STATEMENT ON
FARM CREDIT PROBLEMS
AND IMPLICATIONS FOR
AGRICULTURAL BANKS

PRESENTED TO

COMMITTEE ON BANKING, FINANCE
AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

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10:00 a.m.
Thursday, March 21, 1985
Room 2128, Rayburn House Office Building

Mr. Chairman, and members of the subcommittee, I appreciate the opportunity to discuss with you the current agricultural situation and its implications on insured commercial banks engaged primarily in serving agricultural areas.

During the 1970s, in anticipation of continued export growth, increasing commodity prices and inflation in land values, many farmers, especially mid-size operators, borrowed heavily to expand operations. This higher debt was supported by using land values rather than by cash flow performance or prospects. Farm debt doubled from 1976 to 1981, the same period during which interest rates spiraled upward, which brought about higher debt servicing requirements. Also during this period petroleum prices were at high levels which contributed to increased production and operating costs.

Beginning in the 1980s, the anticipations of the 1970s failed to materialize. Exports dropped off and commodity prices declined or stagnated while interest and production costs were at high levels. Accordingly, land values declined and farmers who became reliant on rising values to finance their operations, now were forced to rely on generated cash flow which, for many, proved inadequate. Debt servicing, especially for the mid-size operator, became a significant problem.

Commercial banks provide less than 25% of total farm credit, the Farm Credit System being the largest lender with just over 40% of farm credit. There are about 4,100 agricultural banks in the country. An agricultural bank is defined as one in which agricultural loans comprise 25% or more of total loans.

Over 80% of the agricultural banks in the country are concentrated in 16 midwest and plains states. Agricultural banks comprise 45% of the 7,400 banks in the 16-state area. The banks in this area have loans totaling $21 billion or 41% of farm credit advanced by all banks. The majority of these institutions are state chartered banks not members of the Federal Reserve System which are jointly supervised by the states and FDIC. Needless to say, the supervision of these banks over the years has allowed the FDIC to amass considerable experience and expertise in evaluating agricultural banks and credits under both favorable and unfavorable economic circumstances.

Financial stress in the agricultural sector has contributed to deterioration in bank agricultural loan portfolios and impacted bank performance. During much of the 1970s, agricultural banks typically outperformed their non-agricultural counterparts. Return on assets was generally higher while the loan loss rate was consistently lower. With increasing pressure on agricultural banks because of problems in agriculture, their performance has been diminishing. This was especially exhibited during the last quarter of 1984.

Loan loss rates for agricultural banks in the 16-state area increased from 0.3% in 1980 to 1.4% in 1984 versus 0.4% and 0.7%, respectively for non-agricultural banks in the area. Non-performing loan data is not available prior to 1982; however, from 1982 through 1984 the non-performing loan rate for the agricultural banks increased from 2.4% to 3.7% contrasted to the non-agricultural banks which maintained a rate of around 2.8% for this period. Accordingly, earnings have been impacted in the agricultural banks with return on assets declining from 1.4% in 1980 to 0.7% in 1984. The non-agricultural banks, on the other hand, held between a 0.9% and 1.0% return over this period. The net interest margin for the agricultural banks, however, remained comparable to the non-agricultural banks from 1980 through 1984, hovering around 5%, indicating that the former, in spite of loan problems, have been able to maintain sufficient yields on their assets. Whether or not this situation will continue if agricultural credits deteriorate further is uncertain.

Capital ratios for the agricultural banks reflect a modest increase from 1980 through 1984 and continue to be relatively strong. For this period capital ratios for agricultural banks increased from 9.3% to 9.8% and remained generally a full percentage above non-agricultural banks. It should be noted however, that in apparent anticipation of further loan losses, agricultural banks, during this period, have substantially increased loan loss reserves, which comprises a component of capital. All but 600 agricultural banks in the 16-state area continued to pay dividends through 1984, some without apparent supportive earnings positions. For 1984, 337 banks paid dividends greater in amount than net income, and 234 paid dividends while reporting net losses.

A review of some recent FDIC supervisory statistics may serve to enhance the perspective on agricultural banks. There were, as of March 15, a total of 919 problem banks of which 303, or 33%, were agricultural banks. This represents a proportional increase over 1983 when agricultural banks were 20-24% of the total number of problem banks. 267 of the problem agricultural banks are located in the 16-state area where most of the nation's agricultural banks are situated. These banks comprise 53% of the 499 problem banks in that area.

By closely supervising agricultural problem banks, as other problem banks, the FDIC can provide a sound appraisal of credits and recommendations to management as the possible general courses of action. Specific courses of action as to whether to curtail credit lines, restructure, forebear or foreclose, and when to do so, and with respect to which borrowers, are bank management decisions that should be made with a view toward minimizing losses. Certainly we are receptive to a showing by any bank management that they are working with their agricultural borrowers and doing all that can be done reasonably under the circumstances to run a safe and sound banking operation.

When banks present warning signs of problems or are in danger of insolvency, the FDIC responds according to the severity of the situation, whether the problem stems from agricultural credits, real estate credits, energy credits or otherwise. We increase the number and frequency of examinations or visitations, and off-site reviews and surveillance become more intensive. Formal or informal administrative actions may be initiated as necessary. If efforts to turn the situation around are not successful and the chartering authority closes the bank, the FDIC may be then forced into its role as receiver and try to arrange a purchase and assumption, or if necessary, pay off depositors.

As of March 1, 1985 outstanding formal enforcement actions by the FDIC against banks in the 16-state area numbered 175 compared to 424 against banks nationwide. They are broken down as follows: 11 termination of insurance actions under Section 8(a); 137 cease and desist actions under Section 8(b); and 4 temporary cease and desist actions under Section 8(c); and 23 suspension and removal actions under Section 8(e); and (g). Cease and desist orders are outstanding against only 141 state nonmember problem banks, indicating the effectiveness of the analysis and attention accorded by the FDIC, in conjunction with state authorities, to each problem situation outside the formal administrative action process.

The trend of assets classified at examinations of the agricultural banks reflects a substantial increase from 22% of capital in 1980 to 50.7% in 1983, then declining to 44.5% in 1984. This decline is not necessarily cause for comfort because a number of banks not examined since January 1984 and until now not considered of supervisory concern, appear to have experienced deterioration according to recent offsite reviews. Scheduled follow-up examinations may reflect increased classifications in these institutions. Of note is that classifications at examinations of non-agricultural banks reflect a greater increase over the same period, from 27.9% of capital in 1980 to 74% in 1983 then also declining somewhat in 1984. Worthwile mentioning in this regard is that in a recently conducted agricultural bank survey by the American Bankers Association, 88% of the respondents indicated no major disparity between their banks' agricultural problem loan list and the findings of examiners.

Failed bank statistics provide further perspective on the agricultural bank situation. There was a substantial increase in the number of bank failures in the 16-state area, from 14 in 1982 to 39 in 1984, and this upward trend appears to be continuing in 1985. Through March 15, 12 bank failures have occured, well over half of the 18 failures nationwide. Agricultural bank failures nationwide increased from 9 in 1982 to 25 in 1984 with 11 in 1985. During the period from January 1, 1984 to February 5, 1985 the FDIC expended around $280 million to facilitate failed agricultural bank transactions. This cash infusion then became available as a funding source for worthy agriculture borrowers.

An FDIC study of agricultural bank failures that occurred between January 1, 1984 and February 5, 1985 indicates that none was solely due to adverse economic conditions. Although a depressed agricultural economy perhaps accelerated the failures, the primary cause in many instances was mismanagement coupled in some cases, with insider abuse.

The FDIC is acutely aware of, and sympathetic to the agricultural crisis; however, there is little we can, by ourselves, do to alleviate the agricultural credit problem. We will continue our policy of realistic and fair evaluations of farm banks and farm credits, and, participate in initiatives to aid in the recovery of the agricultural sector consistent with considerations of safety and soundness.

Policy directives have been issued by the FDIC to its examiners during the past two years reinforcing the importance of realistic, objective and fair analysis and appraisal of agricultural credits and banks holding those credits. In addition, FDIC management has met with examiners on a frequent basis to discuss agricultural credit issues. Our personnel from senior management through senior staff levels have also met with various groups representing both banking and agriculture, on a national, regional and local basis, in an effort to exchange information and viewpoints and thereby attain greater mutual understanding.

The FDIC has made a special effort to offer assistance to states where agricultural problems are prominent. For example, we have provided technical assistance and personnel to Iowa and Nebraska in handling certain failed financial institutions even though they were not covered by federal deposit insurance. Also, we have expedited the processing of applications for deposit insurance for new banks and existing non-insured banks from within these states so that necessary adequate banking facilities could be afforded smaller communities.

In discussing FDIC initiatives relating to agricultural situation, I believe it is appropriate to address the subject of net worth certificates. In the existing net worth certificate (NWC) program for banks with a substantial amount of real estate loans, a bank is eligible for the NWC program only if it has capital below a certain level and has opeating losses <u>not due to mismanagement</u>. The NWCs are non-negotiable and thus the recipient bank obtains no cash or lendable funds through the program. The purpose of the program for the real estate banks has been to carry the bank until it can return to profitability and recapitalize itself.

The problems with agricultural credits are different from those in real estate and the same kind of support program will not work for several reasons. The real estate problems were caused by loans which are of fundamentally sound credit quality, i.e., the borrowers have an established record of repayment and there is little question about their continued ability to repay. However, the loans carried low, fixed interest rates at a time when the banks needed to pay much higher rates in order to retain funds. Thus, operating losses resulted not from inability to collect principal but from an excess of day-to-day operating expenses over day-to-day income. As the principal of these low-yielding loans is repaid, the bank is able to reinvest it at higher yields. This combined with general reduction in interest rates which we have seen, allows reasonable expectation that the problem of real estate banks will eventually be solved with the passage of time. NWCs help to keep the banks alive until this interest margin is redressed.

With the agricultural credits, however, there is no reasonable expectation that the mere passage of time will correct the situation. Loans for current operating costs might be all or partially covered from crop proceeds, but that still leaves some farmers with insufficient cash flow to do anything about the large overhang of accumulated debt for land and equipment purchases. The equipment continues to depreciate in value by the mere fact of aging. It would take the undesirable and, we hope, the unlikely prospect of significant new inflation to increase the value of previously acquired land to a level where it could be sold for sufficient amounts to repay the acquisition loan. And even if there was such an unlikely value increase, the sale of the land would represent the same effect as putting the present owners out of business and further burdening the purchaser for increased acquisition debt. The only prospect for increased land values is profitability in the farm sector.

As I previously mentioned, agricultural banks have not suffered high losses in earnings and capital levels remain reasonable for the bulk of banks. Of the approximately 4,100 agriculture banks in the United States, based on year-end 1984 data, only 16 had capital ratios less than 5% and only eight of those were under 3%. This does not appear to constitute a significant problem for which a NWC program can offer relief.

The banks that would receive NWCs are stockholder owned and a NWC program would represent an unwarranted subsidy to stock investors who are and ought to be the risk-takers. Should a bank's capital become depleted because of significant farm losses and the bank received FDIC assistance, the result would be to provide nothing to the borrower but it would preserve the existence of the stockholder's investment in the bank. Contrast this with the real estate problem in the thrift industry where all of the NWC recipients are non-stockholder, mutually-owned institutions. There is no benefit to ownership in those situations.

A NWC program for those agricultural banks which do approach the brink of insolvency will likely result in rewarding and thus encouraging incompetency. Our earlier referenced study of the agricultural banks that failed in 1984 and early 1985 indicates the primary cause of failure as mismanagement, coupled, in some cases, with abusive insider transaction. These are hardly the kinds of situations that would either permit or qualify for NWC assistance. The present NWC law precludes support for losses due to mismanagement.

The present NWC law provides that assistance cannot be given that would be costlier than liquidating the bank. Keeping an insolvent bank open and thus probably perpetuating unsatisfactory management is likely to result in an increase of new bad loans and further diminution of quality in existing problems. Thus, the situation would be made worse and when the bank eventually had to be liquidated because it could not turn itself around or be recapitalized, the potential exposure to despositors, creditors and the FDIC would be greater. In other words the NWC program would serve to delay failure, not prevent it, and during the delay losses could increase the costs to the Federal deposit insurance fund and others.

While the FDIC is limited in its powers and policies in how it may assist the farmers and the problem of failed banks in this country, the states do have avenues open for assistance. Many state laws restrict the opening and expansion of banks in their states. Changes in the branching laws and holding company laws could ease the pressure on banks. Several regions of the country are experimenting with regional interstate banking compacts. While the process of getting various state legislatures to pass comparable interstate banking laws is cumbersome, the benefits of diversifying funding and lending opportunities may make this effort worthwhile. Other state laws which prohibit ownership of land by corporations, for example, or which exact a punitive tax penalty on the conversion of agricultural land to nonagricultural purposes, restrict the entering and exiting of persons from the agricultural industry. States should attempt to assure that the benefits of these laws truly exist and that the costs of such restrictions do not exceed such benefits.

The FDIC will continue to put forth its best effort to carry out its responsibilities in face of dramatic changes in the banking industry combined with significant problems occurring in not only agriculture but other sectors of the economy. We will continue to explore alternatives that will enable us to better work with these changes and problems without detracting from the free enterprise system or erode confidence in the nation's banking system.

For these reasons and because a NWC program would not result in useable funds for farmers, the FDIC opposes NWC initiatives for agricultural banks.

Attached are schedules listing the 16 midwest and plains states containing the majority of the nations agricultural banks and showing performance characteristics and supervisory statistics for agricultural and non-agricultural banks in this area.

Sixteen Midwest and Plains States
Data as of 12/31/84

	Agricultural Banks (000,000 Omitted)		
	Number	Total Deposits	Agricultural Loans
Colorado	70	1,758	558
Idaho	12	754	226
Illinois	412	10,119	2,195
Indiana	93	3,550	730
Iowa	529	14,100	3,843
Kansas	417	7,547	2,243
Michigan	22	851	178
Minnesota	389	7,327	2,126
Missouri	288	6,331	1,483
Montana	74	2,113	470
Nebraska	396	8,099	2,924
North Dakota	136	3,123	844
Oklahoma	156	3,708	811
South Dakota	127	5,189	1,451
Wisconsin	191	4,121	1,026
Wyoming	25	743	161
Total	3,337	79,433	21,269
Percentage of all Agricultural	84%	80%	83%

AGRICULTURAL BANKS - PERFORMANCE CHARACTERISTICS

Agricultural Banks 16 Midwestern and Plains States
Performance Characteristics

	1980	1981	1982	1983	1984
Non performing	-	-	2.4	2.8	3.7
Capital Ratio	9.3	9.4	9.5	9.7	9.8
Loans/Assets	56.4	53.0	51.7	51.0	52.1
Return on Assets	1.4	1.4	1.3	1.1	0.7
Net Interest Margin	5.2	5.4	5.3	5.2	4.9
Net Loan Losses/Loans	0.3	0.4	0.7	1.0	1.4

Non Agricultural Banks - 16 Midwestern and Plains States
Performance Characteristics

	1980	1981	1982	1983	1984
Nonperforming	-	-	2.8	2.7	2.8
Capital Ratio	8.6	8.5	8.4	8.3	8.4
Loan/Assets	57.2	54.9	53.7	52.6	54.3
Return on Assets	1.0	1.0	0.9	0.9	0.9
Net Interest Margin	5.2	5.3	5.3	5.2	5.1
Net Loan Losses/Loans	0.4	0.4	0.7	0.3	0.7

PROBLEM BANKS

	Number of Problem Banks				
	1983	1984	To Date 3/15/85		
			Total	Agricultural	Other
16 Midwest and Plains States	293	445	499	267	232
34 Other States, D.C. and Puerto Rico	307	355	420	36	384
Total	600	800	919	303	616
Subtotal - 16 Midwest and Plains States as % of Total Problem Banks	49%	56%	54%		

1985 - Agricultural Banks as % of Total Problem Banks	33%

AGRICULTURAL BANK FAILURES

	1982	1983	1984	To Date 3/15/85
Number of bank failures in 16 midwest and plains states	14	15	39	12
Other states	28	33	40	6
Total Bank Failures	42	48	79	18
Number of Agricultural Bank Failures	9	11	25	11
Banks in 16-state area as a percentage of total bank failures	33%	32%	50%	66%
Agricultural Bank failures as a percentage of total bank failures	21%	23%	32%	61%