

# Federal Land Bank in Mississippi victim of 'creative accounting'

by Sue Atkinson and Joyce Fredman

On May 20, 1988, the Farm Credit Administration closed down the Federal Land Bank of Jackson, Mississippi and appointed a receiver to manage the \$2 billion institution until its assets are liquidated. The first Federal Land Bank ever to be closed down, it provides loans to almost 22,000 farmers in Mississippi, Louisiana, and Alabama. The Jackson bank had reported a \$44.3 million loss for last year, and has been losing \$4.7 million per month since January of this year.

It took squads of bank examiners and liquidators to deal with the closing, the largest bank action ever. With assistance from the Federal Deposit Insurance Corporation, 360 regulators were dispatched to the bank and its 90 branches. They are now in the process of finding other arrangements for the provision of credit to the farmer-borrowers from the three-state area.

This grim incident reflects the insolvent condition of the Farm Credit System overall, of which the Jackson bank is a part. The Farm Credit System accounts for one-third of all United States agriculture debt—approximately \$60 billion of a \$180-200 billion total. The structure of farm debt in the United States is now disintegrating at such a rate as to threaten the U.S. food supply.

## Federal Land Banks

The Federal Land Banks (FLB) were conceived as a credit vehicle for farmers who had difficulty obtaining liquidity for their production needs. The system was set up in 1917 and there are 12 such banks in the country—now 11, plus one liquidation. The banks do not take deposits, their sole function being to lend to farmers. Most of their money comes from selling securities on the bond market. For example, one week after the liquidation of the Jackson bank, the government announced that among the agency issues would be a Federal Farm Credit Bank three-part bond sale totaling \$3.02 billion. An \$828 million issue due Sept. 1 yields 7.25%, while a \$1.4 billion issue due Dec. 1 yields 7.625%. The \$791 million of bonds due June 1, 1989, will have a yield of 7.90%.

As the name implies, Land Bank loans are often, although not always, collateralized by land, as opposed to production loans, collateralized by crops. What is mandated is that when a farmer borrows, he must buy stock in the bank, known as

"B" stock, representing 5% of the loan, which is pledged as collateral. Should such stock drop to less than 25% of its face value, it is required that the bank seek assistance from the Farm Credit Assistance Board (FCAB).

The system seemed to function, and by 1968, farmers were able to pay off everything they had borrowed. But with the advent of Paul Volcker and high interest rates, all that changed. As the farm crisis of the 1980s deepened, the federal policy was to either ignore the problem, or paper over the difficulty without addressing the underlying cause.

The 1987 Agricultural Credit Act is exemplary. This allowed the Treasury to open credit lines to such institutions on favorable terms. But farmers kept going under. It was not nearly enough. At the beginning of 1988, through this vehicle, the Federal Land Bank of Jackson received \$30 million in short-term funding, a drop in the bucket considering their \$1.9 billion in liabilities and \$646 million in bad loans.

Out of the 11 remaining Federal Land Banks, over half are estimated to be in a condition similar to the Jackson bank. The FCAB has just announced an infusion of \$90 million into the Federal Land Bank of Louisville, Kentucky, and has received a request for \$128 million to assist the Federal Land Bank of St. Paul, Minnesota, the largest agricultural lender in the United States.

## FCS 'creative accounting'

The situation is indicative of how the Farm Credit System has dealt with the farm crisis. Rather than acting to provide farmers with credit, top FCS officials have resorted to "creative accounting" tactics to make their banks appear solvent. It was announced on May 3 that the FCS nationwide had a combined profit of \$165 million in the first quarter, due entirely to a \$160 million reduction in the loan-loss reserve and a \$10 million net gain on other property owned. The system's net interest income of \$146 million—the difference between interest income and interest expense—fell \$5 million short of its other expenses of \$151 million.

Alan D. Fass, president and chief executive of the Federal Farm Credit Banks Funding Corp., used doublespeak when he reported recently, "The improvement in the agricultural economy experienced in the latter half of 1987 continued into the first quarter of 1988. The Farm Credit System has been

able to reduce its loan-loss reserves because borrowers are considered better able to repay their loans.”

The farm economy looks good only to people who think a Potemkin Village is real. One of the factors contributing to this illusion is the fact that liabilities have been reduced by loan restructuring and write-offs. Another factor is that farmers' expenses have been reduced due to participation in government programs. Under the land set-aside requirements, you don't pay for seed, fertilizer, pesticides, gas, and equipment—because you don't plant. When both liabilities and expenses are lower, a balance sheet appears very much improved. Unfortunately, the improvement was not achieved through increased cash flow—which would have indicated an improved farm economy.

The FCS system officially considers its borrowers better able to repay their loans because the loan analysis is being done differently. In order to redistribute all of the reserves in the system through losses, each loan analysis done used two years' interest expenses and two years' depreciation expenses, as well as a 100% collateral requirement. As reported in *EIR* (Nov. 5, 1987), the FCS at that time decided to change its loan analysis in order to make its loan portfolio appear improved. We are now seeing the results of that hocus pocus.

The obvious question here is: Why are these now excess funds in the reserve for losses such that \$160 million can be removed? In the first place, the losses being reported were made up of both actual losses and expected losses. The expected losses were being produced by the loan analysis form using two years' interest expense and two years' depreciation expense. (That form was in temporary use for just under two years, in order to redistribute the excess funds in the system.)

According to the charter passed by Congress to establish the Farm Credit System (and later amended), the reserve for loan losses cannot have a balance equal to more than 3.5 percent of the outstanding loan volume. With the top-quality loans leaving the system and the bad ones being collected, the loan volume has fallen dramatically. This accounts for the excess funds in the reserve for loss account.

The next obvious question is: Why is the net interest income short of covering the other expenses by \$5 million? Because the system cannot charge a high enough rate to cover its expenses. It boasts that it is aggressively trying to recapture its share of the market. It is going to be offering a lower rate of interest to top-quality borrowers than banks can offer.

In April, the commercial bankers complained of this practice to Secretary of Agriculture Richard Lyng and members of Congress. Bankers were assured that no taxpayer money in the form of a Farm Credit System bailout would be used to subsidize interest rates. The FCS cannot long continue to subsidize its best rates with money from the reserve for loss account. It is a practice totally dependent on the creative accounting being employed.

Another problem facing the FCS is the restructured balances being held in the loan accounts; these are not accruing

interest, but are not being written off as losses. A decision must be made as to their disposition. They must be either collected from the borrowers or charged off against the reserve for losses. Depending on the amount of restructuring done by the system, there could be adverse effects in the future on either the borrowers or the financial condition of the system itself.

### **Who is lender of last resort?**

The Farm Credit System finances its lending by issuing short- and intermediate-term bonds. The rates of these bonds are usually slightly above those issued by the U.S. Treasury. Prior to the 1987 bailout by the government, the Farm Credit bonds were never officially backed by the government, but backing was always implied. This made them a very secure investment, so funding was not a problem.

As actual losses in parts of the system started mounting, the rates on the bonds started increasing. As projected losses mushroomed, investors started worrying about the government backing. System officials started pressuring Congress to back the bonds in order to assure their sale and lower interest rates to farmers in order to make the lending rates competitive and thereby keep the best borrowers. The approved bailout package contained a guarantee for the bonds, which started bringing down interest rates. However, now, even government backing may not be enough.

Another ineffective move by the government was to cut administrative costs at the FCS, supposedly to save money and preserve the system. A congressional directive was issued to merge banks within each district and then merge the 12 districts into 6. Each level of the system adds a spread to the bond rate in order to cover its expenses. In order to get the rate more competitive, some of the spreads had to be eliminated. This could not have been accomplished without a push by the government, because the by-laws state that the local boards of directors, as well as the stockholders, must approve all mergers. Normally, farmers will fight to maintain control of their local association, and will reject merging unless forced to.

The system has been in the process of reorganizing since 1984. Take the Eighth District, of Iowa, South Dakota, Nebraska, and Wyoming, as an example. In 1984, the Farm Credit Bank of Omaha began merging the staffs of the Federal Intermediate Credit Banks, the FLB, and the Bank of Coops. In 1985, the 40 Production Credit Associations and 33 FLBAs began merging their staffs into 15 regional service centers. They have reorganized twice since and are in the process of doing so again. Now they are organizing into one staff per state in preparation for the merger of two district banks. The stress on the staffs has been incredible. Many who have been in the system their entire careers have left. This has two effects. One is to reduce salary and benefit expenses. The other is to eliminate those who understand the manipulation taking place.