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Committee on Agriculture

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Mr. Chairman and members of the subcommittee, my name is Jason Henderson and I am the Vice President and Branch Executive of the Federal Reserve Bank of Kansas City – Omaha Branch. I appreciate the opportunity to talk with you about agricultural credit conditions in the current economic and financial environment.

AGRICULTURAL CREDIT CONDITIONS

The economic and financial downturn has weakened the farm economy and raised concerns about access to credit for agricultural borrowers. Shrinking global demand, falling commodity prices, and higher production costs have trimmed farm profits. As a result, reduced cash flows have raised the demand for credit by agricultural enterprises.

While agricultural borrowers are concerned about credit availability, agricultural lenders are equally concerned about the creditworthiness of their borrowers as the farm economy weakens. Delinquency rates and charge-offs on agricultural loans remain near historically low levels but have edged up recently, eroding loan quality. Consequently, agricultural lenders have tightened credit standards on various types of agricultural loans. Agricultural enterprises most susceptible to being denied credit are small farm operations owned by young or beginning farmers.

Despite these risks, ample credit appears available at historically low interest rates. Profitability in agricultural banks and relative strength in the rural economy could support rural lending. Still, the recent erosion in agricultural loan quality has led agricultural lenders to tighten credit standards and shift more financial risk to borrowers.

Agricultural Credit Demand

My colleagues and I at the Federal Reserve Bank of Kansas City survey agricultural bankers in our seven-state region four times a year to track developments in the farm economy. Our recent data indicate weakness in the agricultural economy has shifted demand for loans toward financing short-term investments. With profits shrinking, plans have slowed for capital purchases such as farmland and equipment, which require intermediate and longer term investments (Chart 1). At the same time, the demand for operating loans has risen, due to lower cash flows and higher production costs.

Agricultural producers' capital spending plans have fallen amid weaker farm income expectations. When profits rise, farmers and ranchers typically use higher cash flows to pay for various types of capital expenditures. Capital spending was stronger in 2008, coinciding with stronger farm incomes. Strong farm spending, in turn, helped insulate the rural economy from the worst of the recession in 2008 (Henderson and Akers).

While strong farm incomes boosted farmland and machinery sales over the past few years, these sales have slowed recently as farm income expectations weakened. In the fourth quarter of 2008, farmland sales in the Kansas City Fed's district had fallen from the previous year.[1] Moreover, capital spending had slowed markedly with further declines expected in 2009. Similarly, the Association of Equipment Manufacturers recently reported slower growth in farm tractor and combine sales.[2] Anecdotal reports indicate further contractions in machinery and farmland sales through 2009.

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[1] The Kansas City Federal Reserve District covers the states of Colorado, Kansas, Nebraska, Oklahoma, Wyoming, northern New Mexico, and western Missouri. See Henderson and Akers (2008) for more information.

[2] Tractor and combine sales data were obtained from *U.S. Ag Flash Reports*, Association of Equipment Manufacturers.

In contrast to capital spending, operating loan demand continues to rise steadily. Operating loan demand often rises when prices fall and revenues decline. Shrinking cash flows constrain farmers' ability to pay off existing operating loans, leading to an increase in carry-over debt. At the end of 2008, commercial bankers reported an increase in farm carry-over debt as loan renewal or extensions jumped and loan repayment rates declined.[3]

Higher production costs also increased operating loan demand. Since the 1920s, farm production costs have risen at an average pace of almost 2 percent a year, but in 2008, production costs surged 11.7 percent.[4] The largest gains emerged from energy-derived inputs – fuel, fertilizer, electricity and pesticides. Livestock producers faced a surge in feed costs. While some decline is expected in 2009, farm production costs – especially for crop producers – are expected to remain historically high, raising the credit demand of agricultural enterprises.

Agricultural Loan Activity

Agricultural lenders appear to be expanding loanable funds to meet rising loan demand. Commercial banks continue to report ample funds for agricultural loans. In general, they have expanded their total volume of agricultural loans, and they have done so at historically low interest rates. Moreover, government sponsored lenders have also expanded agricultural loan activity.

According to the Federal Reserve Bank of Kansas City's fourth quarter survey, 70 percent of bankers reported the same amount of funds available for farm operating loans as the year before. An additional 14 percent reported having more funds available. Moreover, these

[3] Indexes on farm loan renewals or extension and repayments rates are available from the *Agricultural Finance Databook*, Board of Governors of the Federal Reserve System, www.federalreserve.gov.
[4] Farm production costs were obtained from the Farm Income and Costs Briefing Room, Economic Research Service, U.S. Department of Agriculture, www.ers.usda.gov.

banks expected to have roughly the same amount, if not more funds, available for lending in the first half of 2009.

Few bankers were refusing loans due to a shortage of funds. In December 2008, only 4.3 percent of bankers in the Kansas City survey reported refusing a farm loan due to a shortage of funds. This refusal rate was up slightly from levels reported in previous quarters and on par with levels reported prior to 2008.

The Kansas City survey data are consistent with other national reports, which have also shown increased agricultural loan activity. Farm loan volumes rose sharply in 2008, led by record gains in farm real estate loans.[5] In the first quarter, commercial banks greatly expanded farm operating loan volumes (Chart 2).[6] Rising loan volumes were driven by expanding the number and size of farm operating loans.[7]

Other agricultural lenders are also extending more credit to agricultural enterprises. For example, the Farm Credit System significantly expanded its agricultural real estate mortgages and production/intermediate term loan volumes in 2008. The Farm Service Agency experienced a rise in its direct operating loan portfolio, although its guaranteed loan portfolio eased. And, Farmer Mac loans and guaranteed securities rose in 2008.

Commercial banks appear to be tapping federal government and Federal Reserve funds. In response to higher risk, commercial bankers indicate they are increasing their use of guarantees from the U.S. Department of Agriculture's Farm Service Agency. In January 2009, Farmer Mac and the Independent Community Bankers Association initiated a program to improve credit availability for farm real estate mortgages. Moreover, smaller commercial banks

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[5] Summary statistics for farm real estate and non-real estate loan volumes were calculated from the Quarterly Reports of Condition of Commercial Banks and obtained from the *Agricultural Finance Databook*.

[6] Non-real estate loan volumes obtained from the Survey of Term of Bank Lending to Farmers available in the *Agricultural Finance Databook*.

[7] In the first quarter, loans to the livestock industry declined as the livestock sector struggled to post profits.

have access to primary and secondary credit funds through the Federal Reserve's discount window and can request funds for seasonal credit, especially during the planting and harvest seasons, when funding needs are more significant.[8]

Agricultural enterprises are also receiving credit at historically low interest rates. According to agricultural credit surveys by the Federal Reserve, interest rates on all types of agricultural loans have dropped significantly below 2006 levels.[9] In the Kansas City Federal Reserve district, the average interest rate on operating loans declined to 7.0 percent in the fourth quarter of 2008.[10]

Tighter Credit Standards

While agricultural lenders are generally extending credit at lower interest rates, they have altered loan terms and tightened credit standards in response to increased risk in agricultural lending. Agricultural loan quality has declined amid lower farm income expectations and increased volatility in agricultural markets. In response, agricultural lenders, and commercial banks in particular, have shortened loan maturities and raised collateral requirements.

In 2008, agricultural loan quality at commercial banks began to erode. After improving during the first part of the year, the average risk rating on agricultural loans edged up heading into 2009. Commercial bankers reported higher risk ratings, as livestock profits were elusive and margins declined for the crop sector.

Along with elevated risk ratings, delinquency rates and charge-offs on agricultural loans also edged up. In 2008, delinquency rates on agricultural loans climbed steadily, rising 30

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[8] More information on the Federal Reserve's discount window and seasonal credit program is available at www.frbdiscountwindow.org/index.cfm.

[9] Data obtained from Federal Reserve agricultural credit surveys can be obtained from the *Agricultural Finance Databook*, or from the Federal Reserve Bank of Kansas City, www.kansascityfed.org/agcrsurv/agcrmain.htm.

[10] During the same time, the average rate on farm real estate loans fell from roughly 8.5 percent to 6.75 percent.

percent during the year. [11] At the same time, net charge-offs on agricultural loans doubled. Delinquency rates and net charge-offs on agricultural loans were higher in the largest 100 U.S. banks.

Still, delinquency rates and net charge-offs on agricultural loans remain historically low and well below other types of loans. For example, in the fourth quarter of 2008, the delinquency rate on all types of loans and leases was more than triple the rate on agricultural loans. Similarly, net charge-offs on all loans were more than eight times the size of net charge-offs on agricultural loans.

Nevertheless, commercial bankers responding to the Kansas City survey reported raising collateral requirements on operating loans (Chart 3). In the fourth quarter of 2008, the collateral requirements index rose well above year-ago levels, as a quarter of the bankers reported higher collateral requirements. Higher collateral requirements on agricultural loans were also reported by commercial bankers in other Federal Reserve districts.

In response to higher risk, commercial banks have also reduced the length of operating loans. For example, after steadily rising since 2001, loan maturity on agricultural loans dropped 20 percent, to 12 months, in the fourth quarter of 2008. Simply put, as agricultural risk increased, banks were more reluctant to extend loans for longer periods of time.

Recent research indicates that smaller farm operations and operations owned by young and beginning farmers are generally more likely to be denied credit, due to the limited experience and net worth and higher debt levels of the owners (Briggeman, Towe, and Morehart; Harris, et al). While these types of operations are likely to have more difficulty obtaining credit in the current environment, programs are already in place to support their financial needs.

[11] Charge-off and delinquency rate data were obtained from the Board of Governors of the Federal Reserve, www.federalreserve.gov/releases/chargeoff/.

Agricultural Lending in 2009

The recession poses some risks to agricultural lending in 2009. Concerns about the availability and cost of funds and the creditworthiness of borrowers remain. However, the robust performance of agricultural banks and relative strength in the rural economy should support rural lending.

Access to funds is a persistent concern for agricultural banks. Banks raise funds from a variety of sources – equity and debt markets, deposits and nontraditional sources such as Federal Home Loan Banks. Bank deposits are a major source of loanable funds for agricultural banks. Lower interest rates on CDs and other savings vehicles could slow bank deposit growth. Yet, despite lower interest rates, domestic deposits at agricultural banks continue to expand, which should support agricultural lending,[12]

Managing funding costs is an everyday challenge for commercial banks. In September 2008, the financial crisis fueled a spike in the London Inter-Bank Offered Rate (LIBOR), a benchmark for short-term rates that banks pay to borrow funds from other banks and a measure for bank funding costs. Since then, LIBOR has declined, suggesting that funding costs have fallen, which will support agricultural lending.

Agricultural lenders are always concerned about the creditworthiness of agricultural borrowers. In 2009, profit margins are expected to narrow for crop producers and remain negative for livestock producers (Henderson and Akers). While historically low, delinquency rates and charge-offs on agricultural loans rose in 2008. Weakness in the agricultural economy could further erode the creditworthiness of agricultural borrowers and lead to tighter lending standards and higher collateral requirements on agricultural loans.

[12] Domestic deposit data obtained from *Statistics at a Glance*, Federal Deposit Insurance Corporation (FDIC). FDIC identifies agricultural banks as commercial banks with agricultural loans accounting for at least 25 percent of their loan portfolio.

Because of their prominent use as collateral, declines in farmland values at the end of 2008 are a concern. Federal Reserve surveys indicate that farmland values edged down in the fourth quarter of 2008, but remained well above year-ago levels. Still, further declines in farmland values could shrink the amount of collateral available for agricultural loans, especially at small and mid-sized banks that more frequently use farm real estate as collateral. [13]

The strong performance of agricultural banks, which are generally relatively small banks located in rural communities, should help sustain agricultural and rural lending. The Federal Reserve defines agricultural banks as commercial banks with agricultural loans accounting for more than 14 percent of their loan portfolio.[14] In the fourth quarter of 2008, agricultural banks continued to post historically high rates of return, while all commercial banks reported negative returns (Chart 4). Agricultural banks also had much stronger performance than other similarly sized small commercial banks -- those with less than $500 million in assets. Stronger returns should help underpin agricultural and rural lending.

Finally, the relative strength of the rural economy should support agricultural and rural lending. Last year, the relative strength of the farm and energy industries and a shallower decline in housing activity allowed rural economies to avoid the worst of the recession (Henderson and Akers). In contrast to home prices in most urban areas, rural home values continued to rise through most of 2008 (Wilkerson 2008). And, job losses were less prevalent on rural Main Streets as manufacturing and service firms that supported the agricultural and energy sectors posted strong gains. More recently, the recession has established a stronger foothold in rural America, but rural economies continue to outperform their urban counterparts. While the

[13] Small and mid-sized farm lenders had less than $25 million in farm loans. Large farm lenders had more than $25 million in farm loans. See the *Agricultural Finance Databook* for a more detailed description.
[14] Agricultural banks have an agricultural loan concentration higher than the average agricultural loan concentration for all commercial banks. In 2008, the average agricultural loan concentration was 14 percent.

recession will limit rural economic gains, the relative strength in rural economies could help limit losses on other types of loans and support rural lending.

In sum, the global recession has trimmed economic prospects for the agricultural and rural economy, raising concerns about the availability of credit for agricultural enterprises. Delinquency rates and charge-offs have risen but remain at historically low levels. Agricultural lenders responded by tightening credit standards, especially for those segments of the agricultural sector experiencing losses. While agricultural borrowers are being asked to accept more financial risk, credit remains available for creditworthy borrowers.

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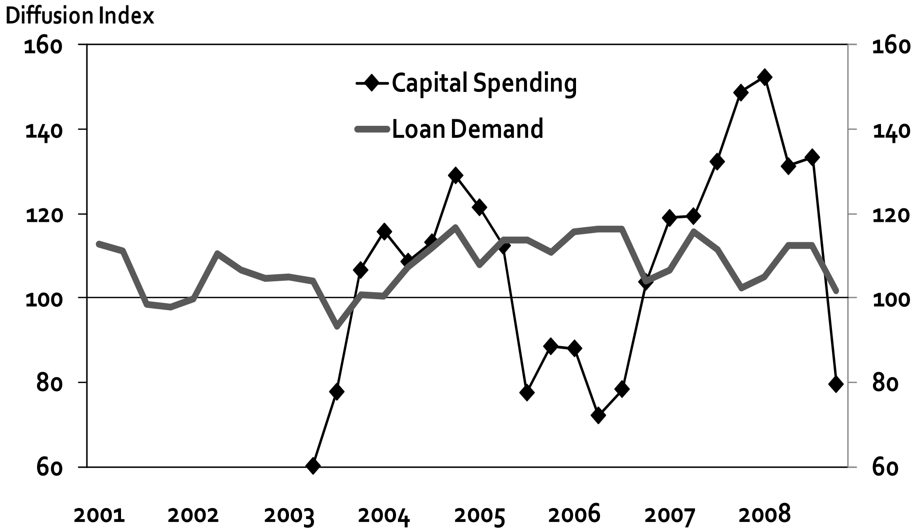
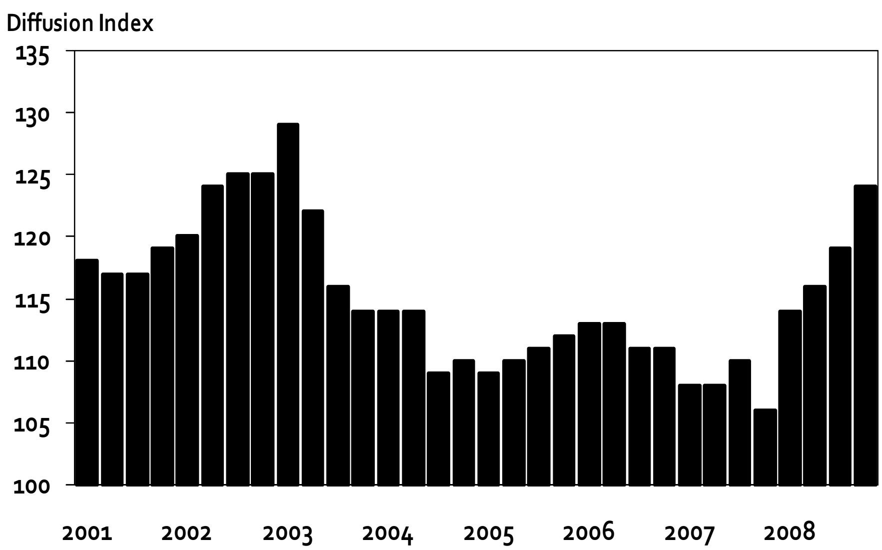
Chart 1:
Capital Spending and Farm Operating Loan Demand
(Tenth Federal Reserve District)



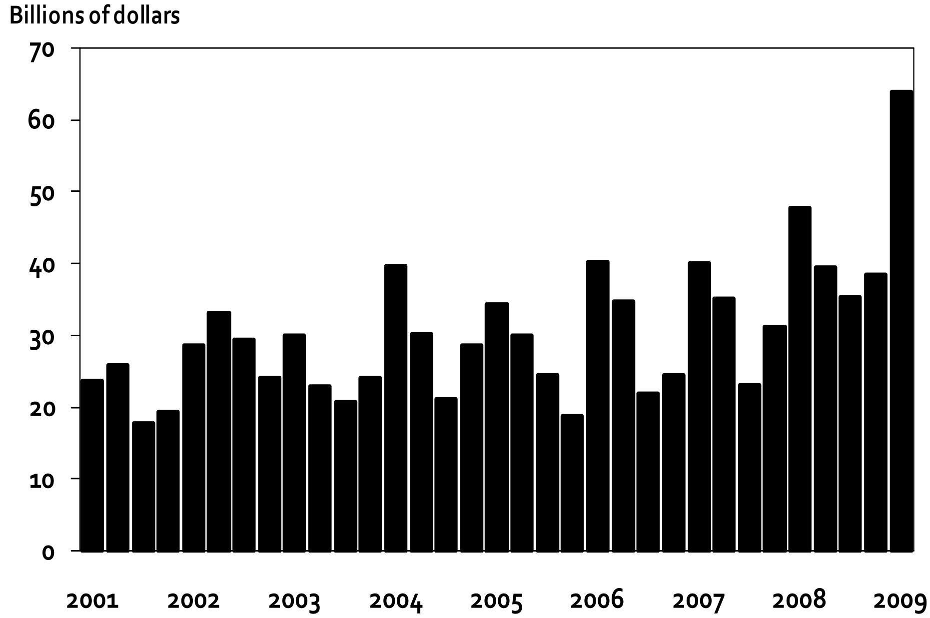
Source: Federal Reserve Bank of Kansas City
Index values above 100 indicate more bankers reported higher capital spending or loan demand, while values below 100 indicate more bankers reported lower capital spending or loan demand compared to the previous year.

Chart 2:
Collateral Requirements on Operating Loans
(Federal Reserve Bank of Kansas City)



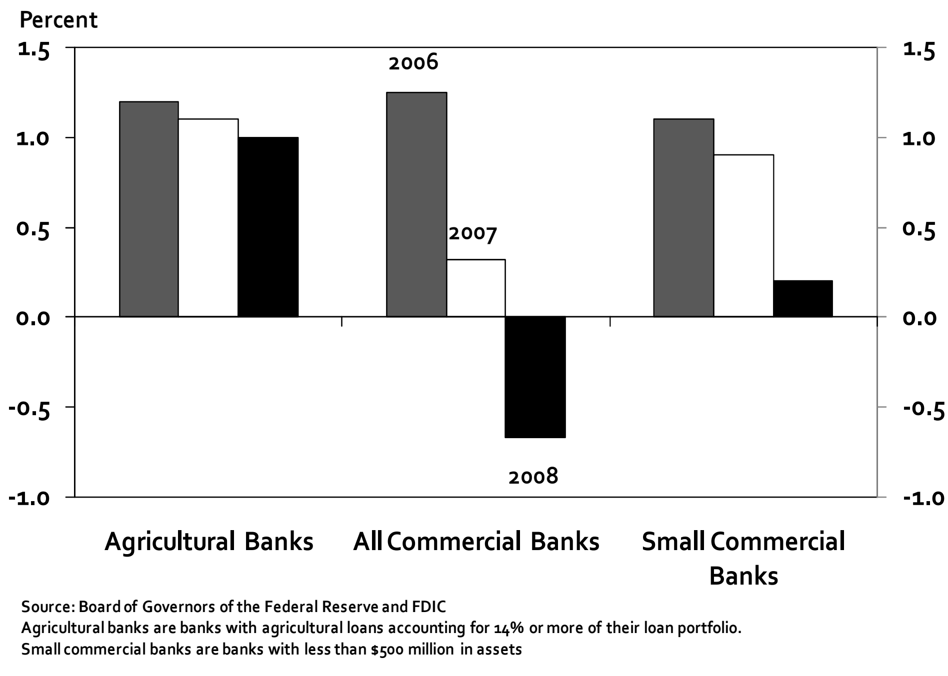
Source: Federal Reserve Bank of Kansas City
Index values above 100 indicate more bankers reported higher capital spending or loan demand, while values below 100 indicate more bankers reported lower capital spending or loan demand compared to the previous year.

Chart 3:
Volume of Non-Real Estate Bank Loans to Farmers
(Current Operating Expenses)



Source: *Agricultural Finance Databook*

Chart 4:
Average Rate of Return on Assets



Source: Board of Governors of the Federal Reserve and FDIC
Agricultural banks are banks with agricultural loans accounting for 14% or more of their loan portfolio.
Small commercial banks are banks with less than $500 million in assets