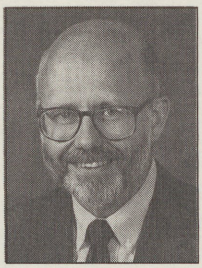
Outlook for Ag Lending:

The Market, the Competition, and How Bankers Should Respond

by Bert Ely



Bert Ely is the principal in Ely & Co. Inc., a financial institutions consulting firm in Alexandria, Va. Bert tracks conditions in the banking and thrift industries, monitors agricultural finances, and promotes deposit insurance reform.

Farm finances are in much better shape today than they have been in two decades. Ag bankers also are competing effectively against their non-bank competitors, as evidenced by banking's increased share of the ag credit market. But in a stagnant market for farm credit, bankers must watch the Farm Credit System (FCS) like a hawk to ensure that FCS does not gain new lending powers or engage in another round of reckless lending, as it did in the 1970s, that would trigger another farm crisis.

The Market Today

As shown in Chart 1, farming's balance sheet has returned to normalcy after the speculative farm real estate bubble inflated during the 1970s and then burst in the early 1980s. However, the total real value of farm real estate will continue to decline as farmland prices rise less than the rate of inflation and as total farm acreage declines. Fortunately, the collapse in the early 1980s of farm asset values, which knocked out approximately $580 billion in the market value of farming's net worth (Chart 2) is well behind us.

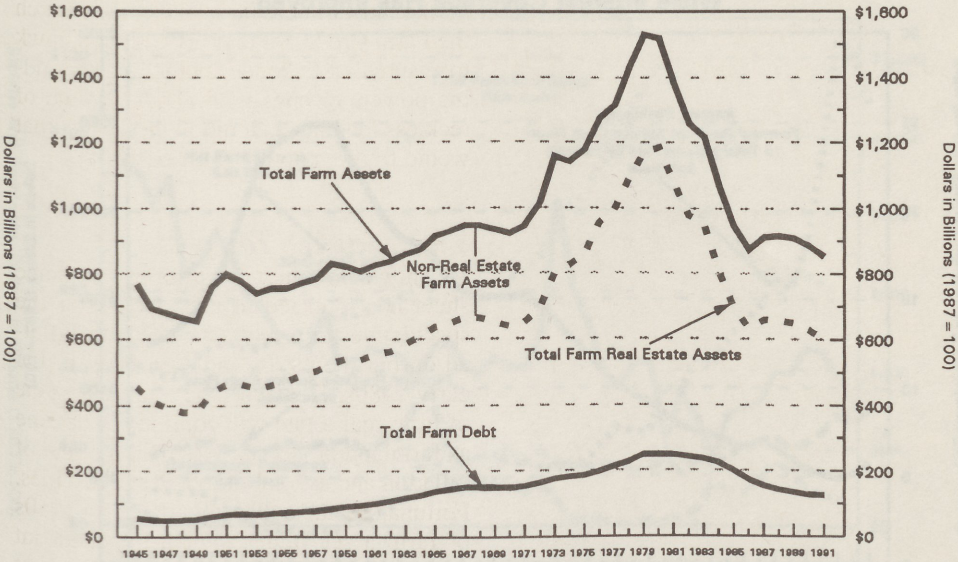
Farming's total debt, in inflation-adjusted terms, has dropped by one-half since 1980, returning to its level of 30 years ago (Chart 3). Most likely, total farm debt will decline further in inflation-adjusted terms before bottoming out. Except for a spike in the early 1970s, farmers' pre-debt service cash flow, in inflation-adjusted terms, has been fairly steady while farmers' interest coverage has recovered from its 1980s' low. Net farm income meanwhile has returned to its historical level, in terms of inflation-adjusted dollars per acre (bottom line of Chart 4). Lower interest rates have helped to boost farmers' net income.

Farm income also has become less dependent on government payments, as shown by the bottom line on Chart 5. This is a healthy trend because government payments to farmers probably will continue to decline as the federal government strives to reduce the budget deficit. The history of farm real estate values back to 1909, as shown in Chart 6, suggests that farm real estate today on average is at or

Chart 1

Balance Sheet for American Farmers: 1945-91

Adjusted for Inflation and Based on Market Value of Assets

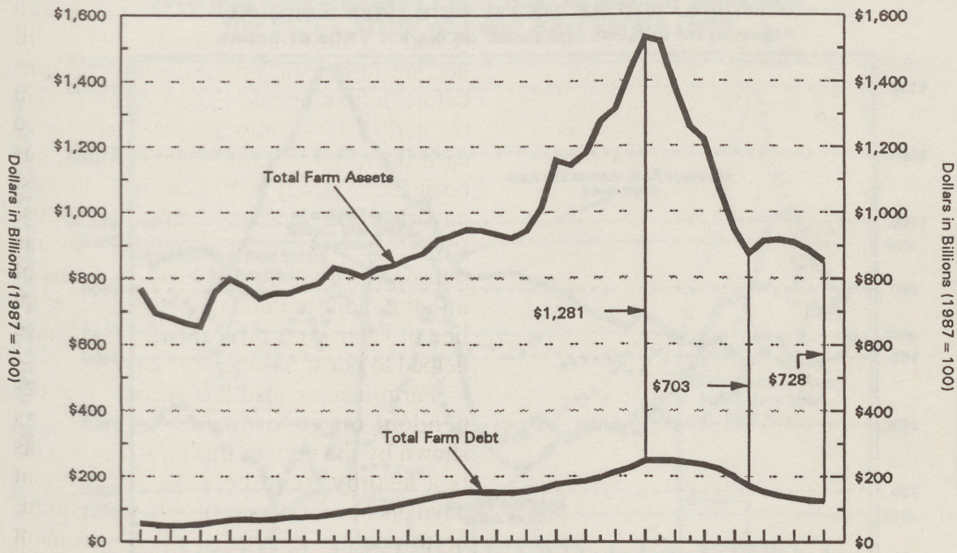


Note: The net worth of all farmers equals the difference between total farm assets and total farm debt.

Chart 2

Farmers' Net Worth at the 1979 Peak, the 1986 Trough, and End of 1991

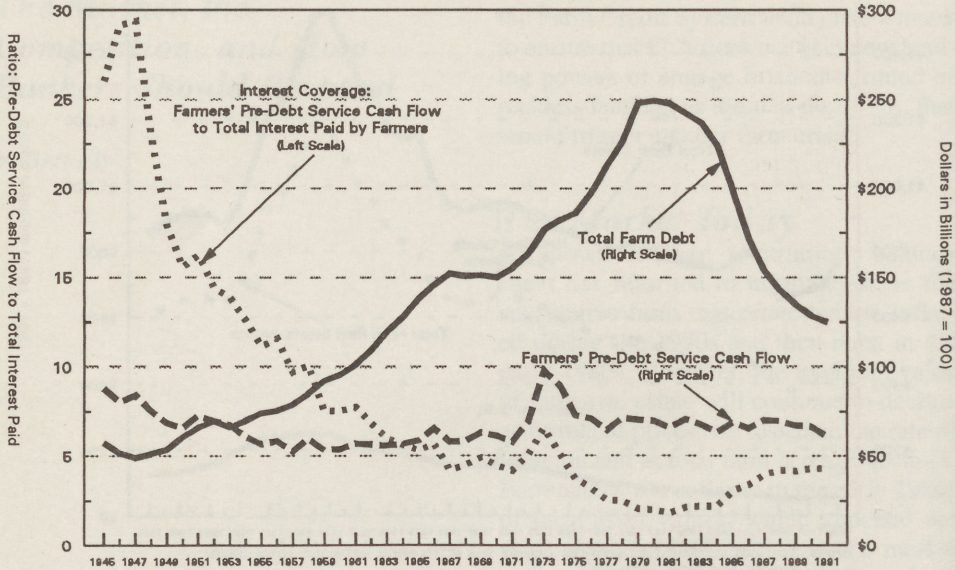
Adjusted for Inflation and Based on Market Value of Assets



Note: The net worth of all farmers equals the difference between total farm assets and total farm debt.

Chart 3

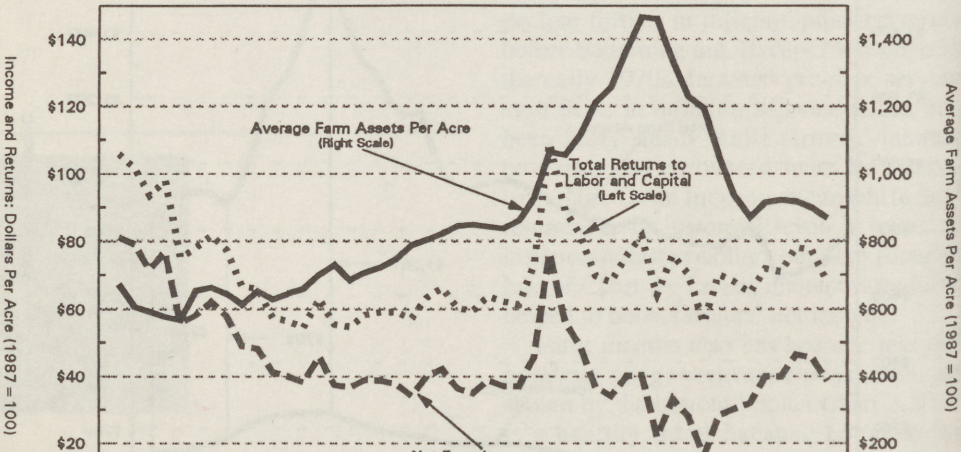
Real Debt of Farmers Has Dropped by Half Since 1980
While Interest Coverage Has Improved



Note: Pre-debt service cash flow equals net cash income plus interest expense minus total capital expenditures.

Chart 4

Net Farm Income Per Acre Has Improved as the Average Farm Assets Per Acre Have Declined
Adjusted for Inflation and Based on Market Value of Assets



Note: Total returns to labor and capital include net farm income plus interest paid by farmers, wages paid to farm labor, and rent paid to nonoperator landlords. Net farm income includes government payments to farmers.

Chart 5

Net Farm Income Has Improved in Recent Years Even Though Government Payments Have Declined

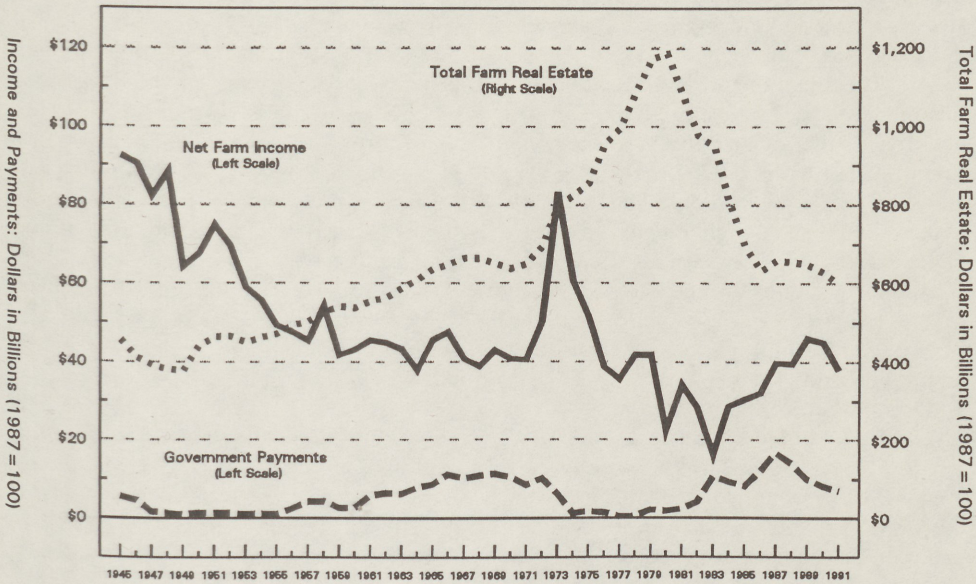
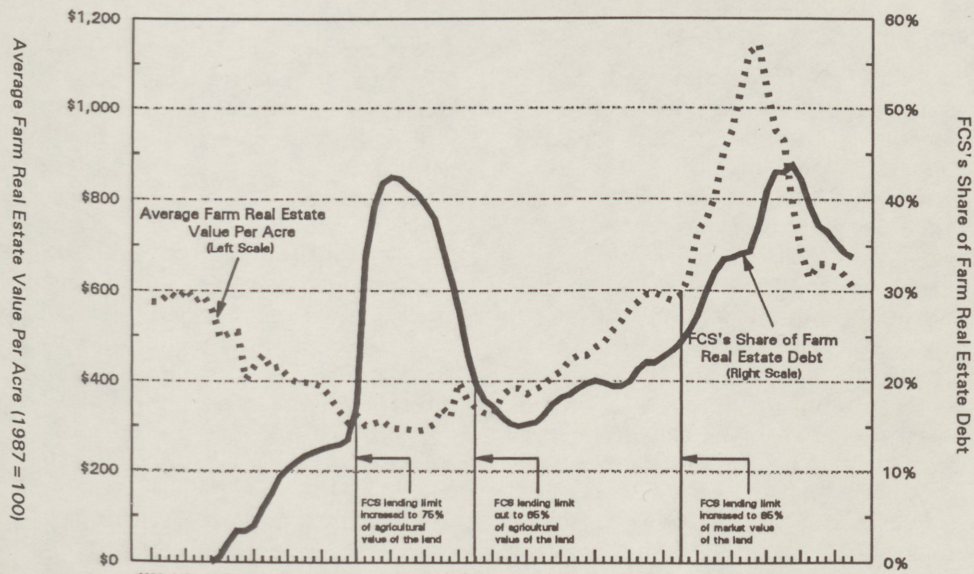


Chart 6

Average Real Value of Farm Real Estate Per Acre and the FCS's Share of Farm Real Estate Debt



near an equilibrium value of $600 per acre, measured in 1987 dollars. Note how FCS's share of farm real estate debt has tracked the inflation-adjusted value of farm real estate since the early 1950s. Farming's leverage appears to be leveling off (Chart 7); however, leverage is partially a function of farm size. Larger farming operations on average are more highly leveraged.

Another round of farm real estate speculation could be devastating to agriculture, and to ag lenders. Fortunately, as the solid line on Chart 8 shows, the real (inflation-adjusted) rate of interest on FCS real estate loans still is high enough to deter this speculation. A return of low real rates probably would spark another round of speculative excess in agriculture, especially since the FCS can still employ excessively liberal lending criteria.

Despite farmers' improved cash flows, disinvestment in agriculture has continued (shaded area on Chart 9). This condition is a hangover from agriculture's problems in the 1980s to the extent that farm buildings and equipment are worn-out or obsolete. Net investment per acre in farm machinery and equipment is continuing to decline (Chart 10); however, part of this decline may represent better equipment utilization that evidences more efficient farming practices.

The Farm Credit System

Bankers have to keep a wary eye on the FCS even though it has regained its financial health, as the bottom line (FCS capital) in Chart 11 shows. Much of the improvement in FCS's capital ratio reflects the fact that it has not grown in recent years (top two lines of Chart 11). However, FCS has clearly become overcapitalized, which could lead to future mischief, if losses from this year's flooding do not severely impair its capital. Consequently, FCS's non-interest-bearing capital now funds 14.7% of its loan portfolio (Chart 12). This "free" capital gives FCS the potential to get even more competitive on rates than it now is.

Interestingly, FCS's pricing advantage, relative to commercial banks, has not changed dramatically in recent years, as Chart 13 illustrates. However, by sacrificing net income, FCS could increase its pricing edge over commercial banks. Despite its pricing edge, though, FCS has lost market share in a stagnant marketplace as banking's market share has reached record levels (Chart 14). FCS is still the largest single source of farm real estate credit nationally, but commercial banks are gaining (Chart 15). In non-real estate lending, though, banking's market share growth has exceeded FCS's loss in market share (Chart 16).

In terms of the total amount of farm loans outstanding, FCS has shrunk substantially in recent years as commercial banks increased their ag lending (Chart 17). Bankers must be doing something right to gain on their subsidized and politically favored competition. FCS's drop in farm real estate loans has accounted for most of its decline in total loans (Chart 18) as banking's farm real estate loans have continued to grow, hopefully with minimal interest rate risk. Even though FCS's non-real estate lending has grown slightly in recent years (Chart 19), its growth rate has not matched the banks.

The Competition

Bankers battle against other competitors besides the FCS. However, bankers can and often do overcome the perceived advantages of other types of lenders. Equipment manufacturers, for example, are reported to be offering very attractive financing terms to help move the merchandise. These manufacturers will always be pesky competitors, but bankers can beat them through good, efficient service.

Suppliers of seeds and other inputs represent essentially the same type of financing competition as do the equipment manufacturers. Farm co-ops have the added advantage of being able to borrow cheaply from the cooperative banks within FCS. Life insurers have played a declining role in farm real estate financing, in part because of the real estate problems that have afflicted many insurers. However, they will not totally withdraw from the ag real estate market.

Farmers Home Administration represents a declining source of farm credit as

(more on page 10)

Chart 7

Farmers' Leverage Appears to Have Leveled Off

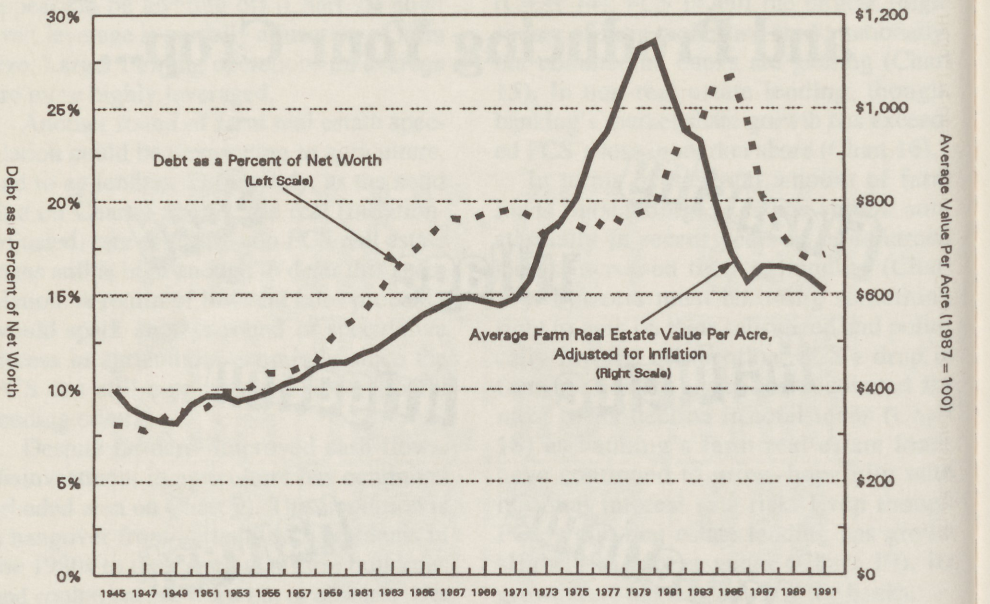
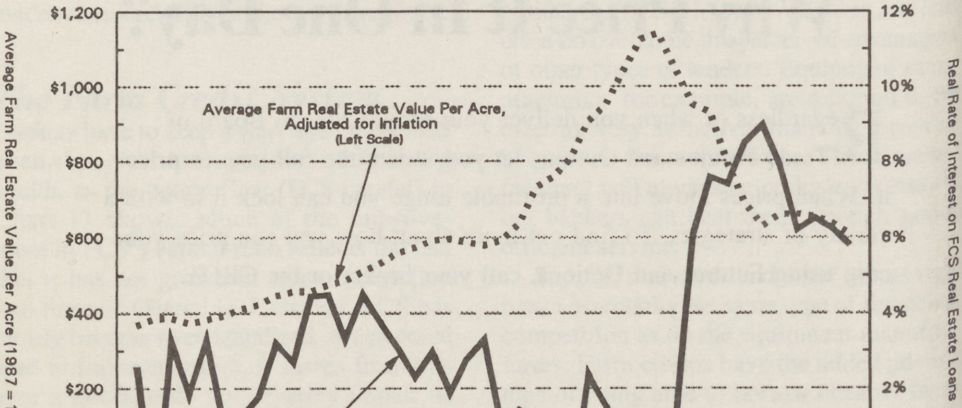


Chart 8

Low Real Rates of Interest on FCS Real Estate Loans are Dangerous to Farming



Note: Real rate of interest equals the average interest rate on FCS real estate loans minus the rate of inflation as measured by the GDP deflator.

Chart 9

Disinvestment in Agriculture Has Continued Even Though Farming's Cash Flow Has Improved in Recent Years

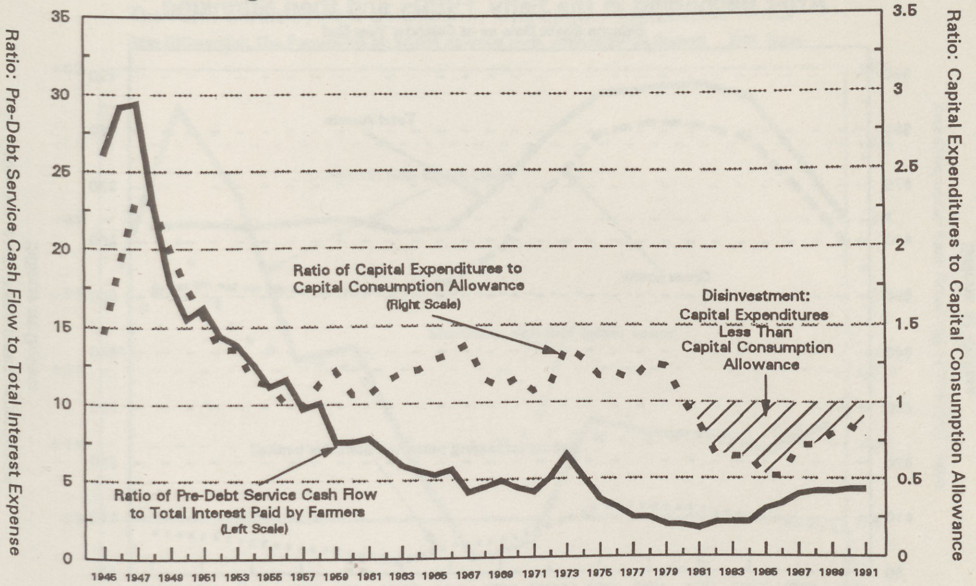


Chart 10

Net Investment Per Acre in Farm Machinery and Equipment, Adjusted for Inflation, Has Declined Sharply Since 1977

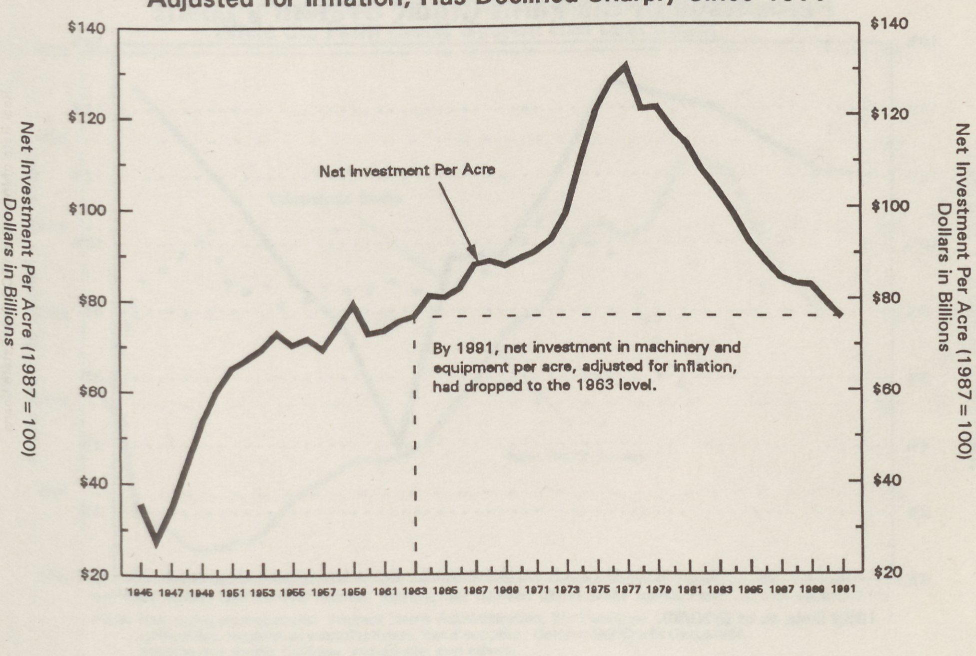
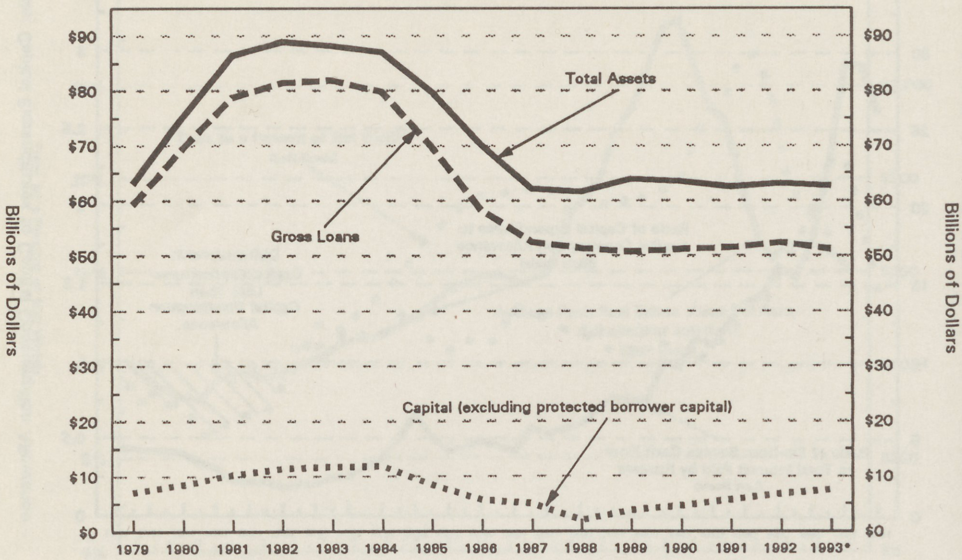


Chart 11

The Farm Credit System's Balance Sheet Has Stabilized After Ballooning in the Early 1980s and then Shrinking

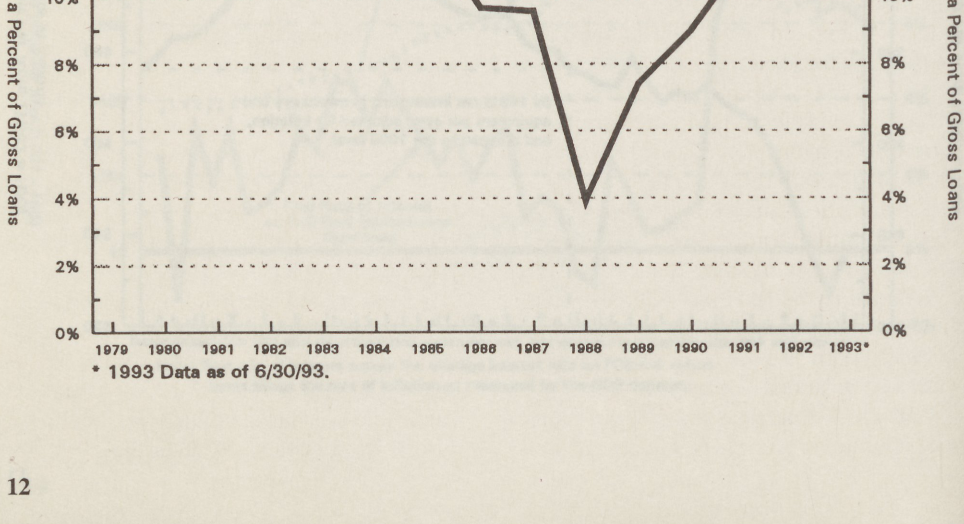
Balance Sheet Data as of Calendar Year-End



* 1993 data as of 6/30/93.

Chart 12

Non-Interest Bearing Capital Is Funding an Increasing Percentage of the Farm Credit System's Loans



* 1993 Data as of 6/30/93.

Chart 13

The Farm Credit System Consistently Underprices Commercial Banks

Rate Differential: The Percentage by Which Average Bank Interest Rates Exceed FCS Rates

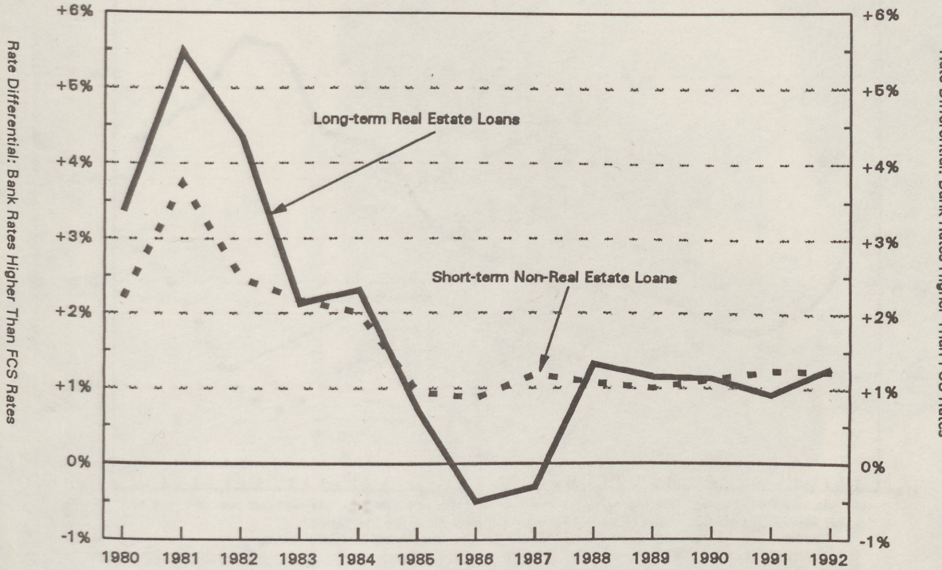
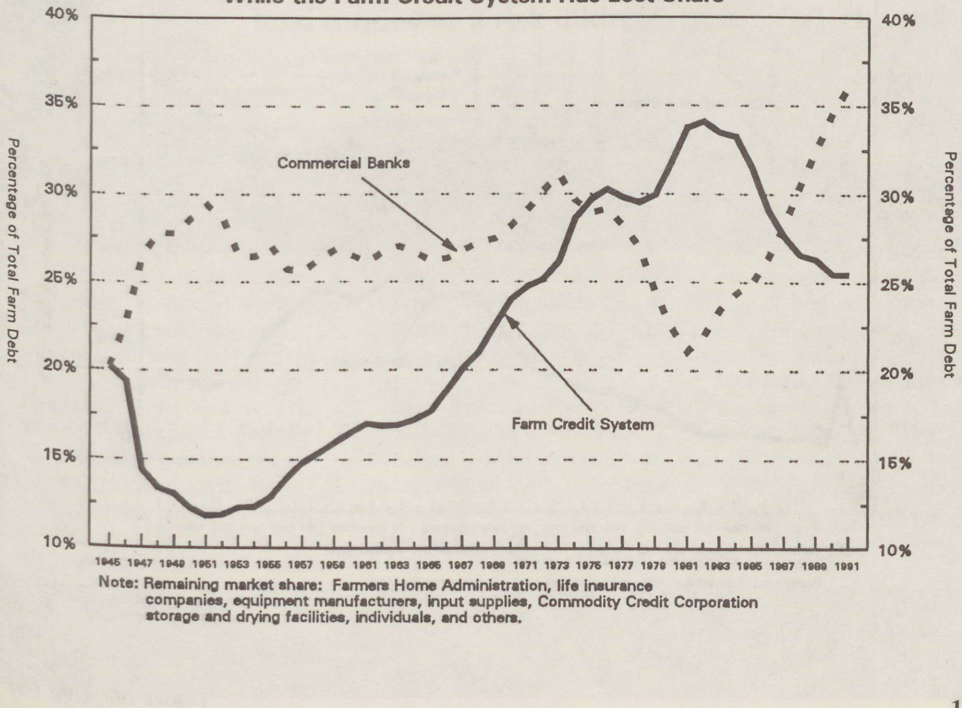


Chart 14

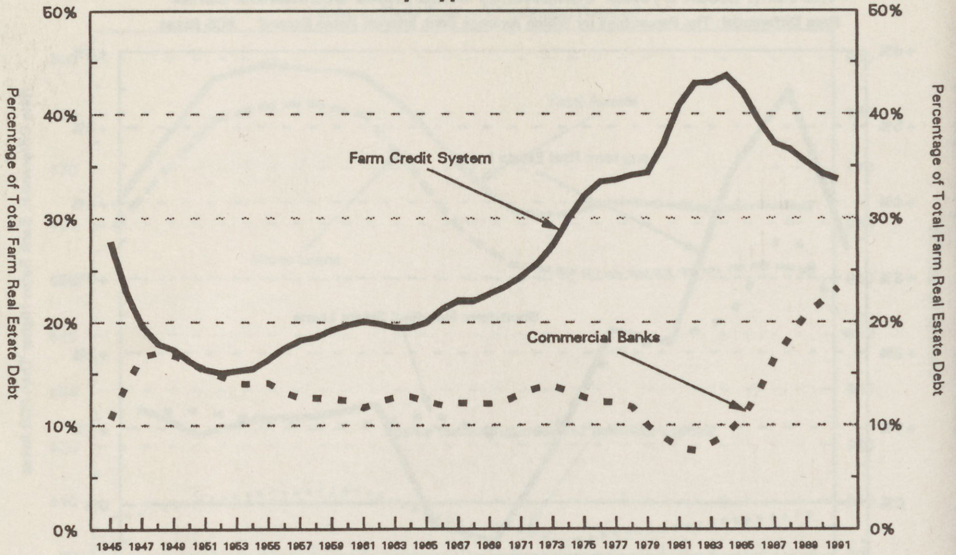
Commercial Banks Have Gained Loan Market Share While the Farm Credit System Has Lost Share



Note: Remaining market share: Farmers Home Administration, life insurance companies, equipment manufacturers, input supplies, Commodity Credit Corporation storage and drying facilities, individuals, and others.

Chart 15

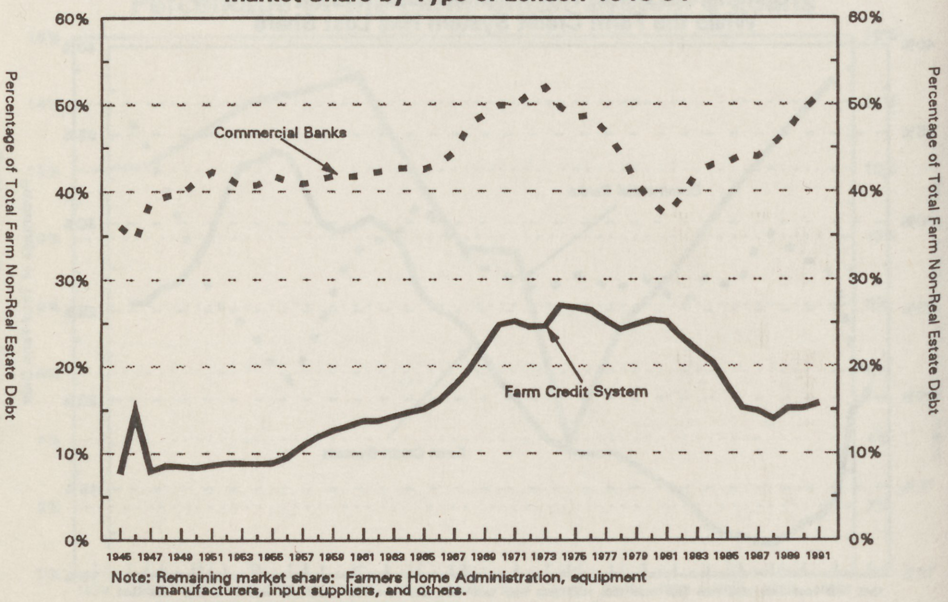
Farm Real Estate Debt
Market Share by Type of Lender: 1945-91



Note: Remaining market share: Farmers Home Administration, life insurance companies, Commodity Credit Corporation storage and drying facilities loans, individuals, and others.

Chart 16

Farm Non-Real Estate Debt
Market Share by Type of Lender: 1945-91



Note: Remaining market share: Farmers Home Administration, equipment manufacturers, input suppliers, and others.

Farm non-real estate debt includes debt of operator households.

(more on page 16)


"How does a risk-avoiding ag lender like me lend money to a risk-taking farmer? Very carefully."
Steve Hatz, Ag lender
First Tier Bank
Omaha, Nebraska
"When we look at equity and assets, we always want to know what's your marketing plan and do you use futures? I know a farmer has to be a risk taker. So we look very closely at how he's managing his risk. We'll advance more to our customers who have strong hedge positions in the market. In fact, today, 90% of our customers use futures and options. Not just to be sophisticated…but because part of the whole process today is to use the tools you need to grow."
Steve Hatz, and many like him, believe in limiting risk by using the price management tools of the '90s—futures and options. The Chicago Mercantile Exchange lists futures and options on live cattle, feeder cattle, pork bellies, hogs and broiler chickens. For a risk manager's tool kit that includes information on futures and options and the latest contract specifications, call 1-800-331-3332.
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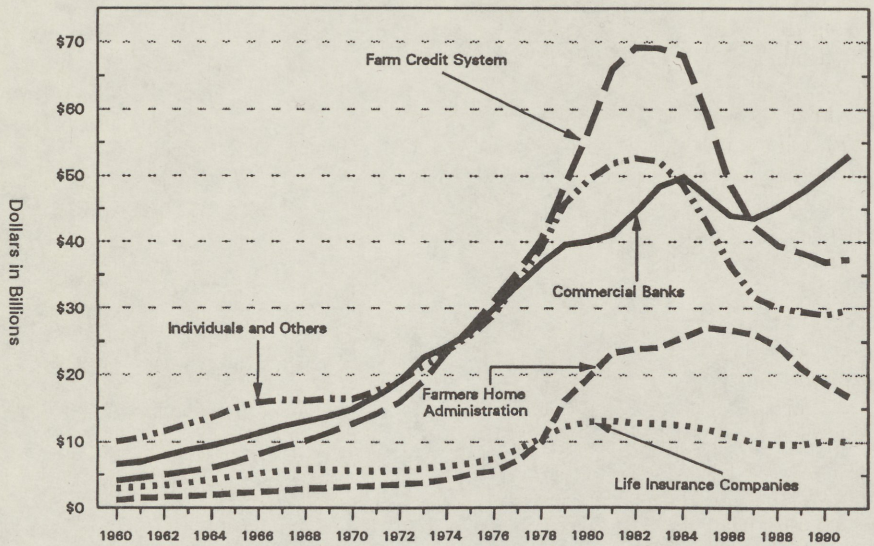
Chart 17

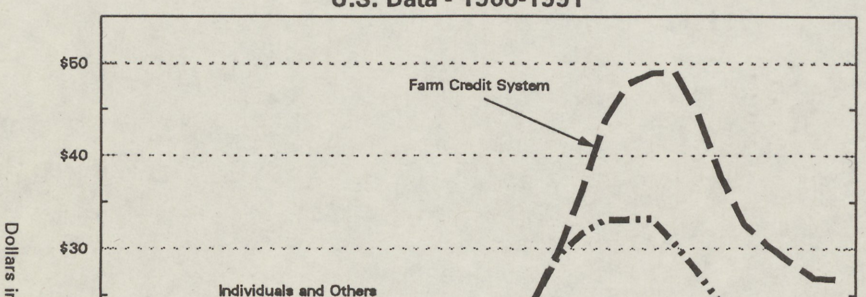
Total Farm Debt Outstanding by Type of Lender
U.S. Data - 1960-1991*



* Calendar year-end data.
Note: Total farm debt outstanding includes debt of operator households.

Chart 18

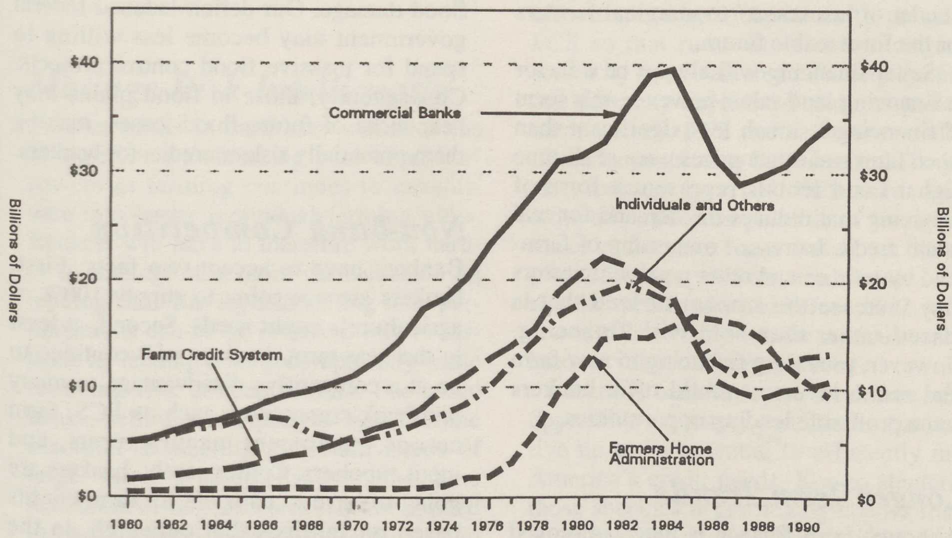
Farm Real Estate Debt Outstanding by Type of Lender
U.S. Data - 1960-1991*



* Calendar year-end data.
Note: Farm real estate debt outstanding includes debt of operator households.

Chart 19

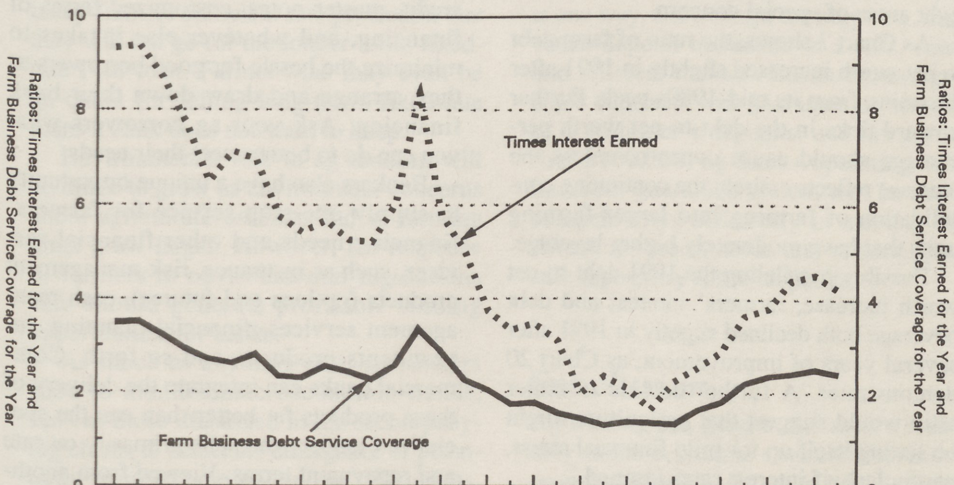
Farm Non-Real Estate Debt Outstanding by Type of Lender
U.S. Data - 1960-1991*



* Calendar year-end data.
Note: Farm non-real estate debt outstanding includes debt of operator households

Chart 20

Times Interest Earned and Farm Business Debt Service Coverage
U.S. Farms - 1960-91



Note: Farm Business Debt Service Coverage equals net cash farm income divided by interest plus principal payments.
Times Interest Earned equals net farm income before interest and taxes divided by interest payments.

marginal farmers slowly recover from the problems of the 1980s or exit farming. Mike Espy, the Secretary of Agriculture, has suggested that Farmers Home might be eliminated; however, the Department of Agriculture undoubtedly will continue to be a "lender of last resort" to marginal farmers for the foreseeable future.

Seller financing will always be a factor in financing land sales; however, this form of financing is much less significant than when farm real estate prices were at all-time highs. Land rentals represent a form of financing that reduces the demand for real estate credit. Increased ownership of farmland by retirees and other passive investors may increase the amount of land that is leased rather than sold with financing. However, providing financing to new farm real estate investors could offer bankers some profitable lending opportunities.

Longer Term Trends

Although farm finance is much improved from the crisis of the early 1980s, the challenge facing agriculture today is to strengthen farm finances in the face of the continuing decline in the real value of farm real estate. Some key farm financial ratios highlight areas of special concern.

As Chart 7 shows, the ratio of farm debt to net worth increased slightly in 1991 after declining from its mid-1980s peak. Further upward ticks in the debt-to-net worth percentage should cause concern, unless the increase reflects entirely the continuing consolidation of farming into larger farming units that have moderately higher leverage.

Possibly paralleling the 1991 debt-to-net worth increase, farmers' interest and debt coverage both declined slightly in 1991 after several years of improvement, as Chart 20 demonstrates. A further decline in either ratio would suggest that agriculture might be setting itself up for mild financial stress, particularly if interest rates jumped.

A farm credit expansion fueled by low real interest rates could cause another farm debt crisis. Farmers and bankers need to be very, very wary of a return to the days of low real interest rates, low cash returns on farm equity capital, lending based on appraised values, and expectations of ever higher real estate prices.

The Great Midwest Flood of '93 has raised serious questions at the federal level about the desirability of continuing to spend substantial sums of tax dollars to prevent flood damage. Our deficit-ladened federal government may become less willing to spend for massive flood control projects. Consequently, those in flood plains may bear more of future flood losses, making them potentially riskier credits for bankers.

Non-bank Competition

Bankers have to accept two facts: First, bankers are not going to supply 100% of agriculture's credit needs. Second, at least in the near term, bankers will continue to be at a competitive disadvantage to many non-bank competitors such as FCS, farm co-ops, equipment manufacturers, and input suppliers. Consequently, bankers are going to have to compete for farm credits based on services that outweigh, in the borrower's mind, the lower rate that he or she might be able to obtain from a non-bank source of financing.

To improve their service to ag borrowers, bankers should utilize pre-set lines of credit, master notes, customized terms of financing, and whatever else it takes to minimize the hassle for good borrowers as they arrange and draw down their bank financing. Ask your ag borrowers what you can do to better meet their needs.

Bankers also have a unique opportunity to supply one-stop service for farmers' financing needs and other financial services, such as insurance, risk-management products (options and futures), cash management services, financial planning, investments products, and so forth. Commercial banks can integrate the delivery of these products far better than can the specialized lender who sells primarily on rate and repayment terms. Viewed from another perspective, farmers should be seen as more than just borrowers.

Key to good service is staying in touch with the customers you want to keep. That takes personal interaction on the farm and in the bank so that farmers and their needs are foremost in their bankers' minds. Also, educate borrowers, particularly the less sophisticated ones, as to what makes a borrower a good credit risk, and why. Many business borrowers, including farmers, simply lack that understanding.

Manage Risk Intelligently

Smaller banks in particular will continue to experience a shrinking pool of ag borrowers as farming continues to consolidate into larger individual farming units. Bankers will have to therefore work harder to manage this more concentrated ag lending risk. Buying and selling loan participations can be an effective way to disperse ag lending risks geographically while reducing risk concentrations. For some banks, selling participations may become essential in meeting the credit needs of larger farming units. However, the same loan underwriting standards must be applied to participations bought as are applied to loans made.

Making fixed-rate real estate loans to match FCS's terms is very tempting, but this interest rate risk must be managed carefully. Fixing rates for three or five years may give many farmers sufficient rate protection that they will not go for the longer-term, fixed-rate FCS loan. Farmer Mac may even be an outlet for selling long-term, fixed-rate loans a bank does not want to keep.

Environmental risk in ag lending will continue to grow as environment concerns about agriculture escalate and as farming units grow larger. However, the response of farmers to environmental regulations also should generate profitable lending opportunities for banks.

As much as anything else, ag bankers need to monitor macroeconomic trends, such as those illustrated in the accompanying charts, to detect the emergence of potentially troublesome economic conditions, such as speculative bubbles, that could cause losses for borrowers, and therefore for banks. If such a condition begins to emerge, bankers will have no choice but to tighten credit standards in anticipation of a future crisis.

How to Gain a Competitive Advantage

First, watch FCS like a hawk. FCS's efforts to broaden its lending franchise must be fought at all times. Longer term, serious efforts must be undertaken to privatize FCS so that rural America no longer is served by two retail credit delivery systems, one privately capitalized and one government-backed. FCS now is in an excellent financial position to be privatized. To prevent another ag crisis, FCS needs to be stripped as soon as possible of its right to make real estate loans based on the appraised value of farm real estate; FCS should operate as it did before 1972, when it could lend only on the agricultural or income value of farm real estate.

Second, banking must break free of its oppressive regulatory shackles so that it can live up to its potential to efficiently meet America's credit needs. Key to shattering those shackles is privatizing deposit insurance and the accompanying safety-and-soundness regulation that seeks to minimize deposit insurance losses. The 100% cross-guarantee concept, which Rep. Tom Petri (R-Wis.) introduced as legislation last year and that he will reintroduced later this year, is one way, and perhaps the only way, to privatize deposit insurance in a safe, sound, and efficient manner. Because cross-guarantee contracts will guarantee or insure all of a customer's deposits, and not just the first $100,000, ag banks operating under the cross-guarantee system will be able to compete more efficiently in meeting rural America's credit needs and in serving as a safe repository for its deposits.

Conclusion

Ag lending is a good business in a reasonably stable economic environment, if done properly. Done badly or in a bad environment, ag lending can easily destroy a bank, especially a small rural one. Consequently, ag lenders must constantly hone their skills while keeping an eagle eye on macroeconomic conditions that could undermine even good borrowers and their bankers. ▲