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1972

Cooperation

A PROPOSAL
FOR A POOLED REFORMULATION OF THE CAPITAL STRUCTURE
OF
BANKS FOR COOPERATIVES

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- May 1972 -

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Prepared for presentation at the W.A.E.A. Annual Meeting, Logan, Utah, July 24-26, 1972.

Background

> "The old Farm Board, as you know, has been discontinued, and in the short time I have been here I have found that the application for 90 percent of the loans (to agricultural cooperatives) which have come before us should never have come to Washington. They should have been handled regionally."[1]

This statement, made in 1933 by the Hon. Henry Morgenthau, Jr., Governor of the Farm Credit Administration, succinctly expressed the philosophy underlying the structure of this nation's system of Banks for Cooperatives as it was initiated (June 16, 1933) and currently exists. The structure was decentralized and patterned along the lines of the existing 12-district Federal Land Bank system.[2,3] The decentralized structure was chosen so that, ".... the business needs of agricultural cooperatives could be better handled by an agency...in each bank district..."[4] A thirteenth, or Central Bank for Cooperatives, was located in Washington, D.C. to facilitate the handling of the remaining 10 percent of the loan volume which Morgenthau suggested could not be serviced regionally. As originally conceived, the Central Bank was to fulfill an ancillary role of dual purpose, i.e. "... to make loans to large regional cooperatives .... also to the district Banks for Cooperatives."[5] In 1955, the dual purpose was adjusted to a singular function, i.e. joint participation with district banks in loans to cooperatives of such a magnitude as to exceed the district bank's allowable lending limit (set at 25 percent of its net worth).

The Impending Problem

As noted, the Central Bank was to be a relatively small subordinate organization. The bulk of the loan volume and related decisions were to rest regionally within the 12 district banks. Unfortunately, the draftsmen of the 1933 Act failed to foresee a major shift in the financial needs of this nation's agricultural cooperatives. They failed to predict the rapid growth in both number and size of individual loans in excess of $1 million. They failed to anticipate the dramatic growth in total loan volume within the system. And finally, they failed to realize that in response to this shift in cooperative's financial requirements, the Central Bank for Cooperatives would burst from within its subordinate status to become a major "centralized" force within the total system. As the Central Bank is asked to participate in an ever-increasing proportion of the system's total loan volume, it assumes a steadily increasing share of responsibility in the loan decision area. While this is in open violation of the decentralized philosophy of the original bank structure, it also places an additional financial burden on the district banks who must capitalize the Central Bank's expanding operations.

The remainder of this paper will discuss three areas. First, those adjustments in the financial needs for cooperatives will be documented. Second, the implications of these adjustments on the capital structure of the Banks for Cooperatives system will be discussed. Finally, the authors shall submit a proposal designed to meet the changing financial needs of cooperatives, while retaining the decentralized structure of the system and reducing the capitalization burden on the 12 district banks.

Cooperative Bank System Loan Trends

Historically, the Banks for Cooperatives system has experienced an irregular growth in the number of loans made. Beginning in 1946, however, the number of loans outstanding grew rapidly from about 1,000 to almost 2,400 in 1958. By the mid-1960's, the number of loans reached an all-time high of 2,488 and now appears to be declining moderately. This modest decline is attributed to the decrease in number of cooperatives (17 percent from 1957-1967) operating within the U.S. and is expected to continue at about 2 percent per year.[7/,8/]

Although the number of loans is decreasing, the number of lines of credit[9/] in excess of $1 million each is growing substantially. In fact, such lines totalled 178 in 1960, 345 in 1970 and are expected to reach 516 by 1980.[10/,11/]

If realized, these 516 lines of credit would account for 80 percent of the projected total system dollar loan volume by 1980. Moreover, even within the large loan category, the growth in number and incidence of lines of credit in excess of $20 million each exceeds the growth rate elsewhere, e.g. from 6 in 1960 to 30 in 1970 and projected 57 by 1980 or accounting for 48 percent of total dollar volume in 1980 compared to only 14 percent in 1960.[12/,13/]

Total annual loan volume has also grown substantially in recent years. From the time of the system initiation until 1960 (23 years), the total loan volume had grown to $500 million. In the 10 years following 1960, however, the total loan volume grew an additional $1,200 million, reaching $1,749 million by the end of 1970. Estimates are that by 1980 this figure could reach as high as $5,495 million; placing upon the system a demand for loan funds of an unprecedented magnitude.[14/,15/]

As large loans increase in number, become more concentrated in the $20 million-or-more category, and comprise a growing proportion of the system's total loan volume, increased Central Bank participation becomes a corollary within current lending limitations. As the system was designed, the Central Bank was to handle but 10 percent of the system's total loan volume. Nevertheless, by 1965 their credit-extended volume participation had reached 40 percent. By 1969, the Central Bank was sharing equally with the 12 districts the total lines of credit-extended volume, and by 1970 this jumped to 55 percent.[16/] In regard to actual loan volume outstanding, year end, Central Bank participation reached 34 percent in 1970 and jumped to 40 percent in 1971.[17/] Given current estimates of 1980 total loan volume and applying those adjustments relating to size of loans, one soon realizes that by 1980, 60 percent of the system's total loan volume will be beyond the lending limits of the district banks and, thereby, require Central Bank participation. This will create an environment almost totally contradictory to the decentralized structure of the system.

Implications on the Capital Structure

To be on the conservative side, let's assume that by 1980 the Central Bank will be asked to participate in 50 percent of the $5,495 million total loan volume. Under current legislation, the system must maintain an 8:1 debenture to net worth ratio. To generate the $2,748 million in total loans, therefore, by 1980 the Central Bank would have to be capitalized (by the district banks) at $344 million. As of June 30, 1971, Central Bank capitalization totalled $118 million, of which $87 million is attributable to the district bank's adjusted equity capital.[18/] To meet the 1980 cooperative credit needs, therefore, the Central Bank would have to be capitalized at 3 times its current level. From the district banks' point of view, this points towards the need for $226 million in additional monies to be invested in the Central Bank. However, experience has shown that by 1980 the Central Bank will likely generate internally (e.g. retained surpluses) approximating 20 percent ($45 million) of the added capitalization needs. Only the remaining $181 million would have to be provided by the 12 district banks in proportion to the 10-year moving average of their participatory loans outstanding with the Central Bank.[19/]

By comparing current district participatory loan volumes with those projected for 1980,[20/] one can ascertain each district's approximate loan volume growth rate. Similarly, each district's share of the 1980 total loan volume can be so determined. These data show each district's proportionate use of the Central Bank and their respective assessments of the $181 million capital requirements. The resultant financial burden on each district now becomes more obvious. To be more specific, each district bank will have to be assessed 8.62 cents per $1 increase in their current level of Central Bank participation; total assessments will vary from a low of $4.469 million for the New Orleans bank to a high of $37.164 million for St. Louis.

Most, if not all district banks will be hard-pressed to generate funds adequate to meet the impending capital assessments while still retaining a semblence of internal efficiency and competitive interest rate schedules. Moreover, even if they were to succeed in capitalizing the Central Bank at the required level, the decentralized character of the system would become subservient to the centralized control of the Central Bank (over half the system's total loan volume would rest with the Washington facility).

Alternative Solutions

To the problems noted above, there would appear to be three alternative solutions. The alternatives and related comments follow:

1) Maintain the system's present structure and accelerate the incidence of inter-district bank loan participations.

When a line of credit exceeds a district bank's lending limit, other district banks (rather than the Central Bank) may choose to participate in it. If initiated, the above alternative would enable the system to better service the growing number of large borrowers. Unfortunately, there are numerous limitations associated with this alternative. First, inter-district bank participation is voluntary and if district bank B has unused net worth lending capacity, but chooses not to participate with bank A, then the leverage efficiency of the entire system is adversely affected. Second, this alternative has no impact in regard to facilitating the growth of total loan volume within the system. Total system net worth is not increased and the additional debentures, therefore, cannot be sold. Finally, under this alternative, loan management would soon become fragmented amongst several participating districts. Important decisions which were once the responsibility of the originating district bank and perhaps the Central Bank must not be agreed upon by multiple independent (district) decision making units. This management fragmentation will likely contribute to operational inefficiencies, time lags in loan processing, administrative duplication, a growth of routine paper work and complexities in allocating margins on inter-bank participations.

2) Increase the lending limits for district banks.

Again this alternative is designed to deal with the large loan problem. In brief, raising the lending limits would enable district banks to service larger borrowers without soliciting participation by the Central Bank, other district banks and/or commercial banks. But, like alternative 1, it contributes nothing to the system's ability to generate an additional $3,500 million in loanable funds by 1980. Because of the system's growth in total loan volume, a district must still expand its capitalization of the Central Bank even though that district is now able to handle somewhat larger loans. Second, to have a meaningful impact on the maximum size of loan served within a district, the lending limit would have to increase far above that which is deemed acceptable for security purposes. Commercial banking interests, in particular, would question the wisdom of such a move.

3) Create a pooled reformulation of the system's existing capital structure.

This alternative proposes the establishment of a net worth pool. As presently capitalized, each district bank maintains its own pool of net worth. For loans not requiring Central Bank participation, the system, therefore, maintains 12 separate pools of capital where one would suffice. The single pool would suffice because the system's capital need is not dependent upon the number of loans but rather on their size. For example, in a branch banking (commercial) operation, one pool of capital serves as many as 100 branches. In the intra-district Federal Land Bank system, the Federal Land Bank maintains the pool which is used by all of their member associations. The proposed Bank for Cooperatives' pool would constitute a composite of the net worths of all 13 cooperative banks. Borrowing cooperatives would buy stock in the district banks as they do at the present time. The district bank, however, would then reinvest a like amount in the Central Bank. The Central Bank then would become the capital pool for the entire system.

An advantage of this pooled reformulation is its ability to support the Central Bank's expanded loan volume while reducing the intensity of the need for districts to raise large amounts of additional capital. In addition, this can be accomplished within existing lending limits, and no major change of existing inter-district or district-Central Bank relationships is foreseen. This alternative also permits efficient use of debenture to net worth leverage since all of the system's net worth can be brought to bear on a single loan requirement. This alternative also avoids the administrative fragmentation associated with the first alternative and does not adversely affect the fiscal security of the system as would be the case with a rise in lending limits.

Incidental to the major attributes of this alternative is its ability to materially enhance the system's service to large borrowers. If this pool were in existence in 1970, for example, it would have totalled approximately $283 million, and provided a capital base in excess of the estimated need by the system to service its expected 1980 loan volume.

This capital reformulation would have some influence on internal operations within the system and some changes would necessarily need to be made. It is believed that the infringement on managerial authority of the districts would be no greater than it eventually will be under the present system. For example, any district might, if it chooses, operate below the debenture to net worth ratio. District-commercial bank relationships would be expected to continue. These would have to be supported by debenture issues for commercial bank borrowings or with a working arrangement with the Central Bank capital pool. The debenture determinations would be made as they are under the present system. Districts would be expected to keep present reserves and build additional reserves from their own earnings and earnings from the Central Bank pool. This proposal would have no effect on the personnel decisions, district operations, advertising and public relations or the conventional intercourse with borrowers. It is envisioned that district banks would have the right of commitment on loans without approval up to the limits that are now used or as they would be changed in the future. Decision making prerogatives on loans would remain with the district banks to be shared by the Central Bank when its participation in loans would be required as at present. This proposal, therefore, would tend to preserve the decentralized character of the system and avoid further erosion of district autonomy. Finally, with the proposed reformulation of the capital structure we can maintain the desires of the architects of the system by originating and servicing the loans in the districts while still meeting the changing and challenging demands of the cooperative agribusiness industry and its expected growth in total credit needs.

References Cited

1/ Hearing before the Committee on Agriculture, House of Representatives, 73rd Congress, 1st Session on H.R. 5790, Serial B, May 26 & 27, 1971, page 12, statement by Henry Morgenthau, Jr., author's own statement in parentheses.

2/ F. F. Hill, Deputy Governor, Farm Credit Administration, 1939, Banks for Cooperatives; A Quarter Century of Progress, June, 1960, p. 22.

3/ Reference 1/, H. Morgenthau, Jr., p. 12.

4/ Reference 1/, Dr. W. I. Myers, p. 30.

5/ Reference 1/, Dr. W. I. Myers, p. 26.

6/ "Loans Made and Outstanding", 37th Annual Report, The Farm Credit Administration, Table 33, p. 116.

7/ J. T. Lesley, H. A. Seagraves, L. L. Boger, "Capitalization of the Central Bank for Cooperatives," September, 1969, p. 15.

8/ Reference 7/, Lesley, Seagraves, Boger, p. 16.

9/ "Lines of Credit" refer to bank-approved sums of money which cooperatives may borrow if they wish. "Loans Outstanding" refer to sums of money actually borrowed by cooperatives at a point in time. Hence, loans outstanding may equal but never exceed lines of credit.

10/ "Banks for Cooperatives Comparison of Large Lines of Credit", Farm Credit Administration, Cooperative Bank Service, November 16, 1970.

11/ J. T. Lesley, M. A. Ensley, L. L. Boger, "Report from Capital Study Committee", Central Bank for Cooperatives, September, 1970, p. 9.

12/ Reference 7, Lesley, Seagraves, Boger, p. 25.

13/ Average lines of credit in each category multiplied by number of loans and converted to percentages.

14/ Reference 11/, Lesley, Ensley, Boger, pages 7-8.

15/ "37th Annual Report, 1969-70", The Farm Credit Administration, Table 6, p. 116, and Reference 7/ and Reference 11/.

16/ "Comparative Analysis of Operations", Banks for Cooperatives, Year Ended June 30, 1960-1970.

17/ Reference 16/, Years 1953-1970.

18/ Proceedings, Central Bank Conference, Attachment 3, May 26-27, 1971, Dallas, Texas.

19/ This is the assessment procedure now agreed to by all district banks as a means for capitalizing the Central Bank for Cooperatives.

20/ Reference 11/, Lesley, Ensley, Boger, p. 11.