Transition in Agriculture: A Strategic Assessment of Agriculture and Banking*

David J. Leatham
John A. Hopkin

The American Bankers Association (ABA) initiated an assessment of the role of banks in providing credit and other financial services to the farm sector. The study reviews the trends in banking; projects the future economic conditions in agriculture; provides an assessment of the existing agricultural credit delivery system; and addresses the credit and banking policy changes needed to strengthen the ability of banks to serve the changing financial needs of agriculture. The findings of this study are summarized in this article.

INTRODUCTION

Agriculture and the ag-finance industry are undergoing fundamental structural changes the effects of which will touch every agricultural support industry and reach into the fabric of American rural life. These changes appear irreversible and are forcing many banks and other lenders to make basic decisions regarding their future role in providing credit and other financial services to the farm sector. To provide information needed for making such decisions, the American Bankers Association (ABA) initiated an assessment project with the following objectives:

- to examine where agriculture and banking are heading and help identify the services, products and programs that will help ag banks supply the credit and financial services to farmers;
- to identify legislative and regulatory changes that will help bankers serve their farm customers; and
- to provide ag banks a format for planning strategies to better insure their viability.

*Technical Article No. 22605 of the Texas Agricultural Experiment Station.

The authors are, respectively, Assistant Professor and Stiles Professor of Finance in the Department of Agricultural Economics, Texas A&M University.
To accomplish these objectives, the study:

- examined significant trends in banking as they affect banks serving agriculture;
- projected important dimensions pertaining to the economic future of agriculture;
- assessed the agricultural credit delivery system;
- identified important credit and banking policy issues; and
- prepared a strategic planning guide for agricultural banks.

A brief overview and summary of the key findings of the study are summarized below.\(^1\)\(^2\)

## TRENDS IN BANKING

The study addresses many important trends in banking over the past two decades. Those of most significance to ag banks include the following:

**Falling Profitability.** Whereas, the profitability of ag banks has, historically, exceeded that of nonag banks, since 1984 profitability of ag banks has been under that of nonag banks. A sustained decline in credit quality, including higher loan losses, has been a dominant cause of this reversal.

**Deregulation.** The virtual elimination of deposit-rate ceilings in the 1980s, plus reduced constraints of product services by S&Ls, investment banks and by nonag bank financial conglomerates (e.g., Sears and Merrill-Lynch) has removed the isolation which many rural banks had enjoyed in earlier years.

**Reduced Restrictions on Branching and Multibank Holding Companies.** Although Congress largely has failed to address these issues, many states are enacting laws favorable to branching and multibank holding companies; and regional banking zones are now a reality, especially in the eastern-coastal regions.

**Expansion of Electronic Banking.** The expansion of automatic teller machines (ATMs) and electronic point-of-scale terminals is allowing larger banks, S&Ls and financial conglomerates to reach into thousands of local markets for funds, thereby increasing competition to rural banks.

**Volatile Interest Rates.** Economic conditions have been unstable since the late 1960s, as reflected by erratic changes in GNP, inflation rates and interest rates. To the extent that such instability continues, banks will need to become more expert in the use of financial futures and other interest-rate sensitivity management techniques.

**Transformation of the Correspondent Banking System.** The "upstream" correspondent has played a vital role in farm bank lending in the past. This system is undergoing important changes, spurred by (1) higher real interest rates which have encouraged economizing on compensating balances in the correspondent banking process, (2) expansion of electronic technology that lowers costs of funds transfer, (3) the 1980 deregulation act requiring the "Fed" to offer its services to all depository institutions at set rates, and (4) the development of interstate banking. As a consequence, the elements of both the costs and benefits, as well as the products, of correspondent banking are changing.

Continuation of the above trends will affect the ability of traditional rural banks to meet the financial-service needs of their community and to prosper. Traditional lending, based predominantly on traditional deposit funds, is not promising in this changed climate. Clearly, the new competitive environment will require new management strategies and new sources of funds.
FUTURE ECONOMIC CONDITIONS IN AGRICULTURE

From analyses of trends in world supply-demand balance, changing consumer demand patterns in the US, shifts in the competitive position of US agriculture internationally, the changing structure of agriculture and trends in vertical integration for selected commodities, the following conclusions were drawn regarding the future of agriculture's economic environment:

(1) A strong consensus exists that real prices for farm products will continue their general downward trend. This trend will pressure farmers and ranchers to adjust.

(2) Technological innovation will intensify as the turn of the century is approached.

(3) Technological change and shifts in consumer demands will occur on a "spotty" commodity-by-commodity basis. Differential rates of adjustment will be required by commodity or subsector of agriculture and by region of the country.

(4) Large farms appear to have substantial economic advantages over moderate-size farms. These advantages include the ability to realize lower costs per unit of output as farm size increases, the ability to sell products at higher prices, and the ability and incentive to adopt new technologies more rapidly.

(5) The trend in the structure of farming is toward a bimodal distribution of farm sizes. However, moderate-size low-debt farms that adopt four keys to survival should remain solvent. They are state-of-the-art technology, judicious investment strategy, astute marketing and business management practices, and conservative financial management strategies. The survival chances for high-debt farms is considerably lower, regardless of size.

(6) Political pressures will grow to reduce the rate of technological change and diminish the exit of moderate-size farms. Resulting actions could hurt US farmers' comparative advantage in international markets.

(7) Efficiency, consumer demand, and technical forces are developing to integrate segments of agriculture vertically. Increased vertical integration may be fostered by nontraditional arrangements for debt and equity capital.

The impacts of the 1985 farm bill on 10 typical farm situations for four commodities in five locations were analyzed. Conclusions regarding the farm-level policy impacts are:

- Farmers depend on farm programs for their economic livelihood. Withdrawing these programs would create serious short-run financial problems. While these problems would be particularly severe for moderate-size farms, they would also extend to larger more efficient farmers. Strict enforcement of the $50,000 payment limit would have a particularly adverse impact on large farms.

- Farms are very sensitive to macroeconomic policy. The greatest improvement in financial condition for crop and dairy farms could be achieved through balanced budget initiative that combined a tax increase with a reduction in government spending.

- Major incentives exist for change in the structure of agriculture. The consistent advantages of larger crop and dairy farms combined with changes in government policies will accelerate the pressures for farm consolidation. Overall pressures
for change will be the greatest for dairying, followed by producers of corn, cotton and wheat.

The forces of change in farming and agribusiness extend to the structure of rural communities, dividing rural America into two major segments: (1) relatively pure agricultural regions that offer limited off-farm opportunities and support for land values; and (2) rural–urban agricultural regions where off-farm job opportunities, second homes, retirement homes and tax-shelters support land values and income to farm families.

ASSESSMENT OF THE AGRICULTURAL CREDIT DELIVERY SYSTEM

Total farm debt increased steadily following World War II, reaching a peak of $217.2 billion in 1982, from which it declined to less than $205 billion, January 1, 1986. *Farm real estate debt* expanded very rapidly between 1970 and 1984, with the Federal Land Bank increasing its loans outstanding by nearly 600 percent during the period. At the same time, all other farm real estate lenders declined in selective importance except Farmers Home Administration, which declined, initially, but then rebounded to new record levels in recent years.

*Nonreal estate farm debt* increased sharply during the 1970–1983 period, but then declined. Commercial banks have long been the dominant supplier of non-real estate debt. Their relative importance declined, however, from 49% in 1975 to 36% in 1986. During this same period, Production Credit Associations (PCAs) declined from 27 to 15%. The biggest gains were made by government lending agencies: Farmers Home Administration (FmHA) which increased from 3 to 17%, and the Commodity Credit Corporation (CCC) which fluctuated severely during the period, but held a record 17% in 1986.

The Changing Structure of Banks Financing Agriculture

The changes that have occurred over the past two decades in the sizes and types of banks that finance agriculture were analyzed using FDIC call report data. This analysis showed that:

- Two decades ago, small rural banks (with less than $25 million in assets) held 70% of bank farm loans, compared to about 18% today.
- Nonagricultural banks (farm loans comprising less than 10% of bank assets) that hold farm loans in excess of $2 million are, today, the most important single bank group financing agriculture and their importance is increasing. The large regional and multinational banks (with assets greater than $2 billion) are a growing component of this group.
- Banks in which farm loans comprised 40% or more of assets are mostly small, rural, unit banks. Their numbers are relatively small (385 in 1984) but fluctuate sharply from year to year, reflecting the high variability in their annual volume of farm loans and operating loan carryovers. Most “problem” ag banks are in this group. A much larger than proportional share of smaller ag banks has been in financial difficulty in recent years. However, a detailed analysis of the Federal Reserve’s Functional Cost data for 1979–1983 indicates that few economies of size were associated with different sized agricultural banks. The problem appears
to be not so much their inability to achieve economies of size in new technology as in management’s inadequate control of costs and higher costs associated with their farm loan investment decisions.

The Cooperative Farm Credit System

The history, growth and the development of the current financial problems of the Cooperative Farm Credit System (FCS) were reviewed in the major report. By 1984 strong evidence emerged that an increasing number of Associations and some districts were in serious financial difficulty. Public hearings on these problems continued throughout much of 1985, culminating in the Farm Credit Amendments Act of 1985. This act provided changes that could have far-reaching implications for FCS and for banks.

- The act strengthens the Farm Credit Administration (FCA) as an arms length regulator of FCS, giving it powers similar to the regulators of other financial intermediary systems such as commercial banks and savings and loan associations. The FCA is given responsibility to set credit and accounting standards and provided cease-and-desist powers to insure that established policies and standards are maintained. The 13 member Federal Farm Credit Board and the governor of FCA are replaced by a three-member board appointed by the President, with one of the three serving as CEO of the agency. Thus FCA is removed from supervision by a board elected by the units it is supposed to regulate.

- The Farm Credit System Capital Corporation was created for the financial warehousing and service of nonperforming loans and acquired property of FCS. Its purpose is to administer “self-help” among the units of the system by channeling funds from strong banks and districts to those in financial difficulty. It can also channel money from the Treasury to system banks in difficulty when funds are appropriated by Congress.

- Other provisions of the act prohibit the chartering of more than one local association to serve the same territory (thus maintaining an important degree of local autonomy); provide new assurances for the protection of borrower/stockholder interests; and give the same state and local tax exemptions for obligations issued by the Capital Corporation as those issued by the Farm Credit Banks.

The Farm Credit Amendments Acts of 1985 and 1986 are manifestations that strong political support for a viable cooperative credit system remains. Assuming that this political support will continue, the following projections seem warranted:

- Agency status for FCS debentures will continue. The concept of Treasury support to the system in times of economic crisis was clearly established. Consequently, the favorable pricing of FCS debentures will likely continue.

- The process of coordinating policies, services and performance standards will continue to move forward. More emphasis will be placed on financial performance at all levels and efforts to achieve such performance will move the system further toward a more centralized system.

- The move toward consolidation of geographic boundaries and, ultimately, management of local PCAs and FLBAs into service centers will continue, but not without strong opposition in some districts.

- FCS units will become more aggressive in developing and marketing related financial services needed by commercial farmers.
The FCS has access to a variety of maturity options on funds with which to match the maturities of their loans, thereby materially reducing interest-rate risks. This access provides FCS an advantage in risk management over most commercial banks in competing for term loans to agribusinesses and large-scale producers. This potential should be more fully exploited in the years ahead.

The present challenge for FCS is to emerge from its financial crisis and remain competitive. During 1985 and 1986 the system lost $5.3 billion, due to heavy loan losses and high costs of funds. Further loan losses are projected. The profit outlook is further aggravated by nearly $50 billion in outstanding securities at rates of 9% or higher—some up to 14% and with some maturities extending beyond the turn of the century. The Farm Credit Amendments Act of 1986 authorizes FCS to capitalize losses on these securities and spread them over 20 years. Offsetting these losses and ultimately repaying the Treasury for possible long-term loans that the system will likely receive to bail them out of their present dilemma, while at the same time rebuilding an equity capital base and still maintain competitive rates to borrowers will be especially challenging to system management over the next decade. Notwithstanding these problems, FCS will likely survive and emerge with its historic advantages still largely intact and with changes in structure and procedures which could strengthen its competitive position in total farm lending.

Public Credit Programs

The research report briefly reviewed the purpose, development, and problems of the two major public credit programs for agriculture—the Commodity Credit Corporation (CCC) and the Farmers Home Administration (FmHA). Both agencies dramatically increased their level of lending after 1981. Although the present high level of CCC loans should decline from present high levels, the role of CCC loans is not likely to diminish in the foreseeable future.

Important changes are occurring in FmHA loan programs, although these changes are sometimes pushed aside by temporary political expediencies. There is increased realization that chronic financial problems in agriculture cannot be resolved by credit programs. Hence, a strong shift is underway from direct FmHA lending to loan guarantees to those farmers who can demonstrate loan repayability but who cannot for various reasons, qualify for financing from a commercial lender. There is also reduced emphasis on concessionary interest rates as a form of subsidizing FmHA borrowers.

New Developments in Financial Intermediation for Agriculture

Because of deregulation, new technology and changing political and economic environments some new institutions and/or programs are emerging. Three were identified and discussed in the report.

Several new Agricultural Credit Corporations (ACCs) have been organized. Some have been organized as subsidiaries of bank holding companies which may or may not operate as other financial institutions (OFIs), a financial institution to which the Federal Intermediate Credit Bank (FICB) may make loans and discount agricultural paper. Others are independent of commercial banks and usually have
arrangements to allow some loans to be discounted with the FICB. They tend to operate over broad, unbounded geographic areas. They provide to owners (banks, groups of banks and others) interested in moving into new, promising geographic areas more flexibility to do so than would be possible through new bank charter. Most new ACCs look for clients with minimum loans of approximately $500,000. Distance from headquarters is usually not an issue in reaching for new clients.

There is a strong movement toward regional ag-finance centers. This movement assumes that a number of farmers: (1) are willing to establish a new banking relationship that may be 50 or more miles away; (2) will demand financial services in addition to the traditional operating line of credit and intermediate-term loans; (3) are willing and able to communicate with highly trained financial experts on matters of market planning, tax planning, risk management and cash flow financing; and, (4) will pay sufficient interest and service fees to make these services profitable. This movement, if successful, will vitally affect much of rural America.

Alignment of Bank Segments with Agricultural Markets

Figure 1 illustrates a simplified representation of the interrelationships that are emerging with rural communities, agriculture, and banking. It defines three types of banks and relates them to what is happening to the farmers and rural communities they serve. These are:

Traditional Banks. Mostly organized as unit banks. They serve producers surrounding small, isolated rural communities. Ag loans tend to dominate their portfolio. Many of these banks will decline as farms consolidate and as larger banks shift their business to larger ag-center banks.

Vanguard Banks. Typically organized as multi-office banks but include, also, many unit banks. They are located in ag-trade centers or in communities that are emerging into centers. They likely will serve a multi-county area. Ag loans comprise a lower percent of their portfolio than for most traditional banks. Vanguard banks will become an increasingly important supplier of debt capital to agriculture. The distinction between traditional and vanguard will depend more on what happens to their community and markets than on their organizational structure.

Megalithic Banks. Located in urban centers and serve large commercial producers and agribusinesses. They are, mostly, organized as multi-office firms although a few are large, metropolitan, unit banks. They are and will continue to be an important supplier of capital to agriculture.

A STRATEGIC PLANNING GUIDE

Clearly, many segments of agriculture and agricultural banking are at a crossroads in their future. Making the needed adjustments to remain economically viable will demand careful analysis and planning. A strategic planning guide was developed as part of this study. It was designed to help rural bankers assess the present and future position of their farm clients, the community they serve, and their bank. It should help interested users bring together the information needed to identify and assess their alternatives for the future. Its usefulness will depend largely on the
**Agricultural Banks**

<table>
<thead>
<tr>
<th>Type</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRADITIONAL</td>
<td>Declining</td>
</tr>
<tr>
<td>VANGUARD</td>
<td>Developing</td>
</tr>
<tr>
<td>MEGALITHIC</td>
<td>Increasing</td>
</tr>
</tbody>
</table>

**Agricultural Markets**

<table>
<thead>
<tr>
<th>Type</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small part-time farms</td>
<td>Stable</td>
</tr>
<tr>
<td>Mid-size farms</td>
<td>Declining</td>
</tr>
<tr>
<td>Large farms</td>
<td>Increasing</td>
</tr>
<tr>
<td>Small local agribusiness</td>
<td>Changing</td>
</tr>
<tr>
<td>Large corporate agribusiness</td>
<td>Increasing</td>
</tr>
</tbody>
</table>

The arrows represent primary future alignment among bank segments and market segments. They do not suggest exclusive alignment.

**Figure 1.** Long Run Primary Mapping of Bank Segments with Market Segments.

The thoroughness with which individual banks address the issues discussed in the guide.

**IMPLICATIONS FOR AG BANKS**

Some implications of the above issues and changes include:

- There will be a growing need for finance-related services and many ag banks have strategic advantages in providing these services. Efforts to deregulate constraints on banks offering such services should be beneficial to agriculture.
- Gaining access to long-term funds with which to make farm real estate loans will be vital if banks are to remain competitive with the combined PCA and FLBA units in supplying short-term loans to agriculture. Efforts already underway by national banking associations and insurance company representatives to assess the feasibility of developing a secondary market for farm real estate debt are encouraging. Other avenues also need to be explored.
- At no time since the great depression has the inadequacy of “collateral” lending for agriculture been so clearly demonstrated as during the last decade. Many of the “bad loan” problems now faced by farmers and their lenders could have been avoided if decisions regarding the magnitude, maturity and repayment schedules of farm loans had been based on loan repayability as reflected by projected cash flows rather than on the projected market price of collateral.
- Banks which cannot (or which choose not to) be a part of a multi-unit system should consider other alternatives for spreading their loan and deposit risks over broader geographic areas.
• The FmHA loan guarantee program could become an effective tool by which ag banks can reduce their high risks inherent in concentrating their loan portfolio in a single, high-risk industry. More effort is needed by administrators and operating staff of FmHA and by ag lending officers to resolve the present operations and communication problems presently hampering this program.

• Rural banks which have been and are experiencing significant changes in their farm customer base, in their community and in their competitive environment are encouraged to formally address the challenge of undertaking a detailed assessment of alternatives and making strategic plans for the future. To assist in this process, a detailed strategic planning guide was prepared and published as part of a study.

REFERENCES
