Sources of Loanable Funds for Agricultural Banks

By Marvin Duncan
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Commercial banks have supplied a major part of the credit needs of farmers over the past few decades. In recent years, however, a changing regulatory environment, an increased demand for agricultural loans, and a growing competition for sources of loanable funds have raised the possibility that banks may be less able to effectively serve this market in the future. Smaller community-oriented banks, which have been most heavily involved in agricultural lending, may be particularly affected. These banks may find it very difficult to compete against other financial institutions, including large banks, in the new financial marketplace.

Recognizing the importance of these smaller, community-oriented banks to agriculture and to rural communities, the Federal Reserve Bank of Kansas City recently sponsored a symposium to examine the future sources of loanable funds for agricultural banks. This article summarizes the principal papers and comments presented at that symposium, held on December 8-9, 1981, in Kansas City, Missouri.

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AGRICULTURAL CREDIT TRENDS

At the outset of the symposium, Peter Barry of the University of Illinois examined the growth of credit use by farmers and the role of commercial banks in servicing the demand for that credit. It was reported that use of debt in the farm sector has grown rapidly since 1950 when farm debt totalled $12 billion. On January 1, 1981, outstanding farm debt was projected at $177 billion. The annual compound rate of growth for total farm debt has increased from an average of 7.1 per cent in the 1950s, to 7.9 per cent in the 1960s, and to 11.5 per cent in the 1970s (Table 1). Moreover, since 1975, the annual growth rate for total farm debt has averaged 14 per cent. This accelerating growth in farm debt has made the farm sector one of the fastest growing components of the U.S. credit market.

Commercial banks have historically been major suppliers of credit to the farm sector (Table 2). Banks' share of total farm debt reached a postwar high of 28.2 per cent in 1952, then declined to the 24-26 per cent range during the next decade before reaching another peak of 30.5 per cent in 1974. Since then, banks' share of total farm debt has fallen sharply to

25.2 per cent in 1980. Since 1974, the market share of Farm Credit System outlets grew from 25.7 to 30.9 per cent and the share held by Farmers' Home Administration almost doubled, from 5.2 to 9.9 per cent.

The distribution of farm debt among banks is strongly influenced by bank size, location, specialization, and types of branching. Money center banks generally finance larger operations, especially those involved in livestock production. In states with liberal branching laws, however, smaller farming operations are also served by money center banks. Large banks are further involved in agriculture through financing agribusiness and international trade, and through loan participations with smaller banks. Regional banks provide direct loans to farmers and agribusiness, as well as loan participation to smaller banks. The smaller community banks in rural areas are most heavily involved in direct farm lending.

Table 1
ANNUAL COMPOUND GROWTH RATES FOR FARM DEBT AND INFLATION, 1950-80
(Per Cent)

	1950-60	1960-70	1970-80	1975-80
Total Farm Debt	7.1	7.9	11.5	14.0
Farm Real Estate Debt	8.0	9.2	10.9	12.2
Non-Real Estate Farm Debt	6.3	6.5	12.2	16.2
Consumer Price Index	2.2	2.6	7.4	8.2

Table 2
TOTAL FARM DEBT OUTSTANDING, ALL LENDERS, MARKET SHARES, 1950-1980

Year	Total Debt	Farm Credit System	Commercial Banks	Life Insurance Companies	Farmers' Home Administration	Commercial Credit Corporations	Individuals and Others
	$ 1,000	%	%	%	%	%	$
1950	12,454	11.3	23.9	9.4	4.4	13.8	37.2
1955	17,660	10.8	23.2	11.6	4.5	12.6	37.3
1960	24,775	15.3	25.6	11.4	4.3	4.7	38.7
1965	36,804	16.5	25.6	11.7	5.2	4.2	36.8
1970	53,027	21.5	26.2	10.8	5.8	5.0	30.7
1971	54,484	23.2	27.3	10.3	5.9	3.4	29.8
1972	59,114	24.0	28.3	9.4	5.7	3.8	28.7
1973	65,344	24.3	29.2	8.6	5.5	2.7	29.5
1974	74,137	25.7	30.5	8.0	5.2	1.0	29.5
1975	81,833	28.5	29.6	7.7	5.2	0.4	28.7
1976	90,832	29.5	29.1	7.4	5.7	0.4	27.6
1977	102,632	30.3	29.3	7.2	5.4	1.0	26.9
1978	119,273	29.6	28.1	7.4	6.0	3.8	25.2
1979	136,073	29.2	26.8	7.4	7.2	3.8	25.6
1980	157,323	30.9	25.2	7.7	9.9	2.9	23.4

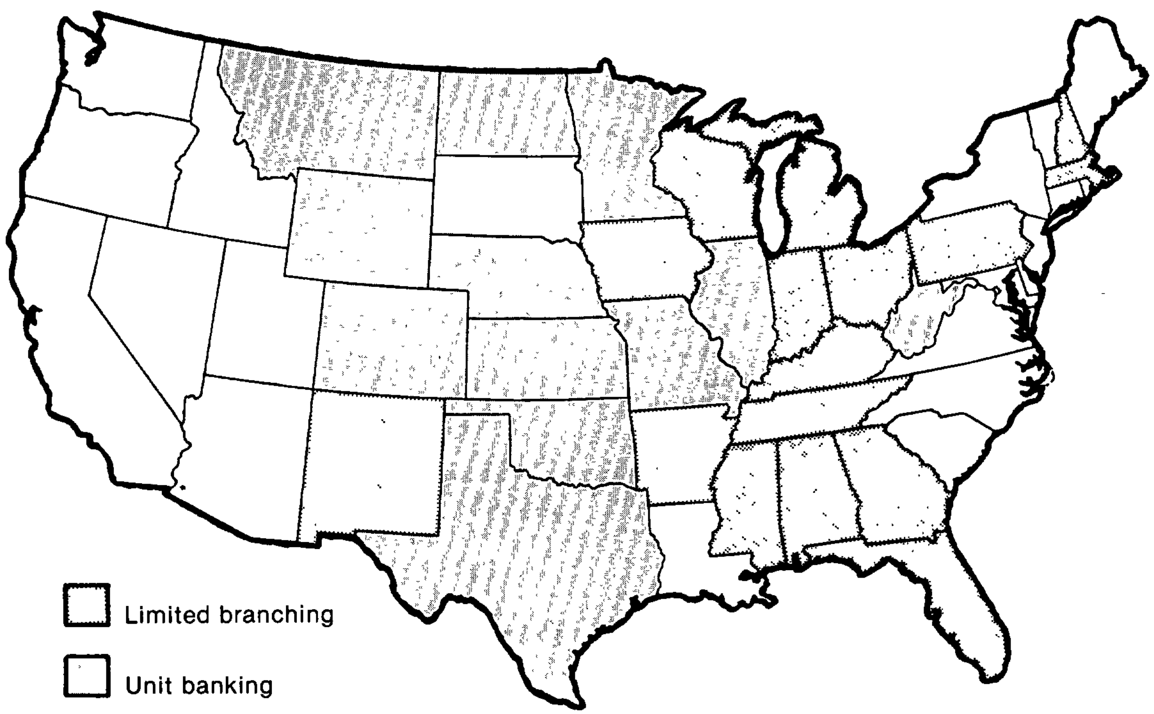
SOURCE: USDA Statistical Bulletin 650, pp. 49-51.

Banks in the commercial agricultural areas of the Midwest and Great Plains, where most unit banking states are located, are often heavily involved in farm lending (Chart 1). For example, banks in the 12 unit banking states account for nearly half of all non-real estate loans held by all U.S. banks and about a third of all farm real estate loans held by all U.S. banks. Banks in unit and limited branching states together account for about 80 per cent of all non-real estate loans held by all U.S. banks.

The concentration of farm lending at smaller rural banks means that loan and deposit conditions at these banks can be significantly affected by fluctuations in farm income. These banks draw heavily on local sources of funds. Since farm loan demand at these banks has grown much more steadily than available funds have, periodic stresses in bank liquidity and relatively large fluctuations in the availability of loan funds to farmers have occurred. As loan requests have grown larger, a greater percentage of them have been exceeding banks' legal lending limits. Additionally, banks have faced increased competition for deposit funds from savings and loan associations and money market mutual funds.

Thus, Barry asserted, rural banks with a heavy concentration of lending in agriculture are facing increased problems in acquiring loanable funds at prices that permit them to competitively serve agricultural borrowers.

Chart 1



THE CHANGING ENVIRONMENT FOR AGRICULTURAL BANKING

Increased risk for agricultural producers —and for their bankers—is likely to be an important factor in the changing environment of the 1980s. Farm product prices are increasingly dependent on export demand, while production expenses are importantly affected by the price of imported energy. Farm income promises to be higher in the 1980s, but perhaps equally as variable as in the 1970s. Nonetheless, a study cited by Barry suggests that credit demand by farmers is likely to grow at perhaps 9 to 11 per cent per year during the decade. Factors expected to add to farm debt requirements will be continued farm enlargement, increased intergenerational transfers, new technology, growing farm markets, and price inflation. As total debt levels increase, there will be some increased risk for farmers and their lenders. But the changing environment involves changes in the structure of the nation's financial sector, as well.

As Governor J. Charles Partee of the Board of Governors of the Federal Reserve System explained to the symposium audience, the list of challenges for banking is extraordinarily broad.

Interest rate volatility over the past year has been without parallel in modern times. The competition for deposit funds is intense. Major new shifts in the competitive environment are present or on the horizon, including nationwide NOW accounts, expanded lending authority for thrift institutions, pricing of Federal Reserve services, an accelerating trend toward electronic funds transfers, and a phaseout of Regulation Q interest rate restraints. Moreover, these changes are occurring in an environment of high inflation, sluggish business activity, escalating energy costs, and uncertain adjustments in the structure of geographic and product markets. While it is still too early to fully assess the impact of these changes on agricultural banks, Governor Partee concluded:

> In the last several years, these banks too have been subjected to great changes in their operating environment, and this trend seems bound to continue.
>
> How small banks will fare will depend on whether they choose to compete aggressively for deposits, whether they place greater emphasis on floating rate loans in order to balance interest sensitive assets and liabilities, and whether they can maintain their credit standards in these difficult and changeable times. So far, many small banks appear to have done quite well in adjusting to their new circumstance.

SOURCES OF LOANABLE FUNDS

In view of growing demand for agricultural credit, the changing environment for commercial banks, and the increased competition for loanable funds, the symposium focused on potential sources of funds available outside of a bank's particular community. The following section examines the future usefulness and availability of these sources of funds.

The Role for Correspondent Banking

Changes in the banking environment resulting from technological innovation and the Depository Institutions Deregulation and Monetary Control Act of 1980 can be expected to change the correspondent relationship between money center banks and downstream respondents. In one sense, changes in financial institutions are opening new opportunities for agricultural bankers, as new banking services are being offered by a broader range of institutions. On the other hand, greater competition among these institutions means they will be increasingly profit oriented. In the new environment, money center banks may feel less responsibility to service overline requests from regional or local banks unless the business is at least as profitable as other investment opportunities, such as those in energy, international trade, and consumer lending.

Past relationships between money center banks and smaller banks have been relatively limited and based on the smaller banks being a stable net supplier of funds to money centers at relatively low cost. Smaller banks have historically utilized correspondents to satisfy critical needs for additional loan funds. According to John Ballantine, vice president of the First National Bank of Chicago:

> Use of correspondent banks could become more important to country banks, but only if the quality of agricultural loans and the rates of interest on these loans are sufficient to assure competitive returns to money center banks.

Regional correspondent bankers, however, remain somewhat more sensitive to demand for agricultural loan funds, according to Jim Timberlake, senior vice president of the Fidelity Bank in Oklahoma City. While reluctant to bypass the respondent banks and service the loan demand directly, regional correspondents will have difficulty in working through respondents unless loan quality and interest rates are competitive with other loans available. Indeed, in the absence of adequate documentation and competitive interest rates on overline loans, both regional and money center banks may increasingly service selected large agricultural customers directly.

If correspondent banks have difficulty in serving increased demand for overline loans, agricultural banks may find it necessary to consider other alternatives. These alternatives may include obtaining guaranteed Small Business Administration (SBA) or Farmers' Home Administration (FmHA) loans, marketing mortgage loans to Federal organizations, or placing loans with insurance companies. Correspondent banks, on the other hand, could free additional funds by charging fees for services rather than by requiring compensating balances, by pooling farm loans for sale, and by improving the secondary market in agricultural loans.

The Role of Government

Credit has been an important tool of Federal agricultural policy for more than 50 years. Indeed, Federal agricultural credit policies have assured abundant loan funds and competitive interest rates for agriculture, and these conditions have been major factors in the transformation of farming into the highly industrialized, productive, capital intensive industry it is today. But it is precisely because of the changing financial and structural characteristics of U.S. agriculture that public policymakers are re-examining the role of government credit programs.

In the early years of government credit programs, alternative credit sources were not readily available, were very costly, and had repayment schedules not adapted to agriculture. Over the past few decades, however, commercial banks, the Farm Credit System, and insurance companies have all served agriculture very well and there has been no shortage of credit for sound loan requests.

Nonetheless, government extension of credit —typically at below-market rates of interest— has been increasing, principally through FmHA and SBA programs. The increase in outstanding loans under emergency credit programs of the FmHA and SBA has been particularly rapid. The share of institutionally held non-real estate debt owed to the FmHA and the SBA increased from 3.5 per cent in 1975 to more than 17 per cent in 1980. When combined with Commodity Credit Corporation (CCC) debt, the three governmental agencies had nearly 25 per cent of all non-real estate farm debt owed to institutional lenders at the beginning of 1980, up from less than 5 per cent in 1975.

Some FmHA programs serve their intended function of aiding small, lower income farmers. For example, over 68 per cent of the money loaned in FmHA's farm ownership program in 1979 went to farmers with less than $12,000 of net cash income and less than $120,000 net worth. More than 74 per cent of operating loan money went to farmers in the same category.

The economic emergency programs, however, are a different matter. The majority of money loaned under these programs has gone to large, higher income farms. These programs extended over a third of their money in 1979 to farmers with more than half a million dollars in assets. Farms with gross value sales of over $40,000 represented one-fifth of all U.S. farms but received more than two-thirds of the money loaned under the emergency programs in 1979. Emergency programs may be viewed as assistance not only to farmers but to banks and the Farm Credit System as well. Without these programs, financial institutions would have to arrange for settlements with financially

Table 3
POTENTIAL QUALIFICATION FOR SEASONAL BORROWING

	Original Guidelines		Current Guidelines	
	1973	1976	1976	1979
Potentially qualifying banks:				
Number	1,931	1,478	2,729	2,310
Nonagricultural	1,030	875	1,763	1,681
Moderately agricultural	432	302	516	383
Heavily agricultural	469	301	450	246
As a percentage of:				
All member banks	34	25	47	41
Nonagricultural	25	20	41	39
Moderately agricultural	44	32	54	47
Heavily agricultural	68	50	74	54
Percentage of member-bank loans at potentially qualifying banks:				
Total loans	8	6	13	11
Farm loans	27	19	36	27

NOTE: Banks are classified by their ratio of total farm loans to total loans, as follows:
Under 25 per cent.................................Nonagricultural
25 to 49 per cent...........................Moderately agricultural
50 per cent and over..........................Heavily agricultural

troubled customers.

The recent growth of government credit to agriculture has raised the question of whether agriculture continues to need special treatment in the credit markets. Most analysts argue that the economic health of agriculture is sufficiently good to enable farmers to compete for loan funds at market rates. A number of recent studies indicate the agricultural sector is primarily made up of (1) small farms with sufficient off-farm income to compare favorably with non-farm family incomes and (2) larger commercial farms that are capital intensive businesses earning competitive returns. Thus, such credit programs may be unnecessary except for some new entrants into farming.

What, then, is the future of government credit as a source of loanable funds for agricultural banks? In a paper reporting the results of a U.S. Department of Agriculture study, John Lee, Stephen Gabriel, and Michael Boehlje pointed out:

> Perhaps the more fundamental farm credit issues of the next several years will be those dealing with the role of public lenders to agriculture and what to do about minimizing undesirable side effects of credit policies, especially the structural and resource-misuse impacts of subsidized credit. If the concerns are taken seriously, one could envision proposals for such actions as scaling back FmHA programs and targeting them more precisely on those potentially viable small, beginning and minority farms who genuinely need help; shifting some of the risk-sharing function from emergency loans to sound insurance schemes; and taking a variety of steps to minimize land price inflation.

The Federal Reserve Seasonal Borrowing Privilege

Commercial banks too small to have reliable access to national money markets and experiencing significant seasonal outflows of funds have access to the Federal Reserve discount window for seasonal borrowing. The seasonal borrowing privilege provides a method for banks to even out short-term outflows and inflows of loanable funds. The threshold levels of funds outflows needed to qualify for seasonal borrowing increase as bank size increases. The minimum duration of outflows required to qualify is four weeks. Since most small banks have become year-round sellers of Federal funds, qualifying banks are permitted to continue their normal sales of Federal funds while borrowing under the seasonal privilege.

When the seasonal borrowing privilege was instituted in 1973, 34 per cent of Federal Reserve member banks qualified for seasonal borrowing. Within three years, the relative size of seasonal outflows had fallen so much that only 25 per cent of member banks qualified. A 1976 revision in the regulation governing the seasonal discount privilege almost doubled the number of qualifying banks at that time (Table 3).[1] But a continued decline in seasonality has

[1] In August of 1976, the Board of Governors of the Federal Reserve System revised the guidelines pertaining to the Seasonal Borrowing Privilege. Those banks with deposits of less than $500 million would be eligible for seasonal borrowing, if they could show a seasonal need for credit. The seasonal credit qualification is defined as the institution's measured seasonal need minus a certain deductible amount calculated as a proportion of its average deposits over the previous year. The precise calculation of the deductible is 4 per cent of the first $100 million of deposits, 7 per cent of the next $100 million, and 10 per cent of any deposits over $200 million. The minimum duration of qualifying outflow was reduced to 4 weeks. The Board of Governors also decided to allow banks to continue their normal sales of Federal funds while borrowing under the seasonal privilege.

since further reduced their number. Agricultural banks are more likely to qualify for borrowing under the seasonal privilege than are non-agricultural banks. In 1979, potentially qualifying banks accounted for 27 per cent of farm loans compared with 11 per cent of all loans.

Two other factors importantly affect whether a bank's seasonal outflow is large enough to qualify for seasonal borrowing. Regional differences are apparent, with eligible banks in the Northeast, upper Midwest, and far West much more likely to qualify than banks in other areas. Bank size is also important, with greater diversification and higher qualifying thresholds making it less likely that larger eligible banks qualify.

A comparison of actual and potential seasonal borrowing provides some insight into the degree to which the privilege is being utilized by banks. In 1979, seasonal borrowing totalled $144 million on an annual-average basis, or 25 per cent of estimated potential borrowing. Peak month borrowing, however, equalled 38 per cent of potential borrowing. Although only one-fifth of qualifying banks borrowed under the seasonal privilege, these banks held farm loans equalling 40 per cent of the farm loan total at potentially qualifying banks. Agricultural banks represented 41 per cent of eligible banks in 1979, and on a peak-month borrowing basis, these banks borrowed about 60 per cent of their estimated potential (Table 4).

According to Emanual Melichar, a senior economist at the Board of Governors of the Federal Reserve System, the usefulness of seasonal borrowing to banks will tend to decline if seasonality in bank funds flows continue to decline. Borrowing totals may rise in the near future since nonmember banks just became eligible to borrow in 1980. But if, as

Table 4
INCIDENCE OF SEASONAL BORROWING, ACTUAL AND POTENTIAL, 1979

	Actual	Potential	Actual as Per Cent of Potential
Borrowing banks:			
Number	482	2,310	21
Nonagricultural	282	1,681	17
Moderately agricultural	112	383	29
Heavily agricultural	88	246	36
As a percentage of:			
All member banks	9	41	21
Nonagricultural	7	39	17
Moderately agricultural	14	47	29
Heavily agricultural	19	54	36
Percentage of member-bank loans at borrowing banks:			
Total loans	3	11	25
Farm loans	11	27	40

appears likely, small banks develop greater interest and improved access to money market sources of funds, both the underlying need for and the relative use of seasonal borrowing would likely diminish.

The Farm Credit System—Another Source of Loanable Funds

The Farm Credit System (FCS), a borrower owned farm cooperative, is composed of federally chartered but privately owned banks and associations.[2] These institutions are supervised and examined by the Farm Credit Administration, an independent Federal regulatory agency. The FCS has been remarkably successful in serving the credit needs of agriculture. As of January 1, 1980, the System held 30.9 per cent of all outstanding farm debt, compared to 25.2 per cent for commercial banks (Table 1).

The FCS is required by law to serve all agricultural areas during all economic times and conditions, but it is not a lender of last resort. It is not a depository institution and hence has developed very efficient procedures for raising funds in the nation's money markets. In 1980, Farm Credit Banks sold $93.8 billion of securities to support their lending to agriculture. Loans to borrowers are priced at the average cost of funds to the FCS. Thus, during periods of rising interest rates, Farm Credit outlets offer interest rates that are typically lower than those available at commercial banks, which typically price loans at the marginal cost of money.

The FCS outlets offer very tough competition for agricultural banks, because of these two characteristics: unlimited access to loanable funds and average cost pricing of funds to borrowers. These same characteristics also make the Farm Credit System a potentially desirable source of loanable funds for agricultural banks. The Farm Credit Act now provides for (1) an expanded authority for the FCS banks to participate with other lenders outside the system, (2) an improved PCA/commercial bank participation program, and (3) expanded authority to discount loans from financial institutions other than PCA's at Federal Intermediate Credit Banks (FICB's)

While other financial institutions (OFI's) have had access to FICB's discount window since enactment of the Agricultural Credit Act of 1923, the provision has not been widely used. As of June 30, 1980, there were only 167 OFI's discounting with FICB's, 136 of which were commercial banks or affiliates of commercial banks. Reluctance by banks to obtain funding from an institution regarded as a competitor, and reluctance by FICB's to provide funds for banks in direct competition with PCA's, have thus far limited the use of OFI discounting.

In the future, though, the use of OFI discounting may increase. FICB's, as a result of 1980 amendments to the Farm Credit Act, can now discount for OFI's the same types of loans that PCA's are authorized to make. Moreover, FICB discounting is to be available on a reasonable basis to qualifying banks, agricultural credit corporations, and other OFI's. While many bankers remain skeptical about how useful and how accessible such discounting will be, Donald Wilkinson, governor of the Farm Credit Administration, wrote in a paper prepared for the symposium:

> The Farm Credit System anticipates an expansion of participation programs and OFI discounting through the FICB's. The intent of the 1980 Amendments is to ensure

[2] The Farm Credit System is composed of the 12 Federal Land Banks (FLB's) and 492 Land Bank Associations, the 12 Federal Intermediate Credit Banks (FICB's) and 424 Production Credit Associations (PCA's), and the 13 Banks for Cooperatives (BC's). All are borrower-owned cooperatives.

> that deserving farmers have adequate credit either through Farm Credit lending institutions or through commercial bank relationships when this approach is necessary and in the best interest of the agricultural community.

A New Market to Provide Loanable Funds to Rural Banks

Despite the prospect of improved access by agricultural banks to loanable funds from the Farm Credit System, Raymond Doll, former director of research at the Federal Reserve Bank of Kansas City, argued for a market mechanism whereby commercial banks could develop their own funds:

> Emphasis should be placed on developing a market that enables rural banks to compete equitably with other financial institutions for the purpose of raising needed funds in the nation's financial markets, including satisfactory methods for handling credit overlines.

Rural banks need access to non-deposit funds to support the continued economic growth of their communities. This need goes beyond simply meeting credit demand by agricultural producers. Hence, Farm Credit System discounting and loan participations for agricultural purposes can satisfy only part of the funds needs of rural banks. Moreover, rural banks need a more efficient and reliable mechanism to obtain funds than those presently available through the correspondent banking system. Without such a mechanism, banks may not be able to meet the competition from Farm Credit System outlets and other financial institutions. Finally, if banks control their own fund intermediation mechanism, availability of loan funds will likely be more reliable.

Two organizational alternatives for implementing a fund intermediation mechanism were proposed by Doll. A private banking venture could be capitalized by the banks themselves. Such a venture would require a nationwide organization of rural banks to provide adequate diversity, market size, and efficiency. A second alternative suggested by Doll was a federally sponsored agency. Such a system could be capitalized initially using member bank capital in district Federal Reserve Banks. Federal Deposit Insurance Corporation (FDIC) insurance could be extended to cover securities offered for sale by that federally chartered organization of banks.

Walter Minger, senior vice president at the Bank of America, had reservations about such proposals. The notes or loans that would underlie the securities to be offered for sale presently lack the commonality required for readily accepted collateral. Moreover, since the proposal anticipated funds being used by many different customers and on different terms, Minger questioned whether banks were willing to forego their present independence in order to adopt clean, uniform procedures for handling collateral. He warned against a proliferation of such entities that would perhaps have limited market acceptance. Doll, however, had suggested one national entity. Although Minger questioned the complexity of the proposed systems and the problems associated with them, he also noted that the benefits that could accrue to rural bankers and their customers could far outweigh the problems involved.

New Opportunities in Liquidity Management

Balance sheet management will require greater attention in the changing environment for banking, as banks increasingly shift from their earlier emphasis on asset management to liability management. Changes in the competitive environment, with many new entrants offering financial services, may also have their greatest effect on the liability side of the balance sheet. The removal of Regulation Q, along with the advent of money market certificates, money market mutual funds, and NOW accounts, have all made fund acquisition more costly.

In an effort to manage these changes, large banks have been focusing simultaneously on both asset and liability management. As Donald Miller, vice chairman of Continental Illinois Bank, noted in a paper to the symposium:

> In recent years, the tremendous volatility in interest rates has necessitated the evolution from liability management to funds management techniques that can deal with the consequent volatility in bank earnings.

The bank objectives in funds management have involved insuring the availability of purchased money when it is needed, minimizing the cost of these funds, and engaging in strategic planning to meet long-term funding requirements.

Miller suggested that community banks may not have as much flexibility as larger banks in balance sheet management.

> Unlike those of its money center counterpart, the community bank's assets and liabilities are heavily influenced by the demand for and supply of funds in its immediate market area. Consequently, it does not enjoy the flexibility of adjusting the interest-rate sensitivity of its liabilities or its assets as easily or as rapidly as the money center bank.

In an effort to maintain interest rate margins, small banks have turned to liability instruments formerly used almost exclusively by money center banks and larger regional banks. These instruments include large denomination CD's, repurchase agreements, Federal funds purchased, and Treasury Tax and Loan Notes (TT&L).

But these instruments are only partially useful in controlling a community bank's maturity structure. What appears to be needed is a variable maturity instrument with a flexible rate. Sanford Rose, associate editor of the *American Banker,* in discussing Miller's paper, called for creation of a negotiable retail certificate of deposit as an alternative.

Given the difficulty of fine tuning the liability side of the balance sheet, community bankers have turned to the asset side to neutralize growing interest rate exposure. Variable-rate mortgages and loans are becoming more common but, as Rose noted, not as common as might have been expected under the circumstances. Small bankers could sell participations to regional banks or other investors, but that would require greater uniformity of documentation and adjustment of loan rates to reflect market conditions than small bankers have heretofore been willing to accept.

Given the term and maturity constraints in community bankers' loan portfolio and the desire to fine tune the bank's rate sensitivity, and to compensate for uncontrollable segments of the balance sheet, bankers could turn to their investment portfolio. Here again, however, the large minimum size of many money market instruments ($500,000 to $1 million) and the possible depreciation of the portfolio constrain the bankers' ability to fine tune. Thus, Rose suggested prudent and effective use of interest rate futures could offer the ideal hedge against interest rate fluctuations moving against a bank's gap.

Looking to the future, Rose asked agricultural bankers to rethink their profit sources in view of the new environment for banking:

> Bank profits have historically come from (1) credit intermediation, (2) funding, and (3) regulation. The regulation profit is disappearing, and the funding profit is threatened in the short run and may be nonexistent in the long run. Banks should therefore be concentrating on enlarging the profit from credit intermediation. Yet it is my contention that a nostalgic preoccupation with preserving funding profits is tending to impede management's ability to enlarge the profit from credit intermediation, which can be achieved only through a vastly expanded program of loan brokerage.

CONCLUSION

Over the next decade, increasing credit demand along with increased competition for deposits and loans make it imperative for agricultural bankers to develop more reliable and efficient sources of loanable funds. For a variety of reasons, three prominent sources of funds in the 1970s may not accomodate the growth in demand by agricultural banks. Indeed, these three sources of funds—correspondent relationships, government sources, and the Federal Reserve's seasonal borrowing privilege—may all become relatively less important for many agricultural banks.

What alternative sources of loanable funds might be available? For many agricultural banks, participation relationships with Production Credit Associations, Banks for Cooperatives, and Federal Land Banks, as well as discounting relationships with Federal Intermediate Credit Banks, offer promise as funds sources. Agricultural banks should consider aggressively pursuing these relationships with the Farm Credit System, to determine the extent to which the system can provide loanable funds.

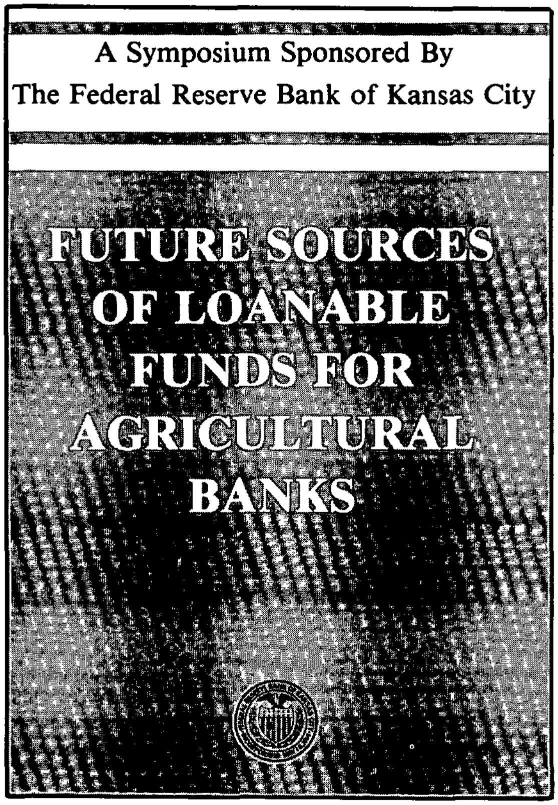
Secondly, bankers should evaluate the prospect of forming their own institution to gather funds from the nation's money markets. Such an effort would entail adopting much more uniform documentation, loan terms, and competitive rates on agricultural loans than banks have thus far been willing to do. Moreover, congressional action would probably be required to address usury and antitrust implications of such a plan.

Finally, bankers should consider developing appropriate liability and asset instruments for sale in secondary markets. For example, pooled sales of FDIC-insured $100,000 certificates of deposit ought to be explored. Loan packages of a specific type and maturity, at a competitive market rate, could be offered for sale to investors, sold to regional and money center banks, or sold to other community banks.

Agricultural banks have not been as creative as they might be in developing new instruments and services to meet customer demand. In the past, during periods of monetary restraint, outside sources of funds carried higher costs than internal sources. However, the cost of internal funds now tends to follow the cost of external funds. Thus, bankers may become more receptive to increased use of outside sources. Money market CD's have been responsible both for the change in the cost of internal funds and for bankers' receptivity to increased use of external funds.

Moreover, greater attention to the credit intermediation function of banking may help in meeting the new challenge facing agricultural banks. The challenge in the 1980s will be to successfully build upon traditional sources of loanable funds by developing a range of new funds sources that meet the emerging needs of agricultural banks.

Future Sources of Loanable Funds for Agricultural Banks



Farmers and ranchers—as well as the firms supplying farm inputs and handling farm products—have greatly increased their use of debt financing in recent years. Much of this credit has been supplied by commercial banks. In fact, about 25 per cent of all credit outstanding to agricultural producers on January 1, 1980, was extended by commercial banks.

As loan demand has continued to climb at these banks, they have had to become more aggressive in acquiring loanable funds, both from within their communities and from outside sources. Moreover, changes in the competitive and regulatory climate for financial institutions have greatly increased competition for loanable funds while opening new opportunities for acquiring these funds.

In December 1980, the Federal Reserve Bank of Kansas City sponsored a two-day symposium on this important topic, proceedings of which are now available. Proceedings are also still available from previous years' symposiums, *World Agricultural Trade: The Potential for Growth* and *Western Water Resources: Coming Problems and the Policy Alternatives.*

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