STATEMENT ON
FARM CREDIT PROBLEMS IN AGRICULTURAL BANKS
AND IMPLICATIONS FOR
BANK REGULATION

PRESENTED TO

COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND
CONSUMER AFFAIRS

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9:30 a.m.
Friday, April 26, 1985
Room SD-538 Dirksen Senate Office Building

Mr. Chairman, and members of the subcommittee, I appreciate the opportunity to discuss with you the problems being experienced by insured commercial banks engaged primarily in serving agricultural areas and the implications on regulation of these banks.

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 Cooperative 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. Of these, banks with agricultural loan-to-total loan ratios of 25 to 50 percent (roughly 2,375 banks) hold about $14.5 billion in agricultural loans. The banks are typically small, with average assets of about $32 million. Banks with agricultural loan-to-total loan ratios greater than 50 percent represent a little over 12 percent of all commercial banks (about 1,775 banks) and hold about 24 percent of the total volume of farm loans held by all commercial banks (or about $12.5 billion). Again, these banks are typically small, having an average asset size of just over $20 million.

In more general terms, the potential exposure of commercial banks to continued agricultural problems seems small when comparing the volume of assets of banks which are more highly concentrated in agricultural loans to those less concentrated. For example, banks with agricultural loan-to-total loan ratios of less than 10 percent hold nearly 89 percent of all domestic bank assets, while banks with agricultural ratios greater than 25 percent hold only a little less than 6 percent of all such assets. Nevertheless, the absolute volume of assets involved in banks which are more agriculturally oriented is not inconsequential. Assets at agricultural banks total about $114 billion. Furthermore, a significant number of banks with farm loan ratios between 10 and 25 percent may well have substantial amounts of loans that are not designated as farm loans, but which are directly or indirectly tied to the health of the agricultural economy. A further complicating factor is the geographic concentration of farm loans among commercial banks.

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 April 12, a total of 931 problem banks of which 315, or 34%, were agricultural banks. This represents a proportional increase over 1983 when agricultural banks were 20-24% of the total number of problem banks. 282 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 56% of the 506 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 April 12, 1985, outstanding formal enforcement actions by the FDIC against banks in the 16-state area numbered 197 compared to 453 against banks nationwide. They are broken down as follows: 20 termination of insurance actions under Section 8(a); 146 cease and desist actions under Section 8(b); and 3 temporary cease and desist actions under Section 8(c); and 28 suspension and removal actions under Section 8(e); and (g). Cease and desist orders are outstanding against only 149 of a total of 322 area state nonmember problem banks, indicating the FDIC, in conjunction with state authorities, is able to effectively deal with problem situations outside its 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. Worthwhile mentioning in this regard is that in a recently conducted agricultural bank survey by the American Bankers Association (ABA), 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 April 12, 15 bank failures have occurred in this area, well over half of the 25 failures nationwide. Agricultural bank failures nationwide increased from 9 in 1982 to 25 in 1984 with 16 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.

It is unlikely credit problems in agricultural banks will lessen in 1985, or possibly even 1986. The aforementioned ABA survey evidenced that more of these banks' farm borrowers are experiencing financial stress, and, that there was little hope for any improvement in bank loan portfolios, at least through mid-1985. Agricultural banks will likely face continued higher proportions of delinquent loans and loans on which accrual of interest has been discontinued due to their quality. Further, there is a sizeable number of highly leveraged borrowers. According to the 1985 Agricultural and Credit Outlook of the Farm Credit System, nearly 61% of commercial banks' farm borrowers have a debt-to-asset ratio greater than 40%, and somewhat more than one-half of these borrowers exceeded 60%. This situation will warrant continued close bank supervision by regulators and, probably, more conservative lending practices in banks servicing the agricultural sector.

The FDIC is both knowledgable and appreciative of the agricultural difficulties; 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.

The FDIC will continue its conscious efforts to exercise its responsibilities in face of banking problems related not only to agriculture but other sectors of the economy. We will continue to investigate ways that will increase our effectiveness in dealing with these while striving to maintain confidence in the banking system and the deposit insurance fund.

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	8,009	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
Returns 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
Non performing	-	-	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 4/12/85 Total	Agricultural	Other
16 Midewest and Plains States	293	445	506	282	224
34 Other States, D.C. and Puerto Rico	307	355	425	33	392
Total	600	800	931	315	616
Subtotal - 16 Midwest and Plains States as % of Total Problem Banks	49%	56%	54%		

1985 - Agricultural Banks as % of Total Problem Banks	34%

AGRICULTURAL BANK FAILURES

	1982	1983	1984	To Date 4/12/85
Number of bank failures in 16 midwest and plains states	14	15	39	15
Other states	28	33	40	10
Total Bank Failures	42	48	79	25
Number of Agricultural Bank Failures	9	11	25	16
Banks in 16-state area as a percentage of total bank failures	33%	32%	50%	60%
Agricultural Bank failures as a percentage of total bank failures	21%	23%	32%	64%