Rural Credit Markets

More Changes Ahead

by Marvin R. Duncan

Agricultural credit markets have received a great deal of attention in recent years—from lenders, borrowers, legislators, and regulators. The widely reported problems of the Farm Credit institutions and financially distressed farms were the genesis of three major pieces of farm credit legislation within the last three years. Concurrently, the country witnessed the highest number of rural commercial bank failures since the Great Depression.

With an easing of financial stress, both for borrowers and lenders, many are breathing a sigh of relief and looking forward to a period of renewed stability. They are, however, mistaken. Agricultural credit markets and delivery systems are undergoing fundamental changes. The sum total of these changes seems likely to be more fundamental and far-reaching than anything seen in the past 50 years.

Prospective changes in the agricultural credit markets are even more far-reaching than the changes of the past 50 years. Both lenders and borrowers will be challenged. Those who are financially strong, nimble in seizing new opportunities, and effective in business will prosper. Others will experience significant difficulties.

Changes Will Make A Difference

The first change is that financial markets have grown more efficient and have become integrated both nationally and internationally. In the United States, banks and thrift institutions currently purchase most of their loanable funds at interest rates that reflect national financial market pricing. Moreover, investors have a wide range of options and interest rates from which to choose when deciding where to put their money. This means that the costs of funds for rural banks and interest rates to borrowers closely reflect national financial market conditions.

Funds now readily flow across international boundaries from one money market to another. As financial markets have become more integrated, they have tended to become more liquid. Opportunities for above average rates of return tend to be short-lived as investors quickly search them out. Thus, markets have become more efficient.

These developments have practical significance to farmers and to rural lenders. Financial market integration has led to broader and more stable access to credit. However, interest rates in rural markets and standards for credit quality now more closely reflect national market rates and industry-wide standards. Farmers have sometimes been dismayed with these changes. In the "good old days" they were often able to borrow from a rural bank or Farm Credit institution at below money market rates, with soft underwriting standards, especially during periods of monetary restraint by the Federal Reserve.

Increased competition in the financial marketplace has eroded some of the advantage that the Farm Credit institutions previously had over other rural lenders. The Farm Credit banks raise their loanable funds by selling securities in the agency market at interest rates of 15-50 basis points more than U.S. Treasury debt instruments of comparable maturity. However, that advantage appears to be diminishing. For example, high quality commercial paper has recently sold at rates below Farm Credit banks' discount notes. Thus, the Farm Credit institutions have and will continue to experience heightened competition from commercial banks as the differential in loanable funds costs diminishes.

The second change is the loss of the unique character of agricultural lending. This stems from lenders selecting market niches into which they will concentrate their lending efforts. For example, large scale commercial farmers represent one such niche and part-time farmers another.

As this way of looking at agricultural credit markets has developed and as farming has grown more business-like, lenders have discovered that a commercial farm loan requires analysis and servicing similar to a loan to a manufacturer or other large business firm. Moreover, the loan can often best be handled by someone in the commercial lending area of the bank, perhaps aided by some limited agricultural knowledge. This is, of course, very different from a decade ago when an agricultural officer with some limited commercial lending background would have handled the loan. By the same argument, small farmers and rural residents are seen to have credit needs more closely resembling small non-farm businesses and consumers.

Whether this categorizing of agricultural lending proves more effective than dealing with agricultural borrowers as a group may still be arguable. But to most lenders, the concepts of selecting market niches on which to focus marketing efforts and of using general banking loan officers to handle the credit appears to be well accepted.

These market segmentation strategies pose a challenge to rural banks and to Farm Credit institutions as other lenders bid away profitable segments of their traditional customer base. Alternatively, rural banks and the Farm Credit institutions may be able to provide better service to a broader range of customers than the larger banks—especially if they also employ a modified market niching approach.

The third change is the breaking down of the barriers separating banks and Farm Credit institutions from other business firms. This change could be even more wrenching than the first two changes. Across the United States, agribusiness supply and marketing firms, including regional farm cooperatives, are evaluating the benefits of getting into the financing of agricultural production and processing.

Indeed, some large firms such as John Deere and Company, Cargill, and ConAgra already have a substantial beachhead in agricultural lending. For those firms, the issue may be whether they can profitably lend money to farmers for a broader range of purposes than they currently do. For other agribusiness firms, often facing a stable market for their primary product line and with excess capacity in their sales and delivery system, agricultural lending may appear as an attractive new profit center. Moreover, for them, credit could be a valuable link between their traditional customer base and their other product lines.

Abetting this new competition is the secondary market in farm real estate mortgages that was made possible by the establishment of the Federal Agricultural Mortgage Corporation—Farmer Mac. Farmer Mac will make it easier for banks

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and thrift institutions to invade the Farm Credit institutions' near monopoly in farm real estate lending by enabling lenders to sell real estate loans, thereby limiting their interest and credit risk. However, a host of other agribusiness firms could also enter farm real estate lending.

If financial markets accept Farmer Mac, other secondary market transactions could soon develop outside of Farmer Mac in short-term equipment loans—or possibly production loans—attracting new competition into a currently shrinking market for agricultural credit. Rural banks and Farm Credit institutions would come under increasing pressure to be innovative and more cost effective, and to offer competing products, such as point of sale financing and credit card-type borrowing lines, to farmers at agricultural supply firms.

A fourth change is lower profit margins, a natural consequence of increased competition. Agricultural lenders are learning what commercial bank lenders have known for some years. The lending business is no longer as profitable as it once was. Interest rate margins have narrowed. Thus, lenders are increasingly looking to fee and service income to augment earnings from lending and to provide other more profitable financial services.

Indeed, as farmers grow larger and more sophisticated, they also will be asking for a broader range of financial services from their lenders. These will include broader insurance and real estate services, as well as a range of investment banking services. Whether rural bankers and the Farm Credit institutions will obtain broader statutory authority themselves, or serve as a conduit through which other firms provide these services to farmers remains to be seen.

Challenges Implicit to Changes

In summary, the rapid pace of change observed in financial markets is a prelude to further changes on tap for agricultural lenders and their borrowers. On balance, these changes will continue to make agricultural credit markets more efficient.

To succeed in the new environment, lenders must become financially and managerially more resilient and more nimble in identifying and utilizing opportunity. Borrowers also will be challenged to seize opportunities and become better managers. For those who are up to the challenges, the future of agricultural finance is promising; for those who are not, it is bleak. Nonetheless, the changes are upon us.

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