Current Trends in Commercial Agriculture
Statement of
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Consolidation in the Farm Credit System
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Good morning! Chair and Chief Executive Officer Dr. Jill Long-Thompson, Kenneth Spearman, Leland Strom, and invited guests, my name is Alton Thompson, Provost and Vice President for Academic Affairs at Delaware State University. I am also a member of the Board of Directors of Carolina Farm Credit, an affiliated Agricultural Credit Association (ACA) of the AgFirst Farm Credit Bank. I would like to thank you for this opportunity to share my thoughts at this symposium relative to the factors influencing consolidation as it relates to current trends in commercial agriculture and the potential impact on the mission of the Farm Credit System.

I would like to begin by associating myself with the comments of Mary Ahearn of the USDA/Economic Research Service and Paul Ellinger, Head and Professor of Agricultural and Consumer Economics at the University of Illinois.

I thank you, the Farm Credit Administration, for your focused and strategic efforts to work with the farm credit banks and the affiliated ACAs as we provide real estate and production financing to nearly one-half million of the nation's farmers, ranchers, agribusinesses, rural homeowners, agricultural cooperatives and rural communities.

As I considered my discussion topic, and in conversations with Mary and Paul, I am going to spend a few minutes talking about a few trends with emphasis on commercial agriculture, primarily in the southern and eastern regions of the U.S. and its ramifications and impact for the Farm Credit System in terms of consolidation. As was mentioned by Mary and Paul, we are defining commercial agriculture, not necessarily as large-scale production of crops and livestock for sale intended for widespread distribution to wholesalers or retail outlets, but farm operations of all sizes and types. In addition to the research studies cited, my comments are based, in part, on discussions among fellow association directors in the board room and in the halls at the annual meetings of the Farm Credit System.

As a backdrop to my discussion, in 2013, the national economy grew at a 2.5% annual rate. Consumer spending has accelerated at about the same pace during the year. Some lingering effects of the “Great Recession” continue to have an impact as can be evidenced by the lackluster growth. However, some financial progress is being made. Many businesses, including agribusinesses, continue to improve their financial health through lower expenses and becoming more profitable. Additionally, households have been working down debt burdens and saving more. Most economists forecast the GDP growth at 2-3% for 2014.

The USDA Economic Research Service forecasted 2013 net farm income to be up for the second year in a row at over $131 billion. These data represent all-time record levels of farming income. In terms of farm structure, over the last three decades, the number of farming operations has remained relatively stable at 2.2 million. Production, however, has shifted to larger farms which have a competitive advantage over smaller farms in most commodities. The reason for this is the average cost of production per unit declines as the size of the operation grows which is referred to as economies of size. However, this relative stability masks several shifts in the distribution of production and significant growth in the amounts of goods and services produced by the agricultural sector. From 1991 to 2007, the percent of very large farms (those over $500,000 in inflation-adjusted annual sales) has grown from 2.6 to 4.8. Their share of total U.S. production grew from just over a fourth to nearly half. At the other end of the spectrum, small commercial farms accounted for a third of farms in 2007, down from half of all farms in 1991. Small commercial farms’ share of production declined from about 40 percent to just over 20 percent, mirroring the rising share of production on very large farms (O’Donoghue *et al*, 2013).

A clearer picture of the increasing concentration of production on larger farms can be seen by looking at the farm size for which half of all acres harvested (or animals raised) is on larger farms and half is on smaller farms. For example, in 1987, half of all hogs was produced on farms that sold 1,200 head or more. By 2007, half of all hogs sold was from farms that produced 30,000 head or more--an increase of 2,400 percent over 20 years. In addition to hog operations, the increasing dominance of confined animal feeding operations and a growing reliance on production contracts (11% in 1969 to 40% in 2008) have contributed to the growth of large, specialized poultry and dairy operations (O’Donoghue *et al*, 2013).

In addition, the shift in production to very large farms partly reflects technological advancements in farming. Production of hogs, fed cattle, poultry, and milk, for example, moved into climate-controlled buildings, which reduced the impact of weather. Improvements in disease control, handling, transport, and nutrition increased the number of production cycles per year. These advancements helped standardize production, making it easier for livestock producers to operate on a large scale. Technological factors, such as the development of larger and faster equipment, information and Global Positioning System (GPS) technologies, and more routine pest control through genetically modified seeds expanded the crop acreage that producers could effectively control (Hoppe, 2010; O’Donoghue *et al*, 2013).

It should also be noted that small commercial farms are profitable and still account for a considerable share of production for some commodities: 55 percent of poultry, 40 percent of hay, 37 percent of other livestock (largely grazing animals other than cattle), and 30 percent of tobacco, a crop with a long history of production on small farms. In addition, small farms' share of beef production—largely from cow/calf or stocker enterprises—and grain and soybean production was similar to their 22-percent share of all production (Hoppe, 2010).

Because of the higher average returns realized by large farms, competitive forces will likely continue to reduce the number of small commercial farms and shift production to larger farms. Natural life-cycle processes will reduce the role of small commercial farms over time since so many of their operators are currently at least 65 years old (Hoppe, 2010).

The dual structure of agriculture, notwithstanding, there still remains a huge place in the market for that middle scale grower in all of the commodity groups. The integrator community fully understands that everyone is not going to want to build multiple units of a commodity and leverage assets in the millions. Additionally, disease control dictates that there remains a huge market in the middle, whereby agricultural integrators actually prefer some middle scale operations spread out over a larger geographic area, simply to control disease risks.

To Consolidate or Not to Consolidate?

Before discussing the benefits and drawbacks of consolidation of the Farm Credit System, a brief overview of the fundamental causes and effects of consolidation may be useful.

Critics contend that consolidation restricts the availability of credit to beginning young small farmers, and specialty crop farmers, for it reduces the quality of servicing loans, increases the complexity of the bank, which can raise transaction costs, and lead to greater inefficiency, thereby reducing the competitiveness in local markets. In addition, consolidation allows for a monopolistic control of real estate and production financing along with other credit services. However, evidence, although somewhat inconclusive, suggests that consolidation greatly increases the diversity of commercial banks' loan portfolio (or broader array of financial services). It also expands overall lending capacity and may provide benefits for better diversification of assets and liabilities. Moreover, it increases profitability and shareholder value, spreads overhead costs, and provides a wider scope of products and services. Then, there are benefits produced from scale economies that follow from the consolidation of administrative costs and back-office operations. Finally, there will be consolidation of branches following bank mergers when bank branching networks overlap (Hughes *et al*, 1998; Jones and Critchfield, 2005)

Consolidation should allow banks and associations to exploit economies of scale in their service centers. In a study conducted by the Wharton School of Business, the benefits of consolidation were called into question by citing a number of empirical studies that reported inconclusive findings. In an article published by the Federal Reserve Bank of San Francisco, Furlong found little evidence that merged banks improve cost efficiency relative to other banks. (Eliminate excess capacity in areas like data processing, marketing or overlapping branch networks.) However, relative to enhancing revenues by adjusting output (products) mixes to enhance revenues, research does show that bank mergers do tend to be associated with improvements in overall performance, in part, because banks achieve higher valued output mixes. One example is banks shift toward higher yielding loans and away securities. Synthesizing the market-value approach with the production-based approach, researchers at the Wharton School of Business also found that banks that consolidated experienced clear gains in financial performance and tended to have benefitted from enhanced safety, i.e., insolvency.

The empirical evidence clearly shows that there is no single reason for the consolidation trend and no single underlying cause. Rather, the trend might best be viewed as the result of the globalization of the marketplace, technological changes, deregulation, and macroeconomic factors. Briefly, globalization, in tandem with information technologies, affected nearly every aspect of the business of banking: the demand for banking services, the character and intensity of sector competition, and the very structure of the industry.

Dramatically lowered costs and the ability to transmit information almost instantaneously around the globe effectively made the financial services industry less time and space dependent. In the new knowledge-based global economy, banks, other financial institutions, and individual investors were able to transfer huge amounts of capital around the globe with one click of a mouse. Yet, while these new technologies enabled financial firms of all types to engineer new products and implement new technologies to manage risk, they also resulted in a sharply more competitive marketplace for banking and financial services. To survive and prosper, banking organizations needed to respond to this new environment. Consolidation was one response. Following deregulation of the banking industry to be more responsive to marketplace realities, consolidation accelerated. Macroeconomic factors (floating exchange rates, increased volatility of interest rates, oil price shocks, precipitated series of rolling regional recessions) also played an important role in consolidations (Jones and Critchfield, 2005).

As the largest agricultural lending organization in the U.S, the Farm Credit System is affected by these same trends (globalization of the marketplace, technological changes, deregulation, and macroeconomic factors) and has responded in a similar manner, in large part, because of congressional action in 1987.

In terms of the Farm Credit System, over the past 20 years, the number of regional banks has decreased from 9 to 4, while the number of associations has decreased from over 200 to 78. The Farm Credit System provides nearly $175 billion in loans, leases, and related services (more than one-third of the credit needs) to farmers, ranchers, rural homeowners, aquatic producers, timber harvesters, agribusinesses, and agricultural and rural utility cooperatives. A question to be vetted at this well-timed symposium is should we continue to consolidate, and if so, how much more consolidation is needed in the FCS's search for competitive excellence in meeting the credit needs of agriculture and other key sectors in the nation's rural economy?

One would expect that globalization, technology, and deregulation should have resulted in increased competition, greater efficiencies through economies of scale, increased profits, and a greater return to shareholders. As stated above, to the extent to which these occurrences have actually happened, the research studies are mixed. On the positive side, findings suggest that consolidation has resulted in somewhat greater profit efficiency. On the negative side, researchers have not been able to identify any of the broad-based improvement in cost efficiency that one might have expected from economies of scale. In addition, FDIC researchers found little evidence that either consumers or shareholders have benefited from consolidation in the banking industry. There is, however, growing evidence that increases in market power at the local level may be adversely affecting consumer prices.

Concluding Remarks

Contrary to the prevalent beliefs that larger farmers are more likely to work with commercial banks and not farm credit, that farm credit is fueling its own demise by lending to operators who become larger and larger, and that farm credit is lending in ways that pushes concentration, which in turn, pushes their customers into commercial banks, these larger operators are more likely to stay with farm credit. While the banking industry likes those large loans, evidence shows that farm credit still does quite well competing for this business. These data also show that Farm Credit System needs to improve on its performance relative to serving the credit needs of small farmers, those farms with gross cash income less than $10,000.

One of the core values of the Farm Credit System is excellent customer service with a focus on relationship building and "sticking with farmers during the down cycles." In talking with association directors around the country, I believe that customer service is one of the System's "hedgehogs" and supports its value proposition to provide access to a competitive source of credit to meet the needs of its owners and customers. Another strength of the Farm Credit System is the mature and visionary leadership at the administrative staff and board levels.

The impact of consolidation on bank structure has been obvious while its impact on bank performance has been harder to discern. There remains uncertainty about the importance of the various factors behind the merger trend but also about the effects of consolidation on banks' stockholders. The connection to cost efficiency, in particular, remains tenuous. However, recent studies accounting for the combined effects of adjustments affecting costs and revenues suggest that mergers have had a positive effect on bank performance.

Regardless of the trends in commercial agriculture, before we fully understand either the causes of consolidation in the Farm Credit System or its ramifications, more work need to be done, particularly at the association level. Although the early impact of the recent merger between CoBank and U.S. AgriBank is positive, as manifested most succinctly by the key financial ratios, we need to continue to monitor the impact on farmer-borrowers at the local or district level.

Finally, since FCA has not ruled unfavorably (to my knowledge) on any proposed merger, I reviewed the FCA application instruments designed to capture the requisite data needed to make decisions about whether or not to merge or consolidate banks and associations. I wanted to determine the extent to which the right questions were being asked or whether the right information was being requested. I have to admit that the application instruments were well-designed, quite comprehensive, sufficiently detailed, and contained a robust section to be completed by the association board of directors, who are disproportionately farmers. Based on my experience, these farmer-directors are quite knowledgeable and articulate relative to all aspects of their farm operations (and other farm operations in their communities or districts), including both the internal and external factors affecting financial performance/viability. In addition, given their demonstrated commitment to agriculture and rural America, I am quite comfortable with their recommendations to FCA related to mergers and/or consolidations.

Again, thanks for the invitation to share my views.

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