Transitions in Agriculture: Perspectives on the Farm Credit System

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One of the most remarkable trends in the United States has been the transformation from a largely agrarian society a century ago with one-third of the population working and living on a farm to a highly urbanized society, where fewer than two percent of the population lives or works on a farm. A century ago when rural prosperity was closely linked to agricultural prosperity, the foundation of today's Farm Credit System (FCS) was built from the passage of the Federal Farm Loan Act of 1916.

Despite the relative farm prosperity in the years leading up to World War I, agricultural credit was inaccessible or high in cost, especially for land financing. A series of Presidential commissions yielded a recommendation for the creation of a cooperative credit system for farmers, patterned after Germany's successful, century-old Landschaft system. The Federal Land Banks, along with hundreds of National Farm Loan Associations, were established by the 1916 Act.

Following World War I, the farm economy collapsed as farm prices fell in response to greater supplies and weaker demand. With high debt burdens, production credit contracted and congress responded by passing the Agricultural Credits Act of 1923. The 1923 Act created 12 Federal Intermediate Credit Banks (FICBs) to supply farm lenders with funds for short-term farm loans. Yet, the farm economy remained depressed with farmers unable to pay for their expenses and make loan payments. With the Nation mired in the Great Depression, congress passed the Emergency Farm Mortgage Act of 1933 to provide farm financial relief and the Farm Credit Act of 1933, which recapitalized and established the FCS as a group of cooperative lending institutions to provide short-, intermediate-, and long-term loans for agricultural purposes, including for cooperative borrowers. The policy focus was decidedly on improving creditworthiness and keeping farmers on their farms.

The Farm Credit System (FCS)

The Cooperative System is a nationwide network of borrower-owned financial institutions comprised of 82 direct lending associations, 3 Farm Credit Banks, and one Agricultural Credit Bank that serve nearly 500,000 owners/borrowers. System-wide assets total $247 billion, with loans totaling $191 billion. Funding is obtained through the sale of System-wide securities. Approximately, 70 percent of loans are made to farmers and ranchers, with the balance made to residents of rural communities, agricultural and rural utility cooperatives, and other eligible borrowers.

The Farm Credit Administration (FCA)

The FCA is an independent agency within the Executive branch responsible for regulating and supervising entities of the Farm Credit System, including the Federal Agricultural Mortgage Corporation (Farmer Mac). The FCA is responsible for ensuring a safe, sound, and dependable source of credit and related services for agriculture and rural America.

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Over the next 3 decades agriculture underwent immense structural adjustments as mechanization lead to a continuous exodus from farming. After peaking at 6.8 million farms in 1935, the total number of U.S. farms had fallen to just 2.7 million by 1969 - a 60 percent decline. In that year, the Farm Credit Board established a commission on agricultural credit to review the FCS's charter and the future credit needs of agriculture. In their report, they expressed concern over the rising age of farmers and the growing capital needs necessary to enter into farming. Among their recommendations was a call for the Farm Credit System to have a goal to provide greater opportunity for competent young farmers to obtain adequate amounts of credit consistent with sound lending practices while recognizing the well-being of the applicant and reasonable protection of the lender. The report went on to recommend that a System-wide coordinated program be developed to serve this need and that ongoing research was important and necessary.

Following the report, Congress passed the Farm Credit Act of 1971, giving the System more flexibility in lending to production agriculture and authorized new lending activities. While the legislation did not specifically address the special credit needs of young farmers, the issue remained in the forefront as the farm economy flourished in the 1970s.[2] In 1974, a year of record net farm income, the FCS sponsored a national conference on the Financial Needs of Young Farmers.[3] At the conference, Secretary of Agriculture Earl Butz pointed out that the biggest limiting factor to young farmers was access to sufficient capital to utilize their productivity and management abilities.

With farm costs rising and farm numbers dropping below 2.5 million, Secretary of Agriculture Bob Bergland in 1979 initiated a study on the structure of agriculture. The January 1981 report, *A Time to Choose*, concluded that the policies and programs of that time were accelerating or reinforcing the trends to ever-larger farms and new policies were necessary. It was in this period, that Congress amended the 1971 Act, requiring that FCS lenders make special efforts to serve the credit needs of specific classes of individuals - young, beginning, and small farmers.

Addressing Capital Barriers: Young, Beginning, and Small Farmers and Ranchers

The 1980 amendments made to the 1971 Act under Section 4.19 (12 USC § 2207) requires each FCS association to have a program for furnishing sound and constructive credit and related services to young, beginning, and small farmers and ranchers (YBS or YBS farmers).[4] These programs are to coordinate with other FCS lenders, as well as government agencies and private sources of credit. Annual reports to the FCA on the program activities and progress in meeting program objectives are required. The 1980 amendment did not define key terms such as "young," "beginning," or "small" or what constitutes "program" or "reporting," and as such, were left to regulation.

Nearly two decades after *A Time to Choose*, Secretary of Agriculture Dan Glickman appointed the National Commission on Small Farms to examine the status of small farms and make recommendations

[2] Young and beginning farmer terminology were often interchangeable.

[3] *Financing Young Farmers, Report of the Conference on Financial Needs of Young Farmers, February 25-27, 1974*, Farm Credit Administration.

[4] The YBS program must be consistent with the policies of each association's district bank and is subject to the bank's review and approval.

for supporting small family farms. Their 1998 report, *A Time to Act*, defined small farms as those having less than $250,000 in annual farm sales. Late in 1998, the FCA adopted this definition, as well as the USDA definition of a beginning farmer as one having 10 years or less of farming experience.[5] FCA also modified its young farmer definition to loans made to a borrower under the age of 36 years.

YBS Program Requirements

Per section 4.19 of the 1971 Act, FCA regulation requires that the board of directors of each System association develop a program to provide sound and constructive credit and services to YBS farmers. Regulations (12 CFR § 614.4165) require the program to include: a mission statement that describes the program's objectives and specific means to achieve the objectives; annual quantitative targets for credit (loans) based on their understanding of reasonably reliable demographic data for their lending territory; annual qualitative goals to offer related services that are responsive to the needs of YBS farmers; coordination of credit and services with other System lenders and government and private sources; outreach efforts; and methods to ensure such credit is provided in a safe and sound manner and within the lender's risk-bearing capacity.

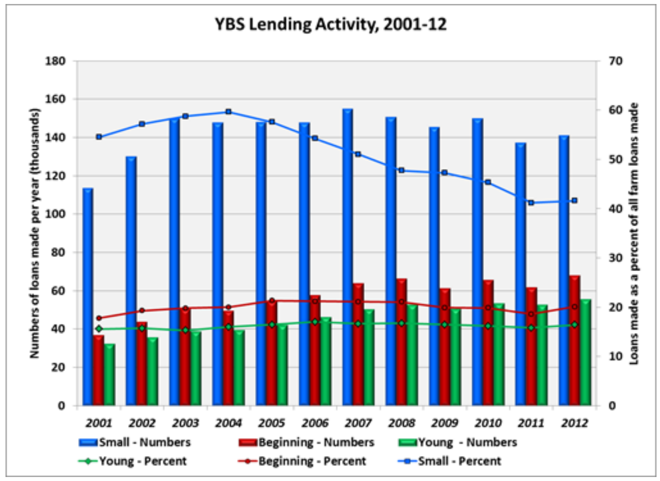
Board oversight and reporting are integral parts of this regulation. Each association's operational and strategic business plan must include the goals and targets for YBS lending and each association must have an internal control program to manage the YBS program including quarterly reporting to the association's board of directors. The annual report of each association includes a section on YBS lending, including a description of YBS demographics and its YBS program and its results.

The FCA Board has recently approved two guidance documents on providing credit to YBS farmers. The 2007 guidance interpreted the phrase "sound and constructive credit" for YBS farmers to ensure that all System lenders are fully engaged and use all available authorities to assist YBS farmers to begin, grow, or remain in agriculture or aquaculture. The 2012 guidance illustrates how YBS regulations can serve as a framework for System lenders to provide credit to all farmers and ranchers who have a basis of credit, with particular attention focus on improving service to those farmers producing in local/regional food systems.

The FCA Board also amended its operational and business planning regulation (12 CFR § 618.8440) in 2012 to require FCS direct lending institutions to include a human capital plan and marketing plan in their business plan. The human capital plan includes strategies and actions to strive for diversity and inclusion in the association's workforce and management. The marketing plan strategically addresses how the association will ensure that it is responsive to the credit needs of all types of agricultural producers having a basis for credit.

[5] Definition in 7 U.S.C. § 1991.

Trends in YBS Lending



Under the current reporting requirements, the System's new lending to YBS producers was generally increasing until 2008, but since then the trends have been relatively flat (See figure). Despite an upturn in 2012, the percentage of total new farm loans going to any YBS category has been trending down since the mid-2000s, with a more notable decline for the small farmer category. One of reason for the larger decline in small farm loans is the growth in farm incomes since the mid-2000s that pushed many farmers above the $250,000 threshold. Young farmer lending has been more stable in recent years. One possible explanation for this is an increase in the next generation of farmers joining their family farming operations. Under reporting guidelines, the YBS groups are not mutually exclusive, and so a single loan can qualify under each YBS category.

YBS Programs and the Loan Decision

YBS programs play a significant role in the System's financing of the transitions in agriculture. New entrants into agriculture, whether they are taking over a current farming operation, modifying that operation, or beginning a new operation, face challenges in meeting traditional underwriting standards, commonly referred to as "creditworthiness." The difficulties encountered are typically the lack of a strong financial position, collateral, and performance history. In short, assessing the creditworthiness of these applicants remains a challenge for all lenders, particularly as the capital requirements in many segments of agriculture rise and in instances when farming experience is limited.

As a result, the decision matrixes used in serving the next generation of farmers may challenge lenders primarily in the type of creditworthiness matrixes they use. These challenges vary based on the type of agriculture practiced and the link to an established farm or the beginnings of a new farming operation. The challenges become more acute when a person is starting a new agricultural operation. To serve these farmers, a System association's YBS program should take into account the new farmer's strengths, such as production and financial skills, while recognizing that the creditworthiness analysis may not include the level of capital or collateral strength normally used in analyzing a loan request.

System lenders use a combination of tools to assist them in assessing creditworthiness for these new farmers. In addition to the flexible loan underwriting standard tools, other tools can include pricing the loan at a concessionary or reduced interest rate, reducing or eliminating certain loan fees, and using loan guarantees from federal programs like the Farm Service Agency, state sponsored programs, or private sources. In addition, some System associations dedicate some of their capital to support the more than normal risk that these loans may contain.

Training is a component of a System association's YBS program that can assist in helping a farmer be creditworthy. Examples of training programs include business planning, financial planning, and risk management planning. In addition, some associations provide scholarships for YBS farmers to attend training opportunities including those developed within the Farm Credit System and those outside of the System, like local land grant universities. Mentoring is also used by some associations to assist new farmers.

The range of YBS demographics can pose challenges for System institutions in meeting their YBS program goals. FCA oversight and examination activities encourage System institutions to assess their performance and market penetration in the YBS area. This self-assessment increases each institution's awareness of its mission and prompts it to earmark the appropriate resources to serve the YBS market segment. In addition, FCA continues to review and consider various policy options for supporting the System's YBS programs.

Challenges in data, definitions, and research

The availability of timely data and research is important to understanding the role of credit in the transitions within agriculture. While annual USDA surveys of farmers and analysis by the Economic Research Service provide helpful insights at the national level, the Census of Agriculture remains the most comprehensive source of information at the local level. But the Ag Census does have limitations, due to its 5-year frequency, its snap shot picture, and limits on its accessibility. Another concern is a lack of its financial information, which worsened when the Census's Agricultural Loan Ownership Survey was discontinued. These data issues present challenges in understanding transition issues for lenders, including System lenders, when designing, marketing, and assessing their YBS programs.

There are also concerns about how well the Ag Census measures new entrants into agriculture, such as urban agriculture operations. At the other end of the spectrum, are concerns about whether the broad farm definition muddles the picture of those operations that are either truly at the beginning stages of a farming career or are trying to exit agriculture. USDA surveys capture existing farmers, but not those that tried to enter into farming and failed. Nor do they provide much information about those owning farmland that might rent to young, beginning, or small farmers. Filling these information gaps may require special studies and coordination among government agencies, universities, and others.

Defining new entrants or exiting farmers presents another opportunity for further study. Originally, FCA defined a beginning farmer as those having less than 6 years of farming experience, but later adopted USDA's 10-year definition. Likewise, FCA originally defined small farmers by dollar amounts of annual sales and by assets owned, but later adopted the Small Farm Commission Recommendation, which is based solely on annual sales. Are these and other metrics appropriate in identifying and characterizing the intended individuals today or in the future? All these and other issues invite further study.