

ABA's Annual Farm Bank Performance Review 2010

Key Findings

- Traditional banking practices – a focus on the fundamentals of credit, solid underwriting standards, and knowledge of the customer's business – contributed to the success of Farm Banks in 2010.
- The US banking industry is the nation's most important supplier of credit to agriculture providing more than 50 percent (\$127 billion) of all farm loans.
- Farm Banks increased employment by over 1 percent in 2010 and employ 76,337 rural Americans.
- Small loans made up a majority of bank farm and ranch lending with nearly \$69 billion in small and micro-small farm and ranch loans on the books at the end of 2010.
- Farm Banks increased farm loans by 4.9 percent in 2010, despite a very challenging economic climate. Farm Banks held \$60.0 billion in farm loans at the end of 2010.
- Earnings and asset quality at farm banks improved in 2010.
- Farm banks are well-capitalized – 97.8 percent were categorized as well-capitalized, the highest capital rating given by bank regulators.
- There were 2,236 Farm Banks in the country at the end of 2010. This compares to 2,295 at the end of 2009. The majority of Farm Banks are located in the heartland of America, on Main Street.

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.

ABA's Annual Farm Bank Performance Review 2010

The U.S. banking industry is the major provider of credit to agriculture with slightly more than \$127.4 billion in farm loans extended (over 50 percent of the total farm credit outstanding in the United States), as of year-end 2010.

Moreover, the U.S. banking industry is a major source of credit to small farmers. The banking industry reported holding approximately \$68.7 billion in small farm loans with \$22.7 billion in micro-small farm loans on the books.¹ The number of outstanding small farm loans totaled almost 1.2 million with the vast majority – almost 900,000 loans – under \$100,000.

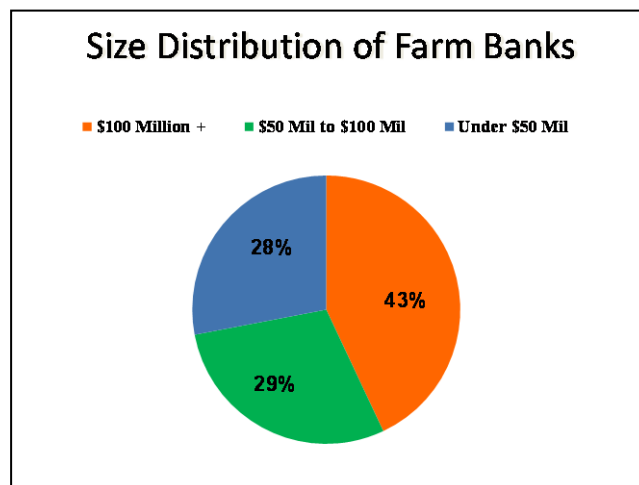
The agricultural sector continues to outperform the broader national economy and, as a result, farm banks² posted a solid performance for 2010 and fared better than the overall banking industry. Farm income was up in 2010 on the strength of high commodity prices and good harvest. This has translated into a solid performance on the part of our nation's farm banks. Farm banks reported a strong increase in earnings and improved asset quality in 2010. In addition, farm banks, as a group, remained well-capitalized through 2010.

This paper examines the 2010 performance of the 2,236 banks that specialize in lending to agriculture –down from 2,295 banks that met the definition in 2009 – and compares their performance over time with the performance of non-farm banks.³

Farm Bank Demographics

The average-sized farm bank exceeded \$100 million in assets, holding \$130.5 million at the end of 2010. However, half of all farm banks were smaller than \$84.0 million in assets. Forty-three percent of all farm banks were larger than \$100 million in assets; but 29 percent were under \$50 million in assets. As of December 2010, 77 agricultural banks held more than \$500 million in assets.

About 72 percent of all farm banks are located in the Plains (834 banks) and Corn Belt (765 banks).⁴ The Northeast follows



¹ 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.

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 13.95 percent for 2010. Twenty-seven banks with more than \$1 billion in assets had a ratio of farm loans to domestic loans greater than or equal to 13.95 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 13.95 percent.

⁴ USDA regional classification system.

with 296 farm banks, the South has 227 farm banks, and the West has 114.

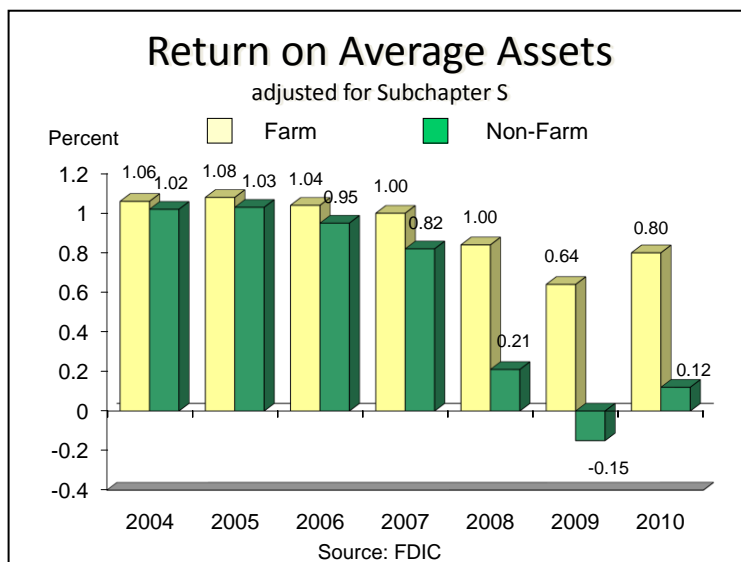
The average farm bank has three offices – two branches and a main office – and 34 employees. Over 57 percent of all farm banks have two or fewer offices. However, the largest farm bank had 44 offices, including the main office. Also, over 83 percent of farm banks have transactional websites, which allows the bank customers to execute transactions on their accounts through the website. Roughly four-fifths of farm banks have state charters.

As of year-end 2010, 732 farm banks had been granted trust powers with 553 currently exercising those powers. Farm banks reported \$13.8 billion in managed assets and \$5.9 billion in non-managed assets.

Additionally, approximately 53 percent or 1,178 of all farm banks had Subchapter S filing status with the Internal Revenue Service. The earnings of Subchapter S farm banks are taxed like partnerships – meaning the earnings of the bank are the responsibility of the farm banks' shareholders who pay the taxes. The Farm Credit System, on the other hand, is a government sponsored, tax-advantaged, retail lender. 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 Earnings Recover to 2008 Levels

Farm bank earnings recovered significantly from the year earlier; however, they remain below the historical norm that occurred prior to the recession. Income before taxes and extraordinary items totaled \$3.1 billion, 33.6 percent higher than in 2009. This recovery of income brings earnings back to a level similar to that of 2008. Over 92 percent of all farm banks were profitable in 2010 and approximately 58 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).⁵



The aggregate return on average assets (ROA) for farm banks (adjusted for Subchapter S) rose to 0.80 percent in 2010 from 0.64 percent in 2009. In comparison, non-farm banks, as a whole,

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.

were less profitable, with an adjusted ROA of 0.12 percent. For the five years prior to 2008, ROA for farm banks was between 1.01 percent and 1.08 percent.

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 average adjusted ROA of 0.82 percent versus 0.65 percent for farm banks with under \$100 million in assets.

Operating profits per employee were \$39,900 in 2010, up from \$30,500 in 2009.

The net interest margin for farm banks was almost unchanged for 2010 declining by 1 basis point to 4.07 percent.

Balance Sheet Developments

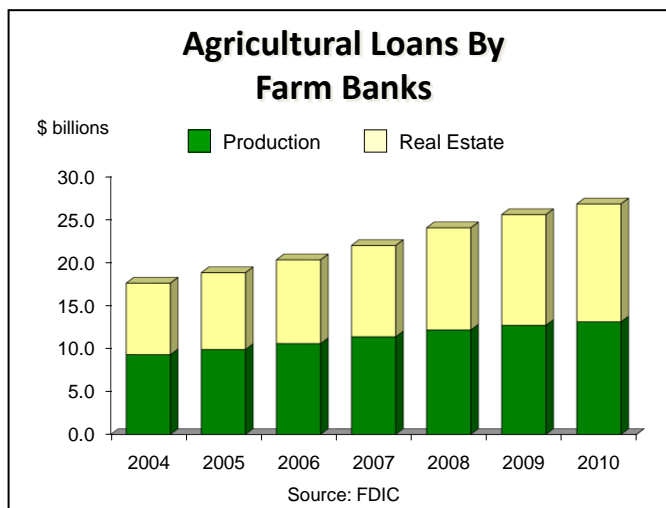
Assets up 4.5 Percent

Farm banks held approximately \$291.8 billion in assets in 2010, up 4.5 percent from 2009. Approximately 92 percent of farm banks' total assets were earning assets in 2010.

Farm Banks Increase Farm Loans by 4.9 Percent

Farm banks experienced modest loan growth in 2010. Total loans and leases rose by 1.1 percent to \$181.1 billion. Loan growth did not keep up with total asset growth, therefore loans as a percent of total assets fell from 64.2 percent in 2009 to 62.1 percent in 2010. Though this ratio has been declining for the past couple of years, it is still near the longer term trend. In comparison, loans made up 61.5 percent of assets in 2001.

Farm real estate and production loans at farm banks increased 4.9 percent to \$60.0 billion in 2010 from \$57.2 billion in 2009. Growth in agricultural lending therefore was faster than loan growth as a whole. In total, a little over 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 6.5 percent, or \$1.9 billion, to \$30.7 billion. Outstanding production loans grew by a lesser 3.2 percent, or \$0.9 billion, to a total of \$29.3 billion. The difference in growth rates was likely driven by the fact that farm incomes continue to be very high; therefore farmers are continuing a multiyear trend of using a greater amount of cash to pay for inputs such as fertilizer and fuel.



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 2010, slightly over 51 percent of farm loans were to finance farm real estate.

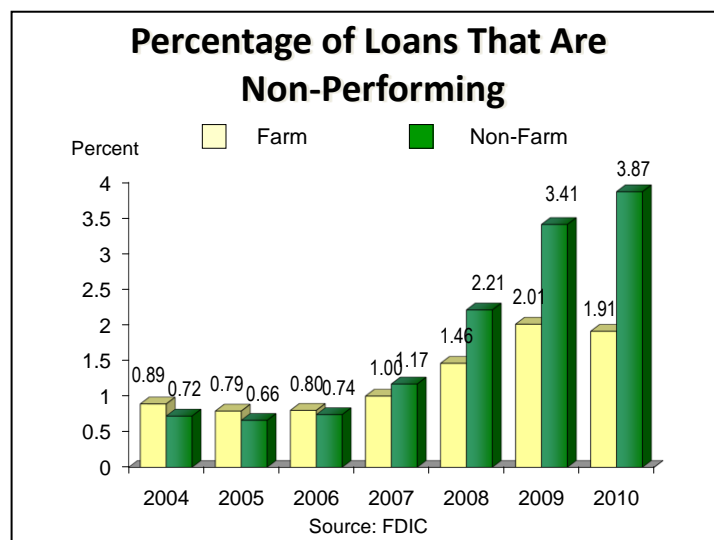
Moreover, farm banks are meeting the credit needs of small farmers. Small farm loans (loans with an original amount equal to or less than \$500,000) from farm banks totaled \$41.5 billion as of the end of 2010. Farm banks reported holding \$14.6 billion in farm loans with an original value of \$100,000 or smaller. Additionally, farm banks held an additional \$13.3 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 1.5 percent to \$72.2 billion. The residential (one-to-four family) real estate loan component grew 0.9 percent to \$38.4 billion, while commercial real estate loans expanded by 2.1 percent to \$33.9 billion. However, as construction activity continued to fall off in 2010, construction and land development loans fell 15.8 percent to \$7.7 billion. Similarly, commercial and industrial (C&I) loans reflecting sluggish business activity over 2010, fell by 1.2 percent to \$24.3 billion. Consumer loans, which are about 6.3 percent of total loans at farm banks, fell 6.5 percent 2010 to \$10.6 billion. Farm banks did report an increase in unused commitments, which rose 2.7 percent in 2010 to \$28.2 billion.

Asset Quality Improves

After deteriorating for three consecutive years, farm bank loan quality improved in 2010. Total non-performing assets (assets 90 days past due or more and non-accruals) fell 3.4 percent during 2010 to \$3.5 billion. The ratio of non-performing loans to total loans was 1.91 percent, compared with 2.01 percent a year earlier.

However, other real estate owned (OREO) increased dramatically, rising by 31.8 percent to \$1.6 billion in 2010. This increase in OREO reflects continued weakness in the real estate markets. On a positive note, the rate of increase in OREO slowed from 2009's growth rate of over 80 percent. In 2010, OREO represented 0.55 percent of farm bank assets.



Loan loss provisions fell 23 percent to \$1.3 billion in 2010. A decrease in the provision for loan losses indicates management's expectation that future loan losses will decline. However, this

decline followed an increase in loan loss provisions of over 80 percent in 2009. Therefore, though asset quality is indeed turning the corner, the rate of provisioning remains high by historical standards. Loan loss provisions at farm banks were approximately 0.75 percent of average loans, down from 0.99 percent in 2009. Total loan loss reserves – \$2.88 billion at year-end 2010 – were up 5.5 percent from 2009. 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 including OREO, fell to 48.8 percent in 2010 compared with 51.2 percent at year-end 2009.

Unlike farm banks, non-farm banks continued to see modest asset quality deterioration in 2010. Non-performing loans as a percentage of total loans rose 46 basis points to 3.87 percent. However, loans 90+ days past due fell to 0.20 percent of total loans compared to 0.25 percent a year ago. Loan loss reserves as a percent of non-performing loans and OREO, fell to 30 percent from 34 percent.

Non-performing Agricultural Real Estate Moves Higher

Non-performing farmland loans at farm banks rose by 25.6 percent to \$408 million as of December 2010, greatly exceeding the prior cyclical peak of \$172 million in 2003. Though the amount of nonperforming loans continued to grow, this rate was slower than the over 80 percent jump a year earlier. As a percentage of total farmland loans, non-performing agricultural real estate loans were 1.33 percent in 2010 – up from about 1 percent in 2003.

Loan Losses Decline for First Time in Five Years

Net loan charge-offs (charge-offs less recoveries) of farm banks declined by 12.0 percent in 2010 to \$11.4 billion. This ended three consecutive years of large increases, including a large jump in 2009 of almost 80 percent. The reversal is encouraging; however, charge offs still remained at high levels throughout 2010. As a percent of average loans, the net charge-off rate fell 12 basis points to 0.49 percent in 2010.

Deposits at Farm Banks Rose by Almost 6 Percent

Farm bank deposit liabilities increased 5.8 percent in 2010 to \$245.3 billion, while core deposits increased 6.0 percent to \$199.0 billion. The modestly higher relative growth of core deposits reverses a recent trend of core deposits becoming a smaller portion of the total deposit mix. Still, they account for a relatively low ratio of total deposits by historical standards. Core deposits accounted for 85.6 percent of total domestic deposits in 2001 but only 81.3 percent in 2010. In comparison, deposits at non-farm banks increased 3.5 percent in 2010 to \$838 billion.

Farm banks held \$64.0 billion in transaction accounts as of December 2010, up 6.0 percent from 2009. Demand deposits comprised slightly more than half of all transaction accounts at \$32.4 billion – up 8.5 percent from a year ago.

Non-transaction deposits at farm banks expanded in 2010. Total balances in non-transaction accounts were \$181.2 billion – up 4.7 percent from a year ago. The composition of non-transaction deposits was \$70.5 billion in savings deposits (passbook savings and money market

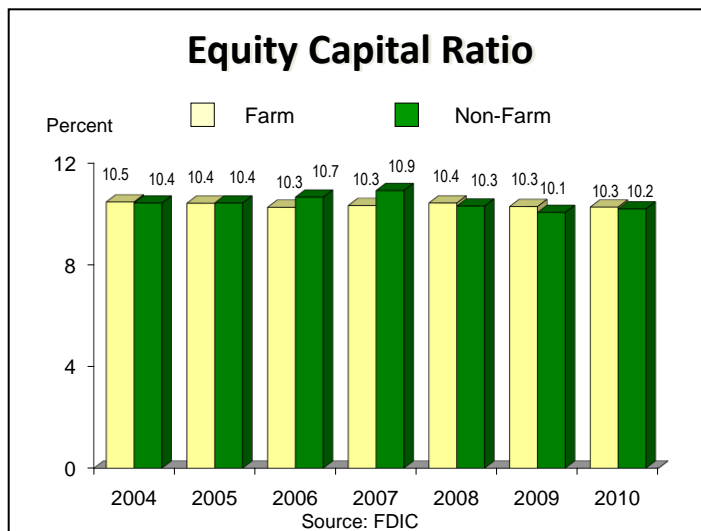
deposit accounts), \$64.8 billion in small denomination time deposits (under \$100,000), and \$46.0 billion in large denomination time deposits.

Brokered deposits fell by 8.3 percent in 2010 after growing by about 25 percent over the prior two years. The decline in 2010 reversed the growth trend of most of the past decade. Still brokered deposits at farm banks totaled \$6.1 billion – an amount almost double that of 2005. Out of total brokered deposits, a little over 25 percent of the total were reciprocal deposits in 2010.

Farm Banks Remain Well Capitalized

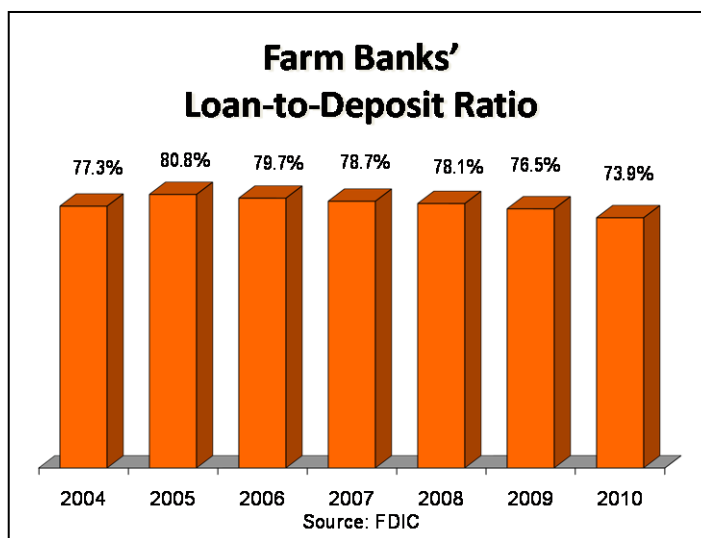
Equity capital at farm banks increased 4.3 percent to \$30.0 billion in 2010 and core capital increased by over \$1.6 billion to \$28.3 billion. The farm bank equity capital-to-average asset ratio was 10.27 percent, essentially unchanged from the 10.29 percent reported in 2009. In comparison, the equity capital-to-average asset ratio was 10.20 percent for non-farm banks, up slightly from 10.08 percent in 2009.

As of December 2010, ten farm banks, or 0.5 percent of institutions, failed to meet the minimum standard to be categorized as adequately capitalized. This is a decline from 12 institutions in 2009. The vast majority of farm banks, 97.8 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 has fallen for two consecutive years to 76.5 percent and 73.9 percent in 2009 and 2010, respectively. The ratio is now back to near where it was during the 2001 recession - it was 73.1 percent that year. With a significant expansion of the money supply over the last few 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 2010. As of the end of the year, approximately 53 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. In 2010, the decline continued - advances fell 16.8 percent to \$10.1 billion. Much of this decline is likely due to the favorable price of deposits as short term interest rates are at historical lows.

Income Statement Developments

Income at farm banks recovered in 2010. Farm banks reported income before taxes and extraordinary items of \$3.1 billion, 33.6 percent higher than in 2009. After adjusting for Subchapter S status, the return on assets was 0.80 percent – 16 basis points higher than 2009's ROA – and return on average equity (ROE) rose by 142 basis points to 7.59 percent in 2010.

Interest Income Lower but Interest Expense Falls by Greater Amount

Net interest income rose for the third year in a row at farm banks, as net interest income grew at an annual rate of 4.7 percent, or \$462 million, to almost \$10.3 billion in 2010. The low interest rate environment caused total interest income to fall by \$472 million (or 3.3 percent) compared to 2009; however interest expense fell by \$934 million (or 21.3 percent) in 2010.

Non-Interest Income Grows Faster than Non-Interest Expenses

Farm banks saw modest non-interest income growth in 2010, rising 5.9 percent to almost \$2.2 billion. Non-interest income as a percent of net operating income was 17.3 percent, up slightly from 17.2 percent in 2009.

Non-interest expenses increased 3.1 percent in 2010 to \$8.1 billion. Overhead expenses as a percentage of average assets in 2010 fell to 2.84 percent from 2.90 percent in 2009.

The efficiency ratio for farm banks posted an improvement, falling by 119 basis points to 62.90 percent in 2010. This means that it costs a farm bank about 63 cents to generate one dollar in revenues. The efficiency ratio for non-farm banks was 73.56 percent as of the end of 2010.

Employment Levels Increase

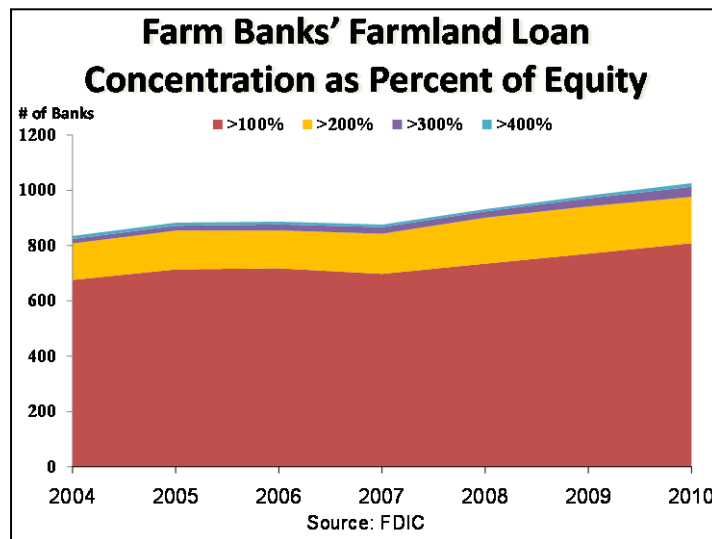
Full time employees at farm banks increased 1.2 percent resulting in the total employment of 76,337 rural Americans. Expenditures on salaries and benefits increased 4.0 percent to \$4.3 billion, accounting for 55.4 percent of all overhead expenses. This is up from 53.2 percent in 2009. The average employee's compensation (salary and benefits) at a farm bank was \$57,022 in 2010 – up 2.9 percent from 2009.

Farm Banks are Well Positioned for the Future

The outlook for the farm sector is very favorable for 2011. USDA is projecting a farm net cash income for 2011 of \$98.6 billion, up \$7.3 billion (8 percent) from 2010, and \$26.8 billion above its 10-year average (2000-2009) of \$71.8 billion. This anticipated increase in net cash income is fueled by a surge in commodity prices. USDA is estimating that crop receipts will rise by over 14 percent in 2011. On the other hand, total production expenses are set to jump \$20.2 billion (7.0 percent) in 2011 to a nominal record \$307.5 billion – the first time that expenses will have exceeded \$300 billion.

Additionally, farm business balance sheets continue to improve due to record farm income and the appreciation in farmland values. Farm debt to asset ratio is projected to fall 60 basis points to 10.7 percent in 2011.

USDA expects farm sector debt to increase slightly in 2011 to \$241.6 billion from \$240.3 billion in 2010. Farm real estate debt is forecasted to fall by 0.6 percent, while non-real estate debt is expected to rise by 2.0 percent in 2011.



One area of concern for bank regulators has been the recent rapid appreciation in farmland values in some areas of the country. In a speech on March 10th, FDIC Chairman Sheila Bair stated that while FDIC does not “see a credit problem in agriculture at this time, the steep rise in farmland prices we have seen in recent years creates the potential for an agricultural credit problem sometime down the road.”

As noted earlier in this report, the share of farmland loans at farm banks has risen as a percent of total farm loans. Despite this increase in farmland debt as a portion of total farm loans, at the end of 2010 very few farm banks are overly concentrated in farm real estate loans, as measured as a percent of the bank’s equity.

Farm banks are actively managing risk associated with agricultural lending. Underwriting standards on farm real estate loans are very conservative and these standards have not changed for a decade. The key consideration of farm bankers is the ability of their farm customers to repay their debts regardless of the collateral position of their customers. To help manage risk, farm banks regularly stress test their customers’ portfolios to see whether the loans will cash flow under different scenarios.

Moreover, there is not any evidence that the increases in farmland prices are being fueled by credit, as data from various Federal Reserve Banks show that the demand for credit to finance new land acquisitions has been relatively flat.