



## Interest Rate Risk – Know Your Exposure

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Easing U.S. monetary policy has resulted in low interest rates for borrowers and savers. The Federal Reserve has kept interest rates near zero for two and a half years and purchased more than \$2 trillion in long-term securities. The Federal Reserve's second round of easing, commonly referred to as QE2, is scheduled to end in June 2011. Federal Reserve chairman Ben Bernanke has indicated the Federal Reserve is in no hurry to increase interest rates after the most recent central bank policy meeting. Most market investors assume the Federal Reserve will maintain the low federal fund rate policy to the end of 2011 with potential interest rate increases in 2012. The timing and magnitude of increases will depend on improvements in domestic and international economic growth as well as inflationary expectations.

The sharp rise in food, energy and commodity prices in the first four months of 2011 raised market anxiety about inflationary expectations. However, Fed officials said they expected the increase to be transitory. The recent decline in commodity prices has provided some support for this view.

So what does this mean for farmers? Low interest rates have provided financial relief for borrowers. A potential risk for farm and nonfarm borrowers is that they became more indebted than they otherwise would have under normal interest rate environments. A general rule of thumb is that interest costs on farms should not exceed 20-25 percent of gross farm income.

The Kansas City Federal Reserve reports that the average interest rate on non-real estate agricultural loans is 4.86% at the end of the first quarter of 2011. Thus, with only a modest increase of 50 basis points, interest rates would result in a 10% higher interest expense if passed on to the borrower. Approximately, 75% of agricultural loans at banks are variable or floating rate loans that will change as market interest rates change. The Wall Street Journal prime rate is 3.25%, the lowest since the mid 1950s. Given the historical low levels of interest rates, increases in rates are inevitable, although the timing and magnitude of the increase remains uncertain. Farmers should assess the impact of potential increases in interest rates on their future profit margins and loan repayment ability.

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Have you evaluated your exposure to increases in rates? A recommended first step is to communicate with your lender and understand how changes in market rates affect your interest cost. Variable and floating rate products will usually have a spread from a base rate. There may also be discrete points in time when interest rates can change. Some loan contracts may change when the base rate changes while others may only change monthly, quarterly or annually.

An increase in interest rates will also be a huge headwind for farmland prices. A recent University of Illinois study by Schnitkey and Sherrick propose scenarios that suggest capitalized farmland value declines could exceed 20% if interest rates increased 100 basis points (1 percentage point).

Interest expense can be simply viewed as renting money. Similar to renting farmland, you should only take on more debt and interest cost when your expected returns exceed your expected costs.