Commodities, Credit, & Crop Insurance:

Perspectives on Risk Management Tools and Trends for the 2018 Farm Bill

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Introduction

Mr. Chairman and members of the committee, thank you very much for the opportunity to testify today. My name is Brenda Kluesner and I serve as a loan officer with Royal Bank in Cassville, Wisconsin testifying today on behalf of the Independent Community Bankers of America (ICBA).

The focus on the farm bill titles being discussed today is of great interest to thousands of community banks serving rural America and the agricultural sector. The nation's community banks strongly support America's farmers and ranchers and our rural communities. We look forward to assisting you on the next farm bill to help boost the prosperity of the farm sector.

Royal Bank

Royal Bank is a locally owned and operated full-service community bank with a geographical footprint serving nineteen Central and Southwestern Wisconsin markets. Royal Bank provides extensive services to the agricultural community in order to help crop farmers and livestock and dairy operators thrive and grow. Royal Bank has $400 million in assets with over $90 million in agricultural loans. Approximately one-third of these loans have USDA FSA guarantees. Royal Bank provides quality financial products and services through a network of locally controlled offices, taking pride in prompt personal service and a financially successful organization.

The Role of Rural Community Banks

Community banks play an important role in the nation's economy. There are approximately 5,800 community banks in the U.S. Thousands of community banks are in small, rural, and even remote communities. Community banks under $10 billion in assets provide slightly over 75 percent of all agricultural credit from the banking sector. Community banks under $1 billion in assets extend approximately 56 percent of non-real estate loans from the banking sector to the farm sector and 62 percent of the real estate credit. Community banks also provide approximately 40 percent of all small business loans even though they hold only 10 percent of banking industry assets. Therefore, it is important Congress keep in mind the important role community banks play in agricultural finance and keeping our rural communities healthy and vibrant.

Focus of Testimony

My testimony today presents five principles we believe should be incorporated into the next farm bill and discusses briefly the background of the current farm economic situation.
My testimony also stresses the importance of farm programs to the agricultural sector from a community bank perspective. The farm bill, crop insurance and USDA programs are all essential to keeping a healthy farm economy. A strong farm safety net and ample funding for guaranteed farm loans can help prevent or alleviate a potential farm credit crunch from developing if continued low commodity prices persist over the next couple of years.

Principles for the Next Farm Bill

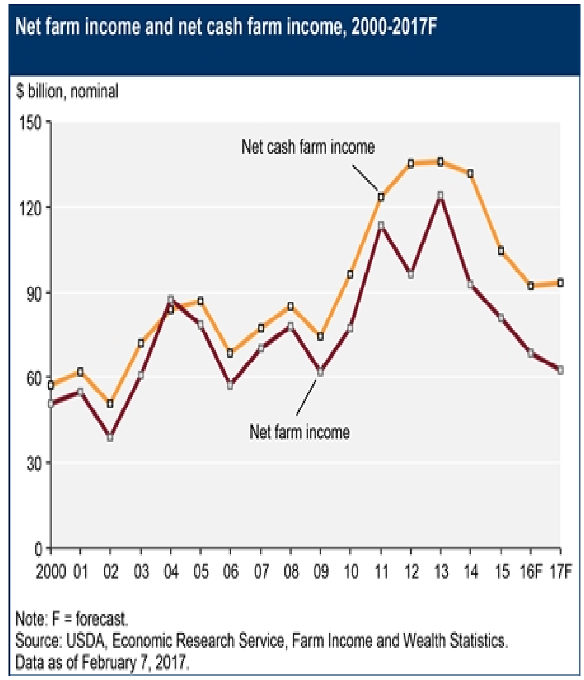
Regarding the topics being discussed today, we propose five key principles we suggest should be incorporated into the next farm bill. These principals are as follows:

1) Congress should provide ample funds for commodity programs, crop insurance and USDA guaranteed loan programs to help producers weather a potential farm income or farm credit crisis;
2) Changes should be considered to any programs under the House or Senate Agriculture Committees' jurisdiction if the end result is to assist farmers and ranchers and the community banks that serve them;
3) Congress should direct federal agencies to reduce regulatory burdens impacting producers and no regulations should be proposed or adopted that are not based on specific statutory or legislative language or which could add unnecessary or inappropriate regulatory burdens to users of various programs;
4) Congress should require federal agencies to implement programs in a manner that treats all categories of participants or stakeholders in each program fairly;
5) Direct government loan programs should be designed in a manner that compliment – not undercut – the lending activities of private sector lenders.

Background on the Farm Economy

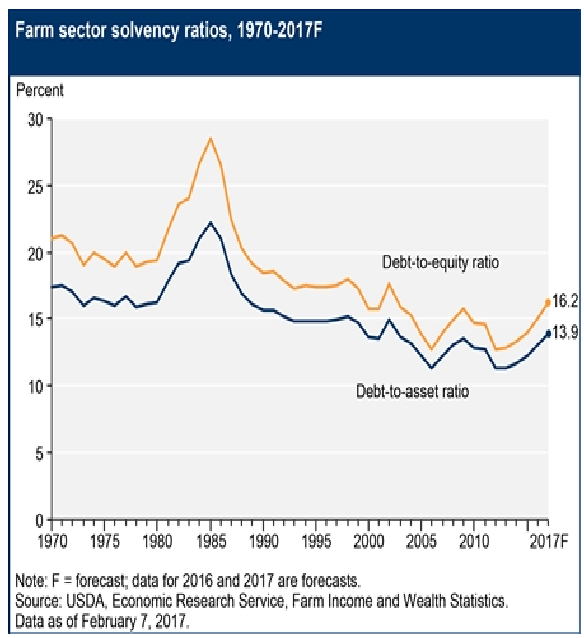
Some experts have said we are only one normal harvest away from dire conditions in the farm economy. Last year we may have dodged a bullet. In 2016 we had a convergence of two important factors that held further problems with farm finances at bay. We had very bountiful crops in many areas and significant farm program payments. One or both of these factors may not occur this year.

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



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

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



Importance of a New Farm Bill

Mr. Chairman and committee members, we encourage Congress to adopt a new multi-year farm bill by the time or shortly after the current farm bill expires next September. Past farm bills have experienced delays and extensions. The road to passage of farm bills is fraught with legislative land mines and passing them is never easy.

It is important to keep in mind that having a five or six year farm bill in place provides producers and lenders and other stakeholders a longer-term timeframe in which to engage in business planning decisions allowing them to make commitments for several years into the future. Short-term timeframes of a year or two are not conducive to making the full array of business decisions that are required by today's farming operations.

Many producers either do not cashflow or are on the precipice of not being able to cashflow. If commodity prices continue to remain at current depressed levels, the financial condition of many producers will deteriorate further. These are just a couple of reasons why a farm bill with strong commodity programs needs to be put in place upon expiration of the current bill.

The Importance of Crop Insurance

Last year, 1.2 million crop insurance policies were sold, protecting over 130 crops on almost 300 million acres of farmland. Those crops carried an insured value of approximately $100 billion.

As the manager of Royal Bank's extensive crop insurance operations which protect 20,000 acres of Wisconsin farmland, I must underscore the importance of this vital program to ensuring the long-term viability of our producers and their ability to repay farm loans. There have been a number of proposals in recent years to cut or gut the premium subsidies to farmers, introduce means testing or reduce payments to crop insurance agents. Adopting these types of amendments would have unintended and negative consequences which could harm many producers and their lenders.

As manager of a large crop insurance portfolio in our bank, I'm very aware that cutting premiums to farmers, for example, will diminish their financial solvency, could threaten their ability to remain on the farm in the event of adverse weather and could undermine their ability to repay their loans. This is not the set of policies we should be considering when we are in the midst of the fourth straight year of declines to net farm income. These declines have cut net farm income in half from 2013 levels. We need to protect premium subsidies to farmers and the financial stability and infrastructure of the overall program while keeping in mind this is a complex program for agents to manage.

A specific change we recommend is to allow farmers to report their acres for crop insurance purposes to either their crop insurance agent or to the USDA Farm Service Agency instead of requiring producers to report to both. This is an example of a duplicative regulatory requirement that could be streamlined.

How Farmers are Coping with Low Commodity Prices

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

Some community banks have as much as eighty percent or more of loans made solely to farmer or ranchers. In some rural communities the entire community is dependent on agriculture. In these communities all of the banks' lending is related to agriculture either directly or indirectly.

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

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

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

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

Due to financial stress and the projected farm financial deterioration over the next couple of years, some farmers have made the decision to exit farming. They have decided to exit due to the difficulty of being profitable in the current environment. Most farmers still have adequate to strong equity.

However, their working capital and cashflows are not sufficient to continue operating. While some producers have sufficient capital to withstand losses over the next couple of years, other producers will sell assets like land to remain viable.

In the worst position would be young, beginning and small farmers particularly if they have high debt levels or if they have little to no backing from their extended family or their parent's farm assets. These are the farmers that would be most at risk of having to exit production agriculture. However, if low farm prices continue over the next couple of years we are likely to witness a larger exodus of farmers from agriculture including larger farmers and ranchers.

We expect bank regulators will challenge banks who are trying to work with producers if they are projected to have negative cash flows for the next year or two despite having a strong equity position. This is where USDA guaranteed loan programs could have a tremendously positive impact as explained below.

The Importance of USDA Guaranteed Loan Programs

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

Provide Adequate Funding – One issue that seems to regularly occur is the farm loan programs can run out of funding. There needs to be enough flexibility in USDA programs to allow the transfer of funds within USDA between programs if they temporarily run out of funding and allow funding above the appropriated caps when needed. Any extra funds that may be needed could come from temporary or stopgap funding via the commodity credit corporation. The goal should be to prevent a backlog of approved loans that won't be funded until the next fiscal year.

Similar flexibility and backstop funding should be provided for USDA's Business and Industry (B&I) loan program. The B&I program has historically realized full utilization and the program's delinquency rates are at an all time low.

Especially in this economic environment, farmers may not have much time to get their loans funded after approval. This type of flexibility should be authorized in the farm bill. We should keep in mind, particularly for the guaranteed farm loan programs, that the farm ownership (real estate) program operates at no cost as costs are covered by the origination fee. The operating loan program has only a very minor cost yet helps lenders provide hundreds of millions of dollars to producers who would not otherwise obtain credit.

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For fiscal year 2017, the appropriation of $21 million allowed lenders to make $1.96 billion in guaranteed operating loans. FY2018 appropriations for USDA farm loans should at least match FY2017 levels.

Raise Loan Limits – It is important Congress raise lending limits for the USDA guaranteed farm operating and ownership programs from the current $1.4 million limit to $2.5 million or greater to reflect today's higher farmland costs. This could be especially important for young, beginning or small farmers who want to become established within their family's existing farm operation/structure. The family's farm may need to expand to accommodate the next generation of the farm family, such as a son or daughter, but they could be prevented from doing so at the current loan limit.

Additionally, many farmers are denied access to USDA guaranteed loans because their credit needs may exceed the loan limit. Raising the loan limit is not intended to impact all of the bank's farm customers. Rather, it is intended to help those farmers who may exceed the loan limit and allows community banks to keep pace with those occasional customers who have credit needs above the arbitrary USDA loan limit.

The guaranteed programs operate at minimal federal costs. Therefore, Congress could accommodate additional credit to farm borrowers with only a negligible cost to the federal government, ensuring the survival of thousands of family farmers. Bipartisan legislation has been introduced in Congress to address this issue and we recommend passage.

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

Whether direct loan limits are increased or not, these programs need to ensure direct financing from USDA complements bank financing to ensure direct loans, particularly larger ones, don't subtract from financing already being provided by banks. Also, since these programs have a 'credit-elsewhere' test, this requirement should be tight enough to ensure producers don't shop for credit denials, for example, from money center banks that are not making farm loans. In addition, many borrowers apparently do not pursue direct loans due to the amount of paperwork they have to fill out. Paperwork requirements should be reexamined.

Additional Recommendations for USDA Credit Programs

Bankers in our survey made a number of recommendations to improve USDA credit programs:

- Minimize origination fees as they can discourage use of USDA programs;
- Minimize paperwork requirements – a need cited by many bankers;
- Remove the USDA's recently imposed requirement that producers have an environmental assessment within the past 12 months prior to financing a smaller livestock facility or 24 months prior to financing a larger livestock facility;
- Provide lenders consistency when using USDA loans across state lines as the requirements often differ, making use of the programs more difficult in these instances;
- Increase USDA staffing levels which will quicken approval times for loans;
- To free up USDA staff and reduce wait times for farmers, crop insurance reporting should be done either through private crop insurance agents or USDA but not both;
- Allow banks to choose which USDA-FSA office to work with to help ensure a timely loan approval process and minimize any loan approval issues in certain counties;
- Better software integration to allow USDA information sharing with the private sector;
- Improve requirements for loss settlements in the case of borrower liquidation.

Comment on NEPA Restriction

USDA adopted a final regulation to implement and reconcile changes to the National Environmental Protection Act (NEPA). USDA's final rule included a provision not contained in the proposed regulation. At issue is USDA's requirement that prohibits any refinancing of debt within 12-24 months after any ground disturbance or construction. This prevents producers from accessing the guaranteed loan program and raises the costs of financing for producers and is unnecessary in many cases.

Farmer Mac Recommendations

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

Preventing the Next Farm Credit Crisis

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

For example, regulators typically require banks to keep a list of farmers who don't make **all** scheduled payments regardless of the amount of their equity. If regulators see the farmers' names a second time in a subsequent exam, they tend to classify the loan. If the volume of these loans reaches a high enough percentage of the bank's capital, the bank will be placed under an 'enforcement action.' However, if banks make these loans as USDA guaranteed loans, examiners will only classify 10 percent of the loan, reducing the amount of banks' classified loans by 90 percent if guaranteed by USDA. For example, on a $1 million loan, a ninety percent USDA guarantee would reduce the amount classified from $1 million to $100,000 – a ninety percent reduction in the amount that counts against the bank's capital.

Banks fear regulators may over-react to the downturn in prices and classify more loans. Having an expanded, robust and well-financed guaranteed loan program could remove pressures on banks to withhold financing from many producers and avoid a farm credit crunch.

Farm Credit System Abuses

There are multiple abuses of Farm Credit System's (FCS) lending authority which we believe Congress should also address going forward. While not the focus of today's busy hearing, we look forward to discussing those issues again with Congress in the near future.

Conclusion

Congress has the power to help avoid a farm credit crisis. Yes, we need a strong farm safety net for commodities and we need a strong crop insurance program – both vital to producers and lenders. We also need to enhance, streamline and adjust USDA guaranteed lending programs in the next farm bill to ensure they fulfill their potential to be a key component of the farm safety net and to help prevent the next farm credit crisis.

Thank you for holding this hearing. ICBA and our nation's nearly 6,000 community banks look forward to working with you in writing the next farm bill.