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Statement by

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of the Federal Reserve System

before the

Senate Committee on Banking, Housing and Urban Affairs

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I am pleased to appear before this Committee today to review the problems being experienced by banks in our agricultural communities and to discuss various proposals that have been advanced to ease the strains resulting from these problems. As you know Mr. Chairman, Chairman Volcker recently sent you a letter that presented the Federal Reserve Board's views on these matters and in conjunction with that letter a rather extensive study by our staff of farm credit conditions and their impact on farm banks was forwarded to the staff of your Committee. Accordingly, I intend to structure my remarks this morning to highlight the main points made in those documents.

The problems currently afflicting the agricultural sector of our economy are more serious than any encountered since the Great Depression of the 1930's. Farm incomes and farm asset values have declined sharply over the current decade as crop prices -- responding to a major increase in world supplies of farm products relative to demand -- have dropped substantially from boom-time levels of the late 1970's. All of our farmers have been adversely affected by these developments but not to the same degree. Farmers that are relatively debt-free generally continue to have strong financial positions although significantly less so than a few years back. In contrast, farmers who entered the 1980's substantially in debt have experienced an erosion in their financial health that generally is the more serious the greater the degree of their leveraging.

Our staff estimates suggest that perhaps a third of the full-time producers on commercial-sized family farms are experiencing moderate to severe financial stress. This group owes about one-half of the farm debt of all such operators. The problems of these farmers, of course, have been compounded by the relatively high interest rates that have prevailed over the current decade. In addition, their efforts to restructure debt, or to reduce it by selling some of their assets, have been hampered greatly by the decline in farm asset values.

The great proportion of farm debt is owed to the Farm Credit System, the Farmers Home Administration and individuals. But about one-quarter of the total is provided by commercial banks, and the banks that have concentrations of such loans have been experiencing increasing strains in recent years. For example, loans delinquent 30 days or more at agricultural banks amounted to 7 1/4 percent of total loans at the end of last year, up from 6 1/4 percent a year earlier. This increase took place even as these banks charged off more than 2 percent of their total loans over 1985. These loan losses and the need to add to loan loss reserves because of the increasing volume of poor performing and nonperforming loans have substantially reduced the earnings of many farm banks. Indeed, in all too many cases earnings have turned negative and capital has been eroded, sometimes substantially so. The result has been that an increasing number of farm banks have failed (68 last year) and the number of seriously troubled banks has risen substantially.

It is important to keep the present situation in proper perspective, however. Over 95 percent of the total loans at all agricultural banks are performing, and one-half of these banks reported earnings equal to at least 10 percent of their equity. Also agricultural banks generally have a substantial capital cushion to absorb loan losses. The capital asset ratio for all agricultural banks averaged 9 3/4 percent in September of last year, higher than it was at the start of the decade and well above the 7 1/2 percent ratio for the entire banking system.

There are a number of recent developments that should work to assist the farm economy, including the recent dramatic fall in energy prices and the substantial declines in interest rates and in the exchange value of the dollar that have occurred over the past year or so. The recently enacted farm bill also offers an additional source of support for farm incomes. At the same time, however, prospective supply conditions for farm products both at home and internationally, suggest that a substantial rebound in crop prices, and thus in farm incomes, is not likely to take place over the foreseeable future. Certainly it would appear unwise to base public policy on the assumption such a rebound will take place. Accordingly, while farmers that are now financially healthy should be able to avoid serious problems and many borderline farm operators may be able to work out of their current difficulties, many other farmers with relatively heavy debt loads face a continuation of serious difficulties. That means, of course, that a sizable number of farm banks will also continue to experience severe strains.

Mr. Chairman, it is altogether understandable, that the Congress is seeking to identify approaches by which appropriate assistance can be provided to troubled farm banks to aid them and their farmer customers to get through this period. As I indicated at the beginning of my remarks, the Board, at the request of the Congress, has reviewed a number of proposals that are under consideration by Congress to accomplish this goal. In my remaining time I will summarize the Board's assessment of these proposals and review certain supervisory policies the Board intends to employ to provide assistance to basically sound, well-managed farm banks.

Debt Restructuring

One approach that can be taken to deal with the present debt problems of farm banks and their farmer customers is to restructure that debt. Traditionally, when borrowers have been unable to meet their debt service obligations but appeared to have a reasonably good prospect of eventually repaying a loan, lenders have been willing to practice forbearance by changing the terms of loan agreements to make them more compatible with the altered economic circumstances of the borrower. In addition, in some cases, lenders have extended additional credit to troubled borrowers when it appeared that that might significantly improve their prospects of ultimately returning to economic health and repaying all their indebtedness.

In considering voluntarily arranged loan restructurings, the treatment of such restructurings by Generally Accepted Accounting Principles deserves special emphasis. In particular, Financial Accounting Standards No. 15 specifies that in cases in which the total of cash receipts that can reasonably be expected to be received under the terms of a restructured loan are at least equal to the original principal value of the loan, a lender need not change the value of the loan shown on its books.

Given the seriousness of the exiting problems in the agricultural sector, the Federal Reserve believes that regulatory policies followed by examiners in classifying loans should give full consideration to GAAP accounting procedures.

In addition to debt restructurings that are undertaken voluntarily by both lender and borrower without governmental assistance, there are, of course, a number of proposals for restructuring the terms of farm debt that would involve the government in a decidedly more active way. Some have proposed that a moratorium be imposed on loan foreclosures (by either the Federal or state governments). This amounts to a kind of forced restructuring of debt because over the moratorium period farmers would retain title to and use of their land while being relieved of the drain that interest and principal payments place on cash flow. Such a restructuring would clearly assist farm borrowers, at least in the short-run. But such help would come at the expense of farm lenders and could prove particularly detrimental to the financial health of already weakened farm lenders. The imposition of such arrangements, moreover, would cast a long shadow over future credit extensions.

Other proposals for government assisted debt restructuring arrangements would induce voluntary participation by both borrowers and lenders through the provision of government subsidies or guarantees. Such governmental arrangements -- as for example those offered by the Farmers Home Administration -- have the quality of generally assisting both farmers and farm banks. At the same time, such assistance does not come free; its provision would add to government costs either immediately or in the future and thus present yet another obstacle to achieving a much required reduction of the Federal deficit.

Net Worth Certificates and Loan Loss Write-Off Deferrals

Other proposals under consideration by the Congress -- the stretch-out of loan loss write-offs and issuance of net worth certificates -- would not result in an immediate expenditure of public funds, although both likely would add to the FDIC's costs over the longer run. Both these devices would boost regulatory capital without injecting real capital the basic objective being to buy time to enable a bank to restore its real capital. This end would be accomplished with the net worth certificate approach through an exchange of promissory notes between the troubled bank and the FDIC (or possibly its primary regulator) and with the loan loss deferral approach by permitting a write-off of loan losses over an extended period of time.

One important difference between the two approaches, as they have generally been proposed, is that loan loss stretch outs would be available to all banks meeting specified qualifications while net worth certificates could be issued to selected institutions on a more discretionary basis. While in theory a loan loss deferral program could be structured to provide more targeted assistance, in practice this might be difficult.

In its letter to this Committee, the Board expressed strong reservations about the use of either net worth certificates or loan loss stretchouts. In particular, the Board noted that they raise the question of whether regulatory accounting practices should differ significantly from Generally Accepted Accounting Principles. Since under these proposals regulatory accounting statements would show levels of capital that substantially exceeded that reported on financial statements prepared under GAAP, this would tend to cause public confusion and impair the usefulness and credibility of regulatory financial statements.

In addition, the Board noted that such techniques do not address a bank's fundamental financial situation. While they buy time for a bank to improve its condition, they do not in themselves provide a direct means for achieving that end. Consequently, in the Board's view, these approaches are likely to be largely ineffective for most seriously troubled institutions whose real capital has been wiped out or greatly depleted by loan losses and whose earnings prospects are poor. In these cases the Board believes it would be far better to seek a permanent solution to the bank's problem by having it obtain new capital or, if its problems are too severe, by merging it with a stronger institution.

There are, of course, less extreme situations in which a bank has suffered set-backs but retains a sizable amount of capital -- although considerably less than normally maintained or perhaps even less than required to meet minimum regulatory standards -- and has reasonably good prospects for recovery over time. In these situations, however, a more straight-forward way of buying time for institutions would be simply for supervisors to permit them to operate for some interval with capital at levels below supervisory standards. The Federal Reserve already follows this capital forbearance approach in applying its capital guidelines. We recognize that an important function of capital is to absorb unexpected losses, and that a bank that has recently utilized its capital for this purpose may not be in a position to replenish its capital resources immediately, although its long-run prospects may be quite favorable.

One problem that does arise when a bank's capital is temporarily depleted is that its single borrower loan limit is reduced commensurately because this limit is based on a percentage of capital (15 percent in the case of national banks). Thus, although a loan may have been within the single borrower limit at inception, a reduction in capital that results from loan losses will lower the bank's loan limit, thereby precluding the restructuring of loans that are above the reduced single borrower limit. This would occur even though the absolute amount of the loan would not be increased. It is our view that if this problem could be dealt with and if the agencies would agree to utilize the provisions of existing generally accepted accounting standards as set out in FASB #15, it would not be necessary nor would there be any advantage to issuing net worth certificates or endorsing the deferral of loan losses.

Mr. Chairman, in your letter to Chairman Volcker you also asked for comment on the March 6 testimony of Charles Sethness, Assistant Secretary of the Treasury, and that of the ABA and IBAA. First, regarding Mr. Sethness's testimony, I believe it clear from my remarks that his views on the various proposals for assisting farm banks reviewed here today parallel those of the Board. On the other hand, the ABA and IBAA have endorsed the stretching out of loan losses over a number of years. The Board, as I reviewed earlier, has reservations regarding this approach, for the reasons I stated.

To sum up, it is clear that a substantial number of farm families and farm banks are experiencing difficulty of greater or lesser degree at the present time. In light of this situation, the Board believes that the Congress and the banking agencies should take actions that will provide assistance to the agricultural sector while, at the same time, not undercutting effective and appropriate supervision of and accounting for the activities of farm banks. In particular, the Congress and state legislators could make a much needed contribution by helping to maintain the provision of banking services to small communities. The Garn-St Germain Act of 1982 presently prohibits acquisitions of troubled banks across state lines before they have failed and acquisitions of failed banks with assets under $500 million. The banking agencies believe that these two constraints should be eased by allowing failing bank acquisitions across state lines and by reducing the size criterion so as to maintain the banking services in farm communities. An easing of state restrictions on branchings could also help maintain banking services in small towns in cases when a separately organized and capitalized bank might not be viable.

There are also important things that can and should be done by the banking regulators in these difficult times.

1. Reaffirm the policy of not discouraging banks from exercising forbearance on farm loans that are being restructured when there is a reasonable prospect that this will work to the mutual benefit of the bank as well as the borrower.

2. Consistent with this general policy on forbearance the agencies should be forthcoming in applying the principles of FASB #15. That is, the agencies should not require that a loss be recognized on a farm loan unless the anticipated cash receipts of the restructured debt are insufficient to cover the principal amount of the loan.

3. Also, in keeping with the spirit of that approach the agencies should modify regulatory reporting requirements so that loans appropriately restructured, no longer need be classified as nonperforming loans.

4. The single borrower limit should be changed or interpreted to prevent restructured loans from being held in violation of the limit based solely on the temporary decline in the bank's capital.

5. The agencies should offer a clear statement of their intention to employ a simple policy of capital forbearance.