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STATEMENT ON

FARM FINANCIAL CONDITIONS AND
THEIR IMPACT ON AGRICULTURAL BANKS

PRESENTED TO the House

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND
INSURANCE

BY

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Mr. Chairman, and members of the subcommittee, I am honored to have this opportunity to testify on the subject of the farm credit situation. My statement concerns two major areas: 1) the exposure of of commercial banks to problems within the agricultural industry and 2) the current condition of agricultural banks. However, before addressing these areas I think it is important to say a few words about the nature of the agricultural problem and the financial condition of agricultural producers, since they will ultimately have some impact on financial institutions.

Current agricultural problems are often depicted in terms of a large and small farm context. We often hear the problem portrayed in terms of the smaller, less efficient sized farms being unable to compete with larger farms, who are able to utilize the latest and biggest technology. But this phenomenon has been going on for quite some time, and while it is true that it has resulted in the disappearance of a large portion of the farm population over the years, it has not resulted in the kind of financial difficulties we are witnessing today. In reality, economies of size or technological change have very little to do with current financial problems.

During the 1970s, the agricultural community developed an increased optimism concerning the outlook for agricultural producers. Agricultural exports during the 1970s grew at record rates while real farm income averaged well above the previous two decades. In a world of high population growth and relatively limited production capabilities, it was believed that U.S. agriculture would continue to reap large benefits. Marginal land was brought into production and land prices were bid up at rates well above the overall rate of inflation.

During the 1980s, however, agricultural exports did not continue their upward spiral, and in fact, leveled off. The increased value of the dollar relative to other currencies, increased production abroad, commodity price supports at home, and foreign debt problems were all factors which contributed to the worsening export picture. At the same time, domestic agricultural production continued at record rates, and real interest rates increased substantially from their bargain rates of the 1970s, making increased debt loads substantially more burdensome.

These developments have had their major impact on cash grain farms of the Midwest and Northern Plains states, although other farm types and areas have certainly been affected. While national statistics indicate that large farms are not experiencing the degree of financial stress that medium size farms are experiencing, these data are probably biased since cash grain farms of the Midwest and Northern Plains states are under-represented in the largest farm size group. According to agricultural economists who are knowledgeable about financial conditions of agricultural producers in the Midwest, debt load, not farm size, is the critical factor in determining the degree of financial stress experienced by any given producer.

In essence, many debt contracts based on the optimism of the 1970s are no longer viable given interest rate and export market developments thus far in the 1980s. A recent USDA study indicates that about one-third of all family-size commercial farms, owing over 46 percent of all farm debt, had financial problems ranging from difficulty servicing debts to technical insolvency.[1]

A complicating development for both producers and financial institutions is the recent decline in farm real estate values. The largest declines have occurred in the Midwest and Northern Plains states, with some states exhibiting declines in farm real estate values of as much as 28 percent from their 1981 peak values. Indications are that further declines are in the offing, although in many areas land values have fallen to the point where an investment at current prices (with a substantial portion of the purchase price borrowed) would bring a positive return to some investors. At the same time, farm real estate markets are currently thin, and given the current pessimistic outlook in rural areas, it is not clear that land values will necessarily cease their downward trend at a point where economic returns suggest they should. Because of this possibility, it is important in dealing with financial problems that we not pursue policies which inadvertently create additional downward pressure on farm real estate values.

Commercial Bank Exposure to Agricultural Problems

Commercial banks are an important provider of credit and other financial services to agricultural producers. As of the 3rd quarter of 1984, farm debt outstanding at reporting lending institutions totalled just over $166 billion. Commercial banks held almost one-third of this total, or $51.9 billion, 80 percent of which was not secured by real estate. The largest institutional lender to agriculture is the Cooperative Farm Credit System,

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[1]USDA, "The Current Financial Condition of Farmers and Farm Lenders," Agriculture Information Bulletin Number 490, March 1985.

which provided just over 40 percent of all farm debt last year. Commercial banks, the Cooperative Farm Credit System, and the Farmers Home Administration provide the bulk of institutional lending to agriculture. Non-institutional lenders (or individuals) provided roughly another $50 billion to agriculture last year.

Chart 1 depicts the degree of farm loan concentration among commercial banks. For example, banks with farm loan-to-total loan ratios greater than 50 percent represent a little over 12 percent of all commercial banks (about 1775 banks) and hold about 24 percent of the total volume of farm loans held by all commercial banks (or about $12.5 billion). As the numbers above suggest, these banks are typically small, having an average asset size of just over $20 million. Nevertheless, they represent a large number of banks that appear to be highly susceptible to the ongoing agricultural stress.

Over 28 percent of all commercial banks (roughly 4150 banks), holding over 50 percent of all farm loans (almost $27 billion), have farm loan-to-total loan ratios greater than 25 percent (see Chart 1). Of these, banks with farm loan-to-total loan ratios of 25 to 50 percent (roughly 2375 banks) hold about $14.5 billion in farm loans. Here, as in the previous group, the banks are typically small, with average assets of about $32 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 farm loan-to-total loan ratios of less than 10 percent hold nearly 89 percent of all domestic bank assets, while banks with farm 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 so called agricultural banks (where 25 pecent or more of their loan portfolio is in farm loans) 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.

As recent experience would suggest, the susceptibility of commercial banks to agricultural stress varies considerably across the geographic landscape. Not only have agricultural producers in the Midwest and Northern Plains states experienced greater stress than other regions, but commercial banks in many of those areas are more dependent on the farm economy. Chart 2 depicts the potential exposure of the fifteen states with the largest volume of farm loans. States shown in the northeast quadrant of Chart 2 are those where both the dollar volume of farm loans and the susceptibility of commercial banks to farm stress are high. Similarly, Chart 3 presents data for banks located in nonmetropolitan areas.

Of course most states that appear in Chart 2 also appear in Chart 3. Removing the metropolitan influence serves to further illustrate the high degree to which many banks in these states are reliant on the farm economy. In addition to high farm loan-to-total loan ratios, banks located in nonmetropolitan areas within these 15 states hold farm loans equal to roughly one-half (or $26 billion) of all farm loans held by U.S. banks. Further, to the extent that other loans in more metropolitan areas are related to the agricultural economy, the exposure in several of these Midwest and Plains states may be considerably larger than the farm loan data alone would suggest.

Current Condition of Agricultural Banks

Agricultural bank performance has been on a downward trend over the past two years. Two years ago, agricultural banks were significantly under represented on the FDIC's problem bank list. Although agricultural banks constitute roughly 28 percent of all commercial banks, only about 22 percent of problem banks in June of 1983 were agricultural banks (see Table 1 and Chart 4). By June of 1984, however, the percentage of problem commercial banks designated as agricultural had increased to over 34 percent, and by the end of 1984 agricultural problem banks constituted about 36 percent of the problem list. However, more recent data -- including the last half of 1984 and the first two months of 1985 -- indicate that the rate of increase in the number of agricultural problem banks has slowed considerably from the first half of 1984.

Looking at problem bank data by geographic region is also illustrative of agricultural banking trends. The bulk of agricultural banks, as well as banks indirectly tied to agriculture, are located in the Midwest and Northern Plains states. Of the total increase in problem banks during 1984, about 75 percent of the increase can be accounted for by eleven contiguous states located across the Midwest and Northern Plains regions.

These trends are somewhat disturbing. Nevertheless, it should be remembered that agricultural banks have gone from a position of clearly outperforming other banks, to a position of moderately poorer performance. For example, while major increases in problem banks occurred in the 11 state area just referred to, the problem bank rate (i.e., problem banks as a percent of total banks in those states) at the end of 1984 in these same states was equal to 6.2 percent, compared to 5.5 percent for the nation. Similarly, the problem bank rate for agricultural banks was 6.9 percent at year-end 1984, compared to 5.2 percent for non-agricultural banks. At the present time, these differences are not what one would characterize as large.

Additional data on the relative performance of agricultural banks are presented in Charts 5-12. These data were calculated from year-end Call Reports on banks with total assets of less than $100 million. Agricultural banks with assets less than $100 million include about 97 percent of all agricultural banks. When looking at profitability measures (as depicted in Charts 5 & 6), we see the same trend that was depicted by problem bank statistics. Over the last two years agricultural banks relative to other small banks have gone from a clearly superior status to a position where profits are moderately below their counterparts.

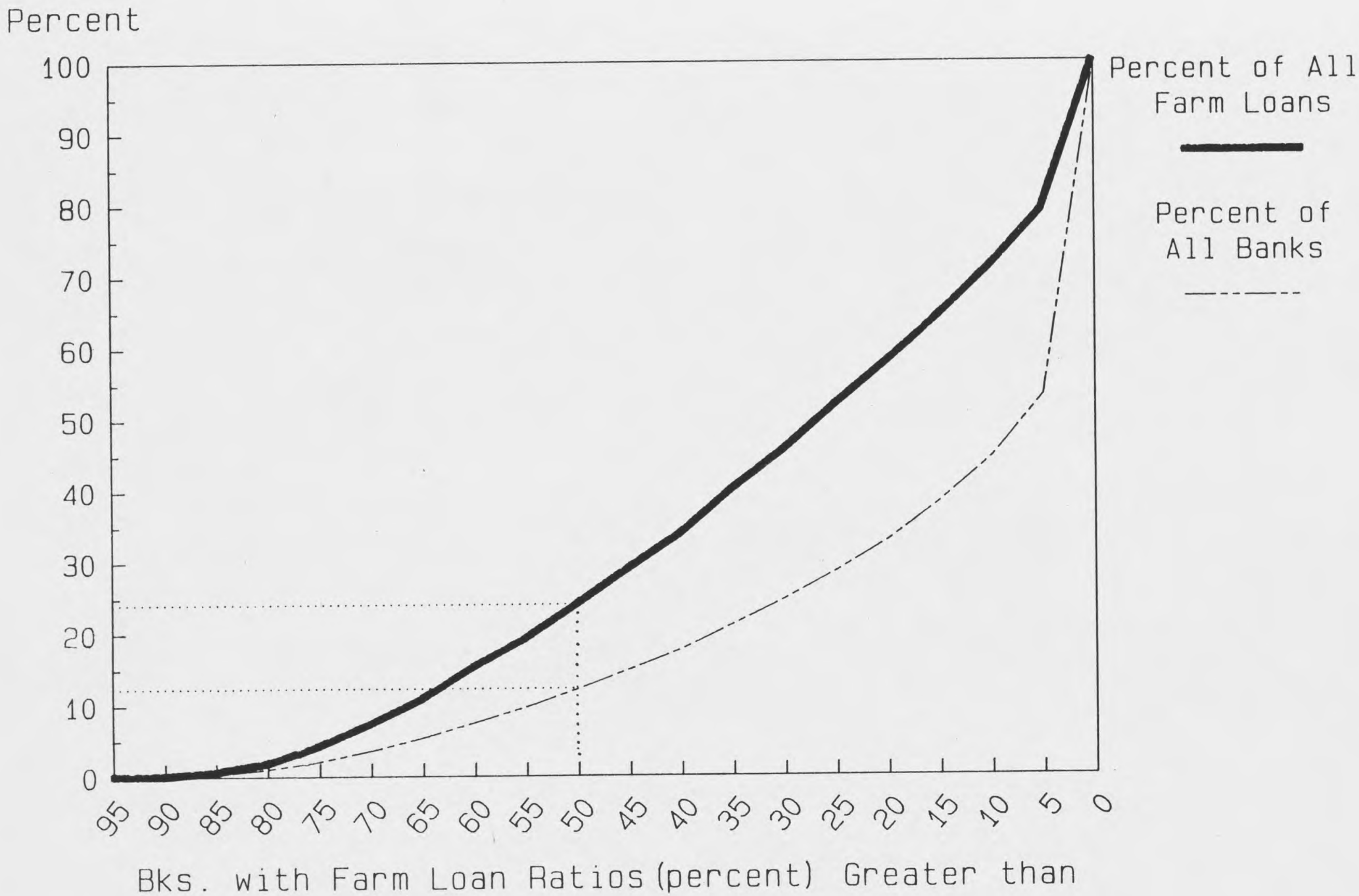
Of the major factors in bank profitability (net interest margin, overhead and noninterest income, and net loan losses), increases in net loan losses at agricultural banks (see Chart 7-10) appear to be the major reason for their lower profitability over the past two years. While lower net interest margins at agricultural banks are partially responsible for their lower profitability, problems with interest margins have been with interest income rather than interest expense, indicating that nonperforming loans may be the source of lower interest margins as well. Regardless of the reasons for lower interest margins, the increase in net loan losses at agricultural banks was sufficiently large -- going from just under 1 percent of average loans during 1983 to 1.37 percent during 1984 -- to have accounted for the major portion of the drop in profitability during 1984.

Despite increases in loan losses and declining profitability over the past few years, agricultural banks have been able to maintain their traditionally higher capital ratios (see Chart 11). In fact, the aggregate capital-to-asset ratio for agricultural banks was higher at year-end 1984 than at any other time during the previous 4 year period, and continues to be well above other small banks. The fact that agricultural banks have set aside loan loss provisions substantially in excess of their loan loss experience (see Chart 12) during the past few years, has been partially responsible for their improved capital ratios. Essentially, agricultural banks have been accepting lower current profits in order to maintain their capital ratios.

Conclusion. In summary, there are a relatively large number of commercial banks that are closely tied to agriculture. Roughly 4,150 commercial banks with farm loan-to-total loan ratios greater than 25 percent hold almost $27 billion in agricultural loans. At the same time, these banks possess slightly less than 6 percent of all domestic bank assets, and total farm loans at all commercial banks comprise only about 4.3 percent of all loans held by commercial banks. Thus, while continued agricultural stress will, no doubt, pose some problems for these institutions, it is unlikely that it will pose significant problems for the deposit insurance fund.

Recent trends in agricultural problem bank statistics, as well as profitability and loan loss trends at agricultural banks are disturbing. At the same time, the profitability of agricultural banks is only marginally below other small banks, and their aggregate capital ratio has remained stable. Nevertheless, given the financial prospects for the agricultural industry, as well as recent loan loss trends, agricultural banks will likely face some trying times ahead.

Chart 1
Farm Loan Concentration Among Commercial Banks



Note: Farm loan ratio is farm loans-to-total loans.

Chart 2
Farm Loan Exposure by State

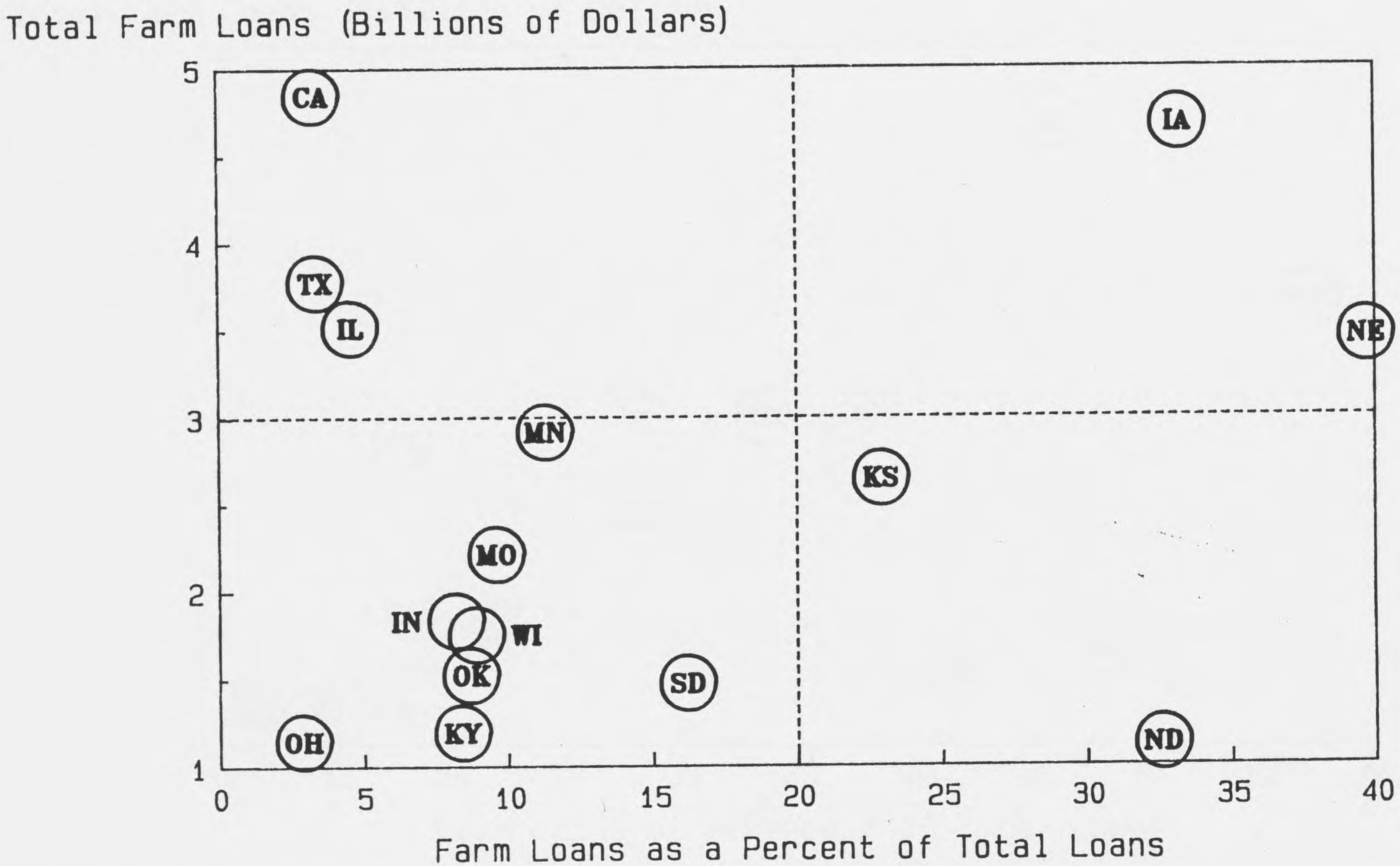


Chart 3
Farm Loan Exposure by State
(Nonmetropolitan Areas Only)

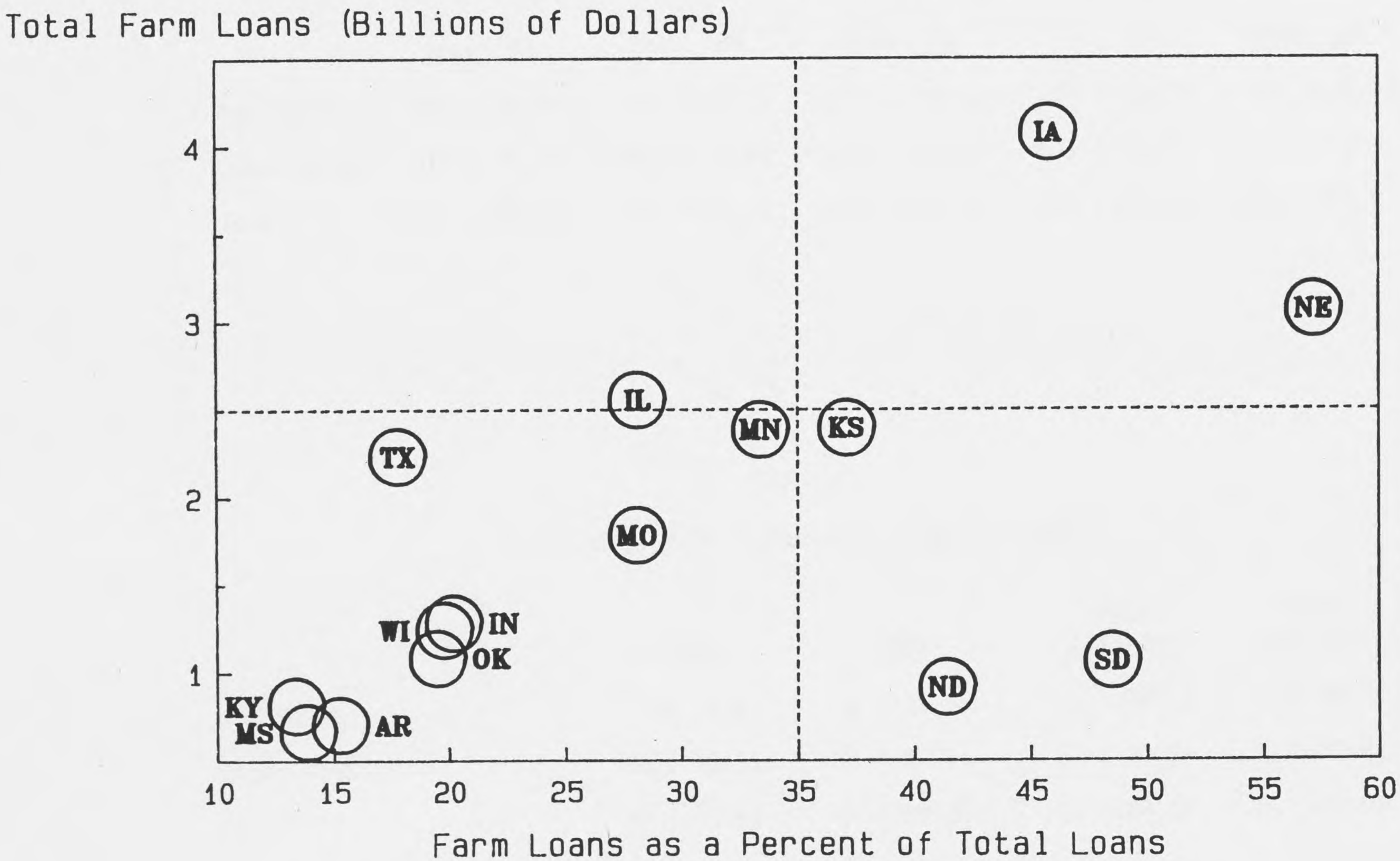


Table 1

Problem Commercial Banks by Type of Bank

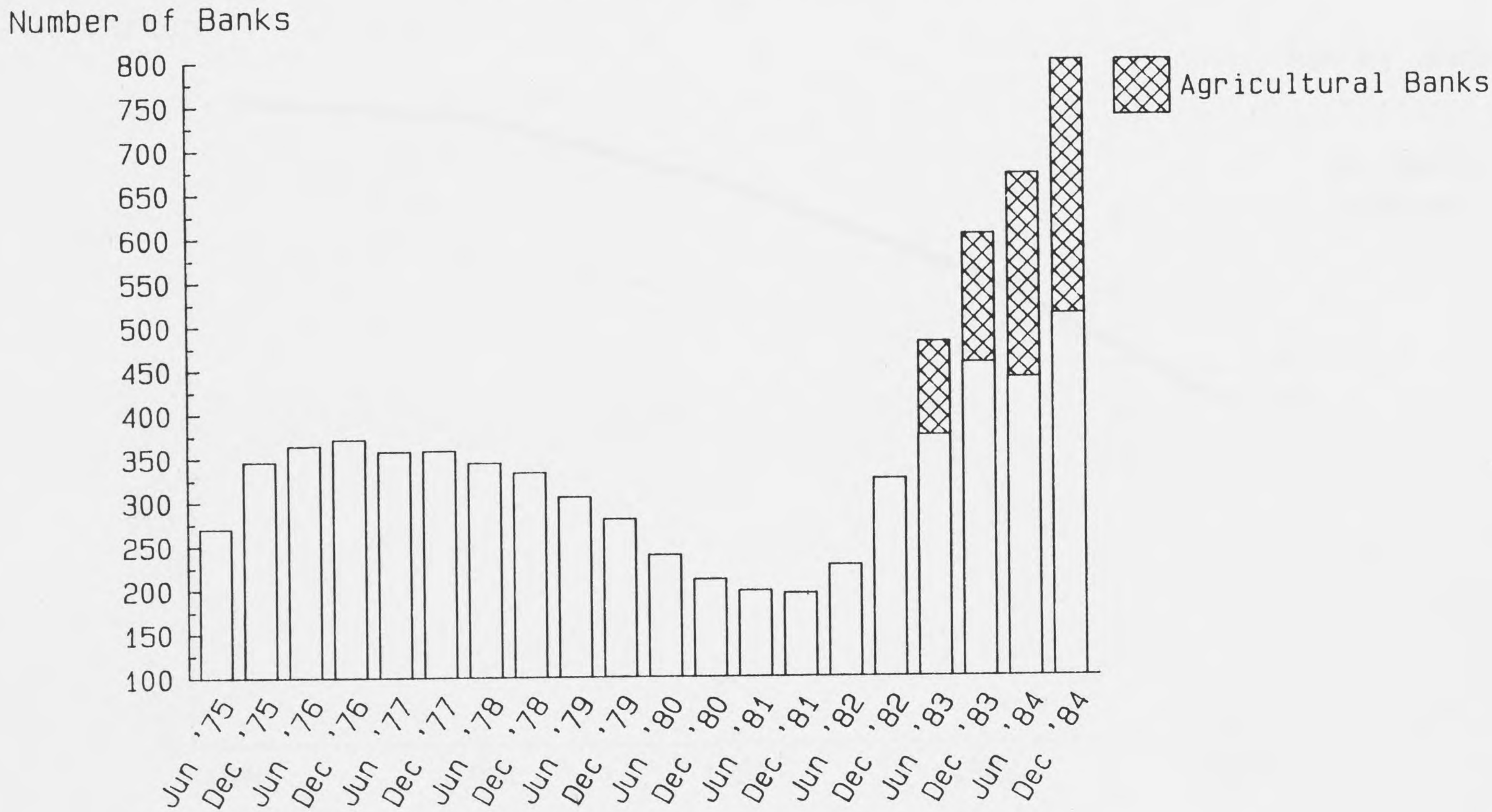
	June '83	Dec. '83	June '84	Dec. '84	Feb. '85
Ag. Banks	106 (22.0)	146 (24.2)	231 (34.4)	288 (36.1)	313 (36.7)
Other Banks	375 (78.0)	457 (75.8)	440 (65.6)	512 (63.9)	540 (63.3)
Total	481 (100.0)	603 (100.0)	671 (100.0)	800 (100.0)	853 (100.0)

Table 2

Commercial Bank Failures by Type of Bank

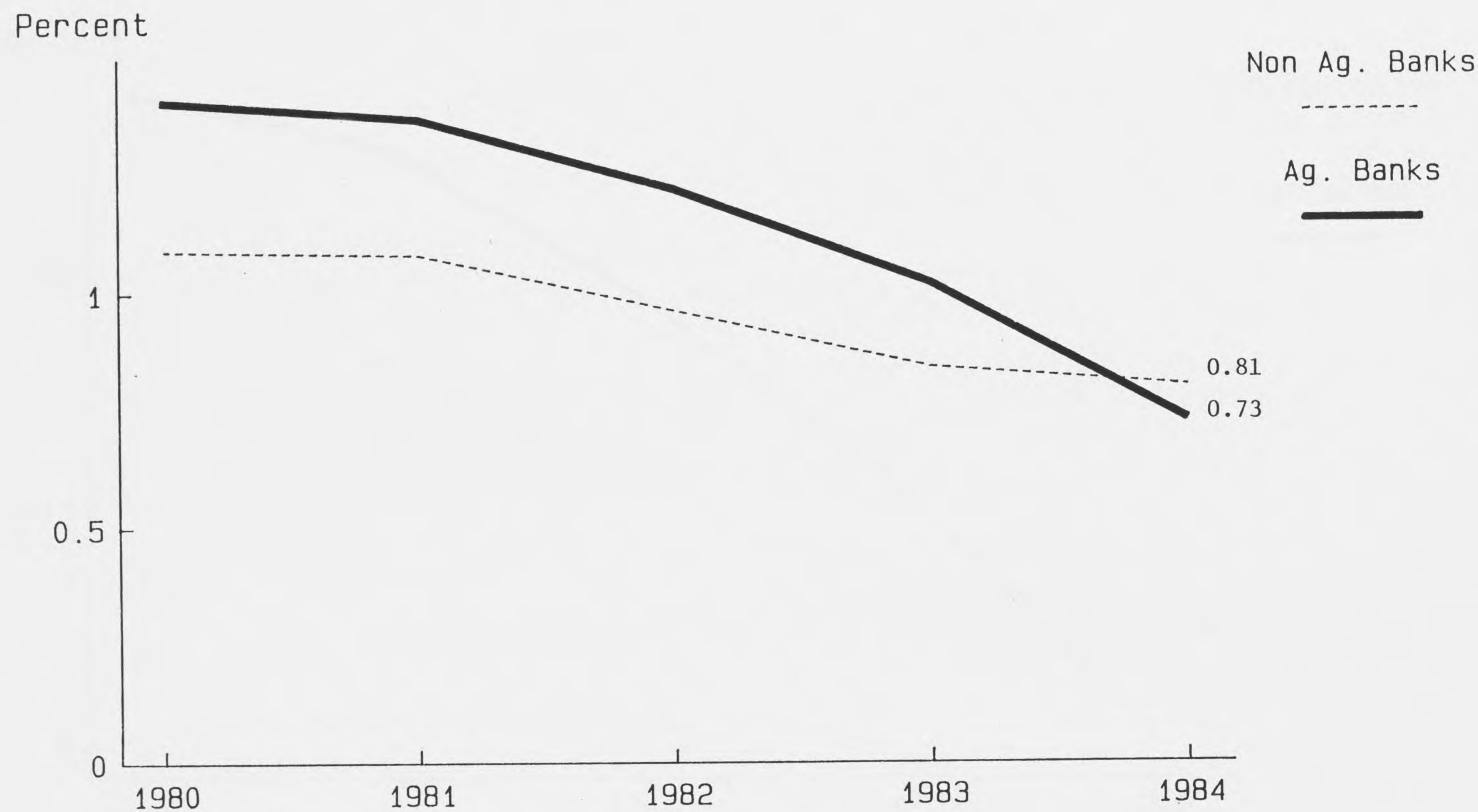
	1982	1983	1984 Jan.-Jun	1984 Jul.-Dec.
Ag. Banks	7 (21.2)	6 (13.6)	8 (19.1)	17 (50.0)
Other Banks	26 (78.8)	38 (86.4)	34 (80.9)	17 (50.0)
Total	33 (100.0)	44 (100.0)	42 (100.0)	34 (100.0)

Chart 4
Problem Banks by Type of Bank
(Commercial Banks Only)



Note: Agricultural bank distinction is not used prior to June 1983.

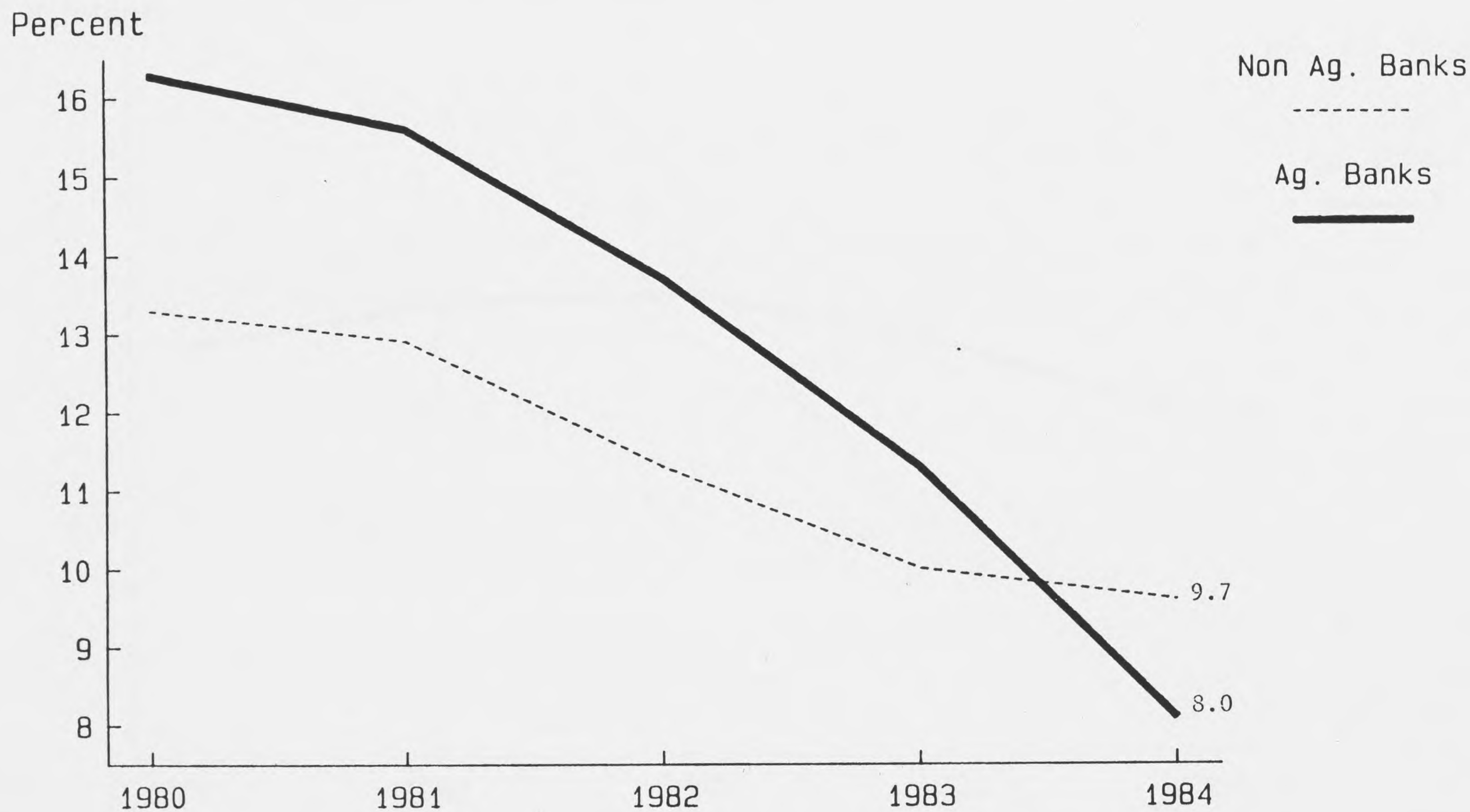
Chart 5
Return on Average Assets



Note: Only includes banks with
assets less than $100 million

Chart 6

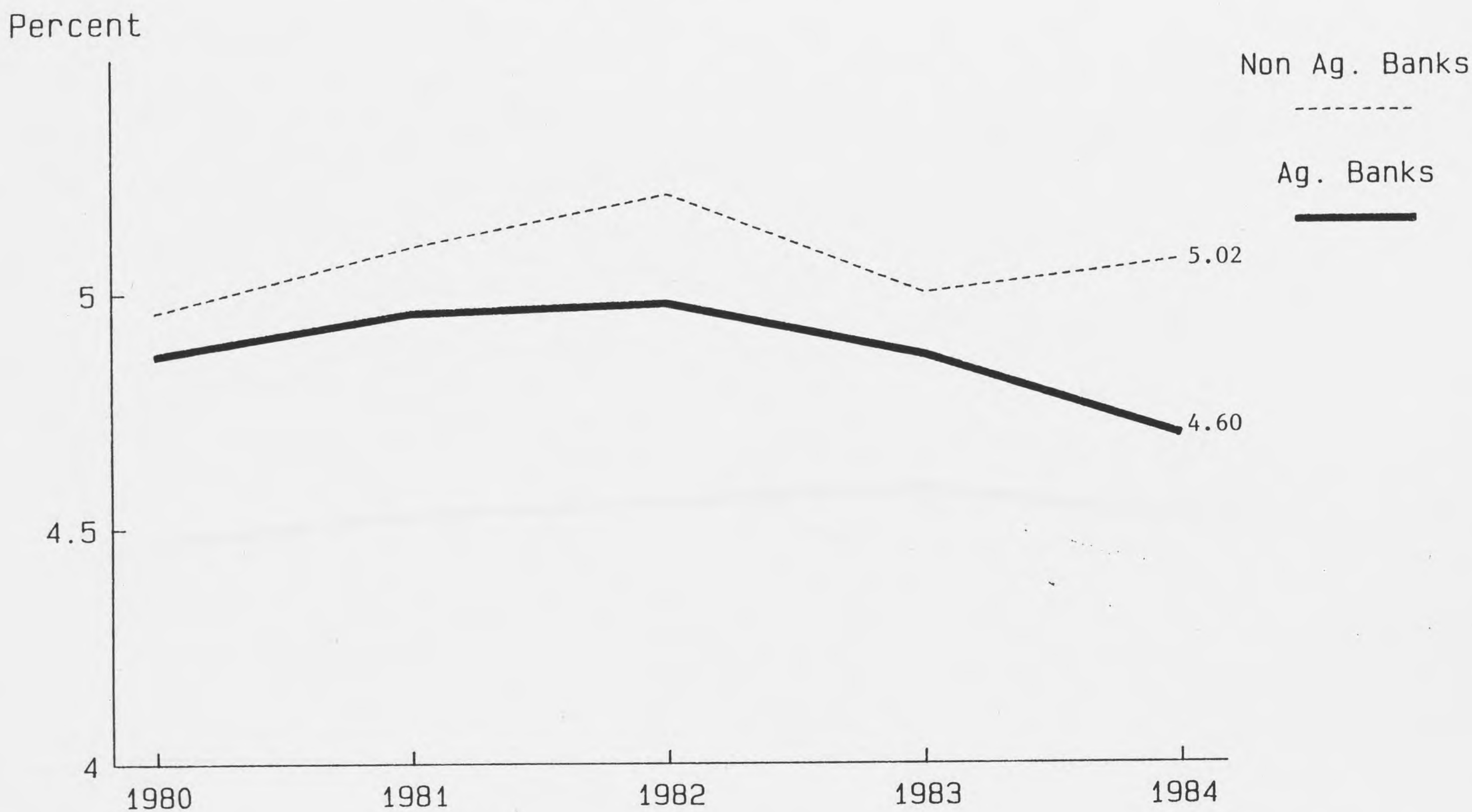
Return on Average Equity



Note: Only includes banks with assets less than $100 million

Chart 7

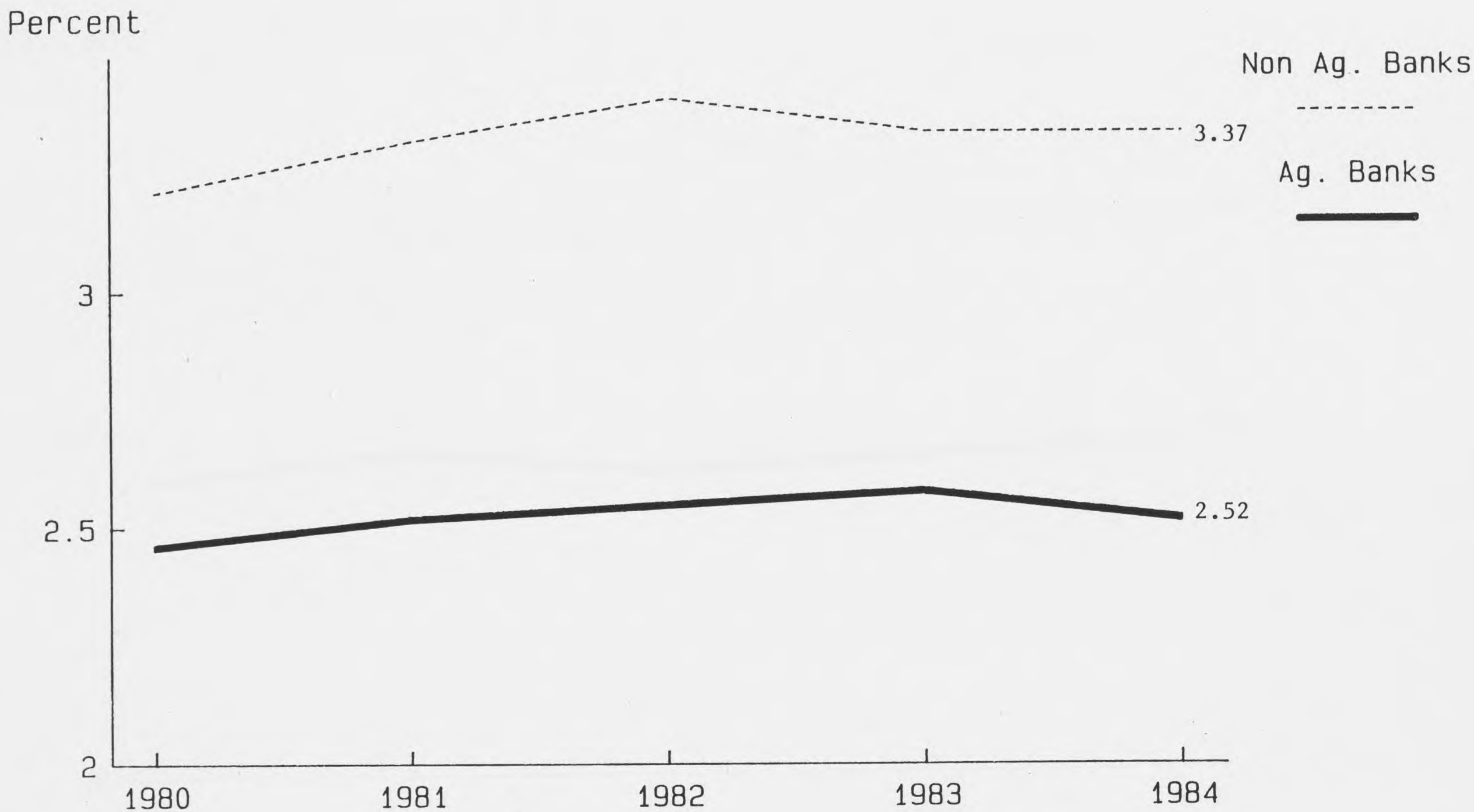
Net Interest Margin
(Tax Equivalent Basis)



Note: Only includes banks with
assets less than $100 million

Chart 8

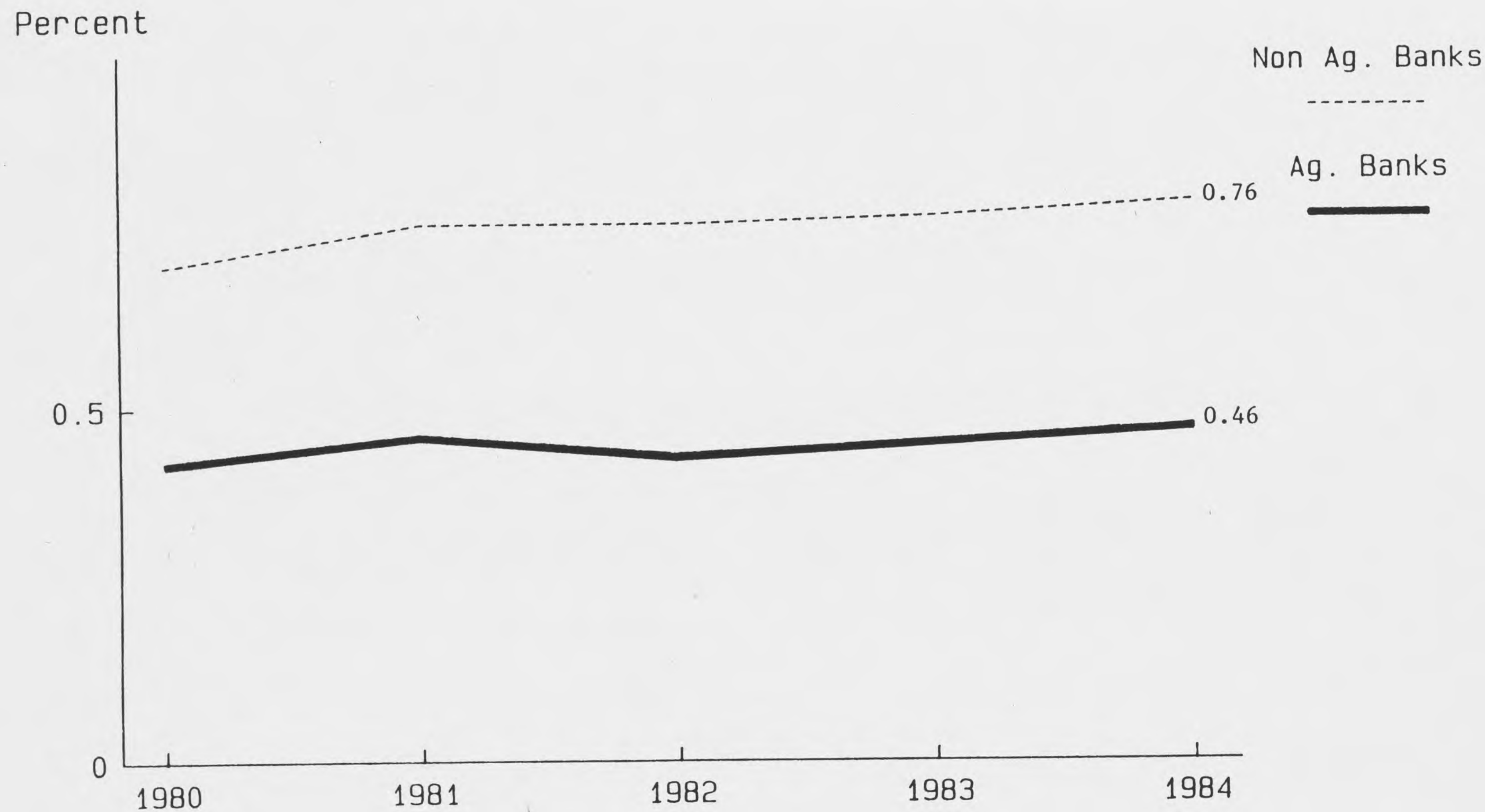
Overhead as a percent of Average Assets



Note: Only includes banks with
assets less than $100 million

Chart 9

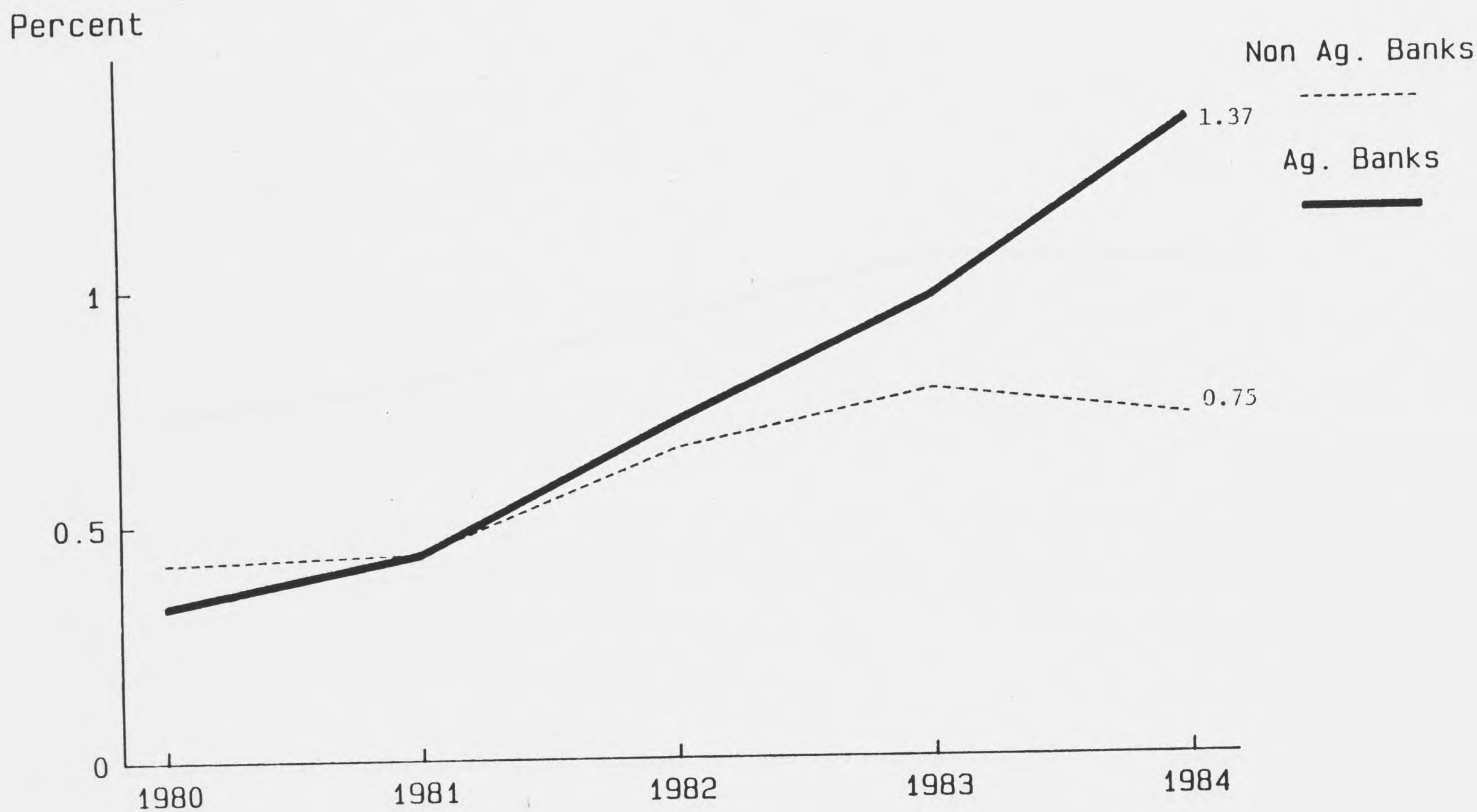
Non-interest income as a percent of Average Assets



Note: Only includes banks with assets less than $100 million

Chart 10

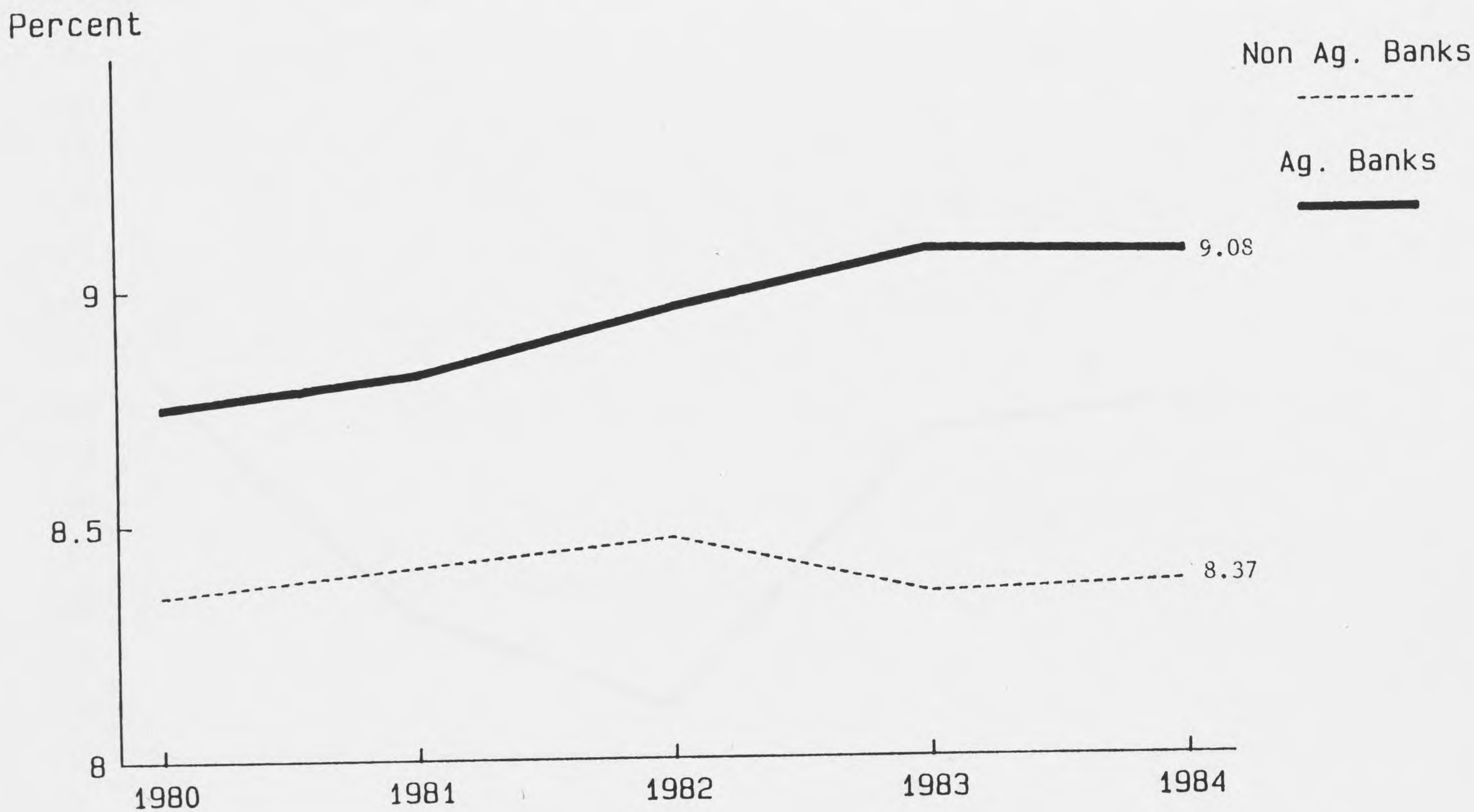
Net Loan Losses as a percent of Average Loans



Note: Only includes banks with assets less than $100 million

Chart 11

Capital-to-Asset Ratio



Note: Only includes banks with assets less than $100 million

Chart 12

Note: Only includes banks with assets less than $100 million