Farm Finance

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Farm Credit Use Up For 6th Straight Year

The volume of farm business debt is expected to increase in 1998 for the sixth consecutive year. Farm credit usage has increased in recent years, buoyed by generally favorable income conditions in the farm sector. Factors at work in 1998 include expectations of quite stable interest rates coupled with overall lower net cash income for the farm sector. Total farm business debt—real estate and non-real estate loans—is forecast to reach about $172 billion by the end of 1998, up about 3.8 percent from 1997 and the highest level since 1985.

At the end of 1997, farm business debt amounted to $165.9 billion, up 6.2 percent from a year earlier. The 1997 increase was the largest annual percentage gain in outstanding loans since 1981 and placed the sector's debt level about $28 billion above the previous low in 1989. In recent years, the growth in nominal farm debt has outpaced inflation. From yearend 1993 to the end of 1997, total farm debt grew 16.7 percent, compared with an increase of 9.7 percent in the GDP deflator, which reflects price changes in all goods and services transactions in the U.S. In contrast, from yearend 1989 through yearend 1993, farm debt grew 3 percent while the GDP deflator increased by 14.4 percent.

Nationwide, farm operators' expanding use of credit is not expected to place excessive demands on their ability to meet their debt obligations. Increases in total farm debt in the 1990's have been well below the double-digit expansions of the 1970's. And total farm debt at the end of 1997 was still 14.4 percent below 1984's peak.

Most agricultural lenders benefited from the continued growth in loan demand in 1997, and these lenders are in a strong financial position in 1998. However, changes in loan volume and the composition of loan portfolios vary among the four traditional classes of farm lenders—commercial banks, the Farm Credit System (FCS), USDA's Farm Service Agency (FSA), and life insurance companies.

Together, these lenders accounted for almost 77 percent of all farm loans outstanding in 1997. The remaining share of farm credit comes from individuals and from nontraditional lenders, primarily input and machinery suppliers, cooperatives, and processors. All farm lender classes saw increases in outstanding loan volume in 1997, except for the government "farm lender of last resort"—the FSA—which accounted for only 5 percent of all farm business loans in 1997.

Activity Up for Real & Non-real Estate Loans

Agricultural lenders generally found the demand for agricultural credit strengthened more for non-real estate than real estate loans both in 1997 and for the period from yearend 1992 through 1997. Farmers are using the increased borrowing to expand operations, update capital, and purchase additional farmland—often at higher prices than a year ago. Real estate, non-real estate, and total outstanding loan volume increased 4.9, 7.6, and 6.2 percent, respectively.

Non-real estate loan volume increased $5.68 billion in 1997, up 7.6 percent from 1996. Non-real estate loans are typically for farm inputs, equipment, and machinery. Some 58 percent of the growth in total farm loan volume in 1997 occurred in the short- to intermediate-term non-real estate loan portfolio. Outstanding non-real estate FCS loans increased by $2.76 billion or 6.9 percent, compared with $5.47 billion, or 8.9 percent, for commercial banks.

In 1998, non-real estate business loans outstanding are anticipated to increase about 4 percent. Farmers are expected to spend about $185 billion for agricultural inputs and $164.4 billion in cash expenses, the same level as 1997 for both, although USDA forecasts increases in prices of most agricultural inputs in 1998. In the first two seasons following enactment of the 1996 farm legislation, farmers planted 261 million acres annually to the eight major field crops (corn, sorghum, barley, oats, wheat, rice, upland cotton, and soybeans). These crops accounted for virtually all of the changes in principal crop acreage during the past 2 years. Total area planted to these crops is projected to decline 1.57 percent in 1998. The expansion in farm business loans following the farm act has been due largely to increases in prices of inputs such as fertilizers rather than to changes in the amount of planted acres.

Strong machinery sales help maintain the demand for short- and intermediate-term farm loans. Unit sales of farm tractors, combines, and other farm machinery were strong in 1997. Purchases of farm tractors totaled 75,608 units, up 13 percent from 1996. Combine purchases were up 7.2

percent to 9,662. Tractor sales are forecast to be strong again in 1998, although they may not reach the 1997 level. Overall demand for machinery, including combines, is anticipated to be steady.

A larger share of loan demand for these inputs is now met by "captive" finance firms owned by the machinery companies. Such nontraditional lenders are defined as institutions whose primary contact with farmers has historically been to provide goods and services other than credit.

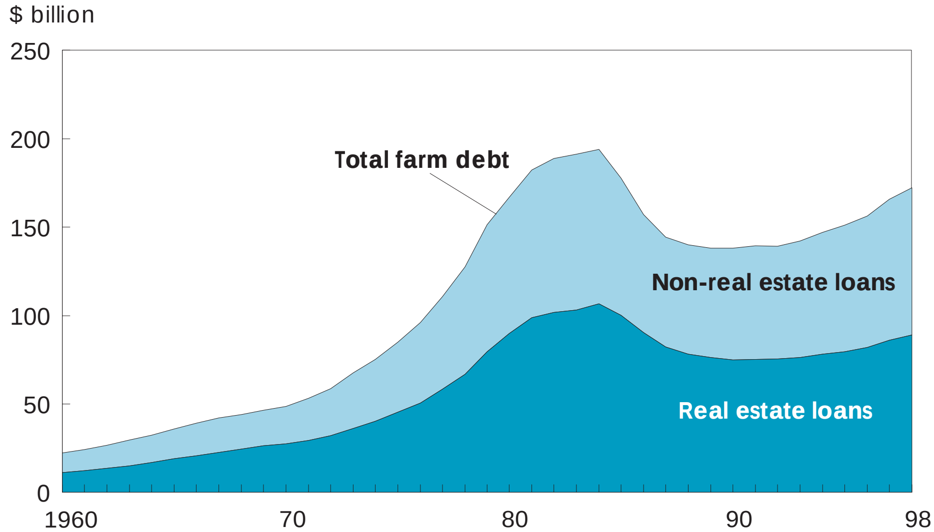
Farm real estate loan volume increased $4.1 billion or 4.9 percent in 1997. Outstanding FCS real estate loans accounted for $1.45 billion or 35.9 percent of the increase; commercial banks gained $1.96 billion or 48.6 percent of the total increase. FCS reported a 5.6-percent increase in farm mortgage loans outstanding for the year ending December 31, 1997. This compares with 3.5 percent in 1996 and 0.8 percent in 1995. Among life insurance companies, total farm real estate lending activity (their entire farm loan portfolio) was up 4.8 percent during calendar 1997.

Outstanding farm real estate loans are expected to increase about 3.5 percent in 1998. Activity in the land market and higher farmland prices should continue to create stable demand for mortgage loans (real estate credit). U.S. farmland values per acre increased 6.2 percent in 1996, 5.8 percent in 1997, and are expected to advance about 5 percent in 1998, marking 12 straight years of U.S. farmland value increases.

The increase in nominal U.S. farmland values during 1993-97—35.9 percent—tripled the 11.5-percent increase in the GDP deflator. In contrast, the rate of increase in farmland values following the 1987 low lagged inflation through 1992. The 1993-97 increases represent the strongest yearly gains, both in nominal and real terms, since the recovery began in 1987.

Farmers are expected to use their available credit lines more fully in 1998 than in 1997, based on ERS projections of the maximum debt that farmers could repay out of current income. The amount of farmers' income available for payments on loans determines the maximum debt

Farm Business Debt To Rise Again in 1998



1998 forecast.
Economic Research Service, USDA

farmers can take on, given current interest rates and loan terms.

The *debt repayment capacity use* (actual debt expressed as a percentage of maximum feasible debt) will increase for the second consecutive year to about 61 percent in 1998—although it remains close to the 1990-95 average and is well below the levels of the early to mid-1980's. Farmers in 1997 tapped a greater share of the credit estimated to be available to them (56 percent) than in 1996 (49 percent) in order to maintain or expand their operations. The effect of favorable interest rates throughout 1997 was not sufficient to offset the combined effects of rising debt and lower net cash income. The 1996 level represented a drop in use of debt repayment capacity from the previous year despite a rise in farm business debt, as net cash income levels rose and interest rates declined.

Lenders Respond to Growth

From yearend 1992 through 1997, total farm debt grew $26.6 billion or 19.1 percent. Commercial banks led the growth with $15.4 billion, followed by nontraditional lenders with $8.5 billion and the FCS with $4 billion. Total debt expansion in 1998 is expected to be about $6.3 billion, compared with the 1997 increase of $9.7 billion.

Commercial banks, the largest source of farm business credit, accounted for 40.5 percent of all farm loans outstanding at yearend 1997. The total volume of outstanding farm loans by commercial banks reached $67.2 billion in 1997, up 8.9 percent from 1996. For farm real estate lending alone, the expansion was even stronger, rising 8.4 percent and marking the 15th consecutive year of gains. Commercial banks accounted for 56 percent of the growth in total farm debt outstanding in 1997.

The recent growth in farm loan demand experienced by commercial banks is reflected in their loan-to-deposit ratios. In the year ending September 30, 1997, average loan-to-deposit ratios grew to 70.3 percent for agricultural banks, up from 59.7 percent 4 years earlier. Agricultural banks are those whose ratio of farm loans to all loans is higher than the average for all other banks.

High loan-to-deposit ratios do not necessarily constrain the origination of new loans. Commercial banks have many nondeposit sources of funds, and profitable, well-managed banks often have very high loan-to-deposit ratios. Although rural banks make considerably less use of nondeposit funds than banks headquartered in metropolitan areas, evidence shows that most rural banking markets are served by

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Farmers & Bankruptcy Law Reform

The current debate on national bankruptcy policy is affecting agriculture, with Federal legislation pending that would extend the life of the flexibility provisions for family farmers under Chapter 12 of the bankruptcy code. The rising tide of bankruptcy filings in the U.S. despite a strong economy has prompted legislative proposals to address the problem. In 1997, a record 1.4 million bankruptcy petitions were filed, up 19.1 percent from a year earlier and the seventh consecutive annual record.

The National Bankruptcy Review Commission, authorized in 1994, presented a 1,498-page report to Congress with 172 recommendations in October 1997. The report contains a chapter on farmer bankruptcy, including recommendations to make Chapter 12 farmer bankruptcy legislation permanent, to increase the eligible debt limit from $1.5 to $2.5 million per farm, and to change payment procedures of bankruptcy court trustees. For the agricultural sector, income risk has increased, adding to the significance of the bankruptcy issue—under the 1996 Farm Act, farm payments are no longer tied to commodity prices. Although no major, sustained weather adversity has occurred since implementation of the 1996 farm legislation, this perennial threat adds another factor to the agricultural bankruptcy equation.

A revised bankruptcy policy is likely to emerge in the current Congress, driven by the impending Chapter 12 sunset date of October 1, 1998, and by popular support for extending protections for family farmers. Chapter 12, which originated with the Family Farmer Bankruptcy Act of 1986, was a response to the farm financial crisis of the early to mid-1980's. Added to the bankruptcy code on November 28, 1986, Chapter 12 was set to expire on October 1, 1993, but Congress extended it for another 5 years.

In July 1997, legislation was introduced in the Senate to make Chapter 12 permanent, and passed by voice vote in October. The House has not acted on this legislation, but a bankruptcy package that includes Chapter 12 extension was passed by the Judiciary committee on May 14, 1998.

Chapter 12 gives family farmers considerably more leverage to demand concessions from lenders in the bankruptcy process than under the code normally governing reorganization of business debt (Chapter 11). Most farmer bankruptcy reorganizations are now filed under its provisions. Chapter 12 allows family farms (as defined in the bankruptcy code) with regular income to adjust their debts and protect their assets. It makes available to farmers a bankruptcy procedure whereby debtors submit a repayment plan directly to the bankruptcy court, with no review by creditors (the equivalent of a Chapter 13 bankruptcy program for individuals with regular income). Chapter 12 bankruptcy plans are made for 3 years, but with court approval may be extended to 5 years.

Creditors cannot reject a court-approved debt repayment plan developed under Chapter 12 if the plan will provide them at least as much as under a Chapter 7 filing, in which debtor assets are liquidated. Farmers can reduce the amount they owe, extend the payment period, and lower the interest rate on existing loans to the current fair market rate or lower. As a consequence, secured creditors' bargaining positions are weakened. The writedown or "discharge" of secured debt is limited to the current market value of the underlying land or other asset, which can be less than the original loan value. In return, the farmer agrees to a repayment plan for the remaining debt.

When Chapter 12 went into effect in 1986, its immediate impact was to slow the pace of farm liquidations. Since its enactment through December 1997, some 19,610 cases have been filed under its provisions. The farmer bankruptcy rate, based on Chapter 12 data, has stabilized, although at a level above that for all farmer bankruptcies prior to the farm financial crisis of the early to mid-1980's.

Chapter 12 presents policymakers with a dilemma. Do the benefits of Chapter 12 outweigh the costs? And how are the costs distributed? If failing economic operations should not survive, then Chapter 12 has not been a success. According to ERS analysis, the major marginal effect is to encourage both inefficient farmers, who would otherwise liquidate, and efficient farmers, who would otherwise continue their operations at greater expense, to reorganize their businesses under the protection of bankruptcy. The Chapter 12 provisions increase the legal and administrative costs of bankruptcy by encouraging bankruptcy filings by some farmers who would not otherwise have done so. They also raise indirect costs by giving farmers the opportunity to reorganize inefficient farms, although this impact could be mitigated by allowing lenders to recapture writedowns in secured debt if asset values recover.

If good social policy dictates keeping farmers in business regardless of their profitability, then Chapter 12 has succeeded. It provides family farmers facing bankruptcy a streamlined means to reorganize their debts and keep their farms. And the impact of Chapter 12 goes beyond the 19,610 farmers who have filed under its provisions through 1997 because the potential leverage it affords debtors encourages lender-borrower negotiations out of court and encourages more prudence in granting farm credit.

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For more information on bankruptcy and other issues in agricultural and rural finance, visit the Economic Research Service web site at http://www.econ.ag. gov/epubs/pdf/aib724/

banks that use nonlocal sources of funds to some extent. Overall, adequate funds are available from banks for agricultural loans, with few banks reporting a shortage of loanable funds.

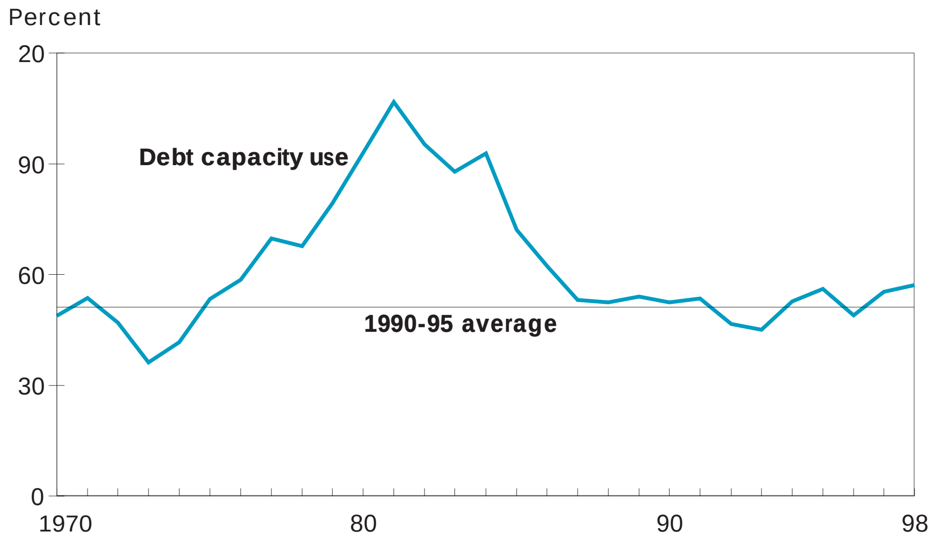
Overall lending by individuals and others will increase about 5 percent. This category includes land contract sales of real estate, and merchant and dealer credit on the non-real estate side. The growth of merchant and dealer credit is forecast to expand over 7 percent in 1998, with much of this growth generated by captive or subsidiary finance divisions of farm input suppliers. Life insurance company lending to farmers is expected to be quite strong in 1998, with a forecast growth of 4 percent. Active companies continue to have sufficient loanable funds to meet demand and are aggressively competing on rates, terms, and loan-to-value ratios.

The FCS—a collection of federally chartered, borrower-owned credit cooperatives that lend primarily to agriculture—held total farm business loans of $42.6 billion at the end of 1997, up 6.9 percent from a year earlier. It accounted for 28.4 percent of the increase in all outstanding farm loan volume in 1997. FCS non-real estate loans grew by an impressive 45.4 percent from yearend 1993 through 1997. FCS mortgage debt is expected to rise about 3.8 percent in 1997, the fourth consecutive annual gain after declines in 9 of the previous 10 years.

The FCS, which has access to national money markets and can provide needed farm credit at competitive rates, is well positioned to supply farmers' future credit needs. The system has demonstrated financial strength in recent years while undergoing massive restructuring of its organization and procedures. In an effort to enhance loan quality and expand market share, the FCS is offering farm customers competitive interest rates and credit arrangements. The FCS gained farm loan market share the past 3 years after a gradual loss over the previous 12 years, and in 1998, FCS farm business debt is forecast to increase about 3.5 percent.

FSA outstanding farm loans declined in 1997. The agency held only 5 percent of all farm business debt in 1997, down from 16.3 percent in 1987. The availability of direct FSA loans to operators of family-sized farms unable to obtain credit elsewhere continues to decline as the agency continues the emphasis on guaranteed loans that began in the early 1980's. Despite adequate loan authority in fiscal 1997, total FSA direct loans decreased 8.7 percent in calendar 1997 to $8.3 billion, and its loan portfolio is expected to continue declining.

Farm Loans As Share of Repayment Capacity Is Stable



1997 and 1998 projected; based on Economic Research Service projections of maximum debt that farmers could repay out of current income.

Economic Research Service, USDA

FSA's funding authority to *guarantee* loans by commercial and cooperative lenders will be down 11.6 percent in fiscal 1998. Loan guarantees totaling $1.57 billion were issued in fiscal 1997, down 14.9 percent from fiscal 1996, despite the emphasis on guaranteed loans. FSA loan demand in 1998 is difficult to predict because it depends in part on the extent of adverse weather as well as on economic conditions that affect the farm sector. The increase in farm business loans guaranteed by the Small Business Administration in recent years has resulted in a downturn in demand for FSA-guaranteed loans.

Adequate Credit Access in 1998

The outlook for 1998 indicates that competition remains keen among lenders for high-quality farm loans. Trends in the general economy should maintain stable to lower interest rates, which will tend to sustain farm loan demand.

But the generally favorable conditions that have strengthened the financial position of farm lenders over the past several years could change somewhat in 1998. Lenders will be dealing with a farm sector whose economic performance is forecast to be slightly under the 1990-97 average. Net cash income declined 8.2 percent in 1997 and is forecast to decline another 5-6 percent in 1998. And the impact of the forecast decline in 1998 will not be evenly distributed over all farm operations but will vary by region, commodity, and farm size.

Producers continue to be cautious in acquiring new debt, and lenders continue to carefully scrutinize the creditworthiness of borrowers. Farmers will need to demonstrate adequate cash flow, and some marginal operators and beginning farmers will continue to lack credit access. Some farmers experiencing rising debt and/or lower net cash income may have difficulty meeting their debt service obligations. But farmers who are good credit risks are in a strong position to acquire credit in 1998.

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