987 act assistance as temporary, not permanent, capital of System banks for regulatory purposes; and
- require FCSIC 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.

GAO recommends that FCA require the System to exclude FCSIC's Insurance Fund from its combined financial statements.

Agency Comments

GAO requested comments on a draft of this report from the System, FCA, FCSIC, and the American Bankers Association. All four organizations provided written comments, which are summarized and evaluated in chapter 5 and reproduced in appendixes III through VI.

The commenters expressed widely varying opinions on GAO's analysis, conclusions, and recommendations. This final report includes additional analysis, which further supports GAO's positions.

1987 Act Assistance Repayment and FCSIC Issues

The System took strong exception to GAO's positions on the assistance repayment and FCSIC issues discussed in chapter 2, and disagreed with all of GAO's recommendations. FCA, FCSIC, and the American Bankers Association generally agreed with GAO's conclusions and supported GAO's recommendations on these issues.

The System affirmed its support for the assistance repayment framework of the 1992 act. GAO agrees that the 1992 act cleared up important issues, such as how System banks should meet and record their assistance obligations, but GAO continues to believe that the overall framework for assistance repayment can and should be further improved. FCA and FCSIC generally agreed with this position. The American Bankers Association also agreed with these recommendations without comment.

The System urged GAO to withdraw or modify its recommendations regarding FCSIC and the Insurance Fund. In particular, the System urged GAO to recommend that FCA and the System jointly submit the question of how the System should account for the Insurance Fund to the Emerging Issues Task Force of the Financial Accounting Standards Board for resolution. In December 1993, FCA formally accepted a System proposal for additional disclosure on the treatment of the Insurance Fund as System assets and capital in the notes to the System's combined financial statements. According to FCA, this revised form of disclosure on the Insurance Fund resolves its concerns. GAO still believes that this matter needs resolution because it allows the System's financial statements to be inconsistent with FCSIC's concerning the Insurance Fund. GAO also believes that treating FCSIC's Insurance Fund as a System asset and as System capital is inappropriate, both from a public policy and an accounting standpoint.

GAO includes additional analysis of FCSIC issues in appendix I to this final report in response to System, FCA, and FCSIC comments. Both FCA and FCSIC supported GAO's recommendations on accounting for the Insurance Fund, but suggested further analysis be done before they are implemented. (As noted above, FCA has since resolved the FCSIC accounting issue to its satisfaction.) The American Bankers Association also supported these recommendations on the basis that implementing them would promote fairer competition between the System and commercial banks.

Unfair Competition

The American Bankers Association was critical of GAO's analysis of the predatory pricing controversy and urged GAO to reassess its conclusions. ABA's concerns were (1) what predatory pricing definition was actually used for GAO's analysis; (2) FCA's definition of predatory pricing, which ABA contends is contrary to applicable law; and (3) whether the proper economic analysis was used on competition from GSEs. The System stated that it fully concurred with GAO's conclusions. FCA had no comment. FCSIC questioned GAO's conclusion that the System's status as a GSE gives it a cost of funds advantage over commercial banks. GAO clarified certain aspects of its analysis of predatory pricing in this final report, but GAO's position on this issue is unchanged.

Expanding the System's Charter Beyond Agriculture

The American Bankers Association had further reservations about GAO's review of issues surrounding an expansion of the System's charter beyond agriculture. It suggested that GAO focus on whether the System is still necessary to support agriculture, adding that, in its view, the System should be allowed to decline naturally if the answer to this question is no. The System offered additional arguments in support of expanding its powers, but took the position that, overall, there was little that was controversial in GAO's analysis. FCA stated that more work needs to be done to arrive at a final public policy position on expanded powers for the System. FCSIC had no comment. GAO acknowledges these differing views in the text of this final report.

Contents

Related GAO Products

Tables

Figures

Abbreviations

ABA	American Bankers Association
ACA	Agricultural Credit Association
APB	Accounting Principles Bulletin
ARB	Accounting Research Bulletin
BC	Bank for Cooperatives
CIPA	Contractual Interbank Performance Agreement
CPA	capital preservation agreement
FAC	Farm Credit System Financial Assistance Corporation
FASB	Financial Accounting Standards Board
FCA	Farm Credit Administration
FCB	Farm Credit Bank
FCSIC	Farm Credit System Insurance Corporation
FICB	Federal Intermediate Credit Bank
FLB	Federal Land Bank
FLBA	Federal Land Bank Association
FLCA	Federal Land Credit Association
GAAP	generally accepted accounting principles
GSE	government-sponsored enterprise
OMB	Office of Management and Budget
PCA	Production Credit Association
SAB	Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concepts
SFAS	Statement of Financial Accounting Standards
SPE	special purpose entity
USDA	U.S. Department of Agriculture

Introduction

U.S. agriculture underwent a financial crisis in the 1980s following a decade of prosperity. During the 1970s, export markets for farm products grew rapidly, crop yields were good, commodity prices were high, and real interest rates were low. Optimistic about their future incomes and with rapid rises in their land values, farmers borrowed heavily to buy new equipment and increasingly expensive farmland. As late as 1980 and 1981, experts were predicting continued agricultural prosperity. Subsequent events, however, proved these predictions wrong as the positive trends abruptly reversed themselves.

Many farmers were unable to pay their debts. As the value of the collateral securing these debts declined, more agricultural banks failed than at any time since the Great Depression of the 1930s. Unprecedented losses prompted federal financial assistance to the Farm Credit System (System) as well as major structural and operational reforms. Beginning in 1987, increased government spending on farm programs and improved market conditions sparked an agricultural recovery. In recent years, agricultural banks have been among the most profitable in the banking industry. The System is also recovering, although some System institutions are still in transition.

The Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624, 104 Stat. 3359) required us to conduct a 10-point study of certain matters related to the cost and availability of credit in rural America. This report addresses the eight questions on the cost of credit and competition between the major lenders to agriculture: the System, commercial banks, and insurance companies.[1] Chapter 2 describes how the federal assistance to the System was used and how it will be repaid. Chapter 3 covers the controversy over the loan pricing practices of the System and others. Finally, chapter 4 looks at the role and mission of the System and the issue of expanding it beyond agriculture.

Background

The System is a government-sponsored enterprise (GSE). System institutions are now privately owned, but the System was chartered by Congress to serve the public purpose of facilitating the flow of funds to

[1]Another recent GAO report addressed the other two questions, which focus on the availability of credit. See Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992).

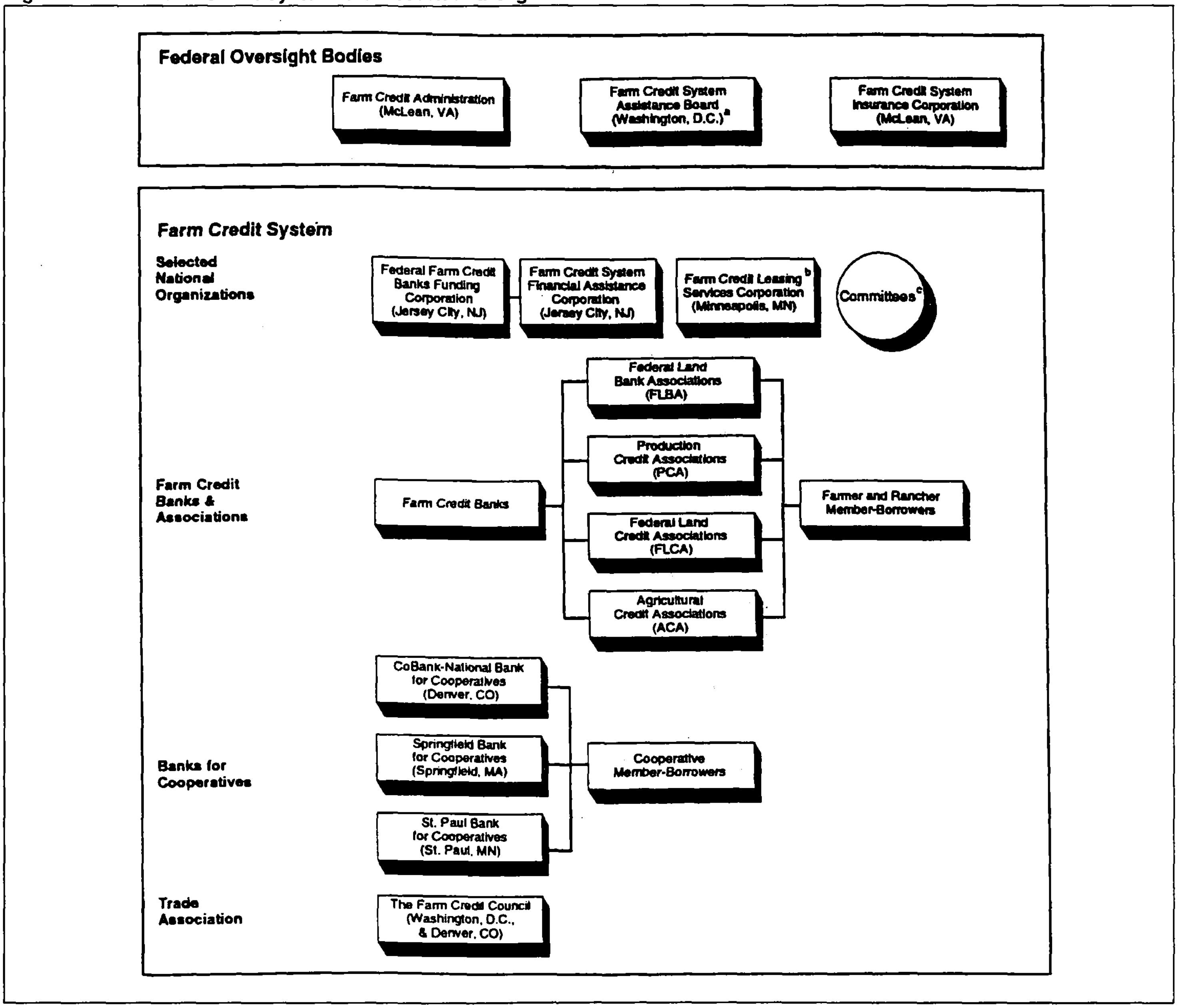
agriculture.[2] System institutions are cooperatives; they are owned by member-borrowers who must buy stock as a prerequisite for borrowing. On December 31, 1992, the System reported $63.2 billion in assets and had $52.4 billion in loans on its books. The System holds about one-fourth of total U.S. farm debt, or approximately $35 billion of the $140 billion reported in recent U.S. Department of Agriculture (USDA) statistics. The System also lends to agricultural cooperatives, rural utilities, rural homeowners, and others.

Like other GSEs, the System raises funds on the national capital markets at a relatively low cost on the strength of its ties to the federal government. Its banks are jointly and severally liable for the Systemwide debt securities they issue through the Federal Farm Credit Banks Funding Corporation (Funding Corporation). The System currently includes 14 operating banks, about 250 related local lending associations, and several national coordinating organizations and committees. Figure 1.1 shows how the System is overseen and organized. The Farm Credit Administration (FCA), an independent federal agency, is the System's regulator.[3]

[2]The System is not a single legal entity, but it is often referred to as "a GSE" for convenience, as we do in this report. The major GSEs are financial institutions chartered by Congress to achieve the public purposes of facilitating the flow of funds to agriculture, housing, and higher education. In addition to the System, these enterprises are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Bank System, and the Student Loan Marketing Association (Sallie Mae).

[3]FCA also regulates the Federal Agricultural Mortgage Corporation (Farmer Mac). Farmer Mac was created in 1988 to sponsor a secondary market in agricultural real estate loans. While Farmer Mac is a System institution, its operations are completely separate from those of System banks and associations.

Figure 1.1: How Farm Credit System Is Overseen and Organized



[a]The Farm Credit System Assistance Board terminated on December 31, 1992, as provided for in the Agricultural Credit Act of 1987.

[b]This entity provides leasing and related services to eligible System borrowers, including agricultural producers, cooperatives, and rural utilities.

[c]These standing committees include the Presidents Planning Committee, which is composed of the presidents of System banks, the Funding Corporation, and the Farm Credit Council. This committee is not subject to federal oversight.

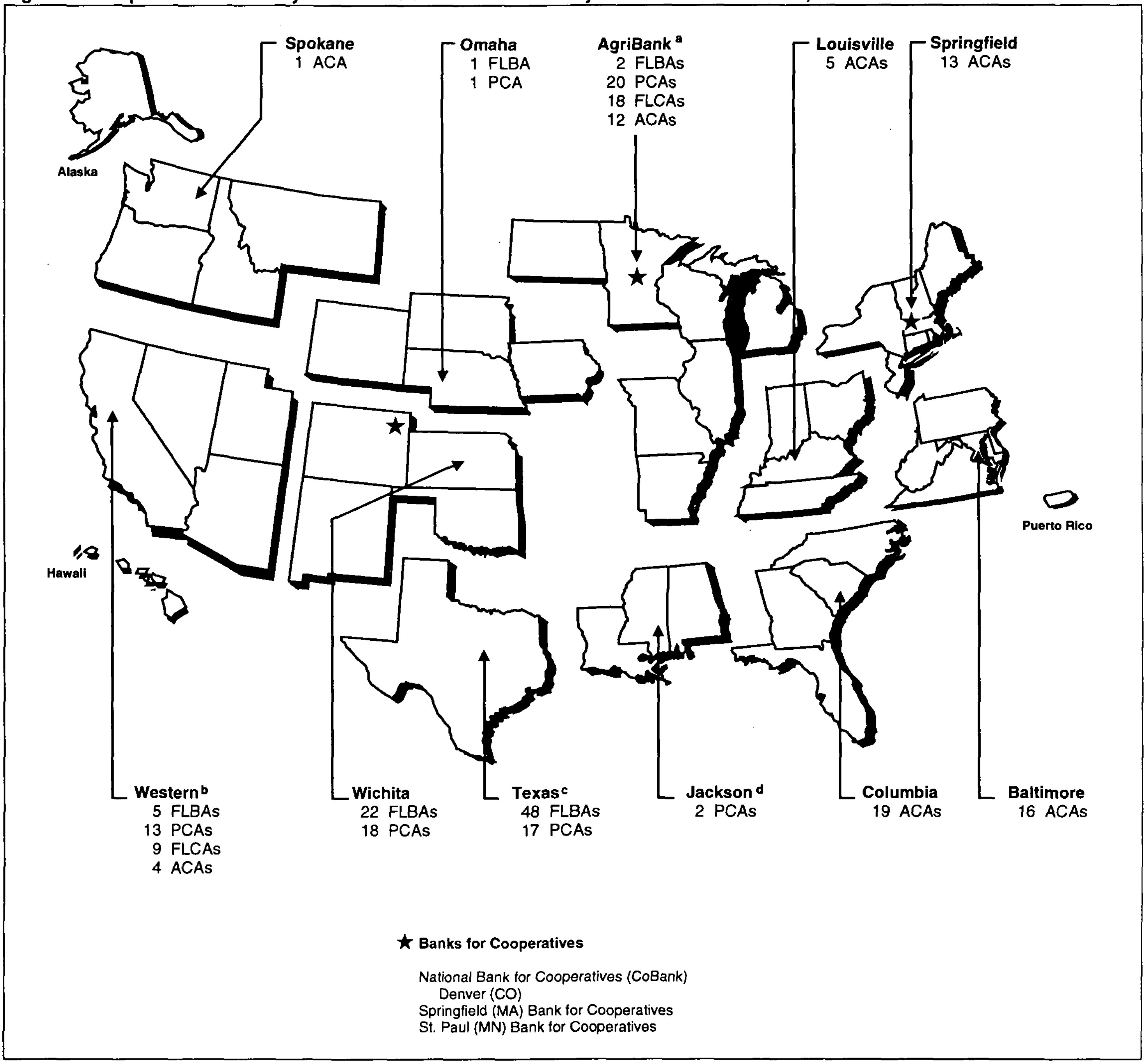
Source: Prepared by GAO.

The core of the System was established between 1916 and 1933. Historically, the System was organized in 12 districts, each of which contained 3 legally distinct types of banks supported by 2 types of associations. In 1916, Federal Land Banks (FLB) and related associations, later known as Federal Land Bank Associations (FLBA), were authorized. Federal Intermediate Credit Banks (FICB) were set up in 1923, and related Production Credit Associations (PCA) were authorized in 1933. Also in 1933, 12 district Banks for Cooperatives (BC) and a Central Bank for Cooperatives were created. The federal government provided start-up capital for all System institutions. After the start-up funds were fully repaid by the FICBS, PCAS, and BCS in 1968, the amounts remained available to FCA in revolving funds to make temporary capital stock investments in these institutions if necessary.

The Farm Credit Act of 1971 (P.L. 92-181, 85 Stat. 583) codified the law governing the System and updated and expanded its charter. Responding to the System's financial crisis, Congress made important amendments to this law in 1985 and 1986 and when it passed the Agricultural Credit Act of 1987 (P.L. 100-233, 101 Stat. 1568).[4] The 1987 act mandated certain structural changes in the System and encouraged others. It required all FLBS and FICBS to merge to form Farm Credit Banks (FCB), permitted the BCS to consolidate, and allowed other mergers between banks. The number of operating banks has since dropped from 37 to 14. The 1987 act also encouraged FLBAS and PCAS that shared substantially the same geographical territory to merge into a new type of association known as an Agricultural Credit Association (ACA). FLBAS could convert to Federal Land Credit Associations (FLCA) and become direct lenders to farmers like other types of System associations rather than act as agents for FCBS. The number of associations had fallen from over 400 in the mid-1980s to 246 as of October 1, 1992. Figure 1.2 is a map of the System banks and their related associations.

[4]Other amendments were made between 1989 and 1992. When we refer to the "Farm Credit Act" in this report, we mean the Farm Credit Act of 1971, as amended.

Figure 1.2: Map of Farm Credit System Banks and Associations by District as of October 1, 1992



[a]AgriBank was formed in May 1992 from the merger of the St. Louis and St. Paul FCBs, resulting in 11 System districts.

[b]The Western FCB also funds a PCA in eastern Idaho.

[c]The Texas FCB makes long-term loans in Alabama, Louisiana, and Mississippi. It also funds certain PCAs in New Mexico.

[d]The Jackson FLB is in receivership. The Jackson FICB merged with the Columbia FCB in 1993.

Source: FCA data.

Federal Assistance to the System During the Mid-1980s

The System experienced severe financial stress in the mid-1980s. The problems came from a combination of external and internal factors: deterioration in agriculture, increased volatility of interest rates, and poor management practices. In 1985, the System reported a record $2.7 billion loss, followed by a $1.9 billion loss in 1986, prompting a qualified opinion from its external auditors as to its ability to continue operating without assistance.

FCA established the Farm Credit System Capital Corporation (Capital Corporation) in June 1985 to administer contractual loss sharing/capital preservation agreements between System banks. Amendments to the Farm Credit Act passed in December 1985 formalized the Capital Corporation and authorized it to receive and administer federal financial assistance from the Treasury. Such assistance would have had to be appropriated by Congress. These amendments also authorized FCA to use amounts available in the revolving funds discussed earlier—combined into a single fund of $260 million—to purchase stock in the Capital Corporation. Before the 1985 amendments were enacted, the System's cost of issuing debt had increased dramatically relative to that of other GSEs. It quickly fell once this federal support for the System was made available.

The 1985 amendments provided that federal assistance was only to be considered after the System's surplus (retained earnings) was so low that further contributions from stronger System banks or losses at weaker ones would likely preclude them from making credit available on reasonable terms. The stronger System banks transferred over $1 billion to weaker ones during 1985 and 1986. However, several healthy System institutions challenged in court the requirement that they subsidize unprofitable institutions they did not control. In some instances, the courts upheld the challenges. By mid-1986, the System's cost of funds had again begun to rise, reflecting continuing losses and investors' uncertainty over whether the federal assistance authorized by the 1985 amendments would, in fact, be provided.

In October 1986, Congress again amended the Farm Credit Act. These amendments, among other things, authorized System banks to delay recognition of certain expenses and losses and to disregard generally accepted accounting principles (GAAP) in doing so.[5] We reported that we had serious reservations about relying on legislatively sanctioned regulatory accounting to deal with the System's problems. We wrote that it could not only seriously overstate the earnings of System banks, but also slow reforms in management practices and operations.[6] In fact, the accounting relief did not substantially delay the need for federal financial assistance.

The System was able to continue borrowing throughout its financial crisis, but only at a relatively higher cost than it had historically. The rates on the System's 6-month securities peaked at roughly 115 basis points over comparable Treasury securities in 1987 before a new set of federal assistance mechanisms became law.[7] In the 1987 act, Congress authorized issuing up to $4 billion in Treasury-guaranteed bonds to fund assistance to the System. It also required the Treasury to advance some of the interest payments on these bonds. Bonds worth $1.261 billion were actually issued and must be repaid along with Treasury interest advances estimated at $444 million to $580 million. The 1987 act established two temporary, special-purpose entities to carry out the assistance program. It also chartered another new entity to insure the System's debt and to provide assistance to troubled institutions in the future, if needed. These entities, which are discussed further in chapter 2, are described below.

Two Temporary Entities Carry Out 1987 Act Assistance Program

The Farm Credit System Assistance Board (Assistance Board) was the successor to the Capital Corporation and sunset on December 31, 1992. Unlike the Capital Corporation, the Assistance Board was independent of both the System and its regulator. Its board of directors was composed of the Secretaries of Agriculture and the Treasury and a farmer nominated by the President and confirmed by the Senate. The Assistance Board aided four FCBS: Louisville, Omaha, St. Paul, and Spokane. It also authorized

[5]The System began preparing its combined financial statements using GAAP at year-end 1985 and has continued to do so since that time.

[6]See Farm Credit: Actions Needed on Major Management Issues (GAO/GGD-87-51, Apr. 1, 1987).

[7]See pp. 83-89 of our previous report, Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990), for a more complete discussion of how GSEs' federal ties influence their ability to continue borrowing even when they experience serious financial difficulties and are perceived to be in danger of failing. On p. 88 of that report, we presented a graph illustrating the System's and Fannie Mae's cost of funds relative to comparable Treasury debt between 1980 and 1989.

assistance for the liquidation of the Jackson FLB. FCA placed this bank in receivership in May 1988 at the Assistance Board's request.

With the approval of the Assistance Board, the Farm Credit System Financial Assistance Corporation (FAC), the other temporary organization, raised the funds used for assistance by issuing Treasury-guaranteed 15-year bonds. FAC is a System institution with the same board of directors as the Funding Corporation. When FAC's authority to issue debt expired on September 30, 1992, it had raised $1.261 billion. FAC, not the individual System banks and associations, booked the liability for this debt. However, the law contemplates that System banks will provide the funds to repay it. In 2005, System banks must also repay the Treasury for advancing up to $580 million or about one-third of the interest payments on these bonds. They are responsible for the remaining interest payments when due. The amount of interest to be advanced by the Treasury depends on the System's overall financial condition between now and the year 2000. FAC estimated in 1991 that the Treasury interest advances will add up to only $444 million, but they could be as much as $580 million. These advances provide an economic benefit to the System and involve a corresponding cost to taxpayers that we estimate at over $200 million. The recent Farm Credit Banks and Associations Safety and Soundness Act of 1992 (P.L. 102-552, 106 Stat. 4102), among other things, authorizes a new assistance repayment plan.

Insurance Corporation Became Fully Operational in 1993

The 1987 act also established the Farm Credit System Insurance Corporation (FCSIC). It insures the debt issued by the System and may provide financial assistance to troubled System institutions in the future. FCSIC's board of directors consists of the same persons that make up FCA's board.[8] FCSIC became fully operational on January 1, 1993, after the Assistance Board terminated. System banks have been paying premiums to build up the Farm Credit Insurance Fund (Insurance Fund), which FCSIC controls, since 1989. The Insurance Fund has, in effect, already been tapped to liquidate the Jackson FLB.

The 1987 act provided that the "joint and several liability" of the System banks for Systemwide debt securities cannot be invoked until the Insurance Fund is exhausted. In other words, an individual System bank may still be called on to absorb losses incurred by another bank, but only after all the money in the Insurance Fund has been used. Thus, the

[8]The chairman of FCSIC's board cannot be the same person as the chairman of FCA's board, however. FCSIC's board will consist of different persons than FCA's board beginning in 1996. By law, no members of either FCSIC's or FCA's board can be affiliated with any System institution.

Insurance Fund is the first but not the only source available to cover such losses. The target or "secure base" amount of the Insurance Fund is 2 percent of insured obligations or about $1.1 billion based on the current level of insured System obligations. FCSIC may set a different target size for the Insurance Fund if necessary to make it "actuarially sound." As discussed further in chapter 2, with premium and investment income of over $100 million annually, we project the Insurance Fund could reach its secure base by 1998, if no further claims are made. The Insurance Fund had a net balance of $488 million as of December 31, 1992.

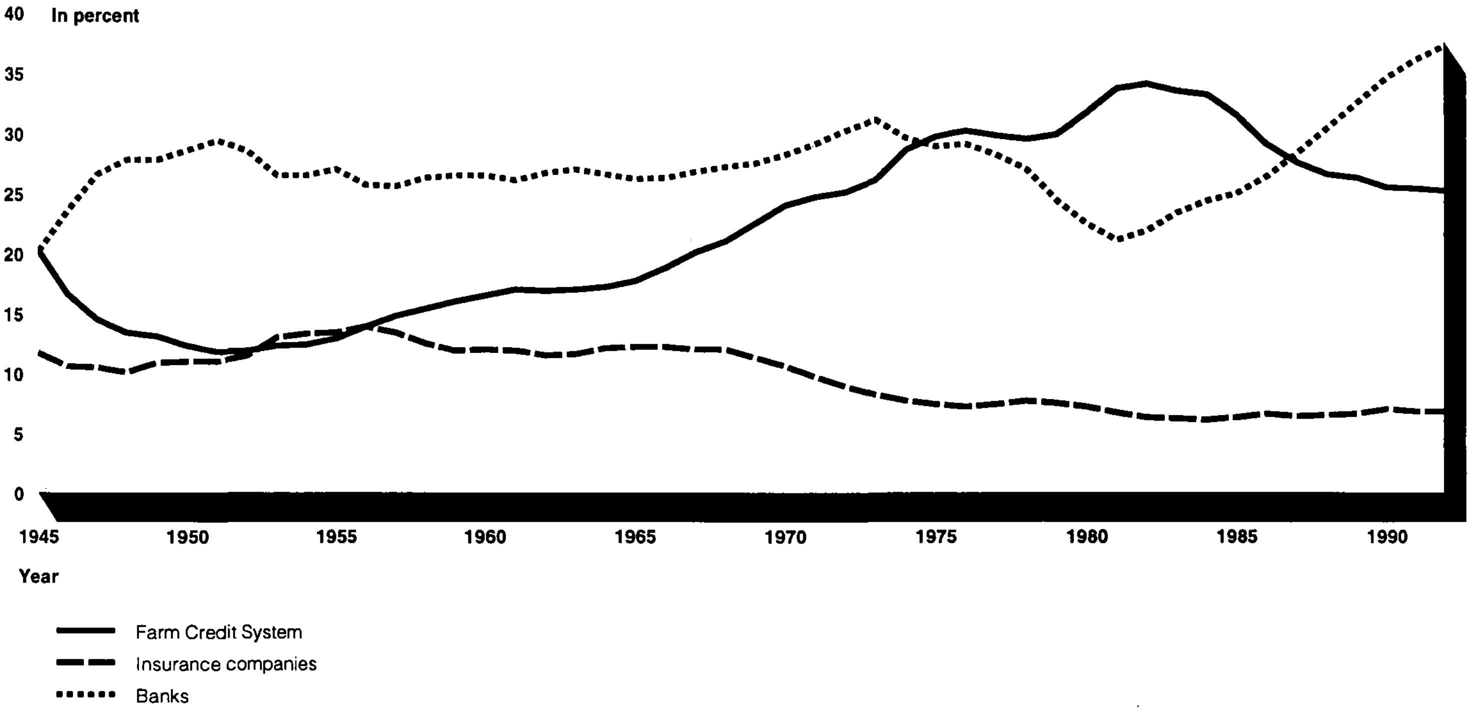
The balance of the Insurance Fund was reduced in 1990 when FCSIC booked a liability in anticipation of repaying a significant portion of the $388 million in FAC debt issued to liquidate the Jackson FLB.[9] The balance remained positive, however. This was due to the premiums which had accrued and because $260 million of taxpayer money—the amount in the revolving fund previously available to FCA to help assist the System through the Capital Corporation—had been transferred to FCSIC as initial capital in 1989. Unlike the other federal assistance provided to the System under the 1987 act, there is no provision for repaying this amount.

Causes of the System's Financial Stress

The System participated in the 1970s agricultural boom, experiencing dramatic increases in loan volume and market share. Between 1971 and 1982, farm debt held by the System rose from $14.2 billion to a high of $69.2 billion, and its market share increased from 25 percent to a peak of 34 percent. As figure 1.3 shows, the System was the largest agricultural lender during much of this period.

[9] According to our projections, FCSIC will have to repay about $250 million of this debt. (See ch. 2.)

Figure 1.3: Historical Market Shares of Major Agricultural Lenders, 1945-1992



Source: USDA.

Two factors contributed to the System's growth. First, the Farm Credit Act liberalized collateral requirements for System loans. Like many other agricultural lenders, many System institutions decided how much to lend based more on the value of the collateral (such as land) securing the loan than on the borrower's ability to make loan payments from current income. Second, and perhaps more importantly, the System sought a larger market share by offering interest rates below those of its competitors.

System institutions priced loans based on the average or historical cost of their outstanding debt, not the marginal or current cost of funds as most other lenders do. Also, most System institutions offered a single rate for each type of loan to all borrowers, regardless of their creditworthiness. FCA approved all System loan rates in advance. Market interest rates generally rose during the 1970s and early 1980s. But average-cost pricing allowed the System to offer loans with rates well below those of its competitors. For example, in 1980, System rates on operating loans averaged 12.74 percent—more than 2 percentage points lower than the 15-percent average rate charged by small commercial banks. As a result, the System's loan volume and market share grew rapidly.

The System financed this increased loan volume partly by issuing long-term, fixed-rate, noncallable securities. However, most System loans carried monthly variable rates, and borrowers could prepay them without penalty. When market interest rates declined in the mid-1980s, many System banks were locked into high-cost debt and could not lower variable loan rates enough to remain competitive without incurring heavy losses.[10] As a result, many of the most creditworthy borrowers left the System and refinanced their loans elsewhere.

The 1986 amendments to the Farm Credit Act removed FCA's authority to approve System loan rates. This change was consistent with the 1985 amendments, which established FCA as an independent, "arm's-length" regulator. The 1986 amendments also, in effect, allowed System banks to use regulatory accounting to mask the impact of the high-cost debt on their books and thereby lower loan rates. However, the policy section of the 1986 amendments provided that the System should not use this new flexibility or regulatory accounting to lower its rates below competitive market levels. The System soon abandoned average-cost pricing and offering one rate to all borrowers in favor of "differential pricing" programs. Most System institutions now take borrowers' relative creditworthiness into account in setting loan rates, which are based on their current cost of funds.

As we previously reported, the System has made a serious effort to improve its asset/liability management practices, which include loan pricing practices.[11] Complaints from other agricultural lenders about unfair or unsafe System loan pricing practices persist, however. Most complaints are based on the competitive advantages that accrue from the

[10]In September 1986, about $30 billion or half of outstanding System debt carried interest rates of 10 percent or more. By that time, interest rates on new System bonds had fallen to about 7.5 percent. Most of this high-cost debt has either matured or has been retired—only about $3 billion remained outstanding in late 1992, or about 5 percent of System liabilities. Most of the direct assistance provided to the four FCBs was used to pay the premiums and associated costs necessary to restructure high-cost debt.

[11]See Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

System's GSE status or on the fact that System banks have been granted regulatory and accounting relief for their assistance repayment obligations. We explore this controversy further in chapter 3.

System's Financial Condition Has Improved

The amount of debt farmers owed shrank by about one-third during the mid-1980s, with the System experiencing a larger decline than others. Total farm debt has stayed at about $139 billion to $140 billion for the past several years and is expected to grow only slowly in the 1990s. Although the System is no longer the largest agricultural lender, its loan volume and market share have now stabilized.

Beginning in 1989, the System began to show profits from its lending operations. Reported net income was $695 million in 1989, increasing to $986 million in 1992. Reported returns on assets ranged from about 1 percent in 1989 to 1.57 percent in 1992. These returns are roughly comparable to those of the commercial banks that lent heavily to agriculture during this period. This improvement in core earnings has enabled the System to rebuild its capital base. All System banks and all associations reported compliance as of June 30, 1992, with FCA's new 7-percent minimum regulatory capital adequacy standard. This standard became final on January 1, 1993, when a 5-year phase-in period ended.

Although we identified some questionable accounting and regulatory treatments that we believe have overstated earnings and capital levels, there has been real improvement in the System's financial condition and performance. To encourage continued improvement, all System banks signed a Contractual Interbank Performance Agreement (CIPA) that became effective on January 1, 1992. CIPA establishes performance standards for the banks to achieve by the year 2000.

According to System officials, CIPA standards are comparable to those nationally recognized rating organizations use to assign "A-" ratings to debt issued by commercial banks. In 1990, the Treasury proposed that all GSEs operate so as to obtain the highest available "AAA" ratings to reduce risk to the federal government. The System responded that it would be virtually impossible for it to do so because lending to agriculture is considered a high-risk business. We review some of the issues surrounding an expansion in the System's charter beyond agriculture in chapter 4.[12]

[12]When we refer to the "System's charter" in this report, we mean the basic charter of the System as described in the Farm Credit Act.

Objectives, Scope, and Methodology

As noted above, we prepared this report in response to eight legislatively mandated questions on the cost of credit in rural America. We distilled the eight questions into three objectives for this study: (1) whether and how the federal financial assistance granted to the System will be repaid; (2) the extent and fairness of competition between commercial banks and System institutions, the two largest providers of agricultural credit; and (3) whether the System's charter should be changed to permit diversification. We met several times to discuss our approach with two trade organizations that represent the System and commercial banks: the Farm Credit Council and the American Bankers Association (ABA). We also met with staff of the USDA Economic Research Service and other academic researchers, to discuss the agricultural credit market in general, and reviewed recent USDA and other publications.

To answer the questions concerning assistance repayment, we reviewed the statutes and legislative history on assistance, previous GAO and other studies (see Related GAO Products at the end of this report), and records of pertinent congressional hearings. We then did work at FCA, the Assistance Board, FAC, the Funding Corporation, FCSIC, and selected System banks, including three of the four assisted FCBs. In doing this work, we had numerous discussions with officials and reviewed relevant documents such as correspondence, memoranda, agreements, legal and accounting opinions, minutes of board meetings, business plans, and financial statements and examination reports for the years 1989 to 1992. We also discussed assistance repayment issues with an official of the Office of Management and Budget (OMB). To prepare our response to agency comments on a draft of this report, specifically the System's, FCA's, and FCSIC's comments on Insurance Fund accounting issues, we prepared an analysis of relevant accounting literature and had discussions with officials of these organizations. This analysis is presented in appendix I.

To address the questions on competition, we analyzed management and regulatory information on the loan pricing practices of the System, commercial banks, and insurance companies. We focused on the Midwest because most complaints of unfair competition against System institutions originated there. We reviewed these complaints for the years 1989 through 1991 at FCA and the Assistance Board as well as selected FCA examination reports on System banks and associations for the same period. We also interviewed officials and received data on loans made during 1991 from the FCBs in St. Louis, St. Paul, and Omaha. We obtained data on loans made by commercial banks operating in the Midwest for the same year from the Federal Reserve Board. Our statistical analysis of the 1991 data is discussed further in appendix II. In addition, we met with representatives of the Nebraska Bankers Association and the Nebraska Independent Bankers' Association to discuss their March 27, 1990, testimony on "predatory pricing" by System institutions. We discussed this testimony with System and FCA officials. We also interviewed officials at commercial banks that are members of state banking organizations affiliated with ABA in Illinois, Kansas, and Wisconsin. To get the perspectives of insurance companies, we interviewed officials at five of the six companies that have at least $1 billion in agricultural loans outstanding.

To answer the question on diversification by changing the System's charter, we reviewed the statutes and regulations that govern it as well as records of recent congressional hearings and legislative proposals. We also discussed these proposals with the Farm Credit Council and ABA.

The System, FCA, FCSIC, and ABA provided written comments on a draft of this report. These comments are presented and evaluated in chapter 5 and are reprinted in appendixes III through VI.

We did our work between July 1991 and July 1993 in accordance with generally accepted government auditing standards.

Federal Assistance to the System and Repayment Plans

The Farm Credit Banks and Associations Safety and Soundness Act of 1992 sets up mechanisms for repayment of the federal assistance the System received in the mid-1980s. Under the 1992 act, System banks must periodically deposit funds with FAC toward the eventual repayment of much of this assistance. The new law clears up some important issues, but accounting and regulatory weaknesses remain. We make recommendations to address these weaknesses. We recommend that Congress require reimbursement of the initial infusion of $260 million in taxpayer money that was transferred to FCSIC as start-up capital for the Insurance Fund. Not doing so is inconsistent with Congress' policy requiring "industry financing" of federal insurance funds by other financial institutions. It is also a departure from the 1987 act's overall policy that the System repay federal assistance.

In addition, we agree with OMB and FCSIC that the insurance premiums System banks pay to FCSIC do not belong to the System. The insurance premiums are not amounts voluntarily set aside as "self insurance" as the System suggests. FCA had agreed with this position until recently when it accepted a System proposal for revised disclosure on the Insurance Fund in the notes to the System's combined financial statements that, according to FCA, resolves its concerns. In considering this insurance premium issue, we recommend that FCA require that FCSIC's Insurance Fund be excluded from the System's combined financial statements. Acting on this recommendation would reduce the System's reported combined capital, but would better position the System to benefit from FCSIC assistance in the future if the need for such aid arises.

Overall, making the changes we recommend would, according to our estimates, have still left the System with a combined capital ratio of over 10 percent as of December 31, 1992. Going forward, we believe taking action to resolve the accounting issues surrounding FCSIC's Insurance Fund is particularly important. If this is not done, we believe the System's combined earnings, assets, and capital for 1993 and beyond may be materially overstated.

Federal Assistance to the System Under the 1987 Act

The 1987 act set up a complicated framework for federal financial assistance to the System involving the Assistance Board, FAC, the Treasury, System banks and associations, and FCSIC. It authorized FAC, with Assistance Board approval, to issue up to $4 billion in 15-year, Treasury-guaranteed bonds to fund the assistance. The 1987 act also required the Treasury to advance additional funds to cover some of the interest payments on these bonds. FAC issued $1.261 billion in bonds, paying a weighted average interest rate of about 9.24 percent to investors. We estimate the effective cost to the System to be under 7 percent, assuming it repays the assistance by 2005 as anticipated.

The System's combined financial statements do not clearly present certain benefits of the 1987 act program. The 1987 act allowed the System banks that received most of the assistance—about two-thirds of the total—to treat it as a capital investment by FAC. By law, System banks are, in effect, allowed to postpone paying dividends on FAC's capital investment in individual banks. During the first 10 years this investment is outstanding, the Treasury must advance an estimated $444 million to $580 million to FAC so that it can, in turn, make interest payments to investors in the debt issued to raise money to buy stock in troubled System banks. All System banks must eventually provide funds to reimburse the Treasury for these advances, but they are not required to pay for the use of these funds. Thus, taxpayers are providing an economic benefit to System banks that reduces the effective cost of capital assistance to about 6 percent. Paying for this form of aid also involves System "self help": by law, directly assisted System banks must pay a share of the cost of capital assistance, and other System banks must make up the difference. When the 9.42-percent rate on the remaining assistance and FCSIC's obligation to absorb some of the costs of the Jackson FLB liquidation are taken into account, the effective cost to all System banks of repaying the federal aid provided under the 1987 act can be estimated at about 6.81 percent.

The economic benefit to the System associated with the Treasury interest advances involves a corresponding cost to taxpayers since these funds cannot be used now for other public purposes, even if System banks repay them later as planned. Currently, we estimate the benefit to the System at $229 million to $264 million. The ultimate benefit depends primarily on the total amount of interest (or dividend) payments the Treasury makes on System banks' behalf. This, in turn, depends on the financial condition of the System as a whole over the next few years. As the System's condition improves, this benefit declines. The ultimate cost to taxpayers depends not only on these factors, but also on market interest rates. Currently, we estimate this cost at $209 million to $243 million.

When FAC invested in troubled System banks, these banks reported an increase in capital. However, all System banks were granted accounting and regulatory relief under the 1987 act that allowed them to avoid reflecting the costs of the assistance program in their individual financial statements. Our analysis shows that all System banks have now recovered to the point that they can fully acknowledge their assistance repayment obligations.

How Assistance Was Funded

FAC issued $1.261 billion of debt to fund assistance to the System before its statutory authority to do so expired on September 30, 1992. This debt consists of several FAC bonds, all issued between July 1988 and September 1990. Table 2.1 shows the issue dates, interest rates, principal amounts, and maturity dates of these bonds.

Table 2.1: Cost of Bonds Issued to Fund 1987 Act Assistance

Issue date	Interest rate (percent)	Principal amount (in millions)	Maturity date
July 1988	9.375	$450	July 2003
November 1988	9.45	240	November 2003[a]
April 1989	9.50	157	April 2004[a]
June 1990	8.80	325	June 2005
September 1990	9.20	89	September 2005[a]
Wtd. avg./Total	**9.24**	**$1,261**	

[a]These FAC bonds, a total of $486 million, are callable in whole or in part at par after 10 years.

Source: GAO.

How Assistance Was Used

The funds raised through the sale of FAC bonds were used to provide four categories of assistance. The Treasury's commitment to advance interest payments on the FAC bonds is currently treated as a fifth assistance category. These categories are described further below.

Table 2.2 shows the amounts of the five assistance categories and the approximate dates on which each must be repaid. It also illustrates that the 6.81-percent effective cost to the System of this assistance is less than the 9.24-percent cost of the FAC debt issued to fund it. Expressed in dollars, this difference is the estimated $229 million to $264 million benefit to the System associated with the Treasury interest advances.

Table 2.2: Effective Cost to System Banks of 1987 Act Assistance

Assistance category	Effective cost (percent)[a]	Principal amount (in millions)	Repayment date
CPA payables	9.42	$417	July 2003 to April 2004
Assistance preferred stock	6.22	419	July 2003 to September 2005
Jackson FLB liquidation	4.71[b]	388	July 2003 to June 2005
Other uses	6.15	37	July 2003
Wtd. avg./Total	**6.81**	**$1,261**	
Treasury interest advances	N/A	$229-264[c]	September 2005

[a]These costs were calculated based on the mid-point of the discounted cash flow yields for the various categories, including the FAC projected and maximum Treasury interest advances. In 1991, FAC estimated the actual amount advanced by the Treasury would be $444 million. The maximum amount the Treasury could have to advance is $580 million.

[b]This figure is based on the System's cost net of our projections of FCSIC's estimated liability for repaying, at its maturity, much of the principal portion of the FAC debt issued to fund the Jackson FLB liquidation.

[c]The $229 million to $264 million range shown in the table is based on the FAC projected Treasury interest advances and the maximum advances. These figures equal the net present values of the cash flows among the Treasury, FAC, and System banks, discounted at the rates on the underlying FAC bonds. The estimated cost to taxpayers of $209 million to $243 million is the net present value of these same cash flows discounted at a current market rate of 7 percent.

Source: GAO.

The first assistance category involves proceeds from the July 1988 and April 1989 sales of FAC bonds. Most of these funds were used to make payments of $417 million that the healthier System banks would otherwise have had to make to weaker banks under their capital preservation agreement (CPA) for the third quarter of 1986 (CPA payables).

The second assistance category concerns direct assistance to particular System banks. Between November 1988 and September 1990, with the approval of the Assistance Board, FAC sold more bonds and raised additional funds to purchase a total of $419 million of assistance preferred stock in the FCBs of Louisville, Omaha, St. Paul, and Spokane. Buying the stock was the mechanism used for funneling assistance to these banks.[1]

[1]To get Assistance Board certification to receive assistance, these four FCBs agreed to significant operating changes and reporting requirements. The terms of these agreements regarding loan pricing are discussed further in chapter 3.

The third assistance category also concerns a particular System bank. The Assistance Board asked FCA to place the Jackson FLB in receivership, and FCA did so in May 1988. FAC issued a total of $388 million in debt to liquidate this bank, again providing funds through the mechanism of buying assistance preferred stock in it. Most of the FAC debt for the Jackson FLB liquidation was issued in June 1990. As discussed later in this chapter, FCSIC has assumed responsibility for repaying the principal portion of this debt at maturity. Meanwhile, the Treasury and the System will continue to pay interest on it.

The fourth assistance category, Other uses, is relatively small. It consists of the remaining $37 million of FAC debt proceeds. This money was used for other purposes permitted by the 1987 act, such as paying the operating expenses of the Assistance Board.

The fifth and last assistance category is the Treasury interest advances. On all FAC debt except that issued to fund the CPA payables, the Treasury must advance all interest due during the first 5 years that the bonds are outstanding. The Treasury must also pay up to 50 percent of the interest on these bonds during the second 5 years, and System banks must pay the remainder. During the last 5 years, System banks must pay all interest when due. In 1991, FAC estimated that the Treasury interest advances will total $444 million, but they might be as much as $580 million.[2] When the last FAC bond matures in 2005, FAC must reimburse the Treasury for these advances, using funds collected from System banks. As shown in table 2.2, the $229 million to $264 million benefit associated with the advances reduces the effective cost of assistance to System banks. For the reasons discussed earlier, this benefit to the System involves an economic cost to taxpayers that we estimate at about $209 million to $243 million.

Who Must Repay Assistance

FAC makes the principal and interest payments to the investors who hold FAC bonds by collecting the necessary funds from System banks, the Treasury, or FCSIC.[3] Figure 2.1 shows which organizations are responsible for providing these funds. It also notes that System banks will provide

[2]System banks are paying all of the interest on the $417 million in FAC debt issued to fund the CPA payables. The Treasury is advancing interest payments on the other $844 million in FAC debt. During the second 5 years these bonds are outstanding, the Treasury share of the interest payments will drop and the System's share will increase by 10 percent for each 1 percent that the unallocated surplus of the System as a whole exceeds 5 percent of assets. We calculated that on December 31, 1992, unallocated surplus was equal to 6.1 percent of the System's reported total assets.

[3]Under the 1987 act, System associations were required to help repay the Other use assistance and Treasury interest advances. The 1992 act gives the FCBs responsibility for all of their related associations' assistance repayment obligations.

funds to FAC so that it can reimburse the Treasury for the interest payments it must make during the first 10 years most FAC bonds are outstanding.

Figure 2.1: Organization Responsibilities for Repayment of FAC Debt for Assistance

	Payments on FAC debt			
	Interest			
Assistance categories	1st 5 years	2nd 5 years	3rd 5 years	Principal
CPA payables	Banks	Banks	Banks	Banks
Assistance preferred stock	Treasury	Treasury[a] Banks[b]	Banks	Assisted FCBs[c]
Jackson FLB liquidation	Treasury	Treasury[a] Banks[b]	Banks	FCSIC
Other uses	Treasury	Treasury[a] Banks[b]	Banks	Banks
Treasury interest advances	Banks	Banks	N/A	

[a]Treasury's share of interest payments in the second 5 years could be up to, but not exceed, 50 percent.

[b]The System's share of interest payments in the second 5 years is set at 50 percent. This percentage can increase based on a formula using the System's amount of unallocated surplus to its assets.

[c]FCSIC must provide funds to repay the principal amount of these FAC bonds if the assisted FCBs do not do so.

Source: Prepared by GAO.

The 1987 act structured assistance so that System banks and associations were not required to book any significant liabilities. However, since FAC's accounts are included in the System's combined financial statements, FAC debt appears as a liability on the balance sheet prepared for the System as a whole.

The System's combined financial statements currently show a liability for the full face amount of FAC debt,[4] without adjusting for the more than $200 million of economic benefit associated with the Treasury interest advances. In our view, it would have been more appropriate and meaningful for the System to report an increase in capital for this benefit when it was initially granted. We believe FAC (and System banks) should still make this accounting adjustment.[5]

Mechanisms for Assistance Repayment

Under the 1987 act, there was no formal mechanism for System banks to accumulate funds for assistance repayment and neither the public nor FCA could easily chart their progress toward financial recovery. Acknowledging that the framework of the 1987 act left many significant accounting and regulatory issues undefined, the System banks formed a work group in early 1991 to develop an assistance repayment plan and took some steps toward implementing it at the end of that year. In addition, during 1992, two of the four assisted FCBs redeemed their assistance preferred stock early.

The 1992 act incorporates the System's assistance repayment plan with some minor modifications. It expands FAC's role in assistance repayment. FAC must begin to collect and invest annual assessments from System banks to accumulate funds for the eventual repayment of the CPA payables assistance and the Treasury interest advances. The 1992 act also contains provisions regarding assistance preferred stock. We describe the mechanisms for repayment of each category of assistance in this section. These mechanisms continue to provide accounting and regulatory relief to System banks.

[4]FAC debt was sold to investors at a price slightly below 100 percent of the face amount of the bonds to adjust for the difference in the bonds' stated interest rates and market interest rates at the moment of issuance. Therefore, the System's balance sheet actually shows slightly less than the full face amount of FAC debt.

[5]As discussed in Accounting Principles Bulletin (APB) No. 21, Interest on Receivables and Payables, when debt is issued on market terms, the face amount is equivalent to the present value of future interest payments plus the present value of the principal to be repaid at maturity. FAC debt was not issued on market terms, from the System's point of view, because the Treasury interest advances on certain FAC bonds provide an economic benefit to FAC, which is passed through to System banks. Therefore, in accordance with APB No. 21, FAC should have recorded a liability for less than the full face amount of these FAC bonds by establishing a related discount and accreting it over time.

CPA Payables

System banks must pay all principal and interest on the FAC bonds issued for the CPA payables, just as they do on the debt securities they issue in the normal course of business.[6] However, in a departure from GAAP, the law states that the FAC debt issued for the CPA payables cannot be reported as a liability of any System bank. As discussed in more detail later, the System calculates the unrecorded liability based on only the principal amount due at maturity, resulting in a lower figure for each bank's share of the debt than we used in our analysis.

The 1992 act required System banks to enter into agreements to make annual payments to FAC, beginning no later than December 31, 1992, toward the eventual retirement of the debt issued for the CPA payables.[7] These annuity-type payments, plus the interest FAC earns on investing them, are designed to accumulate to 90 percent of the principal amount of the underlying FAC debt by the time it matures in 2003 and 2004. The banks must then pay the remainder. These payments will reduce the banks' unrecorded liabilities for the CPA payables over time. However, the banks may reschedule their payments if making them would reduce their capital below the regulatory minimum. The 1992 act does not limit the number of times payments can be rescheduled.

Assistance Preferred Stock

The law contemplates that the FCBs that received direct aid in the form of assistance preferred stock will provide funds to repay the underlying FAC debt when due by redeeming the stock. It also gives these banks the option not to redeem the stock at that time or to redeem it early.[8] Because of these provisions, recording the assistance as capital rather than as a liability of the assisted FCBs (and the Jackson FLB) can be justified under GAAP. However, GAAP allows for a different treatment than these banks currently use that more clearly reflects the economic substance of this

[6]The banks share in these payments pro-rata based on the size of their (and their associations') portfolios of accruing "retail" loans to farmers. This avoids double-counting for the "wholesale" loans the FCBs make to the associations that lend directly to farmers.

[7]The three BCs have had such agreements in place and have been making these payments to FAC since 1990. The Texas FCB began to set funds aside during 1991 in anticipation of doing so. The Spokane FCB was not required to begin making these payments to FAC until December 31, 1993.

[8]Before an assisted FCB redeems its stock, the law requires FCA, in consultation with the Treasury, to certify that the FCB will remain viable after it does so. An assisted FCB that is so certified can still choose not to redeem the stock. If it does not or cannot redeem the stock before the underlying FAC debt matures, the law requires that it pay what is, in effect, a punitive dividend rate. Until that time, the law characterizes the stock as paying no dividends.

direct aid, while still allowing them to treat all of it as capital.[9] We believe this alternative treatment also better reflects the benefits and costs of early redemption of assistance preferred stock.

During 1992, two of the four assisted FCBs received Assistance Board, FCA, and Treasury approval to arrange with FAC to redeem their assistance preferred stock early. In September 1992, at a cost of $47.7 million, the Omaha FCB purchased Treasury zero-coupon securities that will fully cover the $107.2 million in FAC debt underlying the bank's stock when it matures in 2003. The Omaha FCB recorded the $59.5 million difference as surplus. The bank transferred the Treasury zero-coupon securities to FAC, which placed them in a trust. The underlying FAC debt remains outstanding, and the Treasury continues to advance interest on it. AgriBank, which was created from the merger of the St. Paul and St. Louis FCBs in May 1992, completed a similar transaction in December 1992. AgriBank had $133.4 million in assistance preferred stock outstanding before the transaction in which it transferred securities worth $59.4 million to FAC and recorded $74 million as surplus.

The Omaha FCB and AgriBank together redeemed about $240 million, or about one-half of the total of this assistance category, and recorded about $134 million as surplus. By redeeming their assistance preferred stock early, these two banks, in effect, realized the economic benefit of not having to pay dividends on this stock at market rates.

The 1992 act requires assisted FCBs to set aside earnings in special "appropriated unallocated surplus" accounts so that they will be able to redeem assistance preferred stock when the underlying FAC debt matures.[10] The appropriated surplus remains "at risk" and can be used to absorb future losses, but only after the other retained earnings of the assisted FCBs are exhausted.

Jackson FLB Liquidation

Because the Jackson FLB is in receivership and will not redeem its assistance preferred stock, FCSIC will repay the principal portion of the

[9] As discussed in Securities and Exchange Commission Staff Accounting Bulletins (SAB) Nos. 64 and 68, redeemable preferred stock that is not issued on market terms should be booked at its fair market value. That is, the book value of such stock should be adjusted by the difference in a market dividend rate and the actual dividend rate. This difference is then recorded as part of surplus or retained earnings, or as paid-in capital.

[10] The assisted FCBs (except the Spokane FCB) began to use the 1992 act formula at year-end 1991. Under the 1992 act, the assisted FCBs must target annual set asides equal to the greater of (1) one-fifteenth of the assistance preferred stock or (2) one-third to one-half of earnings as called for in their agreements with the Assistance Board.

underlying FAC debt at maturity. This arrangement parallels the default provisions on assistance preferred stock specified by law. It is spelled out in a contract among FAC, FCSIC, and other interested parties signed in April 1990. FCSIC will meet this obligation by first using all amounts available in the FAC Trust Fund, then tapping its Insurance Fund. We project that FCSIC will have to use at least $250 million from the Insurance Fund in the years 2003 and 2005 as a result of the Jackson FLB liquidation.[11]

Other Uses

System banks must repay the relatively small amount of Other uses assistance when due early in the next century. Each bank already records a liability for its share of the principal portion of this obligation on its balance sheet. As discussed later, we believe the banks should record liabilities for both the principal and the interest portions of the Other uses assistance. Under the 1992 act, the FCBs must assume responsibility for their related associations' shares of this obligation as for all other assistance categories.

Treasury Interest Advances

The 1987 act empowered FCA, in consultation with the Treasury, to decide how to handle repayment of the Treasury interest advances once the principal amount of the FAC debt had been paid off, requiring only that System institutions share the cost "on a fair and equitable basis." Because of the difficulty of making a reasonable estimate of how much each of them would ultimately have to repay, System banks and associations did not record any liabilities for the Treasury interest advances. While this decision may have been justifiable under GAAP, it did not result in a meaningful accounting for these obligations.

Recognizing this, System banks and associations, with FCA's concurrence, began to record liabilities for the Treasury interest advances at year-end 1991. However, they recorded liabilities only for the advances that had been made so far, not the estimated total. As discussed in more detail later, we do not believe the Treasury interest advances should be presented as a separate category of assistance. Instead, the economic

[11]The FAC Trust Fund contains the proceeds of the sale of nonredeemable FAC stock to healthy System institutions required under the 1987 act, less the amounts refunded to them in accordance with 1988 and 1989 amendments to the law. The FAC Trust Fund is to be used to cover defaults on assistance obligations. With a December 31, 1992, balance of about $73 million, it will grow to about $136 million in 2005 assuming it is invested at 5-percent interest and no further defaults on assistance occur. This would leave FCSIC to cover about $252 million of the $388 million cost of liquidating the Jackson FLB when the FAC debt underlying the assistance preferred stock it issued matures between 2003 and 2005.

benefit associated with these advances should be reflected in the accounting entries for other assistance categories.

Under the 1992 act, the banks must make annual annuity-type payments to FAC, beginning on or about December 31, 1992, toward the eventual repayment of the Treasury interest advances.[12] These payments will offset the banks' recorded liabilities over time, but the 1992 act also permits System banks to ignore the impact of these transactions on their regulatory capital ratios until the year 2000.[13] In effect, this allows both assisted and nonassisted banks to count their shares of the $444 million to $580 million face amount of Treasury interest advances as regulatory capital.

Weaknesses in Assistance Repayment Mechanisms

By specifying mechanisms for System banks to accumulate funds to meet their assistance repayment obligations, the 1992 act addresses one weakness of the 1987 act. As described above, the 1992 act sets forth schedules for amounts to be set aside to repay three large categories of assistance. This will provide some discipline to System banks in planning for their repayment. The 1992 act mechanisms also provide assurance to interested parties, including the System banks themselves, that funds for repayment will be readily available when needed. However, the new law still provides both accounting and regulatory relief to the banks. They can continue to avoid recording the real costs of assistance now and can continue to count it as permanent capital for regulatory purposes.

We think this relief is inappropriate and unnecessary. We strongly supported the reforms of the mid-1980s that were designed to put the System on a solid basis of financial accounting so that its member-borrowers, investors, and the government would know the true financial condition of System institutions.[14] We do not believe the new law

[12]Initially, FAC will calculate the banks' payments based on its estimate of the total amount of interest the Treasury will advance. The exact total of the Treasury interest advances will not be known before the year 2000. Until that time, the 1992 act establishes a range for the size of the banks' annual payments. They must be equal to between 4 and 6 basis points of the banks' (and their related associations') loan volume. After the year 2000, FAC can adjust the payments up or down depending on the actual amount of the Treasury interest advances and on how much it has already collected from the banks. The Spokane FCB is not obligated to begin making these payments to FAC until December 31, 1993.

[13]In 2000 and 2001, the banks can continue to count 60 percent and 30 percent of the Treasury interest advances, respectively, as regulatory capital. By 2002, when they must fully acknowledge the impact of the related liabilities on their balance sheets in calculating their regulatory capital ratios, the annuity-type payments will likely have offset most or all of these liabilities.

[14]See Farm Credit: Actions Needed on Major Management Issues (GAO/GGD-87-51, Apr. 1, 1987).

goes far enough to achieve this objective. Although the 1992 act mechanisms will reduce the overstatement of System banks' capital positions in time, the public and FCA do not currently have completely accurate information on their financial condition.

Similarly, as we recently reaffirmed in our 1991 report on GSE regulation,[15] we believe FCA should be able to exercise the full range of powers granted to it as an independent, arm's-length regulator of the System in 1985. Among the key authorities we believe a regulator should have is the ability to set minimum capital requirements. The elements of regulatory capital should include only those items that protect the government's financial interests. Assistance preferred stock, for example, does not meet this criterion since FCSIC and the Treasury are exposed to risk of loss on this investment should System banks be unable to repay it. Another key authority a regulator should have is the ability to act in a timely manner to ensure compliance with these regulations through a clear, fair, and reasonable process. Following these principles would help ensure that System banks meet their assistance repayment obligations while operating in a safe and sound manner. Again, in our view, the 1992 act falls short of this goal.

System banks have agreed to CIPA standards that more clearly recognize the impact of assistance repayment obligations on their capital positions. However, we believe it would be unwise to rely on CIPA as a substitute for federal regulation. CIPA is an arrangement between the banks that they can and probably will modify from time to time. The banks did not successfully deal with the financial stress of the mid-1980s through the Capital Corporation or other interbank arrangements. It was this failure that led to the need for federal assistance and intervention in the first place.

In this section, we first discuss the System's analysis of the effects of the 1992 act provisions regarding assistance and present our analysis of the banks' financial statements as of December 31, 1992. Our analysis shows that eliminating the accounting and regulatory relief is feasible. It demonstrates that all System banks can now meet minimum regulatory capital standards under our recommendations. We then review several regulatory relief provisions of the 1992 act that we believe should be reconsidered.

[15]See Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

Eliminating Accounting and Regulatory Relief Is Feasible

As part of the development of its new repayment plan, which was incorporated in the 1992 act, the System work group requested that each bank project its financial condition and performance through the year 2005 when the last of the assistance must be repaid. The work group then analyzed the impact of the plan on the banks' regulatory capital ratios. This analysis showed that several System banks would have regulatory capital ratios near 20 percent over many years; one assisted FCB attained a ratio of over 50 percent by the time its assistance had to be repaid. These ratios are well in excess of FCA's 7-percent minimum and are due in part to projected real improvements in the banks' capital positions. However, some of this apparent improvement is explained by accounting and regulatory relief. We independently performed an analysis similar to that of the System work group. Using more conservative assumptions about growth in System loan volume and earnings distributions, we reached the same general conclusion that the work group did. We found that all System banks could meet and many could substantially exceed the minimum regulatory capital requirement.[16]

We also analyzed how our proposals for improving the regulatory and accounting treatment of assistance repayment obligations would have affected System banks as of December 31, 1992. To do this, we adjusted the banks' published financial statements and the regulatory capital ratios they reported to FCA based on what we believe to be a more realistic accounting treatment of their assistance obligations. First, we assumed that System banks directly acknowledged the self-help aspects of the 1987 act assistance program by recording liabilities to FAC related to all banks' shares of the dividends on assistance preferred stock at the below-market rates that represent the effective cost of this capital. Second, we adjusted the regulatory capital ratios of the assisted FCBS to avoid counting both the face amount of the assistance preferred stock and the amounts contained in related surplus accounts as regulatory capital. Finally, we credited all System banks for the amounts they have so far deposited with FAC toward repayment of the Treasury interest advances and the CPA payables assistance. We then computed new regulatory capital ratios for all banks.

Our results, presented in table 2.3, show that all banks would have been able to meet FCA's final 7-percent minimum regulatory capital requirement that took effect on January 1, 1993. These results illustrate that putting

[16]We must emphasize that we did not attempt to predict the actual performance of the System over the next 15 years. Neither our analysis nor the banks' projections takes the possibility of another 1980s-style financial crisis in agriculture into account. Our analysis also did not take other unpredictable events, such as last year's midwestern floods, into account. Such adverse conditions could, of course, impair the ability of System banks to meet their assistance repayment obligations.

System banks on a sound basis of financial accounting for assistance obligations would not subject any of them to serious financial stress.

Table 2.3: Regulatory Capital Ratios of System Banks Before and After Eliminating Accounting and Regulatory Relief as of December 31, 1992

In percent

Bank	Reported	Adjusted
Springfield FCB	9.4	7.2
Baltimore FCB	13.5	8.3
Columbia FCB	19.7	16.8
Louisville FCB	14.7	11.7
Jackson FICB	14.5	13.7
AgriBank	9.3	8.3
Omaha FCB	10.1	8.6
Wichita FCB	14.6	13.1
Texas FCB	15.6	13.6
Western FCB	10.9	8.9
Spokane FCB	9.9	8.2
Springfield BC	9.7	9.4
St. Paul BC	10.1	9.0
CoBank	9.7	8.2

Source: Prepared by GAO.

Changes Needed in System Accounting Treatment for Assistance

Currently, System banks account for most payments they are required to make to FAC as if each were a separate, noninterest-bearing obligation that was unrelated to how assistance was used. GAAP requires recording noninterest-bearing liabilities at their present values and is flexible enough to justify treating transactions between related parties, such as System banks and FAC, according to their legal forms.[17] The System's treatment relies on the fact that the law does not specifically characterize the FAC debt issued to fund the CPA payables assistance as a direct obligation of the banks and separately discusses the banks' responsibilities for the principal payments and the interest payments on the FAC debt issued for Other uses. System officials also concluded that only the Treasury interest advances made to date needed to be recorded as liabilities by the banks and FAC. This accounting treatment does not recognize that the Treasury, FAC, and System banks have well-defined future legal rights and obligations to each

[17]In 1991, we recommended that GAAP be clarified to require such transactions to be accounted for based on their economic substance. See Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991), pp. 32-33.

other related to these advances. The treatment we suggest recognizes these rights and obligations.

We believe the treatment we suggest is more appropriate because it better reflects the economic substance of the 1987 act assistance. Some of the assistance is clearly a loan from FAC. Therefore, we believe System banks should record it as a liability in the usual way. As noted earlier, all banks are required to pay both the principal and the interest on the FAC debt underlying the CPA payables assistance when due, just as they are on the debt securities they issue in the normal course of business. In our view, this loan from FAC should not be treated differently. System banks should record it as a liability at its face amount. The same is true of the other use assistance, except that the Treasury is currently advancing interest on these FAC bonds. Therefore, System banks should record this liability at less than its face amount to reflect the economic benefit of these advances.[18]

The preferred stock issued by the assisted FCBs and the Jackson FLB should reflect the accounting treatment discussed earlier regarding the benefits associated with this stock. They and other System banks also have related obligations that need to be accounted for: they must supply FAC with funds to make interest payments on the debt issued to fund the original stock purchase. We adjusted all banks' balance sheets to reflect these liabilities to FAC.

In summary, the System's accounting treatment for most categories of assistance may be in accord with a legal form and as a result may arguably be a justifiable alternative under GAAP. However, in our view, this treatment does not accurately reflect the economic substance of the transactions and is therefore not the most appropriate or meaningful GAAP alternative for the assistance the banks received under the 1987 act.

Changes Needed in Regulatory Capital Provisions of the 1992 Act

As noted earlier, the 1992 act maintains the regulatory relief granted under the 1987 act, permitting System banks to continue to disregard most of the costs of assistance and to count it as permanent regulatory capital over a long period. We believe continuing this relief is inappropriate because, from the point of view of protecting the government's financial interests, the federal assistance granted under the 1987 act is a temporary form of capital.

[18]To do this, System banks should follow APB No. 21, the accounting guidance discussed in footnote 5 of this chapter.

CPA Payables and Treasury Interest Advances Provisions Do Not Correct Regulatory Capital Distortions

Under the 1992 act, System banks can reschedule their annuity payments to FAC for the CPA payables apparently without limit if making these payments reduces their capital below the regulatory minimum. Thus, a weak bank could, in principle, both avoid regulatory sanctions and postpone these payments until 2003 and 2004 when the underlying FAC debt is due. Such a bank would then face a large liability and reduction in capital. Delaying regulatory intervention in cases like these would, we believe, be counterproductive.

Another problem concerns the payments and liabilities for the Treasury interest advances. As mentioned earlier, the 1992 act allows System banks to, in effect, count these advances as permanent capital[19] for regulatory purposes until the year 2000. These amounts, however, are not capital: they are shown as expenses (that is, reductions in capital) in System banks' financial statements.

If System banks make their annual payments to FAC as scheduled for the CPA payables and Treasury interest advances, the overstatement in their capital positions will not increase and, after the year 2000, will disappear. However, neither the public nor FCA will have accurate, readily available information on System banks' financial condition for the next several years. Also, since banks that are in fact weak could appear to have adequate capital for some time to come, FCA might not have sufficient regulatory basis for taking prompt action to require them to correct their performance problems or for enforcing changes if banks protest. For those reasons, we believe that these provisions of the 1992 act are imprudent and should be reevaluated. System banks, in their CIPA program, imposed stricter standards for these categories. Their CIPA program increases the capital standards banks must meet to compensate for these liabilities posing as capital.

Assistance Preferred Stock Provisions Result in Serious Distortion of Regulatory Capital

The law does not permit FCA to acknowledge that the assistance preferred stock is, from the point of view of protecting the government's financial interests, a temporary form of capital. Until they redeem it, the assisted FCBS can continue to report the stock as capital on their balance sheets, along with disclosures as to its terms and conditions. However, we believe the amount of assistance preferred stock that counts as regulatory capital should be reduced to zero as the maturity date of the underlying FAC debt approaches. Otherwise, a serious distortion in the remaining assisted FCBS' regulatory capital positions will develop over time. The reason for this is

[19]Permanent capital for most financial institutions is defined by regulation, rather than by statute. The definition of permanent capital for System institutions is set out in section 4.3A(a) of the Farm Credit Act.

that both the face amount of assistance preferred stock and the funds set aside to repay it under the 1992 act mechanisms described above count as regulatory capital.

We believe the law should be amended so that FCA has the authority to address this. The System banks, in designing their CIPA program, agreed that counting both the face amount of assistance preferred stock and the appropriated surplus set aside to repay it was an inappropriate way to measure progress toward achieving higher levels of financial condition and performance. In calculating compliance with CIPA, the capital of the assisted FCBs is reduced by a fixed amount each year to eliminate the double-counting.

FCSIC Issues

FCSIC became fully operational on January 1, 1993, when the Assistance Board sunset. On December 31, 1992, it reported total assets of $656 million. Besides its initial capital of $260 million, FCSIC had collected or accrued about $400 million in insurance premiums and investment income. As discussed earlier, FCSIC will take responsibility for repaying the $388 million in FAC debt issued to liquidate the Jackson FLB when this debt matures. This is FCSIC's only significant liability. On December 31, 1992, the estimated present value of this obligation was $166 million.[20] This left the Insurance Fund with a net balance of $488 million.

System Should Repay $260 Million Transferred to FCSIC

FCSIC's initial capital came from the transfer, in 1989, of $260 million from FCA revolving funds originally set up to provide start-up capital to new System institutions. As discussed in chapter 1, after all System institutions had repaid the federal government for the funds used as start-up capital, the revolving fund remained available to FCA to meet emergencies. The 1987 act authorized the transfer of the revolving fund to the Insurance Fund but, unlike all previous taxpayer money provided to the System, the law does not require repayment of this amount.

We believe that Congress should require FCSIC to return this initial capital infusion of $260 million to the Treasury. Our analysis shows that FCSIC could make up the difference by collecting premiums from System banks for about 3 years longer than currently anticipated. We have stated a strong preference for financing federal insurance funds from industry

[20]Under APB No. 21, which is discussed in more detail in footnote 5 of this chapter, it is appropriate for FCSIC to record a liability for the present value of the FAC debt issued to fund the purchase of assistance preferred stock in the Jackson FLB, since FCSIC is responsible for repaying only the principal portion of this debt.

sources. In fact, we believe that industry should bear this burden unless doing so would irreparably harm healthy institutions.[21] Congress employed this principle with previous industry-financed insurance funds in the 1950s and in the most recent reform of commercial bank deposit insurance—the Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. 102-242, 105 Stat. 2236). That legislation provided increased borrowing authority, not an appropriation, to the Bank Insurance Fund. Any such loans from the Treasury must be repaid through additional premiums paid by insured commercial banks, preserving the industry-financed nature of federal deposit insurance. Another reason to return the $260 million is that this transfer without repayment is a departure from the overall policy of the 1987 act that the System repay federal assistance.

Repayment of $260 Million Is Feasible

To test the feasibility of returning FCSIC's initial capital infusion, we projected the impact this would have on the Insurance Fund. We did this by calculating the present and future fund balance assuming that the entire $260 million had been returned to the Treasury's general fund on January 1, 1993, when FCSIC became fully operational. We chose a lump sum payment on this date to illustrate the effect of immediate repayment. If the money were returned later, or in a series of payments over time, the impact on FCSIC would, of course, be lessened. The projection used several simplifying assumptions, the most important being that FCSIC would not be called on to pay any claims other than for the Jackson FLB.[22] We considered several scenarios using different growth rates for System loan volume and rates of interest on FCSIC investments in Treasury securities for compounding the fund balance. We started with FCSIC's financial statements as of June 30, 1992, when the balance of the Insurance Fund was $440 million.

If System loan volume remains constant, and FCSIC earns 5 percent on investments, we project the Insurance Fund will reach its secure base in the second quarter of 1998. If FCSIC had returned $260 million to the Treasury on January 1, 1993, we project that the secure base would be reached 3 years later in the second quarter of 2001. Under this scenario, the balance in the Insurance Fund would have fallen to about $245 million on January 1, 1993. However, since FCSIC is taking in more than $100 million in premium and interest income annually, the initial capital

[21]See Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

[22]The simplifying assumptions we adopted are similar to those FCA used to assess the impact of the Jackson FLB receivership on FCSIC. For example, we ignored FCSIC's operating costs. We also ignored the differential insurance premiums on certain categories of System loans since these are relatively small and difficult to quantify.

infusion would be replaced by 1996. We believe the improving financial condition of System banks makes further immediate large claims on the Insurance Fund unlikely.

Consequently, we believe FCSIC can return the $260 million to the Treasury general fund within a reasonable period of time without undue risk. Even if a large, unexpected claim on the Insurance Fund is made in the near future, before the secure base amount is attained, taxpayer money would not necessarily be required to meet it. Instead, System banks could be called on to support each other under the joint and several liability provisions of the Farm Credit Act. As noted earlier, all System banks now meet or exceed regulatory minimums for capital. On December 31, 1992, the combined capital of all System banks was well over $4 billion.

FCSIC's Insurance Fund Should Be Removed From System's Balance Sheet

FCSIC is, in effect, treated as a System institution in the System's combined financial statements even though it is an independent federal entity. The premiums FCSIC collects from System banks are "on-budget"—they are counted as income of the federal government. Yet, in its financial statements, the System does not expense these premiums, reports FCSIC's earnings on them as "other income" of the System, and reports the Insurance Fund as a "restricted asset" and as "restricted capital." As an OMB official emphasized to us, FCSIC's income and assets are public, not private funds.[23] The Insurance Fund, like its predecessor the revolving fund, was established by and is maintained and controlled by the federal government, not by the System. We do not believe it can be properly characterized as a form of self-insurance as the System suggests. For this reason, among others, we believe that the System should not combine FCSIC's financial statements with its own or use any accounting treatment that has this effect.

More importantly, while including the Insurance Fund in the System's financial statements improves its combined earnings and capital now, doing so also means the System as a whole is not well positioned to derive the intended benefit from FCSIC assistance in the future. The purpose of the Insurance Fund is to avoid a situation in which problems at weak System banks (or associations) adversely affect the operations of other banks or of the System as a whole. FCSIC is to do this by providing replacement

[23]OMB classifies the Insurance Fund as a "public enterprise fund," the same budget classification applied to the account that contains the assessments System institutions pay to cover FCA's operating costs. Public enterprise funds are defined in the Budget of the United States Government for Fiscal Year 1994 as "accounts for business or market-oriented activities conducted primarily with the public and financed by offsetting collections that are credited directly to the fund."

capital to improve troubled institutions' condition or to cover defaults. However, unless the System removes the Insurance Fund from its balance sheet, future FCSIC assistance will not increase System capital for the simple reason that, under the current treatment, FCSIC capital is already part of System capital. Put another way, only if the Insurance Fund is removed would FCSIC assistance increase the capital the System as a whole could report to investors during future difficult times.

In July 1989, FCA issued an accounting bulletin that stated that FCSIC premiums should be expensed on the System's combined financial statements and that the Insurance Fund should not be included as a restricted asset. The bulletin was set aside by a district court on procedural grounds and FCA did not appeal the court's decision. FCA officials indicated that FCA may promulgate regulations on this matter. In December 1993, the System proposed, and FCA formally accepted, a form of disclosure that lists the Insurance Fund separately before combining it with other System accounts and provides supplemental information.[24] This revised disclosure will appear in the notes to the System's combined financial statements for the year ended December 31, 1993. The FCA Board approved in December 1993 a proposed regulation on disclosure to investors that incorporates the System's revised disclosure for the Insurance Fund. According to FCA, because of these actions, it no longer has a dispute with the System's accounting treatment of the Insurance Fund.

We believe this issue still requires resolution because the System's financial statements remain inconsistent with those FCSIC publishes, even though both prepare GAAP-based financial statements audited by independent public accountants. One problem is that both the System and FCSIC claim the Insurance Fund as an asset. In addition, as discussed further in the next section, the System and FCSIC do not currently report the same balance for the Insurance Fund.

The recent agreement between FCA and the System concerning Insurance Fund disclosure still inappropriately allows the combination of System and FCSIC accounts. FCA noted in its July 1989 accounting bulletin that since

[24]The System's proposed disclosure maintains that the assets and related capital of the Insurance Fund are "restricted assets" and "restricted capital." The proposed disclosure notes that the Insurance Fund is under the direct control of FCSIC and not any System institution. For the Insurance Fund, the proposed disclosure specifies mandatory and discretionary uses, possible authorized forms of expenditure by FCSIC, and estimated obligations. The proposed disclosure also contains supplemental schedules to the basic combined financial statements showing System accounts combined without the Insurance Fund, then the Insurance Fund accounts separately, and ultimately combining the System and Insurance Fund accounts.

neither common control nor common management exists between FCSIC and System institutions, FCSIC's accounts should not be combined with the System's. Therefore, FCA concluded that including the Insurance Fund on the System's combined balance sheet is inconsistent with GAAP. On the other hand, the System argues that since FCSIC's assets can only be used to benefit System institutions, presenting the Insurance Fund as a restricted System asset and as restricted System capital is the most appropriate (and indeed the required) accounting treatment under GAAP. Both FCA and the System have opinions from independent public accountants to support these views. We concluded, based on our review of applicable accounting guidance, that the exclusion of the Insurance Fund as System assets and capital would result in a more appropriate presentation of the System's financial condition. While we agree that the revised disclosure is useful, we continue to believe that complete removal of the Insurance Fund from System combined financial statements is the better presentation. The basis for our conclusion is discussed in detail in appendix I.

Effects of Removing Insurance Fund From System Balance Sheet

Removing the Insurance Fund from the System's balance sheet would have no effect on the financial reports of any individual System bank because it is only claimed on the System's combined statements. The System's overall reported earnings for 1989 to 1992 would have been significantly different, however, if the Insurance Fund had not been treated as a System asset. Expensing the premiums System banks paid to FCSIC and omitting FCSIC's investment income would have lowered reported earnings for these years by about 11 to 15 percent. As of December 31, 1992, removing the Insurance Fund would have reduced the System's combined capital by \$656 million. The adjustment related to the Jackson FLB discussed below would partially offset this reduction. Over time, the effect of removing the Insurance Fund from the System's balance sheet will become more significant. It will result in larger reductions in reported total capital the longer action is delayed. Once the Insurance Fund reaches its secure base amount, removing it would reduce the System's reported capital ratio by about 2 percentage points.

Because of differences in accounting for the Jackson FLB's failure, the System and FCSIC do not now report the same balance for the Insurance Fund. Currently, the System reports FCSIC's total assets as the Insurance Fund, rather than first subtracting FCSIC's liability for the Jackson FLB liquidation as FCSIC itself does. System officials justify this by noting that the System already records the underlying FAC debt on its balance sheet. We are concerned that labeling FCSIC's total assets as the Insurance Fund may mislead investors, even though notes to the System's financial statements disclose the facts of the Jackson FLB arrangement.

As noted earlier, System banks and FCSIC signed a contract in 1990 under which FCSIC has responsibility for repaying the FAC debt issued to liquidate the Jackson FLB. Thus, we believe the System's combined balance sheet should reflect FCSIC's commitment to pay off this debt. FCSIC currently estimates this commitment to be $166 million. This would eliminate the discrepancy between the figures the System and FCSIC report as the Insurance Fund balance.

Conclusions

Because of the way the 1987 act structured the program of federal assistance to the System, individual System banks were not required to and have not recognized the full costs of the 1987 act assistance package. By characterizing FCSIC's Insurance Fund as a form of self-insurance, the System is not well positioned to realize the intended benefit of future federal help should the need for it arise. This is because the replacement capital available in the Insurance Fund is, under the System's current accounting treatment, already counted as part of the System's capital.

System banks have partially acknowledged their obligations relative to the 1987 act assistance by supporting legislation that establishes mechanisms for them to accumulate funds to repay the bulk of FAC debt. In addition, two of the four assisted FCBS have already made arrangements to repay most of the direct assistance they received. Nevertheless, we believe further improvements can and should be made in the accounting and regulatory treatment of the System's assistance repayment obligations. Even though overstated, the financial condition of System banks has greatly improved. Thus, the System can make such changes now without doing significant damage to its business or creating undue concern in the investor or borrower communities. These changes would help give a true picture of the System's financial health and ensure appropriate regulatory oversight.

Our analysis also suggests that FCSIC can return $260 million in taxpayer money transferred to it under the 1987 act within a reasonable period of time without undue risk. We believe the System should repay this amount; failure to do so would be inconsistent with past practice and recent legislation reaffirming Congress' policy in favor of industry financing of federal insurance by competing financial institutions as well as a departure from the 1987 act's overall policy that the System repay federal assistance.

We also believe it is inappropriate to include FCSIC's income and assets in the financial statements prepared for the System as a whole. We concluded that doing so overstates the System's current earnings, assets, and capital. More importantly, if the System continues its present accounting treatment for FCSIC premiums and the Insurance Fund, it will not be able to record any increase in earnings or capital in the event one or more System institutions experience serious financial difficulty in the future. This, in effect, deprives the System of the intended benefits of the statutory mechanism to provide federal support in times of stress.

Recommendations

We recommend that Congress

- require that System institutions record all categories of assistance granted under the 1987 act using the GAAP that best reflects the economic substance of this federal aid;
- provide FCA statutory authority to recognize all categories of 1987 act assistance as temporary, not permanent, capital of System banks for regulatory purposes; and
- require FCSIC 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.

We also recommend that the FCA require the System to exclude FCSIC's Insurance Fund from its combined financial statements.

Loan Pricing and Competition Among Agricultural Lenders

After the System received federal financial assistance, some competitors, notably small midwestern commercial banks, accused it of engaging in below-cost predatory pricing and other unsafe or unfair lending practices. They pointed out that, as permitted by law, System banks did not record liabilities for all of their assistance repayment obligations. This, they maintained, obscured System institutions' true cost of doing business and whether System loan rates were high enough to cover all costs. Our economic analysis and review of FCA's oversight revealed little evidence of unfair or unsafe loan pricing practices among System institutions. However, the System's status as a GSE and a cooperative does give it cost advantages over some other agricultural lenders. These advantages also figure in the complaints of unfair competition against the System.

In this chapter, we first discuss how System loan pricing practices (and regulatory oversight of those practices) have changed since the reforms of the mid-1980s. Second, we discuss how the System's cost structure differs from that of large and small commercial banks and insurance companies. Finally, we compare System loan rates with those of these other lenders, both nationally and in selected midwestern local markets.

The Economics of Unfair Competition

In March 1990, representatives of the Nebraska Bankers Association, the Nebraska Independent Bankers Association, FCA officials, and the president of the Omaha FCB testified before a House subcommittee on the subject of predatory pricing by the System.[1] At issue was whether the System's lending practices could be considered predatory or just appropriately aggressive and competitive.

According to economic theory, a firm engages in predatory pricing when it temporarily sets its prices below cost to eliminate or discourage competitors and so gain a monopolistic or dominant market position. The successful predator firm then charges higher prices and earns higher profits over the long run. In recent years the courts, including the U.S. Supreme Court, have aligned with economists who believe that true cases of predatory pricing are rare. In 1986 decisions, for example, the Supreme Court relied on economic analyses suggesting that predatory pricing schemes are rarely tried and even more rarely successful because of the low probability that a firm could gain a monopoly for long enough to

[1]See Predatory Pricing Within the Farm Credit System, hearing before the Subcommittee on Policy Research and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 101st Cong. 2d Sess. (1990).

recoup its short-term losses.[2] Other economists, however, believe that predatory pricing can be a rational and profitable strategy under certain conditions.[3] One recent contribution to the economic literature notes that if a competitor is a public rather than a private entity it may try to maximize its size or output rather than its profit. Under these circumstances, this study concludes, the public firm may set its prices so low that competitors have to withdraw from the market.[4]

Although the System is privately owned, as a GSE it is a quasi-public organization. At the March 1990 hearing, the midwestern commercial bankers emphasized this in their discussions of predatory pricing, saying that aggressive competition from the System was hurting them. They also questioned whether the System's loan pricing practices were safe and sound. In the late 1970s and early 1980s when the System was using average-cost pricing to build its market share and regulatory oversight was lax, such criticism was certainly warranted.

In 1986 amendments to the Farm Credit Act, Congress addressed problems with System loan pricing practices. It authorized the System, rather than FCA, to set loan rates, opening the way for System rates to become more market-oriented. The amended policy section of the Farm Credit Act noted that farmers' credit needs are best served if System institutions provide "equitable and competitive" rates. The tension between equitable and competitive helps explain some of the recent controversy over the System's loan pricing practices.

Many System institutions still emphasize the equitable side and strive to offer the lowest possible loan rates consistent with safe and sound operations. This operating philosophy is based on the cooperative tradition of "service at cost." It has the effect of minimizing earnings and may contribute to perceptions of unfair competition. Member-borrowers of these institutions usually receive low or zero rates of return on their stock. Other System institutions now emphasize the competitive side.

[2]This is the view of the "Chicago School" of economics. See Matsushita Electric Industry Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986); Cargill Inc. v. Montfort of Colorado, Inc., 479 U.S. 104, 121 (1986).

[3]The work of many of these economists reflects insights gained through the application of game theory in models in which the firms have incomplete (asymmetrical) information. In some of these models, predatory pricing pays off for firms that establish a reputation for tough competition or falsely signal that they have a cost advantage, thereby discouraging other firms from entering the industry. For surveys of this literature, see Jonathan B. Baker, "Recent Developments in Economics that Challenge Chicago School Views," Antitrust Law Journal, Vol. 58 (1989), pp. 645-655; and J.A. Ordover and G. Saloner, "Predation, Monopolization, and Antitrust" in Richard Schmalensee and Robert D. Willig, eds., Handbook of Industrial Organization, Amsterdam, North-Holland, 1989, Vol. 1, pp. 545-562.

[4]See John R. Lott, Jr., "Predation by Public Enterprises," Journal of Public Economics, Vol. 43, No. 2 (November 1990), pp. 237-251.

They charge essentially the same loan rates other lenders do, attempting to make profits and pay high dividends on the stock their member-borrowers own.

FCA and the Assistance Board Encouraged Changes in System Loan Pricing Practices

FCA examiners review System institutions' policies and procedures for making and pricing loans in annual examinations, criticizing any questionable practices they observe. FCA enforcement actions have required changes in loan pricing practices at some troubled FCBs and associations. Between 1989 and 1991, FCA also responded to at least 39 complaints of unfair competition by System institutions. These included 25 complaints citing specific instances of alleged predatory pricing or other improper loan pricing practices. FCA confirmed none of the allegations. In annual examinations not related to any complaint, FCA concluded that one association was engaging in what FCA defined as predatory pricing and took enforcement action against the association in 1990.

The Assistance Board required the four assisted FCBs, sometimes with the help of outside consultants, to improve their policies and procedures for pricing loans. Assistance Board officials did not believe any assisted FCB engaged in unsafe or unfair loan pricing practices. They did acknowledge that some of these banks and their related associations were competing aggressively for new business.

FCA Examined Loan Pricing Practices Carefully, Identified Problems, and Required Corrective Action

FCA reviews the loan pricing practices of System institutions in annual examinations. The loan pricing examination is based on the guidance provided in FCA's Examination Manual. In various policy statements, FCA defines predatory pricing as

> "The practice of setting interest rates to attract or retain borrowers with a willful disregard for the costs of doing business, or well below prevailing rates in the market area due to the failure to monitor competitor rates."

We believe this definition is not, as asserted by ABA, contrary to applicable law.[5] FCA examiners use this guidance and their knowledge of System institutions to assess if a particular institution's loan pricing policy is consistent with its earnings goal and whether this goal will enable the institution to meet regulatory capital requirements. They then determine whether loans are actually being priced in accordance with the policy. Examiners look for evidence that the institution is aware of competitive market rates (for example, that it surveys other agricultural lenders in its area) and can show that they influence its pricing decisions. Examiners also incorporate any allegations of improper loan pricing or underwriting into plans for the institution's annual examination.

During the 1988 and 1989 examinations of some assisted FCBs, examiners focused particular attention on loan pricing practices. At one such bank, they assessed compliance with an FCA enforcement action that required the bank to revise its policies and procedures in this area. Examiners judged that the bank's new practices complied with the enforcement action in 1991. FCA also criticized some associations that now set rates on loans to farmers in many areas of the country.[6] For example, one examination report urged an association affiliated with an assisted FCB in the Midwest to adopt higher profit targets on loans to reach its earnings and capital goals more rapidly. However, FCA found no evidence of predatory pricing at this association. We discuss two other examples in the next section. A senior FCA official told us that, from a safety and soundness perspective, not many associations are now pricing loans inappropriately.

FCA Found Only One Case of Predatory Pricing

Between 1989 and 1991, FCA responded to at least 39 inquiries about unfair competition by System institutions. Almost all of the inquiries (33 out of the 39) were made by or on behalf of small commercial banks in the Midwest. Twenty-five complaints cited specific instances of alleged predatory pricing or gave examples of questionable loan pricing or

[5]In comments on a draft of this report, ABA contends that the policy section of the Farm Credit Act sets out the predatory pricing standard of "below competitive market rates" to be used by FCA. ABA asserts that this is the proper legal standard rather than the standard of "well below prevailing rates" used by FCA in investigating predatory pricing complaints. The legislative history of the policy section indicates that Congress did not intend to dictate a specific predatory pricing standard to FCA. Rather than addressing interest rates within the context of predatory pricing, the statute was intended to address concerns over possible dissipation of System capital and earnings due to System institutions' charging interest rates below competitive market rates. The legislative history also shows that Congress did not intend to constrain FCA's regulatory authority over System loan pricing practices to the literal terms of the policy statement, but rather to invest FCA with substantial discretion to oversee these practices in the context of ensuring the System's safety and soundness and capital adequacy.

[6]Some FCBs essentially control the rates on the retail loans associations make by setting minimums or targets. Several FCBs limit the types of retail loans the associations in their territories can offer.

underwriting practices. Many small bankers said System institutions were offering low or favorable rates to the most desirable customers (or only to new borrowers), which they could not match and make a profit.

FCA found that no System institution had acted improperly in making or pricing any of the loans cited in these complaints. FCA conducted detailed investigations of 12 of the 25 specific cases.[7] The FCA examiners looked at whether the loan in question was priced below some measure of the institution's cost and whether it was made in accordance with approved policies. In some cases, examiners discussed the terms of the loan with System loan officers and reviewed documentation on the loan's profitability. In other cases, they compared the loan rate with the System institution's cost of funds. These investigations, in our opinion, provide a reasonable basis for FCA's responses.

FCA took enforcement action in 1990 against an association in the West that, based on its examinations in 1989 and 1990, FCA believed was engaging in predatory pricing. No specific complaints had been made against this association and it was not related to an assisted FCB. FCA officials told us that examiners must document a pattern and practice of predatory pricing before FCA will require an institution to take corrective steps. In this case, FCA examiners found that the association was pricing most loans only slightly above the prime rate and well below the rates its competitors were offering borrowers of equivalent creditworthiness. The association was in poor financial condition and needed to increase earnings to shore up its capital base. Among other things, FCA directed this association to increase the rates it was charging and to survey its competitors regularly.

In another case, FCA warnings to an association preceded a specific complaint. In a 1991 examination, FCA noted that a high percentage of one midwestern association's loans were priced at the rates reserved for its most creditworthy borrowers. These rates were low relative to those of its competitors. Examiners criticized the association for failing to document how competitive rates influenced its rate structure and warned that predatory pricing complaints might be made against it. Since the association was well capitalized and profitable, FCA took no other action. A short time later, a predatory pricing complaint was made against the association. It was one of the 12 complaints cited above that FCA

[7]FCA routinely requested the names of the customers involved and other detailed information from those who made these allegations beginning in 1990; it received complete responses in only four cases.

investigated and rejected. The association was located in an assisted FCB's territory.

Assistance Board Approved New Loan Pricing Policies of Assisted FCBs

The Assistance Board generally agreed with FCA's definition of predatory pricing. It focused on the impact of the assisted FCBs' loan pricing practices on the banks' long-run viability. The Assistance Board required some of the assisted FCBs to hire outside consultants to help design new asset/liability management strategies, including new loan products and pricing programs. Assistance Board officials did not believe any assisted FCB priced loans improperly or competed unfairly.

Under the 1992 act, FCSIC is the successor to the "assistance agreements" between the Assistance Board and the assisted FCBs. The assistance agreements quote from the Farm Credit Act and FCA regulations in describing the objectives of the new loan pricing policies. More specifically, the assistance agreements state that no assisted FCB should make loans at rates below its marginal cost or competitive market rates. The Assistance Board defined "marginal cost" as the monthly cost of funds plus operating expenses less the impact of adjustments to the allowance for loan losses. Some assisted FCBs compare their interest rates with this formula directly. All supplied the Assistance Board with extensive asset/liability management information. The Assistance Board also received regular reports on the assisted FCBs' surveys of competitive market rates. While associations operating in the assisted FCBs' districts did not submit reports to the Assistance Board documenting their compliance with these standards, the Assistance Board expected the FCBs to monitor them and regularly reviewed information on association financial condition and performance. FCSIC officials plan to monitor assisted FCBs in a similar fashion.

Assistance Board officials appeared to rely primarily on the marginal cost criteria to assess compliance with the assistance agreement conditions on loan pricing. Competitive market rates, they said, were difficult to use because surveys of prevailing rates may not be accurate. They pointed out that competition for the business of some high-quality, low-risk borrowers is intense. This may result in both System institutions' and other lenders' granting preferential rates to selected customers.

Assistance Board officials discussed allegations of predatory pricing with management of the assisted FCBs and FCA examiners. They also spoke with commercial bankers and trade associations who made complaints. The

Assistance Board referred the few specific instances of alleged predatory pricing that were brought to its attention to FCA for further investigation.

Cost Structures of the System and Others

GSE status provides the System with cost advantages over other agricultural lenders. These advantages enable it to legitimately offer lower rates on at least some types of farm loans and still earn profits. Moreover, because it is a cooperative, the System may target lower profit margins than its competitors. This suggests that System institutions may have advantages in cost of funds and required profit margins. We could not determine whether System institutions have advantages with respect to operating costs, the other component of the cost of making loans.

To determine how agricultural lenders set rates on loans, we interviewed officials at selected System institutions, commercial banks, and insurance companies. We constructed a hypothetical agricultural real estate loan and a hypothetical farm operating loan and asked the lenders to "price" them. The rates they quoted varied widely. Some System institutions used a worksheet to derive target rates on the loans by adding up their cost of funds, expected costs of servicing the loans, a premium for accepting prepayment risk and credit risk, and a profit margin. Some commercial bankers went through a comparable exercise to set their desired loan rates. But both types of lenders also recognized the necessity of adjusting their rates to meet the competition. Both said they offer especially attractive rates to certain borrowers to develop or continue a long-term relationship.

While agricultural lenders may calculate their target loan rates by adding their expected costs and a margin for profit, individual lenders probably have little control over prevailing rates in the highly competitive agricultural credit market. It might be more realistic, therefore, to view these calculations as profitability rather than pricing exercises. The lender will only make the loan if the spread between prevailing rates and what the loan will cost is large enough to reach a profit target.[8] Consequently, individual lenders' cost structures determine what kinds of loans they are willing to make as well as influencing the prices of these loans. Ultimately, their costs will also determine how many loans they make and what their share of the market will be. Agricultural lenders' costs have three components:

[8]For insurance companies, agricultural lending decisions are further constrained by the need to harmonize agricultural loans with the composition and maturity of the company's overall portfolio. Our discussions with insurance companies indicated that they do not use, either explicitly or implicitly, the kind of build-up or cost-plus pricing that System institutions and commercial banks do.

- Cost of funds. For System institutions, this is the rate they must pay on the bonds they issue in the national capital markets. For commercial banks, the cost of funds depends largely on what they must pay to attract deposits.
- Operating and overhead costs. These are the costs incurred in making and servicing loans and the overhead associated with running a financial institution.
- Profit margins. To obtain capital, profit margins on loans must be sufficient to offer stockholders the prospect of an acceptable rate of return on their investment.

Precise comparisons of the costs various agricultural lenders incur are problematic. For one thing, lenders' records do not isolate how much servicing particular loans or types of loans costs them. We can, however, identify areas where evidence suggests that cost differentials exist.

Cost of Funds

There is evidence that the System's GSE status, with access to national capital markets, affords a competitive advantage in raising funds for long-term lending. Long-term debt issued by System banks and insured by FCSIC sells at rates comparable to debt issued by AAA-rated firms—a credit rating that only one U.S. commercial bank currently enjoys. In fact, most commercial banks lending to farmers do not have direct access to long-term funds.[9] This advantage probably accounts for the System's dominance in the market for farm mortgages. While the System has a cost advantage over commercial banks in raising long-term funds, that advantage does not extend to life insurance companies. Premium income provides life insurers with long-term funds that have enabled them to capture 13 percent of the market for farm mortgages.

On the other hand, the System does not appear to have any advantage over commercial banks in obtaining short-term funds. If we use the weighted average of rates on savings accounts and certificates of deposit to measure their cost of funds, then commercial banks' cost of funds are low. Bank rates on federally insured savings accounts and certificates of deposit are usually lower than rates on short-term Treasury bills, while the System typically issues short-term bonds and notes at rates above those on

[9]Commercial banks have some indirect access to long-term funds for agricultural lending through System banks and Farmer Mac. For example, commercial banks that lack sufficient funds to meet demand for farm loans can "discount" or sell such loans to System banks or borrow from the FCBs just as associations do. Few of them choose to exercise this option, however. One of the purposes of establishing Farmer Mac in 1988 was to enable commercial banks to offer long-term mortgages by promoting the development of a secondary market for the sale of agricultural real estate and rural housing loans. Farmer Mac does not yet play a major role in agricultural credit.

Treasury bills. Market share evidence supports this view. At the end of 1991, commercial banks made 50 percent of farm operating loans, while System institutions accounted for only 15 percent.

Operating Costs

In addition to the cost of funds, agricultural lenders incur many other costs in operating a financial institution. For example, a lender must assess a borrower's creditworthiness, process loan payments, and update information about the borrower's business over the life of the loan. Lenders also incur fixed costs for buildings, licenses, examinations by regulators, etc.

Differences in structure, charter, and regulatory requirements for the System and commercial banks make direct comparisons problematic. For example, both System institutions and commercial banks must now pay insurance premiums. Since System institutions pay FCSIC a premium of 15 basis points on accruing loans and commercial banks pay the Federal Deposit Insurance Corporation, on average, 25.4 basis points on domestic deposits, System institutions would appear to have lower insurance costs. However, the commercial banks that raise large amounts of funds through foreign deposits or other sources (primarily large banks) pay less per dollar of assets for insurance than System institutions of the same size.[10]

Likewise, while FCA and commercial bank regulation is similar, the regulatory burdens are not identical. For example, System institutions are expected to lend to all eligible farmers as well as comply with various state and certain unique federal borrower rights laws that apply to farmers. On the other hand, commercial banks must meet the requirements of the Community Reinvestment Act of 1977 (P.L. 95-128, 91 Stat. 1147). This law is designed to encourage banks to help meet the credit needs of their local communities in which they are chartered, consistent with safe and sound operations. Commercial banks receive and must disclose ratings on how well they fulfill these objectives.

Our review of the handful of studies comparing the operating costs of System institutions and commercial banks did not permit any strong conclusions. However, the limited evidence available suggests that a lender's size is more important than its charter. Some studies suggest that

[10]Loans comprise more than 80 percent of assets at most System institutions, while domestic deposits equate to, on average, just over 50 percent of assets for all commercial banks. However, this percentage is much higher for small banks (about 90 percent for banks with total assets of less than $25 million) than for large ones.

the System's cost of making agricultural loans is comparable to that of large commercial banks and lower than that at small banks.

Profit Margins

The System acquires capital by requiring borrowers to purchase stock as a condition for receiving a loan. Minimum stock purchases have been reduced to 2 percent of the loan balance or $1,000, whichever is less, from 5 to 10 percent historically. In the past, most borrowers' stock was automatically redeemed when the loan was repaid. Today, System member-borrowers may be required to retain their stock for some period, whether or not they receive dividends or patronage refunds. Commercial banks raise capital by offering investors a share of their earnings through dividends or capital gains. System institutions and commercial banks can also retain earnings to build capital.

A System institution can benefit its member-borrowers by earning profits to pay dividends or by offering a discount on loan rates as an indirect dividend payment. The tax exemptions available to System institutions allow them to retain or distribute more of their earnings than commercial banks can.[11] On the other hand, if a System institution does not pay dividends, or pays dividends that do not compensate for risk, then the loans it makes must carry lower rates than those offered by other lenders who do not require a stock purchase. System institutions inform borrowers of the effective rate on their loans assuming that no dividends are paid on the required stock purchase.

Loan Rates of the System and Others

Average rates on System loans at the national level and in selected local market areas fall between the average rates charged by large and small commercial banks. In the Midwest, data we collected and analyzed suggest that even on similar kinds of loans, System institutions charge rates that are lower than those offered by nearby small (assets up to $500 million) agricultural banks. It is not clear, however, how much of the difference in rates is due to the way these two types of lenders set loan prices and how much is due to other factors.

National Average Rates on Farm Loans

At the national level, data compiled by USDA show that in the fourth quarter of 1991 (the latest period for which all figures were available during our review), average rates on operating loans ranged from 8.10 percent at large

[11]FCBs, FLBAs, and FLCAs are exempt from most taxes. BCs, PCAs, and ACAs are not tax-exempt, but as cooperatives they can distribute their earnings to member-borrowers and thus avoid the corporate taxes that a commercial bank would have to pay.

commercial banks to 10.70 percent at small commercial banks. Commercial banks supplied about half of all farm operating loans in 1991. The difference of 2.60 percentage points between large and small banks is presumably related to advantages of scale. For example, large banks may demand a smaller risk premium because of their ability to diversify risk. In addition, because they make larger loans that are less costly to service, they may incur lower per unit costs. In comparison to banks, interest rates charged by System institutions in the fourth quarter of 1991 averaged 9.86 percent[12] on operating loans, 1.76 percentage points more than large banks but 0.84 percentage points less than small banks.

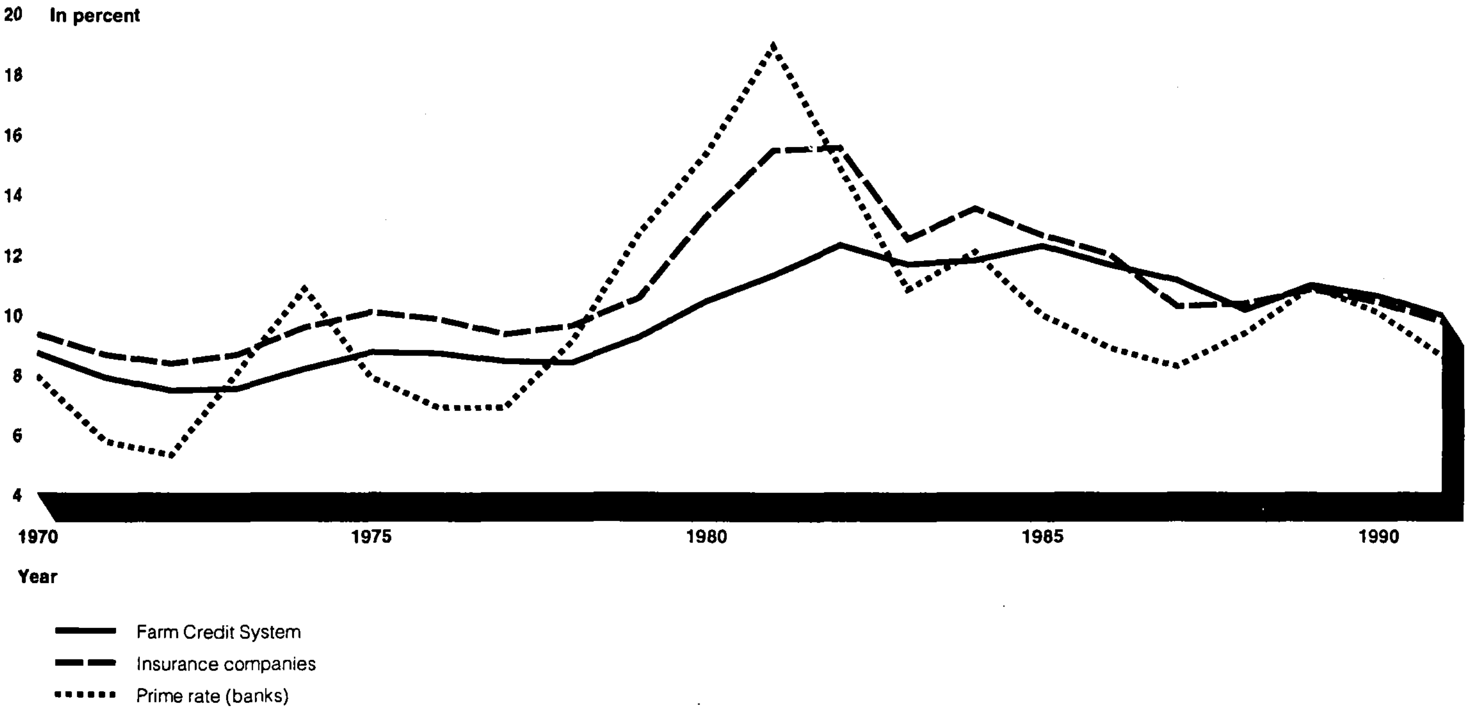
During the same period, interest rates on agricultural real estate loans from System institutions averaged 9.46 percent. The System held about 33 percent of all farm mortgages in 1991, and insurance companies, the other traditional suppliers of these loans, held about 13 percent. There was little difference between the average rates System institutions and insurance companies charged. As was the case with operating loans, System lending rates for farm mortgages were, on average, higher than rates at large banks but less than rates at small banks. Interest rates on agricultural real estate loans at all commercial banks averaged 9.74 percent in the fourth quarter of 1991, with large banks charging an average rate of 9.14 percent and small banks charging an average of 10.27 percent. Figures 3.1 and 3.2 present the average rates charged by the major agricultural lenders on both types of loans from 1970 to 1991.

[12]Assuming a System institution pays no dividends over the life of the loan, the minimum stock purchase requirement has the effect of adding 0.20 percentage points to the rate on loans under $50,000. The USDA figures for average rates presented do not consider System stock and, thus, are slightly lower than the average effective rates on System loans.

Figure 3.1: Interest Rates on Farm Operating Loans, Annual Average, 1970-1991

Source: USDA.

Figure 3.2: Interest Rates on Agricultural Real Estate Loans, Annual Average, 1970-1991



Source: USDA.

Farm Loan Rates in Regional and Local Markets

Unfortunately, there are few data on agricultural loan interest rates in regional and local markets, although there are meaningful differences between regional and local rates and the national averages. For example, in the fourth quarter of 1991, the average interest rate on operating loans reported by commercial banks in the Richmond Federal Reserve district was 9.40 percent, compared to 11.00 percent in the Minneapolis district. Similarly, average rates for new System operating loans ranged from 9.09 percent in the territory served by the Baltimore FCB to 10.67 percent in the Western district.

Since much of the controversy over the System's loan pricing practices focuses on the Midwest, we collected and analyzed data on farm loans made in 1991 by System institutions and small commercial banks competing in 12 selected midwestern local markets. These areas were served by three different FCBs. We found the same relationship in these local markets that the national averages suggest: System rates appear to be lower than those of small banks, even on similar kinds of loans.

In 10 local markets, we could directly compare the mean effective rates on System and small bank operating loans.[13] In all of these markets, the average rate on loans made by System institutions was either lower than or not meaningfully different from[14] the average rate on loans made by the small banks in the same area in 1991. In 8 out of the 10 areas, the average System loan rate was lower in at least one quarter during 1991. These comparisons of average rates on loans made by the two lenders could be misleading, however. For example, the average rates could be different not because of the way the loans were priced, but because of differences in the characteristics of the loans.

To examine this further, we employed multiple regression analysis to test the relationship between the effective rates on similar System and small bank loans. Using this technique, we could compare rates in all 12 local markets for both farm operating and real estate loans. Our regression model included variables to control for differences in the size, maturity, and other characteristics of the loans as well as when and where they were made. Results from this analysis suggest that System rates tend to be lower than small bank rates, even for similar kinds of loans. On operating loans, System rates were estimated to be 0.59 percentage points less than rates charged by competing small banks. On real estate loans the difference was somewhat greater, with rates at System institutions estimated at 0.99 percentage points less than rates at these banks.[15]

Our regression model explained only a limited portion of the difference between System and small bank loans. Thus, we were not able to determine conclusively whether these differences were due to some unknown loan characteristic (such as the borrower's creditworthiness) or to systematic differences in the way the lenders priced the loans. Nonprice competitive factors may also play a role. Surveys of farmers reveal that loan rates are not the only thing farmers consider when they choose a

[13]The effective interest rate is defined as the nominal rate of interest adjusted for the frequency of interest compounding and the System stock purchase requirement, assuming no dividends are paid on the stock over the life of the loan.

[14]Technically, there was no statistically significant difference between the rates charged by the two lenders.

[15]This difference is consistent with the hypothesis that the lenders' cost structures give them advantages in making certain types of loans, as reflected in market share data.

lender. Factors such as the level of service the lender provides also enter into these decisions.

Although the inferences we can draw from our statistical analyses of prevailing rates in local markets are limited, they are generally consistent with both the national data on farm loan rates and the cost-based comparisons presented in the last section. We describe our statistical analyses in more detail in appendix II.

Conclusions

Although the System has cost advantages over some competitors due to its GSE status, our economic analysis uncovered little evidence to support charges of predatory pricing by System institutions. On average, rates on System loans are lower than those offered by small commercial banks, higher than rates at large banks, and about the same as rates available from insurance companies. While some System institutions have been competing aggressively in recent years, we agree with FCA and the Assistance Board that such competition was, with few exceptions, legitimate. At System institutions whose loan pricing practices presented safety and soundness concerns, FCA and the Assistance Board took action to encourage or require corrective steps.

The System's Charter and the Question of Expanded Powers

The System's current role and mission were set out in the early 1970s, although some minor changes have been made in recent years. This chapter reviews some of these changes and notes issues that would need to be resolved before any major expansion in the System's authorities is granted. The System's charter may need to be modified as agriculture and rural America continue to change.[1] However, we do not believe the System needs expanded authorities to ensure its viability in the near term.

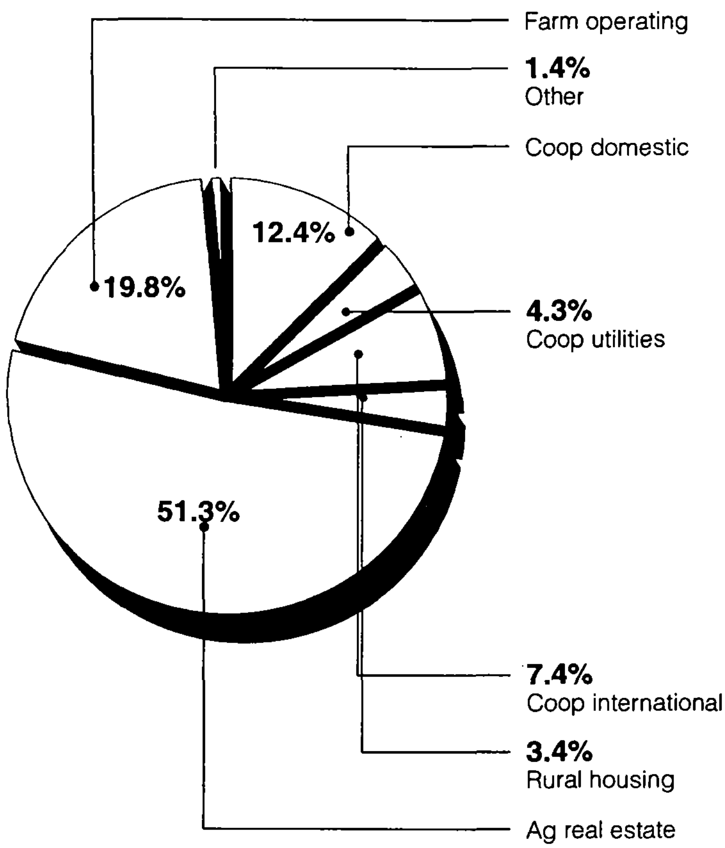
System Has a Limited Charter

Like other GSEs, the System has a limited charter because it was established to serve a specific economic sector—in this case, agriculture. The Farm Credit Act and FCA regulations specify who the System may serve and which lines of business it may engage in. The System makes credit and other services available to all eligible borrowers across the nation. The System is not required to serve borrowers that cannot get credit elsewhere because of their poor financial condition, but it can and does compete with private sector lenders for the most creditworthy borrowers.

The FCBs and related associations can lend to farmers, ranchers, producers or harvesters of aquatic products, some farm-related businesses, and rural homeowners. The BCs may serve agricultural and aquatic cooperatives (and other entities that do business with cooperatives), and rural utilities. The BCs also finance exports and imports of goods and commodities produced by cooperatives. CoBank makes most of these loans, nearly all of which carry federal guarantees through the Commodity Credit Corporation. Figure 4.1 shows the composition of the System's loan portfolio as of December 31, 1992.

[1] Our earlier report in response to 2 of the 10 mandated study questions addresses credit availability in rural America in more detail. See Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992).

Figure 4.1: Composition of the Farm Credit System Loan Portfolio, 1992



Source: GAO.

The Farm Credit Act and FCA regulations restrict the types of loans the System can make and set conditions for some lines of business. Some of these restrictions exist to ensure that System institutions remain focused on agricultural lending. Others limit competition between System institutions and other financial institutions. For example, FCBs and associations can lend to rural homeowners (other than farmers and ranchers) who live in towns with not more than 2,500 inhabitants. Such loans must be to buy, build, or improve a moderately priced home and may not total more than 15 percent of the loans in an FCB's portfolio. As another example, FCBS must get prior approval from FCA before they can offer technical assistance, insurance, or other financially related services to farmers. They must also show that they and their related associations can offer these kinds of services without compromising their core business. We support close regulatory oversight when financial institutions expand into new lines of business.

Recent Changes and Proposals for Changes in System's Charter Have Been Relatively Minor

Congress has approved or considered numerous minor changes to the System's charter over the past several years. Those advocating updated and expanded powers argue that the System needs them so it can continue to meet farmers' needs while competing with other institutions as financial services markets evolve. They have also proposed changes in System authorities on the grounds that certain credit needs in rural America are not being met. Opponents of such changes contend that increased competition from the System would make an already unfair situation worse, making it harder for some competitors (such as small banks) to survive.

One change to the System's charter was authorized by the Food, Agriculture, Conservation, and Trade Act of 1990. That law modified the rules on System financing of processing and marketing operations of eligible farmers. Previously, FCBS and associations could make these kinds of loans only if the member-borrower produced at least 20 percent of the output handled by the processing or marketing organization. Current law requires only that the applicant supply "some portion" of the organization's throughput. The law does, however, set a 15-percent limit on the percentage of an FCB's portfolio that may consist of loans made under the new, less restrictive standards on throughput.

Another change to the System's charter was authorized by the 1992 act. It involves the System's role in financing rural development. The 1992 act removes restrictions on System institutions' guarantees of tax-exempt instruments such as municipal bonds issued by rural communities to fund water systems or other infrastructure projects. CoBank will probably do most of this business; it already has experience in lending to rural utilities. Our study on rural credit availability notes that some state and local governments are concerned about their ability to finance needed rural infrastructure improvements. However, in some areas, the study points out, the tax base is too small to support large bond issues or to repay loans; many rural communities cannot service even subsidized debt.[2] Thus, it is not clear how much of the unmet need for this type of credit System institutions or any other commercial lender can fill.

System advocates have proposed changing the definition of "rural homeowner" to permit the System to serve such borrowers in communities with populations up to 20,000 rather than 2,500.[3] Opponents of this change, including ABA, point out that many FCBs do not fully use their existing authority. Advocates counter that the current size of FCBs' rural housing portfolios does not show the true demand for System rural home loans. We did not find any data conclusively establishing whether there is an unmet need for rural housing loans in general. In another recent study, however, we found the greatest need among high-risk borrowers who do not meet most lenders' (including the System's) credit standards.[4]

Should the System Be Allowed to Diversify Beyond Agriculture?

Before the 1992 act, the question of allowing the System to diversify beyond agriculture was being examined. For example, in 1990 the Treasury proposed that all GSEs obtain AAA ratings (the highest possible) from nationally recognized rating organizations on the basis of their financial condition and performance, not their GSE status.[5] The System responded that it would be virtually impossible for it to attain such a rating because of its restricted charter and the volatile, high-risk nature of agriculture. As with all GSEs, there is a tradeoff between the System's serving its public purpose and the risk of concentration in one economic sector.

Our analysis suggests that, in the near term, the System does not need far-reaching changes to its charter to ensure the viability of most institutions. Total U.S. farm debt and the System's share have stabilized, and, as we noted earlier, most System institutions are operating profitably

[2]See Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992).

[3]The Farmers Home Administration uses a 20,000-population limit (for communities outside metropolitan statistical areas) to establish eligibility for its primary program for rural housing.

[4]See Federal Agricultural Mortgage Corporation: Potential Role in the Delivery of Credit for Rural Housing (GAO/RCED-91-180, Aug. 7, 1991).

[5]The System, like other major GSEs, has an AAA rating because of its ties to the government. In a 1991 Treasury study, one rating organization indicated that, without GSE status, the System would be rated BB. This rating is below the investment-grade range and is considered speculative or high-risk.

and are on target toward meeting their assistance repayment and other obligations. Some FCBs are holding higher levels of investments in government securities or other financial instruments than they traditionally have. System officials point out that this is one way of diversifying risk away from agriculture. Proposed FCA regulations would limit System institutions' holdings of investment securities to 20 percent of assets, reflecting FCA's belief that the System should not use its GSE status to make excessive investments.

In the long term, changes in the role and mission of the System need to be considered in light of continuing structural change in agriculture and in rural America. This could involve simply updating the System's charter to ensure that it is not hampered by outdated restrictions in serving its existing customer base. Alternatively, if judged desirable in the context of the nation's rural development agenda, the System's powers could be expanded so that it can serve new customers. More structural change and consolidation in the System may be needed, as well.[6]

Many small commercial banks may also need to find new business opportunities or merge with larger institutions. A 1990 study noted that the share of farm debt held by small agricultural banks declined about 5 percentage points during the 1980s.[7] The study also suggests that only those commercial banks (and System associations) that are large and efficient enough to offer a range of financial services will be able to maintain or expand their markets. Thus, since most observers expect farm debt to grow slowly, this may be the only way to preserve adequate levels of income.

In agriculture, a trend toward fewer, larger, and more capital-intensive farms has been under way for decades. According to USDA estimates, over half of the nation's food and fiber is now produced by the 100,000 or so largest farms that have annual sales over $250,000. And, while only about 1 in 7 of the approximately 2 million farms has annual sales over $100,000, these larger farms account for roughly two-thirds of total farm debt. Agricultural lenders will certainly pursue these valuable customers. At the other end of the spectrum, most small farmers rely on off-farm income to

[6]The 1992 act requires us to report to Congress on the advantages and disadvantages of merging the FCBs into fewer, regional banks. As noted in chapter 1 of this report, during 1992 and 1993, mergers were consummated or announced that will reduce the number of System banks in the near future.

[7]See Alan D. Barkema and Mark R. Drabenstott, "The Outlook for Agricultural Lenders and Policymakers in the 1990s," in Financing Agriculture in the 1990s: Structural Change and Public Policy, Proceedings of the 1990 Meeting of the Federal Reserve Committee on Agriculture and Rural Development, Federal Reserve System, Washington, D.C., 1991.

support themselves and their families. These part-time operations are more numerous, but do not require large amounts of credit.

The rural economy has shifted away from its traditional reliance on agriculture and other natural resource industries. According to USDA, these industries now directly employ fewer than one rural resident in eight. Moreover, during the 1980s, the only rural places that grew relative to metropolitan areas were retirement communities and trade centers that benefited from the demise of neighboring small towns.

Competitive and Other Issues Raised by Expanded Powers for the System

Questions about the impact of increased competition on other rural financial institutions would inevitably accompany a major expansion in the System's charter, just as they have been raised in debate on the relatively minor changes discussed in recent years. In addition, there are at least two other issues that would need to be addressed. Which System institutions should be granted new powers? Should new borrowers who are not agricultural producers be required or allowed to buy stock in System institutions?

As agricultural finance becomes more sophisticated, the traditional division between the FCBs and associations and the three BCs is blurring. For example, several FCBs have recently participated in large BC (CoBank) loans to finance agricultural exports to the former Soviet Union. CoBank's management is committed to actively seeking these and other opportunities for growth and development of new business, including lending to noncooperatives. Doing so could place the institution in the position of financing nonmembers who are in direct competition with CoBank voting stockholders, a situation the bank has promised to make reasonable efforts to avoid. This points up the need to decide to what extent the System should remain an agricultural cooperative as expanded powers are evaluated.

An official at the Farm Credit Council, the System's trade organization, told us that a System work group is being formed to discuss changes in the System's charter, including these issues. Opinions on how System powers should be expanded and how to integrate new lines of business differ among System institutions and, in some cases, between their directors and management, we were told.

Conclusions

With the System, as with all GSEs, there is a tradeoff between meeting a public purpose and concentration in one economic sector. The System does not need expanded powers to ensure its viability in the near term. However, over time, as agriculture and rural America continue to change, the System's charter may need to be modified to bring it up to date and, if judged desirable within the context of the nation's rural development agenda, expanded to allow the System to serve new customers.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the System, FCA, FCSIC, and ABA. All four organizations provided written comments, which appear in appendixes III through VI. Their views are presented and evaluated in this chapter. More detailed responses to certain points appear in the appendixes. Changes responding to technical comments were incorporated directly into the text where appropriate.

The commenters expressed widely varying opinions on our analysis, conclusions, and recommendations. This diversity of opinion illustrates that federal assistance to the System and the System's position in the agricultural credit market remain controversial issues, just as they were during the mid-1980s crisis.

Overall Comments

Only the System and FCA made comments on the draft report as a whole. The System stated that, while there was much in the draft report with which it agreed, there were several areas with which it took strong exception. The System also expressed the opinion that our work did not appropriately respond to the requirements outlined in the statute that mandated us to conduct this study. FCA commented that, overall, the draft report was balanced and well researched.

The System stated that the draft of this report failed to specifically address 6 of the 10 mandated study questions dealing with other agricultural lenders. In response, we note that all eight questions addressed in this report concern the System; those covered in chapters 3 and 4 also concern other lenders active in rural America. In addition, as indicated on page 1 and elsewhere, this report is the second report we issued to fulfill the statutory requirements. Two of the 10 mandated questions were addressed in our earlier report entitled Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992).

The System also stated that this report did not address the mandated questions on the System's ability to remain competitive while repaying assistance, but focused instead on accounting issues surrounding FCSIC and other matters not raised by Congress as issues or concerns. We believe these questions and issues are closely interrelated and that we appropriately addressed them.

Comments On Chapter 2

The System took strong exception to our positions on the assistance repayment and FCSIC issues discussed in chapter 2 and disagreed with all of our recommendations. FCA, FCSIC, and ABA generally agreed with our conclusions and supported our recommendations on these issues.

Repayment of 1987 Act Assistance

Stating that both of our recommendations on assistance repayment should be rejected, the System reaffirmed its support for the framework of the 1992 act. In the System's view, this framework best supports the objective of complete financial recovery for the System and best serves the public policy goal of maintaining the System as a dependable source of credit for farmers and their cooperatives. We agree that the 1992 act addressed some significant weaknesses of the 1987 act, but we continue to believe that the overall framework for assistance repayment can and should be further improved. FCA and FCSIC generally agreed with our recommendations regarding assistance repayment. ABA also agreed with these recommendations but had no specific comment on them.

Recommendation on Accounting for Assistance

The System stated that our recommendations on improving the accounting and regulatory treatment for assistance repayment obligations implicitly ask Congress to abandon the financial assistance structure of the 1987 and 1992 acts. It added that, in certain instances, our recommendations would impose regulatory accounting principles instead of GAAP. The System also took the position that the 1992 act mechanisms will render most of our recommendations moot as banks make annual payments to FAC.

We expanded and clarified our discussion of the 1987 act assistance program in chapter 2 in response to the System's comments. Our objectives in doing so were to clarify why we believe making changes in current law and in the System's accounting practices would better achieve the goals of the 1987 act. We did not and do not advocate that the System adopt regulatory accounting principles instead of GAAP. Our position is that both System banks and the System as a whole should use the most appropriate and meaningful GAAP treatment for assistance. We changed the wording of our recommendation to Congress regarding System banks' accounting practices to emphasize this.

In our draft report, we focused on the need for System banks to record liabilities for those categories of assistance they must repay on specific dates: the CPA payables, Other uses, and Treasury interest advances. FCA agreed with us that System banks should record liabilities for these categories at their face amounts, except with regard to the Treasury interest advances. FCSIC concurred with FCA's position, adding that recording such liabilities would facilitate better analysis of individual System banks' financial condition and performance. Having considered these matters further, we now believe that the Treasury interest advances should not be viewed as a separate assistance category. Rather, as FCA and FCSIC pointed out, these advances provide an economic benefit to the System. They reduce the effective cost to the System of repaying much of the 1987 act assistance. Therefore, we concluded that the System should reflect the economic benefit associated with the Treasury interest advances in the accounting entries it makes for the main assistance categories, instead of presenting repayment of the advances as a separate cost. We changed the text of chapter 2 accordingly.

Recommendation on Regulatory Treatment of Assistance

The System's comments suggest that it believes regulatory relief may be needed by some System banks, if not now, then at some time before assistance is repaid. For example, the System wrote that the "transition period" through the year 2000 for the Treasury interest advances "recognizes the uncertainties of the agricultural economy and the remaining levels of nonaccrual loans" at some System institutions. We believe System banks should accumulate at-risk capital to deal with these business realities, as most of them are already doing. In our view, no System bank should be relying on any kind of regulatory relief instead. Nor do we believe continuing the regulatory relief for System banks will contribute to their ability to repay assistance. We still believe that this relief is both inappropriate and unnecessary.

FCA suggested we modify our recommendation to Congress regarding counting all assistance as temporary, not permanent capital of System banks for regulatory purposes. FCA noted that our recommendation could be directed to it if Congress granted FCA the discretion to define permanent capital by regulation. We agree with the principle of granting federal regulators of financial institutions, including FCA, discretion to set regulatory capital standards, subject to congressional oversight. Accordingly, our final report recommends that Congress provide FCA statutory authority to count 1987 act assistance to System banks as temporary rather than permanent capital for regulatory purposes.

FCSIC recognized our recommendation addressed only System assistance from FAC, but it is concerned about any legislative constraints on future assistance it might provide to troubled institutions. FCSIC commented that it believes FCA should have the flexibility to determine what types of FCSIC assistance could count as permanent capital. We plan to address FCA's and

FCSIC's views on the regulatory treatment of future assistance from FCSIC as part of our study of FCSIC issues required by the 1992 act.

FCSIC Issues

The System urged us to withdraw both of our recommendations regarding FCSIC and the Insurance Fund. FCA and FCSIC suggested further analysis be done before implementation of the first recommendation requiring repayment of the $260 million provided by Treasury. FCA and FCSIC supported the second recommendation requiring the exclusion of the Insurance Fund from the System's financial statements, but they again felt that additional study would be necessary before any action was taken. However, in December 1993, FCA formally accepted a System proposal for additional disclosure in the notes to the System's combined financial statements on the treatment of the Insurance Fund as System assets and capital. According to FCA, this revised form of disclosure on the Insurance Fund resolves its concerns. ABA supported our recommendations on FCSIC issues on the grounds that implementing them would promote fairer competition between the System and commercial banks.

Recommendation to Require Repayment of $260 Million Transferred to FCSIC

The System strongly disagreed with our recommendation that Congress require FCSIC to reimburse the Treasury for its initial capital infusion of $260 million and urged us to reconsider it. Among other things, the System said that the transfer of the $260 million from the FCA-administered revolving fund to FCSIC was consistent with its historical use for the benefit of the System and agriculture and did not reduce the industry-financed nature of the Insurance Fund. However, as also noted in the System's comments, the amounts in the revolving fund were not originally supplied by System institutions, but by taxpayers in general. Thus, this portion of the Insurance Fund cannot be said to have been industry-financed.

The System further noted that the Insurance Fund is on budget, just as the revolving fund was on budget. FCSIC also pointed this out, adding that returning the $260 million to the Treasury would not reduce the federal deficit. We agree that doing so would not have an immediate budgetary impact. However, if FCSIC collected an additional $260 million from System institutions to capitalize the Insurance Fund, over time, taxpayers in general would have to pay that much less for other public purposes. FCSIC also commented that should Congress pursue this recommendation, the timeframe in which repayment of the $260 million would be required would be critical. We generally agree with FCSIC on this point. Our recommendation states that Congress should consider the financial condition of the System and the Insurance Fund before taking action.

Recommendation to Exclude Insurance Fund From System Financial Statements

The System also strongly disagreed with our recommendation to exclude the Insurance Fund from the System's financial statements. It urged that we withdraw this recommendation and, instead, recommend that FCA and the System jointly submit the matter for resolution to the Financial Accounting Standards Board (FASB). FCA wrote that it intends to review and may develop a regulation concerning the System's accounting treatment of the Insurance Fund. FCSIC concurred with FCA, suggesting that the issues involved need to be analyzed further during the development phase of such a regulation. As noted earlier, ABA supported this recommendation. Recently, FCA accepted a System proposal for a form of disclosure in the notes to the System's combined financial statements that lists the Insurance Fund separately before combining it with System assets and capital and provides supplemental information. The FCA board, in December 1993, approved a proposed regulation on disclosure to investors that incorporates the System's disclosure proposal. According to FCA, its concerns about System disclosure for the Insurance Fund are resolved by the System's proposal.

Addendum I to the System's comments, prepared by the Funding Corporation, discussed the System's position on accounting for the Insurance Fund and related matters at length. We reviewed our earlier work in light of these comments and met with representatives of the Funding Corporation and the System's external auditors to discuss our differing positions at their request. We also had further discussions with FCA and FCSIC officials. In response to the System's, FCA's, and FCSIC's comments, we added appendix I to this final report. It discusses how we believe GAAP applies to the System's treatment of the Insurance Fund. Primarily because we present and discuss the Funding Corporation's detailed comments in appendix I, we did not separately reproduce them in this report. Appendix III contains the System's summary of the Funding Corporation's comments.

In the draft report, we did not give our views on how the System should account for the Insurance Fund because FCA had already done so. We believe FCA has the statutory authority to ensure that the System is using what FCA determines to be an appropriate GAAP treatment for the Insurance Fund. Further, we believe FCA oversight of the System's accounting practices is important since the System—like some other GSEs but unlike most major U.S. corporations—is exempt from Securities and Exchange Commission reviews of its financial reports.

We clarified our recommendation to FCA to address some of the System's concerns with the wording used in the draft report. We considered, but did not adopt, the System's suggestion that we recommend submitting the Insurance Fund accounting issue to FASB's Emerging Issues Task Force. We note the recent agreement between the System and FCA on added disclosure for the Insurance Fund in the notes to the System's combined financial statements, but still believe that FCA should require the System to exclude the Insurance Fund from its combined financial reports.

System Comments on Effects of Excluding Insurance Fund

The Funding Corporation's comments state that it believes excluding the Insurance Fund from the System's combined financial statements is a "non-GAAP" accounting treatment. The Funding Corporation also stated that if the System is required to adopt this treatment, the likely result will be an increase in the System's cost of funds. The Funding Corporation added that it believes this will, in turn, negatively affect the financial condition of System institutions, increase the cost of credit to agricultural producers and cooperatives in general, or both.

For the reasons stated in appendix I, we disagree with the premise that excluding FCSIC's Insurance Fund from the System's combined financial statements is contrary to GAAP. We also believe that if the Funding Corporation works constructively with the investor community, FCA, and FCSIC, the risk of a negative reaction in the capital markets due to this change in the System's accounting practices can be minimized. As noted in chapter 2, even with this change, the System's combined capital ratio would still have been over 10 percent as of December 31, 1992. Because the banks' capital positions are stable or improving, removing the Insurance Fund will not seriously reduce the System's combined capital ratio if action is taken soon. We do not think these accounting adjustments will have any affect on the cost of agricultural credit.[1]

In our draft report, we concluded that not only should the System exclude the Insurance Fund in future periods, but that it should restate its past financial information. We reached this conclusion because the System's earnings since 1989 would have been much lower if FCSIC premiums had been expensed. Restatement of past financial reports is required when a

[1]Even if investors do react negatively to these changes, we believe any resulting increase in the System's cost of funds is likely to be only temporary. We do not think it would be significant enough to cause an increase in the cost of agricultural credit in general. There is ample credit available for agriculture at present, and, as noted in chapter 1, both the System and commercial banks have benefited from strong earnings in recent periods. This is in part because they have not decreased lending rates as fast as their cost of funds has fallen. Therefore, we believe that the System, commercial banks, or both could absorb at least some cost increases without having to raise farm loan rates.

change in reporting entity is made. However, we believe this change may also be characterized as a correction of an error, the cumulative effect of which would be reported in the period the change is made.

Comments On Chapter 3

ABA was critical of our analysis of the predatory pricing controversy addressed in chapter 3 and urged us to reassess our conclusions. The System fully concurred with our conclusions. FCA had no comment on chapter 3. FCSIC questioned the broad application of our conclusion that the System has a cost of funds advantage over commercial banks.

Review of FCA Oversight

ABA expressed concern because we did not take note of what ABA contends is an FCA predatory pricing definition that is contrary to the applicable statute. In ABA's view, FCA's definition does not conform to what ABA contends is the proper legal standard set out in the policy section of the Farm Credit Act, and therefore, FCA's loan pricing examinations and investigations of predatory pricing complaints are not based on the proper legal standard. As noted on page 56 of this final report, we believe FCA's definition of predatory pricing is not, as asserted by ABA, contrary to applicable law.

Economic Analysis

ABA also found the draft report unclear as to what definition of predatory pricing we used in our economic analysis. ABA further stated that in its opinion, standard economic analysis is inadequate to assess competition from GSEs such as the System. In the draft report, we pointed out that some economists believe that public entities, by their very nature, are likely to set prices that are in effect predatory and thus harmful to private firms. This discussion now appears on page 54. We acknowledge that standard economic analysis does not establish that there is no predatory pricing in the U.S. agricultural credit market under all valid economic definitions of that term. However, we tried to take a middle-of-the-road approach to the question of predatory pricing. We continue to believe that the economic and statistical analyses we performed are appropriate ways to approach the difficult issue of competition from quasi-public entities like the System.

System Cost of Funds

FCSIC was uncomfortable with any language that appeared to imply a broad conclusion on a competitive advantage the System has over other agricultural lenders. FCSIC stated that the cost of funds issue was highly complex and was subject to future variations that are not possible to predict. We think the data show that the System has a cost of funds advantage at this time. We believe as FCSIC does that this issue is complex and that the System's and commercial banks' relative advantages in raising loanable funds may vary over time.

Comments On Chapter 4

ABA had further reservations about the analysis and conclusions presented in chapter 4, our review of issues surrounding an expansion of the System's charter beyond agriculture. ABA suggested that we focus on whether the System is still necessary to support agriculture, adding that in its view, the System should be allowed to decline naturally if the answer to this question is no. The System offered additional arguments in support of expanding its charter in its comments, but took the position that, overall, there was little that was controversial in our analysis. FCA stated that more work needs to be done to arrive at a final public policy position on expanded powers for the System. FCSIC had no comment. We modified this final report to acknowledge these differing views at appropriate places in chapter 4.

Insurance Fund Accounting Issues

As noted in chapter 2, the Farm Credit Administration (FCA) recently accepted a System proposal for additional disclosure of the treatment of the Insurance Fund as System assets and capital in the System's combined financial statements. Previously, FCA staff had taken the position that the Farm Credit System's accounting treatment of the Insurance Fund was not in accordance with generally accepted accounting principles (GAAP), which we continue to believe is an appropriate position. FCA, however, has agreed to accept the additional disclosures in lieu of further pursuit of a required change in accounting by the System. While we agree the proposed added disclosure is beneficial, disclosure is no substitute for proper accounting. The System takes the position that presenting the Insurance Fund as a restricted asset and as restricted capital of the System is the most appropriate and meaningful GAAP treatment. In comments on a draft of this report, the System disagreed with our recommendation that FCA require the System to exclude the Insurance Fund from its combined financial statements. The Funding Corporation, which is responsible for preparing the System's statements, suggested we provide an analysis of the accounting issues involved to support our recommendation. This appendix contains a discussion of the relevant accounting guidance in this area as well as analyses of accounting arguments presented by the System in its comments.

We do not believe including the Insurance Fund in the System's combined financial statements results in the most appropriate presentation of the System's financial condition. Our belief is based on our review and analysis of applicable accounting guidance, primarily that regarding combined financial statements and the definition of an asset. This appendix also contemplates (1) how the Insurance Fund should be presented on the Farm Credit System Insurance Corporation's (FCSIC) GAAP-based financial statements and (2) how the revolving fund—the Insurance Fund's predecessor—was presented on the System's past GAAP-basis statements.

Background

The footnotes to the System's combined financial statements indicate that they include the accounts of System banks, their related associations, the Jackson Federal Land Bank (FLB), the Farm Credit System Financial Assistance Corporation (FAC), the Insurance Fund, and the allocated earnings of certain service organizations owned jointly by System banks, by reason of the "financial and operational interdependence" of the System banks and associations. In its comments on a draft of this report, the Funding Corporation indicated that the fundamental reason for preparing combined financial statements for the System is that System banks are jointly and severally liable for substantially all of the debt shown in these statements. Since the amounts in the Insurance Fund represent protection against default on these liabilities, and can only be used to benefit the System, the Funding Corporation believes these assets and related capital should be included in the System's statements.

The Funding Corporation noted that FCSIC obtains its premiums only from System banks and does not completely indemnify them against risk of loss since investors in Systemwide debt can, after the Insurance Fund is depleted, look to System banks' joint and several liability for repayment. The existence of the Insurance Fund does not, in the Funding Corporation's view, transfer any risk of loss from System banks to other parties. Thus, it believes the amounts in the fund have characteristics similar to deposits. The Funding Corporation considers FCSIC to be a special purpose entity set up to administer the Insurance Fund. It sees the fund itself as a trust that can, by statute, only be used for purposes that directly or indirectly benefit the System as a whole. The Funding Corporation therefore presents the Insurance Fund as a restricted System asset and capital account. Individual System banks do not record any portion of the Insurance Fund as capital.

Accounting Guidance Does Not Fully Support System's Treatment of the Fund

We believe the implication in the System's financial statements that the Insurance Fund is part of the assets and capital currently available to the System to repay its liabilities is misleading. In addition, we believe it is misleading to present the Insurance Fund as an asset and capital on the GAAP-based financial statements of both the System and FCSIC. On the basis of our review of applicable accounting guidance, we do not believe it is fully justifiable under GAAP to record the total Insurance Fund as an asset and as capital of the System, even if shown as restricted accounts. However, since the System has a legitimate claim on a portion of the assets in the Insurance Fund related to the failure of the Jackson FLB, we believe it is appropriate for the System to recognize this probable future benefit in its combined financial statements.

Fund Characteristics Not Entirely Consistent With GAAP Definition of an Asset

The Funding Corporation's rationale for treating the Insurance Fund as a System asset relies heavily on accounting guidance for the definition of an asset. The Funding Corporation refers to Statement of Financial Accounting Concepts (SFAC) No. 6, Elements of Financial Statements. Paragraphs 25 and 26 of SFAC No. 6 define an asset as follows:

"Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly, or in combination with other assets, to contribute directly or indirectly, to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred."

The board of directors of FCSIC, by law, has responsibility for directing both the mandatory and permissive uses of the Insurance Fund. The mandatory use is to ensure payment of principal and interest on Systemwide debt and certain other securities should a System institution be unable to meet its obligations. The permissive uses include providing assistance to troubled System banks and associations and covering FCSIC's operating expenses. The law gives FCSIC's board of directors discretion to grant or deny assistance to these System institutions and to purchase services and engage in other transactions necessary to carry out FCSIC's purposes.

In effect, the System's access to resources from the Insurance Fund is triggered only at such time as assets of a System institution deteriorate to such a degree that assistance is required. We do not believe a future benefit to the System from the Insurance Fund becomes "probable" within the meaning of paragraph 26 of SFAC No. 6 until one or more System institutions' financial condition becomes seriously deteriorated. This position is further supported by paragraph 191 of SFAC No. 6 as follows:

"Since the transaction or event giving rise to the entity's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an entity's assets but have not yet become its assets. An entity has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future." [Emphasis added.]

We believe the substance of FCSIC's Insurance Fund is one of resources available only in the event System institutions experience financial difficulty. Indeed, it is not inconceivable that the Insurance Fund could be totally expended providing assistance to problem banks or associations with no direct payment made from the fund to satisfy insured System obligations. Therefore, the implication in the System's financial statements that the Insurance Fund is part of the assets currently available to repay Systemwide debt is misleading. The Annual Information Statement issued by the Funding Corporation with the System's 1992 financial statements addresses this issue by disclosing that there is no assurance that amounts in the Insurance Fund will be available to fund the timely payment of principal and interest on insured System obligations.

As noted in chapter 2, after the assets of the Jackson FLB seriously deteriorated, a contract was signed in 1990 that, in effect, establishes a claim for replacement assets from the Insurance Fund. This claim does represent a probable future benefit, as defined by SFAC No. 6, to the System arising from past transactions and events. In our view, only this portion of the Insurance Fund should be presented as an asset on the System's combined balance sheet.

Financial Statements of FCSIC and the System Both Present Fund as Assets and Capital

FCSIC issues separate GAAP-basis audited financial statements. In these statements, the Insurance Fund is presented as assets and capital of the entity FCSIC. To support its position that the Insurance Fund should be treated as an asset and as capital of the System, the Funding Corporation compares the Insurance Fund to a trust and the amounts in the Insurance Fund to a deposit. We do not believe either of these analogies is valid or that they are consistent with the treatment of the Insurance Fund on FCSIC's GAAP-basis statements. We believe it is misleading to present the Insurance Fund as an asset and as capital of both the System and FCSIC, and that it should be removed from the System's statements.

Comparison of Fund to Deposit Not Valid

To support its position that amounts in the Insurance Fund have characteristics of deposits, the Funding Corporation refers to the accounting guidance on deposits of excess insurance premiums discussed in Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies. Funds considered to be a deposit asset on the books of the insured are carried as a liability on the books of the insurance company,[1] which is not the case on FCSIC's financial statements.

The Funding Corporation cites the following from paragraph 44 of SFAS No. 5:

> "To the extent that an insurance contract . . . does not, despite its form, provide for indemnification of the insured . . . against loss or liability, the premium paid less the amount . . . to be retained by the insurer . . . shall be accounted for as a deposit by the insured . . . . Those contracts may be structured in various ways, but if, regardless of form,

[1]SFAS No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, states: "Amounts received as payments for investment contracts [which are defined in the statement as contracts that do not transfer significant insurance risk] shall be reported as liabilities."

their substance is that all or part of the premium paid by the insured . . . is a deposit, it shall be accounted for as such."

We do not believe the Insurance Fund presently contains any "excess" amounts, since it had not reached its statutorily defined minimum or "secure base" as of December 31, 1992. Therefore, in our view, SFAS No. 5 does not support recording any portion of the Insurance Fund as a liability of FCSIC at this time. In addition, the law is silent on the disposition of FCSIC's net assets in the event the fund is dissolved. It does not require FCSIC to return these amounts to the System.

Moreover, we do not believe the Insurance Fund fits the definition of a liability of FCSIC given in SFAC No. 6, the same guidance discussed earlier for the definition of an asset. Paragraph 35 of SFAC No. 6 defines liabilities as

"[P]robable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

Paragraph 168 of SFAC No. 6 clarifies this definition by stating that

"An item does not qualify as a liability of an entity under the definition in paragraph 35 if (a) the item entails no future sacrifice of assets, (b) the item entails future sacrifice of assets, but the entity is not obligated to make the sacrifice, or (c) <u>the item involves a future sacrifice of assets that the entity will be obligated to make, but the events or circumstances that obligate the entity have not yet occurred</u> . . . ." [Emphasis added.]

No event or circumstance that will obligate FCSIC to transfer any significant portion of the assets in the Insurance Fund to the System has yet occurred, except for the 1990 signing of the contract obligating FCSIC to cover the cost of the Jackson FLB's failure, for which a liability is now reflected on FCSIC's books.[2] Accordingly, we do not believe the Insurance Fund balance can be properly treated as a liability of FCSIC.

We do not believe the Insurance Fund currently contains any "excess" amounts or that it fits the definition of a liability of FCSIC. Therefore, we do

[2]FCSIC's 1992 financial statements show two relatively small liabilities in addition to the $166,444,000 "liability for estimated insurance obligations" related to the Jackson FLB's failure. These additional liabilities are $147,000 for accounts payable and accrued expenses and $1,173,000 to retire eligible borrower stock in a Production Credit Association in receivership.

not believe the Funding Corporation's comparison of the Insurance Fund to a deposit is valid.[3]

Comparison of Fund to Trust Not Valid

The Funding Corporation also compares the assets in the Insurance Fund to those of a trust. According to the American Institute of Certified Public Accountants' publication Audits of Banks, trusts are not assets of the trustee and are not to be included in the trustee's financial statements. Using this analogy, FCSIC would not include the Insurance Fund in its GAAP-basis financial statements. Therefore the presentation of FCSIC's GAAP-basis financial statements is inconsistent with the Funding Corporation's position that FCSIC is simply a trustee.

To support its position that the Insurance Fund is, in essence, a trust, the Funding Corporation compares it to a sinking fund. According to The Handbook of Financial Markets, the term "sinking fund" originally meant cash (or assets readily sold for cash) set aside by an issuer to retire bonds at maturity. This source goes on to note that in modern practice there is no literal sinking fund. Instead, bonds with sinking fund provisions are redeemed, either by the issuer or by a trustee, according to a set schedule before maturity.[4] This is not the case with Systemwide debt securities; the Insurance Fund's mandatory use is to retire such debt in an event of default. In any case, investors in Systemwide debt do not have a claim on the assets in the Insurance Fund similar to that on assets set aside in sinking funds. As noted earlier, the Insurance Fund may be totally expended providing assistance to troubled System banks or associations, leaving no funds available to retire Systemwide debt securities. Therefore, we do not believe the Funding Corporation's position that the Insurance Fund is a trust is valid.[5]

Characterization of FCSIC as a Special Purpose Entity Does Not Justify System Accounting Treatment

We agree with the Funding Corporation that FCSIC can be said to be a special purpose entity (SPE), and, accordingly, we acknowledge that the Insurance Fund can be used only for purposes that directly or indirectly benefit the System. We do not agree, however, that the available guidance

[3]In its comments on a draft of this report, the Funding Corporation also compared the amounts in the Insurance Fund to compensating bank balances. These are amounts commercial banks require borrowers to deposit as a condition of receiving a loan. They are typically returned when the loan is repaid. Since the System is not currently borrowing from FCSIC or from the federal government to fund its operations, we do not believe this analogy is valid.

[4]See The Handbook of Financial Markets, eds. Frank J. Fabozzi and Frank G. Zarb (Homewood, IL: Dow Jones-Irwin, 1987), p. 254.

[5]In its comments on a draft of this report, the Funding Corporation also drew analogies between the Insurance Fund and accounts set up to hold prepayments on loans and escrow accounts.

on SPES provides adequate justification for the System's accounting treatment of the Insurance Fund.

The Funding Corporation noted in its comments on the draft report that if an SPE were found to have no real business purpose except to facilitate a transaction on behalf of another reporting entity, and/or the SPE had no real equity holders who were at risk, the legal form of the SPE could be ignored for accounting purposes and the transaction accounted for according to its substance. We generally agree with this comment. However, although FASB has recognized this accounting concept, there is currently little accounting guidance applicable to SPES.

We believe FCSIC meets the definition of an SPE cited by the Funding Corporation in that FCSIC exists to benefit the System by contributing to the security of debt securities in System institutions. Also, FCSIC does not have equity holders in the usual sense. This is because FCSIC is a public, not a private entity, and thus does not issue capital stock. As discussed above, however, we do not believe the Insurance Fund is currently available to the System and should not be treated as a System asset. Rather, we believe FCSIC's accounts should be included with those of the federal government, as indeed they are. Therefore, in our view, the Funding Corporation's argument that FCSIC is an SPE is not a valid justification of the System's current accounting treatment of the Insurance Fund.

Predecessor to Insurance Fund Was Not Included in System's Financial Statements

The System's GAAP-basis combined financial statements before January 1989 did not include the revolving fund, an account of FCA that was the predecessor of the Insurance Fund, and was, as discussed in chapters 1 and 2, transferred into the Insurance Fund in 1989. The revolving fund was not funded by the System. The revolving fund assets continue to be included in the Insurance Fund, which the System now claims as an asset and capital.

While only System institutions currently pay premiums into the Insurance Fund, the payment of such premiums is not voluntary. The System's 1992 Annual Information Statement aptly characterizes FCSIC premiums as assessments by a federal entity established to provide assistance to System institutions. Moreover, the System did not establish the Insurance Fund or the revolving fund voluntarily. The System's relationship to the

Insurance Fund is no different than that of its predecessor.[6] Also, the purpose of the Insurance Fund is essentially the same as that of the $260 million transferred from the revolving fund. Therefore, there is no justification for a change in the System's accounting treatment of the assets of the former revolving fund under GAAP. Nor is there justification for a different accounting treatment of premiums paid into the Insurance Fund.

Accounting Guidance Does Not Support Combining FCSIC's Accounts With the System's

The Funding Corporations's comments indicate that it does not believe that any assets and liabilities presented in FCSIC's financial statements, other than the Insurance Fund, should be included in System's statements. We find this position inconsistent with the Funding Corporation's position that since FCSIC is an SPE with no real business purpose, all of its resources should be viewed as System assets. In any case, including the Insurance Fund in the System's financial statements has the same effect as combining the accounts of the entity FCSIC with those of the System. We do not believe existing accounting guidance supports this treatment.

Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements, is the primary GAAP guidance for preparing consolidated and combined financial statements. Under ARB No. 51, common ownership is needed to justify preparing "consolidated" statements, but "combined" statements may be prepared where there is "common management" or "common control" between two or more organizations:

> "There are circumstances . . . where combined financial statements [as distinguished from consolidated statements] of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations . . . . They might also be used to combine the financial statements of companies under common management."

The accounts presented in the separate financial statements of FCSIC should not be combined with those of System institutions under ARB No. 51, since by law there can be no common management or control between FCSIC and System institutions, individually or collectively. Lack of control over administration of the Insurance Fund was the basis for an FCA staff belief that the inclusion of the Insurance Fund in the System's combined

[6] The Funding Corporation points out that the System has control, in part, because it can challenge FCSIC's failure to use the Insurance Fund to cover defaults or FCSIC's use of the Insurance Fund for unauthorized purposes. However, other parties besides the System are also able to challenge FCSIC actions, as they can FCA actions, if they believe them to be improper.

financial statements is not in accordance with GAAP. Even though FCA has changed from this position, as noted earlier, we continue to believe that this is an appropriate position.

Conclusions

We recognize that some arguments exist for including the Insurance Fund in the System's financial statements. However, we believe that, on balance, the arguments for excluding the Insurance Fund are stronger and result in a more appropriate presentation of the System's financial situation. We believe the overriding consideration in determining the proper accounting treatment should be that the impact of such treatment results in the most meaningful presentation of the subject financial statements. We believe that both the technical GAAP guidance as well as this principle of meaningful presentation support excluding the Insurance Fund from the System's financial statements.

Interest Rates Charged by System Institutions and Competing Small Commercial Banks

To assess the rates prevailing in agricultural credit markets, we collected interest rate data and related information on new farm loans originated during a sample week in each quarter of 1991 by System associations in three midwestern districts. Each district was then divided into local market areas (defined by an association's chartered territory or by state). Similar data from small to medium-sized commercial banks were then obtained from the Board of Governors of the Federal Reserve System for all local markets for which data were available.[1] Commercial bank data constraints limited the total number of local market areas in the study to 12 out of a possible 32. These 12 markets were distributed over 6 states.

The number of observations (new loans) in the System group totaled 1,852, of which 780 or 42.1 percent were classified as agricultural real estate loans. The total number of observations in the commercial bank group was 4,224, of which 134 or 3.2 percent were classified as agricultural real estate loans.

Mean Interest Rates at System Institutions Are Lower Than at Small Commercial Banks

For each market area we computed the mean effective interest rate on operating loans, by quarter, charged by System institutions and the competing commercial banks.[2] A statistical test was then conducted to determine if significant differences existed between the mean quarterly effective interest rate of each lender. The results of this test appear in table II.1.

[1]Loan data obtained for commercial banks were limited to small and medium-sized "agricultural" banks operating in the defined local market areas. Agricultural banks are defined by the Federal Reserve Board as any bank whose ratio of farm loans to total loans exceeds the unweighted average of the ratio at all commercial banks on a given date (16.49 percent on June 30, 1991). A minimum of three agricultural banks was sampled in each market. All sampled banks had less than $500 million in total assets.

[2]The effective interest rate was defined as the nominal rate of interest adjusted for the frequency of interest compounding and the System stock purchase requirement. We assumed no dividends were paid on the stock over the life of the loan.

Table II.1: Mean Effective Interest Rates on Farm Operating Loans in Selected Midwestern Local Markets, 1991

		Sample size		Mean effective rate		
FCB/Area	Quarter	System	Banks	System	Banks	Difference
A/1	1	36	30	10.74	12.03	-1.29[a]
	2	18	30	9.98	11.62	-1.64[a]
	3	13	37	10.62	11.57	-0.95[a]
	4	12	37	9.77	10.86	-1.10[a]
A/3	1	25	101	10.79	12.01	-1.22[a]
	2	10	91	10.15	11.39	-1.24[a]
A/4	1	46	21	10.86	11.09	-0.23
	3	11	23	10.32	10.97	-0.65[b]
	4	14	24	9.21	10.52	-1.31[a]
A/5	1	35	15	10.51	12.11	-1.60[a]
	2	36	22	10.33	10.89	-0.56
	3	23	20	9.94	10.94	-1.00[a]
	4	17	16	9.70	10.34	-0.64[b]
A/6	1	15	22	10.51	11.13	-0.62
	2	23	47	10.65	10.86	-0.21
	3	17	28	10.10	11.07	-0.97[a]
	4	25	24	9.40	10.48	-1.08[a]
B/8	1	41	361	11.54	11.81	-0.27
	4	11	270	10.49	11.15	-0.66[b]
B/9	1	33	178	11.40	11.74	-0.34[a]
	2	17	170	11.16	11.40	-0.24
	4	13	132	10.58	10.87	-0.29
B/10	1	12	129	11.61	11.40	0.21
	4	18	259	10.50	10.62	-0.12
C/24	1	22	23	12.32	12.72	-0.40
	2	22	20	11.96	12.57	-0.61[a]
	4	12	34	11.09	11.18	-0.09
C/26	1	28	104	11.93	12.14	-0.21
	2	14	98	11.62	11.78	-0.16
	4	13	103	11.07	10.73	0.34

Note: "Difference" equals System minus Banks.

[a]Statistically significant at a 1-percent level of confidence.

[b]Statistically significant at a 5-percent level of confidence.

Source: GAO.

In selecting market areas and time periods in which to make these comparisons, we eliminated all those with fewer than 30 observations or fewer than 10 loans from both System institutions and small banks. While there were too few observations to make comparisons in every quarter for all market areas, the results obtained indicated that the mean effective interest rate charged by System institutions was either lower than, or not statistically different from, the mean effective interest rate charged by commercial banks in every instance where direct comparisons were possible. The mean rate charged by System institutions was never significantly higher than the mean rate charged by competing commercial banks in the same quarter. In 8 of the 10 areas, the difference in mean rates was statistically significant in at least one quarter during 1991. Although the magnitude of the interest rate differential varied over time and by market area, one local market (area 1) exhibited a large and significant difference in all four quarters of 1991. Several others also exhibited large differentials in mean effective rates between the two lenders.

We regard this evidence as only suggestive. Because the data were drawn from only a sample of loans in each quarter and because only a small number of commercial banks from each market were surveyed, the results may not be representative. Additionally, because of the limitations associated with an analysis involving averages, we were not able to determine if the differences were due to variations in the characteristics of the loans or to real systematic pricing differences between the lenders. Yet, the results from the means analysis are at least consistent with the interest rate structure suggested by the national data, in which System rates on operating loans are, on average, slightly below those of small to medium-sized banks.

Regression Analysis Reinforces Finding That System Interest Rates Are Lower Than Small Commercial Bank Rates

Since individual loan characteristics could cause the means comparisons to be misleading, we attempted to determine if the observed differences in interest rates persisted once we controlled for the possible effects of several other potentially influential factors. To do this, we employed multiple regression analysis to test the relationship between the effective interest rates on individual loans and a dummy variable that identified the lender, while controlling for the effects of time, location, and various other attributes of the individuai loans (see table II.2 for variable definitions).[3] With this technique, we could use data for all 12 market areas and all 4 quarters of 1991. Since the agricultural credit market is for the most part segmented into real estate and nonreal estate markets, separate regressions were run for agricultural real estate loans and operating loans.

Results from our regression analysis indicated that System rates on both types of loans were lower on average than rates on similar loans made by small to medium-sized commercial banks (see table II.3). For operating loans, System rates were estimated to be approximately 0.59 percentage points less than interest rates charged by competing small to medium-sized banks in the sample. For agricultural real estate loans the difference was somewhat greater, with effective interest rates at System institutions being 0.99 percentage points less than rates at competing small banks. The larger difference observed on agricultural real estate rates is consistent with the argument that the System has an advantage in making long-term loans due to its lower cost of funds. This is reflected by the System's large market share in agricultural real estate lending.

Not surprisingly, the results also indicate that interest rates generally declined over the year and that rates varied considerably between individual markets, by the size of loan, and by the maturity (length) of the loan.

[3]Use of the dummy variable method to ascertain the various effects of different explanatory variables requires some care in interpretation. For example, all parameter estimates in our equation indicate to what extent the intercept value would be affected if that particular loan characteristic were applicable and all other effects were held constant. The interpretation is straightforward in the case of the SOURCE, LTYPE, and GSTAT variables, i.e., a real estate loan originated by a commercial bank (SOURCE=1) is estimated to be 0.987 percentage points greater than one that is originated by a System institution. However, the interpretation of the parameter estimates associated with the dummy class variables, which characterize loans by quarter (Q), local market area (AREA), size (SIZE), and maturity (MAT), must be interpreted relative to a preselected intercept value. In our model, the coefficient of the intercept is estimated for a relatively small loan (SIZE0: less than $10,000) originated in market area No. 1 (AREA1) during the first quarter of 1991 (Q1) and which has a maturity of less than 1 year (MAT01). Hence, the parameter estimate of the variable SIZE5, for example, reflects the percentage point difference in the interest rate between a small loan (less than $10,000) and a relatively large loan ($250,000 or more). For real estate loans, this difference is -0.725 percentage points. That is, the interest rate on farm real estate loans greater than $250,000 is roughly three-quarters of a percentage point less than a similar loan made for less than $10,000.

The adjusted R-square values associated with our regression model are somewhat lower than would be desirable (0.5798 for the real estate equation and 0.2830 for the nonreal estate equation).[4] The magnitude of the adjusted R-square indicates that a considerable amount of the variation in observed interest rates remains unexplained by the variables used in our model.

Hence, because of the limited data available to us and because of the relatively low explanatory power of the regression model, these results do not allow us to conclusively determine if the differences between interest rates were purely lender-related, as suggested by the significance and magnitude of the SOURCE variable coefficients, or if some unknown borrower characteristics (such as creditworthiness) and/or nonprice competitive factors were responsible for all or part of the disparity.

In summary, while our statistical analyses did not uncover conclusive evidence indicating that interest rates on new loans originated in 1991 by System institutions were less than rates charged by small to medium-sized commercial banks for similar loans, the bulk of the evidence suggests that this is the case. Our results are consistent with the prevailing interest rate structure suggested by the national summary data collected by the U.S. Department of Agriculture in which System rates averaged somewhere between rates charged by large and small to medium-sized commercial banks.

As previously mentioned, tables II.2 and II.3 contain our multiple regression analysis variable definitions and results.

[4]The R-square value is a measure of the explanatory power of the model (with a value of 1 being the maximum). The adjusted R-square value is a related measure that takes into consideration the number of explanatory variables used in the equation.

Table II.2: Farm Loan Interest Rate Regression Model Variables

Variable name	Definition
RATE	Effective loan rate. This is the dependent variable of the regression.
SOURCE	Lender. This is a dummy variable equal to 1 if the lender is a commercial bank or 0 if a System institution.
Qnn	Quarter. These three dummy variables equal 1 if the loan was made in the quarter, otherwise 0.
AREAnn	Local market area. These 11 dummy variables equal 1 if the loan was made in the area, otherwise 0.
LTYPE	Loan type. This is a dummy variable equal to 1 if the interest rate on the loan is fixed, otherwise 0.
GSTAT	Guarantee status. This is a dummy variable equal to 1 if the loan is guaranteed by the federal or a state government, otherwise 0.
SIZEn	Loan size. These five dummy variables define the following size classes. SIZE1 equals $10,000 to $24,999; SIZE2, $25,000 to $49,999; SIZE3, $50,000 to $99,999; SIZE4, $100,000 to $249,999; and SIZE5, $250,000 or more.
MATnnn	Maturity or length of the loan. These four dummy variables define the following maturity classes. MAT13 equals 1 year to less than 3 years; MAT35, 3 years to less than 5 years; MAT510, 5 years to less than 10 years; and MAT10, 10 years or more.

Source: GAO.

Table II.3: Farm Loan Interest Rate Regression Model Results

	Real estate loans		Nonreal estate loans	
Variable	Estimate	t STAT	Estimate	t STAT
INTERCEPT	11.890[a]	42.490	11.778[a]	125.320
SOURCE	0.987[a]	10.679	0.589[a]	12.071
Q2	-0.302[a]	-3.923	-0.331[a]	-8.986
Q3	-0.314[a]	-3.494	-0.396[a]	-10.125
Q4	-0.792[a]	-9.285	-0.903[a]	-23.282
AREA2	-0.020	-0.117	-0.064	-0.218
AREA3	0.188	1.238	0.057	0.754
AREA4	-0.038	-0.230	-0.311[a]	-3.512
AREA5	-0.248	-1.696	-0.367[a]	-4.153
AREA6	-0.025	-0.172	-0.458[a]	-5.304
AREA8	-0.036	-0.264	0.172[a]	2.599
AREA9	0.133	0.944	0.102	1.449
AREA10	0.177	1.155	-0.192[a]	-2.691
AREA24	0.378[b]	2.024	0.821[a]	8.802
AREA26	-0.098	-0.462	0.408[a]	4.087
AREA29	0.665[a]	3.094	1.176[a]	9.963
LTYPE	-0.044	-0.594	-0.012	-0.368
GSTAT	0.727[a]	4.712	0.106	1.244
SIZE1	-0.039	-0.362	-0.173[a]	-4.826
SIZE2	-0.159	-1.671	-0.370[a]	-7.615
SIZE3	-0.500[a]	-5.172	-0.502[a]	-8.606
SIZE4	-0.528[a]	-5.054	-0.427[a]	-5.370
SIZE5	-0.725[a]	-5.029	-0.580[a]	-3.768
MAT13	0.380	1.356	-0.167[b]	-2.008
MAT35	-0.319	-0.979	-0.286[a]	-3.162
MAT510	-1.001[a]	-3.809	-0.391[a]	-4.638
MAT10	-1.300[a]	-5.433	-0.644[a]	-8.575
R-SQUARE	0.5971		0.2874	
ADJ R-SQUARE	0.5798		0.2830	
F VALUE	34.536		64.871	
PROB>F	0.0001		0.0001	

[a]Statistically significant at a 1-percent level of confidence.

[b]Statistically significant at a 5-percent level of confidence.

Source: GAO analysis of Farm Credit System and Federal Reserve Board data.

Comments From the Farm Credit System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

THE FARM CREDIT COUNCIL

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April 1, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

See p. 75.

We appreciate the opportunity to respond to the draft report entitled Farm Credit System: Repayment of Federal Assistance and Competitive Position. The comments contained herein are provided on behalf of the institutions of the Farm Credit System and represent the collective views of those institutions.

The draft report has been prepared in response to the directive established in the Food, Agriculture, Conservation and Trade Act of 1990 (Section 1842, P.L. 101-624) that the Comptroller General conduct ". . . a study of certain matters related to the cost and availability of credit in rural America . . . ." That directive included a total of ten issues, six of which dealt with the activities of lenders other than the Farm Credit System. The draft report fails to specifically address several of these non-System issues.

In addition, the questions raised by Congress in Section 1842(a)(1) and (2) of the 1990 Farm Bill focus on the relationship between System loan volume and the System's ability to repay assistance, and the ability of the System to remain competitive while repaying assistance, building capital, etc. In its draft report, the GAO fails to address these key questions and instead focuses on accounting issues surrounding the Farm Credit System Insurance Corporation and other matters not raised by Congress as issues or concerns.

Our response is organized to follow the chapters of the draft report. While there is much in the report with which we agree and we compliment the GAO on the work

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See comment 1.

Mr. Johnny C. Finch
April 1, 1993
Page 2

they have done, there are several areas with which we take strong exception. Those are detailed in the discussion that follows.

Our response contains two addenda. The first is a detailed discussion of the issues surrounding the GAO recommendations dealing with the System's accounting treatment of the Farm Credit Insurance Fund. This first addendum was prepared by the Federal Farm Credit Banks Funding Corporation and is a concise discussion of the issues surrounding the GAO recommendations. This is an extremely important matter having significant implications. The second addendum contains a number of technical comments to the text of the draft report.

Once again, we appreciate 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,

Maxey D. Love, Jr., Chairman
Presidents Planning Committee

Enclosures

GAO DRAFT REPORT:

CHAPTER 2
FEDERAL ASSISTANCE TO THE FCS AND REPAYMENT PLANS

The Food, Agricultural, Conservation, and Trade Act of 1990 required GAO to study rural credit costs and availability. As presented by GAO, one of its objectives was to study "whether and how the federal financial assistance granted to the Farm Credit System will be repaid?"

Before reviewing GAO's specific recommendations, it is essential to keep in mind that the GAO report is the result of a 1990 Congressional request. To read the report without recognizing the significant efforts made by the Congress and the Farm Credit System since 1990 to resolve the issues surrounding repayment of financial assistance would be remiss.

First, the Congress passed the Farm Credit Banks and Associations Safety and Soundness Act of 1992 (1992 Act). The 1992 Act prescribes specific methodologies for the ultimate repayment of all elements of financial assistance and for the recognition of the related expense and balance sheet impacts in accordance with generally accepted accounting principles (GAAP). Starting in early 1991, the System worked toward the development and enactment of this legislation. The 1992 Act appropriately retains the structural legal framework of the assistance provisions of the Agricultural Credit Act of 1987 (1987 Act) and accommodates the requirements of GAAP. The System believes this is absolutely essential.

In 1987, Congress framed a response to the depression in agriculture and the financial stress in the Farm Credit System by balancing the multiple and diverse interests of the farmers who were unable to pay their loans and who were stockholders in the Farm Credit System, Farm Credit institutions needing assistance, Farm Credit institutions that still had financial resources, the U.S. taxpayer, etc. The solution created by the 1987 Act included System self-help and the provision of financial assistance through the creation of the Farm Credit System Financial Assistance Corporation (FAC) and the Farm Credit System Assistance Board. FAC was created as a System entity that would issue debt guaranteed by the U.S. Treasury. The funds thus raised by FAC were to be utilized to provide the different types of assistance authorized by the 1987 Act. Since FAC is a System institution, the debt issued by FAC is recorded as an obligation of the System in the consolidated Systemwide financial statements, but is not reflected as a liability of any individual bank.

Second, the System has taken important steps toward internal self-discipline by all banks entering into a Contractual Interbank Performance Agreement (CIPA). CIPA establishes performance standards for the banks to achieve by the year 2000, with interim targets as well. GAO incorrectly concludes in its draft report that the System implicitly supports its recommendations because the CIPA standards incorporate the financial impact of repaying financial assistance. <u>CIPA is an internal self-discipline mechanism entered into by and between the banks</u>. As such, the fact that it incorporates planning for contingencies is appropriate. However, the conclusion drawn by GAO clearly is not justified.

See comment 2.

Third, as noted by GAO, since 1990 the financial performance of the System has improved significantly. In fact, in 1992 two of the four operating banks to receive financial assistance requested and received approval to redeem their Assistance Preferred Stock early. Because of this improved financial performance, GAO answers the critical question whether the assistance will be repaid by concluding that "[b]arring another unexpected crisis in agriculture, the FCS should be able to repay the $1.841 billion in bonds issued to fund federal financial assistance and interest advances from the Treasury when due early in the next century."*

Despite the clarifications in the 1992 Act relating to who will repay and how such repayment will be accomplished, as well as its own conclusions concerning adequate repayment ability, GAO expresses the view that accounting and regulatory weaknesses concerning financial assistance remain. The recommendations contained in GAO's draft report concerning financial assistance repayment implicitly ask Congress to abandon the financial assistance structure it adopted in the 1987 Act and clarified in the 1992 Act, and, in certain instances, to impose RAP instead of GAAP. GAO makes the following conclusions and recommendations based on policy direction different than that embraced by the Congress, and <u>its recommendations simply are not supported by the facts</u>:

See pp. 76-78.

<u>FCA and the public do not currently have accurate information on System banks' financial condition.</u>

* As noted, the draft report makes reference to the need for the System to repay ". . . the $1.841 billion in bonds issued . . . ." This is incorrect. The Financial Assistance Corporation only issued $1.261 billion in bonds. The difference is an amount equal to the assumed amount of interest that will be paid by the Treasury over a ten-year period. This amount may be less depending on the financial performance of the System. The $1.841 billion number should only be used with a very clear explanation of what it represents.

See comment 3.

- 2 -

See pp. 76-78.

1. *GAO is concerned with the possible overstatement of capital position because of the treatment of Capital Preservation Agreement assistance and Treasury interest advances.*

   Response: The only portion of financial assistance not recognized on Farm Credit System bank financial statements is related to repayment of the principal portion of FAC debt issued to fund Capital Preservation Agreement accruals. This amount is now $390 million, approximately one-third of the total FAC debt. All interest obligations and all other principal amounts are incorporated into the System bank financial statements. In addition, the impact of not recording this one item is fully described in financial statement footnotes. As a result of the 1992 Act, each System bank has entered into an agreement with FAC which provides for annual annuity-type payments to be used to repay the principal portion of FAC debt issued to fund Capital Preservation Agreement accruals. Annually, the funds that are transferred to FAC under these agreements are expensed.

   The System whole-heartedly agrees that neither FCA nor the public should have inadequate information on which to assess the System's progress toward financial recovery. In our judgment and the judgment of Congress, the 1992 Act's provisions for paying funds on an annual basis along with full disclosure in the financial statements provides adequate disclosure.

See pp. 76-77 and comment 4.

2. *The GAO believes that the banks should record liabilities for assistance at face amount rather than their present value.*

   Response: Because the assistance repayment obligations of System banks are to make payments to FAC, not to the investors in FAC bonds, GAAP provides for recording non-interest bearing liabilities at their present values. GAO concedes that the current accounting treatment accords with the form of the law and is in conformance with GAAP. Moreover, the fact that the Omaha FCB and AgriBank retired their preferred stock on a present-value basis (which GAO's draft report acknowledges at page 52) underscores the correctness of the System's position concerning present-value accounting. We note also the reference to FCSIC's use of

- 3 -

present-value accounting for its Jackson-related liability, at pages 65-66 of the draft report.

See pp. 76-78 and comment 5.

3. *GAO concludes that it is feasible to eliminate the remaining accounting and regulatory relief.*

Response: GAO's analysis of the System's financial condition indicates that "FCS has recovered to the point that its banks can now record their liabilities for assistance repayment on their balance sheets and still meet new regulatory capital requirements." While this observation, taken alone, may seem accurate, it ignores several important points. First, the System is still in the midst of significant structural and operational changes which were made available and, in fact, encouraged by the 1987 Act. Such significant shifts make it prudent not to be overly aggressive in the short run, relative to assistance recording.

Second, almost all System institutions have benefitted in recent years from good agricultural economic conditions. We cannot expect this to continue indefinitely, and some slippage in the System's financial condition and performance must be anticipated when this occurs since the System is almost totally restricted to serving agriculture. Finally, the 1992 Act was intended to render moot most of GAO's recommendations over the next several years as payments are made to FAC to accumulate funds for, among other things, debt issued to fund Capital Preservation Agreement payables. (It is worth noting in this regard that GAO's views as expressed in the draft report were well known when Congress opted instead for the approach adopted in the 1992 Act.) Short-term actions in this area could be disruptive to the longer term objective of full and timely repayment of all FAC debt and related interest.

FCA's regulatory powers are insufficient.

1. *GAO is concerned with a bank's ability to reschedule Capital Preservation Agreement payments if such payments would reduce the bank's capital below the regulatory minimum. GAO concludes that a weak bank could, in principle, both avoid regulatory sanction and postpone payments.*

- 4 -

See p. 45 and comment 6.

Response: To conclude that a bank, by rescheduling its Capital Preservation Agreement obligation, would be able to avoid regulatory intervention is simply a gross over-simplification. The Farm Credit Administration (FCA) has broad safety and soundness regulatory authorities, as well as a full arsenal of cease and desist and civil money penalty authorities. If a bank is unable to meet its Capital Preservation Agreement obligation, that inability is the result of other underlying causes. FCA clearly has the authority and the responsibility to intervene in appropriate circumstances, based on those underlying causes. Consequently, to conclude that this narrow issue would delay regulatory intervention is simply unrealistic.

During the development of the 1992 Act, the System concluded that no incentive should be provided to a bank to delay its payments (i.e., its total obligations should in no way be reduced and, in fact, future years' payments should be increased by a corresponding amount). On the other hand, it was also agreed that little would be gained toward a bank's ultimate repayment if such bank were required to operate below FCA's minimum regulatory capital requirements. The current approach — the approach adopted by the Congress — provides prudent safeguards for all parties involved.

2. *Payment of Treasury Interest Counted as Permanent Capital.*

See pp. 39-40 and p. 77.

Response: In developing the 1992 legislation, some System banks believed strongly that it was necessary to retain this regulatory protection as the System worked constructively with Congress to remove prior uncertainties as to the repayment mechanism for Treasury-paid interest. In return for a transition period on regulatory permanent capital calculations, the System supported specific identification of repayment responsibilities and a pre-funding process to assure that adequate funds are available when due. This transition period recognizes the uncertainties of the agricultural economy and the remaining levels of non-accrual loans in some institutions. It should also be noted that the FCA's minimum capital requirement is well above that for other financial institutions.

- 5 -

See comment 7.

3. *Law should be amended to reduce the value of assistance preferred stock by FCA regulation.*

 Response: In the 1987 Act, care was taken by Congress to provide for permanent capital assistance to troubled banks, since those banks were not just in need of additional borrowed funds. Accordingly, the 1987 Act provided for FAC to invest in an institution's capital stock, and FAC could not require such stock to be retired. That decision, like all other equity decisions, was left with the affected institution itself, subject to FCA approval. Thus, the FAC investment is, in form and in substance, permanent capital.

 In addition, the two assisted banks that have not retired their preferred stock early are building appropriated surplus accounts to help assure their financial progress. This mechanism, however, is only an indication of the financial progress of the bank, and the surplus itself will not be used to retire the stock at some future date. Rather, it will remain as retained earnings of the bank and, therefore, it also qualifies as permanent capital.

In sum, the System firmly believes that the financial assistance provided by Congress in the 1987 Act has been critical to the System's financial recovery and its ability to remain as a dependable source of credit to farmers and their cooperatives. Similarly, the repayment mechanisms fashioned by Congress in the 1992 Act serve the best interest of all parties to assure the attainment of long-term objectives. Any efforts that would jeopardize these long-term results for a short-term gain, different than that adopted by Congress, must be carefully evaluated and, generally, rejected.

See p. 78.

GAO's Recommendation that FCS Repay Funds Transferred to FCSIC.

The GAO recommends that the System repay about $260 million in funds transferred to the Insurance Corporation under the Agricultural Credit Act of 1987. GAO justifies this recommendation by stating that (a) the revolving funds were Treasury monies, (b) unlike all other assistance to the System, these funds were not required to be repaid, (c) the Insurance Fund should be industry financed, and (d) the recent bank bailout legislation requires commercial banks to repay any borrowings

- 6 -

from the Treasury by the Federal Deposit Insurance Corporation. The System strongly disagrees with this recommendation and urges that it be reconsidered.

Back in the late 1920's and the early 1930's, the Congress authorized the creation of several revolving funds which had as their purpose the encouragement of the creation of organizations of producers to provide credit to agriculture. The revolving funds were to be used to provide seed capital. The source of the monies in the funds was varied — the repayment of certain loans extended by the Secretary of Agriculture, unobligated balances from the Reconstruction Finance Corporation, unobligated balances in certain loan programs, and appropriated funds. As the System fulfilled its mission to work with farmers during the very difficult times of the Great Depression, the use of these funds changed from seed capital to assistance capital to be used by the System's regulator to underpin an institution made weak by its continued efforts to "meet the emergency credit needs of borrowers." For about 50 years, the "revolving funds" maintained their integrity as individual accounts on the books of the Federal government. Among other things, these funds were used as cooperative seed capital, bank capital, and price stabilization funds.

In 1987, the Congress decided to expand the level of protection which stood between losses by System institutions and the potential need for appropriations of Federal taxpayer funds. To this end, the Farm Credit System Insurance Corporation was established. The Congress chose to merge the former revolving fund assets into the Insurance Fund. This action did not result in any Federal outlay of Federal funds, nor did it "provide" the System with taxpayer funds as GAO states in its draft report. From the government's accounting perspective, funds were transferred from one account to another. From the Congress' perspective, their action maintained the purposes of the revolving funds consistent with what they had been for nearly 50 years. GAO's recommendation ignores this history.

See comment 8.

Second, GAO claims that the transfer of these funds was inconsistent with the assistance provisions of the 1987 Act in that they were not required to be repaid. GAO simply ignores the fact that the only funds the System was required to repay were those that were actually used. As previously stated, these funds were not "provided to the FCS" by the

- 7 -

1987 Act; they were transferred to the Insurance Corporation, another Federal account. Had such funds instead been directly invested in a System institution, requiring that they be "repaid" would have been consistent with the provisions of the 1987 Act.

Third, GAO indicates in its draft report that, in its view, the Insurance Fund should be industry financed. The System is in the process of capitalizing the Fund. To date, the System has contributed in the form of premiums more than $287 million to the Fund, all of which has counted as Federal revenues. While the Congress chose to limit these capital contributions to the Fund once the secure base of 2 percent of insured obligations is reached, through interest earnings (which to date total approximately $109 million) the Fund will continue to grow beyond the secure base level with no upper boundary. Under current law, System stockholders will be denied the use of these funds. This will be an ongoing "economic tax" on these institutions serving to benefit the taxpayer.

See comment 9.

Finally, the GAO cites the repayment requirement for direct Treasury assistance to the Federal Deposit Insurance Corporation as precedent for a repayment requirement in the case of FCSIC. The GAO compares the assistance mechanism in the case of one fund to the establishment of the other. GAO attempts to compare the 1991 provision of assistance to the FDIC and commercial banks to the 1933 action of Congress to create the precursor of the Insurance Fund. GAO implies the "System" received a direct appropriation when the revolving funds were made a part of the Insurance Fund. This should be clarified since there was no direct appropriation to the Insurance Fund. 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.

See p. 79 and comment 1.

GAO's Recommendation that the Insurance Fund Should Not be Included in the System's Combined Financial Statements.

(*NOTE:* Addendum I contains a detailed discussion of the System's views regarding the recommendations in the draft report relative to the accounting treatment of the Farm Credit Insurance Fund. The following is a summary of that discussion.)

- 8 -

See comment 10.

The General Accounting Office (GAO) asserts, in its draft report, that the Farm Credit Insurance Fund (Insurance Fund) administered by the Farm Credit System Insurance Corporation (FCSIC) should not be included in the Farm Credit System's (System) combined financial statements. The stated reasons for this assertion are as follows:

1. Investors may be misled by the System's existing presentation of the Insurance Fund in its combined financial statements because the total balance of the Insurance Fund is shown as a restricted asset rather than being shown as a net amount calculated after ". . . first subtracting [from the total assets of the Insurance Fund] the liability for the [Federal Land Bank of Jackson] liquidation . . ." (see page 71). (See System Response 3.)

2. The FCSIC is a Federal agency whose assets and income are included in the Federal budget. Therefore, it is inappropriate for the System to also include those items in the System's combined financial statements (see pages 6, 12 and 69). The following statement is also made on page 69: "As an [Office of Management and Budget (OMB)] official emphasized to us, FCSIC's income and assets are public, not private funds." (See System Response 4.)

3. The Farm Credit Administration (FCA) has a letter from an external auditor supporting its position that it is inappropriate for FCSIC (and the Insurance Fund) to be included in the System's combined financial statements (see page 70). (See System Responses 1, 2, and 5.)

4. The GAO, OMB, FCA, and FCSIC agree that it is not appropriate for the Insurance Fund to be included in the System's combined financial statements (see page 12). (See System Response 6.)

Based upon its determination that the Insurance Fund has been improperly included in the System's combined financial statements for the years ended December 31, 1989, 1990 and 1991, the GAO makes the following two recommendations relating to the System's accounting and financial reporting with respect to the Insurance Fund:

- 9 -

1. The Chairman of the FCA should prohibit the System from including the Insurance Fund in the System's combined financial statements (see pages 17 and 73). (See System Response 9.)

2. The System's combined financial statements for the years ended December 31, 1989, 1990 and 1991 should be restated to exclude the Insurance Fund (see pages 12 and 70). (See System Response 10.)

The System's Response:

See app. I.

1. The Insurance Fund should be included as a restricted asset in the System's combined financial statements because such accounting treatment is in accordance with generally accepted accounting principles (GAAP). (Addendum I, pages 5-9.)

2. The System should continue to issue combined financial statements which include the Insurance Fund as a restricted asset because GAAP-basis financial statements are the most meaningful to the primary users of the System's combined financial statements. Further, independent public accountants have opined that the System's combined financial statements, which include the Insurance Fund as a restricted asset, are GAAP-basis financial statements. (Addendum I, pages 9-12.)

3. The System believes that its presentation of the Insurance Fund as a restricted asset in its GAAP-basis combined financial statements is not misleading to investors in the debt securities it issues (or to other interested parties), and, indeed, is the most meaningful presentation for all parties to gain a comprehensive understanding of the protection mechanisms available against any default with respect to such securities. (Addendum I, pages 12-13.)

See comment 11.

4. While we agree the FCSIC is a Federal agency, the inclusion of its assets and income in the Federal budget does not preclude the Insurance Fund from being included in the System's combined financial statements under GAAP. Further, we reject the notion that the assets in the Insurance Fund are "public" funds, if that concept means the Insurance Fund can be used for any purpose other than those purposes set forth in the Farm Credit Act, which

- 10 -

clearly specifies that the Insurance Fund can be used solely for the benefit, direct or indirect, of the System. Rather, the FCSIC has a fiduciary role in relation to the System and the administration of the Insurance Fund which is not dissimilar to that of a trustee in relation to a beneficiary and the assets held in trust for such beneficiary. (Addendum I, pages 13-15.)

5. While the FCA has a letter from an external auditor supporting its position that it is inappropriate for the Insurance Fund to be included in the System's combined financial statements, based upon facts and circumstances which may not have been known or fully understood at the time the letter was issued, we believe it would be appropriate for the FCA to have such external auditor reconsider its conclusions in light of all the facts and circumstances surrounding the issue of whether inclusion of the Insurance Fund as a restricted asset in the System's combined financial statements is in accordance with GAAP. (Addendum I, pages 15-16.)

See comment 12.

6. We respect the rights of the GAO, OMB, FCA and FCSIC to express their views as to whether or not it is appropriate for the Insurance Fund to be included in the GAAP-basis combined financial statements of the System. We believe, however, the controlling determination of whether the accounting for a particular transaction (or set of transactions) is in compliance with GAAP should be made by those not only knowledgeable about the System, but also most knowledgeable about authoritative accounting pronouncements and literature and the practices of entities issuing GAAP-basis financial statements. Further, if the intent of the statement in the GAO draft report with respect to the dissenting views of the GAO, OMB, FCA and FCSIC is to imply that such agencies set GAAP, we take issue with that view. Rather, we submit that GAAP is established by the authoritative pronouncements and literature of recognized accounting bodies, such as the FASB, and other accounting authorities and/or by the practices generally employed by organizations in recording in their accounting records the transactions related to their various activities. (Addendum I, pages 16-17.)

- 11 -

See comment 13.

7. The GAO has not asserted, nor provided any meaningful analysis, in its draft report that (a) the inclusion of the Insurance Fund in the System's combined financial statements is not in conformity with GAAP, or (b) the exclusion of the Insurance Fund from the System's combined financial statements is in conformity with GAAP and is more preferable than the System's "inclusion" method of accounting for the Insurance Fund. Therefore, we would suggest such basic analysis be performed before the GAO advances any recommendation that the System be required to change its method of accounting for the Insurance Fund. (Addendum I, pages 17-18.)

See comment 14.

8. Based upon statements in the GAO draft report with respect to recording a liability for the liquidation of the Federal Land Bank of Jackson and to restating the System's combined financial statements, we believe a fundamental misunderstanding may exist about the accounting relative to these issues. In addition, the GAO draft report contains other errors or omissions with respect to accounting or financial reporting issues. Therefore, we would respectfully urge a more comprehensive analysis be performed of the application of accounting principles in this matter before the GAO recommends that the System be required to change its method of accounting for the Insurance Fund. (Addendum I, pages 18-21.)

9. The GAO is respectfully urged to withdraw the recommendation in its draft report for the Chairman of the FCA to prohibit the inclusion of the Insurance Fund in the System's GAAP-basis combined financial statements. (Addendum I, pages 21-22.)

See comment 10.

10. The GAO is respectfully urged to withdraw the recommendation in its draft report for the System to restate its combined financial statements for the years ended December 31, 1989, 1990 and 1991. The ramifications of such a restatement (or prospective exclusion of the Insurance Fund from the System's combined financial statements) may not have been fully appreciated before such recommendation was placed in the draft report. (Addendum I, pages 23-24.)

- 12 -

See p. 79 and comment 15.

11. The GAO is urged to include in its final report a recognition of the fact that the System has previously proposed, and continues to support, an approach to resolve the Insurance Fund accounting conflict. Such approach provides for the FCA and the System to jointly submit for determination by an authoritative accounting body (such as the Emerging Issues Task Force of the FASB) the questions of (a) whether either or both of the "inclusion" and "exclusion" methods of accounting for the Insurance Fund in the System's combined financial statements are acceptable under GAAP, and (b) which method, if both are acceptable under GAAP, is "preferable" under Accounting Principles Board Opinion No. 20 and other authoritative pronouncements. Further, this approach would bind the System to use in its GAAP-basis combined financial statements issued for 1993 and subsequent years the method of accounting for the Insurance Fund which is determined through such process to be preferable under GAAP. (Addendum I, pages 25-26.)

- 13 -

GAO DRAFT REPORT:

CHAPTER 3
LOAN PRICING AND COMPETITION AMONG AGRICULTURAL LENDERS

In Chapter 3 of its draft report, GAO indicates that its economic analysis did not reveal evidence of unfair competition — or "predatory pricing" — by the System. GAO notes that, while some System institutions have been lending aggressively, the System's regulator, FCA, has found in its investigation of complaints of unfair competition that in nearly all cases such lending was legitimate competition. Although not surprised by these findings, the System is certainly pleased with and fully concurs in them. Recent levels of System profitability serve to confirm the absence of predatory pricing on the part of System institutions and, in fact, such earnings levels compare favorably with or exceed the earnings of other financial institutions.

Rather than concern themselves with below-cost "predatory pricing," System institutions are and have been appropriately focused on the continued accumulation of retained earnings to (1) build capital to ensure the timely repayment of all financial assistance provided under the 1987 Act, (2) meet and exceed the financial performance requirements of the Contractual Interbank Performance Agreement (CIPA), and (3) rebuild System capital to enable the System to withstand future financial adversity inherent in lending to a single sector of the economy as cyclical as agriculture.

See comment 16.

Although we fully concur with GAO's findings relative to the absence of predatory pricing, the System does, however, take issue with the suggestion on page 85 of the draft report that System institutions "may have advantages [over their competitors] in . . . required profit margins." We believe the System's strong commitment to accumulate retained earnings as well as recognize its obligations under the 1987 Act to provide competitively priced credit to agriculture is clearly at odds with this suggestion.

See comment 17.

Further, it should be noted that GAO's analysis of the competitive situation among providers of credit to agriculture is much broader than the System and commercial banks. In today's marketplace, there are many other participants, including suppliers, finance companies and individuals, who are also involved in making credit available and influencing the competitive situation.

- 14 -

GAO DRAFT REPORT:

CHAPTER 4
THE FCS CHARTER AND THE QUESTION OF EXPANDED POWERS

Chapter 4 of the draft report looks at the System's charter and the question of expanded authorities. Overall, there is little controversy in the chapter, but a few points should be amplified. These amplifications and some additional comments follow:

Page 103, Last Paragraph.

The draft report suggests the System is advocating additional powers on the grounds that certain credit needs in rural America are not being met and to more fully meet farmers' needs while competing with other institutions. The report also points out that opponents of expanded authorities contend that increased competition from the System would make an "already unfair situation worse."

Response: Opponents of the Farm Credit System have repeatedly maintained that the System has an unfair advantage and that rural areas are adequately served by other financial institutions. Those making the claim seem to forget that the System was created due to market failures of the commercial banking sector and that there is little evidence that these market failures have been eradicated. For example, the System was created due to commercial banks' inability to adequately fund loans in an environment of agricultural expansion. Even during the last three decades, commercial banks have been in and out of the agricultural market depending on farm sector profitability and the movement in other market interest rates. This volatility has hurt agriculture. Moreover, commercial banks in rural areas tend to have a low loan-to-deposit ratio which would suggest that these banks are more interested in investing in government notes and bonds than in rural areas. Also, while the System may have GSE status, commercial banks have deposit insurance and interest-free demand deposits that, in effect, serve to level the playing field.

- 15 -

The System may be seeking changes in its lending authorities not only because the number of farmers (and hence its principal client base) are declining, but also as a means to service and stimulate the rural economy and rural agenda. Opponents of expanded authorities for the System argue that there is no rural credit shortage, but literature on the subject is inconclusive. The current economic recovery, nearly two years old, has been extremely anemic. It has been argued that this slow recovery can be traced, in part, to the low level of credit expansion. If opponents of the System act to stifle competition while continuing to operate with low loan-to-deposit ratios with all of the negative implications, we seriously question the likelihood of rural America's seeing any sustained growth. Would additional credit to rural America help stimulate the economy and offset some of the decline in farm numbers? Almost certainly!

Page 105, 1st Paragraph:

The draft report states that the System's advocates support changing the definition of "rural homeowner" to include any community with a population up to 20,000 rather than the existing 2,500 base. Opponents of this change, including the ABA, point out that many System banks do not fully utilize their existing rural housing authority, and thus, the argument goes, new powers are unnecessary. GAO also states that it did not find any conclusive data establishing whether there is an unmet need for rural housing loans in general.

Response: It is correct that most Farm Credit Districts are below the existing 15 percent rural home limitation. However, this was not always the case, and circumstances could quickly change. In the early 1980's, a number of Districts were approaching the 15 percent limitation, and a few Districts stopped lending altogether for rural housing. The System is currently below the 15 percent limitation for a number of reasons. First, rural housing loan volume declined sharply in the mid-1980's during the agricultural credit crisis. Second, prior to 1987, the 15-percent limitation on rural housing applied primarily to Federal Land Banks. However, following the mandated merger of the Federal Land Banks and Federal Intermediate Credit Banks, rural home loan volume has been spread over a larger base.

Interestingly, parts of the System experienced a substantially higher relative drop in rural housing loan volume in relation to agricultural loan

- 16 -

volume during the mid-1980's. Why? Those rural home owners who could refinance did so at other lending institutions because interest rates on System rural home loans were well above those at other institutions. System interest rates were higher because of the System's average cost pricing policies (in a structurally declining interest rate market) compared to the marginal cost pricing policies of its competitors. Also, the System's regulator, FCA, would not allow System banks to lower their interest rates commensurate with market rates. While rural home loan volume fell off rather sharply throughout the System, it is instructive and perhaps indicative of a credit shortage that not all rural home loan volume left the System. The Baltimore Farm Credit District illustrates this point. In the Baltimore District, rural home loan volume totalled $295 million at year-end 1982; four years later, at year-end 1986, rural home loan volume totalled $186 million, a 37 percent decline. While a decline of this magnitude is severe, one has to ask, given the relative advantage commercial banks enjoyed over Farm Credit, why the System lost only a portion and not all of its rural housing volume to commercial banks? From peak to trough, the decline in agricultural loan volume in the Baltimore Farm Credit District during the 1980's was only 15 percent.

With rural housing, the System has served a niche market where commercial banks have shown little or no interest. One of the System's market niches is in rural homes that do not meet the requirements for the secondary market. For example, the Federal National Mortgage Association has a requirement that no more than 30 percent of the overall value of the property can be in the land. Rural homes (non-farm) with substantial acreage oftentimes cannot satisfy this requirement. On the other hand, many rural commercial banks do not want to write a fixed-rate mortgage or in some cases do not want the loan at all. Also, in areas where mortgage loan originators are few, commercial banks do not actively pursue originations for sale in the secondary market. In these areas, the System plays a vital role in housing rural America.

Page 106, 1st Paragraph:

The draft report notes that in 1990, the Treasury proposed that all GSEs obtain an "AAA" rating from nationally-recognized rating organizations based on their financial condition and not their GSE status. The report further notes that the System responded that it would be virtually impossible to obtain such a rating because of its restricted charter.

- 17 -

Response: The System has taken a number of steps in trying to strengthen its debt rating based on performance and not GSE status. Among other things, the System adopted the Contractual Interbank Performance Agreement (CIPA), which penalizes Districts for under-performing. Also, the System recognizes, as does the market, that it is virtually impossible for a single sector lender to obtain an "AAA" rating. Broadening the System's charter and expanding its financing role to rural America would go a long way toward diversifying risk and helping the System serve its public purpose without putting public funds at risk.

Page 106, 2nd Paragraph:

The GAO analysis suggests that, in the near term, the System does not need far-reaching changes to its charter to ensure the viability of most institutions.

Response: This is probably true, but it is not clear from the report what GAO considers the short-run to be -- one year, five years, seven years? Moreover, GAO's point that expanding FCS powers is not needed to promote safety and soundness "in the near term" is really more accurately a statement that such action is not needed "in good agricultural economic times." We believe that this statement is not so much a function of short- versus long-term as it is a function of the System's stability while serving a fairly cyclical industry.

Furthermore, while the System may not need changes to remain viable, the System most certainly needs changes to adequately support rural America and the rural development agenda. Expanded lending authorities, be it for rural housing, farm- and cooperative-related businesses, rural infrastructure, or the like, will put more capital in rural areas and make them more viable. In addition, expanded authorities will help the System keep pace with the dynamic changes taking place in modern-day agriculture. For example, in some cases, eligible borrowers are expanding and changing their businesses, both vertically and horizontally, to remain competitive, and in the process they are becoming ineligible to borrow or continue to borrow. Laws and regulations governing loans to farm-related businesses, marketing and processing facilities, etc., will require more flexibility to accommodate the changing nature of agriculture and agribusiness.

It is somewhat surprising in this regard that the ABA would oppose giving the System new authorities that would strengthen rural America. By strengthening rural America and improving the incomes of rural

- 18 -

residents, commercial banks would likely see the demand for their loans and services increase, thus enhancing their own profitability. However, the System's effort at expanding its authorities and being a viable lender in rural areas may become more critical in the coming years as more and more commercial banks merge, leaving fewer rural banks that truly understand the needs of local communities. Moreover, likely changes in farm income support programs, international trading rules, and direct governmental farm lending programs may result in greater price volatility for the farm sector. Without greater lending diversity, the System could well face increased financial stress.

Page 109, 2nd Paragraph:

The draft report notes that the System is beginning to discuss possible changes in its charter and what these changes might be.

Response: The System, through its internal planning process, has begun the process of exploring what new authorities will be needed for the System to meet the needs of agriculture and rural communities in the 21st century. This will be an ongoing process involving the participation of each Farm Credit District and the Banks for Cooperatives, as well as consulting firms, universities, and other interested parties.

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- 19 -

The following are GAO's comments on the Farm Credit System's letter dated April 1, 1993.

GAO Comments

1. We did not reproduce either of these addenda in this report. In appendix I, we present and discuss the Funding Corporation's position on Insurance Fund accounting issues put forth in the first addendum to the System's comments. The technical comments in the second addendum were incorporated directly into the text where appropriate.

2. Our final report was revised to remove this implication reference but we retain the point that the Contractual Interbank Performance Agreement (CIPA) standards, which all System banks have agreed to, more clearly recognize the current effect the obligation for assistance repayment has on bank capital positions.

3. We have revised the report to clearly identify that the System has used and is obligated to repay the $1.261 billion for bonds issued to fund the assistance authorized under the 1987 act. In addition, the System must provide funds to reimburse the Treasury for advancing it interest payments for these bonds, estimated at $444 million to $580 million.

4. In our view, the way the Omaha Farm Credit Bank (FCB), AgriBank, and FCSIC accounted for the transactions cited here provides no support for System banks' practices in general. These transactions are related to specific obligations of particular entities that are not the same as those of System banks in general.

5. For the effects of structural change, one such change encouraged by the 1987 act is the conversion of associations from Federal Land Bank Associations (FLBA) to Agricultural Credit Associations (ACA) or Federal Land Credit Associations (FLCA). This means that FCBs increasingly operate as "wholesale" rather than "retail" lenders. Structural change of this kind increases the distortion of System banks' regulatory capital that results from the accounting and regulatory relief granted for assistance repayment.

6. We clarified the text in the report to better express our concern with this aspect of the regulatory relief granted by the 1992 act. We noted that if weak banks delay making annual payments to FAC for the capital preservation agreement (CPA) payables assistance, a serious distortion of regulatory capital could result. We also noted that a weak bank's

appearance of adequate capital might undermine FCA efforts to correct related performance problems.

7. As noted on page 46, in designing their CIPA program, System banks took a different position on the nature of the assistance preferred stock and the related appropriated surplus accounts than presented here.

8. As discussed in chapter 1 on page 24, the Insurance Fund has, in effect, already been tapped in connection with the liquidation of the Jackson FLB. In this sense, amounts in the Insurance Fund (which include the $260 million transferred from the revolving fund) have been invested in a System institution in connection with the 1987 act assistance program. In chapters 2 and 5 and in appendix I, we explain why we believe the System should acknowledge this fact now.

9. As FCSIC noted in its comments, Congress required commercial banks to repay the amounts the federal government contributed in the 1930s to the deposit insurance fund. Congress also did so later, in the 1950s, when it required System institutions to begin repaying the taxpayer money they had earlier received as start-up capital.

10. We made only one formal recommendation in the draft report, the first one the System cites on page 10. This is essentially the same recommendation we make on page 52 of chapter 2. However, the System is correct in pointing out that in the draft report, we concluded that the System's combined financial statements for 1989-1991 should be restated. As discussed in chapter 5 on page 80, we did not emphasize this in our final report.

11. In our view, the System's current accounting treatment of FCSIC's Insurance Fund is not the most appropriate GAAP treatment. In the draft report, we emphasized the fact that FCSIC premiums and the Insurance Fund are on-budget to make clear that the statutory mechanisms under discussion constitute a federal insurance program for System institutions. We added that they are not a form of self insurance to make this distinction more apparent in chapter 2.

We also added footnote 23 on page 48 of chapter 2 to clarify that the amounts in the Insurance Fund have the same budget classification as the assessments System institutions pay to cover FCA's operating expenses, namely "public enterprise funds."

Finally, as discussed in appendix I, we do not believe it is appropriate to characterize FCSIC as simply a trustee for the System, and we did not do so in the final report.

12. We believe the Funding Corporation is correct in pointing out that, ideally, those most knowledgeable about the practices of entities issuing GAAP-based financial statements should make determinations as to the most appropriate accounting treatments for particular transactions. However, as noted in chapter 5, in the case of virtually all large private issuers of securities in the U.S. financial markets, the Securities and Exchange Commission (SEC) reviews these determinations and has the authority to require changes in particular entities' accounting practices.

The System is one of the government-sponsored enterprises (GSE) exempt from these SEC reviews, but not from similar reviews by FCA. The SEC certainly has more experience in reviewing the financial reports of major U.S. corporations than FCA does. Nevertheless, we believe FCA has the statutory authority to review the System's financial statements to ensure that they are prepared in accordance with GAAP, and, if it determines that they are not, to require changes.

Of course, this does not give FCA the authority or the duty to set GAAP. We did not mean to suggest that any of the federal bodies cited here set GAAP for private firms. However, we have certain responsibilities for establishing accounting principles for public entities. Indeed, one of the major GSEs—the Federal Home Loan Bank System—currently prepares its combined financial statements in accordance with these standards.

13. We added appendix I to this final report in response to this comment as well as comments from FCA and FCSIC. This appendix discusses the Funding Corporation's position and our views as to the proper interpretation of GAAP with respect to FCSIC's Insurance Fund in detail. As noted on page 92, we concluded that the System's current treatment is not the most appropriate one under GAAP.

14. In the draft report, we identified accounting for the Jackson FLB as a problem related to Insurance Fund accounting, stated the Funding Corporation's rationale for its treatment of the Jackson FLB assistance in this context, and noted that FCA had not formally addressed this issue. The Funding Corporation omitted these statements from the quotation from the draft report it analyzed. This passage now appears on page 50 and 51.

Nowhere in the draft report did we suggest that the System record a liability for the Jackson FLB. On the contrary, as noted in this final report on page 51 and elsewhere, we believe the System's combined financial statements should reflect FCSIC's commitment to pay the costs of liquidating this bank as an asset. The question of restating the System's past financial information is addressed in comment 10.

We also edited other parts of chapter 2 in response to the technical points the Funding Corporation raised with regard to other accounting issues. These changes did not affect the substance of our final report.

15. We did not indicate the System's support for this alternative in the draft report because Funding Corporation officials did not mention it to us during our review.

16. Even if System institutions provide competitive returns on equity for their member-borrowers, as noted on page 62, the tax advantages available to System institutions enable them to retain or distribute more of their earnings than most of their competitors can. In this sense, System institutions do have a competitive advantage in required profit margins.

17. We focused only on the major lenders to agriculture named in the statute that required us to conduct this study: the System, commercial banks, and insurance companies. As illustrated in figure 1.3, these lenders currently hold more than three-fourths of total U.S. farm debt.

Comments From the Farm Credit Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Farm Credit Administration

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April 2, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Finch:

See p. 75.

Thank you for the opportunity to provide comments on the General Accounting Office's (GAO) draft report entitled "Farm Credit System: Repayment of Federal Assistance and Competitive Position." This letter represents the Farm Credit Administration's (FCA) response to the draft report.

Overall, the report is balanced and well researched. We have, however, highlighted the following recommendations and conclusions contained in the report that we believe require clarification or where additional information is needed to put the particular issue in its proper perspective.

<u>GAO Recommendation</u>

We recommend that Congress require:

-- Recording all categories of assistance (except assistance preferred stock) as liabilities of individual Farm Credit System (FCS) banks (at their face amounts), and that the banks make contributions toward assistance repayment as scheduled.

<u>FCA Comment</u>

See pp. 76-77.

Except with regard to the liability for Treasury advances, we agree with your recommendation that the banks of the FCS should record all categories of assistance (except assistance preferred stock) as liabilities based on their face amount. Unlike the interest that is being accrued and paid on debt issued in the normal course of business, the Farm Credit Banks (FCBs) will not repay the Treasury-advanced interest until some time in the future. During this intervening period a benefit is accruing to the FCBs, and this benefit should be reflected as the discount of the face amount due Treasury. Each year this discount will become smaller, resulting in a charge to

2

income and a reduction to capital. We believe that this treatment is in accordance with generally accepted accounting principles (GAAP) and most appropriately reflects the true economics of the transaction and the timing of benefits in relation to the cash flows.

Our comment relative to making contributions toward assistance repayment as scheduled is discussed below.

GAO Recommendation

We recommend that Congress require:

-- that for regulatory purposes, all categories of assistance (including assistance preferred stock) be recognized as temporary, not permanent, capital of the FCS banks.

FCA Comment

See p. 77.

The FCA has no specific objection to considering the Farm Credit System Financial Assistance Corporation assistance as a form of capital other than permanent capital for regulatory purposes. However, the FCA disagrees that Congress should require this treatment. We would prefer that the FCA be granted statutory authority to determine the components of capital, rather than have capital components defined in statute. With such authority, the FCA could make reasonable designations of various components of capital--such as permanent and temporary and the appropriate capital treatment of assistance and its ultimate repayment. This would require deleting the statutory definition of permanent capital as well as the forbearance provisions like counting Treasury-paid interest as regulatory capital and allowing banks to reschedule their capital preservation agreement (CPA) payables if making those payments would reduce their capital below the regulatory minimum. FCA's position is consistent with GAO's statement that a financial regulator should have authority to set minimum capital requirements.

With this view, the FCA suggests that you recommend Congress grant the FCA full authority to define components of capital. With such a change, your recommendations could then be directed to the FCA.

See comment 1.

We also note that the analysis performed by the GAO concluded that all of the FCS banks would have capital ratios in excess of the FCA's 7-percent minimal regulatory capital requirements even if they record all of their liabilities. This analysis may need to be reevaluated given the fact that the provisions of the 1992 Act allow for the sharing of capital based on agreement. The 1992 Act authorized the counting of allocated equities as permanent capital as provided under an agreement between the bank and each association. The specifics of the agreements may change an individual FCB's regulatory capital position and your conclusions accordingly.

3

GAO Recommendation

We recommend that Congress require:

-- FCSIC to return its initial capital infusion of $260 million within a reasonable period of time, taking the financial considerations of the FCS and the Insurance Fund into consideration.

FCA Comment

The FCA concurs with the comments of the Farm Credit System Insurance Corporation provided in its letter of April 2, 1993.

GAO Recommendation

-- that the Chairman of the Farm Credit Administration prohibit counting FCSIC funds as income or assets of the FCS.

FCA Comment

See p. 49 and comment 2.

The FCA has consistently taken the position that the Insurance Fund should not be included in the FCS's combined financial statements because it is a Government-controlled fund. As you know, FCA's substantive position was outlined in a July 1989 Accounting Bulletin. The bulletin was set aside because a district court concluded that the bulletin violated the Administrative Procedure Act. The FCA intends to review the matter and may develop a regulation concerning the treatment of the Insurance Fund in the FCS's combined financial statements.

GAO Conclusion

The GAO concluded that the FCS does not now need to expand its charter to ensure the viability of most institutions. GAO's primary support is that, over the past several years, FCS institutions have attained profitability and are on target toward meeting their assistance prepayment and other obligations.

FCA Comment

While the FCA agrees that the FCS has regained profitability over the recent past, this is due in large part to improved economic conditions, primarily the low interest rate environment and the improvements in the agricultural economy. As evidenced by the financial crisis of the mid-1980's, a change in the interest rate environment had a significant impact on FCS borrowers and their ability to repay. The FCS is still a single-industry lender, and by definition has a high concentration of loans in a high risk environment.

4

We believe there is more work to be done in this area. Any final position regarding additional authorities must take into consideration the continuing structural changes in agriculture and in rural America.

GAO also notes that the FCBs are holding higher levels of investments as a way of diversifying risk. The FCA has proposed investment regulations that permit diversification within specified limits but reaffirm the FCA's belief that the FCS institutions should not be permitted to use their Government-sponsored enterprise status to fund investment portfolios excessively.

Sincerely,

Dorothy L. Nichols

Dorothy L. Nichols
Chief Operating Officer

Enclosure

The following are GAO's comments on the Farm Credit Administration's letter dated April 2, 1993.

GAO Comments

1. We took these new provisions of the 1992 act into account in the course of updating the analysis cited here from June 30 to December 31, 1992. This analysis now appears on pages 42-43.

2. Subsequent to this comment letter, FCA and the System reached an agreement on added disclosure of information on the Insurance Fund in the notes to the System's combined financial statements, which caused FCA to change this position. In December 1993, the System proposed a form of disclosure for the Insurance Fund that, according to FCA, resolves its concerns about this issue. After FCA formally accepted this proposed form of disclosure, the FCA Board approved a proposed regulation on disclosure to investors that incorporates the System's proposed disclosure format for the Insurance Fund.

Comments From the Farm Credit System Insurance Corporation

Note: GAO comment supplementing those in the report text appears at the end of this appendix.

Farm Credit System Insurance Corporation

April 2, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

See p. 75.

Thank you for providing the Farm Credit System Insurance Corporation (Corporation) the opportunity to comment on the draft GAO report entitled, Farm Credit System: Repayment of Federal Assistance and Competitive Position. Our views on the four GAO recommendations are outlined below:

1. GAO recommends that Congress require recording all categories of assistance as liabilities of the Farm Credit System (FCS) banks, except direct aid to Farm Credit Banks.

It has been the Corporation's position that all banks should be required to record all obligations to repay Financial Assistance Corporation (FAC) debt, other than direct assistance, as liabilities on their financial statements. This position is in accordance with generally accepted accounting principles and would more clearly show the true liabilities of the individual banks and facilitate better analysis of their financial condition and performance.

See pp. 76-77, pp. 39-40, and comment 1.

However, with regard to the future liability for Treasury paid interest, we believe that this liability is most appropriately recorded at a discounted amount, which is the current practice, rather than at face amount. The Farm Credit banks will not pay this interest until a future date and will continue to benefit from the Treasury payments during the interim. Each year the discount would be reduced, reflecting a charge to income and a reduction to capital until at the liability's maturity, the face amount is reflected.

2. GAO recommends that Congress require that all categories of assistance be recognized as temporary, not permanent, capital of the FCS banks for regulatory purpose.

See pp. 77-78.

While the Corporation recognizes that the GAO's recommendation addresses System assistance from the FAC, the Corporation would be concerned about any legislative constraints on types and conditions of financial assistance it might provide. The Corporation may provide financial assistance to a FCS institution at some future date and believes it appropriate for the FCA to

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2

have the authority to determine whether such assistance might count as permanent capital. The Corporation may need the flexibility to utilize forms of debt or equity instruments to bolster the permanent capital of a troubled institution. An example of such an instrument is subordinated debt. Subordinated debt purchased by the Corporation would clearly be reflected on an institution's balance sheet allowing accurate analysis of the institution's financial position. The Federal Deposit Insurance Corporation (FDIC) has successfully used subordinated debt in providing financial assistance. The Corporation recognizes that in some cases, the assistance it might provide could be structured to enable a troubled institution to return to viability and repay such assistance. However, the Corporation strongly believes that the FCA should have the flexibility in dealing with troubled institutions to determine what types of assistance could count as permanent capital.

3. GAO recommends that Congress require FCSIC to reimburse the Treasury for its initial capital infusion of $260 million within a reasonable time, taking the financial condition of the FCS and the Insurance Fund into consideration.

See p. 78.

The reimbursement by the FCS of the $260 million initial infusion provided to the Corporation would, as you note, achieve the goal of an industry-financed Insurance Fund for the FCS. We believe more research needs to be conducted to determine the impact on the FCS prior to the implementation of any such recommendation. We believe the specter of an immediate repayment plan could have a negative impact on the condition of the FCS and the Insurance Fund and should be carefully considered before the recommendation is implemented.

Should the recommendation be pursued by Congress, the timeframe in which repayment would be required would be critical. 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. After reaching the secure base amount, a gradual repayment plan of the type Congress established for the FDIC would not have these drawbacks. The FDIC became operational in 1933; requirements for gradual repayment of its initial government capital began when the Bank Insurance Fund exceeded $1 billion. The FDIC completed its repayment by the early 1950's.

In addition, when viewed in light of the treatment of outlays from the Insurance Fund for federal budget purposes, the GAO recommendation may not achieve desired results. Outlays are treated as expenses and have the effect of increasing the deficit; income is treated as revenue and has the effect of reducing the deficit. As a result, while the revolving fund provided as seed money might be recaptured, its value would not be recognized for deficit reduction purposes.

4. GAO recommends that the Chairman of the Farm Credit Administration prohibit the FCS from counting FCSIC funds as income or assets.

We concur with the FCA's comments in their letter of April 2, 1993 that this issue needs to be analyzed further during the development phase of any regulations related to the issue.

See pp. 81-82.

3

An additional observation is that the report makes several assertions regarding the Farm Credit System's competitive advantage over commercial banks with respect to cost of funds. We believe the issue of who has an advantage in the area of cost of funds is highly complex and varies depending upon a number of circumstances. Our experience with this issue indicates that what we perceive as facts today are often mitigated by other factors over time. For example, there is no discussion of access to financial markets through the Federal Home Loan Bank System, which borrows on Wall Street at extremely favorable rates due to Government Sponsored Enterprise status comparable to that of the FCS. This access was first provided to commercial banks in addition to savings and loans as a result of the Financial Institutions Reform Recovery and Enforcement Act. This advantage for many commercial banks is in addition to the explicit government guarantee on deposits up to $100,000. There are likely to be other examples of mitigating factors relative to your conclusions. Given the nature of this issue, it is likely that your report will have considerable public exposure. We think it appropriate to carefully consider any language that suggests a broad conclusion when in our judgement these issues are complex and a comprehensive study has not been completed.

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

Sincerely,

Mary A. Creedon

Mary A. Creedon
Chief Operating Officer

The following is GAO's comment on the Farm Credit System Insurance Corporation's letter dated April 2, 1993.

GAO Comment

1. We agree with FCSIC and FCA that the Treasury interest advances represent an economic benefit to the System that should be recorded as such. However, we believe this benefit should be reflected in the accounting entries for the main categories of assistance. We do not believe the System's current practice of recording a separate liability for the advances themselves is the most appropriate GAAP treatment.

Comments From the American Bankers Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

AMERICAN
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March 30, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
United States General Accounting Office
General Government Division
Washington, DC 20548

Dear Mr. Finch:

See p. 75.

The Government Accounting Office has submitted the draft report, Farm Credit System: Repayment of Federal Assistance and Competitive Position, to the American Bankers Association's Agricultural Bankers Division Executive Committee for comment on the contents. The agricultural bankers that we represent are direct competitors of the Farm Credit System institutions. Therefore, the question as to whether FCS institutions are unfair competitors is a matter of considerable significance to our member banks. The ABA is the national trade and professional association for America's commercial banks, from the smallest to the largest. ABA members represent about 90 percent of the industry's total assets. Approximately 94 percent of ABA members are community banks with assets less than $500 million.

Comments on Chapter Two

The American Bankers Association takes a consistent stance that the banking industry is in favor of fair competition, but that fair competition requires a level playing field. Many of our competitors possess governmentally created competitive advantages that make for an uneven playing field. Thus, we support the conclusions of the GAO that the Farm Credit System Insurance Corporation's capital infusions should be repaid by the Farm Credit System institutions. The FCSIC insurance premiums and earnings from investments should not be treated as income for the Farm Credit System as a whole, nor should the insurance fund be continued as an asset and countable as capital by FCS. These changes would be consistent with the treatment of the Bank Insurance Fund and would promote fairer competition. Thus our committee supports the recommendations of the GAO found at the end of chapter two of the draft report.

AMERICAN BANKERS ASSOCIATION

CONTINUING OUR LETTER OF

March 30, 1993

SHEET NO. 2

Comments on Chapter Three

With respect to chapter three on loan pricing and competition, the GAO study concludes that FCS institutions have cost advantages resulting in rates on FCS loans being lower than those offered by small community-based agricultural banks but higher than rates of large banks and roughly equal to rates available from insurance companies. The GAO concludes that only a few exceptions to legitimate competition have been found. In reaching this conclusion, the GAO conducts an extensive discussion of "predatory pricing".

Now on p. 7.

On page 13 of the executive summary, the GAO defines "predatory pricing" as when an institution "consistently and willfully prices its loans below its own costs and prevailing rates of its competition". In the expanded discussion of "predatory pricing" beginning on page 75 of the report, the GAO states that a firm engages in "predatory pricing" when "it temporarily sets its prices below costs to eliminate or discourage competitors and so gain a monopolistic or dominant market position. The successful 'predator' firm then charges higher prices and earns higher profits over the long run".

Now on p. 53.

See comment 1.

This second definition is not exactly consistent with the original definition found in the executive summary. Worse, a third definition of "predatory pricing" arises within the Farm Credit Administration's Examination Manual, by which FCS institutions are judged. That definition is:

> The practice of setting interest rates to attract or retain borrowers with a willful disregard for the costs of doing business, (sic) or well below prevailing rates in the market area due to the failure to monitor competitor rates. (Page 79 of the GAO draft report.)

Now on p. 55.

See comment 2.

Thus, our first criticism of the GAO's chapter on "predatory pricing" is that we are unable to determine which definition of "predatory pricing" is utilized by the GAO in making its assessment as to whether FCS institutions are unfair competitors. Additionally, we are doubtful that any of the three definitions found within the GAO Report is appropriate in assessing "predatory pricing" by a Government Sponsored Enterprise (GSE). In looking at the two definitions of "predatory pricing" offered by the GAO (on page 13 and on page 75), we note that the

AMERICAN BANKERS ASSOCIATION

CONTINUING OUR LETTER OF March 30, 1993

SHEET NO. 3

definitions appear to come from a classic free enterprise, capitalistic economic model. Therefore, they are definitions created without reference to the nature and function of a GSE.

Now on p. 64.

Government Sponsored Enterprises and their satellite institutions are not "firms" within the ambit of that term in such an economic model. If GSEs were firms, then the "predatory pricing" exhibited by the FCS in the late 70's and early 80's, as demonstrated in the interest rate chart on page 94, would have led to a bankruptcy and dissolution of FCS institutions. Instead, it lead to a bankruptcy and refunding of the GSE. Thus, we conclude that the "predatory pricing" definition used by the GAO is inadequate for the purposes of analyzing unfair competition by the FCS.

See comment 3.

Of even greater concern to our committee is that the GAO has failed to note that the FCA's definition of "predatory pricing" is contrary to the statutory mandate creating the FCA and the Farm Credit System. The GAO notes that the FCA has found only one case of "predatory pricing" (page 80 and following). Since the FCA's definition says that "predatory pricing" does not exist unless the pricing is "well below prevailing rates in the market area due to the failure to monitor competitor rates", it is not surprising that only one case has been found. However, 12 USC 2001(c) reads in part:

> "that in no case is any borrower to be charged a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent creditworthiness and access to alternative credit."

The GAO fails to tell us whether the FCA examination manual provides any guidance to examiners as to what constitutes a rate being "well below" prevailing rates. Therefore, we assume that examiners use the normal meaning of the phrase and thus overlook most FCS institutions' predatory pricing. However, the proper legal standard is not whether the rate is well below prevailing rates, but whether it is below competitive market rates. Further, the FCA's definition limits such a finding to only those cases in which there is a failure to monitor competitor rates. The statute does not require a finding of being below competitive market rates be limited to instances where there has been a failure to monitor competitive rates. The statute includes any such pricing, such as "predatory pricing" in which the FCS institution is knowingly pricing below competitive rates in order to attracted certain credits.

AMERICAN BANKERS ASSOCIATION

CONTINUING OUR LETTER OF
March 30, 1993

SHEET NO. 4

See comment 4.

Thus, the committee concludes that the second chapter of the GAO Study is fundamentally flawed in its approach to analyzing "predatory pricing". The chapter fails to address what should be the appropriate definition of predatory pricing when analyzing the pricing of a government sponsored enterprise. Further, in studying predatory pricing, the GAO has ignored the pricing directive provided by the Congress in the statute for FCS institutions: any pricing at a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent credit worthiness and access to alternative credit is not to be allowed. We urge the GAO to revisit this issue in light of the statutory mandate.

Comments on Chapter Four

With respect to chapter four on the FCS charter and the question of expanded power, the Committee had further reservations. We agree with the GAO's conclusion that FCS institutions do not need far-reaching changes to its charter to insure the viability of most institutions. However, the GAO concludes that over time, as agriculture and rural America continue to change, the FCS's charter may need to be modified. The GAO analyzes the continuing changes in the agricultural borrower's market towards fewer, larger, and more capital-intensive farms and notes that over time FCS institutions and many small commercial banks may need to find new business opportunities or to merge with larger institutions. This conclusion seems to skip an intermediate step in the analysis with respect to FCS institutions.

See comment 5.

If the role for which FCS institutions were created is no longer needed, then the question is should FCS institutions be continued or should they decline naturally as the need for them declines. Apparently, the GAO has concluded that the only way to preserve adequate levels of income for FCS institutions will eventually be to offer a broader range of financial services or to expand their markets. This seems to beg the question as to whether the FCS institutions should be continued.

Whether or not FCS institutions should have expanded powers depends on whether the agricultural industry requires government sponsored enterprise funding in the future and not whether FCS institutions need expanded business lines in order to continue in existence. We suggest that the GAO more sharply focus its

AMERICAN BANKERS ASSOCIATION

CONTINUING OUR LETTER OF March 30, 1993

SHEET NO. 5

comments on whether the agricultural industry has any need for expanded credit products that will require funding through the FCS rather than whether FCS institutions need additional income.

In conclusion, we appreciate the opportunity afforded to the ABA Agricultural Bankers Division Executive Committee to comment on the GAO's report. If you should have any additional questions about our comments, please call me or one of the following ABA staff: John Blanchfield at 202/663-5100 or Paul Smith at 202/663-5331.

Sincerely,

Michael Weasel

Michael Weasel

The following are GAO's comments on the American Bankers Association (ABA) letter dated March 30, 1993.

GAO Comments

1. We regret the confusion that arose over the language used in the definition of "predatory pricing" at various points in the report. We edited the sentence from the executive summary to make it conform more closely with the phrasing used in chapter 2. We discuss FCA's definition further in comment 2.

2. In this final report, we tried to make a clearer distinction in chapter 3 between the economic analysis we designed and conducted on the one hand and our review of FCA's investigations of System loan pricing practices on the other.

As noted in chapter 5, we acknowledge that the standard economic analysis we conducted does not establish that there is no predatory pricing within the U.S. agricultural credit market under all valid definitions of that term. Our review of the economic literature on predatory pricing, including one study specifically addressing competition between public and private organizations, now appears on page 53 of chapter 3.

3. We believe, as stated on page 56 of this final report, that FCA's definition of predatory pricing is not, as asserted by ABA, contrary to applicable law. The standard ABA suggests—based on the "below competitive market rates" language of the policy section of the Farm Credit Act—was not intended by Congress as a definition of predatory pricing. Rather than addressing System loan rates within the context of predatory pricing, the policy statement was intended to address concerns over possible dissipation of System capital due to charging below market rates such as those set using average-cost pricing during the late 1970s and early 1980s.

The legislative history of the policy section indicates that Congress intended to invest substantial discretion in FCA to oversee the safety and soundness of System loan pricing practices and did not intend to constrain FCA's regulatory authority to the literal terms of the policy statement in the statute. For example, the House Agriculture Committee noted that while the policy statement indicated factors to be considered with respect to System loan rates, it was not a provision of positive law and did not purport to constitute a formula for the determination of such rates.

4. We edited chapter 3 of this final report in an attempt to clarify our analysis and conclusions. However, we did not change our earlier position that, with few exceptions, System institutions have not engaged in predatory pricing.

5. We agree that whether the System is needed today is a legitimate question. Clearly, much in rural America has changed since the System was created 75 years ago. In our view, the answer to this question is a matter of judgment—it needs to be addressed in the context of the nation's rural development agenda. We added a statement to this effect to our conclusions in chapter 4.

We also edited the passage referred to here to make clear that expanding the System's charter beyond agriculture is one way, but not the only way, for System institutions to achieve the efficiences that may be needed for them to remain viable. It appears on page 72, which now notes that updating the System's charter and further consolidation also support this goal.

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Related GAO Products

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

Government-Sponsored Enterprises: Changes in Securities Distribution Process and Use of Derivative Products (GAO/GGD-93-70BR, Mar. 16, 1993)

Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992)

Inspectors General: Issues Involving the Farm Credit Administration's Chairman and IG (GAO/AFMD-92-27, Nov. 29, 1991)

Government-Sponsored Enterprises: Using Private Risk Ratings for Exemptions From Federal Regulations (GAO/GGD-92-10, Nov. 6, 1991)

Federal Agricultural Mortgage Corporation: Potential Role in the Delivery of Credit for Rural Housing (GAO/RCED-91-180, Aug. 7, 1991)

Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991)

Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991)

Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991)

Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990)

Farm Credit: Basis for Decision Not to Assist Jackson Federal Land Bank (GAO/GGD-90-16, Dec. 13, 1989)

Options for Dealing with Farm Credit System Problems (GAO/T-GGD-87-11, Apr. 7, 1987)

Farm Credit: Actions Needed on Major Management Issues (GAO/GGD-87-51, Apr. 1, 1987)

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