

*Testimony of Dennis Everson*

*On Behalf of the*

AMERICAN **BANKERS** ASSOCIATION

*Before the*

United States Senate

Committee on

Agriculture, Nutrition and Forestry

June 13, 2006



Testimony of Dennis Everson  
On Behalf of the  
AMERICAN **BANKERS** ASSOCIATION  
Before the  
United States Senate  
Committee on  
Agriculture, Nutrition and Forestry  
June 13, 2006

Mr. Chairman and members of the committee I am pleased to be here today representing the American Bankers Association (ABA) to discuss the agricultural credit programs offered by the United States Department of Agriculture, Farm Service Agency (FSA) and to give you our industry's recommendations on how these programs can be improved to allow the banking industry to better meet the credit needs of more farmers and ranchers.

My name is Dennis Everson and I am President of the Agri-Business Division at First Dakota National Bank in Yankton, South Dakota. I am a former Chairman of the American Bankers Association's Agricultural and Rural Bankers Committee (ABA). I am currently a member of the board of directors of the South Dakota Bankers Association, and I serve on the board of directors of the Federal Agricultural Mortgage Corporation (Farmer Mac). My bank, First Dakota National Bank, is the oldest bank in what was the Dakota Territory, and my bank is also the oldest Farm Service Agency Preferred Lender (PLP) in the United States. First Dakota National bank has \$623 million in total assets, \$203 million in agricultural loans, and we service total agricultural loans of \$333 million.

ABA, on behalf of the more than two million men and women who work in the nation's banks, 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.

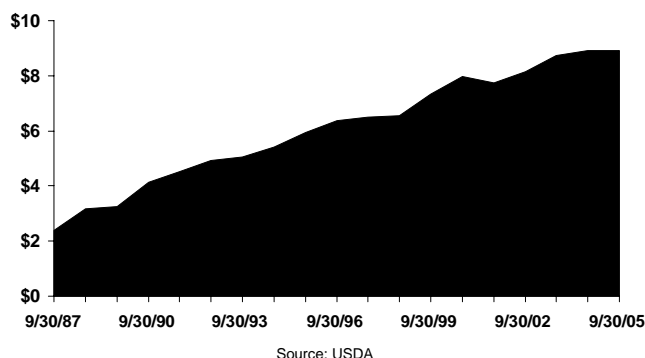
**The Banking Industry Works Closely With USDA To Meet the Credit Needs of Farmers and Ranchers**

I am pleased to report to you that the relationship between the banking industry and FSA is strong and that we are all working together to provide credit to farmers and ranchers who would not be able to get credit without the guaranteed loan program. Thanks to the determination of my peers around the country, and the willingness of FSA to constantly make adjustments and improvements to their programs, the FSA guaranteed farm loan programs enabled 46,000 farmers and ranchers to have 62,500 loans with an outstanding principal balance of \$8.9 billion at the end of FY 05.

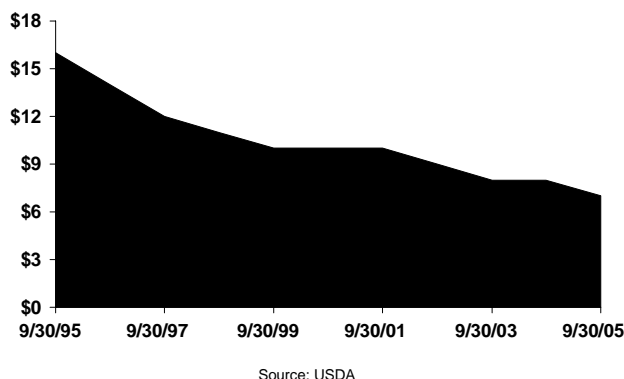
Every year approximately \$2.2 billion of new credit is advanced under the FSA guaranteed loan program, in the form of approximately 10,300 new loans. Loans are made to purchase and improve farm real estate, build new farm buildings, make conservation improvements, purchase machinery, livestock, and crop inputs, and refinance debt.

The credit made available under these programs is going to modest sized farms and ranches as the average guaranteed loan in FY 05 was \$212,000. Twenty-six percent of all FSA guaranteed loans made in FY 05 went to farmers and ranchers who FSA defines as beginning farmers, and nearly twelve percent of all guaranteed loans were made to farmers and ranchers who FSA classifies as socially disadvantaged farmers.

**FSA Guaranteed Principal Outstanding**  
(\$ in Billions)



**FSA Direct Loan Principal Outstanding**  
(\$ in Billions)



**The Transition from Direct USDA Lending to Credit Guarantees Has Gone Well**

For the last 30 years Congress and succeeding administrations have supported the transition from direct USDA loans to providing credit guarantees to private sector lenders (and government backed lenders like the Farm Credit System). Private sector lenders do a better job of underwriting and servicing agricultural credits, and FSA’s role is to oversee the lenders. In

addition, instead of hiring a large field staff to administer a direct loan portfolio, the guaranteed loan programs leverage the assets of the commercial lenders to do the field work. However, guaranteed loans do not work for every farmer and rancher. Even with a 90% guarantee against potential loan losses, not all producers can qualify for this type of credit. Congress and succeeding administrations have continued to fund a direct loan program to meet the needs of these very limited resource farmers.

## Banks Make the Most Guaranteed Loans

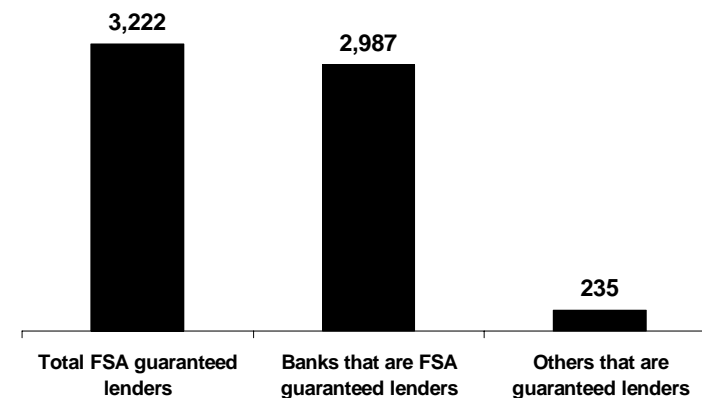
I am pleased to report to you that banks make more loans under the FSA guaranteed loan programs than anyone else. Today, there are 3,222 lenders that participate and of that number, 93% or 2,987 are banks.

### The Preferred Lenders Program

Earlier I mentioned that First Dakota National Bank is the oldest FSA Preferred Lender in the country. This program, long championed by the American Bankers Association, and implemented by FSA in the late 1990s allows banks like

mine to assume more responsibility for the loan making and loan servicing functions once FSA approves the process under which we manage agricultural credit making. Once we have achieved PLP status, we can process loans faster than ever before. Today, as a PLP lender I can get an approval from FSA within three days. This process has allowed me to work with my customers much more efficiently. There are currently 160 PLP lenders throughout the country.

### Who are the financial institutions that make credit available by utilizing the FSA Guaranteed Loan program?



*Banks provide the overwhelming number of farm loans that are guaranteed by FSA*

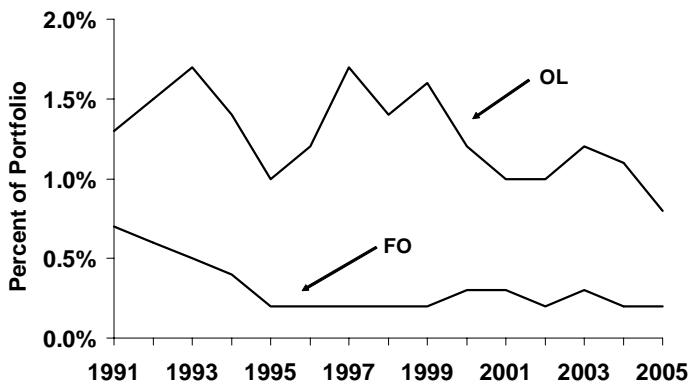
Source: USDA

### FSA Guaranteed Loan Losses Have Been Very Modest

Considering the fact that FSA guaranteed loans are made to those farmers and ranchers who have some sort of credit deficiency, the losses incurred under the program have been very modest and have been comparable to non guaranteed lending by banks and other lenders. This is a great success story that does not get told enough. Loan losses are low because banks make the initial

credit decision, and are responsible for servicing the loan from cradle to grave. In addition, private sector lenders know that FSA will not pay on the guarantee until the lender liquidates and accounts for all of the collateral that was pledged for the loan. Private lenders must strictly adhere to FSA

### FSA Guaranteed Loan Losses (Fiscal Year Data)



Source: USDA

policies and procedures in order to ensure that the guarantee will be honored in case of a loan loss. Any bank that has had experience with guaranteed loan liquidations knows that FSA is very thorough in their settlement procedures. Over the years, led by the American Bankers Association, the banking industry has worked closely with FSA to ensure that bankers understand the unique responsibilities that come with the credit guarantee.

### **The Banking Industry and FSA Are Committed to Constant Program Refinement to Continually Improve Program Delivery**

The relationship has not always gone swimmingly between FSA and private sector lenders over the past thirty years. FSA personnel, who were trained to be very focused on providing supervised credit directly to farmers and ranchers, were skeptical about changing their focus from direct lending to providing credit guarantees to banks and others. Banks and their regulators questioned if FSA would honor the guarantee if there was a loan loss. The lack of understanding between the two sides resulted in some early program delivery problems that at times seemed insurmountable. By the 1990s, it was clear to everyone that things had to change in order for the program to meet the expectations of policy makers, and of the farmers and ranchers who would benefit the most if program delivery issues were resolved. In 1992, Congress authorized the Preferred Lenders Program, but rollout was delayed as USDA reorganized Farmers Home Administration and the Agricultural Stabilization and Conservation Service into a new agency, the Farm Service Agency.

In the middle 1990s bankers began a series of discussions with FSA personnel that has resulted in many positive improvements to the program. These “stake holder” meetings are designed to bring bankers and FSA personnel together to talk about how things can be done better, and to gather ideas for future program enhancements. These meetings have been phenomenally successful as can be seen in the growth of the program from the late 1990s to today. In addition, a group of bankers who specialize in guaranteed loan making and servicing have been meeting together annually for the last seven years to discuss how the program is working and to share process improvements. No one makes these people travel from all over the country to get together annually; they do it because they are helping their farm and ranch customers by making the program a success.

A robust secondary market for FSA guarantees has developed during the same period. Many banks now sell their FSA guarantees to Farmer Mac so the banks can re-liquify, and make more credit available. The customer benefits because banks are able to offer more fixed rate financing since, by selling the loan the interest rate risk is shifted from the customer and the bank to the secondary market.

More recently, FSA has adopted loan analysis software that is the same that is used by thousands of banks, thus further aiding constructive conversations every day between FSA personnel and private sector lenders.

All of this progress has created a large and dedicated national affinity group composed of bankers and FSA personnel who are focused on constant program improvement, with an eye on better serving those farmers and ranchers who need some additional financial help. The success of the FSA guaranteed loan programs over the years is due to the willingness of all parties to openly express what is good for future program development.

We are concerned about several recent proposals and developments that we believe will negatively impact future program use.

### **ABA Opposes Increased Fees on FSA Guaranteed Loans.**

We believe that increasing loan fees on the FSA guaranteed loan program is inconsistent with the goals of the program, which is to help those farmers and ranchers that need some additional support for their borrowing, but that could qualify for commercial credit if they had some additional support.

As we understand the Administration's proposal, the guaranteed loan program administered by FSA would stop being an appropriated program, and would be transformed into a fee based program. FSA plans to implement the new fee structure starting on October 1, 2006.

According to the proposed rule published by FSA in the *Federal Register* on May 15, fees are to increase across the board from 90 basis points (bps) to 150 bps on all loans, with an annual maintenance fee of 75 bps on guaranteed operating lines of credit. The public has until July 14, 2007 to review and comment on the proposed rule.

What does the proposed fee increase mean in costs to an average borrower? The following two scenarios outline what the fee is under existing regulations, followed by what the same producer could expect to pay under the new FSA proposal:

#### **Current Regulation**

A farmer borrows \$150,000 to finance equipment and \$75,000 to plant crops.

The banker structures the credit request in the form of 2 separate loans:

- A \$150,000 term loan amortized over 7 years
- A \$75,000 line of credit that can be paid back and re-advanced over a 5 year period

USDA requires a fee of .90% (90 bps) on the entire package:

\$225,000 X .90%= **\$2,025**. If the customer does not change their credit package during the term of the loans; this is the entire cost to acquire the credit.

### Proposed Fee Structure

USDA is proposing the following fee structure:

\$150,000 term loan X 1.50%= **\$2,250**

\$75,000 line of credit X 1.50%= **\$1,125** *plus* an annual fee of .75% each year just to have the line of credit available.

- Year 1 \$75,000X.75%= \$563
  - Year 2 \$75,000X.75%= \$563
  - Year 3 \$75,000X.75%= \$563
  - Year 4 \$75,000X.75%= \$563
  - Year 5 \$75,000X.75%= \$563
- Total for line of credit = **\$2,815**

Total cost of the same credit package under FSA's new proposal = **\$6,190**. **This is a 206% increase.**

A fee increase of this magnitude will have a negative effect on the program, because it will impact those farmers and ranchers that can least afford an increase in their costs. We are also concerned that the increased fee could result in some farmers and ranchers being disqualified for guaranteed loans altogether, which would place additional demands on the already limited direct loan program.

Finally, without an annual appropriation to support the guaranteed farm loan programs future fees could range widely year to year, a fact that USDA acknowledges in the proposed rule. The federal government calculates what the cost of providing a credit program like the FSA guaranteed loan program by annually calculating the "subsidy rate". The subsidy rate varies by loan program and is based, in part, on the previous year's loss experience for the particular loan program. If there were a drought in one part of the country that caused the loss rate for the guaranteed line of credit to increase, for example, the subsidy rate the following year would be increased, meaning that there would be less loan funding available because the government's cost of providing credit had gone up under that program. In order for FSA to continue to be able to provide the same level of funding, FSA would have to increase fees again.

**Recommendation:** The ABA opposes increasing the fees on FSA guarantees. Further, we request level funding for the FSA guaranteed loan program, at a level that would allow annual guaranteed loan making in the \$2.5 to \$3.0 billion range, which is consistent with annual demand over the past few years. In addition, we support legislative language that would prohibit USDA from raising the fee without Congressional authorization.

### **Use of the Term, “Average Agricultural Loan Customer Interest Rate”, Should be Abandoned**

Banks and other lenders that make loans using FSA guarantees are supposed to price guaranteed loans based on a concept that is impossible to define. Due to the inability of anyone to objectively define the concept, banks that make guaranteed loans have been exposed to increased lender liability. This month, for example, a small bank in Oklahoma was forced to pay \$2.127 million to settle a lawsuit based on the claim that the bank charged the customer an interest rate that was higher than the “average agricultural loan customer rate”.

The statute authorizing the guaranteed loan program, for loans sold into the secondary market (7 USC Sec. 1929(h) (2)) states the following:

“The interest rate payable by a borrower on the portion of a guaranteed loan that is sold to the secondary market under this chapter may be lower than the interest rate charged on the portion retained by the lender, but shall not exceed the average interest rate charged by the lender on loans made to farm and ranch borrowers.”

The Farm Service Agency has taken this definition from the federal statute and has applied it to all FSA guaranteed loans. FSA’s handbook, “Guaranteed Loan Making and Servicing” (2-FLP) requires that each lender comply with the following:

“Neither the interest rate on the guaranteed portion nor the unguaranteed portion may exceed the rate the lender charges its average agricultural loan customer.”

We do not believe that FSA has done an adequate job of objectively defining “average agricultural loan customer” because they do not know what it is. Is that an average rate on all loans that are currently outstanding at a particular institution? Is it on loans of the same duration? Is it for all types of loans made to anyone who is a farmer or rancher? The statute is unclear, and FSA’s regulation is equally problematic. Essentially both the statute and the regulation attempt to define what cannot be clearly and objectively defined.

Market forces should determine the rate of interest charged on loans guaranteed by FSA just as market forces determine the interest rate charged on all other financial products offered by

banks. The agricultural credit marketplace is very competitive. The internet has created a great deal of transparency about interest rates, loan terms, and collateral requirements. The marketplace is transparent. Attempts to impose an artificial cap on interest rates have backfired. Instead of it being a protection to the borrower, it has exposed the lending community to additional lender liability, resulting in a reduction in the number of banks and other lenders that are willing to use the program. The net result will be that fewer farmers and ranchers will get the credit they need. The small bank in Oklahoma I spoke about earlier will no longer use the program.

**Recommendation:** The provision in statute should be repealed, and FSA should eliminate all references to pricing from their regulation. Market forces should determine the price of credit. As the regulations currently stand, any bank that writes a guaranteed loan is exposed to additional lender liability because no one can consistently define who is an average agricultural loan customer. The statute and the regulation does not protect borrowers. Instead of making more credit available, more lenders will not use the program.

### **The Resumption of Borrower Term Limits Will Represent a Significant Obstacle to Credit Access for Farmers and Ranchers**

In the mid 1990s Congress sought to limit the amount of time that a borrower would be eligible for either direct or guaranteed credit from FSA. *The Farm Security & Rural Investment Act of 2002* suspended what is commonly referred to as borrower term limits. ABA supported the suspension. When the 2002 legislation expires, term limits again take effect and the result could be devastating to those farmers and ranchers who still need the additional support that an FSA guarantee provides them in meeting their credit needs.

While we strongly support the idea that all farm and ranch businesses should be able to stand entirely on the strength of their individual balance sheet and earnings statements, we recognize the reality that there will always be a number of farms and ranches who will require some type of credit enhancement in order to continue to fund their operations. Requiring these firms to meet an arbitrary deadline for eligibility is inconsistent with the program.

**Recommendation:** Language imposing borrower term limits on FSA direct and guaranteed loans should be repealed.

### **The Family Farm Definition Needs to Be Based on Fact, Not Subjective Factors**

Over the years FSA has attempted to define a family farm, for purposes of determining eligibility, in many different ways. These attempts, no matter how well intended, have failed.

For example, the current definition requires lenders to subjectively determine if the farm is “*recognized* in the community as a farm”, and that it “has a *substantial* amount of the labor requirements for the farm and non-farm provided by the borrower’s immediate family”, and that it

“may use a **reasonable amount** of full-time labor and seasonal labor during peak loan periods”. (2-FLP pages 6 and 7, emphasis added)

We are concerned that some legitimate family farms do not qualify for a guaranteed loan because of the subjective nature of the definition. Approval officials differ based on their interpretation of the regulation. Without a definition that can be objectively defined and clearly documented, there will continue to be uneven application of the definition around the country.

**Recommendation:** FSA should adopt a definition that can be objectively measured and documented. We recommend the definition of a family farm be limited to two objective criteria; the majority of the credit needs of the borrower are met under the FSA guaranteed loan limit (currently \$852,000 and adjusted annually for inflation) and the entity being financed files a federal farm tax return (1040 Schedule F or appropriate corporate form).

### **Recommendations to Improve the Interest Assist Program**

Perhaps one of the most useful, but scarce resources USDA has available to assist farmers and ranchers who need some additional financial assistance is Interest Assist (IA). A farmer or rancher who can not meet cash flow requirements under commercial interest rates may qualify for IA if his lender is willing to continue financing the operation. Under the program, FSA buys down the lender's interest rate by 4% by paying the lender the 4% that is shaved off the borrower's loan rate. The borrower benefits because they pay a greatly reduced interest rate. The lender benefits because they are able to continue the credit relationship and are made whole for the reduction in the interest rate. We believe that IA fills an important gap between those borrowers who can only qualify for direct loans from FSA and those who could qualify for a guaranteed loan if they did not have to pay full market rate. Interest Assist has been criticized for being expensive because it is a direct payment, but the loans are still made and serviced by private sector lenders, which presents a far lower cost structure to the government than if the loans were made and serviced directly by FSA.

Interest Assist provides lenders with additional tools that can be used to provide a greater range of customers with access to capital. The program continues to be relevant and important to financing a segment of producers that could not be reached without it. We believe that IA should be better defined and targeted so the maximum number of qualifying farmers and ranchers benefit.

In late 2005 FSA published a proposed rule seeking to revise some aspects of the Interest Assist program. The Agency has not yet finalized the proposed rule. We would like to restate and amplify several of our recommendations from that comment letter:

## **Who Should Benefit From Interest Assist?**

Every year the IA program is over subscribed. Current regulations allow any farm or ranch borrower to receive IA if their cash flow indicates they have a need for it. Given the scarcity of Interest Assist, we believe who benefits from IA should be better targeted so that the limited funding is used to meet a clearly defined set of criteria. We believe that a discussion between the lending community and FSA would be the best forum for deciding how to establish better targeted and more objective criteria for who should benefit.

## **Maximum Interest Assistance Payment**

FSA proposed to reduce the maximum amount of debt on which an applicant may receive IA from \$852,000 (at the present time) to \$400,000. We disagreed with FSA about placing a limit of \$400,000 on the amount of debt eligible for IA. We are concerned that the proposed rule would limit a benefit that Congress intended to be available across the board. Based on this concern we opposed reducing the debt level upon which an applicant may receive Interest Assist.

## **Summary**

The guaranteed farm loan programs administered by FSA and extended to producers by the banking industry have worked well. The commitment by the banking industry and by FSA to constantly seek ways to improve the program has created an effective and cost efficient public-private partnership. Fifty thousand farmers and ranchers have credit because over 3,000 private sector lenders understand, support, and use the program.

The program is efficiently administered and serviced because banks deploy their resources to service the loans which have resulted in minimal loan losses. In FY 05, for example, loan losses were only .2% on loans secured by farm real estate, and .8% on non real estate secured loans. Given all of the uncertainties of farming and ranching, and the fact that these borrowers require a credit enhancement to qualify for commercial credit, it is a remarkable achievement.

The FSA guaranteed farm loan program is an important tool that we use to provide credit to the broadest array of farmers and ranchers. Without it, a significant segment of the borrowing population would have a much more difficult time finding capital. We have made great strides in making this program work more efficiently for everyone, and we hope that we can continue to make additional improvements.

Thank you for the opportunity to express the views of the American Bankers Association. I would be happy to answer any of your questions at this time.