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Draft Underwriting and Repayment Standards for the Federal Agricultural Mortgage Corporation

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Testimony on

Draft Underwriting and Repayment Standards for the Federal Agricultural Mortgage Corporation[1]

Eddy L. LaDue

Mr. Chairman and members of the Farmer Mac Board, I am pleased to be here to participate in this public forum on behalf of the Farm Financial Standards Task Force. I am Eddy LaDue, Professor of Agricultural Finance at Cornell University, Ithaca, New York. My responsibilities at Cornell include teaching, research and extension education in the agricultural finance area. I am also Chairman of the NC-161 regional research subcommittee on credit scoring. In addition, I serve as a Steward on the Farm Financial Standards Task Force Subcommittee on Universal Financial Reports.

The Farm Financial Standards Task Force (FFSTF) consists of experts, who serve without pay, from all facets of the farm financial industry. The Task Force was assembled with monetary contributions from the American Bankers Association, the Farm Foundation, and the Farm Credit System. The Agricultural Bankers Division of the American Bankers Association is presently serving as the Secretary and Communications Coordinator for the Task Force. However, the activities of the Task Force are not controlled by the American Bankers Association, or any other group.

The membership of the FFSTF includes representatives of all types of lenders - commercial bankers, Farm Credit System loan officers, insurance industry lenders, Farmer's Home Administration lenders, and other non-institutional lenders - as well as regulators of financial institutions, academicians, farm financial research specialists, representatives of the USDA Extension Service and the Economic Research Service, members of the accountancy profession, representatives from farm groups, farm software firms, and other industry specialists. The goals of this task force are to establish universally acceptable farm financial standards. Specifically to: 1) identify certain ratios common to all areas of the country; 2) identify standard methods of calculating these ratios; 3) draw up standardized farm financial statement formats that may be used by all farm

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lenders, and 4) review and identify content standards and/or calculation standards for farm financial software.

The formal findings of the FFSTF will be published in November 1989. However, our work to date gives us a keen appreciation for the amount of effort that has been expended by the Farmer Mac Task Force on Credit Underwriting Standards to bring their recommendations to their current status.

Developing credit underwriting standards that are appropriate for nationwide application is a monumental task. In light of this, it is quite understandable that the Farmer Mac Credit Underwriting Task Force chose to focus on a limited number of critical issues and to establish only a basic set of standards. This strategy may make it easier for the poolers and the regulators to set up more specific credit guidelines and operating procedures. It may also allow greater flexibility in adjusting pooler and regulator standards as experience will dictate.

While it is not specifically stated, it appears that the Farmer Mac Credit Underwriting Standards Task Force intended for the draft credit underwriting standards to be specific enough to clearly establish the kinds of loans that are to be sold through the Farmer Mac program, but general enough to allow regulations to be adapted to all kinds of agricultural enterprises and adjusted through time. We strongly recommend that the final standards retain a similar degree of flexibility to allow these adaptations and adjustments to occur.

The work of the FFSTF has clearly illustrated the difficulty in setting minimum or maximum standards that are appropriate for any geographical region, farm enterprise or size. The character of this problem is illustrated by the work of Robert Morris Associates on commercial business enterprises. Just as Robert Morris Associates has discovered that one ratio value does not fit all types of business, we feel the Farmer Mac Board must recognize that different values of parameters will be appropriate for different geographical regions, different farm enterprises and different farm sizes. Robert Morris Associates has identified the ratio parameters for over 355 different businesses based on submissions by only 89,000 businesses. A similar degree of diversity undoubtedly exists for the over 600,000 farm operators who sell $40,000 or more of farm products per year.

The financial ratios identified by Farmer Mac in the proposed Credit Underwriting Standards are commonly placed in general ratio categories of solvency, liquidity and debt coverage. There are two other categories of ratios that are often examined by the experts in farm financial analysis - efficiency and profitability.

While it is understandable that Farmer Mac may not be as concerned about farm or financial efficiency, we feel it is imperative that Farmer Mac, or any prudent lender, be concerned about the profitability of a borrower's farming operation. This is especially important when the borrower's farming operation will be requiring long-term loan funds for the purchase of real estate. We also must remember that undue emphasis on any one ratio or ratio category to the exclusion of other ratio categories,

could lead to an inaccurate determination on the financial health of the operation.

Thus, in recognition of the divergent conditions of agriculture that we all are familiar with, we would like to submit the following comments on those portions of the Farmer Mac Credit Underwriting Standards that are of concern to the Farm Financial Standards Task Force.

FAMC Credit Underwriting Standard 2 states that "The borrower will provide at least the current year's fair market value balance sheet and three years of income statements (current & two preceding years) to be analyzed, with adjustments made to at least the current financial statement to reflect the value of production (by recognizing noncash expenses and changes in inventory, accounts payable, accounts receivable and prepaid expenditures)."

The Farmer Mac Credit Underwriting Task Force is to be commended for their efforts to structure the requirements of this standard in such a way that will not preclude "newer" or beginning farmers from using Farmer Mac financing. However, the notes that accompany these standards indicate that "the one-year rule should be applied only when sound credit judgement permits". The Farm Financial Standards Task Force would concur with this comment, and add that it is important to have balance sheet information available for the same number of years as required for the income statements to allow the most meaningful analysis of the farm operation. Thus, we would recommend that the Farmer Mac Credit Standard be strengthened to require three years of fair market value balance sheets and income statements, with the notation that exceptions to this standard will be permitted for entities that have been in operation for less than three years, and/or only when sound credit judgement permits. These newer entities should then be required to comply with a minimum one-year fair market value balance sheet standard.

Furthermore, the FFSTF is concerned that some of the wording that currently exists in this standard may result in confusion by farm financial analysts. The term "value of farm production", as used in much of the farm accounting and financial literature, is a value added concept that is usually calculated as gross receipts minus purchased livestock and/or feed. I believe the intent of the calculation method listed in the standard is to calculate accrual adjusted net income or accrual adjusted earnings. Thus, it may be more appropriate to utilize such terminology in regards to that particular calculation. In addition, the term financial statement is used in this sentence as an apparent substitute for income statement. We believe that use of the term income statement in this context would be more appropriate and more understandable by farm financial analysts. Beyond these concerns, there is no indication as to how the FAMC will treat off-farm assets or income derived from these assets. Will these items be included or excluded from the balance sheet and income statement? FAMC Credit Underwriting Standard 3 states that "The entity being financed should have a proforma (after closing any new loan) debt-to-asset ratio of 50 percent or less. Exceptions to this standard will be permitted for entities that present a strong history of earnings or liquidity."

It must be stated that a 50 percent debt-to-asset ratio is a conservative standard, and one that should allow investors in Farmer Mac to have confidence in the quality of the loans made under the Farmer Mac program. In addition, Farmer Mac has allowed for exceptions and recognition that other standards, such as debt coverage and liquidity, are also important in analysis of a loan application.

The FFSTF would be concerned if too much emphasis were placed on the debt-to-asset ratio to the exclusion of other factors. As we have learned during the financial problems of the 1980s, profitability and sustainable cash flow should be given more emphasis than the total debt-to-asset ratio of the farm operation. Too much emphasis on debt-to-asset ratios may encourage lenders to adopt asset-based lending techniques.

Basically similar businesses can have significantly different debt-to-asset ratios depending on minor differences in their method of operation. For example, the debt/asset ratio can be distorted by CCC sealed grain. A farm with $100,000 in CCC grain, $800,000 of total assets, $100,000 of CCC loans and $450,000 total debt will not have a 50 percent debt/asset ratio. However, if the grain were sold instead of sealed, the total assets would be $700,000 and total debts would be $350,000 - hence, a 50 percent debt/asset ratio.

A farming operation utilizing leased assets, on an annual or long term basis, to contribute to the overall profitability of the operation is another example. It is possible such a farm with a large percentage of leased assets in relation to owned assets, may have a debt-to-asset ratio greater than 50 percent, yet be able to easily cover all of its debt obligations due to the enhanced farm profitability. Thus, there are many circumstances that may need to be taken into account when Farmer Mac applies its "exceptions rule" to the 50 percent debt-to-asset ratio requirement.

FAMC Credit Underwriting Standard 4 states that "The entity being financed shall generate sufficient earnings and liquidity to meet all capital obligations as they come due over the term of the loan and, in addition, provide a reasonable margin for capital replacement and contingencies. This standard is achieved by having: 1) total debt coverage in a financing of no less than 1.25:1; 2) a current ratio of no less than 1:1. Both of these ratios will be computed on a proforma basis (after closing any new loan). Elements of the debt coverage ratio shall include historical and projected earnings."

The FFSTF has some concerns about subjecting all types of farming operations, with no exceptions, to identical parameters for debt coverage and liquidity ratios. Rather than setting absolute standards for these parameters, exceptions should be permitted where sound credit judgement permits, or flexibility should be established to permit different parameters for different types of farming operations.

In general, the FFSTF agrees with Farmer Mac that calculating debt coverage on a proforma basis is absolutely necessary. However, the method suggested by Farmer Mac for calculation makes the standard very severe for

some farm operations, and very liberal for others. Farms or ranches with a significant degree of leverage and a small amount of machinery and other replaceable assets could find the 1.25:1 ratio a very severe requirement. This would be particularly true when a large amount of debt service represents repayment of principal on intermediate term credit lines used to maintain breeding livestock. On the other hand, farms with a modest degree of leverage and a large amount of machinery, cattle and other assets that must be replaced could meet the 1.25:1 ratio even when the cash flow was insufficient to maintain their current assets.

The FFSTF would suggest that it may be appropriate to include an estimate of capital replacement among the items subtracted from net income in calculating the numerator for the capital debt coverage ratio. This would allow Farmer Mac the flexibility of setting a somewhat lower minimum standard for the debt coverage ratio.

Once an appropriate calculation method for debt coverage ratio is in place, it may allow Farmer Mac to lessen its reliance on the current ratio standard. Since the current ratio is merely a balance sheet concept that only indicates the relative magnitude of current assets to current debts at one point in time, it is not a reliable indicator of the business's ability to make debt payments over time. Furthermore, on some farms the current ratio is not a good indicator of a farm's ability to make payments at any point in time. For example, a grape farm on December 31, may have no current assets except some cash on hand to be used for family living and other expenses during the spring and summer, and a very modest amount of supplies. There is little reason why these current assets should equal or exceed current liabilities which would include principal payments on all intermediate and long term debt. Similarly, a dairy farm that buys all the feed used may have little in current assets except an account receivable for last month's (or one or two week's) milk check and a small amount of feed. This could easily total less than the principal payments on term debt due during the next 12 months. If the 1:1 current ratio is adopted, farms such as these would be excluded from Farmer Mac funding. This, in turn, will reduce the options for geographic and commodity diversity that are required by law for Farmer Mac pools. At the least, the FFSTF would recommend a re-examination of the presently suggested parameters regarding the current ratio. A better solution would be the recognition by Farmer Mac that different current ratio requirements would be appropriate for different farm types and regions.

FAMC Credit Underwriting Standard 5 states that "The loan-to-appraisal value ratio in a financing shall not exceed 75 percent. Also, a minimum 1:1 cash flow debt service coverage ratio from the subject real estate will be required. The analysis of this ratio shall be computed on an owner-operated basis."

The FFSTF does not feel the 75 percent loan-to-appraisal value is unreasonable. However, in order to maximize the use of the Farmer Mac program, it might be prudent to set the standard to allow mortgage insurance to be used to help reach the required 75 percent loan-to-value ratio for farm real estate as well as rural housing. In reality, such insurance does not now exist, but could be developed if it were recognized

by Farmer Mac as a tool to help carry the risk of higher loan-to-value ratios.

The FFSTF is also concerned about the suggested 1:1 cash flow to debt service coverage ratio for the subject real estate. We feel that adoption of this standard would unnecessarily limit the number of farm operations that could make use of the Farmer Mac program. For example: 1) farms with cash flow from other parts of the farm businesses that could be used to make principal payments on added real estate, 2) farms to be expanded through purchase of nonbearing, or to be established, orchards and vineyards, 3) farms where real estate is being purchased for use in the development of breeding herds, or 4) farms with important and continuing off-farm income.

We would like to point out that most farmers recognize that the term owner-operated is usually used as a contrast to the terms manager-operated or corporate-operated, rather than as a descriptive method for calculating returns. Thus we would recommend the use of terms such as marginal cash flows or incremental cash flows in an effort to avoid such confusion to the agricultural finance community.

Additional clarification of the term "incremental" would also be helpful. At present the meaning is unclear. For example take the farrow-to-finish hog operation that would like to purchase an 80 acre tract of good crop ground for growing corn. In reality, in the majority of years, if the corn crop were sold off this farm it might not satisfy the total debt requirements. However, if the corn is fed through the hogs on the "other" part of the operation, it might increase overall profitability enough to justify the real estate purchase. We assume that by incremental you mean calculation of the increase in cash flows for the whole operation. However, making such calculations would be extremely difficult in many cases. Further, it adds little to the analysis of cash flows required in Credit Standard 4.

Some members of the FFSTF pointed out that a 1:1 cash flow debt service coverage ratio from the subject real estate would exclude speculators from use of Farmer Mac. However, the FFSTF would suggest use of other procedures or requirements might be more effective in restricting use of Farmer Mac by land speculators. These suggestions are detailed more fully in the comments on FAMC Credit Underwriting Standard 9. FAMC Credit Underwriting Standard 9 states that "Farmer Mac invites comment on whether income from sources other than the entity being financed (i.e. off-farm income), should be given consideration in the credit underwriting standards."

Off-farm income is an important source of cash flow for many farm businesses, including a large number who are more than full time farmers during the periods when heavy crop work is done. Such income should be counted in the cash flow of the business, either as a direct entry or as an off-set to family living withdrawals.

Farmer Mac should not look at discounting off-farm income as a means of controlling speculator abuse of the Farmer Mac program. Rather, Farmer Mac could control speculator abuse through other eligibility criteria.