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STATEMENT ON

FARM BANK PROBLEMS AND POLICY OPTIONS

PRESENTED TO

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

BY

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Room SD-538, Dirksen Senate Office Building
March 11, 1986
9:30 a.m.

Mr. Chairman, I am pleased to have the opportunity to come before the Senate Banking Committee to discuss farm bank problems and policy options. The FDIC submitted a report entitled, "Farm Bank Problems and Related Policy Options" to the Senate Banking Committee on February 18. As requested, the report provided an assessment of current conditions and the outlook for agricultural producers and banks, as well as a discussion of related policy options. Today, I would like to briefly review the prospects for farm banks and provide a specific set of recommendations to assist troubled farm banks.

For many of the banks that support the farm sector it is becoming increasingly difficult to withstand the pressures created by the adverse developments in the agricultural sector during the past five years. There are close to 4,000 banks that have 25 percent or more of their loan portfolios in farm loans. This represents about 28 percent of all commercial banks. Most of these banks are located in the Midwest and Great Plains states, and are typically small, with total assets equal to only about four percent of all U.S. commercial bank assets. While there were only seven agricultural bank failures in 1982 and seven more in 1983, there were 25 farm bank failures in 1984 and an additional 62 agricultural bank failures this past year.

Current trends suggest that, at least for the next year, farm bank problems and failures are likely to continue at levels at least equal to those experienced during 1985. While profitability has been trending down for small banks in general, it has been falling more rapidly at agricultural banks. Net loan losses at agricultural banks nearly tripled over the past two years.

Presently, the FDIC's problem bank list includes 468 farm banks, about 40 percent of the total for commercial banks.

Despite this, there are a number of positive signs. The aggregate primary capital ratio for agricultural banks is about 10 percent, roughly equivalent to what it was two years ago, and well above that of other small banks. Moreover, most farm banks are performing well and only about one percent of all farm banks have a primary capital ratio below six percent.

A number of suggestions have been offered to ease the strain on agricultural banks. Net worth certificates, interest rate buydowns, loss deferral programs, and forbearance on regulatory capital standards are among the policy options that have been suggested. The FDIC is sympathetic to the motives behind these proposals. Most of the options are designed to buy time for participating institutions to resolve the problems created by a weak farm economy.

But one must keep in mind that the basic problem faced is one of the difficult conditions of the agricultural economy, not a banking problem. The banks may provide some short-term and limited aid, but only a return to prosperity for the farmer can bring a cure. We must exercise care that we do not create a banking system problem because of the difficulties in the agricultural or any other sector.

A carefully constructed program that enables farm banks to defer or be reimbursed for some portion of their losses could help reduce the number of farm

bank failures, increase credit available to farmers and limit further disruptions to farm communities. Farmers would benefit since banks would have a greater incentive and ability to exercise forbearance with their troubled borrowers. As the number of farm bank failures declined, there would be fewer instances where creditworthy borrowers would be forced to look for new lending institutions and fewer instances where local residents would be left without banking services. There also could be some positive effect on public confidence in the banking system.

A significant drawback, however, is that there are potentially large costs associated with loss deferral and similar programs designed to aid troubled banks. Some portion of these costs would be administrative, since a substantial number of banks may be candidates for assistance over the next two years. However, the greater concern relates to the ultimate costs of any relief program should economic conditions not improve sufficiently over the next several years to allow the marginal banks and borrowers sufficient opportunity to return to profitability. Relief programs may only delay failures and our experience suggests delay results in larger losses to the FDIC insurance fund.

There are also equity considerations. How does one justify giving special treatment to banks that have financial difficulties due to agricultural problems when other financial institutions are suffering from problems due to weaknesses in other areas. A longer-run issue concerns the precedent we would be setting. There may be an incentive for increased risk-taking if we assist banks that have difficulties as a result of lending to certain sectors of the economy.

Also, it may be difficult to maintain the credibility of our accounting and supervisory standards.

In this regard, I am pleased to point out that a part of the solution actually may be found with tools already available to banks under generally accepted accounting standards. GAAP provides for considerable flexibility with respect to loss recognition of restructured loans. The Statement of Financial Accounting Standards #15 for Accounting by Debtors and Creditors for Troubled Debt Restructurings provides for deferral, by allowing reduced value to be recognized through future interest payments. Let me illustrate: A three-year $1,000 12 percent loan is renegotiated as an $800 five-year 10 percent loan (total payment is 5 x 80 = $400 + $800 = $1200). No loss is reported and the $200 of payment over the original principal is reported as interest received over five years. Thus, this method facilitates restructuring loans. Principal payments can be made over an extended period and interest rates reduced. Loans can be repaid without requiring any immediate writeoffs. Income loss is recognized through reduced interest income. For loans that meet FASB standards, the impact on the lending bank is very similar to loss deferral. This option should be made available to all banks and, as indicated, its use conforms to generally accepted accounting standards. In the past this has not been the uniform practice of bank regulators, and especially the FDIC. I have instructed FDIC examiners, and urge that all Federal bank examiners be instructed, to accept the FASB #15 concept in classifying loans so long as they are comfortable with respect to the ultimate collectibility of such restructured loans.

Separately, we have been looking at the way we require renegotiated debt to be reported. This is an area that has been of concern to many agricultural bankers. We favor revising reporting requirements on such loans and setting up a separate reporting category, "Restructured and In Compliance With Modified Terms." This will require a unified approach by all bank regulators.

In certain situations, where the economic environment accounts for most of a bank's difficulties, some form of capital forbearance may be appropriate in addition to the effect of the application of FASB #15. Various approaches are possible. Loan loss deferral programs and the use of net worth certificates provide means of avoiding bank capital requirements by maintaining book capital. The same results can be accomplished simply by allowing a bank's capital to fall below minimum requirements without taking enforcement actions. Banks might be given longer than "usual" to restore capital. This form of forbearance is simpler than net worth certificates and loss deferral. It does not involve the administrative burden of net worth certificates or the accounting variance of loss deferral. However, as bank capital levels decline so will loan limits to single borrowers and, at some point, this could pose a problem. Simply put, each of the capital forbearance approaches have certain disadvantages that must be considered.

Perhaps the simplest approach would be to create an election for banks to charge loan losses to a special allowable capital account which would then be amortized over a period of time (perhaps five years). The special capital account would be similar to a bad debt reserve account but could be used as

capital only when necessary to create required capital levels or to provide needed single-borrower capital capacity. The combination of FASB #15 and, when appropriate, capital forbearance could provide considerable latitude to weakened farm banks that have a good chance of surviving. Such policies could also go far in continuing to provide financing to farm borrowers and limiting disruptions in the farm community.

Whatever policy options are eventually chosen by regulators or the Congress, it is likely that there will continue to be some failures among farm banks. Much of the disruption to farm communities that results from bank failures could be reduced if ways were found to ensure that a failed bank's customers continued to receive banking services. It is our intention to continue with efforts to reduce these disruptions by modifying our procedures with respect to the handling of bank failures. Whenever possible, the FDIC will attempt to find purchasers of failed banks, limiting the number of deposit payoffs. We will also pursue avenues which may enable us to pass a larger portion of a failed bank's assets on to an acquiring bank. It is our view that such efforts can limit many of the secondary effects of bank failures and can be accomplished at modest costs. I will be pursuing this matter with you in more detail when deposit insurance reform is the subject of the day.

We also believe that individual states in the farm sector should take a close look at their branching laws and their laws governing the disposal and valuation of real estate acquired by commercial banks. More liberalized branching laws would enable banks to achieve greater diversification which would help banks

avoid future difficulties due to weakness in a particular sector of the economy. More immediately, liberalized branching laws would help limit the disruptions to farm communities caused by bank failures by increasing the likelihood that a failure could be handled by merger rather than through a deposit payoff. Restrictive branching laws cost the FDIC's insurance fund money and perhaps additional premiums should be charged to compensate the fund and encourage changes in state laws.

Liberalizing the laws governing the disposal and valuation of real estate acquired by commercial banks may ease some transition costs by allowing banks to lease land back to farmers, rather than selling it and putting an additional downward pressure on land prices.

To summarize, the FDIC makes the following recommendations:

- Banks should be allowed to account for modifications of loan terms as reduced income. Thus, no loss will be recorded at the time of restructuring when such treatment is in accordance with the Statement of Financial Accounting Standards #15 for Accounting by Debtors and Creditors for Troubled Debt Restructurings.

- Banks should be allowed changed disclosure requirements for renegotiated loans, providing an accurate description of their status.

- Federal regulators should recognize the special nature of farm problems and that, in appropriate situations, some form of capital forbearance is desirable.

- The states should be encouraged to liberalize overly restrictive branching laws thereby increasing the likelihood that weak banks will be merged or otherwise acquired by healthier institutions.

- The states should be encouraged to examine the permissible period that banks may hold farm real estate to help preserve value and limit forced sales of such property into a weak market.

- For its part, the FDIC will continue to pursue policies that will minimize the disruption in the community and the cost to the insurance fund of bank failures.