INDEPENDENT COMMUNITY BANKERS of AMERICA

Review of Credit Conditions: Report from Agricultural Lenders

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Independent Community Bankers of America

House Agriculture Committee

Subcommittee on Commodity Exchanges, Energy, and Credit

December 11, 2019

Washington, D.C.

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INTRODUCTION

My name is Steve Handke. I serve as the Regional President and Chief Administrative Officer of the First Option Bank. I am testifying today on behalf of the Independent Community Bankers of America (ICBA) where I serve as the Chairman of ICBA's Agriculture-Rural America committee.

On behalf of the more than 52,000 community bank locations across the nation represented by ICBA, we thank you Chairman Scott and Ranking Member Scott and the members of this Subcommittee for convening today's hearing: "*Review of Credit Conditions – Report from Agricultural Lenders*."

The nation's community bankers have been closely monitoring the ongoing challenges facing our agriculture sector. The availability of credit to rural America is vital for our nation's farmers and ranchers and the thousands of community banks that serve rural America.

FIRST OPTION BANK

First Option Bank was chartered nearly 100 years ago in Osawatomie Kansas and today has nine locations offering a variety of financial products to the communities we serve. We offer livestock and crop loans, operating lines of credit, and equipment and agricultural real estate loans. We are a $425 million asset bank in Eastern Kansas and Northwestern Missouri.

Since the moment we opened our doors in 1923, First Option Bank's top priority has been to serve our customers by providing them with the best banking services while serving as a steward of the community. We believe it's our job to help our customers thrive financially and to make the communities we serve a better place to call home. There have been many changes in the banking industry during our decades of existence. But even with all the changes, First Option Bank has thrived with the dedication of the owners and staff and the support of our customers. Community involvement, superior customer service, honesty and integrity are long-standing traditions of First Option Bank. Those traditions will continue as we look forward to serving our communities both during these difficult times in agriculture and into the future.

Mr. Chairman, on a personal level, agriculture and the availability of credit is very important to me. I was born and raised on a farm in Northeast Kansas near Atchison. Our family farm raised crops and livestock, specifically a small cattle feedlot. I worked on the farm while attending college at Kansas State University and the farm remains in our family today.

COMMUNITY BANKS' PRESENCE IN RURAL AMERICA

You may be surprised to know the banking industry, fueled by community banks, is the largest ag lender supplying about 42 percent of all ag credit. The Farm Credit System (FCS, System) supplies slightly over 41 percent as of year-end 2018. The FCS is the largest ag real estate lender due to their tax exemption on income from real estate loans allowing FCS to choose predominantly the very best loans while ignoring lower quality credits. Banks are the largest non-real estate lender (production loans).

To emphasize the important role community banks play in serving agriculture, as of the first quarter 2019, there were 1,315 farm banks representing nearly one-quarter of all FDIC-insured institutions. Agriculture loans held by FDIC-insured institutions totaled $184 billion. Community banks hold nearly 70 percent ($127 billion)[1] of total agriculture loans from the banking sector. When including all community banks of less than $10 billion in asset size, these banks hold approximately 80 percent of all ag loans from the banking sector.

There are thousands of community banks in rural areas. Community banks are four times more likely to operate offices in rural counties.[2] Community banks remain the only banking presence in more than 600 counties (nearly 20 percent of all U.S. counties) and they hold the majority of banking deposits in rural counties and small cities.[3]

The bottom line is community banks are vital to the health of hundreds of thousands of farmers and ranchers as well as millions of other customers in rural America. It is vital to ensure these banks survive to ensure our rural communities survive. Congressional actions can play an important role in determining the fate of community banks in rural areas.

FOCUS OF TESTIMONY

We recently asked our Agriculture-Rural America Committee, comprised of two-dozen bankers from across the nation, four general questions:

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[1] FDIC 2019 Annual Risk Review – Section III – Key Bank Risk Issues: Agriculture; page 17
[2] FDIC Community Bank Study, December 2012, page 4
[3] Federal Reserve Bank of St. Louis *REVIEW,* May/June 2013, page 201

1) Have you seen deterioration in your ag loan portfolio over the past year? Is this causing you to deny financing and if so, to what degree?

2) Have market facilitation payments (MFP) kept your farmers in business and how long should these payments continue?

3) Will you rely more on USDA guaranteed loans to keep producers in business?

4) In addition to agricultural trade agreements and maintaining a robust farm bill, are there other actions Congress can take to keep farmers afloat? What is your greatest worry?

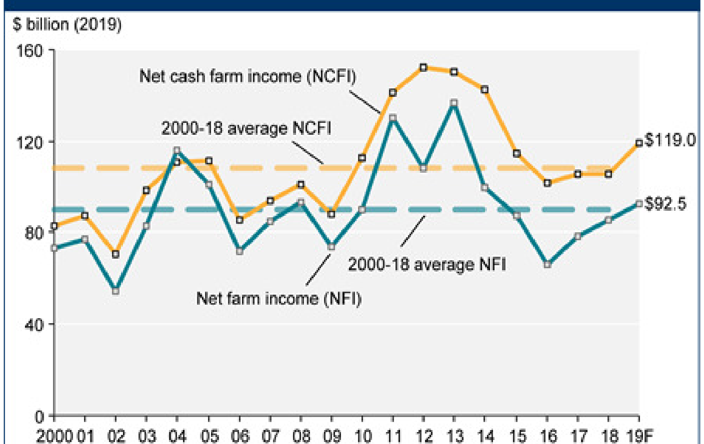
The results of this survey inform the content of this statement.

ONGOING CONCERN REGARDING THE FARM ECONOMY

With the farm economy now in its sixth year of low commodity prices and reduced farm incomes from the 2013 peak and with ag exports under pressure from the China trade dispute, it is extremely important to have the 2018 farm bill's safety net in place including commodity price protections and crop insurance.

USDA's November forecasts[4] of net farm income suggests net farm income will increase $8.5 billion (slightly over 10 percent) to $92.5 billion in 2019, after increasing in both 2017 and 2018. In inflation-adjusted 2019 dollars, net farm income is forecast to increase $7.0 billion (8.2 percent) from 2018. If realized, in inflation-adjusted terms, net farm income in 2019 would be 32.3 percent below its peak of $136.6 billion in 2013. The 2019 net farm income level is slightly above its 2000-18 average of $90 billion. A significant portion – $22.4 billion – of farm income in 2019 is being driven by government payments which may be unsustainable.

Net farm income and net cash farm income, 2000-19F



Note: F = forecast. Values are adjusted for inflation using the chain-type GDP deflator, 2019=100.
Source: USDA, Economic Research Service, Farm Income and Wealth Statistics.
Data as of November 27, 2019.

4 https://www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/farm-sector-income-forecast/

Regarding whether ag lending portfolios are deteriorating, many community banks are concerned about the negative impact of low commodity prices. Most bankers have found ag portfolios remaining stable but with some deterioration. Credit is plentiful, competition for loans intense, and interest rates remain near historically low levels, benefitting farmers.

We may be witnessing the beginning of an uptick in the number of farm loans being considered sub-standard. Banks have been able to lend using real estate as collateral. But the impact of catastrophic weather conditions in several states may reduce real estate values locally making it more difficult to restructure debt or inject working capital into the operation. According to the FDIC, the number of ag banks considered unprofitable has reached 3.5 percent as of Sept. 30, up from 2.19 percent during the same period a year ago.

Many producers who have been hit hard by the flooding in the Midwest and weather calamities in other regions have found it difficult or impossible to plant all of their crop acreage or fully breed for cow/calf herds. As a North Dakota banker commented, "We currently have the majority of our corn crop still in the field. Wet conditions, poor grain quality and excessive drying costs have many contemplating leaving the crop in the field until spring conditions dry the crop further. We anticipate a sharp reduction in net farm income for 2019 with uncertain abilities to underwrite some 2020 farm operations." Many banks are just starting their loan renewals so the true outlook for ag loans will be better known in coming months.

The MFP payments have been very helpful to many producers and their local communities, but not all producers. Farmers who are small grain producers, for example, receive less than producers of other crops and producers of some commodities will not qualify although they believe their markets have been impacted. For farmers who do qualify, bankers have stated these payments should be more predictable for planning purposes so they can be included into cashflow projections.

Many bankers suggest these payments should continue until prices impacted by reduced trade with China rebound as there could be a lag between any agreement with China and the time it takes for certain commodity markets to respond. Bankers suggest that MFPs for many customers have been the difference between losing money versus making a slight profit and paying bills.

Reducing debt loads, delaying new purchases, controlling production costs, utilizing wise marketing strategies and ensuring overall sound management practices are keys to producers' long-term success.

Make no mistake, community banks are making every effort to keep their farm and ranch customers in business. An article from the *Milwaukee Journal Sentinel*[5], for example, depicts how a Wisconsin community banker worked with a dairy farm to keep it operating so the family could pass the farm on to the next generation. The family had invested more than three decades of hard work into the operation. The bank helped them restructure the farm instead of selling out. The banker's actions ensured the dairy farm would be transferred from one generation to the next instead of witnessing the loss of another Wisconsin dairy.

USDA GUARANTEED FARM LENDING PROGRAMS

Generally stable farmland prices in many states have allowed producers to restructure their loans and shore up working capital. USDA's guaranteed farm loan programs have also assisted in allowing community banks to continue working with family farmers and ranchers. However, in some cases borrowers will need to liquidate a portion of their assets to continue farming and we could witness an increase in farmland sales due to financial stress.

Bankers emphasize the difficulty in restructuring debt with an FSA economic emergency loans or guarantees will be in proving a positive cash flow at today's commodity prices. Even if farmland collateral is available, cash flow will often be negative. Bankers have commented there needs to be some **flexibility in cash flow determination.**

We expect community banks will increase their use of USDA guaranteed loans. The farm bill's increased **loan limits to $1.75 million will be helpful but** given the rise in farm debt to $416 billion (up one-third in the last seven years) and the average cost of cropland at $4,000 per acre, **we believe this limit may need to be increased modestly.** Additionally, new producers also need guaranteed loans as they begin their farming operations or grow in size.

As one banker noted, "without USDA guarantees we would have been in liquidation with 25 percent of our ag portfolio!" In some geographical areas that suffered flooding, payment deferrals will be necessary due to the lack of planted acres and poor yields. The loan guarantees allow bankers and their customer additional time to work through these temporary setbacks.

Some producers seek to avoid using USDA guarantees due to paperwork burdens and slow approval times. In some counties, bankers report that USDA is very "picky" about which loan applications get approved and won't approve loans of struggling farmers. One banker stated, "a young farmer with no net worth and little cash flow can obtain a guarantee with ease, but an established farmer going through a tough cash flow situation will be denied."

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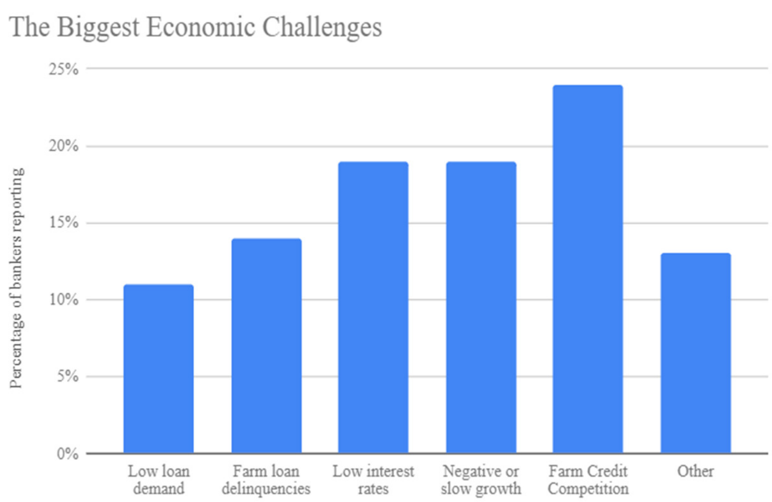
[5] *Milwaukee Journal Sentinel*, Nov. 15, 2019, Glauber, https://pulitzercenter.org/reporting/wisconsin-leads-nation-dairy-farm-closures-meet-banker-who-tries-help-her-fellow-farmers

Bankers are concerned about the decline in USDA field office staff which could grow much worse in the next few years as many USDA field office employees become eligible for retirement. Could some of these retirees be rehired temporarily to deal with seasonal peak workloads? Funding for USDA staffing needs to be adequate to ensure enough employees are available to administer programs.

FCS EXPANSION THREATENS RURAL COMMUNITIES

For a healthy rural America, we must have a competitive environment based on a level playing field among lenders, one which allows community banks to remain viable. It is particularly important to ensure that community banks are not disadvantaged vis a vis the competitive landscape with institutions such as the FCS. The FCS is a huge financial conglomerate with over $276 billion in total loans and $354 billion in total assets.

As a government sponsored enterprise (GSE), the System enjoys significant tax and cost of funds advantages over private-sector, tax-paying community banks. Although commercial banks hold slightly more of the overall agricultural credit (42 percent versus 41 percent) compared to the FCS, the FCS has a significantly higher percent of the farm real estate loan volume. The latter reality is due to the FCS's tax exemptions on income from real estate/mortgage loans which allow FCS lenders a huge advantage when competing to lend money to the same borrowers for the same financial purposes.



The FCS often utilizes these advantages to cherry pick the best customers from community banks' loan portfolios. This weakens community banks' ongoing viability. A recent survey[6] of bankers in a 10-state region conducted by Creighton University's Heider College of Business lists the threat of FCS competition as banks most

[6] October Rural Mainstreet Index Climbs Again: Trade War and Stalled USMCA Batters Economic Confidence; https://www.creighton.edu/economicoutlook/mainstreeteconomy/; Chart from *Farm Journal's AgWeb*: https://www.agweb.com/article/rural-bankers-economic-confidence-dips-two-year-low

significant challenge over the next five years. The threat of FCS competition was a larger challenge than 'negative or slow growth' or 'farm loan delinquencies.'

Due to FCS's significant competitive advantages as a unique governmentally privileged retail GSE, ICBA opposes expansion of the FCS into non-farm lending, realizing such expansion comes at the expense of community banks and the viability of our rural communities. Members have introduced legislation to allow banks some, but not all, of the tax benefits the FCS and credit unions enjoy.

The "*Enhancing Credit Opportunities in Rural America (ECORA)*" Act (S. 1641 and HR 1872) exempts from taxation interest income on farm real estate loans and also rural home mortgages in towns of less than 2,500 residents. We urge you to cosponsor this legislation which would allow community banks to continue working with their farm and ranch customers in these perilous times.

A FEW KEY ISSUES PERTAINING TO THE FCS

FCS lenders apparently wish to become the equivalent of commercial banks but with a much-reduced regulatory burden.

Checking Account Product Offering. A recent example is the offering of a checking account product by Farm Credit Services of America, which promotes a "WorkSmart Line of Credit" or LOC. Their website[7] features videos stating the LOC offers a **checking account** product **with a remote deposit feature** allowing customers to "**avoid taking a check to the local bank**" and then transferring funds into the LOC. The financial product also provides a Mastercard feature with a 1 percent "cash-back" benefit drawn from the LOC and a patronage-related dividend of 0.90 percent of a customer's eligible daily loan balance. FCS institutions are not supposed to offer checking accounts or take deposits. The FCS's venture into the world of banking products threatens the future existence of many community banks.

This committee is concerned with the question of how to keep farmers in business and ensure credit access to rural Americans. If FCS lenders become the equivalent of commercial banks then our rural communities will see a further decline in the number of community banks and many rural Americans could lose access to banking services. All because the FCA is being given too much latitude in allowing the unbridled expansion of the FCS. Ultimately, this is not good for farmers and ranchers or for rural America.

[7] https://www.fcsamerica.com/products-services/ag-loans-leases/worksmart-line-of-credit

Young-Beginning-Small (YBS) Farmers. The FCA recently published a Notice of Proposed Rule Making regarding the FCS's YBS programs. The FCA asked numerous questions regarding how to best design the metrics for determining YBS access to FCS lending. ICBA pointed out the FCA's current methodology allows numerous ways to inflate the YBS lending statistics.

ICBA recommends that the methodology be revised to clarify the actual number of individual YBS borrowers, regardless of how many categories each borrower may qualify in. Under the current methodology, if two FCS lenders share a YBS loan, the same borrower can be counted three times by each lender. Thus, one YBS borrower can be counted at least six times in the FCA's YBS numbers if the loan is shared between two FCS institutions.

This type of distortion for YBS lending activity doesn't give Congress a meaningful yardstick to measure FCS's YBS lending. As FCS institutions consolidate and merge, how great will the decline be if YBS numbers are reported accurately without multi-counting? We suspect the decline, if recorded accurately, could be considerable.

Buying, Selling or Holding USDA Guaranteed Loans from Non-FCS Lenders. FCA recently published a proposed rule to allow FCS lenders to buy, sell and hold the guaranteed portion of USDA loans.

ICBA opposes this proposal and believes it needs to be withdrawn or limited. We believe it allows FCS to duplicate the secondary market activities of Farmer Mac, the actual secondary market created by Congress to increase liquidity in rural America. We do not believe Congress intended for FCS to create a duplicate secondary market that could undermine Farmer Mac's ability to serve this sector of the market.

We question whether the statute actually allows FCS to engage in such transactions with non-FCS lenders as the statute doesn't reference non-FCS lenders. We have asked FCA to withdraw the proposal or allow such transactions only between FCS lenders and ensure such transactions occur only with USDA and Farmer Mac. Limiting these transactions to FCS lenders selling to or buying from Farmer Mac will actually enhance the secondary market as it would increase business volume conducted by Farmer Mac rather than undermine Farmer Mac's business by duplicating their mission.

FCS Proposal for Blanket Self-Approval of Investments. The FCS seeks to skirt the case-by-case oversight of the FCA for approving "investments." Although congressional agriculture committees wisely rejected such proposals during the 2018 farm bill debate, the FCS has appealed to the Appropriations Committees seeking report language urging such laxity.

ICBA opposes removal of the FCA's upfront case-by-case approval and oversight of risky FCS investment activities. Further, we oppose the investment scheme generally as it allows lending for non-agricultural purposes if labeled as "investments." We believe FCS investments need to be limited to the lending constraints of the Farm Credit Act (Act).

CONCLUSION

A strong farm bill and well-funded crop insurance program are essential to help farmers survive. Bankers are concerned the growing world supply of grain stocks will keep downward pressure on grain prices. It is important for Congress to pass the USMCA trade agreement.

Congress should help ensure the efficient functioning of USDA guaranteed farm loan programs and consider increasing loan limits above the $1.75 million level. Bankers are concerned that banking examiners will be too strict when examining farm loans.

Thankfully, community banks are not fair-weather lenders but seek to work with their producers in both good times and bad. Community banks have worked with their farm and ranch customers in past economic downturns and have excellent skills at risk mitigation as they work to keep producers in business.

Mr. Chairman and members of the subcommittee, thank you once again for conducting this hearing. Let's work together creatively to enhance solutions to assist our nation's farmers and ranchers and the community banks that serve them.