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## *Adequacy of Credit for Commercial Agriculture in a Growing Economy*

**T**HIS CHAPTER is concerned with the problem of financing commercial farmers. It is a different problem from those discussed in some of the previous chapters which have dealt largely with poverty in agriculture. As a national problem, poverty in rural areas is perhaps more important than financing commercial agriculture, and it no doubt demands serious consideration. But poverty is much broader than a farm credit problem. We can no more solve the social problem of poverty in agriculture with credit than we have been able to solve it with an agricultural price support program. In both instances the problem is merely perpetuated.

### DEFINITION OF CREDIT

Credit is defined here as the ability to sell debt.<sup>1</sup> In this sense, banks do not extend credit but the borrower does; he exchanges credit for cash. Viewed in this way, credit is a commodity which a person or firm possesses. It can be both created and destroyed.

The price which a specified firm's credit can command from different lenders on a given day in the market likely varies surprisingly little if the same facts are known equally to all parties. That is to say, the criteria by which a firm's credit is evaluated (priced) tend to be quite consistent among lenders in a given geographic area at a given time. Of course, these criteria do differ among areas and they do change over time. Examples are numerous, even in the twentieth century, where bankers with imagination and courage have developed new and bold criteria for pricing the credit of farmers, farmers' organizations, and firms serving agriculture.<sup>2</sup> More research is needed to determine and appraise the processes and criteria by which farm credits

<sup>1</sup> Before the Civil War, Lawyer-Economist Macleod wrote: "If it were asked what discovery has most deeply affected the fortunes of the human race, it might probably be said with truth — the discovery that debt is a marketable commodity." Quoted by John R. Commons, *Institutional Economics: Its Place in Political Economy*, University of Wisconsin Press, Madison, 1959, p. 397.

<sup>2</sup> Marquis James and Bessie R. James, *Biography of a Bank*, Harper & Brothers, New York.

are valued in the capital market and how these might be modified to the benefit of all parties.

As an illustration, over the years different kinds of insurance programs have been developed for, or applied to, agriculture, thereby reducing some of the risks inherent in farming. Hail and frost insurance on crops, fire insurance on farm assets, and life insurance for the farmer are examples. Traditionally, farmers use insurance sparingly, relative to the risks associated with their business. However, many farmers and bankers are aware of the fact that adequate insurance materially alters the price of credit. That is, insurance alters the amount of cash for which they can exchange their credit or the amount of debt they can sell. Whether or not the benefits of a particular insurance program exceed the costs is an issue which each farmer must resolve considering his own circumstances. More attention should be given to this aspect of credit. For example, a wider use of futures contracts by farmers as a hedge against price declines can materially increase the volume of loanable funds to a potato farmer. Similarly, credit insurance, to which Diesslin refers in the closing paragraphs of Chapter 13 and which is being used in other areas with apparent success, might well be used in financing commercial agriculture.

The definition of credit as the ability to sell debt makes both clear and reasonable the proposition that in order for a farmer to obtain money from the capital market he must possess credit. He can no more exchange credit for cash when he has no credit than he can exchange cattle for cash when he has no cattle. It becomes imperative that farmers build a strong credit base and credit rating so that this "commodity" can be sold at a favorable price in the financial market. As is stressed in Chapters 12 and 18, farm credit increasingly must compete with that of other industries and businesses for the limited supply of loanable funds in the market.

#### SOME LIMITATIONS OF BROAD-AGGREGATIVE COMPARISONS

Based on comparisons of estimated returns to capital in agriculture versus other industries, using very broad aggregations, Baughman and Wetmore conclude in Chapter 12 that total capital in agriculture appears to be in excess of the optimum amount. Similar conclusions using essentially the same macroanalysis are cited in other chapters. Without disagreeing, these conclusions based on such broad aggregation are of limited use — either in defining agriculture's problems or in developing corrective policy. Diesslin correctly stresses in Chapter 13 that agriculture is becoming increasingly varied. The returns to superior management have never been so great nor the cost of inferior management so severe (cf. Chapter 23). Likewise, differences in land and water quality, climate, and scale of operation appear to be increasingly important.

There simply are too many vastly different universes included in our statistics on American agriculture to permit them to be analyzed as a

single homogeneous body. To conclude from aggregative comparisons that agriculture has no severe capital supply problems, overlooks many farms operated by capable managers but located in areas which industry by-passed and which have no correspondent ties with metropolitan banks. Similarly, such generalization glosses over other areas where new technology, new products, or new markets offer investors opportunities for unusual financial reward.

Based on macroanalysis one can easily conclude, as do Baughman and Wetmore, that the prospective need is not to attract additional capital, but rather to provide for transfer of ownership of assets to fewer and larger units. But in regions where agricultural adjustments already have occurred, history does not substantiate this claim. For example, New England has undergone severe adjustments since 1910. In 1960 there was but a fraction of the number of farms and farmers which existed in that area in 1915. Production has been concentrated into relatively few farms. Many farms — including buildings, fences, and machinery — have been released from cultivable farming and abandoned to unplanned forests. In the process of adjustment, however, much of the agricultural capital of the region in 1910-1920 became obsolete. New capital was needed to develop the larger, consolidated farms on the bottomlands and to equip them with modern buildings, machinery, and equipment.

In the adjustments with which most of agriculture is confronted in other areas (although the situation is most critical in the Southeast and in the cutover areas of the North Central and Northwest, it is not limited to these regions), there will be additional conversions of cultivable land into forest, and abandonment of farmstead, fences, and machinery. At the same time, with new consolidations of productive land, there will be many opportunities for investment in such farm improvements as land leveling, drainage, supplemental irrigation, modern machinery, and improved foundation breeding stock. Outside capital will be needed and attracted.

### THE ROLE OF EQUITY CAPITAL IN AGRICULTURE

The dominant role of equity capital in agriculture has been emphasized in other chapters. This is the only conclusion one can reach based solely on summary tables of the Balance Sheet of Agriculture. The author agrees with those who feel that the importance of equity capital in financing agriculture has been overemphasized. On a national scale, it largely represents inflated values of the same quantity and quality of land resources that have existed since about 1920. If land values have reached their peak, this equity will not continue to grow. Instead, it might decrease. One must look more and more to sources other than this traditional form of equity capital to finance agriculture's adjustment.

In the past, the insistence of many farmers on limiting the rate of their firm's growth to that at which the farm family could accumulate

equity capital has tended to (1) place the family under such an accelerated saving program that some aspects of the family's personal welfare were neglected, and (2) restrict the scale of operation to less than optimum for the capacity of management. The situation is beginning to change since in some farming areas more emphasis is being given to resource control and less to ownership.

Vertical integration is modifying the equity capital structure in some areas, as indicated in Chapter 8. The author does not agree, however, with those who point to the existence and growth of vertical integration as evidence that financial institutions are failing to meet the needs of agriculture. Vertical integration exists for a number of reasons. The failure of market prices to coordinate sufficiently the decisions of producers — with respect to quality, timing, and efficiency of production — to the desires of consumers is most likely the dominant force. Imperfections in the labor and management markets also have been factors. Of course, vertical integration could not have occurred as it has in poultry production without outside capital. Many of these firms have been able to put together such a coordinated production, processing, and marketing technology — combined with outside risk capital and business management — that they have quality credit to market. The individual farmers who are a part of the integrated unit had few or none of these vital assets by themselves to begin with. The vertically integrated firm is thus able to sell its debt to banks, and then "retail" the funds thus derived to the grower under a program of strict supervision. Although such supervision is costly, it already is necessary to the production process, and little or no additional cost is incurred in also supervising the financing. Financing institutions are not able to charge a rate sufficient, in most instances, to pay them for making "farm management" loans, i.e., loans under close farm management consultation and supervision (cf. Chapter 11).

More important than vertical integration in modifying the future capital structure of agriculture will be the increasing use of the corporate entity which offers such advantages as: (1) Under corporate organization, the continuity of the firm is less dependent on the continued survival of specific individuals; (2) it provides greater tax flexibility — including income taxes, inheritance taxes, and gift taxes; and (3) it can help provide a more continuous supply of capital. The corporate organization per se is not in conflict with efficient, commercial family farms.

## ESTATE PLANNING AND TRUST MANAGEMENT

There is no other industry in which capital assets are a vital part of the business where so little attention is given to estate planning. Farmers traditionally have given little attention to this matter. And yet, few other businesses have as much to lose from inadequate or improper estate planning. Furthermore, with the changing organizational structure of agriculture and the increased role of equity capital owned

by parties distinct from management, there is an increasing need for experienced trust management of agricultural properties. Commercial bank and trust companies are strategically equipped, institutionally, to provide this service. Personnel must be professionally trained and experienced, however, to manage the agricultural properties. In too many instances, trust departments of country banks have the reputation of being efficient farm real estate liquidators.

In defense of their position, however, it should be pointed out that in many states the courts do not recognize the differences among management inputs required to manage an agricultural trust as opposed to a portfolio of securities. Consequently, the court fails to compensate the trustee for the added cost of managing farm properties, and the trustee has only one alternative — convert the farm assets into securities which can be managed at a cost commensurate with the court's allocation. This whole area of estate planning and trust management contains another very important set of problems for research and extension which agricultural colleges and other research groups have largely overlooked.

#### GETTING FUNDS FROM SURPLUS TO DEFICIT AREAS

Baughman and Wetmore correctly stress in Chapter 12 that agricultural loans are becoming more closely linked with urban and industrial supplies and demands for funds. They imply that agriculture's isolation and insulation from the forces operating in the financial centers have worked to its advantage. They argue that closer linkage with the financial centers probably will be disadvantageous to farmers. This is true only under very special circumstances — i.e., in periods of very tight money, such as the period since mid-1958. Historically, most isolated farming areas have been classified "capital deficit." Isolated independent unit banks can loan only a fraction of the bank deposits in that area. Their limited funds can be augmented by correspondent city banks, but correspondent banking is considerably less effective than a branch banking system in equating demand and supply of loanable funds among areas and among industries. There are instances where a branch bank in an expanding, isolated, and totally agricultural area has had loans outstanding equal to nearly four times total bank deposits in that area — a loan-deposit ratio unheard of for a unit bank. The impact of these funds on the economic development of the locality is tremendous.

Also, a country bank can augment its loanable funds by organizing an agricultural credit corporation with which it can secure funds from the financial centers through the Federal Intermediate Credit Banks. Because banks failed to utilize this service, Congress established the Production Credit Associations in 1933. Local PCA's, operating through the FICB's, have been quite successful in funneling funds from surplus to deficit areas.

One important consideration in the adequacy of agricultural credit deserves at least passing comment. It concerns organizing agricultural

credit institutions so as to minimize the impact on the lender of the risks inherent in agriculture. For example, as with unit banks, PCA losses in a specific locality are borne entirely by the local unit. This forces association managers and lending committees to be more conservative than they otherwise need be. Since unit banks and PCA's face the same problem — concentrating their loanable funds to agriculture in a single geographic area — one might expect them to behave in about the same way with respect to risk; and, in reality, most of them do. A method is needed for broadening the lending base geographically. For PCA's, the forthcoming acquisition of the FICB's and the profit and loss pooling which this will make possible, should go far in correcting the situation. For banks, branch operation must be ranked above correspondent banking as a means of spreading geographically-oriented agricultural risks for commercial banks.

### COMPREHENSIVE CREDIT SERVICE

Much has been said in Chapters 11, 13, and 15 about "package credit," a "balanced credit program," or "comprehensive credit service." These terms have been used to mean different things to different people. In general, however, the authors have expressed opposition to piecemeal financing under which a farmer gets part of his capital needs from uncoordinated places for uncoordinated purposes. It is agreed that the farmer should be able to secure a complete and well-balanced financial meal at one table and, if possible, at one sitting. Time and again there are cases where an otherwise sound short-term credit program is jeopardized by unwise long-term financing from a different source, and vice versa. The advantages of coordinated complete financing with one institution are undeniable.

In Chapter 13 Diesslin suggests that package credit "can be provided best in financing the farm as a single unit of operation and not by breaking it down into short-, intermediate-, and long-term segments." This proposal is questioned here. Diesslin appears to be recommending that this complete and balanced meal be achieved by throwing these choice ingredients together and serving "hash." Certainly hash is esthetically less satisfying. Furthermore, it requires more confidence in the cook — and this is a key issue in an undertaking where mutual confidence is critical. An annual "budget" loan designed with — and for — the individual farmer and geared to the expected flow of money into and out of his business is a useful tool with which to meet a farmer's seasonal operating expenses.<sup>3</sup> Similarly, intermediate- and long-term loans are useful tools with which to meet problems for which they were individually designed. Diesslin's recommendations would seriously diminish the usefulness of these tools.

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<sup>3</sup> Not only is it useful to the lenders, but to the farmers as well. Our experience is that once a farmer has brought his level of planning and management up to the standard required to operate within the "spirit" and framework of the budget, he becomes a strong advocate of the method.

Diesslin further suggests that long-term credit be used when borrowed capital is needed continuously over a period of years, whether the funds are used for a long-term investment or a series of short-term investments. He adds that "as much long-term credit as possible should be used" to finance intermediate-term improvement programs, and suggests that amortization be extended over a long period — 10 to 20 years in some cases — so that repayments will be low.

In essence, Diesslin is asking for the kind of financing that a large industrial corporation obtains from selling public debentures. This, however, requires a type of credit few farmers have to sell. Rather stringent conditions must be met before the SEC permits a firm to sell debentures to the public. Furthermore, unless the firm is in a strong financial position and has a good business reputation, the rate would have to be exorbitant to attract risk capital. Consequently, most small business firms — including most commercial farms — find that lending institutions, rather than the public, are the best market for their type of credit.

Diesslin's suggestions (Chapter 13) for modifying agricultural credit programs can be evaluated in terms of three primary issues:

1. Adequacy of funds. A financial program should make enough money available to meet the total needs on which both the farmer and lender agree, and should be available when the farmer needs it. The suggestions are sufficient on this count, but they are not necessary.

2. Control. Sufficient control must be provided to assure (a) that the money will be used for the purpose for which it was allocated and (b) that the expected income derived from the financed activity will be used to apply on the loan as agreed by both parties. Frequently this control is as essential to the farmer as to the lender. Control is critical in all businesses and business arrangements. Controllers' departments and budget bureaus do not exist only to make arbitrary rules for operating departments. They are a necessary part of every business. The more dynamic the business, the more important are planning and control. Proper control would be more difficult if all of Diesslin's suggestions were followed.

3. Flexibility. Adequate provision must be made for flexibility in the program. In any dynamic business, conditions change — sometimes suddenly — calling for a change in plans. Agriculture is classic in this respect. The principal argument for Diesslin's request for long-term loans to finance short-term investments is to provide a maximum of flexibility by allowing the farmer to accumulate and hold cash. He appears to favor open-end and partially amortized mortgages for the same reason. However, "capital flexibility" comprises more than the form in which the loan is made. It requires having uncommitted funds available on short notice. The farmer need not have cash if he has credit (marketable debt). Therefore, a farmer should not only build up his credit rating so that he can exchange it for more capital when he needs it; he should reclaim his credit (i.e., pay off his loan) under favorable circumstances so that he can again exchange it for capital if and when

no credit reserve and, therefore, limited flexibility. Generally speaking, a farmer can hold credit cheaper and more securely than he can hold cash, and if his rating is good, his credit provides him the same flexibility as does an equal volume of cash.

Again, this writer agrees with those who argue for complete package financing, wherein the banker and farmer jointly work out a complete financing program fully coordinated to meet all the farmer's needs. In most cases this program will consist of at least three parts, all of which are coordinated so that they dovetail together to form a coordinated program. They are: (1) Long-term real estate loans. Flexible payments might very well become the accepted procedure for farm real estate loans of the future, although partially amortized loans will be made only by those lending institutions which have long-run equity-type capital to invest. (2) Intermediate loans of various sorts, wherein the repayment schedule is geared to the earning capacity (but does not exceed the economic life) of the asset being financed. (3) Annual operating loans which follow a budget carefully planned to coordinate with the fund flow of the farm business.

#### NEED FOR AGRICULTURALLY TRAINED MEN IN BANKING

Obviously, a high standard of performance can be obtained only when an alert banker who understands agriculture sits down with a competent farm businessman. It is happening, although only in a few places. However, in almost all areas progress is being made in bringing persons trained in agriculture into the banking profession. But this process is too slow to meet the needs. Special training is needed for those already in banking who have no background in agriculture. Bankers, of course, are like everyone else in that they have an instinctively negative reaction to things they do not understand. Without question, the extent to which bankers understand agriculture affects the adequacy of agricultural financing.

The Bank of America in the mid-1950's began special training programs conducted by the state university and state college systems. These intensive programs are generally of two-weeks' duration. Their primary objective is to acquaint bankers with the agriculture of their state from a farm manager's or decision-maker's point of view. Four such seminars were conducted in 1960, each on a different campus and each specializing in a different type of agriculture. These training programs are opening up new horizons for many of the Bank's officers, helping them to approach the challenge of financing agriculture with more understanding and confidence.

Attention should be directed toward the important differences in the capital structure of agriculture in the several geographic regions of the United States, and to the significant differences in the institutions, terms, and conditions under which capital flows into agriculture in these regions. Greater attention needs to be given to these differences to determine why they exist, and to measure their impact on the productivity, flexibility, and financial condition of agriculture in each area.