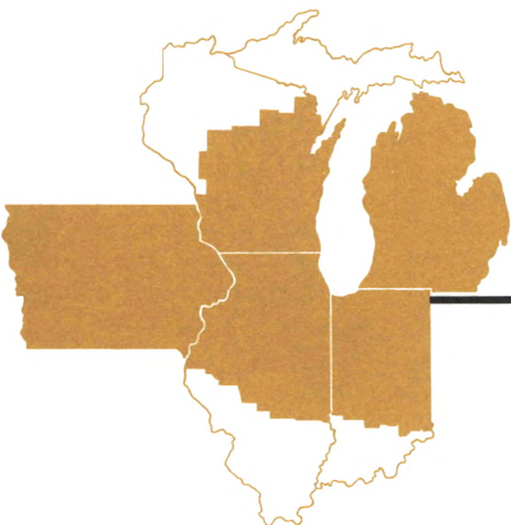
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1966 January

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Farm income up—financial situation improves

Farm income surged strongly upward in 1965 after four years of stability. Estimated at 14 billion dollars, total realized farm income increased about 1 billion dollars from the 1964 level and was the highest since 1952. With the continued decline in number of farms, realized net income per farm rose to an estimated 4,100 dollars from about 3,700 dollars the previous year. This sharp income gain reflected in large part the higher prices for livestock and increased Government payments to farmers.

Government payments made directly to farmers rose about 230 million dollars last year to an estimated 2.4 billion dollars. These payments accounted for about 16 per cent of realized net farm income and for about a quarter of the gain from a year earlier.

Financial position improves

The financial position of farmers improved markedly in 1965. Reflecting the substantial rise in net income, farmers increased their holdings of bank deposits and investments while also adding to their inventories of machinery, motor vehicles and household furnishings and equipment. Crop inventories also increased as a result of the record production of crops.

Farm real estate prices rose further in 1965 and, along with the increases in quantity and prices of other assets, boosted the total value of farm assets to a record high of 253 billion dollars on January 1, 1966—up about 7 per cent from the year-earlier level.

Not all of the rise in value of farm assets, however, represented an increase in net worth. Farm debts also rose. Farmers stepped up their use of credit to purchase farmland and machinery and to finance operating expenses. With loan funds readily available and with a good record of repayments on existing loans, lenders actively continued to seek farm loans.

At the end of 1965, an estimated 39.4 billion dollars of farm debt was outstanding, up 3.4 billion from the year-earlier amount.

BUSINESS CONDITIONS is published monthly by the Federal Reserve Bank of Chicago. Roby L. Sloan was primarily responsible for the article "Farm Income Up—Financial Situation Improves," Dorothy M. Nichols and Diane B. Revie for "Deposits and 'Borrowed Funds'" and David W. Maaske and Roby L. Sloan for "Meeting Rural Credit Needs."

Subscriptions to **Business Conditions** are available to the public without charge. For information concerning bulk mailings, address inquiries to the Federal Reserve Bank of Chicago, Chicago, Illinois 60690.

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Monetary Theory and Policy: A Bibliography; Part I, Domestic Aspects: Recently published by the Board of Governors of the Federal Reserve System, this volume includes books, articles and other contributions issued in English from 1950 to date (November 1965, 127 pp., $1.00). Copies of this booklet may be purchased from the Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

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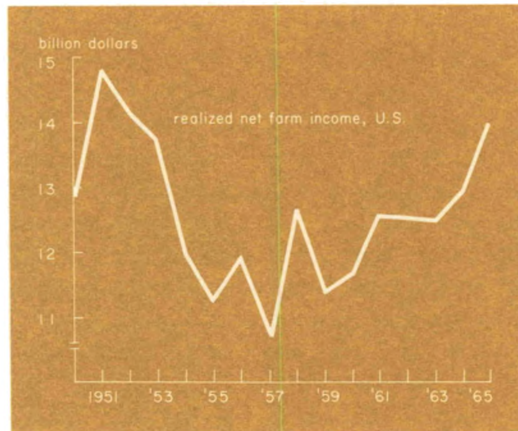
Loans secured by farm mortgages accounted for about 2.2 billion dollars of the increase and non-real estate loans—made typically to help finance equipment purchases and to pay operating expenses—are estimated to have increased about 1.2 billion dollars. This was the third consecutive year in which the increase in total farm debt equaled or exceeded the 3 billion dollar mark.

Despite the sharp rise in farm debt during 1965, equity in the industry increased to a record total of about 212 billion dollars and at this level accounted for 84 per cent of the total value of farm assets. While this ratio has declined in recent years, it is clear that most farmers have sizable equity in their business.

Farm income highest since 1952



In the Midwest

Developments in the Seventh Federal Reserve District were similar to those for the nation although probably even more favorable. The production of livestock is relatively more important in the District states than in the nation, and in most areas of the District bumper crops were harvested.

Net income increased sharply. Although receipts from crop marketings were down slightly in the first nine months of 1965, total cash receipts from farm marketings in this period rose 7 per cent from the corresponding year-earlier period. During the closing months of the year, receipts from crops rose considerably, reflecting the record 1965 harvest.

Cash receipts of District farmers from sales of livestock and livestock products were considerably above the year-earlier level throughout 1965. Total United States supplies of red meats were six to seven pounds per person below the 175 pounds in the previous year, and livestock prices, therefore, rose substantially. The decrease in meat supply primarily reflected the sharply curtailed production of pork which dropped about 10 per cent. Production of beef was slightly larger than in 1964, but because of the increase in population, supplies of beef per capita declined also.

In part, the reduced supplies and higher prices of meat animals last year reflected farmer's adjustments to the low prices in 1963 and 1964. During that period, large supplies depressed prices of both cattle and hogs to the lowest levels in several years. But with the reduced supplies in 1965, meat animal prices averaged nearly one-fifth above the 1964 level. As a result, profits from typical cattle feeding programs were the highest in six or seven years and for hogs were the highest in more than a decade.

Financial assets of District farmers were markedly enhanced by the rise in income. Demand deposits at agricultural banks in the District—those in which farm loans account for a large proportion of total loans—in November 1965 were about 5 per cent above the same month of the previous year, and this year-to-year gain was more than double each of the previous four years. Time deposits at these banks—continuing their long-term upward trend—rose quite sharply, although relatively less than at banks in urban areas.

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Farmland prices in the District rose strongly. The average value per acre of "good" farmland in October 1965 was about 7 per cent above the year-earlier level, according to reports from country bankers. Increases were general throughout the District with the largest gains occurring in Illinois, Indiana and Iowa where farmers benefited the most from the comparatively high livestock prices and the record crop production. In each of the Corn Belt states, increases of 7 to 10 per cent were reported, compared with gains of 4 to 5 per cent during the preceding 12 months.

The further efforts of farmers to enlarge and improve their farms and to further mechanize their operations continued to increase their demand for credit during the past year. Bank loans to farmers rose sharply in 1965; at midyear, loans secured by farm mortgages were up 13 per cent and short-term non-real estate loans were up 5 per cent from year-earlier levels. Other institutional lenders had recorded sizable increases in loan volume through mid-fall.

Repayment of principal on farm real estate loans during the past year compared favorably with the high rates of repayment in other recent years. Banks in the District reported that loans were generally repaid as scheduled during 1965. Delinquencies and foreclosures continued to be at very low levels, and the proportion of new loans made to refinance existing debt appears to have declined somewhat during the past year.

More of the same?

Some of the factors that pushed farm income to a higher level in 1965 will be present again in 1966. But the overall impact is not likely to result in as large an increase in the current year as in 1965.

Income from hogs may rise further as a result of smaller supply and higher average prices. The fall pig crop was indicated by U.S. Department of Agriculture surveys to be down about 5 per cent. Slaughter supplies, therefore, are expected to be relatively small and prices relatively high through the early summer of 1966. However, with abundant feed supplies and favorable hog prices, farmers apparently are taking steps to increase production. Hog prices during the latter part of 1966, therefore, will depend largely on how much supplies are increased.

Cattle on farms and ranches at the beginning of 1966 were estimated to total about 106 million head, a million fewer than a year earlier. Cattle marketings, however, were estimated by the USDA to be as large as, if not larger than, in 1965. With only a modest increase in beef supplies and a further reduction in total supply of red meat, little change in average prices is expected. However, District farmers' income from cattle may decline from last year's exceptionally favorable results because of higher prices paid for feeder cattle last fall and in the current winter.

For the major field crops, this year's receipts will be supported somewhat by the continued large volume of marketings in the first half of 1966 from the record 1965 harvest. Receipts from marketings during the last half of the year will depend largely on the size of the 1966 harvest, which cannot be foreseen at this time. There has been a strong upward trend in yield per acre in the past several years because of increased applications of fertilizer, better cropping practices and improved machinery. Thus, with normal weather conditions it would seem likely that this trend would continue for most of the major crops.

Farm production expenses are currently expected to show a somewhat smaller rise than occurred in 1965 primarily because of lower feed prices and a further decline in the amount of hired farm labor. With continued upward

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pressures on wage rates and prices of many of the manufactured items purchased by farmers, however, the rise may approach the billion dollar advance that occurred last year.

The amount of Government payments will depend largely upon the extent to which farmers participate in the various commodity programs, but the payments are expected to rise substantially, perhaps by about a billion dollars from the 1965 level. Most of the increase in payments would be to cotton farmers, although wheat and feed grain producers probably will receive higher payments, reflecting changes in the provisions of the farm program. The new Cropland Adjustment Program will also require higher payments to farmers in 1966.

Obviously, any projection of farm income at this early date may be wide of the amount actually realized. Based on present indications, the USDA has estimated that net farm income in 1966 may be 2 to 4 per cent above last year's level. At this time, such a projection appears plausible for the Midwest as well as the nation.

With the indicated higher income, coupled with the expected further advance in farm asset prices, the financial position of farmers should be further strengthened in 1966. Many farmers probably will find it profitable to use even larger amounts of borrowed capital as they seek to increase the size of their operations and as they expand purchases of materials and services needed for efficient production of crops and livestock. But the increase in debt likely will be less than the increase in value of farm assets, thus permitting farmers' equity in their business to increase further.

Deposits and "borrowed funds"

The recent trend for banks to become more active as borrowers in the money and capital markets has attracted a great deal of attention—and some apprehension—by bankers, financial analysts and supervisory authorities alike.

In a very real sense, of course, the banking system has always been a high-leverage industry—that is, it has operated with a low ratio of capital to assets. Deposit liabilities have provided the main source of bank funds, and these funds are essentially debt that to a large extent is payable on demand. Commercial banks have traditionally shunned borrowing of the types used by other businesses to raise funds—that is, issuing notes or debentures with a fixed maturity—fearing that depositors might interpret such borrowing as a sign of weakness.

Banks faced increasing competition for their funds during the postwar period from other financial institutions and the developing market for short-term instruments such as Treasury bills. As interest rates rose, interest-sensitive investors, notably large corporations, tended to shift surplus funds out of idle demand deposit balances. Deposit growth slowed as loan demand grew in the postwar business expansion. As a result, banks were under increasing pressure for lendable funds.

In the latter part of the Fifties, many com-

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mercial banks began to meet the competition for funds by increasing rates paid on time deposits. (Federal Reserve Regulation Q was liberalized several times after 1956 as rates paid on time deposits rose to the maximum levels previously permitted.) Also, these banks generally have become more aggressive in the search for funds in non-deposit form—that is, through various forms of borrowing.

While continuous borrowing from Federal Reserve Banks is not considered appropriate under Regulation A, there is strong evidence that many commercial banks have become less reluctant to borrow from other sources. Their willingness to bid in the short-term money market for time deposits and borrowed funds has changed their role from passive acceptors of deposits to active competitors for funds whenever profitable investment opportunities are in view.

There are a number of instruments that banks can use to capture funds that would not flow to them in their traditional role as holders of the working balances and savings of the communities in which they are located. To acquire long-term funds, capital notes and debentures can be issued. Such securities are subordinated to deposits in case of liquidation. An increasing number of banks have moved in this direction over the past several years.[1]

More recently, some banks have stepped up efforts to sell savings bond-type certificates. These obligations—designed for the small investor—are technically time deposits. They are issued on either a current interest payment or discount accrual basis and usually mature in five years but with provision for repayment on interest dates or according to a fixed redemption schedule. Moreover, as described in the article on pages 11-16, there are several avenues through which small banks in rural areas can obtain the funds with which to meet local credit needs.

The large banks that tap the national money market for short-term funds of business and institutional investors use four major types of obligations: 1) negotiable time certificates of deposit (CDs), 2) promissory notes, 3) repurchase agreements (RPs) and 4) Federal funds. The purpose of this article is to compare and contrast these four instruments. Only the first (CDs) are technically deposits. But the close resemblance between CDs and promissory notes has muddied further the distinction—never very clear—between deposits and borrowings and raised questions as to the appropriateness of differences in the legal treatment of various types of bank liabilities. The table on pages 8-9 outlines the principal characteristics of each instrument.

Deposits are deposits

What is a deposit? This type of liability, which is peculiar to the banking business, is not defined specifically in existing law. Nevertheless, the assumption that deposits are self-evidently different from other bank liabilities has been woven into banking practice, literature and regulations. In general usage, a deposit occurs when money is received or held by a bank in the normal course of business.

For purposes of reserve requirements and interest rate regulation of member banks, the Federal Reserve Act requires the Board of Governors of the Federal Reserve System to distinguish between "time" deposits and "demand" deposits. Deposits made for 30 days or more, or savings accounts where a

[1]For a discussion of this development see "Banks' Issues of Senior Securities" in *Business Conditions,* December 1965.

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30-day notice of withdrawal is at least technically required, are time deposits. All other deposits are demand deposits.

Negotiable time certificates of deposit fall into the time deposit classification. In accepting such a deposit, the bank issues a contract (certificate) with a specific maturity and rate of interest. As time deposits, the CDs are subject to reserve requirements for member banks and the ceilings on interest rates imposed by Regulation Q.

Although time certificates of deposit have been in use in one form or another for a long time, the features that make the CD a significant money market instrument for the large banks have developed only in the last four years. (Time certificates issued largely to individuals by relatively small banks have been in fairly wide use for many years. These typically are not marketable.) By offering attractive rates for time deposits, many banks hoped to retain funds that might be shifted out of demand deposits and, indeed, to enlarge their lending power by attracting funds that previously had been invested in other money market instruments. The growth of outstanding CDs to more than 16 billion dollars at present indicates their success. Corporations are the major buyers.

CDs of major banks, in addition to the attractive yield, are highly liquid. Time deposits cannot be withdrawn prior to maturity. As negotiable instruments, however, CDs may be sold in the secondary market provided by certain U. S. Government securities dealers, who stand ready to buy and sell the CDs of large well-known banks. The issuing bank, of course, has the funds until the maturity date indicated on the certificate.

Banks, in their efforts to "buy" time deposit funds, have tailored the terms of CDs to investors' needs. Maturities are often geared to the corporate tax date. Although maturities can be scheduled to fit the convenience of the depositor, marketability is better for CDs with popular due dates. The sale of CDs to customers outside the local area enables banks to obtain funds from a broader area and by varying the rate offered, the nationally known banks can closely control their inflow of funds.

Promissory notes, as currently defined, are not deposit liabilities. The notes were originally classified as borrowings by the Comptroller of the Currency and the Federal Reserve System.[2] Yet they serve basically the same purposes as CDs, and as with the latter banks can alter the amount by changing the rates at which the instrument is offered to investors.

Compared with CDs, however, the notes possess certain advantages to the issuing bank. The funds raised through selling notes can be fully invested in earning assets since the notes do not require the maintenance of legal reserves, nor are they subject to Federal Deposit Insurance Corporation assessments. More important, perhaps, the issuing banks are not bound by interest rate ceilings or minimum maturities. Therefore, on the assumption that a bank can always attract funds at some rate, the notes are a potentially useful supplement to CDs should the level of short-term interest rates rise above the maximum that banks can legally pay for time deposits. Notes may be issued for less than 30 days, and the notes may be paid off prior to maturity. This feature somewhat offsets the lack of a strong secondary market.

Despite these advantages, the volume of promissory notes has grown slowly compared

[2]The Comptroller has subsequently ruled that such liabilities are not borrowed funds for purposes of the borrowings limitations applicable to national banks.

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Types of "borrowed" funds

	Negotiable time certificates of deposit (CDs)	Promissory notes	Repurchase agreements (RPs)	Federal funds	
Type of obligation	commercial bank time deposit with a specified maturity, evidenced by a receipt	borrowing by sale of promissory note: may be negotiable or nonnegotiable	commitment to repurchase securities	interbank loan of immediately available funds	**Type of obligation**
Definition:					**Definition:**
Comptroller	time deposits (as defined by Federal Reserve)	non-deposit liability	sale of securities	purchase of funds	**Comptroller**
State authorities	time deposits (as defined by Federal Reserve)	rules vary	rules vary	rules vary	**State authorities**
Federal Reserve	time deposits: evidenced by an instrument bearing the amount deposited and payable not less than 30 days after date of issue	borrowing	borrowing	borrowing	**Federal Reserve**
Limitation on amount outstanding	none	national banks: none except where limited by state law (Comptroller ruled notes not subject to borrowing limitations) state banks: governed by state laws and regulations (New York law prohibits negotiable notes; no limit on nonnegotiables)	national banks: none except where limited by state law (Comptroller ruled RPs are security transactions) state banks: governed by state laws	national banks: none state banks: governed by state laws	**Limitation on amount outstanding**
Limitation on interest rate	maximum set by Regulation Q and FDIC; some states regulate rates that can be paid by any bank operating in those states	none	none	none	**Limitation on interest rate**
Reserve requirements	subject to 4 per cent for Federal Reserve member banks; state requirements for state nonmember banks	none	none	none	**Reserve requirements**
Maturities	minimum of 30 days: maximum unlimited; in practice most shorter than one year	no legal limit; in practice negotiable notes usually under one year, nonnegotiable notes mostly under 60 days	no legal limit; most 1-90 days	one business day	**Maturities**
Collateral	none specifically pledged; backed by general assets of the bank; insured up to 10,000 dollars by FDIC	none specifically pledged; backed by general assets of the bank	securities involved in the transaction	unsecured: U. S. Government securities sometimes pledged	**Collateral**
Typical transaction size	100,000 dollars and higher	1 million dollars and higher; 100,000 dollars legal minimum for nonnegotiables in New York	1 million dollars and less	most trades are for 1 million dollars and higher	**Typical transaction size**
Interest basis	on face amount; 360-day year	on face amount or at discount; 360-day year	on face amount; 360-day year	on face amount; 360-day year	**Interest basis**
Market facilities:					**Market facilities:**
Primary	offered on open market directly and through brokers	sold directly to investors	telephone negotiation, confirmed in writing	telephone negotiation, confirmed in writing; markets made by brokers and some large banks	**Primary**
Secondary	secondary market by several U. S. Government securities dealers; redemption prior to maturity not permitted	no secondary market; issuing banks usually buy back paper prior to maturity	none	none	**Secondary**
Lenders	corporations, financial institutions, state and local government, individuals	corporations, financial institutions, state and local governments, individuals	corporations, securities dealers, other banks, individuals	other commercial banks	**Lenders**
Amount outstanding	16 billion dollars (year-end 1965)	500 million dollars (year-end 1965)	fluctuates: less than 2 billion dollars	fluctuates: 1 to 4 billion dollars	**Amount outstanding**

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with CDs. This partly reflects the uncertain legal status of the notes, which though approved by the Comptroller of the Currency for national banks, are of doubtful legality in some states. State law prohibits New York banks from issuing negotiable notes. Recently, the state banking department gave the New York banks authority to issue an "acknowledgement of an advance" to a corporate customer with the limitations that the instrument be nonnegotiable and in denominations of at least 1 million dollars. (This requirement was subsequently lowered to 100,000 dollars.) Maturities on most of the notes issued by the New York banks have been quite short—often only a few days—and negotiability has therefore been less important. If and when New York banks are permitted to sell negotiable notes, the interest of corporate treasurers in obligations of the large New York banks may stimulate development of a secondary market.

Both CDs and promissory notes are unsecured. The CD holder has a slight protection due to FDIC insurance up to 10,000 dollars. It is generally assumed that the short-term notes are not subordinated to unsecured deposits in case of liquidation although there is no legal precedence for this view. In any case, the reputation of the issuing bank is extremely important. Large corporations have provided the main market for both negotiable and nonnegotiable notes. Since the Comptroller of the Currency exempted promissory notes from the statutory borrowing limits, there is no restriction on the amount that banks may borrow by this means except where limited by state laws and, of course, the willingness of investors to purchase claims on the bank.

Day-to-day money

Whereas promissory notes maturing in 30 days or more are an alternative to CDs, the shorter notes are a substitute for repurchase agreements but with the advantage that they require no collateral. As a source of funds for banks, RPs involve the actual sale of securities (usually U. S. Governments, U. S. agency or municipal issues) by the bank to an investor. The investor is protected from the risk of market fluctuations in the value of the securities by the bank's agreement to repurchase them at a specific time at the sale price plus interest. In effect, the transaction represents a loan from the buyer to the bank with the security as collateral. Such a transaction at one time was ruled to be borrowing and was subject to legal limitations on the amount of borrowings. The Comptroller at the present time exempts all RPs from such limits although this is not the case under all state laws.

Banks usually obtain RP funds from large corporations. Frequently the transaction is made in response to a corporate customer's desire for a short-term investment. The maturity and amount can be tailored to the lender's requirements, and payment is made in immediately available funds. To negotiate such a transaction, however, the bank must have suitable unpledged securities on hand. The decline in investment portfolios in recent years has made the RP a less convenient tool for the banks.

Banks also can use the Federal funds market to supplement deposits. Federal funds transactions are essentially loans from one bank to another with a one-day maturity. They usually are effected through the transfer of funds on the books of the Federal Reserve Banks from the reserve account of the seller (lender) to the reserve account of the buyer (borrower). The purchase of Federal funds has been a convenient means of covering temporary shortages in reserves for

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many years. Although Federal funds are strictly one-day money, the buyer is often able to tap this source day after day, varying the amount of net purchases in accord with short-run changes in his needs.

The purchase of Federal funds may or may not involve the pledge of securities. Before the Comptroller exempted Fed funds transactions from the borrowing and lending limits applicable to national banks in 1963, small banks could sell funds in amounts large enough to be marketable only on a secured basis. Since the 1963 ruling, there is effectively no legal restriction on these transactions except where state laws apply.

A more practical limit is the availability of funds. Because the purchase of Federal funds is a direct alternative to borrowing from the Federal Reserve Banks to adjust reserves, the discount rate was long considered a ceiling on the rate that banks would pay for Federal funds. In the past year, trading at rates competitive with other money market rates has become a common practice, and this has enhanced the reliability of this market as a source of funds in periods when money is less plentiful.

Stretching from day-to-day borrowings of Fed funds up to CDs of a year or more, major commercial banks now have a wide range of potential sources of funds. At any given time an individual bank's choice depends on relative rates and expectations with respect to rate trends, availability and the time period for which funds are needed. The future developments in the use of these instruments will depend in part on legal rulings with respect to differences in the treatment of various liabilities which are beyond the control of individual banks. From a practical standpoint, the distinction between deposits and borrowings is increasingly less clear.

Meeting rural credit needs

Loan demand at commercial banks has increased rapidly in recent years and at many banks has outpaced the growth of deposits. This has been the experience of banks serving rural areas as well as banks located in the larger urban centers. With rising prices for farm real estate, increasing size of farms, greater investment in equipment and rising operating expenses, farmers' requirements for both long-term capital and operating funds are expected to increase further.

The possibility that credit demands of farmers and other rural businesses may continue to rise at a faster pace than deposits of rural banks has caused many country bankers, as well as some of their customers, to give consideration to all possible means of boosting the prospective supply of funds available to serve local credit needs.

While interest has focused primarily on the probable overall supply and demand for credit in individual communities, concern about the adequacy of credit service for the larger individual borrowers also has been noted. As farms and other rural businesses expand in size and in the amount of capital investment per worker, the credit needs of some of the customers of rural banks have outgrown the

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maximum credit these banks can extend to individual borrowers. For example, nearly one-third of the banks in the Corn Belt states reported in a survey, conducted by the American Bankers' Association, that they received qualified loan applications during the first half of 1965 that exceeded their lending capacity.

Loan-deposit ratios rise

During the past 10 years, deposits of Seventh Federal Reserve District "agricultural" member banks (those in which agricultural loans account for 35 per cent or more of total loans and are located in towns of less than 15,000 population) have risen about 60 per cent. Loans, on the other hand, have risen more than 100 per cent. Even though the total dollar amount of deposits was up more than loans, the ratio of loans to deposits at these banks has risen from 37 per cent in mid-1955 to 48 per cent in mid-1965. This trend is evident also in the rising number of agricultural banks having loan-deposit ratios above 50 per cent—a ratio which many country bankers conventionally describe as "loaned up." The proportion of agricultural banks in which loans exceeded 50 per cent of total deposits rose from 16 per cent in 1955 to 45 per cent in 1965; those reporting loan-deposit ratios of 60 per cent or more increased from 4 to 18 per cent.

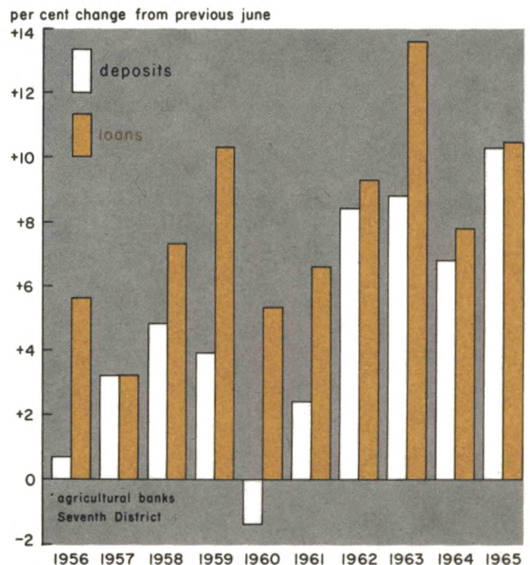
Banks' share declines

Evidence that credit demand in rural areas has grown faster than the ability, willingness or capacity of country banks to provide credit service is also found in the growth of farm debt and of agricultural loans at banks. Farmers' total debt has increased sharply since the mid-Fifties—from 15 billion to about 36 billion dollars at the start of 1965. In addition, the rise of farm debt has been at an increasing rate. The average annual increase from 1955 to 1960 was 1.7 billion dollars while from 1960 to 1965 farm debt rose at an annual average of 2.4 billion.

Although agricultural loans at banks have increased rapidly during this period, the proportion of total farm loans extended by banks has declined. In the states of the Seventh District, for example, banks accounted for more than 82 per cent of the non-real estate loans to farmers held by all commercial lenders in 1955. This share had declined to about 76 per cent in 1965, even though the total amount of such bank loans had nearly doubled.

A similar development has occurred in real estate financing. Although banks' holdings of farm mortgage loans have risen substantially, their share of the total farm real estate debt held by all lenders declined rather steadily until 1962. During the past three years, the commercial banks' relative position in this

Loans outpace growth in deposits



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type of credit has strengthened somewhat.

Needs to rise further

General agreement exists that capital requirements of agriculture as well as those of other industries in many of the smaller centers will continue to rise in the years ahead. A recent study published by the Farm Foundation, for example, estimates that capital requirements for a typical commercial dairy farm in the Lake states in 1980 may be around 70,000 dollars compared with 43,000 in 1963. In the Corn Belt, the estimated capital requirement in 1980 ranges from 157,000 dollars for a hog-beef farm to 235,000 for a cash-grain farm compared with 99,000 and 137,000 dollars, respectively, in 1963. As investment per farm increases, many individual farmers may find it increasingly advantageous to utilize a single source of credit to supply their short-, intermediate- and long-term credit needs.

Needs can be met

The banking system in the United States would appear to be capable of providing the various types of credit required in rural areas—with the possible exception of some long-term real estate mortgage credit and some marginal high-risk credit—and in sufficient amounts. This assumes, of course, that individual banks are operated efficiently and competitively and that the banking system overall provides an effective and adaptive mechanism through which funds flow into and out of areas in response to needs and interest rates.

There is no reason to expect that any one industry or area will generate from its own resources the precise supply of loanable funds needed by that industry or area at any given time. In some areas, an abundance of funds is generated relative to the opportunities for local investment while in other areas the opposite situation may prevail. One of the jobs of the banks and other financial institutions is to distribute loanable and investible funds among areas, firms and individuals in such a way as to serve the highest priority needs. Even in favorable circumstances, this tremendously complex task can be accomplished effectively only if there is flexibility of interest rates paid to savers and investors and of rates charged borrowers, so that changes in these rates and the differentials between them can guide the flow of funds among the various areas and users.

Deposit growth in rural areas has been comparatively slow, in part, because total employment and income in these areas has not risen as fast as in many urban areas. Deposit growth is affected also by the interest rates paid on time and savings deposits relative to the interest rates or dividends paid by other financial institutions both in the area and outside. In the Seventh District, a survey conducted early in 1965 indicated that nearly 16 per cent of the agricultural banks paid 3 per cent or less on "passbook" savings deposits.

With modern means of communication, liquid financial assets do not necessarily "reside" in the same communities as their owners but tend to flow to areas of highest interest rate. While small banks in rural areas probably could not attract sizable amounts of time or savings deposits from sources outside the area, by providing an attractive local market for savings they can intercept more of the community's current savings. They might succeed in retaining at least a portion of the funds accumulated by individuals retiring from farming or other activities even if the owners of such funds were to move to other areas.

If there is unsatisfied demand for credit in an area, interest rates on time and savings

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deposits and on loans will probably be higher than if there is an abundance of funds available. In addition to interest rates, deposit growth may be affected by the particular types of deposit services offered. Maturity, negotiability, withdrawal provisions and method of computing interest all may affect the attractiveness of a deposit service.

Key role for correspondent banking

Even with thorough cultivation of local sources of deposits, banks in some areas still may find that additional sources of funds are needed to provide adequate credit to farmers and others. Correspondent arrangements with banks located outside the area provide the most obvious means of channeling funds into the capital-deficit communities. Various surveys have indicated that commercial banks typically maintain correspondent relationships with several banks in other cities.

The volume of loans handled through correspondent banking arrangements appears to have increased considerably in recent years. Agricultural loans of the weekly reporting member banks in leading cities of the Seventh District, for example, have nearly doubled since 1960. Many of these loans were originated by rural banks. However, there still may be qualified agricultural loan applications not now accommodated by small banks which could be served through the joint actions of more than one bank.

The arrangements made between respondent and correspondent banks vary greatly, depending upon the particular type of loan and the policies of the respective banks. The rural bank typically will negotiate the loan but will lay off all or a portion of it to the correspondent bank.

In some instances the correspondent banks accept only "overline" loans—those in which the originating bank retains a portion equal to its legal limit for loans to individual borrowers. In other circumstances, where the loan-deposit ratio may be higher than desired, most or all of the loan may be sold to the correspondent. In some instances, the correspondent may agree to participate in a specified portion of the total portfolio in certain types of loans. The correspondent relationship therefore can be geared to the individual bank's needs and can accommodate loans that exceed the bank's individual loan limit as well as situations where the total loan volume is pushing above the desired level.

If correspondent arrangements are to provide an effective means of channeling funds, the rural banks must be willing and able to provide adequate credit information on loan applicants and, in most cases, to service and collect the loans. On the other hand, city correspondents must be willing to handle large numbers of comparatively small loans and have personnel who are familiar with agricultural credit and the banking practices in rural areas. The further development of the potentials of correspondent banking may provide a closer linkage between banks in capital-scarce communities and the national money market.

The linkage between country banks and the national money market also could be tightened somewhat if banks in capital-

Loan-deposit ratios of member agricultural banks

	Average as of June			
	1955	1960	1964	1965
Illinois	32.8	38.7	41.0	43.8
Indiana	33.9	42.8	43.8	45.4
Iowa	42.5	50.7	54.8	52.2
Michigan	43.0	51.5	56.5	55.0
Wisconsin	36.2	42.7	46.7	46.3
Seventh District	37.2	44.7	47.6	48.0

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deficit areas were to utilize the farm loan discount facilities provided by the Federal Intermediate Credit Banks (FICBs) pursuant to the Federal Farm Loan Act, as amended, in 1923. Banks may discount agricultural loans directly with this institution. Also, bank personnel may organize an agricultural credit corporation and discount loans made by the corporation with the FICBs. The FICBs obtain funds by selling debentures to investors, thereby tapping the national money and capital markets.

While the discounting of agricultural paper with the FICBs can provide access to some additional funds, the amount is limited by the capital of the discounting bank. No commercial bank can discount with the FICBs an amount of loans that would increase its total liabilities (other than deposit liabilities) above that permitted by the laws governing state and national banks or an amount that exceeds twice its paid in and unimpaired capital and surplus. National banks can have borrowed funds, including discounts, in an amount equal to the paid-in capital plus one-half the surplus, while the banking regulations of the individual states vary greatly.

A second method of discounting agricultural loans with the FICBs is through the creation of a bank-affiliated agricultural credit corporation. Although there is no legal connection between a bank establishing such a corporation and the corporation, the capital stock typically is owned by the stockholders of the bank and the corporation is managed and operated by one or more of the bank's directors, officers and employes.

The corporation is capitalized to accommodate the volume of agricultural loans expected to be discounted with the FICBs. Present laws permit the FICBs to extend credit to the corporation up to 10 times the unimpaired capital stock although a somewhat smaller multiple would probably be utilized in normal operation.

Principal advantage of this arrangement is that the amount of loans that can be made is limited by the capitalization of the corporation, not by the ability to generate additional deposits. Some bankers who are or expect to be faced with a larger demand for agricultural credit of short and intermediate term than can be accommodated through their bank have organized agricultural credit corporations. To make such an undertaking worthwhile, sufficient year-around loan demand must be available to justify the capital investment. If the demand for agricultural credit is largely seasonal, it might not be possible to earn a satisfactory return on the capital invested in an affiliated agricultural credit corporation.

Commercial banks have made only limited use of the discount facilities of the FICBs—less than 50 bank-affiliated agricultural credit corporations are currently operating in the nation and only about a half dozen banks are currently discounting agricultural loans directly with FICBs.

Real estate represents a large portion of total investment in many farming areas.

Non-real estate farm loans outstanding in District states

January 1	Commercial banks	Production Credit Assoc.	Ag. Credit Corp.	Farmers Home Admin.
	(per cent of total)			
1955	82.4	12.1	0.7	4.8
1957	79.0	12.6	0.6	5.1
1959	79.8	15.5	0.6	4.1
1961	78.2	17.4	0.5	3.9
1963	77.1	17.7	0.8	4.4
1965	76.0	18.6	0.8	4.6

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Farm real estate credit outstanding in District states

January 1	Commercial banks	Life ins. co.	Federal Land Banks	Farmers Home Admin.	Individuals and others
			(per cent)		
1955	15.9	29.7	16.6	1.5	36.2
1957	14.6	29.5	17.6	1.3	36.7
1959	14.1	29.0	18.6	1.6	36.8
1961	13.8	27.8	20.0	1.7	36.6
1963	14.1	26.5	21.0	1.9	36.5
1965	14.8	25.9	20.8	1.8	36.7

Commercial banks, because of the nature of their deposits and the priority given to serving the short-term credit needs of the community, often may be unable to provide from the bank's resources the long-term mortgage loans needed to finance transfers of farm real estate. There are numerous investors, however, who seek long-term loans. Since the local banker usually is familiar with both the property and the borrowers in such transactions, he is in a favorable position to provide credit service if he has access to the necessary funds.

Many banks have entered into arrangements with one or more insurance companies or other long-term lenders that will handle such long-term credits. In some cases the bank acts as agent, and in other cases the agreement provides that the long-term lender will buy the mortgage from the bank within a given period. Through this means a bank can obtain access to funds which enable it to handle the long-term farm loans for local customers without jeopardizing the liquidity of its loan portfolio.

A number of banks in recent years have turned to investors, usually located outside the local community, as a source of funds. In some instances, this has taken the form of negotiable time certificates of deposit (CDs). These certificates usually are of short maturity and in some instances have caused difficulty because either too high a price was paid for the funds or because it was difficult to "turn over" the certificates when they matured. A close "relative" of the CD is the short-term note which recently has come into limited use. These instruments probably will be used mainly by the large money market banks and at this time appear to be of limited application in enabling rural banks to meet growing demands.

Another means of obtaining funds from investors is the sale of capital notes or debentures. These generally have 10-year maturities or longer and therefore assure that the funds will be available for a number of years. This means of obtaining funds also provides a fixed annual interest obligation as well as the eventual need for paying or refunding the debt. The amount of funds that can be acquired in this way is limited by both the relevant banking laws and regulations and the willingness of investors to purchase such securities at rates that banks are willing and able to pay.

A final source of funds is borrowing from other banks. Banks that are not members of the Federal Reserve System may borrow from other commercial banks while those that are Federal Reserve members may borrow from both commercial banks and a Federal Reserve Bank. Such borrowing normally is limited to unusual, seasonal or emergency needs and is not expected to provide a continuing source of additional funds. The main distinction between borrowing from a commercial bank and borrowing from a Reserve Bank is that the latter will always be in a position to extend the loan if it is for an appropriate purpose.

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