Farm Finance

Jack Harrison

Farmers to Cut Borrowing Amid Income Uncertainty

In 1999, after 7 years of debt expansion, farm-sector borrowing is expected to decline by $1.3 billion. Low prices for many key agricultural commodities, and significant weather and disease problems in some regions, have both farmers and their lenders concerned about farmers' ability to repay existing loans and qualify for new production loans. While net cash farm income has been strong in recent years and 1999 is forecast to be above the 1990-98 average, last year saw increasing variability in farm-sector economic performance by region and commodity.

Debt Level Still Relatively High

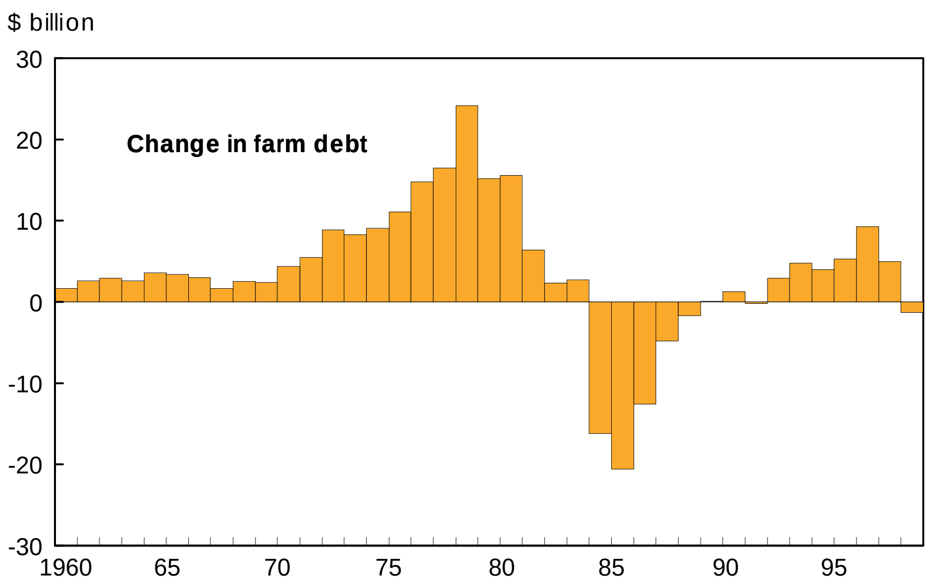
Since yearend 1992, total farm business debt has grown 22.5 percent—$31.3 billion—with nearly half of that increase coming in 1997-98. Farm business debt—real estate plus nonreal estate loans—is estimated at $170.4 billion at yearend 1998, up 3 percent compared with a 6-percent increase in 1997. But a projected decline of 0.5 to 1 percent in 1999 will reduce total farm debt to about $169 billion, still the second-highest debt level since 1985. The decline in part reflects a change in farmers' outlook toward debt. Both farmers and lenders learned during the farm financial crisis of the 1980's that borrowing cannot substitute for adequate cash flow and profits.

The 1999 forecast reflects a relatively low incidence of farmers borrowing their way out of cash-flow problems, as well as the likelihood of fewer new capital investments. Adequate levels of working capital as well as additional Federal funds made available by legislation passed in 1998 are also helping to reduce loan balances and hold down new borrowing. Given the expectation of lower prices and income in 1999, as well as continuing uncertainty about economic recovery in nations that are major importers of U.S. farm products, farmers are likely to remain cautious about debt use.

Farm income is projected to decline in 1999—net cash income by 6 percent and net farm income by 7 percent. In 1998, incomes were lower for many farmers—particularly those specializing in corn, wheat, soybeans, and hogs—as continued high levels of production for many farm commodities were more than offset by substantial price declines. This year promises to be financially challenging for these farmers. Although numerous farm subsectors were profitable in 1998—e.g., broilers, cattle, vegetables, fruits, nursery and greenhouse products—and have a strong outlook for 1999, subsectors with losses will outweigh those with gains.

Favorable trends in the general economy should continue to maintain stable interest rates, and farm-sector equity will rise by

Farm Debt to Head Down in 1999 After Rising Since 1993



1999 forecast.

Economic Research Service, USDA

$16.9 billion, primarily because of rising farmland prices. But neither higher equity nor stable—or even lower—interest rates may be sufficient to offset the effect of lower incomes. Even if farmers lower their credit use in 1999, USDA's Economic Research Service is forecasting that lower income will cause farmers' use of debt repayment capacity—the maximum debt that could be repaid from current income—to rise to 57 percent in 1999, up from 55 percent in 1998 and 53 percent in 1997.

Nonreal Estate Loans Grow Faster

Four institutional lenders—commercial banks, the Farm Credit System (FCS), USDA's Farm Service Agency (FSA), and life insurance companies—accounted for 77.5 percent of all farm business loans outstanding at yearend 1998, with the remaining share held by individuals and nontraditional lenders, primarily input and machinery suppliers, cooperatives, and processors. Except for the FSA, farm lenders' outstanding loan volume increased in calendar year 1998.

Agricultural lenders generally found the demand for agricultural credit strengthened more for nonreal estate than for real estate loans in 1998. Total loan volume outstanding increased 3 percent, with nonreal estate loans up 3.4 percent and real estate loans up 2.6 percent. This was the sixth straight year that growth in nonreal estate loans exceeded growth in real estate loans, but the volume of outstanding real estate debt still surpasses nonreal estate debt—$87.8 billion compared with $82.8 billion.

Nonreal estate business loans outstanding increased $2.72 billion in 1998, some 55 percent of the 1998 rise in farm debt. Nonreal estate loans—mainly short- to intermediate-term loans—are typically used for farm inputs, equipment, and machinery. FCS outstanding nonreal estate loans increased $597 million—3.9 percent—while commercial banks' rose $1.51 billion—3.6 percent.

Despite adequate FSA loan authority in fiscal 1998, total FSA nonreal estate loans outstanding decreased 4.1 percent in calendar 1998 to $4.1 billion and are forecast to be about the same level in 1999. However, although total direct FSA obligations (operating, ownership, and emergency) declined to $739 million, down 0.8 percent from fiscal 1997, direct operating loans alone—funds used primarily to meet production expenses—were up 8 percent over fiscal 1997, reaching $557 million.

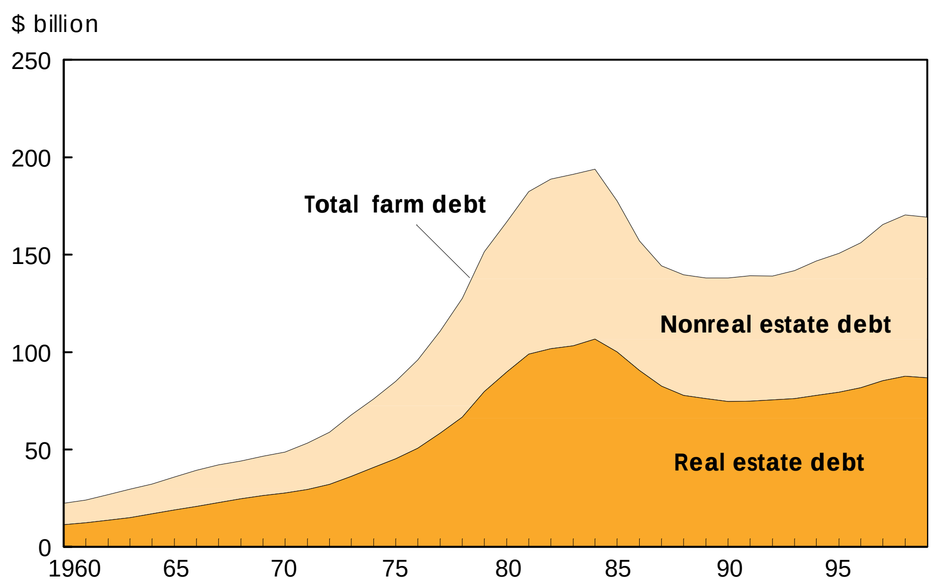
In 1999, nonreal estate loans outstanding should decrease about 0.5 percent based on production and expense projections. Total planted acres for eight major field crops—corn, sorghum, barley, oats, wheat, rice, cotton, and soybeans—are projected to decline 2.1 percent to 250.7 million acres. Since these eight crops accounted for virtually all the fluctuations in field crop acreage in recent years, input quantities will likely stay near or slightly lower than 1997 and 1998 levels, assuming no major change in production practices.

With production, input quantities, and input prices projected to remain fairly stable, farmers' production expenses in 1999 are expected to total $186.1 billion, up 0.5 percent over 1998, but still 1.3 percent below total 1997 production expenditures. These decreases relative to 1997 are the first significant declines in production expenses since the 6-percent declines in 1985 and 1986. Cash production expenses are forecast to increase only 0.4 percent in 1999, still 1.7 percent—$2.9 billion—below the 1997 level, and farm-sector interest expenses are anticipated to decline 3.1 percent to $13.7 billion, a drop of $431 million.

Reduced machinery sales in 1999 will also dampen the demand for short- and intermediate-term farm loans. Unit sales of farm tractors, combines, and other farm machinery continued the strong trend of recent years into 1998 before dropping off significantly in the second half of the year. The overall farm machinery sales forecast for 1999 is for a significant decline across a range of equipment. The Equipment Manufacturers Institute (EMI), for example, projects lower sales for many equipment categories, including declines of 8 percent for 2-wheel-drive tractors, 17 percent for 4-wheel-drive tractors, and 15 percent for self-propelled combines.

Farm real estate loans outstanding increased $2.2 billion in calendar 1998. Commercial banks' real estate loan portfolios, holding 31 percent of total real estate debt, increased $1.4 billion—5.7 percent—marking the 16th consecutive year of gains in commercial bank real estate loans. FCS real estate loans were

Nonreal Estate Debt Now About Half of Farm Debt



1999 forecast.

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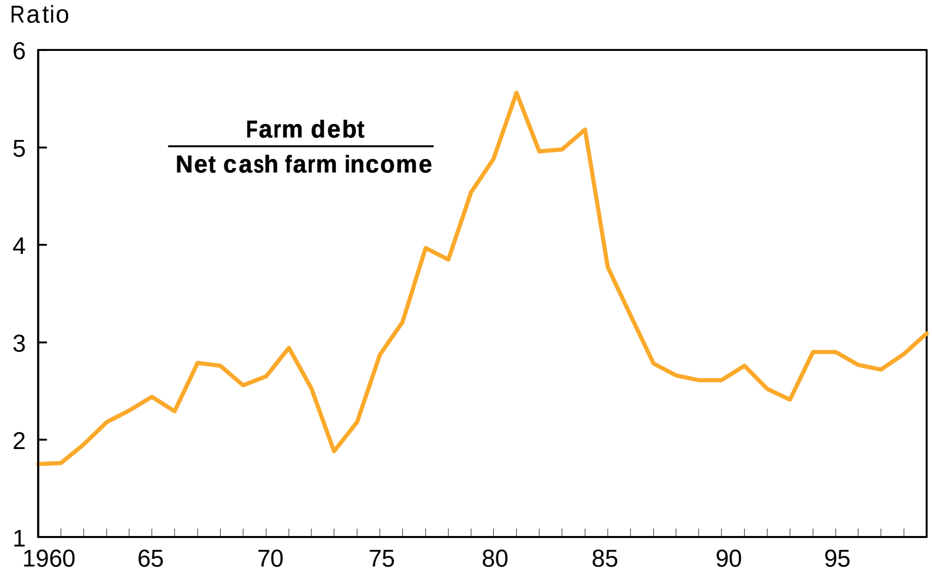
up $1 billion—3.7 percent—and life insurance companies' real estate loan portfolios gained about $220 million—2.3 percent. However, FSA real estate loans dropped $247 million—5.7 percent—and loans by individuals and others fell $187 million—1 percent.

For 1999, farm real estate loans outstanding are expected to decrease about 1 percent, in part reflecting reduced demand for mortgage loans (real estate credit) from smaller increases in farmland prices. U.S. farmland values have risen for 13 straight years (1987-99 inclusive). Per-acre U.S. farmland values increased an estimated 5.2 percent in 1997 and 1.8 percent in 1998, but are expected to slow to 1.5 percent in 1999, partly because of lower expected returns from farming. Falling commodity prices may disproportionately affect land values in areas specializing in commodities that are experiencing price declines.

U.S. Farm-Sector Debt Remains Manageable



1999 forecast.
Economic Research Service, USDA

Lenders Remain Strong, But More Cautious

Continued growth in loan demand contributed to the robust financial condition of most commercial agricultural lenders in 1998, and these lenders are in a strong position in 1999. However, the composition of loan portfolios and changes in loan volume vary among the four traditional farm lender categories.

Commercial banks are the largest source of farm business credit, accounting for 41 percent of all farm loans outstanding in 1998 and nearly 60 percent of 1998 growth in total farm debt outstanding. Commercial banks' total outstanding farm loan volume reached $69.9 billion in 1998, up 4.4 percent from 1997.

The FCS—a collection of federally chartered, borrower-owned credit cooperatives that lend primarily to agriculture—held 25.8 percent, or $43.9 billion, of total farm business loans at the end of 1998, up 3.8 percent from a year earlier. The FCS accounted for 32.5 percent of the increase in all farm loans outstanding in 1998. FCS nonreal estate loans have made a strong showing in the past 5 years, gaining 50.3 percent during 1993-98. The FCS real estate loan market share reached 32.1 percent, edging up for the third consecutive year after a decade of decline from the 43.7-percent share held in 1984.

Direct loans from FSA, the government "farm lender of last resort," accounted for 4.8 percent of all farm business loans at yearend 1998, down from 5.2 percent in 1997. FSA's total direct loans outstanding decreased 4.9 percent in calendar 1998 to $8.2 billion, with real estate debt down more than nonreal estate debt.

Lenders have grown more cautious in extending agricultural credit. While the current situation does not warrant the label of crisis, the farm loan portfolio losses of the early to mid-1980's are a recent memory. Lenders in 1998 were able to manage most farm loan repayment challenges given relatively healthy farm incomes in recent years and additional Federal financial assistance. The 1999 farm financial situation is not expected to lead to unmanageable deterioration in lenders' portfolios. But if conditions that materialized in the agricultural sector in 1998 persist—i.e., lower farm prices for key commodities, coupled with uncertainties about the duration of the downturn—lenders will increasingly face requests for renewal of poorly performing loans and for new loans to customers who are less creditworthy. Given a possible drop in income and tighter credit standards, some farmers would need to reconsider any plans to use debt capital.

During the downturn of the 1980's, farm lenders learned that credit should not be used as a replacement for lost earnings, and that earnings, not asset inflation, assures debt repayment. Losses to both lenders and farmers made it clear that farm businesses need a positive cash flow in order to manage debt obligations successfully.

Today, despite low commodity prices, lenders appear confident about the majority of their farm customers. Most farmers are not as heavily leveraged (indebted) as they were 10-15 years ago. Veteran lenders cite significant differences from the 1980's, including lower interest rates, greater

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Full report (ERS-AIS-71) is available on the ERS website at
http://usda.mannlib.cornell.edu/reports/erssor/economics/ais-bb/1999/

owner equity, better credit analysis and monitoring methods, and improved management skills of producers. Lenders, on sounder financial footing themselves, have greater flexibility to work with financially stressed customers to restructure debt and provide credit for operating expenses.

The farm financial crisis of the 1980's altered the agricultural lending environment. A general enhancement of loan oversight resulted in tighter regulation for all types of agricultural lenders, and lender regulators now insist that banks follow strict guidelines for approving borrowers and that loans conform to sound banking practices. Bank examiners currently report few problems with underwriting practices for agricultural loans. They do, however, continue to monitor the extent to which banks' agricultural loan portfolios are tied to major crops affected by declining payments under the 1996 Farm Act, as well as the usual performance measures of banks' soundness, such as capital and asset levels.

As the banking industry continues to move toward reducing lenders' risk, the ongoing changes are putting added pressure on producers. Loan application procedures are becoming more complex, and loan approval may be harder to obtain because lenders' cash flow projections based on expected commodity prices indicate some farmers may have added difficulty meeting debt service requirements.

Can Lenders Supply Adequate Credit?

Readily available and reasonably priced credit facilitates the high-technology production methods necessary for U.S. producers to compete in global markets. Currently, overall availability of funds is not a problem, since agricultural lenders have more loan money on hand than they can profitably lend to the pool of creditworthy borrowers made smaller by current short-term price projections. Clearly, any credit crunch that borrowers may perceive in agriculture is not from reduced availability of funds but from recent changes in methods for loan processing and credit analysis—changes that were implemented in response to the current risk environment surrounding agricultural credit but based on lessons from the past.

The FCS is well positioned to supply farmers' future credit needs. It has demonstrated financial strength in recent years as it underwent massive restructuring of its organization and procedures. The FCS has access to national money markets and can provide needed farm credit at competitive rates. In 1999, FCS farm business debt is forecast to decrease about 2.2 percent, with mortgage debt expected to decline 1.7 percent and nonreal estate debt to decline about 3 percent. But FCS has gained farm loan market share the past 4 years (1995-98) after a gradual loss of share the previous 10 years.

The recent growth in commercial bank farm loan demand is reflected in agricultural banks' average loan-to-deposit ratio, which grew to 72.5 percent in the year ending September 30, 1998, up from 57 percent 6 years earlier. High loan-to-deposit ratios do not necessarily constrain the origination of new loans, since 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 do banks headquartered in metropolitan areas, banks in most rural markets today can access nonlocal sources of funds. Overall, most banks have adequate funds available for agricultural loans, although a few report a shortage of loanable funds.

Requests for FSA loans is one indicator of farm financial health, typically increasing when farm financial conditions deteriorate. The pace of applications for FSA assistance and loan obligation volume in the first quarter of fiscal 1999 was up from the same quarter a year earlier. FSA's fiscal 1999 total loan authority—covering direct and guaranteed loans for ownership, operating, and emergency purposes—is up 17.7 percent over fiscal 1998 obligations. Federal funding for FSA-guaranteed loans—69 percent of FSA's fiscal 1999 authority—continues to be considerably greater than the amount authorized for direct loans to operators of family-sized farms unable to obtain credit elsewhere. In fiscal 1998, FSA issued loan guarantees—for loans made by commercial and cooperative lenders—totaling $1.44 billion, down 8.8 percent from a year earlier. FSA's fiscal 1999 authority for loan guarantees is up 13.7 percent.

FSA authority to issue direct loans (ownership, operating, and emergency) is up 27.4 percent for fiscal 1999. On February 26, 1999, the Administration requested a supplemental appropriation that would include authority for $105.6 million to support additional FSA farm loans of $1.1 billion, 51.1 percent for direct loans. Passed by the House and Senate, this legislation is pending in conference.

The general financial health of agriculture today is stronger than in the mid-1980's when the sector last experienced significant financial stress. Overall, agricultural borrowers are less leveraged and more liquid, and those who survived the 1980's are probably better financial managers today. Clearly, however, agricultural lending is embarking on an era of increased uncertainty that translates into more stress for specific portfolio segments. Many of the contributing factors are beyond the control of individual farmers and lenders, and certain critical factors, such as weakened ability of foreign customers to buy U.S. agricultural products, may not go away soon. AO

Jerome Stam (202) 694-5365 and James Ryan (202) 694-5586
jstam@econ.ag.gov
jimryan@econ.ag.gov

Upcoming Reports—USDA's Economic Research Service

The following reports will be issued electronically on dates and at times (ET) indicated.

May

12 World Agricultural Supply and Demand Estimates (8:30 a.m.)
*13 Cotton and Wool Outlook (4 p.m.)***
*Oil Crops Outlook (4 p.m.)***
*Rice Outlook (4 p.m.)***
*14 Feed Outlook (9 a.m.)***
*Wheat Outlook (9 a.m.)***
*18 Sugar & Sweeteners Yearbook**
*20 Agricultural Outlook**
25 Livestock, Dairy, and Poultry (4 p.m.)
U.S. Agricultural Trade Update (3 p.m.)

*Release of summary, 3 pm
**Available electronically only