A Study of the Risk of Issuing FSA Guarantees on Contract Land Sales to Beginning Farmers

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Financing Agriculture and Rural America:
Issues of Policy, Structure and Technical Change
Proceedings of the NC-221 Committee Annual Meeting
Denver, Colorado
October 7-8, 2002

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Abstract

Risks associated with guarantees of land contracts are expected to be greater than guarantees of loans made by commercial lenders. Farmers utilizing seller-financing have greater debts, less cash flow, less equity in real estate, and less solvency than farmers utilizing regular FSA guarantees. Consequently, defaults and loan loss levels are expected to be 50 percent higher than loss rates on guaranteed loans made by commercial lenders. In addition, ambiguities in real estate laws concerning the administration of land contracts would likely result in higher servicing and liquidation costs. Therefore, if the contract land sale guarantee is structured as the current program, the costs per dollar lent would be much higher than for traditional guarantees.

Guaranteeing the payment rather than the principal could reduce risks associated with guarantees of land contracts. Under this alternative FSA would make a guarantee to the seller equal to one annual installment which would be paid upon default by the buyer. Because total losses are limited to an amount equal to one or two annual installments, this alternative would greatly limit potential losses. However, the frequency of losses for seller financed loans would be greater than if this option was used on regular guarantees.

In summary, FSA guarantees of land contracts should enable a limited additional number of beginning farmers to acquire farmland. As long as losses are limited, the risk associated with the issuing land contract guarantees should not be notably greater than for losses occurring in the traditional guarantee program.

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The Farm Security and Rural Investment Act of 2002 amended the Consolidated Farm and Rural Development Act (CONACT, 7 USC 1922 et. seq.) by adding 310F. Section 310F requires the Secretary of Agriculture to implement a pilot program whereby the Secretary will guarantee loans made by private sellers of a farm or ranch on a contract land sale basis to a beginning farmer or rancher. However, the requirement is conditional upon the Secretary's determination by October 1, 2002 as to whether "guarantees of contract land sales present a risk that is comparable with the risk presented in the case of guarantees to commercial lenders." USDA's Farm Service Agency is required to undertake a study of risks associated with guarantees of land contracts. Upon completion of the study, the Secretary shall determine whether to implement the pilot program. If it is determined that the risk associated with guarantees of land contracts are notably higher than the risk associated with guarantees on loans made by commercial lenders, the Secretary need not implement the program. The CONACT, as amended, requires implementation in not fewer than 5 States, as determined by the Secretary, to guarantee 5 installment land sales in each State in each fiscal year 2003 through 2007.

The approach of the study is to consider risk as if it were fully implemented and not limit the analysis to only the impacts of the pilot program. Risk is considered in both absolute and relative terms. Absolute risk refers to the overall dollar volume of losses expected while relative risk refers to loss rates. It shall be important to consider risk in both contexts because while loss rates could be high, the dollar volume of losses may be so low as to be inconsequential. While the statute mentions only contract land sales, seller mortgages are also considered in the analysis as these instruments are close substitutes.

Background

Through implementation of this program, the apparent Congressional intent was to facilitate the acquisition of farmland by young and beginning farmers. In recent years, Federal farm policy has promoted programs that provide assistance to young and beginning farmers and ranchers.

It is well established that U.S. farmers are becoming older. USDA statistics show that nearly half of all farmers were over age 55 in 1999 (table 1). Given the increasing age of US farmers, there has been a concern that there is sufficient number of young, beginning farmers to replace retiring farmers thereby assuring the continued production of food and fiber. But, much of the management and control of farm assets appears to have already transferred to younger farmers with farmers under the age of 55 accounting for nearly 70 percent of all production. The age of landowners is another issue, however. Older farmers and landowners still appear to control much of the farmland with 57 percent of the farmland owned by individuals over the age of 55. While, it appears that older farmers and landowners supply the fixed capital or land, younger farmers supply labor and operating capital.

Given the advancing age of farmland owners, it appears there is likely to be an increase in the farmland transfers in upcoming years. A goal of policymakers is to assure that young and beginning farmers have adequate opportunities to purchase this farmland as it becomes available. But young and beginning farmers frequently lack the financial resources necessary to purchase

farmland. Consequently, they must rely on Federal guaranteed loans, direct FSA loans, or seller financing to obtain the capital necessary to purchase farmland.

It shall be important to consider the relationships among financing instruments used by young or beginning farmers. If seller financing is a substitute for direct or guaranteed loans, implementation of the program would be expected to reduce demand for direct or guaranteed loans. And, if these programs are substitutes, implementation would not result in any additional beginning farmers acquiring land. Rather, there would be a substitution of owner financing for FSA guarantees of commercial loans. If individuals considered not likely to utilize traditional FSA programs use seller financing, implementation of the program would result in an increase in demand for FSA loan programs. The level of expected demand and expected losses determines the risk of FSA land contract guarantees. The expected demand for guarantees of land contracts will depend on several factors; the amount of farmland expected to transfer, numbers of beginning farmers purchasing land, the demand for seller financing, and the manner in which the program is designed. Loan losses arising from guarantees of land contracts should be influenced by expected economic conditions and program parameters.

Table 1. Distribution of Farms, production, and land by age of operator.

	Operator Age Class					
	Under 35	36-45	46-55	56-65	Over 65	All farms
	--percent--					
Farmers	7	20	26	22	24	100
Production	9	29	32	19	10	100
Farmland/1	2	9	31	20	37	100
1/ Source: 1999 AELOS; Includes farmers and non-operator landlords						

Historical Use of Seller Financing

Seller financing was once a very popular method to finance farmland sales. High interest rates and correspondingly tight credit markets of the 1970's forced sellers to offer financing in order to sell their property. Statistics provided by USDA's Economic Research Service (ERS) reveal that shares of debt owed by individuals has been declining since 1975. ERS, however, does not specifically estimate the total amount of debt owed to individuals and others. Rather, it is calculated as a residual; total debt less debt owed to the Farm Credit System, banks, FSA, and insurance companies. Besides individuals it would include debt owed to SBA and state and county lending agencies. Nonetheless, it indicates that use of seller financing has declined.

There is a great deal of regional variability in the use of seller financing. Compared to other parts of the U.S., seller financing is a more important source of credit in the upper Midwest in terms of both market share and volume (figure 2). States with the largest agricultural production displayed a greater use of owner financing (figure 3). Market share is greatest in Mountain States while volume is greatest in the Corn Belt (figure 4). It is used sparingly in the Southeast and Northeast.

As previously discussed, land contracts and seller provided mortgages are generally regarded as close substitutes for sources of credit. The choice of one instrument versus the other

may depend on the jurisdictional laws within a State and custom. In some States the laws applying to land contracts are so restrictive as to make them, in effect, mortgages. Missouri, Texas, California, and Pennsylvania are examples of States with higher volumes of seller financing, with most provided through seller provided mortgages. States selected for implementation of the pilot program would need to have substantial volume of transactions within a state to provide volume to gauge the success of the program. But, there are only 3 States with outstanding volumes of land contracts in excess of $300 million (table 2). And, land contracts represent the primary source of owner financing in only 15 states.

States with large volumes and large market shares represent the strongest candidates for the pilot program. Since land contracts and seller mortgages may be close substitutes, it may be necessary to consider all sources of owner financing in determining where to implement the pilot program. For example, California and Texas rank 9th and 12th with respect to outstanding land contract volume. Yet, when all owner financing is considered, they rank 1st and 3rd (table 3). If the guarantees are provided only on land contracts, there is the possibility that sellers that previously would have used a seller mortgage, will now be more inclined to utilize land contracts.

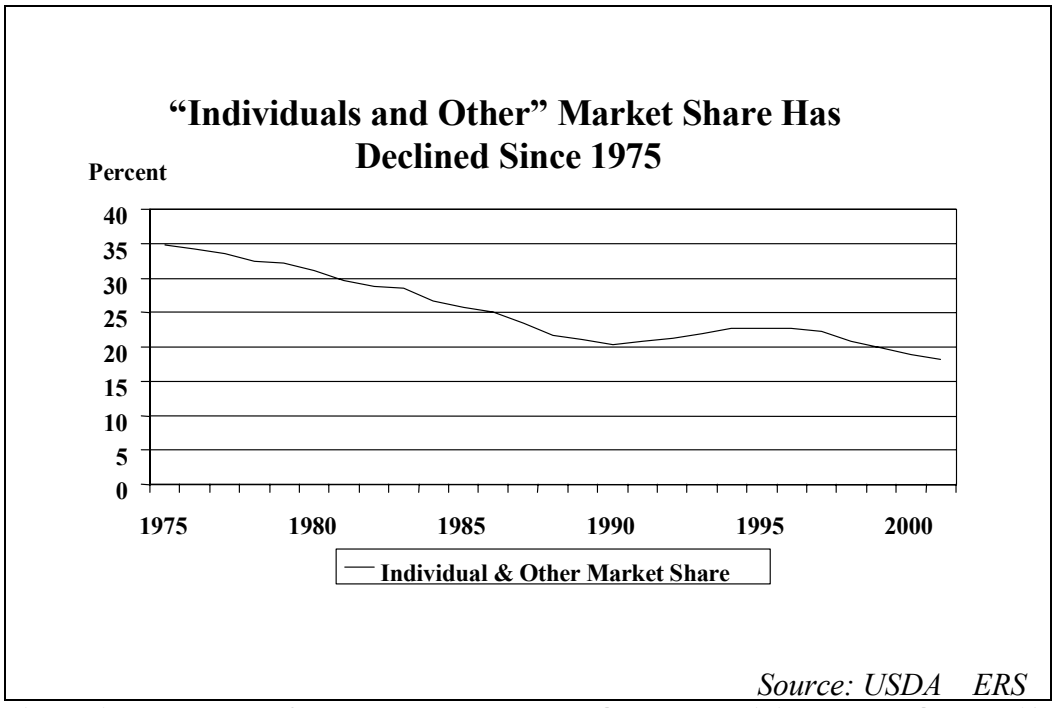

Figure 1. Percentage of Farm Real Estate Debt Owed to Individuals and Others, 1975-2000.

Table 2. States with over $100 Million Outstanding in Land Contracts		
Rank	State	Land Contract Volume
1	Minnesota	530,426
2	Wisconsin	461,225
3	Iowa	326,763
4	South Dakota	271,718
5	Indiana	209,462
6	Nebraska	199,496
7	Oregon	178,663
8	Illinois	177,152
9	California	173,701
10	Montana	169,853
11	Kansas	166,820
12	Texas	154,086
13	Ohio	148,890
14	Idaho	126,637
15	Michigan	119,473
Source: 1999 AELOS		

Table 3. Top 15 States By Outstanding Volume and With Owner Financing Market Share of Over 5.5 Percent					
Rank	State	Farm Operator Debt Owed Through Seller Mortgages and Land Contracts	Rank	State	Farm Operator Debt Owed Through Seller Mortgages and Land Contracts
		Market share / Outstanding Volume			Market share / Outstanding Volume
1	California	6.7 / 965,003	8	South Dakota	10.8 / 362,290
2	Minnesota	11.1 / 828,790	9	Oregon	9.6 / 350,320
3	Texas	9.0 / 733,743	10	Idaho	11.1 / 342,263
4	Wisconsin	11.6 / 598,993	11	Ohio	7.6 / 323,674
5	Iowa	6.0 / 466,804	12	Indiana	5.6 / 243,561
6	Montana	14.1 / 395,008	13	Washington	8.0 / 234,772
7	Pennsylvania	14.4 / 374,870	14	North Dakota	6.7 / 218,870
			15	Michigan	7.4 / 195,957
Source: 1999 AELOS					

How Much Farmland Will Transfer to Beginning Farmers?

The greater the number of farms likely to transfer in upcoming years, the greater the overall demand for land contract guarantees. Despite the increasing age of farmland owners, there is not likely to be a large quantity of farmland coming on the market in upcoming years. First, a large share of the farmland is likely to already have a succession plan in place where a

descendent is expected to inherit the farm[1]. Over a quarter of all farmland, 27.6 percent, is owned in a corporate or family partnership, and not likely to come on the market in the event of death of the senior partner (table 4). Second, the transfers are likely to be spread over a long period of time. Application of average life expectancy to those who own land either jointly with a spouse or individually indicates that 28.9 percent of all farmland is owned by individuals with life expectancy of less than 15 years (table 4). Assuming transfers occur in direct relation to life expectancy, the turnover rate would be expected to increase from 1.6 percent to 1.9 percent. This means that a parcel of land would be expected to change hands once every 50 years as opposed to once ever 66 years. Despite the increasing age of landowners, the amount of farmland coming on the market for sale in upcoming years will likely be negligible. In 1999, about 2.7 percent of all farmers with annual sales over $5,000, or 58,000, purchased land. Less than half, or about 26,000, utilized credit in the purchase. Even after considering the advancing age of landowners, the number of farmers buying farmland with credit is not likely to exceed 30,000 per year.

The amount of farmland available for purchase will likely increase on an annual basis, though probably not enough to have any notable impacts on farmland markets. Still, over the next 15 years we are likely to witness a change in the structure of farmland markets as other entities acquire this land. Individuals or other entities with the most capacity to repay and collateral to offer as security, would be in the greatest position to purchase this additional land. If young and beginning farmers are to acquire farmland, they will likely need credit. But, in many cases they fail to meet the underwriting standards of commercial lenders and must, therefore, turn to noncommercial sources of credit such as owner financing.

Table 4. Acres of Farmland by Life Expectancy of Owner.

	Life Expectancy in Years for Land Owned Individually or Jointly				Landed Owned by Corporate or Family Partnership
	< 10	10-15	15 – 20	Over 20 years	
Percent of farmland acres	14.9	14.0	11.3	32.3	27.6
Percent of owners	17.0	14.0	12.4	44.1	12.3
Average acres owned	336	299	271	218	559
Estimated capital gains as % of current value	68.1	62.3	54.5	46.3	54.6
Age of owner	79.6	71.3	64.6	48.9	54.6
Source: 1999 AELOS					

[1] While it may be possible for a land contract or seller mortgage be used to finance a buyout of other heirs, such exchanges would not be eligible for FSA guarantees because they involve related parties.

Factors Influencing the Use of Seller Financing

Young and beginning farmers are more likely to utilize seller financing when financing a farmland purchase. There are two types of seller financing with respect to real estate, installment land contracts and seller financing with mortgage or deed of trust.[2] The installment land contract, sometimes called a contract for deed provides that the buyer will make payments in installments to the seller over a period of years. When the complete purchase price is paid with interest, a deed from the seller to the buyer is recorded. The purchaser exercises all rights of ownership, though in fact, the seller remains the owner of the land until the purchase price is paid. In case of default, a buyer would forfeit all previous payments to the seller. Under seller financing with a mortgage or deed of trust, a deed from the seller to the buyer is recorded. The purchaser becomes the owner of the land but the seller holds the mortgage or deed of trust and can foreclose if the purchaser fails to make payments.

The use of land contracts requires mutual agreement between both the buyer and seller. The turnover rate of 1.6 percent for farm real estate implies a "sellers market" whereby sellers are in a much better position to dictate sale terms. Thus, it is important to consider the seller's motivations for offering financing. Landowners who have been in possession for long periods may have significant capital gains taxes if the property were sold outright. Consequently, the ability to treat capital gains tax as an installment could also encourage sellers to utilize seller financing[3]. It is estimated that if those farmland owners with less than 20 years of life expectancy sold their land, more than half of the proceeds would be subject to capital gains tax (table 4). A seller may be able to obtain a higher rate of return on a land contract than alternative investments or they could obtain a higher price. Continued low interest rates on savings accounts may encourage the use of seller financing. Sellers may be motivated to offer financing terms as an enhancement to sell property. This would be used when there is a shortage of buyers or for unique or poor quality land. It is important to recognize that when there are qualified buyers with either the cash or credit capacity, a seller is less likely to offer financing terms. Even in today's economic environment, there are a large number of potential buyers with either the cash or credit capacity to purchase farmland.

Buyers are most likely to seek seller financing when they are not able to obtain credit from traditional sources. Tight cash flows and limited capital are common reasons that a farmer would pursue seller financing. Young and beginning farmers are more likely to fall within this category. Compared to all farmers, young, beginning farmers receive 12 percent of their credit from individuals compared to 8 percent for all farmers (table 5).

Those who used seller financing tend to be of higher risk than those relying on other sources of credit. This is reflected in greater debts, less cash flow, less equity in real estate, and less solvency (table 6). Those relying on seller financing operated smaller farms and were younger. Many users of seller financing may be unable to obtain credit elsewhere because of tight cash flow. It was estimated that 70 percent of those using seller financing had a term debt coverage ratio of less than 1.0 (table 6). These facts suggest seller financing and FSA guarantees are not close substitutes. That is, FSA guarantees and owner financing each serve unique groups

[2] Another instrument used in real estate is the sales contract that must be distinguished from other instruments. A sales contract assumes that the seller will remain in possession until closing in the near future while the seller mortgage and land contract covers a term of 20 or more years.
[3] Under certain conditions IRS tax rules allow capital gains to be recognized as an installment for seller provided mortgages or deeds of trust.

of clientele. This program would result in an overall increase in program demand, as FSA clientele would expand to include the less creditworthy users of seller financing**.**

Table 5. Shares of Total Credit Supplied by Lender Groups.

	Market Shares of All Farm Operator Debt		Market Share of Loans Used to Buy Land
	Young, Beginning Farmers 1/	All Farms	Farms Acquiring Land in 1999
FCS	14	23	26.4
Banks	53	52	47.3
FSA direct	8	5	3.2
FSA gte	10	7	D
Individuals	12	8	4.6

Source :Average of 1998-2000 from ARMS
1/ 10 years or less of farming experience and under 40 years of age.
D=insufficient data

Through implementation of underwriting standards, FSA could prevent some of the riskier seller financed loans from receiving guarantees. Still, it is likely that even with underwriting standards, loans provided by sellers are going to be riskier than traditional loans with FSA guarantees. Even with the presence of a guarantee, a regulator may question loans of marginal quality. Thus, a bank would be less likely to make a loan if it could be called into question by their examiners. FSA requires that for all guaranteed loans, cash flow coverage of 100 percent must be shown. Yet, FSA guaranteed FO loans made in the late 1990s reported cash flow coverage of 150 percent (table 6). This would seem to indicate reluctance on the part of lenders to make loans of more marginal quality, even with a guarantee. But, sellers are not regulated and examined, as is the case for commercial lenders. Also, sellers do not have to be concerned about the impact of loan losses on the capital of the financial institution. These facts suggest that sellers would be less risk averse in their lending decisions than commercial lenders. Because sellers are likely to be less risk averse and those utilizing seller financing are less creditworthy, it is expected guarantees of land contracts are more riskier than regular guarantees. Given the regulatory oversight that would be required, it is unlikely that FSA could effectively implement underwriting standards sufficiently strict as to insure that land contract guarantees pose no greater risk than regular guarantees.

In some instances, seller financing is commonly used in conjunction with credit provided by commercial lenders. Over 95 percent of bank and FCS borrowers received all of their debt from these respective lenders. Whereas in seller financing, only 86 percent of those receiving seller financing received all of their debt from the seller. A common method used in seller financing is to "take back a second", in cases where the buyer may not have sufficient cash for a down payment. In this case the seller may provide financing for a share of the purchase price which would function as the down payment, thereby reducing the loan-to-value ratio for the

lender. The lender takes a 1st mortgage while the seller takes a 2nd mortgage. But under Section 310F of the CONACT, these types of transactions would not be eligible for guarantees. Thus, if only those cases where the owner supplied the purchase money are considered, individuals market share would be less than the 4.6 percent reported in table 5.

Considering all factors, the demand for these land contract guarantees is likely to be slight. First, there must be a transfer of farmland between unrelated parties. Also, the buyer must be a qualified beginning farmer that is unable to obtain credit from conventional sources, yet be able to demonstrate cash flow. And finally, it must be in the interest of the seller to enter into such a contract. Using an expected turnover rate of 1.9 percent for farmland, less than half of those buying land using credit, and a 4 percent market share for seller financing, it appears that only about 350 to 400 beginning farmers would be expected to utilize land contracts each year (table 7). Assuming that 20 percent of these would receive FSA guarantees, there would only be about 80 contracts receiving about $15 million in guarantees each year. If the guarantees extend to all seller financing or there is a substitution of land contracts for seller-provided mortgages, demand for guarantees could double. While only $15 million in new volume per year may seem low, this would be roughly equivalent with what has been experienced for the downpayment loan program. Like the proposed program to guarantee land contracts, the downpayment loan program is used by beginning farmers to purchase farmland. In recent years there have been between 100 and 150 downpayment loans annually, with an annual volume of $5 to $8 million.

Legal Risks

In addition to the risks arising from the poorer credit quality associated with seller financing, land contracts can especially present certain legal risks. Many of the risks associated with land contracts vary according to State law. Accordingly, it is important that all applicable State laws be considered. While many of these risks do not directly impact the guarantor (FSA), they can result in costly legal delays in finalizing any loss claims. Typically, there is very little legal structure to installment land contracts (ILC). While some States do have laws governing their use, these laws are typically designed to protect the purchaser and do not provide any guidance. Consequently, there is likely to be disputes concerning the rights of buyers and sellers and interests of those parties, which can only be settled through lengthy adjudication.

The difficulty in maintaining clear title given that the seller remains in possession of the property can result in disputes. Disputes can result in more lengthy and costly liquidations. Also liens may attach through either the buyer or seller. Since the seller holds the title, the seller's debtors may file claims against the property. Since the buyer may hold an equitable interest in the property, even though he/she does not hold title, a creditor may file a claim on behalf of the buyer against the property. Recording the land contract does not always protect against claims. Neither would having the title held by an escrow agent. Creditors would still be able to file claims against any interest that the buyer or seller may have in the property. Sellers may believe that forfeiture enables a seller to more quickly obtain property back in case of default. While in some cases forfeiture can avoid foreclosure and rights of redemption, the law in many States is so vague and subject to legal manipulation that sellers can not rely on it. Sellers must be careful to follow correct legal procedures with respect to forfeiture or acceptance of late payments or risk losing to the buyer some of their interest in the land. Nearly all States require a notice of forfeiture. In some States the laws concerning ILC's have become so intensive and complex as to resemble mortgage law with rights of redemption and rights of restatement.

Table 6. Characteristics of Farms Acquiring New Real Estate Debt by Primary Source of Credit, 1998-2000

	Farm Credit System	Banks & S&Ls	FSA Direct	FSA Guarantee	Life Insurance Co.	Seller Financing
			Dollars per farm			
Farm Assets	1,239,594	660,716	922,994	680,351	2,093,855	740,051
Farm Debt	340,243	229,050	351,793	227,802	620,884	333,526
New Mortgage Debt	199,498	115,433	154,670		235,264	173,234
Net Worth	899,351	431,666	571,201	452,549	1,421,971	406,525
Gross farm sales	358,416	144,278	260,152	150,922	495,659	214,267
Net farm income	50,242	9,305	65,502	30,563	59,016	31,442
Net cash farm income	71,559	22,392	53,833	25,984	77,375	27,267
Total household inc	79,767	77,489	68,175	81,435	47,920	51,798
			Percent			
Beginning farmers as share of total	17	16	22	35	9	36
Debt-asset	27.45	34.67	38.11	33.48	29.65	45.07
Term debt coverage	1.11	.73	1.04	1.56	.47	.48
Share of farms with Negative cash coverage	43	44	58	43	60	70
Real estate debt/ Real estate assets	32.56	36.72	51.18	41.77	29.32	57.32
Loan to value/1	85	81	D	94	D	D
Distribution of borrowers with debt owed to:						
FCS	98.6	1.2	-	-	-	-
Banks & S&L's	0.3	97.5	0.4	-	-	1.5
Sellers	-	13.0	-	-	-	86.5
Operator age (years)	47	47	46	44	52	36
Acres owned	651	287	322	380	1,881	265
Acres operated	1,160	590	789	746	2,716	767
Acres purchased /1	152	88	D	198	d	146

/1 Using 1999 Data only; Ratio based only on value of land purchased as the survey did not value of additional land which may have been offered as security.
D/ Insufficient data
Source: 1998-2000 ARMS

Table 7. Projected demand for owner financing of land contracts. 1/									
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Beginning farmers buying land									
All owner financing	854	850	900	949	997	993	989	984	980
Land contracts only	342	340	360	379	399	397	395	394	392
Receiving FSA gte (%)	0	5	10	20	20	20	20	20	20
FSA contract gte's issued 2/	0	34	180	76	80	79	79	79	79
Volume originated ($ Mi)	0	6.2	33.7	14.6	15.9	16.3	16.7	17.1	17.5
Cumulative volume ($ Mi)	0	6.2	39.9	54.6	70.4	86.7	103.4	120.5	138.0

1/ Based on a 1.9% land turnover rate, 50% of all farmland sales using credit, 4% market share for seller financing, 36% of all seller financing is too beginning farmers, and 40% of all owner financing through land contracts.
2/ It is assumed that upon implementation of the program, there would be a larger demand for these guarantees. Any land contract issued within the last few years could be renegotiated in order to be eligible for a guarantee. This accounts for the large demand in FY2004, where the projected amount was increased by a factor of 2.5.

Some States require mandatory foreclosure while other states allow the land contract to convert to a mortgage after certain conditions are met. States with no laws governing land contracts are no better as resolution of any dispute will likely require court intervention. In States where land contracts resemble mortgages, sellers may prefer to record a mortgage or deed of trust, resulting in little use of land contracts.

Another legal hazard of seller financing is that the relationship between a buyer and seller may not qualify as an arm's length transaction. An arm's length relationship is a term used to describe a type of business relationship, that an entity should have with an associate to avoid a conflict of interest. In many cases where seller financing is used, blood or marriage relates the parties. Loans between related parties are likely to provide terms and conditions that are more favorable to the buyer at the seller's expense. For example, amortization schedules may be arranged to meet a tight cash flow by graduating payments.

When the seller is also the lender, there is an inherent conflict of interest that can result in property values being overstated. The sellers may be inclined to overstate property value so that the buyer meets minimum loan-to-value requirements. To minimize losses, commercial lenders would have an interest insuring that any agreement reflects market value and commercially reasonable terms and conditions. A seller may want to obtain the highest possible price for the property while a lender would want a fair market value such that there is minimal risk of loss. Lenders essentially determine the amount they will loan against the property. But if the seller is also the lender, there is less of an incentive to minimize losses. This risk is increased by the presence of the FSA guarantee that essentially guarantees the land value at 90 percent of the value at the time of loan closing. With a guarantee, this risk becomes even greater, thus encouraging sellers to inflate the price of their land, and seek a guarantee. Hence, appraisals are going to be much more important in conducting these transactions.

There is also the risk that if land values fall, buyers and sellers may collude in order to collect the loss payment. For example, assume land values fall by 10 percent and the buyer defaults. The seller files a loss claim with FSA collecting an amount equal to the land value decline. The seller subsequently sells the property to the previous buyer for 10 percent less than

the original amount. The buyer benefits from a lower price while the seller receives a loss claim. This risk can be controlled by implementing restrictions on sales, requiring public sales of all property on which a loss claim is paid, and/or implementing offsets against buyers on whose account loss claims were paid.

Projection of Losses

The most quantitative measure of risk would be expected losses. Loan loss rates were projected using farm level data obtained from the 1999 Agricultural Economics Land Ownership Survey (AELOS). Using a financial simulation model, projections were made of the financial performance of farms that purchased land in 1999 using either owner financing or FSA guarantees. This data set included farm level data for a farm business's balance sheet and farm and nonfarm income. The financial performance of each of these farms was simulated over a 15-year time horizon. Projections concerning prices, Government payments, interest rates, and inflation were taken from the July 2002 FAPRI Baseline which incorporated the impacts of the 2002 Farm Bill. Under this baseline, farmland values are expected in increase at an average annual rate of 3.0 percent. The assumption was made that default would only occur after 80 percent of all equity had been exhausted. When faced with a cash flow shortfall it was assumed that farmers would first use available cash and investments. If the cash flow shortfall still existed or there was no remaining cash, principal payments would be deferred. Next, it was assumed that equity would be utilized to secure the carryover. This would reflect an extension of additional credit to finance carryovers. If all available financing options had been used and a cash flow shortfall still existed, liquidation would occur. The loss claim was estimated as the minimum of the projected loss or 90 percent of the outstanding principal balance. Under these circumstances, the projected loss rate on real estate loans receiving an FSA guarantee in 1999 would be 1.39 percent, under the baseline scenario. This amount would be in line with current loss levels (table 8). This projected loss rate represents a weighted average of losses for all farms in the sample over the 15-year forecast period discounted back to the obligation year. In general, losses are expected to be low primarily as a consequence of strong balance sheets and incomes that are expected to be stable under the 2002 Act.

If FSA guarantees had been provided on all seller financed real estate loans made in 1999, projected losses would have been 1.64 percent for the baseline scenario[4] (table 8). This is about 50 percent higher than loss levels for regular guarantees. This is not unexpected, given that seller financed loans are of higher risk than guarantees provided on loans made by commercial lenders. Declines in land values would result in higher expected losses. Assuming land values declined by an average of 3 percent annually, expected loss claims for guarantees on seller financed loans would increase to 3.75 percent which is still about 50 percent higher than the projected loss claims for regular guarantees.

[4] Only seller-financed loans with cash flow coverage of at least 75 were considered in the simulation. The assumption was made that underwriting standards would be implemented that would prevent those with the greatest cash flow difficulties from obtaining a guarantee. Still there would likely be enough latitude with respect to such things as projected yields, prices, or withdrawals such that those with cash flow ratios slightly below 1.00 could show a positive cash flow and receive a guarantee.

Table 8. Projected loss rates for land purchase loans using owner financing and FSA guarantees of bank loans.

Annual Change in Land Values	Project loan loss rates (%)			
	Loss Guarantee 2\		Payment guarantee 3\	
	Credit Source		Credit Source	
	Sellers	Commercial lender w/ FSA gte	Sellers	Commercial lender w/ FSA gte
3.00% 1/	1.64	1.12	1.39	1.02
0.0%	2.23	1.43	1.42	1.03
-3.0%	3.75	2.05	1.71	1.08

1/ Baseline scenario
2/ Assumes FSA guarantees 90 percent of outstanding principal payable to the seller upon liquidation.
3/ Assumes FSA guarantees an amount equal to one annual installment payable to the seller upon default by the buyer.

The "Promise to Pay" Option

If structured as existing guarantees of loans by commercial lenders, the proposal to provide guarantees of land contracts would result in increased risk and loan losses for FSA. Given the limited expected demand for this program, the dollar volume of losses would likely be negligible. On an individual loan basis, however, loan losses would likely be significantly greater than for a typical guaranteed loan. Because of the high risk per loan, there is the potential that FSA could experience a large dollar volume of losses. In addition there are significant legal risks associated with guarantees of land contracts. If economic conditions were to change such that demand for seller financing greatly increased, FSA could face significant losses from land contract guarantees. Thus, cost effective implementation of this program requires that losses be limited. An alternative to guarantees against loss of principal is to guarantee regular payments to the seller. Under this "promise to pay" option, FSA would make a payment to the seller equal to the amount of one or two annual installments upon default by the buyer. This payment would be made regardless of what happens to land values. In case land values fall by an amount greater than the annual installments, the "promise to pay" option would reduce losses relative to a loss claim. On the other hand, the promise to pay could result in higher losses if land values increase after the loan is made. The promise to pay option should also reduce liquidation costs, as appraisals would not be required to establish loss claims and avoid delays arising from disputes between the buyer and seller. However, there is the risk that the incidence of payments to sellers would be more frequent under this alternative than under the traditional loss claim. The share of loans that default is going to be greater than the share of loans on which a loss claim is paid. Since seller financed loans are of a higher risk profile, more would experience repayment problems than for regular guaranteed loans. This may be controlled, somewhat, through the threat of administrative or treasury offsets on the buyer/borrower. Presumably, the threat of offsets would encourage a buyer/borrower to pursue all available alternatives before default.

Nonetheless, it is likely that loss payments would occur more frequently under a promise to pay option. At a minimum, loss payments on the promise to pay option would occur at the same frequency as loss claims on regular guarantees. Under the baseline scenario, loss rates under the promise to pay option are projected to be slightly lower than would be the case for regular guarantees. For example, for seller financing the loss rate for loss claims is 1.64 percent

compared to a loss of 1.39 percent for promise to pay assuming a 3 percent annual increase in land values (table 8). If land values fall, the differential between loss claims and promise to pay would increase. Under promise to pay losses are limited to one annual installment compared to potential losses under a regular guarantee that could reach 90 percent of the principal balance. This floor on potential losses greatly limits the potential loss exposure under the promise to pay option.

It is possible that two annual installments rather than one would be guaranteed. Simulations were undertaken where loss rates under the promise to pay option were projected using varying default rates and assuming that 2 annual installments were guaranteed (see table 9). It was assumed that defaults would follow the same pattern over time as has occurred in the past with 50 percent of defaults occurring within 5 years of origination. A 20 year amortization and 7.5 percent interest rate was also assumed. The top row represents the share of loans expected to have a least one default triggering a loss payment for one annual installment. The left column refers to the share of loans that are expected to have a second default triggering a loss payment on the second annual installment. For example, a 25 percent initial default rate with a 40 percent subsequent default rate would result in a 2.2 percent loss.

Historical patterns suggest that a default rate of between 15 and 20 percent would be expected with a subsequent default rate between 25 and 30 percent. This would suggest an expected loss rate of about 1.5 percent which would be comparable to loss rates expected for regular guarantees. One advantage of the promise to pay option is that is greatly limits downside risk. Even with initial default rates as high as 35 percent and subsequent default rates of 100 percent, expected losses would only be 4.4 percent (table 9). Thus, it would appear that if the guarantees were structured in the promise to pay manner, the expected range of losses would be no less than those for guarantees and not notably greater than those for regular guarantees.

Table 9. Distribution of potential losses based on varying levels of defaults

Subsequent Default	Percent of Loans Expected to Default Initially.				
	15	20	25	30	35
	Losses as percent of initial loan size				
10	1.1	1.4	1.8	2.1	2.5
25	1.2	1.6	2.0	2.4	2.8
40	1.3	1.8	2.2	2.7	3.1
50	1.4	1.9	2.4	2.9	3.4
75	1.7	2.2	2.8	3.3	3.9
100	1.9	2.5	3.2	3.8	4.4

Estimations based on historical patterns of default, 20 year amortization, and a 7.5% interest rate and guarantees of 2 annual installments.

Summary

Evidence presented herein indicates that the risk associated with guarantees of land contracts would be greater than for regular guaranteed loans. As a group, those utilizing seller financing are of a greater risk profile than those utilizing guaranteed bank loans with higher indebtedness and tighter cash flows. With less equity and tighter cash flows, these guarantees of land contracts would be expected to be more likely to experience repayment problems. It is estimated that loss rates would be 50 percent higher for guarantees of land contracts compared to loss rates on guaranteed loans made by commercial lenders. In addition there are numerous other risks associated with guarantees of any seller provided loans (see table 10).

If the contract land sale guarantee is structured as the current program, costs are likely to be much higher. Greater losses will result in greater subsidy rates and, consequently, a higher program cost. The ambiguities in real estate laws concerning the administration of land contracts will increase servicing and liquidation costs. Rules and regulations governing FSA's administration of this program would need to be much more specific than traditional guarantees.

One alternative which could limit potential risks would be the "promise to pay" option. Under this alternative FSA would make payments to the seller/lender equal to one or two annual installments upon default by the buyer/borrower. Because total losses are limited to an amount equal to the annual installments, this alternative would greatly limit potential losses. However, the frequency and level of losses for seller financed loans would be greater than if this option was used on regular guarantees. Our analysis showed that as long as losses are limited, the risk associated with the promise to pay should not be notably greater than for the traditional guarantees.

Farmers utilizing seller financing and those using regular FSA guaranteed loans appear to represent unique groups of clientele. Therefore, implementation of the land contract guarantees could enable FSA credit programs to benefit a broader range of farmers. Implementation of this program would likely achieve the objective of enabling more beginning farmers to acquire farmland. Because a very specific set of circumstances will be required before the guarantee is provided, the number of individuals that would benefit from this program is likely to be small. A land contract guarantee requires a land transfer between unrelated parties where the buyer must be a beginning farmer that meets FSA eligibility requirements. Eligible beginning farmers must be unable to obtain commercial credit despite being able to demonstrate sufficient income for repayment. Also, the seller must be inclined to offer the land for sale on a contract.

In summary, FSA guarantees of land contracts should enable a limited additional number of beginning farmers to acquire farmland. As long as losses are limited (promise to pay option), the risk associated with the issuing land contract guarantees should not be notably greater than for losses occurring in the traditional guarantee program.

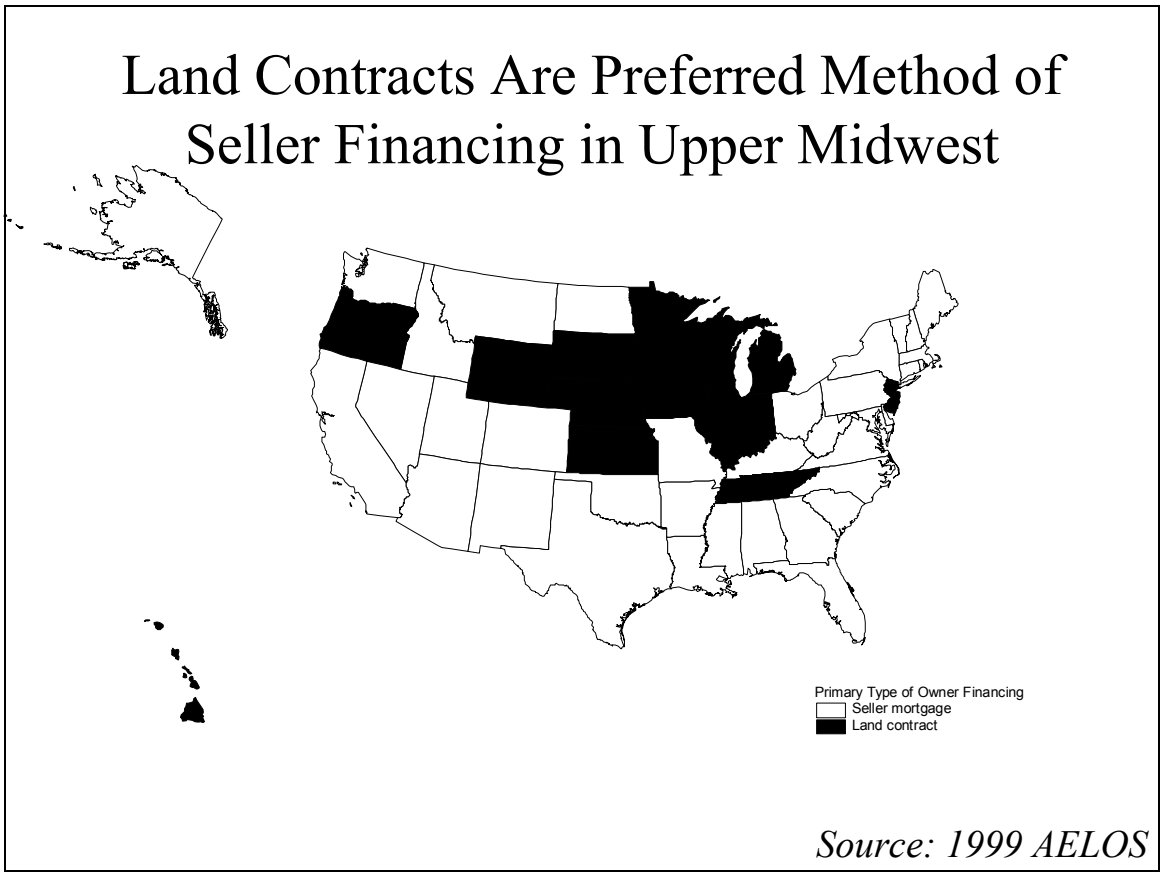

Figure 2. States Grouped According to Whether Primary Source of Owner Financing was Seller Mortgages or Land Contracts.

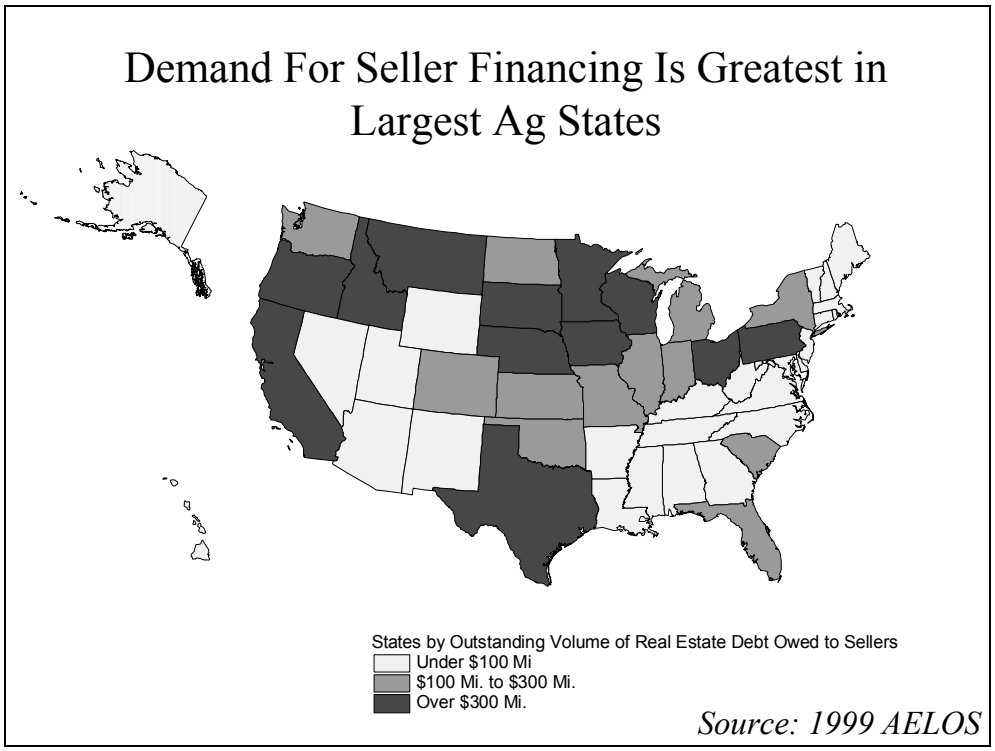

Figure 3. States Grouped by Volume of Real Estate Debt Owed to Sellers.

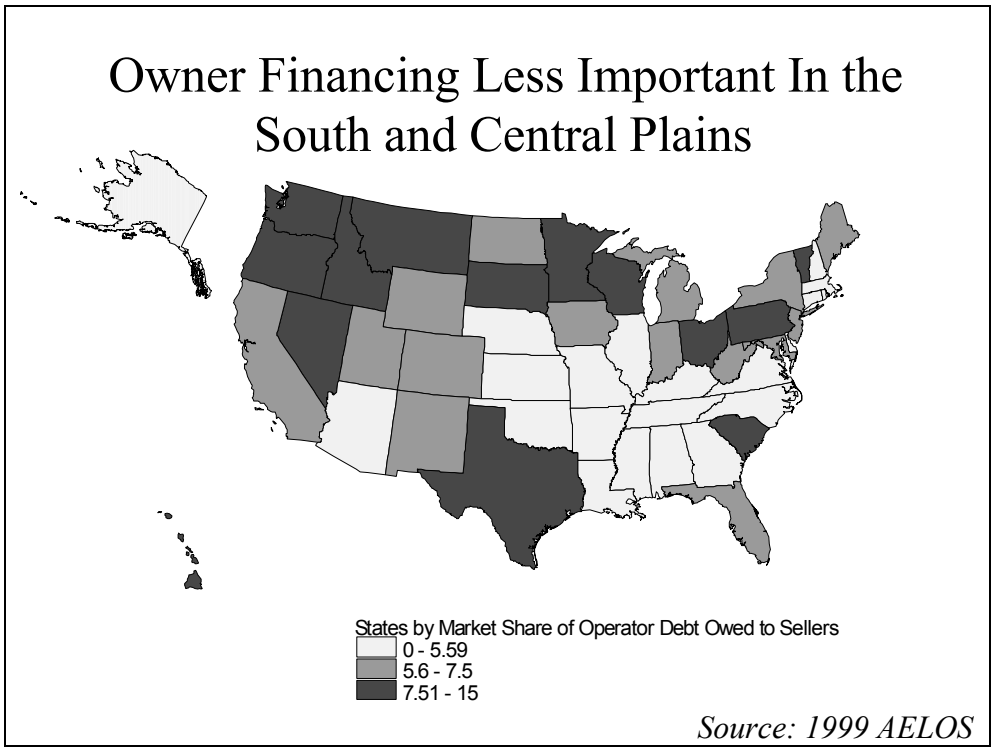

Figure 4. States Grouped According to Market Share of Farm Operator Debt Owed to Sellers.

Table 10. Summary of risks and hazards associated with providing guarantees on land contracts.		
Risks	Hazards	Control Measures
Seller financing not an arm's length transaction	Seller has incentive to overstate property value especially with guarantee.	--Require a minimum of 2 outside appraisals. --Provide guarantees of payments and not principal.
	Especially in cases of loans between related parties, the seller may provide terms and conditions that are favorable to the buyer but greatly reduce the value of the loan. For example, amortization schedules may be arranged to meet a tight cash flow by graduating payments.	--Require that no guarantees will be made of loans between related parties. --Require that terms of these loans meet certain guidelines. For example, a 30-year amortization at a stated interest rate.
As is the case with banks, sellers do not have underwriting standards concerning the borrower's repayment ability and availability of adequate security	Those who use seller financing are of a higher risk profile than other borrowers. Consequently, repayment difficulties and loan losses are more likely.	Require all loans to meet the same requirements as expected for any non-preferred lender.
Little legal structure in State laws concerning land contracts	Legal disputes can arise between buyers and sellers requiring adjudication which would consequently delay settlement and increase losses.	--Require all owner financed loans which are guaranteed to be structured as a seller mortgage or deed of trust. --Rather than guaranteeing against loss of principal which requires liquidation for settlement, provide guarantees of payment stream to seller.
In the case of land contract, sellers can mortgage their since they still have title	FSA left with guarantee on a subordinated loan.	--Require title to be held by a 3rd party escrow agent.
No procedure for liquidation—at default seller retains title. There may not be a sale price to establish a final loss claim.	Even with appraisals there may be legal disputes concerning the accuracy of loss claims	--Require a public sale before final loss claim may be established. --Base loss claim on something other than collateral value.

Land price declines may result in collusion between the buyer and seller in order to collect loss claims.	A sells to B for $1,000 per acre. Price falls to $900. B defaults enabling a to collect a $100 loss claim. B then buys land back from A for $900.	--Require property to be sold at public auction when a loss claim can is paid. --Implement offsets against the buyer in cases where loss claims are paid. --Prohibit seller from resaling property to original buyer after loss claim is paid.
Seller financing can be used in conjunction with other sources of credit. Example, a bank provides a loan equal to 50% of purchase price while remainder is provided by seller	FSA may be left with a guarantee of a subordinated position.	To obtain guarantee, buyer would have to maintain 1st lien priority.
Sellers do not have any established procedures for servicing and liquidating problem loans.	Buyers may be treated disparingly creating the potential for legal action against FSA. Delays in servicing of problem loan accounts could increase losses.	--FSA could establish procedures for servicing these accounts which would be implemented by the escrow or servicing agent.