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BANKING AND FARM FINANCE: THE PRESENT CHALLENGE

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at the

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BANKING AND FARM FINANCE: THE PRESENT CHALLENGE

As we prepare to enter yet another season of expanded farm credit demands, it seems an appropriate time to explore with you a situation that is most basic to the future of bank financing of agriculture. For many years, farm credit demands have been expanding much faster than have the resources of rural banks. Though this has never been a comfortable situation for the banks involved, these banks have nevertheless been able to increase farm loans faster than their own deposit growth by employing a cushion of liquidity built up during the years of the Second World War. In this way, the banking system has held the decline in its share of farm financing to a fairly slow erosion.

Now, however, many banks have exhausted the wartime cushion of liquidity. The problem of obtaining funds to meet rising farm credit demands is thus reaching a critical point at more and more rural banks. In some Western States, in fact, a majority of rural banks can probably already rank this among their more urgentfarm finance problems.

There are many facets to this problem, and on each of them I believe there is much confusion among those who are only casually familiar with the situation. I hope we can today clarify some of the facts and issues involved in pertinent questions such as these: What have farmers been doing with the enormous amount of money they have borrowed during the postwar period--have their credit demands been wise in view of the production surplus situation that

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generally prevailed? Why have rural bank resources not kept pace with the credit demands of their communities? Should national policymakers be concerned with the ability of the banking system to finance agriculture, or should they be indifferent as to where these requests are met, or as to whether they are met at all? In what ways can rural banks develop funds to meet the rising loan requests? What role is appropriate for the Federal Reserve System in such efforts?

This farm and bank problem is national in scope. It is found to some degree over the entire country, and is particularly prevalent in the nation's major farming areas. But on a regional, state, or local basis, in a country as diversified as the United States, there will of course be various differences from any general picture that I may paint for the United States as a whole. In some ways, for example, your general situation in Virginia differs markedly from that of the typical agricultural bank in the Middle West. On the other hand, some individual banks in Virginia may nevertheless be facing a situation much like that of the Midwestern bank. Regardless of differences in their individual situations, all banks may eventually be affected by national discussions and policies stimulated by the over-all national problem.

Before I finish, I do intend to take a look at your farm credit situation in Virginia. I might note right now that certain conditions in this State are quite different from those in the major Western farming areas. Your farms and their individual credit demands are on average much smaller, while your banks engaged in financing

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farmers tend to be much larger and to serve a more diversified economy. On paper, it seems that this combination would not encounter the problem I have outlined. Why is it, then, that your banks are losing their share of the farm financing business at a faster rate than banks in the country as a whole? Maybe we can at this meeting start some thinking and action that will help to reverse this trend.

First, let us establish two key facts and projections about our national farm economy: (1) the use of credit in agriculture has been increasing rapidly for the past twenty years, and will likely continue to increase for some time to come; (2) the total farm economy has been growing much more slowly than the rate at which the use of credit is expanding, and this condition will prevail in the near future.

We can easily document that these statements are correct general descriptions of the recent past. Twenty years ago, an agricultural economy benefiting from wartime demands had just finished reducing its total debt for the fourth straight year, paying it down to $8 billion, of which less than $2 billion was owed to banks. That was also the last year in which farmers reduced their indebtedness. They now owe $42 billion, $11-1/2 billion to commercial banks. During the past decade, their total debt rose by 140 per cent, and their bank debt by 128 per cent.

But this great flow of credit into agriculture was not accompanied by corresponding growth in the aggregate farm economy. Over these ten years, gross farm sales were up 44 per cent, production expenses up by 48 per cent, net income up by 37 per cent, and the farm population down by 39 per cent.

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Will this disparity between credit demands and aggregate growth continue in the near future? To ascertain the likelihood of this projection, we need to know the uses to which the credit has been put. Obviously, it was not used to support a vigorous expansion of the total industry. Instead, it went into modernization of the production process and of the structure of the industry. Both courses of action were made possible by technological advances and were encouraged by the cost-price squeeze. Credit facilitated the purchase of more efficient machinery, the expanded use of such inputs as fertilizer, the enlargement of acreage and enterprises on individual farms, and the transfer of a more costly capital plant from one generation to the next.

Thus the flow of credit enabled individual farmers to achieve large gains in productivity, sales, and net incomes. By the very nature of these gains, however, there were at the same time far smaller increases in total farm income, in total economic activity in rural communities, and in rural population.

We all expect a continued flow of the technological advances that have permitted farmers to make these adjustments. We all expect that farmers will continue to have profit incentives that will make them want to implement these advances. It is also reasonable to expect that the financial magnitude of these adjustments will continue to be substantially greater than farmers' current savings. Projections I have seen therefore show large additional increases in farm credit demands. John Brake of Michigan

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State University, for instance, estimates that farm debt may reach $100 billion in 1980, which would require net credit inflow of about $58 billion during the next 14 years.

The operating efficiencies and farm enlargement that farmers have been financing with credit have been in the national interest, and will continue to be so. These adjustments have significantly lowered the unit cost of farm products and have thereby made a substantial contribution to the improvement of the level of living of our entire population. As we have in the past, we want to continue to encourage farmers to make profitable adjustments of this kind, and to employ credit as appropriate and necessary in this work. Thus we both expect and want increased farm credit requests.

Now let us look at the implications of this situation for rural banks. The growth of a typical bank's resources is naturally closely related to the growth of the economy of its community. We have already shown that the rural economy is growing more slowly than the rate at which its credit demands are increasing. Farm credit demands on banks in the rural economy have therefore expanded faster than the resources of these banks.

Two types of problems arise from this circumstance. First, the size of credit requests of individual farmers has on average been increasing faster than the size of their banks. More loan requests of individual farmers therefore exceed the amounts that their bank can legally or comfortably grant from its own resources. Second, in responding to the increased aggregate credit demands by expanding

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loans faster than deposit growth, banks have been depleting, and in some cases exhausting, their store of Government securities and other liquid assets accumulated during World War II, when deposit inflow greatly exceeded loan demand.

The present farm finance challenge to our banking system is to maintain its share of such business in the face of these circumstances. I personally would like to see banks continue to be the leading source of farm credit. I believe that banks are in many ways uniquely able to finance agriculture in an efficient manner. Since the presence of a bank office in each community is already required for general business reasons, the loan officer can be closer and better attuned to the individual situations and needs of his farm customers than is likely to be the case for alternative institutions. If he is good at his job, he can provide superior financing arrangements which should result in superior progress of his farm borrowers.

A great many banks face this challenge in that they are heavily involved in farm financing and heavily dependent on the rural economy--surprisingly many banks considering that farm loans amount to only 5 per cent of total loans in the banking system. Last June, 44 per cent of all banks in the nation had one-fourth or more of their total loan volume in loans to farmers. Twenty-two per cent of all banks had over half of their loans in agriculture.

As they exhaust their cusion of liquidity, these rural banks must develop current sources of loanable funds. First, they should strive to attract the savings being generated in their

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communities, because they cannot rely on increases in aggregate demand deposits. Chances are good that demand deposits will continue to expand less rapidly than economic activity, as individuals and businesses continue to discover ways in which to conduct their increasing volume of transactions on a proportionately smaller balance in their checking accounts. They are taking the funds not needed for immediate spending and placing them where they will earn interest or dividends. To enable the banking system to provide the economy with the bank credit necessary to achieve a desirable rate of sustained economic growth, monetary authorities will likely maintain policies and regulations that allow the banking system to be competitive in attracting savings. Within that framework, it will be up to each rural bank to adjust its rates and policies to prevent an outflow of such funds from its community. As rural residents get more knowledgeable about alternative opportunities, and as they increasingly accumulate amounts worth worrying about, rural banks will have to become and remain competitive in the rates they pay on time and savings deposits to keep these savings from flowing directly into urban centers.

Somewhere along here, we should note that not all country banks are close to experiencing a loanable fund shortage. Some funds could become available over the next few years if some bankers would stop operating their banks as deposit strongboxes and instead transform them into institutions that are meeting the credit needs of farmers and other businesses in their communities. Of the 6,000 banks at which farm loans accounted for more than 25 per cent of total loans

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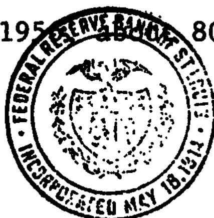
outstanding, over 1,000 banks were in the relatively easy position indicated by a loan-deposit ratio below 40 per cent as of last June. Of these, 312 had ratios below 30 per cent. In a study made at the Federal Reserve Bank of Kansas City, it was found that many of these banks were located in the same town as other banks with high ratios. From this, I would conclude that these banks did not lack lending opportunities.

But these hoards of funds and the anticipated rural savings fall considerably short of meeting the projected credit needs of agriculture. Obviously, the rest of the funds are going to come from the urban economy. Some will continue to flow into agriculture by way of farm mortgage loans made by insurance companies. Some will enter through expansion of loans by Federal Land Banks and production credit associations, financed by sale of bonds in the urban money centers. And some will come in via the banking system. The proportion that takes this route will be greatly influenced by the effort and imagination that bankers put into this task.

Correspondent participations in farm loans are one way in which funds can flow from urban centers into agriculture by way of the banking system. This route is particularly important because it serves the additional function of enabling local banks to continue to serve those farm customers whose credit needs have expanded beyond the legal lending limit of these banks. We have recent evidence that participations have shown remarkable gains in breadth and magnitude during the past decade. In 195[illegible] about 800 banks had originated



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$80 million in outstanding farm loans in which 400 banks were participants to the extent of $43 million. Last June, a similar survey showed that 2,500 banks had originated $575 million in outstanding farm loans in which 1,100 banks were participating to the extent of $300 million.

This 600 per cent expansion in such lending is of course encouraging, but we must note that the amount of the participations still amounted to just 2.6 per cent of total farm loans at banks. The many meetings and articles in which this topic has been discussed have clearly shown that this is not an easy path for funds to take, but rather one that requires much effort and cooperation on the part of both the rural and city banks involved. To make a really substantial contribution to the total supply of farm credit at rural banks, as opposed to dealing merely with the overline problem, participations would have to be developed to the extent that they could be routinely employed in the financing of family farm enterprises in our principal agricultural regions. Participations would have to be used in farm loans which, while perhaps much above the national average size of $3,500, would still be small in comparison with the average business loans made by the urban banks being asked to participate. Perhaps it is asking too much to expect that participation procedures can become so routinized and efficient that their use in such loans would be profitable to both banks involved. On the other hand, this is exactly the kind of endeavor in which standardization, automation, and improved

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communications are daily working miracles. The remaining essential ingredient, interested and knowledgeable farm loan officers at both participating banks, may be harder to come by, but again not impossible.

However, it may be that imaginative bankers may develop completely new means to channel urban funds to rural banks in larger and more efficient units. There may be ways in which the assets or liabilities of rural banks can be made acceptable to the national credit markets. Perhaps packages of farm loans, or debentures secured by farm loans, could be sold if appropriately insured or guaranteed. Or perhaps ways will be devised to make certificates of deposit of small banks more appealing to investors. These ideas indicate the direction in which the thinking of some agricultural banking leaders is turning at the present time.

The question of action by the Federal Reserve System is often raised in these circumstances, in terms such as this: If the Federal Reserve recognizes that an economic sector or geographic region is a credit deficit area, why does it not make special arrangements for banks to rediscount the loans of this sector or area, thereby virtually assuring that its credit demands will be met? The pros and cons of this question are perennially debated. Within the System, such discussions have thus far concluded that it would be unwise for the seven men of the Board--however learned and able they might be--to undertake to alter the impersonal allocation of funds made by our market economy, by deciding that the credit demands of some particular sector are more deserving than those of another, and thus worthy of being subsidized.

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The Federal Reserve System does, however, assume a large role in providing funds for seasonal or irregular swings in lending by the banking system. Many rural banks experience relatively large seasonal fund outflows. During the postwar period, Federal Reserve policy has contemplated that each member bank would do what it could to maintain sufficient liquidity to be able to meet the seasonal swings that it might normally expect to experience. Credit assistance at the discount window was supposed to be confined to those cases in which seasonal needs exceeded the bounds that could reasonably be met by use of the bank's own resources. The bulk of seasonal assistance from the Federal Reserve has come in the form of open market purchases of securities to supply reserves to the banking system as a whole, with such reserves flowing to individual banks in need as they sold securities or otherwise raised funds from the central markets. So long as most banks had ample liquidity cushions consisting largely of U.S. Government securities, such a policy appeared quite appropriate. But now, with many banks rather fully loaned, it is less and less possible for them to keep sufficient liquidity to meet seasonal peaks without a great deal of scrambling, and perhaps even some curtailing of off-peak credit accommodation of their communities. Accordingly, the Federal Reserve is currently studying the advisability of helping individual member banks to meet a larger portion of their needs for seasonal credit assistance at the discount window. Such expanded seasonal assistance is being studied as one part of a comprehensive reappraisal of all aspects of the discount mechanism that is now underway within the System.

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Another way in which urban funds can flow into rural areas through the banking system is if such flow occurs between urban and rural branches of branch banks. Further expansion of branch banking must be included among the ways in which the banking system can improve its potential for financing farmers. But I would stress the word "potential" in that statement. While a branch system is expanding by acquiring rural unit banks, it is likely to be simultaneously acquiring personnel skilled in farm lending and to be emphasizing its farm finance business. But as time goes on, I suspect that much internal effort is necessary to keep top management appraised of the significance of the economic base that farming likely provides for its trade area and to keep its staff competent in farm lending.

Let me draw here on what I learned during a visit to Canada two years ago. In Canada, the entire nation is served by eight banks, each of which has hundreds of branches. A few years ago, by the bankers' own testimony, the rural branches engaged in farm lending were often run by persons on the bank's management ladder who would have to spend a couple of years there before moving back to city branches where their real future supposedly lay. These persons generally had no prior training in farm credit, and no particular incentive to learn it. To quote the report of the Royal Commission on Banking and Finance, " . . . the continuous movement of bank staff through the branch system and the emphasis on other forms of lending often means that bank staff in rural areas lack the special knowledge of their agricultural customers and their problems found in the unit banks in the United States."

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What percentage of our unit banks really justify the generous praise of the Royal Commission? And what percentage of our branch banks have avoided the situation in which the Canadian banks found themselves?

When I started, I promised to review your situation in Virginia. You may be pleased with some of the comparisons that follow, but with some others, as I have already indicated, I hope that you will be displeased enough to go out and do something about them.

As in the nation, farm credit demands in Virginia are growing rapidly. During the last ten years, total farm loans were up by 98 per cent and bank farm loans by 84 per cent.

The farm economy in Virginia is growing even more slowly than in the nation. In the last decade, cash receipts from farming are up by just 14 per cent and production expenses by 17 per cent, while net income decreased by 6 per cent. Total net income of farm operators declined from 4 per cent to only 2 per cent of total personal income in the State, and only about half of the farm net is cash income.

In contrast to the national situation, few Virginia banks are primarily dependent on agriculture. Only 14 per cent of the banks had as much as one-fourth of their loan volume in farm loans last June. Also, most of the banks active in financing agriculture had loan-deposit ratios upwards of 50 per cent, whereas two-fifths of the nation's agricultural banks were below that figure. These

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Virginia banks tend to be much larger institutions than the typical agricultural bank nationally. Most have capital and surplus above $200,000, whereas nearly half of the agricultural banks nationally are below this figure.

The ratio of agricultural bank size to farm loan size is especially large in Virginia compared to the national average, since the banks serving farmers are larger than average and individual farm credit demands are smaller than average. The average Virginia farm borrower owed $3,500 to banks last June, whereas the average borrower nationally owed $5,900. We can also note that one-third of Virginia's farmers who borrowed from banks were customers of the eight banks at which farm loan volume exceeded $3 million, whereas nationally only 18 per cent of the farm borrowers dealt with banks that large. Nationally, farm customers at these banks owed an average of $10,500 last June, whereas in Virginia the farm customers at these large banks owed an average of only $3,300.

The decrease in banks' share of farm financing during the past ten years was sharper than in the nation. At the beginning of the decade, bank non-real-estate farm loans in Virginia were 76 per cent of the institutional non-real-estate total, while now they are down to 68 per cent. The national change was from 72 per cent to 67 per cent. The proportion of farm financing done by production credit associations showed a correspondingly greater rise in Virginia than in the nation.

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It may be hazardous to venture opinions about the reasons for trends such as these without making a considerably more detailed investigation. But on the basis of these figures I am nevertheless tempted to conclude that Virginia's farm borrowers have become somewhat less well received and served by some of its banks. Most of the banks they deal with are primarily involved in nonfarm lending and on the whole now have fairly high loan-deposit ratios.

Many of these banks would say that they have no farm business, forgetting for the moment the amount of agribusiness they have, including that of farm equipment, feed, seed, fertilizer, and insecticide dealers, together with the farm product processors and distributors, all of which are dependent basically on the farm business of their area. As a result, some farmers are being forced to look for other sources of credit rather than to their local banks. And, by the same token, city banks who pride themselves on their correspondent services but who fail to recognize the interdependence of their agribusiness and the farm business of their country correspondents may also be overlooking both an opportunity and a responsibility to serve the total needs of their areas.

Though other needs may appear more lucrative at the moment, the credit needs of agriculture are vital and must be met, if not by banks then by other financial institutions or, ultimately, by government agencies. The answer is largely up to the bankers, both city and country. Are you meeting the challenge?

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