SRC Annual Summary of Agricultural Conditions

The Division of Supervision, Regulation, and Credit at the Federal Reserve Bank of Minneapolis conducts an annual survey of Ninth District state member banks (SMB) that have agricultural concentrations.[1] SMBs with agricultural concentrations are tiered into three groups, depending on the quantitative and qualitative risk metrics of each institution.

During the fourth quarter of 2017 and the beginning of the first quarter of 2018, the annual SRC Agricultural Survey was conducted using a risk-focused format. The timing was post-harvest but before the traditional first-quarter credit renewal period. The survey sample prioritized the banks that we deem to have the greatest risk,[2] including 88 percent (14 of 16) of the riskier banks and 36 percent (5 of 14) of the less risky banks, for a total coverage of 63 percent (19 of 30). The banks surveyed represented all agricultural areas in the District.

The survey conversations were conducted with bank presidents or senior agricultural loan officers. Questions revolved around projected 2017 and 2018 debt service coverage (DSC) ratios, operating loan demand, customers who may have carryover debt, land sale activity and prices, and the outlook for the near future. These are the key results:

- 74 percent of the bankers anticipate their median borrower to have a DSC to be below breakeven in 2017
- 26 percent of the bankers anticipate that more than 10 percent of their customers will have carryover debt from 2017[3]
- The volume of farmland sales remains low and often tied to individual circumstances, making it difficult to determine the overall stability of farmland values.

Summary of Survey Results

The 2017 survey results indicate that bankers and producers are attempting to adjust to the low commodity price environment. This was apparent as 74 percent of bankers surveyed indicated they expected their typical agricultural borrower's DSC ratio to be at breakeven or below. Bankers anticipate these poor DSCs despite reporting strong yields across much of the crop production areas, which helped offset the lower commodity prices to some degree. A positive note was that many bankers said the current (2014) Farm Bill support programs have benefited producers who have a DSC slightly below breakeven.

Survey results were consistent with the trends in recent years. Low commodity prices and relatively high fixed costs have compressed margins and created operating losses over several years for many producers. While the losses have been partially mitigated by strong yields in many parts of the District

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[1] Agricultural Risk Coordinator Jay Hendrickson conducted the survey and prepared the summary.

[2] Banks have a concentration in agricultural lending when the sum of loans to finance agricultural production and loans to finance purchase of agricultural real estate exceeds either 25% of total loans or 100% of tier 1 capital plus the allowance for loan and lease losses (ALLL). Banks are considered to be highly concentrated in agricultural lending when total agricultural loans exceed 300% of tier 1 capital plus the ALLL

[3] Some producers with DSCs below breakeven (i.e. operating losses) are still able to avoid carrying over operating debt through other means such as remaining working capital, or long term restructuring of real estate.

and by government program support, bankers have observed a significant reduction in producer working capital. During this survey, bankers also indicated that they are seeing a reduction in producer noncash equity.

2017 Anticipated Producer Performance

Bankers reported that carryover debt is a prevalent issue in the District. Nearly all bankers expected to see some level of carryover from the 2017 operating cycle. Most reported that they anticipated the level of carryover debt to be moderate. However, about a quarter of bankers surveyed anticipated that more than 10 percent of their customers would have carryover debt, and a few anticipated that more than a quarter of their borrowers would have carryover debt from the 2017 cycle.

Cattle prices improved throughout the District during 2017.[4] Since many of the District's livestock operations sell their production in the fall, bankers reported that producers were able to take advantage of the improved pricing. During survey discussions, nearly half of bankers indicated their customers planned to increase their herd size modestly, while the remainder said their customers were purchasing replacements only. Bankers reported that feed supply generally was adequate but that areas in the western parts of the District had some manageable feed-availability issues.

While nearly half of the banks surveyed indicated stable farmland prices, the remaining banks reported more than modest declines. Low transaction volume is skewing the results, and bankers indicated that many of the sales have been estate sales and not true arm's-length transactions. As a general observation, banks that were in the crop-growing regions of the District reported greater declines in farmland values, but there were inconsistencies even within these regions.

Bank Response to Current and Expected Conditions

Key survey topics included customer restructuring options, risk-rating techniques for customers with carryover debt, and use of government guarantees.

Nearly all bankers surveyed stated their commitment to working with borrowers. Bankers reported using several common approaches to working with weaker borrowers, including terming out the carryover debt, restructuring long-term debt, and adding an FSA guarantee. Since farmland prices were relatively stable, banks' collateral position has generally remained adequate for these restructured loans.

The use of government guarantees to help mitigate credit risk is an increasingly popular option among bankers surveyed, with 37 percent indicating that more than 10 percent of their agricultural portfolio had government guarantees in place.[5] The remaining two-thirds of bankers indicated their portfolios had anywhere from a couple of loans with a guarantee up to 10 percent of the portfolio.

Bankers surveyed said that they have had very few instances of having to cut off lending to borrowers, as that is typically done only when there are long-term viability concerns. However, 63 percent of bankers indicated that they had cut off credit in at least some instances. Bankers also reported having

[4]The District's cattle producers are primarily cow/calf operations, although a few SMBs also finance feedlot operations. See graph A-2 in Appendix 1.

[5]Most government guarantees in use are from the Farm Service Agency (FSA).

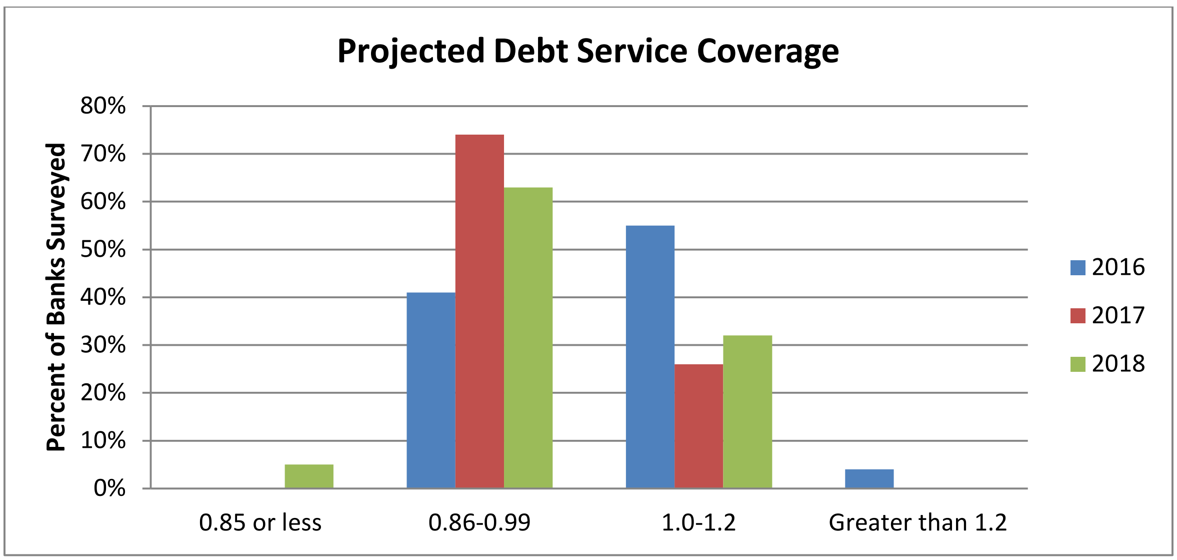
more difficult conversations with borrowers related to family living expenses. Off-farm income and reduction of discretionary expenses are the main topics. Generally, the banks report that borrowers have more success increasing family income than decreasing family expenses.

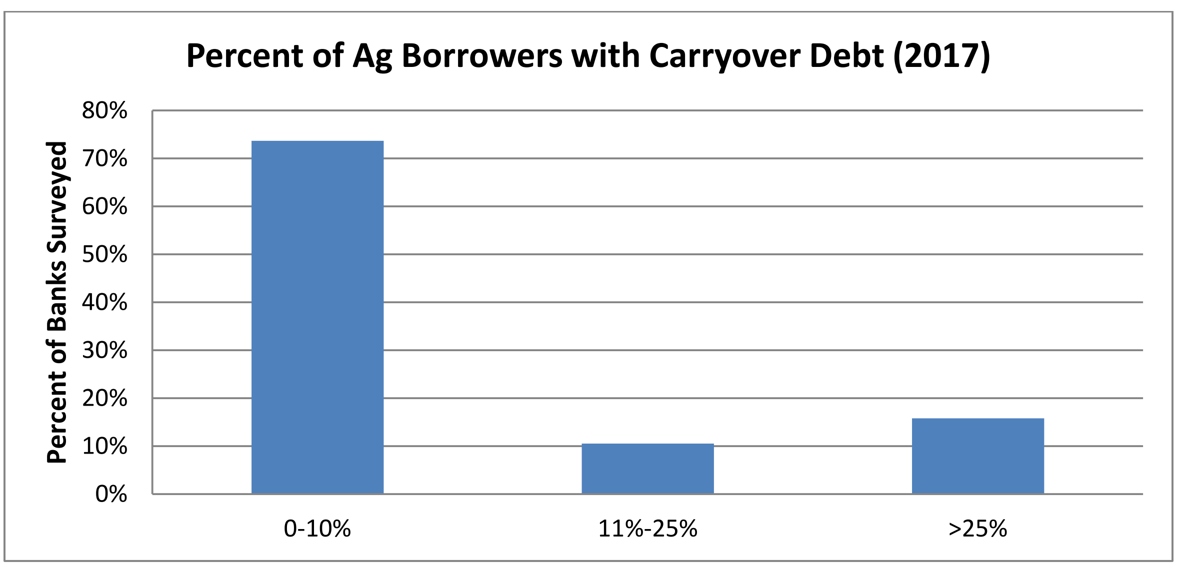
Beyond risk management on a loan-level basis, banks report taking steps to manage the risk on a top-down basis. For example, 37 percent of those surveyed indicated that their banks had made upward adjustments to the allowance for loan and lease losses based on the current environment. Bankers also indicated a general increase in board discussions related to capital and liquidity considerations in the current environment.

Banker Responses to Key Questions

The charts that follow reflect banker responses to key questions discussed during the survey calls.

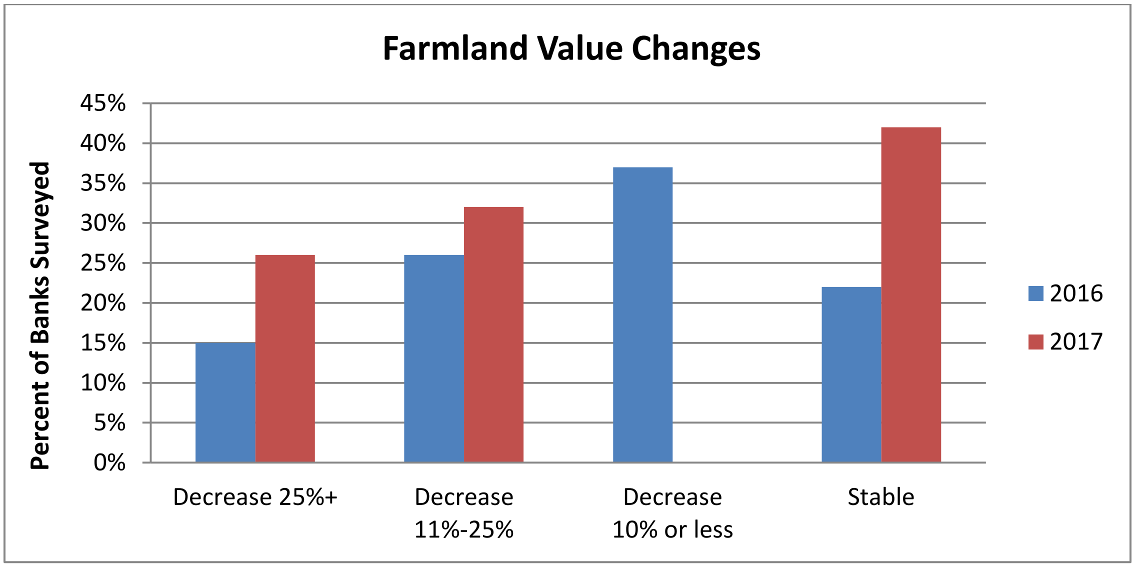
Debt Service Coverage and Carryover Debt

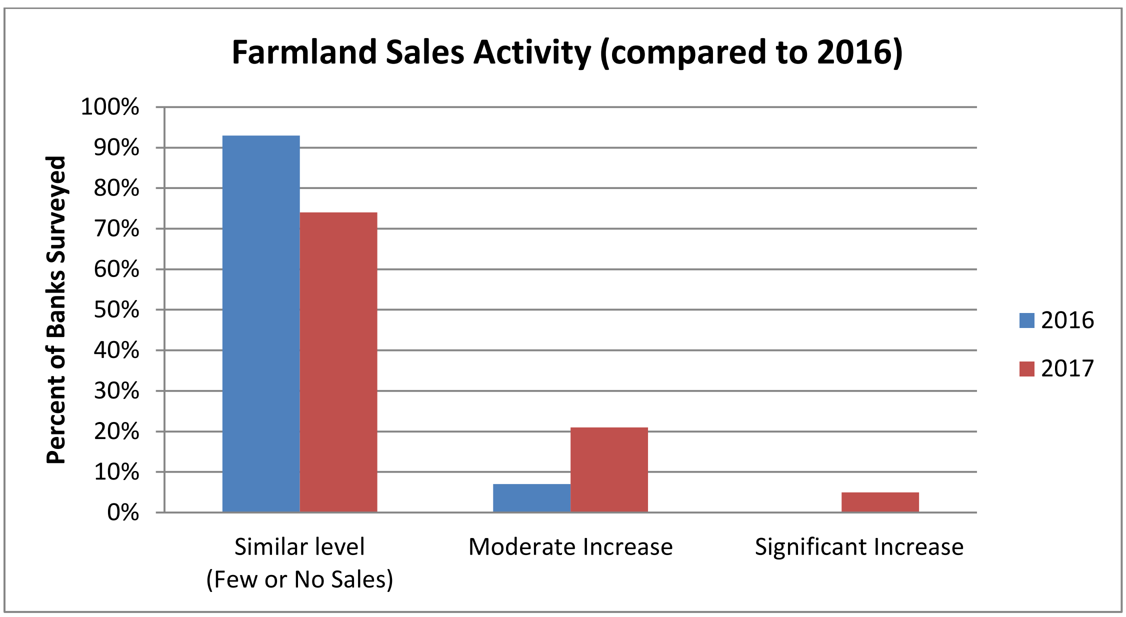




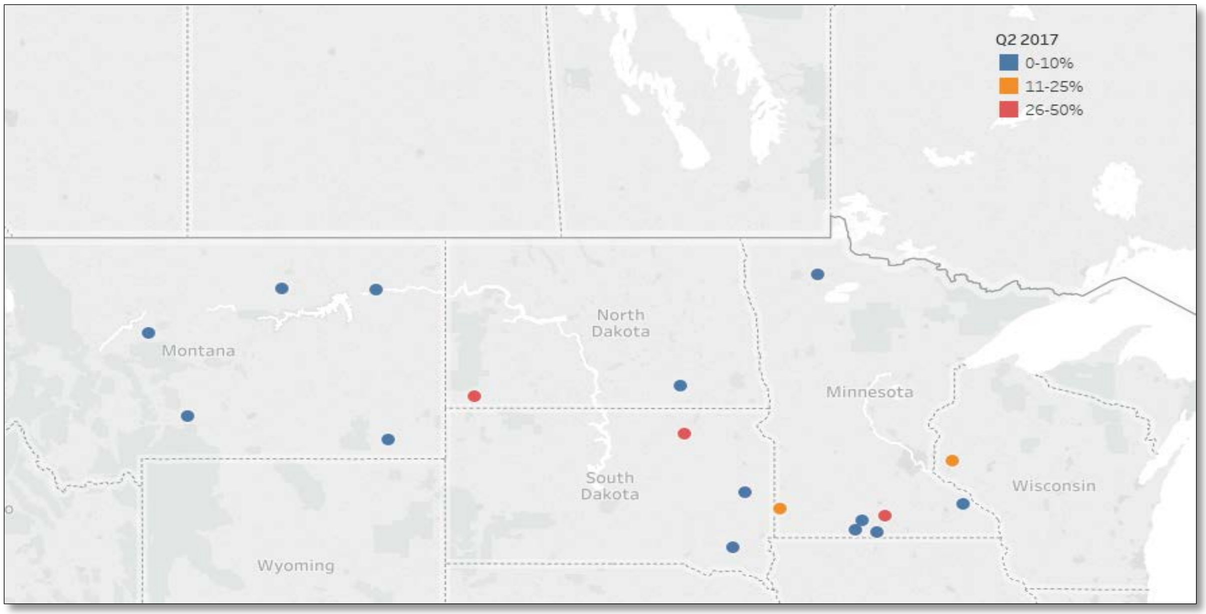
The preceding charts reflect the increasingly tight producer margins in 2017, with a slight improvement expected in 2018 if yields and weather conditions hold. Producers with tight margins have often used up existing working capital, and equity deterioration may be beginning.

Farmland Valuation and Sales Activity



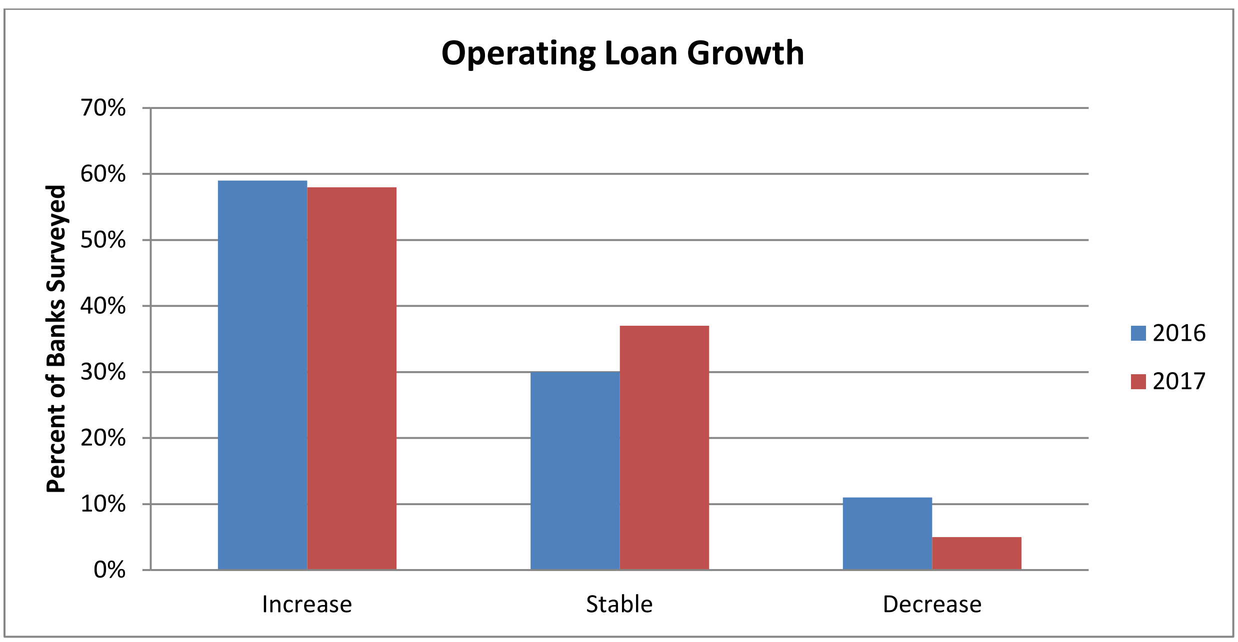


Survey responses related to land values were inconsistent. While significantly more bankers indicated stable prices than in 2016, more bankers also reported significant decreases of more than 10 percent. Low transaction volume seems to be the driver behind the variance, making it difficult to determine a true market value or ascertain a definite trend. Bankers indicated that many of the sales have been estate sales and not true arm’s-length transactions.



General trends show that the banks in livestock regions (Montana) showed less farmland value stress, with all bankers reporting stable values or slight deterioration. More deterioration was reported in crop regions, but the extent is idiosyncratic, as bankers from the same regions gave differing responses.

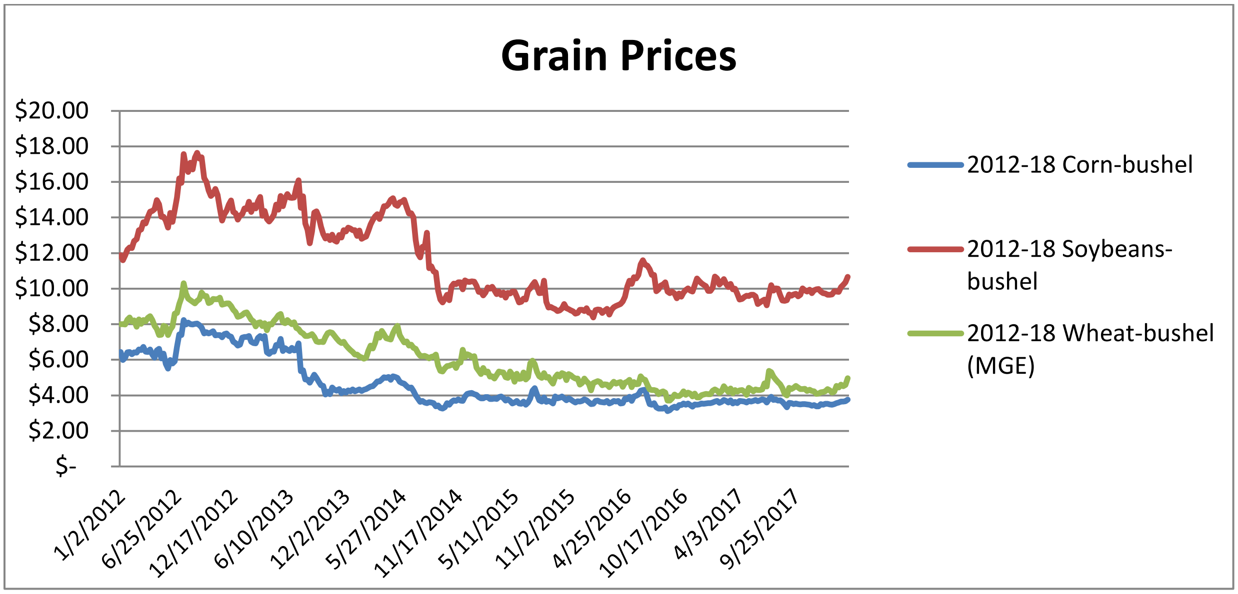
Agriculture Bank Growth



The growth in operating loan demand suggests that the working capital position of borrowers has continued to weaken. Many of the bankers surveyed indicated that carryover debt was driving at least part of the growth.

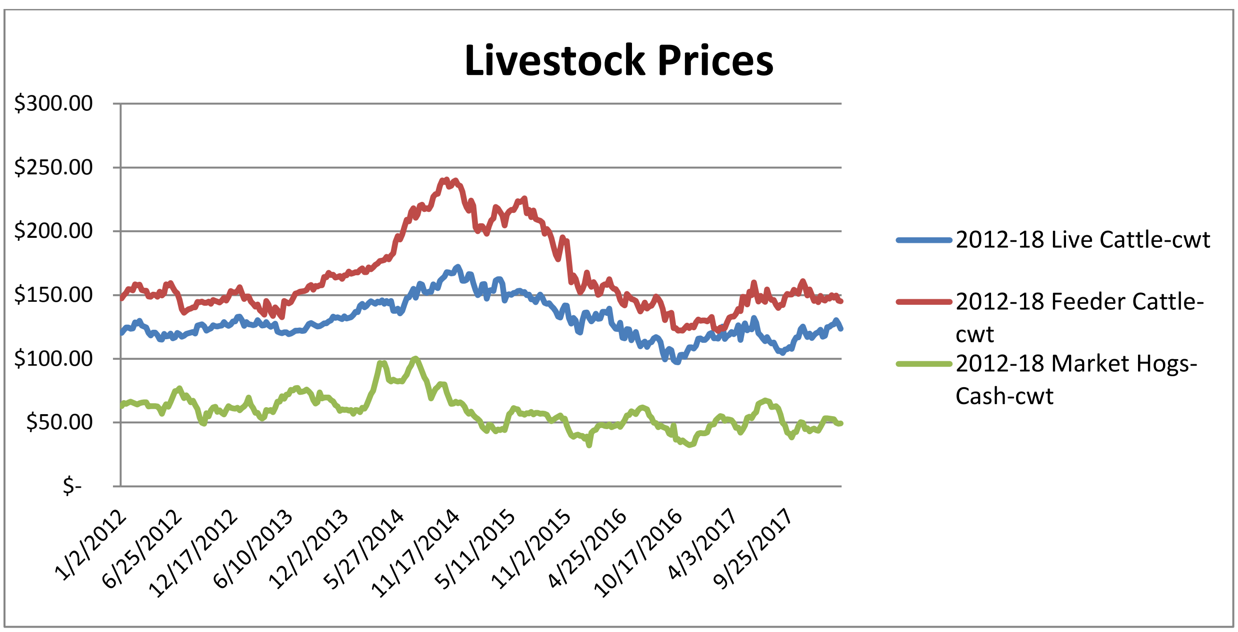
Appendix 1 – Selected Macro-Data Graphs

A-1: Grain Prices



Trends show that District crop prices appear to have found a new pricing normal. Bankers report that producers are struggling to adjust to the environment, and as a result, margins have narrowed.

A-2: Livestock Prices



Livestock prices have risen slightly, which has improved producer profitability.