

2006 Farm Bank Performance

Total U.S. farm debt was estimated at \$225 billion in 2006. The U.S. banking industry continues to be the major provider of credit in the agricultural marketplace holding slightly more than \$106.9 billion in farm debt, as of year-end 2006. Moreover, the U.S. banking industry is a major source of credit to small farmers with almost \$28.7 billion in small farm loans¹ on the books.

With strong farm income and appreciating farm land values, farm banks² posted a solid performance throughout 2006. Agricultural lenders reported favorable asset quality, were profitable, and continue to build capital. There was no farm bank failure in 2006 and only four farm banks have failed since 2000.

This paper examines the performance of the 2,362 farm banks in 2006 and compares their performance over time with the performance of non-farm banks.³

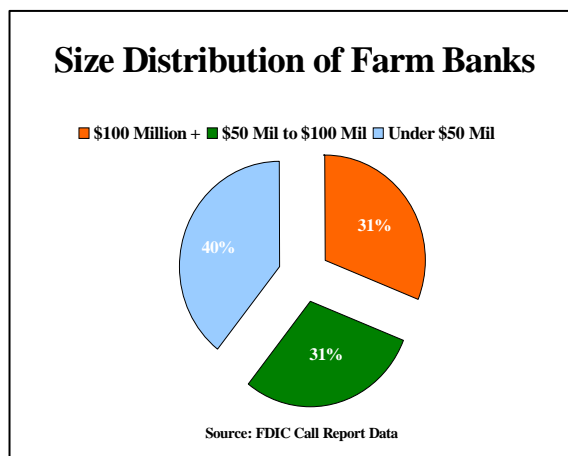
Farm Bank Demographics

For the first time in the history of this report, the average-sized farm bank exceeded \$100 million in assets, holding \$100.5 million in assets. However, half of all farm banks were smaller than \$63.3 million in assets. Thirty-one percent of all farm banks were larger than \$100 million in assets; but 39.5 percent were under \$50 million in assets. As of December 2006, 43 agricultural banks held more than \$500 million in assets.

Nearly 73 percent of all farm banks are located in the Plains (926 banks) and Corn Belt (795 banks).⁴ The Northeast follows with 308 farm banks, the South has 205 farm banks, and the West has 128.

The typical farm bank has three offices – two branches and a main office – and 31 employees. Almost 61 percent of all agricultural banks have two or fewer offices. However, the largest farm bank had 42 offices, including the main office. Also, almost 64 percent of farm banks have transactional websites. And nearly 79 percent of farm banks are state charters.

As of year-end 2006, 762 farm banks had been granted trust powers, but only 581 currently exercised those powers.



¹ A small farm loan is defined as a loan with an original value of \$100,000 or under.

² 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 13.94 percent for 2006. Seventeen banks with more than \$1 billion in assets had a ratio of farm loans to domestic loans greater than or equal to 13.94 percent.

³ 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 13.94 percent.

⁴ USDA regional classification system.

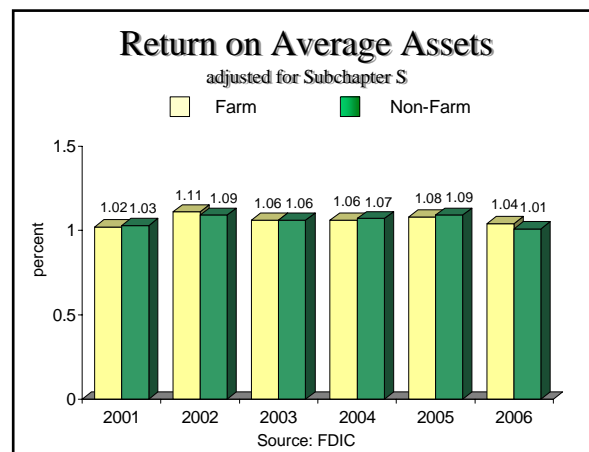
Additionally, approximately 46 percent or 1,098 of all farm banks had Subchapter S filing status with the Internal Revenue Service. Unlike the Farm Credit System, the earnings of Subchapter S farm banks are taxed. The earnings of these institutions are taxed like partnerships – meaning the earnings of the bank are appropriated to the shareholders who pay the taxes.

Performance of Farm Banks

Farm banks posted strong earnings in 2006. Income before taxes and extraordinary items totaled \$3.4 billion, \$104 million more than the amount earned in 2005. Slightly more than 97 percent of all farm banks were profitable in 2006. But only 994 farm banks (or 42 percent) reported an increase in the 2006 profitability compared to a year earlier, as measured by return on average assets (adjusted for Subchapter S tax status), while 1301 farm banks reported a decline in profitability.⁵

The return on average assets (ROA) for farm banks (adjusted for Subchapter S) was 1.04 percent in 2006. But nearly 54 percent of the farm banks had an adjusted ROA below 1 percent in 2006. Non-farm banks had an adjusted ROA of 1.01 percent.

On average, larger farm banks are more profitable than their smaller counterparts. Ag banks with \$500 million or more in assets had an adjusted ROA of 1.25 percent versus 0.94 percent for farm banks with under \$100 million in assets.



Over the last couple of years, farm banks have experienced margin pressure, as the yield curve flattened due to rising short-term rates and sticky long-term interest rates. As a consequence, 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 2006, farm banks had seen a 17 basis point decline in their net interest margins to 3.86 percent.

Balance Sheet Developments

Assets

Farm banks held approximately \$237.3 billion in assets in 2006, up 7.3 percent from 2005. Approximately 92 percent of farm banks' total assets were earning assets in 2006.

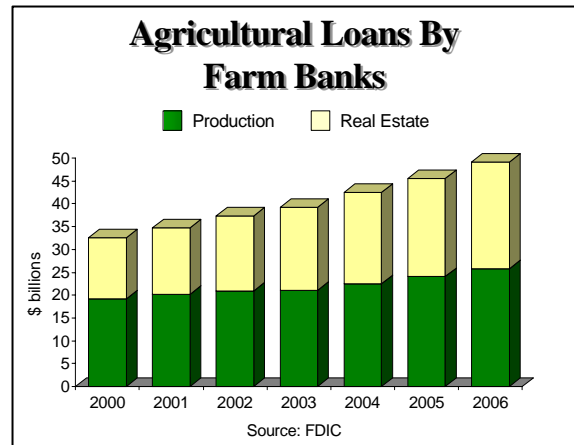
Farm Loans Grew by 8 Percent

Farm banks experienced favorable loan growth in 2006. Total loans and leases jumped by 8.6 percent to \$154.9 billion, faster than the five-year compound annualized growth rate of 7.8 percent. With loan growth surpassing asset growth rates, loans comprised a larger portion of farm bank

⁵ [(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.

assets. In 2006, loans comprised 65¼ percent of farm banks' assets. In comparison, loans made up 62 percent of assets in 2000.

The demand for farm credit rose in 2006. Agricultural loans for farm real estate and production at farm banks increased 8 percent to \$49.1 billion in 2006 from \$45.5 billion in 2005. In fact, almost 1 in every 3 dollars lent by a farm bank is an agricultural loan. Fueled by appreciating land values, outstanding farm real estate loans grew 8.7 percent to \$23.4 billion. Loans to finance agricultural production also advanced, growing at an annual rate of 7.3 percent to \$25.8 billion in 2006.



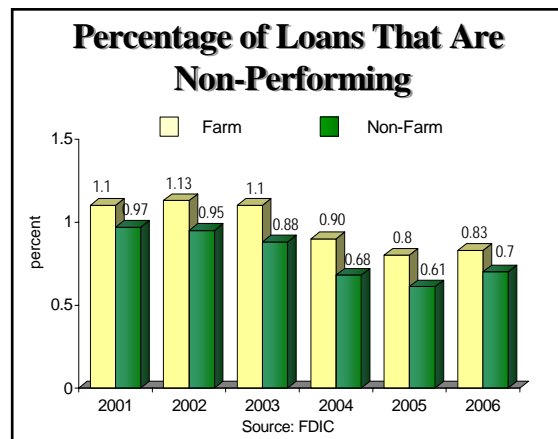
Since the end of 2000, the composition of farm loans has changed. In 2000, approximately 41 percent of farm loans held by farm banks were farmland loans. As of the end of 2006, 47.6 percent of farm loans are to finance farm real estate.

Moreover, farm banks are meeting the credit needs of small farmers. Small farm loans (loans with an original amount equal to or less than \$100,000) totaled \$18.7 billion as of the June of 2006. In fact, about 32 percent or 751 agricultural banks originate farm loans that are \$100,000 or smaller. Farm banks held an additional \$10.7 billion in farm loans with an original value between \$100,000 and \$250,000. So, farm banks generate nearly \$29.4 billion in loans to small farmers (loans with an original value below \$250,000).

Reflecting the fact that farm banks provide a full range of services to their communities, non-farm real estate loans increased 10.1 percent in 2006 to \$68.5 billion, while commercial and industrial (C&I) loans expanded by 10.1 percent to \$23.2 billion. The residential (one-to-four family) real estate loan component grew 5.7 percent to \$31.4 billion from \$29.7 billion in the previous year. Commercial real estate loans post strong growth in 2006 – expanding by nearly 11 percent to \$26.4 billion. Consumer loans, which are about 7 percent of total loans at farm banks, grew 1.3 percent in 2006 to \$11.5 billion.

Asset Quality

While there was an increase in nonperforming assets at farm banks, asset quality remained favorable in 2006. After posting two consecutive yearly declines, total non-performing assets (assets 90 days past due or more and non-accruals) rose 12.2 percent during 2006 to \$1.3 billion – but is still 3.6 percent below 2003 levels. The ratio of non-performing loans to total loans was 0.83 percent, compared with 0.80 percent a year earlier. Loans 90+ days past due – a good leading indicator of future credit problems – were 0.26 percent of total loans, slightly higher than



the 0.23 percent in 2005 and well below 0.40 percent reported in 2001.

Loan loss provisions rose 3.9 percent to \$407.1 million in 2005. 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 0.27 percent of average loans, down from 0.29 percent in 2005 and 0.46 percent in 2002. Total loan loss reserves – \$2.1 billion at year-end 2006 – were almost 159 percent of nonperforming loans in 2005 compared with 170 percent at year-end 2004.

Non-farm banks saw a slight decrease in loan quality. Non-performing loans as a percentage of total loans rose 9 basis points to 0.70 percent. Loans 90+ days past due were 0.15 percent of total loans – basically unchanged from the figure of 0.14 percent a year ago. Reserves for loan losses stood at \$8.9 billion, 171 percent of non-performing loans.

Non-performing Agricultural Real Estate Loans

Non-performing farmland loans at farm banks increased by \$7.3 million to \$138.4 million as of December 2006, but is below the recent 2003 cyclical peak of \$183 million. As a percentage of total farmland loans, non-performing agricultural real estate loans were 0.59 percent in 2006 – down from 1.01 percent in 2003.

Loan Losses

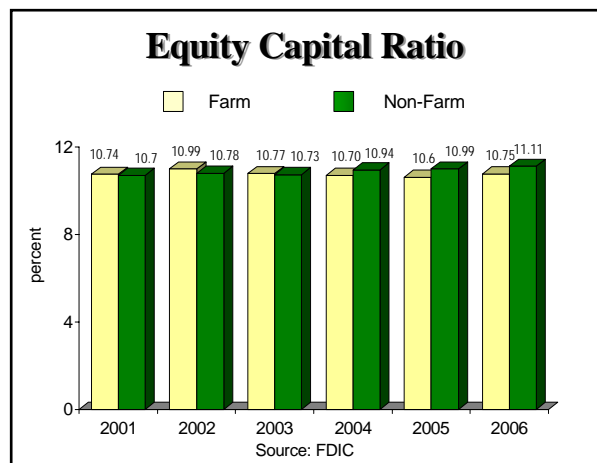
After declining for two consecutive years, net loan charge-offs (charge-offs less recoveries) of farm banks rose in 2006 to \$324 million from \$315.3 million in 2005, but is below the 2004 levels of \$342.2 million. Net charge-offs as a percentage of average loans at farm banks was basically unchanged at 0.22 percent in 2006 compared to 0.23 percent the year before.

Liabilities

Farm bank deposit liabilities increased 7.7 percent in 2006 to \$196.2 billion, while core deposits increased 5.1 percent to \$160.4 billion. Deposits at non-farm banks, on the other hand, increased 11.2 percent in 2006 to \$875 billion.

Farm banks held \$50.1 billion in transaction accounts, as of December 2006 and demand deposits comprised slightly more than half of all transaction accounts at \$26.1 billion – up less than 1 percent from a year ago.

With rising short-term interest rates, non-transaction deposits at farm banks expanded in 2006. Total balances in non-transaction accounts were \$135.6 billion – up 11.1 percent from a year ago. The composition of non-transaction deposits was \$47.2 billion in savings deposits (passbook savings and money market deposit accounts), \$63 billion in small denomination time deposits (under \$100,000), and \$35.8 billion in large denomination time deposits.



Brokered deposits at farm banks have more than doubled, since the end of 2004, to \$5.8 billion.

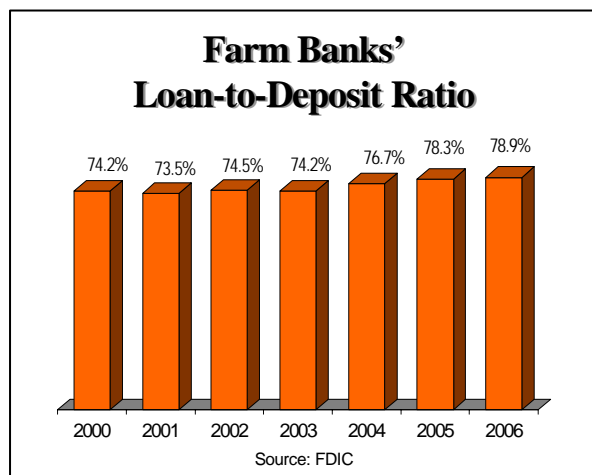
Capital

Equity capital at farm banks increased 8.5 percent to \$24.5 billion in 2006. Farm bank equity capital-to-average asset ratio was 10.75 percent, 15 basis points higher than the 10.60 percent reported in 2005. By comparison, the equity capital-to-average asset ratio was 11.11 percent for non-farm banks.

As of December 2006, only one farm bank did not meet the minimum standard to be categorized as adequately capitalized and 99.5 percent of all farm banks were in the well-capitalized category.

Funding Loan Growth

The loan-to-deposit ratio at farm banks remained high by historical standards. The ratio increased to almost 79 percent in 2006 – up from 73.5 percent in 2001. However, very few farm banks reported an inability to meet the credit needs of their customers due to lack of funds.



Federal Home Loan Bank (FHLB) advances continue to be a source for loanable funds. The Gramm-Leach-Bliley Act of 1999 changed the collateral and membership requirements for joining the FHLB System for community banks (banks with total assets less than \$500 million) by allowing the use of small business, housing, as well as agricultural loans as collateral for FHLB advances. As of the end of 2006, approximately 54 percent of all farm banks had borrowings from the FHLB System. Advances from the FHLBs at farm banks grew from \$6.5 billion in 2001 to \$10.5 billion in 2006. However, farm bank use of the FHLB advances fell by 3.5 percent in 2006 – the first

decline since the data began to be reported. The over-collateralization requirements have limited the development of this resource as an important funding tool for farm banks.

Income Statement Developments

Farm banks reported income before taxes and extraordinary items totaled \$3.4 billion dollars, \$104 million higher than the previous year's figure. After adjusting for Subchapter S status, the return on assets was 1.04 percent – 4 basis points lower than 2005's ROA – and return on average equity (ROE) fell by 31 basis points to 10.09 percent in 2006.

Interest Income and Interest Expense

Net interest income at farm banks grew at an annual rate of almost 5.1 percent to \$8.5 billion in 2006. Farm banks experienced a \$2.3 billion (or 19 percent) improvement in interest income in

2006. However, this increase in interest income was offset by \$1.9 billion (or 48 percent) increase in interest expenses.

Non-Interest Income and Non-Interest Expenses

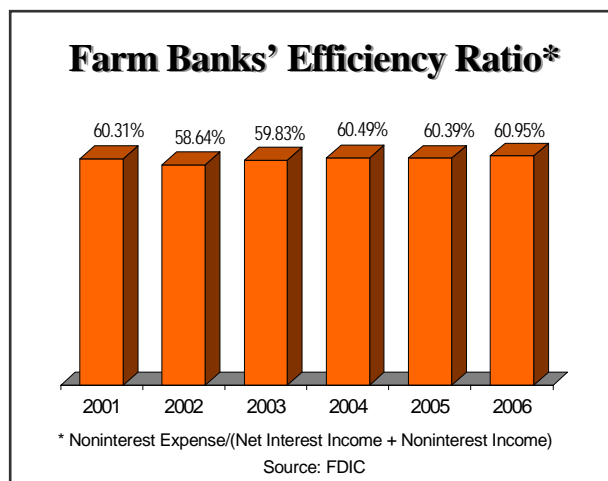
Farm banks saw the rate of growth in non-interest income slow in 2006 – posting a growth rate of 5 ¼ percent compared to 10.5 percent for the previous year. As of year-end, non-interest income stood at \$1.8 billion.

Non-interest expenses increased 6.8 percent in 2006 to \$6.4 billion. Despite the increase in costs, overhead expense as a percentage of average assets in 2006 fell 2 basis points to 2.83 percent – but above the 2001 through 2005 average.

The rise in non-interest expenses can be attributed mainly to the increase in personnel expenses as full time employees at farm banks increased 3.1 percent from 71,200 in 2005 to 73,429 in 2006. Expenditures on salaries and benefits increased 7 percent to \$3.65 billion, accounting for 56.7 percent of all overhead expenses. This is up from 54 percent in 2000.

Total operating income grew at a lower rate in 2006 than operating expenses causing the farm bank efficiency ratio to edge higher to 61 percent. This means that it costs a farm bank about 61 cents to generate one dollar in revenues.

However, the efficiency ratio has been inching higher over the last couple of years after reaching 58.6 percent in 2002. The efficiency ratio for non-farm banks was almost 64.5 percent as of the end of 2005.



Looking Forward

In general, the farm sector is in good health heading into 2007. Farmers are optimistic that higher grain and corn prices will yield better farm income in 2007. According to the USDA, “net farm income in 2007 is forecast to be 16.2 percent above its 10-year average.” Net farm income is projected to be \$66.6 billion in 2007, up by \$6 billion from its 2006 level and \$9 billion above its 10-year average of \$57.4 billion. Gross farm income is expected to be 22.7 percent above its 10-year average, but production cost will be up 24.6 percent over its prior 10-year average.

Farm business balance sheets have shown an improvement over the last couple of years. Increases in farm debt were more than offset by gains in farm assets.

An improved outlook with regard to future farm profitability is expected to cause total farm debt to rise 4.0 percent in 2007 to \$235 billion by the end of the year. Debt secured by farm real estate is expected to increase 3.8 percent, while non-real estate debt is expected to rise about 4.3 percent.

According to the Federal Reserve Bank of Chicago *AgLetter*, bankers expect farm capital expenditures to increase in 2007. “About 70 percent of the bankers anticipated increased purchases of machinery and equipment in 2007. Around 40 percent expected higher spending on land purchases, improvements, buildings, and facilities in 2007 than in 2006.”⁶ Increased capital expenditures should lead to stronger loan demand. Also, loan renewals and extensions are expected to rise.

Finally, farm banks, like most banks, will continue to experience margin pressure squeeze in 2007. Interest rates are not likely to change and the yield curve will remain flat to slightly inverted during 2007.

⁶ *Ag Letter*, Federal Reserve Bank of Chicago, February 2007.