

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

Risk assessment that focuses on market, credit, and operational risk may overlook stroke-of-the-pen risks that expose FDIC-insured institutions to a wide range of events that originate outside the financial services sector. This article introduces the concept of stroke-of-the-pen risk and looks at its unique applicability to the banking industry. [See page 3.](#)

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

Risks to the banking industry have sometimes emerged from unexpected sources. This article focuses on three historic policy shifts that significantly affected FDIC-insured 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 Financial Accounting Statement 125 during the mid- to late 1990s. The authors argue that while each of these policy changes served a clear and important purpose, each also contributed to a more challenging operating environment for banks that ultimately led to financial losses for a segment of the industry. [See page 4.](#)

Implications of the Sarbanes-Oxley Act for Public Companies and the U.S. Banking Industry

The unanticipated collapse of several large, high-profile corporations—including *Enron*, *Tyco*, and *WorldCom*—in 2001 and 2002 contributed to a crisis of investor confidence and prompted far-reaching legislative and regulatory reform. The Sarbanes-Oxley Act of 2002 (SOX) represents a cornerstone of this reform effort. However, its impact on corporate America is only beginning to be understood. Could this monumental stroke of the pen pose risks to depository institutions? This article surveys the effects of SOX on public companies, including FDIC-insured institutions. [See page 11.](#)

What Does the Future Hold for U.S. Agricultural Subsidies?

The strong recent financial performance of the U.S. agricultural sector and FDIC-insured farm banks rests somewhat precariously on federal policies that heavily subsidize farm producers. This tends to make both farmers and their bankers vulnerable to a legislative stroke of the pen that might alter these policies. Pressure to cut U.S. farm subsidies has been building as a result of both the ongoing World Trade Organization negotiations and the presence of a large federal budget deficit. This article examines how farm program cutbacks might affect farmers and their lenders. [See page 20.](#)

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

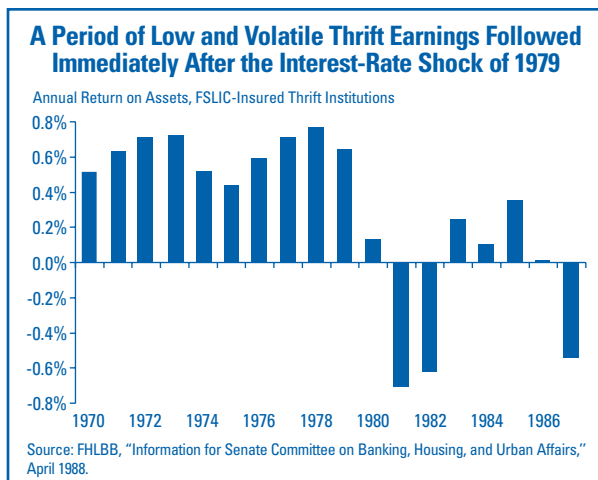
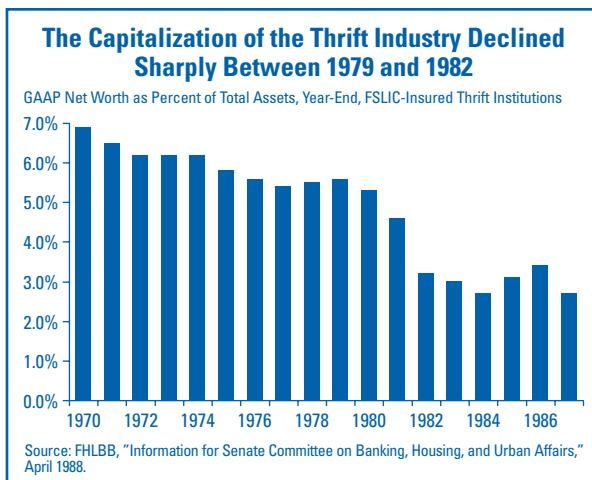


Chart 2



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 Liabilities¹⁶

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.

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

Axilrod, Stephen H. 1985. U.S. Monetary Policy in Recent Years: An Overview. *Federal Reserve Bulletin*, 71:14-24.

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.

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

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Implications of the Sarbanes-Oxley Act for Public Companies and the U.S. Banking Industry

The fall of several high-flying corporations, such as *Enron*, *Tyco*, and *WorldCom* in 2001 and 2002, resulted in the collapse of employee pension plans, a drastic devaluation of corporate stock, a decline in investor confidence, and a scrambling by legislators and regulators to restore the public's confidence. These events prompted many to ask how these corporate abuses could happen. The mid-1990s had been characterized by strong corporate growth, more aggressive risk taking by some managers, and a generally profitable corporate sector, with only 70 public company bankruptcy filings in 1994. However, by the early 2000s, the tide had turned, and public company bankruptcies peaked at 257 in 2001.¹

Corporate governance generally can be defined as the process of managing an organization's affairs or ensuring accountability. It can include a range of activities, such as setting business strategies and objectives, determining risk appetite, establishing culture and values, developing internal policies, and monitoring performance. Corporate fairness, transparency, and accountability commonly are viewed as goals of corporate governance. To some, corporate governance simply means more active and involved participation by the board of directors; others emphasize corporate "democracy" or broader shareholder participation.

In the wake of widespread abuse and corporate scandal, corporate governance issues emerged as the focal point for reform. Lawmakers and the administration moved quickly to stem the damage to investor confidence with the enactment of the Sarbanes-Oxley Act of 2002 (SOX). The rationale behind enactment of SOX was to strengthen public financial reporting, improve internal control processes, ensure auditor independence, and make corporate decision makers responsible for their actions. This article provides an overview of the SOX legislation, reviews key areas of study that have emerged since the legislation was enacted, assesses the implications and costs of SOX for public companies and FDIC-insured institutions, and summarizes new regulations and standards implemented as part of other corporate governance reform initiatives (see the box on page 19, "Other Recent Corporate Governance Reforms").

¹ *Bankruptcy Week*. January 10, 2005. www.BankruptcyData.com.

Overview of the Sarbanes-Oxley Act of 2002

Following the recent corporate scandals and the resulting demand for greater transparency and increased integrity in financial reporting, Congress and the administration wanted to help assure stakeholders that



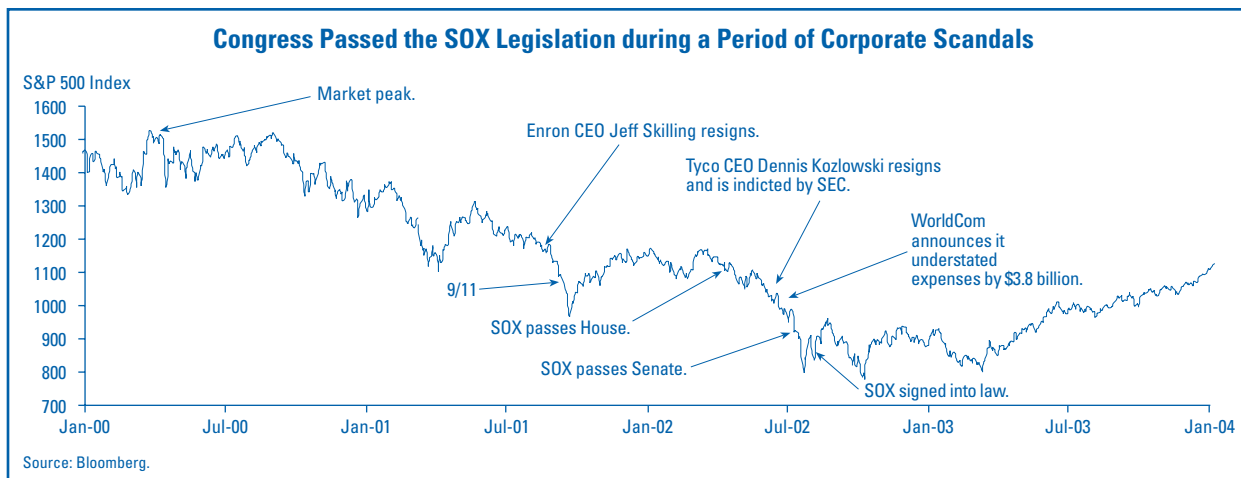
public companies were operating in a sound manner. Therefore, SOX provisions focus on the implementation of sound corporate governance practices. Two of the more frequently cited sections of SOX are Section 404, which addresses management's responsibility for establishing sound internal controls and assessing the effectiveness of these controls, and Section 302, which requires company chief executive officers (CEOs) and chief financial officers (CFOs) to certify the accuracy of company financial statements. Key provisions of the SOX legislation are summarized below.

Impact of SOX on the Corporate Sector

Three distinct areas of analysis and study have emerged since enactment of the SOX legislation: 1) the effect on compliance costs, 2) the effect on the quality of corporate earnings and the level of earnings management, and 3) the effect on firm and managerial behavior. Even though the research on SOX is preliminary, the historical impact of SOX and the effects of several large corporate scandals can be assessed by looking at changes in stock prices following certain significant events (see Chart 1 on page 12).

Recent reports suggest that compliance costs for public companies are ratcheting upward. *Financial Executives International (FEI)*, a research firm focusing on the business community, surveyed 217 public companies with average revenues of \$5 billion. The survey results show spending on SOX-related services averaged \$4.4 million during 2004, eclipsing the \$3.1 million these firms expected to spend on compliance-related

Chart 1



issues.² In addition, the results indicate that compliance with Section 404 of SOX has spurred most of the increase. About 39 percent of compliance costs are for external services such as consulting, while 30 percent are earmarked for auditing fees. A separate survey of Fortune 1000 firms found that these companies spent an average of \$7.8 million on SOX compliance in 2004.³ About a quarter of these costs were related to audit fees, consistent with the results of the FEI survey.

In a widely cited research paper on the economic implications of SOX, Ivy Xiyang Zhang of the *University of Rochester* measured returns to stock prices on key legislative dates, ranging from the introduction of SOX in congressional committee to enactment of the bill, and found a large abnormal loss for companies on these dates.⁴ Tallying the losses, Zhang's research showed the net private costs of compliance with Section 404 were about \$1.4 trillion and concluded that investors perceived the purchase of nonaudit services and investment in internal controls as costly.

Executives have expressed mixed feelings about the costs and benefits of compliance with SOX. A survey conducted during first quarter 2005 by *Foley & Lardner*, a national law firm providing interdisciplinary services

to global corporations, shows that 38 percent of private company executives believe the costs equal the benefits.⁵ Interestingly, 29 percent responded that the benefits outweigh the costs, while almost the same share (28 percent) believe the costs exceed the benefits. Mixed results were also found in the FEI study cited above. Although 55 percent of respondents to the FEI survey believe SOX increased investors' confidence with financial statements, the vast majority (94 percent) also believe the costs of complying with SOX exceed the benefits. Finally, a survey by the *Risk Management Association* found that 59 percent of financial services firms believe SOX has "greatly" or "somewhat" helped management to implement an operational risk program that would minimize the risk of losses from inadequate internal processes and systems or from external events.⁶

Although survey results suggest that the enactment of SOX is beginning to boost investor confidence, opportunity costs also must be considered. The SOX legislation contains numerous compliance requirements that force corporate management to shift resources away from product development or customer service activities. Costs also are attributed to learning new systems and internal controls, complying with strict timelines, and overseeing the work of others to deter fraud. Company executives are responsible for certifying the accuracy of company financial reports and may face penalties and fines for issuing misleading statements.

² FEI Survey on SOX Section 404 Implementation. March 2005. www.fei.org/news/press.cfm.

³ Charles River Associates. April 2005. *Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies*. www.sec.gov/spotlight/soxcomp/soxcomp-all-attach.pdf.

⁴ Zhang, Ivy Xiyang. June 2005. *Economic Consequences of the Sarbanes-Oxley Act of 2002*. AEI-Brookings Joint Center for Policy Research. www.aei.brookings.org/admin/authorpdfs/page.php?id=1154.

⁵ Foley & Lardner LLP. March 10, 2005. *The Impact of Sarbanes-Oxley on Private and Nonprofit Companies*. www.fei.org/advocacy/sarbanesoxley.cfm.

⁶ Risk Management Association survey on Sarbanes-Oxley. May 2005. www.rmahq.org/RMA.

This environment could prompt management to become more risk averse and, as a result, constrain product development and innovation.⁷

Earnings management is a term commonly used to describe the use of generally accepted accounting principles (GAAP) to control how a company's financial statements are reported. For example, managers can use various methods for recording inventories and depreciation that can have the effect of smoothing reported earnings across time. Researchers have tried to determine if SOX has improved the reliability of financial statements. Gerald Lobo of the **University of Houston** and Jian Zhou of the **State University of New York–Binghamton** found that earnings management declined during the year when CEOs and CFOs certified the accuracy of their company's financial statements.⁸ Firms most likely to certify early fell into a larger asset size category, reported higher quality earnings, and had a higher percentage of institutional shareholders. However, other research concludes that CEO and CFO certification did not affect stock prices, suggesting that

investors perceived no benefit from the certification process. Uptal Bhattacharya, Peter Groznik, and Bruce Haslem of **Indiana University** studied the market reaction of firms that began to certify their results and found the market did not react to the news of financial statement certification.⁹

In a separate study, **Northwestern University** professors Daniel Cohen, Aiysha Dey, and Thomas Z. Lys examined earnings management behavior, measured by accruals, for more than 6,000 firms. They determined that earnings management increased through the 1990s but declined after the enactment of SOX.¹⁰ However, these researchers stop short of concluding that earnings management declined only because of the enactment of SOX. Rather, other events, such as the corporate scandals of the early 2000s, also are contributing factors. To date, a paucity of data clouds the impact of SOX on earnings management, and this area will benefit from additional research.

⁷ Powell, Scott S. May 2, 2005. Seeking a Cure for Sarbox. *Barron's*.

⁸ Lobo, Gerald J., and Jian Zhou. Forthcoming. To Swear Early or Not to Swear Early? An Empirical Investigation of Factors Affecting CEOs' Decisions. *Journal of Accounting and Public Policy*. <http://ssrn.com/abstract=651423>.

⁹ Bhattacharya, Uptal, Peter Groznik, and Bruce Haslem. September 2002. *Is CEO Certification of Earnings Numbers Value-Relevant?* <http://ssrn.com/abstract=332621>.

¹⁰ Cohen, Daniel A., Aiysha Dey, and Thomas Lys. February 1, 2005. *Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods*. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=658782.

Key SOX Provisions

- **Created the Public Company Accounting Oversight Board (PCAOB)** with responsibility for overseeing the actions of public accounting firms. The PCAOB oversees the auditors of public companies; protects the interests of investors; and supports the preparation of informative, accurate, and independent audit reports.
- **Establishes auditor standards**—requires audit partner rotation, provides guidance on audit committee reporting responsibilities, places restrictions on hiring external audit staff to avoid auditor/client conflicts of interest, and permits state regulators to determine whether PCAOB standards should apply to smaller accounting firms.
- **Establishes management standards**—outlines audit committee standards, requires CEOs and CFOs to certify the accuracy of financial statements, prohibits management from attempting to influence an audit, establishes guidelines and penalties for certain inap-

propriate actions by officers and directors, bars persons who violated certain Securities and Exchange Commission (SEC) regulations from serving as corporate officers or directors, and prohibits insider-trading violations.

- **Mandates appropriate disclosures**—requires accurate material disclosures in reports, restricts personal loans to executives, requires internal control disclosures in annual reports, provides for timely disclosure based on material changes in a company's financial position, and details the extent of financial expertise on the audit committee.¹¹

¹¹ The full text of the Sarbanes-Oxley Act of 2002 may be found at www.loc.gov/law/guide/pl107204.pdf. Other summaries of SOX may be found at www.aicpa.org/info/sarbanes_oxley_summary.htm; Executive Summary of the Sarbanes-Oxley Act of 2002, www.csbs.org/government/legislative/misc/2002_sarbanes-oxley_summary.htm; and the Public Company Accounting Oversight Board, www.pcaobus.org.

Another line of study has examined managerial behavior and executive compensation contracts. The results of some of the analysis suggest a direct relationship between managerial contracts and the incidence of corporate fraud.¹² Firms whose executives had contracts with higher equity-based compensation relative to total compensation were more likely to experience fraud. However, the adjustment in managerial compensation following the enactment of SOX may have influenced how corporations make investment decisions. A paper by researchers at Northwestern University indicates that incentive compensation relative to total compensation declined following implementation of the SOX provisions.¹³ Furthermore, after controlling for macroeconomic effects such as gross domestic product (GDP) growth, the data show that expenditures on research and development, as well as capital expenditures, also declined.

SOX also has influenced company decisions about whether to issue equity shares to the public or to remain privately held. Researchers at the *University of Chicago* found that the frequency of firms going private increased following passage of SOX.¹⁴ However, firms most likely to go private were smaller and characterized by a greater percentage of insider ownership. For firms that go public, registration and compliance costs have risen in recent years. Foley & Lardner estimate that SOX requirements and the costs of listing on stock exchanges have doubled since 2002 to an average of \$2.3 million for firms with market capitalization less than \$900 million.¹⁵

In addition, the SOX legislation is affecting merger and acquisition (M&A) activity. For some companies, selling to a larger company has been easier and less costly than trying to take the company public, either because of compliance costs or the inability to receive analyst attention.¹⁶ In a roundtable sponsored by *PricewaterhouseCoopers* in spring 2004, leading M&A executives

said SOX-related issues are emerging in merger negotiations.¹⁷ For example, targets that have been slow to comply with Sections 302 and 404 have led to postponement of deals that otherwise would have been considered acceptable. Panelists also noted that due diligence was becoming more complicated and was lengthening the process of closing deals.

The Cost of SOX Compliance for FDIC-Insured Institutions

In the case of FDIC-insured depository institutions that issue equity shares to the public, SOX compliance costs vary with institution asset size, operating controls, management experience and staffing levels, financial condition, local economic conditions, and the institution's product offerings. However, regardless of the size and type of institution, some published studies show that overall compliance costs have increased since the enactment of SOX.

An article in the May 2005 issue of *US Banker* states that the costs of complying with SOX can reach as high as \$2 million for publicly traded community banks. The article concludes that these costs are becoming a significant factor in some banks' decisions to go private and avoid SEC reporting requirements. "To add \$1 million to \$2 million in costs—with no income to show for it—makes a huge difference. Community banks are having a hard enough time with compliance anyway," observes Patrick D. Daugherty, a partner with Foley & Lardner, who was interviewed for the *US Banker* article.¹⁸ A May 2005 *ABA Banking Journal* article estimates that compliance costs specifically related to legal, audit, Section 404 consulting, and administrative activities may exceed \$500,000 annually for a community bank.¹⁹

The *American Bankers Association (ABA)* estimates that auditing expenses of community banks in the

¹² Johnson, Shane A., Harley E. Ryan, and Yisong Sam Tian. April 16, 2003. *Executive Compensation and Corporate Fraud*. <http://ssrn.com/abstract=395960>.

¹³ Cohen, Daniel A., Aiysha Dey, and Thomas Lys. July 23, 2004. *The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs*. <http://ssrn.com/abstract=568483>.

¹⁴ Engel, Ellen, Rachel M. Hayes, and Xue Wang. May 6, 2004. *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*. <http://ssrn.com/abstract=546626>.

¹⁵ Thornton, Emily. May 24, 2004. Why Small Companies Want a Little Privacy. *Business Week*.

¹⁶ Quittner, Jeremy. November 1, 2004. Private Matters. *Business Week*, 50.

¹⁷ Corporate Development Roundtable: The Impact of Sarbanes-Oxley on M&A Transactions. July 2004. *PricewaterhouseCoopers*.

¹⁸ Patrick Daugherty participated on a panel on "Why and How to 'Go Private'" during the 2004 National Directors Institute held May 19, 2004, in Chicago. The theme of this year's conference was "Corporate Governance Reform: What's Working and What Isn't." Daugherty noted that "by delisting, small (public) companies can save up to \$2 million annually."

¹⁹ Baran, Mark R., and Katherine M. Koops. May 2005. Escaping SOX. *ABA Banking Journal*.

mid-Atlantic states tripled from \$193,000 in 2003 to \$600,000 in 2004.²⁰ Finally, the results of a survey conducted by the *Independent Community Bankers of America (ICBA)* from December 1, 2004, to February 25, 2005, show that the average outside Section 404 compliance costs of publicly traded community banks total slightly more than \$202,000.²¹

Although *Call Report* data do not specifically break out SOX-related compliance costs, such expenses are included as part of commercial bank noninterest or overhead expense. Total overhead expenses have been increasing at large and small commercial banks, a trend that may offer some insight into the impact of complying with provisions of the SOX legislation.²² For larger commercial banks (holding assets greater than \$500 million), total overhead expenses doubled from \$122 billion in 1995 to an annualized \$246 billion by the first half of 2005.

Although the *dollar volume* of overhead expenses increased among large commercial banks, the *ratio* of overhead expenses to average assets tells a different story. This ratio reflects how well a bank is managing overhead expenses as a percentage of average assets, and it actually dropped 52 basis points from June 30, 1995, through June 30, 2005. Much of this improvement occurred during the past three years and is attributed to the “other noninterest expense” component of total noninterest expense.²³ A closer look at the components of this ratio sheds light on trends in expense and asset growth for large banks. During the past ten years, overhead expenses grew at an average annual rate of 7.33 percent, possibly a reflection of higher SOX-related compliance costs, while the growth in average assets averaged 8.65 percent. This more rapid growth rate may be masking the potential effects of higher expenses for these institutions.

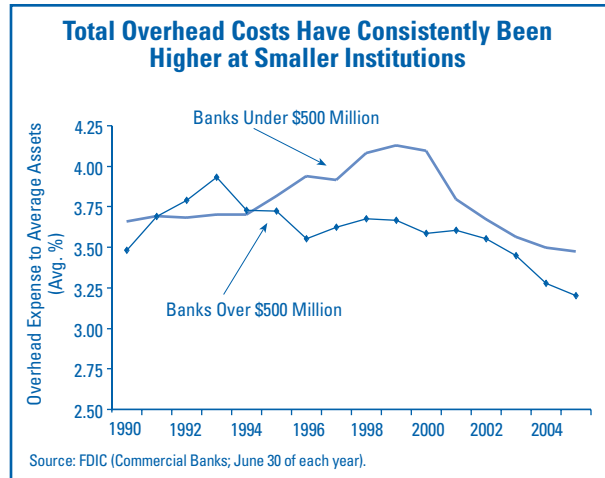
²⁰ Abernathy, Wayne. March 31, 2005. *ABA Letter to SEC Proposes Regulatory Relief for U.S. Businesses*. www.aba.com.

²¹ ICBA surveyed ICBA-member publicly held community banks. The response rate was 13 percent, with 91 banks responding. The survey included costs for 2004 or 2005, depending on the year in which each institution complied or is required to comply with Section 404.

²² FFIEC (Federal Financial Institutions Examination Council) Reports of Condition and Income—*Call Reports*.

²³ Per *Call Report* instructions, noninterest expense equals the sum of salaries and employee benefits, expenses of premises and fixed assets, amortization expense of intangible assets, and other noninterest expense. Other noninterest expense includes expenses such as postage, legal fees, advertising, insurance premiums, sales tax, and auditing fees.

Chart 2



Smaller commercial banks also are reporting lower overhead expense ratios. However, the improvement in this ratio during the past decade was less than that of larger commercial banks, largely because of a slower growth rate in average assets (see Chart 2). Again, most of the improvement occurred in recent years and was attributed to other noninterest expenses. During the past ten years, total overhead expenses have remained relatively stable for smaller institutions—around \$27 billion. However, average assets have grown more dramatically—from \$775 billion in 1995 to slightly more than \$800 billion in 2003, totaling \$840 billion by the first half of 2005. The growth in average assets has outpaced the growth in noninterest expenses, helping to explain the decline in the overhead expense to average assets ratio, despite the added compliance costs that may be attributed to the enactment of SOX.

Although commercial banks are reporting improvement in their overhead ratios, some banks, particularly smaller publicly traded banks, are considering strategies that would exempt them from complying with SOX, such as going private.²⁴ Since January 2003, banking institutions have filed more than 40 “going-private” transactions.²⁵ An article published by the *Federal Reserve Bank of Richmond* discusses SOX compliance costs and previews the challenges one bank, *Darlington County Bancshares*,

²⁴ Sisk, Michael. June 2005. *Going Private*. *US Banker*, and Krebsbach, Karen. May 2005. *SOX Costs Prompt Switch From Public to Private*. *US Banker*.

²⁵ Baran, Mark R., and Katherine M. Koops. May 2005. *Escaping SOX*. *ABA Banking Journal*.

Corporate Governance for FDIC-Insured Institutions

Among FDIC-insured institutions, corporate governance determines how management and boards of directors set corporate objectives, run daily operations, consider stakeholder or shareholder interests, ensure safe and sound operations, comply with applicable laws and regulations, and protect the interests of depositors. Insured financial institutions are operating in an increasingly complex and rapidly changing environment. Bank management and directors must know how to fulfill their fiduciary responsibilities in a manner that will ensure the institution's stability and soundness. Although not specifically developed in response to the SOX legislation, the FDIC's *Pocket Guide for Directors* offers timely guidance and suggestions for an institution's board of directors:²⁷

- Select and retain competent management.
- Establish, with management, the institution's long- and short-term business objectives, and adopt operating policies to achieve these objectives in a legal and sound manner.
- Monitor operations to ensure they are controlled adequately and are in compliance with laws and policies.
- Oversee the institution's business performance.
- Ensure the institution helps to meet its community's credit needs.
- Maintain independence when overseeing and evaluating management's actions and competence.
- Keep informed about the activities and condition of the institution and the economic and business environment in which it operates.
- Ensure the daily operations of the institution are in the hands of qualified management.
- Supervise management by establishing clearly communicated written policies that address all significant activities, monitoring the development and implementation of management reports, providing for independent reviews and testing of compliance with board policies and procedures, and heeding supervisory reports.
- Avoid preferential transactions involving insiders.

²⁷ The FDIC's *Pocket Guide for Directors* is available at www.fdic.gov/regulations/resources/directors/index.html.

faced with the going-private decision.²⁶ The advantages of going private include greater management flexibility, fewer reporting requirements, fewer resources devoted to compliance, and more efficient use of capital. This strategy has its disadvantages, however, such as limited access to the capital markets; costs of going private, such as legal fees; greater exposure to unsolicited takeover offers; and fewer control procedures, which could expose an institution to resource mismanagement.

Looking Ahead ...

Discussion continues among policymakers and legislators about the effectiveness and costs of SOX. Comments that appear in the text box on the following page show that the effects of this legislation continue to be hotly debated, raising the possibility of future legislative changes to the provisions of the Act. In fact, in late

March 2005 the ABA proposed some degree of regulatory relief for corporations, including small banks and businesses. The two-part proposal, submitted to the SEC, recommends increasing the shareholder threshold for companies governed by SEC reporting requirements, as well as reexamining the audit of internal control testing required by SOX.²⁸ Also in March, the ICBA urged the SEC and PCAOB to exempt community banks with total assets less than \$1 billion from compliance with Section 404.²⁹ In addition, Representative Jeff Flake (R-Arizona) introduced a proposal in mid-April 2005 that would make compliance with Section 404 of SOX voluntary.³⁰ Overall, the enactment of the SOX legislation has pushed the corporate governance debate to the fore, and this debate is unlikely to be resolved in the near term.

²⁸ ABA. March 31, 2005.

²⁹ Letters to regulators. March 31, 2005. Implementation of Internal Control Reporting Provisions of the Sarbanes-Oxley Act of 2002. www.icba.org.

³⁰ Flake, Jeff. Congressman Flake Introduces Legislation Reforming the Sarbanes-Oxley Act, United States Congress, April 15, 2005. www.house.gov/apps/list/press/az06_flake/050415SARBOX.html. See also Congressional Record, 109th Congress, H2100.

²⁶ Campbell, Doug. Summer 2005. Lights Out. *Region Focus*. Federal Reserve Bank of Richmond.

SOX Dissenters

Several prominent policymakers have criticized SOX and are calling attention to possible negative consequences. The views of two dissenters, in their own words, appear below.

Alex Pollock, Resident Fellow at the American Enterprise Institute and former President and Chief Executive Officer of the Federal Home Loan Bank of Chicago, believes “there’s no doubt that this [SOX] is tremendously costly. We don’t know exactly how much. Estimates range from millions of dollars per firm for large firms and many billions of dollars in the aggregate. The implicit costs of diversion of employee and management behavior are high. The accounting and legal costs are high. Virtually every audit committee around the country is watching its audit fees escalate by huge amounts, going up as much as 50 to 100 percent. And, as we’ll get to later, the opportunity costs are also very high, although it is very hard to know exactly how high. Whatever these costs are, in general we know they are disproportionately higher for smaller companies.”

Mr. Pollock suggests three reforms to “reduce the net economic cost, the cost in excess of the benefits, of Sarbanes-Oxley. With regard to governance by boards of directors, there is only one reform that I think is really meaningful. That is ensuring significant stock ownership by all directors. Second, regulatory reform. The SEC and the PCAOB have to acknowledge their own role in creating the morass of Sarbanes-Oxley cost and bureaucracy, not just blame it on the accountants, and then try to write more sensible, balanced rules. And thirdly, Congress should acknowledge its own role in creating Sarbanes-Oxley. They did something in a hurry, subject to a lot of political fear. The best effort that I’m aware of to fix Sarbanes-Oxley is a two-page bill introduced by Congressman Jeff Flake, a Republican of Arizona, which I recommend to everybody.”³¹

³¹ Pollock, Alex J. May 18, 2005. Economic Consequences of Sarbanes-Oxley. *AEI*. http://aei.org/publications/pubID.22625,filter.all/pub_detail.asp.

Peter J. Wallison, a Resident Fellow at the American Enterprise Institute and former Counsel to President Ronald Reagan and General Counsel to the U.S. Treasury Department, believes SOX stresses the wrong aspects of financial profiling. He states, “In adopting the act, Congress acted hastily, without adequate thought, and apparently without an understanding of the problem it was seeking to address.

“In reality, the underlying cause of the collapse of investor confidence was the recognition that audited financial statements prepared under GAAP or any other system of financial statement preparation currently in use could never give a completely accurate picture of the prospects of public companies. As a result, the appropriate policy for Congress would have been to diminish the importance of audited financial statements by encouraging the disclosure of information that is more useful to investors and less subject to manipulation by corporate management.

“There is a consensus among financial experts that companies are valued, not on the basis of their audited earnings, but on the basis of their current and estimated future cash flows.

“For this reason, Sarbanes-Oxley’s sole focus on audited earnings as the key to corporate financial disclosure was wholly misplaced. After Enron, WorldCom and others, Congress and many investors were concerned about the accuracy of financial statements. The correct solution was not to create a massive regulatory structure to improve the auditing process but to encourage companies and the SEC to develop methods that will provide investors with information on company cash flows, making it easier for analysts and investors to understand how effectively and efficiently the company is able to generate cash.”³²

³² Wallison, Peter J. January 23, 2003. Poor Diagnosis, Poor Prescription: The Error at the Heart of the Sarbanes-Oxley Act. *AEI American Enterprise Institute*. http://aei.org/publications/pubID.15714,filter.all/pub_detail.asp.

SOX Supporters

SOX also has its ardent advocates. Views of several prominent SOX supporters, also in their own words, appear below.

Former Federal Reserve Board Chairman Paul Volcker and former SEC Chairman Arthur Levitt Jr. state in a policy paper that appeared June 14, 2004, in the *Wall Street Journal*, “measures to reform the auditing profession and to assure its independence were central elements of the new legislation. Complementing them were strong new corporate governance rules ranging from who can sit on their boards and audit committees to new and clear responsibilities for internal controls and the accuracy of financial reports. These reforms were long overdue, and have made companies more transparent and accountable to shareholders. We are under no illusion that complying with Sarbanes-Oxley and other new regulations will come for free; financial and managerial effort as well as money is required. But we believe that those costs are justified in light of the benefits—the price necessary to pay for more reliability in accounting, clear accountability to shareholders, and more robust and trusted markets. We should not let the relatively quick rebound of the markets induce a collective amnesia toward the real pain and loss that investors suffered, or blind us to the critical role that Sarbanes-Oxley has played in restoring investor confidence and strengthening our free market system. While there are direct money costs involved in compliance, we believe that an investment in good corporate governance, professional integrity, and transparency will pay dividends in the form of investor confidence, more efficient markets, and more market participation for years to come.”³³

William H. Donaldson, who recently stepped down as Chairman of the SEC, believes SOX restores consumer confidence in the stock market and creates healthy business practices. He states, “It is already clear that Section 404 is helping to strengthen the business opera-

tions of these U.S. and foreign issues who have seized the opportunity to use the internal controls assessment as a managerial opportunity and not simply a compliance exercise.”³⁴

Treasury Secretary John W. Snow, when asked if Congress should modify SOX, responded that “Sarbanes-Oxley was critically important legislation that met a real need for the country at the time of those scandals. Sarbanes-Oxley played a very important role in reaffirming the norms of good corporate behavior, and, in some ways, I think [it] was absolutely essential. Corporate capitalism depends on trust.” Treasury Secretary Snow concedes aggressive politicians and investors may rush to “criminalize innocent mistakes,” leaving little room for companies to feel assured they can make such mistakes. “The nature of business is that you aren’t always going to be right.”³⁵

George David, United Technologies Chairman and CEO, states, “Sarbanes-Oxley is not bad. We redid 30,000 financial processes in the company to meet the regulations. We spent \$40 million on it last year, though we’ll spend less in 2005. Ultimately, it makes the company better. There’s no silver bullet here. People think you can write a new regulation, and there will be no WorldCom, Enron, or Tyco. That’s not true. How long has the criminal justice system been in place? We can improve regulations, but problems will still come up. We have a very good system of governance in the [average] American company. We have better governance than in most parts of the world. Everybody is anxious about [getting rid of] problems. It’s a hazard that won’t go away.”³⁶

³³ Levitt, Arthur Jr., and Paul Volcker. June 2004. *In Defense of Sarbanes-Oxley*. AEI-Brookings Joint Center. www.aei-brookings.org/policy/page.php?id=188.

³⁴ From a speech by William Donaldson in London. January 25, 2005. U.S. May Ease Corporate Accounting Deadlines for Foreign Firms. www.usembassy.org.uk/gb007.html.

³⁵ An interview with *Business Week* senior writer Rich Miller. January 4, 2005. Sarbanes-Oxley: A Sense of “Siege.” A Q&A with Treasury Secretary John Snow on Corporate Reform. <http://msnbc.msn.com/id/6798606/>.

³⁶ Brady, Diane. April 25, 2005. Sarbanes-Oxley Is Not Bad. *BusinessWeek Online*. www.businessweek.com/magazine/content/05_17/b3930023_mz001.htm.

Other Recent Corporate Governance Reforms

The breakdown in corporate governance systems in the early 2000s precipitated the enactment of the Sarbanes-Oxley Act, but this piece of legislation was not debated and implemented in a vacuum. At the same time SOX was being implemented, other corporate governance changes were in the making, as many policymakers and industry leaders recognized the need for a concerted reform effort that would strengthen corporate governance and restore the public's confidence. These reform initiatives are far-reaching and extend to some highly visible organizations in the nation's financial services sector—the NASDAQ Stock Market Inc. (NASDAQ) and the New York Stock Exchange (NYSE), the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), and the Financial Accounting Standards Board (FASB). Key corporate governance rules and standards implemented by these groups are summarized below.

The NYSE standards require that independent directors comprise a majority of a company's board of directors; the audit, compensation, and nominating committees remain independent; companies develop an internal audit function; members adopt a code of business conduct and ethics; and stockholders vote on stock option plans and any material changes to these plans. The NASDAQ standards mandate that the majority of corporate board members be independent, the authority of audit committees be expanded, the role of independent directors in compensation and nomination decisions be strengthened, shareholders approve all

stock option plans, companies develop codes of conduct, and companies promptly disclose insider stock deals for transactions exceeding \$100,000.

The AICPA issued guidance to help auditors detect misstatements resulting from fraud. In addition, the AICPA implemented standards to enhance the quality control processes and procedures of U.S. audit firms. These standards were issued following the collapse of Enron—during a time when many public companies were seeking new audit firms. AICPA members also granted the professional association greater flexibility to ensure that it can act in the public interest should a member violate the accounting profession's code of ethics.

Changes implemented by the FAF, which oversees the FASB, attempt to improve the efficiency of the FASB rulemaking process, as the FASB had been criticized for delays in issuing new accounting standards. Under these new operating procedures, the voting requirement of the seven-member FASB board was streamlined from a supermajority to a simple majority. In addition, FASB shortened the proposed rule comment period as a means of expediting the issuance of new accounting guidance and standards. The failure of Enron, which had several off-balance-sheet partnerships with guarantee provisions, prompted the FASB to issue guidance for variable-interest entities and guarantees. This guidance addresses accounting requirements for a variety of investment and financial enterprises and requires a company entering into a guarantee agreement to record an upfront liability.

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What Does the Future Hold for U.S. Agricultural Subsidies?

The banking industry's vulnerability to "stroke-of-the-pen" risk extends into the nation's farm sector. Strong performance in the agricultural sector and among farm banks would be seriously challenged if an underpinning of this success, high levels of domestic government support payments, were to be scaled back because of the results of international trade negotiations or U.S. congressional budget debates. Should agricultural subsidies be lowered or phased out altogether, not only would farm income be hurt, but the value of farm land also could decline, and the financial condition of the nation's farm banks could weaken. The effects of these policy changes would be significant and far-reaching and therefore warrant close scrutiny.

Performance of U.S. Agricultural Sector Remains Strong: Effect of Subsidies Is Clear

The U.S. agricultural sector is riding a wave of positive numbers. Net farm income of almost \$74 billion set a record in 2004; this strong performance is expected to continue into 2005 with forecasted income of more than \$64 billion.¹ Relatively high livestock prices and substantial government support payments to farmers are compensating for low commodity prices (see Chart 1). In addition, farm real estate values have climbed rapidly in many areas, bolstering farmers' balance sheets.

A key contributor to net farm income, government payments to farmers have exceeded \$10 billion each year since 1997 (see Chart 1). Before 2002, these payments largely took the form of emergency assistance to help farmers through periods of low commodity prices. Since the enactment of the Farm Security and Rural Investment Act of 2002 (Farm Bill), the level of government support has been tied to commodity prices. As strong harvests for corn, soybeans, wheat, and cotton have dramatically lowered prices for these crops, government payments have helped fill the gap.

Pressures are building in Congress to scale back farm subsidies. In the longer term, the outcome of international trade negotiations may result in the U.S.

¹ Economic Research Service, U.S. Department of Agriculture (USDA). Figures for 2004 and 2005 are forecasts.

government cutting or discontinuing many subsidy programs, possibly as soon as 2007, when the next farm bill will be negotiated.

In the short term, Congress could cut farm subsidies to help close federal budget shortfalls. Any such reductions would be a blow to farmers' cash flows and incomes and could affect farmland prices, as the expectation of continuing subsidies has been capitalized into land values. This article explores the events and pressures that could scale back farm subsidies and examines the implications for farmers, their lenders, and farmland values.



The World Trade Organization and U.S. Agricultural Subsidies

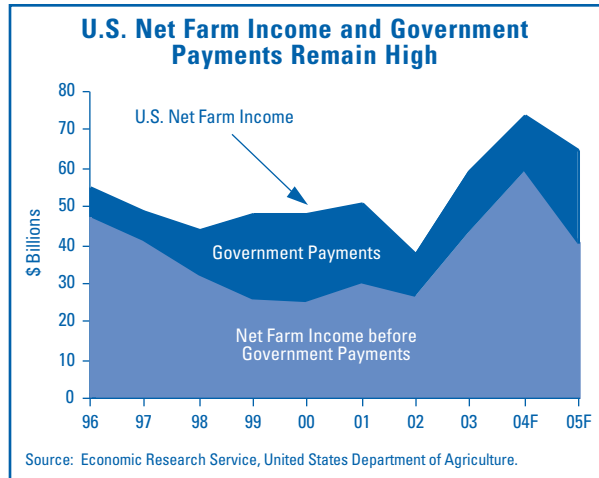
The United States is a member of the *World Trade Organization (WTO)*, a forum for the negotiation of international trade rules that help lower trade barriers and improve the flow of goods.² International trade negotiations from 1948 to 1994 reduced tariffs on manufactured goods from 38 percent to 4 percent, while total merchandise trade expanded an impressive 18-fold.³ Economic data show a strong link between free trade and economic growth, and liberal trade policies—those with fewer restrictions on the trade of goods and services—enhance competition and drive innovation.⁴

² The WTO was created January 1, 1995, as the successor of the General Agreement on Tariffs and Trade (GATT). International trade negotiations have been ongoing since the GATT was formed in 1948. In response to protectionist strategies pursued by several countries in the 1930s, which many believed contributed to the severity of the Great Depression, 32 countries formed the GATT in the postwar period as a forum for multilateral negotiations, initially to reduce tariffs on manufacturing goods. The WTO has similar goals but is wider in scope, with a stronger institutional base.

³ Ingco, Merlinda, and John Nash. 2004. *What's at Stake? Developing-Country Interests in the Doha Development Round*. In *Agriculture and the WTO: Creating a Trading System for Development*. Washington, DC: The World Bank, 7.

⁴ World Trade Organization. 2005. *Understanding the WTO*. Geneva, Switzerland: WTO, 13. www.wto.org/english/thewto_e/whatis_e/tif_e/understanding_e.pdf.

Chart 1



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

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.

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

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

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.

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

What Does the Future Hold for U.S. Agricultural Subsidies?

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*.

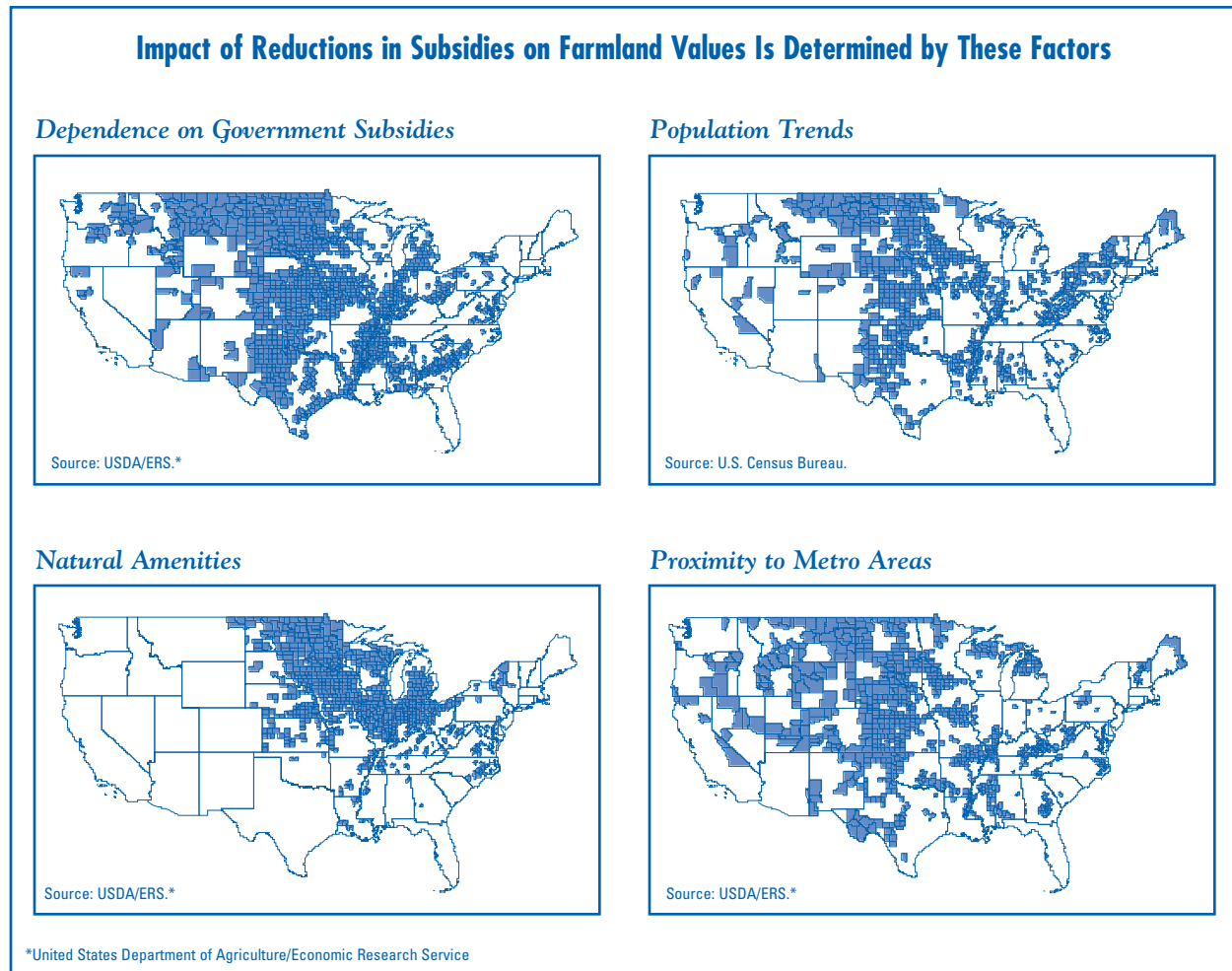
¹⁴ Moss, Charles B., and Andrew Schmitz. 2003. *Government Policy and Farmland Markets: The Maintenance of Farmer Wealth*. Ames, Iowa: Iowa State Press.

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



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 signifi-

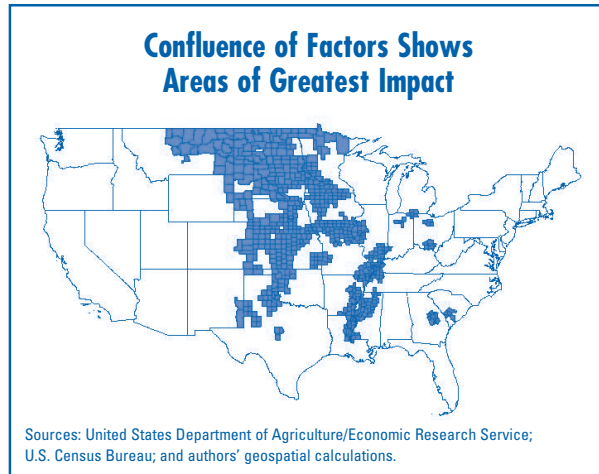
cantly on government support, as do the Mississippi Delta and the South. If payments are reduced, these areas would experience the greatest impact, both to farmers’ incomes and farmland values.

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



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

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

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.

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