

FINANCIAL STRESS IN AGRICULTURE: IMPLICATIONS FOR LENDERS

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Farmers as well as their lenders are concerned about how the current financial crisis as well as the uncertainty of a U.S. and possibly global recession will impact their business. We discuss the implications for farmers in the companion article *The Financial Crisis: Implications for Farm Borrowers*; here our attention focuses on lenders. What are the implications of this increased financial stress in the credit markets as well as the higher volatility and risk in agriculture on farm lenders?

Cost of Funds Will Rise Modestly

The increased uncertainty in the financial/capital markets has resulted in additional risk premiums in those markets, and consequently higher cost of funds for those financial institutions that source their money from national money markets. For the Farm Credit System which sources funds by selling agency bonds in these national markets, the cost of funds has increased 40 or so basis points – less than ½ percent. For rural commercial banks, the main source of funds has been local deposits, and these funds sources have increased in cost only marginally. Lenders with higher costs of funds will either pass those increased cost through to their customers, or absorb these additional costs through cost savings elsewhere or lower profit margins. The end result is that costs for making agricultural loans will increase only modestly.

More Oversight/More Documentation

In previous periods of financial stress regulatory agencies increased their scrutiny of the financial institution and its policies and procedures, and there is no reason to believe it will be different this time. Additional regulatory oversight for all financial institutions, irrespective if they have participated in the sub-prime housing market lending activity, will likely occur. Furthermore, the increased financial risk in the agricultural sector suggests that not only regulatory agencies, but also bank management and loan review committees will likely be more diligent in evaluating the credit risk of the portfolio as well as individual customers. This increased regulatory and review process will increase the work load for the typical bank loan officer; he or she will be expected to more carefully document the risk and repayment capacity of the borrower be more diligent in verifying historical financial performance, more accurately assess future repayment capacity, carefully evaluate and document secondary sources of repayment including security and collateral positions, and monitor more frequently and regularly actual financial performance of the borrower.

Funds Will Be Available

As noted earlier, most agricultural lenders source their funds from national money markets in the form of

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agency bonds in case of the Farm Credit System, or local deposits in the case of commercial banks. In general, these funds sources have not been subjected to the “freezing of capital markets” phenomenon that has characterized the investment banking industry and the interbank lending activity of national and global banks. Consequently, the liquidity problems and unavailability of credit characterizing the national money markets and other sectors of the economy are unlikely to occur for rural agricultural lenders. Most agricultural lenders will have fully adequate funds to loan to their credit-worthy customer base.

What Will Your Competitor Do?

Differences in the cost of funds between various financial institutions as well as differences in loan losses in their current portfolio, combined with different risk appetites on the part of various financial institutions, could have modest impacts on the pricing policies and thus competition in the agricultural loan market. Some lenders may choose to increase their interest rates to reflect the higher cost of funds and risk in the industry, whereas other lenders may be more hesitant to do so. Consequently, there may be more differentiation in interest rates for agricultural loans this upcoming year than has occurred in the past. But it is likely that these differences are fundamentally more cost driven than motivated by attempts to grow loan volume through aggressive pricing and marketing strategies. Agricultural lenders are not likely to be aggressively pursuing new customers in this financially stressful business climate.

Agricultural lending always has been and will continue to be a competitive business, but the intensity of that competition may lessen somewhat until some of the financial stress issues are resolved.

Lending Costs Will Rise Somewhat

As suggested earlier, agricultural lenders may find pricing decisions more complex in the future. In general, all cost of lending is expected to rise modestly. The cost of funds may increase for some lenders – particularly those sourcing funds from national money markets. Furthermore, lenders may choose to add a modest additional risk premium to their interest rates to reflect the prospects for additional risk in agricultural lending – this risk premium will clearly depend on the credit-worthiness of the customer and will likely require more detailed analysis of the relative risk of various farm borrowers. And the administrative and monitoring costs are also expected to rise modestly as examiners and loan review committees expect the loan officer to obtain and analyze additional information to make an informed credit decision, as well as to spend more time in farm visits and other activities to monitor the financial performance of the customer. These additional incremental costs will differ by loan maturity, expected use of the loan funds, and financial characteristics of the borrower – suggesting that loan pricing decisions will be more complicated -- requiring more analysis -- and that interest rates will vary from customer to customer more frequently within the same financial institution. This increased differential in interest rates among customers also means that it will be more difficult to compare rates across institutions, making it more difficult to determine the appropriate response if a competitor offers a lower interest rate to the borrower.

Demand More From Your Borrowers

Finally, the prospects of additional risk in the agricultural industry suggest that lenders may become more conservative in their credit policies and underwriting standards. In some cases this may mean more aggressive use of covenants and restrictions on funds use. In other cases it may suggest obtaining additional collateral and security for the credit request. Some credit requests may be only partially funded, or funded

only after significant refinancing or other debt restructuring is implemented. And in some cases it may mean turning down the credit request and asking the customer to go elsewhere. Saying no is never easy under any circumstances, but it may be that refusing a loan request is in the best interest of both lender and borrower. Lenders are likely to have to say no more frequently during this period of financial stress in the farming sector.

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