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Rural and Farm Finance Policy Analysis Center

Main Street Banks are Not the Go-To Lenders for All Farm Businesses

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To fund purchases of land, facilities, machinery and operating inputs, farms often use debt financing. In recent years, providers of such financing have changed significantly. This brief summarizes the changes and details sources of financing most used by farms today.

Key Takeaways

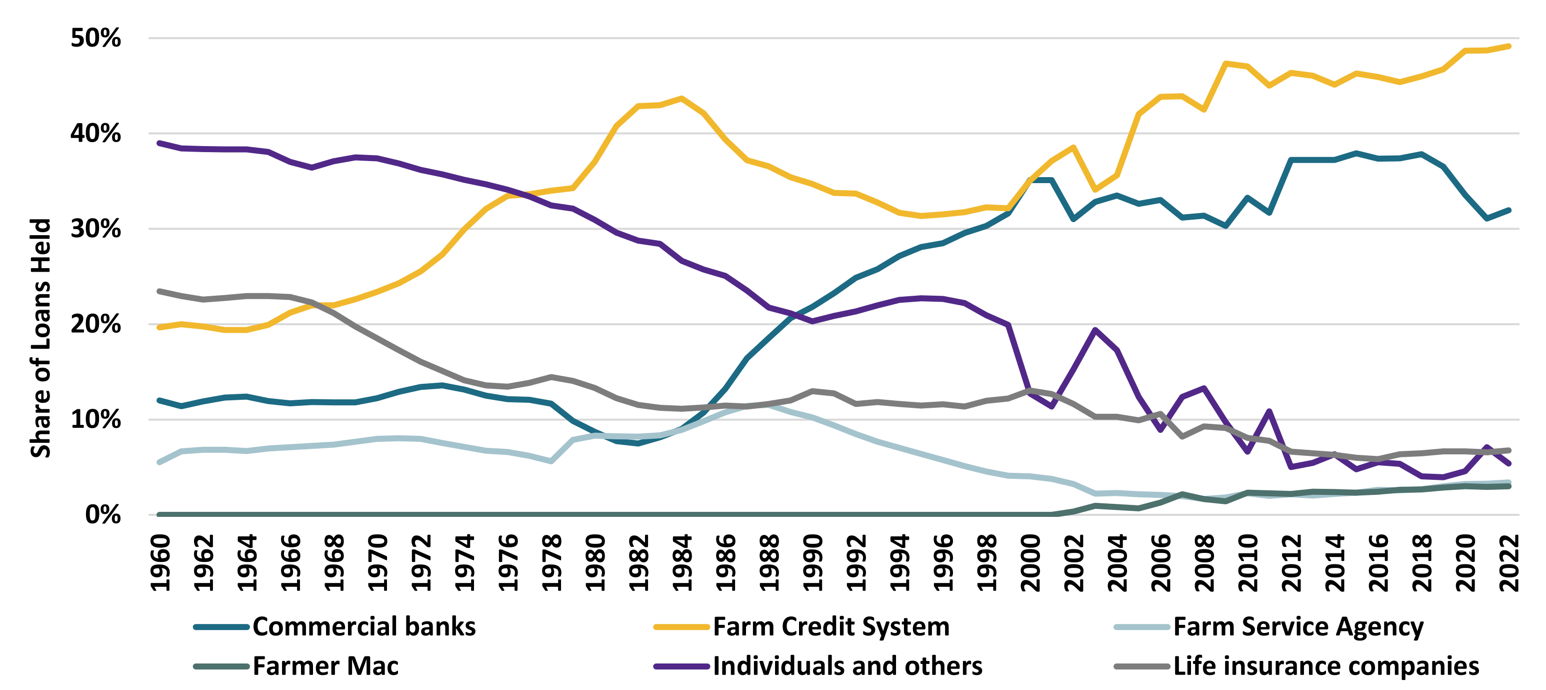
- Sources of debt used to purchase land, facilities, machinery and operating inputs have changed over time.
- General economic conditions, lending regulations, interest rates and the state of farm finances have influenced from where farms seek financing.
- Farm Credit associations and commercial banks dominate today's ag real estate loanmaking. Historically, individuals and others were the primary financers.
- Non-real estate financing once originated predominantly from commercial banks. In recent years, Farm Credit associations have increased loan activity in this space.
- Farms have secured USDA Farm Service Agency loans more frequently during times of farm financial stress.

Diverse lenders extend credit to farms

Most of the debt extended to U.S. farms originates from the following sources, based on USDA Economic Research Service classifications.

- Regulated through the Federal Financial Institutions Examination Council, ***commercial banks*** are community banks dotting rural main streets as well as financial institutions with regional, national or international footprints. For decades, privately held entities have been consolidating into larger institutions. The consolidation has led to many hometown banks bearing regional and national brand names. To finance loans, commercial banks borrow federal funds and accept customer deposits.
- Cooperatively owned ***Farm Credit System*** institutions — termed "associations" — recognize their farm business borrowers as member-owners. Although associations primarily serve farm businesses, they also extend credit in other scenarios, including rural home loans. Regulated by the Farm Credit Administration, the associations typically do not take deposits. Instead, they generate funds for lending through government-backed bonds issued through the Federal Farm Credit Banks Funding Corporation. Because of their cooperative structure, Farm Credit associations distribute a portion of annual profits to member-owners. Regulated by the Farm Credit Administration, Farmer Mac serves as the secondary market for agricultural real estate loans from a variety of primary credit sources. It packages loans it buys into securitized bundles, which it may resell or retain.
- ***Life insurance companies*** manage large sums of money generated by customers paying policy premiums. They invest those dollars to generate returns and mitigate risks of paying out future claims. Agricultural land may be part of the investment portfolios. This participation in farm lending traces back to the 1800s. Generally, life insurance companies provide financing to larger landholders. Because they keep their transaction costs relatively low, insurance companies also provide competitive lending terms relative to terms available from community banks, seller-financed transactions and Farm Credit associations.
- To finance operating costs and land, the ***USDA Farm Service Agency*** (FSA) makes direct loans to farms, and it guarantees loans made by partnering commercial banks or Farm Credit associations. FSA has had less stringent credit and financial history requirements for borrowers than other lenders do. It supports several programs meant to finance specific types of assets. For example, its storage facility loans program finances spaces to store commodities such as grains and oilseeds.
- ***Individuals and other entities*** also lend to farms; this activity is often referred to as nontraditional agricultural credit. The typical lender depends on whether an underlying asset is real estate or something else. For real estate loans, the lender may be the seller, related third party or unrelated third party. For non-real estate loans, the lender may be an input supplier, such as an equipment manufacturer or feed, seed or fertilizer supplier.

Figure 1. Percentage of Real Estate Farm Debt Held by Source



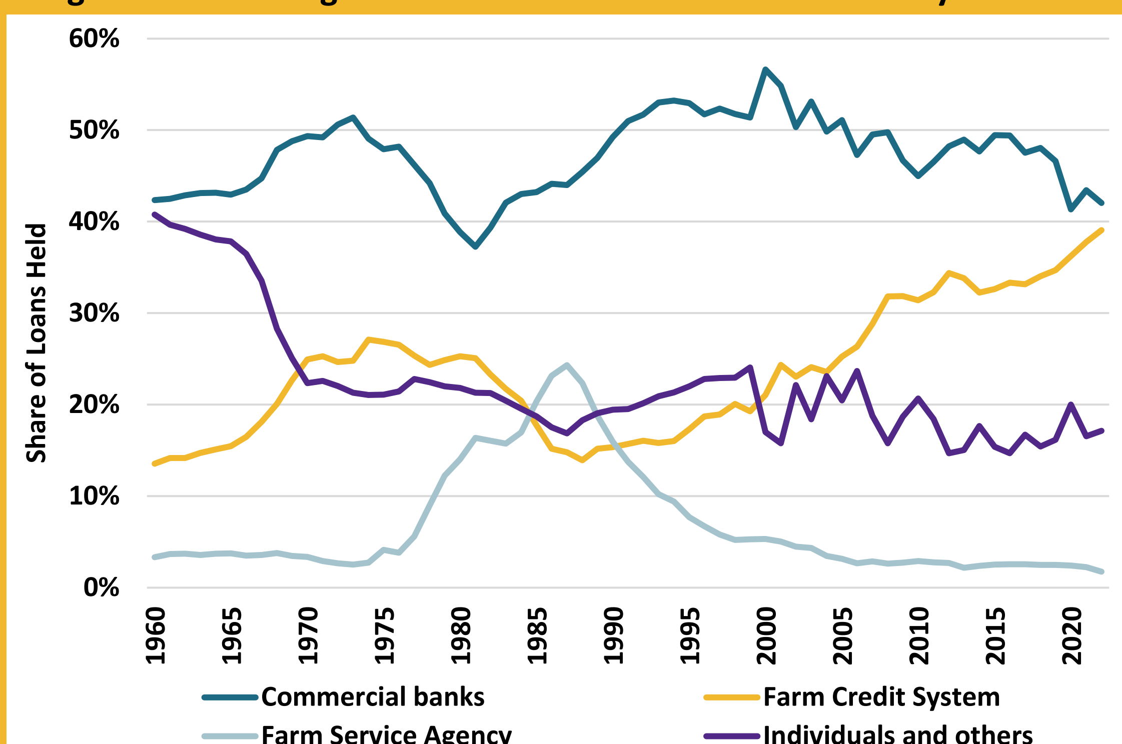
Source: Rural and Farm Finance Policy Analysis Center graphic using data from USDA Economic Research Service.

Farm lender market shares shift

In recent decades, the extent to which farm businesses have sourced financing from different types of lenders has changed. For farm real estate loans, Figure 1 shows Farm Credit associations and commercial banks captured the greatest market shares for the past 20 years. Historically, individuals and others provided the most debt financing for real estate investments. With respect to FSA financing, it has represented a relatively small portion of the total. However, as the historical data suggest, FSA has captured a greater market share of farm debt during periods of farm financial stress, such as the 1980s.

Historically, farmers most commonly arranged non-real estate financing with commercial banks, but Figure 2 illustrates that Farm Credit associations increasingly have provided financing for these purchases, which include production inputs such as machinery, equipment, seed and feed. Like shown in the farm real estate data, FSA's role in financing non-real estate debt reached its maximum point during the 1980s when farm financial struggles made seeking financing elsewhere more difficult.

Figure 2. Percentage of Non-Real Estate Farm Debt Held by Source



Source: Rural and Farm Finance Policy Analysis Center graphic using data from USDA Economic Research Service.

Driving these shifting market share changes have been regulatory, market and economic factors. These five contributed highly to changes observed in farm real estate and non-real estate debt financing.

1. ***During the 1980s rural economic depression*****,** many farm businesses were financially stressed and facing or experiencing bankruptcy. At the same time, many rural commercial banks experienced foreclosure. Farm businesses had little choice but to access loans and refinance assets through FSA.

2. ***During the rebound years of the 1990s*****,** farm businesses were able to transition financing needs from FSA to commercial banks or Farm Credit associations. As farm businesses' finances strengthened, borrowing from FSA was no longer an option.

3. ***During the 2000s — particularly following the Great Recession —*** the commercial banking industry had new regulations to follow. Although farm businesses were not specifically tied to the home mortgage meltdown's origins, the one-size-fits-all regulations impact all lending activities, including those in the farm sector tied to community banks. The Baker Institute for Public Policy at Rice University details how small institutions have faced disproportionately high compliance costs.

4. ***Beginning in the early 2000s, interest rates declined*****,** which reduced returns for parties including insurance companies and individuals who would directly lend to farms. This period offered Farm Credit associations an opportunity to return a higher proportion of profits to member-owners and, thereby, drive down the net interest rate paid by their farm business borrowers.

5. ***The Farm Service Agency functions as the lender of first opportunity*****.** Since the 2008 farm bill, FSA has increasingly offered direct loans with appealing interest rate and repayment terms. It has focused on serving several classes of farm businesses, including those with limited-resource owners, veteran owners, socially disadvantaged owners, beginning farmer or rancher owners and urban locations. These operations are a small percentage of all farm businesses, but they account for a higher percentage of total FSA dollars loaned today than in the past.

Interest rates may shape farm businesses' choice of lender

With today's higher interest rate environment, loans have greater default risk. Some lenders to farm businesses offer more competitive lending terms at different interest rates. It would be easy to use history to help understand future shifts in farm loan volume by lender type. Given changes in farm business structure, capital structures and regulation, however, forecasting these shifts is difficult.

All Riffs from RaFF are available at raff.missouri.edu/publications

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The Rural and Farm Finance Policy Analysis Center (RaFF) at the University of Missouri aims to help policymakers and stakeholders understand rural economic and financial conditions and trends and explore how existing and proposed policies affect rural and farm finances.