Remarks by
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Ever since its founding, St. Louis has been the gateway between urban and rural America. This is where the west -- and the farm belt -- begin. And so it's fitting that we launch our discussion of agricultural lending and risk management in the 21st century here, too.

As a business and as a way of life, farming in America has never been for the lazy or timid. The risks are great; the rewards at best uncertain.

The risk/reward ratio for farmers has been most unfavorable of late. At a time of remarkable growth in the nonfarm economy -- with most Americans enjoying record prosperity -- net farm income was down last year, for the second year in a row. Too many American farmers are hurting today.

Their pain stems from some familiar factors -- and some not so familiar ones. Recession in East Asia. One of the worst droughts on record. Foreign competition. A strong dollar. Silos bulging with years of surplus.

Not surprisingly, people are wondering aloud whether a repeat of the early 1980s is in the offing. Then, too, we saw declining crop and livestock prices, shrinking foreign markets, and a rising dollar. And the cost -- to individual farmers and the financial institutions that served them -- was immense.

Between 1980 and 1988, some 200,000 to 300,000 farmers underwent bankruptcy, foreclosure, or financial restructuring. Agricultural banks failed in numbers not seen since the 1920s, when they were harbingers of the more widespread financial devastation of the Great Depression. Three hundred and four ag banks went under between 1984 and 1989, representing at their peak nearly 60 percent of all bank failures -- at a time when there were many.

So it's natural that questions should be raised about the current distress in the agricultural economy, and whether it points to another bitter harvest of ag bank failures to follow.

Like most questions about the future, it's not one that can be answered easily or definitively. But the evidence gives us real basis for optimism that the financial system may well be spared the spillover effects of the current farm distress.

That would be a great blessing, and not only for the ag banks themselves, their owners, and employees. During the 1980s, ag bank failures made the farm crisis more painful and more personal. Fewer lenders meant fewer choices and higher costs for borrowers. That was often enough to spell ruin for farmers who were already operating close to the edge.

Credit availability could prove just as decisive today. Farmers may be able to ride out the hard times if they are able to obtain the financing they need to tide them over until better times return. If not, heartbreak may once again become a commonplace on our farms. It's an irrefutable fact: the condition of our agricultural banks is inextricably linked to the health of America's agricultural economy.

One of this great city's most famous adopted sons, Cardinals' pitcher Jay Hanna Dean -- better known as Dizzy -- was sometimes accused of tooting his own horn too loud and too often. He saw things differently. "If you've done it," he reasoned, "it ain't braggin.'"

Ag bankers today <u>can</u> brag, about the successes they've achieved to date and the things they're doing to safeguard the future. Many of the traditional benchmarks of bank health look good right now. In 1998 -- the last full year for which reliable statistics are available -- farm banks reported increased earnings, strong loan growth, good asset quality, and capital at historically high levels, both in absolute dollar terms and as a percentage of assets. Preliminary 1999 statistics show only a slight deterioration in these numbers.

Yet these trends tell only half the story -- and that story demands both qualification and explanation. First, we cannot ignore the fact that some indicators of ag bank health <u>are</u> trending down -- only slightly, in most cases, but down nonetheless. The proportion of farm banks that had nonperforming loans greater than 25 percent of capital increased from three and a half to five percent between 1998 and 1999. The OCC's most recent survey of credit underwriting practices predicts rising credit risk in ag lending for 2000. Farm loan restructurings and renewals are up. More and more commercial lenders are resorting to subsidized Farm Service Agency financing to cope with a rising number of weakened borrowers.

Like bankers all over the country, ag bankers have to deal with dwindling core deposits and a growing reliance on higher cost wholesale funds in order to sustain loan growth. And, while ag banks -- defined as banks with ag loans to total loans greater than

25 percent -- have made some progress toward product and geographic diversification in recent years, they are still inordinately exposed to the perils of concentration inherent in their business.

The second caveat concerns the future. There is simply no guarantee that ag banks will continue to perform as they have should farm conditions worsen -- or even if they get no better. If we should experience still another year of declining farm income -- which is exactly what the official projections call for -- then all bets are off.

The USDA estimates that government payments to farmers -- which reached a record $22 billion in 1999 -- will drop by almost 20 percent this year. New production capacity is coming on line from countries like China and even India -- countries that not very long ago were big net importers of grain. The possible combination of lower government payments and still-depressed crop prices will surely test the resourcefulness of farmers and farm lenders. With all of these trials looming, the worst thing we could do today is to get caught up in an excess of self-congratulations.

Yet some cautious optimism <u>is</u> in order. That the future is unknowable and that significant risks lie ahead does not change the fact that ag banks have shown much greater resilience during this agricultural downturn than in previous ones. The question we want to consider is why.

There’s no short answer. A long list of macro and micro factors have helped blunt the impact of today’s farm income shortfall. As analysts have noted, the parallels between agricultural conditions in the early 1980s and those of today are valid only up to a point. In the earlier period, many farmers were undone by rising interest rates, which doubled or even trebled the cost of financing and automatically deflated the value of the land that secured that debt. By comparison, largely as a result of today's benign interest rate environment, land values are holding firm, despite depressed commodity prices. That's a big reason why farmers' total equity rose last year for the tenth straight year even as real farm income was trending downward.

Farmers are also benefiting from the general economic prosperity and low inflation of our times, which stand in sharp contrast to the deep recession of the early 1980s. Credit is just one farm input whose cost has been stable of late. In 1998, total farm expenses dropped for the first time in more than a decade, and the preliminary 1999 data suggest an increase for last year of barely one percent. Even the recent run-up in energy prices should affect operating balance sheets only at the margin.

But perhaps the key variable is the fact that, no matter how you choose to measure it, farmers today are substantially less leveraged than they were in the early '80s. In 1981, farmers carried debt equal to about five and a half times their cash income. Today the ratio is about three to one. Adjusted for inflation, farm debt today stands at about the same level that it was in 1965. And farmers' debt-to-assets ratio, which peaked at 23 percent in 1985, is now about 16 percent. If one of the lessons of the farm crisis of early 1980s was to avoid excessive debt, it's a lesson that American farmers have clearly taken to heart. It's a lesson that other Americans businesses and consumers could benefit from, as well.

That's not the only lesson farmers have had to internalize in order to stay afloat. In today's challenging environment, they're learning to be just as attentive to their finances as to their fields and crops. That's why the most sophisticated farmers are increasingly taking advantage of forward sale and marketing arrangements for their crops and livestock, as well as hedging, production controls and other stratagems to help offset price volatility and assure themselves a predictable income stream. Indeed, the most prosperous farmers today are those who had the acumen to lock in grain prices at a profit. By contrast, today's most troubled farmers are those who decided to operate on a current basis, in hopes of a price recovery -- a recovery that obviously hasn't occurred and, frankly, is unlikely to occur any time soon.

Farm lenders deserve considerable credit for the relative health of the today's ag balance sheet -- and for their customers' more sophisticated approach to risk management. After the experience of the 1980s, many ag bankers vowed to change the way they did business. Many have. There's proof of that to be had in the terms of the loans they make -- as well as in the loans they refuse to make. Ag bankers today are more likely to insist on higher down payments and extensive financial analysis to determine the borrower's ability to generate adequate cash flow. No longer are bankers so willing to extend a loan based on collateral values or speculative expectations. No longer are they so quick to offer new loan products -- or to enter new markets -- without having the necessary managerial expertise on board. They increasingly use external risk reviews to augment internal risk identification procedures. More and more, they've become leaders in the use of government guarantee programs to control credit risk while allowing their weaker borrowers to continue farming.

So, although much more remains to be done, the best ag bankers have become some of the best risk managers in the entire banking industry. In this challenging agricultural climate, they've had no choice. I can tell you this: tomorrow's challenges will demand no less.

As I've already suggested, one of the most impressive developments of recent times is the way ag bankers are working with their farm customers to help them manage their own credit risk. With us here today are bankers who have adopted a variety of creative approaches to help their customers become better risk managers. We've heard about one bank that requires borrowers to develop and submit marketing plans as part of the loan application process. Loan officers complete break-even analyses on cattle borrowers, and routinely require hedging as a condition for loans. This is a bank that even operates its own 80-acre farm to help it stay abreast of developments in the field.

Then there's the bank that's organized a club for farm borrowers. The bank brings in local university experts to discuss such topics as marketing alternatives, price risk, business planning and budgeting, financial risk management, production risk, international conditions, and human resource management. And then it makes these university experts available as a kind of financial extension service to borrowers who need them. We'll hear more about this innovative arrangement tomorrow morning.

The OCC applauds these trends, which we view as critically important to maintaining the health of ag banks in these difficult times and into the challenging future that we now face.

We support these risk management initiatives in various ways. We believe that holding conferences such as this will help spread the word about the exciting developments that we see and promote better communication between ag bankers and their examiners. For our part, we view your input as crucial in helping us understand current conditions and the impact of our policies on your business.

As supervisors, we, too, have tried to make constructive use of the lessons of the recent past. The experience of the 1980s underscored the need to avoid broad swings between the extremes of excessive forbearance and rigor in classifying farm loans -- or any other loans. It highlighted the importance of a balanced, flexible, and consistent approach to supervision -- one that encourages examiners to judge each loan relationship on its merits while ensuring that banks adhere to prudent lending practices and accurate disclosure of the risks embedded in their loan portfolios. And we also learned from experience that supervisors should encourage bankers to work with borrowers -- farmers and others -- who may be experiencing temporary difficulties, so that credit -- the lifeblood of our entire economy -- is not unduly restrained.

The OCC's supervisory policies, recently memorialized in our <u>Agricultural Lending</u> handbook, emphasize that examiners <u>must</u> take into account prudent efforts by bankers to work with their troubled farm borrowers when classifying credit risk. It advises examiners not to automatically criticize loans solely due to negative cash flows, or because farmers may need more time to service their loans, or because previous debt has been carried over.

And it advises examiners to carefully weigh the full range of relevant factors affecting the condition of the farm credit. Is the loan performing according to its original or reasonably modified terms? Is the collateral sufficiently liquid and controlled to protect the loan? Is the borrower's financial condition -- and financial track record -- fundamentally sound?

The answers to these questions -- rather than some arbitrary framework -- are supposed to guide our examiners in determining the appropriate supervisory response to take. If we get it right -- and I believe that we do, most of the time -- we can avoid both unnecessary overreaction to adverse conditions and the excessive latitude that can lead to more serious problems later on.

Obviously, you and your customers are the two key parties to the lending transaction. But the law -- and the needs of our general economy -- prescribe an important role for us as supervisors, as well. In the spirit of communication that brings us together here in St. Louis, I wanted to take this opportunity to explain to you why we take the approach we do and what we aim to achieve by it.

And what we aim to achieve is this: a safe, sound, and competitive banking system fully capable of fulfilling its historic role in financing our nation's agricultural sector. If banks are to remain a reliable source of agricultural loans in both good times and bad, they must remain financially strong. That's the goal that I as Comptroller am committed to achieving.

I want to thank you for your commitment to that goal and encourage you to continue working creatively to safeguard the health of the farm economy and the agrarian way of life. These are things that mean much to our people -- all of our people. We're counting on you.