



2005

# Selling out the Farm - The Impact of the Farm Security and Rural Investment Act of 2002 on Lending Institutions and the Small Farmer

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## Recommended Citation

Amanda Stokes, *Selling out the Farm - The Impact of the Farm Security and Rural Investment Act of 2002 on Lending Institutions and the Small Farmer*, 9 N.C. BANKING INST. 243 (2005).

Available at: <http://scholarship.law.unc.edu/ncbi/vol9/iss1/12>

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## Selling Out the Farm?

# The Impact of the Farm Security and Rural Investment Act of 2002 on Lending Institutions and the Small Farmer

### I. INTRODUCTION

American farm and ranch families embody some of the best values of our nation: hard work and risk-taking, love of the land and love of our country . . . . This bill is generous, and will provide a safety net for farmers . . . . It will allow farmers and ranchers to plan and operate based on market realities, not government dictates.<sup>1</sup>

—President George W. Bush, *Remarks Upon Signing the 2002 Farm Bill*

Between 1995 and 2003, Ken Lay of the Enron Corporation received \$22,486 in federal farm subsidies to idle land he owns in Texas.<sup>2</sup> Basketball player Scottie Pippen, formerly of the Chicago Bulls, received \$210,520 in federal farm subsidies during the same time period for idling land he owns in Arkansas.<sup>3</sup> While the average payment to the bottom eighty percent of farm subsidy recipients between 1995 and 2003 was \$6,918,<sup>4</sup> John Hancock Mutual Life Insurance and Georgia Pacific, both *Fortune* 500 companies, received a total of \$2,923,611.79.<sup>5</sup>

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1. George W. Bush, Remarks upon Signing the Farm Bill, (May 13, 2002) (Federal News Service).

2. The Environmental Working Group, *Top Recipients of Subsidies in the United States*, at <http://www.ewg.org:16080/farm/persondetail.php?custnumber=011434621> (last visited Feb. 6, 2005).

3. *Id.* at <http://www.ewg.org:16080/farm/persondetail.php?custnumber=005157951> (last visited Feb. 6, 2005).

4. The Environmental Working Group, *Total USDA-Subsidies in the United States*, at <http://www.ewg.org/farm/progdetail.php?fips=00000&progcode=total&page=conc> (last visited Feb. 6, 2005).

5. The Environmental Working Group, *Top Programs in the United States, 1995-2003*, at <http://www.ewg.org/farm/addrsearch.php?s=yup&stab=US&city=&c=See+Recipients&zip=&last=&first=&fullname=john+hancock+mutual> (last visited Feb. 6, 2005); <http://www.ewg.org/farm/addrsearch.php?s=yup&stab=US&city=&c=See+Recipients&zip=&last=&first=&fullname=georgia+pacific> (last visited Feb. 6, 2005).

Federal farm subsidy programs have remained controversial since their inception in 1933.<sup>6</sup> While many Americans view subsidies as a good way to help the nostalgic “small family farm” survive, others disagree with the overall philosophy behind subsidies.<sup>7</sup> These critics feel that subsidies amount to little more than a food tax on consumers,<sup>8</sup> or that they thwart truly free trade in an age of increased globalization.<sup>9</sup> Despite this constant controversy, however, subsidies have been a mainstay of American agricultural policy for over half a century and show no signs of becoming obsolete.<sup>10</sup>

America’s acceptance of federal subsidy policy was formally reaffirmed on May 13, 2002, when President George W. Bush signed into law the Farm Security and Rural Investment Act (FSRIA).<sup>11</sup> Although many continue to debate the general efficacy of farm subsidies, this Note examines the specific issue of how FSRIA subsidies negatively impact the financial relationship between small farmers and lending institutions.<sup>12</sup> The issue merits attention as according to the

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6. Edward Lotterman, *Farm Bills and Farmers: The Effect of Subsidies Over Time*, FED. RES. BANK MINNEAPOLIS, Dec. 1996, at <http://woodrow.mpls.frb.fed.us/pubs/region/96-12/farbill.cfm> (last visited Feb. 6, 2005).

7. See Brian M. Riedl, *Still at the Federal Trough: Farm Subsidies for the Rich and Famous Shattered Records in 2001*, HERITAGE FOUND. BACKGROUNDER, Apr. 30, 2002, at 1.

8. See Brian M. Riedl, *The Cost of America’s Farm Subsidy Binge: An Average of \$1 Million per Farm*, HERITAGE FOUND. BACKGROUNDER, Dec. 10, 2001, at 1. The Heritage Foundation estimates that subsidies result in \$190 billion in food taxes on American families and an additional burden of \$271 billion in inflated food prices. *Id.*

9. See Center for Strategic and International Studies (CSIS), *Reaction to U.S. Farm Act Highlights Tension between Domestic Politics and International Obligation* (July 1, 2002), at [http://www.globalization101.org/news.asp?NEWS\\_ID=29](http://www.globalization101.org/news.asp?NEWS_ID=29). “America’s trading partners have condemned [American subsidy policies] as a politically driven, protectionist measure that violated World Trade Organization (WTO) rules on agricultural subsidies established in the Uruguay Round of trade talks.” *Id.* According to the Federal Deposit Insurance Corporation (FDIC), the WTO talks scheduled to occur in December of 2005 will focus on a new trade framework, including “outlines for formulas for reducing import barriers, export subsidies, and domestic support programs.” John Anderlik et al., *The U.S. Agricultural Sector: Recent Events Highlight Ongoing Systemic Risks*, FDIC OUTLOOK, Fall 2004.

10. See, e.g., Bush, *supra* note 1.

11. 7 U.S.C. § 7901 (2004).

12. USDA ECON. RES. SERV., *Briefing Room: Farm Structure Glossary*, at <http://www.ers.usda.gov/Briefing/FarmStructure/glossary.htm#smfarm> (last visited Feb. 6, 2005). This Note adopts the USDA definition of the small farmer. *Id.* Identifying the line between “small” and “large” farms, however, is not without difficulties. For an excellent discussion of the problems inherent in defining the small farm, see generally Farm Foundation, *Small and Underserved Farmers* at <http://www.farmfoundation.org/2002FB/8-5.pdf> (last visited Feb. 6, 2005). This Note also primarily considers the relationship between small farmers and commercial banks. It is important to note, however, that there

2002 Census of Agriculture, small farmers make up ninety two percent of the all farmers in the United States.<sup>13</sup> Careful examination of FSRIA indicates that as subsidy payments to large farms increase, a cycle emerges that increases the risk of lending to small farmers, who are defined as those farmers making an annual income of less than \$250,000.<sup>14</sup> As this risk of lending to small farmers increases, lending institutions should engage in careful risk management when deciding to extend credit to small farmers.<sup>15</sup>

Part II of this Note describes the advent of agricultural subsidies in America, outlines Congress' attempt at reform in 1996, and discusses the passage of FSRIA and how FSRIA constituted a poorly devised return to pre-1996 agricultural policy.<sup>16</sup> Part III focuses on the mechanics of the FSRIA subsidies, how FSRIA subsidies increase the risk of lending to small farmers, and what lenders can do to minimize this risk.<sup>17</sup> Finally, Part IV discusses the impact of FSRIA, as well as FSRIA's specific impact on both lending institutions and the health of the small farm.<sup>18</sup>

## II. AN OVERVIEW OF AMERICAN AGRICULTURAL POLICY: 1933 TO 2002

### A. *The Rise of Subsidies in the United States*

The speculation-induced prosperity of the 1920s crumbled on Black Thursday,<sup>19</sup> sending the entire economy into a tailspin.<sup>20</sup> By

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are additional avenues of credit, although strictly limited, available to farmers through the Farm Credit System (FCS). See Susan A. Schneider, *Financing the Agricultural Operation: Recent Developments and Current Trends*, 4 DRAKE J. AGRIC., 216, 225-30 (1999). While the FCS is a "network of federally-chartered, borrower-owned cooperatives that was specifically created to provide a competitive source of agricultural credit," the institution has been significantly limited in its authority and lending abilities over time. *Id.*

13. USDA NATL. AGRIC. STATISTICS SERV., *Economic Class of Farms by Market Value of Agricultural Products Sold and Government Payments*, at [http://www.nass.usda.gov/census/census02/volume1/us/st99\\_1\\_003\\_003.pdf](http://www.nass.usda.gov/census/census02/volume1/us/st99_1_003_003.pdf) (last visited Feb. 6, 2005). The raw data suggest that 1,969,188, or ninety two percent of American farms make less than \$250,000 per year. Large farms, on the other hand, or those farms making more than \$250,000, constitute only eight percent of American farms, or 159,794. *Id.*

14. See *infra* notes 94-126 and accompanying text.

15. See *infra* notes 94-206 and accompanying text.

16. See *infra* notes 19-88 and accompanying text.

17. See *infra* notes 89-206 and accompanying text.

18. See *infra* notes 207-218 and accompanying text.

19. See GARY B. NASH & JULIE R. JEFFREY, *THE AMERICAN PEOPLE, CREATING A*

1933, further deterioration of the economy had spawned a wave of bank failures alongside widespread unemployment and hunger in rural areas.<sup>21</sup> Adverse weather in the midwest further exacerbated the crisis.<sup>22</sup> During this time period, annual farmer income fell to approximately fifty percent of the national average income.<sup>23</sup>

The Agricultural Adjustment Act of 1933 (the AAA) purported to provide a pragmatic response to the crisis.<sup>24</sup> Creating the mechanisms that would be drawn upon by later federal farm legislation, the AAA “authorized direct payments to producers who curtailed output of crops and livestock,”<sup>25</sup> and made these payments available to subsidize specific commodities including grains, cotton, and tobacco.<sup>26</sup> In 1938, Congress amended the AAA to include, among other things, a provision making commodity loans available to qualifying farmers as a method for stabilizing farm income and decreasing supply.<sup>27</sup> Although the AAA was amended repeatedly over the years to subsidize a growing number of specified commodities, its basic structure would remain in force for nearly sixty years.<sup>28</sup>

### *B. The Freedom to Farm in 1996*

Once the AAA was enacted, Congress merely passed a farm bill every few years to extend its basic structure, usually with minor modifications.<sup>29</sup> As a result, most farm policy analysts expected existing legislation to be extended again in 1995.<sup>30</sup> One journalist quipped that “every four years, just like the Winter Olympics, Congress

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NATION AND A SOCIETY 810 (Bruce Borland ed., Harper Collins 1994). On Oct. 24, 1929, “it first seemed that everyone was trying to sell, but at the end of the day the panic appeared over. It was not. By mid-November, the market had plummeted to 224, about half of what it had been two months before. This represented a loss on paper of over \$26 billion.” *Id.*

20. See Lotterman, *supra* note 6.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. See Lotterman, *supra* note 6.

27. *Id.*

28. *Id.* Although beyond the scope of this Note, Lotterman traces American agricultural policy in detail from 1933 to 1996. *Id.*

29. *Id.*

30. See Lotterman, *supra* note 6.

reauthorizes farm programs.”<sup>31</sup> In 1994, however, public concern over federal budget deficits, compounded with a deregulatory mood in Congress, suggested that legislative modification of farm subsidy programs was possible.<sup>32</sup> High commodity prices and a positive outlook for the export market in 1995 also contributed to the atmosphere favoring reform, as the favorable economic conditions would allow farmers to perform even in the absence of federal subsidies.<sup>33</sup>

Reform came to fruition in the Federal Agricultural Improvement and Reform Act of 1996 (FAIR).<sup>34</sup> The fundamental goal of FAIR was to give farmers “more control over their planting decisions in return for fewer subsidies.”<sup>35</sup> Instead of providing subsidy payments only when specific crops were grown, as the AAA did with grains, cotton, and tobacco, FAIR created a system of “production flexibility contracts” (PFCs).<sup>36</sup> PFCs were fixed payments that would be made regardless of what crops a farmer chose to plant.<sup>37</sup> This system of PFCs gave FAIR its informal name, the Freedom to Farm Act, and provided the farmer with more discretion over his planting choices and the factors he could take into consideration when making planting decisions.<sup>38</sup> PFCs were not permitted to fluctuate with market prices until the end of each fiscal year and would decrease annually until they were phased out over a period of seven years.<sup>39</sup> Since traditionally subsidized crops were capital intensive and usually had to be grown on large amounts of land to be profitable, the 1996 legislation gave small farmers the unique ability to sample new markets and react to changing market conditions while providing a safe harbor in which they could adjust if innovative ideas failed.<sup>40</sup>

FAIR thus ended a sixty-year old tradition of subsidizing the

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31. Charles Schumer, *Pork the Farmers' Favorite Meat*, WALL ST. J., May 17, 1995, at A20.

32. See Lotterman, *supra* note 6.

33. Chris Edwards & Tad DeHaven, *Farm Subsidies at Record Levels as Congress Considers New Farm Bill*, CATO INST., Oct. 18, 2001, at 4.

34. See Riedl, *supra* note 8, at 1; John E. Frydenlund, *The Erosion of Freedom to Farm*, HERITAGE FOUND. BACKGROUNDER, Mar. 8, 2002, at 2.

35. See Riedl, *supra* note 8, at 2.

36. *Id.*

37. See Edwards & DeHaven, *supra* note 33, at 4.

38. *Id.*

39. *Id.*

40. *Id.* at 5; see also Frydenlund, *supra* note 34, at 3.

production of corn, wheat, rice, and cotton.<sup>41</sup> Although FAIR failed to dismantle peanut, sugar, and dairy subsidy programs, analysts described FAIR as “an historic break from farm policies of the Depression Era.”<sup>42</sup> This was so because FAIR envisioned a transition toward market-oriented agriculture by phasing out crop subsidies over time, replacing federal legislation with the free market as determinative of commodity prices.<sup>43</sup> FAIR was statutorily set to expire in September of 2002, at which time the law would revert to the 1949 subsidies legislation unless Congress intervened.<sup>44</sup>

### *C. Passage of the Farm Security and Rural Investment Act in 2002*

By 1997, some of the effects of FAIR were becoming clear. Deregulation was “one of the biggest experiments ever conducted on the U.S. food system,” and unprecedented crop switching and a new managerial focus were changing the business of farming.<sup>45</sup> Instead of merely acting as production machines, farmers had to exercise business acumen, something subsidy programs had never required, and indeed, possibly discouraged.<sup>46</sup> Despite the higher risks associated with making market-based choices, farmers were able to diversify planting and assume a greater role in the decision-making process.<sup>47</sup>

Midway through 1998, however, prices of major commodities, including wheat, corn, and soybeans began to fall, despite a drought that threatened to eliminate the entire crops of farmers in the southern United States.<sup>48</sup> Further compounding the general unease, demand for

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41. Bruce Ingersoll, *Farm Bill Ending Some Crop Limits, Biggest Subsidy Efforts Moves Forward*, WALL ST. J., Mar. 22, 1996, at A3.

42. Bruce Ingersoll, *Congress Passes New Farm Bill that Dismantles Subsidy Programs after Much Vote Trading*, WALL ST. J., Apr. 1, 1996, at A16.

43. Ingersoll, *supra* note 41.

44. Ingersoll, *supra* note 42.

45. Scott Kilman, *Turning the Soil: Free Market Comes to the Farm, Throws Some Folks for a Loop*, WALL ST. J., June 16, 1997, at A1.

46. *Id.*

47. *Id.* Interestingly, during this time period, the business of agricultural consulting emerged as a way to help newly deregulated farmers make crop decisions. *Id.*

48. Scott Kilman, *Decline in Exports to Asia and a Drought Worry Farmers*, WALL ST. J., July 16, 1998, at A2. “In 1997, an international economic crisis that began in Thailand spread to other Asian countries. This set off a downturn in the economic and financial condition in Asia, the largest market for U.S. agricultural and food products.” Frydenlund, *supra* note 34, at 4.

U.S. agricultural products throughout Asia began to decline as economic troubles on that continent mounted.<sup>49</sup> While economists doubted that agriculture was heading towards a financial crisis similar to that of the mid-1980s,<sup>50</sup> public pressure resulted in a \$60 billion congressional aid package that contained \$4.2 billion in emergency aid that would boost farm commodity prices and aid farmers in the south.<sup>51</sup> This bill was the first of many emergency farm bills that had the effect of eliminating much of the monumental deregulation achieved under FAIR.<sup>52</sup> President Bush signed the last supplemental farm emergency bill in July of 2001,<sup>53</sup> and by December of 2001, Congress was locked into a debate over how to handle the expiration of FAIR in 2002.<sup>54</sup>

#### *D. Substance and Scope of the Farm Security and Rural Investment Act (FSRIA)*

During this debate, proponents of the bill that would become FSRIA “maintained that rural communities across America rely on agriculture as their primary source of income,” and that without farm subsidies, the small family farm would disappear.<sup>55</sup> Detractors

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49. See Kilman, *supra* note 48.

50. See generally Lotterman, *supra* note 6. By the mid-1980s, land prices had decreased by as much as fifty percent in some areas and agricultural banks began to fail as the property they obtained as a result of foreclosure was worth significantly less than when they accepted the property as security for farmers' debt. *Id.* Congress passed the Food Security Act of 1985, which contained a \$70 billion bailout plan for farmers that would extend over a three-year period. See Marj Charlier, *Farm Fallout: Rural Crisis May Hurt Rest of Economy, Many Experts Believe*, WALL ST. J., Dec. 24, 1985, at A1. Despite passage of the Food Security Act, economists at the time predicted that ten percent of farmers would be out of business by 1987, defaulting on \$25 billion in farm debt. *Id.* From 1985 until 1995, there were no moves to reform agricultural policy, despite the devastation that was left behind. See generally NEIL E. HARL, *THE FARM DEBT CRISIS OF THE 1980S* 224 (Richard Kirkendall ed., Iowa State Univ. Press 1990).

51. *Selling the Farm*, WALL ST. J., Oct. 12, 1998, at A18. Interestingly, the extra farm aid may not have been the Clinton Administration's idea. At least one editorial referred to the farm aid as “a [Republican] concession to Senate Democrats to preserve their support in [Clinton's] impeachment proceedings.” *Id.*

52. Edwards & DeHaven, *supra* note 33, at 2.

53. See David Rogers, *Bush Will Sign Farm-Rescue Bill, But Issue Still Will Haunt Budget*, WALL ST. J., Aug. 6, 2001, at A14.

54. See Riedl, *supra* note 8, at 1. It is timely to note that as early as Sept. of 2001, at least one analyst predicted that the farm bill “would more than wipe out what remains of non-Social Security surpluses projected for the next few years.” David Rogers, *House GOP Plans Massive Farm-Spending Bill*, WALL ST. J., Sept. 7, 2001, at A2.

55. See Beau Hurtig, Note, *The 2002 Farm Bill: One Small Step for Family Farmers*,



maintained that the legislation was regressive and too expensive, as it was projected at the time to add over \$183 billion in agricultural spending over a ten-year period.<sup>56</sup> Despite these concerns, Congress passed FSRIA, which will expire in 2012 unless Congress takes action to extend it.<sup>57</sup>

According to the Congressional Budget Office, FSRIA will increase direct government spending on agricultural programs by \$87.3 billion through 2012.<sup>58</sup> When combined with spending authorized prior to its enactment, FSRIA will bring total spending on agricultural programs to \$869.3 billion over this time period, with a record \$242.5 billion or twenty eight percent of that sum going to the commodity subsidy programs alone.<sup>59</sup>

Although FSRIA purports to address a range of issues, including conservation, energy, trade, agricultural research, and nutrition, this Note is primarily concerned with Title I of FSRIA, which regulates commodity subsidy programs.<sup>60</sup> FSRIA subsidizes statutorily specified commodities through three main avenues: direct subsidy payments,<sup>61</sup> counter-cyclical payments,<sup>62</sup> and marketing loans.<sup>63</sup>

Unlike the system of non-crop specific PFC payments created by FAIR, FSRIA harks back to the days of the AAA and effectively

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*One Giant Leap Towards Corporate Production in Iowa*, 29 IOWA J. CORP. L. 199, 207 (2003).

56. *Id.* Despite a spirited debate, however, FSRIA passed the House of Representatives with a vote of 280-141 and the Senate with a vote of 64-35. See Keith Gray, *Farm Security and Rural Investment Act of 2002*, Ala. Farmer's Fed'n (July 23, 2002), at <http://www.alfafarmers.com/issues/farmbill.phtml>.

57. See Paul C. Westcott et al., *The 2002 Farm Act: Provisions and Implications for Commodity Markets*, USDA ECON. RES. SERV., Agric. Information Bulletin Number 778, Nov. 2002, at 4.

58. Congressional Budget Office Pay-As-You-Go Estimate, H.R. Farm Security and Rural Investment Act of 2002, at <http://www.cbo.gov/showdoc.cfm?index=3468&sequence=0> at 5 (last visited Feb. 6, 2005).

59. *Id.*

60. 7 U.S.C. § 7901 (2004). Commodities that are directly subsidized include wheat, corn, grain, sorghum, barley, oats, upland cotton, rice, soybeans, and other oilseeds. 7 U.S.C. § 7901(4). Commodities that may receive market loan assistance include wheat, corn, grain, sorghum, barley, oats, upland cotton, extra long staple cotton, rice, soybeans, other oilseeds, wool, mohair, honey, dry peas, lentils, and small chickpeas. 7 U.S.C. § 7901(8).

61. See *infra* notes 66-70 and accompanying text.

62. See *infra* notes 71-76 and accompanying text.

63. See *infra* notes 77-80 and accompanying text.

reties direct subsidy payments to specific crops.<sup>64</sup> Eliminating the freedom to farm, these direct payments are fixed on a per unit rate for the entire life of FSRIA, instead of under the FAIR model of fixing the payments at the end of each fiscal year upon assessing current market conditions.<sup>65</sup>

A farmer will receive a direct subsidy payment if the market price of a FSRIA-specified commodity is below the target price established in FSRIA.<sup>66</sup> The direct payment itself is the market price of the crop plus the direct payment rate statutorily set in FSRIA.<sup>67</sup> The amount of this payment will depend largely on how much land a farmer owns and the ultimate size of his crop yield.<sup>68</sup> Unlike the system devised in FAIR that did not require farmers to grow a specific crop in order to receive a subsidy payment, farmers may receive a direct subsidy payment under FSRIA only if they grow one of the specific subsidized crops.<sup>69</sup> Thus, unlike FAIR programs that kept managerial control and flexibility in the hands of the farmer, direct payments cede decision-making control back to the government.<sup>70</sup>

In another departure from FAIR, FSRIA also makes counter-cyclical payments (CCPs) available to supplement the direct payments.<sup>71</sup> If the average market price of the subsidized commodity plus the direct payment rate to the farmer falls below the FSRIA-mandated target price for the commodity, then the government makes a CCP at a rate that covers the difference.<sup>72</sup> For example, the target price for corn in 2002 is \$2.60 a bushel and the direct payment rate is \$0.28 a bushel.<sup>73</sup> If the season market price of corn is \$2.20 per bushel, the direct payment made will be \$2.48.<sup>74</sup> Since this is below the statutory target price of \$2.60, the farmer will receive a CCP of \$0.12.<sup>75</sup> Similar

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64. See Wescott et al., *supra* note 57, at 4.

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. See Wescott et al., *supra* note 57, at 4; see also *supra* notes 34-47 and accompanying text.

71. See Wescott et al., *supra* note 57, at 5.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

to the direct payment system, base acreage is a large variable in the CCP calculation and the total CCP a farmer receives will in large part depend on how much land he farms.<sup>76</sup>

Finally, FSRIA established a system of federally-backed commodity loans in addition to direct payments and CCPs as a way to provide loans “to farmers of [commodities specified in FSRIA] when market prices are low.”<sup>77</sup> The Secretary of Agriculture is not permitted to monitor loan rates based on market conditions, unlike the loan requirements that existed under FAIR.<sup>78</sup> A farmer may receive loan assistance if he grows a FSRIA-specified crop and pledges his yield as collateral for the loan.<sup>79</sup> These loans are nonrecourse and will be deemed paid in full if the farmer simply forfeits his crop in its entirety to the government, regardless of the crop’s actual market value.<sup>80</sup>

Passage of FSRIA led some critics to wonder if it represented the final abandonment of the reform-era policies of FAIR.<sup>81</sup> While some provisions of FAIR carried over to FSRIA, albeit in altered form,<sup>82</sup> FSRIA constitutes a substantive reversal of the reforms initiated in 1996.<sup>83</sup> Instead of “furthering the [FAIR] trend toward market orientation in the agricultural sector,”<sup>84</sup> FSRIA programs deny the farmer flexibility in planting choices,<sup>85</sup> fix various payment rates statutorily rather than in accordance with market activity,<sup>86</sup> and fix acreage requirements around historical levels rather than modern conditions,<sup>87</sup> all of which weaken the ability of the small farmer to compete effectively.<sup>88</sup>

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76. *Id.*

77. *See* Westcott et al., *supra* note 57, at 6.

78. *Id.* at 5.

79. *Id.* at 6.

80. *Id.*

81. *See* Riedl, *supra* note 8, at 1.

82. *Id.* at 2. Although beyond the scope of this Note, FSRIA continues the land-idling conservation programs of FAIR. *Id.* The marketing assistance loan program is also found in FAIR, but FSRIA alters the way in which loan rates are determined. *See generally* Westcott et al. *supra* note 57, at 5.

83. *See supra* notes 29-80 and accompanying text.

84. Westcott et al., *supra* note 57, at 2.

85. *See generally* Riedl, *supra* note 8, at 2.

86. *See* Westcott et al., *supra* note 57, at 4.

87. *See id.* at 5.

88. *See infra* notes 94-126 and accompanying text.

## III. FEDERAL SUBSIDIES AND FINANCING THE SMALL FARM

A. *The Mechanics of FSRIA Subsidies: How Subsidies are Distributed*

As the discussion above indicates, “eligibility for farm subsidies is determined not by income or poverty standards, but by the crop that is grown.”<sup>89</sup> Although FSRIA provides \$242.5 billion in subsidies, only thirty three percent of the 2.1 million farmers counted in the 2002 Census of Agriculture received any government aid at all.<sup>90</sup> Even if a farm does fall into the percentage of U.S. farms actually growing a subsidized crop eligible for subsidy payments under FSRIA, only one percent of all recipients of commodity subsidies receives twenty three percent of all available monies.<sup>91</sup> Further aggregation shows that the top twenty percent of subsidy recipients receive eighty seven percent of all the available monies.<sup>92</sup> In the unlikely event that small farmers are actually growing federally subsidized crops, they are unlikely to benefit under FSRIA, since small farmers are statistically likely to fall within the bottom eighty percent of farms benefiting from subsidy money, receiving only thirteen percent of all subsidy monies.<sup>93</sup>

B. *Unprofitable Cycle—How FSRIA Subsidies Increase the Risk of Lending to Small Farmers*

FSRIA subsidies increase the risk of lending to small farmers through a cyclical process.<sup>94</sup> In general, financial institutions lend when the person to whom they are lending can pay back the sums borrowed, plus interest.<sup>95</sup> In the agricultural realm, financial institutions look upon federal farm subsidies as a consistent and guaranteed source of cash flow.<sup>96</sup> When a farmer has access to this stable and reliable source of

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89. Riedl, *supra* note 7, at 1.

90. The Environmental Working Group, *What's the Plan? U.S. Farm Subsidies, 1995 through 2003*, at <http://www.ewg.org:16080/farm/findings.php> (last visited Feb. 6, 2005).

91. The Environmental Working Group, *supra* note 4. 17,073 farms comprise the top one percent and they receive twenty three percent of the subsidies. *Id.*

92. *Id.*

93. *Id.*

94. See *infra* notes 94-126 and accompanying text.

95. See LISSA L. BROOME & JARRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 141 (West Group, 2001).

96. See Laurent Belsie, *Farm Subsidies Prop up Midwest Land Values*, THE CHRISTIAN

cash flow, he becomes an attractive candidate to receive valuable loans.<sup>97</sup> As the discussion below will describe, FSRIA subsidies interrupt this normal business relationship when it comes to the small farmer and financial institutions.<sup>98</sup> The end result of this cycle increases the risk of lending to small farmers, as the mechanisms of FSRIA subsidies themselves perpetually deprive the small farmer of the federal guarantee that makes agricultural lending less risky.<sup>99</sup>

### 1. The Subsidy Cycle, Capital Intensity, and Land Values

Both direct payments and CCPs made under FSRIA are calculated based on the amount of the subsidized crop grown and the acreage on which the crops are grown.<sup>100</sup> Therefore, the more a farmer can produce of a subsidized crop, the higher the subsidy payments he will receive, implicating considerations of capital investment and land ownership. As discussed above in section II.D, FSRIA subsidy payments are tied to specific crops, such as corn, wheat, and other grains, which tend to be crops requiring significant capital investments in the form of large machinery and other equipment.<sup>101</sup> This level of capital might not be readily available to the small farmer, thus limiting his ability to grow these crops and take advantage of any federal subsidy monies from the beginning.<sup>102</sup>

Further, since a farm can produce more crops on more land, the

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SCI. MONITOR, Jan. 4, 2002, at 2.

97. *Id.* at 3.

98. *See infra* notes 100-126 and accompanying text.

99. *See infra* notes 100-126 and accompanying text.

100. *See Westcott et al., supra* note 56, at 5.

101. *See, e.g.,* USDA ECON. RES. SERVICE, *Wheat Production Costs and Returns Per Planted Acre*, at <http://www.ers.usda.gov/data/costsandreturns/data/current/C-Whea.xls> (last visited Feb. 6, 2005). For example, the total operating costs in the United States per planted acre of wheat, excluding government payments, was \$67.79, up almost \$10 from 2002. *Id.* When the costs of equipment and labor are factored in, total costs soar to \$191.41 per acre, up almost \$20 from 2002. *Id.* In making these calculations, the USDA assumes that the enterprise size will be at least 296 planted acres, recovering 40.8 bushels of wheat per acre at \$3.07 per bushel. *Id.* To put costs in perspective, before receiving federal assistance, each acre of this large enterprise will only make \$125.26 per acre of wheat, while the total cost per acre is \$191.41. *Id.*

102. *Id.* In the above wheat example, the mere cost of running the 296 acre wheat farm is \$56,655 per year, but only 36.1% of farms in the United States make an annual income of more than \$50,000. *See* USDA ECON. RES. SERV. at [http://www.usda.gov/nass/pubs/agr03/03\\_ch9.pdf](http://www.usda.gov/nass/pubs/agr03/03_ch9.pdf) (last visited Feb. 6, 2005).

result of the FSRIA subsidy formula is that large-acreage farms will receive more subsidy payments.<sup>103</sup> To be profitable, FSRIA-subsidized crops such as corn, wheat, and other grains must be commercially grown in large quantities, which in turn requires large amounts of land.<sup>104</sup> By tying the amount of payments to historical yields and amount of base acreage, FSRIA subsidies favor those farms with vast acreage, as well as those farms that can afford the machinery and equipment necessary to harvest those types of crops.<sup>105</sup> Thus, not only may it be difficult for a small farmer to be in the business of growing these traditional crops, even if they could, they are unlikely to own enough land to obtain a significant subsidy payment under the FSRIA formula.<sup>106</sup>

Land ownership is also important to consider, as farm landowners also benefit indirectly from subsidies “because farm subsidies largely get capitalized in higher farm land values.”<sup>107</sup> If the landowners grow subsidized crops, federal farm subsidies provide a practically guaranteed stream of income to recipient landowners, thereby propping up the overall value of the real estate.<sup>108</sup> Further, an increase in land value affords greater access to credit, and large farmers may use their land as collateral to obtain additional funds, which they may in turn use to increase production or purchase new equipment, technology, or land.<sup>109</sup> Therefore, while large farmers that own the most land benefit from subsidies in the form of direct payments and CCPs, they also benefit indirectly as a result of increased land values.<sup>110</sup> By borrowing against their land, large farmers obtain financial resources that allow them to further advance their already formidable economies of scale.

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103. See Wescott et al., *supra* note 57, at 5.

104. See *supra* note 101. The wheat example used in note 101 assumes that a farm will dedicate at least 296 acres to growing wheat. In 2002, 75.8% of United States farms, all making less than \$250,000 per year, had acreage ranging from 73 acres to 496 acres. *Id.* Farms making more than \$250,000, or 7.3%, have acreage ranging from 1,708 acres to 3,455 acres. USDA ECON. RES. SERV. at [http://www.usda.gov/nass/pubs/agr03/03\\_ch9.pdf](http://www.usda.gov/nass/pubs/agr03/03_ch9.pdf) (last visited Feb. 6, 2005).

105. See *supra* notes 66-88 and accompanying text.

106. See Belsie, *supra* note 96.

107. Edwards & DeHaven, *supra* note 33, at 7.

108. Belsie, *supra* note 96, at 1.

109. *Id.*

110. See *supra* notes 100-109 and accompanying text.

## 2. The Impact of Higher Land Values on the Small Farmer

FSRIA extends subsidy benefits through 2012, and federal farm subsidies have existed in some form for the past seven decades.<sup>111</sup> Federal farm subsidies are, therefore, considered to be stable and predictable sources of cash flow.<sup>112</sup> One study concluded that just \$1 of direct subsidy payments to a farmer “tends to add \$5.40 per acre to the value of farm land.”<sup>113</sup> This same study, using a slightly different model, found that an additional \$1 of CCPs to a farmer could increase land values by \$7.02 per acre.<sup>114</sup> This significant increase in the value of farmland creates a vicious cycle, with high farmland prices making it difficult for young people and non-landowners to purchase farms.<sup>115</sup> Even if small farmers do own their land, this increase in value is unlikely to be significant enough to offset the fact that a small farm often does not produce a high enough yield to realize direct subsidy benefits.<sup>116</sup> Further, if small farmers do own their own land, it is not likely to be large enough in terms of base acreage to justify the capital costs necessary to farm the FSRIA-subsidized crops.<sup>117</sup>

In order to stay in the business of farming, some farmers rent the land that they farm. In 1999, about forty five percent of U.S. farmland was operated by a farmer other than the landowner.<sup>118</sup> Under share lease arrangements, a common form of lease agreement between landowners and farm operators, the landlord “shares in the risk of market returns and thus receives a share of the subsidy directly from the government.”<sup>119</sup> The landlord, by virtue of his superior bargaining power, typically sets the lease rates in a manner that extracts a large proportion of subsidy payments from tenants.<sup>120</sup> An additional \$1 of

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111. See *supra* notes 24-54 and accompanying text.

112. See *supra* notes 95-109 and accompanying text.

113. See generally Barry K. Goodwin et al., *Landowners' Riches: The Distribution of Agricultural Subsidies* (May 2003), at <http://economics.uchicago.edu/download/Ir-Chicago.pdf#search='landowners%20riches:%20the%20distribution%20of%20agricultural%20subsidies'>, at 13.

114. *Id.* at 14.

115. Edwards & DeHaven, *supra* note 33, at 7.

116. See *supra* notes 100-109 and accompanying text.

117. See *supra* notes 100-109 and accompanying text.

118. Goodwin et al., *supra* note 113, at 1.

119. *Id.* at 3.

120. *Id.*

CCPs, for example, may raise the rental rate by about \$0.53 per acre, allowing the landowner to absorb any subsidy benefit intended to go to the farm operator under the guise of higher rents.<sup>121</sup>

FSRIA subsidies thus reward farms that grow capital intensive crops on large amounts of owned land.<sup>122</sup> Consequently, the subsidies may act to preclude non-landowning small farmers from becoming landowners. This occurs because the guarantee of federal money to farms that grow subsidized crops raises land prices, thereby pricing the small farmer out of the real estate market.<sup>123</sup> If small farmers do not already own their own land, they may resort to renting, oftentimes at a high cost and under unfavorable lease agreements.<sup>124</sup>

In short, not only do small farmers seldom receive direct subsidy money, they are also generally precluded from buying land that could bolster their cash flow.<sup>125</sup> This unprofitable cycle increases the risk of lending to small farmers because the mechanisms of FSRIA subsidy programs decrease the small farmer's earning potential.<sup>126</sup> As the risk of lending increases, lending institutions should engage in careful risk management when deciding to extend credit to small farmers.<sup>127</sup>

### C. *Managing Risk in Agricultural Lending—Cautionary Lending*

Small farmers are unlikely to receive higher cash flow either through direct subsidy benefits or by way of the consequential land appreciation.<sup>128</sup> As large farms continue to grow, it is unlikely that small farms will be able to compete effectively, as weak cash flows may lead to a decrease in overall investment in the small farm and increased accumulation of debt over time to fund the enterprise.<sup>129</sup> In other words, if a small farmer has a weak cash flow, “[his] financing demands . . .

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121. *Id.*

122. *See supra* notes 111-117 and accompanying text.

123. *See generally* Goodwin et al., *supra* note 113.

124. *Id.* at 2.

125. *See* Westcott et al., *supra* note 57, at 6.

126. *See supra* notes 100-126 and accompanying text.

127. *See infra* notes 128-206 and accompanying text.

128. *See supra* notes 100-126 and accompanying text.

129. RICHARD E. JUST & RULON D. POPE, *Finance and Risk Bearing in Agriculture*, A COMPREHENSIVE ASSESSMENT OF THE ROLE OF RISK IN U.S. AGRICULTURE, 375 (Ariel Dinar, ed., Kluwer Academic Publishers 2002).



could increase substantially at the same time that [his] creditworthiness is declining.”<sup>130</sup>

In short, as their cash flows fall relative to those of large farms as a result of the subsidy structure enacted in FSRIA, small farmers may look to borrow additional funds from lending institutions in order to expand or improve their operations.<sup>131</sup> The risk is that small farmers may be ultimately unable to service their debt due to lack of stable and reliable income streams.<sup>132</sup> Further, small farmers may not have valuable land assets that could be held as security by lenders.<sup>133</sup> FSRIA, by effectively excluding small farm operations from federal subsidies, increases the amount of risk lending institutions face when considering whether to extend credit to small farm clients.<sup>134</sup>

### 1. Possible Inter-Institutional Risk Management Strategies

However, these issues do not necessarily suggest that lending institutions should automatically refuse to lend to small farmers, as lenders have developed mechanisms that help in the assessment of lending risk to agricultural clients.<sup>135</sup> By increasing the size and diversity of their cumulative loan portfolios, for example, lending institutions can diffuse the “stand-alone credit risk” of individual agricultural loans.<sup>136</sup> Although diversification could be difficult for agricultural banks because they primarily hold agricultural loans,<sup>137</sup> risk-

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130. *Id.*

131. *Id.*

132. *Id.* at 376.

133. *See supra* notes 100-126 and accompanying text. While marketing loan assistance may fill this gap at least in part, the small farmer would have to be eligible for the program by growing one of the specifically covered commodities, in a volume significant enough to yield a large enough loan. *See supra* notes 77-78.

134. *See supra* notes 89-126 and accompanying text. As of 2002, commercial banks, the Farm Credit System, the Farm Service Agency, and life insurance companies accounted for 79.3% of outstanding farm loans. Commercial banks provide the majority of credit to the agricultural sector. *See Jerome Stam, et al., Agricultural Income and Finance Annual Lender Issue*, USDA ECON. RES. SERVICE, Mar. 11, 2003, at 7. Commercial banks hold 17.6% of all agricultural real estate debt, and 21.8% of non-real estate agricultural debt. *Id.* Agricultural banks, or those commercial banks whose “ratio of farm loans to total loans exceeds the unweighted average of the ratio at all banks on a given date,” hold a slim majority of farm loans. *Id.*

135. JUST & POPE, *supra* note 129, at 375.

136. *See id.*

137. *See Stam et al., supra* note 134.

adjusted pricing schemes that group borrowers into several credit risk classes for monitoring and pricing may help diffuse risk of default.<sup>138</sup>

Lending institutions may also collect and process more information about the creditworthiness of agricultural borrowers prior to lending.<sup>139</sup> Lending institutions increasingly utilize highly complex agricultural credit risk models that work to predict the probability of loss.<sup>140</sup> New advances in econometrics and increased lender access to technology make it increasingly easier for lenders to manage risk within these model-generated risk management categories.<sup>141</sup> These complex models are able to take into consideration a variety of factors, such as interest rate fluctuations and other unique operational risks associated with agricultural production.<sup>142</sup> Since most lenders are already experienced at generating risk ratings and credit scores, these econometric modeling concepts may prove highly useful for managing agricultural lending risk.<sup>143</sup>

Agricultural lenders may also make use of a tactic known as a "farm visit" to maintain contact with and to monitor small farm clients.<sup>144</sup> The farm visit occurs when a lender actually travels to the farm being financed in order to assess performance and examine record keeping; this tactic falls into a category of risk management known as performance management.<sup>145</sup> A lender may use farm visits to monitor potential risk by maintaining a close relationship with the small farmer

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138. JUST & POPE, *supra* note 129, at 375.

139. *Id.* at 377.

140. *Id.*

141. See generally Nick Walraven & Peter Barry, *Bank Risk Ratings and the Pricing of Agricultural Loans* (Sept. 2003), at <http://www.federalreserve.gov/pubs/feds/2003/200353/200353pap.pdf>. Loans are typically placed in one of five categories. *Id.* at 5. Loans in Category 1 bear virtually no risk of loss to the bank. Loans in Category 2 are "very unlikely" to result in a loss to the bank. *Id.* Category 3 loans bear "moderate risk" of loss to the lender. *Id.* Loans placed in Category 4 bear an "acceptable degree of risk," but were in some way slightly substandard. *Id.* Finally, Category 5 loans bear the highest degree of risk, and were described as "special mention loans." *Id.*

142. JUST & POPE, *supra* note 129, at 377.

143. *Id.* at 378. Concepts of risk modeling are evolving as banks' credit risks continue to evolve. See Walraven & Barry, *supra* note 141, at 24. "The future will likely bring wider use of dual rating systems (frequency of default by borrower and severity of default associated with loan transactions), as well as closer linkages between loan pricing, credit risk, economic capital, and risk-adjusted returns on capital." *Id.*

144. JUST & POPE, *supra* note 129, at 379.

145. *Id.*

and engaging in more frequent and personalized contact.<sup>146</sup> Lenders may thus minimize risk by familiarizing themselves with the characteristics and financial habits of their small farm client.<sup>147</sup> In extreme cases, lenders may maintain personnel on the farm site, giving the lender on-line access to the farmer's accounting system.<sup>148</sup> By maintaining increased contact, if the small farmer experiences trouble, the lender is likely to know sooner and be able to take prompt action to address any problems before the situation deteriorates.<sup>149</sup>

Lenders may also reduce risk by holding a credit reserve for small farm clients as a means of providing emergency liquidity.<sup>150</sup> Farmers refer to lenders that offer this practice as "friendly bankers."<sup>151</sup> Lenders may take this credit reserve and extend it as a line of credit to a farmer, and this reserve may also be used flexibly to provide carry-over loans or refinancing in times of adversity.<sup>152</sup> With this risk management technique, the lending institution can "fall back on the credit reserve in times of adversity when financial obligations are difficult to meet."<sup>153</sup>

Lending institutions may also control risk through debt contract provisions that revert significant control to the lender under times of extreme adversity.<sup>154</sup> As the "stake in the borrower's unit increases and as more of the costs of the borrower's actions are incurred by lenders through increased credit risks,"<sup>155</sup> contract provisions can shift control rights to the lender.<sup>156</sup> The lender may achieve this control through contract provisions that determine everything from the repayment schedule of the loan, to requiring mandatory site inspections, to setting the accounting formats the farmer must use and mandating what types of insurance the farmer must hold.<sup>157</sup> By constraining the actions the small farmer may take in a variety of situations, the lender manages its

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146. *Id.*

147. *See id.*

148. *Id.*

149. *Id.*

150. JUST & POPE, *supra* note 129, at 379.

151. *Id.*

152. *Id.* at 381.

153. *Id.* at 379.

154. *Id.* at 381.

155. *Id.*

156. JUST & POPE, *supra* note 129, at 381.

157. *Id.*

risk and improves the loan performance forecast.<sup>158</sup>

Finally, lenders may exert significant influence on the way a small farmer manages his own risk by simply encouraging other risk management practices.<sup>159</sup> For example, a lender may encourage its small farm client to “employ forward contracts for crop sales, [to hedge] in futures markets, [to obtain] crop insurance, [or to engage in] other risk management practices.”<sup>160</sup> These practices do not necessarily have to be formally agreed to in a written contract, but may be subtly encouraged by increasing communication with small farm clients and by acting as a flexible lender.<sup>161</sup> By encouraging prudent farm management, lending institutions can further protect their investment.

## 2. Possible Governmental Risk Management Assistance

While the above strategies primarily focus on strengthening the relationship between the farmer and the individual lender, the federal government may also offer risk management assistance to the lender.<sup>162</sup> The Federal Agricultural Mortgage Corporation, or Farmer Mac, was created by the Agricultural Credit Act of 1987, which added a new Title VIII to the Farm Credit Act of 1971.<sup>163</sup> Farmer Mac is a government-sponsored entity that is fully stockholder owned.<sup>164</sup> Farmer Mac operates a secondary market for first lien agricultural real estate loans, “created to improve the availability of long-term credit at stable interest rates” to farmers by shifting the risk of agricultural lending through securitization from banks to investors.<sup>165</sup> Like the familiar Fannie Mae and Freddie Mac, Farmer Mac funds its loan purchases by “issuing debt or securities backed by pools of loans and selling them into the capital markets.”<sup>166</sup> Farmer Mac is able to guarantee these mortgage-backed

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158. *Id.* at 382.

159. *Id.*

160. *Id.*

161. *Id.*

162. *See infra* notes 163-197 and accompanying text.

163. 12 U.S.C. §§ 2279aa et seq. (2000).

164. Farmer Mac FAQ's, at [http://www.farmermac.com/Borrowers/About/about\\_famc\\_faq\\_main.asp](http://www.farmermac.com/Borrowers/About/about_famc_faq_main.asp) (last visited Nov. 21, 2004).

165. Farmer Mac Information, at <http://www.farmermac.com/> (last visited Nov. 21, 2004).

166. Farmer Mac Programs, at [http://www.farmermac.com/Lenders/Program\\_Desc/fmac\\_main.asp](http://www.farmermac.com/Lenders/Program_Desc/fmac_main.asp) (last visited Nov. 21, 2004).

securities with a \$1.5 billion line of credit at the United States Treasury.<sup>167</sup>

Farmer Mac operates two main programs, known as the Farmer Mac I program and the Farmer Mac II program.<sup>168</sup> In the Farmer Mac I program, Farmer Mac purchases qualified loans from lenders who are approved sellers.<sup>169</sup> In order to become a qualified seller, the lender must meet specified criteria.<sup>170</sup> These criteria include a “demonstrated ability to and service of mortgage loans which qualify for Farmer Mac’s full or part-time farm program, maintenance of a minimum net worth of \$1 million according to GAAP accounting rules, maintenance of Fidelity Bond and Errors and Omissions coverage, and ownership of Farmer Mac Class A or Class B Common Stock.”<sup>171</sup> Once a lender applies for and meets these criteria, Farmer Mac will purchase first lien real estate loans directly from the lender.<sup>172</sup>

The Farmer Mac II program is open to any lender or other seller of USDA guaranteed loans and no additional approval of the seller or stock purchase is required.<sup>173</sup> Lenders are simply required to “originate USDA guaranteed loans in accordance with existing USDA standards and procedures.”<sup>174</sup> These lenders may then “sell the guaranteed portions of USDA loans directly to Farmer Mac.”<sup>175</sup> The USDA guarantees three main types of loans, from the Farm Service Agency (FSA), the Rural Business Service (RBS), and the Rural Housing Service (RHS).<sup>176</sup>

It is important to briefly discuss the FSA, as modern congressional limitations on FSA lending abilities may reduce the widespread effectiveness of the Farmer Mac II program, since FSA

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167. Farmer Mac FAQ’s, *supra* note 164.

168. *Id.*

169. *Id.*

170. Farmer Mac I Sellers, at [http://www.farmermac.com/Lenders/Program\\_Desc/FMI/fmacI\\_main.asp](http://www.farmermac.com/Lenders/Program_Desc/FMI/fmacI_main.asp) (last visited Nov. 21, 2004).

171. *Id.*

172. *Id.*

173. Farmer Mac II Programs, at [http://www.farmermac.com/Lenders/Program\\_Desc/MI/fmacII\\_main.asp](http://www.farmermac.com/Lenders/Program_Desc/MI/fmacII_main.asp) (last visited Nov. 21, 2004).

174. *Id.*

175. *Id.*

176. *Id.* The FSA has a website devoted to describing its farm loan programs. See <http://www.fsa.usda.gov/defl/default.htm>.

loans are a type of USDA-guaranteed loans.<sup>177</sup> The FSA was created within the USDA in 1946 for the express purpose of “providing credit to eligible farmers who [could not] obtain credit elsewhere.”<sup>178</sup> The farm financial crisis of the 1980s,<sup>179</sup> however, took a deleterious toll on the FSA’s loan portfolio.<sup>180</sup> During this time period, the economic fragility of FSA borrowers, combined with questionable lending practices led to widespread defaults and large losses.<sup>181</sup> As a result, Congress reduced the already limited lending authority granted to the FSA, and by 1999, FSA directing lending was at its lowest rate since 1946, when the agency was first created.<sup>182</sup>

Through participation in its programs, however, Farmer Mac can help lenders minimize risk by employing securitization technologies that shift the credit risk to Farmer Mac while leaving the loans with the originating institution to perform managerial functions.<sup>183</sup> While securitization by Farmer Mac is a valuable risk management tool, the limitations of this approach should be noted.<sup>184</sup> In order to qualify for Farmer Mac I, a lender must meet certain criteria, including having a minimum net worth of \$1 million and purchasing a set amount of Farmer Mac stock, which may be unrealistic for some lenders.<sup>185</sup> Further, if a lender qualifies as a seller, Farmer Mac will only purchase first lien mortgage loans secured by real estate.<sup>186</sup> While there are likely many of these first lien loans, this risk protection will not extend to any second loans made for refinancing purposes or loans intended for the purchase of new technology or for improvements that may be secured by something other than real estate.<sup>187</sup>

While Farmer Mac II requires no further accreditation beyond simply holding USDA-backed loans,<sup>188</sup> other problems arise. As noted in the discussion above, FSA loans are a type of USDA-backed loans

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177. *Id.*

178. *See Schneider, supra* note 12, at 230.

179. *See supra* note 50.

180. *See Schneider, supra* note 12, at 230.

181. *Id.*

182. *Id.*

183. Farmer Mac Programs, *supra* note 166.

184. *See infra* notes 185-190 and accompanying text.

185. *See Farmer Mac I Sellers, supra* note 170.

186. Farmer Mac FAQs, *supra* note 164.

187. *See id.*

188. Farmer Mac II Programs, *supra* note 173.

that Farmer Mac will accept.<sup>189</sup> After the crisis in the 1980s when FSA lending power was reduced, compounded with the FSA's special status as a "lender of last resort," a lender may not be likely to hold many of these loans.<sup>190</sup>

The FDIC also discusses a number of the risk management techniques discussed above, and adds the additional consideration of amortization schedule management.<sup>191</sup> An amortization schedule reflects the time period over which the principle and interest due on a loan are paid back, that may help lenders minimize risk.<sup>192</sup> An amortization period that is too long may leave the lender under-secured towards the end of the loan, "when the borrower's financial circumstances may have changed."<sup>193</sup> On the other hand, a too-rapid amortization can "impose an undue burden on the cash flow capacity of the farming operation," which may lead to default.<sup>194</sup> Accordingly, lenders should examine whether or not their amortization scheduling is correlating with the "useful economic life of the underlying collateral and with the operation's debt service capacity."<sup>195</sup> The FDIC recognizes that "orderly liquidation of agricultural debt" is critical in preventing collection problems from occurring.<sup>196</sup> As such, lenders may want to reexamine their amortization decisions on agricultural loans.<sup>197</sup>

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189. *Id.*

190. *See* Schneider, *supra* note 12, at 230. As FSA receives limited funding for direct loans, applicants sometimes have to wait for funds to become available. *See* FSA Information, at <http://www.fsa.usda.gov/dafl/default.htm> (last visited Nov. 21, 2004). To qualify for a direct loan, the applicant must be able to show sufficient repayment ability and pledge enough collateral to fully secure the loan, which may also pose problems for young farmers or farmers experiencing financial difficulties. *Id.*

191. Fed. Deposit Ins. Corp. Manual of Examination Policies at <http://www.fdic.gov/regulations/safety/manual/Section3-1.html#AgriculturalLoans> (last visited Nov. 21, 2004).

192. BLACK'S LAW DICTIONARY 93 (8th ed. 1999).

193. *See* Fed. Deposit Ins. Corp. Manual of Examination Policies, *supra* note 191.

194. *Id.*

195. *Id.*

196. *Id.*

197. *See supra* notes 191-196 and accompanying text.

### 3. The Federal Government's Recognition of the Risk in Agricultural Lending

Lenders, especially those regulated by the FDIC, will be glad to note that regulators seem to have recognized the risk in agricultural lending and are working to issue helpful guidelines to bank examiners.<sup>198</sup> For example, while examiners should still be critical of an institution's managerial activities, they should also be more lenient in recognizing "when the bank is taking reasonable steps to deal with these external risk factors."<sup>199</sup> Thus, it appears that the FDIC is willing to adopt a flexible approach when lenders are taking unconventional but constructive steps to deal with the difficulties of agricultural lending, such as loan restructuring or providing extended terms of repayment.<sup>200</sup> In order to determine the health of the lender's loan portfolio, FDIC examiners have indicated a willingness to recognize informal payment agreements between the farmer and the lender, even if they are not reflected on the promissory notes themselves.<sup>201</sup> So long as lenders are engaging in risk management in a prudent manner, the FDIC appears willing to tolerate a heightened level of creative risk management.<sup>202</sup>

Each financial relationship between a lender and a small farm client will be unique, and the strategies described above may apply in different ways to various situations.<sup>203</sup> While some of these strategies may not fit every situation, and although some may not be applicable to every bank and every farmer, these management strategies are potential ways in which lending institutions can work to minimize the risk of lending to small farm clients.<sup>204</sup> Although FSRIA subsidy policies may increase the risk of lending to small farm clients by decreasing the overall cash flows of small farms relative to large farms,<sup>205</sup> lending

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198. *Supra* notes 191-196 and accompanying text.

199. *Supra* notes 191-196 and accompanying text.

200. *Supra* notes 191-196 and accompanying text.

201. *Supra* notes 191-196 and accompanying text.

202. *See supra* notes 192-201 and accompanying text.

203. *See generally* Agric. Lending, First Nat'l Bank of Shelby, at <http://www.ots.treas.gov/docs/4/48050.pdf> (last visited Nov. 23, 2004). This is an interesting Office of Thrift Supervision (OTS) article that details how a Nebraska bank successfully employed various risk management techniques outlined in this Note to improve its agricultural lending practices. *Id.*

204. *See supra* notes 128-202 and accompanying text.

205. *See supra* notes 94-126 and accompanying text.



institutions can and should take steps to implement effective risk management with respect to lending to small farmers.<sup>206</sup>

#### IV. CONCLUSION—SELLING OUT THE FARM? THE IMPACT OF THE FARM SECURITY AND RURAL INVESTMENT ACT OF 2002 ON LENDING INSTITUTIONS AND THE SMALL FARMER

The institution of the small farm has enjoyed historical prominence and support throughout American history. As the “foremost proponent of the agrarian ideal,” Thomas Jefferson envisioned a nation of small and independent farmers that would provide the foundation for the American republic.<sup>207</sup> Although the percentage of the American workforce engaged in agriculture has declined over time since the industrial age, ninety two percent of those engaged in agriculture are small farmers.<sup>208</sup> Further, Americans still cling to the vision of the small family farm as one of the last bastions of old-fashioned independence and self-reliance.<sup>209</sup> Considering farming one of “mankind’s noblest crafts,” many see the decline of the small farmer as the victory of industrial process over a way of life.<sup>210</sup> While time may not be on the side of the small farmer, strong American support for the small farmer as a nostalgic reminder of its earlier days compounded with the large percentage of American farmers still qualifying as small farmers warrants at least a cursory exploration into how the institution may be preserved.<sup>211</sup>

From the inception of subsidies during the Great Depression to the recent signing of the Federal Security and Rural Investment Act in 2002 (FSRIA),<sup>212</sup> politicians often justify farm subsidy legislation by the

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206. See *infra* notes 207-218 and accompanying text.

207. See Lisi Krall, *Thomas Jefferson's Agrarian Vision and the Changing Nature of Property*, 36 J. ECON. ISSUES 131 (2002).

208. See USDA NATL. AGRIC. STATISTICS SERV., *supra* note 13.

209. See, e.g., Small Farmer’s Journal: *Who and What We Are*, at <http://www.smallfarmersjournal.com/docs/pg/about.html> (last visited Jan. 7, 2005).

210. *Id.*

211. See *id.*; see also USDA NATL. AGRIC. STATISTICS SERV., *supra* note 13. But see Steve Cocheo, *Disappearing Harvest?*, ABA BANKING J., Nov. 2002, at 41. In this piece, Dr. Steven Blank of the University of California at Davis argues that the production of food and other agricultural products will altogether “disappear from the United States because it will be unprofitable to tie up resources in farming and ranching.” *Id.*

212. 7 U.S.C. § 7901 (2004).

need to improve the impoverished condition of the small farmer.<sup>213</sup> Rarely, however, have subsidy programs gone to benefit the small rural farmer reminiscent of the old Jeffersonian ideal.<sup>214</sup> In reality, federal subsidy programs increasingly pad the pockets of large corporate farms, and contribute to income instability for the small farmers that subsidy legislation is said to benefit.<sup>215</sup>

While subsidy legislation may increasingly sound the death knell to small farm viability in the United States, FSRIA also negatively impacts the banking industry, as subsidy programs increase the risk lending institutions incur if they chose to lend to small farming operations. If lending institutions want to maintain this client base, especially in areas where agricultural lending has been a traditional part of the community banking function, lenders will have to take on additional means of risk management in order to avoid losses.<sup>216</sup>

While policies enacted in 1996 under the Farm and Agricultural Improvement and Reform Act (FAIR) were not perfect, they signaled a move towards market-based reform of agricultural policies and the so-called "freedom to farm."<sup>217</sup> Unfortunately, FSRIA largely squelched any movement away from traditional federal subsidies reminiscent of the Depression Era.<sup>218</sup> While it will be interesting to see if current conditions compel Congress to modernize subsidy legislation or make it more relevant to the small farmers used in political rhetoric to justify the legislation, it does not seem likely that the inefficient and unrealistic price supports set out in FSRIA will end any time soon. Until FSRIA expires or unless Congress intervenes, lenders will have to engage in

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213. See generally Goodwin, et al., *supra* note 113, at 19. Put another way, "the idea that subsidies preserve the small family farm is a political myth, but a useful one for tugging the heartstrings of voters who contribute their tax money to this cause." George Melloan, *Farm Subsidies, Like Death and Taxes, Just Won't Go Away*, WALL ST. J., May 29, 2001, at A23. Perhaps impliedly recognizing the plight of the small farmer, President John Fitzgerald Kennedy said that "the farmer is the only man in our economy who buys everything at retail, sells everything at wholesale, and pays the freight both ways." Quotation at <http://www.nonstopenglish.com/reading/quotations/index.asp?search=freight> (last visited Feb. 6, 2005).

214. See Goodwin, et al., *supra* note 113, at 19. For an interesting discussion of Thomas Jefferson's impact on American agriculture, see generally Krall, *supra* note 207.

215. See The Environmental Working Group, *supra* note 5.

216. See *supra* notes 128-206 and accompanying text.

217. See generally Riedl, *supra* note 8, at 1.

218. See, e.g., Bush, *supra* note 1 (discussing FSRIA and outlining the federal government's continued support of federal farm subsidy legislation).

careful risk monitoring efforts in order to manage the risks that come with extending credit to a small farm borrower, or lose small farm clients altogether, which would be detrimental to both the farming and banking industries.

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