

Briefs

Farm Finance

Rise in Interest Rates—An Unwelcome Prospect for Farm-Sector Borrowers

Despite interest rates on farm loans declining in first-quarter 1999, farm-sector borrowers seeking new loans may face somewhat higher interest rates later in the year. Increasing demand for loans plus a recent action by the Federal Reserve Board to raise short-term market interest rates—albeit a modest 0.25 percent—may reverse the downward trend of the last 2 years.

Changes in interest rates affect the farm sector's interest expenses and asset values, farmers' choices of loan maturities and repricing intervals—the period from the date the loan is made until the first date the interest rate may be adjusted—and their ability to restructure loans. Lower rates help to reduce farm expenses and encourage loan refinancing, allowing farmers to use equity built up over time in homes and farm real estate to provide liquidity. Increases in market interest rates raise farm lenders' cost of funds, which is passed on to farmers in the form of higher rates on new loans, and raise the indexes used to adjust outstanding variable-rate loans.

The market value of farm assets is inversely related to interest rates. A rise in market interest rates would not only increase farm business and household interest expenses, but also reduce the market value of farm-sector assets and farmer net worth, making it more difficult for farmers to qualify for new loans and refinance old loans. Real estate refinancing tends to fluctuate with changes in mortgage interest rates. Home mortgage refinancing is already slowing because of rising mortgage interest rates. Increases in farm real estate interest rates would reduce the potential for farm real estate refinancing needed by farmers experiencing financial stress.

The majority of farm real estate loans are balloon notes—loan payments are applied to interest only, leaving a large final principal payment—with a term of 5 years at most. Farmers who have balloon notes, and must pay off outstanding balances with lump-sum payments or else

refinance, are especially vulnerable to the risk of rising interest rates.

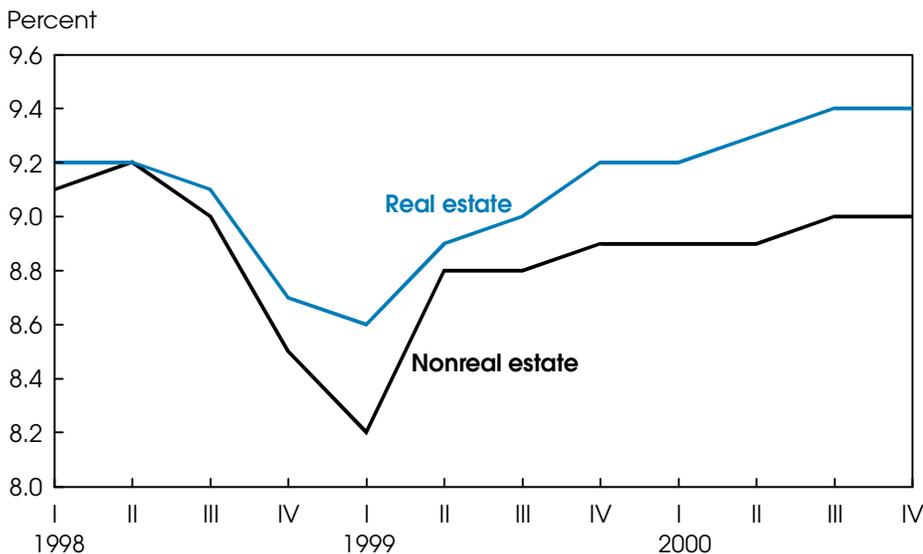
Any increase in interest rates would be especially unwelcome given the current situation in the farm economy. Trends in commodity prices and farmland values offer little optimism for the farm sector during the remainder of the year. Many areas are reporting stable or even declining farmland values, with expectations of further declines if commodity prices do not improve. Data on lending in the Upper Midwest show increased borrowing and loan renewals or extensions, as well as an increase in the percentage of farmers at their debt limit. Meanwhile, repayment on farm loans has slowed. In Iowa, about 20 percent of farm borrowers at agricultural banks, 10 percent of Farm Credit System borrowers, and about 30 percent of Farm Service Agency borrowers will require major loan restructuring in order to continue operations.

Another indication of the current farm financial stress in the Midwest is the increase in applications to Illinois' State Guarantee Program for Restructuring Agricultural Debt, which helps farmers refinance their loans. To qualify, a farmer must have a debt-to-asset ratio between 0.4 and 0.65 (a ratio above 0.4 is considered an indicator of potential financial stress, and over 0.65 indicates too high a risk of default). By mid-1999, applications to the Illinois program had already reached four times the total for last year.

About 10 percent of U.S. farmers in 1997 had debt-to-asset ratios at or above the 0.4 threshold, and higher interest rates could increase the proportion of heavily indebted farmers. Farmers with an income shortfall—unable to pay off old short-term loans or qualify for new ones if interest rates should rise—may be able to roll over unpaid operating loans into long-term debt, perhaps with FSA-guaranteed loans. However, some farmers who might not be able to project adequate cash flow to work out their indebtedness by restructuring may choose to risk drawing on assets not related to the farm business—e.g., personal savings or retirement funds—while others may choose instead to liquidate. **AO**

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Farm Lending Rates Are Rising This Year After First-Quarter Decline



Commercial bank farm lending rates. Rates for third-quarter 1999 and later are forecast. For real estate rate, second-quarter 1999 is also forecast.

Economic Research Service, USDA