

## **Grain Elevator Credit Sales Contracts and Alternatives to Reduce Their Risk to Producers\***

Credit sales contracts for grain have been widely used as a marketing tool by farmers and elevators. For farmers, they represent a method (accepted by the IRS) to delay the constructive receipt of grain income into a later tax period. During periods of when storage capacity is short these contracts move grain into the market channel earlier than might otherwise be the case. Farmers can relinquish title at harvest and still maintain pricing flexibility later in the year when prices may be stronger.

**Credit sales contracts are also useful in promoting the orderly flow of limited volume special characteristic grains. Timing problems can arise in specialty grain contracts where producers are paid a fixed premium above the commodity market price. Because there is often a need to maintain a uniform flow of product to a processing plant or end user the contractor may use a “buyers call” provision in the contract. But the producer may not want to price the grain at the time it is “called.” Credit sales contracts allow the grain to be physically delivered when the buyer calls it, but gives the producer the opportunity to price it at a later time when the commodity price may be better.**

Other marketing advantages from using credit sales contracts arise from time to time. Such advantages vary depending on availability of transportation, the need to rotate farm-stored grain and similar factors. In times of excess commercial storage capacity, some elevators have used this form of transaction as a competitive device to gain possession of grain early in the season and to take advantage of merchandising opportunities. These marketing advantages accrue to both farmers and grain merchants and have caused the contracts to become more popular during the past several years. Still there are some serious problems associated with credit sale contracts.

### **Interruption of Debtor-Creditor Relationships**

Credit sales contracts interrupt some of the accepted title and risk management relationships among farmers, elevators, and their lenders. It is the interruption of these established debtor-creditor relationships that may create a problem. In most cases where the elevator is financially sound, has adequate cash, and does not default on secured loans, the contracts do not create a serious problem. However, when an elevator begins to encounter financial difficulty there is a serious potential for abuse. Issuing more credit sale contracts as a means of borrowing needed cash becomes a nearly irresistible temptation when the best alternatives involve issuing bad checks for grain and losing the license, filing for protection under Chapter 11, or liquidating under Chapter 7.

A somewhat predictable pattern is followed when financial difficulty arises. The first symptom is a shortage of working capital and difficulty in obtaining cash to meet current obligations and payables. This condition may arise because an operating loss has drained cash from the

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business. It may occur because a speculative position in the commodities market has resulted in a precipitous loss. It may occur because the business has attempted to grow more rapidly than its capital base will permit. It may occur because a large receivable cannot be converted to cash. Mismanagement, fraud, grain quality loss, inadequate financial accounting and other factors may also be causes for the problem.

Whatever the reason for the cash problem there is an acute need to generate additional liquid funds quickly. This may be done through short term borrowing or issuing additional equity. But if lenders balk and new investors cannot be found to purchase equity the problem remains. At this point the business would be forced to cease operations unless additional cash can be injected. Furthermore, the possibility exists that secured lenders may initiate proceedings leading to involuntary bankruptcy.

For a firm operating in the grain business the credit sale contract offers another alternative. New credit sales contracts permit the elevator to take possession of the grain and convert it to cash. Furthermore there is little or no outside review or limit placed on how much cash is raised in this way. The elevator may raise a great deal if necessary. The documents are typically written so that payment cannot be made prior to some future date. Whether it is done to delay constructive receipt of income to the farmer or to allow the producer to take advantage of market movements, the payment is not due immediately. Clearly the intent of such a transaction is not to make a loan from the farmer to the elevator. Nonetheless it fulfills the major purpose of a short-term loan for an elevator in this cash short position. In particular, it reduces the need for ready cash at the time the grain is purchased and it buys additional time for the elevator to locate additional cash.

In fact the producer is supplying high risk capital to the elevator with no explicit interest return on that capital and no security position if the elevator fails. Only the savings in storage expenses and the possibility of price improvements offer a potential return for the action. Treatment of this capital in past bankruptcy and liquidation cases has established it as being in a very high risk position for the seller. Thus the seller should carefully evaluate the financial position of the elevator before entering into such a contract if this risk is to be minimized or even held to an acceptable level.

### **Misuse of Contracts Can Affect Others Not Signing Them**

While the majority of credit sales contracts are executed in good faith by all parties and can provide the benefits described at the beginning of this paper, their misuse can have widespread disastrous effects. Misuse can create serious problems for sellers to the elevator, the seller's lenders, the elevator's lenders, and those responsible for the regulation and licensing of firms in the grain industry. Even third parties who buy from or sell to the elevator using cash or forward cash contracts (rather than credit sale contracts) can be put at risk when credit sales contracts are misused. Nonsufficient funds, checks or repudiation of cash forward contract are both possible side effects. Beyond that external effects on other business in the community are often observed as a result of large dollar losses concentrated in a relatively small geographic area.

These potential problems have led to a number of suggestions to reduce the risks created by credit sales contracts. Each has advantages and disadvantages. Among suggested solutions are the following:

1. Totally eliminate the use of credit sales contracts as a legal means of selling grain.
2. Regulate the use of the contracts more strictly by placing limits on the dollar amount of contract that may be issued based on financial position.
3. Establish an indemnity fund to cover losses in credit sales contract.
4. Require more complete financial disclosure to farmers before they sign credit sales contracts.
5. Require some type of escrow account when grain is moved.
6. Require a letter of credit from the elevator's lender for credit sale contracts.

### **Totally Eliminate Credit Sales Contracts**

It is tempting to approach the problem by simply eliminating credit sale contracts altogether. The producer would not be permitted to relinquish title to the elevator without the safeguards provided in the warehouse law to protect producers — including indemnity fund protection. There is no potential for abuse once the contracts have been eliminated. Although some have questioned whether such a measure would violate constitutional rights to contract other disadvantages would accompany a total ban as well. This approach would create several kinds of marketing problems for producers and competitive problems for some elevators. First, when storage is in short supply it would remove one of the main incentives to move grain further into the market channel. Producers would not be able to move excess grain into elevators without either pricing it or placing it under warehouse receipt. Once the available storage at the warehouse has been exhausted, the producer would be forced to price the grain at the time of delivery before the elevator could move it into commercial channels. This would lock the farmer into the position of selling at a seasonal low or accepting an abnormally wide basis in most years.

A second disadvantage in this approach is the problem it creates for farmers who wish to delay receipt of income into the next calendar year. Such producers would be forced to store the grain at harvest and carry it into the next year. The current practice of selling grain at harvest to be priced in the next calendar year would be eliminated. Unless the farmer was willing to accept current price and receive the income at the time of sale the grain could not be marketed. Buyers call options for specialty grains would need to be replaced with more complex pricing mechanism.

Finally (and perhaps most problematic) the banning of credit sale contracts would put Iowa out of step with the grain industry in the Midwest. Availability of credit sales contracts from elevators in surrounding states would create a situation where Iowa elevators would lose the business of many producers who want to defer income into a later tax year. It is not unreasonable to expect that significant volumes of grain within 50 miles of the border would move across state lines to elevators offering credit sales contracts with “reduced” or “free” storage provisions and income or price deferrals programs.

The net effect of forcing the credit sale to out of state elevators is undesirable in several respects: (1) It increases the cost to Iowa producers who wish to obtain the benefits of income deferral and the marketing flexibility offered by the contract; (2) it places Iowa elevators at a competitive

disadvantage to elevators in other states; (3) it forces Iowa producers wanting to use credit sales contracts to do business with elevators not operating under the regulatory protection of the Iowa warehouse and grain dealer laws.

### **Place Limits on the Dollar Amount of Contracts Issued by Individual Firms**

Some have suggested that an upper limit (based on equity) be placed on the amount of credit sales any firm can issue. This approach has been employed by the CCC and USDA warehouse authorities as a means of limiting uniform storage agreements and licensed storage capacity. While it will not totally prevent losses in the event of elevator failure it provides a rip-stop to limit the magnitude of losses in two ways. First, as an elevator approaches insolvency, fewer and fewer contracts can be legally issued. Second, if an insolvency should occur, it is more probable that at least some equity will be available to cover unsecured creditors holding credit sales contracts. A major advantage to this approach is that the credit sales contract activity is geared to solvency rather than being open ended.

There may be several problems with this approach. There is a possibility of financial deterioration following the establishment of the equity limit. For example, a severe operating loss or a commodity speculation loss (accompanied by a reduction in equity) may occur at any time. Such a loss may occur shortly after the allowable level of credit sales contracts for an elevator has been established. It would be difficult to ensure that intent of the law was being accomplished under these circumstances.

A second problem with the use of equity-based programs is the accuracy of the asset valuation. Overstatement of fixed or current asset values would result in overstated equities. Fair and equitable application of an equity based limit on credit sales contracts would require the use of CPA audits to provide a minimal level of assurance that assets and liabilities are properly stated.

### **Using Balance Sheet Solvency and/or Liquidity Standards**

**Some have proposed the use of balance sheet ratios as standards or as indicators to determine the maximum level of credit sale contracts to be issued. For example a solvency ratio such as the total debt-to-total asset ratio (D/A) is now used as one means to determine whether a grain dealer should be permitted to issue credit sales contracts. Others have proposed the use of a liquidity standard such as the ratio of current assets to current liabilities (current ratio) as a means to determine the elevator's capacity to issue credit sales contracts. A higher current ratio would indicate that the elevator would have the liquidity to promptly pay for grain purchased.**

**Using one or both of these financial ratios as a standard to evaluate financial condition is appropriate but there are limitations that should be recognized. Financial ratios are a static measure of balance sheet relationships and therefore specific to a particular point in time. To be useful they must be based on accounting definitions and practices that are accurate and consistently applied across the firms in the industry. This means that a CPA audit will be required to ensure reasonably comparable ratios.**

There are two additional considerations to be recognized when using financial ratios as a regulatory standard for licensing or issuing permits to use credit sales contracts.

First, the grain business is cyclical in nature. As a consequence, the current assets (e.g., inventory and accounts receivable) and short-term liabilities (e.g., seasonal loans and trade payables) will routinely expand and contract at different points in the year. At times these routine expansions and contractions can radically change the value of some of the financial ratios from the balance sheet (as will be demonstrated below).

A second condition is the effect the unique sales mix in an individual firm can have on the values of ratios during the year. Many Iowa grain elevators have one or more significant farm input businesses such as agronomic supplies, feed, seed and petroleum. Inventory, accounts receivable, short-term borrowing and payables can differ greatly between an elevator with 90 percent grain sales and one where grain accounts for only 50 percent of sales. For example, the firm with 90 percent of its sales in grain can usually function safely with a lower current ratio than the supply firm with 50 percent grain sales.

As the name implies, debt-to-asset ratio is used to measure the relationships between the total value of all the debt and the total value of all assets on the balance sheet. In grain firms this relationship routinely fluctuates widely during a 12-month period. Since one of the functions performed by an elevator is inventory accumulation and holding, the quantity of both assets and debt is not as stable as it would be in a firm retailing consumer goods or manufacturing a product. In fact, the assets and debt in an elevator can increase explosively during harvest and early winter from the base levels existing in late August or early September.

Consider an example elevator with an asset position of \$3 million and debt of \$1 million on August 30. The debt-to-asset ratio would be  $\frac{\$1 \text{ mil}}{\$3 \text{ mil}} = .33$  D/A Ratio. If the elevator were to purchase and hedge \$5 million worth of corn and soybean between September 1 and March 1 (using seasonal debt secured by negotiable warehouse receipts) it would have \$6 million total debt and \$8 million total assets. The debt-to-asset ratio would then be  $\frac{\$6 \text{ mil}}{\$8 \text{ mil}} = .75$  D/A Ratio. This example illustrates a problem in establishing arbitrarily restrictive debt-to-asset ratio standards.

So long as the inventory quality is maintained and it is properly hedged the true solvency of the elevator has changed very little despite a radical increase in the debt-to-asset ratio. To be sure, debt-to-asset ratios above the .75 level begin to carry greatly increased risk. The purpose of the example is not to imply that debt-to-asset ratios do not matter. It is rather to demonstrate the wide seasonal variation and the need for a degree of flexibility and discretion in applying it as a standard.

The capacity of the elevator sector to accumulate and market grain effectively could be reduced if overly restrictive standards are applied. One likely response to reducing the acceptable standard for the debt-to-asset ratio in many elevators would be to change their

fiscal year end-date to a month when they hold very low inventory levels. This would have the effect of reducing the level of the D/A reported in the audit, but would change very little else. In the example above simply changing the fiscal year end from March to August would result in reporting a D/A of .33 rather than a D/A of .75. Other possible strategies weaker firms might employ include delaying write-off for bad debts or impaired assets as a means to maintain higher base asset levels.

In summary, the debt-to-asset ratio can be a useful indication of financial risks, if the seasonal variation in the grain business is understood. Very high D/A ratios can be a red flag for extra supervision, especially if they occur when seasonal borrowings and inventory levels are low. A D/A standard that permits some regulatory discretion based on review by a skilled analyst is likely to be most effective. Significant reductions in the standard are likely to increase the number of firms that regulators must supervise more closely and this will require additional resources.

Some would argue that a current ratio might serve as a better standard than D/A. The current ratio provides an indication of the firm's liquidity. It is calculated by dividing current assets (those assets expected to be converted to cash within 12 months) by the current liabilities (those liabilities that are due and payable within the next 12 months). The ability of an elevator to convert current assets to cash and satisfy payables promptly is generally improved when the elevator has more current assets than current liabilities. A firm with a current ratio of 1.5 would have \$1.50 of current assets for each \$1.00 of liabilities that will be due and payable within 12 months.

However the current ratio can be affected by the seasonal inventory accumulation and holding activities of the elevator in much the same way that the D/A ratio is affected. For example an elevator with \$1.5 million of current assets and \$1.0 million of current liabilities on August 30 would have a current ratio of  $\frac{\$1.5 \text{ mil}}{\$1.0 \text{ mil}} = 1.5$ . However, if the firm purchases and hedges \$2.5 million of corn and soybeans (using a seasonal loan secured by warehouse receipts) during the period September 1-December 30 its current ratio would change. Current assets (inventory) would increase by \$2.5 million to \$4 and its current liabilities (seasonal loan) would increase by \$2.5 million to \$3.5 million. The current ratio in December would then be  $\frac{\$4.0 \text{ mil}}{\$3.5 \text{ mil}} = 1.14$ .

As was the case with the D/A ratio, it could be argued that the fundamental financial position had changed very little despite a decline in the value of the current ratio. Once the grain inventory is sold and the seasonal loan repaid, the current ratio would again rise. The fact that the current ratio can vary over a wide range does not mean that it is unsuitable for use as a regulatory standard. Liquidity is important. However, as was the case with D/A regulatory, discretion is needed.

A potentially useful alternative liquidity measure is working capital. Working capital is defined as the difference between current assets and current liabilities. In the example

above, working capital would have been a much more stable measure of liquidity than current ratio. Working capital in August and December would have been unchanged.

The working capital position at the two points in time would be as follows:

	<u>August</u>		<u>December</u>		
Current assets	=	\$1.5 million	Current assets	=	\$4.0 million
Current liabilities	=	<u>\$1.0</u> million	Current liabilities	=	<u>\$3.5</u> million
Working capital	=	\$0.5 million	Working capital	=	\$0.5 million

Had the elevator experienced a real decrease in liquidity the working capital would have fallen.

Using a flexible working capital standard tailored to sales mix rather than a current ratio could help to account for the differences in sales mix among individual firms as well. Farm supply sales typically involve inventory that is less liquid than grain. Farm supplies also generate larger levels of accounts-receivable than grain. Therefore, the working capital required is typically higher for a dollar of supply sales than for a dollar of grain sales.

Adoption of a working capital standard based on the dollar sales volumes for grain and farm supplies would permit more accurate assessment of the level of working capital needed in an individual firm. The standard could be stated as a percentage of the total sales for each activity. Using a targeted standard could also help to separate some of the cyclical grain inventory accumulation and holding effects on the balance sheet from the true reductions in liquidity that might cause difficulties in paying for grain promptly. While no measure can totally eliminate seasonal effects this could eliminate some of them.

#### **Establish an Indemnity Fund for Credit Sales Contract Losses**

Some have proposed the establishment of a new indemnity program funded through a producer assessment on each bushel of grain sold under credit sales contracts. The indemnity fund would be similar to the one now operated by the state. That fund protects warehouse-receipted grain (including the recently delivered and undeclared grain held in open storage) in all state licensed warehouse facilities. It also protects the cash grain sales through those grain dealers who hold an Iowa Grain Dealers License. The credit sales fund could be administered similar to the way the current warehouse fund is now administered. Payments would be made to producers who have written credit sales contracts with a failed dealer and have not been fully paid for the grain they have delivered.

This kind of mechanism sounds appealing on the surface. However, there are several important differences between the protection of warehouse receipted inventories or cash transactions and the protection of credit sales transactions. Unless there is overt fraud, the losses from warehouse receipted-grain usually arise from shortages due to shrink, internal measurement error, or quality deterioration. While these problems can be serious, the regular warehouse examinations required by state law provide a reasonable degree of protection for the indemnity fund. Losses not arising from criminal actions are typically less than the total value of the inventory.

Similarly the potential losses from cash transactions tend to be limited. Licensed grain dealers in Iowa are required to pay cash for grain purchased immediately or within a period not to exceed 30 days. If they fail to do so or if payment is made with bad checks the losses are indemnified through the fund within prescribed limits. Because there is a requirement for prompt payment, liquidity problems in a financially troubled dealer usually become apparent before large losses occur. The potential for losses from the fund arising from these transactions tend to be modest as a result.

Risk exposure to a fund covering credit sales contracts differs from the risk exposure to a fund covering warehouse receipted grain and cash transactions in two important ways. First it is not as immediately apparent when a dealer or elevator may have difficulty paying for the grain. The grain dealer has taken title to the grain and may legally sell it without paying the farmer until months later. This means that the fund could be responsible for losses accumulated over a much longer time period than the 30 days required for cash transactions.

Second the quantity losses may be larger than would typically occur in warehouse-receipted grain. Unless the warehouse operator has committed a criminal act and deliberately sold warehouse-receipted grain, the losses for warehouse-receipted grain will be limited to shrink, internal measurement error and quality loss. At least some of the inventory value may remain to offset the elevator's storage liability. With a credit sale contract the dealer is not committing a fraudulent act by selling the protected grain. Thus there is a potential liability for a much larger quantity of grain with little or no remaining inventory to cover that liability. The potential for loss to the fund is much more open-ended.

The larger potential loss exposure due to these two differences means that the cash balances in a credit sales contract indemnity fund would probably need to be much larger than those currently carried in the warehouse and grain dealer's indemnity fund. Based on the limited experience with covering credit sales contract losses, it is expected that an even a larger fund (perhaps two or three times the size of the existing warehouse and dealers fund) could be depleted after some bankruptcy events. Liquidity of the fund is critical factor in its value to the claimants. When the fund is depleted it may be necessary for the State of Iowa to back the fund temporarily until it can be replenished. Otherwise producers who have been assessed for the fund may not be paid promptly for their losses.

In addition to concerns about larger loss exposure, some have concerns about the incentives such as a fund might create for financially troubled dealers. As stated above credit sales contracts interrupt some of the title, risk management, and financial discipline relationships between a dealer and its lenders. When the lender refuses to provide additional credit, credit sales contracts can be used to obtain cash. A cash short dealer might be even more likely to issue credit sales contracts as a means to get the needed cash if it knows that a large pool of funds exists to indemnify its customers. The very existence of a large pool of funds may create an adverse incentive for a financially troubled dealer and its secured lenders to use credit sales contracts to improve their position at the expense of

**the fund. When customers are protected by an outside source of funds strategies to shift as much of the risk and potential loss to them as possible are more likely.**

**Market disruption is also a possible outcome when a financially troubled dealer uses credit sales contracts as a financing strategy. The troubled dealer is bidding for credit sale grain as means to obtain critically needed cash rather than to generate a grain-marketing margin. Pricing in the local market can be severely distorted when it is related to the need for cash rather than the supply and demand fundamentals in the local grain market. Financially sound dealers find it difficult to compete effectively in such a distorted market.**

**Finally some have raised concerns about assessing producers across the entire state to fund an indemnity program targeted to local areas. The larger dollar exposure and possible adverse incentives are major concerns. Misuse of the fund by a troubled dealer in some local area to protect its local customers is viewed as potentially serious problem. Producers in some parts of the state would then be in a position of financing high-risk strategies of financially troubled dealer in other locations.**

**Private insurance programs (similar to ones that have been offered by some Iowa insurance companies in the past) have been cited as a possible alternative to involuntary assessments through a state operated indemnity program. Such programs would permit those producers who were concerned with credit sales risks to purchase protection and those producers who do not use the contracts as extensively or who are not concerned about possible losses could opt out.**

#### **Required An Escrow Account to Be Maintained to Cover Any Credit Sales Contracts**

**The suggestion has been made that an escrow account be set up for any grain that is sold under credit sale contract. The idea behind such accounts would be to assure that sufficient cash would be available to the seller in the event of insolvency and at the same time preserve the income deferral characteristics of credit sales contracts.**

**There is little doubt that escrow provisions could accomplish one or the other of these objectives very effectively. However, there may be serious difficulties in achieving both at the same time. That is the escrow accounts may be set up so that the buyer of the grain has so little control over the balance that a bankruptcy trustee could not pull these assets into a bankruptcy proceeding. However such an insulation of the proceeds from the sale of grain may imply that constructive receipt of the proceeds by the producer has occurred. This would prevent the producer from deferring income into a later tax year. Action of this kind should not be taken until the legal and tax ramifications of both these issues can be better understood.**

**Another potential disadvantage of the escrow approach is the fact that funds which could be legitimately used by the financially sound dealer are moved to a separate escrow account. This means that financially sound dealers must substitute other capital (either internal or borrowed) to replace what has been escrowed. An opportunity cost to the dealer and in many cases additional costs to all producers using the elevator would result.**

**Although procedures may exist to allow dealers access to the escrowed funds for use in operations the producers' access to the fund in bankruptcy may be lost when this is done.**

**Finally there could be difficulty in safely managing escrowed funds. In years where there is a great deal of credit sale contract activity the annual volume of escrowed funds could approach 1 billion dollars. The relatively low maximum level (\$100,000 per depositor) for insured accounts in typical banks would not be adequate. It would be necessary for elevators to find places where the escrowed funds could be safely deposited for short periods of time with minimal cost and risk.**

### **Require More Complete Financial Disclosure to Farmers Prior to Executing a Contract**

Those who wish to avoid intervention as much as possible have suggested an approach where the producer decides which elevators are financially sound enough to justify assuming the risks associated with selling under credit sales contract. They favor a system where producers are given access to adequate financial information on the elevator and allowed to decide for themselves whether it is prudent to write a credit sales contract with the elevator. The producer would then assume full responsibility for the consequences if the elevator failed.

To make this approach work the elevator would need to provide accurate financial statements (including a balance sheet and statement of cash flows) to the producer prior to execution of a contract. In order to prevent misrepresentation of assets and liabilities an unqualified opinion audit from a CPA would be necessary. The farmer would then make a "yes" or "no" decision based on informed knowledge of the elevator's condition.

Several problems exist in this approach. While farmers now make such decisions without the financial information, many would not possess the specialized skills necessary to evaluate the information if it were available. Even where the producer has the necessary experience and background to evaluate a complex financial statement there is no way for a producer to determine how many additional credit sales contracts might be issued to other producers. The elevator may be in sound condition when the producer sells using a credit sales contract but issue too many contracts to other farmers after that point.

Beyond these problems many firms in the industry would resist disclosure. A significant number of the elevators in Iowa are not publicly held corporations. As a consequence, they are not required to provide financial statements to outsiders. Many single proprietorships, partnerships and closely held corporations would consider making financial information available to potential credit sales contract customers to be an invasion of their privacy.

### **Provide An Irrevocable Nontransferable Letter of Credit to the Producer**

It has been suggested that producers could be protected by a nonnegotiable irrevocable letter of credit payable after a specified future date to the Iowa Department of Agriculture and Land Stewardship. In this way the producer would be paid even though the elevator had failed. One advantage of this kind of approach is the maintenance of the secured lenders position in determining the gross amount of credit available to the borrowing elevator. It would therefore be

less disruptive to the normal debtor-creditor relationships established for other types of transactions.

In many ways it is similar to the type of lending that occurs when company-owned grain is purchased by the elevator and stored for sale at a later time. The elevator typically establishes a line of short-term credit with a lender for the purchase of grain as farmers wish to sell. This credit is drawn upon as the company-owned inventory is built and repaid later after the inventory has been liquidated.

The line of credit is extended by a lender who has presumably determined a prudent level of borrowing given the elevator's assets, other liabilities, available security, and, in most cases, its history of profitability. Lenders usually monitor financial position and profitability of the elevator closely through monthly reporting.

The credit sale contract short-circuits this external discipline by the lender. It allows the elevator to increase the level of operating credit without direct lender knowledge or any restraint based on financial condition.

Backing credit sales contracts with a letter of credit from the secured lender would reinstitute this kind of discipline on the elevator. At the same time the elevator would have access to the liquid assets from credit sales contracts in much the same way it now does. The elevator would be expected to arrange a line of credit with the lender to cover expected credit sale contract grain purchases before the lender would issue a letter of credit. The lender would make a judgment about the credit-worthiness of the elevator in establishing this level. The elevator would then be free to write any level credit sales contracts less than the line of credit and provide the bank with a security interest in the inventory or proceeds from sale of grain. As the elevator's credit sales contracts are liquidated, the letter of credit may be cancelled if the elevator is capable of making payment to producers. If not, the lender makes payment on the letter of credit and moves against the security interest it holds in the elevator's assets.

There may be several disadvantages to this approach. Some lenders are not accustomed to the use of letters of credit. This could create problems in operating under such a system for clients of those lenders. The standing of the letters of credit in bankruptcy and their treatment by the IRS could also be a potential problem. Additional legal analysis would be desirable before concrete action is taken.

Finally, an additional transaction cost results from issuing the letters of credit. Although the actual cost and the opportunity cost is much less than the alternatives of escrowing or banning the contracts, it would be somewhat higher than taking no action.

## **Regulatory Monitoring and Enforcement**

**Establishing financial standards, indemnity programs or other regulatory requirements are part of the solution, but these measures by themselves cannot reduce the financial risks credit sales contracts pose for farmers. In fact they are likely to be of very limited value without effective monitoring and enforcement. Enlightened oversight by regulatory agencies (staffed with competent and properly trained personnel) is critical if standards**

**and other programs to reduce risks are to be effective. Otherwise they may only create a false sense of security for producers.**

**Rapid consolidation in the industry over the past two decades has resulted in much larger elevators with greatly expanded trade areas. They are not only larger, but also more sophisticated and complex. While these larger firms are less likely to fail, the number of farmers affected when a failure does occur is larger and the secondary effects on other sectors in the rural community are more widespread. Quite simply the stakes are much higher. Oversight and enforcement efforts must keep pace with the changes now occurring in the industry. An adequate number of well-trained staff with the appropriate analytical skills will be necessary to provide that oversight.**