

Obtaining and Using Agricultural Credit Effectively

Quick Notes...

Credit is important and necessary in nearly all commercial farm businesses.

Be sure uses of credit contribute to the improvement of future net income in the business.

Credit should be considered as one tool in a financial management package. Credit can expand buying power, however, if purchases are not related to income and payments are missed, the result is a poor credit history. In some cases use of too much credit may lead to bankruptcy.

The name of the game is building a good credit record. Steps should be taken to establish a credit rating before credit is needed. In order to establish a good credit record consumers must understand and meet credit terms, pay back obligations as agreed, contact creditors if a payment must be missed, and correct billing errors through correspondence with the company.

Types of Credit

Revolving credit: Offered by retail stores and banks through credit cards. Finance (interest) charges are added whenever there is an account balance from one month to the next.

Some institutions are adding charges on all transactions, eliminating the grace payment period.

Credit sale: The consumer buys goods or services and promises to pay in regular payments. The credit is arranged by the seller of the product, and in most cases, the merchandise is used as security for the loan. Credit sales are frequently arranged for furniture and automobile purchases. The seller may sell the credit contract to a bank or other financial institution. The financial institution becomes the holder-in-due course and will receive all payments from the consumer.

Consumer loan: A consumer borrows money from a person or company that is regularly in the business of making loans, such as a bank, savings and loan association or credit union. A consumer loan may be either secured or unsecured, paid in installment payments or as one lump sum-principal and interest payment.

Establishing a Credit History

Availability of credit is based on three factors. The amount of credit available in the marketplace, the individual's ability to pay (salary or other income), and the willingness to pay (your credit history). No one is automatically entitled to credit and this is why a good credit history is important.

Suggestions for establishing a credit history:

- Apply for a credit card from a bank or department store. If you have no source of income, apply for credit at a small, independent shop. You may not get credit from all small shops but many will want your business.
- Take out a small loan to pay for a purchase or simply take out the loan, deposit the money in a savings account and pay the account back in payments.
- Arrange to buy an appliance or furniture with a consumer loan.
- Ask that a jointly held account be changed to your name.
- If you change your name, be sure to inform all of your creditors and the local credit bureau.
- Don't forget, take the time to check your credit file. If you are married, contact creditors who have records in your spouse's name alone and request that the credit be reported in your name, too.

Selecting a Lender for an Agriculture Loan

Selecting a lender or lenders is one of the most critical aspects of financial management. A farm/ranch operator should shop for credit and investigate many institutions and sources before making a final decision. In doing so, the borrower must be prepared to make judgments as well as to be judged.

Here are five major criterion to use in rating the potential quality of the credit service:

First, select a knowledgeable lender who understands agriculture.

Second, a lender must have experience in agricultural credit and a commitment to agriculture.

Third, choose a lender who is willing to discuss lending policies and terms and provide prompt action to credit requests.

Fourth, a lender must have the capacity to meet anticipated credit needs.

Finally, select a lender who has a reputation of honesty and integrity.

Preparing for the Lender

Now that you have selected a lender, the next step is to prepare for the credit request. Here are five tips in negotiating a financial package with your lender.

First, as a borrower you must provide current, accurate financial statements and supporting records. A current balance sheet with supporting schedules and inventories is essential. A record of earnings and a projected cash flow for your business are also needed.

Second, arrange credit in advance.

Third, allow your lender time to review your plans and make suggestions. Many major purchase decisions are made on the basis of emotion. A lender can be a source of sound advice and counsel in reviewing your credit request.

Remember, explanation of your goals and plans builds confidence and trust, and strengthens your working relationship.

Fourth, inform your lender of problems and changes. Even the best of businesses may be faced with adversity that may reduce the ability to repay. Inform your lender of changes in plans

or unforeseen problems that will interfere with making loan payments.

Finally, maintain a high level of integrity. If a lender is expected to be honest and above board at all times, then the same attribute will be expected of you, the borrower. Inaccurate information and failure to honor commitments will jeopardize the borrower-lender relationship initially and could last a lifetime.

Calculating Interest Charges on Loans

Lenders use three major methods to calculate interest charges:

1. The add-on method
2. The discount method
3. The remaining balance method

The first two methods are not commonly used by major agricultural lenders, but are used by finance companies that may make some agricultural loans.

Add-on Method: Under the add-on method, the lender calculates the total interest charge by multiplying the entire loan amount by the contractual interest rate, and then multiply the total interest cost by the number (months, years) covered by the loan. The interest charge is added to the principal to determine the total amount to be repaid. This amount is then divided by the number of repayment periods to determine each payment.

Example: Assume a \$3,000 loan to be repaid in two annual installments. The annual contractual interest rate is 6 percent. Then the total interest charge is:

$$\$3,000 \times .06 \times 2 = \$360.00$$

and the annual payments will be:

$$(\$3,000 + 360) \text{ divided by } 2 = \$1,680.00$$

Discount Method: The discount method

calculates total interest the same way as the add-on method, with one exception. The interest is subtracted from the loan amount and the borrower receives the balance.

Example: Using the same data as before (\$3,000 loan amount, 6 percent annual interest rate, over 2 years). The total interest charge is again \$360.00.

$$\$3,000 \times .06 \times 2 = \$360.00$$

The borrower would receive \$2,640.00:

$$\$3,000 - \$360.00 = \$2,640.00$$

And would repay two installments of \$1,500.00 each:

$$\$3,000 \text{ divided by } 2 = \$1,500.00$$

Remaining Balance Method: When the remaining balance method is used, the interest charge is computed in each period by multiplying the contractual interest rate by the principal balance remaining at the beginning of the period (the unpaid balance). The major difference between this method and the previous two, beyond the complexity of the mathematical calculations, is that interest is not charged on principal that has been repaid.

Long-Term Loan Repayment Methods

Money borrowed for long-term capital investments usually is repaid in a series of annual, semi-annual or monthly payments. There are several different ways the amount of these payments can be calculated. For example, loans may be repaid in a series of 1) equal total payments per time period (amortization); 2) equal principal payments per time period; or 3) equal payments over a specified time period with a balloon payment due at the end to repay the balance.

Equal total payment method: Each payment includes the accrued interest on the unpaid balance, plus some principal. The amount of the annual payment applied toward the principal will increase with each payment.

Example: Assume a \$10,000 loan at a 12 percent annual contractual rate to be repaid in eight annual payments. Under the equal total payment method, the annual payment for this loan is \$2,013.03 for each of the 8 years. This was determined by multiplying the amortization factor for 12 percent interest and 8 year payment period times the loan amount. The portion of each payment that is interest and the portion that is principal will vary with each payment. At the end of the first year, interest is charged on the full \$10,000 principal outstanding:

$$\text{Interest} = \$10,000 \times 0.12 = \$1,200$$

Thus, the principal payment is the difference:

$$\text{Principal payment} = \$2,013.00 - \$1,200 = \$813.00$$

The remaining principal balance after the first payment is:

$$\text{Remaining principal balance} = \$10,000 - \$813. = \$9,187.$$

Interest in the second year is charged on the remaining balance:

$$\text{Interest} = \$9,187 \times 0.12 = \$1,102.44$$

$$\text{Principal payment} = \$2,013 - \$1,102 = \$910.59$$

$$\text{Remaining principal balance} = \$9,187 - \$910.59 = \$8,276.41$$

Equal principal payment method: The equal principal payment plan also provides for payment of accrued interest on the unpaid balance, plus an equal amount of the principal. The total payment will decline through time because, as the remaining principal balance declines, the amount of interest accrued declines.

Example: Assume the same loan as above, (\$10,000, 12 percent interest, to be repaid in eight annual payments).

First Year:

$$\text{Interest} = \$10,000 \times 0.12 = \$1,200$$

$$\text{Principal Payment} = \$10,000 \div 8 = \$1,250$$

$$\text{Total payment 1st year} = \$1,250 + \$1,200 = \$2,450$$

$$\text{Remaining Principal Bal.} = \$10,000 - \$2,450 = \$8,750$$

In the second year:

$$\text{Interest} = \$8,750 \times 0.12 = \$1,050$$

$$\text{Principal Payment} = \$1,250$$

$$\text{Total Payment} = \$1,250 + \$1,050 = \$2,300$$

$$\text{Remaining Principal Balance} = \$8,750 - \$1,250 = \$7,500$$

These two payment plans are the most common methods financial institutions use to compute loan payments on long-term investments. Individual lenders will use both of these, but also may use a balloon system. The balloon payment method often is used to reduce the size of periodic payments, but also to shorten the total time period in which the loan is fully repaid. To accomplish this, a portion of the principal will not be amortized (paid off in a series of payments) but will be due in a lump sum at the end of the loan period. For many borrowers, this means the amount to be repaid in the lump sum must be refinanced, which may be difficult.

Variable Interest Rates: Many lenders now use variable interest rates, which greatly

complicates calculation of the amount of payment due. The most common way to amortize a loan under a variable interest rate calculates the amount of principal due, based on the interest rate in effect on the payment due date. The interest payment is then calculated in the normal fashion.

Managing Credit Use

Once obtained, a major challenge arises in properly managing the credit in your business. The three basic financial statements - the balance sheet, income statement and cash flow statement - are basic tools used to monitor the financial strength of your business. When compiled and supported by accurate financial information, these tools can provide the support needed for many of the strategies and financial decisions which you will face.

Any successful business, whether it's an agribusiness firm, farm, corporation or small business, must meet certain criteria if it is to be successful over a period of time, particularly if credit is used. A successful business must exhibit strength in the following areas:

1. Repayment ability and capacity.
2. Liquidity and solvency.
3. Profitability and financial efficiency.

SOURCES:

- 1.) Obtaining and Using Credit Effectively - David M. Kohl, Cornell University.
- 2.) Credit-Having It When You Need It - Judy McKenna, Colorado State University.
- 3.) Credit Shopping for and Selecting - Judy McKenna, Colorado State University.
- 4.) Long-Term Loan Repayment Methods - Paul Gutierrez, Norm Dalsted, Colorado State University.
- 5.) Calculating Interest Charges on Loans - Norman Dalsted and Paul Gutierrez, Colorado State University.

Lenders frequently refer to the five C's of credit which are:

1. Capital (referring to your liquidity and solvency).
2. Capacity (Meaning your repayment ability and profitability).
3. Collateral (or minimizing risk to the lender).
4. Conditions (for granting and repaying the loan).
5. Character (referring to honesty, integrity and your management ability).

Both lists, though not exclusive, nor in any specific order of importance, provide a systematic checklist that either a farmer or lender can use to assess the financial status of the business. Credit can be a soft cushion or a migraine headache depending upon how it is used. Credit is an important money management tool, however, excessive monthly interest charges can absorb dollars that might be spent in better ways.