Why Credit Lines Get in Trouble

There are many reasons why credit lines get in trouble. The following material can be used as a diagnostic tool to identify the cause of the credit line problem. Solutions can be developed once causes have been identified.

Unrealistic prices and yields
Unrealistic assumptions may lead to errors in analyzing the repayment capacity of a loan. Typical errors pertain to estimates of selling prices and crop yields. However, poor assumptions about efficiency factors such as pigs per litter or rate of gain are also common.

The borrower may intentionally use unrealistic assumptions in order to receive or keep a line of credit. However, the use of unrealistic assumptions can also be unintentional. The borrower may not have sufficient business records to realistically describe the business.

Lack of communication
Successful loan repayment is often based on open discussion between lender and borrower. Lack of communications and trust by either party often results in a breakdown of the business relationship.

Lack of partial budgeting
Partial budgeting involves projecting the added costs and added returns from a capital investment. Unless partial budgeting or a similar procedure is used to verify the additional income generated from an investment, the repayment capacity of the investment may fall short. Just because an investment decision involves new technology or is common among other farmers does not mean that it is profitable or financially feasible.

Uncontrolled living expenditures
Many farmers are negligent about monitoring and controlling family living expenditures. Monitoring expenditures involves keeping records of the money spent for family living. Keeping the business and family financial transactions in separate checking accounts will often be helpful.

Successful control of family living expenditures often involves developing and monitoring budgets of expected family living needs.

Lack of business direction
The operator’s planning horizon for many farmers is often one production period. So, the business lacks...
any long-term goals or direction. The operator often is heard saying, *I guess the lender will let me farm one more year.* This lack of long-range business planning is often accompanied by a lack of progress on long-term debt repayment.

**Failure to structure repayment**

If possible, the repayment terms of the loan should be tied directly to the additional income generated from the investment. Unless the loan repayment is structured and the investment income designated for loan repayment, the income will be spent elsewhere and the debt carried over from year to year.

**Repaying debt too rapidly**

Reducing debt as quickly as possible is often a good objective. However, trying to repay debt too rapidly may unnecessarily cause a shortage of cash for operations. The length of debt repayment should be tied to a conservative estimate of the life of the assets the borrowed funds were used to purchase.

**Purchasing capital assets with cash**

Using cash reserves to purchase capital assets may result in cash shortages in the future. Sufficient cash should be maintained to cover intermediate and long-term debt payments, income taxes, family living expenditures, and other items.

**Buying non-productive assets**

Using borrowed funds to purchase non-productive assets requires the repayment to come from other sources. The alternative repayment sources should be carefully identified in advance.

**Carry over debt**

Short-term loans that cannot be repaid are often carried over from one production period to the next. Unless properly monitored, carry over debt may grow until it jeopardizes the health of the business. Carry over debt is often too large to be repaid during one production period. It may need to be paid over a period of years. Progress should be made each year in retiring carry over debt.

**Poor risk management**

A cash buffer should exist between the projected repayment ability of the business and the business debt repayment schedule. For example, if the debt repayment schedule is based on the repayment ability in an average year, a shortfall will occur in low income years. This shortfall is often covered by borrowing additional money. Due to this additional debt, the total debt load cannot now be serviced in average years.

**Poor use of profit windfalls**

A good crop or the sale of crops or livestock at high price levels often provides additional income. However, the additional money is often consumed or used to purchase non-productive assets rather than repaying debts. As a result, when below average prices or yields occur in the future, there is no reserve for debt payments.

**Using multiple credit sources**

Farmers often obtain credit from a variety of sources. Usually the larger the number of credit sources the more difficult it becomes to monitor overall debt repayment. Consolidating credit and reducing the number of sources may improve the ability to successfully project and monitor debt repayment.

**Ignoring tax consequences**

Although interest payments are tax deductible, principal payments are not. So debts are repaid with after-tax income. This calculation needs to be included in the debt repayment analysis.

Assets sold to repay debt may also have significant tax consequences. The sale of low basis property may trigger a large tax liability which may significantly reduce the amount of funds available for debt repayment.