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AEI Presents *Nothing Borrowed, Nothing Gained: How Farm Financing Works, and When it Doesn't or The Countercycle and the Future of Ag Lending*

Episode 3 | A Loan Walks into a Bank

Sarah Mock: *This is Nothing Borrowed, Nothing Gained: The story of ag lending - past, present, and future.*

I'm Sarah Mock.

Have you ever had someone, a family member maybe, or a friend, wind up for a conversation about this incredible money-making opportunity they've discovered? The bummer thing about these conversations is they're rarely just a celebration of this person's success, right? This is the start of a pitch, where inevitably the conversation will work around to how you can invest some of your time or money in this incredible opportunity and probably make some sweet cash for your troubles. For regular folks, this can be a pretty uncomfortable conversation. For bankers, it's a job hazard.

Heather Malcolm: There's actually a sheep dairy here in Montana, when we were looking at that specific request, it was one of the first ones all under one roof in the state of Montana. So, I learned a lot about sheep dairies.

Sarah Mock: That's Heather Malcolm, she's a vice president at Bank of the Rockies in Montana and when an ag or food related loan requests comes across her desk it's her job to figure out whether or not it's a sound idea. That decision to make or reject a loan is not one that she, or the bank, took lightly.

Heather Malcolm: We have, quite a due diligence or an underwriting method when we look at all ag operations. We, look at not only the borrower, the repayment capacity, the character, how much cash they have or equity into the transaction. We also take a look at the property itself. Is the property going to be what the producer wants it to be? Is it irrigated ground? Will it produce what we think it will? Or are there some other challenges with the property?

Sarah Mock: It's safe to say that in many, maybe most, cases a lot of time and effort, goes into the due diligence process before a bank makes a loan, and many

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of you have probably been on the other side of this equation spending weeks or even months, handing over the most private and sensitive financial information to help get a lender to a place of confidence and conviction. But how the heck can banks afford all of this effort?

To answer that -- we'll have to learn how, exactly, a bank works. That's what we're going to cover today. By exploring two major aspects of the ag banking sector -- First, how banks function as businesses and where their money comes from. And second, what they add to the money equation to justify their existence.

But let's start with the easiest question here: How exactly does a bank, let alone an agricultural bank, work as a business?

I put that question to Nate Franzen, the President of Ag Banking at First Dakota National Bank.

Nate Franzen: in its most basic form banks take deposits from citizens, pay them interest, pay them a fair return on those deposits. Give them other services that are convenient to them from mobile banking to home equity, to all kinds of things. But then turn around and let them that money back to folks that needed extra money. So, if you think about it, it's a way to make money flow. Some people have more money than they need, so they have money in savings. Other folks, need to access money, and the bank acts as that intermediary, that facilitates that.

Sarah Mock: So that's the kind of basic business model of a bank. It's essentially a kind of trading house for money, where what the bank brings to the table is the ability to take on some of the risk. Let's me connect those dots. Some people have excess money -- they're savers. Savers would like their money to earn interest, which they can get by lending it out. They can lend it out themselves, of course but that would require them to take on all the effort and risk of vetting borrowers, hunting down regular payments, and dealing with delinquencies. Then there are debtors -- people in the market to acquire extra money, they would likely also have a hard time working with the many individual savers they might need if they wanted to access any significant amount without a bank. The bank then, serves as the intermediary. They have refined the process of accumulating and protecting the treasure from many savers, and of vetting and interacting with reliable borrowers.

But I want to narrow in on a couple of Nate's words here -- the idea that banks make money flow. I think that's an apt description, but also, I think what banks do

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is often even more important than that -- banks don't just make money flow, they make it grow.

Here's Brent:

Brent Gloy: So, if I take out a loan and then I put my deposit back in the bank, they can lend that deposit out again because we have fractional bank rules that states banks only have to hold a certain amount of capital back for all their deposits. The loan gets made multiple times, from the same initial deposit.

Sarah Mock: Fractional banking is just about as close as you can get to creating money out of thin air, and banks do it all the time. It goes something like this. Say I put \$100 into a savings account at my local bank. The bank takes \$90 of those dollars, saving 10% in reserves, and loans that to a small business to make a capital investment. Say that small business uses that \$90 to buy a piece of equipment, maybe from my neighbor. My neighbor receives that \$90, in exchange and puts that into their bank account. Now the bank technically has \$190 on its books. They can now use the \$81 in my neighbor's savings, again, holding 10% in reserve, and they can make a new loan. If that \$81 ends up back in a bank account, which could well happen, the bank will have turned that original \$100 into \$271 on their balance sheet.

In that way, banks don't only help money flow where it's most valued, they help money grow as they earn returns for their savers. I'll grant that there are likely some of you right now who are feeling some anxiety around the idea of a business being as highly leveraged as the bank I just described. In other words, it's a little scary to think there's only \$27 in the vault when there's \$271 owed to depositors. But the thing is, that level of reserves to leverage is not abnormal.

Here's Nate again:

Nate Franzen: Banks in general are very heavily leveraged. So, we talk about leverage in a farm, for example, and 50% owner equity or 50% debt to asset is considered, approaching a little more heavily leveraged farm operation. In banking, we live at 90% leverage. We have 10% equity, 10% capital on average, some banks have a little more, some have a little less, but that's basically the range of, capital. And then everything else is leverage.

When I say leverage our depositor dollars, those are liability. So those are our liabilities. We owe our depositors their money back if they ever need it. Our assets are the loans we make. So, we take the money from those liabilities, our depositors, and we lend it

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out to other customers with the agreement they're going to pay it back over time. And that's really how a bank fundamentally works.

And of course, because we take in money and lend it back out and have an obligation to pay it back to our depositors over time and have an obligation to lend it out in a fair and equitable manner to the public - we have regulations in place to monitor that and make sure that we're upholding those expectations.

Sarah Mock: Just to flesh it out further -- it's worth understanding that all the money a bank has, to buy everything from the building the bank is housed in to those weird long chains the pens are on, to pay employees, to invest in things like e-banking websites, security guards, and state of the art vaults – none of that comes not directly from the money of savers.

The cash to pay business expenses and to create its profit instead comes from interest on loans or other investments, *minus* the interest that's paid to savers. So, if you've ever wondered how your local bank can charge you 4% interest on a loan, but your savings account only earns .4% interest, that 3.6% spread is keeping the lights on at your local branch. But how do banks determine those two interest rates, the one for borrowers and the one for savers?

Nate Franzen It's a factor of competition for sure, but it's just also a factor of the markets. What the economy in general expects for return on excess funds versus what the economy in general is able to charge on dollars lent out. And some of that we can control at a local level, but there's a lot of national and overall economic pressures on that as well.

Sarah Mock: To Nate's credit, this is aptly succinct, if not quite vague, explanation of something that's really pretty complicated. So, I asked Brent to flesh out the interest rate picture for us–

Brent Gloy: The interest rate is really the price for money and its value is determined by the interaction of supply and demand. And there's people who have capital that Linda and, all of us, if you have money in your bank account, you're supplying capital and other people that have a demand for it. So, they want to buy something that maybe they can afford otherwise. You need a new car or a new house or something else. So, you go out and you say, here's what it's going to cost to do it. And if there's lots of people that want houses and a lot of demand that tends to increase the interest rate, other

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things equal, but there's also supply issues too. And then it gets really complicated, by, things like the Federal Reserve.

Sarah Mock: When Nate said, “interest rates are a factor of the market” this is what he meant - interest rates at every level are impacted by national and even global supply and demand factors, not least because capital markets across the economy are deeply interconnected. But there's also the question of why your specific banks rates might be a little different than others.

Brent Gloy: If banks can make loans to people that pay them more than it costs them to get those deposits, they make money. If they have a cost of creating those loans - they have to have a loan officer and they have to, sell that credit, or get customers. So, they have to go out and attract people. And so, there's a cost of, doing that and what they charge you has to compensate for that now. They can't just charge anything. So, if I have a bank and I say, “Well, I’m going to capture a lot of credit risks so I'm going to charge really high rates because I think a lot of people aren’t going to pay me back.” You won't make any loans, right? Because those same people can go to another lender, and they might have a different view about the credit risk. And so, they might offer that loan at a lower rate. So, it's a true market where people make those assessments and make those loans.

Sarah Mock: When Nate said, “interest rates are a factor of competition.” This is what he meant. And this is an important point, because, listening to the financial news especially, it can make it feel like the interest rate is a fact of nature, set by a mysterious force somewhere far away for reasons that are impossible to fully understand. But the thing is, banks -- and individuals for that matter -- actually do have a bit of flexibility when determining interest rate, and that flexibility comes down to their assessment of the risk. Low risk borrowers are likely to get access to lower interest rates. But there's another factor in how banks set interest rates, both for borrowers and for savers, and it has to do with a different kind of risk -- time.

Here's David:

David Widmar: It starts to become interesting when you start adding all these products. like A CD or a money market, and those are ways to get people to give their money for a little bit longer to the bank. And so, I think another issue with credit is the timing and

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the duration of how long you're willing to give that money as a deposit or how long you're needing to borrow that money.

Sarah Mock: To understand this time factor for interest rates, I want to introduce you to one of the most talked about charts in finance - meet the yield curve – or, more precisely, the interest rate yield curve. This metric tells us, essentially, what kind of returns you can get at any given moment from investing excess cash in U.S. treasury bonds. Bear with me here, if you're not one for investing in the stock market or following financial news, this still matters, because as long as you have a savings account, and particularly if you have a high yielding savings account, like a CD, this info is crucial. Because though the yield curve specifically tracks U.S. treasuries, it also does a good job capturing the economy-wide sentiment around the relationship between time and money.

Here's Nate:

Nate Franzen: It's supposed to slant upward as you go out longer periods of time. Meaning if you're going to invest in a treasury that's a one-month treasury or a one-year treasury, meaning you want to be able to get back at your money in a short period of time, they're going to pay you a little lower rate and the longer you're willing to let somebody use your money, the more rate they'll pay you for that privilege, so to speak. So, we're no different in a bank. If you just want your money in a money market or in a checking account, and you want to be able to access it immediately any day, every day, then we're not going to pay you quite as much interest because we have to be ready to pay you any day. So, we have to keep that money very liquid. We have to be able to give it to you on your demand whenever that might be.

Sarah Mock: This time factor of money is critical, especially for banks. Consider, I have a 30-year fixed rate mortgage - for a bank to make such a loan in a perfectly free market, my bank would have first had to track down a saver, or many savers, who was willing to part with hundreds of thousands of dollars in deposits for three decades, and to do so knowing that no matter the market conditions, their rate of return would never go up. Needless to say, very few people would probably opt for this arrangement, and if they did, they'd want to be paid handsomely for it and banks get that.

Nate Franzen: Now, if you're willing to give your money to us and leave it there for a longer period of time, we're willing to pay you more for that. So, the longer you're willing

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to leave it, the more generally we're willing to pay you and that's where you get into CDs. Whether it's a one-year, two-year, three-year, four-year, or five-year CD, we'll pay you more as you go out on that yield curve typically. And the reason we'll pay you more. As we know with certainty, we have access to use that money for that period of time. And the more certainty we have, the more ways we can deploy those dollars to guarantee some level of margin for us, in the meantime. But when that's very liquid, a money market or checking accounts, we have less guarantees.

Sarah Mock: To drive this point about yield curves home, I want to talk about an edge case. As Nate said, a normal yield curve slants upwards, because the longer you're willing to hand over your money for, the less risky it is to the institution you've lent it to, and thus the more interest they're willing to pay on it. But sometimes, like recently, in fact, the chart starts to look a little different.

Nate Franzen: They start talking about an inverted yield curve and inverted yield curves can be signs of a pending recession coming. That's one of the concerns in the market today and really all in an inverted yield curve is, is it means the treasuries on the short end, one-year, two-year treasuries. have higher rates than five-to-10-year treasuries. When that happens, it's called an inverted yield curve. And that's generally not a healthy situation for the economy over the long term so people start to get a little bit panicky when they see that happening. And that's a little bit of some of the fears that have been talked about here in recent times, with this inflationary environment we're in. Because we have high inflation today, the market is saying, yes, rates on the short side have to go up to push back inflation. And then the long end is more of a longer-term bet. So, investors are looking at five- or 10-year money and saying, okay, we have inflation today, but we have confidence that, the Federal Reserve and others will get this inflation under control. So, we realize short term rates have to go up, but we think long-term rates are still going to settle back down eventually and so, the right place for long-term rates to be is something lower. And all of a sudden that yield curve starts to flatten out and potentially, invert.

Sarah Mock: The idea of the inverted yield curve matters to agricultural lending in no small part because recessions matter to agriculture. Though the ag economy is often countercyclical, and so shielded from the worst of economic hardships associated with broad economic downturns, it's worth considering that some of the worst recent years for farm bankruptcies were between 2008 and 2011, aligning closely with the Great Recession. In other words, the ag economy is

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certainly not immune from the broader economic hardship that might be in the forecast given that the yield curve has been inverted for much of 2022.

Another way to think about the yield curve, is as a barometer for the duration of risk. Wherever the yield is highest – that's where the market believes the most risk is, and thus where they need to get paid the most to play. In the ag sector too, various investments come with different levels of short- and long-term risk, and those risks can significantly impact the quality of an opportunity. Notice though, inverted yield curves don't cause recessions, nor do they actually move risk around, they simply indicate what people think will happen. This is the psychology of the market, the imperfect and often quite irrational aspect, what economists call the "animal spirits."

How do banks run their businesses in the stampede-zones of these spirits? We'll get into their whole value-add, after the break.

COMMERCIAL

Sarah Mock: I mentioned a few minutes ago that what the bank brings to the table is the ability to take on some of the risk. This is the service that a bank sells. But what risks, exactly, do banks take on? The answer is complex, according to Nate, but there are actually a lot of different kinds of risk that banks manage simultaneously.

Nate Franzen: Our number one risk is always our credit risk. So, our number one risk is we lend money out and the borrower can't pay it back. And the reason that's our number one risk is if you think about it, we're taking depositors' money, we're lending it out. And if that borrower can't pay it back, now all of a sudden it puts the bank in a position where we may not be able to pay back our depositor when they want their money back. That's how banks fail. So, ultimately, that's our number one risk is credit risk. That's why I tell our clients all the time, we're not equity capital, we're not in the business of taking high risk. We're in the business of lending money that must be repaid back. And so, we're not taking the highest level of risks in the marketplace, equity is much higher risk, right? If you want to own stock in a company, then you're taking the most risk, lenders there's just get paid first before equity gets their money. that is the pecking order of capital and access to capital. And there's a good reason for that, right. Because we have the obligation to make sure our depositors get their money back. And if we don't lend responsibly, we put our company in jeopardy of being able to do that.

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Sarah Mock: This is a key distinction to consider in our modern times when there is a lot of equity capital in the world. Especially when we look at other sectors, high tech, I think the idea of equity investment, say from angel investors and venture capitalists, gets blended into our mental model of debt financing, as if they were different brands of similar products. But as Nate aptly explains -- they are not.

Selling a bit of a company to raise funds is a much riskier activity, and more importantly, it's an activity that banks often can't or don't, participate in. For most of the last 20 years or so, venture capital has been relying on a model of making 100 investments where as long as 10 are successful and two or three spectacularly so, the overall portfolio still works out. This strategy creates opportunity for 100 business owners to get access to capital to build something, and if most of them earn nothing at all, the venture capitalist isn't necessarily worse for wear.

Banks do not work like this.

Between the constraints of using savers money, the regulation that comes along with that, the relatively high levels of overhead in banking compared to venture, and the need to moderate risk -- the average bank doesn't have the ability to deal with high levels of failure or loan default -- and banks tend to lend like this is true. But banks have other pressures they face as well, including internally.

Nate Franzen: Interest rate risk is a significant risk to us. The Savings and Loan Crisis in the 1980s where lots of savings and loan banks went broke - the reason most of them went broke is because of interest rate risk.

What they did that created problems for them as they took short-term money. They took depositors' money that was short-term money markets, checking accounts, whatever, where they had to be able to pay them back quickly, if the deposit or wanted their money back, they took that money and they lent it out long-term on houses for 15 and 30 years. Well, the problem with that of course, is if the depositor comes in and says, "You know what, I want my money back now." We can't give them their money back because it's tied up in a 15- or 30-year loan. So, we call it asset liability management within the banking industry. We're constantly managing how we price deposits, our liabilities, and how we price our assets, loans, and make sure that we're managing that so that it's balanced up well, so that if a depositor comes in and wants their money, we can pay it back.

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Sarah Mock: Again, I think this idea of interest rate risk bears a fine point, because understanding it requires understanding an aspect of banking that we haven't discussed yet. That is, that banks often, especially over the very short term, can get capital another way, other than from depositors.

See on a day-to-day basis, banks are required to have a certain percentage of their capital in reserves. From the very first example I used, that \$10 they need to keep in the vault out of my original \$100. But a bank is a complicated business, and on a given day, the amount of loans they've made, and deposits returned might have eroded the hypothetical cash in the vault below that \$10 mark. For compliance reasons, the bank needs to make up the difference, often on a very short term -- even just overnight. This money might be borrowed from other banks, or it might be borrowed directly from the Federal Reserve in some cases. But the key here is, that very short-term rates can change a lot, and fast, and banks who need to lend between themselves or from the Fed don't have the option to shop around like consumers do for a car loan or mortgage.

Here's Brent:

Brent Gloy: The rate they pay to acquire funds, deposits, or CDs or other things - loans from the Federal Reserve or other banks are generally very short-term in nature. So those interest rates reprice frequently, daily, if not more frequently. So, their cost of funds is changing almost every day and if you make a loan for a long time, that has a fixed interest rate, you all of a sudden have a tremendous amount of risk. Why? Because if you make that loan and you don't have a big enough wedge between what you promised, what you gave the person the money for, and they promised to pay that and your cost of funds goes up all of a sudden, you're not getting paid enough interest. And so, you're negative and you lose money on that loan.

Sarah Mock: Losing money on a loan, or a portfolio of loans, isn't just bad luck for a bank, it's the difference between living to lend another day, or going under. There are a number of other risks that banks face as well, business risk-- competing with other banks, reputational risks -- ensuring that savers have conviction in the good management of their funds, HR risk, regulatory risk, tech and cyber security risk, the list goes on and on. All of this comes together to cement the idea that, again, cliches aside, banks really are not only invested in the businesses they lend to, they are dependent upon them. Nate points out that, for example, if an ag loan can't be repaid and bankruptcy results, that's often a bad a situation for the lender as well as for the borrower.

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Nate Franzen: The better our clients do, the better we do as a bank. We're in sync on that. If our clients struggle, we're going to struggle as a bank. If our clients are having problems, I can guarantee you that's going to evolve into problems for the bank. And, we have a very in-sync and inline motivation to work together to all be as successful as possible.

Sarah Mock: Considering all the challenges inherent in lending in general, and then layering on the unique challenges of banking farms – with their long cycles, their inconsistent cash flows, and their heavy exposure to global commodity markets - it begins to make a little more sense why, especially during tough economic times, banks have often dismissed ag lending as simply too risky. But despite its limitations, Nate argues that ag lending has actually been less risky than other kinds of business lending over the long term.

Nate Franzen: If I look at our bank's track record, if I look at the banking industry's track record with charged off loans, losses on loans, basically loans they've made that weren't able to be repaid, the rate of losses on loans is higher to businesses than it is to farmers and ranchers over time. So, I can make the case that it's less risky. I will tell you there are bankers, that'll hear this podcast, that'll say, "I disagree with you Nate Franzen, I think it's more risky." So again, to me, it gets back to where's your expertise. How well do you understand what you're doing and, and how well you assess that risk and that varies depending on the bank, and their leadership and their expertise they have.

Sarah Mock: Nate's final idea here is kind of what this whole story of ag lending is about. Yes, there are standard operating procedures and various tools that have helped refine how banks and other lenders evaluate the riskiness of loans. But lending, especially ag business lending, is yeoman work. Doing it well requires a deep understanding of the space, the inherent risks, the natural cycles, and the specific players involved. The work of a highly skilled and successful lender is in identifying lending opportunities with little relative risk, and high likelihood of repayment, and avoiding those scenarios where the risk is too high relative to the amount of interest available. There's no magic formula for determining the difference between these two, and it takes some serious due diligence, a lot of expertise, and probably some good gut instincts to do it well enough to earn interest for your depositors and keep the lights on. That, in short,

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is the value a bank provides, and though the process can be costly, doing it well can also be quite lucrative.

But there is another side to the loan equation that is just as important, but way less commonly talked about. We've talked in depth about how a bank works, how it operates as a business, how it makes money on lending, and grows, but that whole proposition is based on the assumption that, especially when it comes to businesses, that credit can be valuable – and that receiving a loan is good business for the borrower as well as the lender. Because obviously, credit is not always valuable, taking out a loan is not always a wise business decision, So, when does the business model of lending work for borrowers?

This explanation begs another example, and you'll forgive me if it's kind of lame.

And this time I'll be the hypothetical business owner. Let's say I own the local diner and I approach my bank for a \$100 loan. I offer a business plan of how I'm going to use the funds that goes like this - business is booming at the diner -- to the tune of \$5 in pure profit a week, but I'm having a hard time keeping up with the crowds. I have a cooktop where I can cook four hamburger patties at once, which really slows me down. If I could get the \$100, I need to buy a second cooktop, I could make eight hamburgers at once, that would double my productivity and help me earn twice as much profit, up to \$10 a week.

Let's say the bank does some due diligence and agrees with my most assumptions. they offer to lend me the \$100 for 50 weeks, and we agree that I'll pay \$2 in interest per week. Including the principle that I owe, that's a \$4 payment to the bank for my new cooktop, which, you'll notice, still leaves me with more than I would have otherwise made each week in profit. Plus, at the end of 50 weeks, I'll have an eight-burger cooktop free and clear. This is the kind of business lending situation where credit makes the most sense. Where gaining access to funds in the short term leads to more growth over time than was otherwise possible. If the bank had turned down my loan, you'll note, I could have still bought the cooktop, if I had reinvested all my profits, in twenty weeks, but that twenty-week delay would have meant foregoing growth, and maybe even losing customers who would only return so many times to a restaurant with slow service. The notable thing in this example is that the interest on the loan, in this case, represents a fraction of the overall growth that I achieved. In other words, I earned \$5 additional, and only had to pay \$4 of them to the bank, and those only for 50 weeks. For better or worse, we don't always think about the business case for debt this way in agriculture, as an investment in increased productivity.

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Brent Gloy: I think more realistically, what they do is they do it in gross dollars. So, it's, "Well, I'm going to borrow this and that interest bill on that it's going to be like \$20,000 and when I do this work or buy this land or whatever, I'm going to have that \$20,000 plus X dollars more left, and I can service that debt." And so, I think people think of it that way a little bit, but they don't necessarily think about it and realize that well, sometimes, the reason it works is because you're subsidizing it with your equity, the return to your equity, which is what you really don't want to do. So, yeah, it's 4%, maybe I make a 4%, sometimes I'll make a 2%, but I still have enough money to service that debt because half of the money in this land is mine. They don't really realize that they're making them a really low rate of return on what they've invested because the lender gets paid first. So, I think people think about it in gross dollars a lot more often than they do in rates of return.

Sarah Mock: This point is subtle but important. Again, if I got a 4% loan to purchase an asset, in an ideal world, the asset is going to help my business earn more than 4% in additional return, so that after I pay the interest, I'll still be earning a new profit. However, it's also possible, in a real-life business, to simply shift funds around, and make the interest payments I need to make, even if I'm sacrificing margin, or worse, equity to do it. In other words, I took a loan for 4% to buy an asset, and it's only earning me 2%, I have to pull the additional 2% in interest payments from somewhere else in the business simply to break even on the loan. Consider my previous scenario -- If I had accepted a 6% weekly interest rate to buy the \$100 cooktop -- I'd be earning \$10 a week and would owe \$8 of it to the bank -- including the principal, leaving me with only \$2 in weekly profit, less than I had before I got the loan. In this case, the better decision is really to wait the 20 weeks and buy the new cooktop with cash. Were I to except this loan, this is a terribly risky situation for both my business and the bank, and perhaps concerningly, this is not an uncommon situation.

Brent Gloy: It always drives me crazy; you might go to buy a car or something, and so, what's the first question the salesman will ask you? Say, you have something to trade. What's the first question he's going to ask? "How much are your payments now?" O.K. and he's going to try and talk you into buying this new car and keeping your payments the same or something like that. And so, people think of it oftentimes in that way and it's not a very good way to think about it. Doesn't necessarily matter what your payments are. The question is what's the credit going to cost me, that I'm going to have to use? And is it a good decision to buy this car on credit or not?

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Almost everybody would know that going to Walmart and putting a toaster on credit is a bad decision. It's not a very smart thing to do. You don't want to buy something like that on credit. So, they inherently understand that, but then when it comes to million-dollar investments, they don't necessarily think through it the same way. So, the question is, how are they approaching it? Are they really thinking about what is the cost of credit? Is that the most effective way to control this asset? Maybe it's leasing the asset would be a better way to do it. Maybe it's not having the asset, is a smarter thing to do.

David Widmar: That spread this idea of like, I'm going to take this money at 3% I'm going to make 4% or 5% or 10%. What's often not talked about is the risk like you're taking on the risk and that's why creditors stand in line at bankruptcy court, they get, the first crack at getting their money back. And as you step out on that yield curve, as you reach out to get higher and higher rates of return, you take on more and more risks. So, I think that's another element that gets woven into that debt story. I think sometimes we get the process of evaluating an investment and then deciding how we should pay for it we intertwine those. And so, I guess in an ideal world, you would say, "Is this a good investment? Is this house a good purchase? Is this real commercial real estate, a good purchase? Is this farmland a good investment for our business or for me individually? And then the second piece of that is okay, how should I pay for it? Should I use equity? Should I use some form of debt? Should I use a short form of debt? Should I use long-term debt? How should I structure this to pay off in a year or three or maybe should I pay it off over 20 or 30 years? So sometimes we get those flipped and that goes back to Brent's conversation about you going to go buy the car.

The first thing the person asks you is "What are your current payments?" Cause if you can afford the current payment, how much car can they give you over how many years? If we're not really good managers, we flip that around - it's the bank approved me to buy this house at this much money, or they approved me to buy this farmland at this much money. And that's what can get us into trouble is now we asked how much can I get approved for? Then we back into that, yeah, it's a good investment. I got approved from the bank to do this. And I think that can get us into trouble. If we don't untangle those decisions.

Sarah Mock: After all of this discussion about how conservative banks have to be, and how many different kinds of risk they manage, the story of the car salesman here seems counterintuitive. Car loans, like mortgages, can be a little different from business loans, because the "return" they offer to borrowers is calculated more in getting to work comfortably or having a roof over your family's

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head, rather than dollars and cents margin. But it's also not so different, as David mentioned here, compared to what can happen in ag lending in particular, which is that borrowers will determine how much to borrow based on what the bank will lend them, rather than based on the actual return to the investment.

In the context of the story, we've told here, that might seem incongruent, when lenders want to be good partners, and to experience success when their borrowers are successful. But what Nate didn't highlight in his discussion of how banks work, is that banks are not necessarily concerned with how a farmer collects the funds they use to repay their loan. At some level, they can't be -- trusted partner they might be, but bankers don't usually have active decision-making power in a business, nor would they necessarily want that. So, they have to protect their investment some other way. That other risk mitigator is collateral, or the assets a bank determines it can take over to recoup its costs if the loan and interest can't be repaid. From the farmer's side of the table, collateral, usually in the form of owned assets like farmland and equipment, is not really on the table because the money they plan to repay the interest with is going to come from growth, from future earnings, realized through the loan.

But from the bankers' side, collateral is very much on the table. This is what makes the "I'll take whatever the bank thinks I'm good for" theory of debt so problematic. Because the bank is not lending based on what the farmer is likely to earn, they're lending based on that combined with the collateral value. To return to the diner, the bank would offer me the 6% loan on a 5% opportunity, despite it being a pretty crappy business decision on my end, because they can see that I have another cooktop, a bunch of utensils, and a building, that, if push comes to shove, will make them more than whole on the loan and the interest. To hammer home this point - banks are businesses. A business with its own strategies, its own risks, its own customers, and vendors. An individual banker can surely be a trusted advisor, one who does have incentives aligned with a farm business -- that is, to see enough success and growth to comfortably repay the loan. But a bank, in general, is not in business exclusively to serve its borrowers, nor do banks -- baring perhaps a few of the very largest -- have access to infinite capital or the ability to absorb infinite loss. Banks can, and do, fail, and to avoid doing so, they have to make money -- enough to keep the lights on and to compete in a sector that's becoming increasingly consolidated. Knowing this, among other things, the idea of trusting the bank to determine the right level of debt for you or your business is ludicrous. You are the bank's

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customer, and it is usually in a business's interest to get their customers to buy the highest amount of product that they can possibly afford.

Bear with me on one final trip to the diner-- it's worth pointing out that the second loan we discussed, with the 6% weekly interest on my cooktop, is likely the better loan for the bank. It earns them higher interest on the same investment, and as long as I don't shop around too hard and find a better rate, they'd be happy to charge it to me -- knowing that if my precarious situation goes south, they'll be first in line for my assets at the bankruptcy hearing. A good heuristic to take away from this conversation perhaps - remember that a banker's first priority is what's in the best interest of the bank. There are surely many that prioritize and celebrate shared success with their customers, but the bank is running their own business, and managing their own risks. It's up to you to run yours.

This is just one of the reasons why it's so important to understand how banks work, because it's key to knowing how to think about borrowing for a business in general, but also how to think about negotiating for capital and debt, and critically, how to understand being rejected for a loan.

Brent Gloy: If you go on Twitter or just read anything about new farmers or something, there's always this, "We need credit. We need access to loans and the bank won't give me a loan." Well, oftentimes when that's the case, the solution is not to make the bank give you a loan or to encourage the bank to give you a loan. The reason the bank probably not giving them a loan is because they didn't think it had a high chance of being successful. And so, of course then if you get the loan, it could work out really well or it could work out really poorly. And then there's a problem -- "Now I've got this loan somebody has to help me pay it back or I should have never taken this out." Credit, I think everybody wants it but it oftentimes a private sector doesn't want to give it out because they know that not everybody can repay it.

David Widmar: A banker kind of is like the bouncer at a party. You check in with them to get access into the party. So, you're really friendly with them and it's the start of something really exciting and really good. And then when things go really bad in the party and a fight breaks out or something gets really serious, the bouncers go in and they clean it up. And they're the last person you want to see at the end of the night. And so, I guess the other way to think about this is, Purdue [University] has done this decades-long survey called The Large Commercial Producer survey. One of the interesting questions that they ask, who's the trusted advisor? Who is the advisor that producers turn to, to get good advice? And oftentimes, if not every time, ag

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lender is at the very top of that survey. They're asking about agronomists and all other folks in the ag space but it's the ag lender who's that trusted advisor who they really put a lot of stock in what the banker says. A lot of stories in ag will start with, "I was talking to my banker..." Whatever rumor or anecdote he's going to share, it's going to be really important because I talked to my banker about this. But then on the other side, when the euphoria ends, we always, as a human species, want to find a villain. We want to have somebody who we can point to and say, "This is the reason why things went bad." And it could have just been the nature of the beast. There aren't necessarily people out there who are acting in bad interest, there are just bad circumstances. And oftentimes that lender is the one who tells that grower that, "No, we can't give you another line of credit." Or "We have to foreclose on this property." And so again, this gets back to this idea is that the banker - they're not necessarily the one that was responsible or they're at fault for delivering the bad news, but they're often the messenger that delivers that bad news.

Sarah Mock: Now that we understand the business proposition of debt for a business, which is, in short, to fuel returns greater than the cost of the interest, it's a bit clearer why banks often refuse to lend to farmers when they're at their most vulnerable. To give a loan to a producer to say, help them dig out of a financial hole, is not only a dangerous proposition for a bank, who, I'll say again, owes essentially all their money to their depositors. It's also counter to the whole idea of business lending. A cash infusion might help in the short term to overcome a hurdle for a farm business, but if overcoming the hurdle only leads the farmer breaking even -- how will they afford the interest? On top of that, what if the infusion doesn't lead to a break even at all, but simply stanches the financial bleeding temporarily? In the aftermath, the cash flow will, in all likelihood, still be going the wrong way, but now faster, because there will be interest piled on top.

Possibly the best news on the ag banking front to share is that there are some pretty smart people in the ag banking space, who care a lot about the sector and the people in it. Take Heather Malcolm, the Montana banker from the top of the show, and the potential borrowers who hoped to open a sheep dairy. After some rigorous diligence, Heather approved the loan, and the business is thriving. But even if the bank had said no, that wouldn't have necessarily been the end of the road for these Big Sky milkers. There are more than just banks lending to farmers, and there has been for quite some time.

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David Widmar: The first farm credit loan was made in 1917 to a guy by the name of A.L. Stockwell and he had a family farm in Larned, Kansas. And so, he received the system's first long-term low interest advertised agricultural loan.

Sarah Mock: But what's farm credit been up to since then? That's next time on *Nothing Borrowed, Nothing Gained*.

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Until next time, remember –

Curt Covington: The good times never last.

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