Problems facing agricultural banks

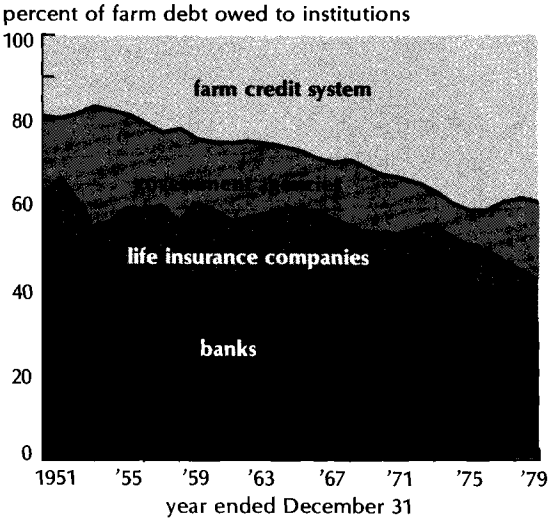
Gary L. Benjamin

Growth in farm debt picked up sharply in the 1970s. During the past ten years, farm debt has risen at an annual rate of 11.7 percent, compared with 7.5 percent in the 1950s and 1960s. Outstanding farm debt now totals $160 billion, three times the total of ten years ago.

Growth has been especially rapid for the last four years. But growth at banks has not kept pace, resulting in a substantial loss of market share. Farm debt owed to banks has risen at an annual rate of 10.5 percent since 1975, compared with 17 percent for all other institutional lenders. Because of the slower growth, the proportion of institutionally held farm debt owed to banks has declined to a third. Down from 40 percent in 1975, that is the smallest market share for banks in the post-World War II era.

Competitive imbalances that favor other lenders account for part of the loss in market share. Competition from the farm credit system and government agencies can be tough for banks and, in some respects, inequitable. The farm credit system—which includes federal land banks and production credit associations—has a competitive edge in its exemption from usury ceilings, and its tax advantage. Government agencies that lend to farmers (Commodity Credit Corporation, Farmers Home Administration, and the Small Business Administration) also have these advantages, plus recent mandates from Congress and the Administration to provide farmers special loans. Government agencies have been the fastest growing institutional lender serving farmers in recent years. Much of this growth reflects new and more liberally subsidized programs for farmers affected by natural disasters and economic distress. More borrowing under the commodity price support program (partly to rebuild grain reserves) and a liberalized program to expand on-farm storage facilities has also contributed to the rise in government lending to farmers.

Share of farm debt owed to banks has declined sharply



Also accounting for the loss in market share was the reemergence of problems peculiar to banks, especially rural banks. Most of the problems tie to liquidity pressures that began building at rural banks in the late 1970s. But some of them tie to the increased borrowing needs of agriculture—needs that press against the limits on credit banks can extend to single borrowers.

The liquidity problem entails issues regarding sources of funds. The problem of lending limits entails issues regarding the adequacy of capital at rural banks relative to the credit needs of farm-loan customers.

Liquidity problems

Liquidity is a general measure of the balance between funds flowing into a bank and those flowing out. It also bears on the bank's flexibility in converting fairly fixed assets into liquid assets. Evidence of liquidity

pressures at rural banks usually appears as a rise in loan-to-deposit ratios. Ratios at agricultural banks have risen sharply in recent years as banks tried to meet strong loan demand while deposit growth slowed. Loan-to-deposit ratios at agricultural banks in the Seventh Federal Reserve District averaged 67 percent last year. That compared with averages of 54 to 57 percent in the first half of the 1970s.

Further evidence of recent liquidity pressures shows in bankers' assessments of the availability of funds for lending. As tracked by quarterly surveys of agricultural banks in the Seventh District, the availability of funds has been very low since late 1977.

Swings in the liquidity of agricultural banks reflect the dependence of rural banks on local deposits as a source of funds. Swings can be triggered by sudden changes in local economic conditions, such as a drop in farm earnings. Or they can come from disintermediation. As market rates of interest rise, with the rates banks can pay on most deposits fixed by ceilings, funds that would ordinarily support deposit growth are attracted to other investments. Disintermediation then tends to slow deposit growth. For some banks, it creates a net outflow of deposits.

Rural banks do not have the size, reputation, market area, and other attributes that allow urban banks to use nonlocal sources of funds to offset swings in local deposits. Rural banks are nearly always precluded from efficiently bidding for such national money market funds as foreign deposits, large negotiable certificates of deposit, repurchase agreements, fed funds transactions, and commercial paper sales.

Disintermediation problems at rural banks have eased somewhat with the introduction of deposit instruments with floating interest rate ceilings tied to yields on new Treasury issues. Willingly or begrudgingly, rural banks have accounted for a large part of the six-month $10,000 minimum balance money market certificates of deposit issued since they were first authorized in June 1978. Much of this, however, has represented more a restructuring of local deposits than a net inflow of new deposits.

Cyclically rising market rates of interest can also affect the liquidity of rural banks by limiting their flexibility in adjusting security portfolios to meet loan demand. A rural bank's lending capacity is largely governed in the long run by its ability to attract deposits. But it can fund faster loan growth in the short run by liquidating securities. This was clearly the situation in the late 1970s when loan-to-deposit ratios at rural banks rose sharply.

Even so, rising rates of interest complicate the procedure two ways. On the one hand, market rates tend to rise faster than rates on farm loans, with the result that short-run profit incentives for banks shift from loans to such other investments as Treasury securities, municipals, and fed funds sales.[1] On the other hand, rising market rates cause prices of the fixed-rate instruments in a bank's investment portfolio to decline. Under these conditions, the bank is likely to lose on the security transaction if it liquidates an investment so it can fund loan requests.

Liquidity pressures clearly undercut the ability of bankers to meet the strong farm loan demand of the past few years. Despite rapidly rising loan-to-deposit ratios, farm debt owed to banks rose only 32 percent after 1976. The debt owed to individuals and others rose only 38 percent, but the increase was 56 percent for the farm credit system, 66 percent for life insurance companies, and 240 percent for government agencies.

Legal lending limit problems

Because most of the relative slowing in bank lending to farmers traces to liquidity problems, some of the market share lost to other lenders may be regained when market rates turn down again. Even so, developments of the past decade support the view that individual legal lending limits have increasingly

[1]This results partly from the farm credit system's practice of pricing loans on the basis of an average cost of funds. Changes in rates on farm loans often lag changes in money market rates. The rates do not usually reach the cyclical peaks and troughs of other rates.

Variations in basic legal lending limits for banks in the Seventh District

Legal lending limits set the maximum credit a bank can extend to a single borrower. The limits are designed primarily to protect depositors by spreading loans among a large number of borrowers in different lines of business.

National banks are subject to limits imposed by the Comptroller of the Currency. State banks are subject to limits established by state agencies. The limits are calculated as a percentage of a bank's capital base. The applicable percentage and the accounts that can qualify as part of the capital base vary with the regulatory agency. Variations in basic lending limits between banks in Seventh District states are summarized below.

Variations in basic legal lending limits for banks in district states[1]

	Applicable percentage	Eligible capital accounts
Nationally chartered banks	10	Common stock, preferred stock, surplus, subordinated notes and debentures,[2] undivided profits, one-half of reserve for loan losses, reserve for contingencies
State chartered banks		
Illinois	15	Common stock, preferred stock, surplus
Indiana	15	Common stock, preferred stock, surplus, subordinate notes and debentures[2]
Iowa	20	Common stock, preferred stock, surplus
Michigan	20[3]	Common stock, preferred stock, surplus subordinated notes and debentures[2]
Wisconsin (the higher of)	15	Common stock, preferred stock, surplus, subordinated notes and debentures[2]
	or	
	20	Common stock, surplus

[1]The legal lending limit is equal to the applicable percentage times the sum of the dollar value of the eligible capital accounts.

[2]Subordinated in right of payment to the claims of depositors.

[3]With the approval of two-thirds of the bank's board of directors. Otherwise 10 percent.

There are numerous additions and exemptions to the basic lending limits. At national banks, for instance, loans guaranteed by government agencies (such as Farmers Home Administration or Federal Housing Administration) are not subject to lending limits. With the proliferation of guaranteed lending programs of the Farmers Home Administration in recent years, this exemption has been of increasing importance to rural banks. National banks can lend the equivalent of up to a fourth of their eligible capital base to a single borrower, provided the funds are used to buy feeder livestock and the livestock securing the loan is worth at least 15 percent more than the loan. Similar provisions are available for loans on commodities, such as grain, secured by warehouse receipts.

handicapped rural banks in their efforts to finance farmers.

In a recent survey, for instance, more than half the agricultural banks in the district reported they had more farm-loan customers with credit needs exceeding the bank's lending limit than five years ago. Only 4 percent reported they had fewer customers with credit needs in excess of the bank's lending limit.

The continuing decline in farm numbers in the 1970s, along with the rapid growth in farm debt, has led to a much greater concentration of debt. Preliminary indications are that per-farm debt among units with annual sales of $40,000 or more may be close to

$200,000.[2] Roughly half that is probably nonreal estate farm debt.

These figures have to be interpreted cautiously when related to legal lending limit. Debt per farm, for example, sometimes involves two or more borrowing units, especially where there is a tenant and a landlord. The figures, nevertheless, provide a general impression of the concentration of debt.

Distribution of agricultural banks in the Seventh District, by legal lending limits, December 1972 and December 1977

	Legal lending limit (thousand dollars)							
	25 or less	26 to 50	51 to 75	76 to 100	101 to 150	151 to 200	201 to 300	301 to more
Illinois								
1972	9.6	42.1	25.7	10.0	7.9	1.8	2.1	0.7
1977	1.4	17.5	22.9	10.0	28.2	9.3	6.1	4.6
Indiana								
1972	4.6	27.8	28.7	9.3	17.6	4.6	5.6	1.9
1977	0	6.5	10.2	13.9	29.6	13.0	15.7	11.1
Iowa								
1972	5.2	40.3	25.0	16.9	9.1	2.3	1.0	0.3
1977	1.9	13.0	21.4	25.0	17.5	12.0	6.8	2.3
Michigan								
1972	0	8.9	16.5	19.0	27.8	10.1	10.1	7.6
1977	0	0	2.5	13.9	24.1	20.3	19.0	20.3
Wisconsin								
1972	4.6	27.2	21.9	21.2	16.6	7.3	1.3	0
1977	1.3	12.6	12.6	13.9	25.8	15.2	13.9	4.6
District								
1972	5.9	34.6	24.4	14.8	12.5	3.9	2.7	1.2
1977	1.3	12.4	17.5	16.4	24.1	12.5	9.8	5.9

An earlier analysis of growth in lending limits at agricultural banks in the Seventh District further supports the view that legal lending limits increasingly handicap bankers in financing farmers. That analysis shows that, despite considerable growth from 1972 through 1977, nearly 14 percent of the agricultural banks in the district in 1978 were confronted with basic lending limits of $50,000 or less. A third operated at limits from $51,000 to $100,000. A fourth had limits from $101,000 to $150,000.

Largely because of differences in banking structure, agricultural banks in Illinois and Iowa tend to have the lowest lending limits. More than half the agricultural banks in Illinois and over three-fifths in Iowa had lending limits of $100,000 or less at the end of 1977. That limit applied, by contrast, to only 30 percent of the agricultural banks in Indiana, 16 percent in Michigan, and 40 percent in Wisconsin.

A legal lending limit of $100,000 would be restrictive compared with the borrowing requirements of many farmers. USDA budgets for 1978 showed, for example, that grain farmers in the Midwest had variable per-acre costs (excluding labor and interest) of roughly $36 for soybeans and $82 for corn. For a 500 acre farm raising equal amounts of corn and soybeans, that would amount to roughly $30,000 in operating costs that had to be financed either by equity or debt. If half the farm was cash rented at $100 an acre, another $25,000 would be added to current operating costs.

Purchase of a major item of machinery such as a tractor or combine, could add $50,000 or more in borrowing needs. Purchase of another 40 acres of land would result in $30,000 to $85,000 in borrowing needs. Numerous other expenditures, such as family living or real estate improvements, could further boost the need for credit well beyond the legal lending limits of many agricultural banks.

Implications for the future

The performance of banks relative to other farm lenders in recent years may not point solely to the problems at banks. Some

[2]Farms of this size represent only 22 percent of all farms but account for 56 percent of the farm assets, 71 percent of the farm debt, and 81 percent of the cash receipts from farm marketing. Such farms are increasingly considered "commercial full-time" farms. Given recent averages of per-acre yields and prices, farms with a minimum of 200 acres would likely have annual sales of $40,000 or more. The average farm in the district states is slightly over 200 acres.

elements of the increase in government lending have caused observers to think programs were too liberal and might be subject to abuse.

Although much less of an issue, growth of the farm credit system is not without some questions of appropriateness. Whether it is appropriate for the system to raise funds at very favorable rates in national money markets and distribute them almost exclusively in loans to farmers—while receiving tax concessions and exemptions from usury ceilings—may be debated more in the years ahead. The question is more relevant now that the farm credit system accounts for 40 percent of the institutionally held farm debt than a decade ago when it held 31 percent, two decades ago when it held 25 percent, and three decades ago when it held only 18 percent.

Aside from these issues, there are genuine concerns about the future roll of rural banks in agricultural lending. With the public, including the rural public, more aware not only of differences in interest rates but also some of the new investments that compete with deposits, rural banks may need to become more innovative in holding and expanding their local deposit base. Proposals to phase out ceilings on interest rates paid on deposits, if implemented, may help rural banks maintain their deposit base.

Judging the future deposit base at rural banks requires some assessment of the economic health of rural communities. Most analysts are optimistic about the outlook of agriculture, which bodes well for rural communities and rural banks. The uncertain outlook for energy, however, throws into question continuation of the urban-to-rural shift in population. Further increases in energy prices could slow, or even reverse, this trend.

Questions about the adequacy of legal lending limits at rural banks are somewhat easier to handle. There seems no reason to expect the decline in farm numbers to end, although it might abate. Operating farm debt, and maybe total farm debt, will very likely continue to be held by ever fewer farmers. To offset the resulting pressure on lending limits, rural banks will have to increase their capital base.

The dual concerns of liquidity and legal lending limits cannot be divorced from the overall question of bank structure. Studies of the impact on agricultural lending from branch banking and multibank holding companies show mixed results. It is not inconceivable, however, that with the greater access to sources of funds that such banking structures provide, as well as the expanded capital base inherent in these organizations, rural banks may eventually look with more favor on such arrangements.