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The Intersection of Farm Credit and Farm Policy

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The Current Situation

The fall of 2008 is witnessing the implementation of a new farm bill combined with the turbulent, if not crisis, situation in the financial and credit markets. These two events are not without interaction, as historical farm program provisions have played a critical role in the ability and capacity of farmers to obtain credit.

The historical motivation for government intervention in agriculture comes from the social need to ensure an abundant and dependable supply of food and fiber. As such, we have a long history of supporting agricultural production by supporting the farmer's profit capacity. It takes no leap of logic to see that agricultural lenders have an interest and stake in the underlying support provided to their borrowers. Insurance products, safety nets, and direct government support to farmers translate into guarantees, collateral, and reduced risk for agricultural lenders.

While congress passed a bailout plan to re-establish the efficient flow of credit, markets remain extremely volatile; and we still expect tighter credit, higher term interest rates, and higher credit standards moving into the 2009 crop year. As we look forward to implementing a new farm bill and uncertain credit markets, it is useful to examine the potential impacts one has on the other.

The Connection between Credit and Policy

Starting with the most direct connection between farm policy and credit are the programs that intend to ensure the availability of financing for farmers and ranchers. The USDA through the Farm Service Agency (FSA) stands as the "lender of last resort" to provide direct loans to producers that can not obtain credit elsewhere. In addition, many loan programs are made available to provide financing and/or more affordable term financing to certain segments, such as young or beginning farmers. FSA also provides underwriting or guarantees for farm & ranch loans, reducing the risk of commercial lenders' portfolios and ensuring the availability of credit for agricultural production.

Traditional government commodity programs have also been instrumental in credit decisions. The loan rate program effectively creates a minimum price upon which a producer (and therefore his lender) can rely. In commodity markets where prices are uncertain, knowing the worse case scenario on the price received component of a farmer's ability to repay an operating note alleviates some aspect of the credit risk. Similarly, the historical target price programs and the recent counter-cyclical payment program offer a source of added revenue to the farmer when prices fall, again reducing at least a portion of the lender's risk in financing crop production. In 1996, fixed direct payments where added to the policy tools providing support to production agriculture. Direct payments,

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being certain well in advance, provide potential collateral for operating loans, thus reducing lender risk.

While crop insurance is not often considered in the context of farm bill provisions, the subsidized premiums for crop insurance have helped create a tool that might otherwise not be available to agriculture. Agricultural lenders have used crop insurance to further reduce loan default risk by requiring for some borrowers to purchase at least a minimal level of crop insurance.

Most of the tools supporting the production of the country's food and fiber on the surface seem to have the greatest impact on the credit risk of short term operating loans. However, the impact goes much deeper. The history, current existence, and anticipation of future government support for agriculture provides at least some level of comfort concerning the repayment capacity on intermediate term loans for equipment as well as long term loans for agricultural land.

Changing Commodity Markets

In addition to the recent derailing of the credit markets, significant losses on Wall Street, and signals of declining domestic and global economies, agriculture has also experienced dramatic changes in commodity prices and production costs over the last few years. How will these changes along with a new farm bill interact with agricultural credit?

Although we have seen some retreat recently, agricultural commodity prices have skyrocketed over the last several years. While cotton and peanut prices have remained in the neighborhood of traditional loan rate and target price levels, the food and feed grain complex has risen to record levels. At the same time, the demand push to plant more acres and rising energy cost have also raised the cost of production to record levels. Consider the following ballpark figures for corn. In 2006, it took around $1.50 in variable expenses to produce a bushel of corn, and that bushel eventually fetched a handsome $3.04 in the market. Now, consider the credit relationship during that growing season. Many agricultural lenders would have loaned the operating money (about $1.50/bu.) with the safety of knowing the loan rate would ensure the producer at least $1.95 per bushel. Consider the 2009 crop, the same $1.95 loan rate does not cover an expected variable cost in the range of $2.50 per bushel. Most expectations would suggest that the 2009 market should provide a per bushel return above the $2.50 variable costs, but when it comes to evaluating credit risk in today's environment, expectations and suggestions provide no security. Over the same 2006-2009 time period, the variable cost of production for cotton has increased from around $0.46/lb to almost $0.74/lb. A cotton loan rate of $0.52/lb. does not sufficiently secure an operating loan in the neighborhood of $0.74/lb. Additionally, the overall profit potential is very slim, calling into question the repayment capacity for longer term loans tied to cotton production. This environment, in conjunction with the reduced supply of liquidity in the financial markets, suggests that agricultural lenders should be looking more intently at credit ratings, repayment capacity, and equity positions.

Potential Help from the 2008 Farm Bill?

While the levels of commodity loan rates and target prices for some crops seem to be less relevant, the 2008 Farm Bill provides two new programs that have the potential to re-establish some sense of certainty for agricultural operating loans. However, the rules for both programs are yet to be determined and each appears to provide a positive but potentially less direct effect on credit risk.

The ACRE Program

The Average Crop Revenue Election (ACRE) program provides a payment to producers by crop and by farm in the case where both state level revenue and the individual farm revenue fall below specified trigger levels. The program has provisions for adjusting the trigger levels each year based on moving averages of commodity prices and revenue; therefore, it is designed to scale to changing market and yield levels over time. The scaling concept means that the trigger or guarantee level of revenue has a good chance of being relevant compared to the level of operating money borrowed to produce a crop. Another benefit is the apparent flexibility to decide which crop to plant on ACRE enrolled base acres each year. Production on land in excess of base acres will not be eligible. On the downside, the revenue protection is not a complete guarantee for the producer or lender. It is entirely possible for a producer to realize a revenue shortfall relative to their own revenue trigger and receive no payments because the state revenue did not fall below the state trigger. The ACRE payment timing may also take away from its potential to alleviate credit risk. The final calculation of revenue, and therefore any payment, is not possible until the end of the crop marketing year. By that time, a producer and lender are well into the next year's crop and operating loan. It is important to note the ACRE payment benefit is capped at 25% of the ACRE revenue trigger level.

Finally, signing up for the ACRE program has a cost. A producer must give up 20% of the direct payment, which many lenders have come to rely upon as a source of collateral. Additionally, enrolling a farm in ACRE means accepting a 30% reduction in loan rates for that farm's production. These costs may be significant, not only in absolute value, but in losing the credit risk reduction provided by direct payments and loan rates.

The SURE Program

Another new provision of the 2008 Farm Bill is a permanent disaster program known as SURE (Supplemental Revenue Assistance Payments). Like ACRE, the idea of the SURE program is to provide benefits for losses in revenue. Intended for disaster situations, SURE covers a person's entire operating revenue rather than a single enterprise or farm. Essentially, a whole farm revenue guarantee is established at 115% of the implied guarantee of purchased crop insurance (using price and yield elections along with proven yields). The program requires the purchase of crop insurance and will make up 60% of difference when actual farm revenue falls below the guarantee. Actual farm revenue in this case includes indemnities, crop value, 15% of direct payments, and all other government payments. Whether SURE will provide any security to a farm's operating line of credit is uncertain. While it does establish a disaster program that is formula driven rather than requiring the passage of legislation for every disaster, benefits still require the declaration of a disaster for the county by USDA and benefits are limited, so larger farms would see less value. The newness and complexity of the program suggest it will take some time before SURE will have any significant impact on credit risk and perceived repayment capacity.

Other Considerations

Payment to individuals are limited for both ACRE and SURE. Additionally, the structure of payment limit is changing with the 2008 farm bill. While the structure is changing to direct attribution to individuals, the overall level of limitation is similar (especially for married couples) to the past. However, to the extent that some producers' government program benefits may be more restricted, credit repayment capacity could be diminished. One potential change on the horizon could have longer term impacts on the future of farm program benefits. With ever increasing federal budget deficits, it is reasonable to presume that budget reconciliation legislation may be debated in the coming years. The possibility of a reconciliation calling for spending cuts in the farm bill brings into question the longevity of program benefits at their current levels.

Credit Outlook

The 2009 combined environment of tighter credit markets, volatile commodity prices, escalating agricultural production costs, and changing farm policies will, at a minimum, cause agricultural lenders to be more cautious. As some of the traditional farm policy provisions may be providing less support for credit repayment and the 2008 farm bill provisions are untested in the eyes of lenders, we would expect a tighter credit situation in the coming year. In addition, some lenders may have no choice but to ration the limited supply of credit to which they have access in the financial markets. For the 2009 crop, expect lenders to ask more of their borrowers, both in the form of collateral and a solid production year plan proving repayment capacity. Crop insurance, although much more expensive with higher commodity prices, may be more important in the credit equation than ever. Revenue products like Crop Revenue Coverage (CRC) may provide the most security with the ability to cover an individual's revenue in higher valued commodity markets. Farm Service Agency loan guarantees may also be in higher demand. These guarantees usually require more time and paperwork, but they can protect a lender's balance sheet. So, the bottom line is plan ahead, plan well, and start the conversation with your lender sooner rather than later.