



AGRICULTURAL LENDING

First National Bank of Shelby



PARTICIPANT PROFILES

The First National Bank of Shelby ("FNB-Shelby" or "the Bank") is located in Shelby, Nebraska and has approximately \$23 million in total assets. FNB-Shelby is a subsidiary of Pinnacle Bancorp, Inc., a bank holding company created in 1993 that owns 19 banks located throughout Nebraska, Colorado, Wyoming and Kansas, and has total assets of \$1.9 billion.

FNB-Shelby has become a significant agricultural lender in the central Nebraska region and also has become very aggressive as a residential mortgage lender. The Bank, which had only \$42,000 in residential mortgages in 1992, added an array of competitive mortgage products and programs and had, by year end 1997, increased its volume more than 70 times over its 1992 level, including FHA and VA loan

originations. The Bank also is a very active lender in federally guaranteed loan programs, such as the Farm Service Agency¹ and the Small Business Administration ("SBA"). Moreover, FNB-Shelby has established a diverse portfolio of consumer and community development loans, as well as having become more active in long-term, fixed rate agricultural real estate and acreage lending.

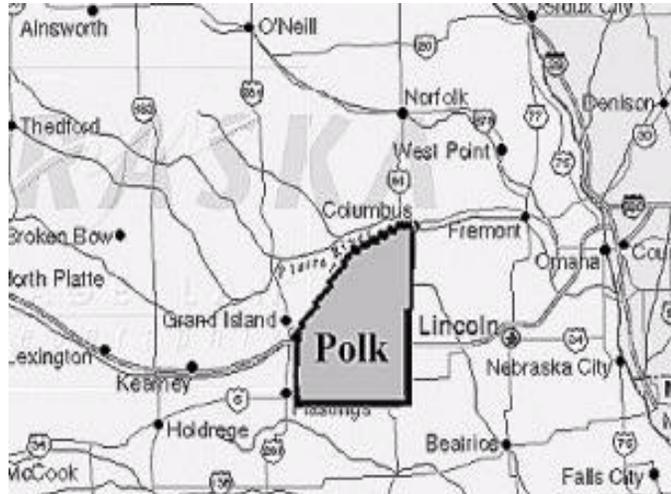
¹ The Farm Service Agency was formed during the Department of Agriculture's 1994 reorganization. It incorporates programs from several agencies, including the Agricultural Stabilization and Conservation Service, established by Congress in 1935 to give committees of local farmers a voice in how Federal programs are implemented in their counties. Programs from the Farmers Home Administration and the Federal Crop Insurance Corporation also were incorporated into the Farm Service Agency.

COMMUNITY BACKGROUND

FNB-Shelby's primary lending market is Polk County, located 83 miles west of Omaha, Nebraska. The U.S. Census Bureau estimates that Polk County's population as of 1997 was 5,628. Employment in Polk County is primarily concentrated in the agriculture

industry and a growing services industry. The 1990 census revealed that the county had a total labor force of 2,583 workers, with farm-related employment accounting for 710 of these jobs. The largest non-farming employer is the local government, which, in 1990,

employed 511. According to 1998 data from the U.S. Department of Housing and Urban Development, estimated median family income in Polk County is expected to be \$41,800. The Bureau of Business Research for the University of Nebraska-Lincoln estimates that the county's unemployment rate was 2 percent in 1995 and, as of April 1998, it may be as low as 1.6 percent.



Shelby, a town estimated in 1996 to have just 680 inhabitants – 10 fewer than the 1990 census – is located on the eastern edge of Polk County. The primary economic activities in Shelby are farming, cattle feeding, hog production, and retailing. There is very little manufacturing activity, but the service industry continues to grow. Since 1995, eight businesses have built or purchased and renovated buildings in the town. Public/private businesses, such as the FNB-Shelby, the Post Office, a senior/community center, and a public library, have enhanced the community and stimulated economic development.

Further economic development progress can be seen in the housing sector. Nine new homes were constructed during the past two years at an average cost of \$125,000. This was in stark contrast to the average cost of existing single family homes, which was only \$29,000. Of the new homes constructed, seven were single-family and two were duplexes. The town also has one low-income multi-family dwelling.

COMMUNITY NEEDS

In Shelby, agriculture is an integral part of every day life. Whether it is crops or livestock, agriculture-related businesses are essential to the area economy. The agriculture industry, however, is facing political and economic changes that are making local lending more complex and competitive. The 1996 Farm Bill imposed limits on federal spending beginning in 1996. While there was a slight increase in spending in 1996 and 1997, federal funding will decrease from \$5.8 billion in 1998 to \$4.008 billion in 2002.² Federal farm subsidies, which are being

reduced, provide both the farmers and the lenders with some sense of security. When land is farmed under price supports from the federal government, the farmer has a guaranteed market and a guaranteed price for a least a percentage of his crop. Without the price supports, lending becomes more difficult. An element of risk is added to a business that is already burdened with more potential pitfalls than most.

In addition to the uncertainties presented by reduced federal funding for farmers, banks

and thrifts are finding that a greater share of the farm market is being handled by nontraditional lenders such as insurance companies and mortgage companies. In addition, major machinery purchases are often being financed by the captive finance companies of the manufacturer. Just as many people find it convenient to finance a car with the manufacturer, at the point of sale, farmers are taking advantage of similar conveniences when purchasing tractors, combines, and other essential equipment.

Shifting public emphasis coupled with increased competition suggests that traditional lenders must make adjustments in order to maintain and expand their customer base. As a financial institution that is heavily involved in and focused on its community, FNB-Shelby determined to develop products and services that would give its customers more options and support the agricultural industry in the area.

In this new environment, FNB-Shelby recognized a need for comprehensive technical assistance, particularly for small or first-time farmers. FNB-Shelby's management indicated that in the late 1980s many financial institutions in the area focused on large borrowers and depositors. But it was often the small farmer, who generally wanted less than \$150,000 in financing, who needed flexible lending instruments and extensive technical assistance. FNB-Shelby, the only bank located in Shelby, has taken a hands-on approach to lending to small farmers who may be very good at farming but may lack the technical and analytical expertise necessary to ensure maximum profitability of the business.

² U.S. Dept. of Agriculture, "1996 Farm Bill Fact Sheet," April 1996.

BEST PRACTICE PROGRAM OR PRODUCT

Historically, FNB-Shelby has provided a limited line of short-term agricultural loan products to its customers. The Bank's agricultural loan portfolio consisted of loans for livestock purchases, crop production, equipment purchases and repairs, and administrative operating loans. These loans were typically one-year renewable lines of credit. However, beginning in 1992 FNB-Shelby made a concerted effort to diversify its loan products to meet the needs of small farmers in the community. Diversification required that the Bank take a full inventory of its loan portfolio and develop a strategy for extending additional credit to borrowers without putting its financial position at risk. A series of lending initiatives were undertaken and are described below.

As FNB-Shelby became more committed to agricultural lending, it became essential to establish new funding sources. As it turned out, the Federal Home Loan Bank of Topeka ("FHLB-Topeka"), had a number of products that the Bank could take advantage of for managing its liquidity position. The cyclical nature of agricultural lending makes sound liquidity management essential. A community bank that is loaned out during peak seasons will be unable to truly serve the needs of its community. Situations like that will force farmers to seek funding elsewhere. The Bank pledged its residential mortgage loan portfolio as collateral, enabling it to secure \$2.2 million in revolving credit from the FHLB-Topeka.

With the availability of funds from the FHLB-Topeka FNB-Shelby was able to make more loans to its customers and further stimulate economic growth in the community. Although the FHLB-Topeka program does not require lenders to track or report loan activity, the Bank estimates that \$1 million of the initial revolving line of credit has been extended to borrowers in the form of automobile loans, agricultural loans and real estate loans. FNB-Shelby's president credits the FHLB-Topeka's program with providing the Bank just the liquidity management tool necessary, at the right price, to enable the Bank to be more responsive to the needs of the community.

Another popular initiative for the Bank has been the First-Time Agricultural Real Estate Land Buyer Program ("Land Buyer Program"). In 1993, FNB-Shelby joined with the Nebraska Investment Finance Authority ("Finance Authority") and the Farm Service Agency to deliver affordable agricultural land purchase loans to first-time buyers. The Land Buyer Program is designed to encourage first-time farmers and ranchers to invest in the agriculture industry and economic development of the community.

The Land Buyer Program is primarily used to finance land purchases for agricultural production, such as crops and livestock. The major requirements of the Land Buyer Program mandate that the borrower (i) be a first-time agricultural land buyer; (ii) have less than 10 years experience as a farmer or rancher; (iii) have net worth of less than \$250,000; and, (iv) be substantially involved in farming the land. While the property financed using the Land Buyer Program may include a house, the value of the house may only account for 30 percent of the appraised value of the total property.

Each Land Buyer Program transaction requires three sources of financing. The borrower provides 10 percent of the purchase price as a down payment. Thirty percent of the financing is supplied through a direct loan from the Farm Service Agency, which receives a second lien position. The Farm Service Agency may charge a preferential interest rate of not less than 4 percent.³ As the lead lender, FNB-Shelby funds the remaining 60 percent and obtains the first lien position. Once the loan is closed, FNB-Shelby swaps the loan for a partially tax exempt bond from the Finance Authority. The terms of the bond are identical to the terms of the loan, and the loan proceeds are the source of repayment for the bond. The tax exempt status of some of the proceeds of the bond enable the Bank to offer a reduced rate on the loan while still earning a market rate of return on the entire transaction. The Bank currently offers a 30-year loan with a 10-year fixed interest rate of 6.25 percent. After the first 10 years, there is an adjustment feature that will increase the rate of interest to 25 basis points over the national prime rate.

In 1998, FNB-Shelby became active in originating agricultural loans for the secondary market utilizing an agreement with the Federal Agricultural Mortgage Corporation ("Farmer Mac"). The Farmer Mac agreement is important to the Bank because it (i) expands the Bank's loan products, and (ii) gives FNB-Shelby the flexibility to portfolio agricultural loans or package them for the secondary market. Currently, Farmer Mac is purchasing three loan products from its participating lenders:

- 1) A 15-year fixed rate product with a 15-year maturity.
- 2) A 5-year reset rate product that adjusts in five years to a new Farmer Mac 5-year rate.
- 3) A 1-year Treasury ARM Product with a 15-year maturity. This product has a lifetime cap of 6 percent over the initial rate.⁴

Similar to the residential secondary market, FNB-Shelby derives fee income from the origination of loans sold to Farmer Mac. The major underwriting difference between a Farmer Mac loan and a conventional residential mortgage is that lenders may use both the adjusted gross income and the depreciation amount on the federal income tax return Schedule Form F⁵ to determine the borrower's income.

In addition to offering new loan products, FNB-Shelby is focusing on the growing need to provide more technical assistance to all borrowers both before and after loans are made. For small farmers, understanding changes in the economic landscape, diverse financial instruments and banking services can be intimidating. FNB-Shelby's management believes that providing comprehensive technical assistance to their borrowers is a key

component in the success of their lending programs.

Realizing how critical technical assistance can be, FNB-Shelby loan officers are trained and encouraged to focus on educating the borrower; walking him or her through the entire loan process before a loan is made. Technical assistance offered by the Bank may include financial statement analysis, cash flow projections, and tailored financing to meet the needs and abilities of the borrower. After a loan is made the Bank continues to provide technical assistance in an effort to reduce the likelihood of default. To date, FNB-Shelby has been successful in minimizing its losses in part because of the careful post-closing monitoring it does.

³ Farm Service Agency loans are currently being made for 10 years at 4 percent interest.

⁴ Western, Doane. "What is Farmer Mac: Farmer Mac Real Estate Loans." <<http://www.avicom.net/doane/page2.html>> Online. Internet. 26 Mar. 1998.

⁵ The profit and loss statement form.

EXPERIENCES AND OBSTACLES

With the presence of an agricultural secondary market, the Bank has an opportunity to offer more financial options to the consumer. Year-to-date, FNB-Shelby has three Farmer Mac loans in the "pipeline" and is optimistic about the potential of the relationship and its ability to make the Bank competitive with other

financial services providers in the area.

The Land Buyer Program is an important initiative for the Bank because it has helped young borrowers with limited experience and assets become farmers and FNB-Shelby customers. For example, FNB-



Financed by the FSA's Beginning Farmer Program and NIFA, this 75 acre ranch was purchased by one of FNB's young farmers.

Shelby recently helped a young farmer purchase 75 acres of undeveloped farm land in Rising City, NE. The purchase price for the land, which will be used to grow crops, was \$150,000. He will farm his 75 acres, along with 400 adjacent acres that he is currently renting, in order to achieve profitability. There is an enormous potential to develop this and similar borrowers at an early age and service their accounts as they grow.

There is a strong need to educate the borrower through training and technical assistance.

Many of the smaller or first-time borrowers may not have the expertise needed to manage the business side of their farms profitability. Therefore, the Bank has placed a significant emphasis on educating the borrower regarding its products, programs, and issues that may effect their business. Developing a comprehensive in-house technical assistance program has been a plus for the Bank because it has enhanced their client relationships and allowed FNB-Shelby to focus on these accounts more frequently.

CURRENT STATUS

Overall, the Bank's venture into agricultural lending has paid significant dividends. Since 1992, FNB-Shelby has made 335 agricultural loans totaling almost \$14 million. Additionally, its approach to customer service

and focus on providing customers with comprehensive technical assistance have been equally successful. Since, 1992 the Bank has not recorded a default on an agricultural loan.

PARTNERSHIPS

The following entities have cooperated and partnered with FNB-Shelby to deliver affordable capital and competitive products to borrowers: The Federal Home Loan Bank of

Topeka, Nebraska Investment Finance Authority, Farm Services Agency, and Farmer Mac.

ADDITIONAL INFORMATION CONTACTS

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