

Approved February 21, 1986  
Date

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE

The meeting was called to order by Sen. Neil H. Arasmith at  
Chairperson

9:00 a.m./~~p.m.~~ on February 20, 1986 in room 529-S of the Capitol.

All members were present except:

Committee staff present:

Bill Wolff, Legislative Research  
Bruce Kinzie, Revisor of Statutes

Conferees appearing before the committee:

Sen. Robert Talkington  
Harold Stones, Kansas Bankers Association  
Chip Wheelen, Pete McGill and Associates  
Charles Moyer, Kansas Independent Bankers Association  
Bill Fuller, Kansas Farm Bureau  
Michael Heitman, Kansas Banking Department.

The minutes of February 19 were approved.

The hearing began on SB 555 dealing with amortization of losses by banks which had been requested for introduction by Sen. Robert Talkington who testified first in support of the bill. (See Attachment I).

Sen. Karr asked Sen. Talkington if this would supercede the examiner's power. Sen. Talkington answered that it will not bind the FDIC. He is hoping that the FDIC will agree with it and accept it. He feels that there is a strong possibility that the FDIC will accept it.

Harold Stones, Kansas Bankers Association, testified next in support of the bill. He also distributed copies of articles which indicate the federal government will be of no assistance in solving this problem. (See Attachments II and III). He said there would be a cost to the State Banking Department, but the bankers do not mind paying it. Sen. Werts asked how the C.P.A.s would handle this, and Mr. Stones said he was not certain, but he assumes it will be by footnote.

Sen. Karr asked why five years was used for the extension. Mr. Stones said there was no magic in five, but if a shorter time than five were used, it would not be workable. Regulators feel the longer it is extended beyond five, the more problems they will have. Mr. Stones said it is the minimum time that would help banks. Sen. Karr asked further if this would have saved any banks in 1985, and Mr. Stones replied that it saves the saveable bank but that he would not know how many that would be.

Chip Wheelen, Pete McGill and Associates, followed with testimony in support of SB 555. (See Attachment IV).

Charles Moyer, Phillipsburg banker on behalf of the Kansas Independent Bankers Association, gave further testimony in support of SB 555. (See Attachment V).

Bill Fuller, Kansas Farm Bureau, testified in support of SB 555. (See Attachment VI).

The concluding testimony was given by Michael Heitman, Kansas Banking Department, in which he expressed the concerns the banking department has with the bill. He also submitted an analysis of the department's cost projections. (See Attachments VII and VIII).

Sen. Werts asked if the department's regulatory concerns could be incorporated into regulatory language. Mr. Heitman said that if it is the intent of the bill to give the commissioner this authority, he could provide this language by tomorrow. This concluded the hearing on SB 555.

The meeting was adjourned.

SENATE COMMITTEE

ON

FINANCIAL INSTITUTIONS AND INSURANCE

OBSERVERS  
(Please print)

DATE	NAME	ADDRESS	REPRESENTING
02/20/86	John Spurgeon		Budget Div
2/20/86	Jack Montgomery	Topeka	Gov - Policy
	TOM PALACE	"	Salvage League Services
2/20/86	Jim M...	"	KBA
2/20/86	Don Stiff	"	KBA
2/20/86	Rich Nichols	"	KBA
2/20/86	Harold Stone	"	KBR
2-20-86	Jim McBride	"	Observer
	M. Hawver	"	Cap-Juni
	Rich McKee	Topeka	Kansas Livestock Assoc.
"	Chip Wheelen	Topeka	Legis. Policy Group
"	Jacque Dakes	Topeka - Yates Center	State Exchange Bank
	J. Peterson		
"	Kinda McGill	Topeka	Ks. Independent Bankers Assn.
"	Dean Johnson	Hutchinson	Hutchinson Nat'l Bank
	Mark A. Starr	Hutchinson	Starr Bank (Consolidated)
"	Jim W. Cooper	Garnett	Kansas State Bank
"	Evelyn L. Schumacher	Hays	1st Nat'l Bank
"	Daryl L. Wright	Topeka	KOK
"	Charles V. Meyer	Phillipsburg, Kans	Kans. Ind. Bankers Assn.
"	Bill Juller	Manhattan	Kansas Farm Bureau
"	John Hanna	NR Topeka	AP

# KANSAS SENATE

ROBERT V. TALKINGTON

SENATE PRESIDENT

P.O. BOX 725  
IOLA, KANSAS 66749-0725



CHAIRMAN:  
LEGISLATIVE COORDINATING COUNCIL

CHAIRMAN:  
ORGANIZATION, CALENDAR AND RULES

MEMBER:  
INTERSTATE COOPERATION  
JUDICIARY  
WAYS AND MEANS

## OFFICE OF THE PRESIDENT

STATE CAPITOL  
TOPEKA, KANSAS 66612-1565  
913-296-2419

TESTIMONY IN SUPPORT OF SENATE BILL 555

FEBRUARY 20, 1986

I REQUESTED THIS COMMITTEE, THE SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE, TO INTRODUCE SENATE BILL 555 AS A MEANS OF PROVIDING ASSURANCES THAT BANKING SERVICES WILL CONTINUE TO BE AVAILABLE TO ALL SECTORS OF THE KANSAS COMMUNITY.

IF ENACTED INTO LAW, THIS MEASURE WOULD PERMIT BANKS IN KANSAS, WITH THE APPROVAL AND MONITORING OF THE STATE BANKING COMMISSIONER, TO AMORTIZE LOSSES OVER A FIVE YEAR TERM, INSTEAD OF ONE YEAR AS IS CURRENTLY PERMITTED. THE AMORTIZATION EXTENSION WILL PERMIT BANKS WITH LOANS WHICH HAVE PROVEN TO BE UNCOLLECTABLE TO "WRITE-DOWN" SUCH LOANS IN A MANNER WHICH WILL REDUCE THE RISK THAT THE BANK WILL BE FORCED TO CLOSE ITS DOORS.

BY EXTENDING THE AMOUNT OF TIME AVAILABLE FOR THE BANK TO AMORTIZE, WE WILL PROVIDE RELIEF FROM SOME OF THE PRESSURES THAT FORCED 13 KANSAS BANKS TO CLOSE IN 1985. MOST KANSAS, AND NATIONAL, BANK FAILURES WERE NECESSARY BECAUSE THE BANKS' CAPITAL WAS DEEMED INSUFFICIENT FOR THE AMOUNT OF LOANS ON THEIR BOOKS. WHEN EXISTING LOANS ARE CONSIDERED "BAD" OR "UNCOLLECTABLE" BY THE STATE BANKING COMMISSIONER OR FEDERAL DEPOSIT INSURANCE

*S. FII 2/20/86*  
*Attachment I*

CORPORATION, THE BANK MUST INCREASE ITS OWN CAPITALIZATION TO OFFSET THE LOAN. BECAUSE MANY OF THOSE LOANS, WHICH WERE DEEMED UNCOLLECTABLE, WERE TO FARMERS AND PEOPLE IN THE OIL AND GAS INDUSTRY, TWO ECONOMIC SECTORS WHICH HAVE BEEN EXPERIENCING VERY DIFFICULT TIMES, THE BANKS HAVE SUFFERED WITH THEIR DEBTORS AS THE ASSESSED VALUE OF FARMLAND AND OIL AND GAS PROPERTIES HAVE DECLINED. THE DECLINE IN ASSESSED VALUES COINCIDES WITH THE MARKED DECLINE IN PRICES FARMERS AND ENERGY PRODUCERS ARE RECEIVING FOR THEIR PRODUCTS AND THUS BANKS DO NOT HAVE THE INFLUX OF NEW DEPOSITS AND CAPITAL TO OFFSET THE LOSS OF COLLATERAL ASSET VALUE.

CURRENTLY, A BANK MUST DEDUCT AN AMOUNT EQUAL TO THE LOSS IT HAS EXPERIENCED, DUE TO THE DECLINE IN THE VALUE OF THE COLLATERAL ASSETS OR THE CUSTOMER'S CASH FLOW, FROM ITS LOAN LOSS RESERVES. THESE RESERVES ARE CREATED FROM BANK INCOME OR BANK CAPITAL. WHEN THE AMOUNT OF LOSS EXCEEDS OR APPROACHES THE AMOUNT OF RESERVES, THE BANK'S CAPITAL IS VULNERABLE AND REGULATORS MAY SEEK TO CLOSE THE BANK.

EVEN IN INSTANCES WHERE BANKERS AND FARMERS OR BUSINESSMEN SEEK TO RENEGOTIATE THE CUSTOMER'S DEBT LOAD BY HAVING THE BANK WRITE-DOWN THE DEBT TO A MORE MANAGEABLE LEVEL, IN RETURN FOR ADDITIONAL COLLATERAL, THE BANK MUST NOW ABSORB THOSE WRITE-DOWNS IMMEDIATELY FROM RESERVES, INCOME OR CAPITAL.

SENATE BILL 555 IS DESIGNED TO ASSIST BANKS TO REMAIN SOLVENT AND THEREBY ASSIST THE FARM AND BUSINESS COMMUNITIES TO REGAIN THEIR HEALTH. THE LONG-TERM DETRIMENTAL EFFECTS OF FAILED BANKS IMPACT NOT ONLY ON THE BUSINESS AND AGRIBUSINESS COMMUNITIES, BUT ON EACH INDIVIDUAL WHO HAS A SAVINGS OR CHECKING ACCOUNT IN THE LOCAL BANK. CONVENIENCE OF SERVICE IS IMPORTANT TO ALL KANSANS AND THIS BILL WILL HELP ENSURE THE CONTINUED SURVIVAL OF THE AVAILABILITY OF BANKING SERVICES TO THE STATE'S CONSUMERS.

THE PUBLIC INTERESTS ARE PROTECTED, IN THIS MEASURE BECAUSE THE BANK COMMISSIONER WILL APPROVE AND MONITOR THE ENTIRE PROCESS. BANK INTEGRITY WILL BE ENSURED AS WILL THE PUBLIC WELL-BEING.

THANK YOU FOR THE OPPORTUNITY SPEAK WITH YOU ON THIS IMPORTANT ISSUE, I WILL RESPOND TO QUESTIONS.



The KANSAS BANKERS ASSOCIATION  
A Full Service Banking Association

TO: Senate Committee on Financial Institutions and Insurance

FROM: Harold Stones, Kansas Bankers Association

RE: Senate Bill No. 555

Thank you, Mr. Chairman, and Members of the Committee for this opportunity to appear as a **PROPONENT** for SB 555. I would like to outline the following important issues:

I. In the agricultural midwest, we must accept as fact that there is too much debt for the agricultural economy to repay. This large debt, a good share of which most certainly will not be paid, must be allowed to be assimilated over a period of time, or results will be most negative to rural banks and their communities.

II. For at least 18 months, the KBA has been actively pursuing dialog with our colleagues in other states, our national trade associations, with federal and state regulators, and with federal and state legislators regarding the need for some type of **CAPITAL MAINTENANCE ASSISTANCE**, for ag banks and their customers.

A. When a loan becomes "classified" by regulators, either due to an inability of the customer to cash flow and keep payments current, or due to a decline in the value of the collateral asset compared to the amount of the loan, that bank must deduct an amount equal to the loss it has experienced from its loan loss reserves. These reserves are created from either bank income or bank capital. When the amount of loss exceeds the amount of reserves, and when there is not sufficient income to add to that reserve, then the bank's capital is vulnerable to go below regulatory minimums, and the bank is subject to enforcement actions which may lead to closure. These losses, even though some are not yet actually realized, must now be written down all at once. There is no current ability to amortize them over a time period.

B. When an agricultural or small business customer has a debt load that is too large to be serviced, which is not unusual today, the best thing to happen, if the customer is at all salvageable, is for the banker and the customer to renegotiate that debt. In many cases, the banker will write down the debt

to a more manageable level, sometimes in return for additional collateral or other items of collateral strength. But the bank must now absorb those write-downs immediately from reserves, income or capital. When the capital falls below regulatory minimums, the bank is told to replenish it within a certain time period, and if this is impossible, the bank is subject to enforcement action which may lead to closure. It is easy to see the pitfall to many ag bankers which reegotiation can present in today's regulatory environment.

C. This is why the KBA has been working to try to organize a multi-state effort to attempt to get regulators and/or legislators to agree to some kind of capital maintenance assistance-----and a solution is very close at hand. **THERE IS NOW VIRTUAL UNIVERSAL AGREEMENT AMONG REGULATORS THAT SOMETHING MUST BE DONE. THIS HAS BEEN THE CASE FOR LESS THAN SIX MONTHS, BUT, FORTUNATELY, IT IS NOW THE CASE.**

III. On Thursday and Friday, February 13 and 14, a Joint American Bankers Association/Independent Bankers Association of America Task Force, of which I am a member, met in Washington. The Task Force has spent hours and days meeting with bankers all over the midwest and with other officials in study and deliberation. Final Recommendations of this Task Force are attached at the end of this testimony book, and have been approved by the highest governing bodies of both organizations. The highest priority recommendation of this unprecedented joint Task Force is to enable prudently managed banks to amortize their loan losses over a multi-year period, as SB 555 authorizes for State regulators.

We visited at length with key officials of the FDIC, the Comptroller of the Currency, the Federal Reserve, and the Department of the Treasury. We also had in-depth discussions with key staffers of the House and Senate Committees on Agriculture and Banking.

A. There appears to be total agreement that some form of capital assistance will be forthcoming, but, except for FDIC officials, there was some resistance to the amortization concept as compared, for example, to simply lowering capital requirements in certain cases. We pointed out, however, that amortization has advantages which no other solution has, which will accrue to the benefit of the ag bank and the borrower---These advantages are:

1. Amortization of losses over time is the ONLY solution which will allow a bank to continue servicing the credit needs of its community while undergoing this agricultural reorganization we are now experiencing. These loans may be badly needed for earnings to the bank, and the credit badly needed to keep rural communities alive. If the solution is to simply allow a lower capital requirement, many of these loans would be beyond the bank's limit, thus compounding the problems for both the bank and the bank's community.

2. Amortization is the overwhelming choice of community and rural banks all over the mid-west, and, after explanation, is the overwhelming choice of their customers. This specific solution would be greeted with tremendously positive enthusiasm, and these attitudes are scarce today in many parts of rural Kansas. Just the positive overtones that Topeka and Washington understand their difficulties and are doing this important act to be of assistance would have a positive result that is difficult to measure.

3. It is possible to carefully regulate and monitor. It may require more examiners to do so, but please remember that these funds are paid directly in fees by the banking industry. Amortization is, as we see it, a solution that is possible to "save the saveable" and is totally "self-help", in that it is funded by the industry.

B. The regulators are now re-thinking their possible solutions in the light of the issues originated by this Joint Task Force, and we will have a good idea of their final proposals when each testifies to the Senate Banking Committee very early in March.

IV. Since the solution must be a coordinated effort, and all federal regulators are conferring to reach a "universal" solution, and since we also expect federal bill to be introduced by the Senate Majority Leader on this subject, we like the "generic" language found in SB 555. It does not deal with the specifics of how long such period might be employed, and gives fairly unilateral powers to the Commissioner. This should allow for an accomodation so all regulatory bodies can achieve consistency for banks, and so that national banks and state banks can be treated equally.



The Kansas Bankers Association would commend the Kansas Senate Committee on Financial Institutions and Insurance for showing leadership on this issue, and respectfully ask for swift action through the legislative process, in order to communicate the desires of the Legislature to federal authorities. At the very end, it would probably be well to hold the bill in Conference so that more time could be allowed to insure Kansas law is "compatible" with the national solution. But we compliment the Kansas Legislature and urge your forceful action in order to encourage and guide the national solution. It is this kind of leadership which is most needed during these times.

## RECOMMENDATIONS OF THE ABA-IBAA TASK FORCE ON AGRICULTURAL CREDIT

February 4, 1986

The banking industry considers it essential that steps be taken early in 1986 to assist commercial banks and their agricultural borrowers in coping with the accumulation of problem farm debt. The IBAA and ABA met jointly in Dallas, Texas, on January 15-16 and, based on that meeting, will seek measures that can help to stabilize the capital structure of agricultural banks and to assist individual agricultural borrowers in managing their debt during this critical period. Recognizing that agricultural banking can return to profitability only when the agricultural economy is again profitable, the fundamental premise of these proposed measures is that agriculture is experiencing massive change and bankers and their agricultural borrowers need a reasonable period of time to adapt.

We will seek to implement such measures through regulatory action to the extent that they can be carried out under existing law, and we will seek legislation where existing law is inadequate. Our Associations will pursue a plan of action involving three main elements: (1) stabilization of bank capital; (2) stabilization of agricultural borrowers; and (3) stabilization of farm real estate values.

### Stabilization of Bank Capital

The most immediate problem confronting agricultural banks is the impact on bank capital of sudden and massive agricultural loan losses. In 1984, agricultural production loan losses charged off by commercial banks totalled \$900 million--an increase from \$436 million in 1983. Such charge-offs for the first two quarters of 1985 were \$520 million, almost double the \$280 million charged off in the first two quarters of 1984.

These extraordinary charge-offs are eroding the capital structure of many agricultural banks as the loan losses are deducted from the banks' available capital. As a bank's capital is reduced, both the total capacity of the bank to extend credit and the size of individual loans that the bank can make are correspondingly reduced. If a bank's capital falls below the minimum required by the regulatory agencies, the bank is subject to enforcement actions which may lead to closure.

"The Farm Credit Act Amendments of 1985" (PL 99-205), signed by the President on December 23, 1985, was Congress' response to a similar problem in the Farm Credit System. Faced with mounting agricultural loan losses, the Farm Credit System requested Federal backing to guarantee its continued access to capital in the credit market. Congress and the Administration responded to the Farm Credit System's request for assistance with PL 99-205.

To keep agricultural banks open and to maintain their capacity to extend credit to borrowers, we recommend that special measures be implemented to preserve the capital structure of agricultural banks. Agricultural banks traditionally have been well capitalized, but the persistent downturn in the farm economy since 1981 is severely pressuring the capital structure of hundreds of agricultural banks. The farm economy will recover in time, providing a basis for greater earnings and replenishment of the capital

structure of agricultural banks. In the meantime, we need special measures to prevent banks' capital from being precipitously eroded by requirements that banks offset problem farm loan assets whose market value has been reduced.

Our first priority as a means of preserving banks' capital is to change regulatory accounting procedures and enable prudently managed banks to amortize their loan losses over a multi-year period. Such a procedure is relatively simple to administer, would assist a broad segment of banks and their borrowers, and would entail no direct government cost.

Two other options that warrant consideration as ways to assist banks in maintaining adequate capital during this stressed period in agriculture are:

- regulator-assisted injections of capital into certain troubled banks. (For example, a qualifying agricultural bank might acquire additional capital from the Federal Deposit Insurance Corporation in the form of debt or equity.);
- unfunded capital certificates similar to net worth or income capital certificates currently used for certain thrift institutions.

Because of the potential direct impact on bank's capital, we shall also focus careful attention on proposed changes to the Internal Revenue Code. For example, banks can currently carry net operating losses back ten years and obtain refunds for taxes paid in those years, thereby increasing capital. Proposed tax reform legislation would change the carryback period to three years and any excess losses would be carried forward. If this change were to become law, agricultural banks now incurring net operating losses would lose some of their ability to maintain an adequate level of capital.

We will work with the Administration, the bank regulatory agencies, and the Congress to obtain action early this year to relieve pressure on agricultural banks' capital structure.

#### Stabilization of Agricultural Borrowers

While we need action early this year to stem the erosion of agricultural banks' capital accounts, we also need stabilization of agricultural borrowers' debt situations and ability to cash flow their debt. For that purpose, we recommend further expansion of the Farmers Home Administration (FmHA) agricultural loan guarantee programs and authority. In the current budgetary situation, the FmHA loan guarantee program is the least costly means of stabilizing and extending agricultural debt. In addition, expansion of the \$490 million interest rate buy-down program included in the 1985 Farm Bill would provide major cash flow assistance to agricultural borrowers at minimal direct cost. We also need clarification this year of the FmHA's preparedness to provide direct loans to qualifying farmers who cannot be financed in full by commercial lenders.

#### Stabilization of Farm Real Estate Values

We seek the development of an institutional secondary market for longer term real estate loans originated by commercial banks. A secondary market would provide access to additional funds and diversify the risks and returns

from farm lending. One option is to pool FmHA-guaranteed loans for resale as mortgage-backed securities to investors.

Proposals for warehousing of problem agricultural loans and/or acquired assets also merit continued examination. Permitting banks to hold real estate assets for a longer period of time also merits consideration. Stabilizing land values is necessary to restoring health to the agricultural economy.

ABA-IBAA TASK FORCE  
ON  
AGRICULTURAL CREDIT

Chairman (1)

Randall A. Killebrew  
President  
First National Bank  
P.O. Box 299  
Petersburg, IL 62675

Members (12)

Mel Adams  
President  
Keith County Bank  
315 North Spruce Street  
Ogallala, NE 69153

B. F. "Chip" Backlund  
President  
Bartonville Bank  
1220 Savings Center Tower  
Peoria, IL 61602

Michael E. Fitch  
Vice President, Agribusiness Affairs  
Wells Fargo Bank, N.A.  
475 Sansome Street, 14th Floor  
San Francisco, CA 94163

Bud Gerhart  
President  
First National Bank  
P.O. Box 479  
Newman Grove, NE 68758

Glen E. Lemon  
Chairman and Chief Executive Officer  
First Bank and Trust Company  
P.O. Box 200  
Booker, TX 79005

Paul E. Lindholm  
Chairman and President  
Farmers & Merchants State Bank  
P.O. Box 248  
Clarksfield, MN 56223

Howard L. McMillan, Jr.  
President, Deposit Guaranty Corporation  
P.O. Box 1200  
Jackson, MS 39205

J. Bruce Meriwether  
President  
The First National Bank  
Box 148 - 7th and Town Clock Square  
Dubuque, IA 52001

Mark W. Olson  
President  
Security State Bank  
P.O. Box 715  
Fergus Falls, MN 56537

Tom Olson  
President  
Lisco State Bank  
P.O. Box 105  
Lisco, NE 69148

Harold A. Stones  
Executive Vice President  
Kansas Bankers Association  
707 Merchants National Building  
Topeka, KS 66612

Alan Tubbs  
President  
First Central State Bank  
914 Sixth Avenue  
De Witt, IA 52742



OFFICE OF THE CHAIRMAN

January 21, 1986

*Harold*  
Dear Mr. ~~Stones~~.

Thanks for your letter of December 30. It was my pleasure to meet with the Kansas bankers. I think we all agree that opening the lines of communication between the FDIC and members of the banking community will go a long way toward solving some of the concerns and frustrations of the banking community. I am also very interested in the recommendations of the Task Force on Agriculture. This task force issue paper is another important example of working together to resolve issues.

As you know, the FDIC postponed the effective date of the proposed limited disclosure plan developed last May. We feel that this postponement will give us an opportunity to create, with other federal regulators, a uniform approach for disclosure, and an approach that will be acceptable to both the public and the banking community.

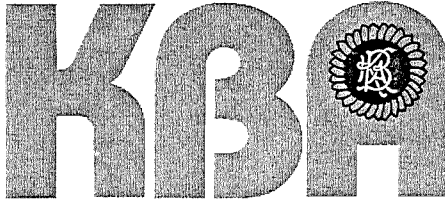
I look forward to hearing from you soon.

With best wishes.

Sincerely,

L. William Seidman

Mr. Harold Stones  
Executive Vice President  
The Kansas Bankers Association  
707 Merchants National Building  
Eighth and Jackson  
Topeka, Kansas 66612



The KANSAS BANKERS ASSOCIATION  
A Full Service Banking Association

January 28, 1986

The Hon. William Seidman, Chairman  
Federal Deposit Insurance Corporation  
FDIC Building, 550 17th Street, NW  
Washington, DC 20429

Dear Chairman Seidman:

This communication is a result of a special meeting of the KBA Task Force on Agriculture, and was called for the express purpose of making suggestions to you prior to your appearance before the Senate Committee on Banking, Housing and Urban Affairs. The KBA Task Force is responding directly to your request for input during your most positive visit with us last December 20. We have taken your request seriously; the paper which follows is the result of considerable thought and study, and sums up our best effort concerning recommendations for agricultural banks.

#### **PREAMBLE**

We would first ask you to stress that the agricultural credit issue is of NATIONAL proportion and is a NATIONAL problem. We are concerned that this is not universally accepted in Congress. We will not dwell on all the data which supports such a conclusion, because you already are familiar with them, but we believe such a concept needs to be stressed by someone with your perspective and stature.

#### **I. CAPITAL MAINTENANCE**

Our goal is to work toward the survival of the responsible, well-managed bank, whose difficulties stem from the current temporary economic decline we are now experiencing. If survival is assured, then that bank can continue to responsibly serve its agricultural customers and its agricultural community. Without such survival, many rural communities will simply cease to exist. Therefore, the survival of the bank is crucial to the customers who are to be served.

We would suggest that if any industry today is subjected to a 50% decline in asset value, severe stress and turbulence will occur. We compliment many agricultural bankers for managing so very well, even many of those in banks with problems. Not all sectors of our society could manage nearly as well given a similar set of circumstances.

The root of the problem is loan losses, and their immediate effect on the capital structure of the bank. It is difficult, if not impossible to attract additional private capital in today's economic agricultural environment. Therefore, loan losses may be sufficient to render the bank

Office of Executive Vice President • 707 Merchants National Building  
Eighth and Jackson • Topeka, Kansas 66612 • (913) 232-3444

(OVER, PLEASE)

*Atch. III*  
*S. FII 2/20/86*



insolvent, whereas, if given assistance and time, the responsible, well-managed bank could be expected to survive and in the future again become a profitable, viable community institution. It is this kind of bank which we address, and about which we are very concerned.

We strongly ask consideration for some type of "Capital Maintenance Assistance." Such assistance could take several forms, such as:

- A. Amortization of loan losses over time;
- B. Temporary relaxation of capital requirements;
- C. Some type of capital certificate plan;
- D. Direct infusion of capital in exchange for some type of security, as was successfully accomplished by the Reconstruction Finance Corporation during the last severe ag recession.

Of the options presented above, we favor amortization of losses over time, because this could prevent a bank from ever being in the critical position of needing relaxation, certificates or direct infusion, and would seem to give the banker greater freedom for customer renegotiation, which should strengthen both the bank and its problem customers. We believe such amortization should be for at least five years in order to be effective.

We would contemplate that before a bank would be considered qualified for such Capital Maintenance Assistance, it would be required to submit a detailed plan to all relevant regulators, and perhaps to another bank, if such bank held a stock loan. The plan should contain specific actions which would be designed to achieve future profitability and soundness. Such a plan would be unilaterally approved by the relevant regulators before such bank could become eligible, and the plan would need frequent periodic review by the regulators. This would insure that such assistance would be granted to responsible institutions; to institutions with a reasonable chance for future success whose problems are the result of adverse economic conditions.

We truly believe such a program as outlined above would not result in a wholesale abuse of assistance which simply leads to greater problems over time, as has happened to a segment of the thrift industry. We believe the Congress and Administration may look upon recent experiences of certain thrifts and be very reluctant to grant an assistance package to agricultural banks, but we believe the above plan would eliminate the problems which occurred when no apparent plan for the future was submitted. The above "Capital Maintenance Assistance Plan" is our highest priority.

## II. ADVERSE TAX CONSEQUENCES

Current IRS Code requirements are very harmful to ag banks and their customers. Let us assume a situation where a farmer has \$100M basis in land with \$150M current market value and a loan secured by such land for \$200M. Assume the farmer and banker mediate an agreement which would allow the bank to assume ownership of the land in return for the forgiveness of debt.

The \$50M difference between basis and current market value capital gains tax will have to be paid by the farmer. But the \$50M difference between loan balance and current market value will have to be declared ordinary income by the farmer, unless he/she is adjudged bankrupt or insolvent. This ordinary income factor has stopped many voluntary loan workouts, and has moved farmers to Chapter 7 and 11 bankruptcy courts faster than anything else. We would not quarrel with the capital gains tax, but the ordinary income resulting from loan forgiveness should be waived, and the IRS Code amended to accommodate such waiver.

### **III. FDIC ADVOCACY**

Kansas bankers were thrilled to hear you refer to us as your "customers", and your comments that all insurance companies, including the FDIC, should be interested in keeping their clients "alive" as long as possible. We applaud your attitude and urge its continuance. When adverse legislation, such as UCC Farm Products' Clear Title or Chapter 13 Bankruptcy application to farmers is presented in the future, which adversely affects the safety and soundness of banks, we will very much appreciate FDIC's early and strong response to Congress.

### **IV. DISCLOSURE**

Although this may not be a legislative issue, we repeat our plea for eliminating discrimination in disclosure regulations. Until all financial institutions who compete for the consumer's depository dollar, are required to disclose in a uniform manner, then the application of this requirement to only a few of us is extremely detrimental to our public confidence factor.

Surely minimum standards of uniformity would include the Federal Home Loan Bank Board and the National Credit Union Administration in any decision agreed upon by FDIC, OCC and the Federal Reserve Board. Without them, any disclosure regulation will be extremely discriminatory.

We implore you to insure that disclosure regulations are applicable to all or to none, in the name of simple fairness.

### **V. FUTURE PROFITABILITY OF BANKS**

Since one of the most important factors in safety and soundness of banks is profitability, one of our most important goals is to enable the bank additional sources of revenue. Banks need to achieve additional powers so that they can provide a full range of services to their customers, such as insurance, securities brokerage and real estate brokerage powers. This would give us equality with other types of non-bank financial institutions such as department stores and brokerage houses, as well as with savings and loan service corporations. In addition, less of the load of revenue production would have to be borne by the borrower.

The Hon. William Seidman  
January 28, 1986  
Page Four

\* \* \* \* \*

Chairman Seidman, again, please accept our thanks for coming to Kansas, and for giving us this opportunity for input. Please accept our best wishes for continued success.

Yours most sincerely,

Harold A. Stones  
Executive Vice President

HAS/mjw



The KANSAS BANKERS ASSOCIATION  
A Full Service Banking Association

January 28, 1986

The Hon. Bob Dole  
United States Senator  
SH-141 Hart Senate Office Bldg.  
Washington, DC 20510

Dear Senator Bob:

This letter will follow up oral communications I have had with Mike Pettit and John Petersen concerning areas of legislation which we believe agricultural banks badly need. This letter contains a communication written at the request of FDIC Chairman Seidman during his December 20 visit to Kansas. This was a very positive meeting, and we thank you for arranging it.

You will note that our highest priority is for some kind of "Capital Maintenance Assistance" which we would like to see in the form of a five-year minimum amortization of loan losses over time. We believe this could save responsible, well-managed banks from their temporary economic problems, and (as we have outlined in the Seidman letter) a plan could be submitted so that banks do not simply dig deeper problems for themselves as has occurred in certain segments of the thrift industry.

We also outlined a need for legislation to correct adverse tax consequences to the borrower when voluntary loan workouts are in the process. Under Section II of the Seidman paper, we attempt to outline this problem in detail.

Sen. Bob, we very much appreciate your time and effort in our behalf, and stand ready to work to assist this legislative project in every way possible. If there are specific research efforts which need to be undertaken, testimony to be presented, or meetings to be held, the KBA will enthusiastically follow any of your suggestions.

We thank you very much for your interest and your assistance.

Cordially,

Harold A. Stones  
Executive Vice President

HAS/mjw

cc: KBA Governing Council  
KBA Federal Affairs Committee  
KBA Task Force on Agricultural Opportunities

Friday, January 31, 1986

To: Bill Duvors  
FEE

# Treasury Readying Expanded Banking Bill

## Expect Call for New Powers, Thrift Aid; but FDIC Takeover of FSLIC Unlikely, Says Seidman

By ROBERT TRIGAUX

WASHINGTON — William L. Seidman, chairman of the Federal Deposit Insurance Corp., met Thursday with Treasury Department officials who are busy drafting a banking bill that sources say is expected to be introduced in Congress as early as this spring.

The bill, observers suggest, will resemble closely the department's major deregulation proposal of 1984 and will call for expanded powers for banks, particularly in the securities field. In addition, the Treasury Department bill — or a separate proposal — may contain legislative proposals on deposit insurance reform, especially plans to help shore up the troubled Federal

Savings and Loan Insurance Corp.

In a wide-ranging interview, Mr. Seidman declined to provide specifics of the bill but said he suspected proposals for bank deregulation would be part of the Treasury draft. He also said that plans once pushed to merge the FSLIC into the FDIC are now only a remote possibility.

"As far as I know, that proposal is not alive," Mr. Seidman said.

The Treasury bill, according to sources, will promote a general expansion of bank powers, but most observers are keying on the new elements from the Treasury Department to aid the FSLIC. Among the options Treasury is considering is providing the

Plans to merge the FSLIC into the FDIC are now remote. 'As far as I know, that proposal is not alive.'

— William L. Seidman



FDIC

FSLIC with promissory access to funds — possibly from the Federal Home  
→ Seidman: Page 14

(COVER, PLEASE)

# Seidman . . .

Continued from Page 1

Loan Bank System and the Treasury — to help shore up public confidence in the thrift insurance fund.

The goal, as one observer described it, would be to restrict the size of many of the nearly 500 deeply troubled thrifts and keep them under tight regulatory control while the remaining healthy part of the thrift industry grows. One option, borrowed from recent legislation to aid the Farm Credit System, would be to empower the FSLIC or its governing body, the Federal Home Loan Bank Board, to shift assets within the Federal Home Loan Bank System and to offer a large credit line from the Treasury. Other options still being reviewed are additional insurance assessments on the thrift industry, ways to shore up the thrift industry's capital, and the ongoing development of the so-called "406 Corp." to sell off FSLIC-held assets of failed thrifts.

In addition, observers note, the Treasury Department is examining means to sell off combinations of healthy and sick thrifts to nonthrift companies, including bank holding companies. Generally, banking organizations thus far have been restricted to bidding for troubled thrifts.

During the interview, Mr. Seidman also noted that:

- The FDIC this year may begin recording losses from its 1984 rescue of Continental Illinois. Mr. Seidman cited criticism by a General Accounting Office report of the FDIC's failure to report losses from the rescue, "so we have to clear that matter out."

- Included in nearly 10 bank supervision ideas being studied by the agency are proposals to permit loan losses to be amortized over longer periods of time and to make available net worth certificates, or regulatory promissory notes, to assist all types of troubled commercial banks — not only agricultural banks. "It's my sense that politically it would be very difficult to restrict them to one kind of bank. Other banks with other interests could make a comparable case," Mr. Seidman said. He will testify before the Senate Banking Committee on the agricultural bank problem on March 8, and on deposit insurance reform a few days later.

- The agency backs in principle the Federal Reserve proposal to introduce a risk-based capital plan to the banking industry. The FDIC will unveil its own version of a risk-based capital program within a few weeks, according to Mr. Seidman. He said that risk-based insurance premiums, which must gain congressional approval, can coexist well with risk-based capital plans, which can be introduced by regulation. "I don't think they are alternatives at all. Both are efforts to try and bring a marketplace type of discipline by trying to evaluate risk," he said.

- On his own appointments to the FDIC, Mr. Seidman said he is still looking and interviewing. He suggested the structure of the agency could change at the top. "I'm looking for the 'Refrigerator' of regulators," he said, referring to Chicago Bears lineman William Perry.

- On disclosure rules, he said the FDIC will await the outcome of the Comptroller of the Currency's review of the issue in February. The two agencies, along with the Federal Reserve and the Bank Board, will seek a compromise on the issue, he said. Of the Fed, Mr. Seidman conceded that "I've noticed no great enthusiasm on their part for it."

- There is no new word from the White House on the expected appointment of C.C. Hope, a former president of the American Bankers Association, to join the FDIC board of directors. Irvine Sprague, whose term has expired, remains in that post at the agency. ■

# Farm Lender Posts '85 Loss Of \$2.7 Billion

## Farm Credit System Cites Bad Loans, Accounting And Regulatory Woes

By CHARLES F. MCCOY

Staff Reporter of THE WALL STREET JOURNAL

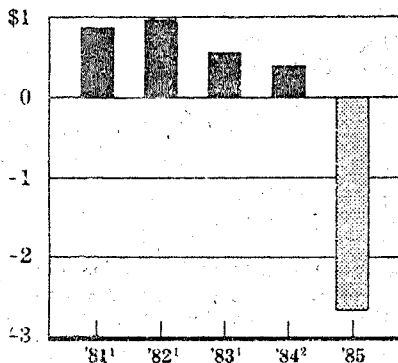
The Farm Credit System reported a \$2.7 billion loss for 1985, by far the largest annual deficit posted by a U.S. financial institution.

The loss was in line with what the farmer-owned system has been projecting since late last year when it was forced to seek a government rescue from a morass of bad farm loans, dubious accounting and lax regulation. Last December, Congress passed legislation giving the agricultural lender access to Treasury funds once the system reorganizes itself and exhausts its own resources.

Those resources are rapidly dwindling. The system reported that non-accrual

### Farm Credit System: Now Deep in the Red

Profit and loss, in billions of dollars



<sup>1</sup>Includes only results of the system's 37 main banks

<sup>2</sup>Restated to consolidate results of all system lending outlets

loans—those on which no payments are being recorded—swelled to \$5.32 billion, or 8% of total loans, as of Dec. 31, compared with \$1.84 billion, 2.2% of loans, a year ago. It had \$928 million in other non-earning assets—mainly foreclosed farmland—and an additional \$4 billion in substandard credits it calls "other high risk" assets. The system's primary capital, funds available to offset losses on those troubled assets, totaled just \$6.59 billion at year-end.

Last year, the system earned \$373 million. Year-ago figures are restated because the system has consolidated hundreds of its local lending outlets, some of which formerly reported results separately.

### System's Feeble Condition

The system's feeble condition and huge 1985 loss, more than twice Continental Illinois Corp.'s \$1.08 billion 1984 deficit, underscore the federal government's ballooning exposure to costs stemming from the farm economy's decline.

The system holds \$66.62 billion of the nation's \$210 billion farm debt. The Farmers Home Administration, a government agency, holds another \$28 billion. According to a recent General Accounting Office report, more than half of the FmHA debt is owed by farmers whose debts exceed 70% of their assets—usually the point of no return for farmers; most farm experts don't think the agency will recover much of that. The losses of the Farm Credit System, the FmHA and farm banks backed by the Federal Deposit Insurance Corp. may ultimately cost the government \$15 billion to \$20 billion, many farm economists believe.

"The agriculture collapse will make all previous government financial interventions look like nickel and dime stuff," said Neil Harl, an economist at Iowa State University.

The Farm Credit System's provision for loan losses in 1985 jumped ninefold to \$3 billion. Loan write-offs nearly tripled to \$1.11 billion. At Dec. 31, the system's reserve for future loan losses stood at \$3.19 billion, almost three times the year-earlier level.

### Accounting Switch

Those huge increases partly reflect the system's wrenching switch to the "generally accepted accounting principles" used by most publicly held corporations. For years, the system relied on homemade accounting rules that masked the severe deterioration in its loan portfolio. The system's 1985 results, however, received an unqualified audit opinion from Price Waterhouse, the Big Eight accounting firm called in this year to conduct the first audit in the system's 53-year history.

The system's results suggest that it has been hurt badly by borrower defections. The system's \$66.61 billion in loans represents a drop from \$78.48 billion at Dec. 31, 1984. Only \$1.11 billion of loans were written off, indicating that billions of dollars of loans were pulled out by farmers worried about the system's condition or angered by some of its actions. System bankers say the defectors generally are the more solvent borrowers who can get credit elsewhere; the loss of those good loans damages the system by increasing its concentration of troubled credits.

The system's giant loss didn't ruffle the market for the bonds it sells to raise funds. Since Congress passed its rescue measure, the yields on the bonds have narrowed to between 35 and 55 basis points above comparable Treasury bill yields. Before the

bailout bill, the system had to pay premiums of as much as 130 basis points above comparable Treasury bills, deepening its operating loss. Before its troubles became known, system bonds traded at only two to five basis points above Treasury bills. A basis point is 1/100th of a percentage point.

As troubled as the system is, the GAO study suggests FmHA may be in worse shape. Considered the farm lender of last resort, its average borrower has a debt-to-asset ratio of 83%. About one in eight of its borrowers hasn't made a payment in more than three years. Just between January 1985 and July 1985, it dished out almost \$3 billion to farmers with debt-to-asset ratios greater than 70%. "That's just money down the rat hole," a former FmHA official said.

Attachment III

# Economic & Marketing Information

for Missouri Agriculture

Vol. XXVIII, No. 8

August 1985

Department of Agricultural Economics, 200 Mumford Hall, Columbia, Missouri, 65211

TO K&A Gen. Council  
K&A Trade Forum Ag  
K&A Fed. Del. Com

## FARM CREDIT SITUATION: IMPLICATIONS FOR AGRICULTURAL POLICY

J. Bruce Bullock  
Chairman, Agricultural Economics

FROM: HAB —  
A very succinct  
summary of our present  
situation! —

### Cause of the Financial Stress

There is financial stress in the agriculture. USDA reports that about 386,000 farms have less than 60 percent equity in their farm businesses. By early 1986, the USDA estimates, about six percent of U.S. family size commercial farms will have negative net worth. They also estimate that if current economic conditions continue, an additional 2.8 percent of family farms will become insolvent each year.

The current financial problems were created because debt expanded annually by the amount of increases in asset values rather than at the rate dictated by growth in repayment capacity (Table 1). Repayment capacity from farm earnings never existed for a large part of the agricultural debt expansion over the past 10 years.

There is more farm debt than can be repaid from farm and non farm income of those who owe the debt. High interest rates and the strong value of the dollar compound the pressures created by the excess debt situation.

Borrowing money against inflated asset values with inadequate earning capacity for debt repayment makes sense only if inflation continues forever, or if the assets are sold at their inflated value (and the debt repaid) prior to termination of inflation. Obviously, neither of these developments occurred. Inflation was drastically slowed and the inevitable decline in land values came. Land values established in 1981 made sense only if inflation continued at levels anticipated in 1981.

The symptoms of an excess debt situation are increasing inability of borrowers to make interest and principal payments on schedule and a subsequent increase in loan foreclosures and bankruptcies. The observed rise in loan delinquencies has occurred simultaneously with record levels of real interest rates and substantial increases in the value of the U.S. dollar. Thus, government economic policies designed to bring inflation under control have been blamed for much of the financial problems in agriculture. Most of the policy proposals for dealing with the farm finance situation have focused on treating the negative cash flow and loan delinquency symptoms of the excess agricultural debt rather than on correcting the problem itself. Those who view high interest rates and the strong dollar as causes of the current farm finance situation have tended not to look beyond these factors in their search for the causes and cure of the farm finance problem.

The decline in land values consumed farmers' equity and hence their lenders' margin of collateral. Consequently, the debt/asset ratios of farm borrowers increased and the quality (as measured by collateral margin) of the lenders' agricultural loan portfolio declined.

Declining land values removed the impression of financial well being that both farmers and their lenders had for the past 10 years. Without the umbrella of inflation driven increases in land values to collateralize expanded debt to cover cash flow shortages, the agricultural sector is faced with rising delinquency rates on farm loans and increasing numbers of loan foreclosures and bankruptcies.

<sup>1</sup>USDA, "The Current Financial Conditions of Farmers and Farm Lenders," Economic Research Service, Agricultural Information Bulletin No. 490, March 1985.

USDA data showing the cash flow deficiencies of financially stressed farmers suggest that the magnitude of farm debt swamps the impact of "high" interest rates for most farms experiencing financial stress. Reducing current interest rates by 50 percent (100 percent in some cases) would not eliminate the cash shortfall of farms with excess debt.



TABLE 1

## KEY INDICATORS OF CHANGES IN ECONOMIC HEALTH IN U.S. AGRICULTURAL SECTOR

	Net Farm Income Bill \$	Value of Farm Assets Bill \$	Farm Debt Bill \$	Incomes as % of Asset Value	Debt Asset Ratio	Farm Debt ÷ Net Farm Income
1940-49	11.8	90.3	9.45	13.1	.11	.80
1950-59	12.8	171.5	17.3	7.5	.10	1.35
1960-69	12.4	247.4	36.7	5.0	.15	2.96
1970-79	23.6	521.9	83.7	4.5	.16	3.55
1980	21.2	1005.5	159	2.1	.15	7.50
1981	31.0	1089.8	175	2.8	.16	5.65
1982	22.3	1083.5	202	2.1	.19	9.05
1983	16.1	1045.2	216	1.5	.21	13.42
1984 <sup>1</sup>	31	1031.1	215	3.0	.21	6.94
1985 <sup>2</sup>	22	NA	217			9.87

<sup>1</sup>preliminary

<sup>2</sup>forecast

Excess debt (debt that cannot be repaid from income generated by the asset purchased with borrowed capital) is the cause of the current financial stress in agriculture.

How much excess debt is there? USDA data indicate that there is approximately \$50 billion of agricultural debt that cannot be paid from current income (both farm and non farm sources) of farmers owing that debt.<sup>2</sup> This is 23.5 percent of the total debt owed by U.S. farmers. Three fourths of this excess debt is held by farmers with less than \$100,000 in annual gross sales. Forty-five percent of the debt is owed by farms with less than \$50,000 annual sales.

<sup>2</sup>Bullock, J. Bruce, "Farm Credit Situation: Implications for Agricultural Policy." FAPRI #4-85, Department of Agricultural Economics, University of Missouri-Columbia, March 1985.

### Policy Options and Their Potential Effectiveness

#### Provide Higher Price Supports

Many point to higher farm commodity prices as a cure for any problem facing agriculture. However, USDA data call into serious question the capacity of higher support prices to solve the current financial problems in agriculture. Farm prices would have to be increased far beyond likely acceptable levels to correct the financial problems for most of the 386,000 farms with the most severe financial stress.

Price support increases of this magnitude are not feasible. The current financial problems of U.S. agriculture are too large to be solved by price and income support programs alone. Somehow the debt must be decreased.

#### Provide Government Loan Guarantees

Government loan guarantees do not increase the repayment capacity of farmers with

financial problems. A loan guarantee program will successfully deal with the financial stress problem only if the program requires that the excess debt situation of the borrower be corrected as a precondition for obtaining the loan guarantee. Otherwise the unavoidable wealth losses required to correct the excess debt problem will be transferred from borrowers and lenders to the government (assuming the government does not confiscate the assets of the defaulting borrower). Government loan guarantees are certainly a viable policy option, but they should be recognized as a loss transfer mechanism.

#### Add Liquidity to the Land Market

One proposal is an agency to purchase land. The agency would give strength and liquidity to the land market and lease the land back to the farmer so that the farming operation could be continued. If the land purchase agency expected to receive a competitive return on funds invested in land purchases and if land were purchased at a price equal to the selling farmer's debt, the lease payments would be about the same as the interest payments the farmer had been making on the land debt. The borrower's title would be traded for release from making principal payments.

The land purchase/lease back agency would completely solve the cash short fall problems only for about 20 percent of the highly leveraged farms. The remaining farms would still have several thousand dollars in annual cash short falls.

The land purchase proposal does deal directly with the problem of excess debt. It removes the burden of principal payments from the farmer, but does not remove interest payment obligations.

#### Expand Government Loan Programs

More credit, even at subsidized interest rates, is not the solution to excess debt. A strong case can be made that liberal government lending policies promulgated by Congress through FmHA have already compounded rather than eased the farm credit problem. Government lending programs provided 20 percent of the growth in non real estate farm debt over the past 12 years. FmHA operating loans increased 70 percent in 1976. This was followed by annual increases of more than 50 percent over the 1978-80 period. FmHA provided 34 percent of the increase in farm non real estate debt during the 1979-82 period. FmHA market share of non real estate farm debt

increased from 3 percent in 1973 to 15 percent in 1983.

Much of this debt was for disaster loans. Disaster loans are not a help for farms that already have more debt than can be repaid. Borrowed funds can profitably be used only on investments that yield a return higher than the interest rate at which the funds were borrowed. Paying last year's production expenses on a failed crop from borrowed funds produces no return on investment. There is a genuine need for farm programs to provide mechanisms for disaster relief. However, to avoid doing more harm than good this disaster relief must take the form of grants or indemnity payments from insurance. Providing farmers with money to deal with disaster should not make the business financially less sound.

#### Do Nothing

One policy option is to simply let the chips fall where they may. This would mean that the losses will be shared between borrowers and lenders. A do nothing government program would result in a substantial transfer of asset ownership from borrowers to lenders and/or a substantial increase in the amount of land sales. Land prices have already fallen 33 to 47 percent in the Corn Belt. Forcing the complete adjustment to occur through land sales would generate additional declines in land values--something which may occur regardless of the policy selected. However, a do nothing policy is likely to cause an over reaction in land prices in the short run.

A do nothing policy is workable. The market will adjust. The results will include a substantial increase in the number of loan foreclosures and farm bankruptcies. It will also result in a substantial increase in the number of agricultural bank failures. An agriculture and a lending industry would emerge after a do nothing policy, but a do nothing policy would bring major structural changes in both industries. The impacts of these changes would spill over into main street of rural communities. Policy makers will have to decide if these changes are an acceptable price to pay for getting rid of excess debt.

#### Remove Excess Debt

Solution to the excess debt problem requires that the excess debt and associated principal and interest payments be removed from the agricultural balance sheet and cash flow. Public policy will determine how these wealth transfers are distributed among borrowers, lenders, and the government.

## Conclusions

The magnitude of the excess farm debt problem requires large scale and immediate corrections. Failure to correct the problem will completely consume the equity of farmers holding the excess debt. Failure to correct the problem will also threaten the economic viability of financial institutions currently providing credit to agricultural producers.

There seems no way of avoiding the wealth transfers and losses resulting from creation of the excess debt and the asset devaluations that followed. Failure to recognize the losses and to terminate the growing debt service obligations associated with the excess debt compounds the problem.

The challenge facing policy makers is to determine how those losses are to be distributed among borrowers, lenders, and the government.

High interest rates per se are but part of the problem. The problem is so large that interest rate subsidies could provide only partial relief to the symptoms of the excess debt problem.

The magnitude of the excess debt problem renders price support policies ineffective as a solution. The farm finance problem must be dealt with separately from price and income policies. The finance problem should be dealt with before price and income policies of the 1985 farm bill are developed.

A policy decision should be made quickly. If there is to be relief through government programs, it should be implemented as soon as possible to terminate the losses and the dis-

ruption caused by the current situation. If the decision is to do nothing, then lenders and borrowers need to know that so they can initiate immediately the adjustments to minimize losses.

\* \* \* \* \*

### Editor's Comment

Professor Bullock's analysis is stark. It does not dwell on the pain of current adjustments. It does correctly point out that there is too much debt and the real question is about who will "eat" it when the jugglings stops.

The analysis does not say what we all know. If the government ends up with the excess debt, it will be passed to the citizens - those who pay taxes and those who are the recipients of government programs which would be cut as a result.

How we decide to deal with the farm credit situation will affect who owns the land. One reviewer of this newsletter asked "Why should the public care who owns the land? Someone will farm it." The question is relevant, but it misses an important point. It does not deal with the speed at which adjustment can be absorbed without producing social disruption. I think we run real danger of taking change faster than we can assimilate it.

Not said at all is that current pressures may be seen as a way in which farm production costs and land costs are being pushed downward to create a domestic agriculture which must have lower costs in order to be competitive internationally.

*Robert J. Bevins*  
Robert J. Bevins  
Extension Economist

COOPERATIVE EXTENSION SERVICE  
U.S. DEPARTMENT OF AGRICULTURE  
UNIVERSITY OF MISSOURI  
CLARK HALL, COLUMBIA, MISSOURI 65211

OFFICIAL BUSINESS  
PENALTY FOR PRIVATE USE, \$300

*Rumpelstilzchen spun straw into gold. Last quarter dozens of leading businessmen spun past sins into current virtue.*

## Rumpelstilzchen accounting

*(GAAP Accounting in business & GAAP Accounting in banking are TWO different animals) - i.e. - NO ONE tells business WHEN to take chargeoffs - They don't have regular examinations!! FORBES suggests an AMORTIZATION OF LOSSES*

By Ben Weberman

**H**AS STANDARD OIL Co. (Ohio) Chairman Alton W. Whitehouse been rereading the story of Rumpelstilzchen, who spun straw into gold? In Sohio's fourth-quarter 1985 report, just out, Whitehouse says that Sohio's profit (\$379 million) "would have increased 11%" over 1984's fourth quarter—only it didn't. Why not? A little matter of a \$1.15 billion writeoff. And what's a writeoff among friends? Just a paper entry. An "extraordinary" charge.

Or is it "just" a paper entry? In Sohio's case the writeoff is a confession that Sohio blew well over \$1 bil-

lion of shareholders' money when it decided to acquire Kennecott, the big copper-mining company. Sohio paid \$1.8 billion for Kennecott five years ago. Did its value fall by \$1 billion in a single quarter? No. It was a bad deal from the beginning, overpriced and ill-timed.

Hold it: Doesn't this suggest that Sohio was actually overstating its earnings over those five years that the Kennecott investment was deteriorating? Certainly it was evident well before Dec. 31, 1985 that the acquisition was a bad mistake.

Sohio portrays the writeoff as a brave and virtuous step. "We've

streamlined the company," explains Sohio spokesman John Andes. "It gets us in shape to deal with the market and proceed as a very healthy company into 1986."

Past sin into future virtue. Bad judgment into praiseworthy realism.

David Hawkins, a finance professor at the Harvard Business School, isn't impressed. "The writedowns are usually taken well after the events actually occurred," says Hawkins, "which makes you think you can't believe any of the numbers over the last few years."

Rumpelstilzchen accounting, also

Chas. B. Slackman

known as Big Bath accounting, was used by dozens of businessmen in 1985's fourth quarter. It seemed a good time to take the hit. The stock market was strong enough to absorb the modestly bad news, and, besides, everyone was doing it.

Why do managers wait so long to take their medicine? Why are they so reluctant to write down assets on a regular basis? "Because it doesn't make them look like very good stewards of shareholders' interests," says a partner at Arthur Young & Co., who asked not to be identified, "particularly if they were the ones who said, 'Let's buy this business.'"

Avon Products' Chairman Hicks B. Waldron took the Big Bath. Waldron recently informed shareholders that he sold Avon's Mallinckrodt, Inc. division and booked a charge of \$223 million in last year's fourth quarter. The charge washed fourth-quarter net income from \$73.7 million in 1984 to a loss of \$140 million in 1985.

Weren't Avon's pretax earnings then overstated by \$223 million, up until the writedown? A reasonable question. But Waldron ignored that. Accentuating his "asset redeployment program," Waldron said he expected "earnings to improve steadily in 1986."

An immediate benefit, of course, of a Big Bath is to make your vital return on equity number look better. If you decrease the denominator faster than the numerator, the value of any fraction will grow to the sky.

When T. Boone Pickens was chasing after Unocal, for example, Fred Hartley stoutly defended Unocal's shale oil investment. With Pickens out of the way, Hartley wrote the investment off in last year's fourth quarter, at a cost of \$250 million. The beauty of Big Bath accounting is that you decide when to face the music.

A modest proposal: Let managements take their Big Baths subjective-

ly, but make them take the charges against future earnings, rather than bunching them up in one quarter's accounts as a special item. Since management overstated past earnings, why not make them understate future earnings to compensate? This is not allowed under current accounting rules, but say this for such a proposal: It would make managements pay for their mistakes where it really hurts.

Nothing wrong with admitting mistakes, but don't expect investors to forget that many of these same managements were responsible for the bad judgment in the first place. ■



## Kansas Legislative Policy Group

301 Capitol Tower, 400 West Eighth, Topeka, Kansas 66603, 913-233-2227

TIMOTHY N. HAGEMANN, Executive Director

February 20, 1986

### TESTIMONY

to

SENATE COMMITTEE

on

FINANCIAL INSTITUTIONS and INSURANCE

Senate Bill 555

Mr. Chairman and members of the Committee, I am Chip Wheelen of Pete McGill and Associates. We represent the Kansas Legislative Policy Group which is an organization of County Commissioners from primarily rural areas of the State. We appear today in support of the provisions of SB 555.

For those of you who are not acquainted with the KLPG, we should point out the unique characteristics of our tax base. Our assessed valuations are principally attributable to two types of property; agricultural real estate and minerals production. This means that many of our taxpayers are either farmers or oil and gas producers.

We do not believe it is necessary to describe for you the unfavorable conditions that have affected our agri-business sector and the minerals industry. You are well aware of these facts. The important point is that these taxpayers depend to a great extent upon local banks for the credit necessary to finance their farming and business operations.

We believe that enactment of SB 555 would assist toward allowing our local banks to continue making loans to the people who finance our local governments because their property comprises our tax base. To county officials, it could mean the difference between collecting property taxes and issuing delinquency notices. For this reason, we respectfully urge you to recommend SB 555 favorable for passage.

*S. FII 2/20/86  
Attachment IV*

TESTIMONY  
before the  
HOUSE COMMITTEE  
on  
COMMERCIAL & FINANCIAL  
INSTITUTIONS

by  
Charles I. Moyer

Kansas Independent  
Bankers Association

February 20, 1986

S. FII 2/20/86  
Attachment V

TESTIMONY

before the

HOUSE COMMITTEE ON COMMERCIAL AND FINANCIAL INSTITUTIONS

Charles I. Moyer

February 20, 1986

Mr. Chairman and Members of the Committee:

My name is Cy Moyer, Executive Vice President of the First National Bank of Phillipsburg, Kansas. I am here on behalf of the Kansas Independent Bankers Association in support of Senate Bill 555.

SB 555 provides assistance and needed flexibility for farmers and businessmen and their banks by allowing amortization of loan losses. There is a need for such legislation in rural Kansas.

For a returning strong rural economy in Kansas, we need to keep the viable farmers and rural businessmen in business. We need to develop strong policies to stabilize Kansas farm real estate prices, farm machinery prices, as well as employment and business in rural Kansas.

Kansans cannot wait until Washington enacts legislation or federal regulatory authorities develop changes in regulatory requirements. In the first place, their concerns are much wider in scope than rural Kansas. Even though our senators and congressmen from Kansas are concerned and want to help, the large majority of the U.S. Senators and Congressmen do not understand our need nor do most of them

care about our agricultural crisis in rural Kansas.

If we are going to improve and keep rural Kansas viable and financially stable, we have to start lending a helping hand to rural Kansans. In the past, agricultural legislation has attempted to solve the farmer's problems by increasing the level of income for the farmer such as the PIK program in 1983. The Administration and Congress have moved towards a market-oriented solution to the problems facing agriculture with the new farm bill that has just been enacted. In other words, farm operations must show a positive cash flow under current market conditions.

To adjust to this new concept, the farmer that has debt, must eliminate or greatly reduce farm debt now if he is going to survive. But time is needed for bankers, farmers, and rural businessmen to adjust from the previous farm programs to the market-oriented farm concept. Senate Bill 555 is a step in the right direction for such adjustment. This bill permits banks and their rural customers to work through some critical times so that both the lender and the customer have the opportunity to continue in business. This bill enables banks to use responsible reamortization of, not only losses but also possible write-downs. Loans can be renegotiated with farmers and rural businessmen. Amortization permits farmers or rural businessmen to operate under present farm prices while bringing about a positive cash flow instead of liquidating or cutting their operations to where it is no



longer feasible or viable. It allows the farmer to reduce his debt so that his current income would support the repayment of it on a stronger basis.

I realize that this concept is a directly legislated change in accounting rules that are generally accepted at the present time. Current law forces banks to write-off any losses in a loan portfolio against its capital at the time these losses are recognized. In normal business conditions this is a sound practice, but in the current critical situation in our agricultural economy, the pressure on smaller rural banks' capital is so great it actually adds to the problem facing both farmers and banks. Losses on agricultural loans can cause reductions in bank capital. The capital reduction then in turn forces a bank to call in more loans, generating more losses, forcing still further reduction in bank capital, and so on, in a destructive cycle. This could destroy both the bank and many viable rural Kansas farmers and businessmen. At the very least, banks may no longer be able to serve as strong ag lenders to their communities, thus compounding the problems caused by the loss of a major source of credit.

Amortized farm loan loss accounting as proposed in SB 555 can help agricultural banks remain competitive suppliers of credit to farmers and rural businessmen. It permits the banks to absorb part of their farm lending losses over a period of time sufficient for the agricultural economy and

Charles Moyer

2-20-86

Page -4-

bank capital and earnings to recover. This legislation, if enacted, will work to provide needed assistance for rural Kansas farmers, businessmen, and lenders who are being squeezed by the ongoing agricultural crisis. That crisis, in turn, is the downward spiral of farm real estate and machinery values.

I respectfully urge your support of Senate Bill 555. If there are any questions, I will be happy to respond.



# PUBLIC POLICY STATEMENT

SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE  
Senator Neil Arasmith, Chairman  
February 20, 1986

RE: S.B. 555 - Allow Banks to Amortize Loan Losses Over a Period  
of Five Years

Presented by:  
Bill R. Fuller, Assistant Director  
Public Affairs Division  
KANSAS FARM BUREAU

Mr. Chairman and Members of the Committee:

I am Bill Fuller, Assistant Director of the Public Affairs Division of Kansas Farm Bureau. I am speaking on behalf of the farmers and ranchers who are members of Kansas Farm Bureau. We are PROPONENTS of S.B. 555 ... a bill allowing banks to amortize loan losses over a period of five years.

Whether or not farm operators have a chance to restructure debt over the next few years will be largely determined by the flexibility that financial institutions will have in dealing with individual farmers' debt problems. Policy adopted by the delegates representing the 105 County Farm Bureaus at the 67th Annual Meeting of Kansas Farm Bureau stated:

## AGRICULTURAL CREDIT

"...In these difficult times neither farmers nor lenders will succeed by themselves if the other fails.

...

*S. FII 2/20/86  
Attachment VI*

**Commercial banks face difficulties in continuing to work with many agricultural borrowers. We support programs which will assist banks in providing service to rural communities in Kansas. We believe commercial banking institutions should have a longer time to write off agricultural loan losses. ..."**

For the last five years agricultural finance policy has been driven by the "one more year" syndrome. The goal has been to keep borrowers and lenders solvent for one more year in the hope that the debt/income situation would correct itself. Agriculture has run out of "one more year." Since farm operators and lenders are partners and one cannot survive without the other, actions must be taken to help both. How banks are forced to classify loans and how long they have to write off loan losses will determine how much debt relief they can provide farm operators.

We feel so strongly about the bank regulatory issue addressed in S.B. 555, we are working through our National Organization to address the problem in the U.S. Congress. The 1986 policies adopted by the State Farm Bureaus for the American Farm Bureau Federation on January 16, 1986 included the following **new policy** concerning commercial banks:

#### **AGRICULTURAL FINANCE**

**"... recommend that commercial banking institutions be given increased authority to extend the period of time for writing off agricultural loan losses. ..."**

In closing, we believe it is essential banking regulations be eased so that banks have an opportunity to work with farm borrowers, yet not jeopardize the bank's future. We urge the passage of S.B. 555. I will attempt to answer any questions you may have. Thank You!

TESTIMONY OF: Michael D. Heitman, Deputy Bank Commissioner  
Kansas Banking Department

PRESENTED TO: The Senate Committee on Financial Institutions and  
Insurance

DATE: February 20, 1986

SUBJECT: Senate Bill No. 555/Loan Loss Amortization

The referenced bill requires that the State Bank Commissioner determine the eligibility, feasibility, and on-going viability of a plan submitted pursuant to the proposed language. This supervisory function will significantly impact the financial resources and overall supervisory capacity of our department. Additionally, there are regulatory issues which are not clearly addressed within the proposed language.

1. Fiscal Impact: The timely processing of the estimated number of applications will require additional office staff, equipment, space, etc. Our projections indicate that the associated cost in fiscal year 1987 is approximately \$166,000. This summary is based upon a ninety (90) day turn-around time parameter, a one (1) week processing period for each application, sixty (60) immediate applications and one hundred twenty (120) subsequent applications.

We also assume that we can hire the additional staff from outside the department, not having to raid the ranks of our field personnel. Reality will probably dictate that field examiners be utilized which will significantly diminish our capacity to adequately monitor all state-chartered banks including meeting the mandatory eighteen (18) month examination requirement established by statute. This must be avoided.

We have submitted a detailed analysis and summary of our cost projections to the Acting Budget Director. Chairman Arasmith has been given a copy of this response.

It is going to be difficult and costly to determine the acceptability of any given plan. Consequently, we suggest that if a deviation from generally acceptable accounting standards is deemed acceptable in principle, that all banks be deemed eligible once loan losses result in an impairment of capital. Determining the viability of any given five (5) year projection will, in reality, be most difficult and will be based on a refined but arbitrary process.

-more-

S. FII 2/20/86  
Attachment VII

2. Other Regulatory Concerns: Matters in need of clarification pertaining to legislative intent:

- (a) Insolvency - Pursuant to K.S.A. 9-1902, the bank is deemed to be insolvent when "the actual cash market value of its assets is insufficient to pay its creditor liabilities..." The proposed language would not prevent the closing of an insolvent bank. Amortization does not affect the market value of the underlying asset. Hence, it appears the intent of the legislation is that it apply to solvent banks only.
- (b) Type of Examination - The language refers to "any examination". We request clarification as to the type of examination, i.e., regulatory examination.
- (c) Quarterly Call Reports - By statute, banks must file quarterly call reports in a form prescribed by the Commissioner and publish the same. Inasmuch as the purpose of such publication is to allow the public to assess the overall financial condition of the bank, we request clarification pertaining to the specific treatment of known losses carried as an asset.
- (d) Utilization of Amortization - Is it the intent of the legislation to allow a bank to utilize the amortization option any number of times? If so, are they restricted to the initial five (5) year period with the original schedule being adjusted for subsequent losses which would be amortized over the existing time parameter?
- (e) Amortization Implementation - Is the amortization to begin at the beginning of the five (5) year period or at the end of the first year? Are adjustments to be monthly, quarterly, semi-annually or annually?
- (f) Recoveries - How is the schedule to be adjusted for recoveries pertaining to loans which are a part of the amortization program?

We request that the language of the bill clearly reflect the intent of the legislation pursuant to these matters.

MDH:jas

Eugene T. Barrett, Jr.  
Bank Commissioner



Michael D. Heitman  
Deputy Commissioner

OFFICE OF

BANKING DEPARTMENT  
TOPEKA

February 18, 1986

Mr. Gary L. Stotts  
Acting Director of the Budget  
State Capitol Bldg. - Room 152-E  
Topeka, Kansas 66612

Re: Fiscal Note - Senate Bill No. 555

Dear Mr. Stotts:

The referenced bill would amend K.S.A. 9-1807 to allow a state-chartered bank to amortize loan losses identified within an examination provided that 1) additional capitalization is required, 2) the bank submits a written plan outlining specific steps to be implemented to avoid further deterioration and to return to profitability, and 3) the Commissioner accepts the bank's plan of corrective action. Additionally, the Commissioner is required to conduct regular reviews of the effectiveness of the bank's plan.

The subject bill, if passed in its present form, would significantly impact the resources of this department. Pursuant to our supervisory responsibilities contained within the amendment, this department will be required to 1) prepare formal guidelines governing the contents of an amortization application, 2) review each application to determine accuracy, viability, and completeness, 3) initiate and follow through on correspondence attempting to clarify and support statements and projections contained within the applicant's plan, 4) prepare a complete and self-contained analysis of the plan including a final recommendation of acceptance or rejection, 5) clarify and resolve questions or concerns resulting from the Commissioner's review of the preliminary recommendation, and 6) devise and implement an information system pertaining to the tracking and monitoring of pending applications as well as those subsequently approved.

The fiscal impact is directly related to the number of applications received. Our projections will include all banks presently below capital guidelines or considered likely to be in the future. Some of these banks have the capacity to resolve the capital deficiency through an infusion of new funds; however, we believe all will elect to pursue amortization of losses rather than provide new capital.

-more-





OFFICE OF

## BANKING DEPARTMENT

TOPEKA

-2-

1. Projected Applications: Presently, there are sixty (60) state-chartered banks operating below the capital guideline of six (6%) percent equity capital and a fully funded loan loss reserve. All have resulted from state or FDIC examinations. Consequently, we anticipate an immediate application from all sixty (60) banks.

One hundred thirty eight (138) state-chartered banks are rated "3", "4" or "5". We project this group to expand to one hundred fifty two (152) by fiscal year end June 30, 1986 (based upon the growth rate of twenty-nine (29%) percent experienced between July 1, 1985 and January 31, 1986) and to one hundred eighty two (182) by fiscal year end June 30, 1987 (based upon the assumption that economic conditions are stabilizing which should lead to a corresponding decline in the growth rate of problem banks). All banks in this group are likely to incur losses which will, to some degree, result in a capital level below regulatory guidelines. Consequently, we anticipate receiving applications from this group through fiscal year end June 30, 1987.

We conclude the following:

Immediate applications - 60

Subsequent applications - 122 or 10.2 applications per month

2. Processing Time: The initial application will be reviewed for accuracy and completeness. Most applications will (from experience) require clarifications, additions, and corrections. Once a completed application is received, a thorough analysis pertaining to the feasibility of the plan must be conducted culminating in a written, self-contained recommendation for acceptance or rejection.

We conclude that this process, including subsequent follow-up and review, will average one (1) week per application.

Staffing Needs: The individuals conducting the feasibility of the bank's proposal must possess skills comparable to those required of a Review Examiner. Their examination experience must be sufficient to reasonably deduce fact from wishful thinking and logically support their conclusion. It is in this regard that we deem examination experience of five (5) years or more to be necessary.

-more-

Eugene T. Barrett, Jr.  
Bank Commissioner



Michael D. Heitman  
Deputy Commissioner

OFFICE OF

**BANKING DEPARTMENT**  
TOPEKA

-3-

One individual will work an average of forty-seven (47) weeks per year. Hence, one (1) review examiner could process approximately forty-seven (47) applications per year or approximately four (4) applications per month.

We will receive an immediate influx of sixty (60) applications. Using a ninety (90) day turn-around parameter, the following personnel would be needed:

(a) First ninety (90) day period - Five (5) additional review examiners (5 review examiners X 4 applications per month = 20 applications per month. 60 applications divided by 20 = 3 month turnaround.)

During the first three (3) month period an additional thirty (30) applications would be received. This group plus the applications received during months four (4) and five (5) would require the continued utilization of five (5) review examiners. (30 applications + 20 received = 50 applications divided by 20 = 2-1/2 months.)

(b) At the end of the fifth (5th) month ten (10) unprocessed applications would be on hand. We estimate that from this point on, a ninety (90) day turnaround period could be maintained with two (2) permanent review examiners.

(c) The additional review examiner staff would require one (1) additional secretarial position.

4. Office Space: The additional staffing will require the acquisition of approximately 350 square feet of space.

5. Office Furniture, Fixtures and Equipment - Desks, chairs, phones, file cabinets, Herman Miller partitions, etc.

6. Legal Expenses: Estimated \$2,500

7. <u>Summary:</u>	Personnel Cost	\$ 154,617
	Office Space	\$ 3,300
	Fixtures & Equipment	\$ 5,749
	Legal	\$ 2,500
	TOTAL:	\$ 166,166

Additionally, if the Comptroller of the Currency would not allow the national banks to utilize the same regulatory accounting techniques or if the means of acceptance were more restrictive, this department could easily experience a significant increase in applications to convert to a state-charter.

-more-

Eugene T. Barrett, Jr.  
Bank Commissioner



Michael D. Heitman  
Deputy Commissioner

OFFICE OF

**BANKING DEPARTMENT**  
TOPEKA

-4-

Although it is unlikely the State Banking Board would look favorably on such applications, the processing and investigation of said applications would represent a significant detriment to the realization of our on-going supervisory requirements pertaining to existing state-chartered banks.

Sincerely,

A handwritten signature in cursive script that reads "Michael D. Heitman".

Michael D. Heitman  
Deputy Commissioner

MDH:jas

cc: File (4)