

# ABA's Annual Farm Bank Performance Review 2009

## *Key Findings*

- Traditional banking practices, a focus on the fundamentals of credit, solid underwriting standards, and knowledge of the customer's business all contributed to the success of Farm Banks in 2009.
- The US banking industry is the nation's most important supplier of credit to agriculture providing more than 50 percent (\$126 Billion) of all farm and ranch loans.
- Small loans dominated bank farm and ranch lending with nearly \$96 billion in small and micro-small farm and ranch loans on the books at the end of 2009.
- Farm Banks increased farm loans by 6.1 percent in 2009 --- despite a very challenging economic climate. Farm Banks (as defined by ABA) held \$58.9 billion in farm loans at the end of 2009.
- Earnings and asset quality at farm banks declined in 2009; however, performance was still relatively strong.
- Farm banks are well capitalized --- 98.9 percent were categorized as well capitalized, the highest capital rating given by bank regulators.
- There were 2,295 Farm Banks in the country at the end of 2009. This compares to 2,247 at the end of 2008. The majority of Farm Banks are located in the heartland of America, on Main Street.
- Farm Banks employ 76,821 rural Americans and Farm Banks increased employment by nearly 1 percent in 2009.

*The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than \$165 million in assets.*

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The U.S. banking industry is the major provider of credit to agriculture with slightly more than \$126.3 billion in farm loans extended (over 50 percent of the total farm credit outstanding in the United States), as of year-end 2009.

Moreover, the U.S. banking industry is a major source of credit to small farmers. The banking industry reported holding approximately \$70.3 billion in small farm loans with \$25.1 billion in micro-small farm loans on the books.<sup>1</sup> The number of small farm loans on the books of bank almost reached 1.3 million with the vast majority – almost 1.0 million loans – under \$100,000.

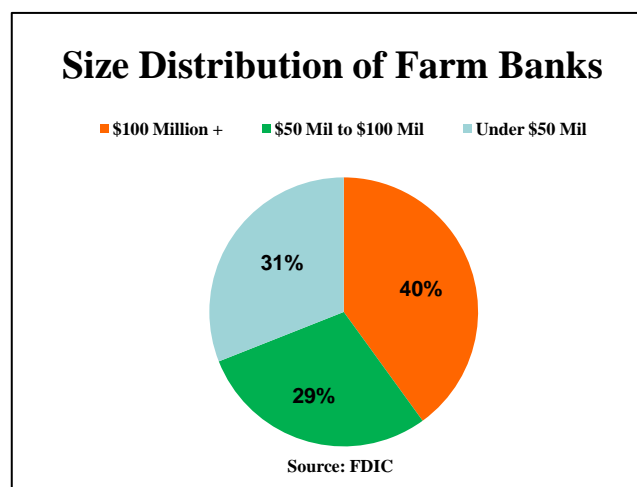
Farm banks saw weakening conditions along with the rest of the banking industry in 2009. However, with farmers' income remaining solid and land values in agricultural communities stable, farm banks<sup>2</sup> continued to post relatively solid performance throughout 2009. Though agricultural lenders continue to fare better than the banking industry as a whole, asset quality has continued to weaken in the face of deteriorating economic conditions. However, the very solid capital positions, and conservative lending strategies of farm banks upon entering the downturn has allowed these institutions to enter this period in a strong position. As a whole, they have remained well capitalized through 2009.

This paper examines the 2009 performance of the 2,295 banks that specialize in lending to agriculture and compares their performance over time with the performance of non-farm banks.<sup>3</sup> This total is up from the 2,247 banks in 2008 that met the farm bank definition.

### Farm Bank Demographics

The average-sized farm bank exceeded \$100 million in assets, holding \$123.3 million in assets at the end of 2009. However, half of all farm banks were smaller than \$81.0 million in assets. Forty percent of all farm banks were larger than \$100 million in assets; but 31 percent were under \$50 million in assets. As of December 2009, 73 agricultural banks held more than \$500 million in assets.

About 72 percent of all farm banks are



<sup>1</sup> A small farm loan is defined as a loan with an original value of \$500,000 or under. A micro-small farm loan is a loan with an original value of \$100,000 or less.

<sup>2</sup> Farm banks are defined by the American Bankers Association as banks with assets less than \$1 billion whose ratio of domestic farm loans to total domestic loans greater than or equal to 13.52 percent for 2009. Twenty-six banks with more than \$1 billion in assets had a ratio of farm loans to domestic loans greater than or equal to 13.52 percent.

<sup>3</sup> Non-farm banks are defined as banks with assets less than \$1 billion whose ratio of farm loans to total loans is below the un-weighted average of 13.52 percent.

located in the Plains (882 banks) and Corn Belt (768 banks).<sup>4</sup> The Northeast follows with 301 farm banks, the South has 228 farm banks, and the West has 116.

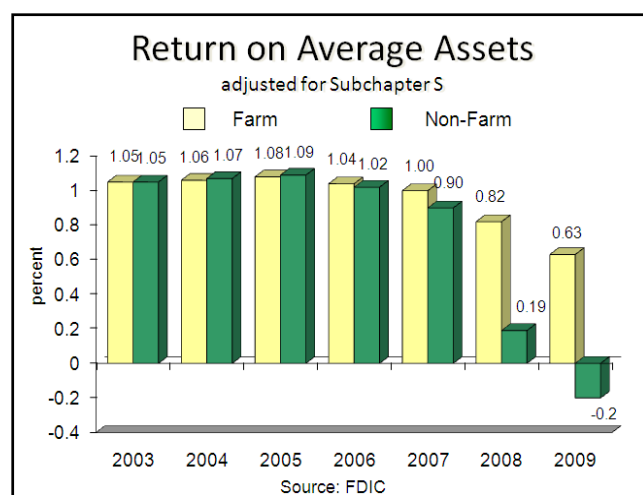
The average farm bank has three offices – two branches and a main office – and 34 employees. Over 55 percent of all agricultural banks have two or fewer offices. However, the largest farm bank had 44 offices, including the main office. Also, over 78 percent of farm banks have transactional websites, which allows the bank customers to execute transactions on their accounts through the website. Roughly 80 percent of farm banks have state charters.

As of year-end 2009, 752 farm banks had been granted trust powers, but only 572 currently exercised those powers. Farm banks had \$3.7 billion in managed assets and \$1.6 billion in non-managed assets.

Additionally, approximately 52 percent or 1,194 of all farm banks had Subchapter S filing status with the Internal Revenue Service. Unlike the government sponsored, tax advantaged, retail lending Farm Credit System, the earnings of Subchapter S farm banks are taxed. The earnings of these institutions are taxed like partnerships – meaning the earnings of the bank are appropriated to the shareholders who pay the taxes. Farm banks are not tax-exempt and cannot avoid paying taxes by retaining earnings like Farm Credit System lenders. Further, Subchapter S banks do not control entities that are exempt from federal taxation like Farm Credit System institutions.

### Farm Banks See Lower Earnings, but Largely Remain Profitable

Farm banks earnings declined significantly from the year earlier; however, they remained relatively strong in 2009, especially compared to the broader banking industry. Income before taxes and extraordinary items totaled \$2.3 billion, 21.5 percent lower than in 2008. Over 88 percent of all farm banks were profitable in 2009 and approximately 32 percent of farm banks



reported an increase in their 2009 profitability compared to a year earlier, as measured by return on average assets (adjusted for Subchapter S status).<sup>5</sup>

The aggregate return on average assets (ROA) for farm banks (adjusted for Subchapter S) fell modestly from 0.82 percent in 2008 to 0.63 percent in 2009. In comparison, non-farm banks as a whole were not profitable, with an adjusted ROA of -0.20 percent. For the five years prior to 2008, ROA for farm banks was between 1.01 percent and 1.08 percent.

<sup>4</sup> USDA regional classification system.

<sup>5</sup> [(Income Before Extraordinary Items – (Income on Tax-exempt Loan and Lease Obligations + Tax-exempt Income on Securities – Interest Expense Incurred for Tax-exempt Securities)) \*0.66 + (Income on Tax-exempt Loan and Lease Obligations + Tax-exempt Income on Securities – Interest Expense Incurred for Tax-exempt Securities)] Divided by Average Total Assets.

As has been the case in the past few years, on average, larger farm banks were more profitable than their smaller counterparts. Ag banks with \$500 million or more in assets had an adjusted ROA of 0.85 percent versus 0.69 percent for farm banks with under \$100 million in assets.

Operating profits per employee were \$28,800 in 2009, down from \$42,300 in 2008.

Over the last number of years, farm banks have experienced margin pressure. The net interest margins for farm banks have remained below 4 percent since the end of 2002. In 2002, net interest margins were 4.03 percent. By year-end 2009, farm banks had seen a 27 basis point decline in their net interest margins to 3.76 percent.

## Balance Sheet Developments

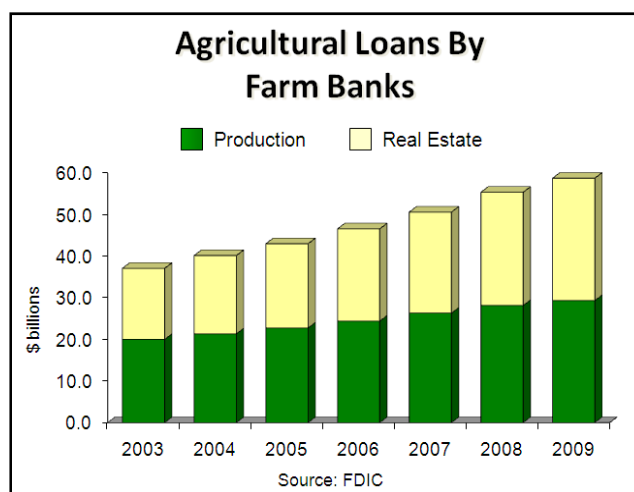
### *Assets up Over 5 Percent*

Farm banks held approximately \$284.7 billion in assets in 2009, up 5.8 percent from 2008. Approximately 91 percent of farm banks' total assets were earning assets in 2009.

### *Farm Banks Increase Farm Loans by 6.1 Percent*

Farm banks experienced modest loan growth in 2009. Total loans and leases rose by 2.3 percent to \$182.3 billion. Loan growth did not keep up with total asset growth, therefore loans as a percent of total assets fell from 65.9 percent in 2008 to 64.0 percent in 2009. However, this is still quite high when compared to historical rates. In comparison, loans made up 61.5 percent of assets in 2001.

Farm real estate and production loans at farm banks increased 6.1 percent to \$58.9 billion in 2009 from \$55.5 billion in 2008. Growth in agricultural lending therefore was faster than loan growth as a whole. In total, about 1 in every 3 dollars lent by a farm bank is an agricultural loan. Though both loans backed by farmland and loans to finance agricultural production grew over the year, the growth in total farm lending was primarily driven by real estate loans. Outstanding farmland loans grew by 8.1 percent, or \$2.2 billion, to \$29.6 billion. Outstanding production loans grew by a lesser 4.2 percent, or \$1.2 billion, to a total of \$29.4 billion. The difference in growth rates was primarily due to the fact that many inputs to production such as fertilizer and fuel had fallen in price in 2009 compared to their levels in 2008, requiring less financing.



### *Farm Banks are Major Real Estate Lenders*

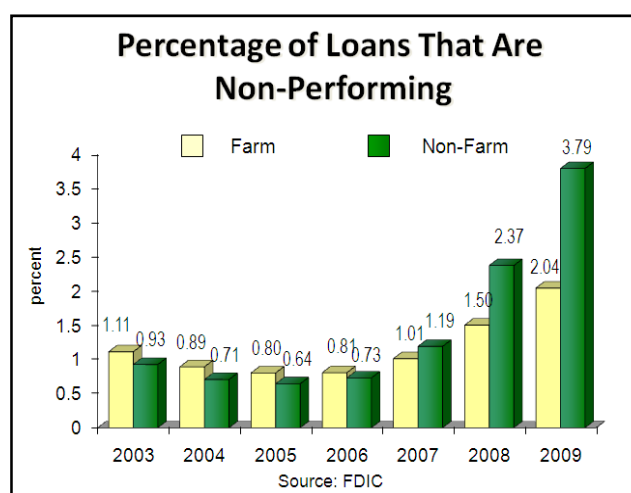
Over the past decade, farm real estate loans have become a larger share of the overall farm loan portfolio. In 2001, approximately 42 percent of farm loans held by farm banks were farmland loans. As of the end of 2009, slightly over 50 percent of farm loans were to finance farm real estate.

Moreover, farm banks are meeting the credit needs of small farmers. Small farm loans (loans with an original amount equal to or less than \$500,000) from farm banks totaled \$35.3 billion as of the end June 2009. Farm banks reported holding \$10.3 billion in farm loans with an original value of \$100,000 or smaller. Additionally, farm banks held an additional \$12.4 billion in farm loans with an original value between \$100,000 and \$250,000.

Reflecting the fact that farm banks provide a full range of services to their communities, outstanding non-farm real estate loans grew by 5.2 percent to \$71.7 billion. The residential (one-to-four family) real estate loan component grew 4.1 percent to \$38.2 billion. The commercial real estate portion expanded by 6.6 percent to \$33.5 billion. However, as construction activity fell off greatly in 2009, construction and land development loans fell 16.9 percent to \$9.3 billion. Similarly, commercial and industrial (C&I) loans reflecting slower business activity over 2009 due to the recession, fell by 2.1 percent to \$25.1 billion. Consumer loans, which are about 6.3 percent of total loans at farm banks, fell 1.7 percent 2009 to \$11.6 billion. Additionally, unused commitments at farm banks fell 5.0 percent in 2009 to \$28.0 billion.

### *Asset Quality Continues to Weaken*

Along with the banking industry as a whole, farm bank loan quality continued to diminish significantly over 2009. However, performance remained relatively strong compared to the broader industry. Total non-performing assets (assets 90 days past due or more and non-accruals) rose 40.4 percent during 2009 to \$3.8 billion. The ratio of non-performing loans to total loans was 2.04 percent, compared with 1.50 percent a year earlier. Other real estate owned also rose greatly, increasing by 81.2 percent to \$1.2 billion in 2009 – representing 0.43 percent of farm bank assets.



Loan loss provisions rose 75 percent to almost \$1.8 billion in 2009 from a little over \$1.0 billion in 2008. An increase in the provision for loan losses indicates management's expectation that future loan losses will rise. Loan loss provisions at farm banks were approximately 1.01 percent of average loans, up from 0.61 percent in 2008. Total loan loss reserves – \$2.8 billion at year-end 2009 – were up 17.7 percent from 2008. Despite the increase, provisioning did not keep up with the increase in non-performing assets, therefore total reserves, as a percent of non-

performing assets, fell to 74.4 percent in 2009 compared with 87.3 percent at year-end 2008. Prior to 2008, total reserves were higher than 100 percent of total nonperforming loans.

Non-farm banks saw continued loan quality deterioration in 2009. Non-performing loans as a percentage of total loans rose 142 basis points to 3.79 percent. Loans 90+ days past due were 0.27 percent of total loans compared to 0.25 percent a year ago. Though reserves for loan losses increased \$2.9 billion in 2009 to \$13.3 billion, as a percent of non-performing loans, reserves fell to 49 percent from 61 percent.

### *Non-performing Agricultural Real Estate Moves Higher*

Non-performing farmland loans at farm banks jumped by 81.7 percent to \$347.1 million as of December 2009, greatly exceeding the prior cyclical peak of \$172 million in 2003. As a percentage of total farmland loans, non-performing agricultural real estate loans were 1.17 percent in 2009 – up from about 1 percent in 2003.

### *Loan Losses Up for the Fourth Consecutive Year*

Net loan charge-offs (charge-offs less recoveries) of farm banks had a large jump for the second straight year reaching \$1.4 billion in 2009 up 78.3 percent from 2008. As a percent of average loans, the net charge-off rate increased 33 basis points to 0.79 percent in 2009.

### *Deposits at Farm Banks Rose by Over 7 Percent*

Farm bank deposit liabilities increased 7.5 percent in 2009 to \$236.8 billion, while core deposits increased 6.8 percent to \$191.8 billion. Over recent years, core deposits at farm banks have become a smaller portion of total deposit liabilities. Core deposits have fallen from 85.6 percent of total domestic deposits in 2001 to 81.0 percent in 2009. In comparison, deposits at non-farm banks increased 9.4 percent in 2009 to \$888 billion.

Farm banks held \$59.4 billion in transaction accounts as of December 2009, up 9.0 percent from 2008. Demand deposits comprised slightly more than half of all transaction accounts at \$30.2 billion – up 5.8 percent from a year ago.

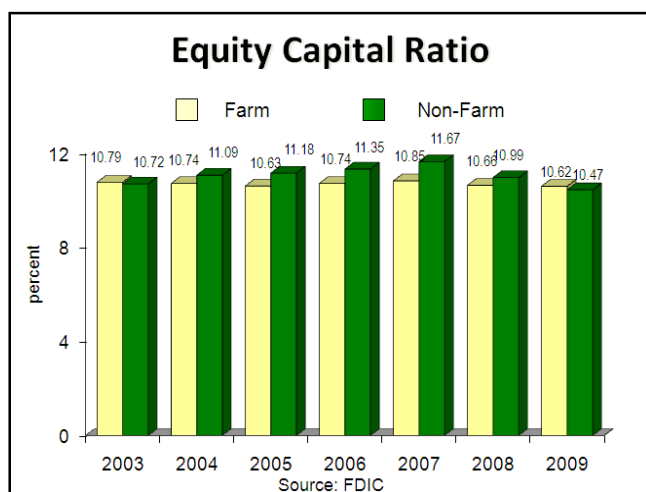
Non-transaction deposits at farm banks expanded in 2009. Total balances in non-transaction accounts were \$177.4 billion – up 7.0 percent from a year ago. The composition of non-transaction deposits was \$63.9 billion in savings deposits (passbook savings and money market deposit accounts), \$68.7 billion in small denomination time deposits (under \$100,000), and \$45.0 billion in large denomination time deposits.

Brokered deposits grew by 3.4 percent in 2009 after jumping over twenty percent in 2008. They have more than doubled since the end of 2005 to \$7.2 billion.

### *Farm Banks Remain Well Capitalized*

Equity capital at farm banks increased 5.7 percent to \$29.2 billion in 2009 and core capital increased by over \$1.3 billion to \$27.2 billion. Farm bank equity capital-to-average asset ratio

was 10.40 percent, 30 basis points lower than the 10.70 percent reported in 2008. In comparison, the equity capital-to-average asset ratio was 10.47 percent for non-farm banks, down from 10.99 percent in 2008.

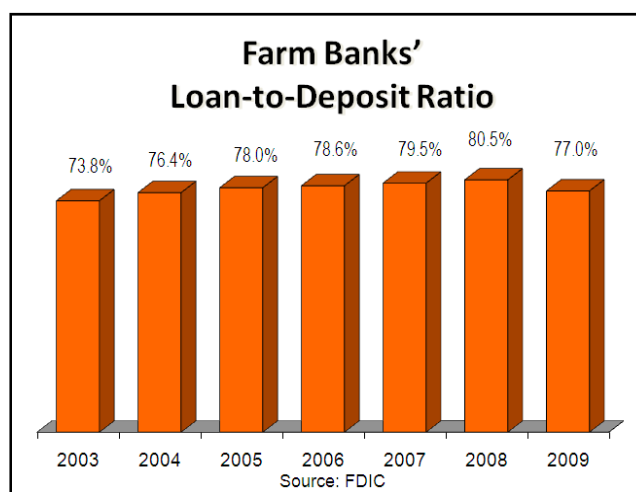


As of December 2009, twelve farm banks, or 0.5 percent of institutions, failed to meet the minimum standard to be categorized as adequately capitalized. Though this was an increase from five institutions in 2008, the number was still small. The vast majority of farm banks, 98.8 percent of them, were categorized as well-capitalized, the highest capital rating.

### *Farm Banks Have the Liquidity to Meet Loan Demand*

After rising significantly in recent years, the loan-to-deposit ratio at farm banks fell back in 2009 to 77.0 percent. The ratio was over 80 percent in 2008. Still, the lower rate in 2009 was relatively high compared to historical standards. It was 73.1 percent in 2001. With a significant expansion of the money supply over the last two years coupled with many investors' desire for safety, banks have had no shortage of deposits at their disposal. The overwhelming majority of farm banks reported no shortage of funds in meeting the credit needs of their farm customers, according to surveys by the Federal Reserve Banks of Dallas, Richmond, San Francisco, Kansas City and Minneapolis.

Federal Home Loan Bank (FHLB) advances continue to be a source for lendable funds; however, their relative importance as a source of farm bank funding diminished in 2009. As of the end of the year, approximately 55 percent of all farm banks had borrowings from the FHLB System. Advances from the FHLBs at farm banks grew from \$6.3 billion in 2001 to a peak of \$14.0 billion in 2008. Total advances then fell from this peak in 2009, declining 13.0 percent to \$12.2 billion. Much of this decline is likely due to the favorable price of deposits as short term interest rates are at historical lows and because many customers sought safety in 2009.



## **Income Statement Developments**

Farm banks reported income before taxes and extraordinary items of \$2.3 billion, 21.5 percent lower than the previous year's figure. After adjusting for Subchapter S status, the return on

assets was 0.63 percent – 19 basis points lower than 2008’s ROA – and return on average equity (ROE) fell by 186 basis points to 6.07 percent in 2009.

### *Interest Income Lower but Interest Expense Falls by Greater Amount*

Net interest income at farm banks grew at an annual rate of 5.8 percent, or \$543 million, to almost \$10.0 billion in 2009. However, total interest income fell by \$919 million (or 6 percent) compared to 2008. Therefore, for the second straight year the improvement in net interest income was due to a decrease in interest expenses, which fell \$1.5 billion (or 25 percent) in 2009.

### *Non-Interest Income Grew Slower than Non-Interest Expenses*

Farm banks saw modest non-interest income growth in 2009, rising 3.5 percent to a little under \$2.1 billion. Non-interest income as a percent of net operating income was 17.2 percent, down slightly from 17.5 percent in 2008.

Non-interest expenses increased 9.0 percent in 2009 to \$8.0 billion. Overhead expenses as a percentage of average assets in 2009 rose to 2.89 percent from 2.82 percent in 2008.

Full time employees at farm banks increased 0.8 percent resulting in the total employment of 76,821 rural Americans. Expenditures on salaries and benefits increased 3.5 percent to \$4.23 billion, accounting for 53.2 percent of all overhead expenses. This is down from 56.0 percent in 2008. The average employee’s compensation (salary and benefits) at a farm bank was \$55,264 in 2008 – up 2.1 percent from 2008.

The efficiency ratio for farm banks rose by 206 basis points to 64.11 percent in 2009. This means that it costs a farm bank about 64.1 cents to generate one dollar in revenues. The efficiency ratio for non-farm banks was 76.95 percent as of the end of 2009.

### **Farm Banks are Well Positioned for the Future**

Moving into the future, economic and financial market conditions continue to have a high degree of uncertainty. However, farm banks entered this period with very strong capital positions and continuously improving performance, so as a whole they have been able to weather the storm. Despite continued weakening of asset quality, largely driven by non-farm real estate loans, earnings have still been relatively strong and farm banks have remained profitable. Furthermore, although the underlying fundamentals affecting the farm economy are not as strong as they were during the commodity price run up of past years, by historical standards they still remain quite strong.

Though asset quality will likely continue to diminish along with the banking sector as a whole, there is some evidence, that at least in the case of community banks, that an inflection point may be near. Therefore, though charge-offs will continue to be a major concern for farm banks, the worst may soon be over.

After reaching an historic all time high in 2008, net farm income fell back 36 percent to \$56.8 billion in 2009. Moving into 2010, net income is expected to increase somewhat as commodity prices have stabilized and global demand for agricultural products begins to recover. Prices of fuel and fertilizer inputs have also fallen from their highs of a couple years ago, keeping the cost of production in check. USDA is forecasting that net farm income will rise 11.8 percent to \$63 billion 2010. By historical standards, this places net farm income near the past ten year average.

Additionally, farm business balance sheets improved greatly in the years leading into the downturn, due to record farm income and the appreciation in farmland values. Therefore, increases in farm debt were more than compensated for by increasing asset values. Though USDA predicts a decline of farmers' assets of 3.5 percent in 2010, the solid base from which farmers began will continue to support relatively strong agriculture loan performance. In fact, it is likely that any continued weakness in farm bank assets will be primarily focused in the non-farm loan portion of their portfolios. However, even in this area, residential and other real estate prices have held up better in rural communities than the country as a whole.

USDA expects farm debt to decline 6.8 percent in 2010 to \$233 billion by the end of 2010. Both real estate debt and non real estate debt is expected to decline 6.8 percent due to a slowdown in investment in farm equipment, lower prices for production inputs, as well as slightly lower farmland values.

An additional factor to consider, however, is that Congress is poised to enact the most comprehensive financial institution legislation in nearly 80 years. The legislation will create new challenges for farm banks, and for all banks. Farm banks have demonstrated that they are remarkably resilient and adaptable to business and economic challenges. While it isn't entirely clear what the industry will look like going forward, the focus of farm banks on traditional, conservative banking practices has served the industry well in the past and will do so in the future.

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*Drafted by Eric Brescia, Research Manager – Economic and Policy Research*