

Appendix C

Proposals to Change Farm Credit System and Commercial Bank Authorities

In recent years, Congress has considered proposals to expand the lending authority of the Farm Credit System (FCS) and the commercial banking system's access to FCS funds, both for the expressed purpose of improving credit delivery for rural development. As with other legislative initiatives, competing proposals to expand FCS and bank authorities exist and these proposals change over time to satisfy the desires of potential supporters. Therefore, our assessment of their impact is based on the general nature of the proposed changes rather than on the specific provisions of any particular initiative.

The mandate for this study requests an assessment of the advantages and disadvantages of modernizing the FCS and allowing commercial banks greater access to FCS funds from a variety of perspectives, including those of the FCS, commercial banks, rural borrowers, rural communities, and the Federal Government. While no attempt is made to quantify the costs and benefits of the various proposals for each of these constituent groups, the advantages and disadvantages are enumerated and, when sufficient information is available, their relative importance is compared.

In addition to assessing the proposals themselves, this appendix also addresses congressional concern over the ability of commercial banks to obtain loanable funds should local deposits prove insufficient to meet demand. Since this issue is central to evaluating the advantages of providing banks greater access to FCS funds, it is covered before discussion of proposals to do so.

Proposals To Modernize and Expand the FCS

This section addresses items (7) and (8) in the Congressional mandate for this study:

(7) the advantages and disadvantages of the modernization and expansion proposals of the Farm Credit System on the Farm Credit System, the United States

banking system, rural users of credit, local rural communities, and the Federal Government, including—

(A) any added risk to the safety and soundness of the Farm Credit System that may result from approval of a proposal; and

(B) any positive or adverse impacts on competition between the Farm Credit System and the banks of the United States in providing credit to rural users;

(8) the nature and extent of the unsatisfied rural credit need that the Farm Credit System proposals are supposed to address and what aspects of the present Farm Credit System prevent the Farm Credit System from meeting the need.

In recent years, proposals have been made to expand Farm Credit System powers, including expanded authority to finance rural housing, infrastructure, business, and rural development. Expanding FCS authorities is not unusual (fig. C-1). Since 1916, Congress has broadened FCS authority considerably beyond its initial purpose of providing long-term, fixed-rate farm mortgages. Current authorities include lending to primary agricultural producers and their cooperatives, harvesters of aquatic products, certain farm-related businesses, certain rural homes in communities of 2,500 or less, and certain rural utilities; and financing agricultural exports. The proposals discussed here are based broadly on two sources: the discussion of changes to FCS powers centered around the Rural Credit and Development Act of 1994 (H.R. 4129) introduced in the House of Representatives, and a recent Congressional Research Service bulletin on agricultural credit issues (Chite, 1996). In general, these proposals would broaden the System's current authority to provide loans for rural housing, infrastructure, and farm-related businesses, and would authorize equity investments in rural development authorities.

Figure C-1—Important changes in FCS lending authorities

The FCS charter has undergone a number of changes.

- 1916** Federal Land Banks and Federal Land Bank Associations created to provide long-term, fixed-rate mortgages.
- 1923** Federal Intermediate Credit Banks created to provide operating credit through commercial lenders.
- 1933** Production Credit Associations created to provide short-term operating credit directly to farmers and ranchers. Banks for Cooperatives created to finance purchasing and marketing cooperatives.
- 1935** Banks for Cooperatives authorized to finance cooperatives that furnish utility-, business-, and financially related services to farmers.
- 1955** Federal Land Banks authorized to make nonagricultural loans to farmers and ranchers.
- 1956** Production Credit Associations authorized to make nonagricultural loans to farmers and ranchers.
- 1971** Federal Land Banks allowed to lend up to 85 percent of market value of property (previous limit was 65 percent of agricultural use value of property).
Federal Land Banks and Production Credit Associations authorized to lend to nonfarm rural homeowners.
Production Credit Association and Bank for Cooperatives loans to commercial fishermen authorized.
Farm-related business loans authorized.
- 1975** Farmer membership for electric and telephone coop eligibility lowered from 80 percent to 70 percent.
- 1978** Production Credit Associations authorized to make loans of 7 to 15 years to commercial fishermen.
- 1980** Banks for Cooperatives authorized to finance agricultural exports that benefit U.S. farmer-owned cooperatives.
Federal Land Bank and Production Credit Associations authorized to finance certain processing and marketing loans.
Federal Land Bank Associations authorized to finance aquatic loans.
Farmer membership for electric and telephone coop eligibility lowered to 60 percent.
- 1985** Banks for Cooperatives authorized to finance noncooperative Rural Electrification Administration borrowers.
- 1987** Banks for Cooperatives authorized to finance subsidiaries of eligible borrowers and, on a limited basis, joint ventures and partnerships in which an eligible borrower is involved.
- 1990** Banks for Cooperatives authorized to finance installation, expansion, and improvement of rural water and waste disposal systems.
Processing and marketing lending authorities of Farm Credit Banks and FCS associations liberalized.
- 1991** Banks for Cooperatives authorized to make federally guaranteed loans for agricultural exports to “newly emerging democracies” until September 1995.
- 1992** Prohibitions against underwriting or enhancing tax-exempt municipal debt for rural communities removed.
Banks for Cooperatives authorized to make operating loans to rural water and sewer systems.
- 1994** Banks for Cooperatives authorized to finance more agricultural exports. Banks for Cooperatives’ authorities to finance subsidiaries of eligible coops expanded.
- 1996** Rural Utilities Service certification of eligibility for rural electric and telecommunication utilities repealed.
Current cooperative borrowers remain eligible for Bank for Cooperatives financing as long as farmers comprise more than 50 percent of membership.

Sources: Hoag, W.G., *The Farm Credit System: A History of Financial Self-Help*, The Interstate Printers & Publishers, Inc., 1976. CoBank, CoBank History, unpublished. Farm Credit Administration, FCA Handbook, 1992.

Proposals To Expand FCS Authorities

Housing. Some FCS associations are authorized to finance moderately priced, single-family residences in rural areas with populations of 2,500 or less, with loans covering up to 85 percent of appraised value of the residence securing the loan. Rural housing loans may not exceed 15 percent of all loans outstanding in any bank or association. The Farm Credit System Reform Act of 1996 authorizes financing of rural home loans in excess of 85 percent of appraised value if the borrower purchases private mortgage insurance. Home equity loans can be made for the purpose of improvements to the dwelling. Proposals seek to increase the population limit to 20,000 and the portfolio limit to 20 percent and to extend the purposes for which home equity loans can be made.

Infrastructure. The FCS Safety and Soundness Act of 1992 provided Banks for Cooperatives with the authority to finance the installation, maintenance, expansion, improvement, and operation of water and waste disposal facilities in rural areas. The Act also removed the prohibition on FCS enhancement of certain municipal tax-exempt debt, and a recent IRS ruling removed a lingering technical obstacle to such activity. Banks for Cooperatives (and Agricultural Credit Banks) also have authority to lend to any electric or telecommunication utility that qualifies for USDA/Rural Utilities Service (RUS) credit and subsidiaries of such utilities that provide utility services, such as cable television and cellular phone service, that RUS may not finance. Proposals seek FCS authority to make water purification and sewage treatment loans and to extend Banks for Cooperatives' financing of utility services to include purchase of services from utility-like providers (for example, generators of electricity) and of rural telecommunications companies that do not currently borrow from RUS.

Business. Currently, FCS institutions have authority to lend to farm-related businesses, to make marketing and processing loans to eligible farm borrowers, and to lend to eligible cooperative businesses. Often, businesses that process or market the products of cooperatives or member-borrowers do not meet current requirements. A proposal has been made to expand FCS authority to make loans to agricultural businesses that market or process agricultural or

aquatic commodities or furnish farm-related goods and services to farmers. (The Farm Credit Administration has recently eased some of these restrictions through regulatory action.) Another proposal would allow FCS institutions to provide financing to businesses that are involved in new, non-food, or non-feed uses of farm commodities. FCS institutions currently have authority to sell whole loans, but can only purchase whole loans if they are Farmer Mac poolers. They also have authority to buy or sell portions of loans as participations. Proposals have also been made to allow FCS institutions to buy whole loans. These proposals are discussed in the final section of this appendix (Broadening Commercial Bank Access to FCS Funds).

Equity Investments in Rural Development Authorities. To address the Administration's proposal to revitalize rural America, it has been proposed that FCS institutions be authorized to make equity investments in rural development authorities (similar to Small Business Investment Corporations or Community Development Corporations). These authorities would provide equity capital and financial services to beginning farmers, agricultural producers, and rural entities attempting to comply with environmental mandates. The proposal included FCS authority to make equity investments in such organizations and to discount and participate in loans with them.

Advantages and Disadvantages for the FCS. An expansion of FCS lending authorities would enhance the business opportunities and flexibility of FCS institutions. With the exception of funding rural development authorities, these proposals are generally consistent with existing expertise and lines of business, expanding FCS's potential customer base for loans similar to ones already being underwritten. The housing proposal would allow residents of larger rural communities to qualify for FCS financing and allow some FCS lenders to make and hold more loans by increasing the portfolio limit on rural housing loans. Some areas of the Northeast and Southeast, where FCS institutions have been particularly active in financing rural housing, could face rationing of FCS rural home loans if this restriction is not changed and if FCS lenders are unwilling or unable to sell home loans after origination. Qualified

home loans may currently be sold to Fannie Mae, Freddie Mac, or Farmer Mac.

The rural infrastructure and farm-related business requests are similar in that these proposals would also allow the FCS to continue to serve certain customers as their characteristics change. For example, if the business organization of a rural utility changed or if the share of a firm's inputs originating from a member borrower or cooperative dropped below current requirements, the proposals would allow these borrowers to continue receiving FCS loans.

FCS lenders are subject to high concentration risk because of their charters to serve limited economic sectors and specific geographic areas. These proposals would allow some FCS lenders to better diversify their loan portfolios, reducing their risk exposure. Inefficient diversification causes FCS lenders to maintain high capital levels and loan loss reserves compared with commercial banks—even when borrower stock and the Farm Credit Insurance Fund balance are omitted from FCS capital. High capital levels reduce risk, but also limit economic activity. Lower but still prudent capital levels would allow FCS lenders to make more loans for a given capital base, lowering operating costs.

The major disadvantages to the FCS of expanding lending authorities include concerns about cross-subsidization of new borrowers by previous or current borrowers, and safety and soundness concerns. Loan payments of current and former borrowers have provided FCS institutions with retained earnings and premiums to build the Farm Credit Insurance Fund. Such borrowers lose ownership rights to this capital when they pay off their loans and their “stock” is retired at par. Borrowers who paid relatively high interest rates in the late 1980's and early 1990's to help rebuild FCS capital may find that newly eligible borrowers reap benefits not afforded to past customer-owners. Safety and soundness concerns are discussed separately below.

Advantages and Disadvantages for Commercial Banks. The proposed changes to FCS authorities would increase competitive pressure on commercial banks in some markets for some loans. Local FCS institutions will respond to changes in authorities differently. In many areas, FCS institutions will be slow to use new authority. In other areas, FCS

lenders may aggressively pursue new business opportunities where managers believe them to be profitable and/or to offer risk management benefits.

FCS advantages related to favorable taxation and access to intermediate- and long-term funding could, at times, allow some FCS lenders to aggressively compete for certain types of loans, just as some FCS lenders have at times been able to dominate farm real estate lending. However, it is unlikely under the current proposals that such loans represent a large enough share of many small, rural banks' business to cause serious distress.

FCS lenders will continue to face three notable constraints on their ability to compete with commercial banks in rural housing, infrastructure, and farm-related business lending. These constraints will limit the adverse impact of expanding FCS authorities on commercial banks.

- They are limited in the range of financial services they may offer—deposit taking is prohibited—precluding them from being full-service intermediaries and limiting their attractiveness to some borrowers.
- Since capital standards make it difficult for new lending to be self-capitalizing, retained earnings and growth in retained earnings limit the extent and speed of expansion.¹
- With the exception of the Banks for Cooperatives, FCS lenders face geographic restrictions on their activity and growth (discussed in more detail below).

The proposal to establish rural development authorities in which commercial banks would be allowed to make equity investments could benefit rural banks otherwise struggling to meet Community Reinvestment Act (CRA) requirements. However, recent changes in CRA regulations limit the potential benefit small rural banks might receive.

¹ FCA regulations require FCS institutions to hold a minimum of 7 percent of total surplus and 3.5 percent of core surplus to risk-weighted assets. Surplus does not include stock purchased as a condition of receiving a loan. Thus, new lending could not be supported solely by stock (capital) purchased by a borrower when a loan is made.

Advantages and Disadvantages for Rural Borrowers and Communities. Expanded FCS lending could improve performance in noncompetitive markets or submarkets, benefiting newly eligible borrowers and local economies by lowering costs to borrowers, improving services, and promoting economic activity. Such areas could also benefit from enhanced integration with national money markets, potentially increasing the efficiency of market-based capital allocation.

A disadvantage to rural borrowers and communities is the danger of exacerbating boom/bust cycles as some claim FCS lending did in the 1970's and 1980's (Carey, 1990). Changes in FCS management and supervision make such an extreme outcome less likely. However, FCS lenders have tax and market access advantages that artificially lower their operating costs. If these advantages are passed on to newly eligible borrowers in the form of lower interest rates, competitive pressures will increase asset values, benefiting existing owners of assets and eligible borrowers at the expense of future owners and ineligible borrowers. In addition, no assurance exists that communities or populations will uniformly or universally benefit from any changes.

Advantages and Disadvantages for the Federal Government. The FCS helps equalize the cost and availability of credit in rural markets by offering credit to eligible borrowers on fairly uniform terms nationwide. Expanding FCS lending authority could expand these benefits to other rural sectors. The Federal Government could benefit if expanding FCS powers reduces rural credit market imperfections, enhancing rural and national economic growth. These benefits could arise if FCS lenders introduce low-cost competition into local markets. However, FCS lending practices (including documentation and appraisal requirements), portfolio restrictions that prevent efficient diversification, and the inability to offer deposit and checking services may prevent it from competing to serve the market for smaller eligible loans—reducing potential benefits. In addition, the practice of generally granting exclusive territories to FCS associations limits the effect of expanded FCS authority on market competition.

Disadvantages for the Federal Government include potential revenue losses and expanded contingent lia-

bilities associated with GSE lending. Since the FCS enjoys considerable benefits related to its GSE status, including certain tax exemptions and special status for FCS obligations, any benefits accrued to the Federal Government must be weighed against these costs.² While expanded lending authorities may benefit rural areas and enhance economic growth, some expanded FCS lending will represent loans that would have been made by lenders that pay higher marginal tax rates. Such crowding out increases the cost to the Federal Government of any additional lending and economic activity that such a policy change might induce. Since the authorities under consideration are not effectively targeted to markets where failures clearly limit economic potential, it is less likely that the net effect will be positive. In addition, alternative policies to enhance market performance, including reform of restrictive banking laws and regulations, have not been in place sufficiently long to assess their impacts on rural markets.

The one change that is clearly related to an acknowledged market failure relates to rural development authorities. These authorities would be similar to Small Business Investment Corporations (SBIC's) and Community Development Corporations. The performance of such entities was poor during the 1986-93 period for which research results are available. However, SBIC's run by for-profit lenders tended to perform better than others (Brewer et al., 1996). Since FCS institutions have no experience or expertise with such activities, considerable learning and investment would be required to achieve success.

² District Farm Credit Banks and lending associations that specialize in long-term farm mortgages (Federal Land Bank Associations and Federal Land Credit Associations) are exempt from all taxation except that on real property. Banks for Cooperatives and other lending associations are fully taxable as corporations or cooperatives. Interest earned on FCS obligations is exempt from State and local income taxes. The special status of FCS securities provides further benefits that keep the cost of funds lower than it would otherwise be. All GSE securities can be used as collateral for public deposits and for borrowing from Federal Reserve Banks and Federal Home Loan Banks. This makes them attractive investments for banks and thrifts. In addition, FCS securities can be held in unlimited amounts by national banks, and the Federal Reserve can buy and sell them in open market operations. They are issued and payable through the Fed's book-entry system, which allows funds and securities to be electronically traded. Despite the absence of any explicit statutory or contractual Federal guarantee, the presumption of an implicit Federal guarantee is widely held.

The Effects of Expansion on FCS Safety and Soundness. The U.S. General Accounting Office (1990) cites the farm credit and thrift crises as results of inadequate Federal supervision of the risk-taking and capital levels of financial institutions. However, expansion of powers into new lines of business also played a role in both crises. In the early 1980's, Congress allowed thrifts to take equity positions in real estate development and to invest in noninvestment grade (junk) bonds without requiring appropriate adjustments to capital levels or increased supervision. The FCS suffered substantial losses from loans to fishermen in the early 1980's, just a few years after authority to make such loans was expanded in 1978. Poor lending practices also contributed to these losses. In addition, part of the run-up and collapse of land values has been attributed to FCS practices (Carey, 1990). Financial supervision was strengthened after each crisis, but only after Federal assistance was provided.

To avoid further financial crises, any expansion of FCS powers could be accompanied by appropriate authority for its regulator to ensure continued safety and soundness. Because investor funds are directly insured by the Insurance Fund, indirectly by joint and several liability, and implicitly by the Federal Government, investors cannot be expected to discipline risk-taking by FCS institutions. If the insurance fund reaches its target level by early 1998 as currently projected, even the minor penalty of risk-based premiums will no longer be operative. Since its reorganization in 1985, however, the Farm Credit Administration has emerged as the strongest GSE regulator (U.S. General Accounting Office, 1994).

Another safety and soundness concern relates to the FCS Insurance Fund. The fund protects bondholders from losses on systemwide security issues and mitigates the problems encountered with joint and several liability during the farm debt crisis. The Farm Credit System Insurance Corporation (FCSIC) will assess premiums on FCS banks until the fund reaches its secure-base of 2 percent of insured FCS liabilities. To the extent that expanding powers increases lending opportunities for the FCS, it will also increase insured systemwide securities and delay full funding of the Insurance Fund.³

Effect of Expansion on Rural Credit Market Imperfections. Although GSE's were designed to address market imperfections, recent proposals to expand FCS authorities (with the exception of the proposal for rural development authorities) have not been directed at specific market failures. Advocates argue that increasing rural lending is necessary to improve rural development even though the linkages between credit, development, and the proposals to expand FCS authority are tenuous.

However, rural credit markets remain less than efficient. Regulations and laws, including branching restrictions and limits on bank ownership and affiliation, prevent entry and competition. Some 25 percent of rural counties are served by two or fewer commercial banks and may have markets too small to support many competitors. As of 1994, fewer than 7 percent of rural banking markets (compared with over 55 percent of urban markets) met Department of Justice standards of competitiveness (Rhoades, 1995).⁴ Removal of barriers to market entry and innovation benefits rural areas.

Under current law and regulation that allocates exclusive territories to most FCS lenders, expansion of FCS authority introduces at most one additional competitor in each submarket. For changes in FCS authority to provide the greatest possible public benefits, exclusive FCS territories would have to be eliminated and operating procedures reviewed to enhance incentives for FCS lenders to compete both with each other and with other providers of rural credit. To avoid unfair competitive advantages, lender taxation and regulation could be harmonized as well.

An alternative to expanding FCS powers could be removal of regulation or other barriers to entry that may prevent some rural credit markets from attaining competitive efficiency. Research has shown that relative inefficiency among FCS associations is high compared with inefficiency among commercial banks (Collender, 1991). This indicates that some benefits

³ For a more detailed discussion of FCS safety and soundness issues, see Collender and Erickson (1996).

⁴ In general, bank mergers that result in a post-merger Herfindahl index in any local market of more than .18 and produce an increase in this index of more than .02 are viewed as potentially anti-competitive. The Herfindahl index of concentration is the sum of the squared market shares of competitors (Whalen, 1995).

of GSE status have not been conveyed to FCS borrowers/owners. FCS corporate structures facilitate inefficiency because usual ownership rights to retained earnings are not vested and FCS institutions are generally protected from intrasystem competition (Collender and Erickson, 1996). While various measures of FCS inefficiency have improved in recent years, these basic FCS characteristics may prevent many borrowers/owners from realizing the benefits of these gains.

Commercial Bank Liquidity

Before addressing proposals to broaden commercial bank access to FCS funds, the potential need for such proposals is addressed. In particular, this section of the appendix addresses part of the final item in the Congressional mandate for this study:

(10) problems that commercial banks have in obtaining capital for lending in rural areas...

Historically, rural banks have sought access to nonlocal, nondeposit funds for a variety of reasons, including: (1) seasonal patterns in loans and deposits; (2) patterns of deposit and loan growth related to economic cycles; (3) an inability to compete for deposits because of binding interest-rate ceilings; (4) restrictions on loan size as a percentage of bank equity capital; (5) a desire to fund longer term loans; and (6) the need to reduce portfolio and other risks.

Concerns about rural access to nonlocal funds arise from competitive and demographic changes in rural credit markets that may increase competition for local savings, the primary source of loanable funds for rural banks. Such changes include falling barriers to entry such as the lifting of restrictions on bank branching, increasing acceptance of uninsured vehicles for household savings such as mutual funds, reduced consumer commitment to locally based financial intermediaries, and advances in information processing and telecommunications that make long-distance saving/banking an attractive alternative for an increasing number of rural residents.

From year-end 1989 to 1994, mutual fund balances increased by \$1.2 trillion while deposits at banks, thrifts, and credit unions fell by \$89 billion (U.S. General Accounting Office, 1995). Commercial banks now hold a smaller share of total credit market

liabilities (15 percent) than do mutual funds and pensions (21 percent). Data are not available to assess directly how this shift in savings behavior has affected rural commercial banks or rural credit markets. The General Accounting Office concludes the overall impact on credit markets is negligible.

Measured by the ratio of total loans to deposits, liquidity has fallen, on average, at rural commercial banks. The average loan-to-deposit ratio for banks headquartered in rural areas rose from roughly 61 percent in 1990 to 68 percent by year-end 1995. In an analysis of agricultural (more than 10 percent of loans for agricultural purposes) and other rural banks, their increasing loan-to-deposit ratios were explained mostly by a shift in assets from securities to loans. A minor portion of the increase was explained by a shift in the sources of funds away from deposits (Barry and Associates, 1995).

Loan-to-deposit ratios reflect management decisions about the most profitable sources and uses of a bank's funds. Changes can reflect the relative attractiveness of holding loans or securities in a bank's investment/asset portfolio as well as the cost of deposits relative to other liabilities. Factors other than deposits can also affect these decisions. For example, the attitudes of regulators toward different bank activities can be very important. In the early 1990's, factors that made securities attractive relative to loans included regulatory concerns about potential bank failures, new risk-based capital rules, and the high yields available on intermediate- to long-term securities. By 1994, concerns about bank failures had diminished and the yield curve had substantially flattened, increasing the attractiveness of loans relative to other investments.

GSE funds are an alternative source of liquidity for deposit-taking financial intermediaries, including commercial banks, credit unions, and thrifts. Liquidity is increased when commercial banks sell qualifying loans outright to GSE's or pledge them as collateral for advances. Besides enhancing liquidity, access to GSE funds can improve profitability and risk management. Profitability is improved at banks for which the cost of these advances is less than the cost of raising new retail deposits (Hartzog et al., 1990). Selling loans also allows capital-constrained banks to make more loans without increasing equity

capital, which is a very expensive undertaking. Making and selling loans can be profitable because banks earn fees for originating and servicing loans that they no longer hold in their own portfolios. Sometimes servicing rights are sold as well. In addition, GSE funds tend to be readily available under well-specified conditions. This availability allows banks to take advantage of loan opportunities as they arise, and is particularly useful when other sources of funds are unavailable.

Risk management is enhanced because GSE funds are available with longer maturities than are usually available on deposits at commercial banks. Advances can be used to control interest rate risk by allowing banks to match funding to the maturity, payment structure, prepayment options, and other features of the loans they make. When loans are sold without recourse rather than pledged as collateral, the associated credit and interest rate risks are no longer liabilities of the bank. Similar but less profitable benefits can be obtained through private market securitization because extra collateral or other enhancements are usually required to make the securities attractive to investors.

Two policy changes have also altered the availability of nonlocal funds to rural commercial banks. In 1992, the Federal Reserve changed the terms of its seasonal borrowing program from subsidized pricing to a market-based index and, in 1989, eligible commercial banks were given access to the Federal Home Loan Bank System.

Alternate Sources of Liquidity and Risk Management. Commercial banks have access to numerous risk management and liquidity alternatives (see supplement, pp. 99-103). Such alternatives help ensure banks' ability to respond to local changes in loan

demand from creditworthy borrowers. Alternate sources of liquidity and loanable funds include:

- emergency, adjustment, and seasonal lending from Federal Reserve Banks;
- existing access to direct GSE funds from the FCS and Federal Home Loan Bank (FHLB) System;
- the market for Federal funds and repurchase agreements;
- access to indirect GSE funds through securitization of eligible loans through Fannie Mae, Freddie Mac, or Farmer Mac;
- bankers' banks and other correspondent banking relationships;
- brokered deposits; and
- non-GSE securitizations of both consumer and business loans.

Risk management alternatives include:

- financial derivatives (futures, options, and swaps);
- matching maturity or cash-flow characteristics of loans through synthetic debt (defined below) or other sources such as FHLB advances;
- Federal and State government loan guarantee programs;
- private securitization; and
- correspondent relations with other financial institutions, including bankers' banks, to share the risk of larger or longer term loans.

Sources of Liquidity and Risk Management (Supplement to Appendix C)

Federal funds and repurchase agreements. Federal funds are unsecured short-term loans that are settled in immediately available funds. Any institution that holds large balances at a Federal Reserve Bank, including commercial banks, thrifts, foreign governments, and the U.S. Treasury, can trade Federal funds. Repurchase agreements (or repos) are short-term loans secured by government securities and settled in immediately available funds. Repos are similar to Federal funds except that they are collateralized and therefore less risky. Most transactions are overnight but longer maturities can be negotiated in both markets. Federal funds and repos are both important short-term investments for many rural banks and essential sources of short-term liquidity throughout the U.S. financial system. The extent to which rural banks rely on these funds is discussed below.

Securitization. Securitization is the process of bundling and rearranging the cashflows from pools of financial assets, such as loans or leases, into securities with characteristics that are attractive to investors. The process of securitization was pioneered (with the aid of explicit or implicit Federal guarantees on the cashflows) in the residential mortgage market by the Government National Mortgage Association, an agency of HUD, and by Freddie Mac and Fannie Mae, two housing GSE's. Their success brought widespread acceptance of securitization in the 1980's. Private poolers now securitize many types of financial assets, including credit card receivables, automobile loans, and equipment leases. Private securitizations are often enhanced to improve their attractiveness to investors. Such enhancements can include third-party insurance and over-collateralization—the commitment of collateral whose value substantially exceeds that of the securities sold to back up the asset pool.

Derivatives and synthetic debt. Derivatives, including futures, options, and swaps, are widely traded financial contracts that offer many risk management possibilities. For example, rural commercial banks are often concerned about their inability to access fixed-rate, long-term funds. Derivatives can be used to create synthetic long-term debt at prices comparable to those of FHLB advances. For example, Hartzog and others found in 1990 that an interest rate swap could be used to create synthetic 3-year debt at a comparable price to that available on a 3-year, fixed-rate advance from the FHLB of San Francisco. However, very few rural banks use derivatives. Barry and Associates found that, in 1994, 1 in 10 urban banks used interest rate swaps while only 1 in 500 agricultural banks (those with a ratio of agricultural loans to total loans over 10 percent) and 1 in 50 nonfarm rural banks did so.

Federal Reserve discount window (especially its seasonal borrowing program). All commercial banks, thrifts, and credit unions with reservable deposits have access to the Federal Reserve discount window, whereby the Federal Reserve System fulfills its role as lender of last resort. Access is restricted to specific authorized purposes. Depository institutions must draw on alternative sources of funds before coming to the discount window and are expected to adapt to economic and financial circumstances without relying on discount window borrowing. Acceptable reasons for borrowing include sudden unforeseen outflows, temporary and unexpected difficulties in obtaining funds from other sources, and unexpected increases in loan demand. Most borrowing is for very short periods (overnight). One exception, the seasonal borrowing program (SBP), was established to address concerns that many rural and agricultural credit markets served by small banks were constrained by insufficient access to nonlocal money markets. This limited access was attributed to the lack of readily available information about small banks and a general belief that loans to them were higher risk investments for other financial institutions. Limited access to nonlocal funds, a relatively inelastic supply of local deposits, and regular deposit outflows during periods of seasonal loan demand, were thought to force rural banks to keep a high proportion of assets in low-yield, highly liquid securities during other seasons, reducing total lending and constraining local economic growth.

To use the SBP, eligible institutions must be small (generally less than \$250 million in deposits) and have recurring seasonal swings in net funds available (deposits less loans). Qualifying institutions can borrow for up to 9 months per year and pay a variable market-based interest rate.⁵ Borrowings must be fully collateralized and most have weekly or 30-

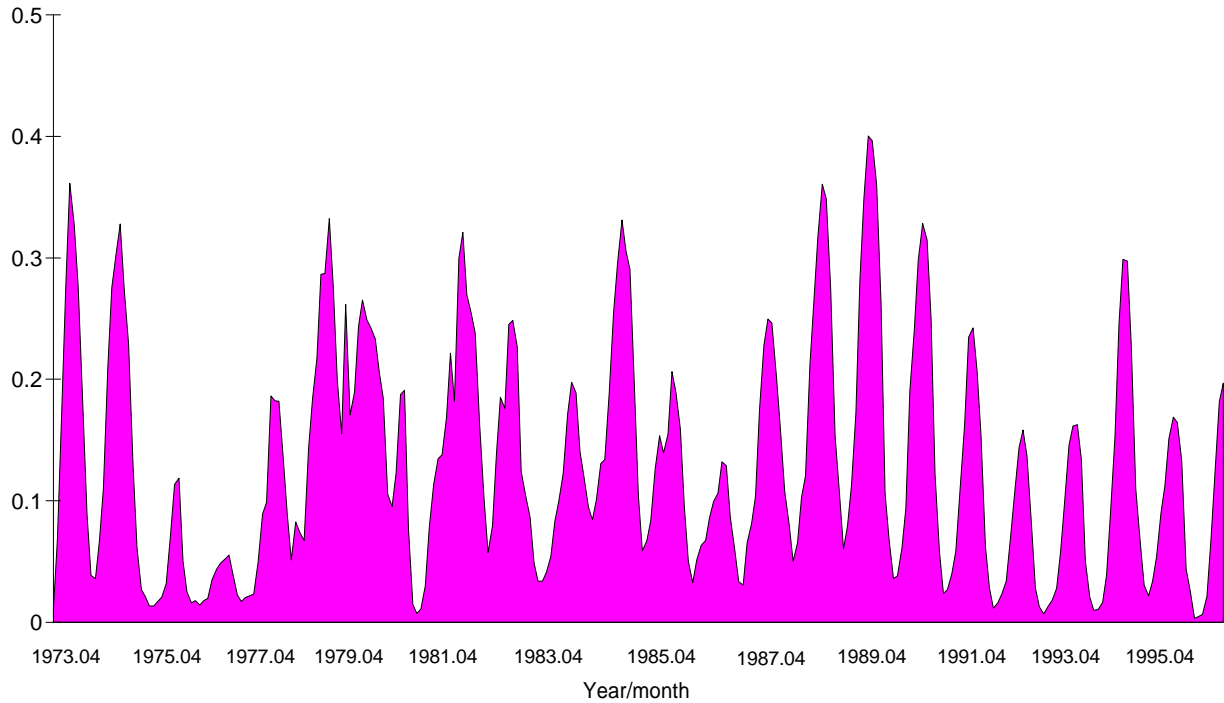
⁵ The interest rate for the SBP was subsidized until 1992 when it was set at the average of the Federal funds rate and 90-day rate on large CD's over the previous reserve maintenance period to the nearest 5 basis points. A basis point is one-hundredth of a percentage point.

Figure C-2

Federal Reserve seasonal borrowing program advances, 1973-96

Seasonal borrowing program advances are small relative to FHLB advances.

Inflation-adjusted dollars (billion)



Source: Compiled by ERS from Federal Reserve Board.

day maturities. These short-term loans can be rolled over on maturity if program requirements are met. Figure C-2 shows the history of SBP advances.

Correspondent banking (including bankers' banks). Demand deposits and compensating balances are maintained at correspondent banks to facilitate check clearing and payments for services purchased. This network of deposits links small and large banks and banks in different areas.

Correspondent banks provide check clearing and related cash transactions, investment services, and credit-related services for their customer banks. They invest surplus funds for small banks, trade Federal funds and other securities, provide funds through participations so that small banks can originate and service (but not hold) loans that exceed their legal (capital-based) lending limits, and borrow at the Federal Reserve discount window for smaller banks. However, correspondent banking has not been without its problems. Rural banks have complained about the reluctance of correspondent banks to grant overlines for nonfarm loans, the high cost of maintaining compensating balances, the lack of overlines during periods of tight money, and differences in underwriting standards that cause correspondent banks to reject some participations or overlines.⁶ The increased risk of correspondent banking caused by bank failures in the 1980's and the growth of multibank holding companies caused a decline in independent banks' access to credit services from correspondents.

In response to this decline and other complaints, bankers' banks were established. Bankers' banks are cooperatives owned by independent banks and authorized to provide services only to financial institutions. They do not compete

⁶ Banks are not allowed to make loans of greater than 15 percent of their equity capital to any one borrower. An overline is a loan participation by a correspondent in the amount by which a given loan exceeds this limit.

with banks for retail customers, but they do compete with correspondent banks and other wholesale providers of bank services. Bankers' banks may also provide data processing and training for bankers on how best to use their services. Since correspondent banking is the main business of bankers' banks, they may be more responsive to the needs of their bank-customers.

Federal Home Loan Bank System Advances. The FHLB System provides advances and related products and services to support residential mortgage lending. Advances are secured loans to member institutions. The status of the FHLB System as a GSE enables it to fund advances at rates just slightly above those paid on U.S. Treasury securities. The purpose of advances is to improve liquidity of mortgage loans held by depository institutions and to ensure a readily available source of new mortgages. Collateral for advances is limited to residential mortgages; qualified, privately issued mortgage-backed securities; securities issued, insured, or guaranteed by the U.S. Government or a government agency (including GSE's); funds that a member has deposited in an FHLB; or other real estate-related collateral acceptable to the FHLB. Advances are normally overcollateralized, depending on the type and quality of collateral offered, and are limited to 30 percent of a member's capital if not secured by residential mortgages, deposits in an FHLB, or Treasury or agency securities.

Every FHLB is required to offer advances for maturities ranging from overnight to 10 years and may make advances for even longer terms if consistent with safe and sound operations. Other terms may be tailored to the needs of the borrowing institution such as fixed or variable interest rates, balloon payments, or prepayment options that allow penalty-free prepayment on specified dates. This flexibility allows borrowers to use advances to control interest rate risks by matching funding or other features with the structure of loans in their portfolios. At midyear 1996, FHLB advances were overwhelmingly for short or intermediate terms (fig. C-3).

Several eligibility rules restrict FHLB membership and advances. Prospective members must be financially sound and have a minimum of 10 percent of their assets invested in residential mortgage-related loans or investments at the time of application. A minimum stock purchase is required both for membership and for advances. Higher levels of stock are required for institutions less actively involved in residential lending. However, dividend policies in recent years have often made stock purchase an attractive investment. Advances to commercial banks and credit unions are limited to 30 percent of aggregate advances.

Although advances are intended to benefit the residential lending market, fungibility prevents exact knowledge of how advances are used or the extent of their impact. In any event, FHLB advances offer more flexibility than is available through other housing-related GSE's. In contrast to the other housing GSE's (Fannie Mae, Freddie Mac, and Farmer Mac), FHLB funds can support any size mortgage, and FHLB advances allow for flexibility in underwriting—policies are set by each member institution—commercial bank, thrift, credit union, etc.—within limits set by its regulators.

Preliminary results based on December 1994 data show that:

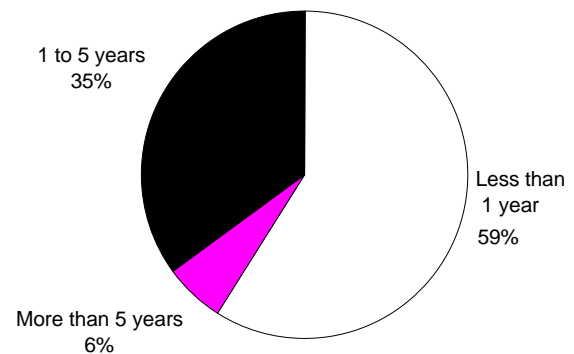
- Of 10,450 commercial banks with headquarters in the 50 States and the District of Columbia, 3,133 were current members, 2,053 were probably ineligible and 5,264 were probably eligible for membership but had not chosen to join.⁷

⁷ References to banks that are eligible or ineligible for FHLB membership are based on publicly available information. Nonpublic factors also affect eligibility. Therefore, the numbers reported are estimates.

Figure C-3

FHLB advances by initial maturity, 1993

FHLB provides roughly equal amounts of short and longer term advances.



Source: Compiled by ERS from U.S. Department of Housing and Urban Development.

- For ineligible commercial banks, mortgage-related assets accounted for an average of just 11 percent of their total assets; for eligible banks and member banks, the average was 26 percent and 30 percent, respectively.⁸
- Commercial banks with headquarters in rural areas account for 56 percent of all banks in the data set; 55 percent of ineligible banks; 58 percent of eligible banks; and 53 percent of member banks.
- Rural commercial banks that were members of the FHLB System were larger (average assets \$134 million) and held a greater ratio of mortgage-related to total assets (29 percent) than rural banks that were eligible (\$62 million, 25 percent) or ineligible (\$78 million, 9 percent).
- Urban commercial banks that were members of the FHLB System were smaller (average assets \$560 million) and held a greater ratio of mortgage-related assets (31 percent) than urban banks that were eligible (\$839 million, 27 percent) or ineligible (\$870 million, 14 percent).
- Rural access seems to be of greatest concern in the Topeka (where 39 percent of rural banks are ineligible), Des Moines (where 24 percent of rural banks are ineligible), and Dallas (where 19 percent of rural banks are ineligible) districts. These districts include areas where bank branching has been restricted historically.

Farm Credit System advances and direct participations. District Farm Credit Banks (FCB's) have the obligation to lend to commercial banks for short- and intermediate-term agricultural purposes under conditions comparable to those imposed on FCS lending associations. However, the requirements commercial banks must meet to obtain these funds are quite restrictive, and other requirements lower the attractiveness of establishing access. FCS advances are available to other (non-FCS) financial institutions (OFI's) that:

- are significantly involved in agricultural lending (defined as having at least 15 percent of their loan volume at its seasonal peak in eligible loans);
- have limited access to regional or national capital markets (judged by the ability of institutions of similar size and circumstances to regularly use such instruments as bankers' acceptances, commercial paper, and negotiable certificates of deposit);
- have a continuing need for funds for agricultural lending (generally must show a seasonal peak loan-to-deposit ratio of 60 percent for the last 3 years for depository OFI's or OFI's affiliated with a depository institution);
- do not use FCS funds to expand other types of lending.

In addition, OFI's must

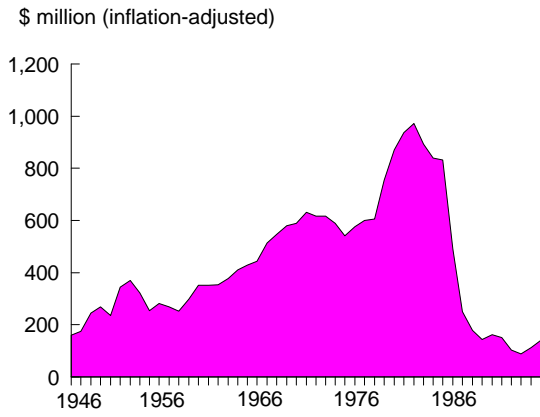
- submit to examination by FCA or allow FCA access to its report of examination;
- establish a credit line for a minimum 2-year term and estimate the average daily balance. Failure to maintain an annual average daily balance of at least 70 percent of the estimate subjects the OFI to a commitment fee of 1 percent of the difference between the estimated and actual average daily balances;
- meet minimum capital requirements that may be above those imposed by its regulators.

In 1983, commercial banks receiving funding through this authority could be cost-competitive with FCS associations and did not lose customers to them (American Bankers Association, 1983). Nonetheless, restrictions and concerns about doing business with a direct competitor limit the appeal of this mechanism to very few banks. In 1995, only 22 commercial banks made use of this authority. Figures C-4 through C-6 show the history of OFI lending. FCS banks and associations can also buy participations from commercial banks. This authority applies to both nonreal estate loans and real estate loans. The commercial bank must retain the lesser of 10 percent of the total loan amount allowed under lending limits set by its regulator. Unlike access to FCS funds through its OFI authority, commercial banks can use participations on an as-needed basis.

⁸ Mortgage-related assets can account for more than 10 percent of ineligible commercial banks' total assets because other criteria also exist for membership, including capital adequacy and asset quality requirements.

Figure C-4
Total inflation-adjusted FCS lending to Other Financial Institutions, 1946-94

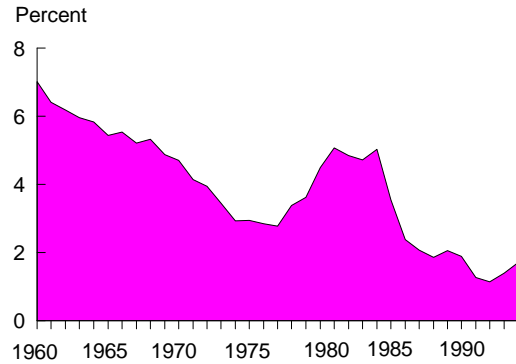
OFI lending peaked in the late 1970's and early 1980's when monetary policy was tight.



Source: Compiled by ERS from Farm Credit Administration.

Figure C-5
Other Financial Institution lending's share of total FCS nonreal estate lending, 1960-94

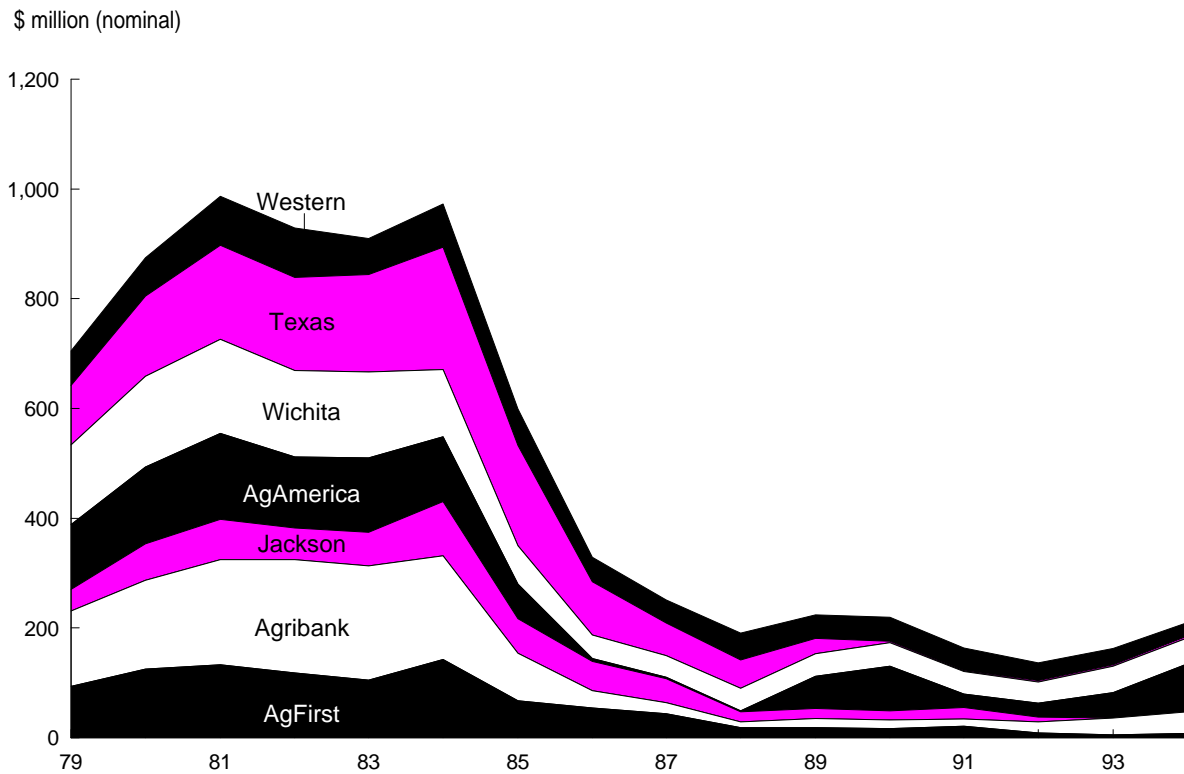
The relative importance of OFI lending has fallen over time.



Source: Compiled by ERS from Farm Credit Administration.

Figure C-6
FCS lending to Other Financial Institutions by FCS district, 1979-94

Four districts account for the bulk of OFI activity.



Source: Compiled by ERS from Farm Credit Administration Annual Reports. OFI lending in the Springfield/CoBank district has never been significant.

Changes in Liquidity of Rural Credit Markets.

High loan-to-deposit ratios do not necessarily constrain the origination of new loans.

Commercial banks have many nondeposit sources of funds, and profitable, well-managed banks often have very high loan-to-deposit ratios.

Although rural banks make considerably less use of nondeposit funds than do banks headquartered in urban areas, evidence shows that most rural banking markets are served by banks that do use nonlocal sources of funds to some extent. In terms of credit market performance, uniform and fair access to nondeposit sources of funds is more important than is their use by any particular set of commercial banks because, in many instances, use will not be profitable for any particular institution at any particular time. From a public policy perspective, concern about the ability of market participants to exchange services at competitive prices takes precedence over concern for the viability of particular institutions. Therefore, we focus here on evidence related to the impact of nondeposit sources on rural credit markets rather than on banks based in rural areas.

Evidence from 1994 bank call report data and FHLB membership data illustrate how commercial banks with offices in rural credit markets (including urban-headquartered banks) use nonlocal funds. Table C-1 presents the percentages of rural markets served by banks that use FHLB advances or are eligible to use them, that are net buyers of Federal funds or repos, or that use "other borrowed money" (including Federal Reserve, FCS, and FHLB advances as well as many other sources of nondeposit funds).

The great majority of both rural and urban counties are currently served by at least one FHLB member commercial bank, but less than half the commercial banks meet eligibility requirements for FHLB membership in a greater percentage of rural counties compared with urban counties. A broader measure of access to nonlocal, nondeposit sources of funds is the "other money borrowed" item from bank call reports. Large seasonal fluctuations occur in the use of these sources of funds, with usage peaking in the fourth quarter. At both midyear and year-end 1994, far greater percentages of rural counties than urban counties were served by no banks using any of these funds. The disparity is greater when comparing the

use of funds with maturities greater than 1 year.

These observations could be explained by a lack of profitable opportunities to use borrowed funds, lack of management knowledge or desire to use the markets for these funds, or other reasons.

Call report data also show the extent to which counties are served by net importers or net exporters of funds through the markets for Federal funds and repurchase agreements. Net importers borrow more money on this market than they lend. Because of the short maturities on these funds, quarterly average balances rather than ending balances are reported. For the fourth quarter 1994, relatively more urban counties than rural ones had more than half their banks importing these funds, little changed from the second quarter. During both the second and fourth quarters, no banks were net importers of these funds in a far greater percentage of rural counties than urban counties.

Rural banks now have many options to control risk and access nonlocal funds. They have sought repeatedly to expand access to GSE funds, but have made only limited use of them except in cyclical upturns. The Federal Reserve discount window was subsidized until recently, after which use declined substantially. FHLB advances have been more heavily used, but considerably less than in urban areas. Current interest coincides with a change to more market-based pricing of Federal Reserve discount window lending and concerns of some rural banks that limitations on FHLB eligibility and, therefore, access to advances may put them at a competitive disadvantage.

Private market solutions to some of the limitations of small rural banks include bankers' banks and synthetic debt. Bankers' banks can more easily establish the reputation and volume necessary to access some of these markets economically. These banks are more likely than the smaller banks they serve to find it profitable to establish expertise and sophistication in accessing nonlocal funds. They also exist to serve the interests of their member banks rather than competing with them in retail markets and are more likely to supply correspondent services throughout the business cycle than are other commercial banks. The FHLB of San Francisco estimated in 1990 that synthetic debt could also be used to attain intermediate-

Table C-1—Commercial bank market use of nonlocal, nondeposit funds, 1994^{1,2}*Rural bank markets rely less on nonlocal, nondeposit funds.*

	June 30		December 31	
	Urban	Rural	Urban	Rural
	<i>Percent</i>			
Counties served by at least one FHLB member commercial bank	na	na	70	95
Counties where less than half of the banks are eligible for FHLB membership	na	na	8	0.5
Counties with no bank relying on:				
nonlocal funds	41	66	5	30
nonlocal funds with maturities greater than 1 year	48	72	8	40
net imports of short term funds through Federal funds purchases or repurchase agreement sales	5	25	4	24
Counties where over half of the banks are net importers of short term funds through Federal funds purchases or repurchase agreement sales	56	42	59	43

na = not available.

¹ Bank markets are synonymous with counties. All banks with an office located within the county, including banks headquartered elsewhere, are included in the bank market.

² Nonlocal funds include promissory notes; notes and bills rediscounted, including commodity drafts rediscounted; loans sold under repos that mature in more than one business day and sales of participations in pools of loans that mature in more than one business day; loans or other assets sold with recourse or sold in transactions in which risk of loss or obligation for repayment of principal or interest is retained by, or may fall back upon, the seller that must be reported as borrowings for purposes of these reports; due bills representing the bank's receipt of payment and similar instruments, whether collateralized or not; Federal Reserve Bank or FHLB borrowings; certain overdraft balances with depository institutions; purchases of "term federal funds"; notes and debentures issued by consolidated subsidiaries of reporting bank; and borrowing not reported elsewhere, including borrowing from the FCS.

Source: Calculated by ERS from the Federal Deposit Insurance Corporation, Summary of Deposits file; the Federal Reserve Board, Report of Condition and Report of Income file, June 30, 1994; and the Federal Housing Finance Board, Federal Home Loan Bank System Membership Database, December 31, 1994.

term funds priced comparably to FHLB advances (Hartzog et al., 1990). No limits exist on access to this type of funding.

Available evidence indicates only limited demand (especially in rural areas) for longer term, fixed-rate funding sources. Farmer Mac has had little success with fixed-rate products priced for periods longer than 5 years. More than 85 percent of FHLB advances are for periods shorter than 5 years. While 60 percent of rural counties were served by at least one bank using "other money borrowed" with greater than 1-year maturity in 1994, in only 16 percent did more than half the banks use such funds. About one-third of rural counties were served by banks that did not import even short-term funds to meet liquidity needs or investment opportunities in 1994.

Broadening Commercial Bank Access to FCS Funds

This section addresses item (9) and part of item (10) in the Congressional mandate for this study:

(9) the advantages and disadvantages of the proposal by commercial bankers to allow banks access to the Farm Credit System as a funding source on the Farm Credit System, the United States banking system, rural users of credit, local rural communities, and the Federal Government, including—

(A) any added risk to the safety and soundness of the Farm Credit System that may result from approval of the proposal; and

(B) any positive or adverse impacts on competition between the Farm Credit System and the banks of

the United States in providing credit to rural users; and

(10) how access to Farm Credit System funds would improve the availability of capital in rural areas in ways that cannot be achieved in the system in existence on the date of enactment of this Act, and the possible effects on the viability of the Farm Credit System of granting banks access to Farm Credit System funds.

The options for expanding commercial bank access to FCS funds are complex. Although the basic nature of likely effects is foreseeable, judging magnitudes is impossible, especially given the lack of specific legislative and regulatory language. We discuss the following options in the broadest possible terms and make no attempt here to discuss specific details:

- rechartering the FCS to mirror the structure of the Federal Home Loan Bank System; and
- expanding FCS authority to buy whole loans in rural areas.

A rechartered FCS. Rural bankers have proposed reorganizing the FCS as the rural equivalent of the Federal Home Loan Bank System to provide them with a new, reliable, and low-cost source of loanable funds. The bankers' proposal is complex and would fundamentally change the structure of the FCS, including its ownership. Commercial banks would be allowed to join the FCS if they held at least 10 percent of their assets in agricultural or rural loans. Eligible banks could buy stock in FCS banks and exercise voting rights. Member commercial banks could obtain loanable funds through advances collateralized by FCS-eligible loans or by acceptable securities, much as FHLB System members do. FCS lending associations would have the option of obtaining commercial bank charters or maintaining their narrower FCS charters. FCS associations and member commercial banks would have equal access to funding through FCS banks, to dividends on FCS bank stock, and to control of FCS bank management.

Expanding FCS authority to buy whole loans.

Various proposals made in the last few years would facilitate the buying and selling of whole loans by FCS lenders. Such proposals include relaxing certain borrower stock requirements and borrower rights provisions. Proposals have focused on both FCS-eligible loans and on rural business loans that the FCS cannot make directly. Unlike the bankers' pro-

posal, the FCS proposal would allow, but not require, any particular transaction. Loans would only change hands if two parties wanted to trade. This proposal might increase bankers' access to GSE funds at any particular time or it might not.

Rechartering the FCS—advantages and disadvantages for the FCS. Rechartering would affect FCS associations differently from FCS district banks. The major advantage for FCS district banks would be to increase their business volume and opportunities while maintaining their special GSE status with limited direct competition. Such a change could improve profits at the district banks. A potential disadvantage that district banks would have to bear initially would be exposure to unfamiliar risks if the definition of eligible collateral for FCS advances is changed. FCS district banks may need new expertise to successfully advance funds to new commercial bank owner-borrowers. Such a change would require increased vigilance to ensure safety and soundness.

Rechartering would disrupt the current structure of business relations between FCS associations and FCS district banks. Costs borne by FCS associations and their borrower-owners would arise primarily from dilution of control in FCS district banks and from loss of competitive advantage provided by exclusive access to FCS funds. FCS district banks are owned exclusively by their affiliated associations with the exception of CoBank, Agricultural Credit Bank, which is owned by member-borrower cooperatives including five affiliated FCS associations. Placing a fair value on this loss of control would be difficult, and no proposal has been made to compensate associations and their borrower-owners for any loss in value. In any event, commercial bank ownership of substantial portions of FCS bank stock would effectively end the traditional farmer control and focus of many FCS institutions (particularly FCS banks and associations that choose to convert their charters).

Another disadvantage for FCS associations would be their status as mandatory members while bank membership would be voluntary. The combination of mandatory and voluntary members can force mandatory members to bear extra costs in times of financial difficulties as voluntary members choose to exit, withdraw their capital, and cut their losses. Such behavior could destabilize an FCS bank's capital and

increase interest rate risk with negative consequences for the Farm Credit Insurance Fund and other FCS banks under joint and several liability.

Rechartering the FCS—advantages and disadvantages for commercial banks. Commercial banks drafted this proposal and expect to accrue many benefits from its implementation. Judging by the experience commercial banks and thrifts have had with the FHLB's, eligible banks would receive access to taxpayer-subsidized funds with minimal conditions at less than the marginal cost of retail deposits (Hartzog et al., 1990). These funds would be available in a variety of maturities to meet both the short-term liquidity needs of bankers as well as their desire for longer term, fixed-rate funds. Longer term funds can be used to manage interest rate risks associated with longer term loans. Any improved ability to manage these risks could enable bankers to compete more aggressively for longer term loans—a market that many small, rural banks have not typically pursued. In addition, although eligible collateral would be restricted to agricultural or rural development assets (loans and securities), bankers could use advances to expand into other business opportunities as long as they maintain eligible collateral. In the FHLB System, once commercial banks have qualified for membership they need not maintain the initially required level of qualifying assets.

Using 1994 data, we estimated the extent to which commercial banks that are ineligible for FHLB membership would gain access to GSE funds through this proposal.⁹ Of the 1,132 ineligible rural commercial banks, 75 percent would be eligible under this proposal for access to FCS funds given their current loan and securities portfolios. In contrast, only 8 percent of the 922 ineligible urban banks would be eligible. The disparity in impact between rural and urban banks arises from the generally low proportions of agricultural and rural development loans held by urban banks.

Commercial banks would bear no significant disadvantages from adoption of this proposal, but access to FCS advances could have negative impacts on distressed banks in some situations. For example,

⁹ To estimate eligibility under this proposal, we treated industrial development bonds as if they were qualifying rural development assets.

access to liquidity that may be provided irrespective of a bank's general financial health creates a potential for excessive risk taking. Advances may also have a negative effect on liquidity if they tie up collateral that could otherwise be used for emergency borrowing from the Federal Reserve. Such a liquidity effect depends on whether the FCS would require a higher ratio of collateral value to money advanced than does the Federal Reserve as lender of last resort.

Rechartering the FCS—advantages and disadvantages for rural borrowers and communities. Rural borrowers and their communities could expect to benefit from broader access to FCS funds in several ways. Since these funds are subsidized,¹⁰ to the extent they are used, lenders, borrowers, and their communities would share a transfer from the general tax paying public. Uniform lender access to FCS funds could improve retail competition for longer term loans, especially in rural areas where few lenders currently use FHLB advances or other sources of longer term funds. Such access could improve integration of isolated rural markets with national money markets, increasing overall efficiency in market-based capital allocation. However, since many banks will neither choose to join nor take out FCS advances, and some that do will be in markets with little competitive pressure, the level and distribution of any benefits will vary from community to community.

Another potential advantage would stem from increasing competitive pressure on FCS associations. Available evidence indicates large inefficiencies compared with commercial banks—an observation consistent with lack of competitive pressure on some FCS associations (Collender, 1991). In addition, high profits and large capital reserves at many FCS institutions indicate that they retain many benefits of GSE status. This proposal would increase competitive pressures on FCS associations without completely eliminating their cost advantage, potentially channeling a greater share of benefits to borrowers and their communities.

¹⁰ As discussed above, subsidies on FCS loans arise from the tax advantages of FCS institutions and their ability to raise funds at interest rates that do not fully reflect the riskiness of FCS operations in aggregate or of individual FCS institutions.

Rural borrowers and communities face some disadvantages as well. Subsidies, including credit subsidies embodied in GSE lending, get bid into asset values, providing a windfall for owners of assets at the time subsidies are instituted and raising costs for later owners. Subsidized credit can also encourage borrowers to take on too much debt, increasing their risk of financial distress during times of low or variable income. Rural savers may face reduced demand for their deposits, since advances substitute for raising more deposits to fund profitable lending opportunities. Reduced demand could mean marginally lower local rates on savings at commercial banks.

Rechartering the FCS—advantages and disadvantages for the Federal Government. As with expanding FCS authorities, rechartering the FCS may reduce rural credit market imperfections and enhance rural growth for the reasons cited above. However, the level and distribution of any benefits will vary from community to community, depending on competitive conditions and the practices or initiative of local lenders.

As with expanded FCS authorities, the major disadvantages to the Federal Government include increased contingent liabilities of the U.S. Treasury to cover GSE defaults and reduced revenue from the shifting of business from fully taxable to tax-privileged institutions. Although current law clearly states that no Federal guarantee exists on FCS liabilities, it may be politically difficult for Congress or the Administration to allow a GSE to default. FHLB advances to banks with headquarters in rural areas have grown from roughly \$5 billion at year-end 1994 to roughly \$15 billion at September 30, 1996. Advances from the FCS could total several billion dollars within a few years of rechartering, raising concerns about the potential for rapidly increasing Federal contingent liabilities. Concern about these contingent liabilities is exacerbated by the ability under this proposal of commercial banks to flee the FCS in difficult times.

Since FCS advances would be tax-advantaged, the Federal Government is also concerned that they be used for the purposes intended. For example, bankers could use FCS advances to purchase securities rather than to make additional loans. There is also no assurance that high-priority populations or

areas would benefit. And credit subsidies embodied in GSE lending can themselves cause market distortions.

The Federal Deposit Insurance Corporation (FDIC) has expressed concern about the impact of FHLB advances on bank safety and soundness. Access to advances allows institutions to increase leverage, can enable rapid, unsafe growth in securities portfolios or loans without the constraints imposed on brokered deposits; can prolong the life of a failing bank; and can impose other costs on the FDIC as insurer, supervisor, and liquidator of failed federally insured financial institutions (FDIC, 1995). Such concerns would also apply to FCS advances.

Rechartering the FCS—safety and soundness consequences for the FCS. The FCS has successfully recovered from the farm financial crisis of the mid-1980's. Legislative and voluntary reforms to its safety and soundness—including establishment of the Farm Credit System Insurance Corporation, reform of FCA, establishment of the Contractual Interbank Performance Agreement, and establishment of the Market Access Agreement—have been largely effective. The FCS is currently well capitalized and its insurance fund is currently projected to reach the target “secure-base” amount by early 1998. FCS banks have also entered into two voluntary agreements that give them strong economic incentives to maintain high financial standards (Collender and Erickson, 1996).

Converting the FCS to an FHLB System structure raises questions about Farm Credit Insurance Fund (FCIF) coverage and premiums. Using a current financial scenario, the fund is now 87 percent funded. If insured liabilities are increased primarily because of advances to commercial banks, FCS institutions could end up paying to insure liabilities incurred for their competitors.

Competitive pressure could eventually cause financial distress for some FCS associations, while stronger FCS associations would be more likely to seek the greater freedom associated with commercial bank charters and remove assets and capital from the FCS. Congress has set a precedent by passing special legislation allowing the former California Livestock Production Credit Association to retain capital it may otherwise have had to forfeit to the

Insurance Fund upon conversion of its charter. Other methods exist for associations interested in charter conversion to circumvent this forfeiture. Thus, charter conversions envisioned in this proposal could, in a time of widespread distress, allow healthy institutions to remove capital and assets from the FCS, slowing replenishment of the FCIF, weakening joint and several liability, and increasing the contingent liability of the Federal Government.

The voluntary status of commercial bank membership could exacerbate this problem. Again, in times of financial distress, commercial banks could redeem their stock and abandon the FCS and its difficulties to associations whose stock cannot be so easily redeemed. These concerns could be mitigated if stock were not redeemable at par, but tradable on a secondary market as is the case with publicly held corporations.

Finally, commercial banks seeking advances may put up the weakest possible collateral, and distressed or failing banks will be among the most anxious to take out advances. Such possibilities are well known within depository financial institutions, and mechanisms exist to reduce the likelihood of widespread losses. However, in contrast to current FCA regulations, this proposal would remove FCA access to examination reports from commercial banks receiving advances. Some compensating mechanisms will be needed to maintain the current level of safety associated with advances. The FHLB's solve this problem through collateral requirements, securing legal rights to collateral when borrowing members appear to be financially weak, and the existence of a priority lien should the FDIC close a member institution with outstanding advances.

Expanding FCS authority to buy whole loans—advantages and disadvantages for the FCS.

Allowing FCS associations to buy FCS-eligible loans from other lenders would have negligible effects on FCS institutions. FCS associations can already participate in loans with commercial banks. FCS and FCA personnel have sufficient knowledge and experience with eligible loans that they could be expected to accurately evaluate the risks and value of any given transaction. The history of FCS/commercial bank cooperation leaves little reason to believe such authority would be actively used by many commer-

cial banks. To the extent that commercial banks choose to offer loans for sale, FCS associations would retain the right and the responsibility to independently evaluate loan quality, and would have the option but not the obligation to purchase any loan offered.

Allowing FCS associations to buy whole loans currently ineligible for FCS direct lending presents other advantages and disadvantages. Buying such loans would allow FCS associations to diversify their loan portfolios while affording sellers the opportunity to use a new funding source that is not competing in the particular retail submarket. However, evaluating the risk and value of such transactions may initially be difficult for FCS and FCA personnel.

Allowing FCS institutions to sell whole loans to outside entities could be an important tool for managing portfolio risks. Many FCS institutions have poorly diversified loan portfolios. Such portfolios require larger amounts of risk-bearing capital than do efficiently diversified portfolios. Holding large amounts of capital, as many FCS institutions currently do, raises costs for borrower/owners.

Expanding FCS authority to buy whole loans—advantages and disadvantages for commercial banks.

In contrast to rechartering the FCS to mirror the FHLB System, expanded authority to buy whole loans would leave the choice to make a particular transaction to the discretion of individual FCS institutions. Thus, the impact on bank liquidity would vary across regions and over time. Although the American Bankers Association (ABA) reported in the early 1980's that banks selling participations to FCS associations were at least as happy with those transactions as banks were with correspondent banks, many banks have been reluctant to share information on customers with a direct retail competitor (ABA, 1983). These concerns would be less problematic if the loans being traded were not FCS-eligible. Allowing the FCS to buy whole loans collateralized by farm real estate would allow the FCS to compete directly with Farmer Mac, potentially bringing the benefits of competition for these loans to commercial banks and other originators.

Expanding FCS authority to buy whole loans—advantages and disadvantages for rural borrowers and communities. It is unlikely that rural borrowers

or communities would gain much from allowing FCS associations to buy FCS-eligible loans. FCS institutions are not likely to voluntarily supply their competitors with a new competitive tool. Allowing FCS associations to buy FCS-ineligible loans could lower the cost of funding such loans and stimulate new loan activity. If more loans were made available or loan prices were reduced, rural borrowers and their communities would benefit. However, since this proposal would not be sufficient to entice new entrants into most markets, it is unlikely that many benefits would accrue to borrowers rather than lenders. To the extent that any increased lending financed the local purchase of goods and services that would not otherwise have been made, rural communities could benefit.

Expanding FCS authority to buy whole loans—advantages and disadvantages for the Federal Government. It is unlikely that this proposal would effectively address rural credit market imperfections. Borrowers would still face the same set of competitors, and little additional activity is likely to be generated unless authority is granted for the FCS to deal in loans in areas it cannot lend to directly. To the extent that such an initiative might be successful, results will vary greatly from community to community depending on local conditions and institutions.

Again, the major disadvantages to the Federal Government include the possibility of increased contingent liabilities of the U.S. Treasury to cover GSE defaults and reduced revenue from shifting business from fully taxable to tax-privileged institutions. Allowing FCS institutions to buy whole loans for currently ineligible purposes could broaden GSE funding (and accompanying contingent liabilities) to new areas of the rural economy.

Expanding FCS authority to buy whole loans—safety and soundness consequences for the FCS. Adopting this kind of expansion in FCS authority would probably not generate substantial safety and soundness concerns. While evaluation of the risk and value for new areas of lending may be unfamiliar, safeguards are in place to prevent excessive risk-taking by FCS institutions. It is also unlikely that this type of authority would weaken FCS viability. If FCS institutions are able to buy or sell whole loans to achieve

better diversified portfolios, FCS safety and soundness could be improved.

Conclusion

Proposals to expand and modernize the FCS favor FCS institutions, generally to the disadvantage of commercial banks, while proposals to expand access to FCS wholesale funds through mechanisms similar to those of the FHLB's favor banks, generally to the disadvantage of the FCS. Both sets of proposals primarily aim to help particular lenders take advantage of opportunities, largely in niche markets, rather than solve clearly defined credit market problems. That is, proposed changes complement or enhance the competitive advantages of particular lenders without plausibly addressing the intensity of rural financial market competition or other market imperfections.

Review of the available evidence suggests that, on the whole, rural financial markets are reasonably efficient at allocating financial resources among competing uses. Problems exist, particularly for financial products not available from regulated financial institutions (e.g., equity financing and credit for high-risk ventures) and in noncompetitive local markets. However, with the exception of the proposal to allow the FCS to invest in rural development authorities, the proposals discussed here fail to address financial market shortcomings.

Rural borrowers and communities could benefit from expanded FCS lending activity or from rural bank access to FCS funds, since both initiatives increase the availability of subsidized credit. To the extent that Federal subsidies are passed on to borrowers, loan costs could decline and, with expanded lending authority, the FCS could add one additional competitor to the local markets FCS lenders choose to serve. However, rural communities as a whole would probably not experience improved credit market performance, nor would many benefits be likely to accrue to currently underserved populations.

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