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# LESSONS LEARNED FROM THE FARM DEBT CRISIS OF THE 1980's

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*W.I. Myers Memorial Lecture*

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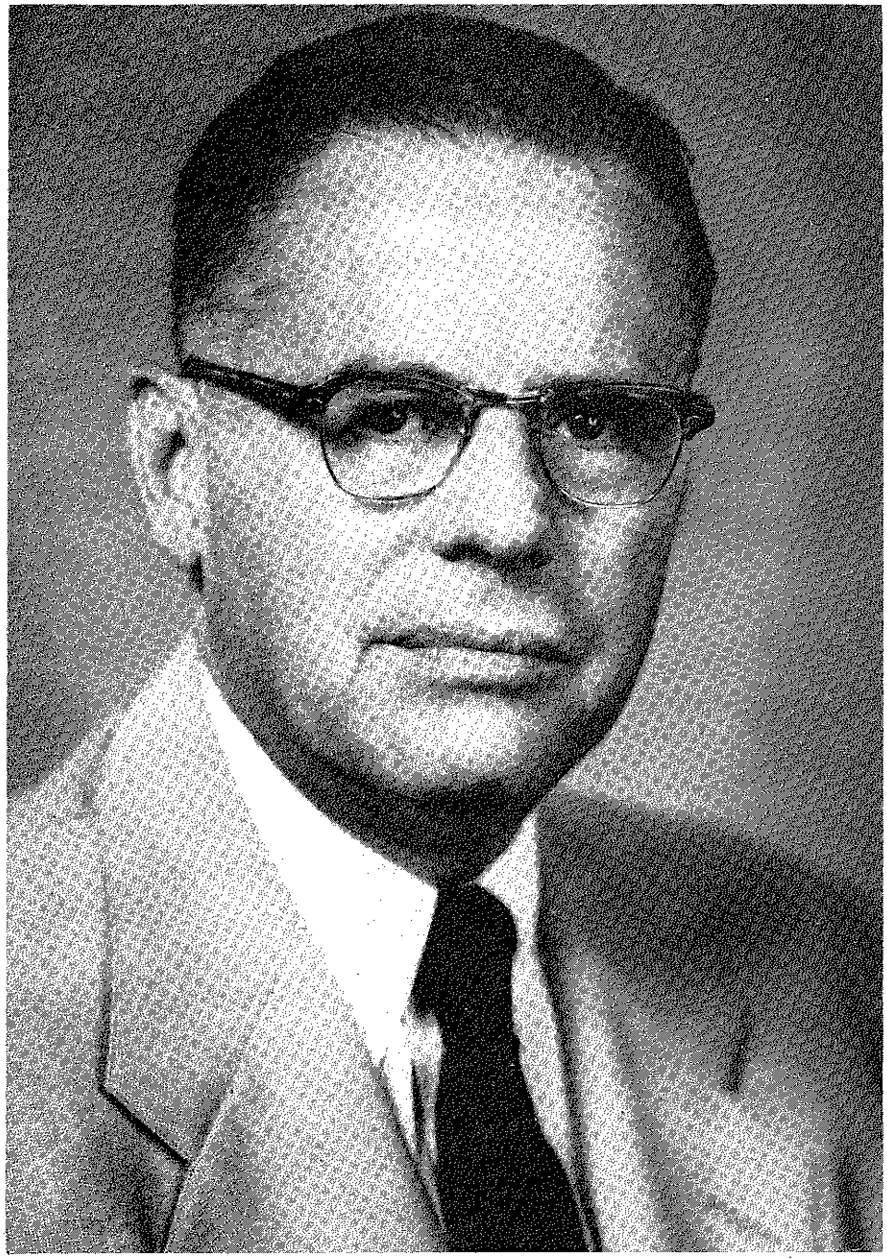

William I. Myers (1891-1976) was one of the early agricultural economists who worked on problems of agricultural finance. He was appointed a full professor of farm finance at Cornell University in 1920. In 1932, Professor Myers was asked to prepare recommendations for a legislative program to solve the agricultural finance problems of those times. His proposals found approval from President-elect Roosevelt, and his ideas formed the foundation for the creation of the Farm Credit Administration and the present Federal Cooperative Farm Credit System. Then, at the request of President Roosevelt, he was granted a leave of absence from Cornell in March 1933 to serve as assistant to Henry Morgenthau, then chairman of the Federal Farm Board. Morgenthau was appointed the first governor of FCA, and Myers became Deputy Governor. Then, when Morgenthau became Secretary of the Treasury in September 1933, Myers was appointed governor of the Farm Credit Administration. He served in that capacity until 1938 when he returned to Cornell University as head of the Department of Agricultural Economics. In 1943, he became Dean of the College of Agriculture serving until 1959.

The purpose of the W. I. Myers Memorial Lecture is to bring to this campus an outstanding agricultural finance economist to lecture on a timely topic. The lecture is sponsored by the Cornell University Department of Agricultural Economics as a part of its continuing emphasis in agricultural finance.

**Lessons Learned from the Farm Debt Crisis of the 1980's***

-- by Neil E. Harl**

Society would be well served if the lessons learned in the farm crisis of the 1980's could be identified and memorialized to assure ready access on the occasion of the next major economic downturn in agriculture. Without much doubt, the sector will once again experience the trauma of the 1980's sometime in the twenty-first century. It is not known when a farm crisis will re-emerge, whether in 2035, 2040 or 2050. But it is likely to occur when memories -- and warnings handed down to succeeding generations -- have faded and the galaxy of economic conditions is positioned to create a sense of euphoria among farm decision makers.

## I. The General Setting

It is not new for agriculture to be subjected to rapid economic and social change. Over time, agriculture has adjusted to conditions of greater efficiency with a steady decline in the percentage of the population and the percentage of the capital stock needed to produce needed food and fiber products. The decline has been especially marked since the 1930's as developments in plant and animal breeding and machinery and chemical usage, and improvements in the level of management ability of farmers, have combined to cause an acceleration in the movement of labor out of the sector. Agriculture has truly been a development sector as the industry has "downsized" itself in relative terms, freeing labor and capital for use in the non-farm economy. The development occurring in agriculture has been beneficial to the general economy, permitting the reallocation of resources to a burgeoning service sector, high technology manufacturing and product development and other sectors and subsectors.

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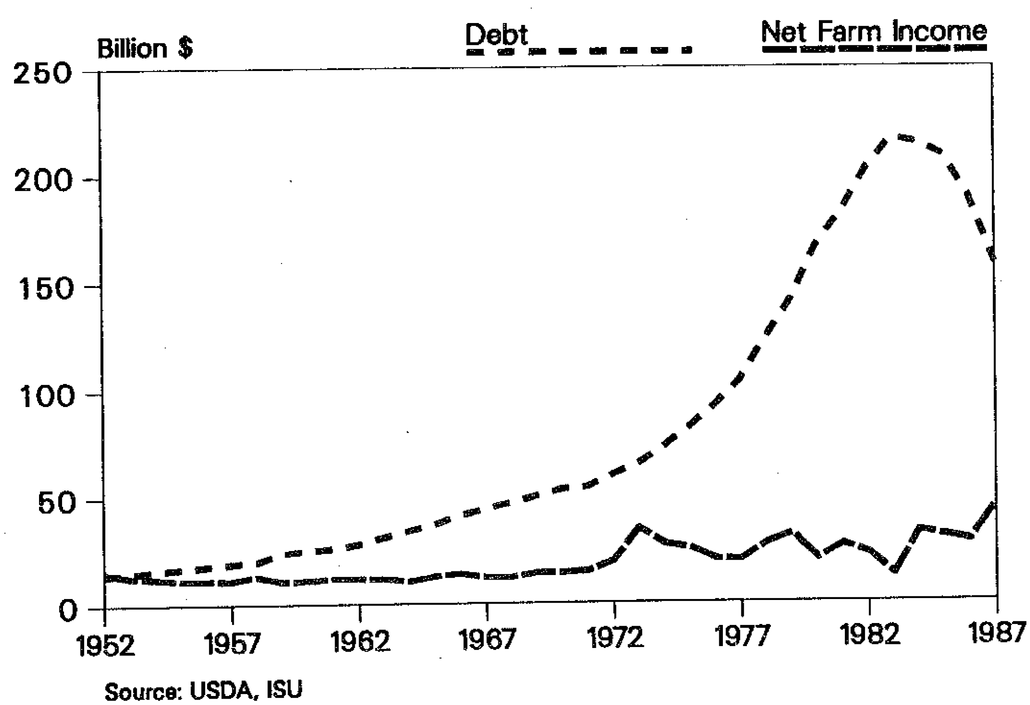
The debt problem

What has occurred in agriculture in the past five years in terms of firms failing because equity was exhausted or operating credit was denied has had little to do with efficiency, however. In fact, many of the firms at risk have been among the most efficient in the industry. The distinguishing feature has been the amount of debt held which has been excessive as measured by the economic environment of the 1980's.

The amount of debt in U.S. agriculture increased dramatically after 1950 as shown in Figure 1. Total farm debt outstanding in 1950 totalled $11.2 billion, rising to over $216 billion nationally in 1983, before commencing a decline in 1984 as some debt has been paid off or discharged otherwise and as the economic environment has discouraged the contracting of new debt. Total debt stood at about $188 billion at the end of 1986 and dropped to about $158 billion at the end of 1987 (including CCC debt).

Figure 1. Net Farm Income and Debt.



Extent of financial stress

As of January, 1987, nearly 22 percent of the farmers nationally had debt-to-asset ratios of greater than 40 percent and were responsible for more than 67 percent of the farm debt.

Table 1. Percentage of Farms and Debt to Asset Ratio for Each Region and for the United States, January, 1987.

| | Debt to Asset Ratio | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 41-70 | | | 71-100 | | | Over 100 | | |
| | Farms | Assets | Debt | Farms | Assets | Debt | Farms | Assets | Debt |
| Northeast | 10.9 | 7.6 | 33.8 | [a] | [a] | [a] | [a] | [a] | [a] |
| Lake States | 18.1 | 20.6 | 34.9 | 8.4 | 9.4 | 24.7 | 5.1 | 3.8 | 17.2 |
| Corn Belt | 13.9 | 17.4 | 34.3 | 6.5 | 6.1 | 18.8 | 5.0 | 3.8 | 17.2 |
| Northern Plains | 20.2 | 19.7 | 34.4 | 8.0 | 8.1 | 22.2 | 4.7 | 2.6 | 13.3 |
| Appalachian | 8.0 | 7.1 | 33.2 | 2.0 | 1.8 | 13.7 | 1.9 | 0.7 | 7.7 |
| Southeast | 10.6 | 12.9 | 29.7 | 1.6 | 9.2 | 33.4 | 4.6 | 1.3 | 11.9 |
| Delta States | 9.4 | 10.7 | 26.8 | 4.5 | 4.9 | 18.7 | 5.4 | 2.1 | 19.0 |
| Southern Plains | 10.7 | 9.4 | 35.2 | 3.0 | 1.6 | 9.1 | 2.5 | 1.6 | 20.1 |
| Mountain States | 11.5 | 14.7 | 35.0 | 4.2 | 3.9 | 14.1 | 3.5 | 1.6 | 10.4 |
| Pacific States | 10.4 | 34.0 | 34.9 | 4.2 | 5.0 | 18.3 | 2.4 | 0.7 | 7.1 |
| United States | 13.0 | 14.1 | 34.0 | 5.0 | 5.1 | 19.2 | 3.7 | 2.0 | 13.9 |

Source: Financial Characteristics of U.S. Farms, January 1, 1987, Agr. Inf. Bull. No. 525, Econ. Res. Service, U.S. Dep't of Agriculture, August, 1987, App. Tables 30, 33.

[a]Data insufficient for disclosure.

In terms of both income and solvency, USDA classifies farms into four groups --

Favorable (debt to asset ratios of 0.40 or less and positive income)
Marginal income (debt to asset ratios of 0.40 or less and negative income)
Marginal solvency (debt to asset ratios of more than 0.40 and positive income)
Vulnerable (debt to asset ratios of more than 0.40 and negative income)

Table 2 shows the distribution of operators, assets and debt among the four classes.

Table 2. Distribution of Operators and Debt by USDA Classification.

| | Favorable | Marginal Income | Marginal Solvency | Vulnerable |
|---|---|---|---|---|
| Operators | 47.41 | 30.96 | 11.12 | 10.51 |
| Debt | 22.66 | 10.27 | 32.06 | 35.02 |

Source: Financial Characteristics of U.S. Farms, January 1, 1987, Agr. Inf. Bull. No. 525, Econ. Res. Service, U.S. Dep't of Agriculture, August, 1987, Table 11.

The impact of debtor distress on lenders has been substantial. In 1985, the Farm Credit System incurred a $2.7 billion loss, the largest one-year loss of any U.S. financial institution. The loss for 1986 totalled $1.9 billion. With the help of creative accounting, the loss was reduced to $17 million in 1987. A total of 68 agricultural banks failed in 1986 out of a total of 138 failed banks. The numbers of agricultural bank failures declined to 58 in 1987 while the total number of failed banks rose to 184 (plus 19 banks that received FDIC assistance and remained open).

The massive reduction in farm debt in the 1980's is the most visible feature of the farm debt crisis. That phenomenon dramatized the resilience of the financial system in dealing with excess debt and provided new insights into the economic and social disruptions that almost certainly accompany such an event. Hopefully, lessons have been learned as to -- (1) how to prevent such a period from reoccurring and (2) how to cope with the trauma if indeed it were to recur.

## II. Key lessons learned in the 1980's[1]

### The danger in aberrational conditions

The first lesson -- and perhaps the most significant -- is the critical importance of spotting aberrational conditions and discounting their long-term relevance. Years ago, my father used to say, "If you see something that's too good to be true, it probably is." Decision makers can be lulled into economic complacency and confidence by forces that appear permanent but are clearly not sustainable.

Obviously, this lesson was forgotten in the 1970's as inflation was allowed to rage at elevated levels long enough to give individuals the belief that inflation would always be with us. But the lesson is far broader than inflation in the 1970's. The same factor was at work in the 1980's as investors in fixed income securities came to believe that 16 percent interest on an insured basis was the permanent condition of the human family. That was no more sustainable than the inflationary era of the 1970's.

The lesson is also important for agriculture any time the demand for food products is temporarily elevated, as in war time.

There lies buried deep in every psyche the persistent belief that the future somehow holds only good economic news; that the bad old days won't return. For decades, I heard my father wax eloquent about the 1930's. Indeed, I could even remember the last half of that decade. But deep down I doubted that agriculture would ever be subjected to such punishment again. We had become clever enough to sidestep such problems and to avoid the trauma of another decade of foreclosures, bankruptcies and deep debtor distress. Clearly, that was not the case.

Indeed, for agriculture it's well to keep in mind that the nature of the sector assures that, long-term, product prices will fluctuate near the cost of production on marginal lands. If profits rise, farmers as good economic citizens expand production. That brings price down as supply increases. Similarly, if losses occur, some farmers cut back on production so price will rise as supply falls. Therefore, in any era (as in 1972-73), when farm prices rise sharply, the message should be clear: it is aberrational; take advantage of the better times but beware of making investments on the assumption that the better times will continue. The capacity of agriculture to expand production is absolutely awesome. Moreover, it's well to keep in mind that increases in profitability are likely to be capitalized quickly into land values.

How can we be sure that this lesson is learned and relearned every generation? Relearning that lesson periodically helps to guard against the kind of economic downturn experienced in agriculture in the 1980's. For if the lesson is not learned, the agricultural sector is almost certain to experience periods of major economic trauma.

This problem is compounded by the fact that society seems to have a bias in favor of good news. The bearer of bad news or of caution is rarely appreciated in any era and is especially unwelcome in good times. As an example, during the boom times of the 1970's, I can recall no instance when administrators at Iowa State University were told that the work being done in research and in extension was driving up land values, adding to feelings of economic buoyancy. But I can say that as soon as highly visible efforts were mounted to address the farm debt crisis of the 1980's, delegations were pounding on the dean's desk demanding that those wild-eyed agricultural economists be curbed --they were driving down land values.

If indeed it is correct, that society's preference for good news creates a bias against research and extension work that identifies the aberrational and magnifies the perceived risks emanating from the aberrational, society should make a concerted effort to commission scholars to take the long view and to keep before decision-makers the downside risks from non-sustainable conditions. Agriculture, and indeed all of society, would be well served with such advice and counsel.

Capacity of creditors to broker losses

Perhaps the second most important lesson of the farm crisis of the 1980's has been that creditors have an enormous capacity to "broker" losses.[2] Just as rivers have a large capacity to deal with biodegradable pollutants, given time, distance and oxygen content in the water, creditors have a great capacity to absorb losses given time and the presence of some borrowers who are not in financial difficulty.

The loss sharing process. In the 1980's, as collateral values plummeted and cash flows proved to be inadequate to meet loan commitments, creditors were thrust into the unaccustomed role of "brokering losses."

Losses from interest payments missed and principal payments not made, and losses suffered when collateral values were well below principal balances when loans were liquidated, were shared among several parties in the adjustment process -- (1) the borrower who was in default and unable to make payments, (2) the lender, (3) other borrowers not in financial difficulty and (4) the federal government.

• The sharing of losses by the borrower and the lender are traditionally straightforward and are to be expected. After a borrower defaults on loan obligations, the borrower nearly always loses all assets other than assets exempt from execution. This happens in the event of default in good times; it also happens if default occurs in a time of widespread economic stress.

In normal times, the lender loses to the extent collateral values are less than the remaining amount owed after liquidating all of the borrower's non-exempt assets.

But in times of widespread economic stress, the loss sharing process does not stop with the borrower and the lender. Others are touched by losses being suffered. The expansion of loss sharing is partly because the rules of loss sharing are modified legislatively and partly because of economic circumstances that permit losses to be passed on to other customers.

• Borrowers not in financial jeopardy contribute to the loss sharing process as interest rates are elevated to cover loan losses and to reflect diminished lending competition in rural areas. In the 1970's, had there been a half percentage point difference in interest rates among lenders in a rural community, borrowers would have flocked across town over lunch to the cheapest source of money. In the 1980's, most farmers considered themselves lucky to have one source of money, not multiple sources. Few lenders wanted to increase their exposure to agricultural lending. Many lenders were willing to maintain their exposure for long standing, credit-worthy customers but were not enthusiastic about taking on new risks. Moreover, during the 1980's, the Farm Credit System was laboring under high cost bonds issued in the late 1970's and early 1980's without a call provision and was rapidly downsizing its loan portfolio as good, credit-worthy borrowers fled the system and as an effort was made to contain system losses. Moreover, FmHA was under strong pressure within the administration to limit lending, especially direct loans.

The result appears to have been that the "price surface" for loanable funds remained several basis points above where the interest rate would have been in normal times. Thus, borrowers not in financial difficulty ended up paying a premium for borrowed funds. Part of the interest bill for financially sound borrowers was to help defray the costs linked to losses being suffered by the lender. Indeed, it was recognized during the 1980's that -- (1) borrowers who were sufficiently strong credit risks to be able to move completely outside agricultural lending could obtain funds at lower cost and (2) lenders in agricultural areas with little or no exposure to farm loan losses were earning record or near record profits as they were able to take advantage of the elevated interest rate structure without the attendant losses.

- The federal government also participated in the loss sharing process directly and indirectly in three significant ways -- (1) the federal government, through FmHA, made good on loan guarantees as part of the federal loan guarantee programs,[3] (2) lender losses were translated into reduced federal (and state) income tax liability with the government bearing a portion of the burden for loan losses by lenders doing well enough economically to be paying income tax and (3) federal farm subsidy payments rose to record levels in 1985 and 1986 and contributed immensely to the loss sharing process. As to the latter point, it appears that Congress, for various reasons, chose not to fund a major targeted intervention effort for financially troubled farm debtors. Rather, the Congress elected to maintain commodity price support programs at a more generous level than would likely have been the case otherwise. Informal estimates of additional federal funding of $10 billion under the price support program because of the farm debt problem do not appear to be unreasonable. That approach was not a very efficient way to deal with the farm debt problem, with approximately 60 percent of the payment amount going to farmers not experiencing financial difficulty. But the benefits from the flow of price and income support program funds into rural areas at the depth of the farm crisis cannot be overemphasized.

The contribution of the federal government to the loss sharing process through commodity price support payments weakened substantially the critical and self-righteous comments of those who were able to survive the farm crisis by dint of hard work and scrimping. Those comments were mostly directed to those who had debt forgiven in bankruptcy or otherwise. Without federal commodity price support benefits, a far larger segment of farm debtors would have been unable to meet their payment obligations. Moreover, without commodity price support benefits, lenders would have been far less successful in coping with loan losses.

Indeed, there was little room left for self-righteous and critical comments even though such comments were occasionally heard.[4] Everyone in agriculture -- borrowers and non-borrowers alike, lenders and those selling inputs -- all benefitted from the added income from the generous commodity price support programs.

Thus, unless losses came too quickly or in too large an amount, lenders were successful in "brokering" them to several participants in the process. If losses did come too quickly or in too large an amount, lenders failed. One of the important lessons of the 1980's was that loan losses can be successfully brokered if spread over enough years. What lenders cannot endure are massive defaults that provide no opportunity for sharing the losses with others.

A similar process seems to have been at work with respect to losses suffered in the first instance by input suppliers. Modest losses appear to have been passed along to customers as part of the cost of doing business. Again, the government commodity price support programs were helpful in maintaining a higher level of economic buoyancy in rural communities which was helpful as losses were shared.

This "socialization" of losses is, to a degree, inconsistent with the traditional view that borrowers unable to repay principal plus interest suffer the consequences. The circumstances of the 1980's assured that the costs of the loan default were not -- and could not -- be limited to the borrower and the lender. Other participants were necessarily and inescapably involved because of the nature and magnitude of the problem.

<u>Rules governing loss sharing.</u> From the beginning of recorded history, the legal system has furnished the rules governing remedies upon borrower default. The rights of creditors have been spelled out in the legal system. The traditional creditors' remedies have included mortgage foreclosure and forfeiture of installment contracts with Uniform Commercial Code default procedures added in more recent time. Debtors have never been totally without rights, however, and in the modern era have been eligible for bankruptcy with discharge of debt. In

the 1930's, 28 states enacted statutes providing for moratoria on farm real estate mortgage foreclosure. In the 1980's, the moratorium received relatively less attention, perhaps because of the impact on lenders and on lending and the realization that other intervention approaches could be fashioned to better achieve relief for debtors.

It should be emphasized, however, <u>that loss sharing would have occurred in the 1980's had there been no modification in the legal framework governing default</u>.

<u>The necessity to restructure debt</u>

The third important lesson from the 1980's was that in the face of serious and widespread economic difficulty, the restructuring of debt -- including stretching out principal payments, reducing interest rates and even forgiving principal -- may be far preferable for the debtor, for the lender and for society generally than to insist that obligations be paid in full.

Resistance to debt restructuring understandably comes from creditors. But it also comes from some who are not directly affected. In the latter group, there seems to be a feeling that it is somehow unethical for society to let a debtor off the hook with less than full payment of what is owed.

What should not be forgotten in all of this is that bankruptcy is a well-established, constitutionally-assured bottom line solution for debtors. As much as some might like to resurrect them, debtor's prisons and the drawing and quartering of debtors are both unlikely to make a comeback. Therefore, when debtor distress is widespread and serious, it makes little sense to insist that debts be paid when the obligations most assuredly will not be met. As the debtor approaches insolvency, it makes eminent sense to take steps to keep loans performing rather than to force liquidation, displacing the farm family, triggering tax liability on the liquidation and incurring significant liquidation costs. Thus, any time the long term recovery for creditors with restructuring is greater in present value terms than liquidation, restructuring is economically advisable.

As the farm debt crisis of the 1980's progressed, the wisdom of restructuring became clearer and more obvious. Initially, the attention was focused on restructuring with the inducement of loan guarantees by the federal government.[5] By mid 1985, some lenders, notably commercial banks in the middle west, had concluded that restructuring should be undertaken whenever it was in the lender's best interest. The conflict posed by some lenders subscribing to loan restructuring and others steadfastly refusing even where it was clearly in the lender's best interest to do so led to three significant developments. All three were designed to produce a rational outcome for borrower and lender, taking into account the economic circumstances.

- Mandatory mediation, enacted in Iowa and Minnesota and considered in several other states, was a rational (but not costless) procedure to force the parties to examine all sides of the issue and, hopefully, reach agreement on a rational outcome.

- Chapter 12 bankruptcy, effective November 26, 1986,[6] was designed to enable eligible farm debtors to write down debt to collateral value to make the debtor stable.[7] Thus, Chapter 12 bankruptcy was a form of enforced debt restructuring with the process activated by debtor action. Under Chapter 12 bankruptcy, the amount of debt above collateral value is treated as unsecured debt which is discharged if not paid during the three to five year period covered by the bankruptcy reorganization plan. Under a typical Chapter 12 plan, less than 10 percent of the unsecured debt is paid.[8]

Arguably, Chapter 12 does not increase the loss taken by lenders but it does -- (1) possibly require that the loss be recognized sooner than the lender or the lender's examiners would have required, (2) preclude the lender from recovering more if the borrower's economic position improves (either because of better fortunes for agriculture or because Aunt Lillian dies) and (3) cause the lender to lose some of the control traditionally held over the default-liquidation process.

Although the amount of use of Chapter 12 has been substantial, as noted in Table 1, the influence of Chapter 12 goes well beyond the number of filings.

Table 1. Number of Chapter 12 Filings in the North Central Region Since November 26, 1986

| | Number As Of | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1-31-87 | 3-31-87 | 5-31-87 | 7-31-87 | 9-30-87 | 11-30-87 | 1-31-88 | 3-31-88 | 5-31-88 | 7-31-88 | 9-30-88 |
| IL | 46 | 121 | 179 | 233 | 250 | 282 | 301 | 329 | 350 | 369 | 373 |
| IN | 30 | 74 | 153 | 199 | 216 | 292 | 322 | 339 | 351 | 365 | 376 |
| IA | 73 | 188 | 264 | 290 | 308 | 329 | 350 | 360 | 379 | 387 | 396 |
| KS | 59 | 102 | 139 | 210 | 244 | 275 | 299 | 312 | 323 | 334 | 342 |
| MI | 18 | 48 | 87 | 137 | 148 | 166 | 181 | 194 | 216 | 220 | 232 |
| MN | 46 | 69 | 91 | 120 | 126 | 142 | 154 | 155 | 168 | 173 | 180 |
| MO | 18 | 109 | 172 | 206 | 225 | 246 | 281 | 298 | 332 | 350 | 361 |
| NB | 96 | 220 | 409 | 491 | 556 | 578 | 626 | 674 | 704 | 722 | 741 |
| ND | 25 | 51 | 74 | 87 | 113 | 140 | 167 | 179 | 188 | 202 | 209 |
| OH | 23 | 87 | 142 | 163 | 187 | 203 | 227 | 243 | 267 | 272* | 272* |
| SD | 106 | 208 | 315 | 438 | 512 | 410 | 502 | 525 | 544 | 552 | 560 |
| WI | 38 | 89 | 129 | 154 | 179 | 199 | 213 | 226 | 241 | 250 | 258 |
| | 578 | 1,366 | 2,154 | 2,728 | 3,064 | 3,262 | 3,623 | 3,834 | 4,063 | 4,196 | 4,300 |

*Through 6-30-88 only.

The availability of Chapter 12 has encouraged creditors to negotiate debt restructuring arrangements outside bankruptcy. Indeed, the major negotiating task is often the task of deciding who gains what would otherwise be expended for filing costs, attorney's fees and trustee's fees if the debtor files for bankruptcy.

- The third enactment, the Agricultural Credit Act of 1987,[9] was in the form of "borrowers' rights" for those borrowing from the Farm Credit System and the Farmers Home Administration. The concept of borrowers rights involves enforced debt restructuring along the general lines of what had been happening among many private lenders for at least 30 months before enactment of the borrower's rights provisions in early 1988.

Better data and analysis needed

Another highly important lesson from the farm crisis of the 1980's was that accurate, up-to-date information on the financial condition of farmers is absolutely essential if the economic and financial condition of farmers is to be effectively monitored. While data were available on the aggregate amount of debt, no dependable data sources provided information on the distribution of that debt among farmers.

Vulnerability of agriculture to high interest rates

An important lesson to policymakers was that agriculture is highly vulnerable to high interest rates. With interest rates being a major mechanism for implementing monetary policy, this lesson is an important one.

Agriculture's vulnerability derives from the relatively high level of capital intensity in the sector and the relatively low rate of return on assets. That combination assures that agriculture is heavily impacted domestically by changes in the interest rate.

In addition, U.S. agriculture is export sensitive. With interest rates related to exchange rates, U.S. agriculture, as it was in the early 1980's, can be severely impacted domestically by a policy of tight credit and, at the same time, affected adversely in export markets with a rise in the value of the dollar against other currencies.

Financial stress extended to advisors

A lesson learned painfully in the 1980's is that financial stress for borrowers poses problems for attorneys, accountants, psychiatrists and other advisors at the very time when assistance was most needed. In the 1980's, decisions were often made on a base of far less than perfect knowledge because debtors simply did not feel they could afford, and in some instances did not have funds to employ, legal and tax advice needed to make rational decisions, for example. Likewise, the emotional strain of financial stress all too often was translated into family abuse, alcohol and drug problems and even suicide.

This development also meant that the mid 1980's were a highly stressful time for the attorneys and other professional advisors in rural areas who were willing to provide assistance, often at greatly reduced rates, to those most heavily indebted. Instances were noted of "burn out" among advisors after several months of intensive representation of debtors.

Attention should be given to the development of arrangements to assure needed professional assistance when funds are not available to pay for help. In the 1980's, the total cost for such aid would have been relatively modest compared to the loan losses being incurred.

Basic family needs of debtors should be met

One of the most unfortunate aspects of high levels of debtor distress was the toll on the family. Indeed, many of the more touching stories published about the farm crisis of the 1980's related to impacts upon the family.

Greater recognition of the need for family assistance in terms of assuring the basic needs for survival (food, shelter, clothing, medical assistance), school costs and family counseling would be helpful. During the 1980's, these needs were met in some areas primarily by church, church-related and other private organizations. Even in those rural areas that were eventually served adequately by private groups, the lag in initiating assistance meant that some needs in the early months of the farm crisis simply were not met. In other rural areas, relatively little assistance was provided.

As with the lesson related to the need for professional assistance, attention should be given to assuring adequate funding and staffing of outreach efforts and, at a minimum, organizing with a minimum of response time once the need is established.

Most states maintain offices for disaster assistance and relief. In general, those offices have been chartered to respond to physical disasters. A reorientation of charge and charter would provide the basic leadership and organization momentum which, in conjunction with extension services, mental health centers, church and church-related groups, should assure a faster response time in the future when economic disaster strikes.

The United States has a long and proud tradition in responding generously to devastation from flood, fire, storms, earthquake and other physical phenomena. The objective should be to achieve the same level of response to economic disaster.

The hazards of non-diversity in loan portfolios

One of the most visible effects of the farm crisis of the 1980's -- and certainly the most important to policymakers in Washington -- was the impact on lenders. Indeed, had the farm crisis not posed a threat to the financial fabric of the country, through the aggregation of loans in the Farm Credit System, there would have been even less responsiveness from Washington.

The federal response a half century or so from now, at the time of the next farm crisis, might be even less forthcoming as the agricultural sector continues to diminish in relative importance in the country. Therefore, it seems prudent to take seriously the lesson of vulnerability from non-diversity in loan portfolios and develop a greater degree of built-in protection for the sector. It is not at all clear that agriculture can count on the United States Treasury to be the ultimate "rescue fund" in the future.

The problem of vulnerability has been the greatest in the Farm Credit System.[10] Except for loans to farmer cooperatives, the system lends principally for agricultural purposes and takes as collateral principally agricultural property. Actually, loans to farmer cooperatives add relatively little diversity inasmuch as the fortunes of farmer cooperatives tend to parallel the fortunes of their farmer members.

Although the Farm Credit System's problems have been attributed also to farmer control and inept management, and those factors may have played a modest role, the overwhelming reason for the rapid financial deterioration of the system during the 1980's is believed to have been the concentration of loans in the agricultural sector.

Many rural-area banks also loan heavily to farmers. But even the smallest rural-area bank generally has some loans to individuals and enterprises somewhat insulated from the fortunes of agriculture.

The importance of paying some attention to the Farm Credit System's condition relates to the degree of dominance of the system in agricultural lending. In 1983, when outstanding farm debt totalled $216 billion,[11] the Farm Credit System had become the dominant farm lender in the United States. The system held nearly 32 percent of the total farm debt in 1983, with Federal Land Banks holding more than 43 percent of farm real estate debt. PCA's held almost 23 percent of non-real estate debt before experiencing a decline in 1982.[12] By the end of 1985, those figures had decreased substantially. PCA's held 7.5 percent of the non-real estate debt while the Federal Land Bank's share of real estate lending had declined to 21 percent.[13]

At the same time, the reserves of the Farm Credit System, including farmer-owned stock, had declined from $11.8 billion in 1984 (of which $6.2

billion was surplus) to $5.64 billion at the end of 1986, with system surplus totalling only $1.45 billion on December 31, 1986.[14] The condition of the system continued to deteriorate through 1987 and into 1988 with financial assistance authorized in early 1988.[15]

Concern about system vulnerability is not new. A 1952 report prepared by a committee chaired by a former governor of the Farm Credit Administration focused on the problem of PCA's sharing the risks of losses from large loans.[16] The governor of the Farm Credit Administration had tried, without success, to gain support for changes to better enable the Production Credit Associations to weather economic adversity. In its report, the committee stated --

> "aside from the Government revolving fund, the production credit associations have no way of sharing risks nor recourse to any comparable assistance in times of stress. Under the present structure, each production credit association stands alone with respect to the risks of outstanding loans; there is no way now of spreading an association's risks beyond the limits of its territory. Because of the possibility of conditions which may be beyond the control of borrowers or the association arising in a particular territory, it is evident that individual associations could find themselves in an adverse financial condition beyond their ability to cope with."[17]

In a letter to W. G. Murray, a member of the committee, Gov. I.W. Duggan, who by that time had left the Farm Credit Administration, stated:

> "Your very nice letter brought forcibly to mind the fact that I had completely failed in making any progress in developing a program for operating the risks among PCA's. In fact, I even failed to convince those in the Production Credit System that they had any problems. Possibly, they will have to go through a wringing out process before they realize the situation..."

The Farm Credit Board, in 1966, approved risk-sharing plans in eight farm credit districts.[18]

One way to build protection for farm lenders against economic downturns is by increasing the level of diversity in loan portfolios.

Diversity in farm lending can be achieved in various ways --

- Geographical diversity has been inherent in the national scope of the Farm Credit System. There is, indeed, evidence that the original 12 Federal Land Bank districts were established to avoid "one-crop" districts.[19] Geographic diversity has been helpful in enabling the system to withstand economic adversity related to weather, other natural disasters and localized price and income adversity. Indeed, geographic diversity was initially helpful in withstanding the effects of the farm crisis of the 1980's. However, healthier districts soon resisted the pooling of available reserves which limited the benefits of geographic diversity.

Under the Agricultural Credit Act of 1987 a degree of geographic diversity is retained with each bank responsible for obligations issued on its behalf and jointly and severally with the other banks on consolidated or system-wide obligations as called upon by the Farm Credit Administration.[20]

- Horizontal diversity could be achieved by lending to those whose economic fortunes are not related to agriculture. If the Farm Credit System were to move in this direction, the system would be virtually indistinguishable from other large, diversified lenders. Permission for such a broadening of lending authority is unlikely.

- Vertical diversity could be accomplished by lending to greater segments of the input supplying and output processing components of the agricultural sector. The value of vertical diversity relates to the extent to which the fortunes of borrowers in the expanded group move in cycles contrary to the fortunes of agriculture, rather than moving in tandem.

- Functional diversity could be achieved by adding an expanded line of financial and other products to the system. Long-range plans developed earlier in the 1980's by the Farm Credit System would have moved the system toward greater functional diversity. While the value of diversity, including functional diversity, would be significant, a question is raised as to whether there is adequate justification for governmentally-assisted creation of another large financial conglomerate. Again, permission for such a move seems unlikely.

- The remaining possibility for achieving diversity is to attain diversity over time. This involves building capital reserves in good economic times with the realization that the reserves will be utilized in times of economic adversity for the sector.

The creation of the Farm Credit System Insurance Corporation (FCSIC) which is an FDIC-type fund for the Farm Credit System is a move in the direction of greater reliance on time diversity.[21] Beginning five years after enactment of the legislation, the FCSIC is to insure the timely payment of principal and interest on obligations issued on behalf of the system. Each system bank, beginning in 1989, will pay an annual premium (0.15 percent on loans in accrual status, 0.25 percent on nonaccrual loans) on the average principal outstanding. The premiums will be scaled back when the FCSIC balance reaches two percent of all outstanding obligations or whatever amount is considered an actuarially sound amount. Considering the experience of the 1980's, an amount substantially in excess of two percent may be needed.

To the extent agricultural lenders cannot achieve diversity and cannot build sufficient reserves, problems can again be anticipated on the occasion of the next economic downturn for the sector. For the Farm Credit System, that means the U.S. Treasury will likely continue to play a back-up role, albeit more limited, hopefully, than in the 1980's.

The farm crisis was a "systems" problem for the entire rural community

An important lesson of the 1980's was that the farm crisis was not merely a debtors' problem or a lenders' problem. The farm crisis of the 1980's was a systems problem and soon touched virtually every segment of the rural community. Discharged debt went ricocheting through local communities, inflicting economic damage. Debt burdened farmers reduced their level of purchases, to the detriment of the merchants and professional people. Financially stressed farmers were unable to pay property taxes when due, thus impacting school districts and county government. Failed banks inflicted damage on all borrowers unable to obtain credit elsewhere and on the community if the bank closed. Thus, an attitude emerged of recognized interdependence which tended to curb the polarization of financially secure farmers on the one hand and heavily indebted farmers on the other.

The merits of prudence in lending

A lesson learned painfully by lenders (and learned in an equally painful manner by borrowers) in the 1980's was the importance of prudence in lending. Much has been made of the shift by lenders from cash-flow lending to asset-based lending in the early 1970's, enabling greater amounts to be loaned. Likewise, much has been made of the relaxation of real estate lending limits in the Farm Credit Act of 1971.[22] Without much doubt, both contributed to the lending practices which characterized the late 1970's and early 1980's. More important, however, was the attitude that success of an institution was measured by the growth in loans outstanding. The notion of "merchandising money" downplays the importance of prudence in lending.

It is fundamental that a dependable supply of capital is vital for the continued good health of the agricultural sector. It is equally fundamental that capital made available at bargain rates, other than as part of a narrowly targeted disaster relief program, does no favor for the sector. Low cost capital induces overproduction in the aggregate and encourages greater use of capital by individual farmers with the result of increased vulnerability to financial distress.

The need for a team effort by USDA and the state universities

A lesson learned in the 1980's that should not have been necessary was the realization that the United States Department of Agriculture and the state universities should work as a team in endeavoring to solve agriculture's problems. All are funded with public moneys and it is reasonable for society to assume a modicum of cooperation and teamwork. Unfortunately, that was not the case in the 1980's.

It should be a high priority for the administrators involved to do whatever is necessary to assure that the pettiness and lack of cooperation that occasionally surfaced during the farm crisis of the 1980's are forever buried.

The importance of a reservoir of good will and support in the nonfarm sector

Finally, a lesson learned during the 1980's was that agriculture enjoys an enormous reservoir of good will among non-farm individuals in this country. Polls and surveys repeatedly showed that a strong majority were highly supportive of efforts to provide economic assistance to heavily indebted farmers. Indeed, some surveys showed surprisingly strong support in terms of a willingness to pay additional taxes for that purpose.

This is a highly important and valuable resource that should be drawn upon only when needed and then in a responsible manner. If agriculture expects to maintain such support in the future, governmental assistance, whether for debt relief, drought relief or commodity price supports, must be rational, defensible and administered in a manner designed to maintain the confidence of the non-farm world. Moreover, it is incumbent upon agriculture to be supportive of needs important to the non-farm sector as a reciprocal gesture of good will and a reaffirmation that we are, indeed, one people.

There is a belief, deeply imbedded in the American culture, that a healthy food producing system, organized around a family farm structure, is an important component of our food and agriculture policy. The experiences of the 1980's, as this country was confronted with a threat to the agrarian part of the culture, reaffirm the importance of that objective.

## III. Conclusion

While the lessons of the 1980's are fresh in our minds, we should resolve to see that those lessons are transmitted to succeeding generations. Hopefully, if we are successful the level of trauma from economic disruptions in the sector in the twenty-first century will be lessened.

Footnotes

1. This section is drawn from Chapter 10 of N. Harl, A Perspective on the Farm Crisis of the 1980's (forthcoming).

2. See N. Harl, "Issues in Agricultural Finance," Proceedings of the American Agricultural Economics Association Workshop, East Lansing, Michigan, July 31-August 1, 1987, pp. 143-148.

3. See Chapter 3 of N. Harl, op. cit. note 1 for a discussion of the Debt Adjustment Program (DAP) which involved a loan guarantee.

4. See, e.g., J. Perkins, "Farmers Seethe Over Government Decision to Write Off Ag Loans," Des Moines Register, 1J, March 6, 1988; Bill Wyant, "How to Keep a Pro Manager Going: Restructure His Loan," Farm Futures, Vol. 16, No. 7, May 1988.

5. See Chapter 3 of N. Harl, op. cit., note 1.

6. See Figure 2-7, Chapter 2 of N. Harl, op. cit., note 1.

7. See N. Harl, Agricultural Law, vol. 13, Section 120.08, 1988.

8. Faiferlick and Harl, "The Chapter 12 Bankruptcy Experience in Iowa," J. Agr. Tax'n & Law, vol. 9, No. 4, pp. 302-336, 1988.

9. See Chapter 4 of N. Harl, op. cit., note 1.

10. See N. Harl, "Policy Considerations Related to Further Intervention in the Farm Credit System," J. Agric. Cooperation, vol. 2, pp. 57-73, 1987.

11. See Chapter 2 of N. Harl, op. cit., note 1.

12. G. Amols and W. Kaiser, "Agricultural Finance Statistics, 1960-83," USDA, ERS Stat. Bull. 706, April, 1984.

13. U.S. Department of Agriculture, Agricultural Finance: Outlook and Situation Report, ERS AFO-26, March, 1986, table 12.

14. Farm Credit System, Combined Financial Statement Data, December 31, 986.

15. Agricultural Credit Act of 1987, Pub. L. 100-233, 101 Stat. 1610 (1988).

16. F. F. Hill, et al, "Risk Problems of Production Credit Associations," USDA, FCA Bull. CR-5, January, 1952.

17. _Id._ at ii.

18. W. G. Hoag, _The Farm Credit System: A History of Financial Self-Help_, Interstate Printers and Publishers, 1976, p. 159.

19. Hoag, note 17, p. 215, I. Wright, _Farm Mortgage Financing_, McGraw-Hill Book Co., pp. 80-81.

20. Pub. L. 100-233, Sec. 3-3, 101 Stat. 1620 (1988), amending 12 U.S.C. § 2155.

21. Agricultural Credit Act of 1987, Pub. L. 100-233, Sec. 302, 101 Stat. 1610 (1988), adding 12 U.S.C. § 2277A _et seq_. See N. Harl, Testimony before the Committee on Agriculture, Nutrition and Forestry, Subcommittee on Agricultural Credit, U.S. Senate, March 26, 1987; N. Harl, "Policy Considerations Related to Further Intervention in the Farm Credit System," _J. Agr. Coop._, vol. 2, 1987, pp. 63-64.

22. Pub. L. 92-181, 85 Stat. 583 _et seq_ (1971).