April 4, 2017

Testimony of

Nathan Franzen

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

before the

Commodity Exchanges, Energy, and Credit Subcommittee

United States House of Representatives

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Chairman Scott, Ranking Member Scott, and members of the Subcommittee, my name is Nate Franzen, and I am the President of Agri-Business at First Dakota National Bank in Yankton, South Dakota. First Dakota National Bank is a family owned and locally controlled community bank with $1.5 billion in assets and $890 million in agricultural lending. We have 375 employees and have 19 branch locations and 6 loan production offices serving South Dakota and Nebraska.

First Dakota National Bank was the first bank to become a Farm Service Agency Preferred Lender in March of 1999 and has been involved in guaranteed and direct loans ever since. But there are two unique agricultural programs that bring me great pride due to their success. The first is our Beginning Farmer and Rancher program. This program was established in 2012 and provides a one year educational experience for young and beginning farmers and ranchers. Throughout this yearlong educational program we expose our beginning farmer and rancher participants to leading educators and industry leaders. We do this with one goal in mind: educating and sharpening the skills of our beginning farmers and ranchers to increase their odds of future viability and success. The second program was established in 2013. It is a consulting department within our agriculture division called Keep Farmers Farming. Its intent is to help our farms and ranches deal with the most important challenges they face. These challenges include strategic planning, estate planning, transition planning, best business practices, as well as marketing and risk management. We are making a real difference in our Ag industry by helping our farms and ranches enhance their performance and plan for transition and legacy. These two programs will help bring young and beginning farmers and ranchers back to their family operations and keep our family farms and ranches viable for generations to come.

I am also a past chairman of the American Bankers Association's Agricultural and Rural Bankers Committee. I appreciate the opportunity to present the views of rural bankers on credit issues in the upcoming Farm Bill.

The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, midsize, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend nearly $8 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% of all banks – reported agricultural loans on their books at year end 2015 with a total outstanding portfolio of over $171 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% 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 (FSA) 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.

Entities like Farmer Mac provide another avenue for banks to increase credit availability. By purchasing loans from banks, Farmer Mac allows banks to lower interest rates for their customers and provide better loan products. With the agricultural economy potentially going through some stressful times in the near future, Farmer Mac will need legislative changes. ABA believes the most needed change is the removal of the current 1,000 acre limitation.

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 $320 billion behemoth offering complex financial services. To put this in perspective, if the Farm Credit System were a bank it would be the seventh largest in the United States, and larger than 99.9% of the banks in the country.

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.

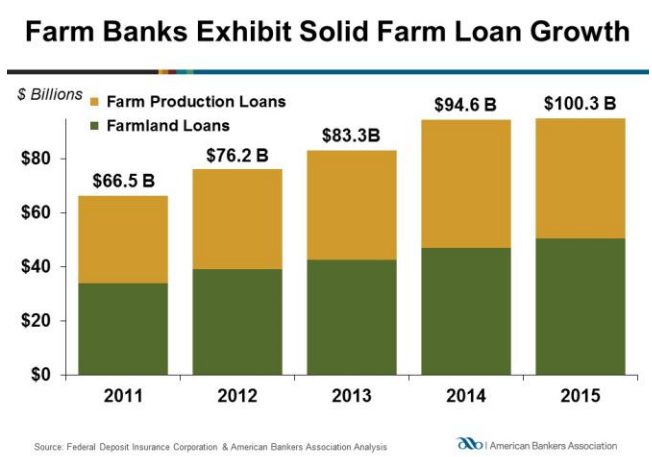
In my testimony today I would like to elaborate on the following points:

- Banks are a primary source of credit to farmers and ranchers in the United States;
- The 2014 Farm Bill can be considered a success for its protection of crop insurance, the Conservation Reserve Program (CRP), and the removal of term limits on FSA Guaranteed Loan Programs;
- The next Farm Bill will require some changes to FSA loan programs including higher lending limits, enhancements in technology, and addressing the rapid retirement rates of FSA staff. Additionally, changes will need to be put forward on commodity programs and data collection;
- Farmer Mac is a valuable partner for lenders and the Farm Bill will need to be a vehicle to improve Farmer Mac;
- The Farm Credit System has become large and unfocused. It should refocus its mission on helping farmers and ranchers in need of subsidized credit.

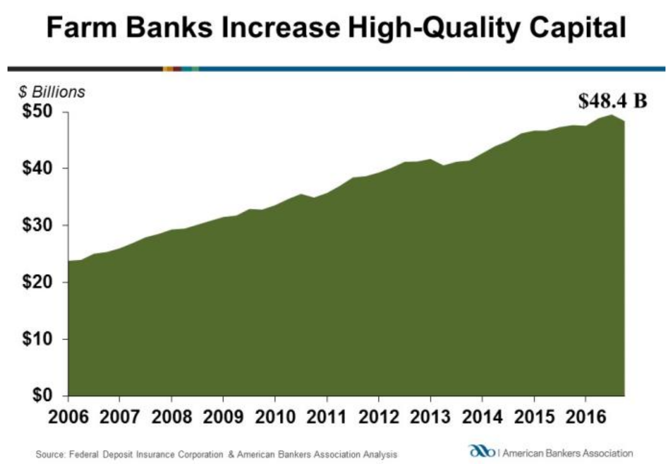
I. Banks Are a Primary Source of Credit to Farmers and Ranchers in the U.S.

For my bank and for many of our 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 15.65 percent farm or ranch loans (to all loans).

At the end of 2016, there were 1,912 banks that met this definition. Farm lending posted solid growth during 2016. Total farm loans at farm banks increased by 5.3 percent to $103.4 billion in 2016 up from $98.3 billion in 2015. 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 9.2 percent, or $4.5 billion, to a total of $54.0 billion. Farm production loans rose by 1.3 percent, or $641 million, to $49.4 billion. Farm banks are a major source of credit to small farmers – holding more than $48.4 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 2016. The number of outstanding small farm loans at farm banks totaled 766,762 with the vast majority – over 495,600 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 3.7 percent to $48.4 billion in 2016. Since the end of 2007, farm banks have added $20.9 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

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 the last five fiscal years losses have ranged from a high of 0.6% in FY10 to a low of 0.3% 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.

III. Changes Needed in the Next Farm Bill from a Banker's Perspective

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

The most important change that should be made to the next Farm Bill is an increase to the current loan limit of $1.399 million on FSA Guaranteed Loans. The formula for indexing the programs has not kept up with the increasing costs 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 that reality. ABA has endorsed H.R. 831, the Beginning Agriculturist Lifetime Employment Act of 2017 (BALE Act), introduced by Representative Mike Bost. This legislation would increase the cap on GFOs and GOLs to $3.5 million. We believe this increase is necessary for lenders to be able to help as many producers as possible going forward. The BALE Act would also increase the size of Direct Operating Loans and Direct Ownership Loans from $300,000 to $600,000. This legislation is an important first step to modernizing FSA loan programs.

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

Another step in modernizing loan programs would be upgrading and improving technology. This would create a more efficient and responsive USDA. As I mentioned before, ABA is very involved in FSA Guaranteed Loan Programs, but the lack of basic upgrades to technology has greatly delayed the industry's ability to process loans at an efficient rate. Without simple updates, such as better functioning websites to check on loan balances, we are creating unnecessary work for FSA staff. As we have learned in the banking industry, updating technology can create greater efficiency across an organization, which ultimately benefits our customers.

Along with the changes to the loan programs and upgrades to technology, there needs to be serious consideration for increasing staff levels at FSA. As veteran staff retires, there isn't enough new staff being trained to take over their loan portfolios. This is creating a knowledge gap within FSA loan programs and is making it much harder to turn around loans in a timely fashion. When it comes to financing agriculture, especially operating loans, loans need to be made as quickly as possible so farmers can get back into the field. As the agriculture committee is aware, windows for planting or harvesting can close very quickly and our loan programs need to keep pace.

I believe FSA should consider bringing back their interest assistance program. This program helps to buy down the cost of interest for young and beginning farmers, which is timely considering the rising interest environment we are entering. In the past, the program allowed FSA to buy down as much as four percent of all guaranteed operating loans. If this program were to be reinstated, ABA suggests that the program would be no more than two percent, would be eligible for only beginning and young farmers, and would be eligible for all FSA guaranteed loan programs.

Another issue that should be further examined by the Agriculture Committee is the National Environmental Policy Act (NEPA) regulations that have been put in place for Confined Animal Feeding Operations (CAFO) for FSA loan programs. I fully understand why the regulations have been put in place, but there needs to be serious examination on potential changes to the regulations. Additionally, I have found that the regulations can vary from state to state and county to county, making it very difficult to properly put together the loan. The Agriculture Committee should consider offering changes to the NEPA regulations on CAFOs so lenders can better serve this constituency into the future.

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 Agriculture Risk Coverage (ARC) and Price Loss Control (PLC). This became problematic because while producers were making the election in July 2013, corn futures were over $7 per bushel, with wheat futures being over $9 per bushel. Now, corn is less than $4 per bushel, and wheat is $4.50 per bushel. This dramatic drop in prices could not be foreseen by any producers.

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 problems on yield calculations.

While crop prices and a one-time program election were both issues, the timing of payments greatly affected 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 their payments during the same year in which they planted their crops, and lenders had 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. Lastly, we should not be making educated guesses on what payment may be received. Instead, there should be certainty within the programs to allow for an accurate calculation.

IV. Farmer Mac is a Valued Partner for the Banking Industry

Farmer Mac is a valuable tool in the toolbox for agricultural bankers because it provides another avenue for banks to increase credit availability. By purchasing loans from banks, Farmer Mac allows banks to lower interest rates for their customers and provide better loan products. With the agricultural economy potentially going through some stressful times in the near future, Farmer Mac will need legislative changes. ABA believes the most needed change is the removal of the current 1,000 acre limitation. The 1,000 acre limitation was put in place in the 1987 Farm Credit Act and has become outdated with the increasing size and scope of modern agriculture.

ABA also believes there should be a serious discussion about Farmer Mac being able to buy all guaranteed loans from USDA. This flexibility would encourage more banks to be involved in guaranteed loan programs across USDA. It should be noted, that these proposals would not only benefit banks, but also the Farm Credit System, who is our biggest competitor. ABA believes that we need to do everything in our power to help finance all of agriculture, and we are all in this together.

V. The Farm Credit System is a Large Government-Sponsored-Enterprise That Primarily Serves Large Borrowers at the Expense of 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 $320 billion in assets.*** If it were a bank, it would be the seventh largest bank in the United States. It is tax-advantaged and enjoyed a combined local, state, and federal tax rate in 2015 of only 4.0 percent (a significant decrease from the effective tax rate of 4.5 percent in 2014). The tax advantages enjoyed by the FCS in 2015 were worth $1.296 billion or 28% of the Farm Credit System's net income in 2015[1].

The Farm Credit System is a Government-Sponsored-Enterprise

In spite of their size, profitability, and tax advantages the Farm Credit System presents 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 (FCSIC) 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 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]

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

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

[2] Federal Farm Credit Banks Funding Corporation; 2013 Annual Information Statement of the Farm Credit System; February 28, 2014, page 23

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 dropped 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 highly 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 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 offer assistance to Congress as it writes the next Farm Bill. With

[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

the changes that have been outlined earlier, the banking industry will continue to help producers be strong into the future. Bankers still see great opportunities in agriculture and they 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.