The Next Farm Bill: Credit Programs

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The Next Farm Bill – Credit Programs

Introduction

Mr. Chairman and members of the subcommittee thank you very much for the opportunity to testify today on a topic of great interest to thousands of community banks serving rural America and the banking industry in general.

My name is Steve Handke and I serve as the President and CEO of the Union State Bank of Everest, in Everest, Kansas. I am testifying today on behalf of the Independent Community Bankers of America (ICBA)[1].

Union State Bank of Everest

The Union State Bank of Everest was chartered 116 years ago in 1901 and still operates out of the main office in Everest, a small community of 300 people. Today the bank manages over $300 million in total assets and operates in the fertile agricultural counties of five northeast Kansas communities and two northwest Missouri communities. Fifty percent of our loans are to farmers, primarily corn and soybean producers, although the communities we serve are almost entirely agricultural dependent.

Our bank provides an array of services to the seven communities we serve to satisfy their banking and credit related needs. Our bank is staffed by wonderful employees who work tirelessly to assist the communities we do business in. We live and work with the citizens in these communities and we do whatever we can to enhance their financial livelihoods and quality of life. We know our customers on a first name basis and we strive to build relationships through the individualized, hands-on service we provide to our customers and borrowers. I have been privileged to be one of four bank Presidents to serve over 20 years as the bank's CEO and my family has farmed near Everest for four generations.

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[1] **About ICBA**
The Independent Community Bankers of America®, the nation's voice for more than 5,800 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. With 52,000 locations nationwide, community banks employ 760,000 Americans, hold $4.7 trillion in assets, $3.7 trillion in deposits, and $3.2 trillion in loans to consumers, small businesses, and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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The Role of Rural Community Banks

On a broader scale, community banks play an important role in the nation's economy. There are approximately 5,800 community banks in the U.S. Thousands of community banks are in small, rural, and even remote communities. Community banks provide approximately one-half of all agricultural credit from the banking sector. Community banks under $1 billion in assets extend approximately 56 percent of non-real estate loans to the farm sector and 62 percent of the real estate credit. Community banks also provide approximately 40 percent of all small business loans even though they hold only 10 percent of banking industry assets. Therefore, I believe it is important the authors of the next farm bill keep in mind the important role that community banks play in agricultural finance and keeping our rural communities healthy and vibrant.

Focus of Testimony

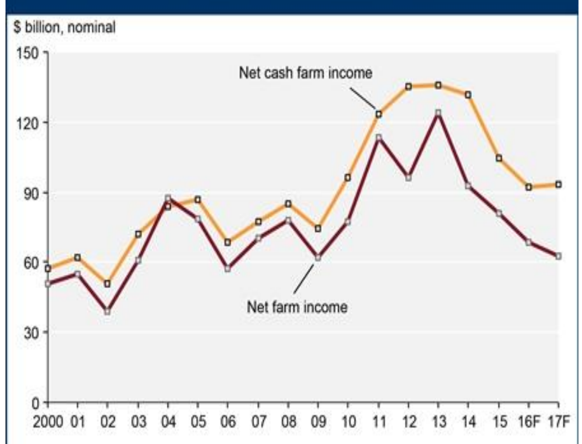
Our testimony touches on the interaction between the current state of the farm economy from a community banker perspective and the necessity of USDA credit programs. My testimony explains how we can help prevent or alleviate a potential farm credit crunch from developing over the next couple of years if continued low commodity prices persist.

Some observers of the ag credit markets have said recently we are only one normal harvest away from dire conditions in the farm economy. Last year we may have dodged a bullet. In 2016 we had a convergence of two important factors that prevented the worsening farm financial situation from escalating more than it did. These factors were a very bountiful harvest in many crop producing areas of the U.S. and significant farm program payments. It is possible that one or both of these factors will not occur this year.

The Current Credit Situation in Rural America

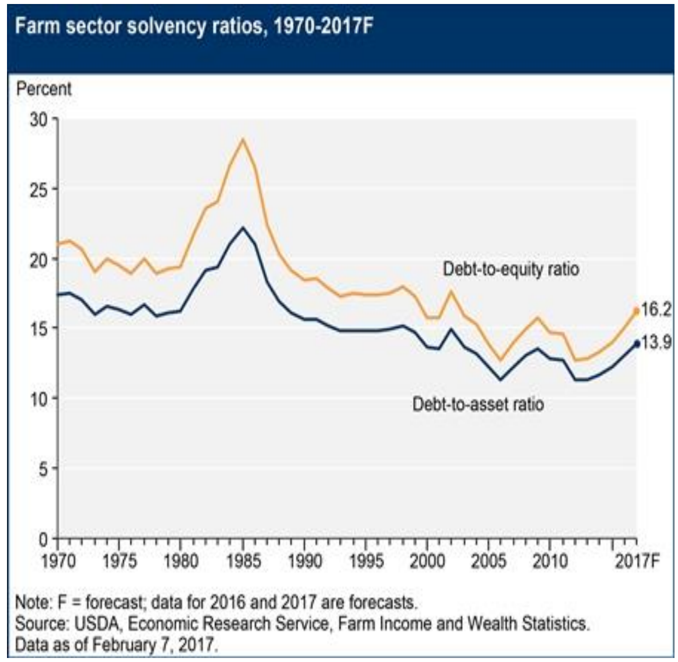
USDA's February farm income forecasts, relative to 2016 levels, projects farm sector profitability measures for 2017 to range from nearly flat to declining. Net cash farm income, one measure of profitability, is forecast at $93.5 billion, up 1.8 percent compared to the 2016 forecast. Net farm income, a broader measure of profitability because it includes noncash values such as inventory flows and economic depreciation, is forecast at $62.3 billion for 2017, down 8.7 percent compared to 2016.

Net farm income and net cash farm income, 2000-2017F



Note: F = forecast.
Source: USDA, Economic Research Service, Farm Income and Wealth Statistics.
Data as of February 7, 2017.

USDA has also calculated that 10 percent of farmers are highly or extremely leveraged. Farm real estate debt in 2017 is expected to reach a historic high of $240.7 billion in nominal terms. An additional contributing factor to the increase in farm real estate debt is increasing use of real estate as collateral to secure nonreal estate borrowing. Farm nonreal estate debt is expected to continue to increase in 2017. Real debt levels are approaching where they were prior to the 1980s farm financial crisis.



USDA notes debt is predicted to grow and the value of farm assets is anticipated to decline, leading to an increase in the farm sector debt-to-asset ratio and debt-to-equity ratios. Such trends reflect a modest increase in farm financial risk exposure from 2015. The 2017 debt/asset and debt/equity ratios, if realized, would be the highest since 2002. Liquidity ratios have weakened over the past several years and working capital has diminished. The 2017 debt service ratio, which measures the share of production available for debt payments, at 0.28 is at its highest since 2002. The times interest earned ratio, which measures the farm sector's ability to meet interest payments out of current net farm income, at 4.4 is at its lowest since 2002.

Community Bank Perspective

Over the last several years, community banks have been able to serve their farm borrowers by providing ample credit at near historically low interest rates. However, the decline in farm income has placed stress on the ability of farm borrowers to cash flow. Higher expected interest rates may add to this stress. ICBA conducted a survey of its Agriculture-Rural America Subcommittee which consists of over 25 bankers from all farm regions of the U.S. Following are some of the findings in response to questions.

Some community banks have as high as eighty percent, possibly more, of their loans made solely to farmer or ranchers. However, in rural communities such as Everest, where my bank is located, the entire community is dependent on agriculture. In these communities all of the banks' lending is entirely related to agriculture.

When asked what the level of financial stress is within their portfolios, in many cases bankers stated that seventy-five to one hundred percent of their producers were feeling financial stress due to low farm prices. In some cases the percentage was much smaller, around ten percent, and was dependent on which commodities were produced as some producers are diverse enough to still be profitable.

Other causes of financial stress included high rental rates, living expenses that are too high relative to farm income, too great of an investment in farm machinery, and other factors such as weather. Healthcare can be a major living expense impacting producers.

When asked if producers could strengthen their financial situation by lowering their expenses, including family living expenses, some bankers indicated this may be possible, although producers have already tightened their financial belts in many cases. Producers are having a hard time trying to reduce input costs such as fertilizer expenses or renegotiating rental rates due to the willingness of other farmers to pay the higher rental rates. Producers are trying to reduce expenses on seed, chemical and fuel costs through pre-payments or changing vendors. Even with these possible reductions, their ability to cash flow will be difficult. Some producers have already locked in expenses for several years into the future.

As producers have moved from expansion mode to survival mode there will be greater demand for debt restructuring such as through extending loan maturities. Many farmers with tight cash flows are using up working capital and are expected to borrow more in the future. Bankers also report an increase in credit demand from producers who are being told by the Farm Credit System (FCS) to look elsewhere for credit.

Due to financial stress and the projected farm financial deterioration over the next couple of years, some farmers have made the decision to exit farming. They have decided to exit due to the expected difficulty of being profitable in the current environment. Most farmers still have adequate to strong equity; however, their working capital and cashflows are not sufficient to continue operating. While some producers have sufficient capital to withstand losses over the next couple of years, other producers will sell assets like land to remain viable. However, we expect bank regulators will challenge banks who are trying to work with producers if they are projected to have negative cash flows for the next several years despite having a strong equity position. This is where USDA guaranteed loan programs could have a tremendously positive impact as explained below.

Community ag banks would report that many of their farm borrowers are at best breaking even if borrowers have low debt including low carryover debt or have a diversity of commodities including commodities that have a degree of profitability. In the worst position would be young, beginning and small farmers particularly if they have high debt levels or if they have little to no backing from their extended family or their parent's farm assets.

These are the farmers that would be most at risk of having to exit production agriculture. However, if low farm prices continue over the next couple of years we are likely to witness a larger exodus of farmers from agriculture, including larger farmers and ranchers.

USDA Credit Programs

Many banks are using the USDA guaranteed farm loan programs and Farmer Mac to help borrowers restructure debt to get their annual cash needs down. There was much less interest in these programs three to four years ago at a time when you wrote the last farm bill. However, things have changed for the worse and these types of programs will have a much greater demand in the years ahead.

Provide Adequate Funding – One issue that seems to regularly occur is that the programs often tend to run out of funding. There needs to be enough flexibility in USDA programs to allow the transfer of funds within USDA to these programs in the event they temporarily run out of funding. Additionally, the authorization for the dollar amount for various loan categories needs to be raised significantly. Some programs, such as the guaranteed operating loan program, are self funding and therefore have no costs. Why should the dollar volume related to these loans be limited?

Bankers report often having loans approved that cannot get funding from USDA. This causes additional stress upon borrowers. Bankers stress that time can be of the essence for many producers who are not able to simply wait for Congress to act by authorizing and appropriating additional funding.

Raise Loan Limits – It is extremely important that Congress raise the lending limits for the USDA guaranteed farm operating and ownership (real estate) programs from the current $1.4 million loan limit to $2.5 million or greater to reflect the higher cost levels of modern day agriculture. There is not a cost for guaranteed farm operating loan program as this program is self-funding based on the origination fee. There is only a very slight cost to the guaranteed farm ownership program. Therefore, Congress could accommodate billions of dollars in additional credit to farm borrowers with only a minimal cost to the federal government, ensuring the survival of thousands of family farmers.

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Legislation (HR 5733) was introduced in the previous Congress by Congressman Bost to raise the loan limits on guaranteed farm loans to $2.5 million to $3.5 million. Our survey showed strong support for these higher loan levels indexed to an inflation adjustment. For some banks serving producers with higher production costs, a $2.5 million loan is their average loan size. The higher loan limits would help producers cope with the higher cost of land, machinery, and other costs. Bankers state the current $1.4 million loan limit is simply too low and it often prevents banks from restructuring loans or causes many farmers to not qualify for guaranteed loans.

The direct loan programs are also a valuable financing tool for many farmers and ranchers, especially younger ones that are buying land. These programs assist the ability of farmers to cash flow and have attractive interest rates benefiting producers over the life of their operation. The programs can help young farmers in either getting started in farming or in transitioning a family farm to the next generation.

If direct loan limits are increased, these programs need to ensure that direct financing from USDA is leveraged with bank financing to ensure larger direct loans don't detract from financing already being provided by banks. Also, since these programs have a 'credit-elsewhere' test this requirement should be tight enough to ensure producers don't shop for credit denials, for example, from money center banks that are not making small farm loans anyway. In addition, many borrowers apparently do not pursue direct loans due to the amount of paperwork they have to fill out. Paperwork requirements should be examined. Additional funding would need to be appropriated to ensure such expansion doesn't undermine existing guaranteed lending.

Other Recommendations for USDA Credit Programs

Bankers in our survey made a number of recommendations to improve USDA credit programs. Some of these suggestions include:

- Minimize origination fees as they can discourage use of the programs;
- Minimize paperwork requirements – a need cited by many bankers;
- Remove the USDA's recently imposed requirement that producers have an environmental assessment within the past 12 months prior to financing a livestock facility;
- Provide lenders flexibility when financing USDA loans across state lines as the requirements often differ, making use of the programs much more difficult in these instances;
- Important to increase USDA staffing levels to providing more lending staff which will decrease approval times for direct and guaranteed loans;

- To free up USDA staff, reduce taxpayer expense, and reduce wait times for farmers, crop reporting needs to be done through private crop insurance agents instead of requiring double reporting through agents and USDA personnel;
- Allow banks to choose which USDA-FSA office to work with to help ensure a timely loan approval process and minimize any loan approval issues in certain counties;
- Improve requirements for loss settlements in the case of borrower liquidation.

Farmer Mac Recommendations

We are aware that Farmer Mac has three technical changes they would like to make to their charter. One change deals with the eligibility of farms organized as family trusts; a second change deals with Farmer Mac's ability to purchase the guaranteed portion of USDA guaranteed loans not under the ConAct of 1972; and the third provision would remove an arbitrary loan limit for loans of less than 1,000 acres. Based on our understanding of these provisions, we believe community banks would be supportive of these changes. We would be happy to discuss these changes further with the committee.

One Way to Help Prevent a Farm Credit Crisis

We have heard from bankers that regulators are now very closely scrutinizing bankers' ag loan portfolios during examinations. Since stressful times in agriculture may persist for several years, it is important regulators not over react and put unnecessary pressures on ag lenders. Ag lending is often cyclical in nature with good times followed by bad times and good farm lenders know how to weather the normal ups and downs of agricultural markets. As has been said, many of the best loans are made in difficult times.

For example, regulators typically require banks to keep a list of farmers who didn't make all scheduled payments on their loans, regardless of the amount of their equity. If regulators see the farmers' names a second time in a subsequent exam, they will tend to classify the loan. If the volume of these loans reaches forty percent of bank capital, then the bank will be placed under a so-called 'enforcement action.' My bank has $30 million (10%) capital. If we have $12 million in classified farm loans, we would be subject to an enforcement action. These loans could be classified even if the producer has a huge amount of equity as can often be the case. Producers can often be land rich and cash poor. Yet, their loans could be classified if the producer has missed an occasional payment.

I read recently where the Federal Reserve Bank of Kansas City said thirty percent of farmers cannot make all of their payments. It would not take many farm loans, at approximately $1 million in size or greater, for a bank's classified loans to reach forty percent of their capital.

A solution to this potential dilemma for the bank is to make these loans as USDA guaranteed loans. With a $1 million loan, a ninety percent USDA guarantee would reduce the amount of a loan classified by the regulator from $1 million to $100,000 – a ninety percent reduction in the amount that counts against the bank's capital.

Banks fear that regulators may over-react to the downturn in commodity prices and begin classifying loans. Having a much expanded, robust and well-financed guaranteed loan program could remove pressures on banks to withhold financing from many farm customers, thus significantly helping to avoid a farm credit crunch.

This subcommittee and other Congressional committees may want to conduct a hearing with banking regulators to discuss how they will deal with stress in the farm economy to be sure they have the insight they need to deal with future agricultural credit issues.

Conclusion

Congress has the power to help avoid a farm credit crisis. Yes, we need a strong farm safety net for commodities and we need a strong crop insurance program – both vital to producers and lenders. But we now need to also elevate the status of USDA guaranteed lending programs in the next farm bill. Things have changed in the farming sector and not for the better. We need to stop thinking about USDA guaranteed lending programs as a less important add-on to the farm bill and begin thinking about it as a major tool, along with commodity programs and crop insurance, to keeping thousands and thousands of farmers in business in what may be severely stressful times ahead.

Thank you for holding this hearing. ICBA and the community banking industry looks forward to working with you in writing the next farm bill.