WHAT ARE THE CHALLENGES NOW FACING AGRICULTURAL LENDERS?

Remarks by Chas. N. Shepardson, Member of Board of Governors, Federal Reserve System, at meeting of American Institute of Cooperation, Fort Collins, Colorado, on August 19, 1957.

Never in the history of agriculture have we seen such an evolution -- yes, almost a revolution -- in agriculture technology as we have seen during and since World War II. New methods, new materials, and new machines have all combined to increase productivity per acre, per animal, and per man-hour of labor. This, in turn, has brought a series of important changes that are affecting both agriculture and the general economy.

First, let us consider the impact of increased productivity per acre and per animal unit. Since 1940, per acre production of major crops has gone up approximately 30 per cent for wheat, 55 per cent for corn and 65 per cent for cotton. Meat, milk and egg production have increased about as much. Beef production per head of cattle on farms has gone up over 35 per cent, milk per cow 30 per cent, and eggs per layer 68 per cent. In the aggregate, production per acre is up about 20 per cent and per animal breeding unit 27 per cent.

The increase in human productivity is even more striking. Although farm employment dropped 31.5 per cent from 1940 to 1956, production per man increased 95 per cent with the result that gross farm production for human use increased 37.5 per cent in the same period.

While this increased productivity of labor has been the key to the rising standard of living throughout our economy, it has special significance in the credit problems and policies of farmers and farm lenders. These problems stem from the fact that increased productivity is primarily the result of the substitution of capital for labor. For example, land and animal productivity is being increased by the use of improved seeds, feeds, and breeding stock and more and better fertilizers, insecticides, herbicides, and other agricultural chemicals, together with the increased use of purchased power in the form of fuel and electricity. Of course, this increases cash operating costs, and per capita operating capital requirements for these items rose from $750 in 1940 to $2622 in 1956.

More and better power and machinery increase the number of land and animal units that a man can handle but they called for an investment of $1,748 in 1956 compared with $220 in 1940. The ability to handle more land leads to fewer and larger farms and land investment per worker rose from $2,461 to $10,793. In the aggregate, this amounts to an increase in investment per worker from $3,631 in 1940 to $15,163 in 1956, part of which, of course, reflects the rise in prices and depreciation of the dollar during this period. Naturally, this investment per farm worker varies widely with different areas and different types of farm enterprises. It ranges from an average of $59,000 for the Corn Belt grain farm to $35,000 for a North Plains cattle ranch, $14,000 for a Northeast dairy farm, and $8,000 for a Southern Piedmont cotton farm.

There is no indication of any reversal in this trend of rising investment per worker. In fact, continued improvement in the standard of living, both of the farmer and of the population as a whole, is dependent in no small measure on its continuance. However, this continuing increase in capital requirements calls for more credit and on different terms.

Twenty years ago the farmer was concerned with two types of credit. One was long-term real estate credit used most frequently in the acquisition of land or for the consolidation of debts. Traditionally, farmers have feared mortgages on their farms and have sought to get out from under a mortgage debt as fast as possible even at the expense of crippling their operating efficiency. The other was short-term credit used primarily for current cash operating expense incident to crop production or feed lot operations. Such credit was usually self-liquidating at the end of the season.

In this situation we had need for two fairly distinct types of lenders. There was the long-term real estate mortgage lender represented by such groups as the Federal Land Banks, insurance companies, and individual lenders. Real estate loans were normally made for moderately long periods with or without renewal privilege but rarely with any scheduled provision for amortization.

In the short-term area, we had the PCA's, commercial banks and merchants. Loans in this area were almost invariably for one year or less and were primarily for current cash operating costs. Except for the purchase of feeder livestock, these costs were relatively small. With home-produced power and a minimum expenditure for off-farm supplies and services, a farmer's need for current cash was negligible. Security for such loans varied from nothing more than a man's note to chattel mortgages on the crop and all the livestock and equipment on the place. In most cases, however, amounts were small and the lender was more concerned with the adequacy of the security than he was with the soundness of the operation and its repayment potential. Loans were scattered among long and short-term institutional lenders, merchants and private individuals, with each concerned about the security of his own loan but rarely with anyone in position to make an overall appraisal of the entire operation.

Today, the situation has changed. Out of the 4.8 million farms in the country, approximately 2 million commercial farms turn out close to 90 per cent of our agricultural production. Without minimizing the social contribution of the part-time and residential farms and their credit needs, it is to these commercial farms that the country must look for its food and fiber, and it is on these farms that the greatest need for adequate and appropriate credit has developed.

What are these needs? First, let us look at the long-term area. With the increasing size of farms and the rising cost of land, the investment in land itself for some operations may be more than the average man can reasonably expect to accumulate during his lifetime. This means that he may have need for a mortgage loan that can be amortized down to a conservative level and the balance carried on a continuing basis for a relatively long term. Like any other business, a farm that is adequately staffed, stocked and equipped, and that has the necessary working capital for efficient operation, has a far better earning potential and hence is a better credit risk than the one in which too much of the available resources are tied up in land or plant with the result that operations are handicapped through lack of equipment or resources to take advantage of fortuitous opportunities that may arise. This is even more important in farming, with its susceptibility to the hazards of nature, than in almost any other business. For these reasons, it would seem important that farmers avoid tying up too much of their resources in land or committing themselves to amortization payments that take so much of current income as to cripple their operating budget.

Since mortgage loans are limited initially to a safe percentage of a conservative evaluation, it would seem that amortization payments, each one of which further enhances the security, might well be held to minimum amounts perhaps with options for prepayments. We should never lose sight of the fact that mortgage payments are in effect forced savings and that if we attempt to enforce too much saving at the expense of current living we sooner or later drive the young farmer, on whom we depend for the future, out of business.

Next, let us look at the short-term area. When the farmer shifted from horsepower to mechanical power, he immediately undertook a big cash expense for fuel and maintenance of his power equipment. The advance in production technology involving the increased use of commercial feeds, fertilizers, insecticides and other agricultural chemicals, together with improved seeds, adds to productive efficiency but it also adds to the cash expense and the need for short-term credit. As the volume of this credit increases, it becomes more and more important that it be geared to an established line of credit based on the over-all earning potential of the borrower. The introduction of high speed power equipment introduces a time factor that makes it possible to minimize many of the hazards of nature that formerly cost the farmer heavily in the form of damaged crops. For example, an insect infestation that formerly would have destroyed a crop before a farmer could get to it with horse-drawn equipment can now be saved with an airplane or possibly even with high speed tractors. Important time can be saved and a serious loss averted by the prompt replanting of a crop destroyed by rain or frost. This can frequently be done with day and night tractor operations where a horse operation, with its fatigue limitation, would be too slow to make it worthwhile. But time is of the essence and the farmer must be in position to know that he can cover the added expense without having to take time out to make new credit arrangements. In other words, he needs a line of credit that he can count on to meet day-to-day developments. Obviously, the establishment of such a line of credit must be predicated on a knowledge of the borrower's total financial picture, as I shall discuss later.

In addition to the changes in these long and short-term needs, a new need has developed in recent years in the intermediate-term area. This covers loans for items that have a continuing usefulness over a period of years and that cannot reasonably be expected to be paid for out of one year's operation. The recent Federal Reserve survey of farm loans at commercial banks showed that loans of this type constituted 37.6 per cent of all loans, accounted for one-third of the dollar amount outstanding, and were owed by one-half of the borrowers. These loans may be divided into four principal categories -- equipment and machinery, foundation livestock, land and building improvements, and consumer durables.

Developments in mechanization have resulted in increased man-hour productivity but they have also resulted in more complicated and expensive machinery which should be amortized over a period reasonably related to its productive life. Tractors, harvesters of various types and other major pieces of equipment certainly have as long a life and more productive value than most automobiles. If 25 per cent down payments and 30 or even 36 month terms on cars can be justified -- and they are becoming increasingly common -- it would seem that dairy equipment, tractors, and more especially crop harvesters, which are used only a few weeks or months at most each year, might well be financed on similar terms. Yet the survey to which I just referred showed that, of the loans on farm equipment representing 20 per cent of the total loans outstanding, 60 per cent had maturities of 12 months or less and 90 per cent of two years or less.

Production of livestock and livestock products is already a major farm enterprise in this country. Furthermore, the most encouraging prospect for increased consumption of agricultural produce is in the form of livestock and livestock products. This means that we should anticipate and encourage the diversion of more land to livestock production. But here again the farmer is faced with an investment in breeding animals that can pay out only over a period of years. For example, the average productive life of either a beef or dairy cow should be something over four years. However, the bank loan survey showed that 87 per cent of these loans, most of which were cattle loans, had maturities of 12 months or less. You cannot starve a profit out of a cow. Yet many dairy and beef cattle men, either from lack of judgment or pressure by the lender, have curtailed needed feed and care in order to meet onerous amortization payments and thereby sacrificed profitable production.

The third type of intermediate-term credit need is for land and building improvements. Here again expenditures are large and benefits accrue over a period of time. There has been more general recognition of this situation by lenders as illustrated by the fact that loans for this purpose averaged larger than for any other purpose except acquisition of land and that they were written for longer terms. Forty-eight per cent had maturities of 18 months or more and 36 per cent had maturities of 4 years or more. These longer maturities may be further explained by the fact that 63 per cent of the dollar amount was secured by real estate mortgages whereas two-thirds of all other loans for intermediate term investments were secured by chattel mortgages.

With the increasing interest in irrigation, drainage, and clearing and leveling of land, together with building modernization for functional efficiency, there is going to be a growing need for this type of credit. In this connection, it would seem that, as a result of such improvements, more consideration might be given to reappraisal of the farm valuations as a base for mortgage credit. Certainly, land that has been leveled and prepared for irrigation or that has been cleared, terraced and sodded to good pasture or that has modern, efficient buildings for handling the farm operations has a greater productive value than before and should provide an improved base for credit. In fact, fuller and more prompt recognition of such improved productivity as a base for more credit would greatly increase the opportunity for a man with limited resources to acquire an unimproved or run-down farm and build it into a profitable productive unit.

The fourth category of intermediate-term investments covers consumer durables. In general, this includes household equipment and automobiles which contribute primarily to the living comfort and convenience of the farm family but which may add little to the productive efficiency of the farm operation. Loans for such purposes should be based on the net income and resources of the farm family rather than on the amount they will contribute to the productive capacity of the farm business. It should be borne in mind, however, that living conditions make up an essential part of the compensation for farm labor, either family or hired, and that some investment in household conveniences may be an essential part of the cost of farm labor.

Obviously, with these changing needs in the long and short-term areas and with the introduction of this new need for intermediate-term investments, farming has become big business and its credit needs must be handled on more and more of a business basis both by borrowers and lenders. Fortunately, lenders generally have been aware of this and commendable progress is being made. However, there are several things that would seem to justify further consideration.

One is the recognition of the fact that a farm operation is an integrated business. While there is need for long, intermediate, and short-term credit and possibly from different lenders, the amounts involved require that they be based on the earning and repayment potential of the operation as a whole and not on single crop or livestock enterprises or, as has so frequently been the case, on the adequacy of the collateral. This is especially true of the intermediate and short-term credit and to an increasing extent of long-term mortgage credit as it is used more and more for intermediate purposes.

This, in turn, calls for more business planning in projecting needed expansion and improvements and more careful projections of earnings expected to result from such investments. It calls for analysis of the over-all financial resources and credit requirements of the operation, including the need for reserves against unpredictable hazards. I realize, of course, the difficulty of such planning, particularly because of the hazards to which farming is subject. On the other hand, I believe the hazards can be more adequately met than has frequently been the case in the past. For example, credit life insurance has done much to remove the hazard of the untimely death of the operator. In fact, the whole gamut of insurance coverages available today has done much to eliminate or reduce many of the old hazards. Of course, this is an added expense but with the amounts involved today few farmers can afford to carry this risk themselves. Other business has long since recognized this fact.

Fluctuations in market prices certainly create a problem in estimating income, yet greater attention to available market information regarding supply and demand and projected production could do much to overcome this difficulty.

Certainly, weather hazards are unpredictable but the man who bases his yield estimates on a few favorable years without regard to the long-run average of weather in the area is incurring unnecessary risks, particularly if he adjusts his operations and standard of living upward to unusual and unsustainable levels. Our recent drought experience provides ample evidence of this.

Standards for the establishment of adequate reserves against these hazards need to be developed as well as planned provisions for prepayments in good years against the deferments that must be and usually are granted in bad years. Unfortunately, many farmers lack the business training and skill to do this kind of planning. Here is the great challenge to lenders. Of course, such planning, analysis and loan supervision cost money. This is another argument for a one-step credit service. Such analysis and supervision can be more effectively and economically rendered by one lender for the entire credit program of the borrower than by several lenders, each covering only one phase of the operation. Such costs should be set up as service charges separate from the basic interest rate and should be sold as a service that is worth the price.

In this connection, I am reminded of the story in a recent paper by J. L. Robinson, Agricultural Economist for the Federal Extension Service, about the farmer who called on his lender to see if he could arrange for credit to buy some machinery. After analyzing the situation, the lender agreed to make the loan. Seeing the farmer sometime later and having heard nothing further about the loan, he remarked, "I suppose you decided not to buy that outfit you wanted." The farmer replied, "Yes, I bought it but I financed it with the dealer. I wanted to save my credit with you... to fall back on if I need it."

This illustrates the thinking of too many borrowers and the need for understanding that the prudent lender is going to base his loan commitments on the borrower's total credit picture in any event or else he is going to charge a rate that protects him. In this case, for instance, it developed that the farmer paid the dealer 15 per cent against the 7 per cent offered by the lender.

The Farmers Home Administration has provided an excellent example of a program to cover a farmer's total credit needs. Since FHA loans are limited to clients who are ineligible for normal commercial credit, supervision costs have been high but the number of clients who have graduated to regular commercial credit is indicative of what can be done with proper planning and credit supervision.

Many banks are now providing total credit needs of their farm customers although most of the intermediate and longer term needs are on a tentative renewal basis with few planned commitments that the borrower can count on. This may be all right for the protection of the lender but it is inadequate for the needs of the borrower who must be able to see ahead on his plans and operations. This need in other business has been recognized for some time and intermediate-term loans for business and industry, based on approved plans and projections and subject to review and supervision by the lender as to performance, have been in use for several years. Farm lenders must find the way and devise the safeguards necessary to meet the farm credit needs in this area. Failure to do so may result in pressure for further direct government lending through FHA or some similar agency.

The recent extension of PCA terms up to 5 years in proper cases is a step in meeting this need and the further broadening of Land Bank credit for general farm purposes is another. The use of open end mortgages offers a possible method of establishing lines of credit without the trouble and expense of repeated examinations and recordings of mortgages or other collateral.

To provide the type of service I have suggested, lenders must be staffed with or have access to the services of men with a broad background of training and experience both in credit and in the credit needs of modern farming. Many banks are establishing agricultural departments to meet this need. In some cases city banks with few direct farm loans of their own are establishing such departments to service the needs of their small country correspondents who are unable to provide this service themselves. Unfortunately, the progress so far is still inadequate to meet the needs of the country.

The Farm Credit System seems to have gone farther than the banks in this respect. I would raise a question, however, as to whether many of the local PCA's and Farm Loan Associations are adequately staffed with properly trained men or whether they are placing too much reliance on availability of their local boards.

In connection with the problem of staffing and also the cost of analyzing and servicing loan requests, I would raise a question as to the possibility of closer coordination of the several units of the Farm Credit System. The opinion is frequently advanced that long and short-term credit are two different things requiring different men with different training. This may be true within limits but with the increasing size, complexity and interdependence of farm credit needs today and the need for each lender to have the whole picture, closer coordination is inevitable. Certainly, it would seem that two cooperative farm lending organizations, serving overlapping needs of essentially the same farmers, might well consider the greater use of common quarters and joint staff, thus permitting more efficient use of staff and clerical personnel and more ready access to credit files of common interest to both agencies. Commendable progress has been made in this direction. I am convinced, however, that the rising cost of the technical supervision required to service these new credit needs will necessitate further steps in this direction.

The attracting and holding of competent agricultural credit men also presents the problem of providing for the future growth and progress of such men. This is a problem for the personnel division of every organization. Perhaps the secretaries or managers of local PCA's and NFLA's might be moved from smaller to larger associations as their ability and experience warrant and possibly to the district offices. This is common with county agricultural agents in many states. No institution can afford not to have a sound management training and promotion program if it expects to attract and hold the type of management personnel essential to the growth and development of any sound business today. This applies to cooperative as well as private business.

Another big need of farm lenders is more current and comprehensive research and statistical information on the changing credit needs of agriculture. This might include better current information on the magnitude and type of need in different areas and different sectors of the farm economy; the establishment of more adequate norms for reserves against loss in different sectors based on loss experiences and their causes; and certainly studies as to the implications of the growing importance of vertical integration in several phases of agriculture.

I have already talked too long and I have not mentioned the challenges to the Bank for Cooperatives. While much that I have mentioned is of interest to them, this problem of vertical integration would seem to be one of special significance. If cooperative hatcheries, feed companies and processing plants move into this area of financing producer operations as some appear to be doing to meet the competition of private concerns, their credit problems in this area will provide a real challenge to the Bank for Cooperatives. In fact, this development has broad implications for the entire agricultural economy.

In conclusion, let me add one thing. I have talked at some length about the growing need for more adequate farm credit. I would emphasize that this need for adequacy is more in suitability of terms than in amount. Coupled with this is the need for more wisdom in the use of credit. In some cases an increased line of credit is surely justified. Credit invested to improve income over the cost of the credit advanced is profitable to both borrower and lender. On the other hand, credit extended to a losing operation that cannot be put on a paying basis is a loss to all concerned. In such cases the amount of credit extended might better be reduced or even withheld entirely. The lender may be able to protect himself through liquidation of his security but the borrower who continues to pour credit into a losing business will eventually lose his equity at which point the lender loses a customer.

My challenge to all farm lenders, then, is to provide and encourage the more intelligent use of credit on terms appropriate to the needs and to sell the borrower on the idea that supervision requisite to the servicing of such credit is worth what it costs.