Lean years in agricultural banking

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Then the cows that were ugly in appearance and thin-fleshed began to eat up the seven cows that were beautiful in appearance and fat . . . and the thin ears of grain began to swallow up the seven fat and full ears of grain.

Genesis 41: 3-7

There is by now little doubt that the problems of agriculture have adversely affected the performance of rural banks. Since 1982 agriculturally oriented banks have experienced increasing levels of loan losses and problem loans, resulting in greatly reduced earnings rates. As disturbing is the fact that in recent quarters, ag bank performance has continued to deteriorate while other banking sectors have shown considerable improvement.

Historically, agricultural banks have outperformed industry averages with high earnings, high capitalization, and low levels of problem assets. Present economic conditions have imperiled this record. Nationally, failures of ag banks have risen from 13 percent of all failures in 1983 to 32 percent in 1984—and this proportion continues to rise.[1]

Not only are the ag-related credit problems unprecedented by any measure of recent experience, but they are also ill-timed for the predominantly small agricultural banks. Increasing credit problems, combined with deregulation of consumer deposit rates and increased competition, have presented great challenges to the management of these community banks.

But how serious is the ag bank situation and what are the implications of continued problems at these banks for systemic bank soundness?

Focus on the heartland

As one of the principal financing sources for farming, agricultural banks reflect the changing status of American agriculture. Measuring the impact of ag problems on banks, however, requires that additional consideration be given to the structure, asset diversification, and relative capitalization of these firms. These considerations vary widely in different regions of the country. For example, while recent ag-related credit losses at commercial banks have been most severe in California, where 6 percent of the outstanding ag loans at banks in the state were written off in 1984 compared to 2 percent nationwide, the impact of these losses on banks has presented less of a problem because most of the losses were incurred at the large banks, where ag loans constitute a relatively small portion of those banks' total portfolios.[2]

Modest levels of ag lending or a larger portion of farm borrowers with secondary sources of income has left the banks in the Southeast somewhat less vulnerable to the effects of present agricultural difficulties.[3] Similarly, banks in the Northeast and Southwest (with the exception of Texas) have reported that agricultural credit problems are contained or relatively modest in terms of their impact on bank soundness.

What remains is the traditional heartland of America, encompassing the Midwest and Plains states. Both this region's extensive reliance on agriculture and ag-related business, and its heavy emphasis on the troubled corn, wheat, and soybean sectors have raised concern regarding the continued vitality of its banking system.

The following statistics compare the performance of agricultural and nonagricultural banks in the heartland, herein defined as the area comprising the Chicago, Kansas City, Minneapolis, and St. Louis Federal Reserve Districts[4] (Figure 1). While the statistics illustrate a dramatic decline in ag bank performance and a somber near term outlook, they also point to some of the underlying strengths these ag banks possess.

In terms of banking, this four district area is notable not only for its location at the epicenter of the farm banking problem, but also

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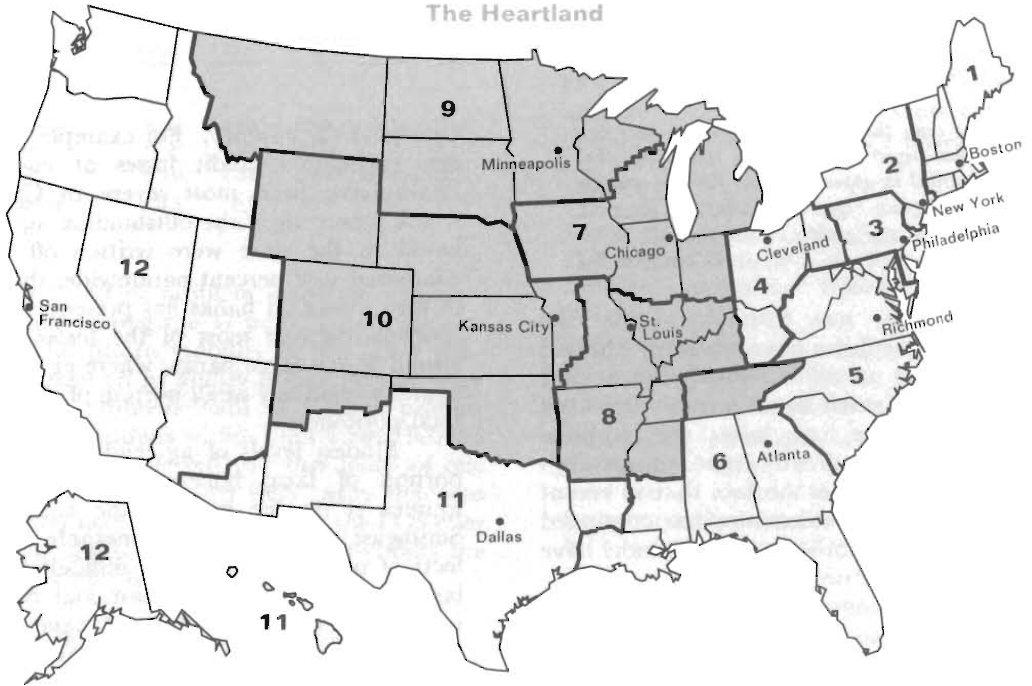
Figure 1
The Heartland



for its large number of banks. Although the region accounts for less than 25 percent of the nation's banking assets, it holds over 50 percent of the nation's commercial banks (Figure 2). A significant portion of these banks are agriculturally oriented.

There is no standard definition of what constitutes an ag bank, but for purposes of comparison, ag banks are herein defined as those banking firms with non-real estate farm loans equal to or exceeding 30 percent of their total loan portfolios.[5] Using this criterion, approximately one third of the heartland's 7,858 banks are agriculturally oriented. In terms of asset size, ag banks in the region are most heavily represented in the less than $25 million category. Few ag banks in the area exceed $50 million in assets (Figure 3). Due to their small size, these banks, while representing 17 percent of the U.S. commercial banks, hold less than 3 percent of U.S. banking assets.

The concentration of ag banks in the region varies considerably by state, with the largest number of ag banks domiciled in Iowa, Nebraska, Kansas, Minnesota, and Illinois. On a percentage basis, Iowa, Nebraska, and the Dakotas hold the largest proportions of ag banks, in each case exceeding 65 percent of the state's banks (Figure 4).

Figure 2
Distribution of U.S. commercial banks

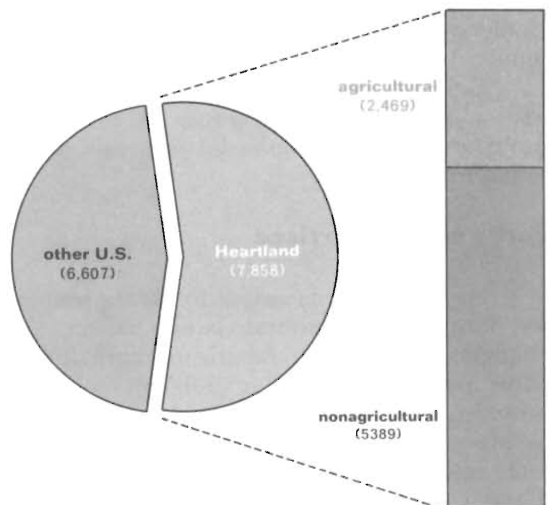
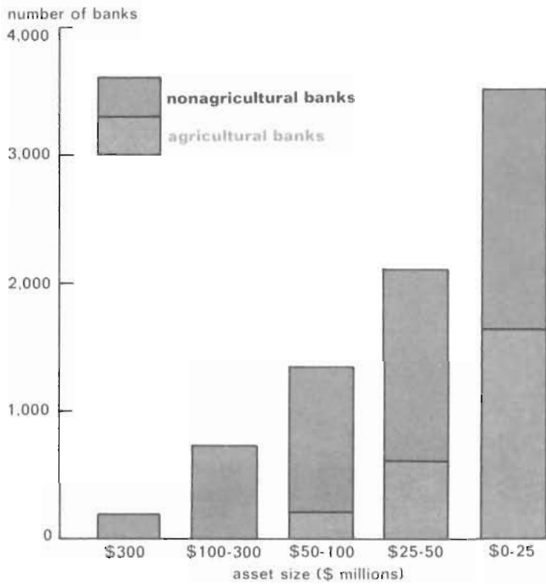


Figure 3
Distribution of banks by asset size—Heartland



But to conclude that the agricultural problems affect only these institutions understates the problem. In those states most heavily dependent on agriculture, bank performance measures have deteriorated even for those banks not defined as ag banks, reflecting the spillover effect on local merchants and consumers. These deteriorations are, however, not comparable in degree to the ag bank declines.

Root of the problem

The problems of the farm banks are a direct reflection of the region's embattled economic base. Plummeting farm earnings have resulted directly in increased farm loan charge-offs and uncollected interest on delinquent loans, while also resulting indirectly in reduced overall economic activity. Direct agricultural lending is a significant component of bank lending in the region. Roughly one third of the region's banks have 30 percent or more of their loans outstanding to agriculture while another 30 percent of banks hold some ag loans (Figure 5).

One needs only to compare the recent loan loss history of the region's ag banks with others to appreciate the degree of losses already recognized. While ag banks' loan loss rates relative to loans outstanding were slightly lower than the region's non-ag banks in 1980, by 1984 the ratio had multiplied over five-fold. In 1984 alone, the region's ag banks had writ-

Figure 4
Segregation of banks by state

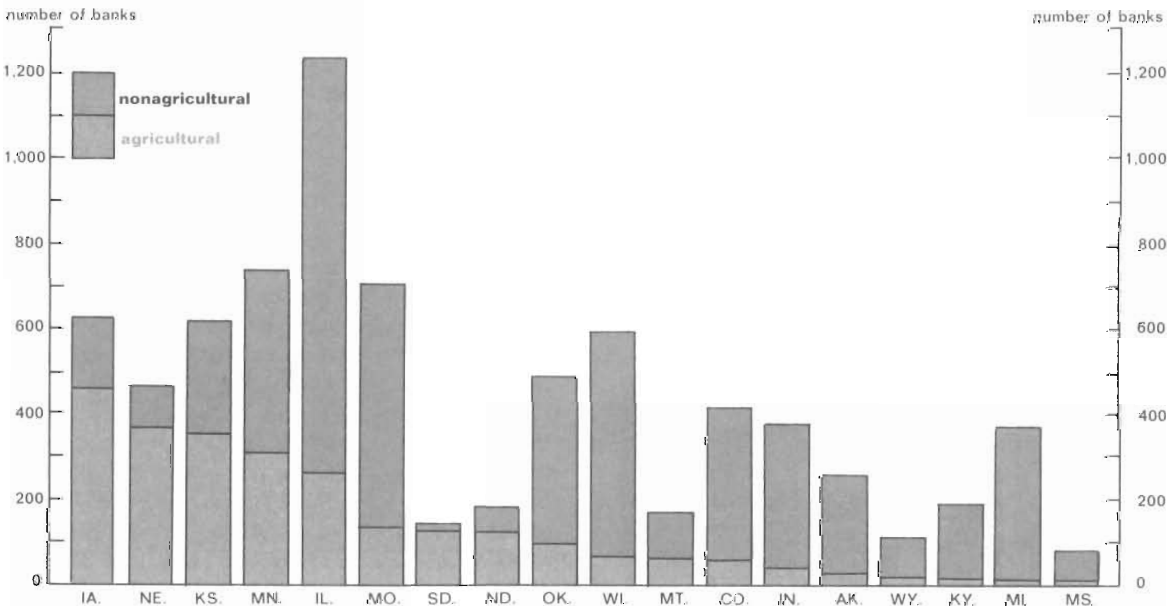
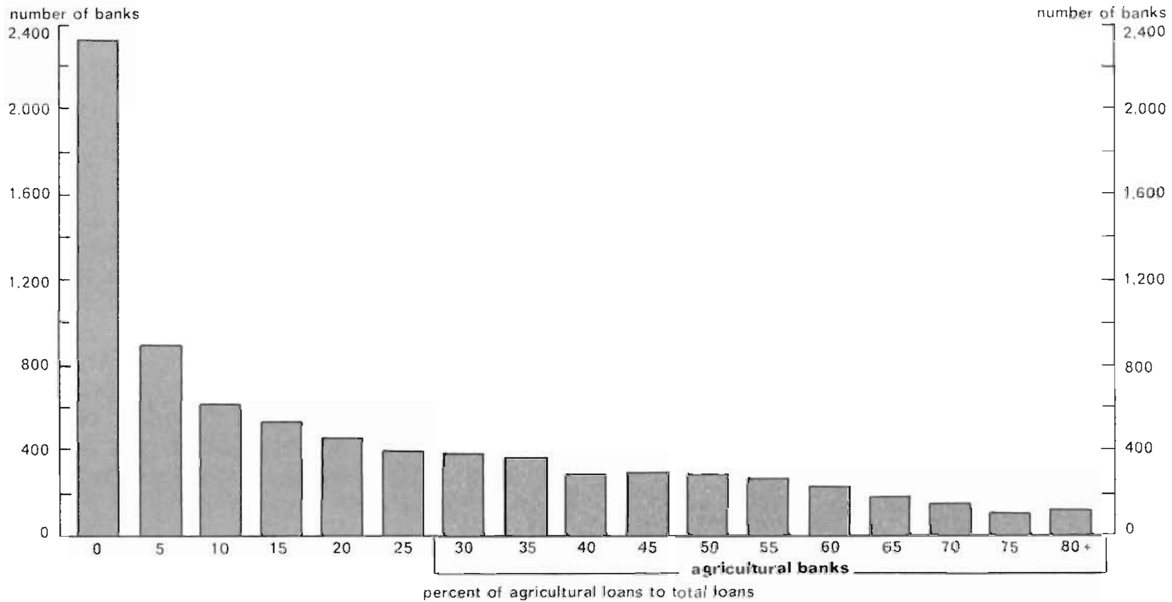


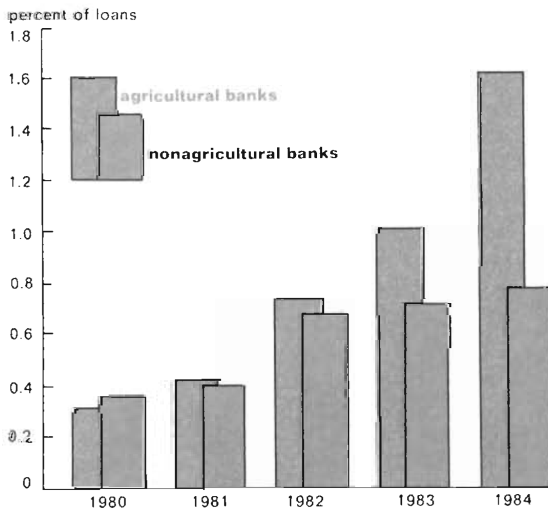
Figure 5
Ratio of agricultural loans to total loans in Heartland banks



ten off 1.6 percent of their loans, double the rate of non-ag banks for that year (Figure 6).

Increased losses were widespread among the ag banks. In 1980 slightly more than 8 percent of the region's ag banks had loan losses exceeding 1.1 percent of loans. In 1984 this percentage of banks had risen to more than 41 percent (Figure 7).

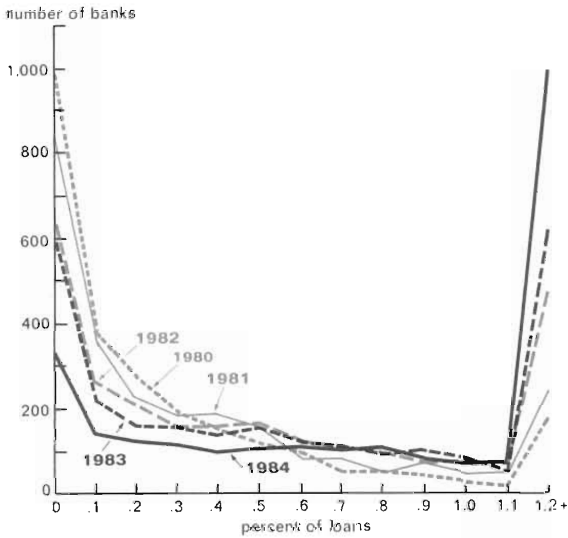
Figure 6
Net loan losses—Heartland



Despite the unprecedented levels of loan losses already taken, the degree of distress in the ag bank portfolios—as measured by the level of nonperforming loans relative to total loans outstanding—continues to increase, portending continued high rates of loan loss. The level of nonperforming loans at the region's ag banks rose from under 3 percent of loans in 1983 to 4 percent at year-end 1984, while at the non-ag banks, nonperforming levels moderated slightly from 3 percent to 2.8 percent (Figure 8). Preliminary data for the first quarter of 1985 indicate that these divergent trends are continuing. In some ag areas, the ratio of nonperforming assets to loans has risen by as much as one full percentage point in the first quarter alone. Although first quarter data may reflect some seasonal effects, clearly the credit problems at ag banks show no sign of abating.

Responding to the declining quality of their loan portfolios, ag bankers in the region have enlarged loan loss reserves. In 1980, ag banks in the region held reserves, on average, of .93 percent of loans. At year-end 1984, the ratio of reserves to loans had risen to 1.37 percent. Despite this significant increase, present

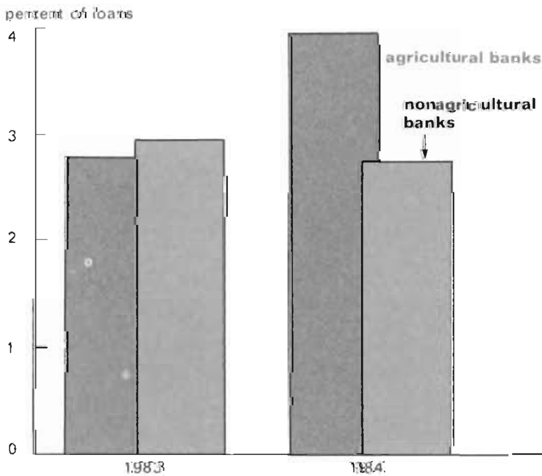
Figure 7
Loan losses—frequency distribution
(2,469 agricultural banks)



reserves represent lesser relative coverage of losses recently incurred and, more importantly, of the nonperforming assets that are currently outstanding.

The impact of credit problems on ag bank performance has been striking. Provision expenses needed to minimize the growing disparity between reserve levels and problem loans—particularly in the face of high direct

Figure 8
Nonperforming assets—Heartland



write-offs—have consumed ag bank revenues and greatly diminished ag bank profitability.

Withering profits

Reflecting the drag on revenues of nonperforming assets and the costs of replenishing loan loss reserves, the average of ag banks' return on assets in 1984 declined 50 percent from its 1980 level (Figure 9). Similar to the loan loss experience, earnings declines among the ag bank population were widespread (Figure 10). Adverse trends are evident both in ag bank net interest margins and loan loss provisions (Figure 11). This contrasts with the performance of the region's non-ag banks, where improving margins (driven by increasing loan demand) have more than offset more modest increases in loan loss provisions.

Although certainly a negative trend, the ag bank earnings declines appear somewhat less alarming when viewed in the context of these banks' historically superb earnings performance. Despite the decline in ag bank ROAs in 1984, the group's average rate was still only modestly lower than that of non-ag banks in the region. The ability of the banks to remain profitable (in the aggregate) despite high charge-off levels is testament to the strong underlying profit capacity of these firms.

Figure 9
Return on assets—Heartland
(7,858 banks)