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Agricultural Credit: Institutions and Issues

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Summary

The federal government has a long history of providing credit assistance to farmers by issuing direct loans and guarantees, and creating institutions to fill gaps in rural markets. These institutions include the Farm Credit System (FCS), which is a network of borrower-owned lending institutions operating as a government-sponsored enterprise, and the Farm Service Agency (FSA) of the U.S. Department of Agriculture (USDA), which makes or guarantees loans to farmers who cannot qualify at other lenders. When loans cannot be repaid, special bankruptcy provisions (Chapter 12) help family farmers work through debt problems and continue farming, sometimes avoiding foreclosure.

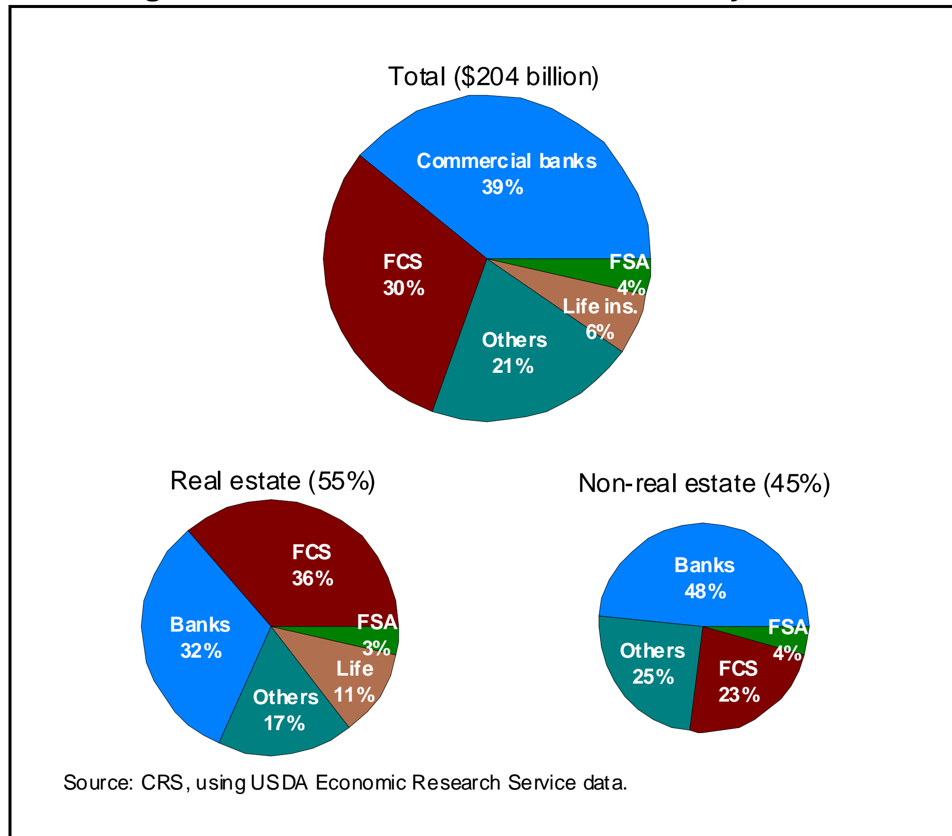
In 2004, congressional interest in agricultural credit focused on the attempted exit from the Farm Credit System by one association (S. 2851, and hearings in the House); the renewal of Chapter 12 (S. 2864, H.R. 975); oversight of Farmer Mac (hearings in the House); reducing taxation on commercial agricultural lenders (S. 1263); and annual appropriations bills for USDA. This report will be updated as events warrant.

Lending Institutions

Five types of lenders make credit available to agriculture, the first two of which are more or less affiliated with the federal government: the Farm Credit System (FCS), USDA Farm Service Agency (FSA), commercial banks, life insurance companies, and individuals and others. Creditworthy farmers generally have adequate access to loans, mostly from the largest suppliers — commercial banks, FCS, and merchants and dealers.

Figure 1 shows that commercial banks lend the largest portion of the farm sector's total debt (39%), followed by the Farm Credit System (30%), individuals and others (21%), life insurance companies (6%), and the Farm Service Agency (4%). Separating real estate and non-real estate loans, the FCS has the largest share of real estate loans (36%), and commercial banks have the largest share of non-real estate loans (48%). Although FSA has a 4% share of the market through its direct lending program, it guarantees loans made by other (commercial) lenders accounting for approximately another 4% of the market.

Figure 1. Market Shares of Farm Debt, by Lender



Farm Credit System (FCS).[1] Operating as a government-sponsored enterprise, FCS is a network of borrower-owned lending institutions. It is not a government agency or guaranteed by the U.S. government. However, Congress established the system in 1916 to provide a dependable and affordable source of credit to rural areas at a time when many lenders avoided farm loans. Statute and oversight determine the scope of FCS activity, and provide benefits such as tax incentives.

Five large FCS banks provide funds to 97 credit associations that, in turn, make loans to eligible borrowers who must meet standard creditworthiness requirements. FCS funds its loans with bonds sold in capital markets. For more about FCS, see CRS Report RS21278, *Farm Credit System*.

USDA's Farm Service Agency (FSA).[2] FSA is referred to as a lender of last resort because it makes direct loans to family farms unable to obtain credit from other lenders. FSA also guarantees timely payment of principal and interest on some loans made by commercial lenders. FSA loans finance farm land purchases, annual operating expenses, and recovery from emergencies or natural disasters. Some loans are made at a subsidized interest rate. To qualify for an FSA guaranteed or direct loan, farmers must have enough cash flow to make payments.

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[1] Farm Credit System institutions are described at [http://www.fca.gov/FCS-Institutions.htm].

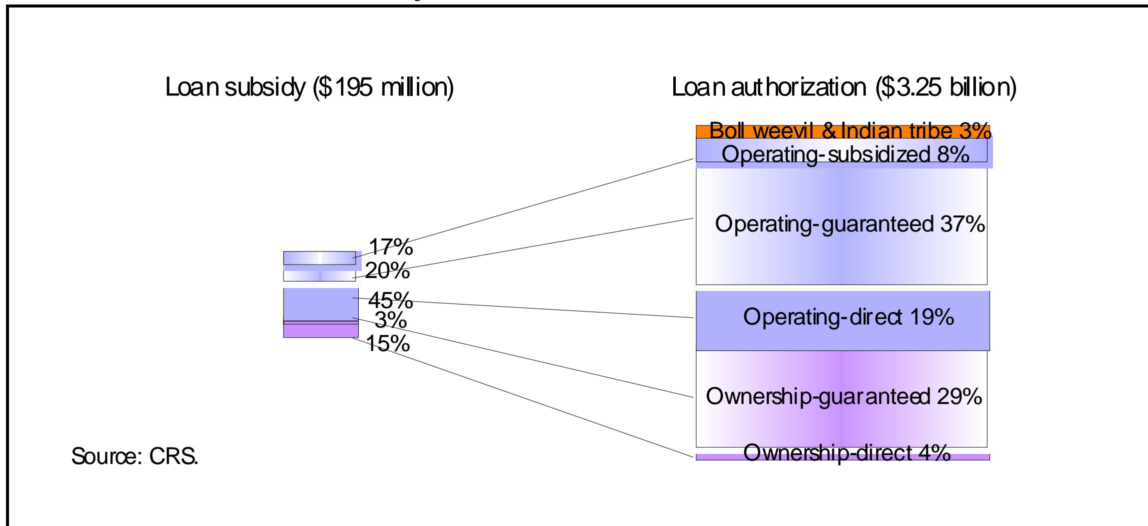
[2] USDA Farm Service Agency loan programs are described at [http://www.fsa.usda.gov/dafl].

FSA Lending Changes in the 2002 Farm Bill. The 2002 farm bill (P.L. 107-171) authorizes USDA lending programs through 2007 (Title V), subject to annual appropriations. The new law allows FSA to lend more to beginning farmers for down payments. It creates a pilot program to guarantee seller-financed land contracts; the pilot is available to five contracts per state per year in Indiana, Iowa, North Dakota, Oregon, Pennsylvania, and Wisconsin. Losses due to USDA-imposed quarantines qualify for emergency loans. Shared appreciation agreements — contracts under which USDA forgives part of a real estate loan in return for sharing any price appreciation over a specified period — that have become delinquent may be reamortized for up to 25 years.[3]

FSA Appropriation for Farm Loans. FSA receives an annual federal appropriation (loan subsidy) to cover interest rate discounts and anticipated loan defaults. The amount of loans that can be made (loan authority) is larger. The enacted FY2004 loan subsidy was $195 million to support loans totaling $3.25 billion (**Figure 2**). For FY2005, USDA requested $557 million more in loan authority but $34 million less in loan subsidy. The ability to propose greater loan authority with a smaller appropriation is possible due to two factors: USDA adjustments in historical performance ratios, and bigger increases in the lower-cost unsubsidized guaranteed loan programs.

Both the Senate-reported FY2005 agriculture appropriations bill (S. 2803) and the House-passed FY2005 bill (H.R. 4766) provide smaller appropriations and loan authorities than requested. S. 2803 would provide $155 million to cover $3.36 billion in loans. H.R. 4766 would provide $158 million to subsidize $3.82 billion in loans. For more on FY2005 appropriations, see CRS Report RL32301, *Appropriations for FY2005: U.S. Department of Agriculture and Related Agencies.*

Figure 2. USDA Farm Service Agency Appropriations: Loan Subsidy and Loan Authorizations, FY2004



[3] For a side-by-side comparison of credit provisions in the 2002 farm bill, see the Economic Research Service, [http://www.ers.usda.gov/Features/FarmBill/Titles/TitleVCredit.htm#Service]. For more on the pilot program to guarantee seller-financed contracts, see FSA at [http://www.fsa.usda.gov/dafl/pilot%20program.htm]. For more on shared appreciation agreements, see CRS Report RS21145, *Shared Appreciation Agreements on USDA Farm Loans.*

Other, Nongovernmental Lenders. Commercial banks lend to farmers through both small community banks and large multi-bank institutions.[4] Another category of lenders is "individuals and others." This category consists of seller-financed and personal loans from private individuals, and the growing business segment of captive financing by equipment dealers and input suppliers (e.g., John Deere Credit and Pioneer Hi-Bred Financial Services). Life insurance companies historically also have looked to farm real estate mortgages for diversification.

Farmers' Balance Sheets

Debt levels vary greatly among farmers. Only 66% of farmers have any debt (farm or nonfarm), and only 38% have farm debt. USDA expects total farm debt to rise by 2.9% in 2004, reaching a record $204 billion.[5] Total farm assets are expected to rise by 3.1% in 2004, reaching $1.4 trillion and resulting in a 14.7% debt-to-asset ratio. Debt-to-asset ratios for the sector have been relatively stable for the past decade. Thus, farm equity has been rising because increases in debt typically have been offset by larger gains in farm land. Economists attribute much of the continued growth in land values to government payments.

Recent strength in farm income generally has given farmers more capacity to repay their loans or borrow new funds. However, in the past year, the sector's use of its debt repayment capacity (measured as the actual debt relative to the maximum feasible debt) rose to 60% in 2004 from 54% in 2003. Although credit conditions are good overall, some farmers may experience financial stress due to individual circumstances.

Farm Bankruptcy: Chapter 12

In response to the farm financial downturn of the early 1980s, Congress added Chapter 12 to the Bankruptcy Code in 1986 (P.L. 99-554). It has special provisions for farmers compared with other bankruptcy chapters, strengthening farmers' bargaining position with creditors. Chapter 12 is more about reorganization of debt than bankruptcy because it allows secured debts to be written down to the fair-market value of the collateral and repaid at lower interest rates over extended periods. Chapter 12 is seen by many as a policy response to the social stigma attached to family farm failures during the Great Depression. It gives struggling farmers another chance to reorganize and repay their debts, rather than forcing them into liquidation and off the farm.

Chapter 12 has succeeded in keeping some farmers in business and has encouraged informal lender-farmer settlements out of court. But it has increased costs to society by encouraging inefficient farmers who would otherwise liquidate to remain in business, and allowing efficient farmers who could otherwise continue to farm to charge off part of their

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[4] Commercial bank issues are summarized by the American Bankers Association at [http://www.aba.com/Industry+Issues/issues_ag_menu.htm] and the Independent Community Bankers of America at [http://www.ibaa.org].

[5] Economic Research Service, at [http://www.ers.usda.gov/Briefing/FarmIncome/wealth.htm].

debts. Bankruptcy costs include legal fees and the efficiency costs from continuing to use labor and capital in otherwise inefficient enterprises.[6]

Policy Issues for Congress

Chapter 12 Extension. Congress retroactively extended Chapter 12 of the U.S. Bankruptcy Code for another 18 months through July 1, 2005, under S. 2864 (P.L. 108-369, October 25, 2004). Chapter 12 had expired on January 1, 2004, and its renewal was captured in the larger debate over comprehensive bankruptcy reform, even though the Chapter 12 provisions are not viewed as controversial. Given the impending sunset on July 1, 2005, renewal of Chapter 12 will be an issue for the 109th Congress.

When Chapter 12 was enacted, it contained a sunset provision of October 1, 1993. Congress subsequently has renewed the law ten times with temporary extensions. Although such extensions usually have been enacted with little opposition, frequent sunset dates create uncertainty for lenders and producers, especially when the provision expires without action to extend the law.

Congress has been considering comprehensive bankruptcy reform for several years. H.R. 975 passed the House on March 19, 2003, and addresses consumer bankruptcy, small business bankruptcy, and Chapter 12 (see CRS Report RL31783, *Bankruptcy Reform in the 108th Congress*). But the Senate has not considered the bill during the 108th Congress. H.R. 975 would make Chapter 12 permanent, expand eligibility by raising the debt limit from $1.5 million to $3.237 million, require only 50% (instead 80%) of debt to come from the farming operation, allow the requirement for 50% of income to be from farming to apply to one of three years preceding filing instead of just the immediately preceding year, and extend benefits to family fishermen. H.R. 975 is very similar to bills passed by both the House and Senate during the 107th Congress (H.R. 333), but omits the Schumer amendment, which prevents discharge of liability for willful violation of protective orders and violent protests, including those against reproductive health services.

Facing the January 1, 2004, sunset and attempting to keep Chapter 12 active, the Senate passed S. 1920 by unanimous consent on November 25, 2003, for a six-month extension (until July 1, 2004). Two House bills (H.R. 3540 and H.R. 3542) were introduced, but no action was taken before the first session ended. On January 28, 2004, the House took up S. 1920 with an amendment in the nature of a substitute consisting of the text of H.R. 975, including an amendment to make Chapter 12 retroactive to January 1, 2004. This version passed the House by a vote of 265-99, but the Senate did not take action for a conference committee. Action on S. 2864 (P.L. 108-369) temporarily resolved this impasse.

Allowing FCS Institutions to Leave the System. Statutory language allowing institutions of the Farm Credit System to terminate their membership was enacted in 1987

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[6] For more background and analysis on farm bankruptcies, see the USDA Economic Research Service at [http://www.ers.usda.gov/Briefing/Bankruptcies] and CRS Report RS20742, *Chapter 12 of the U.S. Bankruptcy Code.*

(12 U.S.C. 2279d). It is not clear whether Congress intended the provision to be used by outside companies to purchase parts of the System.

In an unprecedented move, an institution of the government-sponsored Farm Credit System, Omaha-based Farm Credit Services of America (FCSA), initiated procedures on July 30, 2004, to leave the FCS and be purchased by a private foreign bank (Rabobank). After much public controversy, the FCSA board of directors voted on October 19, 2004, to terminate its agreement with Rabobank before seeking approval from the System's federal regulator. Although Congress had no direct statutory role in the approval process, the House held hearings on the implications of the deal,[7] and Senators Daschle and Johnson introduced S. 2851 to require public hearings and a longer approval process.

Although the current attempt was aborted, FCSA's initial decision to be bought by a private firm has affected the agricultural and banking industry's view of the Farm Credit System. The controversy highlighted provisions in the Farm Credit Act that both proponents and opponents of FCS have been raising regarding the System's desire to expand its scope of lending practices. Future legislative efforts to address these issues may be affected by how these recent events unfolded. For more information, see CRS Report RS21919, *Farm Credit Services of America Ends Attempt to Leave the Farm Credit System.*

Farmer Mac Mission and Governance. Farmer Mac is the secondary market for agricultural loans and is part of the Farm Credit System. An October 2003 report by the Government Accountability Office (GAO) recommended that Congress consider legislation that would establish clearer goals for Farmer Mac. GAO also found concerns with risk management practices (including geographic concentration), lack of secondary market development, and lack of independence in Farmer Mac's board of directors.[8]

Since the GAO report, questions have arisen about whether new financial instruments created by Farmer Mac (a certain type of swap) are reducing insurance premiums paid to the Farm Credit System's insurance fund without any corresponding reduction in risk exposure. On June 2, 2004, the House Agriculture Committee held a hearing on Farmer Mac and the GAO report.[9]

Commercial Bank Taxes on Agricultural Loans. On June 13, 2003, Senator Hagel introduced S. 1263, the Rural Economic Investment Act. The bill would exempt commercial banks from paying taxes on income from loans secured by agricultural real estate, including residential loans in rural areas with fewer than 2,500 people. Proponents say the bill would boost rural development and give commercial banks equal treatment for tax exemptions long available to the Farm Credit System (12 U.S.C. 2098). Critics say such exemptions are not warranted since agriculture no longer faces a credit constraint and other industries do not receive such preferential treatment.

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[7] The hearing transcript is available at [http://agriculture.house.gov/hearings/108/10838.pdf].

[8] Government Accountability Office, "Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed," GAO-04-116, October 2003, [http://www.gao.gov/new.items/d04116.pdf].

[9] The hearing transcript is available at [http://agriculture.house.gov/hearings/108/10831.pdf].