FARM CREDIT ADMINISTRATION

Quarterly Report

Risk Analysis of Farm Credit System Operations

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Financial Performance of the Farm Credit System

FCS Commodity Concentrations and Related Management Strategies in the Farm Credit System

FCS Purposes and its GSE Charter, the National Bank Charter, and Financial Reform Reports

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Major Financial Indicators

Quarter Ending March 31, 1997

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PREFACE

The Risk Control Division (RCD) of the Office of Policy Development and Risk Control (OPDRC) publishes an analysis of the condition and performance of the Farm Credit System (FCS or System) each quarter. The analytical focus of these reports is the identification of risk, both from within the System and from the economic and policy areas.

This issue presents an analysis of the overall financial performance and condition of the System as of March 31, 1997, and two special reports. In addition, a review of corporate restructuring activity among System institutions during the six-month period from January 1, 1997, through July 1, 1997, and a summary of major financial indicators for the System are provided.

The report uses a variety of information sources, including quarterly Farm Credit Administration (FCA or Agency) Call Report data, System quarterly reports, U.S. Department of Agriculture (USDA) reports, and other Federal, State, and commercial information sources. Unless otherwise indicated, projections and analyses are those of Agency analysts and reflect their own analytical judgments.

The graphic and tabular material on financial performance reflects information from reports filed with the Agency by the close of business, June 1, 1997. Additional information on other agricultural lenders and financial markets is maintained by the RCD, OPDRC.

System institutions are required to make certain disclosures to stockholders, investors, and the general public. Disclosure to investors in Systemwide securities is made by the Federal Farm Credit Banks Funding Corporation (Funding Corporation) on behalf of the issuing banks and by individual System institutions in reports to their respective stockholders. The quarterly *Summary Report of Condition and Performance of the Farm Credit System,* published by the Funding Corporation, provides a detailed set of tables showing the financial results for the Farm Credit banks combined with their affiliated associations.

Questions regarding the content of this report may be directed to C. Edward Harshbarger, Division Director, RCD, or to John C. Moore, Jr., Senior Economist, RCD.

EXECUTIVE SUMMARY

This issue (1) describes a growing and strong FCS with a small increase in credit problems, (2) provides evidence of the credit concentration risks that arise because the FCS is, by law, a single sector lender, and (3) offers benchmark information for beginning to evaluate how risks in the FCS may be affected by pending financial restructuring legislation for the banking, brokerage, and insurance industries.

The FCS continued the pattern of stronger loan growth begun in 1995, reaching almost $62 billion in gross loans by March 31, 1997. Three of the four primary categories shared the increase; long-term real estate loans were up 2.7 percent (year over year), farm operating and intermediate-term loans were up 5.7 percent, and domestic loans to cooperatives were up 3.9 percent, while international loans to cooperatives were down 19.3 percent, mostly due to paydowns in loans to Mexico and Russia.

Capital strength also grew, to $10.8 billion, or 14.3 percent of assets. However, net income for the quarter was $303 million, off by 14 percent from the same quarter of 1996, for three primary reasons. Competition drove down net interest spreads earned by the FCS, personnel and operating costs increased, and additional provisions for losses were made to recognize increased credit risk in a few loans to processing and marketing cooperatives. These additional loss provisions reflected difficulties encountered as a result of volatile grain prices in 1996. Despite these specific credit problems, the credit quality in the overall loan portfolio was stable.

The report on commodity concentrations in farm lending recognizes that an individual adverse event or economic development for a commodity can put a large share of a given institution's loan portfolio at risk. The 221 FCS banks and associations have different exposures to credit risk, owing to the types of commodities in their service area and the proportion of any one commodity in their portfolio. The report summarizes data on commodity concentration risk and describes some management techniques for dealing with this type of risk.

Commodity concentrations are found to be quite high in a few banks and in a larger number of associations. At the Farm Credit District level, commodity concentration in single commodities is highest in the CoBank District portfolio in the Northeast (40 percent dairy) and in the Texas District (39 percent cattle). At the association level, commodity risk concentrations often exceed 50 percent in one commodity group.

One article summarizes the market and technological forces that are causing Congress to consider how to authorize financial service institutions with broad product bases in banking, brokerage, and insurance. It notes that the same forces are affecting the FCS and questions how these changes will affect the ability of the FCS to carry out its mission. The article does not attempt to answer this question, but it provides a background in three areas, while noting how the new studies from USDA and Treasury are related to these issues. Subjects addressed are the statutory purpose and related economic mission of the FCS, its contribution to competitive rural credit markets, similarities of the FCS charter and the national bank charter, and some challenging questions focused on ensuring a future with a competitive rural credit delivery system that is in the best interest of the borrower.

The article on corporate restructuring of System institutions notes that the number of lending institutions continues to decline mostly as a result of mergers in the Texas District FLBAs over the first six months of 1997. The System, as of July 1, 1997, was comprised of six FCB's, one ACB, one BC, and 213 associations.

Financial Performance of the Farm Credit System for the First Quarter, 1997

Janet Goktepe

Overview: Loan and Capital Growth Continued; Earnings Decreased as Operating Expenses, Nonaccruals, and Provision for Loan Losses Increased

Net income for the first quarter of 1997 declined 14.4 percent, compared with the first quarter of 1996, to $303 million. Net interest income declined by 4.0 percent, compared with the same period of 1996, to $533 million.

The credit quality of loan portfolios of most System institutions remained constant during the first quarter of 1997, compared with the same period of 1996. However, several System institutions experienced asset quality deterioration in certain segments of their portfolios. Nonaccrual loans increased 25 percent, from $778 million at March 31, 1996, to $974 million at March 31, 1997. Nonaccruals increased from 1.3 to 1.6 percent, respectively, of total loans outstanding. Delinquencies increased in a few System institutions, but decreased in most institutions and all districts overall.

Gross loans outstanding grew 2.6 percent, from $60.4 billion at March 31, 1996, to $62.0 billion at March 31, 1997. The allowance for loan losses was $1.8 billion, compared with $1.7 billion at March 31, 1996. Capital as a percentage of total assets increased from 13.6 percent to 14.3 percent over the year.

Earnings Decreased as Interest Spreads Narrowed and Operating Expenses Increased

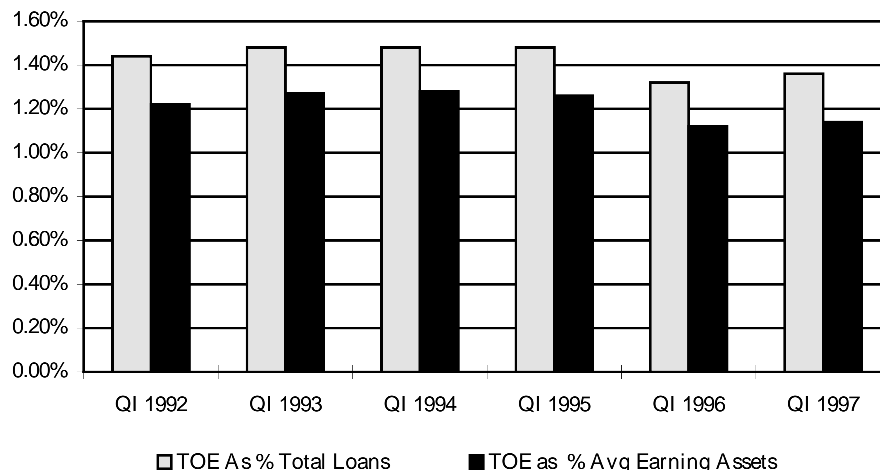
The decline in net income between the first quarter of 1996 and 1997 was caused by several factors, including a decrease in net interest income; increases in salaries and employee benefits, an increase in other operating expenses; and an increase in the provision for loan losses.

Net interest income decreased to $533 million for the quarter ended March 31, 1997, compared with $555 million for the quarter ended March 31, 1996. The decrease in net interest income resulted from a decline in the spread[1] between the yield on earning assets and the cost of interest-bearing debt of 27 basis points, from 2.30 percent (annualized) in the first quarter of 1996 to 2.03 percent in the first quarter of 1997. This decline was a result of competitive loan pricing pressures and decreases in interest income, especially on nonaccrual loans.

The provision for loan losses was $40 million for the first quarter of 1997, compared with $18 million for the first quarter of 1996, an increase of about 122 percent. Increased provisions occurred in the CoBank, ACB and the St. Paul BC. The increase in the provision was due primarily to management decisions that additional allowances for loan losses were necessary to provide for increased credit risks caused by higher input prices paid by a number of processing and marketing cooperatives, additional credit risks associated with growth in loan volume during 1995 and 1996, and adverse weather conditions in certain parts of the country.

Total operating expenses as a percentage of total loans increased from 1.32 percent (annualized) at March 31, 1996, to 1.36 percent at March 31, 1997 (Chart 1). The increase was due primarily to a 6.6 percent increase in salaries and employee benefits, from $122 million at March 31, 1996, to $130 million at March 31, 1997. Total operating expenses increased 6 percent, from $197 million for the first quarter of 1996 to $209 million for the first quarter of 1997.

Chart 1. Total Operating Expenses (TOE) as a Percentage of Total Loans and as a Percentage of Average Earning Assets, QI 1992–QI 1997.



Source: Data derived from Federal Farm Credit Banks Funding Corporation Quarterly Information

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[1] Spread refers to the difference between interest rate yield on earning assets and the cost of interest-bearing debt.

Statements—First Quarters 1992–1997.

Loan Volume Continued to Grow in All Loan Sectors Except Export Financing

All loan sectors except export financing grew between March 31, 1996, and March 31, 1997. Gross loans outstanding increased 2.6 percent, from $60.405 billion at March 31, 1996, to $61.968 billion at March 31, 1997 (Table 1). Long-term real estate loans (excluding loans to cooperatives) grew from $28.891 billion to $29.668 billion, or 2.7 percent. Short- and intermediate-term loans to agricultural producers grew 5.7 percent, from $13.690 billion to $14.469 billion. These increases were due primarily to the System's continued marketing efforts and competitive pricing programs during the past 12 months. Gross loans outstanding increased at March 31, 1997, over the same period of 1996 in all System banks except AgAmerica, FCB, and CoBank, ACB.

Table 1. Percentage Changes in Loans Outstanding of the Farm Credit System Combined Banks and Associations—March 31, 1992 to March 31, 1997

	QI 1992-QI 1993	QI 1993-QI 1994	QI 1994-QI 1995	QI 1995-QI 1996	QI 1996-QI 1997
Long-Term Real Estate Loans	-0.83	-1.24	-0.41	2.94	2.69
Short- and Intermediate-Term Loans	-2.21	9.17	5.73	13.88	5.69
Domestic Loans to Cooperatives	4.87	17.53	6.90	22.81	3.87
Loans Made in Connection with International Transactions	7.84	-4.48	-16.68	-1.27	-19.26
Total Loans	**0.47**	**4.05**	**1.32**	**9.46**	**2.59**

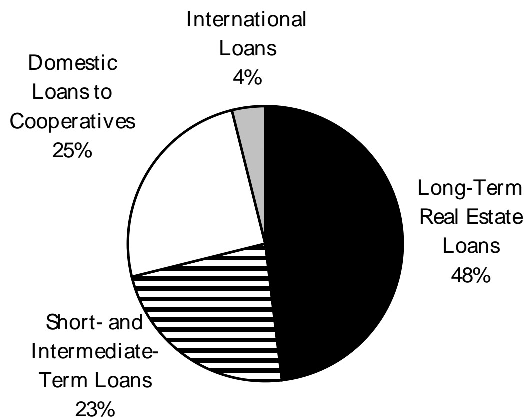
Source: Data derived from Federal Farm Credit Banks Funding Corporation Quarterly Information Statements—First Quarters 1992–1997.

Domestic loans to cooperatives grew from $14.875 billion to $15.450 billion, or 3.9 percent. This increase was due to demand for inventory and receivable financing by agricultural and rural utility cooperatives. Loans made in connection with international transactions declined from $2.949 billion to $2.381 billion, or 19.3 percent. The decrease was due primarily to paydowns in international loans to Mexico and Russia. Credit risk in the international loan portfolio is minimized by the significant concentration in guaranteed trade financing programs. At March 31, 1997, 94 percent of the System's international loans were guaranteed by the USDA's Commodity Credit Corporation.

Over the past 5 years, System loan volume has grown primarily because of domestic loans to cooperatives and short- and intermediate-term loans to agricultural producers. For example, at March 31, 1993, domestic loans to cooperatives accounted for 18 percent

of the System's total loan volume, compared with 25 percent today (Chart 2). Short- and intermediate-term loans accounted for about 20 percent of the total portfolio, compared with 23 percent today. Long-term real estate loans declined from 55 percent to 48 percent, and loans made in connection with international transactions declined from 7.2 percent of the System's portfolio to 4 percent.

Chart 2. Percentage Share of FCS $62.0 Billion Loan Portfolio by Loan Purpose at March 31, 1997



Source: Data derived from the Federal Farm Credit Banks Funding Corporation Quarterly Information Statement—First Quarter 1997.

Asset Quality Remained Stable Overall Despite Increases in Nonaccruals; Delinquencies Increased in a Few System Institutions

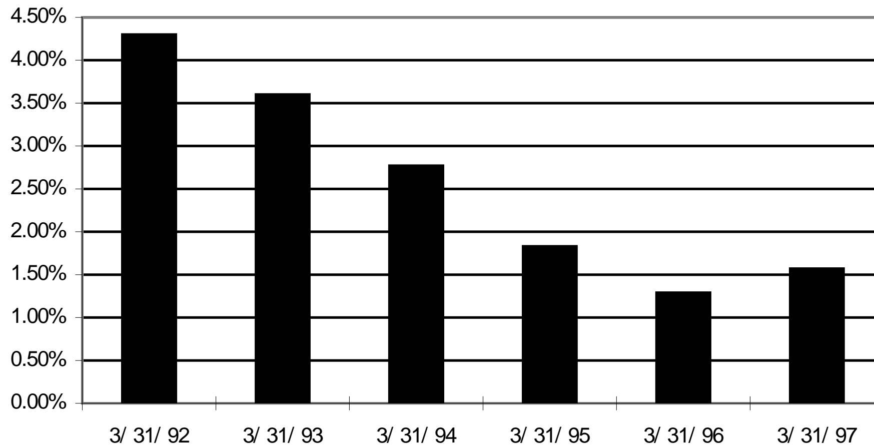
Nonaccrual loans (where accrual of interest has been suspended because of doubts as to the collectability of principal and interest) were $974 million at March 31, 1997, and $778 million at March 31, 1996, an increase of about 25 percent. The increase was due primarily to deterioration in the credit quality of loans to a limited number of processing and marketing cooperatives (i.e., loans in the St. Paul BC and CoBank, ACB). These borrowers are experiencing continued operating difficulties related to unusually high grain prices in 1996.

Nonaccrual loans are still a small percentage of total loans, increasing from 1.3 percent at March 31, 1996, to 1.6 percent at March 31, 1997 (Chart 3). Nonperforming assets as a percentage of capital remained constant at March 31, 1997, compared with the same period of 1996, at 12.2 percent, a decline from 16.8 percent at March 31, 1995.

Nonaccrual loans as a percentage of gross loan items increased in CoBank, ACB, the St. Paul BC, and the Texas FCB, but decreased or remained the same in all other System banks. Between March 31, 1996, and March 31, 1997, nonaccruals as a percentage of gross loan items increased from .06 percent to 1.3 percent at CoBank, ACB, from .08

percent to 5.6 percent at the St. Paul BC, and from .7 percent to .8 percent at the Texas FCB.

Chart 3. Nonaccrual Loans as a Percentage of Total Loans, QI 1992–QI 1997



Source: Data derived from the Federal Farm Credit Banks Funding Corporation Quarterly Information Statements—First Quarters 1992–1997.

The allowance for loan losses increased to $1.811 billion at March 31, 1997, compared with $1.696 billion at March 31, 1996. Managements of System institutions considered the increase adequate to protect against identified losses inherent in the loan portfolio.

Delinquencies, often used as an early warning indicator of emerging credit difficulties, did not indicate problems, based on first quarter 1997 numbers. The proportion of delinquent loans (loans more than 30 days past due) in the System's loan portfolio remained low during the first quarter of 1997, and delinquencies as a percentage of gross loan items decreased overall in all districts between the first quarter of 1996 and the first quarter of 1997.

There were increases in delinquencies in certain institutions and groups of institutions. Delinquencies in the St. Paul BC increased from .6 percent to 1.9 percent between the first quarters of 1996 and 1997. Delinquencies also increased for the following: PCAs combined, from 2.7 to 2.8 percent; Wichita District PCAs, from 2.7 to 2.8 percent; AgriBank District PCAs, from 2.2 to 2.4 percent; and the Midlands PCA in the AgAmerica District, from 2.2 to 3.1 percent.

Total Capital Grew as Surplus and Restricted Capital Increased

The System's capital as a percentage of total assets was 14.3 percent at March 31, 1997, compared with 13.6 percent at March 31, 1996. Total capital grew from $9.957 billion to $10.790 billion, or 8.4 percent. Surplus grew from $6.861 billion to $7.671 billion, or 11.8 percent. Surplus as a percentage of total capital increased from 68.9 percent at March 31, 1996, to 71.1 percent at March 31, 1997. Capital stock and participation certificates fell 5.9 percent, from $2.037 billion to $1.917 billion.

Total capital includes "restricted capital,"[2] which represents the aggregate assets in the Farm Credit Insurance Fund. As of March 31, 1997, restricted capital was $1.202 billion, or 11 percent of total capital of $10.790 billion. Restricted capital grew 13.6 percent from $1.058 billion at March 31, 1996, and almost 30 percent from $922 million at March 31, 1995.

At March 31, 1997, all System banks and associations were in compliance with the 7 percent minimum capital to risk-adjusted assets ratio standard required by FCA (Regulation 12 CFR § 615.5205, Minimum Permanent Capital Standard). All but three System institutions were well above the minimum standard.

The FCA's new capital regulations (12 CFR Part 615—Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations, Subpart K—Surplus and Collateral Requirements, § 615.5330, Minimum, Surplus Ratios), which became effective in March 1997, added total surplus ratio and core surplus ratio standards for all institutions and a collateral ratio standard for banks only. All banks and associations met the minimum total surplus ratio (total surplus must be at least 7 percent of risk-adjusted assets) at March 31, 1997.

Two banks and one association did not meet the minimum core surplus ratio standard (i.e., core surplus is at least 3.5 percent of risk-adjusted assets) at March 31, 1997. To comply with FCA regulations, these institutions are required to submit, to the FCA (within 60 days following the quarterend in which noncompliance is determined) for approval, a capital restoration plan for achieving and maintaining the standards. (Subsequent to March 31, one of the two banks had gained compliance.)

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[2] The assets in the Insurance Fund and the capital related thereto are designated as "restricted assets" and "restricted capital," respectively. The classification of the Insurance Fund as restricted capital is based on the statutory requirement that the amounts in the Insurance Fund, which is under the control of the Insurance Corporation, are to be used solely for purposes specified in the Farm Credit Act of 1971, as amended, all of which benefit, directly or indirectly, System institutions.

FCS Commodity Concentrations and Related Management Strategies in the Farm Credit System

Stephen Gabriel and Regina Pacheco

Lending concentrations are defined as relatively high portfolio exposures to borrowers whose sources of repayment would be affected similarly by changes in economic conditions, policy, or other factors. Concentrations occur in the System by virtue of the statutory limitations that limit borrower eligibility. Almost 93 percent of loan volume of Farm Credit System banks and associations at September 30, 1996 was in loans to agricultural producers for farm real estate or non-real estate purposes. (The remainder were loans for rural housing ,aquatic, processing and marketing, farm related business, or other purposes). Also, most Farm Credit institutions are granted charters with specific geographic territories, resulting in specific commodity concentrations, such as corn, wheat, or dairy. These commodity concentrations occur because within many geographic areas a combination of agronomic, climatic, and economic factors limits the range of commodities produced.

In addition to commodity concentrations, Farm Credit institutions face geographic, collateral, and single-borrower concentrations[3] that must be managed to limit the risk exposure of the institution. However, the focus of this article is on commodity concentrations.

Commodity concentrations pose a risk to Farm Credit institutions because a single adverse event or economic development related to that commodity can put an inordinate amount of the institution's portfolio at risk, threatening its financial viability. For example, if the price of cotton were to fall dramatically and an institution's loan portfolio consisted of 40 percent cotton loans, that institution could be placed under serious financial stress if enough of those cotton loans failed to perform. In many situations, commodity concentrations are unavoidable. This article discusses various strategies that institutions can implement to manage commodity concentration risk.

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[3] Farm Credit Administration regulations restrict the exposure that Farm Credit institutions can have to individual borrowers.

Commodity Concentrations by Farm Credit District

Commodity concentrations in each Farm Credit district as a whole are determined by the geographic, agronomic, climatic, and economic characteristics of the district. Some districts are more diversified than others. Because the district encompasses a larger territory than any single association, one would expect less concentration at the district level than at the association level. This expectation is borne out in the data.[4]

The districts with the highest degree of commodity concentration are CoBank and Texas.[5] The CoBank District loans to System associations all occur in several northeastern States (former Springfield District) where the dominant commodities produced are dairy products. Over 40 percent of the CoBank loan volume to associations is to producers of dairy products, which amounted to $722 million at the end of 1996. The next highest commodity concentration in the CoBank district is berry crops, to which just 4.8 percent of the portfolio is devoted.

In the Texas District, 39.0 percent of the loans are to cattle ranchers. These cattle loans total $1.5 billion. Another 15 percent, or $600 million, are to cotton producers. Although the Texas District has a relatively high exposure to cattle loans, the recent stress in the cattle sector, owing to low product prices and high feed costs, did not cause the financial stress to the System lenders that might have been expected, because many cattle producers have other sources of repayment. As part-time producers, they were able to weather the difficult economic situation by relying on nonfarm income.

Cattle is the leading commodity in terms of concentration for several districts other than Texas, including Wichita (26 percent or $981 million), AgAmerica (17 percent or $1.2 billion), and AgFirst (11 percent or $898 million). Corn, wheat, and dairy are also important commodities in many districts. In Wichita, 24 percent of the loans are to wheat farmers, making wheat a close second to cattle. Wheat loans in the Wichita District amounted to $884 million at year-end 1996. In the AgAmerica District, the portfolio is just slightly less concentrated in corn (16.8 percent) than cattle; in the AgFirst District, dairy lending (9 percent) is a close second to cattle.

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[4] The Loan Account Reporting System (LARS) database is used to identify portfolio concentrations in specific commodities. The commodity associated with each loan in the LARS database is the one that accounts for at least 50 percent of the producer's sales. If no commodity produced on a farm amounts to at least 50 percent, the farm is placed in a more general category, such as grain, field crops, general farms-primarily livestock, etc. Hence, a loan identified as a corn loan may be the obligation of a farmer with as little as 51 percent of sales from corn and as much as 49 percent from soybeans or hogs. Yet the farmer is identified as a corn farmer. Although this definitional factor may be considered a limitation to the LARS data for analyzing commodity concentrations, the LARS information is still useful in identifying significant exposures to specific commodities.

[5] This report does not cover concentrations in loans to cooperatives.

In the AgriBank District, corn (20 percent) and dairy (13 percent) are the most important commodities in terms of concentration. More than $3 billion in corn loans are on the books of institutions in the AgriBank District. The figure is nearly $2 billion for dairy loans. In the Western District, the leading commodities are dairy (16 percent, or $753 million) and grapes (14 percent, or $667 million).

Commodity Concentrations by Farm Credit District, December 31, 1996*
Top Two Commodities

District	Commodity	Concentration (%)	Loan Volume ($000)
CoBank	Dairy	40.4	722,429
	Berry Crops	4.8	86,316
Texas	Cattle	39.0	1,478,380
	Cotton	15.4	583,436
Wichita	Cattle	26.4	980,681
	Wheat	23.8	884,327
AgriBank	Corn	20.5	3,109,834
	Dairy	13.0	1,972,277
AgAmerica	Cattle	17.2	1,181,635
	Corn	16.8	1,157,124
Western	Dairy	15.8	753,443
	Grapes	14.0	667,096
AgFirst	Cattle	11.0	898,466
	Dairy	9.1	745,018

*Data based on LARS.

District Commodity Concentrations

AgFirst

Although the AgFirst District enjoys the greatest commodity diversification as measured by district-level commodity concentrations, many individual associations within the district have substantial commodity concentrations in their loan portfolios. For example, eight associations have concentrations in cattle in excess of 20 percent of their total loan volume. Four associations exceed a 35 percent concentration in cattle.

One association has a 67 percent concentration in citrus; two institutions have more than 50 percent of their loans to producers of poultry and eggs. Another association has a concentration of over 50 percent in hog loans. Soybeans account for over 50 percent of the portfolio of one association; tobacco loans represent more than a third of the loan volume at two associations.

AgFirst District

Number of Institutions with Commodity Concentration of 20 Percent or More*

Commodity	Number of Institutions
Cattle	8
Citrus Fruits	3
Corn	1
Cotton	2
Dairy	6
Hogs	3
Poultry/Eggs	10
Soybeans	2
Timber Tracts	4
Tobacco	6
Vegetables & Melons	1

*Based on LARS data. December 31, 1996.

Western

The Western Farm Credit District is also relatively well diversified, yet some associations within the district have significant commodity concentrations. For example, one association has nearly a 50 percent concentration in cattle. Eight associations have more than a 20 percent concentration in dairy, while two have more than a third of their loans to dairy farmers. In three associations, grapes account for over 40 percent of the total loan portfolio. Two associations have roughly half their loans to rice producers.

Western District

Number of Institutions with Commodity Concentration of 20 Percent or More*

Commodity	Number of Institutions
Beef Cattle Feedlots	1
Cattle	3
Cotton	3
Dairy	8
Deciduous Tree Fruits	1
Grapes	5
Irish Potatoes	1
Ornamental Floriculture & Nursery Products	2
Rice	4
Tree nuts	3
Vegetables & Melons	2

*Based on LARS data. December 31, 1996.

AgAmerica

The AgAmerica District consists of just three large multistate associations. Consequently, the degree of commodity concentration in these associations is moderate compared with some in other districts. Still, one of these associations has more than a 20 percent concentration in both cattle and corn. Another has over a 30 percent exposure in corn loans.

AgriBank

Several associations in the AgriBank District have sizable concentrations in corn, dairy, poultry and eggs, and rice. Six associations have more than a 50 percent concentration in corn loans—two have nearly 80 percent of their portfolios in corn loans. A number of associations have substantial dairy exposures; ten associations have more than a third of their portfolios in dairy loans, six of which exceed 50 percent. In two associations, poultry and eggs account for more than half the loan volume; five associations have over a third of their loans made to rice producers.

AgriBank District

Number of Institutions with Commodity Concentration of 20 Percent or More*

Commodity	Number of Institutions
Cattle	6
Corn	11
Cotton	4
Dairy	15
Hogs	3
Poultry/Eggs	3
Rice	5
Soybeans	6
Sugarcane & Sugar Beets	2
Wheat	6

*Based on LARS data. December 31, 1996.

Wichita

Cattle are the dominant commodity in the Wichita District. Four associations have more than 70 percent of their portfolios dedicated to cattle lending. Two associations have cattle concentrations of about 50 percent. Sixteen have concentrations in cattle loans that exceed 20 percent. Another association has more than 70 percent of its loans to producers of Irish potatoes. Wheat loans are important in the Wichita District; six institutions have more than a 20 percent portfolio concentration in wheat.

Wichita District

Number of Institutions with Commodity Concentration of 20 Percent or More*

Commodity	Number of Institutions
Beef Cattle Feedlots	3
Cattle	16
Corn	2
Cotton	1
Irish Potatoes	1
Soybeans	1
Wheat	6

*Based on LARS data. December 31, 1996.

Texas

In the Texas District, eleven institutions have concentrations in cattle that exceed 20 percent, nine of which are greater than a third. One association has more than 85 percent of its loans in cotton; another has more than a 60 percent concentration in cotton. Dairy lending accounts for about half the portfolio of one association.

Texas District

Number of Institutions with Commodity Concentration of 20 Percent or More*

Commodity	Number of Institutions
Cattle	11
Cotton	4
Dairy	2
Poultry/Eggs	1
Rice	1

*Based on LARS data. December 31, 1996.

CoBank

The most important commodity in the CoBank District is dairy. There are only five associations in this district, and four have significant concentrations in dairy lending. Two associations have more than 70 percent of their loans to dairy farmers, another has nearly half. The portfolio of one association has over a third of its loans to producers of Irish potatoes.

CoBank District

Number of Institutions with Commodity Concentration of 20 Percent or More *

Commodity	Number of Institutions
Dairy	4
Irish Potatoes	1
Ornamental Floriculture & Nursery Products	1
Forest Nurseries & Gathering Forest Products	1

*Based on LARS data. December 31, 1996.

Management Strategies for Dealing with Commodity Concentrations

The following section presents a general summary of the strategies FCS institutions use to manage the risks associated with commodity concentrations in their portfolios.

Information Systems
Most FCS institutions have information systems (IS) capable of identifying primary areas of business risk, such as commodity concentrations. These IS also enable management to segregate commodity concentrations. The identification of concentrations allows management to recognize and manage potential risk associated with such concentrations.

The sophistication of IS utilized by FCS institutions varies. In addition to identifying concentrations, many systems can also segregate commodity concentrations by credit classification and various borrower credit factors (e.g., repayment capacity, owner's equity, loan amount to collateral value ratio) for a more in-depth analysis. This capability allows the institution to identify potential weaknesses in borrowers' financial conditions and proactively manage the situation. In some instances, the IS also provide the capability to perform sensitivity modeling on the portfolio or segment of the portfolio to project the effect of decreases in prices, yields, or other factors. Some institutions supplement district IS with their own systems or hire staff with programming skills to create specialized (nonstandard) reports from the systems. These initiatives further aid in the proactive management of portfolio risk. Some districts are in the process of implementing updated information systems or analyzing the benefit of implementing new systems to improve information and increase applications available (e.g., sensitivity modeling).

Commodity Studies
Commodity studies provide management and credit staff with information about commodities financed within the institution's territory and may alert them to potential risk. Commodity studies may also project the effect on the institution's financial condition of any perceived risk in a particular commodity. The use and comprehensiveness of commodity studies vary by institution. Some may complete commodity studies in conjunction with the planning cycle. These studies provide an overview of the institution's concentration exposure and condition of prevalent industries financed. These studies may also be used to develop management's expectations regarding servicing of these commodities (increase marketing or limit exposure). Other studies are completed periodically or as needed. These studies may provide a more in-depth analysis of a particular commodity, including historical information and economic outlook. They may also evaluate the current condition, including credit classification and financial position, of the institution's borrowers with repayment capacity reliant on the commodities. In addition, some studies may project

the effect of expected industry conditions on the borrowers' financial positions and quality of the loan portfolio.

Underwriting Standards
Underwriting standards provide the basis for evaluating credit factors (defined financial or operating ratios) on individual loans by outlining minimum guidelines for creditworthiness of borrowers. Loan underwriting standards help ensure that characteristics of the institution's loan portfolio are consistent with its risk-bearing ability. Many FCS institutions utilize commodity-specific underwriting standards as a tool to manage risk for major commodities financed. Because of the increased risk posed by concentration in a particular commodity, commodity-specific underwriting standards may require compensating strengths in the credit factors for borrowers whose repayment capacity relies on the commodity. The underwriting standards are normally assessed on an ongoing basis and updated periodically. These standards may be modified in response to a change in risk in that particular portfolio segment. For example, the repayment capacity standard may be increased as the institution nears its maximum acceptable risk level for this commodity.

Loan Participations
An institution can use participations to diversify commodity concentrations within its loan portfolio. System institutions have the authority to participate in loans within their district, outside their district, and outside the System (e.g., with commercial banks or insurance companies) to diversify their loan portfolio.

The use of participations in the System is increasing. System institutions sold $5.1 billion in participations in the first quarter of 1997, up from $3.8 billion during the first quarter of 1996. CoBank and St. Paul BC accounted for most of this increase. Slightly over three-quarters of direct lender associations were involved in either purchasing or selling participations, mostly with other System institutions.

While the sale of most participations result from institutions complying with lending limitations or the desire to diversify risk in large loans, some institutions recognize the potential benefit of diversifying commodity concentrations in their portfolio through participations. An institution can sell loan participations in a commodity in which the institution has a large concentration. An institution may also purchase loan participations in a commodity in which it does not have a significant concentration to achieve diversification in the portfolio.

In some districts, groups of institutions have created strategic alliances to pool large loans. While such alliances are generally utilized to market large customer loans or participate loans that exceed an institution's lending limit, they may also be utilized to reduce commodity concentration risk.

Capital to Offset Risk

An institution's management may decide to build and retain higher levels of risk funds (capital and allowance for loan losses) to insulate the institution from the potential risk of commodity concentrations. Once commodity concentrations are recognized, institutions may modify their capital plans and/or allowance for loan loss levels to account for the risk. Management may even establish limits on the amount of a particular commodity in the portfolio as a percentage of loan volume or capital. Such limits may encourage the association to limit exposure through participations. In addition, the use of differential underwriting standards may limit exposure to a particular commodity.

Additional Strategies

Some institutions are utilizing Farm Service Agency guarantees and encouraging borrowers to use crop insurance and advance contracting when available. Use of these tools to reduce risk to individual borrowers helps reduce overall risk posed by the particular commodity financed. However, the use of advance contracts, futures, and other derivatives also introduces risks to the borrower and the institutions which need to be recognized and managed.

The FCA's Role

During the examination process, FCA examiners evaluate the effectiveness of an institution's loan portfolio management practices, including management of portfolio concentrations. If the FCA finds that an institution is not effectively managing any existing commodity concentration, it requires that the institution implement an action plan to correct such weaknesses.

FCS PURPOSES AND ITS GSE CHARTER, THE NATIONAL BANK CHARTER, AND FINANCIAL REFORM PROPOSALS

George D. Irwin

The U.S. financial system is in the midst of major changes, thanks to technological advances in computers, communications, and financial techniques. Financial products and services formerly in separate industries have become more alike and have developed new forms. One of the impacts is that the laws and regulations that created and govern financial institutions are being reexamined.

In fact, for the past several years, Congress has been considering additional[6] changes to the laws that separate banking from other financial services, and banking regulators have strongly supported the need for such change (see Exhibit 1 for recent statements). Regulators have also made a number of changes within existing law that reduce other barriers between banking and the related fields of securities and insurance. On the other hand, the continued existence of the Farm Credit System as a Government-sponsored enterprise (GSE) has been challenged at regular intervals since the 1980s, and efforts to adjust this body of law[7] and regulations to the new market circumstances have been challenged.

In view of this evidence that market forces are pressing for changes in the banking charter, it is reasonable to ask whether there will be impacts on the safety and soundness of the FCS or on its ability to carry out its statutory mission of ensuring competitive credit markets in rural America. How will these market and technology forces and changes to competitors' charters affect the ability of the FCS to carry out its mission?

This article does not answer these questions; rather, it reviews three specific sets of information to provide the background needed to develop answers. First, it outlines the statutory purposes of the FCS. Second, it compares the Federal charters and roles of the two traditional types of financial institutions active in rural areas, the FCS banks and associations and national commercial banks. The former are generally regarded as Federal entities and the latter as private firms, yet they share many characteristics.

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[6] Previous changes include interstate branching of national banks, which became effective June 1, 1997, and various modifications granted by other legislation over the past decade or more.

[7] A recent USDA report to Congress (reference 10) concluded that neither changes proposed by the FCS nor ones proposed by commercial banking interests would achieve significant improvement in rural financial markets, which, the study concluded, have been performing rather well. However, the study did not cover how future financial restructuring might affect these markets.

Third, the article notes a major change in the rural credit environment. It suggests that the dominant issue for the future is not the competition between the FCS and commercial banks in rural markets. Rather, it is the appropriate response to competition that both face from third parties in the new financial environment. The article also points out that competitive balance among the traditional agricultural lending institutions must also be maintained for the public purpose defined in the Farm Credit Act to be accomplished.[8]

Statutory Role of the Farm Credit System

Congress established the public purpose of the FCS by a policy stated in Section 1.1 of the Farm Credit Act. The Act calls for "a permanent system of credit and closely related services" for agriculture that is "farmer owned and controlled," is chartered to serve all areas of the country under all economic conditions, offers "competitive rates," authorizes a variety of loan purposes, and serves farmers and ranchers, their cooperatives, "selected farm-related businesses necessary for efficient farm operations," and certain other types of borrowers named in the Act.

The primary focus of the statute is to *benefit farmers and the rural sector*, not to serve the interests of the FCS or other providers of agricultural credit. This role determines the scope of service and the safety and soundness bounds within which the FCA must establish rules and regulations for the FCS.

Economic Missions of the FCS

The public interest is to have a continuing, competitive market in agricultural credit through all phases of the business cycle, and the FCS is one policy instrument to help achieve this goal.

A properly functioning FCS provides high value to the agricultural sector at no direct cost to the Federal Government (neither the FCA nor the FCS receives appropriated funds) by performing two missions. Recognizing both missions is the key to understanding the permanent role of the FCS in rural financial markets:

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[8] In a similar vein, Federal Reserve Governor Meyer stated, "The primary standard by which all modifications [of banking authorities] should be measured is the benefit to consumers of financial services." (Remarks by Federal Reserve Governor Lawrence H. Meyer at the 99th Assembly for Bank Directors, Southwestern Graduate School of Banking, January 24, 1997.) Former Federal Deposit Insurance Corporation (FDIC) Chairman Ricki Helfer, speaking to Women in Housing and Finance on May 20, 1997, said, "the only interest the bank regulatory agencies should serve is the public interest."

1. Ensure that there is *no credit gap* for eligible groups in rural America and that rural areas do not suffer disproportionately in periods of credit constraint; and

2. Promote *competitive market results* in rural credit markets by its presence, whether or not a credit gap exists, by alleviating or preventing market imperfections.

The role of the FCS is to be proactively available in order to prevent credit gaps from arising or interest rates from being set at noncompetitive levels. The role is *not* to sit back, wait until problems arise in the supply or price of agricultural credit, and then step in to correct them. Those who object to FCS competition with their institutions may be objecting to the competitive purposes established in statute, or they may be concerned that an inequity exists between the GSE authorities and the national bank authorities.

Farmer-owners, not the FCA, determine whether there is a need for loan programs authorized under the law. Congress did not prescribe that the FCA should create any further needs tests in order for loan programs to exist. The charter authority establishes the presumption that there is a need *for farmers to have the option* of establishing an FCS institution and carrying out loan programs as authorized by the Act. The FCS is to be a competitive presence, to offer eligible borrowers an alternative.

Success in this role, from the public policy viewpoint, is measured primarily by the adequacy of financing and the competitiveness of terms to the eligible borrowers, both now and in the future. Loan volume generated by the FCS is important to the extent that some level and stability of volume is necessary for efficient operation and long-term viability. The FCS and its competitors will each attempt to gain loan volume, but success of the Farm Credit Act is measured by the results of the competition—do the farmer-customers get good services at competitive rates?

Contribution to Competitive Rural Credit Markets

Congress has created a very effective mixed rural credit system, with Farm Credit institutions owned cooperatively and commercial banks owned by investor shareholders. Cooperatives are intended to operate directly in the interest of users, to minimize costs of customer borrowing, and to be innovative in providing customer-adapted services. One effect of their presence is to encourage competitive market behavior by investor-owned banks, which might otherwise have greater opportunity to exercise local market power to the disadvantage of borrowers. Conversely, the banks impose discipline on the FCS institutions, which might otherwise have less incentive to control operating costs.

The long-standing Federal policy of maintaining both the FCS and other institutions with Federal charters[9] has served rural areas well.[10] It has made financial markets efficient, effective, and competitive for farmers and rural America. However, the *issue of competitive advantage between* these institutions with Federal charters should be viewed as *secondary to* the *issue of the survival of both* in a less regulated environment. *The fundamental competitive advantage question* for the future is *between federally chartered and regulated institutions* on one hand, *and the newer, unregulated institutions* on the other. Both the FCS and other Federal charters need to be examined from this viewpoint.

Nevertheless, the secondary issue of competitive balance among the various Federal charters is worth some discussion. I believe it has been inappropriately overlooked in the public policy debates shaping financial markets for the future.

Federally Chartered Commercial Bank vs. GSE Charter

Federal charters are not the rule in the United States—most corporate charters are issued by States. But combinations of State and Federal charters are fairly common for financial institutions and certain other areas of great national significance. The FCS institutions are federally chartered, as are national commercial banks, Federal savings and loans, and Federal credit unions.[11]

The Federal charters for all kinds of financial institutions are intended to achieve some national purpose. But the public debate has treated classes of federally chartered institutions very differently.[12] Federally chartered commercial banks are characterized as private, even though their charters share many of the attributes of the class of Federal charters called Government-sponsored enterprises. The GSEs are generally characterized as public, though they have many private characteristics. As a matter of fact, both have public characteristics and both have private characteristics.

Both the FCS institutions and commercial banks are commercial lenders. Like the FCS, many commercial banks and thrifts have Federal charters and implied Federal support

[9] Commercial bank, thrift, and credit union charters may also be granted by the States. However, the option of Federal charters, and the interchangeability of many provisions and benefits, indicates a national policy concern.

[10] See reference 10, supporting this conclusion.

[11] In addition, the FCS institutions are described as instrumentalities of the United States, are listed as mixed- ownership Government corporations under the Government Corporations Control Act, and are subject to U.S. General Accounting Office audit. These attributes may contribute to the market perception of FCS securities. However, they receive no appropriated funds, and extensive safeguards have been established to limit any potential Federal liability.

[12] In the current good economic times, both the U.S. Treasury and institutions that compete with the FCS have suggested that GSEs may not be needed any longer, should be restricted in the ways they compete, or should be stripped of GSE attributes (privatized). This rationale tends to treat GSEs as public and treat commercial banks as private, a treatment questioned earlier in this article.

in raising funds. Both have charter restrictions on the kinds of customers and services they may provide. Both commercial banks and the FCS have access to a Government safety net.[13]
Both are now facing increased pressures from less regulated competitors and find their charters to be more binding than they would like. Congress has utilized both as public vehicles to improve rural access to credit and has imposed a Federal regulator. Both also have unique tax laws and exemptions, special accounting treatments, and insider access to monetary mechanisms.

On the other hand, both commercial banks and the FCS have private shareholders. In one case, shareholders are investors in commercial bank stock. In the other, shareholders are farmer-users of the FCS. In one case, profits flow to investors; in the other, they belong to the farmer shareholder-users. In many ways, national banks resemble GSEs, but with the advantage of a charter that gives them broader authorities.

The FCS charter is narrower in two major ways:

1. The FCS lacks authority to take deposits. Instead, it generates most of its funds by selling securities to investors in national and international financial markets.

2. The FCS institutions have a relatively narrow charter of lending authority and may offer only a narrow range of financial services to their customers. They may serve production agriculture and aquaculture, rural housing, processing and marketing, farm related service businesses, farmer cooperatives, rural utilities, and agricultural exporters.

Both types of institutions have similar attributes that are public and similar attributes that are private. (These attributes are described more fully in reference 2.) Rather than treating one as entirely private and the other as entirely public, it seems appropriate to focus on *keeping in competitive balance* the sets of attributes that each type of institution enjoys, so that each continues to be able to serve the purposes for which it was granted a Federal charter. The intent is to benefit farmers, ranchers, and rural America.

Rural Financial Markets for the Future

A broader issue, noted briefly in an earlier section, may be even more significant for rural financial markets. There is a danger in focusing so much attention on the balance

[13] Federal Reserve Governor Meyer describes the commercial bank safety net as deposit insurance, the discount window, and payment system guarantees. He says, "The result is that banks are, in effect, subsidized by the Government." (See citation in footnote 8.) The FCS has investor insurance and GSE attributes.

between these two kinds of regulated financial institutions that serve rural markets. The risk is that both may be allowed to become obsolete for rural America in the face of change in overall financial markets.

Two forces are at play, one internal and one external. First, new credit delivery mechanisms are developing that appear to lower costs and to be of significant value to rural credit customers. These mechanisms are reflected in the great expansion in trade credit associated with farm input and product markets and in the great increase in the opportunities to securitize loans. Second, all commercial banks, including those in rural America, would gain new powers from the current proposals to modernize the overall U.S. financial system. That fact alone raises the question of what adjustments may then be needed to maintain competitive balance for the FCS.

But the question goes deeper. At this point, it is impossible to project whether the consolidation of financial services powers will be positive or negative for banking services in rural America. Yet a positive answer has vastly different implications for the future of the FCS than a negative answer. More importantly, both leave a continuing Federal policy role for the FCS in maintaining efficient rural credit markets.

Keeping rural commercial banks and FCS institutions viable as well as balanced with respect to each other is likely to be a very large challenge for the future, yet achieving this goal should get the best results for the rural credit customer.

Conclusion

The recent reports from Treasury (reference 3) and USDA (reference 9) add a new dimension to these long-standing issues. The Treasury recommendations for financial services restructuring point out tremendous financial market changes and suggest extensive broadening of the national bank charter so that these institutions may remain competitive with other sources of financing and financial services in the future. The recommendations are silent on how these changes ought to be addressed in the GSE charter of the FCS. The USDA study concludes that rural financial markets have worked relatively well in the past, but the study was not intended to address the future performance of these markets.

The two studies leave the reader to infer that no change may be necessary in either the FCS authorities or in rural commercial bank authorities for rural financial systems to continue to serve well in the future. This article argues that such an inference would be wrong, and that the changes ahead in financial services charters raise legitimate safety and soundness issues and Federal policy issues for the FCA.

Two points need to be emphasized. First, changes in rural credit markets may be needed as a result of broader financial restructuring now taking place. Second,

although a competitive balance among regulated financial institutions is important in ensuring high quality service to rural areas, a competitive balance with other, less regulated financial institutions may be equally important. Changes may be required in all financial institution charters if the rural financial system is to continue to perform its public purposes as well as it has done in recent years.

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17. Treasury Department, "Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation," Statement of Deputy Secretary Lawrence H. Summers before Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises of the House Committee on Banking and Financial Services, July 24, 1996.

18. Treasury Department, *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*, Report to the Congress, July 11, 1996.

Exhibit I. Statements of Other Regulators Supporting the Need for Financial Modernization

- Comptroller of the Currency, Eugene Ludwig, discussed the need for modernizing regulations on June 17, 1996:[14]

> The truth is that banks had little choice but to become involved in the mutual fund industry if they wanted to continue serving the financial needs of their customers ... can you imagine how banking would have been affected had we not allowed banks to engage in mutual fund activities? What we need from our legislatures is much more than an exercise in allocating turf among competing interests or industries ... Rewriting the laws that govern banking and financial services must be based on fundamental principles—principles that *respect rather than fight market forces* that are reshaping the banking industry. ... the OCC and the administration are working now to develop the principles that we believe should guide us in this arena, and ... changes in law, regulation, and supervisory practice that would be required. (Emphasis added.)

- Comptroller Ludwig on March 13, 1997:[15]

> Financial modernization is first and foremost a safety and soundness issue. Strategic risk—in this case the risk of not being able to offer the products and services that the market demands—is, in the long term, the most important risk facing the financial industry today. In our dynamic economy, if banks are not able to offer new products, to evolve as the markets evolve, they will not survive as healthy entities. Accordingly, I am pleased to see the Congress ... has given financial modernization priority on its agenda ... I am similarly pleased that the Federal Reserve has taken action in this area. The OCC, too, will continue, as we have for the last several years, to allow the system to evolve.

and

> It is not enough for a statute or regulation to allow banks to evolve if the law or regulation permits evolution only in such an inefficient way that banks cannot actually compete with other entities.

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[14] Remarks of Comptroller of the Currency, Eugene A. Ludwig, before the New York State Bankers Association, June 17, 1996.

[15] Remarks of Eugene A. Ludwig before the annual Financial Services Forum of the New York State Bankers Association. Washington, D.C., March 13, 1997.

- Comptroller Ludwig, testifying on March 5, 1997:[16]

> Government restrictions on financial institutions that are not clearly justified by safety and soundness or other public policy concerns hurt the long-term health of our financial institutions.

- Similarly, Federal Reserve Governor Lawrence Meyer recognized these imperatives in speaking to bank directors on January 24, 1997:[17]

> The financial services industry is moving in the direction of expanded activities and increased competition, with or without congressional action, *driven by market realities*, financial innovations, technological change, and global competition. Federal banking regulators are cooperating in this process, often reluctantly, but recognizing already existing erosions to regulations. (Emphasis added.)

- FDIC Chairman Ricki Helfer said the following on January 16, 1997:[18]

> The challenge to the regulators is to develop safety-and-soundness regulation that comes as close as possible to market discipline, *without imposing inefficient, ineffective regulations* ... that unduly inhibit the important function ... that they perform for the economy. (Emphasis added.)

- Federal Reserve Chairman Alan Greenspan, testifying on February 13, 1997, supported the need for financial modernization, but also recognized the need to limit the scope of the "sovereign credit subsidy" to the banking system:[19]

> We strongly urge an extensive increase in the activities permitted to banking organizations and other financial institutions, provided these activities are financed at nonsubsidized market rates and do not pose unacceptable risks to our financial system. While a level playing field requires broader powers, it does not require subsidized ones.

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[16] Oral Statement of Eugene A. Ludwig before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the House Banking and Financial Services Committee, March 5, 1997.

[17] Remarks by Federal Reserve Governor Lawrence H. Meyer at the 99th Assembly for Bank Directors, Southwestern Graduate School of Banking, January 24, 1997.

[18] Remarks of Federal Deposit Insurance Corporation Chairman Ricki Helfer at FDIC symposium entitled History of the Eighties: Lessons for the Future. Arlington, Va., January 16, 1997.

[19] Testimony of Chairman Alan Greenspan before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services, February 13, 1997.

and

> In this century, the Congress has delegated the use of the sovereign credit (of the U.S.) ... the power to create money and borrow unlimited funds at the lowest possible rate ... to support the banking system. It has done so indirectly as a consequence of deposit insurance, the Federal Reserve discount window access, and the final riskless settlement of payment systems transactions. The public policy purpose was to protect depositors, stem bank runs, and lower the level of risk to the financial system from the insolvency of individual institutions. In insuring depositors, the Government ... substituted its unsurpassable credit rating for those of the banks. Similarly, provisions of the Federal Reserve Act enabled banks ... through the discount window ... and ... payments using Federal Reserve credits. All these uses of the sovereign credit have dramatically improved the soundness of our banking system and the public's confidence in it. In the process, it has profoundly altered the risks and returns in banking.

and

> But all good things have their price. The use of the sovereign credit ... creates a moral hazard that distorts the incentives for banks. ... This then creates the necessity for the Government to limit the degree of risk it absorbs by writing rules under which banks operate.

- Comptroller Ludwig also disagreed with Greenspan's evaluation of sovereign risk in his March 5, 1997, testimony:

> Some argue ... that banks benefit from a kind of subsidy through Federal deposit insurance and participation in the payments system and discount window, whereas bank holding companies are less likely to benefit to the same extent. This argument simply doesn't stand up to analysis.

- Chairman Helfer testified in support of modernization, but disagreed with Greenspan's assessment of sovereign risk on March 5, 1997:[20]

> Modernization of the financial system is necessary to achieve an efficient and competitive financial services industry ... banks are innovating and adapting to a changing marketplace. Nevertheless, banks have experienced a relative decline in market share and relatively slower growth. Financial modernization should strengthen banking organizations by allowing diversification of income sources and better service to customers.

[20] Testimony of Chairman Ricki Helfer at hearing on Financial Modernization before the Capital Markets, Securities and Government Sponsored Enterprises Subcommittee of the House Banking and Financial Services Committee, March 5, 1997.

and

The lesson we draw from these events (four major regional or sectoral downturns since the early 1980s) is that attempts to ensure the safety and soundness of insured institutions by limiting market competition ultimately fail ... To maintain the safety and soundness of the financial system, institutions must be allowed to diversify.

and

FDIC agrees that banks receive a gross subsidy from the federal safety net. However, banks also incur costs, both direct and indirect, that at least partially offset this gross subsidy. The relevant question ... is ... whether banks receive a net subsidy. On balance, the evidence indicates that if a net subsidy exists, it is very small.

Corporate Restructuring of Farm Credit System Institutions

Elna Luopa

The number of System lending institutions continues to decline as a result of association mergers in the first half of 1997. As of July 1, 1997, the System was comprised of 6 FCBs, 1 ACB, 1 BC, and 213 associations as follows: 65 PCAs, 57 Federal Land Bank Associations (FLBAs), 60 Agricultural Credit Associations (ACAs), and 31 Federal Land Credit Associations (FLCAs), or a total of 221 banks and associations, compared with 235 as of July 1, 1996. Most of the reductions occurred as a result of mergers of FLBAs in the Texas District. (Detailed information on corporate restructuring activity during the fourth quarter of 1996 appeared in the previous report.)

From January 2, 1997, through July 1, 1997, approvals were granted for four different mergers involving eleven FLBAs affiliated with the FCB of Texas, a merger of a PCA and an ACA affiliated with AgriBank, FCB, and an expansion of territory for an FLCA, also affiliated with AgriBank. Two mergers that had been approved by the FCA Board took effect during this period—one in the Texas District and the other in CoBank, ACB's Northeast Region.

In March, CoBank, ACB, headquartered in Denver, Colorado, and AgriBank, FCB, located in St. Paul, Minnesota, announced a strategic alliance to identify opportunities that would enhance the capacities of the two banks to serve their customers as they move into the 21st century. The joint project will explore the current markets served by the two banks, their customers' future needs, and alternative organizational structures for the delivery of future financial services. Outside consultants are assisting the banks with the joint project. The board chairmen have publicly stated that the alliance is not a prelude to merger, however such an option is not being ruled out. Combined, the banks hold $36.0 billion of the System's total assets of $75.3 billion.

Associations Affiliated with the FCB of Texas

Since January 1, 1997, the FCA Board has preliminarily approved the following FLBA mergers in Texas: (1) the FLBA of Paris into the FLBA of North Texas; (2) the FLBA of Corsicana into the FLBA of Waco; (3) the FLBAs of Kerrville and Mason into South Central FLBA of San Marcos, the continuing association to be renamed Capital of Texas FLBA; and (4) the FLBAs of Brownwood, Coleman, and Haskell into the FLBA of San Angelo, the continuing association to be renamed the FLBA of Texas. Stockholders of the FLBAs of Paris and North Texas subsequently approved their merger, which became effective May 1, 1997. The FCA's final approval of the three remaining mergers is contingent on approval by the voting stockholders of the FLBAs of each merger group.

Also, the FCA granted final approval for the merger of the FLBAs of Caprock-Plains of Plainview and High Plains FLBA of Pampa into the FLBA of Amarillo, the continuing association now known as Panhandle-Plains FLBA. The merger became effective February 1, 1997.

An additional merger proposal from two Texas District FLBAs has been received.

Associations Affiliated with CoBank, ACB

Empire Farm Credit, ACA, and First Pioneer Farm Credit, ACA, received the FCA's final approval to merge. The merger became effective July 1, 1997. The continuing association, First Pioneer, serves Massachusetts, Connecticut, New Jersey, Rhode Island, mid- and eastern New York, and six counties in New Hampshire.

Farm Credit Financial Partners, Inc., a service corporation of CoBank, ACB, located in Springfield, Massachusetts, provides support services for the ACAs' operations in the New England States, New York, and New Jersey. The Corporation obtained the FCA Board's approval to amend its charter and articles of incorporation to permit the ACAs in CoBank's Northeast Region to hold stock in the corporation. Prior to passage of the Farm Credit System Reform Act of 1996, System associations were not permitted to organize or hold stock in service corporations authorized by the Act. Upon completion of the stock transactions between the ACB and the ACAs, CoBank will retain a 25 percent interest in the corporation and the ACAs will hold the balance of the outstanding capital stock.

Associations Affiliated with AgriBank, FCB

On June 5, 1997, the FCA Board preliminarily approved the merger of the PCA of Southeast Wisconsin into Farm Credit Services of Western Wisconsin, ACA. If voting stockholders of each association approve the merger, the resulting ACA will be known as Harvestland Farm Credit Services, ACA. Concurrent with the merger approval, the FCA Board conditionally approved a charter amendment request from Farm Credit Services of Southeast Wisconsin, FLCA, to add 13 counties to its territory. The FCA Board's condition requires the FLCA to provide its stockholders with a disclosure regarding the effects of the expansion of its territory. The charter change will result in the FLCA's territory being identical to that of the Harvestland ACA. The FLCA will change its name to the Harvestland Farm Credit Services, FLCA. Both Harvestland associations will have common staff and operate under a joint management agreement.

ACTIVE SYSTEM INSTITUTIONS [1]
AS OF JULY 1, 1997

Bank Affiliation	PCAs	FLBAs	ACAs	FLCAs	ACB	FCBs	BCs	Total
AgFirst FCB	1	–	39	–	–	1	–	41
AgriBank, FCB	19	–	11	19	–	1	–	50
FCB of Wichita	18	22	–	–	–	1	–	41
FCB of Texas	16	35	–	–	–	1	–	52
Western FCB	10	–	5	11	–	1	–	27
AgAmerica, FCB	1	–	1	1	–	1	–	4
CoBank [2]	–	–	4	–	1	–	–	5
St. Paul BC [3]	–	–	–	–	–	–	1	1
7/1/97 Total	65	57	60	31	1	6	1	221
7/1/96 Total	66	69	60	32	1	6	1	235
Changes	(1)	(12)	–	(1)	–	–	–	(14)

[1] Service corporations are not included since they do not make loans.
[2] CoBank, ACB, has authority to serve cooperatives nationwide and ACAs in the former Springfield District.
[3] The St. Paul Bank for Cooperatives has authority to serve cooperatives nationwide.

Major Financial Indicators by System, Quarterly Comparisons[1]

Tom R. Risdal

Dollars in Thousands	At and For the 3 Months ended				
	Mar 31 '97	Dec 31 '96	Sep 30 '96	Jun 30 '96	Mar 30 '96
Farm Credit System Banks [2]					
Gross Loan Volume	57,044,815	56,466,631	56,587,082	56,778,256	55,935,408
Formally Restructured Loans [3]	273,632	307,530	328,813	314,345	313,013
Accrual Loans 90 or More Days Past Due	16,818	6,283	15,220	45,244	35,302
Nonaccrual Loans	583,049	253,869	292,989	303,742	319,978
Nonperforming Loans % [4]	1.53%	1.01%	1.13%	1.17%	1.19%
Cash and Marketable Investments	11,088,751	11,274,574	10,797,050	11,368,932	10,788,273
Total Capital/Total Assets [5]	8.54%	8.46%	8.57%	8.39%	8.49%
Total URE/Total Assets	3.94%	3.87%	3.96%	3.83%	3.84%
Total Net Income	155,501	120,947	154,142	160,344	186,801
ROA [6]	0.93%	0.71%	0.90%	0.94%	1.13%
ROE [6]	10.79%	8.23%	10.57%	11.18%	13.22%
Net Interest Margin %	1.62%	1.60%	1.62%	1.71%	1.79%
Operating Expense Rate [7]	0.52%	0.73%	0.60%	0.61%	0.61%
Associations (excluding FLBAs)					
Gross Loan Volume	33,779,492	34,062,673	33,792,140	33,105,217	31,144,834
Formally Restructured Loans	83,062	87,959	90,451	94,413	99,158
Accrual Loans 90 or More Days Past Due	44,947	21,775	18,345	45,157	48,535
Nonaccrual Loans	391,334	390,935	442,427	455,525	458,034
Nonperforming Loans %	1.54%	1.47%	1.63%	1.80%	1.94%
Total Capital/Total Assets [5]	17.15%	16.69%	16.55%	16.63%	17.37%
Total URE/Total Assets	12.65%	12.06%	12.11%	12.02%	12.36%
Total Net Income	166,927	160,551	142,343	149,676	170,737
ROA [6]	1.90%	1.76%	1.57%	1.75%	2.09%
ROE [6]	11.02%	10.46%	9.44%	10.28%	11.90%
Net Interest Margin %	3.50%	3.39%	3.28%	3.50%	3.72%
Operating Expense Rate	1.77%	2.01%	1.82%	1.91%	1.96%
Total Farm Credit System [8]					
Gross Loan Volume	61,968,000	61,178,000	60,909,424	61,178,699	60,405,383
Formally Restructured Loans	230,000	246,000	264,543	272,723	298,738
Accrual Loans 90 or More Days Past Due	61,000	28,000	34,264	84,614	82,918
Nonaccrual Loans	974,000	645,000	735,411	759,227	778,085
Nonperforming Loans %	2.04%	1.50%	1.70%	1.83%	1.92%
Total Bonds and Notes	62,571,000	62,343,000	62,045,482	62,857,224	61,406,717
Total Capital/Total Assets [5]	14.50%	14.32%	14.24%	13.80%	13.79%
Total Surplus/Total Assets	10.19%	9.91%	9.82%	9.47%	9.36%
Total Net Income	303,000	250,000	288,595	307,521	354,167
ROA [6]	1.61%	1.34%	1.54%	1.66%	1.96%
ROE [6]	11.33%	9.51%	11.14%	12.21%	14.46%
Net Interest Margin %	2.91%	2.93%	2.90%	3.00%	3.14%

Source: Call Reports and Reports to Investors

[1] Some of the previously published quarterly data have been restated to include subsequent adjustments.
[2] Includes Farm Credit Banks, the Bank for Cooperatives, and the Agricultural Credit Bank.

[3] Excludes loans past due 90 days or more.
[4] Nonperforming Loans are defined as Nonaccural Loans, Formally Restructured Loans, and Accrual Loans 90 or More Days Past Due.
[5] Total capital includes protected borrower stock. References to capital in text do not include protected borrower stock ($124 million at March 31, 1997).
[6] Income ratios are annualized.
[7] Defined as operating expenses divided by average gross loans, annualized.
[8] Cannot be derived through summation of above categories due to intradistrict and intra-System eliminations. Data rounded in Report to Investors starting with December 31, 1996.

Major Financial Indicators by District[1]

Tom R. Risdal

Dollars in Thousands	At and For the Quarter Ended March 31, 1997							
	Total Assets	Gross Loan Volume	Nonaccrual Loans	Allowance for Loan Losses	Cash and Marketable Investments	Capital Stock [2]	Earned Net Worth [3]	Total Net Worth
Farm Credit System Banks								
Wichita	4,809,324	4,004,869	45,541	132,355	809,707	345,725	321,431	667,156
Texas	4,228,502	3,647,570	30,778	46,640	504,276	100,738	247,501	348,239
Western	4,927,041	4,065,663	0	22,977	723,846	199,321	172,084	371,405
AgriBank	16,859,634	13,449,135	128,771	217,305	3,348,259	566,466	776,348	1,342,814
AgAmerica	6,976,815	6,082,378	38,601	49,693	802,721	562,377	390,856	953,233
AgFirst	9,081,969	7,581,282	0	8,467	1,355,297	298,682	314,932	613,614
CoBank	19,118,512	15,872,054	204,473	215,589	3,181,293	840,042	473,171	1,313,213
St. Paul BC	2,764,138	2,341,864	134,885	65,616	363,352	229,304	36,020	265,324
Total	68,765,935	57,044,815	583,049	758,642	11,088,751	3,142,655	2,732,343	5,874,998
Associations (excluding FLBAs)								
Wichita	818,145	745,738	5,664	24,576	15,179	52,389	150,467	202,856
Texas	827,453	769,052	15,408	26,144	4,027	58,412	155,393	213,805
Western	4,886,677	4,612,824	57,600	108,908	34,759	146,303	638,880	785,183
AgriBank	12,911,303	12,108,748	88,125	237,193	68	349,611	1,681,846	2,031,457
AgAmerica	6,107,740	5,586,715	87,021	277,744	32,626	144,572	824,261	968,833
AgFirst	8,534,660	8,208,294	106,765	245,707	4,226	272,045	1,338,725	1,610,770
CoBank	1,861,874	1,748,121	30,751	48,616	6,468	70,881	280,152	351,033
Total	35,947,852	33,779,492	391,334	968,888	97,353	1,094,213	5,069,724	6,163,937
Farm Credit System Totals								
	75,274,000	61,968,000	974,000	1,811,000	11,818,000	2,041,000	7,671,000	10,914,000

[1] Aggregations of district data may not equal totals due to eliminations.
[2] Includes protected borrower stock.
[3] Includes net unrealized gains/losses on investments available for sale.

Glossary

As used herein, the following terms have the following meanings:

ACA—Agricultural Credit Association, the successor association resulting from an FLBA/PCA merger

ACB—Agricultural Credit Bank, the successor Bank resulting from a BC/FCB merger

Associations—FLBAs, FLCAs, PCAs, and ACAs

Banks—the FCBs, the ACB, and the BC

BC—Bank for Cooperatives

Consolidated Bank Debt Securities—debt securities issued by a combined Bank group pursuant to Section 4.2(c) of the Farm Credit Act

Farm Credit Act—Farm Credit Act of 1971, as amended

FCA or Agency—Farm Credit Administration

FCB—Farm Credit Bank

FCS or System—Farm Credit System

FLBA—Federal Land Bank Association

FLCA—Federal Land Credit Association, an FLBA that has been granted direct-lending authority

Funding Corporation—Federal Farm Credit Banks Funding Corporation

GSE - Government-Sponsored Enterprise

Insurance Corporation—Farm Credit System Insurance Corporation

Insurance Fund—Farm Credit Insurance Fund, maintained by the Insurance Corporation pursuant to the Farm Credit Act

IS—information systems

OPDRC—Office of Policy Development and Risk Control

PCA—Production Credit Association

RCD—Risk Control Division

ROA - Return on Assets

ROE - Return on Equity

Systemwide Debt Securities—Federal Farm Credit Banks Consolidated Systemwide Bonds, Federal Farm Credit Banks Consolidated Systemwide Medium-Term Notes, Federal Farm Credit Banks Consolidated Systemwide Discount Notes, and any other debt securities that may be issued by the Banks pursuant to Section 4.2 (d) of the Farm Credit Act

URE - Unallocated Retained Earnings

USDA—U.S. Department of Agriculture

Copies Available from
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Farm Credit Administration
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