Commentary

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The papers presented by Jim Timberlake and John Ballentine are both excellent and thought-provoking. Timberlake is probably correct in arguing that banks serving agricultural areas are likely to experience increased competition, not only in raising loanable funds but also in lending them. In the future the growth in the supply of loanable funds at agricultural banks is likely to be limited. Nonbank competitors, such as thrift institutions and money market mutual funds, are likely to compete more aggressively for consumers' savings and are likely to make relatively few agricultural loans. The competition in making agricultural loans, though, may be increased as government programs, mainly those administered by the Farm Credit System, expand, tapping the national money markets for funds to make agricultural loans.

Ballentine, on the other hand, is right in stressing that loan participations should be profitable from the standpoint of a correspondent. Agriculture will have to pay a competitive rate for funds or the funding of agriculture will largely fall by default to the Federal government. However, I would caution correspondent banks that what really matters is the long-run profitability of customer relationships, not the profitability and rates charged in any particular quarter or year. Rates on agricultural loans typically rise less rapidly than the prime loan rate, and also decline less rapidly. Over the long run, agricultural loans are likely to be quite profitable, and from the standpoint of a correspondent purchasing participations, are likely to require little direct servicing and to be highly collateralized.

On balance, I am optimistic that the majority of agriculture's credit needs can be met by rural banks with loan participation assistance from the regional correspondents. Money center banks will play a role, but it will be limited as it has been in the past.

While I largely agree with the major points in each of the papers, I also feel that meeting the loan participation needs of rural and agricultural banks will require a renewed commitment by correspondents in future years. Over the years, the growth in the proportion of agricultural banks requiring loan participation assistance and in the dollar magnitude of participation loans has been dramatic. For example, surveys indicate that in 1945 only about 26 per cent of the rural banks required loan participations, but by 1959 the figure had risen to 67 per cent, and by 1979 to 72 per cent.[1] Similarly, in 1978 it was estimated that correspondents were holding about $11.2 billion in loans which had been originated by community banks. Of this total, commercial and industrial loans comprised 63 per cent; real estate loans, 15 per cent; agricultural loans, 14 per cent; and other loans, such as pools of instalment loans, 8 per cent.[2] These figures, however, probably understate the magnitude of agricultural loan participations. Many banks tend to classify credit to corporate farming ventures and feedlots as commercial loans, rather than as agricultural loans.

The most recent survey dealing with loan participations was conducted by the American Bankers Association in 1979.[3] In that study, questionnaries were sent both to correspondent banks and to their respondents.[4] Correspondent banks overwhelmingly ranked assistance with check collection and loan participations as the two most important correspondent services. Country banks assigned a slightly lower ranking to loan participation services, but the difference is probably not significant. However, country banks also indicated that loan participation assistance was the correspondent service most in need of improvement. Interestingly, correspondent banks felt that loan participations were among the most profitable of correspondent

1. Robert E. Knight, "Correspondent Banking, Part II: Loan Participations and Fund Flows," *Monthly Review,* Federal Reserve Bank of Kansas City, December 1970, p. 13, and unpublished results from the ABA survey cited in footnote 3.

2. "New Survey Finding: Correspondent Banks Report Fast Growth in Loan Participations," *ABA Banking Journal*, September 1978. p. 52.

3. Robert E. Knight, "New Profile Study of Correspondent and Respondent Banks." *ABA Bonking Journal*. November 1979, pp. 50-61.

4 Throughout these comments, the terms "correspondent bank" or "correspondent" refer to a bank accepting deposits from other banks and, in return, offering services, such as loan participation assistance, to these banks. "Respondents," or banks in general. are considered to be the recipients of these services.

services, but that they were also one of the most difficult to provide.

The reasons for the seeming dissatisfaction on the part of country banks and of the difficulty on the part of correspondents in meeting loan participation requests is not immediately clear. Undoubtedly several factors contribute to this feeling. Country banks, for example, frequently complain that their ability to place participations depends on monetary policy. During periods of tight money, correspondents appear to be less willing to accept participations in loans. Correspondents, on the other hand, often argue that agricultural banks tend to make loans at lower interest rates than the correspondent would charge if it were making the loan directly. Many correspondents also cite loan documentation as a problem with loans originated by country banks. There is little doubt that correspondent banks have experienced increased concern about their positions with participation loans should the borrower or the originating bank experience financial difficulties. Courts have held that if a participation loan turns sour, the correspondent's recourse is to the originator of the loan (the country bank), and not to the original borrower.[5] Moreover, if the originating bank were to experience financial difficulty, the correspondent might find itself an unsecured creditor.

Although they are less frequently cited, two other factors have undoubtedly also contributed to the difficulty some banks have experienced in obtaining agricultural loan participations. First, some large correspondents make relatively few agricultural loans and are not readily prepared to evaluate the quality of requests for participation assistance in such loans. Second, a tendency may exist for correspondents to doubt the ability of smaller banks to manage and administer large complex credits properly. In either case, a correspondent might be inclined to delay unnecessarily in making a decision on the credit or may decline the credit without a thorough exploration of the particulars.

To the extent these problems exist, none would appear to be insolvable. Low interest rates are likely to be less of a problem for correspondents in the future because the growth in money market CD's and other purchased money, coupled with the volatility of interest rates, has forced most country banks to evaluate their cost of loanable funds on a more frequent basis. Fluctuating-rate loans tied to

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5. F William Vandiver, Jr., "Loan Participations—Upstream/Downstream," *Journal of Commercial Bank* Lending, December 1977, p. 52.

a money market rate of interest are becoming much more common at agricultural banks. The acceptability of such loans to borrowers, moreover, is demonstrated by the growth the Farm Credit System has experienced over the years. However, a bank's ability to write variable rate loans also depends on the capacity of the borrower to absorb sizable rate increases. This capacity is often limited for small businesses and agricultural units which operate in markets in which individual firms have little influence on the prices received for goods sold or produced. In any event, during periods of monetary ease, loan rates frequently decline less at agricultural banks than they do at correspondents, with the result that at such times the yield on participation loans should be relatively attractive to correspondents.

Loan documentation and the confidence of correspondents in the ability of respondents will undoubtedly continue to be problems with participation loans, but could largely be overcome if both the correspondent and the originating bank were willing to work together. Legal problems regarding the security position of a correspondent can also be resolved as each bank is named in the loan and security agreements, and each holds a copy of the master note for its pro rata share of the loans.

Looking to the future, the demand for participation loan assistance is likely to grow dramatically, particularly if interest rates trend downward. This growth is likely to occur for a variety of reasons. First, the high inflation rate of recent years has resulted in the credit needs of many bank customers growing much more rapidly than the lending limits of their banks. At the same time, the growth in bank capital, and bank lending limits, has been slowed by the depressed prices which have existed for several years for bank stock. As a result, banks have generally been unable to raise new equity capital externally without severely diluting the holdings of present stockholders.

A second factor that will contribute to the growth in the demand for participation loans is the Monetary Control Act of 1980. This legislation granted thrift institutions significantly expanded powers, such as the ability to offer NOW accounts and to serve as full-service family financial centers. With thrift institutions becoming more competitive, deposits are likely to be siphoned from commercial banks, and the profitability of commercial banks is likely to be lowered. This diversion of funds is likely to cause rural and agricultural banks, at least in the short run, to grow less rapidly than would otherwise be the case. Without expanded participation assistance, these banks may have to restrict credit availability to agricultural and business customers. In addition, the reduced profitability of banks is likely to slow the growth of bank capital and bank lending limits.

Correspondents, on the other hand, are likely to find that meeting the loan participation needs of respondents is more difficult than it has been in the past. Historically, the volume of participation loans held by correspondents has averaged significantly less than the volume of deposits which correspondents have received from respondents. As a result, correspondent banking departments have tended to generate loanable funds for other areas of their banks. However, during the next few years the ability of correspondent departments to generate a surplus of loanable funds is likely to be diminished. Under the Monetary Control Act, Federal Reserve member banks will gradually have their reserve requirements lowered, while nonmember banks will have to begin posting reserves with the central bank. Correspondents can reasonably expect that member banks will increase their balances at correspondents somewhat during this transition period. As their reserve requirements are lowered, member banks are likely to hold additional balances with correspondents. These funds will serve both as a claim on future correspondent services and to meet their anticipated liquidity needs, which can be satisfied less readily with the reduced reserve balances at the Federal Reserve.

However, a sizable proportion of the reserves nonmembers will be required to hold is likely to come from the balances these banks presently maintain at correspondents. Moreover, some nonmembers which do not have readily available funds to post as reserves are likely to want to pay for correspondent services by paying fees, rather than by holding compensating balances. The net result is likely to be that correspondent banks will have fewer funds to use for loan participations at the same time that the demand for participation assistance is likely to be growing strongly.

In the past, correspondent banks have done a reasonably good job in meeting the loan participation needs of agricultural banks. There may, however, have been a tendency to turn the flow of participation loans on or off too frequently, depending upon the posture of monetary policy. Moreover, there is no question that the share of the loan market held by commercial banks has been declining, particularly for agricultural credit. Most agricultural banks would prefer to work with correspondents in funding overline and liquidity loan participations, but there are alternatives. For example, banks can obtain marketable loans and also make loans above their lending limits by securing a loan guarantee from the Small Business Administration or the Farmers Home Administration. They can secure additional liquidity by marketing mortgage loans to the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, etc. They can attempt to place longer-term agricultural loans with insurance companies, some of which are in the market for such loans most of the time. In some cases, they can rediscount paper with the Farm Credit System or they can rely on the seasonal borrowing privilege at the Federal Reserve. Many of these options do not channel funds directly to agriculture. They would, however, permit country banks to take care of their business or mortgage loan customers and simultaneously acquire loanable funds which could be used for agricultural loans.

On the other hand, most of the credit needs of agriculture could probably be met within the present correspondent framework. The funds for overline and liquidity loans could be provided directly by correspondents, which are in a relatively good position to purchase loanable funds .whenever required. Alternatively, many country banks have relatively low loan-to-deposit ratios. Increased swapping of participations among these banks, arranged either directly or through correspondents, would provide a means of ensuring that the loan participation needs of these banks will continue to be met. Similarly, to the extent the interest rate on an agricultural loan is too low to satisfy a correspondent, a correspondent could consider swapping loans with a respondent wishing participation assistance. The swap could be for the same dollar amount and at the same interest rate as the respondent's participation loan.

Larger correspondent banks could also develop pools of farm loans in which they sell participations. Or perhaps the pools could be funded with sales'of commercial paper, which might be guaranteed by an insurance company to improve its marketability. Maybe a means could even be found to market agricultural loans directly. Exploratory efforts are presently underway by community banks to devise a means to tap the national or regional money markets to raise capital for banks. If these efforts are successful, the direct marketing of agricultural loans would appear to be a simple step forward. Perhaps a secondary market for agricultural loans could be developed. This secondary market could be similar to those which presently exist for mortgage loans and for government guaranteed business loans.

Other possibilities exist, but if the correspondent banking system is to continue to be the primary means for meeting the loan participation needs of smaller banks, it must be alert to change and be ready to adapt. The system has been shown to be capable of functioning effectively. What is needed today is a determination by both agricultural banks and their correspondents that the credit needs of rural areas will be met in the future.