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CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: Recovery Continues for Banks | Follow Agricultural Financial Conditions with New Survey

The Drought's Impact on Eighth District Agricultural Conditions

By Gary Corner

The drought that impacted much of the United States this summer has had varying impacts on both crop and livestock producers across the U.S. and in the Eighth District. For crop producers, particularly producers of corn and soybeans, the reduction in crop yields has led to a spike in commodity prices. However, government-backed crop insurance programs provide many of these producers—and their lenders—with an important safeguard against the yield reductions from this drought. As a result, the impact of the drought on crop producers appears to be somewhat tempered.

Livestock producers, on the other hand, generally do not benefit from these same insurance safeguards. Facing a spike in their input costs, as feed costs rose and as pastureland conditions deteriorated, livestock producers have had to make more immediate choices. Some have chosen to cull their herds at temporarily depressed prices. Those who chose to maintain the size of their herds until input costs decline have taken a calculated risk that conditions will improve. This risk, however, could lead to even more severe losses for these producers and, perhaps, their lenders.

Unfortunately, rains that blanketed much of the country in September occurred too late to have any material impact on this year's crop yields, feed costs or pastureland conditions. Weather conditions in the months ahead will serve as a strong indicator for how crop and livestock producers will fare in the spring.

TABLE 1

Drought Impact on Agriculture Bank Performance

	June 2012		June 2011	
	District	Nation	District	Nation
Number of Ag Banks	147	1,519	152	1,526
Average Assets	$142M	$134M	$133M	$124M
Ag Loans to Total Loans	38.48%	43.49%	36.77%	41.70%
Return on Average Assets	1.29	1.28	1.05	1.08
Net Interest Margin	3.90	3.86	3.97	3.91
Return on Equity	11.57	11.81	9.78	10.46
Provision Expense to Avg. Assets	0.19	0.16	0.36	0.24
Nonperforming Loans and OREO to Total Loans and OREO	1.49	1.97	1.66	2.43

SOURCE: Reports of Condition and Income for Insured Commercial Banks. Compiled by Daigo Gubo.

Mild Winter and Early Planting

At the beginning of the year, agriculture conditions suggested that 2012 would be a strong year for the industry. Farm incomes had been strong for most of the past decade, and a mild winter facilitated early planting. The winter wheat crop yield was strong. The

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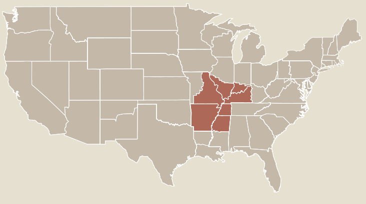
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



Selected St. Louis Fed Sites

Dodd-Frank Regulatory Reform Rules
www.stlouisfed.org/rrr

FRED (Federal Reserve Economic Data)
www.research.stlouisfed.org/fred2

Community Development's Household Financial Stability Initiative
www.stlouisfed.org/household-financial-stability

CENTRAL VIEW

Follow Regional Agricultural Financial Conditions with New Quarterly Survey

By Kevin L. Kliesen

Kevin L. Kliesen is a business economist and research officer at the Federal Reserve Bank of St. Louis.

As noted in this issue's cover article, "The Drought's Impact on Eighth District Agricultural Conditions," the summer drought has decimated Eighth District corn and soybean crops and forced many livestock and dairy operations to cull their herds because of parched pastures and high feed costs. What impact will this have on farm income, farmland prices and farm credit conditions?

While the final harvest tallies won't be available for several more months, the St. Louis Fed's new quarterly survey of the expectations of agricultural banks, the *Agricultural Finance Monitor* (http://research.stlouisfed.org/publications/afm/), indicates that bankers expect a significant impact on farm income across most of the District in the third quarter of 2012 compared with a year earlier.

With the launch of its survey, the St. Louis Fed now joins the Kansas City, Chicago, Dallas, Minneapolis and Richmond Feds in producing a regional agricultural financial conditions report. In addition to farm income, the *Monitor* reports bankers' expectations of farmland values, farm loan repayment rates, required collateral, farm loan interest rates, and credit supply and demand. (The St. Louis Fed survey was developed and conducted with the help of the Kansas City Fed.)

Third-Quarter 2012 Lender Expectations

On average, lenders across the Eighth District expected third-quarter 2012 farm income and capital expenditures to be significantly lower than the third quarter of 2011. Based on a diffusion index methodology with a base of 100 (results above 100 indicate proportionately higher lender expectations compared with the same quarter a year earlier; results lower than 100 indicate lower lender expectations), the average expectations index for third quarter 2012 was 81, compared with an index of 140 for the second quarter 2012. Meanwhile, farmland values were expected to remain the same, or rise slightly, over the next three months, while demand for agricultural loans was expected to remain healthy, even higher in some areas. In addition, third-quarter 2012 loan repayment rates were expected to be on par with second-quarter 2011 rates.

How close are expectations to eventual reality? A 2009 study by the Kansas City Fed ("Can the Ag Credit Survey Predict National Credit Conditions?") shows a strong

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Recovery Continues for Banks in District, Nation

By Michelle Clark Neely

Bank earnings were up moderately at the national level but were mixed in District states in the second quarter, while asset quality improved once again across all states. Overall, the District and national banking industries are in considerably better shape now than they were one year ago.

For all U.S. banks with assets of less than $15 billion, return on average assets (ROA) jumped 13 basis points between the first and second quarters to 1.06 percent and is up 41 basis points from a year ago. ROA dropped 2 basis points to an average of 0.91 percent for banks in District states; despite the decline, ROA in District states is still up an average of 36 basis points from a year ago. ROA increased between the first and second quarters at Arkansas, Illinois, Indiana and Missouri banks, while it declined just one basis point at Mississippi banks. ROA declined 26 basis points in Kentucky, primarily because of a seasonal decline in a line of business at one institution. Despite that drop, Kentucky banks still posted the highest ROA among District states, at 1.21 percent.

At the national level, the jump in ROA in the second quarter was almost solely due to a 15-basis-point increase in noninterest income. A slight uptick in net interest income and a small decline in loan loss provisions also contributed to profit increases. Within District states, there were generally small increases or decreases in the three major components of earnings—net interest income, net noninterest expense and loan loss provisions—but no consistent pattern that explains why ROA ticked up or down. Banks in Arkansas and Indiana outperformed their national peers in the second quarter, while Illinois, Kentucky (absent the one institution), Mississippi, Missouri and Tennessee banks posted lower average profit ratios. Although loan loss provisions have dropped significantly over the last year and have provided a boost to earnings, they have likely hit a trough, as many

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TABLE 1

Earnings Performance[1]

	2011: 2Q	2012: 1Q	2012: 2Q
RETURN ON AVERAGE ASSETS[2]			
All U.S. Banks	0.65%	0.93%	1.06%
All Eighth District States	0.55	0.93	0.91
Arkansas Banks	1.11	1.01	1.09
Illinois Banks	0.38	0.72	0.74
Indiana Banks	0.57	1.06	1.07
Kentucky Banks	0.87	1.47	1.21
Mississippi Banks	0.69	0.91	0.90
Missouri Banks	0.65	0.90	0.91
Tennessee Banks	-0.08	0.89	0.83
NET INTEREST MARGIN			
All U.S. Banks	3.90%	3.88%	3.89%
All Eighth District States	3.85	3.85	3.84
Arkansas Banks	4.27	4.16	4.16
Illinois Banks	3.69	3.66	3.64
Indiana Banks	3.83	3.90	3.91
Kentucky Banks	4.17	4.27	4.09
Mississippi Banks	3.94	3.99	4.04
Missouri Banks	3.68	3.66	3.68
Tennessee Banks	3.86	3.92	3.90
LOAN LOSS PROVISION RATIO			
All U.S. Banks	0.62%	0.37%	0.36%
All Eighth District States	0.74	0.41	0.40
Arkansas Banks	0.52	0.32	0.35
Illinois Banks	0.96	0.58	0.55
Indiana Banks	0.66	0.30	0.28
Kentucky Banks	0.53	0.37	0.34
Mississippi Banks	0.60	0.23	0.24
Missouri Banks	0.53	0.38	0.38
Tennessee Banks	1.02	0.34	0.36

Compiled by Daigo Gubo

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES: [1] Because all District banks except one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.

[2] All earnings ratios are annualized and use year-to-date average assets or average earnings assets in the denominator.

Quarterly Report
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banks are now in a position of running off loan loss reserves in excess of required levels.

Asset Quality Better

Asset quality measures continue to improve, nationally and in District states. The nonperforming assets ratio—nonperforming loans plus other real estate owned (OREO) to total loans plus OREO—dropped 36 basis points for all U.S. banks to 4.27 percent in the second quarter. One year ago that ratio topped 5 percent. The average nonperforming assets ratio for District states also declined more than 30 basis points in the second quarter to 4.71 percent. Within the District, Indiana banks posted the lowest nonperforming assets ratio in the second quarter (3.30 percent), while Illinois banks recorded the highest ratio (5.74 percent). Although problem loans remain stubbornly high, asset quality has improved at Illinois banks, with the nonperforming assets ratio down 50 basis points from the first quarter and 100 basis points from a year ago.

TABLE 2

Asset Quality Measures[1]

	2011: 2Q	2012: 1Q	2012: 2Q
NONPERFORMING ASSETS RATIO[2]			
All U.S. Banks	5.15%	4.63%	4.27%
All Eighth District States	5.42	5.03	4.71
Arkansas Banks	6.09	5.33	5.11
Illinois Banks	6.74	6.24	5.74
Indiana Banks	3.80	3.49	3.30
Kentucky Banks	3.61	3.82	3.72
Mississippi Banks	4.56	4.19	3.91
Missouri Banks	4.74	4.73	4.43
Tennessee Banks	5.96	5.17	4.89
LOAN LOSS COVERAGE RATIO[3]			
All U.S. Banks	58.37%	62.49%	66.56%
All Eighth District States	56.52	61.02	64.04
Arkansas Banks	53.94	65.52	68.43
Illinois Banks	45.63	50.13	52.59
Indiana Banks	74.62	67.05	70.38
Kentucky Banks	69.01	69.02	71.80
Mississippi Banks	63.45	74.71	77.89
Missouri Banks	72.25	71.53	77.17
Tennessee Banks	57.21	66.33	67.21

Compiled by Daigo Gubo

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES: [1] Because all District banks except one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.
[2] Loans 90 days or more past due or in nonaccrual status, plus other real estate owned (OREO), divided by total loans plus OREO.
[3] Loan loss reserves divided by nonperforming loans.

Improvement Widespread

In general, nonperforming loan rates fell across all asset classes in all District states. The only exceptions to the general decline occurred in Kentucky, where nonperforming construction and land development loans edged up; in Arkansas, where nonperforming commercial and industrial loans rose slightly; and in Tennessee, where nonperforming consumer loans increased.

Lower nonperforming loan rates led to large increases in loan loss coverage ratios in the second quarter. U.S. peer banks had set aside about 67 cents for every dollar of nonperforming loans at mid year, up about 4 cents from the previous quarter and more than 8 cents from a year ago. The trend was similar in District states, with the average loan loss coverage ratio increasing about 3 cents between the first and second quarters and up almost 8 cents from a year ago. Among District states, Mississippi banks recorded the highest average coverage ratio (77.89 percent), while Illinois banks recorded the lowest (52.59 percent). Every District state but Illinois posted higher coverage ratios than the national average in the second quarter.

Capital Up

Tier 1 leverage ratios edged up again in the second quarter. Nationally, the tier 1 leverage ratio averaged 10.1 percent, up 13 basis points from the first quarter and 26 basis points from a year ago. The average for District states in the second quarter increased a more modest 4 basis points to 9.61 percent. Arkansas and Kentucky banks had average leverage ratios that topped 10 percent, while Missouri banks (9.33 percent) and Illinois banks (9.36 percent) posted ratios that trailed the District state and national averages.

Michelle Clark Neely is an economist at the Federal Reserve Bank of St. Louis.

Drought's Impact

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United States Department of Agriculture (USDA) predicted in spring 2012 that corn yields would be around 166 bushels per acre—a record for corn producers. Given this prediction, many expected corn inventories to grow significantly, putting downward pressure on prices. In fact, as late as June 2012, corn was priced in the mid-$5 range per bushel, well off 2011 prices.

The Drought Hits

Unfortunately, summer weather conditions did not cooperate. The critical pollination periods for corn and soybeans are generally late June and late July, respectively. But in 2012, excessive heat and dryness was the prevalent weather pattern across most District states, with rain shortfalls reaching 15 inches in some areas. The benefits of a mild winter and early planting were lost. In severely struck areas, many farmers resorted to cutting crops for silage. This weather pattern largely continued through August when the residual rains from Hurricane Isaac provided District states with needed moisture.

Crop Forecasts Are Significantly Revised

By early July, many analysts and academic institutions began revising their forecasts for the agricultural sector. For example, the USDA revised its corn yield forecast down 26 percent to 123 bushels per acre. Other institutions, such as the University of Missouri's Food and Agricultural Policy Research Institute, updated their forecasts in August to factor in the impact of the drought.[1]

The University of Missouri's revised long-term baseline forecast now reflects the following for the agriculture sector:

- Corn prices are now expected to average $8.10 per bushel for the crop harvested in 2012, exceeding last year's record by about 30 percent. This is expected to result in steep reductions in corn domestic use, exports and carryover stocks.
- Soybean prices are now expected to average $16.27 per bushel, up from about $13 per bushel this spring and about 30 percent above last year's record. This is expected to result in sharply reduced levels of soybean crush and exports.
- These higher prices for corn and soybeans are expected to elevate prices for other grains and oilseeds. For example, wheat prices are expected to increase to $8.42 per bushel, in spite of record 2012 U.S. wheat yields.
- Ethanol production is now expected to decline by 10 percent for the 2012/13 corn-marketing year. Higher ethanol prices are expected to result in sharply reduced ethanol exports and increased imports, but domestic ethanol consumption is expected to decline by just 2 percent.
- The increase in feed prices is expected to result in reduced production of meat and milk, pushing up prices for those products. Consumer food prices are expected to increase by more than 4 percent in 2013.
- High prices are expected to keep 2013 corn acreages near its 2012 peak, and soybean and wheat acreage are

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Excessive heat and dryness was the prevalent weather pattern across most District states, with rain shortfalls reaching 15 inches in some areas. The benefits of a mild winter and early planting were lost.

Drought's Impact

continued from Page 5

both expected to increase as well. Cotton acreage, however, is expected to decline in 2013 because of weak cotton returns relative to returns of other competing crops.

The University of Missouri is also concerned that if its forecasts materialize and more acreage is planted to compensate for this year's losses, a return to more normal weather and growing conditions in 2013 could result in a sharp reduction in crop prices because of excess supply.

Crop Production in Eighth District States

Among the 655 community banks[2] headquartered in the Eighth District, 147 of them are considered agricultural banks.[3]

To begin to assess the impact of the drought on agriculture producers in these states and on their lending institutions, we compared yield estimates for several key crops as of September 2012 with actual 2011 yields as reported by the USDA. In general, agriculture producers in the seven states that make up the District harvest more soybeans than corn. Unfortunately, the drought's biggest impact appears to be on corn and soybean production. The charts at the bottom of Pages 6-9 highlight the estimated changes in yield for four key crops produced in the seven states. These estimates come from the USDA's September 2012 Crop Production report.

The Importance of Crop Insurance

Despite the drought's impact on the corn and soybean crops, the impact on farmers and on their lenders is expected to be mitigated by the use

Corn

TABLE 2

Changes in Yield for Corn, 2011–2012

Corn	Area Harvested (1,000 acres)		Yield Per Acre (bushels)		Production (1,000 bushels)		Change in Production
	2011	2012	2011	2012	2011	2012	
Arkansas	520	640	142.0	160.0	73,840	102,400	+38.7%
Illinois	12,400	12,600	157.0	116.0	1,946,800	1,461,600	-24.9
Indiana	5,750	6,050	146.0	100.0	839,500	605,000	-27.9
Kentucky	1,300	1,490	139.0	65.0	180,700	96,850	-46.4
Mississippi	740	800	128.0	147.0	94,720	117,600	+24.2
Missouri	3,070	3,350	114.0	75.0	349,980	251,250	-28.2
Tennessee	735	870	131.0	82.0	96,285	71,340	-25.9
District States	24,515	25,800	146.1	104.9	3,581,825	2,706,040	-24.5
U.S.	83,981	87,361	147.2	123.4	12,358,412	10,778,589	-12.8

SOURCE: USDA's September 2012 Crop Production report

Of the seven states in the District, Arkansas and Mississippi are the only two that are expected to experience year-over-year increases in corn production. Part of the reason for this seemingly good news is that these two states dedicate less acreage to corn than do other District states such as Illinois and Indiana. In addition, Arkansas benefited from irrigated farmland while Mississippi experienced more favorable weather conditions during the summer of 2012. Corn production in these states, given record-high commodity prices, is expected to generally bolster farm income in these areas. Overall, however, corn producers in District states are expected to experience a decline in corn production that is nearly twice the percent decline expected for all corn-producing states nationwide. Expected yield per acre should be well shy of the expected national average.

of crop insurance. The USDA's Risk Management Agency (RMA), created in 1996, manages the Federal Crop Insurance Corp. (FCIC), which was founded in 1938. Since 1998, private insurance companies reinsured by FCIC have sold and serviced all Multiple Peril Crop Insurance (MPCI) authorized under the Federal Crop Insurance Act. A contract of insurance exists between insured farmers and their commercial insurance providers. Premium rates and insurance terms and conditions are established or approved by FCIC. Reinsurance agreements exist between FCIC and the commercial insurance providers.

Crop insurance program highlights include:

- MPCI covers against loss from many weather conditions including drought, excess moisture, hail, wind, frost, tornado, lightning and flood, as well as other conditions, such as insect infestation, disease, fire and earthquake.
- Private crop insurance companies are fully backed by the federal government. Private insurers are stress-tested to verify they have financial reserves adequate to meet 400 percent of the potential loss on their crop insurance book of business. On July 1, 2012, all 16 AIPs (approved insurance providers) passed this stress test.
- The service delivery side of the program is handled by each private company but overseen by the USDA's RMA, which sets the rates that can be charged and determines which crops can be insured. Private firms are obligated to sell insurance to every eligible farmer who requests it and retains a portion of the risk.

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Soybeans

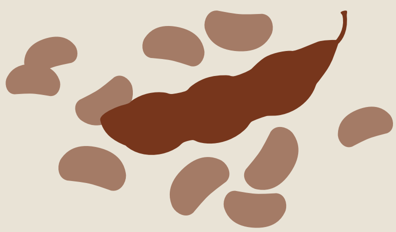
TABLE 3

Changes in Yield for Soybeans, 2011–2012

Soybeans	Area Harvested (1,000 acres)		Yield Per Acre (bushels)		Production (1,000 bushels)		Change in Production
	2011	2012	2011	2012	2011	2012	
Arkansas	3,270	3,200	38.0	39.0	124,260	124,800	+0.4%
Illinois	8,860	8,350	47.0	37.0	416,420	308,950	-25.8
Indiana	5,290	4,990	45.0	37.0	238,050	184,630	-22.4
Kentucky	1,480	1,380	39.0	34.0	57,720	46,920	-18.7
Mississippi	1,800	2,100	39.0	41.0	70,200	86,100	+22.6
Missouri	5,200	5,150	36.5	28.0	189,800	144,200	-24.0
Tennessee	1,250	1,290	32.0	31.0	40,000	39,990	0.0
District States	27,150	26,460	41.9	35.4	1,136,450	935,590	-17.7
U.S.	73,636	74,635	41.5	35.3	3,056,032	2,634,310	-13.8

SOURCE: USDA's September 2012 Crop Production report

Soybean producers have fared better than corn producers in Eighth District states. Soybean yields are expected to decline only slightly more in District states (18 percent) than nationwide (14 percent). The outlier among the District states is Mississippi, which the USDA expects will experience a sizable percentage gain in soybean production because of the additional acres planted and higher yields per acre in 2012 versus 2011.



Drought's Impact

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- The USDA subsidizes the crop insurance premium, thus encouraging more farmers to purchase MPCI. The goal is to reduce producers' dependency on federal crop disaster payments when natural disasters occur.
- Agricultural lenders frequently will require highly leveraged borrowers to carry crop insurance and obtain an assignment to the crop insurance proceeds.
- Crop insurance is increasingly viewed as providing the cornerstone for active risk management programs for all types of borrowers.

Impact on Livestock Production in Eighth District States

While crop insurance may help many crop producers partially offset losses caused by various perils, a more material impact could be felt by livestock producers who are forced to pay sharply higher feed bills as a result of the drought.

According to the University of Missouri, higher feed costs affect animal products differently. Figure 1 on Page 9 summarizes the dramatic increase in feed costs by animal in dollars per pound. The blue bar represents current conditions, with corn at $8 per bushel, soybean meal at $550 per ton and hay at $200 per ton. The gray bar represents more "normal" input prices, with corn at $5 per bushel, soybean meal at $300 per ton and hay at $150 per ton. Under current conditions, pork producers appear to have experienced the sharpest increase in feed costs. According to the University of Missouri, if these price levels persist in 2013, feed expenses could rise to three times the 1990-2004 average and more than 70 percent above the 2007-2010 average.

Increased feed prices will force livestock producers to adjust to the changed economics in their industry. For example, some producers may choose to partially (or even fully) liquidate their herds as prices escalate. Higher livestock production costs will also be felt by consumers as the market seeks equilibrium. Typically, 15 to 20 percent of total food costs are driven by agriculture commodity prices, so total food inflation will not grow at the same rate as commodity prices. However, agriculture products

Rice

TABLE 4

Changes in Yield for Rice, 2011–2012

Rice	Area Harvested (1,000 acres)		Yield Per Acre (pounds)		Production (1,000 cwt)		Change in Production
	2011	2012	2011	2012	2011	2012	
Arkansas	1,154	1,280	6,770	7,200	78,100	92,160	+18.0%
Mississippi	158	123	6,850	6,900	10,823	8,487	-21.6
Missouri	128	177	6,490	6,700	8,308	11,859	+42.7
District States	1,440	1,580	6,752	7,121	97,231	112,506	+15.7
U.S.	2,618	2,677	7,067	7,334	185,009	196,318	+6.1

SOURCE: USDA's September 2012 Crop Production report

Arkansas remains a national leader in rice production, accounting for nearly half of all U.S. production. Overall, the U.S. rice crop is small. Strong foreign competition limits exports. Much of the land used in rice production is irrigated, which gave the crop important protection from this summer's drought. The USDA forecasts a record-high yield of 7,334 pounds per acre nationally, which could result in downward pressure on rice prices.

with relatively less processing, such as protein, tend to have a higher rate of price pass-through to consumers. Consequently, meat and dairy products have higher correlations between farm prices and consumer food prices than fruits and vegetables do.

Impact on Agriculture Bank Performance

Ultimately, it will be important to determine how the 2012 drought could impact the performance of the 147 agriculture banks headquartered in the Eighth District. Given that banking performance data are reported only on a quarterly basis, it will be important to track agriculture bank performance over the next few quarters to truly begin to ascertain the impact—which the most recent data do highlight going into the summer drought. Agriculture banks with less than $10 billion in total assets appear well-positioned to handle some of the stresses in the agriculture sector. For example, through the second quarter of 2012, agriculture banks exhibited high profitability (as measured by return on assets) and strong asset quality (as measured by nonperforming loans and other real estate owned to total loans and other real estate loans). Year-over-year performance of District agriculture banks and their national peers has also been remarkably consistent. This suggests that most agriculture banks, on average, have an appropriate financial buffer to withstand the impacts of the drought this year. (See Table 1 on Page 1.)

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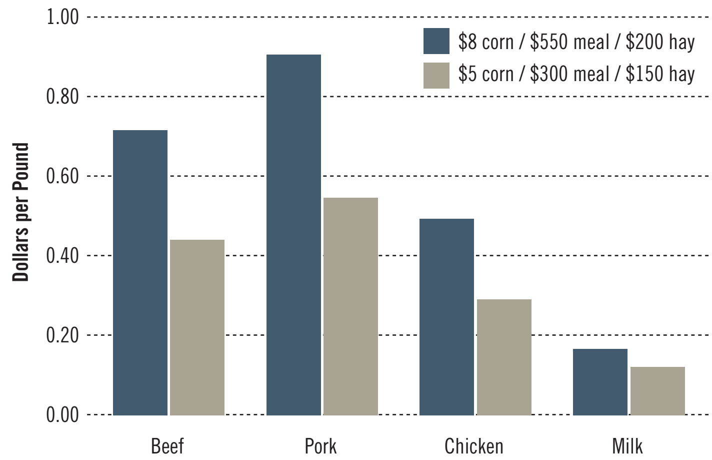
FIGURE 1

Feed Costs



SOURCE: University of Missouri Food and Agricultural Policy Research Institute, *2012 Drought: Considerations for Animal Agriculture*, Aug. 3, 2012

Cotton

TABLE 5

Changes in Yield for Cotton, 2011–2012

Cotton	Area Harvested (1,000 acres)		Yield Per Acre (pounds)		Production (1,000 bales)		Change in Production
	2011	2012	2011	2012	2011	2012	
Arkansas	660	580	929	993	1,277	1,200	-6.0%
Mississippi	605	460	952	991	1,200	950	-20.8
Missouri	367	330	969	945	741	650	-12.3
Tennessee	490	375	796	755	813	590	-27.4
District States	2,122	1,745	911.8	932.5	4,031	3,390	-15.9
U.S.	9,461	10,443	790	786	15,573	17,109	+9.9

SOURCE: USDA's September 2012 Crop Production report

In general, cotton production is expected to be down across all District states because of the fact that less acreage was planted in 2012 than in 2011. Nationwide, cotton production is up, however, which is expected to lead to downward pressure on cotton prices. Prices were already somewhat depressed because of record-high price levels in 2011. Sharply increased world cotton acreage placed downward pressure on prices in 2011.

Drought's Impact

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Similar to the situation for agriculture banks, recent years of strong farm income will likely provide many farm operators with an appropriate financial buffer to withstand the impacts of the drought. Bankers with good risk management practices are positioned to identify problems by identifying the level of crop insurance in place and ensuring that files contain appropriate documentation. It would not be surprising to see some ancillary businesses, such as equipment dealers, experience near-term sales declines because of a more cautionary spending approach on the part of farmers. Given the rise in feed costs, lenders with high exposure to livestock production may encounter greater challenges over the next few months.

Summary of the Drought's Impact

Despite historic drought conditions, crop producers and lenders in Eighth District states appear likely to exit the year in satisfactory financial condition. Additionally, crop producers in some states have actually been able to maintain their yields throughout the drought and may even experience a windfall as a result given record-high prices, particularly for corn and soybeans. Since the majority of crop producers also have crop insurance, it appears likely that many crop producers will be able to offset a portion of any lost revenue.

The situation is somewhat different for livestock producers, as higher feed costs and the loss of hay from destroyed pastureland are impacting their cost of doing business. Some producers have already culled their herds in response to these higher input costs, which will likely increase the prices paid by consumers. Even if drought conditions ease by the next growing season, decisions made today, particularly in regard to herd size, may have a more lasting effect. Ultimately, the impact on agriculture banks will become more apparent over the next few months as drought insurance claims are submitted and final payments determined.

Gary Corner is a senior examiner at the Federal Reserve Bank of St. Louis. *The author thanks Daigo Gubo for his assistance.*

ENDNOTES

1 www.fapri.missouri.edu/outreach/publications/2012/FAPRI_MU_Report_06_12.pdf

2 Community banks are defined as those having $10 billion or less in total assets.

3 These are community banks with agriculture real estate and production loans making up 25 percent or more of total loans.

Central View

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correlation between reported lender expectations in its surveys and future loan repayment rates and collateral requirements.

The inaugural St. Louis Fed survey was conducted June 15 to June 29, 2012, and was based on the responses of 88 agricultural banks located within the boundaries of the District. The next survey, which is now under way and will be released in mid-November, includes two additional questions about the percentage of loans covered by crop insurance and the expected impact of drought on farm incomes.

Are Covered Bonds an Alternative to Asset-Backed Securities?

U.S. retail investors were permitted to purchase covered bonds for the first time during the spring when the SEC allowed the Royal Bank of Canada to register and publicly sell covered bonds in the U.S. market. Previously, only "qualified institutional investors" were permitted to purchase covered bonds. Meanwhile, separate bills now in the House of Representatives and Senate seek to establish a legal framework for covered bond issuance by U.S. banks. Why is there now a legislative effort to establish a covered bond market in the United States?

Covered bonds have attracted the attention of U.S. lawmakers in the aftermath of the financial crisis primarily as an alternative to asset-backed securities (ABS), which have been widely blamed for providing perverse incentives to loan originators and fueling the recent housing bubble. Securitization, or the process of creating ABS by packaging assets together (such as loans) and selling their payment streams, potentially engenders a principal-agent problem. The principal-agent problem occurs when one party (the agent) is charged with making decisions on behalf of a second party (the principal) but the agent is not fully incentivized to act in the principal's best interest.

Senior research associate Brett Fawley and economist Luciana Juvenal of the St. Louis Fed explore covered bonds in an *Economic Synopses* published earlier this year. They explain covered bonds, the motives for legislating a market for them, and the pros and cons of covered bonds versus ABS.

>> **MORE ONLINE**

"Coming to America: Covered Bonds?" by Brett Fawley and Luciana Juvenal
http://research.stlouisfed.org/publications/es/article/9362

DIALOGUE WITH THE FED

Beyond Today's Financial Headlines

November Dialogue To Look at the Emerging Giants of India and China

The St. Louis Fed's popular "Dialogue with the Fed" discussion series for the general public continues on Nov. 13 with "Emerging Giants: Perspectives on India and China."

This dialogue will be hosted by B. Ravikumar, vice president, and YiLi Chien, senior economist, both with the St. Louis Fed's Research division. Cletus Coughlin, senior vice president and policy adviser to the Bank's president, will moderate the question-and-answer session after the presentation. A reception with light refreshments will start at 6:15 p.m. with the presentation beginning at 7 p.m. Register now at www.stlouisfed.org/dialogue

Watch the Series Online

Did you miss any of the previous sessions? Visit www.stlouisfed.org/dialogue to see the videos and presentations from:

OCT. 1, 2012	"Robo-signing, the London Whale and Libor Rate-Rigging: Are the Largest Banks Too Complex for Their Own Good?"
MAY 30, 2012	"Deuda Soberana: Una Tragedia Griega Moderna"
MAY 8, 2012	"Sovereign Debt: A Modern Greek Tragedy"
NOV. 21, 2011	"Understanding the Unemployment Picture"
OCT. 18, 2011	"Bringing the Federal Deficit Under Control"
SEPT. 12, 2011	"Lessons Learned from the Financial Crisis"

A full report on the Oct. 1 and Nov. 13 Dialogue sessions will appear in the winter 2012 issue of *Central Banker*.

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