Managing Risk in the Texas Panhandle

by B.A. Donelson

First State Bank is an agricultural bank located in Stratford, Texas, a town of about 1,800 people, situated in the Texas Panhandle. It has $61 million in assets and loans totaling more than $33 million. These loans are primarily for pasture cattle and farming operations. The bank has a history of a strong capital position and a good earnings record.

The area has considerable grass and wheat pasture for cattle. Our trade area runs from the upper Texas Panhandle and extends into New Mexico, Colorado, Kansas and Oklahoma. We define it as being any place we can drive to make an inspection and return home the same day. This is a big area and to have customers over this wide an expanse is not unusual for banks like ours.

We currently are financing our largest number of cows since the early fifties. There are a limited number of cow-calf operations and most of these would be considered a sideline to the overall operation of our customers.

Sherman County is in the heart of the cattle feeding industry. Within 20 miles of our bank there are some 300,000 cattle on feed at any given time. We also do a great deal of lending to irrigated and dryland farming operations.

We have seen a tremendous increase in the number of sprinkler operations in our trade territory which has significantly increased our loan volume. In the past four years we also have increased our farm real estate lending.

Dryland crops consist mostly of wheat with some milo; dryland corn has been grown on a trial basis over the past couple of years. Irrigated production consists of wheat, corn and some milo and seed. Approximately 95% of the irrigated summer crop grown by our customers at this time consists of corn either for grain or ensilage.

Our most unusual product for the area might be our Trust Department. The Trust Department has $17 million in assets, of which a large portion is made up of land we manage. This land totals approximately 30 thousand acres located in the Oklahoma and the Texas Panhandle.

Experienced Personnel

It has been a mission of our bank to make a profit while maintaining safety and soundness for our customers. We think one of the keys to being profitable is maintaining employees that have good educational backgrounds and a length of service that allows stability for our customers. Among our lending officers we have one with 30 years of experience, one with 25 years, one with 20 years and two with approximately nine years of experience each. We feel this has contributed to our effort to remain profitable and make sound decisions. We also feel it is very important to have a familiar face for the customers when they come into the bank to make loan arrangements.

Risk Management

One concern we have is interest rate risk. Not only from an income position but also from a capital standpoint. We have attempted to maintain this risk in a manageable position and felt it was important for us to go outside for additional help. We use the GENOA management firm from Dallas and they have served us well.

Another major business risk we have comes in the form of loan quality. Agricultural loans are very cyclical and because of that we see lots of peaks and valleys. Generally between wheat, sorghum, corn

B.A. Donelson is president and CEO of First State Bank, Stratford, Texas.

and cattle, two of the four usually will be profitable. Unfortunately, this year (1994) may be the exception because cattle have not done well. We also have had one of our poorer wheat crops and are very concerned about our corn and milo crops.

To manage these risks, we feel we must start with good operators. We have many customers who are progressive and who make the changes necessary to keep up with the times. In order to supplement management, we realize the need to have good, consistent collateral equity in those cattle loans. Our goal is to maintain 25% equity in our customers' operations. We currently are seeing the value of having had those margins. Although our watch list is up significantly, we believe that for the most part, even with the kind of cattle market we've had, we are going to have very little fallout in terms of customer loss.

Using Futures Markets

Along with good management and proper margins, we think the opportunity to use commodity futures is one of the most important tools our customers have. In the cattle business, as we have seen this past spring, there have been tremendous swings in the market. If our customer is aware of these markets and how to use them, we think he or she has a good opportunity for profits. Even though we have some customers who are reluctant to use commodity futures, we really try to emphasize to them that they should be aware of what the market is like and what their opportunities are.

We encourage our reluctant marketers to buy at least one contract, actually do a trade, follow it through and see what happens. We feel that getting their feet wet in the futures markets will increase their comfort level.

Our customers have a good opportunity to protect themselves by using both the hedging and options contracts. We do ask that if we are going to fund their margin calls that we take a lien on the margin account and that we fund the account from the bank. We are not interested in funding Texas hedges.

The bank has sponsored a few seminars and helped with some outside meetings and dealings with the commodity markets. This has been very helpful to everyone. Unfortunately, to a great degree, you wind up preaching to the choir, but we see that the ability to use these markets has really spread through our customer base over the past five years.

Marketing Plans

Management is paramount in crop marketing. Along with this we feel a good marketing plan is very helpful. We have had individuals such as Dr. Art Barnaby, an Agricultural Economist from Kansas State University, come and conduct sessions for our customers. It is harder to get the crop producer to utilize hedging and options contracts because there are so many variables in production. However, as we have reviewed our customers' history with them over the past few years, we believe they are more aware that the production risk is not as much as the marketing risk. It is my understanding that this year approximately 70% of our grain crop is marketed in either forward contracts or hedges and options.

The Role of Crop Insurance

We feel insurance has to be part of the crop management program. We ask that all dryland farms be covered by federal crop insurance. It has been very helpful, but unfortunately there have been abuses by people who are planting for the insurance and that is creating a problem for all of us. We personally think an improved federal crop insurance program could be beneficial and our trade associations, the American Bankers Association and the Independent Bankers Association of America have lobbied in support of crop insurance reform legislation. We feel it is problematic when customers who purchase federal crop insurance end up with less than those who decide not to purchase it. Those who don't participate hope for some ad hoc disaster program, which they usually get, and in addition receive more benefit than the federal crop participant. We hope the program will be changed to benefit the individual who is a solid participant.

We do ask that our irrigation farm customers cover their crops against hail losses. Many of them are using FCIC as the basis for their insurance and covering additional dollars on top of that by what we call "piggybacking" the insurance. They are saving significant dollars and really guaranteeing themselves against the all-inclusive wipe out.

Crop insurance is not very popular with customers, but as we continue to see significant losses, it appears the insurance has to be included as part of the production cost. We would anticipate that virtually all our customers carry at least their production cost in coverage.

Regulating Commodity Futures

I think it would be best if there could be less regulation of commodity trading. I know there is a perception that the cattle futures market is manipulated by packers owning too much of the live cattle market. I think positions held by hedge funds and commodity funds have a negative impact. Besides the perceived manipulation of the market, maybe the fact that producers are wary of using these markets leaves them open to more exposure. If there was any way these funds could be controlled privately it would be helpful in restoring the confidence of the producer.

Risk Management's Importance

Our risk management program helps our producers by leveling out the rough spots whether it be cattle or farming. The margins are so thin it is almost impossible for a producer to come back from a major disaster or loss. Years ago when I began in ag lending, you didn't worry quite so much because it was possible to make up a loss in one year. At this time it is extremely difficult, and consequently, we must take out the valleys and try to ensure a stream of constant income.

If we are able to stabilize the producers income, he is going to be a more consistent purchaser of goods, services and equipment. This also benefits consumers by ensuring less volatility in the prices of agricultural products since there will be underlying stability in the capacity of farmers to purchase production inputs.

Having a risk management plan, even if not a formally written one, certainly has to be a part of good management practice. We do have instances where we make loans without a hedging plan, especially with cattle. Even with crops we feel like there are certain times the customer is strong enough and has enough other assets that we have no need to request a plan from that customer. Most of the good borrowers have already adapted some risk management plans of their own.

Continued Consolidation

Regarding agriculture's future, I would suggest that American agriculture will still see continued consolidation. As we are seeing consolidation in banking, there is an economy of scale that can be met in no other way. By consolidating, a single manager can market more crops and spread capital out over a larger number of acres. This will continue whether we like it or not. It is our feeling that where we might have $30 million in loans and 300 customers today, we will probably still have $30 million in loans but only half that number of customers 10 years from now.

Conclusion

We will continue to monitor our risk management program through crop insurance as well as through utilizing hedging and options contracts. We think providing continued education and a greater level of sophistication for our customers are the best ways to achieve that end. We will certainly continue to promote efforts to assist individuals and groups in coming to a greater knowledge of hedging and marketing. ▲