Deteriorating Farm Finances Affect Rural Banks and Communities

Financial problems in the agricultural sector are eventually transmitted to farm lenders. As cash flow problems cause farmers and farm-related businesses to fall behind on loan payments, the quality of lenders' loan portfolios deteriorates. Lenders must set aside reserves to cover actual and anticipated loan losses. These and other adjustments by agricultural lenders to cope with their problem loans can affect credit availability for the community at large.

Bank financial problems caused 69 agricultural banks to fail last year, and some predict even more agricultural bank failures this year. While bank failures dramatically portray the problems of farm lenders, the failures generally are not as devastating to local banking services as many fear. In the past, most failed rural banks reopened almost immediately under new ownership.

A more widespread problem for rural areas may be the growing number of agricultural banks with serious financial problems. As banks adjust their lending decisions to deal with weaknesses identified by bank regulators, "marginally qualified" borrowers are likely to be denied credit. This may force some farmers into bankruptcy, but it will also reduce credit to nonfarm businesses, putting rural communities in agricultural areas of the country at a disadvantage in attracting new businesses and holding existing firms. Depending on the size and structure of the local banking system, less credit availability could dampen the growth potential of the local nonfarm economy, just when off-farm employment is needed by members of foundering family farms and by people displaced from agriculture.

Agricultural communities in unit-banking and limited-branching States have local banking systems heavily involved in agricultural loans. Furthermore, since small agricultural banks depend on local borrowers, these banks will likely make every effort to service the credit needs of farmers despite their cash flow problems. This may help some farmers who would otherwise be denied credit, but could depress the community's economy if local banks support agriculture at the expense of the nonfarm sector.

Agricultural communities with branches of a large bank or affiliates of a large multibank holding company are likely to find themselves in a better situation. Creditworthy borrowers should continue to have access to credit despite the financial condition of the agricultural sector.

Agricultural Banks Feel Pinch of Farm Financial Stress

As a group, rural banks, and even agricultural banks (which comprised over half of the commercial banks headquartered in rural America), continued to add to their capital reserves through the end of 1984. But several signs indicate that financial problems among farmers hurt some agricultural banks. For example, some banks increased their capital only at the expense of lower profits caused by setting aside more funds for possible loan losses.

Table 1—Potentially vulnerable commercial banks

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<td>419</td>
<td>453</td>
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1Banks that have problem loans (those past due 30 days or more and still accruing interest), nonaccruing loans, and renegotiated loans greater than capital.

Source: Federal Reserve Board of Governors.
Much of the large increase in annual bank failures since 1981 has been among agricultural lenders. The 118 commercial banks that failed in 1985 is the most since the Depression; a majority were agricultural banks. Nonetheless, the failed banks were generally small, they were often replaced immediately via reopening as a new bank or takeover by an existing bank, and most customers had their deposits fully insured by the Federal Deposit Insurance Corporation (see “Rural Bank Failures Not A Big Problem — So Far” elsewhere in this issue).

Banks weakened by the number of borrowers having trouble repaying their loans may represent more of a long-run problem for rural communities. Some of these banks will eventually fail; others will work out their problems. The relevant question is what happens to bank service during the adjustment process.

Between June 30, 1983, and June 30, 1985, the number of agricultural banks at which past due and nonperforming loans exceeded bank capital increased by 215 percent. Over the same period, “vulnerable” nonagricultural banks increased by only 20 percent (table 1). Attempts by some agricultural banks to cover bad loans may reduce the availability of credit to existing customers and to new businesses. In areas with a high incidence of weakened banks, a lack of local credit may hurt growth.

Farm financial problems will probably not threaten the overall stability of the commercial banking system. Agricultural loans and bank holdings of Farm Credit System securities together amount to only 3 or 4 percent of the banking system’s total assets. Recent legislation (The Food Security Act of 1985 and The Farm Credit Amendments Act of 1985) will provide a breathing spell for the farm sector to make necessary adjustments. Nonetheless, many farmers and agricultural banks will have problems—and some will go out of business—during the next several years. Continuing farm financial stress could weaken the banking systems serving several States. Most commercial bank lending (not just that to farmers) in Iowa, North Dakota, and Nebraska is by agricul-

Farm Lenders and Risky Agricultural Loans

Banks are not the only agricultural lenders, nor even the largest. The major institutions involved in agricultural lending are the Farm Credit System, the commercial banking system, and the Farmers Home Administration. These lenders held over two-thirds of total farm debt outstanding at the end of 1984 ($212.9 billion), with the remaining farm debt held by individuals, life insurance companies, the Commodity Credit Corporation, and others. We concentrate on banks in this article because their importance to rural communities extends well beyond their loans to farmers.

Although many banks make loans to farmers, and farming is pursued in most areas of the country, we focus on two subgroups—agricultural banks and agriculturally dependent counties. The Federal Reserve Board categorizes a bank as “agricultural” if it has a higher than average concentration of agricultural loans within its loan portfolio (currently this includes banks with 17 percent or more of their loan portfolios in farm real estate and production loans).

Agricultural counties are the 702 rural counties where 20 percent or more of total laborer and proprietary income was derived from farming during 1975-79 (see map in Hines article, p. 11).

These counties were home to approximately a third of U.S. farmers and accounted for an equal share of agricultural sales in 1982. Banks headquartered in these counties on average made 45 percent of their loans for agricultural purposes; thus agricultural counties are likely to include many of the communities hit by bank problems originating in the farm sector.

Most farmers start having difficulties meeting their debt commitments at debt/asset ratios of around 0.4; that is, when their debt reaches 40 percent of the value of their assets. Therefore, debt owed by farm operators with negative net cash flows (insufficient income to pay current production expenses, debt repayment, and family living expenses) and with debt/asset ratios of 0.4 or more is considered to be at risk. Banks hold about $15 billion of farm loans (amounting to 45 percent of their farm operator loan portfolios) in this risky category.

Over $7 billion of this is owed by farm operators whose debts are more than 70 percent of the value of their assets (debt/asset ratio of 0.7); these loans are rated very risky. Barring some form of government intervention, or unexpected improvements in commodity prices, many farmers in this group will be forced to leave farming within a year or two. Lenders to farmers who default on their loan obligations can sell the assets (land, crops, and machinery) pledged as collateral for the foreclosed loans but, with market prices for such items currently depressed, lenders are unlikely to recover the full value of the outstanding loan balances.

Heavy losses by any of the major farm lenders can hurt rural communities, but only commercial banks serve a wide range of credit needs for farm and nonfarm rural businesses alike. The Farm Credit System (FCS) lends almost exclusively for agricultural purposes. The FCS has suffered large loan losses and, as a result, has increased the interest rates it charges. Many fear that this will turn potential borrowers and financially sound farmers into search of less costly credit. A reduced level of lending by the FCS (or the Farmers Home Administration) implies fewer “outside” funds flowing into rural communities. This could indirectly affect rural economies if local banks do not expand their farm loans, or if they do so at the expense of nonfarm borrowers.
tural banks (fig. 1). The amount of credit supplied by banks in these and several other States is very sensitive to developments in the agricultural sector.

For many rural businesses, local credit availability is more important than credit conditions at the State or national levels. Deteriorating loan quality will probably hurt banking systems serving local economies highly dependent upon agriculture as a source of income. While these communities are often in the Midwest, some are in other regions of the country.

Banks Serving Agricultural Counties

Banks less dependent on farming and banks owned by large banking organizations (with loans throughout the State or Nation) can minimize the effects on rural communities from problems in the farm sector. While over two-thirds of all rural counties are served by at least one nonagricultural bank, that is the case for only a third of the agricultural counties (table 2). And agricultural counties are less likely to contain branches of large banks, or banks owned by large multibank holding companies (firms owning two or more legally independent banks). In fact, about 40 percent of these counties contain offices of fewer than three banks. Because of the relatively few banks per county, local credit could be significantly curtailed by the current financial condition of agriculture in these counties if even one local bank has to adjust its loan portfolio.

A commercial bank can take several steps to make up for deteriorating quality in its agricultural loans. If the bank serves an area characterized by a highly diversified economy with unmet loan demand by the nonfarm sector, it can shift its loan activity away from financially strapped farmers toward nonfarm businesses. Banks with branches throughout the State or banks that are part of a multibank holding company are likely to find it easiest to shift loanable funds away from the agricultural sector. Unit banks, on the other hand, are more likely to serve local markets only. The viability of a small unit bank is tied to the fortunes of local borrowers. If most local borrowers are farmers with financial problems, as might be expected in many agricultural counties, unit banks may make every legal effort to continue servicing farm credit needs despite their borrowers’ cash flow problems.

Banks with the option of shifting loanable funds away from agriculture might decide not to, because turning down farm loans could force some farmers into bankruptcy and convert problem loans into actual losses. Thus, commercial banks may extend additional credit to farmers with cash flow problems, hoping that their financial plight will improve enough to repay their loans. But extending additional credit to risky borrowers reduces the overall quality of a bank’s loan portfolio. Bank regulations then require that the bank increase its loan loss reserves, which will reduce the bank’s overall ability to lend to businesses, both farm and nonfarm. Depending upon local market conditions, banks serving agricultural areas of the country may also raise their interest rates, or collateral requirements, or both, to all their loan customers so as to recoup the higher

![Figure 1](States_Highly_Dependent_on_Agricultural_Banks)
As rural banks adjust to weakened farm portfolios, credit to other rural sectors may be reduced, dampening growth of the local nonfarm economy.

costs of serving risky farm borrowers and to minimize the possibility of additional problem loans.

If communities are served by diversified, competitive bank structures, problems of individual banks will have less effect on local credit availability. But communities with many banks, even nonagricultural banks, may still be vulnerable if the local economy is heavily influenced by the farm sector. This seems likely in many of the agriculturally dependent communities since farmers’ financial problems tend to affect the nonfarm sector and to depress the local economy; as of June 1985, the proportion of nonagricultural loans classified as nonperforming was 3.8 percent for banks headquartered in agricultural counties compared with only 2.6 percent for banks headquartered elsewhere. Even non-agricultural lenders are likely to find their deposit base growing slowly, if at all, and more losses on their nonfarm loans to local businesses.

The presence of a branch of a large bank, or a bank that is a member of a large multibank holding company, might better indicate that the local banking system can withstand prolonged agricultural stress. But only 27 percent of agricultural counties are served by such a bank (table 2). Thus, most agricultural counties lack direct service by larger, more diversified financial institutions. Of course, bank operating policy is an important factor in determining how helpful “outsider” banks are in stabilizing credit conditions in agricultural counties. Branches of large banks should have the resources available to continue extending credit; whether the banks choose to extend the credit is another matter.

It is not surprising that agricultural loans make up a high percentage of total loans made by banks with offices in agricultural counties. Banks serving agricultural counties are typically small agricultural banks, though large regional and money center banks have offices in some agricultural counties in statewide branching States. Banks serving agricultural counties average 45 percent of loan volume for agricultural purposes (higher in unit banking states and lower in States that permit statewide bank branching) compared with 11 percent for the average bank with no office in an agricultural county.

For many agricultural counties, heavy agricultural lending makes local banking systems vulnerable to deteriorating financial conditions in the farm sector. The ability of local banking systems in unit banking and limited branching States to continue to provide credit within agricultural counties may be hampered by the small size of banks and by the lack of larger, more diversified financial institutions.

Prospects Grimnest for Midwest

The depressed farm economy has already taken its toll on many banks serving agriculturally dependent counties. The 1985 failure rate for banks headquartered in agricultural counties was more than double that for banks headquartered elsewhere. Banks headquartered in agricultural counties reported an average 5.6 percent of their agricultural production loans as nonperforming in June 1985; banks headquartered elsewhere reported only 3.3 percent of their agricultural production loans as nonperforming. Above 8 percent of agricultural production loans were nonperforming at over 25 percent of banks headquartered in agricultural counties. This last group of banks must make adjustments that could curtail their lending.

New guidelines by the Federal Reserve Board establish a minimum level for primary capital at 5.5 percent of total bank assets. Based on our simulations, if all commercial banks had written off 10 percent of the value of their agricultural loan portfolio during 1985, roughly 2 percent would be in imminent danger of failure, with primary capital falling below 2 percent of assets.

Over 9 percent of commercial banks, serving 913 counties (297 of which are agricultural counties), would have had primary capital below 5.5 percent of total assets. In four States—Nebraska, Idaho, South Dakota, and Iowa—a 10-percent write-off of farm debt would have left more than 20 percent of commercial banks with inadequate capital. Among banks headquartered in agricultural counties, 4 percent would be in imminent danger of failure and nearly 21 percent would have inadequate levels of primary capital.

While the above example is based on a very high write-off rate by historical standards, it may not be unrealistic for some Midwestern banks with large loan concentrations in cash grain farming. And since a majority of the banks identified as being vulnerable by these simulations were located in the Midwest, the results may match up fairly closely with the number of banks that will have to make adjustments to cover farm loan losses in the near future. On the brighter side, the simulations indicate that problems associated with the farm economy are likely to affect banks in relatively few counties outside the Midwest.

Bank Regulators Ease Rules

Several actions are now underway or being actively considered to ease the
adjustments taking place in the farm sector. In March of this year, the Federal Reserve Board and other agencies that regulate banks jointly announced plans to relax capital restrictions for banks believed to have a reasonable chance of regaining their economic health within a 5-year period.

Regulators also modified rules governing the handling of restructured loans (terms changed by the bank to make it easier for the borrower to repay the loan) in a way designed to help banks maintain their lending levels. Congress was debating stronger legislation at the same time. And the administration placed additional funds in the farm operating loan program so that the Farmers Home Administration could maintain its role as lender of last resort during the spring planting season.

Most observers agree that the above changes and last year’s legislation (the Food Security Act of 1985 and restructuring of the Farm Credit System) will provide some breathing room to rural economies and financial markets. But it is almost as certain that the situation will remain difficult for several years. Some farmers and farm banks are beyond help and will not make it, and farm income is not expected to improve in the near future. Also, communities highly dependent on agriculture will face the task of diversifying their economies at a time when the necessary credit is difficult to obtain.

For Additional Reading...


The Role of Analysis in Economic Development: Lessons from Minnesota’s Iron Range

States may not be getting their money’s worth from development programs formulated without benefit of economic analysis. Minnesota’s programs for its Iron Range, located in the northeastern part of the State, illustrate how analysis can get sacrificed in political tug-of-wars. The resulting programs may overlook projects with a good chance of success or encourage projects that will not achieve economic development goals.

Minnesota’s 1983 legislature passed a series of measures that greatly expanded the State’s involvement in economic development. These included an enterprise zone program, incentives for small businesses, subsidies for employing certain types of workers, tourism promotion, and an office to develop international trade. Those new measures are on top of Minnesota’s Iron Range fund; this fund alone has provided more than $35 million for business ventures since mid-1982.

In 1984, Virginia created the Rural Virginia Development Foundation to provide capital and training programs for new and expanding small businesses.

Also in 1984, Pennsylvanians approved a $190-million economic development bond referendum that provides for State loans and grants to help employees take over plants threatened with closings, to assist small business “incubators” (which provide space and services for new businesses), to provide startup capital, and for other activities.

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These examples demonstrate that States are devoting more resources to influencing economic development. But they may be getting shortchanged. Lawmakers often do not know what contributes most to economic development, yet are reluctant to stipulate that development programs use economic analysis to help find the most promising directions and the projects with the best chance of success.

Careful analysis can lead to more effective use of public funds.