Maintaining the Cutting Edge

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Editors: Cara L. Mitchell
Kim B. Anderson

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CRYSTAL BALLS, OUIJA BOARDS, AND PALM READING
VIEWS ON THE FUTURE OF AGRICULTURAL FINANCE

MARVIN R. DUNCAN*

The crisis in agricultural finance is over, but its aftermath remains with many farmers, financial institutions, and rural communities. American agriculture has undergone an immense secular structural adjustment. An estimated 150,000 farmers are in the vulnerable category, with perhaps 50,000 who will not recover. Those who can get healthy are doing so. Those who cannot will ultimately have to change their occupations. Public policy attention should now shift from farm financial crisis management to the more difficult, but more productive, task of developing greater off-farm economic growth in non-metropolitan America. Because of Chapter 12 bankruptcy laws, state statutory impediments to foreclosure, and restructuring of debt by lenders, many financially troubled farmers are obtaining debt relief by write-downs of principal and interest. Some farmers blame their lenders for their own financial problems, but the farm lenders themselves have suffered substantial losses. Events in recent years and changes being contemplated by the Congress could well change the face of agricultural lending in the in the United States for years to come.

Text

The big news is that the farm crisis is over in the United States. Land values are stabilizing, farm income is record high, the expected flight of farmers from the land has not materialized to nearly the extent feared, and farmer optimism is returning. But the crisis leaves behind it a legacy of change for many farmers, financial institutions, and rural communities. The secular structural adjustment that American agriculture experienced was immense. Its effects will be felt for years to come. And it is unlikely that the sector can, or would want to, return to the conditions that caused the adjustment.

The U.S. Department of Agriculture says that 150,000 farmers are in what it calls the "vulnerable" category. Of that group, some 50,000 have irretrievably failed. Those who can get healthy are doing so. Those who cannot will ultimately have to find new occupations. Public policy attention should now shift from farm financial crisis management to the more difficult, but more productive, task of developing greater off-farm economic growth in non-metropolitan America to aid rural communities and assist those who can no longer earn a living from farming.

Agricultural lenders too have absorbed heavy losses. The losses suffered by the Farm Credit System are legend and the numbers of commercial agricultural banks that have failed are the largest since the Great Depression. These problems have carried over into rural communities where many small businesses have closed their doors and where the very financial fiber of the communities themselves has worn thin.

*Member, Farm Credit Administration Board, McLean, Virginia

The advent of the Chapter 12 bankruptcy code last November set off a new wave of farm failures. According to recent figures from Dun and Bradstreet, it appears that most of the 93-percent increase in farm bankruptcies recorded in the first half of 1987 can be attributed to Chapter 12 as farmers seem to be taking advantage of the code's more lenient debt reorganization provisions. It also appears that lenders are more willing to restructure troubled debt in efforts to avoid Chapter 12 proceedings.

Debt restructuring that is based on sound business practices makes good sense and is both a necessary and constructive part of the solution to farm financial problems. But if it merely delays the inevitable, it may be an injustice to both the borrower and the lender. Many farmers have rationalized that their lenders were partners when they borrowed money and should share in the losses when the money cannot be repaid without disrupting the farmer's business or life style. History will indicate that lenders did share in those losses, sometimes to the point that the lender was driven from business.

Some recent state and federal laws have substantially strengthened the position of borrowers in dealing with creditors. Regardless of whether that new legal tilt is needed to deal with current conditions, the laws will have longer run implications for credit availability and price. These implications typically will be adverse to farmers. The longer run results will likely include fewer lenders actively pursuing farm loan business, more difficulty for marginally credit worthy borrowers in obtaining funds, greater difficulty in obtaining home and farmstead improvement loans, and somewhat higher interest rates reflecting the higher risk in agricultural lending.

Lenders will be far more cautious in their approach to lending. Not only will they pay more attention to markets, cash flow, and repayment capacity, they will be more conservative and demand greater equity positions and more collateral from their borrowers. It is also likely that some traditional agricultural lenders will look elsewhere for more diversified business. So if farmers gain some short term benefit through extra liberal restructuring, they may face bigger problems in the long run. It is now time for lenders and borrowers to discuss their mutual future needs. An equitable legal framework will benefit both in the longer run.

Of course, the decline in agricultural loan volume in the past couple of years indicates this cuts both ways. Many farmers are "making do" with older equipment, using less fertilizer and pesticide, and are not looking to expand or add to their real estate holdings. Farmers realize they must use less leverage in their businesses. But with farm real estate values stabilizing and farm incomes relatively high, expansion opportunities for farmers likely will require more debt financing in a year or two as the volume of agricultural debt stabilizes and returns to a slow growth rate.

I said at the outset that the crisis in agricultural finance is over. That statement recognizes that farm lenders must still work through billions of dollars in non-performing loans and dispose of large inventories of acquired properties. In that process some troubled farmers will be saved and some with little or no debt will pick up farm land at bargain prices. One innovation worth mentioning in this regard is the guaranteed buy back program being offered in the St, Paul Farm Credit District. Life in rural America may well be changed, but it will go on.

Before we look too far into the future, let's look very quickly at where we are. There is no question that conditions are beginning to improve. More than 82 percent of all farms with annual sales greater than $100,000 generated positive net cash farm income in 1986. Land prices have stabilized. Inflation remains under control. The dollar has weakened while currencies of some of our trading partners, particularly Japan, have strengthened. Interest rates have moderated. The 10-year Conservation Reserve Program, now at 23 million acres, may reach its goal of 40 to 45 million acres by 1990. The paydown of farm debt continues and may go as low as $150 billion. And government farm program outlays remain substantial, despite some cuts being proposed by the Office of Management and Budget.

Given this brighter scenario, let us now turn to the future of agricultural finance beginning with the Farm Credit System.

We begin with the assumption that the Congress and the Administration have decided that public policy continues to require a special credit system focused on the agricultural sector. The next considerations are what that will cost and what form such a system will take.

Legislation has been introduced in both the House and the Senate designed to return the system to viability. What the legislation lacks is a price tag. An analysis of the problem undertaken by the Farm Credit Administration indicates that a total assistance package of as much as $5.2 billion would return most system institutions to viability by the end of 1994, $4.1 billion of which would be required during the first two years. That estimate could sharply increase if the provision of federal funds is linked to a reduction in interest rates charged borrowers or to legislated loan restructuring. While such proposals would be popular among farmers, federal budget realities seem likely to require that loan restructuring be business based and interest rates set high enough to cover operating costs. A line has to be drawn between a workable businesslike solution to the system's financial and operating problems and a social program solution to the problems of its troubled borrowers. If it isn't, the Farm Credit System will become a second Farmers Home Administration in the sense that it will be restructuring loans that would be commercially unacceptable.

If that happens, the system will require regular infusions of federal assistance because it is unlikely that credit worthy borrowers will be satisfied to pay the higher costs associated with social program responsibility.

The other unresolved questions are how to accommodate the need for financial assistance within the constraints of the federal budget and the perceived need for statutory change in the structure and operation of the system itself. The perception is that changing the structure of the system would somehow automatically result in substantial cost savings, primarily through a reduction in personnel and in bricks and mortar. The fact of the matter is that large numbers of competent people will be required to work through the system's nearly 100,000 troubled loans, although some savings could be attained once that process is completed. The biggest culprit affecting the system's cost of doing business at the present time is the high cost of the system's outstanding securities. Currently, the cost of outstanding debt for system instititions is edging upward as market rates rise. Moreover, several Federal Land Banks either have negative net interest margins or negative returns on equity and assets as a result of reducing borrower interest rates in an effort to hold volume in a shrinking credit market. In the longer run, both restructuring the delivery system to attain operating efficiencies and pricing to cover long run costs of doing business will be necessary if the system is to survive as a private sector borrower owned lender.

A controversial element of the proposed legislation involves the creation of a secondary market for farm loans. The proposed legislation would establish a Farm Mortgage Corporation allowing Farm Credit System institutions and commercial lenders to package their agricultural real estate loans for resale to investors as tradable interest bearing securities. The corporation would provide "credit enhancement" through the Federal Farm Credit Banks Funding Corporation and, ultimately, through the government to guarantee investors that they will receive timely payments of principal and interest. The fundamental attributes of this "securitization" by the Farm Mortgage Corporation are two-fold. One is to shift the bearing of interest rate risk to investors and away from either the borrower or the lender at a market-determined price. Because risk is reduced, so may be the capitalization needs of Farm Credit System institutions and other farm lenders. Being able to sell assets in a well defined market means lenders can be more innovative in the kinds of loan products they offer.

Another important consequence of securitization is market enforced credit standards. To sell as part of a pool or package, loans must meet credit and appraisal standards. Those standards are constantly tested and refined by investor response to loan backed securities and by the judgement of independent rating companies who evaluate the quality of their offerings. The result is that pricing of loan products is market driven, a fundamentally healthy circumstance for everyone involved.

If the secondary market is limited to real estate loans, it will pave the way for 5,000 to 6,000 commercial banks, thousands of savings and loan associations, and dozens of insurance companies to enter agricultural real estate lending or expand their lending activities. But if non-real estate farm loans are also included, it gives a green light as well to countless merchants, dealers, manufacturers, exporters, processors, distributors, and cooperatives who may wish to sell financial services to their customers. Whatever happens will affect the Farm Credit System as well as other farm lenders and will undoubtedly have significant ramifications for the future of agricultural finance. A secondary market would create more competition among a wider range of lenders. Some would gain and some would lose. That competition would result in more innovative loan products and services.

While the farm crisis may have passed, its aftermath must still be worked through. More importantly, it is now time to look broadly at public policy options and business practices that can be of longer term benefit to U.S. farmers and their lenders, as well as to rural America. In fact, a new and even more challenging agenda awaits.

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