Statement for the Record
of
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on
Current Agricultural Conditions
and the Outlook into 2000
for the
Committee on Agriculture
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Mr. Chairman and members of the Committee, I appreciate the opportunity for the Federal Deposit Insurance Corporation to provide a written statement for the hearing record on current agricultural conditions and the outlook for the remainder of 1999 and into 2000. Global market conditions, combined with agricultural trouble spots in the United States, make this hearing particularly timely.

Let me first summarize our major observations and conclusions. Global factors surrounding supply and demand conditions and a strong U.S. dollar kept commodity prices low in 1998. Forecasts suggest that low commodity prices will continue into 1999. However, farmers generally were in a strong position entering last year's growing season and many have the financial resources to withstand a year or two of poor performance. Yet, pockets of particular vulnerability do exist, particularly in North Dakota and Minnesota.

The nation's 2,371 insured institutions with significant agricultural loan portfolios remain in generally strong financial condition. These banks report solid earnings performance, strong capital positions, and only isolated asset quality problems. However, a number of banks do report high concentrations in agricultural loans and other elements of higher risk. The FDIC is closely monitoring these risk indicators for further signs of deterioration. At the same time we are participating in banker outreach programs with FDIC-supervised institutions and encouraging bankers to work constructively with agricultural borrowers who are experiencing temporary setbacks.

In the longer term, low commodity prices may accelerate the trend toward fewer, but larger agricultural producers. This long-term trend has broader economic effects as well, including the ongoing and intensifying depopulation of rural America. Insured institutions operating in this environment may be forced to adapt to reduced loan demand and a diminished deposit base.

The remainder of this testimony will discuss these observations and conclusions in greater detail. First, it will discuss current agricultural conditions and the outlook for the future. Agricultural credit will be addressed next. The statement will then outline the

supervisory issues raised by agricultural lending. Finally, it will address some long-term challenges for smaller agricultural producers and lenders.

CURRENT AGRICULTURAL CONDITIONS AND OUTLOOK

Excessive supplies, weak demand, and a strong U.S. dollar sent commodity prices to their lowest levels in a decade. The United States Department of Agriculture (USDA) forecasts that farmers will face continued low prices in 1999. Corn, soybeans, and wheat prices are expected to decline by as much as 20 percent. Hog prices are expected to improve slightly but will remain below the cost of production for most small producers. The value of agricultural exports is forecast to decline for the second consecutive year in 1999. The USDA has forecast a decline in net farm income for 1999, marking the third consecutive year of declining net farm income from the record set in 1996.

While the USDA forecasts agricultural land prices to gain one and one-half percent during 1999, the depressed agricultural economy has begun to put downward pressure on land prices in selected areas. Typically, these areas have seen recent land price gains and are major production areas for commodities now under significant price pressure. The first evidence of this trend appeared in a second quarter 1998 survey of agricultural bankers by Federal Reserve Banks in Chicago, Minneapolis, and Kansas City. Farmland price weaknesses were reported in Iowa, Kansas, Nebraska, Montana and northeast North Dakota. A decline in value of irrigated cropland and ranchland also was reported in Missouri. This emerging downward trend in land prices in several states reflects an expectation of lower farm income for the near future. In addition, a decline in farmland values will weaken farm balance sheets.

Amidst these negative trends, costs of production declined in 1998, the first year-to-year reduction in costs since 1992. Lower costs of production are due to low interest rates, low fuel costs, and reduced fertilizer expenses. In addition, livestock producers are incurring lower feed costs. However, lower production expenses are only a small relief. There is significant variation in production expenses across the country and among producers. For some producers, commodity prices remain below the cost of production.

Further, many regions of the country experienced difficulties in 1998 due to severe weather. Texas and parts of Oklahoma and New Mexico endured drought conditions that damaged livestock, cotton, corn, and hay crops. Likewise, little precipitation and abnormally high temperatures affected cattle, cotton, corn, soybean and other crops in Arkansas, Louisiana, Mississippi, Alabama and Georgia.

Farm equipment manufacturers, including Deere & Co., Case Corp., and New Holland, reported weak demand for farm equipment in the fourth quarter of 1998 and warned that sales will suffer into next year. Manufacturers have moved quickly to reduce production of large tractors and combines in response to lower levels of demand. Both Deere & Co. and Case Corp. have announced the extension of temporary layoffs and

additional permanent layoffs. Case Corp. plans a restructuring that will include the closing of two plants.

AGRICULTURAL CREDIT

Farmers, in general, were in especially sound financial condition entering 1998 after posting record profits in 1996 and strong results in 1997. As a result, many have the financial wherewithal to withstand one or two years of poor performance. Yet, pockets of vulnerability to continuing low commodity prices exist. For example, farmers in North Dakota, Montana and northwest Minnesota are particularly susceptible to continuing low wheat prices that could force many farmers into bankruptcy. Farm banks in this area are already reporting elevated delinquency levels.

Banks active in agricultural lending typically do not immediately show the effects of one year, or even two consecutive years, of poor agricultural conditions. Delinquent or problem loans are generally "carried-over" into operating loans for the subsequent year. However, continued low commodity prices may impede farmers' ability to demonstrate adequate cash flow for operating loans needed to plant crops this spring. Inadequate cash flow may force banks to base lending decisions on the value of available collateral rather than cash flow. This may or may not be sufficient to support the required financing.

One recent study[1] of Iowa farmers concludes that persistent low commodity prices will lead to significant deterioration in the financial health of farms. The study simulated the continuation of 1998 commodity prices through a three-year period from 1998 to 2000. The analysis showed that if the current level of low prices persists through 2000, more than one-third of Iowa's farms would require financial restructuring or liquidation. The results of the study may be applicable to other parts of the Corn Belt where corn, soybeans, and hogs are primary commodities.

Farm debt was forecast to increase by 3 percent in 1998 to $170 billion and decline to $169 billion in 1999. Growth in farm debt has been moderate with farm debt in 1997 remaining below the peak of $193 billion in 1984. According to the USDA, commercial banks remain the largest creditor to farmers (see chart on following page). Commercial banks provided 40 percent of total farm credit in 1997. Forecasts indicate that this percentage will increase slightly to 41 percent in 1998 and 1999. Despite this dominance in market share, commercial banks are experiencing strong competition for agricultural loans. Resurgence in lending activity in the Farm Credit System since 1994 and loans provided by other nonbank lenders[2] have provided stiff competition for commercial banks.

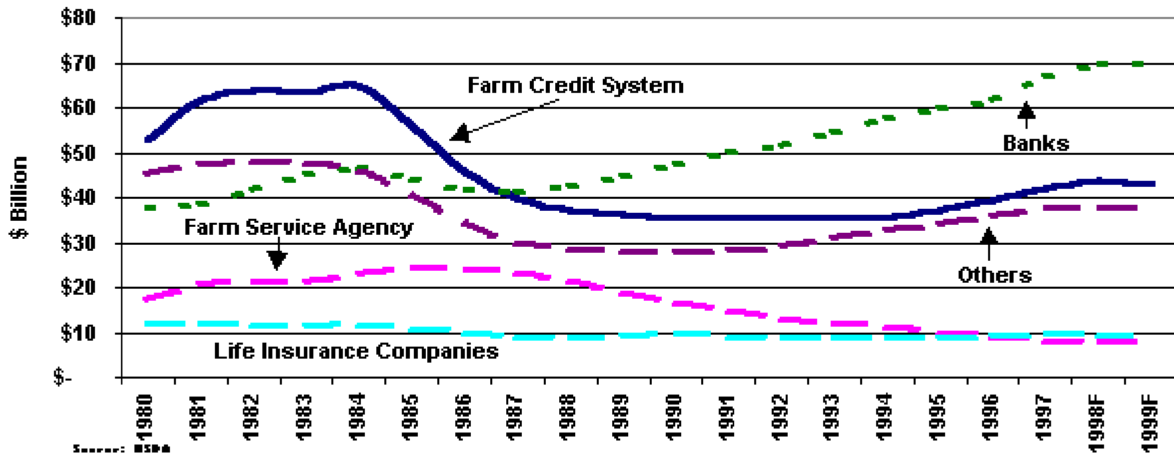


Figure 1

FDIC-insured institutions reported $77.6 billion in direct agricultural loans outstanding as of September 30, 1998. These loans were spread among 7,586 institutions. Nearly two-thirds of total agricultural loans were related to production, while the remaining third represented agricultural real estate loans. From year-end 1988 through the third quarter of 1998, insured institutions' agricultural loans grew 70 percent compared to overall loan growth of 31 percent.

The number of farm banks (defined as those insured institutions with agricultural loans exceeding 25 percent of total loans) totaled 2,371 as of September 30, 1998. These farm banks held agricultural loans totaling $33.8 billion, or 44 percent of total agricultural loans reported by insured institutions. Aggregate farm-bank assets totaled $125 billion, equaling just 2 percent of the nation's banking assets. The average farm bank had total assets of just $53 million.

Most agricultural financing is held by larger, more diversified, financial institutions. Insured institutions that make agricultural loans, but do not meet the threshold definition of a farm bank, held agricultural loans totaling $43.8 billion, or 56 percent of total agricultural loans. Seventy-eight of the top 100 insured institutions in terms of dollar volume of agricultural loans outstanding do not meet the definition of a farm bank. Loan portfolios at these institutions are more diversified compared to farm banks. California, in particular, has a number of large institutions that despite substantial agricultural loan portfolios, are not particularly susceptible to problems in agriculture because their agricultural lending is a relatively small part of a more diversified loan portfolio. Also, the California economy is more diverse and less reliant on the agricultural sector than other regions.

Many farm banks have high agricultural loan concentration levels The table below depicts agricultural loan concentration as a percent of Tier 1 capital.[3] Over 900 banks

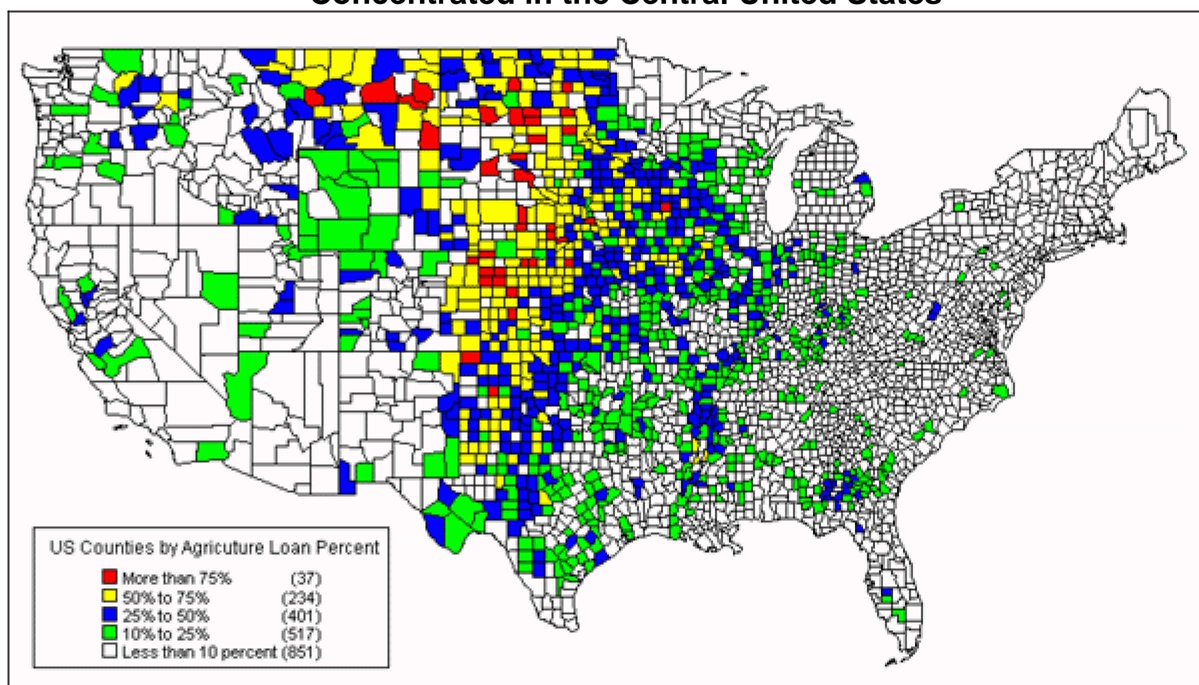
with total assets of $48 billion reported over 300 percent of Tier 1 capital invested in agricultural loans.

Many Farm Banks Have Significant Concentrations In Agricultural Loans		
Agricultural Loans To Tier 1 Capital	**Number of Banks**	**Total Assets (millions)**
Greater Than 300%	916	$47,762
200% to 300%	679	38,013
100% to 200%	613	32,061
Less Than 100%	163	7,365

Source: Call Reports, September 30, 1998. Reports of Examination.

Farm banks are spread among 35 states, but the majority of these banks are concentrated in the central portion of the United States. Ten states[4] serve as headquarters to 1,934 farm banks, or 82 percent of the nation's total number of farm banks. The shaded areas on the following map depict those counties where exposure to agricultural loans is high.

Bank Exposure to Agricultural Loans is Concentrated in the Central United States



Source: Bank Call Reports, September 30, 1998.

On the whole, farm banks thus far have maintained profitability despite competitive pressures and declining crop prices. Farm banks reported return on assets of 1.3 percent in the third quarter of 1998. The aggregate net interest margin was 4.3 percent compared to 4.7 percent at other small nonfarm banks. The narrower margin may reflect the strong competition farm banks face from other nonbank competitors. However, the trend in farm bank net interest margin has been steady and does not indicate any significant margin erosion over the past twelve quarters. Farm banks, as a group, maintain tight overhead expense controls: noninterest expenses as a percent of earning assets measured only 3 percent compared to 4.6 percent at other small nonfarm banks. Farm banks generate modest noninterest or fee income. This suggests that farm banks are very narrowly focused on traditional lending and have few alternative revenue sources to bolster earnings performance. This is in contrast to many larger banks and some smaller nonfarm banks that have expanded revenue sources by delivering fee generating products and services.

The average Tier 1 capital ratio (Tier 1 capital as a percent of average total assets) for farm banks of 10.6 percent has been stable over the past twelve quarters. This ratio is substantially higher than the national average for all insured institutions of 7.8 percent, but is similar to other small nonfarm banks. Reported asset quality at farm banks remains strong. Loan charge-offs and total past due loan levels have been relatively stable over the past twelve quarters. The current level of charge-offs to total loans is less than 0.25 percent and is just over one-third of the national average. Significant growth in agricultural loans may be straining liquidity among farm banks. In aggregate, farm banks' loan-to-deposit ratio equaled 72 percent as of September 30, 1998, compared to just 53 percent at year-end 1990. Further, there are a number of farm banks with significantly higher loan-to-deposit ratios. Over 630 farm banks had loan-to-deposit ratios greater than 80 percent.

In spite of these overall positive results, some farm banks have characteristics associated with elements of higher risk. These institutions may be exposed to greater financial difficulty should stress in the agricultural industry continue over a sustained period. The table on the following page shows the current risk areas associated with farm banks.

Farm Banks Exhibiting Selected Risk Elements		
Risk Element	Number of Banks	Total Assets(millions)
Unprofitable Farm Banks	50	$1,763
Tier 1 Capital Ratio < 6.0%	14	538
Past Due Loans/Total Loans Ratio >10%	44	1,486

Loan-to-Deposit Ratio > 80% And Agricultural Loans/Total Loans > 50 %	637 286	37,597 13,175
Loan-to-Deposit Ratio > 90% And Agricultural Loans/Total Loans > 50%	185 92	10,718 4,363
CAMELS Rating 3, 4, or 5	93	4,958
Source: Call Reports, September 30, 1998. Reports of Examination		

SUPERVISORY ISSUES

Through the examination process, collection of financial data, and underwriting surveys prepared by examiners, we have observed recent increases in agricultural carryover debt, past due loans, and adverse classifications at some FDIC-supervised institutions. In light of USDA forecasts that reflect declining prices for various livestock and grain, we are closely tracking these risk indicators and other emerging problems in the agricultural sector. Problems, however, have not yet risen to a level that is cause for critical concern.

The FDIC recognizes that the effects of such external factors on agricultural borrowers are often transitory. The FDIC Manual of Examination Policies provide standing instructions for FDIC examiners to show flexibility when reviewing agricultural loans temporarily affected by economic or weather-related events. Examiners are instructed to recognize that prudent efforts by financial institutions to work with these borrowers are consistent with safe and sound financial institution practices and are in the public interest. The FDIC also issues periodic Financial Institution Letters ("FIL"s) to address specific problems. For example, in August 1998, the FDIC issued a FIL to all FDIC-supervised institutions in Texas and Oklahoma to encourage those institutions to work constructively with agricultural borrowers hurt by the drought that affected much of their states. In addition, emerging problems in the agricultural sector are tracked closely and noted in quarterly publications provided to our examiners. Much of the information is also available on the FDIC's Internet web site.

LONG-TERM PERSPECTIVE

Lower commodity prices will intensify the long-range trend in agribusiness toward fewer, but larger producers. The hog market in 1998 provides a telling example of the impact of low prices on the long-term structure of agriculture. Modern large-scale producers have achieved lower costs of production through technological and managerial innovation. These operators, who continue to produce at high volumes to realize economies of scale, are better able to weather periods of low prices. Smaller producers typically lack the resources to achieve the lower costs necessary to survive

in an extended down market. Although the pork industry as a whole will continue to expand production, increasing numbers of smaller hog producers could continue to be forced out of the industry. While these economies of scale may not be replicated to the same extent among other commodities like crops, the general trend is toward consolidation among producers.

Long-term trends in agriculture have broader economic effects as well. An ongoing and intensifying trend affecting rural America -- primarily the Great Plains region -- has been rural depopulation. This demographic trend is a result of consolidation and technological advancement in agriculture. A great majority of geographically isolated, farm-dependent counties have lost population and remain susceptible to further population erosion. The immediate consequences of rural depopulation include skewed age profiles, real or perceived negative attitudes toward local investment, and weakening links between agriculture and the local economy.

These long-term trends in agribusiness and rural communities affect local commercial banks as well. Larger farms rely less on the local economy for all inputs, including financing. Smaller community banks may face a decline in loan demand and greater competition from nonlocal banks and nontraditional lenders. Big agribusiness operations will require larger loans and banks will need to acquire more specialized expertise to market and manage agricultural loan portfolios. Banks in counties with declining populations may have difficulty maintaining an adequate deposit base. Reductions in deposits, especially those from local farmers and business owners, resulting from households leaving the area or selling the family business may present challenges to local banks seeking viable lower-cost local funding sources.

CONCLUSION

Several successive years of low prices and poor production in parts of Minnesota, Montana and North Dakota have caused a decline in asset quality for farm banks located in those states. Continued low wheat prices that are forecasted for 1999 would further distress farm borrowers and lead to increased asset quality problems for farm banks in those states.

Most farm banks elsewhere are entering 1999 in good financial condition. However, a continuation of low commodity prices in 1999 and 2000 would stress farm borrowers and may lead to more asset quality problems in farm banks throughout the country. The FDIC will continue to encourage financial institutions to work constructively with agricultural borrowers in financial distress and has issued standing instructions to examiners to recognize that prudent efforts by financial institutions to work with borrowers experiencing temporary setbacks are consistent with safe and sound financial institution practices.

FOOTNOTES

[1]Jolley, R.W. and A. Vontalge. "How Many Iowa Commercial Farm Businesses Will Survive Until 2000?" Iowa State University. September 20, 1998.
[2] Other nonbank lenders include input suppliers like feed, seed, and chemical suppliers and farm implement dealers.
[3] Tier 1 (core) capital includes: common equity plus noncumulative perpetual preferred stock plus minority interests in consolidated subsidiaries less goodwill and other ineligible intangible assets. The amount of eligible intangibles (including mortgage servicing rights) included in core capital is limited in accordance with supervisory capital regulations.
[4] The ten states with the largest number of farm banks are Iowa (340), Nebraska (266), Minnesota (250), Illinois (245), Kansas (242), Texas (180), Missouri (119), Oklahoma (113), North Dakota (102) and South Dakota (77).

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