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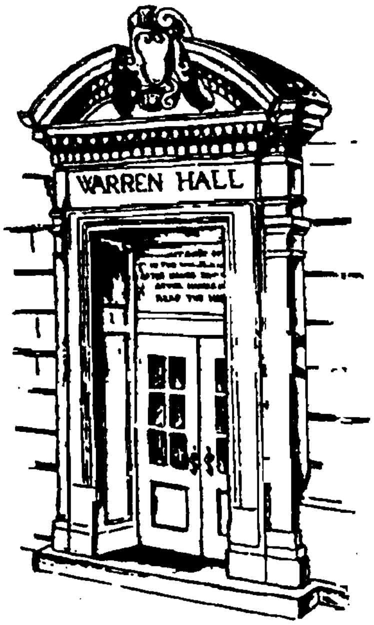

Staff Paper

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FARM LENDING PROGRAM CHALLENGES FOR THE FARM SERVICE AGENCY

Eddy L. LaDue

Farm Lending Program Challenges for the Farm Service Agency

Eddy L. LaDue[1]

One set of programs that are the responsibility of the new (Consolidated) Farm Service Agency (FSA) is the farmer loan programs of the former Farmers Home Administration (FmHA). As FSA attempts to integrate and coordinate the former FmHA, Agricultural Stabilization and Conservation Service (ASCS) and Federal Crop Insurance programs, the farm credit programs will pose some particular challenges. The purpose of this paper is to discuss some of the issues relative to the farm credit programs that may be important in understanding and dealing with these challenges. Topics covered include the rationale for government lending to farmers, a historical perspective on farm credit programs, a short review of our experience with the important farm loan programs, a discussion of some of the problems associated with providing federal farm credit and some thoughts about current and potential relationships with other lenders.

The Rationale for Government Lending to Farmers

As we think about the credit programs, it is useful to review the rationale for government involvement in lending. That is, why do we have farm credit programs that are run by the government? There are two basic rationales that have been used. The first is **Imperfect credit markets**. This rationale suggests that there are some farmers not able to obtain credit who would be able to get credit in a perfectly functioning credit market. This rationale was likely more important 40 or 50 years ago, in the early days of FmHA, than it is now. Credit markets have changed considerably over that period.

Banks are larger with much more branching into and out of rural areas. This keeps banks in a rural area from being dependent on credit mobilization in that rural area and allows credit to flow from urban banking centers into rural areas if needs so dictate. It is, of course, possible for funds to be withdrawn from rural areas by the same branching system, but the vehicle for flow of funds in either direction, according to market needs, exists.

The creation of Farmer Mac (Federal Agricultural Mortgage Corporation) gives most lenders the ability to convert rural housing and real estate loans to loanable funds by selling them through the Farmer Mac program. It also allows them to pass interest rate on to the credit market. This provides another procedure for moving funds into rural areas.

The Farm Credit System has reorganized to improve the efficiency with which it provides funds to farmers and rural home owners. The reorganization allows the System, which has always been competitive in some areas, to be an even more competitive lender.

Farm suppliers and processors are becoming more active in credit markets. They have always done considerable unplanned lending through open account financing, but a number of companies are now entering credit markets with planned lending programs. Companies like John Deere have operated successful credit programs for many years. Individuals also continue to be important sources of lending, particularly on real estate.

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These changes in the credit institutions serving agriculture have made it a more competitive and more perfect (from an economic perspective) market than it was 40 or 50 years ago. There are few obvious holes in present credit markets. The only imperfection that may remain in agricultural credit markets is the lack of availability of funds for beginning farmers. Because of the problems experienced in the farm recession and the savings bank crisis of the 1980's, regulators have established a strong set of safety standards that keep lenders (both banks and Farm Credit) from making high risk, high rate loans. Such are particularly important for beginning farmers, and could be expected to be provided by a perfectly functioning market. Thus, there appears to be an imperfect-credit-market rationale for beginning farmer loans by government.

The second, and most used, rationale for government credit programs is that the programs are designed to meet **social objectives** of society. Society decides to provide credit to people who would not receive credit in a perfectly operating credit market. There is no objective test of whether programs are needed to meet these kind of needs. Society decides whether they want such programs. For many years, reducing farm tenancy was on objective of society. Thus, programs to allow farmers to buy their own farms were developed. Historically, reducing chronic farm poverty was an important social objective. However, recently average farm incomes have reached a level similar to that of nonfarm incomes. Thus, social programs are now more likely to be aimed at low income farmers, to help the rural poor. Subsidized interest rate programs for loans to low income farmers is such a program. Lower rates provide a subsidy to improve income and may improve the cash flow situation sufficiently to make loans viable.

Loans to beginning farmers may also meet social objectives. As the capital requirements of agriculture increase, it becomes more difficult for people who are not the sons or daughters of farmers to get started in farming. To avoid the development of a landed gentry, to keep farming competitive by making entry into agriculture possible for a wider range of people or to insure maintenance of as many family farmers as possible, society may support programs for beginning farmers.

Emergency loans are usually justified on the basis of social objectives. As a result of some natural disaster or other occurrence beyond farmers' control, commercial credit will not be provided because loans do not cash flow or can not be secured. Low rates provide a subsidy to ameliorate income loss and credit availability provides a second chance.

FSA, of course, does not decide what programs to offer, Congress does. But, to appropriately administer programs, I think it helps to have an understanding of, and think about, why such programs are offered. A number of people are seriously wondering whether government farm credit programs, like those FmHA has been offering, have served their purpose and should be discontinued at this time. Bill Herr, who has done much of the research on FmHA over his distinguished career, has recently advanced this point of view in an article in Agricultural Finance Review[2]. As Congress attempts to deal with budget deficits they may look hard at the rationale for at least some of the programs presently offered.

A Historical Perspective

The current position of government farm credit programs is the result of a long and varied history. The programs were started in the 1930's in response to depression hardships. It started as the Resettlement Administration in 1935 and was changed to the Farm Security Administration

[2] Herr, W.M. "Are Farmers Home Administration's Farm Loan Programs Redundant?" *Agricultural Finance Review*, Vol. 54, 1994, pp. 1-14.

(1937), the Farmers Home Administration (1946) and, finally, incorporated into the Farm Service Agency in 1994. Farm Operating (OL) and Farm Ownership (FO) loans were provided from the outset. These two basic programs have continued throughout. These loans were generally successful[3], at least in part due to the supervised nature of the credit.

Emergency loans were added in 1949. Many other programs were added through time. Many of the added programs were nonfarm programs that were designed to improve rural communities and rural incomes. Through this process FmHA ended up with a large number of generally complex programs.

During the 1970's and 1980's the supervised nature of farm credit declined. Supervisors had a multitude of programs to learn and administer. Cost cutting moves limited personnel numbers. The complexity of farming increased much faster than the capacity and training of supervisors, resulting in an inability to provide quality supervised credit in many cases.

The Economic Emergency[4] loan program, which was funded during the 1978-84 period, was a major factor in the increase in loan volume by FmHA. This program was available to anyone who was impacted by the price/cost squeeze who could not get credit. Since all farmers were adversely affected by the price/cost squeeze, this meant than any farmer who could not get credit elsewhere could get credit from FmHA. Many very marginal loans were made under this program. This program increased new emergency loans to over $3 billion per year during 1978-82.

During 1983-88, and again for a while during 1993, foreclosure moratoriums were in effect on FmHA farm loans. Thus, the major "club" the lenders use to insure payment of loans was unavailable during that period. A lender who cannot force payment will be the last to be repaid. Loan payments were delayed and government losses on loans increased. Farmers who had trouble making payments or could not make the payments on all loans realized that there was no penalty for not making payments on FmHA loans. Since FmHA does not charge "interest on interest", the normal compounding of interest costs did not occur. Interest mounted on unpaid loans, but not nearly as fast as it would on other loans. The social stigma of not paying loans to the government is lower than the stigma of not paying other lenders. The combination of being "government" and being unable to foreclose was deadly.

The combined effect of excessive Economic Emergency loans in 1978-82 and the foreclosure moratoria are largely responsible for the large losses during the early and mid 1990's. Considerable lender "pressure" and attention are usually necessary to minimize losses on marginal loans.

Prior to 1976, FSA was a modest player in agricultural credit markets. Total loan volume was under $5 billion in the US and $100 million in New York State (Figures 1 and 2). Loan

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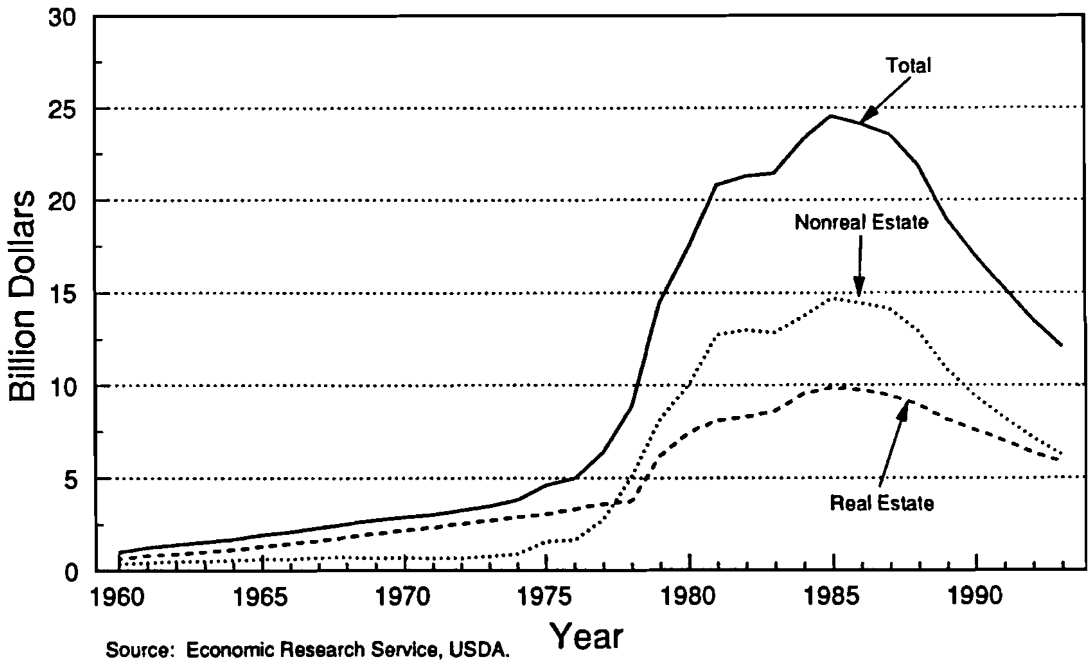
3 Evaluations of FmHA farmer loan programs can be found in: LaDue, E.L. and G.N. Christensen "Factors Influencing Farmers Home Administration Borrower Progress and Success: Farm Ownership and Operating Loan Programs" *NCJAE* vol 7, no. 1, January 1985. LaDue, E.L. "An Analysis of the Farmers Home Administration's Major Farm Loan Programs" AE Research Bulletin 84-16, December 1984. Herr, W. "Toward an Analysis of the Farmers Home Administration's Direct and Guaranteed Farm Loan Programs" USDA, ERS, Staff Report No. 9116, April 1991. Herr, W. and E. LaDue "The Farmers Home Administration's Changing Role and Mission" *Agr Fin Rev*, vol 41, July 1981, pp. 58-72. Barry, P.J. "Needed Changes in the Farmers Home Administration Lending Programs" *AJAE*, vol 61, no. 2, May 1985, pp. 340-351 and the discussion of this article by E.L. LaDue on pp. 352 and 353.

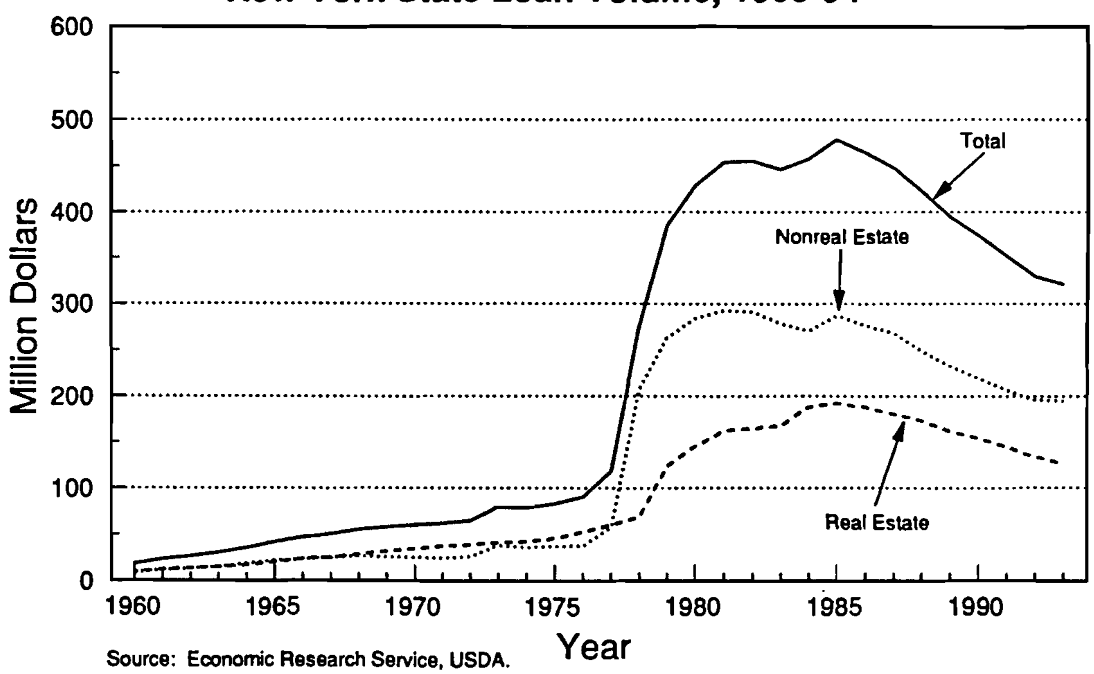
4 This is a separate program from the Emergency Loan program which is used in case of natural disasters.

Figure 1. Farm Service Agency (Farmers Home Administration) United States Loan Volume, 1960-94



Source: Economic Research Service, USDA.

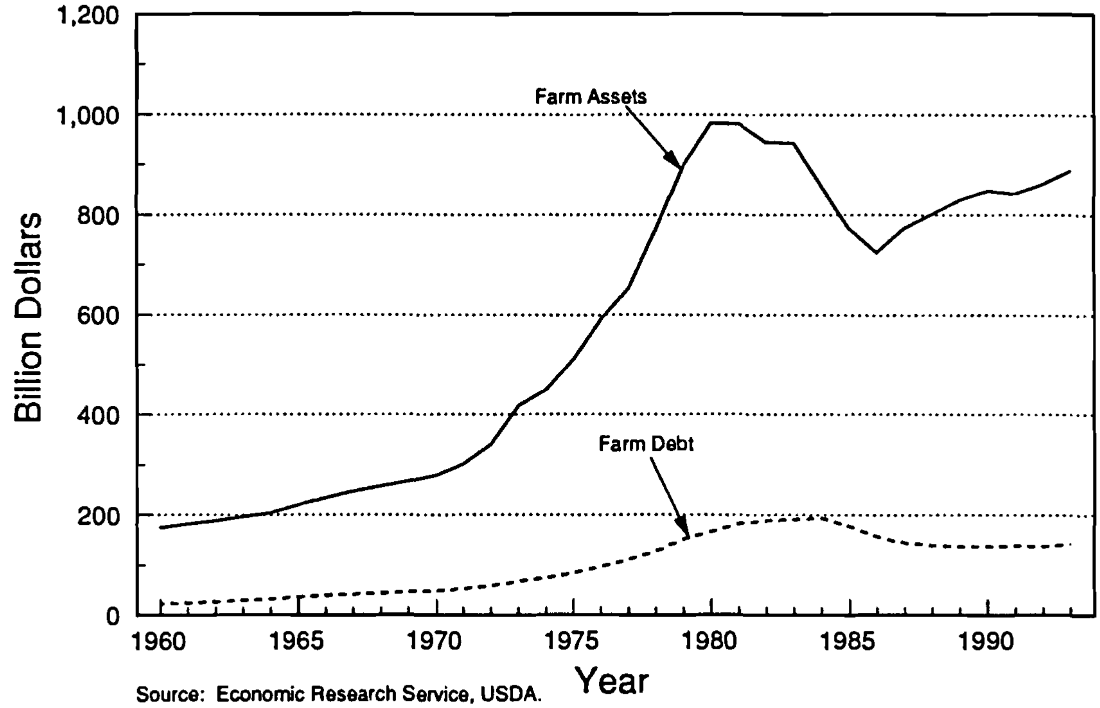
Figure 2. Farm Service Agency (Farmers Home Administration) New York State Loan Volume, 1960-94



Source: Economic Research Service, USDA.

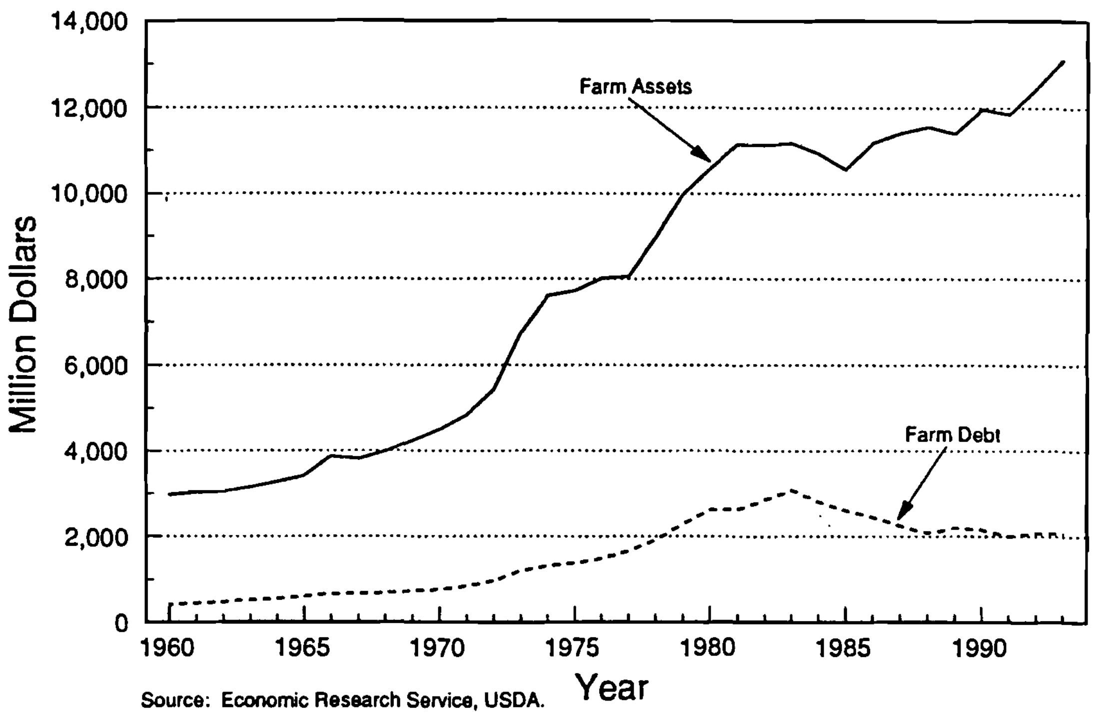
volume had crept up over time, but was still quite modest. During the late 1970's and early 1980's loan volume rose sharply. Large increases occurred during the Carter administration years of 1976-80 and then again during the farm recession and FmHA foreclosure moratorium period of the mid 1980's. This higher level of outstanding loan volume contributed to the general increase in farm debt that was occurring in both the US and in New York State (figures 3 and 4). Other lenders were also experiencing increased loan volume.

Figure 3. U.S. Farm Assets and Debt 1960-94



Source: Economic Research Service, USDA.

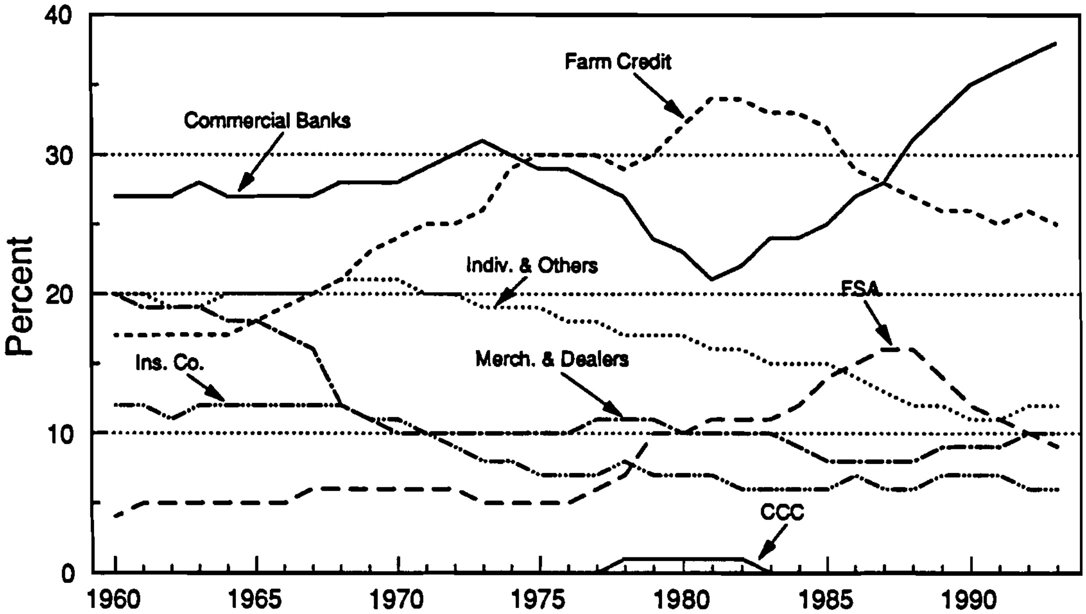
Figure 4. New York Farm Assets and Debt 1960-94



Source: Economic Research Service, USDA.

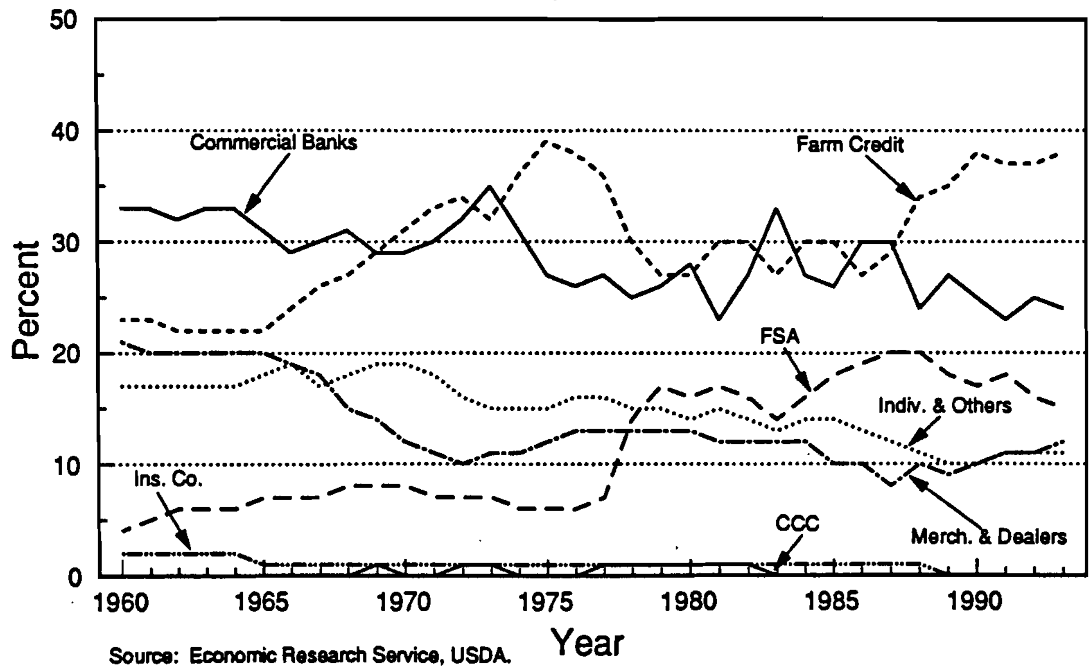
The modest loan volumes for FSA prior to 1976 resulted in relatively small market shares, usually approximately five percent at the national level and in the six to eight percent range for New York State (Figures 5 and 6). The increase in FSA loan volume of the late 1970's and early 1980's was more rapid than that experienced by other lenders, leading to increased market share. Market share reached a maximum of about 15 percent in the US and 20 percent in New York State. During the 1990's, market share declined toward pre -1976 levels.

Figure 5. Market Share of United States Farm Debt by Lender Total Debt, 1960-94



Source: Economic Research Service, USDA.

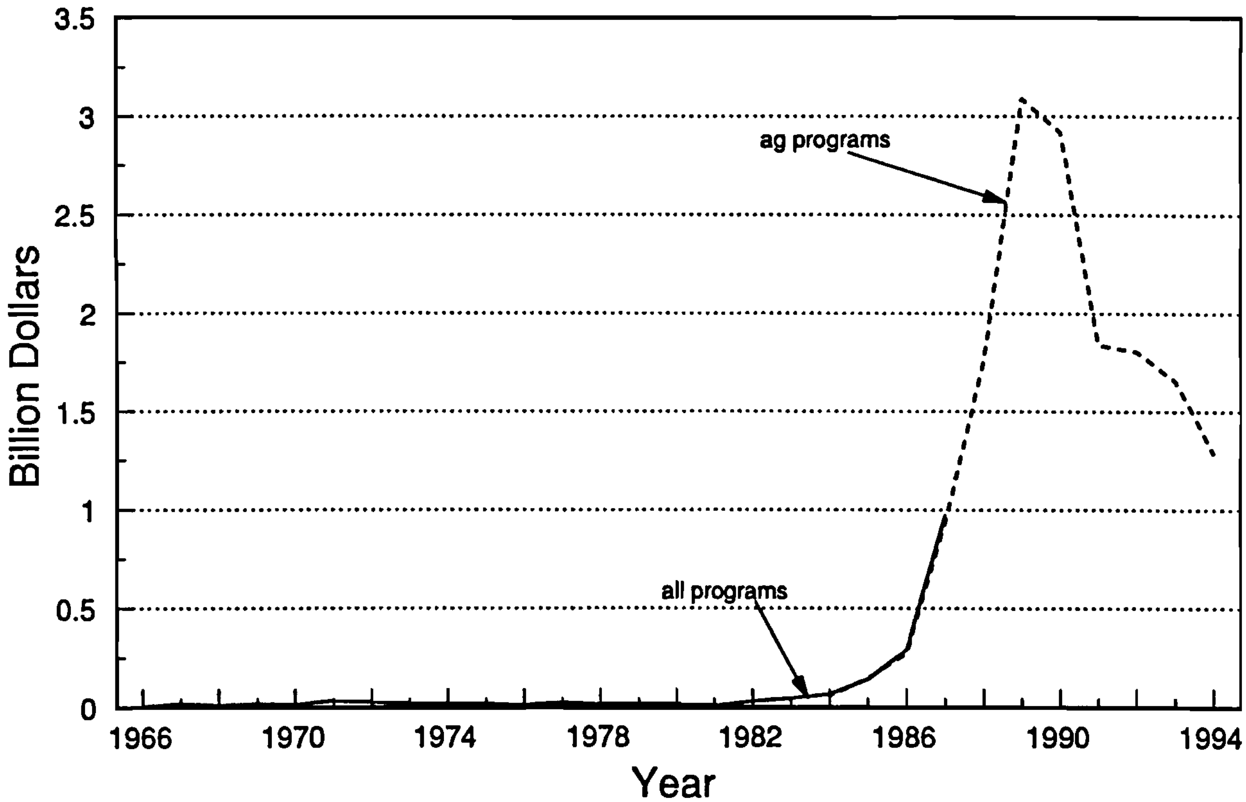
Figure 6. Market Share of New York State Farm Debt by Lender Total Debt, 1960-94



Source: Economic Research Service, USDA.

In terms of losses, FSA was a very successful agency prior to the mid 1980's. Loan losses for the entire agency were practically zero (figure 7)[5]. The high loan losses that have received so much attention during the past few years are really a new phenomenon. This is the first and only time losses of this magnitude have been experienced during the entire 60 year history of these programs. The write-off's do, however, represent large amounts of money. There is good reason for the high level of administrative and political attention they are receiving. They result from the emergency lending of the late 1970's and early 1980's, the foreclosure moratoria and an administrative decision to recognize and write off losses that have been accumulating for a number of years.

Figure 7. Farm Service Agency Loan Write-off's

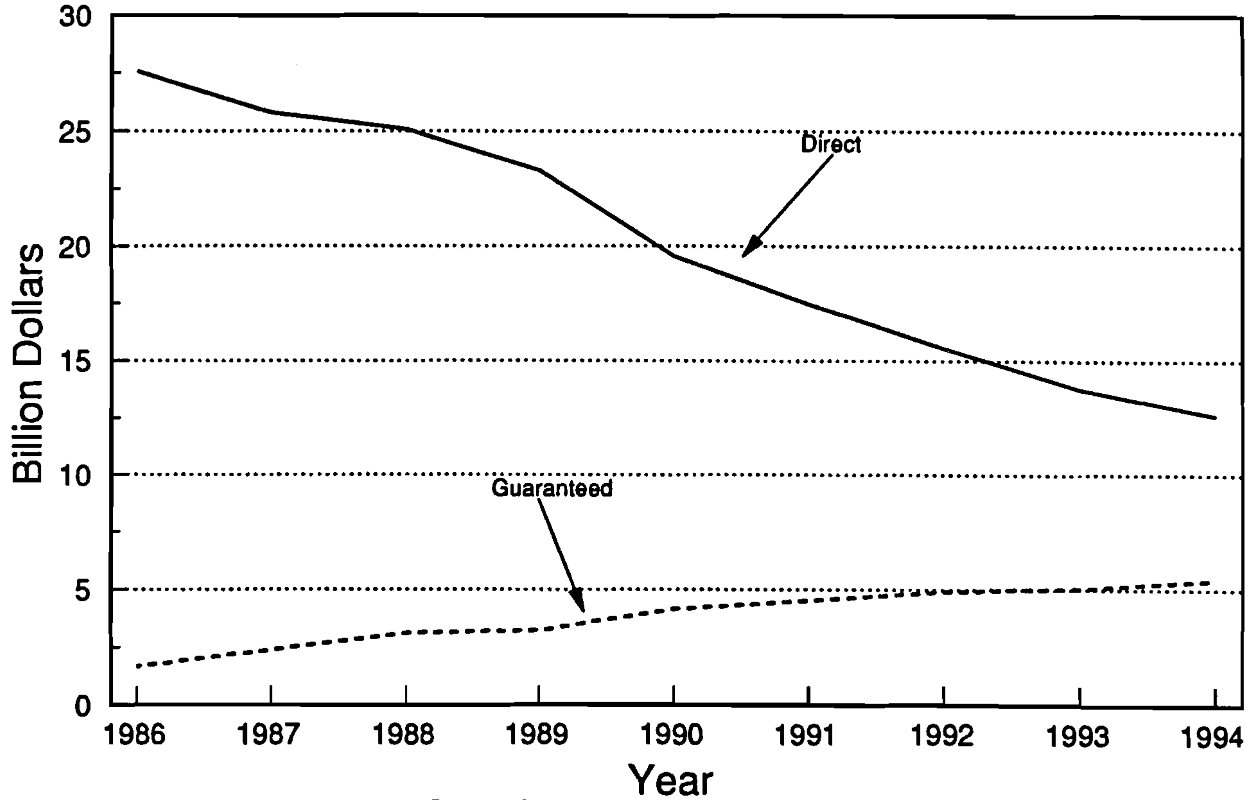


Source: A Brief History of the Farmers Home Administration USDA, Feb. 1988. Agricultural Credit Insurance Fund Write-off's and Losses on Insured Loans 1984-94, Budget Division.

[5] The solid line in Figure 7 represents write-off's of the entire FmHA. The dotted line represents losses on agricultural loans only.

Although guaranteed loan volume far exceeds direct loan volume, outstanding loans are predominantly direct loans (figure 9). This implies that there is still a considerable direct loan servicing responsibility for FSA, and that responsibility will likely exist for a number of years, even if few direct loans are made. The decline in total loan volume has resulted from guaranteed loans increasing at a slower rate than the direct loans are paid off.

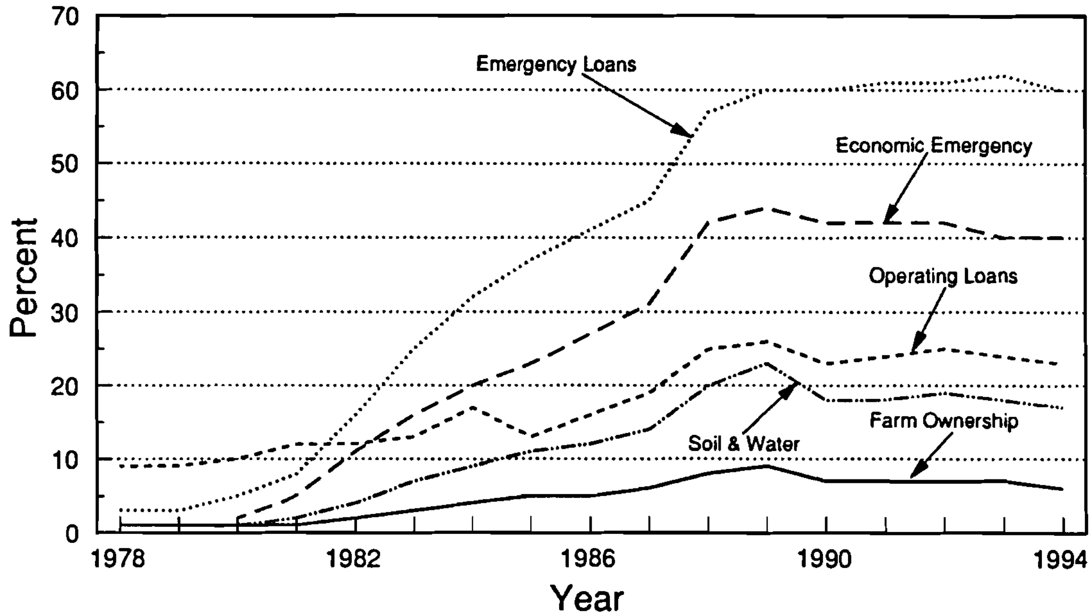
Figure 9. Farm Service Agency
Direct and Guaranteed Loan Volume Outstanding



Source: Agricultural Income & Finance, ERS, USDA, Feb 1995.

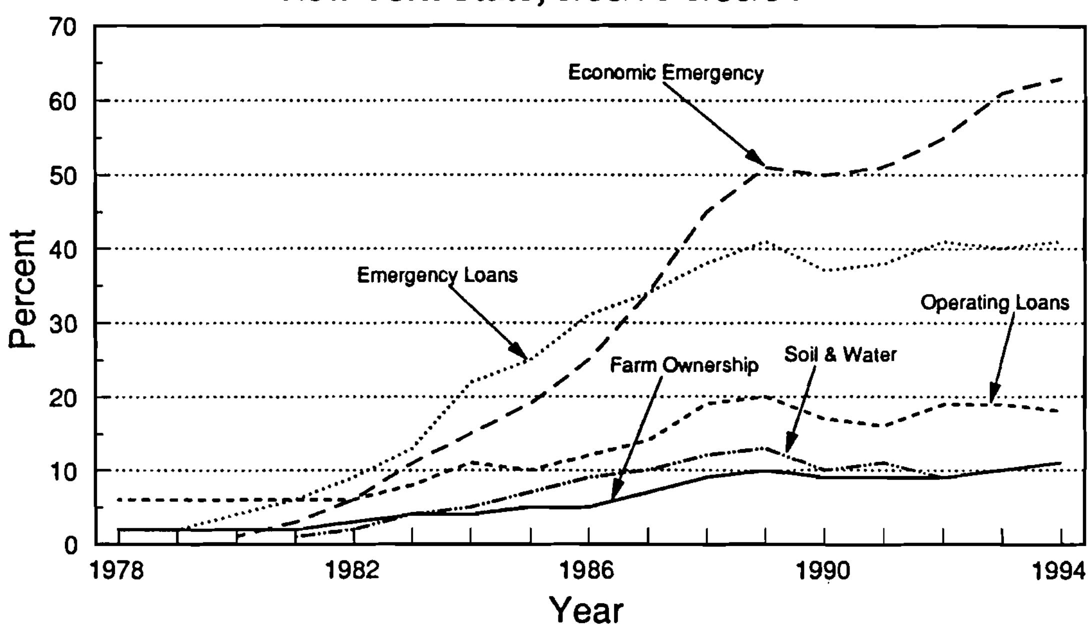
An important fact to understand about FSA is that there are significant differences between farm loan programs. Throwing all FSA farmer programs in one basket is a mistake. The emergency loan programs have experienced much higher delinquency rates than the other programs (figures 10 and 11). The OL, FO and Soil and Water loans all experience much lower delinquency rates. In addition, the losses on these non-emergency loan programs are also higher than they would have been if there had been no emergency loan programs, because once a borrower qualifies for one loan program there is a tendency to extend loans from other programs to the borrower as FSA tries to help them succeed.

Figure 10. Farmers Home Administration Delinquent Loan Volume by Farm Loan Program United States, 9/30/78-9/30/94



Source: FmHA Report Code 616.

Figure 11. Farmers Home Administration Delinquent Loan Volume by Farm Loan Program New York State, 9/30/78-9/30/94



Source: FmHA Report Code 616.

It is interesting to observe that regular Emergency Loans had higher delinquency rates than Economic Emergency loans in the US but lower rates in New York State. This likely represents the results of different administration of the Economic Emergency loan program during the 1976-82 period. New York's EE program was administered in a very liberal and aggressive fashion.

Important Farm Loan Programs

The Operating Loan (OL) program was part of the original charge for providing government credit to farmers. Operating loans are made to farmers who cannot get credit elsewhere, for the purpose of buying operating inputs (nonreal estate assets), such as cattle, machinery and crop needs. It was a very successful program from the 1930's through the 1970's. It was used to help people get started and remain in farming. Losses have generally been within the realm of reasonable expectation for the types of risks that were taken. Such a loan program is likely a necessary part of a beginning farmer program.

The Farm Ownership Loan (FO) program, which was used to help people buy and build real estate assets, was also quite successful during the 1930's through the 1970's. This program recorded the lowest level of losses of all the farmer loan programs. Farm Ownership loans have been de-emphasized during the past few years under the view that the government should help people get started in farming, but it should not help them buy their farm. This program is a useful part of a beginning farmer program, particularly in the Northeast where whole farm leasing is not as well developed as it is in some other parts of the country. This is, at least partly, due to the predominance of livestock (dairy) farming.

The Emergency Loan (EM) program provides loans to people with losses due to natural disasters. One problem with this program is that "disaster" has been interpreted to include normal (predictable) occurrences, such as excess rain in New York and drought in Texas. Thus, lots of people qualify for such loans every year. Losses have been high. At least part of the reason for the high losses is the basic flaw in the rationale for emergency loans. That basic flaw is the assumption that you can "loan" people out of trouble. Unfortunately, this does not usually work. People with major losses need grants if they are to stay in business. Loans tend to "dig the hole deeper" and "delay the inevitable."

Much of the disaster loss could be handled by insurance (crop, flood, hail, hurricane, etc.). Insurance has the advantage that those who experience losses receive payments, not loans that have to be repaid. Emergency programs have considerable political appeal, so insurance has not been required to handle the burden. Farmers are not dumb. Why pay for insurance, if the politicians are going to pass emergency legislation every time there is really a disaster? A subsidized crop insurance program that gives people payments (grants) when losses occur may be a way to disguise grants to those who have experienced a disaster and get the population of potential beneficiaries to contribute to those grants. As the amount of subsidy is reduced, the program moves closer to insurance and those who should be self insuring against things such as too much water in New York or to little water in Texas, will start to do so.

The Economic Emergency (EE) program provides loans to people who suffer from the price/cost squeeze and cannot get credit elsewhere. This program was funded only during the 1978-84 period. Practically every farmer suffers from the price/cost squeeze, so every farmer who could not get the credit he or she desired qualified for EE credit. Further, the program was administered in a very permissive environment, so that almost every request for loans was granted. County supervisors who denied loans during much of the period when this program was funded, because they believed the loan to be a poor credit decision, had their decisions overturned by the politically appointed state director, either as part of his/her interpretation of policy or in response to pressure from the denied applicant's Senator or Congressperson. Losses with this program are very high. Many of the recipients could not make it without a periodic infusion of cash (loans). This program is no longer funded.

Soil and Water Loans are for soil and water, including environmental improvement. The level of funding and the purposes are limited. Losses have been relatively low.

Problems Associated with Providing Federal Credit

1. The government makes a poor loan officer[7].

Selecting successful borrowers is not an exact science; some judgment is involved. Considerable improvement in the degree of quantification of the loan evaluation process has occurred over the past several years, but many aspects still need the application of judgment and experience. Thus, appropriate management of a loan portfolio requires well trained loan officers with administrative support for their decisions. Attempts to legislate the loan rejection/approval process are deemed to fail, and such attempts make the loan officers look like poor lenders. The appeals process should not represent a different standard. Applicants should not be able to appeal to Congress. Congressional pressure on an individual loan decision leads to poor results. Congressional staffs do not have the time or expertise to determine whether a particular loan request should receive funding, so they end up providing congressional pressure on behalf of all who request help.

The challenge for FSA will be to find the resources to provide the level and amount of training required, resist congressional pressure on behalf of individual loans and make overturning of loan officer decisions on appeal the exception, not the rule.

2. Changing government focus makes a vacillating loan officer.

A change in the Administration in power, or a change in the policies of an existing Administration, can cause a farmer's loan to be declined, even though his neighbor in very similar circumstances received a loan last month. This can make the loan officer look arbitrary. In many cases the policy decision appears to the applicant to be arbitrary. Other lenders have some of the same problems with changing policies as the need for loan volume versus loan quality fluctuates, but they do not have to explain their decisions to outsiders and no one demands that they be absolutely consistent from borrower to borrower.

Since policy changes are likely a fact of life, the challenge for FSA will be to keep the public informed about changes as they occur and instill in all FSA contact people the need to explain the rationale for policies and changes in policies. This may require specific training on the rationale and reasons for various programs and policies. An explanation that "this is government policy," which implies "I do not have the foggiest reason why they would make such a rule," is not a very satisfying explanation for most people.

3. Servicing procedures are cumbersome.

The loan servicing procedures developed during the late 1980's were designed to be absolutely fair and consistent, and avoid arbitrary decisions. They have a lot of good aspects. They are a fact of life - they will not disappear. However, these procedures bend over backward to be sure that a borrower gets his/her rights and are dauntingly complex. This makes problem loans very time consuming and costly to administer, and makes the chances of appeal of decisions high.

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7 The term loan officer includes County Supervisors, Assistant County Supervisors and others involved in direct lending and loan guarantees.

It also makes delinquency rates difficult to reduce because the same delinquent loan stays around for years, instead of being written off and forgotten. Commercial lenders (banks, Farm Credit System, insurance companies, etc.), with problem loans during the 1980's, wrote off, refinanced and restructured such loans within a short period of time (a quarter or year in many cases). They were then able to move forward with a clean balance sheet after only a short period of severe income losses.

FSA will need to be sure all loan officers clearly understand and can explain the servicing procedures, so that they will be followed correctly. They will also need to be ready to explain why the delinquency rate tends to stick at higher levels than some would expect.

4. A lender of last resort should expect higher losses than commercial lenders.

FSA makes loans that other lenders will not make because the loans are high risk. Thus, the losses on these loans should be higher than the loss ratios experienced by commercial lenders. Applying the same loss standards is inappropriate. The question that remains is, how much higher level of losses should be expected? Obviously, this depends on the riskiness of the loan programs administered. But, it is clearly inappropriate to tell FSA to make loans to high risk borrowers and then assume there is something wrong with program management if losses are higher than banks or Farm Credit. To some degree, this is a problem of public perception, but we need to continually inform the public and congress that legislation should not be based on such a perception.

5. Most farmers cannot make payments on 100% loans (100% debt).

Margins in farming (and most other businesses) are not high enough to provide the cash flow to make the payments on 100 percent debt on the entire business[8]. Even though FSA has the authority to make loans of 90 to 100 percent, most borrowers are not well served by making such loans. New entrants should either gain equity while working for others or have other farm (use of family machinery or land) or nonfarm (nonfarm income) that can be committed to the business. Further, some farms will be able to handle more debt than others. Not all farms or potential farmers are alike. This means that loan officers must be able to determine how much debt a farm can carry.

FSA will need to have well trained loan officers who can evaluate actual farm situations, treat program limits as maximums to work within, rather than entitlements, and perform the lending function in the same manner as other lenders.

6. How to provide supervised lending, again.

A key to the success of farmer loan programs during the 1930's to the 1970's was the supervised nature of lending. Many low income farms are low income because of poor management decisions. It is unlikely that FSA loan officers will be trained to provide the level of service needed for modern agriculture - a lot of training would be required. The borrower training that has recently been started will not likely be a replacement. Borrower training would need to be substantial, is not sufficiently farm specific and does not use the "whip of being the loan officer" to insure change or action. The consultant approach used during the late 1980's is expensive and,

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8 For discussion of this issue, see: Casler, G.L. "Are You Willing to Give Away Your Farm? or Can Your Son or Daughter Afford to Buy Your Farm?" Securing Your Future Fact Sheet, Cornell Cooperative Extension, SYF 2.1,11/92. LaDue, E.L. "Alternatives to 50-50 Partnership Arrangements" Department of Agricultural, Resource, and Managerial Economics Staff Paper 95-02, Cornell University, June 1995. LaDue, E.L. "Financing Entry of Young Farmers" *Agr Fin Rev*, vol. 39, November 1979.

again, does not get the farmer committed to change. Maybe a management advisory team for each farm, including a consultant, the loan officer, and possibly others, could do the job. It will be difficult to get loss levels down to pre 1970 levels without an effective substitute for supervised credit.

7. Maintaining loan officer quality.

Retirements, promote from within policies, limited training budgets and downgrading of farm loan officer positions has reduced average loan officer quality. Some reduction in the complexity of the job may result from the specialization that is implied by separating farm from other loan programs. So, loan officer quality after the consolidation is unknown. However, to expect good loan decisions in today's complex farm environment, loan officers must be well trained. Training must be continuous. Salary levels must be high enough to attract and keep quality personnel.

8. Efficient service from remote locations.

Fewer loan officers and greater distances from the farm to the loan office increase the service challenge. Many people are "spoiled" by having an office in their backyard. Operating procedures need to be modified to make the trip "to the farm" or "to the FSA office" efficient. "Fill out this form, and come back" will not work. Having credit people only at some locations will initially create come confusion. Some cross training, particularly of front office personnel, will be necessary. Personnel in all offices must be able to provide clear and concise information and help on how farmers can access the credit people. Front office people need to have a "user friendly, sales oriented" mentality, not a "what do you want from the government now" mentality.

Current and Potential Relationships with Other Lenders

Government farm lending programs are, and should remain, complementary with commercial lender programs. Judicious use of the test for credit, in some form, should avoid competition. The place where competition is the biggest problem is the emergency loan programs. This problem could be solved by limiting all emergency loan programs to guaranteed loans. Making all emergency loans guaranteed loans may also be a way to limit the high losses experienced by the emergency loan programs.

During the 1980's FSA loans were used to bail commercial lenders out of many bad decisions and situations. Borrowers with financial problems, who might result in a loss to the commercial lender if their loans were foreclosed or if the farmers were allowed to continue without change, were encouraged to apply to FSA for financing. A financing plan developed by FSA, that would give the farmer an improved chance of success, would usually involve paying off the commercial lender. Thus, the commercial lender was bailed out of a possible loss. Some of shifting of potential loss is bound to happen due to the uncertainties surrounding any farm situation. However, FSA should remember that it is not necessary to bail commercial lenders out of every bad situation.

Interactive relationships with other lenders should be maintained at the county/regional level for smooth functioning of guarantee programs. A high level of understanding and trust is necessary for everyone to do their job efficiently. At the current time, this exists in some counties, but definitely does not exist in other counties. Positive steps to develop and maintain good working relationships should be taken by all parties. Like good fences, working relationships need to be built and maintained.

The increased use of such things as guarantees and down payment loans imply that FSA personnel will become part of the financial lending/advisory team for a farm business. They will be **the** lender on few, if any, farms. This increases the focus on abilities to work with others and as part of a group. It also reduces the "power" of FSA loan officers. Loan officers will need training on group relationships, approaches to group problem solving and interactive communications.

Currently commercial lenders find great variability in the competence and helpfulness of FmHA county staff. Lack of helpfulness frequently stems from lack of knowledge or understanding of programs. The multitude of programs and rules for each program contribute to this problem. In some cases, for a variety of reasons, the personnel are not motivated for excellence. Regionalization and specialization may help with this problem. As least it may provide an opportunity to change for the better.

A Final Word

As you work with legislators in designing the govemment farm credit programs of the future, it seems to me that the historical evidence points in certain directions. All government farm credit programs are not alike. The emergency programs have been largely unsuccessful. It is difficult to loan someone out of financial trouble. It appears to make sense to either eliminate these programs and focus on a crop insurance approach (my first preference) or limit emergency programs to guaranteed loans only. There is logic for a government beginning farmer program. Some direct funds are very useful in this type of program. Thus, a combination of direct and guaranteed loans would likely be optimal. Loan officers should be trained to evaluate risk and individual farm potential, and treat program maximum loan amounts as parameters to work within, not entitlements. Not everyone who thinks they would like to farm has the capacity to succeed.

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