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Financial institutions for agriculture: A view to the future

by Marvin Duncan and
Richard D. Taylor

The outlook for farmers and their financial services institutions is undergoing fundamental change. No longer do farmers desire only credit services. They also want insurance, lease financing, trust, brokerage, merger and acquisition, financial management and other services.

After the painful adjustment of the 1980s, farmers, lenders, and public policy-makers no longer speak only of the credit needs for agriculture. Instead, most discussion and planning is focused on supplying credit demand (i.e., indicative of the capacity to repay borrowed funds)—which is a very different perspective that likely will support a healthier U.S. agriculture. Because of this changed focus, Farmers Home Administration (FmHA) lending of last resort has been refocused to guarantee targeted lending rather than to function primarily as a direct lender.

Agriculture and its credit demand will likely be drawn into the mainstream of American business. Except for unique situations, the business management of agriculture will become more like that of other enterprises, and agricultural lending will lose much of its unique character and specialized treatment, although lender structure may change slowly.

Before we expand on our views about the role, organization and services of future financial institutions serving agriculture, we speculate about the factors changing those institutions—the economic environment and the changing farmer-borrower.

The broader economic environment

The broader economic environment will condition the agricultural credit outlook. Three factors appear especially important—inflation, agricultural exports and technology.

Price inflation will likely be held under tight control. The nation's core inflation rate fell to 3–3.5 percent during 1992. Indeed, the core rate of inflation in 1992 declined five of the last six months. While the early 1993 core inflation rate has risen, few analysts believe that indicates a re-emergence of inflation problems. To many analysts, that core rate comes close to representing effective price stability. Food price inflation, up only about 1 percent in 1992, will further restrain increases in the Consumer Price Index. Continued slow money growth, near the bottom of the Federal Reserve's range for M2, will also restrain inflation.

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Agricultural export sales will probably grow only slowly. In the 1980s, substantial government support in the form of GSM credit and Export Enhancement activity was needed to hold exports at about $40 billion. In real dollars, exports are slightly less than twice as large today as in 1960. Strong growth in export tonnage also may be difficult to achieve in the 1990s. The United States will likely focus more of its effort on adding more value to that tonnage sold abroad to sustain export sales growth.

Technology will support greater specialization, increased scale of production, and more vertical integration in the U.S. economy. Agriculture is also affected by the increased capacity to use information, control the production environment, and increase output through use of production-enhancing technology that is so dramatically changing the face of American manufacturing and service businesses. Domestic technology adoption is spurred further—in a catch-up sort of effort—because of the ease with which technologies can cross international boundaries, changing the competitive balance in the process.

These technologies already are reshaping U.S. livestock production. In 1987, 73 percent of fat cattle sold annually came out of lots with capacities of more than 1,000 head. That proportion probably will increase. Meanwhile, the proportion sold out of lots of less than 100-head capacity has declined to only about 10 percent. Slaughter plants with new processing technology have relocated to areas with concentrations of large-capacity feedlots.

Even more rapid and perhaps more dramatic are the changes occurring in the swine industry. Concentration of production into units of more than 1,000 head has increased by a factor of about 7 between 1978 and 1987. In 1987, about 58 percent of hogs sold came from these large units. That proportion is almost certainly higher today. The sharpest proportional declines have been in units selling less than 200 hogs annually. Hogs marketed from the large production units increasingly bypass the open marketplace, moving under negotiated contract prices.

The same forces of concentration also affect crop production. Moreover, the opportunities for vertical coordination are increasing along with the growth in contractual arrangements for crop marketing.

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Source: Economic Indicators of the Farm Sector, various issues. USDA, Washington D.C. National Financial Summary, 1990. ERS, USDA, Washington D.C.

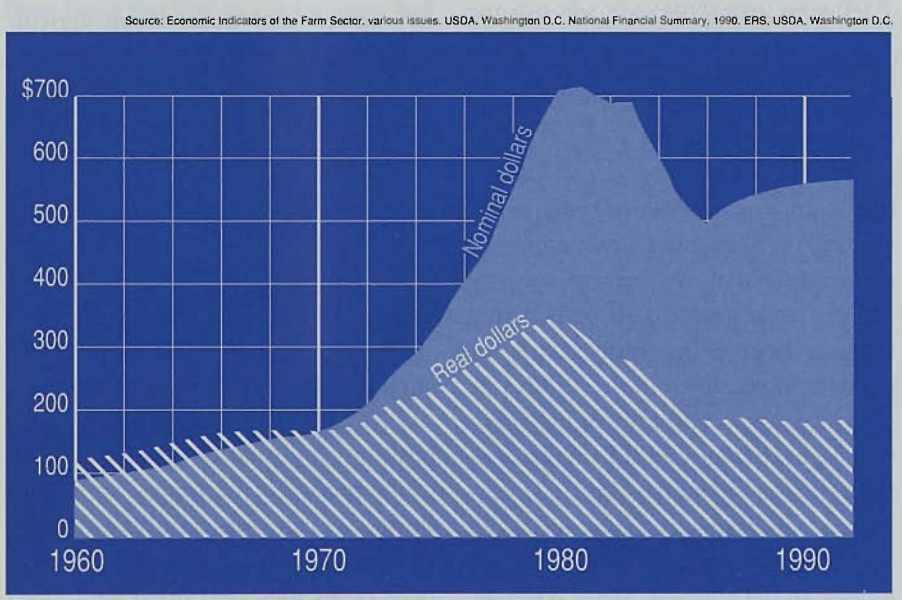

Figure 1. United States farmland value per acre

The changing farmer-borrower

Broad changes in the underlying economic environment will spur fundamental changes in the way agricultural borrowers conduct their businesses and relate to lenders. First, farmers will become much more attuned to managing a profit spread. Just like their urban counterparts, farmers will focus on creating a profit spread and work to insulate that from external volatility. Much more attention will be focused on cost containment and fixing the cost structure in a predictable fashion. Product pricing strategies will protect the profit spread but leave upside price opportunities open. Price risk will receive greater attention and will be managed consistent with the farm's financial ability to bear risk.

Since the opening of the American frontier, farmers have considered land as a store of value. In the post-World War II period, land ownership became an even more important and reliable wealth creator. Hence, farmers leveraged themselves to purchase land—not just to assure access to its productive capacity but also to enjoy its wealth effect.

That was particularly true between 1970 and the early 1980s, as rising inflation, farm subsidies to underwrite risk, and growing export sales spurred land value increases, as shown in figure 1. In the future, all three factors may

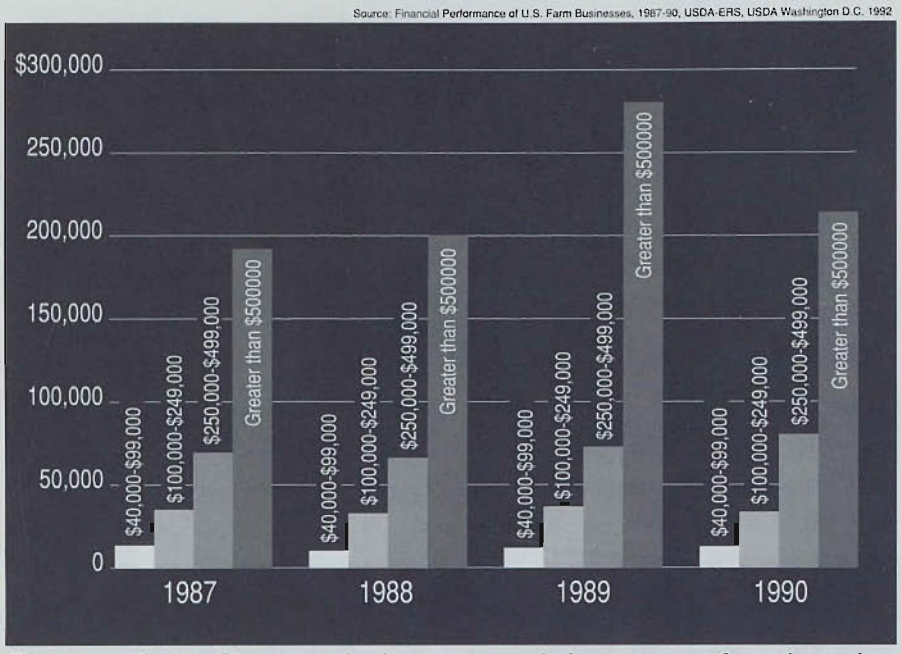

Figure 2. United States agriculture net cash income per farm by sales category

have a less positive—perhaps negative—effect on land values. Thus, farmers are learning that ownership of farmland may no longer build wealth, particularly when a substantial proportion of debt capital is used in the acquisition.

High quality seed, profit-maximizing fertilizer and pesticide programs, equipment management, production and marketing programs can all produce higher returns on investment than land ownership. While the proportion of U.S. farmland leased has not yet begun to increase, many expect it will do so. Lenders also report, anecdotally, that many farmers—especially younger ones—no longer focus on land ownership as the only means to gain control of the asset.

Much of agricultural lending is supported by lender security interests in land and equipment. As farmers—and especially newer farmers—devise and rely more on methods to control rather than to own production assets, lenders will be forced to rethink their credit products, underwriting standards, and sources of security. Guidelines for these new developments will be found more frequently outside agriculture than in past agricultural lending.

Farmers also are managing control of equipment differently. First, they are improving maintenance to extend its useful life. Tractors 10 to 20 years of age that still perform well are now common on farms. Second, farmers and agribusiness firms use lease financing and rental more frequently; the value of such leases outstanding doubled in the 1980s.

Scale and specialization in U.S. agriculture have increased. In the process, farm size has bifurcated. About 71 percent of all farms produce less than $40,000 in annual sales and often lose money on the business. Most, if not all, family income comes from off the farm. Farming, then, often represents a lifestyle choice.

Only about 7 percent of U.S. farms sell over $250,000 annually. Yet these farms produce the bulk of the nation's food and fiber. Moreover, they capture most of the sector's profits (figure 2). In 1990, farms with over $500,000 in sales averaged $213,688 in net cash income. Farms with sales of $250,000 to $500,000 averaged $80,715. By comparison, farms with sales of $40,000 to $99,999 averaged only $13,961 in net cash income. The point of emphasis seems clear: the largest farms are earning much larger profits and are capturing most of the sector's net cash income. Small farm profits are often inadequate to support family living expenses.

Generational transfers in agriculture appear more likely to use family assistance or outside equity funds. The scale of farming required to meet family living and debt retirement typically far exceeds the resources of a new farmer. In midwest and Great Plains agriculture, farmers can expect to extract 10 to 15 percent of gross farm marketings for family living purposes without jeopardizing the firm's financial stability. With desired family living requiring $25-35,000 a year, the scale of farming implied is apparent. Moreover, off-farm income from one or both spouses—already frequent among younger farmers—will become more common.

Data on debt-bearing capacity in farming tend to affirm that only especially profitable or otherwise unique businesses can comfortably carry more than about 40 percent debt. Greater debt poses high and often prolonged exposure to business failure.

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Finally, borrower/lender relationships are becoming more arm's length in character. Lenders require more balance sheet, profitability, and performance data from farm customers. Banks'

underwriting standards have become more demanding. Borrowers who maintain and understand business financial information discover that helps them build stronger and more productive relationships with their lenders.

Future ag lenders

Lending to agriculture will be more competitive. In real terms the agricultural sector's non-real estate indebtedness peaked in 1979 and has fallen sharply since then. Real estate indebtedness peaked in 1981 and also has fallen since then. Farmers have reduced their leverage to more manageable levels. They are not likely to aggressively use debt soon, unless there is a fundamental change in the economic environment. Thus, lenders wishing to add farm loans to their portfolio must bid aggressively against other lenders, offering specialized credit products and competitive interest rates.

There is substantial excess capacity among agricultural lenders. Agricultural banks across the nation have a loan-to-deposit ratio of only 54 percent. Bankers say this is largely because of weak credit demand. This ratio is far lower than the 80 percent posted for all commercial banks. Farm Credit System (FCS) associations also are aggressively working to add good loans to their portfolios. Nonetheless, the loan portfolio of the FCS has continued to slowly decline. Some early indicators suggest FCS loan volume could stabilize or perhaps increase somewhat in 1993.

Agricultural banks may have more difficulty servicing the credit demand of their customers because most agricultural banks are small. For example, in the Great Plains States, almost 88 percent of commercial banks have assets of less than $100 million. That ranges to a high of 90 percent or more in North Dakota, Nebraska, and Kansas. For the United States, only 76.5 percent of the banks have assets under $100 million. Among those banks with assets below $100 million, the average size in the Great Plains is only $32.4 million. Thus, many of these banks are too small to service the full credit demand of their larger customers. Yet these smaller banks can provide personalized service such as checking, consumer loans, and insurance to their rural customers.

FCS institutions are perhaps more easily able to meet the credit demand of larger customers, but legal constraints restrict which customers they can serve and the services they can offer. Nonetheless, across the lending business today, lenders are actively attempting to differentiate services and operate in specialized markets.

The introduction of risk-based capital standards and similar loan loss reserve procedures into commercial banking and the FCS institutions means fewer differences in the regulatory climate in agricultural compared to nonagricultural lending. Greater uniformity in examination procedures and regulatory oversight across lending systems also implies a more similar competitive environment. The presence of the Federal Agricultural Mortgage Corporation (Farmer Mac) eventually will bring greater uniformity in underwriting standards, so lenders can do business in the secondary market for agricultural real estate mortgages. Finally, the Financial Standards Task Force Report, which emphasizes standardized analytical ratios and definitions, will bring greater uniformity to the business procedures of all agricultural lenders.

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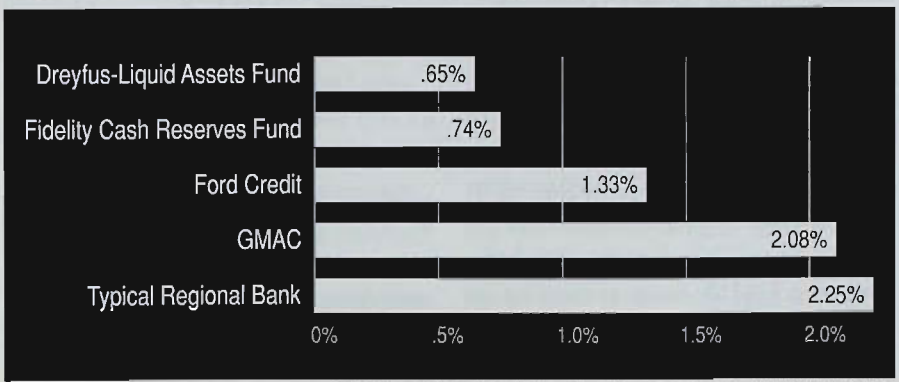
The risk weighting assigned to different assets to determine lender capitalization will likely discourage lending and encourage holding assets, such as agency securities or mortgage-backed securities. Less capital is required to support other assets than is required for loans (figure 3). Consequently, to alter the current bias against lending, policy makers and lenders may need to revisit risk weighting rules.

Insurance companies, which have been very unevenly regulated across different states, face a changed regulatory

Figure 3. Noninterest expense as a percentage of earning assets and deposits



Source: Reinventing the Bank, The Challenge for the 1990's, Andersen Consulting, Arthur Andersen & Co. 1992

environment. Regulators now require that insurance companies identify and reserve for potential loan losses. Regulators also require capital levels that more accurately reflect portfolio risk. Finally, regulatory oversight is becoming more uniform and more effective across different state regulatory bodies.

Across all lenders, however, the regulatory playing field will remain uneven. Banks, FCS institutions, and insurance companies may find themselves at a growing disadvantage to a variety of financial service firms or the finance arms of agribusiness firms. These firms typically function under a different and more flexible regulatory regime. In sum, their costs of doing business are usually significantly lower than those of traditional lenders. For example, Ford Credit has a markedly lower non interest expense structure than is true for the typical regional bank. As a result, they have taken business from depository institutions, including commercial banks and insurance companies.

Financial service firms with no historical linkages to agriculture will likely play a larger and more innovative role in servicing demand from the agricultural sector. These firms are already involved in lease financing of equipment and facilities and will probably do more. Insurance companies and other real estate lenders will sell real estate loans to those better able to manage the risk entailed. Mortgage pools and pension funds will likely become more important in financial intermediation to agriculture. Money market funds will provide wider investment opportunities to farmers which may increase the movement of funds out of rural communities.

In addition, many agribusiness firms—Pioneer or John Deere, for example—are able to use credit services to smooth production schedules, to link customers more closely to the firm and to cross-sell products. Thus, these firms may not require the same rate of profitability from direct lending operations that would be required by a bank. Vigorous competition and innovation of nontraditional lenders will likely cause even more of these firms to offer credit services.

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Policy makers and farmers, both, will be uneasy about the staying power of nontraditional lenders in agricultural lending. If stock analysts criticize these firms for undue exposure in agricultural lending, will these firms quickly reduce their lending, tighten lending standards, or shift the geographic scope of their lending? Furthermore, if these firms can attract the best customers in an area, what will be the impact on the risk in portfolios of traditional lenders serving the same area?

The FmHA has a new and more strategic mission in agricultural lending. It has now focused on a more limited direct lending role to assist new farmers and to provide a second chance to financially troubled farm borrowers. Increasingly, FmHA will be a guarantor of loans made by traditional lenders. To achieve its public policy mission, however, the FmHA must streamline its guarantor procedures to be more manageable and predictable for commercial lenders. To do so will require some cultural changes on the part of the FmHA—and probably on the part of direct lenders as well.

Conclusions

Substantial changes are ahead for financial firms which serve agriculture. Among the changes one could expect are the following:

- Probably many fewer banks and FCS institutions will serve agricultural producers and rural America. Smaller institutions will merge to gain size needed for efficiency and to meet customer requirements.
- Lending institutions will create more product and customer differentiation. Market niches will be more numerous but more narrowly defined. Smaller lenders will market products as agents for larger institutions or as franchisees for providers of branded financial service and credit products.
- Banks will become more profitable by adding unique services and by marshalling deposit growth in a more cost effective manner.
- More strategic alliances will occur among unlike lending institutions and lenders of different sizes to better serve customers.
- More credit sources will be available to borrowers, but with greater lender market segmentation of customers.
- A growing number of businesses will link inputs, credit, production, and marketing together through coordination, contracts, and linked ownership.
- FmHA will be more important, strategic and businesslike in its role.
- Crop insurance will become a more important tool in production risk management.
- Competition among lenders will remain intense in a slow growth credit market.
- Agricultural lending will no longer be a unique discipline. ◘