

Statement of
Jason R. Henderson
Vice President
Federal Reserve Bank of Kansas City
before the
House Committee on Agriculture
Subcommittee on Department Operations, Oversight, and Credit

April 14, 2011

Thank you, Mr. Chairman and members of the sub-committee. My name is Jason Henderson. I am Vice President and Economist with the Federal Reserve Bank of Kansas City. In this capacity, I lead several Federal Reserve initiatives that track economic conditions in the farm economy, including the *Agricultural Finance Databook*, which summarizes trends in national farm lending and the Survey of Agricultural Credit Conditions for our seven states in the Tenth Federal Reserve District. I appreciate the opportunity to discuss some of our findings regarding national agricultural credit conditions and farmland values.

Agricultural Credit Conditions

In 2009, the recession and fragile financial markets cut farm incomes and raised concerns about credit availability for agricultural borrowers. Since then, a stronger global economy has spurred booming farm incomes. Surging crop prices are boosting profits for crop producers and many livestock operations are still able to maintain some level of profitability even in the face of high feed costs. With a resurgent farm economy, agricultural loan demand is shifting.

The most dramatic shift has emerged from the decline in farm operating loans. With strong cash flows at the end of 2010, farmers, especially crop producers, paid off operating loans. In addition, many pre-paid a large portion of their input costs at the end of last year, curtailing loan demand. Based on Federal Reserve surveys, commercial bankers across the nation reported higher loan repayment rates and fewer extensions and renewals for operating loans, with loan volumes falling more than 22 percent below year ago levels in the first quarter of 2011.

In contrast, commercial banks expanded lending to livestock producers. With higher costs for feed and feeder cattle straining livestock profits, loan demand from livestock enterprises increased. Even in the face of tighter credit standards and rising delinquency rates, commercial

banks expanded loan volumes for livestock approximately 15 percent last year. In the first quarter of 2011, commercial bank lending for livestock held near last year's elevated levels.

In addition, loan volumes for farm machinery and equipment have risen sharply. Larger profits prompted many crop producers to expand their capital investments and business contacts reported brisk sales of tractors, combines, trucks, pivot-irrigation systems, grain bins, and other farm equipment. For example, according to the Association of Equipment Manufacturers, four-wheel drive tractor sales jumped roughly 30 percent in 2010. In the first quarter of 2011, commercial bankers reported that loan volumes for farm machinery and equipment surged 72 percent above year ago levels.

Finally, farm real estate loan volumes rose solidly with booming cropland values. According to Federal Reserve and university surveys, cropland values in many Midwestern states have soared more than 20 percent over the past year. The northern and southern Plains also enjoyed stronger farmland value gains as robust energy markets lifted land lease revenues for oil exploration. By the end of 2010, farm real estate loan volumes at commercial banks and Farm Credit associations rose solidly, and industry contacts noted that life insurance companies, vendor creditors, and non-farm investors remained active in agricultural markets.

The Outlook for Agricultural Lending

Going forward, agricultural lenders appear to be in position to meet the credit needs of farmers. Agricultural bankers report having ample funds for farm loans and continue to lend to farmers at historically low interest rates. Bankers are beginning to ease collateral requirements on farm loans after stronger repayment rates trimmed delinquencies on farm loans. With

healthier loan portfolios, agricultural banks are enjoying stronger earnings than their banking peers, which should further underpin future lending activity.

Still, questions surrounding the availability of credit and collateral requirements persist. The most pressing concerns and stringent requirements have likely emerged for livestock producers struggling with profitability and for smaller farm operations owned by young and beginning farmers with less equity. Our research at the Federal Reserve Bank of Kansas City indicates that these operations are more likely to struggle with debt repayment and be denied credit.

As a result, the sustainability of farm profits and agricultural land values pose the greatest risk to agricultural credit conditions. Agriculture is a boom and bust industry. While many crop producers expect another year of hearty profits, these profits could be fleeting. For example, according to the U.S. Department of Agriculture's long-term projections, average annual corn prices could fall to \$4.10 per bushel by 2013 and remain less than \$4.25 per bushel through 2020, cutting net returns above variable costs by 30 percent. Profit margins for other major field crops are also projected to decline. Shrinking returns could threaten booming cropland values, and if capitalization rates return to their historical averages, cropland values could fall by as much as a third, eroding the financial health of the farm sector.

In the face of volatile markets and uncertain profits, low leverage ratios and larger levels of working capital are often the best risk management strategies for farmers. Most measures of financial leverage remain at historical lows, but it is still an open question whether farmers have learned these lessons from past farm crises and will resist the temptation of borrowing at low interest rates.

In sum, near-term prospects for U.S. agriculture remain bright. Delinquency rates have eased and, while tight, credit standards for agricultural loans are beginning to loosen. With lofty incomes, many farmers invested in machinery, equipment and farm real estate, while others paid down debts to weather any unexpected storms building on the horizon. While volatile commodity markets and rising production costs are threats to future farm profits, credit is still available.

Mr. Chairman, thank you for inviting me today, and I will be happy to respond to any questions at the appropriate time.

Agricultural Finance Databook

“Cropland Values Climb and Agricultural Finances Strengthen”

By Jason Henderson and Maria Akers

April 2011

Agricultural finance conditions strengthened amid soaring farmland values, booming farm incomes and rising commodity prices. Elevated farm incomes, especially in grain-producing regions, drove cropland values as much as 20 percent above year-ago levels. Strong farm and nonfarm investor demand and skyrocketing land prices enticed some landowners to list farms for sale. Robust energy markets also placed upward pressure on farmland values in the northern Plains, where land lease revenues for oil exploration surged. Farmland value gains, however, were more modest in the southern Plains, as drought conditions intensified. Rising farmland values and brisk sales raised farm real estate loan volumes at commercial banks moderately at year-end.

With stronger loan portfolios, agricultural banks ended the year with their best performance since the start of the financial crisis. Farm loan delinquencies fell as more farmers paid off loans at the end of 2010. Bankers also reported fewer loan renewals or extensions, potentially foreshadowing future declines in noncurrent loan volumes. The return on assets and equity at agricultural banks marched higher during the year, while the returns at other small banks held steady. Moreover, in a year when more than 150 commercial banks failed, fewer than 10 were agricultural banks.

Strong farm incomes transformed non-real estate loan portfolios at commercial banks. Rising incomes curbed demand for short-term production loans but fueled capital investment that lifted intermediate-term loan volumes for machinery and equipment. The volume of loans for

operating expenses waned at the first of the year as both crop and livestock producers used current incomes to pay for operating expenses. In contrast, farm machinery and equipment loan volumes rose sharply with a rebound in capital spending. With softer non-real estate loan demand, more bankers reported a rise in funds available for farm loans. Collateral requirements generally held steady, and interest rates continued to trend down.

Section A

Resurgent capital spending on farm machinery and equipment shifted lending activity toward intermediate-term loans. With rising incomes, farmers sharply increased their capital spending levels, in turn boosting intermediate-term loan volumes on farm machinery and equipment (Chart 1). In fact, farm machinery and equipment loan volumes jumped 73 percent above year-ago levels in the first quarter of 2011 and their average size almost doubled. These loans were extended for slightly shorter terms compared to last year but at much lower effective interest rates that averaged 4.4 percent (Chart 2).

In contrast, rising farm incomes trimmed operating loan demand as farmers used cash to pay for operating expenses. The volume of operating loans plunged 22 percent below year-ago levels in the first quarter. Bankers reported weak loan demand and strong pre-payment of operating expenses. Winter storms during the February survey period and the atypical timing of the survey might have exacerbated the declines in loan originations in the first quarter of 2011. Operating loan maturities were about 2 months longer than average at 11 months, and the average effective interest rate edged up to 5.3 from a fourth quarter low.

After rising substantially during the last half of 2010, the volume of feeder and other livestock loans at commercial banks posted modest declines. In the first quarter, the volume of feeder livestock loans fell 9 percent below year-ago levels, even though rising feeder cattle

prices pushed average loan amounts higher. The average maturity for feeder livestock loans fell to just under 8 months, and the average effective interest rate held around 5 percent.

Small and mid-size commercial banks were more affected by shrinking non-real estate loan volumes than large commercial banks. The size of farm loan portfolios at banks with \$25 million or less in farm loans contracted 12 percent year-over-year, while the size of farm loan portfolios at banks with more than \$25 million in farm loans held steady. At the same time, the composition of farm loan portfolios shifted away from smaller loans toward larger loans of more than \$100,000.

Section B

Agricultural banks closed 2010 with their strongest financial performance in two years. The rate of return on assets at agricultural banks strengthened in the fourth quarter to 0.9 percent, in contrast to 0.1 percent at other small banks (Chart 3). Moreover, the average rate of return on equity at agricultural banks jumped to 8.4 percent in the fourth quarter, compared to 1.1 percent at other small banks. In addition, the percentage of agricultural banks with negative income as a share of average equity fell by more than a third. After rising during most of 2010, average capital ratios at both agricultural banks and other small banks edged down in the fourth quarter but remained near year-ago levels.

Non-real estate loan performance strengthened in the fourth quarter. The volume of outstanding non-real estate farm loans at all commercial banks ended the year slightly below 2009 levels. Delinquent non-real estate loans have trended down since early 2010, comprising just 2.0 percent of outstanding farm production loans in the fourth quarter (Chart 4). Also, the volume of non-real estate loans 30 to 90 days past due dropped to its lowest level since 2008.

With declining delinquency rates, fourth quarter net charge-offs fell more than 25 percent below year-ago levels.

Loan performance measures for real estate loans improved at year-end. Farm real estate loan volumes at all commercial banks settled 2.0 percent above year-ago levels. After rising steadily during the past three years, the share of nonperforming farm real estate loans eased slightly in the fourth quarter to 2.7 percent. In addition, the volume of real estate loans 30 to 90 days past due leveled off, which could signal further declines in delinquency rates. Net charge-off amounts grew in the fourth quarter, but they accounted for about the same percentage of outstanding farm real estate loans as last year.

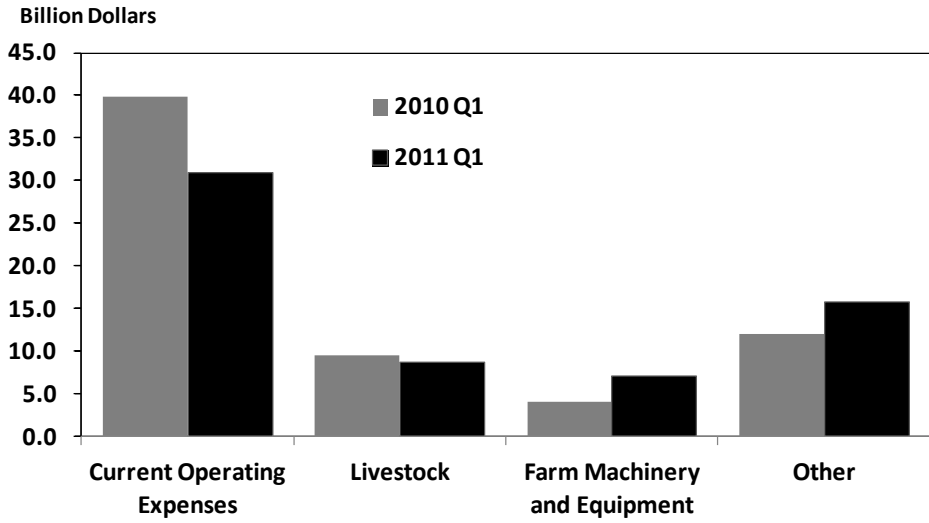
Section C

Rising farm incomes propelled farmland values higher at the end of 2010. Large year-over-year farmland value gains were seen across the Corn Belt and into the northern Plains where energy production is booming. In fact, North Dakota enjoyed the strongest annual increase in farmland values largely due to land lease revenues from expanded oil production (Map 1). Crop producing states such as Northern Indiana, Northern Illinois, Iowa, Nebraska, and Kansas reported another round of robust farmland price increases in the fourth quarter. Cropland values, however, increased more modestly in the southern Plains as drought conditions threatened crop yields and limited cattle grazing. Even with slightly more farms for sale at the end of the year, strong demand from farmers and nonfarm investors kept bidding brisk and pushed values higher. Bankers in the Chicago Federal Reserve District expected growth in farm real estate loan volumes relative to last year. Many Federal Reserve survey respondents anticipated that farm incomes and farmland values would rise further in the coming months.

Overall demand for farm loans stalled in the fourth quarter with less borrowing for production expenses and an upswing in loans for capital purchases. Several districts noted a decline in operating loan demand as many farmers used income to pre-pay for crop inputs. In addition, bankers in the Chicago, Dallas and Richmond Districts reported fewer feeder cattle and dairy loans in the fourth quarter. Still, a majority of bankers expected operating loan volumes would rebound prior to spring planting. Federal Reserve surveys also noted a rush of machinery and equipment loans at the close of 2010 as farmers upgraded equipment and took advantage of new tax depreciation rules.

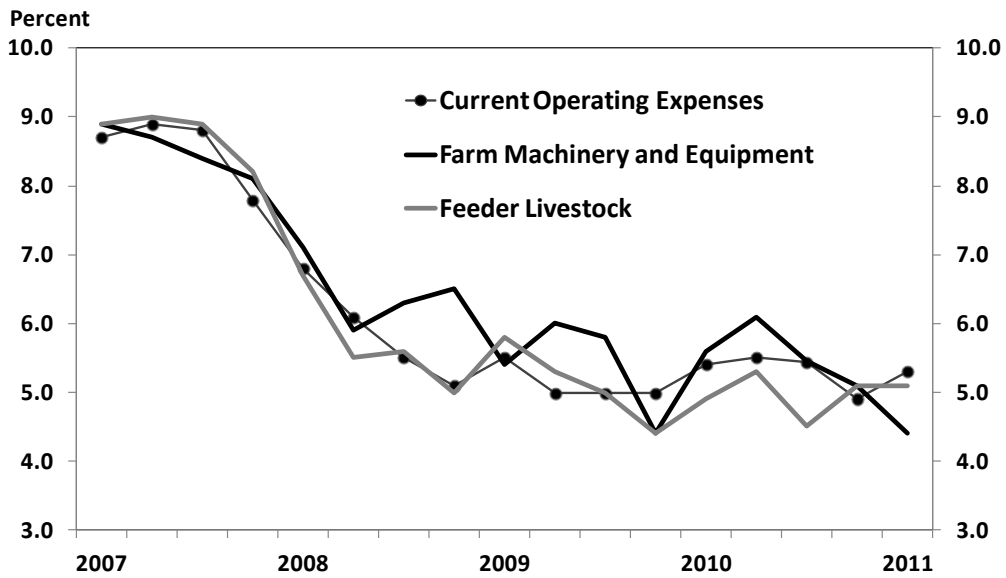
Farm credit conditions strengthened further as farmers paid off loans in earnest at year-end. According to Federal Reserve surveys, loan repayment rates at agricultural banks continued to climb and were markedly higher in the Chicago, Minneapolis, and Kansas City Districts. Moreover, loan renewals and extensions fell in all Districts but Richmond. Most bankers, but particularly those in the Chicago and Kansas City Districts, noted ample funds were available for loans, and very few loans were referred to non-bank credit agencies. Collateral requirements generally held steady or eased slightly. Interest rates trended down for both real estate and non-real estate loans.

Chart 1: Loan Volume by Purpose of Loan



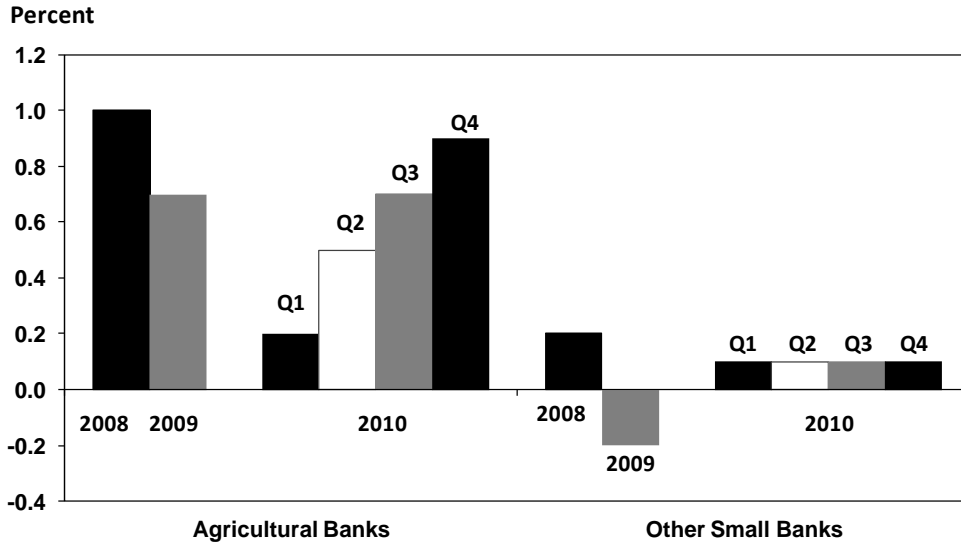
Source: Agricultural Finance Databook, Section A

Chart 2: Average Effective Interest Rates on Farm Loans



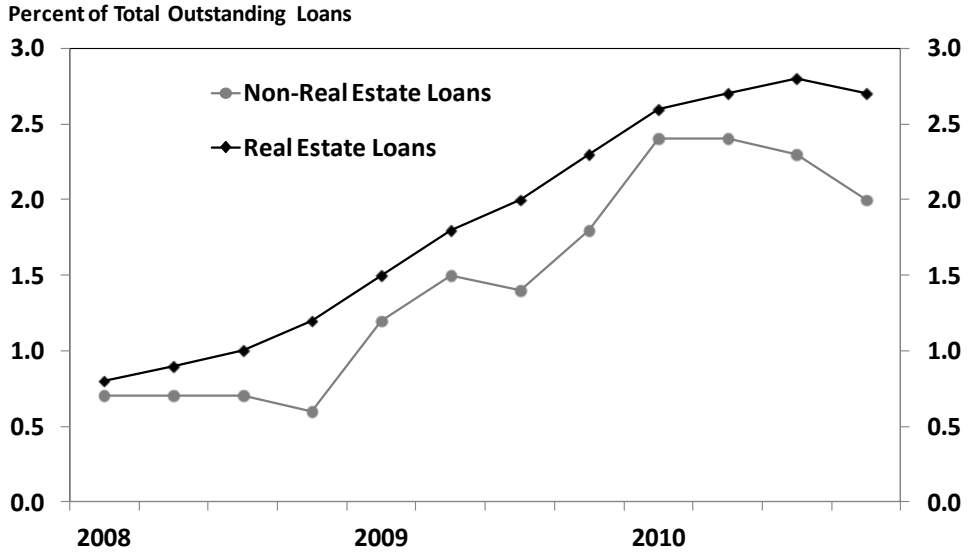
Source: Agricultural Finance Databook, Section A

Chart 3: Rate of Return on Assets



Source: Agricultural Finance Databook, Section B

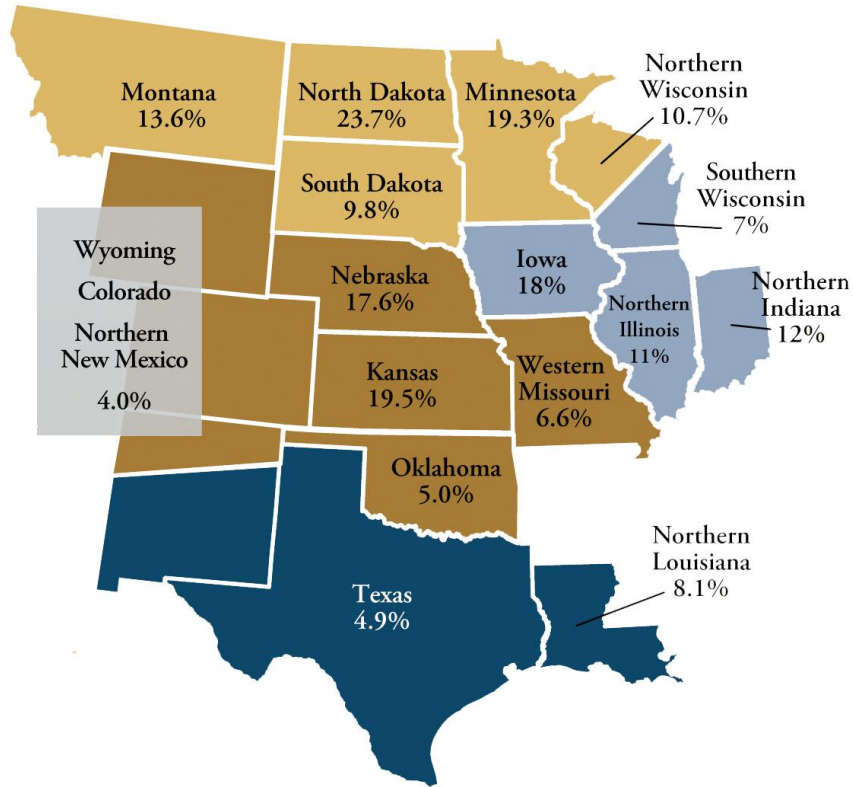
Chart 4: Nonperforming Loan Volumes



Source: Agricultural Finance Databook, Section B

Map 1: Good-Quality (Non-irrigated) Cropland Values

(Percent change Fourth Quarter 2009 to Fourth Quarter 2010)



Source: Federal Reserve District Surveys (Chicago, Minneapolis, Kansas City, Dallas)