The Future role of banking in South African Agriculture with special reference to the financing of short-term inputs

M P Lamont, South African Reserve Bank

Introduction

Events of the past decade may be harbingers of things to come. Financial institutions and particularly those involved in agriculture stand on the threshold of a new decade. Given their experiences throughout the 1980s, perhaps they can be forgiven if they enter its portals with some trepidation. Will events of the 1990s be a mere extension of the turbulent decade which has just ended? Or will the next ten years forge their own distinctive character to challenge again the ingenuity and sometimes the patience and relationships of farmers and bankers alike?

Farm finance to the centre stage

Much discussion has taken place in the 1980s on the extent of the financial distress in the agricultural sector, the reasons for it and possible solutions. Perhaps never before have so many taken an interest in farm finance. While a detailed comment on all actions and studies undertaken is beyond the scope of this paper, a brief reference to certain developments of which some are contradictory, is warranted.

Owing to a number of steps that have been taken by the monetary authorities which reflect a new philosophy, style and technique of policy application, farm financing, through the Land Bank, has become more market orientated. This was specifically done to reduce the disruptive impact which this system of financing had exerted on the effectiveness of monetary policy measures. Presently the Land Bank is procuring most of its funds by way of bills, promissory notes and debentures. The interest rates on these instruments are totally market related.

The above-mentioned changes have had an insignificant impact on the flow of funds to agriculture, particularly via co-operatives, mainly as a result of the mitigating effect the various aid programmes have had on interest rates payable by farmers in the drought-stricken areas. As soon as these interest subsidy programmes run out (end August 1992), the playing field on which agricultural lenders compete will be more even. I believe that the increased competition among traditional lenders resulting in a wider range of loan products and services, market driven interest rates and more prudently regulated and capitalised institutions, all bode well for farm borrowers.

Finally, a number of studies by the Jacobs Committee have shown that the dramatic expansion in the level of money made available for agriculture was made worse by virtue of the type of lending policies in place prior to and early in the 1980s. Many loan applications were typically evaluated in terms of whether the farmers had sufficient collateral to support them. Events of the 1980s served to reinforce that the agricultural sector continues to be largely subject to the whims of nature and fluctuating commodity prices. As well, however, its vulnerability to changes in fiscal, monetary, agricultural and trade policies of other countries was vividly demonstrated. Farm finance, and in particular the role of lenders, came under close scrutiny, perhaps to an extent not previously experienced. Finally government financial support to the agricultural sector reached new levels. All of these factors are likely to play a continuing role in determining the financial well being of agriculture in the coming decade.

Financing of farm inputs

Since 1975 the value of intermediary goods and services bought by South African farmers increased by 16 per cent per annum to R7 550 million in 1989. This represents approximately 74 per cent of agriculture's contribution to gross domestic product. A study by the Reserve Bank shows that banks' credit extension in the form of discounts and advances increased at an average annual rate of 19 per cent between 1970 and 1986. The rate of increase in bank lending tended to move broadly in accordance with the business cycle.

During the period 1970 to 1986 overdrafts remained the most important vehicle of bank lending, although the growth rate of this type of lending was substantially lower than that of leasing or instalment sales (18,5 per cent compared to 24,2 per cent and 27,5 per cent respectively). With the exception of agriculture where loans are largely made to the non-corporate sector (76 per cent), the loans to all other sectors are made mainly to corporate businesses.

Discounts and advances of the banks to enterprises engaged in agriculture (forestry and fishing included) remained at a level of about 10 per cent of the banks' loan portfolio during most of the period 1970-1986. This sector's contribution to gross domestic product, however, declined from a level of about 8 per cent in the early 1970s to a level of about 5 per cent in the middle of the 1980s. This development indicated an increase in the relative indebtedness of agricultural enterprises to the banks during this period. This sector's borrowings from the banks increased from R360 million in 1970 to R4 657 million in 1986 i.e. at an average annual rate of 17,4 per cent, compared with an average annual rate of increase of 13,3 per cent in the nominal value of this sector's output. Although recent statistics on a sectoral basis are not available, bank lending to agriculture may have amounted to R9 500 million by the end of 1989. Borrowings by agricultural produce merchants and dealers, including agricultural co-operatives, increased from R50 million to R447 million, i.e. by 14,7 per cent per annum.

Available statistics on instalments and leasing finance show that by the end of 1989 banks' financing of agricultural equipment amounted to R608 million compared to R814 million by the end of 1985. Instalment sales to non-incorporated agricultural business averaged roughly R800 million per annum between

1984 and 1989 while leasing transactions averaged R285 million per annum.

In comparison, amounts drawn from the Land Bank between 1980 and 1988 for the financing of production requirements and for packaging purposes increased from R1 318 million to R2 906 million, i.e. by an annual rate of 10,4 per cent.

Emerging issues

There are several emerging developments that could have an impact on agriculture and the agricultural finance industry in the medium to longer term. Agriculture and those serving agriculture must be aware of the forces influencing their future. For discussion purposes, these trends are divided into two groups: those trends in agriculture of importance to agricultural bankers, and those trends in banking of importance to their borrowers.

First, the entire area of enhanced **global trade,** particularly in agriculture, is taking on a new significance as nations attempt to cope with over production, trade related subsidies, import controls and a wide host of non-tariff barriers. There is almost certain to be significant future implications for supply managed industries, for instance, as international trade restraints essential for these programmes run head-on into the free trade requirements for more open trading across all borders, both domestic and international.

Second, the view that substantial climatic change will occur over the next several decades seems to be gaining support amongst scientists. While to date the models developed to predict future climatic conditions do not appear to be very precise, there seems to be general agreement that a warming trend is occurring that has the potential to change the agricultural landscape quite significantly over time. In the short-term, greater year-to-year variability in climate and in crop production levels is a distinct possibility — not good news for farmers or bankers.

Third, there is a growing concern over the environment and the role of fertilizer and pesticide use in its deterioration. Already there is a growing interest in practices that reduce chemical use in agriculture. One concept is low input sustainable agriculture (LISA) which includes biological pest control, crop rotations and reduced chemical use. While it is impossible to predict a rapid swing to this concept or variations of it, it seems likely that in the 1990s bankers will be presented with requests to finance new farming practices and techniques designed to be more environmentally friendly. New combinations of land, labour and capital might well be involved, not to mention different cash flows.

Fourth, we are beginning to see new levels of **consumer advocacy** and especially a move towards a more militant animal rights movement. That development is bound to have repercussions on how we deal with future production in some of our more intensive livestock operations.

Fifth, agriculture will increasingly be characterised by takeovers, mergers and vertical integration, especially to protect farm markets. At the same time the structure of farming is towards a bimodal distribution of farm sizes, i.e. more part-time farms, fewer mid-size farms and more large commercial farms. Banks will need to segment their agricultural market between these categories.

Sixth, an agribusiness industry that is more complicated, more concentrated and more competent adds up to an environment which spawns tougher competition. In the March-April 1990 **Harvard Business Review,** Michael Porter stated that —

"A nation's competitiveness depends on the capacity of its industry to innovate and upgrade. Companies gain advantage against the world's best competitors because of pressure and challenge. They benefit from having strong domestic rivals, aggressive home-based suppliers, and demanding local customers . . . Ultimately, nations succeed in particular industries because their home environment is the most forward-looking, dynamic and challenging."

The goal of all involved in agriculture should not be surviving, but achieving international competitiveness. And not just once, but continuously.

Seventh, because changes beget conflicts and primary industries such as agriculture typically lose political strength in the economic maturation of a country, farmers and agribusinesses will have to learn better the art of compromise and coalition building. More so, because "farm thinking" will be overrun by "rural thinking" and the old enemy, the middleman, will become a great ally of farmers in modern agricultural policy.

There are undoubtedly other issues that will confront and confound us in the next decade. But I think that I have outlined enough to make the case that our future farming industry will continue to be tested on a number of fronts. And I am further led to the conclusion that these developments can be summed up in three key scenarios:

First, there will be greater year-to-year **variability in production levels,** leading to greater price volatility at the farm level.

Second, **profit margins** will continue to be tight and both production and financial efficiency will take on even more significance in the successful operation of future farms.

Third, **government involvement** in the industry will become increasingly volatile as policy makers wrestle with the need to maintain a competitive farm industry for trade related purposes yet at the same time recognise an obligation to protect the interests of those farmers who will be simply unable to survive in the new economic environment.

One word perhaps best sums up the dilemma. That word is uncertainty. And one strategy seems most likely to succeed in this environment. That strategy is flexibility. Or, if you like, flexibility tempered with adaptability — for the farmer, for the lender, for the supplier, for the retailer and for the consumer.

The past thirty years have also witnessed remarkable changes in South Africa's financial services industry, as indeed in the economy at large, and the evolution currently under way suggests that the next decade will bring new developments as fundamental as any in the past. A number of developments will have a strong bearing on the banking industry in particular. Three issues come to mind:

Firstly, there will be more blurring of demarcation lines between formerly separated sectors in the financial system. While financial institutions have used diversification strategies as a major weapon for competing vigorously in the rapidly growing and increasingly widening markets for financial services and products, the authorities will support this trend to ensure that "players" in the market will compete with equal weapons on a "level playing field".

Secondly, there will be an increasing need for co-operation between different participants in financial markets to improve efficiency problems. Such co-operation will occur and play an

important role in four broad areas:

- Development of the technological infrastructure of the financial systems, notably in areas such as payment systems, and information, trading, clearing, settlement and depository systems in the securities markets;
- Organisation and management of markets, notable stock exchanges and regulated over-the-counter markets;
- Financing large projects, and development of financial products;
- Co-operation between "producers" and "distributors" of financial products and services.

Thirdly continuing regulation and supervision, albeit in new forms and by new criteria, are needed as a matter of national interest, and are also demanded by the general public for its protection. The shape and structure of the finance industry of the future, therefore, will depend not only on market forces and technology, but also on the approach taken by the legislative and supervisory authorities. Financial reporting and information and risk management systems will have to be improved.

With this background scenario, let me move now to the specific issue of farm credit and the role that banks are likely to play in the decade ahead.

Institutional requirements

The ability of banks to serve the agricultural industry will be governed by how well they can continue to meet a number of key institutional requirements.

First, banks are profit-oriented businesses as indeed is the case with any organisation that seeks to remain solvent over the longer run. If they are to play a future role, this profitability base must be preserved. That means ensuring a reasonable return to shareholders, while protecting the interests of depositors and meeting the legitimate demands of borrowing clients. The capacity to meet these multi-faceted objectives requires a very close attention to ongoing interest rate spreads, services fees, control of operating costs and above all, minimisation of loan losses.

Second, banks must generate the required base to meet the needs of borrowing clients. Banks are financial intermediaries who "buy" their deposits from clients having surplus cash to invest, while lending these funds to clients who require additional capital. They work on the spread between what is paid for the deposits and what they are able to charge for the loan. Thus a bank's ability to lend and the lending rates themselves are in large measure determined by the rates which must be paid for the deposits — rates which in turn must be passed on to the borrowing client. And rates over which individual banks have little control!

Third, the ability of banks to provide special lending services such as fixed rate loans is closely related to their ability to gain offsetting fixed-rate deposits for a similar term. Banks must be ever conscious of the need to match their loan and deposit portfolios. Failure to do so can be rather damaging to any lender who has committed a block of long-term fixed rate loans only to find rates on the offsetting deposit balances are moving rapidly upward. Negative margins don't do a lot for any business!

Lastly, bankers are subject to certain rules and regulations that determine in large, the latitude with which they can modify business practices and procedures.

These conditions, then, place some important constraints on how banks do business. In particular, they force banks to adhere to some rather rigorous lending guidelines. In particular it means that they have to be constantly upgrading their ability to assess both repayment capacity of the borrower and the probable value of the security offered for each loan. That can be a tough assignment in these days of large fluctuations in price, productions, and asset values. It's likely to be even more difficult in the future.

These lending requirements are hardly new to the banking industry. But the growing volatility of the national and international economies have placed new demands on their ability to succeed. And, like most businesses these days, they've become more conscious of the need to establish the relative profitability of various banking segments, whether it be personal lending, corporate lending or loans to agriculture. Thanks to computer technology, lenders are now much more knowledgeable about their relative degree of profitability in each key market segment. You can be sure that given this information, a good deal more attention is now paid to lending practices in any given sector where losses are currently being encountered. While that may not sound very accommodating, it is the only recipe that can keep a lender from placing his own business in jeopardy.

What can borrowers expect

Five oberservations come to mind.

First, interest rates to the farm sector will continue to be established in line with rates accorded to other sectors, given the size of the loan, the degree of risk, the amount of administration and the term of the loan. That means that farm borrowers must be prepared to compete with other businesses with regard to interest rate levels.

Second, loan terms for fixed rate farm lending will be determined by the availability of offsetting deposits, and not by the specific needs of the farm borrower.

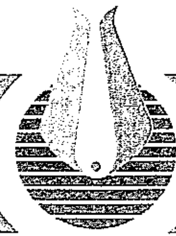
Third, the available loans for a given farmer will be largely determined by the projected capacity for repayment of the debt, backed up by a realistic assessment of the value of the security. Most of the decision emphasis will be on debt serviceability, however, given the fact the collateral security values have a bad habit of weakening when times get tough.

Fourth, loan costs are going to be increasingly tied to the direct costs of lending, with any additonal bank services likely to be charged out on a fee basis rather than included in the overall interest costs. This is due in part to the narrowing spreads on loans as well as in recognition of the user-pay principle whereby clients pay for the specific services they receive rather than face an inflated interest rate that is presumably going to cover all of the associated non-lending services.

Perhaps I can best sum up by suggesting that future farm financing will be increasingly oriented to a **business approach**, using projected evidence of debt serviceability as a major lending criteria. That suggests a need for a more businesslike approach to financial planning by farm borrowers.

Looking to the future

At this point, I would like to toss out what I think are the sort of initiatives that need to be taken by both government and private lenders if the needs of the farming community are to be adequately met in this rapidly changing economic and political environment.



First, I would like to think that governments in their wisdom will allow private lenders the scope and flexibility needed to develop the programmes which fully meet the needs of tomorrow's commercial farmer. There is no inherent reason why a business-like farm operation can't continue to qualify for conventional credit on the same basis as other businesses, especially if the lender is willing to accommodate the biologically induced cycles that are so much a part of the farm industry. That means creating a level playing field in terms of legislative intervention — and it especially means taking no legislative action which will favour one group of borrowers only at a disadvantage to others. In particular, the banks would like to see co-operatives not being favoured by provisions such as the lien on crops. This issue will soon need to be addressed to the satisfaction of both parties. The role of government is to create a framework that widens people's opportunities for choice, eliminates impediments to productive activity and sees that gains benefit society as a whole. In fact, the abolition of privileges is the essence of structural reform.

Second, if we are to make the most of the current situation, government will need to withdraw some of the punitive legislation that has been put in place with the avowed intention of either helping farmers in financial distress or deprive farmers, particularly non-white farmers to pursue farming wherever they desire. I refer here to the debt moratoriums and restraints on farm land ownership. And I especially refer to the increasing tendency for government legislation to come between a lender and his security. Certainly, governments have a responsibility to aid farmers in financial distress. But my experience with moratoriums and credit restraint programmes of a universal nature suggests that these usually do more harm to the farmers who are not in trouble than they ever do to assist the farmers that do have problems.

Thirdly, we need to put a lot more emphasis on increasing the level of income stability within the industry. Certainly, marketing boards have brought a large measure of security to producers within the supply managed commodities. But future problems are likely to emerge in this area as the ability to control international border movements run into conflict with the more open trading requirements of free trade initiatives. Considerable work has been done through crop insurance and the various stabilisation programmes to smooth out year-to-year income flows. Much more needs to be done if we are to safeguard future incomes of producers in all areas.

Fourth, we need to develop a truly national approach to credit use. For far to long now, we've seen different suppliers of credit trying to outsmart one another or being in conflict. All suppliers of credit need to form a partnership to serve the farming community and not vice versa. The face of agribusiness has far to long been scarred by unhappy moments and many of these scars resulted from "family brawls". The time has come that agriculture's face should be lit by smiles.

Some concluding comments

The past ten years have left all of the banks a little more cautious and probably a lot more experienced in the vagaries of the farm credit market. But they haven't deserted the industry and don't intend to unless events beyond their control force such a decision. Clearly, government initiatives now and in the near future will have a major bearing on how well they can meet the farm credit needs of the nineties. If more and increasingly restrictive credit legislation is introduced in the farm sector, then they'll probably have little choice but to consolidate into those areas of the farm sector where they can be comfortable with the risks. And in the process, loan charges are likely to rise to offset what they see as increasing risk levels and related loan losses. But this need not be the scenario and indeed should not be the scenario. Action can be taken to help financially troubled farmers without creating problems for other borrowing clients. The problem won't be solved by tying the lenders' hands in the recovery of loans or secured assets. Loan moratoriums, debt write-downs, intervention in the recovery of security — all of these options have been tried and all have been found wanting. There's a great opportunity for government and the private sector to work together in the future in order to make the best of the opportunities and challenges awaiting them over the next decade. Let's make the best of this option!