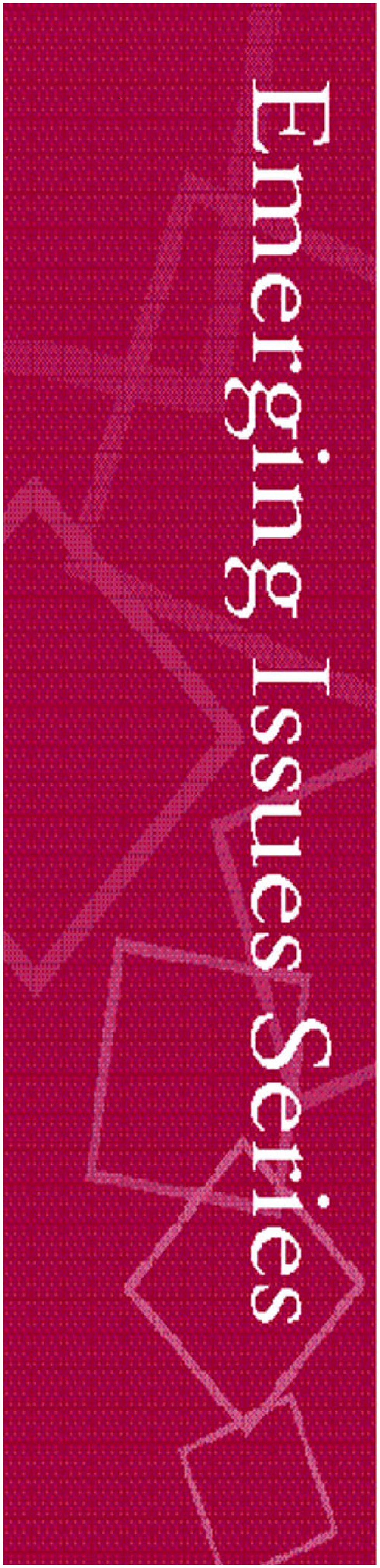

Agricultural Lending: What Have We Learned?

Catharine M. Lemieux

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AGRICULTURAL LENDING: WHAT HAVE WE LEARNED?

Catharine M. Lemieux[1]

Our current economic expansion is now the second longest in our nation's history. Last year we saw record simultaneous lows for inflation and unemployment combined with low interest rates, despite the third largest decline in the United States stock market and continued problems in international economies in countries ranging from Southeast Asia to Brazil and China.

For agriculture, this international economic turmoil has meant decreased demand for agricultural products at a time when the safety net for agriculture has been vastly altered. In the 1980s a drop in export demand was a contributing factor in the decline in prices for major crops. Land values plummeted. The average price of an acre of farmland declined more than 60 percent between 1981 and 1987.[2] Farm income hit bottom in 1983 at $14 billion compared with nearly $50 billion in 1997.[3] Hollywood made movies about the demise of the family farm. Between 1984 and 1990, 322 agricultural banks failed.[4]

This is not the story of the 1990s. Today, farm debt stands at approximately $170 billion compared with compared with $216 billion, nationally, in 1983.[5] Things are different for banks too. In the late 1980s banks were adjusting to new stiffer risk-based capital requirements that meant many banks had to build capital at the same time they were faced with increasing problems in their loan portfolios. Today, loan reserves are high. Bank profits and capital levels are strong. Statistics tell us that both the farm sector and the banking industry have greater reserves to weather adverse economic conditions than they did in the 1980s. However, United States Department of

Address any correspondence about this paper to Catharine M. Lemieux, Federal Reserve Bank of Chicago, 230 South LaSalle Street, Chicago, Illinois 60604, telephone (312) 322-4246 or e-mail Catharine.M.Lemieux@chi.frb.org. Requests for additional copies should be directed to the Public Information Center, Federal Reserve Bank of Chicago, P.O. Box 834, Chicago, Illinois 60690-0834, or telephone (312) 322-5111. The Emerging Issues Series Working Papers are located on the Federal Reserve Bank of Chicago's Web at
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[1] Catharine Lemieux is the Director of Policy and Emerging Issues in Bank Supervision and Regulation at the Federal Reserve Bank of Chicago. The views expressed in this paper are those of the author and do not reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

[2] USDA Economic Research Service. Farm Real Estate Values. April 1996. Stock #86010

[3] USDA Economic Research Service. Financial Characteristics of U.S. Farms. Various issues.

[4] USDA Economic Research Service. Agricultural Finance Situation and Outlook. Various issues.

[5] USDA Economic Research Service. Financial Characteristics of U.S. Farms. Various issues.

Agriculture and the Food and Policy Research Institute's economic forecasts for 1999 certainly indicate that these reserves will be tested.
What can we take away from the experience gained during the 1980s? Agricultural bank failures did skyrocket, but the interesting thing is that the failures were scattered throughout the country. Seldom did more than one bank fail in any one county. The surviving banks must have had some recipe for success that allowed them to weather the severe adverse economic conditions that prevailed during that time period. Following are a few "lessons" that are as applicable today as they were in the 1980s.

1. Current, historic, and prospective agricultural economic conditions must be taken into account when determining the longer-term quality of agricultural loans. Agricultural economists tell us that long-term, product prices will fluctuate near the cost of production on marginal lands. When farm prices rise sharply, producers respond by making investments on the assumption that the better times will continue. The capacity of agriculture to expand production is absolutely amazing. As production expands, prices will fall. Loans to finance the assets required to increase production may have looked good based on optimistic price forecasts. However, the picture may change when prices fall.

2. Current financial information is essential. The difference between producers that survived the 1980s and those that didn't was often leverage. When financial conditions become depressed, a highly leveraged producer may have little cash flow to support the debt. Jinkins, Hanson and Olson found that debt-to-asset ratios over 40% put an operation at serious risk from a downturn in the economy.[6] One aspect of today's economy that increases the likelihood of becoming highly leveraged is the ease of acquiring consumer debt. All consumers, farm families included, are bombarded by credit card solicitations, low cost refinancing offers and offers of home equity lines of credit often by financial institutions from outside the area. Ordering credit reports on farm borrowers may not be common practice, but it should be considered. You don't have to leave home to spend money anymore -- the Internet, home shopping network and catalogue shopping now provide rural families with as many opportunities as their urban neighbors to live beyond their means.

3. Lending against appreciation rather than cash flow is inviting trouble. A downturn in the agricultural outlook is quickly reflected in the price of farmland and other specialized assets at the same time cash flow dries up. The decline in farmland prices in the 1980s is an extreme example of just how quickly appreciation can vanish. If one borrower is under financial stress because of a downturn in the economy, it is likely that others are also affected and may be less than eager to purchase additional farm assets from distressed operators. With fewer buyers, losses from forced sales in depressed markets can be considerable.

4. Agriculture is export sensitive. International events can have a big impact on the health of agricultural portfolios. Agricultural economists have noted that the crops produced in the Midwest, wheat, corn and soybeans, were particularly influenced by the export boom in the 1970s and offer

[6] Jinkins, John E., Gregory D. Hanson and Kent D. Olson. "Can We Successfully Gauge National Farm Financial Conditions? Evidence from the Triangle Nonpayment Model." Presented paper at the American Agricultural Economics Meetings, Vancouver, Canada. July, 1990.

this as an explanation for the wider swing in land prices in this region when exports declined. Whether it is the default on Russian debt, the Southeast Asian crisis or the grain embargo of the 1970s, international events have a significant impact on agricultural prices. Bankers need to be aware of the potential impact these international events can have on their borrowers' cash flow and, ultimately, asset values.

5. Problems do not get better with age. Forbearance does not necessarily result in the best outcome for borrowers or banks. Promptly identifying problems does not prohibit a banker from working with a troubled borrower. However, the books and records of banks should, at all times, accurately reflect the risks inherent in their portfolios. Allowing unrecognized losses to accumulate will depress the confidence the public has in an institution. If a community looses confidence in a banking organization they will register their concerns with their feet, demanding higher rates on deposits or investing elsewhere.

6. Beating the competition by lowering underwriting standards may not be the road to prosperity. Studies done by the Federal Reserve Bank of St. Louis found that the most significant difference between banks that failed and those that survived was the ratio of total loans to assets.[7] Banks with aggressive lending policies were less able to withstand the economic turbulence of the 1980s.

7. Concentrated loan portfolios are a major risk. Another study done by the Federal Reserve Bank of St. Louis found that banks that had invested more heavily in loans had a higher portion of their portfolio in agricultural loans, compounding the risks of their management strategy.[8] Strategies that enhance diversification and support rigorous underwriting standards, including performing cash-flow analysis on borrowers, could have mitigated this risk.

8. Consolidation in agriculture and banking will lead to a more diverse group of lenders chasing fewer borrowers. Competition from nonbank lenders became aggressive when agricultural income increased, but they quickly withdrew when problems became severe. Farm Credit associations and insurance companies have been accused of cherry picking in the past. Agricultural banks must be careful that they are not the residual lenders to the agricultural sector, being left with the smaller, less profitable borrowers when times are good and expected to provide the financing necessary to carry producers over the rough spots when times are tough. Increasing competition and a declining borrower base must be factored into agricultural banks' strategic plans.

These lessons all point to the importance of paying attention to the basics. The 1990s have been a time of recovery for the agricultural sector. However, there are two more "lessons" that have been reinforced by events in the second half of this decade that need to be added to this list.

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[7] Belongia, Michael T., and R. Alton Gilbert. "The Effects of Management Decisions on Agricultural Bank Failures." American Journal of Agricultural Economics (November 1990): 901 - 10.

[8] Kliesen, Kevin L., and R. Alton Gilbert. "Are Some Agricultural Banks Too Agricultural?" Federal Reserve Bank of St. Louis Review 78, no.1 (January/February 1996): 23 - 35.

9. Savvy marketing can often be the difference between profitable and unprofitable farming operations. Being able to produce a high quality agricultural product is no longer enough to guarantee success. With the change in farm programs it is even more important to closely look at the marketing plans of producers. The difference between being subject to the whims of the market and locking in a price through forward contracting, hedging or other sales contracts can be considerable. However, it is necessary to look at the fine print. The surprise some experienced when they understood the downside risk of the Hedge-to-Arrive contracts should have been enough to make everyone look at any type of forward sales agreement very closely.

10. Farmers are dependent on processors. Bottlenecks in any portion of the farm to market supply chain can severely impact prices at the farm gate. Few realized the closure of Thornapple Valley's processing plant in Michigan would have so seriously reduced the pork processing capacity last year. Locking in the ability to market the quantity produced through production contracts is a risk management tool that cannot be overlooked.

The real question though is, are we using the lessons that we've learned? In today's environment it is critical that we use all of the "lessons" on how to make sound loans and minimize risk while still serving the credit needs of agriculture. Increasing pressure to build business may have allowed lenders to become complacent, and rising farm incomes may have helped them avoid paying the price. There is nothing new or startling in the "lessons" chronicled here. They all call for attention to the basics, doing your homework on all aspects of the borrower's operation. As competition intensifies among agricultural lenders, and borrowers are more susceptible to market pressures, agricultural lenders that follow these “lessons” will be the ones to survive and prosper.

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