Managing Risk for Success

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I am here today to talk about managing risk for success. I will present it from a lender's perspective in order to give you an inside look at what goes on and is going on in the lending business today. Knowledge is power. If you know more about your lenders it will help you deal more effectively with them.

Background:

President of a rural bank with two branches in southeastern Minnesota. 30 minutes from Rochester.

Total assets of $22 Million.

Part of a bank holding company that controls 5425 Million in bank assets.

We have a rural focus.

I have been in the finance business for 25 years.

Farm Credit System 1975 to 1982

Regional bank from 1982 to 1988

Took over a failed rural community bank in 1988 and have been in community banking ever since

I would like to frame my presentation by going back to August of 1981.

The prime interest rate just hit 20.50%

This represented almost a 100¡/a increase from the same month a year earlier when the prime rate was 11.12%.

Land values reached their peak at $1,941 per acre in southeastern Minnesota that same year.

We had just come from a period of time when:

It was being said that we had reached a new plateau in commodity prices.

Land prices and rents had increased significantly. People were saying, "They only make so much land you better buy now. Leverage it, it do whatever it takes to control it because it will never be cheaper."

Lenders were anxious to lend money.

Spending for new equipment and capital improvements was up.

Many lenders and producers were ignoring reasonable long-term projections for yields and prices.

Input costs were increasing and gross profit margins decreasing.

There were price support programs in place.

The turkey and chicken industries were vertically integrated.

Farms were being consolidated.

Let's turn the clock ahead a little to July of 1988.

It is 3:45 in the afternoon and the lobby of the bank has just closed.

The FDIC is inside notifying the ownership, management and staff that the bank has been declared insolvent and is being closed and the assets sold.

I am standing outside a rural bank in Blooming Prairie, MN with the new owners.

The FDIC notifies us that we can enter the bank.

We have a staff meeting notifying the executive officers of the bank that they no longer have jobs and the rest of the staff has to reapply for their jobs.

The next day we open under a new name and a state bank charter.

The media is there. It is a big deal that another rural bank has failed.

It was a time of emotional hysteria, militant defiance and contentious relations between lenders and borrowers

Now the prime rate is 9.29% and average land values in southeastern MN have dropped to $782.

Farms are being consolidated.

Now it's October of 1999.

The prime rate is 8.25% and average land values in southeastern MN are $1,567.

We have Roundup ready beans.

Exports have the Asian Flu and other areas such as South America have created competition that will be hard to beat because of their cost structure.

Machinery sales are declining.

The EU is refusing delivery of certain GMOs.

Protesters are trampling and burning plots of genetically modified plants.

Lenders are still anxious to lend money.

Profit margins are shrinking.

County board meetings are crammed with people opposed to farmers putting up livestock facilities because they will ruin the quality of life in rural America.

Landlords are waiting to see what kind of farm program there will be before they sign contracts so they can get the most rent possible.

The government is still involved in subsidizing agriculture through LDP payments in spite of the Freedom to Farm Act of 1996

The hog industry has been vertically integrated and we're working on dairy.

DuPont has purchased controlling interest in Pioneer.

Monsanto is a takeover target.

Cargill has purchased Continental Grain.

Biotechnology is the buzz.

Farmers are using satellites to farm.

Farms are being consolidated in record numbers.

Processors and agricultural service providers are being consolidated

What were the risks in 1981?

Global politics (The Grain Embargo)

Interest rates o Government policy

Weather o Market

Character

Health of the principal operator

Lack of understanding of the fundamental changes going on in the industry

Life was simple then. Risk was easier to analyze.

What are the risk factors today?

Global production affecting supply and demand.

Consumer attitudes and acceptance of our production (ie, GMO issue, Bovine Growth Hormone, Mad cow disease, e. coli bacteria outbreaks)

Local policies regarding feedlots

Compulsive gambling or spending

Consolidation of processors

All the other risks that existed before

Risk management is defined as, "Procedures to protect the assets of a business or its potential for future profit against possible losses or to minimize losses if they occur, especially in the reference to a specific venture or undertaking."

If lenders and farmers had managed for interest rate risk when 1981 the farm crisis maybe wouldn't have been a crisis. What if farmers had locked in their interest rates on their term and real estate debt and were operating on their own cash to put in the crops instead of being leveraged to the hilt? How could we expect the farmers to know when the lenders didn't even know. Look at the savings and loan debacle that followed. They got in trouble because they took depositors money in the form of short term certificates and savings accounts and lent it out on long term fixed rate mortgages. Their cost of funds went crazy and they couldn't do a thing about it. What if interest rates went up significantly today? What would things be like?

The increase in interest rates precipitated the decline in land values that followed. If a lender had loaned 80% of the peak value of land in 1981 the debt per acre would have been $1,552. Seven years later that same land was worth $782. Those balance sheets didn't look very good and the loans didn't look good. Who would have known? Did the lenders know? Obviously not! Did the borrowers know? Obviously not! Then who's fault was it? We needed to blame someone. So everyone blamed each other and that's when things got bad. That is when the lenders should have sat down with their customers and laid out a strategy to dig out. In order to dig out they needed a very strong and well disciplined risk management plan. There had to be trust between the lender and borrower but unfortunately most of that had disappeared. Those that were fortunate enough to have a good lender and a good relationship were able to work together and work their way out.

In time land values increased, prices increased which improved profitability and many of the wounds on the balance sheets healed up. The unfortunate thing is that there are a lot of souls of the poor farm families that were forced to leave farming that are wandering the farts fields today. They didn't understand what they needed to do and didn't have a lender that understood either. That doesn't need to happen if you position yourself and manage risk.

I have found that farmers don't like to meet with their lenders. I had one farmer say that coming to see me was like going to the dentist. In order to deal with lenders it helps to understand who they are and why arc they so concerned about what can grow wrong.

Things you need to know about lenders:

Lenders are in business to make money
Lenders are not philanthropic
Lenders enjoy making loans
Lenders enjoy seeing their customers succeed
Lenders do not enjoy collecting loans
Lenders don't ask for financial information to make your life miserable
Lenders have families arid hobbies like fishing and biking just like other ordinary people
Lenders take themselves too serious once in a while
Lenders don't like surprises
Lenders appreciate good communications

THINGS YOU SAY THAT SCARE LENDERS:

Thank you for tile loan, I don't know how I'll ever repay you.

The bad news is I can't repay my loan this year. The good news is it looks like I'll be with you another year.

I need the money because I wrote the check.

How could I be out of money I still have blank checks.

I just got hailed out and I don't have insurance.

I need a loan for another bin because I still have last year's beans.

Lenders have the responsibility to keep their institutions solvent. They will not be around nor will the institution be around if they make a lot of loans they can't collect. Banks are highly leveraged (7-15% capital) and make money on funds entrusted to them by depositors. The regulatory agencies make sure that the banks are not jeopardizing the safety of the depositors money and the money in the FDIC insurance fund so they watch them very closely. Most of the assets of an average hank are loans.