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CRS Report for Congress

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 Service Agency (FSA) of the U.S. Department of Agriculture (USDA), which makes or guarantees loans to farmers who cannot qualify at other lenders, and the Farm Credit System (FCS), which is a network of borrower-owned lending institutions operating as a government-sponsored enterprise.

The 110th Congress is expected to address agricultural credit through both appropriations and authorizations bills. Appropriators will consider funding for FSA's farm loan programs, and the agriculture committees may consider changes to FSA and FCS lending programs. The 2007 farm bill is expected to be the venue for many of the authorizing issues, although stand-alone legislation may be used for extensive reforms. This report will be updated.

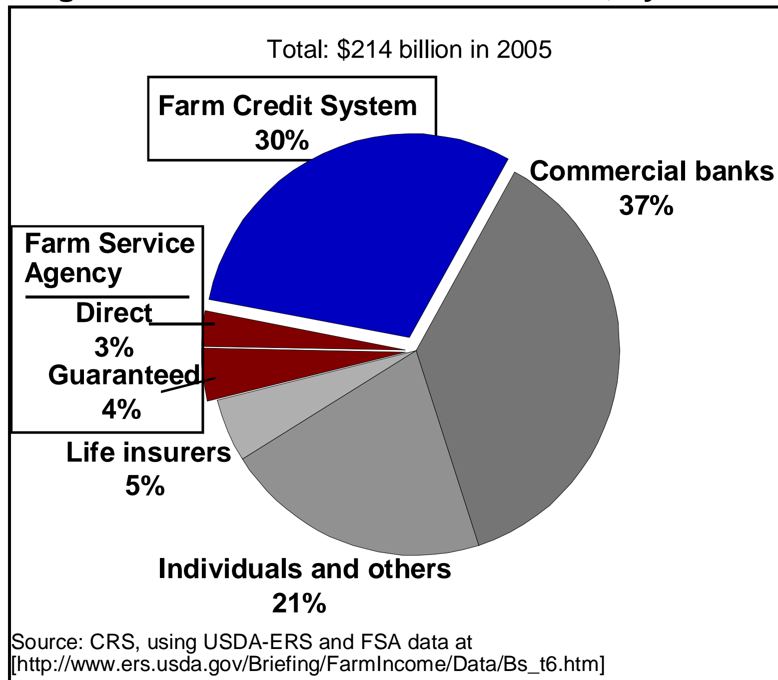
Background

The federal government has a long history of providing credit assistance to farmers. USDA's Farm Service Agency (FSA) issues direct loans and offers guarantees on loans made by commercial lenders. The direct and guaranteed loans are intended to assist farmer borrowers who do not qualify for regular commercial loans. Therefore, FSA is called a lender of last resort. The Farm Credit System (FCS), second only to commercial banks as a holder of farm debt, is chartered by the federal government as a cooperatively owned commercial lender to serve only agriculture-related borrowers. FCS makes loans to creditworthy farmers much like commercial banks, and is *not* a lender of last resort. Statutory authority for both the FSA and FCS lending programs is permanent, but omnibus farm bills, such as the expected 2007 farm bill, often make adjustments to the eligibility criteria and operations of the loan programs.

Other sources of credit for agriculture include commercial banks, life insurance companies, and individuals, merchants, and dealers. **Figure 1** shows that commercial banks lend the largest portion of the farm sector's total debt (37%), followed by the Farm Credit System (30%), individuals and others (21%), and life insurance companies (5%). The Farm Service Agency provides 3% of the debt through direct loans, and guarantees

another 4% of the market (through loans issued by commercial banks and FCS). 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%).

Figure 1. Market Shares of Farm Debt, by Lender



Source: CRS, using USDA-ERS and FSA data at [http://www.ers.usda.gov/Briefing/FarmIncome/Data/Bs_t6.htm]

Credit is an important input to agriculture, with all lenders holding about $214 billion in outstanding farm loans in 2005. Yet only about 66% of farmers have any debt (farm or nonfarm), and only 38% have farm debt. The types of farms holding the most debt include the larger commercial farms that produce most of the output, and medium-sized family farms.

Creditworthy farmers generally have adequate access to loans, mostly from the largest suppliers — commercial banks, FCS, and merchants and dealers. According to reports from lenders, credit conditions are good, and default rates have been trending lower to levels not seen since before the credit crisis of the 1980s. Overall, USDA data show that debt-to-asset ratios for the farm sector have been stable or slightly declining over the past decade, indicating that the sector is not highly leveraged with debt. Recent strength in farm income has given farmers more capacity to repay their loans or borrow new funds. Farm equity has been rising because increases in debt typically have been more than offset by larger gains in land values.

Nonetheless, despite the relatively strong farm economy in recent years, some farmers continue to experience financial stress due to individual circumstances, and may be unable to qualify for loans. Agriculture is also prone to business cycles that may pose financial difficulties. Thus, many interests in production agriculture continue to see some need for federal intervention in agricultural credit markets.

Farm Lending Institutions

Commercial Banks, Life Insurers, and Individuals. Together, commercial banks, life insurance companies, and individuals and others provide 63% of total farm debt without federal support or mandate. Commercial banks provide most of the loans to farmers through both small community banks and large multi-bank institutions.[1] Life insurance companies historically also have looked to farm real estate mortgages for diversification. 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).

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. 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.

Statute and oversight by the agriculture committees determine the scope of FCS activity, and provide benefits such as tax exemptions. The system is regulated by the Farm Credit Administration (FCA). The program has permanent authority under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*). Major amendments generally have been enacted as stand-alone legislation, but Congress has used omnibus farm bills to make minor adjustments to the law.

FCS does not receive an annual appropriation, but is privately funded. Appropriators in recent years, however, have placed a limit on the size of the FCA's budget, which is funded by assessments on FCS institutions. For more background about FCS, see CRS Report RS21278, *Farm Credit System*, by Jim Monke.

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.[4] 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 uses omnibus farm bills to make changes to the terms, conditions, and eligibility requirements.

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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.icba.org].

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

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

[4] Historically, the USDA's lending agency was the Farmers' Home Administration (FmHA), created in 1945. A reorganization in 1995 moved the farm lending programs into FSA.

FSA makes farm ownership and operating loans 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 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.

Since the 1980s, the emphasis within the FSA farm loan program has gradually shifted toward making relatively fewer direct loans and issuing more in guarantees. This lessens farmers' reliance on direct federal lending, and helps leverage federal dollars since guaranteed loans are cheaper to subsidize. In the late 1990s, about 30% of USDA farm loan authority was for direct loans. That ratio dropped to about 21% in FY2003, before rising again to about 25% in FY2004-FY2006.

Certain portions of the FSA farm loan program are reserved for beginning farmers and ranchers (7 U.S.C. 1994 (b)(2)). For direct loans, 70% of the amount for farm ownership loans and 35% of direct operating loans are reserved for beginning farmers for the first 11 months of the fiscal year (until September 1). For guaranteed loans, 25% is reserved for such farmers for ownership loans and 40% for farm operating loans 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 (7 U.S.C. 2003).[5]

As an example of the type of statutory changes made in a 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 law 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).

Authorizations and Appropriations for Farm Loans. The 2002 farm bill authorized a maximum loan authority of $3.796 billion for direct and guaranteed loans for each of fiscal years 2003-2007 (7 U.S.C. 1994(b)(1)). Also, the law specified how this would be divided between direct and guaranteed loans, and within each of these categories how much could be used for ownership loans versus operating loans. The farm bill further instructed that not more than $750 million of the guaranteed operating loan amount may be used for the interest assistance (subsidized) guaranteed loan program (7 U.S.C. 1999), which reduces the interest rate on the loan by 4%.

Although the agriculture committee authorizes the farm bill with the multi-year "loan authority," the appropriations committee controls the annual discretionary appropriation to FSA to cover the actual cost of making loans (the "loan subsidy"). This loan subsidy is directly related to any interest rate subsidy provided by the government, as well as a

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[5] Further background on FSA programs and delivery mechanisms are available in a USDA report to Congress, "Evaluating the Relative Cost Effectiveness of the Farm Service Agency's Farm Loan Programs," by Charles Dodson and Steven Koenig, at [http://www.fsa.usda.gov/Internet/FSA_File/farm_loan_study_august_06.pdf]

projection of anticipated loan losses. The actual amount of lending that can be made (the appropriated loan authority) is several times larger than the appropriated loan subsidy.

For FY2007, the farm loan program is unchanged from FY2006 under the year-long continuing resolution (P.L. 110-5). $150 million in total loan subsidy is supporting the $3.52 billion in loan authority. This results in an effective "multiplier" of 23 ($23 dollars of loan authority for each $1 of loan subsidy). Guaranteed loans have higher multipliers than direct loans, and farm ownership loans have higher multipliers than operating loans. The highest multiplier in FY2006 is 208, for guaranteed farm ownership loans. The lowest is eight, for subsidized guaranteed operating loans, which have a 4% interest rate subsidy. Appropriations for the salaries and expenses of FSA personnel administering the loan program are $309 million in FY2007.

For FY2008, the Administration requests $3.37 billion in loan authority (-4.3%) to be supported by $152 million of loan subsidy (+1.7%). Guaranteed loan levels would decline less than 1% overall, although subsidized operating loans would decrease 8%. Greater reductions impact the direct farm loan program, which would decline 12%, including a decrease of 18% for direct ownership loans and 6% for direct farm operating loans. Despite the reduction in direct loan authority, subsidies for the direct loan programs would rise by over 10%. Administrative expenses would increase by 3.3%. As in recent years, nothing is requested for emergency loans due to carryover funds.

Policy Issues for Congress

Farm Service Agency. Authority for the size of FSA's farm loan program is specified in the 2002 farm bill and expires at the end of FY2007. The 2007 farm bill is seen as a vehicle to set new loan authorization levels for FSA, although actual funding would continue to be set by annual appropriations acts.

Some have expressed a desire to increase the $200,000 limit per farmer on direct farm ownership and operating loans.[6] These limits were set in 1984 for direct farm ownership loans, and in 1986 for direct operating loans, and have not kept pace with inflation. (Limits for guaranteed loans were raised in 1998 and indexed for inflation.)

Another potential issue is the "term limits" set in statute for farmer eligibility. Currently farmers are limited to receiving direct operating loan eligibility for seven years, and guaranteed operating loans for 15 years (7 U.S.C. 1949). A provision in the 2002 farm bill (Sec. 5102 of P.L. 107-171) suspended application of the 15-year limit through the end of 2006, and P.L. 109-467 extends the suspension provision until September 30, 2007. An increasing number of farmers are reaching their term limits, and may face financial collapse if they are not able to "graduate" to commercial credit. Term limits are intended to prevent chronically inefficient farms from continuing to receive federally subsidized credit, but the political and social consequences of letting these family farms fail are sometimes unpleasant. Thus, there will be pressures to again extend the eligibility allowance or revisit the purpose of the term limits requirement.

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[6] Glenn Keppy (Associate Administrator, USDA-FSA), testimony before Senate Agriculture Committee hearing, "Review USDA Farm Loan Programs," June 13, 2006, at [http://agriculture.senate.gov/Hearings/hearings.cfm?hearingId=1940].

Farm Credit System. In recent years, FCS has expanded its lending, to a limited degree, beyond traditional farm loans and into more 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, FCS released a report titled *Horizons*, which highlights perceived needs for greater lending authority to serve a changing rural America.[7] Some see Horizons as a precursor to legislative action to expand lending authorities, possibly in the 2007 farm bill, or to more regulatory changes expanding the allowed scope of lending.[8]

The scope of lending authority could grow under an October 2006 proposed rule to expand eligibility for farm processing and marketing loans (71 FR 60678, October 16, 2006). The intent appears to be to allow financing for larger value-added farm processing firms that are being built with more outside capital and involvement than in previous decades. Opponents fear that the regulation could allow more non-agriculture financing.

Selected FCS institutions also have begun investing in "agricultural and rural community bonds" as a pilot project, with the approval of FCA. The bonds, issued by private or public enterprises, are assets to the FCS institution with structured payment terms. The bonds effectively result in loans to businesses and communities, some of which may not otherwise qualify for FCS loans. For the FCS institution, the bonds are treated as an investment and thus not subject to loan eligibility regulations.

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. Commercial banks assert that, with financial deregulation and integration, there is no credit shortage for agriculture and the federal benefits for FCS are no longer necessary. FCS counters this 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.

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 (FCSA) initially voted for the sale, indicating to some that FCS may no longer need government sponsorship. A general outcry led FCSA to withdraw from the deal.[9] Commercial bankers say that institutions should be allowed to leave FCS if they want more lending authorities. In 2004, FCS asked Congress to eliminate the provision allowing institutions to leave the system (12 U.S.C. 2279d). It is not clear whether Congress, in 1987, intended the provision to be used by outside companies to purchase parts of FCS. In 2006, the Farm Credit Administration amended the rules governing how an FCS institution 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.

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

[8] Bert Ely, "The Farm Credit System: Lending Anywhere but on the Farm," at [http://www.aba.com/NR/rdonlyres/E1577452-246C-11D5-AB7C-00508B95258D/45256/Horizons2006ELYFINAL.pdf].

[9] For further background, see CRS Report RS21919, *Farm Credit Services of America Ends Attempt to Leave the Farm Credit System*, by Jim Monke.