

TESTIMONY OF

GARY CANADA

on behalf of

THE AMERICAN BANKERS ASSOCIATION

presented to the

COMMITTEE ON AGRICULTURE, NUTRITION,
AND FORESTRY

U.S. SENATE

MAY 16, 2001

Mr. Chairman and members of the Committee, I am pleased to be here on behalf of the American Bankers Association (“ABA”) to participate in this important hearing to examine the current state of credit in agriculture, to discuss current farm legislation, and to discuss future federal agricultural policy that will help ensure a sound economic footing for American agriculture.

I am Gary Canada, president of the Bank of England in England, Arkansas. In addition, I am chairman of the ABA’s Agricultural and Rural Bankers Committee. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership-- which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks -- makes ABA the largest banking trade association in the country.

For those of you who are not familiar with my state, England is located about 20 miles southeast of Little Rock. The Bank of England was chartered in 1898 and has provided credit to farmers, businesses and others in and around England since that time. Today, in addition to our headquarters in England, we have banking centers in Scott and Lonoke, Arkansas.

In our area, farmers produce cotton, rice, soybeans and fish. For most of my banking career, I actively farmed in the England area. My son, who took over the farm in 1997, is the fourth generation to farm the same ground. While he is now completely in charge of the farm, I still get called when he needs extra help.

My bank has \$66 million in total assets, and a total loan portfolio of \$50 million. Over half of our loans are to farmers, and most of the rest of our loans are to businesses that either supply the producers in our area or are dependent upon their financial health for survival. My bank actively participates in the USDA, Farm Service Agency (“FSA”) guaranteed loan program. At present, 30 farmers have loans from my bank that are guaranteed by FSA. We also participate in credit programs provided by the Small Business Administration (“SBA”).

Mr. Chairman, as you begin the long and difficult process of designing a new federal farm policy, those of us who labor every day to support agriculture wish to thank you and this committee for your prompt and effective response to the critical needs of farmers and ranchers. By acting swiftly in 1998, 1999, and 2000, you helped avert what could have become a serious and extended period of economic disruption and financial ruin for many farmers and ranchers.

American agriculture continues to face an uncertain future. The banking industry shares the concerns of producers about the future economic viability of agriculture. Our industry provides the vital credit that farmers and ranchers need to be successful. At the end of 2000 banks had nearly \$75 billion in loans outstanding to farmers and ranchers- - an increase of 3.3% over the previous year. In 2000, the banking industry surpassed all other lenders in loans secured by real estate and non-real estate secured loans. More farmers and ranchers borrow more money from the banking industry than from any other

source. For every dollar of agricultural credit outstanding, 41 cents is loaned by the banking industry.

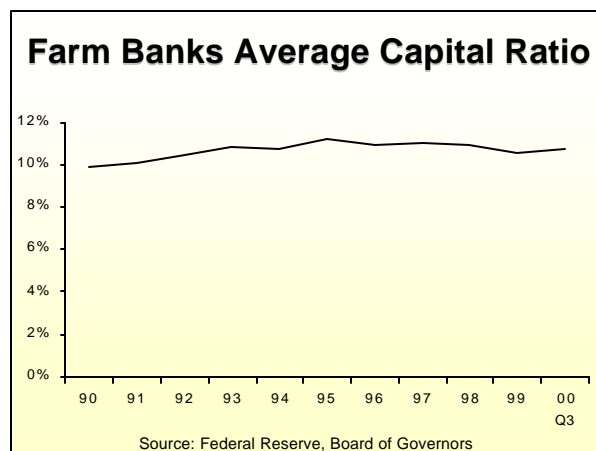
I lend money to farmers and ranchers in England not because I have to, and not because some regulator tells me that I must, but because agricultural lending has been good business for my bank. Further, agricultural lending has been good business for thousands of other banks in the country and that is why the banking industry has made such a significant investment in the industry. Agriculture is a capital-intensive business. Each year my customers must borrow large amounts of money to be able to plant crops, purchase livestock, buy machinery and equipment, and improve their land.

As an agricultural banker, it is my job to assess the risk in every loan and to assess the potential for repayment on every loan we make. We do our very best to examine all aspects of the deal before we make the loan. It is important that I make such a careful assessment, because it is not my money that Bank of England loans out, it belongs to the Main Street merchants, the hospital, the schools, the local restaurants and the men and women who live and work in and around England. I know that on an intellectual level you know this, but this is a reality with which I work every day.

In saying all of this, I want to tell you what my producers need most in terms of federal agricultural policy. I can sum it up in one word: certainty. If producers could present a plan to their bank at the start of each crop year that shows how their cash flow will work, banks would have a greater level of confidence about the credit that they are extending. We would be able to make more credit available in a more timely manner. The banking regulators would have a greater level of comfort in the loans that they are examining. Our farm supply businesses would be able to better project their annual performance, and that would make it easier for my bank to determine their repayment ability and on and on. As you labor to craft a new policy for agriculture, please keep this in mind and if you can just provide some certainty for my customers and the rest of agriculture, you will have accomplished much.

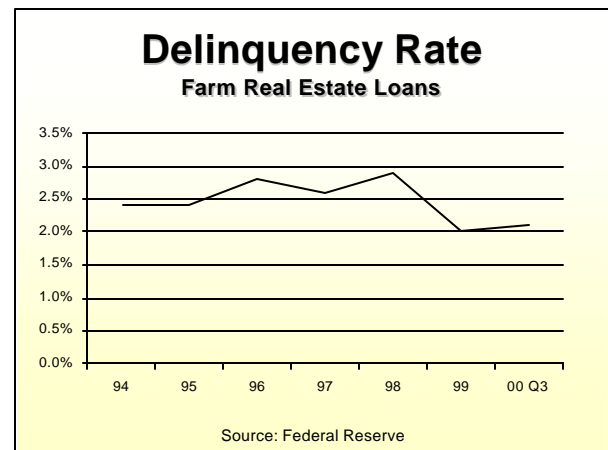
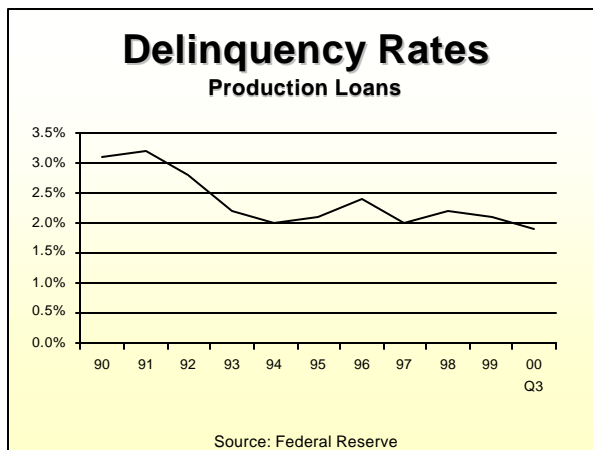
Despite A Difficult Agricultural Economy, Agricultural Banks Remain Strong

Despite low commodity prices for key agricultural commodities and regional weather and disease problems, widespread negative effects on banks' farm loan portfolios have not materialized. The sound state of farm banks today is the result of the strong non-farm economy, improved credit underwriting standards and high levels of government assistance in 1998, 1999, and 2000 that enabled farmers to meet their debt obligations.

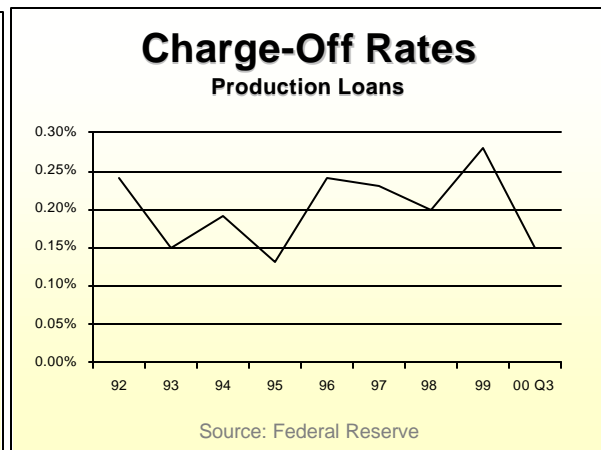
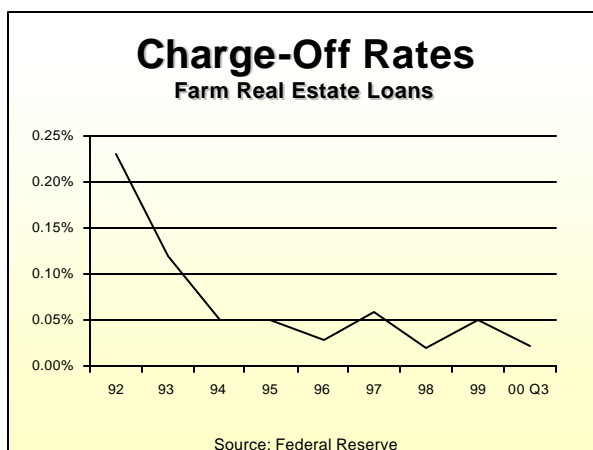


Agricultural banks tend to be better capitalized than other small banks. The average capital ratio at an agricultural bank stood at 10.7 percent as of the third quarter of 2000. As of September 2000 almost all agricultural banks met the regulatory definition of being “adequately” capitalized and more than 98 percent of all agricultural banks meet the definition of being “well” capitalized. Farm banks were able to build capital during the 1990s because they have been profitable.

Loan quality remains strong for agricultural banks. As of September 2000, in aggregate farm banks reported \$0.9 billion in farm production loans as delinquent (30 days or more past due) or 1.9 percent of the outstandings. Non-performing farm production loans (past due 90 days accruing interest and non-accruals) was 1.2 percent. Additionally, \$700 million in farm real estate loans were delinquent as of the third quarter 2000. As a percent of the portfolio, delinquent farm real estate loans stood at 2.1 percent. This compares favorably to the previous year’s ratio of 2.3 percent.



Further evidence of the strength of farm bank portfolios is reflected in the relatively low charge-off rates for both farm real estate and production loans. The charge-off rate for farm real estate loans stood at .02 percent – below the charge-off rate reported in 1999. For farm production loans, the charge-off rate was slightly lower than the rate reported in the last several years at .15 percent.



Despite the positives that I have reported to you about the agricultural credit portfolio and the financial performance of agricultural banks, continued low commodity prices and the uncertain nature of future federal assistance to agriculture have raised our concerns about our farm and ranch customers. I have never seen the morale of my farm customers lower. The uncertainty in agriculture has also had a negative impact on farm supply and Main Street businesses in my community and across all rural America.

ABA Center for Agricultural and Rural Banking

Our growing concern about the health of the agricultural economy and the role that our member banks play in the health of rural America led to the creation of the ABA Center for Agricultural and Rural Banking in 1999. The center is focused on the unique challenges faced by banks in rural America, and provides information, training, education, and advocacy for this unique constituency.

Farm Bill Listening Sessions Conducted in 2001

From early January to early May 2001, staff of the ABA Center for Agricultural and Rural Banking conducted 19 farm bill listening sessions in 14 states. Nearly 1,000 bankers, producers, businesspeople, state legislators, local federal officials and other stakeholders participated in the sessions held from North Dakota, south to Texas, west to Oregon and southeast to my state.

The sessions covered a wide range of topics from federal support for agriculture to trade to FSA program delivery to expectations and recommendations for the 2002 farm bill. I would like to share with you some general findings from the sessions:

- There was near unanimous agreement that the federal payments made available to producers in 1998, 1999, and 2000 made the difference whether their customers had adequate cash flow. Further, participants agreed that, if economic conditions remain the same, federal support consistent with what was made available in 2000 would be needed in 2001.
- In many commodities, farmers are receiving the lowest prices they have received in 20 or 30 years. Low commodity prices are universal and nation-wide. We spent a lot of time discussing the causes and consequences of this very negative economic situation.
- Bankers have worked with their customers to continue to find ways to help them continue their operations another year. Fortunately, farming was very profitable for much of the 1990s and farmers were able to build equity. That equity reserve is what has allowed banks to continue to term out debt so that farmers can get operating credit another year. Many bankers noted that ongoing cash losses will deplete equity reserves to the point that financing options will become much more limited.

- Crops that depend heavily on export markets have been hard hit; this is especially true for cotton. Participants in the listening sessions urged our staff to communicate to you that the future of American agriculture is dependent upon policies that support free and open trade.
- One bright spot in agriculture is cattle. Prices received by producers, at all points of the production cycle have been good. Areas that we visited that have cattle production have generally been faring better than areas that are completely dependent upon crops.
- High-energy costs, increased prices for inputs, and scarce water for irrigation in the Pacific Northwest in 2001 are new, dark clouds on the horizon.
- There was a great deal of discussion about the current federal payment structure. The planting flexibility afforded by the 1996 legislation was seen as a major positive change by the participants. The dependence upon the Loan Deficiency Payments (LDP) as a price support mechanism was less universally praised. LDP is only an effective price support mechanism when a farmer has a normal to above normal yield. When drought or other factors hurt yields, the LDP is reduced and the farmer suffers a diminished cash flow. In many areas of the country, LDP payments have been large because farmers have experienced above average yields. Other areas that we visited, Texas and Kansas for example, have had extensive drought, and farmers there are faced with greatly reduced cash flows because their LDP payments were negligible. Many bankers concluded that they are uncomfortable with a price assistance program that works best only when there is an average to above average crop yield.
- Bankers and others that attended the sessions were very positive about the improvements that were made to crop insurance programs in the Agricultural Risk Protection Act of 2000. It appears that the determination of Congress to make crop insurance a credible risk management tool is beginning to pay significant dividends.
- Of all the many policy options that we discussed during our listening sessions, the need to create a farm policy that is consistent and allows for some level of certainty, for the farmer and the bankers that finance them, was a consensus conclusion at all of our sessions.

USDA, Farm Service Agency Guaranteed Loan Programs

At every listening session we discussed the USDA, Farm Service Agency. FSA distributes LDP payments, administers agricultural disaster assistance and administers the guaranteed farm loan program. At many locations the audience was very positive about the performance of the FSA. At other locations we heard about ongoing problems with FSA.

The guaranteed loan programs offered by the FSA are one of the most cost-effective and highest impact tools that Congress can provide to farmers and ranchers during difficult economic times. Because the FSA guaranteed loan programs are such an important part of access to credit, we have some very specific recommendations for you to consider in the 2002 farm bill.

In the recent past there have been shortages of guaranteed loan funding. Because you and others recognized the need, Mr. Chairman, Congress acted several times to make supplemental funding available. We thank you for responding to us and we believe that funding for the remainder of FY 2001 will be adequate.

Recommendation: We urge you to continue to make funding for the FSA guaranteed loan programs a priority. With the continued uncertainty in the agricultural economy, there must be a dependable level of funding for all FSA programs. Recent improvements to the program have established the guaranteed loan program as a credible tool for the private sector to use to deliver credit to farmers and ranchers. In order for this tool to continue to work, funding must be available.

We thank you for temporarily repealing the 15-year term limit on borrower eligibility and we strongly recommend that it be permanently repealed. For many years the banking industry has worked with USDA to successfully graduate farm borrowers from direct USDA loans to guaranteed loans and then on to non-guaranteed bank credit. However, we do not believe that Congress envisioned the kind of economic situation that we currently face when it acted to place a limit on a borrower's eligibility for guaranteed loans. Clearly, economic realities justify an immediate change.

Recommendation: Given the fact that the agricultural sector is expected to be under continued financial stress, borrower term limits should be permanently eliminated.

There continues to be widespread confusion, on the part of FSA, about what happens if a customer fails to achieve a 100% cash flow. If a farmer has a cash flow coverage of less than 100%, this means that he was unable to meet all of his operating and debt obligations, but it does not mean that the business is in eminent danger of failing. Even in the best of years, many farms may not experience 100% cash flow coverage. Many times, when cash flow is less than 100%, a business borrows money. My point is that an exclusive focus on cash flow coverage by FSA is flawed, and that this may be an artificial barrier to credit for many farmers and ranchers. When we underwrite a loan at my bank we look at other factors such as available collateral. In many cases, I might be willing to make a loan to the producer even if his cash flow is not 100% if I know about other, offsetting factors. Given the current economic situation, it seems that we should be exploring additional ways to determine the credit worthiness of a customer and not relying on a single determinant.

Recommendation: If the bank has indicated that it will approve and fund the loan, FSA should approve the guarantee, with a lower percentage of guarantee if necessary, if the cash flow coverage is less than 100%. Give banks the option of making the loan

(and taking on the additional risk) if they feel that there are other factors that offset a cash flow deficiency.

In 1992, Congress approved a low documentation loan program for FSA guarantees. The idea was to significantly streamline the paperwork on smaller loan requests to encourage banks and others to make more credit available to smaller farmers and ranchers in a more timely manner. At that time, the loan limit for low documentation loan applications was set at \$50,000. Since that time farms and ranches have grown in size and the expertise of the banks that make FSA guaranteed loans has increased.

Recommendation: Increase the ceiling on low documentation FSA guaranteed loan applications to \$150,000.

Today, many USDA services still require direct farmer contact by the FSA, guaranteed lending is not one of them. It is the bank that makes the direct contact with the customer, it is the bank that does the on-site inspections and appraisals, completes the loan underwriting to their and FSA standards, and it is the bank that commits the funding for the loan.

Today there are many FSA Preferred Lenders (“PLP”) operating in multi-county and even multi-state regions. As a PLP, lenders can receive permission to make FSA guarantees in any state where they can demonstrate they can adequately manage and service the accounts. However, lenders must still place the individual applications in the local county office. All too often, this is where lenders encounter inconsistencies in processing and loan servicing. Inconsistencies in program administration by FSA were the main complaint that our staff heard when they conducted the listening sessions. We believe that program delivery and administration problems stem from the highly localized delivery structure that USDA maintains for the guaranteed loan program.

Recommendation: FSA should consolidate guaranteed loan making and loan servicing at state offices, or in specialized districts in very large states to ensure consistency and maximum efficiency of program delivery.

In 1998, 1999, and 2000 Congress approved additional, emergency assistance to farmers and ranchers due to low prices or weather related problems. As I noted earlier in my statement, these additional funds helped to avert a major economic crisis in agriculture. With one major exception, USDA has done an exemplary job of distributing the funds to farmers. Many farmers assign their USDA program benefits to banks for collateral. To perfect the assignment, the banker and the borrower sign an USDA assignment form and file it with the local FSA office. The form allows the farmer to indicate either specific program payments to assign or to assign all program benefits to their banker. USDA, in 1998, 1999, and 2000 determined that the additional, supplemental payments authorized by Congress could not be assigned with an existing assignment form-- even if the “all programs” box was checked on the form.

In commercial transactions, an assignment of benefits attaches to present and future receipts of the debtor. USDA, acting counter to the standards of commercial transactions, required farmers and bankers to execute and file new assignment forms each time Congress authorized a new payment program. This interpretation by USDA has created a mountain of paperwork-- to say the least.

Recommendation: FSA should create a blanket assignment form for USDA benefits that would attach to all program benefits, now and in the future, in order to stop an immense, costly, and confusing paper chase.

Creating Additional Ways for Producers to Better Manage Financial, Price, and Weather-Related Risk

During our listening sessions, bankers and others were very aware and complementary of the work that this committee and others have done to improve the Federal Crop Insurance program in recent years. We urge you to continue to seek ways to make crop insurance a more effective tool for producers to manage production and price risk.

ABA has supported incentives for producers to save money for times when their cash flows are reduced for many years. The efforts by Senator Grassley to create Fisherman, Farmers and Ranchers Risk Management (“FFARRM”) accounts are to be commended. In our listening sessions, bankers have been universally enthusiastic about FFARRM accounts. FFARRM accounts will benefit rural America in several ways. Primarily they will encourage producers to save cash when they have a surplus and will allow them to balance their cash flow when their earnings are down. Secondly, FFARRM accounts could become an important source of new deposits for banks like mine, allowing my bank to make additional credit available to my customers.

Recommendation: Pass legislation that will create FFARRM accounts this year.

Finding funding for beginning farmers and ranchers has always been difficult and it is especially difficult during tough economic times. One of the best sources of lower cost debt capital for beginning farmers are loans that are originated by banks through state industrial revenue bonds. This popular program, called “Aggie bonds”, allows banks to use the bonding authority of participating states to fund qualified beginning farmer loans. Approximately 15 states have aggie bond programs. Unfortunately, the states that have the program encounter funding shortages because the bonds are subject to state revenue bond caps. As a result, aggie bonds compete with other state bonding priorities and frequently do not receive top priority. More credit could be made available by banks to more beginning farmers if aggie bonds were exempted from the state bonding caps. Senator Grassley has introduced legislation that would do precisely this, and we urge you to pass this legislation this year.

Recommendation: Pass legislation this year that will exempt aggie bonds from state revenue bond caps.

Banks are the Primary Source of Economic Development Credit in Rural America

Our farm bill listening session discussions were not confined to just the challenges facing production agriculture. At many sessions we discussed rural economic development issues as well. Banks are the engines of economic activity in their community. Bankers overwhelmingly support efforts to stimulate economic development in rural America by lending to the businesses that support in some way, or add value to the crops and livestock produced by farmers and ranchers.

In many ways, the challenges facing bankers in lending to non-farm rural businesses are greater than the challenges they face in lending to production agriculture. In lending to production agriculture, there is usually a strong collateral base supporting the loan as well as a ready market for the assets of the operation should the business fail. In non-farm rural lending, the asset base of the company may be as intangible as good will, or there can be a complete lack of a market for the assets of the company. These unique challenges make it difficult for banks to provide credit to some non-farm businesses. In Washington, the ABA has worked closely with a number of farm and cooperative organizations to develop a proposal to create new sources of equity capital in rural America. We hope that new sources of equity capital can be developed to enable rural businesses access to equity capital on par with urban businesses.

Recommendation: Anything Congress can do to incent the flow of private debt and equity capital into rural America would be beneficial.

One of the most widely used federal non-farm credit programs is the USDA's Business and Industry guaranteed loan ("B&I") program. B&I guarantees allow banks like mine to make loans available to businesses that present a higher than average credit risk profile to our institutions. With the B&I guaranty we can make loans to help retain existing businesses and to help attract new businesses to our communities. There have been some problems with the program in the recent past. Some credits have failed and Rural Business-Cooperative Services, the USDA agency that administers B&I, has had some administrative problems. As a result, the agency has taken some prudent steps to control loan losses, most notably working with a federal regulator to audit some credits. We believe that this is a positive step. Unfortunately the damage has been done and now all lenders and all future borrowers are being asked to pay the price with increased subsidy costs, which limit the availability of funding, and increased loan fees.

Recommendation: We oppose increasing loan origination fees on B&I guaranteed loans. USDA has proposed increasing the fee to 3% (a 50% increase). The fee increase will have a negative impact on access to credit for many rural businesses.

Summary

I hope I have been able to convey to you the substantial commitment the banking industry has made to agriculture and rural America as well as the concerns that agricultural bankers like me has for our farm, ranch, and rural communities. I want to

assure you that bankers will work with their customers to restructure debt, to provide credit for operating expenses for the coming year, to find ways for beginning farmers to get started and to provide the financial services and financial stability that rural communities need. We will continue to provide credit to those farmers and ranchers who can make the necessary and rapid adjustments to the new global environment. Even in this uncertain environment, competition for safe and sound credit opportunities is strong, and that competition among lenders benefits the producer.

Credit, however, cannot be used as a replacement for earnings and profits. One of the key lessons learned in the farm crisis of the 1980s is that agricultural businesses must be profitable in order to successfully manage their debt obligations. This was a hard-learned lesson, but a lesson never to be forgotten.

The ABA looks forward to working with you as you address the challenges facing our nation's farmers, ranchers, and rural communities. I will be happy to answer any questions that you may have at this time.