The Seasonal Borrowing Privilege: Experience Versus Potential as a Source of Funds for Rural Banks

National Agricultural and Rural Affairs Conference
American Bankers Association
Houston, Texas
November 17, 1975

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For some years several analysts in the Federal Reserve System have been studying ways in which small banks might be provided with reliable access to principal money markets or with other reliable sources of funds to ameliorate the disadvantages inherent in lack of market access.[1/] The seasonal borrowing privilege emerged from this work as one type of assistance that could appropriately be provided through the Federal Reserve discount mechanism.

Over the last few years, the discount windows of the Federal Reserve Banks have been increasingly used by rural banks in need of funds to supplement their own resources. This trend reflects greater recent needs as well as new administrative features. Farm loan demands were exceptionally strong from mid-1972 to mid-1974, while monetary policy actions tended to be restrictive because of rapid general price

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The views expressed herein are solely those of the author and do not necessarily represent the views of the Board of Governors of the Federal Reserve System.

1/ Much of this work is included in Improved Fund Availability at Rural Banks--Report and Study Papers of the Committee on Rural Banking Problems, published by the Board of Governors of the Federal Reserve System in June 1975. Significant earlier papers include "Report on Research Undertaken in Connection with a System Study," by Bernard Shull, in Reappraisal of the Federal Reserve Discount Mechanism, Volume 1, pp. 27-75 (especially pp. 52-65 on "the bank adjustment problem"), and "Capital and Credit Requirements of Agriculture, and Proposals to Increase Availability of Bank Credit," by Emanuel Melichar and Raymond J. Doll, in Reappraisal of the Federal Reserve Discount Mechanism, Volume 2, pp. 107-173, both published in 1971 by the Board of Governors of the Federal Reserve System.

inflation. In 1973, therefore, 31 per cent of member banks used the Federal Reserve discount window at some time during the year. In 1974 the proportion rose still further to 34 per cent. Thus it is no longer true that the discount window is used mainly by a relatively few large banks.

Administration of the discount window also acquired new dimensions. A decade ago the Federal Reserve System undertook an extensive reappraisal of its discount mechanism in the context of a new banking environment characterized by greatly reduced liquidity at banks and by the advent of liability management. In the course of this study it became apparent that in such an environment small banks were greatly disadvantaged by their relative inability to market their liabilities or otherwise raise funds in principal money markets. By and large, these markets were not structured--nor are they now--to handle instruments issued by small institutions in small denominations. Partly to help offset the effects of this market imperfection, the Federal Reserve study committee in 1968 recommended two new borrowing privileges at the discount window: a seasonal borrowing privilege that would be available to smaller banks regularly experiencing relatively large and prolonged intra-year fluctuations in fund availability, and--to expedite routine borrowing for shorter-term adjustment purposes--a basic borrowing privilege that would provide each member bank with a specified credit line upon which it could draw on a "no questions asked" basis for a certain number of weeks each year.

The generally inflationary economic environment following 1968 did not provide a setting particularly conducive to major liberalizations of discount window policy. Nevertheless, the Board of Governors implemented a seasonal borrowing privilege in April 1973. Now, after three "seasons" of experience, this program is being reviewed. Administration of the privilege may be streamlined and somewhat liberalized before the 1976 agricultural season. Also, a Federal Reserve task force is actively developing a program for a basic credit line for all member banks.

DEFINITION

The seasonal borrowing privilege as presently administered is available to a member bank that meets two main requirements: First, the bank must lack reasonably reliable access to national money markets. Such access has been found to be primarily a function of the size of a bank. Banks with less than $100 million in deposits can be presumed to lack such access, along with many larger banks up to a deposit size of perhaps $250 million. Second, the bank must have a seasonal need for funds which arises from a combination of expected patterns of movement in its deposits and loans. If the combined seasonal outflow of funds exceeds 5 per cent of the bank's average annual deposits, the bank qualifies for seasonal borrowing and is able to borrow funds equivalent to the remainder of the customary seasonal outflow.

POTENTIAL

By studying past loan and deposit data for each individual member bank, the Federal Reserve System has annually identified most of the banks that would probably qualify for seasonal borrowing during the coming year. In 1973, for instance, it was determined that about 1,900 banks, or about one-third of all member banks, would probably qualify. The Federal Reserve Banks have made a special effort to notify these particular banks of their probable qualification and to encourage them to contact their discount officer to explore further their possible need and qualification for seasonal funds. The banks that entered into seasonal borrowing arrangements would be assured of the ability to draw upon a predetermined credit line over a specified period, with the arrangement renewable from year to year.

Comparison of the characteristics of the potentially-qualifying and other banks indicated that the probability of qualifying was strongly related to the relative importance of farm lending. Of the member banks at which farm loans comprised one-half or more of the loan portfolio, approximately two-thirds qualified for seasonal borrowing. In contrast, only about one-fourth of banks that held relatively few or no farm loans appeared to qualify. Thus it seemed that the seasonal borrowing privilege could become, over time, an especially significant source of funds for many small rural member banks that had previously seldom or never used the discount window. With the Federal Reserve serving as a reliable source of funds for part of the agricultural seasonal outflow, these banks could employ more of their own resources for other needs--perhaps intermediate-term farm loans or rural development loans.

EXPERIENCE

The seasonal borrowing privilege was announced on April 5, 1973, and became effective on April 19. There was little time in 1973, therefore, for banks to make plans and arrangements prior to the onset of the cropping season. Nevertheless, 220 banks did use the privilege before the end of the year. Total daily borrowing averaged $95 million, with a peak of $187 million reached in late August.

In 1974 there was more time for banks to make formal arrangements before their period of seasonal need. Seasonal borrowing plans were set up for 368 banks, and 321 banks actually used the privilege during the year. Total daily borrowing averaged $84 million after reaching a peak of $174 million in early August.

In 1975 banks had less need for outside funds by the time the seasonal peak arrived, and in addition the Federal funds rate remained below the discount rate from January through June. These factors apparently combined to cause the number of banks arranging for seasonal borrowing to drop to 218. By September 30, 109 banks had actually borrowed under the privilege. Use was nominal during the first half of the year but picked up during the summer. The year's peak use probably occurred in the last week of September, when 47 banks borrowed a total daily average of $73 million. Forty-one of these banks had deposits under $100 million and accounted for 57 per cent of the total seasonal borrowing that week.

After the 1973 season, several analyses were made of the characteristics of the banks that had used the privilege. As expected, from among the group identified as potentially-qualifying banks, those with the greater apparent need for funds--as measured by the relative size of their seasonal outflow and by the level of their loan-deposit ratio--proved more likely to borrow. But in addition, use of the privilege turned out to be strongly and positively related to bank size; thus, on a relative basis, small agriculturally-oriented banks were poorly represented among the actual users. Also, many of the seasonal borrowers had been previous users of the discount window, indicating that the new privilege had not attracted many banks from the large body of previous nonusers. More recently, a study of 1974 borrowing in the Minneapolis District further revealed that banks owned by holding companies were far more likely than other potential qualifiers to have actually used the privilege. This finding raises the possibility that a considerable proportion of seasonal borrowing thus far, even at relatively small banks, may have been more closely related to the availability and cost of alternative sources of funds than to the considerations underlying the rationale for the privilege.

PROSPECTS

At any rate, these analyses clearly indicate that potential seasonal borrowing is far greater than the use to date, and that the gap between the two is relatively greatest among the small independent banks--many of which are active farm lenders.

Part of the responsibility for realizing more of the potential of the seasonal borrowing program undoubtedly rests with the Federal Reserve. For instance, a study just completed in the Chicago Federal Reserve District indicates that most potential qualifiers for seasonal borrowing have in recent years switched part of their secondary reserves from Treasury bills into continual sales of Federal funds. But the Federal Reserve currently does not permit seasonal borrowing by sellers of Federal funds. Obviously this guideline must be modified for these banks to become seasonal borrowers without being required to sacrifice a liquidity-management practice that is apparently convenient and profitable.

Part of the responsibility also rests with rural bankers. Obviously they are now already managing their resources in ways that allow them to meet the annual agricultural seasonal outflow of funds--otherwise that seasonal would not be evident in their loan and deposit data. But this is accomplished at a cost in terms of their ability to meet other loan demands. The seasonal borrowing privilege allows these bankers to switch to relying on the Federal Reserve Banks for a specified part of the seasonal funds, thus releasing an equivalent amount of their own resources for increased year-round lending or for additional seasonal demands not previously met. Rural bankers should determine whether they have this further opportunity to serve their individual communities.

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