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REPORT OF THE NATIONAL COMMISSION ON AGRICULTURAL FINANCE

John R. Brake

**Proceedings of
Regional Research Committee NC-161**

**FINANCING AGRICULTURE IN A CHANGING
ENVIRONMENT: MACRO, MARKET,
POLICY AND MANAGEMENT ISSUES**

**St. Louis, Missouri
October 2-3
1989**

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May 1990

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John R. Brake

EXECUTIVE SUMMARY

The National Commission on Agricultural Finance believes that the agricultural sector has adequate total credit available. Intermediation mechanisms are generally working. A healthy degree of competition exists contributing both to the availability of credit and to the working of intermediation mechanisms. In the opinion of the Commission the marketplace should allocate credit flows, and restrictions, where they exist, should be removed. For example, state barriers to the free flow of capital across state lines are inappropriate.

The Commission is concerned that national policies which use subsidized credit programs to address farm income problems misdirect resources and create inefficiencies. Also, regulation of agricultural lenders varies unduly among types of lenders and localities. More consistency is needed. Improvements are needed as well in the delivery system, particularly in the farm business information area.

Reorientation of agricultural finance policy in several directions is suggested. Credit programs should be separated from social policy, letting the market drive the first and government address the second. Especially important is that private financial institutions not be saddled with the overhead of social programs. As a principle, the Commission agrees that government programs should not keep people in agriculture if their operations are not economically viable; yet an effective safety net and transition programs are needed for those forced to exit. And, while many changes have been made in debtor/creditor conflict situations, still improved mechanisms are needed to better resolve such problems.

The Commission believes enhancement of equity capital markets in agriculture would be useful. Easier investment and liquidation of agricultural equity capital would contribute to stability and performance of the sector. Particularly useful would be innovative private (minority) equity arrangements, perhaps in land parcels, as means to help young people enter farming. The Commission points out that full ownership of the means of production is not basic to viable farm units. Many means of acquiring and controlling capital other than owning can be used to enhance establishment and profitability of farm units.

The Commission makes three major recommendations for action:

- * Efforts are needed to develop: a) a universal loan application, and b) accounting standards for farm businesses. Efforts should address both loan documentation and accounting practices for analyzing farm businesses and for collateralizing loans. As sales of agricultural loan instruments become regional and national, such documentation and standardization are essential.
- * Risk management alternatives for farmers, especially multiple-peril crop insurance, needs additional study. Both areas and crops included in coverage should be expanded. When reevaluation is completed, Congress should choose between crop insurance versus disaster payments. Using both won't work.
- * Additional means are needed for export financing of agricultural products. Export financing either does not exist or is ineffective for some agricultural products and in some (particularly, developing) countries. Possible solutions include expanded authority for National Bank for Cooperatives export financing and development of more agricultural export guarantee programs.

John R. Brake, W.I. Myers Professor of Agricultural Finance, Cornell University. This is a copy of the Report of the National Commission on Agricultural Finance, February 22, 1989. The Commission was created by Title V, Section 501 of the Farm Credit Amendment Act of 1985.

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ACKNOWLEDGEMENTS

The National Commission on Agricultural Finance wishes to acknowledge the contribution of the Farm Credit Administration in calling the Commission together for its initial meeting and in acting as the Government financial office processing financial commitments of the Commission. The Commission is also indebted to the Farm Credit System Assistance Board for its administrative help.

The Commission wishes to indicate its appreciation to McPherson Bank and Trust Company, McPherson, Kansas, to First Bank, Minneapolis, Minnesota and to Klossner State Bank, Klossner, Minnesota for arranging and hosting additional Commission meetings. Their hospitality contributed materially to the Commission's efforts.

The members of the Commission wish to recognize and credit the writing of this report to Commission member John R. Brake, the W.I. Myers Professor of Agricultural Finance, Cornell University. Professor Brake accurately captured the input from other members and has assembled the report accordingly. The other members are exceedingly grateful for his willingness to share his lifetime of educational and professional experience. Otherwise, it is quite likely that the report could not have been compiled.

FOREWORD

The agricultural sector has seen extremely difficult times as the optimism and excesses of the 1970s turned sour in the '80s. Only fifteen years ago began a period characterized by increasing demand for farm products, rapidly expanding export markets for grains, exploding land values, and eventually, double digit inflation. Farm incomes and prospects were the best in memory.

The turn of the decade, however, brought major reversals. A global agricultural recession began. Historically high interest rates led to an expensive dollar which helped curb, and then decrease, U.S. exports. High interest rates and falling farm incomes undercut land values. The agricultural sector dropped into a recession exceeded only by the 1930s.

Farm financial problems reached the front pages as highly indebted farmers began to default on loans. Collateral values underpinning loans eroded. Large numbers of heretofore successful farming operations became financially vulnerable. Farm equities dropped precipitously. Loan losses began to reach the financial institutions which had provided the debt capital to agriculture. Substantial numbers of agricultural banks began to fail. Similarly, the Farm Credit System experienced substantial capital losses.

In response, Congress and the courts took several actions. Government foreclosures were halted. The 1985 Farm Credit Act promised aid to the Farm Credit System if needed. A Chapter 12 bankruptcy for farmers was put in place. Later, the Farm Credit Act of 1987 provided government financial assistance for the Farm Credit System, implemented borrower's rights, and established a secondary market for farm real estate loans.

The 1985 Farm Credit Act also specified appointment of a National Commission on Agricultural Finance. The charge of the commission was to consider... "methods to ensure the availability of adequate credit to agricultural producers and agribusiness, taking into account the long-term financing needs of the agricultural economy"..., and to consider the roles of the various agricultural lenders in meeting those financial needs. To achieve diversity of views and experience, members were to be appointed by the President (7), the Speaker of the House (4), and the President pro tempore of the Senate (4). The thirteen members eventually appointed brought both a depth and diversity of experience to the Commission.

In its several meetings the Commission discussed a number of issues, particularly issues related to the long term availability of credit to the sector. The Commission also shared concerns about the unique nature of agricultural financial markets and financial market performance. The Commission believes that financial markets should be allowed to achieve their purpose with a minimum of interference or barriers.

Government's role should be to oversee and regulate markets toward this end. While the concern of the Federal Government in reacting to farm financial problems of the moment is appropriate and understandable, ad hoc attempts at problem resolution may result in unwise rules, procedures, and changes in policies that will hinder or restrict market forces and competition to the ultimate disadvantage of those for whom the help was designed.

In short, "fine tuning" or rules, procedures and policies to meet problems of the moment or to achieve broader public goals through single-purpose institutions seldom works as well as market forces and competition. Further, such responses always beg the dual questions of when the crisis is serious enough to merit such special response and when the crisis is over so that "special programs" can be terminated. The difficulty for elected representatives in answering these questions when constituents demand special treatment suggests that Congress should be wary of adjusting terms of loan contracts, purposes of financial institutions and functions of financial markets.

PERSPECTIVES AND CONCERNS

1. THE SECTOR HAS ADEQUATE CREDIT AVAILABLE, AND INTERMEDIATION MECHANISMS ARE WORKING.

Creditworthy farmers find no lack of available credit. The four major providers of credit, i.e. commercial banks, Farm Credit System (FCS), insurance companies, and USDA's Farmers Home Administration (FmHA), adequately cover the credit needs of a range of borrowers from those with solid loan applications meeting standard credit criteria to those for whom no credit is available elsewhere as is the case with FmHA. Demand for credit to the agricultural sector has fallen by about one-third since reaching its high in 1983. This decrease resulted both from a conscious effort of farmers to pay down the debt when they were able and also from more critical loan analysis by lenders to assess the creditworthiness of borrowers. Still another indication of the adequate availability of credit is the relatively low returns to additional capital invested in agriculture. Low returns on capital are consistent with adequate, rather than limited, capital availability.

There is no evidence of a shortage of debt capital for American farmers who are creditworthy. Commercial banks appear to have ample liquidity. Similarly, the Farm Credit System continues to have an efficient intermediation process. Its financial problems, similar to other lenders, are related more to bad loan and funding decisions than to inherent weaknesses in its intermediation process. Most agricultural lenders continue to look for constructive lending opportunities in agriculture.

In addition to the four major institutional providers of credit mentioned above, two new secondary markets are in process of establishment. The Federal Agricultural Mortgage Corporation ("Farmer Mac") is a secondary market for agricultural real estate loans and rural housing. Existing lenders who have purchased stock will be able to originate loans which poolers will package and sell into the secondary market. Similarly, an "Aggie Mae" is in process of establishment, patterned after the Small Business Administration secondary market. With market makers, pooled loans and government guarantee of timely payments, "Aggie Mae" will provide a formal secondary market for FmHA loans. These two new secondary markets will provide additional sources of credit and will permit access to pensions, trusts, and other investors. This network is adequate for delivery of credit to the sector.

Intermediation mechanisms are working. Intermediation collects funds from savers and investors and funnels it to borrowers who need additional funds. At the same time, intermediation moves funds from surplus areas to deficit areas.

Savers and investors face a wide variety of investment instruments including bank CDs, savings accounts, Federal Farm Credit System bonds, and others. These and other instruments for collecting savings and investments are competitive and provide numerous opportunities for investment. Similarly, borrowers have several alternative credit institutions from which they can obtain funds, and interest rates

and terms are generally competitive among institutions. Because the Farm Credit System, insurance companies, and the Farmers Home Administration are regional or national in scope, there are essentially no pockets of capital shortage. Existing intermediation mechanisms do move funds from surplus areas to deficit areas.

Further, "Farmer Mac" and "Aggie Mae" will go a long way to assure that the intermediation mechanism continues to work. Spreading the risk nationally will be a great help to small banks. There is need, however, for a continuing educational effort by the American Bankers Association, the Independent Bankers Association, and other trade associations to inform small banks of these new tools so they will use them to promote liquidity, provide risk diversification, and provide a new source of capital.

Until the establishment of "Farmer Mac", most farmers who used private sector sources of capital were unable to tap securities markets because, among other reasons, they were of insufficient size and volume to meet the liquidity needs of investors. With an operative secondary market, farmers should be able to obtain terms lenders could not, or would not, provide if they had to keep the loan on their own balance sheets. This applies especially to long-term, fixed-rate loans.

The many participants and processes aid the workability of the intermediation mechanism. For example, input suppliers and machinery dealers often provide credit to support their product sales. Their competitive push is driven both by marketing considerations for product sales and by changing laws with respect to debtor/creditor relationships which recently favor product suppliers over traditional lenders. While its workability is not yet evident, "Farmer Mac" will augment the intermediation process for long-term debt that is already in place through the Farm Credit System and insurance companies.

Market shares among each of the primary financial intermediaries continue to shift as a result of competitive pressures. Shares are also difficult to measure because of the different institutions involved, the differing services offered, and the changing markets. Nevertheless, farmers and rural inhabitants throughout the country have as wide an array of financial products at competitive rates as ever. Consequently, effectiveness of the intermediation process should not be confused with disturbances in the agricultural environment as a result of ill-guided policies and normal structural evolution.

Improvements are needed, however, in the credit delivery system. Credit delivery is hampered by lenders' difficulty in obtaining information to quantitatively assess performance of prospective borrowers. While an increasing number of borrowers do make available good coordinated records, many borrowers still do not have adequate records or financial statements from which to make informed credit analysis decisions. This situation may stem from the fact that lenders historically made credit decisions based on collateral and not coordinated financial statements. Also, Cooperative Extension programs may have underemphasized the importance of farm records. Perhaps disproportionate extension resources have been directed toward production rather than business information.

Thus, current problems in the delivery system can be attributed largely to several interrelated factors. 1) Lenders failed to recognize and mandate the need for coordinated financial statements prior to the agricultural depression of the early 1980s. 2) Some lenders have not streamlined processes and policies in order to meet the needs of various borrower groups. 3) Many borrowers are experiencing difficulty in adjusting to the new information requirements exacted by lenders. 4) Cooperative Extension and others may not have given sufficient emphasis to programs aimed at making farmers better business managers.

For those farmers who are creditworthy, the delivery system needs to be improved in additional ways. First, with fewer delivery points for both the Farm Credit System and commercial banks and the relocation of lending services to regional trade centers, it will be increasingly important that the agricultural sector use modern communications technology for transactions of its credit business. Lenders and borrowers will need alternative communication linkages to replace the brick and mortar and frequent contact which have characterized the historical delivery system. Also, the secondary market for agricultural real estate is as yet unproven. It remains to be seen whether local lenders will be able to originate and sell loans at prices and

costs which are competitive with the Farm Credit System.

The credit delivery system is made up both of large regional and national entities as well as a number of relatively small independent lenders. These smaller banks are particularly limited by many restrictive state banking laws which inhibit the free flow of funds. This prevents independent banks from becoming equal competitors with the major regional and national deliverers of agricultural credit.

As agriculture recovers from its 1980s problems, farmers will likely be shopping more for their credit in years ahead. A local bank or PCA will have to compete in a regional sense, if not a global one, for customers. Farmers will become more financially savvy. They will obtain their credit where the overall package is most advantageous; that is, where the price is competitive, where the courtesy, respect, knowledge and analysis of the lender indicate overall good judgment in the extension and servicing of that credit. Access to the new "Farmer Mac" and "Aggie Mae" sources of funds will help force lenders to be more mindful of customer service and new products to keep good customers and to attract new ones.

2. LENDER COMPETITION EXISTS AND IS DESIRABLE.

Competition among agricultural lenders creates an environment for efficient allocation of capital to agriculture and rural economies. Farmers and rural inhabitants are provided accessible, reasonably-priced credit and other financial products in almost all areas of the country as a result of competitive market forces. Competition is advantageous because it forces lenders to adopt technology and gain efficiencies in order to lower their average cost of credit delivery. Similarly, competition contributes to progressive product lines and services from which farmers and rural inhabitants can select.

Competition among private lenders is essential for two reasons. First, competition provides for choice at the individual borrower level and has the added advantage of providing a market-based discipline for the competitiveness of the lending programs of agricultural creditors. Secondly, competition is important in order to maintain more than one intermediation process between suppliers and users of capital.

In future years, competition will become more pronounced, and the delivery system will evolve accordingly. Competitive advantage should result from technical efficiency rather than legislative authority. In the past, even with high levels of regulation among financial intermediaries, the field of play has seldom been level. The Farm Credit System has had a decisive advantage in obtaining funds from the nation's capital markets. Commercial banks, on the other hand, rely on deposits to acquire loanable funds. Conversely, commercial banks with their broad charters can more effectively manage their portfolio for risk through balancing of nonagricultural loans and investments while the FCS is restricted and limited in scope to agricultural enterprises. Some small rural commercial banks have neither of the advantages, and some insurance companies have both. Moreover, even as the competitive advantage shifts from one institution to another, the borrower still gains by having access to more than one reliable source of credit.

Competitiveness should not imply an absolute leveling of the capabilities of various lenders, but rather assurance that equivalent opportunities exist to provide credit services to farmers under comparable capital and intermediation costs. Management competence and market discipline exercised by both customers and stockholders should be the ultimate determinants of competitive success. Competition is the American way, and competition will keep bankers, insurance companies, the Farm Credit System, and others alert to the kinds of management efficiencies and product innovation that will assure farmers and ranchers the lowest possible costs for credit.

3. THE MARKETPLACE SHOULD ALLOCATE CREDIT FLOWS; RESTRICTIONS TO CREDIT FLOWS SHOULD BE REMOVED.

Credit is essential in agriculture as it is all business sectors to enhance the overall flow of investment capital into agriculture. The marketplace alone should determine the ultimate flow of capital.

Often, as policymakers have addressed farm problems, the resultant programs were inconsistent with market forces. Most notably, problems have arisen from attempts to maintain low cost capital flows into agriculture when the marketplace viewed the risk as too great. For instance, support prices, subsidized interest rates, and tax incentives, all tend to distort the flow of capital. In addition, programs aimed at beginning, limited resource or failing farms tend to alter the flow of capital while doing little to augment the general welfare of the farm population. In a competitive economy such as agriculture, credit flows should be market driven.

Similarly, restricting the flow of credit into agriculture can cause resources to be misallocated and lower the overall efficiency of the sector. For example, some people are wary of nonfarm equity moving into agriculture and have even managed to legislate barriers to keep this from happening based on the theory that outside equity of any kind would be detrimental to the structure of the family farm. In fact, some states have erected barriers to prevent corporate ownership of farms in order to preserve a traditional way of life. In reality, these policies tend to be self-defeating. Trying to maintain the status quo will ultimately force change. In the meantime, these artificial barriers that impede the flow of capital and the allocation of resources do little to improve the overall health of the agricultural sector.

If regulation and capitalization requirements for financial market participants are reasonably consistent and equitable, and there are not undue barriers to entry in the marketplace, then the market should provide rational allocation of financial resources. A more useful role for the government is to ensure that market access is equal and open, that borrower and lender rights are appropriately defended, and that similar rules for lending apply to all market participants. A role beyond that has the combined effect of producing distortions in both financial markets and farm commodity markets. Given the increasing variety of financial instruments and the enormous breadth of financial markets, both nationally and internationally, attempts to intervene at particular points to affect credit flows will likely have unanticipated and undesirable long-term consequences. The enormous fluidity and fungibility of financial instruments and markets increasingly argues for a regulatory and watchdog role as opposed to an interventionist or participant role for the government.

4. REGULATION AND CONTROL OF THE VARIOUS AGRICULTURAL LENDERS SHOULD BE CONSISTENT.

The current confusing battery of agricultural lending regulations would be more helpful to both borrowers and lenders if they were more consistent, if not more uniform. The mechanisms of supervision and oversight vary greatly among the four major lenders. Some use GAAP (Generally Accepted Accounting Practices). Some use RAP (Regulatory Accounting Practices). And, government agencies regulate subject to the whims of the Congress. The superstructure of laws and regulations governing agricultural lending institutions should, and needs, to be uniform.

Currently, the major institutional lenders in agriculture are supervised by various regulatory agencies with varying regulatory requirements and controls. For instance, the Farm Credit System has its arms-length regulator, the Farm Credit Administration. Commercial banks are subject to regulation by the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency and state banking authorities depending upon their charter and status as member or nonmember banks. Similarly, federally chartered savings and loan associations are regulated by the Federal Home Loan Bank Board, and insurance companies must adhere to state insurance laws. As a result, there is an overall lack of consistency among institutional lenders which sometimes causes excessively liberal or conservative credit decisions.

In one sense, consistent regulation and control are most appropriately viewed in the context of the opportunities available to the respective lenders financing agriculture. Striving for consistent capitalization requirements vis-a-vis agricultural assets on the balance sheet and for similarity in risk classification of those assets by regulators are appropriate and important goals. Clearly, capital requirements should be differentiated according to the riskiness of the loan. Without consistency in both risk classification and

capitalization requirements, lenders' decision-making will not reflect accurate market risk considerations, nor will the competitive playing field be reasonably level.

While it may be difficult to get consistency among states, many of whom have put limits on lending institutions within their borders, national/Federal regulators should apply uniform regulatory standards to all agricultural lenders, including Farm Credit System Institutions. Uniform loan classification, capitalization, and loan loss reserve standards should be enforced by all federal regulators. From that level playing field, the success of one lender over another will be based on customer service, unique products, and astute management. Regulation, itself, should not, and need not, become a leveling device.

5. CREDIT AT ANY COST IS NO SUBSTITUTE FOR INCOME.

Agriculture's major problem is inadequate income. Subsidized credit misdirects resources and creates inefficiencies. It does not resolve the underlying income problem. In fact, low cost credit often exacerbates the income problem. Agricultural commodity markets become distorted when production decisions are not based on the market cost of capital. Individual investment decisions made in the context of below market costs for capital will not be rational unless such below market rates can be sustained indefinitely. The dilemma of substituting credit for income is thus a growing and spiraling one and difficult to stop once begun. With the realization that the agricultural marketplace is global, comes a reality that inappropriate policies causing the misdirection of resources serves only to lessen U.S. competitiveness.

The availability of low cost loans of a "disaster" nature has lured many borrowers into a cycle of nonpayment and interest accrual. Unfortunately, a whole generation of producers has become accustomed to dealing with adversity by increasing debt rather than economizing. Most lenders have come to realize that sound loans are based on "cash flow", not solely on security. The answer to natural disasters is not more credit.

Instead, farmers must find new risk management tools such as crop insurance. If crop insurance isn't working for some farmers, then the answer is insurance reform, not easy credit. Such reform needs to work toward farmer affordability and improved methods for calculating losses. Use of county average yields, for example, penalized the superior producer who suffers losses. Policies which force harvest of a lost crop to prove actual losses when the yield does not even pay harvesting costs are uneconomic both for the farmer and for the insurance program. The Federal crop insurance program needs study and overhaul both to correct past problems and to develop appropriate coverage for additional crops and new geographic areas.

For years, both government and private sector lenders contributed to the financial ruin of many farmers by granting credit that was based not on cash flow, but on inflated equity. Except in years of steep inflation, a farmer cannot borrow his way out of debt. Even then, when the inflation ends, the farmer still has to find cash flow to repay the debt.

In short, credit should be based on income. It is not a substitute for income. Credit is appropriate and contributes to profitability when the income generated from the business is sufficient to pay off the credit in a timely manner. Otherwise credit should not be granted.

6. FEDERAL AGRICULTURAL FINANCE POLICY NEEDS REORIENTATION.

Federal credit programs should be driven by financial considerations; their use as instruments of social change is undesirable. Federal credit programs administered by the Commodity Credit Corporation and the Farmers Home Administration have been utilized to achieve social goals in agriculture. Historically, these programs have directed funds to geographically and demographically selected borrowers, provided financing to young and beginning farmers, provided liquidity during emergency situations, and inventory financing for crop farmers. The popularity of these programs as policy instruments is in their ease of administration. However, the real cost of these programs is not as easily assessed.

The argument against Federal credit programs being used as instruments of social change is that the resulting distortions in both capital markets and agricultural commodity markets becomes increasingly problematic and intractable over time. To say it differently, if Federal programs are to be driven by financial considerations, then their role should be primarily to assure that market access is adequate and that regulatory and capitalization constraints are consistent; emphasis should be on guaranteeing private lending endeavors as opposed to originating and servicing loans as a direct participant. Clearly, the government has a legitimate role in encouraging the development and inflow of resources into agriculture (as it does the outflow of resources from agriculture). But, it has a variety of instruments other than credit programs available to use for those purposes.

A major flaw in U.S. farm credit policy is its failure to distinguish between programs which aid agricultural development and those which are essentially social programs. For example, the Agricultural Credit Act of 1987 has put FmHA, and to a lesser extent FCS, in the position of keeping the producer on the land if at all possible. It assumes cash flow viability after servicing options. Court cases, i.e., *Coleman vs. Block and Coleman vs. Lyng*, precluded FmHA from taking any adverse action. As of November, 1988, approximately 70,000 FmHA borrowers were more than 180 days delinquent. These borrowers received notices from FmHA; and when the class action injunction of *Coleman vs. Lyng* is lifted, 10,000 of these will be candidates for liquidation.

This is not to argue that the government turn its back on those forced out of agriculture. The needs of those people also must be addressed, but they should be addressed separately as a part of the social policy and safety net of the American system.

Perhaps a first step in this direction would be to discontinue direct Federal Government lending to agriculture. Rather than Farmers Home Administration making direct agricultural loans (which tend to get into social change considerations), it should become a guarantor of loans originated by other agricultural lenders.

The role and responsibility of private financial institutions should be separated from the role and responsibility of government/taxpayer supported programs. Private financial institutions including the Farm Credit System are stockholder owned and should not be manipulated by statute or regulation to provide subsidies to borrowers to effect social goals. Financial institutions which are required to maintain capital and risk management positions consistent with the expectations of their owners and regulators cannot reasonably be expected to bear the cost of initiatives such as mediation, abrogations of creditors' rights, and targeted lending programs without benefit of special compensation or incentives to do so. While such initiatives may or may not be desirable from a socio-political perspective, their economic costs should not be borne unilaterally or disproportionately by financial institutions. Failure to recognize this crucial point will, over time, unduly harm the performance of financial institutions or cause them to look for opportunities outside the agricultural sector to the ultimate detriment of agriculture.

Furthermore, a financial institution cannot effectively compete in today's financial environment when extraordinary constraints or regulation are placed on the institution in efforts to attain social goals. Failure to separate responsibilities only puts undue burden on institutions which are not designed to function in such a manner and can ill afford them. FmHA, for example, as a lender of last resort, has slowly been transformed, in the name of borrowers' rights, from a lender to a grantor. By pushing nongovernment lenders in the same direction, we risk limiting the amount of available credit to agriculture and raising the cost of what is available. Pushing the social change role onto private lenders will turn them away from agriculture into other lending opportunities.

Government programs should not keep people in agriculture if their operations are not viable. Since the Agricultural Adjustment Act of 1933, government has maintained a fairly prominent profile in agriculture. Typically, policies in agriculture have been more reactive than proactive. They attempt to raise farm income following national disasters or limit supply after a bountiful season. This is understandable given the political ramifications agriculture has on the national economy. In essence, policy attempts to enhance the welfare

of farmers while maintaining low grocery bills for the customer. Although possible, this reactive approach is an impediment to agriculture as it tries to compete in world markets. By political and moral necessity, agricultural policy must maintain a safety net, but attempts to maintain a way of life when the farm business is not viable will only result in American agriculture being less competitive in the global marketplace.

Although there are fewer proponents, the proactive policy approach would be a more efficient vehicle in which to serve the welfare of agriculture. Rather than having policy directives which work toward maintaining nonviable farm enterprises, directives should facilitate the transition of excess resources into alternative sectors. To accomplish this, appropriations could be channeled to a program similar to unemployment compensation, a human resource transition program, if you will, thereby lessening the burden on farm families and workers. And with appropriate programs, more farmers would choose farm liquidation on a non-adverbial basis. At present they fear they cannot compete in a non-agricultural world. The end result would still be low food costs for consumers as resources exit and other farmers adopt technological efficiencies. Over the longer run, U.S. agriculture would be more competitive and probably less of a fiscal burden.

Efforts to keep all who want to farm in farming, regardless of capacity and ability, leads to antagonism by other farmers and other sectors of the economy. Efficient farmers do not like the Federal handouts, nor do the many farmers producing nonsupported commodities-- citrus, fruits, canning and freezing crops, nuts, meat producers, and others. They rightly ask why inefficient, nonviable units in agriculture should be supported at taxpayer expense.

What is desperately needed is the courage and conviction to separate social programs from farm business issues. Farm programs should not keep people in agriculture when their operations are not viable. Such programs even hurt the very people they were intended to help--the farmers themselves. They waste critical years of their very productive lives. At the same time, there should be a social safety net available to farm families as to other individuals and families when their business fails or they lose a job. When farmers are not competitive and their financial situation dictates that they leave agriculture, their exit needs to be eased by an increased effort to assist them with the transition to a new endeavor.

7. IMPROVED MECHANISMS ARE NEEDED FOR THE RESOLUTION OF DEBTOR/CREDITOR PROBLEMS.

With the agricultural depression of the early to mid 1980s and increased numbers of farm failures, policymakers imposed new rules and changed existing rules with respect to loan mediation, foreclosure, and bankruptcy. In response to a crisis, some of these changes were understandable; but for the longer term, the trend may well be in the wrong direction. Over the longer run, mandated mediation, delays in resolving loan contract disagreements, and legal proceedings all cost money. These costs will be passed on to the borrower in the form of higher cost credit. Further, those marginal borrowers most likely to cause increased expenses will be denied credit.

The issues are really two-fold. First, stability is needed in law and regulation as it relates to borrower and creditor rights so that both parties may enter into the contract without undue risk of a major change in rules or expectations. Secondly, new mechanisms such as Chapter 12 and the borrower rights provisions in the Farm Credit Act as they apply to the Farm Credit System and Farmers Home Administration should be applied uniformly and expeditiously across the country so that resolution is, in fact, reached in a fair way.

Current mechanisms for the resolutions of debtor/creditor issues do not address some of the fundamental problems. Bankruptcy codes such as Chapter 7, 11, and 12 do bring about a solution, but often the solution is at high cost to both the debtor and the creditor. State mediation programs also have shortcomings. Borrower rights provisions applicable to the Farm Credit System are an attempt at providing an equitable resolution to problems, but they are inadequate. One problem with most of these mechanisms is that they fail to acknowledge the difference between high cost and low cost operators. As a result, poor managers and less promising resources are as likely to be returned to the industry as efficient ones.

Another problem is that borrower rights provisions are not applicable to all lenders. During depressed times such as those that have taken place since 1982, forbearance is justified and prevents excessive contraction in the industry. Yet, mechanisms that force debt write-off, and then return high cost operators back into the sector to wait for better times, do little to benefit the agricultural economy.

A more appropriate longer-term goal would be better loan servicing and open and honest communication between the borrower and the lender. Competition in the marketplace will help move events in this direction. Lenders who practice full and clear disclosure to borrowers and monitor the loans carefully will attract more business. Mandated mediation, on the other hand, will reduce credit availability. Perhaps mutually agreed upon mediation prior to loan closing would be simpler and a better approach over the longer term. This would keep the process simple, and it would require that both lender and borrower be educated about the rules of the game if either side makes mistakes.

8. ENHANCED AND VIABLE EQUITY MARKETS ARE NEEDED FOR THE AGRICULTURAL SECTOR.

Equity markets are an important source of capital for all business sectors of the economy. Agriculture presents a unique risk to equity markets relative to the variability and uncertainty of income streams as a function of weather, biological problems, and changing supply and demand conditions.

Existing barriers to equity markets are both legal and historical. The restrictions on corporate farming have also added to these difficulties. As a nation of fifty sovereign states, states have had the right to enforce their own laws; but with the increasingly national and international nature of agricultural production and markets, perhaps some of these laws need to be changed and barriers to obtaining outside equity removed. It seems essential that agriculture should also be enabled to utilize nonfarm or outside equity just as other business endeavors do. For many farm firms, at least, some separation of ownership and management such as has taken place in industry has already occurred and is appropriate. These changes may be particularly important for grain farming where restrictions are most apparent.

Traditionally, farmers have not had access to equity capital markets in the same organized fashion as enjoyed by other businesses either through public stock markets or over-the-counter markets. Outside equity capital coming into agriculture has been in lumpy forms primarily through purchase of land by outside investors or through inheritance in which farmers have left their farms to sons and daughters who moved off the farm and into other occupations. An important part of the nonfarm investment in agriculture in the Midwest has been in this latter form.

It is at least conceptually feasible that farmers could sell minority shares of stock in their farm business provided that financial accounting standards for agriculture were enhanced, a market regulatory discipline developed, and an investment made in developing such a market (presumably with government facilitation). A major function for an equity market is to provide liquidity for investors wanting to sell their farm equity. If such mechanisms could be put in place and made operative, then farmers would have access to equity capital without losing management control of their businesses provided that information flows and performance expectations could be developed in a way sufficient to satisfy investors.

Equity capital need not mean huge corporate farms. Neither does outside equity capital require organized national markets to facilitate the flow of capital—at least not to start. A well-managed, family-sized farm with debt service in line with cash flow could provide a good investment opportunity to a local retired, or ought to retire, professional. A group of such farms may provide an investment opportunity for local teachers' pension programs. Shared equity mortgages may be another approach.

A growing number of farmers realize the need for outside equity and agree in principle. However, education and mechanisms need to be put into place to bring about a more generally usable equity market. The huge dollar value of U.S. agriculture suggests that there would be sufficient demand for such equity markets to prosper.

If the equity market were to be made viable for the agricultural sector, the cost of equity as a source of capital may prove to be too great as investors seek returns to compensate for perceived agricultural risks. It is important to bear in mind that investors are already blessed with a substantial array of attractive equity investment alternatives. Market opportunities, however, should determine whether such a market succeeds rather than artificial barriers.

9. CONTINUING ATTENTION IS NEEDED ON MEANS FOR YOUNG PEOPLE TO ENTER FARMING.

The fact that adequate credit is available to agriculture in general usually is not much help to the beginning farmer. With few exceptions, one cannot "borrow" one's way into farming. Assuring easy access to abundant credit, even at preferential rates, has not been a particularly successful approach.

As noted below, there are advantages to leasing land as opposed to owning all the means of production. This is especially true for beginning farmers. The difficulty is that most landlords prefer to lease, not to young farmers just getting started, but to the older, well established operators with known abilities.

Private equity, therefore, is a promising route to explore. While the concept is typically more applicable to large operations, there is potential for application to young, starting farmers. There is, of course, considerable inherent risk in providing equity capital to beginning farmers. The return must be very high or investors must be insulated from the risk. High returns are uncertain, but the risk can be reduced to acceptable levels if the equity interest is in the land. Generally speaking, investors expect only modest immediate returns (rents) on land purchases. Their main objective is long term capital gains. Therefore, it is far less costly to attract equity capital to land than to a minority interest in an overall farm enterprise which includes that land.

While there is no well established market for minority interest (stock and limited partnerships) in farm enterprises and establishment of such a market would likely be difficult, there is a socially accepted market in land parcels. These could readily serve as units of minority interest. Increased use of the land parcels as means of providing equity to beginning farmers would need support of educational programs particularly with respect to specification of buyout arrangements by the farmer at later dates.

Lacking are incentives for using investments in land parcels as a vehicle for assistance to beginning farmers. Several ways of providing such incentives can be envisioned, including tax incentives, favorable farm program benefits, and preferential access to land in FmHA and FCS inventory. While these may be controversial, it is also clear that government assistance to young farmers will be a political issue in the next few years anyway. The large land inventory of FmHA and FCS will insure attention to the liquidation procedures. The decline in the rural population in many parts of America, and the strong political interest in rural development will reinforce concern over the problems of the beginning farmer. Given past programs, the natural tendency will be to make FmHA land available to young farmers at subsidized interest rates. As noted earlier, the Commission believes the use of subsidized interest rates is a questionable approach. A more innovative approach is needed rather than repeating past mistakes.

In short, there are serious financial obstacles to entry into the business of farming. There will certainly be strong continuing pressures to provide assistance to beginning farmers. Attracting private equity capital offers advantages over subsidized interest rates as an approach to solving this problem. And, that equity interest can be in land as well as in minority shares or limited partnerships.

10. FULL OWNERSHIP OF THE MEANS OF PRODUCTION IS NOT NECESSARY FOR VIABLE FARM PRODUCTION UNITS.

Ownership of some of the means of production may well be a useful goal, and it is certainly a traditional and historic goal of farm families. By tradition, as assumed objective of agricultural producers is to own producing assets. It was also assumed that realizing such an objective is essential to maintaining family farms. Evidence suggests, however, that in some areas of the country, family operated farm production

units have been very successful without concentrating on ownership of land. Furthermore, farms can be very extensive and employ a variety of financing techniques (ownership, leasing, renting, borrowing) in their businesses without straying from the concept that management, control and some ownership rest in the hands of a farm family. In a market environment where financial innovation is encouraged, agriculture as an industry should also utilize innovative techniques for controlling assets without owning them. Examples abound in other industries (and for that matter, in agriculture) where family businesses have become very large and successful by not limiting themselves to asset ownership as a means of acquiring or controlling capital.

Most business sectors do not own all of their production resources. Even service industries lease or rent all or some portion of their plant and equipment. Many farmers, likewise, lease production resources when it is more profitable to do so. One reason for historical emphasis on ownership is farm policy whose program benefits are capitalized into farm assets, thus providing additional benefits to farmers and landowners rather than as operators. Furthermore, federal credit programs which encourage ownership of production by beginning and limited-resource farmers tend to force additional risk on borrowers who can least afford it. At times and under certain circumstances, ownership of the means of production is a prudent business decision. The problem is that, in a dynamic economy, circumstances change. In the end, the decision to accept additional risk of ownership could prove costly to the family farmer operator as many farmers discovered when the bottom fell out of unrealistic land prices in the early eighties.

During the farm crisis of the mid 80s, it became very apparent that highly indebted farmers were hardest hit. Entry for young people into farming is risky if not prohibitive when they attempt to buy both real estate and equipment. Many times it makes more sense to lease real estate or equipment or both until sufficient cash equity can trigger a purchase. The point is, it is certainly not essential to own while getting started in farming; and while ownership may be a useful long-term goal, it is neither essential, nor perhaps even desirable, that each and every farmer own all of the farm's resources. All in all, the maintenance of viable farm units does not imply full resource ownership, and future policies should recognize this fact.

RECOMMENDATIONS FOR ACTION

1. AID AND SUPPORT EFFORTS TO DEVELOP: 1) A UNIVERSAL FARM LOAN APPLICATION FORM, AND 2) "GENERALLY ACCEPTED ACCOUNTING PRACTICES" FOR FARM BUSINESSES.

This recommendation is a first step in strengthening the relationship between borrowers and lenders. The current status of financial records being used by farmers leaves much to be desired. Financial records are often not consistent from farm to farm, state to state or lender to lender. Many farmers still lack an adequate set of records. Further, quality records could have helped many farmers recognize their financial problems and to avoid some of the losses of the early 1980s. Farmers were too often unaware of developing problems, and lenders focused too much on balance sheets while neglecting other financial statements. Further, farmers were often frustrated by the different forms required by different lenders. In short, farmers need records on a par with other businesses.

The proposal is especially timely because the Federal Agricultural Mortgage Corporation is now working on standards for use in the upcoming secondary market. Loan documentation will necessarily need to be consistent among lenders and across the country. This ongoing work toward documentation for real estate debt instruments presents an opportunity to develop financial standards for the purpose of farm business evaluation and analysis. Similarly, for purposes of "Aggie Mae" and FmHA's continuing move toward more guarantees and less direct lending, FmHA should adopt the same basic documentation forms. Without question, over time some loans originated by FmHA will be sold into the secondary market which will require uniform documentation. This effort deserves full support.

There is a second more fundamental part to the recommendation which would involve development of standard accounting practices and terminology, generally accepted accounting principles, (GAAP) for farm businesses. Currently, USDA, state agricultural colleges, and others use different terminology and different procedures to calculate basic financial information on farm businesses. Moreover, with the advent of personal computers and their adoption by many farmers, a number of firms have developed computer software packages for farm records and analysis. Without some coordination and generally accepted standards, such programs will tend to be more and more diverse. It's time for an effort to get nationwide consistency among those advising farmers on financial statements. The need is to specify a central core of information, some generally accepted accounting practices for farm records on which marketers of record analysis and farm financial management educators could build.

Once some generally accepted accounting practices for agriculture are developed, Congress should authorize their use by FmHA. The agency needs to be in tune with practices of other lenders, and standard records would be an educational tool to assist FmHA borrowers to graduate to private lenders. Also, FmHA borrowers should not be at a disadvantage for lack of documentation in the "Farmer Mae" and "Aggie Mae" markets.

The Congress and Administration need to see that this total job gets done. The time has come for a universal loan form. We assume the "Farmer Mae" effort will get the job done; however, that may not address the more fundamental question of standard accounting practices. If the private sector is unable to agree on standard accounting practices, the Congress should act to appoint an appropriate task force to develop them. The Commission suggests that such a task force could benefit from representatives from underwriters for the secondary market, lenders, producers, CPAs, investors and academics involved in farm record educational programs.

2. GIVE PRIORITY ATTENTION TO RISK MANAGEMENT ALTERNATIVES FOR FARMERS.

The National Commission on Agricultural Finance wishes to emphasize the need for agricultural lenders to counsel their producer-borrowers about task management alternatives, such as the multiple-peril crop insurance program. Lenders in the agricultural community have a special obligation to advise producers on the need to consider ways of protecting themselves from business risks that may affect their ability to obtain credit. Insurance is often an integral part of a sound business risk management strategy. Although crop insurance may not be the best answer in all cases, lenders have a particular responsibility to their stockholders and to their borrowers to see that it is considered, where appropriate, in producer-borrower financial planning.

The Commission further encourages the ongoing reevaluation of the effectiveness and operations of the crop insurance program and its aggressive expansion into additional crops and geographic areas. Two key concerns are that it be affordable for farmers and that those who do suffer crop losses receive payment for realized losses at the level selected.

When the reevaluation is completed, Congress needs to take a single position related to crop insurance versus disaster payments. Both won't work. Producers won't support and participate in crop insurance programs until disaster payments are either eliminated or properly integrated with crop insurance programs. Properly integrated means assistance should only be made available for loss occasioned by perils or causes of loss not covered by crop insurance.

3. EXPAND AGRICULTURAL EXPORT FINANCING ALTERNATIVES.

If the U.S. is to maximize export opportunities for agricultural goods, attention is needed on means for improving their financing. The Commission understands that, with few exceptions, large and medium sized U.S. banks have withdrawn from agricultural export financing. Much of the financing is now done by U.S. branches of foreign banks who are utilizing CCC guarantees. Perhaps the only major U.S. owned institution competing on a day by day basis is the National Bank for Cooperatives, but it is limited to financing only

30-40% of agricultural products due to its restrictions on financing cooperative originations.

Further, there are many cases where no CCC guarantee exists for an importing country or for an agricultural commodity serving a "niche" market. These often apply to small but growth markets in developing countries. While the Export-Import Bank might be considered as an insurer in such cases, their insurance costs, based on their experience with capital goods, tend to be unduly expensive for agricultural products. Hence, the Export-Import Bank is used very little for agricultural products. In short, the process for nurturing and assisting (particularly) small scale U.S. agricultural exporters is not as accommodating as that of some of our trading competitors.

Congress should consider additional means for fostering our agricultural exporters, especially the less well established exporters opening up new markets and/or selling to developing countries.

Among others, two possibilities should be considered: 1) extend the authority of the National Bank for Cooperatives to finance U.S. agricultural exports without restriction to only cooperative originations, and/or 2) devise some form of guarantee available to institutions providing financing to support countries otherwise not creditworthy for straight commercial credit on their U.S. agricultural imports.