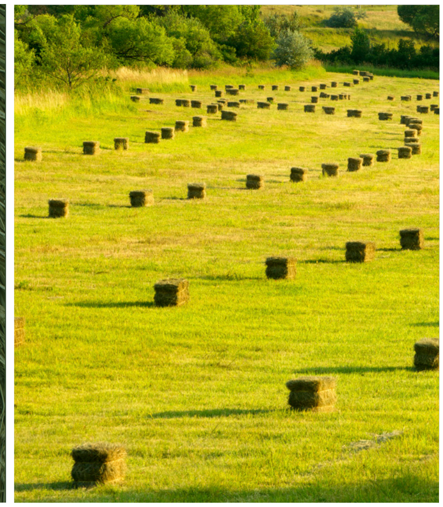
SURVEY *of* TENTH DISTRICT

Agricultural Credit Conditions

3rd Quarter 2012

Federal Reserve Bank *of* Kansas City



Drought-Reduced Incomes Boost Farm Lending

By Jason Henderson, Omaha Branch Executive, and
Nathan Kauffman, Economist

Drought cut District farm incomes in the third quarter, boosting demand for farm operating loans. Farm incomes fell sharply during the quarter as escalating feed and fuel prices pushed production costs higher. Shrinking incomes spurred demand for farm operating loans as corn and soybean farmers and cow/calf operators searched for funds to pay for rising input costs. Bankers also approved more loan renewals and extensions compared with the previous quarter, as loan repayment rates dipped slightly. Capital spending plummeted in the third quarter and bankers expected further declines in the next quarter.

Livestock enterprises faced the biggest shifts in farm income and loan demand. As drought conditions intensified during the summer, pastures dried up, feed costs soared with grain prices and income at livestock operations slumped. The sharpest income declines emerged in cattle feedlot and hog operations. Bankers expected high crop prices and crop insurance payments to support crop incomes. Nevertheless, bankers reported that corn and soybean incomes fell below last year's highs due to elevated fuel costs and reduced yields. In contrast, incomes for District wheat producers rose, with a rebound in wheat production and high wheat prices.

The drought had little impact on District farmland markets. Bankers indicated that demand for quality farmland outpaced supply, even with more land being put up for sale. Bankers also reported that marginal cropland sold well in some areas. Both non-irrigated and irrigated cropland values remained well above year-ago levels, although the price gains began to slow. Meanwhile, interest rates for both real estate and non-real estate loans declined further in the third quarter, posting new record lows.

Bankers expressed some concerns about the effects of the drought extending into 2013. The spike in feed costs forced some herd liquidations in the District. Bankers indicated that further liquidations may be warranted if grain inventories remain low and inadequate moisture levels persist.

Chart 1
Tenth District Farm Income and Farm Loan Demand

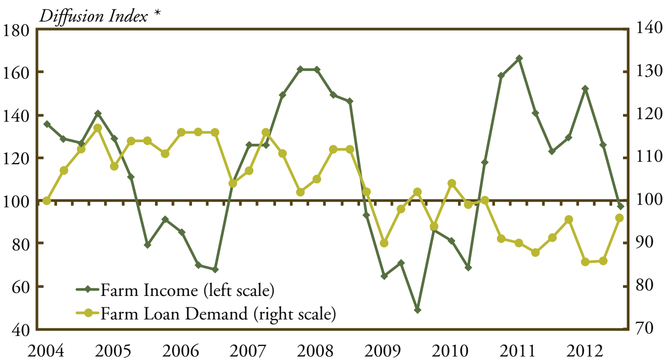


Chart 2
Tenth District Farm Loan Repayment Rates and Renewals and Extensions

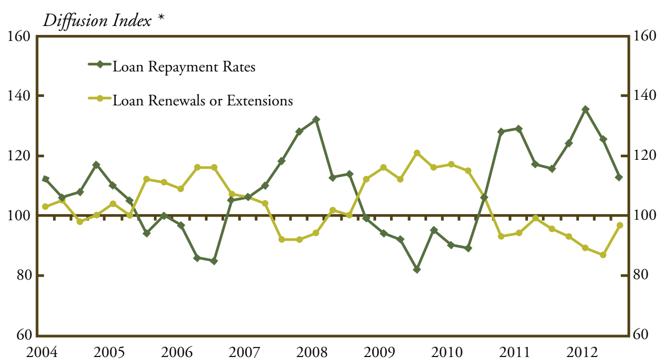
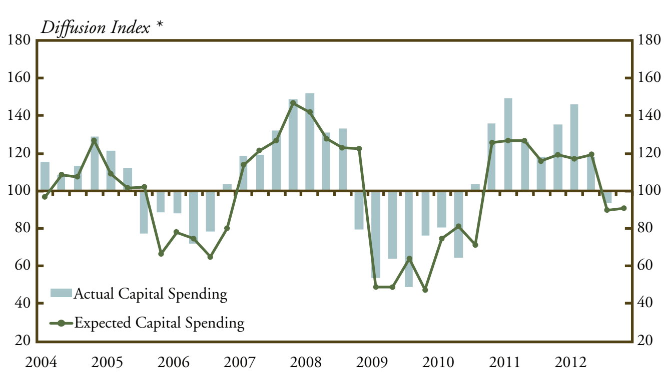


Chart 3
Tenth District Capital Spending



Net farm incomes tumbled in the third quarter as prospects for a bumper harvest wilted. After remaining above year-ago levels for two straight years, farm incomes fell below year-ago levels during the quarter (Chart 1). Rising feed and fuel prices raised production costs, cutting into incomes, although crop insurance payments and higher crop prices should offset some yield losses. Bankers expected further income declines in the fourth quarter as drought conditions were expected to linger throughout the District.

Dwindling farm incomes boosted demand for farm operating loans in the third quarter. District bankers reported the steepest quarterly increase in operating loan demand since the first quarter of 2010. Surging feed and fuel costs in the third quarter forced many corn and soybean farmers and cow/calf operators to seek short-term financing. Bankers had adequate funds for new loans and offered more loan renewals and extensions as loan repayment rates eased (Chart 2). Bankers expected loan demand to soften somewhat in the fourth quarter as crop prices and feed costs moderated in September and harvest neared completion.

In contrast, shrinking incomes curtailed farm spending on capital purchases. As with farm incomes, bankers reported lower capital spending compared with year-ago levels for the first time since early 2010 (Chart 3). Capital spending was expected to remain low in the fourth quarter, with some bankers commenting that farmers were awaiting election results and tax policy decisions before making significant purchases.

** Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than, or the same as in the year-earlier period. The index numbers are computed by subtracting the percentage of bankers who responded "lower" from the percentage who responded "higher" and adding 100.*

Chart 4
Tenth District Farm Income and Loan Demand
(Third Quarter 2012)

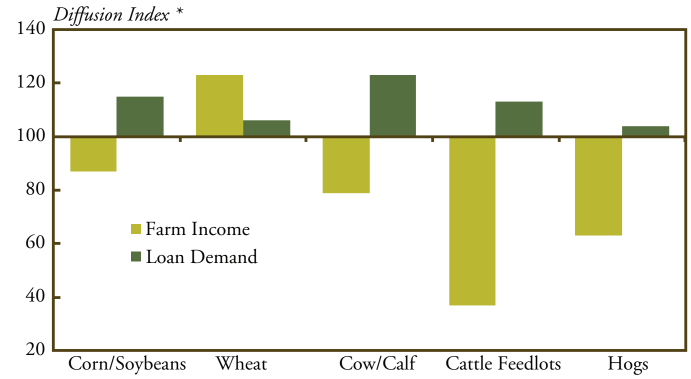
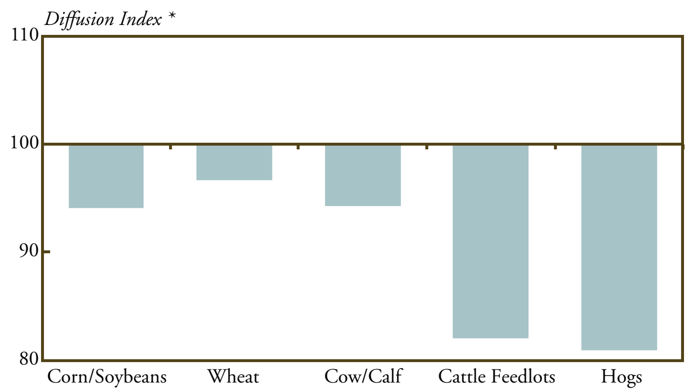
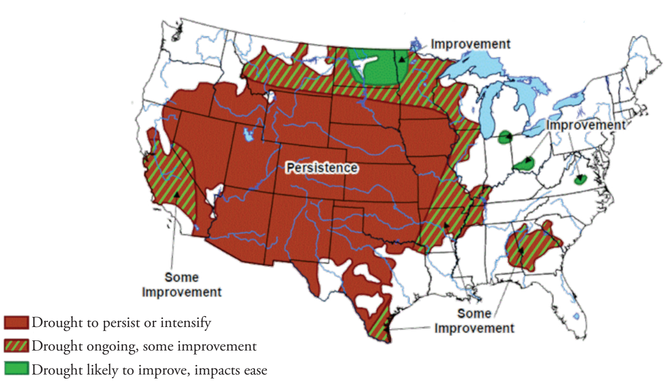


Chart 5: Tenth District Farm Loan Repayment Rates
(Expectations for Fourth Quarter 2012)



Map 1
U.S. Seasonal Drought Outlook



Source: University of Nebraska, released November 1, 2012

Livestock producers bore the biggest drought burden (Chart 4). Livestock incomes fell more sharply than crop incomes as surging feed prices and rapidly deteriorating pastures raised production costs. Farm incomes plummeted for cattle feedlot operators, but ranchers and hog producers also faced significant income declines. Bankers reported lower incomes from corn and soybean production, primarily in nonirrigated areas. Wheat incomes, however, were higher due to a solid harvest that preceded the drought and a subsequent run-up in wheat prices after the onset of the drought.

Rising input costs and lower income led to stronger loan demand for all sectors of the District's agricultural economy. Livestock operators, though, exhibited the sharpest demand for operating loans. Approximately 40 percent of bankers indicated that the drought led to higher operating loan demand for cow/calf operations, and 30 percent of bankers reported higher operating loan demand for cattle feedlots. Bankers also noted increased operating loan demand for crop producers paying for rising harvest costs. Survey respondents expected lower repayment rates over the next quarter as a result of the drought (Chart 5).

Bankers expressed concern that the drought could persist into 2013. Exceptional drought conditions continued to cover a large portion of the District, and current forecasts showed the drought persisting into next year (Map 1). Subsoil moisture levels were extremely low in the District as winter wheat planting began. Some bankers noted that inadequate rain or snowfall over the winter months could cause crop prices to remain high, force additional herd liquidations, and possibly constrain next year's crop growth.

** Bankers responded by indicating whether conditions during the current quarter were higher than, lower than, or the same as in the year-earlier period for farm income and as a result of the drought for loan demand. The index numbers are computed by subtracting the percentage of bankers who responded "lower" from the percentage who responded "higher" and adding 100.*

Chart 6
Tenth District Farm Interest Rates

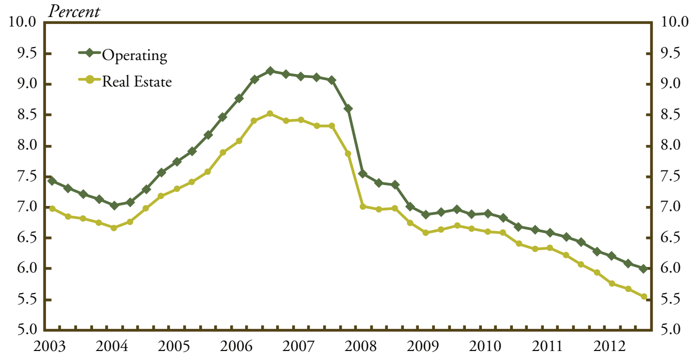
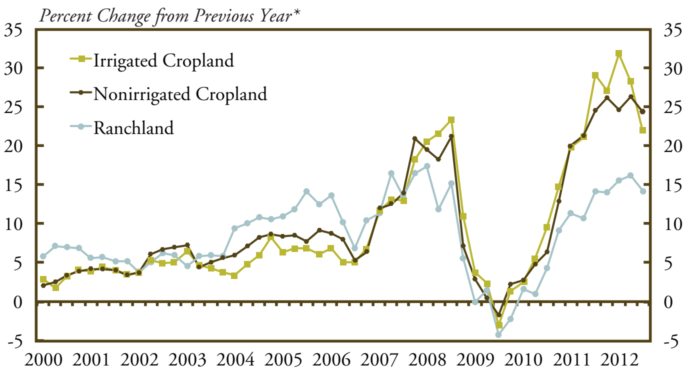


Chart 7
Tenth District Farmland Values-Annual Gains



Percent changes are calculated using responses only from those banks reporting in both the past and the current quarter.

Table 1
Farmland Value Gains by State

*Percent change from the previous year***

	Non-irrigated	Irrigated	Ranchland
Kansas	22.3	25.0	17.4
Missouri	22.8	n/a***	8.3
Nebraska	30.2	23.3	16.8
Oklahoma	12.9	10.8	15.3
Mountain States	18.8	16.5	13.3
District	24.4	21.9	14.3

***** Percent changes are calculated using responses only from those banks reporting in both the past and the current quarter.***
****** Not reported due to small sample size.***

The drought did not appear to have significant impact on farmland markets in the third quarter. Farmland values rose further during harvest, though gains were more modest compared with the surge seen during the past two years. District cropland values moved nearly 3 percent higher in the third quarter and ranchland values edged up around 2 percent. Drought conditions had little effect on the demand for farmland, and bankers expected sales to remain solid even with a seasonal upswing in the number of farms for sale after harvest. Lenders continued to lower average interest rates on both farm real estate and farm operating loans to attract borrowers in an extremely competitive lending environment (Chart 6).

With additional gains during the third quarter, average farmland values once again set new records in many areas of the District. Nonirrigated cropland prices rose nearly 25 percent above year-ago levels in the third quarter, and irrigated land values remained more than 20 percent higher than 2011 levels (Chart 7). In addition, ranchland values appreciated an average of 14 percent during the past year. With farmland value gains slowing, however, about three-quarters of survey respondents felt that farmland values would stabilize at high levels heading into 2013.

Nebraska and Kansas posted the strongest farmland value gains in the third quarter (Table 1). Non-irrigated farmland values in Nebraska surged the most, rising 30 percent above year-ago levels. Kansas experienced the strongest irrigated farmland value gains with prices rising 25 percent annually. Ranchland values were around 15 percent higher in all District states except Missouri. Land value gains continued to accelerate faster than cash rents as annual rental rates increased an average of 12 percent for both cropland and ranchland in the third quarter.

BANKER COMMENTS *from the* TENTH DISTRICT

"Gross income looks good for agriculture but the margins are continually being squeezed by the increasing costs of the inputs." –Eastern Oklahoma

"Farm operations have plenty of liquidity – the drought will have little effect on loan repayment this year." –Northwest Missouri

"A few farmers had exceptional crops if they received rains, but they are very spotty." –Southeast Colorado

"Crop insurance has been vital to the long-term stability of our farmers and their ability to withstand two years of drought in our area." –Western Kansas

"Income will be stable due to crop insurance payments; however, farmers will spend less on capital items such as equipment replacements or upgrades." –Western Missouri

"Producers will borrow a lot more because they will be out of old crop and unable to market throughout the spring and summer." –Northeast Nebraska

"Borrowers are struggling to decide if they should purchase hay for the winter or reduce the cow herd." –South-Central Wyoming

"We have experienced extremely strong land price increases on high-quality cropland and some more marginal cropland." –Northwest Missouri

"Drought is lowering breeding stock numbers by 10 to 15 percent due to culling and lack of feedstocks. The economic impact of the drought will be felt more in 2013 than in 2012." –Western Nebraska

"If drought continues and does not improve by next spring, this area will most likely see a reduction in total crop acres and no growth in livestock numbers." –Central Wyoming

***Note:** 241 banks responded to the third-quarter Survey of Agricultural Credit Conditions in the Tenth Federal Reserve District—an area that includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico and the western third of Missouri. Please refer questions to Jason Henderson, Omaha Branch executive, or Nathan Kauffman, Economist at 1-800-333-1040, or **Jason.Henderson@kc.frb.org** or **Nathan.Kauffman@kc.frb.org** 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.*

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