

A New Market to Provide Loanable Funds to Rural Banks

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The technological capability exists for transferring millions of dollars throughout the world in a matter of hours by use of modern telecommunications. Yet many rural banks in the Great Plains have difficulty in obtaining needed funds to finance economic development in their communities. These banks need access to nondeposit sources of funds comparable to those available to competing institutions. The thesis of this paper is to suggest that improved secondary markets for bank asset and liability items will provide rural banks in capital-deficit rural areas with such access on a competitive basis.

The problems facing rural banks have been well studied and known for a long time. The most recent major effort was made when the Board of Governors of the Federal Reserve System established a study committee in 1970 "to continue investigation of rural banking problems that had been pointed out in the 'Report of a System Committee' as part of the *Reappraisal of the Federal Reserve Discount Mechanism*."¹ A decade later little has been done to implement recommendations made in the report. Instead, effort has continued to be devoted to perfecting correspondent banking practices, improving markets for finance acceptances, obtaining discount credit through the Federal Intermediate Credit Banks, and changing banking organization.

Perusal of banking data over the past two decades suggests that the banking system continues to be confronted with the problems outlined in the report. On January 1, 1960, commercial banks were providing 27 per cent of outstanding farm loans in the United States

1. Board of Governors of the Federal Reserve System, *Improved Fund Availability at Rural Banks*, Washington, D.C., June 1975, p. 1.

vs. 16 per cent by the Farm Credit System. On January 1, 1980, the figures were 25 per cent and 31 per cent, respectively. The Farm Credit System surpassed commercial banks in relative importance as a source of farm credit in 1975 for the first time, and has gained in relative importance consistently since that time.

In recent years, agricultural (overline) loans carried by metropolitan banks in the Tenth Federal Reserve District have not grown at as rapid a rate as have loans made by non-metropolitan banks. This appeared to be true for states that prohibit multi-bank holding companies, for those that permit them, and for New Mexico, where limited branch banking prevails. In some instances, differences of opinion prevail on metropolitan bank boards as to how the banks' resources should be invested. At least in the Tenth District, these differences hinge on the relative importance of investments made primarily within the region surrounding the metropolitan area vs. those made in outlying non-metropolitan areas. As long as compensating balances remain as a method of financing correspondent bank account services, the direction such managerial decisions take can be of crucial importance to rural banks.

Another difficulty facing rural banks is the problem of obtaining overline loans for purposes other than farm loans. Rural banks report that many city correspondents are reluctant to grant overline loans for nonfarm purposes. Thus, if overlines are needed in a rural area for other than a farm loan, a rural bank's problems are compounded. The FICB alternative does not prevail except for farm loans. This problem will intensify with the changing growth trends in both non-metropolitan and metropolitan areas. During the past decade, for the first time since such areas have been designated, non-metropolitan areas have grown more rapidly than metropolitan areas. Such changing growth trends almost certainly will be reflected in changing financial trends, as new employment and living patterns emerge.²

To summarize, it appears as if the recommendation of the Federal Reserve System Committee on Rural Banking Problems needs to be pursued. Furthermore, emphasis should be placed on the importance of developing a market that enables rural banks to compete equitably with other financial institutions to raise needed funds in the nation's

2. For an interesting study related to this issue, see Andrew J. Sofranko and Frederick C. Fliegel, "Newcomers to Rural Areas: What Impacts Are They Having," *Rural Development News*, Vol. 6, No. 1, June 1980, North Central Regional Center for Rural Development, Iowa State University, Ames.

financial markets, including satisfactory methods for handling overline loans. Unless such provision is made, non-metropolitan banks will need to deal in a diverse mixture of instruments with agencies operating under different authorities, and use cumbersome practices, if they are to provide financial services needed in their communities.

Specifications for Achieving Market-Perfecting Actions

Part of the difficulty confronting rural banks that prevents them from offering securities that meet the credit and liquidity standards of national money market participants results from the fact that they operate under more restrictive rules and authorities than do their nonbank competitors. To make their instruments competitive in national money markets, small rural banks need to have equal access to financial markets, which means being able to package securities so they are just as attractive as those of other market participants. This suggests a market in which the numerous financial instruments of all the different participants can be bought and sold on a comparable basis.

Such a system does not prevail today. To illustrate, the nonbank financial institutions can issue a wide variety of instruments and market them under specifications that are not available to rural banks. Inequalities also prevail in financial markets with respect to such items as applicability of usury laws, rate variability under Regulation Q, and tax considerations. Such inequities and differences prevent competitive equality.

If equality is to be encouraged by permitting rural banks to raise funds effectively in national money markets, the instruments developed for this purpose must stress safety, efficiency, and liquidity. The safety issue involves many factors pertaining to items such as financial strength of issuer, collateral, kind of financial instrument, and capability of issuer. Participants in national money markets would know little if anything about most of these factors for an isolated rural bank's instruments. On the other hand, they know that commercial bank management is carefully observed, supervised, and examined by the FDIC, the Comptroller, or the Federal Reserve System. In addition to the strong incentive that already prevails for bank management to stress safety, such overseeing provides additional assurance. If a security were issued jointly by a group of such banks, the instrument could possess substantial diversity and proba-

bly be quite safe. But as Sandberg points out, investors still would "be interested in the number of banks involved, size of the individual banks, geographical dispersion of these banks, degree of diversity in the bank's lending operations (for example, do all banks in the pool engage in considerable lending to the cattle industry?), and degree of liability of each bank — whether each bank is liable for all the obligations of the pool or only for some specified portion."³

Furthermore, considerable effort would need to be devoted to putting an adequate package together. Little activity is likely to result, nor are the packages likely to be most desirable, if an individual banker is depended upon to put it together. The liquidity of such a package also would be questionable. The market for such paper would be thin because of lack of knowledge about, and the small quantity of, such instruments that are likely to be available.

Size of the package and total volume of each issue also are important in evaluating efficiency and liquidity considerations. Transactions in national money markets are conducted in sizable units, usually multiples of \$100,000, with some participants dealing in units of millions. It costs little more to make a \$1,000,000 transaction vs. a \$100,000 transaction. Because of the small spread that usually prevails between the cost of funds and the returns earned in highly competitive markets, such efficiencies become crucial. An active market or an issuer who is willing to deal on a repurchase agreement basis is necessary if a marketable instrument is to have a high degree of liquidity. An active market is preferable for providing liquidity, but to have such a market, a large volume, in terms of both number of instruments and total dollar volume, is necessary. Since this would mean hundreds of millions of dollars of outstanding paper for each of the numerous instruments rural banks might want to deal with, there may be times when a repurchase arrangement for certain of the instruments might be desirable.

Such difficulties suggest the need for a highly developed, well-organized, and well-capitalized umbrella organization which would be able to package a wide variety of asset and liability instruments based on rural bank paper and to make these instruments marketable on a competitive basis.

3. Board of Governors of the Federal Reserve System, *Improved Fund Availability at Commercial Banks*, Washington, D. C., June 1975, p. 22.

Organization

Whatever form of organization is chosen, local rural banks must have easy access at modest cost to continuously updated market information for all instruments traded. With modern telecommunications, a central office could most efficiently collect and update money market information, package the securities, and sell or buy instruments in the money markets to raise or repay funds. An intermediary organization of this type would enable rural banks to place acceptable instruments in the money markets and provide financial services for their communities.

Consideration also must be given to evaluating whether the organization should be confined to operating only with banks or be expanded to permit all major financial institutions to participate. With the changes brought about with passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, strong arguments can be developed for permitting all rural financial institutions to participate if they so desire.

If the organization becomes as strong as envisioned, it is possible that at times the instruments it packages could sell at more favorable prices than many of the highly specialized instruments on the money markets at present. From the viewpoint of efficient marketing, it would be desirable to have one organization package and place all types of qualified instruments on the money markets. This could be advantageous to the public and helpful in the implementation of monetary policy. However, permitting all financial institutions to use such a market would pose virtually insuperable difficulties because of their diverse organizations, activities, reserves, and supervision. Therefore, the subsequent proposals will be applied only to instruments of insured commercial banks.

A Private Banking Venture

One alternative with substantial appeal is an institution organized as a private venture by the banks themselves. Membership would be available to all insured commercial banks that agree to help capitalize the market and abide by specified bylaws covering such items as fees, instruments to be traded, investments to be made, and trading rules. The amount of capital needed and methods used in capitalizing such an institution would be of crucial importance and could vary widely depending upon volume, and upon the kinds of operations performed by the chartered agency.

The fee structure developed could be a flat fee, a percentage of dollar volume, an add-on to the interest rate, or any combination of these. Regardless of the method used, the fees must relate to the cost involved for each individual transaction, be adequate to pay expenses, including insurance, and provide for adequate reserves and payment of a return on capital. This is a difficult package to develop, but there is much experience with such pricing, and the difficulties are surmountable.

Enabling legislation would be required to make such a venture possible, since most rural banks are subject to state banking laws. Yet for such an institution to be at all effective, membership would have to be open to all banks on a comparable basis. Federal banking legislation, including antitrust legislation, would need to be clarified to permit banks to purchase stock in the venture and capitalize it adequately.

The success of such a private venture would depend upon securing the initial participation of a large number of banks located in widely diverse regions. Thus, the basic question is: Who will provide the leadership and the funds to bring about the necessary legislative changes, to organize on a nationwide basis, and to provide for adequate capitalization of such a venture? Small rural banks do not have adequate resources, while large city banks may view such an institution as a competitor, particularly if current procedures are retained.

Williford, in discussing agricultural credit corporations, suggests, "There has been no evident real interest on the part of either large banks or government regulators in backing such an organization. Therefore, any initiative in the development of an intermediary structure must be forthcoming from groups of rural banks on a private commercial basis. To date, there have been no successful ventures such as this organized."⁴ Williford views the intermediary structure as a group of regional banks. Such a structure would be inadequate to provide needed services. Again, emphasis must be placed on the need for a nationwide organization of rural banks if the market is to provide for adequate diversity, size of market, efficiency, and flow of information. Also, Agricultural Credit Corporations provide for agricul-

4. George H. Williford III, *Agricultural Credit Corporations and Alternative Funds Sources: Potential for Rural Commercial Banks*, Thesis, Stonier Graduate School of Banking, June 1980, pp. 67-68.

tural credits only, and what is needed is a broad-based market for asset and liability items of rural banks. The agricultural sector already is much better provided with broad-based financial services than is the non-agricultural rural sector. Since legislative changes would be required, it is highly improbable that a consortium of regional, less-well-known rural banks can provide the necessary impetus to establish such an organization. In all instances where comparable organizations have been established, the impetus has come from Congress.

Since banks already have an adequacy of regulatory agencies and unification is essential, the most logical solution to the problem is for Congress to pass enabling legislation permitting existing regulatory agencies to reorganize and carry out the necessary additional functions.

A Governmentally Sponsored Agency

Virtually all financial institutions are operated under government charters. Banks must be chartered either by the federal government (Comptroller of the Currency) or by a state government (usually a banking commission). Since governments grant the charters, they expect banks to provide appropriate financial services to the communities in which they are located. Historically, many rural banks in capital-deficit areas that are subject to loan limit regulatory restrictions have not always adequately served their communities. The result has been creation of specialized credit agencies which, as pointed out previously, are permitted freedoms not available to rural banks.

Because of the unique problems facing rural banks, strong arguments prevail for governmental sponsorship of an agency that would encourage increased mobility in the flow of funds through the competitive marketing of bank asset and liability items. Historically, Congress in organizing specialized credit agencies has permitted them considerable flexibility in packaging and marketing issues for the purpose of raising funds in the national money markets. Furthermore, they have been granted substantial freedom in deciding how to best resolve such difficulties as loan limits. Banks need similar flexibility.

Since Congress is responsible for implementing monetary policy and nationwide uniformity is needed if good money market instruments based on bank liability and asset items are to be developed,

government sponsorship is recommended. This could best be achieved by extending the powers of the Federal Deposit Insurance Corporation and the Federal Reserve System (perhaps even combining them) and permitting them to organize and take on the task of making rural bank paper more marketable, as well as providing other assistance to banks in rural communities in solving their loan limit problems. Both the FDIC and the Federal Reserve are well qualified and organized for conducting this type of activity. FDIC has experience in insuring deposits and evaluating both asset and liability items of commercial banks in its efforts to see that banks are safely operated and their depositors protected. Their experience is ideal for dealing with banks in developing insurance for other bank liability and asset items. The Federal Reserve now deals with banks on monetary matters and with money market instruments. Cooperatively, the two agencies could establish rules for creating instruments that the FDIC could insure, and the Federal Reserve System could provide information to the banks, package the instruments, and market them.

Circumstantial evidence suggests that the wide variety of financial agencies, operating under different rules and regulatory authorities and with different restrictions, are not conducive to the equitable allocation of capital to its most productive needs. This may partially explain the slowdown in the rate of growth in productivity, an important issue if the United States is to combat inflation and remain competitive both domestically and internationally. More mobile financial markets would do much to rectify present inequities and encourage allocation of capital to its most productive uses.

Both Congress and the administration recognize that a liberalization of banking rules is necessary in the modern world. The main thrust of a White House study released this summer "is that technological changes — such as the availability of machines that offer a range of electronic banking services — and the growing competition from financial institutions other than banks are inconsistent with laws that now limit banking operations."⁵

As was pointed out at the beginning of this article, technology has long been able to resolve rural banking's dilemma and social institutions that restrict use of modern technology are responsible for many of banking's problems. The White House study "proposes liberalization of the Douglas Act of 1956, which prohibits a bank holding

5. *The Kansas City Times*, Friday, July 11, 1980, p. D7.

company from acquiring an out-of-state bank unless specifically authorized by the legislature of that state.”⁶ Many other controversial issues pertaining to banking structure also are raised. Since there is no evidence suggesting that changing bank structure is of significance in solving rural bank problems, a system needs to be devised that would permit market forces more freedom in solving rural finance problems and enable rural banks to become more viable financial institutions in their communities. An intermediary structure as is being proposed would be helpful in attaining the proposed objectives.

Capitalization

Adequate initial capitalization would be needed to provide for organization expenses, physical facilities, personnel, supervision, and operating expenses while the intermediary structure is being established, and to protect against loss while reserve funds are being built up. Although a substantial sum would be required, the historical experience of the organizations now providing comparable services (Farm Credit System, Federal Deposit Insurance Corporation, Federal Home Loan Banks, and Corporate Central Credit Unions) has been excellent. These organizations have been able to cover losses and build up sizable reserves in addition to repaying government capital injected when the institutions were organized. Creation of the proposed organization should be easier than was organizing and starting these institutions.

More information and experience also is available for developing an operating procedure and rate structure than was available to the institutions just mentioned. Furthermore, it would be to the interest of both the Federal Reserve System and FDIC to have an effective market for rural bank instruments and to be involved in such an activity. The System, in addition to keeping well informed on a diverse group of money market instruments, would be able to provide useful services to rural banks. It is well known that there was little direct incentive for rural banks to belong to the Federal Reserve System prior to passage of the Depository Institutions Deregulation and Monetary Control Act of 1980. With passage of the Act, there is virtually none.

Since the Federal Reserve has little else to offer member banks under present law that is not available to nonbank financial institu-

6. Ibid.

tions, why not permit member banks to use the value of their stock investment in the Federal Reserve as their capitalization for the proposed market? Nonmember rural banks could subscribe in proportional amounts to become members. All participating banks would help elect the directors of the Federal Reserve Banks. Permissive legislation would need to be passed providing that the \$1.2 billion of paid-in capital stock now held by member banks in the Federal Reserve System, plus \$1.1 billion in surplus, be used for initial capitalization of the new intermediary organization. This amount, plus that added by nonmember banks (if all joined), could provide up to approximately \$2.8 billion for initial capitalization.

The FDIC had approximately \$9.8 billion of reserves for insuring commercial bank deposits as of the beginning of this year. This is an adequate reserve to provide safety for deposit-type instruments of commercial banks, even if the \$100,000 limitation were increased or removed. Additional reserves would be needed to insure the safety of the asset-type instruments. The **\$2.3** billion of Federal Reserve System capitalization, plus the \$0.5 billion potentially available from nonmembers, would provide a substantial amount for such needs if enabling legislation so permitted. This, plus an adequate fee structure (e.g., 0.4 per cent to be added to reserves or paper backed by a well-diversified portfolio of prime bank notes), should permit the market to cover costs and build up adequate reserves as the market expands. Such a procedure would permit significant capitalization during the developmental stage and, with a proper fee structure, permit capitalization to grow with expansion of the market. Furthermore, with each issuing bank being at least indirectly responsible for the original paper used for backing such instruments, losses from guaranteeing should be minimal.

The value of all stock in the intermediary organization would be included as part of the capital of each subscribing bank and used in computing the bank's loan limit. As each bank increased its use of the market beyond a certain ratio, it would be required to buy additional stock. For example, if a bank initially had \$10,000 of stock and this provided for \$1,000,000 of outstanding activity, as its outstanding activity exceeded \$1,000,000, the bank would be required to purchase additional stock at, say, 1 per cent for all excess activity.

Unlimited dividend payments would be permitted from earnings on the intermediary's activities after adequate provision was made for reserves. Each individual bank would be allowed to withdraw such

dividends in cash or apply them toward increasing the individual bank's capital in the intermediary organization.

Instruments to be Handled

If local deposits do not provide adequate funds to meet community needs, outside sources of funds must be sought. However, risk exposure increases when a rural bank seeks such sources of funds for making additional loans. If the risk becomes too high, the adequacy of the bank's capital must be reevaluated. If a bank's risks become too high in relation to its capital, all of the risks that are supposed to be controlled by loan limit requirements merely emerge somewhere else.

Gable points out that there are four qualities that any rural bank asset or liability must possess before it can be marketed on a regional or national basis.⁷ He lists these as convenience, continuity, safety, and liquidity, which are the same qualities stressed previously. Regardless of whether the rural bank wishes to raise funds by the sale of, or by borrowing on, assets, or through use of liabilities, these four qualities are crucial.

For rural banks in capital deficit areas, one source of nondeposit funds is sale of bank assets. The primary assets of a bank are fixed assets, U.S. government securities, municipal issues, and loans, since these are the basic assets held by rural banks.

Selling a bank's fixed assets has limited potential as a source for raising funds, while relatively good markets already prevail for U.S. government securities and municipal issues. Thus, loans remain the basic asset available in large quantities if an adequate system can be developed for marketing them. Many rural banks already market mortgage loans successfully. In these cases the selling bank usually continues to service the mortgages. If mortgages are sold relatively soon after they are made, the bank's liquidity problem is minimized. If mortgages are packaged and sold after being held for some time, especially when interest rates are escalating, the bank is faced with a capital loss.

In some instances, rural banks have successfully sold blocks of consumer installment paper to institutional investors. However, as Gable points out: "This type of loan is deficient in all of the necessary

7. Board of Governors of the Federal Reserve System, *Improved Fund Availability at Rural Banks*, p. 24.

characteristics, and to obtain a continuing market, sellers must provide high-quality paper, as well as a higher rate of return, to compensate for the lesser degree of liquidity and convenience.”⁸ Marketability of this type of paper could be improved substantially if the packages were screened and insured by an organized market, diversified by including paper from a number of different banks, and made more liquid by substantially improving the market.

Since rural banks in capital-deficit areas have been short on funds to lend, it is not unusual to find such banks with more than two-thirds of their total assets in short-term loans. The most logical place to obtain additional nondeposit sources of funds is through creating marketable instruments based on such loans. An intermediary organization of the type proposed would enable such a market to be developed. The Farm Credit System has had good experience in using this technique for raising funds in the money markets on farm loans made by its agencies. They had been able to pay off all of the government capital that was injected and build up a surplus of \$1.6 billion in addition to the capital stock investment of \$2.6 billion as of January 1, 1979. With the supervision to which rural banks are subject, and with their generally careful management, use of similar techniques should be equally successful.

If rural bank notes with standard maturities and diversification with respect to number of banks, purpose of loan, and security can be packaged into large instruments, the issues can be guaranteed or insured at minimum cost. Adequate supervision to insure that only high-quality paper is marketed, along with favorable experience over a period of years, would establish the reputation of such instruments and make them highly marketable. Historical experience suggests that such paper could be guaranteed at a cost of between one-fourth and one-half of a percentage point added on to the interest rate. Money market instruments based on such paper and guaranteed by the FDIC would be expected to sell at, or below, the commercial paper rate. Thus, it seems reasonable to assume that such funds could be obtained and insured for rates comparable to those for short-term agency paper. With rates the commercial banks charge for non-real estate farm and other loans, the spread should be sufficient to allow, payment of the operating costs for obtaining the funds, to provide a servicing fee for the rural bank, and to provide much more adequate

8. *Ibid.*, p. 25

financing for the nation's hinterlands. Furthermore, it will enable commercial banks to remain viable financial institutions in many capital-deficit rural areas.

The most common liability items used by commercial banks to obtain funds are certificates of deposit, Federal funds, and bankers' acceptances. As Sloan points out: "Funds acquired by issuing liabilities would not be restricted to any particular use, but rather could be employed by the issuing banks in all of their loan and investment activities. In addition, liability instruments could be tailored in size and maturity to fit the needs of the investor as well as the bank, thus enhancing their marketability."⁹ Although all of these techniques are available now to rural banks, their use could be enhanced substantially by the availability of a good market for instruments issued by rural banks which are not well known in the money markets. Small rural banks frequently pay a substantial rate premium on CD funds compared with large banks. Access to competitive money markets would minimize this spread and make funds more readily available to capital deficit rural communities. Virtually the same arguments hold for use of Federal funds and bankers' acceptances.

An example of how an organization of the type proposed could be helpful under prevailing conditions can be illustrated with the use of CD's. Since the FDIC insures CD's up to \$100,000, the organization could obtain funds competitively from the money markets in large units and unpackage them in units of \$100,000 or less per bank. If a small bank needed \$500,000, the funds could be provided from 5 different sources and the full \$500,000 insured. Thus, funds could be provided at competitive rates despite the fact that the rural bank is unknown in the money markets. Obviously, the rural bank would need to demonstrate that it has an adequate capital structure and the capability for making good investments before such funds would be made available.

In summarizing, there are relatively good markets available today for many of the instruments used by the larger money center banks. However, a well-organized and-capitalized market such as that just proposed would improve the marketability of all bank paper, including some of the better instruments now being satisfactorily marketed by large money center banks. Such a market also would make

9. *Ibid.*, p. 33.

the commercial banking system, through which this nation implements its monetary policy, a more viable competitor in many rural communities.

The Loan Limit Problem

Although loan limits pose particularly difficult problems for most small rural banks, there are good reasons for having such limits. Good loans occasionally become 'classified and, in some instances, uncollectable. Therefore, a bank should not be permitted to make a loan of such size that, if uncollectable, the capital structure of the bank would be impaired. Despite prevailing loan limit regulations, some banks still have capital impairment difficulties because of violations of the regulation or poor management. A market of the type proposed could be helpful in solving such problems. Furthermore, such a market should be permitted to put together a package that would enable a number of small rural banks each to assume a certain proportion of a loan request that is too large for one or a small number of the rural banks to make.

The problem immediately arises as to how the qualities of convenience, continuity, safety, and liquidity can be assured so as to make this type of loan feasible through an intermediary market. A special difficulty exists because the safety provided by having a widely diversified package of notes from a variegated group of banks would not prevail. Would enough small rural banks be willing to take a portion of such a loan and bear the risk of it becoming classified and perhaps uncollectible? Would a large city bank be interested in taking such an overline at competitive rates? Obviously, it would depend upon how well such loans are made and supervised and how well this information is known in the markets.

If the loan is made to an established, well-managed local company with good security, and if this information is known in the markets, funds will be available at competitive rates. If the loan is questionable, depository institutional financing should not be provided. It is essential that large loans to an individual or firm be carefully evaluated, supervised, and secured if the funds are to be raised competitively.

Thus, it would be essential for any market handling such paper to have a competent staff to work with rural banks in making and supervising large overline loans needed in a rural community. In this connection, it is interesting to point out that the Farm Credit Admin-

istration, when confronted with the problem of loan limits, established its own regulations pertaining to such limits for all of its offices. The Farm Credit System has had a number of years of favorable experience in dealing with the overline loan problem with farm and ranch loans. With proper organization and a competent staff, an organization such as is being proposed should provide for better overline loan service for the banking system than prevails under current conditions.

Although recent data are not available, "Melichar and Doll reported that the 855 member banks with 50 per cent or more of their portfolio in farm loans in 1966 received farm loan participations equal on average to only 22 per cent of the balances they maintained with correspondent banks."¹⁰

Hopefully, the situation has improved substantially since 1966, but evidence suggests that the banking system still finds it difficult to provide net financing to capital-deficit rural banks. Compensating balances and loan limit problems are largely responsible. Substituting a fee schedule for some correspondent banking services, providing competitive rates through improved markets for rural bank instruments, and providing a competent staff to assist in handling large overline loans made by rural banks could be advantageous to both rural and city banks in providing better financial services to the nation's economy.

For example, an intermediary market could provide several alternatives for financing overline requests by a rural bank without having to maintain a large correspondent balance. In addition to efforts to market the overlines to city banks as an investment, they could be split among a diverse group of rural banks that happen to have excess funds.

Williford, in speaking about participations of rural banks in his proposed agricultural credit corporations, suggests, "The loans can be originated by the individual banks and participated to the corporation. The banks, on the other hand, could accept applications to be submitted to the loan corporation, with the loans made directly by the ACC. Whichever method is utilized, a portion of each loan should be retained by the individual banks. If each bank keeps approximately 25 per cent of each loan submitted, it will preserve their interest in the credits, which should maintain the quality of the loans handled by the

10. *Ibid.*, p. 12.

corporation."¹¹ Use of a comparable procedure for overline loans handled by the intermediary market should prove quite helpful in improving fund flows in the nation and making rural banks more viable financial institutions.

Potential Criticisms and Responses

Obviously, proposals of the magnitude suggested will be criticized by antagonists. The criticisms are likely to range from legitimate concerns relating to impact of the proposals on banking to those simply arguing for maintaining the status quo. In this section, some of the obvious concerns will be pointed out and discussed.

A major concern that needs to be acknowledged is the impact such an intermediary market would have on the dual banking system. Would it tend to force virtually all banks to become subject to Federal regulation? Instead of destroying the dual banking system, the objective is to strengthen rural banks, which are predominantly state banks.

The real attack on the dual banking system in recent years has come from creation of specialized nonbank financial institutions because the banking system did not provide adequate financial services. Furthermore, Congress has responsibility for monetary policy and the nation's financial system under Article 1, Section 8 of the Constitution. It must have considerable control over banks if it is to carry out this responsibility. Congress, almost from its inception, determined that implementing monetary policy was a complex, full-time job and delegated this responsibility. Currently, the basic delegation is to the Federal Reserve System. However, the Comptroller, FDIC, and others are involved. Although the various state banking commissions and specialized credit agencies are deeply concerned about monetary policy implementation, it is Congress that has the ultimate responsibility. It did not destroy the dual banking system when it created the Federal Reserve and FDIC, or when it passed laws pertaining to the Comptroller of the currency. The proposed market would not create a new agency and would not have to weaken the prevailing system. Instead, it is designed to strengthen the banking system and improve financial services generally.

Some member banks will ask why their funds, invested in capital

11. Williford, *Agricultural Credit Corporations and Alternative Fund Sources*, p. 80.

stock in the Federal Reserve System, should be used to finance a competing intermediary market. The market is designed to improve the viability of the banking system generally. An important requirement of monetary policy is that funds flow competitively to all regions of the nation and all sectors of the economy. If they do not, experience indicates that specialized agencies will be created to improve mobility. Since all subscribing banks would be permitted to buy and sell approved instruments in the market, the competitive flow, of funds would be enhanced. This would strengthen the banking system, not weaken it, and both money center and rural banks would benefit.

Some individuals in the Federal Reserve System and FDIC are likely to object to their organizations taking on the additional functions proposed in this paper. One source of concern will be the use of present funds to provide the initial capital for the proposed market. It can be argued that this would dilute capitalization of the two organizations, since much more activity would be backed without adding new capital. The argument is valid, but it should be pointed out that as the new activities expand, fees would provide additional capital. Reserves would also be expanded as activity increases. Hopefully, good management and a realistic fee structure would enable the market to cover costs and build up reserves. As has been pointed out, the experience of comparable agencies created by Congress has been good. With the experience of the Federal Reserve and FDIC, the additional increased risk exposure should be minimal.

A number of individuals, including some rural bankers, contend that a market of the type proposed would cause rural interest rates to be higher than under the present system. The argument is valid only for some individuals, and then only part of the time. Historically, interest rates in many rural areas have been highly inflexible, resulting in relatively low rates at some times and relatively high rates at other times. During the episode of high interest rates early this year, special provision was made to provide for lower rates for farmers.

A number of rural bankers indicated they were able to get farm overline loans with their city correspondents at below prime because they carried good compensating balances. Other rural bankers indicated they were taking overlines to the local PCA, where rates were more favorable than with their city correspondent. Such comments imply that farmers were getting better than competitive rates, but at least four observations must be made: (1) This was the same period

that many farmers were complaining about being unable to obtain credit to plant their crops, (2) There have been more times during the past decade when farm loan rates were substantially above prime rates than when they were below, (3) With the historical inflexibility of rates, PCA's and a number of rural banks held rates below market rates by operating on reserves, on the accurate assumption that the abnormal levels would be short lived, and (4) Low rates based on large compensating balances are a subterfuge. Although one could devote a complete text to this topic, good competitive markets would minimize the abnormal swings in rates, cause better allocation of credit, and, on average, lower rather than raise interest rates. Only those few who actually might have been receiving subsidized rates for some reason would end up paying higher rates.

Summary and Conclusion

Rural banks have difficulties in providing financial services to their communities that are not confronted by their contemporaries. This has had an impact on the flow of financial services geographically and has created problems for both individuals and commercial banks in capital-deficit rural areas. Since basic monetary policy is implemented through the capital markets, it is necessary that these markets be highly competitive and allow funds to flow freely to where they are needed.

Historically, the banking system has not always functioned effectively in achieving a high degree of mobility in the flow of funds. For example, Congress passed legislation creating and developing the Farm Credit System to improve the flow of credit to rural areas. The Farm Credit Service has done an excellent job of improving the competitive flow of funds to agriculture. The same objectives could have been achieved through the banking system had it not been inhibited by institutional rigidity and, in some instances, by bank management. The major weakness currently is that rural banks in capital-deficit areas continue to be inhibited from performing their job by institutional barriers, and existing provisions for bringing capital into these areas for nonagricultural purposes remain woefully deficient. With rural areas now growing more rapidly than metropolitan areas, effort must be devoted to improving mobility in capital flows if many rural banks are to properly service their communities.

The problem has been studied for several decades, but to date most

efforts at solving the difficulty have taken the direction of creating nonbank financial institutions to enhance the flow of funds to certain regions and sectors of the economy. This makes it more difficult for banks to effectively compete, since the nonbank agencies operate with different rules and regulations, under different authorities, and with different organizational and procedural requirements. The result is that commercial banks, the major financial institutions through which monetary policy is implemented, find it increasingly difficult to provide adequate financial services to their constituents.

The problem is urgent. Yet neither the banking system nor the regulatory authorities have been able to resolve the difficulty under the present institutional environment. What is needed is enabling legislation which will permit prevailing bank regulatory agencies to provide services for subscribing banks that will result in improved competitive financial services for all facets of the economy. It is believed that an intermediary market of the type proposed will provide banks with the necessary flexibility for better serving the economy.