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Some Measures of the Quality of Credit in Agriculture

Farmers in the United States owed a large debt at the end of 1963—$33 billion to be exact. This was a record amount that topped the previous peak in 1922 by $18 billion and stood $25 billion above the low point in 1946. Farmers had pushed their debt to this height by borrowing substantial amounts during the post-World War II period, especially in the 1950's. Moreover, for the past three years, they have evinced a willingness to take on even more debt.

Judging from the low farm mortgage foreclosure rate in the nation, repayments of farm debts have generally kept pace with the borrowing expansion. Nevertheless, the record size of the debt, its rapid growth in recent years, and recollections of extensive farm foreclosures and other farm financial strains in the late 1920's and 1930's have led some persons to question farmers' ability to pay their debts in the future. In effect, these persons are asking, "What is the present quality of credit used in agriculture?"

What Is "Quality"?

"Quality" in farm loans or farm credit frequently means different things to different persons. As a general proposition, however, most persons would probably agree that the critical element in loan quality is risk. The relationship is inverse: As the risk on a given loan increases, its quality decreases. When a loan is made, a high degree of risk may be inherent if its terms do not fit the borrower's earning capacity, net worth, or the structure of his business. Risks may also be inherent in the borrower himself if he is profligate, in ill health, or financially strained by family troubles. Moreover, the risks from unknown future events, such as changes in technology, transportation, and world trade patterns, can, and often do, have considerable influence on the quality of loans repayable at a future time. Because weather is highly unpredictable, it can have an especially potent influence on the ultimate quality of farm loans, while future trends in farm income must also be counted as an important determinant of credit quality.

To assess credit quality, both the lender and analyst must weigh the risks inherent in a loan. They must consider not only the types of risks that may be incurred, but how formidable they are and how persistent they seem to be. The inquirer may appropriately ask several questions: Have farm debts risen excessively in relation to farm assets and income? How sound are farm borrowers' repayment potentials? Were the farm loans made on suitable terms? Were they made for legitimate reasons? Were farm assets satisfactorily appraised? Answers to these questions, as well as a final estimate of the quality of credit, depend heavily on subjective judgment bolstered by past experience, but there are certain measures that the inquirer may consult in forming his judgment.

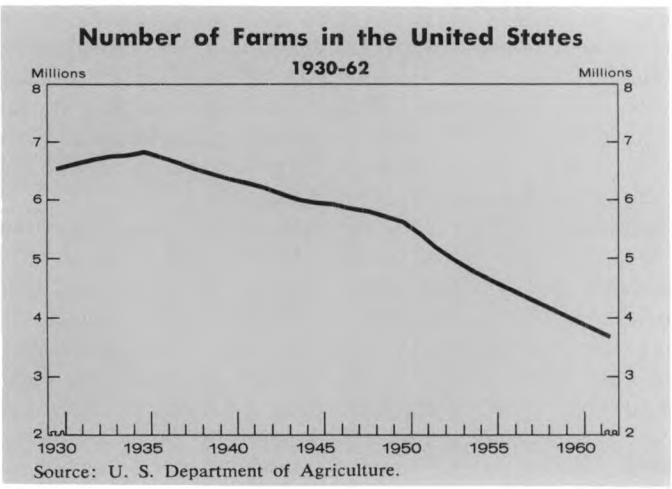
Growth in Farm Assets, Income, and Debt

A substantial rise in farmers' assets and equities accompanied the growth in farm debt in the 1950's and early 1960's. Farm assets on

January 1, 1963, were valued at about $216 billion in the aggregate, two-thirds more than in 1950, according to the United States Department of Agriculture. However, liabilities against assets more than doubled from the $12-billion total in early 1950 to about $30 billion on January 1, 1963. Farmers' total equity rose 56 percent in the period to $186 billion. At the beginning of 1963, the farm economy's debt-equity ratio was 16, higher than the post-World War II low of 9 in 1946 but below the ratio of 23 in 1940. These ratios were much lower than similar ratios for nonfarm industries. In 1962, for instance, the debt-equity ratio for chemical manufacturers was about 64; it was 48 for drug manufacturers and 46 for lumber manufacturers. Even though farm debt remained relatively small when cast against farm assets, it had risen more rapidly since 1950 than had asset valuations.

As farmers' economic status improved, farm incomes also expanded substantially. In the nation, gross farm income excluding Government payments rose from about $32 billion in 1950 to about $41 billion in 1963, a 28-percent gain. Gross farm income in the District states —Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee—rose from about $3 billion in 1950 to $4 billion in 1962. Government payments to farmers in the nation, including those for price support programs designed to stabilize farm incomes, totaled about $1.7 billion in 1963, well above the $283-million total in 1950. Farmers' off-farm income in the nation also rose 17 percent during this period. This rise in farmers' gross incomes occurred despite a 6-percent decline nationally in prices for farm products from 1950 to 1963. However, total net farm income—the return to the farmer and his family from their labor, management, and capital investment—dropped from about $13.2 billion in 1950 to $12.8 billion in 1963 principally because farming costs increased.

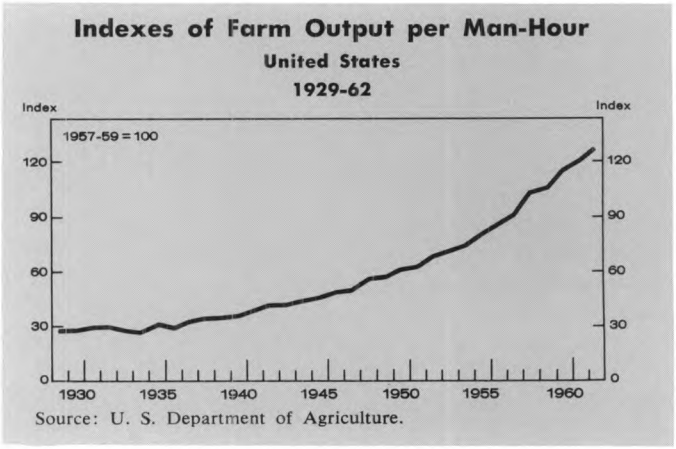
The aggregate data reveal some sharp adjustments in the overall farm financial structure, but they partially obscure the widespread structural changes on individual farms. Because the number of farms declined more than



a third during the 1950-63 period, the average farmer operated a much larger unit and, consequently, received a higher farm income. Total assets per farm climbed from about $17,000 in 1950 to about $51,000 in 1963; average gross income per farm increased from about $5,700 to about $11,500; and net income per farm rose from about $2,300 to about $3,400. The average farmer, however, also borrowed more money. In 1963, he obtained farm real estate loans averaging $14,000, compared with $4,700 in 1950.

Structural changes in farm businesses during the 1950-63 period have also heightened farmers' debt repayment ability. The rapid decline in the number of farms and the growth in their size imply that more of the farm debt now outstanding is owed by operators of larger, more productive farms than in previous years.

Another development that has strengthened farmers' debt repayment ability since 1950 is the gain in farm productivity and, hence, in profit potential. Nationally, output per man-hour on farms in 1962 was double the level in



1950, and total farm output was 24 percent larger, according to the USDA. In the major regions of the Southeast and the Delta, delineated by the USDA in its farm output statistics, output per man-hour grew 146 percent and 177 percent, respectively, during the 1950-62 period, while total output expanded about one-third.

Adjustments in Credit Procedures

Growth in farm assets, incomes, and productivity during the period of rapidly rising farm debt since 1950 has been accompanied by changes in farm lending procedures and in the administration of farm credit. Loan amortization, a plan devised several decades ago to assist farmers in systematically liquidating their mortgage debts, is more widely used by long-term lenders today. Among other things, loan amortization, which allows a farmer to spread long-term farm debt repayment over a 10- to 30-year period, reduces the risk from unexpected adversities in farming in a given year. Then, too, it is an explicit recognition that farming is a long-term business with a slow capital turnover. Federal land bank farm mortgage loans, which totaled 20 percent of the farm mortgage debt outstanding on January 1, 1963, are usually amortized loans with maturities extending to forty years for certain enterprises. Life insurance companies, which hold about 22 percent of the farm mortgage debt outstanding, also provide amortized long-term farm loans. The proportion of farm real estate loans written with long maturities has risen in recent years, reflecting in part more widespread use of the amortization principle.

Meanwhile, procedures in lending for farm operating purposes have evolved to such an extent that advancing funds to farmers solely on short-term notes has assumed a more subordinate role. Lenders now make more intermediate-term loans for working capital purposes. Typically, they relate a farmer's debt repayment schedule closely to his farming needs for supplies, machinery and other working capital, and to his cash receipts. This technique entails a detailed analysis of farm operating budgets, but it facilitates a more systematic repayment of loans. Production credit associations have utilized this budgeting procedure extensively in past years and, in 1961, they were authorized by Federal legislation to make term loans with maturities extending to seven years.

Commercial banks also have adopted lending procedures for term loans that afford farmers flexibility in financing their businesses and promote successful loan repayment. According to the Federal Reserve System's agricultural loan survey on June 30, 1956, about 14 percent of farmers' non-real estate bank loans had maturities exceeding one year, compared with 6 percent in 1947.

Few Loan Delinquencies and Foreclosures

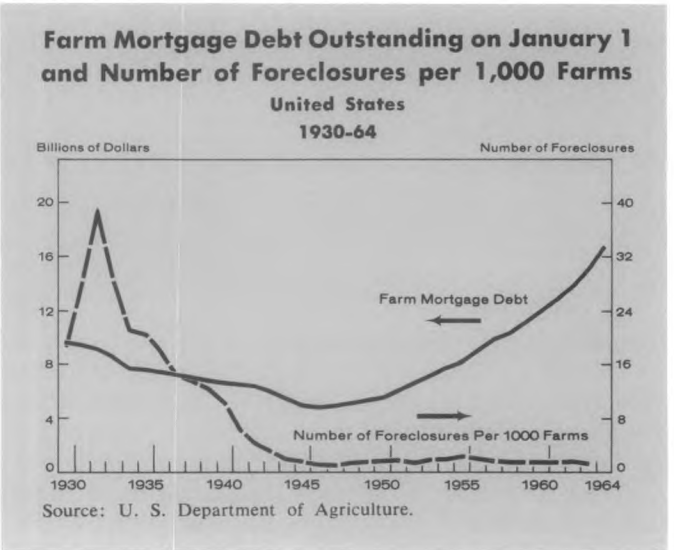
Although farm financial developments since World War II have been characterized by an expansion in farm debt, farm creditors report favorable trends in the traditional indicators of farmers' financial health. Typically, the current record of borrowers is measured from two vantage points—loan delinquencies and loan repayments. The longer-term record of debt repayment is measured by repossessions and foreclosures.

According to data from twenty life insurance companies published quarterly by the USDA, 591 farm mortgage accounts had interest payments that were three months overdue in the quarter ending on June 30, 1963. This was about the same number as a year earlier and amounted to only a small fraction of the 192,000 loans in their portfolios. Delinquencies did not rise in the fourth quarter last year, although some loans in Florida had been jeopardized by freezing temperatures earlier in the year. At Federal land banks, the number of loan delinquencies and extensions, which has been small in recent years, declined somewhat from the year-earlier level in the last half of 1963. The Farmers Home Administration also reported few current delinquencies in its portfolio.

Farm mortgage loan repayments in 1963 were being maintained, although there were more long-term farm loans outstanding than in earlier years. Farmers' repayments to insurance companies flowed in at a rate of 2.1 percent of the loans outstanding during the second quarter of 1963. This repayment rate was slightly higher than the 2.0-percent rate a year earlier and in mid-1961.

Comprehensive statistics from short- and medium-term creditors covering loan renewals, repossessions of equipment, sales of chattels, the write-off of bad debts, and the like are not available. Financial magazines, trade creditors, and official Government statements on farm finance, however, report a minimum of such credit distress signals. A stepup in loan renewals was reported for late 1963 in the Midwest primarily because cattle marketings were delayed, while adverse weather conditions in Florida were responsible for an upsurge in that area.

An exceptionally low farm foreclosure rate has persisted from 1947 through 1963. In the nation, the number of foreclosures per 1,000 farms, after reaching a peak of about 39 in 1932, declined to one in 1947 and has hovered about that rate ever since. The latest available data on foreclosures for twenty life insurance companies holding about 192,000 farm loans indicate a continued low level of farm foreclosures during the quarter ending

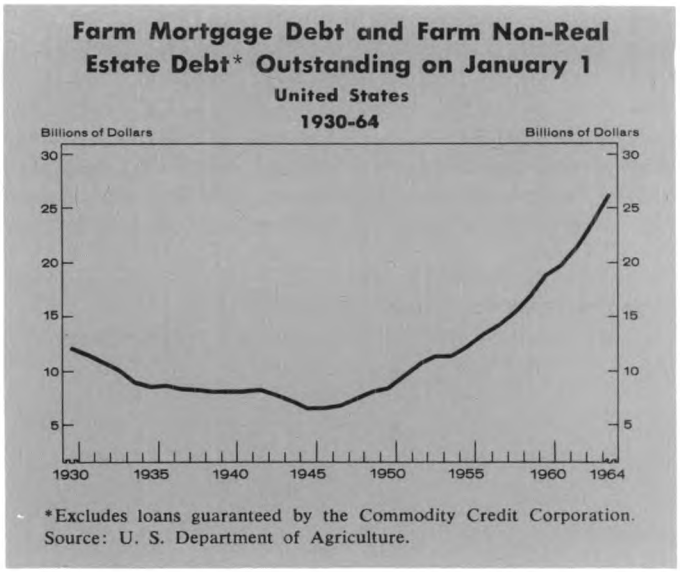


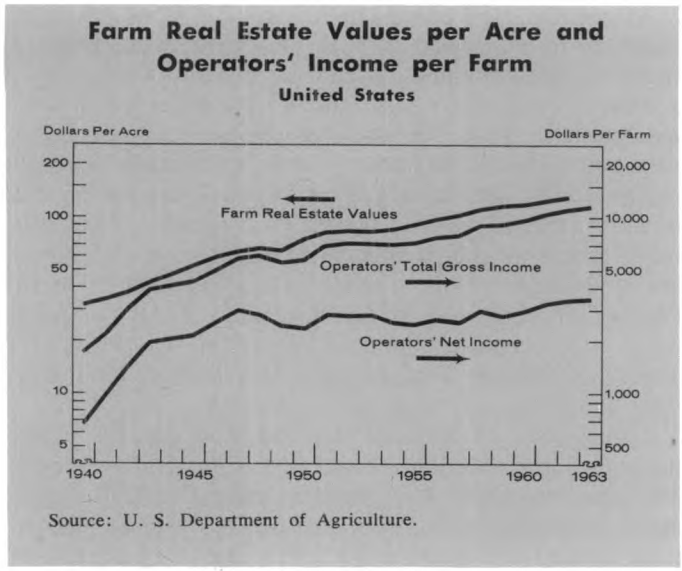
on June 30, 1963. At that time, 74 mortgages were in the process of foreclosure, somewhat fewer than the number a year earlier. Federal land banks, with about 379,000 loans outstanding, reported 254 loans called for foreclosure in the last half of 1963. A year earlier, 248 loans had been foreclosed. The Farmers Home Administration, which held 96,517 farm mortgage loans in its portfolio on December 31, 1963, reported that it had acquired 23 farm properties by foreclosure in the last quarter of 1963, the same number as a year earlier.

Possible Weaknesses

Whether farmers will maintain the debt-repayment record established since World War II cannot, of course, be determined. Although past trends in farmers' incomes and changes in lenders' techniques for extending credit are elements that have tended to minimize risks and maintain the overall quality of farm loans, some recent developments cast a shade of doubt, at least over farmers' ability to settle their debts as quickly as they have in the past few years.

Farmers augmented their debts quite rapidly in 1962 and 1963. In the nation, non-real estate debt outstanding at all operating banks and production credit associations, the principal short-term farm creditors, rose 14 percent in 1963 in contrast with more moderate gains of 9 percent and 5 percent in 1962 and 1961, respectively. This upsurge in farm loans outstanding occurred partly because farm production expanded. In the Sixth Federal Reserve District, where extensive gains in loans occurred last year, some impetus also came from credit advanced to citrus growers in Florida whose groves required rehabilitation and from loan extensions granted to growers and their suppliers.





Farm mortgage debt outstanding with all long-term lenders rose at a steeper rate in 1963 than in the preceding three years. On January 1, 1964, the total in the nation was about a tenth more than a year earlier, according to the USDA. Gains in 1960, 1961, and 1962 had been 6, 8, and 9 percent, respectively. At commercial banks, farm real estate loans outstanding increased about 15 percent in 1962 and probably by a similar amount in 1963, contrasting sharply with the 6-percent rise in 1961 and the 4-percent gain in 1960. These loans, however, have been for relatively small amounts. In the first half of 1963, the average commercial bank loan in the nation was about $9,000, well under the $31,000 average for farm mortgage loans made by life insurance companies.

Although farm debt expanded substantially in 1963, reflecting especially farmers' demand for long-term farm loans, the average interest rates farmers paid on loans differed little from the rates paid in 1962 and 1961. The supply of loanable funds, however, became more plentiful, partly because the national monetary authorities acted to provide the economy with ample funds during the 1960-63 period. With an ample supply of funds to lend, long-term farm lenders competed more vigorously for loans, especially in 1962 and 1963. Some marginal borrowers could have obtained excessively large credit advances.

In view of the slight decline in aggregate net farm income in 1963, the sizable rise in farm real estate values that also occurred in that year must be considered a further cause for uneasiness about the quality of credit. In November 1963, the value of farm land and buildings for the nation rose 6 percent above the year-earlier level. This gain further extended the almost uninterrupted rise since the 1930's in farm real estate valuations. The upward trend in values had been checked by a decline in 1949 and had been slowed in 1959 and 1960, but its advance quickened again in 1961 despite stability in net farm income per acre, which had held for several years at about $13.50 nationally.

Loan Standards Under Pressure?

These farm financial developments in 1963 led some analysts to inquire whether farmers' favorable loan experience since World War II and the expanded supply of loanable funds in recent years have not tended to draw lenders into competing for loans by reducing their lending standards and accepting more risks in their loan portfolios. Loans made by long-term farm lenders are heavily influenced by their overall appraisal and loan policies. If farm land appraisals are raised and loan-to-value ratios are liberalized, a new and higher element of risk may be inherent in the loans. Such changes in these key policies may cause lenders to relax their selectivity among farm borrowers and allow an uneconomical amount of credit to flow to marginal borrowers without a compensating buildup in their reserves for losses. With farm land values rising disproportionately to farm income, the dangers from unhealthy credit extensions based on higher appraisals may increase.

Another hazard crops up when competitive urges among farm lenders cause them to make farm loans that are not closely related to farmers' needs. They may make excessively large loans or they may make loans whose proceeds are used for speculation in land or other farm assets.

This Bank obtained some evidence pertinent to these points in September 1963 from a survey of farm loan appraisers, farm real estate dealers, and farm lenders in the District states. Most of the respondents said that long-term lenders in the region had tended to lift their appraisals of farm land somewhat in the past two years and to lend a moderately larger proportion of the appraised values. This reflected, in the respondents' views, both an increase in loanable funds and greater competition for productive farm loans. The respondents believe that farm land values in District states have increased in the past decade primarily because relatively little farm land was offered for sale, while commercial farmers, the most numerous and insistent bidders, sought land to enlarge their units.

Several respondents in the survey said that some speculative activity in the farm land market had probably occurred near communities that are growing rapidly and have a substantial base for future economic development. They cited the Florida Peninsula and the coast along the Gulf of Mexico as areas in which some speculative use of farm credit might have occurred.

In their analysis of current developments in the farm land market, however, the respondents subordinated changed appraisal and loan policies. Few respondents suggested that the policy changes were unsound when measured against the long-term production and income prospects of the individual farms involved. They suggested that a stepup in appraised values for well located, easily operated farms in good repair and with fertile soils would be justified under present and foreseeable farming conditions. In their view, many of the farms that changed hands or were mortgaged in the past decade had increased in value as a result of improvements made on them or increased production potential.

Future Trends Affect Quality

Whether the evaluations of the respondents in the survey prove correct hinges to a great extent upon how well farm lenders have judged the future. The quality of farm credit they extend now depends greatly upon developments in years ahead, especially the course of farmers' income. Although income projections can be highly undependable, it is often useful to assess the possible trend.

The USDA in a recent projection of the farm economy to 1968 suggests that farmers as a group may fare reasonably well through that year at least. This projection, which assumes a continuation of present farm programs, anticipates further growth in population and consumer incomes and a small decline in prices of farm products.

According to the USDA, a further enlargement of farms is also in prospect, as are increased farm mechanization and efficiency. Farm output in the nation may increase about 11 percent from the 1963 level. Net farm income per farm is expected to rise, perhaps by a tenth, if the number of farms continues to shrink at the present rate.

A continued marked decline in the number of farms in the next decade will tend to reinforce these expectations because the management and control of the nation's farms will shift further to commercial farmers through farm transfers and consolidations. This process also may generate some upward pressures on the level of farm land values.

Summing Up

Looking back over the record of farm loans made in the 1940's and 1950's, the evidence does not show clearly that their quality fell below a desirable level. Most farmers repaid their loans promptly or at least within extended time limits satisfactory to their creditors, and farm foreclosures held at a low point for a prolonged period. Many farmers probably used their borrowed funds to increase their earnings.

Unwise credit practices today, however, can reduce the quality of lenders' loan portfolios and lead to future loan delinquencies and foreclosures. If loan appraisals overstate the real worth of farms, if farm credit is widely applied to speculative uses, and if marginal borrowers are encouraged to invest excessively, the quality of credit will deteriorate even if farm income in the nation does not move lower. If income does decline, this deterioration could cause trouble, especially among the less efficient farm borrowers.

ARTHUR H. KANTNER

District Member Banks Still in Cost Squeeze

High operating expenses plagued District member banks again in 1963. Dollar operating revenue rose appreciably during the year, but expenses drained off a larger share than in 1962—75.2 percent, compared with 74.0 percent. This marks the third consecutive year in which operating expenses have outpaced gains in total revenue of member banks. As a result, net current earnings declined from 26.0 percent of total revenue in 1962 to 24.8 percent.

Net income (after taxes and adjustments to reserves) dropped from 15.7 percent to 14.9 percent of total revenue. Both the ratios of net income to total capital accounts and to total assets were fractionally lower in 1963 than in the previous year.

These and other ratios measuring the performance of member banks were calculated from regular reports of condition and the report of income and dividends for the year 1963. The ratios, which are shown in the table on Page 6, represent simple averages of individual bank ratios, *i.e.*, each bank's ratios are weighted equally.

The continuing competition for time and savings deposits contributed heavily to the rise in operating expenses in 1963. Interest on these accounts increased from 22.5 percent of revenue in 1962 to 24.1 percent in 1963. The average rate paid moved up from 3.12 percent to 3.29 percent. Total time deposits, moreover, represented a larger proportion of total deposits than in the previous year—37.9 percent, compared with 36.3 percent.

On the revenue side, interest and dividends on other securities, expressed as a percent of total revenue, rose slightly from the 1962 level. Interest and discount on loans also increased, reflecting both a larger portfolio and a higher average return. Service charges on deposit accounts, however, dropped slightly after hovering at the 8.0-percent level during the two previous years.

Member banks shifted their assets in the direction of higher-yielding loans and other securities during 1963. U. S. Government securities, as a percent of total assets, fell only slightly from the 1962 level, while a significant decline occurred in cash assets.

Total capital accounts improved in relation to other balance sheet items between 1962 and 1963. The ratio to total assets increased from 8.6 to 8.8 percent, and the ratio to total deposits rose from 9.6 to 9.8 percent.

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