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# THE GLOBAL FINANCIAL CRISIS: IMPLICATIONS FOR CAPITAL TO AGRIBUSINESS

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<sup>2</sup>*Paper presented at the Second AGRIMBA-AVA Congress 2011 “Dynamics of international cooperation in rural development and agribusiness” in Wageningen, The Netherlands, 22-24 June 2011.*

**Abstract:** The global economy has continued to experience lingering effects of the global financial crisis that began in 2007. Although attention was initially given to the liquidity crisis and survival of some the world's largest corporations and institutions, the financial crisis is likely to have long-lasting implications for agribusiness. As the world slowly recovers from the crisis, another round of problems are emerging as governments and international institutions attempt to unwind the positions they took in an effort to prevent the global economic bubble from bursting. Perhaps the most problematic factor for businesses is access to capital in sufficient amounts and at affordable rates. Governments and institutions, particularly in the United States (U.S.) and the European Union, have increased their financial obligations as the result of activities taken to curtail the economic crisis. These financial obligations and the associated financial risks place pressure on financial markets and tend to restrain the availability of capital and increase the cost of capital for businesses. However, the U.S. agricultural credit market has not experienced problems to the same extent as general business (commercial and industrial) and real estate credit markets have. In general, U.S. farm businesses have a strong balance sheet, adequate repayment capacity, sufficient amount of assets to offer collateral for loans, and reasonable profits. Thus, U.S. farm businesses have had an ample supply of credit at relatively low interest rates.

**Keywords:** financial crisis, capital, credit, agribusiness, liquidity

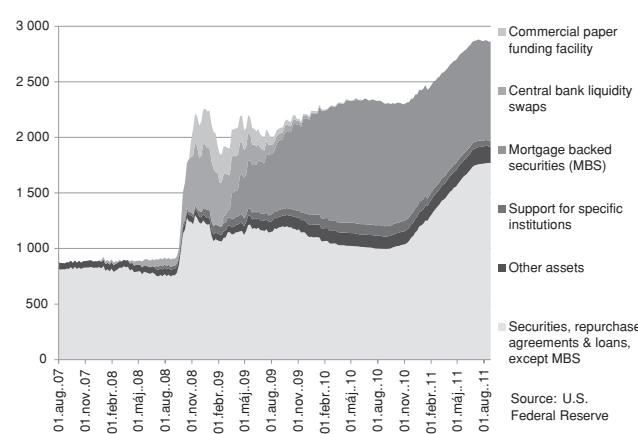
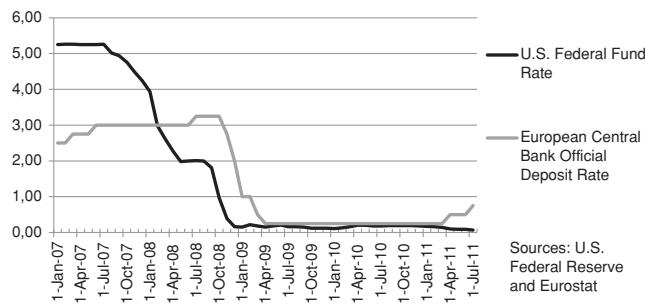
## 1. Introduction

The global economy has continued to experience lingering effects of the global financial crisis that began in 2007. Although attention was initially given to the liquidity crisis and survival of some the world's largest corporations and institutions, the financial crisis is likely to have long-lasting implications for agribusiness. As the world slowly recovers from the crisis, another round of problems are emerging as governments and international institutions attempt to unwind the positions they took in an effort to prevent the global economic bubble from bursting.

## 2. Central Bank Action

Early during the financial crisis, the United States (U.S.) Federal Reserve System (Fed) took the traditional step to stabilize the financial system by lowering the federal funds rate target from 5.25% in September 2007 (*Figure 1*). However, liquidity concerns remained. As the Fed continued to lower the federal funds rate, it took another step to assist the liquidity situation by creating the Term Auction Credit Facility in December 2007, which allowed institutions to purchase funds in the open market without going to the discount window

(*Blinder 2010*). The Fed also began lending to nonbank dealers after the rescue of Bear Stearns in March 2008. With the failure of Lehman Brothers in September 2008, solvency as well as liquidity concerns were heightened. The Fed created the Commercial Paper Funding Facility, initiated Maiden Lane Facilities to provide Support for Specific Institutions (i.e., rescued American Insurance Group), announced the Mortgage Backed Security program, and accelerated cuts to the federal funds rate to near zero, all by December 2008. As a result, total reserves at depository institutions skyrocketed, but also did the Fed's assets leaping from \$907 billion on 3 September to \$2,256 billion on 17 December 2008 (*Figure 2*). Although additional programs would be created, for example, the Term Asset-Backed Securities Loan Facility, the dye had been set. In exchange for pushing and holding down liquidity risk and solvency risk premiums for financial institutions and businesses in the short run, the Fed's balance sheet had expanded and its leverage (assets:capital ratio) had multiplied more than two fold from 22:1 to 51:1. These short run actions may have long run consequences as the Fed downsizes its balance sheet by unwinding its positions. Although this only outlines the actions taken in the United States, similar actions and monetary expansions have occurred in other countries, such as the United Kingdom, Switzerland, and Sweden (*Anderson et al., 2010*).



Like individuals and businesses before them, governments and institutions in the United States and in many areas of Europe have increased their financial obligations as the result of financing activities taken to curtail the economic crisis and avert an economic meltdown. As this was occurring, financial institutions were reassessing their appetite for risk and their willingness to extend credit. Later came calls from the public for regulatory reform that have led to added financial market oversight, which in turn have driven credit institutions to draw back further.

### 3. Impacts

U.S. commercial banks and other financial institutions were beneficiaries of the Fed's liquidity and solvency programs. The first program addressed the liquidity crisis by providing ample amounts of reserves. The second program, the Capital Purchase Program, addressed the solvency crisis by making capital infusions in financial institutions. Of the more than 8000 eligible U.S. financial institutions, 707 received a total of \$205 billion beginning in October 2008. By end of 2010 approximately 80% of these funds had been repaid and very few of the beneficiaries had failed (Contessi and El-Ghazaly, 2011).

Although the vast majority of banks have returned to a sound liquidity and solvency status, particularly banks in

rural areas that had not piled on residential mortgage, commercial real estate, and non-agricultural business (commercial and industrial) loans, there have still been 380 U.S. bank failures since the beginning of 2008 through 19 August 2011 (*Federal Deposit Insurance Corporation*, 2011). Although 380 bank failures is a large number, they account for less than 5% of the 8534 U.S. banks that began the period.

Banks continue to be under pressure from both sides of the loan-making debate. On one side is the pressure from politicians for banks to make loans in support of growing the economy. On the other side is the pressure from regulators for banks to improve overall credit quality and increase the safety and soundness of their assets. Although the pressure from politicians to make loans has been long and on-going since well before the financial crisis and, in fact may have contributed to the crisis, the regulatory pressure has been in reaction to the crisis.

Prior to the crisis, many banks and other financial institutions had relaxed credit standards, particularly for real estate and commercial and industrial lending. This included a general relaxing of the five C's of credit for loan evaluation purposes. The five C's are: 1) character, 2) capital, 3) capacity, 4) collateral, and 5) conditions (Gustafson, 1989). Correspondingly there was less attention given to assessing loan applicant: 1) credit history, 2) balance sheet, 3) cash flow/repayment capacity, 4) asset valuation, and 5) profitability given the general economic trends. And even if attention was given, the minimum levels necessary to meet loan qualifications had been lowered. However, the lowering of loan eligibility criteria had not occurred to the same extent for agricultural lending.

Most financial institutions are quite familiar with their farm customers since they often serve them for many years and are very much aware of their character/credit history. Farm businesses have also maintained strong capital/balance sheet positions. In fact, U.S. farm sector equity is forecast to increase to \$2,082 billion at year-end 2011 from \$1,782 billion at year-end 2008, a 17% increase (U.S. Department of Agriculture, 2011). The \$300 billion increase in equity is the result of farm asset values increasing by the same amount over the time period while farm debt remained the same. Of the \$2,324 billion of farm assets, \$1,973 billion (85%) is farm real estate. Moreover, farm real estate has been the leading contributor to the increase in asset values with an increase of \$270 billion (16%) since 2008. Given the increase in U.S. farm asset values, there should be adequate assets available to serve as collateral for financial institutions to make farm loans.

Even though the overall U.S. economy has been slow to improve the past several years, the repayment capacity/cash flow situation for U.S. agriculture has improved. Farm net cash income is forecast to increase \$26 billion (30%) from \$89 billion in 2008 to \$115 billion in 2011 (U.S. Department of Agriculture, 2011). Since interest rates have remained low and farm debt has been relatively constant, there has been adequate repayment capacity in the U.S. farm sector.

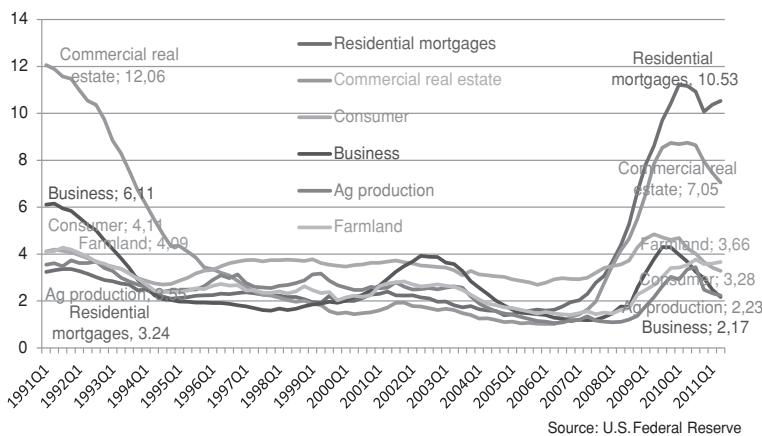


Figure 3. Loan delinquency rates at U.S. commercial banks (%)

However, this does not mean that repayment capacity is uniform across the country. Certain farm businesses, such as dairy farms, those with a large amount of debt, or those that lost non-farm income as the result of the weak U.S. economy, may be experiencing repayment difficulties.

Loan delinquency rates can be used as an indicator of credit problems occurring in various sectors of the economy. In general, the agricultural credit market has not experienced problems to the same extent as general business (commercial and industrial) and real estate credit markets have.

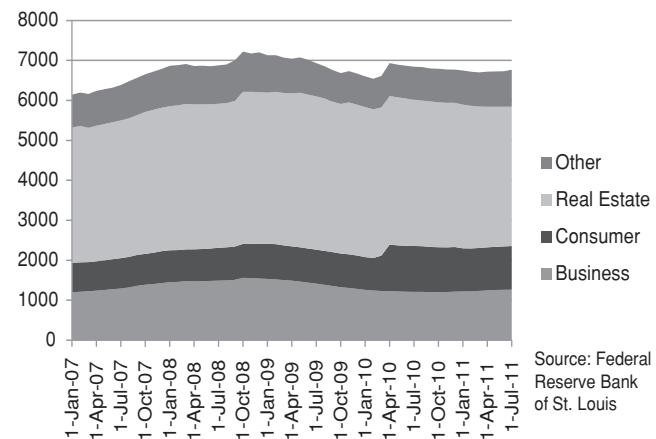


Figure 4. Total loans and leases at U.S. commercial banks (\$Billions, seasonally adjusted)

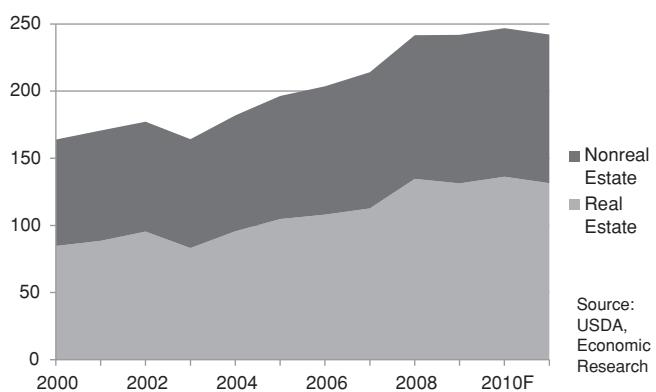


Figure 5. U.S. farm debt (\$Billions)

The recent rise in loan delinquency rates at U.S. commercial banks began in 2007 when rates were between 1% and 3%, some of the lowest rates seen in the last 20 years (Figure 3). Delinquency rates had increased during previous recessions in the early 1990s and 2002, but not as quickly as they did in 2007 through much of 2009. The rise was particularly steep for residential mortgage and commercial real estate loans with delinquency rates peaking at 11.22% and 8.75% in 2010. Delinquency rates for agricultural production and farmland loans have risen as well, but not nearly to the same levels as residential and commercial loans. With current delinquency rates of 2.23% and 3.66% for agricultural production and farmland loans, they are similar to those for business and consumer loans (2.17% and 3.28%). As was the case for delinquency rates, commercial business and real estate loan volumes have been more problematic than agricultural production and farmland real estate loan volumes. After rising for a number of years, general business and real estate loan volumes have fallen 19% and 10% from their peaks of October 2008 and May 2009 (Figure 4). However, agricultural farm non-real estate and farm real estate debt volumes have changed relatively little the past four years, averaging \$110 billion and \$133 billion, respectively (Figure 5).

Although the agricultural credit market is relatively strong, the regulatory pendulum has swung from lax to tight. Moreover, many lenders have decided to switch their focus from growth and profit to safety and soundness. This has led to less emphasis on making loans of all types and more emphasis on investing in government securities. And even though agricultural credit remains available, loan eligibility criteria have been strengthened making qualifying for loans more difficult.

#### 4. Looking Forward

Perhaps the most problematic factor for businesses is access to capital in sufficient amounts and at affordable rates. Certain things are beyond the control of individual businesses. As the result of governments and institutions increasing their financial obligations to restrain the economic crisis, the credit environment has changed. These financial obligations and the associated financial risks have placed pressure on raising taxes, more agency and bankruptcy costs, greater likelihood of credit and liquidity constraints, increasing credit reserves, bearing additional regulatory costs, more inflation, higher interest rates, and more conservative behavior. If these changes occur, they will be the impetus for more restricted availability of capital and, for those agribusinesses that are able to attract capital, a higher cost.

However in this new environment of regulatory oversight and conservative lending, agribusinesses still have some control in their ability to attract capital. They must be ever more cognizant of the importance of attracting capital by

having their five C's of credit—character, capital, capacity, collateral, and conditions—in the best possible position in order to attract credit. Therefore, as businesses compete for capital, they must have a clean credit history, a strong balance sheet, superior repayment capacity, an ample supply of assets to offer as collateral, and be in position to operate profitably even in a weak, but slowly recovering economic environment.

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