A Critical Appraisal of the Adequacy of our Agricultural Credit Structure as Related to Commercial Banks

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at meeting of Tennessee Valley Authority, Knoxville, Tennessee, on March 30, 1960.

The growth in amount and changes in type of the credit needs of agriculture have been discussed at length in other portions of this program. To avoid burdening you unnecessarily with repetition, I shall only summarize briefly those points which appear to be pertinent to a discussion of the role of commercial banks in the agricultural credit structure. Before doing so, however, I would like to mention three points that would seem to merit our attention in connection with the broad problem of agricultural credit.

First, agricultural credit is no longer an isolated or local problem. It is subject to the same influences that affect the rest of the economic community and must bear its share of the problem of balancing the national demand for credit with the supply of saving. In recent years, credit markets have become more unified because of better information and communication. Funds that originate in one section of the country are no longer confined to outlets in that area but seek the most advantageous investment outlet throughout the economy. By the same token, those in need of funds have access not merely to local sources but also, directly or indirectly, to many other sources of credit. As many of you in this audience will recall, this has not always been true. I can well remember

the time when local credit conditions were insulated to a considerable degree from general credit conditions in the nation. The development of the whole farm credit system, together with structural changes in the commercial banking system and in the regulations governing it, has served to facilitate the mobilization and allocation of credit resources as needed throughout the country.

The second factor that must be recognized in this connection is the decline in the proportion of agricultural credit to total credit. In 1929, the first year for which we have reliable figures, farm debt was about 6 1/2 per cent of total debt. In 1959 this relationship had sunk to less than 3 per cent. The reason for this relative decline, of course, is that farm production is a declining proportion of a constantly growing total; over the same thirty-year stretch the ratio of agricultural product to total product declined from 9 1/2 per cent to about 4 1/2 per cent. It is interesting to note, however, that the ratio of farm debt to farm product ended this three-decade interval at about the level at which it started.

A third factor at work in the money and capital market is the fact that new additions to capital investment are continuing to "pay off" in the form of additions to net earnings. In this connection, it seems to me important for all of us to keep in mind that economic growth, about which there is so much talk at the present time, is dependent upon increased productivity per man-hour of labor. This increased productivity, spurred by advancing technology, is implemented primarily through the substitution of capital for labor. The doctrine of economic maturity

that was expounded in the 1930's has been proven utterly fallacious. Capital has continued to be increasingly productive in many fields and especially so in agriculture. One of the big questions in connection with our future growth is whether we can generate sufficient savings to provide the capital essential for further technological advances in productivity. This, in turn, leads to the problem of allocating available funds to the most productive use, a problem which I shall return to later.

Now for a brief summary of the changes in credit needs of agriculture resulting from the phenomenal technological advances in productivity which we have witnessed in recent years and can anticipate in the years ahead. The need for larger, more efficient units and the accompanying demand for land, augmented by the demands of urban expansion and inflation hedge-buying by investors, has resulted in a greatly increased demand for mortgage credit. There has been a growing concern, however, over the continuing rise in land prices in the face of declining farm commodity prices and a corresponding reduction in rate of return on farm real estate which last year fell to an average level of approximately 3 per cent. This, together with some reduction in inflationary pressure, may account in part for the withdrawal of some of the investors from the market and the apparent leveling off in farm land prices. In any event, there is still need for further consolidation of farm units and there is apt to be a continuing strong demand for mortgage credit in all cases where the resulting increased productivity can show a profitable return on the investment.

The increased use of purchased inputs has resulted in a growing need for short-term production credit. The biggest change, however, results from tremendous technological advances in machinery, equipment and facilities and shifts in major farm enterprises, together with major land improvements incident to irrigation and drainage, all of which call for greatly increased amounts of intermediate-term credit geared to the repayment potential of the operation.

In summary, farmers need varying but increasing amounts of long, intermediate, and short-term credit. While specific uses may be assigned to those several types of credit, the fact is that the several farm enterprises and even the family living expenses are closely interwoven with the success of the operation as a whole. I mentioned earlier that one of our major problems in the future will be the generation of sufficient savings to provide the capital essential to economic growth. This means that at all times lenders will need to allocate credit carefully and with a close eye to the constructive use and continuing profitability of credit. Adequacy of collateral is important but extension of credit for an operation that does not give promise of improving the repayment potential of the borrower and that depends upon attrition of equity for its liquidation is of questionable value to either the borrower or the lender. For these reasons there are real advantages in handling the farmer's various credit needs through one source.

From the standpoint of the lender, farm loans in general are relatively small and the cost of servicing is correspondingly high. Furthermore, if attention is to be given to the constructive use of the loan,

the lending institution must be staffed with trained personnel who can appraise the loan in terms of its value to the borrower's total operation and in light of his total financial position. This can be better and more economically done by one lender who is familiar with the total problem than by several who are only interested in separate parts of the operation. The farmer, too, is better served by one lending agency which is familiar with all phases of his operation and the interrelationship of his several credit needs.

This brings me to the ability of commercial banks to meet these diverse credit needs of farmers. First, let us look at the mortgage credit sector. As holders of demand deposits, banks are limited by liquidity needs in the amount of long-term assets that they may hold. Hence, the holding of farm real estate loans which are relatively non-liquid must be limited. Nevertheless, commercial banks are an important source of farm mortgage credit and on January 1, 1959 they held $1,443 million of mortgage loans or approximately one-eighth of the total and over one-fifth of the institutionally held loans. Furthermore, many banks have established connections with insurance companies and other long-term lenders whereby such lenders take over the loan and engage the bank to handle its servicing.

In loans other than for the purchase of land, commercial banks have always held a dominant position and on January 1, 1959 they held approximately $4 billion of such loans out of a total of $9.5 billion other than C.C.C. loans. However, the changes in size and type of farm operations and the accompanying change in size and type of credit needs,

including the tremendous expansion in need for term credit with terms adjusted to the flow of income and repayment potential, have presented many problems. It is true that some small country banks have found the credit needs of their larger farm customers to exceed their loan limits. In such cases they have usually been able to secure participation from their city correspondent banks although occasionally they may have to send the borrower elsewhere for his needs.

In the intermediate-term field, the problem is further complicated by the need for more adequate analysis of the total operation in order to establish realistic terms and also by the need for more competent supervision of the loan. In the past, and even today, many bankers make what are essentially intermediate-term loans on a short-term basis with tangible or intangible commitments as to renewals. As long ago as 1921, the U. S. Department of Agriculture, in a study of bank lending practices, criticized the unrealistic terms of many farm loans and said, "Some means must be found for providing the crop and livestock producers with credit running for such terms as the nature of their business demands." It should be remembered, however, that banks did little term lending of any kind at that time. It is only in more recent years that they have ventured into term loans for business and still more recently into consumer instalment loans. Notwithstanding these later developments, a Federal Reserve study of farm loans in 1956 indicated that 60 per cent of the banks rarely made non-real-estate loans with maturities of longer than one year and only 9 per cent made extensive use of longer term maturities.

For many years commercial banks generally resisted term loans to farmers, partly at least, on the assumption that such loans were frowned on by the Federal supervisory agencies. Any impediment stemming from that cause was removed some years ago when the Federal supervisory agencies issued a statement that there is no Federal law or regulation prohibiting intermediate-term loans to farmers and that, "Like all classes of loans, each loan of this type should be evaluated on the basis of its own characteristics, the risk involved, the character, ability and financial responsibility and record of the borrower, value and character of collateral, and the feasibility and probability of its orderly liquidation in accordance with the repayment plan."

While we have no current statistics on recent developments in this area, there are some indications of a marked upward trend in the use of term loans. This has doubtless been accelerated in part by the increased activity of other lending agencies in this area. A further indication of such a trend is the increasing use of agriculturally trained men by commercial banks. According to the American Banker Association figures, approximately 900 banks have men so qualified at the present time compared with 300 in 1950. So far most of these men are located in the larger country banks. Many small country banks seem to feel that they do not need or cannot afford such specialized help. In some cases, however, their needs in this connection are served by the agricultural departments of their city correspondents who have found this to be a worth-while and much needed service. In such cases the city bank farm loan man frequently assists the country bank in the analysis of the farm

business, appraisal of the loan, and establishment of terms, and then may agree to participate in the loan to the extent desired by the local bank. Unfortunately, some city banks with a large clientele of small country correspondents have failed to see the opportunity for a real service to their correspondents in this area.

In conclusion, we may say that commercial banks can and many are doing an admirable job of meeting the total credit needs of farmers on an enlightened and realistic basis so far as terms and amounts are concerned. With the assistance of insurance companies and other long-term lenders in the mortgage field and with the cooperation of forward-looking city correspondents in over-line participation and in appraisal and supervision of larger and longer term loans, they are able to render competent and efficient service to their borrowers. Through the handling of all of the farmer's needs in one package, they can reduce the cost of servicing and supervision and at the same time provide him with a more convenient one-stop service.

The Agricultural Commission of the American Bankers Association is working diligently to promote interest in this type of service on the part of more banks. The amount and complexity of farm credit needs are bound to increase and it is axiomatic that, unless present lenders meet that need, other agencies will be developed to fill the gap. At the same time it should be remembered that available credit should be allocated first to its most productive uses in the interest of long-term economic growth, especially in times of credit stringency, and that such uses will in the long run be most profitable to the borrower, the lender and the

community. By the same token, not all requests for credit can or should be met since extension of credit to an unsound and losing operation eventually results in loss to all concerned. Unqualified borrowers might be better advised to liquidate their operations and get into something with a more promising outlook rather than to hang on to a losing proposition and risk the gradual attrition of such equity as they possess.

Finally, while many banks have a higher loan to deposit ratio than in many years and hence may need to be more selective in the allocation of available credit, there is no reason to believe that they will not be able to meet all legitimate credit needs of agriculture in the period ahead. It must be remembered, however, as mentioned earlier, that with increased credit demands and with agriculture representing a smaller part of total needs, farmers may face increasing competition from the rest of the economy for available funds.