

Seasonal Borrowing Privilege

John Rosine

July 1975

Working Paper #: 42

Rsch. File #: 334.1

NOT FOR DISTRIBUTION

## THE SEASONAL BORROWING PRIVILEGE

The Federal Reserve System's seasonal borrowing privilege was initiated in April, 1973. The intent of the privilege was to provide a seasonal source of funds to banks in regions which are highly dependent on a seasonal industry, such as agriculture or tourism. Such banks often depend on the seasonal industry for their main source of deposits and make large volumes of loans to the seasonal industry. Moreover, their deposit inflows frequently coincide with seasonal downturns in loan demand; consequently, funds are most available when loan demand is lowest and are least available when loan demand is at a peak. The seasonal pattern is a recurring one; since many of the banks experiencing seasonality have little access to national money markets, they typically hold large volumes of liquid assets in the off-season in anticipation of the cyclical upswing in loan demand. Liquid funds are often held in the form of United States government securities which can be drawn down easily as loan demand increases. It was hoped that the seasonal borrowing privilege--by providing banks with a reliable alternative seasonal liquidity source--would enable those banks to draw down their liquid assets as well as to use their own deposits to boost loan volume in local nonseasonal industries.<sup>1</sup>

The privilege was implemented via an amendment to the Federal Reserve System's Regulation A.<sup>2</sup> The amendment specified that a bank's eligibility for seasonal borrowing would be contingent on having a "seasonal need for funds" which persisted for a period of at least eight weeks. A bank with access to national money markets was considered to be ineligible.

Once a bank was established as eligible, it was still required to meet some seasonal needs from its own funds. Accordingly, a "deductible" clause specified that the seasonal borrowing by a bank would cover only the seasonal needs in excess of 5 percent of the bank's total average deposits in the previous year. The volume and duration of seasonal loans were to be based on historical seasonal fluctuations in loans and deposits, and the bank was expected to make advance arrangements for its seasonal credit needs with its district's Federal Reserve Bank.<sup>3</sup>

Concepts underlying the seasonal borrowing privilege can be illustrated graphically, as in Figures 1a-1c. Figure 1a shows the hypothetical seasonal flows of funds at a typical agricultural bank. Deposits begin declining in the spring as farmers use their cash balances to pay for farm inputs. Credit needs increase at the same time. The difference between loans and deposits--defined as "net fund availability"--declines seasonally through the spring and summer, then increases as farmers harvest their crops and increase their cash balances, as in Figure 1b.

The "seasonal needs" at the agricultural bank are quantified as the variation in net fund availability relative to the peak in net fund availability, as in Figure 1c. For instance, in this illustration the peak in net fund availability occurs in January. Consequently, the example shows, seasonal needs are zero in January and positive in all other months. For the bank to be eligible for seasonal borrowing, the seasonal need must persist for at least eight weeks, in which case the bank may borrow to cover seasonal needs in excess of 5 percent of the previous calendar year's deposits.

Figure 1a

Deposits and loans at ag banks typically fluctuate reciprocally; as cash balances fall and rise, credit demand rises and falls.

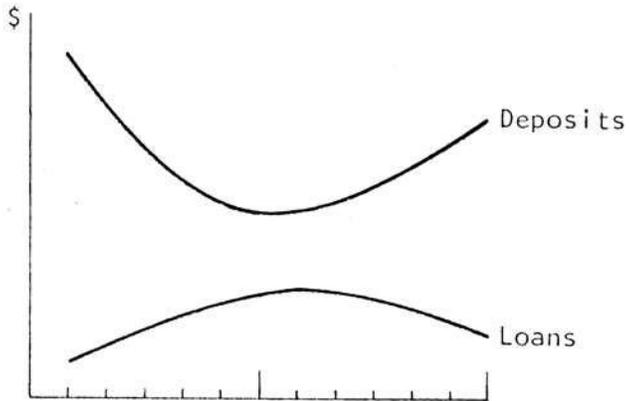


Figure 1b

Funds available for new lending, therefore, contract and expand seasonally at these banks.

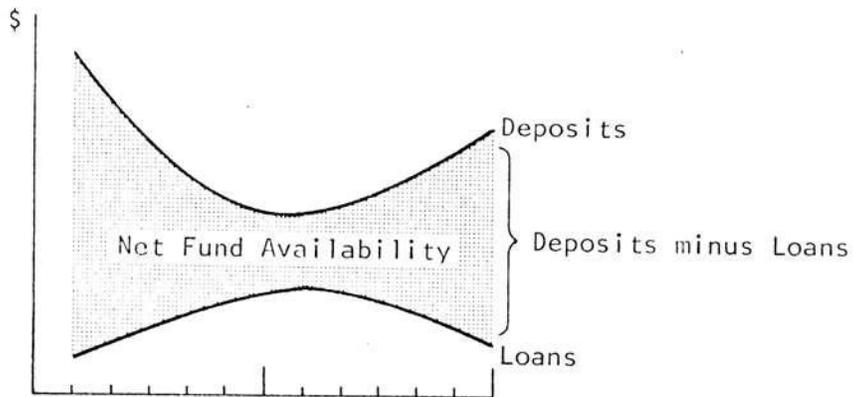


Figure 1c

A bank's "seasonal needs" is the amount necessary to extend the one-month peak in lending power throughout the rest of the year.

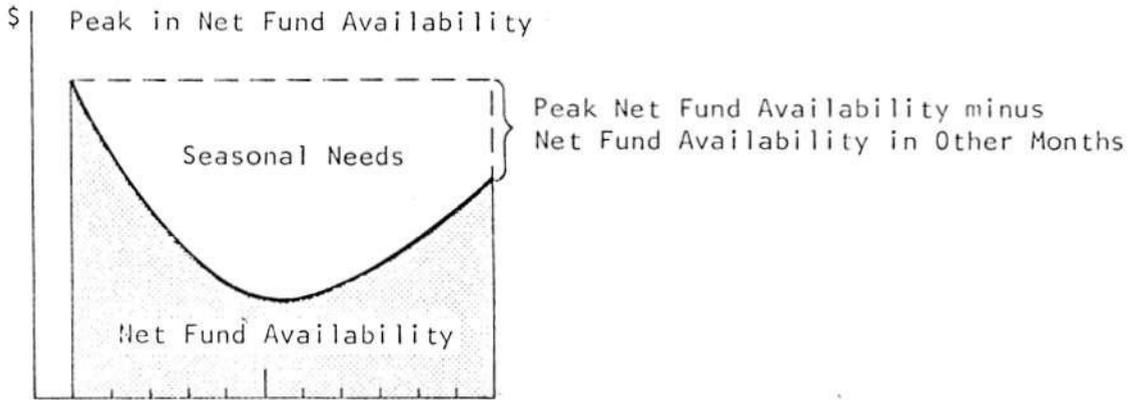
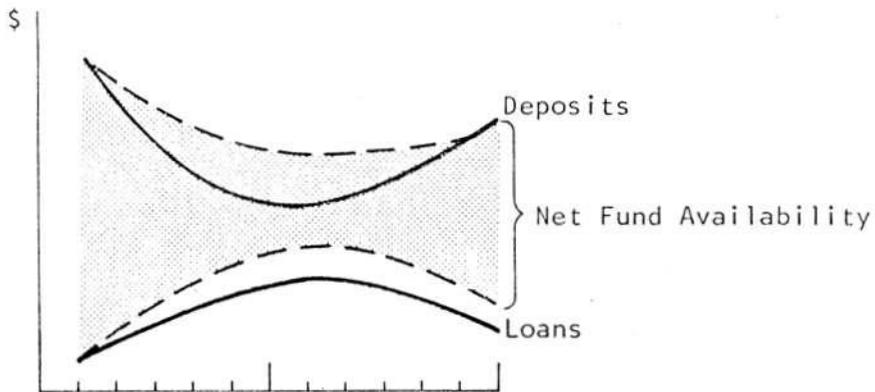


Figure 2

Seasonal borrowings add to the bank's supply of loanable funds so nonseasonal community lending can increase without risking the funds needed for normal seasonal loan demand.



The seasonal borrowing privilege can be used, as in Figure 2, to boost total loanable funds by supplementing the deposits of the local community. Consequently, the bank which borrows can boost year-round lending without ever drawing net fund availability below a desired minimum level.

It should be noted that the flows depicted in Figures 1a-1c and in Figure 2 are by no means the only conceivable patterns. The inflow of cash into an isolated agricultural bank, for instance, depends on the rate at which farmers sell their crops. The rate of sales depends, in turn, on farmers' expectations of price movements over the course of the marketing year. It is, in addition, by no means certain that farmers will sell their crops in the fall.<sup>4</sup>

The seasonal patterns of fund flows in 1974 did in fact differ somewhat from traditional patterns, both for the banks which used the seasonal borrowing privilege and for those which did not. However, it cannot be determined if this was due to the changed structure of farm markets or to other economic factors influencing fund flows.

Previously, peaks in net fund availability had been reached as early as January with lows coming as early as June (see Table 1). In past years, an inflow of funds from the wheat harvest provided some midsummer relief to rural banks, but this did not happen in either 1973 or 1974. Loan demand remained strong through the summer. Moreover, in 1974 farmers appeared to hold grain far past the "normal" time of sale.

In the district, nearly 50 banks used the seasonal borrowing privilege in 1974, a substantial increase over 1973 when only 18 banks used the privilege (see Table 2).<sup>5</sup> The district's volume of seasonal loans peaked in August, 1974, at better than \$20 million.

Table 1  
Peaks and Troughs in  
Aggregate Net Fund Availability  
1970-74

<u>Year</u>	<u>Borrowing Banks</u>		<u>Nonborrowing Banks</u>	
	<u>Peak</u>	<u>Trough</u>	<u>Peak</u>	<u>Trough</u>
1970	Mar. 4	July 1	Jan. 1	June 24
1971	Apr. 7	June 23	Mar. 3	June 23
1972	Mar. 8	June 28	Jan. 5	June 21
1973	Mar. 7	July 4	Jan. 1	June 27
1974	Mar. 6	Aug. 21	Mar. 6	Aug. 21

Table 2  
Number of Banks Which Used the  
Seasonal Borrowing Privilege  
in 1973 or 1974, by State

<u>State</u>	<u>Eligible Banks</u>	<u>Number of Banks Borrowing</u>	
		<u>1973</u>	<u>1974</u>
Michigan	2	0	0
Minnesota	112	4	14
North Dakota	37	8	16
South Dakota	33	1	4
Wisconsin	12	2	1
Montana	72	3	14
Ninth District	268	18	49

Still, fewer than one-fourth of the banks that appeared eligible actually used the privilege;<sup>6</sup> and in the aggregate, the volume of borrowings amounted to only 2 percent of the total loans outstanding at all borrowing banks. It should be noted that many of the banks for which the seasonal borrowing privilege might be ideally suited are not members of the Federal Reserve System and, hence, are not eligible for seasonal borrowing. Moreover, some of the large member banks in the Ninth District have access to national money markets and therefore are not eligible for seasonal borrowing. But the reasons why a greater number of apparently eligible member banks did not use the privilege are not entirely clear.

There are several hypotheses, however. One might hypothesize, first, that the banks which were the least liquid in 1974 would have been the most likely banks to use the seasonal borrowing privilege.<sup>7</sup> The evidence here is mixed. There is some indication that the seasonality of loan demand was more severe in 1974 at borrowing banks than at nonborrowing banks. In the aggregate, the decline in net fund availability at borrowing banks from March 6 through August 21 (from peak-to-trough in net fund availability) was 36 percent, compared to 16 percent at nonborrowing banks. Over that period, deposits grew slightly at nonborrowing banks but declined by nearly 4 1/2 percent at borrowing banks; loan growth was about the same for the two groups of banks. At both groups of banks, part of the decline in net fund availability was offset by reducing the holdings of United States government securities, and in both cases, the cutback in holdings of United States securities--expressed as a percentage of loans outstanding--was also about the same for the two groups of banks (and amounted to about a fourth of the total securities held on March 6). In the fed funds market, the borrowing banks as a

group remained a net purchaser of fed funds throughout most of 1974; the group of nonborrowing banks was, on the other hand, a net seller of federal funds until late in the summer of 1974. Thus, it appears that the borrowing banks were indeed less liquid than the nonborrowing banks and that the seasonal borrowing privilege was indeed helping to boost liquidity where it was most needed, though it should be noted that some of the borrowing banks had loan-to-deposit ratios of less than 50 percent at the time they were borrowing (see Table 3).

---

Table 3

Loan-to-Deposit Ratios at  
Borrowing Banks, June 30, 1974

<u>Ratio</u>	<u>Number of Banks</u>
Greater than .70	22
.600-.699	16
.500-.599	8
Less than .500	<u>3</u>
	49

---

A second hypothesis is that agriculturally oriented banks might be more likely to utilize seasonal borrowing than urban banks.<sup>8</sup> Agricultural banks have a larger proportion of their loans to farmers and therefore are more engaged in seasonal lending than are nonagricultural banks. Moreover, data indicates that the proportion of banks apparently eligible for seasonal borrowing rises as the bank is more involved in farm lending.<sup>9</sup> In 1974, however, many of the Ninth District banks which

borrowed had less than 20 percent of their loans to farmers. In the first half of 1974, when farm loan demand was rising rapidly, many of the borrowing banks were cutting back on farm lending, both in relative and in absolute terms.

A third hypothesis is that, since the seasonal borrowing privilege was tailor-made for small banks which lacked access to national money markets, the independent banks in rural areas would rely most heavily on the seasonal borrowing privilege. The evidence of 1974, however, does not support this hypothesis. The majority of Ninth District banks which used the seasonal borrowing privilege in 1974 were members of multibank holding companies, and--it can be argued--they have a greater access to nonlocal sources of funds than do other banks. When holding company banks did make use of the privilege, they borrowed greater volumes, than did other banks, for longer periods of time.

Table 4

Affiliation of Banks Using  
The Seasonal Borrowing Privilege in 1974

<u>State</u>	<u>Banks Thought To Be Eligible For Seasonal Borrowing</u>	<u>Multibank Holding Company Banks Which Used The Privilege</u>	<u>Other Banks Which Used The Privilege</u>
Michigan	2	0	0
Minnesota	112	11	3
Montana	72	7	7
North Dakota	37	9	7
South Dakota	33	2	2
Wisconsin	<u>12</u>	<u>0</u>	<u>1</u>
Ninth District	268	29	20

Table 5

Potential and Actual Use  
of the Seasonal Borrowing Privilege  
By Affiliates of Multibank Holding Companies  
And By Other Banks

	Number of Banks Apparently Eligible		Number of Banks Borrowing		Percent of Apparently Eligible Banks Which Borrowed	
	<u>Affiliates</u>	<u>Other</u>	<u>Affiliates</u>	<u>Other</u>	<u>Affiliates</u>	<u>Other</u>
Michigan	2	0	0	0	0.0	0.0
Minnesota	37	75	11	3	29.7	4.0
Montana	18	54	7	7	38.9	13.0
North Dakota	9	28	9	7	100.0	25.0
South Dakota	7	26	2	2	28.6	7.7
Wisconsin	<u>1</u>	<u>11</u>	<u>0</u>	<u>1</u>	0.0	9.1
Ninth District	74	194	29	20	39.2	10.3

The heavy use of seasonal borrowing by multibank holding company banks was perhaps the most interesting development in 1974. A majority of the banks which used the seasonal borrowing privilege were affiliates of multibank holding companies (see Table 4). A greater proportion of the eligible multibank holding company banks used the privilege than did other banks. Roughly three of every seven affiliate banks used the privilege (see Table 5); only about one in eight of the remaining banks used the privilege. The total volume of borrowing by multibank affiliates was better than two-thirds of total seasonal borrowing over nearly all of 1974 (see Table 6).

---

Table 6

Share of Total Seasonal Borrowings  
Held by Multibank Holding Company Affiliates

<u>Last Wednesday In</u>	<u>Share of Total</u> (percent)
February	100
March	100
April	84
May	77
June	79
July	70
August	79
September	83
October	88

Characteristically, the affiliates of multibank holding companies were not heavily involved in farm lending--at least not as much as other borrowing banks. Only 10 percent of the affiliates had made more than 40 percent of total loans to farmers, compared to better than three-fifths of the other banks (see Table 7). Moreover, the affiliate holding company banks were cutting back on farm loans over the first half of 1974, a time when farm-loan demand was growing rapidly (see Table 8). (It still may be, however, that the holding company banks were carrying a greater volume of seasonal loans than they would have carried in the absence of a seasonal borrowing program.)

A fourth hypothesis is that the high cost of funds, coupled with usury ceilings in Ninth District states, tended to discourage seasonal lending by banks. There is perhaps some credence to this claim. Seasonal funds are not a free good, and the discount rate through the summer of 1974 was 8 percent. In addition, interest rates on farm loans are typically less variable than interest rates on commercial loans, and this tended to encourage a shift away from seasonal lending in the summer of 1974 as rates on nonfarm loans rose substantially higher than rates on farm loans. Other evidence, however, weighs against the cost-of-funds hypothesis: for instance, many banks--even those which did not use the seasonal borrowing privilege--turned to the costly fed funds market for funds in 1974 when they might have borrowed at a lower rate under the seasonal borrowing privilege.

Other hypotheses have been suggested which attribute the 1973 and 1974 seasonal borrowing experience to existing attitudes and institutions in the rural banking sector. Margaret Bedford suggests that the low rate of borrowing in 1973 may have been due to the late date at

Table 7  
 Farm Loans as a Proportion  
 of Total Loans  
 at Borrowing Banks  
 (June 30, 1974)

<u>Percent</u>	<u>Holding Company Affiliates</u>	<u>Other Banks</u>
0-20	15	7
20.1-40	11	0
40.1-60	2	5
60.1-80	1	7
80.1-100		1

---

Table 8  
 Adjustments in Balance Sheet Items  
 December 31, 1973-June 30, 1974

	<u>Holding Company Affiliates</u>	<u>Other Banks</u>
Percent Change in Total Loans	+ 9.6	+12.4
Percent Change in Loans Secured By Farmland	0.0	+19.7
Percent Change in Loans to Farmers	- 4.0	+11.3
Percent Change in Commercial Loans	+20.7	+29.7
Percent Change in Deposits	- 0.9	+ 0.5
Loan-to-Deposit Ratio, Dec. 31, 1973	0.647	0.624
Loan-to-Deposit Ratio, June 30, 1974	0.715	0.699

which the privilege was implemented; by April of 1973, many banks had already made their plans for the rest of the year.<sup>10</sup> Likewise, it has been suggested that the 1974 experience was due to a failure by banks to anticipate the sharp upturn in loan demand which actually occurred in the summer of 1974. This argument suggests that, had more banks arranged for seasonal borrowing in advance, the volume of seasonal loans might have been substantially larger.

Still another hypothesis attributes the low rate of borrowing by smaller banks to the "reluctance theory," by which it is argued that bankers in general have a reluctance to be indebted to the Federal Reserve System.<sup>11</sup>

#### Summary

The intent of the seasonal borrowing privilege was to supplement bank liquidity during yearly times of seasonal pressures. Since the seasonal borrowing privilege offers banks a reliable source of seasonal liquidity, it was hoped that rural banks would cut back in their holdings of liquid securities (to meet seasonal needs) and would use their funds to boost loan volume in their local communities. Is this being accomplished?

The answer is not yet apparent. The data shows that among borrowing banks, loans in 1974 did increase--at the expense of United States government securities (see Table 9). But the same thing was true among nonborrowing banks, indicating that it may have been general business conditions, rather than the seasonal borrowing privilege, which was responsible for the portfolio adjustments at rural banks.

It appears that some banks did make good use of the seasonal borrowing privilege to supplement their liquidity. However, a bank's liquidity at any point in time depends on a number of secular and

cyclical influences, as well as on recurring seasonal influences, and thus whether the borrowed funds were being used primarily to help meet the loan demand of a seasonal industry is not clear.

---

Table 9  
U.S. Government Securities  
as a Percentage of Loans Outstanding  
on the Date of Peak Net Fund Availability

	<u>Borrowing Banks</u>	<u>Nonborrowing Banks</u>
1974	.1895	.2004
1973	.2551	.3336
1972	.3256	.2977
1971	.2438	.3244
1970	.2536	.2588

---

Nor is it evident that there are any systematic reasons why some banks used the seasonal borrowing privilege while others did not. There is, however, some indication that the borrowing banks were more hard-pressed for funds. Apparently, the multibank holding company affiliates were quicker than other banks to make use of the seasonal borrowing privilege. But the small agricultural banks for whom the seasonal borrowing privilege was primarily intended did not make heavy use of it.

Will the seasonal borrowing privilege come to be used by more banks in the future? Possibly; though as Emanuel Melichar writes, a word of caution is in order:

"...a patient and persistent effort will be required to demonstrate that banks can employ the privilege to benefit their communities."<sup>12</sup>

It might be added that considerable effort has already been taken by bank officials to encourage the use of the seasonal borrowing privilege--but whether there will be a payoff to such efforts is still uncertain.

FOOTNOTES

<sup>1</sup>For a more detailed discussion of the design of the seasonal borrowing privilege, see Emanuel Melichar, "Toward a Seasonal Borrowing Privilege: A Study of Intra-Year Fund Flows at Commercial Banks," in Reappraisal of the Federal Reserve Discount Mechanism, Vol. 2, (Washington, D.C.: Board of Governors of the Federal Reserve System, 1971-72), pp. 93-106.

Also, Emanuel Melichar, "Seasonal Discount Assistance at Rural Banks: Evaluation of a Federal Reserve Proposal," Agricultural Finance Review, U.S. Department of Agriculture, Vol. 30 (July 1969), pp. 44-57.

<sup>2</sup>Advances and Discounts by Federal Reserve Banks--Regulation A, Board of Governors of the Federal Reserve System (Washington, D.C.: April 19, 1973), pp. 3-4.

<sup>3</sup>The general guidelines of Regulation A were made more specific in an action taken by the Board of Governors on April 3, 1973, prior to the implementation of the privilege.

The more specific guidelines were intended to help individual Reserve Banks and lending officers judge whether a bank actually lacked "reasonably reliable access to national money markets" and also to determine the terms of seasonal credit for which banks would be eligible. Access to national money markets was presumed to be largely a function of bank size. Any bank with deposits of less than \$100 million qualified automatically for seasonal borrowing. Banks with deposits in excess of \$250 million were automatically ineligible. For banks in the intermediate range--with deposits ranging from \$100 million to \$250 million--consideration was to be given to the specific bank's liability management practices and other factors which might indicate its degree of access to national markets.

Banks were expected to arrange for seasonal borrowing in advance of the period of seasonal need. Hence, bankers were required to project the amount and duration of their seasonal needs. The requirement seemed reasonable insofar as banks' seasonal needs are recurring from year to year. The rationale of the advance specification was that, first, it was necessary for review procedures by Federal Reserve lending officers and, second, that an advance estimate of seasonal credit needs was necessary for the overall coordination of monetary operations. However, "prearrangement was not intended to prevent a reconsideration of a seasonal credit accommodation, either as to amount or duration."

Though the rates on seasonal funds might differ from market rates, arbitrage by banks was to be curbed through the monitoring activities of Federal Reserve Banks. Lending officers were given authority to reopen discussion of seasonal needs in instances of flagrant abuse of the privilege. Nonetheless, net sales of federal funds in small amounts were not to be regarded as inappropriate so long as the sales represented "temporary measures to avoid excess reserves."

<sup>4</sup>In fact, several behavioral patterns might be adopted by producers. At harvest time, they may draw down commodity inventories to

pay off loans and to increase cash balances. Or they may, alternatively, choose to postpone their cash receipts in hopes of capitalizing on favorable price movements. The producer is more likely to postpone his sale if he expects price rises.

Thus there is no a priori reason for seasonality in fund flows. Indeed, the typical seasonal pattern observed in the postwar period may have been merely a consequence of having had a particular pricing structure in these years. In this period, government-held stocks insured that market prices would not deviate far from loan rates at any time in the cropyear. Consequently, farmers could not expect price gains from holding commodities over the cropyear, and sales--or CCC loans--tended to be bunched in the autumn months following harvest. Thus the deposit inflows at rural banks and the loan repayments at rural banks would also be highest in the autumn months.

But in the current free-market agriculture the situation has changed. Prices are highly variable. Expectations of price gains may induce farmers to hold crops far past the "typical" marketing dates. Rather than opting to hold his wealth in the form of cash balances, the farmer may choose to hold down his cash balances, maintain his stocks of commodities temporarily, and perhaps extend his loans at rural banks. Loan demand might then well persist far past the typical seasonal borrowing period. Of course, if storage facilities are not available or credit cannot be obtained, sales may be bunched at harvest time. Still, it seems likely that the seasonal fund flows in a free-market agriculture will differ from the typical pattern in an administered agricultural pricing system.

<sup>5</sup>The experience in the Ninth District corresponds to the experience in other agricultural districts and in the nation. For a review of the experience in the Kansas City and Dallas districts, see, respectively, Margaret E. Bedford, "The Seasonal Borrowing Privilege," Monthly Review, Federal Reserve Bank of Kansas City (June 1974), pp. 10-16; and Carl G. Anderson, Jr., "Seasonal Borrowing Increases: Further Gains Seen for 1975," Farm and Ranch Bulletin, Federal Reserve Bank of Dallas (March 1975).

The national experience for 1973 is summarized in Emanuel Melichar and Harriet Holderness, "Seasonal Borrowing at the Federal Reserve Discount Window," Agricultural Finance Review, U.S. Department of Agriculture, Vol. 35 (October 1974), USDA-ERS, pp. 42-51.

<sup>6</sup>A tentative listing of the banks which appeared eligible for seasonal borrowing was prepared by the Board of Governors of the Federal Reserve System. The list served merely as an estimator of bank eligibility and was not meant to discourage nonlisted banks from borrowing. In fact, several of the banks which have borrowed were not listed on the original Board printout. The term "eligible bank" as used in this paper refers to banks listed on the Board's computer printout. Other banks were in fact eligible, but their eligibility was not recognized until they actually applied for use of the privilege.

<sup>7</sup>Melichar cites the secular decline in rural bank liquidity as one of the primary reasons for the new seasonal borrowing privilege. See Melichar, "Toward a Seasonal Borrowing Privilege: A Study of Intra-Year Fund Flows at Commercial Banks."

<sup>8</sup>Virginia Timenes and Emanuel Melichar, "Seasonal Borrowing Privilege: A New Dimension in Administration of the Federal Reserve Discount Window," 1973 Proceedings of the American Statistical Association (Washington, D.C.: 1974), p. 608.

<sup>9</sup>Ibid.

<sup>10</sup>Bedford, p. 13.

<sup>11</sup>The reluctance theory insofar as it applies to the regular discount mechanism is discussed in Clay J. Anderson, "Evolution of the Role and the Functioning of the Discount Mechanism," Reappraisal of the Federal Reserve Discount Mechanism, Vol. 1, (Washington, D.C.: Board of Governors of the Federal Reserve System, 1971-72), pp. 135-163.

<sup>12</sup>Melichar and Holderness, p. 50.

BIBLIOGRAPHY

- Advances and Discounts by Federal Reserve Banks--Regulation A. Board of Governors of the Federal Reserve System, Washington, D.C., April 19, 1973.
- Anderson, Carl G., Jr. "Seasonal Borrowing Increases: Further Gains Seen for 1975," Farm and Ranch Bulletin, Federal Reserve Bank of Dallas, March 1975.
- Anderson, Clay J. "Evolution of the Role and the Functioning of the Discount Mechanism," in Reappraisal of the Federal Reserve Discount Mechanism, Vol. 1, Washington, D.C.: Board of Governors of the Federal Reserve System, 1971-72.
- Bedford, Margaret E. "The Seasonal Borrowing Privilege," Monthly Review, Federal Reserve Bank of Kansas City, June 1974, pp. 10-16.
- Melichar, Emanuel. "Seasonal Discount Assistance at Rural Banks: Evaluation of a Federal Reserve Proposal," Agricultural Finance Review, U.S. Department of Agriculture, Vol. 30 (July 1969), pp. 44-57.
- Melichar, Emanuel. "Toward a Seasonal Borrowing Privilege: A Study of Intra-Year Fund Flows at Commercial Banks," in Reappraisal of the Federal Reserve Discount Mechanism, Vol. 2, Washington, D.C.: Board of Governors of the Federal Reserve System, 1971-72.
- Melichar, Emanuel and Harriet Holderness. "Seasonal Borrowing at the Federal Reserve Discount Window," Agricultural Finance Review, U.S. Department of Agriculture, Vol. 35 (October 1974), pp. 42-51.
- Timenes, Virginia and Emanuel Melichar. "Seasonal Borrowing Privilege: A New Dimension in Administration of the Federal Reserve Discount Window," in 1973 Proceedings of the American Statistical Association, Washington, D.C.: 1974.