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Dear Mr. Fitzpatrick and Dr. Thomson:

Recent commentary, “Stripdowns and Bankruptcy: Lessons from Agricultural Bankruptcy Reform,” suggests that the creation of Chapter 12 bankruptcy used to address the ag crisis in the 1980s is a viable solution for addressing today’s delinquent home mortgages.¹ While there were many hard lessons learned from the meltdown of the farm economy in the 1980s, the creation of Chapter 12 bankruptcy is perhaps one of the least valuable legacies from that period.

The paper attributes Chapter 12 with resolving much of the financial troubles of family farmers in the 1980s and implies this approach could be a solution for today’s mortgage situation. The realities of the 1980s were far more complicated than the paper’s narrow retelling of history, and in fact, Chapter 12 bankruptcy was only a narrow piece of how the farm debt crisis of the 1980s played out.

¹ Fitzpatrick, Thomas J. and James B. Thomson, “Stripdowns and Bankruptcy: Lessons from Agricultural Bankruptcy Reform,” Federal Reserve Bank of Cleveland, Economic Commentary Number 2010-9, August 3, 2010.

What Happened in the 1980s?

A commodity price boom in the late 1970s and early 1980s drove an inflationary spiral in agricultural real estate. Farmland values, which had been relatively stable for over 60 years, increased rapidly as farmers and investors started to bid the new commodity price increases into land values. By the mid 1980s there was a full blown speculative bubble in farmland prices. Most farm real estate loans were financed by local banks, the Farm Credit System, and USDA Farmers Home Administration. Many of the debts were structured with adjustable interest rates.

The Federal Reserve's decision to wring inflation out of the economy by raising interest rates was devastating to farmers and ranchers who had borrowed heavily to purchase farm land. Simultaneously, grain prices fell sharply immediately following the announcement of the January 1980 embargo of grain exports to the Soviet Union. The declining grain prices left farmers with less revenue to service their debt while interest rates were increasing for many loans, pushing farmers into delinquency.

As more farmers defaulted on their loans, more farm real estate went on the market, resulting in precipitous price declines. In Iowa, the gold standard of farmland, prices fell 50 percent. Rising interest rates and declining commodity and farmland values devastated many family farmers. Numerous policy responses were enacted to address the crisis, with the creation of Chapter 12 bankruptcy being only one.

Chapter 12 was Part of the Response to the Farm Debt Problem, But Was Not the Catalyst

Two court cases resulted in farm debt write-downs on a scale much greater than Chapter 12. *Coleman v. Block* in 1987 and *Coleman v. Lyng* in 1988 prompted Congress to pass new laws requiring the USDA Farmers Home Administration to reduce principle balances on many of their loans.² At the time, Farmers Home Administration held 30 percent of all farm debt. As part of the new law, the USDA had to meet with every debt-stressed borrower to offer loan servicing options that included the determination if the borrower was entitled to a loan write-down. These restructurings resulted in the USDA writing off nearly half of its existing loan portfolio.

Around the same time, Congress provided a cash infusion to the Farm Credit System following its near collapse. The terms of the Farm Credit System recapitalization created "borrower's rights" in which System lenders had to provide their debt-stressed farm customers with the opportunity to have their mortgage principle balances reduced.

Despite the commentary's emphasis on Chapter 12, federal court action, Congressional legislation, and the need to recapitalize the government-sponsored Farm Credit System had more to do with farm debt write-downs than Chapter 12.

Commercial bankers, who were not subject to the USDA loan servicing requirements or part of the Farm Credit System bailout, challenged Chapter 12 filings in court. As opponents to Chapter 12 warned at the time, the U.S. Bankruptcy courts *were* overrun with nearly 6,000 Chapter 12 cases in 1987, a year after the bankruptcy chapter's creation. After 6,000 cases were filed in the first year, filings dropped to near 2,000 the following year and remained below that level into the

² *Coleman v. Block*, 663 F.Supp. 1315, 1331-32 (D.N.D.1987) and *Coleman v. Lyng*, 864 F.2d 604 (8th Cir.1988).

next decade. The paper attributed the fall in cases to Chapter 12 “work[ing] without working,” by driving banks and borrowers to make private loan modifications instead of seeking bankruptcy filings. Aside from the policy responses, farm cash flows improved considerably as commodity prices recovered and interest rates declined in the early 1990s, improving farmers’ financial stability. *In any case, the reduction in Chapter 12 cases following 1987 was not driven by fears of Chapter 12 leading to private modifications as the paper asserts, but by the court-mandated USDA write-downs, the restructuring of the Farm Credit System, and improving ag conditions.*

Most Ag Loan Modifications Were Not Cram Downs

The loan modifications done by USDA and by the government-sponsored Farm Credit System lenders in the 1980s were not “cram downs” in the same sense as the mortgage principle reduction proposals that are being discussed today. In the case of all USDA farm loan modifications, the borrower was required to enter into a “shared appreciation” agreement, which entitled USDA to recoup a portion of any gains realized through the future sale of the property. Many of the loan modifications performed by the government-sponsored Farm Credit System also contained shared appreciation clauses. Through these agreements, the USDA and Farm Credit System lenders recouped some of the losses they realized from the initial modifications. “Shared appreciation” contracts differ entirely from the mortgage cram downs being proposed, because all of the proposals being discussed today would not entitle the lender to future gains in market value.

Home Mortgage “Cram Down” Would Indeed Hurt Credit Availability

Chapter 12 introduced many new risks to agricultural lending, limiting credit availability and increasing borrowing costs. The paper claims, “[Chapter 12 bankruptcy] did not change the cost and availability of farm credit dramatically,” citing a 1989 GAO report that actually argues the opposite.³ Seventy-eight percent of commercial bank respondents in the cited GAO report said they were less willing to lend to farmers who had filed for Chapter 12 bankruptcy, and 56 percent said they were less willing to lend to farmers who would be eligible but had not filed for Chapter 12. Additionally, the report found that those who “said they were less likely to restrict credit availability to farmers as a result of Chapter 12 bankruptcy were the ones most likely to say that they raised interest rates to recover losses taken as a result of the Chapter 12 process.”

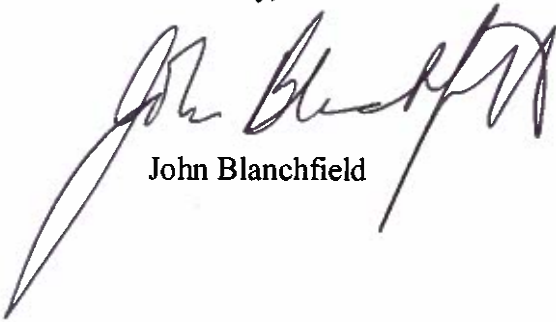
Research by the USDA found that creditors charged farm borrowers an average of 25 to 100 basis points more in interest to recoup the costs of Chapter 12.⁴ The report stated, “Much higher costs will be borne by financially weaker farm borrowers, either in the form of increased interest or other charges, or in their inability to obtain loans at any price.”

³ “Participants’ Views on Issues Surrounding Chapter 12 Bankruptcy,” United States General Accounting Office, May 1989.

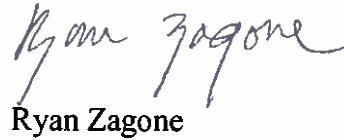
⁴ “Do Farmers Need a Separate Chapter in the Bankruptcy Code?” Agriculture Information Bulletin No. 724-09, United States Department of Agriculture, October 1997.

Chapter 12 bankruptcy is part of the historical record of the 1980s farm debt crisis. It was of limited value to the farmers who filed in the 1980s, was destructive to the banks that suffered losses on existing deals, and was harmful to farmers who needed credit after it was enacted. Farmers and ranchers who borrow today are still paying the price. Other factors drove lenders to write-down debt, and in most cases, lenders required borrowers to enter into shared appreciation agreements which entitled lenders to future gains from the sale of property, making the so-called "write-downs" something completely different from the mortgage reductions being discussed today. The attempt to use the Chapter 12 experience as a road map to solve the current home mortgage crisis is based on a limited and flawed retelling of history that does not provide a realistic view of the ag crisis or an accurate road map for solving the current home mortgage crisis.

Sincerely,



John Blanchfield



Ryan Zagone