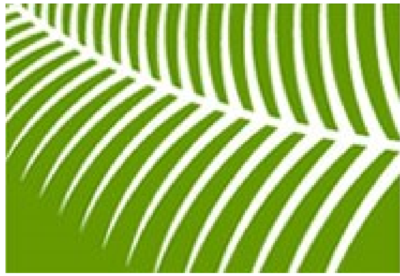

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AGRICULTURAL CREDIT OUTLOOK
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Perspective

Before trying to look ahead, it seems useful to take a moment to obtain perspective. When beginning my professional career in agricultural finance, I remember looking at data from the 1930s. It seemed odd that the debt to asset ratio of the sector increased as the depression wore on while both debts and assets of the sector decreased. I had not expected to see that phenomenon repeat, but we are again witnessing an increase in the debt/asset ratio of the farming sector while both asset values and debt are decreasing.

By the 1950s and 1960s agricultural finance economists were arguing the importance of credit as a tool of production, as a means for increasing return to equity, and for expanding a business to achieve size advantages. The focus of those articles was usually on repayment capacity and on earning a return in excess of interest costs. By the 1970s, the ease of lending and borrowing on equity to capture inflationary gains in land and durables had helped equity replace repayment capacity as the major (but questionable) criterion for credit.

Further, as Melichar has aptly pointed out on numerous occasions, the returns to assets in agriculture since 1960, except for the '73-'75 "blips", have been relatively stable--although the "blips" mentioned served as a basis for sector capital gains that were a major reason for current problems. As the huge real capital gains of the 1970s were replaced by large real capital losses in the 1980s, balance sheets of individual farm operators deteriorated like the "emperor's clothes" revealing the naked lack of debt repayment capacity.

Hence, while sector returns to assets were relatively stable, sector returns after interest payments had, by 1982, become negative due both to excessive sector debt in relation to earnings (repayment capacity) and high rates of interest.

Since 1982 the nation's farmers have scrambled to adjust their businesses in light of the new realities: 1) higher real (and nominal) interest rates, 2) deflation in output prices, and 3) the resulting loss of value of durable assets. This scramble to adjust is particularly difficult because of the extreme negative cash flow effects of declining commodity prices. Lower asset values also limit the ability of financially stressed farm operators to sell off assets to pay down debt. Hence, the paydown in debt does not match the decrease in durable asset values, and the aggregate farm debt/asset ratio rises. It would be even worse, however, if the U.S. economy had remained in recession because there would be few jobs for displaced farmers to obtain. Those effects are not uniform though, and a strengthening U.S. economy is of limited help to an isolated rural community almost completely dependent upon agriculture.

Outlook for Farm Credit

1) Outstanding farm credit will continue to decline.

Farmer paydown of debt and write-offs of bad debt by farm lending institutions will reduce outstanding farm debt in January 1986 compared to year earlier and likely also in January 1987 compared to 1986. My guess is that outstanding farm credit will shrink by a 3-4 percent annual rate by January 1986 and again by January 1987 although CCC lending will likely be up in the year ending January 1986.

2) Farm credit will be more difficult to obtain.

The continuing difficulties of the nation's farmers, now spreading into the financial system, will lead to closer scrutiny of farm operations, additional caution and conservatism with respect to approval of new loans, and requirements of more complete documentation as a basis for lending. Lenders are scared about the financial condition of agriculture.

It would be nice to predict that lenders had learned from their mistakes of the past and that they will do a better job of lending next year and in coming years. Unfortunately, that is not likely to be the case. The overemphasis on balance sheets in the 1970s has continued into the 1980s and will likely continue in the next several years. Too many lenders will look at declining equity of individual balance sheets, use that as a reason to cut back on loans to those businesses, and again overlook the importance of repayment ability. This short sightedness,

(in some instances, an overreaction to current trends), will lead to mistakes that force viable operations out of business and that undercapitalize others.

3) Farm credit will be available to those who can sell their credit needs.

Those farmers who are not too deeply in debt and/or can make a rate of return in their businesses high enough to repay the loans they seek will be able to obtain credit. They may have to visit more than one lender to do so, and they will need to maintain records and to understand their businesses well enough to sell the lender on their creditworthiness. This is simply a continuation of the changing lender-borrower relationship which, within the past half dozen years, has changed from a lender-courting-borrower relationship to a farmer-good-guy-lender-bad-guy or borrower-courting-lender relationship depending on the degree of financial stress and the individual situation.

4) Important and far-reaching changes will occur in farm lending institutions.

The Cooperative Farm Credit System (CFCS) is seeking government help to deal with their developing problems of loan losses. That help is likely to be slower in coming than desirable, but ultimately some form of help will be forthcoming. The potential damage from failure of the CFCS to both the agricultural sector and to the total financial system is simply too great not to keep the System afloat. The real questions concern the form and timing of the help and the implications of that help for future organization and operation of the System. The only insight I have to offer is that, whatever the form of help, it will be too long in coming.

In dealing with its developing problems, the CFCS is already making changes that have important implications. The consolidation occurring at the local and district levels at an almost unbelievably rapid rate is removing decision-making from local to regional, and regional to national levels. In short, massive centralization of decision-making is taking place as a part of the System's own response to its problems. Local PCA and FLBA boards will have less say in loan decisions. In fact, as a result of ongoing reorganization to substantially larger or even district-wide PCAs, there may be no such thing as a "local board" left. One might question whether a form of organization that worked well for 50 to 67 years until 1982 or 1983 should now be discarded. In fact, one could argue that some of the

current problems resulted in large part from district bank pressures for local employees to obtain loan volume, penetrate the market, etc.

In a similar manner, those districts having the worst problems are seeing their decision-making taken away, perhaps appropriately, toward more centralization. But, the question is, if decision-making is taken away from some districts, won't the same policies be applied to the rest?

As a result of System losses, higher interest rates to cover loan losses of other borrowers, and potential future losses, the CFCS is losing some of its best borrowers. Others are questioning whether to remain in the System. If they remain, they foresee higher cost credit, risk of loss of their stock, and loss of local control by their elected loan committees and local boards.

These difficulties are also tearing at the organizational fabric of the CFCS. Past policies to capture more of the market, to shift regulatory power to district banks and to market a consolidated debt instrument backed by all parts of the System have left it vulnerable to the economic problems of the agricultural sector. Hence, after more than 50 years of sharing the benefits of cooperation--agency status, group access to money markets at near Treasury rates, and joint-obligation, consolidated systemwide bonds--some parts of the System appear ready to go-it-alone rather than share the "hard times" now upon them.

One can understand the perspective and rationale of those districts with low loss rates who are trying to avoid the losses incurred by other districts. Nevertheless, if districts are allowed to disassociate from the System, the organizations that will emerge are, at best, difficult to predict, if indeed, they survive at all.

In short, there are likely to be more changes, and more substantive changes, in the Cooperative Farm Credit System in the next one to three years than at any time since its creation. These will likely include much more centralized decision-making, less local control and reduced responsiveness of loan officers, government recapitalization of the system, and a somewhat smaller agricultural loan portfolio.

<u>Commercial banks</u> have a new opportunity to serve agriculture if they are not overwhelmed with their own problems of deregulation, interest rate risks and default risks. Increasing numbers of agricultural banks have failed

in each of the last three years. This trend will continue into 1986. Like the CFCS many agricultural banks need public help if they are to survive--though the banking system apparently is not at risk.

Equitable treatment of private sector agricultural lenders would imply that public help should be made available to agricultural banks as well as to CFCS. Unfortunately, bankers as a group are not willing to publicly state their need for such help. Also, since the problems from agriculture are not systemwide within banking, but rather involve problems of individual banks, the means for providing public help are difficult to envision and prescribe. Unless agricultural bankers or their spokespersons acknowledge their need for help, no public help will be forthcoming and individual banks will continue to fail at an unusually high rate.

Nevertheless rural banks will take the opportunity provided by CFCS problems to pick up many of the better borrowers leaving the Farm Credit System. Banks do have a problem, however, in providing real estate credit to their borrowers. Variable interest rates should diminish their hesitancy to make at least some long term loans. Yet, with the consolidation of PCAs and FLBAs occurring in many regions, banks will find it more difficult to share financing with FLBAs than in the past. They will need to establish new relationships with life insurance companies or develop ways to foster a secondary market for real estate paper.

Commercial banks have a temporary interest rate advantage over CFCS lenders in much of the country. As interest rates have declined, marginally priced bank rates have dropped more than the CFCS rates which are based on average costs of money. Both CFCS and bank rates have dropped more slowly than basic money market rates during recent months because of the need to cover losses and to increase loss reserves. Interest rates sooner or later will turn upward again. When they do, banks will see their interest rate advantage diminish as their rates rise faster than those of CFCS.

FmHA's future is more difficult to predict. Since the early 70s, FmHA has changed from a minor player to a major lender in the farm credit market. In case you hadn't looked lately, FmHA is the second largest source of nonreal estate farm credit behind commercial banks. Because it is a government agency, it's role tends to be inconstant. The present administration would like to get FmHA out of farm lending, but events and Congress won't let that happen.

During crises, including this one, FmHA tends to get new authorities for lending. Hence, their farm lending, even though there was substantial footdragging at times and places, has increased. Since the present financial problems are likely to continue for awhile longer, FmHA's involvement in taking over stressed farm situations and its role as a means of shifting some of the private sector losses to the public sector will likely continue and may well become more important.

5) Farm lenders need to improve their debt servicing and counseling of borrowers.

In difficult times, better communication is needed between lender and borrower. Lenders will, and should, take the initiative. At least annual consultations are needed to review the borrower's records and farm plans, but a part of the discussion should also include lender policies. Too many farm borrowers have been surprised when the lender shut off further credit or gave notice of foreclosure. Perhaps worse yet, we are hearing of instances where the lender encourages (or forces) paydown of debt and then immediately proceeds to foreclose.

Both better quality records and improved ability to interpret those records are needed. Had more lenders understood the importance of debt service ability and _earned_ increment added to the balance sheet, there would have been fewer lender and borrower losses. Lenders must also encourage farm managers to emphasize their role as manager of the business, and they must refrain from pressuring for imprudent cost control and sale of assets that enhance short-term cash flow but reduce the potential for profitability and business survival. Lenders may also need help from others such as extension agents to counsel farm families. When records show an inability to continue farming, extension and other local agencies can play an important role in helping farm families through the transition.

Outlook for Farm Interest Rates

No one knows, of course, where interest rates are headed. Neither do I. With the benefit of some large econometric model, perhaps I could mislead you into thinking otherwise. Interest rates, however, are people-made rather than a result of nature. Therefore, let me suggest what the people who effect interest rates may bring about.

The interest rate policies of the last five years, i.e. a contractionary monetary policy in response to an expansionary fiscal policy, brought the agricultural sector perilously close to the edge of disaster (some people went over the edge). The sector is still reeling from those policies as are some other sectors including most basic commodity sectors. One must assume that the monetary authorities are aware of this and that they will think twice about implementing policies to raise interest rates--especially in the absence of evidence of significant new inflationary pressures. Also, there is reason to believe the monetary authorities have changed from the policy of focusing only on money supply to the exclusion of interest rates, and therefore, that interest rates in the relatively near term will be less volatile than in the past five years. Unfortunately, there is little evidence that fiscal policies will improve to take the pressure off monetary policy.

Over the next year, then, I expect stable to slightly declining interest rates. Probably rates will remain between present levels and one percentage point lower unless the economy starts to overheat. Even then interest rate volatility is likely to be less than in 1979-1983. Agricultural lenders can be expected to continue to maintain higher margins than used to be the case over basic costs of money to cover losses.

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