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Could Prices of Farmland be the Next Big Bubble?

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WASHINGTON — When regulators come knocking at the Bank of Newman Grove, Neb., inquiring about loan risks, Chairman Jeffrey Gerhart has a "stress test" ready to show how his portfolio would fare if rural land prices dropped 25 percent. Or 50 percent. Or 75 percent.

"I hope it's not going to go to heck in a handbag out here, but this allows us to look at those worst-case scenarios," said Gerhart, a fourth-generation banker in the 800-person town two hours west of Omaha, deep in the heart of Nebraska's corn and soybean belt. He began stress testing his bank's assets, about 90 percent of which are agricultural, in the last two years after prodding from staffers at the Federal Reserve Bank of Kansas City.

Farmland prices in Nebraska rose 30 percent in the second quarter from a year earlier, according to a survey by the Kansas City Fed, driven by soaring farm income from elevated agriculture commodity prices and record-low interest rates. That's the high end of increases in cropland valuations of 8 percent or more throughout the region stretching from Oklahoma to North Dakota and from Nebraska to Michigan, according to surveys by three Federal Reserve banks. The Fed banks — Kansas City, Chicago and Minneapolis — oversee about three-quarters of the nation's farm banks.

Regulators and bankers like Gerhart are trying to use smarter policies and better information to prevent this asset price surge from forming what Yale economist Robert Shiller called his "dark-horse bubble candidate for the next decade."

Examiners at the regional Fed banks and the Federal Deposit Insurance Corp. are scrutinizing the lending standards, concentration levels, and loan documentation and risk management practices at the country's 2,144 farm banks. Risks that could curb the frothy farmland prices include a punishing drought in some states and volatile global commodity markets that could plunge and strip away crop income.

Low interest rates pose another threat, former Kansas City Fed President Thomas Hoenig has warned. Hoenig dissented against all eight decisions of the Federal Open Market Committee last year, citing concern that an "extended period" of near-zero interest rates could lead to a "build-up of future imbalances" such as asset bubbles, and create risks to "financial stability."

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Shiller’s warning has the Fed on guard, based on interviews with Fed regulators, economists and policy makers. His prediction of a national housing bubble in a 2005 revised edition of his book “Irrational Exuberance” proved prescient. Regulators missed the risks in residential and commercial real estate that led to a financial crisis, the longest and deepest recession since the Great Depression, 9.1 percent unemployment and nearly 400 bank failures since 2008.

That concern affects farm bankers like Gerhart, who employ new tools to help assess risk. “Stress testing is the buzzword of the last couple years,” said Gerhart, who evaluates how his assets would perform in a downturn using a bank lending software package from WebEquity Solutions in Omaha, Neb.

Gerhart’s tests show that if land prices dropped 25 percent or 50 percent his bank’s loans should not be negatively affected. A 75 percent drop would “have an impact,” he said.

The risks of a farmland bubble have been highlighted in a series of sessions held by regulators this year. The Farm Credit Administration hosted a roundtable in February. The FDIC sponsored a “Don’t Bet the Farm Symposium” in March. In July the Kansas City Fed organized a conference on “Recognizing Risk in Global Agriculture.”

Attendees at the Kansas City conference included officials from the FDIC, the U.S. Department of Agriculture, the Office of the Comptroller of the Currency, Farm Credit Administration, and the Federal Reserve banks of Minneapolis, Chicago, Dallas and the Fed’s Board of Governors. The group considered questions like what would happen if crop prices fell by half, if government subsidies for agriculture or ethanol disappeared, or if land prices tumbled by 30 percent or more.

“It’s not that we think this is going to be the most likely outcome,” Jason Henderson, the Kansas City Fed’s lead agricultural economist, said in an interview. “It’s a discussion of the black swans and fat tails — the low probability events that catch people off guard.”

Henderson runs the Kansas City Fed’s Omaha branch and leads several of the Fed’s efforts to track the rural economy. He has encouraged supervisors across the central bank’s system to monitor the capitalization rate of farmland, or the income from land divided by its capital cost.

"Are they going to resist that temptation of low interest rates and strong incomes and keep leverage low?" he said. "It's the next couple of years that are going to be key to determining that future of agriculture."

Soybean prices at $11.64 a bushel and corn at $6.06 a bushel, though lower than in August, remain above their decade-long averages of $8.31 a bushel and $3.27 a bushel respectively. The Department of Agriculture said Aug. 30 that farm income will jump 31 percent this year to a record $103.6 billion.

These estimates were made even with drought conditions in much of southern Kansas, Oklahoma and Texas, the three biggest U.S. growers of hard, red winter wheat used to make bread. The states have had less than half of normal rainfall in the past 90 days, National Weather Service data show.

The Fed's Beige Book, an anecdotal survey of economic conditions released on Sept. 7, reported that "farmland values rose further" in several districts even as "harsh summer weather strained agricultural activity."

The growth in demand for food, spurred by the rising middle class in China, India and other emerging markets, is likely to continue. Even with signs of a slowing economy in the U.S. and globally, the United Nations Food and Agriculture Organization said overall food prices in August were only 2.8 percent below their peak in February.

Consequently farmland prices are booming, according to regional Fed surveys. Values were 20 percent higher in the second quarter than a year ago in the district of the Kansas City Fed, which oversees 614 agriculture banks. The Chicago Fed, which oversees 538 banks, reported a 17 percent increase for the same period in its district, the most since the 1970s. Non- irrigated farmland in the Minneapolis Fed district, which oversees 393 banks, increased 13.9 percent.

By comparison, at the peak of the housing bubble, real estate prices were rising 17 percent year over year, according to the S&P/Case-Shiller index of property values in 20 cities.

Hoenig cited Fed interest-rate policy as being "an important factor" in the runup in farmland prices during an interview last month.

In the early 1980s the bubble burst and land prices notched annual drops of more than 10 percent in four of the next five years. The aftermath forced thousands of farms into foreclosure, pushed small towns to the brink of depression and brought down 347 banks in the Kansas City Fed's district from 1982 to 1992.

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Memories of the 1970s bubble and bust have made regulators and bankers more cautious this time, said David Oppedahl, a business economist at the Chicago Fed who compiles the bank's AgLetter. "It just doesn't seem like it's the same set of circumstances because the farmers remember that time period, and lived it, and so have a lot of the bankers and regulators," he said. "You have some experience that is helping to keep people from going too far from what they can afford to do in their plans."

In a survey at the end of 2010, lenders reported to the Kansas City Fed that loans were between 50 percent and 90 percent of the value of the land, with an average of just over 70 percent. Higher loan-to-value ratios pose greater risk to lenders. At the peak of the housing bubble, by comparison, the National Association of Realtors reported in 2006 that more than 40 percent of borrowers put no money down for loans, a loan-to- value ratio of 100 percent.

On occasion bankers have found the regulators to be over- zealous, said John Blanchfield, who runs the ABA Center for Agricultural and Rural Banking at the American Bankers Association.

"The FDIC is convinced there's a bubble and they're not going to miss this bubble, by God," he said. Regulators are concerned about banks' concentrations of agriculture loans, he said. "How are these bankers supposed to respond to that? Every direction in 500 miles from their bank is corn fields."

Blanchfield notes the "manic" tone of some stories about agriculture, such as a July 10 article in Time magazine titled "Want to Make More than a Banker? Become a Farmer!"

"When I saw that I said 'the farm boom is over' because now Time is reporting it," he said, referring to a common belief that favorable coverage in mainstream magazines can signal that an investment or asset has peaked.

Far from Wall Street's gyrations and Washington's impasses, Newman Grove's Gerhart believes he is prepared for whatever may come for the $35 million bank.

"We're used to prices going up and down like a Boone County road, a county west of us that's pretty hilly," he said. The new stress testing "better educates the banker, the borrower and the examiner so we are all on the same page."--With assistance from Kathleen Hays in New York.

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