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The Farm Credit Outlook

We all know the agricultural credit markets have received a great deal of attention in recent years -- from lenders, borrowers, legislators, and regultors. The widely reported problems of Farm Credit institutions and their distressed borrowers were the genesis of three major pieces of agricultural credit legislation within the last three years. That's partly because they lost $2.8 billion in 1985, $1.9 billion in 1986, and would have lost $485 million in 1987 had it not been for some creative accounting and a substantial reversal in their allowance for loan losses. But it's also partly because they have so many distressed borrowers.

Commercial banks, however, also had their problems. But with them, the price of failure was really failure. In the past three years, 438 commercial banks have failed. Of that number, 178, or 41%, were classified as agricultural banks.

With an easing of financial stress for both borrowers and lenders, many were breathing a sigh of relief and looking forward to a period of renewed stability. I use the past tense because the drought is causing many farmers to be gasping for breath instead of breathing sighs of relief. The outlook for lenders, while not good, may be tempered somewhat depending on the extent to which:

- farmers used advanced Federal payments instead of loan funds to finance their planting;

- farmers are insured by Federal Crop Insurance Corporation;

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- farmers have residual financial strength because of strong income due to past farm programs and profitable livestock prices; and

- A Federal disaster assistance program is developed beyond what's on the books now.

None the less, those farmers close to the edge of financial crisis may be pushed over by the drought -- and that could result in another round of loan restructuring by Farm Credit institutions. While too early to be specific, that is not good news for these institutions, many of which are already financially weak.

The drought notwithstanding, those who were looking for renewed stability in agricultural credit markets were mistaken. Both the markets and delivery systems are undergoing some very fundamental changes, perhaps more far-reaching than anything seen in the past 50 years. I'd like to discuss four such changes as I see them.

Changes Underway in Financial and Credit Markets

The first change is that financial markets have grown more efficient and have become integrated, both nationally and internationally. In the United States, banks and thrift institutions currently purchase most of their loanable funds at interest rates that reflect national financial market pricing. Moreover, investors have a wide range of options from which to choose when deciding where to put their money.

This means that the cost of funds to rural banks and the interest rates they charge their borrowers closely reflect national market conditions. Funds now readily flow across international boundaries from one money market to another -- say London or Tokyo to New York.

As financial markets have become more integrated, they have also tended to become more liquid. Moreover, opportunities for above average rates of return tend to be short-lived as investors quickly search them out; and thus markets become more efficient.

These developments have practical significance for farmers and rural lenders. Financial market integration has led to broader and more stable access to credit, and to interest rates in rural markets and standards for credit quality that now more closely reflect national market rates and industry-wide standards.

Farmers have sometimes been dismayed by these changes. In the past, they were often able to borrow from a rural bank or Farm Credit institution at below market rates and with soft underwriting standards, especially during the period of monetary restraint by the Federal Reserve Board, which formulates and manages the monetary policy of the United States.

Increased competition in the financial markets has eroded some of the advantage the Farm Credit institutions had over other rural lenders. The interest rate spreads of bonds issued by the Farm Credit Banks to raise loan funds have traditionally been only 15 to 50 basis points over the cost of comparable issues of the U.S. Treasury. That meant a substantial cost advantage over loanable funds acquisition costs of other lenders. But recently, high quality commercial paper has sold at rates below those of the discount notes of the Farm Credit Banks.

The second change is the loss of the unique character of agricultural lending. That stems in part from lenders selecting market niches into which they concentrate their lending efforts. For example, large commercial farmers represent one such niche and part-time farmers another. Similarly, financing crops that are enrolled in a U. S.

Government subsidy program may represent one niche and non-program crops another niche.

As this way of looking at agricultural credit markets has developed, and as farming has become more business oriented, lenders have discovered that a large loan to a commercial farmer requires analysis and servicing not unlike a loan to a manufacturer or large retailer. Such farm loans can often be best handled by someone in the commercial lending department of the bank, perhaps aided by some specialized knowledge of agriculture.

This is quite different from a decade ago when a loan officer specializing in agriculture, but with only a little commercial lending experience, would have handled the loan. And as many of those agricultural loans grew with inflation, the record clearly indicates that more than a few were not very well handled.

By the same token, small and part-time farmers and rural homeowners have credit needs more closely resembling small non-farm businesses and consumers.

Whether this categorizing of agricultural lending proves more effective than dealing with agricultural borrowers as a group remains to be seen. But to most lenders, the concept of selecting market niches on which to focus marketing efforts and of using general banking loan officers to handle this credit seems well accepted.

These market segmentation strategies pose a challenge to rural banks and to Farm Credit institutions as other lenders take aim at profitable segments of their traditional customer base. Alternatively, rural banks and system institutions may be able to provide better service to a broader range of customers than the larger banks, especially if they customize credit packages and personnel in a modified market niche approach.

The third change is the breaking down of the barriers separating banks and Farm Credit institutions from other business firms. Across the United States, agribusiness supply and marketing firms, including regional farm cooperatives, are evaluating the benefits of getting into the financing of agricultural production and processing.

For those agribusiness firms, the issue may be whether they can profitably lend money to farmers for a broader range of purposes than they currently do. For other agribusiness firms, often facing a stable market for their primary product line, with excess capacity in their sales and delivery systems, and with facilities already in place, agricultural lending may appear as an attractive new profit center.

Abetting this new competition is the secondary market in farm real estate mortgages that was made possible by the establishment of the Federal Agricultural Mortgage Corporation (Farmer-Mac). The Farmer-Mac is an institution much like the Federal National Mortgage Association (Fannie Mae) which provides for the sale of home loans into the secondary market. Fannie Mae has proven very successful in facilitating the expansion of lending for purposes of home ownership.

The Farmer-Mac will make it easier for banks and other financial institutions to expand their activities in farm real estate mortgage lending, while remaining liquid and limiting their interest rate and credit risk. It also paves the way for a host of agribusiness firms to enter that market.

The Farmer-Mac makes it possible for loan originators to sell loans to certified agricultural market facilities, called poolers. These institutions will package the loans to serve as collateral for securities sold to investors.

The securities will be backed by a reserve required by law and by a $1.5 billion line of credit from the U.S. Treasury. If the financial markets accept the Farmer-Mac, other secondary markets could develop in such things as loans on machinery and equipment, rural business loans, and possibly production loans.

As a result of Farmer Mac, rural banks and Farm Credit institutions will come under increasing pressure to be innovative in their offering of loan products and services, while being more cost effective in their operations. And that's a difficult combination for any institution to deal with.

The last change I'd like to discuss involves the lower profit margins that are evolving as a natural consequence of increased competition in a shrinking market and increased market efficiency. Agricultural lenders are now learning what large commercial banks have known for years -- that the lending business is no longer as profitable as it once was. As a result, lenders are increasingly looking both to fees and service income to augment earnings and to providing other more profitable financial services.

Indeed, as farmers grow larger and more sophisticated, they too will be seeking a broader range of such services from their lenders. These will include such things as insurance, real estate, and investment banking services.

If small rural banks and Farm Credit institutions are to provide these services, they will need to gain that expertise and/or legal authority -- or choose to serve as a conduit through which other firms provide the services, much in the way money center and regional commercial banks may act in a lead bank capacity to tap specialized banking services for its customers .

In summary, the rapid pace of change observed in the financial and credit markets is a prelude to further changes on tap for agricultural lenders and their borrowers. On balance, these changes will continue to make agricultural credit markets more efficient.

To succeed in this new environment, lenders must become more resilient and more nimble in identifying and capitalizing on opportunities. For those who are up to the challenge, the future of agricultural finance is promising. For those who are not, it is bleak.

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