It takes a lot of effort but...

There's an "active market" today for small farm loans

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Credit availability is a common constraint for small farmers. The biggest problem is that the cost of making loans does not vary much with the size of the loan. Therefore, the earnings potential for the lender is much greater from a large loan than a small loan. There are other problems such as lack of collateral or high risk of specialty crops that limit access to credit for many small farmers. Despite these difficulties, the Farmers Home Administration, the Farm Credit System and several innovative lenders in the private sector have developed programs to improve the credit environment for small borrowers.

Understanding the financing of small farms requires understanding business strategy, general loan procedures, sources of funds, lending capacity and the general mandate of lending institutions. What follows are (1) an explanation of the unique problems related to small farm financing, along with the factors that can complicate any farm loan, (2) an outline of the analysis process on which loan decisions are based, and (3) descriptions of the major institutions that lend to small farms and their unique characteristics.

Costly financing

Small farms represent a large segment of the credit market in terms of numbers but not in terms of loan volume. The earnings potential from a large loan is much greater to the lender than earnings from a small loan. In general, small loans are not a high risk, just low profit. Furthermore, lenders are finding it more difficult to make loans to small farmers because of the costs they incur and because of federal regulations that inhibit their flexibility in making loans.

Costs to the lender begin with the initial interview, followed by an analysis and writeup. The analysis includes a credit report. When hard assets are used as collateral, there are title searches, appraisals, state and county searches for liens on equipment and county searches for liens on crops. The loan is then reviewed by the lender's loan officer, by the Federal Deposit Insurance Corporation, by the state, by another member of the institution making the loan, and, possibly, by an outside private audit. At this point, the analysis and verification are rewritten, and the hard assets and production site are inspected.

Also costly is the preparation of legal documents, including the note, loan agreement, deeds of trust and the borrower's rights package that is required by the Real Estate Protection Act and the Truth in Lending Act. The Universal Commercial Code (UCC) filing serves as the deed of trust for the crop and establishes the lender's position in the security of the crop. Cost per filing is usually between $35 and $50. Costs of administering the loan, once approved, include inspecting the crop site one to three times during the growing season, receiving payments, answering questions, providing copies of documents if requested, and finally, sending the letter of maturity to the borrower. (This letter is sent when the loan terminates.)

The loan generates income to the lender from application and origination fees as well as from interest payments. The loan application fee is always a flat rate. The loan origination fee is a percentage of the loan amount. Commercial banks charge points. The Farm Credit System requires its borrowers to buy stock in proportion to the size of the loan. (This is discussed in greater detail later.)

Large commercial banks find that transaction costs are the same, regardless of the size of the loan; they therefore prefer large, well secured loans over small ones. For small loans, cost to the lender is too great relative to the earning potential. In general, large banks are reluctant to make loans under $500,000. While $500,000 is not a small loan for many types of businesses, it is relatively small for agricultural production in California, where a $1 million loan is considered to be moderate. The Farm Credit System and state banks specializing in small- and medium-family farm loans typically make loans ranging from $200,000 to $350,000. A loan must be somewhere around $50,000 to $60,000 before it is remotely profitable. Smaller loans are made to existing customers for as little as $5,000.

Additional problems

For small farmers qualifying for loans, lack of equity is common. Many small farms, well capitalized because of second incomes, have little collateral. Lenders want collateral that will guarantee repayment of the loan. Typical secondary sources of repayment include equity in land, cash in the bank, a cosigner, hard as-

sets such as equipment, and retained earnings from previous crops. Young people starting in farming may have no collateral of their own, but often their parents are in farming and can cosign the loan, acting as a proxy for capital and also for a track record. Another source of secondary repayment important to small farm financing is the Farmers Home Administration loan guarantee program (to be discussed later).

A second problem is lack of working capital. Livestock and orchards are common part-time small farm operations; borrowers needing working capital often have a reasonable amount of equity, but if the first lien on the property is large, the lender may be unwilling or unable to take the risks associated with a second or third lien.

Making a big down payment on land is often difficult for a small farmer. This is complicated by the fact that some lenders may consider a parcel of land of less than 25 acres a home site, not commercial agricultural property; the land could be appraised at a value similar to a single lot in town, depending on the location of the parcel. In general, smaller parcels tend to be close to town. Furthermore, many real estate lenders do not make land loans and may require that a house be built on the property before they will make the loan. At the very least, a working well must be present. This could result in an unworkable situation for a farmer.

Another problem is that sometimes small loans are considered consumer type lending. Such loans follow a different set of regulations from that of agricultural loans and may increase transaction costs to the lender.

Lack of experience in farming and/or farm management is another critical factor. Experience is perhaps the hardest quality to prove and the most difficult for a lender to assess. A 3-year track record for a commodity in question is the best source of information. Education and work experience are other factors used to prove management ability.

Complicating factors

Many factors make a loan complicated and costly, including the farm's enterprise mix. Small farms are often highly diversified. While diversity usually translates into reduced risk, it also means that the projected budget for each enterprise must be reviewed separately. Furthermore, each crop must be inspected and verified. This increases cost for the bank. The physical distance between farm and bank may become a factor here; the greater the distance, the more expensive the inspection visits.

Typically, the marketing plan for the borrower's operation is cut and dried. The farmer has a contract with a processor, cooperative or broker. Specialty crops carry higher risk than conventional because they are difficult to grow, market, or both. Often, the size of the market is small, but the price received is high. There may not be a possibility of a contract. Underwriting standards for these crops are stricter than for conventional crops.

Government programs add further complications, particularly when more than one government agency is involved. The definition of farm entities to meet federal water, Farmers Home Administration (FmHA) or the Agricultural Stabilization and Conservation Service (ASCS) requirements vary. All lenders employ attorneys to check compliance with government regulations, adding to the cost of making the loan.

One example is the 960-acre limitation for receiving federal water. To increase the amount of federal water available to it, a farming operation may have to be divided into several entities, with a loan required for each separate entity. The local water district administers the water allocations. This acreage limitation is not a problem for many small farms, but it does come into play for relatively small loans for family farms involving partnerships which include more than 960 acres.

The $50,000 payment limitation for receipts from the USDA Farm Program complicates loans similarly. Any individual is allowed to receive $50,000 from one entity and $25,000 from each of two other entities as long as he or she does not have more that 50% interest in the second two entities. To be part of an entity, you must demonstrate that you are contributing management and capital. This means that each entity must show its own source of funding. The situation is further complicated by the fact that ASCS, which administers the farm program, will not allow loans to be cross-collateralized. In other words, partners cannot cosign and or sign loans as individuals. Personal guarantees are not allowed. The FmHA has its own set of rules as to what constitutes a qualifying entity. Compliance with regulations of wetlands and other environmental concerns also adds to costs and processing time.

Lease arrangements add another layer of complexity to any loan analysis. In general, rents are getting higher. Banks prefer to see share/rent arrangements wherever possible because it means the landlord is sharing the risk. More farmers are leasing equipment and custom hiring than in the past to share equipment with neighbors. This, too, adds to the number of documents to be verified and to the loan's overall complexity.

Loan analysis

Lenders assess the risk-carrying capacity of the borrower according to his or her working capital, equity and leverage. Working capital, the value of current assets minus current liabilities, is a measure of the cash that could be raised in a short time minus the debt payments due during that same period. In contrast, equity is the net value of all owned assets in the business minus all associated debt. It is a measure of the funds that the farmer personally has invested in the business. Leverage is the ratio of total debt (short-term and long-term) to equity. It is a measure of risk exposure. When this ratio is greater than one, the lender(s) have more invested than the borrower. When the leverage ratio increases over time, the relative level of debt increases. When the ratio decreases, the farmer builds up equity.

The borrower's repayment capacity is studied by the lender, who wants to know what recourse the borrower has if something goes wrong. Secondary sources of repayment include off-farm income, bank deposits, hard assets (such as equipment), equity in land, a cosigner, and retained earnings from previous crops. A lender looks at overall debt coverage capability of the borrower as well as the ability of the security itself to cover the debt. A real estate security is looked at in terms of the income it generates, relative to loan payments, and also the size of the loan, relative to the property's value (the loan-to-value ratio). Of course, capacity for repayment comes from consistent profitability. Profits build working capital and equity. Working capital provides the ability to weather short-term disasters; equity creates the resiliency needed to withstand long-term adversity.

The financial analysis conducted by the lender is derived from financial statements, tax returns and other documents provided by the borrower. For a new borrower, 3 to 5 years of information are requested. A repeat customer need only provide information for the previous year.

In the first cut of a loan analysis, the lender looks at specific financial measures and reviews a set of standards the applicant must meet. These standards are not cut and dried. For example, a strong secondary repayment capacity, in the form, say, of off-farm income, can counterbalance a low projected profit margin. Perhaps the most critical factor in loan analysis is management ability — and it is also the most difficult to measure and document. In recent years, the availability of water to the borrower has also become important in agricultural lending.

Lenders generally lend about 80% of the projected costs on a production loan. A

conservative assumption is made that gross income will equal total costs. In lender terminology, the margin factor on projected costs is 20%. The margin is the gross income minus the financed expenses. The margin factor is the margin divided by total expenses. This allows for a 20% error in projections of costs or income without a problem in repayment. If there is a strong secondary source of repayment, lenders will lend up to 100% of the projected expenses. Some lenders require upfront equity equivalent to the size of the production loan. A typical real estate loan requires a 40% down payment or 40% equity in other property. For example, another property owned by the borrower can be refinanced to get the equity out and to use it as a down payment. Coming up with this large amount often poses problems for small farmers.

Lenders will not reduce interest rates to create a loan cash flow, with the notable exception of the FmHA rate reduction program (which is described later). The rate is based on the amount of the loan and the strength of the borrower. All things being equal, larger loans get a lower interest rate than smaller loans. Therefore, small borrowers may end up with high interest rates. The interest rate spread can be more than 4% on production and real estate loans.

Sources of credit

Credit for small farmers is available from commercial banks, the Farm Credit System, insurance companies, Farmers Home Administration and rural development corporations. These groups coordinate with one another to develop loans that will appeal to small farmers and to the lender.

Local banks. Local banks are a source of short-term credit for production loans. Primary sources of funds for production loans are bank deposits; local banks, therefore, encourage their borrowers to deposit their profits back in the bank. In fact, loan fees and the interest rate may be reduced when there is a full banking relationship. The fact that the primary source of funds is deposits limits the size of the loans local banks can make. Furthermore, community banks try to provide all services to the agricultural community. For these reasons, some local banks have aggressively sought out small farm customers.

Banks cannot do long-term lending from deposits that are very liquid. From a bank management perspective, the short-term characteristics of the sources of funds (that is, deposits) do not match long-term characteristics of the uses of funds (that is, long-term loans). In order to bring the characteristics of the sources and uses of funds into balance, some banks sell long-term loans to insurance companies with which they are affiliated. Selling loans also increases the volume of loans the bank can make. (This relationship is discussed in more detail under the section, Life Insurance Companies.)

Farmer Mac. The Federal Agricultural Mortgage Corporation (Farmer Mac) is operated by an independent entity within the Farm Credit System. Farmer Mac was designed to create a secondary market for farm mortgage loans. The creation of a secondary market increases the availability of long-term credit to farmers by providing greater lending capacity to various farm-lending institutions.

The basic approach of the secondary market is to allow agricultural mortgage marketing institutions (commercial banks, Farm Credit System institutions, investment companies, insurance companies, etc.) to buy loans, pool them and then sell securities in the form of $100 face value bonds. Farmer Mac oversees these transactions and guarantees 90% of the value of the securities. The remaining 10% is what is called the subordinated debt and absorbs the risk for the rest of the security. It would take a major disaster to erode more than 10% of the security, inasmuch as the loans are pooled from all over the country for various types of farming operations. Furthermore, historically, overall farm mortgage default rates have never been above 10%. Therefore, the holder of the 10% subordinated debt holds nearly all of the risk.

Nonetheless, the creation of secondary markets for farm mortgage loans theoretically allows banks with short-term funding in the form of deposits to make long-term loans. It also allows insurance companies to do more lending in agriculture than they could do otherwise. Finally, it allows poolers to combine loans in such a way as to reduce risk. Activity in this market has been relatively low so far. It is too soon to predict how substantial the impact will be on agricultural credit.

Life insurance companies. Life insurance companies sell insurance policies to policy holders that result in the accumulation and holding of large financial reserves. In turn, life insurance companies seek long-term, low-risk investments to match the long-term characteristic of their assets. Involvement of life insurance companies in agricultural lending varies significantly from company to company. Loans may be made directly through a company office or through mortgage brokers, real estate companies or commercial banks.

A local bank affiliated with an insurance company uses the company's forms and underwriting standards. Once a loan is made, the bank sells it to the insurance company, thereby replenishing the bank's assets. The bank services the loan and keeps the loan origination and servicing fees as earnings; the interest payments go to the insurance company. The relationship with the insurance company allows the bank to do a larger volume of business than it would otherwise and reduces the bank's exposure to risk. At the same time the insurance company has low servicing overhead costs for the loans and is able to spread its risk exposure over a large geographic area. The insurance company has the option of pooling the loans and selling them through Farmer Mac.

An example is Prudential Life Insurance, which has relationships with about 80 banks representing almost every agricultural region in the United States, including three banks in California: Feather River State Bank, California Valley Bank and Bank of the Sierras. The networking of banks has added another product that a full-service bank can offer its customers with little additional overhead. Although most of the loans are not pooled, Prudential made its first Farmer Mac sale in June 1992.

The most common loans obtained through insurance companies are for 7, 10 or 15 years, with a balloon payment at the end. This means that the loan is not fully amortized at the end of the loan period and there is still a substantial outstanding principal. Most people tend to refinance at the end of the loan or to sell the property at that time. The longer the length of the loan, the greater the risk to the lender and the higher the interest rate. The interest rate for a given loan term can vary about 0.7% based on the riskiness of the loan. Theoretically, a loan can be for up to 75% of the appraised value of the farm property. Generally, the loan is for 60% of its value.

Farmers Home Administration. The Farmers Home Administration (FmHA), an agency of the U.S. Department of Agriculture, provides loan guarantees and direct loans to family-size farmers who are unable to otherwise obtain credit from the commercial sector. FmHA guarantees loans from commercial banks and the Farm Credit System for up to 90% of the loan and interest. In fact, FmHA is moving away from making direct loans and is increasing its loan guarantee program. Besides reducing risk exposure of lenders, the loan guarantee program increases the legal lending limits of banks because guaranteed loans are not included in the ratio of unsecured debt to deposits.

Keep in mind that the FmHA guarantee is a "loan loss" guarantee that protects

the lender and not a "loan" guarantee that assures available funds to the borrower. As such, the guarantee, like a cosigner, is a proxy for capital.

FmHA programs include operating loans and farm ownership loans. Repayment terms range from 1 to 7 years for direct loans. The term and interest rate for guaranteed loans is negotiated with the lending institution. The limits are $200,000 for direct loans, $300,000 for guaranteed ownership loans and $400,000 for guaranteed operating loans.

If a borrower qualifies for a loan in all ways except cash flow, assuming the current FmHA interest rate, the borrower may qualify for the "limited resource interest rate," which is usually about 3 percentage points below the going rate. The loan can be made if the reduced rate results in a positive cash flow. The loan guarantee program includes a similar provision called "interest assistance." FmHA can subsidize interest payments up to 4 percentage points if it will improve cash flow to the point of making the loan acceptable to the lending institution. However, critics of this provision claim that, if a loan is that close to being unacceptable, it is too risky even with an interest rate subsidy.

Other critics of the loan guarantee program cite heavy paperwork and government bureaucracy as deterrents from using the program. However, FmHA will give qualifying lending institutions "preferred lender status" which allows them to use their own forms instead of FmHA's. This takes a lot of the work out of the application.

Farm Credit System. The Farm Credit System (FCS), authorized by Congress in 1916, created a cooperative system of 12 Federal Land Banks. The original mandate was to provide farmers with long-term real estate mortgage loans at more reasonable terms than those offered by other lending institutions. Currently, the FCS makes loans through three associations. Production Credit Associations (PCAs) make operating and equipment loans and Federal Land Bank Associations (FLBAs) make real estate loans. Agricultural Credit Associations (ACAs) have resulted from the merger of a PCA and a FLBA in the same geographic area in an attempt to make the Farm Credit System more efficient. One entity can make real estate loans as well as operating and equipment loans. The banks and associations that make up the FCS are chartered, supervised and examined by the Farm Credit Administration, which gains its authority from the Farm Credit Act of 1971, as amended in 1985.

Primary source of funds for the Farm Credit System is the sale of bonds and notes. Most bonds are issued in denominations of $5,000. Typical bond maturity is 6 months, but maturity may vary when the FCS is trying to match the term of its sources of funds with its loan portfolio. Notes are issued daily with maturities of between 5 and 270 days in denominations of $50,000.

Another source of funds for the FCS is the purchase of stock by its member borrowers. For PCAs, the stock requirement varies among associations in the western district between 2 and 10% of the amount borrowed. For FLBAs, it varies from 6 to 10%. The stock requirement is usually made part of the loan. The borrower can get the stock back as the loan is paid back. There is also an up-front loan fee that is the same, regardless of the size of the loan. Technically, the FCS could sell loans through Farmer Mac, but to date it has not elected to do so. The Western District Farm Credit System, which includes California, met with Farmer Mac representatives in December 1992 to discuss possible sales of loans.

FCS loans can also take advantage of FmHA loan guarantees, but FmHA will not guarantee a loan that is rolled over; a delinquent loan, therefore, has to have a new promissory note restructured before a guarantee can be made. In addition, to meet all FmHA requirements, borrowers still have to meet FCS minimum standards. In theory, the FCS would like to have a separate set of criteria to help small and beginning farmers, but in reality this is difficult due to current regulation of the FCS aimed at ensuring fair lending practices and avoiding high-risk loans. However, associations have been known to ignore loan size and make small loans to low-risk customers.

To better service small farmers and reduce costs, the FCS developed a short-form application about 10 years ago and streamlined the credit writeup. This helped reduce the costs of smaller loans. Once borrower long-term performance is established, only annual information is required for a loan and the credit check and verification are not as involved as they are for a new borrower.

Another help to small borrowers is extended maturity. A revolving line of credit for a production loan can be made for up to 4 years. That way there is no need to redocument every year and the costs of making the loan are reduced. Only annual financial statements and annual crop progress reports are updated. The borrower also avoids having to pay the application fee each year. However, multi-year production loans can be problematic for borrowers because they are not permitted to be flexible in what they plant.

Regional development corporations. Several regional development corporations in California make loans and guarantee loans to small businesses under the auspices of the California Department of Commerce, Office of Small Business. Two of these, California Rural Coastal Development Corporation (Cal Coastal) and Valley Small Business Development Corporation, make direct loans to farmers using the FmHA loan guarantee program. Loans are available for production, real estate and refinancing. Cal Coastal also guarantees loans from other lending institutions. The primary purpose is to assist farmers already in operation. Special emphasis is given to farm operations that will create or retain jobs.

Conclusion

Serious problems are associated with small farm financing, the main one being the low earnings potential for lending institutions relative to the cost of making and booking loans. Banking regulations make the required documentation for the loan analysis fairly uniform, regardless of farm size. Furthermore, because of federal regulations and basic business practices, it is impossible to have different underwriting standards for different groups of borrowers. In particular, small farmers often cannot meet minimum underwriting standards because of their lack of equity, working capital and/or experience. Small farm enterprise diversity and specialty crops are other factors that restrict lending to small farmers because they add paperwork and costs to lending procedures as well as increasing perceived risk.

Despite these problems, several government programs are facilitating small farmer access to credit. The Farmers Home Administration has had an impact on small farm financing through direct loans and its loan guarantee program. The secondary market for farm real estate loans is beginning to improve the salability of loans and is thus increasing the flexibility of original lenders. The Farm Credit System's streamlining of applications and procedures for small loans has also improved the lending environment for small farmers.

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Assistance from the Farm Credit System, Farmers Home Administration, Feather River State Bank, Prudential Life Insurance Company, Cal Coastal and Valley Small Business Development Corporation is gratefully acknowledged.