

BL-040 REVISED

Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products

August 10, 2007

To: The Chairman of the Board
The Chief Executive Officer
All Farm Credit System Institutions

From: Nancy Pellett
Chairman and Chief Executive Officer

Subject: Revised Bookletter 040 - Providing Sound and Constructive Credit to Young, Beginning, and Small Farmers, Ranchers, and Producers or Harvesters of Aquatic Products

I. Purpose

This updated booklet provides guidance on interpreting the phrase "sound and constructive credit," in § 4.19 of the Farm Credit Act of 1971, as amended (Act), as well as Farm Credit Administration (FCA or Agency) regulation 614.4165, on the young, beginning, and small (YBS) farmers and ranchers mission (YBS regulation) of the Farm Credit System (FCS or System). This interpretation is important to ensure that all System institutions are fully engaged and use all available authorities to assist YBS farmers, ranchers, and producers or harvesters of aquatic products (YBS farmers) to begin, grow, or remain in agricultural or aquaculture production. The booklet also retains the definitions for all three categories, "young," "beginning," and "small" farmers.

II. YBS Mission

Section 4.19 of the Act requires System associations to establish programs for furnishing " . . . sound and constructive credit and related services to young, beginning, and small farmers and ranchers." The YBS regulation, which implements the Act's YBS provision, requires System direct-lender associations to include, in their YBS programs, minimum components to ensure that they can successfully fulfill their YBS mission.

All agricultural producers face a significant number of challenges, including access to capital and credit; the impact of rising costs on profitability; urbanization and the availability of resources, like land, water, and labor; globalization; and competition from larger or more established farms. However, the hurdles that YBS farmers face are even greater due to their lack of an agricultural production history, inexperience in production agriculture, low capital position, or limited credit history. The System's YBS mission is therefore crucial to enabling YBS farmers to begin, grow, or remain in agricultural production and to facilitate the transfer of agricultural operations from one generation to the next.

III. YBS Definitions

The following definitions are the same as those adopted by the Agency when this booklet was

originally issued, December 1998, with the exception of referring to young, beginning, and small *farmers* instead of *borrowers* . The categories remain separate and distinct, and a loan to one borrower may meet the definition for any or all of the categories, but a loan does not have to meet all three to be considered a loan to an YBS farmer.

Young farmer: A farmer, rancher, or producer or harvester of aquatic products who is age 35 or younger as of the loan transaction date.

Beginning farmer: A farmer, rancher, or producer or harvester of aquatic products who has 10 years or less farming, ranching, or aquatic experience as of the loan transaction date.

Small farmer: A farmer, rancher, or producer or harvester of aquatic products who normally generates less than \$250,000 in annual gross sales of agricultural or aquatic products.

Additional direction on these definitions is included in the call report instructions provided by the Agency each year to all System institutions.

IV. Providing Sound and Constructive Credit to YBS Farmers

What is sound and constructive credit?

The agricultural operations of most YBS farmers require a significant amount of diversity in income and assets (a combination of agricultural and nonagricultural) for the total operation to remain viable. Therefore, to address the needs of this critical group of System borrowers, sound and constructive credit is defined as credit that is used by YBS farmers to begin, grow, or remain in agricultural production. Sound and constructive credit may include credit for nonagricultural as well as agricultural purposes.

Credit parameters for bona fide farmers

FCA regulation [613.3000\(a\)\(1\)](#) defines a bona fide farmer as "a person owning agricultural land or engaged in the production of agricultural products . . ." FCA lending objective regulation [613.3005](#) envisions financing the full credit needs of full-time farmers, and more conservative agricultural credit and restrictive nonagricultural credit for less than full-time farmers. The regulation also envisions only agricultural credit for those bona fide farmers whose business is essentially other than farming.

Determining a YBS farmer's commitment to agricultural production

The degree to which an YBS farmer is engaged, or intends to be engaged, in agricultural production determines the type and amount of credit that is available to the borrower. System institutions should analyze each application to determine the applicant's commitment to agricultural production and therefore the type and amount of agricultural and nonagricultural credit needed to begin, grow, or remain in agricultural production. Indicia of a borrower's commitment to agricultural production could include, but is not limited to, the following factors:

1. The degree of day-to-day involvement the borrower must have in the agricultural production operation, through either labor or management, or both, to evidence a clear commitment to agricultural production;
2. The intent of the borrower to actively engage in agricultural production, as evidenced by his education, training, experience, business plan or some other means;
3. A level or projected level of gross agricultural income or production that evidences a clear

commitment to agricultural production; or

4. The terms and structure of the loan, as well as planned use of loan proceeds, evidence a commitment to be truly engaged in agricultural production.

The foregoing and other criteria should be applied and weighed in a manner that best allows a System institution to meet the unique circumstances of each YBS farmer. For example, an applicant's lack of ownership of agricultural assets may be offset by considerable experience as a farm manager with demonstrated production responsibilities, evidencing a commitment to agricultural production. This commitment may make him or her a strong candidate for credit under the institution's YBS lending program.

Credit enhancements for YBS farmers

One of the most significant challenges for many YBS farmers with little or no agricultural income or assets is complying with an association's traditional loan underwriting standards. Typically, YBS farmers often have a combination of little or no assets to pledge as collateral, little or no historical production records, and little or no on-farm management experience. To provide sound and constructive credit under the Act's YBS mandate, the YBS regulation, and within the general parameters of FCA's lending objective regulation at [613.3005](#), System lenders should consider creating a program of reasonable credit enhancements and credit coordination programs for this often less financially stable, yet crucial group of farmers. Credit enhancements could include applying more flexible interest rates or fees, underwriting standards, and collateral requirements on such loans, as well as obtaining guarantees, such as Farm Services Agency guarantees.

System lenders may also want to consider a YBS lending policy that treats a subset of part-time YBS farmers as bona fide, full-time farmers. The subset would consist of those farmers with a high degree of commitment to begin, grow, or remain in production agriculture operations and a demonstrated intent to progress toward agricultural production as their primary business and vocation. The phrase "primary business and vocation" is used in FCA's lending objective rule at 12 C.F.R. § [613.3005](#) to define a "full-time, bona fide farmer." It is up to each association to select a method for determining who meets the definition of a full-time farmer. The determination of full-time for this subset of YBS farmers will have to be made, in most cases, using qualitative rather than quantitative criteria. Qualitative criteria could include an applicant's education, training, experience, business plan, or some other means that evidences the YBS farmer's commitment or intent to progress toward production agriculture as his or her primary vocation. Whatever method is chosen to determine who may be treated as a "full-time" farmer, it is critical that System institutions base the method on reasonable criteria. We note that the USDA's Agricultural Resource Management Survey counts full-time farmers as those operators who report farming as their major occupation.

Providing these YBS farmers with all of the credit and services available to full-time farmers would be considered another type of credit enhancement. Generally, any credit enhancement that improves an YBS farmer's prospects for success in agricultural production will be considered reasonable. Nonetheless, System lenders should consider their risk-bearing capacity in determining whether a credit enhancement, or combination of credit enhancements, is reasonable for their institution.

Setting aside capital for the YBS mission

In order to provide for the types of credit enhancements needed to adequately serve the YBS markets (which typically pose more risk), System institutions should consider setting aside capital that they are willing to put at risk to support programs that meet the credit needs of these YBS farmers. The amount of capital made available should be based on the strength of the institution's financial position, risk management tools, and safety and soundness controls. The Agency recognizes that designating capital for YBS lending will require considerable judgment by the System lender to ensure that it balances the credit needs of YBS farmers with the association's risk-bearing capacity.

Coordinating YBS credit with other entities

As required by § 614.4165(c)(3) and to reduce the risk associated with YBS programs, System lenders should consider increasing coordination with other System institutions, government agencies, and the private and public sectors to make use of all risk mitigation tools, such as state and federal loan guarantees or other such programs (both government or privately sponsored). Additionally, this regulatory section requires System lenders to develop outreach initiatives that could include, but are not limited to, using YBS advisory committees.

Sharing best practices

To ensure that all System institutions are implementing the most effective YBS programs possible, we encourage FCS institutions to share their best practices. This sharing of best practices is important to ensure that the System as a whole provides all YBS farmers the credit they need to begin, grow, or remain in agricultural production.

YBS farmers with minimal involvement in agriculture

The credit enhancements and capital designated for YBS programs are not intended to apply to those applicants *whose business is essentially other than farming*. As discussed in Agency guidance on *Other Credit Needs* in Examination Bulletin: FCA 2006-2, each System institution should include in their lending policies and procedures a reasonable definition of this phrase that could also apply to YBS borrowers.

V. YBS and Other Credit Needs Lending Policies

System institutions are strongly encouraged to review and modify their YBS policies and programs in response to the guidance in this booklet. For example, System lenders may want to include in their YBS lending policies a description of the types of credit enhancements available to YBS farmers, as well as measurements and controls to ensure that the credit enhancements are applied to the suitable group of YBS farmers. Appropriately revised YBS policies would include:

- Expanding the criteria used to determine a full-time farmer to include those part-time YBS farmers with a demonstrated intent to progress toward farming as their primary business and vocation,
- A list of factors which must be documented in the loan file that will be used to demonstrate the YBS farmer's commitment or intent to progress toward agricultural production as his or her primary business and vocation (see indicia under *Determining a YBS farmer's commitment to agricultural production* above), and
- A set of internal controls, including an audit program, to ensure that its YBS policies and program are implemented for the benefit of YBS farmers to begin, grow, or remain in agricultural production.

The guidance in this booklet also is intended to complement the guidance issued by the Agency on

Other Credit Needs in Examination Bulletin: FCA 2006-2. Therefore, System institutions are also strongly encouraged to amend their *other credit needs lending* policies and programs to develop different criteria for determining the amount of *other credit needs* financing available to YBS farmers. Such criteria should take into consideration the factors used to determine the degree to which a YBS farmer is engaged, or intends to be engaged, in agricultural production.

VI. Examples

The following examples highlight how a System lender may implement the guidance in this booklet. These examples illustrate the types of loans that would likely be consistent with a sound and constructive YBS program. To ensure that such credit remains sound, System institutions should consider supporting such loans through the use of at-risk capital set aside to serve the YBS market or through other risk mitigation tools.

- 1. Facts:** A beginning farmer applies for a \$45,000 loan to rent 300 acres of corn/soybean cropland. He works for a local corn and soybean farmer and has a written agreement with his employer to rent the equipment necessary to operate this acreage. He will also market his product with his employer. His goal is to use this acreage as a way of working toward becoming a full-time farmer. His loan application includes a business plan describing how he plans to grow his business. **Analysis:** This YBS farmer does not own any assets to pledge as security, however, he has considerable farming experience in the type of operation that he is proposing to begin and an educational background in agriculture. Thus, this farmer has a demonstrated intent to progress toward farming as his primary business and vocation. **Result:** The beginning farmer could be treated as a full-time farmer. The association may need to rely more heavily on the applicant's education and farming experience to make this loan. However, this loan would likely be consistent with a sound and constructive YBS program.
- 2. Facts:** A recent college graduate with a degree in Animal Science applies for a \$75,000 loan to rent land, purchase cattle, and for operating funds to begin a cattle operation. The applicant worked on a cattle ranch before and during college. She will also work for the local feed dealer in town. Her loan application included a business plan describing how she plans to grow the business. **Analysis:** This YBS farmer does not own any assets to pledge as security; however, she has both education and farm experience in the cattle ranching operations she is beginning. Thus, this farmer has a demonstrated intent to progress toward farming as her primary business and vocation. **Result:** The young and beginning rancher could be treated as a full-time YBS farmer. The association may need to rely more heavily on the applicant's education and farming experience to make this loan. However, this loan would likely be consistent with a sound and constructive YBS program.
- 3. Facts:** A young farmer rents 200 acres of farmland, owns his equipment, and owns a welding shop located in a rural area. His gross farm income is \$12,000 and gross income from the welding shop is \$60,000. He requests a \$200,000 loan to refinance his high-cost, long-term debt incurred when purchasing the welding shop. He would like to expand his agricultural production acreage, but first he needs to increase his cash flow by refinancing this high-cost debt. **Analysis:** This farmer has a demonstrated intent to progress toward farming as his primary business and vocation. The income from the welding shop is critical to the growth and success of the farm and, therefore, this loan contributes to the young farmer's ability to remain in agricultural production. **Result:** The young farmer could be treated as a full-time YBS farmer, and the loan would likely be consistent with a sound and constructive YBS program.
- 4. Facts:** A small farmer operates a wheat and cattle operation. He rents all his land and equipment from his father and intends to take over and grow the operation as owner once his father retires. His spouse is a licensed dentist. They apply for \$300,000 to purchase the local rural dental office. The

income from this non-farm business is needed for the farmer to continue and grow his operation.

Analysis: This farmer has a demonstrated intent to progress toward farming as his primary business and vocation. Financing this business enterprise helps both the YBS farmer diversify and grow his operation, and also helps the local rural area by continuing to provide local dental care. **Result:** The small farmer could be treated as a full-time farmer, and the loan would likely be consistent with a sound and constructive YBS program.

5. **Facts:** An applicant requests a \$2 million loan from a System association to purchase agricultural land. He is classified by the association as a "beginning" farmer since this is his first purchase of agricultural land. While the property has the capacity to produce agricultural products, the borrower does not currently intend to engage in agricultural production. However, the borrower has sufficient ability to repay the loan with income generated by his nonagricultural business. **Analysis:** Although likely eligible for this System loan as a bona fide farmer due to his purchase of agricultural land, the indicia point to the conclusion that this borrower has not demonstrated intent to progress toward agricultural production as his primary business and vocation. **Result:** While this loan likely could be made, and other credit enhancements may be afforded by the association's sound and constructive YBS program, this beginning farmer should not be treated as a full-time farmer.
6. **Facts:** A small farmer requests \$65,000 to purchase a 1.5 acre rural plot of land near a large metropolitan area and \$1,000 in operating funds for inputs and equipment to grow fruits and vegetables. The applicant is an immigrant to the United States who works in construction and sells produce at farmers' markets on the weekends. He would like to grow his small farm business by purchasing small plots of land as he can afford them with the intention of moving out of construction except as needed to supplement his farm income. Produce sales currently bring in a modest annual income of approximately \$5,000. **Analysis:** This farmer represents a growing trend in agriculture that is seeing immigrants getting into small and specialized agricultural production operations. Although currently the farmer is working in construction, he has demonstrated an intent to progress toward farming as his primary business and vocation through his serious commitment to agricultural production. **Result:** The small farmer could be treated as a full-time farmer, and the loan would likely be consistent with a sound and constructive YBS program.
7. **Facts:** A young and beginning farmer who has a small general law practice in a rural town requests a \$150,000 term loan to begin a vineyard operation on the property owned by his parents – property that he will one day inherit – that is located in his community. The income from his small practice annually nets \$45,000. He also requests a \$30,000 term loan for improvements to the law practice. The applicant, who has been nurturing a serious interest in grape varieties, wines, vineyards, and wine regions for a number of years, intends to spend a portion of each day running the day-to-day operation. As his wine business grows, he intends to devote less and less time to his legal practice. His business plan, submitted with the loan application, describes how he intends to implement his vision of developing a successful and prestigious label that will offer a variety of red and white wines. **Analysis:** Although he is currently practicing law, this applicant has a demonstrated intent to progress toward farming as his primary business and vocation. The income from his law practice is critical to his entrance into the winemaking business, so providing him with financing for his legal needs as well as his agricultural needs will help him sustain and grow his winemaking operation. **Result:** The small and beginning farmer could be treated as a full-time farmer, and these loans would likely be consistent with a sound and constructive YBS program.