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# AGRIBUSINESS MANAGEMENT

## A LABEL CHANGE FOR FARM CREDIT

Those persons employed in this nation's agribusiness industry can ill afford to ignore the balance sheet for U.S. agriculture. Preliminary estimates for 1983 suggest that production agriculture currently functions on a base of debt capital totaling \$215 billion. While total assets employed have, since 1980, remained almost constant at about \$1,000 billion, our farmers' equity position has actually been reduced by \$50 billion since 1981.<sup>1</sup>

Within this context of agriculture's total debt obligations, the role fulfilled by the nation's Farm Credit System has grown appreciably. For example, in 1973, Federal Land Banks were providing about one-fourth of the total debt capital used to acquire agricultural real estate. By 1983, their share of total farm real estate debt had reached over 43 percent, while life insurance companies and commercial banks reduced their presence. With regard to non-real-estate production credit, funds provided by PCA-Federal Interstate Credit Banks during 1973-1983 remained relatively stable at 20-23 percent of the total. At the present time (1983), it would probably be safe to say the Farm Credit system has nearly \$70 billion invested in U.S. production agriculture. An additional \$9-10 billion in debt capital (loans outstanding) has been provided to our nations' agricultural cooperatives by the system's Bank for Cooperatives.<sup>2</sup> Insofar as these data reflect loan balances outstanding at year end, they actually underestimate the magnitude of credit services provided annually.

<sup>1</sup> *Agricultural Finance*, "Outlook and Situation," USDA, ERS., AFC-23, December 1982, p. 5.

<sup>2</sup> *48 Annual Report*, The Farm Credit Administration, 1981, pp. 2-4.

As the system's total loan balance approaches \$100 billion in the 1980s, one must be concerned about agriculture's ability to support this debt with future operations. If this question is of concern to our farmers, it must also be of concern to our agribusiness industry. And within this environment of general concern, a new factor must now be added.

## Proposed Removal of Agency Status

Insofar as federal budget deficits have grown appreciably in the last few years, both the Reagan Administration and the Office of Management and Budget have accelerated their review of federal borrowing practices. Federal borrowing, of course, includes not only the sale of securities by the U.S. Treasury, but also the borrowings of several other "agencies," some of which are government owned and others which are merely government-sponsored. The Farm Credit System is one of the latter "sponsored" agencies. Borrowing by the Farm Credit System, therefore, is lumped into total federal borrowing accounting data and serves to further inflate the level of the federal government's participation in this nation's money markets. With the government's greater presence in the money markets, upward pressures are created on the rate of interest which treasury and the agencies must pay to sell their securities. The sale of Farm Credit System securities are actually off-budget borrowings in the sense that funds thereby generated are not available to, or used by, the federal government. Attempts to restrict the market activities of sponsored agencies have proven to be politically unpopular and nearly impossible to administer. An obvious alternative would be to simply force a label change on the

organizations, or to defederalize all or some of the sponsored agencies. Were the Farm Credit System to lose its "agency status," its money market borrowings would no longer comprise a federal government presence in the market and an accounting of those borrowings would be attributed to the private sector where they could no longer inflate the federal budget deficit. This alternative might first appear as little more than a bureaucratic sleight-of-hand. At worst it could be judged as an exercise in innovative federal accounting practices. In fact, neither is the case and agribusiness managers must begin to contemplate the true impacts of such a proposal, should it be implemented.

### **Proposed Changes**

Late in 1981, the Office of Management and Budget first advanced the proposal to remove federal agency status from the Farm Credit System. Insofar as the system is by far the largest single sponsored agency borrower, it's easy to understand why they were selected. If the proposal were implemented, the system would become a totally private organization and their actions in the money markets would no longer comprise a portion of the omnipresent Fed. As knowledge of the OMB proposal spread, it was first interpreted by many as little more than a label change for the Farm Credit System, i.e., federal land banks and federal intermediate credit banks would be obliged to remove the word "federal" from their titles. Only later did the full impact of the proposed change become evident.

At the annual meeting of the Wisconsin Federation of Cooperatives in 1982, Donald E. Wilkenson, Governor of the Farm Credit Administration, outlined the specific contents of the proposal. They were:

- (1) Restrict the amount of system securities that could be held by federal reserve system banks.
- (2) Remove federal reserve discount privileges, except those normally available to private financial institutions.

- (3) Restrict federal reserve banks investment in system securities.
- (4) Prevent system securities from being used as collateral for public deposits.
- (5) Disallow credit unions and savings and loan investments in system securities.
- (6) Removal of tax-exempt status from federal land banks, federal land bank associations, and federal intermediate credit banks.
- (7) Remove state and local tax exemption on income derived from system securities.
- (8) Remove the name "federal" from all system banks and associations.
- (9) Subject system securities to SEC regulation.
- (10) Subject the system to the same state banking regulations as commercial national banks.

A quick review of Governor Wilkenson's outline produces two obvious findings. First, the proposed loss of agency status extends deeply and materially beyond a single label change for the system. Second, many of the proposed changes look suspiciously close to those long requested by commercial banking interests in the U.S.

Once again, insofar as the proposed changes might directly impact a major component of agriculture's current debt structure, agribusiness managers must gain some appreciation of the possible repercussions. Hopefully, the discussion which follows will contribute to such an improved understanding.

### **Easing Some Fears**

We must keep in mind that OMB's proposed changes remain just that, i.e., proposals only. Legislation to enact these proposals has not yet surfaced nor has it been actively debated. Hence ours is a speculative discussion in the sense that actual cause-and-effect scenarios cannot be known until changes are actually implemented. But within this setting, some fears might be alleviated. For example, it is already known that the proposed changes

would not actually reduce the level of federal budgetary expenditures. The Farm Credit System already pays its own way, including all operating expenses of 37 farm credit banks and hundreds of PCA's and land bank associations. The system also covers those costs associated with selling its securities and the costs of its regulatory body, the Farm Credit Administration. In this sense, no federal dollars are currently involved in support of the system and none would be saved as a result of its "defederalization."

Second, it has long been argued that while system securities are not now technically guaranteed by the U.S. Treasury, many investors have long perceived that such a guarantee exists. If such a misperception, in fact, exists, it would be impossible to quantify. I would assert that large investors in system securities are not so generally misinformed and that benefits occurring to this supposed perception are largely nonexistent. As the real autonomy between the system and the U.S. Treasury is further exhibited, the marketability of system securities will not suffer appreciably.

Finally, the removal of the "federal" label from system components will more clearly demonstrate the aforementioned autonomy. However, I doubt that this label change alone will affect the market acceptance of system securities, e.g., those securities are currently offered under the name of the Consolidated Farm Credit System and convey the consolidated strength of the system, not its sponsored-agency status.

### **Specific Impact**

In a recent paper prepared by Sydney Staniforth, Professor Staniforth seeks to assess some of the specific impacts of the OMB proposal.<sup>3</sup> Expanding somewhat on his thoughts, I would assert that the relevant issues are as follows:

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<sup>3</sup> Staniforth, Sydney D., *Economic Reserves*, Dept. of Agricultural Economics, University of Wisconsin, Madison, June 1983, 70.80.

*Commercial Bank Interests:* Commercial banking interests have long argued that the system has always operated under "favored conditions" and that benefits occurring to the system make it extremely difficult for commercial banks to compete on a fair and equitable basis. At different times commercial banking interests have asked for a relaxation of those restrictions affecting them, or a tightening of those restrictions affecting the system. If we can place aside the merits and/or the legitimacy of this long-standing issue, it is interesting to note that commercial banks (as a category) are currently the largest single investors in system securities. In fact, 45 percent of system securities are currently being purchased by commercial banking institutions. The OMB proposal would prevent the use of system securities as collateral for government deposits and further restrict the amounts of system securities a bank could hold to 10 percent of their capital and surplus. Insofar as most banks already hold enough treasury securities to meet their reserve requirement, the first constraint would have minimal impact. In the latter case, however, commercial banks would have to reduce their current holdings of system securities (by \$6-8 billion according to Staniforth). The banks' ability to broker system securities to other investors would be commensurately reduced. This 10 percent restriction, of course, applies to a bank's investment in securities of any one individual or corporation. At an earlier stage in its history, the system issued securities written individually against each of 37 farm credit banks (rather than the current consolidated issue). Were the system to return to a practice of 37 separate banks issues, this latter 10 percent constraint would effectively disappear. But herein lies another issue. The system converted to a consolidated security on the basis that system-wide participation reduces investor risk and creates a more attractive (lower) rate of interest. It is doubtful that a return to separate system bank issues would, therefore, remediate the larger problem.

Finally, commercial banks are greatly concerned about the judged liquidity of system securities. If judged liquid by the federal reserve system, such securities could be used as collateral against the borrowings from the federal reserve banks. In the absence of such a ruling by the federal reserve system, it is likely that the OMB proposal would result in a sizable reduction in commercial bank holdings of system securities. This possible loss of a market for system securities could be serious and would likely force the system to reach elsewhere for a secondary market for its paper. Accessing such new markets at competitive rates is both slow and difficult. In some cases, the system might find it necessary to "tailor-make" their securities to better meet the unique portfolio needs of investors with whom the system has never before dealt. As the system was adjusting to this new market, it would no doubt be subjected to some upward adjustments in its cost of funds. The ripple effect of such market adjustments would rapidly impact agricultural borrowers as most are carrying variable interest loan contracts. How costly this would be to the total agricultural economy is difficult to assess. However, if interest rates were increased to one percent above their current levels, cash flow from agriculture would increase by \$800 million annually.

*Tax Exemption Impacts:* At the present time, interest income paid to investors in system securities is subject to federal income tax, but exempt from state and local income taxes. This exemption would be lost under the proposed OMB changes. Many states do not currently impose an income tax on their residents while those which do, impose a tax rate which is small relative to the federal level. Hence, if one considers the net yield of a system security held by an individual investor, the reduction in that measure of earnings would be minimal. Furthermore, insofar as income taxes paid at the state level are deductible from taxable income as determined at the federal level, some investor recovery from the OMB proposal is seen. Hence, after-tax returns to holders of system

securities would be reduced under the proposed changes, but will likely remain equal to or greater than after-tax returns to holders of U.S. Treasury securities (which retain their state and local exemption). Staniforth argues, and I agree, that this proposed change will have little discernible impact on the marketability of system securities in the traditional market. Finally, we must not forget that federal personal income tax receipts will actually be reduced (nominally) as a result of OMB's proposal. Hence, a set of proposals originally designed to lessen a perceived federal budgetary deficit will actually diminish annual federal revenues to at least a modest degree.

*Regulatory Impacts:* The system is currently regulated by the Farm Credit Administration which serves system banks in a manner similar to that provided commercial banks by state and national bank examiners. FCA is also responsible for maintaining the investor credibility of system securities; at times even placing dollar limits on such offerings. It remains somewhat unclear just how, if, and to what extent, those functions performed now by FCA would change were the system to lose its sponsored agency status. Currently, it must be recognized that political influences of all kinds are focused upon FCA as Congress and the Administration can intercede to redefine limits, practices, and procedures within the system. The question is whether the loss of agency statutes will provide for the system a further defense of its state of autonomy. It is simply not known if political influences will lessen or seek other avenues under defederalization. What is known is that FCA would be obliged to share its regulatory role with the Securities and Exchange Commission and state banking commissioners. System banks would be subjected to most of the same restrictions now placed on private commercial banking institutions. System securities would require SEC documentation and clearance. At the state level, system compliance with truth in lending legislation and consumer protection laws would prevail. Staniforth argues that the cost of such compliance and supervision

"would be of no consequence" and, "help to maintain the credibility and acceptability of system securities in national money markets." I am not personally convinced of this finding. First, most of the 37 district banks in the system operate in more than one state. Hence they will be burdened by a multiplicity of differing regulations. Second, while regulatory compliance is needed, it is not an inconsequential activity. Numerous man-hours and many resources are employed by the system and as the number of regulatory bodies doubles or triples, the magnitude of expenses incurred will also increase proportionally. Finally, it is doubtful that the blessings of SEC and state banking commissioners will add much to the credibility of system securities. The past history of the system and its internal viability as a prime agricultural lender will remain the paramount factors in establishing and maintaining this credibility.

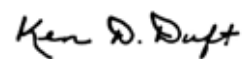
### **Summary**

As discussed above, added regulatory requirements could increase the operating costs of the system, perhaps even appreciably. However, insofar as the system's total operating costs comprise only .2 percent of total loans outstanding, the system could likely assimilate this new cost structure, while minimizing borrower impact. The proposed tax changes will impact system investors minimally and borrowers likely not at all. Of much greater concern is the possible loss of the securities market which the OMB proposal might impose. Commercial banks currently holding large amounts of system securities would be forced to reduce such holdings and search, instead, for securities issued by organizations retaining their sponsored agency status, e.g., FHA. Under such conditions, investment funds would be diverted from agriculture into housing or other economic sectors. To cover this loss of investing clientele, the system would be forced to reduce their lending at a time when agriculture's demand for such funds has reached an all-time high or, go in search of a secondary market in which higher

rates would prevail (at least temporarily). Were such higher rates passed on to agricultural borrowers, the resultant burden could be most damaging. Were the supply of the system's loanable funds reduced, it is doubtful that commercial banks and/or other institutions could rapidly fill the void.

The Farm Credit System is large, well-capitalized, and efficiently managed. The proposed label change involves a depth of issues beyond that perceived by most system observers. Yet the OMB proposal would not cause the system to collapse. Additional costs would be incurred as the system wrestled with additional regulatory constraints and as it sought to develop new markets for its securities. Of course the underlying incentive for the proposed change is a desire to shift a very large portion of the federal borrowing function from the public sector to the private sector where the current administration believes it best belongs. In this sense, the benefits derived and the costs incurred have been identified in type but not magnitude. Agribusiness managers must understand the tradeoffs in this issue. Political philosophy and the cost of debt capital invested in agriculture are very much at odds here.

Sincerely,



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