Farm Bank Performance During 1996

by Keith Leggett

Total agricultural credit expanded for the fourth consecutive year to $155.5 billion in 1996. Agricultural loans held by banks increased $2.5 billion to $61 billion. Despite this expansion in farm lending by banks, however, the industry's share of agricultural credit – 39% – declined for the first time since 1981.

The loss of market share does not seem to have adversely affected the financial performance of farm banks;[1] in fact, 1996 was another highly profitable year. Farm bank capital remained at high levels both in absolute dollar terms and as a percent of assets. Asset quality remained healthy despite problems in the livestock industry. In 1996, only two farm banks failed; since 1993 only five farm banks have failed.

Performance of Farm Banks

The nation's 3,247 farm banks had strong earnings in 1996 driven by increasing loan volume and lower operating costs. Farm banks earned a record $2 billion in 1996, $146 million higher than the amount earned in 1995. Farm banks reported a 1.22% return on average assets (ROA) in 1996. By comparison, the ROA reported by nonfarm banks[2] was 1.26 percent, and the nationwide average for all banks was 1.25 percent.

Increased competition for loans caused interest rates on both farm real estate and production loans to fall in 1996.[3] According to the ABA *1996 Farm Credit Situation Survey,* many farm banks have identified the resurgent Farm Credit System as their primary competitor. By arbitraging its government sponsored enterprise (GSE) status, the Farm Credit System is able to offer below market rates to attract new customers or maintain existing relationships. This means that farm banks must reduce their loan rates to remain competitive and to maintain their customer relationship.

Despite this decline in loan rates, farm banks maintained their net interest margins by primarily increasing their loan volume – net interest margins at farm banks declined only 7 basis points to 4.23% in 1996. By contrast, net interest margins at nonfarm banks dropped 10

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basis points to 4.52%. Banks nationwide reported an 11 basis point increase in net interest margins to 3.98% in 1996.

Balance Sheet Developments

Assets

Farm banks held $172 billion in total assets in 1996, up 7.6% from the previous year. Every major asset category experienced vigorous gains during the year except securities. Roughly 92% of farm banks' assets were earning assets in 1996.

Total loans at farm banks grew 10.2% during the year to $96.16 billion. Loans accounted for 56% of farm bank assets in 1996, up from 54.7% the previous year. On the other hand, the proportion of securities in their portfolios fell to 32.4% from 33.6% the year before. As a result of the robust loan growth, farm banks' loan-to-deposit ratio rose to 65.1% in 1996 from 60.4% in 1994.

This relatively high loan-to-deposit ratio at farm banks – coupled with continued strong loan demand – may lead to a situation where the demand for credit outpaces deposit growth and alternative funding sources. According to the ABA *1996 Farm Credit Situation Survey,* more than a quarter of the banks reported that deposits were not growing fast enough to meet loan demand.[4] Moreover, a large number of the farm banks surveyed indicated that they used nondeposit sources to meet liquidity or loanable funds needs – 81% used federal funds, 34% used advances from the Federal Home Loan Bank, and 19% used seasonal borrowings from the Federal Reserve Discount Window.

While the majority of the farm banks currently have the resources to meet the credit needs of their customers (particularly since a large portion of their securities and loans mature in less than one year and the vast majority in less than five years), if credit demand continues at its current pace, farm banks may face a shortage of loanable funds in the near future.

Loans

Loan growth was strong in 1996 as farm banks continued to shift their asset mix away from lower yielding securities toward higher yielding loans. Real estate loans expanded by 13.4% in 1996 to $45.9 billion, and C&I loans increased over 9.6% to $14.2 billion.

Agricultural loans, both for land purchases and production, rose 6.7% in 1996 to $34.7 billion, from $32.5 billion in 1995. Despite the growth in the dollar volume of agriculture loans outstanding, agricultural loans have steadily decreased as a percent of farm bank loan portfolios. In 1993, 38.8% of farm bank portfolios was held in agricultural loans; by year-end 1996, it had declined to 35.8 percent.

Loans to finance agricultural production rose 5% to $22.1 billion, up from $21.0 billion in 1995. Strong growth rates continued to be reported in farm loans backed by real estate, which rose 9.9% during the year to $12.6 billion. The rapid growth in this category is the result of increased use of land as *collateral* for agricultural loans, as only a very small portion of these loans are for land *purchases.*

Non-farm real estate lending at farm banks rose 14.8% in 1996 to $33.3 billion. Residential real estate loans grew 13.8% to $21.7 billion from $19 billion the previous year. Banks nationwide also reported increased demand for residential real estate loans.

Consumer loans at farm banks rose 8.8% in 1996 to $13 billion. Non-farm banks reported a 3.7% growth in loans to individuals, and all commercial banks reported 4.8 percent growth in loans to individuals.

Asset Quality

Asset quality remained favorable for all commercial banks during 1996. As of December 31, 1996, nonperforming assets plus OREOs stood at $73 billion or 1.6% of total assets, unchanged from a year before. Reserves for loan losses at $53.6 billion were 73.4% of nonperforming assets.

Farm banks reported that nonperforming assets plus OREOs increased $198 million to $1.1 billion, a 21% increase. The ratio of nonperforming assets to total loans was 1.1 percent, compared with 1% a year ago. Loan loss provisions increased 50.2% from $209.7 million in 1995 to $314.9 million in 1996. Total loan loss reserves – $1.5 billion at year-end 1996 – represented 142% of nonperforming loans compared with 163% at year-end 1995.

There have been some concerns that increased lending by all commercial banks may be compromising underwriting standards and hence increasing risk. The Federal Reserve's Senior Loan Officer Opinion Survey found some evidence that banks were easing their loan standards for commercial credit due to stiff competition from banks and nonbanks. The Federal Deposit Insurance Corporation found little evidence of lending by farm banks based upon artificially inflated land values, but about 10% of the institutions examined were identified as having unrealistic cash flow projections.[5]

Loans 90+ days past due – a good leading indicator of future credit problems – were 0.40% of total loans for farm banks, up only slightly from 0.35% a year ago. For all commercial banks, loans 90+ days past due also rose in 1996 to 0.36 percent.

Nonperforming Agricultural Loans

Nonperforming agricultural loans as a percent of total agricultural loans rose to 1.2% in 1996 from 1% in 1995. However, these increases in nonperforming agricultural loans are not a result of compromised underwriting standards; rather, they reflect weather-related problems, such as the drought in the Southern Plains, and sectorial weaknesses in the livestock industry. Farm banks also reported that $172.3 million in loans were restructured in 1996, down 2.4% from the previous year.

According to the ABA's *1996 Farm Credit Situation Survey,* farm banks reported that there was an overall improvement in the quality of the farm loan portfolio in 1996. Almost 50% of the banks reported an improvement in the overall quality of the farm loan portfolio for the last six months of 1996. This represents a 24% increase over the comparable period in 1995. Over the same time interval, the number of banks reporting a decline in the overall performance of the farm loan portfolio fell from 34% to 12.5%.

Loan Losses

Net loan charge-offs (charge-offs less recoveries) at farm banks reversed its earlier trend and expanded for the second consecutive year to $235.4 million from $154.9 million in 1995. Net charge-offs as a share of average loans at farm banks rose to 0.26% in 1996, up from 0.18% the year before. Net charge-offs of farm production loans to total net charge-offs increased to 0.62% in 1996 from 0.21% in 1995. Nationwide, net charge-offs as a percent of loans and leases for all banks increased to 0.58% from 0.49%.

Deposit Liabilities

Total deposit liabilities at farm banks rose 7.3% in 1996 to $148.3 billion. Reversing a trend, noninterest- bearing deposits grew at a faster rate in 1996 than interest- bearing deposits. Core deposits at farm banks increased $7.9 billion to $131.7 billion in 1996. By contrast, nonfarm banks and all commercial banks reported increases of 10.1% and 5.6% in deposits, respectively.

Approximately 18% of the farm banks reported a decline in their deposit base. The primary reasons cited were increased competition from mutual funds and other depository institutions. Those farm banks that reported an increase in deposits indicated that improvements in local economy was the principal cause.6

Capital

Equity capital-to-assets ratios increased for all banks nationwide in 1996. As has traditionally been the case, farm banks maintained a higher equity capital-to-assets ratio – 10.3% – than other banks in 1996. Total equity at farm banks rose 6.4% to $17.8 billion in 1996.

Nonfarm banks reported an equity capital-to-assets ratio of 9.8 percent, and for all commercial banks the ratio was 8.20% in 1996.

Income Statement

In 1996, farm banks reported that their net income increased $146 million to $2 billion, from $1.86 billion the previous year. As a result, ROA remained unchanged at 1.22 percent. However, return on equity (ROE) slipped 4 basis points to 11.67 percent. The decline in ROE can be attributed to the continued accumulation of equity capital at farm banks in 1996.

Interest Income and Interest Expense

Net interest income at farm banks increased 6.6% to $6.67 billion in 1996, compared to a 6% increase in 1995. Despite increased loan pricing pressures, net interest margins declined only 7 basis points to 4.23 as farm banks shifted their asset mix toward increased holdings of higher-yielding loan assets.

Noninterest Income and Noninterest Expense

Noninterest income at farm banks increased by 14% to $1.11 billion during 1996. Moreover, noninterest income as a percent of average assets increased 3 basis points to 0.67 percent. Fee income on deposit accounts stood at $607 million, and constituted the largest component of noninterest income for farm banks.

Farm banks continued to successfully contain their costs in 1996 – noninterest expense increased only 4.9% in 1996 to $4.58 billion. Noninterest expense as a percent of average assets fell from 2.9% in 1994 to 2.8% in 1996.

Farm banks' success in managing costs is reflected in their overhead or efficiency ratio, which is well below the industry norm. A low ratio is indicative of an efficient institution, since it measures how well a bank uses its earnings capacity. The efficiency ratio at farm banks stood at 2.67% in 1996, a slight improvement from the 2.74% ratio reported a year earlier, and well below the average ratio of 3.51% for banks nationwide.

Looking Forward

According to the USDA, net cash income for most farms specializing in crops and in most regions is expected to decline in 1997. However, net cash income is anticipated to increase for farms specializing in livestock.

Additionally, the 1996 farm legislation (Federal Agriculture Improvement and Reform (FAIR) Act) will potentially increase the volatility of the agricultural sector of the economy as the federal government sets aside 60 years of supply-management policies. This legislation may generate large revenue swings due to reductions in carryovers and the lack of government-carried stocks. While in the short-run the impact of the FAIR Act is viewed as minimal, the longer-term implications are not obvious.

Notes

[1] Farm banks are defined as commercial banks with assets less than $500 million whose ratio of domestic farm loans to total domestic loans exceeds the unweighted average of this ratio at all FDIC-insured commercial banks. This ratio stood at 16.23% in 1996, 16.62% in 1995, 16.29% in 1994, 16.59% in 1993, 16.63% in 1992, and 16.76% in 1991.

[2] Nonfarm banks are defined as commercial banks with assets less than $500 million whose ratio of farm loans to total loans is below the unweighted average of this ratio at all FDIC-insured commercial banks.

[3] In 1996, interest rates on new non-real estate loans fell by 100 basis points in 1996 and interest rates on real estate loans fell by 50 basis points. The interest rate on 10-year U.S. Treasury bonds declined by 13 basis points in 1996.

[4] About one out of three banks under $100 million in assets reported that deposit growth was not growing fast enough to keep up with loan demand.

[5] Federal Deposit Insurance Corporation, Report on Underwriting Practices, September 1996.

[6] 1996 Farm Credit Situation Survey, American Bankers Association. ▲