THE CHANGING ROLE OF AGRICULTURAL FINANCING AND THE POSSIBLE EFFECT ON AGRICULTURAL PRODUCTION: A BANKER'S VIEWPOINT

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INTRODUCTION

Since the early '70s, South Africa has experienced double-digit inflation, such that the purchasing power of money has diminished rapidly. This has had severe effects on the agricultural sector, since input costs have risen continuously but producer prices have generally not increased at a similar rate.

Excessive money creation was a key factor contributing to inflation. Beginning in 1988, the monetary authorities attempted to address this problem and to curb inflation by implementing a policy of positive real interest rates, that is, interest rates are kept above the inflation rate at all times. This is in contrast to the 1970s and 1980s, when for much of the time interest rates were negative in real terms. This led to excessive credit extension, which helped to drive up debt levels in the economy and in the agricultural sector.

In addition agriculture in the 1970s could pay lower interest rates than the market demanded. Farmers could borrow money via the Land Bank and agricultural co-operatives at interest rates below the prime lending rate of commercial banks. This made it even more attractive for the agricultural sector to obtain credit. As a result, farming debt rose rapidly.

In 1983, the De Kock Commission found that the system of agricultural financing via the Land Bank and the agricultural co-operatives seriously undermined the implementation of monetary policy. In response to the commission's recommendations, monetary policy became more market-orientated during the 1980s and market-related interest rates were increasingly applied in agriculture.

The agricultural sector has therefore been shocked in recent years by a "double" increase in interest rates: namely a decline in subsidised interest rates for the sector and the imposition of positive real interest rates for the economy as a whole. The result has been that agricultural interest payments have increased dramatically, causing debt accumulation. Interest has become one of the largest single input cost items in agriculture (R2,8 billion in 1992).

The marketing of agricultural products is determined mainly by the Marketing Act as it is applied by the different marketing boards (control boards).

The pricing and marketing policies applied by the marketing boards in the '70s and the early '80s also contributed to the financial position in which the agricultural sector finds itself today. The policy was usually applied on the basis of production costs (cost-plus basis), so that costs, rather than the level of demand, played a key role in determining prices. This approach led, amongst other things, to the stimulation of field crop production which could not be attributed to the operation of market forces. From the mid-80s, market forces were allowed to play a greater role in the pricing and marketing policy of field crop industries. The maize industry in particular was subjected to these changes, and this inevitably led to a decrease in production (which was more closely related to market forces). The result was a structural change in the South African agricultural sector: field crop production was scaled down in favour of animal production and horticulture. This process of change is likely to continue well into the '90s.

TRENDS OF AGRICULTURAL DEBT

Graph 1 shows the total asset and debt position of agriculture for the past two decades in real and nominal terms. Although farming debt has risen considerably from R1,4 billion in 1970 to R16,4 billion in 1991, the real debt position has been declining since the mid-80s.

The total nominal exposure at the end of 1992 is estimated to be lower than the figure for 1991 by about R900 million, that is, to stand at R15,6 billion due to government subsidies of R3,4 billion to the farming sector during 1992.

Graph 2 shows the net solvency position of the agricultural sector as a whole. The assets and liabilities of the total agricultural sector were used to arrive at this figure. The graph shows that the agricultural sector is in a fairly healthy state if a norm of 50 per cent is taken. However, it is important to bear in mind the distribution of agricultural debt within the farming community.

Although the average debt might be acceptable, the debt distribution curve shows that some farmers are debt free, while others are insolvent. The financial position of a sample of 1 000 farmers in the summer rainfall areas of the Transvaal and Orange Free State showed that the financial position of at least 78 per cent of farmers falls within the average debt load. From the above it can be concluded that the farming sector's financial position is relatively sound.

THE MAJOR PLAYERS IN AGRICULTURAL FINANCING

Lending, drought aid schemes and subsidies

In lending to the agricultural sector, commercial banks apply the same credit criteria as they do to lending to any other business. The agricultural sector has always been an important market for the commercial banks. The motivation for commercial bank lending to this market is obviously to further their goals, that is, to improve the value of their shareholders' interests over the long-term. To achieve this goal they have to grow their assets and profits in real terms and decide about an appropriate market share and mix.

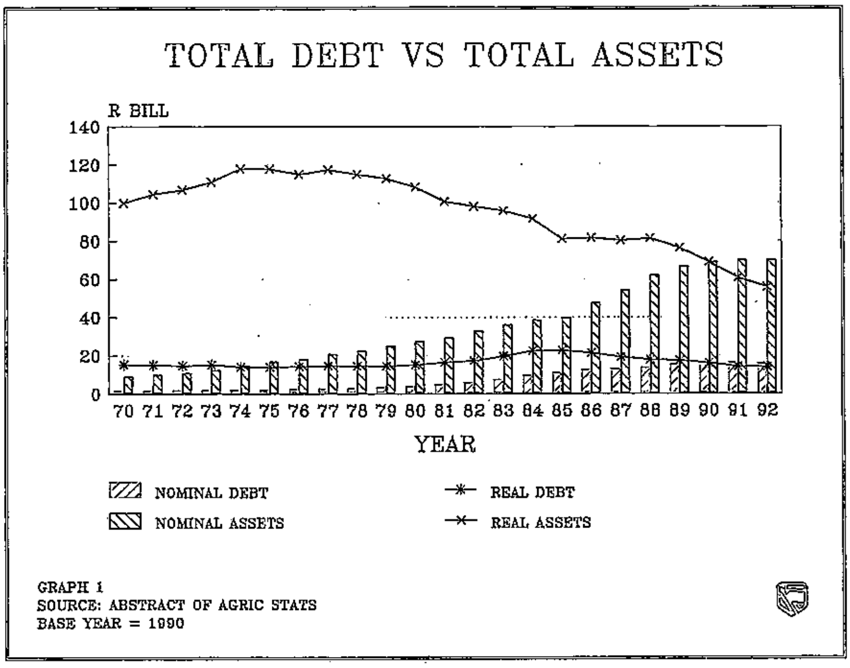
Similarly the co-operatives have played an important role in South African agriculture, providing inputs and services to farmers and acting as agents to the various marketing or control boards to ensure a co-ordinated approach in the marketing of controlled products.

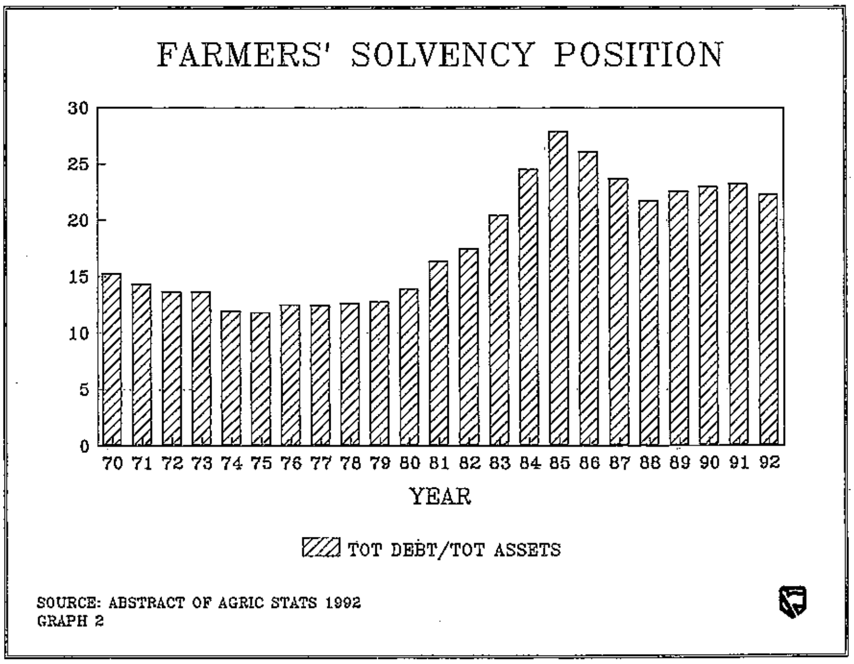
Over time, co-operatives evolved to become important suppliers of credit to members by providing production credit. The Land Bank provided these funds to the co-operatives at preferential rates.

It was during the '70s that co-operatives emerged as major players in agricultural lending and their market share grew from 6 per cent in 1970 to 23 per cent in 1980 (see chart 1A and 1B). Over this period when co-operative debt grew, co-operative interest rates were in the region of 8 to 10 per cent while commercial bank prime interest rates were between 10 and 13 per cent. This made co-operative borrowing more attractive to credit seeking farmers. It could be debated whether lower interest rates were the only cause of this growth in co-operative lending.

After the bumper harvests of the 1980/81 production season, commercial agriculture moved into a phase of large-scale borrowing from the co-operatives, but also from commercial banks. Over this period, commercial banks began increasing in popularity as a source of borrowed funds. Between 1981 and 1982 commercial bank debt grew by 35 per cent as opposed to an annual average increase of 8 per cent a year over the preceding 10 years.

Many farmers borrowed heavily to finance expansion programmes and purchase agricultural machinery and equipment. The reasoning behind this was possibly to reduce income tax liabilities due to various favourable tax concessions at the time.

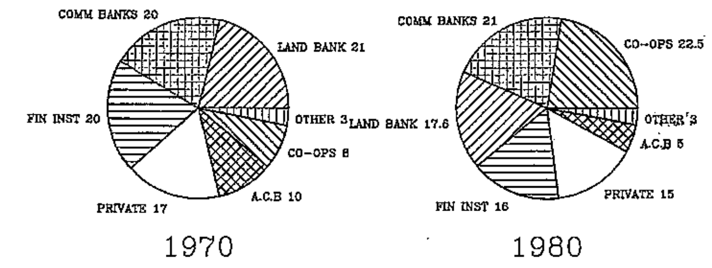

TOTAL DEBT VS TOTAL ASSETS
R BILL
140
120
100
80
60
40
20
0
70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92
YEAR
NOMINAL DEBT
NOMINAL ASSETS
REAL DEBT
REAL ASSETS
GRAPH 1
SOURCE: ABSTRACT OF AGRIC STATS
BASE YEAR = 1990


FARMERS' SOLVENCY POSITION
30
25
20
15
10
5
0
70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92
YEAR
TOT DEBT/TOT ASSETS
SOURCE: ABSTRACT OF AGRIC STATS 1992
GRAPH 2

OUTSTANDING AGRICULTURAL DEBT

PERCENT MARKET SHARE

CHART 1 A

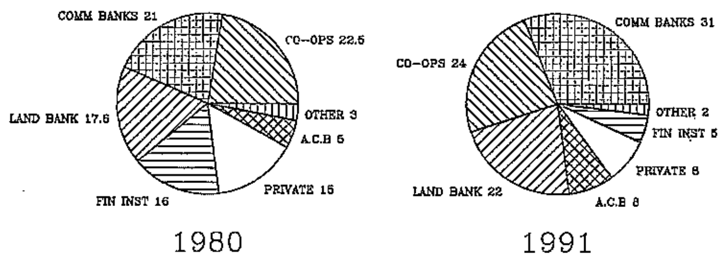


Source: Abstract of Agricultural Statistics 1993.

OUTSTANDING AGRICULTURAL DEBT

PERCENT MARKET SHARE

CHART 1 B



Source: Abstract of Agric Stats Statistics 1993.

After the drought of 1982/83, government together with the Land Bank announced an annual aid programme to those farmers in the summer rainfall grain-producing areas. This emergency aid was implemented by the Land Bank through the co-operatives and came in the form of three major assistance packages.

The first was that total farm debt could be consolidated under a bond-structured long-term loan for up to 22 years at the Land Bank. The second aid package allowed for the consolidation and subsidising of existing production loans under a debt carryover scheme for 6 to 10 years at the co-operatives. Finally members of co-operatives were allowed access to further production credit at subsidised interest rates.

By 1990 farmers had R3,8 billion outstanding with the co-operatives, of which R1,1 billion was covered by the R800 million government guarantee scheme and other emergency drought relief schemes.

After the disastrous affects of the 1991/92 drought were realised, the government's blanket guarantee to the Land Bank in terms of co-operative debt left the government with higher claims and payments than originally planned for. In 1992 government agreed with organised agriculture to a payout of R2,4 billion and to absolve itself from any further commitment to present and future outstanding debts. Of this payout, R1,2 billion was to cover the debts from the carryover scheme, while the remaining R1,2 billion was paid as an input subsidy to compensate for the "losses" due to the 1991/92 drought.

Security

Preferential treatment enjoyed by the Land Bank, co-operatives, and the Agricultural Credit Board created distortions when granting credit facilities to farmers. In terms of the Co-operatives Act, co-operatives have the right of an automatic lien on a farmer's crop if the farmer has been granted production credit under the various assistance schemes. However, co-operatives are increasingly registering bonds over farmers' properties in addition to their lien over crops.

When the Land Bank becomes involved in long-term financing, loans are advanced only against adequate security. The Land Bank finances only against first bonds. Should other financiers already be involved, they are normally required to back-rank. Often financiers agreed to these requests in the past to enable farmers to qualify for this cheaper Land Bank finance. Financiers who were required to back-rank did not always benefit from these actions and in many cases it was to their detriment.

The Agricultural Credit Act, Section 21-28, gives wide powers to the Agricultural Credit Board. Although this arrangement has its merits, it does become an easy way out for some farmers as it tends to erode one of the most important business principles, namely accountability.

Given the limitations of a competitive environment, commercial banks have endeavoured to adhere to lending practices based on the risk profiles of farming businesses. Needless to say, that some commercial banks have learnt very quickly that it does not pay to compromise on basic lending principles. Commercial banks do not enjoy any form of preferential treatment as the common law and the Insolvency Act regulate the potential claims which they as lenders are entitled to in cases of liquidation or sequestration.

Since the mid-80s all commercial banks have had to provide for bad debts from agriculture at levels higher than in the past. These write-offs due to liquidation or sequestration proportionally exceeded write-offs of other sectors since the mid-80s.

In some instances, commercial banks might have declined requests for further finance by some farmers experiencing cash flow problems in the absence of adequate tangible security. This stance is not surprising given the preferential treatment of some creditors. Furthermore, due to the composition of a farmer's balance sheet, should a customer not have any further tangible security to offer, he could be insolvent or not have the ability to repay his debts.

A statement made by a Mr Justice Williamson in October 1988 emphasises the unfortunate predicament of the commercial banks due to the Agricultural Credit Act: ".... the provisions of the Act are indubitably a very great restriction upon the ordinary rights of commercial bank creditors and they confer most extraordinary benefits upon farmers, such extraordinary benefits that I am amazed that commercial banks are involved in agricultural lending at all ..."

THE CHANGING ROLE OF AGRICULTURAL FINANCING

Levelling the playing fields

Rationalisation of the agricultural sector began in 1983. Adjustments to agricultural financing came when the recommendations or the De Kock Commission in terms of monetary policy resulted in market orientated interest rates for farmers (see Graph 3).

The stance of the government at present, and in the past, was to assist farmers with subsidies only if and when a certain event could be classified as a natural disaster. The question could be asked whether a countrywide drought is a natural disaster. Before answering the question one has to consider the following:

* South Africa is, agriculturally speaking, a semi-arid country with water as a major limiting resource;
* In South Africa droughts are the norm and not the exception;
* Most parts of South Africa have a skew distribution of rainfall, that is, the average rainfall is not a good indication of the most probable rainfall; and
* Due to the skew distribution of rainfall it can be expected in some cases to have up to seven out of ten years of below average rainfall.

Given the risk factors in agriculture, we can deduce that interference in the "risk factors" through subsidies will distort the effective allocation of resources and lead to a farming sector not sensitive to the "real risk" factors, that is, rainfall.

It could be said that those farming practices which were the least exposed to subsidies in the past are generally speaking better adjusted to risk factors. Although intervention by government through subsidies is welcomed by all the players in the agricultural sector, intervention should obviously be made in harmony with the long-term physical constraints.

It is encouraging to note that there is a movement away from subsidies in agriculture and increasingly a movement towards a "freer-market" lending environment. Not only did government withdraw from the co-operative carry-over debt guarantee, but the message came clearly through to all financiers that no more preferential treatment in terms of subsidising co-operatives and Land Bank loans would occur. The same set of rules in terms of subsidies would apply to all financiers.

Deregulation and changes in agricultural marketing

Recommendations made by the recent Kassier Commission may affect the role co-operatives will play in future.

In the past all co-operative member farmers had equal representation in the functioning of the co-operative as well as equal access to credit, regardless of farm size and infrastructure. With the freeing up of agriculture as a whole and the possible removal of the statutory powers of the control boards, the functions of the co-operatives will increasingly encompass various other areas such as marketing and processing of agricultural products.

As more emphasis will be placed on co-operatives providing a value-added service, considerable stress will be placed on their capital and management resources.

For these reasons co-operatives will probably choose to establish large public and private companies. An amalgamation of small co-operatives with larger ones will occur to pool human and infrastructural resources and co-operatives will offer existing, and possibly new outside investors the chance to purchase shares. This will become necessary for co-operatives to raise the capital needed to maintain their businesses in what will increasingly become a very competitive environment.

Risk management and lending

The sympathetic stance that financing institutions such as the Land Bank and co-operatives took towards the agricultural sector in the past was the result of organised agriculture's endeavour to keep farmers on the land and to ensure continuous production.

It could also be said that commercial banks were sympathetic towards the agricultural sector. To assist farmers through the difficult times commercial banks often compromised on their lending principles and for instance, agreed to reduced interest margins as well as service fees charged.

In this regard, an important fact that should not be overlooked is that the risk profile of farmers is higher than that of commercial businesses, while returns from the agricultural sector are much lower due to finer margins.

Obviously this is the result of the sympathetic stance towards the agricultural sector and in the short-term financiers might well be expected to cross-subsidise the farming sector. However, given basic business principles, in the long run even farmers will substitute a "less profitable" sector with a more profitable sector. It is only logical that in any business, market share will be appraised along with profitability.

The one important principle affecting the future of any financier is the "risk reward" principle, that is, the higher the risks the higher the rewards should be. Obviously this aspect can be appraised only on an individual basis and factors such as solvency, liquidity, security and management of an individual relationship will determine the safety or risk and the pricing. Should organised agriculture not give careful and particular attention to this aspect, agriculture might well find itself without financiers.

Recently co-operatives started to move towards a differentiated pricing policy for credit facilities in line with risk profiles of individual farmers.

In the past many financiers used to do security based lending. One can criticise this behaviour, but given the availability of financial statements and cash flow plans and the risks associated with farming in general, it might have been a sensible action.

The inability of many farmers to provide comprehensive and proper sets of financial statements still poses its own challenges to the agricultural lender. One can foresee that in future the farmer will have to comply with a stricter set of rules before finance is made available.

Repayment ability

Future financing of the agricultural sector will depend heavily on its ability to redeem debt. This aspect is of vital importance to all the role players involved in agricultural financing.

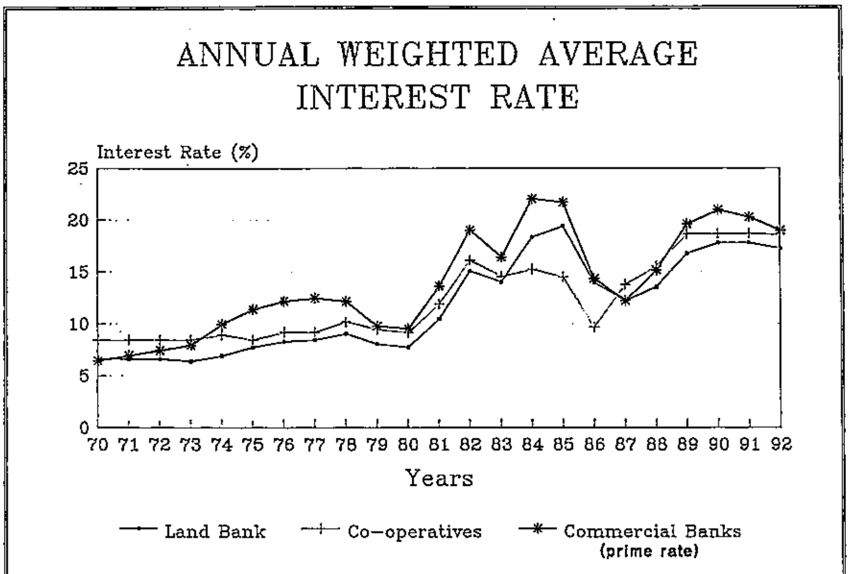
One approach in examining the redeemability of agricultural debt is by looking at critical debt levels over the past 20 years. The critical debt level gives an indication of the maximum debt that a farming enterprise, evaluated according to its net income before taxation, can repay.

Graph 4 shows total debt as a percentage of critical debt. As the graph indicates, during the '70s up to 1981, total debt amounted on average to 17,25 per cent of critical debt. Actual debt was therefore barely a fifth of the critical debt levels. The tough times experienced during the early '80s is amplified by the rapid increase in total debt over and above the critical debt level (1983 and 1984).

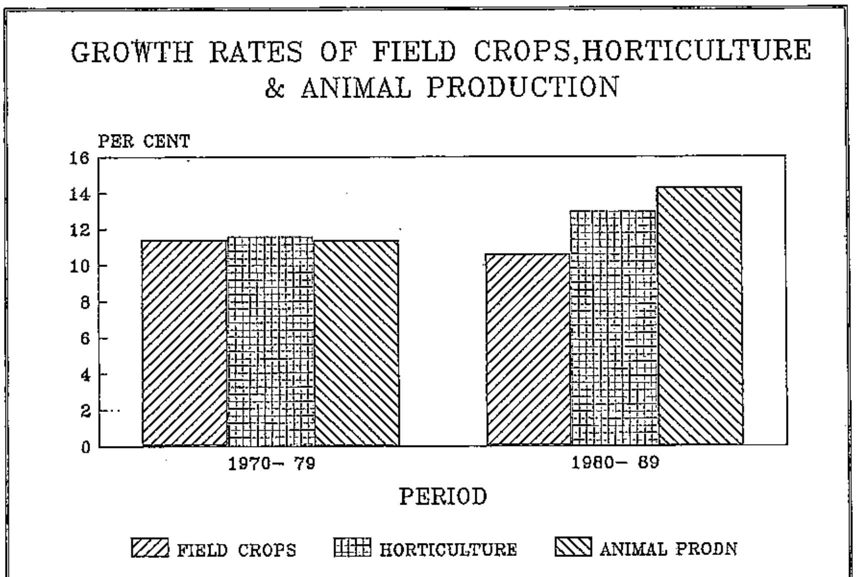
The ratio improved during the second half of the '80s, but as the graph illustrates, total debt levels are increasing again. Last year total debt was about 58 per cent of critical debt. If the long-term trend continues on its present course, the viability of the agricultural sector will be seriously weakened.

This no doubt helps explain the move of agricultural financiers towards risk-related lending. Farmers will have to accept that the price they pay for borrowing funds will be set according to their individual risk profiles.

Furthermore, we believe that there will be a



Graph 3
Source: Directorate of Agricultural Economic Trends



SOURCE: ABSTRACT OF AGRIC STATS
GRAPH 4

move to a more structured repayment scheduling (term loans) to instill a more disciplined approach on the part of borrowers.

THE EFFECTS OF FUTURE FINANCING ON PRODUCTION

Changing trends in agricultural production

Farming practices, mainly in the traditional grain producing areas, are also undergoing structural change. In terms of crop potential, South Africa has neither the climate nor the soil fertility potential to guarantee ideal yields over consecutive seasons. Furthermore, many large-scale farmers have recognised the declining profitability of grain production. Farmers are either diversifying to a greater extent or totally restructuring their farming activities to reduce climatic and environmental risk elements.

Graph 5 gives an indication of the changing composition of farming enterprises. It shows the growth rates of the field crop and livestock sectors in terms of their Rand contribution to gross agricultural income. The periods from 1970 to 1979 and from 1980 to 1989, crop production shrunk by 7,5 per cent while animal production increased by a massive 25,4 per cent.

A big advantage of livestock production is the improvement in the frequency of income. Livestock production (meat, milk and eggs) allows for farmers to earn income on a more frequent basis compared to grain crops.

Emerging commercial farming

Changes in the socio-political and economic arenas will require a change in the lending behaviour of agricultural financiers to the emerging commercial farming segment. In the past the existing financing delivery systems were not readily accessible to all sectors of the farming community. This has led to the economic underdevelopment of emerging commercial (small-scale) farmers in general.

Greater support will need to be given to the emerging commercial farming sector by a future government to bring it onto an equal footing with the rest of commercial agriculture. This will have implications for the financing of agriculture to bring about a more equal access to credit. Special finance delivery systems in favour of emerging farmers will have to be developed and implemented. This aspect will most likely have an impact on future production patterns.

CONCLUSIVE REMARKS

An essential requirement for agricultural financiers to ensure sustainable agricultural production will be to:

* Understand their customers' needs and to maintain a mutually beneficial and profitable long-term relationship;
* Apply risk-reward pricing policies down to an individual level;
* Be able to adapt quickly to a changing environment; and
* Ensure a proper diversified portfolio to withstand the ups and downs of agriculture.

The agricultural sector is now in the midst of far-reaching changes affecting not only future production but also financing mechanisms.

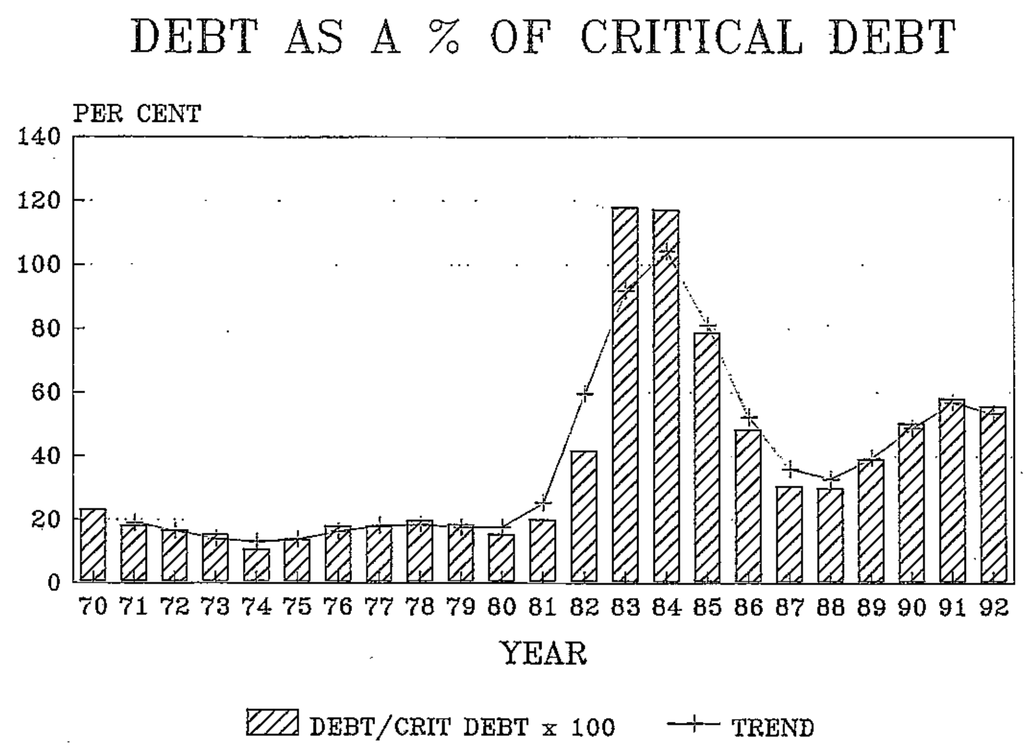
Changes in the financing arena in the form of reduced government intervention, subsidy removal and the amendment of certain preferential acts should level the playing fields thus creating a situation of fair competition for all financiers.

Should the above-mentioned factors be allowed to transpire, agricultural production will adjust itself over time to ensure an optimal allocation of resources taking risk profiles into consideration. This will induce the cultivation of agricultural produce for which the country and farmer have a competitive advantage. This will further ensure less erratic and a more stable level of production for the country as a whole.

Conservatism will be an essential ingredient in the financing recipe. This will be necessary in the light of the erratic nature of our climate and agricultural production.

A further important factor which will draw increasing attention is the growth of the new emerging commercial farming sector. All role players involved in financing will have to take note of this emerging sector and innovative, thinking will be required to successfully and profitably satisfy the needs of this sector.

Lastly, it can be said that financiers of the agricultural sector, in particular commercial banks, do value their farming customers. Furthermore, the vast investment and infrastructure of the major banks in the rural areas not only makes sense, but ensures that this sector will be adequately serviced in the years to come.



SOURCE: ABSTRACT OF AGRIC STATS
GRAPH 5