A Summary of the Report on the Relative Cost Effectiveness of the Farm Service Agency's Farm Loan Programs

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A Summary of the Report on the Relative Cost Effectiveness of the Farm Service Agency's Farm Loan Programs

by
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Abstract

Results of a study completed for Congress indicate direct program borrowers are more financially stressed than guaranteed borrowers and that many current farm loan program borrowers may not be able to continue farming, at least in the short-term, without access to government subsidized credit. The study findings are generally consistent with the missions of the direct and guaranteed farm loan programs, yet the combination of higher delivery costs and loan subsidy costs means direct lending programs require larger amounts of federal resources to meet their objectives than do similar guaranteed farm loan programs. However, serving many limited resource or otherwise economically disadvantaged farmers through guaranteed loan programs may be difficult without significant program adjustments or additional financial subsidies.

Keywords: Credit Subsidies, Farm Loan Programs, Farm Service Agency Direct Government Loans, Federal Loan Guarantees.

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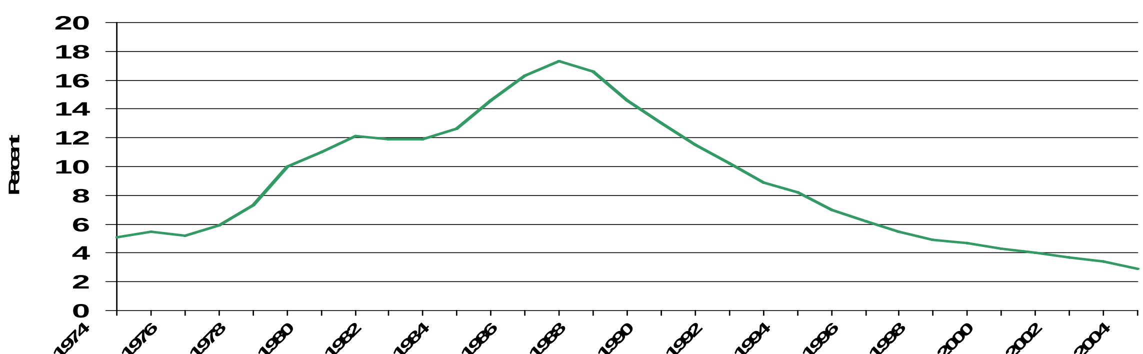
Introduction

The federal government's credit programs specifically designed to serve agriculture are those administered by the U.S. Department of Agriculture's Farm Service Agency (FSA). Through the FSA and predecessor agencies, USDA has been involved in farm credit markets since the Great Depression. While the reach and breadth of federal farm credit programs have fluctuated, they have been an important source of credit to family farmers through times of economic impoverishment, prosperity, and political change (figure 1).

FSA delivers credit assistance to family farmers through direct lending programs, where loans are made and serviced by FSA staff, and through loan guarantee programs, where loans are made and serviced by commercial lenders but guaranteed against loss by FSA.
Direct farm loans have historically been more costly and their loan repayment performance has generally been weaker than have guaranteed loans for similar purposes and terms.

The higher delivery cost and weaker loan repayment performance of direct loans has raised Congressional concerns over the need for continuation of this delivery system when alternative guaranteed delivery mechanisms are available. It is in this context that Section 5301 of the Farm Security and Investment Act of 2002 (P.L. 107-171) required the Secretary of Agriculture to undertake an evaluation of the direct and guaranteed loan programs administered by FSA. Congress directed that the study should examine the effectiveness of direct and guaranteed loans programs in meeting the credit needs of agricultural producers in an efficient and fiscally responsible manner.

Figure III-1. Direct loan program share of total U.S. farm business debt, 1974–2004.[1]



[1] Includes emergency loans.
Source: USDA, Economic Research Service.

This paper summarizes the major conclusions of the report that was submitted to Congress as required by the Farm Security and Investment Act of 2002 (Farm Service Agency 2006). That report documented FSA's direct and guaranteed farm loan program missions and performance over historical periods of time, examined the characteristics and the loan performance of different loan cohort groups during recent time periods, and compared the costs of the direct and guaranteed loan delivery systems in reaching their mandated objectives. The study period included loans made over a 5-year period from fiscal year 2000 through 2004. The analysis also includes emergency disaster loans, even though this program was not specifically mentioned in Section 5301 of the Act.

The Role of FSA's Farm Loan Programs

Federal credit programs attempt to resolve imperfections in credit markets or address concerns about social equity. Generally, federal credit programs have been motivated by the perceived failure of private sector lenders to adequately, efficiently, and fairly serve all segments of the borrowing public. These programs influence the allocation of credit by channeling capital to, or away from, particular groups to promote certain policy objectives or goals. Historically, farm credit markets have been considered susceptible to market failures resulting from insufficient lending resources, imperfect competition, and information asymmetries.

Imperfect competition occurs because geographic isolation or a limited number of farms may result in a scarcity of farm lenders serving a local market. Information asymmetries arise when lenders have insufficient farm business knowledge or information with which to properly evaluate farm loan requests. Information asymmetries may also arise when farm borrowers lack a sufficient track record to enable lenders to adequately evaluate their loan requests. Insufficient lending resources occurs when small lenders operating in local markets lack the liquidity necessary to fund otherwise creditworthy applicants.

The occurrence of one or more of these failures may result in some creditworthy farmers or underserved groups being unable to obtain credit or having to accept less favorable loan terms. While both FSA guaranteed and direct farm loan programs can be utilized to address the aforementioned market failures, loan guarantees are generally considered a more effective approach. Loan guarantees address market failures by lowering lending risks, which effectively lowers a lender's costs and thereby encouraging lenders to increase the supply of loans and increasing lending competition.

FSA loan programs may also act to reallocate resources to disadvantaged borrower groups and regions. Direct loan programs, in particular, may be intended to reallocate capital toward disadvantaged groups of farmers considered less likely to qualify for loans in a competitive credit market. Primary beneficiaries of direct loan programs include socially-disadvantaged and beginning farmer groups. Socially-disadvantaged groups include racial and ethnic minorities and women. While both direct and guaranteed loan programs have targeting rules requiring that a share of lending authority be reserved or set-aside for use by socially-disadvantaged and beginning farmer groups, direct loans are more highly targeted for this purpose.

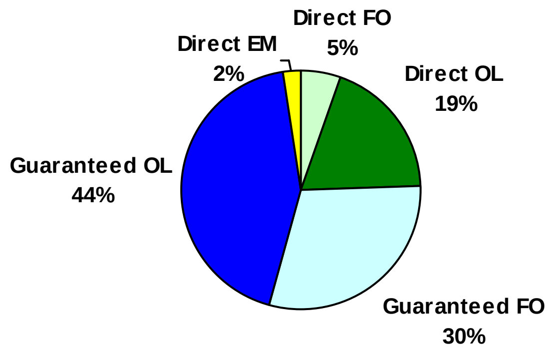
FSA's Two Delivery Mechanisms

FSA accomplishes its credit mission through two distinct delivery mechanisms: direct and guaranteed loan programs. Direct farm loans are made and serviced by FSA office staff, whereas guaranteed farm loans are made and serviced by qualified commercial, cooperative, or nonprofit lenders. Both delivery systems provide loans for farm ownership (FO) and operating (OL) purposes, whereas emergency loans (EM) are only delivered via direct loans. While there is some overlap in their respective objecitves, direct programs are broadly intended to assist those deemed underserved by credit markets because of creditworthiness concerns, such as beginning farmers and socially disadvantaged groups, while guaranteed programs are broadly intended to address market failures that may arise from information asymmetries, lack of competition, or lack of lending resources. Office of Management and Budget guidelines encourage the use of loan guarantees over direct loans, except in situations where the subsidy needed for a guarantee is greater than can be provided through a direct loan (OMB).

Differences in general eligibility criteria, loan size limits, and loan purpose requirements between the direct and guaranteed programs are reflective of their somewhat different missions. A qualified guaranteed loan applicant must have been unable to obtain credit from private lenders at competitive rates and terms without the presence of a guarantee. Meanwhile, a qualified direct loan applicant must have been unable to obtain credit from private lenders at competitive rates and terms *even with the presence of a guarantee*. Such differences in borrower eligibility make it more likely that direct lending programs serve more economically disadvantaged farmers. In addition, the direct program's smaller loan caps make it more likely that direct programs serve smaller farms which are more likely to be economically disadvantaged. Direct loan funds are also more highly targeted to groups deemed to be underserved, resulting in a greater share of loan funds going to farmers meeting beginning and socially-disadvantaged farmer qualifications.

Irrespective of the delivery mechanism, these federal loan programs are generally intended to serve as temporary and not permanent credit sources. Graduation to commercial credit, particularly in the direct program, is encouraged through time limits on borrower eligibility and periodic reviews. Guaranteed credit is seen as a first step to graduation from federal credit (direct lending programs) to commercial sources of credit. Of the $3.4 billion in average total annual FSA lending during the 5-year study period, guaranteed lending programs accounted for approximately three-quarters of the total (figure 2). Direct EM and direct FO loans represent only a small share of total program obligations and hence are niche sources of credit to the farm sector.

Figure 2. Share of total loan obligation volume by, program area, fiscal 2000-2004.

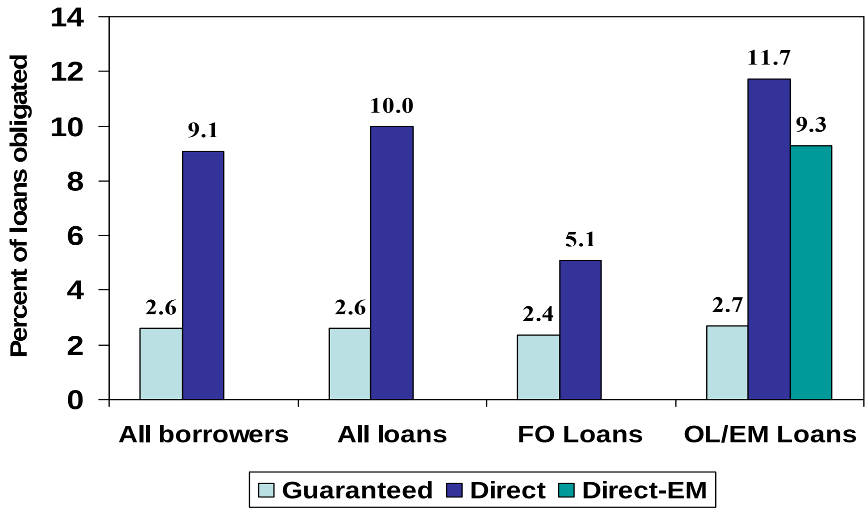


Source: FSA Report Code 205, various years.

Guaranteed Loan Program Performance is Superior

Generally, direct loans did not perform as well as guaranteed loans during the study period of fiscal 2000 through fiscal 2004. Both the average monthly and 90-day delinquency rates for direct loans and direct loan borrowers was 3 to 4 times higher than for guaranteed borrowers who originated loans during the same time period (figure 3). Compared to direct loans, guaranteed loans were more likely to perform without any repayment problems. For example, the share of guaranteed loans obligated in fiscal 2000 that performed with no repayment delinquencies, restructurings of the original loan contract, or loan write-off or loss through fiscal 2004, was more than twice that of direct loans.

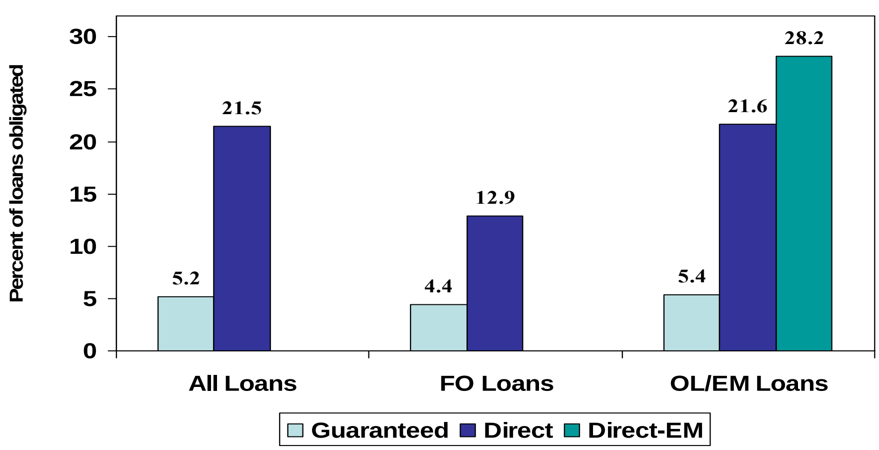
Figure 3. Average 90-day delinquency rate, for loans obligated in fiscal 2000, by program, as of the end of fiscal 2004.



Source: USDA Farm Loan Program Database.

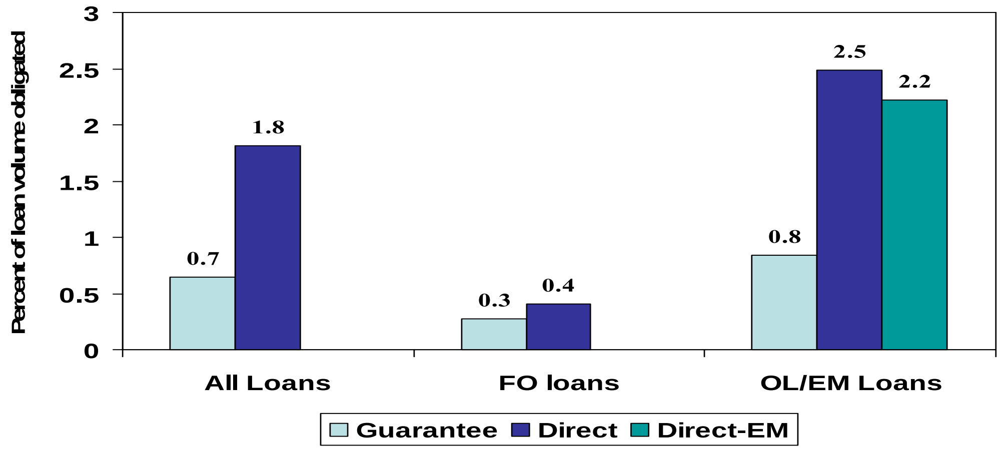
Direct loans were found more likely to be restructured because of repayment problems, with over one-fifth of fiscal 2000 direct loans being restructured by the end of fiscal 2004. This restructuring rate compares with a rate of 5 percent for guaranteed loans during the same period (figure 4). While overall loss rates for commercial and noncommercial loans alike were very low during the study period, they were greater for direct loans than for guaranteed loans. Of all direct loans originated in fiscal 2000, 2.5 percent resulted in a debt write-off or loss by the end of fiscal 2004, compared to 1.9 percent for guaranteed loans (figure 5).

Figure 4. Percent of loans obligated in fiscal 2000 that had been Restructured, by program, as of the end of fiscal 2004.



Source: USDA Farm Loan Program Database.

Figure 5. Percent of loan volume obligated in fiscal 2000 that had been written-off, by program, as of the end of fiscal year 2004.

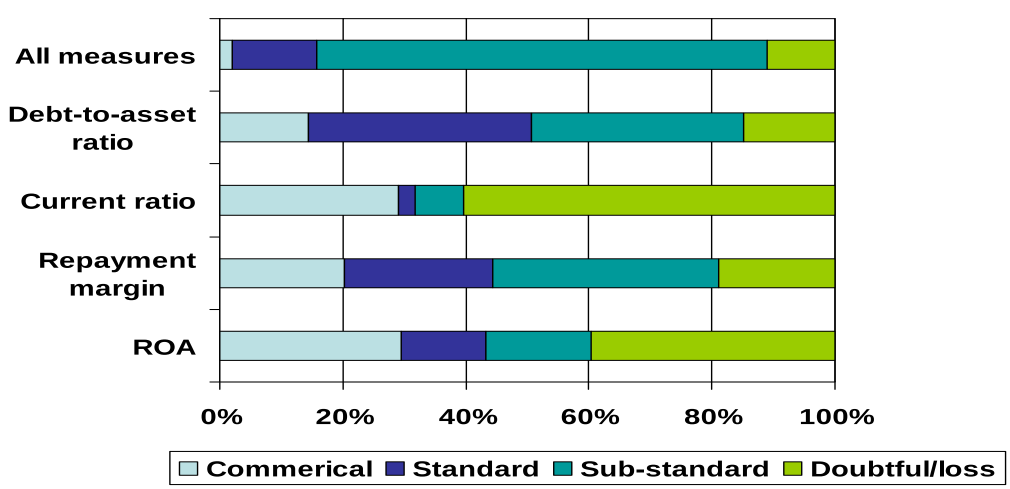


Source: USDA Farm Loan Program Database.

Direct and Guaranteed Loan Programs Serve Different Clientele

In general, the study results reflect distinct differences in the two delivery systems. Nearly all of direct loans were made to groups deemed to be marginally creditworthy by private sector lending standards (figure 6). Only a few percentage of all direct borrowers were likely to meet all commercial lending standards. Generally, FSA guaranteed loans went to groups who appeared more creditworthy than direct borrowers, yet the majority appeared unlikely to meet commercial lending standards at commercially available rates and terms.

Figure 6. Distribution of fiscal 2000 to 2004 direct borrowers, by financial measures and classifications at time of obligation.



Source: FSA's Farm and Home Plans fiscal 2000 to fiscal 2004.

By design, direct programs should serve higher risk applicants than the guaranteed program. Compared to guaranteed borrowers, direct borrowers carried greater amounts of debt relative to their net worth or assets, had lower net worth, received less off-farm income, were more likely to have cash flow difficulties, and operated smaller family farms (table 1). Many of these borrowers appear unable to meet commercial credit standards and would likely have had difficulty either continuing or beginning in farming without access to direct loan programs. Therefore, their financial profile appears to be consistent with the agency's mission of serving farm borrowers unable to access commercial credit at reasonable rates and terms, but yet able to project at least some level of debt repayment ability.

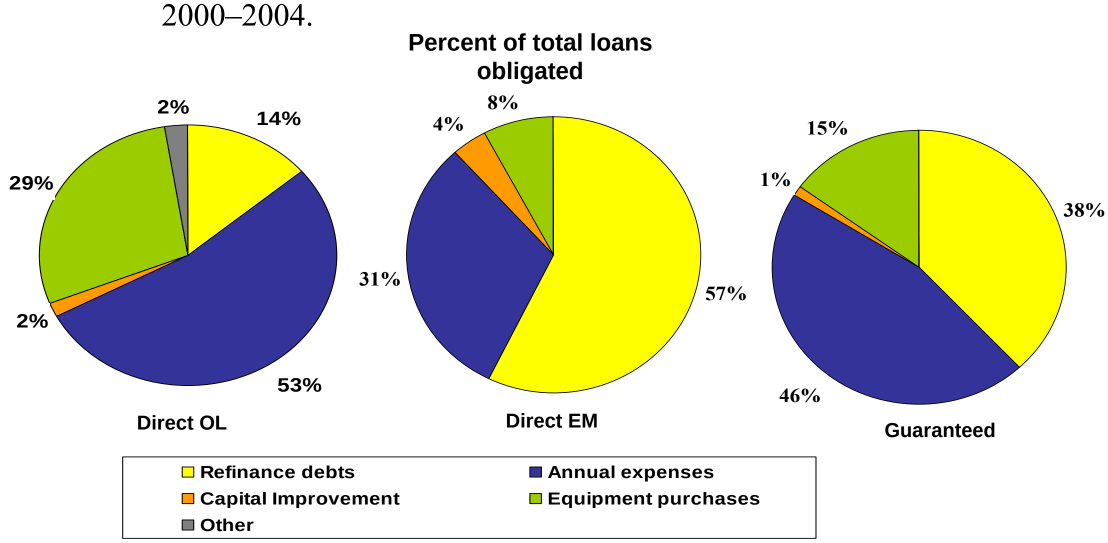
Table 1. Selected characteristics of FSA and non-FSA borrowers who received loans during fiscal or calendar years 2003 and 2004.

	Farmers receiving loans in 2003 and 2004[1]		
Characteristic	Direct borrowers	Guaranteed borrowers	Non-FSA program debt[2]
Farm balance sheet:		Dollars per farm	
Total assets	385,388	787,953	746,923
Farm land	196,913	484,851	487,168
Total debt[3]	297,163	384,331	278,477
Net worth	88,225	403,623	486,446
Farm income statement:			
Gross cash farm income	141,253	223,549	157,547
Operating expenses	121,966	208,853	130,888
Net cash income	19,287	14,696	26,659
Off–farm income	20,251	38,202	68,078
		Percent	
Farm debt-to-asset[4]	77.1	45.7	33.7

[1]Data on FSA direct borrowers was obtained from the post-close Farm Business Plan. Data on guaranteed borrowers and non-FSA borrowers were obtained from the ARMS for 2003 and 2004. In most cases the Farm Business Plan only provided data on expectations of income and expenses, while the ARMS represented actual data. [2]Among farms with over $50,000 in annual sales. [3]Including annual operating debt repaid. [4]FSA's Farm Loan Program National Internal Review, which surveys loans of higher risk, indicated an average debt-asset ratio of 0.68 for 2003-2004.

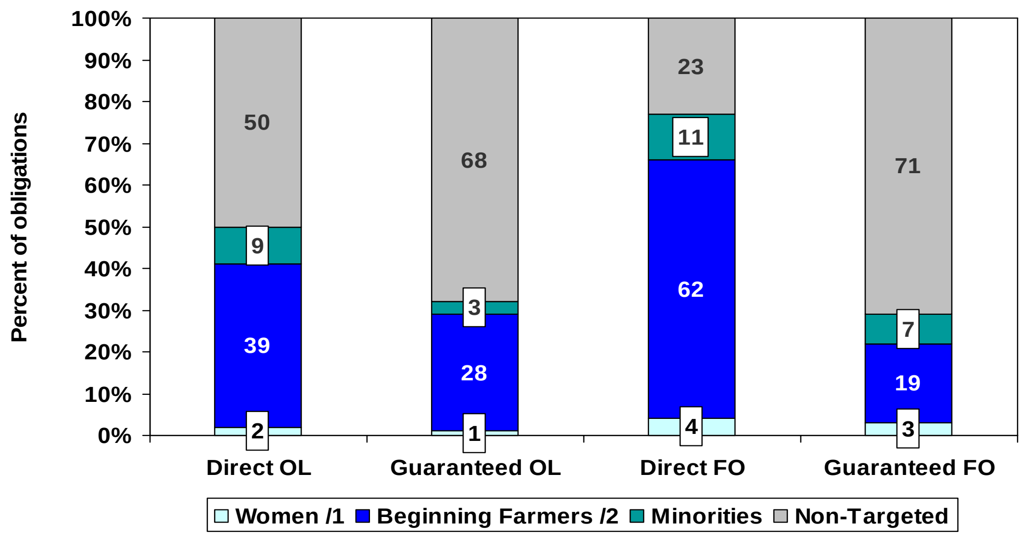
Direct loans are much smaller in size and reflect the smaller family farming clientele that they serve. Direct loans were more likely to be used to finance new investments, such as the purchase of additional farmland, while guaranteed loans were frequently used to refinance existing indebtedness (figure 7). Results also indicate that the direct lending delivery system is more focused on serving groups considered socially or economically disadvantaged. A higher share of total direct lending went to socially disadvantaged farmers and beginning farmers than in the loan guarantee program (figure 8). However, because of greater annual lending authority, guaranteed loan programs actually provide greater amounts of credit to these underserved borrower groups.

Figure 7. Distribution of OL and EM loans obligated, by purpose, fiscal 2000–2004.



Source: USDA Farm Loan Program Database.

Figure 8. Share of loan origination volume by program and target class, fiscal 2000-2004.



1/ Women who are neither a member of racial or ethnic minority nor a beginning farmer. 2/ Beginning farmers who were not members of a racial or ethnic minority group.
Source: USDA Farm Loan Program Database.

Many Direct Borrowers Unlikely to Be Served Through Guaranteed Programs

The study results suggest that many farmers currently receiving direct loans might not be served through a guaranteed-only delivery system without significant program changes. Consistent with results of previous studies, the complete or partial graduation rates of direct FSA borrowers to FSA guaranteed loans is relatively low and this occurrence is reflective of the generally higher risk profile of these borrowers. The higher default probabilities and servicing costs associated with direct loans discourage commercial lenders from serving many within this higher-risk clientele without further incentives and/or subsidies. Even with a complete federal loan guarantee, commercial lenders may be reluctant to serve many high-risk direct borrowers because greater loan servicing costs would render the loans unprofitable.

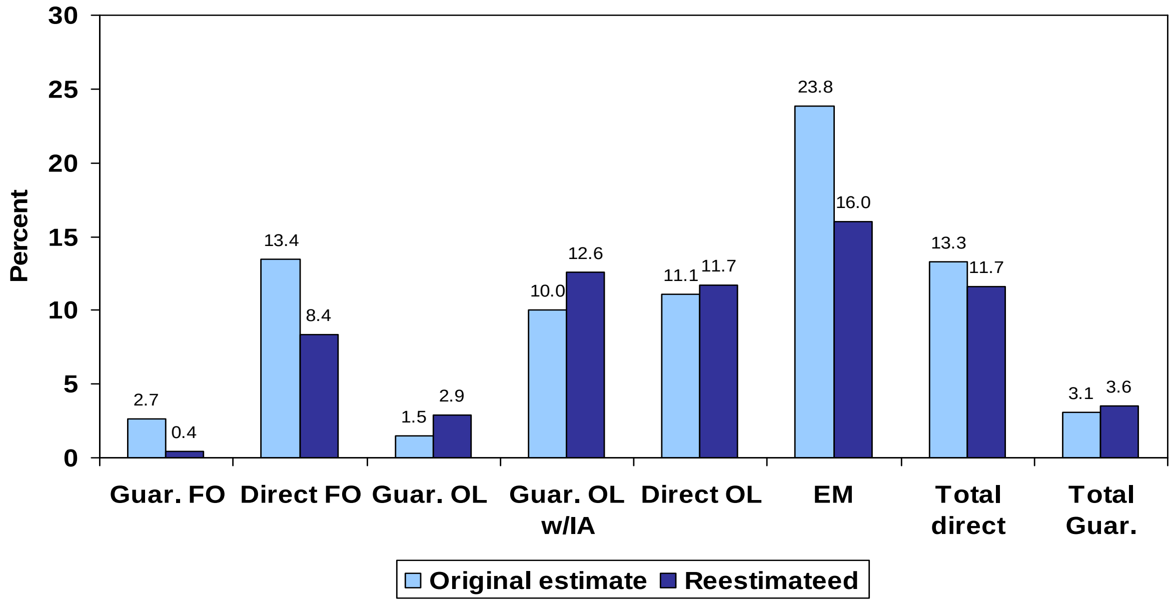
Additionally, there are a number of issues which would adversely impact the ability to serve direct borrowers through a guaranteed delivery system. Direct borrowers are afforded borrower rights provisions, such as loan decision appeals and debt restructuring rights, that commercial lenders are not required to provide. If these provisions were imposed on guaranteed loans without significant compensation, they would likely deter lenders from using USDA farm loan guarantees. The direct loan delivery system also provides borrowers with supervised credit, and guaranteed lenders would be reluctant to implement supervised credit procedures, such as borrower training programs, without recouping the costs of such actions. Further, the current guaranteed program does not provide universal coverage of all farm credit markets. One-third of U.S. counties were estimated to have a limited presence of farm lenders likely to participate in the loan guarantee program. Without program changes and/or additional incentives, some regions, at least initially, may have insufficient lenders to deliver FSA guaranteed loans.

Hence, it appears that a significant portion of borrowers currently eligible for direct farm loans may not be served under a guarantee-only delivery system, even with additional incentives or subsidies. An assessment of the size of this group, the policy merits of such an outcome, and the level of additional subsidies and program adjustments needed to facilitate transfer of direct borrowers to the guaranteed program were deemed beyond the scope of this report.

Direct Loan Programs Have Higher Delivery Costs

Compared to the guaranteed loan program, direct loan programs are more likely to serve disadvantaged farmers, but that service comes at a cost. On average, direct loans require greater public resources than similar guaranteed loans for each dollar lent. For all direct loans made from fiscal 1992 through fiscal 2004, loan subsidy costs averaged 11.7 percent of total obligation volume, compared to just 3.6 percent for the guaranteed program. Said another way, it costs the federal government an average of 11.7 cents for each dollar lent in the direct program and an average of 3.6 cents for each dollar lent in the guaranteed program (figure 9).

Figure 9. Average loan program subsidy rates, fiscal 1992-2004.

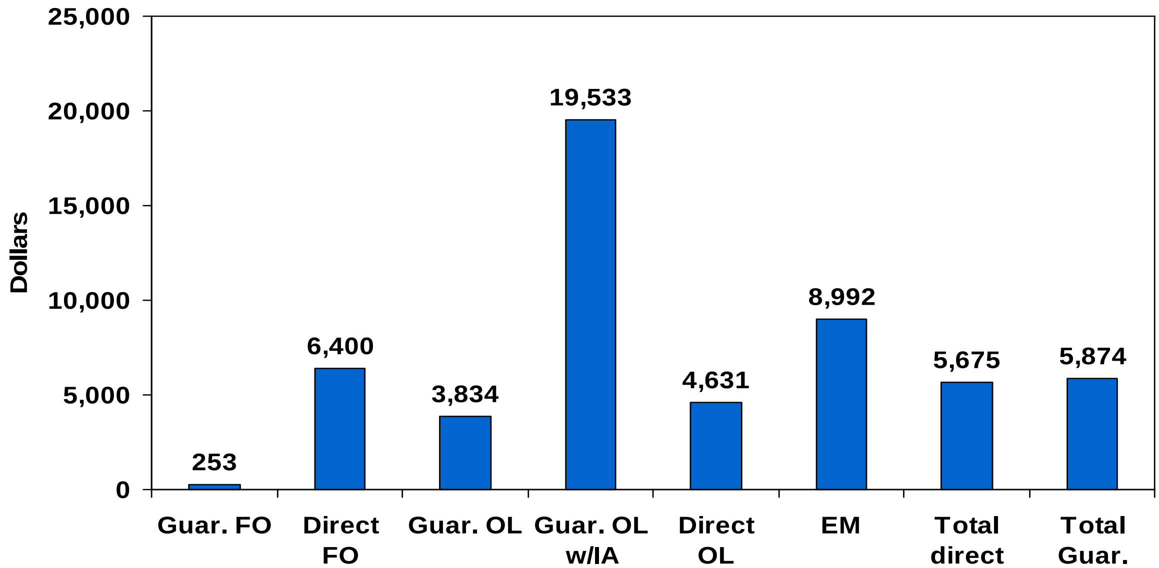


Source: Federal Budget of the United States for Fiscal 2006, Supplementary Tables for Credit Programs.

In general, loan subsidy costs were found to be higher for direct loans, because their interest rate subsidies, anticipated loan defaults, and loss rates are notably higher. In addition, FSA collects a guarantee fee on guaranteed loans, which produces an income stream which helps offset a portion of loan subsidy costs. Most of the total loan subsidy costs were found to be associated with operating loan programs, which accounted for 83 percent of the total farm loan subsidy costs. Guaranteed farm ownership loans had the lowest subsidy rate and represented just 1 percent of total loan subsidy cost, but accounted for one-quarter of total farm loan program loan obligation volume from fiscal 1992 through fiscal 2004. The lower subsidy rate reflects a very low default rate, an absence of interest rate subsidies to borrowers, and the collection of a guarantee fee.

While direct loan programs had higher subsidy rates and costs in general, an exception to this finding was the guaranteed operating loans made with interest assistance. Over one-quarter of total loan program subsidy costs were associated with this interest rate subsidy program. The interest assistance program was found to provide an average net subsidy cost of over $19,500 per loan or 4 times that of a direct OL loan (figure 10). The delivery of this subsidy was geographically concentrated among borrowers, with one-third of all such loans going to 67 U.S. counties.

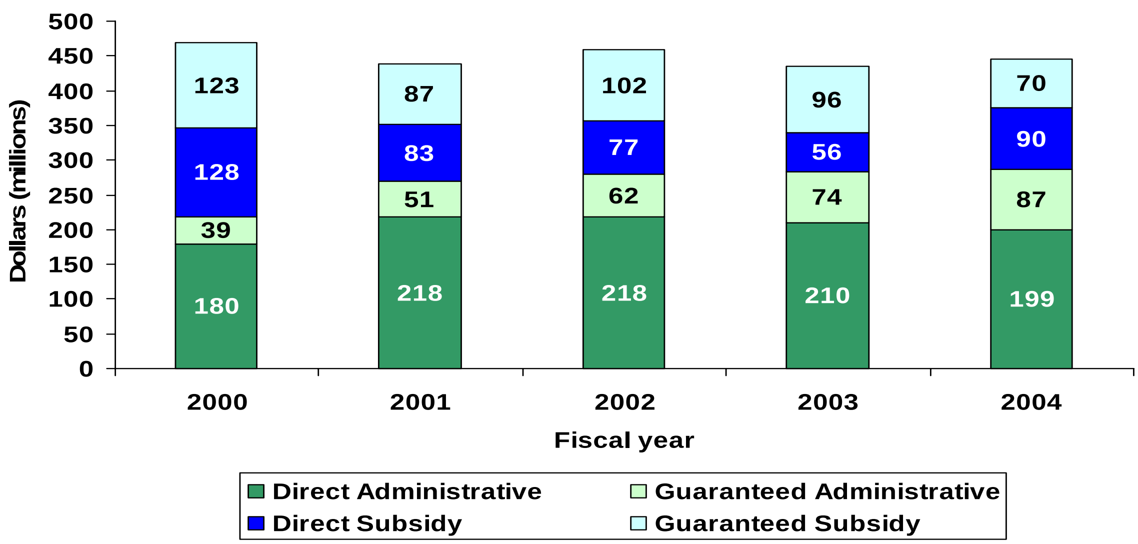
Figure 10. Average net subsidy cost per loan obligated, fiscal 1992-2004.



Sources: Federal Budget of the United States for Fiscal 2006 and FSA loan data.

When the administrative costs for the two delivery systems are included in the analysis, the cost differential between the two delivery systems widens. Total administrative costs to operate all the farm loan programs were found to be greater than the loan subsidy costs of the programs (figure 11). The majority of these costs were associated with the direct lending programs. For fiscal 2000 through fiscal 2004, estimated direct program administrative costs averaged $205 million per year, which compared to an average of just $63 million per year for delivery of the guaranteed loan program.

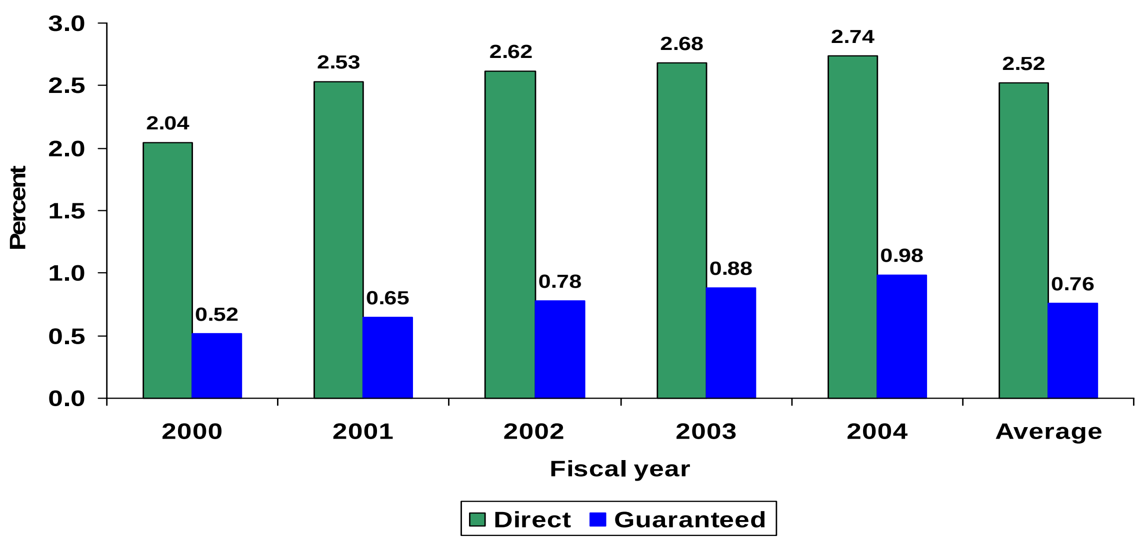
Figure 11. Annual loan program costs, by type, fiscal 200-2004.



Source: Estimated using data from Federal Budget of the United States and FSA data, for various years.

While FSA's annual total administrative costs for delivery of farm loan programs have been relatively stable since 1992, when adjusted for inflation, administrative costs per caseload have been on the rise. This is particularly true for direct lending, where program caseloads declined 27 percent in the five years beginning in fiscal 2000. Calculated administrative expense ratios indicated that direct lending programs are significantly more costly to administer than guaranteed loan programs. The ratio shows that $100 dollars of guaranteed loan volume cost $0.76 to administer, while the same volume of direct loans cost $2.52 during the period (figure 12). While administrative cost per caseload have increased in recent years, the greater amount of resources (staff-years) available per case may be a factor improving loan servicing and underwriting performance, and hence, could be reducing loan subsidy costs. Through most of the study period, a healthy farm economy improved the farm loan performance of all lenders, resulting in less need for loan servicing and reducing administrative costs relative to what may have occurred in more typical time periods.

Figure 12. Farm loan administrative operating expense ratios, fiscal 2000-2004.



Source: Estimated using data from Federal Budget of the United States and FSA data, for various years.

The government's administrative costs are greater for the direct program primarily because these loans are made and serviced by FSA staff, while guaranteed loans are originated and serviced by commercial, cooperative, or nonprofit lenders meeting established criteria for being a guaranteed lender. The direct loan program requires FSA staff to provide a greater level of oversight and supervision. Moreover, lending and servicing costs are higher on these loans than on private sector farm loans (FSA guaranteed or not) due to the higher risk profile of direct loan borrowers and because strict regulatory guidelines for making or servicing direct loans must be adhered to by FSA staff. An analysis of work measurement data shows that direct loan servicing accounts for about two-thirds of all administrative costs (figure 13).

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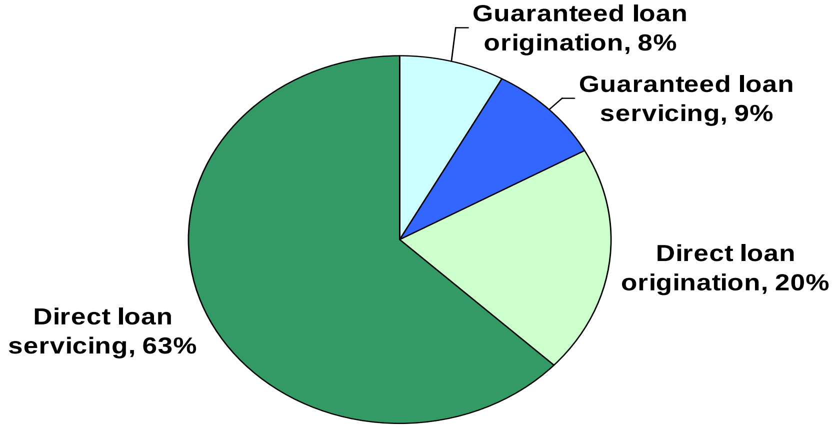
Figure 13. Share of total FSA staff years used for different loan functions, fiscal 2000.



Source: Farm Service Agency, Farm Loan Programs Delphi Study, Fiscal 2000.

Summary

The congressional study concluded that direct program borrowers are more financially stressed than guaranteed borrowers and that many current farm loan program borrowers may not be able to continue farming, at least in the short-term, without access to government subsidized credit. The study findings are generally consistent with the missions of the direct and guaranteed farm loan programs, yet the combination of higher administrative costs and greater loan subsidy costs means direct lending programs require much larger amounts of federal resources to meet their objectives than do similar guaranteed farm loan programs. However, serving many limited resource or otherwise economically disadvantaged farmers through guaranteed loan programs may be difficult without significant program adjustments or additional financial subsidies. Even with additional subsidies or complete guarantees, commercial lenders could be unwilling to serve some current direct loan borrowers due to the higher servicing costs associated with these higher risk accounts.

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