Southern Agricultural Lending and Farm Credit Conditions

Bryon J. Parman and Max W. Runge

Loan Demand and Repayment

With the majority of US farmers and ranchers needing loans for operation or expansion, borrowing costs and fund availability are an important component of US production agriculture. In the decade from 2005 to 2015, high farm incomes and rapidly appreciating agricultural asset values, primarily land, encouraged liberal lending practices by agricultural credit providers. With farmers enjoying relatively higher net incomes, producers required relatively less funds opting to self-finance in some cases. Moreover, interest rates began to decline reaching historic lows after 2010. As a result, interest as a percentage of operating expenses for farms nationwide declined drastically through 2012 (Figure 1).

Following the downturn in commodity prices that began in 2014, demand for agricultural loans has risen. Figure 2 from the Federal Reserve Bank of Kansas City illustrates the dramatic increase of farm operating loans beginning toward the end of 2013 and continuing through 2016. Specifically within the Southern region which includes Texas, Oklahoma, Louisiana, Arkansas, Kentucky, Tennessee, Mississippi, Alabama, Georgia, The Carolina's and Florida, demand for loans has been higher in subsequent years peaking at 40% higher in the first quarter of 2015, and 30% higher at the beginning of 2016 (Federal Reserve Bank of St. Louis).

While demand for loaned funds has increased due to tighter profit margins for southern producers, loanable fund availability has declined as well as the rate of loan repayment. The St. Louis Federal Reserve *Ag Finance Monitor* reports that relative to 2013, loanable fund availability was nearly 20% lower in the 2nd quarter of 2014, 40% lower in the 2nd quarter of 2015, and projected to have be 30% lower in 2016. The same report shows that the loan repayment rate across much of the south has declined nearly 50% from the 2nd quarter of 2013 through the 1st and 2nd quarters of 2016 (Figure 3).

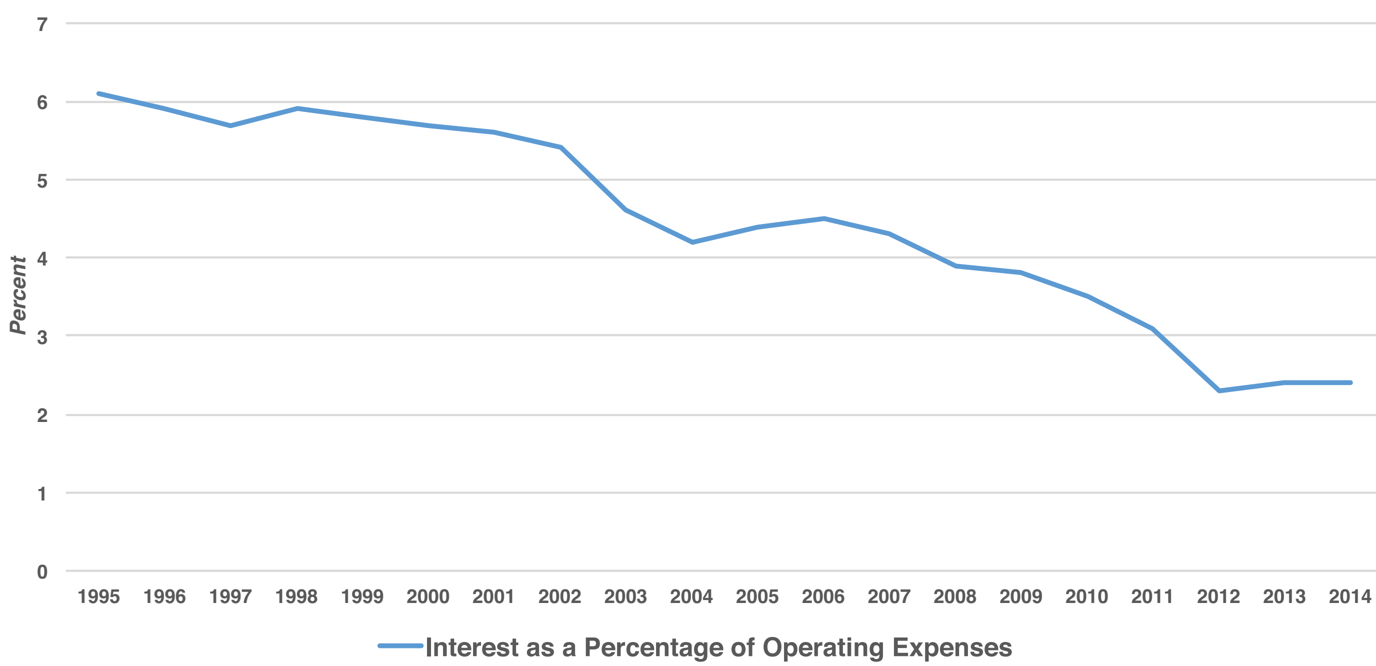

Figure 1. Interest as a Percentage of Agricultural Production Expenses.
Source: USDA, National Agricultural Statistics Service, Quick Stats.

Interest Rates

Perhaps the lone bright spot for borrowers struggling with debt has been that interest rates continue to remain low across the United States and in the Southern region. Figure 1 shows the decline in interest rates as a percentage of operating expenses. However, during periods of farm financial hardship, high interest rates and low or negative cash flows creates a negative feedback loop accelerating leveraged farms into dangerous financial situations. If interest rates are high, and farm profitability is low or negative, servicing any new debt becomes an additional burden on an already strained cash flow situation. If the situation continues, and the

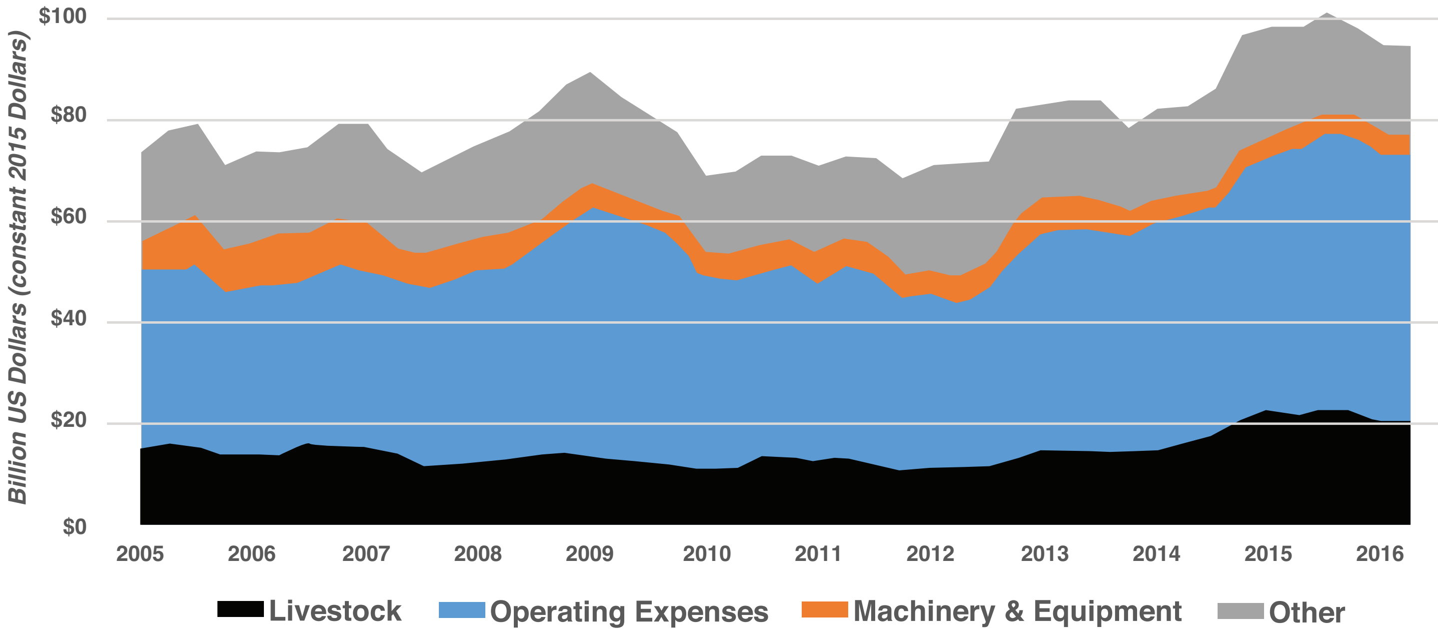

Figure 2: Non-Real Estate Farm Loans by Purpose, 2005 - 2016.
Source: Federal Reserve Bank of Kansas City. *Agricultural Finance Databook*, Table A.3, *https://www.kansascityfed.org/~/media/files/publicat/research/indicatorsdata/agfinance/tables.pdf*

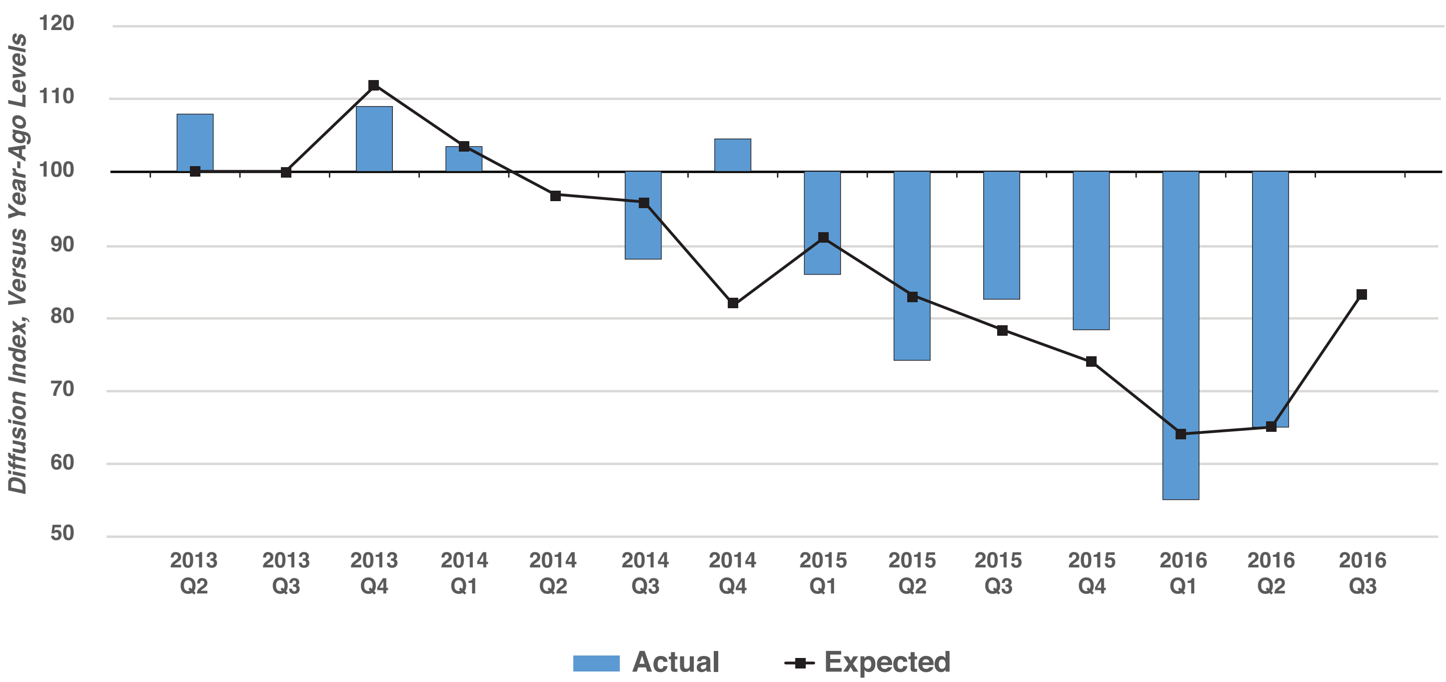

Figure 3: Rate of Loan Repayment Across the 8th Federal Reserve District
Source: Federal Reserve Bank of St. Louis. *Agricultural Finance Monitor*, Second Quarter 2016, p. 6.

Table 1: Loan to Value Ratio's in the Mississippi Delta Region.

Loan-to-value rations for selected 2016 vs. 2015 agricultural loans			
	2016	***2015***	***Spread***
Land/Real Estate	75%	78%	-3%
Machinery/Medium Length	73.8%	75.6%	-1.8%
Cattle/Livestock	63.5%	66.8%	-3.2%

Source: Mississippi State University Extension, "Mississippi Credit and Lending Conditions: 2016," Publication Number P2968, *http://extension.msstate.edu/publications/publications/mississippi-credit-and-lending-conditions-2016*

producer becomes less credit worthy, the end result is often bankruptcy.

According to the Federal Reserve Bank of Dallas, fixed interest rates across Texas and Northern Louisiana remain mostly unchanged in 2016 hovering around 6% for operating, cattle, machinery, and real estate loans. Interest rates across the 8th Federal Reserve District in St. Louis which includes Arkansas, Tennessee, Northern Mississippi and Western Kentucky reports fixed interest rates slightly lower than Texas on average at around 5.2 – 5.5% for real estate and operating loans respectively. Mississippi State University's 2016 Survey of Lenders reports interest rates lower than that of the St. Louis Federal Reserve with long, intermediate, and short term rates all around 4.6%.

The benchmark for the interest rate is generally set by the US Federal Reserve. While interest rates given to farmers are usually much higher than the Federal Funds Rate, increases/decreases in the Federal Funds Rate translate into changes in what farmers can expect to pay in interest. The last increase in the Federal Funds Rate occurred in December of 2015 where the Federal Reserve increased rates from 0 - 0.25% to 0.25% - 0.50%. As recently as September 2016, the Federal Reserve announced that the next rate hike may occur toward the end of 2016. While no major plans are in place currently to increase rates much above where they stand right now, an increase of just 1% - 2% could put many producers in jeopardy of becoming unable to service any new debt.

Credit Availability

With three successive years of low commodity prices from 2014 through the present, farmers have been forced to burn through any operating capital reserves generated in the decade prior, and recently has begun eroding asset values/owner equity. The Mississippi State University Survey of Lenders reports that 61% of Southern farmers have less than one year's operating capital available while the other 39% have just over one year remaining. The same report finds that, on average, 21% of farm operators were unable to pay off their 2015 operating loan in its entirety and were forced to convert it into intermediate-term debt. Many in the lending and agricultural finance community believe the percentage of farmers unable to repay 2016's operating debt will be larger than last year.

The current state of higher agricultural loan demand and less favorable financial projections for Southern farms has begun to strain the Federal Farm Programs. Farm Service Agency (FSA). Demand for FSA backed operating loans were up 22% in 2016 while demand for FSA backed real estate loans were up 27% (Looker, 2016). For the most part, FSA Direct and Guaranteed loans are intended for "New and Beginning" farmers, or other targeted groups where the FSA backs loans that conventional lenders would not normally fund. However, with many producers across the United States and the South unable to cash flow their enterprises recently, demand for FSA loans has been overwhelming.

Tightening of the credit belt can be reflected in the Loan-to-Value or "LTV" ratios lenders are offering. The LTV rate is the percentage of new purchases lenders are willing to finance. A higher LTV percentage indicates that lenders are willing to take more risk and are more optimistic regarding repayment or asset appreciation. A recent publication from Mississippi State University Extension, "Mississippi Credit and Lending Conditions: 2016," based on a survey of agricultural lenders, appraisers, farm managers and agricultural economists shows that the average loan-to-value rate are lower in 2016 than in 2015 (Table 1). While earlier data is unavailable, conversations with agricultural loan officers and creditors suggest that LTV's prior to 2015 were as high as 80% or 90% for farm real estate loans prior to 2013 when asset values were appreciating rapidly.

The lower LTV rates indicate a weakening in farmer credit worthiness and repayment capacity from the lenders surveyed. Decreasing farm equipment values has also affected lenders guidelines for collateralizing debt with farm equipment. According to the 2016 Mississippi State report, some lenders allow up to 80% of the book value of farm equipment, but the average is 62.7 on new loans.

Summary and Outlook

The most important question going forward concerns how long input/output prices stay such that many farmers are unable to cover year to year expenses. If input costs can soften enough or farmers can forward contract themselves closer to break-even, the current farm financial situation need not look like farm financial crisis' of decades past.

However, should things continue into 2017 and beyond similar to 2014 – 2016, there does not exist an unlimited supply of loanable funds. As more and more farmers are forced into transforming operating loans into term debt, more farmers may find themselves unable to secure financing in subsequent years. Further compounding the problem is that lenders can only afford to carry a limited number of underperforming loans. Farm program have also shown that they may lack the capacity to keep up should demand for FSA backed loans increase markedly in the next few years.

Perhaps the largest concern for farmers and lenders is the erosion of creditworthiness. Debt to asset ratio's and debt to equity ratios in 2016 remain strong, still hovering near 12.45% and 14.21% respectively. While not as low as seen in 2013 (the strongest year in the last decade), those ratio's indicate that the average Southern producer is not overleveraged. However, should producers accelerate the use of equity to finance debt, the value of their assets/ equity will inevitably decline accelerating the rate of creditworthiness erosion. In essence, several successive years of losses could turn what was once a financial strength into a weakness rapidly at the same time that producers need funding the most.

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