The Basics of Collateral

Collateral is something a borrower owns and is willing to pledge to the lender as a way of guaranteeing the repayment of a loan.

Examples of collateral include real property, such as real estate; or personal property, which includes equipment, crops, and livestock. The value of collateral needs to be greater than the value of the loan; their difference in value is called the **collateral margin**. Lenders require collateral margin to protect them. Should the loan not be repaid, the collateral margin ensures enough money to collect the collateral and sell it for repayment of the loan.

Below are descriptions and examples of the way Premier Farm Credit approaches collateral as a part of a loan package. There are numerous items that go into compiling a loan; collateral is just one part of the credit process. Premier Farm Credit has three collateral standards based on the type of loan.

Real Estate Loans

A real estate loan is used to purchase or refinance real estate, or complete capital improvements to real estate already owned. The duration of these loans typically ranges from five to thirty years. The value of property being purchased has to be appraised by a certified real estate appraiser. This person will determine the value of the property. After the appraised value is established, Premier Farm Credit will loan a maximum of 65% of the appraised value. The remaining 35% of the loan, which is known as the margin, can be achieved through additional real estate collateral, applying a cash down payment or a combination of these two techniques.

Example:
Sue Farmer purchases 160 acres of dryland for $352,000 and wants to obtain a loan from Premier.
Premier orders the appraisal and it comes back at $336,000.
Premier can loan 65% of appraised value. $336,000 x 65%=$218,400.
The difference between the purchase price and loan amount is $133,600, this has to come from the borrower as a cash down payment or additional real estate for collateral.

The Basics of Collateral, continued

Operating Loans

An operating loan is usually a one-year duration and it is used to secure a 1st lien position on chattel property. Like the appraisal for real estate, a chattel inspection is needed to achieve an operating loan. A chattel appraiser will verify ownership, quantity, quality, condition, and marketability of the collateral that is pledged for the loan. In an operating loan the margin is typically 30%.

Example:
Joe Farmer needs to borrower $200,000 in operating funds for farm expenses throughout the year.
$200,000 x 30%=$60,000
Premier will need to secure $260,000 in collateral to fulfill the 30% margin requirement.

Intermediate Term Loans

A term loan is used to finance purchases of capital goods. This includes equipment, livestock, agricultural related buildings and irrigation equipment. These loans typically mature at three to seven years. The length of the loan depends on the item being financed. For example, a used tractor would only be financed for up to five years while a new tractor could be financed for up to seven years. This is due to the life of the equipment. A term loan requires 25% margin which can be paid as a cash payment or a trade-in on old equipment.

Example:
Joe Farmer purchases a new combine. The invoice price is $300,000.
Premier can loan 75% of the invoice price. $300,000 x 75%= $225,000.
The difference between the purchase price and loan amount is $75,000. This has to come from the borrower as a cash down payment or additional equipment for collateral.
In this situation, if the borrower has traded in their old combine for $75,000 or greater, then Premier could use this as the margin in the new loan.