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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 rural lending institutions. 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 help family farmers reorganize debts and continue farming (P.L. 109-8 made Chapter 12 permanent and expanded eligibility).

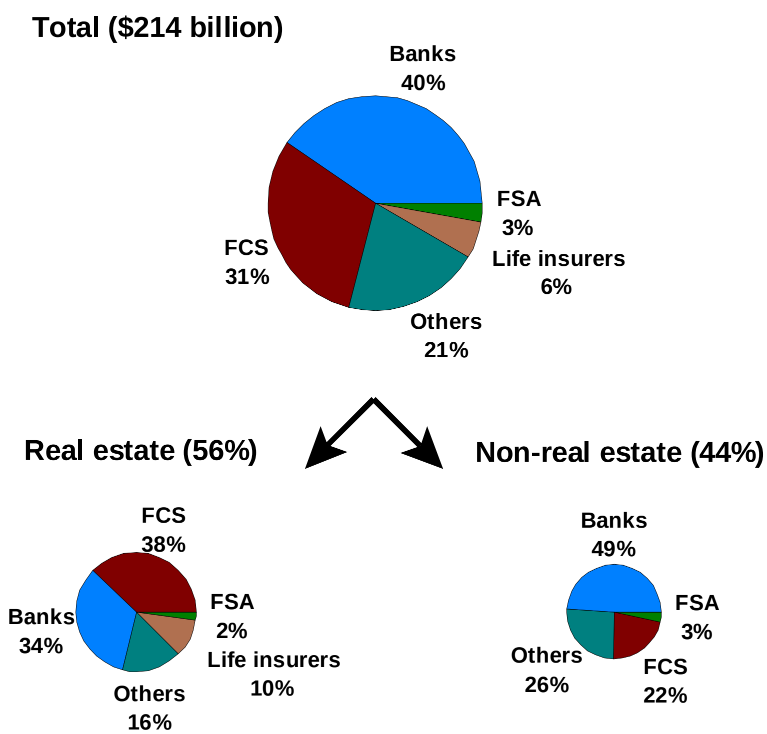
Legislation proposed in the 109th Congress for agricultural credit includes S. 238 and H.R. 399 (the Rural Economic Investment Act), which would exempt commercial banks from paying taxes on profits from farm real estate loans, thus providing similar benefits as to the Farm Credit System. The Administration proposed raising user fees charged by USDA to commercial banks that issue guaranteed farm loans, but Congress is rejecting the idea in appropriations legislation (H.R. 5384). This report will be updated.

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 (40%), followed by the Farm Credit System (31%), individuals and others (21%), life insurance companies (6%), and the Farm Service Agency (3%). Ranked by type of loan, the FCS has the largest share of real estate loans (38%), and commercial banks have the largest share of non-real estate loans (49%). Although FSA has a 3% share of the market through its direct lending program, it guarantees loans made by other (commercial) lenders accounting for approximately another 4%-5% of the market.

Figure 1. Market Shares of Farm Debt, by Lender, 2005



Source: CRS, using USDA Economic Research Service data at [http://www.ers.usda.gov/Briefing/FarmIncome/Data/Bs_t6.htm].

Commercial Banks and Other Nongovernmental Lenders. Commercial banks provide most of the loans to farmers through both small community banks and large multi-bank institutions.[1] Another important 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.

Farm Credit System (FCS).[2] Congress established the Farm Credit System in 1916 to provide a dependable and affordable source of credit to rural areas at a time when commercial lenders avoided farm loans. 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. FCS is not a lender of last resort; it is a for-profit lender with a statutory mandate to serve agriculture. Statute and oversight determine the scope of FCS activity, and provide benefits such as tax incentives. Funds are raised through the sale of FCS bonds and notes on Wall Street. Five large banks allocate these funds to 96 credit associations that, in turn, make loans to eligible creditworthy borrowers. For more about FCS, see CRS Report RS21278, *Farm Credit System*.

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[1] 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].

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

USDA's Farm Service Agency (FSA).[3] The USDA Farm Service Agency (FSA) is a lender of last resort because it makes direct loans to family-sized farms that are unable to obtain commercial credit. FSA also guarantees timely payment of principal and interest on qualified loans made by commercial lenders such as banks and the Farm Credit System. The programs have permanent authority under the Consolidated Farm and Rural Development Act (CONACT, 7 U.S.C. 1921 *et seq.*). However, Congress frequently uses omnibus farm bills to make changes to the terms, conditions, and eligibility requirements of these programs.

FSA makes farm ownership (FO) and operating loans (OL) to operators of family-sized farms. The maximum direct loans are $200,000 per borrower, while the maximum guaranteed loans are $852,000 per borrower (adjusted annually for inflation). Emergency (EM) loans are available for qualifying natural or other disasters. Some guaranteed loans have a subsidized (below-market) interest rate. To qualify for an FSA guaranteed or direct loan, farmers must demonstrate enough cash flow to make payments.

Some funds are reserved for beginning farmers. Seventy percent of the amount for direct farm ownership loans and 35% of direct operating loans are reserved for the first 11 months of the fiscal year (until September 1). Twenty-five percent of the amount for guaranteed farm ownership loans and 40% of guaranteed operating loans are reserved for the first six months of the fiscal year (until April 1). Funds are also targeted to "socially disadvantaged" farmers based on race, gender, and ethnicity.

Changes in the 2002 Farm Bill. Title V of the 2002 farm bill (P.L. 107-171) authorized funding levels for FSA loans for FY2003-FY2007 and expanded access to loans for beginning farmers. The 2002 farm bill also increased the percentage that USDA may lend for real estate loan down-payments and extended the duration of eligible loans. It created a pilot program to guarantee seller-financed land contracts, available to five contracts per year in each eligible state (originally implemented in Indiana, Iowa, North Dakota, Oregon, Pennsylvania, and Wisconsin; in 2005, the program expanded to include California, Minnesota, and Nebraska).

FSA Appropriation for Farm Loans. FSA receives an annual appropriation (loan subsidy) to cover interest rate discounts and anticipated loan defaults. The amount of loans that can be made (loan authority) is many times larger. The enacted FY2006 loan subsidy is $151.3 million to support loans totaling $3.785 billion (**Table 1**).

For the pending FY2007 appropriation, the Senate-reported bill (H.R. 5384) would provide $146.2 million to subsidize the cost of making an estimated $3.427 billion in direct and guaranteed FSA loans. This represents an 8.5% decrease in loan authority from FY2006, but equals the Administration's request. The House-passed version of H.R. 5384 would provide $3.552 billion of loan authority, $124 million less than the Senate. Most of the overall decrease in loan authority in both bills from FY2006 is for guaranteed farm ownership loans, down 13%. USDA asserts that there is less demand for the program. Neither bill provides new funds or authority for emergency loans, citing sufficient carryover. The Senate bill includes language (Sec. 753) to expand eligibility for farm loans to "commercial fisherman" by modifying the CONACT.

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

Table 1. FSA Loan Appropriations, FY2006

FSA Loan Program	Loan Subsidy (million $)	Loan Authority (million $)	Implicit multiplier
Farm Ownership Loans (FO)			
Direct	10.7	208	20
Guaranteed	6.7	1,400	208
Farm Operating Loans (OL)			
Direct	64.7	650	10
Unsubsidized Guaranteed	34.8	1,150	33
Subsidized Guaranteed	34.3	275	8
Indian Tribe Land Acquisition	0.1	2	25
Emergency Loans (EM)	0	0	—
Boll Weevil Eradication	0	100	—
Total	**151.3**	**3,785**	**25**
Subtotal: Direct loans	75.4	960	13
Subtotal: Guaranteed loans	75.9	2,825	37

Source: CRS, based on H.Rept. 109-255 to accompany H.R. 2744 (P.L. 109-97)

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 1.1% in 2006 to $216.5 billion.[4] Total farm assets are expected to rise by 6.3% in 2006, reaching $1.9 trillion. Thus, farm equity has been rising because increases in debt have been offset by larger gains in land prices. Farm land values rose by 16% in 2005 and are expected to rise 7.7% in 2006. Economists attribute much of the continued growth in land values to subsidies, although prices near cities also rise from development potential.

USDA economists estimate that the farm sector will use about 62% of its debt repayment capacity in 2006 (measured as the actual debt relative to the maximum feasible debt), up from a 53% average over 1995-2004. As usage of debt capacity rises, financial risk in the sector rises. Although credit conditions are good overall, some farmers may experience financial stress due to individual circumstances (10%-20% of commercial- and intermediate-sized farms).

Farm Bankruptcy: Chapter 12

In response to the farm financial crisis 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

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

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 debts. Bankruptcy costs include legal fees and the efficiency costs from continuing to use labor and capital in otherwise inefficient enterprises.[5]

Chapter 12 was enacted with an initial sunset provision of October 1, 1993. Congress renewed the law 11 times with temporary extensions and made it permanent in 2005 under Title X of the Bankruptcy Abuse Prevention and Consumer Protection Act, P.L. 109-8. The act expands eligibility by raising the debt limit, lowering the percentage of debt that must come from farming, and extending benefits to family fisherman.[6]

Policy Issues for Congress

FSA Fees for Guaranteed Loans. The Administration's FY2007 budget request proposed to increase the user fee that commercial lenders pay to FSA in order to receive the federal guarantee. The level of the fee is not stated in statute, but is set through regulations. Currently, the fee is 1% of the guaranteed portion of the loan (7 CFR 762.130(d)(4)(ii)). The Administration proposed increasing the fee to 1.5%, and calculated that the increase would offset $30 million in appropriations. Both the House and Senate agriculture appropriations bills reject the fee increase with identical bill language.[7] Separate from appropriations, this issue was discussed at a Senate Agriculture Committee hearing in June 2006 that reviewed agricultural credit issues.[8]

Exempting Taxes on Agricultural Loans for Commercial Banks. In the 109th Congress, S. 238 and H.R. 399 (the Rural Economic Investment Act) would exempt

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[5] 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*, by Robin Jeweler.

[6] A"family farmer" includes an individual and spouse, or a family-owned partnership or corporation, with debts of less than $3,237,000, 50% of which arise from the farming operation. The debtor must derive at least 50% of gross annual income from farming. A "family fisherman" is an individual and spouse, or a family-owned partnership or corporation, engaged in a commercial fishing operation whose debts are less than $1,500,000, 80% of which arise from the fishing operation. The debtor must derive at least 50% of gross annual income from fishing.

[7] House-passed and Senate-reported version of H.R. 5384: "*Provided further*, That none of the funds appropriated or otherwise made available by this Act shall be used to pay the salaries and expenses of personnel to collect from the lender an annual fee on unsubsidized guaranteed operating loans, a guarantee fee of more than one percent of the principal obligation of guaranteed unsubsidized operating or ownership loans, or a guarantee fee on subsidized guaranteed operating loans administered by the Farm Service Agency."

[8] Senate Agriculture Committee, "Review USDA Farm Loan Programs," June 13, 2006, at [http://agriculture.senate.gov/Hearings/hearings.cfm?hearingId=1940].

commercial banks from paying taxes on profits from agricultural real estate loans. The definition would include residential loans in rural areas with fewer than 2,500 people.

Proponents, including the American Bankers Association, 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 (for commercial banks or the FCS) since agriculture no longer faces a credit constraint and other industries do not receive such preferential treatment.

Farm Credit System Authority. In recent years, the FCS sought to expand its lending authorities beyond traditional farm loans and into rural housing and non-farm businesses. FCS also generally desires to update the Farm Credit Act of 1971, which last was amended comprehensively in 1987. In early 2006, the FCS released a report titled Horizons, which highlights perceived needs for greater lending authority.[9] Some see Horizons as a precursor to legislative action, possibly in the 2007 farm bill debate.

Commercial banks oppose expanding FCS lending authority, saying that commercial credit in rural areas is not constrained and that FCS's government-sponsored enterprise (GSE) status provides an unfair competitive advantage. FCS responds to this debate by asserting its statutory mandate to serve agriculture (and by extension, rural areas) through good times and bad, unlike commercial lenders without such a mandate.

Termination/Buyout of FCS Associations. The controversy over GSE status and lending authority was highlighted in 2004 when a private bank, Netherlands-based Rabobank, tried to purchase an FCS association. The board of directors of Omaha-based Farm Credit Services of America initially voted for the sale, indicating to some that FCS may no longer need government sponsorship. Although Congress had no direct statutory role in the buyout process, the House held hearings on the implications,[10] and Senators Daschle and Johnson introduced S. 2851 in the 108th Congress to require public hearings and a longer approval process.

In 2004, FCS asked Congress to eliminate the provision (12 U.S.C. 2279d) allowing institutions to leave the System. Commercial bankers say that institutions should be allowed to leave FCS if they want more lending authorities than currently allowed. It is not clear whether Congress, in 1987, intended the provision to be used by outside companies to purchase parts of the System.

In July 2006, the Farm Credit Administration, the federal regulator of FCS, amended the rules governing how an FCS bank or association may terminate its charter (71 FR 44409, August 4, 2006). The changes allow more time for FCA to review the request, more communication, and more shareholder involvement. For further background, see CRS Report RS21919, *Farm Credit Services of America Ends Attempt to Leave the Farm Credit System*, by Jim Monke.

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[9] The Horizons report is available at [http://www.fchorizons.com].

[10] House Agriculture Committee, "Review the Farm Credit System and its Provisions for Associations to Exit the System," at [http://agriculture.house.gov/hearings/108/10838.pdf].