Retirement Planning: The Missing Link in Expanding Customer Relationships?

by Dr. Alex White, Dr. David M. Kohl, Troy D. Wilson, and Amanda J. Wilson

Introduction

Relationship lending has rapidly emerged as one of the popular "buzzwords" in the lending industry. Developing and maintaining a strong relationship with the borrower was a major focus of the 1996 ABA National Ag Lenders Convention held in Kansas City. Recently, several articles have addressed the importance and profitability associated with developing a stronger relationship with the borrower (Boehlje; Kohl, et al.). This article discusses retirement planning and investing services as methods of improving the lender-borrower relationship.

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Retirement planning is a largely-neglected function in personal financial management. Over one-half of the U.S. population between the ages of 18 and 34 have not begun to save for retirement, while one-fourth of U.S. adults between the ages of 35 and 54 have no retirement savings (Tyson). This is reflected by the decrease in the personal savings rate for U.S. adults from 6.2 percent of disposable income in the 1970s to 3.4 percent in the late 1980s (Bovenberg). Amazingly, more than 30 percent of adults over the age of 65 have no income from personal savings during their retirement years (*Associated Press*). These factors, compounded by the fact that people are living two-and-one-half to three times longer and spending more money in their retirement years, present a great challenge to lenders and borrowers (*USA Today*).

Agricultural producers tend to view investment in the farm as their retirement portfolio. Excess funds typically are used to pay down existing debt or to purchase real estate, machinery and equipment, livestock, or other production-related

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assets (Marker). This strategy may help to increase the equity position of the producer, as well as gain the producer short-run tax benefits through increased depreciation expense. While investment in the operation may be profitable, it may also result in a relatively risky, insufficient, and/or illiquid portfolio at the age of retirement. The operator may face cash flow problems as he/she is forced to liquidate farm assets on an untimely basis to generate enough funds to meet living needs during retirement. This presents an opportunity for agricultural lenders to strengthen the relationships with their borrowers. By providing retirement planning and investment services for their clients, agricultural lenders put themselves in position to cross-sell services which may be perceived as extremely valuable by their clients.

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Retirement planning and investing services have the potential to diversify and improve the client's overall financial position, while increasing the lender's profitability. Retirement planning is also a prerequisite for facilitating the transfer of the family farm business to the next generation, which is consistent with maintaining a long-term relationship with the client. An example of how retirement investments may facilitate farm business transfer involves a 35-year-old son purchasing the family farm from his 65-year-old parents. Transfer of the farm was made easier because nearly 80 percent of the parents' retirement living needs came from IRA and Keogh distributions rather than proceeds from the sale or lease of the farm.

Qualified retirement investments such as IRAs[a], SEPs, Keoghs, 401(k)/403(b) plans and Retirement Savings Plans (Canada) are powerful financial planning tools currently available to agricultural producers and small business owners. These plans offer annual tax deductions, as well as tax-deferred growth of both principal and earnings until the funds are withdrawn at the age of retirement. However, these investment vehicles are not widely used by the U.S. population. Currently, less than 30 percent of the U.S. population have IRAs or Keogh plans (Avery and Kennickell), while less than one-third of the U.S. workforce participates in 401(k) plans (*USA Today*). A 1995 Virginia Tech study found that 37 percent of surveyed agricultural producers use IRAs, 10 percent use SEPs, and only 4 percent use Keogh plans for retirement investments (Marker). The lack of use of SEPs and Keoghs may be because producers are not aware of the existence of or the benefits of SEPs and Keogh plans. Further, this study found that only 34 percent of surveyed producers feel they are adequately preparing for retirement, 35 percent feel they are not adequately preparing for retirement, and 31 percent are not sure if they are adequately preparing for retirement. Thus, there appears to be a large potential market for retirement planning and investment services.

Advantages to Producers

Analytical Model

What are the advantages of retirement services to agricultural producers? A 1995 study by White examines the impacts of retirement investment on a simulated agricultural operation. This study investigates several retirement investment scenarios for farm families, and analyzes the impacts on wealth accumulation, liquidity at age of retirement, investment risk, and tax implications associated with these investments. The analytical model in this study simulates the annual cash flows and capital asset appreciation for an agricultural operation over a 30-year planning horizon. Four retirement options are examined: 1) no qualified retirement plans used [all excess funds re-invested in the operation], 2) IRAs used for producer and spouse, 3) IRAs and a SEP used, and 4)

IRAs, SEP, and 401(k) used by the operator and/or spouse. For each retirement option, three separate farm capitalization cases are examined: 1) a beginning of period debt/asset ratio (D/A) of 50 percent; 2) a beginning of period D/A of 65 percent; and 3) a beginning of period D/A of 65 percent for an operator who leases a majority of the land for his/her operation.

Wealth accumulation is measured using mean ending values for farm assets, total assets, and net worth at the end of the 30-year period for each scenario. Liquidity at age of retirement is measured by the diversity of the operator's portfolio at the age of retirement. The capital accounts of interest are farm assets, a liquid account (money market), a taxable account (after-tax investments), IRA accounts, SEP accounts, and 401(k) accounts. The model reports the mean ending value of each account as a percentage of total assets.

Risk associated with each scenario is measured in two ways. First, the probability of meeting estimated living needs during retirement is calculated for each scenario. Meeting living needs is defined as having an ending net worth capable of generating an income stream, in addition to Social Security benefits, greater than or equal to the operator's estimated annual living needs during the retirement years. The second risk measure is the probability of farm failure. A farm is considered to be a failure if the debt/asset ratio (including personal assets and all investment portfolios) for the operator exceeds 75 percent.

Tax implications are measured using two methods. The first method is the mean discounted total Federal tax liability over the 30-year period. For each scenario, annual Federal income tax liabilities are calculated for each year and discounted back to 1995 dollars using annual estimates of inflation. The second method of examining tax implications is calculation of the breakeven tax rate on retirement investments at the age of retirement. This is the tax rate at which all tax-advantages of retirement investments are eliminated. The breakeven tax rate is calculated assuming the current marginal tax rates remain constant until the age of retirement for the operator, and there are no deferred taxes on farm assets or assets in the taxable portfolio. The assumption of no deferred taxes may seem unrealistic; however, it provides the most conservative estimate for the breakeven tax rate.

Results

Wealth Accumulation

Investment in qualified retirement plans, such as IRAs, SEPs, and 401(k)s, has a significant impact ($p < 0.0001$) on wealth accumulation for the simulated agricultural producer. In general, the use of retirement vehicles leads to increased mean ending total assets and net worth. The use of IRAs by themselves is not of great importance in building wealth because of the phase-out of tax-deductible annual IRA contributions based on adjusted gross income. However, the use of SEPs and 401(k) plans dramatically increases the mean ending total assets and net worth for producers. For the 50 percent D/A scenario, the use of all retirement vehicles generates mean ending total assets 200 percent greater than when no retirement vehicles are used. Mean ending net worth when all retirement vehicles are used is 150 percent greater than mean ending net worth when no retirement investments are used. For producers who lease a majority of their real estate, the use of all retirement vehicles generates mean ending total assets 250 percent larger than when no retirement vehicles are utilized.

Investment in IRAs, SEPs, and/or 401(k)s does not significantly reduce total farm assets, under the assumptions of the model ($p > 0.90$). The model assumes a growth rate of 2 percent per year in assets to account for farm growth over time. Thus, the size and growth of the farm are not adversely affected by investing funds in retirement accounts instead of reinvesting funds in the farm. This result holds true regardless of the degree of leverage for the operation.

Liquidity

The diversity of the producer's portfolio is similar across all methods of capitaliza-

tion. With no retirement plans, the producer's assets are heavily concentrated in farm assets. For conservative investment strategies for producers with a 50 percent D/A, the percentage of total assets invested in farm assets ranges from 91-94 percent. As more retirement plans are utilized, the percent of assets invested in the farm decreases. This is especially true for producers with an aggressive investment strategy. For example, in the 50 percent D/A scenario when all retirement vehicles are used, producers with conservative investment strategies have 67 percent of total assets invested in the farm, whereas producers with aggressive investment strategies only have 25 percent of their total assets invested in the farm. Producers with an aggressive investment strategy who use all possible retirement plans tend to have more capital invested in nonfarm assets than they have invested in farm assets.

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Risk

The probability of meeting estimated living needs during retirement is relatively high (0.95-1.00 for 50 percent D/A scenario; 0.81-1.00 for both 65 percent D/A scenarios) for producers with low estimated living needs ($30,000/year), regardless of retirement plan, investment strategy, or level of expected Social Security benefits. However, the model assumes the producer begins the planning period with substantial net worth. As the level of estimated living needs increases, the probability of meeting living needs tends to decrease. There is relatively little difference in probability of meeting living needs between the use of IRAs and a combination of IRAs and a SEP ($p > 0.04$). However, use of IRAs or IRAs in combination with SEPs tends to provide an annual stream of income much greater than the estimated living needs.

The probability of farm failure is similar between operations starting with a 50 percent debt/asset ratio and operations starting with a 65 percent debt/asset ratio which lease a majority of their land. For these cases, the probability of farm failure varies between 3-6 percent for various combinations of retirement plans and investment attitudes. The probability of farm failure for operations starting with a 65 percent debt/asset ratio (without leasing land) is dramatically higher. The range of probability of failure for this case is 13-20 percent. The use of all retirement plans tends to decrease the probability of farm failure. This is a result of the nonfarm investments maintaining the debt/asset ratio below 75 percent.

Tax Implications

The mean Federal tax liability is not significantly reduced by the use of IRAs. This is due to the phase-out of allowable contributions to IRAs. SEPs and 401(k)s significantly reduce the producer's tax liability over the planning period ($p < 0.0001$). Thus, use of retirement vehicles helps reduce the total amount of income taxes a producer must pay over his/her lifetime. As agricultural producers tend to be concerned with minimizing their tax liability, the use of retirement investments can reduce the tax liability without significantly reducing the size or growth of the farm.

The breakeven average tax rate for the retirement categories is quite high for all methods of capitalization. The breakeven tax rate between IRAs and the use of no retirement plans is greater than 60 percent for the producers with conservative investment preferences. This indicates the average tax rate (not the marginal tax rate) at the time of retirement must be greater than 60 percent (for conservative producers) to negate the advantages of investment in IRAs. The breakeven tax rate for less-conservative producers is greater than 90 percent. As SEPs and 401(k)s are used, the breakeven tax rate increases further.

Degree of Leverage

The degree of leverage has an impact on the producer's preparation for retirement. In general, as the degree of leverage increases, investment in retirement vehicles becomes more important. This is especially true for operators who lease a majority of their assets. While greater degrees of leverage may reduce the annual tax liability, it tends to put more pressure on annual cash flow through increased debt service requirements. This reduces the cash margin available for investment, which tends to slow the growth of the producer's equity. For operations which lease their assets, the slower growth in equity leads to an insufficient retirement portfolio (farm and nonfarm) at the age of retirement. Thus, producers who lease their assets and do not invest their profits for retirement may have difficulty meeting their family living needs during retirement.

Implications

The results of this study provide interesting implications for agricultural producers and for agricultural lenders. From the producer standpoint, sound retirement planning and investing has the potential to strengthen the producer's financial position. As discussed above, investment in qualified retirement plans typically leads to increased wealth accumulation, increased liquidity at time of retirement, lower risk, and substantial tax benefits. Retirement planning and investing has the potential to be a powerful management tool for agricultural producers.

Aside from strengthening the producer's financial position, retirement investments may be extremely important in transferring the farm business to the next generation. There are four main sources of income during retirement: proceeds from sale or lease of the farm assets; distributions from retirement investments; Social Security benefits; and continued employment during retirement. If we ignore Social Security benefits and continued employment during the retirement years, it is clear that an increase in income from retirement investments lowers the pressure on the producer to sell/lease the farm assets to obtain funds for living needs. This implies that the producer can transfer the farm assets to the next generation more slowly, or in smaller parcels, which lowers the initial debt load of the incoming generation. Also, increased income from retirement investments may allow more flexibility in disposition of the farm assets, as the producer is less dependent on the proceeds from sale of the assets. Along the same line, retirement accounts lessen the impact of deferred taxes when the farm assets are sold. Thus, retirement investments can provide the producer with the time and flexibility necessary to make a sound decision as to the disposition of the farm assets.

The odds of retaining a client increase dramatically when the client uses more of the lender's services.

There are several implications for the lending industry. Knowing the importance of retirement planning and investing to the producer, lenders may consider developing a marketing plan to meet the retirement needs of agricultural producers. Aside from satisfying the client, there are benefits to the institution. First, the lender may reduce the risk associated with a particular client by offering sound retirement planning and investing services. These services help strengthen the financial position of the client; as there is typically less risk associated with a stronger client, the lender has lower risk associated with the loan. Anecdotal evidence suggests there is a strong positive correlation between the use of retirement plans and loan performance. Further, the lender may increase the profits earned from each client by offering retirement services.

Retirement services also allow the lender to strengthen the relationship with the borrower and the borrower's family. This has been referred to as the "web of ser-

vices" (*Associated Press*). The odds of retaining a client increase dramatically when the client uses more of the lender's services. For example, the odds of losing clients are 1:1 if they only use one of your services; 10:1 if they use two services; 18:1 if they use three services. The lender has 100:1 odds of losing a client when that client uses four or more of the institution's services. Similarly, the lender has an opportunity to increase the number of relationships with the farm family by offering retirement services. One generation may influence the other generation to develop a retirement plan.

Further, as the lender makes the producer and family aware of the benefits of retirement planning, the opportunity to cross-sell related services increases. Once the family understands the implications of retirement planning, they may begin to think more about their future. This presents the opportunity to cross-sell investing/brokerage services, estate planning services, tax planning/preparation services, and insurance services.

Another implication to lenders is related to the mature loan market in agriculture. During a mature loan market, lenders need a way to differentiate themselves from the competition. Retirement planning and investing services may provide the necessary incentive for customers to come to the bank even though they currently do not need a loan.

Marketing Retirement Planning and Investing Services to Agricultural Producers

This raises three important questions: Who should a lender target for retirement services? How can a lender market retirement services to the targeted agricultural producers? How can a lender provide these services? The first question has no specific answer. Older producers, who are closer to retirement, are obvious possibilities; but younger producers have time on their side, more specifically, time value of money (compounding). Profitable producers will have more funds to invest in retirement plans; less profitable producers will have greater need of the retirement services. Almost every agricultural producer can benefit from retirement planning!

The answer to the second question will vary among institutions. The first statement a producer will make, when approached about retirement investing, is typically, "There's no money left over at the end of the year." Many producers prefer to use "excess" funds to pay down existing debt or invest in farm-related assets. Others prefer to invest only after paying their income taxes, thus foregoing the tax benefits of retirement investments. Thus, the lender must be prepared to overcome these attitudes. The following guidelines are intended to help market retirement services to agricultural producers.

First, involve the spouse in the marketing process. The spouse tends to be more open to off-farm investments. They typically do not want the farm assets to be their sole source of retirement income. Along the same line, involve the entire family in the marketing decision. In many cases, the younger generation will more readily see the benefits of retirement planning. They may start a retirement program for themselves; but, more importantly, they may help to sell the idea to the older generation.

Secondly, explain to the producer the concept of "paying yourself first". The statement "If you don't take care of (pay) yourself, who will?" usually gets a producer's attention. Have the producer agree to set up an automatic payment program so that he/she never "sees the money" going into the retirement account. This reduces the temptation to divert funds from retirement investment to other uses.

Next, alert the client to the fact that retirement investments are exempt from bankruptcy judgment and lawsuits. These funds cannot be used as settlement for such cases. This fact provides a sense of security to the client.

The last guideline is to consider working with an accounting firm and/or a financial planning firm. These professionals should keep up-to-date on the latest developments in the retirement area. The lender can avoid the cost (time, energy, funds) of keeping on top of these issues

by forming a strategic alliance with accountants and/or financial planners.

This leads to the third question raised: "How can a lender provide these services?" Should retirement services be provided in-house or via strategic alliances with financial planning firms? There are advantages and disadvantages to each method. The lender should carefully consider the benefits and the costs associated with in-house versus out-sourced services.

Summary

Retirement planning is a neglected function in personal financial management; but, retirement planning may have dramatic impacts on the business of an agricultural producer. A study by White suggests that investment in retirement vehicles, such as IRAs, SEPs, Keogh plans, and 401(k)/403(b) plans by an agricultural producer leads to higher ending net worth, increased liquidity at time of retirement, lower risk associated with the financial performance of the firm, and reduced income tax liability over the life of the producer. These factors present a great opportunity for lenders. By offering retirement planning and investing services, a lender may strengthen the relationship with the client, as well as increase profits to the institution.

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End Note

[a]Individual Retirement Accounts (IRA) have been available to taxpayers since 1982. Taxpayers may make annual contributions, limited to the lesser of $2,000 or 100 percent of compensation. Contributions may be tax-deductible or non-deductible, depending on the individual's participation in other qualified retirement programs. All earnings of an IRA grow tax-deferred until the funds are withdrawn from the account.

Simplified Employee Pension plans (SEPs) are IRA-based retirement plans for self-employed persons and their employees. The maximum annual contribution to a SEP is the lesser of $22,500 or 15 percent of compensation. All earnings of the SEP are tax-deferred until the funds are withdrawn from the account.

Keogh plans are also retirement plans for self-employed individuals and their employees. The maximum annual contribution to a Keogh plan depends on the type of plan. In general, maximum contributions are the lesser of 20% of gross earned income or $30,000. Again, all earnings are tax-deferred until withdrawn.

401(k) and 403(b) plans are salary reduction plans which enable employees to contribute pre-tax earnings to a tax-deferred investment plan. ▲