Commentary

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Mr. Doll has titled his presentation "A New Market to Provide Loanable Funds to ***Rural*** Banks." I believe this is the constituency that would have the greatest interest in the subject, although it will probably be both urban and rural small banks, and possibly even banks of regional size, that will be interested in alternative sources of loanable funds.

The nature of the economic activities, or at least the way in which these activities are organized in the non-urban areas, is changing. Banking, and indeed all financial aspects, must of necessity change also. Rural banks have been trying to do business in a 20th and soon 21st century environment with late 19th century tools and products. Hence, it is particularly apropos that we consider Mr. Doll's presentation as a possible method to help rural banking fit into the new financial environment.

There is another aspect of the rural environment that will cause rural banks almost as much concern as has the problem of an adequate money supply. The title of Mr. Doll's paper gives a clue to this other aspect.

In years past, most rural banks have been involved in the principal business of their customers, production agriculture. Seasonal credit requirements were reflected in the swings in loan outstandings and in the loan-deposit ratios throughout the farm year. Farmer balance sheets did not (and do not now) exhibit very high leverage. Things in the rural areas are beginning to change, and the rate of change is accelerating: (1) There is a move from the city back to the country. (2) The non-urban inhabitants are viewed as untapped or only modestly exploited sources of deposit funds. (3) Rural areas are viewed as desirable locations for industry. (4) There is a growing tendency by

farmers to integrate forward into the processing and marketing aspects of the food system. (5) Increasing amounts of purchased inputs required in the food system, particularly in the production phase, are resulting in farmers integrating horizontally into the input supply sectors of production agriculture. (6) In some areas, multinationals and large corporate interests are entering the supply, processing, marketing, and service aspects of the food system. (7) The growing urbanization of the countryside adds yet another dimension.

The rural banker's world is no longer simple and uncomplicated, no longer peopled by lifetime friends and acquaintances. The rural banker is now beset by all kinds of people and organizations that seem to be greedy, avaricious, aggressive, too profit-oriented. All seem to be less constrained by custom or legalities in pursuing their various objectives, all of which all seem to focus on taking away a share of the rural banker's business.

While an over-simplified observation, it is nonetheless true that the simple 90-day farm note is no longer adequate to meet the needs of the people coming in the front door of the rural banks. In some markets, things are so competitive the bankers are obliged to bring their products and services out to the customers' homes or businesses. And in a few test areas, banking business is conducted by wire, with no face-to-face contact at all between banker and customer. People want home loans, farm real estate loans, consumer credit to purchase $10,000-15,000 cars and $1,000 refrigerators, large advances to send the youngsters to college, short- and long-term business loans, inventory financing, investment loans, loans to acquire another entity or to buy out a partner, production credit to farm and seasonal credit to run a business. Companies want unsecured loans predicted on balance sheet ratios and corporate performance, plus all the services such as loan accounting, payroll, money market investments, trusts, etc.

No one is truly isolated any more. The readership of the Wall Street Journal and the various investment letters issued by fund managers and brokerage houses is probably higher on a per capita basis in the rural areas than in the cities. People have a much better awareness of what their money is worth. And there are more people around who are going after the rural inhabitants' money. The need for capital is growing at a pace that some predict will result in the supply of money falling short of need at some point in the future. These increasing capital needs are worldwide in scope. Users of funds in one industry

in one geographic region are competing with users of funds in another industry and another area. The pool of money is being tapped by many. Each one of us has a straw in the soda. The pool, as the soda, is finite in quantity. The question I must answer then is, "Does Mr. Doll's recommendation meet the needs of the rural banker for loanable funds?"

A defect in his proposal is that the notes or other evidences of loans underlying and collateralizing the securities sold to the investing public lack commonality. To the best of my knowledge, all securities offered in the market today are supported by assets which have, depending on the instrument, great similarity.

The proposal anticipates a need by a rural bank for funds that will be utilized by lending short, intermediate, and long to borrowers who are consumers, farmers, business people, corporations, partnerships, public bodies, etc. Each of these borrowers will have varying degrees of financial strength and will report their financial conditions in various ways and with varying levels of exactness. The underlying security will be equipment, land, real estate, contract rights, unsecured notes, livestock, warehouse receipts, etc. The banks themselves will be diverse in character, performance, financial strength, operations, and in the formats and documentation used in loan administration.

It is difficult to see how the paper of banks would be readily accepted absent the clean, uniform qualities built into other collateral presently supporting some of the investor-accepted instruments.

To overcome the shortcomings arising from having many originators of loan paper (the securities that will support the issue of the debt instruments to be sold to investors), Mr. Doll suggests that the agency become the instrumentality for promoting uniformity of procedures and documents in the banks having ownership in the agency. This may be successfully accomplished, but I believe the small banks will need to be under much more stress over lack of loanable funds than they are now to willingly forgo their independence. Yet the investor will shun an investment that incorporates any problems. He's not concerned with our problems. We need to be concerned about his needs. That's why I don't believe one type of investment security can be collateralized by paper evidencing loans made for varying terms — short, intermediate, and long — and by various types of assets, and still be a merchantable security.

Organizations similar to the one Mr. Doll suggests may already be

in existence or in the process of being formed. Two organizations were founded prior to legislation. The six in-process became possible as the result of a little noticed amendment in Section 711 of the Depository Institutions Deregulation and Monetary Control Act passed in 1980. Only national banks can presently take advantage of this provision. State chartered banks and interstate bank holding companies would appear to have greater difficulty in organizing a like-type fund-gathering entity because of permissive legislation required in each state. In utilizing the funding capabilities of one of these "bankers' banks," rural national bank stockholders may gain some advantage over their state bank competitor, but only to the extent that loanable funds are provided.

Cost of funds is not the advantage built into this concept. A means to acquire loanable funds is the major reason for interest by smaller banks.

As permitted by the Act, the CD's that are sold are essentially backed only by the faith and credit of the underlying stockholder bank. There is no other collateral or security. It seems to me that one of the requirements any marketer of money market instruments must meet is to be in the marketplace regularly with an adequate offering of securities. To date, the volume sold by so-called "bankers' banks" would not seem to meet this criteria, which I believe should be at least $100 million per month. Regular availability, which implies an adequate number of sales, enough volume, and the maintenance of secondary market, are keys to the success of a new funding and discounting mechanism. Mr. Doll has not spoken to the need of a secondary market, which is a necessary ingredient for a market instrument designed for high liquidity.

If the chartered national banks can successfully organize, implement, and operate a financial instruments marketing mechanism of the type the recent legislation would allow, or as Mr. Doll proposes, the owners and users would gain some benefits. The resulting entities may well be highly competitive, but a dramatic increase in the number of marketing agencies bringing the same or similar products to market could tend to confuse the investors and limit market acceptance of the concept. An aggressive marketing campaign to attract investor interest to the new market's securities might well divert funds presently invested in agency paper. In this manner, the present level of investment in agricultural financing may not be enhanced, but merely redistributed among a larger number of securities.

The question of alternative investments for bank funds may be germane to the discussion. Mr. Doll suggests that capital now tied up in Federal Reserve Bank stock be used to capitalize a marketing organization under the aegis of the Fed. By allowing this means of providing paid-in capital, the Fed would permit its stock to do double duty.

If this is not acceptable, then a venture privately organized among the rural banks might be more feasible. I would suspect that given the opportunity to create a collateral base having several important characteristics — (1) geographical dispersion of risk, (2) dispersion of risk over a broad spectrum of different types of loans, (3) risk dispersion over varying period of time, (4) some risk distributed over different borrowers (individuals, partnerships, corporations, Sub-Chapter S corporations, public entities, and political subdivisions) — might permit greater use of financial leverage than has traditionally been permitted by bank examiners. If a bank's equity contribution to the new corporation could be leveraged 25 or 28:1, as is the case with large banks, or 100:1 as Mr. Doll proposes, there could be several benefits to the stockholder banks.

Funds invested in the new venture may have a better return on investment than any other investment a bank can make. With high leverage there is less demand on the cash flow of the marketing venture for dividends on invested capital. Of course, with high leverage goes the parallel needs for skillful management of assets and liabilities, building and maintaining adequate loan'loss reserves, providing default insurance, and the like, so that the most significant aspect of the cost of doing business, the interest expense on securities purchased by investors, can be easily covered by interest earned on loans.

It seems to be that rural banks will continue to be more heavily involved in agricultural credit than any other type of loan. It is absolutely imperative that any financial marketing organization set up by banks have sufficient leverage so that the major drain on cash generated from operations goes to pay interest to investors while a minimal amount goes to dividends.

I hope Mr. Doll's recommendations will serve as a catalyst for further discussion and research. What is proposed is quite complex. It encompasses an organization that will (1) Offer securities to the investor market of a quality that may result in interest rates possibly only a few basis points above those enjoyed by government securi-

ties, (2) Maintain a pool of assets comprising the debt instruments of the various kinds of customers the investing banks have loaned money to, (3) Serve as the distribution point to allocate funds from the pool of investor-provided money as the shareholder banks apply, (4) Supervise the credit criteria, standards, documentation, extent, and quality of financial exhibits that shareholder bank staff must utilize if the funding sources are to be made available to the shareholder banks, (5) Control the creation and growth of sizeable reserve accounts and bill and collect the fees assessed to shareholder banks, provide a means to distribute participations in over-limit credits made by shareholder banks, and referee the settlement of defaulted loans, and (6) Roll over the securities issues as they mature, pay principal and interest to investors, and maintain a secondary market for the investor securities.

I suggest that the proposal is too complex to have bankers, the Federal Reserve System, Congress, investors, the Comptroller, the FDIC, and other friendly and unfriendly competitors either endorse or not actively oppose the creation of an institution — a sizeable new money market force — that does very much more than provide for discounting privileges or loan funds. Yet getting into bank supervision and over-limit loan participations, and permitting funding activities in which the equity or capital supporting the lending function is much more highly leveraged than is traditional, as well as imposing uniform operating standards and procedures, are probably necessary if the new market is to float an acceptable investment instrument.

Mr. Doll has proposed anew an idea that has attractive features and would serve the funding requirements of a great many rural bankers. The good aspects outweigh the defects. But the shortcomings are not the real inhibitor in getting things such as this proposal underway. Both the Federal Reserve System and the Congress of the United States have proven to be more adversaries than supporters of commercial banking and of the efforts the industry has made to resolve serious problems in the farm credit field.