CHANGING FINANCIAL MARKETS: POLICY AND RESEARCH ISSUES

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Introduction

The U.S. financial system is going through a major metamorphasis, due in large part to deregulation and changing technology. There has been a major relaxation of regulations on financial intermediaries in terms of pricing, where they can operate as well as what services they can provide. Computer technology and other innovations are resulting in economies of size and scope in the industry. Financial intermediaries are declining in number and increasing in size through mergers and consolidations, and many intermediaries are emerging as supermarkets of financial services.

It is reasonably certain that the traditional, specialized agricultural lenders cannot be insulated from these changes. Many rural banks have been acquired by holding companies, or have merged with other banks. In several Farm Credit System districts banks and associations are being consolidated. To date, however, there has been much less change in the range of services these lenders provide, while many other financial intermediaries have rapidly diversified their services. For example, credit cards, checking accounts, brokerage services and competitively priced deposit instruments are now a common part of the menu at savings and loan associations. The S&Ls are also diversifying from housing loans into consumer and commercial loans

These regulatory, structural and technological changes have been accompanied by a marked deterioration in the quality of agricultural loan portfolios. Melichar estimated that nearly two-thirds of the nation's farm debt is owed by operators with debt asset ratios over 0.4 who are experiencing varying degrees of financial stress. Nearly one-third is owed by operators with debt asset ratios over 0.7 and these borrowers are, or likely will be, involved in forced liquidations, barring a significant increase in farm incomes and asset values. On balance, most agricultural lenders to date have had sufficient reserves to absorb their increased loan servicing costs and losses. A few, however, have failed, and most forecasts indicate that the farm recession is not yet over.

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Our perception is that traditional agricultural lenders will be forced to wrestle with some of the following questions:

(1) Can traditional agricultural lenders survive and flourish unless they diversify their loan portfolios into activities that are at least partly countercyclical to the ups and downs in farm incomes?
(2) Can traditional agricultural lenders compete for customers without offering a broader range of services?
(3) Can traditional agricultural lenders attract and retain the high quality and well trained staff needed to operate complex lending and funding operations?
(4) To what extent must lenders become more heavily involved in helping borrowers to manage their market and interest rate risks?

Emerging Issues

In an attempt to get a handle on financial market changes, we are conducting a pilot study in which C.E.O.s of financial institutions and some farmers in a nonmetropolitian Ohio county are being interviewed. Included are commercial banks, FCS, FmHA, S&Ls, merchants and dealers and life insurance companies. The research is designed to obtain qualitative rather than quantitative data. Each CEO and two or three employees are invited to have lunch with three or four faculty members and a graduate student in a local restaurant. There is no questionnaire, although a general description of the research project is provided in advance. No notes are taken, confidentiality is assured and every effort is made to encourage candid, open, two-way communication. Each session is scheduled for about two hours.

We will return to the research design issue later. At this point we want to indicate the kinds of information we are collecting, based on only two interviews completed--one with the PCA and FLBA presidents together and the other with the CEO and three loan officers of an affiliate of a multi-bank holding company. The PCA serves a six-county area and has a loan volume of approximately $60 million, down from $85 million three years ago. The FLBA has $76 million in loans in a three-county area, and their volume has been relatively stable. The bank has about $160 million in total assets with $20 million in farm loans.

Our respondents are understandably preoccupied with the effects of both a farm and local nonfarm recession. Managing a farm loan portfolio in 1984 is a series of almost daily confrontations with borrowers, the courts, regulators, stockholders, and the news media. Our respondents readily admit that in the past,there was too much "asset based" lending based on too little financial information. Nevertheless, there is a reluctance on the part of lenders to assist borrowers in record-keeping and other management services. One reason for this reluctance is that several large lawsuits against farm lenders in Ohio have been based on the concept of a fiduciary relationship.

If lenders do not assist farmers in providing an increased volume of necessary financial information, who will? With some exceptions, university records systems serve a very small percentage of farmers. Accountants and bookkeepers are primarily oriented to tax form preparation and many do not understand agriculture. More farmers may be able to do it themselves with advances in micro computer software.

Our survey revealed that the "third party" system that is common in LDCs also exists in the U.S. A former commercial bank agricultural loan officer is now a self-employed consultant to Ohio farmers in financial trouble. We were told that he is especially helpful in preparing FmHA loan applications. His services also include marketing and financial consulting, and debt restructuring through both in-state and out-of-state lenders. Is the demand for "third party" consultants growing? What do their services cost? What is the quality of their services?

Personnel administration is a growing problem for agricultural lenders. The skill needed to manage a farm loan portfolio has increased substantially since 1980. It appears that commercial banks are making more progress in this area than are the FCS lenders. With significantly higher entry-level salaries, banks are attracting our best undergraduates, and the larger banks requiring an advanced degree. The PCA-FLBA consolidation in the Fourth District has caused many of their loan officers to look elsewhere, and again, some of the better ones have been hired by commercial banks. How many borrowers are following their loan officers to the new job?

We think there is significant clientele shifting and this perception was confirmed in our interviews. It appears that many "marginal" borrowers are moving to FmHA but many "average" and "blue chip" borrowers are shifting back and forth between PCA and commercial banks. We were told that a farmer's loyalty to a financial cooperative is worth about 50 basis points!

We recently conducted a more formal survey of ex-PCA borrowers in another county. The results for 108 loans paid off between January 1, 1981 and May 1984 were:

Category	Percent
I. Acceptable quality, new lender by choice	39%
II. Credit weakness, new lender	34
III. No short or intermediate term credit needs	18
IV. No longer farming (foreclosures, bankruptcies, etc. excluded)	9

The 108 loans paid off during this period represented 30 percent of the total number of loans, but 50 percent of the volume, so the shifting clientele tend to be large volume borrowers. In our interviews the PCA and commercial bank CEOs indicated that they had lost some "good" loans and some "bad" loans to their competitors; however, neither admitted to taking on any new "bad" loans. As one CEO put it, "I've never made a bad loan, but I've had lots of loans go bad after I made them"!

In our commercial bank interview, we probed the deposit side of their operation. Their loan deposit ratio is currently below 0.5 and it was readily admitted that they were making no attempt to compete for deposits. "Our competitor is paying higher rates on CDs than we are, and one of us has to be wrong." During the week of our interview, this bank's average daily investment in federal funds was $13 million. This "exporting" of funds would be expected because of the serious local recession in this community. In addition to serious farm financial stress, the 1982 county unemployment rate was almost 17 percent.

This CEO has the authority to set rates paid on deposits, depending on local competition; however, all investment portfolio management, including federal funds movements, are centered in the system's lead bank. Our perception is that this CEO was sent in to "clean up" the loan portfolio and that most of the problems were in the agricultural portion. Ten percent of the agricultural loans were currently involved in some type of forced liquidation. This CEO had a city background and seemed to be especially appalled by most farmers' lack of financial information and risk control. A new agricultural loan specialist had just been added to their staff.

In addition to clientele shifting, some lenders, PCAs for example, are shrinking their agricultural loan portfolios in response to stress. Some others, FmHA for example, are expanding theirs. Contraction in our case study PCA is due to loan losses, adverse publicity and more recently, inability to match competitors interest rates. PCA's spread has increased from 1% in 1980 to over 3% currently to cover losses, increased average operating costs and to meet their share of loss-sharing agreement assessments.

The portfolio contraction-expansion phenomenon is not well understood. Why are some lenders, including some commercial lenders, expanding in the midst of adverse economic conditions? How quickly will those that have contracted expand when economic conditions improve? Are some lenders going to be "in and outers" and are they going to "skim the cream" of the agricultural loan market, creating further deterioration in the quality of traditional lenders' portfolios? Our respondents are so preoccupied with the current dilemma that they have difficulty in describing how they will respond when agriculture's fortunes improve.

Methodological Issues

We believe that, for the kinds of questions and issues we are addressing, our informal, case-study approach is more appropriate than a random-sample with highly quantitative methodology. Financial intermediation is a relatively straight-forward process and it is fundamentally the same across lenders and locations. All lenders have sets of preferred and non-preferred borrowers and they have remarkably similar procedures and approaches for dealing with each group. All lenders must fund their operations and while the mechanisms differ, the problems and risks are similar. If this is true, the information obtained from in-depth interviews with 10 CEOs will be very similar to that obtained from a random sample of 100.

We also believe that the best way to examine the health of a local economy is to view it through a lender's eyes. With this approach we not only learn, for example, how many manufacturing plants have closed, but we also know which plants closed, when they closed and why they closed. Similar comprehensive diagonses of stagnant farm resource markets, farm firm failures, and other economic phenomenon are also provided. We are reasonably confident that we will have developed a fairly comprehensive profile of this rural financial market when our series of interviews is completed.

This pilot-study phase will be followed by more structured analyses of the supply of and demand for financial services by farmers and others. This phase will undoubtedly require a more comprehensive data base from surveys and secondary sources. We will be surveying farmers to probe the extent of, and reasons for, clientele shifting. We also hope to learn much more about how farmers are meeting the increased, lender-imposed requirements for financial and management information.

Concluding Observations

Deregulation, technological change and the repercussions of farm financial stress are creating a rather lengthly research agenda. Our first step in identifying these issues is to simply talk to the people who are the most directly involved.

Deregulation and structural change may permanently alter the character of our rural financial markets, but it is very unclear as to how. For example, we need to examine the implications of competition between independents, affiliates, statewide, and interstate branches of commercial banks, S&Ls, brokerage houses and others. They may compete directly with each other for the same clientele or they may target specific sectors. We also need to more fully understand the expansion-contraction and clientele shifting patterns as both farm and nonfarm sectors experience increased instability in the years ahead.

An immediate outgrowth of the farm recession has been an increased demand for skilled people and management information. The roles to be played by universities, lenders, consultants and computers in responding to these demands are unknown.