

THE FINANCIAL CRISIS: IMPLICATIONS FOR FARM BORROWERS
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The financial crisis in the capital/credit markets combined with the potential for an economic slow-down/recession in the U.S. economy (possibly globally) has the potential to impact the financial markets for lenders and their expectations from their farm customers. What should you expect from your farm lender as you approach him/her to review your financial performance and renew your credit line this year?

Increased Financial Risk

Without a doubt, the increased price volatility combined with significant cost increases have resulted in increased risk in the agricultural sector. This increased risk means that lenders will be more cautious and conservative in their lending or underwriting policies. Farmers should not be surprised that their lender this upcoming year will be asking for additional documentation and evidence concerning how the borrower is planning to reduce or mitigate the risk he or she faces. They will be asking questions concerning whether they have forward priced any of their products; the kind of land rental arrangements that have been negotiated and at what price; if they have any of their fertilizer, seed or feed costs locked in and at what price, what level of crop insurance are they planning to purchase, are there plans for any machinery or equipment purchases this upcoming year, what other sources of income are available to make loan payments, etc. In some cases, lenders may be requesting additional security or collateral for a loan, or they may be unwilling to fund the entire loan request because of concerns about the risk and repayment capacity of the borrower given the increased risk in the industry. Farmers should be prepared to provide additional documentation for their loan request this upcoming year -- more complete evidence of expected repayment capacity including a projected cash flow is more likely to be part of the documentation expected this year compared to previous years.

Credit Availability

Because most of the credit providers for farmers (rural commercial banks, the Farm Credit System and mid-size banking institutions) have not participated to the same degree in the subprime mortgage lending business, they have not incurred the same level of losses and financial stress as investment bankers and some of the national and international commercial banking institutions. Furthermore, those lenders focused on farm loans typically source their funds from more reliable and readily available local deposits and Agency bonds rather than "hot money" such as inter-bank/inter-institutional loans, daily money market funds or similar purchased funds that have become increasingly unavailable as the financial crisis has sped throughout the banking/investment/financial industry. The agricultural sector has not been significantly impacted by the "freezing up" of funds sources that has impacted other firms and industries. Some farmers who have encountered losses or other financial problems may encounter difficulty in obtaining adequate

credit this upcoming year, and lenders are likely to tighten underwriting standards and become more conservative in lending policies. Because of the increased risk in the agricultural sector lenders might require increased collateral, personal guarantees or other conditions as part of the loan arrangement. But most farmers will be able to source adequate credit to finance their farming operations this upcoming year.

Documentation Requirements

The strong repayment performance of the agricultural sector during the past few years has generally given farm lenders confidence in their farm borrower's repayment capacity and credit worthiness. But the increased risk in the agricultural sector because of higher input costs and declining prices combined with increasing scrutiny on the part of examining agencies, irrespective of lending institution, has resulted in more concerns on the part of lenders about the current financial condition of their customers irrespective of their past history and performance. Consequently, lenders are asking for increased documentation of credit requests and future repayment ability; farmers should not be surprised when their lender asks for more complete documentation of their cash flow and income generating performance, their use of crop insurance and various other risk management strategies and their willingness to adjust family withdrawals to assure that they can repay their loan.

Interest Rates

Farmers are not expected to face dramatically changed interest rates this upcoming year as a result of the current crisis in the capital/financial markets. As the Fed and monetary authorities globally lower interest rates in response to the crisis, short term rates for operating loans could decline slightly – 25 to 50 basis points or one-quarter to one-half percent. However, some lenders, particularly those obtaining funds from national money markets, are facing somewhat higher costs of sourcing their funds – Farm Credit System Bonds for example are carrying higher rates of 40 to 50 basis points for issuances in September compared to July 2008. And the risk premium associated with loans in general is also expected to increase, resulting in slightly higher interest rates. An additional concern in the financial community is what the various government assistance programs combined with the Fed policies to lower interest rates and increase the money supply might do to inflation rates in the long run – increasing inflation expectations are typically reflected in rising interest rates for longer term financial instruments. Consequently, longer term interest rates for mortgage and capital expenditure debt may increase slightly – one-half to one percent – as a result of the financial crisis in the money markets.

Funds Utilization

The strong financial position of most farm borrowers has meant that lenders have been willing to make a large majority of their agricultural loans with few limits or restrictions on funds use or borrower behavior. When the perceived risk of an industry increases and lenders become more conservative in their underwriting or credit policies, one response is to impose more covenants on their borrowers – more limits or requirements with respect to funds utilization or risk management strategies. Farm borrowers are likely to more frequently be required to sign loan agreements that include various forms of restrictions or covenants this upcoming year. Such covenants might include the requirement to buy crop insurance, to not make any capital expenditures without prior approval of the lender, to forward price a portion of the crop and/or livestock product sales, to provide quarterly summaries of inventories, etc. Farmers should anticipate that their lender is likely to be more diligent in their oversight of the farming operation given the increased

risk in the industry. Such oversight might also include periodic farm visits to check inventories and growing conditions, monitoring of checking and deposit account balances and spending behavior, and more frequent requests for progress reports and financial documents including cash flow projections and expenditure summaries to make sure financial performance has not deteriorated unexpectedly.

Operating Line Requirements

The rapid rise in fertilizer, seed and chemical prices has not only resulted in significant increases in farmer's costs, but it has also increased the amount of funds they need to purchase these items – their operating credit line. For many farmers, the size of the loan needed to plant the crop in 2008 almost doubled compared to 2007, and further increases are expected for the 2009 crop. Rapid increases in feed cost have resulted in significant increased operating fund requirements for livestock producers who buy their feed during the past 12 months; recent declines in corn and soybean prices are expected to moderate these credit needs this next year. Farmers should anticipate that their lender will expect more accurate documentation of how much they expect to have to pay for fertilizer, seed and chemicals, and whether or not there is a risk that the input supplier may not be able to fulfill their commitments. Lenders may even ask questions about the financial stability/solvency of the input supplier – higher cost and increasing requirements to pay cash to input manufacturers has put some input suppliers under severe financial pressure, and due diligence concerning the ability of the elevator or supplier to deliver inputs or pay for the products purchased is increasingly warranted. And a surprising higher expense this upcoming year for many farmers may be income taxes. For those farmers who have had high incomes the past couple of years, the pre-payment of fertilizer, seed and chemical expenses has been used in part to reduce the taxable income reported on the schedule F and thus the income tax obligation. It is possible that this procedure of prepaying expenses and delaying cash sales may be less effective this upcoming year in managing the income tax liability, and income tax obligations could increase significantly exactly at a time when the farmer is facing capital and credit constraints.

In some cases, farmers are concerned that their lender may not be willing or able to provide funds when they are needed by the borrower. In other industries, it is not uncommon for a businessman to arrange a line of credit and pay a fee to guarantee or insure that full line of credit is available when needed. This commitment fee is frequently set at a modest level – for example 0.5 to 1% of the entire line of credit. For those farmers who are concerned about whether or not funds will be available when needed, it may be worthwhile to negotiate such an arrangement and pay a commitment fee.

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