INCREASING AGRICULTURAL BANKRUPTCIES IN THE U.S.

Manjula Guru, The Kerr Center for Sustainable Agriculture, Inc.
James E. Horne, The Kerr Center for Sustainable Agriculture, Inc.

SUMMARY OF CONTENT

It is widely believed in the corporate sector that in the age of virtual business, most banking customers do not need 'brick and mortar' banks once an account has been opened. This belief has paved the way for the saturation of banks, and this in its turn has led to brutal competition and then consolidation of banks in the United States.

The U.S. banking industry has been consolidating at a rapid rate over the last fifteen years, largely because of the liberalization of state geographic restrictions on branching and holding company acquisitions. The banking consolidations over the years have significantly reduced the number of small banks, and because of that the impact of these bank mergers and acquisitions on small business lending (SBL) has been considerable.

These developments have led to the total supply of bank credit to members of the farming communities falling substantially, the farmers applications for loans being turned down increasingly, and in a substantial rise in the bankruptcy rate among the farming community. The impact of this development has been felt considerably by farmers, as is evident from the increasing number of farm bankruptcies.

This paper proposes to examine this impact on the US agricultural enterprises, especially as experienced and perceived by small family farmers. Analysis is based on case studies conducted by The Kerr Center.

INTRODUCTION

It is widely believed in the corporate sector that in the age of virtual business, most banking customers do not need "brick and mortar" banks once an account has been opened. This belief paved the way for the saturation of banks, which in turn led to brutal competition and then consolidation.

The U.S. banking industry has been consolidating at a rapid rate over the last fifteen years, largely because of the liberalization of state geographic restrictions on branching and holding company acquisitions. The banking consolidations over the years have significantly reduced the number of small banks, and with that the total supply of bank credit to members of the farming communities has fallen substantially. The impact of this development has been felt considerably by farmers, as is evident from the increasing number of farm bankruptcies.

The U.S. banking industry has transformed itself over the last decade. Seven of the ten biggest commercial banking companies of 1988 as ranked by the Fortune magazine have been acquired since that year. Citicor was acquired by the Travelers Group in October 1998, Chase Manhattan by Chemical Banking in March 1996, Security Pacific by Bank America in April 1992, Bank America by Nations Bank in September 1998, Manufacturers Hanover by Chemical Banking in December 1991, First Interstate

Bancorp by Wells Fargo in April 1996, Bankers trust by Deustche Bank in December 1998, etc., etc. And so many more developments have taken place since 1998 that it's impossible to keep track of them.

Farmer bankruptcies are controversial and emotional not only for the parties concerned but also for other observers as well. Whether regarded in the general sense of a business closing down or in a narrower legal sense, they are thought to indicate a signal not only regarding the economic and social well – being, but also about the structure of the rural economy as well. Sometimes they are regarded as a measure of the success or failure of the various public policies (such as price supports, export subsidies, conservation rules, environmental regulations, and public credit funding), directed at improving the economic status of the farm sector (USDA/ ERS, 1996). Public concern over farm policy therefore rises when bankruptcy appears to be taking an inordinate toll on smaller farms.

With the decline in the number of small banks, the impact of the bank mergers and acquisitions on small business lending (SBL) has been considerable. The farmer's applications for loans are being increasingly turned down, and the ones fortunate enough to get a loan are having their loans suddenly foreclosed upon. The result is the rising bankruptcy rate among the farming community. This paper proposes to examine this impact on agricultural enterprises, especially as experienced and perceived by small family farmers.

BACKGROUND

Farmers and Bankruptcy Policies:

The long run effects of bankruptcy statutes depend greatly on the economic performance of the sectors in question. Bankruptcies occur during both prosperous and troubled economic times, but the effect of the law obviously is much more noticeable when times are hard.

Bankruptcy generally describes proceedings undertaken in a Federal Court when a debtor is unable to pay or to reach agreement with creditors. The bankruptcy code contains four operative chapters (chapters 7, 11, 12, and 13), under which personal or business bankruptcy petitions may be filed. The debtor rehabilitation provisions of the code (chapters 11, 12, and 13) differ from the Chapter 7 proceedings because the debtor looks to rehabilitation and reorganization, rather than liquidation, and the creditors look to future earnings of the debtor, rather than property held by the debtor, to satisfy their claims.

Chapter 7 bankruptcy is also called "straight bankruptcy" or liquidation." It is the simplest and easiest form of bankruptcy proceedings. Bankruptcy per se is a federal statutory proceeding whereby qualified individuals may surrender if their nonexempt property does not pay their debts completely, and the debts are discharged. The usual Chapter 7 bankruptcy takes between 100 to 180 days, costs around $160.00 and, the debtor usually has to appear only once in a court - at the meeting with the creditors. Once a discharge is given by the bankruptcy court, the debtor's dischargeable debts are forgiven. The debtor will still be obligated to pay any debts that the bankruptcy court determines should not be discharged for equitable reasons or are not dischargeable under federal law.

Unlike Chapter 7 bankruptcy, Chapter 12 is a reorganization of the debts, not a liquidation of the debtor's property. Chapter 12 of title 11 was enacted in 1986 to provide specially - tailored bankruptcy relief for "family farmers." A total of 18, 212 Chapter 12 cases have been filed since it was enacted in 1986.

The reason for filing a Chapter 12 petition is that the debtor wishes to buy time to reorganize his debts, and intends to dismiss the petition within a period of time and pay his debts. The purpose behind filing the petition is simply to gain a breathing period and to avoid imminent foreclosures or lawsuits during the period. In other words, Chapter 12 involves restructuring the debt when a person wants to keep his property and does not wish to leave it. However, only a family farmer with "regular annual income" may file a petition for relief under Chapter 12. The debtor's annual income must be sufficiently stable to permit the debtor to make payments under that chapter, although it may fluctuate seasonally and a regular monthly income is not mandatory. It should be noted that creditors might not force a farmer into a Chapter 12 bankruptcy proceeding.

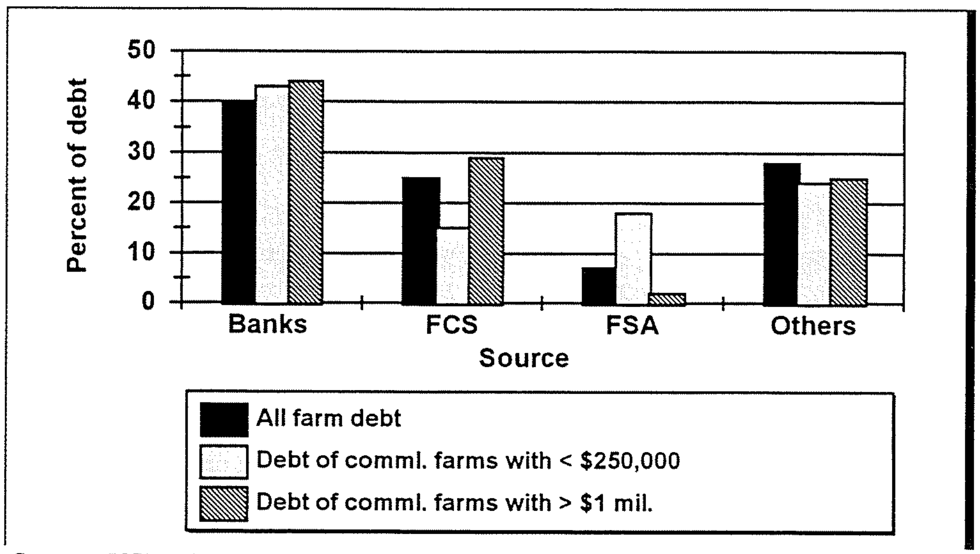
A Chapter 12 bankruptcy is more streamlined, less complicated, and less expensive than Chapter 11, which is better suited to the large corporate reorganization. A plan under this chapter involves full or partial repayment of debts while assets are shielded from creditor action. On the other hand, Chapter 13 was designed for wage earners who have a steady monthly income. Accordingly, neither the Chapter 11 nor Chapter 13 are suited to the needs of the typical family farmer.

CREDIT FOR RURAL FARMERS

Farming is a capital - intensive industry, and farmers rely on credit to finance a small but significant portion of the assets they employ. The farming communities credit needs are served by a wide range of lenders, with banks, the Farm Credit System, USDA, and life insurance companies being the major institutional sources of credit, as shown in Figure 1. Surveys of lenders and borrowers suggest that competition for creditworthy borrowers has been very intense among agricultural lenders for the past several years (USDA, 1996).

The most visible components of the financial market faced by rural borrowers are the commercial banks and thrifts located within their communities. Not only are bank and thrift offices prominent community landmarks, but they in fact supply most of the credit used by rural borrowers. It has been observed in this regard, that the rural credit delivery system in the U.S. consists largely of privately owned banks, providing financial services with the intent of earning profits.

Figure 1
Sources of credit for U.S. agriculture, 1995.



Source: USDA/ ERS, 1997.

Banks with headquarters in rural areas operated 74% of the commercial bank offices located in rural America, and held 74% of the deposits collected by rural commercial bank offices as of June 1994. They provide credit for a wide range of uses, including home mortgages, consumer loans, agricultural loans, and commercial / industrial loans. In addition to lending, rural banks hold tax - exempt securities used to finance state and local government activities.

Table 1
Distribution Of Urban And Rural Counties
By Bank Market Structure, 1994.

	U.S.	Urban	Rural	Persistent poverty
	(%)	(%)	(%)	(%)
Counties with an office of:				
No banking firm[1]	0.6	0.0	0.9	0.9
1-2 banking firms	20.6	4.2	26.4	43.0
3-5 banking firms	41.3	21.9	48.2	47.1
6-9 banking firms	24.5	34.4	21.0	8.4
10 or more banking firms	13.0	39.5	3.5	0.6
Counties served by:				
Only local banking firms[2]	6.9	1.1	8.9	16.1
Only "non local" banking firms	29.2	21.3	32.0	31.4
Both local and non local firms	63.9	77.6	59.0	52.5
Only small banking firms[3]	24.6	4.2	31.9	48.2
At least one large banking firm	67.4	93.6	58.0	41.7
Only small banks	37.3	8.1	47.7	60.4
At least one large bank	50.7	84.4	38.7	28.6
	(#)	(#)	(#)	(#)
Total number of counties	3,089	813	2,276	535

Source: USDA/ ERS, 1997

Relative to the banking industry as a whole, rural banks hold fewer loans as a percentage of deposits. While in 1994, 27% of rural counties were served by two or fewer banks (including the branches of banks with headquarters elsewhere). In contrast 40% of urban counties were served by ten or more banks (see Table 1). It has been reported that the poorest counties tend to have the least competitive banking markets (USDA/ ERS, 1997).

Bank ownership is viewed as an important determinant of performance by some. Some rural advocates feel that outside ownership of rural bank offices might prove detrimental to local development prospects. Large banks may transfer funds from rural offices for lending elsewhere, and non-local managers may lack information needed to evaluate loan applications fairly. Other arguments favor outside ownership because large banks provide more kinds of financial services, can handle larger loan requests, and are less affected by downturns in the local economy.

Nationwide banking industry consolidation trends have made a difference in the ownership of rural banking markets. One third of the rural counties are served solely by local banking organizations (banks with no offices outside the county), which is down significantly since 1980. Slightly more than half of the rural counties have offices of both local and non-local banking organizations.

ANALYSIS

The small size of rural communities and the small size of rural borrowers limit the number of lenders that can profitably compete for rural loans. As a result, many of the rural markets and farming communities are not well served. In some rural communities, and especially for members of the farming communities, the range of available financial services and institutions is too small to ensure an efficient allocation of financial resources.

Farmers in rural America face a number of problems when applying for loans -

(1) risk financing (equity for new businesses, long - term operating loans for businesses and community organizations, etc.) is difficult to find;

(2) transaction costs are often higher for rural borrowers whose financial needs are unusually large or complex (by local standards) as they have to shop over a wider geographic area and deal with a broader range of institutions than is typically true in urban settings; and

(3) access to credit and other financial services remains a problem for those who fail to qualify for commercial loans because of low incomes, low skills, and lack of collateral.

The bank's decision to approve a loan depends on both economic considerations and consumer preferences. Economic considerations include such factors as the borrower's income and the prices and qualities of other goods and services. The desires of potential consumers who are unwilling or unable to pay are not included in economic demand. Requests from those who are unable or unwilling to repay loans and their associated costs are not considered to create economic credit demand. The logic applied by the lending institutions is that if they were, demand would quickly outpace supply.

Commercial banks in rural areas and Farm Credit Service lenders are both generally financially sound and able to respond to increases in economic demand. Both groups of lenders have increased their lending in recent years and claim to be prepared to meet future demand for commercial credit. Despite this observation, substantial evidence exists that many rural credit markets remain imperfectly competitive (USDA, 1996). These imperfections often result in operating inefficiencies among some rural lenders, with higher credit costs and tighter loan approval standards for some rural borrowers.

CASE STUDIES

The Kerr Center conducted four case studies around the state of Oklahoma of family farmers who've chosen to file for bankruptcy. Our report title the "U.S. Farm Crisis," which will be released later this year, not only discusses their cases, but also examines the fundamental problems underlying the banking industry.

All four of the farmers we talked to were well educated and had been farming most of their lives. As one of them put it:

"What else can I do? This is my life, and it would kill me to stop farming."

The growth of industrial agriculture and the gradual wipe out of local banks and their replacement by banks headquatered elsewhere have all led to their filing for bankruptcy. When faced with the dilemma of giving up farming and going in for Chapter 7, or of filing under Chapter 12 and continuing the struggle, these family farmers have courageously elected the latter.

All four have faced unhelpful bankers, a credit system that's not meant for hard working rural folk and definitely not for small sized farms. When asked what their advice to the young people of this nation would be, they all gave the same reply: *"Get a real job, and get a safe future."*

WHAT'S THE FUTURE FOR FARMING?

It is widely known that the younger generation today no longer even thinks about farming as a full time career. And in fact no farmer today would like his children to enter this no longer economical life. This change in attitude could be attributed to one of the following factors-

(1) Farmers no longer want to struggle and be at the mercy of the commercial banks, which are replacing the rural ones and are not interested in their financial and agricultural troubles. Unlike the traditional rural banks to which the farmers were used to and which understood the problems faced by members of the farming communities, the farmers now have to deal with large corporate entities, which not being based in their county are not in touch with the life there. Farmers therefore want to get out of the farming profession and turn towards a more stable life.

(2) High interest rates prevent the farmers from repaying any existing bank loan, in the event of any unforeseen circumstances. The cost per dollar borrowed (i.e., the interest rate) generally declines with the loan size because of relatively fixed loan evaluation and processing costs. As a result, since the typical rural borrower's loan is smaller than the typical urban borrower's, the average borrowing costs are higher in rural areas, other things being equal.

(3) Chapter 12 increases total lending costs to all farmers and restricts credit availability to some degree, depending on the current economic vitality of the farm sector. Because of the threat of Chapter 12, commercial banks are wary of granting credit to young producers, as well as marginal borrowers. They have thus adopted tiered interest rate structures and increased the interest rate spread to riskier borrowers partially in response to Chapter 12.

CONCLUSION

There is no doubt in conclusion that commercial banks dominate most rural financial markets and are well positioned to provide financial support to rural sectors of the economy. Since 1991, loan loss provisions and problems have declined for commercial banks nationwide. While the farmers as such are not doing well and are increasingly filing for bankruptcy, the financial condition of banks not head-quartered in rural America was particularly healthy as of 1996.

Rural communities continue to grow or decline based on their inability to compete regionally, nationally, and increasingly globally. It should also be noted that while rural America lacks many opportunities for economic growth that exist in urban areas, financial market operations are not the only potential barrier. Many other factors, including work force quality, transportation costs, various regulations, and availability of other business services, appear to have as much if not more of an effect on rural competitiveness (USDA, 1997).

REFERENCES

USDA/ ERS. *Do Farmers Need a Separate Chapter in the Bankruptcy Code?* Agriculture Information Bulletin No. 724-09. October 1997.

USDA/ ERS. *Credit in Rural America*. Agricultural Economic Report Number 749. April 1997.

USDA/ ERS. Are Farmer Bankruptcies A Good Indicator of Rural Financial Stress? Agriculture Information Bulletin No. 724-06. December 1996.

USDA/ ERS. Collander, R.N., and A. Erickson. *Farm Credit System Safety and Soundness.* AIB-722. October 1996.

ENDNOTES

[11] A banking firm is an independent bank or a bank holding company. All of the bank offices and affiliates of a bank or holding company constitute one banking firm. Thus, a banking firm may own many banks in a county, but these banks are all treated as a single competitor.

[1] A local banking firm has all its offices and affiliates in one county; all others are considered non-local, even if the banking firm includes a locally headquartered affiliate.

[1] A small bank or banking firm has assets of under $250 million; a large bank or banking firm has assets over $ 1 billion.