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ON
IMPACT OF THE 1996 DROUGHT ON OKLAHOMA
BANKS AND BORROWERS
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
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ELK CITY, OKLAHOMA

Good afternoon Chairman Leach and Representative Lucas. Thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on the effect of the drought on banks and borrowers in Oklahoma. As a financial institution regulator, who also happens to be a farmer, I am following the effects of this drought closely. My testimony will discuss the current condition of banks in Oklahoma, the FDIC's recent efforts in the supervision of institutions in drought-affected areas, and the reasons why the current conditions in Oklahoma are much different than the agricultural crisis experienced in the 1980s.

Current Condition of Oklahoma Banks

Three hundred and forty insured commercial banks operate in Oklahoma. Forty-one percent of these (138 institutions) are identified as agricultural banks. These banks hold more than $5 billion in assets which represents 16 percent of the total assets of commercial banks statewide. Noncurrent loan ratios of banks in Oklahoma remain far below their historical highs. Only five Oklahoma banks, three of which are agricultural banks, reported a net loss for the first quarter. An analysis of March 1996 call report data indicates that Oklahoma's agricultural banks are financially sound. However, there has been a slight increase in delinquency ratios and, while we believe there is no cause for alarm, the FDIC is closely monitoring the situation.

As you know, most of Oklahoma is experiencing moderate to severe drought conditions. The effects of the drought have been felt strongly in western Oklahoma where there are 106 agricultural banks. The FDIC is the primary federal regulator of 75 of these agricultural banks, the vast majority of which (88 percent) are well managed and are rated highly under the Uniform Financial Institution Rating System.

Current Supervisory Approach

As the primary federal regulator of the majority -- and insurer of all -- of Oklahoma's banks, the FDIC is aware of the problems that banks may experience when a major sector of their market is economically distressed. Bankers, borrowers and regulators have all learned a number of hard lessons from the agricultural crisis of the 1980s. This experience highlights the need for a proactive examination and supervisory process to assess trends and anticipate potential problems. Bank supervision is an ongoing process that does not begin and end with the on-site examination. While we have increased the frequency of on-site examinations and visitations, we have also dramatically improved our off-site monitoring capabilities in order to identify emerging trends between examinations and prepare accordingly.

The FDIC has worked with bankers to encourage more sophisticated agricultural loan analysis. Analysis of a borrower's cash flow has supplanted the strictly collateral-based lending that was common in the 1980s. In addition, bankers now follow better underwriting practices and have improved appraisal and documentation policies. We believe that these more proactive initiatives have had a positive impact on the financial condition of the agricultural banking sector and have resulted in Oklahoma banks being in a much better position to handle problems associated with the drought.

As supervisor and insurer, the FDIC must balance its obligation to ensure a safe and sound banking system with the need to allow lenders and borrowers the flexibility to work through any loan problems caused by the drought. To ensure the consistent application of a balanced supervisory approach and to improve our ability to identify any emerging problems, the FDIC has undertaken several initiatives.

The FDIC has recently reissued guidance to examiners stressing that examiners should be objective, realistic and fair in their assessment of agricultural credits. While examiners must be alert to, and critical of, operational and managerial weaknesses in banks, they must also recognize when an institution is taking reasonable and prudent steps to deal with external risk factors, such as weather conditions or commodity prices, that are beyond the institution's control. Regulators should not criticize the institution or its management and directors for taking responsible actions to address such situations. When reviewing an institution's loan portfolio, examiners do not classify a loan solely based on current performance. Instead, examiners consider the total lending relationship, including the borrower's historical performance and financial strength, the value of any collateral, and other sources of repayment. We encourage bankers to work with borrowers and, even if a loan is adversely classified, examiners do not and would not suggest foreclosure or sale of collateral. Such a decision is, properly, the prerogative of bank management.

The FDIC also has intensified its use of off-site monitoring systems to identify emerging problems. When we identify developing problems affecting a number of institutions, we normally consult the appropriate state banking department to determine what action may be necessary. In some cases, a telephone call to bank management may be all that is necessary to assess a deteriorating situation in an institution's agricultural loan portfolio. Other cases may require an on-site visitation by examiners or the acceleration of the institution's next full-scope on-site examination.

Additionally, in an effort to gain a better understanding of the degree of local agricultural problems in western Oklahoma, the Dallas Region of the FDIC and the Oklahoma State Banking Commissioner's office jointly conducted informal, on-site visitations at 11 banks in early June. The institutions were selected based on their significant involvement in agricultural lending and on their diverse geographical locations across western Oklahoma.

The results of these visits suggest that regulators and bankers need to continue to monitor the situation and take appropriate action without overreacting. The bankers who provided information during these visitations observed that, although many farmers and ranchers in western Oklahoma have been hurt by the drought, there are factors that have helped to lessen the overall impact on the area's economy. One factor is the sporadic nature of the drought. In some areas only a few miles separate farms with acceptable wheat production from those with crop failures. In addition, while wheat yields are generally down, higher wheat prices are helping to offset some of these losses. Poor pastures and high feed costs are holding cattle prices down and adversely affecting cattle producers.

We have gained further insight into the effects of the drought by recently conducting an informal survey of FDIC field office supervisors. In western Oklahoma, respondents reported that there are some early signs of deterioration in the overall financial soundness of a limited number of agricultural borrowers. These borrowers are being closely monitored by the financial institutions.

In addition, examiners are reminding bank management of the importance of closely monitoring borrowers in drought-affected areas. This includes regularly analyzing borrower cash flow as well as timely and complete collateral inspections and verifications. In accordance with the existing interagency policy statement concerning loan loss reserves, examiners are reminding bank management that they should be vigilant regarding factors, such as the drought, that may lead to higher than normal credit losses compared to the bank's historical loss experience.

In addition to the efforts of examination staff, the FDIC's Division of Insurance is analyzing economic, agricultural and climatic information to assess any potential impact on the economies of the southern plains states and the risk to the insurance funds.

The next six months will be critical. An extended drought would hamper the planting of wheat in the fall and may continue to hold cattle prices down. This, in turn, could lead to longer-term loan problems as farmers and ranchers are unable to repay their loans, increasing the possibility of defaults, foreclosures, and liquidations.

Differences from the Agriculture Crisis of the 1980s While there is no doubt that Oklahoma and other states are feeling the effects of the drought, we should be cautious in comparing its effects to the difficulties experienced by the agriculture industry and lenders during the early to mid-1980s. Agricultural conditions in the 1980s were the result of an extraordinary combination of economic factors that led to extensive farm and bank problems. The cycle of inflation and disinflation, along with soaring interest rates and appreciation of the dollar triggered events that proved ruinous for farmers and farm lenders alike.

The boom/bust cycle in farmland prices in the 1980s led to speculative lending and borrowing that, in the long run, was unsustainable. Rising interest expenses consumed most, if not all, of the farm sector's profit margin. In addition, a rising dollar and foreign political developments led to a severe contraction in grain exports.

Today's economic environment is far more stable. Inflation and interest rates remain relatively low. Prices for farmland have risen at rates consistent with overall price inflation and the outlook for foreign demand and farm exports appears positive, overall. Also, in contrast to the 1980s, the financial institution sector is strong today. The current drought, therefore, is taking place at a time when macroeconomic factors are much more favorable than during the 1980s.

Although the situation today is different in many ways from the 1980s, this does not minimize the hardships being endured by farmers and ranchers in Oklahoma or the potential risks faced by agricultural lenders. If the drought continues, its effects are likely to translate into higher loan delinquency rates and increasing levels of loan classifications. We also know from previous experience that being well-capitalized today does not eliminate the risk of a bank's failure in the long run if adverse conditions persist. However, the strength of the banks in this area and the absence, to date, of larger economic problems are positive factors that should help local banks, farmers and ranchers handle this downturn in the agricultural business cycle without the upheaval that occurred in the 1980s.

Conclusion

In conclusion, agricultural banks in western Oklahoma have begun to experience slight increases in delinquency rates and early deterioration in the financial condition of some borrowers. However, it is important to reiterate that these problems are weather-related and vastly different from the speculative boom/bust agricultural cycle of the 1980s. Also, due to improved underwriting practices, farmers and ranchers, in general, are not over-leveraged and are in a better position to withstand the drought.

Most banks are currently well positioned to help farmers and ranchers work through the problems caused by the drought. The FDIC is encouraging banks to work with borrowers experiencing, what we hope are, temporary problems. We also are emphasizing to examiners the need for a balanced approach in evaluating lending relationships with borrowers as part of the examination process. We will continue to monitor the situation closely and pursue reasonable regulatory initiatives should they become necessary.

Thank you. This concludes my statement. I will be happy to answer any questions.

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