Some Thoughts on Federal Agricultural Policy

by:
Terry Hague

Editor's Note: Terry Hague testified on behalf of ABA before the House Agriculture Committee's Subcommittee on Conservation, Credit, Rural Development and Research on June 20, 2001, in Washington, D.C. The following article is excerpted from his testimony.

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American agriculture continues to face an uncertain future. The banking industry shares the concerns of producers about the future economic viability of agriculture. Our industry provides the vital credit that farmers and ranchers need to be successful. At the end of 2000, banks had nearly $75 billion in loans outstanding to farmers and ranchers – an increase of 3.3 percent from the previous year. In 2000, the banking industry surpassed all other lenders in loans secured by real estate and non-real estate secured loans. More farmers and ranchers borrow more money from the banking industry than from any other source. For every dollar of agricultural credit outstanding, 41 cents is loaned by the banking industry.

I lend money to farmers and ranchers in Cherokee, Okla., not because I have to, and not because some regulator tells me that I must, but because agricultural lending has been good business for my bank. Further, agricultural lending has been good business for thousands of other banks in the country, and that is why the banking industry has made such a significant investment in the industry. Agriculture is a capital-intensive business. Each year my customers must borrow large amounts of money to be able to plant crops, purchase livestock, buy machinery and equipment, and improve their land.

As an agricultural banker, my job is to assess the risk in every loan and to assess the potential for repayment on every loan we make. We do our very best to examine all aspects of the deal before we make the loan. It is important that I make such a careful assessment because it is not my money that Farmers Exchange Bank loans out; it belongs to the Main Street merchants, the hospital, the schools, the local restaurants, and the men and women who live and work in and around Cherokee.

I want to tell you what is needed most by my producers in terms of federal agricultural policy. I can sum it up in one word: certainty. If producers could present a plan to their banks at the start of each crop year that shows how their cash flow will work, banks would have a greater level of confidence about the credit that they are extending. We would be able to make more credit available in a more timely manner. The banking regulators would have a greater level of comfort in the loans that they are examining. Our farm supply businesses would be able to better project their annual performance, and that would make it easier for my bank to determine their repayment ability, and on and on.

Despite a Difficult Agricultural Economy, Agricultural Banks Remain Strong

Despite low commodity prices for key agricultural commodities and regional weather and disease problems, widespread negative effects on banks' farm loan portfolios have not materialized. The sound state of farm banks today is the result of the strong nonfarm economy, improved credit underwriting standards and high levels of government assistance in 1998, 1999 and 2000 that enabled farmers to meet debt obligations.

Agricultural banks tend to be better capitalized than other small banks. The average capital ratio at an agricultural bank stood at 10.7 percent as of the third quarter 2000. As of September 2000, almost all agricultural banks met the regulatory definition of being "adequately" capitalized. More than 98 percent of all agricultural banks met the definition of being "well" capitalized. Farm banks were able to build capital during the 1990s because they have been profitable.

Loan quality remains strong for agricultural banks. As of September 2000, in aggregate farm banks reported $0.9 billion in farm production loans as delinquent (30 days or more past due) or 1.9 percent of the outstandings. Nonperforming farm production loans (past due 90 days accruing interest and non-accruals) were 1.2 percent. Additionally, $700 million in farm real estate loans were delinquent as of the third quarter 2000. As a percent of the portfolio, delinquent farm real estate loans stood at 2.1 percent. This compares favorably to the previous year's ratio of 2.3 percent.

Further evidence of the strength of farm bank portfolios is reflected in the relatively low charge-off rates for both farm real estate and production loans. The charge-off rate for farm real estate loans stood at 0.02 percent – below the charge-off rate reported in 1999. For farm production loans, the charge-off rate was slightly lower than the rate reported in the last several years at 0.15 percent.

Farm Bill Listening Sessions Conducted in 2001

From early January to early May 2001, staff of the ABA Center for Agricultural and Rural Banking conducted 19 farm bill listening sessions in 14 states. Nearly 1,000 bankers, producers, business people, state legislators, local federal officials and other stakeholders participated in the sessions held across the country, including one in Cherokee.

The sessions covered a wide range of topics from federal support for agriculture to trade to Farm Service Agency (FSA) program delivery to expectations and recommendations for the 2002 farm bill. Some general findings from the sessions:

• There was near unanimous agreement that the federal payments made available to producers in 1998, 1999 and 2000 made the difference whether their customers had adequate cash flow. Further, participants agreed that, if economic conditions remain the same, federal support consistent with what was made available in 2000 would be needed in 2001.

• In many commodities, farmers are receiving the lowest prices they have received in 20 or 30 years. Low commodity prices are universal and nationwide. We spent a lot of time discussing the causes and consequences of this very negative economic situation.

• Bankers have worked with their customers to continue to find ways to help them continue their operations another year. Fortunately, farming was very profitable for much of the 1990s and farmers were able to build equity. That equity reserve is what has allowed banks to continue to term out debt so that farmers can get operating credit another year. Many bankers noted that ongoing cash losses will deplete equity reserves to the point that financing options will become much more limited.

• Crops that depend heavily on export markets have been hard hit; this is especially true for cotton. Participants in the listening sessions urged our staff to communicate to you

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that the future of American agriculture depends upon policies that support free and open trade.

• One bright spot in agriculture is cattle. Prices received by producers at all points of the production cycle have been good. Areas that we visited that have cattle production generally have been faring better than areas that are completely dependent upon crops.

• High-energy costs, increased prices for inputs and scarce water for irrigation in the Pacific Northwest in 2001 are new, dark clouds on the horizon.

• There was a great deal of discussion about the current federal payment structure. The planting flexibility afforded by the 1996 legislation was seen as a major positive change by participants. The dependence upon the Loan Deficiency Payments (LDP) as a price support mechanism was less universally praised. LDP is only an effective price support mechanism when a farmer has a normal to above-normal yield. When drought or other factors hurt yields, the LDP is reduced and the farmer suffers a diminished cash flow. In many areas of the country, LDP payments have been large because farmers have experienced above-average yields. Other areas that we visited, Texas and Kansas for example, have had extensive drought. Farmers there are faced with greatly reduced cash flows because their LDP payments were negligible. Many bankers concluded that they are uncomfortable with a price assistance program that works best only when there is an average to above-average crop yield.

• Bankers and others who attended the sessions were very positive about the improvements that were made to crop insurance programs in the Agricultural Risk Protection Act of 2000. It appears that the determination of Congress to make crop insurance a credible risk management tool is beginning to pay significant dividends.

USDA, Farm Service Agency Guaranteed Loan Programs

At every listening session we discussed the USDA, Farm Service Agency. FSA distributes LDP payments, administers agricultural disaster assistance and administers the guaranteed farm loan program. At many locations the audience was very positive about the performance of the FSA. At other locations we heard about ongoing problems with FSA.

The guaranteed loan programs offered by the FSA are one of the most cost-effective and highest impact tools that Congress can provide to farmers and ranchers during difficult economic times. Because the FSA-guaranteed loan programs are such an important part of access to credit, we have some very specific recommendations for you to consider in the 2002 farm bill.

Recommendation: We urge Congress to continue to make funding for FSA-guaranteed loan programs a priority. With continued uncertainty in the agricultural economy, there must be a dependable level of funding for all FSA programs. Recent improvements to the program have established the guaranteed loan program as a credible tool for the private sector to use to

deliver credit to farmers and ranchers. In order for this tool to continue to work, funding must be available.

For many years the banking industry has worked with USDA to successfully graduate farm borrowers from direct USDA loans to guaranteed loans and then on to non-guaranteed bank credit. However, we do not believe that Congress envisioned the kind of economic situation that we currently face when it acted to place a limit on a borrower's eligibility for guaranteed loans. Clearly, economic realities justify an immediate change.

Recommendation: Given the fact that the agricultural sector is expected to be under continued financial stress, borrower term limits should be permanently eliminated.

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There continues to be widespread confusion, on the part of FSA, about what happens if a customer fails to achieve a 100 percent cash flow. If a farmer has a cash flow coverage of less than 100 percent, this means that he was unable to meet all of his operating and debt obligations, but it does not mean that the business is in eminent danger of failing. Even in the best of years, many farms may not experience 100 percent cash flow coverage. Many times, when cash flow is less than 100 percent, a business borrows money.

My point is that an exclusive focus on cash flow coverage by FSA is flawed, and that this may be an artificial barrier to credit for many farmers and ranchers. When we underwrite a loan at my bank, we look at other factors such as available collateral. In many cases, I might be willing to make a loan to the producer even if his cash flow is not 100 percent if I know about other, offsetting factors. Given the current economic situation, it seems that we should be exploring additional ways to determine the creditworthiness of a customer and not relying on a single determinant.

Recommendation: If the bank has indicated that it will approve and fund the loan, FSA

should approve the guarantee, with a lower percentage of guarantee if necessary, if the cash flow coverage is less than 100 percent. Give banks the option of making the loan (and taking on the additional risk) if they feel that there are other factors that offset a cash flow deficiency.

In 1992, Congress approved a low documentation loan program for FSA guarantees. The idea was to significantly streamline the paperwork on smaller loan requests to encourage banks and others to make more credit available to smaller farmers and ranchers in a timelier manner. At that time, the loan limit for low documentation loan applications was set at $50,000. Since that time, farms and ranches have grown in size and the expertise of the banks that make FSA guaranteed loans has increased.

Recommendation: Congress should increase the ceiling on low documentation FSA guaranteed loan applications to $150,000.

Today, many USDA services still require direct farmer contact by the FSA. Guaranteed lending is not one of them. It is the bank that makes the direct contact with the customer, it is the bank that does the on-site inspections and appraisals, completes the loan underwriting to their and FSA standards, and it is the bank that commits the funding for the loan.

Today, there are many FSA Preferred Lenders ("PLP") operating in multi-county and even multi-state regions. As a PLP, lenders can receive permission to make FSA guarantees in any state where they can demonstrate they can adequately manage and service the accounts. However, lenders must still place the individual applications in the local county office. All too often, this is where lenders encounter inconsistencies in processing and loan servicing. Inconsistencies in program administration by FSA were the main complaint that our staff heard when they conducted the listening sessions. We believe that program delivery and administration problems stem from the highly localized delivery structure that USDA maintains for the guaranteed loan program.

Recommendation: FSA should consolidate guaranteed loan making and loan servicing at state offices, or in specialized districts in very large states to ensure consistency and maximum efficiency of program delivery.

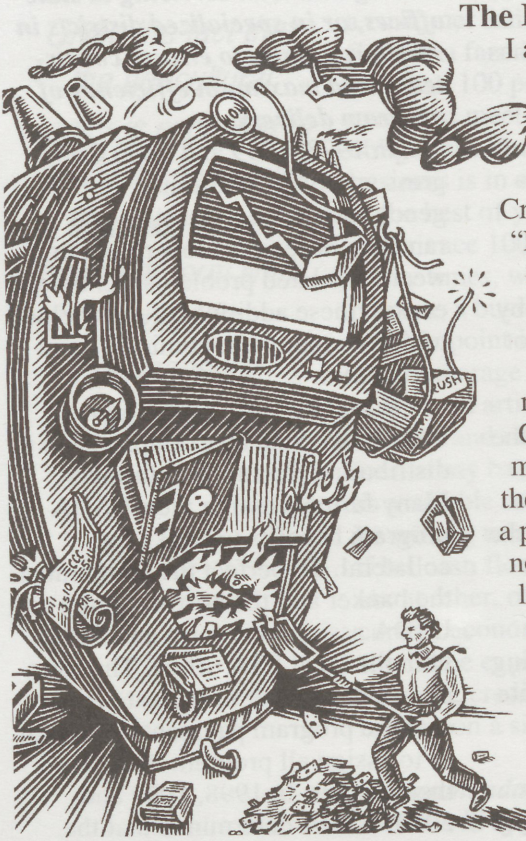
In 1998, 1999 and 2000 Congress approved additional, emergency assistance to farmers and ranchers because of low prices or weather-related problems. As I noted earlier, these additional funds helped to avert a major economic crisis in agriculture.

With one major exception, USDA has done an exemplary job of distributing the funds to farmers. Many farmers assign their USDA program benefits to banks for collateral. To perfect the assignment, the banker and the borrower sign an USDA assignment form and file it with the local FSA office. The form allows the farmer to indicate either specific program payments to assign or to assign all program benefits to their banker. In 1998, 1999 and 2000, USDA determined that the additional, supplemental payments authorized by Congress could not be assigned with an existing assignment form – even if the "all programs" box was checked on the form.

In commercial transactions, an assignment of benefits attaches to present and future receipts of the debtor. USDA, acting counter to the standards of commercial transactions, required farmers and bankers to execute and file new assignment forms each time Congress authorized a new payment program. This interpretation by USDA has created a mountain of paperwork – to say the least.

Recommendation: FSA should create a blanket assignment form for USDA benefits that would attach to all program benefits, now and in the future, in order to stop an immense, costly and confusing paper chase.

The Farm Credit System



I agree with the position of the U.S. Department of the Treasury ("Treasury") regarding the proposal to grant national charters to Farm Credit System ("System" or "FCS") institutions. In a May 2, 2001, letter to the Farm Credit Administration ("FCA"), Treasury advised FCA to withdraw the proposal. Treasury noted that the need to expand a GSE-subsidized creditor into a market that is being well served by the private sector does not advance a public purpose. Treasury further noted that "freed from the current limitations focusing service on the eligible borrowers within their service area, a Farm Credit association could pursue the most profitable borrowers, regardless of location, without the same sense of obligation to serve each eligible borrower."

The System was chartered when there were very limited credit opportunities for farm and ranch borrowers. It was an important part of the credit delivery system for rural America in the last century. Times changed drastically for FCS in the 1980s. Burdened by a portfolio of bad loans, the System sought taxpayer assistance in 1987. From 1984 to 1994, FCS shed customers and reduced its portfolio *by nearly 45 percent.* Today, its outstanding portfolio of loans to farmers and ranchers is only 74 percent of what it was in 1984.

During the same period that FCS shrank by nearly 45 percent, the banking industry increased loans to farmers and ranchers by more than 22 percent. While System institutions actively shed customers, banks helped farmers and ranchers. Today, banks have 41 percent of the market because we actively sought agricultural credits from all segments of the market. The banking industry did not focus solely on high-volume deals at the expense of small, beginning and minority farms. FCS, on the other hand, has a well-documented pattern of lending to older, larger and wealthier farmers. This policy has damaged its reputation in farm country. Farmers and ranchers have never forgotten how FCS treated them when the System was insolvent. Rather than focusing on small, beginning and family farms, FCS would like Congress to "modernize" its charter to help it move further away from the people that built and sustained the System.

As the leaders of the system persist in their drive for a broader charter, I question the need to continue the GSE status of the FCS. Why should the American public continue to subsidize, and guarantee the misadventures of, a tax-advantaged retail lender when it is clear that the private sector is meeting the needs of agriculture and rural America? As noted in the Treasury's letter, "We question whether enabling a GSE-subsidized competitor to better compete in this market advances a public purpose." I question it as well, and believe that it is time for Congress to review the public policy purpose of FCS and its GSE status.

Summary

Bankers will work with their customers to restructure debt, to provide credit for operating expenses for the coming year, to find ways for beginning farmers to get started and to provide the financial services and financial stability that rural communities need. We will continue to provide credit to those farmers and ranchers who can make the necessary and rapid adjustments to the new global environment. Even in this uncertain environment, competition for safe and sound credit opportunities is strong, and that competition among lenders benefits the producer.

Credit, however, cannot be used as a replacement for earnings and profits. One of the key lessons learned in the farm crisis of the 1980s is that agricultural businesses must be profitable in order to successfully manage their debt obligations. This was a hard-learned lesson, but a lesson we should never forget. jal