The Farm Credit System—
Resolve Its Growing Credit-Quality Problems
While Strengthening Its Regulation

By Bert Ely

Introduction

American agriculture is suffering from extraordinary financial stress from multiple sources, unlike anything farmers and ranchers have experienced in several decades. Those stresses, and their consequences, are reverberating within the Farm Credit System (FCS), as this paper will summarize.

After briefly describing the FCS, the paper catalogs the risks facing the FCS and its borrowers, reflecting the challenges American agriculture faces today. These heightened risks have led to growing credit-quality problems within the FCS, which in turn have revealed increased regulatory shortcomings within the FCS and of its regulator, the Farm Credit Administration (FCA). The paper concludes with public policy recommendations that would strengthen the FCA as a regulator, resolve the FCS's growing credit-quality problems, and modernize the structure of the FCS.

What is the Farm Credit System

Chartered by Congress in 1916, the FCS is America's oldest government-sponsored enterprise yet it is little known outside of rural America, where it is a major lender to agriculture and agriculturally related activities. The FCS consists of four regional banks and 68 associations that lend directly to farmers, ranchers, agribusinesses, and cooperatively owned rural utilities.

The associations range in size from one that serves borrowers in four Midwest states and with total assets exceeding $30 billion down to the smallest association with just $51 million in assets serving five counties in southeast Arkansas. The four banks, which provide most of the funds the associations lend, borrow those funds in the capital markets, through the Federal Farm Credit Banks Funding Corporation. At Sept. 30, 2019, the FCS had total assets of $354 billion, including loans of $276 billion.

Visit fca.gov for links to substantial information about FCS institutions, including maps of the territories served by the banks and associations as well as links to the banks' and associations' websites and call reports.

The FCS banks and associations are cooperatively owned by their borrowers. That is, FCS borrowers are stockholders in the association or bank they borrow from. With the exception of preferred stock issued by a few FCS institutions, the stock in FCS institutions does not trade; instead shares in an FCS institution are directly issued and redeemed by that association or bank. The borrower/owners elect the institution's directors, who in turn select and oversee the institution's senior management.

The FCA is an independent regulatory agency led by a three-member board of directors appointed by the president and confirmed by the Senate. In addition to establishing regulations that flesh out the Farm Credit Act, the FCS's authorizing statute, the FCA employs personnel, comparable to bank examiners, who periodically examine the finances and lending activities of FCS institutions. The FCS banks also provide some oversight of the associations they lend to by virtue of being by far the association's largest creditor.

The FCS is in good financial condition today, having long since recovered from the losses it experienced in the 1980s that triggered its congressional bailout in 1987[1]. It is important, though, to remember that the underlying causes of the FCS insolvency preceding that bailout could occur again, especially if commodity prices continue at their low levels, the trade war does not cease, adverse weather conditions persist, and interest rates increase to more normal levels.

FCS borrowers face the same risks today as all farmers and ranchers

In testimony on Nov.19, 2019, to the Subcommittee on Commodity, Exchanges, Energy, and Credit of the House Agriculture Committee, FCA Chairman and CEO Glen Smith summarized the risks facing farmers and ranchers today, stating:

> Many U.S. farmers and ranchers are facing a more challenging economic environment than in past years. Trade uncertainties, large commodities supplies, and weather extremes have suppressed farm prices and producer returns for key commodities. USDA estimates net cash farm income in 2019 will remain well below record levels set six to seven years ago.[2]

Smith's comments about the high level of farm debt are especially relevant to the financial risks and challenges the FCS faces over the next few years:

> Debt is also rising. U.S. farmers have taken on an estimated $41 billion in additional farm debt over the past three years. Adjusted for inflation, total farm debt outstanding is nearing the record set almost 40 years ago. Income shortfalls have cut working capital and elevated borrowing needs. With cash flows tight, the number of producers finding it difficult to repay their loans is growing, albeit at a modest pace. Increasingly, producers are restructuring their debts to improve their cash flow.
>
> High-cost producers and <u>those with significant leverage are feeling financial pressure</u>. Producers most vulnerable to financial stress are farmers with crop losses (particularly corn and soybeans in parts of the Midwest in 2019). The combination of low prices and crop losses is creating a significant challenge for some producers. Smaller or higher-cost dairy farms represent another segment experiencing stress despite the improvement in milk prices[3] [emphasis supplied].

The financial stresses agriculture has experienced this year have been widely reported, reinforcing Smith's message. For example, the Federal Reserve Bank of Kansas City's Ag Credit Survey dated Nov. 14, 2019, reported that "Farm Finances Continue to Weaken Amid Ongoing Uncertainty.[4]"

A recent *New York Times* article observed that "the damage from the destructive spring flooding in the Midwest has been followed in parts of the country by a miserable autumn that is making a bad farming year worse, with effects that could be felt into next spring.[5]"

A growing concern among those monitoring agriculture's financial health is the possibility that a bubble has emerged in farmland values that may soon begin to deflate, as occurred during the 1980s' ag crisis. One committee member, Rep. Austin Scott (R-GA), expressed concern about "fragile" land values should interest rates rise; i.e., the market value of agricultural land would decline, which would adversely affect the balance sheets of farmers and ranchers, and those who lend to them.

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[1] The causes of the FCS's financial distress in the 1980s are discussed in "The Farm Credit System: Reckless Lender to Rural America," by Bert Ely and Vicki Vanderhoff, November 1990.

[2] https://www.fca.gov/template-fca/news/HouseTestimony19nov2019.pdf, page 2.

[3] Ibid.

[4] https://www.kansascityfed.org/en/research/indicatorsdata/agcreditsurvey/articles/2019/11-14-2019/farm-finances-continue-to-weaken-amid-ongoing-uncertainty

[5] Schwartz, John; Heavy Rain, Early Snow and Stressed-Out Farmers," November 22, 2019, pg. Be.

Another indicator of agriculture's worsening financial condition: *The Wall Street Journal* reported that Deere & Co. forecast lower sales and profits next year, "predicting U.S. farmers will remain reluctant to buy machinery after a disappointing harvest. . . . [l]ingering trade tensions coupled with a year of difficult growing and harvesting conditions have caused many farmers to become cautious about major investments in new equipment.[6]"

The FCA has effectively acknowledged the growing credit quality problems within the FCS, though its Financial Institution Rating System, or FIRS ratings of FCS banks and associations, as published in a report FCA staff submitted to the FCA's board of directors.[7] FIRS ratings are comparable to bank CAMELS ratings, with a 1 rating for the strongest FCS institutions and 3 or lower for the weakest.

As of September 2019, 72 institutions were rated—31 had a 1 rating, 34 had a 2 rating, and 7 had a 3 or worse rating. That distribution of ratings was worse than in December 2016, when 77 institutions were rated—44 had a 1 rating, 31 had a 2 rating, and just two had a 3 or worse rating. The increase of five 3-or-worse-rated institutions over a 33-month period is very troubling, a trend that almost certainly will continue as the financial stresses farmers and ranchers are experiencing continues to grow.

A key source of the FCS's growing credit problems lies with production and intermediate credit loans to farmers and ranchers. As a chart shows on page 19 of the Sept. 30, 2019, report of the FCS's financial condition and performance, the percent of production and intermediate credit loans classified as less than acceptable nearly tripled, rising from a low 4.4 percent at December 2014 to 11.9 percent at September 2019.[8] This sharp deterioration in the quality of this type of loan reflects the oft-heard observation that farmers and ranchers have been experiencing increasingly severe working capital problems in recent years.

The total number of loans classified as less than acceptable rose by a lesser percentage, but still that percentage more than doubled over the same period, rising from 3.6 percent to 7.4 percent. That percentage increase tracked the increase in real estate mortgages classified as less than acceptable, which rose from 3.6 percent at December 2014 to 7.4 percent at September 2019.

The key public-policy question today: How well has the FCS recognized in its financial statements its likely loan losses should agriculture's financial stresses continue unabated? It is increasingly evident that many FCS associations have lagged in recognizing likely loan losses arising from growing credit-quality problems, as evidenced by the steady increase in recent years in loans classified as less than acceptable. A forthcoming change in the timing of loan-loss recognition discussed below will bring this problem to a head by the end of next year.

FCS associations experiencing growing credit-quality issues

An analysis of the quarterly financial statements FCS institutions file with the FCA indicates the high likelihood that many FCS associations were slow during the first nine months of 2019 to recognize in their financial statements the growing deterioration in their borrowers' finances.

This appended table—"Comparing Key Ratios for FCS Associations"—which groups the associations by the bank which funds them, lists two key ratios of asset quality as of Sept. 30, 2019, and then in the right two columns shows the amount of change in those two ratios between Dec. 31, 2018, and Sept. 30, 2019. The percentages in red in the right columns indicate that the association believed it faced a **reduced likelihood** of incurring a loss on its loans despite an overall deterioration in agricultural finances this year. Percentages in black acknowledge an increased risk of loss.

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[6] Tita, Bob, "Deere Forecasts Sales Drop," The Wall Street Journal, September 29, 2019, pg. B3.
[7] Farm Credit System Condition and Performance, September 30, 2019, pg. 22. (https://www.fca.gov/template-fca/about/2019DecQuarterlyReportonFCSCondition.pdf?utm_medium=email&utm_source=govdelivery)
[8] Ibid., pg. 19.

As the likelihood of incurring an actual loss on a loan increases, a lender should add that expected increase in loss to its allowance for loan and lease losses (ALL) to reflect that inevitable loss in its current financial statements. Despite the broad deterioration in agricultural loan quality during the year, less than half of the associations (32 of 68) boosted their ALL as a percentage of total (gross) loans outstanding while the percentage at another five associations did not change.

For the FCS associations as a whole (bottom line of the table) **the ALL percentage actually dropped slightly**, by .004 percent to .527 percent at Sept. 30, 2019, from .531 percent at the end of 2018, when deteriorating credit conditions among FCS borrowers should have produced a higher ALL percentage during 2019. Less than half of the associations (32 of 68) boosted their ALL as a percentage of total loans outstanding while that percentage at another five associations did not change.

Thirty-one associations, holding almost one-third of all association loans, actually reduced their ALL as a percentage of gross loans during the first nine months of 2019. **Figure 1**, which contrasts the distribution of ALL percentages for all FCS associations at Dec. 31, 2018, with Sept. 30, 2019, illustrates how little those percentages changed during 2019 despite deteriorating credit quality.

Increased credit-quality problems during 2019 also were evidenced by an increase in nonperforming assets as a percent of gross loans outstanding plus other property owned (OPO), which consists of repossessed real estate and non-real-estate assets. The FCA defines non-performing assets as consisting of OPO, nonaccrual loans, accruing restructured loans, and accruing loans 90 or more days past due.[9] Of the 68 associations, 38 reported an increase in non-performing assets as a percent of gross loans plus OPO during the first three quarters of 2019 (numbers in red) while 28 showed a decrease in that percentage; two were unchanged.

For the associations collectively, the non-performing asset percentage increased .09 percent, from .94 percent at the end of 2018 to 1.03 percent at Sept. 30, 2019. **Figure 2** shows the distribution of the non-performing-asset percentage for each association for the two period-end dates. An increase in the non-performing asset percentage was somewhat more common for the associations funded by CoBank (16 out of 21) than for the associations funded by the other three banks (22 out of 47).

Associations can hold down their non-performing asset percentage by being slow to shift troubled loans to a nonaccrual status, by restructuring loans, which merely kicks the can down the road, and moving slowly to foreclose on troubled real estate loans or to repossess equipment financed by past-due loans. FCA examiners and credit-monitoring personnel at the four banks need to be especially diligent at this time to ensure that the associations they monitor are acting in a timely manner to properly account for their troubled loans and non-performing assets. Whether that is occurring across the FCS is a critical question the Senate and House Agriculture Committees should address.

FCS is experiencing increased regulatory failures

An increasingly evident problem within the FCS is regulatory failure, specifically the inability of the FCA and the four FCS banks to adequately monitor accounting and credit-risk management practices within FCS associations. Examples abound, as summarized below.

Farm Credit Services Southwest, which served most of Arizona and southern California, was effectively forced to merge with Farm Credit West on Nov. 1, 2015, following the revelation in 2014 of "a sudden significant increase in the level of delinquent loans affecting an identifiable portion of the association's lending portfolio.[10]" On Aug. 9,

[9] https://ww3.fca.gov/fcsinfo/crs/Lists/UCRInstructions/Attachments/94/UCR%20Instructions.pdf, page 9.
[10] Document can no longer be retrieved electronically.

2017, **Lone Star Ag Credit**, headquartered in Fort Worth and serving portions of central and north Texas, issued a Notification of Non-Reliance on Previously Issued Financial Statements" for 2016 and the first quarter of 2017 due to just-discovered "appraisal and accounting irregularities.[11]" Lone Star has resolved those problems and preserved its independence.

More recently, on July 1, 2019, American AgCredit (AAC) announced the completion of a Plan of Combination under which it acquired all of the assets and liabilities of **Farm Credit Services of Hawaii** (FCSH), with each stockholder of FCSH becoming a stockholder of AAC. FCSH will be formally dissolved in the next few months.[12] This combination is not the usual merger of two FCS associations; rather it seems that FCSH incurred some liabilities that ACC did not want to assume through an outright merger. In effect, it appears that FCSH was a failed institution, yet the FCA has said nothing about its disappearance beyond approving a "proposed plan to combine" the two associations.[13]

One of the most troubling and systemically critical conditions that has emerged in recent years are loans from FCS banks to FCS associations that have less than acceptable credit quality. Given deteriorating credit quality among FCS borrowers, and the threat that deterioration poses to the solvency of FCS associations, the FCA and the FCS bank funding that association should move quickly, and forcibly if necessary, to rectify conditions at an association that has less than acceptable credit quality to prevent a possibly troubled association from failing. That has not happened in at least a few situations.

For at least a year, loans from AgFirst to one association have been classified as Other Assets Especially Mentioned (OAEM), or less than satisfactory. Given that AgFirst disclosed the total assets of that association as of Sept. 30, 2019, it was quite easy to determine that the troubled association is Farm Credit of the Virginias (FCV), which serves western Virginia and most of West Virginia. Ironically, the FCA's headquarters in McLean, Virginia, lies within FCV's territory.

According to the AgFirst's third-quarter 2019 financial report, "no District Associations were operating under a written agreement [i.e., an enforcement order] with the FCA . . . One association [presumably FCV] was operating under a special credit agreement" with AgFirst. In its third-quarter 2019 report to its member/borrowers, FCV merely stated in Note 4 to its financial statements that "on Jan. 16, 2019, [AgFirst] approved a waiver of [FCV's] events of default" under FCV's financing agreement with AgFirst. One can reasonably doubt if any FCV member/borrower figured out what that sentenced signaled.

Each of the other three FCS banks indicated that they had "special mention" loans outstanding with some of the associations they fund. AgriBank had $1.17 billion of such loans outstanding at Sept. 30, 2019, up $100 million from Dec. 31, 2018. At Sept. 30, 2019, the Farm Credit Bank of Texas reported that a $231.2 million loan had a Special Mention classification.

Finally, CoBank reported $2.2 billion in Special Mention loans as of Sept. 30, 2019, to two of the associations it funds and that it held a $471 million participation in a loan made by the Farm Credit Bank of Texas to one of the associations that bank funds. CoBank stated that the "Special Mention classifications primarily reflect internal control and other operational weaknesses at these associations, some of which were material weaknesses." That statement should ring loud alarm bells at the FCA and on Capitol Hill. Possibly associations with loans classified as "Special Mention" are among those associations with a FIRS classification of 3 or worse.

CECL's likely impact at the end of 2020

As discussed above and as is readily apparent from the accompanying table and charts, credit quality within the FCS

[11] https://sitebridge.farmcreditbank.com/f/other/38/Notification-of-Non-Reliance-on-Prev-Issued-Financial-Stmts-FINAL.pdf
[12] https://www.agloan.com/aac-fcsh-announce-combination/
[13] https://ww3.fca.gov/news/Lists/News%20Releases/Attachments/584/NR-19-11-06-13-19.pdf

has deteriorated, an understandable consequence of the stresses American agriculture and rural America more broadly have experienced in recent years. However, FCS institutions must implement, as of the end of 2020, a much more conservative methodology for estimating likely future loan losses. Essentially, lenders subject to CECL must forecast reasonably expected future losses from groups of loans that currently exhibit no credit problems or prospective losses. Consequently, according to a rule the FCA has proposed governing the adoption of CECL by FCS institutions, there will be an "earlier recognition of credit losses than under the existing incurred loss methodology." [14]

This new accounting rule, called Current Expected Credit Loss, or CECL was promulgated by the Financial Accounting Standards Board, or FASB[15], for larger business enterprises seeking to obtain an unqualified auditors' opinion on their annual financial statements.

Under the proposed rule[16] the FCA published on Sept. 23, 2019, all FCS banks and associations must implement CECL, beginning with their financial statements for the first quarter of 2021. Additionally, as of the end of the fiscal year ending Dec. 31, 2020, every FCS institution "will record a one-time adjustment to its credit loss allowances [i.e., its ALL] as of the beginning of its fiscal year of adoption [i.e., 2021] equal to the difference, if any, between the amount of credit loss allowances [now] required under the [present] incurred loss methodology and the amount of credit loss allowances required under CECL."

That is, the fourth-quarter 2020 financial statements of each FCS institution must reflect a one-time adjustment to its allowance for loan losses. For many FCS institutions, the adjustment could represent a substantial charge to their fourth-quarter 2020 and full-year 2020 earnings, especially if the credit quality of their outstanding loans declines during 2020. Some institutions might consequently experience a loss for 2020 or at least be restricted in the amount of patronage dividends they can pay to their member/borrowers.

Actions the FCA and Congress must take to strengthen FCS credit quality in order to protect agriculture and rural America from FCS missteps

It is clear from the events described above and the stressful conditions farmers, ranchers, and agribusinesses have experienced in recent years, which will likely continue into 2020, that the FCS will experience financial distress for at least the next few years. While it is unlikely that American agriculture or the FCS will experience a financial trauma comparable to what occurred during the 1970s, the coming years could be the toughest years the FCS has experienced since then.

Before conditions worsen further, compounded by the likely short-term effects of implementing CECL, the FCA must become more aggressive in its safety-and-soundness supervision of FCS institutions, including monitoring the lending relationship between the associations and the FCS banks that fund them.

To that end, the FCA needs to abandon its longstanding practice of not publishing its enforcement orders and other regulatory actions. Although an FCA policy statement[17] states that "final enforcement orders, formal agreements and conditions imposed in writing . . . be disclosed to the FCS and the public," that statement includes a classic Catch 22—

[14] https://ww3.fca.gov/readingrm/Handbook/FCA%20Pending%20Regulations%20%20Notices/Current%20Expected%20Credit%20Losses%20Methodology%20-%20Proposed%20Rule.pdf, pg. 49685.

[15] FASB is the independent, private-sector organization that establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow Generally Accepted Accounting Principles (GAAP). FCS institutions adhere to GAAP so that their annual financial statements can be certified by a CPA firm.

[16] https://ww3.fca.gov/readingrm/Handbook/FCA%20Pending%20Regulations%20%20Notices/Current%20Expected%20Credit%20Losses%20Methodology%20-%20Proposed%20Rule.pdf, pp. 49684-49640.

[17] https://ww3.fca.gov/readingrm/Handbook/_layouts/15/WopiFrame.aspx?sourcedoc={920F0A1E-1839-493C-BE19-E13751EA460D}&file=Disclosure%20of%20the%20Issuance%20and%20Termination%20of%20Enforcement%20Documents.docx&action=default

disclosure will not occur if the FCA's Office of General Counsel "determines that a disclosure adversely affects a civil or criminal investigation."

There is no indication that the FCA has ever published an enforcement order. Publishing enforcement actions would put member/borrowers, i.e., the owners of a regulatorily sanction association, on notice that there are problems in their association that need to be addressed. The bank regulatory agencies have long published their enforcement orders, apparently without compromising any investigation.

The number of troubled associations, as evidenced by the FIRS ratings and the increased reporting of Special Mention loans from FCS banks to FCS associations, should raise questions about the supervisory capabilities of the four banks. As I explained in a recent report, "Restructuring the Farm Credit System—why now and how to do it,"[18] the time has come to simplify the structure of the FCS by abolishing the four banks, empowering FCS associations to obtain their funding directly from the Federal Farm Credit Banks Funding Corporation, and strengthening the regulatory and supervisory powers of the FCA so that it becomes a more effective regulator and ceases being a cheerleader and enabler for the FCS.

Congress needs to address the regulatory issues within the FCS summarized above, before conditions within the FCS worsen further, and to begin the task of restructuring the FCS.

[18] https://www.aba.com/-/media/documents/industry-insights/bert-ely-restructuring-farm-credit-system.pdf