

An ag banker's views

C. Robert Brenton

As a banker from the heartland of the country, an area that has spawned a very large, sophisticated, high-tech international agribusiness, I wonder how many understand either the nature or the extent of the recent changes and problems we have witnessed in the agricultural sector, and whether anyone can predict what the future will bring as a result of these changes. The recent economic damage has been substantial; here in Iowa, land prices have plummeted as much as 50 to 60 percent, a number of rural banks have closed, PCAs have frozen stock, and losses have been incurred by ag-related businesses large and small.

When, several months ago, Neil Harl from Iowa State University said that many farmers with debt-to-asset ratios of over 40 percent were in difficulty, I thought he was being an alarmist, but I don't think so now. Early in January, 1985, the Ag Banking Division of the American Bankers Association conducted a survey that showed that 41 percent of its farm borrowers lost money in 1984. It also estimated that 37 percent of its farm borrowers would have negative net farm incomes in 1985. In addition, *The Wall Street Journal* recently reported that earnings of the huge Farm Credit System, which holds about 37 percent of the nation's \$212 billion farm debt, have plunged by 50 percent over the past two years. Last year its Production Credit Associations sustained their first overall loss in the System's history.

Sociologist Paul Lasley of Iowa State University predicted at a recent governor's conference that "The current agriculture crisis is likely to change the face of rural America, leaving it with fewer people, fewer businesses, and more dependent on government aid."

Most would agree that great changes are in store for the world food production

process. These changes result from evolutionary processes and not from a single event. While the changes have occurred gradually, adjustment to them could place additional strain on an already financially troubled sector.

One area of change is in the market for agricultural products. Thirty years ago, we sold relatively little corn, soybeans, and other agricultural products outside the United States. Now 40 percent of our corn and soybean sales are in foreign markets. Another change is the percentage of people living in rural areas. In the year 1900, 59.5 percent of the United States' population was classified as farmers. Now, farmers number less than 3 percent of the population.

Technology has also had a tremendous effect. Back when I was a small boy, one good man could pick 100 bushels of corn in a day, and now one average man can pick 100 bushels in 30 seconds. Few people realize the magnitude of the impact of technology on agriculture unless they have been personally exposed to it.

It is difficult to predict the full effect of technology in agriculture, not just in the United States, but around the world. Someday, foreign countries will catch up technologically in agriculture, as they have in the auto and steel industries, and recently even in some high-tech businesses. The largest seed company in the world, Pioneer Hi-Bred International, Inc., now predicts that it will soon have more seed business out of the United States than in.

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Though the United States' food industry stretches nationwide and food production makes up 20.3 percent of our gross national product, most of the current economic disaster seems to be centered in the Midwest. I am a member of an informal group of Midwestern bankers, led by state banking associations in conjunction with the American Bankers Association, that has voiced several concerns about the effects of the current stress on their institutions. First, we feel that at best, quite a number of farmers in the next few years are not going to make it. This will lead to more trouble for banks and other financial institutions. Forty banks have closed so far this year, the majority of them in rural areas. This pace will certainly continue for several more years. (It should be noted, however, that with a few exceptions, these banks were sold and quickly recapitalized.) Our group also recognizes the need to work toward market-determined world food and agricultural prices, but is concerned that this be done gradually or the impact on agribusiness will be drastic, and perhaps unmanageable. Any phase-down of farm programs must therefore be spread over a number of years. Furthermore, the group believes that government, businesses, and farmers must work closely together in order to compete in worldwide food production, and to develop stronger and more successful international sales efforts.

For farmers, lenders, and agriculture-related businesses to survive this period of stress, several actions must be taken.

—Farmers Home Administration programs must continue to be funded.

—Bank regulators must, within the limits of prudence, allow banks that are well run

to absorb their losses over a period of time and to rebuild earnings.

Although in aggregate, ag bank earnings remain acceptable if no longer outstanding, the degree of decline has not been equally distributed. In terms of the relative percentage of banks registering losses in 1984, ag banks surpassed their non-ag counterparts, reversing what in 1980 was a quite favorable comparison (Figure 12).

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—Deregulation of banks must continue so that they can compete with their less regulated competitors.

—Legislation should allow banks to use Capital Certificates similar to those the thrift industry has been using to augment capital during this period of stress.

—The Federal Reserve should be ready to be of greater assistance to rural banks and other agricultural lenders, if necessary, through development of helpful programs.

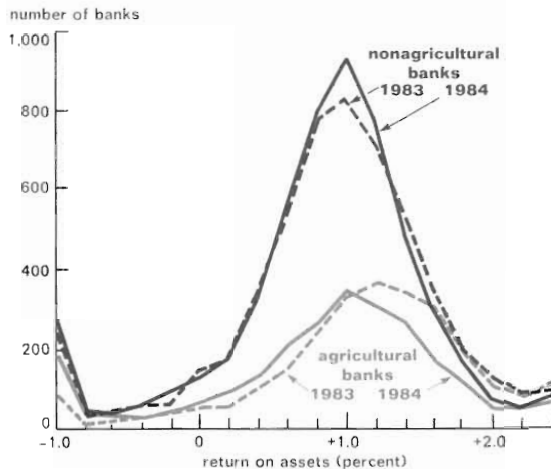
—Congress and the Administration should develop a safety net program something like the Reconstruction Finance program of the 1930s. The cooperative Farm Credit System has, in fact, proposed legislation along these lines to support the Federal Land Banks and other farm real estate lenders, and in turn, the farmers.

While the amount of land that will end up in lenders' hands because of foreclosures is still uncertain, there appears to be a potentially massive problem. Land constitutes some 75 to 80 percent of farm assets, and land values have dropped as much as 50 to 60 percent. Substantial problems would certainly be created in any industry if the value of its major asset were to drop so precipitously.

As we ag bankers are coming up for air a third time and as county and statewide tax collections are beginning to suffer, bankers and economists in other sectors are finally beginning to see that we have a problem that requires some attention. The agribusiness is a huge, vastly complicated, global business. As it changes, measures such as those outlined above need to be taken in the banking system and in the financial world to minimize the shock and to allow those who wish to survive to do so.

Further, the decline in ag bank profitability would be more pronounced were it not for tax credits utilized in recent years. Virtually no ag banks in the region relied significantly on tax credits to augment income in 1980. In 1984, by contrast, over 15 percent of ag banks utilized significant⁶ tax credits, again rising to exceed non-ag levels (Figure 13).

Figure 10
Return on assets—frequency distribution



While the recent earnings performance of the region's agricultural banks is sobering, near term earnings prospects appear equally somber. In view of the continuing weakness in the loan portfolios and the uncertainty regarding the continued ability to recognize tax benefits, one must look beyond current earnings to other, more enduring strengths when assessing ag bank prospects and soundness.

Buffer stocks

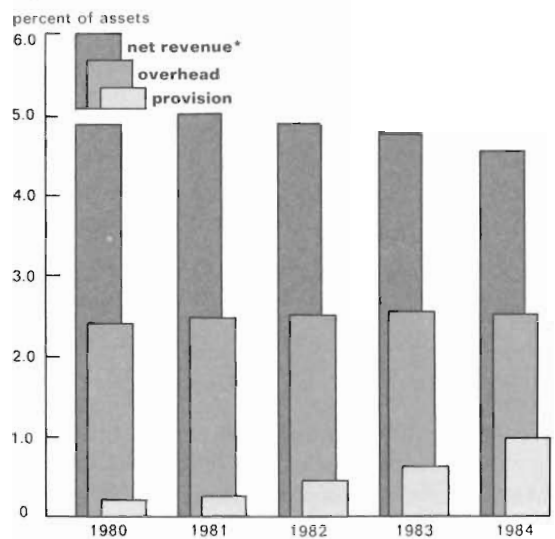
The viability of any banking organization is, in the first instance, a product of its current and potential earnings capacity. When earnings falter and prospects are clouded, one must look to the firm's capital base as the buffer to absorb prevailing losses and maintain depositor confidence.

Strong capital levels are a great fundamental strength of the region's agricultural banks. Both the traditional conservatism of ag bankers and the extended period of healthy profits in the 1970s have facilitated strong ag bank capitalization. Further, despite reduced earnings, ag banks in the region have continued to increase capital ratios during the 1980s through modest growth and low relative dividend payouts. While the most predominant value of primary capital in relation to assets was 8 percent at the region's non-ag banks at year-end 1984, the most predominant level at the ag banks was 9 percent (Figure 14).

The significance of strong ag bank capitalization is most apparent when capital is related to the quality of bank assets. Though the ratio of nonperforming assets relative to loans at the ag banks at year-end 1984 was more than one percentage point higher than that at the non-ag banks, when related to bank capital, the ratio was virtually identical (Figure 15). Hence, the relative level of unencumbered capital of ag banks has declined only to parity with non-ag banks.

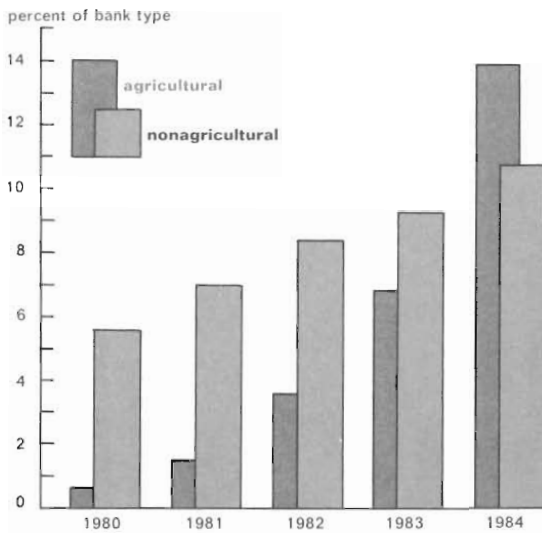
The outlook is somewhat less sanguine when consideration is given to the additional leverage held in the agriculturally oriented bank holding companies. Although their underlying bank subsidiaries may be well capitalized, the additional leverage of the holding companies may result in considerably lower consolidated capitalization. According to year-end 1984 bank holding company data for the Chicago Federal Reserve District *only*, the 313 agriculturally oriented bank holding companies⁷ in the district hold aggregate debt averaging 47 percent of parent equity. Hence *consolidated* capitalization, on average, would be approximately one third lower than underlying subsidiary capital. Further, the distribution of leverage levels is widely disbursed, as

Figure 11
Earning analysis—Heartland agricultural banks



*Includes net interest income (tax equivalent) and other income.

Figure 12
Percent of banks with net losses



nearly one third of the District's ag BHCs have no debt (Figure 16).

The debt of ag BHCs principally consists of notes held by prior shareholders and by bank financings. Most small bank holding companies rely solely on their bank subsidiaries for dividends to service such debt. Bank dividends may be constrained by statutory limitations or regulatory actions if underlying bank performance warrants. As such, cash flow difficulties may surface at BHCs where high parent debt, lower relative subsidiary capitalization, and poor earnings performance coincide. In some cases, refinancing or debt restructuring may be required.

Passion and intellect

Inevitably the problems of present day agriculture evoke comparisons to the agricultural banking crises of the 1920s. Declining commodity prices and land values, increasing foreclosure rates, and an intensifying climate of tension and uncertainty are features unfortunately common to both periods.

However, equally compelling differences can be cited. Many of the differences, in fact, result from programs whose origins lie in the events and lessons of the twenties and thirties. In the case of banks, federal deposit insurance stands as a bulwark of confidence for depos-

itors. The importance of insurance cannot be overstated during a period of stress such as this. By reassuring depositors, federal deposit insurance prevents isolated bank insolvencies from compounding into a widespread liquidity-driven catastrophe such as that of the 1920s. To further insure adequate liquidity for the farm sector, the Federal Reserve in March, 1985, revised and extended its seasonal leading program. The Federal Reserve noted that there were few if any signs to indicate that agricultural banks generally would experience any unusual shortfall of liquidity. The action was taken, nevertheless, to have in place a means to offset any unforeseen liquidity strains that might arise in local areas or for individual banks, thus threatening the necessary flow of credit to farmers.⁸

Direct farm programs, although certainly not panaceas, provide additional external support. The federal loan programs of the Farmers Home Administration have lessened the direct exposure of banks to some of the most troubled ag credit. More recently, the loan guarantee provisions of the federal "Debt Restructuring and Assistance Program" have provided some measure of assistance. Although none of these initiatives will eliminate farm and farm bank stress, they do distinguish present reality from the noninterventionist approach of the pre-1930 era.

Figure 13
Significant tax credits—Heartland
(7,858 banks)

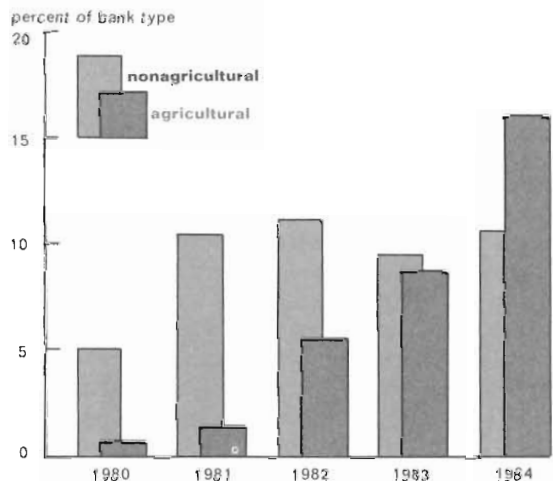
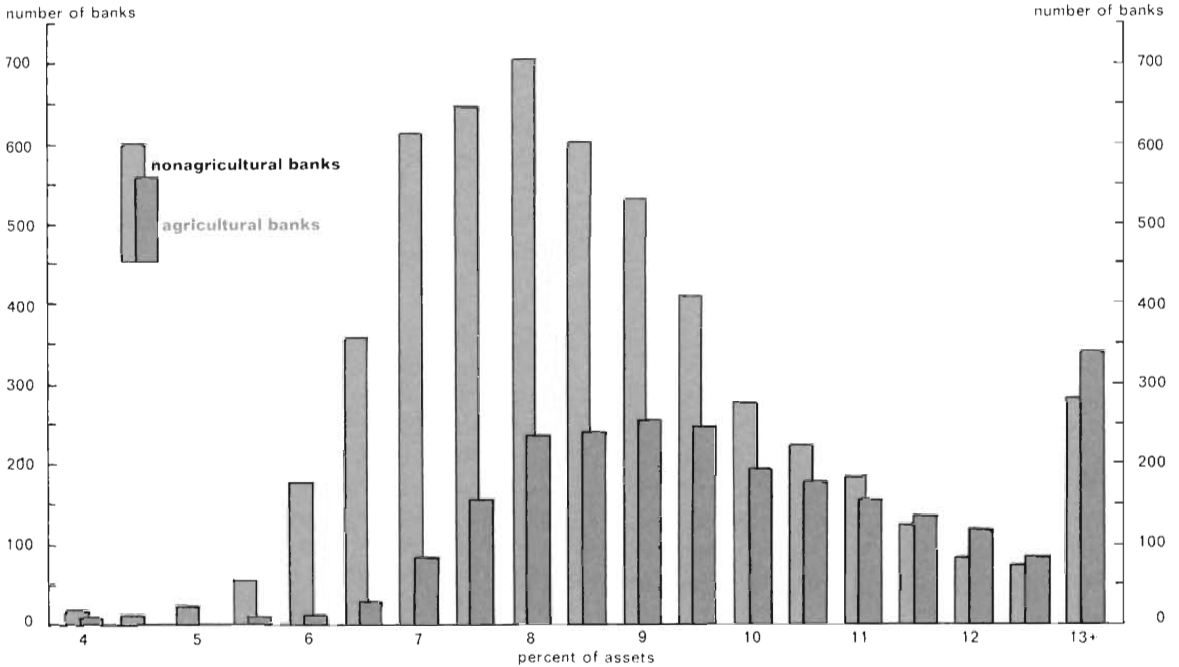


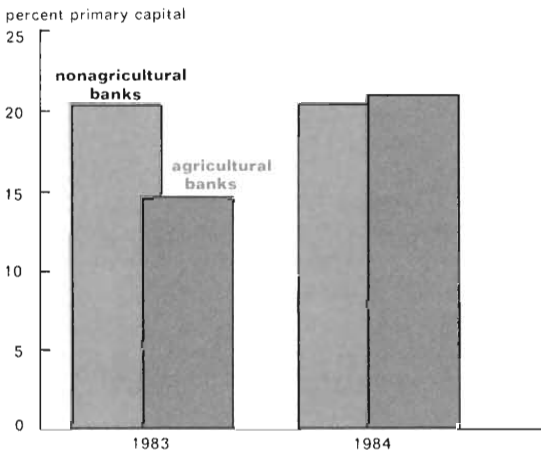
Figure 14
Primary capital/assets—1984



A more apt similarity for the present agricultural trauma can be found closer to home—if not geographically, at least chronologically. Present difficulties in U.S. energy and mining concerns reflect many of the same

maladies as agriculture-heavy investment during the boom times of the 70s followed by reduced demand, a strong U.S. dollar and reduced inflationary expectations. Some of the more troubled energy and mining sectors in Texas, Oklahoma, and the Mountain States sit on the periphery of the heartland, and in some cases overlap ag bank market areas. This is a hard irony for those institutions that attempted to insulate themselves from exposure to one industry by diversifying into the other.

Figure 15
Nonperforming assets—Heartland



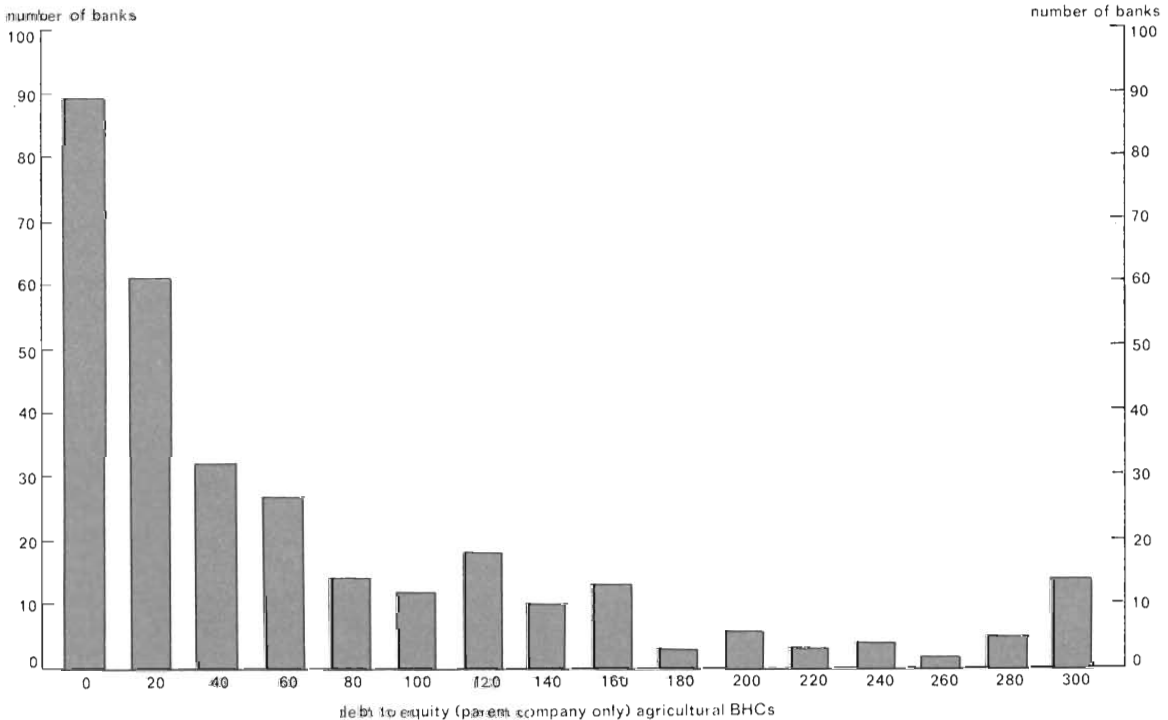
Still, while adjustments may be shared by other sectors and may pale in comparison with the debacle of the 20s, hard times in America's farm belt remain all too much a reality. Calm deliberation and cooperative effort are most critical at this time to contain the problem and limit its effects. Although some external support exists, the majority of the burden will continue to be borne by agricultural banks and their communities.

Some key pressure points:

● **Funding—**

Over 80 percent of ag bank assets are funded by local deposits or bank equity. This great

Figure 16
Parent leverage—Seventh District agricultural BHCs



strength allays fears of a massive systemic liquidity crisis. Ag banks may focus their attention more fully on addressing credit issues and cleansing their portfolios forthrightly without fearing the caprice of Tokyo debt traders or news flashes in London. Local depositors, however, should be reassured and made aware of the risks—and protections—their accounts hold.

● **Forbearance—**

The massive reversal of agricultural fundamentals has required extraordinary cooperation on the part of lenders, borrowers, and others. Markets for farmland and equipment can, at best, be categorized as unsettled. Continued, prudent forbearance on the part of *ag bankers* is essential to permit an orderly adjustment to the new economics of agriculture. *Bank regulators*, recognizing this, have instructed examiners to consider carefully this factor in order to avoid exacerbating the problem. This policy does not necessarily result in a reduced volume of loans deemed to present an unusual amount of risk (referred to as classified loans)—failing

to recognize risk levels would not make the problems go away and would ultimately undermine the reliability of the examination process—but does result in the tolerance of a higher level of classified loans so long as the bank is making its collection decisions and otherwise servicing the loans in an informed, prudent manner and the overall risk position is supported by an adequate reserve and equity capital base. Some *ag BHC debt holders* may also find refinancing and debt restructuring a viable approach to bridge temporary shortfalls.

● **Fortification—**

The financial strengths of the agricultural banking system have already been demonstrated through the prudence and conservatism shown during better times. This character must continue. With present prospects for agricultural recovery uncertain, the choice between disinvestment and perseverance—flight or fight—for agricultural bankers has never been more difficult or more important. Community ag bankers have attributed past strengths to local ownership and local man-

agement. The ability of the agricultural banks to fortify and thereby serve as a buffer between local depositors and the risks of present day agriculture will greatly influence the future vitality of the farms and communities of the heartland that they serve.

Conclusion

Although stresses will continue, the overall soundness of the agricultural banking system remains secure, resting on the twin pillars of strong capital and stable deposits.

The stresses, however, do not fall equally on all firms and increasing numbers of troubled farm banks are an unmistakable reality. As stresses mount, bank failures will most likely continue to rise and will undoubtedly exceed past experience. Due to the large number of small banks heavily affected by ag conditions, the increase in problem banks and bank failures may appear quite dramatic, but due to the ag banks' modest relative size and principally local and insured funding, there is little likelihood of a pyramiding transmission of problems into the banking system as a whole. Absent a profoundly severe and protracted period of agricultural stress, resolution of the banking problems that do occur in the region can be accomplished through traditional supervisory methods and mergers.

With little prospect of near-term improvement in the agricultural economy, however, agricultural banks will call mightily on their underlying strengths as the painful adjustments in agriculture proceed. Not unlike that of the farmers they finance, the ability of individual ag bankers to weather the lean years is in large part a reflection of the degree to which provision was made for these times during the years of plenty—combined with their ability to husband present capital and human resources.

And let them collect all the foodstuffs of the . . . good years . . . and the foodstuffs must serve as a supply for the land.

Genesis 41: 35-36

¹ K. Keplinger and others, "Agricultural Banks in the Southeast: How Are They Faring?" *Economic Review*, (Federal Reserve Bank of Atlanta, May, 1985).

² Statement of J. Charles Partee, member of the Board of Governors of the Federal Reserve System, before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs, April 26, 1985, (*Federal Reserve Bulletin*, June, 1985) p. 436.

³ K. Keplinger, *Economic Review*, May 1985.

⁴ All data, unless otherwise noted, are derived from the reports of income and condition. (FFIEC Forms 031-034). All data for the four-district area exclude Continental Illinois National Bank and Trust Company of Chicago and First National Bank of Chicago.

⁵ Ag loans in this study are derived from Call Report data, schedule RC-C, line 3, loans to farmers, and do not include real estate loans secured by farmland. Real estate loans secured by farmland, on average, total less than 1 percent of loans at "non-ag" banks and approximately 5 percent of loans at ag banks in this region. As such, the omission does not appear material to the general conclusions of the study.

⁶ Nonperforming loans include loans past due 90 days or more, nonaccrual loans, and restructured loans.

⁷ Significant tax credits are defined as tax credits that represent 0.10 or more relative to average assets on an annual income statement.

⁸ Ag BHCs are defined as BHCs with subsidiary banks that, when combined, meet the 30% test used to define ag banks. All data are derived from FR Y-9 and Y-6 reports.

⁹ J. Charles Partee, *Federal Reserve Bulletin*, June, 1985, p. 437.