

Remarks for CFTC Public Meeting on April 22, 2008

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I'd like to thank Acting Chairman Walter Lukken and the Commodity Futures Trading Commission for the invitation to participate in this important forum today. I appreciate the opportunity to be here and to hear the discussion.

The Federal Reserve Bank of Kansas City closely monitors financial developments in the agricultural sector given the concentration of agricultural industries in our region, which includes the states of Colorado, Kansas, Nebraska, Oklahoma, Wyoming, and parts of Missouri and New Mexico. As a regulator, the Kansas City Federal Reserve Bank supervises approximately 170 state-chartered commercial banks and nearly 1,000 bank holding companies. And, emerging from our monetary policy responsibilities, we also monitor broad agricultural and grain market conditions.

In my remarks today, I will focus on the availability of credit from commercial banks to the agricultural sector by providing a general overview of current banking conditions and then highlighting the results of our most recent quarterly Survey of Agricultural Credit Conditions in the region.

Among the issues we have been monitoring is grain elevator operations and financing. The first signs of financial strain began to emerge in January when bankers were telling us that some customers were low on cash as they anticipated higher farm input prices – primarily fertilizers and chemicals – and pre-purchased crop inputs for spring planting. As these grain elevators became financially constrained, some began to require farmers to pre-pay to bolster their cash balances.

Since mid-February, the surge in agricultural commodity prices has further strained the cash positions of grain elevators. As some elevators faced growing margin calls with record prices, business contacts in our District began to report that grain elevators were requesting additional lines of credit. More recently, some grain elevators have limited (and in some cases eliminated) their offerings of forward, basis and other contracts to limit further strains on cash flows.

With grain elevators requesting larger credit lines and the deleveraging underway in some national credit markets, it is natural to wonder about the capacity and willingness of commercial banks to extend credit. To answer that question, let me describe the general state of the banking industry.

Overall, the U.S. banking industry is sound with \$1.3 trillion in capital. However, in 2007, net operating income for all banks fell (Chart 1). The decline in income was more prevalent in larger banks and was a result of higher loan loss provision expenses, especially in regions with severe contractions in the housing market. Likewise, net operating income for banks in the Kansas City region declined in 2007 with margin pressures squeezing profits, but remained above the national average (Chart 2). Regional and other small banks with large concentrations in construction and land development have experienced increases in problem loans, although the current levels remain below historic highs. And, on the whole, capital levels remain well above regulatory minimums.

Agricultural banks, in general, have fared better than other banks of comparable size. For ag banks, the rate of return to assets remains at the historical average, despite average rate of return on equity edging down to its 2001 low. Return rates at agricultural banks were stronger than other small banks. Net charge-offs remain at historical levels. (Chart 3).

Overall, the condition of the banking industry suggests it remains well positioned to extend credit in today's environment.

Beyond the ability to lend, one might ask to what extent do banks remain willing to lend and under what terms? We look to the respondents to our District's agricultural credit survey, which surveys more than 300 bankers in our District each quarter, to give us a sense of current credit terms. At the outset, I should note that our survey indicates that the Farm Credit System has more direct exposure to grain elevator financing than commercial banks. In March, roughly two-thirds of the respondents indicated that local elevators were receiving funding from the Farm Credit System (Chart 4). Less than a third noted that commercial banks were funding local elevators.

Based on the price volatility in commodity markets, we asked a series of special questions in the March 2008 survey and learned that only a quarter of the respondent banks were actively engaged in grain elevator financing. Of these banks, 40 percent of them reported that grain elevators had enough cash to cover current margin calls (Chart 5). And over a third of them reported that local grain elevators had ample cash to cover

current and future margin calls. Less than a quarter of them reported that local grain elevators were struggling to meet margin calls.

Those that did report customers with financial strains were generally concentrated in the wheat-growing regions of our District (eastern Colorado, western Kansas, panhandle of Oklahoma and parts of New Mexico (Map 1). And even there, reports of struggling grain elevators tended to be heavily localized. One survey respondent noted that the line of credit for a single elevator had risen eight-fold and required participation of the credit with three other banks. Contacts with larger commercial banks indicate that bigger grain elevators are also tapping larger lines of credit. With larger demands for credit, banks are reporting increases in the number of participation agreements, where two or more banks participate in deals to extend credit to grain elevators.

How are banks responding to this increased demand for credit? Across the country, commercial banks appear to have funds available for such loans. Federal Reserve agricultural credit surveys for the Kansas City District, as well as those in other Federal Reserve districts, continue to report that funds available for loans expanded over the past year. In fact, the availability of loan funding in the Kansas City District reached its highest level in four years in March (Chart 6). And conversely, the number of loans refused due to shortages of funds continued to fall (Chart 7). The amount of funds available for loans has risen as agricultural banks experience record-high loan repayment rates and a continued contraction in loan renewals and extensions by farmers (Chart 8). At the same time, farm loan demand has declined in the past six months, freeing up additional funds at agricultural banks.

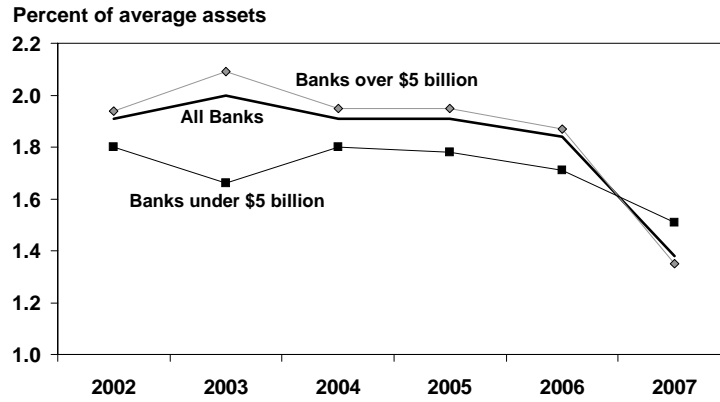
The interest rate environment has also been favorable for ag credit. Recent declines in national interest rates have led to steep cuts in agricultural loan interest rates. In March, District banks reported that farm interest rates dropped to their lowest levels since 2004 (Chart 9). On the other hand, we have seen growing attention on the part of banks to underwriting standards. For example, collateral requirements appear to have edged up, although they remain well below 2003 levels (Chart 10). As a result, given current market conditions, as grain elevators seek additional lines of credit, they might expect increased scrutiny by lenders of their business operations, risk management practices, and financial statements.

In summary, the banking industry remains sound and able to provide credit as grain elevators increase their credit lines as a result of margin calls. To date, creditors appear to be working effectively with the elevators to ensure that financing needs are met, and there is no indication that this should not continue to be the case. That said, while credit is available, banks are likely to pay careful attention to the strength of risk management of these elevator operations when deciding to increase advances.

That concludes my remarks. Thank you.

Chart 1:

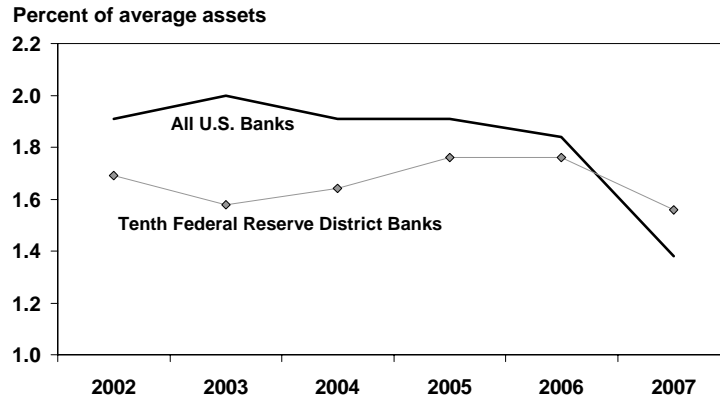
Earning Performance at Commercial Banks



Source: Reports on Conditions and Income
*All US Commercial Banks – Net Operating Income Before Taxes, as a percentage of average assets.

Chart 2:

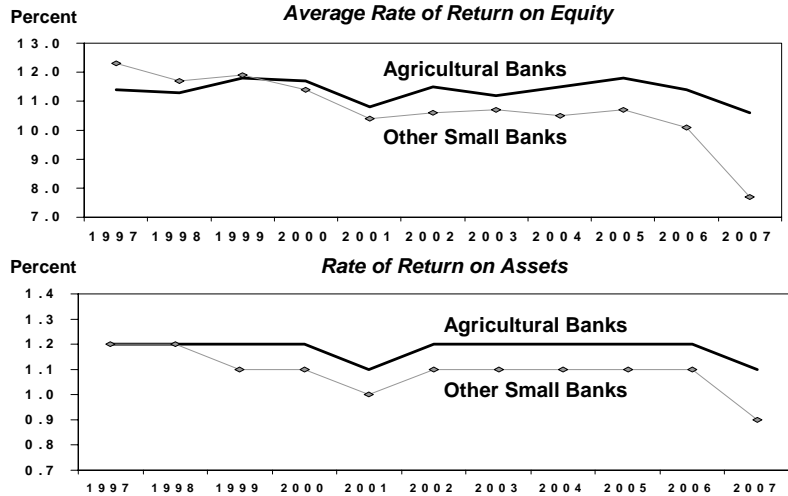
Earning Performance at Commercial Banks



Source: Reports on Conditions and Income
*Tenth District Banks without Wells Fargo Subsidiaries

Chart 3:

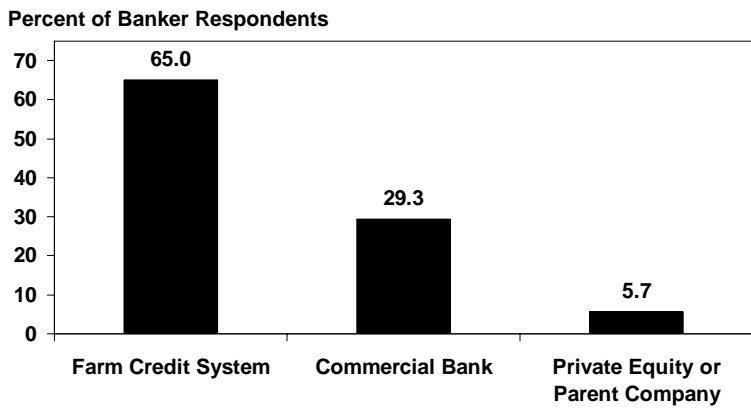
Financial Performance of Agricultural and Other Small Banks



Source: Agricultural Finance Databook, Federal Reserve Board of Governors
 *Small banks have less than \$500 million in assets

Chart 4:

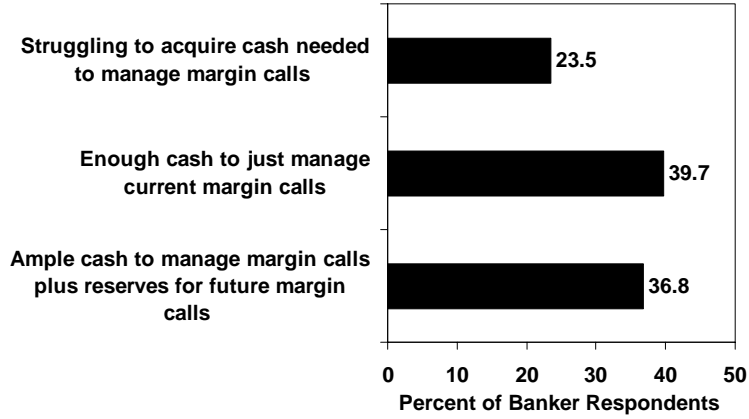
Where do Local Elevators Receive Funding?



Source: Federal Reserve Bank of Kansas City

Chart 5

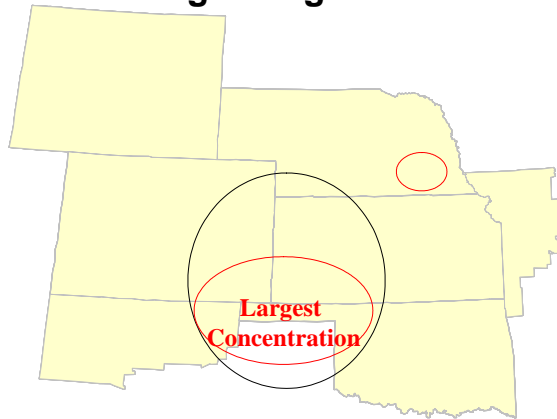
What is the Financial Position of Grain Elevators?



Source: Federal Reserve Bank of Kansas City

Map 1:

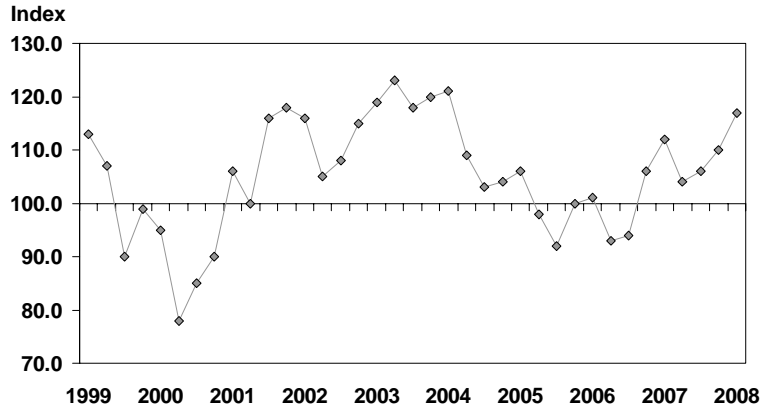
Regions with Banks Reporting Grain Elevators were Struggling to Manage Margin Calls



Source: Federal Reserve Bank of Kansas City

Chart 6:

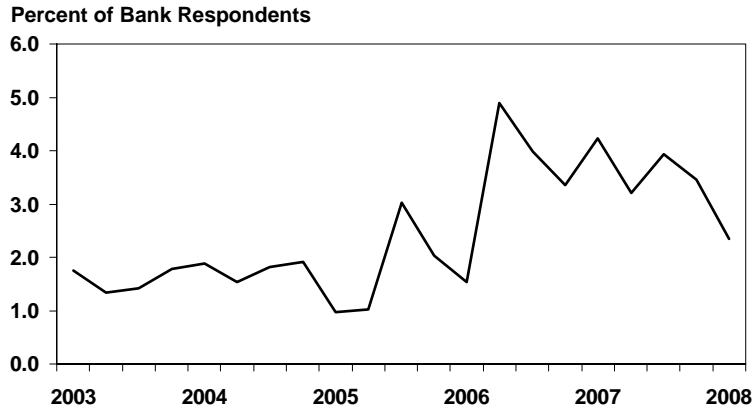
Loan Fund Availability
(Tenth Federal Reserve District)



Source: Federal Reserve Bank of Kansas City

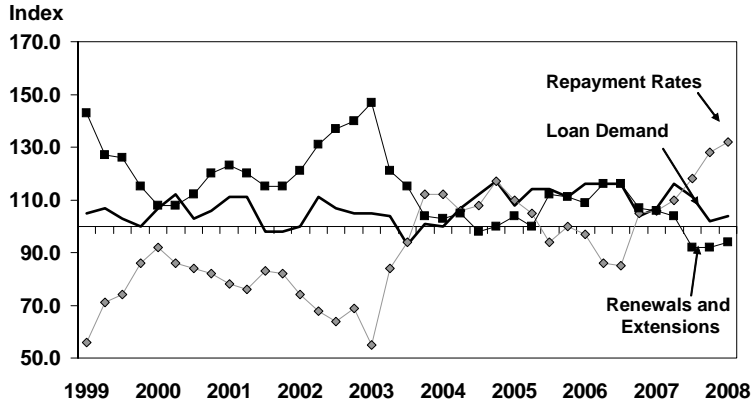
Chart 7:

Loans Refused Due to a Shortage of Funds
(Tenth Federal Reserve District)



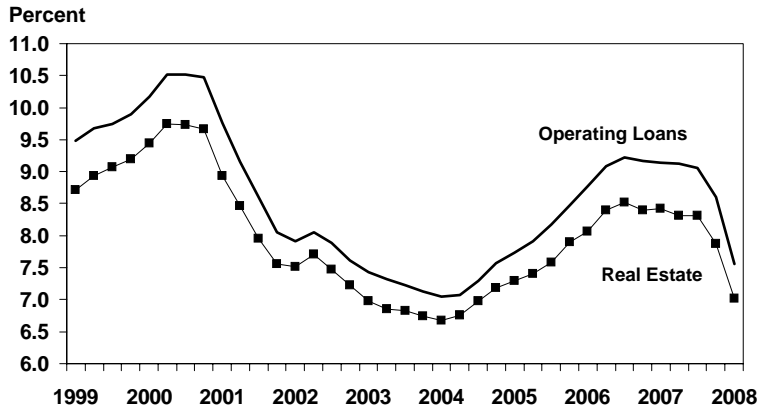
Source: Federal Reserve Bank of Kansas City

Chart 8:
Loan Demand, Repayment Rates, and
Renewals and Extensions
 (Tenth Federal Reserve District)



Source: Federal Reserve Bank of Kansas City

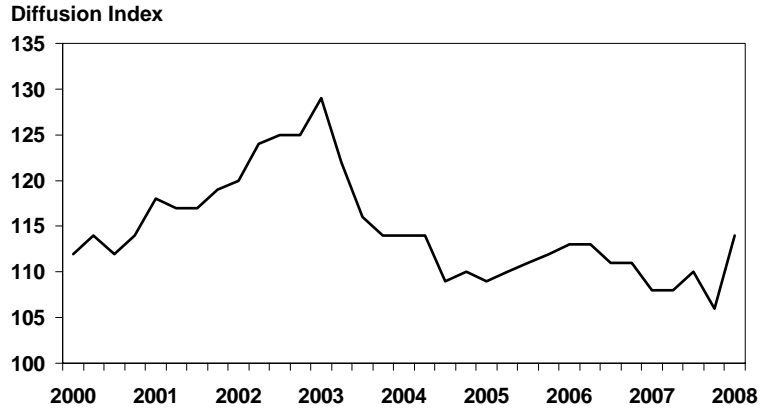
Chart 9:
Agricultural Interest Rates
 (Tenth Federal Reserve District)



Source: Federal Reserve Bank of Kansas City

Chart 10:

Collateral Requirements for Farm Loans (Tenth Federal Reserve District)



Source: Federal Reserve Bank of Kansas City