Farm Bank Performance During 1998

by Keith Leggett

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Total agricultural credit expanded for the sixth consecutive year to $170 billion in 1998. Agricultural loans held by banks exceeded $69.9 billion, resulting in a 41 percent market share. According to the U.S. Department of Agriculture (USDA), banks accounted for 60 percent of new farm credit extended in 1998.

Despite low prices for key commodities and weather and disease problems in several regions of the country, farm banks[1] turned in another solid performance in 1998: earnings were good; capital remained at high levels both in absolute dollar terms and as a percent of assets; and asset quality remained favorable. In 1998, only one farm bank failed, and only seven farm banks have failed since 1993.

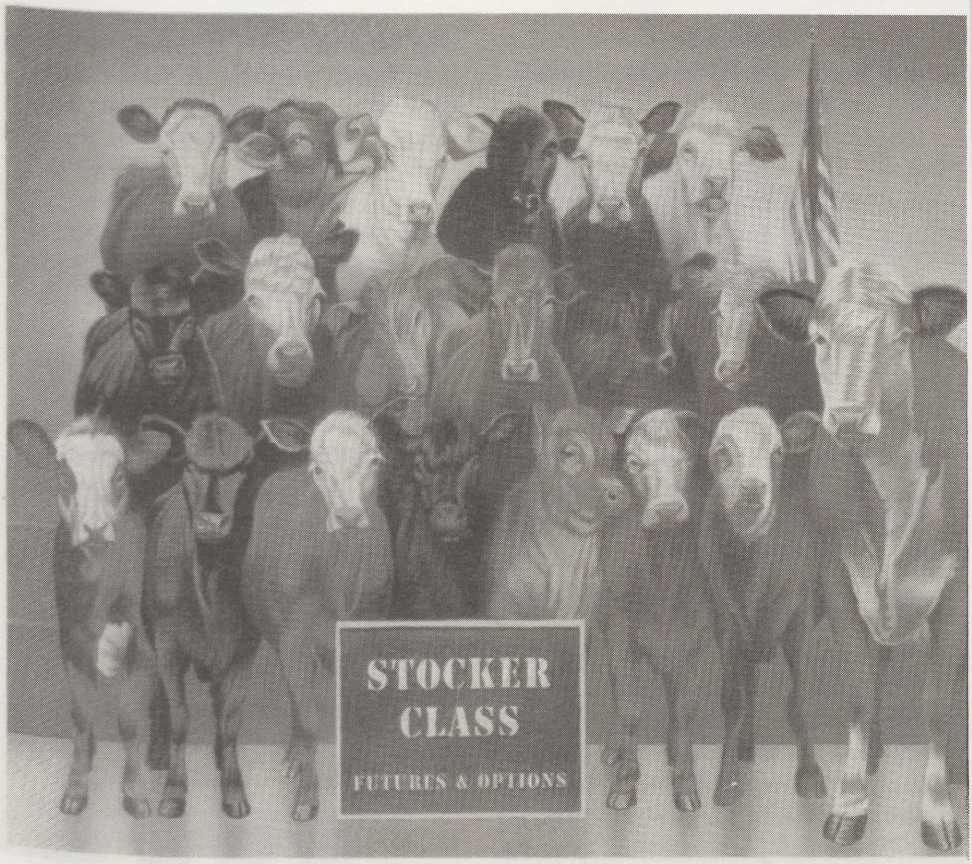
The following analysis looks at the performance of the 2,951 farm banks in 1998 and compares it with the performance of the same set of institutions in previous years; with the performance of nonfarm banks;[2] and with the performance of the overall banking industry.

Performance of Farm Banks

Farm banks had strong earnings in 1998, driven primarily by increased loan volume. These banks earned $2 billion in 1998, $66 million more than

[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 for both 1997 and 1998, 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.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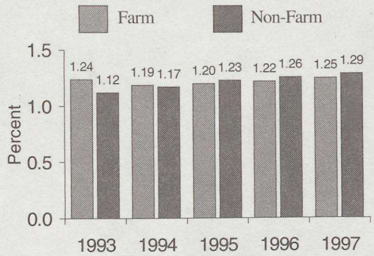
Return on Average Assets



Source: FDIC

the amount earned in 1997. Farm banks reported a 1.21 percent return on average assets (ROA) in 1998. By comparison, the ROA for nonfarm banks was 1.24 percent, and the average for all commercial banks was 1.19 percent.

Compression in the yield curve in 1998 along with increased competition for loans[3] caused net interest margins at farm banks to decline 10 basis points to 4.14 percent in 1998. Net interest margins at nonfarm banks fell 13 basis points to 4.43 percent, and banks nationwide reported a 14 basis point decrease in net interest margins to 4.07 percent in 1998.

Balance Sheet Developments

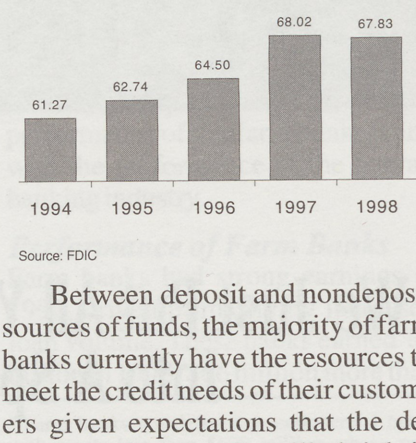
Assets

Farm banks held $175 billion in total assets in 1998, up 8.7 percent from 1997. Every major asset category experienced gains during the year. More than 93 percent of farm banks' total assets were earning assets in 1998.

The loan-to-deposit ratio at farm banks remained at a high level by historical standards. According to the American Bankers Association's *1999 Farm Credit Survey Report,* this high loan-to-deposit ratio may be causing funding problems for some small farm banks. The survey showed that, for those farm banks reporting deposit growth, one in two banks with under $100 million in assets reported that deposits were not growing fast enough to keep up with loan demand. On the other hand, only one out of five banks with $100 million or more in assets reported deposit growth was not keeping pace with loan demand.

A large number of the farm banks surveyed – ranging from 40 percent of banks with less than $50 million in assets to almost 70 percent of banks with more than $100 million in assets – used Federal Home Loan Bank advances to meet loanable funds needs.[4] Between 70 and 80 percent of the farm banks surveyed used Fed funds to meet liquidity needs.

Loan-to-Deposit Ratio



Source: FDIC

Between deposit and nondeposit sources of funds, the majority of farm banks currently have the resources to meet the credit needs of their customers given expectations that the demand for farm credit will shrink in 1999. However, if credit demand re-

[3] According to the ABA *1999 Farm Credit Survey Report,* 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.

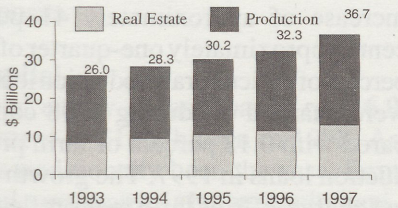
[4] *1999 Farm Credit Survey Report,* American Bankers Association.

1999. However, if credit demand rebounds to the level of the past several years, farm banks could face a shortage of loanable funds in the near future.

Loans

Farm bank loan growth was strong in 1998. Real estate loans expanded by 10.7 percent in 1998 to $49.6 billion, and C&I loans increased 9.2 percent to $14.9 billion.

Agricultural Loans By Farm Banks



Source: FDIC

Agricultural loans, both for land purchases and production, rose 7.3 percent in 1998 to $37.3 billion, from $34.7 billion in 1997. But despite the growth in dollar volume, agricultural loans have steadily decreased as a percent of farm bank loan portfolios. In 1994, 39.1 percent of farm bank portfolios was held in agricultural loans; by year-end 1998, it had declined to 36.6 percent.

Loans to finance agricultural production rose 4.6 percent to $23.3 billion, up from $22.2 billion in 1997. Strong growth rates continued to be reported for farm loans backed by real estate, which rose 12.1 percent during the year to $14 billion. The rapid growth in this category of lending is the result of increased use of land as *collateral* for agricultural production loans, as well as the purchasing of new real estate or refinancing existing real estate loans.

Nonfarm real estate lending at farm banks rose 10.2 percent in 1998 to $35.6 billion; the residential real estate loan component grew 7.7 percent to $21.7 billion from $20.2 billion the previous year.

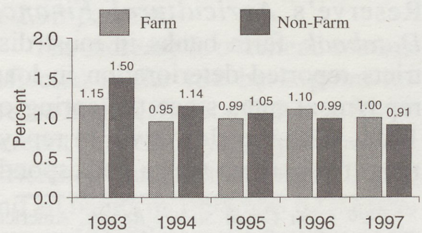
Consumer loans at farm banks rose 2.9 percent in 1998 to $12.3 billion. For all commercial banks, loans to individuals grew 1.7 percent.

Asset Quality

Despite low commodity prices and weak demand for agricultural exports, asset quality at farm banks remained favorable in 1998. The ratio of nonperforming loans to total loans was 1.1 percent, compared with 1 percent a year ago. Loans 90+ days past due – a good leading indicator of future credit problems – were 0.4 percent of total loans for farm banks, up slightly from 0.35 percent a year ago. Farm banks reported $129.9 million in restructured loans in 1998, down 4.3 percent from the previous year.

Loan loss provisions increased 25.6 percent from $292.4 million in 1997 to $367.2 million in 1998 as farm banks began to set aside reserves to cover potential credit problems. Total loan loss reserves – $1.55 billion at year-end 1998 – represented 139 per-

Percentage of Loans That Are Non-Performing



Source: FDIC

cent of nonperforming loans compared with 151 percent at year-end 1997.

Asset quality improved for nonfarm banks during 1998. As of Dec. 31, 1998, nonperforming loans as a percent of total loans declined 3 basis points to 0.89 percent. Loans 90+ days past due were 0.31 percent of total loans – basically unchanged from year-end 1997. Reserves for loan losses stood at $5.4 billion, 164.2 percent of nonperforming loans.

During 1998, bank regulators expressed concerns that 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. However, according to the FDIC's *Report on Underwriting Practices,* examiners found few problems with underwriting practices for agricultural loans.

Nonperforming Agricultural Loans

Nonperforming agricultural loans increased $67 million to $323.1 million as of December 1998. As a percent of total agricultural loans, nonperforming agricultural loans rose to 1.12 percent in 1998 from 0.96 percent in 1997.

According to the Federal Reserve's *Agricultural Finance Databook,* farm banks in most districts reported deterioration in loan repayment rates since the spring of 1998. With the slowdown in repayment rates, there was a corresponding increase in loan renewals and extensions.

Loan Losses

Net loan charge-offs (charge-offs less recoveries) on the total loan portfolio at farm banks increased for the fourth consecutive year to $254.3 million from $213.9 million in 1997. Net charge-offs as a share of average loans at farm banks experienced a slight increase to 0.26 percent in 1998 from 0.24 percent the year before.

Net charge-offs of farm loans rose $16.2 million to $55.9 million – an increase of approximately 41 percent. Approximately one-quarter of 1 percent of agricultural production loans were charged off during 1998 compared with 0.18 percent of farm production loans in 1997. The growth in net charge-offs of farm loans reflects the increased level of stress to certain segments of the farm economy.

Deposit Liabilities

Total deposit liabilities at farm banks rose 8.4 percent in 1998 to $149.7 billion. By contrast, nonfarm banks and all commercial banks reported increases of 14.3 percent and 7.6 percent in deposits, respectively. Interest-bearing deposits grew at a slower rate in 1998 than noninterest-bearing deposits. Core deposits at farm banks increased $9.4 billion to $130.6 billion in 1998.

Despite the rise in deposits for farm banks as a whole, the *1999 Farm Credit Survey Report* indicates that "[b]etween 10 to 21 percent of the survey participants reported a decline in their deposit base during the 12 months ended June 30, 1998." Approximately 24 percent of farm banks reported a decline in their

[5] *1999 Farm Credit Survey Report*, American Bankers Association.

reasons cited for declines in the deposit base 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] Additionally, the volatility in financial markets during the second half of 1998 may have contributed to the growth in deposits.

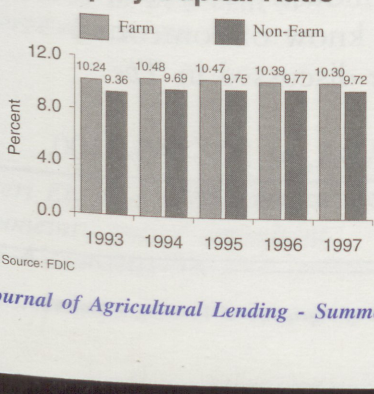
In 1998, brokered deposits at farm banks grew by 7.9 percent to $873.8 million. However, brokered deposits account for less than 1 percent of total deposits.

Capital

Total equity at farm banks rose 6.9 percent to $18.2 billion in 1998. As has traditionally been the case, farm banks maintained a higher equity capital-to-assets ratio than other banks – 10.16 percent in 1998. Nonfarm banks reported an equity capital-to-assets ratio of 9.63 percent, and for all commercial banks the ratio was 8.5 percent in 1998.

As of December 1998, only two farm banks did not meet the minimum requirements to be categorized as adequately capitalized, and 98.7 percent of farm banks are in the well-capitalized category.

Equity Capital Ratio



Source: FDIC

Income Statement Developments

In 1998, farm banks reported that their net income increased $66 million to $2 billion and ROA increased to 1.21 percent. Return on equity (ROE) fell 53 basis points to 11.36 percent. The decline in ROE can be attributed to the growth in capital at farm banks.

Interest Income and Interest Expense

Net interest income at farm banks increased 5.3 percent to $6.6 billion in 1998, compared to an 8.8 percent increase in 1997. Interest income grew by $771 million in 1998 to $12.6 billion, while interest expense grew by $439 million to $6 billion.

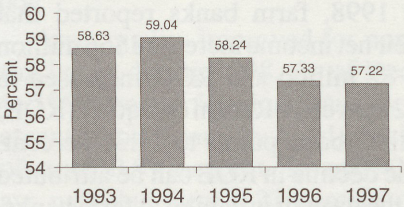
Noninterest Income and Noninterest Expense

Noninterest income at farm banks grew 9.5 percent to $1.1 billion during 1998. Moreover, noninterest income as a percent of average earning assets rose 1 basis point to 0.7 percent from 0.69 percent in 1997.

Rising personnel expenses and the cost of Y2K remediation pushed up farm banks' noninterest expense by 8.3 percent in 1998 to $4.63 billion. This is considerably higher than the growth rate during the mid-1990s, which averaged about 4.5 percent per year. However, noninterest expense as a percent of average earning assets in 1998 was virtually unchanged at 2.98 percent.

The increase in overhead costs is reflected in the 138 basis point increase in the efficiency ratio to 58.09 percent in 1998. By comparison, the efficiency ratio for nonfarm banks and all banks in 1998 was 62.47 percent and 60.98 percent, respectively.

Efficiency Ratio



Source: FDIC

Looking Forward

The global financial crisis is likely to have a continuing negative effect on the U.S. agriculture economy. While most Asian economies appear to be posed to rebound from the deep recession that gripped the region, a full recovery is going to take between three and five years. Coupled with a stronger dollar, this translates into weaker world demand for U.S. farm exports. This also means that commodity prices are expected to remain depressed for the next several years. According to the U.S. Department of Agriculture, the overall demand for credit by the farm sector will decline for the first time in seven years by ½ to 1 percent due to uncertainty about how long these economic conditions will persist. **jal**