Introduction

Positioning Agriculture and Rural America for the 21st Century

In January 1999, the American Bankers Association (ABA) formed a 10-member national Task Force on 21st Century Agricultural Banking. This Task Force was conceived out of a need to rapidly respond to recent volatility in agricultural economic conditions, as well as the need for a longer-term response to address structural changes of the food system and rural America. The Task Force reviewed various reports, the works of previous ABA task forces, current briefing materials, and discussed various recommendations over the course of six months.

Since 1911, the ABA and its member institutions have taken a leadership role in responding to developments and concerns in agriculture and rural America. This report continues ABA's tradition of excellence in serving rural America. In establishing this Task Force, the ABA has drawn upon a broad cross-section of ABA agricultural banking leaders that represent the network of approximately 20,000 banks and branch offices located in rural communities and major agricultural production areas from across the nation.

Three audiences with a vital interest in the work of the Task Force were identified: bankers, policymakers, and customers in agriculture and rural America. Bankers will be in better position to respond to the developing concerns in agriculture and rural America, if they are a part of the dialogue and search for solutions to changes in the rural economy. Policymakers, who are searching for more effective solutions, will be better able to respond if they know and understand conditions in the financial services industry, best practices and banker recommendations for action. Finally, agricultural producers, rural customers, and rural leaders look to their hometown bankers for leadership, ideas, and suggestions; so they can survive, thrive, and position rural America for the 21st Century. Citizens in rural America want to know that their bankers are searching for solutions to emerging trends and the banking industry will help to position rural America for the next millennium.

The Task Force identified the following fundamental strategies for responding to the emerging trends and structural changes in agriculture and rural America:

- Create a Framework for Farmers & Bankers to Manage Agricultural Risks.
- Create New Avenues for Local Bank Access to National Capital Markets.
- Create Tools for New Ventures & Opportunities in Rural America.

In addition to the policy recommendations, the Task Force placed high priority on creating a Center for Agricultural and Rural Banking. The Task Force believes a Center should be established to provide national leadership and visibility for ABA initiatives and responses to short- and long-term concerns in agricultural and rural banking. The Task Force envisions that much of the leadership for implementing the following policy recommendations should be encompassed in the Center's work. Since the Center proposal represents a recommendation that is internal to the ABA organization, it has been developed as a separate proposal to the ABA Board. Coupled with the policy recommendations, the Center may well be one of the more important deliverables recommended by the Task Force on 21st Century Agricultural Banking.

I. Create a Framework for Farmers and Bankers to Manage Agricultural Risks.

The Task Force identified three major principles to be used in designing a framework for farmers and their bankers to manage agricultural risks. A world-class risk management system would:

- Promote self-help solutions
- Allow individuals to determine their own destiny with minimal government intervention
- Utilize public-private partnerships rather than bureaucratic top-down approaches to program design and implementation

Consistent with these principles, the Task Force strongly supports the following priorities:

A. FSA Guaranteed Loan Funding is a Top Priority.

The USDA, Farm Service Agency (FSA) Guaranteed Loan Programs represent a model public/private partnership that has worked for agriculture. During the 1980s, the federal government believed the way to respond to the credit problems of farmers and ranchers was through a massive direct loan program. At one time, USDA had nearly $28 billion in direct loans to farmers and ranchers. The problems USDA had with the direct loan program in the 1980s need not be reviewed. It suffices to summarize that these problems contributed to a rethinking of the role of government. The government's primary delivery strategy was changed to foster working with the banking industry – instead of competing with it.

Since the 1980s, FSA's Guaranteed Loan Program has been a public-private partnership success story. Some 48,000 farmers and ranchers have 65,000 loans from banks and other private sector lenders that are guaranteed by the Farm Service Agency (FSA). Each year FSA receives approximately 15,000 requests for new guaranteed loans. Today, the guaranteed loan portfolio has about $6.8 billion outstanding and currently only about 2.4% of the payments are past due. In other words, the banking industry's non-guaranteed loan portfolio to farmers and ranchers currently has a past due rate of 1%. Considering the fact that FSA guaranteed loans

are made only to those farmers and ranchers that have some type of credit weakness, this portfolio of guaranteed loans is performing very well.

More than 80% of all Farm Service Agency guaranteed loans are written by banks. The Task Force believes the Guaranteed Loan Program is an essential tool to help farmers and ranchers get the credit they need. Agricultural bankers are very judicious in the use of the programs, and the regulations require each lender to certify on every application submitted to USDA that credit cannot be provided at comparable rates and terms without the guarantee. Lenders typically service guaranteed loans more closely than other loans. USDA regulations require close monitoring of the borrower's performance, maintaining close tabs on the collateral and constant monitoring of the customer's financial condition. Further, if the situation requires a lender to liquidate the account, USDA requires that all collateral and sales proceeds be accounted for before the lender may apply for a loss payment. FSA has adequate safeguards to make sure poor underwriting and loan servicing practices are not tolerated. Lenders that fail to meet these strict conditions lose money. This process assures a true three-way partnership among the farmer, the banker, and the FSA.

1. Immediate and continuing action to create an adequate supply of nationwide funding for FSA Loan Guarantee Programs.

As rural leaders contemplate how the federal government should respond to the needs of the agricultural sector during challenging times now and in the future, the Guaranteed Loan Programs offered by the USDA should be regarded as be one of the most cost-effective, high impact tools that Congress can provide. This program is not an answer to low agricultural prices, but it is an effective short-term response targeted directly to financial stresses faced by farmers and ranchers. Benefits of the program do not go to farmers who are not financially stressed or those who are beyond help. The program's scarce resources are targeted only to those farmers with cash flow problems for which the assistance can make a critical difference between financial survival and failure.

In FY 1999, USDA experienced unprecedented demand for FSA guaranteed loan funds. For the first time in the history of the program, funding for all FSA guarantees was exhausted well before the end of the fiscal year. In May 1999 Congress approved additional supplemental funding, but that funding was quickly exhausted as well. Demand for guaranteed loans was high in 1999 due to the worsening economic conditions in agriculture and banks trying to do everything they could to restructure their customer's loans to accommodate reduced cash flows.

In the short run, increased flexibility for internal reallocation of USDA funding can alleviate some timing and funding gaps for agriculture, temporarily. However, it is critical that a greater commitment be made by Washington to assure farmers that adequate funding is available in a timely manner. Demand for guaranteed loan funds will likely grow dramatically if commodity prices do not improve. The shortfall in funding for FSA Guaranteed Loan Programs

is seen as a critical problem that demands the attention of the Congress and the administration. If the guaranteed loan programs offered by USDA are not adequately funded, it will be increasingly difficult for banks to meet the credit needs of all of their farm and ranch borrowers.

2. FSA should continue to streamline programs and provide regulatory flexibility.

The Farm Service Agency has recently reformed the FSA Guaranteed Loan Programs along the lines that ABA has advocated for a number of years. The Task Force hopes that the new regulations for the Preferred Lenders Program, low documentation loan application for small loans, and many other program improvements will result in an FSA program that will more efficiently deliver greater access to capital for a wider range of agricultural borrowers. If the agricultural economy continues to erode, more and more farmers and ranchers will need the type of assistance provided by the FSA Guaranteed Loan Programs.

Due to developments in the agricultural economy, the Task Force recommends several immediate actions to increase the flexibility for the FSA Guaranteed Loan Program. The Task Force recommends that FSA abandon the 110% cash flow coverage requirement. This recommendation is particularly important as more farmers experience cash flow problems. A cash flow coverage of 100% should be sufficient for FSA, especially if the bank is willing to make the loan.

FSA's current system of program delivery continues to reflect an earlier time when resources were more plentiful. Over the last 40 years, predecessor agencies (FmHA and ASCS) deployed vast delivery networks that were highly local and heavily dependent on skilled labor. The people who built this delivery system are to be commended for their contributions to the health and well being of rural America. But times continue to change for rural America, and FSA must reinvent itself to meet the future challenges of rural America. FSA should consolidate guaranteed loan making and loan servicing at state offices, or in specialized districts in very large states to ensure consistency and efficiency of program delivery.

For example, loan officers for one bank in South Dakota deal with nine different FSA County Offices. Due to complex set of procedures that must be followed when administering the guaranteed loan program, there are inevitable inconsistencies among the nine offices. Further, it no longer makes economic sense to try to maintain a delivery network that worked best before there was fax or e-mail communication. The banking industry has the local infrastructure necessary to deliver credit. FSA's role is to provide the necessary oversight for the private sector lenders and this can be done much more efficiently.

3. Immediate action to remove the 15-year FSA borrower eligibility limit.

Congress should revisit the term limits on guaranteed loan eligibility. While bankers have moved many farm borrowers from direct FSA loans to guaranteed bank credit, and then to non guaranteed bank credit, there are some borrowers who–for a variety of reasons–must continue to have their credit guaranteed by FSA in order for the private sector to lend to them. Agricultural bankers in some areas are starting to encounter more and more borrowers who are running out of eligibility. In addition, this requirement has created severe administrative challenges for the FSA. Given the fact that the agriculture sector is expected to be under increased financial stress, the current term limits should be eliminated.

4. Organize an annual stakeholders meeting with USDA.

The purpose of an annual stakeholders meeting would be to provide an opportunity for two-way communication between USDA agencies providing rural credit enhancement programs and bankers serving agriculture and rural America. The agenda for a stakeholders meeting might include a review the performance of USDA credit enhancement programs, progress made in streamlining implementation of the programs, and discussion of next steps in the ongoing process.

B. Crop Insurance Reforms.

The Task Force supports a stable and reliable federal crop insurance program with private sector delivery. America's bankers and their customers know that dependable crop insurance can, and frequently does mean that bankers are able to approve operating loans and other types of credit for farmers struggling to stay ahead in higher risk situations, volatile weather, and challenging agricultural markets. Insurance can help producers recover their input costs when crops are damaged by unexpected circumstances, protecting them from financial disaster.

The Task Force examined numerous aspects of the current crop insurance programs and discussed various improvements for the future. While crop insurance has worked for farmers that buy it, the Task Force believes more needs to be done to make these programs more effective for all of America's farmers and ranchers.

1. Stronger links between crop insurance and income protection are needed.

Efforts to link crop insurance protection with price protection have been marginally successful. According to USDA, only about 16% of corn and soybean producers, who have bought

the higher levels of crop insurance coverage, take revenue insurance. New innovations such as whole farm revenue or cost of production insurance may prove to be more efficient than insuring each enterprise separately on the same farm. In addition, livestock producers face similar challenges with access to feed and forage during adverse weather conditions. More can be done to develop, test, and remove barriers for implementing innovative concepts that hold promise for addressing the risk management needs of the nation's farmers and ranchers.

2. Actuarial soundness is not working in the present system.

While it does not make sense for government to try to indemnify farmers from all crop related problems, a world class agricultural insurance system should provide affordable coverages so that most farmers are covered for all significant crop losses and major disasters. The need for additional disaster assistance continues to be necessary, in part, because of the inadequacy of the present crop insurance system. Farmers in high-risk areas should have access to more affordable crop insurance for covering all significant production shortfalls without the persistent periodic need for disaster assistance on an ad hoc basis. Farmers in lower risk production areas should benefit from even lower premiums. Otherwise, regional distortions in planting and industry investment decisions will occur.

The Task Force believes that even if the concept of actuarial soundness were redesigned in a way that increased the cost of the program, it would still be less costly than if Congress continues to intervene with ad hoc disaster payments.

3. Yield coverages and price elections are not adequate and are inflexible.

Many producers are working on very thin profit margins. Crop insurance, at the higher levels of coverage, is disproportionately more expensive because as the producer buys up, the federal subsidy declines. The highest subsidy should be on the highest level of coverage rather than the lowest level of coverage. While USDA should be commended for earmarking $400 million in FY1999 to provide producers with added incentive to buy crop insurance, producer participation will likely decline if this one time incentive disappears and/or if major reforms do not occur.

Catastrophic Coverage (CAT) and Non-Insured Assistance Program (NAP) has been universally rejected by farmers. CAT is a “floor” level of insurance that producers buy and NAP is a program intended to protect producers that grow non-insured crops. The Federal Crop Insurance Corporation (FCIC) acknowledges that CAT and NAP coverage is not sufficient to provide farmers with adequate coverage, and only two thirds of the farmers that have CAT coverage purchase buy-up coverage. Livestock producers face similar problems with access to feed and forage coverage during adverse weather conditions.

Insurance coverage is based on an individual farmer's Actual Production History (APH). If a farmer has had a string of bad years, his APH will be reduced, thus reducing the level of insurance coverage that he can buy in the future. Many farmers have had their APH reduced to the point that it is no longer economically feasible for them to buy the insurance. Farmers that have experienced multiple year crop disasters are hit with a double disincentive: lowered yield coverage and higher premium rates.

The current system of buying insurance based on a market price established months before crops are actually harvested creates a situation that drives farmers away from the program. Farmers typically do not want to insure all of their output at prices in the spring, which may be below their cost of production. Therefore, price elections need to provide a floor with upside potential if the market moves up.

C. Create Incentives to Save for Bad Times.

While crop insurance represents one cornerstone for creating a world-class agricultural risk management system, Congress should not overlook incentives to encourage farmers and ranchers to save for bad times. Government incentives for a savings program might take on several forms: matching contributions, interest rate bonuses, tax credits or deferred income tax incentives. The Task Force supports the concept of income stabilization savings accounts and believes there are several benefits of such a program.

1. Incentives for savings are self-help investments in farm income stability.

Farmer contributions to income stabilization savings accounts represent an investment–not an operating expense. The accumulation of annual contributions and compounded interest adds to asset growth on the farmer's balance sheet and represents a diversification in sources of income to further reduce net income risk for the farmer. The availability of self-help savings accounts allows the government to annualize a portion of ad hoc disaster program costs into farm income stabilization incentives over time–reducing unexpected government disaster program costs and enhancing the predictability of agricultural risk management program spending.

2. Deposits in Federally Insured Depository Institutions create economic vitality.

Contributions to a farm income stabilization savings account should be deposited in Federally Insured Depository Institutions to assure that farmer and government contributions are maintained in a secure manner. Self-help savings accounts have the potential to increase deposits that would then increase the lending capacity of many rural banks. This in turn represents increased potential for economic development in rural communities.

D. Greater Conservation Reserve Program Participation.

In general, the nation's farmers have appreciated the increased planting flexibility afforded by the 1996 farm bill. However, the increased prospects for agricultural exports have not played out due to unforeseen troubles in the Asian economy and other factors. As a result, good weather and large crops have the potential to provide excess capacity and overproduction. The Conservation Reserve Program (CRP) represents a *de facto* acreage reduction program that could ease the pressure of excess capacity on agricultural prices. The 1996 farm bill continued authority for CRP at 35 million acres. At the same time, the criteria for accepting acreage into the CRP shifted the focus from soil conservation to enhancing water quality. The currently enrolled acreage stands at about 31 million acres. In recent months, some agricultural leaders have called for increasing the CRP acreage authorization up to 40 million acres. The Task Force believes that increased authorization and funding for more CRP participation may be a cost-effective approach to addressing the potential for longer- term agricultural surpluses in an environmentally sound manner.

II. Create New Avenues for Local Bank Access to National Capital Markets.

The Task Force on 21st Century Agricultural Banking builds on the work of a previous ABA banker group that was focused on rural economic development. Like them, the Task Force believes there is growing evidence that several gaps exist in rural capital markets. After reviewing several options for supporting economically sound agricultural and rural development projects, the Task Force concluded that Congress must place a higher priority on closing rural capital market deficiencies.

Historically, the federal role in closing capital market gaps has been implemented through direct assistance and Government-Sponsored Enterprises (GSEs) with access to the “agency market.” GSEs include the Federal Home Loan Bank (FHLB) system, Farm Credit System (FCS), Fannie Mae, Freddie Mac, and Farmer Mac. The Task Force believes the public mandate and the appropriate role for GSEs are to work with and assist private sector institutions in closing the identified gaps in capital markets–not to compete with private sector institutions in retail markets. Unfair competition, inefficient resource use, and duplication of effort often result when GSEs compete directly with private sector institutions. The Task Force identified the following priorities for creating greater bank access and re-deploying GSEs to close gaps in rural capital markets.

A. Expand FHLB Authority, Expertise, and Flexibility.

The Task Force concluded that expanding Federal Home Loan Bank (FHLB) authority and linkage with banking networks in rural communities would help fill gaps in rural financial markets. The FHLB system has historically focused on underwriting home loans in urban markets. Expanding FHLB authority and linkage with banking networks would improve access to credit for business, housing and infrastructure for rural areas. Access to agency markets has been severely limited for many banks that operate in rural markets. The FHLB provides an efficient means of bringing lendable funds to rural America through commercial banks because the FHLB is able to sell debt in the agency market. The Farm Credit System (FCS) also sells debt in the agency market, but unlike all of the other GSEs, the FCS is a direct retail lender.

Expansion of FHLB authority would provide one step toward creating a level playing field in serving the broader capital needs of rural America.

1. Immediate action to expand FHLB authority.

As the deposit base erodes for many banks in rural communities, a number of viable rural development opportunities may be forgone due to barriers in accessing funding. Expanded access to the FHLB represents an additional source of liquidity for banks in rural communities to meet the credit needs of their local economies.

Banks play a key leadership role in rural economic development by being active in business, industrial, and infrastructure lending. Expanded FHLB access would permit banks in rural areas to match the maturity of the funding source with that of a rural development project, reducing interest rate risk to the borrower and the lending institution. Many banks are also familiar with FHLB loan procedures because they have used the system to support home loans and other limited loan activity. Linking the FHLBs and rural banks would be a good match that would enhance access to capital for rural America.

2. Immediate action to maximize the value of rural collateral.

Currently, the Federal Home Loan Bank System is revising its underwriting standards to better serve its emerging majority of bank members. FHLB expertise and historical underwriting standards have been designed for housing markets situated in urban areas. To successfully serve the unique needs of rural America several changes to FHLB service are required.

First, educational efforts to further develop rural capital market expertise are needed within the FHLB system. Banks from rural communities that are addressing a gap in the local capital markets should be able to utilize collateral beyond the FHLB's previous standards designed more for urban markets. In addition, the FHLB system needs to develop expertise in agriculture, rural business, and infrastructure financing.

Second, the FHLB system needs underwriting standards more appropriate for rural community development. If this is accomplished, banks using the FHLB could more readily serve loan requests typical of rural development infrastructure, technology-based businesses, and value-added agricultural projects.

Finally, expanded FHLB authority should not be limited to small business loans. Banks that serve rural community capital markets typically serve all market segments in the community.

B. Two Visions for the Future of the Farm Credit System.

The Task Force concluded that the Farm Credit System (FCS) has clearly been afforded substantial subsidies. It has been estimated that the FCS's corporate income tax subsidy in 1997 was approximately $350 million or 75 basis points per dollar of funds loaned. When additional tax advantages granted at the state and local levels are added along with the implicit subsidies received by FCS access to the "agency market," the total subsidy delivered to the Farm Credit System equals $600 to $800 million per year. This amounts to a pricing advantage of 150 basis points (or 1.5% APR) on the average FCS loan for agricultural purposes.

Recent changes in FCS lending practices suggest the FCS has targeted larger, well-established farm families that are in a strong financial position. Thus, government subsidies are going to larger, established farm families in strong financial position. Low income, small, beginning, and young farmers are less likely to receive FCS financing and therefore do not receive the benefit of the federal subsidy.

In 1999 the Farm Credit Administration (the regulator of the Farm Credit System) proposed a controversial new rule that will result in rapid consolidation within the Farm Credit System and abandonment of their original public purpose. The proposed rule, titled Customer Choice by the FCA, would allow FCS institutions to make loans outside of their designated territories. Serious public policy issues have been raised by the proposed rule. The Task Force believes that it is a waste of public resources and a serious safety and soundness issue for segments of a government sponsored enterprise to compete with itself and other private sector institutions. The FCA does not appear to be exerting their regulatory responsibilities. Instead, the FCA seems to be working to undermine the safety and soundness of the Farm Credit System. Left unchecked, the Farm Credit System may revisit the financial problems they encountered in the 1980's. The threat of renewed reckless lending by the FCS is a threat not only to the stability of rural America but to the American taxpayer as well.

In the final analysis, the FCS is using its unique tax advantages and GSE agency market advantages to "cherry pick" loans from private sector lenders. The FCS was created by Congress to fulfill capital market gaps for farmers and cooperatives in areas where credit was not available. The Task Force concludes there are two long-term options for the FCS. The first option is for Congress and FCS to refocus their mission to work with rural private sector lenders. The second option is to allow FCS institutions to become privately owned and capitalized institutions and to surrender their GSE status. For those FCS institutions that wish to remain part of the FCS, Congress should review the mission of the FCS in order to make sure that a public policy objective is being met.

1. Option 1: FCS becomes a source of liquidity for all rural lenders.

As outlined in the 1994 ABA Task Force report, *New Tools for Commercial Banks in Rural America*, there is potential for the FCS to enhance its role as a source of liquidity for rural banks in the Farm Credit Act of 1971. Under these provisions, commercial banks and other private sector lenders may form Other Financial Institutions (OFI). An OFI may, under very prescribed circumstances, borrow from Farm Credit Banks to support their lending to farmers, ranchers and producers or harvesters of aquatic products. Unfortunately, the inflexibility of the OFI structure precludes appropriate participation by non-FCS institutions. In 1994 the American Bankers Association recommended a more flexible reconfiguration of the Farm Credit System that would enable the FCS to provide wholesale funding to commercial banks for rural lending purposes.

Unfortunately, the FCS rejected this concept. The Task Force believes that this concept should be reexamined. If the FCS wishes to maintain its tax subsidies and agency market access, then it must provide a clearly recognized public benefit. Reconfigured to provide rural lenders with access to lendable funds, the government subsidies afforded to the FCS would be distributed more evenly to all farm borrowers, not just those currently targeted by FCS retail lenders.

2. Option 2: Allow the FCS to privatize.

If the FCS wishes to compete at all levels in the rural retail credit markets with private lenders, then its access to unfair tax subsidies and agency market status should be abolished. Privatizing would allow the FCS institutions to operate more freely, unencumbered by geographical boundaries and public mandates other than those experienced by other private sector lenders.

C. Place More GSE Emphasis on Closing Rural Capital Market Gaps.

GSEs perform an important role in providing an external source of funds for banks and closing the gaps in local capital markets. GSEs have been instrumental in creating standardized underwriting practices and fostering the creation of secondary markets. However, the benefits of GSEs have been disproportionately experienced in urban areas. To serve the needs of rural America, it is particularly important that GSEs make a greater commitment to rural America where unique gaps exist. In particular, underwriting standards and regulatory complexity should not arbitrarily restrict access for smaller loans and smaller lenders that are unique to rural capital markets.

1. Fannie Mae and Freddie Mac should expand efforts to serve rural housing markets.

Fannie Mae and Freddie Mac have traditionally been less involved in rural housing markets. While these GSEs have recently developed programs targeted to rural and under-served areas, they could play a much larger role. Today, only a small part of both GSE portfolios is based in rural America. Significant effort must be made to get Fannie Mae and Freddie Mac more involved in meeting the credit needs of rural home borrowers.

2. Farmer Mac should continue its important function in agricultural credit delivery.

The Federal Agricultural Mortgage Corporation (Farmer Mac) has a presence in rural communities through its participation in the secondary market for farm real estate mortgages and rural housing. Farmer Mac's impact is still small in the agricultural mortgage market, but it holds great promise. Through Farmer Mac, banks are able to extend fixed rate, long term real estate mortgages to their customers while passing interest rate risk to secondary market investors. The Task Force believes that Farmer Mac should continue its important function in the delivery of agricultural credit.

D. Support Efforts to Increase Availability of Rural Equity Capital.

For startup businesses and expansions, access to equity capital often means the difference between doing a project and not doing a project. Several studies indicate equity capital is less available in rural America compared to metropolitan areas. At the same time, new models of agricultural production (value-added cooperatives, producer alliances, producer networks, and supply chains) require significant amounts of equity capital. In rural areas, where capital gaps exist, bankers can transform enhanced access to equity capital into increased loans, jobs, and vitality for the rural economy. The Task Force recommends the following to improve rural equity capital access.

1. Regulatory flexibility for rural banks to enhance equity capital.

In general, banks have some flexibility to form special purpose entities called Other Financial Institutions (OFIs), such as bank Community Development Corporations (CDCs) or Small Business Investment Corporations (SBICs). However, the ability of smaller rural banks to form these special purpose entities is often severely constrained because of a regulatory limit

on bank capital that can be invested in these entities. The current limit is 5% and this limit effectively curtails the ability of rural banks to form bank CDCs and SBICs on a scale that is meaningful. The Task Force recommends that the capital limit for banks in rural and other under-served areas be increased, if they are well capitalized and if there are no supervisory concerns. This will provide greater flexibility to enhance rural equity without jeopardizing the safety and soundness of the bank.

Federal and state incentives for equity capital development should contain some targeting to rural America. Incentives designed to encourage investment may have little impact on equity capital availability in rural areas, unless they are specifically targeted and designed to do so. The Task Force recommends that future federal and state initiatives for encouraging equity capital should give some special targeting consideration to assure that rural America is not bypassed.

2. Banks are critical to the successful development of rural equity capital networks and entrepreneurs.

Banks serving agriculture and rural areas have long provided critical assistance in mentoring rural entrepreneurs. Rural business development centers and entrepreneur mentoring programs increasingly play a critical role in providing technology and technical assistance. As new initiatives are developed in the public sector, it is critically important that banks be involved to enhance opportunities for success.

For example, the USDA has maintained authority since 1996 to provide loan guarantees for eligible farmers who borrow funds from private lenders to capitalize new value-added cooperatives. This Cooperative Stock Purchase Program (CSPP) has been underutilized for two reasons. First, few bankers and farmers are aware of the program. Second, eligibility requirements and regulations have made the program impractical for most new fledgling cooperatives. The Task Force believes that this is just one example of how more could be done to enhance the public private partnership if the private sector was better integrated into the development and deployment of public initiatives.

E. Greater Flexibility for Banks to Use Innovative Forms of Business Organization.

Various innovative forms of business organization, such as Subchapter S corporations and Limited Liability Companies, are available to a wide range of businesses. In order to create greater opportunities to raise capital, banks should be provided greater flexibility and choice concerning organizational structure. Providing greater flexibility for banks serving rural America would stimulate more rural economic vitality.

III. Create Tools for New Ventures & Opportunities in Rural America.

Nationally, rural community populations possess a higher percentage of senior citizens. In many rural communities, those who are over age 55 increasingly hold businesses, farms and ranches. As a result, it is increasingly common for the control of capital to be transferred out of a rural community to estate heirs who live in metropolitan areas. As the number of families, relatives, and friends with control over accumulated wealth decline in rural America, potential capital gaps widen. The long-term impacts include reduced opportunity for creating new farming operations, new business ventures, and reduced ability to retain local entrepreneurs.

The Task Force identified two critical areas for strengthening and positioning rural America for the emerging challenges of the global economy (1) creation of new and updated tools for young and beginning farmers and (2) creation of more effective tools for new ventures and new opportunities in rural America. The specific recommendations include the following:

A. Aggie Bonds for Young Farmers and Rural Entrepreneurs.

Fifteen states currently administer state industrial revenue bonds for agricultural borrowers. They are commonly referred to as “aggie bonds”. Aggie bonds represent a cost-effective method of providing reduced interest rate loans to young and beginning farmers for capital purchases of farmland and equipment. Local lenders are able to offer below market interest rates to qualified young and beginning farmers because of the federal (and state) tax exemption on these bonds. Typically, a designated state agency issues the bonds and charges a nominal processing fee. Banks using the program are able to provide interest rates to the eligible beginning farmers that are one to three percent lower than commercial farm loan rates. The Task Force has four recommendations regarding aggie bond programs.

1. Educate the banking community about aggie bonds.

Currently, only bankers serving agriculture and rural communities in the 15 states with active aggie bond programs are likely to know very much about the use and value of these programs. As a result, there is a need for ABA to conduct a national training initiative for bankers serving rural capital markets in the other 35 states to learn more about the program.

2. Remove the federal industrial revenue bond cap on aggie bonds.

Unfortunately, aggie bonds are subject to a federal volume cap on industrial revenue bonds (IRBs) and must compete with industrial projects for bond allocation. This results in insufficient volume for aggie bond programs. In many states, aggie bond availability is severely limited and deserving young farmers and ranchers are not able to benefit from these bond programs unless they are at the right place at the right time. Opportunities that may exist for a beginning farmer at one point in time may not exist six months later during the next fiscal year. Arbitrary allocations have real impacts in terms of providing equal opportunity for beginning farmers and impose unequal hardship conditions on otherwise eligible beginning farmers. Timing of finance is often a critical factor in the acquisition of agricultural property.

State officials often favor using the state's IRB volume allocation on higher value industrial projects or housing that shows greater returns in the short run. Because aggie bonds are different from typical IRBs, they are often at a competitive disadvantage for receiving IRB allocations. In contrast to IRBs, aggie bonds cannot exceed $250,000 and the average size is less than $125,000. They are purchased by local lenders and are not rated, underwritten or sold into capital markets. In contrast, typical IRBs are used by corporations, issued in greater than million dollar amounts, are often underwritten, and sold to capital market investors. Within individual states, the IRB volume cap is often allocated to larger manufacturing and multi-family housing projects. Therefore, small beginning young farmers and startup businesses in rural and underserved areas are often left without adequate access to aggie bonds due to the federal IRB volume cap.

3. Allow USDA and SBA guarantees on aggie bonds.

Currently, banks that utilize aggie bonds are not allowed to secure a federal guaranty on the credit. Making aggie bonds eligible for USDA and/or SBA guarantees would sufficiently reduce repayment risk such that the borrower's interest rate could be reduced by a larger increment. Both USDA and SBA maintain that they are prohibited from providing a guarantee on a tax-exempt issuance. However, there is a precedent for this recommendation. Elements of the Farm Credit System are tax exempt, and yet the entire Farm Credit System enjoys access to USDA and SBA guarantees on loans they originate. Therefore, this recommendation represents a step toward creating a more level playing field in rural capital markets.

4. Expand trading of aggie bond authority.

Some states have begun to trade unused bonding authority. If aggie bonds are not exempted from the federal IRB volume cap, the Task Force believes many bankers would be interested in accessing unused authority that might exist in neighboring states.

B. USDA and SBA Loan Guarantee Programs for Young and Beginning Farmers and Rural Community Entrepreneurs.

The development of young and beginning farmers and rural community entrepreneurs is a fundamental necessity to ensure U.S. leadership in the emerging global agricultural markets and food industry of the future. As new trends in technology, market segmentation, specialization, and contractual integration accelerate the coordination and management of agricultural resources and markets will become more entrepreneurial and business oriented. In the past, young and beginning farmers have primarily entered production agriculture under the tutelage of parents, neighbors and relatives. Today an increasing number of beginning farmers are returning to the farm after accumulating capital, gaining experience, acquiring management skills, and being mentored in other farming operations, the food industry, or other segments of the economy.

Because the threshold for entry into agriculture has continued to rise, the Task Force believes that now is the time to evaluate the system for assisting young and beginning farmers and other rural community entrepreneurs. As discussed in Chapter I of this report, the Task Force believes USDA Guaranteed Loan Programs embody the essential tools for helping farmers and ranchers to access the credit needed during rough economic conditions in agriculture. FSA and SBA guaranteed loan programs are critical for helping young and beginning farmers to access the credit needed for entry into agriculture.

C. Expand Use of Linked Deposit Programs.

Several states–such as Texas, Ohio, and Iowa–have developed linked deposit programs specifically for assisting local banks with intergenerational transfer of existing rural businesses. In each case, a local bank accepts an application from a borrower who is eligible for the linked-deposit program. The borrower and bank submit an application to the appropriate state agency. The state agency agrees to deposit funds for a certificate of deposit (CD) in the local bank equal to the amount of the approved loan. The state accepts a below market interest rate on the

CD with interest payable at loan maturity. The Task Force believes that linked deposit programs are an important way that some agricultural and rural borrowers can be assisted in securing the capital they need at an affordable cost.

D. Reshape Education for Young Farmers and Rural Entrepreneurs.

Emerging trends in production agriculture require new and different approaches to education, training, and mentoring. Educational needs are becoming more specific to the enterprise and resources to be managed by the beginning farmer and rural entrepreneur. The Task Force identified the following needs for consideration in reshaping education, training, and mentoring programs.

1. Support programs that leverage information technology.

Today, commercial farmers and business people in the U.S. can access the best information resources anywhere around the globe to assist them in making better management decisions. Young and beginning farmers and rural community entrepreneurs must increasingly have access to the best information available via Internet and distance education to enhance the success of their operations. The Task Force supports efforts to leverage information technology for disseminating the latest in agricultural research, education and information to assure equal access for all producers and rural community entrepreneurs.

2. Create rural SBDCs and networks for young farmers and rural entrepreneurs.

Several industry groups, government agencies and universities are developing specific programs to provide the latest information regarding industry-specific developments for young and beginning farmers. The Task Force believes that banks would welcome the opportunity to partner with agricultural industries, agencies and universities for specific educational workshops that include marketing, farm accounting, financial and risk management. Furthermore, the Task Force welcomes opportunities to dialogue with agribusiness and farm interests, government agencies, universities, and policy makers on the lessons learned from Small Business Development Centers. These lessons may be useful in formulating similar strategies for developing young and beginning farmers.

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.

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