Avoiding Loan Problems By Setting Up a Note Control System

by Paul E. Lindholm

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Perhaps it is easier to do than to explain. Never-the-less, it works in both good and bad times. It left us with less than $100,000 in ag loan losses in a $10,000,000 agricultural loan portfolio when farm land prices dropped 60% within 5 years. It has given us 48 new ag loan customers during the past 30 months with an aggregate $6 million in profitable new ag loans. It is simple for us and popular with our farm customers. Let me try to explain it to you.

Let us first take the example of a cash crop farmer. His loan is due with us (or someone else) and he wants to set up financing for the coming year. A financial statement is prepared, being especially careful about quantity and value.

We make two simple calculations. The first is to determine the net working capital. (We cheat a bit in the definition by including the market value of intermediate assets along with current assets.) We then deduct the current and intermediate liabilities to arrive at our own definition of working capital.

The next information desired is the dollar amount of real estate debt service per tillable acre.

We then carefully review the assets listed and proceed as follows:

1. Any prepayment of 1988 crop expenses would be set aside for later consideration.
2. We determine inventory that will be sold during the coming year. If this inventory consisted of crops on hand and deficiency payments receivable, we would set up a separate note to be paid out of 1987 crop proceeds. The note would be due prior to 1988 crop harvest.
3. Our next calculation is to subtract the totals of 1988 crop prepayment and 1987 crop payments from the total operating indebtedness to arrive at what we would consider carry-over debt. We look at the assets to see what the farmer will still have on hand one year from now to collateralize his carry-over loan. These assets will normally consist of machines, equipment and vehicles. We would normally loan up to about 40-50% of current net market value.

If the carry-over loan is more than about 50% of collateral value, we consider whether or not there is convincing circumstances that the borrower can service higher than normal operating debts. Such circumstances would be debt- free land owned and operated by borrower. (It should be further noted in this regard that Minnesota State law exempts $20,000 of equipment in the event of bankruptcy and that value is subtracted from the equipment value before we begin to make our percent of loan value calculations.)

If the carry-over debt exceeds 50% of equipment and vehicle value and we do not find some compelling reason that the debt can be serviced, we will need to consider alternative methods such as real estate loans, guaranteed FmHA loans or not financing the borrower. This percentage of debt cannot be universally identified; however, our guidelines have been proven correct for our area.

We have encouraged direct lending by FmHA when necessary and feasible. A few borrowers have also gone to other lenders more generous, but a high percentage of those borrowers have not been able to sustain their farming operations more than 3 years.

You will recall that we made a memo of the amount of prepaid 1988 crop expense. We now determine the total amount of funds needed to produce the 1988 crop, including the prepaid expenses already allocated to the 1988 crop note. The balance will be due in November or December of the crop year.

The 1988 crop advance does not have to be paid in November or December of this year. However, the farmer does need to come into the bank, because we now have bushels rather than acres for our collateral.

The bushels of grain and value should then be sufficient to pay off the 1988 crop note, interest on the carry-over loan and reduce the carry-over loan somewhat in a normal year. A higher reduction will be obtained in a good year and the principal balance left the same or even increased within an allowable limit in a year of lower production and/or commodity prices.

The farmer quickly understands the situation if his 1988 crop will not liquidate the crop loan, pay the interest on the carry-over, reduce the carry-over and pay other obligations. Recognizing the shortfall himself makes it much easier for the farmer to make adjustments. (It is easier for all of us to make changes when we arrive at the decision ourselves rather than having someone tell us.)

Equipment purchases during the year are financed at 100% of cost and made due at the same time of the carry-over, assuming that the resultant loan amount will still be within the maximum 40-50% of collateral value. We can answer quickly whether or not it is possible to loan the money by looking at the carry-over note since the note itself states the value of collateral and we can determine the margin available.

However, a prudent banker may want to take into account the present legislation mandating lower target prices for several crops through 1990 and the possibility of less public support of federal farm programs under current budget deficits.

A question concerning additional land purchase can quite effectively be analyzed by calculation of the increased annual debt service per tillable acre.

An appropriate amount of debt service per tillable acre can be reasonably determined by comparing the dollar amount with cash rent less real estate taxes. However, a prudent banker may want to take into account the present legislation mandating lower target prices for several crops through 1990 and the possibility of less public support of federal farm programs under current budget deficits.

The note control system can be easily applied to livestock enterprises. The loan value of the livestock and feed can be set up to pay out of market livestock. For a dairy enterprise, the loan value of the feed can be transferred from a crop loan to an installment loan to be paid out of milk proceeds. The basic concept is to set up one or more control notes that will be paid out of products marketed during the year and a carryover loan for the balance.

These basic concepts have been very helpful to my ag lending during the past 20 years and I am confident they will serve well in the future. Individual case judgement is still required both on the up side and the down side, depending upon the management ability, production capacity and personal financial management of the borrower.

I would suggest that you think about establishing a note control system for your own agricultural loan portfolio. You may end up with 3 or 4 notes for one borrower, but paper is low-cost. Most of the notes will be paid before they are due and you can take a look at the collateral before you renew the ones that come due without full payment.

This note control system gives control of lending that is understood by the borrower. It establishes an early warning system for both the borrower and the lender.

As I said, it is harder to explain than it is to do. The best thing about the note control system is that it works for us.