

Government Creation of a New Secondary
Market for Rural Bank Paper:
A Feasibility Study

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GOVERNMENT CREATION OF A NEW SECONDARY MARKET FOR
RURAL BANK PAPER: A FEASIBILITY STUDY

Many financial intermediaries transfer resources between agricultural and nonagricultural sectors of the economy. But several observers have suggested that because at least one type of intermediary, small agricultural banks, has poor access to national credit markets, credit is not allocated efficiently. Some of these observers have gone on to suggest that the Fed play a role in helping rural commercial banks tap national money markets.

In response to this suggestion the Federal Reserve System's Board of Governors appointed a committee in January of 1970 "to study agricultural credit problems, with particular attention to possibilities for improvements in the marketability of bank agricultural paper."^{1/}

That committee did find a role for the Federal Reserve System in improving fund availability at rural banks. In particular, it proposed that the Federal Reserve System: 1) promote use of the discount window by small banks, 2) encourage revision of correspondent banking practices to reduce the proportion of funds absorbed by correspondent balances, and 3) improve the mechanism for marketing negotiable instruments issued by small banks.

Of these three proposals the last appears to have generated the most widespread interest in the financial community. And the Directors of the Minneapolis Federal Reserve Bank, therefore, judged it worthwhile

^{1/}"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.

for the Research Department of this Bank to investigate a way to improve the mechanism for marketing the negotiable instruments of small rural banks. Specifically, the Research Department was directed "(t)o examine and report on the feasibility of creating a new institution for secondary marketing of agricultural paper generated at the local bank level in the Ninth Federal Reserve District."^{2/}

The study which we conducted in response to this charge was based on the following view: any proposed government activity in the economic sphere must satisfy two requirements in order to be judged feasible. The first of these requirements is that there is prima facia evidence that the benefits associated with that activity exceed the costs. The second requirement is that it is an activity which would not be undertaken by agents in the private sector in the absence of any government intervention.

The primary objective of our study was, therefore, to determine whether or not the creation of a new institution for the secondary marketing of agricultural paper generated at the local bank level satisfied these key requirements. Our analysis of the existing agricultural finance market led us to conclude that if the federal government's rules and practices pertaining to nonbank agricultural lending are unchanged, then the first of our requirements is not satisfied by this activity. The present paper describes the reasoning which underlies this conclusion.

The paper is divided into three sections. In the first section we briefly describe the operations of some nonbank participants in the agricultural finance market. In the next section we examine the evidence

^{2/}Ninth Federal Reserve District State-of-the-Bank Report 1977/1978, October 1977, Appendix, page. 16.

on the benefits and costs of creating a new institution of the type specified in the Director's charge and conclude that it does not support the case for government intervention. The last section contains some remarks on the future importance of rural commercial banks in the agricultural credit market and some thoughts on a possible change in government policy which would affect the banking system's role in agricultural lending.

SOME NONBANK SUPPLIERS OF CREDIT TO AGRICULTURE

The previously cited Federal Reserve study of fund availability at rural banks provides a very complete description of the ways in which rural banks currently obtain their lendable funds. That study provided ample documentation of the fact that only a small portion of these funds are obtained in central money markets. And, if rural banks were the only institution operating in the agricultural finance market, one might infer from that fact that links between national credit markets and the agricultural sector are poorly developed. However, commercial banks are neither the only nor even the largest financial intermediary participating in that market.

In this section we discuss three nonbank institutions, the Farm Credit System, the federal government, and life insurance companies, which handle most of the credit moving into the agricultural sector of the economy. Our aim in presenting these descriptions is twofold. First, we hope to give the reader a "feel" for the depth of the agricultural credit market. And second, we provide factual information which will be used in the arguments presented in the succeeding sections.

The Farm Credit System

The Farm Credit System (FCS) is this country's major source of agricultural credit. It is a cooperative system in that it is owned exclusively by its patrons. The USDA has projected that about \$36.4 billion of farm debt would be held by the FCS in 1978. This is, approximately 31 percent of total agricultural debt projected for that year.

The system's structure is summarized in the following quote:

The Farm Credit System is organized on a district basis. Each of the 12 Farm Credit Districts has a Federal Land Bank, a Federal Intermediate Credit Bank, and a bank for cooperatives In addition, a Central Bank for Cooperatives, owned by the district banks, is located in Denver, Colorado.

The Federal Land Banks make long-term first mortgage loans through more than 500 Federal Land Bank Associations. These farmer-owned Associations in turn own the Land Banks. The Banks also loan to nonfarm rural home owners.

The Federal Intermediate Credit Banks provide loan funds to more than 400 local farmer-owned Production Credit Associations. Farmers, ranchers, and farmers of the sea borrow from these associations for seasonal operating purposes and to finance capital expenditures for periods up to 7 years. The Intermediate Credit Banks also provide funds for farm loans to about 100 other lenders, including agricultural credit corporations and commercial banks.

The Banks for Cooperatives provide financing for facilities and operating loans to more than 3,000 marketing, farm supply, and business service cooperatives that own the Banks. The Central Bank for Cooperatives participates with them in giving loans to the larger cooperatives as a method of spreading the risk. This Bank also serves all the other Banks of the System by operating a money desk that transfers funds from Bank to Bank.^{3/}

The System currently obtains almost all of its funds through the sale of Consolidated Farm Credit System debentures. These debentures

^{3/}W. Gifford Hoag, The Farm Credit System: A History of Financial Self-Help, Interstate Printers & Publishers, Inc., Danville, Illinois, 1976, pages xiii and xiv.

are marketed in the national money markets at interest rates only slightly in excess of rates paid on federal government debt of comparable maturity. These low interest rates are attributable not only to the perceived riskiness (or lack thereof) of FCS debt, but also to the fact that interest earned on FCS debentures enjoys the same tax treatment as interest income on U.S. government debt.

Another noteworthy characteristic of the FCS is that a large portion of its income is tax exempt. As a result, in 1976 the combined operations of the system yielded a net income before taxes of about \$356.5 million on which it paid about \$12.2 million in taxes. This works out to an enviable tax rate of 3.4 percent.

The Federal Government

The federal government is also a very active participant in agricultural credit markets. The federal agencies which are involved most with agricultural lending are the Farmer's Home Administration (FmHA), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA). Together these agencies are expected to provide about \$9.4 billion in agricultural credit in 1978 or approximately 8 percent of the total. In addition, FmHA and SBA guarantee a substantial amount of debt held by other lenders. Government obligations are sold in national financial markets to obtain funds for the loan programs of these agencies.

The largest government lender to agriculture is the Farmer's Home Administration. This agency's name is not as descriptive of its activities as it might be. In addition to \$4 billion in real estate debt, it holds almost \$3 billion in nonreal estate debt. Also, much of its real estate debt holdings is in the form of loans for rural nonfarm

housing. Because of this diversity FmHA's activities, the agency is expected to be renamed the "Farm and Rural Development Agency."

The loans made by FmHA are often of a fairly risky nature. For example, the real estate purchases of many young farmers have been financed totally by FmHA or through FmHA participations with commercial lenders or Federal Land Bank Associations. In fact, many loans made by FmHA can only be made if the applicant has been refused credit by other local lenders. It is important to recognize, however, that this does not mean FmHA's activities have no direct and significant impact on the demand for credit from other financial intermediaries.

The Commodity Credit Corporation provides loans on stored commodities and for storage facility loans. Commodity storage loans currently comprise the main part of this agency's loan portfolio. The USDA predicts substantial increases in CCC credit outstanding in 1978 as market supply of several eligible commodities is expected to exceed market demand at the loan rates which will be in effect next year. When market prices are much higher than loan rates, commodity storage loans are usually provided by commercial lenders or the Farm Credit System. Furthermore, the relatively low interest storage facility loans offered by the CCC compete directly with other lenders. And the importance of these loans in the CCC portfolio could grow rapidly should projected excess supplies be realized and persist in future years.

The Small Business Administration is, when compared to FmHA and CCC, a fairly small agricultural lender. It has less than 100 offices serving the agricultural community as compared to almost 1,800 maintained by FmHA. Congress has authorized the SBA to classify farms as businesses eligible for loans under its regular and emergency programs.

New legislation is pending regarding the role of the SBA in agricultural lending. The FmHA would take over some SBA programs under that legislation.

Life Insurance Companies

Life insurance companies currently provide about 7 percent of agricultural credit. This is entirely in the form of real estate debt. The premiums of life insurance policy holders are the source of funds for this intermediary.

The investments of life insurance companies are in no way limited to the agricultural sector of the economy. These institutions put their funds where they can earn the highest returns (adjusted for risk, of course). As a result of this sensitivity to rate of return, the quantity of credit provided to agriculture by life insurance companies has been quite variable as compared to the credit supplied by other agricultural lenders. The year-to-year variability in credit extended to agriculture by these agencies has been accompanied by a fairly persistent downward trend in their share of the agricultural credit market.

A Unified Market

We have discussed three nonbank financial intermediaries in this section. It is our contention that their credit services are close, though not perfect, substitutes for the credit services provided by commercial banks. Thus, there are real alternatives to commercial banks as suppliers of credit to agriculture. Whether or not the total credit flows are of the right magnitude and the flows are allocated efficiently amongst the various financial intermediaries will be discussed in the following section.

BENEFITS AND COSTS OF GOVERNMENT INTERVENTION

We indicated in the introduction that we had failed to find prima facie evidence that the benefits from creating a new institution for the secondary marketing of agricultural paper generated at the local bank level exceeded the likely costs of doing so. In fact, our economic analysis and interpretation of the data tends to support the view that this action would have a negative impact on economic efficiency.

Economic theory predicts that, with few exceptions, activities or exchanges which yield a net benefit to society will be carried out by profit-seeking individuals. And those activities and exchanges which do not yield a net social benefit will be ignored. This is what economists mean when they assert that the market mechanism generally allocates resources efficiently.

The few exceptions to this rule, normally referred to as market failures, occur when the benefits and costs measured by private entrepreneurs differ from the benefits and costs to society. Typically, a difference between the signs of net social benefits and of net private benefits can be attributed to the existence of externalities, public goods, natural monopolies, or government intervention. Only when there is such a difference, and the market consequently allocates resources inefficiently, is government intervention feasible in the sense that it can improve the market allocation.

Of course there are only a limited set of interventions which can remedy a particular market failure. And conversely, there are only a limited number of market failures which can be remedied by a particular intervention.

There are two distinguishable types of market failures which could be wholly or partially eliminated by government creation of a new

secondary marketing institution for agricultural paper generated at the local bank level. First, we could have an inefficient division of credit between agricultural and nonagricultural sectors with too little credit making its way into agriculture. And second, the existing pattern of financial intermediation between agricultural and nonagricultural sectors could be inefficient with too much credit flowing through nonbank intermediaries relative to rural commercial banks.

The first of these market failures could result from the existence of poor links between agricultural and nonagricultural finance markets due, possibly, to regulation. Yet in the previous section we described the operations of three nonbank financial institutions which were actively involved in intermediating funds transfers between these sectors. Thus, it is unreasonable to infer from the current low volume of rural bank borrowing in national money markets, as some observers have, that agriculture is isolated from nonagricultural financial markets.

But even if this inference is unreasonable, isn't it true that there is direct evidence that the agricultural sector has been allocated less credit than would be prescribed on grounds of economic efficiency? No, not of which we know. In fact, if the relationship between average returns and marginal returns to credit is not substantially different in the agricultural sector than it is in nonagricultural sectors, the contrary view is supported by the data. For as Baughman^{4/} has noted, the average return to land and capital in agriculture has been persistently

^{4/}Ernest T. Baughman, "The Economic Role of Financial Intermediaries-- Challenges of a Changing Agriculture," in A New Look at Agricultural Finance Research, edited by John A. Hopkin, Agricultural Finance Program Report No. 1, University of Illinois, 1970, pages 85-92.

quite low relative to the return in other sectors. Thus if the average return-marginal return relationship is about the same across sectors, economic efficiency would be served by moving credit out of agriculture and into sectors where it yields a higher return. While not employing this line of argument the Agricultural Credit Task Force of the American Bankers Association echoed Baughman's sentiments when it concluded that "(a)griculture has been adequately financed in recent years, and it will be adequately financed in the future."^{5/}

It should be emphasized that the view regarding credit adequacy in agriculture expressed by Baughman and the ABA's task force is the prevailing view presented in the agricultural finance literature. And we have been unable to turn up any new evidence in support of the contention that less than the efficient amount of credit is flowing into the agricultural sector from national money markets. Indeed, as we pointed out above, the persistently low rates of return on land and capital discussed in the Baughman study, calculated by the USDA and bemoaned by Farm Strike '77 participants, can be viewed as evidence of a credit surplus in agriculture.

But the fact remains that a very small amount of credit flows from national money markets, through rural banks, and into agriculture. Could this not be construed as evidence of market failure, at least insofar as banks are concerned? We believe there are sound economic arguments that go along with that interpretation of the data and which are consistent with a credit surplus in agriculture as well.

Economic theory suggests that we should observe an inefficient pattern of intersectoral credit flows under current market arrangements.

^{5/}"Report of the Agricultural Credit Task Force," The American Bankers Association, June 1973, page 23.

FmHA and CCC credit is directly subsidized by the federal government, and FCS credit is indirectly subsidized because of that system's preferential tax status and because of its initial capitalization with an interest-free government loan. But no such subsidies have been bestowed on intersectoral credit flows through commercial banks. Thus, commercial banks are at a competitive disadvantage in the business of transferring funds from the national money markets to the agricultural sector of the economy, even if they are as efficient or slightly more efficient in terms of the real resources they use in carrying out these transfers.^{6/}

It is, furthermore, unlikely that the competitive advantage of federal government agricultural lenders and the FCS will merely bring about a shift in lender and no change in the total credit extended to agricultural borrowers. Any downward pressure on agricultural loan rates resulting from government subsidies is reflected in increased total loan volume. Hence, in addition to possible inefficiencies in the pattern of intersectoral credit flows, the overall flow of credit into agriculture is likely to be inefficiently large relative to the credit flows into sectors which don't have similarly subsidized intermediaries.

Thus, the only type of market failure or inefficiency which we believe is supported jointly by the data and economic theory is the result of government intervention. This intervention has tended to subsidize credit flows into the agricultural sector through certain government agencies and the Farm Credit System at the expense of other credit-using sectors of the economy and other credit suppliers such as

^{6/}The difference in objectives of commercial banks and the cooperative FCS is likely to magnify the resource allocation problems resulting from differential taxation of their respective incomes and interest payments.

commercial banks, savings and loan associations, and life insurance companies. It is our opinion that the government could not create a viable secondary marketing institution in this setting without a subsidy and that there is no prima facie evidence that that would have desirable consequences.

A new institution of the type under consideration here would be performing the same functions which are currently being performed by the Farm Credit Administration together with the Federal Intermediate Credit Banks, the Federal Land Banks, and the Banks for Cooperatives. Unless given the tax treatment enjoyed by these cooperative agencies, this new marketing institution would clearly be unable to provide funds from national money markets to rural commercial banks at the same price that, say, the Federal Intermediate Credit Banks can provide national money market funds to the Production Credit Associations. So one would not expect rural banks to effectively compete as suppliers of funds acquired in those national markets. This is not to say that they cannot compete as suppliers of credit. They can. But the source of their credit supply is likely to be almost entirely made up of deposits.

Of course, arguing from theory alone does not carry the weight of direct empirical evidence. There are no regulations prohibiting the formation of institutions for the secondary marketing of agricultural paper. Yet, except for organizations like Bankers Funding, Ltd., which market secondary participations in SBA- or FmHA-guaranteed loans (such guarantees are a form of credit subsidy), no such institutions exist. Our faith in the free market system leads us to infer not that people are ignoring an opportunity to engage in a profitably activity but rather that the secondary marketing of rural bank generated agricultural

paper is not a profitable activity. And how does one create an unprofitable institution without providing subsidies? We do not have an answer to that question.

If the government did subsidize the secondary marketing of agricultural paper generated at the local bank level the flow of funds to agriculture from national money markets through rural banks would increase. But this altered pattern of credit flows would be at the further expense of other sectors of the economy as well as the dwindling number of relatively unsubsidized financial intermediaries. While we are unable to state with certainty that the net social benefits resulting from this reallocation would be negative there is just as certainly no prima facie evidence that it would be positive.

Our view of the desirability of such an intervention is in complete accord with that expressed by the Federal Reserve Board's Committee on Rural Banking Problems. In discussing "widely held views and opinions" with which that Committee took exception it stated:

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 sectors or in subsidizing the bank credit which they obtain. The committee agrees that such eventualities would be undesirable^{7/}

As noted above, however, we disagree with that Committee's assessment of the validity of this "third view."

It should be emphasized that we are saying nothing regarding whether or not it is in the best interests of society for the government to provide additional assistance to commercial banks and to agriculture.

^{7/}"Improved Fund Availability at Rural Banks," op. cit., page 2.

That is a question of income distribution and it is well-known that there are more efficient ways of redistributing income than by creating new marketing institutions. Straightforward cash gifts to owners of rural banks and agricultural enterprises would probably be the most efficient form of assistance to these groups.

RURAL BANK AGRICULTURAL LENDING: OUTLOOK AND A POSSIBLE NEW ROLE

Some readers might get the impression from our comments that we believe rural commercial banks do not have a very bright future in the agricultural lending market. We would like to dispel that notion.

The data offers no support for the fear uttered by the ABA Credit Task Force that an increasing proportion of agricultural financing is taking place outside of the banking system. During the last ten- and twenty-year sample periods the proportion of agricultural debt held by banks has had a slightly positive trend. And this has held up during periods in which agricultural debt has increased at a very rapid pace. In the absence of substantial changes in government policy or market conditions we perceive no reason to expect a decline in the share of agricultural credit supplied by commercial banks in the foreseeable future.

A Possible Change in Government Policy

In carrying out our feasibility study we were on the lookout for policy changes which could increase the efficiency of the agricultural finance market. One such change which seemed to us relatively simple to implement was a shift in emphasis from the direct issuance of credit by government agencies to the guaranteeing of loans issued by other lenders.

We do not believe the government should be in the business of servicing loans. Private institutions can perform that function and the incentives for them to do it more efficiently than government agencies are well known. By offering guarantees and/or subsidies for loans satisfying certain criteria the government could ensure that loans now being made by its agencies would be made by nongovernment lenders. Since there is a secondary market for government guaranteed loans, rural banks could participate in the provision of the credit which had previously passed through government agencies. The gains in efficiency from this type of policy change should benefit agricultural lenders and agricultural borrowers as well as the American taxpayer.

Thus we conclude our report on one study with a suggestion for another study--a study to examine the feasibility of replacing direct Federal lending to agriculture by government guaranteed and/or subsidized lending by private intermediaries.