February 2017

Testimony of

Shan Hanes

On Behalf of the

AMERICAN BANKERS ASSOCIATION

before the

Agriculture, Nutrition and Forestry Committee

United States Senate

Testimony of

Shan Hanes

On behalf of the

American Bankers Association

before the

Agriculture, Nutrition and Forestry Committee

of the

United States Senate

February 23, 2017

Chairman Roberts, Ranking Member Stabenow, and members of the Committee, my name is Shan Hanes, and I am the President and CEO of First National Bank in Elkhart, Kansas. First National Bank is a $78 million bank with a main location in Elkhart, Kansas and one branch serving Rolla, Kansas and the surrounding area. We have 21 employees and we predominantly lend to the agricultural sector. Despite our small size, the bank is the largest lender in the county. We represent an average sized bank in rural Kansas.

I am also a member of the American Bankers Association's Agricultural and Rural Bankers Committee. I appreciate the opportunity to present the views of rural lenders and the impact of the Agricultural Act of 2014, better known as the 2014 Farm Bill.

The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits and extend over $9 trillion in loans. ABA is uniquely qualified to comment on agricultural credit issues as banks have provided credit to agriculture since the founding of our country. Over 5,000 banks – over 82 percent of all banks – reported agricultural loans on their books at year end 2015 with a total outstanding portfolio of over $172 billion.

The topic of today's hearing is very timely. There have been many successes within the 2014 Farm Bill that have directly affected agricultural lenders. However, the agricultural landscaped has changed considerably since the passage of the last Farm Bill. Agricultural lenders have often been the first group to feel the effects of the changing agricultural landscape, and the role that public policy has played in shaping that landscape.

The agricultural economy has been slowing, with farm sector profitability expected to decline further in 2017 for the fourth consecutive decline. However, farm and ranch incomes for the past five years have been some of the best in history. With the 2014 Farm Bill in place, farmers, ranchers and their bankers achieved a level of certainty from Washington about future agricultural policy. Interest rates continue to be at or near record lows, and the banking industry has the people, capital and liquidity to help American farmers and ranchers sustain through any turbulence in the agricultural economy.

Banks continue to be one of the first places that farmers and ranchers turn when looking for agricultural loans. Our agricultural credit portfolio is very diverse – we finance large and small farms, urban farmers, beginning farmers, women farmers and minority farmers. To bankers, agricultural lending is good business and we make credit available to all who can demonstrate they have a sound business plan and the ability to repay.

In 2015, farm banks – banks with more than 15.5 percent of their loans made to farmers or ranchers – increased agricultural lending 7.9 percent to meet these rising credit needs of farmers and ranchers, and now provide over $100 billion in total farm loans. Farm banks are an essential resource for small farmers, holding $48 billion in small farm loans, with $11.5 billion in micro-small farm loans (loans with origination values less than $100,000). These farm banks are healthy and well capitalized, and stand ready to meet the credit demands of our nation's farmers large and small.

In addition to our commitment to farmers and ranchers, thousands of farm dependent businesses – food processors, retailers, transportation companies, storage facilities, manufacturers, etc. – receive financing from the banking industry as well. Agriculture is a vital industry to our country, and financing it is an essential business for many banks, mine included.

Banks work closely with the USDA's Farm Service Agency to make additional credit available by utilizing the Guaranteed Farm Loan Programs. The repeal of borrower limits on USDA's Farm Service Agency guaranteed loans has allowed farmers to continue to access credit from banks like mine as they grow, ensuring credit access for farmers across the country.

We remain concerned with certain areas of the agricultural credit market. In particular, we are worried that the Farm Credit System – a government sponsored entity – has veered away

from its intended mission and now represents an unwarranted risk to taxpayers. The Farm Credit System was founded in 1916 to ensure that young, beginning, and small farmers and ranchers had access to credit. It has since grown into a $315 billion behemoth offering complex financial services. To put this in perspective, if the Farm Credit System were a bank it would be the ninth largest in the United States, and larger than 99.9 percent of the banks in the country.

This system operates as a Government Sponsored Entity and represents a risk to taxpayers in the same way that Fannie Mae and Freddie Mac do. It benefits from significant tax breaks – valued at $1.3 billion in 2015 – giving it a significant edge over private sector competitors. Moreover, the Farm Credit System enjoys a government backing, formalized by the creation of a $10 billion line of credit with the U.S. Treasury.

The Farm Credit System has veered significantly from its charter to serve young, beginning, and small farmers and ranchers, and now primarily serves large established farms, who could easily obtain credit from the private sector. In fact, the majority of Farm Credit System loans outstanding are in excess of $1 million. Any farmer able to take on over $1 million in debt does not need subsidized credit. Moreover, the volume of small borrower loans accounted for 14 percent of all new Farm Credit System loans in 2015.

Our nation's farmers and ranchers are a critical resource to our economy. Ensuring that they continue to have access to adequate credit to thrive is essential for the wellbeing of our whole nation. America's banks remain well equipped to serve the borrowing needs of farmers of all sizes. An important step in ensuring credit availability is to review entities such as the Farm Credit System and ensure that they stick to their charter of helping young, beginning and small farmers.

In my testimony today I would like to elaborate on the following points:

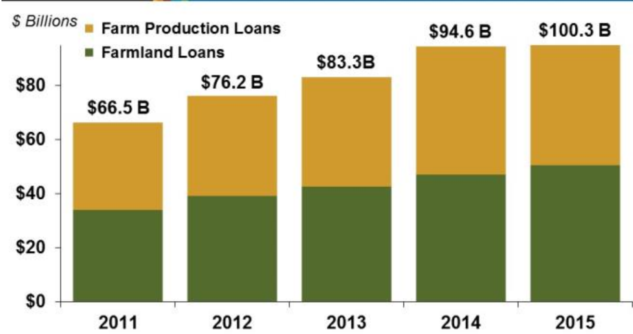
- Banks are a primary source of credit to farmers and ranchers in the United States.;
- The 2014 Farm Bill was successful by supporting crop insurance, the conservation reserve program and by removing term limits on USDA Guaranteed Farm Loan Programs. However, the next Farm Bill will require some necessary changes to Agriculture Risk Coverage (ARC) and Price Loss Coverage (PLC) programs, especially on the timing of payments;

- Banks work closely with the USDA to make additional credit available via the Guaranteed Farm Loan Program but there is a need to increase the loan cap within these programs;
- The Farm Credit System has become too large and unfocused, using taxpayer dollars to subsidize large borrowers and congress should consider legislation that would level the playing field with the Farm Credit System.

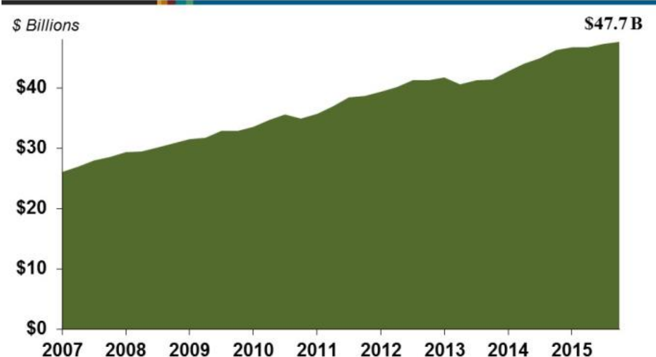
I. Banks Are a Primary Source of Credit to Farmers and Ranchers in the U.S.

For my bank and for many ABA members, agricultural lending is a significant component of their business activities. ABA has studied and reported on the performance of "farm banks" for decades and, we are pleased to report that the performance of these highly specialized agricultural lending banks continues to be strong. ABA defines a farm bank as one with more than 15.5 percent farm or ranch loans (to all loans).

At the end of 2015, there were 1,976 banks that met this definition. Farm lending posted solid growth during 2015. Total farm loans at farm banks increased by 7.9 percent to $100.3 billion in 2015 up from $94.6 billion in 2014. Approximately one in every three dollars lent by a farm bank is an agricultural loan.



Farm real estate loans grew at a faster rate than farm production loans. Outstanding farm real estate loans grew at a pace of 9.1 percent, or $4.2 billion, to a total of $50.6 billion. Farm production loans rose by 6.6 percent, or $3.1 billion, to $49.8 billion. Farm banks are a major source of



credit to small farmers – holding more than $47.8 billion in small farm loans (origination value less than $500,000) with $11.5 billion in micro-small farm loans (origination value less than $100,000) at the end of 2015. The number of outstanding small farm loans at farm banks totaled 761,192 with the vast majority – over 496,200 loans – with origination values less than $100,000. Farm banks are healthy and well capitalized and stand ready to meet the credit demands of our nation's farmers large and small.

Equity capital —often thought of as the strongest form of capital—at farm banks increased 4.9 percent to $47.7 billion in 2015. Since the end of 2007, farm banks have added $19.5 billion in equity capital, building strong high-quality capital reserves. These capital reserves will enable farm banks flexibility as the agricultural sector adjusts to lower commodity prices — allowing bankers to work with and serve the needs of our nation's famers — and will also act as a buffer, proving insulation from the risks associated with any downturn in the agricultural sector.

One area of concern for farm bankers and their customers has been the rapid appreciation in farmland values in some areas of the country. The run up in farmland values has not been a credit driven event. Farm banks are actively managing the risks associated with agricultural lending and underwriting standards on farm real estate loans are very conservative. The key consideration in underwriting any loan is the ability of the customer to repay regardless of the collateral position in the loan. To further manage risk, we regularly stress test our loan portfolios to judge repayment capacity under different scenarios.

After several years of large increases in farmland values, the consensus view among bankers I know is that the increase in cropland values has slowed. USDA estimates of lower commodity prices for the third consecutive year in 2016 seem to have modestly cooled off the demand for farm real estate. We watch the farm real estate market very closely, as do my customers. In recent years, over four-fifths of the agriculture sector's asset values were held in real estate. USDA estimates a 1.2 percent decline in the value of farm real estate in 2016.

II. The Agricultural Act of 2014 Had Many Successful Components, But Improvements Remain Necessary

One success of the 2014 Farm Bill was the continued support of crop insurance programs. Agricultural lenders use crop insurance as a guarantee to help secure financing for operating credit. With crop insurance, a lender has the ability to provide support based on individual producers' proven crop yields. This allows lenders to tailor a loan to a producer's operation and allow for year-to-year adjustments within that operation. Without crop insurance acting as a safety net, producers would be in a much more challenging financial situation in the event of disaster. Crop insurance has allowed lenders to provide the best possible terms for operating loans because it helps to lower the risk for the lender. ABA has been a long-time supporter of crop insurance programs and would like to see the programs expanded to help as many producers as possible.

Another success of the 2014 Farm Bill was the continuation of the Conservation Reserve Program (CRP). CRP is vital in rural areas as it provides another use for land that may be otherwise unsuitable for farming. From a lender perspective, CRP is another tool in the toolbox for landowners to use when they are trying to diversify their holdings. Additionally, CRP can provide a steady stream of income for producers, especially older producers.

I would like to thank Congress, especially the Agricultural Committees, for repealing borrower term limits on USDA Farm Service Agency guaranteed loans in the 2014 Farm Bill. Term limits restricted farmer access to capital, and with the expansion of the farm economy over the past ten years, there are some farmers who are not able to obtain credit from banks like mine without a guaranty from USDA. The USDA's Farm Service Agency guaranteed loan program has been a remarkable success. Today, nearly $12 billion in farm and ranch loans are made by private sector lenders like my bank and are guaranteed by the USDA. There are nearly 43,000 loans outstanding – of course some farmers have more than one guaranteed loan, so this number is not to be confused with the number of individual farmers and ranchers, but the numbers of individuals accessing credit under this program is very significant.

This program has grown over the past five years, with less than $9 billion outstanding at the close of FY 08 to nearly $12 billion today. The loans made by banks like mine under this

program are modest in size. The average outstanding guaranteed real estate loan is $439,000 and the average outstanding guaranteed non real estate secured loan is $250,000. Clearly, we are reaching customers who have modest-sized operations, who are in the process of starting their farm or ranch operation, or who are recovering from some sort of financial set-back. Despite the fact that these customers do not have either the earnings or collateral to qualify for conventional credit, losses in the program have been extremely small. Over recent fiscal years losses have ranged from a high of 0.6 percent in FY10 to a low of 0.3 percent in FY13. These are extremely low losses – especially for customers who are perceived to be a higher risk than other customers, hence the need for the USDA credit enhancement. Bankers who utilize the guaranteed farm loan programs offered by USDA know what they are doing and work very closely with their farm and ranch customers to properly service these loans. The Farm Service Agency deserves a great deal of credit for administering such a successful public/private partnership. We urge you to continue to support this very worthwhile program.

I want to reiterate that the 2014 Farm Bill was very successful from a lender's perspective. However, there are some substantial changes from the lender's perspective that need to be considered as Congress starts working on the next Farm Bill.

When the 2014 Farm Bill was written and approved, commodity prices were considerably higher than after implementation of the programs. As you are aware, the 2014 Farm Bill required that the producer make a one-time election between the Agriculture Risk Coverage (ARC) and Price Loss Coverage (PLC) programs. This become problematic because while producers were making the election in July 2013, corn futures were over $7 per bushel, with wheat futures were over $9 per bushel. Now, corn is less than $4 per bushel, and wheat $4.50 per bushel. This dramatic drop in prices could not be foreseen by any producer.

Coupled with the drop in prices, the decision to use county yields instead of state yields should have provided assistance to the individuals most in need when yields were low, but this was often not the case. Instead, due to the variability in National Agriculture Statistics Service (NASS) data, two fields on each side of a county line, may have drastically different payments, with my customers seeing the difference as high as $90 per acre. Additionally, from a lender's point of view, NASS data has not been as accurate as data from the Risk Management Agency (RMA), which led to difficulties in yield calculations.

While crop prices and a one-time program election were both issues, the timing of payments greatly impacted lenders. Payments could not be calculated until the final county yield was determined and the marketing year was complete. This means producers do not receive payments during the same year in which the crop was planted, and lenders were left to deal with the fallout of this timing issue. For example, we are currently completing renewals for our farm customers. We look at their financial progress for 2016 and set their operating lines for 2017. However, we cannot calculate 2016 payments until October of 2017. From a lender perspective, this has caused a real problem with our regulators, as we cannot use a payment that may be received a year later in the profits calculation for this year. Furthermore, lenders should not be making educated guesses on what payment might be received. Instead, there should be certainty within the programs to allow for an accurate calculation.

III. Banks Work Closely With the USDA's Farm Service Agency to Make Additional Credit Available by Utilizing the Guaranteed Farm Loan Programs

As I mentioned before, the removal of term limits on USDA's Farm Service Agency Guaranteed Loan Programs was a much needed reform to the Guaranteed Loan Programs. However, the current loan limit of $1.399 million on Guaranteed Operating Loans (GOL) and Guaranteed Farm Ownership Loans (GFO) is simply not keeping pace with the growing cost of agriculture. It is much more costly for a young, beginning or small farmer to get into agriculture, and the guaranteed loan programs need to reflect this reality. ABA has endorsed H.R. 831, the Beginning Agriculturist Lifetime Employment Act of 2017 (BALE Act). This legislation would increase the cap on GFOs and GOLs to $3.5 million. We believe this increase is necessary to ensure lenders are able to assist as many producers enter and grow into the future of agriculture.

With any increase to Guaranteed Loan Programs, there will need to be an increase in funding for the programs. Unfortunately, there has been a shortage of funds for the past three years, so it is vital that the necessary funds are appropriated for the programs in advance. These programs continue to create a great public-private partnership between lenders and USDA, and future funding should reflect the strength of the programs.

IV. The Farm Credit System has become a Large, Unfocused Government Sponsored Entity at the Expense of American Taxpayers

I mentioned earlier in my testimony that the market for agricultural credit is very competitive. I compete with several other banks in my service area, finance companies from all of the major farm equipment manufacturers, several international banks, credit unions, life insurance companies and finance companies owned by seed and other supply companies to name a few. The most troublesome competitor I face is the taxpayer-backed and tax-advantaged federal Farm Credit System (FCS). The FCS was chartered by Congress in 1916 as a borrower-owned cooperative farm lender at a time when banks did not have the legal authority to make long-term farm real estate loans. Over the ensuing 100 years the FCS has received numerous charter enhancements, and has ventured into areas that are not appropriate for a farmer-owned farm lending business.

Today *the FCS is a large and complex financial services business with $315 billion in assets.* If it were a bank, it would be the ninth largest bank in the United States. It is tax-advantaged and enjoyed a combined local, state, and federal tax rate in 2015 of only 4.2 percent—a rate lower than what 75 percent of American taxpayers pay. The tax advantages enjoyed by the FCS in 2015 was worth $1.296 billion or 28 percent of the Farm Credit System's net income in 2015[1].

Today's Farm Credit System is a large, unfocused Government Sponsored Entity presenting the same kind of potential threat to the American taxpayer as Fannie Mae and Freddie Mac. As a Government Sponsored Enterprise (GSE) like Fannie Mae and Freddie Mac, the American taxpayer is the ultimate back stop should the Farm Credit System develop financial problems. This reality was formalized in 2013 when the Farm Credit System Insurance Corporation arranged a $10 billion line of credit "with the Federal Financing Bank, a federal instrumentality subject to the supervision and direction of the U.S. Treasury – to which the Federal Financing Bank would advance funds to the [Farm Credit System] Insurance Corporation. Under its existing statutory authority, the [Farm Credit System] Insurance Corporation will use these funds to provide assistance to the System Banks in exigent market

[1] Federal Farm Credit Banks Funding Corporation; 2015 Annual Information Statement of the Farm Credit System; March 7, 2016. Page F-3

circumstances which threaten the Banks' ability to pay maturing debt obligations. The agreement provides for advances of up to $10 billion and terminates on September 30, 2014, unless otherwise extended."[2] The agreement has been extended each year since.

We believe the farmers who own stock of the Farm Credit System—and the American taxpayers who back it—deserve a better understanding of what transpires between the Farm Credit System and the U.S. Treasury, but very little information is available to the public. Unlike the housing GSEs which are subject to reform efforts to lessen the taxpayer's exposure, the Farm Credit System seems to be increasing its dependence upon the U.S. Treasury.

Congress created the Farm Credit System as a public option for farm finance when farmers were having trouble getting the credit they needed from non-government sources. The conditions that led to the creation of the Farm Credit System nearly 100 years ago no longer exist, and yet we continue to have a government assisted, tax advantaged farm lender providing credit to customers who would be able to easily borrow from taxpaying institutions like mine. In fact, the heavily subsidized credit that FCS lends goes to those who need it least. Despite amendments to the Farm Credit Act of 1980 requiring each FCS lender to have a program for furnishing credit to young, beginning and small farmers and ranchers (YBS), the share of new YBS loans to total new FCS loans continues to ***be dismal***—even as the assets of the system have expanded enormously. Loans to small farmers have steadily drop over the past several years with small farm loans declining from a high of 30 percent of total new loan volume in 2003[3] to just 14.1 percent in 2015. Clearly, those who would benefit the most from the taxpayer subsidized credit made available by the FCS are not receiving the benefits that Congress intended them to receive.

Conclusion

The banking industry is well positioned to meet the needs of U.S. farmers and ranchers. U.S. agriculture has begun to adjust to lower commodity prices after enjoying one of the longest periods of financial prosperity in history. USDA projected that at year-end 2016, farm and ranch solvency ratios — debt-to-asset and debt-to-equity ratios — would rise to 13.23 and 15.25

[2] Federal Farm Credit Banks Funding Corporation; 2013 Annual Information Statement of the Farm Credit System; February 28, 2014, page 23
[3] "FCA's Annual Report on the Farm Credit System's Young, Beginning, and Small Farmer Mission Performance: 2013 Results". Office of Regulatory Policy, June 12, 2014 Board Meeting

percent, respectively. Even as these measures have increased, each remains low relative to historical levels. During the past few years, while farmers experiences unprecedented high commodity prices and rising farm profits, farmers used their excess cash profits to retire debt and to acquire additional equipment and land. As a result, farmers and ranchers today have the capacity to tap their equity should there be a decline in farm profitability resulting in diminished cash flows. While no farmer or rancher wants to take on additional debt, the strength of the U.S. farm and ranch balance sheet gives producers options to do so if the need arises.

The banking industry remains cautious as it looks forward to the next Farm Bill. There is a very real concern that declining commodity prices will negatively affect the farm economy and make credit situations tighter. This is why the banking industry will continue to be involved in the Farm Bill process and will continue to offer assistance to Congress as it writes the next Farm Bill. With the changes that have been outlined earlier, the banking industry will continue to help producers remain strong into the future. Bankers still see great opportunities in agriculture and will stand with their partners in agriculture to develop the best Farm Bill for all.

Thank you for the opportunity to express the views of the American Bankers Association. I would be happy to answer any questions that you may have.