A FARMER'S GUIDE TO AGRICULTURAL CREDIT

Prepared for:

ALBERTA AGRICULTURE AND FORESTRY

Growing Forward 2
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Canada

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This Factsheet is to act as a resource for some common, not so common questions regarding Agricultural Credit asked by Farmers.

Readers who have more complex credit requirements are advised to seek professional assistance for Credit, Legal and Accounting Professionals regarding their specific credit needs and concerns.

A FARMER'S GUIDE TO AGRICULTURAL CREDIT

INTRODUCTION

This guide is designed to help you better understand credit. In the current risky economic environment, credit should be managed as closely and as carefully as other production inputs. Like seeds and chemicals, agricultural credit options are changing and expanding with new and innovative products, and can be complicated by legal concerns. Many agribusinesses now extend credit, while traditional lenders are working harder for your business. Borrowers are offered more alternatives and need to develop procedures to evaluate those choices. These alternatives give borrowers the opportunity to better manage their financial affairs.

This guide outlines a practical approach to evaluating loans. A borrower begins by establishing short-and long-term financial objectives for his or her farm operation. Then a borrower must understand the debt service capacity of his/her farm business, and the farm's ability to service that debt. To evaluate credit options, the borrower must understand all provisions and obligations, and be aware that the interest rate is not the only issue. The interest rate is not an entry on the Income and expense statement, it is the amount of interest paid. This is a function of the interest rate and the amount of debt outstanding. The terms and conditions will affect hwo the borrower will manage their financial risk

A borrower must be comfortable with the levels of uncertainty or have provisions that reduce uncertainty to match his or her risk tolerance. A borrower should be confident that the credit arrangement will meet his or her objectives and should periodically review their credit arrangements to stay on track with those objectives.

Many terms used by lenders and others offering credit are defined in the glossary of this guide and are illustrated in the following sections. Learning the language of credit will be important as you manage your finances. Before entering any formal loan agreement, consult with a lawyer, accountant, or farm financial consultant.

TYPES OF AGRICULTURAL LOANS

In this guide, agricultural loans are categorized as *short-term* or *long-term*, depending on their maturity. Lenders often describe loans by the purpose or terms of the loan. Descriptions also change from Lender to Lender. *Short-term loans* are often used for operating expenses. Loan amortizations usually matches the length of the agricultural production cycle (e.g., 3 to 18 months), hence a short-term loan. However, this may be described as line-of-credit financing under a credit commitment, which specifies the amount and timing of the disbursements and payments of the loan. The line-of-credit may be a single disbursement due at a specified future date or a revolving line-of-credit, operating loan, in which the borrower may borrow and repay as needed during a specified time period, usually subject to a maximum borrowing limit. On a non-revolving line-of-credit, a borrower is entitled to a specified amount of funds, and repayment does not allow the borrower to draw those funds again. These short term loans can be secured against inventory at an agreed percentage of current market value or against real property.

Long-term loans are used to finance depreciable assets such as machinery, equipment, breeding livestock and improvements, and to acquire, construct and develop land and buildings, They are usually are amortized over periods longer than 18 months. Depending on the security and commitment various credit instruments and credit facilities can be used. Each with their own unique features and covenants.

LOAN DOCUMENTS

Loan transactions typically include several documents for the borrower to sign, depending upon the type of loan and the credit institution.

A loan or credit agreement is a written agreement between a lender and a borrower stipulating the terms and conditions associated with a financing transaction, and the expectations and rights of the parties involved. The loan agreement may indicate reporting requirements, possible sanctions for lack of borrower performance and any restrictions placed on a borrower. It may set out the interest term and options for conversion and or renewal.

A borrower should be aware of any demand clauses in a loan or credit agreement. A demand clause is a provision that allows the lender to demand payment at any time. Even though the demand provisions are seldom carried out, a borrower should be comfortable with paying the loan upon demand, especially in times of economic uncertainty.

A note or promissory note is a document in which the borrower agrees to repay a loan at a stipulated interest rate within a specified period of time. The note may specify a variable, fixed or adjustable rate, and whether line-of-credit financing is being used. Its use and terms vary from credit institution to credit institution.

A security agreement is a legal document signed by a borrower granting a security interest to a lender in specified personal property pledged as collateral to secure a loan. Essentially, a security agreement states what happens to the collateral if a borrower fails to perform as promised.

A financing statement is a document filed by a lender with public registry. The statement reports the security interest or lien on the borrower’s non-real estate assets and is registered at the Provincial personal property registry. The mortgage serves the same purpose in financing real estate and is registered at the Provincial Land Titles office.

All loan documents must be read and understood as these documents set out the rights and responsibilities of the lending institution and the borrower. These rights and responsibilities are governed by Federal and Provincial Laws, Statutes and Regulations.

TERMS AND CONDITIONS OF THE LOAN

As discussed earlier, a borrower needs to understand the financing and security agreements completely. This section outlines the primary loan terms and conditions included in most financing agreements.

Disbursement of Funds

Disbursements for long-term loans are usually a single payment advanced at a specified time. Some short-term operating loans may be single disbursements, but the trend in the lending industry is to establish a revolving lines-of-credit. This feature allows the borrower to reduce interest costs by using funds when needed and repaying funds as surplus cash is available.

Disbursement of funds on operating lines-of-credit are handled many ways. Many commercial banks allow the customer to draw funds to a specific agreed to limit. The borrower’s loan balance is increased and funds are added to the borrower’s account as funds are disbursed.

Payment Type

Payment type refers to the method of repayment. Payments on line-of-credit financing generally occur when the borrower has surplus funds. Depending on the financing agreement the total balance outstand can be revolving. An interest payment may be requested on a monthly basis, and possibly, as agreed percentage of the outstanding on the outstanding principle balance at a certain point in time, ie. The first of each month. On long term loans, a payment schedule maybe negotiated on a monthly, quarterly, semi-annual and annual basis, depending on the cash flow, the purpose of the loan and the quality of the security provided by the borrower. A borrower should ask the lender to produce a copy of a payment schedule that specifies principal and interest payments over the life of the loan. The borrower can then compare payment patterns on different loans.

There are three common payment types. One payment type for a long-term loans is the blended payment method. This method requires a fixed payment (interest plus principal), which repays a loan over a specified period of time at a specified interest rate. This repayment process if often referred to as equal amortization. Part of each payment is allocated to principal and part to interest, with successive payments retiring more and more principal.

A second method to calculate the payment on a long-term loan is fixed principal payment with interest due on the unpaid balance. The fixed principal amount is usually calculated by dividing the loan amount by the total number of payments. Under this method, the initial payments of principal and interest are the largest, and the ability to cash flow these payments must be considered. This method of payment requires less total interest over the life of the loan because more of the principal is repaid earlier in the loan.

Table 1 shows a comparison between the blended payment method and the fixed principal method. The loan is for $100,000, to be repaid over five years at ten per cent interest. The payment remains constant ($23,137.40) with the blended payment method. With the fixed principal method, the annual payment ranges from $25,000,000 in year one to $21,000 in year five. Total interest payments are $1,898 higher with the fixed payment method.

A third payment type is a balloon payment loan. Balloon payment loans are relatively shorter-term loans (e.g., five years). At the end of the period, the entire unpaid balance of the loan is due; the principal must either be paid in full or new loan terms must be negotiated. The initial payments are usually based on a longer amortization period (e.g., ten to 30 years) under the assumption that the loan will be paid off, renewed or financed at maturity. If interest rates fall and credit conditions improve, a borrower could negotiate more favorable loan terms at renewal. On the other hand, if interest rates rise or credit tightens, the loan terms may become less favorable. In addition, the borrower's risk is considerably higher since the lender may decide not to renew the loan at maturity. Borrowers considering balloon payment loans need to inquire about the fees added each time the loan is renewed.

Table 1. Fixed Blended payment vs. Fixed principal methods

Loan Terms: $100,000, five years, 5 per cent interest, one annual payment per year.

Fixed Blended Payment Method

Payment #	Principal	Interest	Payment Amount	Ending Balance
1	$18,074.90	$5,062.50	$23,137.40	$81,925.10
2	$18,989.94	$4,147.46	$23,137.40	$62,965.16
3	$19,951.31	$3,186.09	$23,137.40	$42,983.85
4	$20,961.34	$2,176.06	$23,127.40	$22,022.51
5	$22,022.51	$1,114.89	$23,137.40	$0.00

Your payment on $100,000.00 with an amortization period of 5 years will be $115,687.00.

Fixed Principal Payment Method

Payment #	Principal	Interest	Payment Amount	Ending Balance
1	$20,000.00	$5,000.00	$25,000.00	$80,0000.00
2	$20,000.00	$4,000.00	$24,000.00	$60,000.00
3	$20,000.00	$3,000.00	$23,000.00	$40,000.00
4	$20,000.00	$2,000.00	$22,000.00	$20,000.00
5.	$20,000.00	$1,000.00	$21,000.00	$0.00

Your payment on $100,000.00 with an amortization period of 5 years will be $115,000.00.

Table 2 illustrates a Term loan with balloon payment on term maturity. Payments in the first four years are identical to a 20-year amortized loan. After the fifth payment, $8,066.84 the outstanding loan balance of $89,378.39 is due and payable unless arrangements are made to renew this loan agreement. This amount must be paid in full or refinanced at interest rates prevailing in year 5. Although the lender may refinance this Term payment loan, there is no legal obligation to do so. The decision to renew will be based on the lender’s consideration of credit and economic factors as they apply at the time of renewal. A borrower selecting a balloon payment loan should be comfortable with risks associated with balloon payment loans. If a borrower is considering refinancing with a different lender upon maturity, additional administrative and closing costs may be incurred.

Table 2. Payment pattern of a Term loan and balloon payment loan.

Loan Terms: $100,000, 5% Fixed interest, five year term, one payment per year based on a 20-year amortization.

Payment#	Principal	Interest	Payment Amount	Ending Balance
1	$2,004.34	$5,062.50	$8,066.84	$96,995.66
2	$3,156.43	$4,910.41	$8,066.84	$93,839.23
3	$3,316.23	$4,750.61	$8,066.84	$90,523.00
4	$3,484.11	$4,582.73	$8,066.84	$87,038.88
5	$3,660.50	$4,406.34	$8,066.84	$83,378.39

Interest Rate and Term

Since it is the visible "price tag" of a loan, the interest rate is often used to compare loans. Loans carry fixed, adjustable or variable interest rates. A fixed rate loan carries the same interest rate until the loan is paid off. A variable or adjustable rate loan has provisions to change the interest rate based on changes in market rates of interest, a specified index or other factors determined by a lender. Interest rates on adjustable rate loans or mortgages can only change at intervals specified in a not or loan agreement. For example, the interest rate on a five-year adjustable rate mortgage can change once every five years.

A variable rate loan may also designate intervals in which interest rates may change, but in some variable rate loans a change in the interest may be at the discretion of the lender. If a borrower has a variable or adjustable rate loan, he or she should know how often and how much the interest rate may change. The borrower should also be able to calculate how changes in interest rates affect the loan payment. A borrower should ask the lender to estimate the scheduled payment at various rates of interest. The borrower should be comfortable with the uncertainty involved with potential interest rate changes. If not, the borrower may request loan terms that reduce the interest rate risk.

If the interest rate on a variable or adjustable rate loan is linked to a specified index rate, a lender typically adds a margin above the index rate to determine the interest rate. In Canada the most used index rate is the Charter Bank's prime rate. For example, if the Bank Prime rate is 3 per cent and the margin is two per cent, the interest rate on a variable rate or adjustable rate loan is 5 per cent. If the Bank prime rate changes to 4 per cent in the next adjustment period, the interest rate charged will be 6 per cent.

Many characteristics of variable and adjustable rate loan differ among lenders. The interest rate index (if any), margin, length of adjustment period and caps (upper limits) are the major distinguishing features. These features may be negotiable.

Interest rate index: The variable of adjustable interest rate is sometimes linked to an interest rate index. Many lending institutions use their average cost of funds or another internal rate as the basis to price loans. Other common indices include one-year Treasury securities rates, 90-day Treasury bills, bankers' acceptance or bond yields. Differences between the indices can be substantial. Federal funds rates and 90-day Treasury bill rates can change every day, while the prime rate changes less frequently. A borrower should ask the lender about historical patterns of the index rate. In addition, if the lender is using the institution's internal rate, a borrower should ask how often the lender changes this rate.

Margin: The margin refers to the percentage points that the lender adds to the rate index to determine the rate charged to the borrower. The margin covers the costs of administering the loan, a risk premium, and a profit margin for the lender. The note or loan agreement will state if the margin is to remain constant over the maturity of the loan.

Length of adjustment period: The adjustment period is the length of time before the lender can change the borrower's interest rate. At the end of each adjustment period, the interest rate may be adjusted to reflect changes in the index (if an index is used). The note may allow for other terms of the loan to change at each adjustment period.

Caps: Rate caps may be associated with variable or adjustable rate loans. They limit how much the interest rate can change at each adjustment period. Many loans also have life-of-loan rate caps which limit interest rate movements over the entire life of the loan. Often a cap may be purchased as an optimal feature of the loan.

Compound interest: arises when interest is added to the principal loan, so that, from that moment on, the interest that has been added also earns interest. This addition of interest to the principal is called compounding.

In order to define an interest rate fully, and enable one to compare it with other interest rates, the interest rate and the compounding frequency must be disclosed. Since most people prefer to think of rates as a yearly percentage, the Federal government Interest Act requires financial institutions to disclose the equivalent yearly compounded interest rate on deposits or advances. For instance, the yearly rate for a loan with one per cent interest per month is approximately 12.68 per cent per annum (1.0112 − 1). This equivalent yearly rate may be referred to as annual percentage rate (APR), annual equivalent rate (AER), effective interest rate, effective annual rate, and by other terms. These government requirements assist consumers in comparing the actual costs of borrowing more easily.

For any given interest rate and compounding frequency, an "equivalent" rate for any different compounding frequency exists.

Compound interest may be contrasted with simple interest, where interest is not added to the principal (there is no compounding). Compound interest is standard in finance and economics, and simple interest is used infrequently (although certain financial products may contain elements of simple interest). The majority of mortgage loans in Canada are compounded semi-annually.

A borrower should be aware of each of these factors affecting a variable or adjustable rate loan. Moreover, the combination of the factors and the resulting implications must be considered. For example, if a lender has a volatile interest rate index, a borrower should consider some type of cap. Lenders will negotiate on the different variable and adjustable rate features. For example, a lender may lengthen the adjustment period in exchange for a higher margin. A borrower should feel comfortable with the variable or adjustable rate features and be willing to discuss changes in a loan package.

Fees and Service Charges

As a general rule, loan fees or "points" are charged at the time the loan is made. A point is one per cent of the amount loaned. In addition, there may be other service charges for which the lender will require reimbursement. Service charges and fees are typically charged for:

- Loan application fee
- real estate appraisals,
- credit searches,
- legal costs,
- mortgages registration and deeds,
- mortgage title insurance premiums
- title searches.
- Property tax adjustment

Fees and service charges increase the borrower's cost. Figure one shows the estimated increased cost over the life of a loan for one point paid at origination on a ten per cent loan with annual payments.

Some lenders will reduce the interest rate in exchange for a fee at origination. This is called a rate buy down. A borrower must estimate the potential benefit from a rate buy down. For example, suppose a lender offers to reduce a borrower's interest rate on a fixed-rate loan by 0.20 per cent (20 basis point) for one point at origination. The cost is the same if the loan is expected to be paid off in 12 to 13 years If the loan is expected to be paid off in more than 13 years, a borrower should benefit by the rate buy down, while a borrower's anticipated return would be less if the loan is expected to be paid off in less than 12 years. A borrower should ask the lender to estimate the break-even points for each loan alternative.

Payment Frequency

The frequency of payments differs among loans. Typically, intermediate- and long-term loans are structured with monthly, quarterly, semi-annual or annual payments. More frequent principal payments generally reduce the total interest paid over the life of the loan. A similar factor to consider is the timing of the payments. Obviously, it is preferable to have payments which correspond with high cash inflows. A borrower should establish a payment pattern with a lender that coincides with his or her cash flow.

Loan Amortization

Loan Amortization is simply the time until the loan is fully due and payable. A borrower should evaluate his or her ability to generate cash to repay debt when comparing loans with different amortization. As a rule of thumb, a borrower should not select a loan amortization that is longer than the anticipated life of the asset being financed. Shorter amortizations result in lower total interest payments over the life of the loan and more rapid accumulation of equity in the asset being financed. In contrast, loans with longer amortizations will have lower loan payments and, therefore, free up cash for other uses. Thus, trade-offs between shorter and longer loan amortizations should be carefully evaluated.

Table three shows annual payments among loans of different amortizations and interest rates. For example, the annual payments on a $100,000, 20-year loan at three per cent would be $6,736.56. The payments on a similar 25-year loan would be $8,066.84. A borrower could also use Table three to estimate the change in annual payments as interest rates changed.

Loan Payment Calculators can be found on financial institution websites i.e. Farm Credit Canada -Tools and Resources page https://www.fcc-fac.ca/en/tools-and-resources.html

Table 3. Annual payment on $100,000 at different interest rates and amortizations

Annual Payment

Amortization Years	3%	5%	7%	9%	11%
5	$21,849.49	$23,137.40	$24,469.12	$24,844.47	$27,263.23
10	$11,736.48	$12,989.70	$14,318.48	$15,721.17	$17,196.10
15	$8,390.30	$9,674.97	$11,064.57	$12,554.57	$14,139.51
20	$6,735.56	$8,066.84	$9,529.35	$11,113.17	$12,806.83
25	$5,757.19	$7,139.76	$8,675.98	$10,348.14	$12,137.13

Collateral Requirements

Collateral refers to the assets pledged as security in a loan transaction. The legal documents representing a lender's interest in collateral include a mortgage in the case of farm real estate loans and a security agreement for operating and intermediate-term loans. Nearly all farm real estate loans are secured by a mortgage on a tract of land. Operating loans and intermediate-term loans may be secured or unsecured, although secured loans are more common. Unsecured loans generally involve smaller loans to financially strong borrowers who usually are long-term customers of the lending institution.

Intermediate-term loans generally are secured by the asset being purchased. Examples are tractors, combines, equipment, facilities and breeding livestock. Operating loans usually are secured by current assets and sometimes by intermediate assets as well. Examples of collateral for operating loans are farm supplies, crop and livestock inventories, growing crops, government payments and deposit accounts. A blanket filing may be used on a line-of-credit financing so that the security agreement applies to essentially all of the current and intermediate assets and, if stipulated, to property acquired in the future as well.

A security agreement usually includes covenants about selling, insuring and/or maintaining collateral. Many security agreements for real estate purposes now include provisions regarding the storage and disposal of hazardous wastes. A borrower should be aware of the procedures and notifications that need to be made upon selling or modifying assets used as collateral.

A borrower should also be aware of the lender's right to collateral upon default. A security agreement or mortgage will specifically outline the lender's and borrower's rights upon default.

Prepayment Penalties

A borrower should be aware of prepayment penalties. A prepayment penalty is a fee charged by a lender when a loan is paid prior to its maturity. Prepayment penalties vary significantly among lenders. Prepayment penalties will increase the cost of refinancing a mortgage and reduce the flexibility of changing loan alternatives, such as refinancing if interest rates decline. In Canada prepayment penalties are often the greater of 3 months interest or interest differential. Interest differential is the difference in the state rated and the cost of funds at that time.

Refinancing

As interest rates fall, refinancing may become more attractive. Better service, lengthening of maturity, more favorable noninterest lending terms, and customer dissatisfaction may also motivate a borrower to refinance. In addition to the interest rate reduction, a borrower should estimate fees and prepayment penalties that would result from refinancing the loan. These fees and penalties may overcome any interest rate savings. Furthermore, if the borrower is switching from a fixed-rate loan to a variable- or adjustable-rate loan, he or she should evaluate the differences in risk associated with these loans.

Loan Conversion

A conversion option provides the ability to convert from one type of loan to another (e.g., from fixed rate to variable, and vice-versa) at any time or at the end of an adjustment period. This option may require a fee.

Reporting Requirements

The detail and frequency of financial reports required from a borrower will differ from lender to lender and by type and size of loan. Many real estate lenders require annual financial statements. Others only require statements when originating or renegotiating a loan. The borrower should feel comfortable with the financial statement requirements, but choosing a lender that requires the fewest reports may not be in the borrower's best interest. Most borrowers are already preparing periodic financial reports for management purposes. Thus, reasonable reporting requirement should not be a significant factor in the borrower's choice of lender.

The financial statements include a balance sheet formulated at the same time each year and an income statement. A cash flow budget may also be helpful. Using accurate and verifiable data is important.

Credit Evaluation Procedures

Many agricultural lenders analyze the creditworthiness of agricultural borrowers using a combination of judgement and formal credit scoring models or risk assessment worksheets. This approach seeks to combine various measures of business performance (e.g., profitability, solvency, liquidity, repayment history and collateral) with other information about the borrower to reach an overall credit score. This credit score may be used in making loan decisions, determining the borrower's interest rate, deciding about loan supervision and monitoring business performance. Borrowers can aid in the evaluation process by keeping comprehensive financial records (e.g., balance sheets, income statements, flow of funds summaries) and presenting this information to the lender in a timely, well-organized and thoroughly documented fashion. Annual statements should be prepared at the same time each year to allow for more appropriate comparisons over time. In turn, the borrower can ask a lender to review the results of the credit evaluation process so that both parties clearly understand the strengths and weaknesses of the farm business, and thus develop more effective financial plans in the future.

Risk Management

A borrower's risk management practices that help to stabilize farm income and improve the likelihood of successful loan repayment will assist in obtain credit. Examples include enterprise diversification, resistant seed varieties, crop insurance, holding financial reserves, limits on borrowing, crop share leases, off farm work, and marketing practices such as forward contracting, frequency of sales, futures and option contracts and others. Lenders may respond to these practices with more favorable financing terms, lower interest rates, and access to credit.

Late-Payment Penalties and Default Provisions

Even though most borrowers plan to make timely loan payments, unforeseen circumstances sometimes results in late payments. The Federal government's Interest Act prohibits a lender from charging penalty interest. A borrower should also be aware of the conditions under which the loan is considered in default and if there are grace periods that are specifically written in loan documents. Some loan agreements provide for flexible payment program should some unforeseen circumstances occur. This may be an interest only payment with a principal payment deferral to the end of the interest term. Late payment as set out in the loan agreement may trigger a monthly account monitoring fee.

Other Considerations

It is beyond the scope of this guide to describe rating techniques for lenders or their institutions; however, a borrower should seek to develop confidence and trust with both lenders and lending institutions.

FARMER'S CHECKLIST FOR AGRICULTURAL CREDIT

Review the following items as you evaluate different loans. Before evaluating the specific terms of loans, consider goals for your family and farm and strive to choose a loan package that you are comfortable with, as well as one that meets your business objectives. You need to understand the terms and the risks of individual loan alternatives. Since lenders have developed different loan term products to meet the needs of their customers, you should consider those loan terms which satisfies your objectives and matches your level of risk tolerance.

1. First and foremost, understand your obligations and responsibilities before signing a note and other documents associated with a loan transaction.

2. Know the total cost of all fees due at loan origination and annually. Divide the total amount of fees by the loan amount to determine the number of points charged at origination.

3. Review what constitutes a loan default and what can accelerate the bank's demand for payment. If a demand was made, how this would affect your operation?

4. Determine the type of loan payment. 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. You should consider available options if the loan is not renewed.

5. 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. Does the loan have flexible terms? Can you defer principal payments due to different risk demands?

6. Is the interest rate fixed, variable or adjustable? What are the payments at higher interest rates? How much interest rate risk can you assume?

7. If the loan carries a variable or adjustable interest rate, ask about the index, is it the Bank's 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.

8. Ask about prepayment penalties. Is the higher of three months interest or interest differential? How does this affect the cost to refinance?

9. Ask about prepayment privilege? Can additional principal payment be made during the year? Does the loan terms contain an annual prepayment privilege? What percentage of the original disbursed balance?

10. Ask about reporting requirements? What loan conversion options are available?. Is the loan term open or closed?

11. Understand the consequences of late payments. In addition, understand foreclosure procedures, collateral obligations and all borrower rights. Are there any loan management fees triggered by late payments.

12. Consider other factors, including your previous experience with the lender and lending institution, the lender's overall agricultural expertise, and the lender's knowledge of your operation.

A FARMER'S CHECKLIST FOR AGRICULTURAL CREDIT

SAMPLE CASE FARM

Suzi and Steven Adams operate a 1900-acre grain farm in the Central Alberta. They have three children David, Emily and Joe. David will be attending Agriculture 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 $430,000.00. 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 A Farmer's Checklist for Agricultural Credit to compare two different loan alternatives available to Suzie and Steven.

Loan Alternative Overview

Loan Alternative overview	Loan #1	Loan #2
Loan Amount	$430,000	$430,000
Interest rate	4.5%	3.7%
Loan Term	5 year fixed	One 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 Five years	Annually
What is the index? Bank 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
Is 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 time that was unclear. Suzi and Steve had their lawyer review each document and clarify their obligations; especially the items related to collateral, their financial and environmental responsibility.

2. **Know the total cost of all fees due at loan origination and annually.**
   Loan one origination fee is $2,150 or 0 .50 percent of loan amount.
   Loan two origination fee is $4,300 or one percent of loan amount.

   Neither loan has any additional annual administration fees unless late payments are made.
   A 20-year repayment period, the origination costs increase the cost of Loan 1 by approximately 0.37percent and Loan two by approximately 0.22 percent. However, Loan two 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 two is a five-year balloon payment loan, Suzi and Steve asked to have the cost of Loan 2 estimated for a five-year loan. Using Figure one and a five-year repayment period, the origination costs increase the cost of the loan by approximately 0.59 percent.

3. **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 two assures Suzi and Steve that no loan has been called on demand in the last five 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.

4. **Determine the type of loan payment. Annual, Semi-annual, or monthly**
   Suzy and Steve have determined for their operation, 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. You should 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 one has a balloon payment in five years and Loan two every year... Although the 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.

5. **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 one are $33,201.91 and due in March, while initial payments for Loan two 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 two is willing to change the payment dates from October to March upon request.

   If maturity increases to 25 years, the annual payments for Loan one and Loan two 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 two, which is scheduled to adjust every year.

6. **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 – Five year Fixed at 4.5 percent. With no prepayment privileges

   Loan 2 – Open Variable Adjustable every year, currently 3.7 percent. Bank Prime 2.7 percent plus one percent. Adjusted every year at Bank prime rate plus one 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 percent. Or a 3 percent increase in the current Bank prime rate to 5.7 per cent.

7. **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 two is the institution's stated Bank's prime rate and the adjustment period is one year. The margin is one percent and will remain at one percent for the life of the loan, should it be renewed at the same product every year over the next five years. Currently there is a one percent 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 interests will slowly climb over the next five 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 percent to 6.7 per cent.

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

   Loan one has a prepayment penalty. The greater of interest differential or three month's interest.

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

9. **Ask about prepayment privilege?**

   Loan one has a ten percent annual prepayment privilege or $43,000 during the year. *Loan two* does not allow prepayment during the year, though funds can be applied to principal reduction on annual renewal.

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

    Both loans require financial statements upon origination and annually.

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

    Loan two 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 one is fixed for the five year term with no conversions option.

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

11. **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 occurs.

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

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

    Each lender has an established reputation in the community. Over the past five 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 two, both of the alternative packages achieved this goal. They were uncomfortable 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 verbal assurance that Loan two will be renewed in annually for the next five 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.

GLOSSARY OF AGRICULTURAL CREDIT TERMS

A

- **Acceleration Clause**: A common provision of a loan, mortgage, or other debt obligation providing the lender with the right to demand or otherwise require that the entire outstanding balance be immediately due and payable such as in the event of default.
- **Account Payable:** An amount owing to a creditor, usually arising from the purchase of goods or services, that is due to be paid within a short period of time, often less than 12-months, or within the normal operating cycle (where the cycle is longer than a year) to avoid default.
- **Account Receivable:** An amount owed to the business usually arising from the sale of goods or services.
- **Accrual Income**: See net income.
- **Adjustable-Rate Loan**: See Variable Rate Loan.
- **Adjusted Debt Service Capacity**: The amount available for debt servicing calculated as net income (after tax) plus interest plus depreciation minus gains/losses on disposal of assets minus extraordinary income minus deferred income taxes minus dividends minus living expenses plus off farm income.
- **Adjustment Date**: See Interest Adjustment Date.
- **Administrative Costs**: A lender's operating and fixed costs charged for completing and servicing a loan.
- **Advance Payment Program**: An Agriculture and Agri-Food Canada financial loan guarantee program that gives producers access to credit through cash advances on the value of their agricultural products during a specified period. Under this loan program, the Government of Canada guarantees repayment of cash advances issued to farmers by their producer organization. These guarantees are designed to help the producer organization borrow money from financial institutions at lower interest rates and issue producers a cash advance on the anticipated value of their farm product that is being produced and/or that is in storage.
- **Advance:** The payment of money, the provision of credit or the giving of value and includes a liability of the debtor to pay interest, or other charges or costs in the connection with an advance of funds or other value to, or on behalf of, the debtor.
- **AFSC**: See Agriculture Financial Services Corporation.
- **Agriculture Financial Services Corporation**: An Alberta crown corporation that provides farmers, agribusinesses and other small businesses loans, crop insurance, livestock price insurance, farm loans, commercial loans and farm income disaster assistance.
- **Amortization Period:** See Amortization.
- **Amortization**: The paying off of debt with a fixed repayment schedule in regular installments over a period of time.
- **Amortize / Amortizing:** See Amortization.
- **Annual Percentage Rate**: is an annual rate, expressed as a percentage, that relates the amount and timing of value advanced, or to be advanced, to, or on behalf of, the borrower in connection with a loan to the amount and timing of value given or to be given by the borrower in connection with the loan, disregarding the possibility of prepayment or

default. It is an actuarial representation of the total financing cost of credit expressed as a percent per annum. The annual percentage rate (APR) is calculated similarly across different institutions and is designed to allow for easier borrower comparison of loan products.

- **Appraisal**: The written summary by a qualified individual setting forth an estimated value of a specific asset or group of assets, usually used in reference to real estate.
- **Appreciation**: The increase in value of an asset over time.
- **APR:** See Annual Percentage Rate.
- **Arm's Length**: Relationship or transaction between persons who act reasonably in their separate economic interests, not in concert, and without control of on person over the other.
- **Assets**: The items and property owned or controlled by an individual or business that have commercial or exchange value. Items may include claims against others or other intangibles. All assets are reported on a balance sheet at market or cost value less accumulated depreciation.
- **Assignment**: The transfer of title to property or other rights in or related to property (or other assets or liabilities) from one person or entity to another.
- **Average Cost of Funds**: A method of determining the cost of funds at a lending institution. This method uses an average cost of existing funds. In contrast, the marginal cost of funds uses cost of new funds only.

B

- **Balance Sheet**: The financial statement that reflects the values of an individual or business assets and the financial claims on these assets at a specific point in time.
- **Bank Draft:** See Draft.
- **Bankruptcy**: A legal process governed by the Bankruptcy and Insolvency Act for an individual or corporation who can no longer pay back debts. The debtor assigns all assets —with some exceptions —to an Insolvency Trustee who sells or uses them to help pay the debt to the creditors. The two general types of bankruptcy are voluntary and involuntary. A voluntary bankruptcy is initiated when the debtor voluntarily assigns into bankruptcy. In an involuntary bankruptcy, the creditor forces the debtor into bankruptcy by way of the court process.
- **Base Rate**: An interest rate used as a basis to price loans. A margin reflecting the riskiness of the individual or operation is added to or subtracted from the base rate to determine the loan rate. The lender funding, operating cost and required return are reflected in the base rate. The base rate in Canada is often the Bank or other lender's posted prime rate or prime rate plus a margin.
- **Basis Point**: Usually used in describing interest rate movements or interest costs. One basis point is 1/100 of 1per cent. For example, 50 basis points is 0.5per cent. Sometimes, a basis point is referred to as a *bip* or *bips*.
- **Blanket Mortgage**: A mortgage on more than one parcel of real estate.
- **Bridge Loan**: A temporary, single-payment loan used by creditors to bridge the time period between the retirement of one loan and the issuance of another. An example is a loan used for the down payment on a new real estate purchase while awaiting closing of a sale of another parcel of real estate or payment of a short term receivable.

C

- **CALA**: See Canadian Agricultural Loans Act.
- ***Canadian Agricultural Loans Act***: Federal Loan Guarantee Program to Increase the availability of loans for the purpose of the establishment, improvement and development of farms. Where a lender may feel that there may be some risk to a loan proposal but with some risk mitigation the proposal has merit, they may apply under the Canadian Agricultural Loans Act for a guarantee. Under the Act the Minister of Agriculture is liable to pay to the lender 95per cent of the loss sustained on a CALA registered loan provided that the requirements of the Act and regulations have been met.
- **Cap**: Used with variable- or adjustable-rate loans to refer to the maximum allowable interest rate that the variable or adjustable rate loan can attain.
- **Cash Flow Budget**: A financial statement reflecting the projected sources and uses of cash. Items on the statement are usually categorized as business or nonbusiness with subdivisions for funds from business operations and funds from financing.
- **Caveat:** From the Latin word meaning “Let him beware.” It is a registered document containing a warning or caution that there are persons, other than the registered owner, claiming an interest in the land and stating the nature of the claim. The interest claimed may or may not be a valid interest in the land but if its validity is disputed and upheld by the courts, any person dealing with the land subsequent to the registration of the caveat is subject to the interest claimed.
- **CCAA:** See Companies’ Creditors Arrangement Act.
- **CCT:** See Certified Copy of Title.
- **Certified Copy of Title:** Document that identifies the current registered owner(s) and shows all outstanding registered interests in land, such as mortgages, caveats, easements, surface leases, and builders' liens.
- **Chattel**: Personal property generally (e.g., tractors, grain, livestock, vehicles) that is not a fixture to land or otherwise excluded from the legal definition of a chattel.
- **Clear Title:** A clear title is free of any claims, mortgages, liens and other financial encumbrances and has no financial encumbrances or interests other than that of the owner.
- **Closing Costs**: The costs incurred by borrowers and sellers in completing a loan or land sale transaction. Included are origination fees, inspections, title insurance, appraisals, legal and realtor fees and other costs of the closing.
- **Closing**: Process by which all fees and documents required by a buyer of land or other assets or a lender prior to disbursing loan proceeds are executed, transmitted, and filed (as appropriate) so as to complete the obligations under the relevant agreement. Usually used in reference to the completion of a real estate, loan, or share transaction that transfers rights in exchange for monetary or other consideration.
- **Co-Borrower:** See Co-Signer.
- **Co-Debtor:** See Co-Signer.
- **Collateral**: Property pledged to assure repayment of debt.
- **Commitment Fee**: The fee associated with the establishment of a loan commitment. The fee may be expressed as a percentage of the loan commitment or a flat fee amount and is often due and payable upon the commitment issuing.

- **Commitment**: An agreement between a lender and borrower to lend up to a specified amount of money at a specified future date subject to specific performance criteria and terms (including repayment). A commitment will often include the commercial terms of the loan agreement.
- ***Companies' Creditors Arrangement Act***: Federal law allowing insolvent corporations that owe their creditors in excess of $5 million to restructure their business and financial affairs under court supervision.
- **Compensating Deposit Balance**: A minimum deposit balance that is sometimes required by a bank or other lender from a borrower. The balance is usually expressed as a percentage of the total loan commitment and/or a stipulated percentage of the amount of commitment actually used by the borrower.
- **Compound Interest**: Compound interest is interest added to the principal of a deposit or loan so that the added interest also earns interest from then on. Each time interest is payable it is added to the principal and thereafter also incurs interest. For example, a new deposit balance is estimated each day for daily compounding. Common compounding periods are daily, monthly, quarterly, annually and continuously. The more frequent the compounding, the higher the effective rate of interest.
- **Conditional Surrender of Lease:** a type of security granted as against a leasehold interest in Crown land, such as a grazing lease, where the lease is 'mortgaged' to a lender as security for a loan allowing the lender, on default, to assign the leasehold rights to a qualified third party for value (with consent of the Crown as to the transferee).
- **Consideration -** The amount actually paid for something (not necessarily the same as its value).
- **Consolidation Order:** A method, in Alberta, and some other provinces where a debtor can voluntarily seek out a legal proceeding (also known as an orderly payment of debt program) to help make their payments. The order will consolidate all unsecured debts and determine an amount that the debtor must pay to the agency or Court on a periodic basis. Upon receipt of the payments, the agency or Court will make payments to the creditors on behalf of the debtor.
- **Conveyance -** A document which transfers property from one person to another.
- **Cooperative**: An organization that is owned by and operated for the benefit of its patrons.
- **Co-Signer**: An individual in addition to the borrower who signs a note or loan agreement and thus assumes responsibility and liability for repayment as a principal debtor.
- **Cost of Funds**: Refers to the interest and non-interest cost of obtaining equity and debt funds. See, for example, commitment fee. See also Marginal Cost of Funds and Average Cost of Funds.
- **Covenant**: A legal promise in a note, loan agreement, security agreement or mortgage to do or not to do specific acts; or a promise that certain conditions do or do not exist. A breach of a covenant can lead to the injured party pursuing legal remedies and can be a basis for foreclosure in a mortgage secured loan, or trigger an acceleration clause.
- **Credit Scoring**: A quantitative approach used to measure and evaluate the creditworthiness of a loan applicant. A measure of profitability, solvency, management ability and liquidity are commonly included in a credit scoring model.

- **Credit Union**: A member-owned financial cooperative, democratically controlled by its members, and operated for the purpose of promoting thrift, providing credit at competitive rates, and providing other financial services to its members.
- **Credit Verification**: The process involved in confirming the creditworthiness of a borrower.
- **Creditor:** A creditor is a person who is owed money, goods or services.
- **Creditworthiness**: The ability, willingness, and financial capability of a borrower to repay debt.
- **Current Ratio**: A liquidity ratio calculated as current assets divided by current liabilities.

D

- **Debt-to-Asset Ratio**: A solvency ratio calculated as total liabilities divided by total assets.
- **Default**: The failure of a borrower to meet the financial obligations of a loan or a breach of any of the other terms or covenants of a loan or related security documents (ex: General Security Agreement or Mortgage).
- **Delinquency**: The status of a loan where the principal and/or interest payments on a loan are overdue. The borrower, in a delinquent loan, is in default.
- **Demand Loan**: A loan with no specific maturity date. The lender may demand payment on the loan at any time subject to its terms.
- **Depreciation**: A decrease in value of an asset, such as buildings or chattels, caused by age, use, obsolescence and physical deterioration. A non-cash accounting expense that reflects the allowable deduction in book value of assets such as machinery, buildings or breeding livestock.
- **Down Payment**: The equity amount invested in an asset purchase usually at time of entering into the agreement or closing. The down payment plus the amount borrowed generally equals the total value of the asset purchased.
- **Draft**: An order for the payment of money drawn by one person or bank on another. Often used in the dispersal of an operating loan to a borrower for payment of bills.
- **Due and Payable**: A term referring to the time when any account payable, debt, or payment on a debt, must be paid or has become payable.

E

- **Easement:** A right acquired by one person from another, permitting use of the other's land for a purpose such as a right-of-way across it.
- **Effective Interest Rate**: The calculated interest rate that may take account of fees and compounding, in contrast to a quoted rate of interest.
- **Employment Verification**: The confirmation of status and conditions of employment of a potential borrower as part of the underwriting process.
- **Encumbrance**: Any charge on land or claim or interest that limits the right of property. Examples include liens, mortgages, leases, easements and caveats.
- **Equity Capital**: See net worth.

- **Execution of Instruments -** The signing and delivery of documents by the parties as their own acts and deeds, usually in the presence of witnesses, and sometimes under seal.

F

- **Fair Market Value:** the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in an open and unrestricted market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell.
- **Farm Credit Canada**: This is a federal crown corporation, whose purpose is to enhance rural Canada by providing specialized and personalized financial services to farming operations, including family farms. Although once exclusively a farm lender, Farm Credit Canada is now also organized to provide funding to enterprises that are closely related to or dependent on farming. It is Canada's largest agricultural lender.
- **Farm Debt Mediation Act**: Federal Law that provides for a process of mediation between insolvent farmers and their creditors. See also Farm Debt Mediation Service.
- **Farm Debt Mediation Service**: Federal government service that offers financial counselling and mediation services under the Farm Debt Mediation Act to farmers who are having difficulties meeting their financial obligations. It is a free and voluntary service for both farmers and for creditor(s). The service helps bring farmers and their creditor(s) together with a mediator in a neutral forum in an attempt to to reach a mutually acceptable solution to the farmer's financial difficulties.
- **FCC:** See Farm Credit Canada.
- **FDMA**: See Farm Debt Mediation Act.
- **FDMS:** See Farm Debt Mediation Service.
- **Fees**: A fixed charge or payment for services due to the lender or third party in association with a loan transaction or other transaction.
- **Financial Statement**: A written report of the financial condition at a given time of a person, corporation, or other entity. Financial statements include balance sheet, income statement, statement of changes in net worth and statement of cash flow.
- **Financing Statement**: A statement filed by a lender with the Personal Property Security Registry. The statement reports the security interest or charge on the borrower's asset(s).
- **First Mortgage**: A real estate mortgage that has priority over all other mortgages on a specified piece of real estate.
- **Fixed-Rate Loan**: A loan that bears the same interest rate until loan maturity.
- **Fixture:** Chattels which are affixed to real property in such a manner that their primary purpose becomes the better use of the land rather than the better use of the chattels.
- **Floating Rate Loan**: See variable-rate loan.
- **Foreclosure:** An action in Court taken after a breach of the conditions of the mortgage, usually the failure to repay the mortgage debt in which the lender seeks to extinguish the borrower's right to redeem and offer the property for sale, or take title and possession, under process of law and supervision of the court.

G

- **General Security Agreement**: A security interest in favor of the lender charging all of the debtor's personal property. The charge is often referred to as an "All PAAPP" (All Present and after-acquired Personal Property) or a GSA.
- **Grantor**: A person or entity conveying an interest in property, real or personal.
- **GSA:** See General Security Agreement.
- **Guarantee:** generally, a written agreement whereby a person, corporation, or other entity, enters into an obligation to answer for an act or default or omission of another.
- **Guarantor**: A person or entity that takes the financial responsibility of another person's debt or other obligations in the case of default.
- **Guaranty:** alternative spelling of Guarantee, see Guarantee.

H

I

- **Income Statement**: Summary of the revenue (receipts or income) and expenses (costs) of a business over a period of time to determine its profit position. The income statement is also referred to as a profit and loss statement, earnings statement or an operating statement.
- **Insolvency / Insolvent:** The inability of an individual, corporation or other entity to pay their liabilities as they become due and/or who has ceased to pay current obligations as they become due and/or whose aggregate property, at fair market value is insufficient to pay all obligations due or becoming due.
- **Interest Adjustment Date**: the date from which your lender first starts accruing interest under a loan. Usually, this is the date that funds are disbursed under the loan. The interest adjustment date is set because the lender is funding, and you have use and benefit from the loan prior to making the first payment under the loan.
- **Interest Only Loan:** A loan that does not amortize. The borrower pays only the interest outstanding and at the expiry of the term the full amount originally borrowed, the principal, becomes due and payable.
- **Intermediate-Term Loan**: A loan to be repaid (or amortized) over a period of 18 months to 10 years, with 3 to 5 years being most common. Intermediate-term loans typically are used to finance machinery, equipment, automobiles, trucks, breeding livestock, improvements, and other durable, yet depreciable, assets.

J

- **Joint Tenancy**: The type of ownership of land that involves two or more owners where each owner has the right of survivorship such that when one owner dies, that person's interest automatically passes to the other owner(s). When only one survivor remains, the joint tenancy ceases. See, contra, Tenancy-in-Common.

K

L

- **Land Titles Act:** An Alberta statute that regulates the creation, priorities, and termination of legal rights in real property in Alberta under the land titles system of ownership.
- **Law of Property Act:** An Alberta statute that deals with, amongst other things, the enforcement of security against land in Alberta.
- **Lease**: Acquiring the control of an asset (e.g., land, machinery) by renting for a specified period of time. A rental payment is made by the lessee (or tenant) to the lessor (or landlord) to cover the lessor's cost of ownership. Examples include operating leases, capital leases, and real estate leases.
- **Lease-Option**: See Lease-Purchase
- **Lease-Purchase**: A financing arrangement in which an asset (ex., a tractor) is leased for a period of time and then may be purchased at a price specified in the lease-purchase contract. Also called a lease-option.
- **Legal Description** - The description of land that for unsubdivided land gives number of section, township, range and meridian and that for subdivided land gives lot, block and plan number or unit and plan number and appears on the Certified Copy of Title. Municipal addresses quoting streets or avenues are not legal descriptions.
- **Legal Lending Limit**: A legal lending limit on the total amount of loans and commitments a financial institution can have outstanding to any one borrower. The limit usually is determined as a specified percentage of the financial institutions own net worth or equity capital. Its purpose is to avoid excessive exposure to the credit risk of an individual borrower.
- **Lien**: A financial claim or charge by a creditor on property or assets of a debtor in which the property may be held as security or sold in satisfaction (full or partial) of a debt. Liens may arise through borrowing transactions where the lender is granted a lien or charge on the borrower's property. Other examples of liens include tax liens against real estate with delinquent taxes or a builder's lien against property on which work has been performed but not paid for.
- **Line-of-Credit**: An arrangement by a lender to make an amount of revolving credit available to a borrower for use over a specified period of time. It is generally characterized by a loan agreement and periodic and partial disbursements and repayments of loan funds throughout the term.
- **Liquidation**: The sale of assets, voluntary or otherwise, to generate cash needed to meet financial obligations, transactions or investment opportunities.
- **Liquidity**: The ability of a business to generate cash, with little risk of loss of principal value, to meet financial obligations, transactions or investment opportunities.
- **Loan Agreement**: Typically refers to a written agreement between a lender and borrower stipulating covenants, terms and conditions associated with a financing transaction and in addition to those included in any accompanying note(s), security agreement(s) and/or other loan documents. The agreement may indicate the obligations of each party, reporting requirements, fees or other charges for lack of borrower performance, and restrictions placed on a borrower.

- **Loan Commitment**: An agreement to lend up to a specified dollar amount during a specified period. Often a loan commitment will contain and set the key commercial terms of the loan ultimately being provided.
- **Loan Committee**: A committee of loan officers, executive personnel and/or directors of a financial institution who establish lending policies and/or approve loan requests that exceed the lending authority of individual loan officers.
- **Loan Conversion Provision**: An option provided by a lender to a borrower to change loan terms at a future date. For example, at loan origination a lender may provide a borrower with an option to convert from a variable to a fixed-rate loan. The lender may charge the borrower a fee for providing and exercising an option.
- **Loan-to-Asset Value**: The ratio of loan balance to the value of assets pledged as collateral to secure a loan.
- **Long-Term Loan**: A loan to be repaid (or amortized) over a period of time exceeding 10 years, with 20- to 30-year loans being common when financing real estate.

M

- **Marginal Cost of Funds**: A loan pricing method by a financial institution in which interest rates on new loans are based on the cost of new funds acquired in financial markets to fund the loans. This pricing policy contrasts with loan pricing based on the average cost of funds already acquired by the lending institution.
- **Matured Mortgage:** A mortgage secured loan where the term has expired and the full remaining balance is due and payable. See also Maturity.
- **Maturity**: Amount of time until the loan is fully due and payable. For example, a 5-year loan has a maturity of 5 years regardless of the amortization period.
- **Mortgage**: A legal instrument that conveys a security interest in real property to the mortgagee (i.e., a lender) as collateral security for the loan.

N

- **Net Income**: A measurement of the net return. Also called accrual net income. The primary difference between cash and accrual net income is that accrual income includes adjustments for changes in inventory and changes in accrual items like prepaid expenses, accounts payable and accounts receivable. Accrual net income more accurately reflects the profitability of a business over an accounting period.
- **Net worth**: The financial claim by owners on the total assets of a business, calculated as total assets minus total liabilities equals net worth. Also called equity capital and ownership equity.
- **Non arm's length**: Relationship or transaction between two persons who are related to each other or otherwise acting on less than commercial terms. See also Arm's Length.
- **Non-revolving line-of-credit:** A line-of-credit in which the maximum amount of a loan is the total of loan disbursement(s). Repayments do not make loan funds available again as in a revolving line-of-credit.
- **NOSI:** See Notice of Security Interest.
- **Note:** See Promissory Note.

- **Notice of Security Interest:** A notice, registered against the title to land to which goods will be or are affixed to land, that preserves the priority of the personal property security interest in the goods that become affixed.

O

- **Off-Farm Income**: Income earned by a farmer operator or member of the operator's family from employment off the farm or from investments made in non-farm activities or ventures.
- **Operating Line of Credit:** A revolving credit facility designed to be used as a short term operating loan. See operating loan.
- **Operating Loan**: A short-term loan (i.e., less than one year) to finance crop production, livestock production, inventories, accounts receivable and other operating or short-term liquidity needs of a business.
- **Origination Fee:** A fee charged by a lender or broker to a borrower at the time a loan is originated to cover the costs of administering the loan, evaluating credit, checking legal records, verifying collateral and other administrative activities.
- **Overdraft / Overdrawn**: a deficit in an account or loan caused by drawing more money than permitted or available.
- **Ownership Equity**: See net worth.

P

- **Parcel** - A specified area of land.
- **Pari Passu:** Where two or more assets, creditors, or obligations are equally managed without any display of preference as between them. For example, in a Syndicated Loan the lenders may share in equal preference to each other.
- **Partial Release**: Release of a portion of collateral of the borrower that is secured under a secured loan. Often this will occur as part of a refinancing of a loan, renewal, or sale of the secured collateral with the consent of the lender.
- **Per Diem Interest:** The amount of interest added to a loan on a daily basis, often calculated as part of a payout process.
- ***Personal Property Security Act*:** An Alberta statute that regulates the creation, registration, and priority of security interests in all types of personal property within the province of Alberta. All other provinces have similar statutes.
- **Personal Property**: Any tangible or intangible property that is not designated by law as real property. Personal property is not fixtured or immovable.
- **PMSI:** See Purchase-Money Security Interest.
- **P-Note**: See Promissory Note.
- **PPSA:** See Personal Property Security Act.
- **Preferred Creditor:** a preferred creditor is a creditor that has a claim to any funds that are available in priority to general unsecured creditors.
- **Prepayment Penalty**: An amount charged by a lender on a loan paid prior to its maturity.
- **Prime Rate**: Refers to an individual lender's interest rate charged to its most creditworthy borrowers.

- **Principal**: The non-interest dollar amount of a loan outstanding at a point in time, or the portion of a payment that represents a reduction in loan balance. Principal is distinguished from interest due on a loan or the interest portion of a loan payment.
- **Pro forma statement**: A projection into the future. Examples are a pro forma balance sheet and a pro forma income statement. Often a pro forma statement is used to assess profitability of a proposed venture.
- **Pro Rata**: A proportionate allocation of a loan, asset, or obligation. A method of assigning an amount to a fraction, according to its share of the whole.
- **Profit and Loss Statement**: See income statement.
- **Profitability**: The relative profit performance of a business, enterprise or other operating unit. Profitability comparisons often occur over time, across peer groups, relative to projections, and relative to norms or standards.
- **Promissory Note**: A written promise to pay. A document in which a borrower promises to repay a loan to a lender at a stipulated interest rate, which could be zero percent interest, within a specified time period of time or upon demand by the lender.
- **Purchase-Money Security Interest:** A security interest taken or reserved in collateral to secure payment of all or part of its purchase price or otherwise enabling the debtor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights.

Q

R

- **Rate Adjustment**: A change in interest rate on an existing loan. Rate adjustments may occur on variable- or adjustable-rate loans.
- **Rate of Return on Assets:** A profitability measure representing the rate of return on business assets during an accounting period. Rate of Return on Assets is calculated by dividing the dollar return to assets during the accounting period by the value of assets at the beginning of the period or the average value of assets over the period. Often Rate of Return on Assets is used to assess profitability or compare two or more proposed business ventures.
- **Rate of Return on Equity**: A profitability measure representing the rate of return on the equity capital which owners have invested in a business. Rate of Return on Equity is calculated by dividing the dollar return to equity capital during an accounting period by the value of equity capital at the beginning of the period or the average value of equity capital over the period. Often Rate of Return on Equity is used to assess profitability or compare two or more proposed business ventures.
- **Real Property Report**: A legal document that certifies boundary locations of land and the location of all visible public and private improvements relative to property boundaries. A registered Alberta Land Surveyor is the only individual who can legally prepare a Real Property Report.
- **Real Property**: Land, buildings, fixtures, minerals and other kinds of property that are legally classified as real property.

- **Refinancing**: A change in an existing loan designed to extend and/or restructure the repayment obligation or to achieve more favorable loan terms by transferring the financing arrangement to another lender or loan.
- **Renewal**: A form of extending an unpaid loan in which the borrower's remaining unpaid loan balance is carried over (renewed) at maturity into a new term at the beginning of the next financing period.
- **Repayment Ability**: The anticipated ability of a borrower to generate sufficient cash to repay a loan plus interest according to the terms established in the loan contract.
- **Restrictive Covenant** - A contractual restriction on the use of certain land for the benefit of other land.
- **Revolving Line-of-Credit**: A line-of-credit made available to a borrower in which the borrower can usually borrow, repay and re-borrow funds at any time and in any amounts up to the credit limit, but not above, during a specified period of time.
- **Risk Assessment**: The procedures a lender follows in evaluating a borrower's creditworthiness, repayment ability, and collateral position relative to the borrower's intended use of the loan proceeds. Risk assessment is similar to credit scoring and risk rating. See Underwriting.
- **Risk Premium**: The adjustment of a lender's base interest rate in response to the anticipated level of a borrower's credit risk in a loan transaction. Higher risk loans may carry higher interest rates, with the rate differential representing the risk premium.
- **Risk Rating**: The relative amount of credit risk associated with a loan. The lender may use credit scoring or other risk assessment procedures to evaluate loan requests and group borrowers into various risk classes or ratings for purposes of loan acceptance or rejection, loan pricing, loan control, degree of monitoring and level of loan documentation and security required.
- **Risk Tolerance**: The degree of safety a lender wished to have. Also called risk aversion or risk attitude.
- **ROA:** See Rate of Return on Assets.
- **ROE:** See Rate of Return on Equity.
- **RPR:** See Real Property Report.

S

- **Second Mortgage**: The use of two lenders (or loans from one lender) in real estate mortgage financing in which one lender holds a first mortgage on the real estate and another lender (or the same lender through a second loan) holds a second subordinated mortgage as against the same parcel of land. The first mortgage holder has first claim on the borrower's mortgaged property and assets in the event of loan default, foreclosure or bankruptcy; accordingly, a second mortgage is of higher risk to the lender and often has a higher interest rate to compensate for this higher risk. See Risk Premium.
- **Secured Creditor:** A secured creditor is one who takes collateral for the extension of credit, such as by way of specific mortgage, security interest and/or general security agreement.
- **Secured Loan**: Loans in which specific assets (e.g.: real property, chattels) have been pledged by the borrower as collateral to secure the loan. Security agreements and mortgages serve as evidence of security in secured loans.

- **Security Agreement**: A legal instrument signed by a debtor granting an interest, charge, or lien to a lender in specified, or all, personal property pledged as collateral to secure a loan or loans.
- **Simple Interest**: A method of calculating interest obligations in which no compounding of interest occurs. Interest charges are the product of the loan principal times the annual rate of interest times the number of years or proportion of a year the principal has been outstanding.
- **Sole Ownership**: An individual, corporation or other entity is the only owner of the asset.
- **Solvency**: A condition of financial viability in which net worth is positive and the business is expected to meet its financial obligations as they come due. An insolvent business has a zero or negative net worth and questionable viability. Solvency indicators include the debt-to-asset ratio, debt-to-equity ratio and the equity-to-asset ratio. See also Insolvency / Insolvent.
- **Statement of Farming Activities:** Canada Revenue Agency form T2042 used to report farm income and expenses as a part of filing federal income tax returns.
- **Surety:** Person or entity that has been requested by another (principal) and agrees to be responsible for the performance of some act if the principal fails to perform as promised, such as a Guarantor under a Guarantee.
- **Syndicated Loan**: A loan in which two or more lenders share in providing loan funds to a borrower. Generally, one of the participating lenders originates, services, and documents the loan (the lead bank or lender) on behalf of the syndicate of participating banks or lenders.

T

- **Tenancy-in-Common**: In this type of ownership there are two or more owners called tenants-in-common who hold title to an asset, often Real Property, without a right of survivorship such that when a tenant-in-common dies, that person's share in the asset goes to his or her estate, not automatically to the other co-owner(s).
- **Tiered Loans**: Loans grouped according to the risk characteristics of borrowers. Higher risk classes generally are charged higher interest rates to compensate the lender for carrying the increased credit risk.
- **Title Insurance**: Insurance which protects a purchaser or mortgage lender against losses arising from a defect in title or certain other matters relating to real estate, other than defects that have been specifically excluded.
- **Title Opinion**: A legal opinion rendered by a lawyer as to the status of the title to an asset (often real estate).
- **Torrens System**: A system of land ownership and transfer where a government office has custody of all original land titles and all original documents registered against them, issues certificates of the state of title, and guarantees accuracy of the certificates of title issued under the system backed up with insurance to compensate for errors if they arise.
- **Total Debt Service Ratio:** A debt service measure that financial lenders use to give a preliminary assessment of whether a potential borrower is already in too much debt, generally calculated as the total cost of debt servicing divided by gross revenue.
- **Tranche:** A piece, portion or slice of a loan or structured financing product.

- **Trend analysis**: The use of financial measures or ratios over several time periods to evaluate business performance over time.

U

- **Underwriting:** the process that a lender uses to assess the creditworthiness or risk of a potential borrower. Credit verification and employment verification are often parts of the underwriting process.
- **Undivided Interest** - The interest of a tenant in common in land.
- **Unsecured Creditor**: An unsecured creditor is one who gives credit but who does not take any security for the debt owed to them.
- **Unsecured loans**: Loans for which there are no items of security pledged by the borrower as collateral to secure the loan.
- **Usury**: the criminal practice of making monetary loans that unfairly enrich the lender through an effective annual rate of interest in excess of sixty percent per annum, in violation of the Criminal Code of Canada.

V

- **Variable Rate Loan**: A Variable Rate Loan, also called an adjustable rate or floating rate loan is a loan that has provisions to change the interest rate at pre-specified points in time based on changes in a market index, a lender's cost of funds, prime rate, or other factors as determined by the lender by formula, reference to an outside event or events (for example the Bank of Canada rate), or otherwise. Often a variable rate loan will be expressed as a banks prime or base rate plus or minus a margin. (e.g.: base + 3per cent). Generally, rate changes occur in response to changes in the lender's cost of funds of a specified index. The frequency and level of rate adjustments may or may not be established in the loan contract.
- **Vendor financing**: A loan provided by the seller of property to a buyer in order to finance the buyer's purchase of the asset. Vendor Financing can be secured or unsecured.

W

- **Working capital**: The differences between current assets and current liabilities. Often used as a measurement of liquidity of a business.
- **Writ of Enforcement**: a document, filed with the Court, which permits the taking of enforcement steps against a judgment debtor by a judgment creditor and is often registered against the judgment debtor in the Personal Property Registry and against the title to debtor's lands.

X Y Z

5. Acknowledgement

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6.Other references

Determining the Type and Source of Financing Required
http://www1.agric.gov.ab.ca/$department/deptdocs.nsf/all/apa2328