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<u>Credit Decisions: Factors Beyond the Numbers</u>

By Dr. David M. Kohl

A question from a well-respected banker during a recent agricultural bankers' conference motivated me to write about factors beyond the numbers in credit decisions. He stated, "Many new and beginning lenders are attending banking schools. What are their areas of deficiency and what are you and the other instructors emphasizing?"

The new agricultural lender is multi-dimensional. More are coming into the field with a non-farm or non-agricultural background, and more institutions are recruiting from non-agricultural schools. Next, more individuals are making a transition to lending mid-career, some with experience in agriculture and others outside the field. A big trend is more women agricultural lenders and more institutions hiring individuals without a college degree.

In banking schools, the instructors emphasize financial statement analysis with the normal trend and ratio analysis. However, we emphasize that the financial statements and subsequent ratio analysis do not necessarily always have the answers. The financial statements often generate the questions that need to be asked to uncover risk and business development opportunities. The lender of the future must know how to calculate the numbers, think critically about the output, and connect the dots. This is where credit risk rating systems have generally made many lenders more complacent. I have often said, "Do not check your brains at the door." These systems are a tool, not the end-all answer.

Special emphasis is placed on communications. Courses on writing loan narratives with proper grammar and attention to one's statements are being reinforced as a communication tool. The instructors emphasize that these statements could be used against the institution or the lender if legal action is being taken. Oral and non-verbal communication is being taught throughout the lending process. Customer relations mistakes are often made between the credit analyst and the relationship officer. Being a credit analyst or reviewer behind the desk requires one to think through the whole process when making credit decisions.

Evaluations received from attendees of schools and conferences will often show that the participants want more financial analysis. However, veteran instructors know the importance of balancing financial analysis with factors beyond the numbers, otherwise known as the art of lending. Let's draw on an excellent presentation from Sam Miller of

BMO Harris Bank and Nate Franzen of First Dakota National Bank at the recent American Bankers Association's Agricultural Bankers Conference in Omaha, Nebraska, for some perspective in this area.

Sam indicated that most farm and ranch businesses are family businesses, which often have relationship issues. These issues are manifested as the business grows and more cousins are in business relationships and sometimes with outside family business partners. Agriculture business transition will accelerate later in the decade as baby boomers pass the reins to the next generation of stakeholders. Sometimes up to four generations are involved in this transition process. The lender will often be the unofficial facilitator or an advisor in this transition. A strong set of financial ratios, financial statements, and underwriting standards can quickly go upside down if this transition process is procrastinated, does not occur at all, or has some bumps. Will the generational transfer build on the experience and wisdom of the vintage generation with the integration of the energy and the talent of the next generation? This is where vision, core values, and goals are critical for the process to be effective. Remember, estate planning is the transfer of assets while business transition planning is the evolution of business management.

Next, business owners will often not tell you about their problems. If you discover problems, then it is important to have the borrower come up with solutions and alternatives. For example, there may be a cash flow or profit issue. A quick fix would be to restructure debt to build financial liquidity. However, sometimes the ultimate solution may be to examine costs, marketing, production practices, and operational efficiency. Often, problem-solving is a side-by-side proposition between the borrower and lender. However, for this process to be successful the borrower must assume accountability.

Of course, excessive family living costs and "killer toys" are sometimes the issue. This is where the farm inspection and the customer interview can uncover issues and also provide solutions. Observation of what is being said and not being said is a skill that is often honed in by the master agricultural lender.

Management of workers and labor productivity is becoming a bigger challenge in the equation. As businesses engage more technology, more qualified employees and management are necessary to take advantage of the innovation that is critical as agricultural operations become bigger and the industry consolidates.

It is critical to assess risk and overall confidence by asking questions. For example, a producer may not be skilled in marketing or finance. Have they engaged the right people to make up for these deficiencies? This will be necessary to take the business to the next level. Sam and Nate both identified the "imposter syndrome." Do your borrowers have the confidence to manage more debt and a larger business? Are the partners and spouses on board with the strategic direction? I have observed situations where a major expansion is called off before construction began because the partners or spouses were not on board.

Financial honesty, integrity, and character are very important. This goes both ways in the borrower-lender relationship. Do the individuals that you deal with communicate what they are going to do and follow through with their commitments? Are their financial statements transparent with accurate reporting of assets and liabilities? Remember, greed's cousin is fraud. One only has to observe the scandals in the world of cryptocurrency to get a taste of fraud on a larger scale.

Credit decisions can be complex in a rapidly changing economic environment. Balancing both the science of the numbers and the art of the nonfinancial factors is what more instructors and mentors need to bestow on the next generation of agricultural lenders. I encourage mentors and instructors to get the "new kids on the block" into more training programs that will help them grow as individuals. As a new lender, take the opportunity to enroll in these programs whenever possible. We hope to see you at some of our schools, conferences, and training sessions in the future!

Global Economy – What Recession?

In the last column, our discussion focused on the possibility of a global recession starting in Europe, then China, and eventually moving to the United States.

Recent data from Europe would suggest that the Euro sector avoided a recession with a slightly positive growth rate. Digging deeper, Germany, the fourth largest economy in the world, had a negative growth rate along with Great Britain. However, the other European countries boosted the overall growth rate to a positive number. Europe dodged an economic bullet as a result of mild winter weather. This reduced inflation, which is still high at just under 10 percent. Mild weather coupled with strong tourism and exports to North America were factors for more favorable economic performance. Moving forward, the Russo-Ukrainian War, inflation controls, interest rate hikes, and other geopolitical and economic shocks could move this region of the globe into recession territory very quickly.

Moving to China, the zero-tolerance COVID-19 lockdown is over. Some project Chinese economic growth in the 4 to 5 percent range. The Chinese citizens have saved $2.7 trillion during the three-year lockdown. If they start spending these funds, expect the Chinese economy to rebound. However, caution needs to be heeded. A turnaround in the Chinese economy could result in higher oil and commodity prices. China consumes 10 to 15 percent of the globe's oil and energy. Also, the Chinese spending habits may be curtailed as a result of only 30 percent of the $2.7 trillion being held in liquid assets similar to our money markets. Seventy percent of the savings is held in longer term, maturing instruments like our certificates of deposit (CDs). Next, Chinese debt levels are very high, which may curb investment patterns that were occurring over the past 30 years. Longer-term, China's negative population growth rate will be a drag on economic performance.

Food and energy inflation is taking a toll on the economic performance of emerging nations around the world. Crop performance in major agriculture areas of the globe as a result of weather patterns and shipping flows will be very important to monitor for future commodity prices over the next decade.

Domestic Economy

The Leading Economic Index (LEI) is still suggesting a recession in 2023 is in the making. This index has been down three-tenths of one percent for three consecutive months, which is a sign of a pending recession. The diffusion of the LEI measures whether the factors comprising the LEI are trending positive or negative. In recent months, the diffusion has been ugly in the 20 to 25 percent range. However, the most recent reading of the LEI diffusion jumped to 60 percent, while the overall trend of the index is still negative.

Oil prices have been in the $80 per barrel range as a result of mild winter weather in Europe, China's slow economy, and the U.S. gearing up for oil production.

Copper prices have been increasing as a result of the sluggish supply and demand in China and the overall needs for the green energy movement.

The Purchasing Manager Index (PMI) is still under 50, indicating a contracting economy. However, it is above recession levels which would be a number in the low 40s.

Unemployment figures suggest a strong labor market in most sectors except for technology. The stimulus savings and the low workforce participation rate are driving this part of the economic metrics.

Housing starts are currently less than 1.5 million units annually, which is indicative of a slowdown in this important sector of the economy. If this number moves towards one million units, this could be another possible sign of a recession.

Factory utilization figures would suggest strength in this area of the economy; however, many companies are rebuilding inventories.

The Index of Consumer Sentiment is rebounding with a reading in the 60s, but is still illustrating a lack of consumer confidence. Consumer spending drives 70 percent of the U.S. economy. If this metric moves above 75, this would be a factor suggesting that the U.S. might have avoided a recession.

Inflation is stubborn. Recent figures show a 6.4 percent headline inflation rate and 5.6 percent core inflation rate, which excludes food and energy. The Federal Reserve has desired inflation rates of 4 and 2 percent for headline and core inflation, respectively. Examining the inflation rates over just the last six months of 2022 would suggest that we are nearing the 4 and 2 percent rates of inflation; however, the Federal Reserve will take the longer 12-month view. This is the reason that Federal Reserve strategies and actions often ripple in the economy 8 to 18 months later.

Expect interest rates to increase by one quarter of one percent in the next few meetings and eventually land in the 5.0 to 5.5 percent range. This means that the prime interest rate would be between 8.0 and 8.5 percent. Hopefully, interest rates will be below the critical level of 7 to 10 percent which would be a behavioral economic tipping point for businesses, households, and wealth creation.

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Lender and Business Dashboard Economic Indicators (for the month of January)

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	110.3			✓
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	47.4		✓	
Housing Starts (millions)	1.309		✓	
Factory Capacity Utilization	78.3%		✓	
Unemployment Rate	3.4%	✓		
Core Inflation	5.6%			✓
Headline Inflation	6.4%			✓
Oil Price ($/barrel)	$85.31		✓	
Yield Curve	-1.14			✓

Lender and Business Dashboard Economic Indicator Benchmarks

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	Increasing	Flat to Decline	Decline 0.3% for 3 consecutive months AND >1% over the period
LEI Diffusion[1]	>60%	40%-60%	<40%
Purchasing Manager Index - PMI	>50	41.7-50	<41.7
Housing Starts (millions)	>1.5	1.0-1.5	<1.0
Factory Capacity Utilization	>80%	70%-80%	<70%
Unemployment Rate	<6%	6%-8%	>8%
Core Inflation	0%-2%	2%-4%	>4% or <0%
Headline Inflation[2]	0%-4%	4%-5%	>5% or <0%
Oil Price[3] ($/barrel)	<$50	$50-$100	>$100
Yield Curve[4]	Steep	Flattening	Inverted

[1]Ten indicators make up the LEI - measures % that are increasing; [2]Includes food & energy;
[3]Consumer's perspective; [4]3-Month Treasury Bill rate to 10-Year Bond rate