Broadening the Horizon and Adding Value in Agricultural Finance Research

Marvin Duncan

Proceedings of
Regional Research Committee NC-161

FINANCING AGRICULTURE IN A CHANGING ENVIRONMENT: MACRO, MARKET, POLICY AND MANAGEMENT ISSUES

St. Louis Farm Credit Bank
St. Louis, Missouri
September 23-24
1991

Department of Agricultural Economics
Kansas State University
Manhattan, KS 66506
February 1992

BROADENING THE HORIZON AND ADDING VALUE IN AGRICULTURAL FINANCE RESEARCH

Marvin Duncan

I. The Regional Committee's focus on financial institutions is overdue.

1. There is a changing legal and regulatory framework affecting financial institutions.

2. There are changing relationships among the regulated institutions, i.e., mergers, consolidation, etc.

3. Nonregulated firms providing financial services are becoming much more important in agriculture.

4. There is increased emphasis on broader service offerings by financial firms or their parent firms.

5. Foreign-owned financial institutions have become more important as lenders to commercial U.S. agriculture.

6. Integration of production, especially in the livestock sector, is changing the business relationships and credit providers in U.S. agriculture.

7. Therefore, not only is a primary concentration on credit needs by producers no longer adequate, but an understanding of changing institutional arrangements by lenders is also necessary to adequately understand the contemporary agricultural finance environment.

II. The proposed regional project outlines a program of research focused around four objectives. I have developed by comments on the proposed project around each of its four objectives.

OBJECTIVE 1. MARKET EFFECTS OF REGULATORY AND STRUCTURAL CHANGE.

1. I prefer to focus on the evolutionary changes in financial regulation and the attendant reasons behind change as opposed to addressing change as abrupt shifts in traditional reality.

2. Regulatory change must be viewed in context of evolving financial markets, i.e., national and international integration, commercial paper, junk bonds, etc.

3. Unless the role of foreign financial institutions in the U.S. market is accounted for, the conclusions reached will be incomplete and flawed.

4. The emerging role of nonfinancial firms in financial intermediation is not well understood, certainly less well in agriculture, i.e., integration of production, processing, and marketing.

5. A consistent and comprehensive data base is very useful, but very expensive to maintain. Policy question: Should regulators all maintain the same or similar information systems? Similar seems more practical.

6. Business school marketing techniques may offer new insight into financial institution behavior. Business strategies focused on market share are increasingly reflective of bank behavior. Bank Administration Institute, Robert Morris Associates, Federal Reserve System, and FDIC performance data may be useful.

7. Role of International Bank of Settlements in unifying bank regulation. The Basel Accord established a worldwide capital standard for international banking.

OBJECTIVE 2. ECONOMIC EFFICIENCY AT MARKET AND FIRM LEVELS.

1. Competition is far from an adequate indicator of interest rates. Banking structure, risk bearing capacity, and legal framework are all important as well.

2. On balance, the research effort embedded in this objective will be an important one.

3. The application of production theory to bank efficiency should provide very useful information; but comparisons of rurally based institutions to other financial institutions would be useful also.

4. Most banking literature suggests efficiency of operation occurs as size well below that of Farm Credit Banks. Cost curves flatten out for the FCS. Without internal competition, however, the FCS doesn't have the same impetus as commercial banks to merge as a means of eliminating under-utilized capacity.

5. Commercial banks in merging, especially in overlapping territory, can eliminate competition, obtain pricing influence, and can efficiently use back room functions.

6. Understanding of the efficiency based motivation of nonfinancial firms will be important to comparing competitive behavior, i.e., multiproduct firm problem where products are complementary over some range of output.

7. What are the efficiency and structural implications of outsourcing certain bank management functions? i.e., human resources, accounting, asset/liability management, etc.

8. Looking only at the activities of financial firms dedicated to agriculture may provide an unduly narrow opportunity set. Many firms are in consumer banking, middle market lending, real estate, etc., across rural, suburban, and city locations.

9. Segmentation of the agricultural lending market appears to be an increasingly important distinction in the area of policy and financial performance research.

10. The focus of agricultural finance economists on agricultural production credit is increasingly dated and inappropriate. Rural businesses need state of the art financial services, perhaps even more than farmers, to support economic development.

11. Insights into what agricultural lending <u>should</u> provide seems value laden. What are farmers willing to pay for?

OBJECTIVE 3. THE PROPER ROLE OF CREDIT PROGRAMS.

1. This research is important and long overdue!

2. What are the localized effects of these program on those who are beneficiaries?

3. What are the localized effects of the programs on those who are not beneficiaries?

4. Is too much or too cheap credit a problem for the farm sector. Does it contribute to oversupply of product and overpricing of fixed resources?

5. How can the spillover effects be neutralized when subsidy program are undertaken?

6. What is the interaction between government programs and private sector lending? Is it competitive, complementary?

7. What is the opportunity cost of public credit programs? Would these funds yield higher returns if used elsewhere? Rural development, for example.

8. Can Farmer Mac be competitive? What is the role of FCS and other competitors, the role of government regulators?

9. What are the firm and market level consequences of public risk bearing? Does it foster inefficiency? How does the government manage the risk it assumes?

10. More than efficiency is involved in interest rates among FCS loan institutions. Debt costs, capital requirements, and risk in the loan portfolio are all important issues. How are interest rates adjusted, what criteria might be reasonable?

11. Agency status for FCS institutions has been an overstudied area. Economists may not be the appropriate investigators. Rating agencies already do shadow ratings. For the FCS, as a whole, they currently would sell debt in the junk bond market in the absence of government support. Private insurance might be a possible option to offset agency status, itself a bundle of attributes with some more important than others. An important issue, currently, is how the Agency Market is regulated for safety and soundness.

12. The FCSIC is not fully patterned after the depository insurance funds. The fundamental differences include that the FCSIC is responsible to repay government guaranteed assistance borrowing, premiums are on basis of loans outstanding (adjusted for government guarantees), but coverage is on debt issued, not deposits, and the liability of the fund is not limited as in depository funds.

13. What is the impact of distortions on earnings as reported by FCS given current accounting of the FCSIC fund on market pricing of debt and on borrower confidence.

14. The capital structure of FCS institutions is consistent with the Basel Accord.

OBJECTIVE 4. MODEL ORGANIZATIONAL AND OPERATIONAL CHARACTERIZATIONS OF LENDERS.

1. I doubt that models which explain the actions of only those serving the agricultural sector is meaningful in an increasingly integrated financial marketplace. Other designations which encompass the more complex relationships that are emerging may be more meaningful.

2. Models that don't account for foreign bank lending, leasing, and nonfinancial firm credit activities may not be very meaningful.

3. Linkage to bank management and macroeconomic models will results in better explanatory performance.

III. Closing thoughts.

   1. Agricultural lending may no longer be a very meaningful distinction. It may instead be becoming simply a specialized form of business lending.

2. More attention to the motivation and the stability of financial institutions, themselves, is needed. In the past decade we have seen the widespread damage caused when institutions become unstable.

3. Accountants, financial markets operations, and financial regulators may be more skilled than agricultural economists in answering some questions.

4. Differentiation of lending practices and credit availability within the agricultural sector and across business sectors raises important policy issues.

5. Integration of the agricultural production industry in an increasingly important issue with credit and public policy implications.

6. It is important to understand the role and motivation of nontraditional lenders.

7. Simplicity is in analysis often more useful in helping to make operational the results than is complexity.