Farm Bank Performance During 1997

by Keith Leggett

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Total agricultural credit expanded for the fifth consecutive year to $162.2 billion in 1997. Agricultural loans held by banks increased to more than $64 billion for a 39.7 percent market share. In 12 of the past 13 years, banks have increased their market share of agricultural credit. According to USDA, in 1997, banks accounted for 45 percent of all new farm credit.

Farm banks[1] had another excellent year in 1997. Farm banks remained highly profitable; capital remained at high levels both in absolute dollar terms and as a percent of assets; and asset quality remained good. In 1997, only one farm bank failed, and only six farm banks have failed since 1993.

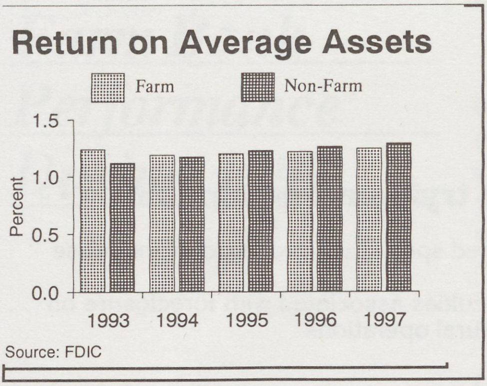
The following analysis compares the performance of the 3,095 farm banks in 1997 to the performance of the same set of institutions in previous years; with the performance of nonfarm banks;[2] as well as with the performance of the overall banking industry.

Performance of Farm Banks

The nation's 3,095 farm banks had strong earnings in 1997, driven by increasing loan volume, good interest rate spreads and low loan loss provi-

[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 16.22 percent in 1997, 16.23 percent in 1996, 16.62 percent in 1995, 16.29 percent in 1994, 16.59 percent in 1993, 16.63 percent in 1992, and 16.76 percent 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.

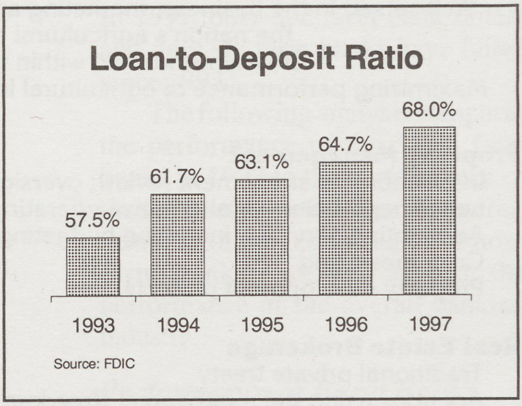


the previous year. Every major asset category experienced vigorous gains during the year except securities. More than 93 percent of farm banks' assets were earning assets in 1997.

Total loans at farm banks grew 13.1 percent during the year to $100.1 billion. Loans accounted for 58 percent of farm bank assets in 1997, up from 55.9 percent the previous year. On the other hand, securities fell to 30.4 percent of farm bank portfolios from 32.6 percent the year before. As a result of robust loan growth, farm banks' loan-

sioning. These banks earned a record $2.1 billion in 1997, $206 million higher than the amount earned in 1996. Farm banks reported a 1.25 percent return on average assets (ROA) in 1997. By comparison, the ROA for nonfarm banks was 1.29 percent, and the average for all banks was 1.23 percent.

Despite increased competition for loans,[3] net interest margins at farm banks increased 6 basis points to 4.29 percent in 1997 – reversing a trend of declining net interest margins over the previous four years. Net interest margins at nonfarm banks were virtually unchanged at 4.53 percent, and banks nationwide reported a 6 basis point decrease in net interest margins to 4.21 percent in 1997.



Balance Sheet Developments

Assets

Farm banks held $172 billion in total assets in 1997, up 8.4 percent from

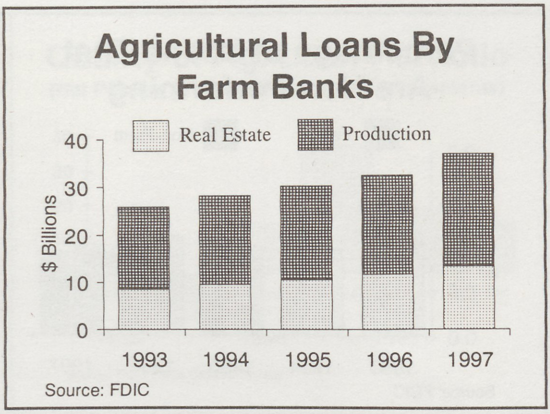
to-deposit ratio rose to 68 percent in 1997. As Figure 2 shows, loan-to-deposit ratios have increased steadily during the past five years.

The 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. Almost half (49 percent) of the banks that responded to the ABA 1997 Farm Credit Situation Survey reported that deposits were not growing fast enough to meet loan demand.[4] However, only 1 percent of responding banks re-

[3] According to the ABA 1997 Farm Credit Situation Survey, many farm banks have identified the resurgent Farm Credit System (FCS) as their main competitor. By arbitraging its government sponsored enterprise (GSE) status, the FCS is able to offer below-market rates to attract new customers or maintain existing relationships.

ported that they turned down creditworthy customers in the last 12 months because of the lack of loanable funds, and all of these institutions were smaller than $100 million in assets.

A large number of the farm banks surveyed indicated that they used nondeposit sources of funds to meet liquidity or loanable funds needs – 85 percent used federal funds, 45 percent used advances from the Federal Home Loan Bank (in 1996 only 33 percent of banks were using advances), 26 percent used repurchase agreements, and 19 percent used seasonal borrowings from the Federal Reserve Discount Window.



In sum, while the majority of farm banks currently have the resources to meet the credit needs of their customers, if credit demand continues at its current pace, these banks may face a shortage of loanable funds in the near future.

Loans

Loan growth was strong in 1997 as farm banks continued to shift their asset mix away from lower yielding securities toward higher yielding loans. Real estate loans expanded by 15 percent in 1997 to $47.8 billion, and C&I loans increased 12 percent to $14.5 billion.

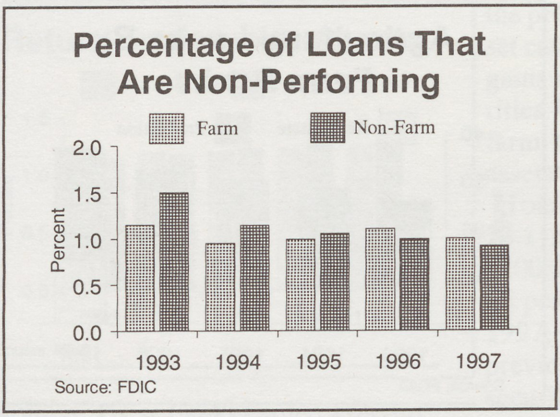
Agricultural loans, both for land purchases and production, rose 13.6 percent in 1997 to $36.7 billion, from $32.3 billion in 1996. But despite the growth in dollar volume, agricultural loans have steadily decreased as a percent of farm bank loan portfolios. In 1993, 39.4 percent of farm bank portfolios was held in agricultural loans; by year-end 1997, it had declined to 36.8 percent.

Loans to finance agricultural production rose 13.5 percent to $23.5 billion, up from $20.7 billion in 1996. Strong growth rates continued to be reported in farm loans backed by real estate, which rose 13.7 percent during the year to $13.2 billion. The rapid growth in this category is the result of increased use of land as *collateral* for agricultural loans; only a very small portion of these loans are for land *purchases*.

Nonfarm real estate lending at farm banks rose 15.5 percent in 1996 to $34.6 billion. Residential real estate loans grew 14.2 percent to $21.6 billion from $18.9 billion the previous year. Banks nationwide also reported increased demand for residential real estate loans.

Consumer loans at farm banks rose 6.7 percent in 1996 to $12.8 billion. Nonfarm banks also reported a 6.7 percent growth in loans to individuals, and all commercial banks re-

[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.



ported loans to individuals as unchanged.

Asset Quality

Asset quality at farm banks remained favorable in 1997. The ratio of nonperforming loans to total loans was 1 percent, compared with 1.1 percent a year ago. Loans 90+ days past due – a good leading indicator of future credit problems – were 0.35 percent of total loans for farm banks, down slightly from 0.40 percent a year ago. Farm banks also reported that $147.4 million in loans were restructured in 1997, down 8.8 percent from the previous year.

Loan loss provisions increased 10 percent from $301.2 million in 1996 to $332.1 million in 1997. Total loan loss reserves – $1.5 billion at year-end 1997 – represented 150 percent of nonperforming loans compared with 142 percent at year-end 1996.

The only cloud on the horizon was a 2.5 percent increase in the dollar volume of nonperforming assets plus OREOs, which rose to $1.2 billion in 1997.

Asset quality was also favorable for all commercial banks during 1997. As of Dec. 31, 1997, nonperforming assets plus OREOs stood at $33.7 billion or 0.67 percent of total assets, down from 0.76 percent a year before. Loans 90+ days past due also declined in 1997 to 0.33 percent. Reserves for loan losses at $54.7 billion were 162.4 percent of nonperforming assets.

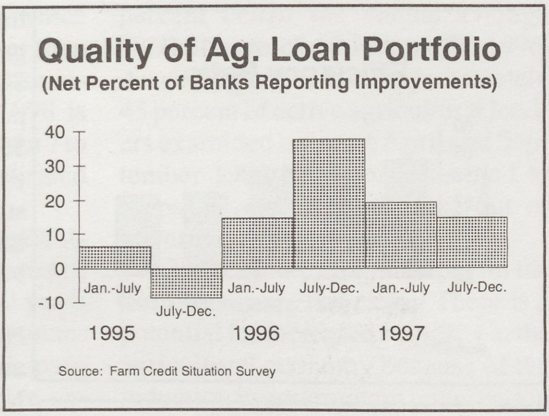
There have been some concerns that increased lending by all commercial banks may be compromising underwriting standards and hence increasing risk. The Federal Reserve's Senior Loan Officer Opinion Survey found some evidence that banks were easing their loan standards for commercial credit because of stiff competition from banks and nonbanks. However, the Office of the Comptroller of the Currency found that the lending standards for agricultural loans could be characterized as either conservative or moderate at 98 percent of the banks surveyed.

Nonperforming Agricultural Loans

Nonperforming agricultural loans declined $11 million to $280.4 million as of December 1997. As a percent of total agricultural loans, nonperforming agricultural loans fell to 1 percent in 1997 from 1.16 percent in 1996.

According to the ABA's 1997 Farm Credit Situation Survey, farm banks reported that there was an overall improvement in the quality of the farm loan portfolio in 1997. This marks the fourth consecutive six-month period during which farm banks reported net improvements in the condition of farm loan portfolios. Almost one-third of the banks reported an improvement in the overall quality of the farm loan portfolio for the last six months of 1997, while only about 18 percent of the banks indicated a deterioration.

One-quarter of the banks responding to the Farm Credit Situation Survey reported that farmers in their market area had run into financial difficulties due to their use of hedge-to-arrive contracts. About 7.5 percent of responding banks reported holding loans that may be at risk because of these contracts.



Loan Losses

Net loan charge-offs (charge-offs less recoveries) on the total loan portfolio at farm banks increased for the third consecutive year to $249 million from $230.8 million in 1996. Net charge-offs as a share of average loans at farm banks experienced a slight drop to 0.26 percent in 1997 from 0.27 percent the year before.

Net charge-offs of farm loans fell by $16.6 million to $45.5 million – a decline of approximately 27 percent. The decline in net charge-offs of farm loans reflects the continued improvement in the farm economy and in the asset quality of farm bank portfolios.

Deposit Liabilities

Total deposit liabilities at farm banks rose 7.6 percent in 1997 to $147.2 billion. By contrast, nonfarm banks and all commercial banks reported increases of 12.1 percent and 7 percent in deposits, respectively. Interest-bearing deposits grew more rapidly in 1997 than noninterest-bearing deposits. Core deposits at farm banks increased $7.7 billion to $129.1 billion in 1997.

In 1997, farm banks increased their reliance on brokered deposits as a source of funding. Brokered deposits grew by 41 percent to $821.2 million; however, brokered deposits account for less than 1 percent of total deposits.

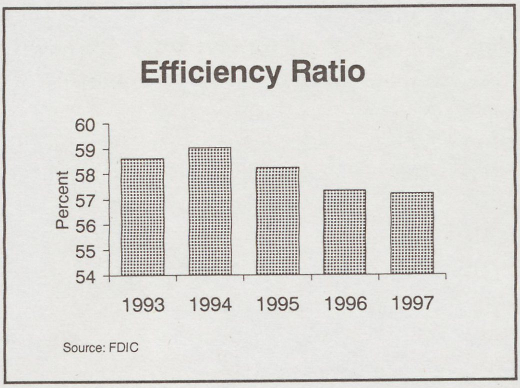
Approximately 24 percent of farm banks reported a decline in their deposit base in 1997, up from 18 percent in 1996. The primary reasons cited were increased competition from mutual funds and other depository institutions. Those farm banks that reported an increase in deposits indicated that a stronger local economy was the principal cause.[5]

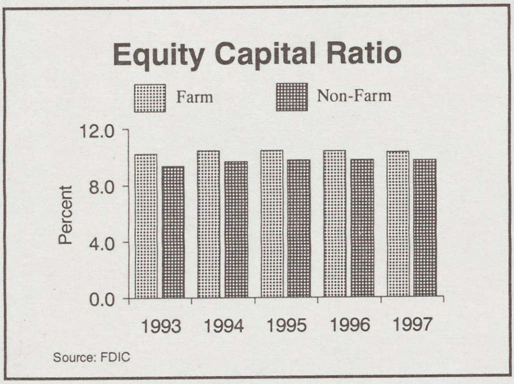
Capital

Total equity at farm banks rose 9.1 percent to $18.1 billion in 1997. As has traditionally been the case, farm banks maintained a higher equity capital-to-assets ratio than other banks – 10.3 percent in 1997. Nonfarm banks reported an equity capital-to-assets ratio of 9.7 percent, and for all commercial banks the ratio was 8.33 percent in 1997.

As of December 1997, all farm

[5] 1997 Farm Credit Situation Survey, American Bankers Association.





banks met the minimum requirements to be categorized as adequately capitalized, and 98.6 percent of farm banks are in the well-capitalized category.

Income Statement Developments

In 1997, farm banks reported that their net income increased $206 million to $2.05 billion. As a result, ROA increased to 1.25 percent. Return on equity (ROE) increased 31 basis points to 11.86 percent. The growth in ROE can be attributed to the increased use of leverage by farm banks and the growth in earning assets.

Interest Income and Interest Expense

Net interest income at farm banks increased 10.2 percent to $6.77 billion in 1997, compared with a 7 percent increase in 1996. Interest income grew by $1.1 billion in 1997 to $12.7 billion, while interest expense grew by $507 million to $5.9 billion. The favorable interest rate environment coupled with strong loan demand allowed net interest margins to grow by 6 basis points to 4.29 percent.

Noninterest Income and Noninterest Expense

Noninterest income at farm banks fell by 3 percent to $1.1 billion during 1997. Moreover, noninterest income as a percent of average assets decreased 6 basis points to 0.66 percent.

Farm banks continued to successfully contain their costs in 1996 – noninterest expense increased only 7.5 percent in 1997 to $4.64 billion. Noninterest expense as a percent of average earning assets was virtually unchanged at 3.03 percent.

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 because it measures how well a bank uses its earnings capacity. The efficiency ratio at farm banks stood at 57.22 percent in 1997, 11 basis points lower than 1996 and 100 basis points below the 1995 level. By comparison, the efficiency ratio for all banks in 1997 was 59.15 percent.

Looking Forward

The ongoing financial crises in Asia raise asset quality issues for farm and rural lenders. According to USDA, agricultural exports will be down 3 to 6 percent in fiscal years 1998 and

1999, and the economic performance of the farm sector will be lower than the 1990-1997 average. Net cash income of the farm sector in 1998 is projected to be $52 billion – down 7 to 8 percent from 1997 inflation-adjusted levels.

Moreover, the Federal Agriculture Improvement and Reform Act of 1996 (FAIR Act) sets aside 60 years of federal government supply-management policies. Direct cash payments from the government are expected to be $7.4 billion in 1998 – 17 percent below the annual average $8.9 billion received during 1990-1996. According to the FDIC, approximately 45 percent of active agricultural lenders examined between April and September 1997 have portfolios tied to crops affected by the phase-out of government payments.

The long-term implications for the farm sector are not clear. There is a potential for increased volatility in the agricultural economy because of the reduction in government intervention to stabilize farm commodity prices. jal