# 1980 developments in rural credit markets

*Gary L. Benjamin*

The volatility in interest rates and credit demands in national markets last year was more evident in rural areas than in past cyclical swings of the economy. The increased volatility in rural credit markets partially reflected bleak farm income prospects and uncertainties about the intent and implications of the credit controls imposed in mid-March. But the increased reliance of agricultural banks on interest-sensitive deposits was probably the major factor contributing to the greater volatility in rural credit markets.

The implications of this and other developments of last year are not yet fully comprehendable. But if there is a lesson in the developments of last year, it is probably that many of the barriers that shielded rural credit markets from cyclical swings in national financial markets in the past have been removed. This lesson may be more evident as various provisions of the Depository Institutions Deregulation and Monetary Control Act, signed on March 31, are implemented in the years ahead.

### Farm income in 1980

The 1980 performance of agricultural lenders was greatly affected by the increased volatility in credit markets. It would be an oversimplification, however, to attribute their performance solely to credit market conditions. Developments in the real sector had a significant impact.

Farm income prospects were very bleak in the first half. Farm production expenses registered one of the largest relative increases in the past five decades in 1979 and further large increases were in store for 1980. Record crop production in 1979 portended large increases in carryover stocks and lower grain prices. Grain prices were also held in check by an embargo that lowered grain sales to the USSR from 25 million to 8 million metric tons and halted virtually all other agricultural shipments to the USSR. Livestock prices were suppressed because per capita meat supplies were at record levels following several years of expansion in pork and poultry production. The bleak first-half farm income prospects contributed to a plummeting in capital expenditures by farmers and a temporary decline of unusual proportions in farmland values. Surveys show that Seventh District farmland values declined 4 percent in the first half of 1980. These developments dampened borrowings by farmers, as did the record high interest rates that emerged early last year.

Farm income prospects improved considerably in the second half, but interest rates—after declining in the second quarter—rose to new highs again late in the year. The recovery in farm income was largely captured by livestock producers and those crop farmers whose production was least affected by the summer drought and searing heat. The brighter income prospects in the second half contributed to a strong rebound in farmland values, but did little to boost capital expenditures by farmers.

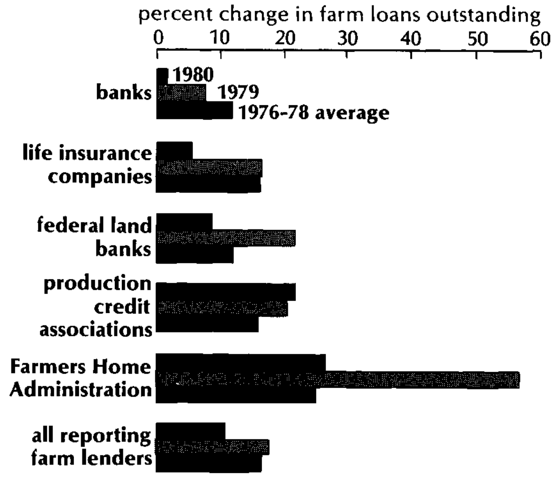
### Commercial lending slowed

Institutions that lend to farmers are a diverse lot with differing organizational structures, investment alternatives, funding arrangements, and management objectives. This diversity accounts for considerable variation among agricultural lenders in their ability to weather periods of extreme volatility in credit markets. Banks and life insurance companies are most likely to curtail farm lending in the face of credit market volatility because of their many investment alternatives, internal profit objectives, and limited access to funding. The performance of the cooperative farm credit system (CFCS) is less susceptible. Because the CFCS consists of cooperatives, its profit objectives are subordinated to the interests of borrowers. Investments by the CFCS are largely limited to the making of loans to farmers and their cooperatives. The system's access to national money markets minimizes funding problems. Government agencies—such as the Farmers Home Administration, the Commodity Credit Corporation, and the Small Business Administration—enjoy even greater insulation from volatility in credit markets. Funding of government agency loans is provided directly or indirectly through the U.S. Treasury. Because government agency lending to farmers is mandated by the Congress or the administration, decisions as to when and how much to lend are dictated by social objectives rather than profits.

The growth in farm debt held by all reporting farm lenders slowed in 1980.[1] Preliminary estimates show farm debt held by reporting institutional lenders rose only 11 percent last year, the smallest annual rise since 1972. But the increase was dominated by government agencies whose farm lending provides various degrees of subsidization.

Farm debt held by commercial (private) lenders—banks, life insurance companies, and the CFCS—rose only 9 percent last year. Except for the 1968-70 period—a time also marked by tight credit markets—that was the smallest annual rise in farm debt held by commercial lenders since the early 1960s. Moreover, farm debt held by commercial lenders increased by a smaller percentage last year than cash production expenses in the farm sector.[2] This had occurred in only two other years—1973 and 1979—since the 1940s. Had it not been for huge increases in government agency lending to farmers, the squeeze on farm financing resulting from the volatility in credit markets would have been far more severe the past two years.

**Last year's slower rise in farm debt was particularly evident at banks and life insurance companies**

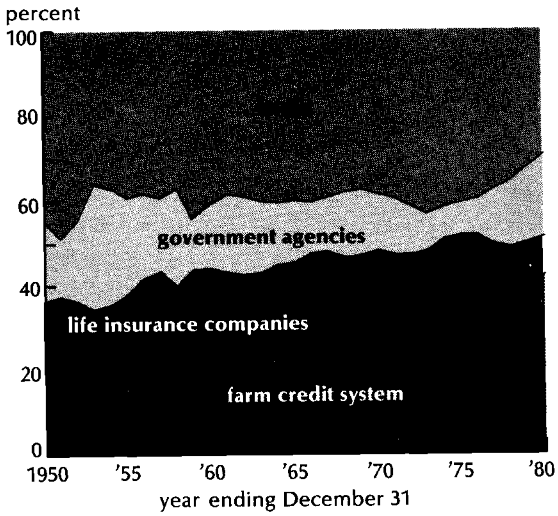



*Commercial banks.* Of the major types of commercial lenders, banks were affected the most by the volatility in credit markets last year. This was of particular significance because banks account for nearly half of the institutionally held nonreal estate farm debt and a fourth of all farm debt. The liquidity of agricultural banks tightened substantially during the latter half of the 1970s as loan growth outstripped deposit growth. Loan/deposit ratios at District agricultural banks peaked in 1979 at levels 10 percentage points higher than in the mid-1970s. Moreover, the cost of funds at agricultural banks escalated rapidly as new types of interest-sensitive deposits proved especially attractive to rural savers. By the end of the first quarter of 1980, money market certificates (MMCs) accounted for 22 percent of resources at District agricultural banks, up from 12 percent six months earlier and up from 6 percent a year earlier. Large time deposits of $100,000 or more—which are also interest-sensitive—accounted for an additional 5 percent of agricultural bank resources.

[1] Reporting institutional lenders account for about 78 percent of the outstanding farm debt. The remainder is held by individuals and nonreporting institutions for which rigorous "benchmark" data are far less readily available.

[2] Despite inflation a cutback in capital purchases held the 1980 rise in cash expenditures for the farm sector to about 10 percent, below the increases of the previous two years.

**Banks' share of all institutionally held farm debt has declined since 1973**




The surge in growth of interest-sensitive deposits largely reflected a restructuring of existing deposits rather than new deposit inflows. Savers converted balances from checking accounts and time and passbook savings accounts into the record-yielding MMC accounts. But total deposit growth at rural banks was abnormally sluggish throughout much of 1979 and the first half of 1980, further aggravating the liquidity positions of rural banks.

The growth in interest-sensitive deposits sharply escalated the cost of funds to rural banks. Because of the higher cost and a rise in the potential returns on alternative investments, rates on bank loans kept pace with the sharp upturn in market rates of interest to a much greater degree than in previous periods of tight credit.

Because of tight liquidity and high loan rates at rural banks, there was widespread concern about the availability of credit to farmers. Some observers, linking the credit availability and low farm income issues together, argued that the plight of farmers was the worst since the Depression. To help ease the situation, the Federal Reserve System in mid-April temporarily streamlined the eligibility requirements for the "seasonal borrowing" privilege, and—for the first time—extended that privilege to nonmember banks. Many banks were eligible and initial interest in the program was very high. But only two loans were actually made under the program because agricultural banks found that the volume of farm loans demanded was unexpectedly low as a consequence of high interest rates and the pessimistic farm income situation.

The effects of these factors on farm borrowings at banks was evident throughout last year. Preliminary estimates show outstanding farm debt held by banks at the end of 1980 was only 1 percent higher than the year before. That represented the smallest rise since the mid-1950s and contrasted sharply with the average annual rise of nearly 11 percent the previous four years. It also marked the seventh consecutive year that the relative increase in farm debt held by banks has lagged that for all reporting institutional farm lenders. As a result, banks' share of all institutionally held farm debt has dropped from 43 percent to a post-World War II low of 30 percent.

The sluggishness that characterized farm lending in 1980 was also evident in all other credit extensions at rural banks. But while total loan portfolios showed little or no growth in 1980, deposit growth at agricultural banks rebounded to an uncommonly high level in the second half. The contrasting trends resulted in a remarkable improvement in liquidity, particularly at rural banks in the Midwest. At agricultural banks in the Seventh District, for example, loan/deposit ratios at the end of 1980 averaged about .605, down sharply from the peak of .676 the year before and the lowest in nearly four years.

*Life insurance companies.* The 1980 performance of life insurance companies—which account for 20 percent of farm real estate debt held by institutional lenders and 7 percent of all farm debt—was also affected adversely by the volatility in credit markets last year. As in the case of banks, last year's retrenchment in farm lending by life insurance companies was more pronounced than in past cyclical swings of interest rates. The retrenchment, which started in late 1979 and lasted throughout 1980, was particularly evident in farm mortgage commitments and acquisitions. New farm mortgage commitments made by life insurance companies in 1980 were down about 55 percent from the year before, while farm mortgage acquisitions were down more than 40 percent. These declines substantially exceeded the retrenchment undertaken by life insurance companies during the 1974-75 cyclical swings in financial markets. Because of last year's cutback, farm mortgages held by life insurance companies at the end of 1980 were only 5 percent higher than the year before. This increase was down sharply from the average annual increase of 18 percent the three previous years and was the smallest annual rise for life insurance companies since 1972.

Last year's retrenchment in farm mortgage lending by life insurance companies primarily reflected liquidity problems, although borrowings were also suppressed by low farm earnings and high mortgage rates. The liquidity pressures arose from the strong policy loan demands that life insurance companies were facing. During the first half, gross policy loans made by major life insurance companies were 71 percent above the rapidly rising level of the year before. Funding those loans proved a substantial burden on life insurance companies' cash flows.

The developments in credit markets last year may have lasting implications for farm mortgage lending by life insurance companies. Life insurance companies have long prided themselves as the last "fixed-rate" commercial farm mortgage lender. But fixed-rate financial contracts of all types have been called into question by the volatility in interest rates over the past year or so. It now appears that, just as in the case of residential mortgage lending, renegotiable rate mortgages became widespread in farm mortgage lending by life insurance companies in 1980. A return to fixed-rate lending is doubtful, at least until interest rates are more stable.

### The cooperative farm credit system

The volatility in financial markets last year affected the performance of the CFCS far less than that of other commercial lenders. The CFCS is the leading farm lender, accounting for 42 percent of all institutionally held farm debt and 32 percent of all farm debt. The system is comprised of three borrower-owned cooperatives that raise funds in national credit markets through the sale of consolidated debentures and lend those funds almost exclusively to farmers and farm cooperatives. Two parts of the system serve farmers directly. Production credit associations—working through Federal Intermediate Credit Banks—provide farmers with short- and intermediate-term loans. Federal Land Banks (FLBs) provide mortgage financing to farmers.

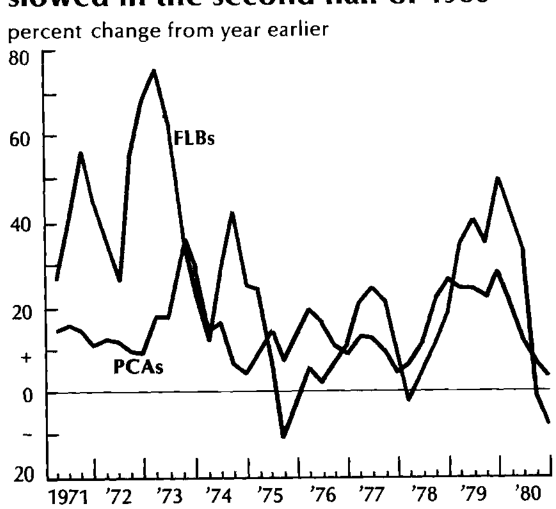
The ability of the CFCS to weather volatility in financial markets better than other commercial farm lenders reflects some unique characteristics of the CFCS that affect liquidity and borrower demand. Because of the ability of the CFCS to raise funds in national money markets through regularly scheduled debenture sales, the system avoids the liquidity problems that typically confront banks and life insurance companies during periods of tight credit markets. The funds cost more, but liquidity is less of a constraint to the CFCS than to private lenders.

Another characteristic that provides the CFCS an advantage during periods of tight credit is the system's practice of pricing loans on the basis of its average cost of funds plus a markup for administrative overhead. This feature, plus the basic cooperative business structure of the CFCS and the restrictions limiting its investments exclusively to loans to member borrowers, provides the CFCS with competitively low interest rates on loans during periods of rising market rates of interest. Loan pricing practices of banks and life insurance companies, in contrast to the CFCS, tend to be tied more to the marginal cost of funds—the cost of funding a new loan—and/or the opportunity rate of return—the return that could be earned by investing the funds in some asset other than a loan. When market rates of interest are rising, the average cost of funds approach to loan pricing results in lower loan rates than the marginal cost or the opportunity rate of return approach.

During most of 1980, CFCS loan rates were substantially below rates quoted by other commercial farm lenders, allowing the CFCS to attract a disproportionately large share of the farm sector's credit demands. While the loan rate advantage typically shifts to other lenders during periods of declining interest rates, the lower rates offered by the CFCS during 1979 and 1980 probably accounted for much of its relatively strong performance.

*Production credit associations.* Loans made by production credit associations (PCAs) were growing rapidly in 1979 and early 1980, exceeding year-earlier levels by 25 percent. But the year-to-year gains narrowed abruptly in the spring and exceeded year-earlier levels by only 5 percent in the second half. For the year as a whole, the rise in outstanding non-real estate farm debt held by PCAs was less than 9 percent, the smallest since 1972 and well below the annual average of 15 percent during the 1970s.

**New lending by FLBs and PCAs slowed in the second half of 1980**




*Federal Land Banks.* Lending activity at FLBs followed a pattern similar to that at PCAs. However, the cutback came late in the second quarter and—because new lending represents a far smaller share of the loan portfolio at FLBs than at PCAs—the dampening effect of no growth in the second half had a much less pronounced impact on outstandings. For the year outstanding loans at FLBs rose more than a fifth, substantially above the average annual rise of 16 percent in the 1970s.

The CFCS for years has used variable-rate lending practices exclusively. Ironically, in 1980 some FLBs modified the variable-rate practice at the very time that other lenders were beginning to realize that variable-rate loans could protect earnings in periods of rising interest rates. Funding the sharply higher new loan demands greatly escalated the average cost of funds at FLBs. At the same time, however, their practice of pricing mortgages on the average cost of funds basis held FLB mortgage rates well below rates available from other lenders, encouraging still higher demand for new borrowing.

To ease the burden of the rising cost of funds on existing variable-rate borrowers and to discourage inordinately high demands from new borrowers, some FLBs in early 1980 temporarily fixed rates on existing loans and adopted fees on new loans. The loan fees reached as high as 6 percent in the spring. Combined with a basic billing rate of 10½ percent and the normal stock purchase requirements, the rise in fees increased borrowing costs at FLBs to market levels and contributed to the flat performance in new FLB lending during the second half.

### Government lending strong

Government agencies that lend to farmers filled some of the slack left by commercial lenders in 1980. In April concerns over low farm income and a perceived shortage of credit from commercial lenders prompted the Congress to extend and expand the Economic Emergency Loan Program of the Farmers Home Administration (FmHA). The original terminating date for that program was extended from May 1980 to September 1981 and authorized outstandings for the program were expanded from $4 billion to $6 billion. Later in the year, widespread drought losses triggered a surge in applications for the FmHA's Disaster Loan Program. Such loans are available at interest rates as low as 5 percent to farmers who suffer a production loss of 20 percent or more due to a natural disaster.

Overall, farm debt held by the FmHA rose 26 percent last year. The increase, although less than the year before, extended the FmHA's record of disproportionately rapid growth since the mid-1970s. The FmHA now accounts for 15 percent of all institutionally held farm debt, up from 7 percent in the mid-1970s. Together, all government farm lending agencies—the FmHA, the SBA, and the Commodity Credit Corporation (CCC)—now account for 20 percent of all institutionally held farm debt, up from 8 percent in the mid-1970s and the highest proportion since the late 1950s when huge surplus stocks of grain rendered the CCC a major holder of farm debt.

The rapid rise in the share of farm debt held by government agencies reflects genuine congressional concerns about saving the so-called family farm, supporting beginning farmers, and protecting farmers from abnormal economic and natural disasters. Despite these concerns, the greatly expanded market share of government agencies has triggered a growing debate over the agencies' proper role in farm lending. The debate is largely focused on the FmHA and involves questions of degree of subsidization, the impact of FmHA lending on commercial lenders, misallocation of resources, and whether the FmHA is serving borrowers that would otherwise be adequately served, given the risk standards of commercial lenders. The outcome of the debate will be partially reflected in legislation that will replace the expiring farm program statutes in 1981. Whatever the outcome, those desiring a responsive government agency role in farm lending have received an additional bargaining point from the impact of volatile credit markets on farmers. It is clear that government agencies have mitigated much of the impact of credit market volatility on the farm sector.