Managing Interest Rate Risk

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Having access to capital and lines of credit is crucial to operating a successful farm business. Managing the cost of capital, or interest rates your business pays, can have a large impact on your farm financial wellbeing. Interest rates have risen over the past six months but are still attractive relative to historical levels that were seen in the early 1980's. With elevated input costs and increasing interest rates monitoring your exposure to interest rate risk will be wise.

On August 10th, the US Bureau of Labor Statistics reported that inflation for the previous twelve months was 8.5%. One of the tools the Federal Reserve has at their disposal to attempt to reduce inflation is raising the federal funds rate. This rate is the rate at which banks lend to each other and sets a baseline for business loans that they finance. The Federal Reserve often raises rates to increase the cost of borrowing in an attempt to reduce demand for loans and curb inflation.

Over the first six months of 2022 operating loans for farms with good credit rose from 4.00% to over 6.00%. A two-percentage jump in interest rates for an average farm with a $500,000 operating note increases interest operating expense by $10,000. As of early September, the CME FedWatch Tool is forecasting a 76.0% probability of a three-quarter percent rate hike for September 21st and 70% chances of two additional one-half percent rate hikes through December 14th. These additional rate hikes would equate to another $8,750 in interest expense.

There are many strategies to consider when managing interest rate risk that are discussed in the following paragraphs. Business loans with variable or adjustable rates were often financed that made sense with a low interest rate environment. With higher interest rates being forecast, these types of loans may no longer pencil out. If possible, consider working with your lender to convert adjustable or variable rate loans to fixed rates and avoid the cost of higher interest.

Using a marketing line of credit to margin futures positions offers great benefits and flexibility for marketing grain. With these credit lines having adjustable interest rates it may be worth considering moving a larger percentage of your hedging positions to a commercial elevator and utilizing their money for margin. Interest expense on a fast market moving against you can add up quickly.

Having excess working capital is a great position to be in. Many farms were fortunate to secure very low and attractive rates when they were available. Business operators may be tempted to use excess working capital to make early payments on term loans. There is nothing wrong with making early debt payments. However, be aware of how "cheap" that capital loan is relative to what we may face in the future. For example, a farmer may have two years left of payments on a piece of equipment financed at 3.00% or less. Instead of paying that equipment loan off early it may be better use of your capital to put towards your operating note at 6.00%.

It is also recommended to be considered in a strong financial position to maintain more than 30% of your total farm expenses as working capital. Having a strong position in working capital allows you to take advantage of opportunities that may arise, negotiate deals with cash payments, and provide a buffer if your farm faces a shortfall or emergency.

Predicting the future is difficult and often considered a fool's errand. However, managing your farms interest expense and knowing where your risk lies will help you make sound farm management decisions and increase profits.

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