Agricultural banks are an increasing percentage of failing banks. In 1983, only five of the 45 banks that failed were agricultural banks. In the first half of 1984, eight of the 43 banks that failed were agricultural banks. In the second half, it was 17 of 35. Ten other failing institutions had more than 10 percent of their portfolio in farm loans. In the first five months of 1985, 18 of the 32 institutions closed were agricultural banks. Undeniably, the failure rate of agricultural banks is accelerating and is likely to remain high in 1985. However, the financial fallout attributable to agricultural bank failures is limited. The reasone for this view is the relatively small size of the typical failing agricultural bank.

In 1984, the average deposit size of the agricultural banks closed was roughly $16 million. In 1985, it was $18 million. In 1984 and 1985, only three very small failed agricultural banks have required deposit payouts by the Federal Deposit Insurance Corporation (FDIC). In virtually all other cases, the deposits and portions of the assets of the disappearing agricultural bank were simply transferred to, or have been assumed by, another institution. Thus, customers of failing agricultural banks generally were not deprived of banking services and have not experienced losses when their institution was closed.

Chart 1: Farm Real-Estate Acreage

The financial outlook of family farms in the foreseeable future is not encouraging. Farm exports are expected to remain weak as long as the value of the dollar does not decline from its current plateau. Even if the exchange rate were to substantially decline in the near term, recent increases in foreign agricultural production capacity may prevent significant U.S. agricultural export gains. Further, government payments to farmers in 1985 are likely to be greatly reduced from 1984 levels, and production expenses, particularly from debt sources, should remain high.

Farm aid bills have been debated in several states. However, the farm aid proposals offered at the state level should provide only marginal relief given the enormous magnitude of the financial problems in the farming industry.

It is becoming increasingly clear that the structure of American farming is undergoing a wrenching adjustment to a new environment. As a consequence, the family farm and the small agricultural bank may be in jeopardy. This agricultural transition, similar to that which is also reshaping the contours of a number of U.S. manufacturing industries, imposes heavy burdens on the individuals, institutions, and localities directly involved. However, because the number of farms and banks bearing the burden of the transition are relatively small when viewed from an industry perspective, the overall impact these adjustments will have on the national economy and on the financial system will probably be minor.

ECONOMIC COMMENTARY

The Best of Times and the Worst of Times

The late 1960s and the 1970s were, by most conventional measures, the most prosperous years for American farmers. The domestic economic experience relatively strong growth. Farm incomes were also greatly influenced by international demand for U.S. food exports.

The events that encouraged export demand over that period included world economic growth, a falling dollar exchange rate, and liberalized trade agreements between the United States and many foreign nations, particularly the Soviet Union.

Between 1971 and 1981, U.S. exports of agricultural products rose from $7.7 billion to $43.3 billion, or from 12 percent to 26 percent of gross farm incomes. This represents an increase from 0.7 percent of U.S. gross national product (GNP) to 1.5 percent of GNP over the 10-year period. A decade of increasing agricultural demand propped up farm prices and incomes. In the 1970-1979 subperiod, the cash received directly from agricultural sales (farm marketings) averaged nearly 11 percent annual rate of increase.

Farm wealth also increased over the decade as the value of farm real estate, which constitutes roughly 75 percent of total farmland assets, tripled. Growing net income, expectations of increasing inflation, and low real interest rates, in conjunction with the land-related wealth gains gave farmers the incentive and the means to assume greater debt loads. As a percentage of farm equity, farm debt rose from approximately 13 percent in 1960 to near 20 percent throughout the 1970s.

Things got worse after 1979. Crop surpluses, a worldwide recession, dollar real appreciation, and domestic food price supports severely undermined the competitive position of U.S. food exports. Between 1981 and 1984, U.S. food exports fell 21 percent to $34.3 billion, representing only 0.9 percent of GNP. Record domestic food production in 1981 and 1982 in turn generated enormous accumulations of farm product inventories. Farmers' expenses increased greatly during the early 1980s as rising real interest rates combined with large debts. In 1980, the index of prices paid by farmers exceeded the prices paid to farmers for the first time in 40 years; it has remained so for five consecutive years. After allowing for government supports and adjusting for increases in purchasing power, the average level of farm income in 1985 was at its lowest in over 45 years.

Like most businesses, U.S. farmers are able to offset a temporary slowdown in cash flow by borrowing against accumulated wealth. Unfortunately, depressed farm incomes, declining inflation, and a flood of farm land sales in 1982 produced the first decline in farm land prices since 1930 (chart 1).

Since 1982, U.S. farm acreage prices have fallen approximately 18 percent. When we consider only the acreage prices in "corn belt" states, such as Ohio, the farm land price declines have been all the more dramatic (about 34 percent in Ohio over the 1982-1985 period). Unable to borrow further, because of low incomes and rapidly eroding wealth, many farmers slipped into insolvency in 1984 and farm bankruptcies rose to record levels.

The Financial Distress in American Farming

by Michael Bryan and Gary Whalen

The views expressed herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.
The primary reason for profitability in spite of a proportionately heavy debt burden appears to be the efficiency of the large commercial banks in operating and generating a disproportionately high sales volume per dollar of assets. For example, at year-end 1983, farms with sales of over $50,000 annually represented only 1 percent of all farms and 11 percent of total farm assets, but generated over 61 percent of direct farm credit. In 1983, the worst of the post-War II farm income years, the income-to-equity ratio for farms with sales in excess of $50,000 was twice that of the average U.S. farm (16.5 percent) and exceeded against only 7.7 percent for all farms.

The farm income crisis has also been magnified by the fact that very small farms, specifically those farms with annual sales of less than $40,000, account for only 25 percent of farm assets and 20 percent of total farm debt. Further, while these farms have generally experienced farmed income losses since 1981, their total incomes are primarily generated from non-farming sources. When non-farming income is included, the income-to-equity ratio of farms with sales under $40,000 was 60.4 percent in 1983. On average, neither the small nor the large farm has quite experienced the severity of the financial problems suggested by industry data.

The farm financial crisis is more accurately a middle-sized farm financial crisis, that is, those farms with annual sales between $40,000 and $500,000. This group, often referred to as the "family" farm, represents 27 percent of all farms. Farmers in this category owned 60 percent of all farm assets. In 1983, their total return on equity was a mere 3.3 percent. These data indicate that the financial problems previously identified in middle-sized farms are far more widespread than previously believed. While the $50 billion farm loan total is considerable, it should be noted that farm loans constitute only 4 percent of total loans made by commercial banks. A large proportion of farm loans are held by relatively small banks that have been forced out of business over the next several years will probably come from this class.

Examination of the trend of the ratio of delinquent loans to total loans at agricultural and other small banks further highlights the influence of recent farm financial difficulties on bank lenders (see table 3). The ratios show worsening farm loan quality on commercial banks, with the deterioration strongly increasing the degree of bank involvement in farm lending. Additional insight on the impact of worsening farm loan quality on bank soundness can be obtained by looking at banks where past due and nonperforming farm loans are a significant percentage of total, because such banks are likely to ultimately fail. At the end of 1984, 613 banks in the U.S., roughly 4 percent of all banks, had delinquent farm loans greater than 20 percent of their portfolios. These banks collectively held $2 billion of farm loans, which amounts to more than 7 percent of their total assets. Data for states with more than 20 such banks in 1984 appear in table 4.

The farm lending behavior of banks has been quite different than that of other lenders. With the exception of the Farmers Home Administration (FmHA), the farm lender of last resort, banks have also continued to expand their lending in significant half of all farm loans held by commercial banks. Table 2 reports delinquent data that indicate the farm financial difficulties have already caused bank loan quality, particularly agricultural bank loan quality, to worsen. This is reflected in relatively high agricultural loan loss rates in 1984. In the United States, net charge off of farm loans were 2.2 percent of farm loans outstanding at year-end. In 1983, 6.1 percent of outstanding farm loans were charged off. The high growth rate in California has been a severe impact on the financial health of a large number of California banks. Because in this state, the bulk of farm loans are held by large institutions that traditionally have relatively low nonperforming rates of their portfolios devoted to farm loans. In the predominantly agricultural states of Missouri, Iowa, and Nebraska, the average agricultural loan loss rate was 2.8 percent. Additional perspective on the trend of declining farm loan quality on commercial banks can be obtained by evaluating the charge-off rate at agricultural and other similar-sized banks over a period of several years.

Nearby 5,000 commercial banks have farm loans outstanding, of which nearly 85 percent, which is the average farm loan ratio for all commercial banks as of year-end 1983, is held by banks for roughly 60 percent of all commercial farm loans. Over 2,000 of these banks are state domiciled and their total farm loans are located in just five states (Iowa, Illinois, Kansas, Minnesota, and Nebraska).


2. In 1985, the USDA redenominated the farm size category to include farms with annual sales of $500,000 or $500,000. The debt figures reported here reflect the new definition.

3. Individuals and other lenders held 23% of the Farmers Home Administration holdings, 12% of the seven federal crop insurance companies' holdings and 6% of the Commodity Credit Corporation holdings.

4. Banks with farm loan ratios above the national average for all banks are treated as agricultural banks under the new simplified discount window borrowing procedure. This decision effectively provides an alternative definition of banks categorized as agricultural.