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# UNDERSTANDING A BANK'S APPROACH TO FARM BUSINESS FACT SHEET

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## ARE YOU GETTING THE BEST DEAL FROM YOUR BANK?

Without access to finance, growing your business and even accessing adequate working capital can be very difficult. Reducing your finance costs by trying to pay as little as possible in interest and fees to your financier is good business practice.

### KEY POINTS

- Sound, well-managed businesses should pay lower interest rates than poorly managed ones.
- Your lending interest rate includes an additional 'customer margin' especially for you!
- Banks need your business and are prepared to fight for it.
- Customer margins and fees are negotiable, except for government fees.
- Knowing how they are calculated will assist you to reduce your finance costs.

PHOTO: P2PAgri

*Managing your bank relationship is a key strategy for business success.*

### Interest Rates

The language used to explain how banks calculate their interest rates can be complicated. In simple terms, banks obtain funds at wholesale rates and on-lend them to borrowers at retail rates. They quote a "base rate" which banks have a legal obligation to advertise weekly in major newspapers in order to keep their customers informed. This covers their costs of funds, operating costs and shareholder dividends. It will be affected by decisions made by the Reserve Bank of Australia (RBA) on the cash rate, the state of the economy and demand for money. Base rates are even differentiated on the basis of the loan – a fluctuating facility such as an overdraft tends to have a higher 'base rate' than a long term fully drawn loan.

### Customer Margin

The interest rate which applies to your business borrowing is calculated using the quoted 'base rate' with an added '**customer margin**'. The customer margin is a reflection of the level of risk the bank perceives in lending money to your business – i.e. the likelihood that the bank may lose money out of the deal. The higher the perceived risk, the higher the 'customer margin' charged.

When calculating your 'customer margin', banks consider the 'Five Cs':

1. **Cash flow:** Cash (also often referred to as 'capacity') is king and always will be! The business must be able to demonstrate capacity to generate adequate cash to meet all costs, including interest payments. Revenue calculations need to be determined using reasonable and achievable assumptions for yields, commodity prices and costs. Historical averages are a great place to start – any significant variation should be justified.

2. **Character:** Your management expertise, integrity and honesty. Previous and future conduct with the bank is important here. What kind of person are you to deal with? A poor credit history makes you a much higher risk. Proven ability to handle difficult times and capitalise on opportunities reduces perceived risk. Sound profit results and improving equity figures year-on-year are the best support you can offer.

3. **Capital:** The financial position of yourself and the business - your assets, liabilities, net worth, equity position and debt ratios. The higher your equity, the lower the risk.

4. **Conditions:** What is happening at a macro level to the industry in which you operate? Global markets for rural commodities are generally strong at present and demand for land is sound. How does the business manage external risk: interest rates, exchange rates, variation in climate and commodity prices? You cannot control them, but good management can reduce the downside risk.

   For example, consider the change in perceived risk by a bank who had loaned funds to a live beef exporter in 2011 when the federal government banned live exports to Indonesia.

5. **Collateral:** The quality and adequacy of the assets you provide as security for the loan. Quality is determined by saleability - are there potential purchasers and how likely are prices to fluctuate? Adequacy is simply the amount of security, and banks express this as Loan to Value Ratio (LVR). A loan of $600k against a farm worth $1m gives an LVR of 60% - the lower the LVR, the lower the risk. Banks will then equate this LVR to a **Security Category** (A-E).

   While your overall equity position is important, banks are more focused than ever on the value of the real estate assets they hold as collateral and this is what the LVR is calculated on. Assets such as livestock, grain and machinery tend to be less appealing forms of security, as they are more risky and therefore attract a higher interest rate when used as collateral.

**Figure 1 Customer Margin Calculator**

| Customer Rating | Customer Margin | | | | |
|---|---|---|---|---|---|
| 10 | 0.9 | 2.4 | 3.9 | 5.4 | 6.9 |
| 9 | 0.8 | 2.3 | 3.8 | 5.3 | 6.8 |
| 8 | 0.7 | 2.2 | 3.7 | 5.2 | 6.7 |
| 7 | 0.6 | 2.1 | 3.6 | 5.1 | 6.6 |
| 6 | 0.5 | 2.0 | 3.5 | 5.0 | 6.5 |
| 5 | 0.4 | 1.9 | 3.4 | 4.9 | 6.4 |
| 4 | 0.3 | 1.8 | 3.3 | 4.8 | 6.3 |
| 3 | 0.2 | 1.7 | 3.2 | 4.7 | 6.2 |
| 2 | 0.1 | 1.6 | 3.1 | 4.6 | 6.1 |
| 1 | 0.0 | 1.5 | 3.0 | 4.5 | 6.0 |
| | **A** | **B** | **C** | **D** | **E** |
| | **Security Category** | | | | |

*This chart is for example only. The numbers contained within it are fictitious, designed only to illustrate the concept of calculating 'customer margin.'*

**Source:** *Tony Hudson, Hudson Facilitation*

The first four 'C's – Character, Cash flow, Capital and Conditions - tend to be considered collectively, to arrive at a number or **Customer Rating** (1 to 10) of you as a borrower.

Collateral (expressed by banks as loan value ratio, or LVR) tends to be considered in isolation. If the business fails in all other areas, collateral is all the bank has to rely on to recoup your debts. Your LVR will be given a Security Category.

Figure 1 is an example of how a customer margin is calculated. It assumes the following Loan to Value Ratios apply to each security category:

Security Category A: LVR: < 30%
Security Category B: LVR: 30 - 50%
Security Category C: LVR: 50 - 70%
Security Category D: LVR: > 70%
Security Category E: No security offered

It illustrates a borrower with very good security, denoted as Category A, and a very good Customer Rating, say Rating 1, receives no additional interest rate margin beyond the quoted Base Rate. However, a borrower with less security, say Category C and with little proven experience in their industry, may have a Customer Rating of 6 and an additional margin beyond the Base Rate of 3.5%. This can amount to substantially greater interest costs to your business if you have a significant level of debt!

## Case Study:

A farmer who has existing debt of $700k and a farm worth $2m that is held by the bank as collateral, would have an LVR of 35% - a 'Category B' security level. If the other 'C' factors taken into account arrived at a Customer Rating of 4, the 'customer margin' applied would be 1.8%. So if the Base Rate was quoted at 9%, for example, the total lending rate for the farmer would be 10.8%.

Now consider the situation where the same farmer has additional real estate assets, such as other farm land or off-farm assets worth $400k, which do not form part of the security for the farm debt. By offering this to the bank, the security category then becomes Category A and with all other factors being equal, the customer margin becomes 0.3%, making a total rate of 9.3%. This would result in a saving of 1.5%, or $10,500 per year on the $700k loan.

### What does this mean for my business?

Now you know how interest rates and particularly customer margins are calculated, there are a number of things you can do to reduce them:

- Be open and honest with your bank – surprise lending needs count against your character.
- If you have additional collateral, use it as a negotiating tool.
- Ask what your customer rating is and how you can improve it.
- Negotiate hard, but recognise the value of relationships with lenders. If banks don't lend money, they don't make profit.
- Make it known you will shop around for the best deal - it's a competitive market. However, also consider the costs involved in moving facilities between banks.
- Target a fee reduction as well as lower interest rates – many fees can be negotiable for the right borrower.
- Be familiar with your cash flow projections. Don't provide information to the bank on the basis it was prepared by your consultant. It is your business; you have to deliver on the numbers.
- Understand clearly your historical financials. Your accountant may have prepared them, but you need to know your own business.
- Be aware of your trading environment – what is happening at a trade and policy level?
- Mitigate external risks where possible.
- Know your cost of production and price projections.
- Have a medium term plan for your business (3-5 years), understand what to show in terms of costs and returns, and present it to the bank.
- If needed, employ expert support - use your consultant, agronomist or accountant to help sell your plan if you need it. Take them to the bank with you.
- Always remember, banks need customers and it's easier for them to keep a customer than to replace one. This is your negotiating strength!

## FAQs

### Is there a difference between banks when it comes to managing the tough times?

Observers of the way different banks manage financially troubled clients state there are differences. These can change over seasons depending on each bank's view of the future of agriculture, their current exposure or debt to any given sector and region, and empathy of the staff in the region. It is difficult to say which banks are the hardest on farmers who find repayments difficult. The best strategy that a farmer can use is to communicate with the bank through both good and bad times. This will help the bank to understand that the farmer is doing their best to manage the risks to both the farm and the bank.

### How significant is the interest rate to a farmer's cost of production?

This is a good question, as a great deal is made in the media of what interest rates banks charge and, as a general observation, most farmers do not freely share this information between themselves. Essentially, the less equity a farmer has in the business, the greater the impact of interest rates on cost of production. However, modelling of farm businesses indicates that yield per ha has the greatest effect on the cost of production, followed by cash costs. Of less impact is interest rate expense.

Prior to banking deregulation in the late 1980s, the bank manager was seen to be the trusted farm business adviser and the relationship with the banker was important. At that time, there were monthly limits on how much credit could be lent and you wanted to be the farmer that the manager had great confidence in. However, since banking deregulation, competition between banks has intensified, farmers tend to switch between banks more, and some state a long-term banker relationship has become less important. It is also important to understand that the front-line banker you know and developed a relationship with may not be the bank officer making the final lending decision on your loan request. So, the long-term relationship with a banker has become less important, but it is still in your best interests to maintain clear and honest communication with your banker, as they represent your best interests to their higher banking management.

### How often should I communicate with my banker?

There are no hard and fast rules here in communicating with your bank. However, banks do not like to be kept in the dark about your business, especially when things get tight. Remain proactive with your bank and demonstrate you are in control of your business by keeping them updated with your business developments and strategies.


*Understanding how banks calculate your 'customer margin' may save your business significant money.*

PHOTO: P2PAgri

Ask your banker how often they would like to hear from you and then follow through by contacting them more than what they suggest! Use the following guidelines to help you form a communication strategy:

- If all is going well, then twice a year is recommended: Once at planning time prior to the season starting and then 6 months later once the season is in full swing.
- If a poor season seems to be in the making, then talk to the banker 2 months before harvest as their life will probably become busier after that as more clients report they are experiencing difficulties.
- If financial difficulties are occurring, then monthly up-dates of how the farm business is going would help your banker to understand your circumstances.
- It is really important to remember that banking is about taking risks: the better you are able to communicate with the bank and demonstrate you are in control of your financial affairs, the lower the perceived risk of lending to your business and consequently, the lower interest you will pay.

## Should I use a professional adviser to put my figures together, so the bank has a greater understanding of my business?

A banker's requirements for business performance data can be different to a farm manager's. It can be a challenge to determine what data requirements a bank views as adequate for their needs. Two main strategies that may help the farm manager in this area are to:

- Hire a professional adviser who understands banking requirements to put together reports needed for improved communication with the bank, or
- Attend training activities to improve management skills in financial monitoring, planning and reporting.

Both strategies are legitimate and depend on the personal preference of the farm manager. However, the bank is very interested in the management capacity of the farm manager. If a professional adviser develops the reports, these need to be fully understood by the farm manager and actively used to guide the business.

It does not matter how professional the reports appear; if the farm manager has no understanding and ownership of the information, the bank will not value the reports and their confidence in the manager's ability will not be improved. As a general rule, the higher the confidence the bank has in the farm manager, the lower their lending margin and interest rate will be.

## How easy is it to shift banks?

While the competition between banks has increased since deregulation of the banking sector, care needs to be taken when considering shifting between banks as there can be considerable expense in the form of government and bank charges. While bank charges can be negotiated, government charges are fixed. In talking to the bank you are proposing to change to, ask them what costs you will incur in shifting. Depending on how keen the new bank is to have your business, they may offer to absorb some or all of the cost of shifting, but it is wise to know this up-front.

You should note that banks find it cheaper and easier to retain customers than to gain new customers to replace the customers they lose. So you have some negotiation power to ask your current bank if they can offer you a better deal. Before you follow through and leave a bank, it is a good strategy to test your current bank and see if you have their best offer. If they can match or better other bank offers, it may be cheaper and easier to stay with your current bank.

Some farming businesses put their finance business up for tender every 3 to 4 years as standard management practice. In this way, the banking relationship can be regularly checked to see if the business still has the best financial deal. When comparing tenders, be careful to compare the interest rate and all fees, so that an accurate comparison can be made.

## USEFUL RESOURCES

**Related GRDC Fact Sheets**

Other related fact sheets in this Farm Business Management series are: Cost of Production (Order Code: GRDC912), Benchmarking (Order Code: GRDC***) and Key Financial Ratios (Order Code: GRDC911).

Copies of all the above fact sheets are FREE plus P&H and available from:

Ground Cover Direct Freephone: 1800 11 00 44 or email: ground-cover-direct@canprint.com.au

These can also be downloaded from www.grdc.com.au/fbm

**Plan to Profit (P2P)**, a whole-farm financial management program with a financial ratio calculator for all commodities: www.P2PAgri.com.au

**Financing Your Farm**– A practical guide to financial growth. 4th Edition.

Published by the Australian Bankers Association, written by Alan Blackburn and Rod Ashby.

This book takes a practical approach to managing farm finances.

## MORE INFORMATION

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