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RURAL FINANCIAL TRENDS: HOW ARE LENDERS AND INTEREST RATES CHANGING?

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- *This information is based on a study conducted by Desi Morrison, Cory Beal and Brian Luff for an Agribusiness Management class at Colorado State University.*

In recent history, it looked to many as if rural financial markets would become dominated by large banks that offered relatively expensive credit to agricultural firms. However, the 1990's have seen a resurgence in smaller banks with a focus on smaller, agricultural producer loans. Moreover, small banks may be more competitive than ever with respect to interest rates. This report outlines some of the important trends in rural credit markets including the types of lenders, volume of loans, interest rate trends and some discussion of specific types and sizes of loans. It is our hope that such information will allow agricultural firms and organizations to make more informed decisions with respect to securing capital, as well as choosing an appropriate lending institution.

Farm Loan Statistics: What is a Typical Farm Loan and Average Interest Rate?²

Although statistics on farm loans may not be of great interest to a producer who is only interested in his or her own individual credit line, the numbers can say a lot about what types of loans are more often available, or more affordable, with certain types of lenders. As some of these trends show, it is also important for agricultural firms to know the going interest rates, as prevailing rates may have changed by a full percentage point since the borrower last secured credit. Although the average loan size has continued to increase throughout the 90's (Figure 1), the largest number of farm loans continue to be in the small loan category (\$1-9,000).³ The average may be skewed by the fact that significantly larger loans are being given in the highest loan category (an average \$385,000 in 1997 compared to \$280,000 in 1986). It should also be noted that the average loan given by large banks has increased by about 40% (\$92,000 in 1997 compared to \$62,000 in 1986), while loans made by smaller banks

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² Note: The data on the interest rate was gathered from The Agricultural Financial Data Book published by the Federal Reserve. The data is derived from quarterly sample surveys of farm loans of \$1000 or more made by commercial banks. This data is then expanded into national estimates for all commercial banks. Before 1989, the survey was part of a broader survey taken from a sample of 348 commercial banks. This sample was broken down into a subset of 250 banks. After 1989, a different subset of 250 banks was taken so this data is no longer part of the broader survey.

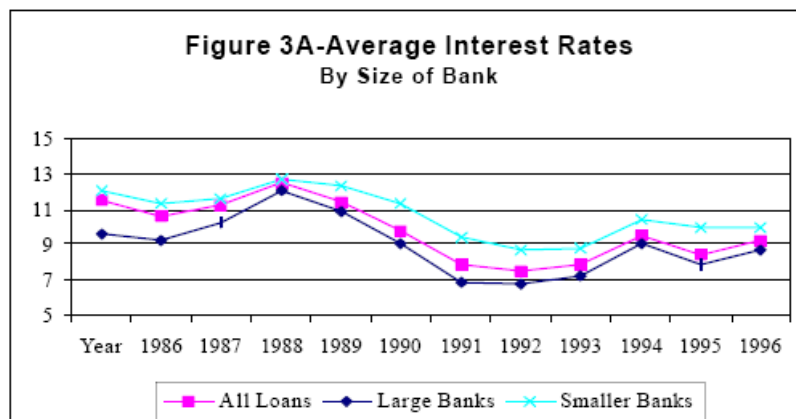
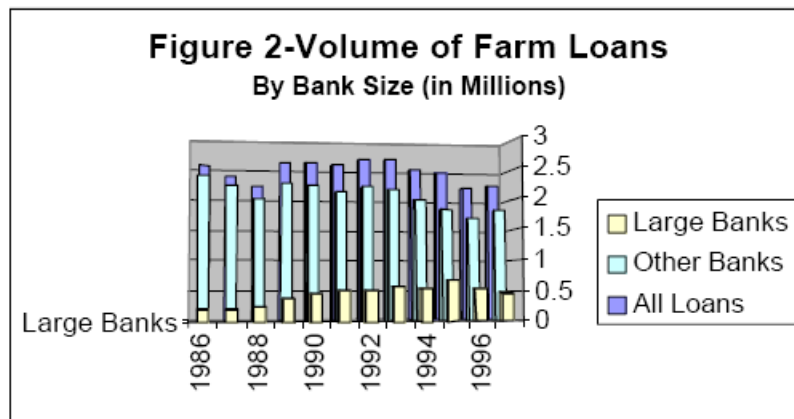
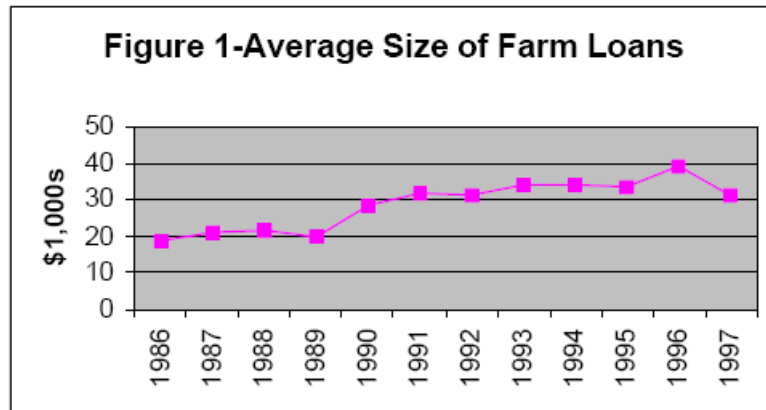
³ It should be noted that these are only non-real estate loans. Thus, loan numbers and loan amounts are biased downwards and interest rates are likely to be biased upwards.

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have only increased by 6% (\$16,300 vs. \$15,300) over the same period.

The number of farm loans made has held relatively steady (Figure 2). Although there are high and low volume years, about 2.5 million loans were made each of the last 12 years. Although larger banks represent a greater number of loans in 1997 than in 1986, other banks (which are relatively smaller in size) have recently began to reverse this trend. This, together with the fact that smaller banks continue to make relatively small loans, should be encouraging news for small and mid-size producers.

As is the case in all credit markets, average interest rates have decreased significantly between 1986 and 1997 (Figure 3). Across all loan types, current rates vary from 8.5-10.2%, with an average rate of 9.2% for all farm loans made in 1997. More specifically, smaller loans, loans made by smaller banks, and operating loans tend to be at the higher end of the interest rate range. Yet, on a relative basis, interest rates on both smaller loans, and those made by smaller banks, are relatively cheaper in 1997 than they were in 1986 (see discussion below for more detailed analysis). Another important trend to note is the increasing usage of floating interest rate loans.



The Changing Structure of Interest Rates

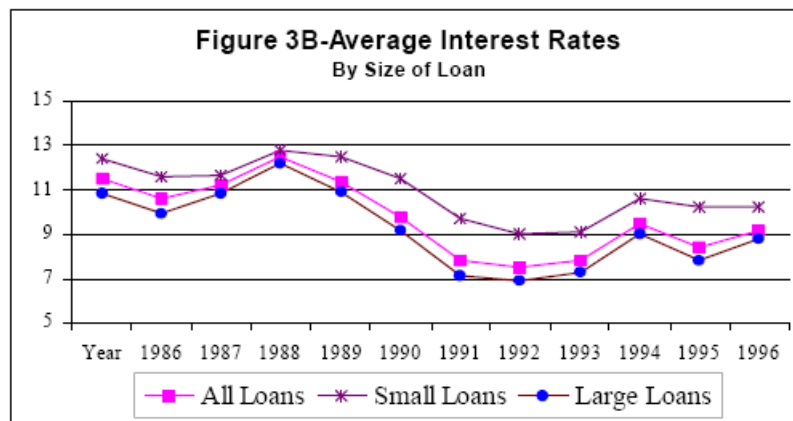
Many agribusinesses prefer to use local lenders for their loans. However, when most firms shop for loans, their main decision criterion is the cost of the loan or interest rates. Therefore, we will spend a little time discussing current interest rate trends. One can compare how bank size, loan size and purpose of loan affect the cost of loans and whether or not the cost of loans has become more or less expensive over time.

The interest rates of agricultural loans made between 1986 and 1997 were analyzed based on volume of loans (supply), type of loan, size of loan, and size of bank. The type of loan variable includes other, general, feeder cattle, live cattle, operating, and equipment. The variables that describe the size of loans are small (\$1,000-\$9,000), medium (\$10,000-\$24,000), large (\$25,000-\$99,000), and extra large (\$100,000 and above). Finally, the variables that describe the size of bank are large bank and other bank.

One would assume that the relative cost of loans would vary according to certain factors. The volume variable should follow basic supply and demand rules (i.e. as interest rates fall, customers will demand more loans). In general, the administrative cost of loans would be greater for smaller loans due to economies of scale. For example, the amount of paper work that lenders use for a \$2,000 loan is comparable to a \$100,000 loan. So, these expenses are relatively greater for the smaller loans. With this increase in volume, economies of scale may dictate decreased costs, some of which are passed on to the consumer.

There appears to be significant differences in interest rates across these factors. As the volume of loans given

by agricultural lenders increased, the interest rate offered declined (as would be expected from demand theory). General loans, operating loans and equipment loans all carried higher interest rates relative to the other, miscellaneous loans category and livestock loans. With respect to loan size, the results followed our expectations, with relatively smaller loans being more expensive than the extra-large (\$100,000 and above) loans. In general, smaller loans were more expensive, followed by medium and large loans. This is related to the above discussion, dealing with economies of scale. With respect to bank size, the interest rates charged by large banks were lower compared to other banks. This can also be related to the discussion on economies of scale where the administrative costs of larger banks are lower than that of smaller banks. If we analyze the trend of interest rates over the 12-year period, we can show that rates declined significantly. We can also pay specific attention to how interest rates on various types of loans varied across time. Comparing large and small banks, it appears that the interest rate gap between the size of banks is narrowing. Larger banks still offer a lower interest rate, but over time, loans from smaller banks are getting relatively less expensive. Thus, smaller banks appear to be more competitive with large banks, a finding supported by data presented in Figure 3a. The trend in interest rate costs for small loans was similarly tested. However, the results show that the cost of small loans stayed the same over the time period--with no relative decrease in interest rates offered. Finally, among the types of loans, we found that equipment loans have become relatively cheaper in recent years. We believe this may be due to the credit competition offered by equipment dealers through their manufacturers (such as Deere and Case).



Outlook for Colorado Rural Financial Markets

Colorado producers have been gradually increasing their leverage over the past few years. Between 1995 and 1996, Colorado farm debt increased by over 6% (from \$3.29 to \$3.5 billion), thereby increasing the average debt-to-asset ratio from 16.0 to 16.2. This is slightly higher than the U.S. average of 15.3, but lower than neighboring states such as Nebraska and Kansas.

With respect to the USDA Mountain region (which includes Colorado), there is some mixed news and expectations. The Mountain region currently represents the highest average interest rates among all regions of the United States, a significant change from 1986 when local interest rates were closer to the national average. It is not clear what economic factors have affected local interest rates, but lender perceptions about farm credit supply and demand conditions may provide some ideas.

Lenders from the Tenth Federal Reserve District (which includes Colorado) were asked their perceptions of trends they expect to see in rural credit markets in the near future. Lenders expected there to be continued higher demand for credit, even though fund availability will remain steady (which would explain an increase in local interest rates). They expect to receive lower loan repayment rates, likely due to higher original maturities and some renewals/ extensions. Also, they will have higher collateral requirements for loans in the near future. Perceptions from this region seem to be very similar to those from lenders nationwide, with one exception. Lenders nationwide did not express a willingness or need to have longer loan repayment periods, or to extend loan repayment periods in the future.

Using This Information in Your Discussions with Lenders

The choice of lender is an important one. Although interpersonal relationships, loyalty, convenience and other noneconomic factors will play a role in choosing a lender, there are some important economic factors to consider. As discussed previously, the level and structure of interest rates change over time, and current information is important in negotiating the terms of new loans.

As illustrated in the section of farm loan trends, there has been a recent uptrend in the number of small loans, credit available from small banks, and the relative competitiveness of interest rates in these market segments. Also, when considering in-house lending on equipment or various other inputs, there is a chance that interest rates offered by manufacturers will be more competitive than those offered by banks. This should be welcome information for those producers who can only justify a small loan, prefer on-the-spot credit or who prefer to work with smaller banks. It appears that the rural credit market may once again find small production and operating loans attractive, thereby increasing credit availability.

It is important to publicize your knowledge about such trends when negotiating your own credit terms. One of the most important strategies you can take when securing credit is knowing the local, prevailing interest rate and understanding your potential strengths and weaknesses (through ratio analysis, collateral available and current leverage). Do not hesitate to strongly negotiate for a competitive rate using such information. It is also important to understand what concerns and perceptions lenders have about local credit market conditions (as discussed above) so that you can put your own financial conditions in context during your discussions.