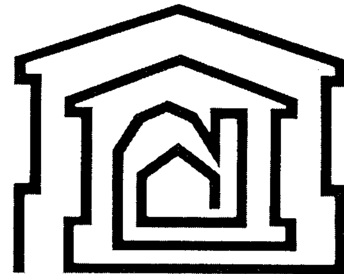
IMPROVED FUND AVAILABILITY AT RURAL BANKS



Report and Study Papers of the Committee on Rural Banking Problems

Board of Governors of the Federal Reserve System June 1975

PREFACE

This volume presents the report of the special committee appointed in January 1970 by the Board of Governors of the Federal Reserve System to study agricultural credit problems, with particular attention to possibilities for improvements in the marketability of bank agricultural paper. The research papers prepared for the committee are also included.

This volume is the outgrowth of a committee suggestion to the Board of Governors in July 1973 that the report and study papers would be of interest to others in the Federal Reserve System, as well as to bankers and other members of the public, and that the Board would benefit further from the comments of these persons on the analyses and proposals presented.

The special committee was made up of members of the Board of Governors and Presidents of Federal Reserve Banks. President Hugh D. Galusha, Jr., of Minneapolis served as chairman until his untimely death in January 1971; the Board of Governors subsequently appointed President George H. Clay of Kansas City to this position. Other committee members included President Monroe Kimbrel of Atlanta and Governor George W. Mitchell. Former Governor Chas. N. Shepardson assisted the committee in his capacity as Special Consultant to the Board.

The committee assembled a staff to assist in developing and implementing a study program. The staff was chaired by Emanuel Melichar, Division of Research and Statistics, Board of Governors. Federal Reserve Bank personnel also serving on the staff were Raymond J. Doll, Kansas City; Richard J. Herder, Minneapolis; Roby L. Sloan, Chicago; and Gene D. Sullivan, Atlanta.

To obtain assistance in carrying out its primary study assignment, the committee also assembled a markets study group with broad knowledge and experience in the areas of bank supervision, Federal Reserve statutory authority, capital and money markets, and agricultural finance. Staff members Raymond J. Doll and Roby L. Sloan also served on the markets study group, which was chaired by Mr. Sloan. Other Federal Reserve Bank personnel in this group included Joseph E. Burns, Dallas; James A. Cacy, Kansas City; Joseph Campbell, Philadelphia; Robert P. Forrestal, Atlanta; Lester G. Gable, Minneapolis; and Irwin D. Sandberg, New York.

The authors of the research papers published in this volume made significant contributions to the committee's work. Some of the papers were prepared by members of the committee's staff or markets study group; others represent studies undertaken at the request of the committee or are special reports on relevant aspects of ongoing investigations that came to the committee's attention. Also contributing to the work of the committee were Robert C. Holland, Board of Governors; James R. Guffey, Kansas City; and Ernest T. Baughman, Chicago. The Board is indebted to those individuals named above and to numerous others who cooperated in the activities of its special committee and who assisted in the preparation of this volume.

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IMPROVED FUND AVAILABILITY AT RURAL BANKS

In 1970 the Board of Governors of the Federal Reserve System established a study committee to continue investigation of rural banking problems that had been pointed out in the "Report of a System Committee" as part of the *Reappraisal of the Federal Reserve Discount Mechanism*. The central cause of these problems, as described in that report, is the inability of small banks—as sellers of assets or liabilities—to raise funds effectively in the Nation's financial markets. Two main results of this limitation were noted. First, because of inability or unwillingness to tap money markets for short-term funds, small banks tend to hold a larger proportion of their assets in liquid form and as a result may be providing less credit to their communities than they otherwise could. Second, if such banks are servicing areas or sectors with an over-all credit deficit, they are frequently unable to obtain outside funds to help close the gap between local supplies of and demands for funds.

The disadvantage at which small banks find themselves in financial markets is a general banking problem, but is also largely a rural problem because small banks tend to be located in rural areas. Several other considerations are involved. Because the principal borrowers from these banks are in the farming and rural business sectors, the financing of these sectors may be affected. The handicapped banks are concentrated in States that prohibit or restrict branching, and so banking structure issues are involved. From yet another point of view, the fact of inadequate access to outside funds reflects adversely on the capabilities or performance of financial mechanisms now used to obtain such funds. These mechanisms include correspondent credit services and the discount functions of the Federal Reserve Banks and the Federal intermediate credit banks.

In the course of their study of these interrelated problems, the committee and its staff encountered several widely held views and opinions that bear on the need for and desirability of the proposals submitted in this report. Because some of these views are not well founded, they should be discussed before the proposals are introduced.

The first widespread view is that many rural banks typically hold funds in excess of real liquidity needs and that this behavior implies little interest in acquiring outside funds. Banking statistics indicate that a number of rural banks do hold liquid funds that appear excessive in the light of modern banking practice. This proportion is less than it may seem at first glance, however, because characteristics such as the seasonal and undiversified lending common at small rural banks require maintenance of greater liquidity, given present institutional arrangements. But more important, statistics

also show that a significant number of rural banks are loaned up and seeking additional funds. These banks are concentrated in areas where local enterprises such as cattle feeding have been expanding at a rapid rate. Banks in such an environment should be able to tap nonlocal sources for additional funds to help meet the temporary local capital deficit.

A second and related opinion occasionally encountered is that rural bankers are generally bound by tradition and reluctant to innovate, and so are either not interested in programs to acquire additional funds or not competent to take advantage of them. The committee found that this view does not appropriately characterize present rural banking. Among rural bankers, the committee encountered much interest in and sophisticated appreciation of the various proposals that were under consideration. While the committee's studies were in progress, an Agricultural Credit Task Force formed by the American Bankers Association (ABA) independently raised and examined many of the same problems and possible remedial actions. A preliminary task force report suggesting aggressive action to secure access to larger financial markets was actively discussed and favored by rural bankers attending the 1971 ABA National Agricultural Credit Conference.

A third view is that actions to provide money market access to small banks would necessarily result in some kind of credit subsidy to agriculture or to rural areas. According to this view, such actions could involve the Federal Reserve System in allocating credit on a preferential basis to these specific sectors or in subsidizing the bank credit they obtain. The committee agrees that such eventualities would be undesirable and believes that its recommendations are free from any such possibilities. On the contrary, optimization of the performance of the private economy and of the impact of Federal Reserve monetary policy actions requires that all major sectors have efficient access to national financial markets. The committee's proposals are intended to move the financial system a step closer toward realization of that requirement.

The committee was concerned with the current and prospective credit demands of agriculture and nonfarm rural development, but only to ascertain that the problem assigned to it was practical rather than theoretical. In general terms, the primary task of the committee was to find ways to remove or ameliorate present restrictions on the ability of certain credit users to engage in competitive bidding for funds in the main private financial markets. Whether these persons are subsequently outbid by others with more profitable projects was not an issue within the committee assignment; nor was the possibility that some persons should receive preferential access or subsidies because their projects are in the public interest. These are legitimate public concerns, but they lie outside the responsibilities that the Congress has assigned to the Federal Reserve System.

The committee sought to examine the various topics that it considered relevant to its assignment. Its staff and other cooperating personnel provided descriptive and analytical papers, as well as discussions of various measures that might be recommended.

The committee examined closely the experience of the Federal intermediate credit banks (FICB's), which, because they discount farm loans made by banks, now represent a channel of money-market access for rural banks. It found that the practices of the FICB's must be revised before a significant expansion of the present nominal volume of such discounts can be expected. Although such revisions would improve credit service to agriculture, in the near term the FICB's appear unlikely to adopt a more accommodative stance toward discounting by banks or bank affiliates. The committee's findings are discussed in greater detail in Appendix A.

A significant increase in the effective size of banks serving rural communities would also improve the degree of money market access that rural areas obtain through the banking system. In most rural areas, the required increase in bank size could be achieved only through branching or holding company affiliation. Most banking organizations resulting from such structure changes would have a primarily urban base, which led the committee to examine the probable impact on credit serv-

ices to the rural communities involved. Larger banking organizations were found to have significant inherent advantages in the provision of credit services and in the ability to employ banking resources efficiently, but it remains uncertain that such organizations do in fact achieve an optimum deployment of funds as between rural and urban sectors or industries. The committee sponsored several studies of the impact of ongoing changes in banking structure and believes that additional research in this area would be useful. This subject is discussed further in Appendix B.

Having considered the entire range of problems and alternative actions, the committee submits proposals in four areas, each of which is discussed in a subsequent section of this report.

The committee proposes that the Federal Reserve System act to improve the ability of smaller banks to obtain nonlocal funds through

(1) vigorous promotion and efficient administration of the new seasonal borrowing privilege, plus implementation of a basic borrowing privilege for small banks and

(2) initiation of efforts to establish or improve mechanisms for marketing of negotiable instruments issued by small banks, including

(3) improvement of the ability of these banks to originate and market finance acceptances.

The committee further believes that the ability of smaller banks to utilize their resources effectively in local lending would be enhanced through

(4) revision of correspondent banking practices to reduce the proportion of funds absorbed by correspondent balances.

IMPROVING ACCESS TO FEDERAL RESERVE DISCOUNT CREDIT

As noted, this committee was established in response to the findings and recommendations in the "Report of a System Committee" in the *Reappraisal of the Federal Reserve Discount Mechanism.* That report concluded that the discount mechanism could play only a limited role as a source of nonlocal funds in credit-deficit areas—mainly through provision of credit for short-term adjustment purposes and for seasonal needs. But for many years the smaller banks have been reluctant to approach the Federal Reserve Banks to arrange for discount credit for even these valid uses. Appropriate use of the discount mechanism by these banks should be stimulated by adoption of basic and seasonal borrowing privileges that, as outlined in the *Reappraisal,* put most borrowing on a rather routine footing.

The seasonal borrowing privilege was implemented in April 1973. It permits member banks that lack reasonably reliable access to national money markets, and that experience seasonal outflows exceeding 5 per cent of their average total deposits, to arrange to meet a portion of their seasonal needs by borrowing from the Federal Reserve Banks. Studies by the Board staff have demonstrated that this privilege could be especially important to rural member banks. Relative to the size of the bank, seasonal outflows tend to be of greatest significance at small banks in rural areas. Often they occur because farmers simultaneously withdraw deposits and expand borrowing during the crop production season. Of the member banks at which farm loans constitute 50 per cent or more of the loan portfolio, about two-thirds have seasonal needs large enough to qualify for the new borrowing privilege. In contrast, about one-third of all member banks are likely to qualify.

Utilization of the seasonal borrowing privilege by the rural banks that qualify can also help these banks in financing the nonseasonal loan demands of their communities. Because these banks have lacked reliable access to nonlocal sources of short-term funds, they have been meeting their seasonal outflows by maintaining the seasonal inflow of deposits and loan repayments in liquid forms until the next seasonal outflow occurs. Thus a considerable part of the banking resources of communities serviced by such banks has been employed productively for only a fraction of each year, perhaps with adverse consequences for community economic development. Use of the seasonal

borrowing privilege would release some of these funds for other lending purposes.

Without encouragement, however, it is likely that many small banks will not approach their Reserve Bank regarding their eligibility for seasonal credit. Therefore, the Reserve Banks must take the lead to ensure that the borrowing privilege is properly utilized for the benefit of communities in which seasonality creates financial strains. The benefits of the seasonal borrowing privilege should be aggressively publicized and promoted by the Reserve Banks, and they should make a special effort, in administering the privilege, to employ procedures that harmonize with the management practices of small banks.

Though the seasonal borrowing privilege represents a significant advance in Federal Reserve recognition of the adjustment problems peculiar to small banks, a significant proportion of such banks do not qualify for the seasonal privilege. Thus it is also important to give attention to the administration of borrowing for other adjustment purposes. Present regulations, though not intended to discourage borrowing by small banks for appropriate short-term adjustment purposes, in practice have unfortunately had this effect. In contrast, if a basic borrowing privilege, designed along the lines outlined in the *Reappraisal,* were extended to these banks, they would be much more likely to utilize Federal Reserve discount credit for appropriate short-term adjustment needs. In addition, the revision of Regulation A may be particularly timely now to help offset the adverse impact on some small banks of the recent changes in Regulations D and J.

Finally, as was recognized in the *Reappraisal,* Federal Reserve discount credit is not a general answer to problems stemming from the structural disadvantage of small banks, particularly those at which loan demands associated with economic and community development are pressing against local financial resources. And, of course, many small banks are not members of the Federal Reserve System and, if they remain nonmembers, are normally ineligible for Federal Reserve discount credit. The most promising general solution to rural credit-deficit problems lies in improving the ability of small banks to raise funds in the main financial markets.

MARKETING OF NEGOTIABLE INSTRUMENTS

To begin to raise funds effectively in national money markets, small banks would have to offer instruments and arrangements that meet the needs of the principal investors active in these markets. The main requirement of these investors is safety of principal. Additionally, the instrument must have a significant degree of liquidity such as provided by short maturities, an active secondary market, or an issuer willing to repurchase the paper. A significant total volume of outstanding paper—measured in the hundreds of millions of dollars—and a continuity of supply are other necessary characteristics that attract buyers and help to establish a secondary market. Also, the procedures of purchase, handling, and redemption must be accomplished conveniently and at relatively low cost, as is true for instruments now traded. One result of this consideration is that most transactions are conducted in sizable units, usually multiples of $100,000 or more.

For the small banks that might seek money market funds, an efficient sales operation is also mandatory because of the fairly narrow average spread between the prospective cost of the funds raised and the return earned from most bank loans. For the same reason, the banks on average could not afford to raise the desired funds in markets in which they would pay significant premiums to compensate investors for real or suspected deficiencies in safety, liquidity, convenience, and other characteristics.

It is not surprising, therefore, that small banks are not raising funds in money markets, because their paper fails on most counts to meet the important market requirements. Evidently, the achievement of significant access to the money market requires the imposition of an intermediary between such banks and the market—an intermediary that can endow the paper offered by small banks with the qualities re-

quired by the market, or that can convert the paper to more marketable forms.

The committee considered several alternative types of intermediaries. One with considerable "grass roots" appeal would be an intermediary organized and capitalized by small banks acting in concert, after passage of enabling legislation to set aside current prohibitions on such activities and investments. It is difficult to know, however, whether a significant venture of this kind lies within the scope of joint activity possible from a large number of widely scattered and relatively isolated small banks. Individual benefits and profit potential may not be commensurate with the skills and effort required. Nevertheless, as a minimum expectation it is probable that regional organizations of small banks could tap regional sources of funds such as State employee pension funds. This would be a significant step toward improved access to nonlocal funds, and the committee therefore endorses enabling legislation such as S.1884 (93rd Congress), which would allow national banks to form jointly owned agricultural credit corporations. Successful experience with such ventures could pave the way for establishment of more general intermediary organizations.

A second possibility is that money market banks, their affiliates, or private nonbank enterprises will undertake to act on a significant scale as market intermediaries for small banks. Such activity would most likely constitute an additional enterprise for an ongoing department that already possesses most of the requisite experience and facilities. Profitable operation may be more likely than in the case of new organizations established by rural banks for the same purpose. The next section of this report discusses the role that money market banks might play in marketing one of the instruments—bankers' acceptances—that might be originated by small banks for eventual sale in money markets. Operations in other instruments may also be possible.

These possibilities, however, must be contrasted with the fact that private initiatives have thus far not provided small banks with significant access to money market funds. And if major private mechanisms do develop, it would be important that they continue to function during periods of monetary stringency as well as in easier times. Mechanisms operated by money market banks or similar institutions might be particularly vulnerable on this score.

These considerations suggest that the intermediary to raise funds for small banks would likely have to take the form of a public agency. Several Federal agencies of a similar nature have already been established; for example, the Federal intermediate credit banks to raise money market funds for the production credit associations, and the Federal home loan banks to perform this function for savings and loan associations. The Congress could use these well-established systems as models for a financial intermediary to service rural banks. In so doing, it would be taking a useful step toward perfecting the financial mechanisms serving rural areas.

In the absence of such legislative action, the Federal Reserve System's interest in perfecting financial markets—in order that the impact of monetary policy actions may be rapidly and equitably distributed throughout the economy—provides a basis for considering Federal Reserve action to improve the access of small member banks to principal money markets. The nature and scope of appropriate Federal Reserve action could vary considerably, and the committee examined various alternatives.

The Federal Reserve Act provides specific authority for the Federal Reserve System to purchase and sell bankers acceptances and time drafts in the open market, and it is probable that this power carries with it the lesser power to act as broker for the purpose of sale of these instruments. The System has for many years continually purchased bankers acceptances in order to assist in the financing of international trade. It should be feasible to extend such operations, with particular attention to development of a market for the acceptances of small member banks. Federal Reserve operations in acceptances should also help to develop a market for the finance acceptances described in the next section.

A market for a single asset instrument, though helpful, would still be considerably removed from the ideal of an effective market

in each type of asset and liability commonly originated by banks. If such markets were available, each bank faced with the need to raise funds would have many options; it could evaluate several alternatives in the light of prevailing market conditions and choose the optimal means at the time. This is the ideal toward which the Federal Reserve System should seek and encourage progress.

A significant step toward improving the ability of small banks to raise nonlocal funds for all lending purposes, involving perhaps the least cost and effort, would be the establishment of a mechanism for marketing a single deposit instrument that small banks could issue. Thus the committee studied in detail the possibility of Federal Reserve assistance in the marketing of a special time deposit instrument. One plan, described in a staff report, would provide that the Federal Reserve System assemble and pool orders from small member banks for sale of special time deposit certificates, and periodically conduct an auction of large-denomination participations in the pool of these certificates. These participations would have the characteristics of safety and size demanded by money market investors, and a secondary market in them would undoubtedly develop to provide liquidity.

An arrangement along these lines appears to offer excellent prospects for efficiently bridging the present gap between rural bank paper and the requirements of the major financial markets. The Federal Reserve System should actively consider establishing such a mechanism, in the absence of other private or governmental initiatives, to improve the ability of small and rural banks to raise funds in those markets.

MARKETING OF FINANCE ACCEPTANCES

If more liquidity could be introduced into the asset side of bank portfolios, adjustments to both short- and long-term imbalances between loan and deposit flows would be facilitated. It would be desirable for a bank faced with loan demands in excess of available funds to be able to sell some loans or equivalent assets already held, or to be able to extend the new credits in the form of immediately marketable instruments. But present markets for most types of bank loans are poorly developed, a situation faced by both large and small banks. In these circumstances, one promising avenue to greater asset liquidity for all banks appears to be the "finance" acceptance, also sometimes called the "ineligible" or "working capital" acceptance, "marketable time draft," or "finance bill."

Though several billions of dollars of bankers acceptances are currently outstanding, the bulk of this amount represents "eligible" acceptances —those acceptances that may be presented for discount at Federal Reserve Banks because they represent credits secured by goods being exported, imported, or otherwise in transit or in storage. Rigorous documentation of such collateral must accompany these acceptances. Thus limited use has been made of acceptances in rural lending, although recently banks in several States have financed cattle-feeding operations by means of finance acceptances marketed through brokers in New York.

However, acceptances do not have to be secured by goods in transit or storage. Any loan can be made in the acceptance form: instead of the usual loan instrument, the borrower signs an order to pay a stated amount on a specified future date, drawn on the bank extending the credit. This draft becomes an "acceptance" if and when the bank chooses to undertake an obligation to make payment— which is physically accomplished by stamping "accepted" on the face of the instrument. With this act the instrument becomes an obligation of the bank as well as of the borrower, and the bank has thereby created an instrument that may be salable in money markets.

As noted in the preceding section, obligations of small banks generally lack the characteristics required by national money markets. However, the differences are least evident in the acceptance form. Since most acceptances are originated through international and domestic trade transactions, many are written in smaller amounts than other money market instruments and also in odd amounts and with various maturities. Thus the characteristics of

acceptances that small banks could originate would not differ materially from some already being created and traded, even though money market investors prefer more convenient instruments. However, such investors generally do not regard the obligations of small banks as being absolutely safe from default and thus they refrain from buying such paper.

In the case of acceptances, there appear to be at least two practical ways of overcoming this remaining difficulty. First, as already noted, some intermediate-size banks have established relationships with brokers for the specific purpose of marketing acceptances, and these banks may thereby gain access to the market. Many intermediate-size banks handle the overline portion of the larger loan requests received by small banks. These participation loans and their own direct loans could be made in the form of acceptances, which would be easier to sell should a need for funds arise.

More generally, however, acceptances issued by small banks could be marketed with the assistance of the banks' money market correspondents. Whereas most investors lack sufficient knowledge about individual rural banks to judge their paper as safe from default, in most cases the principal money market correspondents either already possess or could more readily develop such knowledge. These correspondents may therefore be willing to purchase the acceptances of many small banks at a reasonable discount, endorse them to make them as marketable as their own acceptances, and then sell them to investors. With such assistance from large correspondent banks, acceptances could develop into a source of money market funds for even relatively small rural banks.

A former impediment to origination or endorsement of finance acceptances was that the statutory limit on each bank's issuance of "eligible" acceptances was also generally considered applicable to finance acceptances, which apparently limited the amounts that individual banks created or endorsed. In May 1973, however, the Board of Governors of the Federal Reserve System issued an interpretation that made it clear that this restraint did not apply to finance acceptances. At the same time, the Board proposed to apply reserve requirements against the proceeds from sale of such acceptances. In June the Board announced a reserve requirement identical to that required against large time certificates of deposit. Having taken these steps, the Federal Reserve System should now give special attention to facilitating the use and sale of finance acceptances by small banks that are unable to sell certificates of deposit in major money markets.

CORRESPONDENT BANKING PRACTICES

Small banks obtain many services from other, usually larger banks. Traditionally, they have paid for these services indirectly, by maintaining a demand deposit account at each of the banks rendering services. A portion of rural banking resources is, therefore, at all times maintained in balances at urban banks, rather than being available for lending. The sums involved are significant. In June 1971 banks located or headquartered outside of Standard Metropolitan Statistical Areas held balances in other banks equal to 6.1 per cent of their own deposits. Among States this ratio ran as high as 10.4 per cent for banks in Texas. Within States the smaller banks tended to hold relatively higher balances than larger banks.

The practice of paying for banking services through maintenance of deposit balances in excess of amounts required by clearing and reserve functions arose in the past when available funds at most rural banks far exceeded loan demands. Through tradition and inertia, this practice has continued, even though many rural banks now have other urgent uses for the funds still absorbed by correspondent balances at larger urban banks. The latter banks also have urgent uses for funds, but they are able to raise additional nonlocal funds in financial markets whereas the smaller rural banks are limited mainly to local deposits. It is unfortunate and inappropriate that present correspondent practices thus remove funds from banks that cannot raise funds elsewhere to replace these losses, and move the funds to banks that

usually do have alternative sources of nonlocal funds in money markets.

Therefore, where local credit demands warrant, rural banks should seek correspondent arrangements that permit payment for services on a fee basis rather than through maintenance of balances. The funds that would have been maintained in balances should be put to work in local loans and investments, and the earnings used to pay for correspondent services.

The larger correspondent banks, which have access to alternative sources of funds in money markets, are in a position to aid rural banks in this and other ways (such as by assisting in the marketing of acceptances). It may well be in the long-run interest of correspondent banks to help rural banks to cope with their relatively new tighter liquidity positions. As the Federal Reserve System assumes a greater role in the check-clearing function, as changes in banking organization occur, and as rural bankers become more efficient money managers, balances are likely to prove an obsolete means of payment for correspondent services.

July 25, 1973

APPENDIX A

Discount Credit From Federal Intermediate Credit Banks

The Federal Farm Credit Act has for many years provided that commercial banks may discount farm loans with Federal intermediate credit banks (FICB's). This provision, however, has been little used; on January 1, 1971, only 14 banks had current discount agreements. As an alternative to direct discounting, banks or bank officers can form agricultural credit corporations to make and discount farm loans. But on the same date, only 87 banks were associated with such activities. Outstanding discounts, both direct and through bank-affiliated agricultural credit corporations, totaled a nominal $59 million.

These data were ascertained in the course of an intensive examination of experience with, and prospects for, the FICB discount mechanism, performed for the committee by an academic consultant. The committee was particularly interested in learning why the discount mechanism provided by the statute was not being used to a greater extent, in hopes of discovering the adjustments required to make it a significant source of funds for rural banks.

The most significant and reassuring finding of the study, from the committee's viewpoint, is that the relative disuse of the FICB discount mechanism in large part does not stem from lack of need or lack of interest on the part of commercial banks. In response to a survey, many bankers indicated an interest in the discounting of farm loans by their banks and thought that the mechanism could play a significant future role in farm credit. Banks using the mechanism found it helpful in coping with farm financing problems.

The study added materially to knowledge of the major reasons for disuse, which many have assumed to be primarily due to reluctance by bankers to utilize a source of funds controlled by their major farm lending competitors—the production credit associations. The study confirmed that some bankers feel this way, but also found indications that many FICB's were reluctant to discount loans for banks. For instance, one-third of the rural bankers surveyed were unaware of the mechanism, probably because it received little promotion. Applicants for discount agreements were required to submit proof of need for this service, and acceptable proof was found to vary substantially among farm credit districts. Some districts required documentation of the inadequacy of farm credit service in the applicant's area, including the service provided by the production credit associations. In these districts, no banks and very few bank-affiliated agricultural credit corporations had discount agreements. In most districts, relatively high capitalization requirements discouraged the formation of agricultural credit corporations by the smaller rural banks.

Bankers and bank-affiliated agricultural credit corporations using the mechanism were generally pleased with the results of discounting, but not so pleased with the procedures involved. Many respondents to the consultant's survey noted that procedural guidelines and instructions were not provided, and that the loan documentation required appeared excessive in view of the fact that the FICB would have recourse against the bank as well as the borrower in case of default by the latter.

The two periods of severe monetary restraint during the last decade showed the Farm Credit System (FCS) to be particularly reluctant to accommodate expanded discounting by banks at times when the cost of funds was high and when

some persons feared that available funds might soon be rationed by governmental allocation as well as price. After the second episode of tight credit conditions, the Farm Credit Administration in August 1970 placed a 2-year moratorium on establishment of new discount agreements. Before lifting the moratorium, it implemented new regulations that formally restricted eligibility to banks servicing largely rural areas (banks with at least 25 per cent of loan volume in farm loans) and with a relatively high loan/deposit ratio (at least 60 per cent).

Obviously it is unnecessary for the FICB's to service banks that are large enough to participate in money markets directly; similar logic is reflected in the Federal Reserve System's seasonal borrowing privilege and in proposals made in this report. Through its new farm-loan-ratio requirement, the FCS will indirectly exclude these large banks. But unfortunately this requirement also excludes many small banks in communities in which farming happens to comprise a small proportion of total economic activity because of the presence of other industries, often of an agribusiness nature. Financing of farmers in such communities may be adversely affected. The FCS should therefore consider replacing its farm-loan-ratio requirement with a rule that would permit discounting of farm loans by all banks that lack direct access to money markets.

If only these smaller banks are provided with discounting arrangements, the demand for discounting may not rise unduly during periods of monetary restraint. However, if sudden and major shifts in over-all demand for discounting should nonetheless occur and present problems for the FICB's, increases in discounting by each bank during these periods could be limited to a specified proportion of the bank's historical use of the mechanism.

With eligibility explicitly narrowed, by whatever means, to those banks at which discounting of farm loans at the FICB's would represent a significant improvement in access to nonlocal funds, the burden of establishing a meaningful discount operation clearly rests with the FICB's. In such situations, as with the Federal Reserve System's seasonal borrowing privilege, the larger institution must assume the initiative. If banks are encouraged through promotion of the mechanism, adoption of nationally uniform and logical eligibility criteria, and promulgation of efficient discount procedures, many bankers will welcome the opportunity to use the FICB mechanism, according to the survey made by the committee's consultant.

In establishing this committee, the Board of Governors of the Federal Reserve System expressed the hope that farm credit problems could be ameliorated specifically through improvements in the marketability of bank agricultural paper. Improvement of the FICB discount mechanism appears to the committee to be a feasible means of achieving that specific objective on a significant national scale. As a practical matter, however, given that the FICB's are owned by farm lending competitors of banks, and in view of the concerns and attitudes of some bankers and FCS officials that were noted in the consultant's report, the FICB discount mechanism does not appear to offer a near-term solution to the problems considered by this committee.

APPENDIX B

Impact of Banking Organization on Rural Credit Service

Among the thousands of small rural banks in the Nation, a significant minority are not utilizing their own resources to an optimal degree in local lending. A few of these banks can perhaps properly plead the lack of local lending opportunities. However, too many banks with underutilized resources are located in the same areas and towns as other banks that report loan demands pressing against resources. And numerous cases have been reported of bankers who have worked to help create loan demand, to the great benefit of their communities.

Initiative is often stimulated through competition. In banking, effective competition among banks may be increased by permitting branching and holding-company forms of organization. Because of structural advantages, such as their generally larger size and more diversified market area, these banking organizations are typically able to utilize a greater part of their resources in lending, to tap outside sources of funds more readily, to service larger borrowers more easily, to attract managers with better training, and to employ specialists to handle areas such as farm lending. It seems logical to advise that these advantages be deployed in those rural communities that now suffer from the effects of underutilization by banks of the communities' financial resources.

On the other hand, bankers have warned that the larger organizations, which usually have a principally urban base, are inclined to neglect their credit service to rural communities. Comparison of farm lending trends in States with different

types of banking structure tends to support this hypothesis. In seeking more detailed information about the empirical experience, the committee sponsored several inquiries into the impact of recent changes in banking structure on farm lending and on the degree of local utilization of rural banking resources. In one State, farm lending by banks acquired by holding companies decreased; in another, farm lending by banks that established newly permitted branches increased relative to such lending by nonbranching banks. In two other States, one with limited branching and one newly permitting statewide branching, no statistically significant changes were found in the lending patterns of merged banks 3 years after the mergers. Thus these inquiries found no dominant pattern in the impact of changes in banking structure on the variables studied. Continuing examination of the impact of ongoing changes should prove useful.

These studies, however, did not deal with a central issue in discussions of banking structure: whether certain types of banking organizations, owing to their inherent structure or practices, tend to misallocate their resources among the areas or sectors they service, to the detriment of the longer-run economic development of the region. Additional research addressed to this question should also be undertaken.