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Before the

GENERAL FARM SUBCOMMITTEE

of the

COMMITTEE ON AGRICULTURE

of the

U.S. HOUSE OF REPRESENTATIVES

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The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

.Introduction

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to submit a written statement that describes how the Office of the Comptroller of the Currency (OCC) views the impact of current and projected agricultural credit conditions on national banks. I am responding to the Subcommittee's expressed desire to learn more about the OCC's recently released handbook on agricultural lending and how our examiners use that guidance in their supervisory and regulatory activities in the field.

Today, the U.S. agricultural sector faces its most significant challenges since the mid-1980s. A combination of lower commodity prices and severe weather has created economic difficulties for many farmers in certain regions of the country. The United States Department of Agriculture (USDA) has recently forecasted financial stresses for this

sector of the economy at least into the year 2001. [Note: USDA Baseline projections, February 1998.]

Farmers rely primarily on banks for agricultural credit and, as of September 30, 1998, national banks held \$31.9 billion in agricultural credits -- 18.8 percent of the approximately \$170 billion of farm debt last year. While the national bank system is financially safe and sound and well positioned to weather the financial stress of the agriculture sector in the coming years, certain banks that specialize in agriculture lending may need to carefully monitor and reassess the risks of their loan portfolios.

My primary message to the Subcommittee is that the OCC believes that a balanced examination approach is the best approach to handling stresses in the agricultural economy. Banks should continue to serve their communities and devise ways to help farmers through temporary financial difficulties. However, bankers must also adhere to sound lending practices. Banks' balance sheets must reflect accurately the risks embedded in their loans. Their reserves for loan losses and capital levels must also be sufficient. If banks are to be a reliable source of agricultural loans in both good and bad times, they must remain financially strong. One enduring lesson from the thrift crisis of the late 1980s is that forbearance on the part of the regulators -- particularly at times when the asset values are likely to be less than book value -- only leads to more serious problems for banks and the communities they serve down the road.

Given the current agricultural credit conditions, we felt it appropriate to issue a handbook on agricultural lending. The purpose of the handbook is to help examiners and bankers understand the fundamentals of sound agricultural lending, to consolidate existing OCC guidance, and to see that examiners do not automatically criticize loans solely because farmers may need more time to service them. It reflects our enhanced understanding of agricultural credit issues over the past 15 years. I am submitting a copy of that handbook for the record with my testimony.

National Banks and Agricultural Lending

Before I discuss specifics on national banks and agricultural lending, I would like to provide a brief overview of present and projected economic conditions in the agricultural sector. The USDA forecasts that farm profits in 1999 will decrease 8 percent to \$44 billion from \$48 billion last year. [Note: Economic Research Service, U.S. Department of Agriculture, December 21, 1998.] The Asian financial crisis in 1998 hit Midwest farmers the hardest as it contributed to a drop in the prices for wheat and corn and secondarily contributed to the collapse of hog prices. This year prices on Southern crops, such as cotton and soybeans, are also projected to significantly decline. The Midwest region, not yet recovered from last year's price declines, is projected to experience a decrease in dairy prices. [According to the USDA: hog prices decreased 70 percent from 1997 to 1998; export prices on wheat and corn fell 13 and 14 percent respectively; 1999 soybean export prices are projected to decrease 17 percent from 1998 levels; large overseas harvests of cotton have resulted in a six-month supply, the biggest reserve in 13 years; and due to record high milk prices and relatively high producer returns in 1998, milk production in 1999 is projected to overtake milk demand, resulting in a sharp drop in milk prices.] Recent sources of financial stress such as the Asian financial crisis and the recent devaluation of the Brazilian real have contributed to a decline in American farm exports, an increase in the supply of farm commodities and a stronger dollar. [Note: According to the USDA, exports were \$59.8 billion in 1996 and had declined 10 percent by fiscal year 1998 to \$53.6 billion. The latest export projections for 1999 are \$50.5 billion B a 16 percent decrease from the 1996 figure.] The end result is lower commodity prices, which, coupled with severe weather in certain regions in the country, have placed significant financial strain on parts of the agricultural sector of the economy. Farmers who have assumed a significant level of debt will be under substantial pressure, if farm prices remain low. Thus, we anticipate that some farmers will be unable to service their loans if they continue to be negatively impacted by economic conditions in the agricultural sector.

Agricultural lending is broadly distributed across the national banking system, and the

lack of concentration of agricultural loans reduces the overall risk to the national banking system. Over 70 percent of the agriculture lending of national banks occurs in lenders that do not specialize in agricultural credit. Since these lenders do not specialize in agricultural lending, their overall exposure to agricultural credit problems is limited.

As of September 30, 1998, 27.9 percent (\$8.9 billion) of the national banking system's agricultural credit was held by 528 national banks -- one-fifth of all national banks -- that regulators classify as agriculture lenders. [Note: These are defined by the Federal Deposit Insurance Corporation (FDIC) as banks where agricultural production and farm real estate loans combine to amount to 25 percent of total loans and leases.] We are concerned about the impact of the current financial stresses on the balance sheets of these agricultural national banks and the ability of these banks to extend additional credit, if the stresses continue. For example, agricultural banks, which rely primarily on deposits for funding, are more susceptible to regional economic downturns and liquidity problems than national banks overall. On September 30, 1998, the average deposits to total liabilities ratio for agricultural national banks was 94.6 percent compared to 73.2 percent for all national banks.

Nearly three-fourths of agricultural national banks are in the OCC's Midwestern and Southwestern Districts, [Note: These Districts cover Arkansas, Iowa, Kansas, Louisiana, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, and Texas.] precisely where many farmers are experiencing difficulties. Thus, the potential for credit quality problems with the agricultural loans is regionally concentrated in the national banking system. As of September 30, 1998, 40 national banks had exposures to agricultural lending that exceeds five times their equity capital. Three-quarters of them are in Nebraska, Texas, and Iowa. In addition, 33 national banks hold non-performing agricultural loans in excess of 10 percent of their equity capital. Twenty of these banks are in just two states: Nebraska and Texas.

It is important to keep in mind, however, that the vast majority of the 528 agricultural national banks are small community banks that are typically strong and profitable. In fact,

they average \$66.4 million in assets, less than one-twentieth the size of the average non-agricultural national bank (\$1.5 billion), have an average equity capital to asset ratio of 10.7 percent as of the third quarter of 1998, and experience an average return on assets of 1.1 percent. Thus, despite our focus on the credit quality of agricultural loans, the agency has not to date found weaknesses in bank loan portfolios of the magnitude we saw in the mid-1980s.

OCC's Agricultural Lending Handbook

The OCC has significant supervisory experience dealing with agriculture credit quality issues. We have learned over the years that a balanced examination approach that gives banks the flexibility to work with farmers experiencing temporary financial difficulties is the best approach. During 1984, when national banks last faced substantial agricultural problems, we issued guidance to our examiners instructing them not to classify agricultural credits solely because the borrower's cash flow was negative. [Note: OCC Examining Circular 222, May 21, 1984.] That policy proved useful and effective. We have recently clarified and reissued this guidance as part of our handbook, entitled *Agricultural Lending*. This handbook serves as a single reference source for our examiners and for bankers and draws upon the lessons we have learned through the examination process about making sound agricultural loans and managing agricultural lending risks.

The handbook addresses three important subjects. First, it provides background information on the characteristics of agricultural loans that distinguish them from other kinds of commercial loans. It offers specialized information to augment the more general advice and guidance that we give our examiners about loan portfolio management and credit underwriting. Second, it discusses how we evaluate individual agricultural loans. And third, it describes how we evaluate a bank's agricultural loan portfolio and its administration of that portion of its lending business. Let me discuss each of these areas in more detail.

The handbook highlights the special risks inherent in farm lending, including underwriting, credit administration, and risk management issues. For example, production loans are usually

repaid through the sale of the underlying collateral. On occasion, prices farmers receive for their crops or livestock do not generate sufficient cash to repay the entire loan, necessitating a refinancing of the unpaid portion into next year's loan (referred to as carryover debt). In the handbook, we discuss ways in which bankers can work with their farm borrowers in these situations and we make clear that this carryover debt should not be automatically classified. Also, the handbook points out that agricultural lenders are exposed to significant risks that are not in the control of an individual borrower, such as shifting commodity prices and severe weather conditions. We note that banks can reduce their exposure to those risks with hedging strategies or by requiring the purchase of crop insurance.

The methods by which the OCC evaluates credits receives heightened attention when the economy softens. The Agricultural Lending handbook describes in some detail what we expect our examiners to take into account in making those judgments. The handbook advises them to weigh carefully the full range of relevant factors, including the borrower's financial strength, payment history, future prospects over the life of the loan, and the value and quality of the collateral. The handbook explicitly states that, just because a farmer carries over an unpaid loan from a prior crop year, the examiner should not automatically lower the credit quality rating on the loan through the loan classification process. [Note: Classification of a loan is explained in detail in The Comptroller's Handbook for National Bank Examiners, Section 215.1, March 1990.] Further, the handbook makes it clear that the potential for loan classification does not mean that the banker should terminate the credit. Additionally, our examiners understand that a borrower with a problem or classified loan at one point in time may become a solid customer in the future. Efforts by the bank to restructure loans by extending repayment terms or advancing additional credit, when prudently done, can improve the prospects for repayment. Our examiners consider all of these factors when they judge the quality of agricultural credits.

With regard to assessing the nature of the bank's agricultural loan portfolio and the quality of its management of that business, our primary objective is to make certain the

bank remains strong and healthy so it can continue to be a source of financial support for the community it serves. A bank must maintain sound underwriting practices and solid internal risk management controls. If it makes exceptions to its lending policies, the bank must know the number and type of exceptions it is making and how these exceptions could affect its expected future earnings or exposure to losses in the event of default by the borrowers. The bank must also conduct a periodic independent loan review to identify and evaluate risks. And they must make provisions for possible losses in light of changing economic conditions. These are all essential risk management practices, and remain fully consistent with a flexible loan workout program when borrowers get into trouble. Banks need to work with an otherwise sound borrower experiencing temporary financial difficulties, but the bank must also accurately reflect in its loan portfolio the impact of such a decision.

OCC Examination Approach

We are actively taking steps to make certain that we apply our supervisory policies in a consistent manner. We conduct national and district reviews of our examination approach to avoid overreaction by our examiners to agricultural credit conditions. Additionally we work with other banking regulators to ensure that we all treat similar loans in a similar manner.

Late last year, in an attempt to assure consistency among our examiners and to provide a platform for training some less experienced examiners, we performed a cross-sectional examination of ten agriculture banks. This process, which was led by an experienced agricultural credit examiner, focused on national banks active in agriculture lending. Examiners experienced in assessing agriculture loans were paired with less seasoned examiners and jointly conducted a credit review of each of the ten banks.

At a more local level, the Southwestern District [Note: Includes the states of Arkansas, Louisiana, Oklahoma and Texas.]has established an internal group of examiners experienced in agricultural lending to be an information resource and clearinghouse for agricultural loan classifications. This group reviews proposed classifications and provides feedback to examiners to ensure classification criteria are applied in a manner consistent with OCC

guidelines.

On an interagency basis, we are making some initial efforts to standardize the treatment of certain agricultural examination issues, such as valuing agricultural collateral and analyzing farm cash flows. The Southwestern District office has initiated a program with the Dallas office of the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Bank of Dallas, and the Texas State Banking Department to share information on agricultural conditions and lending activities in the Southwest. We are hopeful that programs such as these will ensure a more consistent regulatory treatment of loans to troubled agricultural borrowers.

Finally, all national banks have the opportunity at any time to raise examination concerns. The OCC's Ombudsman and his staff are responsible for ensuring that the OCC appeals process provides a fair and speedy review of disagreements on agency findings or decisions. The office has the discretion to supersede any agency decision or action during the resolution of an appealable matter.

OCC Outreach

The OCC has an active outreach program and we have stepped up our activities with bankers and trade groups in our Districts that have been most affected by problems in agriculture. Our purpose is to educate bankers about our policies, candidly discuss issues, and identify local problems. This dialogue helps us to strike the right balance in our supervision of agricultural banks, and prevent overreaction to existing economic conditions affecting the agricultural sector. Topics of recent meetings include credit classifications; the impact on agricultural credit conditions of reduced yields on corn and wheat from drought; crops lost to freezes and floods; and low beef and pork prices.

In addition, our District Offices are offering training programs for bankers. For instance, last September, the OCC's Omaha Field Office organized an outreach session on agriculture credit classification for over 200 senior lenders and chief executive officers from banks in Nebraska and Iowa. The program was so successful that it has been incorporated into the training programs of three other OCC field offices.

Conclusion

Although the OCC has concerns about the difficulties farmers are facing in some areas of the country, the current problems in the banking system from exposure to agricultural credits are not as severe overall as those we saw in the mid-1980s. Nearly all agricultural banks hold more capital and have higher levels of loan loss reserves than 15 years ago. Therefore, most agriculture banks are currently in a sufficiently strong financial position to work out problem credits with their farm borrowers.

As Comptroller, I am determined that the OCC maintain a balanced supervisory approach: one that avoids overreaction to problems and results in a steady flow of credit to agriculture, but one that also ensures that national banks remain safe and sound and that the system does not suffer overall from sectoral difficulties. We can achieve these objectives through consistent application of proven policies under which we encourage banks to work with their customers and to adhere to sound lending fundamentals.