AEI PREMIUM

AEI Presents Nothing Borrowed, Nothing Gained: How Farm Financing Works, and When it Doesn't or The Countercycle and the Future of Ag Lending

Episode 4: Credit Where Credit is Due

Sarah Mock: This is *Nothing Borrowed, Nothing Gained*: The story of ag lending; past, present, and future. I'm Sarah Mock. Considering we here at AEI.ag presents made a podcast about the 1980s farm crisis just two years ago, it might be surprising to some of you how much we've talked about it this season. The thing is though, that era did fundamentally transform the way we think about credit and debt in the farm economy. But maybe the most surprising thing is, the 1980s weren't even the first time that the U.S. have encountered a catastrophic failure in ag lending and made a big effort to fix it. The first occasion, arguably, was over 100 years ago. Here's John Blanchfield, our resident ag historian:

John Blanchfield: The first government-sponsored enterprise created was in 1916 of all times and it created through the Federal Farm Loan Act the farm credit system.

Sarah Mock: A lot about agriculture has changed since Congress first legislated the farm credit system into being. But what hasn't changed is the organization's mission - to provide reliable and consistent credit and financial services to American agriculture. But the path to becoming America's oldest government-sponsored enterprise hasn't always been a smooth one. Understanding the story of the farm credit system, how it was created, how it has grown, how it almost fell apart is critical to understanding how it fits into our current ag lending landscape and what risks and opportunities it will bring as the farm economy moves toward a much more uncertain future. So that's our goal for today – to learn what farm credit is and how it works, to understand how it's different than the banking system, and to learn more about how its unique features both helped and hindered the system during its moment of crisis in the 1980s.
To give us the farm credit background we'll need, let me introduce you to someone who's spent most of their career within the Farm Credit orbit.

Jim Knuth: Yeah, it's Jim Knuth and my title is senior vice president of business development.

Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

Sarah Mock: Jim is a born and raised Iowa farm kid, who worked community banks for a decade, starting in the 80s, before he made his way to Farm Credit Service of America in 1996. Despite the organization's longevity, he still hears a lot of misconceptions from both farmers and ag professionals about farm credit. For example, about their current relationship to the federal government.

Jim Knuth: Today, you know, we are not part of the government. We're not funded by the government. We're private, for-profit cooperatives across the United States. We all have territories and we're a farmer-owned cooperative - in other words, we're owned by our customer rancher farmer members. All banks, including us, pay dividends, we simply pay them back to our customer owners. It's called patronage on a cooperative side; the cooperative model means though that we don't have to worry about quarterly earnings or Wall Street or shareholders and ultimately, we can make good long-term decisions for the benefit of our customer owners and our organization.

Sarah Mock: If you want to know how farm credit is different from, say, your local bank, these are some big ones. But there are also some more complicated differences - like the fact that farm credit's original mission, as set by Congress, dictated that they will be fully dedicated to agriculture and rural America, which substantially limits the scope of their lending activities as compared to banks.

Jim Knuth: So, we can only advance funds for the purpose of agriculture. We don't do microchips; we don't do high-rise buildings in the middle of a city - things that other lenders certainly would have the capability of doing. But in terms of what we lend versus other lenders it's the same. Other lenders lend money for a farm purchase for equipment, machinery purchases, for operating purposes, cash rent or seed, or fertilizer - the same as us. We're a 100% dedicated to agriculture. It's all that we do, whereas banks have the ability to finance many types. industries, business, consumer purposes, et cetera so, they're more diversified, we're more specialized.

Sarah Mock: But farm credit's niche focus isn't its most important characteristic, what really sets farm credit apart is not how it lends its money but how it gets the funds in the first place.

Jim Knuth: We are a credit only institution as opposed to banks, which are depositories. So, the first question is where do you get your money? And the answer is

----
Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

we have funding banks that in turn, also work with the funding corporation, and then they sell our bonds to both, domestic and international investors.

Sarah Mock: O.K., that got in the weeds fast. The long and short of this is, the farm credit system gets to sell bonds to raise money. Bonds are kind of like a savings account, but instead of putting however much money you want into the bank and being able to retrieve it whenever you want, a bond costs a set amount, and can be redeemed after a certain period of time for the same amount plus interest. Farm credit bonds mature in one year, 30 years, or any number of years in between. You could buy a fixed rate farm credit bond today, if you've got $1,000, or a floating-rate version, if you've got a $100,000. Theoretically, this means the farm credit system has unlimited access to capital, as long as they can continue to find investors to purchase their bonds. But farm credit's secret sauce traces back to that original government sponsorship.
Here's Brent:

Brent Gloy: The farm credit system sells bonds on Wall Street, which means that basically, investors give them money to lend to farmers and the investors charge them so much and they have to lend it out to farmers at a higher rate to make their profits. Now the unique thing about the farm credit system is they get to do something very special and that's they get to sell those bonds in something called the government agency market, which, the federal government borrows money, at a very favorable rate, the best rates of anybody in the economy. Government agencies get to borrow it very close to that rate. Maybe just a little bit higher, because there is only an implicit guarantee placed on those bonds so, there's no explicit guarantee. The government doesn't say, "If this agency market participant can't pay their loan back, we will cover it." It's only an implicit guarantee. The market believes that if say the farm credit system or Fannie Mae or whoever it might be, can't make their payments the government will cover it. And of course, that's now been proven to be the case. They're viewed as virtually risk-free.

Sarah Mock: These are the characteristics of a government-sponsored enterprise or GSE. Organizations that exist in a gray area with some private-like characteristics but with the implied backing of the federal government and with access to some special privileges. All of this makes farm credit bonds a top-rated investment – meaning there's extremely little risk of investors not getting their money back. Being able to raise funds from bonds rather than deposits makes a

----
Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

difference not only in the amount of capital that can be raised but also in how it's affected by market forces.

Jim Knuth: Really the difference is a lead lag kind of scenario. So, in other words, because we sell bonds, we lead. In other words, if interest rates are going up, ours will go up immediately because of the market and when interest rates go down, ours will go down immediately. Whereas banks will always lag. In other words, if they have low deposit costs, their deposit costs will lag as they start to go up, then pay more on money markets and CDs and vice versa, when things go down, their deposit costs are higher, and it takes a little time for them to come down.
Ultimately, it probably is a washout at the end of the day. We lead both ways, they lag both ways and each one has a benefit on one side and a little bit of a negative on the other side.

Sarah Mock: To go along with their GSE status, farm credit also has its own specialized regulator. This group is called the Farm Credit Administration.

Jim Knuth: Typically, banks are regulated once a year, we have examiners who come in look at loans, look at your whole institution – safety, soundness, practices all of that - the same bar for us. Again, our regulator is very used to working with agricultural lenders so in many ways they know what to look for in terms of safety and soundness. We have classifications just like banks do – trouble assets, accrual, we have loan losses. The business of lending is very similar to a community bank, regional bank, or national bank. Ultimately, we have good competition in the agricultural space and frankly we're not big enough to serve all of agriculture but the community banks, regional banks would have trouble serving all of agriculture. So, it's really been a healthy business dynamic for more than 100 years.

Sarah Mock: Listen, if you happen to work or around in the ag lending sector, I'm sure right now you're doing something between rolling your eyes and full-on yelling at your listening device about this really admirable gloss-over of the often tense and disputed relationship between farm credit and banks. For fairness's sake I want to offer the perspective of a non-farm credit lender here too both on the business and the regulatory differences between banks and farm credit. Please welcome Curt Covington, someone who's spent their whole career in the ag lending space and who's currently at Ag America. As you're about to hear, he's a familiar voice. He's been reminding us that the good times never last at the

----
Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

end of every episode so far. You'll hear more from him in a few weeks. But, for now, I've had him offer his perspective on what exactly farm credit's special treatment can mean to ag bankers.

Curt Covington: So, the farm credit system is regulated by the farm credit administration, which in turn is governed by Congress. Commercial banks on the other hand they're governed by regulatory bodies and that might be the Office of the Controller of the Currency, the FDIC, the U.S. Treasury, state banking regulators. Did I miss anybody? I could go on and on. The farm credit system doesn't have a lot of that regulatory burden - they do have some, don't get me wrong - but they don't have that same degree of regulatory burden because they're not a depository. They're not part of the regulatory system that managed, all the funds, cash and deposits, accounts that flow through – they're not part of that system. And again, I'm not saying they're not regulated, but they're not regulated to the same degree. They're able to execute, in many cases, more quickly and be a little bit more competitive in certain areas, particularly pricing.
Where this really becomes an issue is that banks, and this is true both at the community bank level, which has held to the same responsibilities and accountabilities as the large banks, is how do we serve our customers? And how do we serve our regulators? Because those are your two masters, and it becomes a difficult balancing act.

Sarah Mock: **There's a lot to unpack here, but I think the big take away for now is to acknowledge that though the farm credit system has been largely very helpful for farmers and ranchers and has added diversity to a financial system that has, at times, really struggled to serve agriculture. it also created, from the perspective of the banking sector, an unfair competitor. A fellow lender, one that's for profit but that is backed by the federal government, that gets preferential tax treatment and that gets to play, at least in some ways, by different rules. Don't get me wrong, pretty much everyone I talked to on both sides of the ag banking farm credit divide say there's a place and a need for both in the ag lending world, but I certainly also heard plenty of talk about the need to level the playing field between these two.**
Comparing banks to farm credit is maybe the clearest way to understand how the farm credit system effectively represents government subsidization of ag credit. Although farm credit's ag loans weren't and aren't issued by the federal government, a key reason farm credit bonds are so desirable and therefore the interest rates they offer to farmers are so competitive is that, unlike a bank, the

----
Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

risk of catastrophic default is owned, essentially, by the government instead of being spread between the bank, the funders, and the borrowers. But what happens when the day of catastrophic default comes for farm credit? That's after the break.

Commercial break

Sarah Mock: Farm credit has done a lot of growing and changing in parallel with the commercial banking world over its century-long existence. They've learned a lot of lessons.
The 1980s were, to put it lightly, a really learning experience. This part of Jim's story involves the fact that lenders during the seventies and eighties, both inside and outside the farm credit system, had a lending philosophy that focused more on collateral and assets and less on income and repayment potential. Blended with this philosophy was another all-to-familiar idea:

Jim Knuth: in the 80s the assumption was the value of farm ground could never go down. We all found out that was not accurate in hindsight. But again, much higher loan to values back then, up to 85%. As soon as we hit the 80s and that cycle started, not only were banks and lenders really, I'll call it underwater in their collateral position, but frankly, the math just didn't work. And what I mean by that is with double-digit interest rates and the amount of debt, and the amount of repayment per acre, so to speak there was just no way that agriculture could afford those kinds of payments.

Sarah Mock: Jim's recollection here jives well with the history that Mike Boehljie, that Purdue ag economist, shared with us in our first episode. And Mike has had first-hand experience working with farm credit associations in the aftermath of the 1980s:

Mike Boehlje: We put together a research team to try to help farm credit, understand the severe financial problems that they had. They just didn't believe they had problems.

Sarah Mock: After being created in 1916, the 60 years to 1980 witnessed a lot of changes in the agricultural industry, and by the time of the first great crisis to follow the '29 crash, farm credit had fallen into many of the same holes that the banking system had. They just didn't believe it.

Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

Mike Boehlje: We basically provided research results that suggested that they didn't have current enough information to really understand the problems they had. And we were able to leverage some of the information we had in our surveys in other places to try to provide more current insight into what the financial stress was in the industry and how many of their borrowers were really in financial trouble even though their documentation and records didn't suggest that they had financial difficulty.

Sarah Mock: A critical part of Mike's team's efforts focused on analyzing the state of the ag credit system in the face of rapidly declining farmland values. This is where one of the great strengths of farm credit - their singular dedication to agriculture and rural America - became sort of their Achilles' heel.

Mike Boehlje: How do financial institutions with a heavy focus on farming, no diversification really, which is what the farm credit systems particularly was doing – how does it solve these financial problems? Not only the problems of individual customers, but how does it do it as an organization so that it didn't continue to compound the problem by foreclosing on farm properties and then trying to move them back out into the market when there was no interest in buying farmland, on the part of farmers as well as lenders financing new farmers to buy farmland? And so, we presented that work actually in a congressional hearing.

Sarah Mock: In the end, farm credit agreed with Mike's team, that they didn't have the information they needed to properly understand the issues they had. The issue was in the most basic sense that farm credit associations had given out loans and now too many of them were not getting paid back. This happens at a local level first, when one or two troubled loans, become five, 10 or a whole portfolio. Then one of the 67 farm credit associations across the country started to struggle with too little repayment, then another, and another. Eventually farm credits for regional banks started to be affected by liquidity issues and suddenly holders of farm credit bonds throughout the debt market began to worry that maybe their investment wasn't quite as secure as they thought. Even your average farmer, like Jim Farrell from episode 2, was seeing the writing on the wall.

Jim Farrell: Up in Southeast Minnesota where I was, things were really pretty tense. The farm credit system bank in Minneapolis was for all intents and purposes, bankrupt, they were on the verge. There was one that was taken down in Louisiana that was

----
Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

actually closed and consolidated with another farm credit. Things were tense all over in that area. I forget - they had thousands of farms at the farm credit in Minneapolis.

Sarah Mock: As all of this tension continued to escalate and more and more individuals throughout the economy were likely to be impacted, calls for the federal government to step in became louder and louder. Eventually, the farm credit system was bailed out. I'm going to share a pair of articles - one from the *New York Times*, one from the *Washington Post* - to Illuminate what people thought about this bailout at the time.
The Times piece, published in 1985, talks about the proposed bailout that has yet to come and focused on what a lot of Americans were worried about. Journalist Peter Kilbourn wrote, "A bailout... would do little to relieve the economic pressures facing farmers, which was a key concern for the public. Such aid, sources said, might only favor a single group, the 800 or so farmer-owners of the network." The issue of the farm credit bailout was so important that Bob Dole spoke about it on Face the Nation. But more insightful perhaps, came this quote from an aide to Iowa democratic senator Tom Harkin:
"We've had rural bankers calling to say, 'Don't pour money into these guys' pockets if you're not going to help me too. "
See there was a key divide here, many rural and community banks were experiencing a very similar, if not the exact same crisis that the farm credit system was, which many outside of agriculture were quick to point out were the result of these banks taking too many risks and making loans that ultimately proved imprudent. The problem from these community banks and their farmer-customer perspective was that many of the lenders of the farm credit system also took too many risks and made imprudent loans during the boom years of farming in the late 1970's.
The Reagan Administration was one of the loudest voices proclaiming that lenders in the system were allowed the freedom proposer in the 70s and, in the Whitehouse's view, they should be allowed the freedom to fail in the bleaker farm economy of the day. In fact, representatives of Reagan's administration would go on to say, '43 agricultural banks go under without anybody crying that the taxpayer ought to bail them out." Besides, the source responded, "Where would we get the money?"
Despite this seemingly firm rebuke of even the idea of a farm credit bailout, the Reagan administration never actually denied one, and eventually granted it. The author hypothesizes that this is not due to sympathy for farmers or their lenders,

----
Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

or farm credit in general, but because of the potential losses on Wall Street that those who purchased farm credit bonds might have suffered.
The Post story, published in 1989, offers this conclusion, "The farm credit system was hit hard by its own profligate lending practices and the near-collapse of the U.S. farm economy in the first half of the decade." The farm credit system lost $4.6 billion of its own money from 1984 to 1987. That's more than a billion dollars a year, but the Farm Credit System has survived through infusion of nearly $1 billion worth of federal help and by making sweeping changes in its structure and ways of doing business. In the aftermath of that $1 billion bailout the farm credit system began to repair.
The good news, from an institutional perspective is that farm credit has adjusted its lending philosophy since the 1980s such that it seems a historical repeat isn't likely.

Jim Knuth Now most lenders, not just us are capacity or cash flow based. We still take collateral as a secondary means of repayment. But we're also much more, I'll call it thoughtful, in how much we lend too, especially on fixed assets, like farm ground, even with the run-up farm ground values. We have very much gone away from a loan to value philosophy because it's simply too much. Again, if I loaned you 70% of a $12,000 or $14,000 or a $16,000 acre sale, your annual payments per acre would be something that you couldn't afford, unless you subsidize those acres heavily with other acres you already had paid for. So really, it's about, the land cost per acre on all your acres or a more holistic perspective in terms of cash flow and capacity. And frankly, that discipline has really paid off for agriculture, especially over the last toughest cycle, in 15, 16, 17, 18, 19. You know, that was the toughest cycle probably we've had since the 1980s. But again, we didn't see any of those scenarios, like the 80s.

Sarah Mock: Capacity-based lending or lending based on cash flow, rather than collateral, is a philosophical change that came up with a number of the lending experts that I spoke with. Basically, it's a formal recognition, on the lender's side, of the business model for credit that we spoke about in the last episode. The idea that what should be in place before the credit is extended is a business plan for how the invested funds are going to net at least enough return to cover the interest without decreasing the value of the business. It's a kind of formalization of the assumption that credit is for fueling growth. Failing to do this in the past, Jim says, has been a painful experience for all involved.

Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

Jim Knuth When you get outside of constructive credit where you're saying, “Hey I'm loaning you money and we're not sure how you're going to be able to repay that money.” Then the question really is, are you helping a farmer or a rancher? Or are you simply digging their hole deeper? So that's a, that's always a gray area question in terms of assessing risk. So, while we look at your balance sheet, we look at your assets, we take collateral. Our main concern is the cash flow and profitability of your operation. And then ultimately, how will you be able to repay us?

Sarah Mock: This might not sound quite as nice as the trusted advisor invested in each other success narrative that we hear most commonly in the world of ag credit, but it is real. More importantly, this sentiment is necessary to keep lending systems, both banks and farm credit alike, solvent to lend in the future.
But I want to bring this whole conversation back, to the reason why farm credit was created in the first place.

Brent Gloy: The establishment of the farm credit system was done in part because, there was seen as a need for a long-term and stable supplier of credit to agriculture and the perception that, that wasn't there and that ag, markets and cycles or are longer than the typical, quarter or something - it takes a long time. And there was perceived, and I think actual was a need, to do something produced a lender that had that longer term kind of perspective and in agriculture. And that's partly why we have the farm credit system, which is pretty unique. in the grand scheme of things of the whole U.S. economy, there aren't too many other, specialized lenders like that.

Sarah Mock: It's worth remembering that U.S. policymakers have been consumed for much of the 20th century with how to regulate interest rates and moderate the amount of credit, not just for farmers and ranchers but for homeowners, consumers, and other businesses as well. Farm credit may have been the first GSE, but it certainly wasn't the last. Here's John Blanchfield again:

John Blanchfield: That creation in 1916 led to the creation of many other government sponsored enterprises and they've all had a record of being successful and failing and being successful and failing. And you and I, as taxpayers are all part of that. But for example, Fannie Mae, Freddie Mac, the federal home loan bank - all of these were created in at various times to provide. Stable interest rates and a moderate, regulated supply of credit to various sectors of our farm economy.

Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.

Sarah Mock: The story of farm credit, why it was founded, how it worked, how it's both failed and succeeded is a fascinating one, but at the same time, one of the things I find so interesting about itis that, it's really just the first chapter of the story of the U.S. government inserts itself into ag lending.

John Blanchfield: So, with the farm crisis of the 1980s, one of the things that killed so many farming operations was high interest rates and a lack of affordable credit as a result. And so, Congress decided, with a great deal of lobbying, I must add, by the banking industry, they decided to create a, another, a new government-sponsored enterprise - and that was Farmer Mac.

Sarah Mock: Next time, on *Nothing Borrowed, Nothing Gained*.

Sarah Mock: AEI.ag presents *Nothing Borrowed, Nothing Gained* is a production of AEI Premium, a website and forecasting community where ag nerds like us write, talk, and develop our ideas about the future of American agriculture. To learn more about becoming and AEI premium subscriber and gaining access to a lot of more great content like this podcast, visit aei.ag. If you've enjoyed the show, please rate, review, and subscribe wherever you listen to podcasts, and lookout for Ag Economics Insights, on social media @ ag economists or email us directly at askus@aei.ag. This show was edited, produced, and hosted by me, Sarah Mock, along with my cohosts David Widmar and Brent Gloy. Special thanks to Jim Knuth for joining us on this episode in addition to reoccurring guests John Blanchfield, Mike Buljie and Jim Farrell, and further gratitude to this show's managers Emily Raineri and Sarah Hubbart, and the rest of the AEI team, including, Jeff, Michael, Mason, and Aerin. Until next time, remember:

Curt Covington: The good times. Never last.

Cultivate your thinking. Start your free trial at aei.ag/premium.

© 2023 AEI Premium All rights reserved.