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COMPETITION BETWEEN COMMERCIAL BANKS AND A PRODUCTION CREDIT ASSOCIATION: A CASE STUDY

by

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TITLE

COMPETITION BETWEEN COMMERCIAL BANKS AND A PRODUCTION CREDIT ASSOCIATION: A CASE STUDY

BY

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CHAPTER I

INTRODUCTION

Since the early years of the 20th century, agricultural financing has undergone sweeping changes. Innovations in farming and ranching brought about by new technology and improved methods forced a close examination of contemporary farm credit institutions and practices. The provision of farm credits often was found to be inappropriate and inadequate for the new agriculture. Dissatisfaction with existing credit activities became widespread and vocal. This resulted in organized studies of agricultural lending practice in other lands and criticism of American farm credit markets.[1]

Farm interests expressed dissatisfaction with both mortgage and production lending. Because farmers resented and distrusted the banking and business community they doubted that the Federal

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[1]United States Commission, Agricultural Cooperation and Rural Credit in Europe, Senate Document 261, 63rd Congress, 2nd Session, 1914.

Interest in agricultural credits on a national level was observed in President Roosevelt's Country Life Commission, appointed in 1908. The U. S. Commission referred to above was appointed by President Wilson to accompany a group sponsored by the American Bankers Association and the Southern Commercial Congress to study European credit cooperatives. The majority report of the Commission recommended the chartering of land banks, on both a joint-stock and cooperative basis, but without government subscription. The minority report, supported by the Grange and other farm groups, opposed the cooperative feature. Bills and amendments based on this report led to the Federal Land Bank Act of 1916.

Reserve System could provide improved credit facilities. Farmers urged the federal government to provide adequate credit facilities through creation of new institutions basically concerned with agricultural lending and featuring considerable control by farmers themselves.[2]

With establishment of Federal Land Banks, the federal government began an involved and extensive program of farm credit activity. At first the new credit organizations were divided between cooperative and private ownership. Privately-owned credit agencies soon declined due to mismanagement and the farm depression of the 1920's.[3] Granger and Populist distrust of commercial banking and private mortgage lenders caused reform to be abandoned in deference to new cooperative organizations.[4] The Farm Credit Act of 1933 (the basis for the present Farm Credit Administration) indicated that federal activity in the farm credit area would be directed toward establishing and extending cooperative lending agencies.

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[2] Murray R. Benedict, Farm Policies of the United States, 1790-1950 (New York, Twentieth Century Fund 1953), pp. 114, 139, 145.

[3] C. H. Schwartz, Jr., Financial Study of the Joint-Stock Land Banks. A Chapter in Farm Mortgage Lending (Takoma Park, Maryland, 1938)

[4] Clara Elliot, The Farmers Campaign for Credit (New York), 1927, Chapter 1.

The Agricultural Credits Act of 1923 departed from the Federal Land Bank's emphasis of cooperative organization. The Act emphasized linking private money supplies to various retail lenders. Ten years later the 1933 legislation re-emphasized the cooperative principle. It established the production credit associations (PCA) as cooperative credit outlets for funds created by the 1923 legislation.

Production Credit Associations. As of January 1, 1958 there were 497 production credit associations throughout the United States. All but 42 were completely member-owned. That is, all capital stock subscribed to by the federal government in establishing the associations had been purchased by borrower-members.

Membership, type of agriculture served, and volume and size of loans varies considerably among the associations. For example, the largest 1957 membership was 4,234 reported by a Mississippi association. The smallest membership was 81 for an Oklahoma association. The latter association made only 15 loans in 1957, but the typical loan was over $109,000. Typical loan in the Mississippi association was $2,200.

Midwest associations have served persons able to obtain bank credit. In many Midwest areas served by PCAs the type of borrower and loan characteristics are similar to those of commercial banks. In these areas the problem of direct competition

between banks and PCAs has become noticeable.[5]

Purpose of this Study. It is clear that the PCAs perform essentially the same type of credit service as do commercial banks in rural areas. Providing funds to prepare, harvest and market a crop, and to sustain the farm family during this time, had been the main lending activity by rural banks. As the PCAs became active lending agencies, and as rural banks recovered from discomfort of depression years, clashes were to be expected. Philosophical differences between the cooperative plan and private ownership, and the less philosophical but more obvious day-to-day struggle for borrowers, provided a proper setting for struggle and disharmony.

The purpose of this paper is to examine the nature of competition in a particular farm credit market served by commercial banks and a PCA.

It should be emphasized early in this presentation that this study is primarily one of market competition, rather than of agricultural credit. A study primarily concerned with agricultural credit activity in a particular market area would result in a different analysis than is attempted here.

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[5]W. G. Murray, Agricultural Finance (Ames, Iowa State College Press, 1953), pp. 337-339.

This study will consider market competition as composed of two elements: market organization and market behavior. Economic theory has long considered the organizational nature of competition in treatments of various market structures; but the behavior of competitive units has usually been considered a dependent function of market arrangement. This study will attempt to separate total market competition into organizational and behavioral elements.

Organizational elements include such features as internal financial and operating structure, operating practices, and credit characteristics. Such elements may constitute a market advantage to a firm when compared with organizational limitations of competing firms.

Market behavior involves selection of various activities made possible by organizational elements. Aggressive market behavior implies that a firm possessing organizational market advantages utilizes them in seeking the firm's goals. Passive behavior suggests that actual advantages are not recognized nor utilized. Inter-relationship of market organization and market behavior results in market competition.

A secondary purpose of this study is an evaluation of the organization and behavior demonstrated by a production credit association. This evaluation will be concerned with suitability of the production credit system's cooperative nature as a device for implementing public policy. Any such evaluation will center

on the cooperative production credit system as a mechanism for enacting agricultural credit policy, rather than on the merits of cooperation *per se*.

Method of Analysis. As each PCA area can be said to constitute a production credit market, the proper market for a study of competition may be a single PCA territory. Although each PCA may seem similar to others, the reaction to market forces may be unique. At the same time some features of PCA operations and capabilities are rather firmly controlled by higher levels of the federal farm credit system. For the purposes of this study it did not seem feasible to analyse competition in a specific market situation by analyzing data gathered from often dissimilar markets. Therefore one PCA and the commercial banks within the association's territory have been selected as the basis for this study. Using a single PCA territory it becomes feasible with the resources available to approach in more detail various facets of the topic.

The case selected was the Lincoln, Nebraska, PCA territory, a district involving six counties and 41 commercial banks. Officials of the Eighth Farm Credit District indicate this Association to be average in respect to membership, loan volume, management, and member support. A more detailed description of the region will be provided in Chapter III.

The Lincoln PCA became wholly member owned in 1948 when the last federal stock was retired. In order to study the

characteristics of a cooperative credit agency, the period from 1948-1957 has been included in this study. The years after 1957 did not provide complete data for the comparisons desired, and the years between 1934 (the establishment date) and 1948 did not actually describe a cooperative agency.

In any study based on a single observation care must be taken to emphasize the unique characteristic of the subject considered. While this warning would be more appropriate in presenting the conclusions of the study, it may be prudent to caution the reader. The analysis to follow will attempt to recognize those features pertinent to the singular subject as well as those observations which may have wider application.

Organization of the Study. Since the production credit association, which is the partial subject of this study, was created by legislative action, it is advisable to introduce the reader to the conditions which gave rise to pertinent legislation. A brief description of the provisions of related laws also will be presented. An attempt will be made to discover the intended function of the production credit system within the total agricultural market as contained in both the law itself and the deliberations resulting in legislation.

A description of internal financial and operating characteristics of lenders will be combined with a comparison of certain characteristics of borrowers from both types of lenders. Following this description of lenders, characteristics of loans

made by both types of lenders will be examined. These characteristics include size of loan, use of loan funds, interest rates and other charges, and loan security.

The costs of funds to lenders will be presented along with an examination of the amounts of credit which the lenders have provided and may be capable of providing. The analysis will not attempt to evaluate the adequacy of this volume from the demand side, but will emphasize the channel of funds to lenders.

The traditional reluctance of economics to consider behavior as a flexible variable will be challenged by a comparison of the market behavior demonstrated by lenders. Attitudes of bankers, association management, and borrowers from both lenders will be considered to illustrate the effect of market activity on opposing firms and on the customers within the market. Part of the study will evaluate awareness of credit characteristics shown by lenders and borrowers.

The analysis discussed above will be largely empirical and narrative, with limited attempts to evaluate competition arising from the organizational and behavioral features. The final chapter will summarize, evaluate, and comment on the elements of market competition observed. An additional task of the final chapter will be a discussion of the studies' implications concerning advantages and disadvantages of the cooperative production credit system as an instrument of public policy. Certain

recommendations concerning the most suitable role for the system as based on this study will be suggested.

CHAPTER II

THE LEGISLATIVE BACKGROUND OF THE FARM CREDIT SYSTEM

Before attempting to analyze competition in a single market, it will be useful to examine both the conditions which prompted legislation creating the production credit system and provisions of that legislation. Much of the following chapter will be devoted to legislative evolution of the present system. In addition to this description and evaluation of the various farm credit acts, a review of the intent of major legislation will be attempted.

Hazards and difficulties of suggesting what lawmakers were really trying to do are obvious. However, it is felt that public policy may be observed in the intent of legislation as well as in provisions of the legislation itself. Indeed, any evaluation of a public program requires some comparison between what legislative action was supposed to do and what it actually did.

Farm Credit Legislation Prior to 1923

The first federal farm credit legislation was embodied in Section 24 of the Federal Reserve Act of 1913. From this date to the present Congress has passed at least eight major farm credit laws as well as frequent minor amendments and credit-embodying farm relief acts. The Federal Reserve Act of 1913 attempted to

provide relief for farmers experiencing difficulty in obtaining long term investment funds to purchase or improve land and buildings. Many farmers sought to purchase new land in order to profit from an improving price situation in agricultural commodities, but found that increasing land values had reduced the ability of insurance lenders, mortgage bankers, and private investors to provide funds in the amount and under terms satisfactory to borrowers. The Federal Reserve Act reduced the restriction of lending on mortgages and permitted member banks to lend up to 50 per cent of the market value of farm land on a five year mortgage, provided such loans did not exceed 25 per cent of a bank's capital and surplus or one-third of its time deposits. Loans to one borrower were restricted to 10 per cent of capital and surplus, a provision that limited a bank's ability to serve qualified borrowers, particularly in livestock areas.

Section 24 did little to provide prospective borrowers with a way to get credit. Mortgage lending remained primarily in the hands of insurance firms, mortgage bankers, and local investors. Section 24 did permit increased bank lending on mortgage, but the admission of five year paper into a system designed to provide elasticity and liquidity for banking was open to criticism.[1] Inclusion of Section 24 in the Act did not postpone for long the provision of credit machinery to provide investment capital.

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[1] Eliot, pp. 63-64.

The Federal Farm Loan System. The period 1913-1916 saw a thorough investigation and discussion of long-term credit for farmers. Commissions were sent to Europe to study rural credit systems there; and extensive hearings provided opportunities for farm, banking and business representatives to present their views. After lengthy discussion, the Federal Farm Loan Act was passed on July 17, 1916.[2]

The preamble to this Act proposed "to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm land", and to perform certain fiscal functions. To accomplish these purposes the Act provided machinery in many respects similar to the new Federal Reserve System. A board, the Federal Farm Loan Board, of four Presidential appointees and the Secretary of the Treasury, supervised establishment and operation of twelve Federal land banks in as many districts. Each bank had an initial capitalization of $750,000 to which any person or firm, as well as the Treasury, might subscribe.

Characteristic features of the new systems were the local farm loan associations, cooperative local borrower's groups

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[2] R. J. Bulkley, "The Federal Farm Loan Act", Journal of Political Economy, 1917, pp. 129-147.
and
Eliot, Chapter 2.

similar to those found in Europe. The associations required a stock purchase of 5 per cent of the requested loan from prospective borrower-members. Each association appointed officers who reviewed loan requests, and if the request was approved, accepted and endorsed a mortgage from the borrower to the land bank. This machinery for distribution of funds from land bank to borrower exists, with minor modifications, at the present time.

An important feature of the new system was the manner of providing loanable funds for the land banks. The national capital market was tapped by issuance of debentures, called farm loan bonds, by the Federal land banks. These bonds were secured by United States bonds and by mortgages given by borrowers. The security of the debentures was, and is, imposing with the mortgage, associations, issuing land bank, and other land banks insuring redemption.

Another provision was authorization of privately organized joint-stock land banks, corporations with minimum capitalization of $250,000. These banks dealt directly with borrowers, and were strictly limited in setting interest rates, but were not as narrow regarding purpose and amount of loans as were the Federal land banks. These corporations could issue mortgage secured bonds up to fifteen times the capital stock of the bank. These bonds were the liability not of the whole system, but solely of the issuing corporation.

Although mortgage credit is not the subject of this study, the initial legislation introducing Federal activity in farm credit programs suggests the future path of such activity as the establishment of the farm loan associations involved creation of a large and widespread cooperative system.[3] The majority report of the Joint Commission which studied European rural credit systems recommended cooperative land banks, or joint-stock private banks, but most farm organizations, particularly the National Grange, opposed this plan.[4] Hearings on the bill establishing the Federal Farm Loan System indicated little farmer interest in the cooperative plan, either through farm organizations or personal initiative.[5]

Eliot has observed that the Farm Loan Board questioned the soundness of a credit system in which management and control

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[3]George E. Putnam, "Federal Farm Loan Act," American Economic Review, 1916, p. 770.
and
Murray Benedict, Farm Policies of the United States, 1790-1950 (New York, Twentieth Century Fund, 1953), pp. 143-148.

[4]Agricultural Cooperation and Rural Credit in Europe.

[5]Hearings on Rural Credits, Joint Committee on Rural Credits, 64th Congress, 1st Session (Washington, 1915).

Hearings, House Committee on Banking and Currency, 63rd Congress, 2nd Session (Washington, 1914).

Hearings, Joint House and Senate Committee on Banking and Currency, 63rd Congress, 2nd Session (Washington, 1915).

Hearings, Senate Committee on Banking and Currency, 63rd Congress, 2nd Session (Washington, 1914).

of the banks were vested in the borrowers.[6] This skepticism and concern for the bond holders was manifested in attempts to delay relinquishment of government control over the System's operations, and in insisting on building up reserves and surplus rather than payment of dividends to borrowers. In the Annual Report for 1920, the Board was convinced that salability of the bonds required that Government or public interest be dominant in bank management. The Report suggested permanent board organization of each bank consisting of four directors representing the public, and three representing and selected by the national farm loan associations.[7] Early years of the System reflected little association interest in managing their own affairs, and little activity by the Board in advancing the cause of cooperative credit through publicity and education. The major concern of the Board was establishment of efficient and safe financial operations.[8]

In addition to lack of enthusiasm for cooperative credit demonstrated by the Federal Farm Loan Board, establishment of joint-stock land banks indicated little official support for cooperative sentiment. Despite creation of these private banks, the associations grew in number from 1839 in 1917 to 4657 in

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[6]Eliot, pp. 80-81.

[7]Federal Farm Loan Board, Fifth Annual Report (Washington, November 30, 1921).

[8]Eliot, pp. 82-84.

1925, indicating strong acceptance among farmers. During this period the numbers of joint-stock banks increased from 9 to 25.

The involuntary nature of cooperative membership due to the stock-purchase requirement for borrowers from the system, the priority given to financial soundness rather than extension of cooperative credit by the Board, and establishment of competitive private lenders indicates a cautious approach to cooperation in establishment of the Federal Farm Loan System.

Perhaps the most important financial contribution of the System was the provision for tapping the national savings market and drawing these savings into agricultural capital investment by offering strong security for the lender. A channel of funds between the capital markets and the farm borrower was able to provide greater credit resources to the borrower by making the purchase of farm loan bonds a safe and profitable employment for savings. The most important function of the Federal Land Bank System was to provide safe and competitive security in the national capital markets, thus increasing both the total credit resources available to agriculture and the dependability of credit supply. The machinery for supplying capital to agriculture was vastly improved by organization of land banks, adoption of amortized mortgages, uniform interest rates and appraisal standards, and improved investment status of farm mortgages. The land bank system also was effective in providing interest rate

competition to other lenders, particularly insurance firms,[9] frequently in those areas which prior to the enactment of the system demonstrated the highest rates on capital loans.[10]

The Federal Farm Loan Act met the problem of inadequate, inefficient, and expensive mortgage credit by creating a complete saver-borrower financial channel. The farm mortgage loan was designed to fit peculiarities of agricultural production. Safety of the mortgage lender was greatly strengthened by spreading risks and by combining liability of land banks. Much of the success of the system may be attributed to improving the instrument of farm mortgage lending.

This Act set the pattern for future federal farm credit organization in short-term and cooperative lending activities as well as mortgage credit. The inadequacies of both the farm capital markets and the instrument and techniques of this activity were approached by building a complete financial institution, rather than by extension of government control or subsidy of mortgage lending through the existing market structure. The system corrected a structural inadequacy in a capital market by providing a new channel for funds, and by improving the farm mortgage as an investment security.

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[9]Ibid., p. 78.

[10]George E. Putnam, "Federal Farm Loan System," <u>American Economic Review</u>, March, 1919, p. 57.