CHECKLIST FOR AGRICULTURAL CREDIT

SAMPLE CASE FARM

Suzi and Steve Adams operate a 1900-acre grain farm in central Alberta. They have three children—David, Emily and Joe. David will be attending agricultural college next fall while Emily and Joe are 16 and 13 years of age, respectively. Suzi and Steve would like to expand their operation in anticipation of David returning to the farm after college. Their objective is to structure a loan that reduces the risk of higher interest rates while the children are in college, yet provides the opportunity to prepay their loan should they have a good crop.

A 160-acre quarter of land is currently available for $3,000 per acre, or $480,000. Suzi and Steve would like to purchase the land. They have $50,000 to use as a down payment. Suzi and Steve have visited numerous lenders about financing the remaining $430,000. They have another quarter worth $400,000 that they are willing to provide as additional security, should the bank require it.

# Case Application of Checklist

The following is a demonstration of how to use Checklist for Agricultural Credit to compare two different loan alternatives available to Suzi and Steve**.**

**Loan Alternative Overview**

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| Loan alternative overview | Loan #1 | Loan #2 |
| Loan amount | $430,000 | $430,000 |
| Interest rate | 4.5% | 3.7% |
| Loan term | 5 year fixed | 1-year open variable |
| Loan amortization | 20 years | 20 years |
| Origination fees and service charges | $2,150 | $4,300 |
| What is the payment? | Fixed annual | Fixed Annual |
| What is the prepayment privilege? | 10% | N/A |
| Is the interest rate fixed to maturity? | Yes | No |
| When is maturity? | In 5 years | Annually |
| What is the index? Banks’ prime? | N/A | 2.7% |
| What is the margin? | N/A | Plus 1.0% |
| What is the adjustment period? | N/A | Semi-annual |
| What is the interest cap on interest rate movements per period? | N/A | 1% |
| Are there prepayment penalties? | The greater of interest differential or 3 months interest | No |
| Are there loan conversion options? | No | Yes |

1. **Understand your obligations and responsibilities under the loan agreement and security agreements before signing a note and other documents associated with a loan transaction.**

Suzi and Steve carefully reviewed the loan agreement and mortgage. They asked for more information for every item that was unclear. Suzi and Steve had their lawyer review each document and clarify their obligations, especially the items related to collateral and their financial and environmental responsibility.

1. **Know the total cost of all fees due at loan origination and annually.**

Loan #1 origination fee is $2,150 or 0 .50 per cent of loan amount.

Loan #2 origination fee is $4,300 or 1 per cent of loan amount.

Neither loan has any additional annual administration fees unless late payments are made.

With a 20-year repayment period, the origination costs increase the cost of Loan #1 by approximately 0.37 per cent and Loan #2 by approximately 0.22 per cent. However, Loan #2 is not a 20-year loan. If the lender renews the loan and does not charge additional fees at each renewal, the increased cost approximated above is applicable. Since Loan #2 is a 5-year balloon payment loan, Suzi and Steve asked to have the cost of Loan #2 estimated for a 5-year loan. On a 5-year repayment period, the origination costs increase the cost of the loan by approximately 0.59 per cent.

1. **Review what constitutes a loan default and what can accelerate the bank’s demand for payment. If a demand was made, how you would deal with it?**

The lender for Loan #2 assures Suzi and Steve that no loan has been called on demand in the last 5 years. Even though Suzi and Steve are in a strong financial position and would not likely have a problem refinancing the loan, they are concerned about what loan terms would be available if the loan is called before maturity. They can afford loan payments at the existing loan terms, but with college expenses forthcoming, they are concerned about refinancing at less favorable terms.

1. **Determine the type of loan payment: annual, semi-annual or monthly.**

Suzi and Steve have determined for their operation that annual payments are the best for their cash flow.

**Will the loan be fully paid at maturity? Balloon-payment loans must be paid off or renewed at maturity, perhaps at less favorable terms. The lender is not required to renew. Consider available options if the loan is not renewed**.

Both loans are fixed blended payment loans (equal payments each year), ensuring a steady affordable payment at current interest rates; however, Loan #1 has a balloon payment in 5 years and Loan #2 every year. Although both lenders assure Suzi and Steve that the loan will be renewed if they are not in default, the lenders are not obligated to renew.

1. **Obtain an estimated payment schedule for the loan, and project your ability to meet the loan payments.**

**Determine the months of the year that would be preferable for loan payments. In addition, different loan maturities should be considered to develop a payment amount that is consistent with repayment ability.**

Annual payments for Loan #1 are $33,201.91 and due in March, while initial payments for Loan #2 are $30,900.02 and due in October. Suzi and Steve prefer to make loan payments in the spring because of higher cash sales at this time. Crop sales for Suzi and Steve are typically lowest in the fall. The lender for Loan #2 is willing to change the payment dates from October to March upon request.

If maturity increases to 25 years, the annual payments for Loan #1 and Loan #2 decrease by about $4,000, resulting in payments of $29,150.08 and $26,757.36 respectively. However, if the maturity is increased to 25 years, the total interest paid over the life of Loan #1 increases from $234,038.24 to $298,751.94. Since future interest rates are unknown, it is difficult to estimate the increased interest cost for Loan #2, which is scheduled to adjust every year.

1. **Is the interest rate fixed, variable or adjustable? What are the payments at higher interest rates should the prime rate go up? How much interest rate risk can you assume?**

Loan #1 – 5-year fixed at 4.5 per cent with no prepayment privileges.

Loan #2 – open variable adjustable every year, currently 3.7 per cent. Bank prime 2.7 per cent plus 1 per cent. Adjusted every year at Bank prime rate plus 1 percent.

Suzi and Steve have projected that they can afford to make payments up to $40,000 and still meet other financial obligations. Initially, they could afford an interest rate as high as 6.7 per cent, or a 3 per cent increase in the current Bank prime rate to 5.7 per cent.

1. **If the loan carries a variable or adjustable interest rate, ask about the index (prime rate), margin, adjustment period and caps.**

**Consider the historical patterns and levels of the Bank’s prime rate and determine your ability to meet debt payments should interest rates go up.**

The index for Loan #2 is the institution’s stated Bank’s prime rate and the adjustment period is 1 year. The margin is 1 per cent and will remain at 1 per cent for the life of the loan, should it be renewed at the same product every year over the next 5 years. Currently there is a 1 per cent cap on annual interest rate movements. Suzi and Steve inquired about the historical pattern of the index rate and received the following information. Interest rates are the lowest in modern history and bank economists feel that interest rates will slowly climb over the next 5 years.

Suzi and Steve are concerned that historical patterns of the Bank prime rate were at levels that could make loan payments infeasible. For example, by the third year, interest rates could rise 3.7 per cent to 6.7 per cent.

1. **Ask about prepayment penalties. How does this affect the cost to refinance?**

Loan #1 has a prepayment penalty of the greater of interest differential or 3 month’s interest.

Loan #2 has no prepayment penalties. This gives Suzi and Steve the flexibility to refinance if interest rates start to increase and they wish to lock in a good long-term rate.

1. **Ask about prepayment privilege.**

Loan #1 has a 10 per cent annual prepayment privilege or $43,000 during the year. Loan #2 does not allow prepayment during the year, although funds can be applied to principal reduction on annual renewal.

1. **Ask about reporting requirements and loan conversion options.**

Both loans require financial statements upon origination and annually.

Loan #1 requires financial statement within 120 days of fiscal year end.

Loan #2 requires financial statements 30 days prior to annual renewal.

Suzi and Steve have asked to be evaluated at the end of the year since their accounting system generates reports at this time. This eliminates the burden of preparing statements at another time of the year.

Loan #1 is fixed for the 5-year term with no conversion option.

Loan #2 has a conversion option that allows Suzi and Steve to convert to a different loan type and/or rate for a fee.

1. **Understand the consequences of late payments. In addition, understand foreclosure procedures, collateral obligations and all borrower rights.**

Both loans carry a loan administration fee of $200 per month should late payment occur.

Suzi and Steve have taken the loan documents to their attorney to interpret and compare their obligations, rights and responsibilities.

1. **Consider other factors, including your previous experience with the lender and lending institution, the lender’s overall agricultural expertise, the financial condition of the lending institution and the lender’s knowledge of your operation.**

Each lender has an established reputation in the community. Over the past 5 years, Suzi and Steve have done business with each lender and felt very comfortable in their business relationships. Both lenders are experienced in agricultural lending and understand the risks farmers face.

# Summary

Suzi and Steve established their objectives of expanding the farming operation while maintaining an adequate cash flow to pay for college expenses. They developed a financial plan that allowed their family to meet their short- and long-range objectives. With their plan, they are able to compare loan alternatives that meet their objectives. They determined that loan payments must be below $40,000. By negotiating with the lender for Loan #2, both of the alternative packages achieved this goal. They were uncomfortable with the timing of annual payments. They inquired about changing these provisions. If these provisions cannot be changed, Suzi and Steve will have to determine the criteria they value as the most important and choose the loan package that more closely meets their objectives. Suzi and Steve must also decide if they are satisfied with the lender’s verbal assurance that Loan #2 will be renewed annually for the next 5 years. Suzi and Steve also had their lawyer review and explain their loan documents. They fully understand their responsibilities and they are aware of the consequences of loan default.

Be aware that the best loan package for Suzi and Steve or any other borrower may not be the best loan package for you. There are many more items to consider than just the numbers. Feeling comfortable with your loan, along with developing trust and confidence in your lender and lending institution is essential. Be sure to evaluate all aspects of a loan package and ask informed questions. Ask a lender to change unfavorable aspects of a loan package.