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**STATEMENT BY
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I appreciate the opportunity to appear before this committee to discuss the current difficulties being experienced by banks in our agricultural communities. As members of this Committee are well aware, these problems have been intensifying lately, as more farmers have been finding it difficult, if not impossible, to meet fully the contractual terms of their loan obligations.

The origin of these problems can be traced to the 1970s. Our farm sector experienced a major economic boom during that decade, and many farmers expected the good times to continue in the 1980s. There was, in particular, a general perception that there were limits on potential world production of agricultural products and that this would continue to encourage a rapid growth in farm exports, thus fostering increasing returns to land and other farm inputs. Many also believed the more rapid inflation of the decade would persist, so that long-term indebtedness could be paid off with less valuable future dollars. Acting on these expectations, farmers and other investors acquired additional farm land, bidding up its price in the process. Farmers also invested heavily in new machinery and equipment. Moreover, in view of the apparently favorable outlook for agriculture and, for most of the decade, of interest rates that were low relative to the expected rise in income and asset prices, many thought it advantageous to finance a relatively large share of these investments with borrowed money. Consequently, farm indebtedness surged, rising, after allowance for inflation, about 60 percent from 1971 to 1979.

As it turned out, however, the agricultural boom of the 1970s gave way to a bust in the 1980s. The high farm prices of the 1970s attracted additional resources into agriculture both here and abroad, so that by the start of this decade, the potential for farm production had increased considerably. At the same time, growth in demand for American agricultural products weakened. Farm exports in particular have been reduced by sluggish economic conditions abroad and the high exchange value

of the U.S. dollar, as well as by the expanded ability of other nations to meet consumption needs from their own internal production. These market developments have kept farm prices persistently depressed. As a result, farm income has been low for five years in a row, and land values have been declining since 1981.

Farm debt, though no longer increasing, still is high; and interest rates on farm loans, while down from earlier levels, remain well above those prevailing in the last decade when much of the debt was incurred. Thus, many farmers are faced with the problem of servicing a large volume of debt, at relatively high interest rates, with a substantially reduced level of farm earnings. High interest rates and reduced income flows also have added to the downward pressure on land values, thus further limiting the farmers' ability to pay down debt by selling these assets.

The earnings of all farmers have been adversely affected by lower product prices, but not all are experiencing the same degree of financial stress. Farmers that are relatively debt-free have suffered declines in asset values but are not in danger of falling into insolvency. In contrast, producers who entered the 1980s with only a relatively small equity cushion have been experiencing increasing financial difficulties. Estimates indicate that perhaps a third of the full-time producers on commercial-sized family farms have debt burdens large enough to cause moderate to severe financial stress, and this group owes about two-thirds of all farm debt. The greater proportion of this debt is owed to the Farm Credit System, the Farmers Home Administration and individuals. Nonetheless, about one quarter of total farm credit is provided by commercial banks, and a sizable proportion of the farm loan portfolios of many banks have become troubled to a greater or lesser degree.

Commercial banks experienced only minimal problems in their farm loan portfolios during the 1970s. Such problems began to pick up in 1981 and have been increasing steadily since then. One indication of the deterioration in the quality of

agricultural loans at banks that has occurred since then is provided by data on delinquencies and charge-offs. While not all banks are required to report such data for their farm loans, from available information our staff estimates that at the end of 1984 nonaccrual farm production loans at all banks in the nation totaled about \$1.5 billion, and other nonperforming loans--those past due 90 days or more but still accruing interest, plus renegotiated troubled loans--totaled about \$0.5 billion. In addition, about \$1.0 billion of farm production loans were past due 30 to 89 days. Altogether these poor performing and nonperforming loans constituted about 7-1/2 percent of all farm production loans.

In addition, net charge-offs of farm loans at all commercial banks are estimated to have been about \$900 million in 1984, or a bit more than 2 percent of outstandings. Of this total, \$240 million was reported by banks in California, representing about 6 percent of their outstanding farm loans. While California banks led the nation in charge-offs, these losses presented less of a problem for them than for banks in many other states. This was because most of the losses were booked by major banks with large branching systems, where agricultural loans constituted a relatively small proportion of their total asset portfolios. In contrast, many banks operating in agricultural areas of states that limit branching--states found mainly in the midwest--have had more trouble accommodating to their loan losses because of the high concentration of these loans in their asset portfolios.

Last year's high charge-offs and an increase in provision of loan loss reserves had a marked depressing effect on the profitability of many agricultural banks (banks at which the ratio of farm loans to total loans exceeds the average of such ratios at all banks, currently about 17 percent). On average, returns on equity fell to 9 percent, down from returns averaging between 14 and 16 percent in every year from 1973 through 1982. There was great variation in earnings recorded among

agricultural banks, however, mainly reflecting a sharp difference in loan loss experience. Thus, 12 percent of these banks reported negative earnings last year, and another 9 percent recorded only minimal positive earnings. At the same time, over half earned over 10 percent on equity, and nearly a fifth over 15 percent.

In the aggregate, earnings of agricultural bank were high enough to permit a further buildup in the average capital ratio of these banks, and the capital ratios of most agricultural banks remain high relative to those at nonfarm banks. But more farm banks seem certain to come under financial strain, if farm loan losses continue and intensify. Moreover, as I have noted, a small but troubling number of farm banks experiencing relatively high loan losses have already suffered an erosion of their capital base, thus increasing their vulnerability to failure should such losses continue.

Such extremely adverse results have been occurring in small but increasing numbers. Last year, 32 agricultural banks failed--mostly in the second half of the year--compared with only 7 in 1983. Many of these banks came from a group that had reported delinquent loans at the beginning of the year in excess of the capital of the bank. Unfortunately, the number of agricultural banks in this condition, while still a relatively small proportion of the 5,000 agricultural banks, rose further during 1984. At 102 agricultural banks, nonperforming loans at the beginning of this year exceeded total capital, up from 44 a year earlier. Moreover, at 240 agricultural banks, the combined sum of past due and nonperforming loans exceeded total capital, up from 133 a year earlier. Thus agricultural bank failures seem likely to rise further in 1985--indeed 17 farm bank failures already have occurred.

To sum up the current situation, while the incomes of the great bulk of our farmers have been reduced since the beginning of this decade, those that got heavily into debt in the 1970s are primarily the ones experiencing serious financial strains, with the severity of these strains increasing with the degree of their leveraging. While

such farmers constitute only about one-third of all farmers, they account for about two-thirds of all agricultural debt. As many of these borrowers have found it increasingly difficult to service their loans, banks and other agricultural lenders have been encountering increasing problems. To date, information suggests that the great majority of farm banks remain in good condition despite these problems, but a significant and growing number is experiencing an increasing degree of strain.

That so many of our farm banks remain in relatively strong condition after five years of depressed conditions in the agricultural sector stands, I believe, as a tribute to their management. What this rather clearly suggests is that these banks generally followed prudent standards in extending credit to their farm customers during the boom times of the 1970s, standards which tended to hold down the degree of leveraging permitted individual customers--and in the process helped to dampen tendencies for these customers to become over extended. In addition, many farm banks followed policies that permitted them to maintain reasonably diversified asset portfolios.

Banks that failed to adhere to high standards of quality and asset diversity have been considerably more vulnerable to the effects of deteriorating circumstances of agricultural borrowers. One can point to situations in which a bank that is failing or in extremely troubled condition is located in close proximity to one or more other banks that remain in good condition. In addition, I understand that the FDIC, in a study it conducted of the banks that failed in 1984, found evidence of various kinds of abusive practices, including improper insider transactions, instances of possible fraud, and other forms of irregular management activities.

The management policies and practices of banks, of course, tend to vary along a continuum. Thus, the longer conditions in the agricultural sector remain depressed, the greater will be the number of banks experiencing problems of greater

severity. As I have noted, that process is already quite observable in the trends of recent years. Since no dramatic change appears likely in the current balance between supply and demand in agricultural markets, such trends seem almost certain to continue for some time to come. Put more directly and graphically, it seems quite possible that many more agricultural banks and their farmer customers will experience severe financial dislocations over the next several years. I should hasten to add that at present it still appears that the great bulk of farmers and of farm banks have sufficient financial strength to weather these conditions, although admittedly not without growing strains and problems.

The debt adjustment program, first announced by the Administration last September and then modified in March, will offer farm banks and their farmer customers some assistance in moving through the difficult transition period that appears to lie ahead. As Committee members know, under this program the government will guarantee most of the remainder of a troubled farm loan after the lender reduces the principal amount (or an equivalent in interest charges) 10 percent or more as needed to reduce the borrower's debt service burden to a level that he appears able to handle. As of April 15, the Farmers Home Administration had received only 401 applications for such guarantees, and had guaranteed 129 loans totaling \$19.5 million. The flow of applications has been increasing gradually since the program was revised on March 13, however, and it seems quite reasonable to expect banks and their farm customers to make greater use of these guarantees, if problems in the agricultural sector persist. I understand also that the Farmers Home Administration, under its regular loan guarantee program, this year has guaranteed a substantially larger volume of farm operating loans than in preceding years.

The Federal Reserve also revised and extended its seasonal lending program in March of this year with the objective of making sure that agricultural

banks will have sufficient liquidity to provide needed production loans to their farmer customers. The regular seasonal program, in place since 1973, provides discount window credit to depository institutions with limited access to national money markets that experience recurring seasonal swings in net needs for funds because of the way their deposit flows fluctuate relative to their loan demands. This existing program was liberalized to increase the portion of the seasonal funding needs that the Federal Reserve stands ready to supply to small and mid-sized institutions. In addition, a temporary simplified seasonal program has been established as an alternative source of seasonal credit. Aimed particularly at smaller banks substantially involved in agricultural lending, this program offers institutions with total loan growth above a base amount of two percent the opportunity to fund half of any further loan expansion through discount window loans, up to a maximum amount of five percent of the institution's total deposits.

In announcing the broadening of its seasonal credit program, the Federal Reserve noted that there were few if any signs to indicate that agricultural banks generally would experience any unusual shortfall of liquidity. The action was taken, nevertheless, to have in place a means to offset any unforeseen liquidity strains that might arise in local areas or for individual banks, thus threatening the necessary flow of credit to farmers. Thus far, total borrowing in our seasonal program has been running somewhat below last year's levels. But seasonal credit needs normally continue to expand through the spring and summer and may yet begin to outpace the available liquidity of some farm banks.

The Federal Reserve, as well as the other federal banking agencies, has also recently reiterated its policy of instructing bank examiners to refrain from taking supervisory actions that would discourage banks from exercising appropriate forbearance when working with farmers or other small businesses with delinquent

loans. It is not the intent of this policy to encourage or permit loan decisions that are inconsistent with a bank's long term safety and soundness. The policy recognizes, however, that if there is good reason to believe a borrower's difficulties are temporary in nature, it is prudent banking policy to extend due dates on his loans, and in some cases to grant additional credit to carry him over a period of distress. Reserve Banks have designated senior review examiners with expertise in supervising farm banks to oversee the administration of this policy.

Mr. Chairman, I was asked to comment today on another proposal for assisting troubled agricultural lenders. Legislation has been introduced that would extend the Net Worth Assistance Program--currently targeted to provide assistance to real estate lenders with low capital and weak earnings--to farm banks. Under this proposed program, the FDIC would stand ready to swap its promissory notes for the net worth certificates of those farm lenders whose capital positions have fallen significantly below regulatory standards and have suffered negative earnings in two preceding quarters. The swap is supposed to be reversed when the institution regains its health. While no new funds or permanent capital are provided by this program, it would permit an institution to continue operating with a level of stock holder equity below that which regulatory agencies ordinarily require. In addition, since the FDIC's promise would be a general asset of the bank and thus available to meet the demands of depositors and other creditors in the event the bank is liquidated, it would provide some reassurance to the holders of uninsured liabilities of troubled banks.

At present, the coverage of this proposed program would be quite limited, since the vast majority of farm banks remain well capitalized and have positive earnings. Moreover, while the number of banks that would be eligible for the program seems likely to grow, there are other important drawbacks to be considered. As presently formulated, the program would provide aid to a bank regardless of whether

its problems are temporary or permanent in nature. If the latter, a clearly better approach would be to achieve an immediate shift of its resources to a healthy, better run institution. In addition, in cases where significant loan losses must be taken and capital is thus eroded, it would be better for an institution's capital base to be augmented with new permanent funding sources, rather than with temporary accounting capital that would have to be replaced over time by the retention of future earnings.

Taking these points into consideration, I can see relatively little long-term advantage in the net worth assistance proposal, barring a further substantial deterioration in the condition of farm banks that reaches systemic proportions. Presently, in cases where loan losses prove enough to undermine seriously a banks' capital position, I would think it better to encourage and facilitate mergers with stronger banking institutions, particularly those that are not now so heavily involved in agricultural lending. That would offer several important advantages. First, it would transfer control of the institution's lending resources to a bank with a better management record. Second, it would provide an infusion of real, permanent capital into the bank and thus into agricultural lending in general, rather than a temporary provision of "accounting" capital as would occur with NWA certificates. Finally, mergers with banks outside the community of agricultural banks would promote greater diversification of portfolio risk. In this way, the banking system would come to be better protected against unforeseen developments that, from time to time, adversely affect the financial health of different sectors of the economy.

There is no doubt that the agricultural sector has been going through some very hard times because of unanticipated weakness in farm product markets that will no longer support the built-in structure of high indebtedness. Many banks that have concentrated their lending in the farm area thus are encountering difficulty because of the inability of farmers to service their debts, and it may be that more will be driven

to the point of bankruptcy. But, as I see it, the best way to deal with an erosion of capital is to obtain replacement funds from present or prospective bank owners. And where the bank's problems appear too severe and fundamental to handle in this manner, the best solution is to seek mergers with other institutions that promise a larger, more stable, lending and deposit base.