TESTIMONY
Presented to the Committee on Agriculture
Subcommittee on General Farm Commodities and Risk Management
U.S. House of Representatives
Commodity in Focus: Stress in Cotton Country
by
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DECEMBER 9, 2015

Chairman Crawford, Ranking Member Walz, and Members of the Subcommittee, thank you for taking time to host this important hearing on the general state of the U.S. cotton industry. My name is Mike Wright, Executive Vice-President of the agricultural lending division of City Bank in Lubbock, Texas.

Background

City Bank is a locally owned bank with assets in excess of $2 Billion with an agricultural loan portfolio of about $200 Million, which is of just over 11% of the total borrowing. I was born and raised on a Lubbock County cotton farm, farmed for 8 years and have been involved with ag lending since March of 1982. Agriculture is my background and my lifeblood.

Current Market Situation

Texas is the largest cotton producing state, with about 54% of the total U.S. cotton acreage. In Lubbock and the surrounding 67 county area, cotton is the main economic industry with about 20%-25% of U.S. cotton produced in this region. Cotton production is extremely important for the survival of many rural economies across Texas. Only 4.8 million acres of cotton were planted in 2015, down 30% from 2014 and 24% less than the recent 5 year average. The 2015 cotton acreage is the lowest amount in Texas since 1989. Excessive rains plagued much of the state during planting time and according to the Farm Service Agency, Texas had almost 400,000 prevented planted cotton acre this year.

Losses in cotton area are a tremendous concern for agricultural lenders as this translates into pressure on associated businesses, infrastructure and rural economies who are also our customers. Prolonged production declines of this scale will result in severe strain on the entire cotton infrastructure, which continues to be the backbone of many small, rural communities across Texas. A thriving cotton economy is critical to the success of many local economies.

Low prices and high production costs have created tremendous financial pressure on the agricultural industry. As the 2015 harvest nears completion, producers across Texas are facing incredibly difficult economic conditions. According to a survey by the Federal Reserve Bank of Dallas[1], many Texas cotton growers may actually fare better in earlier drought years than in

[1] Federal Reserve Bank of Dallas. "Special Report: Commodities and Drought." Agricultural Survey. Third Quarter 2015. Available at: https://www.dallasfed.org/assets/documents/research/agsurvey/2011/ag1103b.pdf.

2015. Production costs have been even higher this year as increased rainfall led to additional weed problems. In some areas, excess moisture has negatively impacted yields. In 2011 and 2012, crop insurance guarantees were higher due to much higher prices. This year, crop insurance guarantees are lower and many producers have average yields that will not trigger a crop insurance indemnity. In addition, some producers are dealing with quality issues that will likely result in further discounts to the price they receive for cotton. The projection of continued declines in market revenue coupled with elevated production costs cause serious concerns among the lending community.

Current Lending Situation

In this economic environment, access to credit remains one of the most important resources for agricultural producers. However, with increasing debt and tighter margins, agricultural lenders are facing a tough situation. According to the Federal Reserve Bank of Dallas[2], demand for agricultural operating loans has increased in the third quarter of 2015 and loan repayment rates have slowed. After two years of declining farm income and few expectations for higher commodity prices in the near future, one of our most significant problems at City Bank is getting a producer's loan to show a positive cash flow. The margins in agricultural production have been getting tighter every year due to higher production costs and lower commodity prices. Producers need above average yields just to break even. There is no doubt that some cotton farmers will not qualify for financing next year. We are concerned about our ability to continue to meet the lending needs of America's cotton farmers in years to come. Going into the next crop year, the ability to obtain financing will become increasingly more difficult as crop prices remain low.

Production costs have continuously increased over the last decade. According to Texas A&M extension, production costs have increased by about $72 per acre for non-irrigated cotton and $169 per acre for irrigated cotton since 2008. The increase in seed costs is particularly concerning now that producers are experiencing more problems with chemical resistant weeds. Harvest expenses have increased as well due to a large increase in equipment costs. Cotton is a highly capital intensive crop requiring a much higher investment in equipment as compared to other row crops. A new cotton harvester costs $650,000. Term debt service on these types of inputs is extremely high. With low cotton prices, the cash flows have become much tighter and the margins are even lower. For 2015, the Texas A&M extension budgets show a loss of $18 per acre on dryland cotton and $85 per acre on irrigated cotton.

Looking ahead to 2016, were are anticipating potential cash flow problems from some of our very good customers with a long history with our bank, including producers who are not highly leveraged. The increased short-term debt burden coupled with two years of declining farm

[2] Federal Reserve Bank of Dallas. "Agricultural Survey: Survey Highlights." Third Quarter 2015. Available at: https://www.dallasfed.org/assets/documents/research/agsurvey/2015/ag1503.pdf.

income is particularly concerning. Although some producers will still have some equity position going into 2016, lower grades of cotton and lower prices may lead to a carryover of debt for 2015. With low price expectations for 2016 and carryover debt, these producers may not be able to show a positive cash flow in 2016.

To further intensify the situation, lenders are currently facing even tighter underwriting standards. New banking regulations require a more stringent stress-testing approach and the ability to show a positive cash flow. As noted by an extension economist at Texas A&M, as implementation of additional reform measures continues, credit standards will be higher and the requirements for risk-based capital liquidity will increase[3]. As lenders face stricter standards for loan underwriting, credit analysis, and loan risk rating from bank examiners, the ability to extend riskier loans will be less likely.

Importance of Government Programs

The importance of FSA guaranteed loans cannot be understated in the current economic and lending environment. City Bank is an FSA Preferred Lender in the Guaranteed Loan Program. FSA guaranteed loans provide lenders with a guarantee of up to 95 percent of the loss of principal and interest on a loan. Farmers and ranchers apply to an agricultural lender, which then arranges for the guarantee. The FSA guarantee permits lenders to make agricultural credit available to farmers who do not meet the lender's normal underwriting criteria. Over the years, the Guaranteed Loan program has been a tremendous benefit to the producers as well as to lenders. There have been times when a producer has had a terrible year and maybe his loan is still a good loan but weak in one or more areas of our analysis. The Guaranteed Loan Program allows City Bank to continue working with the producer but a portion of the loan is guaranteed and the producer has some time to work out the situation. Over the years, we have had many producers on guaranteed loans who have been able to work their way back to a direct City Bank loan following a good crop year. As it stands today, City Bank will be utilizing the program even more for 2016. Continued funding for the Guaranteed Loan Program with no additional cuts is a high priority for the agricultural industry.

The elimination of direct payments and counter-cyclical payments significantly increased the risk endured by agricultural producers and lenders. Direct payments provided a reliable source of income for loan repayment. In most cases, direct and counter-cyclical payments would be included as profit in the farming operation and would allow a farm to cash flow and continue farming. As cotton prices have been suppressed in part due to agricultural policies in other major cotton producing countries, U.S. cotton producers are struggling to service their debt and make a profit. While other commodities have a substitute program in the 2014 farm bill, cotton is no longer a covered commodity under Title I programs, so the safety net is entirely comprised of the marketing loan and crop insurance programs. The marketing loan program provides important collateral for lending and is a vital component of the cotton safety net. The proposed

[3] Klinefelter, D. "Back-to-Back Low Returns Bound to Raise Flags with Farm Lenders." AgFax. May 14, 2015. Available at: http://agfax.com/2015/05/14/back-to-back-low-return-years-bound-to-raise-flags-with-farm-lenders-dtn/.

addition of marketing loan certificates would help alleviate some of the financial pressures faced by our growers.

We greatly appreciate the continued support for the crop insurance program and the efforts to eliminate the proposed cuts to crop insurance. Crop insurance is a vital component of the safety net for cotton producers and any additional cuts would be detrimental to the cotton industry. Crop insurance provides assurance to lenders that farmers can repay their operating loans. We appreciate the addition of the STAX program to provide additional risk management for cotton producers. However, due to the uncertainty in area-wide payments as well of the timing of payments, it is difficult to factor a STAX indemnity into loan repayment.

In Texas, 97% of cotton acreage is covered by an individual insurance policy. This area is extremely vulnerable to weather related problems and large temperature variations and weather extremes are very common, even within a 24 hour period. While agriculture has always been a risky business, the risks for cotton producers have been exacerbated in the past few years due to low prices, farm policies of other major cotton producing countries, 2014 farm bill changes to the cotton safety net, and now chemical resistant weeds. The increased risks for producers directly affects the ability to qualify for financing. If a producer has a good financial equity position, can obtain affordable crop insurance and receives government program payments that can be used for loan repayment, banks can use those tools for loan collateralization. Any increase in crop insurance premiums for the producer could greatly affect the affordability of insurance and the ability to secure financing as most lenders will require crop insurance.

Policy Needs

Producers across the cotton belt are struggling with the effects of low prices, weak demand, and growing competition from heavily-subsidized foreign producers. The infrastructure for the U.S. cotton industry (gins, warehouses, marketing coops and merchants, and cottonseed crushers and merchandizers) will continue to shrink unless there is a stabilizing policy for cotton to help sustain the industry in periods of low prices such as currently exists today.

As you have heard from others, the National Cotton Council and other cotton industry organizations have developed a proposal to help bring some stability to the industry. This proposal is based on the administrative authority that Congress has provided to USDA in the current and previous farm bills that allows the Secretary of Agriculture to designate other oilseeds as eligible for farm program participation. We believe that cottonseed, which is an important co-product of cotton production, should be designated as an oilseed and defined as a covered commodity under this farm bill, making cottonseed eligible for the PLC/ARC program. The importance of cottonseed continues to grow, as it now represents about 25% of the total revenue or value from an acre of cotton production.

The addition of a cottonseed support policy will be important to ensure continued economic activity in rural areas that is based on cotton production and the associated activities to process, store, transport, and market cotton and cotton products. A cottonseed support policy could help alleviate the increasing financial stress of the cotton industry and allow for continued credit availability.

Without some stabilizing policy put in place for the cotton industry, given the current and projected prices and costs of production, we can expect to see a continued decline in Texas cotton acres and the associated infrastructure. As further evidence of the need for the cottonseed policy, at least 197 lenders across Texas have written to Secretary Vilsack urging him to take action on the cottonseed proposal to help address the deteriorating situation. The national Farm Credit Council, representing all the local farm credit associations, sent a similar letter outlining the current need for USDA to use whatever authorities available to assist the industry.

From a lenders point of view, it is imperative that actions be taken that can have a stabilizing effect on the U.S. cotton industry. We strongly recommend you use all authorities at your discretion to assist in this situation and specifically that you designate cottonseed as an ‘other oilseed’ for purposes of the Agriculture Risk Coverage and Price Loss Coverage programs. This designation would help bring much needed stability and support to producers, and in these times of low prices, allow them to have the balance sheets necessary to procure production financing.

As I close, let me express my sincere appreciation to the committee for allowing me to testify today. As you move forward I pray that you can show others of our legislature that agriculture is the backbone of this great nation. My family is dependent on it as well as yours. As you leave today, I would hope that you will take the following quote and have it somewhere you will see every day and remember the words: In 1896 William Jennings Bryan said it best, *“Burn down your cities and leave our farms, and your cities will spring up again as if by magic, but destroy our farms and the grass will grow in the streets of every city in the country.”* The American farmer is one of the most efficient producers in the world today. If they can continue to provide food and fiber at a price that allows the American people to spend the largest part of their income on homes, vehicles, televisions and phones, the American farmer will continue to do just that. But if there is no incentive or profit in their actions, then the grass will begin to grow.