PRIVATE SECTOR FINANCING OF FAMILY FARMS

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Farm sector debt increased at an average annual rate of nearly 8 percent between 1950-1970. In the seventies the increase averaged about 12 percent. These increases were more than twice the inflation rate for those periods. Few economic variables--farm or nonfarm--have sustained such a long and high growth rate. Providing this volume of credit to the farm sector has been a major challenge to lenders.

This challenge required actors on the farm credit stage to cast a much larger net for funds in order to accommodate their borrowers' needs. To attract funds banks developed a bewildering array of deposit products--NOW accounts, Super NOW's, money market funds, certificates, IRA's, etc. The decade saw banks obtain enhanced access to FICB's, seasonal borrowing privileges at the Fed, expanded participations with banks as well as PCA's, not to mention regional compacts which obtain funds from larger banks (one of which is a foreign bank) and channel them to smaller member banks. The Cooperative Farm Credit System now issues consolidated systemwide bonds and notes, maintains line of credit with banks and other institutions and sells their securities to a wide variety of investors in the U.S. and abroad. The Federal Financing Bank has made funding for the FmHA more certain, efficient and flexible. Life insurance companies have evolved a variety of products which permit them to obtain more funds.

This is an incomplete list of the methods used by farm lenders to obtain adequate, low cost funds. It is sufficient, however, to indicate that the major actors financing family farms have remained the same, but the arrangements they employ to garner loan funds for the sector has probably changed more in the last decade than in any time since the 1930's. Further deregulation of banks, evolving nonbank financial institutions and discussions about removing the "agency status" from the Cooperative Farm Credit System indicate that the institutional structure serving the farm sector will continue to change but perhaps not as rapidly as in the past decade.

The large appetite of the farm sector for loans successfully challenged lenders to develop new and more efficient sources of funds for their farm customers. In the current decade the challenge may shift to developing more effective loan delivery systems for financing the family farm. This challenge arises out of the present financial condition and structure of the sector. Therefore, I plan to assess current credit conditions in the farm sector, prospects for the demand for credit in early 1984 and the ability of lenders to provide credit to the farm sector during the first half of 1984. I will close by examining changes in the structure of the farm sector for implications this has to the ways farm credit and related financial services are delivered to family farms in the future.

CREDIT CONDITIONS

Sizing up farm credit conditions across the county--never an easy task--is especially difficult this year. Widespread drought on top of the massive PIK program sharply reduced farm output and boosted crop prices. Nevertheless, the combination of higher prices, increased government payments and lower production expenses is expected to result in a significant increase in 1983 net farm income from the year ago level.

A sample of agricultural bankers is surveyed annually by the American Bankers Association in order to obtain bankers' assessments about farm credit conditions. This year's results will be released in about one week. That report will provide an indication of credit conditions in mid-summer, but the toll extracted by drought following the completion of the survey will not be measured. Nevertheless, information and relationships from past surveys are useful in sizing up credit conditions at this time.

In the past there has been a good association between the direction of change in the farm sector's net income and a variety of measures of the condition of the farm loan portfolio at ag banks. For example, weakness in net farm income in 1981-82 sent measures of loan renewals, refinancings, delinquencies and losses to new highs, figures 1 and 2. At the same time, loan repayment rates and ag bankers views of the overall quality of their farm loan portfolio declined to new lows, figure 3.

Farm credit surveys conducted by some Federal Reserve Banks[1] in mid-1983 showed improvement in some of these selected measures of credit conditions from their poor 1982 level. The broader sample of ag banks included in ABA's annual survey is also expected to report some improvement. What is difficult to measure is whether the effects of continued drought after mid-summer dashed this improvement. My judgment is that even with the drought, measures of farm credit conditions would still show some improvement over their dismal levels of mid and late 1982. Factors supporting this view include USDA's projection that 1983 net farm income will significantly surpass 1982's and the equity of the sector should improve for the first time in two years. This gain is likely to occur as farmland values rise in many areas and farm debt shows little or no growth.

DEMAND FOR FARM CREDIT

In the year ending June 30, 1983, the percentage increase (5-6 percent) in total farm debt was among the smallest in twenty-five years.

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[1] See Financial Letter, Vol. 9, No. 8, August 1983, Federal Reserve Bank of Kansas City and Agricultural Letter, No. 1610, August 19, 1983. Federal Reserve Bank of Chicago.

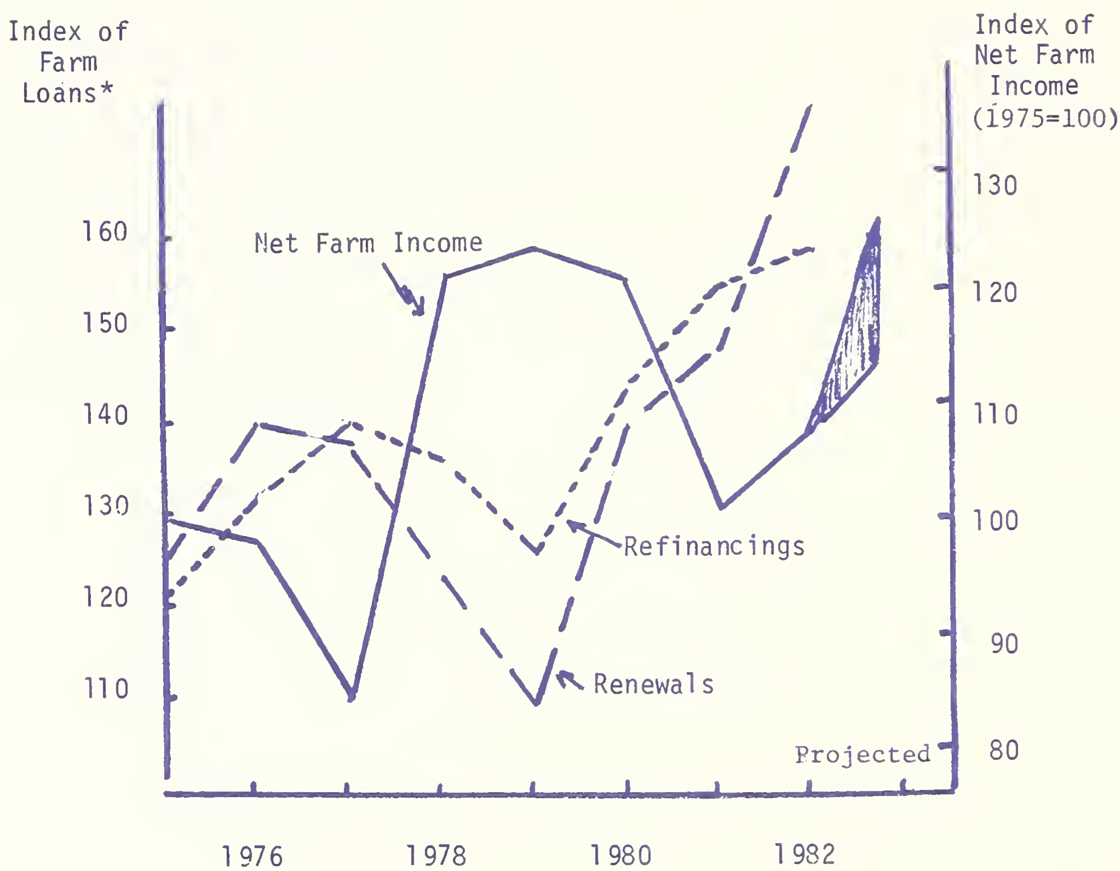

Figure 1. Index of Net Farm Income and Indices of Farm Loan Renewals and Refinancings at Ag-Banks, Mid-year.

*Indices constructed by subtracting the percentage of banks reporting decreases from those reporting increases and adding 100.

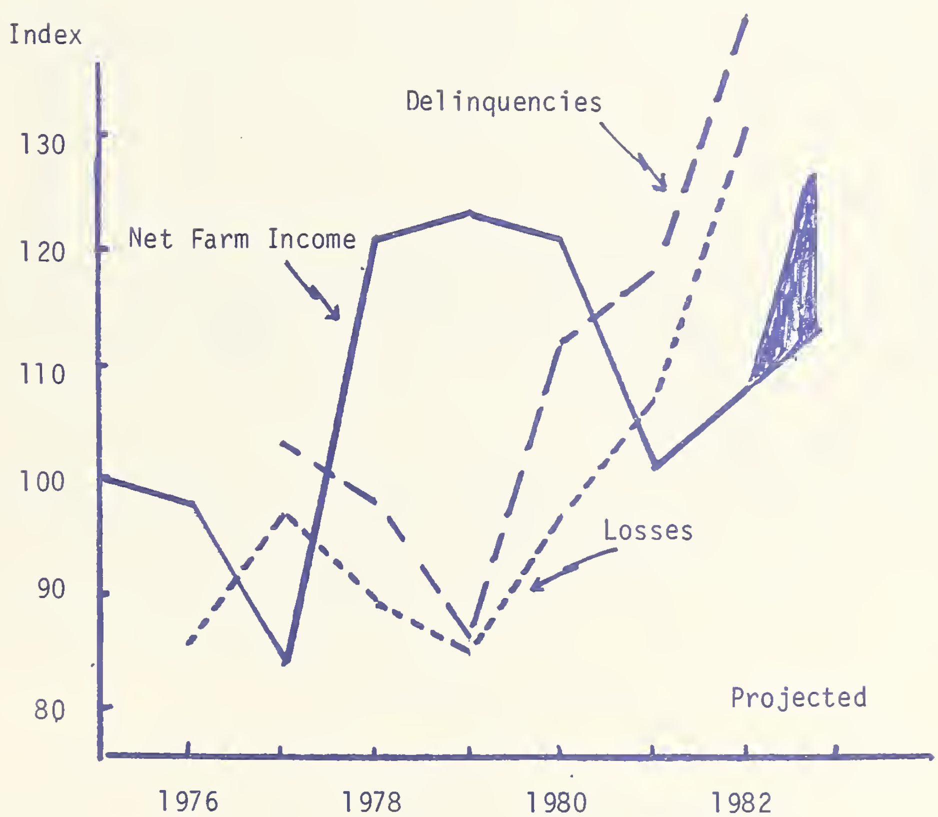

Figure 2. Index of Net Farm Income and Indices* of Farm Loan Losses and Delinquencies at Ag Banks, Mid-year.

*Indices constructed by subtracting the percentage of banks reporting decreases from those reporting increases and adding 100. Index of net farm income, 1975=100.

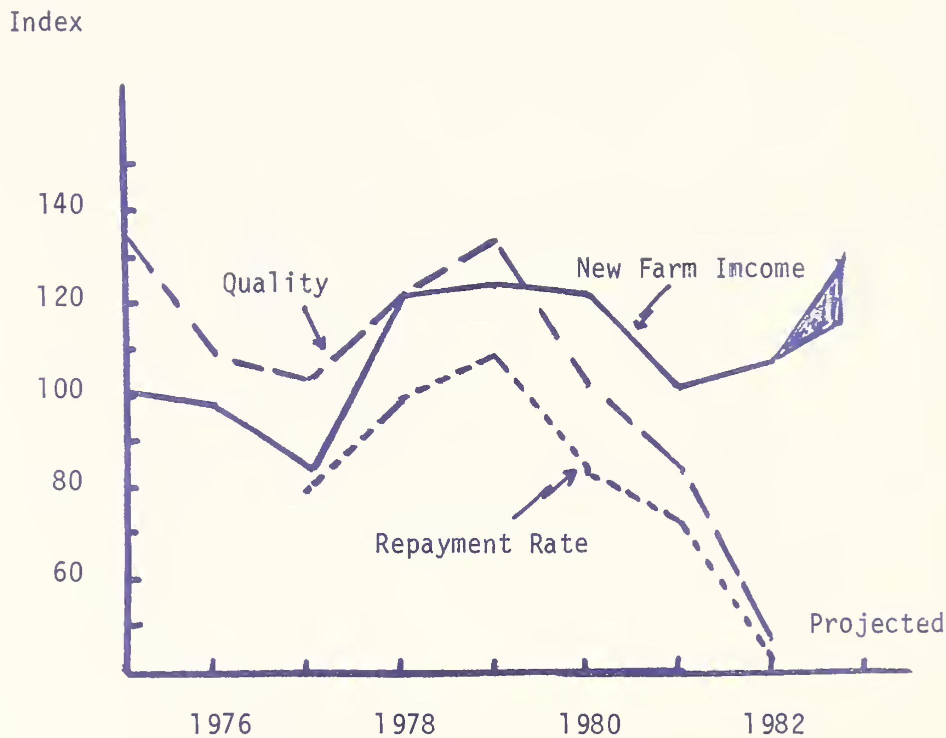

Figure 3. Index of Net Farm Income and Indices* of Farm Loan Quality and Repayments at Ag Banks Mid-year

*Indices constructed by subtracting the percentage of banks reporting decreases from those reporting increases and adding 100. Index of net farm income, 1975=100.

Real estate debt outstanding rose a moderate 2-3 percent while nonreal estate secured farm debt rose about 8 percent.[2]

The small increase in outstanding real estate debt occurred because land values declined and farm real estate transfers were depressed. Higher levels of refinancings, however, helped swell the total.

The PIK program curtailed the need for borrowing for operating expenses and with farm machinery sales depressed, nonreal estate secured farm debt rose by only 8 percent. This was the smallest gain in over a decade for this component of farm debt. Commercial banks registered a 7-9 percent gain over their mid-1982 level and CCC outstandings were up more than 60 percent. However, non-real estate debt outstanding in mid-1983 was down from the year earlier amount for PCA's and FmHa.

In the year ending mid-1983, the weakest demand for credit would likely have been in the regions where land values declined the most and PIK program participation was the greatest. This includes the grain areas of the Midwest and the grain and cotton areas of the South. Strongest credit demands during the past year would likely have been in the livestock, poultry and dairy areas of the West and Northeast.

In 1984 credit demands are likely to undergo a recovery from the depressed levels just described. Land values have come back some and market activity is likely to pick up, bolstering real estate lending. But, what is more important, is the expected increased demand for credit as planted acreage returns to pre-PIK levels. Farm machinery and equipment sales are also likely to be helped by this prospect for an expansion in planted acreage as well as by improvement in 1983 net farm income.

Credit demand in early 1984 may not be as strong among livestock, poultry and dairy farmers as feeding margins turn sour. These views indicate a likely reversal in credit demand between 1982-83 and 1983-84. The areas experiencing the weakest demand last year are likely to show the strongest gain in the current year. And the areas registering the strongest gains last year may be the weakest, comparatively speaking, in 1983-84.

LOAN FUND SITUATION

In mid-1982 ag banks responding to ABA's annual mid-year survey reported they had ample funds. Their average loan-deposit ratio was 62, down substantially from the high of 67 registered in 1979. The ratio for a group of ag banks identified by the Federal Reserve System shows a continued decline in the loan deposit ratio between mid-1982 and 1983.[3] Thus, available funds for farm lending at rural banks continues plentiful.

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[2] Melichar, E., Preliminary estimates of farm loans at insured commercial banks and liquidity ratios at agricultural banks as of June 30, 1983. Mimeo, August 19, 1983, Board of Governors of the Federal Reserve System.

[3] Ibid.

This is not surprising in light of the weak farm loan demand of the past year. Changes in loan deposit ratios between mid-1983 and early 1984 will be affected by drought and funds derived from the PIK program. Drought tends to slow repayments and cause deposits to be drawn down while PIK funds should swell deposits. Overall, the average loan deposit ratio at ag banks in early 1984 may not show much change from current levels. Thus, even should there be a surge in farm credit demands in the first half of 1984, it should be satisfactorily accommodated by banks, units of the Cooperative Farm System and FmHA.

An interesting feature concerning the suppliers of credit is that for 13 consecutive quarters (from the fourth quarter of 1978 through the fourth quarter of 1981), annual rates of increase in outstanding farm loans were greater for PCA's than for commercial banks, figure 4. This was a period of tight credit and increasing interest rates. However, for the last six quarters (the first quarter of 1982 through the second quarter of 1983), the annual rate of increase for banks exceeded that of PCA's. This was a period of increasing availability of funds and lower interest rates.

Over approximately this same period FmHA annual rate of increase slowed from more than 50 percent in the 1978 to 1981 period to virtually no change in mid-1983. This recent experience indicates that changing market shares of major farm lenders seems to depend more upon government policies and conditions in the money markets than upon the nature of the products and services provided by the institution.

Interest rates on nonreal estate farm loans at all banks averaged 13.3 percent in mid-1983 compared to 17.8 percent a year earlier according to data compiled by the Federal Reserve System.[4] Even though rural bank rates are more closely related to conditions in the nations money markets than in earlier years, it is interesting to note that as interest rates rose to their peak in the third quarter of 1981, bank rates on farm loans did not increase as fast as on business loans. At the peak, average rates on farm loans were about 2 percentage points below the prime. Since the interest rate peak, bank farm loan interest rates have declined more slowly than the rate charged on business loans. In mid-1983 they averaged about 2.5 percentage points above the prime rate.

Judged by this recent experience, should the general level of interest rates move higher, farm rates are likely to be more sticky and lag behind, especially given the plentiful supply of funds at ag banks.

On the other hand, if the general level of interest rates remains about the same or declines, bank farm lending rates could continue to ease. Movement of the general level of interest rates, either up or down, would, therefore, likely bring farm rates closer to the prime and that charged by banks on business loans.

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[4] Melichar and Balides, Agricultural Finance Data Bank, Monthly Series, August 1983, Board of Governors of the Federal Reserve System.

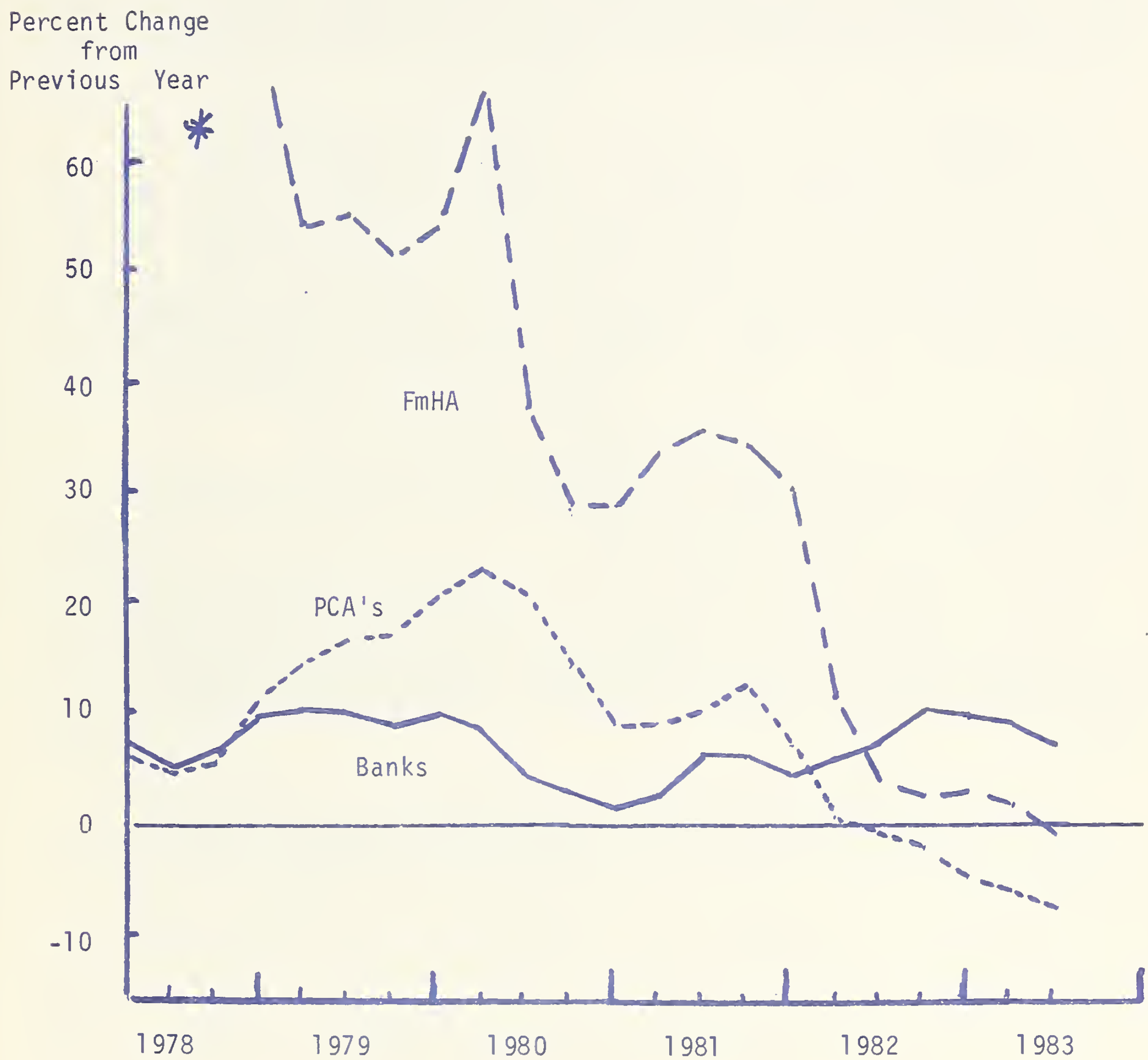

Figure 4. Percentage Change from Previous Year by Quarters for Selected Lenders Providing Non Real Estate Secured Farm Credit

*In 1978 FmHA rates of change ranged from 85 to 106 percent.

THE STRUCTURE OF THE FARM SECTOR AND THE CHALLENGE TO FARM LENDERS

An evolving feature of the farm sector which I believe requires lenders' careful scrutiny is the tendency for the units composing the sector to separate into two groups--small and large farms. Farms between these extremes seem to be declining at the fastest rate. Perhaps the in-between sizes are too large to be operated as part-time farms and not large enough to be full-time farms.

On average, the smallest farms are almost solely dependent upon off-farm income for their income and they use credit sparingly. On the other hand, the large farm subsector is largely dependent upon farming for its income and it uses large amounts of credit. By number it accounts for only about 12 percent of all farms but uses 65 percent of the sector's total outstanding debt. While it has what appears to be a conservative debt-asset ratio (21 percent), it averages higher than for any other size group of farms. But what is more important, they have a high ratio of expenses to gross receipts. Because of this high gross ratio, relatively small changes in commodity prices, production, or expense items (including interest charges) can have serious repercussions on the ability of a firm to meet its financial commitments. One thing lenders and borrowers learned from the 1981-82 experience was how quickly highly leveraged firms can get into difficulty when conditions turn adverse.

Lenders' responses to adverse conditions are many. They include strengthening loan procedures, analysis and documentation. Responses also include identification of risks and encouraging borrowing firms to employ appropriate risk reducing strategies. Managing these risks is a major concern and seems likely to become even more important in the future.

One way to protect a firm from financial risks is to employ modest levels of debts relative to assets. This strategy, however, poses a challenge of a different sort. In order to adopt specialized, capital intensive technologies, more debt capital may have to be employed. In an environment characterized by risk, expansion of the debt ratio may only be possible for managers able to successfully employ risk reducing strategies.

The challenge to lenders is to deliver necessary debt capital, appropriate financial services, and expertise regarding risk-bearing techniques in order to adequately service the large farm subsector. The required level of financial expertise to deliver these products to large family farms may not be present at all farm lending institutions. A midwest banker expressed this view as follows: "Large farms are too large for us to serve and the small farmer doesn't generate enough business for us; we are reducing our commitment to serve the farm community."

As the farm sector continues to divide into large and small farm segments, a similar alignment is expected to occur among farm lending institutions. A large number of smaller rural community banks will likely continue to provide for the less specialized needs of the large number of smaller farms. Some PCA's and FmHA offices may also specialize in serving this market as they are located where such farms predominate. But their market share of the total sector debt will likely decline. However, the bulk of the operating and term credit needs of the large farm segment will be met by a smaller group of larger or at least more specialized ag banks, PCA's and FmHA offices.

Should farm lending institutions not provide adequate finance, make available related financial services, or risk bearing technologies, capital will still flow to the sector, but through different structures. Corporations, agribusiness firms, integrators, leasing firms, to name some, will provide the capital and increase their control over farm production. The challenge to lenders is clear. In the future their market share may be more dependent upon the quality of the financial products and services they deliver than in government policies affecting fund availability and interest rates.

SUMMARY AND CONCLUSIONS

Improvement in 1983 income projected by the USDA and the likely improvement in farm sector equity should strengthen the quality and condition of farm loan portfolios from their dismal level of a year earlier. The PIK program is an important contributor to this assessment. While some farmers continue to be in financial difficulty related to drought and other conditions, disaster and other loan programs provided by the FmHA will be helpful to their recovery. Improved crop prices encourage lenders to stay with their customers and ample funds provide banks with the ability to continue to finance their customers.

The prospect for a significant increase in the demand for farm loans in the first half of 1984 should be satisfactorily accommodated. Ag banks have adequate funds, judged by their loan-deposit ratios.

In the longer run, lenders are being challenged to adequately deliver credit and financial services to the large farm sector if they are to maintain their market share. In the future the name "ag lender" may only apply to those with the specialized expertise and ability to deliver credit and financial services to this market.