
Opportunities for Rural Community Banks in Farm Lending

By Marvin Duncan and Richard D. Taylor

Farm lending has been a comfortable growth industry throughout most of the postwar period. From the late 1940s through the early 1980s, farm debt increased fourfold as community banks and other lenders fed a hungry appetite for farm debt. Inflation helped fuel the upward spiral, raising land values and spurring a sharp buildup in real estate debt.

The 1980s brought this growth to a sudden halt and introduced bold changes that have fundamentally reshaped the farm lending business. Buffeted by strong economic forces, the structure of agriculture was pushed rapidly toward fewer, bigger farms. Meanwhile, financial deregulation unleashed forces that created a much more competitive marketplace for rural lenders.

After a decade of painful adjustment, rural community banks that lend to agriculture are just beginning to identify the opportunities of this new marketplace. The future for rural commu-

nity banks lies in focusing efforts on market niches and building new alliances with other financial institutions, while managing the regulatory burden of the 1990s. This article identifies opportunities for community banks that lend to agriculture and discusses strategies for seizing those opportunities.

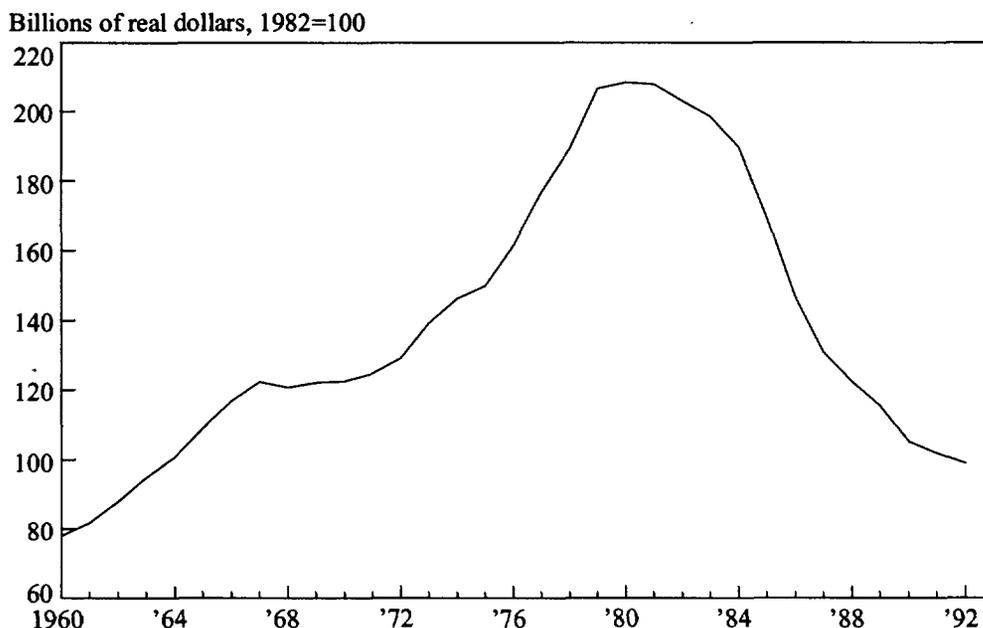
CHANGES IN THE RURAL CREDIT MARKETS

With the 1980s behind them, agricultural banks face a new marketplace. Today's farmers are astute business managers who understand the capacity of their businesses to carry debt. As a consequence, farmers now have an aversion to excess leverage. They seem willing to grow their businesses through equity investment and would rather rent or lease production assets than borrow to own them. Since the mid-1980s, inflation-adjusted agricultural debt has been cut in half (Chart 1).

Today's farm lenders also are more cautious. Across the agricultural heartland, lenders look at a debt-to-asset ratio of 40 percent as the upper end of a long-term comfort zone for farm businesses. No longer are lenders willing to count on rising farmland values to make weak loans stronger. Indeed, real agricultural land values

Marvin Duncan is a professor and chairman of the Agricultural Economics Department at North Dakota State University in Fargo, North Dakota. Richard D. Taylor is a research specialist at the university. This article was adapted from their presentation at the spring 1993 meeting of the Federal Reserve System Committee on Agriculture and Rural Development in Kansas City, Missouri. The views expressed in this article are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

Chart 1

U.S. Agricultural Debt

Source: *Economic Report of the President*, various years; *Agricultural Income and Finance*, various issues.

today are just above their 1960 value (Chart 2). And real land values are not expected to rise in the immediate future.

In today's changing world of agriculture, rural community bankers are being forced to cope with three new realities. They must cope with increasing risk exposure, a changing rural population and farm structure, and a more competitive lending environment.

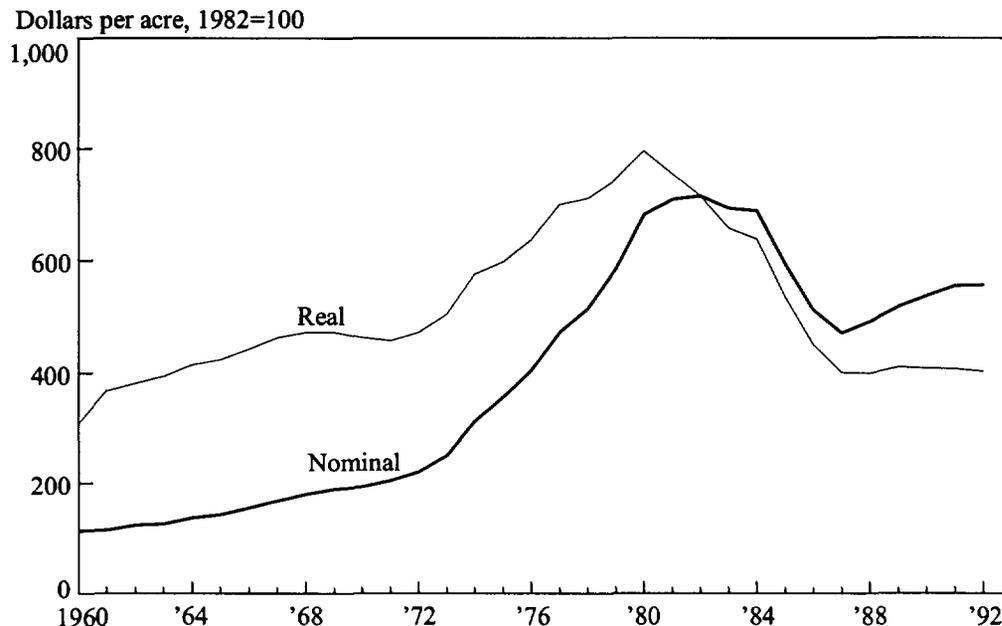
Increased risk exposure in agriculture

Agriculture's twin pillars of stability, strong growth in farm exports and steady-to-rising farm subsidy levels to commercial crop agriculture, have both come into question. Export tonnage

and sales have flattened, real sales have declined substantially, and increased government assistance has been needed to maintain sales at about the recent peaks (Chart 3). Sluggish economic growth has certainly dampened import demand in many countries. Moreover, privatization and democratization in the former Soviet Union and in Eastern Europe promise to turn former U.S. farm commodity customers into competitors before the end of this century as performance of their agricultural sectors improves.

In the United States, changing demographic patterns and rising federal budget stress have shaken the previously unassailable federal subsidy support for agriculture. Today, only 70 of 435 congressional districts represent rural/agricultural areas. Consumer and environmental issues now

Chart 2

U.S. Agricultural Land Values

Source: *Farm Real Estate Market Developments*.

seem closer to the center of agricultural policy debate. Indeed, farm interest groups are in danger of becoming minority players in crafting the 1995 farm program legislation. Amid continuing federal budget stress and shifting national priorities, it will be difficult to contain reductions in federal farm subsidy programs, much less to increase subsidy levels.

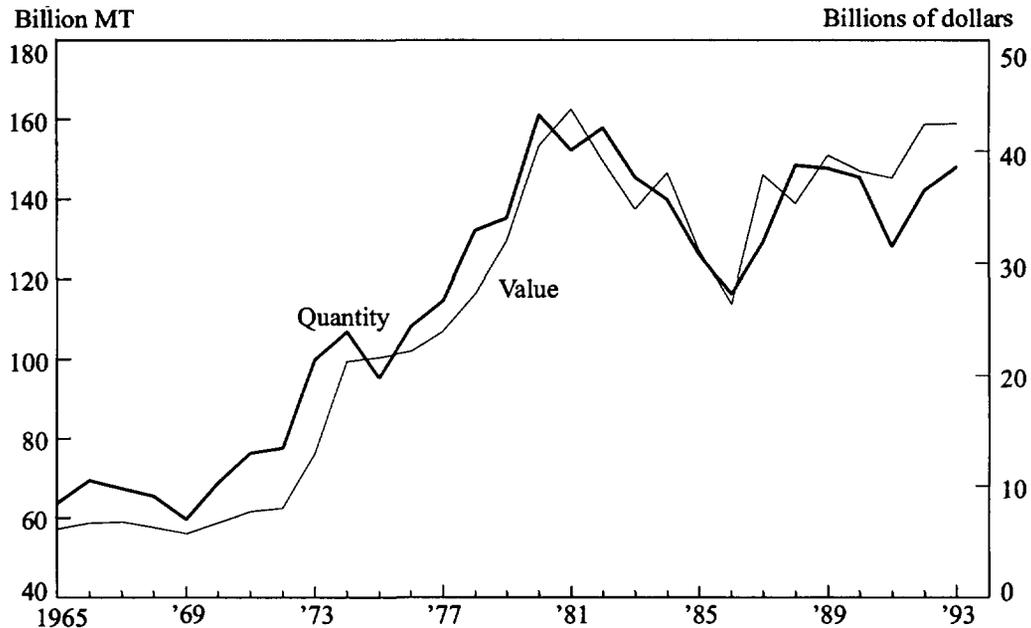
Changing population and farm structure

Population and structural change are both undermining the rural community bank's traditional marketplace. Many smaller rural communities are declining markets as both population and business numbers decline. For example, 73

percent of North Dakota's 366 incorporated places lost population in the past decade—66 percent of these places lost 10 percent or more of their population. At the same time, 89 percent of North Dakota's counties lost population—66 percent of the counties lost 10 percent or more. Indeed, the rural population is not only waning, but it is often aging, too. Moreover, rural population is not growing wealthier.

While the rural community's hold on its population weakens, so does its hold on business. Restructured retail and agribusiness firms are migrating toward county seat or regional centers. In North Dakota, eight county seats or regional centers are located on mainline railroads. Wal-Marts, Kmarts, Menards, co-op supply firms, health care providers, and implement dealerships

Chart 3

U.S. Agricultural Imports

Source: Agricultural Statistics.

flock to these centers. The story is similar across most of the Midwest and Great Plains.¹

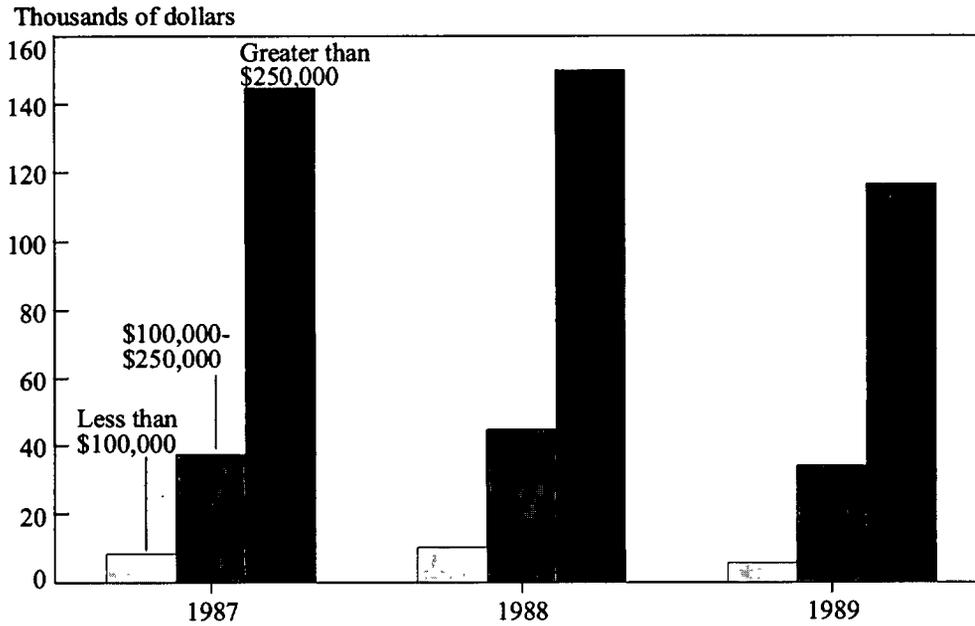
In the past, bankers could follow a “one-size-fits-all” strategy to service their agricultural customers, but not anymore. Nationally, average farm size has grown, while the number of farms has fallen. Moreover, the distribution of farms has become bipolar. At one end of the spectrum, many small farms have operators who generate more nonfarm income than farm income. At the other end, a few large farms reap most of the nation’s agricultural profits (Chart 4). In North Dakota, farm numbers fell 15 percent during the 1980s, compared with a decline of 13.8 percent in the 1970s, 15.5 percent in the 1960s, and 16 percent in the 1950s. By contrast, farm size has increased 33 percent since 1970 to an average of

1,224 acres. The trend is similar across the Midwest and Great Plains.

One of the reasons that farm size has increased is the need to maintain an adequate family income. In the nation’s heartland, typically only about 10 percent of gross farm marketings can be withdrawn for family living expenses without jeopardizing the farm’s long-term financial vitality. As a result, many lenders now believe that a financially viable commercial farm must have \$500,000 or more in annual sales.

As farms grow larger and more complex, so do their requirements for financial services. Financing of mergers, acquisitions, and export sales is increasingly required. Financial management, business planning, trust, and tax services take on increased importance. Strategies to

Chart 4

U.S. Agricultural Profit/Farm: By Sales Category

Source: "Financial Characteristics of U.S. Farms," ERS, *Ag Information Bulletin*.

control business resources through gaining access to the right kinds of debt and equity financing become critical. Needs such as these are in addition to the traditional needs for checking, lending, and insurance. But many of the newer services have been considered too specialized for community-based banks, and some of the services are not permitted under bank charter authority.

More competitive lending environment

Another change of great importance is a more competitive lending environment. New investment opportunities for bank depositors, such as money market mutual funds and NOW accounts, directly challenge rural community

banks for the market in transactions services and thus for a low-cost deposit base. Most rural community banks now offer interest on transactions balances, but that change has come slowly. The performance and product diversity edge that non-deposit institutions have over rural community banks suggests some continued erosion of the deposit base in rural America and an even greater dependence on purchased loan funds by rural community banks, much of it at competitive rates.

To remain competitive, rural community banks must widen the spectrum of financial products they offer. In the past, banks have augmented profits by selling various kinds of insurance to their customers, such as hail insurance, and Federal Crop, auto, casualty, and liability

insurance. To fully exploit that market, banks must be more aggressive in consumer and business lending. But small banks are not holding their own against credit purchases of consumer goods and lending by nontraditional sources, such as GMAC and John Deere, who are also prepared to sell insurance. Moreover, that formerly "on the mat" competitor, the Farm Credit System (FCS), is growing financially strong and offering an array of insurance and other financial products.

Size is also critical to bank survival. Economies of scale exist in banking as in farming. The fixed cost of back office activities can readily be spread over many more customers. Larger institutions tend to enjoy access to more complex products, services, and linkages usually unaffordable to small bankers. Also, technological changes that encourage large-scale livestock and crop production often present credit demands that exceed the lending limits of community banks.

By comparison, Great Plains states represent a microcosm of banking in small rural communities.² There, 88 percent of all agricultural banks are smaller than \$100 million in assets. Of those below that threshold, the average size is \$32 million, and \$29 million in North Dakota. These banks will have problems serving their customers and lending support to business development as the size and complexity of loan requests grow.

In this more competitive environment, regional banks, the FCS, and such specialized and nontraditional lenders as farm input suppliers are all competing with community banks for the best and most profitable customers. In many situations they may be better prepared than the community bank to provide the requested service. This competitive situation promises to place stress on pricing spreads and on managing the risk profile of the community bank's loan portfolio.

The array of competitors providing credit services is likely to grow larger, and the competitors may become more aggressive. The FCS institutions will be most important among them.

Financially stronger, well managed, and with unlimited and preferred access to financial markets to raise loan funds, FCS institutions are formidable competitors. Their cost of funds in the agency market is often only a few basis points higher than that experienced in the U.S. Treasury debt market. With lower costs and a renewed appetite for broadened charter authority made possible through consolidation, they remain powerful in rural U.S. credit markets.

Input suppliers and product marketers, such as John Deere, Pioneer Hi-Bred, and Farmland Industries, will be increasingly active in the credit marketplace, offering hassle-free credit lines to bankers' best customers. These firms frequently use credit services as a marketing tool and a means of cross-selling a broader range of products to the borrower. Credit is used to facilitate and cement customer relationships. Credit is also used to manage sales volume, to smooth production line flows, and to contain manufacturing input costs. Increasingly, however, credit activities will be viewed as a profit center and a course of business growth within these firms.

Electronic technology will speed the growth of competition among all providers of financial services and in the collection of deposits. Most nontraditional lenders already purchase nearly all of their lendable funds at competitive rates. Competition for deposits likely will cause this pricing to move toward a regional equilibrium, as opposed to prices that clear a local market. Eventually, these market rates will reflect international market pressures. Thus, commercial banks that lend to agriculture will pay market rates for more of their deposit base.

Electronic technology will also bring banking services directly to the customer. Convenience for the customer in the local mall or on the home computer will be critical. Cash management and bill payer services will become more common. Some lenders are beginning to put loan officers on the road with notebook computers and phone modems. With so many

choices readily available to customers, banks will have to stress relationship banking and customer service.

CHALLENGES AND OPPORTUNITIES FOR RURAL COMMUNITY BANKS

Despite a daunting array of challenges posed by the changing agricultural marketplace, substantial opportunities also await rural community banks. As the needs of agricultural borrowers have become more specialized, new market niches have spawned. How well banks prepare to serve those niches will determine whether the banks survive and prosper. Banks must also learn to navigate the rising tide of financial regulation.

Capture niche opportunities by forging new alliances

Rural community banks must broaden their menu of specialized deposit accounts to meet customers' needs. Many deposit products can be offered by the bank itself. But because most community banks are too small to create and offer their own money management and investment services, the successful bank must access such services on a customer's behalf. That usually requires creating new alliances to broaden the range of services the bank can offer. Money center and super regional banks, banker trade associations, and nonbank firms all provide such specialized, franchised, or branded services to community banks.

The alliances that rural community banks must forge depend on the marketplace niches that the banks intend to serve. Three primary niches have emerged for community banks in the heartland: larger and more sophisticated customers, small to midsize farms, and agribusiness and rural business.

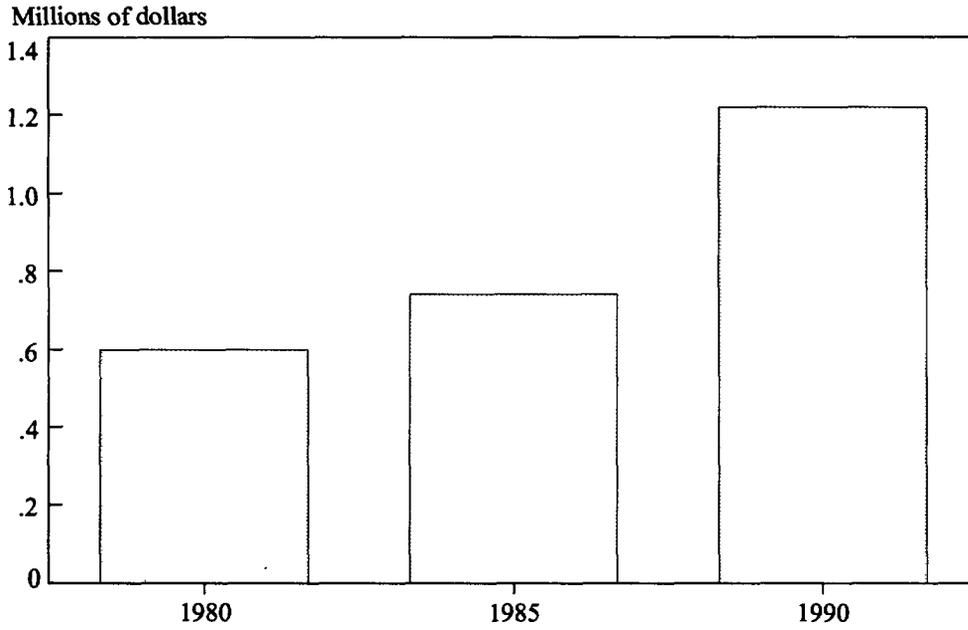
Niche 1: Larger and more sophisticated customers. Gone are the days when a banker who understood the business of one customer understood them all. Today, rural community banks increasingly lend to fewer but much larger farms or business firms. These firms are differentiated by farm enterprise mix, production systems, and ownership patterns.

Serving larger agricultural customers poses two operating challenges for community banks. First, today's larger farms require a new capital structure. More and more kinds of capital are needed to fund larger operations. Agriculture no longer has the capacity to recapitalize itself each generation without great hardship and risk for new entrants. The path to farm ownership and operatorship is being re-invented, as farms search for new ways to gain control of equity and debt capital, create a successful financial structure, and achieve coordination and management of business functions. Large farms frequently have greater specialization of, and probably separation among, the various activities of asset control, production, processing, and marketing of agricultural products. Coordination among farm business activities will increase.

To help large farms build their new capital structure, rural community banks can act as a catalyst to bring together an array of outside capital sources. For example, agricultural equipment leasing has doubled in the last ten years (Chart 5). As lease financing and equipment rental services grow, community banks may choose to deliver sophisticated financial leasing services on behalf of one or more vendors. Equipment manufacturers, independent lessors, and bank leasing subsidiaries offer three potential alliances.

Many states now provide specialized credit assistance to new farmers or start-up businesses. While the programs vary substantially, most include interest-rate buy downs and partial credit guarantees for a time. These may also include limited equity or quasi-equity funding. Marshal-

Chart 5
U.S. Agricultural Equipment Leasing



Source: "The Capital Markets For Farm Firms," by Dean W. Hughes, *Equipment Leasing Today*, July/August 1991.

ing a workable mix of equity and debt capital remains an unsolved problem for startup businesses in rural America—a service that rural community banks may be able to provide.

A second challenge facing rural community banks stems from the need for more seasoned management skills by the operators of large farms and agribusinesses. Professional farm managers are emerging, and commercial farm businesses increasingly require top-flight management. These businesses will not survive the learning curve mistakes of a new entrant. Thus, it is increasingly likely that commercial farms will involve more than one generation. With a succession of owners over time, these farms must help new entrants acquire the superior management skills they need to become senior

managers.

The need for seasoned and specialized management support will be important to rural community banks. Management subsidiaries or trust departments that provide specialized services represent growth opportunities for these banks. The management teams on commercial farms will be demanding customers, but ready to acquire information, marketing, financial management, and coordination services from a range of vendors that should include rural community banks.

Much of what occurs in American agriculture will require financial services that are beyond the capacity of the community-based bank. For that reason, a variety of partnering and alliances across financial institutions is likely. Unless regulatory changes to create a truly equal

charter across institutions make the issue moot, much of that partnering could occur across unlike institutions, each bringing its unique capability to fill financial services demands. If rural community banks are to reach their business potential, they must have greater linkages to regional banks, nonbank financial services firms, and quite likely the Farm Credit System institutions.

Niche 2: Small to midsize farms. Not all farms will grow larger and more complex. Many farmers and rural residents would prefer to retain a large number of small to midsize farms to add vitality to rural community life. The likelihood of retaining substantial numbers of these farms, however, depends on the success of agribusinesses, nonagricultural manufacturing, and service businesses in rural America. Part-time and full-time off-farm employment opportunities hold the key to retaining small and midsize farmers in their communities. Such economic development also happens to be critical to the survival of many community agricultural banks.

These farms will typically not be large enough to capture the scale economies associated with major field crop production. The economies that genetic, nutrition, and environmental control now bring to livestock production are likely to escape most small and midsize farms as well.

Many of these farms, however, will develop agricultural production for niche and specialty markets. That production will be very diverse, ranging from seasonal vegetables and exotic livestock to recreational products, such as horseback riding or camping. The special production and marketing requirements for these enterprises will stretch the skill and knowledge of commercial bankers as they develop credit products and other financial products to serve such customers.

Yet, since these farms may have more labor-intensive enterprises than large-scale agriculture—and will in some cases be very profitable—they represent a credit and financial services market that bankers can ill afford to dismiss. Labor-intensive production, if profitable, promises a

larger community economic impact that will benefit community-based commercial banks. Many of these specialty and niche market products have a higher likelihood of value-added processing close to the source of production than do major field crops. Thus, the payoff from this type of agricultural development could be larger local community payrolls.

Midsize farms often represent a transitional business size. The farms will either grow smaller and become part-time operations or will grow larger to commercial size. Those farms in the process of growing to commercial size represent a long-term opportunity for community bankers. By successfully underpinning a growing business with needed financial services, banks can build a life-long business relationship with the farm operator. Achieving such a relationship requires the lender to understand the farmer's business and growth plans, to be innovative in packaging financial services, and to assume some degree of risk in supporting the customer's business aspirations. Community banks often do this effectively.

Not all small and midsize farms will grow to commercial farm size. Many will remain rural residences or sources of part-time employment—provided that nonfarm employment for their operators is within reasonable commuting distance. For small and midsize farmers to remain productive members of the rural community—and good customers for many of a bank's financial services—agricultural processing and nonagricultural employment are critical. Thus, community banks can play a key role in keeping small to midsize farmers productive by supporting general economic development.

Niche 3: Agribusiness and rural business. Agricultural and consumer lending alone are unlikely to satisfy the range of financial service demands of rural communities. Nor can agricultural and consumer lending by themselves support growth in rural community banks. Commercial banks must also provide financial services to

value-added processing in agriculture and non-agricultural businesses. To serve these segments of industry, rural community banks must forge alliances with different-sized and often unlike financial institutions. Several institutions may join forces on large, complex, and higher risk loans. For example, large-scale loans to startup agricultural cooperatives might combine community banks, regional banks, and banks for cooperatives in the financing package. At the other end of the financing spectrum, the largest agribusiness firms will issue commercial paper, shifting their bank credit demand to longer term maturities and more specialized credit/financial services products.

The typical rural community bank can neither analyze nor successfully fund complex agricultural agribusiness or other business projects. More complex loan activity requires broader business and analytical skills than most small banks are able to provide. Still, rural community banks can identify such opportunities and bring together the skills necessary to help accomplish the tasks. For the rural community bank, managing the customer relationship, perhaps on a fee basis, represents an excellent opportunity for growth. Doing so not only helps develop new customers and increases business volume, but also offers attractive rates of return.

In all three niches of agriculture and rural economic development, government credit guarantees or other debt enhancement will continue to be important. Significant numbers of bank customers will not qualify for credit based on their own financial strength. For such firms, government credit guarantee programs, such as those offered by the Farmers Home Administration (FmHA) and the Small Business Administration (SBA), will be critical to survival. Community bankers need to be familiar with and willing to use these programs, both in direct and guaranteed lending, as important business development and support tools for their customers and for the banks themselves. Guaranteed portions

can be resold, fees can be earned for loan service, and attractive rates of return can be earned by the bank.

Within each local banking market, there is room for a few banks that specialize in processing guaranteed loans and make a market in the sale and purchase of guaranteed and unguaranteed components of the loans. Beyond that, however, participation in these programs can be a critically important business development strategy for the bank. The programs can be essential in expanding nonfarm business opportunities where risks preclude access to adequate traditional debt capital. FmHA and SBA loan guarantees will be important in securing participation of commercial credit and venture capital to capitalize startup businesses.

Manage the regulatory burden

Managing regulatory requirements is a growing burden for rural community banks. But regulatory issues are so important to a bank's success that they merit serious attention.

Environmental risk, if not managed properly, can be a business killer. Once a loan is made, both it and the collateral can become worthless to the bank if significant environmental problems are found. The bank may walk away from loan collateral rather than foreclose and risk becoming the "deep pockets" in an environmental pollution/cleanup situation. Whether due to disposal of farm chemicals, leaking fuel storage tanks, or animal waste runoff into streams or aquifers, the cost of environmental cleanup can be catastrophic. Few lenders will, or should, lend on real estate without an environmental audit by a competent specialist. If evidence of problems is found, a more detailed and costly analysis is called for.³

Larger lenders are more likely than small, local lenders to have ready access to environmental services. Many argue statutory or regu-

latory changes are needed to protect lenders. Currently, however, a competent environmental audit is necessary should any environmental question arise.

Regulators have discouraged broad-based lending outside a community bank's trade area. Community bankers have been comfortable staying within their primary market area when lending, but doing so may no longer provide sufficient risk dispersion in their loan portfolios. Staying so close to home may not provide a sufficiently large or a growing customer base either. Thus, the ability to achieve desired risk dispersion and loan growth may require lending over a broader market area—or creating alliances that achieve that result through other lenders.

If authorities further relax charter and regulatory restraints, commercial banks could become more active in a broader array of financial services functions. Larger commercial banks continue to dismantle the "Chinese Wall" between investment and commercial banking created by the Glass Steagall Act. Foreign banks operating in the United States are often able to use broader charter authority in their home country to help service customer needs. The likelihood of community banks offering their own services, however, as opposed to acting on behalf of another financial services firm, is probably remote.

Regulators will need to change their practices, as well. Too often regulators remain rooted in a traditional mode of operation, focusing on the availability of collateral to support the loan rather than on the performance of the firm and the loan. Despite functioning in an electronic information age, regulators still like to flip loan files. Banks are increasingly automating their business systems, including loan files. Electronic information systems now make more off-site regulatory monitoring possible. This can also be done at a lower cost than traditional examinations.

Regulators' willingness to permit more creative lending is likely to be linked to their capacity

to monitor electronically lenders' information systems on a continuing basis. Better information management systems in a bank will yield a better managed and a more profitable bank—and one with less costly regulatory oversight. Lenders and regulators can cooperate to further the objectives of each other.

SUMMARY

Agricultural lenders in the 1990s face sweeping changes in their traditional marketplace. The structure of agriculture has been altered as today's farms have become larger and fewer, and today's farmers have been forced to plan for waning government subsidies. At the same time, competition in the marketplace has become fierce. Regulatory changes and rapid technological advances have pitted small rural banks against an array of larger, more sophisticated lenders.

To remain competitive, rural community banks must broaden the spectrum of services they offer and lend more aggressively. Three primary market niches have emerged in the heartland: larger and more sophisticated customers, small to midsize farms, and agribusiness and rural business. Most community banks are too small to create and offer their own money management and investment services to all of these customers. But small rural banks can offer access to such services by creating new alliances with money center and super regional banks, banker trade associations, and nonbank firms.

While meeting the competition head-on, rural community banks must pay close attention to the mounting regulatory burden. To survive and prosper, banks must manage the environmental risks attached to agricultural loans. Banks must broaden their product lines as regulations may permit. And banks must develop automated information systems, both to permit more efficient regulatory monitoring and to give banks a more sophisticated management tool.

ENDNOTES

¹ Urban and retirement growth in the Arkansas/ Missouri/Oklahoma Ozarks region and in New Mexico and Colorado run counter to the trend. These retirees bring both income and population, benefiting a range of business activities and the public tax base. But even in those states, declines continue in nonurban and nonretirement areas.

² The Great Plains states include North Dakota, South Dakota, Nebraska, Kansas, Oklahoma, Texas, New Mexico, Colorado, Wyoming, and Montana.

³ Questions have even been raised about potential liability to a lender who finances cattle in a feedyard if the yard is a polluter.

REFERENCES

- Agricultural Income & Finance*. 1993. U.S. Department of Agriculture, Washington, D.C., February, pp. 48-49.
- Agricultural Statistics*. 1992. U.S. Department of Agriculture, Washington, D.C., pp. 408, 486.
- Bacon, Kenneth H., Martha Braunigan, Eleena DeLisser, and Michael Sicouolfi. 1993. "The End of Banking As We Know It," *Wall Street Journal*, July 7-9.
- Duncan, Marvin. 1993. "Farm Lending Beyond the 20th Century," *Agricultural Outlook*, January-February.
- Duncan, Marvin, Collie Gustafson, and Laurence Crane. 1993. "New Rules, New Opportunities for Launching Start-Up Farmers," *AgriFinance*, April.
- Economic Report of the President*. 1992. Council of Economic Advisers, Washington, D.C.
- ERA Ag Information Bulletin*. 1987. "Financial Characteristics of U.S. Farms," January 1, p. 57.
- Farm Real Estate Market Developments. Various dates. USDA-ERS, Washington, D.C.
- Gustafson, Collie R., and Shaun C. Beauclair. 1990. "Community Development and Commercial Bank Performance: A Mutually-Dependent Relationship," *Agricultural Economics Report No. 254*, Department of Agricultural Economics, North Dakota State University, Fargo, January.
- Leistritz, F. Larry, Brenda L. Ekstrom, Janet Wanzek, and Timothy L. Mortensen. 1989. "Beginning Farmers in North Dakota," *Agricultural Economics Report No. 249*, Department of Agricultural Economics, North Dakota State University, Fargo, August.