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Farm Banks Are Doing Well But Face Many Challenges

by:
Richard Cofer Jr.

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The Kansas City region's agricultural sector has been depressed by low commodity prices since 1997, causing strain for the region's farmers. Despite this strain, the aggregate reported financial condition of the region's farm banks remains favorable. This article will discuss why the region's farm banks continue to report satisfactory financial conditions and the factors that could contribute to future deterioration in farm bank performance.

The Agricultural Sector Remains Depressed With Low Commodity Prices

The Kansas City region's farm sector continues to be plagued with low commodity prices. Strong domestic and foreign production of wheat, corn and soybeans have resulted in large carryover inventories, depressing prices every year since 1996, as shown in Table 1. Moreover, the U.S. Department of Agriculture's outlook for these commodities in the 2001 and 2002 marketing years shows little improvement over the low prices seen in 2000. On the positive side, cattle prices continue to trend upward, and hog prices have rebounded somewhat from extremely low levels in 1998 and 1999.

The low prices have caused farm net income to plummet. Net farm income for the region's farmers dropped 28 percent from \$11.1 billion in 1997 to \$8 billion in 1999, the most recent data available on a state basis. The estimated 2000 net farm income, based on national price levels and regional production estimates, would not be any better than in 1999. It should be noted that the region has not experienced any major production problems

Table 1

**Prices are Expected to
Remain Depressed through 2001**

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>Proj. 2001</u>
Corn	3.24	2.71	2.43	1.94	1.80	1.85
Soybeans	6.72	7.35	6.47	4.93	4.65	4.90
Wheat	4.55	4.30	3.38	2.65	2.48	2.55
Cattle	65.05	66.32	61.48	65.56	69.00	75.00
Hogs	56.53	54.30	34.72	34.00	44.00	42.00

Note: Grain prices are for marketing year of each crop.

Crop quantities are per bushel; livestock are per hundredweight.

Source: USDA

during the last two years, which would have caused even lower farm net income results.

Farm Banks Continue to Report Healthy Conditions Despite Depressed Farm Sector

Despite tough times for farmers, as of year-end 2000 farm banks¹ in the Kansas City region reported healthy conditions. In the aggregate, farm banks have experienced a decade of strong financial performance. For example, farm bank earnings, as measured by aggregate return on assets,² have exceeded 1 percent throughout the 1990s and have not dipped below 1.10 percent since 1991; a 1 percent benchmark historically has been the standard for strong earnings.

In addition, farm bank credit quality has been relatively high. As shown in Chart 1, total delinquent and nonperforming loans³ continue to represent a low percentage of total loans when compared to historical levels. Additionally, net loan charge-

offs, which represented just 0.21 percent of total loans as of Dec. 30, 2000, have not increased significantly.

Reported capital and loan loss reserves, which cushion losses in lending and operations, also remain at relatively high levels. The aggregate equity capital ratio was 10.3 percent and the aggregate loan loss reserve to gross loans ratio was 1.5 percent as of the end of 2000. These ratios were much lower at the beginning of the 1980s agricultural crisis, at 8.7 percent and 1 percent, respectively.⁴

Possibly as a result of problems in the agriculture sector, a shift in

¹ As of Dec. 31, 2000, there are 1,212 farm banks in the region representing 60 percent of the nation's farm banks.

² Return on assets is calculated by dividing net operating income by average earning assets.

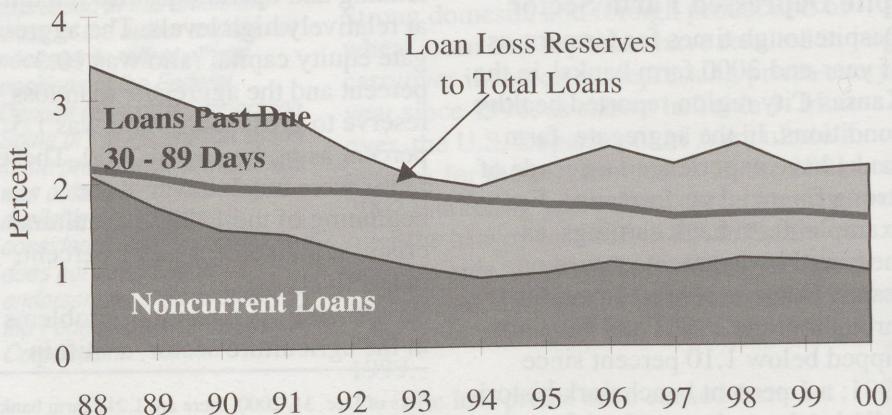
³ Delinquent loans are loans past due between 30 and 89 days. Nonperforming loans are loans that are placed on nonaccrual (not accruing interest) status and/or past due 90 days or more.

⁴ See Table 3 in "Agricultural Sector Under Stress: The 1980s and Today," Kansas City Regional Outlook, third quarter 1999.

farm banks' loan mix has occurred during the past 10 years. In 2000, agricultural loans and consumer loans represented 45.2 percent and 9.7 percent, respectively, of farm banks' aggregate loan portfolio compared with 49.5 percent and 12.4 percent at year-end 1990. However, residential lending and commercial real estate lending⁵ have increased 3.7 percentage points and 4 percentage points, respectively. This change in portfolio emphasis could help reduce somewhat the vulnerability of farm banks to continued weakness in the agricultural sector. However, at the same time, a shift into commercial real estate, traditionally a higher risk loan category, could heighten the susceptibility of these insured institutions to a general economic downturn.

Chart 1

Farm Bank Delinquent Loans Remain Relatively Low



Source: Bank Call Reports

⁵ For the purpose of this article, residential loans include loans secured by one to four family residential properties including home equity loans. Commercial real estate includes all construction and development loans, commercial real estate loans and multifamily residential property loans secured by real estate.

The Factors that Have Shielded Farm Banks From Deterioration So Far Appear Vulnerable

Three factors – government payments, carryover debt and off-farm income – have been critical to farm banks' reported health during the last three poor agricultural years. Examining these factors helps to explain why the region's farm banks have not shown significant deterioration in their reported conditions.

Most importantly, government payments to farmers in 1998, 1999 and 2000 have mitigated some – but not all – of the financial stress caused by low commodity prices. Nationally, government payments set records in each of those years, with 2000's level reaching a record \$22.1 billion. In the region, government payments also have dramatically grown in importance.

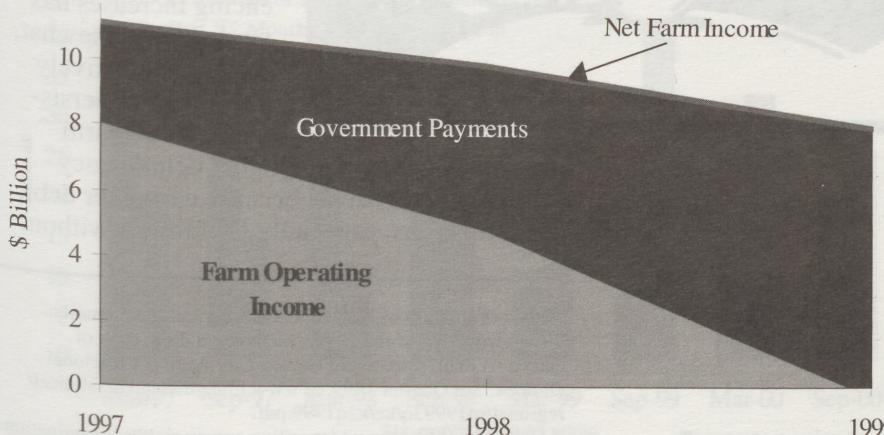
Chart 2 shows how the percentage of government payments to net farm income has grown from slightly over one-quarter of net farm income in 1997 to more than 100 percent of net farm income in 1999. As a result, farmers have become heavily reliant on government payments to meet their debt obligations. This point was stressed by farm bank managers at an outreach meeting in March 2000,⁶ as they stated that many of their weaker farm customers waited for their government checks before repaying their operating loans.

Given USDA's 2001 and 2002 price outlook, it appears that the region's farmers again will rely on government payments in

⁶ March 28, 2000, Agricultural Bankers Roundtable meeting hosted by the FDIC in Omaha, Neb.

Chart 2

The Region's Net Farm Income Levels Have Been Supported by Government Payments



Source: Economic Research Service, USDA

the near-term. Any reduction in government payments could have a negative effect on farm banks, as borrowers will find it even more difficult to meet their loan obligations and living expenses.

The second element helping farm banks continue to report strong aggregate condition is carryover debt. Because of the variability in production and price of agricultural products, bankers frequently carry over unpaid seasonal operating loans into the next season. The expectation is that a good operating season will offset one or two poor operating seasons. This practice effectively delays recognition of credit stress because these loans do not show up in reported delinquency figures. For example, in the 1980's farm crisis, farm banks' delinquency ratios did not rise significantly until 1984, three years into the crisis.⁷

FDIC examiners report⁸ that the share of examined banks experiencing a moderate to significant increase in carryover debt levels jumped from about 10 percent in March 1999 to more than 40 percent by September 1999 (see Chart 3).

Although the percentage of banks experiencing increases has moderated somewhat, it remains relatively high. Further persistence of low farm

revenue could result in higher delinquency figures at farm banks, because carryover debt has limitations, especially for farmers without



⁷ For a discussion of how the current agricultural situation differs from that of the 1980s, including a discussion of carryover debt, refer to the Kansas City Region's *Regional Outlook*, 3rd Quarter 1999, at www.fdic.gov/bank/analytical/ro/ro19993q/kc/k3q1999.pdf.

⁸ FDIC examiner loan underwriting survey results; examinations conducted between September 1996 and September 2000.

substantial real-estate equity to secure carryover loan extensions. Farm borrowers' balance sheets can only be stretched so much before bankers are unable or unwilling to extend additional carryover debt. At that point, delinquency levels escalate rapidly, as seen in the early 1980s.

The third factor that has benefited farm banks is that the strong nonfarm economy has boosted farmers' off-farm income levels. Off-farm income represents a large share of funds used to meet living expenses or make farm-related debt payments, especially for smaller farming operations. 1999 USDA data show that off-farm income represents 69 percent of total household income for farm households with operations with revenues of \$50,000 to \$249,000. These smaller operations are the primary borrowers of many of the Kansas

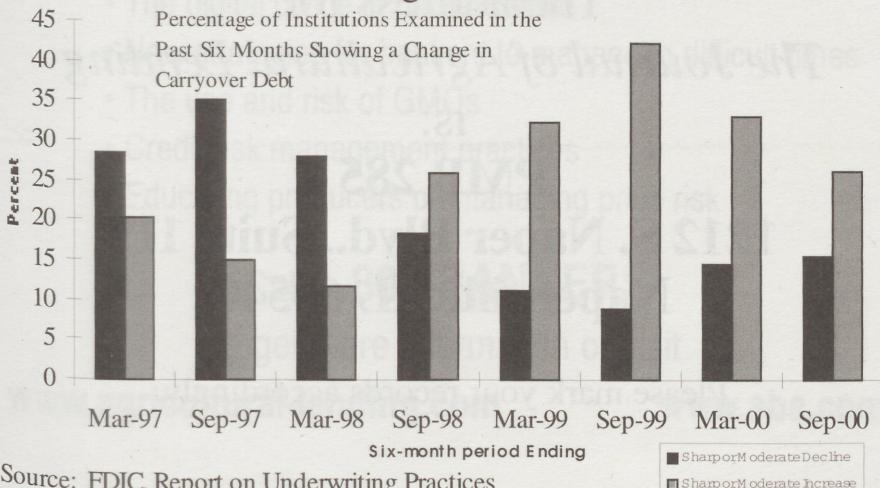
City region's farm banks.

Data released in 1992 by the USDA show that most off-farm jobs are not related to farming. In fact, services and manufacturing employ 51 percent and 17 percent of rural workers, respectively, and government employment accounts for another 17 percent. Therefore, even in Midwestern states where farm production represents the largest source of production output, off-farm income represents a critical share of farming families' total income.

The record-setting national economic expansion has been a tremendous boost to off-farm income, helping rural areas provide a wide range of employment opportunities. But recent economic data and news releases suggest the economic growth has

Chart 3

Carryover Debt Levels Escalated Dramatically in 1998 And 1999, But Began to Decline in 2000



Source: FDIC, Report on Underwriting Practices

slowed substantially and might be at or near zero. Reports about layoffs, lost shifts and idled plants are increasing. A prolonged or severe economic slowdown could be harmful to the well-being of farm banks, as farm borrowers might possibly lose a substantial portion of their household income through lost wages.

Thus far, farm banks have continued to report healthy conditions despite a depressed farm economy. However, stress cracks in the farm banks' condition are apparent. Government payments and off-farm income have played important roles in preventing the cracks from deepening. However, currently there is uncertainty about the health of the general economy as well as uncertainty about the role of government in farming and the direction that will be taken in the 2002 farm bill. Significant changes in these areas, or a significant and widespread crop failure could cause the stress cracks to expand.

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