# Condition of Rural Financial Intermediaries

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Financial institutions serving agricultural areas are experiencing impacts of severe financial stress among farmers for the second time in this century. In both instances, stress resulted mainly from the burden of large amounts of debt-financed land purchases and other farm investments, based on price and income expectations that were not realized.

In the current episode, a large rise in interest rates also reduced the optimal degree of financial leverage. Consequently, many indebted farmers needed to adjust the financial structure of their businesses. Some have been able to do so, while others cannot. While total farm debt apparently peaked in mid-1983, it had dropped only 2% by the end of 1984.

At some financial institutions serving farmers and agribusinesses, a large proportion of farm debt is owed by customers who require partial or total liquidation at a time when asset prices and markets are reflecting sharply reduced expectations. The resulting loan delinquencies and losses far exceed risk premiums incorporated in interest rates, eroding loss reserves and threatening capital positions. The impact is multiplied by the normally high degree of leverage of financial institutions themselves.

The purposes of our paper are to provide a benchmark report on the current status of agricultural lenders in this environment and to highlight a few of the changes underway. A factual focus is a first priority, given the controversial nature of these changes and substantial misunderstanding of the reasons for certain adjustments.

## Farm Loan Experience at Commercial Banks

### *Farm Loan Charge-Offs*

During the first quarter of 1985, net charge-offs of farm production loans at commercial banks totaled about $200 million, equal to 0.5% of such loans outstanding, and up by 60% over charge-offs in the first quarter of 1984. Banks in Iowa charged off one-fifth of the national total. Four states—Iowa, California, Nebraska, and Missouri—accounted for over half the total. In view of rising loan delinquencies, farm loan charge-offs likely will continue to exhibit year-over-year increases in coming quarters.

In 1984, net charge-offs of farm production loans totaled about $900 million, equal to 2.2% of such loans outstanding at year-end. Of this total, about $240 million was charged off by banks in California, equal to 6.1% of their year-end farm loans outstanding. In other states, net charge-offs were equal to 1.8% of outstanding loans. After California, the highest charge-off rates were in Missouri, at 3.0%, and in Iowa, at 2.9%.

### *Delinquent Farm Loans*

Estimated delinquency rates on farm production loans have been trending upward since such data were first required of some banks in December 1982. The relative amount of nonaccrual loans, the most severe delinquencies, is estimated to have risen each quarter, reaching 4.7% of farm production loans outstanding at the end of March.

In contrast to the steady climb in nonaccrual loans, delinquent loans on which banks are still accruing interest have shown considerable seasonal variation, with each year's peak occurring in March. On 31 March of this year, total nonperforming loans (defined as nonaccrual and renegotiated loans plus accruing loans that are past due 90 days or more) had risen to about 7% of outstanding farm production loans, up from about 5.7% a year earlier. Another 3.4% of production loans were past due 30 to 89 days; thus, about 10% of farm production loans were delinquent at the end of the first quarter.

## Conditions at Agricultural Banks

Farm financial difficulties have most affected those small rural banks with relatively high

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concentration in farm lending. There are now about 5,000 "agricultural" banks with a farm loan ratio that is above the current average (about 17%) of the farm loan ratios at all banks. On average at these banks, farm loans constitute 37% of total loans.

Conditions at many agricultural banks have been dominated by recent adverse loan experience. Their farm loan delinquencies are not fully known, as most of these banks have not been required to report their nonaccrual farm loans. They do, however, report fully on their total loan experience.

*Total Loan Charge-Offs*

Net charge-offs of all loans at agricultural banks have risen substantially since 1980. In 1984, such charge-offs were equal to 1.2% of loans outstanding at year end. This was about double the relative level at other small banks, the reverse of the situation that had prevailed for many years before 1983.

Among all agricultural banks, relative charge-offs in 1984 varied directly with their degree of concentration in farm lending. Where farm loans constituted over half the loan portfolio, average net charge-offs exceeded 1.5% of loans outstanding. Average charge-offs at all agricultural banks in several midwestern states also exceeded that level.

In the first quarter of 1985, net charge-offs at agricultural banks were equal to 0.28% of loans outstanding at the end of the quarter, nearly double the relative charge-offs a year earlier. Agricultural banks in Iowa had the highest average charge-off rate, 0.55%, followed by banks in Nebraska at 0.45%.

*Total Delinquent Loans*

Loan delinquency rates at agricultural banks are rising, portending continued high charge-off rates. Only two years ago, loan delinquency rates still were lower at agricultural banks than at other small banks. By the end of 1983, delinquent loans at agricultural banks had reached the same relative level that other small banks had experienced during the last recession. Then by March 1985, delinquent loans at agricultural banks had risen to 7.5% of total loans, well above the average at other small banks.

Of the four categories of delinquent loans, nonaccrual loans rose most rapidly during the past two years. At all agricultural banks, nonaccrual loans rose from 1.0% of total loans in March 1983 to 2.4% of total loans in March 1985. At banks most heavily concentrated in farm loans, the relative increase was even sharper.

A more drastic shift in loan performance was experienced by agricultural banks in certain midwestern states such as Iowa. Two years ago, when loans at agricultural banks nationally were in better condition than loans at other small banks, loans at Iowa agricultural banks were in even better shape. Now, loans at the Iowa banks are in noticeably worse condition than those at agricultural banks nationally.

*Agricultural Bank Earnings*

Net income at agricultural banks has been sharply reduced by their greater loan losses and higher levels of nonperforming loans. However, these banks had been relatively profitable—from 1973 to 1982, average annual returns on equity had ranged from 14% to 16%, and their return on equity in 1984 still averaged 9%. And, as this average implies, many agricultural banks continued to enjoy relatively favorable loan experience. For example, in 1984, loan loss provisions were under 0.4% of outstanding loans at nearly one-third of agricultural banks, and under 1% at nearly three-fifths of the banks. Such relatively low losses enabled nearly one-fifth of all agricultural banks to earn more than 15% on equity in 1984, and over half earned more than 10%.

But in each year since 1980, an increased proportion of agricultural banks experienced loan losses larger than could be covered by annual net earnings. In 1984, 17% of agricultural banks made loan loss provisions that exceeded 2.5% of year-end loans outstanding. Mostly because of such adverse loan experience, 12% of agricultural banks reported negative net income for 1984, compared with an average of only 1% annually during the 1970s.

*Agricultural Bank Failures*

For a small but rising number of agricultural banks, loan losses were large enough to cause failure. In 1983, only seven of the forty-four insured commercial banks that failed, or 16%, were agricultural banks. Last year, the proportion rose to thirty-two of the seventy-eight

failures, or 41%. Still, farm loans constituted only 10% of total loans at the banks that failed. By the second half of 1984, however, agricultural banks accounted for well over half of all bank failures. This trend continued in the first half of 1985. Nearly two-thirds of the fifty-two bank failures were agricultural banks, and farm loans constituted 24% of the total loans at all the banks that failed.

During the past two years, banks that failed came predominantly from the group that had earlier reported levels of delinquent loans that exceeded total capital; thus changes in the relative number of such banks help to indicate probable changes in failure rates. The number of banks with such relatively high loan delinquencies rose by about one-third during 1984, to over 600 banks at year-end, or 4% of all banks. There were significant increases in the number of such banks in several highly agricultural states. However, in most of these states—Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, and Wisconsin—the proportion of banks in this condition at the end of 1984 was still only roughly equal to the national average of 4%. Furthermore, farm loans at such banks nationally averaged only 7% of total loans at the banks. In several states with a relatively high number of these potentially vulnerable banks—California, Colorado, Florida, Louisiana, Oklahoma, Tennessee, and Texas—the low average farm loan ratio at these banks indicates that, on average, farm loans are not responsible for the delinquency problems.

Nevertheless, the number of agricultural banks at which delinquent loans exceeded capital increased sharply last year, from 133 to 240. If rural economic conditions do not improve, it is logical to expect a roughly corresponding increase in failures of agricultural banks during 1985, as is in fact occurring. Five midwestern states—Iowa, Kansas, Minnesota, Missouri, and Nebraska—accounted for over one-half the national total of such potentially vulnerable agricultural banks. In the first half of 1985, 22 of the 34 failures of agricultural banks occurred in these states.

## Unique Aspects of the Farm Credit System

The Farm Credit System (FCS) differs from the commercial banking system in several respects important to an understanding of the current situation.

FCS serves only the agricultural sector, making it more vulnerable than most agricultural banks to downturns in the farm economy. About two-thirds of the outstanding loans in the FCS are farm real estate loans of FLBs and another 11% are to farmer cooperatives, types of loans that are not important at most commercial banks. The FCS national charter calls on it to provide an on-demand lending service to eligible and creditworthy applicants in all geographic areas under all economic circumstances, while commercial banks may have more flexibility in defining their lending business. Its mission focus on lending, with no authority to make other than incidental investments, means that fewer of the FCS assets are carried in liquid form.

Because the FCS funds loans primarily through sale of securities for which its banks are jointly liable, it has developed assistance programs for member institutions that encounter financial difficulty. A commercial bank in difficulty must rely on its own efforts to increase capital. FCS owner-stockholders are also the borrowers, which creates pressures to minimize current interest rates and thus generate only minimal net earnings.

These differences, or unique attributes, may convey advantage or disadvantage relative to a commercial bank serving agriculture. In addition, whether a given attribute is an advantage or disadvantage may vary with the economic circumstances. Each attribute is also important in understanding the problems now occurring and the adjustments underway.

## Condition of the Farm Credit System

Viewed in total, the FCS remains relatively well capitalized. Earnings have more than covered losses and capital has grown. But some individual FCS institutions are experiencing historically unprecedented losses. Recent losses have been heavily concentrated in the Omaha and Spokane Farm Credit districts but are also significant in a number of other districts. Capacity to absorb losses in the banks and associations also varies significantly by district. Both the Omaha and Spokane Federal Intermediate Credit Banks are requiring assistance from the rest of the FCS. In each case, assistance is being provided on a voluntary basis, prior to triggering existing loss-sharing agreements within the FCS. Experience has demonstrated that the

agreements provide help too late, or require more help than would be required with more prompt actions.

A recent special examination by the Farm Credit Administration (FCA) projected serious financial stress in several districts during 1985–89 but concluded that the FCS as a whole has the financial capacity to manage its credit and financial problems. Three critical provisos condition this expectation: (*a*) that no major new economic adversities strike, (*b*) that loan losses do not greatly exceed the levels projected in the study, and (*c*) that the FCS acts promptly and effectively to mobilize its capital and earnings capacity.

The FCS faces three major problems in trying to achieve prompt action. First, capital and its management are dispersed among the 37 banks and the approximately 359 PCAs. Second, the generation of earnings sufficient to protect investors and provide for losses requires larger interest rate margins where possible. But this adjustment faces borrower resistance in a period of declining market rates and weak farm income and is constrained by competition from other lenders. Third, any decision on self-help requires agreement from 13 separate boards. Conditions and disciplines imposed by the grantor districts on the grantee may circumscribe local control or impose other adjustments, which are resented or resisted by some of those affected. The potential grantor districts may also face resistance to the idea of providing assistance.

### *Loan Charge-offs*

During the first quarter of 1985, PCAs recorded loan charge-offs totaling $19.2 million, FLBs recorded $40.7 million, FICBs $1.2 million, and BCs $33 thousand. During 1984, charge-offs on PCA loans totaled $285.9 million, FLBs $110 million (including $19.8 million absorbed by FLBAs), FICBs $21.9 million, and BCs $10.1 million. Charge-offs for 1984 were 1.56% of year-end outstandings at PCAs, 0.21% at FLBs, 0.13% at FICBs, and 0.11% at the BCs. The FCS held $504 million in acquired property on 31 December.

Charge-offs in 1984 thus totaled $428 million, up from $261 million in 1983. The losses in these two years represented a large share of the total charged off in sixty-seven years of operation. It is anticipated that losses will be substantially higher for both 1985 and 1986. While most charge-offs in 1983 and 1984 were at PCAs, in 1985 and 1986 more are expected to occur in the FLB system.

### *Nonperforming Loans*

As at commercial banks, most FCS loan assets are performing; payments are on schedule and no other adverse factors have caused vulnerability. On 31 March 1985, 89.8% of the FLB loan volume, 85.3% of the FICB volume, and 84.3% of the PCA volume were performing.

However, the volume of nonperforming loans has grown rapidly. It should be noted that nonperforming loans are more broadly defined in the FCS than at commercial banks. In addition to nonaccrual and restructured loans and loans delinquent ninety days or more but still accruing, the FCS definition includes accruing loans classified as vulnerable or loss because of severe credit weaknesses and loans in the process of collection, foreclosure, or bankruptcy. Because of underlying collateral and borrowers' efforts, eventual losses will be a fraction of the total amount not performing. The rate of recovery is a critical factor to both the FCS and commercial banks.

On 31 March FLBs held a total of $5.3 billion of nonperforming loans. Some 2.5% of the loan volume was nonaccrual. Total nonperforming loans increased $1.35 billion during the first quarter of 1985. PCAs held $2.7 billion of nonperforming loans on 31 March, up $0.6 billion in the quarter. Some 3.9% of total loan volume was nonaccrual. Another 4.5% of FLB loans and 6.1% of PCA loans were past due thirty to eighty-nine days. FICBs had $2.3 billion in nonperforming loans, and 1.5% of loan volume was nonaccrual. (These figures include loans to PCAs, direct loans to farmers acquired from PCAs, and loans to other financial institutions. Thus, PCA and FICB data are not additive.) The BCs had $615 million in nonperforming status, with 0.2% of loan volume in nonaccrual status.

### *Capital and Earnings*

In 1984, FCS banks generated $442 million in net earnings and associations another $37 million after provision for losses. At year-end, the thirty-seven banks had capital stock of $5.1 billion, and PCAs had $1.9 billion. Earned net worth totaled $4.1 billion for the banks and $2.5 billion for the associations. Reserves for losses were $1.3 billion. Total capital of the thirty-seven banks was 11.9% of loan volume

and reserves for losses were 0.9% of volume. Total capital of PCAs was 21.1% of loan volume and reserves for losses were 2.7% of volume. On average, PCAs could charge off 12.9% of volume without impairing stock.

### *Structural Adjustments*

In spite of these aggregate earnings and capital strength, eleven PCAs have had to be liquidated in the past two years (eight in the Spokane District, two in Omaha, and one in Louisville). In each case, service to borrowers was maintained by assigning territory to adjoining associations. Another fifty-three have been merged for various reasons. In addition, other PCAs have been provided assistance either by investment of FICB capital or by purchase of nonperforming loans. These devices are also used to facilitate mergers.

Loan problems can destroy earning power and erode capital in three ways: (*a*) direct reduction in earnings by increased provision for losses (plus a further reduction if charge-offs exceed total allowances for losses); (*b*) interest costs of carrying nonearning loan assets, both nonaccrual loans and acquired property; and (*c*) loss of loanable funds from the capital of the institution, which contribute to earnings margin an order of magnitude larger than borrowed funds. An institution typically loses the capacity to generate net earnings before its debt-to-capital ratio reaches the statutory minimum. Assistance is provided with the objective of ensuring a continued viable credit service to borrowers. Restoring the viability of the institution may or may not be possible or cost effective.

As a consequence, major structural and operating adjustments are underway to help mobilize both capital and earnings power. Eleven of twelve districts have adopted full or partial joint bank management. A majority have considered various options for consolidation of associations, and six districts are studying the possible advantages of district-wide associations. The desire to maintain local control is an important consideration being balanced against operational efficiency and capital mobilization needs.

At the operating level, a central FCS liquidity pool has been created. In addition, interest rates are being adjusted and costs controlled to ensure that gross earnings continue to cover anticipated losses.

Changes are also underway beyond the district level. In a cooperative democracy, decision making tends to be slow, cumbersome, and by consensus. This is not well suited to a period of stress, nor does it facilitate strategic competitive actions. Thus, some adjustments in decision mechanisms are indicated by both immediate- and long-term considerations. Until the 1971 rewrite of the Farm Credit Act (following repayment of the last of the government capital), the FCA had acted as the "head office" for the FCS.

In many respects, the 1971 act deregulated the FCS, emphasizing local control and decision making, and shifting FCA toward a regulatory role. Most joint actions that were necessary were managed by committees operating by consensus. This approach appeared to work well during prosperous times, when joint liability on securities and FCS-wide loss sharing were mere contingency concepts. The advent of losses triggering these contingencies has caused a reassessment of the balance between local autonomy and common standards and has produced recent actions moving toward some additional, limited areas of central decision making and control. The Farm Credit Capital Corporation has been chartered to manage the liquidation of nonperforming loan assets acquired from a district by the FCS. The Farm Credit Corporation of America has been chartered to develop FCS-wide performance standards, monitor loss sharing, serve as FCS spokesperson, and perhaps eventually provide some other central functions.

Fortunately, the FCS had a blueprint for such changes as provided by its most recent strategic study, called *Project 1995*. When current financial stress has required adjustments, that earlier study speeded the development of a consensus on what should be done.

## Summary

Farm financial stress has severely affected lenders most specialized in farm lending—"agricultural" commercial banks and the FCS. For both, geographic diversification is the primary means for coping with increased risk. The FCS is having to act in some respects more as a national organization to support regions experiencing losses with FCS-wide earnings. Highly agricultural commercial banks in severely stressed areas lack such a support system, and increasing numbers have been

failing. Banks covering a broader geographic area and with a more significant nonagricultural base are likely to prove better able to withstand adverse farm conditions, as they have in California. Thus continued farm stress seems likely to accelerate structural changes in both commercial banking and the Farm Credit System.