FDIC Outlook

FALL 2005

A Message to Our Readers

The FDIC community extends its deepest sympathy to the victims of Hurricane Katrina and Hurricane Rita. The articles in this edition of the *FDIC Outlook* were prepared before the hurricanes struck the Gulf Coast. We will assess the economic implications of these tragic events in future editions of the *Outlook*. The public can rest assured that their federally insured deposits are fully protected—their money is safe in FDIC-insured institutions.

In Focus This Quarter: Stroke-of-the-Pen Risk

This issue of ***FDIC Outlook*** focuses on a special class of risks related to policy changes that arise outside the realm of banks and their regulation. Termed "stroke-of-the-pen" risks, these policy changes may have significant, unintended, and unexpected negative consequences for the U.S. banking industry. FDIC analysts explore the spillover effects that changes in monetary policy, the tax code, accounting rules, and other policies can sometimes impose on insured depository institutions.

The ***FDIC Outlook*** is published quarterly by the Division of Insurance and Research of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators.

The ***FDIC Outlook*** provides an overview of economic and banking risks and discusses how these risks relate to insured institutions nationally and in each FDIC region.

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The Stroke of the Pen: A Unique Class of Risks to Insured Financial Institutions

Financial risk management, as practiced by depository institutions and many other classes of enterprises, tends to be based on a familiar taxonomy of risk classes. The three broadest and most commonly cited classes are credit, market, and operational risk.[1] In addition to these categories, liquidity and solvency risks represent bottom-line measures of an institution's vulnerability to adverse situations. Beyond this basic taxonomy, the recognized categories of risk tend to differ according to where they are applied. Reputational risk is generally of utmost importance to financial institutions because of the central role public confidence plays in their success. Regulatory risk assumes a prominent role for financial institutions because they tend to be heavily regulated.

This issue of ***FDIC Outlook*** is devoted to a special class of risks that may slip between the cracks of these standard taxonomies. What we will call *stroke-of-the-pen risks* share elements with regulatory risk, or the risk that a change in the rules governing the industry could impair an institution's financial performance. However, our understanding of stroke-of-the-pen risks extends beyond changes in the regulatory rules governing banks and thrifts. After all, these rules are targeted to the concerns specific to the institutions themselves as well as their customers, regulators, and other major stakeholders. While changes in bank regulation usually have systematic effects on the banking industry, the outcomes are presumably deliberate and can be anticipated. By contrast, our conception of stroke-of-the-pen risks focuses on changes in policy, regulation, and accounting that address issues arising *outside* the financial services industry, but that can result in systematic risks to banks and thrifts. Such changes often arise in the political process, making them difficult to anticipate. A prime example (one that is addressed in the next article) is a change in the U.S. tax code. Tax reform has unique policy goals, related primarily to efficiency and fairness. Changes in the tax code may have implications for virtually any sector of the economy. But these implications are of particular interest to bank risk managers for two reasons: (1) they may have adverse effects that are difficult to minimize through geographic or product diversification, and (2) negative effects on banks or their borrowers may result from unintended or unanticipated consequences.

The very term "stroke of the pen" traditionally has referred to policy choices or significant actions made unilaterally—decrees that could carry profound positive as well as negative consequences for certain groups or constituencies. U.S. presidential executive orders sometimes are referred to as stroke-of-the-pen actions because they are directives made by one person that may carry momentous implications. What our definition emphasizes is that the risk arises not so much from the fact that the consequences of a policy change have not been evaluated by the person or group that initiated it, but that these consequences have not been evaluated primarily in terms of their effects on insured financial institutions.

In this vein, this issue examines policy changes—past and prospective—arising outside the realm of bank regulation that have led to (or may lead to) significant negative consequences for banks and thrifts. The first article is a historical look at the effects of three such changes: the 1979 change in ***Federal Reserve*** monetary policy targets, the 1986 Tax Reform Act, and the 1996 implementation of Financial Accounting Statement 125 by the ***Financial Accounting Standards Board.*** The second article considers the more recent and much-discussed effects of the 2002 Sarbanes-Oxley legislation on U.S. corporations and financial institutions. A final article looks prospectively at risks associated with possible changes in U.S. farm subsidies that could result from the ongoing ***World Trade Organization*** negotiations and the U.S. budget process. While it is difficult to predict the types of changes that may come about as a result of an ongoing policy process, it makes sense for policymakers—and bank managers—to consider in advance the implications such changes may have for the financial condition of FDIC-insured institutions.

[1] For two examples of risk taxonomies as applied to depository institutions, see Cornett, Marcia, and Anthony Saunders. *Fundamentals of Financial Institutions Management.* New York: McGraw-Hill 1999, 180, and Cade, Eddie. *Managing Banking Risks.* Chicago: FitzroyDearborn Publishers, 1999, 16.

Stroke-of-the-Pen Risk: An Historical Perspective

Insured financial institutions are vulnerable to a variety of risks, including credit, operational, and interest rate risk. For the most part, bank managers and regulators understand the factors and scenarios that may heighten these risks and therefore can develop prudent strategies for minimizing or mitigating a particular institution's vulnerability. However, risk also may emerge from unexpected sources, such as changes in accounting standards, congressional appropriations, macroeconomic developments and enactment of federal and state laws and regulations. As described in the ***FDIC Outlook*** introduction, this exposure can collectively be described as "stroke-of-the-pen" risk, as a single change in policies relating to one area of the economy may bring unanticipated negative consequences for other sectors—including banks and savings institutions.

This article focuses on three historical events that had significant implications for FDIC-insured financial institutions: a 1979 shift in ***Federal Reserve*** monetary policy that led to dramatic increases in interest rates; enactment of the Tax Reform Act of 1986; and implementation of Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Although significant debate and deliberation occurred before these changes were enacted, their implications for insured institutions may not have been fully understood at the time. Overall, the effects of these regulatory, legislative, and accounting changes have been positive; however, some specific provisions complicated the operating environment for banks and thrifts.

A Shift in U.S. Monetary Policy

During the late 1970s, the U.S. economy was characterized by high levels of inflation, interest rates, and unemployment, a condition referred to by economists as "stagflation." While a series of energy price shocks had contributed to rising inflation during the 1970s, by the end of the decade there was also recognition that reforms were needed in the way the Federal Reserve conducted monetary policy.[1] The Federal Reserve's policy had been to *target*—or to seek to preserve stability in—the level of short-term interest rates, with the expectation that doing so would stabilize economic activity. However, prices rose and inflationary expectations began to become firmly entrenched in household, business, and investor decisions. The high inflation rate tended to distort the economic decisions made by all of these groups, impairing the overall performance of the economy.

Because of this economic scenario, the ***Federal Open Market Committee (FOMC),*** in an historic session held on October 6, 1979, approved a fundamental shift in its monetary policy strategy. The new strategy switched the Federal Reserve's immediate focus from targeting short-term interest rates to achieving stability in the growth of monetary reserves and, hence, the supply of money. This shift in operating procedure effectively meant that monetary policy would no longer attempt to cushion the blow of economic shocks, such as a sharp rise in oil prices, at the cost of allowing inflation to rise. Instead, the Federal Reserve pursued a longer-term goal of price stability by emphasizing controlled growth in monetary reserves and the money supply.

The shift in policy necessitated an immediate and dramatic rise in U.S. short-term interest rates. The federal funds rate quickly rose from an already high 11.4 percent in September 1979 to 13.8 percent in October, and to 17.2 percent by March 1980.[2] This change in interest rates was deemed necessary in part to curtail expectations of ever-rising consumer prices, which increased at a year-over-year rate of 11.7 percent in the third quarter of 1979.

In terms of containing inflation, the policy change was considered an unqualified success. The inflation rate peaked at 12.9 percent in the third quarter of 1980. Within three years, consumer price inflation fell to just 2.5 percent.[3] But the impact on the U.S. economy was severe. Back-to-back recessions in 1980 and 1981–82

[1] See Black, Robert P. March/April 2005. Reflections on the October 6, 1979, Meeting of the FOMC. *Review—Federal Reserve Bank of St. Louis,* vol. 87, no. 2, 307.

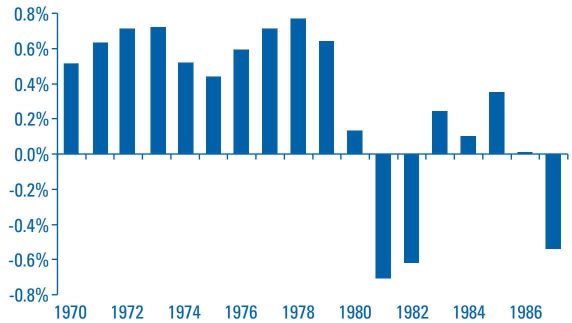
[2] Source: Federal Reserve Board, calculated as a monthly average of rates on trades through New York brokers.

[3] U.S. Bureau of Labor Statistics, as of third quarter 1983.

Chart 1

A Period of Low and Volatile Thrift Earnings Followed Immediately After the Interest-Rate Shock of 1979

Annual Return on Assets, FSLIC-Insured Thrift Institutions

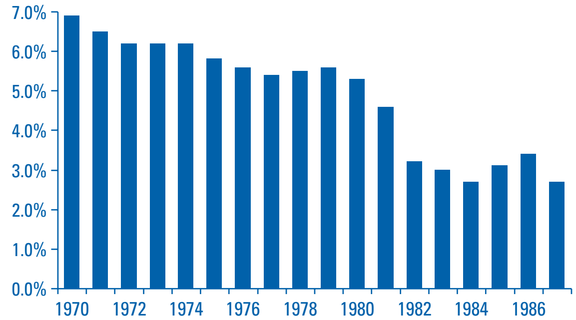


Source: FHLBB, "Information for Senate Committee on Banking, Housing, and Urban Affairs," April 1988.

Chart 2

The Capitalization of the Thrift Industry Declined Sharply Between 1979 and 1982

GAAP Net Worth as Percent of Total Assets, Year-End, FSLIC-Insured Thrift Institutions



Source: FHLBB, "Information for Senate Committee on Banking, Housing, and Urban Affairs," April 1988.

drove the U.S. unemployment rate to a post-Depression high of 10.8 percent by the end of 1982. It was not until September 1987 that the unemployment rate fell to where it had been when the FOMC instituted its October 1979 policy change.

Perhaps less widely appreciated at the time was the effect that high and volatile short-term interest rates would have on financial institutions, particularly thrift institutions insured by the ***Federal Savings and Loan Insurance Corporation (FSLIC).*** The predominant business model for thrifts up to that time was to originate and hold long-term, fixed-rate mortgage loans, funding them primarily with savings deposits of somewhat shorter duration. Through most of their history, this basic strategy had produced steady, if unspectacular, earnings results (see Chart 1). The industry's return on assets averaged 0.62 percent during the 1970s and measured 0.64 percent in 1979. However, by this measure, industry profitability in 1980 declined by four-fifths, to just 13 basis points. The thrift industry as a whole lost $4.6 billion in 1981 and $4.3 billion in 1982.[4] On a before-tax basis, an additional $1.5 billion a year in losses would have occurred during this period.[5]

The financial problems that began for the thrift industry in 1980 coincided with the sudden spike in interest rates associated with the change in Federal Reserve policy. While the long-term mortgage assets held by thrifts continued to pay steady streams of interest, their market value deteriorated as interest rates rose. Meanwhile, the shorter maturity deposit liabilities used to fund thrift balance sheets were quickly becoming much more expensive. As short-term deposits matured, thrift managers were left with an unenviable choice: to either liquidate their mortgage holdings and realize a capital loss, or fund them with market-rate deposits and incur operating losses as long as rates remained high.[6] Given its relatively monolithic business model at the time, with its built-in vulnerability to spikes in interest rates, the thrift industry continued to incur losses as long as high interest rates persisted. Chart 2 shows that the average net worth of the thrift industry declined for six consecutive years after 1979, falling by more than half to just 2.7 percent. By 1981 the gap between book value and market value of the thrift industry's net worth exceeded $86 billion, making the industry as a whole insolvent on a market-value basis.[7]

Legislators, regulators, and thrifts initiated actions in the early 1980s intended to limit or in some cases recoup the losses resulting from the interest rate spike. Congress passed legislation in 1980 to gradually relax the Regulation Q ceilings on deposit interest rates, so that thrifts could offer competitive market rates to attract and retain deposit funding. This move helped to solve one problem for the industry: disintermediation, or the outflow of deposits as savers found higher returns in new instruments (such as money market mutual funds) that paid market rates of return. It did not, however, solve

[4] Federal Home Loan Bank Board, April-May 1988. Staff Report to the Senate Committee on Banking, Housing, and Urban Affairs, 37.
[5] Eichler, Ned. 1989. *The Thrift Debacle.* Los Angeles, CA: University of California Press, 71.
[6] White, Lawrence J. *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation.* New York: Oxford University Press, 70.
[7] Carron, Andrew S. 1982. *The Plight of the Thrift Institutions,* Washington, DC: The Brookings Institution, 19.

the earnings problems resulting from rising deposit costs and shrinking net interest margins. The thrift industry's net interest income for 1981 was a negative $1.8 billion (–0.28 percent of assets), which deteriorated to a negative $4.2 billion (–0.61 percent) in 1982.[8]

Although the thrift industry was losing money rapidly, there was the possibility that a decline in interest rates and a steepening of the yield curve could help thrifts become profitable if they occurred soon. A range of *forbearance policies* enacted by federal bank and thrift regulators in the early 1980s were designed to give the industry extra time to address its financial problems. These policies included a lowering of regulatory net worth requirements, a net worth certificate program that helped undercapitalized financial institutions meet their capital requirements, and adjustments to accounting policies to allow institutions to defer losses into the future.[9]

Legislation enacted in 1982 also allowed thrifts to engage in new types of lending activities that promised to boost asset yields and limit exposures to future interest rate spikes. These new powers included, most notably, the ability to fund commercial real estate (CRE) loans and, under certain conditions, to make equity investments in CRE enterprises. In the generally adverse financial climate facing the thrift industry at that time, a number of institutions significantly expanded their activities in these nontraditional areas. Nonmortgage loans held by FSLIC-insured institutions more than doubled as a percentage of assets between 1982 and 1986, from 3.0 percent to 6.5 percent. But these new investment powers were not a panacea for the industry. While they helped to mitigate the interest-rate risk exposures that had produced the losses of 1980–81, they significantly raised the credit risk profile of many thrifts, leading to even larger problems in the mid- to late 1980s.

A number of studies have documented the roles played by regulatory forbearance and deregulation in contributing to the eventual failure of hundreds of insolvent thrift institutions in the 1980s and early 1990s and the insolvency of the FSLIC itself in 1989.[10] Some studies also emphasize the interest rate squeeze of 1979–1981 as the prime mover of the ultimate thrift industry debacle.[11] A prominent role was also played by the economic adversity associated with the energy industry in the Southwest, the defense industry in New England, and the "rolling regional recession" that depressed commercial real estate markets and imposed large losses on banks and thrifts in both regions. Perhaps it is in part the sheer magnitude of these later losses—2,420 federally insured banks and thrifts failed between 1985 and 1993—that tends to overshadow the role played by the initial interest rate shock in pushing the thrift industry toward its later financial problems.

The Tax Reform Act of 1986 (Tax Act)

The 1986 amendment to federal tax laws on real estate investments represents a prime example of how a policy change can affect financial institutions. With the stroke of a pen, this legislation eliminated the ability to offset passive losses with nonpassive income; increased the capital gains tax rate from 20 to 28 percent; and reinstated straight-line depreciation, dampening demand for CRE investment and putting downward pressure on real estate prices. Ultimately, this legislation tended to depress real estate market values in the late 1980s, which in turn contributed to the subsequent failures of financial institutions with relatively large concentrations in real estate development loans.

In some sense, the Economic Recovery Act of 1981 set the stage for enactment of the Tax Act of 1986, as it lowered marginal tax rates and changed the capital gains rules and depreciation schedules for real estate investments. The 1981 Act allowed investors to recoup their initial investment quickly through tax losses alone, which resulted in real estate investments becoming a favored federal tax shelter. The growing popularity of real estate was reflected on financial institutions' balance sheets. For example, in 1980, commercial bank real estate loans as a percentage of total loans was 18 percent. Five years later, this amount had jumped to 27 percent.

The Tax Act of 1986 wiped out the 1981 tax advantages and made sweeping changes in the treatment of personal and corporate income. (See Table 1 for a comparison of

[8] Federal Home Loan Bank Board. Staff Report to the Senate Committee on Banking, Housing, and Urban Affairs, 32a.
[9] See White. 82-83.
[10] See Federal Deposit Insurance Corporation. 1997. Chapter 4: The Savings and Loan Crisis and Its Relationship to Banking. In *History of the Eighties, Lessons for the Future.* Washington, DC: FDIC.
[11] See Benston, George J. 1985. An Analysis of the Causes of Savings and Loan Association Failures. Salomon Brothers Center for the Study of Financial Institutions *Monograph Series in Finance and Economics,* 4/5, 171.

Table 1

Major Tax Law Provisions Affecting Returns on Commercial Real Estate Investment	Before 1981	After the Economic Recovery Tax Act of 1981	After the Tax Reform Act of 1986
Allowable depreciation life, commercial real estate	40 years	15 years	31.5 years
Allowable depreciation method	Straight-line	175% Declining balance	Straight-line
Passive losses deductible?	Yes	Yes	No
Max. ordinary income tax rate	70%	50%	38.50%
Capital gains tax rate	28%	20%	28%

Source: FDIC, *History of the Eighties, Lessons for the Future.*

the tax changes made throughout the 1980s.) The legislation eliminated many tax deductions and tax preferences and changed the tax treatment of bad debt reserves and tax-exempt securities. Previously, taxpayers generally could use losses and credits from one activity to offset income from another activity. Following enactment of the Tax Act, taxpayers could not use losses and credits to offset income from another activity; instead, passive losses and credits had to apply to other passive income.[12] CRE now became a relatively higher risk investment because the federal government would no longer share the losses of unsuccessful investments.[13] Rental real estate income earned by proprietors and partnerships would be treated as corporate income, and be fully taxed if positive. As a result, investors began to ask higher rents on real estate investments to compensate for higher taxes. The after-tax internal rate of return declined under the Tax Act; much of the difference can be attributed to the elimination of depreciation deductions that had been allowed under the 1981 tax bill.

Overall, the 1986 tax legislation tended to depress real estate values because of changes in the depreciation schedule. Under the depreciation provisions in the 1981 tax law, the after-tax return of CRE investments had increased relative to other assets. The Tax Act of 1986 eliminated this favorable depreciation schedule. As a result, demand for real estate declined and the value of real estate fell. According to the FDIC's ***History of the Eighties, Lessons for the Future,*** $16 billion was invested in real estate limited partnerships in 1985; by 1989, this amount had declined to $1.5 billion. In addition, the quality of banks' real estate loans deteriorated, with nonperforming loans rising from 3.1 percent in 1984 to 4.8 percent in 1990 (see Table 2). The 1980s ended with a two-year total of 406 failed banks that held $64.9 billion in assets.[14] Real estate losses contributed significantly to these bank failures, costing the FDIC billions of dollars in resolution costs and leading to the FDIC's first annual operating loss. The FDIC and the ***Resolution Trust Corporation*** eventually became the nation's largest real estate sales organizations because of the inventories acquired from failed banks and thrifts in areas where real estate values fell precipitously.[15] To be sure, changes in the tax laws

Table 2

Nonperforming Real Estate Loans Rose as a Percent of Total Loans After 1986, As Did Net Charge-Offs.

Year	Nonperforming Loans/Total Loans*	Net Charge-Offs/ Total Loans
1984	3.1%	0.7%
1985	2.9	0.8
1986	3.1	0.9
1987	3.7	0.8
1988	3.3	0.9
1989	3.6	1.1
1990	4.8	1.4

Note: Data are not available for years before 1984.

*Nonperforming loans include loans 90 days past due, non-accruing loans, and repossessed real estate.

Source: FDIC, *History of the Eighties, Lessons for the Future.*

[12] Nixon, Hargrave, Devans, and Doyle. 1986. *The Tax Reform Act of 1986*. Philadelphia: American Law Institute—American Bar Association, F-5.

[13] Passive activity is defined as any business, rental, or trade activity in which the taxpayer does not materially participate.

[14] Annual Report of the FDIC for the Year Ended December 31, 1990, 77.

[15] The Resolution Trust Corporation was created to handle former Federal Savings and Loan Insurance Corporation institutions that became insolvent.

were not the only—and were perhaps not the primary—cause of the bank and thrift losses in CRE loans in the late 1980s and early 1990s. However, the changes were a well documented contributing factor. This situation shows clearly the effects of a stroke-of-the-pen legislative policy change, and reinforces the need for bank management to closely monitor all implications of key tax legislation.

Statement of Financial Accounting Standards No. 125—*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*[16]

In 1996, the ***Financial Accounting Standards Board (FASB)*** issued Statement of Financial Accounting Standards No. 125 (FAS 125) to provide guidance for distinguishing between the transfers of financial assets that should be reported as sales and transfers that should be reported as borrowings. During the early 1990s, the FASB acknowledged that the market's increasingly complicated financial assets made it difficult to determine when transferred financial assets should be removed from the balance sheet and a related gain or loss recognized, and announced efforts to develop plans for an approach that would achieve consistent, credible, and understandable financial statements.

The FASB recognized that financial assets and liabilities can be divided into several categories, such as servicing rights, residual interests, recourse obligations, and pledges of collateral. When accounting for transfers of financial assets, particularly those related to securitizations of assets, concerns arose about whether transactions represented a sale, which would result in the reporting of a gain or loss on sale, or a secured borrowing. Unless accounted for correctly, securitizing assets can make companies appear more profitable than they are and overstate capital levels, while the risks that are often concentrated in the interests that an entity retains in the securitized assets may not have been properly considered in the measurement process. In another stroke-of-the-pen policy change, FAS 125 required that the fair values of retained interests enter into the accounting for securitizations that qualified as sales, thereby affecting the size of the gain or loss on the sale. In the absence of quoted market prices, which was typically the case with retained interests, companies had to estimate the fair value of these interests and support the estimated fair value with documentation using reasonable and supportable assumptions.

FAS 125 proved to be quite complicated, and it became clear that more guidance was needed. In September 1998, December 1998, and July 1999, the FASB issued "Question and Answer" implementation guidance on FAS 125. In addition, in December 1999, the federal bank regulatory agencies issued the *Interagency Guidance on Asset Securitization Activities*, which included discussion of valuations of retained interests in securitizations accounted for in accordance with FAS 125. The interagency guidance emphasized the agencies' expectation that retained interests held as assets would be supported by documentation of the interests' fair values, using reasonable, conservative valuation assumptions that could be objectively verified.

The pitfalls of inaccurately accounting for securitized assets were obvious in the situation of ***Superior Bank FSB***.[17] Starting in 1993, Superior Bank originated and securitized large volumes of subprime residential mortgages and retained residual assets that were a by-product of the securitizations. Residual interests represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied.[18] In 1994, Superior expanded its securitizations activities to incorporate subprime automobile lending. Superior's concentrations of residual assets to tangible capital rose from 122 percent at year-end 1995 to 268 percent at year-end 1999.

Because there was not a ready market for these assets, Superior valued its residual interests using a model. The model was based on the thrift's assumptions of default rates and prepayment rates on the portfolio of loans underlying the securitizations and discount rates.[19] According to the FDIC Office of Inspector General's

[16] In general, FAS 125 applied to transfers of financial assets occurring after December 31, 1996, through the end of the first quarter of 2001, when it was replaced by Statement of Financial Accounting Standards No. 140 (FAS 140), which applies to transactions occurring after March 31, 2001. FAS 140 revised certain aspects of the accounting for securitizations and other financial asset transfers in FAS 125 and required additional disclosures, but it carried over most of the provisions of FAS 125.

[17] Superior Bank FSB, Hinsdale, Illinois. Superior Bank was a federally chartered savings bank outside of Chicago that was regulated by the Office of Thrift Supervision, with deposits insured by the Savings Association Insurance Fund. Superior Bank failed in July 2001.
[18] FDIC Office of Inspector General. Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois. Audit Report No. 02-005, 18.
[19] Ibid.

report on the failure of Superior, the thrift booked large imputed gains based on liberal interpretations of FAS 125.[20] For example, the thrift used unsupported discount rates, and at one point lowered the discount rate by 400 basis points, resulting in a substantial gain. Superior also chose a method of accounting that did not require discounting of funds providing credit enhancement to securitizations, even though those funds were not immediately available to the thrift.[21] The large imputed gains augmented capital and allowed the thrift to continue to lend and securitize.

In 2000, regulators noticed that, although some institutions had shown downward adjustments to reflect the application of the guidance in the 1998 FASB Questions and Answers, Superior's financial data did not have such adjustments.[22] The ***Office of Thrift Supervision,*** with FDIC participation, scheduled an on-site visitation in October 2000 to review residual assumptions, and the agencies focused on residuals at a subsequent examination in March 2001. After examiners found the thrift had not properly discounted cash flows and had used other unsupported assumptions, they determined that the thrift's assets were overvalued by at least $420 million as of December 31, 2000.[23]

When federal regulators required Superior Bank to restate its financial data, the institution was deemed significantly undercapitalized and failed shortly thereafter. At the time of its failure, Superior had $1.7 billion in total assets, of which $842 million were residual assets. The failure cost to the FDIC was an estimated $426 million.

Lessons Learned

The business strategies, investment choices, and risk management decisions of financial institutions are necessarily based on the current economic, accounting, legislative, and regulatory situation, as well as the possibility that this situation may change. However, management can never anticipate all scenarios or the unintended negative consequences that could arise from sweeping policy changes.

[20] FDIC Office of Inspector General. Audit Report No. 02-005. 4.
[21] FDIC Office of Inspector General. Audit Report No. 02-005. 15-16.
[22] Department of the Treasury, Office of Inspector General. February 6, 2002. Material Loss Review of Superior Bank, FSB. Audit Report OIG-02-040, 28.
[23] FDIC Office of Inspector General. Audit Report No. 02-005. 24-25.

The three historical "stroke-of-the-pen" events addressed in this article show the dramatic effects policy changes can sometimes exert on the operating environment of financial institutions. The 1979 shift in U.S. monetary policy was successful in containing inflation and contributed to much improved U.S. economic performance in the 1980s and 1990s. But at the time it was introduced, the full effects of this policy change, in tandem with other domestic and international economic events, were difficult, if not impossible, for financial institution managers and regulators to anticipate. Similarly, the changes mandated by the Tax Reform Act of 1986 brought about significant adverse consequences for insured financial institutions with exposure to CRE loans. The elimination or tightening of real estate tax deductions and preferences contributed to a serious downturn in the CRE market and eventually to failures of insured financial institutions with relatively high CRE portfolio concentrations. Finally, the accounting changes of FAS 125, although developed and implemented to improve the clarity, consistency, and transparency of financial statements, had the unintended effect of potentially complicating accounting procedures for securitized assets, as the example of Superior Bank demonstrates.

The point of emphasizing these episodes of systemic, "stroke-of-the-pen" risk is not to portray them as unmanageable, catastrophic events. As with any other class of risks, bank managers assume ultimate responsibility for monitoring changes in the policy environment and managing their institutions' exposure to these changes. The point is for risk managers to attempt to anticipate the possible consequences of policy changes as early as possible, and to recognize the possibility that such changes may have sweeping effects on their institutions. These episodes show that, despite substantial debate and discussion before the fact, the enactment of policy changes may have unforeseen effects on financial operations, and their negative results can be considerable. While every implication of a policy change cannot be known in advance, management is best served by a business strategy that is watchful for and responsive to such changes.

Suggested Readings

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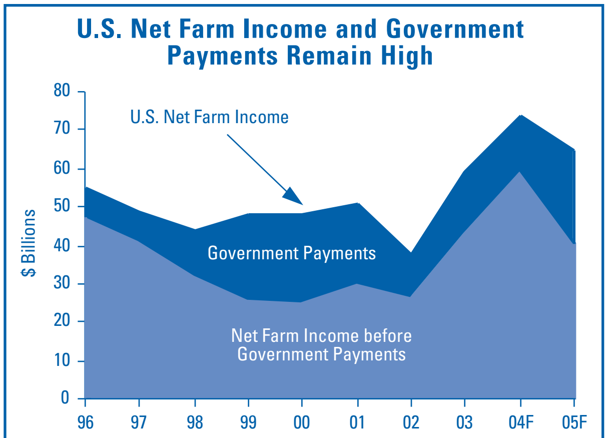
Chart 1



Source: Economic Research Service, United States Department of Agriculture.

However, while most economists agree that a policy of free trade will maximize wealth and output globally, individual country leaders face political pressure at home to maintain policies that benefit particular interest groups. The agricultural sector, in particular, is characterized by strong special interests and has been governed by few trade rules until relatively recently. During the 1970s, the United States strongly supported liberalizing farm trade because it faced increasing competition in world markets. Consequently, during the trade negotiations that began in 1986, agricultural issues ranked high on the agenda.[5] That round of negotiations, which concluded in 1994, resulted in the Agreement on Agriculture, the first significant multilateral treatment of farm sector issues.

Despite the 1994 agreement, however, tariff levels remain significantly higher on agricultural products than on nonagricultural products, and trade continues to be somewhat restricted. Similarly, export subsidies, which countries use to reduce the prices of their commodities and strengthen their competitiveness worldwide, remain widespread. Overall, though levels of agricultural subsidies declined shortly after the agreement's implementation, low commodity prices since 1998 (attributed to strong crop harvests worldwide) have prompted an increase in domestic support payments in most industrialized countries, including the United States.[6]

The Doha Round: Developing versus industrialized countries and a pledge to reduce subsidies.

A new round of WTO negotiations was launched in Doha, Qatar, in November 2001. This series of negotiations, known as the Doha Round, is intended to reduce trade barriers, export subsidies, and domestic support for many goods, with agricultural subsidies a key agenda item.

The Doha Round has sharpened the philosophical differences between developing and industrialized countries. International trade policies are hindering the ability of developing countries to realize the full benefit from their comparative advantages in the agricultural sector—low costs for farmland and labor. Industrialized countries, such as the United States and nations in the European Union, seek to support their agricultural producers through continued subsidy programs. Many economists maintain that agricultural subsidies in industrialized countries contribute to the overproduction of supported commodities and, in turn, depress world prices, hurting producers in developing countries.[7]

A turning point in the Doha Round occurred in August 2004, when industrialized countries agreed to "make substantial reductions in distorting supports, and those with higher levels are to make deeper cuts …"[8] This statement reflects the first time the United States and the European Union committed to reduce domestic support levels. While no timetable has been set to curtail U.S. subsidy programs, the negotiation of the next Farm Bill will be an opportunity for this country to address farm subsidy payments.

Brazil's challenge may strengthen the hand of developing countries.

In September 2002, the Brazilian government sued the United States in the WTO, challenging more than $3 billion in subsidies paid by the U.S. government to its cotton farmers. Brazil argued that the subsidies contributed to increased U.S. cotton output that depressed world cotton prices and undermined Brazilian farmers' livelihoods. Brazil estimated that if U.S. cotton subsidies were eliminated, U.S. cotton exports would decline 41 percent, and worldwide production would fall

[5] Sheingate, Adam. 2001. *The Rise of the Agricultural Welfare State.* Princeton, NJ: Princeton University Press, 183.
[6] Ingco, Merlinda, and John Croome. 2004. Trade Agreements: Achievements and Issues Ahead. In *Agriculture and the WTO: Creating a Trading System for Development,* 36.

[7] Johnson, D. Gale. 1991. *World Agriculture in Disarray.* New York: St. Martin's Press, 9.
[8] World Trade Organization. December 2004. *WTO Agriculture Negotiations: The Issues and Where We Are Now.* Geneva, Switzerland: WTO, 58. www.wto.org/english/tratop_e/agric_e/agnegs_bkgrnd_e.pdf.

29 percent. This would boost world cotton prices more than 12 percent, benefiting cotton farmers in developing countries such as Brazil and West African nations.[9]

The WTO ruled in favor of Brazil in June 2004. The United States appealed the decision, but the WTO's Appellate Body upheld most of the original ruling in May 2005. The decision marked the first time the WTO had ruled against any domestic agricultural support program. In another challenge, the WTO ruled in favor of Brazil against the European Union's sugar subsidy program. Some observers believe the WTO's cotton and sugar decisions could encourage Brazil or other developing countries to file similar complaints against other subsidy programs.

Although progress on international agricultural trade policy is typically very slow, the U.S. farm subsidy program appears to be vulnerable over the longer term. The outcome of the Doha Round negotiations, especially industrialized countries' pledge to reduce domestic support payments to farmers, certainly is problematic. And the WTO cotton and sugar rulings fuel calls for scaling back government payments to farmers. These policy changes indeed have far-reaching consequences and will be carefully monitored by agricultural economists and policymakers.

U.S. Budget Pressures Could Prompt Cuts in Agricultural Subsidies

The 2002 Farm Bill was enacted during a time of federal budget surpluses. However, several key developments have occurred since that time: the extended war on terror, a weakening stock market, and growing budget deficits. Today we face a much different economic scenario, one that requires close scrutiny of all federal spending. In fact, as part of the 2006 budget reconciliation process, Congress must cut $70 billion by September 16, 2005. Of that amount, the House and Senate agricultural committees are tasked with trimming $3 billion in mandatory spending, most of which is for crop subsidies, food stamps, and other nutrition programs. Because the latter two are considered critical social programs, many observers believe crop subsidies will be targeted for cuts. In fact, the administration has proposed the following legislative changes to reduce agricultural subsidies or promote more efficient production decisions:

- Reduce crop and dairy payments to farmers by 5 percent.
- Scale back the commodity payment cap for individuals from the current $360,000 to $250,000.
- Require the dairy price support program to curtail expenditures.
- Base subsidies on historical production, allowing farmers to update their acreage according to what they actually grow.[10]

By far the most serious, the 5 percent across-the-board cut would affect many farmers and potentially strap highly leveraged farmers. The payment cap would be particularly problematic for larger farmers. The five states that stand to lose the most in agricultural subsidies are **California, Texas, Kansas, Arkansas,** and **Nebraska;** these states represent 51 percent of U.S. total reductions under the proposed cap.[11] It is not certain that Congress will adopt these proposals; Congress traditionally has shown a bias against cutting agricultural subsidies. However, the potential fallout from these cuts should be anticipated and analyzed.

Reductions in Farm Subsidies Would Pose Significant Challenges for Farmers and Their Lenders

Since 1997, government subsidies of $120 billion have represented about one-third of the nation's net farm income. About 40 percent of the nation's farms receive government payments for one or more of these crops: wheat, corn, soybeans, cotton, sorghum, rice, barley, and oats. States that specialize in these crops would be disproportionately affected by subsidy cuts. For example, **North Dakota,** which is by far the most heavily subsidized state because of its concentration in wheat production, derived more than 71 percent of its net farm income from government payments from 1990 through 2003.[12]

[9] Benson, Todd. WTO Rules Against U.S. Cotton Subsidies. *New York Times,* June 19, 2004.

[10] USDA. 2005. 2006 Budget Summary. www.usda.gov/agency/obpa/Budget-Summary/2006/FY06budsum.htm.

[11] Report of the Commission on the Application of Payment Limitations for Agriculture, USDA, August 2003.

[12] Economic Research Service, USDA. 2003 is the most recent year for which state data are available.

In a related development, reductions in federal farm subsidies could depress farmland values. U.S. farm and ranch values have climbed in recent years because of strong farm income, increased demand for land for nonfarm uses, low interest rates, and tax advantages. According to ***Federal Reserve Agricultural Lender Surveys,*** land prices for good-quality (nonirrigated) farmland rose between 8.7 percent and 15.4 percent from 2003 to 2004. Ranchland values posted double-digit gains, primarily because of record cattle prices. The ***Real Estate Center at Texas A&M University*** reported that Texas land prices jumped 16 percent on average from 2003 to 2004, with some areas posting gains of more than 35 percent.[13]

Where the expectation of continued high government payments has been capitalized into real estate values, a scaling back of payments undoubtedly would place some downward pressure on land prices. Several studies indicate that government payments in recent years have contributed to higher U.S. farmland values; in fact, a study by economists at the ***University of Florida*** estimates that farmland values have increased 15 to 25 percent across the nation because of government payments.[14] Although the impact on farmland values of lower payment levels would be widespread, the effects would not be felt uniformly across the country. Farmland values in areas that rely more heavily on subsidies slated for reduction would be expected to fall the most. An analysis by the ***U.S. Department of Agriculture*** estimated severe effects in the most heavily subsidized states. For example, in North Dakota, farmland values would decline 69 percent if government payments were removed altogether.[15] While the *elimination* of government payments is highly unlikely, the study shows how closely farmland values and government payments are tied.

Among the nation's farm banks, the use of farmland real estate as collateral has increased in tandem with higher farmland values.[16] At year-end 2004, loans secured by farmland represented 18.6 percent of total loans, a significant rise from 16.4 percent at year-end 2000. Much of this growth was reported among farm banks based in states where farmland prices have appreciated rapidly, such as **Minnesota, Wisconsin,** and **Missouri.**[17] In these states, loans secured by farmland grew 69 percent from 1997 through 2002. By contrast, farm banks in areas characterized by less rapid price appreciation reported only a 10 percent hike in farmland loans.

However, heavy reliance on government payments would not necessarily contribute to declining farmland values in all cases. Certain mitigating factors, such as those described below, exist.

Vibrant economies: While many rural counties, particularly in the middle of the country, are losing population, some counties with strong employment opportunities are attracting more residents. Many of these counties also have strong retail bases. Farmland values in such counties likely would better withstand the adverse effects of subsidy cuts than counties with declining populations.

Natural amenities: Agricultural areas characterized by natural amenities, such as lakes, forests, or mountains, likely will fare better than other areas. As people consider relocating away from urban areas, anecdotal evidence suggests they are looking for land suitable for hunting, fishing, hiking, and camping. These areas are also popular for nonresidential purchases. In the past few years, the value of land used for recreational purposes has contributed significantly to the increase in farmland values.

Proximity to metropolitan areas: Approximately 17 percent of the nation's farms are located near a major urban center, and many of these farms have benefited from higher farmland values because of residential and commercial development. Growing population in many urban centers has driven demand for residential housing, pushing rural land values higher.

Each of these factors could be spurring the appreciation in farmland prices that has occurred to date, reflecting the influence of nonagricultural uses on farmland value. These factors could mitigate the downside effects of

[13] Novack, Nancy. June 2005. Agricultural Credit Conditions: Booming Farmland Values. *The Main Street Economist.*

[14] Moss, Charles B., and Andrew Schmitz. 2003. *Government Policy and Farmland Markets: The Maintenance of Farmer Wealth.* Ames, Iowa: Iowa State Press.

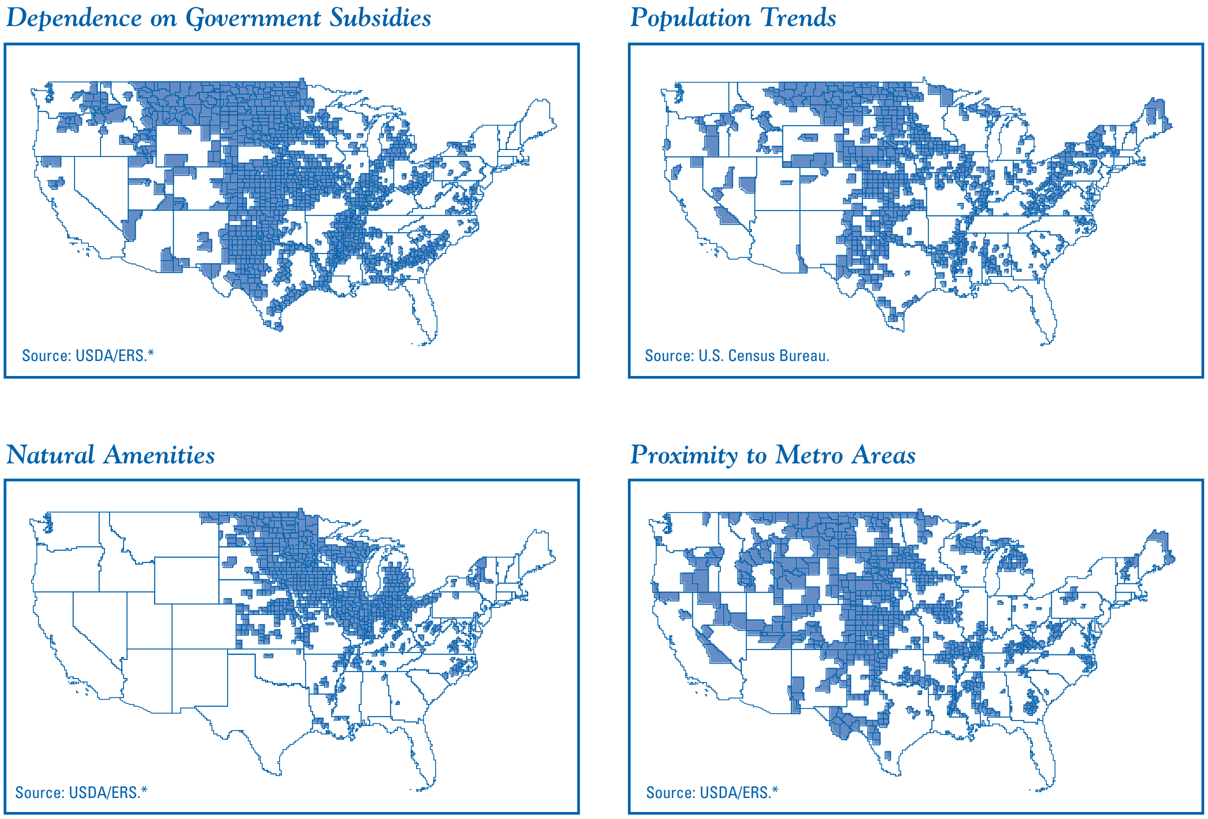
[15] Barnard, Charles, et al. 1997. Evidence of Capitalization of Direct Government Payments into U.S. Cropland Values. *American Journal of Agricultural Economics* 79:1646.

[16] A farm bank is defined by the Federal Deposit Insurance Corporation as having at least 25 percent of its loans to farm operations or secured by farmland.

[17] Areas of rapid farmland appreciation are defined as the top quintile of counties based on farmland price appreciation from 1997 through 2002.

Map 1

Impact of Reductions in Subsidies on Farmland Values Is Determined by These Factors



*United States Department of Agriculture/Economic Research Service

future subsidy cuts. However, the *absence* of these factors also could exacerbate the effects of lower levels of government payments. In summary, where would we expect to find the greatest adverse impact on farmland values? Based on our analysis of the downside potential of these factors, we mapped the results, and Map 1 clearly shows the more vulnerable areas. Of particular concern are areas where government payments are "institutionalized," meaning that during the past 35 years, high farm subsidies have been the norm.[18] As the map shows, the middle of the nation, where heavily subsidized crops are typically grown, depends significantly on government support, as do the Mississippi Delta and the South. If payments are reduced, these areas would experience the greatest impact, both to farmers' incomes and farmland values.

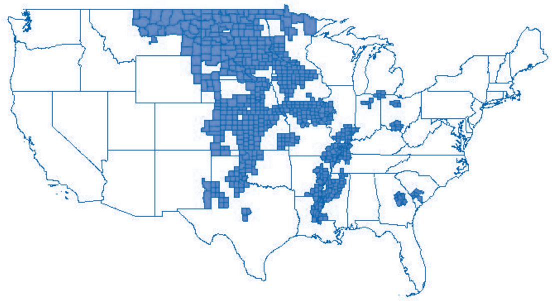
The map also shows the Great Plains, Corn Belt, and Mississippi Delta are being hurt by depopulation.[19] These areas likely do not have vibrant economies that could help sustain farmland values should government payments be reduced. In addition, many areas in the northern Great Plains and Midwest do not have natural amenities to support recreational demand for farmland. And finally, many counties are in remote, rural areas

[18] The analysis of dependence on farm subsidies is based on Bureau of Economic Analysis county-level data for 1969 through 2003 for government payments and net farm income (NFI). If a county's ratio of government payments to NFI ranked in the top quartile in at least half the years covered in our study, or if the ratio never fell into the bottom quartile during that period, the county's reliance on government payments was considered "institutionalized."

[19] For definitions of the geographic terms and a detailed discussion of rural depopulation across the nation, refer to Walser, Jeffrey, and John M. Anderlik. 2004. Rural Depopulation: What Does It Mean for the Future Economic Health of Rural Areas and the Community Banks That Support Them? *FDIC Banking Review* 16:57.

Map 2

Confluence of Factors Shows Areas of Greatest Impact



Sources: United States Department of Agriculture/Economic Research Service; U.S. Census Bureau; and authors' geospatial calculations.

that are not close enough to urban areas for farmland values to benefit from development. These areas also may lack the employment opportunities benefiting areas closer to metropolitan areas.

Although the absence of or weakness in any factor indicates some vulnerability to reductions in government payments, the confluence of shortcomings *across all factors* represents the areas of greatest concern (see Map 2).[20] Our analysis highlights 666 counties characterized by a relatively high dependence on government payments, adverse demographic trends, poor natural amenities, and distance from metropolitan areas. As a result, we would expect farmland values in these counties to be hurt the most should government payments be significantly curtailed.

The most vulnerable counties are in the nation's midsection—the Great Plains states of North Dakota, **Montana, South Dakota,** Nebraska, and Kansas; Corn Belt states of **Iowa,** Minnesota, and Missouri; and the Mississippi Delta, stretching up the Mississippi River from **Louisiana** to **Illinois.** The crops produced in these areas (wheat, cotton, corn, and soybeans) are the most heavily subsidized, and as a result, farmers' reliance on government payments is the greatest. These areas also do not benefit from positive demographic trends, natural amenities, or proximity to metropolitan areas.

A significant number of the nation's farm banks (979 of 1,730 nationwide as of year-end 2004) are headquartered in these areas. Almost two-thirds of these institutions are in five states: Nebraska, Iowa, Kansas, Minnesota, and North Dakota. These farm banks (holding $71 billion in total assets) have performed well in recent years because of historically high levels of net farm income and government subsidies. In addition, these banks have increased farmland lending during the past few years; loans secured by agricultural real estate constituted 19.4 percent of total loans at year-end 2004, up from 16.9 percent four years earlier. Although farmland tends to be a strong form of collateral, these collateral positions could weaken should lower levels of farm subsidies depress real estate values.

Conclusion

Reductions in federal farm subsidy programs are becoming more likely as international trade negotiations and budget shortfalls pressure Congress to modify existing farm programs. If cuts do occur, farmers' cash flows and profits would be hurt. In addition, farm real estate values, particularly in the middle of the country, could decline substantially. As farmland tends to be farmers' most significant asset as well as valuable loan collateral, farmers and their lenders must continue to monitor the potential for payments to be scaled back through budget cuts or the outcome of international trade agreements.

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The authors acknowledge Jeffrey A. Ayres, Senior Financial Analyst, for his work with the geographic information system analysis.

[20] This analysis is based on geographic information system software that allows for the comparison among factors. Each factor is given equal weight.

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