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RURAL CREDIT MARKETS

Challenges For A Sector In Transition

by Marvin Duncan, Michael Boehlje, and David Lins

After peaking at slightly over $206 billion in 1983, farm debt declined to $145 billion by 1990. Since that time, real farm debt has continued to decline, and the mature, traditional farm lending market will likely grow only modestly in the near future. Both rural credit institutions and the agricultural/rural firms they serve now diversify or specialize more than they have previously. The credit and financial services needs have changed and may require adjustments in financial institutions and federal and state legislation. This discussion will attempt to raise the key public and business policy issues that must be resolved to adequately and efficiently serve the changing agricultural sector and rural communities.

How will the next generation of U.S. farmers be capitalized? What is needed to meet the changing demand for financial services? What financial institutions will compete for rural financial services? How can rural businesses and infrastructure be financed? And, what are the appropriate public policy, as well as private sector, responses to the changing rural credit market?

Capitalizing the next generation of farmers

The new generation of farm entrants has financing needs that are different from those of the previous generation. In addition, young farmers' attitudes toward debt and their willingness to use other people's equity capital have changed in recent years.

Financing new entrants

New entrants into agriculture now use different strategies for entry and expansion. Many no longer borrow heavily to purchase land. Instead, they focus on control of business assets rather than ownership. Few crop and livestock farms can comfortably carry debt much above 50 percent of assets, except for relatively short periods. Reliance on debt capital limits a firm's size and its ability to compete in an industry with substantial economies of scale. A business generating annual sales from farm marketings of less than $250,000 often can't both fund firm growth and provide an acceptable level of family income. Young farm families today aspire to a lifestyle equivalent to that of their nonfarm peers with $30,000 or more allocated annually to family living.

Consequently, many beginning farmers now use other options for asset control, including leasing. Should public programs, such as the federal Consolidated Farm Service Agency (CFSA) and various state lending programs, continue to put debt capital into start-up farm businesses which control assets without ownership? Should they continue to offer below-market interest rates and use less stringent credit standards than private lenders?

Equity investment in new farm businesses

Technical change and industrialization have caused some farmers to add outside equity capital and develop more corporate ownership structures. As technological change and vertical integration take root,

the economic value of outside equity investment and limited liability/unlimited life span farms becomes more apparent.

Commercial-scale, technologically advanced farming operations can no longer be created and capitalized within the working life span of one person. In the case of livestock, it seems clear that poultry, swine, and fat-cattle production have demonstrated sufficiently large and predictable profits to attract off-farm investment. Dairy farming is also consolidating. Early signs indicate the same will be true for more specialized kinds of crop agriculture. Yet, many states retain anticorporate farming statutes that create barriers to larger industrialized agriculture production units, such as confinement hog or large-scale dairy operations. Governments should consider removing statutory barriers to outside equity capital in agriculture.

Changing demand for financial services

Demand for financial services, credit being but one of those services, has been changing as well. Increasingly, farmers require specialized credit and other financial products tailored to their particular needs.

Small-scale borrowers

Delivery of most types of credit to small-scale borrowers—those borrowing $25,000 or less—costs dearly when using traditional delivery techniques. Many of the costs, including most costs for origination and service, depend on the type of credit, such as operating credit or mortgage loans, not loan size. Consequently, profit-conscious lenders target the larger borrowers, and either don't provide credit services to small borrowers, or do so using more efficient or less extensive credit review procedures.

In spite of, or perhaps because of, this trend to serve the larger borrowers, small and part-time farmers present a market opportunity for some lenders. Credit products requiring limited documentation and priced to reflect the risk associated with the loan should find a ready market among these farmers. Many have significant levels of off-farm income, and could present a less risky finance opportunity than do larger farmers.

Other solutions have been suggested. Small-scale borrowers could be served by a public institution, such as the CFSA, using subsidized interest rates. Alternatively, interest rate subsidies could be provided for private sector lenders who serve qualified small-scale borrowers, to offset their higher cost. In either case, these solutions come at a cost to taxpayers.

High-performance farmers

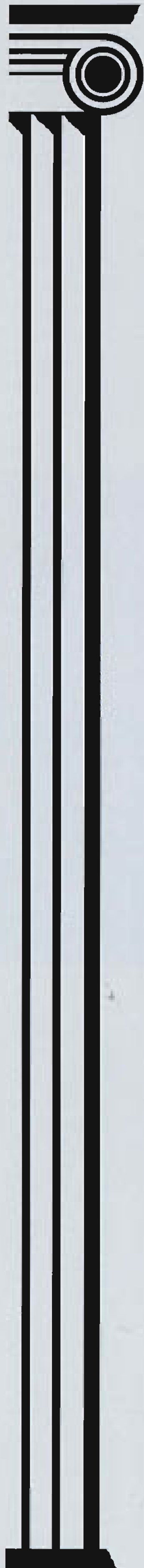
These operators focus on controlling the use of agricultural assets through rental and lease financing arrangements. They have limited appetite for ownership of farm real estate. They seek to own only those assets that they can use intensively. They focus on creating and managing profit spreads in their businesses. They seek high rates of return on equity and assets by using the most effective production systems coupled with astute marketing and financial management.

Yet, lenders have been slow to develop credit products to meet the needs of this growing market segment of agricultural producers. These farmers require credit products based on cash flows and financial performance, not collateral. Their balance sheets may look anemic by traditional standards, but their profit and loss statements present a profile of strong business performance.

Lenders who develop products or adjust credit standards to successfully meet the credit needs of high-performance farmers will find good business growth opportunities. These farmers control a growing proportion of commercial-scale agricultural production. Many high-performance farmers will seek outside equity capital in their businesses and may choose a corporate structure of ownership to facilitate acquisition of equity and quasi-equity capital. They may also ask traditional lenders to help in sourcing equity capital or subordinated debt.

Changing competitiveness in financial services

The balance of power among credit and financial services providers is changing. While the Farm Credit System and commercial banks have been monitoring each other's competitive moves, nontraditional providers of services have quietly been enlarging their market share, capturing business



from customers of both of the traditional suppliers of agricultural credit.

Expanded authority for the farm credit system

The Farm Credit System (FCS) must broaden its customer base if it is to avoid further downsizing and consolidation. There is keen competition in a crowded farm credit market. The growth in rural credit demand will come from three customer groups; the FCS is currently only granted full authority to serve one of these—farms. Farm production firms, agribusiness firms on either the input or processing/distribution side, and nonfarm related businesses will be the big credit users in coming years.

The FCS seeks to expand its customer access in four ways. First, it wants to extend credit to businesses involved in handling, processing, and marketing food products. Second, it wants to extend credit to all businesses located in rural America. Third, it seeks to build on its successful experience in rural housing lending by offering such services across a broader area of rural America, perhaps including suburban development in smaller cities. Finally, it wants to broaden the array of its services beyond credit, to include many related financial services.

While the FCS attempts to gain greater latitude in service authorities through negotiation with the Farm Credit Administration, most changes sought will require new legislation. Public policy makers will determine if unserved market demand exists in rural America, and if the FCS should be permitted to serve it.

Commercial banks

Commercial banks face some of the same problems as the FCS. High-quality loans are hard to find in the quantity desired by commercial banks.

Nontraditional lenders, such as John Deere Credit and Farmland Industries, are capturing some of the best customers of both banks and the FCS. Various institutions compete for customers' savings. Banks continue to merge to better serve the financial needs of their best customers. Many rural banks feel bypassed by the growth of suburban and urban banks.

Bankers would like broader authorities and greater opportunities for fee income. Their desired changes in authorities somewhat mirror those of the FCS. Bankers want to offer a broader range of financial services, including real estate and common stock brokerage. They desire broader branching authority. Some banks would like to deal in the equity instruments of their customers.

Banks feel unduly burdened, relative to their competitors, by broad-ranging safety and soundness regulations. They desire relief from these burdens, or less costly application of existing regulations.

Nontraditional lenders

Most national or regional agribusiness firms, including farmer cooperatives, now offer some form of credit services for equipment or farm supply purchases. Major agribusiness firms also provide production credit, such as in poultry and confinement swine production.

These firms offer quick turnaround on lending decisions, convenient loan terms, and limited credit information requirements of the borrower. Since these firms are very efficient, they sometimes underprice traditional lenders' credit services. But more frequently, they compete based on ease of access and service, and on their ability to expand sales of their principal products through credit programs.

Nontraditional lenders are free to create products and seek customers as market demand dictates. The government regulates nontraditional lenders far less than they do banks and the FCS. State and federal laws on disclosure to investors do protect investors in stock or debt instruments of these firms. Many sell commercial paper to support their credit activities.

Most public policy questions about nontraditional lenders focus on the value they bring to customers, and whether they adequately protect customer interests and avoid undue risk to the nontraditional lenders' parent firms.

Financing rural economic development

Declining rural communities, lagging rural job formation, and reduced federal subsidies for production agriculture have focused more closely the attention of policy makers on strengthening economic growth in rural America.

Rural housing lending

Lack of quality housing works against a community seeking new businesses. The FCS, the CFSA, and commercial banks all provide financing for rural housing. Should the government further broaden eligibility for home loan sales through a secondary market for housing loans in smaller communities or rural settings? Possibly with broadened access to the secondary market, lenders would more actively pursue residential lending in more rural locales.

Financing new and growth businesses

Communities are seeking new business firms and attempting to encourage the growth of firms already established. Rural lenders are considered an important source of debt capital to achieve this growth in business firms.

Yet commercial banks, where most small rural businesses obtain their debt capital, face some challenges. First, most relatively small rural commercial banks have lower lending limits than their somewhat larger urban counterparts. They also have limited capacity to bear the risk associated with lending for new and growth businesses. These banks may not have experience evaluating complex nonfarm business loan proposals. Finally, new businesses frequently require loan maturities longer than those banks can comfortably provide from their shorter maturity deposit base, which typically has a maturity of less than three years.

Two alternatives might be considered to provide increased debt capital in rural communities. First, Congress could grant rural commercial banks access to government agency and government-sponsored entity funds for business development, infrastructure loans, and other loan requests which they cannot service from their deposit base. Second, the FCS could be granted much broader charter authorities to provide debt capital in support of rural economic development. In addition, the Rural Electric Administration and the CFSA might become even more heavily involved in lending or guaranteeing loans to new businesses in rural areas or for rural infrastructure.

Lenders who develop products or adjust credit standards to successfully meet the credit needs of high-performance farmers will find good business growth opportunities.

The role of Farmer Mac

The Agricultural Credit Act of 1987 authorized a secondary market for farm real estate loans—the Federal Agricultural Mortgage Corporation (Farmer Mac). Farmer Mac can increase the liquidity of long-term real estate loans. It can also assist lenders with short-term funds to make long-term loans without encountering the interest rate risk of funding long-term assets with those short-term funds (liabilities).

Many policy makers question whether Farmer Mac, as structured, is needed in the agricultural credit markets. Others suggest growing demand for Farmer Mac products if certain statutory impediments are removed. Perhaps Farmer Mac should be rechartered to also provide a secondary market for rural economic development loans. If lenders could sell these loans to Farmer Mac, their capacity to support higher-risk economic development would be substantially enhanced. Lenders could reliquify their loan portfolios. They could also buy back from Farmer Mac securities backed by loan pools and, in the process, substantially reduce their own portfolio risk.

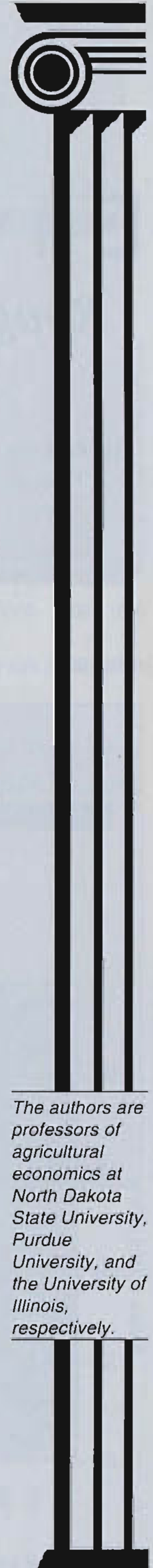
Meeting the challenges

Four challenges are posed for rural credit markets. First, new entrants into farming intend to control the use of production assets, without necessarily owning them. Coupled with the scale of operation needed to provide family lifestyles competitive with those of urban Americans, new entrants will seek to utilize more outside investments in agricultural assets.

Second, demand for credit products is changing. On the one hand, there will be a substantial market for small-scale credit. But, rural lenders must develop low-cost means of delivering and managing such credit. On the other hand, commercial-scale borrowers will demand performance-based credit, rather than the collateral-based credit that has characterized agricultural lending.

Third, changes in competitiveness of lenders is reshaping rural credit markets. The FCS currently is primarily confined, by statutory authority, into slow growth segments of rural credit markets. Commercial banks find that their small size limits their capacity to serve large and complex credits. They have increasing difficulty securing adequate loanable funds from their deposit base. Both of these traditional rural credit systems are also experiencing more competition from nontraditional lenders.

Fourth, and finally, the growth potential for credit and other financial services demands by rural housing, new business formation, and business growth represents an opportunity for lenders that may outstrip that of production agriculture. Yet, lender strategies and public rural credit policies may require change if that potential is to be realized.



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