CSBS RISK SPOTLIGHT

Agriculture Sector Performance & Credit Conditions

SINCE 1902

CONFERENCE OF STATE BANK SUPERVISORS

Introduction

Certain risks are mounting in the farm sector. That is a key finding of the CSBS Risk ID Team, more than 100 state bank examiners nationwide, surveyed during the first quarter of 2016. These examiners witnessed several dynamics at work. Loan volume remained near record levels. Loan delinquencies ticked up, but only slightly. Meanwhile, both farm income and crop prices declined, placing stress on farm balance sheets. While economic returns to date have held up, the combination of falling farm income and rising loan demand represents a trend, if it continues, that might warrant heightened monitoring.

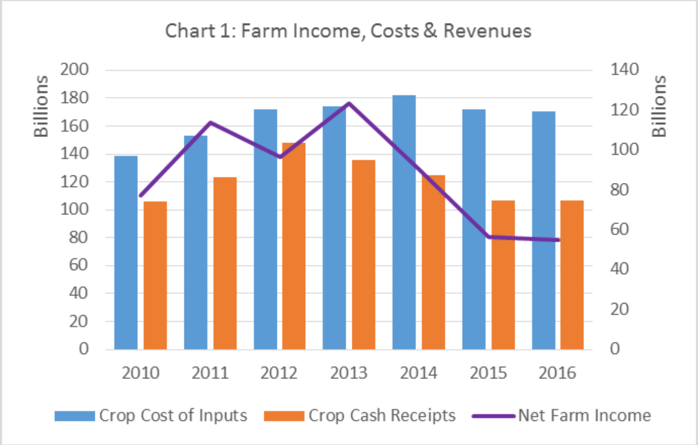
Key Findings

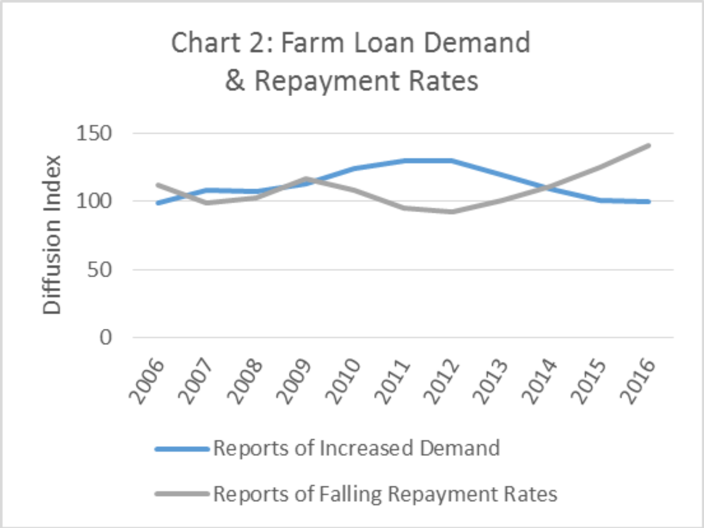
- **A combination of falling farm income and rising loan demand represents a risk to the farm sector**
- **The farm sector is burning through working capital and using more operating loan lines**
- **For the first time since the 1980s, farmers are drawing on other sources to pay operating costs**
- **Poor cash flow is preventing more borrowers from paying off loans from the previous year**
- **Falling profitability of agriculture banks contrasts with rising profits of other small banks**

Agricultural Sector Performance and Credit Conditions

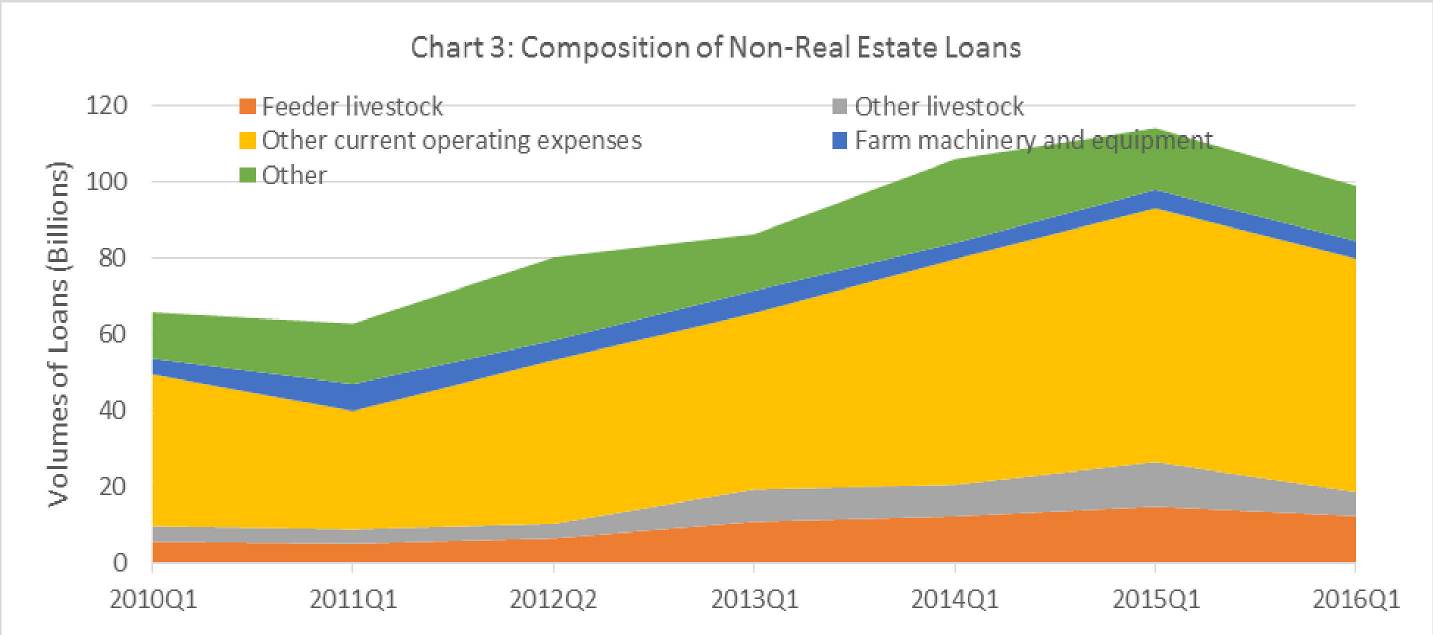
Net farm income continued to slide in the first quarter of 2016. The decline was modest compared to the dramatic fall experienced during 2013-15, albeit from record highs. As seen in Chart 1, major factors contributing to the more recent fall in farm income include a sharp decline in U.S. crop revenue and "sticky" input prices.

Weakening farm income and falling crop prices has forced the farm sector to burn through working capital and increase their usage of operating loan lines. As indicated in the agricultural credit conditions surveys conducted in concentrated agricultural regions, since the second quarter of 2013, loan demand has increased while loan repayment rates have steadily decreased (see Chart 2.) Amid lower profit margins, rising loan demand and flagging repayment rates underscore a heightened sense of risk in farm lending.

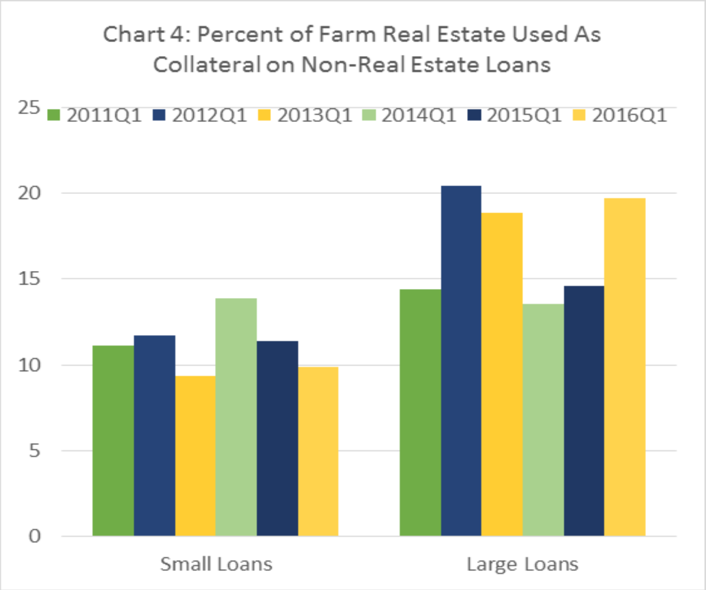




Growing demand for lending has primarily stemmed from a greater need for financing operating expenses. The debt structure of the farm sector reflects this trend in the growing portion of operating loans within new non-real estate farm loan originations.



For instance, as seen in Chart 3, in the first quarter of 2016, the total volume of non-real estate farm loans used to finance operating expenses increased to 62 percent of total non-real estate farm loans. (Non-real estate loans also are used for feeder livestock, other livestock, farm machinery and equipment and other purposes.)

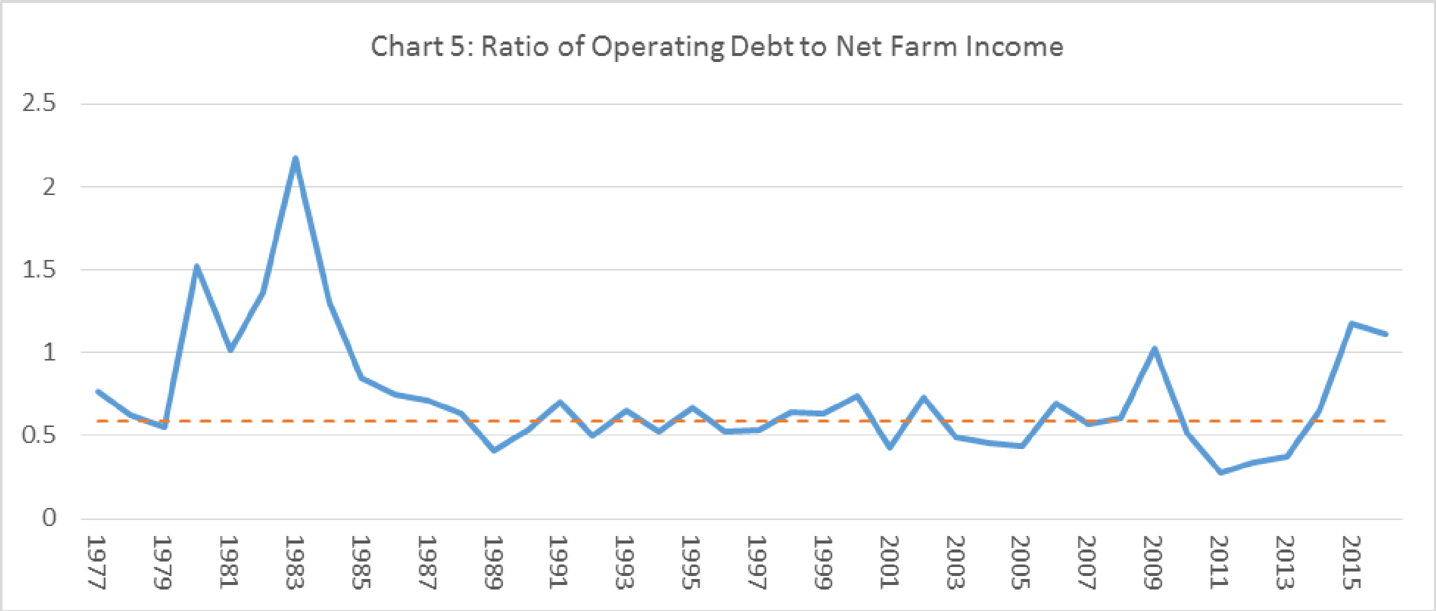


In this segment, large loans (i.e. more than $100,000) comprise more than three-quarters of loan volume during the first quarter — or 11 percent more than the 15-year average. This rising share of large non-real estate farm loans reflects an increasing dependence on financing.

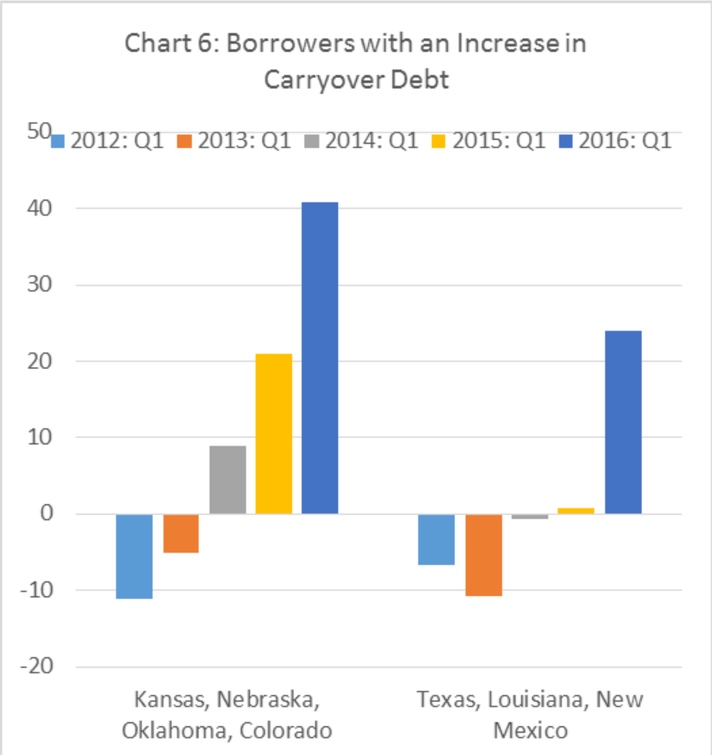
Further, we can see that farm real estate is increasingly being used as collateral for non-real estate loans. This is especially true for larger non-real estate loans. For instance, as seen in Chart 4, during the first quarter 20 percent of large non-real estate loans were collateralized with farm real estate, or twice as much as for smaller non-real estate loans.

The growing reliance on operating loans is particularly concerning when considered in combination with the simultaneous declines in farm income. Measuring the ratio of operating loans to net farm income gives us an indication as to the ability of farmers to fund operating costs (see Chart 5). A ratio above 1.0 indicates a level of indebtedness where producers would need to draw on other income sources or accumulated wealth to pay for recurring operating costs. The historical average since the late 1980s has been 0.54. In 2015, the ratio surpassed the 1.0 mark for the first time since the mid-1980s, and remained above that mark into 2016.

With increasing frequency, poor cash flow in the farm sector is preventing borrowers from paying off loans from the previous year, causing them to carry

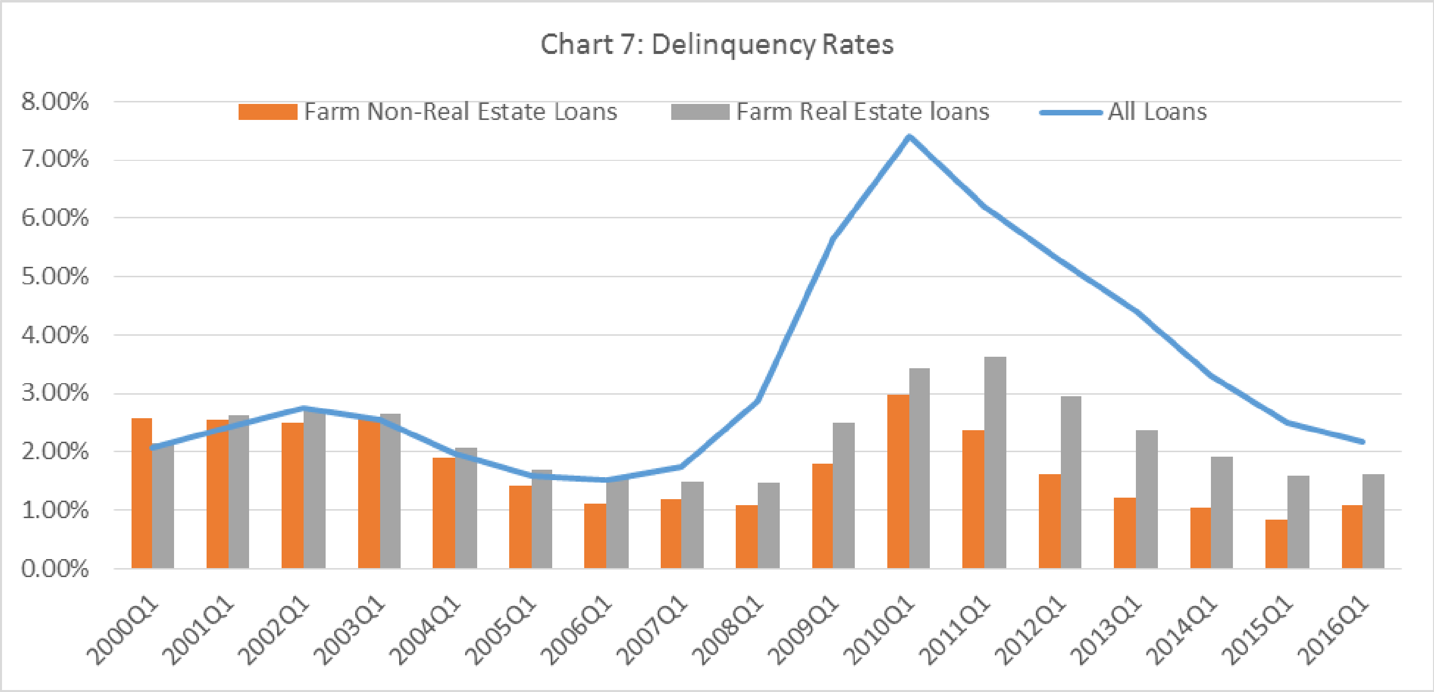


outstanding debt into 2016. The quarterly agricultural credit conditions surveys from the Tenth and Eleventh Federal Reserve Districts show that the levels of carry-over debt have increased dramatically since 2013. As seen in Chart 6, bankers from Kansas, Colorado, Nebraska and Oklahoma, in particular, expect a doubling of carryover debt levels in 2016. We can expect a growing number of farm borrowers to restructure existing operating debt to meet short-term liquidity needs.



As repayment capacity dwindled, delinquency rates on operating loans and farmland loans increased modestly. While the increase still leaves delinquency rates well below the 15-year average, the uptick for agriculture loans stands in contrast to a net decrease in delinquency rates across all loan types (see Chart 7).

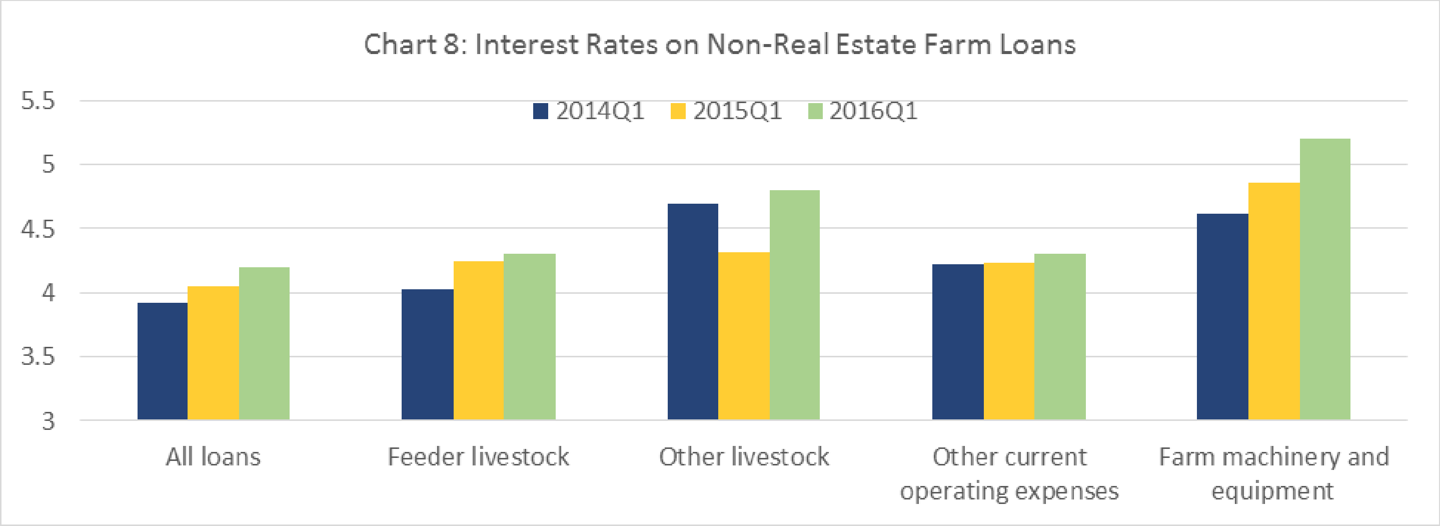
Interest rates on non-real estate loans also increased in the first quarter of 2016. Specifically, as seen in Chart 8, interest rates on loans financing operating expenses and feeder livestock, which account for almost three-quarters of non-real estate loan volume, grew slightly but consistent with growth patterns from previous years. The interest rates on loans for other livestock and farm machinery increased more dramatically, 49 and 34 basis points, respectively. A certain portion of these increases can be attributed to the high portion of variable interest rate loans reacting to minor market movements. But, some of the increase might be attributable to the risk pricing methods of agricultural banks on loans for depreciable intermediate assets in a lean farm economy.



Despite the overall increased lending activity, the profitability of agricultural banks fell even while other small banks grew more profitable (see Chart 9). The narrowing of the profitability gap between small banks and agricultural banks is consistent with trends in delinquency rates on farm loans, discussed above. Fortunately, as profitability has dipped, the average capital ratios of agricultural banks have increased, reflecting a resiliency in a weak farm economy.

Conclusion

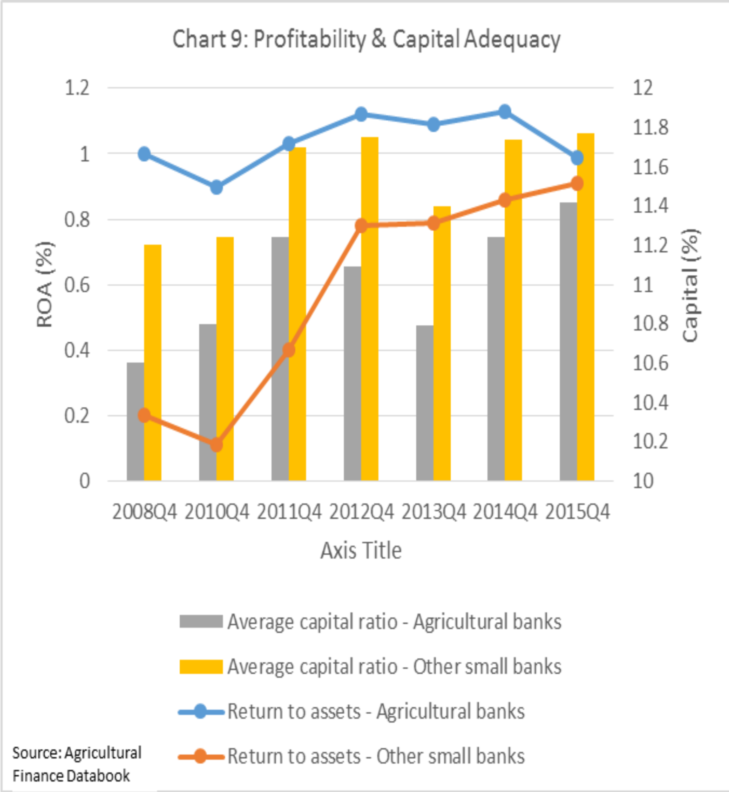
While lending activity remained robust in the first quarter, there was a general deterioration of agricultural credit conditions with declining repayment rates, growth in carry over debt, and modest increases in delinquency rates. Agricultural lenders are seeking to bolster their near-term positions by using a greater amount of farm real estate to collateralize non-real estate loans, as well as by raising interest rates. Even with relatively stable farmland values, poor cash flows might continue to pressure a larger percentage of highly-leveraged farm borrowers in 2016.



About this Report and the CSBS Risk ID Team

Each quarter, members of the CSBS Risk Identification Team complete a standardized survey that collect observations on current risks, developing trends, and different aspects of the supervisory process. For comparison purposes, survey results are compared to prior quarters across CSBS districts. Further, throughout the quarter, team members raise issues and discuss observations that might not be collected by the survey. The results of all these activities are summarized in this report, and a particular risk often is the subject of a separate, periodic ***Risk Spotlight***.

The CSBS Risk ID Team was created to leverage knowledge and skillset of state bank examination staff nationwide. The team has grown to more than 100 examiners, representing nearly every state banking department. The team is led by an Advisory Group, a subset of team members chaired by Lise Kruse, chief examiner of the North Dakota Department of Financial Institutions. Team findings are summarized in this report and provide a window into how state bank examiners see the risk environment affecting state banking institutions. The report also can be used to inform the policymaking, regulatory and supervision functions of states and CSBS.



CSBS District Map