

R I G H T R I S K N E W S

Hidden Costs of Carryover Operating Debt and Interest Rate Risk for Farm Operators

How Much Risk is Right for You?

Managing farm finances often involves borrowing to cover operating expenses such as seed, fertilizer, fuel, and labor. While short-term operating loans are common in agriculture, carrying over unpaid operating debt from one season to the next can create significant financial strain. Coupled with volatile interest rates, carryover debt can erode working capital, tighten cash flow, and weaken long-term viability.



Crop producers are facing thinner margins from lower crop prices and high input prices. Highly leveraged farms (debt-to-asset ratios of greater than 60%) are especially vulnerable because interest consumes a larger share of revenue. When cash flow tightens, rolling unpaid operating debt into the next season may feel necessary, but doing so increases costs and risks. It can quietly erode working capital, raise fixed costs, and increase long term default risk.

Cost of carryover debt

Interest rates have been volatile in recent years, influenced by inflation, global markets, and Federal Reserve policy. For farmers, this volatility matters because (1) variable-rate loans adjust as rates change, increasing interest costs unexpectedly; (2) new operating loans may have higher rates than previous years, raising annual financing costs; and (3) debt restructuring becomes more expensive when rates climb.

A farmer with a \$500,000 operating loan at 6% interest pays \$30,000 annually. If rates rise to 8%, the cost jumps to \$40,000 – a \$10,000 increase without any change in principal. Similarly, a \$250,000 operating loan at 8% costs about \$20,000 in interest if paid off within one year. If \$100,000 of that balance carries over, it adds another \$8,000 in interest the following year – excluding additional fees.

Carrying operating debt into the next year has another cost: it ties up money that could be used for near-term income enhancement. It can limit what management strategies a producer can realistically follow in the next production cycle. It can also reduce or even eliminate opportunities to expand or run more efficiently.

Carrying debt forward can affect two key financial measures: Working Capital and the Debt Coverage Ratio. Practically, it can limit how a producer runs the operation, since limited cash makes it harder to do what is needed to get the best results.



Over time, these added costs strain liquidity and can slowly erode equity. Producers who repeatedly roll over debt risk becoming locked into a cycle where interest payments limit reinvestment, restrict family living withdrawals, and reduce resilience to market or weather shocks. Additionally, added debt may limit the business's ability to recover when conditions improve.

Drawbacks of terming out operating debt

While restructuring can create short-term relief, it commits the farm to years of fixed payments and raises total financing costs. The financial squeeze intensifies as higher balances accumulate more interest, cash flow tightens, and creditworthiness suffers.

Short-term relief creates long-term fixed costs. Turning a carryover balance into a five- to eight-year term note improves immediate cash flow but locks in annual payments for years to come. This reduces flexibility in future years, particularly if margins tighten or unexpected costs arise.

Consider the case of carrying a \$200,000 balance at 8.5% for 12 months. It adds roughly \$17,000 in interest. Converting that balance into a seven-year note at 8% reduces this year's cash requirement but results in annual payments around \$34,000 and more than \$60,000 in total interest.

Consequences of carryover debt

The consequences of converting carryover operating debt to term debt include:

- Margin risk shifts into future crop years. When interest consumes a larger share of revenue, especially on highly leveraged farms, adding term-debt payments increases the likelihood of future carryover if yields, prices, or margins disappoint.
- Repayment capacity metrics weaken. Lenders closely evaluate Capital Debt Repayment Margin and Replacement Margin. Terming out operating debt increases the scheduled annual principal and interest payments, making both metrics harder to keep positive if profits don't rebound.
- Risk shifts from price and yield volatility to interest-rate and duration risk. A term note extends the duration of debt. With a variable rate, future increases raise payments; with a fixed rate, the borrower may be locking in high costs. Interest rates that surged after 2021 and only began easing in 2025 highlight the importance of choosing terms aligned with farm cash-flow capacity.
- Terming out debt may mask deeper structural issues. Restructuring alone does not solve underlying profitability challenges. Operators risk layering debt when adding a term note while still needing a full operating line for the next season, without addressing underlying crop mix, cost controls, marketing discipline, or machinery investment levels.
- Lender perception may shift. Banks are encouraged to work with financially stressed borrowers but they must document and structure carry over debt carefully. Repeated long amortizations without demonstrated repayment capacity may shift an operation into a watch or classified credit category, limiting future borrowing options.
- Principal payments are not tax deductible. Producers should be aware that converting operating expenses into term debt fundamentally changes the tax treatment of those obligations. While operating expenses are typically fully deductible in the year they are incurred, principal payments on term loans are not tax deductible. Consequently, the farm must generate enough after-tax profit to cover the principal portion of these annual payments. This creates a 'tax trap' where the operation requires higher gross revenue than anticipated to service the debt; cash used for principal payments is still subject to income and self-employment taxes.
- Financial pressure increases Human Risk. Carryover debt introduces significant 'Human Risk' by increasing stress levels, which are often cited as a primary cause of conflict in farm families, particularly regarding disagreements over spending and risk-taking. This persistent stress can lead to 'decision fatigue' or defensive decision-making, where managers procrastinate or avoid making choices entirely out of fear of making a mistake. High stress and uncertainty can override conscious thought, causing decision-makers to focus on short-term emotional relief rather than the long-term health of the business.



Strategies to manage debt and interest rate risk

Farmers can take proactive steps to reduce exposure.

- Monitor cash flow closely – Regularly update budgets and projections to identify potential shortfalls early.
- Pair restructuring with operational changes – Operating changes include eliminating unprofitable acres, tightening input bids, and improving marketing discipline. Many lenders saw producers protect break evens and reduce risks in 2025 by improving grain marketing and insurance protection.
- Communicate with lenders – Discuss options for restructuring debt before problems escalate. Some lenders offer fixed-rate conversions or seasonal payment plans.
- Lock in rates when possible – Fixed-rate loans provide stability, especially during periods of rising interest rates.
- Build working capital – Retain profits during good years to create a buffer against future borrowing needs.
- Evaluate marketing and risk management tools – Hedging or crop insurance can protect revenue, reducing the likelihood of carryover debt.

The bottom line

Carrying over operating debt may solve a short-term cash crunch, but it can create one or more new risks, especially when interest rates are high or uncertain. Each roll over increases interest costs, reduces flexibility, and can undermine repayment capacity over time. By understanding these risks and adopting proactive financial and risk-management strategies, farmers and ranchers can better protect their operations and more successfully navigate agricultural uncertainty.

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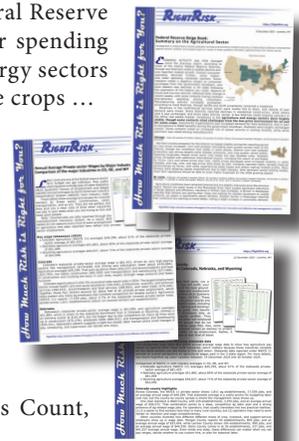
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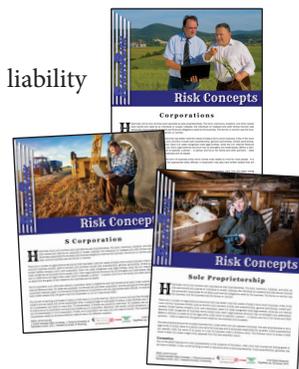
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