

STATEMENT ON  
NET WORTH CERTIFICATES FOR  
AGRICULTURAL BANKS

PRESENTED TO THE

UNITED STATES SENATE  
COMMITTEE ON BANKING, HOUSING AND  
URBAN AFFAIRS  
SUBCOMMITTEE ON FINANCIAL  
INSTITUTIONS AND CONSUMER AFFAIRS

BY

MARGARET L. EGGINTON  
DEPUTY TO THE CHAIRMAN  
FEDERAL DEPOSIT INSURANCE CORPORATION  
WASHINGTON, D.C.

9:30 a.m.  
Friday, April 26, 1985  
Dirksen Senate Office Building, Room SD-538

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to express the FDIC's views on the use of net worth certificates to augment capital in agricultural banks.

The FDIC is acutely aware of the problems in the agricultural sector, particularly the circumstances facing banks. Many of the approximately 9,000 banks under the FDIC's direct supervisory jurisdiction are agricultural banks; they are for the most part located in the midwest and are under \$100 million in size. Through its supervision of these banks over the years, the FDIC has built substantial examiner expertise in evaluating agricultural loans and has become highly knowledgeable about the challenges posed to agricultural banks during both good and bad times.

The FDIC has been making a special effort to assist states with acute agricultural problems. For example, we have provided technical assistance and personnel to Iowa and Nebraska in handling failed financial institutions that were not covered by federal deposit insurance. We also have expedited the processing of applications for deposit insurance for new banks and existing non-insured banks from those states so that adequate banking facilities could be afforded smaller communities.

Because of our longstanding and intimate familiarity with small rural banks, the FDIC is sympathetic to the current distress of many farm bankers. Nevertheless, the FDIC has in no way caused or contributed to the problems and, by itself, can do little to cure them. Our policy is to evaluate realistically and fairly the condition of farm banks and farm credits. We will continue that policy. We will also participate in initiatives to aid in the recovery of the agricultural sector consistent with our mission of ensuring the safety and soundness of the banking system.

Among the proposals to help alleviate the agricultural situation is a net worth certificate program for agricultural banks like the existing net worth assistance program for thrifts. The FDIC firmly opposes such a program for commercial banks with agricultural loan problems. It would do nothing to solve the problems and would, in fact, be harmful to the FDIC, the banking industry and the communities involved.

Proponents of net worth certificates for agricultural banks apparently have little understanding of the financial dynamics of an FDIC-assisted bank failure. While every bank failure involves at least some degree of pain for the people directly affected, the financial assistance rendered by the FDIC in connection with most failures is very substantial and has a positive effect on the failed bank's community.

Let me explain, using a typical \$50 million bank failure to illustrate. Normally, the bank closing takes place at the end of the day on Friday. The FDIC buys all of the failed bank's troubled loans at book value for cash. The amount in a bank of this size would be in the range of \$20 million or more. The "clean" failed bank is then sold to a healthy bank through a competitive bidding process, and the new bank opens at normal hours on Monday morning.

In this typical case, no depositor loses a penny of principal or interest or suffers the slightest delay or inconvenience in obtaining funds. Just as important, the community has been given a new, healthy bank. It is a well-capitalized, well-managed bank with no problem loans and \$20 million or more in FDIC cash that it can put to work in the community. Last year alone, the FDIC injected over \$1½ billion into small communities throughout the country in this fashion.

A net worth program would have no positive effect on either the troubled bank or its community. I.O.U.'s would be exchanged between the bank and the FDIC which would augment the bank's capital on paper; the bank would receive no financial help. The community would be left with a crippled institution with depleted real capital and a large portfolio of bad loans to try to collect. More often than not, the management of the bank would be weak and ineffective. The bank would not be in a position to extend new loans and, in fact, would likely be forced by its financial circumstances to be more aggressive than the FDIC in trying to collect on the problem credits in its portfolio.

The only circumstances in which a net worth certificate program for agricultural banks would make any sense at all, in our judgment, would be if there were so many bank failures occurring that the FDIC could not arrange orderly takeovers by sound banks. Then it would be appropriate to use net worth assistance on a temporary basis until takeovers could be accomplished. Under the Garn-St Germain Act the FDIC has the necessary authority to implement such a program, and we have contingency plans to do so should the need ever arise.

Some people try to justify a net worth certificate program for agricultural banks on the ground that thrifts were given such a program in 1982. However, there are significant differences between the thrift situation and agricultural banks that make the thrift program less objectionable.

1. The problem is different. The thrift problem resulted primarily from loans of fundamentally sound credit quality whose value was significantly diminished by a sharp increase in interest rates. For the most part, there was little question

about the borrowers' continued ability to repay, but the loans carried low, fixed interest rates when the lending institutions needed to pay much higher rates for their funds. Thus, thrift operating losses resulted not from an inability to collect principal but from an excess of day-to-day operating expenses over day-to-day income. As the principal of these low-yielding loans is repaid, the institutions are able to reinvest the funds at higher yields. This, combined with the general reduction in interest rates that has occurred, makes it reasonable to expect that many lenders with low-yielding real estate loans will return to profitability. Net worth certificates authorized by the 1982 Garn-St Germain law allow those institutions to operate until that happens.

For commercial banks strapped with problem agricultural credits, however, there is no reasonable expectation that the mere passage of time will correct the situation. While loans for current operating costs might be able to be repaid from crop proceeds, many farmers would still have insufficient cash flow to reduce the large overhang of debt accumulated for land and equipment purchases. Equipment continues to depreciate, and it is unlikely -- without significant new inflation -- that the value of the more expensive land will return to a level sufficient to cover acquisition loans.

2. Shareholder bailout is inappropriate and counterproductive. Unlike the thrifts assisted under the current net worth certificate program, agricultural banks are stockholder owned, and a net worth certificate program would represent an unwarranted and undesirable lifeline for stock investors who are and ought to be at risk. If a bank's capital were depleted by loan losses and the bank received FDIC net worth assistance, the result would be to allow an insolvent bank to remain in operation instead of forcing the shareholders to invest new capital. Moreover, our supervisory efforts to help rehabilitate troubled banks would be seriously impeded. Typically, among the corrective measures a troubled bank is called upon by its supervisor to take is to raise additional capital. With net worth assistance available from the FDIC, bank shareholders would have a strong incentive to resist such needed corrective action.

3. Cost. The present net worth certificate law for thrifts provides that assistance cannot be given if it would be more costly than liquidating the bank. Because the thrifts' problem is not one of credit quality, as their low-yielding loans mature and the funds are redeployed at market rates, the institutions' prospects improve, and the FDIC's exposure declines correspondingly. This assumes, of course, that management avoids imprudent behavior, which we closely monitor. In contrast, keeping an insolvent commercial bank open provides the occasion for management to make additional poor quality

loans or to mismanage existing problem credits, further diminishing the overall quality in the loan portfolio. That means that when the bank eventually failed, the potential exposure to depositors, creditors and the FDIC would be greater. In other words, net worth assistance would delay failure, not prevent it, and during the delay losses would almost certainly increase the costs to the FDIC and others. Moreover, it would be highly undesirable for federal assistance to be used to preserve existing bank management who, whether through misfeasance or simple ineptness, were responsible for a bank's plight.

With the comparatively large number of problem banks, the FDIC is uniquely sensitive to the problems in the agricultural sector as they affect our nation's banking system. For the reasons I have outlined, however, the FDIC strongly opposes a net worth certificate program for agricultural banks. It would do nothing to solve the problems of agricultural banks, would escalate FDIC losses, and would weaken the banking industry; perhaps most importantly, it would deprive our agricultural communities of the services offered by strong, well-managed banks with substantial amounts of loanable funds supplied by the FDIC.

Mr. Chairman, while there are problems among agricultural banks, there is clearly no crisis. Agricultural banks for the most part are strongly capitalized, profitable and well-managed institutions. Out of 4,100 agricultural banks, based on year-end '84 data, only 52 had capital-to-assets ratios of less than 5% and only 14 had less than 3%; only a comparative handful are in danger of failing. If a crisis should develop, the FDIC, thanks to the Garn-St Germain Act, has the tools it needs to respond. We will not hesitate to use those tools if conditions should ever warrant.

In sum, the proposed legislation is not needed and, if enacted, could only have a deleterious effect.

\* \* \* \* \*