Chapter 15

RUSSELL C. ENGBERG
Farm Credit Administration

Lenders' Problems in Meeting Changing Credit Needs

LENDERS MUST DO MORE than simply provide the amount of loans needed if they are adequately to serve the credit needs of a dynamic agriculture. The quality of credit service is equally important. In this sense, quality includes competent and intelligent evaluation of the prospects and risks in the operation to be financed, counseling on financial management when appropriate, and adaptation of the credit line to the individual requirements, including particularly the schedules of advances and repayments. In short, quality takes account of the best interests of the borrower as well as the safeguarding of the lender's investment in view of current and prospective conditions.

This chapter is concerned with some considerations on the part of lenders in providing the quantity, but more particularly the quality, of credit required by our rapidly changing agriculture. Some of these considerations have been discussed in previous chapters but merit additional emphasis or comment. To a considerable extent, the viewpoints will reflect the lending experience and credit policies of the cooperative Farm Credit System.

ADEQUACY OF SUPPLY OF CREDIT FOR AGRICULTURE

There is general agreement that the total quantity of credit available to agriculture is adequate for the needs (cf. Chapters 3 and 12). The lenders serving farmers and their cooperatives must compete in the market with demands for credit from other segments of the economy. This competition is very active since other users of the nation's credit supply overshadow the needs of agriculture. On December 31, 1959, the total net public and private debt in the United States was $846 billion, of which the portion owed by individual farmers was $22.9 billion, or only 2.7 percent. The agricultural credit facilities appear to be able to compete satisfactorily with other users for the supply of credit available in the market providing, of course, the lenders serving agriculture are willing to pay the market rate of interest (cf. Chapters 17 and 18).

While the over-all supply of credit available to agriculture appears to be adequate, individual lenders may find it necessary from time to time to restrict lending because of limited funds. Occasionally,

commercial banks find themselves in this position because of inadequate capital or heavy investments in other fields. Duggan referred to such possibilities in the Southeast in his discussion of Chapter 3. Diesslin expressed concern in Chapter 13 about the possibility that some life insurance companies may leave the farm mortgage lending field. This would be unfortunate if they should shift investments in that way. There are times when the lack of funds restricts lending by the Farmers Home Administration.

But there are enough lenders and the competition is sufficiently active so that if one credit source holds back on new loans for some reason, other lenders can take up the slack. One can speak more definitely about the way the cooperative Farm Credit System functions in this respect. Its 494 Production Credit Associations and 800 Federal Land Bank Associations serve individual farmers in every farm community of the nation. Through their fiscal agent and sales organization of several hundred security dealers, the Farm Credit Banks obtain from the investment market the loan funds needed by the Associations to handle local demands for loans. Experience during some business cycles has demonstrated that while interest rates vary with the market, the System can obtain whatever loan funds are required even during tight money conditions. Funds borrowed by the System in the investment market are reaching sizable proportions, totaling $3.3 billion in the calendar year 1959, and the System has the expansion capacity to fill any gaps in business-type credit service that may develop.

A further point to be noted in connection with any question about the adequacy of the total amount of credit available is that the nation has not failed to get needed agricultural production because of a short credit supply. On the contrary, there have been charges that lenders have contributed to excessive production — as in the case of broilers. In the aggregate, therefore, the problem faced by lenders is not whether the over-all quantity of credit will be adequate. The critical issue is whether they can adapt the quality factors adequately to farmers' needs in these changing conditions and still keep risks within limits that can be tolerated by business-type lenders.

Hendrix and Lanham deal with some of these issues as applied to low-income farmers in Chapter 14. They conclude that lack of capital and credit is not the basic cause of chronically low incomes in agriculture. The problem arises, rather, from an oversupply of labor and accompanying low returns to labor inputs. The low returns are partly the result, also, of low labor and management capacities.

These circumstances present a problem to business-type lenders in cooperating in low-income area improvement efforts. In view of the situation described by Hendrix and Lanham, financing risks tend to be high. In efforts to assist in local Rural Development programs, the Farm Credit Banks and Associations have found that the number of loans they can make is limited. As Hendrix and Lanham point out, however, there are individual farmers who have the management capacity to use capital effectively and who can be financed on a sound basis. Any

business-type lender attempting to serve low-income areas constructively must be competent to identify these farmers and assess their potentials. Lenders having adequately trained personnel in their offices may be able to contribute substantially to Rural Development programs through credit counseling as well as by making loans.

PROBLEMS OF LENDERS

Turning now to the problems of lenders in financing commercial farmers, there are two areas where the effects of changing agricultural conditions need consideration. One is the effect upon needed changes or modifications in credit service. The other is the effect upon lending risks.

Suggested Changes in Credit Services

Diesslin and others have mentioned a number of changes that are needed to keep credit service up-to-date with needs. These ideas include intermediate-term loans, partial amortization, open-end mortgages, and package credit. One more feature — greater emphasis on credit counseling — might properly be added to this list.

Intermediate-term loans. The increasing investments in nonreal estate capital assets have been accompanied by demands for loans with intermediate terms. While lenders may appear to have been slow to respond to this need, actually they have financed very substantial amounts of intermediate-term types of investments. This has been done by making shorter term loans and then renewing portions used for capital financing under appropriate circumstances. Substantial volumes of such renewals are planned in advance when the loans are made. Such financing is reflected in PCA loan files by the numerous accounts where loan balances fluctuate with seasonal needs but never drop below the amount representing capital financing over long periods.

The PCA's have been writing notes with intermediate terms, also, for those farmers who prefer it done that way. Starting in 1955 on an experimental basis, the volume has steadily grown, amounting to 12 percent of all PCA loans outstanding on June 30, 1959. Two aspects of such loans should be mentioned. As Diesslin points out in Chapter 13, there are certain conditions and circumstances when intermediate terms are not appropriate, particularly when the risks are such that close control should be maintained by the lenders. The other is that after some experience with having separate notes for seasonal and intermediate-term credit needs, some PCA members voluntarily turn to the more common practice of making an annual review of over-all credit needs and setting up a credit program tailored to the specific requirements of the oncoming year. These two features will continue to limit the amount of PCA credit which will show up in the statistics of intermediate-term loans.

Amortization of farm mortgage loans. The growing interest in

partial amortization of farm mortgage loans is another reflection of changes in both agricultural conditions and the values held by farm people. At the time the Farm Loan Act of 1916 was enacted, a common view was that debt was a necessary evil and a farm free of debt was accepted as the goal of all farmers. Amortization was made a requirement for all Federal Land Bank loans in order to hasten the day when the mortgage could be burned.

One effect of changing economic and technological conditions is that the urge to retire debt is giving way to the steadily mounting capital needs of the modern farm (cf. Chapters 6 and 7). Hence, income or funds that might be used to pay off the mortgage can be invested more effectively in other parts of the farm business. In recognition of this trend, the Federal Land Banks were authorized in 1959 to make loans that are only partly amortized, or that will not be amortized at all. These new tools will be tried cautiously, and through experience the circumstances and conditions appropriate for each type of repayment schedule will be worked out (cf. Chapter 17).

Open-end mortgages. Open-end mortgages, under which a borrower could obtain additional advances within stated limits without new appraisal or a new mortgage, also have been suggested as another way to give greater flexibility in credit service. This idea has been discussed in the Federal Land Bank system for many years, and one bank has tried writing such loans in a very limited way. In principle the idea has merit. However, because of wide variations in state laws and because of numerous practical operating difficulties, the Federal Land Banks have not yet found it feasible to offer this feature of loan service.

Package credit. For several years Diesslin has been saying that "package credit" will better serve the needs of modern farmers than financing on a commodity or piecemeal basis. His definition of package credit is closely approached in PCA operations. When financing a farmer or rancher, a PCA prefers to furnish all of the credit needs other than the long-term real estate loan. The typical procedure in making a PCA loan is to set up a budget of the total operation of the farm showing expected income and expenses with probable dates and sources. From such a plan, the total credit needs can be determined with dates when advances will be needed, the sources of repayment, and the dates when funds will be available for principal payments. This takes account of the total farm operation and makes it possible for all but the long-term credit requirements to be handled as one package. It fits the line of credit to the needs of the farm as a unit covering both short- and intermediate-term requirements.

A debatable question may be whether this arrangement is seriously defective because the long-term credit needs cannot be supplied by the same lender. There may be practicable problems for the lender in consolidating the long- and short-term financing. The investment market for long-term funds is in effect separate from the market for short-term funds, and financial intermediaries tend to become specialists in particular types of financing. To a limited extent commercial banks

can make both long-term and short-term loans from the same general source of funds. But lenders obtaining funds from other sources tend to be specialists. This tendency is observed in both the agricultural and nonagricultural sectors of the money market.

This institutional arrangement may not be an insuperable barrier to working out package service. It may be that the advantages of package-type service to the farmer can be realized almost as well through what may be called "one-stop service" where both types of credit are available under one roof or in adjacent offices. Such close working relationships between long- and short-term lenders have been developed extensively by PCA's and FLBA's. Commercial banks which also act as loan agents for a life insurance company are another illustration of such one-stop service.

Credit counseling. Still another way in which lenders may adapt credit service better to changing needs is through increased competence in credit counseling. As commercial farming increases in complexity and size, management skill becomes correspondingly more important. As capital requirements also increase, skill in financial management becomes particularly important. Competent lending personnel to advise on such management problems not only can do a better job of loan analysis, but also can be of real service to farmers (cf. Chapter 11).

The Farmers Home Administration and the Banks for Cooperatives have demonstrated the value and possibilities of credit counseling. In one Farm Credit district, managers of PCA's and FLBA's stated during a series of meetings that their current experience with farmers' needs and demands indicates advances in credit service to individual farmers should be in the area of credit counseling. Business-type lenders will need to determine how much time they can afford to give borrowers within the limits of available income. They may experiment with charging fees of borrowers who wish more attention than can be given under the normal income from the loan. Such an arrangement might be similar to the "farm management loan" idea advanced by Murray in Chapter 11.

Effect of Changes in Agriculture on Risk

In addition to adjustments in credit service, lenders also must give attention to changes in risks that may accompany the changes taking place in agriculture. In discussing the effects on risks, Diesslin points out that since the long rise in farm earnings and farm land values is at or near an end, lenders must give closer attention to farm earnings and the related capacity to repay debts (Chapter 13). During this period of "windfall gains in asset values," lending has been relatively easy. But with the present outlook, loan committees have a much more difficult job of screening applications and deciding which operators will have the necessary debt-repayment capacity. New classes of marginal farmers are emerging (cf. Chapter 1).

Several factors or developments which will affect repayment capacity

generally, and the area of marginal operations particularly, have been cited. Technological advances and the rapidly changing size and scale of commercial farming operations have greatly widened the difference in earning capacity of both farms and operators. This trend will continue and will increase the difficulty of screening out those with inadequate earning capacity.

Effect of differences in land qualities. As far as differences between qualities of land are concerned, it has long been recognized that the difference in debt-paying capacity between good and poor land is significantly greater than the difference in market values of those classes of land. Poor land generally is over-valued, while the best land may be under-valued by the market. Most of the losses sustained by the Federal Land Banks resulted from lending too much on the poor lands. Losses from loans on the better farms were negligible. One effect of the current agricultural revolution has been the widening of the differential in debt-paying capacity between good and poor land. If this is the case, much more careful appraisal of farm land for loan purposes will be necessary.

Effect of management differences. Of greater importance is the widening of differences between individual operators in their ability to manage the resources at their disposal. In Chapter 13, Diesslin suggests that the real net income to a given "bundle" of resources increased for the best third of commercial farms between 1940 and 1960, changed very little for the middle third, but has been cut in half for the lower third. In other words, he suggests that the change in the differential between the net incomes of the upper and lower thirds during this period may be indicated by a change in ratios from 3 to 1 to about 8 to 1. These particular ratios are hypothetical, of course, and illustrate mainly the direction of change. This widening differential reflects the differences in the competence and ability of farm operators. As scientific knowledge increases, as technology advances, and as the amount of capital used by individual farmers expands, competent management becomes increasingly important. Subject to effects of market conditions, weather, and other factors, management accounts for the differences between profits and losses in farming more than ever before.

Management may be of equal or possibly greater importance than amount of capital in affecting earnings and debt-paying capacity. In Chapter 4 Martin recognized that ample capital is necessary to permit the size and character of operation which will yield a satisfactory income; and credit, of course, is an important way of increasing the capital available to a farmer. But Martin points out that there is no gain in granting additional credit or expanding the capital resources in some other manner to an individual farmer who does not have the ability to manage it in a way that will produce a proper return. Productivity of capital or credit in the hands of low-capacity managers may not be great enough to justify a financing program.

These arguments emphasize the necessity of taking an even greater account of the personal factor in future financing. The personal factor

has always been of major importance in acting on loan applications. The changes occurring in agriculture are making it still more important. Greater emphasis on managerial ability increases the need for research work that will describe more completely the earmarks of a good manager (cf. Chapters 20-23). Such research results would aid lenders in identifying loan applicants who have the ability to use additional capital effectively.

Another widening differential cited by Diesslin is that between commercial and noncommercial farms (Chapter 13). The smaller noncommercial farmer simply does not have the resources necessary to produce an adequate income. Small farmers are finding out that they cannot compete and are dropping out and turning to other occupations in increasing numbers. The lender, therefore, must be able to distinguish between those who can build to a satisfactory commercial level with the aid of credit and those who will be better off if they shift to some other way of making a living.

In addition to increasing the problem of the lender in identifying operators who will have the necessary debt-paying capacity or who can be built up to that level, these developments are calling attention to the hazards involved in low-equity financing. In Chapter 17 Governor Tootell points out that the conditions that contributed to the success of low-equity mortgage loans by the Farmers Home Administration from 1935 to 1960 and the 75 percent Land Bank Commissioner loans made from 1933 to 1946 are not likely to be as favorable in the 1960's. Under the present outlook for farm income and land values, the risks in making such low-equity loans will be far greater than under conditions of rising farm income and land values.