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Farmers' and Ranchers' Guide to Borrowing Money

Texas Agricultural Experiment Station
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HIGHLIGHTS

- Farmers and ranchers can view credit as a money-making resource that needs to be used prudently and effectively.
- Lenders tend to evaluate loan requests based on five general criteria:
  — the integrity of the borrower
  — the borrower's financial position and progress
  — the borrower's repayment capacity
  — the collateral or security of the loan
  — the loan purpose
- Knowing loan terms and eligibility requirements is equally important as knowing the alternative sources of credit.
- Agricultural loans are typically classified in two categories: real estate and nonreal estate. The relative importance of lenders making either one or both categories of loans has varied over time and by different regions of the country.
- Farm loans for nonreal estate purposes (operating expenses and farm equipment) come primarily from the following sources in order of their market shares:
  — Commercial Banks
  — Production Credit Associations
  — Individuals, Merchants, and Dealers
  — Farmers Home Administration
  — Commodity Credit Corporations
- Farm loans for real estate purposes (land and improvements) come primarily from the following sources in order of their market shares:
  — Federal Land Banks
  — Individuals
  — Insurance companies
  — Commercial banks
  — Farmers Home Administration
- Commercial banks are the leading source of nonreal estate farm loans and also a minor source of real estate farm loans. However, increasing demands by farmers for loan funds in excess of those which can be supplied are a continuing problem for rural banks.
- Production Credit Associations are major sources of nonreal estate loan funds and have increased their share of loans to farmers over time.
- The Federal Land Banks are the leading sources of real estate farm loans, and their share of real estate loans has increased over time.
- The Farmers Home Administration plays an increasingly important role in lending to farmers and ranchers who cannot get adequate financing from other lenders at reasonable rates.
- Since 1978 about one-third of the increase in Farmers Home Administration lending has been due to the Economic Emergency Loan Programs.

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Farmers' and Ranchers' Guide to Borrowing Money

Danny A. Klinefelter and Bruce Hottel*

INTRODUCTION

Credit and money management are the financial tools that make it possible to build a successful business in an industry which is ever more concentrated in fewer and larger units. The prudent use of credit can enable the business to grow more rapidly than it could through the use of savings and reinvested earnings, so long as borrowed funds return more over time than they cost. In fact, for most farmers and ranchers it is almost impossible to expand without using borrowed funds. Thus, farmers and ranchers have to look at credit as a financial tool and learn to use it effectively. Agricultural producers have to compete for borrowed funds, and that means individual agricultural borrowers have to sell their ability to use money, in order to make money, or lose out to those who can.

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To obtain and use credit properly, borrowers must know the major sources of agricultural loan funds, the types and terms of credit available, and how to approach lenders. This publication is designed to present this information.

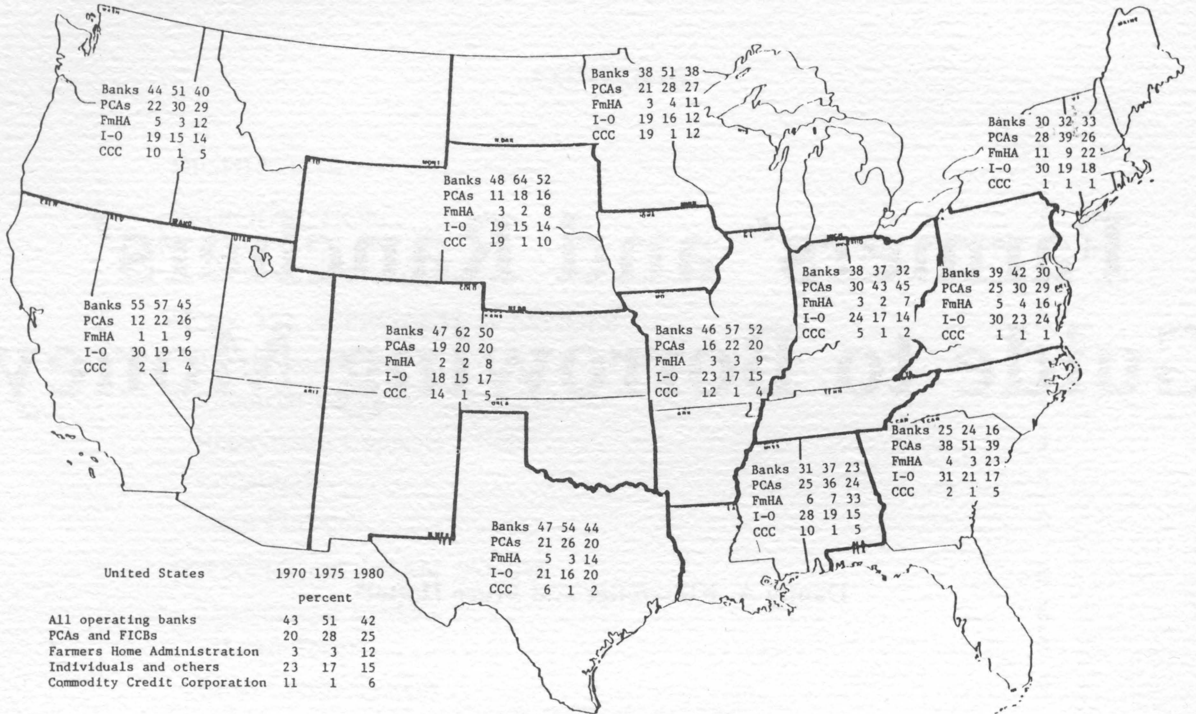
A Perspective

Agricultural loans are typically classified in two categories, real estate and nonreal estate. Real estate loans are usually associated with land purchases or the refinancing of short or intermediate term debt. Loan repayment may extend as long as forty years. Nonreal estate loans are short term operating loans to be repaid in one year or less, or intermediate term loans for capital purchases to be repaid generally in less than ten years. Some lenders make both types of loans.

Figure 1 shows how much of the market in nonreal estate debts is financed by the five types of lenders. This is called their market share. A breakdown of market shares for the total U. S. appears in the lower left-hand corner. In order to show trends, the market shares on January 1 are shown for 1970, 1975, and 1980. Note the significant changes in the market share of Government lending agencies. Commodity Credit Corporation (CCC) loans vary with changes in farm programs over time. The relative importance, however, is markedly different by region of the country based on commodity specialization and existing Government price support programs. The dramatic growth of lending by the Farmers Home Administration (FmHA) is also related to the reduced market shares of commercial banks and Farm Credit System lenders. This is particularly true in areas where there has been a significant concentration of economic emergency and disaster program loans.

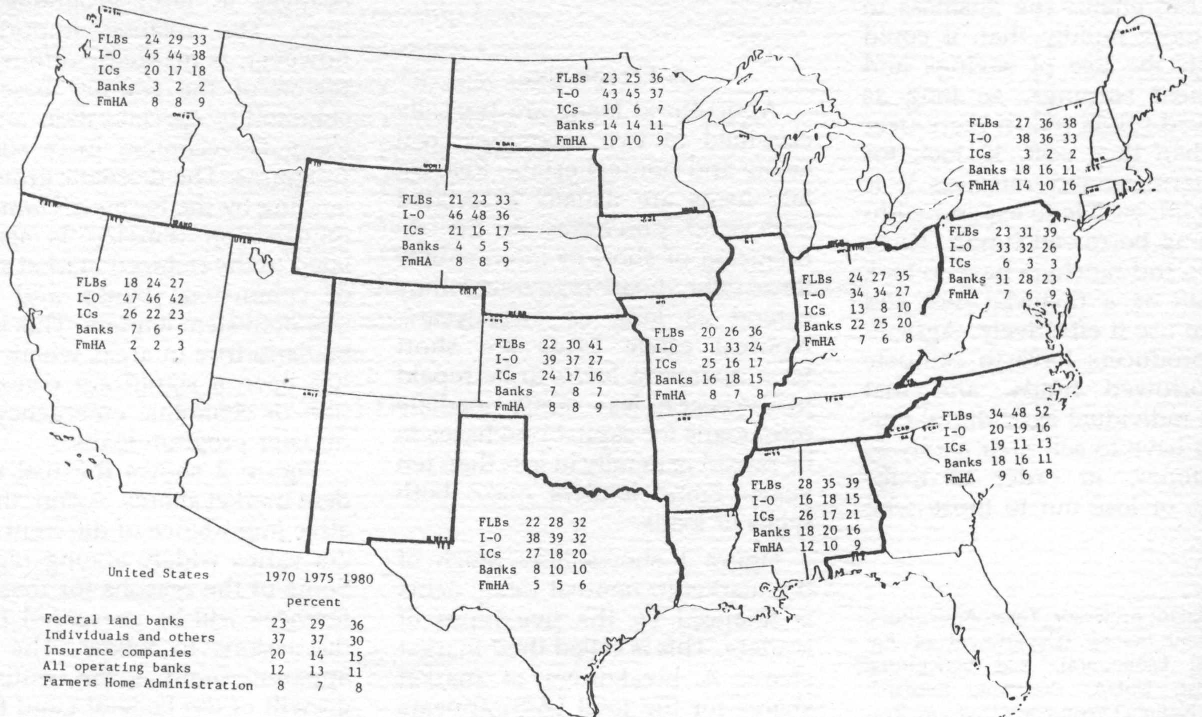
Figure 2 shows the real estate debt market shares. Again, the relative importance of different lenders varies widely among regions. Some of the reasons for these differences will be presented in the discussions to follow. The most apparent trend is the continuing growth of the Federal Land Banks in every region of the country.

Figure 1. Lender shares of farm nonreal estate debt outstanding, by Farm Credit Administration districts, January 1, 1970, 1975, 1980



United States	1970	1975	1980
	percent		
All operating banks	43	51	42
PCAs and FICBs	20	28	25
Farmers Home Administration	3	3	12
Individuals and others	23	17	15
Commodity Credit Corporation	11	1	6

Figure 2. Lender shares of farm real estate debt outstanding, by Farm Credit Administration districts, January 1, 1970, 1975, 1980



United States	1970	1975	1980
	percent		
Federal land banks	23	29	36
Individuals and others	37	37	30
Insurance companies	20	14	15
All operating banks	12	13	11
Farmers Home Administration	8	7	8

HOW TO APPROACH A LENDER

Before approaching a lender for credit, a borrower should understand the basic principles of lending and how a lender decides how much money to lend. A lender who provides either too little or too much credit can seriously damage an operation. Although not all lenders use highly formalized standards, borrowers should know which factors in loan analysis are important (5, p. 8).[1]

Basically, a lender tries to weigh the strong and weak factors in a loan request, to assess whether the borrower can repay the loan (4, ch. 4). To this end, lenders attempt to:

1. obtain correct and adequate information,
2. compile the information in a useful way,
3. weigh the strengths and weaknesses of each credit factor (an explanation of these factors follows),
4. consider the strengths and weaknesses of all credit factors in relation to each other and as a whole,
5. analyze the probable performance of the loan, and
6. make the loan decision based on technical knowledge, the institution's loan policy, and past experience.

The principles of lending can be divided into five basic categories (1) human/management factors, (2) financial position, (3) repayment capacity, (4) collateral, and (5) loan purpose. These are discussed below as they relate to the borrower.

The Human Factor

Any lender considers the individual on which the responsibility of the loan falls. The satisfactory repayment of a loan largely depends on the individual's willingness and ability to perform in accordance with the terms of the loan. The human factor includes honesty, determination to meet obligations, and willingness to cooperate. The individual's attitude toward the lender is significant, since willingness to cooperate and accept the lender's advice forms the basis for mutual respect and confidence that will benefit both the borrower and lender. For individuals who are borrowing for the first time, lenders often check with local agribusinessmen, such as suppliers and purchasers, other farmers, and previous lenders as to the borrower's honesty, character, and reputation. Consideration may also be given to how the borrower gets along with other family members or business associates. With a young farmer just starting out, lenders also consider family background. Although it is not a perfect predictor, the reputation of a borrower's parents is a strong indicator of what can be expected until a young farmer has time to establish his or her own track record.

In analyzing the human factor, there are a number of red flags that cause lenders serious concern and may warrant denial of loan requests. These include the following (4, ch. 4):

1. failure of the borrower to make a full and accurate disclosure of financial information, particularly in listing all debts owed and realistically estimating asset values,
2. a history of past financial problems such as bankruptcy or collection cases,
3. an antagonistic attitude towards other creditors,
4. existence of judgments, tax liens, mechanics liens, etc.,
5. a "slow" rating from other lenders, including trade creditors such as input suppliers,
6. hesitancy or evasiveness in explaining the purpose of the loan,
7. involvement in speculative financial ventures other than the primary business, or undisclosed contingent liabilities,
8. overly optimistic estimates of the business's profitability and cash flow,
9. living and operating the business outside the lender's normal trade area (seeking credit far from home),
10. reluctance to allow the lender to visit the operation,
11. borrowing from numerous creditors,
12. frequently overdrawing bank accounts.

Another important factor is the borrower's financial management ability (5, p.8). Lenders often look at a borrower's record-keeping program and evaluate the quality of the records as well as how the records are used in the decision-making process. A fancy record system means little unless the borrower understands the information and how it can be put to work. Good financial management is to a large extent good cash management, and a capable operator must know how to prepare a cash flow projection to control expenses, to recognize profit opportunities, and to make wise capital investment decisions. Management ability is also evaluated as a function of the economic conditions under which the borrower has been operating. Even a poor manager may do relatively well while commodity prices are high; the question is how well a manager plans for and handles hard times. If a manager is not able to make financial progress under favorable conditions, a lender would be unwise to grant the loan. The ability to adjust to changing conditions is a related characteristic of a good manager.

In judging a borrower's marketing ability, the following stands out: Does the borrower have a well thought out marketing program? A lender wants to see foresight and planning, not spur-of-the-moment decisions or forced sales to cover cash deficits.

In evaluating production management, lenders typically consider yields per acre, daily rates of gain, milk production per cow, percent calf crop, and pigs per sow per year (5, p. 8). Lenders also

[1]Numbers in parentheses refer to items in references at the end of this publication.

attempt to evaluate a farmer's personnel and time-management ability, particularly on large operations. Employee loyalty and job satisfaction have a tremendous bearing on the performance of a business. Whether the farmer establishes time priorities and then follows through is another good indicator of management ability.

In summary, a lender normally evaluates a borrower's overall management ability by observing decisions over time, the ability to solve problems, the nature of loan requests, and financial progress. A complaint of many lenders is the farm borrower who is unable to see the total picture of the farm business. These farmers are too often concerned with short-term problems they cannot control, such as weather and prices, while more important items, such as long-term earnings and long-range production and marketing programs, are ignored. Such farmers fail to establish priorities and usually blame everything and everybody but themselves for their lack of financial progress.

Financial Position

A primary way a lender evaluates a borrower's financial position is through examining the balance sheet. As a minimum, a borrower should provide the lender an updated year end balance sheet. In addition to full disclosure of all amounts owed and realistic values of assets owned, there are two categories of liabilities which many borrowers tend to overlook.

The first category is accrued liabilities (expenses which accumulate over time but have not, as yet, been paid), such as accrued real estate taxes, accrued income taxes, and accrued interest. Although accrued liabilities are obligations which are not yet due, they should be reflected on the balance sheet to present an accurate picture of the business's financial position.

The second category is contingent liabilities. These are potential liabilities such as the guaranty of the debts of others, either as a cosigner or guarantor, and liabilities on contracts. Although contingent liabilities may only be footnoted, it is important that both the borrower and the lender recognize that they exist. Lenders also consider the potential tax liability on assets if they were sold. Land which has appreciated in value is a prime example. A borrower should realize that all the proceeds from the sale of most assets would not be available to cover loans if all else fails, because taxes on ordinary income or capital gains generated by the sale would have to be paid first.

The borrower's net worth or equity provides a measure of his or her risk-bearing capacity. It represents the funds which are available to creditors as a cushion against loss. Increasing net worth over time is the principal indicator of financial progress. Most lenders evaluate the ability of borrowers to handle risk by the amount of debt relative to net worth, or what is known as the leverage ratio. For example, if one's debts were $200,000 and net worth $400,000, the ratio would be .5. A ratio of .5 is usually considered good, a ratio of 1.0 is fair, and above 1.5 often serves as a cause for concern (5, p. 8). However, in a seasonal business like agriculture, the firm's seasonal borrowing peak may exceed its net worth without jeopardizing the financial soundness of the firm. These standards may vary with the level of risk associated with the business. Although borrowers often are irritated by what appears to be over conservatism on the part of lenders, once the ratio of debt to net worth exceeds 1.0, the lenders have more invested in the business than the borrower and, therefore, have more to lose.

The type and location of the operation also help determine risk-bearing capacity. A diversified business can get by with a lower equity because it is less vulnerable to a downturn in prices than a specialized operation, as the risk is spread over more enterprises. Weather patterns, soil fertility levels, and irrigation also cause differences in production risks in different regions of the country. Whether or not a borrower contracts for the sale of products is also considered by the lender in evaluating the risks of lending money.

Lenders know that if a business runs into trouble, the value of a borrower's assets tend to shrink. Forced sales often bring lower values, and legal and liquidation costs can absorb a sizeable portion of the proceeds. The true test of equity from the lender's standpoint is whether it is enough to allow recovery of the loan funds under the worst possible conditions.

A borrower's liquidity position is a measure of whether the borrower can generate sufficient cash to meet financial commitments as they come due without disrupting the ongoing business. The primary balance sheet indicator of liquidity is the ratio of current assets (cash and assets which will be converted to cash within one year) to current liabilities (amounts due to others within one year). This is called the current ratio. If current assets were $100,000 and current liabilities were $50,000, the current ratio would be 2.0. A ratio of 2.0 is usually considered good, while 1.0 is only fair. Probably more important to the lender is the trend in this relationship over time and the composition of the assets. How readily can they be converted to cash? How closely does the normal rate of conversion match with the due dates of the current liabilities? If liquidity is deteriorating over time, loan requests, particularly capital loan requests that have to be repaid over an extended time period, will be scrutinized very carefully and the cause of the decline determined.

Repayment Capacity

The borrower's repayment capacity is primarily determined by cash flow projections (estimates of monthly or annual cash inflows

as compared to cash outflows).[2] The lender weighs the realism of the borrower's projections and the consequences of alternative outcomes. The lender also compares the borrower's past record for matching anticipated repayment to actual repayment.

Lenders like to see borrowers monitor their cash flows on a monthly and a year-to-date basis by comparing projected and actual cash flows as the year progresses. This helps both the borrower and the lender spot potential problems and allows for adjustments in tax management and marketing strategies on a year-round basis.

Borrowers should not expect lenders to fill out their financial statements for them. A lender's job is to analyze loan requests, not to serve as an accountant. Often farmers who could have repaid a loan have been turned down because they could not prove loan repayment ability. Preparing the information and the loan request does three things. It helps the borrower gain a better understanding of the business from a financial point of view, improves the completeness and accuracy of information, and shows the lender that the borrower has thought the loan request through. Together, these factors help borrowers do a bettery job of selling their ideas.

It is extremely important that farmers make realistic projections and have a definite plan for their futures. If during the course of a loan interview or during a farm visit it becomes evident to the lender that the farmer does not have a well thought out plan for the business as a whole, the lender may decide the farmer is a poor risk.

In summary, farmers need to understand that production skills alone are no longer a guarantee of success. Financial management and marketing skills are increasingly important. Borrowers need to have a better awareness of their degree of financial risk. It is no longer enough to analyze the business only in terms of expected or most likely outcomes. A lender expects to see that a borrower has considered the impact of possible adverse outcomes. Particularly important are consideration of alternative prices, yields, percentage increases in major cost items, and finally, but not least, the effect of higher interest rates.

Collateral

Although lenders are concerned with repayment capacity, liquidity, and trends in financial position, they still need security to cover the loan in case of default, death, or disability. A lender will normally require that a loan be secured. Although, in case of default, a lender may attach a borrower's property through court action, an unsecured lender's claim would be subordinate to all existing security interests, judgments, and other liens. It is no wonder that most lenders believe in the old philosophy that an ounce of prevention is worth a pound of cure, because one bad loan can wipe out the profits on many loans.

A major concern of both borrowers and lenders is how much collateral is adequate. Collateral is adequate, if, under the worst conditions, enough of it can be located and repossessed in an acceptable condition that it can be sold for sufficient cash to repay the loan in full and cover the costs involved. The lender has to consider what is available as collateral, and whether another lender also has a security interest in the property. Specific attributes of an asset include the lender's ability to locate and identify it, take possession, prevent its deterioration, establish its value, and find a market for it. Most lenders would prefer not to have as their primary collateral an asset in which other lenders also have an interest.

Every lender expects and in many cases requires a borrower to carry adequate casualty and liability insurance to protect the value of the assets. No lender wants to see the loan collateral disappear due to fire, wind, theft, or a liability suit, unless all or a major portion of it can be replaced by cash in the form of insurance proceeds.

Loan Purpose

Many lenders evaluate loan purpose by classifying loan requests as necessities, needs, and wants (4, ch. 4). Necessities are essential for the continuing operation of the business. Needs could be postponed. Wants can be foregone while the operation continues to function in a normal and efficient manner. The more essential the item, the more likely the loan is to be made. It is important that a borrower establish priorities before approaching the lender.

Lenders also consider loan purpose in terms of its effects on the profitability of the business. Ideally, a sound loan is one which enables the borrower to increase his income by an amount significantly greater than the repayment of the loan. The loan purpose is also a factor in determining the length of the repayment period.

Once loan terms are agreed upon, it is critical that a borrower abide by the repayment agreement. Written loan agreements not only spell out the timing of repayment but the source or sources from which repayment is to come. They also specify how much equity must be maintained before additional collateral or debt reduction is required. Diversion of funds by the borrower which were to be used to repay a loan can seriously damage future loan requests. Even if no written agreement exists, borrowers must be sure they fully understand and comply with the verbal agreement. If circumstances prevent a borrower from meeting the terms of the agreement, it is important to inform the lender immediately and cooperate in reaching a solution.

[2] For explicit directions on how to develop a projected cash flow statement as well as other financial statements discussed in this publication, the reader is referred to Frey, T. L. and D. A. Klinefelter, *Coordinated Financial Statements for Agriculture*, Agricultural Finance, 5520-G Touhy Avenue, Skokie, Ill. 60077.

SOURCES OF LOAN FUNDS

Commercial Banks

There are over 14,000 commercial banks in the United States, and nearly 90 percent of them make agricultural loans. As noted earlier, banks are the leading source of nonreal estate farm loans and are also a major source of real estate loans. Nonreal estate loans account for 75 percent and real estate loans 25 percent of banks' loan volume.

Banks are a leading source of agricultural credit for several reasons. First, banks are located in nearly every community. Second, banks can provide prompt credit service at competitive rates with a minimum of red tape. And third, they are able to provide a full range of financial services.

The U. S. banking system operates under a dual chartering system. This means that a bank may be chartered as either a national bank or a state bank. If a bank is a national bank, it must have the word national in its name. All other banks are state banks chartered by their respective State Banking Commissioners. This dual system results in a variety of rules and regulations that affect bank structure, organization and performance (6, p. 1).

For national banks, the loan limit per borrower is 10 percent of the bank's capital, surplus, undivided profits, and one-half the reserves for loan losses. There is an exception which allows this limit to increase to 25 percent on feeder livestock loans. For state banks, the legal loan limit per borrower varies among states. (For the legal loan limit of state banks see Table 1.) However, the board of directors of a bank may decide to lower the maximum loan limit.

Although there are several forms of bank structure, from a borrowing standpoint the most important distinction is between unit banks and branch banks. The structure of banking allowed is determined by the individual states. In a unit banking system, an individual bank maintains only one place of business, excluding off-premise operations facilities. In a branch banking system, a single

Table 1--Legal limits of state banks (certain exceptions in some states may allow larger loan limits)

State	Legal limit
Alabama	20% of capital, surplus and undivided profits.
Alaska	15% of stock, surplus and undivided profits.
Arizona	15% of capital stock, surplus and debentures.
Arkansas	20% of capital and surplus.
California	20% of capital and surplus.
Colorado	15% of capital and surplus.
Connecticut	10% of capital, surplus and loss reserves.
Delaware	25% of capital, surplus and undivided profits on secured loans, and 10% on unsecured loans.
Florida	10% of capital and surplus.
Georgia	20% of capital and surplus.
Hawaii	20% of capital and surplus.
Idaho	20% of capital and surplus.
Illinois	15% of capital and surplus.
Indiana	15% of capital.
Iowa	20% of capital and surplus.
Kansas	15% of capital and surplus.
Kentucky	30% of capital and surplus.
Louisiana	20% of capital and surplus on unsecured loans; 50% on secured loans.
Maine	10% of capital, surplus, undivided profits and reserves but with the approval of the Board of Directors, can go to 20% if the extra 10% is secured by collateral equal to the extra 10%.
Maryland	10% of capital and surplus.
Massachusetts	20% of capital stock and surplus which exceeds $500,000; 20% of capital stock which is less than $500,000 or 10% of capital stock and surplus whichever is greater.
Michigan	10% of capital and surplus, or 20% with approval by 2/3 vote of Bank Directors.
Mississippi	15% of capital and surplus.
Missouri	15% of capital and surplus if bank is located in a town with a population in excess of 100,000; 20% if located in a town with a population of less than 100,000; 25% if bank is located in a town with a population of 7,000 or less.
Montana	20% of capital and surplus.
Nebraska	25% of capital and surplus.
New Hampshire	15% of capital.
New Jersey	10% of capital, surplus, and undivided profits.
New Mexico	20% of capital and surplus.
New York	10% of capital stock, surplus and undivided profits.
North Carolina	20% of capital and surplus up to $250,000, 10% in excess of $250,000.
North Dakota	25% of capital and surplus.
Ohio	10% of capital and surplus, plus debentures.
Oklahoma	15% of capital and surplus.
Oregon	10% of capital and surplus.
Pennsylvania	10% of capital and surplus.
Rhode Island	10% of capital and surplus.
South Carolina	20% of capital and surplus.
South Dakota	20% of capital and surplus.
Tennessee	15% of capital, surplus and undivided profits.
Texas	25% of capital and surplus.
Utah	15% of capital stock and surplus.
Vermont	$10,000 or 1% of gross assets, whichever is greater.
Virginia	15% of capital, surplus and undivided profits.
Washington	15% of capital stock and surplus.
West Virginia	15% of capital and surplus.
Wisconsin	20% of capital stock and surplus.
Wyoming	20% of capital and surplus.

Source: (1, p. 2).

bank firm can have full-service offices or branches in several different locations. Rural banks in unit banking states tend to be small and are limited in size by the amount of business in their respective communities. In contrast, branch banks are usually able to handle a larger volume of loans by shifting funds from areas of excess supply to areas of excess loan demand. This ability also helps average out seasonal differences between areas. Branch banking eases the servicing of larger loans, since the size of individual loans a branch office can handle depends on the capital structure of the entire banking institution of which it is a part. Although many states prohibit branch banking, in recent years restrictions on branching have eased and this trend will likely continue.

Banks face at least four problems in servicing their customers' loan demands. First, the major source of loan funds for banks is deposits. During some periods, deposit growth has been slower than growth in the demand for loans. This has been a particular problem for small rural banks which have limited access to funds outside their local market. A second problem is the legal limit on the size of loans to an individual borrower. Legal limits on loan size often constrain small rural banks with large farm loan customers. The continuing growth in farm size has accentuated the problem, since the capital structure of many banks has not grown as fast as the loan needs of their larger customers. A third problem of many rural banks is the seasonal nature of the demand for loans and the supply of deposits. Loan demand tends to increase dramatically during the production period, while deposits flow out of the community as farmers pay for their production needs. Rural banks have a severe funds shortage during this period and are then flush with funds during the marketing period when the demand for loans is at its seasonal low. A fourth problem that banks face is the usury laws in some states. These are laws which set maximum interest rates that can be charged on loans to specific categories of borrowers. In periods of tight money and high interest rates, if usury limits on farm loans are below the going market rate of interest, the bank is forced to reallocate its funds to investments and other loan categories not subject to the artifical barriers imposed by the usury laws. To the extent farm borrowers are subject to these limits, the availability of loan funds is restricted during these periods. While farmers can get around most of these laws by incorporating, there are other implications of incorporation which they should research thoroughly before taking that step. Although the Financial Institutions Deregulation and Monetary Control Act of 1980 preempted state usury laws on farm loans greater than $25,000, it left the option to the states to reimpose their ceilings. Moreover, the law did not affect loans of less than $25,000, so many small borrowers will still find loan funds from banks drying up when interest rates increase.

Because there are several things banks can do to overcome some of these problems, borrowers should have an understanding of the most commonly used alternatives. Banks often coordinate their efforts to provide credit and other services to their customers. One such arrangement is correspondent banking. Although banks of any size can establish correspondent banking relationships, in practice, a smaller bank usually becomes a correspondent of one or more larger banks. If the smaller bank cannot handle a loan request because of its legal lending limit or insufficient funds, it can request a participation or direct loan from a correspondent bank. Loan participations are arrangements whereby the correspondent bank shares in the loan made by the originating or "lead" bank. Participation loans use an agreement through which the correspondent bank buys either a portion or all of the loan and acquires a proportionate interest in the interest income and any security. Direct loans are similar in purpose, except the correspondent bank loans money directly to the customer. When participations or direct loans are used to handle the portion of a borrower's loan needs which exceeds the smaller bank's legal lending limit, the process is known as overlining (7).

Historically, in order to utilize the correspondent bank's services, the smaller bank has had to maintain non-interest earning deposits at the larger bank. The income from investing these funds compensates the correspondent bank for its services. However, correspondent banks will likely place greater emphasis on fees and service charges in the future.

The success of correspondent relationships has varied widely. In some instances they have been too costly for rural banks. Problems have also arisen because many city banks are not staffed with agriculturally-trained personnel who can evaluate and service agricultural loans. City correspondent banks often require more documentation and security than the smaller rural bank is accustomed to or willing to require of its customers. Many rural banks hesitate to introduce their better customers to a nearby correspondent for fear of losing them to the larger bank (11, p. 445). Furthermore, many farm borrowers have balked at the interest rates and loan terms required by city banks which have higher costs of purchased funds and more profitable loan alternatives than their local bank.

In selecting a bank the borrower should know the bank's lending limit. If a borrower needs more credit than the bank can loan, the borrower should find out who the bank's correspondents are and how their relationship works. Is the city correspondent committed to serving agriculture and does it employ people who understand the industry? This latter point should be carried one step further, since some banks specialize in different types of agriculture loans. Some correspondent banks work

largely with livestock operations, while others work primarily with cash grain operations. If possible, a borrower may want to arrange to meet with the local banker and the correspondent banker. The borrower must understand fully the requirement for financial information, documentation, security requirements, loan terms, and how interest is charged.

Rural banks have access to other sources of loanable funds besides their own deposits and funds provided by correspondent banks. One means of tapping national money markets is through the sale of bankers acceptances. A bankers acceptance is simply a draft which obligates the borrower to pay a specific sum of money on a specified date. The acceptance is basically another form of a promissory note which is created by the borrower in favor of himself and "accepted" by a bank. When it is accepted the bank places its "accepted" stamp on it, which tells the purchaser that the bank has accepted the risk and that when the acceptance matures the bank will honor the obligation if the borrower fails to do so.

In most cases a rural bank would not have an established name in the market which would allow it to receive the favorable acceptance rates available to the large city banks. But this problem can be overcome by the rural bank arranging for a large correspondent bank to "accept" the draft and sell it in the market.

Banks can also expand their access to loanable funds by establishing relationships with other nonbank institutions. These arrangements may involve working with Production Credit Associations (PCA), the Farmers Home Administration, and life insurance companies.

The use of commercial bank-PCA participants varies widely among regions of the country. There are two principal reasons why the arrangement has not been used more frequently. One is that banks and PCAs view each other as competitors and so the initiation and success of the arrangements depends on the working relationship between the local bank and the local PCA. The attitude of the district Federal Intermediate Credit Bank (FICB) also affects these relationships, as the arrangement between the two institutions is subject to the FICB's approval. The second reason is that because the PCAs are cooperative institutions, the borrower is required to purchase stock in the PCA ranging from 5 to 10 percent of the amount of funds to be advanced by the PCA. Aside from these drawbacks, however, there can be definite advantages to these arrangements. One is that they expand the bank's ability to serve and keep its farm customers. The arrangement also provides a dependable source of funds from outside the bank's local market (6, p. 22).

There are two different arrangements with the Farmers Home Administration (FmHA) which allow a bank to meet its customers' needs either through direct bank loans or by participating with FmHA. The first is the use of guaranteed loans. The borrower works with his bank and seeks approval from the FmHA for a loan guarantee. If the request is approved, FmHA agrees to absorb up to 90 percent of any loss on the loan. Also, only the nonguaranteed portion of the loan counts against the bank's legal lending limit. There are FmHA guaranteed loan programs for both real estate and nonreal estate loans. The eligibility requirements and limits on these programs are discussed in the section of this publication dealing with the FmHA.

The second arrangement is the use of subordination agreements between the bank and FmHA. Loans from both bank and FmHA are closed simultaneously, but FmHA agrees to subordinate its claim on real estate to the bank. These arrangements encourage banks to participate in higher risk loans since they have first claim on all of the security while they advance only part of the funds.

Some banks work with life insurance companies to provide farm mortgage loans. In one form of this relationship, the insurance company has an arrangement with the bank to purchase the mortgage loans made by the bank. Another arrangement involves the bank acting as a "finder" for the insurance company. In this case, the insurance company makes the loans directly and the bank is able to provide financing for customers without tying up its funds in long term loans. The latter arrangement also helps overcome the problem of financing loans which exceed the bank's legal lending limit. Sometimes these loans are serviced directly by the insurance company, while in other cases, the bank may service the loan (6, p. 24).

The framework for a bank's loan policy is determined by the legislation under which it is chartered and by the regulations issued by supervisory agencies. Within this framework, the bank's board of directors formulates general policy outlines. These policies may be formal or informal. Since banks are corporations run by people, their policies vary greatly. Two banks may look alike but be very different. The borrower must keep this in mind when selecting a lender (8, p. 343).

Borrowers must know the loan policies of area banks. For example, some banks have a policy never to loan more than 80 percent of the current market value of livestock. This policy may include provisions for periodic appraisal of the livestock and the requirement for additional collateral or loan reduction if a price decline causes the borrower's equity margin to fall below 20 percent. A visit with a bank's loan officers before loan funds are needed can help identify the bank's policies (11, p. 449).

Loan Terms

Short and intermediate term nonreal estate loans account for about three-fourths the total volume of bank loans, and long term real estate loans account for

the balance. The repayment period (maturity) of farm loans varies considerably with the type and purpose of the loan, as well as bank policy. Bank nonreal estate farm loans tend to be for less than one year. Current operating loans are generally set up to be repaid as soon as the cash they generate is received. Some of these loans are written "payable on demand" because the length of time the funds will be needed is uncertain. But, borrowers should be careful about these arrangements, as circumstances could cause the lender to "call" the loan at a bad time for the borrower.

Loans for intermediate term purposes are generally written for three to five year terms, while terms up to seven years may be negotiated. However, some of these loans are written for one year or less with the understanding that the note will be renewed or rolled over at maturity. This arrangement allows the bank periodically to review the borrower's financial progress and collateral position and provides the opportunity to adjust the interest rate if market conditions have changed. A borrower should be aware, however, that the bank might not extend the loan.

The maximum maturity for real estate loans made by national banks is 25 years. For state banks the maximum terms depend on the law in each state. Some banks will make real estate loans for five, ten, or fifteen years but base the loan amortization on a longer period of time. This will result in a balloon payment at maturity which may be refinanced. The amortization period is the length of time that the scheduled rate of principal reduction would take to repay the debt fully (3, p. 3). During the negotiation of loan terms, borrowers should be aware that amortized loans can be set up in two ways. One plan will result in higher initial payments but less total interest paid over the life of the loan, while the other will produce smaller initial payments but more total interest over the loan period. The basis for preferring one plan over the other is the borrower's cash flow.

Many banks establish a "line of credit" for their borrowers. A line of credit represents a commitment to provide credit as needed, up to a set amount, and over a set period of time. This may involve advances on individual notes or a "master note." Under most line of credit arrangements a borrower can borrow, repay, and borrow again so long as the total amount outstanding at any one time does not exceed the line limit. In some banks the funds are automatically deposited in the borrower's checking account as checks clear the account. Since the farmer is able to borrow funds only for the number of days they are needed, the line of credit arrangement may reduce interest costs. The master note eliminates the need to make a trip to the bank each time funds are needed (8, p. 349).

Interest rates charged by commercial banks vary depending on the demand for credit, general economic conditions, monetary policy, and rates charged by other lenders. Historically, banks have tended to use fixed interest rates over the life of the loan. However, now more banks are shifting to variable or floating interest rates on their loans. Even on those loans with fixed rates, maturities are being shortened to allow the bank to adjust the rate at the time of maturity if market conditions have changed. On longer term loans such as real estate mortgages, such provisions can allow the bank to adjust the rate at set periods within a specified range of rate change. More banks are also shifting to pricing individual loans based on a number of factors. The increased use of individual loan pricing and changes in the terms of loan pricing will likely see major changes during the 1980s. Borrowers must keep themselves alert to changes in loan terms.

Because deposits are a bank's primary source of loanable funds, banks typically consider a borrower's deposit relationship in determining loan eligibility and in setting interest rates. It is true, however, that banks will at times offer to lend in order to attract a customer's deposits. There may also be exceptions to this policy for installment or consumer loans where interest rates are sufficiently profitable. Some banks will require compensating balances as a part of the conditions of a loan. In this case, the borrower is required to maintain a minimum or average deposit balance based upon some percentage of the loan. To the extent this amount exceeds the balances a borrower would carry for normal operating purposes, the requirements increase the effective cost of the loan. Some borrowers might be better off to negotiate a higher interest rate in return for lower compensating balance requirements.

Farm Credit System

The Farm Credit System is an agricultural credit cooperative owned by its member-borrowers. Although the system was originally created and funded by the federal Government, all of the Government capital has since been repaid. The banks and associations of the Farm Credit System are chartered by the federal government and operate under federal law. They are supervised and regulated by the Farm Credit Administration (FCA), an independent government agency.

The Farm Credit System is divided into twelve districts across the United States and is comprised of three major branches. These are (1) Federal Land Banks (FLB) which make farm estate loans through the local Federal Land Bank Association (FLBA), (2) Federal Intermediate Credit Banks (FICB) which provide loan funds for the local Production Credit Association (PCA), (3) Banks for Cooperatives (BC) which loan to farmer cooperatives. Because this publication deals with sources of loan funds for farmers and ranchers, the following discussion does

not cover BCs.

Most of the funds loaned by the Farm Credit System are obtained through the sale of consolidated bonds and discount notes in the nation's money market. The system does not lend Government funds nor are their loans guaranteed by the federal Government. Because of its source of funding, the Farm Credit System does not face the problem of a lack of loanable funds. Periods of tight money simply mean that the system has to pay a higher price for its funds. In addition, the system is exempt from state usury laws by virtue of its federal charter. Thus, it can pass on the full increase in the cost of funds to the borrower and does not have to restrict credit during periods of high interest rates.

Federal Land Banks (FLBs) and Federal Land Bank Associations (FLBAs)

The FLBs are the long term lenders of the Farm Credit System. In addition to the 12 district banks there are 500 FLBAs, most of which have one or more branches. The geographic boundaries of the associations are designed so that they do not overlap except in rare cases.

Loans are made for a variety of purposes, including the purchase of farmland, machinery and equipment, livestock, buildings, and rural housing. A significant portion of loans made are to refinance existing debt, including short term debt. The refinancing of short term debt allows a borrower to restructure debts to improve his cash flow. Although refinancing may be the result of a bad year, most arises from the purchase of additional land. If a borrower has an existing real estate loan, the old loan plus the loan funds for the new purchase are often written as one new loan covering both properties (11, p. 468).

The maturities on FLB loans range from 5 to 40 years and must be secured by the first mortgage. Most loans are now being made on a variable interest rate basis. This allows rates to be raised or lowered depending upon the cost of money to the FLB. Thus, all members of the cooperative share in interest rate increases and decreases. Although some outstanding loans are still based on the FLB's former fixed-rate plan, they represent less than 5 percent of FLB's loans outstanding, and loans are rapidly diminishing as older loans are paid off.

By law, FLB loans may not exceed 85 percent of the appraised value of the real estate offered as security, unless the loan is guaranteed by a Government agency. In the latter case, the limit is increased to 97 percent. However, the borrower may use other land or security as collateral in order to obtain more than 85 percent of the purchase price. In practice, loans are normally for a much lower percentage of the land's appraised value. The actual limit as a percent of market value varies greatly based on the amount of risk perceived in different areas of the country.

A district FLB's legal lending limit to any one individual borrower is 20 percent of the bank's capital and surplus. But larger loans can be made by participating with other district banks. Thus, there is no effective limit on the size of loan that an FLB could make.

Loan payments may be set up on an installment basis monthly, quarterly, semi-annually, or annually. These installments usually include a principal amortization that will fully repay the loan by its maturity. A borrower may repay any part or all of the loan at any time without a prepayment penalty. The FLBs have also initiated a future payment fund which allows a borrower to build up an interest-bearing reserve which may be applied toward the loan in periods when income is insufficient to make the payment. The FLBs have also been willing to work with a borrower to restructure debt rather than foreclosure on a loan, if the borrower is unable to make payments because of adverse weather or low prices.

Because the FLB is a cooperative, borrowers are required to purchase stock in the FLBA in an amount not less than 5 percent nor more than 10 percent of the amount of the loan, depending on the bylaws of the particular association. Normally, the funds to purchase the stock are added to the original loan and the stock is redeemed when the loan is paid out. In addition, many FLB districts also impose loan initiation fees which have been as high as 10 percent of the amount of the loan requested. These requirements naturally increase the effective cost of acquiring the funds actually needed.

To apply for a loan, a borrower must go to the FLBA serving the area in which the property is located. Thus, it is not possible to shop around for a FLBA that will be willing to loan the funds and provide the best service. While the district FLB provides the loan funds, the local association is responsible for receiving the application, handling the appraisal and the credit investigation, and closing the loan. The actual loan-making authority granted to the local FLBA varies. Some FLBs have delegated authority to the local associations up to a specified dollar limit, beyond which the loan must be approved by the FLB.

Like commercial banks, FLBs work with the Farmers Home Administration in making farm real estate loans. These arrangements include joint-closing loans, subordination of FmHA loans, and FmHA guaranteed loans. Joint-closing loans are new loans to farmers and ranchers who would otherwise have too little equity to be eligible for an FLB loan, but who can repay them. The FLB makes one loan secured by a first mortgage and the FmHA makes another loan secured by a second mortgage. Subordination loans are used to refinance an existing FmHA borrower who has become eligible to borrow from the FLB. Through an agreement between

the FLB and the FmHA, the FmHA loan is subordinated to the Land Bank loan. The FLBs also make loans guaranteed by the FmHA (8, p. 361). These have been used in some districts as part of young farmer loan programs.

Federal Intermediate Credit Banks (FICBs) and Production Credit Associations (PCAs)

The 12 FICBs and 424 PCAs are the short and intermediate term lenders of the Farm Credit System. The PCAs obtain their funds from the FICBs and are the direct lenders. In addition to providing funds to the PCAs, the FICBs participate with the PCAs on some larger loans and also discount or purchase agricultural loans for other qualified financial institutions. Like the Federal Land Bank system, the FICBs obtain their funds through the sale of consolidated bonds and discount notes in the nation's money markets. The FICBs do not deal directly with farmers and ranchers. Unlike the FLBAs, the PCAs are separately-chartered financial institutions and are direct lenders rather than simply servicing arms of the district bank. As such, they may participate with commercial banks or with one another in making loans.

Most PCAs serve fairly large areas. Like the FLBAs, their geographic boundaries do not overlap. In order to make their services more readily available to their borrowers, many associations have established full or part time field or branch offices. In some areas these offices are housed with the FLBA.

PCAs can make or participate in loans to farmers or ranchers, producers or harvesters of aquatic products, rural residents of communities with populations of less than 2,500 for rural housing, and businesses providing custom services to farmers and ranchers. PCAs can also make loans for processing and marketing activities which are directly related to the applicant's farm, ranch, or aquatic operation. Note that there are no restrictions on the purpose of the loan for farmers and ranchers. Thus, a farm operator can borrow from the PCA for non-farm purposes. The classification as a farmer or rancher extends to corporations, trusts, and partnerships so long as they are engaged primarily in the production of agricultural products.

PCA borrowers are required to own stock in the association in the amount of 5 to 10 percent of the loan. In contrast to FLB loans, where the stock is normally bought back when the loan is paid off, PCA stock is usually repurchased as the loan is repaid. PCAs also loan the additional funds needed to cover the stock purchase requirement.

The maturities on PCA loans are normally tied to the purpose of the loan. The maximum length of loan is 7 years on loans to farmers and ranchers and 15 years on aquatic loans. In some cases where the useful life of the item being financed is greater than 7 years, the loan will be written to provide for a balloon payment at the end of the seventh year with the understanding that the loan will be refinanced. Term loan repayment may be based on monthly, quarterly, semi-annual, or annual installments. However, most loans, particularly for operating purposes, are made on a budget or line of credit basis where the terms of the loan are tailored to meet the borrower's needs, based on projected cash flows.

PCAs basically use one or two interest rate plans. The first is a single variable interest rate plan under which all borrowers are charged a rate that reflects the average cost of acquiring funds from the district FICB plus a spread to cover the cost of operating the PCA. The second plan involves a variable differential rate, where the rate charged depends upon the average cost of acquiring funds from the FICB plus a differential which varies with the risk classification of the borrower (11, p. 463).

Although PCAs can make both secured and unsecured loans, they usually take a security interest in machinery, equipment, crops, and livestock. While PCAs do not ordinarily make first mortgage loans for the purchase of farm real estate, real estate may be taken as security.

The legal lending limit to an individual borrower is 50 percent of the association's capital and surplus. When the PCA participates with the FICB on a loan, the loan limit increases to 20 percent of the FICB's capital and surplus. Thus, the increasing size of farm loans has not been a problem for PCAs (1, ch. 3).

Applicants for PCA loans must go to the association serving the area in which the operation is located. In general, PCAs have tried to offer loan programs that emphasize a borrower's management ability and repayment capacity as well as the collateral which supports the loan. For this and other reasons PCA's market share has increased substantially over time.

Life Insurance Companies

Life insurance companies provide financing to agriculture primarily through first mortgages on farm real estate. Only recently have a few companies entered into nonreal estate lending. The future growth in this area remains to be seen. Although life insurance companies were the leading institutional source of farm real estate loan funds as recently as 1970, their market share has declined appreciably since that time. However, it appears that this downward trend may have leveled off. The decline has been due in larger part to five factors: (1) the availability of alternative investments with higher returns and comparable risk, (2) an increase in policy loans which reduced their investable funds, (3) a slower rate of growth in investable funds than the rate of growth in farm debt, (4) restrictive state usury laws which were frequently below market rates, and (5) laws in some states which limit insurance companies to 75 percent of the appraised value of the farmland pledged as security.

Farm mortgage lending by life insurance companies is highly

concentrated. Although many companies make such loans, at the end of 1979 five companies held approximately 75 percent of the farm real estate loans outstanding, and the ten largest lenders accounted for 90 percent of the market share held by life insurance companies.

Farm real estate loans made by life insurance companies are typically for large amounts, and the concentration on large loans has been increasing. On the average, farm real estate loans made by life insurance companies are three to four times larger than FLB loans. Most companies set a minimum size on the loans they seek. Minimums vary greatly from company to company but may be $200,000 or more. There are, however, no limits on how large loans may be, except for self-imposed maximums based upon the appraised value of the security. These loan policies are intended to reduce risk and servicing costs per dollar invested in loans.

Life insurance companies also tend to be selective in terms of the areas of the country in which they concentrate their loan activities. Since they have no legal obligation to serve farmers, they select areas where a reasonable degree of safety is combined with a large volume of business. Preference is given to areas where there are large commercial farms, soil types are uniform, and rainfall or irrigation water is dependable (8, p. 374).

Although life insurance companies' investments in farm real estate mortgages are scattered throughout the United States, the market share of farm mortgage loans held by life insurance companies varies considerably by state (9). In the northeastern United States where there are numerous small farming operations, life insurance companies have a relatively low share of the market. In contrast, their market share is over 20 percent in some delta and western states where there are large scale operations. Insurance companies avoid lending in states with restrictive usury laws.

In the past, life insurance companies offered fixed interest rates with relatively long amortization periods. Frequently, loans were set up on 10 to 25 year maturities with a balloon payment at maturity. However, with higher and more variable market rates, loan terms are rapidly changing. Three alternative repayment programs are becoming more common. The first involves the use of shorter maturities, in some cases from 3 to 5 years. These shorter maturities allow the company the opportunity to adjust the interest rate if market conditions have changed significantly. Normally, the loan contract is written to allow for renewal if the payment record has been satisfactory. The second alternative is the use of variable interest rate loans. A third alternative is the use of shared appreciation mortgages (SAMs). With a SAM, the borrower gets a fixed interest rate below the current market rate in exchange for a percentage of the appreciation in land values over a period specified in the loan contract. At the end of this period the land is either sold or appraised and the agreed upon percentage of the capital gains is paid to the lender or refinanced in a new loan (10, ch. 9). In negotiating these terms, a borrower needs to consider the amount of down payment, his income tax bracket, the expected rate of appreciation in land values, and the size of the interest rate discount.

When longer term fixed rate mortgages are used, most life insurance companies include some form of prepayment penalty in the loan contract. A common practice is to allow 20 to 25 percent of the loan to be prepaid in any year without penalty. Prepayments above this amount may be subject to a 2 to 3 percent penalty. The prepayment penalty is used to discourage repayment before the costs of initiating the loan are recovered. Prepayments are usually treated as the final payment(s) due, and cannot be used as a current payment at a later date to avoid default. Thus, a borrower may want to negotiate for a prepayment provision that would allow him or her to pay ahead, to avoid default in the event of hard times (9).

Life insurance companies have generally been willing to work with worthy borrowers during periods of repayment difficulty (8, p. 380). They realize that farm income fluctuates and some adjustments in terms may be necessary. Although interest payments are generally required, principal payments are often extended or deferred, or the loan rewritten if the borrower has a reasonable chance of working out of difficulty. Loans are normally foreclosed only when poor management or misuse of funds lead the company to believe that an extension would merely postpone the inevitable.

Farm real estate mortgages are originated through field representatives or correspondents. Field representatives are company employees and normally cover large geographic areas. They negotiate terms, appraise the property, and recommend the loan to the company's district or home office. Field representatives work directly with commercial banks, real estate agents, and mortgage brokers on loan referrals. Some companies also have correspondent arrangements with commercial banks, mortgage brokers, farm management firms, or individuals who originate and service loans for a fee. Some of these correspondents may work with one or more insurance companies.

Many borrowers seeking long term real estate financing can borrow from either an insurance company or the FLB. Given the choice, a borrower should consider several factors in deciding which lender to use. First, some life insurance companies offer terms in addition to those discussed previously. For example, at least one company allows the borrower to defer principal payments for the first two years of the loan and pay only interest. With companies offering shared appreciation mortgages, it may be possible for a borrower to

negotiate a trade-off between interest rate and the lender's share of appreciation. Second, because variable rates increase the uncertainty faced by the borrower, some borrowers may prefer a fixed rate loan. Third, borrowers need to consider the effect of the Federal Land Bank's stock purchase requirement on the cost of the funds needed. Fourth, both the Federal Land Banks and life insurance companies have periodically charged substantial front end fees which can significantly increase the cost of borrowing. Such charges by the Land Banks have been new loan initiation fees, while insurance companies have frequently employed loan application fees.

Farmers Home Administration (FmHA)

The FmHA is a rural credit agency of the U. S. Department of Agriculture that lends money to farmers, ranchers, and rural residents who cannot get adequate financing from other lenders. Borrowers must demonstrate an inability to obtain credit elsewhere at rates and terms normally charged farmers when borrowing for operating and real estate purchases (13). The policy of FmHA is to administer credit programs in a manner that does not supplant or compete with credit available to rural groups from conventional lending sources. It is, therefore, a lender of last resort. Basically, the role of FmHA is to bear the financial and market risks of rural borrowers that conventional lenders are unwilling or unable to bear.

A wide variety of loans and some grants are available from FmHA. These are offered under four basic programs: farm programs, rural housing programs, community programs, and business and industry programs. Grant funds are generally for rural housing and community development programs only. Loan funds are available for all four basic programs and are either direct, insured, or guaranteed loans. Both direct and insured loans are serviced directly by FmHA personnel.

Guaranteed loans are made by private lenders to farm borrowers who can only meet lender risk requirements with a Government guarantee. Private lenders make and service loans with FmHA guaranteeing up to 90 percent of any loan loss. Two types of loan guarantees exist. If the lender desires to sell notes in the secondary market, the lender will receive a "loan note guarantee" on a fixed loan amount. If the lender desires a guarantee on a line of credit, a "contract of guarantee" is issued. Line of credit guarantees may not be sold by lenders in secondary security markets.

The most important of farmer programs available from FmHA in terms of volume of obligations are the farm operating (OL), farm ownership (FO), emergency disaster loans (EM), and economic emergency loans (EE) (Table 2). Several criteria are used to establish borrower eligibility.

(1) The farmer or rancher must have sufficient experience or ability to succeed in farming and be recognized in the community as primarily and directly engaged in agricultural production. Corporations, cooperatives, and partnerships are eligible for loans if they are regarded as operating family-sized units. A family-sized unit is one that a family can operate and manage itself with a reasonable amount of hired labor. The family must devote more than 50 percent of its time to agricultural production or derive more than 50 percent of family gross income from agricultural production in order to qualify.

(2) The borrower must be unable to obtain sufficient credit elsewhere at reasonable rates and

Table 2—Farmer loan programs of the Farmers Home Administration (FmHA)[1]

Farmer loan programs	As of Sept. 30, 1980			Fiscal year 1980 (Oct., 1979-Sept., 1980)		
	Number of borrowers	Dollar volume outstanding	Percent of FmHA programs	Number of loans	Dollar volume	Percent of FmHA programs
		Mil. dol.			Mil. dol.	
Farm operating (OL)	87,073	1,964.1	4.4	32,211	874.8	6.7
Farm ownership (FO)	118,424	4,883.3	10.9	12,972	954.1	7.4
Emergency disaster (EM)	93,112	7,454.2	16.7	54,394	2,266.9	17.5
Economic emergency (EE)	61,225	4,487.2	10.1	44,887	2,185.5	16.9
Recreation (RL)	248	13.9	*	26	2.3	*
Grazing associations	300	73.6	*	3	4.2	*
Soil and water (Ind.)	15,397	257.0	.1	2,602	54.6	.4
Irrigation and drainage	323	18.6	*	6	.5	*
Indian tribe land acquisition	26	61.9	*	3	6.4	*
Economic opportunity	3,007	2.2	*	--	--	--
Total farmer programs	379,535	19,216.0	43.1	147,104	6,349.3	49.3

*Less than .1 percent of total FmHA programs.
[1]The majority of FmHA loans are insured loans, accounting for over 90 percent of total farm program loans during FY 1980.
Source: Reports Management Branch, FmHA, USDA, Washington, D. C.

terms. The only exception to this rule is emergency disaster loans (EM). An applicant who is able to get credit elsewhere but is otherwise eligible may receive an EM loan up to the amount of actual losses caused by a natural disaster. These loans carry a higher rate of interest than others. A further discussion of the emergency disaster program is included later in this section.

(3) The borrower must be legally eligible to incur the obligations of a loan.

(4) The borrower must be of good character and be able to carry out the terms and conditions of the loan.

(5) The borrower must be a citizen of the United States. In the case of a cooperative, corporation, or a partnership, more than 50 percent interest in the entity must be owned by U.S. citizens, and the entity must be primarily engaged in farming.

The financial certification of eligibility for those making application for FmHA loans is made by a county or multi-county area committee. This committee consists of three individuals familiar with farming and credit conditions in a given area. In addition, all farm program loans require periodic review of borrowers to determine lender eligibility for possible "graduation" to other credit sources.

Specific conditions for each of the four major FmHA farm loan programs include the following:

Farm Operating Loans (OL)

Loans are made for annual production purposes, including the purchase of livestock, poultry, farm and home equipment, and normal operating expenses. Certain debts may be refinanced with FmHA loans to improve the repayment ability of the borrower.

Minor improvements to buildings and real estate may be made, and water systems can be developed for home, livestock and irrigation use. Loans may also be used for horticulture, fish farming, roadside markets and nonfarm business and recreational enterprises.

Terms: Loans for production purposes are to be repaid when crops or livestock are sold. Livestock and machinery loans have a maximum repayment of seven years but may be rescheduled for up to seven additional years.

Loan size limit[3]:

Direct or insured: $100,000

Guaranteed: $200,000

Interest rates:

Direct or insured: Based on Government cost of borrowing[3]

Guaranteed: Negotiated between borrower and lender

Farm Ownership Loans (FO)

Loans are made to buy, improve, or enlarge farms. Funds may be used to refinance debt, develop water resources, do fish farming, or carry on a variety of nonfarm enterprises.

Terms: Repayment is scheduled according to a borrower's ability to repay. The maximum repayment term is 40 years.

Loan size limit[3]:

Direct or insured: $200,000

Guaranteed: $300,000

Interest rates:

Direct or insured: Based on Government cost of borrowing[3]

Guaranteed: Negotiated between borrower and lender

Limited Resource Loans

A special category of loans exists for OL and FO purposes to limited resource farmers who cannot get credit elsewhere and who cannot afford to pay the normal interest rates on FmHA farm loans. The minimum interest rate as of mid-1981 was 5 percent. Limited resource borrowers "graduate" to higher interest rates when their situations improve.

[3]Loan size limits and interest rates are subject to periodic change. As of June 1, 1981, the rate of interest charged for direct or insured farm operating loans was 14.5 percent and for farm ownership loans, 13.25 percent.

Emergency Disaster Loans (EM)

Loans made available to farmers in locations designated as disaster areas by the President or when authorized as natural disaster areas by the Secretary of Agriculture. Loans can be made to compensate for (1) actual physical losses directly related to disaster, (2) annual production expenses and other needs arising from natural disasters, providing the borrower has some "all-risk" crop insurance coverage, if available, and (3) major adjustments in the farming operation necessitated by a disaster. A farmer may borrow up to 80 percent of a physical loss and qualifying production loss, which is at least a 30 percent loss of total farm production. Major adjustment loan(s) may be used to construct or improve farm buildings, purchase equipment, livestock and/or poultry and refinance delinquent loan payments up to an amount which does not exceed the size of operation before the disaster.

New authority granted FmHA by the Small Business Act of July 2, 1980 now authorizes FmHA to make loans for losses in designated disaster locations to farmers that are able to get credit elsewhere. Interest rates on actual loss loans to these borrowers are higher than to borrowers who are unable to get credit elsewhere. This severely restricts, but does not eliminate Small Business Administration disaster loans. Farmers able to get credit elsewhere will be eligible for consideration for SBA loans for farm losses only if they have been turned down for such loans by FmHA because of legal restrictions.

Terms: Loans for annual recurring production expenses are to be repaid each year. Loans covering losses to crops, livestock, supplies and equipment may be scheduled for repayment up to 7 years with rescheduling up to 20 additional years. Loans for real estate may be scheduled for repayment not to exceed 30 years.

Loan size limit:

Direct or insured: Actual losses, or up to $500,000, whichever is less. Maximum total indebtedness, including loans for annual production purposes and for financing major farm adjustments, is limited to $1.5 million per borrower for FY 1980, $1.0 million for FY 1981, and $500,000 for FY 1982.

Guaranteed: This program not operational as of mid-year, 1981.

Interest rates: (direct or insured loans)

Actual loss loans (unable to get credit elsewhere): 5 percent

Actual loss loans (able to get credit elsewhere): based on Government cost of borrowing[4]

Recurring production expenses: Same as with OL loans

Production purposes: Same as with OL loans

Real estate: Same as with FO loans

Economic Emergency Loans (EE)

Loans are made to farmers who are suffering economic hardships due to national or areawide economic stresses, such as a general tightening of agricultural credit, high production costs, or low prices for farm products. This program was created in 1978 primarily to refinance debts and provide operating expenses to carry on farming operations. However, regulations adopted in 1980 restrict the use of the program for refinancing existing debt. Refinancing in full is now primarily for loans for annual family living and farm production debts. For EE loan requests of $300,000 or more, borrowers are required to apply at not less than three conventional lending sources as a test for inadequate credit elsewhere. For loans of less than $300,000, borrowers must apply with their normal lenders as a test for inadequate credit, unless it becomes burdensome for applicants to obtain written declination of credit from other lenders.

Terms: Loans for annual recurring operating expenses are to be repaid when crops or livestock are sold but can be deferred, consolidated, rescheduled, or reamortized, if necessary, for up to seven years. Chattel loans are scheduled for repayment within seven years but may be consolidated and rescheduled for an additional seven to 13 years. Loans for real estate purposes may be scheduled for repayment up to 40 years.

Loan size limit:

Direct or insured: $400,000 with the combined loan total for OL, FO, EE, recreation loans and soil and water loans not to exceed $650,000.

Guaranteed: Same as with direct or insured.

Interest rates:

Direct or insured: (1) Operating purposes — same as with OL loans (2) Real estate — same as with FO loans (Based on Government cost of borrowing)

Guaranteed: Negotiated between borrower and lender.

Synthetic Fuel Loans

Under Title II of the Energy Security Act of 1980, FmHA and the Department of Energy (DOE) will finance plants for producing nonpetroleum fuel. FmHA will make insured loans of $1 million or less per project for small-scale plants capable of producing up to 300,000 to 500,000 gallons of fuel alcohol per year. Guarantee loans are available from FmHA for intermediate-scale plants which will produce up to 15 million gallons per year. Guarantee loans are for construction, acquisition, or conversion of plants, not for working capital. DOE will finance plants producing more than 15 million gallons per year.

Commodity Credit Corporation (CCC)

The CCC is an agency of the U.S. Department of Agriculture (USDA) operating through personnel and facilities of the Agricultural Stabilization and Conservation Service (ASCS) and other USDA agencies. The CCC is the fiscal agency and instrumentality of the U.S. Government for agricultural commodity programs and is authorized by charter and by statute to buy, sell, make loans, store, transfer, export, and otherwise engage in agricultural commodity operations (13).

Farmers, sugar processors, and approved farm cooperative marketing firms can place eligible farm products in approved storage for set time periods and receive a loan from the CCC equal to the product's value (commodity loan rate multiplied by the quantity of product in storage). Loans received from CCC are nonrecourse in the sense that, if farm market prices fall below the loan rate, the commodity pledged as collateral can serve as full payment of principal and interest on the loan, thus assuring a minimum price. Guarantees of minimum farm prices are required or authorized by law for wheat, corn, peanuts, rice, tobacco, wool, mohair, upland and extra long staple cotton, honey, barley, oats, rye, sorghums, milk and its products, flax, soybeans, gum naval stores (rosin), sugar beets, and sugarcane. Loans on tobacco, peanuts, and gum naval stores are made through cooperative producer associations, and on rice, cotton, corn, oats, rye, barley, sorghum, soybeans, wheat, and honey, either directly to farmers or to cooperatives on behalf of their members. A basic eligibility requirement for a CCC loan is farmer compliance with any USDA allotment for set-aside programs and storage in CCC approved facilities.

Lending provisions of the CCC provide two basic options to eligible participants for commodity loans. The first option is the regu-

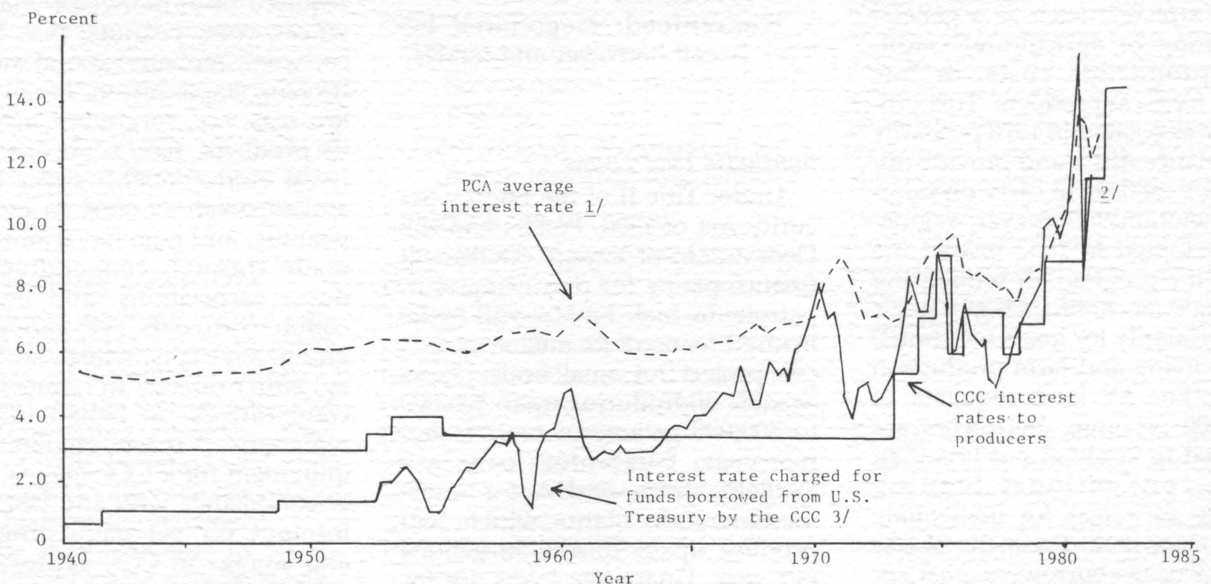
[4]As of June 1, 1981, the rate of interest charged on Emergency Disaster loans where the borrower is able to get credit elsewhere was 15.0 percent.

lar loan program which allows for loan maturities up to approximately 10 months following harvest with provisions sometimes made for several additional months renewal. These loans have been available for basic agricultural crop commodities since the mid-thirties. If commodity prices rise above the loan rate, the participant has the option of selling the commodity prior to or at maturity and of repaying the loan. If loans are repaid, the participant must repay the principal, plus interest based on CCC interest rate charges, and storage costs for the length of the loan. If the CCC takes title to the commodity as fulfillment of the loan obligation, the participant pays no interest on the loan, but must pay storage costs. Thus, the loan program offers farmers or their marketing cooperatives short-term financing to pay debts soon after harvest while holding commodities for later sale and possible benefit from price increases.

A second option for commodity loans, instituted in 1977, is the farmer-owned grain reserve program (FOR) for producers of eligible rice, wheat, corn, sorghum, barley, and oats. Under the reserve program, participants have the same minimum price protection as under the regular loan program but enter a longer term 3-year contract, agreeing to hold grain in reserve until the contract matures or until the national average market price reaches a predetermined release level. Upon loan maturity or at a "call" price currently ranging from 145 to 175 percent of the loan rate (depending on the individual commodity) the participant is required either to repay the loan or to forfeit the commodity. Exceptions to these requirements may be made by the Secretary of Agriculture, as in early 1981 when farmers were granted an indefinite extension on repaying their reserve corn loans. Storage requirements and the interest rate charged on reserve loans may be the same for grain placed under the regular loan program. However, no interest is charged after the first year of the reserve agreement (except when the commodity is in a "call" situation), and annual storage expenses are paid in advance by the CCC.

Loans for storage facilities, drying, and other grain handling equipment are also available from CCC. The Department of Agriculture has sought through loan programs for several years to encourage both increased farm storage and development of improved farm storage facilities, including handling and conditioning equipment. Recourse loans on grain storage and drying equipment are available to participants for up to 75 percent of the cost of construction. Current loan limits cannot exceed $50,000 per farmer. Loan repayment is by four equal annual installments over a period of five years. Interest charges on these recourse loans vary slightly from those charged on nonrecourse and reserve program loans.

Figure 3. Interest rates on Commodity Credit Corporation (CCC) and Production Credit Association (PCA) loans and cost of funds borrowed by CCC from the U.S. Treasury, 1940-81



1/ Annual average rates from 1940 through 1961 with average rates at beginning and mid-year thereafter. Stock purchases and loan fees required of borrowers are not taken into account in rates shown. Source: Compiled from the Agricultural Finance Databook, Board of Governors of the Federal Reserve System, U.S.

2/ Any new CCC loans on 1979 crops after April 15, 1980 were 13 percent as compared to 9 percent on 1979 crops prior to this date. CCC loan rates on 1980 crops were 11.5 percent and 14.5 percent on 1981 crops.

3/ From Lester LeCompte, Commodity Credit Corporation, ASCS, USDA. Rates are as of the beginning and midyear.

Interest Rates for CCC Loans Relative to Other Lenders

Figure 3 depicts general changes in the interest rate structure by CCC and the cost of loan funds from alternative sources (as represented by the PCA rate of interest). Historically, the interest rate charged by CCC has been less than that charged by other lenders. Although the difference between the CCC rate and other costs of debt funds was relatively constant over the 1940-72 period, the average differential has narrowed since 1972. Thus, during more recent years, the cost of money for crop inventory loans from CCC has been close to cost of loan funds from other loan sources. Since the mid-seventies, CCC interest rates to farmers have been generally consistent with keeping charges in line with CCC borrowing costs from the U. S. Treasury.

CCC Lending Relative to Other Lender Financing[5]

An increasingly large share of nonreal estate funds has been provided by loan sources other than the CCC. Since the start of lending programs during the mid-thirties, CCC debt outstanding has trended upward, but the total volume of loans outstanding has risen less rapidly than other sources of nonreal estate debt. The relative decrease in loan funds provided by CCC is explained in part by changes in emphasis of farm programs over time—basically to a program with greater emphasis on direct farmer income assistance and less emphasis on commodity price guarantees. In addition, commodity prices during the seventies generally increased relative to loan rates and further reduced the dependence of U. S. producers on the CCC for minimum price supports. It also could be argued that the strengthening emphasis of Government farm income maintenance programs, in general, has contributed to lenders' willingness to furnish loans to farmers.

Merchants and Dealers

Many merchants and dealers that sell farm merchandise also provide credit for their purchase. Credit programs are offered for a variety of reasons, including (1) to promote sales, (2) to improve the seasonal distribution of sales, (3) to generate a profit on credit operations, and (4) to provide convenience to the customers (10, p. 502). Credit can take various forms. These include 30-day open accounts and credit card purchases where no interest charge may be involved but a cash discount may be forfeited; extended open accounts beyond 30 days where interest rates may or may not be charged; and more formal time contracts, such as conditional sales contracts, written notes, or promises to pay that involve interest charges (6, p. 13).

Farmer eligibility requirements for such financing are similar to those for other lenders. Sellers are basically interested in being paid for goods and services purchased. In some instances, notes and other legal documentation are used to secure the seller's interest.

Credit programs offered by merchants and dealers can be a convenient source of financing, but this should be weighed against loan terms and interest costs. Generally, loans from merchants and dealers are more costly than from other lenders. Often one gets a substantial discount for paying cash, and in some cases this saving may justify borrowing elsewhere. Credit programs used to bolster sales are likely to change rapidly in response to periods of excess supply or demand for the merchant's product. Thus, the cost and availability of funds may vary considerably, depending on how aggressively credit programs are used to boost individual farm sales. With any purchase, the farmer must be satisfied with getting the desired product for the best price. "Free" trade financing that ties one to a particular dealer who is noncompetitive in terms of either price or quality of product can be a very costly source of funds (1, p. 78). However, as long as the farmer is satisfied with both the quality and the price of a product, and no cash discount is available, full advantage of trade financing should be taken as long as the interest cost is equal to or lower than alternative sources.

Individuals

Individuals provide some annual operating and intermediate-term lending to farmers but they are most important in extending long-term financing for the purchase of real estate. Most of this lending occurs when a farmer retires and is willing to finance the land sale with a contract for deed, first mortgage or second mortgage lien (6 p. 13).

Individual seller financing is popular among buyers because it may allow the buyer to purchase real estate with a lower down payment and at more favorable interest rates than possible from institutional lenders (10). Prepayment penalty clauses may or may not be a part of individual real estate sales. However, the cost, terms, and repayment schedules associated with seller financing can vary widely, and often there are important trade-offs between the negotiated price at which land sells and the interest rates charged. Although sellers normally prefer first mortgages on land sales, they may more readily accept second mortgages in cases where other institutional lenders are involved that require a first mortgage. Also, sellers may more readily accept second mortgages in instances where a sale involves an existing mortgage at a favorable interest rate. Shared appreciation mortgages offer an even greater range of alternatives for negotiating terms between buyers and sellers. For example, rather than taking a percentage of any appreciation in value, the seller might take an option to repurchase a specified

[5]For a further discussion of the role of the CCC in agricultural lending, the reader is referred to Bruce Hottel, "The Commodity Credit Corporation and Agricultural Lending," *Agricultural Finance Review*, Economics and Statistics Service, U. S. Department of Agriculture, Vol. 41, July 1981.

portion of the land at the original sale price with the buyer having the right of first refusal (10).

Installment sales are popular among sellers because they allow sellers to spread any capital gains over more than one year and thus reduce income taxes. Recent changes in U. S. tax regulations for 1980 have made installment sales even more flexible in qualifying for long-term capital gains. The *Installment Sales Revision Act of 1980* drops the old rule which disallowed installment reporting of capital gains if one received more than 30 percent of the selling price in the tax year of sale. The amount of down payment is now irrelevant and the only requirement for installment sale qualification is that at least one payment be made in a taxable year after the year of sale.

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