

**THE PROVISION OF CREDIT  
WITH SPECIAL REFERENCE  
TO AGRICULTURE**



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# THE PROVISION OF CREDIT WITH SPECIAL REFERENCE TO AGRICULTURE

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WITH TWO CHAPTERS UPON  
THE PROVISION OF RURAL CREDIT IN ENGLAND

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**TO MY PARENTS**



## PREFACE

THE post-war depression has affected agriculture with especial severity. In consequence agriculturalists throughout the world are showing an increasing interest in problems of rural finance, since they believe that an improvement in the position of farming industries is intimately bound up with the provision of improved credit facilities. In many countries new systems have been devised and existing machinery developed to meet the demands of farming interests for better systems of finance. It is possible that too much is expected from improved credit machinery, but the importance of adequate and carefully planned systems will be readily conceded. In many countries the volume of credit which is granted directly or indirectly to agriculture exceeds that to commerce or industry, while the stability of credit conditions in general is closely bound up with the financing of agricultural production and marketing.

Fundamentally, credit plays the same part in agriculture as in other industries, and the underlying principles are similar; but the conditions affecting the manner in which these principles apply in practice differ to such an extent as to constitute a special rural credit problem. In view of the volume of credit which is required, in the aggregate, by farming industries, and of the importance of these industries in the economic life of the community, the problem is worthy of more attention than is normally devoted to it by economists.

The present study has been undertaken in an endeavour to meet the need, which the writer believes to exist, for a book which combines an analysis of the nature of the credit problem as it affects farming industries and a critical account of some of the more important types of credit intermediary. In planning the book, the writer has had in mind the needs of his own students, which accounts for the space devoted to a consideration of New Zealand conditions. The scope of the study has been limited somewhat by the

information available to one working in a rather remote corner of the world. It is hoped, however, that the book may be of value to students and agriculturalists in other countries.

The writer is indebted to a large number of individuals who have willingly given information and furnished copies of reports. He desires to express his especial thanks to Mr. W. T. A. Beer of King's College, Cambridge, Dr. E. P. Neale, Secretary of the Auckland Chamber of Commerce, and Mr. H. R. Rodwell and Mr. J. O. Shearer of the Department of Economics, Auckland University College, who have made valuable suggestions and criticisms. He is also grateful to Mr. J. O. Shearer for assisting in the preparation of the Index. He would take this opportunity of recording his indebtedness to Dr. J. B. Condliffe, Research Secretary of the Institute of Pacific Relations, who first interested him in agricultural economics and with whom the writer collaborated in his first publication on rural credit. The usefulness of the book has been much enhanced by the inclusion of two chapters on rural credit conditions in England by Mr. R. R. Enfield, of the Ministry of Agriculture and Fisheries, the well-known authority on agricultural economics, and the writer highly appreciates this assistance.

Finally, the writer would record his especial indebtedness to Dr. J. A. Venn, Gilbey Lecturer, University of Cambridge. It was his privilege to work under Dr. Venn's guidance as a post-graduate student during the years 1924-6. Such merit as the present study possesses owes much to Dr. Venn's direction during those years and to his advice and encouragement since. In addition Dr. Venn has read the proof with scholarly care, made many important emendations; and has seen the book through the Press.

This book is the first of a number of studies in economics and commercial subjects which it is hoped will be undertaken from time to time by members of the Department of Commerce of Auckland University College.

H. BELSHAW.

*August, 1930.*



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**PART I**

**THE GENERAL PROBLEM OF CREDIT**



## CHAPTER I

# CAPITAL AND CREDIT

### I. THE DIVISION OF LABOUR

1. In his endeavour to control his material environment to his own benefit, man has found it advantageous to specialize. In large measure the process of economic evolution has been a process of increasing sub-division of labour and specialization of functions. This division of labour has developed along three planes: (a) Within separate businesses themselves there has been an increasing tendency for the various operations to be minutely subdivided, simplified and standardized, while different functions such as manufacture, supervision, selling, accounting, and management have also been undertaken by highly specialized groups or individuals. (b) In addition, individual firms or business units have tended to specialize in the manufacture of a narrow range of commodities, or take over a special set of functions. There are few businesses which perform all the processes necessary from the production of the raw material to the marketing of the finished commodity to the consumer. In many cases, even the work of manufacture is split up into several stages. The finished product at one stage becomes the raw material of the next, and each stage is undertaken by a separate business or businesses. (c) Finally, various localities or countries have tended to specialize more or less in the production of certain commodities or kinds of commodities.

2. In consequence of these conditions, few workers now perform more than a small proportion of the series of operations necessary before a commodity reaches the consumer and fewer still now produce the whole, or even the major part of the things they themselves consume. There are few countries and still fewer localities which produce all the things they need. It becomes necessary,

therefore, for the individual worker to exchange the results of his labour for the results of the labour of others, and for each locality and country to exchange its products for the products of other places.

3. Arising out of the division of labour comes another essential characteristic of modern society: the length of time taken in the process of production. The division of labour has encouraged and been encouraged by an ever increasing use of machinery, for involved in large measure in the division of labour is a separation of complex processes into a number of simpler processes which, being frequently repeated, can be taken over and performed with advantage by mechanical means. Each stage in production implies the prior existence of aids to production in the form of machines, factories, railways, ships and shops. Before ever the making of a commodity is commenced, a considerable amount of time and labour has been expended in the making of such instruments of production, designed to increase the ease and rapidity with which man can perform his varied tasks. Apart from preliminary work of this sort, almost every one of the multitude of minutely subdivided processes of modern production is preceded and followed by other processes taking time. Some of these processes are of long duration. Hence months or even years may pass from the time the first stages of production are commenced to when the commodity is in the hands of the consumer. Thus the wool which is grown on the sheep stations of Australia or New Zealand requires much prior labour in the clearing and cultivation of land, the erection of fences and buildings, the making and installation of machinery and so on. After the sheep are shorn the wool must be transported to various marketing centres where it is stored until sold by auction. It is then transported to the United Kingdom or other parts of the world to await and pass through all the necessary stages of manufacture. Later it may find itself returned to New Zealand or to any part of the world as lengths of cloth; and finally, having traversed the world, it is fashioned after many months into articles of clothing. In the same way most of the common goods consumed in modern society

and especially the goods necessary to assist in future production such as machines, factories, railways and ships require a considerable length of time to be produced and marketed.

## II. NATURE AND USES OF CAPITAL

1. The roundabout methods which arise from the extension of specialization and the division of labour add enormously to economic efficiency. It will be obvious, however, that they cannot proceed very far without the accumulation of a stock of wealth. This stock of wealth is Capital.<sup>1</sup> For our purposes, capital may be classified into four groups:—

- (a) “Instruments” of production such as factories, warehouses and shops, machinery, tools, ships and railways; and in the case of agriculture—machines, buildings, “improvements” such as fencing and drainage, and live stock used for breeding or for the production of commodities such as wool, milk or eggs. It will be convenient also to include land in this group, though for some purposes which need not concern us, land and capital are usually distinguished from each other.
- (b) Stocks of raw materials or semi-finished goods awaiting manufacture. In the case of agriculture these will include seeds, manures, stocks of feed-stuffs for live stock, and in some instances live stock themselves, when (as in the case of pigs, cattle, sheep and poultry) they are prepared directly for the market instead of being used as agents for the production of marketable commodities.
- (c) Stocks of goods on farms, or in factories, warehouses and shops awaiting sale.

<sup>1</sup> I prefer to follow Professor Fisher's definition of capital as a stock of wealth existing at an instant of time, rather than the more common definition as a stock of wealth used to assist in future production; for it seems impossible to distinguish clearly which part of wealth is used to assist in future production and which is not. For a general discussion, see Fisher, *Capital and Income*, Ch. IV.

(d) Stocks of goods in the hands of consumers, more particularly goods in a durable form, such as pianos, furniture, houses and motor cars, the utility of which is not exhausted with one use.

2. Large capital in the form of instruments of production is necessary in order that a composite process of production—say the making of a Ford car—may be divided into its constituent parts, at any rate if workers are to be continuously employed in one operation or a narrow range of operations. Similarly it is apparent that heavy investment in railways, ships, machines and so on, to facilitate transport is necessary if the localization of industry, or the division of labour by localities is to proceed very far; for localized industries must find their markets far afield and for this, cheap and rapid transport services are imperative.

3. Stocks of raw materials and semi-finished goods must be accumulated because the rate of production and the degree of continuity in production are different in various stages of the same industry. Factories and workshops must be continuously employed if they are to attain the maximum degree of productive efficiency, and to ensure this, supplies of raw material must be available when required; but raw materials of agricultural origin, which are more important in total value than the product of mines or of the sea, are not produced in a continuous stream, but in a series of waves dependent on the seasons. Even under modern conditions, when the whole world is frequently drawn on for sources of supply, a perfectly regular flow has not been achieved. Apart from this, there is always the possibility that other conditions, such as the vagaries of transport and the variation in demand for the raw materials from other sources will cause some degree of irregularity in the flow of raw materials to any particular place. This will apply to other kinds of raw material as well as those of agricultural origin. Further, it is seldom likely that any stage of manufacture will be continued with perfect regularity, and it is rare that the variation in the flow of raw materials will coincide exactly with the variation in the rate of manufacture. Since it



is obviously to the advantage of the manufacturer to have materials on hand when he requires to use them, the accumulation of stocks is a necessary condition of most branches of capitalist manufacture. Such stocks are a form of capital.

4. Stocks of finished goods are necessary for two reasons. In the first place, workers must live while production is being carried on. A ship may take a year to produce; a railway system even longer; while both will require to be in operation a considerably longer period before their earnings cover the cost of the material and labour embodied in them. Similarly, a long period will frequently elapse under the modern system of specialization and exchange before goods reach the final consumer and are paid for. In the meantime, workers are paid. Their payment takes the form of money, but this is expended to purchase goods and services. Hence a stock of goods must be accumulated owing to the length of time taken before the ships or railways yield a return sufficient to recompense the effort of all kinds necessary for their making. What applies to ships applies to a greater or lesser degree to all commodities produced under modern "roundabout" methods, especially as the actual marketing frequently takes time. In the second place, most production is in anticipation of demand. The retailer and the wholesaler do not wait until orders are placed with them before purchasing goods. In most cases such a method would involve much delay and inconvenience, especially when the sources of supply of the goods needed are remote. A stock of goods is therefore required for this purpose, and to enable business men to take risks in other directions, by experimenting with new processes, exploiting new markets, and so on.

5. It is clear from the foregoing paragraphs that the accumulation of a considerable volume of capital is necessary for the proper functioning of modern economic society. This process of capital accumulation involves saving. If the volume of capital increases, it implies that society is producing a surplus of goods which is being added to the existing *stock* at a greater rate than the existing stock is

being used up. The actual saving takes place in the form of money, but its effect is felt through an addition to the stock of goods. Normally, saving is for purposes of investment. The money saved is not usually hoarded in a stocking or safe, but is spent in ways which assist in the further production of goods. It may be spent in obtaining a stock of goods for direct sale, in which case the transaction is likely to be transmitted back to the producers of the goods in the shape of additional orders. It may be used in the purchase of new plant and machinery; but in most forms which it is likely to take, additional saving by an individual will be reflected in an increase in the stock of wealth unless offset by reduced saving on the part of others.<sup>1</sup>

### III. NATURE OF CREDIT

1. The relevance of the preceding section to our subject consists in the fact that an appreciable portion of the saving takes place, not by those who actually control or use the capital in production, but by others, who *lend* it to the actual controllers or users. Much of the capital of modern society is saved in small lots, or held as a reserve for short periods to meet future contingencies, and is of very little use to its owner for direct utilization in production. Further, many of those who save have not the necessary opportunities, training, or capacities which would enable them to make effective use of their savings in productive enterprise; while many of those engaged in business are not themselves able to accumulate capital in sufficient quantities for their purpose. (Hence modern economic organization can only function effectively with the aid of elaborate machinery for the transfer of capital from those who accumulate and own it, to those who use it in production.) In short, *credit* is necessary for the proper functioning of modern

<sup>1</sup> The magnitude of the existing stock of wealth may be appreciated by the fact that the total capital of all kinds in the United Kingdom has been estimated at a money value of £14,300,000,000 in 1914 (Stamp, *British Incomes and Property*, p. 404-5), while the aggregate of new savings in the United Kingdom is now estimated at about £500,000,000 annually out of a total national income including pensions and interest on the national debt of £3,800,000,000 (*Britain's Industrial Future*, Report of the Liberal Industrial Enquiry (1928), pp. 101 and 244).

economic society. The term "credit" is used in many senses, and many popular misconceptions arise in respect of it. It will be sufficient for our purposes to distinguish the two main senses in which it is used.

2. In the first place, credit is regarded as "*a condition which enables a person to extend his control, as distinct from his ownership of resources.*"<sup>1</sup> In this sense it represents the *power to borrow* which an individual possesses.<sup>2</sup> The credit of an individual is good when his power to borrow is great. This condition depends fundamentally on confidence. The normal level of credit within a community, or the general extent of the "*power to borrow,*" depends essentially on the level of communal confidence, and on the extent to which that level is sustained.

3. It is well known that the power of a Government or municipality to obtain the control over resources without coercion, or in other words, its capacity to borrow, depends on the estimates of those who save (or who market savings) of its willingness and its capacity to meet the interest charges on loans and finally repay the capital sum represented by a loan. Thus the British Dominions can borrow more readily and more cheaply than some South American republics or municipalities, since in the latter case both the intention and the capacity to repay have often been doubted. In the same way the capacity of individuals within a community to borrow from each other depends on the *general state* of confidence. Expressed briefly, the main conditions on which this general state of confidence depends are as follows:—

- (a) The general character of the people.
- (b) The stability of its social and political institutions.
- (c) The stability of economic conditions.
- (d) The state of the law relating to borrowing and lending, or the readiness with which contracts can be made and enforced.
- (e) The efficiency of the machinery established to facilitate borrowing and lending.

<sup>1</sup> Lavington, *The English Capital Market*, p. 15.

<sup>2</sup> *Ibid.*

The importance of these conditions should be sufficiently apparent as not to require elaboration or exemplification.

4. In the same way, the capacity of a particular individual to borrow (i.e. his credit) depends on the confidence reposed in him by those with resources to lend.<sup>1</sup> This condition of confidence has its essential basis in the estimates of lenders of the integrity of the individual, his capacity to repay, and the nature of the security he has to offer against possible failure to repay. The readiness with which lenders are able to obtain information as to an individual's capacity and integrity, and the accuracy with which they can estimate the value of the security offered are, of course, important factors determining the degree of confidence, and therefore the willingness to lend, or the rate of interest which lenders are prepared to accept. As will be shown later, these conditions are especially important with reference to agriculture.

5. In the second place, credit is regarded as the *actual exercise* of the power to borrow and is represented by an actual loan. A man's credit in this sense consists of the actual resources which he has borrowed, while in the former sense it consists of his potential borrowings. Credit in the second sense is balanced by a debt, so that a debt and a credit are different aspects of the same thing. *In this sense then credit may be defined as the transfer of the control as distinct from the ownership of resources.* In this book, unless the context determines otherwise, we shall regard credit in this manner, rather than as a psychological condition. Credit of this sort involves repayment in the future or the transfer here and now of the control over resources in exchange for the control over resources in the future. Since most people prefer the control over resources now to the control over resources in the future, and since a service is rendered to the borrower in enabling him to have the use of resources owned by somebody else, a charge in the shape of interest is usually made for the loan.

<sup>1</sup> It depends also, of course, on the extent to which he can establish contact with those who have resources available for lending, a factor of great importance in agriculture.

6. Credit in the sense of the *exercise of the power to borrow involves the transfer of the control over a stock of wealth, or capital, so that there is a tendency to confuse credit with capital.* Credit is not in itself capital, but represents a transaction whereby the control over existing capital is transferred from one person to another. Hence an increase in credit does not directly increase the quantity of resources, though it may do so indirectly because the borrower may use the resources more effectively in the production of future goods and services than the lender would do. We may, however, by a useful analogy, regard the general level of confidence, or communal or "social" credit, as a part of the "immaterial capital" of a country. Although it does not, in itself, represent a stock of material goods, it may be regarded as a stock of "spiritual" or psychological goods slowly built up by the community by its past efforts, and assisting towards the more efficient production of goods and services.<sup>1</sup> Similarly, an individual's credit, in the sense of his capacity to borrow, may be regarded as part of his immaterial capital. Such credit may appreciably affect his capacity to produce; for it is a factor limiting the amount of his actual borrowings.

7. A similar confusion tends to arise between money and credit. Most loans represent a transaction in terms of money. It is seldom that the control over resources is transferred direct. Normally, the individual who borrows obtains control in the first instance over a certain sum of money, either as notes or coins; or over a right to expend a certain sum of money. This right may take the form of an agreement with a banker to draw on an overdraft or "deposit" at the bank by means of cheques; or of a "credit instrument," that is a written document, drawn up in a legal form, and representing a loan made under specified conditions. Some credit instruments can be freely transferred or exchanged for money or goods and are the equivalent of money. Money is not credit, however. The credit transaction

<sup>1</sup> In commenting on this concept, Mr. Shearer rightly makes the point that it is difficult to think of such "immaterial capital" as a stock. It is rather a function in the mathematical sense and represents a complex condition.

involves, as we have seen, the transfer of control over *resources*. Money, in the form of cash, or as represented by overdrafts or credit documents, is the agent whereby the transfer of resources is facilitated.

8. The expression of credit in terms of money adds greatly to the readiness with which the control over resources can be transferred. The person who saves does not usually accumulate a stock of a particular kind of goods, but rather a stock of purchasing power in the form of cash, or deposits at a bank, and so on, which can be expended if desired in any way he chooses. Similarly, the borrower does not obtain the loan of a particular stock of wealth, but of a certain amount of purchasing power which is capable of being expended in many different ways. Money therefore *generalizes* purchasing power; and credit, expressed in terms of money, generalizes the transfer of the control over resources. Because credit is expressed in terms of money, a loan is usually regarded as the transfer of control over a certain sum of money and no great harm will be done by so regarding it, provided we do not overlook the fact that the completion of the transaction normally involves the acquisition of control over goods (and services) by the borrower. The transactions we shall discuss in this book are primarily transactions in terms of money, but behind them are transfers of the control over actual resources.

9. We have pointed out that credit consists in the transfer of the control over *resources*, i.e. goods and services, though the form which a loan takes is usually the transfer of a sum of money or its equivalent. For some purposes it is desirable to distinguish between the transaction in terms of money and the transfer of the real resources which is behind it. It is then convenient to define the loan of money as *money credit*, leaving the term *real credit* to describe the transfer of the control over goods and services which this money transfer involves.<sup>1</sup>

This distinction is important for two reasons. In the first place the fact that most credit is expressed in terms of

<sup>1</sup> This distinction is one used by Mr. J. M. Keynes during a course of lectures in Cambridge in 1926.

money tends to divert attention from the real transaction which lies behind it. Since money or its equivalent can be readily created by banks or governments, it tends to be assumed by some that credit can be and should be expanded indefinitely to industry at a low cost.<sup>1</sup> That something else is being transferred besides the actual money is not realized. In the second place, a given quantity of money credit may represent different quantities of real credit at different times or places, because the general level of prices is different. Thus a loan of £1,000 when prices are represented by an index number of 100 will purchase twice the quantity of goods that can be purchased when the index number of prices is represented by 200, and so will represent twice as much real credit.

✓ 10. A credit agent, such as a bank, may advance *money credit* which has been deposited with it, or even create money credit by lending money (or titles to money) in advance of deposits; but the only true source of *real credit* is the savings of the community. Money credit becomes transmuted into real credit to the individual when it is expended by the borrower in the purchase of goods or services. An increase in real credit can only take place in two ways: either through the accumulation of more wealth, and/or the performance of more services, the control over a part of the increase being transferred by way of loans; or through the transfer of the control over an increased proportion of an existing stock of wealth and flow of services. Since the consideration of services only serves to complicate the problem without affecting the principle, we shall assume that all transactions are in goods. An increase in real credit in the former manner can then only take place through additional saving by the community. An increase in real credit in the latter manner may take place only in one or other of two ways. Either owners of an existing stock of wealth may decide voluntarily to increase the proportion which they are prepared to lend rather than

<sup>1</sup> Thus the writer was recently invited to offer an opinion on a scheme for advancing credit to farmers in New Zealand in the form of notes issued by the Government at 2 per cent. per annum, which were to be printed as required.

control it themselves in production;<sup>1</sup> or a third party may intervene so as to force the transfer of the control over an increased proportion of an existing stock of wealth to borrowers. Except in times of national stress when this result may be brought about by Government action, it is only likely to occur through the action of banks, in creating money credit.

¶ 11. A bank may, and frequently does, make advances which are not backed by its own capital or funds deposited with it. These advances are paid out by borrowers in the form of cheques to others, and find their way back as deposits or lodgments in the same, or other banks. Other banks may then increase their advances on the strength of the increased lodgments. The only limit to this process is the fear that cash reserves may prove inadequate to meet the additional demands for cash which the issue of more credit will occasion.<sup>2</sup> On our hypothesis that no more goods are produced, new borrowers will have obtained purchasing power over goods which can only be obtained as a result of an equivalent diminution in the purchasing power of the rest of the community. Since there is no reason to suppose that the whole of this will be taken from previously existing borrowers, it follows that there is a strong presumption that the sum total of real credit in existence has been increased; but only at the expense of large sections of the community. The mechanism whereby this transfer is brought about is through the rise in prices which will result from the creation of new credit not backed by the creation of an equivalent amount of goods. When prices rise, the incomes of wage earners, salaried persons and creditors generally tend to rise more slowly and under the conditions we have postulated it is from these classes that the additional purchasing power of the new borrowers will be mainly drawn. The assumption that the stock of goods will remain unchanged is not, in fact, likely to hold good, for

<sup>1</sup> This seems unlikely on a large scale save as the result of a gradual process of change.

<sup>2</sup> For a full discussion, see Lavington, *op. cit.*, p. 131; Withers, *Meaning of Money*, pp. 64-65; Crick, "The Genesis of Bank Deposits," *Economica*, June, 1927.



some part of the purchasing power withdrawn from the classes mentioned, which would have been expended in goods drawn from the existing stock, is utilized by manufacturers and traders in augmenting the stock.

12. While the above discussion is over-simplified, it serves to point the moral. Additional real credit can only be created as the result of additional voluntary saving unless it is brought about by the over-issue of money credit by banks—whether agricultural or commercial makes no difference—so that prices rise. In this case benefits to new borrowers are accompanied by injurious reactions on the purchasing power of other classes of the community.<sup>1</sup> It is important therefore that banks should so regulate the issue of money credit as to keep prices as stable as is practicable.

<sup>1</sup> There are, of course, reactions on production as well as distribution. The normal result of such a policy is the incitement of a period of boom followed by a period of depression, i.e. the so-called trade cycle is engendered.

## CHAPTER II

# THE DEMAND FOR AND SUPPLY OF CREDIT

### I. DEMAND FOR CREDIT

1. The demand for credit arises because an individual, a business or a public authority<sup>1</sup> desires to obtain the control over a greater quantity of resources than it actually owns. This demand may be classified in different ways according to the purpose in view. For our purpose it seems best to divide the demand for credit into two classes though the line of distinction is not always clear cut in practice. These classes we shall call: 1. Producer's credit and 2, Consumer's credit, the former being divided into two sub-classes: (A) investment credit, and (B) commercial credit. With certain qualifications which we shall mention shortly, we shall be concerned with producer's credit in this book.<sup>2</sup>

#### 1. PRODUCER'S CREDIT

2. Producer's credit includes all loans which the borrower obtains with the intention of utilizing them in enabling him to earn an income. It will therefore cover credit to assist in the transport and marketing of goods and the performance of all kinds of services as well as in the actual making of goods. It is usually expected that interest will be met and principal repaid out of the additional income which the loan makes possible, though sometimes, as in the case of shares in a company, the loan may be permanent and only interest or dividends are paid to the lender who must sell his shares if he wishes his control over capital returned.

<sup>1</sup> In what follows we shall not discuss the credit demands of public authorities such as national or local governments.

<sup>2</sup> Investment credit may also be classified according to the degree of priority over the earnings of the undertaking, e.g. debentures, preference shares, ordinary shares, etc. To discuss these fully is outside the scope of this book.

*A. Investment Credit*

3. Investment credit is that form of producer's credit which is advanced for the construction or purchase of the more fixed or durable forms of capital such as railways, factories, mines or farms. These correspond closely to the "instruments of production" referred to in Chapter I and are usually described as the "fixed capital" of industry.<sup>1</sup> Normally, with the exception noted above in the case of shares in companies, it is expected that both interest and principal will be repaid from the sale of the goods or services for the production of which the fixed capital is used. In most cases this necessitates that the credit shall be advanced for a period of years.

4. The demand for investment credit arises because those with the desire or ability to direct business affairs are frequently unable, or find it inconvenient, to provide sufficient capital out of their own resources to establish an enterprise on a sufficiently large scale for their purposes.

*B. Commercial Credit*

5. Commercial credit is that kind of credit which is used to finance the operating expenses of a going concern. It is normally required to tide the borrower over a process of production by enabling him to meet the expenses contingent on that process, whether it be growing a crop, manufacturing a quantity of shirts, or marketing them. It is true, of course, that production and marketing are *more or less* continuous and that a business does not artificially divide up its operations and its expenses into separate parts. The manufacturer does not perform all the processes in the making of 1000 shirts before commencing the next "batch." At any one time there will be a number of "batches" of shirts each at a different stage in production. Nor does the wholesale merchant wait until he has cleared his shelves before buying in a new supply. He is continuously buying and selling, though not necessarily with perfect regularity. The fact remains, however, that expenses usually precede

<sup>1</sup> Agricultural land is not usually regarded as "capital" but it will be convenient for us so to regard it to avoid a great deal of circumlocution.

receipts and the necessity for commercial credit arises because expenses and receipts do not coincide in time or amount. Expenses will be incurred mainly for five purposes:

- (a) For repairs and the general maintenance of equipment.
- (b) To pay wages and salaries, commissions, etc.
- (c) To hold stocks of raw materials.
- (d) To hold stocks of finished, or semi-finished goods.
- (e) To pay for services such as advertising and transport.

A little reflection will show that in the main commercial credit is required ultimately to provide stocks of finished goods, semi-finished goods or raw materials.<sup>1</sup> Expenses for repairs and maintenance are expenses for wages and materials, while wages, salaries and the like are expended mainly in stocks of goods held by other people. Hence, if we go back far enough, commercial credit represents largely a transfer of the control over stocks of goods. These stocks are constantly being liquidated and paid for by the final consumer and receipts used by the individual who sells them to pay off outstanding debt.

6. Normally, therefore, the individual (or business) will require credit to meet expenses in reference to a given process until the goods are sold, when the loan can be repaid. Meanwhile, he may have commenced operations requiring greater or less expenses; but he is able to liquidate his first loan from the proceeds. It is apparent that the period of time for which loans are required will be shorter in the case of commercial credit than of investment credit, since the time required to complete a given process of manufacture or marketing is less than the time required to repay out of production the investment in fixed capital. Thus a wholesale merchant may buy a stock of goods taking three months

<sup>1</sup> Cf. Robertson, *Banking Policy and the Price Level*, p. 42: "Circulating capital does consist of real goods—not, however, of finished goods only, but of a shifting congeries of goods in all stages of their passage from the soil to the ultimate user or consumer; but it comprises also some goods—such as coal used in industry—which never reach the consumer's hands at all, and some—such as the crop for which the ground has been prepared but which has not yet been sown—which it takes the eye of faith to see." See also Hawtrey, "Working Capital," in *Trade and Credit*, Chap. VII.

to sell, and borrow, say £10,000 for the purpose. At the end of three months he has sold the goods for £12,000 and can repay the loan. If a manufacturing concern borrowed the whole of its initial capital and set out to accumulate a reserve to pay off its debt, it might require ten or twenty years, though frequently the method of raising this capital by means of shares would not necessitate repayment. Similarly, a farmer might incur expenses over a period of from six months to three or four years before his product could be marketed, after which his loan could be repaid; but in most cases it would take twenty or thirty years to pay off the whole purchase price of his farm out of income.

7. In general, a business enterprise does not borrow the whole of the working capital it requires. Some portion of it will represent a part of the initial capital of the concern, or will be accumulated out of past earnings. The greater part of the demand for commercial credit arises because the need for working capital is not constant but fluctuates from time to time. Hence, if the business has sufficient capital to finance its maximum needs, there will be a surplus of funds when the need for working capital declines which will be lying idle unless it is loaned to others who may require it. The normal procedure, however, is for the business to provide a certain residuum of working capital itself and to meet the fluctuating need above this amount by borrowing. Hence the demand for commercial credit arises mainly because the need for working capital is not constant.<sup>1</sup>

## 2. CONSUMER'S CREDIT

8. The two sorts of credit which we have been discussing represent a kind of loan which the borrower expects to be able to repay, together with interest, out of the added income which the loan enables him to earn. So called *consumer's credit* represents a type of loan for the purchase of goods which are not expected to be paid for out of the income derived from their use, but out of other resources.

<sup>1</sup> For a more detailed discussion, see Hawtrey, "What is Finance?" in *Trade and Credit*.

The goods purchased derive their value from the fact that they yield satisfactions direct and not through the assistance they lend in production. The practice of booking groceries at retail stores, or the purchase of a piano, or a motor car on the instalment plan are types of consumer's credit. The distinction between consumer's credit and "producer's credit," (i.e. investment or commercial credit), though useful is apt to be misleading, however. If a farmer obtains his food and clothing on credit from the store-keeper, paying for them out of the proceeds from the sale of crops, this will usually be regarded as consumer's credit. If he obtains an overdraft from an ordinary bank, or borrows through a co-operative credit society, his loan will usually be regarded as commercial credit. Which kind of credit does the loan represent? The goods purchased yield their satisfactions direct and do not appear directly to provide a source of income. On the other hand, they are necessary to enable him to work effectively as a productive agent in the cultivation and harvesting of crops. Many of the goods will be necessary if the farmer does not produce at all; but he cannot produce unless he consumes them. It would appear, therefore, that the same commodities may be both "producer's goods" and "consumer's goods." Further, the same loan may be expended partly in food and clothing, which yield their satisfactions direct, partly in the purchase of seed or manures, or the payment of wages, and partly in purchasing "instrumental" goods, such as ploughs, so that it is not always possible to determine the purpose of a loan from the method of borrowing adopted. In the same way instalment selling is often regarded as a form of consumer's credit, but presents the same difficulties. Some of the goods purchased on the instalment plan increase the productive capacity of the individual, or may themselves be instrumental goods, such as trucks, ploughs, or separators. A motor car may be used for commercial purposes, or for purposes of pleasure, or both. Through the facility which it offers for rapid transport, a motor car may save a good deal of valuable time to the farmer or business man. Even when used solely for purposes of pleasure, it may increase the

efficiency of the (city) owner by increasing his opportunity to enjoy fresh air and sunshine. While, therefore, the broad distinction between consumer's credit and other forms may be valuable for certain purposes, it can only be used very loosely and with proper recognition of its limitations.

9. Stated very briefly, the demand for consumer's credit arises because an individual desires to enjoy the use of goods before he wishes or is able to pay for them. This is especially likely to occur when income is received at intervals or in fluctuating amounts, in which case consumer's credit obviates the necessity for accumulating a reserve of purchasing power in advance; or when the commodity desired is high in price relative to the available income of the consumer so that it cannot be purchased for cash save after the lapse of a period of time during which the necessary funds are saved.

## II. SUPPLY OF CREDIT.

1. The source from which the supply of credit is drawn has been touched upon in Chapter I and only a very brief elaboration is required here. Since credit is the transfer of the control over resources, the existence of a volume of credit implies the prior existence of stocks of resources available for transfer. The only way in which capital or a stock of goods may be accumulated is by saving out of income. As has already been suggested, this consists in refraining from spending on goods available for final consumption, and directing the purchasing power thus liberated to adding to the stock of goods of the various kinds we have enumerated.<sup>1</sup> In part this saving takes place by those who invest the proceeds as fixed or working capital in their own business; in part by those who have no such desire or opportunity: and in part as the result of the actions of banks in increasing the volume of money credit. This last process results, as we have seen, in a forced transfer of purchasing

<sup>1</sup> Note that this stock will include so-called consumer's capital such as pianos which are not finally consumed until they wear out. Note also that the refraining from final consumption may be compulsory owing to the action of banks in creating money credit. See Hawtrey, *op. cit.*, pp. 14-16.

power from certain classes, through rising prices, to new borrowers and is utilized by them to provide fixed or working capital.

2. Voluntary saving may take place for a number of reasons. Some individuals will have incomes so large that they can scarcely avoid saving. Others will save to provide a capital sum against some future contingency; and others to provide a source of income in the future. Still others will accumulate surpluses for short periods, lending them until the time is convenient or the amount sufficient for investment in their own businesses.

3. The savings accumulated for such a variety of reasons may be lent in a large number of different ways through a wide variety of agents. They may be invested in securities through brokers, paid out as premiums to insurance companies, deposited in commercial banks or savings banks, advanced on the security of mortgages through solicitors, and so on. In large measure, short-period savings will be directed to providing the working capital of industry, and long period to providing fixed capital. This is by no means universally true, however, for much investment credit may be advanced by savings banks and similar institutions whose individual depositors lend to them for short periods only, while surpluses available for short periods are often invested in standardized securities which can be sold readily if the funds invested are required for other purposes. Conversely it may happen that an individual with resources permanently available for investment prefers to lend for short periods.

### III. CREDIT INSTRUMENTS

1. The process of borrowing and lending in modern society is carried out in many different ways, and is facilitated by the adoption of many different devices. In most cases some evidence is required indicating that credit has been granted, and on the basis of which claims usually may be enforced by law. In some cases evidence of debt may take the form of book entries only. Probably the greater volume of credit advanced, however, is evidenced by credit



instruments which we have defined in Chapter I<sup>1</sup> as written documents, drawn up in a legal form, and representing loans under specified conditions. The terms under which the loans are advanced, and the time of repayment, will normally be indicated on the documents themselves.

2. It is not necessary to our purpose to describe and discuss in detail the various types which are in general use in modern finance,<sup>2</sup> but at a later stage we shall refer to credit instruments as they are used in the financing of agriculture; broadly, credit instruments fall into two classes: (1) Investment credit instruments, and (2) commercial credit instruments. The former are used mainly to finance the fixed capital of industry and include stocks and shares of companies, mortgages against real estate, long term bonds issued by agricultural banks, and so on. The latter are used mainly to finance the circulating or working capital of industry and include promissory notes, drafts or bills of exchange, bills of sale, warehouse receipts, chattel mortgages and the bonds of agricultural intermediate credit banks used to finance the growing and marketing of crops and live stock.

3. The essence of such credit instruments is that they are titles to a future claim, either to the amount of the bond, mortgage, bill of exchange or draft or to the interest from the stock or shares. In most cases the credit instrument, (and the future claim which it embodies), is transferable.

4. Cheques, bank drafts and bank notes are credit instruments in the sense that they are not backed by 100 per cent. reserve of gold and are dependent for negotiability on confidence in the individual or bank who issues them. They are usually sight instruments, however, i.e. they are used for the discharge of a present transaction and do not represent a future claim or obligation. Hence they are not properly credit instruments. Sight instruments, together with some forms of commercial credit instruments, are often readily negotiable and are often used as media of exchange.

<sup>1</sup> Cf. Hawtrey, *op. cit.*, p. 11.

<sup>2</sup> For a more detailed discussion, see Moulton, *Financial Organization*, Ch. VIII.

It is common to classify such sight instruments somewhat loosely as credit instruments and it is sometimes desirable to follow this practice for the sake of convenience.

#### IV. ECONOMIC ADVANTAGES OF CREDIT.

1. The economic advantages of the use of credit in modern society are very great. On the one hand are large numbers of people who are able to accumulate savings in large or small amounts but lack either the capacity or the opportunity to utilize such savings in production. In some cases the savings themselves are too small, or for periods which are too short or uncertain, to render them capable of effective utilization; but, when aggregated together through the purchase of shares or through deposit in a bank, such savings can be used to advantage. On the other hand are business men engaged in the active direction of production who have the ability to control more capital than they are able to accumulate themselves. Similarly, there are some areas or countries in which the accumulation of capital is inadequate to enable their inhabitants to effectively utilize their natural resources and labour capacities, while there are other areas or countries in which capital is relatively abundant. Obviously the transfer of the control of capital from one class of individuals to the other, or one area or country to the other, will add greatly to the productivity of capital.

2. As regards *fixed* capital, these considerations are the more important in that many modern businesses are of prodigious size and the amount of fixed capital required is so enormous that it would be virtually impossible to provide it except from the savings of a large number of people. As regards *working* capital, it has been pointed out that the demand is not constant but usually varies from season to season or year to year. We have suggested that the trader, manufacturer or agriculturalist may either accumulate sufficient working capital to satisfy his maximum requirements, in which case it will be necessary for him to hold a large amount idle at other times or to lend it in the

form of short period loans; or he may accumulate a certain minimum, and finance the remainder by borrowing. In general, it will be advantageous to adopt the latter plan. Hawtrey points out that on the average over a long period the rate of interest charged on a temporary advance, other than on loans at call or short notice or the discount of a bill, approximates to the same rate as the interest on long term loans.<sup>1</sup> If the business man invests his temporary surplus funds, he must usually do so in such a way that they are withdrawable at short notice in order that they may be available just when required. The rate of interest on such loans—as, for example, on deposits at short notice with a bank—is low.

3. If the maximum requirements for working capital have been met by long term loans these will normally be at a higher rate of interest than will be obtained on the surplus funds temporarily invested by the business man. Hence there will be a loss to the extent of the difference between the two rates. Even if the total capital requirements can be provided by the business man himself, it will pay him to invest the difference between minimum and maximum requirements for working capital in long term investments and borrow for short periods when necessary, since the rate received on his long period investments will be greater than on surpluses deposited at short notice. The business man may, of course, lend his temporary surpluses direct, without the assistance of a banker or other middleman; but this merely means that he is bearing the cost of marketing himself. In most cases there will be no special advantage derived, but rather an additional cost; for the banker is a specialist handling large amounts and can in most cases perform the work of marketing credit more cheaply. Direct marketing in the form of temporary advances "is not worth doing unless it is done on a considerable scale, and the trader who does it is then half-way to becoming a banker. In the same way a trader who uses his surplus funds to buy Stock Exchange securities with a view to selling them again when he needs the money, must acquire the special skill of a

<sup>1</sup> See *Trade and Credit*, p. 121.

dealer in the investment market."<sup>1</sup> In the case of a farmer who is remote from financial centres the time and trouble involved in investing small temporary surpluses, even with a banker, would scarcely be repaid by the interest received, quite apart from the considerations discussed above. In consequence of these conditions the provision to meet what may be called the residual need for working capital by means of credit brings important economies to those engaged in production and makes it possible to utilize in assisting production the temporary savings of a large number of individuals.

4. Hence the use of investment credit makes possible modern large scale industry, while the use of commercial credit makes it possible to keep temporary surpluses more actively employed than they could otherwise be. The gains in productivity arising out of the use of savings which could not otherwise be utilized in production, or the transfer of the control over capital to people or places where it can be utilized more effectively, are reinforced because the practice of borrowing and lending encourages the development of a body of expert middlemen, who pass judgment on the relative merits of different propositions and direct the flow of capital into investment. As in other branches of economic activity, specialization is conducive to efficiency and specialized credit middlemen do much to increase the productive capacity of society by the directive influence they exert on investment. The reward for saving tends to be greater and additional saving of capital is encouraged, thus further augmenting human productiveness. These effects tend to be cumulative, for with increased productivity comes greater capacity to save.

5. The full realization of these economies in modern society is intimately bound up with the use of credit instruments. The advantages consequent on the use of such documents may be briefly stated as follows:—

- (a) In the first instance, the use of marketable securities in the form of stocks, shares or bonds, makes it

<sup>1</sup> Hawtrey, *op. cit.*, *loc. cit.*,

easier to accumulate into large aggregates small amounts of investable capital, in the same way as banks accumulate a large number of individual deposits. The large joint stock company or the public authority requiring a large loan to provide the permanent capital it needs is seldom able to obtain this from one or two individuals, but must endeavour to obtain it from a large number of different sources. The cost of raising the necessary capital by means of direct loans from a large number of widely scattered investors would be enormous. By the use of shares and such securities the total loan required is divided up into a large number of small and equal units, each share being of the same amount as every other share in the same issue. Instead of lending directly such savings as are available for investment, the small investor may purchase securities through specialized marketing concerns. By this means small savings may be utilized for investment in fixed capital at a cost which is much lower than would result if no such securities were used, and the accumulation of large aggregates of capital is facilitated.

- (b) The value of such securities for different concerns can be quoted in more or less standardized form and can be graded according to the degree of risk they involve. The existence of specialized brokers or agents dealing in securities provides a source of information to the investor which reduces the necessity to assess, by personal enquiry or inspection, the value of the property against which the security is offered. Further, while the non-expert investor may sometimes run the risk that the market value of shares is disturbed from its real economic level, by manipulation and other influences of which he has no knowledge, the existence of an active market in shares does in general cause the price of each security to approximate more nearly to its real value to the investor than if no

such market existed. In short, the use of standardized credit instruments creates a market for borrowing and lending which obviates the necessity for establishing personal contacts between borrower and lender and for the individual assessment of the security behind the loan. By this means the market is widely extended, the cost of credit over geographical areas is equalized, and the cost of capital transfer is reduced. Further, the possibility of grading securities according to the degree of risk enables the investor to spread his investments more judiciously.

- (c) Marketable securities provide a useful form of collateral which can be offered to the banker as security against the commercial credit which it provides, thus indirectly reducing the cost of commercial credit by providing a readily assessable form of cover against loans.
- (d) Securities of the type considered above represent, in most cases, an investment for a considerable time. The joint stock company, the municipality, or the farmer, would find it extremely inconvenient if the loans received to finance the fixed capital needed were for short periods and had to be renewed at frequent and uncertain intervals. On the other hand, the investor does not wish to tie up his resources for ever, but will usually prefer to invest them in a readily realizable form. Marketable securities provide him with a type of investment by which this may be achieved. The demand for capital is permanent or quasi-permanent. The supply, as far as the individual is concerned, is frequently short and discontinuous. A permanent demand and a series of short and discontinuous units of supply are equated by the device of credit instruments, which enable the "short lengths of capital" to be added to one continuous aggregate, in the same way as short period deposits are united by the bank. The convenience to the lender, which this gives, lowers the price which

he is prepared to accept for the service of credit provision. In the words of Lavington: "These facilities for the rapid and convenient exchange of securities yield an important social economy; they enable the burden of waiting and risk-bearing to be continuously shifted from one capitalist to another in accordance with the exigencies of his particular circumstances; they enable this burden, therefore, to be continuously shifted to those who, from time to time are most willing to assume it, and will bear it at the lowest price. . . . It follows that by means of this organization each capitalist is enabled to supply capital in the quantity and for the period which is most convenient to him."<sup>1</sup>

- (e) The same sort of economy arises in respect of those forms of *commercial* credit instrument which are readily negotiable. Thus a bill of exchange is a promise to pay a given sum at a future date. It represents normally a credit given by the exporter of goods to the importer and it is expected that the loan will be repaid out of the proceeds from their sale. The seller of the goods will frequently find it inconvenient to hold the bill until it matures and will sell it at a discount. The bill may pass through several hands before it matures, each holder thereby investing in a short-term loan to the purchaser of the goods. The working capital of the purchaser is therefore provided by means of a number of short-period investments during the currency of the bill. If no such negotiable credit instruments were in use, the seller of the goods would often be unable to extend credit to the purchaser, since he would require to make the loan for the whole period himself. Hence bills of exchange and other negotiable commercial credit instruments assist materially in the provision of working capital and thereby stimulate manufacture and trade.

<sup>1</sup> *The English Capital Market*, pp. 224-5.

6. One final point is to be noted. With the systematization of borrowing and lending, titles to debts or credits, in the form of cheques, bank drafts, bills of exchange and promissory notes have become increasingly used as a means of transferring purchasing power instead of gold and other forms of currency proper. It has thus been rendered possible to utilize media of exchange which are both cheaper than gold and are more efficient, especially when purchasing power has to be transferred long distances. These substitutes for gold can be expanded and contracted more sensitively than the supply of gold to meet the needs of industry and trade. While it is outside the scope of this book to discuss these in detail, they are by no means the least important of the economies arising out of the use of credit.



## THE PRICE OF CREDIT

## I. WHY A PRICE IS PAID

1. Credit is not generally given freely, but like any other commodity or service is sold at a price. A loan is comprised of two elements: an amount and a period of time. The price paid for a loan is the *interest* stated as a percentage rate per annum, multiplied by the length of time for which the loan is made. Since a credit or a debt is normally expressed in terms of money, interest is normally paid in money at an agreed rate per £100 of loan per year. This rate may be defined as the *money rate* of interest by contrast with the *real rate* of interest or the *commodity rate* of interest, which is measured by the purchasing power of the money interest. The two do not always change together, or by the same amounts, since the purchasing power of money may change at a different rate from the change in the rate of interest. Further, the real rate of interest may change during the currency of a loan, because prices rise or fall in the meantime.

2. A price is paid for credit for two reasons. As we have stated, the supply of credit necessitates the saving of capital and the transfer of its control from owners to borrowers. Those who save forgo the present consumption of valuable things for the possibility of enjoying the consumption of valuable things in the future. In short, they must *wait*. Most people prefer the present enjoyment to the future enjoyment of consumption. As pleasures become more remote in time, their appeal becomes less strong, and the postponement of enjoyment is faced with reluctance. Normally, identical pleasures appear less and less desirable the longer becomes the period of time before they can be enjoyed. Expressed in economic terms there is a natural *time preference*, or a tendency among human beings to *discount the future*. Hence the present command over purchasing

power will not be exchanged for a future command over purchasing power unless that future purchasing power is greater, or unless its expenditure is deemed likely to bring greater satisfaction because the need is expected to be greater or new avenues of enjoyment are opened up. In other words, the sacrifice involved in waiting must normally be paid for to call it forth. Some individuals have incomes so large that saving is automatic and involves no measurable sacrifice. Others would save to provide against old age or sickness, or to provide for dependents, even if there were no interest, in which case the incentive to save is the anticipation of a greater need—and therefore a greater benefit from the expenditure of a given amount—in the future than in the present. Others accumulate surpluses with banks for short periods on current deposit, on which they receive no interest, and in this case the reward for waiting is the added convenience and certainty resulting from having a store of purchasing power from which future contingencies to make payments may be met. Still other savers are business concerns which accumulate a reserve against future contingencies in the business and which are influenced less by the rate of interest in determining the amount put aside to reserve than the probable future needs and the surplus available for the purpose. While there are many to whom the rate of interest is a secondary consideration as an incentive to waiting, there is still an appreciable proportion of the amount saved in modern society which would not be called forth unless interest were offered as a reward; and since interest is paid for this, it must also be paid for the other units of saving, except in such cases as deposits on current account in respect of which the sacrifice involved in waiting is compensated by the convenience in making payments.<sup>1</sup>

3. On the other hand, those who borrow are prepared to pay interest, either because (a) as in the case of spendthrifts or governments engaged in war, they prefer to increase present consumption at the expense of future consumption,

<sup>1</sup> By some banks, e.g. in the United Kingdom, interest is, in fact, paid on current deposits.

or (b) the capital which they borrow is expected to yield them a greater income in the future than could be earned without it.

4. On the supply side, therefore, interest is the reward for waiting. On the demand side interest is paid because credit confers a service.

5. The *gross rate of interest, or the commercial rate actually paid*, includes elements to allow for such factors as risk and cost of marketing, which we shall discuss later. The *net rate of interest or pure interest* is the amount paid for the actual service of providing credit exclusive of these elements, i.e. for the service of waiting. The sacrifice involved in waiting is not affected by the nature of the business to which a loan is made, and the *pure interest* is the same for all classes of loans. Differences in the gross rate of interest therefore represent differences in the charges for elements in gross interest other than pure interest. In this book we shall be concerned mainly with the conditions affecting the margin between pure interest and gross interest in respect of loans to farmers. Hence we shall have very little to say about the theory of pure interest.

6. If we neglect that part of interest which represents payment for risk, marketing of credit and similar factors, the rate of interest, or the price of credit will be determined, like the price of any other commodity, by general conditions of demand and supply. It is determined, not by the demand for and supply of capital, but by the demand for and supply of the control over capital. Briefly, the demand for credit is determined by the opportunities which entrepreneurs see for the profitable investment of capital in amounts greater than those which they themselves possess. The supply of credit depends on the capacity and the willingness of individuals to save and transfer the results of saving to others. The capacity of individuals to save depends on the possibility of earning a surplus over immediate requirements. The willingness to save depends on general habits of thrift or extravagance, on the degree of security making it possible to enjoy the fruits of saving in the

future, and on the opportunities which are available to use the fruits of saving to augment future income. The extent to which the fruits of saving are transferred depends, as we have seen, on the general level of confidence; on the efficiency of the organization for the marketing of loans and on the reward which is offered by borrowers for the use of credit. As in the case of other commodities or services, an increase in the demand for credit through an extension of the scope for the profitable use of capital will increase its value, i.e. will increase the rate of interest, and this in turn will increase the amount of credit forthcoming by stimulating new saving or by inducing some owners of capital to lend it rather than use it themselves. Similarly, any condition increasing the supply of credit will reduce the rate of interest, and the demand for credit will be stimulated because avenues of production previously unprofitable will now become profitable.

## II. ELEMENTS IN GROSS INTEREST

1. It has been indicated that the price actually paid for credit, i.e. gross interest, is greater than pure or net interest, which is the reward for waiting simply. Gross interest is compounded of the following elements in addition to pure interest:—

- (a) Payment to recompense for the risk and uncertainty involved in making a loan.
- (b) Payment for marketing and management.
- (c) In some cases a monopoly element.

### 1. RISK AND UNCERTAINTY

#### A. *Loss due to Changing Conditions*

2. Modern economic conditions are in a state of continuous change. In no industry or business are conditions absolutely static and invariable. The demand for food and clothing, for the services of transport or for hotel accommodation, in fact for all the goods and services which man requires, varies not only from year to year, but also from season to season or from week to week. Conditions of

supply of goods are constantly changing, due to the discovery of new methods of doing things, to the vagaries of the weather, to pests and accidents, industrial and social disturbances, and so on. Even if these conditions could be correctly foreseen, they would involve a loss or cost which would provide an essential part of the expenses of production. Agents of production are "intractable." They cannot be diverted with a perfect sensitiveness to meet changing needs. In consequence, some productive forces are always incompletely used, and some demands are always incompletely satisfied. If the farmer has sufficient ploughs or horses during the season of the year when they are needed most, they are likely to be only partially utilized during other parts of the year. If the hotel proprietor has sufficient rooms to meet all requirements for accommodation during the holiday season, there will be many empty rooms at other seasons. If the trader is to meet the fluctuating demands of his customers he must hold stocks of goods. Even though such conditions can be accurately foreseen, they involve a cost, either in the nature of capital incompletely utilized or satisfactions reduced to consumers.

### *B. Risk in Business*

3. Under the highly complex conditions of modern society, however, it is impossible to forecast such changes with absolute precision. In addition, therefore, to the losses which are dependent on changes of themselves, even though such changes are capable of accurate forecast, there arises a loss due to the fact that future conditions are not, in fact, perfectly calculable; for it is apparent that the difficulty of adjusting means to ends is enhanced if future changes in conditions of demand and supply cannot be accurately foreseen. "Corresponding to this realised loss" (i.e. to the actual loss due to the fact that conditions of change are not accurately foreseen) writes Lavington, "is the probability of its occurrence, the condition to which the term *Risk* is applied. *Business risks consist, then, in the probability of occurrence of all those losses, and only those losses, which arise from incalculability.* But inasmuch as they arise mainly

in the development of ventures whose prospects are not susceptible of precise mathematical expression, it is convenient to emphasize the fact that they depend more upon personal than upon actuarial valuations. This may be done by slightly amending the definition of Risk: by defining it not as the (actuarial) *probability*, but as the (individual) *expectation of loss*.<sup>1</sup>

4. We may define risk, then, as the unrelieved expectation of loss dependent upon the imperfect calculability of future economic conditions. Before an entrepreneur will engage in an enterprise he requires a return which will recompense him for this unrelieved expectation of loss<sup>2</sup> in addition to the return which would be considered reasonable if future conditions were perfectly calculable.

### C. Uncertainty in Business

5. There is a still further cost, however, arising out of risk as so defined, but distinguishable from it. Risk relates to the fact that, although conditions in a given period may not be calculable with any accuracy, experience may be used as a guide, such that the average loss over a period is known more or less closely and there is the expectation that future loss will approximate to this average. Together with such an expectation of loss, there is also a margin of indeterminateness "The addition that he (i.e. the entrepreneur) has made to his expenses of production covers only his *expectation*; he cannot be sure of either the temporal incidence of his realized losses or of the degree to which they will diverge from his expectations; and the consequent incalculability of his returns imposes on him a further real cost for which he is entitled to obtain compensation."<sup>3</sup> This further real cost may be defined as the cost of *uncertainty-bearing*, and consists in the deviation of actual losses from the expectation of

<sup>1</sup> "An Approach to the Theory of Business Risk," *Economic Journal*, March, 1925, p. 189. This article, which is continued in the *Economic Journal* for June, 1926, is an extremely able and suggestive treatment of the problem, and provides the basis for the present discussion.

*Italics are mine.*

<sup>2</sup> I.e. Unrelieved in the sense that it cannot be eliminated without some additional cost.

<sup>3</sup> Lavington, *An Approach to the Theory of Business Risks*, p. 195.

losses. In short, it arises from the fact that expectations are liable to error.<sup>1</sup>

6. We may illustrate by the case of a dairy farmer, whose operations are subject to change of many kinds. Some cattle will die year by year as the result of disease and accident, or will become unprofitable through old age. In addition, the growth of pasture will vary from year to year with variations in climatic conditions, while variations in the cost of requisites and in the price of finished products will also affect his returns. In order to ensure that his cattle, his farm, and his labour are used to the fullest capacity, he must be able to foresee all the changes with perfect accuracy and meet them with perfect sensitiveness. He will have to be able to increase or reduce his purchases or breeding of cattle in accordance with variations in the prolificacy of his pastures or variations in cattle lost through sickness, accident, or old age; to meet variations in the supply of feedstuffs by carrying over stocks of hay or ensilage from one year to another. Since conditions of demand will still vary, he will require to change from dairying to other branches and back again to dairying with variations in the relative value of crops.

7. In fact, however, it is impossible to effect these adjustments with the necessary degree of rapidity, and even though the variations could be perfectly foreseen, the actual quantity return per unit of productive effort would be less than if adjustments in production could be made instantaneously to meet all variations in conditions. In short, the intractability of resources increases costs. In order to make his operations worth while, the return the farmer (or other business man) receives per unit of product must be correspondingly increased.

8. If, however, he cannot foresee future changes accurately, but is faced instead with an "unrelieved probability" of change, he is less able to re-adjust his productive effort

<sup>1</sup> Hardy, *Risk and Risk Bearing*, p. 1, would appear to confine the definition of risk to this element of uncertainty, for he defines risk as "uncertainty in regard to cost, loss or damage." I prefer Lavington's treatment.

to varying conditions than if results are calculable. In consequence, the actual quantity return per unit of productive effort is further reduced. In order to make it worth his while to continue production, the reward he receives per unit of product must therefore be further increased. He will not be fully rewarded for his effort unless he receives a return to compensate him for the "unrelieved probability of loss" due to the "incalculability of future conditions." In fact, however, we have suggested that it is the *expectation* of such loss rather than the *actual* probability which will influence the individual in deciding what additional return will afford an adequate recompense. In consequence of this expectation then, the farmer or other business man will not invest until the return per unit of produce, i.e. its price, is raised sufficiently to compensate for the expectation of loss resulting from incalculability.

9. Assuming that the business man has implicit faith in his own "expectation" and feels that he can estimate accurately the *average* loss over a period of time, will he also require a higher *average aggregate net income* before he will undertake the enterprise, or will he be satisfied with such an increase in the price per unit of produce as will bring him in the same *average* return as would result if conditions were perfectly calculable? It is apparent that most individuals will prefer a *certain* income, even though it may vary from year to year, rather than an income which varies from year to year in an uncertain fashion, even though the average may be the same. Hence, not only must the *price per unit be increased* to compensate for the expectation of loss due to incalculability of the future, but also the anticipated average aggregate net income must be larger, before the enterprise will be undertaken, in order to compensate for the uncertainty in the variation of income from year to year.

10. We have pointed out, however, that because the expectation of loss is a matter of individual judgment and is not mathematically determined, few people are likely to believe in their own expectations implicitly. The dairy



farmer who *expects* an average of ten cattle to die each year, and who *expects* that these will vary between a minimum of one and a maximum of 15, will not be *sure* either of the limits of probability in any one year, or of the average loss over a period. In addition to the uncertainty in income which we have suggested would occur even though the average expectation were correct, there is this uncertainty as to the extent to which actual losses will diverge from the expected, not only from year to year, but also on the average. This imposes an additional difficulty in adjusting means to ends in production, and opens up the chances of loss greater than those expected. This element of uncertainty, both in the manner in which income will vary from time to time, and in the loss which may be expected, will hinder investment in an undertaking, until the prospects of gain are sufficient to compensate.<sup>1</sup>

11. In general, the greater the degree of risk, or the greater the expectation of loss due to changing conditions, the greater also the degree of uncertainty.

#### D. *Kinds of Risk*

12. We may consider risk and uncertainty together in relation to the price paid for credit, since the two are in general inseparably bound together. We will consider the problem first from the side of production, from which comes the demand for credit, using production in its broadest sense as including marketing, transport and other services necessary to prepare economic goods for consumption.

13. The chief kinds of risk may be summarily classified as follows:—

- (a) *Risks due to natural causes*: This source of risk and uncertainty will include variations in the weather, in the amount and time of occurrence of rainfall and sunshine, frosts, winds, hail, and floods; pests and disease, and fire and earthquake. In this class, too, might be included the risk of loss through the perishability of products. Such kinds of risk are especially likely to occur in agriculture.

<sup>1</sup> Cf. Lavington, *op. cit.*, p. 196-7.

- (b) *Risks due to technical causes*: This source of risk includes such causes as the breakdown of machinery in a factory or on a farm, variations in the quantity or quality of a finished product due to imperfections in the quality of the raw material, in the working of machines, or the skill of labour, delays in transport, and so on, together with errors in judgment as to the efficacy of an operation such as, for example, the drainage of a swamp or the use of a particular kind of fertilizer.
- (c) *Risks due to social hazards dependent on the conduct of individuals or groups*. This class would include robbery, defalcations, forgery, strikes, riots, wars, tariff changes, tax reforms, and prohibitory laws.<sup>1</sup>
- (d) *Risks due to market conditions*: These depend on variations in general conditions of demand and supply which are not exactly predictable. They are obviously closely connected with, and in large measure dependent on, risks of the three types included above. Not only will such conditions afford a direct loss to the producers immediately concerned, but also they will influence conditions of demand and supply for other goods and services not directly affected, for they project an element of change into the demand for and supply of such goods and services. A bad harvest due to unfavourable weather will influence the demand for transport service and the services of middlemen, as well as the productive capacity of those who use the crop as a raw material. In addition, however, are changes in the market due not to such technical, natural or social causes, but to changes in demand dependent on such factors as the introduction of a rival commodity, or a change in fashion, or a movement in the general level of prices; or changes in supply due to the adoption of new methods. All these conditions introduce an element of chance not necessarily connected directly with risks of the three kinds previously mentioned.

<sup>1</sup> Cf. Hardy, *op. cit.*, p. 3.

*E. Conditions on which Risk depends*

14. On the side of production and therefore of the demand for credit, the degree of loss due to risk and uncertainty is closely related to four main conditions: (a) *The frequency, extent and rapidity of change.* If conditions were absolutely stable, it is apparent that there would be no loss due to the incalculability of future conditions, and no uncertainty; for the past would be a perfect guide to the future. The more frequent the occurrence of change and the greater the degree and rapidity of change, the more incalculable are future conditions likely to be, other things being equal, and the greater the degree of risk and uncertainty.

15. (b) *The difficulty of obtaining knowledge as to the future.* It follows also that risk and uncertainty are likely to be increased the more difficult it is to obtain knowledge as to the nature and extent of future change. This difficulty may depend on the nature of the change itself, or upon the form of organization of the industry concerned. Thus, in reference to agriculture, it is impossible to forecast the weather with any certainty for any length of time ahead, owing to the fact that the science of meteorology is not sufficiently advanced; while in respect of marketing conditions and the trend of prices, it becomes difficult for the farmer to obtain information to be used as a basis of forecast owing to the loose integration and the wide area covered by agricultural industries.

16. (c) *The possibility of organizing to reduce or prevent risk.* It will be apparent that some kinds of loss due to changing conditions may be prevented or reduced by providing special technique or organization. In some cases such a provision may take the form of organization to obtain information *in advance* so that changes are anticipated, thereby increasing the capacity to adjust means to ends. In other cases it may take the form of special equipment or conditions of work. Thus an electric power system may have a reserve plant which can be used in the event of breakdown, or a cotton spinning factory may

reduce breaks in threads by adjusting the moisture content of the air, or the risk of fire may be reduced by the use of non-combustible building materials. In a wide variety of ways losses due to change may be reduced: by providing the means to anticipate them more accurately; by establishing equipment which can be utilized when changes occur, even when the changes themselves cannot be accurately foreseen; by providing devices to prevent changes, and so on. It must be noted that, although such provisions may actually reduce risk itself, yet they involve a cost which must be met. The cost of risk bearing may also be reduced by transferring it to those who specialize in the taking of risk. Although the actual risk in each individual enterprise may remain unchanged, the sum total of risk to the specialist in risk taking is less than the sum of all the individual risks because they are spread over a wide variety of undertakings which do not suffer loss at the same time, and because the probability of losses over a wide variety of undertakings can be determined actuarially with a high degree of accuracy. Although this "insurance" against risk by transferring it to a specialist undertaking, such as a fire insurance company, involves a charge, it reduces materially the risk and uncertainty of loss. In place of the uncertain possibility of a serious loss the business man is faced with the certainty of a much smaller periodic payment.

17. (d) *The intractability of resources.* For a given degree and rapidity of change and a given degree of knowledge, it is apparent that the chances of loss will be greater the more intractable are the resources used in production—in other words, the more difficult it is to change rapidly the amount and direction of productive effort. In general this intractability will be greater the more specialized are the agents of production, and the longer the period required in production. Speaking generally, the risk dependent on a given degree of change and imperfection of knowledge is greater, the greater the investment in fixed capital, which is often highly specialized and cannot be directed to other uses at all rapidly.

*F. Risk to the Lender*

18. We may now discuss risk and uncertainty as they affect credit from the side of supply. The conditions we have been discussing influence the amount of risk to the lender; for, *other things being equal*, the greater the degree of risk and uncertainty involved in a given investment of resources in production, the greater the degree of risk and uncertainty to the person who advances credit to enable production to be carried out.

19. In addition, however, we have to consider certain factors as they affect the creditor, which may enhance or mitigate to him the risks of the kind we have been considering. It should be noted first, however, that the conditions determining the price which the lender demands before he will advance a sum of money depend on his own individual estimate of the risk and uncertainty involved to *him* personally; not on the estimates of the entrepreneur of the risks and uncertainty involved in the enterprise to *him* personally. The following conditions will influence the remuneration required (as an element in gross interest) before the lender will advance credit.

20. (a) *The personal factor.* In many forms of lending, such as investment in the stocks or bonds of a Government, municipality or corporation, we may say that the risk element in gross interest is dependent on the lenders' estimates of the degree of risk and uncertainty in the enterprise itself. In many forms of credit, however, the loan takes the form, not of the purchase of stocks or bonds, but of a direct advance to an individual or concern. This may be secured by a lien or mortgage on the business for which the loan is required, by collateral security, or merely by the personal promise of the borrower to repay. The nature of the security will of course affect the gross interest which the lender is prepared to accept, but except where a large margin is allowed and the amount of the loan is regarded as being completely covered by the security, so that the personal factor does not then matter, the lender must take into consideration the integrity and business ability of

the borrower, as well as the nature of the business. If the ability and integrity of the borrower are open to question, this will impose some risk and uncertainty in addition to that inherent in the nature of the business, and this will appear as an element in gross interest.

21. (b) *Nature of security.* Where the nature of the security offered by a business man is the "prospective earning power of his undertaking," the lender meets both the risks inherent in the nature of the business and in the personality of the borrower. Where the loan is secured by a mortgage on the assets of the concern, or collateral security, such as a mortgage or shares of some other undertaking, the risk to the lender now depends on the possibility that the value of the security will fall during the period of the loan. When the security is in the form of a mortgage or lien on the undertaking itself, the risks inherent in the business itself are not entirely removed from the lender, but they can be considerably reduced to him by allowing a sufficient margin. Thus, if a bank advances money to the extent of 60 per cent. of the market value of a crop held in store for a length of time (say six months) sufficient to cover the period of marketing, and holds a lien over the crop in the form of warehouse receipts as security, it runs some risk that the value of the crop may fall by more than 40 per cent., though this risk is not great in ordinary times. It runs practically no risk in so far as the personal integrity and capacity of the farmer is concerned. If the advance is made against a standing crop, the risk involved in a given percentage loan on the estimated value is greater, since the risk of crop failure (dependent in part on the capacity of the farmer) or of an erroneous estimate of crop yield must be added to the risk of a fall in market value. The cost of such an advance will be correspondingly increased. If, however, the loan is advanced for the purpose of marketing a crop against the security of government bonds or a first mortgage on the farm, risk to the lender practically disappears, since the value of such security is not likely to fall appreciably during a period of six months. On the other hand, a loan advanced on first mortgage for the purchase of a farm may involve

some risk to the lender, since the loan is for a longer period, and the value of land may fall in the meantime. Such risk will not be projected as an element in gross interest, unless the lender thinks it possible that the value of land may fall until it is no longer covered by the mortgage. For obvious reasons the gross rate on second mortgage will usually be greater than on first.

22. The risk to the lender will be reduced, and the gross interest will be lessened, where the security is pooled, as in the case of some co-operative credit societies, in which the members are collectively and individually liable for the debts incurred by members through the society; or where a third party of proved standing and greater resources acts as guarantor, as in the case of Acceptance Houses, or of the State when it guarantees the payment of interest on bonds issued by an agricultural bank.

23. (c) *Imperfection of knowledge.* We have stressed the fact that imperfection of knowledge is the essential condition on which risk and uncertainty in production depends. In the same way risk and uncertainty to the lender depend on his lack of perfect knowledge; but in his case imperfection of knowledge as to the conditions affecting the processes for which credit is required may be accompanied by imperfect knowledge as to the integrity and capacity of the borrower or the value of the security offered. The more difficult it is to obtain reliable information concerning these factors, the greater will be the risk element in gross interest, and the greater the cost of credit to the borrower. Speaking generally, the difficulty will be relatively greater in the case of new ventures, and where the business is complex. It will be the greater also the more remote the borrower and lender are from each other, and the smaller and more loosely organized the business units engaged in borrowing and (or) lending. There is likely to be less publicity attached to the operations of small and loosely integrated producers and information is likely to be more difficult to obtain. On the other hand, small and loosely integrated units of lenders will find it more difficult to

develop the necessary machinery to obtain information than large concerns or organized groups, though in some instances, as for example in the case of village storekeepers or money lenders, or small country bankers, they may have opportunities for personal acquaintance which will counterbalance.

24. (d) *The "liquidity" to the lender of resources lent.* By this we understand the ease and rapidity with which a creditor, should he desire it, can resume the control over the purchasing power which he has transferred to the borrower in the form of a loan. In very many instances the lender is faced with the possibility that he may require to use in the future the purchasing power which he is now lending. It will be apparent that he runs the chances of embarrassment or loss if his loans are made in such a form that he is unable to convert them into ready cash when the need arises. Even though an investment may be perfectly sound, the degree of liquidity of resources lent will affect the risk to the lender through the possibility that he may be unable to meet future contingencies. It will therefore influence the price which he is prepared to accept in return for a loan. If the time of repayment is uncertain, this will render his future control over purchasing power less calculable and an element of chance may be thrown into his future business operations or personal plans. Investment in a readily marketable security will be forthcoming at a lower rate of interest than in a security equally sound, but less widely known and therefore less marketable, since the former can be sold more readily to provide cash to meet an emergency. The *length of time* for which a loan is made is also important for similar reasons. A person who deposits money with a bank on current account is prepared to forego money interest, since resources are then held in a form which can be used immediately to make payments. Deposits which can be drawn at short notice, say seven days, are available at a low rate of interest, since their liquidity is only slightly less and they can be translated into actual purchasing power at short notice. As the period of deposit increases to three months, six months or a year, the rate rises, for the degree of liquidity decreases. For a short



period the lender may be prepared to accept something less than the *pure* rate of interest on long loans, the balance between the actual rate and the pure long-period rate representing the value of the convenience to him of being able to hold resources in a form more or less readily available to meet contingencies. For similar reasons, a bank is reluctant to advance more than a certain proportion of its funds for a long period against (say) agricultural land even though the security may be perfectly sound, since it must hold sufficient assets in a form which can be called in readily to meet possible demands by its creditors. Other things being equal, the bank will charge a lower rate for loans at call or short notice than for loans for longer periods. not because long term loans are less likely to be repaid in full when due, but because the short period loans represent a reserve which can be more readily drawn upon in case of need.<sup>1</sup>

## 2. COST OF MARKETING AND MANAGEMENT

25. Since borrower and lender are usually remote from each other and have little knowledge of each other's operations, the transfer of the control over resources has been taken over by a specialized class, or classes, of intermediaries, who are the credit middlemen or retailers of credit. The primary function of such intermediaries is to establish contacts between borrowers and lenders, in the same way as the merchant establishes contact between buyers and sellers of goods. Incidental to this function, and in many cases inextricably blended with it, are other functions almost, if not quite, as important. Thus in some cases the methods of marketing credit adopted lead to the taking over of risk by the marketing agency, or to the reduction of risk by the pooling of security, the spreading of investments, or other means. In some cases, the nature of the loan is changed in the process of marketing, and the credit intermediary overcomes the lack of coincidence in time and amount of loans and borrowings. In some cases also,

<sup>1</sup> See Hardy, *op. cit.*, pp. 27-28.

the credit middleman directs the flow of credit and thereby influences the distribution of productive effort.

26. The services which credit middlemen perform must be paid for, and their cost reveals itself, sometimes as an element in gross interest, sometimes as a special fee or commission. In the latter case, it is reasonable to infer that in the long run creditors will expect to be compensated in the interest they receive for the fee or commission they pay and that this will tend therefore to be projected into the interest charge. It must not be imagined, however, that the performance of services, such as those mentioned, by a special class of dealers in credit will cause the gross rate of interest to be higher than if lenders and borrowers sought out each other. On the contrary, the division of labour which it involves, leads to important economies which reduce the margin between pure and gross interest, and benefit both borrower and lender.

27. In some cases the credit middlemen are comparable, in the services they render, to the real estate agent who sells or buys property on commission, without himself owning it. Thus in some countries solicitors are an important part of the money market, acting as agents who "relieve the investor of marketing work by placing him in contact with a suitable borrower."<sup>1</sup> Similarly, the share broker acts as intermediary between the investing and borrowing public.

28. In other cases the credit middlemen are comparable with the retailer who holds stocks of goods, of which he is the legal owner, for distribution to the consuming public. Thus, ordinary banks perform their function by themselves borrowing and lending resources for which they become legally responsible as principals. While intermediaries of the first type effect contacts between individual borrowers and individual lenders, intermediaries of the second type accumulate a general fund of resources from a large body of investors and advance the funds thus accumulated to a large body of borrowers. The contact they establish is not between two separate individuals, but between two *groups*

<sup>1</sup> Lavington, *English Capital Market*, p. 117.

of individuals. In some cases both the borrowers and the lenders are an homogeneous group in the sense that the advances are for similar purposes, while the lenders advance resources in a particular way. Thus the *Landschaft Banks*, in Germany, and the *Crédit Foncier*, in France, borrow from the investing public by the sale of issues of bonds, each bond in a given issue being similar to every other, and advance the funds thus accumulated to those who desire to purchase or retain the control over landed property. The securities offered by the individual borrowers are similar in kind to each other and usually take the form of a mortgage on real estate. On the other hand, ordinary commercial banks accumulate a heterogeneous mass of investable funds differing widely in amount and in the length and definiteness of the period for which they are deposited with the bank. Some funds will be deposited at call, some at short notice, some for definite longer periods of time. These funds are advanced by the bank for a wide variety of purposes, for widely varying lengths of time, and against many different kinds of security.

29. It has been suggested that the services performed do not consist simply in acting as intermediaries by bringing borrower and lender together. Other economies are necessarily involved in this, in greater or less degree according to the type of credit and the class of intermediary concerned.

30. (a) By collecting and pooling small items of capital individually unimportant and available for a short and uncertain period, commercial banks and similar institutions make a large stock of capital permanently available for business and other uses.<sup>1</sup> Thousands of small deposits supplied for a short and uncertain period would necessitate a heavy cost of marketing if they were sold individually, even though the banks still acted as intermediaries between the separate borrowers and lenders. Through the banks these small amounts are formed into one large aggregate and the short lengths of capital are combined into one long

<sup>1</sup> Cf. Lavington, *op. cit.*, p. 134, *et seq* for a useful discussion.

length.<sup>1</sup> The withdrawal of one small sum tends to be cancelled by another deposit and the net result is that an appreciable proportion of total lodgements is made available for continuous use. A discontinuity of short period investments is transformed into a continuous aggregate. The difficulty is thus obviated of causing the individual borrower to search for an individual lender who happens to hold, for investment, surplus funds coinciding in amount and period of availability with those required. There is, of course, a corresponding economy to the lender. Security to the borrower is increased, since he can obtain loans for the amount and period required; and to the lender, since he can, if he desires, invest his funds in such a form as to leave them readily available to meet possible contingencies. By the establishment of branches and connections with other credit agencies, numerous and widely divergent sources of supply are tapped, and credit can be transferred from place to place with great ease and rapidity.

31. (b) Where, as in the case of banks, the intermediaries are also principals and do not act merely as agents, the function of risk and uncertainty bearing is taken over by the intermediaries. Personal risk to the lender is thereby virtually destroyed, since the bank, and not the individual borrower, becomes responsible for repayment to the lender. This will be shown to be a very important economy of some types of agricultural bank. By virtue of the fact that risk and uncertainty bearing are taken over by the credit intermediary, they are reduced for several reasons: (i) As expert lenders they are able to estimate more accurately than the private individual the relative merits of different undertakings, the business integrity and capacity of the individual borrower, and the value of the security which is offered. "The banks are in intimate contact with practically every business man in the country; and the information which they acquire, supplemented (i.e. in the United Kingdom) by the work of enquiry agents, such as Perry's or Stubb's, and by the personal contact of business men in the great financial centres, is diffused throughout the entire

<sup>1</sup> Lavington, *op. cit.*, *loc. cit.*

business community.”<sup>1</sup> Where, as in the case of the *Landschaft Banks* of Germany, the *Crédit Foncier* of France, and the Federal Farm Loan, or Intermediate Credit Systems, of the United States, banks are engaged in financing the operations of agriculture, they are in a position to appoint expert assessors to estimate the value of the security offered, and the personal integrity and capacity of the applicant for loans, a safeguard which is impossible or very costly to the individual. (ii) By advancing money to a large number of different individuals, for a variety of purposes or in a number of different localities, they are able to spread risks over a wide field, so that the net risk over the business as a whole is very small. (iii) In some cases also, as in co-operative credit institutions, net risk to the undertaking as a whole, and therefore to individual creditors, is reduced by the pooling of security, which becomes collective.

32. In similar fashion, traders such as wholesale merchants, stock, and station agents (e.g. in New Zealand) and country storekeepers, take over the function of risk and uncertainty bearing when they advance credit incidental to their main business of buying and selling. Normally, these borrow from the banks themselves and act as a second line of intermediaries between the lender and the borrower. By virtue of their special knowledge of the business in which the borrower is engaged, and of the special circumstances attached to each case, they are able to reduce the risks involved, though this is far from being transmuted of necessity into a low gross rate to the borrower; while other disadvantages are also associated with this method of credit provision.

33. Although brokers, solicitors, and other intermediary *agents* do not normally take over the function of risk and uncertainty bearing, they may also in fact, reduce risk to the lender by investigating the nature of, and the title to, the security offered, advising clients as to the relative merits of different investments or, in the case of solicitors,

<sup>1</sup> Lovington, *op. cit.*, p. 106.

drawing up the contract in such a form as to safeguard the borrower.

34. (c) A further economy related to the primary service of credit marketing, and at the same time making for the cheapening and increased efficiency of this service, has been the invention of negotiable securities or credit instruments often more or less standardized in form. The importance of the use of credit instruments is discussed in Chapter II<sup>1</sup> and need only be summarized briefly here. It has been pointed out that the use of marketable securities leads to important economies. The actual cost of marketing is reduced because credit instruments frequently avoid the necessity for bringing borrower and lender together. The securities can be bought and sold through specialists in the open market, and can be quoted in small units of value, thus facilitating the combination of a large number of small units into a large aggregate. Standardized securities can be graded according to risk, and the need is lessened for the individual investor to assess by personal enquiry or inspection the value of the assets against which the securities are issued. A wide geographical area may be tapped for funds, the cost of capital transfer is cheapened, and the cost of credit over different geographical areas is equalized. In addition, such securities may provide useful collateral against advances by commercial banks. Further, since securities are often readily marketable, they can be sold readily when cash is required, so that the burden of credit provision may be shifted from one individual to another with ease. Other things being equal, the more negotiable or marketable the security, the lower will tend to be the supply price of capital, or the lower the rate of interest at which investors will be prepared to take it over, for the more readily can it be converted into cash and the burden of credit provision transferred. Since the market for a mortgage on a farm will be more restricted than the market for the shares of a local company, and the market for these than for the shares of a giant combine, the interest demanded on the first will tend to be greater than on the second,

<sup>1</sup> See p. 26 *et seq.*

and on the second than on the third, other things being equal.

35. (d) A related function which banks, solicitors and other agents frequently perform, is the collection and transmission of the interest on loans when they accrue. In the case of intermediaries who are principals, this will be reflected as a cost in the gross interest, i.e. in the margin between the rate paid for loans and the rate received for advances. Where the intermediaries are agents, the cost will be met as a commission or fee. In either case it represents a part of the function of management and therefore involves a cost.

36. It will be apparent that the gross rate of interest will be closely dependent on the efficiency with which the various services which have been outlined are performed. When taken over by specialized concerns, the actual cost of such services will usually be less than when performed by individuals themselves. This will narrow the margin between pure and gross interest, and may be expected to be passed on, partly to the borrower in the shape of a lower gross rate, partly to the lender in the shape of a somewhat higher reward for pure waiting. The effect of the former will be an increased demand for capital and increased productive efficiency, which in turn will make greater capital accumulation possible in the future. The effect of the latter will be an increase in the supply of capital forthcoming. It cannot be over-emphasized that the economies effected do not consist merely in establishing contacts between borrowers and lenders. The supply price of credit is affected by the ability of the marketing agents to reduce risk and secure the liquidity of investments to the lender without impairing their permanence to the borrower, as well as by the cheapness with which contacts are established between borrowers and lenders and the extent to which the investment of small or short period savings is encouraged.

### 3. THE MONOPOLY ELEMENT IN INTEREST

37. Under conditions of perfect competition, differences in the gross rate of interest in different places and in the

provision of credit for different uses would be just sufficient to equate differences in the risk and uncertainty involved and in the cost of marketing as we have broadly interpreted it. For some purposes it is convenient to assume that such free competition exists; but, in actual fact, competition is not perfectly free and differences occur which are not thus explained. Over a large part of the field of industry and commerce competition is sufficiently free and credit is sufficiently mobile to equate interest rates, allowing for differences in risk and difficulties of management; but in some instances the lender is in a position of partial monopoly and the rate is raised in consequence. This applies when the borrower, through ignorance, isolation, or the nature of the credit which he requires, is forced to limit his application for credit to a restricted number of lenders. This applies especially to the farmer in some instances. This subject will be touched on later. For the present, it is sufficient to point out that the assumption of free competition is not universally true, and that in some instances the market to borrowers is limited. In consequence, lenders are in a position of partial monopoly which they are able to exploit by charging a rate of interest higher than that which would rule under perfect competition. This monopoly element is difficult to disentangle in practice, since it is bound up with special elements of risk or difficulties of marketing.



**PART II**

**THE PROBLEM OF RURAL CREDIT**



# THE ECONOMIC ORGANIZATION OF AGRICULTURE

## I. INTRODUCTORY

1. The foregoing chapters have been designed to show the nature of credit and indicate conditions which influence the price paid for it. The remainder of this book will be devoted to an examination of the problems of rural credit and a discussion of certain methods which have been devised in an attempt to meet them.

2. Fundamentally, credit plays the same part in farming as it does in other industries. The differences which separate agricultural from other forms of credit, are differences in degree rather than in kind, and it is for this reason that the general problems relating to credit have been discussed by way of introduction to our main subject. The differences in degree are so great, however, as to constitute a special rural credit problem and to warrant special study. These differences depend mainly upon the characteristics of production and organization in farming; hence a brief examination of the conditions which differentiate its structure from that of industry in general is desirable by way of introduction.

## II. THE ORGANIZATION OF AGRICULTURE

### I. THE AGRICULTURAL COMPLEX<sup>1</sup>

1. In discussions relative to farming industries, agriculture is often spoken of as if it were a single industry, more or less homogeneous in structure, and presenting a uniform set of problems. It is true that certain characteristics are common throughout most farming industries,

<sup>1</sup> See Condliffe and Belshaw, *A Brief Survey of Rural Credit in New Zealand*.

power are largely denied to the agriculturalist, though the remoteness may be substantially removed, as in New Zealand, by the use of electricity and oil as motive forces.<sup>1</sup>

8. Finally, such advantages in the division of labour and the use of machinery, as are possessed by the (relatively) large farm, are offset wholly or in part by the *qualitative* superiority of family labour on the small farm and the greater ease of supervision of hired labour.

9. In most countries the effect of the above conditions has been to encourage the tendency towards the family farm employing little or no hired labour and gaining in the qualitative superiority of the labour employed much that it loses in consequence of the small scope for the division of labour and the use of machinery.

### 3. LACK OF SPECIALIZATION IN AGRICULTURE

10. As the result of these conditions, there is little *functional specialization* in farming. The farmer combines, to a greater degree than in most industries, the functions of capitalist, entrepreneur and labourer. Further, as has been pointed out above, there is less *productive specialization* than in industry. The farmer tends to produce, not one commodity, but several, though it is true that in certain areas, farmers may specialize largely in the production of one crop where soil, climate and market conditions are especially suitable.

11. The lack of functional specialization arises out of the small scale of operations. The lack of productive specialization arises out of a desire so to distribute productive effort as to keep capital and labour continuously employed, to take the maximum advantage of seasonal variations in the weather and of the quality of the land, and to ensure continuity of income. Many crops are either supplementary or complementary to one another and the maximum yields in terms of labour income will often be obtained by mixed farming, which also tends to spread risks.

<sup>1</sup> e.g. In Shearing and Milking Sheds.

**4. DIFFICULTIES OF COMBINATION IN AGRICULTURE**

12. The conditions which have been described above, lend considerably to the difficulties of combination. The difficulties of combining a large number of isolated and comparatively non-specialized individuals operating on a small scale into organizations to express some common purpose are obviously greater than those in effecting combination of large concerns with similar and specialized functions. There is the added difficulty that the nature of the farm economy develops social characteristics and habits of mind that raise a barrier to corporate effort. The details of the farmer's craft are so numerous and varied, and his productive effort is so much less specialized than that of the industrialist, that the advantages of combination are less obvious to him even as his difficulties are correspondingly great. The farmer becomes more self-sufficing, more individualistic and is loath to delegate authority to others. Such a delegation is essential to all combination for a common purpose and is inherent in the principle of the division of labour. This problem is not merely social in significance. It is at the root of those difficulties entailed in the economic integration of the rural community.

13. These conditions react, not only on the primary processes of farming, but also on the performance of the secondary functions of marketing and all it entails, and on the provision of credit. Although the individual farmer is at a decided disadvantage in these respects, yet combination to increase his effectiveness and bargaining power is the exception rather than the rule, despite certain conspicuous examples to the contrary.

**5. RISK AND UNCERTAINTY IN AGRICULTURE**

14. In Part I, Chapter III, the importance of risk and uncertainty as elements in gross interest was emphasised. It was shown that risk, or the "unrelieved probability of loss," was due to changing conditions of demand and supply which could not be foreseen. Such changes and the losses attendant upon them are of great importance in agriculture.

while owing to conditions outlined in previous paragraphs, many of them are difficult to prepare against, save at great cost.

15. For convenience, we may classify the risks of farming into two kinds:<sup>1</sup> A. Technical Risks, and B. Commercial Risks.

### A. Technical Risks

16. These arise mainly out of the operation of the natural forces against which the farmer has to contend and the nature of farm products. As in manufacture, there are some risks consequent on the breakdown of machinery or defective materials (such as seed), but these are of small importance when compared with the risks consequent on the weather, disease and pests. The manufacturer is able to plan ahead and is able to vary his productive effort in fairly close accordance with changes in conditions in demand. The quantity returns to his effort are, in general, readily calculable. He is able to bring about necessary changes in temperature or other conditions by physical means. In farming, on the other hand, the yield of crops or stock is only very loosely related to the intensity of effort, and changes in the weather, or the recurrence of diseases and pests, throw a considerable element of chance into his operations. The work of the farmer, too, is determined from day to day by the state of the weather in relation to the conditions of the soil and the stage of development of his crops. This necessitates a very close attention to the detailed processes of his job. Not only does the *incalculability* of such changes render difficult the preparation against them, but also the constant necessity to be on the watch for them leaves less time and effort available for the performance of the secondary functions of marketing, and for preparation against unexpected changes in conditions of demand, or of supply elsewhere. The difficulty of providing against *commercial* risks is thereby increased.

17. A further risk which we may describe as, in a sense,

<sup>1</sup> We are concerned here with risk to the farmer. Risk to the creditor includes other elements which are discussed later.

technical, arises out of the perishability of many farm products. The possibility of waste during storage, or in transit, is considerable in respect of many agricultural commodities; while the consequent difficulty of holding back surpluses when supply is great relative to demand adds appreciably to *commercial risk*. Where perishable products can be preserved by refrigeration, canning or other methods, this risk is of course very much reduced.

### B. Commercial Risks

18. These arise to a considerable extent from the technical conditions and conditions of organization referred to:

(a) *Effect of Natural Conditions*: Since the quantity returns to effort are seriously affected by natural conditions beyond the farmer's control, it follows that he experiences greater difficulty than the manufacturer in providing against an anticipated increase or decrease in demand by *varying* his productive effort. If the growers of green peas or cabbages correctly anticipate a falling off in demand and reduce the acreage under these crops accordingly so as to avoid a glut and a severe fall in price, their action may be completely negated by a bumper yield dependent on a favourable season. It is apparent that the difficulty of adjusting output to changes in demand occasioned in this manner opens up a considerable probability that returns will fluctuate greatly from year to year and that actual returns will diverge from anticipated returns. In short, commercial risks are very much increased.

19. (b) *Effects of Intractability of Production*. In addition to the difficulty of deliberately varying quantity returns because of the vagaries of nature, there is the further difficulty that productive effort itself cannot be varied sensitively to meet anticipated changes in demand. This arises from two causes:

- (i) *Although some fixed capital (including land proper) can often be turned from one use to another, a great deal of it is highly specialized. Hence a change in the relative demand for different products cannot*

and that it is necessary for purposes of general analysis and comparison to simplify matters in this way. In fact, however, farming is not a single simple type of business, but an industrial complex of many different types of production and marketing. Taken as a whole, it is at least as intricate in its relationships as manufacturing and extractive industries taken as a whole. Farms vary in size from the large bonanza wheat farms in parts of the United States, or the sheep stations of Australia and New Zealand, to the diminutive holdings of peasant proprietors in certain parts of Europe.

2. Even within a given country there are likely to be wide variations in size, tenure and methods of production, while the organization of the secondary functions of processing and marketing may take many and varied forms. It is possible to make a rough classification of farms into various groups and to speak of dairying, sheep raising, wheat growing, fruit farming, and so on; but in general, such a classification cannot be clear cut, for specialization is less pronounced than in industry generally. Each farm has its own peculiar problems. There are considerable variations in organization and practice from farm to farm, even within a given country or district. These differences are of more than superficial importance, since they lead to a great variety of industrial structure, and to many different kinds of relations between farmers themselves, farmers and middlemen, farmers and manufacturers, farmers and consumers.

3. This complexity of structure and wide variety in organization and methods leads to variations in financial organization from farming industry to farming industry, or even from farm to farm. The problem of rural credit resolves itself into the problem of providing capital for the various requirements of a complex industry.

4. By virtue of these conditions, and of conditions to be discussed, the difficulties of credit provision are enhanced and are on the whole much greater than those involved in financing industry and trade in general. The high degree of variety in conditions makes the marketing of credit and the



assessment of risk and security more difficult, unless special machinery is devised.

## **2. THE AGRICULTURAL UNIT OF PRODUCTION**

5. Enough has been said to guard against any undue assumption of uniformity and simplicity in the organization of rural industries, and to stress the fact that the complexity of rural organization raises, of itself, difficulties in the way of providing credit for them. There remains to consider the essential differences between farming and manufacturing or extractive industries. Many of these arise from the smallness of the farm, which is the agricultural unit of production. Apart from the rapidly disappearing ranches of the New World and the plantations of the East, the representative farm tends to be smaller in most countries than the representative factory when compared on the basis of labour employed, capital invested, or value of annual turnover.

6. The size of the economic unit is determined in the main, of course, by the nature of the economic and technical problems which the farmer has to face. The dependence on the weather and the careful attention which must be given to crops or stock, necessitate a close supervision of farm processes which would be impossible under enterprises comparable in size with those of manufacture, in which the speed of effort of the hired worker is determined by the machine or can be gauged in terms of output. Work is largely incapable of subdivision into simple processes which can be adapted to mechanical methods. The difficulty of standardization and irregularity in the "flow" of farm processes prevent effective subdivision of labour and limit the economies possible from the use of machinery. It is difficult to gauge accurately the amount of work done, for farming "lacks the registering finger of the machine." In consequence, the amount of hired labour is small, the difficulties of supervision being intensified through the operation of the law of diminishing returns which prevents the profitable concentration of effort into small areas.

7. For similar reasons, and because of the remoteness of most farms from sources of power, economies in the use of

be met at all sensitively by a change in the type of crop produced without appreciable loss on existing fixed capital. Thus, while ploughs and horse teams may be used equally in preparing the ground for a variety of crops, a dairy herd cannot be used for producing wool, or a milking machine for shearing sheep. Hence a fall in the value of butter and a rise in the value of wool cannot be met at all rapidly by a change from dairying to wool growing without severe loss. Such a change, if general, would throw dairy cattle on the market and cause a slump in their value, and raise considerably the price of sheep, the number of which *could not*, in any case, be increased instantaneously. Milking plant would lie idle, shearing equipment would have to be installed and, indeed, the whole farm economy would have to be materially altered. Similarly, although it may be possible to put land to alternative uses, yet conditions of soil and climate, diseases and pests, and transportation and marketing problems are limiting factors restricting the profitable crop range.<sup>1</sup> Further, when once a system of farming has been established, the technical difficulties involved in a change are often very great.<sup>2</sup> Hence, although economic conditions may warrant a temporary or even a permanent diversion from one crop to another, the specialization of existing equipment and organization will cause a relative surplus of the one crop and shortage of another for an appreciable period. This obviously increases commercial risk.<sup>3</sup>

20. (ii) *The Economic lag in production is very long in agriculture.* For our purposes, we may define the economic lag as the length of time during which costs are incurred before a crop is marketed. The

<sup>1</sup> Cf. Engberg (R.C.), *Prosperity and the Farmer*, p. 28-29.

<sup>2</sup> *Ibid.*, p. 31-32.

<sup>3</sup> It is not suggested that commercial risk due to the specialization of plant is not important in manufacture also.

initial operations in the production of a crop of wheat are incurred months before the crop is sold. The first costs involved in permanently increasing the production of beef or milk must be incurred two or three years before a permanent increase in supply can be effected, since it becomes necessary to breed new live stock which must reach a certain stage of maturity before they are ready for use. The readiness with which supply can be varied is influenced also by the prolificacy of the crop as well as by its *gestation period*.<sup>1</sup> We may consider the gestation period as the period necessary before a crop matures so that it can be used as an agent of production or sold directly for consumption. Thus the gestation period for pigs is shorter than that for horses or dairy cattle, while at the same time, they are more prolific. Hence a shortage in pigs can be met in two or three years, while a shortage of dairy cattle or horses may require six or seven years to be overtaken.

21. The relevance of the economic lag to the problem of risk arises in the first place from the fact that it delays considerably the response to changes in demand and thereby increases the intractability of resources. In the second place, it indirectly increases uncertainty as to the conditions which will exist when the crop is marketed; for obviously the longer the period between commencement of production and marketing, the greater the difficulty of forecast. The possibility of misjudgment is considerably increased. The difficulty of adjusting production to demand is exaggerated and commercial risk is augmented.<sup>2</sup>

<sup>1</sup> The gestation period, while not synonymous with the Economic Lag in production, is a very important factor determining the length of the lag.

<sup>2</sup> For the whole subject of the Economic Lag in Agriculture, see Whetham "The Economic Lag of Agriculture," *Economic Journal*, December, 1925; Belshaw, "The Profit Cycle in Agriculture," *Economic Journal*, March, 1926; "Report of the Committee on the Stabilization of Agricultural Prices," p. 11, *Ministry of Agriculture and Fisheries*, Economic Series, No. 2; and O'Brien (G.), *Agricultural Economics*, Ch. I.

It is important to note that the effects of the Economic Lag are particularly serious during the changes in general prices consequent on the trade cycle (see Belshaw, *op. cit.*), while the Lag also induces special cycles in production within particular industries.

22. Frequently, also, the period of time involved in marketing is very long. This condition reinforces the influence of the economic lag in production proper, and for similar reasons augments commercial risk. Thus, for example, the time required to market New Zealand dairy produce is as much as two or three months, owing to the period required to transport supplies to the London market. Interim changes in prices may occur, which increase commercial risk to the farmer, or to those who advance him money until receipts come in. Commitments entered into on the basis of prices ruling at the time the dairy produce leaves New Zealand may create difficulties if prices fall in the meantime.<sup>1</sup>

23. (c) *The Effects of the Nature of Agricultural Organization.* The small scale and isolation of the farming units, together with the varied and complex problems in production which the farmer has to face, and the consequent difficulty which arises in devoting time and attention to market problems, have a bearing on commercial risk in two ways:

- (i) Difficulty arises in estimating the trend of marketing conditions and in obtaining reliable information as to the relative profitableness of different crops or the relative attractiveness of different markets. Hence productive effort, and the supplies of marketable crops, are likely to be misdirected or placed on the market at the wrong time. Frequently also, the difficulty which the farmer experiences in obtaining finance adds to his commercial risk by forcing him to dispose of crops at a time determined, not by the state of the market, but by the urgency of his need for cash. These difficulties are enhanced when the market is distant, the commodity is perishable, or the demand is uncertain and fluctuating.

24. (ii) Even in cases where market conditions can be estimated with some degree of reliability, there

<sup>1</sup> Frequently goods are purchased f.o.b. by New Zealand agents acting for Tooley Street merchants, or the whole season's output may be sold in advance at a fixed price. The risk is then transferred to the middleman.

is the further difficulty that *the flow of crops onto the market cannot be regulated readily to meet changing conditions of demand*. This difficulty arises partly out of the intractability of production, the effects of natural conditions on crop yield and the perishability of many agricultural crops; but also to a large degree out of the small size and loose integration of farming industries. A large number of individual and isolated farmers make independent decisions as to what crops they will produce and what volume of resources they will devote to each crop. In considerable measure they market their products as isolated units. Their productive effort and their marketing decisions are influenced in very imperfect fashion only by similar efforts and decisions of other farmers. A large number of individual farmers may all be influenced by similar factors in making their decisions, or may grow a crop because others are growing it; but they seldom take into consideration the probable *effects of the decisions of others* and modify their own practice accordingly. Speaking generally, it would pay the individual farmer to increase his breeding of pigs when the majority of his competitors were slackening off their efforts, and reduce pig production when it was becoming popular; but he is more likely to augment or increase his supplies when others are doing the same. In short, in so far as farmers take cognizance of the decisions of others, commercial risk is as likely to be increased as not. There is the further important point that farmers tend to base their production on prices for the previous season. These are in most cases a very poor guide to market conditions at some future time. In some cases also there is the danger that advice may do more harm than good, even when this is given by a competent authority. Information that market conditions are likely to become

worse may cause farmers to curtail production too much. On the other hand it may actually increase output, since many farmers may assume that the information offered will be acted upon by the majority, and they may increase their yield in order to take advantage of the higher prices and curtailment of supply which they expect to result.

25. Frequently also, farmers are slow to make desirable changes owing to "the psychology of the farmer himself—his apathy in some cases, his conceit in others, his refractoriness in others, only his enmeshment of habits, customs, and traditions in other cases."<sup>1</sup>

26. Further, while some farmers may possess sufficient resources and judgment to regulate the flow of their own crops on the market to their own advantage, it is extremely difficult to formulate and put into practice a co-ordinated policy by means of which the aggregate flow of any crop onto the market is effectively regulated so as to obtain higher and more stable prices. Such a policy involves the replacement of a large number of individual decisions by a collective decision expressed through one authority to whom power is delegated.

27. In some cases, attempts have been made in this direction through the organization of co-operative societies and produce pools; but by far the greater proportion of farm produce is not thus controlled. Concerns of this sort may perform valuable service in the collection and dissemination of information as to marketing conditions. They may also direct and regulate the flow of existing supplies onto the market so as to stabilize prices considerably and raise the average price received by the farmer.<sup>2</sup> In these ways commercial risks may be reduced; but even where such bodies exist, their ability to regulate the movement of

<sup>1</sup> Black, J. D., "The Role of Public Agencies in the Internal Readjustments of the Farm," *Journal of Farm Economics*, 1925, Vol. VII, p. 165, quoted Engberg, *Prosperity and the Farmer*, p. 29.

<sup>2</sup> The Co-operative Federations of the Californian Citrus Growers and others provide important examples of the possibilities of such policies.

supplies, and in particular to control the amount actually produced, is limited, while if their policies are unwise, they may actually increase commercial risk to the farmer.

28. Expressed in general terms, the risk to the farmer arises from the fact that the aggregate of costs and the aggregate of receipts vary in different directions and to different degrees. In consequence, there is a fluctuating margin between the two. The farmer is unable to prevent this fluctuation from taking place, nor is he able to forecast it at all accurately. Changes in the aggregate of receipts result from changes in the demand for and price of farm products, and changes in the volume of production are due in large measure to natural forces beyond the farmer's control. For the reasons discussed above, the farmer is unable to adjust the output of any crop or of all the crops he produces, or to vary his aggregate of costs in such a manner as to keep his net income stable, or even to enable him to determine in advance what that *net income* will be.<sup>1</sup>

<sup>1</sup> For a fuller analysis of the factors affecting changes in net income, particularly during the business cycle, see Belahaw, *The Profit Cycle in Agriculture*, *Economic Journal*, March, 1926; and O'Brien (G.), *Agricultural Economics*, Ch. I.

# THE DEMAND FOR CREDIT IN AGRICULTURE

## I. THE DEMAND FOR CREDIT<sup>1</sup>

1. The problem of rural credit is that of providing capital for the various requirements of a complex industry. In agriculture, as in other industries, the demand for capital and therefore for credit, is composite and is made up of a number of demands which differ greatly, especially in the degree of permanence or fixity of the capital goods required. These differences occasion differences in the conditions under which the loans to provide the capital goods must be raised and in the nature of the security against which they are pledged.

2. The capital goods which are required in agriculture may be roughly classified as follows: (a) Land and improvements; (b) Implements, machines, live stock, etc.; (c) Requisites such as fertilizers, seed, petrol, etc.; (d) Stocks of food and clothing. As in all businesses, there is a rough distinction between fixed and circulating or working capital. Fixed capital is embodied in a form which can be used a number of times without exhausting its utility. Circulating capital changes its form or is "consumed" in one use.

3. Broadly, we may say that land and improvements correspond to the fixed capital of industry, since they consist of agents of production which are durable and possess utility for a long time. The fixed capital of agriculture also includes plant and machinery, together with such live stock as are used for breeding purposes, or from which other commodities, such as wool and milk, are obtained without destroying the live stock for use as productive agents.

<sup>1</sup> I have drawn freely in this chapter on "A Brief Survey of Rural Credit in New Zealand" by J. B. Condliffe and H. Belshaw. (Reprint *N.Z. Journal of Science & Technology*, Vol. VII, No. 6.)



4. Live stock which are themselves being prepared for the market, e.g. lambs or cattle which will be sold for slaughter, are more in the nature of raw materials which are being advanced, by fattening, a further stage in production, and partake more of circulating or working capital. This distinction is somewhat blurred in practice, however, since live stock used as agents to produce marketable commodities may themselves be prepared for the market when their usefulness as productive agents is declining, while live stock being themselves primarily prepared for the market may yield marketable commodities in the meantime.

5. The remaining working capital consists of requisites such as seeds, manures and petrol, together with the goods which the farmer and his family consume during the process of production and marketing, as well as the things obtained by the wages paid to hired workers and to those who handle the farmer's products before they are sold. Such wages or other payments for services represent claims to actual goods and services.

6. The demand for capital is translated into a demand for credit. By far the majority of farmers in countries of western civilization are not in a position to buy outright the whole of the capital represented by land and improvements. Some part of the purchase price, and usually some part of the money required to pay for machinery, live stock and later improvements, must be obtained by borrowing. In other words, investment credit is required in just the same way as in other branches of industry.

7. A similar demand arises for what we have called commercial credit. Processes of production and marketing are long, and the need for funds to purchase requisites and food and clothing, and to pay wages, and so on, is not constant. Income from the sale of crops is seldom regular. The farmer might, if he wished, accumulate a sufficient volume of funds to provide all his working capital from one harvest to the next. By doing this, he would have a surplus of funds over a great part of the year which he could not profitably utilize on the farm. This surplus is usually small

in amount and varying in quantity, and the farmer is remote from financial centres, so that profitable avenues of investment are not easy to find for it. Hence, like the business man in other fields, it is usually more satisfactory for him to meet at least some part of his needs for working capital by borrowing, if efficient sources of credit are available.

8. The difficulty, which we have already referred to, of distinguishing between consumer's and producer's capital<sup>2</sup> is especially great in respect of that part of the farmer's working capital required to keep himself and his family. It would be required if he did not produce at all, but he must have a great part of it to be able to work. It is both consumer's capital and producer's capital. Hence it seems best to disregard this differentiation and consider credit of this sort demanded by farmers as producer's credit, especially as the distinction would not normally be made in practice.

## II. CLASSIFICATION OF RURAL CREDIT

### 1. PURPOSES FOR WHICH LOANS ARE OBTAINED

1. The main purposes for which credit is demanded by farmers are as follows:

- (a) (i) The purchase of land and standing improvements.
- (ii) The provision of permanent improvements.
- (b) The purchase of implements and stock.
- (c) (i) "Running" expenses to pay wages, the cost of fertilizers, seeds, and other requisites, and the cost of food and clothing required by the farmer and his family until receipts come in from the sale of crops.
- (ii) The marketing of crops or the holding of crops while in transit or awaiting sale.

These resolve themselves into a demand for credit to pay wages, the cost of the actual services of transport, storage and selling, and to keep the farmer and his family until the crops are sold.

<sup>2</sup> See Part I, Ch. II, p. 16, *et seq.*

2. Loans to purchase land and standing improvements, to provide permanent improvements and to purchase implements, correspond to the "investment" credit discussed in a previous chapter. Loans to meet running expenses or market crops correspond to "commercial" credit. Loans to purchase live stock may be regarded as investment credit when the live stock are used for breeding purposes or as agents to produce marketable crops, such as wool or butter, without themselves being destroyed in the process; or as commercial credit when the live stock themselves are the marketable commodities. In this case, as has been pointed out, they correspond to the raw materials of industry. For reasons discussed in the preceding section, this distinction is somewhat blurred in practice.

## 2. CLASSIFICATION OF TYPES

3. Agricultural credit may be classified in three ways:

- A. According to the purpose for which loans are raised.
- B. According to the length of the loan period.
- C. According to the security against which loans are advanced.

### A. *According to Purpose*

4. The grouping in the previous paragraphs of the purposes for which credit is required in agriculture has been determined primarily by the length of time for which loans are required. A more logical grouping according to purpose divides credit into three main classes as follows:

5. (a) *Settlement and Development Credit.* Settlement credit is that credit which is required to enable the prospective farmer to purchase land and improvements. Development credit is required to develop the land and effect improvements for such purposes as drainage, clearing, the building of barns, shearing sheds and so on. Both these purposes relate to the basic agent, the farm itself, and are therefore grouped together.

6. (b) *Production and Equipment Credit.* This group includes credit to provide implements, live stock, fruit trees, and such running expenses as are involved in the payment

of wages and the purchase of fertilizers, seed and other requisites. In general, it is used for the provision of agents which are less permanent than land and the standing improvements thereon.

7. (c) *Marketing Credit.* Under this heading is included credit to finance the farmer during the period of transit or storage of crops while they are awaiting sale.

8. While the above classification may be useful on occasions, it is on the whole less satisfactory than that which will be considered next. In the first place, the process of production is not completed until the commodity reaches the consumer, while it begins long before the actual running expenses directly chargeable to any particular crop or crops are incurred. A part of some, or all, of the prior expenses arising from the purchase or development of the farm is properly chargeable to each crop. In the second place, the distinction between certain kinds of development credit and certain kinds of equipment or production credit is somewhat artificial. Credit to purchase milking machines (since they are fixed or "standing" improvements and since they increase the market value of a farm), would be classed as development credit. Credit to purchase ploughs (since they are not standing improvements to the farm itself), would be classed as equipment credit rather than development credit. But both ploughs and milking machines add to the efficiency of labour in the production of milk, and so are production credit, while a farm may be improved or "developed" by means of ploughing or by other operations, the cost of which is considered as running expenses. In some cases, too, there may be very little difference in the degree of permanence of the things for which credit is required, though under this classification they would come under different headings.

#### B. *According to Length of Loan*

9. The most useful classification of agricultural credit depends on the length of time for which loans are required, and is closely related to the degree of permanence or fixity of the capital to provide which loans are needed. It therefore follows closely the grouping adopted in the first part of

this section. On the above basis, the classification is as follows:

10. (a) *Long term Credit.* This is normally needed for a period of from, say, three to thirty years, and is required for the purchase of land and standing improvements and the provision of the more expensive durable improvements.

11. (b) *Intermediate Credit.* This is usually required for a period of from, say, six months to three or four years, and is obtained mainly for the purchase of stock and machinery and the less permanent and extensive improvements, and for the production of crops in which the economic lag is great. The term "intermediate credit" originated in the United States.<sup>1</sup> The Federal Farm Loan Act of 1916 established facilities for the provision of long term credit to agriculture, while other institutions, such as the Joint Stock Land Banks and Insurance Companies, also met the same need. Credit for shorter periods was provided by country banks and by the Federal Reserve system. Between the two was a "barren area" not adequately covered by credit institutions. The need for such institutions was acutely felt during the depression of 1920-21 and the Agricultural Credits Act of 1923 was passed, establishing Federal Intermediate Credit Banks. In very many countries, the same institutions meet the demand for both intermediate and short term credit, and the term is less commonly used. Nevertheless, this class of credit is frequently not well provided for, and the distinction between intermediate credit and short term credit (as defined below) is a useful one.

12. (c) *Short term Credit.* This is normally required for a period of a few months, and is obtained for the remaining purposes enumerated in the first paragraph of this section, viz. to provide labour, requisites and other running expenses, and to market crops.

### C. According to the Nature of the Security

13. On the basis of security, agricultural credit may be divided into three main classes:

<sup>1</sup> *Report of the Committee on Agricultural Credits in Australia.* (Dominion Office, No. 1, 1925, p. 20.)

(a) *Farm-mortgage Credit*. This is secured, as the name implies, against land by means of a mortgage over it:

(b) *Chattel and Collateral Credit*. In the former, the security takes the form of a mortgage against such "chattels" as equipment, live stock or farm products, or of warehouse receipts which represent titles to crops held in store. In the latter, security takes the form of titles to the ownership of other kinds of property such as shares, bonds, mortgages or insurance policies:

(c) *Personal Credit*. This is secured against personal notes or promises to pay, and is not backed by a lien on any particular piece of property. Such notes may, or may not, be endorsed or guaranteed by someone else.

14. In addition, security against loans may be either individual or collective. Thus, "farm mortgage" credit may be secured by a mortgage on individual farms, or by means of bonds issued by a land bank, such as the German Landschaft or the Federal Land Banks of the United States, the security against the bonds being the resources of the bank together with *all* the mortgages against which loans are issued by the bank. In such cases, the bank is secured against individual loans by means of individual mortgages, but the security to bond holders or creditors of the bank is collective. In the same way, chattel, collateral or personal credit may be individual, or it may be backed by the mutual guarantee of co-operative societies. The principle of mutual guarantee is adopted by various European credit systems, the Federal Intermediate Credit Banks of the United States, and under the New Zealand Rural Intermediate Credit Act of 1927. Under this last Act the practice is developing for Co-operative Dairy Companies to guarantee the loans advanced to their members.

15. The different classifications adopted above are, of course, closely related to each other. The length of time for which a loan is required depends mainly on the purpose for which it is used, since the period of the loan should be long enough to enable it to be repaid out of the added income which it makes possible. The nature of the security

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is dependent largely on the purpose and period of the loan, though, of course, it is influenced also by the integrity and standing of the borrower. Normally, the longer the period and the more permanent the purpose, the more tangible is the security.

16. Speaking generally, long term credit is advanced for settlement and more permanent and expensive improvements and is secured by a farm mortgage. Intermediate credit is advanced to provide implements, live stock and less permanent improvements, and short period credit to provide labour, requisites and other running expenses, and to hold crops during transit or storage while awaiting sale. The security against intermediate and short term credit will usually be a chattel mortgage, collateral security, or personal notes. Normally, personal security, not backed by a chattel mortgage or collateral, is more likely to be accepted against short period than intermediate credit, though this is not universally true. Short term and intermediate credit is not usually based on farm mortgage security, especially the former, though when the character of the borrower is in doubt or the type of agriculture is risky, this may be required. It happens occasionally, however, that farmers are unable to repay short term or intermediate indebtedness when due, and the debt remains as a mortgage on the farm.

### 3. RELATIVE IMPORTANCE OF DIFFERENT TYPES OF CREDIT

17. The factors determining the relative importance of long term, intermediate and short term credit respectively are numerous and complex and any generalization is not likely to hold except over limited areas. The ratio of fixed to circulating *capital* in agriculture is high, but it does not necessarily follow that the ratio of long term to intermediate and short term *credit* is equally high, since the proportion of fixed and circulating capital respectively provided by *loans* will vary under different circumstances. In the United States the value of all farm property, including land, buildings, machinery and live stock was some 78,000 million

dollars in 1920, of which amount land and buildings represented some 85 per cent.<sup>1</sup> Even if to this total we add the marketing capital required *by farmers* (i.e. not by merchants) to hold and market crops it is probable that the capital requirements for the fixed and productive agents, such as land and buildings, will be on the whole much greater than for more liquid requirements. While the writer is unaware of comparable figures for other countries, this generalization is probably true of most countries.

18. In most young countries, too, the *credit* outstanding for the more permanent forms of capital, i.e. the amount of capital actually obtained by means of loans, will be greater than the credit outstanding to provide more liquid capital. Thus a survey conducted in the United States showed that, in 1924, the mortgage encumbrance of owner-occupied farms was two-thirds of the total debt.<sup>2</sup> Although it is possible that the normal ratio was somewhat disturbed by war and post-war conditions, and that some portion of the mortgage encumbrance arose out of short term or intermediate advances, there seems little doubt that the amount of long term indebtedness is greater than the amount of intermediate and short term indebtedness in the United States and in such young countries as Australia and New Zealand.<sup>3</sup>

19. This condition is not likely to hold to the same extent in older countries in which farms have been established for longer periods and land transfers are less frequent. On old established farms in such countries, the capital embodied in land and improvements may be provided literally out of the proceeds of past production—improvements, buildings, fences, drainage and pastures have come from the surplus produced by the labour of past generations of farmers. In such cases mortgage indebtedness may be small. In younger countries, however, such capital is largely the fruits of borrowing and mortgage indebtedness is more heavy. The greater frequency of land transfers in

<sup>1</sup> See *U.S. Agricultural Year Book*, 1924, p. 187.

<sup>2</sup> *Ibid.*, pp. 189 and 219.

<sup>3</sup> This would not apply to the same extent in respect of original settlers in new areas, who received free or cheap land.



young than in old countries is also a factor of some importance. There is at least the chance that old established farmers will gradually reduce mortgage indebtedness as time passes or will effect improvements out of surplus income. As indebtedness becomes liquidated, the surplus available for further liquidation or improving the land tends to grow. New occupiers, on the other hand, will seldom provide the whole of the purchase price themselves and the balance will be obtained by a long period loan. Where land transfers are frequent, therefore, the mortgage indebtedness outstanding at any one time, and the amount of long term credit demanded during a period of time, will tend to be greater. ✓

20. The tenure of land is also a factor in determining the proportionate importance of different kinds of credit required by the *farmer*. Under a system of tenantry, fixed capital, as represented by land and improvements, is provided by the landlord, while under the *métayage* system (or share farming) the landlord may provide machinery and live stock as well. Normally, the cash tenant requires only intermediate or short term credit, while the needs of the *métayer* or share farmer may be confined to short term credit.

21. The proportion of capital required under the various headings noted at the beginning of this section and also the absolute amount and proportion of credit of the three classes we are discussing naturally varies with the type of farming—a fact which is of some importance in determining the kind of credit machinery best suited to a particular type of farming, and (conversely) the type of farming likely to be encouraged by existing credit institutions.

22. It is obviously impossible to do more than generalize concerning the proportions of capital required in different directions on the main types of farm; but the following statement, relating mainly to New Zealand, which has been checked by experienced and practical farmers, and which is given merely by way of example, serves to indicate the nature of the factors operating.<sup>1</sup>

<sup>1</sup> After *A Brief Survey of Rural Credit in New Zealand*, pp. 338-9.

23. "Generally speaking, dairying in New Zealand is more attractive and easier of access to the settler with moderate capital than most other types of farming. The most noticeable feature of economic development in New Zealand during the past thirty years has been the rapid and continuous development of the dairying industry. The prime reasons for this are: The impetus given by refrigeration, which meant more to dairying even than to sheep raising and still more than to cereal farming; the wonderful climatic conditions making possible exceptionally prolific pastures; and a keen world demand for dairy produce.

24. "But in addition to these powerful factors there are special reasons connected with the financing of dairy farms that make them especially attractive to the small settler. Though the price paid for dairying land is usually higher than for other types of farming, the area is so much smaller that the outlay on the land itself is less. The absolute amount of capital required for land and standing improvements is smaller than in sheep farming or cereal growing. The wise settler prefers a comparatively small area well cultivated, with adequate working capital, rather than a large area with restricted capital—though not all farmers are wise. The regularity of the monthly butterfat cheque provides a continuous source of income throughout the greater part of the year, and makes accounting easier and more certain. The regularity of returns makes it more easy to pay wages for hired labour or to meet other running expenses out of income. Although dairy produce may not be sold on the London market till two or three months after it is produced, marketing credit is obtained readily by co-operative dairy companies from the banks by means of an advance up to a given proportion of the ruling market price. This can be paid over to the farmer, the balance being paid when the season is completed. In sheep raising and cereal farming the expenditure on harvesting, shearing and other running expenses must be made before the main returns of the year come in, and must be met by temporary borrowing, usually upon the security of the wool or harvest. Further, the demand for hired labour in dairying is very small by comparison. On nine farms investigated by the writer in 1919-20, it was calculated that 93·2 per cent. of the labour was provided by the farmer and his family, 5·1 per cent. by permanent hired labour and 1·7 per cent. by casual labour.<sup>1</sup> These figures do not profess to represent the nature of the supply of labour with perfect accuracy, but they serve to indicate that the wages bill on dairy farms is very small. It will be clear that the absolute amount of fixed capital required in dairying is

<sup>1</sup> Belshaw, *The Dairy Industry of New Zealand*. (Unpublished M. A. Thesis.)

less than in the two types with which it is compared, while at the same time, the demand for short term credit is likely to be less, both proportionately (to farm mortgage credit) and absolutely.

25. "In the purchase of stock again there are important differences. Dairy farms approximate more closely to the true type of productive farming, whereas there is a far larger element of speculation and trading in sheep farming at least. On most dairy farms, cows are to be regarded very much in the nature of living machines producing milk with pasture as the raw material. The initial cost of stock is heavy but there is little speculative buying and selling. The credit necessary to stock up the farm is usually of the same nature as that advanced for the purchase of land, and it is a common practice for both land and stock to be financed by means of long term credit secured by a farm mortgage. Having once stocked, the chief need is for replacement, the marketable commodity being mainly dairy produce. On sheep farms, or more particularly, cattle runs, the sheep or cattle themselves are very largely the marketable commodities, and these must be kept pending preparation for the market. The productive process is therefore long, particularly in the case of cattle, and a demand for short term or intermediate credit arises, with which there is no comparable demand in dairying.

26. "Similarly, there is less need in specialized dairy farms for expensive implements. The investigation mentioned above<sup>1</sup> showed that on the nine dairy farms selected, 77 per cent. of the area was in pasture, 7.7 per cent. in unploughable land, 7.2 per cent. in hay or ensilage, 2.3 per cent. in forage crops and 5.8 per cent. in root crops. The proportion under pasture is broadly representative of dairy farms in New Zealand. Under such conditions, expensive equipment for cultivation is not necessary. The specialized dairy farm will keep a two-horse team, a single or double furrow plough, a mower and a few other implement of small size and simple construction. Mixed farms and sheep farms will seldom have less than a six-horse team—probably two or three of them—with more expensive and complicated implements. Not only is there need for more intermediate credit to provide working plant on such farms than on dairy farms, but also heavier outgoings, in the shape of current working expenses, are required. By comparison, working expenses on dairy farms are low and regular. Even if the dairy farm possesses a milking plant, the expenditure, both on the initial instalment and for running the plant, is less than the costs of providing and maintaining horses and implements on a mixed farm."<sup>2</sup>

<sup>1</sup> Belshaw, *op. cit.*

<sup>2</sup> For an estimate of the cost of maintaining a six-horse team, see Fawcett, *N. Z. Journal of Agriculture*, December 1923.

27. From the foregoing discussion it will be seen that the type of farming influences materially the nature of the credit required. On dairy farms the demand for long term mortgage credit is less in amount per farm than on sheep or cereal farms, but bears a higher ratio to intermediate and short term credit. On sheep farms, cattle runs and cereal or mixed farms, the demand for short term and intermediate credit will be much greater both absolutely and in proportion to the demand for long term credit.

28. The contrast which we have thus briefly indicated serves merely to reveal the nature of the factors determining the relative importance of different kinds of credit and may be pursued along similar lines in respect of other classes of farming.

## CHAPTER III

# SOME ELEMENTS IN THE RURAL CREDIT PROBLEM

### I. REQUISITES OF A GOOD SYSTEM

#### 1. THE COST OF CREDIT

1. An adequate and efficient system of credit for agriculture will tap the resources of the money market at a cost which is neither more nor less great than for other purposes, allowing for such differences in risk, convenience to the lender, and expenses of marketing as cannot be removed; or for such special costs as are involved in reducing risk to the lender and increasing his convenience by special organization. A permanent disparity between the rate of interest in agriculture and industry is not *prima facie* evidence that the charges are less fair in one than in the other; for there may be an irreducible margin of difference in inherent conditions which organization cannot remove, or which necessitates types of organization involving greater costs than those needed to market credit to other types of enterprise. Nevertheless, the experience of special types of organization to market credit to agriculture, such as the German Landschaft Banks, reveals the possibility of devising credit machinery of a kind which offsets such special disabilities as affect agriculture and of marketing credit to farming industries at a cost which is comparable with that to sound industrial and commercial enterprises.

2. In many countries, however, agricultural industries suffer from a disparity in the cost of credit which could be greatly reduced, and there is the reasonable presumption that the credit resources of the community are not being directed in such a manner as to derive the maximum advantage from their use. One of the main problems of rural

credit is to remove this disparity or to reduce it to the smallest possible margin by appropriate organization. While it is not easy to state what a fair price for credit should be, or what is the irreducible margin of disparity which should exist in any agricultural district or type of farming enterprise, it is possible to indicate in general terms what conditions are necessary if agriculture is to be placed on a fair competitive footing with other types of enterprise.

3. As has been shown in Part I, Chapter III, the cost of credit is made up of four main items:—the pure rate of interest, the cost of marketing, the cost of risk and uncertainty bearing, and in some cases a monopoly element. In the main, differences in the cost of credit arise from differences in the last three items.

4. From the point of view of cost the requisites of a good system of credit to agriculture may be stated as follows:—

- (a) The system must be so organized that the collection of investable funds and their distribution to borrowers are performed as cheaply as possible.
- (b) Risk and uncertainty must be reduced to the lender to the lowest possible level. This implies, not merely that the chances of loss of interest and principal must be avoided as far as is possible, but also that the investor must be able to realize readily on his investment. Otherwise, he incurs the risk that he may not be able to satisfy his own needs for cash because his resources are "locked up."
- (c) The flow of credit must be so directed that non-competing groups of borrowers and lenders do not emerge. Such differences in the cost of credit as occur in different localities, between different types of farming enterprise and between individual farmers must not be greater than are necessary to equate differences in the cost of marketing and in the risk and uncertainty involved. They must not arise from other types of hindrance to the free movement of funds.

2. CONVENIENCE TO THE FARMER

5. Credit must be granted on such terms as will meet the convenience of the borrower. This implies two main conditions:—

- (a) Loans must be long enough to cover that part of the period of production (in the broadest sense) for which they are required.
- (b) The supply of credit, more particularly of short term credit, must be elastic so that its volume expands and contracts sensitively in accordance with variations in the need from season to season.

3. EQUITY OF THE FARMER

6. The security of the farmer must be conserved by guaranteeing his equity in so far as this is consistent with the security of investors.

II. THE COST OF CREDIT

1. THE COST OF MARKETING

*A. The Composite Nature of the Marketing Function*

1. The primary function of those who market credit is to establish contacts between borrower and lender. It has been suggested that in most cases this primary function is associated with others which are scarcely less important. Frequently the marketing intermediaries find it necessary to collect into one large aggregate a large number of small units of saving, individually of little use, and direct them to where they are required, thus reducing the cost of credit and increasing the supply. In addition, they assess the amount of risk and the value of the security offered against it and protect the lender by drawing up contracts in proper legal form. Frequently, also, they collect the interest and principal of loans, when they are due, and transmit them to the lender. In short, the marketing of credit is not a single simple function but a composite process including several functions which are not normally separated from each other.

The efficiency of the concerns depends, *inter alia*, on the cheapness with which they can perform this composite function.

*B. The Characteristics of Agricultural Organization which affect the Cost of Marketing Credit*

2. In an earlier chapter, the main characteristics of agricultural organization were described. It will be readily apparent that these will have an important bearing on the problem of equalizing the terms on which credit is given to agriculture and to other industries. It has been pointed out that agriculture must be regarded, not as a single simple type of industry organized on a fairly uniform plan, but as an industrial complex, covering many different types. Speaking generally, the farm business is small, and although there is a tendency in some localities to concentrate on the production of one crop or a narrow range of crops, yet in general, agricultural production is much less specialized than commerce or manufacture. By virtue of its intimate dependence on the land, and of the operation of the law of diminishing returns, the farm business covers a much larger area than manufacturing or commercial enterprises of similar size. These latter also tend to be concentrated at particular points and round them grow up commercial and financial undertakings to cater to their needs. From such undertakings the farm is separated by distances which may be sometimes very great. Finally, agriculture is subjected to technical and commercial risks of a special kind arising in particular out of the close dependence of agriculture on natural conditions which cause unforeseen losses and make it difficult to control output; and out of the length of time required for the maturing of crops. These factors raise special elements of difficulty which are likely to be reflected in the cost of credit unless they are provided against by appropriate organization.

*C. The Need for Specialized Institutions*

3. It may be regarded as broadly and generally true that the division of labour or the specialization of tasks, and the



standardization of methods and procedure are conducive to economic efficiency and the lowering of cost; but the economies inherent in these cannot be fully realized unless the volume of business of any particular kind is sufficiently great to keep fully occupied what might be called a minimum working unit. It will not profit a bank to employ a specialist doing nothing else but conduct agricultural business, still less a specialist for each branch of agriculture, unless there is enough business to keep him fully occupied. Nor will it be profitable to devote a great deal of time and energy in evolving a standardized procedure and policy in the making of loans to agriculture, or particular agricultural industries, if the volume of business is small. This reacts not merely on the technique of loan making as such, but also on the assessment of risk and the security against it, and will be an important, even though concealed, element in cost; for it will be clear that a person whose special business it is to investigate the purpose for which agricultural loans are required and assess the value of crops, chattels or real estate offered as security will be likely to perform his task more expeditiously, as well as more efficiently, than one who turns from other work to an occasional transaction in connection with agriculture. Such additional elements in cost may be spread over the transactions as a whole and not charged against any particular loan; but even so it will be desirable to eliminate them as far as possible by the appointment of specialists and the reduction of credit procedure to a routine. Since the scope for these economies is limited by the volume of business transacted, a small concern, or one which specializes in other kinds of business, will not normally be as satisfactory in these respects as a large and specialized institution, though it may sometimes possess advantages of its own.

4. The remoteness of the farmer from financial centres, and the habits of mind which the nature of the farm economy develop are also likely to raise special difficulties. Even if the city financier does not number his city clients among his acquaintances, he does at least move in a very similar atmosphere, and the mere fact of physical concentration of

the businesses with which his clients are connected makes it easier to obtain more or less reliable impressions of their integrity and efficiency. The farmer, who wishes to obtain financial accommodation from a banker, is less skilled than the business man in presenting his case. Frequently, he does not keep books and is able to state his position in less precise terms. He has a different outlook and different interests from the city banker and this is conducive to a less perfect understanding than is likely to arise between the city banker and the city business man. The remoteness of the farm operations, the variety in farm conditions and in the risks to which agriculture is subjected, all impose difficulties which are likely to be reflected in the terms on which credit is granted. These considerations emphasize the need for specialized institutions and indicate the importance of bringing credit institutions more closely into physical proximity to the farmer.

5. From this point of view small banks, located in country centres, possess advantages over large city institutions because of the more intimate nature of the contacts which are established; but there are more or less counterbalancing disadvantages. Frequently, as in the United States before the institution of the Federal Reserve and Federal Intermediate Credit Systems, they tend to become seriously involved in purely local crises, and must have large reserves if they are to maintain a sound position. They are denied many of the economies of administration which go with size. If they operate as isolated units, having little regular and systematic connection with each other, there is a tendency for a number of separate markets to develop, each bank or other credit institution having a limited clientèle and drawing its funds from a restricted area. To the extent that this occurs, competition is not free over the whole credit field and differences in credit terms arise. The separation into different markets is never likely to be absolute, but it may be sufficiently great to lead to an appreciable variety of conditions if the marketing units are small and independent. On the other hand a specialized concern, with many branches, may not only equalize the

credit terms over wide geographical areas, both by reason of its own activities and of its competitive influence on other dealers in credit, but also it may help to place agriculture on fair competitive terms with other kinds of enterprise by virtue of the variety of sources and wide geographical area from which it can draw funds, and of its capacity to draw on the resources of main money markets; and because it may develop a technique which offsets the special disabilities of agriculture.

6. Where an efficient system of central banking exists it may greatly facilitate the work of other institutions in equalizing credit terms over the field of agricultural credit. An efficient Central Bank not only leads to economy in the use of reserves, but also facilitates the freer movement of funds to different areas, and, if proper machinery is devised, places the funds of the main money markets at the disposal of agriculture. The establishment of the Federal Reserve System of the United States, associated with the increased use of agricultural credit instruments as the basis of deposit security with Federal Reserve Banks and assisted by the Federal Intermediate Credit System, has permitted greater economy in the use of reserves—and a freer and more elastic distribution of credit to farmers.

7. It might be argued that the disparities in credit terms which we have been discussing are likely to be avoided without the development of specialized institutions if there exist large commercial banks with wide-spread branches, or if commercial banks, even though they are small, operate as part of a closely integrated system of central banking. This is partially true in predominantly agricultural and pastoral countries, such as New Zealand, in which the banks devote a large proportion of their transactions to agriculture. Even where the proportion of their agricultural business is small, *geographical* differences in credit terms may be very largely obviated; but it is generally true that agriculture remains at a disadvantage with other types of enterprise unless special credit machinery of some sort is devised to meet the peculiar conditions of agricultural production

and organization; for commercial banks possess other limitations which we shall discuss at a later stage.<sup>1</sup>

8. The general tenor of the discussion in the preceding pages is, then, that the terms on which credit is granted to agriculture are more likely to be brought closely into conformity with those of other types of enterprise, and geographical differences are more likely to be removed, if some at least of the institutions marketing credit to agriculture are large and specialized concerns with branches or agents covering wide areas; and if they form part of a closely co-ordinated and integrated banking system.

#### *D. The Need for Credit Instruments*

9. A further essential to the cheap and sensitive transfer of funds is the creation of credit instruments which are readily negotiable. The transfer of metallic money between individuals, especially over large distances, would be risky and cumbersome. Not only do such devices as banknotes, cheques, bills of exchange, warehouse receipts, promissory notes, bonds or telegraphic transfers economize in the use of money, and (in some cases) provide a currency which can be used in its place for ordinary transactions, but also they make it possible for differences in interest rates to be met with rapidity through the provision of cheap and efficient means to transport, and transfer the control over resources.

#### *E. Legal and other Charges*

10. The extent to which legal and other charges can be reduced by the simplification of procedure and the provision of standardized documents is also of importance in reducing the initial cost of making loans, or the cost of renewal, and so in permitting the cheap and rapid transfer of funds.

### 2. RISK AND UNCERTAINTY

#### *A. Factors affecting Risk and Uncertainty*

11. The extent to which savings are directed on reasonable terms to agriculture will depend on the degree of confidence which can be engendered in agriculture as a source of

<sup>1</sup> See Part III, Ch. II; and Part IV, Ch. II.

investment and on the extent to which the convenience of the lender is safeguarded, as well as on the actual cost of marketing. In short, it will depend on the degree of risk and uncertainty.

12. The discussion of the problem of risk in Part I, Chapter III, will have made it clear that the factors affecting the degree of risk and uncertainty to the lender are numerous and complex. From the lender's point of view the main factors to be considered are: The degree of risk and uncertainty in agriculture itself; the ability of the credit intermediaries to assess risk in agriculture; the adequacy of the security and the ability of the credit intermediaries to assess its value; the liquidity of the security offered, or the extent to which the lender can realize on it for cash, should his own needs demand it; and the extent to which, and the ability with which, the credit intermediaries assume the function of risk and uncertainty bearing.

#### *B. Risk in Agriculture. Assessment of Risk*

13. As has been shown, agriculture is subject to peculiar risks owing to its close dependence on natural conditions and to the characteristics of farm production and organization. The great variety of conditions in agriculture and the remoteness of farms from financial centres add to the difficulty of assessing risk and also the value of the security offered. This applies, not only to the risk inherent in the farm enterprise itself, but also to personal risk; for frequently the inability of the farmer to present his position in the most favourable light, the absence of proper accounts and the difficulty which the banker or other dealer in credit experiences in becoming personally acquainted with the farmer or in estimating his ability by personal inspection of his farm, makes possible a wider margin of error in the judgments which the banker or other agent must form of the borrower's integrity and capacity. This further emphasizes the importance of having institutions able to command the services of men who, by long and intimate acquaintance with farmers and farm problems, may be expected to exercise reliable judgments on the degree of

risk inherent in any farm enterprise, the value, of the security and the personal integrity and efficiency of the borrower.

### *C. Adequacy of Security*

14. It goes without saying, also, that loans should not be advanced to the full assessed value of the security. An adequate margin should be allowed against possible misjudgment or against a possible decline in the value of security during the currency of a loan.

15. The proper valuation of security and a good margin between this and the amount of loan are necessary, not only to safeguard the interests of the creditor, but also in the long run, of the farmer, especially in reference to long term credit. If credit for the purchase of land is obtained on too easy terms as regards security, especially when this is associated with a low rate of interest, any advantage tends to be offset by an increase in the value of land, which often rises above its real value as a productive agent. The danger then remains that the farmer may be unable to meet his interest charges and be forced into liquidation. Similarly, the granting of credit on too easy terms for improvements or to meet running expenses may encourage uneconomic expenditure which is not reflected in an increase in income sufficient to meet the additional charges in respect of interest and the repayment of principal. For these reasons, insistence on a reasonable margin is to the best interests of the farmer, for it encourages economical management and reduces the chances that he will be unable to meet his obligations should prices fall. It is even more important that the market price of land should coincide closely with its value as a productive agent.

### *D. The Bearing of Risk and Uncertainty: Collective Security*

16. Of great importance also is the extent to which risk can be transferred from the shoulders of the lender to the credit intermediary or spread over the whole body of lenders, so that the loss in respect of an individual loan does not fall on an individual lender. The capacity of credit

institutions to act as a buffer or to spread risks is one of the important tests of a good credit system for agriculture.

17. The transference of risk from the shoulders of lenders is achieved by commercial banks which act as principals. In this respect bank credit is superior to a loan by an individual lender to an individual borrower, in which case the risk is concentrated on one person. Commercial banks do not advance a particular deposit to a particular borrower, but accumulate a reservoir of funds from a multitude of sources, out of which they make their advances. The bank interposes, not between individual borrowers and lenders, but between a body of borrowers and a body of lenders. Therefore, it cannot pass on the risk involved in a particular loan to a particular lender, but must assume the risk itself—a function for which it is better qualified, in general, than the single lender. The pooling process reduces risk to the investor because the losses resulting from any individual loan are not concentrated on him, but spread over the whole body of lenders.

18. The same end is achieved by the direct adoption of the principle of collective security. In some cases, as for example in the Raiffeisen Credit Banks, the risks involved in *any particular* loan are transferred from the lender to a *group of borrowers*, who assume individual and collective responsibility for the loans which the members of the group contract. In others, as for example in the Landschaft Banks of Germany, and the Federal Farm Loan System of the United States, the necessary funds are obtained by the issue of standardized bonds, against which the final security is *all the mortgages* against which loans are advanced to farmers.

19. In these cases, the extent to which funds are transferred to agriculture depends primarily on the confidence which investors have in the efficiency and integrity of the credit institutions. It will be based on their estimates of the wisdom of those who control such institutions as revealed by past experience. It will be influenced also by the size and standing of the individual concerns. the extent and

character of their reserves and the relationship between the various individual units in the credit system. On this last condition will depend very largely the capacity of the credit system to withstand unexpected shocks and losses.

#### *E. Convenience to the Lender*

20. It has been emphasized that the degree of convenience to the lender is a factor affecting the price at which he is prepared to advance credit. If the loan is liquid, i.e. if he can turn it into cash when the occasion demands it, he will be prepared to accept a lower rate of interest than if his loan cannot be realized upon readily. In the case of ordinary commercial banks this condition is safeguarded by the acceptance of deposits which can be withdrawn at will, or are received for short and definite periods; but the conditions under which loans can be accepted depend very largely upon the conditions under which credit is advanced by the marketing intermediaries—or conversely the conditions under which credit is advanced depend on the conditions under which they are able to borrow from the investing public. Commercial banks are able to accept deposits for short and uncertain periods because their own advances are for short periods—or conversely they find it necessary to keep their assets liquid by advancing loans for short periods, or under such circumstances that they can readily be recalled, because their deposits are for short periods. The nature of deposits and loans mutually govern each other.

21. In agriculture, however, loans advanced on such short terms would have serious disadvantages to the borrower, or conversely, the reliance on short term deposits to finance loans of adequate length would endanger the position of the bank or other financial agent. Since loans are for a longer period, investments with the bank must also be for a longer period. Hence the convenience of the lender must be safeguarded by providing a liquid asset of another kind.

22. An essential point of contrast between agriculture and industry or commerce is the small growth of the joint stock



plan of securing fixed capital in the former, and its remarkable development in the latter. The adoption of the principle of limited liability and the establishment of specialized institutions to float companies and market standardized securities, issued in a variety of forms to suit different classes of borrowers, has permitted the accumulation of amounts of capital sufficient to meet the requirements of the largest business. On the other hand, these conditions would not have resulted in the growth of businesses of the size of modern companies, had there not been economic advantages resulting from large scale operations. In short, the economies of large scale production have made possible the extensive development of the joint stock plan.

23. Reasons for the comparative absence of the joint stock method in agriculture, and the consequent difficulty of tapping the resources of the money market in terms comparable with industry, are to be found in those characteristics of the farm economy which have been described. Owing to the small size of most farms, it would not be worth the while of underwriters to float a company for each individual farm, or for the Stock Exchange in a financial centre to quote its shares on the money market. Further, it would be virtually impossible to assess at all readily the value of the security which was offered in support of shares or debentures tendered for sale. Not only would the value of the property on which these were based vary from district to district, but also from farm to farm. The value of security could only be assessed by expert inspection and this would be a difficult and costly matter, especially in view of the remoteness of farms from financial centres and of the numerous risks to which farming is subjected. At best the market could only be local, and even then the need for expert valuation of properties would remain. Further, success in farming depends to a greater extent than in industry upon the technical efficiency and business acumen of one man—the individual farmer. Since the readiness of investors to advance credit depends in the main on their estimate of the future earning capacity of the investment, the personal factor looms large in the minds of investors in farm

property. The individual investor purchasing a few shares in a farm company would find it difficult, if not impossible, to evaluate this factor and his risk would be correspondingly increased. In consequence of these conditions the cost of marketing would be very great. Risk to the lender would be high and he would demand a very high gross rate of interest. The transfer of shares would be difficult and the investor would experience trouble in disposing of his shares for cash. Hence the problem of long term credit consists in devising an effective substitute for the joint stock method of obtaining the necessary fixed capital. This resolves itself into marshalling the security of farmers and replacing individual by collective security in such a form that it is readily marketable. Commercial banks are unable to advance any considerable proportion of their deposits on long term loans, since this endangers the liquidity of their assets. The same applies to a great extent even to intermediate credit. Institutions especially catering for agriculture may, however, safeguard their own position by the manner in which they obtain their funds. This they are able to do by the provision of standardized securities in the form of bonds issued for a period long enough to cover the period of their advances.<sup>1</sup> If the credit institutions are of good standing these possess a wide market and can be readily turned into cash. The convenience of the lender is ensured without endangering the security of the borrower. By contrast, the farm mortgage securities which result from transactions between individual borrowers and lenders are unstandardized and possess a restricted market. Although they may sometimes be issued on such terms as to be satisfactory to the farmer, yet they are a less liquid asset to the lender.<sup>2</sup> The adoption of some such procedure as the issue of standardized bonds, secured against the reserves of the bank and the aggregate of mortgages which it holds as security from individual farmers, is necessary if the securities are to have a wide market.

<sup>1</sup> As, for example, in the case of the German *Landschaften*, the Federal Farm Loan System and the Federal Intermediate Credit System of the United States.

<sup>2</sup> See Part III, Ch. I.

## 3. THE MONOPOLY ELEMENT

24. In discussing the cost of marketing we have referred to the fact that the imperfect integration of the credit system may prevent the development of a single, homogeneous market and cause more or less separate markets to emerge in which differences in credit terms result. These differences may be due in part to differences in the efficiency of the machinery for marketing credit in the separate markets, but they may be due also to differences in the ratio of credit-supply to credit-demand. Lenders in some markets are able to extract a higher reward for the service of "waiting" because of the imperfect competition of supplies from other sources. These conditions may arise either in respect of different areas or of different classes of farming.

25. The problem goes further than this, however. In many countries, an appreciable proportion of the credit advanced to farmers is granted by individuals or merchants. Where large (and more particularly specialized) institutions exist, to which the farmer has ready access, they may exert a powerful competitive influence which forces the "unorganized" market of individuals and merchants to conform to the standards they impose. In the absence of such competition, however, there tends to be a wide variety in credit terms, due partly to differences in the standing of individual farmers, partly to the different degrees of monopoly power exercised by lenders. In the absence of an "organized" credit market, the field of supply tends to be limited and the farmer is forced to obtain credit from a small number of sources. This may apply to greater or less extent even when well established commercial banks exist; for the nature of the credit which the farmer requires may not be favourably regarded by the commercial banks, or the difficulties he experiences in presenting his case or establishing personal contacts with the banker may impose important hindrances.

26. The large farmer whose financial position is sound will not usually have much difficulty in borrowing on reasonable terms, but the small farmer who is less expert on the

business side of farming and who frequently requires credit in small amounts may often be subjected to open or veiled extortion. This was particularly common among European peasant communities before the development of co-operative credit institutions. Frequently their only source of credit was the village money-lender, who could be relied on to keep their transactions secret and who charged exorbitant rates. Often enough the farmer does not realize the heavy price he is charged, and pays more for the advantages of secrecy and convenience than loans are worth. The purchase of goods on the instalment plan or on credit from storekeepers and merchants possesses decided advantages of convenience to the farmer, but the higher price which the farmer has to pay for the goods frequently represents a prodigious cost which he would not pay if it were expressed as a rate of interest.

27. In such cases a somewhat higher charge than that required on ordinary loans by banks or other institutions may be quite reasonable in view of greater risk or trouble in the management of loans. It represents a fair charge for a cumbersome and inefficient service. But in many cases the additional cost represents a levy which can only be charged because of the ignorance of the farmer or the limitations on effective competition.

28. When the sources of credit on which the farmer may draw are limited, the same sort of monopoly element may creep into the cost of farm mortgage credit. Frequently, however, the superior bargaining position of the lender may be revealed, not in a higher interest charge, but in onerous conditions which endanger the equity of the farmer or limit his freedom of enterprise.<sup>1</sup>

29. The various forms of exploitation which may arise in an unorganized market are difficult of direct control. The only remedy likely to be at all effective is the competitive influence of an organized system.

### III. LENGTH OF LOANS

1. Both the security and convenience of the farmer necessitate that loans be advanced for a sufficiently long

<sup>1</sup> See Part III, Ch. I.

period to enable them to be repaid from the additional income which the loan makes possible. The renewal of loans may involve additional charges in the way of value-assessments, commissions and legal fees which should be avoided, while renewal may be enforced at high rates at a time of stringency or when the urgency of the farmer's needs places him in an inferior bargaining position. The way is then opened for exploitation.

2. We have indicated that credit to purchase farms should be for a period of twenty or thirty years, since it is seldom that such loans can be repaid out of income during a lesser period. It is also important that provision should be made for the amortization of loans, which may be defined loosely as the repayment by small and regular instalments. This encourages thrift and permits of the systematic accumulation of appreciable savings.<sup>1</sup> Further, in view of the fluctuating nature of farm income, it is desirable that provision should be made for the repayment of additional amounts of the principal in good times and the holding over of payment both of interest and principal in bad times, or when the farmer suffers exceptional losses, the deficit being left to accrue as an addition to the principal. A provision of this sort reduces the possibility that the farmer may be forced into liquidation by temporary distress, and provides a means of utilizing surplus income to free himself from debt. Incidentally, also, it makes for greater stability of income.

3. Short period and intermediate credit, we have suggested, should cover the normal period of production and marketing so that loans may be liquidated from the proceeds of crops. By virtue of the long period of production in agriculture, the financial resources of the farmer are likely to be severely depleted towards the end of the season. If credit is inadequate or is advanced for too short a period, the farmer may be forced to dispose of his crops on a bad market instead of choosing his own time. His returns are therefore substantially reduced. If many farmers are

<sup>1</sup> See Note on Amortization, Appendix I.

forced to act in similar fashion the market itself is damaged by a temporary glut, an unnecessary element of price fluctuation is introduced, and it becomes possible for merchants with more abundant resources than the farmer possesses to profit by his misfortunes, by buying cheap and holding for a rise. Hence adequate credit, advanced for a long enough period, not only enables the farmer to avoid selling in a bad market, but also prevents farmers "acting in the aggregate under financial pressure from themselves creating a bad market."<sup>1</sup> It is questionable whether the deliberate holding of crops longer than the normal period in order to regulate prices really pays the farmer in the long run.<sup>2</sup> It is important, however, that the farmer should be able to choose the time of sale within reasonable limits and that it should not be determined for him for his own credit exigencies.

#### IV. ELASTICITY OF CREDIT

1. The problem of loan-period is closely bound up with the problem of elasticity. Most agricultural crops are seasonal, with the result that a large volume of produce tends to be ready for the market within a limited period of time. As a result, there is a heavy increase in the demand for credit to market and transport crops round about the time of harvesting. At the same time, there tends to be an increase in the demand for currency to pay for the services involved in the harvesting, marketing and transporting processes, more particularly to pay wages and the like. It is precisely about this time that the farmer will find his own resources most severely depleted and will require extra funds to pay for harvesting, transporting and storing his crops. If he has been able to arrange for loans sufficient in amount and long enough in duration to tide him well over this period and enable him to hold his crops until a favour-

<sup>1</sup> Enfield, "Report on Agricultural Credit," *Ministry of Agriculture & Fisheries* (U.K. Economic Series, No. 8, p. 17).

<sup>2</sup> See Boyle, "The Farmers and the Grain Trade," *Economic Journal*, March 1925 *et seq.*, in which it is pointed out that the speculative holding of grain does not pay on the average.

able moment arrives for disposing of them, the increased demand for funds to move crops will not embarrass him; but in anticipation of an autumn "drain" on their resources, banks will tend to arrange the period of loans so as to leave their funds as free as possible at the critical season, and may begin to call in loans in advance of anticipation. In such circumstances, the farmer may find his supply of credit dried up at the time when he requires it most and may be forced to sell his crops in order to obtain funds to meet his needs. Under this necessity his bargaining position will be inferior to that of the merchant who can afford to wait if necessary and who, by virtue of his greater business with the banks and more substantial standing, may be able to obtain the credit which has been denied the farmer. It is precisely under such circumstances that farmers, "acting in the aggregate under financial pressure" may themselves create a bad market. In order to avoid such a crisis, it is highly important that the banking system should be resilient, and that means should be devised to vary the supply of credit to correspond to the varying needs of agriculture, industry, and commerce.

2. This implies that additional money credit<sup>1</sup> should be created to balance the increased volume of goods flowing on to the market, and additional currency should be created to provide for the payment of the additional services which are occasioned. The problem thus arising is not peculiarly one of rural credit, but is rather a problem of general banking. It is important, however, especially in a country where agricultural industries are considerable, that machinery should be devised to relate variations in the supply of credit and currency to variations in the demand for these to move agricultural crops. A method must be found whereby crops in process of maturity or coming on to the market are made the basis of the security against which the new credit and currency are created. Perhaps the most striking experiments towards this end are those which are embodied in the Federal Reserve System and Federal Intermediate Credit System

<sup>1</sup> See Part I, Ch. I, p. 12 *et seq.*

of the United States. These are described in a later Chapter.<sup>1</sup>

3. The importance of the factor we have been discussing is not the same for all crops. In dairying, for example, in which the produce is marketed fairly continuously throughout a great part of the year, the problem is seldom acute; but in the case of wheat, wool, cotton and similar crops, in which the yield is more definitely concentrated in time, inadequate finance to prevent a glut may seriously injure the farmer. Even an extra good crop may be a curse instead of a blessing and the tightening of credit or the exhaustion of funds at such a time may cause large quantities to be thrown on the market. Under such conditions the provision of adequate credit machinery may mean all the difference between profit and loss to the farmer. The psychological reactions may be as important as the direct effects.

"The economic life of a community," said Dr. Earle Page in a recent speech,<sup>2</sup> "may be guided by fear or by confidence. A change from one to the other may mean a change in the whole economic situation. Of this we had an instance last year in connection with our wool clip. The position was that there was an exceptionally good clip, a great demand for our products and high prices. Yet the absence of some adequate machinery providing the credit and the confidence necessary to handle the business did hold up the wool sales for a week, and but for the prompt action of the Directors of the newly-formed Commonwealth Bank, might have brought the wool sale into intolerable chaos."

4. The same moral is pointed by the action of the United States War Finance Corporation in relation to the 1921 cotton crop. Fluctuating exchanges and shortage of purchasing power among European buyers caused them to buy on a hand to mouth basis, so that between 1½ to 2 million bales, usually sold in the first six months after the

<sup>1</sup> See Part IV, Ch. IV. The problem is not, of course, simply one of providing seasonal elasticity. It is important also to avoid as far as possible the credit stringency often associated with the trade cycle. This, however, is largely a matter of general credit policy and is not peculiarly a problem of rural finance.

<sup>2</sup> Speech on introducing the "Commonwealth Bank Bill Rural Credits," 19th August, 1925.



harvesting of the crop, had to be carried over. This involved storage and finance and increased the burden of American banks. Since this was unforeseen, reactions threatened to be serious and it appeared that the bottom might fall out of the market. To relieve the situation, the War Finance Corporation arranged finance for over one million bales. There was no longer the danger of a glut, mills were able to carry stocks without fear, and banking and financial institutions were able to offer help they had previously been afraid to advance.

"This happened at the beginning of July, 1921, when the cotton situation was perhaps at its worst. Cotton had been a drug on the market. The small quantities that were being sold only brought 8 cents a pound at the country points, and finance throughout the cotton belt was in a demoralized condition. But when it became clear that 600,000 bales of cotton which had been depressing the market were being financed for a sufficiently long period of time to ensure orderly marketing, there was a radical change in the cotton situation, and the price of cotton rose to 18 cents in 90 days.<sup>1</sup>"

The fruitful experiences of the War Finance Corporation were largely responsible for the establishment of the Federal Intermediate Credit Banks in the United States.

5. While the examples quoted arose mainly out of the exceptional conditions of the post-war period, yet they serve to illustrate a problem which is ever present in greater or less degree.

## V. EQUITY OF THE FARMER

1. It is also important that the equity of the farmer be safeguarded in the event of liquidation. The danger is frequently all too common that the debtor will lose, not only the amount of his undischarged debt, but also his whole investment in land and stock and walk off the farm a penniless man. When foreclosure is unavoidable the farm and stock should be sold in a proper manner and any excess over the debt from the net proceeds of sale returned to the farmer.

<sup>1</sup> Speech cited. (See p. 102, footnote<sup>2</sup>)

## VI. SUMMARY

1. The conclusions of this chapter may be summarily stated as follows:—

(a) These are three main requisites of a good system of rural credit:—

(i) The cost of credit to agriculture should be the same as for other purposes, allowing for such differences in risk, convenience to the lender and expenses of marketing as cannot be removed by appropriate organization. This implies first that an efficient system must be devised for the collection and distribution of investable funds; second, that appropriate methods must be adopted to reduce risk to the lender and enable him to realize on his investment in cash; third, that hindrances to the free movement of funds, which result in the establishment of more or less independent markets, must be avoided.

(ii) The convenience of the farmer should be safeguarded by ensuring that loans are for a long enough period to cover the productive process for which they are required, and that the supply of credit is elastic.

(iii) The equity of the farmer must be safeguarded in the event of liquidation.

(b) The equalization of credit terms with those to other industries and in respect of different areas and types of farming enterprise is likely to be facilitated by the existence of large and specialized institutions with established branches. An efficient system of central banking may greatly assist the work of other institutions in equalizing credit terms over the field of agricultural credit.

(c) The cheap and sensitive movement of funds is facilitated by the use of proper kinds of credit instrument.

- (d) The cheapening of credit to agriculture through the reduction of risk and uncertainty to lenders necessitates the efficient assessment of risk and of the value of the security offered against it. It requires that an adequate margin of security shall be allowed and that devices shall be adopted to spread (and cancel) risks as widely as possible and avoid the concentration of the risk involved in any one transaction on the shoulders of a single individual. The problems involved in the assessment of risk and security are such as again to suggest that advantages are to be derived from the establishment of large and specialized institutions which are able to employ experts spending their whole time on the work. The desirability of insisting on an adequate margin is not peculiar to agriculture. The spreading and cancelling of risk is best achieved when the credit intermediary acts as a principal taking over the functions of risk and uncertainty bearing; or when borrowers adopt the principle of collective security.
- (e) Convenience to the lender is best ensured, without endangering the security of the borrower, when funds are obtained by means of standardized securities with a wide market. For reasons inherent in agriculture itself, the joint stock method of organization is not common and some other method of providing such securities must be devised. This resolves itself into marshalling the security of the individual farmers by the establishment of collective security in a standardized form. An institution specially catering for agriculture may achieve this by the sale of bonds, issued for a period long enough to cover the needs of the farmer and secured against the resources of the institution and the whole of the mortgages or other kinds of lien deposited by farmers with it against loans to them.
- (f) Long term credit to farmers should be for a period of twenty or thirty years or more, and should provide

for gradual repayment by means of amortization. It is difficult for most non-specialized institutions to conform to this condition. Short term and intermediate credit should cover the normal productive process for which it is required.

- (g) Unless the farmer is to be faced with the danger of having to dispose of his crops at an unsuitable time because of his own needs for cash, it is important that credit should be capable of expansion about the time when the bulk of farm crops are ready for the market. A method must be found, whereby crops in process of maturity or coming on to the market are made the basis of the security against which new credit and currency are created.
- (h) In order to safeguard the equity of the farmer, proper methods should be enforced of disposing of his property in the event of liquidation and returning to him any balance over his outstanding liabilities and such necessary costs as are incurred in the process of liquidation.

**PART III**

**LONG TERM CREDIT AGENCIES**



## CHAPTER I

# THE "OUTER MARKET" FOR LONG TERM CREDIT

1. We are now in a position to examine the various ways in which finance is provided to agricultural industries. In Part III we shall consider certain of the methods which are adopted in the marketing of long term credit, leaving a discussion of short term and intermediate credit agencies to Part IV. This chapter will be concerned with a discussion of what may be called the "outer market" for long term credit for want of a better title. The sources of supply in this market will include private lenders, dealers of various kinds, insurance companies, trust companies, and the like.

### I. PRIVATE LENDERS

1. Private lenders are of considerable, though decreasing, relative importance in many countries as a source of long term credit to agriculture. Thus, in the United States, former landowners and other private investors are two of the most important sources of farm mortgage credit, advanced mainly for the purchase of farms. A survey of owner-operator farms quoted in a report published in 1924 showed that 21 per cent. of the total credit of owner-operators was from these sources.<sup>1</sup> In other countries private lenders are also very important, though no figures are available as to their precise extent.

2. Much credit of this type is advanced by the vendors of farms who take out a part of the purchase price against a second mortgage, the balance of debt being placed elsewhere on first mortgage. From the vendor's viewpoint, this method frequently possesses the advantage that it

<sup>1</sup> *U.S. Department of Agriculture, Year Book, 1924, pp. 197-8.*

facilitates sale, while it is advantageous to the borrower in that finance is frequently arranged on easy terms to encourage a sale. The balance may represent a considerable proportion of the market value, so that the occupier's initial capital need only be small. The vendor also knows the farm and is in a somewhat better position to assess its value as security than the outside private investor. On the other hand, there are the corresponding disadvantages that the terms on second mortgage are probably counter-balanced by a higher price paid for the land, and especially that the new farmer's equity frequently tends to be so small that he is unable to meet his indebtedness when conditions are bad. Standing charges become too heavy for the enterprise to meet them under unfavourable conditions. In such circumstances, the security of the vendor may be small, and the apparent advantage of a higher selling price is cancelled.

3. Frequently, solicitors act as intermediaries between private investors and farmers, thus relieving the investor of the work of marketing by placing him in contact with a suitable borrower and reducing risks by examining the security and preparing the contract in proper form. In other cases, loans may be made direct, either by private individuals who have surplus funds available for investment, or by moneylenders.

4. The conditions under which private loans are granted will be numerous and varied, so that to generalize is not easy. Certain general objections are clear, however.

5. In the first place, the very fact that the conditions *are* varied and are in the nature of a large number of private contracts between two individuals, renders it more difficult to control them and grade them up to the best practices than if credit is advanced thus by a smaller number of agencies of a public or semi-public character. Hence it is much easier for exploitation to escape the searchlight of public opinion; for a large concern enjoying a high degree of prestige, and more subject to direct pressure from and regulation by government, is less likely to run the risk of exposure to



public criticism and official interference. Frequently, of course, the conditions under which it is to make advances and raise funds will be stated in its charter of incorporation. Further, under private credit, the local nature of the transactions and the lack of co-ordination between individual lenders renders difficult the sensitive movement of funds to where they are required most, and credit is not evenly distributed according to requirements. There is then a tendency for such conditions of quasi-monopoly to emerge as were discussed in the preceding chapter.

6. In most cases such individual loans are for too short a period and do not normally make provision for amortization, but are usually repayable in a lump sum on maturity. Hence the method does not satisfy the prime necessity of convenience to the borrower, and the incentive to thrift which is usually associated with the principle of amortization is lacking. Further, renewal and replacement charges tend to be heavy and add materially to the cost of credit. There are also elements of danger to the farmer if he suffers bad times and cannot meet his interest charges, or if the necessity for renewal occurs during depression. The danger is enhanced because the risks involved are concentrated on two persons, the borrower and the lender. There is no intermediary to act as a shock absorber and no means of spreading risks widely. Usually the private lender has small reserves to fall back on and for his own safety may have to insist on liquidation. The way is also readily opened up for the imposition of such terms as it is known cannot be met, or will keep the farmer in perpetual bondage, especially in view of the difficulties of public scrutiny and regulation.

7. In a later chapter we shall have cause to refer to the prevalence of such evils in certain parts of Europe before the institution of co-operative credit systems. These applied more particularly to short term and intermediate credit; but that conditions of economic peonage may arise also out of the terms under which long term credit is granted, even in such an economically progressive country as the

United States, has been revealed by hundreds of applications for loans through the Federal Farm Loan system since its inauguration. "There are to-day, however, many land speculators and real estate dealers who make farm-mortgage loans with no other object in view than to fleece their victims of their last dollar. This is readily and legally accomplished by making mortgage conditions so burdensome that only one farmer in a thousand could possibly meet them through the income derived from the operation of the farm."<sup>1</sup> It is too much to expect that other countries are free from such exaction. No similar cases have come under the personal notice of the writer in New Zealand, but it is quite likely that they exist. Even if mortgagees have always been guiltless of such dubious practices, many cases have arisen where mortgagees have been forced to foreclose because of the urgency of their own needs. Frequently, farms were so over-mortgaged in consequence of the post-war boom that foreclosure would have been inevitable under any system. Nevertheless, a properly devised system of long term credit, efficiently managed, would probably have saved many.

8. There is also the possibility that the city investor, operating directly or through a lawyer, may not be in a position to assess the real value of the security offered, and so may advance on such terms as will involve him in loss on liquidation of the property. In any case, the costs of marketing and assessment of security are likely to be higher than with large and specialized institutions. On the other hand, the farmer is likely to lose such equity as he may possess in the land if it is placed on the market.

9. Finally, the market for the mortgage held as security is likely to be narrow and local, and the mortgage must normally be sold as a whole. Hence the canon of convenience to the lender is not adequately safeguarded, since his asset cannot so readily be turned into cash as standardized securities marketable in small units.

10. In view of these weaknesses, long term credit by

private individuals can scarcely be considered to be the ideal form for agriculture. As compared with credit issued by specialized concerns it is likely to be costly, both by virtue of less efficient methods of marketing and assessment, of the expenses of renewal, and of the concentration of risks. It is also less suited to the needs of agriculture because the period of loans is too short, and because the absence of arrangements for amortization makes it more difficult to pay for the farm out of income. It is a less convenient form to the investor because of the narrow market for farm mortgages. Finally, it more readily lends itself to the exploitation of the farmer.

## II. DEALERS

1. Under this heading we consider credit advanced by stock and station agents, auctioneers, commission salesmen, merchants and storekeepers dealing in farm requisites and others who provide credit ancillary to their main business. It is probable that the bulk of the credit provided by concerns such as the above is usually short term or intermediate, though in some regions certain types engage to quite an important extent in the financing of long term loans.<sup>1</sup>

2. Perhaps the most appropriate method of indicating the defects of dealer's credit is to exemplify from the experience of New Zealand, by reference to the so-called "stock and station agents" such as operate in similar fashion in many countries, and will serve to illustrate the dangers of dealer's credit in general. These concerns, which are commercial houses, often of large size with head offices in Great Britain, advance a considerable volume of credit of all sorts to farmers.<sup>2</sup>

3. The primary functions of such firms are to buy the farmer's produce or sell it on commission as well as to sell him implements, seeds, manures, and indeed practically all

<sup>1</sup> This account is mainly a résumé of certain portions of the paper already referred to—Condliffe and Belshaw, *op. cit.*, p. 342-344.

<sup>2</sup> In the United Kingdom dealers have provided much intermediate and short term credit in the past, but have not normally provided long term credit.

farm and household requisites. Arising out of these functions has been the natural development of a banking side to the business to meet the credit requirements of farmers. No doubt direct loans developed out of extended "booked" credit for the purchase of requisites, analogous to the "store" credit discussed in a later chapter, and advances against sales of crops and stock. The competition of firms for business has encouraged the development of this practice and also the advancing of more permanent loans to procure land and implements. It is apparent that the financing of the permanent capital requirements of the farmer brought with it (or might be tied to) an increase in the primary business of buying and selling. The competition of these firms among themselves, therefore, resulted in the development of a considerable business in the financing of land purchase against mortgages.

4. The capital required for this purpose is obtained, partly from the commercial banks, partly from fixed deposits or deposits on current account bearing interest and in some cases from the London market. Since the commercial banks do not give interest on current account, a useful volume of funds is obtained by means of deposits. The profits of the companies are made not so much on their financial transactions as on their commercial operations. The rate of interest charged to farmers is considered about sufficient to meet bank charges and to compensate for the administrative expenses and risks involved.

5. There is no doubt that these concerns have performed a useful service in the provision of credit to New Zealand farming industries. The rapid and continuous development of the rich agricultural and pastoral resources of the country demanded abundant credit on reasonable terms. This was provided very largely by the stock and station agents who played a considerable part in building up the sheep and mixed farming industries. They were less useful in dairying, since it afforded fewer opportunities for profit on the sale of produce and so was less attractive to them. In view of the fact that they specialize in transactions related to farming,

they are in a better position than the banks to assess the value of securities offered and so are useful intermediaries between them and the farmer.

6. On the other hand, they possess serious disadvantages. The desire of agency companies to obtain large profits on their commercial business, and especially the competition amongst the various firms, encourages the extension of loans on inadequate security. Such loans are chiefly conditional on the purchase and sale of all farm requirements and crops through them. The farmer often becomes tied to the firm, for it becomes a condition of his advances that he must purchase his supplies or sell his produce through them or else pay them their commission.<sup>1</sup> He is therefore hampered in not being able to sell just when and where he pleases. This dependence does not stop at being tied in respect of his purchases and sales to a single middleman, but in times of depression he may have to suffer interference with the detailed work of his management. In the long run, these conditions cannot but result in inefficiency. Many, if not most of these firms, are of such a size, that they pay income tax (leviable in New Zealand upon companies) at the maximum rate. Each of their departments has to compete with smaller specialized concerns paying lower rates, and there seems little doubt that the prosperity of agency firms depends to a large degree on the extent to which they can make the farmer financially dependent upon them.

7. In justice to the agency companies, it should be added that in many cases the above conditions are definitely understood as being contingent on the provision of loans, and that from the point of view of the companies it seems reasonable that a borrower who is prepared to accept the advantages of cheap credit on poor security should also be prepared to shoulder the burdens imposed. Although this excuses the agency companies, it does not remove the obvious disadvantages of the system.

<sup>1</sup> Cases have come to the writer's notice of "tied" farmers who have changed over from mixed farming or stock farming to dairying. Since their dairy produce was not sold through the agency company, the farmer was forced to pay the usual commission on the value of his dairy produce even though the produce did not pass through the agent's hands.

8. The weaknesses of credit of this sort do not stop at the limitation imposed on the freedom of action of the farmer. There is the additional disadvantage that loans are seldom for a long enough period, while provision for amortization is not general. It is at least arguable whether the agency firms have not been too liberal to the farmer for his own good. During the long period of prosperity from about 1896 to 1920 when each year's prices were higher than the last and the current term used to describe the Dominion's prosperity was "buoyant," they tended to forget the lessons of the period of adversity and falling prices through which New Zealand struggled from 1873 to 1895. It is questionable whether the real development of the Dominion has not been retarded by the forced speculative development which they have materially encouraged. The granting of credit on too easy terms and on inadequate security has undoubtedly been a factor in encouraging the too frequent transfer of farms and the inflation of land values. The weaknesses of the position were revealed during the slump which followed the hectic expansion and inflation of the post-war years. In very many cases the equity of the farmer was proved to be too small, and scores were forced to relinquish their holdings. Agency companies must bear their share of responsibility for feeding the post-war boom in their anxiety to secure as large a share of the spoil as possible.

9. Their embarrassment was accentuated, when depression set in, by the curtailment of loans from the banks and the withdrawal on a large scale of funds deposited with them. One large company which relied on large sums held at short notice on the London Market suddenly found its supplies of credit called in and was forced to exert pressure on its clients. A whole district was virtually forced into liquidation and has not yet recovered. Those firms which relied on local sources of supply were scarcely more fortunately placed. With the collapse of the market in 1920-21, their assets became frozen and their own sources of credit were seriously depleted. To these conditions must be added, in many cases, heavy over-importation and over-expansion of their commercial activities. In many cases an

attempt was made to relieve the situation by the issue of debentures for large amounts at from  $7\frac{1}{2}$  per cent. to 8 per cent. in order to fund their short term liabilities. The commercial banks arranged extra support and the Government at one time contemplated similar action.<sup>1</sup>

10. Perhaps the most disquieting feature of the situation is that after twenty-five years of continuous prosperity, including the pronounced war and post-war boom, these firms upon whom so much has depended in the past were so hard hit by the first gust of adversity. It would seem that both in respect of their individual businesses and in their financial control over the primary industries of the Dominion, they have relied upon a continuance of the easy prosperity that, in a country such as New Zealand which is both a producer and a debtor, always attends a period of rising prices. The over-capitalization of farming industries, for which they must share a great deal of the blame, the lack of adequate reserves and their reliance on short term sources of loanable funds have involved not only themselves but through them the banks in embarrassment and have reacted on the whole community.

11. The weaknesses and dangers of this method of finance are such that we take it as a general principle, applicable to other countries as well as to New Zealand, that the provision of long term credit should not be associated with the sale of requisites and the purchase of crops and stock, since anxiety to obtain business of this sort may cause unwise finance, associated with the danger of land inflation, over-mortgaging and restriction on the economic freedom of the farmer. It is true that the post-war depression was of exceptional severity and that in many cases agency companies acted commendably in “carrying” farmers who were indebted to them, and who might have been forced into liquidation had they been dependent on other sources of credit; but the post-war situation only

<sup>1</sup> The shares of some of these companies were for some time practically unaleable. The debentures referred to above have also been at a considerable discount, while arrangements have been made in some instances to reduce the original rate of interest payable and also to call up fresh capital from shareholders.

served to reveal, in an intensified form, the dangers which are always likely to be present when the association of financial with commercial transactions submits dealers to the temptation of making advances on easy terms in order to attract commercial business. In a young country, where other sources of long-term credit are inadequate, they may play an important part during the earlier years of development; but their inherent weaknesses as a source of credit are such that they cannot be regarded as a good substitute for properly constituted agricultural banks under the less buoyant conditions of the post-war era.

### III. INSURANCE COMPANIES, TRUST COMPANIES, AND LOAN COMPANIES

1. Insurance companies, investment trusts, farm mortgage companies and the like do a large business in many countries in financing long term loans, though they do not appear to be concerned very much in the provision of short-term or intermediate credit. In the United States these concerns have been an important source of the fixed capital of agriculture. It is estimated that in September, 1924, insurance companies in the United States provided some \$1,781 million against farm mortgages, or round about 20 per cent. of the total mortgage indebtedness. Further, they played an important part in alleviating the post-war depression in agriculture by increasing their loans to farmers at a time when credit from other sources was restricted. Similar in scope, though perhaps on the whole, less important, are trust companies, loan companies, and farm-mortgage companies. These latter handle a large volume of business, chiefly as brokers serving as middlemen between farmers and investors.<sup>1</sup> In Canada, life insurance companies, trust companies and loan corporations are important sources of farm-mortgage credit.<sup>2</sup> In Germany, insurance companies do an important loan business against mortgages, though they find agricultural mortgages less attractive than urban.<sup>3</sup>

<sup>1</sup> See *United States Agricultural Year Book 1924*, p. 197.

<sup>2</sup> Morman, *Farm Credits in the U.S.A. and Canada*, p. 275.

<sup>3</sup> Cahill, *Agricultural Credit and Agricultural Co-operation in Germany*, Cd. 6626 (1913), p. 62.



In the United Kingdom, insurance businesses also advance credit to farmers, though we have no information to what extent or under what conditions advances are made.<sup>1</sup> In New Zealand the operations of such companies are small.

2. Naturally, conditions under which loans are advanced by such institutions are not uniform. Thus, farm mortgage companies (in the United States) act mainly as brokers, while insurance companies act as principals. In some cases, loans are advanced direct to farmers, in others, loans are made through local correspondents, banks or brokers. The smaller insurance companies in the United States purchase most of their mortgages through banks or brokers. The larger companies employ special loan agents or correspondents to handle their business.<sup>2</sup> The method usually adopted by insurance companies in the United States is described by Morman as follows:

"The chief method of placing these loans is through agencies which submit to an insurance company the application for a proposed loan. If the loan is approved, it is made out directly to the insurance company from the borrower. The company's agent is usually known as a local correspondent, oftentimes being selected from a local bank or real estate firm. However, before such agents are selected to submit applications for loans, the territory itself is first inspected by the insurance company. If it deems the field suitable for loaning purposes, it proceeds to determine from time to time the conditions under which it will accept farm paper, and then the company determines the choice of some correspondent from whom it receives applications for loans. Such a correspondent acts as the agent of the borrower and not of the lending insurance company.

"When applications are turned in, the acceptance of loans is generally conditioned, namely, it is customary for insurance companies to demand a year's time within which to make an examination of the property in question through their own official inspector. If, from the findings of such an inspection the insurance company concludes that the loan is unsatisfactory, the local correspondent is expected to take over the loan at par. That is, the insurance company does not shoulder the risk; it is localized with the agent.

"In a number of instances, regular contracts in making loans are made out between the insurance company and the local

<sup>1</sup> See Cmd. 1810 (1923), p. 12.

<sup>2</sup> *United States Agricultural Year Book*, 1924, p. 197.

agency serving as an intermediary between the company and the farmer. One company which makes no regular contracts takes bonds from the local agencies for the faithful performance of their duties. When no contract or bond is used, it is customary to make an arrangement whereby an insurance company may return the loan at any time within a year if, on inspection, the loan is found undesirable."<sup>1</sup>

3. It may be seen that institutions of the types we are discussing are an important and widely distributed source of farm mortgage credit, and that they fill a useful place in the credit system. Many of them are of large size so that they possess ample funds for investments and are able to accumulate large reserves. The larger concerns are able to appoint expert assessors to value property and keep in touch with local demands through their correspondents. By this means risk to the investors is reduced and the stream of capital is directed to where it can be most profitably used. Where the practice of buying mortgages from banks is followed, the specialized loan (and personal) knowledge of such institutions is taken advantage of, and though the banks may have to bear some of the risks of loss, yet their own funds are not tied up to the same extent as if they made the loans out of their own resources. Where these concerns act as principals, they are able to accumulate for continuous use, large sums of money in the shape of small premiums or investments individually of little use. Further, even where they merely act as brokers, as in the case of farm mortgage companies, they possess some advantages. The cost of marketing credit is likely to be less than if loans are made direct or through solicitors, since they are specialized concerns doing a relatively large volume of business. Risk to the investor is reduced by virtue of the facilities which they possess for the expert assessment of property values.

4. On the other hand are certain disadvantages. Although the rate of interest is usually reasonable, the services of the various agents must be paid for, and these sometimes considerably increase the initial cost to the borrower. In some cases the convenience of the farmer is partially provided for by enabling him to pay off any part

<sup>1</sup> *Principles of Rural Credits*, p. 214-5.

of the loan on any interest date, but in most cases the period of the loan is too short to enable it to be repaid in this manner, or to provide for systematic amortization. When conditions are prosperous, and land values are rising, the renewal of loans may involve no difficulty, but there is always the danger that the farmer may have to face the expenses and dangers of renewal at a time of stringency. In some places (e.g. the United States) the competition of land banks is forcing insurance companies and similar institutions to increase their loan periods and to adopt the principle of amortization, so that this objection may be removed in the future.

5. There still remains the objection that the securities dealt in are individual mortgages against single farms. Such institutions do not normally issue standardized bonds backed by the *collective* security of farms. Hence the market for mortgage securities is likely to be limited and local and they cannot readily be turned into cash in times of stress. Although the need for liquid assets is not so great as in the case of commercial banks, so that the menace of *frozen* securities is not so serious, yet the danger is still an important one, and some means of making farm mortgage loans more readily realizable on the money market would be an advantage.<sup>1</sup> In the case of those concerns which merely act as agents, there is the further objection that the risk is confined to two persons, the individual borrower and the individual lender.

<sup>1</sup> See Morman, *Principles of Rural Credits* p. 217.

## CHAPTER II

# COMMERCIAL BANKS

1. Commercial banks vary a great deal in different countries as a source of long term credit. In the United States, it is estimated that about 20 per cent. of the mortgage indebtedness in 1914 was held by State and National Banks as against 17 per cent. in 1921, and probably less in 1923.<sup>1</sup> It would appear that not all of this represents advances for the purchase of land, but that some portion represents loans for other purposes secured by a mortgage against land. In addition, country banks are instrumental in placing farm mortgage loans with insurance companies, savings banks, trust companies and mortgage bankers. In some cases they actually purchase the mortgages themselves, in others they merely act as agents either for the farmer or the investor.<sup>2</sup> It is difficult to obtain comparable figures for other countries.<sup>3</sup>

2. Naturally, the rates of interest against which loans are advanced will vary greatly. Interest charges usually appear to be slightly higher than those charged by other credit institutions.<sup>4</sup> Similarly, the term of loans, the

<sup>1</sup> *Agricultural Year Book*, 1924, p. 195.

<sup>2</sup> *Farm Mortgage Loans* (1921), U.S. Department of Agriculture Bulletin, No. 1047, p. 6.

<sup>3</sup> A Report published in 1923 (Committee on Agricultural Credit, Cmd. 1810, p. 11) states that one-half of the purchase money needed by new occupying owners was provided by banks. Of a total of £46,500,000 traced as having been lent to agriculture by the big five joint-stock banks in 1923, £26 million represented loans made for the purchase of land. (cf. The Agricultural Credits Act, 1928, L. Le M. Minty, *Economic Journal*, June 1930.) As far as other countries are concerned, I have been unable to obtain any information of value.

<sup>4</sup> In respect of the United Kingdom the report quoted, states (1923):—"The rate of interest charged by banks varied from 6 per cent. to 6½ per cent. This has since been reduced to from 5 per cent. to 5½ per cent. The usual charge for overdrafts appears to be ½ per cent. to 1 per cent. above bank rate with a minimum rate of 5 per cent.; relatives and friends, 4 per cent. to 4½ per cent.; solicitors on trustee accounts, 6 per cent. to 7 per cent.; vendors, 5 per cent.; Farmer's Land Purchase Company, 6 per cent. to 6½ per cent. (gross); insurance companies, the market rate plus a

method of appraisal, and the percentage of the appraisal value of farm estate which is loaned will vary considerably. In some cases, as for example in the United Kingdom and in New Zealand, loans will take the form of overdrafts which may be for an indefinite period. Frequently, however, loans will be against farm mortgages for a stipulated period. This period is usually short—seldom more than five years, and frequently less.<sup>1</sup>

3. In respect of the percentage of appraisal value advanced, it is impossible to draw any conclusion of value, especially as the basis on which the appraisal of land is made is quite as important as the percentage of value advanced.<sup>2</sup>

4. Despite the fact that the practice and extent of operations of commercial banks in respect of long term loans to agriculture vary considerably from country to country, or even in different parts of the same country, certain general conclusions can be safely drawn.

<sup>1</sup> In the United States the report quoted (*Agricultural Year Book*, 1924, p. 215) shows that 52 per cent. of loans were for a period of one year or less, 72 per cent. for periods of under five years and 26 per cent. for periods of five years.

In New Zealand, all loans issued by banks appear to be at call, though a sound client has no difficulty in renewing loans, which are not usually called in. Most loans take the form of a fluctuating overdraft.

In South Africa Commercial banks do not normally advance long term credit to farmers or farmer's organizations, or for fixed periods. Long term credit is usually provided by the Land and Agricultural Bank of South Africa. Such advances as are made by commercial banks to farmers are usually in the form of overdrafts payable on demand, or on promissory notes with another name as security.

<sup>2</sup> In the United States the percentage of appraisal value advanced on first mortgage by different institutions was as follows in 1923: Federal Land Banks, about 36 per cent., Joint Stock Land Banks, 39 per cent., Farm Mortgage Companies, 41 per cent., Life Insurance Companies, 45 per cent., State and National Banks, 49 per cent. (*Agricultural Year Book*, 1924, p. 216). In the United Kingdom (as reported in 1923), "banks appear to have lent anything up to the full price of the farms according to circumstances, though usually there was a margin of at least 25 per cent. which the farmer found from his own resources." (Cmd. 1810 (1923), p. 11.) In New Zealand, Commercial Banks advance up to 60 per cent. of the appraisal value.

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fluctuating charge in respect of life insurance, depending on the age of the borrower. In 1923, the average rates charged in the United States were: Federal Land Banks, 5.5 per cent., Life Insurance Companies, 5.36 per cent., commercial banks, 6.89 per cent.

In New Zealand the rates charged appear to be round about 7-8 per cent. In 1928-9 more than half the mortgages outstanding of all kinds from all sources were from 6-6½ per cent."

5. Where, as in the case of some country banks in the United States, commercial banks merely act as agents, placing mortgages with other credit concerns, they may perform a very useful service. The manager of a small bank operating in a country district is frequently in a better position to judge of the personal qualities and credit standing of applicants for loans than the city concerns which may have funds available, and he can offer valuable advice and information to investors or investing companies. Frequently also, he knows his district and from long experience may be in a position to assess the value of a farm with reasonable accuracy, at any rate, as compared with that of similar lands in his district. Nevertheless, country bankers are not usually likely to be effective substitutes for expert and specialist valuers, but since independent valuers are usually available this need not place them at any serious disadvantage. Large institutions with country branches may, of course, have a sufficient volume of agricultural business to warrant the appointment of their own experts.

6. While commercial banks operating in country districts may frequently be useful as *agents*, forming a link between farmers and city investors or companies, they possess considerable weaknesses as direct sources of long term credit. We have pointed out in Part II, Chapter III, that the nature of investments with a bank and the form of loans advanced by it mutually govern each other. If a credit institution advances loans for short periods, it is able to accept deposits for short periods; conversely, if it accepts deposits for short periods it is forced to safeguard its own position by limiting the period of time for which it advances credit. If this is not done, deposits may be withdrawn at a time when a large volume of loans is outstanding. Its assets become "frozen" and it may be forced into liquidation, not because its assets are inadequate to cover its liabilities, but because they cannot be realized at the right time. A great part of the funds of commercial banks in the British Empire or the United States is obtained by deposits, either on current account, drawable at will, or for a short period which is seldom more than a year and is

usually much less. In consequence, limitations are placed on the length of time for which advances may safely be granted. It is true that it is a common practice to invest some resources in securities, but the vast majority of advances are for periods of six months or less. Further, the securities purchased are usually highly standardized and possess a wide and ready market so that they can be disposed of without difficulty should the need arise for ready cash. If commercial banks are to safeguard the liquidity of their assets, they cannot afford to invest more than a small proportion of their resources in long dated loans, and even in respect of these, there is a strong incentive to choose high grade securities which can be disposed of readily. Except in the case of small banks remote from financial centres, advances against the security of farm mortgages are not regarded with great favour, while an attempt is made to ensure liquidity by making loans for short periods from one to five years, or even as in New Zealand by advancing loans in the form of an overdraft at call. It has been stressed above that advances should be sufficiently long to enable the farmer to repay both interest and principal out of income and that in most cases this necessitates that they shall be for a period of from twenty to thirty years. Hence for the purchase of land, and to a lesser degree the effecting of expensive improvements, commercial banks are not a satisfactory source of long term credit for farming industries.

7. From the point of view of the banks, farm mortgages are less satisfactory as a source of investment for surplus funds than first class industrial or public securities, even when held for a short period, since they are not standardized and the market therefore tends to be narrow and local. The purchaser of a farm mortgage can only safeguard himself in many instances by independent valuation of the property, the necessity for which acts as a deterrent to investment. Where insurance companies, mortgage companies and the like provide a market for farm mortgages, the difficulty facing the banks of readily turning mortgages into cash as the need arises is partially obviated; but the risk to the banker as mortgagee cannot be removed altogether.

8. Where the advance takes the form of an overdraft, the bank's assets may be theoretically more liquid, while it may be a less expensive and more convenient form of credit to the farmer, since legal and procuration charges may be eliminated, and any surplus funds may be used to reduce the overdraft. But only the more substantial farmers, well known to the banker are likely to receive advances in this form, while the danger that the loan may be called in suddenly is greater than in the case of mortgage loans.

9. It has been suggested above that small country bankers may prove useful as agents acting for city institutions by virtue of the special local knowledge which they are likely to possess. The disadvantages we have outlined more than outweigh the gains in this respect when bankers are acting as principals, and not merely as agents. The experience of the United States of recent years reveals additional weaknesses. The "excessive number of small banks with small clientele results in an abnormally high overhead cost per unit of business, keen competition for deposits with high interest rates on such deposits, greater risk on loans heavily concentrated in limited areas, and a lack of adequate reserves. Higher costs and greater risks are translated into higher interest rates. A banking situation of this kind carries with it disadvantages to both borrowers and lenders, and while the effects of the (post-war) depression upon the agricultural industry undoubtedly contributed to the failure of many banks, yet these failures were in no small part the result of inefficient banking methods."<sup>1</sup> Where a powerful and closely integrated system of branch banking exists with efficiently managed country offices, as in the United Kingdom or New Zealand, these weaknesses may be obviated, but those we have outlined in preceding paragraphs still remain, while over-competition in the establishment of branches tends towards excessive overhead costs.

10. There is little room for doubt that commercial banks are unsuited, by the nature of their obligations to depositors,

<sup>1</sup> *U.S. Agricultural Year Book*, 1924, p. 214.



to long term credit for agriculture.<sup>1</sup> Since the various types of credit agency which constitute the "outer" market are also unsatisfactory, it is highly important that specialized institutions should be established to cater for the long term credit needs of agriculture. The following chapters are therefore devoted to a discussion of some of the more important attempts which have been made to establish such institutions.

<sup>1</sup> *The Monthly Review of Barclays Bank* (June, 1928) in commenting upon the Agricultural Credits Bill brought before Parliament in 1928 states: "In considering the Bill it should be borne in mind that as the great bulk of banking resources are represented by deposits repayable on demand or at short notice, it is not in accordance with sound principles that the banks should provide permanent capital for industry and within reasonable limits they should confine themselves to loans of a more or less short character." In certain districts, such as the agricultural regions of the United States, and in predominantly agricultural countries such as New Zealand, the rate of turnover of deposits tends to be slower than in the cities or in countries such as the United Kingdom, so that assets may safely be somewhat less liquid; but the rate of turnover is still so rapid as not to justify too large a proportion of advances in the form of long term loans to agriculture.

## CHAPTER III

# THE GERMAN LANDSCHAFTEN

### A. *Origin*

1. The first bank of the *Landschaft* type was founded in Prussia by a Royal Decree of Frederick the Great in 1769. The principles which it embodied have since been introduced with more or less modification into other parts of Germany, the Baltic States, Poland, Norway, Denmark, Hungary, and Russia. The Federal Farm Loan System of the United States, established in 1916, also includes some of the *Landschaft* principles.

Following on the Seven Years' War (1756-63) the Prussian nobility and landed gentry, particularly in Silesia which had been the principal theatre of war, were almost ruined. The credit of the landowners was so seriously impaired that they had great difficulty in obtaining the necessary capital for reconstruction. Foreclosures and insolvency were common and a moratorium decree merely acted as a palliative. Confidence in the estates of the landed aristocracy as a field for investment was so severely shaken that some means of improving the value of security in land was necessary to recovery.

2. In 1767 a Berlin merchant, named Buring, presented to the king a scheme which became the basis of the Decree of 1769. Buring had gained an acquaintance with the working of mortgage institutions in Holland, which granted credit to Dutch colonists on the security of their plantations, and as the result of this acquaintance formulated his project.

3. The basic idea underlying his scheme was the replacement of individual by collective security. The individual mortgage was to be replaced by mortgage bonds. The necessity for raising money directly on mortgages through separate, individual negotiations between borrowers and investors was to be removed by the creation of an organization which should act as an intermediary between the

creditor and debtor. This organization was to be co-operative in the sense that members were jointly and severally liable for the bonds issued. All the land-owning nobility were to be members of the Landschaft whether they had received credit through the Landschaft or not. The early Landschaften were therefore compulsory corporations whose operations were confined to the nobility. All the newer Landschaften are voluntary associations, and the credit field has been extended by a decree of 1849 which decided "that every rural property of not less than 500 thalers in value, the yield of which ensured economic independence to the owner, without his carrying on any other occupation, might be authorized as a Landschaft guarantee."<sup>1</sup>

4. Naturally, the constitution and methods of the Landschaften differ in accordance with local conditions and requirements. It is scarcely necessary, however, to discuss these in detail and we shall be concerned solely with the most characteristic features.

### B. Capital

5. The method of obtaining funds is by the issue of mortgage bonds carrying interest to bearer, the mortgage security being held by the Association. The total value of bonds in circulation on behalf of any Landschaft is not to exceed the total value of mortgages held by it. In the beginning, the mortgage bonds were issued against the security of specific properties, the agreement being between an individual borrower and an individual investor, with the Landschaft as guarantor. This method was finally abandoned for the obvious reason that the value of the bonds became influenced by accident and local conditions and their marketability was thereby affected.

6. Under the method later adopted, the Landschaft Associations are liable to the bondholders for the payment of interest and repayment of bonds, but the borrower is liable to the Association. The holders of bonds possess no rights whatever against any specific piece of property, but

<sup>1</sup> Tcherkinaky, *The Landschaften and Their Mortgage Credit Operations*, p. 17.

only the right to recover from the Association. The form of guarantee behind the bonds is not uniform. Under the earlier *Landschaften* the bonds are backed by all estates on which loans have been made by the *Landschaft*, or in some cases by all estates on which loans *can* be made.

7. The newer *Landschaften* have not been able, for legal reasons, to adopt either of the above bases of collective guarantees, but instead bonds are safeguarded by the creation of special guarantee funds and reserves, the setting up of a fund for the extinguishing of debts and the obligation of members to make supplementary payments within limits.<sup>1</sup> "As sound business management characterizes all the *Landschaften*, the investing public does not attach great importance to the kind of guarantee of the mortgage bonds. The market price is nearly the same whether the bonds are of the old type or the new."<sup>2</sup>

8. Mortgage bonds are issued at par in various denominations of from (say) £5 to £250 in value.

### C. Loans

9. (a) *Method*. Any landowner fulfilling the conditions imposed by the articles of association is entitled to a loan up to a given proportion of the assessed value of his property, and in most cases it would appear that there is no control over the purpose for which the loan is used. Borrowers do not receive cash, but are paid in bonds which they must then sell. The sale of bonds is facilitated by the establishment of banks and loan institutions set up in connection with the *Landschaften* (which strictly speaking are not themselves banks) and which engage in ordinary banking business as well as in facilitating the sale of bonds. Intending borrowers indicate at what rate they wish to borrow, and this naturally affects the price which they will receive from bonds at sale. Thus "if the borrower of a loan of £100 chooses 4 per cent. bonds, he obtains at the predominant market rates (say) £100.6 to £101.6 for his bonds on sale, if he selects 3½ per cent. bonds he obtains £92, and if 3 per cent. bonds, he

<sup>1, 2</sup> Tcherkinaky, *op. cit.*, p. 29.

realizes £84; in each case he pays interest and sinking fund instalments upon the nominal amount of the loan, and thus, with 3 per cent. bonds, though he receives only £84 he pays interest on £100 and his sinking fund payments are likewise based on this latter sum. He is entitled, however, to repay the loan by re-purchasing similar bonds in the open market."<sup>1</sup>

10. The borrower bears the risk of a fall in the value of bonds or secures the advantages of a rise in their value during the period between issue and sale. Since he may repay his debt in bonds similar to those issued to him, he also stands to gain if they fall in value at a later period. Associations make it a common practice, however, to buy back bonds when the market is favourable, so that the gains in this respect are likely to be limited.

11. (b) *Valuation*. In the valuation of property for mortgage purposes, certain well-established rules are followed: "The net annual profit as estimated by the Government for the land tax, multiplied by 25, less certain amounts, must be accepted for the value if satisfactory to the owner. If the owner thinks this value too low, the Landschaften must proceed to a special appraisalment at his expense."<sup>2</sup> The Association then advances bonds up to as much as two-thirds of the value of the property.

12. (c) *Repayment*. Loans are not normally repaid in a lump sum, but are discharged by amortization, i.e. by annual payments, which usually take the form of a percentage of the principal. Thus, if the rate of interest on bonds is 4 per cent., arrangements may be made for the repayment of the debt by an annual amount equal to say  $\frac{1}{2}$  per cent. of the value of the bonds. This steadily reduces the net indebtedness of the borrower until it finally disappears. Although different methods of amortization are followed, the purpose

<sup>1</sup> Cahill, *Agricultural Credit and Agricultural Co-operation in Germany*, Cd. 6626 (1913), p. 14-15.

<sup>2</sup> Herrick, *Rural Credits*, p. 59. The exact nature of the procedure then followed need not concern us. Nor does it appear to be at all uniform, since different writers—Herrick, Cahill, Morman and Tcherkinsky—all appear to give different accounts.

of all is the same—to enable debtors to repay their indebtedness by small annual increments out of the proceeds of production.<sup>1</sup> Normally also, borrowers are permitted to repay their indebtedness at regular interest periods by giving previous notice. Money paid in by way of amortization is used by the Association to redeem bonds. The expenses of the *Landschaft* are usually met by an additional charge of, say,  $\frac{1}{2}$  per cent., so that the rate actually paid is comprised of the rate of interest on bonds, the amortization payment and the percentage charge for running expenses. In course of time many associations have accumulated sinking funds as the result of savings in running expenses, premiums on bonds and other profits, and in many cases these have been used for the reduction of the indebtedness of members.<sup>2</sup>

13. (d) *Resumption*. The *Landschaften* cannot call in loans provided the borrower fulfils his obligations. Associations do however reserve the right to recall loans when the value of the property covered deteriorates—as the result of bad farming, reduction in farm area, decay of buildings, excessive dis-afforestation, neglect to insure buildings, and such causes—to below the value of the loans. They are also empowered to seize the estates of defaulting debtors without notice or order of a court, to administer them compulsorily, or to call for a legal compulsory sale of the properties. Any net balance on sale goes to the debtor.

#### D. Organization

14. The constitution of the *Landschaften* varies. In some cases administration is decentralized, the area covered by an association being divided into sections, each having its own Directorate and Representative Body. In others control is more centralized. The business of an Association is carried out by a Board, consisting of a Director-General, members chosen to represent districts, and other non-voting members called Syndics. Syndics must have had legal training and have passed the necessary examinations qualifying them for the office of judge or magistrate. They

<sup>1</sup> See Appendix I.

<sup>2</sup> See Morman, *Principles of Rural Credits*, p. 85-86.

are permanent, paid officials with no other professional occupation. Apart from Syndics, only owners of property within the area of the Association are entitled to election.

15. Besides the Central Board of Directors, *Local Directors* are elected for the various sections of the area covered by an Association. Such directors must be resident property owners in the district to which they are elected. In addition to local directors a *District Committee* is elected whose business it is to assist in the valuation of properties, supervise properties compulsorily managed by the Association, report on any circumstances likely to impair the value of properties on which loans have been advanced, and attend to any pressing business which cannot be postponed to the next meeting of the Board of Local Directors.

16. The final authority is the *General Assembly*, which is not, as might be expected, an assembly of all members of the Association but is a representative body of members, the constitution of which varies in different Associations. The authority of the General Assembly is supreme, but decisions dealing with matters outside the business management of the Landschaften require the approval of the public authorities.

17. Between the General Assembly and the Directorate is a *Standing Committee*, which was instituted to avoid the heavy expenses and inconvenience involved in calling meetings of the General Assembly. The Standing Committee is intended to serve to represent the general body of members in exercising supervision over the affairs of the Association, and the work of the Directorate. *Membership* of an Association is open to all individuals over whose property it becomes a mortgagee.

#### *E. Estimate*

18. The merits of the Landschaft type of organization should be abundantly clear, and the extension of many of the principles which it embodies is not surprising.

19. We have pointed out that a good system of long term credit for agriculture necessitates certain conditions, which

we may briefly recapitulate as follows: *First*, the security which the farmer has to offer should be effectively marshalled so that he does not suffer from the manner in which his case is presented. *Second*, the period for which loans are advanced should be long and provision should be made for their repayment out of income from the farm without the need for renewal. *Third*, provision should be made against unforeseen contingencies which may prevent the repayment of whole or part of the indebtedness falling due at any given time, but which do not permanently cripple the productive capacity of the farmer. *Fourth*, capital should move readily to those districts where it is most required, on terms comparable with those of industry. *Fifth*, security should be adequate and carefully assessed. *Sixth*, standardized credit instruments should be provided. These last two conditions enable the city investor to advance funds to the isolated farmer, safe in the knowledge that security is good without the trouble and expense of making a personal estimate, and at the same time enable him to withdraw his funds by the sale of securities without necessitating a corresponding withdrawal of funds from the farmer. In other words, they enable long-period loans to be supplied by a continuity of short-period investment without endangering the security of the creditor or debtor. In practice all these conditions are very closely inter-related and provisions essential to one tend to react on another. Authoritative accounts of the workings of the *Landschaften* seem to justify the view that the above requisites of a good credit system have been achieved with a high degree of efficiency.

20. The method of raising the necessary finance by means of bonds guaranteed by the land mortgage credit associations, i.e. the *Landschaften*, achieves the first object of marshalling the security of the landowners. "They enable landowners to mobilize, as it were, their landed possessions by the creation of bonds passing into the general system of securities; instead of only being able, like English landowners, to provide a mortgage security of very restricted currency, German landowners have the advantage of being able to convert a mortgage charge into a security realizable at any time



in the general market.”<sup>1</sup> At the same time, the provision of standardized bonds, or credit instruments, safeguards the convenience of investors by providing them with a liquid asset which they can readily turn into cash.

21. In normal times the security of the bonds is amply safeguarded by the careful assessment of the value of properties against which loans are made, the maintenance of an ample margin and the guarantee of the society supported by the accumulation of adequate sinking funds and by other means. Hence, normally the value of bonds is maintained at a level equal to that of the best State Bonds, and higher than the issues of many high grade industrial and commercial ventures. Thus agriculture obtains its funds on terms at least comparable with those of industry. At the same time, the Associations are efficiently managed and the cost of making loans is small.

22. It has been pointed out also that loans may be for a period of fifty years or more. Loans are amortized gradually out of income, and mortgagors may pay off the whole or part of their indebtedness at any time. Provided the debtor fulfils the conditions relating to his debt, loans are not subject to recall. Hence the essential condition to which we have referred is maintained and farmers have a reasonable chance of repaying loans out of income. Further, although there seems to be no specific provision for the holding over of payments in bad years, in the form of an addition to the principal of debt, yet, in fact, after a certain proportion of the loan is paid off, landowners may borrow a further sum. In practice this is likely to meet the case, except during the first few years during which a loan is outstanding.

<sup>1</sup> Cahill, *op. cit.*, p. 15. The Agricultural Mortgage Corporation constituted in 1928 will, of course, overcome this disadvantage of the English Landowner.

## CHAPTER IV

# THE FEDERAL FARM LOAN SYSTEM OF THE UNITED STATES<sup>1</sup>

## I. FEDERAL LAND BANKS

### 1. DEFECTS OF OLD SYSTEM

1. The Federal Farm Loan System of the United States was instituted by the Farm Loan Act which became effective in July, 1916.

2. The methods of mortgage credit existing prior to the establishment of the Federal Farm Loan System were subject to much criticism. It was complained that loans were too short and renewals were costly and uncertain. Also, rates were often high and varied greatly from place to place more than was warranted by differences in risk. This was partly due to differences in State Laws relating to taxation of mortgages and the protection of creditors, partly to imperfections in the machinery for the geographical distribution of funds. The small farmer, particularly the tenant or the new purchaser, was at a disadvantage when compared with the well-to-do farmer. These conditions arose largely from technical defects in the mechanism consequent on the absence of standardized securities, which caused the market for securities to be narrow and local, and on the duplication and overlapping of the functions of different marketing agencies, which caused wasted effort and added to the cost.<sup>2</sup>

3. Attention was called to the imperfections of the credit system by the Country Life Commission appointed by President Roosevelt in 1908. This was followed by many conferences, committees and commissions of enquiry, and reports of great value were presented. In 1916 the Federal

<sup>1</sup> This Chapter was written early in 1929.

<sup>2</sup> See Willis, *Federal Reserve Banking Practice*, p. 243-4.

Farm Loan Act was passed with a view to remedying the defects against which criticisms had been raised.

## 2. ORGANIZATION

4. The Farm Loan Act provides for two kinds of credit institution; federal land banks and joint stock land banks. The former system is quasi-co-operative in structure, the latter, as its name implies, is a form of private enterprise under the joint stock plan. Federal land banks advance funds through national farm loan associations, which are organizations of farmers. Joint stock land banks lend directly to individuals.

### A. Control

5. We shall not attempt more than a bare outline of the Federal Farm Loan System.<sup>1</sup> The chief executive authority of the System is the Federal Farm Loan Bureau, which is under the general supervision of the Federal Farm Loan Board. In contrast with the German *Landschaft*, the members of the Board are appointed by the President of the United States, not by members of the National Associations. They devote their whole time to the work of the Board. The Board receives reports from all associations and land banks and publishes consolidated statements. All land banks are to be examined twice a year, and associations when the Board directs. In 1926 there were six bank examiners and twenty association examiners appointed by the Board. It also appoints other officers, including receivers, in the event of liquidation of a bank or association, and a registrar and deputy and one or more appraisers for each district. The Farm Loan Board is the authority which grants or refuses charters to Farm Loan Associations.

6. For the purpose of the Act the United States is divided into twelve land bank districts in each of which a land bank is situated. Each land bank is controlled by a board of seven directors, of whom three are local directors "chosen by and representative of associations and borrowers through

<sup>1</sup> See Willis, *op. cit.*, Ch. X for a detailed description.

agencies," three are appointed by the Farm Loan Board as representing the public interest, and one is a "director at large" appointed by the Board.<sup>1</sup>

### B. Initial Capital

7. On the institution of the system, every land bank was required to have a subscribed capital of not less than \$750,000. Shares were issued at \$5 and could be purchased by individuals, firms, corporations, state governments and the United States Government. If, within thirty days after the Board opened subscriptions, any part of the minimum required capital was unsubscribed, the Secretary of the Treasury was to subscribe the balance. For a number of reasons, land bank shares did not appeal to the investing public and out of a minimum subscribed capital of \$9,000,000 the Treasury subscribed \$8,891,270.<sup>2</sup> By 31st December, 1924, however, the Government owned no stock in seven banks, while by December, 1926, the balance of stock held by the Treasury had declined to \$1,058,885.

8. Every land bank and association, together with its capital and reserve or "surplus and income derived therefrom," is exempt from Federal, State or local taxation, apart from taxes on real estate "held, purchased or taken under Section 11 and 13 of the Act."<sup>3</sup> Farm mortgages and farm loan bonds are also exempt from taxation. Real property held by banks or associations is liable to ordinary taxation.

<sup>1</sup> See Willis, *op. cit.*, p. 254.

<sup>2</sup> Reasons for the lack of public interest are given by Morman as follows: "(1) The original capital stock of the banks probably would not pay dividends for a year or two. (2) No voting power is vested in the stock except those shares held by a national farm loan association and by the United States Government. (3) The dividends would probably never exceed 6 per cent., since the aim of the federal land banks as a co-operative plan of mortgage credit was to furnish farmers with loans at a reasonable rate of interest rather than for the making of profit. (4) Like any other bank stock, there was no guaranty of dividends on the investment; and (5) in the course of a few years under the provisions of the Act the stock would have to be redeemed at par, and therefore held no speculative value."

—*Farm Credits in the United States and Canada*, p. 79.

*C. Reserve Conditions*

9. Every Federal and Joint Stock Land Bank is to carry semi-annually 25 per cent. of its net earnings to reserve until a reserve of 20 per cent. of the bank's outstanding capital is accumulated. After it has reached 20 per cent., the annual addition to reserve is 5 per cent. of net earnings, annually. If the reserve is impaired, it must be fully restored before dividends are paid. A suspense account is also opened by each bank, representing the amount of defaults. After two years from the date of default this is debited to the reserve. The net balance, after reserve requirements are met, is available for dividends. No dividends were paid prior to 1st June, 1919. Since then the dividends paid have been as high as 10 per cent. in some banks, though usually they appear to be much lower.<sup>1</sup>

*D. National Farm Loan Associations*

10. (a) *Organization.* Loans are granted through National Farm Loan Associations, which must have received a charter from the Federal Loan Board. These are co-operative in character. They may be formed in any loan district by ten or more farmers, who must be owners or intending owners, whose land is eligible to provide the basis of loans, and who require in the aggregate loans of not less than \$20,000. After formation, new members may be admitted to an association on the vote of two-thirds of the directors. Having gone through the necessary procedure, including the preparation of articles of association which must be approved by the Farm Loan Board, and the election of temporary officers, all of whom are voluntary except the secretary-treasurer, an association forwards its application for loans to the nearest Federal Land Bank, which sends an appraiser to value the properties and investigate the financial position of intending borrowers. If application is then approved, it is forwarded to the Federal Farm Loan Board

<sup>1</sup> In 1928 one-half of the Federal Land Banks were paying no dividends, but building up undivided profits and legal reserves. Many of the Joint Stock Land Banks likewise paid no dividends.—*Federal Farm Loan Board Report, 1928*, pp. 25 and 35.

by the bank, and, on further approval by the Board, a charter is granted. The association may then borrow money from the land bank in its district.

11. (b) *Loans to Members.* Before securing a loan a borrower subscribes to the capital stock of the association to the extent of 5 per cent. of his loan. The association then subscribes to an equal amount of stock in the Federal Land Bank of the district. Borrowers forward the necessary mortgages to the bank through the secretary of the association, who in turn receives the amount of the loans from the bank and makes the necessary payment to members. Advances are made to 50 per cent. of the appraised value of the land and 20 per cent. of the value of improvements on it. Loans are granted on first mortgages only and are limited to the following purposes:

- (i) To provide for the purchase of land for agricultural purposes.
- (ii) To provide for the purchase of equipment, fertilizers, and live stock necessary for the proper and reasonable operation of the mortgaged farm.
- (iii) To provide buildings and for the improvement of farm land.
- (iv) To liquidate indebtedness of the owner of the land mortgaged, either incurred for agricultural purposes or incurred prior to 1st January, 1922.<sup>1</sup>

12. The maximum amount of loan which can be made to any individual farmer is limited by statute. The original Act fixed the limit at \$10,000, but the maximum was raised in 1923 to \$25,000. The minimum amount fixed is \$100. The fixing of a maximum limit is primarily designed to aid the small farmer, but the policy was also intended: (a) To prevent "heavy borrowers calling upon the Federal Land Banks for practically all the funds they could assemble." (b) To curb the "possible tendency to make large loans which constitute easy banking, in order to build up large institutions, thus neglecting the small borrower."

<sup>1</sup> Cf. Willis, *op. cit.*, p. 291.

(c) To insure "safety and stability until Federal Land Banks and Associations have acquired experience."<sup>1</sup>

13. Where associations are not formed, and do not appear likely to be formed owing to peculiar local conditions, Land Banks are authorized to advance loans to individuals through approved agents, who must be a duly incorporated bank, trust company, mortgage company, or savings institution operating under a State Charter. Small advantage has been taken of this method, largely owing to the fact that conditions are not sufficiently attractive to interest those institutions competent to act. Where farm loan associations are in existence the privilege is inapplicable.

14. (c) *Reserves.* Associations are required to accumulate a reserve equal to 20 per cent. of the outstanding capital stock of the association. This is to be accumulated by the transfer semi-annually of 10 per cent. of the net earnings. After a 20 per cent. reserve has been created, 2 per cent. of the net earnings is to be added to it annually. Whenever the reserve is impaired, the credit balance of 20 per cent. must be restored before dividends can be declared. Reserves are to be invested in accordance with rules laid down by the Federal Farm Loan Board. Whenever any association is voluntarily liquidated, a sum equal to its reserve fund must be paid into the land bank of its district, whose property it becomes. The charges levied by farm loan associations are regulated by the Board.

#### *E. Raising of Capital for Loans*

15. The bulk of the funds required by Federal Land Banks are raised through the issue of bonds, against which mortgages are held to the full amount. These mortgages are deposited with a government official attached to each Federal Land Bank who acts as trustee for the bond holders. Each Federal Land Bank may issue bonds up to twenty times its capital and surplus. Under the initial act, Federal Farm Loan Banks issued their bonds independently subject to regulation by the Farm Loan Board. The Agricultural

<sup>1</sup> Willis, *op. cit.*, p. 289.

Credits Act of 1923 provided for the consolidated issue of Federal Land Bank bonds to be sold through a common agency, but owing to the belief that no bank could be held responsible for such issues, the plan was not successful.<sup>1</sup> This difficulty was met by an amendment of March, 1925, which provides that "Each Federal Land Bank on whose behalf consolidated bonds shall be issued under this provision shall in all respects be bound by the Act of the Farm Loan Commissioner and the Secretary of the Federal Farm Loan Board."<sup>2</sup>

16. Bonds run for specified minimum and maximum periods. Thus from 1917 to 1920, 5-20 year bonds (due in 20, but callable after 5 years) were issued; 1921-23, 10-20 year bonds, and subsequently 10-30 year bonds.<sup>3</sup> Provision is made for the issue of bonds of varying amounts: viz. \$40, \$100, \$500 and \$1,000 in 1921. The maximum rate of interest offered for bonds is fixed by the original Act and its amendments.

17. Since the raising of funds by means of bonds and demand for loans by farmers do not always exactly coincide in point of time, the Farm Loan Board adopts the practice of purchasing United States bonds, or certificates of indebtedness, which are temporarily used as security for such bonds as are called for, first mortgages being substituted for such security as loans are made. "This expedient, which is authorized by the Farm Loan Act, not only enabled the land banks to supply farm loan bonds as called for, but made available to land banks at call, large amounts of funds for loaning purposes."<sup>4</sup>

18. These loans are advanced to farmers for periods of from five to forty years at the option of the borrower, all loans being subject to amortization. After a period of five years, the borrower may repay whole or part of the principal outstanding. Proceeds from amortization and other payments are applied:

<sup>1</sup> Willis, *op. cit.*, p. 265.

<sup>2</sup> See *Treasury Department Federal Farm Loan Bureau Circular No. 20*, p. 37.

<sup>3</sup> Willis, *op. cit.*, p. 259.

<sup>4</sup> Willis, *op. cit.*, p. 263.



- “(a) To pay off at maturity farm loan bonds issued by or on behalf of it (i.e. the bank).  
 (b) To purchase at par or below par farm loan bonds . . . .  
 (c) To loan on first mortgage on farm lands . . . .  
 (d) To purchase United States Government Bonds . . . .”<sup>1</sup>

### F. Interest Rates

19. The maximum rate of interest charged by either Federal Land Banks or Joint Stock Land Banks is fixed at 6 per cent., to which are added amortization payments and initial charges in making the loan. The actual rate below this is fixed at the rate at which the issue of bonds prior to the making of a loan was floated, plus a maximum charge of 1 per cent. per annum on the unpaid principal to cover administration costs and profits. The Farm Loan Board has power to review and alter at its discretion the rates charged by land banks. It is the general policy to keep the rates of different banks uniform. Interest charges are available by the land banks to meet interest on farm loan bonds as they fall due, to meet administrative expenses and provide profits.

## II. JOINT STOCK LAND BANKS

1. The second type of organization under the Federal Farm Loan Act is that of joint stock land banks. These are joint stock companies and may be formed by not less than ten “natural” persons who obtain a charter from the Federal Government. The minimum subscribed capital stock required before a joint stock land bank is permitted to do business is \$250,000, of which one-half must be paid up, the rest being subject to call by the directors.

2. In so far as they are applicable, the joint stock land banks have the same powers and are subject to the same restrictions as Federal Land Banks with certain exceptions:

- (a) The territory over which a joint stock land bank can operate is limited to the State in which it has its principal office and one other contiguous State.  
 (b) There is no limitation of the purpose for which loans may be granted, nor of the amount of loans which may

<sup>1</sup> Willis, *op. cit.*, *loc. cit.*

be granted to one individual, though it would appear that in practice the Farm Loan Board exercises an indirect control through its approval or rejection of the security on which bond issues are based.<sup>1</sup>

- (c) A borrower from a joint stock land bank is not required to purchase stock in the bank, as he is required to do in the case of Federal Land Banks.
- (d) The borrower may lease his farm whereas the borrower from a Federal Land Bank must cultivate his own farm either with his own or hired labour.

3. As in the case of Federal Land Banks, the following conditions apply:

- (a) Amortization is insisted on.
- (b) The maximum rate of interest is 6 per cent., exclusive of amortization payments, but the rate is not subject to revision by the Farm Loan Board. Joint stock banks are forbidden to charge more than the interest rate at which the previous issue of bonds was sold, plus 1 per cent. to cover administrative charges and profits.
- (c) The maximum amount of loan is 50 per cent. of the value of land and 20 per cent. of the value of improvements, as appraised according to Section 10 of the Act.
- (d) Applications for loans are on prescribed forms.
- (e) Commissions and other charges are as prescribed in the Act.

4. Since joint stock land banks advance to individuals directly and not through farm loan associations, the practice is to make use of local bankers as agents who operate on a commission basis; or to use salaried representatives.

5. The joint stock land banks raise the greater part of their funds from the issue of bonds, the general provisions being in the main the same as for Federal Land Banks, except that a joint stock land bank may issue, and have

<sup>1</sup> See Willis, *op. cit.*, p. 324.

outstanding, bonds to the extent of fifteen times instead of twenty times its capital and surplus.

6. To 31st December, 1927, eighty-three charters for joint stock land banks had been granted, of which fifty banks were in operation. Of the remainder, nineteen had been merged with other joint stock land banks, the assets and liabilities of four had been taken over by Federal Land Banks, six had been liquidated voluntarily, one was in process of voluntary liquidation, while three were in the hands of receivers.<sup>1</sup>

### III. ESTIMATE OF FEDERAL FARM LOAN SYSTEM

#### 1. DEFECTS REVEALED

1. In attempting to evaluate the success and importance of the Federal Farm Loan System, it should be remembered that it has been operating during one of the most difficult periods in the history of agriculture—the years of post-war dislocation, post-war boom and post-war depression. The circumstances of these years would have been such as to try a long-established institution. The strains of the post-war depression have revealed certain weaknesses which the Farm Loan Board is setting itself out to remedy,<sup>2</sup> while in certain respects, particularly in regard to Farm Loan Associations, the system has not completely fulfilled the expectations of its founders and certain inherent limitations appear. In 1925 the Federal Farm Loan Banks were forced to come to the assistance of the Federal Land Bank of Spokane, which was faced with a considerable number of foreclosures consequent

<sup>1</sup> 11th Annual Report, Federal Farm Loan Board (1927).

<sup>2</sup> See 11th Annual Report of the Federal Farm Loan Board, 1927 (p. 1). "Unsatisfactory conditions that developed in some of the banks during the rapid growth of the system in recent years have been revealed, and measures have been adopted to correct errors and abuses wherever they have been found, and to assist and strengthen the institutions which have been confronted with difficult problems. The re-organization of the bureau has resulted in closer supervision of the banks by the Board, and many changes in policy and practice have been brought about in banks where necessary. These, together with the strengthening of personnel where required, both in the banks and the bureau, justify the feeling that the system has made real progress during the year in the interest of stability and soundness."

on "adverse conditions in large areas of its district;"<sup>1</sup> while in 1927, three joint stock land banks were forced into the hands of receivers. The number of foreclosures, and the amount involved have also been considerable, as the following figures indicate:

FORECLOSURES INSTITUTED FROM COMMENCEMENT OF THE  
SYSTEM TO 31ST DECEMBER, 1927

Federal Land Banks .. ..	18,071	\$57,255,653
Joint Stock Land Banks ..	3,219	\$27,037,321 <sup>2</sup>

2. These, and similar difficulties, appear to have arisen, partly from mismanagement on the part of individual banks, which re-organization and more stringent supervision by the Farm Loan Bureau will in large measure rectify, but largely from the severity of the post-war depression which would have made foreclosures and losses difficult to avoid under any system.

## 2. ACHIEVEMENTS

3. Despite such losses and imperfections as have been revealed, it is highly meritorious to have weathered the post-war years with the high degree of success which has been achieved, and to have advanced to the present position which the system holds in the credit machinery of the United States.

### A. Statistics of Progress

4. Statistics are at best a colourless record of progress and achievement but it requires little imagination to picture what the following figures of growth in mortgages outstanding mean to the United States, particularly when such benefits to debtors, as are mentioned below, are borne in mind:

<sup>1</sup> See *Federal Farm Loan Board Report*, 1925, p. 4.

<sup>2</sup> On 31st December, 1927, the volume of mortgages outstanding was: Federal, \$1,158,000,000; Joint Stock, \$870,000,000. In reference to foreclosures, Willis (*op. cit.*, p. 312) states: "When . . . the difficult period to which they (i.e. foreclosures taken in conjunction with delinquencies, comparison of subsequent sale value with actual loans and record of loan applications cancelled or rejected) relate is recalled, it appears that, while errors were undoubtedly made in some individual cases, on the whole, lending has been on a conservative basis."

NET MORTGAGE LOANS OUTSTANDING OF FEDERAL LAND BANKS AND JOINT STOCK LAND BANKS, ON 31ST DECEMBER OF EACH YEAR, 1918-27

	Million Dollars		
	Federal	Joint Stock	Total
1918	156	8	164
1919	298	61	359
1920	350	78	428
1921	433	85	518
1922	639	219	858
1923	800	393	1193
1924	928	446	1374
1925	1006	546	1552
1926	1078	632	1710
1927	1156	670	1826

While other outstanding figures could be quoted, these will be sufficient for our purposes.

*B. Summary of Advantages*

5. The advantages of institutions such as the Federal Reserve System have been referred to in previous pages and may be summarized briefly:

- (a) The resources of the money market are tapped by the following means:—
  - (i) Standardized securities are issued in units of various values to suit different classes of purchasers. These are "trust" investments, and, since they find a ready sale, the investor is able to dispose of them at his convenience.
  - (ii) An added incentive to investors is offered by making them tax free.<sup>1</sup>
  - (iii) Marketability of bonds is enhanced by the nature and margin of security offered. We note:
    - (1) The value of property is carefully assessed.
    - (2) A wide margin is allowed, since loans are not advanced beyond 50 per cent. of the assessed value of land, plus 20 per cent. of the assessed value of standing improvements, and are on first mortgage only.

<sup>1</sup> Whether or not this is good policy on general economic grounds is a matter which we cannot discuss here.

## THE PROVISION OF CREDIT

- (3) Bonds are advanced, not against individual mortgages, but against the whole body of mortgages, plus other assets of the bank.
  - (4) Under the Federal Land Bank System, members of national farm-loan associations are liable for the debts of members of their own association to the extent of the value of the amount of stock they are required to hold in Federal Land Banks. In addition, the assets of all Federal Land Banks are behind the liabilities of any one bank.<sup>1</sup>
- (b) The flow of funds throughout the country is rendered more even and regular.
- (c) The farmer gains, for the following reasons:
- (i) The system of amortization enables him to pay off his indebtedness by instalments out of income, and makes it easier for him to raise a second mortgage at a later date should he require it.
  - (ii) After five years, the farmer may pay off all or part of the principal outstanding at his convenience. If the rate of interest falls, he may take advantage of the new rate after five years by renewing his loans.
  - (iii) Although legal charges are not affected, the method of amortization reduces the sum total of these over a period of years by removing the necessity for renewal.
  - (iv) In some cases, particularly in remote areas, the rate of interest has been reduced on farm mortgages, while such expenses as are within the control of the banks are low. Only the actual expenses incurred by the bank are passed on.<sup>2</sup>
  - (v) Under the Federal Land Bank System some

<sup>1</sup> It should be noted in passing that the failure of the three Joint Stock Land Banks, already referred to above, prejudicially affected the marketability of the bonds of Joint Stock Land Banks for a time.

<sup>2</sup> It is important to mention, however, that the general advantages of a low rate of interest are overstressed. As far as new purchasers are concerned, the advantages of a lower rate tend to be offset by a corresponding increase in land values after a time, so that the total net interest remains unaltered. This does not apply, of course, in respect of farmers who have renewed an existing mortgage at a lower rate.

portion of the profits is returned to farmers by virtue of the fact that they are shareholders in the banks.

- (vi) The competition of land banks operating under the System is likely to improve conditions under which loans are obtained from other sources.<sup>1</sup>
- (d) The Board and the Federal Land Banks have helped both directly and indirectly in improving farming practice. The establishment of an efficient credit system is, of course, an important factor in this respect. The banks have also endeavoured to educate farmers to better agricultural methods, and in many cases to enforce their suggestions by making them a condition of the granting of loans.<sup>2</sup> In addition, banks in some districts have encouraged co-operative societies of various sorts, while they have directly insisted on improved farming methods, protection against erosion and the like.<sup>3</sup>

#### IV. CONTRAST OF FEDERAL LAND BANKS AND JOINT STOCK LAND BANKS

1. It may be of some interest, in conclusion, to make a brief comparison of the two types of organization operating under the Federal Farm Loan System.

##### *A. Advantages of Federal Land Banks*

2. Theoretically, the Federal Land Banks should possess advantages over the joint stock land banks by virtue of the principles of co-operation and collective security which they embody. Such advantages have been realized only in part. From the point of view of the investor, the bonds of the Federal Land Banks would appear to possess some advantages over those of the joint stock land banks. The capitalization of the individual banks is larger; they accept joint responsibility for the liabilities of each other; the area

<sup>1</sup> The system seems to have been an important factor in lowering interest rates and commissions on loans to farmers. See Morman, *op. cit.* pp. 110-116.

<sup>2</sup> *Report of Federal Farm Loan Board, 1918*, quoted Willis, *op. cit.*, p. 293.

<sup>3</sup> Willis, *op. cit.*, p. 293-4.

covered by each bank is more extensive, and issues of bonds are more uniform and larger in amount; there is a greater degree of supervision by the Federal Farm Loan Board, and a closer relation to the Government.<sup>1</sup>

3. The recent failure of three joint stock land banks also weakened the confidence of investors for a time. Hence joint stock land banks have had to pay a higher rate for loans than Federal Land Banks. Since also joint stock land banks differ very much in size, the nature of the territory they cover, the connections they have with other branches of the money market, and in efficiency of management, conditions under which they obtain finance will also vary a great deal.

4. The cost of operation tends to be lower for joint stock land banks because the average size of loan is higher, and possibly also because they are "under the spur of desire for private profits."<sup>2</sup> The favourable comparison in regard to operating costs may also be explained partly by the fact that they "pick the eyes out of the country" and select best territories to work in. On the other hand, some portion of the profits of Federal Land Banks goes back to members of the farm loan associations, so that what is lost on the "roundabouts" is gained on the "swings." It will be suggested, however, that the swings do not always compensate for the roundabouts.

#### *B. Disadvantages of Federal Land Banks*

5. To the present, the issue appears to be largely undetermined, but for certain reasons the joint stock land banks appear to possess net advantages. In consequence, their scale of operations has grown more rapidly than that of the Federal Land Banks, a circumstance which is suggesting to those in control that some revision of the latter system is desirable. The advantages appear to result from the provision of direct loans rather than through national farm loan associations. In short, co-operation as practised under the system has proved less successful than individual credit.

<sup>1</sup> See Willis, *op. cit.*, p. 329.

<sup>2</sup> *Ibid.*, p. 330.



6. (a) *Weaknesses of Farm Loan Associations.* It has been pointed out that members of a farm loan association borrow through their association, which endorses the mortgages pledged against bonds. Each borrower must invest through the association in the bonds of his bank to the extent of 5 per cent. of his loan from the bank, and is liable to that extent for losses incurred by members of his association. Each association must also accumulate a reserve fund. No such obligations are incurred by a borrower from a joint stock land bank. Hence many borrowers, particularly those requiring large sums, prefer to borrow direct from these institutions rather than indirectly from the Federal Banks.

7. It is true that members of national farm loan associations may derive a return advantage from their investments in Federal Land Bank stock. This stock is held by the association, and not by the individual borrower. Hence the association is also the recipient of such dividends as are paid. In most cases the costs of operation of farm loan associations have eaten into the dividends. Thus, up to November, 1922, dividends amounting to over \$1,827,000 were distributed to 3,645 associations, of which amount only \$937,000, say 50 per cent., was distributed by the associations.<sup>1</sup> While such losses on investments would be small in respect of small loans, they would be sufficient to deter large borrowers from making use of associations. Hence there has been a tendency towards a division of operations, small borrowers being catered for by the Federal Banks, large borrowers by Joint Stock Banks. In some instances the fact that borrowers under the former system must work their lands themselves, while under the latter they may borrow on lands let to tenants will have diverted business to the Joint Stock Banks.

8. (b) *Theoretical Advantages of Farm Loan Associations.* It is apparent that the interposition of farm loan associations would be likely, under any circumstances, to involve an additional cost against which some advantage should arise

<sup>1</sup> Morman, *op. cit.*, p. 126.

to counterbalance. There appear to be three possible ways in which counterbalancing economies might be effected.

- (i) The assumption of some responsibility by the association for the liabilities of members might improve the security against bonds and so reduce the cost of bond issues. The conservative basis of assessment adopted, the close supervision of operations by the Federal Farm Loan Board, and the assumption of joint liability by the Federal Land Banks appear to make this unnecessary.
- (ii) Associations might improve the basis of security by the local and personal knowledge which they might bring to bear in the appraisal of property and by exercising an oversight over subsequent farming practice. In point of fact, independent appraisal is considered necessary, and is probably more efficient, because performed by a specialist, while most farmers lose interest in their association after loans have been procured, so that subsequent oversight—which would probably be resented in any case—is not exercised.
- (iii) Associations might provide the nucleus of further co-operative effort, thus bringing indirect advantages. This hope of the Board has been disappointed.<sup>1</sup>

9. It would appear then that farm loan associations are not only unnecessary but are, in practice, an encumbrance. Hence the Federal Farm Loan Board, in its Fifth Report recommended direct borrowing.<sup>2</sup>

<sup>1</sup> Evidence tendered in 1923 showed that no association had taken upon itself any additional co-operative work. See Willis, *op. cit.*, p. 271.

<sup>2</sup> The reasons given were:—

- (1) "Most farmers, after having procured their loans, take little or no interest in the affairs of the association because they lack the spirit of co-operation.
- (2) "Some associations cease to function after the organizers have obtained their loans, thereby failing to serve their communities in providing farm mortgage loans."

(Quoted Morman, *op. cit.*, p. 127.) To these might be added an additional reason: the difficulty of obtaining competent secretary-treasurers. (See *Report of Royal Commission on Rural Credit, New Zealand, 1926*, p. 22.)

For the reasons quoted, the Board expressed the opinion that Federal Land Banks should be authorized by law "to make loans direct to a borrower in the same manner as Joint Stock Land Banks, except that a borrower should be required to take stock in the Federal Land Bank equal to 5 per cent. of the amount of his loan." (Morman, *op. cit.*, p. 127.)

## CHAPTER V

# LONG TERM CREDIT IN NEW ZEALAND

### I. INTRODUCTORY

1. The capital requirements for both public and private development in New Zealand have been considerable and have necessitated heavy public and private borrowings. In consequence of the comparative newness of the country, the frequent transfer of land, and the small initial capital of a large proportion of the settlers, there are few farms which are unencumbered and the volume of mortgages on rural lands is considerable. A recent estimate, which is probably conservative, places the total value of mortgages outstanding as on 31st March, 1928, at about £151,000,000, of which amount about £110,000,000 was on rural lands with an unimproved value of £148,000,000.<sup>1</sup> The figures are sufficient to indicate the great importance of long term credit in the economic life of New Zealand.

2. Long term credit agencies in New Zealand may be conveniently divided into two groups: private and public. The main private sources of credit are private lenders operating either directly or through solicitors, stock and station agents and other dealers, commercial banks, and a variety of financial institutions such as insurance companies, savings banks, trust companies and loan and mortgage companies which in the aggregate possess large funds for investment. The volume of long term credit from private sources is very great, much greater than from public sources, but it is impossible to hazard a reliable estimate as to the amount.

<sup>1</sup> See *Statistical Report on Wages . . . Land and Land Tax for the Year, 1928*, p. xlvii *et seq.*

3. The main public sources of long term credit are the State Advances Department and the Public Trustee.<sup>1</sup>

## II. PRIVATE SOURCES OF LONG TERM CREDIT

### A. *The Outer Market*

1. (a) *Private Lenders and Dealers.* As in many other countries, private lenders are an important source of long term credit. Some portion of the loans is advanced directly by individuals, but the majority of advances are made through solicitors or represent a part of the purchase money left by the vendor of farm property against the security of first or second mortgage. In New Zealand solicitors transact a considerable volume of financial business and money-lending (as agents) appears to be the primary function of many of them, especially in rural districts. At the present time private investors regard rural lands with disfavour as a basis of security, but such a situation is not likely to be permanent and they will doubtless play an important part in the future as in the past. This is all the more likely in that the "organized" market is far from adequate. Further, the vendor is always tempted to play the part of financier in order to encourage a sale, while the money-lending solicitor is an established institution which will persist.

2. Private loans as they are advanced in New Zealand possess most of the advantages and disadvantages discussed in a previous chapter and to recapitulate is unnecessary.<sup>2</sup>

3. The main dealers advancing long term credit in New Zealand are stock and station agents, whose operations have been discussed above.<sup>3</sup> Despite the serious disadvantages associated with this type of credit, stock and station agents have contributed a great deal to the rapid development of the country and until such time as an adequate, organized market is established, they will continue to play an important part.

<sup>1</sup> The Department of Lands also provides financial assistance for land settlement and development.

<sup>2</sup> See Part III, Ch. I.

4. (b) *Insurance Companies.* No official information is available as to the operations of insurance companies in the financing of agriculture. An attempt was made to obtain the necessary information by means of questionnaires which were sent to twenty-seven companies doing life and fire insurance business in New Zealand. Of these, twenty-one furnished replies.

5. The enquiry revealed the fact that very few insurance companies had funds invested on the security of rural land, and these represented a very small proportion of the total investments of the companies concerned. The total amount outstanding by the twenty-one companies on 31st December, 1928, was only £1,423,000, almost all of it being by one company. In only one case did the percentage of loans on rural security represent as much as 17 per cent. of the total investments of the company. It is doubtful if more than £2m. is advanced to agriculture by insurance companies.

6. A number of reasons are offered for the small volume of investment in rural securities. The majority of the funds are invested in Government and local body securities. In the case of companies dealing mainly in insurance against fire and accident, this policy is favoured mainly because such assets are liquid and can be realized in the event of large losses. Mortgages on property are regarded as being too difficult to realize upon in the event of a sudden need. In general also, insurance companies prefer to invest in large sums rather than in the form of small loans which "demand a considerable amount of attention." In some cases, also, insurance companies find it difficult to compete with the State Advances Department and the Public Trustee. Finally, the burden of company taxation which many insurance companies pay at the maximum rate of 4s. 6d. in the £ on income, makes it difficult for them to compete with private individuals, or smaller concerns, on whom income tax is levied at a lower rate. Hence they prefer tax-free public securities. In some cases, companies which advanced on rural securities before the war, have relinquished them in favour of Government War Bonds at

4½ per cent. which are found to yield a larger net return than rural mortgages and are less troublesome. In some cases the "fictitious" value of farm lands, the fluctuations in the prices of farm products of recent years and the deterioration in pasture, stock and buildings likely to result when farms are sold to new and inexperienced settlers, were offered as reasons for non-participation in rural finance.

7. The whole of the funds advanced are for the purchase of land or the effecting of improvements, and are secured against mortgages, life insurance policies being sometimes held as additional collateral. Loans are advanced upon 50 per cent. to 75 per cent. of the value of the security as assessed by valuers of the companies, or valuers nominated by them. The majority of loans are made direct to farmers, though some are made through solicitors, and stock and station agents. Borrowers are normally charged the current rate on first class mortgage security, which at the present time is 6½ to 7 per cent. The usual period of loans is from three to five years, though borrowers whose position is satisfactory have no difficulty in obtaining renewal. It is not customary to make provision for amortization, which in any case would be difficult owing to the short-loan period. In some cases mortgages carry a limited right of repayment by instalments.

8. The total assets of life and fire insurance companies in New Zealand were about £32m. in 1927, of which amount it is probable that not more than £2m., or say 7 per cent., was represented by mortgages on rural land. It is unlikely that more than 2 per cent. of the total long term credit to agriculture is provided by them. In the United States, on the other hand, insurance companies provided about 20 per cent. of the total mortgage credit in 1924. The contrast points to the existence of hindrances to the extension of long term finance which it is desirable to remove. Life insurance companies at least, which own about two-thirds of the total assets, would appear to be well suited to provide credit to agriculture. Their assets need not be particularly liquid, so that there is no insuperable objection to an

appreciable extension of rural finance on this score. Many of them are large in size and would be in a position to employ valuers if their business expanded. In any case, they are able to engage expert valuers when required. The rates at present charged compare favourably with those from other sources, and, on the whole, they should be efficient marketing agencies. Their main disadvantage at present consists in the shortness of the loan period, but there seems no reason why they should not advance longer loans with safety.

9. The problem is to remove the causes which they advance for their small participation in rural finance. The objection that rural land values are "fictitious," while still justifiable, is becoming less relevant as time passes; for the process of deflation of land values to an economic level, though still uncompleted, is proceeding. The difficulty that advances to agriculture are made in relatively small units will remain; but this objection was not general and does not appear to be of primary importance. The main barrier to effective participation in rural finance appears to be the levying of company taxation at a high rate of 4s. 6d. in the £ and the existence of tax-free public securities, or securities otherwise favoured.<sup>1</sup> From the point of view of rural finance (and for other reasons which it is beyond our province to discuss), it is highly important that company taxation be substantially reduced and that the artificial diversion of funds to public purposes by issuing tax-free securities, or by favouring public loans in other ways, be avoided in the future. The observance of these conditions should encourage a more active participation of *life insurance* companies in rural finance.

10. In so far as *fire insurance* companies require to keep their assets liquid, their main objection to rural mortgages will not be removed by the above means; but investment in the bonds of the Rural Advances Department, the Rural Intermediate Credit Board, or such other institutions as

<sup>1</sup> E.g. By levying a lower rate on debentures issued by a public authority, as occurred in respect of debentures issued between 1920 and 1923.

may be established in the future should thereby become more profitable, and a direct advantage to agriculture thereby accrue.

11. (c) *Finance and Loan Companies.* In certain parts of New Zealand, notably Taranaki, small finance and loan companies have developed which, though limited in scope, are yet of some interest. They are described as follows: "Six men with capital form a company, putting £500 each into the venture. On each £3,000 made up the bank will advance £2 for £1, or £6,000. The six members sign a joint and several guarantee for the £6,000. The £9,000 is then lent on cows, or land, or both—sometimes on a bill of sale over stock, or on a mortgage over land, or on a guarantee—and this security is deposited with the bank as well. The borrower has to reduce the amount by one-third or one-half of every monthly milk cheque, which he assigns until the loan is repaid. Interest is charged at the rate of from 7 to 9 per cent., and if the company gets 8 per cent. on the bank money for which it pays 6 per cent., then a safe and profitable business is the result. Speaking generally, these institutions act as small banks, taking risks in making advances which the banks do not care about."<sup>1</sup>

12. The operations of these concerns appear to be confined to dairy farms, in which returns are regular and security seems good. They have formed a useful link between the banks and the farmer in normal times and are in a better position than the ordinary private investor to estimate a man's personal capacity to run a farm and to estimate the value of the security. The method of repayment by means of a lien on the monthly butterfat cheque is also convenient to the farmer, and virtually embodies the principle of amortization.

13. Nevertheless, the fact that they are relatively small concerns, operating only in respect of dairying with its more or less continuous returns, reveals their limitations as a source of credit. They are of less value in regions where returns are discontinuous and uncertain, and the small

<sup>1</sup> Powdrell, *Dairyfarming in New Zealand*, p. 11.



volume of their reserves makes it impossible for them to carry the farmer over a bad season or two. While they act as a buffer between the banks and the farmer, and in the first instance bear the risks involved, there is the danger that the burden will recoil on the banks in adversity. The objections which have been raised to participation by banks in farm mortgage business are only partially removed by the interposition of this class of intermediary. It is true that the risks are lessened by the claims which the banks may have on the assets of the companies themselves, but the liquidity of the assets of the banks is not substantially greater than if the banks dealt directly with farmers; for the ultimate security is still a mortgage over land. The acceptance of deposits by such institutions is also objectionable. The danger of a run by depositors is very much greater than in the case of commercial banks, because of their smaller size and less adequate reserves; and because their assets are not liquid.

14. (d) *Trustee Savings Banks.* There are five "trustee" savings banks in New Zealand, not connected with the Post Office: viz., Auckland, New Plymouth, Dunedin, Invercargill and Hokitika. The extent of their transactions for the year ended 31st March, 1929, may be gathered from the following figures:

Number of depositors at end of year .. ..	172,185
Total of deposits during year .. ..	£6,307,509
Total withdrawals during year .. ..	£5,839,660
Total amount to credit of depositors at end of year .. ..	£8,478,119

By far the largest of these institutions is the Auckland Savings Bank, which had 130,316 depositors, credited with £5,645,514 at the above date.

15. An attempt was made by the writer to obtain information on the nature and extent of their rural business by questionnaires and four out of five banks furnished replies. The following statement refers to these four institutions. The total amount of long term advances outstanding as at 31st March, 1930, was about £4,730,000, of which amount about £1,340,000 was outstanding to

farmers. The percentage of total long term advances represented by agricultural transactions differed widely:—15 per cent., 30 per cent., 50 per cent., and 90 per cent. So also did the conditions under which loans are granted. These differences appear to arise largely from local differences in farming conditions and in other avenues for profitable investment.

16. The usual period of loans is three or five years; but one institution advances loans for one year only. In all cases, however, it is the common practice to renew loans on maturity, subject to a favourable report on inspection. The purpose of making the advances short-dated is to enable the proper oversight of securities and the revision of terms. Despite serious theoretical objections the policy is claimed to have worked well, and not to have imposed undue hardship on farmers because of the normal practice of renewing loans.<sup>1</sup> In view of the shortness of the loan period, it is obvious that the principle of amortization cannot be applied effectively. Loans are repayable in full on maturity, but provision is made for repayment by instalments at the option of the borrower. The rate of interest charged at the present time is 6 per cent. in three institutions, 6½ per cent. in one and 7 per cent. in another. The usual solicitors' and valuation fees are charged on acceptance of a mortgage. The institution making yearly advances makes no charge for renewal of loans; one institution charges a valuation fee only, one the usual mortgage registration expenses, and two a nominal inspection fee and the usual legal expenses. It is the policy of all to keep renewal expenses as low as possible.

17. Loans are advanced on first mortgage against freehold land only, the amount varying from 50 per cent. to 70 per cent. of the valuation. Assessments are made by professional valuers, or by trustees of the banks.

18. Provided that a conservative policy is followed in the making of advances, savings banks may lend a fairly large proportion of their deposits against rural security with

<sup>1</sup> The institution adopting the policy of yearly advances reports one mortgage which has been overdue for nearly seventy years.

a profit and safety. They must allow a sufficient margin to cover seasonal fluctuations in their funds and to meet all likely withdrawals during a time of depression.<sup>1</sup> Their finances are more stable, however, than those of commercial banks, and they can reasonably utilize a bigger proportion of their deposits to finance long term investments, but they are probably wise in limiting the period of loans. From the farmer's viewpoint, however, this limitation presents the most serious disadvantage under which they operate; for although renewal appears to be common, and not unduly expensive, yet the benefits of steady and continuous repayment do not accrue, and there is always the disturbing contingency, even though an unlikely one, that a prolonged and acute depression may make it necessary for the bank to avoid renewal. Savings banks will continue to play a useful, though limited, part in rural finance. They are never likely to be more than a subsidiary source of agricultural credit.

### B. Commercial Banks

19. There are six commercial banks operating in New Zealand, the extent of whose operations is indicated by the following figures for the year 1928:

Paid up capital	..	..	..	..	£28.4 millions.
Reserved profits	..	..	..	..	23.5 "
Deposits (average of four quarters)				..	53.8 "
Advances	"	"	"	..	46.2 "
Assets	"	"	"	..	62.8 "
Liabilities	"	"	"	..	61.9 "

20. In view of the great absolute and relative importance of farming in the economic life of the country, it is natural that the commercial banks should play an important part in rural finance. No figures are available as to the extent to which the commercial banks finance agricultural transactions, and attempts by the writer to obtain such information from the banks themselves were not very successful. Nevertheless, the financial assistance given to agriculture is

<sup>1</sup> It should be noted that, except in 1922, there has been an excess of deposits over withdrawals since 1920. Nevertheless the possibilities of large withdrawals during prolonged depression must be guarded against.

very considerable, especially if account is taken of accommodation to concerns engaged in buying or selling for farmers, or transporting their produce.<sup>1</sup> One prominent banker estimates that from 60 to 70 per cent. of the total advances of commercial banks in New Zealand is made directly for agricultural production and marketing, but this can be considered nothing more than an educated guess, and is probably much too high. This would be an average of round about £30m. outstanding of recent years. In general, banks do not favour the granting of long term credit for the provision of fixed capital, nor indeed is it proper that they should. No reliable estimate of the actual amount advanced for this purpose is possible; but it seems unlikely that more than 10 per cent. of the present indebtedness of farmers for land purchase or permanent improvements is to commercial banks.

21. The normal practice is for advances to take the form of a fluctuating overdraft between agreed limits. Interest is normally paid on the day-to-day balances, the rate varying according to the ruling charge, the size of the account, and the risk involved. The borrower is at liberty to repay the loan in part or in full without notice, except in rare cases. In some instances the bank itself insists upon periodical repayment. Overdrafts are normally payable on demand, though loans are "never called up apart from a substantial alteration in conditions." During depression the usual policy is to reduce new advances rather than to call in outstanding loans. In view of the fact that loans are recalled on demand, amortization is not possible, but advances are expected to run off within a reasonable time. The value of farms is appraised either by officers of the bank or by outside valuers. The proportion which the advance bears to the appraised value varies considerably, but is usually about 60 per cent.

22. Under the above conditions, farm mortgage credit by banks is a useful subsidiary form. To the substantial farmer, it is a simple and convenient method of obtaining

<sup>1</sup> Much of their business naturally involves the granting of credit to farmers.

finance. The method of financing by fluctuating overdraft possesses the advantage that interest is paid only on the amount outstanding, and within the limits imposed it can be reduced or extended to suit the convenience of the farmer. The financing of fixed and working capital then becomes combined in one account, backed by the same security, a method which saves a certain amount of trouble. The disadvantages previously outlined still apply, however. The small farmer, especially if he is located in a remote area, will have difficulty in obtaining accommodation on satisfactory terms. Although loans are not normally called in, insistence on this provision and the expectation that loans will run off within a reasonable time may necessitate renewal before indebtedness can be liquidated—a contingency which should be removed wherever possible.

23. There remains the necessity to the bank of keeping its assets liquid. The present volume of mortgage transactions to finance purchase or improvements does not appear to be sufficient to offer any serious danger; but any material extension of such advances is manifestly undesirable and, in their own interest, commercial banks must remain a minor source of long term credit.

24. The main danger of "frozen" assets arises, not from direct long term loans to agriculture, but from indirect commitments to agriculture resulting from advances to firms intimately dependent on agricultural prosperity. Where such concerns advance loans to farmers in the course of their business, these may recoil on the banks in times of severe and prolonged depression. In short, the responsibility of the banks for the control of rural finance does not stop with their direct commitments. The banking crisis of 1893 and the post-war boom and depression brought this lesson sharply home.<sup>1</sup>

<sup>1</sup> See Condliffe and Belshaw, *A Brief Survey of Rural Credit in New Zealand*, p. 345. "The banks also must bear their share of responsibility for the post-war boom, which depended mainly upon credit inflation. It is idle now to indulge in recrimination concerning the blame for that orgy of inflation and gambling, but it is obvious that the land-dealers, merchants and agency companies who fed the boom could have been checked in their operations by a restriction on their credit, such as by

*C. The Long Term Mortgage Branch of the Bank of New Zealand*

25. In the year 1925, a Royal Commission was set up by the Government to investigate rural credit systems in other countries. While the Commission was still engaged in its investigations abroad, the Government suggested to the various lending institutions of the country that they should "give consideration to the desirability of engaging in long term loans."<sup>1</sup> The Bank of New Zealand was the only institution which responded to the appeal and advanced proposals which were embodied in the Bank of New Zealand Act, 1926. This interesting and probably unique project embodied the following main provisions:

26. A separate branch was created, virtually independent in the matter of finance, but making use of the existing staff and equipment. The initial capital of the new branch was to be obtained by the creation of shares to the value of £1,406,250, but further increases might be made on the sanction of the ordinary shareholders of the bank, with the approval of the Minister of Finance. Shares were to be divided into two classes, "C" long term mortgage shares, and "D" long term mortgage shares, in the proportion of one "C" share to two "D" shares. His Majesty the King was to have the prior right to subscribe to "D" shares. Holders of the long term mortgage shares were to be entitled to receive a fixed preferential but non-cumulative dividend of 6 per cent. in the case of "C" shares, and 7½ per cent. in the case of "D" shares.

<sup>1</sup> Cf. Werry, *Rural Credit in New Zealand*. (Unpublished thesis.)

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a substantial rise in the rate of interest charged on overdraft. After the boom burst the mischief was done. It was then too late to repair the damage by raising the rate."

"It is true that all sections of the community indulged in the scramble to get rich quickly; but that does not absolve the banks from their responsibility. In their hands, to a great and increasing extent, lie the economic issues before the Dominion. Their responsibility is plain when the history of New Zealand teaches such plain lessons concerning the results of extravagant borrowing, inflation of credit and land values. The long depression of the 'seventies' and 'eighties' was directly due to just such another boom; but the public memory is short and the economic history of the Dominion little known."

27. In addition the bank might raise additional funds by the issue of debentures or debenture stock having a currency of not exceeding thirty-seven years, the amount not to exceed three times the amount of the capital paid up on the shares above specified. Trustees might invest trust funds in such debentures or debenture stock.

28. The capital obtained by the issue of shares and debentures was to constitute a fund to be utilized for the purpose of making advances on first mortgage of freehold or leasehold lands in New Zealand. The terms of mortgages were not to exceed thirty-seven years, repayable by such instalments as the directors prescribed. The amount of such advances was not to exceed two-thirds of the value of the security in the case of freeholds and one-half of the lessee's interest in the case of leaseholds, as certified by a valuer appointed by the directors. The rate of interest was not to exceed 6 per cent. except with the consent of the Governor-General in Council.

29. Provision was also made that the directors might transfer an aggregate amount not exceeding £500,000 from the ordinary funds of the bank to the Long Term Mortgage Fund. Any portion of the Long Term Mortgage Fund not in use might be transferred to the ordinary funds of the bank and bear interest at not less than the rate paid on fixed deposits for three months.

30. It has been frequently stressed in these pages that a commercial bank is unsuited to the conduct of long term mortgage business because of the necessity for keeping its assets liquid. In the setting up of a separate branch, with independent sources of finance obtained for a long period, either by the issue of shares or debentures, this objection is removed and the new branch is comparable in essentials to long term mortgage banks in other countries.

31. In theory, the scheme has much to commend it. It possesses all the advantages of long term mortgage banks, with the added advantage of being able to make use of the existing equipment, widespread branches and staff of the

bank. The statutory provision that advances shall be made at not more than 6 per cent. would appear to ensure a supply of funds at favourable rates. Indeed, after provision is made for taxation, it would appear that the share capital would earn substantially less than the rate of dividend provided for by the Act. One writer regards this as a straight-out loss "which the bank is willing to incur in order to assist the primary producer."<sup>1</sup> It is very questionable whether the bank is actuated by such altruistic motives. In the first place, such losses will be off-set wholly or in part when the bank makes use of its powers to issue debentures, which will probably be taken up at a lower rate than 6 per cent. Further, such funds as are transferred from the ordinary funds of the bank will be procured at a lower rate than 6 per cent.<sup>2</sup> Finally, it is open to the bank to advance only part of the loans demanded, through its long-term branch at 6 per cent., and lend the balance required on overdraft at a higher rate.

32. Potentially, the Act is of great value to the rural community, but up to the present it has achieved very little. To the present the bank has not fully utilized its powers to raise finance. By 31st March, 1930, shares to the value of £703,125 and debenture stock to the value of £102,550 had been issued, and on 31st March, 1930, £319,187 was on transfer from the ordinary funds of the bank. The advances made up to 31st March, 1930, totalled £1,124,862. In view of the short history of the branch, the expansion of long term mortgage business is as much as could reasonably be expected, but it is highly significant that by far the greater proportion of this has been advanced on urban property. Hence, the branch has done very little to improve the facilities offering to the farmer. It is possible that eventually the branch may become an important source of long term credit to agriculture, but there are no evidences as yet of a change of policy.

<sup>1</sup> Werry, *op. cit.*

<sup>2</sup> At the present time it should be noticed, however, that the rate is more than 6 per cent. on ordinary overdrafts.



## III. PUBLIC SOURCES OF LONG TERM CREDIT

## 1. THE STATE ADVANCES DEPARTMENT

*A. The Advances to Settlers Branch*

1. The State Advances Office was established by an Act of 1894 to afford relief and assistance to farmers and workers from high rates of interest, heavy procuration fees, solicitors' costs and other charges associated with the borrowing of money. The preamble to the Act clearly indicates its purpose.

Whereas by reason of the high rates of interest charged on mortgage of land, and the heavy incidental expenses connected therewith, settlers are heavily burdened and the progress of the colony is much retarded; And whereas it is expedient that the Government should afford such relief in the premises as is consistent with the public safety. . . .<sup>1</sup>

2. The system is administered by a superintendent. There is also a Board, consisting of the Minister of Finance and high government officials, whose resolutions are binding on the Superintendent, and whose consent is necessary before loans may be granted.

3. The legislation has been amended at different times and is now embodied in the State Advances Act of 1913 and its Amendments. The business of the Board is not confined to rural lands, but advances are also made to workers for the erection of dwellings, and to local authorities. Small advances have also been made to encourage fruit preserving, cold storage and the fishing industry. Advances by the settlers' branch are not wholly on rural lands, but are also advanced on urban lands for building purposes. During the first thirty-two years of the State Advances Department's existence the Government raised over £30,000,000 for the Department, which advanced £56,200,000 and repaid £22,000,000. Profits during the period amounted to £1,500,000. These figures relate to all departments of the Office, and not merely to advances on rural lands. On 31st March, 1929, current advances on rural land under the

<sup>1</sup> Cf. Hall, "A Brief Review of Rural Credit Facilities in New Zealand," *Economic Record*, November, 1928.

Advances to Settlers branch of the Office totalled nearly £11,000,000, the number of advances being 15,106; and nearly £6,000,000 on urban and suburban land. In addition were 947 advances outstanding under the Rural Advances branch, valued at £1,875,286.

4. In the earlier years interest was charged at 4 per cent., but as the price of Government borrowing has increased, the rate charged to borrowers has naturally risen in sympathy. The general rate on new loans in 1930 is  $6\frac{1}{2}$  per cent. for prompt payment, except on advances authorized for the purpose of repaying mortgages, in which case the rate is  $6\frac{1}{2}$  per cent. reducible to 6 per cent.

5. Loans are advanced for periods up to  $36\frac{1}{2}$  years and are amortized by semi-annual payments. The mortgagor may also repay his debt at half-yearly periods by sums of £5 or multiples thereof.

### *B. The Rural Advances Board*

6. In 1925 the Commission set up by the Government to investigate Rural Credit recommended, as a means of improving long term mortgage credit facilities, "the creation of a special rural credit branch within the State Advances Office,"<sup>1</sup> controlled by a Board on which farmers should be represented. Certain modifications in existing legislation were suggested which it is not necessary to recapitulate. In 1926 the recommendations were given general effect to in the Rural Advances Act. The Act established a separate branch of the State Advances Office, controlled by a Rural Advances Board which is constituted by adding a representative of primary producers to the State Advances Board.

7. The main point of contrast with the system of Advances to Settlers is the method of raising the necessary funds, which may be obtained by the issue of bonds, stock, or other securities. These constitute a floating charge on all the assets of the branch, including mortgages outstanding. The aggregate amount of bonds, stock, and other securities, is not to exceed the capital value of the mortgages held by

<sup>1</sup> Report, 1926, p. 7.

the Superintendent. Trust funds and public moneys may be invested in securities of the branch. On 31st March, 1929, after the second year of operation of the branch, bonds were outstanding to the value of £1,591,850. The advances current totalled 947 valued at £1,875,286.

8. Advances are made on the security of freehold land up to two-thirds of the value of the security, and on leaseholds up to two-thirds of the value of the lessee's interest in the lease. Loans are made to a maximum of £5,500 to any one borrower, and are granted only on the "instalment system" for periods not exceeding thirty-six and a half years.

### *C. Advantages of the System*

9. It will be clear from the statement of advances outstanding on rural security that the State Advances Office has met only a small part of the need for long term rural credit in New Zealand, by far the greater part of the demand being met from other, mainly non-public, sources. It has quite properly restricted its business to first class securities, and has adopted a conservative basis of assessment. These principles probably account in no small measure for the fact that its business has not extended further, despite the fact that its interest charges are usually lower than those charged by other lenders, since competitive lenders have by no means followed similar principles closely, except perhaps in recent years. The policy of the State Advances Department might have been followed with advantage both to its competitors and to the country at large.

10. There can be no doubt that the State Advances Department has operated to the advantage of the country. Although it has transacted a minor part of the total long-term mortgage business, it has exercised an important competitive influence. It has been able to charge a low rate of interest and impose low initial costs. The former condition is attributable in large measure to the advantage which it has possessed as a Government institution in obtaining the necessary capital at a low cost, but in view of the charge of inefficiency very generally levelled against public enterprise, it is not inappropriate to suggest that low operating

costs, a conservative policy in the assessment of security and the absence of the profit making motive have been factors of great importance.<sup>1</sup> The State Advances Office was also one of the pioneers in New Zealand of the principle of amortization in regard to long term rural advances, and is still one of the very few institutions adopting this method.

11. Quite naturally, the State Advances Department is subjected to criticism from time to time. A common ground of criticism is that it has an unfair competitive advantage over other institutions, in that it escapes the taxes levied on its competitors. While the State Advances Department does not pay land tax or local body rates on its own property, yet it obtains no concessions in respect of income tax. Since, however, the State Advances Office owns very little property, these exemptions are of no practical importance. The criticism is somewhat more relevant in the case of the Public Trust, which possesses valuable property in a number of centres, and this would be liable to land tax and local body rates if it were in the hands of private individuals or companies. It is true also that the possibility of raising funds at a low rate through its relation to the State may give it an advantage over its competitors in the field which it covers, and to that extent is perhaps prejudicial to the profits of other financial institutions; but the scope for their activities is still large, and it can scarcely be doubted that the opening up of the resources of the London money market to agriculture has increased the net economic welfare of the country.

#### *D. Defects, Limitations and Dangers*

12. There are, however, certain limitations and disadvantages. The conservative policy to which reference has been made, leaves much business outside the range of its operations. Hence, there will always be much scope for other lenders who are prepared to accept greater risks for the chances of higher gains. The maximum limit of £3,500 by the Advances to Settlers Department and £5,500 by the

<sup>1</sup> Management expenses amount to 2s. 6d. per £100 of the capital employed.

Rural Advances Board, while possessing the advantage of giving preference to small and moderate borrowers, renders it necessary for the large borrowers to apply to other sources.<sup>1</sup> It is probably inexpedient to raise the loan-limits beyond the present maxima, but there is room for an organized market catering, *inter alia*, for large borrowers. There is the further objection that long delays are frequently incurred before loans are granted and that the administration is unduly inelastic. It should be noticed also that the care with which the State Advances Office selects its clients and makes its advances, causes the more doubtful securities to be offered in the unorganized market, thereby adding to the disinclination of private investors to advance funds on rural security.<sup>2</sup> Further, the low rates on State Advances Mortgages do not necessarily represent a clear net advantage, since to some extent at least they have been capitalized in higher land values.

13. One final objection remains. While there is no principle which can be invoked against direct State participation in rural finance, yet there is always the danger to be faced, in a democratic community, that a large body of borrowers may exert pressure on the legislature to further their own interests to the detriment of the rest of the community. It is only fair to state that so far this danger has not revealed itself in the administration of long term rural finance, but in a country such as New Zealand, in which farmers have great voting power, the danger is ever present. The problem to be faced is to retain the advantages of the present system, while avoiding as far as is possible the political danger referred to. It is questionable whether State advances to agriculture should be administered by a State Department subject, through the Minister, to the pressure of party politics. A more appropriate type of organization would be an *ad hoc* body freed from direct

<sup>1</sup> As one writer points out, if a prospective farmer requires more than the maximum amount advanced by the State Advances Office, and obtains a loan from it on first mortgage, he must obtain the remainder on second mortgage at a higher rate which may offset the advantages of a lower rate on his first mortgage advance.—Werry, *op. cit.*

<sup>2</sup> Cf. Werry, *op. cit.*

political control. A necessary condition to such a change is independent finance, which has already been achieved by the provision that the funds for the Rural Advances Department shall be raised by the issue of bonds. The experience of the United States shows that even an *ad hoc* body is not always free from the pressure of politics, but with proper safeguards, the danger could be materially reduced.

## 2. THE PUBLIC TRUST OFFICE

### A. *Extent of Operations and Sources of Funds*

14. The Public Trust Office commenced operations in 1873 and "is designed mainly to afford, at low rates of commission, a secure and convenient recourse in any case where a person either in New Zealand or abroad, and desiring to draw a will, form a trust, or appoint an agent or attorney in the Dominion, may be in doubt or difficulty as to the choice of a trustee, executor, agent or attorney."<sup>1</sup>

15. For the year ending 31st March, 1929, the total value of estates in the office, including unrealized assets, was over £48,000,000. At that date the capital funds invested by the Public Trust Office totalled £31,000,000 of which amount £18,000,000 was invested in mortgages. The amount of mortgage investments standing in the name of the Public Trustee as at 31st March, 1930, was £18,373,708; the funds being obtained from the following sources:

Investments of Common Fund	.. ..	£13,094,665
Public Service, Railways and Teachers' Super-annuation Funds and National Provident Funds invested in the name of the Public Trustee	.. ..	4,820,424
Other <sup>2</sup>	.. ..	458,619
		<hr/>
		£18,373,708

Of the above amount about £9,000,000 is invested in rural security.

<sup>1</sup> *N.Z. Official Year Book*, 1930, p. 967. Information on which the following account is based has been obtained directly from the Public Trustee, and from his annual reports for 1928 and 1929.

<sup>2</sup> Investments made by special direction of testators under the provisions of the Trustee Act, 1908. These do not form part of the Common Fund, and the remarks which follow do not apply to them.

*B. The Common Fund*

16. The device of the Common Fund "is a unique creation in the sphere of trust administration."<sup>1</sup> Normally, in the absence of any specific directions in the trust instrument, a trustee invests his funds in certain selected securities specified by Statute, in the form of a number of independent investments, the risk falling upon the beneficiary. Except for such benefits as may arise from statutory safeguards defining the nature of trust securities, and from the care and experience exercised by the office in the investment of funds, this method possesses all the disadvantages of the private loan. In 1891 a Commission was set up to enquire into the organization and working of the Public Trust Department, and recommended the creation of a "Common Fund" to absorb all cash balances of estates, except where this was expressly forbidden by the creator of the Trust. The monies from the fund were to be invested in securities of a specified nature. The rate of interest was to be fixed by the Governor in Council and capital and interest were to be guaranteed by the State.

17. The advantages of this method are clear. The necessity is avoided of finding suitable investments for small amounts. The cost of marketing is thereby reduced, and the need for effecting a coincidence in the amount and period of individual advances with the amount and period of loans required by individual borrowers does not arise. Small cash balances may be paid into the Common Fund and receive interest at once. The withdrawal of small amounts does not embarrass any individual borrower, and the convenience of borrowers can be considered without prejudicing the interest of beneficiaries. The risk is spread over the whole body of investments and is guaranteed by the State. In short, the pooling of funds serves precisely the same purpose as the aggregation of funds by a bank, with the additional advantage of a State guarantee, which, in the circumstances, is a reasonable proviso, even though in practice it is scarcely necessary.<sup>2</sup>

<sup>1</sup> *Annual Report*, March, 1929.

<sup>2</sup> See *Report of Public Trust Office*, 1929, pp. 9-11 for an able discussion.

*C. Assessment and Supervision of Security*

18. The amount of advances varies from a few hundred to many thousands of pounds and may be made on the security of freehold property, on Crown land held under perpetual lease, lease in perpetuity, renewable lease, or occupation with right of purchase, and on certain native leases. Loans are made on first mortgage up to three-fifths of the estimated value of the estate, in the case of freehold land, and three-fifths of the mortgagor's interest in an estate in the case of leasehold land.

19. The normal basis of assessment is the Government valuation of the property, where this shows a large margin of security. In consequence of the economic disturbances since the war, it has been found necessary to institute an efficient system of supervision and oversight, a provision which has been all the more necessary owing to the increasing adoption of long-dated mortgages which dispense with periodical revaluations. Mortgages come up for revision at regular intervals—usually at the end of every five years—and the necessary steps are then taken to see that the security is maintained in good order and condition. Securities near the main centres of population are inspected by district officers of the department or by property officers attached to the staff; county securities are inspected by farm inspectors of the office.

20. Recognition of the importance of the personal integrity and efficiency of the borrower in determining the value of the security has led to the inclusion of covenants to the effect that sales of property shall not be effected without the consent of the mortgagee, the new purchaser being required to fulfil similar conditions. In order to maintain the value of the security, valuers are requested to state to what extent top-dressing with artificial fertilizers is required on properties over which a mortgage is to be taken, and a covenant specifying what proportion of the property should be top-dressed each year, and what amounts of fertilizer should be used, must be agreed to by the mortgagor. Generally speaking, farmers readily agree to the insertion



of such a provision in the mortgage deed. In addition, "a very complete and careful system has been instituted to maintain constant touch with any securities which show signs of becoming unfavourable. In such cases the operations of the mortgagor are closely supervised and inspections of the security are made by the farm inspectors as often as is necessary. As a result of this oversight the position of many mortgagors who have been in difficulties has been greatly improved, and in many cases such mortgagors have been saved from financial disaster through the advice and supervision of the Public Trust Office."

21. "In other cases, where it has been clear that the mortgagor has not the necessary financial resources to enable him to carry on successfully, the office has co-operated with him in an endeavour to dispose of the property to advantage and to save whatever equity there might be in the security for the owner."<sup>1</sup>

#### *D. Loan Conditions*

22. Provision is made for loans to be advanced on the amortization plan. The majority of rural loans on this basis are for periods of twenty-five years, but loans may be granted on tables which amortize them in ten, fifteen, twenty, thirty, or thirty-six and a half years, the two latter being confined to transactions in which the margin of security is exceptionally good. A number of borrowers prefer flat loans, the usual term being for five years. In general, mortgagors are encouraged to borrow on the principle of amortization.

23. In order to preserve the continuity of his investments as much as possible the Public Trustee does not, as a general rule, accept repayment or reduction of principal before maturity, apart from the amortization payments. Exception is made when a mortgagor desires to dispose of a portion of his land, and the rule may be relaxed when enforcement would result in definite hardship to the borrower.

24. Broadly speaking, the rate of interest on new loans varies in sympathy with the ruling rate on first class

<sup>1</sup> *Report of the Public Trust Office, 1923.*

mortgage security, but tends to be more stable. The present rate of 6 per cent. is somewhat lower than the rate on advances from other sources.

### *E. Advantages*

25. Within the limits imposed by the general nature of its duties and responsibilities, the Public Trust Office is a useful and efficient source of long term credit for agriculture. The value of its advances on the security of rural mortgages is approximately 70 per cent. of the corresponding business by the State Advances Department. Its advantages are similar, in many respects, to those of long term mortgage banks except that the supply of funds is less elastic. It does not raise finance by the issue of bonds, but must rely on the funds which come to it in the ordinary course of its business. It is on a large enough scale to employ expert valuers. Its officers are men of ability with legal training, and with a type of experience which fits them well for the duties involved in financing real estate transactions. The nature of the business of the office is well known, and its branches are sufficiently widespread to permit of reasonably close contact with its clients, a condition which is facilitated by a policy of de-centralized administration and responsibility. The adoption of the principle of long term amortizable loans also places it at an advantage over most other kinds of long term credit agency operating in New Zealand.

26. One important feature of the work of the Public Trust is the care with which it safeguards the interests of its beneficiaries, by the conservative basis of assessment of securities, the adequate margin which it allows, and its oversight of such securities as may conceivably depreciate. The insistence upon certain standards of farming practice, and the expert advising of the farmer which arise in the performance of this function, not only add materially to the security of the investment, but also tend towards the general improvement of farming practice. While control over the activities of the farmer by his creditor may easily become onerous and objectionable, the form of control exercised by the Public Trust would appear to be wholly reasonable

and on balance decidedly advantageous to the farmer himself. The policy of safeguarding the equity of the farmer when liquidation becomes unavoidable is also highly desirable and should be accepted as a general principle in all long term credit transactions.

#### IV. LONG TERM CREDIT NEEDS

1. It will be clear from the foregoing account that a large proportion of the supply of long term mortgage credit in New Zealand is from private sources. The operations of the State Advances Department and the Public Trust Office are both useful and important, but it is questionable whether they provide more than about 20 per cent. of the total long term requirements of agriculture. Although precise information is not available, there is little doubt that the greater portion of the long term credit required is obtained from private individuals and dealers. During the buoyant years, from about 1895 to 1920, this unorganized market appeared to meet the need tolerably well. Interest rates were not unduly high and loans were frequently advanced on a small margin of security. The conditions under which loans were advanced led to land inflation and raised serious difficulties when prices broke and began to move downwards; but it can scarcely be said that credit was inadequate or unduly expensive.

2. These conditions are now passed. Farm mortgages are regarded with small favour by private investors and are considered relatively unattractive by lending institutions. The sources of long term credit can no longer be regarded as adequate; and improved and extended facilities are required. It is desirable, in the social interest, that resources should move more freely into agriculture. In part, this end would be achieved if the disabilities under which large financial institutions labour as the result of the present system of company taxation were removed, but of greater importance is an improvement in the basis of farm mortgage security, and the development and extension of institutions especially constituted to meet the particular needs of long term farm finance.

3. The confidence of private investors, dealers and financial institutions in farm mortgage security has been severely shaken, and though it may be expected to recover eventually it is not likely to do so for some time to come. In consequence, other methods of providing long term credit must be developed. The direction of adequate funds to agriculture will only take place, apart from direct loans by the State, if the confidence of investors in agricultural securities is improved. The most appropriate method of achieving this end is through the operation of large institutions which raise their finance by means of bonds backed by the collective security of farm mortgages, which may be expected to assess the value of the securities with care, and supervise them efficiently, and which allow a good margin of security against all advances.

4. In these respects, the Public Trust Office and the State Advances Department may be regarded as very satisfactory in the main, and if their operations could be extended considerably, the problem of farm mortgage credit would be largely solved. Such an extension does not appear at all likely. The sources of funds on which the Public Trust Office depends are inelastic and are dependent on the monies entrusted to it in the course of its ordinary business. The State Advances Office seems likely to extend its operations gradually and cautiously. There remains the need to establish additional institutions. These should be empowered to advance loans to a larger limit than those fixed in the case of the State Advances Office and the Rural Advances Board—viz., £3,500 and £5,500 respectively, since these maxima are too small for the requirements of many farmers, especially those engaged in sheep farming and arable farming. To meet this need it is desirable that legislation should be enacted empowering the establishment of farm mortgage investment companies along the lines of the Joint Stock Land Banks in the United States or the Agricultural Mortgage Corporation in the United Kingdom.<sup>1</sup>

<sup>1</sup> A proposal of this nature was made by a Special Committee under the chairmanship of Professor Tocker, set up by the Canterbury Branch of the Economic Society of Australia and New Zealand, and outlined in a pamphlet published in 1929.

## CHAPTER VI

# LONG TERM CREDIT IN GREAT BRITAIN

1. Before the war the great majority of English farms were held by tenants and the number of owner-occupiers was relatively small. In the post-war period there took place a fairly rapid increase in the number of holdings owned by occupiers, but even so the tenant system still greatly predominates. In these circumstances, the need for any specialized system of long term credit for land purchase was, until recently, much less great than in some other countries. On the other hand, credit for the execution of capital improvements such as drainage and reclamation, erection and extension of farm buildings was required by many landowners—even before the war—who could not conveniently meet the expenses of such works out of income, while after the war, the increased costs of improvements, together with increased taxation and the greater number of small landowners, made the question of credit facilities for this purpose of considerable practical importance.

### I. CREDIT FOR IMPROVEMENTS

1. Although loans for land improvement were made, before the war (and still are) by the joint stock banks, special facilities and special institutions for the provision of Improvement Credit have existed in Great Britain for about three-quarters of a century. The General Land Drainage Company was formed under statutory authority in 1849, the Lands Improvement Company in 1853, the Scottish Drainage and Improvement Company in 1856, and the Land Loan and Enfranchisement Company in 1860. All these undertook this class of business, but the Lands Improvement Company

later absorbed the first and last of the above institutions. In 1864 an Act, known as the Improvement of Land Act, was passed, authorizing landowners to raise money and to charge their estates for the purpose of executing certain classes of improvements. The act was amended in 1899 by the passing of the Improvement of Land Act of that year, and other Acts have from time to time extended the list of improvements for which estates may be charged.

2. The chief development of this type of credit has been through the Lands Improvement Company which, operating under its own Act, was reported in 1923 to have lent some £13,000,000 in the course of the seventy years of its existence.<sup>1</sup> During the war the business of the company was practically suspended largely owing to a statutory limitation of the rate of interest charged on loans, to 5 per cent. In 1920, however, the limitation was removed by an amending Act, the rate of interest chargeable by the company being henceforth such rate as the Minister of Agriculture might approve. A similar amendment to the Improvement of Land Act, 1864, was made by the Agricultural Credits Act, 1923.

3. As the principle involved in the Act under which the above company operated and also in the Improvement of Land Act is a somewhat unusual one, special reference may be made here to the procedure under the Acts and to the character of the charge created upon the property in accordance with their provisions.

4. Under the Improvement of Land Acts, 1864 and 1899, the procedure is as follows:—

When a landowner applies, for example, to the Lands Improvement Company for a loan, the application is forwarded by the company to the Ministry of Agriculture and Fisheries in order that an official inspection of the land may be carried out. The landowner has to provide the Ministry with detailed specifications and in the case of buildings, or in any other case when required, detailed plans. The Act expressly prohibits the commencement of

<sup>1</sup> *Report of Committee on Agricultural Credit, 1923.* Cmd. 1810, p. 6.

any improvements until the specifications and plans have been approved by the Ministry. The main purpose of this inspection is to establish that the property concerned will, *prima facie*, be improved at least to the extent of the proposed charge. In his report to the Ministry, therefore, the inspector has to state whether the projected improvement will effect a permanent increase in the yearly value of the land exceeding the yearly amount proposed to be charged thereon. This requirement does not, however, apply in certain cases, e.g. the erection or improvement of a farmhouse or cottage for occupation by a person engaged in the cultivation of the lands in question, certain schemes of water supply, the erection, improvement or addition to a mansion house in certain circumstances, and planting.

5. If the Ministry considers the report satisfactory it sanctions the improvement by a Provisional Order which names the landowner, to whom it is issued, the maximum sum to be charged in addition to costs, charges and expenses, the rate of interest and the term of years over which the loan must be repaid. The maximum limit for repayment is fixed at forty years.

6. The Provisional Order creates in favour of the landowner the title to an absolute charge on the completion of the improvements, which title he may assign either absolutely or by way of a security to an improvement company, such as the Lands Improvement Company, or to any other body of persons who may agree to advance the money for the improvement.

7. In order to satisfy itself that the work has been satisfactorily completed the Ministry makes a further inspection, after which it issues an Absolute Order creating a charge on the lands comprised in the Provisional Order, or on some sufficient part of them, to cover the sum chargeable in respect of such improvements, together with interest.

8. The charge is by way of a rent charge payable half-yearly for the term fixed by the Provisional Order. The land charged with payment of the rent charge may comprise not only the land directly improved but also other land which is

shown to the satisfaction of the Ministry by statutory declaration to be held for the same estates or interests, and to be either subject to the same encumbrances, if any, or to be free from encumbrances; and which, in the opinion of the Ministry, may be properly included in the charge.

9. An Absolute Order creates in favour of the grantee a charge which has priority over every other existing and future charge and encumbrance except quit rents, ground rents, chief rents and other charges incident to tenure, tithe-rent charge, charges created or to be created under Acts authorizing advances of public money for improvements, and charges created under the Act of 1864 or amending enactments.

10. The person for the time being bound to make the periodical payments of the charge has to uphold the improvements and, if so required, to certify annually to the Ministry the fact of insurance and payments of premiums.

11. Similar procedure applies in the case of Scotland where the issue of the Provisional and Absolute Orders is made by the Department of Agriculture for Scotland.

12. The special feature of this legislation is, of course, the fact that the charge thus created upon the land improved, ranks in priority to other charges, with the exceptions enumerated above. The protection of the holder of a pre-existing mortgage lies in the official certification that the value of the property will be increased as a result of the improvement, by at least as much as the amount of the charge. Since the passing of the Agricultural Credits Act, 1928, improvement loans under the Improvement of Land Acts have also been made by the Agricultural Mortgage Corporation which started operations in January, 1929. A description of the working of this institution is given below.

## II. CREDIT FOR LAND PURCHASE

1. A variety of causes led, after the war, to a substantial increase in the number of holdings owned by occupiers, until it was estimated that in 1925 over 25 per cent. of the



holdings in England and Wales were thus owned. The corresponding estimate for 1920 was 13·7 per cent., and for 1914, 11·3 per cent.<sup>1</sup>

2. A movement of these dimensions once more raised the question of the provision of adequate long term credit to finance the purchase of land, and for the purpose of capital equipment of farms. But it also raised the wider question of the need for some kind of standard machinery of long term credit based on farm mortgages. In this respect Great Britain occupied an almost unique position amongst advanced agricultural countries, in having no such machinery. Prior to the passing of the Agricultural Credits Act, 1928, farmers relied for long term credit mainly on the banks; on solicitors who invested trustee funds in mortgages on agricultural land (usually not repayable by annual or other instalments, but withdrawable at three months notice); on relatives and friends, and in some cases on the vendors of the land who "left" a portion of the selling price with the purchaser. In the post-war movement towards owner-occupation, the banks were probably the chief source of loans, and in 1926 as much as £26,000,000 was stated to be outstanding in the shape of money advanced upon land.<sup>2</sup> But none of these sources provided the type of long term credit available to farmers in many European countries, in the United States, Canada and elsewhere, viz., loans secured by farm mortgages, repayable by fixed annual or half-annual instalments. It was to fill this gap that the "long term" provisions of the Agricultural Credits Act, 1928, were designed.

3. The wording of the Act, however, gives little clue to the special features which characterize the system that ultimately developed from it, the Act being mainly concerned with enabling the State to take certain steps with the

<sup>1</sup> *The Agricultural Output of England and Wales, 1925*. Cmd. 2815, p. 96. See also *Agricultural Statistics, 1924*, Part I, p. 13. These estimates are approximate only, and in publishing them the Ministry add a note of warning as to their accuracy.

<sup>2</sup> *Report on Agricultural Credit, Ministry of Agriculture and Fisheries, 1926*, p. 36.

object of incorporating a company which would undertake this class of business.

4. The scheme was the outcome of the *Report on Agricultural Credit*, published by the Ministry of Agriculture in 1926, to which reference has already been made. It sought first of all to establish a central mortgage institution embodying some of the principal features of the more successful long term credit organizations in foreign countries. This institution ultimately took shape in the Agricultural Mortgage Corporation which started operations in January, 1929.

5. Under the Statute, the period of loans upon mortgage was limited to a maximum of sixty years, and the amount to two-thirds of the estimated value of the mortgaged property at the time of the loan. The dividends of the corporation on its share capital were restricted to 5 per cent. per annum, but the State undertook to make certain contributions with the object of assisting it during the early stages of its operations, and of improving its financial position. Firstly, the State was empowered to pay to the corporation an annual sum of £10,000 for a period of ten years as a contribution towards its administrative expenses. Secondly, it was empowered to make advances to the corporation for the purpose of establishing a guarantee fund limited in amount to the aggregate of the paid-up share capital. In effect this last provision put the corporation in the position it would have been in if it had accumulated over a period of years a reserve fund equal to its share capital. These advances were made free of interest for a period of sixty years.

6. Like most long term agricultural credit systems, the scheme was designed not merely to establish a standard and uniform system of long term loans, but also to provide machinery for raising money out of which such loans could be granted, secured primarily upon the mortgages contracted in favour of the corporation. Moreover, it sought to meet another need. Agriculture, consisting mainly of a large number of individual enterprises, and being seldom carried on upon a joint stock basis, has been under certain disabilities in comparison with joint stock industry, in

having no standard form of investment stock which could be dealt with upon the London Stock Exchange, in a similar manner to the stocks and shares of industrial companies; the investment market did not afford a channel through which the savings of the public could find their way into agriculture, as they might in other productive industries.

7. The Act therefore provided for the issue by the corporation of debentures from time to time as required, which would both enable it to raise money wherewith to finance its agricultural loans, and also would provide for the first time in this country a standard agricultural investment. The arrangement was similar in principle to that adopted by the mortgage credit institutions in European countries and the Federal Land Banks in the United States of America, though differing in detail.

8. Now it was clear that the rate at which the company could lend to farmers would be determined by the rate of interest to be paid on these debentures, and that the latter, in turn, would depend primarily on the security behind the debentures. This indeed was the crux of the whole question, and it is easy to see that the point was conspicuously in mind when the details of the scheme were in preparation. The debentures of the Agricultural Mortgage Corporation are secured by a Trust Deed in favour of the Whitehall Trust Company, Ltd., creating a first charge on the whole of the undertaking, property and assets of the corporation. Its principal assets consist, firstly, of the mortgages and improvement charges (under the Land Improvement Acts) from time to time held by the corporation in respect of loans made by it; secondly, of the authorized share capital, amounting to £650,000; thirdly, of the guarantee fund equal to the share capital which the Minister of Agriculture and Fisheries was empowered to advance to the company under the Agricultural Credits Act, 1928, and did actually advance by virtue of an agreement dated 24th January, 1929, between the Minister and the corporation; fourthly, of any reserves accumulated by the corporation. A provision is also included in the memorandum of association of the corporation

to the effect that the debenture stock, or other like securities issued by the company and for the time being outstanding, shall not at any time exceed a certain fixed multiple of the Government advance, paid-up share capital and reserves, taken together. This provision, it may be noted in passing, is analogous to the statutory requirement in respect of the Federal Land Banks in the United States established under the Federal Farm Loan Act of 1916, which fixes a maximum ratio between the bonds issued by these banks and their capital and "surplus"; in effect, it secures that the debentures of the corporation will always have behind them, not only an equivalent volume of mortgages and improvement charges (the loans upon which are constantly being repaid) but the additional security in the shape of these funds, representing a definite fraction of the debentures.

9. Debentures issued by the corporation are, under the Act of 1928, included amongst securities in which trustees may invest trust funds.

10. The expectation that the debentures of the corporation, so secured, would command a good price on the market, has been fully confirmed by experience. The first issue was made by the corporation in June, 1929, and consisted of £5,000,000 5 per cent. debenture stocks, 1959-1989 at par. A second issue of £3,500,000 was made on 10th May, 1930, at par. In January, 1931, the stock stood at about 104.

11. The unique feature of the system of long term credit which has resulted from the passing of the Agricultural Credits Act, 1928, is however, not so much any provisions of the Act or any details of the constitutions of the corporation, as the fact that the ownership and control of the corporation is vested in the joint stock banks, and is operated through the branches of the shareholding banks. This alone places the English system in sharp contrast with practically all other long term credit systems in other countries, and gives it certain advantages over some.

12. The share capital is held by the Bank of England and the chief joint stock banks,<sup>1</sup> and the Board of Directors is

<sup>1</sup> The Midland Bank is not a shareholder.

representative of the banks and other financial houses, and of agriculture, together with one director appointed by the Government. It will readily be seen, therefore, that the corporation, so constituted and so controlled, not only has access to the best financial advice, and by reason of its close connexion with the great banks, possesses a certain financial prestige, but it has gained other important advantages. Since loans are advanced to farmers through the branches of the shareholding banks, these acting as agents of the corporation both in receiving applications and in collecting the half-yearly instalments as they become due, the need for any special local organization has been dispensed with. In consequence the cost of administration has been reduced to a minimum, and the corporation has the added advantage of the local bank manager's personal knowledge of the applicant.

13. All these factors have co-operated to enable the corporation to make loans at a low rate of interest. The following table sets out the rate of half-yearly repayments which are at present in force in respect of loans on mortgage of varying periods:

LOANS ON MORTGAGE PER £100 HALF-YEARLY

60 years	..	..	£2 15s. 0d.	payable each half-year.		
50 "	..	..	£2 17s. 3d.	"	"	"
40 "	..	..	£3 0s. 11d.	"	"	"
30 "	..	..	£3 7s. 11d.	"	"	"
20 "	..	..	£4 3s. 9d.	"	"	"
10 "	..	..	£6 13s. 8d.	"	"	"

14. The repayments cover interest on the loan, repayment of principal over the specified period of years, and the corporation's legal and certain other expenses.

15. A farmer desiring to obtain a long term loan through the corporation has a very simple procedure to follow. In the case of anyone banking with a branch of one of the shareholding banks, he makes application to his local bank just as he would if he required ordinary temporary accommodation. He fills in the particulars of his application on a form supplied by the bank who then forward it to the

corporation. The property is valued by one of the corporation's valuers, and if the report of the valuer is satisfactory, the amount which the corporation is prepared to lend on the security of a mortgage on the property is fixed by the directors, and, subject to the borrower's agreeing to the corporation's offer, the amount of the loan is made available to him through the local bank. The half annual instalments are collected by the branches of the shareholding banks, and it is always open to a borrower to arrange for their regular payment by means of a banker's order authorizing the bank to pay the instalments as they become due and to debit his current account with the amount of such payments. The form of mortgage used by the corporation does not entitle the borrower to repay the loan otherwise than by means of the half-yearly instalments, but should the borrower desire to make an earlier repayment the corporation have stated that they are prepared to make an *ad hoc* arrangement on terms to be agreed upon.

16. In regard to the operations of the Agricultural Mortgage Corporation under the Improvement of Land Acts, no special description is required, the procedure is the same as that given above except that the corporation's activities are restricted by the Agricultural Credits Act, 1928, to the making of loans for "agricultural purposes,"<sup>1</sup> and applications by landowners are made through the branches of the shareholding banks, as in the case of long term mortgage loans.

17. The response of farmers and landowners to the facilities furnished by the above scheme has been considerable. Since they started operations in January, 1929, the corporation, up to 20th January, 1931, had made the following advances:

Loans on Mortgage	..	..	..	..	£6,622,861
Improvement Loans	..	..	..	..	18,232
					<hr/>
					£6,641,093

<sup>1</sup> There are a number of improvements to land which may be made the subject of a charge under the Improvement of Land Acts, which are not improvements of an agricultural character.

A further number of advances amounting to a total of £929,839 had also been sanctioned by the directors subject to the satisfactory completion of the formalities. In aggregate, therefore, the corporation has lent or agreed to lend something over £7,000,000 during the first two years of its existence. It seems probable that a large part of these loans has been made for the purpose of refunding pre-existing long term farm debts, but in so far as this has been done upon the basis of a lower rate of interest, agriculture has benefited.

The scope of the corporation's activities has been confined to England and Wales and no similar system has so far been established in Scotland.





**PART IV**  
**SHORT TERM AND INTERMEDIATE**  
**CREDIT AGENCIES**



## CHAPTER I

# THE "OUTER MARKET" FOR SHORT TERM AND INTERMEDIATE CREDIT

### I. PRIVATE LENDERS

1. As was shown in an earlier chapter,<sup>1</sup> private lenders are an important source of long term credit in some countries. It is impossible to assess the amount of short term or intermediate credit by private individuals other than dealers. Except in older countries where this type of credit is represented by the village money-lender, it does not appear to be very important, probably because other and more suitable sources are available, and because the farmer considers it a normal part of his business to utilize the services they offer. The money-lender still appears to play a prominent part in village communities in Eastern countries such as India; but in Europe the spread of co-operation and with it the marshalling of the personal security of small debtors, and especially the lessening of the shame which once tended to discourage open appeals for financial aid, has reduced the power of the money-lender and "clipped the talons of that bird of prey," in many areas.

2. Short term or intermediate credit through private investors or money-lenders has most of the weaknesses we have discussed in respect of long term credit. The concentration of risk on the one lender adds to the cost of risk-bearing and is reflected in a higher gross rate of interest. The difficulty of regulating credit terms is very great and exploitation becomes common. Where other credit institutions exist these may to some extent check exploitation through their competitive influence; but the borrower who

<sup>1</sup> See Part III, Ch. I.

goes to private sources for short term or intermediate credit will frequently do so either because no other sources are available or because the nature of his loan or the security he has to offer is not acceptable to other credit intermediaries. In such cases a higher cost may frequently be reasonable, either because of the greater trouble involved in marketing credit, especially if it is demanded in very small amounts, or because the security is inadequate or unsuitable.

3. The higher rate charged is often greater than would be warranted by these circumstances alone, and depends partly on less efficient methods, but largely on the exercise of monopoly power by the lender. This is particularly likely to occur when credit is not regarded as a normal recourse, but as an unfortunate and drastic expedient necessitated by impending disaster—when the borrower does not wish his indebtedness to be revealed and resorts to the money-lender as a last resort. The experience of certain European countries before the establishment of co-operative banks reveals the extent to which the small farmer, in particular, may be fleeced where such conditions obtain. In western and south-western Germany, “we have no idea of the pest of remorseless usury which has fastened like a vampire upon the rural population of that district. Even the gombeen man cannot compare with the hardened blood-sucker of those usury-haunted parts.”<sup>1</sup> Similarly in Italy, if a poor peasant wanted money, the usurer was delighted to supply it—at from 50 per cent. to 1,200 per cent. “often with a Sunday dinner thrown in as a prescriptive condition.”<sup>2</sup>

4. In some countries the landlord is an important source of short term and intermediate credit to the tenant. Under ordinary tenantry, where the tenant pays a cash rent, he is often able to resort to the same sources as the occupying-owner, since he possesses stock and implements which he can offer as security, as well as his growing crops, so that he need not rely on the landlord. Under the various systems

<sup>1</sup> See Wolff, *People's Banks*, p. 112.

<sup>2</sup> *Ibid.*, p. 296. See also Morman, *Principles of Rural Credit*, p. 7-8.

of share tenantry, however, stock and implements are usually provided by the landlord so that the tenant has little security to offer other than his personal promise to pay. Frequently the landlord then becomes the chief source of credit, though credit from merchants may also be important. The landlord will usually be able to secure credit from commercial banks or elsewhere on reasonable terms, and since this advantage is largely denied the share farmer owing to the meagreness of his assets, the method of landlord-credit is in most cases decidedly to the tenant's advantage. It is also advantageous to the landlord, since it permits of a higher level of efficiency on the part of the share-farmer and so increases the amount going to the landlord as rent. It does not remove the necessity, however, for the establishment of proper credit facilities from other sources for the cash tenant.<sup>1</sup>

## II. DEALERS

1. In Part III, Chapter I, the weaknesses and dangers involved in the provision of long term mortgage credit by stock and station agents, auctioneers, commission salesmen, merchants and other dealers were exemplified. Even as regards short term and intermediate credit it seems desirable, on the whole, to separate it as much as possible from the purchase and sale of requisites or produce, or at least to provide efficient credit institutions which will compete with dealers in their *credit* operations.

2. In general, such agencies as were enumerated in the previous discussion are more suited to the provision of short term or intermediate credit than of long term credit, and a considerable volume of such credit is advanced in very many countries. Usually the amount advanced on each loan is less than the amount of long term credit. In general, the loan can be repaid out of the proceeds from the

<sup>1</sup> The landlord is an important source of credit in many share-farming districts of the United States, and under the *métayer* system in certain parts of Europe. See, for example, "Farm Credit in a Plantation and an Upland Cotton District in Arkansas," *Bulletin*, No. 228, College of Agriculture, University of Arkansas; and Morman, *Principles of Rural Credits*, pp. 225-229 (in reference to the *Latifundia* in Italy).

sale of crops or stock. The debtor is therefore less likely to be *permanently* tied to the dealer, though the danger is not entirely removed.

3. It must be admitted that local merchants, implement dealers, live stock and produce commission firms, auctioneers and the like possess certain advantages as sources of short term and intermediate credit over ordinary commercial banks. Since the nature of their business brings them in close touch with the problems of farming, they are, on the whole, more competent to assess the personal security of the farmer or the value of his crops and stock as security, while there is less necessity for them to keep their reserves liquid so that loans can be extended over a longer period. On the other hand they may hesitate to enquire too carefully into the position of their clients, since resentment against inquisitorial methods may lose them the farmer's business.<sup>1</sup> Further, their reserves are likely to be less than those of commercial banks, so that they are frequently unable to show leniency in bad times even if they should so desire it. This especially applies where businesses are small and cover a circumscribed area. Further, as in the case of long term credit discussed above, they are more likely to be tempted to grant loans on too easy security in order to capture the farmer's business. Such practices invite trouble for both debtors and creditors. The dangers involved, particularly when the type of farming is very risky, are well exemplified in the history of the live stock industry of the United States.

4. "The commission men in the eighties observed an opportunity to secure a large return on money loaned to cattle men, to control a certain portion of the business, and, by aiding the industry in general, to expand their own opportunities for profit. As a rule the commission firms themselves had very limited capital. Some loaned funds secured from Eastern capitalists. Others advanced the funds and then borrowed against the paper by endorsing it and discounting with the banks that were developing in the stock yard centres. . . .

5. "Competition was very keen among the commission men. . . . The financing of the industry by commission men was

<sup>1</sup> See Enfield, *Report on Agricultural Credit*, pp. 33-34.

doomed to failure. In the first place, the commission firms did not have enough capital to make their endorsement of any real value, a fact which led to carelessness, since there is a disposition to be less cautious when handling another man's money. Secondly, apparently no attention was given to the matter of feed. It was assumed that nature would be kind to the borrower. Thirdly, there was no systematic inspection and supervision. Loans were usually made without counting the cattle or so much as seeing them. "Boom Count," or the number of cattle which the owner was supposed to own, based on the original number in the herd, was accepted as the basis of the loan. Even when inspected originally there was little or no supervision during the life of the loan. Fourthly, no limits were placed on the expansion of the particular individual's operations. . . . A man with practically no money could, if he had a good name, obtain a loan for all or practically all of the purchase price of a herd of cattle. Even more startling was the fact that an operator practically without capital of his own would be financed for enormous sums. As the borrower then had nothing except the cattle and his willingness to work, it is clear that enormous losses were possible. Everything went well, however, so long as prices were good, feed plentiful, and winters mild.

6. "The hard winters of 1886 and 1887 caused losses that left many producers bankrupt. Commission companies, banks, and individual loaning on cattle also took severe punishment, many of them following the operators into insolvency. . . . Beginning with 1888 and running until 1892, good prices and favourable natural conditions caused the business of loaning money on cattle to boom. . . . Following a wave of speculation which swept over the cattle country in 1897, a temporary dislocation of the money markets in 1898 set the ball rolling. A large scale operator in Kansas, named Gillette, went 'broke,' leaving wrecked banks and commission companies in his wake. Then the end came swiftly. An accumulation of troubles from the droughts and hard winters, added to a generally careless administration of loans, toppled over the already tottering structure."<sup>1</sup>

7. To the farmer there may be some advantage in obtaining supplies on credit, or in obtaining cash advances without too much formality, and with small legal and procuration fees. This especially applies in the case of firms who are prepared to buy a standing crop in advance, and so take some of the risks of failure or price fluctuations. In the case of

<sup>1</sup> See Larmer, *Financing the Live Stock Industry*, pp. 46-49. See also pp. 226-7.

farm implements, also, there are decided advantages to the farmer, particularly if credit is advanced in the form of instalment sales or hire-purchase agreements, even though the cost of this method is often much higher than the farmer realizes.

8. Nevertheless, the imperfections of dealer's credit of various sorts, even for short or intermediate periods, cannot be ignored. Not only may there be direct exploitation through charging more for a loan than it is worth or than the farmer may reasonably bear, but also there is the ever-present danger, already stressed in the case of long term mortgage loans, that the farmer may be tied to the dealer in respect of the given crop. "If there is any one disposed to dispute the legitimacy of credit in its application to agriculture, let him look at . . . dealer's credit. You may say that farmers do not want credit, that it is too dear for them. Farmers themselves show that they *do* want it by practising it in the wrong way and in the dearest possible form. Reckon up what it costs in higher price, in inferior quality of goods, in dependence upon your dealer in your purchase, and you will find the cost totalling up to a considerable figure. . . . I do not know if the dependence, sometimes amounting almost to peonage, the sacrifice of freedom of action, may not be taken to rank as the heaviest item of the account." So writes Wolff, the well-known authority on rural credit; and the indictment can be substantiated from very many sources.<sup>1</sup> If the farmer were free to choose the time of sale, and were paid the market value of his crops at the time, to be tied to the dealer would be irritating enough but might be excused. Unfortunately, however, the time of sale is frequently chosen by the creditor dealer, with serious loss to the borrower. This complaint against dealer's credit is almost universal, but it will suffice to force the criticism home by one or two examples.

<sup>1</sup> *People's Banks*, p. 63-64. See also Larmer, "Financing the Live Stock Industry," p. 226; *U.S. Department of Agriculture, Year Book, 1924*, p. 230-231; *Report of the Committee on Agricultural Credit (U.K.) Cmd. 1810 (1923)*, pp. 23-26; and Enfield, *op. cit.*, pp. 31-34, for evidence showing how widespread is the phenomenon of the "tied farmer."



9. Frequently auctioneers in the United Kingdom buy<sup>1</sup> live stock on credit on condition that the cattle or sheep or their progeny are sold through them. "By this means the farmer is restricted in his market and consequently may be restricted in his profits. The auctioneer is stated to receive a slightly higher rate of interest on the capital sum involved than the current bank rate, in addition to the commission he receives on re-sales. In some districts, auctioneers also give credit to butchers who buy at their sales; by this means, not only is a constant entry at the cattle sales assured, but purchasers also. If the auctioneer is short of entries, a farmer who is in his hands may be called upon to send cattle to the market; but it is obvious that by doing so he may have to accept a lower price than if he had been free to choose his own time, and what he ultimately pays for credit may remain a matter of uncertainty." In consequence of this system, the auctioneers' hold on some districts has been described as "enormous."<sup>2</sup>

10. The same sort of conditions apply in the United Kingdom in the case of corn merchants and seedsmen. "This often results in a farmer having to buy in the dearest market and sell in the cheapest; he cannot choose his own time and must accept the merchant's price for the corn." The corn dealer "endeavours to buy when the market is congested and probably holds over, pending a rise, thus securing extra profit for himself."<sup>3</sup> Where the level of business morality is high, the experience and judgment of the dealer may, no doubt, prove advantageous to the farmer, but the danger of exploitation, particularly on a falling market, is ever-present and is very difficult to guard against.

<sup>1</sup> The following paragraphs refer to conditions before the passing of the Agricultural Credits Act of 1928.

<sup>2</sup> Enfield, *op. cit.*, pp. 31-32. Note the following also in respect of cattle dealers. "Farmers who are short of capital to purchase live stock procure them from the dealers at what is termed "halves," i.e. the dealer supplies stock, the farmer keeps it, feeds it, improves it, and brings it into a marketable condition, finds the rent, rates, taxes, labour, supervision, etc. The stock is sold, often purchased by the same dealer and at his own price, and the profit, if any, is divided between them, and that is all the farmer gets. This practice is very prevalent amongst dealers with store ewes."

<sup>3</sup> Enfield, *op. cit.*, p. 32.

11. Even in the case of credit on farm requisites and domestic supplies, where veiled robbery of this sort is not so likely to occur, and the farmer is less likely to be "tied," the cost of credit is frequently not appreciated as a cost, and the higher price which must be paid for booked orders works out at a very high rate of interest. In view of the risk and extra trouble the merchant or dealer is, no doubt, justified in charging a higher rate of interest than the bank rate, but the disparity is frequently out of all proportion to the additional risk and other expenses involved.

12. The high cost and extreme disadvantages which may sometimes accrue from this form of credit may be exemplified by the case of store credit in certain districts of the United States. Where fluctuations in crop yields are considerable and the risks great, so that the commercial banks are not active competitors for the farmer's short term or intermediate credit accommodation, the farmer is forced to rely to a considerable extent on the credit from the local store-keeper. Such loans are frequently high priced and advanced on onerous terms. Thus, in the Southern States the total charges on store credit have frequently been as much as 40 per cent. per annum. In Texas, bank credit costs from 10 per cent. to 40 per cent., while farmers pay as much as 60 per cent. per annum on store credit. In a number of counties the average charge for store credit has often been as much as from 30 per cent. to 60 per cent. above the average rates of interest charged by the banks. In North Carolina, the average annual rate of interest has often been equivalent to nearly 40 per cent.<sup>1</sup>

13. These charges are defended on the grounds that cotton is practically the only crop and farming is exceedingly risky. Even apart from the risk involved, which is no doubt heavy in some districts, the costs of marketing and management of such credit are likely to be high and add to the gross interest rate. The loan is not given in a lump sum, but from time to time as goods are purchased, and a considerable

<sup>1</sup> See Morman, *Farm Credits in the United States*, pp. 306-9. See also Morman, *Principles of Rural Credits*, pp. 256-8.

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amount of book-keeping is involved. While such explanations may partially justify the cost they do not justify the method, and the development of a system whereby risks were averaged over a period, where costs of credit marketing and management were less, and where credit could be mobilized in bad times would do much to improve the efficiency of the farmer and add to his security. Under ordinary store credit, or dealers' credit, it would appear that the farmer is paying in each year for the maximum possible risk in any year. Since his creditors have usually smaller reserves than the ordinary banks, the danger of foreclosure is greater and the security of farming conditions reduced. On the other hand, the "risks" are often such as will not be accepted by commercial banks and the need for alternative methods arises.

## CHAPTER II

# COMMERCIAL BANKS

### *A. Operations of Commercial Banks*

1. Commercial banks are amongst the most important sources of credit for agricultural production and marketing. In 1924 the amount of short term credit advanced to farmers by banks in the United States was round about \$3,000,000,000.<sup>1</sup> At the beginning of 1923 the five leading banks in England and Wales had some £20m. outstanding to farmers "for current trading."<sup>2</sup> In Australia and New Zealand, joint stock banks share with agency companies and merchants the bulk of the credit provision for production and marketing. It is apparent, therefore, that commercial banks perform a very useful service in meeting the short term and intermediate credit needs of agriculture.

2. (a) *Variety of Conditions.* As in the case of long-period loans the terms and conditions on which credit for production and marketing is advanced vary greatly. In many cases the rates of interest charged are higher than for long period credit, since the security offered tends to be less tangible and the cost of making short-dated loans is relatively higher.<sup>3</sup>

3. Loans may be advanced on the security of a mortgage against crops, live stock, machinery, or other chattels, or a personal promise to pay, with or without endorsement. Personal security tends to be more important than in the

<sup>1</sup> *U.S. Agricultural Year Book*, 1924, p. 220.

<sup>2</sup> *Barclays Bank Monthly Review*, June, 1928, p. 3.

<sup>3</sup> In some cases in the United States the real charges are increased by extracting commissions, insisting on the retention of minimum balances with the bank, and collecting interest in advance. See *U.S. Agricultural Year Book*, 1924, p. 221.

case of long term loans, though the extent to which loans are advanced without tangible security varies considerably. Thus, while the country banker in the United States "may take various types of collateral, such as mortgages on live stock and machinery, crop liens, warehouse receipts and the like, yet he counts largely on the honesty, integrity and ability of the farmer as his principal security. Approximately two-thirds of the short time bank loans to farmers are made on the basis of personal security."<sup>1</sup> In the United Kingdom, on the other hand, "the banks frequently lend on their personal knowledge of farmers without a definite charge upon their property, *but the extent to which this is done is limited*. The farmer who has title deeds, share certificates or a life insurance policy to deposit with his bank as collateral has no difficulty in securing substantial advances against these securities. The small farmer, however, whose main assets are his growing crops and other stock, *has difficulty in obtaining adequate bank accommodation*."<sup>2</sup> In New Zealand, advances are made against collateral security, farm mortgages, chattel mortgages, and to some extent against warehouse receipts, bills of sale, and life insurance policies.

4. (b) *Recapitulation of Advantages*. Commercial banks possess many advantages, more particularly in the provision of short term credit to agriculture. They are able to establish machinery for the efficient collection of a large volume of investable funds varying greatly in amount and duration, and by pooling them are able to make available a flow of resources to be used in production in such a manner as to offset the variations and differences in the amount and duration of individual deposits with them. They can advance loans in a variety of ways to suit the convenience of borrowers, in accordance, not with the requirements of individual lenders, but with the varying needs of borrowers, within the limits imposed by their *general* policy and the

<sup>1</sup> *Ibid.*, p. 223. The statement refers to conditions in 1924.

<sup>2</sup> Enfield, *Report on Agricultural Credit*, p. 30. It should be noted that this statement was made before the passing of the Agricultural Credits Act, 1928.

*general* state of their own financial position. They are able to establish contacts with main money markets, thus permitting a more sensitive adjustment of credit supply to credit needs at different times and places, while the contacts they are able to establish with each other, or with their own branches facilitates payments and the transfer of credit from place to place. Contingent on their main function of marketing credit, they have evolved methods which permit the use of substitutes for gold as a means of payment and a store of value. These are both cheaper and more convenient than gold itself, as a means of transferring the control of capital between individuals and transporting it from place to place. Such substitutes for gold can be expanded and contracted in volume more readily than gold, and permit of elasticity in the volume of currency and credit not possible without them.

5. By virtue of the methods which they adopt in the collection and dissemination of savings it becomes necessary for them to act as principals and not merely as agents. As has been shown, they are impelled therefore to take over the function of risk and uncertainty bearing, and exercise judgments as to the relative merits of different demands for credit. As expert *general* retailers of credit they exert an important influence in determining the manner in which the resources of society are distributed in production and so tend to increase the productivity of labour and capital. Risk to those who provide them with funds tends to be reduced, both because in general they become experts in the assessment of risk and security and because the methods they adopt lead to the pooling of risk, which causes it to be spread, and in part at least, cancelled out.

6. (c) *Need for Appropriate Credit Instruments.* The ability of commercial banks to cater for the short term and intermediate credit needs of agriculture depends in large measure on the existence of an appropriate credit instrument as security. The contrast between the United States and the United Kingdom (before the passing of the Agricultural Credits Act of 1928) serves to emphasize this factor. We

have mentioned above that the proportion of personal, unbacked credit appeared to be less in the United Kingdom than in the United States; and that while the great part of the remaining *secured* credit in the United States was backed by a lien or mortgage on live stock, crops and machinery, the English farmer, particularly the small farmer, had difficulty in obtaining loans against these assets, and must rely to a greater extent on collateral in the form of titles to property, securities or life insurance policies if he was fortunate enough to possess them. It should be noted too that while the gross value of short term credit advanced by banks in the United States to farmers represented about one-sixth of the aggregate value of stocks or crops, the corresponding proportion in the United Kingdom was about one-twentieth. While these figures are not strictly comparable, they do reveal a marked difference in the relative importance of commercial banks as a source of credit to farmers for production and marketing in the two countries.<sup>1</sup>

7. These circumstances may be explained partly by the fact that country banks in the United States specialize more in agricultural business than do the English joint stock banks and that they are more familiar with agricultural conditions; but there seems little room for doubt that an important, if not the most important cause, was the existence in the United States of the chattel mortgage, a type of credit instrument making agricultural wealth in the form of live stock, crops and machinery readily available as security for loans; and the absence of such an instrument in the United Kingdom.<sup>2</sup>

8. In describing this type of credit instrument, Enfield writes as follows:

“Although other methods are used, the chattel mortgage is the form of security which enables credit to be raised for ordinary trading purposes based upon the temporary agricultural wealth in the possession of the farmer. It is desirable therefore to refer briefly to the way in which this particular instrument is employed. It should be noted that the difficulty of basing credit upon farm

<sup>1</sup>, <sup>2</sup> See Enfield, *op. cit.*, p. 48.

produce is not a theoretical or legal one, but is a purely practical difficulty; any such system must fulfil the following conditions:—

- (a) It must provide against the mortgagor's disposing of the goods which are the subject of the mortgage, without the knowledge of the mortgagee.
- (b) It must provide against the mortgagor's raising money elsewhere on the same security.
- (c) It must enable the goods charged to be easily identified.
- (d) It must leave the mortgagor reasonable freedom to market the goods immediately the market is favourable.
- (e) In the case of default it must provide a reasonably simple method by which the mortgagee can realise the goods which are charged in the mortgage.

A chattel mortgage in the United States of America, is a conveyance of personal property to secure a debt. The chattel mortgage laws are not, however, uniform as between one State and another. In some States, the ownership of the property is transferred at the outset to the mortgagee, while in others the title remains with the mortgagor; in the latter case, however, the mortgagee may secure absolute title if it becomes necessary. The chattel mortgage is a specific charge upon the articles enumerated therein. It may contain a certain number of head of cattle, a certain number of sheep, certain specified farm implements. It may be based upon a growing crop, in which case the area to which the mortgage is to apply is given by the legal description of the land. Most States require that a chattel mortgage should be witnessed by one or two persons, and in some cases attested before a notary. The amount loaned on a chattel mortgage appears seldom to exceed 50 per cent. of the estimated market value of the goods mortgaged.

Most State statutes provide that in case the mortgagor disposes of property which has been mortgaged and appropriates the proceeds, he is liable to an action for conversion; they also prescribe imprisonment as a penalty in such cases, and in consequence few persons, it is stated, are tempted to evade the law. Moreover, a person purchasing property which is the subject of a chattel mortgage is naturally careful to see that the funds realized therefrom are received by the mortgagee, as otherwise the purchaser would take the property subject to the mortgage.

To avoid the possibility of a borrower borrowing from two different sources on the security of the same goods, the almost universal practice is that the legal instruments by which the specific goods are charged, should be registered and open to public inspection. In the United States, when a chattel mortgage is drawn up, it is usually placed on record either at the county court house or, in some States, with the town recorder who keeps



the original copy on a file. The fee for filing is usually 25 cents. The fact that the mortgage is registered is a notice to all of the lien created in the property.

The farmer can dispose of his mortgaged property, but he can only convey such interest in it as he has above the mortgage, and the purchaser is required to see that the terms of the mortgage are fulfilled. In cases when only part of the security is sold, the proceeds thereof must be paid to the mortgagee to reduce the principal of the loan. This offers the farmer an opportunity to secure partial liquidation of the loan.

In regard to identification of the property, the goods are described as specifically as possible when drawing up the mortgage so that they may be readily identified if any question arises. Thus, in the case of live stock, it is customary to give the age, colour, weight, special markings, and any other means of identification. Similar means are employed in the case of farm implements. As regards grain, identification is more difficult, but the average purchaser is stated to be usually very careful in protecting himself, by ascertaining whether there is a mortgage upon the property in question, and will not purchase unless he is satisfied that the claims of the mortgage are met."<sup>1</sup>

9. In the United Kingdom, on the other hand, the only means available (until 1928), of taking a charge upon agricultural crops, live stock or implements was by means of a Bill of Sale. This must be accompanied by an inventory of the chattels over which the Bill of Sale is held, and must be duly attested by one or more witnesses. It must be registered within seven days after its execution, and is subject to *ad valorem* stamp duty. The *Register* of Bills of Sale is open to public inspection, and there is no statutory restriction on the publication in the Press of particulars relating to Bills of Sale. Consequently trade protection papers make it a practice of searching the *Register* and publishing such particulars as they think necessary. Not only does this "dry up the fountain of credit from other sources," but also it carries with it an unnecessary amount of publicity, against which farmers in Great Britain, as well as in most Anglo-Saxon countries, have strong objections. The effects are therefore, first, to increase the difficulties involved in obtaining funds by means of uncovered credit of various sorts, which necessarily forms an important part

<sup>1</sup> *Op. cit.*, p. 43-45.

of the farmer's credit requirements, secondly, to raise a barrier to the provision of loans on the security of temporary agricultural wealth, since the only form of credit instrument available is one to which the farmer takes deep rooted objection because of the publicity entailed, and because the execution of a Bill of Sale is regarded as a last resort only to be used by those bordering on insolvency.<sup>1</sup>

10. It can be seen, therefore, that the existence of a properly devised credit instrument can do much to facilitate the efficient marketing of working capital to farmers by commercial banks. Where such an instrument exists, commercial banks are a very useful source of working capital for farming industries.

### *B. Weakness and Limitations of Commercial Banks*

11. There are, however, certain definite limitations imposed on their usefulness by the nature of their business and the peculiarities of agricultural organization and production.

12. (a) *Difficulties in the Assessment of Risk.* In the first place it must be remembered that, except where co-operative marketing associations exist, the credit relationship is one between the individual farmer and the bank manager. The farmer who can offer readily assessable collateral security in the form of titles to property, securities, or insurance policies, or who keeps books which show that his business is secure, will have little difficulty in obtaining credit on reasonable terms; but the security of this kind possessed by the majority of farmers, especially small farmers, will seldom be adequate to provide the basis for a sufficiency of credit. Further, a comparatively small proportion of farmers keep books, and they are seldom able to marshal and present their case for credit effectively. Hence considerable reliance must be placed on the individual judgment of the banker as to the risk involved. The proper appraisal of risks demands a considerable technical knowledge which

<sup>1</sup> See Enfield, *op. cit.*, p. 49, and *Barclay's Monthly Review*, June, 1928, pp. 2-4. The Agricultural Credits Act of 1928 seeks to remove their difficulties by the provision of a system of chattel mortgages.

few bankers are likely to possess. Hence the small farmer who does not keep books, and who has few assets other than his crops, stocks, and implements, especially if he is remote from a banking centre, is faced with an initial disadvantage which it is not easy to overcome. In commenting on the adequacy of commercial banks as a source of credit in the United Kingdom, the *Report* already quoted (Cmd. 1810), states:

“Credit from the bank is, of course, restricted to men having banking accounts. Admittedly, there are not many farmers without them in Great Britain to-day, but such as they are, they reveal a gap in the credit system. A far larger class is that of small farmers in thinly populated areas who, although they have banking accounts, live so far away from their banks, or for other reasons are so much beyond the ambit of the manager’s acquaintance that they are unable to pledge their personal integrity. We fully realize that the banks are in a unique position to assess the personal factor because of the knowledge they possess of the past and present fluctuations of individual accounts, but the transaction of farmer’s accounts are not an infallible criterion of their credit status. Farming is essentially an undertaking which cannot be easily appraised without considerable technical knowledge, and in these cases the banks have very little to go on beyond the general make up of the farmer as a business man. Some farmers are, of course, largely responsible for this themselves, as they make little or no effort to present what security they do possess in the most attractive form by keeping books worthy of the name and supporting their case by a proper balance sheet.”<sup>1</sup>

13. It is no doubt true that this is largely the farmer’s own fault, but the difficulty remains. Managers of small country banks, such as those operating in the United States, are probably as well qualified by experience to assess the personal capacity and integrity of applicants for loans, the value of the tangible security offered, and the nature of the risk involved as can be expected. Nevertheless, unless special machinery is devised, such advantages as they possess in this respect are offset by their isolation from financial centres. The adjustment of the demand for and supply of loans is very imperfect and wide variations in the cost of credit arise. Further, a purely local crisis may involve them in serious difficulties.

<sup>1</sup> Pp. 24-25.

14. Under a system of branch banking, the free movement of funds from district to district is encouraged, interest rates are equalized and a local crisis has much smaller elements of danger. On the other hand, managers are less likely to be permanently situated in a given district, and transfers and promotions occur. The bank manager is less familiar with his district and with the nature of the risks involved in agricultural loans, and will have to refer many demands for loans to the head office. His desires for promotion will tend towards a conservative policy in the granting of loans, and he is likely to rely less on personal security and more on tangible assets than would a small country banker. The avenues of investment in industry and commerce are likely to be proportionately more important, so that advances unsecured by tangible assets will be less favourably regarded. Under both systems, therefore, disadvantages will occur indicating the necessity for the devising of special machinery to overcome them. Under the American system of independent banks, the disadvantage consists largely in the localization of risks and the fact that the movement of funds from district to district is not sufficiently free. Under the system of branch banking, the disadvantage arises from the fact that the bank manager is less likely to be permanently situated in a given place, and is responsible for his actions to a distant head office which is likely to be unfamiliar with the particular problems of his district, and will tend to limit the extent to which he can exercise individual judgment in the placing of unsecured loans; and from the existence of profitable avenues of investment in more liquid loans to industry and commerce which tend to divert funds away from farm industries.

15. These points in reference to a system of branch banking are touched upon in the *Report on Agricultural Credit* (Cmd. 1810), in relation to the United Kingdom, though the writers of the *Report* are more or less non-committal in their attitude. They do, however, appear tacitly to admit the validity of the criticisms. They state:

“Suggestions have been made to the effect that the banks should be invited to attach agricultural experts to the country

branches in order to remove any impediment to an extension of credit business among farmers which may be due to lack of agricultural knowledge and supervising machinery on the part of the banks. The appointment of agricultural experts of sufficient standing to be of real value would raise numerous difficulties, and we do not regard the suggestion as practicable. In our view, the system of local directors is the best line of development, and one which could, with advantage, be adopted by all the banks, and more widely extended." (p. 22). The need for more adequate and permanent local contacts is also indirectly emphasized by the following statement in reference to Scottish Joint Stock Banks: "Taking everything into consideration, few complaints have reached the committee with regard to the attitude of the Scottish Banks. This may perhaps be explained by the fact that within Scotland there has been no concentration of banking such as has happened in England, and the National Banks, which are well diffused throughout the country, have remained as separate entities. As a result they are well acquainted with their clients. The local agents are, moreover, more or less stationary, which makes for stability in management." (p. 22). The Scottish banks have the advantage of local knowledge and at the same time are of larger size than the country banks in the United States. It is pointed out, however, that the old private banks in the United Kingdom, which were often small, "were always heavily involved in the fortunes of a restricted area and this was a source of weakness at times of local crisis. The Joint Stock Banks spread their risks over a wider area and a greater range of industries, and can better carry periods of depression." (p. 22).<sup>1</sup>

<sup>1</sup> Note also, in reference to Branch Banking, the following remarks in regard to conditions in Canada. (*Monthly Letter of Royal Bank of Canada*, April, 1928): "The matter of intermediate credit is one which concerns the banks immediately. In this respect the Canadian banks are in a very favourable position because their branch bank systems allow them a facility of money circulation to meet extraordinary demand, and also the possibility of small turnover at any one branch. The latter advantage being more and more recognized in commerce generally by the organization of the 'chain store'."

There have been many charges levelled against the banks. The main one, made by Mr. Tory, is to the effect that their charter will not permit them to lend on other than liquid security, and as the farmer's needs extend anywhere from three months to two years, with the preponderance of needs being about six to nine months' duration, the banks are therefore somewhat chary of lending, or else they have to call their loans in at an inconvenient time for the farmer.

To this the banks reply that they do, and are willing to, lend for harvest of crop, seed and live stock, etc., and that they do, and are willing to, renew the notes. Both statements are true under certain conditions. In periods of good prices or good harvest the notes are renewed; but since the local manager is responsible for the loan, he is very liable to call it in at the first sign of poor conditions, which of course does not help the farmer."

16. (b) *Shortness and Uncertainty of Loan Period.* There remains the difficulty, already stressed in reference to long term credit, that the period for which loans are advanced is frequently too short to enable the farmer to repay them from the proceeds of operations for which they are granted. As far as short term credit is concerned, i.e. credit for a period of six months or less, the commercial banks are well suited, with the reservations made above, since the period is not too long to endanger the liquidity of their assets. In consequence, the criticisms levelled against commercial banks relate more to so-called intermediate credit, required for periods of from six months to a few years, than to short term credit proper.<sup>1</sup>

17. It should be remembered, of course, that the period of turnover for many, if not most farm crops, is longer than six months. By virtue of their dependence on funds deposited with them for a short period, commercial banks usually prefer that the majority of their advances shall be for a period of less than six months so that they are not particularly well suited to the intermediate credit needs of farming. This statement must be modified where a large proportion of deposits are for a fairly long period or have a slow turnover. Thus, Benner comments as follows on country banks in the United States:

“The belief that a country bank cannot safely make the so-called intermediate credit loans is due to a misunderstanding of the nature of country bank deposits, and the way a bank protects its reserve position. If the deposits of a bank are not active, it is generally admitted that a slower type of loan may be safely made by the bank. Savings deposits may be safely tied up in long-time investments just because of this—they are very inactive. Now inasmuch as a large part of the demand deposits of a country bank are relatively inactive, they can be safely tied up in loans for longer periods of time than can the demand deposits of a large bank in New York city. In other words, this is saying that the nature of the depositors' demands and the character of the bank's clientele determine what the character of its loans and discounts must be. On the average the paper in

<sup>1</sup> Thus, the *Report of the Royal Commission on Rural Credits* (N.Z., 1926) offers little complaint against the Joint Stock Banks in respect of short term credit, but considers it desirable to set up special machinery for intermediate credit. See pp. 6-7 of the Report.

the rural bank liquidates as rapidly as country bank safety demands. Our country banks can safely hold a large portfolio of rather long term loans of a semi-investment nature for the reason that their deposits are inactive. Granting, however, that a country bank's deposits are relatively inactive, still a large part of its liabilities are demand liabilities and emergency cases may arise when an unusual withdrawal of deposits may occur."<sup>1</sup>

Mr. Benner goes on to show that the Federal Intermediate Credit Banks perform a useful service in meeting this contingency.

18. In most countries where deposits are more active than among American country banks, the necessity for distinguishing between "a bill of exchange and a mortgage" becomes more apparent. Intermediate credit savours more of a mortgage than a bill of exchange, and is unsuitable as a form of investment for any large proportion of funds. It is significant too, that the desirability of outside institutions to provide funds to meet this need is recognized by Mr. Benner even in the case of banks whose deposits are relatively inactive. Still greater is the necessity in the case of banks whose deposits are active, if they are to function effectively.

19. Despite the inactivity of deposits in American country banks, the usual period for which loans are advanced is six months or less, and must be considered too short:

"No complaint has been more frequently made against the short time credit advanced by banks to farmers than that the term of such credit is usually too short. During the year 1923 it is estimated that three-fourths of the short time bank loans to farmers were made for periods of six months or less. Thirty-seven per cent. of the banks reported that their loans averaged from three to six months, and 30 per cent. reported that their loans averaged from one to three months. The length of short time bank loans increases as one proceeds westward and south from the Atlantic seaboard. The percentage of loans over six months ranged in the West from 13 per cent. of all short time bank loans in Nevada, to 65 per cent. in North Dakota, and in the South from 5 per cent. in West Virginia, to 59 per cent. in Arkansas, and yet in only six States (North Dakota, South Carolina, Alabama, Mississippi, Arkansas, and Louisiana) did loans for terms over six months exceed those for six months and under.

<sup>1</sup> *The Federal Intermediate Credit System*, pp. 260-262.

The relatively short term for which banks make personal and collateral loans to farmers illustrates a weakness in the service rendered agriculture by commercial banks. Commercial banks do a deposit banking and must depend upon short term loans to function safely. They are, therefore, not as well suited to the needs of agriculture as to industry. The periods for which farmers need credit with which to produce and market their crops are usually much longer than in industry. In the past, farmers have depended largely upon obtaining renewals of their short time bank loans. In periods of good yields and good prices the practice of renewing loans has not worked a hardship to either banker or farmer. It is a policy which has its advantages to the banker, since it enables him to evaluate from time to time the security for his loans. On the other hand, the dependence upon the renewal of bank loans has not always operated in the interest of the farmer. The short time loan places the farmer at the mercy of the creditor, since payment can be demanded at maturity, even though the purpose for which the loan was made has not been accomplished.<sup>1</sup>

"The real reason for the country banker's reluctance to make loans for over six months," says Benner, "is not so much the fear of tying up his assets in non-liquid form as the fact that there tends to be more risk attached to the longer term loans. If a note comes due every few months, the banker has the opportunity of appraising the security back of it each time the borrower seeks its renewal."<sup>2</sup>

20. The criticism made in the *American Report*, quoted at some length above, may be regarded as applicable in greater or less degree to commercial banks in other countries, while even where they are tolerably satisfactory their position would be strengthened if funds could be rendered available to them for a longer term. In the United Kingdom loans normally tend to be for six months, though they are frequently allowed to run for considerably longer

<sup>1</sup> *U.S. Agricultural Year Book*, 1924, pp. 224-225. See also *Report of Joint Commission of Agricultural Enquiry (U.S.A.) Credit*, Part II, Ch. VIII.

<sup>2</sup> *Op. cit.*, pp. 265-6. This policy is defended on grounds that: "It is no doubt true that this practice puts the farmer at the mercy of the banker, but it must also be remembered that the banker is just as desirous of loaning out his funds, provided that the security is good, as the farmer is of borrowing them. The principal source of bank profits is interest on bank loans, and to the extent that a banker contracts his loans he reduces his income. We may be quite certain that no banker contracts loans for the purpose of reducing his income." (p. 266).



periods.<sup>1</sup> In Australia and New Zealand loans frequently run for a period of one year and may be extended for a longer period; but the common practice is for loans to be in the form of overdrafts at call.<sup>2</sup>

21. Although the practice of renewing loans when necessary appears to be common, it is undesirable that the farmer should be faced with the worry and uncertainty which this entails, and a system providing for loans for a sufficiently long time to cover normal crop periods is highly to be desired.

22. The method of obtaining credit by means of a fluctuating overdraft possesses some advantages, and the following remarks of the Committee on Agricultural Credit (United Kingdom, 1923), may be considered as broadly true of other countries also:

“The Banks realize that the liquidation of agricultural loans is a longer process, as a rule, than the repayment of purely commercial advances, but there is a constant ebb and flow of money from, and into the farmer’s account, which means good business, although the loan account may not be cleared rapidly. In the country districts, an overdraft, unspecified as regards purpose, is more common than definite loans for particular requirements. The overdraft is reduced or extended according to the daily or weekly alternations of receipts and expenditure of the farmer concerned. It is an essentially elastic arrangement, affording both secrecy and simplicity, and one pre-eminently suited to rural conditions. Moreover, it is the cheapest way of obtaining money; the normal rate of interest is 1 per cent. above bank rate, though it is understood that a minimum of 5 per cent. is almost invariably fixed; interest is only charged on the net amount outstanding from day to day and there are no legal or procuration charges such as are usually associated with the advances of money from other sources.”<sup>3</sup>

23. Where the period of loans advanced by this method is sufficiently long, it has much to commend it. The farmer is able to repay principal at will, and required to pay interest only on the actual amount outstanding. The arrangement

<sup>1</sup> See *Report of Committee on Agricultural Credit* (U.K.), pp. 20–21.

<sup>2</sup> See *Report on Rural Credits in Australia* (1928), Dominions Office, No. 1, p. 21.

<sup>3</sup> *Op. cit.*, p. 21.

is elastic and the loan is confidential. Where it is not sufficiently long (when supplemented by the farmer's own capital) to cover the turnover of the crop for which it is required, precisely the same objections occur as those already advanced in reference to specific loans advanced for a definite amount and period. The necessity for renewal arises, and although in normal times renewal may be customary, yet the uncertainty is objectionable from the farmer's viewpoint.

## CHAPTER III

# CO-OPERATIVE PERSONAL CREDIT

## Raiffeisen Agricultural Banks and Schulze-Delitzsch Popular Banks

### I. INTRODUCTORY

1. A co-operative society is a form of business organization whose membership is restricted to those who do business with it. Control is vested in the co-operators who derive benefits in proportion to the amount of business they transact with the society. A co-operative society may, or may not, have share capital, which may be subscribed either by members or by non-members; but control does not depend on the ownership of capital. It is the purpose of co-operative credit societies to organize borrowers or intending borrowers so that they may obtain credit on better terms than they could obtain it individually.

2. The most striking developments of short term co-operative credit for agriculture have been in Germany, and we shall be concerned mainly with describing these. The two types of bank which we shall discuss are the Raiffeisen agricultural banks and the Schulze-Delitzsch people's banks.<sup>1</sup> Both types have as their main business the provision of short term personal credit. Occasionally they may lend on mortgages for long periods, but the majority of loans are short or intermediate advanced against personal or chattel security. The activities of Raiffeisen banks are mainly agricultural. Those of Schulze-Delitzsch are both urban and rural, the former preponderating.

<sup>1</sup> The former system was founded about 1869 by Frederick William Raiffeisen, burgomaster of Weyerbusch, the latter about 1852 by Francis Frederick Schulze of Delitzsch.

## II. RAIFFEISEN AGRICULTURAL BANKS

A. *Fundamental Principles*

1. The three fundamental principals which Raiffeisen embodied in his system were: (a) unlimited liability of members, (b) a restricted area of operations, and (c) gratuitous management. In addition, he laid great emphasis on the "moral elevation" of the rural community, and the social activities of some societies have been considerable.<sup>1</sup> These principles have not always been rigidly adhered to in practice. The majority of members of Raiffeisen societies are occupying owners or peasant proprietors.

2. (a) *Unlimited Liability and Small Share Capital.* Raiffeisen laid great stress on the principle of unlimited, joint, and several liability of members, and this principle has been very largely adhered to in Germany. In 1913, 92 per cent. of the banks were based on unlimited liability, and 8 per cent. on limited liability. A small fraction were based on "unlimited liability to make supplementary payments."<sup>2</sup> The principle of unlimited liability is closely bound up with the general insistence that share capital of members be kept as low as possible. Raiffeisen desired to exclude share capital altogether, but some share capital was insisted upon by law. The law was virtually evaded by fixing the share capital at a very low figure. Thus, in 1910 the average share capital per member of the Raiffeisen system was only 19 marks.<sup>3</sup> Since the peasant proprietors who provide the membership of the societies usually operate on a small scale, insistence on a large share capital would impose an initial barrier to co-operative effort. In view of the low share capital, unlimited liability seemed to be the only means of

<sup>1</sup> See *An Outline of the European Co-operative Credit System* (International Institute of Agriculture), p. 9, and Cahill, *Agricultural Credit and Co-operation in Germany*, Cd. 6626 (1913), pp. 69-70.

<sup>2</sup> There still appears to be a very strong opinion in favour of unlimited liability. "It is an interesting fact that after the stabilization of the mark the system of unlimited liability prevailed in the new rural banks that were founded and that limited liability tends to give place to unlimited." Cf. F. J. Rohr, "Rural Banks in Germany," *International Review of Agricultural Economics*, July-September, 1924.

<sup>3</sup> One mark was equal to about £0.0489, so that the average share holding, was less than one pound sterling.

enabling such farmers to obtain the necessary finance, particularly in the early years of the movement when they were frequently "tied" to the village store-keeper or in bondage to the village money-lender.

3. (b) *Limited Area*. From the principles of low-share capital and unlimited liability, there emerges the necessity for a limitation of the area covered by the operations of any one society, and a simple form of organization capable of management by the co-operators themselves. Unlimited liability renders it imperative that credit shall not be granted except on sound security, and for purposes which are likely to prove economically profitable. It is essential, therefore, that members of a society shall be personally known to each other and shall have full knowledge of the ability and integrity of each borrower, and of the purpose on which a loan is expended. This is all the more important, in that members frequently have little security to offer other than their own personal promise, and the surety of others. When the area of operation is limited:

"The members are intimately acquainted with each other; they know the means and capacity of each other; they know that such a one is industrious and farms well, that another is intemperate or a bad farmer whose circumstances are gradually becoming worse. When loans are proposed, the management can thus gauge accurately, not only the capacity for credit of the intending borrowers, but also how far they are deserving of it. Capable and hard-working members with little capital may be in this way helped without risk. Loans are most usually made on bonds backed by sureties. The latter being naturally for the most part relatives or friends of the borrower living in the same commune, the society can readily judge their financial soundness. The supervision of the purpose to which the loan is put is also facilitated, while the general management of the society can be observed by the members. If business is extended over several communes, the cost of administration is increased, and the scrutiny of details is necessarily less effective. When business becomes so large that it is necessary to employ a trained official or officials giving their whole time to the work, the societies can no longer work cheaply, as salaries and other expenses must be earned either by increasing the interest on loans or decreasing that on deposits. If loans become dear, the principal reason for the existence of a rural bank is destroyed."<sup>1</sup>

<sup>1</sup> Cahill, *op. cit.*, p. 67.

Hence limitation of area is necessary, both to increase security and ensure that expenses of management are kept low. Since the organization of the rural banks is "so to speak, familiar and friendly,"<sup>1</sup> management is simple.

4. (c) *Gratuitous and Democratic control.* The general meeting of members appoints the committee of management, the council of supervision, and the secretary-treasurer. General business is conducted by the committee of management which frequently includes the village schoolmaster or priest. In general, service is given gratuitously on both committees, but the secretary-treasurer usually receives payment. The Board of Supervision, as its name implies, is responsible for the supervision and general control of the activities of the committees of management. It examines the yearly accounts and balance sheet of the society and proposals for the allocation of profits and losses, and presents these for the approval of the annual meeting of members. It also examines the security and standing of members who have received or who apply for loans.<sup>2</sup>

### B. Working Capital

5. The working capital of the banks consists of the share capital subscribed by members, reserve funds accumulated in previous years, savings deposits, deposits on current account, and loans from central co-operative banks, other banks or private individuals.<sup>3</sup> The greater part of the

<sup>1</sup> *Outline of European Co-operative Credit Systems*, p. 11.

<sup>2</sup> For a detailed account of the duties of the above, see Cahill, *op. cit.*, pp. 91-99.

<sup>3</sup> In 1910 the total working capital was as follows, showing that the great proportion of working capital is obtained from outside sources:—

	Marks (Millions)	Per cent. of working total capital
<i>Banks' own funds.</i>		
Share capital .. .. .	24	1.2
Reserve .. .. .	57	2.6
Total .. .. .	81	3.8
<i>Capital from Outside Sources.</i>		
Deposits on current account .. .. .	207	9.7
Savings deposits .. .. .	1,659	78.0
Other liabilities .. .. .	181	8.5
Total .. .. .	2,047	96.2
Total Working Capital .. .. .	2,128	100.0

working capital is provided by savings deposits and deposits on current account in very small individual amounts. Thrift is encouraged by three main systems: (a) school savings banks: (b) monthly house to house collections: (c) domestic saving in small locked boxes.<sup>1</sup> By these means a large and useful aggregate is accumulated out of a considerable number of small savings which are individually of little use.

### C. Loans

6. The credit advanced by Raiffeisen societies is available to members only. The normal period for which a loan is granted is one year, with a maximum of three or five years. Credit may be granted either as a fixed loan or as a loan on current account. The latter is the more popular and is becoming more widely adopted. It possesses the advantage that, within the limits of the amount granted, payments or withdrawals may be made according to the varying position of the borrower from time to time. While the usual purpose for which credit is advanced is to meet the working expenses of the farm, loans are sometimes advanced to erect buildings or purchase land or adjust the claims of co-heirs to a deceased estate. Such loans are from one to ten years at three months' notice.<sup>2</sup> Loans are usually advanced against a promissory note or personal bond endorsed by two or more sureties. Mortgages and collateral security in the form of bonds, insurance policies and the like are also used as security to some extent. The terms of repayment vary according to the object of the loan, the nature of the guarantee and the standing and solvency of the borrower. Usually repayment is by easy instalments and it is seldom that borrowers are obliged to repay the whole loan in a lump sum.

7. Rates of interest are naturally influenced by the rate required to attract adequate deposits and the rate at which funds are available from outside sources. Co-operative central banks are the chief additional sources of credit. Since expenses are kept low, a cheap supply of credit be-

<sup>1</sup> Cf. Rohr, *op. cit.*, p. 356.

<sup>2</sup> Rohr, *op. cit.*, p. 361.

comes available to borrowers. "The rural banks are in a position to provide this cheap credit, even in times of stringency, by reason of their large deposits, their non-speculative business, their competence for supervision, their low cost of management, the absence of aim at high dividends, their organization (provincial central banks, State or other large banks), and, of course, the good eventual security offered by borrowers who are for the most part land-owners."<sup>1</sup>

8. The object of the banks is to provide credit efficiently and cheaply and not to make a profit. Hence, it is not a common practice to distribute dividends. Instead, profits are carried to reserve or are used to further the various social activities so dear to the heart of Raiffeisen himself.

#### *D. Mixed Societies*

9. Not all the Raiffeisen societies are pure credit institutions. Frequently they combine with credit provision the co-operative supply of agricultural requisites and in some cases the co-operative sale of agricultural produce. The supply of groceries and general household requirements is not usually undertaken by the societies. In general, the societies make purchases on the written orders of members and do not incur the risks of price changes by carrying stocks.

10. Some important advantages arise from the combination of functions. The duplication of officers and management is avoided. By virtue of the combination of orders made possible, prices tend to be lowered, while good quality can be ensured. The credit required by farmers may be wholly or partly taken out in the form of requisites. The cost of such credit is less than that of ordinary store credit and the society is safeguarded against loss by virtue of the intimate knowledge possessed of the borrower. The small profits which the society obtains may be used to good account by being transferred to reserves, thus augmenting the funds available for future credit advances. The societies also do useful educative work by obtaining and disseminating

<sup>1</sup> Cahill, *op. cit.*, p. 77.



information on the use of suitable fertilizers, seeds, feed-stuffs and implements. "The habit of inquiring about the quality of goods is fostered and the necessity of quality is brought home to their minds. The widespread practice of requiring orders in advance, together with the insistence upon cash or short-time payments, exercises an influence in the direction of improving business habits among the rural population."<sup>1</sup>

### *E. Central Organizations*

11. The Raiffeisen system of agricultural banking is based upon the co-operative efforts of a large number of small farmers in a large number of small local societies. It was soon recognized that the system would be strengthened and uniform development encouraged by the establishment of a central organization or organizations. Hence three types of central institution have been set up: Federations, Central Banking Institutions, and Central Co-operative Supply Societies.

12. (a) *Federations*. The federations of co-operative societies are unions set up for propaganda, education, defence and inspection. With one or two exceptions, societies do not link up directly with the National Federation, but form provincial unions which join up with the central body. As regards the outer world, they deal with "all questions of legislation, administration and publicity," and as regards internal affairs, "all questions relating to organization, propaganda, audit, advisory powers and instruction."<sup>2</sup> They establish and guide the early activities of new co-operative societies, and do valuable educative work with established societies by the issue of technical publications dealing with book-keeping and management. They are also entrusted with the biennial audits required by law and, by the employment of a body of skilled auditors, are able to encourage the proper conduct of the financial affairs of the local societies and point the way to improved methods.

<sup>1</sup> Morman, *Principles of Rural Credits*, p. 18.

<sup>2</sup> Rohr, *op. cit.*, p. 67.

13. (b) *Central Banks.* Central banks are organized provincially or to cover the area of a single state. These are co-operative societies with limited liability. The majority of such banks are in direct relations with larger institutions, such as the Prussian Central Co-operative Loan Bank, the Prussian State Bank, or the Prussian Central Co-operative Bank. The working capital is provided by share capital, the deposits of members, who are usually co-operative societies, and loans from the larger central banks mentioned above, or other banks. The greater part of the working capital is obtained from deposits, and is utilized in making loans to co-operative societies on current account or for fixed periods.

14. The central banks perform a useful service in equalizing the supply of capital in different localities. Local societies deposit their surpluses with the central banks, from which societies short of funds may draw. When funds beyond those available from local societies as a whole are required, a means is rendered available of drawing on the general money market. By means of branches, central banks are in intimate touch with the requirements of different localities. So they assist materially in the efficient collection and diffusion of savings, give strength to the whole system by virtue of the pooling of surplus funds which they permit and provide a more elastic source of credit than would be available to each local bank operating independently.

15. (c) *The Central Co-operative Supply Associations.* Finally, there are central co-operative supply societies, independent of the Raiffeisen banks, but to which many societies combining credit provision and the supply of requisites are affiliated. Since a small local society purchases limited quantities of goods for its members, it is not usually feasible to enter into direct relations with manufacturers or wholesale merchants. Hence local societies derive advantages from membership in a central institution which combines the orders of hundreds of small societies and derives the economies consequent on bulk purchase, specialized knowledge and greater bargaining power. Such an institution can

safeguard quality by expert selection and testing and can utilize its superior knowledge of market fluctuations to buy "when the price is right."

### III. SCHULZE-DELITZSCH POPULAR BANKS

#### A. *Contrasts in Principle with the Raiffeisen Banks*

1. While Schulze-Delitzsch banks engage mainly in urban business, they are utilized to quite an appreciable extent by agriculturalists. Thus in 1912, 26.61 of the total membership consisted of "independent agriculturalists" and 2.42 per cent. of wage earning agriculturalists.<sup>1</sup> The remaining members consisted mainly of merchants, manufacturers, artisans and wage earners generally, professional men, civil servants and clerks. The average membership in 1911 was 639, so that they are much larger than Raiffeisen banks.

2. Schulze favoured unlimited liability and, although the principle has not been so rigidly adhered to as in the case of Raiffeisen banks, there are still a large number which embrace it. Thus in 1911, 563 out of a total of 952 associations, or 59.1 per cent., adhered to unlimited liability, and 385, or 40.5 per cent., to limited liability, while 4 societies had unlimited liability to make supplementary payments. Before the war, limited liability was increasing in relative importance; but the principle of unlimited liability was considered best in respect of new banks established in areas not familiar with co-operative credit.<sup>2</sup> Popular banks differ from banks of the Raiffeisen type in that share capital is insisted upon, which may be subscribed by members in monthly instalments. On such capital dividends are declared after they are fully paid-up. Share capital, unlimited liability, and reserves constitute the security which the popular banks have to offer against investments with them.

<sup>1</sup> *Outline of European Credit Systems*, p. 28.

<sup>2</sup> *Ibid.*, p. 29.

3. Popular banks differ from rural banks in that they do not follow the principle of unpaid management. The area covered by the operations of individual banks is also much larger than that of Raiffeisen banks. For this reason it is more important to rely on share capital and accumulated reserves as security and less on the unlimited liability of members than in the case of Raiffeisen banks, since the investigation and oversight of the purpose of loans and the character and ability of borrowers is not likely to be so thorough because personal knowledge is less.

### *B. Working Capital*

4. The working capital of popular banks is obtained from the share capital and reserve funds of the banks, deposits and loans. Deposits consist of (a) "savings deposits" in small amounts, which are usually subject to long notice of withdrawal; (b) "ordinary deposits," which are in larger amounts and are often subject to withdrawal at short notice. These "require to be handled with considerable caution, since a slight mistake in the rate of interest given, or in the investment of the money may involve serious losses, when large sums are in question. For this reason it is only the larger societies with highly trained officials which open (this kind of) deposit account";<sup>1</sup> (c) "drawing accounts," which are the equivalent of current deposits subject to cheques in ordinary commercial banks except that the cheque system is not always in operation. For the proper operation of such accounts, a cash reserve must be held and the rate of interest is low.

### *C. Borrowings and Loans*

5. Borrowings consist of: (a) special loans from individuals, companies or other credit associations for such purposes as the extension of premises; (b) loans from savings banks and similar public institutions; (c) loans from commercial banks and other sources, mainly by re-discounting

<sup>1</sup> Fay, *Co-operation at Home and Abroad*, p. 24.

members' paper.<sup>1</sup> Funds thus obtained are utilized in (a) investments, which are necessary as a reserve against the withdrawal of funds deposited with or loaned to banks; (b) loans to members. In 1911, 17.1 per cent. of transactions appeared as investments and 82.9 per cent. as loans to members. Loans to members take four main forms: (a) Loans for fixed period, representing a single definite advance of a given amount. (b) Loans on current account, the maximum amount of loan being fixed, the actual amount borrowed varying with the needs of the borrower as in the case of an overdraft with a commercial bank. (c) Discount of commercial bills representing actual dealings in goods. (d) Mortgages and other land credits, part of which will represent genuine mortgage business, part short term or intermediate loans advanced against the security of mortgages on real estate.<sup>2</sup>

<sup>1</sup> The working capital of Schulze-Delitzsch banks was obtained as follows in 1911:

	Marks (000 omitted)	Percentage of Working Capital
<i>Bank's own funds:</i>		
Share capital .. .. .	247,294	14.8
Reserve funds .. .. .	105,800	6.4
Total .. .. .	353,094	21.2
<i>Capital from outside sources:</i>		
Private deposits .. .. .	1,276,172	76.5
Debts contracted with banks or associations .. .. .	38,984	2.3
Total .. .. .	1,315,156	78.8
Total Working Capital .. .. .	1,668,250	100.0

To this should be added re-discounts 51,497,470 marks. (After *Outline of European Co-operative Credit Systems*, pp. 30, 31.)

<sup>2</sup> The distribution of loans and investments is given as follows for 1911:

	Marks (000 omitted)	Percentage
Loans for fixed periods .. .. .	469,660	28.0
Loans on current account .. .. .	544,065	32.4
Discount of commercial bills .. .. .	218,997	13.1
Mortgages and other land credits .. .. .	158,086	9.4
Investments .. .. .	286,051	17.1
Total .. .. .	1,676,860	100.0

(*Ibid.*, p. 32.)

Investments are represented by cash in hand, deposits with banks and associations, banker's acceptances, shares and bonds, and real estate, including the bank buildings.

6. It can be seen that the operations of popular banks correspond more closely to those of commercial banks than do the operations of Raiffeisen associations, since a large proportion of the business is represented by loans on current account and discounting of bills. This is a further illustration of the principle we have enunciated, that, from their nature, a bank's assets and liabilities tend mutually to govern each other.

7. The security against which loans are offered consists largely of the personal promise to pay, backed by sureties of relatives or friends. In addition, a loan may be secured against goods or other chattels, collateral in the form of shares or bonds, or by mortgages.

8. The usual period for which loans are advanced is for three months or six months, a much shorter period than in the case of Raiffeisen banks. Although the right of renewal is granted in some cases, it is apparent that the period is too short to meet many of the needs of agriculture, so that the usefulness of the popular banks to farming industries is correspondingly limited.

9. The majority of popular banks are affiliated to provincial federations, which in turn affiliate to the General Federations of German Co-operative Societies. By virtue of their urban location, greater size and more liquid business, they are more able to utilize the facilities of the money market than are Raiffeisen banks, and central banks are less necessary. The equalization of funds is, however, facilitated by a special section of the Dresden bank with which the societies keep current accounts, and by a special institution, the *Syndicate for Circulation*.<sup>1</sup>

#### IV. ESTIMATE OF CO-OPERATIVE PERSONAL CREDIT

##### A. Weaknesses and Dangers of Unorganized Personal Credit

1. It will be clear from the above summary account, that co-operative credit has achieved much in Germany

<sup>1</sup> *Ibid.*, p. 36.

and in other countries which have adopted similar methods.<sup>1</sup> Previously, the peasant proprietor was dependent for credit very largely on the village money-lender and the local dealer. Such credit was not only exceedingly costly, but also it tended to tie the farmer to his creditor in such a way that he was virtually in a state of economic peonage. The high cost of credit was due partly to the monopoly position of the money-lender or dealer, partly to the high degree of risk when the loan was backed only by the individual promise to pay, and a mortgage on crops or chattels. Agriculturalists were frequently unwilling to borrow until the need was urgent, and this strengthened the hands of the creditors to enforce onerous terms.

"Such unwillingness on the part of poor people," writes Wolff, "especially the poor peasantry, to come for loans to persons whom they do not know very familiarly, and by whom they do not know themselves to be understood, has been the outstanding crux of the Governments both of France and of Belgium in their endeavours to carry into effect their pet hobby of establishing a form of personal agricultural credit. . . . 'If in a village,' so complained the Belgian Minister, M. Graux . . . 'it becomes known that an inhabitant borrows, people at once begin to suspect that his financial position must be shaken. The trader on the other hand glories in his credit; the larger is his credit the higher stands his repute. The peasant will not borrow till his affairs decline, and then he puts off borrowing as long as he possibly can; he will rather pay a high rate of interest to some avaricious notary who may be trusted to keep his secret, than frankly apply for a loan where interest is low! . . . This description is true all the world over.'"<sup>2</sup>

The dependence thus arising on the private lender is even more pronounced where no alternative sources are readily accessible.

### *B. The Competitive Influence of Co-operative Credit*

2. The development of co-operative credit may be expected to weaken the monopoly position of the private

<sup>1</sup> It is not intended to discuss the systems of co-operative credit as they have developed with greater or less modification in other countries. For a description of co-operative personal credit in Italy, France, Hungary, Belgium, and other countries, see Fay, *Co-operation at Home and Abroad*, Wolff, *People's Banks*, and Herrick, *Rural Credits*.

<sup>2</sup> *People's Banks*, p. 20.

lender in two ways. In the first place it provides an alternative competitive source of credit which reduces dependence on the money-lender or dealer, and so "reduces his power to exploit." In the second place, it gradually familiarizes the farmer with the use of credit as a *normal* part of his business. He then becomes more willing to apply openly for such credit as he needs, and does not wait until his position becomes so bad as to force him to obtain it. The natural effect is thereby to reduce risk to the lender, and make other avenues of credit more readily available.

### C. *Strengthening of Security*

3. While the *competitive* influence is therefore likely to be of some importance, the true significance of a co-operative credit system lies deeper, and its direct advantages are even more marked. The supreme achievement of co-operative credit is to replace private and individual security with collective security. The old adage that "union is strength" is nowhere more true than in the field of co-operative credit when applied among small scale peasant proprietors. Whether or not limited or unlimited liability is adopted does not appear to be of primary importance. When, however, liability is limited it is relatively more important to have share capital and to accumulate reserves. Where liability is unlimited, these are of somewhat less importance; but the investigation and oversight of purposes for which loans are used becomes more necessary in the interests of members themselves, and the area which can be effectively covered by the operations of one society is reduced. In either case the chief basis of security rests in the strength which comes from union for a common purpose.

### D. *Facility in Obtaining Funds*

4. Having once achieved a proper basis of security by collective responsibility, and retained confidence by wise management, it becomes much easier to obtain the necessary funds. The dependence of co-operative banks on small deposits from members and others is a striking tribute to their success in gaining and sustaining the confidence of



small investors. Not only does it perform a useful service by combining small units of saving into a continuous aggregate available for investment, but also it directly encourages thrift by providing a safe repository for small surpluses which are invested instead of hoarded, and which incidentally earn interest.

5. The same factor of added security enables the use of negotiable instruments, such as promissory notes, bills or liens which can be re-discounted with other banks, thereby directing outside funds to agriculture. The establishment of central banks facilitates this process, gives added strength to the system and equalizes the flow of funds to different districts.

#### *E. Equalization of Credit Terms*

6. Further, a co-operative system equalizes the terms on which agriculture and industry or commerce obtain credit by eliminating differences in risk, other than those inherent in agriculture and industry or commerce respectively, and by providing the machinery for a more sensitive flow of credit resources. The dealer or money-lender must "recoup himself for heavy risks by heavy charges. Dealing with unorganized individuals, he is not concerned with lessening risk, but with heaping up compensation."<sup>1</sup> The co-operative society, concerned as it is with the interests of its members, attempts to lessen risk rather than to heap up compensation by a heavy insurance against it in the gross interest charged.

#### *F. Costs of Management*

7. The co-operative society can do less in eliminating the costs of credit marketing. In the popular banks, of the Schulze-Delitzsch type, the costs of management are apt to be heavy. In Raiffeisen societies the money costs are kept down by gratuitous services; but this merely means that the cost takes another form—that of personal service by the individual co-operators. There are, however, counter-balancing advantages to such personal costs. Co-operative

<sup>1</sup> Fay, *op. cit.*, p. 33.

banks are an educative force of great importance. They familiarize farmers with business methods, and thereby react on the efficiency of the commercial operations of the farmer. Further, those qualified to judge speak in terms of enthusiasm on the influence of co-operative societies towards the moral uplift of rural communities.<sup>1</sup> These achievements, though intangible, are not the least of those which must be attributed to co-operative credit as it has developed in Europe.

#### *G. Strengthening of Co-operative Spirit Generally*

8. Finally, co-operative credit societies have encouraged and strengthened co-operation in other directions. The spirit of co-operation, once set in motion, and its efficacy once being demonstrated, tends to grow and be extended in other directions. Societies set up for one purpose are able to perform related functions for their members. While there are advantages in specialization when the scale of operation is sufficiently large, much is to be gained by a combination of functions in small communities, particularly in the reduction of overhead expenses. Then, too, co-operative banks provide a source of credit for co-operative supply or marketing and thereby reduce their dependence on other sources.

#### *H. Non-success in Anglo-Saxon Countries*

9. In view of these potentialities, which appear to have been abundantly realized in many countries on the continent of Europe, the enthusiasm which is so often displayed over the achievements of co-operative credit systems is easily understood.

10. In countries of Western civilization outside Europe, however, particularly in Anglo-Saxon countries, co-operative credit has been less successful, and despite some recent experiments, may be regarded as exceptional. This is due largely to the very different conditions from those operating in Europe. Co-operative credit is more likely to succeed

<sup>1</sup> See Wolff, *op. cit.*, pp. 9-10.

the more urgent is the realized need. Although credit machinery has been by no means satisfactory in such countries as Great Britain, the United States, Australia, or New Zealand, yet numerous credit agencies have existed in competition with each other. Hence the urgency of the need has been less. It should be noted also that co-operative societies on the German model would have to compete for deposits, which are their main source of funds, with established institutions, and would find some difficulty in doing so. Further, where co-operation has developed in such countries, it has been mainly in processing and marketing. In some cases, as for example, among dairy farmers in New Zealand and growers of citrus and other fruits in the United States, such co-operation has been conspicuously successful. Co-operative concerns engaged in processing and/or marketing, have usually found little difficulty in obtaining the necessary credit from other sources and the burden of carrying crops during marketing has been wholly or partially lifted from the farmer.<sup>1</sup> It is significant, however, that the severe post-war depression has encouraged the institution of co-operative credit schemes in several countries, as for example, in Canada and New Zealand. These are not, however, on the German model.

11. There is, however, a further point of contrast of equal importance. Commenting on the success of co-operative credit in Germany, a recent *Report on Rural Credits in Australia*, states:

“Nevertheless, apart from absence of competing credit organizations, its success resulted very largely from the fact that it was well adapted to meet the needs of the European agricultural systems. Not only was there a readiness on the part of farmers in these countries to adopt the principle of mutual guarantees, but the organization of co-operative credit was well suited to the system of intensive farming by a large number of relatively small holders who were accustomed to meet one another in the everyday life of village communities, and thus to

<sup>1</sup> This is not universally true, however. Among about 1000 co-operative societies which failed in the U.S.A. during the ten years prior to the passing of the Intermediate Credit Act of 1923, 282 gave “insufficient capital” as one of the reasons. Cf. *Co-operative Marketing Report of U.S. Senate*, p. 302.

become acquainted with one another and with the general conditions of farming in their districts. In other words, the system fitted in with the manner of life and customs of the rural community, which included other forms of co-operative enterprise, such as the collective purchase of farm requisites, and the collective production of dairy produce and other farm products."<sup>1</sup>

The tradition of mutual help, common amongst European village communities, is less strongly marked in Anglo-Saxon countries, even in the United Kingdom. Farms are, in general, larger, and this fact alone, by increasing the distance between neighbours, renders mutual knowledge and trust less strong and mutual aid less easy to accomplish, while at the same time, the large size of the farming unit renders such aid less necessary, except occasionally at special times such as harvest. The whole tradition and environment is such that the investigation and oversight which mutual guarantee imposes would be resented as inquisitorial. In younger countries these difficulties are, in general, strengthened by the fact that the farming population is more mobile and less stable, so that a tradition of mutual aid has less chance to develop. Success in other branches of co-operation also involves a measure of stability in population, but this does not disprove our main point, since such mutual guarantee as is necessary is rather in the nature of an agreement to deal through the society, and does not involve inspection and oversight of a kind which would be regarded as inquisitorial.

For these reasons, co-operative credit has been less successful in such countries and, when applied, has usually taken different forms.<sup>2</sup>

<sup>1</sup> *Report of the Committee on Rural Credits in Australia*, Dominions Office, No. 1, 1928.

<sup>2</sup> See, for example, the account of recent developments in the provision of rural intermediate credit in New Zealand, Part IV, Ch. V.

## CHAPTER IV

# RECENT DEVELOPMENTS IN THE PROVISION OF INTERMEDIATE CREDIT IN THE UNITED STATES<sup>1</sup>

### I. CREDIT CONDITIONS PRIOR TO THE FEDERAL RESERVE ACT, 1913

1. Prior to the establishment of the Federal Reserve System and the Intermediate Credit System, the provision of intermediate credit in the United States was regarded as unsatisfactory and came in for much criticism by farming interests. The chief grounds for criticism have already been touched upon: (a) Interest rates were too high and varied considerably from district to district: (b) Loans were for too short a period: (c) Currency for crop moving was inelastic and led to credit stringency.

2. The chief agencies providing intermediate credit were local banks, merchants, commission men, and implement dealers. Cattle loan companies existed to finance the live stock industry. The necessity for these arose because of the large size of loans and the long period for which they were required, and the absence of other credit agencies in sparsely settled cattle regions. Grounds for criticism existed, not so much because of the absence of credit middlemen—for there were about 27,000 independent banks in the United States as well as a large number of other agencies—as because of imperfections in the credit machinery. The root causes of difficulty were the loose integration of financial concerns which prevented the easy and rapid movement of funds, the inelasticity of reserve conditions and the scattered location of reserves.

<sup>1</sup> This chapter was written early in 1929.

3. Up to 1914 the United States banking system was the most important example of a de-centralized banking system in the world. Before 1863, banking regulations were left to each State. In 1863 National Banks were permitted to be established. These were not Government institutions, but were under Federal Law, while State Banks were subject to the laws of the different States. With few exceptions, branch banking is forbidden by law, while almost any responsible group of people with a small specified minimum of capital may establish a bank. Hence there was the growth of a large number of independent concerns, many of them of very small size. In the absence of a central bank integrating the scattered independent units, the lack of uniformity in interest rates and the recurrence of local crises are readily understandable; for there was no effective machinery enabling small banks to resort to the main financial centres for funds in the event of temporary difficulties.

4. Till 1913, National Banks were the only banks of issue. In theory State Banks could issue notes, but a tax of 10 per cent. was imposed on these. The tax on the note issue of National Banks was only 1 per cent. Hence the issue of notes was in the hands of National Banks. These were issued against Federal Government bonds deposited with the Federal Treasury, the bonds remaining the property of the National Banks. Notes were issued to the par value of the bonds or the market value, whichever was the lesser, and were convertible into gold. They were backed by 5 per cent. cash deposited with the Treasury. This note issue was inelastic and could not vary with sufficient sensitiveness to meet the demands for currency.<sup>1</sup> The remaining notes in circulation consisted of United States Notes (Greenbacks), Gold Certificates, and Silver Certificates, which were also too inelastic.<sup>2</sup> In consequence, the supply of currency could not be expanded readily to meet the seasonal demand to produce and market crops, and was a source of embarrassment to bankers.

<sup>1</sup> See Fairchild, Furness and Buck, *Elementary Economics*, pp. 458-9.

<sup>2</sup> See Burgess, *The Reserve Banks and the Money Market*, Ch. IV.

5. The nature of the reserve conditions involved similar inelasticity. National Banks were divided into three groups: (a) Banks in the three central Reserve Cities—New York, Chicago and St. Louis. Of these, New York was the most important and was regarded as the central reserve city. (b) Banks in "Reserve Cities," of which there were 47 in 1913. (c) "Country banks," which covered the remainder. The first and second groups had reserves of gold and legal tender notes to 25 per cent. of the value of deposits. The third group had 15 per cent. of reserves which could be kept in banks of the first and second groups, while those in the second group could keep their reserves as deposits in the three centres. While there was a great concentration of cash and responsibility in the three main centres, reserves were scattered in the vaults of a large number of different banks.

6. At the same time there was, and still is, a considerable concentration of surplus funds in New York. The New York money market is the marginal market of the country. Towards it idle money gravitates to find employment pending the time when it is needed. Such funds are kept on deposit with New York banks, invested in short term securities, or lent on the stock exchange for short periods. Such types of liquid investment form the "secondary reserves" of banks all over the country. Before the war, the reserves of New York banks were the important "first line of defence." Credit became strained when they reached the minimum legal limit. There was no machinery permitting elasticity other than the maintenance of surplus reserves above the legal minimum.<sup>1</sup>

7. If an "out-of-town" bank advanced credit to the limit imposed by its reserve ratio, it might further extend its operations by selling securities in New York, or reducing its short period investments. Either plan meant the withdrawal of funds from New York and the depletion of reserves of the New York banks, with consequent credit stringency. Such a situation was especially likely to arise during the

<sup>1</sup> For a useful discussion of the New York Money Market, see Burgees, *op. cit.*, Ch. VII.

autumn demand for funds to move crops. The extent to which banks could advance funds to farmers and marketing agencies was limited by their reserves, and the extent to which they possessed the above means to obtain funds from New York, and a few other centres. In their endeavour to meet the demand for credit to move crops, banks frequently fortified themselves in advance by calling in loans. Hence at the very time when the farmer needed credit most, the lack of resiliency of the credit machine resulted in high rates of interest, while the inelasticity of note issue made it difficult to obtain sufficient currency. At the same time the demand for credit for agriculture reacted prejudicially on the credit position of industry and commerce. The same sort of conditions were also in large measure responsible for the complaint that the period of loans was too short. In good times banks were usually willing to renew loans on maturity, so that the short period for which loans were granted did not occasion undue embarrassment. In times of stringency, however, farmers frequently had great difficulty in renewing loans.

## II. EFFECTS OF THE FEDERAL RESERVE SYSTEM

1. The establishment of the Federal Reserve system led to a marked improvement and a means was devised of integrating the large number of independent banking units. Twelve Federal Reserve Banks, each with its own directors, were established, and a central board, the Federal Reserve Board, was set up in Washington.<sup>1</sup> All National Banks must, and State Banks may, become member banks of the system. The responsibility for general credit control has been transferred from a number of banks in central reserve cities to one unified authority, and machinery has been created making towards greater elasticity and stability of credit conditions.

2. The first important effect is the concentration and elasticity of reserves. The manner in which reserves have been concentrated and the economy in the use of reserves

<sup>1</sup> For a full account of the system, see Burgess, *op. cit.* and Willis and Steiner, *Federal Reserve Banking Practices*.



which has thereby been made possible is revealed by the following table:

PERCENTAGE OF RESERVES REQUIRED ON DEMAND DEPOSITS  
IN NATIONAL BANKS

	Central Reserve City Banks	Reserve City Banks	Country Banks
<i>National Bank Amendment Act</i>			
<i>of 1887:</i>			
Cash in Vault (minimum)	25	12.5	6
With Approved Agents ..	0	12.5	9
	—	—	—
	25	25	15
	—	—	—
<i>Federal Reserve Amendment</i>			
<i>Act, 1914:</i>			
Cash in Vault (minimum)	6	5	4
With Federal Reserve Banks			
(minimum) .. ..	7	6	5
In Vault or with Federal			
Reserve Banks .. ..	5	4	3
	—	—	—
	18	15	12
	—	—	—
<i>Amendment of 1917:</i>			
All in Federal Reserve Banks	13	10	7
	—	—	—

(After Burgess, *op. cit.*, p. 31.)

3. The amount of cash in vault is now left solely to the discretion of the member banks. The aggregate of *working reserves*, which comprises cash in vault, balances due from other banks, and balances due from the Federal Reserve Banks has been reduced from 34 per cent. of total time and demand deposits in 1913 to 20.5 per cent. in 1926. In 1913 cash in vault alone was 13½ per cent. of deposits. In 1926, cash in vault and reserves with Federal Reserve Banks was 9.4 per cent. of deposits.<sup>1</sup> In consequence of these conditions, a much greater volume of credit can be advanced on a given volume of reserves.

4. The concentration of reserves also gives additional strength in time of crisis. "Under the old scheme of bank

<sup>1</sup> Cf. Burgess, *op. cit.*, p. 33.

reserves, each bank set aside its own funds against emergencies. The result was that no single bank was able to set aside a sufficient sum to meet its needs in case of a real emergency; but under the Federal Reserve System the reserves of the co-operating banks are pooled and the emergency of any single member can be met, provided the member has not impaired his borrowing power by dishonest or imprudent banking methods. The strength of the combined reserves is so great that they can be drawn upon heavily at times of general need without fear of exhaustion. And there is the additional important consideration that when the reserves are pooled with the Reserve Banks, they can be used without being paid out, as they form the basis for issues of Federal Reserve notes or further extensions of credit."<sup>1</sup>

5. Elasticity is further facilitated by the relationship which was established between the Federal Reserve Banks and member banks. Reserves of member banks are not necessarily cash, but "deposits" with the Federal Reserve Banks. A member bank which borrows from the Reserve Banks receives a credit deposit which counts as part of its reserves. Borrowing takes the form of the deposit of commercial or agricultural paper with a maturity of up to ninety days or nine months respectively. This paper, which is endorsed by the member banks, is "re-discounted" by the Federal Reserve Bank. Alternately, a member bank may give its own promissory note, payable in fifteen days, and secured by commercial paper, Government bonds, notes, or certificates. Federal Reserve Banks are required to keep 35 per cent. of reserves in gold against their deposits.

6. At the same time, a new kind of currency, the Federal Reserve note, has been created, backed by a security which is both sound and elastic. Notes may be issued to any amount against other classes of notes, drafts, bills of exchange, banker's acceptances, or gold certificates. Thus, notes expand or contract readily as the volume of commercial paper re-discounted by Federal Reserve Banks increases or decreases. A large part of this commercial paper

<sup>1</sup> Cf. Burgess, p. 27.

represents agricultural or other goods in process of production or marketing.

7. The above conditions become relevant to the problem of agricultural finance by the provision that approved agricultural paper may be re-discounted with Federal Reserve Banks for a period not exceeding nine months. Agricultural paper is defined by the Federal Reserve Board as follows: (Regulation A, Series of 1923, 1924).

"A negotiable note, draft, or bill of exchange, issued or drawn, or the proceeds of which have been, or are to be used, for agricultural purposes, including the production of agricultural products, the marketing of agricultural products by the growers thereof, or the carrying of agricultural products by the growers thereof, pending orderly marketing, and the breeding, raising, fattening or marketing of live stock, which have a maturity at time of discount of not more than nine months, exclusive of days of grace."<sup>1</sup>

The Federal Reserve Board has liberally interpreted the above clause.

8. Credit advanced against agricultural paper with a duration of nine months is very largely "production credit." Of equal importance is credit to market crops, and hold them in storage. The Federal Reserve Board has favoured the "orderly marketing" of agricultural products. This is not easy to distinguish in practice from the speculative holding of crops and the Board has not so far given a ruling on the distinction. Hence the decision rests with member banks in respect of each transaction, since the distinction is a matter for individual judgment rather than formal rules.<sup>2</sup> Recognizing the importance of orderly marketing to prevent a glut and a slump in prices, the law discriminates in favour of banker's acceptances drawn to finance agricultural marketing operations. These acceptances are eligible for re-discount with maturities up to six months instead of ninety days, which is the limit fixed for ordinary commercial paper, provided they are secured by warehouse receipts

<sup>1</sup> Quoted Willis & Steiner, *op. cit.*, p. 349.

<sup>2</sup> Cf. Benner, *United States Agricultural Year Book, 1924*, pp. 39-40.

conveying a title to readily marketable staples.<sup>1</sup> This provision has been of great value to farmers and co-operative marketing associations in facilitating the proper movement of crops, since the sale of crops immediately after marketing need no longer be forced by credit exigencies. The following extract serves to stress the significance of the privilege<sup>2</sup>:

"Taking as a basic principle that the carrying of a crop pending its orderly marketing, was an agricultural operation, the Board decided that money borrowed by a grower of farm products to enable him to meet his obligations without immediately selling his crop after harvest was an agricultural loan. Consequently, if a member of a co-operative association delivered his product to the association and then drew a draft against the association, this draft would be classified as agricultural paper. The farmer could discount this draft at his local bank; and if the local bank was a member of the Federal Reserve System, it could re-discount it with its Reserve Bank. In this manner the resources of the Federal Reserve Banks can be drawn upon to aid in the financing of the co-operative marketing movement.

"These drafts were also classified as bills of exchange drawn against actual existing values. This classification is very important, because it excludes this class of paper from the 10 per cent. limitations on the aggregate amount of paper of any one borrower which a Federal Reserve Bank may discount for any one member bank. Inasmuch as these drafts are frequently for large amounts and as the local banks with which the members of the co-operatives do their business usually have a small capitalization, the local banks would be unable to discount many of these drafts if they were held to the 10 per cent. ruling. By giving this paper this special classification, a local member bank is permitted to re-discount as much as 25 per cent. of its capital stock and surplus for any one borrower. This enables the local institution to render a much more efficient credit service to the co-operative movement.

". . . It is difficult to over-emphasize the importance of an adequate discount market for acceptances to the proper financing of the co-operative marketing movement. Located in the interior of the country, as many of these associations are, where local bank resources are not sufficient to their needs, it is imperative that a way be opened whereby they can reach the funds in the larger money markets of the country.

<sup>1</sup> Cf. Benner, *op. cit.*, p. 37 *et seq.* and Burgess, *op. cit.*, Ch. VIII.

<sup>2</sup> Benner, *op. cit.*, p. 41, *et seq.*

"It was the lack of a ready access by borrowers in the interior to our central money markets that was one of the most outstanding defects of our banking system previous to the passage of the Federal Reserve Act. So far as the co-operative marketing associations are concerned, the Federal Reserve System has remedied this by making possible a discount market in which banker's acceptances can be freely negotiated. This credit instrument affords the means by which these marketing associations, although located many miles distant, can easily reach the New York money market. Thus, where local banking resources are inadequate to meet the credit demands of a co-operative association, a way is now afforded whereby the credit association can make arrangements for credit extension with the large banks located in the cities whose standing is such that an investing public will seek to purchase drafts accepted by them in whatever volume offered.

"The resources of the Federal Reserve Banks were placed more directly at the disposal of the co-operative marketing associations when the Board, on 19th December, 1922, issued a ruling permitting the Reserve Banks to purchase, in the open market, banker's acceptances drawn by co-operative marketing associations with or without the endorsement of member banks. These acceptances could have maturities up to six months. They had to be secured by warehouse receipts or similar documents conveying title to readily marketable staple agricultural products. . . . This new ruling placed the open market operations of the Reserve Banks at the disposal of the co-operative associations. In a very real sense it placed at their command the banking resources of the country."

9. The growth in the practice of financing the marketing of agricultural crops by means of banker's acceptances has been very rapid, and the volume of funds thus rendered available is very considerable. Thus, during the two months, March and April, 1925, Federal Reserve Banks purchased \$247,000,000 of acceptances in open market, of which amount one-half was drawn to finance the movement of crops.<sup>1</sup> Of the total of \$1,694,000,000 bills bought in 1926 (exclusive of re-purchase agreements), over \$1,000,000,000 was covered by cotton, sugar, coffee, grains, tobacco, wool, hides and skins, lard and meat, and fruit.<sup>2</sup>

10. In addition, the handling of agricultural produce by middlemen is facilitated by provision for the re-discounting

<sup>1</sup> *Banner, op. cit.*, p. 47.

<sup>2</sup> *Cf. Burgess, op. cit.*, p. 133.

of commercial paper having a maturity of not greater than ninety days.

11. While the wisdom of permitting the re-discounting of agricultural paper for a long period has sometimes been called in question on the grounds that it is not sufficiently liquid,<sup>1</sup> there is little room for doubt of its advantages to agricultural interests. In view of the length of time for which agricultural credit is required to cover the productive or marketing period, the attractiveness of a nine-months or six-months re-discounting privilege is obviously greater than one for ninety days only.

12. One further change may be mentioned briefly in conclusion. Prior to the passing of the Federal Reserve Act, National Banks were forbidden to make loans to farmers on real estate mortgage security. Since such security was often the only satisfactory form available, the service which National Banks could render to agriculture by the provision of intermediate credit was limited, and in consequence of the limitation they were unfavourably situated in their competition with State Banks. National Banks outside central reserve cities may now advance credit for a period not exceeding five years and for an amount not exceeding 50 per cent. of the actual value of the property offered as security. The aggregate of such loans is not to exceed 25 per cent. of the capital and surplus of the bank concerned, nor one-third of its time deposits.<sup>2</sup> This provision extends the sources of credit available, increases the eligible security farmers have to offer and the safety of agricultural operations by National Banks, particularly in the case of large loans which may have to be renewed. The danger of undue lack of fluidity of assets is safeguarded by the maximum limits placed on such loans.

13. We may now summarize briefly the improvements brought about under the Federal Reserve system in providing intermediate credit to agriculture.

<sup>1</sup> See Gregory, *The Present Position of Banking in America*, p. 24.

<sup>2</sup> Cf. Benner, *op. cit.*, pp. 25-6, and Reed, *The Development of Federal Reserve Policy*, p. 135.

- (a) The provision that agricultural paper of a maturity of nine months may be eligible for re-discount with Federal Reserve Banks opens up to the farmer the resources of the money market to a much greater extent than formerly. By the process of re-discounting, the country banker is able to obtain funds readily. A temporary shortage of funds locally available does not lead to a curtailment of loans to the same extent as previously. There is less likelihood of wide district variations in interest rates and less difficulty in obtaining the renewal of loans. The supply of "production" credit is materially increased.
- (b) The eligibility for discount with Federal Reserve Banks of banker's acceptances drawn against agricultural commodities for a period not exceeding six months greatly assists the marketing and storage of agricultural produce and facilitates orderly marketing.
- (c) The extension to National Banks of the privilege of advancing intermediate credit on the security of farm mortgage opens up a new source of intermediate credit to farmers who have no other tangible security.
- (d) Agricultural paper re-discounted or deposited with Federal Reserve Banks is regarded as "deposit credit," which counts as part of the reserves of the member bank. Hence credit can be expanded within the limits prescribed by the requirement that deposits in Federal Reserve Banks shall be backed by 35 per cent. gold. Similarly, agricultural paper is accepted as security for Federal Reserve notes, so that note issue may also be increased readily within the limits imposed by the reserve condition of 40 per cent. gold. These conditions, together with the concentration of cash reserves in the Federal Reserve Banks, permit of the expansion of credit and currency at times when the demand for credit by agriculturalists or middlemen handling agricultural products is heavy. The seasonal strain on credit and currency which tended

to recur periodically before the establishment of the Federal Reserve System has been much relieved, with consequent benefit to farmers.

### III. THE AGRICULTURAL CREDITS ACT OF 1923: THE FEDERAL INTERMEDIATE CREDIT SYSTEM

1. There is no doubt that the credit position of agriculture was very much improved by the operations of the Federal Reserve system. "So substantial was the progress being made in improving the farmer's banking facilities," writes Benner,<sup>1</sup> "that it is quite likely, had there been no serious disturbance in general business conditions, the farmer would have been content to let this progress work itself out."

2. However, the severe depression in agriculture which followed the post-war boom after 1920, raised a demand that the Federal Reserve Act be amended. There is no need to enlarge upon the situation which arose. It is sufficient to stress that the widespread distress which affected agriculture was due primarily not so much to insufficient credit as to the world-wide fall in agricultural prices. This decline, however, resulted in credit stringency and severely tested the credit machine, not merely in America, but throughout the whole world. The natural reaction of farmers to the new position was a demand for additional credit facilities. The position in the United States was so serious that the War Finance Corporation was utilized to give emergency credit relief. This body was not adapted to serve the permanent requirements of agriculture, and permanent machinery was set up by the Agricultural Credits Act of 1923.<sup>2</sup>

3. The Agricultural Credits Act of 1923 provides for the establishment of two classes of intermediate credit institutions: *Federal Intermediate Credit Banks* and *National Agricultural Credit Corporations*. Federal Intermediate Credit Banks constitute a Government system, owned, operated, and controlled by the Federal Government. National

<sup>1</sup> *Op. cit.*, p. 50.

<sup>2</sup> For an account of the War Finance Corporation and its work, see Benner, *op. cit.*, Ch. IV, and Willis & Steiner, *op. cit.*, pp. 409-415.



Agricultural Credit Corporations are owned, operated, and controlled by private enterprise. They receive no aid from the Government but are under the general supervision of the Comptroller of the Currency.

#### A. Federal Intermediate Credit Banks

4. The Act of 1923 provided for twelve Federal Intermediate Credit Banks to be established in the same cities as the Federal Land Banks. It was not expected that the volume of business would be sufficient to warrant the maintenance of a separate organization, and consequently the new banks become part of the Federal Farm Loan System. The officers and directors of the twelve Federal Land Banks were to be *ex-officio* officers and directors of the intermediate credit banks. In fact, special officers have been appointed to manage the affairs of the intermediate credit banks, and their accounts are kept separate. The central controlling authority is the Federal Farm Loan Board.

5. (a) *Capital.* The capital of the Federal Intermediate Credit Banks is provided by the Treasury to an amount not exceeding \$5,000,000 for each bank. For the provision of such further capital as may be required to enable a bank to conduct its business, Federal Intermediate Credit Banks have power to borrow money and to issue and sell collateral trust debentures or other similar obligations with a maturity of not more than five years. These are to be secured by an equivalent amount of cash or "notes or other such obligations discounted, purchased or representing loans made."<sup>1</sup> The total volume of debentures or other obligations is not to exceed ten times the paid-up capital and surplus of each bank. The Federal Farm Loan Board prescribes "rules and regulations governing the receipt, custody, substitution and release of collateral instruments securing such debentures or other obligations."<sup>2</sup> While the initiative in the issue of debentures is taken by each bank, the approval of the Federal Farm Loan Board must first be obtained.

<sup>1</sup> Section 203 (a) of the Act.

<sup>2</sup> Section 203 (b).

Similarly, although each bank may fix its own rate of interest on debentures, not exceeding 6 per cent. per annum, the rate must first be approved by the Board. Each bank is liable for the principal and interest on its own debentures, the United States Government assuming no liability. Each bank is also liable for "such portion of the principal of debentures or obligations so issued as are not paid after the assets of such other Federal Intermediate Credit Banks have been liquidated and distributed."<sup>1</sup>

6. The security against which banks may issue debentures consists of notes, drafts, or bills of exchange, debentures, or "other such obligations," endorsed by a National bank, State bank, trust company, agricultural credit corporation, live stock loan company, savings institution, co-operative bank, co-operative credit or marketing association of agricultural producers, or other Federal Intermediate Credit Bank, provided that the proceeds have been "advanced or used in the first instance for any agricultural purpose or for the raising, breeding, fattening or marketing of live stock."<sup>2</sup>

7. At the close of business on 31st December, 1927, Federal Intermediate Credit Banks had called in \$25,000,000 of the total of \$60,000,000 capital stock available from the Treasury, having \$35,000,000 still callable. The total volume of debentures outstanding was \$51,150,000.

8. Federal Reserve Banks act as agents for Intermediate Credit Banks in the payment of interest and principal on debentures.<sup>3</sup>

9. In addition to the sale of debentures to private investors, Intermediate Credit Banks are able, if necessary, to draw upon the resources of the Federal Reserve Banks, which may purchase their debentures or re-discount their paper. Debentures must have a maturity not exceeding six months, and agricultural paper not exceeding nine months. Since the demand from other sources for debentures has been adequate, their purchase by Federal Reserve Banks has so far been small.

<sup>1</sup> Section 207.

<sup>2</sup> Section 202 (a) (1).

<sup>3</sup> *Benner, op. cit.*, p. 240.

10. The right of Federal Reserve Banks to re-discount the paper of Federal Intermediate Credit Banks is not unlimited. It is specifically provided that Federal Reserve Banks are to give preference to the present and probable future demands of member banks, while the privilege does not extend to paper endorsed by banks or trust companies which are eligible to become member banks but have not done so. Further, no Federal Reserve Bank is permitted to discount paper for any intermediate credit bank when its own reserves are less than 50 per cent. of its aggregate liabilities for deposits and Federal reserve notes in actual circulation.<sup>1</sup> Nor can they re-discount for any one Intermediate Credit Bank more than the total amount of its capital stock and surplus. It is apparent, therefore, that Intermediate Credit Banks will have little resource to Federal Reserve Banks at time of credit stringency when they might be expected to require it most. The privilege is of value, however, in obtaining small supplies of capital, between two issues of debentures, when the amount involved would not warrant the issue of debentures. Finally, Federal Reserve Banks are permitted to buy debentures and acceptances in their open market operations.

11. Debentures and the operations of the banks are tax free, but one-half of the net proceeds of the banks goes to the Treasury. The balance is to be paid into the surplus fund until such time as it reaches 100 per cent. of the subscribed capital of the bank. Thereafter 10 per cent. of net earnings is to be paid into the surplus, and the remainder goes to the Treasury.

12. (b) *Loan Operations.* It is apparent that the technical and administrative difficulties involved in making direct loans to farmers from twelve banks operating over the whole area of the United States would be enormous. For this reason, if for no other, it is necessary to make use of local institutions more closely in touch with the farmer. Hence loans are not made directly to farmers, but either by direct loans to co-operative marketing associations or by the

<sup>1</sup> Cf. Willis & Steiner, *op. cit.*, p. 445.

discounting of agricultural and live stock paper for a number of specified credit institutions. The clauses of the Act defining the loan privileges of Federal Intermediate Credit Banks are as follows:

"Section 202 (a). That Federal Intermediate Credit Banks . . . shall have power . . . :—

- (1) To discount for, or purchase from, any national bank, and/or any State Bank, trust company, agricultural credit corporation, incorporated live stock loan company, savings institution, co-operative bank, co-operative credit or marketing association of agricultural producers organized under the laws of any State, and/or any other Federal Intermediate Credit Bank, with its endorsement, any note, draft, bill of exchange, debenture or other such obligation the proceeds of which have been advanced or used in the first instance for any agricultural purpose or for the raising, breeding, fattening, or marketing of live stock; . . .
- (3) To make loans direct to any co-operative association organized under the laws of any State, and composed of persons engaged in producing or producing and marketing, staple agricultural products, or live stock, if the notes or other such obligations representing such loans are secured by warehouse receipts, and/or shipping documents covering such products and/or mortgages on live stock."

13. Loans, advances or discounts must have a maturity of not less than six months nor more than three years. Advances to co-operative associations are not to exceed 75 per cent. of the market value of the products covered. The amount of paper which can be re-discounted for a bank or similar institution is limited to twice the amount of its paid-in capital and surplus. Discount rates are fixed by the Intermediate Credit Banks, subject to the approval of the Federal Farm Loan Board, but must not exceed the rate paid on the last issue of debentures by more than 1 per cent.

14. From organization to December, 1927, original re-discounts of agricultural and live stock paper aggregated over \$176,000,000 and renewals nearly \$81,000,000, making a total of about \$257,000,000. Original advances to co-operative marketing associations totalled \$232,000,000, and renewals \$142,000,000, a total of \$374,000,000. The sum

total of original loans is, therefore, nearly \$409,000,000, and renewals \$222,000,000. On 31st December, 1927, re-discounts outstanding amounted to \$44,000,000 and direct loans to co-operative associations to \$32,000,000, a total of \$76,000,000. It can be seen, therefore, that intermediate credit banks are already an agency of considerable importance in the provision of agricultural credit.

### *B. State Agricultural Credit Corporations*

15. The Act of 1923 permits of the purchase or re-discount of agricultural paper from State Agricultural Credit Corporations. These are to be distinguished from the National Agricultural Credit Corporations, discussed below. No provision was made in the Act for the method of organization to be followed, the appropriate legislation being left to each State. The Federal Farm Loan Board, however, has defined an agricultural credit corporation as "a corporation organized under the laws of any State for the purpose of loaning money for agricultural purposes as herein defined, or for the raising, breeding, fattening or marketing of live stock,"<sup>1</sup> and has made general rules covering their operation. The above definition is very general. Hence a wide variety of institutions has sprung up. "In some instances they have been established as subsidiaries of banks in order to relieve bank portfolios of slow agricultural paper. In other sections they have been organized by farmers and local business men for the purpose of providing a more ample supply of production credit. In still other parts they have been set up as subsidiaries of co-operative marketing associations with the purpose of providing production credit for the members of the association."<sup>2</sup> Credit corporations must have a minimum paid-up capital of \$10,000 and may re-discount agricultural paper with an Intermediate Credit Bank to ten times their capital and surplus. To 31st December, 1927, 366 corporations had been

<sup>1</sup> *Rules and Regulations of the Federal Farm Loan Board*, Circular No. 15 of Federal Farm Loan Board, p. 11.

<sup>2</sup> *Farm Credit, Farm Insurance, and Farm Taxation*, separate from *Agricultural Year Book*, 1924, No. 915, p. 235, by Olsen and others.

established. On that date re-discounts to the extent of \$22,500,000 were outstanding to them.

### *C. National Agricultural Credit Corporations*

16. National Agricultural Credit Corporations may be formed by five or more "natural" persons. A corporation must have a paid-in capital of not less than \$250,000. If the capital stock is over \$500,000, at least 50 per cent. must be paid in before commencing business, the remainder within six months. Capital stock may be reduced or increased by a vote of two-thirds of the stock-holders, subject to the approval of the Comptroller of the Treasury. Member banks of the Federal Reserve System are permitted to invest an amount not exceeding 10 per cent. of their capital and surplus in national credit corporations. In no case must capital stock be reduced to less than one-tenth of the outstanding liabilities or less than \$250,000. The amount of loans must not exceed ten times the paid-in capital and surplus. Advances to one party are limited to 20 per cent. of the capital and surplus of the corporation, except when secured by warehouse receipts representing readily marketable agricultural commodities. The limit is then fixed at 50 per cent. of capital and surplus. Loans secured by live stock are therefore limited to 20 per cent. of capital and surplus. Each corporation must keep on deposit with the Federal Reserve Bank in its district at least 25 per cent. of its paid-in capital stock or  $7\frac{1}{2}$  per cent. of its aggregate indebtedness, whichever is the larger, in the form of securities, which are held in trust to protect holders of its notes, debentures, drafts, bills of exchange, or acceptances. The National Credit Corporations may issue debentures to obtain the necessary capital for their operations. Conditions governing their issue are the same as for Federal Intermediate Credit Banks except that they are not tax free. Since liabilities are limited to ten times their capital stock and surplus, and since debentures are secured in the same way as those of Federal Intermediate Credit Banks by notes, drafts, bills of exchange, chattel mortgages, warehouse

receipts, and similar credit instruments, the issue of debentures is also limited to the same amount.

17. The Act also provides (Section 207) that National Agricultural Credit Corporations having an authorized capital stock of \$1,000,000 or over may serve as central re-discount corporations. The purpose of these is to provide central institutions for the national agricultural credit corporations, and more especially to serve as intermediaries between credit institutions in live stock areas, and investing institutions in the large cities.<sup>1</sup> The result of the above legislation has been disappointing, for during the first two years of operation of the Agricultural Credits Act only one National Agricultural Credit Corporation was established.<sup>2</sup>

#### IV. ESTIMATE OF FEDERAL INTERMEDIATE CREDIT SYSTEM

1. The achievements of the Federal Intermediate Credit system have justified neither the extravagant hopes nor wild fears which greeted its inception. It appears, however, to have amply justified its establishment.

2. The need for an intermediate credit system was believed to depend upon the inability of commercial banks to satisfactorily supply the credit needs of agriculture for a time long enough to cover the period of production and marketing. Since a large proportion of the liabilities of commercial banks are demand liabilities, assets must be kept liquid. Hence, loans must be for short periods and any considerable proportion of long term or intermediate loans is unwise. In a previous chapter we have quoted an American authority who points out that the turnover of deposits in country banks in the United States is slow, and that, although loans are theoretically for periods too short

<sup>1</sup> See Benner, *op. cit.*, pp. 207-8, and Willis & Steiner, *op. cit.*, p. 459.

<sup>2</sup> For a number of reasons, conditions under which these corporations are permitted to operate are less favourable than those applying to State Agricultural Credit Corporations, so that the latter type has been favoured. See Benner, Ch. VIII, Section III.

to satisfy the requirements of agriculture, the renewal of loans is common in "normal" times.<sup>1</sup> On the other hand, it is equally clear that an unusual or "abnormal" situation may readily face a country bank with a shortage of cash and the necessity for calling in loans. The uncertainty thus created is satisfactory neither to the bank nor to its customer, and an outside source of funds to meet such conditions is required. As has been indicated in the early part of this chapter, the Federal Reserve System provides such a source of funds, either directly through member banks, or indirectly through city correspondents. Hence, the elasticity of bank credit depends upon the efficiency of the Federal Reserve System rather than upon the operations of the Federal Intermediate Credit System. It is significant that despite the operations of the Federal Intermediate Credit System, the practice of country bankers does not appear to have been radically altered.<sup>2</sup>

3. The important service which the intermediate credit system has rendered to agriculture, is not so much in providing elasticity to relieve credit stringency as in directing the flow of capital from financial centres to deficient capital areas remote from such centres.

4. The mechanism whereby the resources of the money market have been tapped is mainly through the issue of debentures. These are standardized negotiable instruments, the security against which is not a particular note, draft, or other lien, on a particular parcel of marketable produce, but the liability of the issuing bank based on the aggregate security of a large number of such obligations. A reliable intermediary is interposed between borrowers and lenders, which becomes responsible for the discharge of each individual debt, and is safeguarded by the proper endorsement of notes by other institutions, by the conservative assessment of the value of goods against which loans are advanced,

<sup>1</sup> *Supra*, Part IV, Ch. II.

<sup>2</sup> *Benner, op. cit.*, pp. 266-7. "The real reason for the country banker's reluctance to make loans for over six months is not so much the fear of tying up his assets in a non-liquid form, as the fact that there tends to be more risk attached to the longer term loans."



and the allowance of an adequate margin. So the intermediate credit banks become a channel through which the flow of credit is directed from individual investors to a large number of credit agents in close touch with actual borrowers. It is obvious too that the distant investor will be more likely to lend to a large institution under careful and expert management than to a small local concern about which he can know nothing, whose managers may be inefficient and which may suffer from purely local causes, especially as the wider area covered and greater variety of business handled by the larger institutions adds to the probability that risks will cancel out. It is important to note, however, that the extent to which country banks have taken advantage of the services of the intermediate credit banks has been small, largely because of limitations on the interest rate which is imposed. Since no such restriction is imposed under the Federal Reserve System, the re-discounting of agricultural paper with reserve banks is much more attractive. A further factor is the limitation imposed on the amount which an intermediate credit bank can re-discount for a local bank: viz., twice the paid-up capital and surplus of the local bank.

5. Hence, the chief agents with which the intermediate banks have done business are not banks, but co-operative societies, state agricultural credit corporations and live stock loan companies. This is shown by the following figures taken from the Eleventh Annual Report of the Federal Farm Loan Board:—

ADVANCES OUTSTANDING FROM FEDERAL RESERVE INTERMEDIATE CREDIT BANKS, 31ST DECEMBER, 1927

<i>Re-Discounts.</i>	\$
National Banks .. .. .	6,650
State Banks .. .. .	159,829
Agricultural Credit Corporations ..	22,527,712
Live stock Loan Companies .. ..	21,213,749
Savings Banks and Trust Companies ..	16,000
<hr/>	
<i>Total Re-Discounts</i> .. .. .	\$43,923,940
Loans to Co-operative Marketing Associations .. .. .	\$31,990,577

6. The amount which co-operative marketing associations obtain through Federal Intermediate Credit Banks, though substantial, is still only a small proportion of their total borrowings. Nevertheless, the general opinion appears to be that they are of real value to the associations in facilitating orderly marketing. The bulk of the finance required is still obtained from the same sources as before, but this finance appears to be easier to obtain in consequence of the activities of the intermediate credit banks. This view is expressed in the Report of the Federal Farm Loan Board for 1925 as follows:—

“Orderly marketing is the foundation of the co-operative selling of farm products and success in orderly marketing depends in large measure upon proper financing. By taking care of credits with maturities of from six months to three years, the intermediate credit system makes it safer and easier for the commercial banks to provide adequate short time credits. Co-operatives report that they have found commercial banks willing to grant ample short term credit when they make proper arrangements for their longer term credit through the Federal Intermediate Credit Banks. Thus the moral assistance rendered the co-operatives by this system has been of greater importance than that rendered by the actual advances.”<sup>1</sup>

The chief value of the system to co-operative marketing associations appears to be in the moral assistance which it renders; the potential sources of capital which it makes available in time of need; and the direction of the flow of capital to capital-deficit areas through its connexion with the money market and the greater marketability which it gives to credit instruments secured against agricultural produce.

<sup>1</sup> *Report*, pp. 9-10. See also *Report* for 1927, p. 19; Benner (*op. cit.* pp. 157-8) writes in similar strain: “There is no doubt that these associations have continued to get the greater part of their credit accommodation, both short time and intermediate from the commercial banks. Nevertheless, they feel that the Intermediate Credit Banks have been of very real service to them. The co-operatives take the position that it was the existence of the Intermediate Credit Banks that made the local banks more willing to extend them credit. These marketing associations now have the Intermediate Credit Banks to fall back upon in case they cannot secure adequate credit accommodation through the regular banking channels, and their leaders feel that this possibility is a potential service on the part of the Intermediate Credit Banks that is of very great value to them.”

7. For similar reasons the Federal Intermediate Credit System appears well suited to meet the needs of the cattle and sheep industries. In these cases the production period for the "crop" is long, and the risks involved from non-renewal of loans are serious, regions covered by the industries are sparsely settled, and existing credit facilities are unsatisfactory. Although the resources rendered available by the system have not yet been fully taken advantage of,<sup>1</sup> beneficial results have already been achieved. Thus, the Annual Report of the Federal Farm Loan Board, 1925 (p. 11) states:—

"The Federal Intermediate Credit system has been very beneficial to stockmen of the West where the resources of commercial banks are too small to enable them to extend the kind of credit needed by live stock producers. In the past these stockmen have depended largely upon loan companies which re-discounted with banks in the larger cities. Ample credit was granted in normal times, but, during periods when deposits increased, new loans or renewals were frequently denied and borrowers forced to pay excessive rates or sell valuable breeding herds or immature live stock on a declining market. This resulted in disorderly marketing, wide fluctuations in values, and heavy losses to the industry. The intermediate credit system now provides dependable re-discount facilities through which sound loan companies and banks may at all times place good live stock paper."<sup>2</sup>

Although the volume of advances made through the intermediate credit system on the security of live stock is still only a small proportion of the total amount advanced to the live stock industry, and although the increased use of the system has been gradual, a steady expansion is foreshadowed.<sup>3</sup> Indirectly, also, the system has been of some value in maintaining reasonable and uniform interest rates.<sup>4</sup>

8. The third important group of agencies acting as intermediaries between the intermediate credit banks and the farmer are State Agricultural Credit Corporations. Since such organizations are permitted to obtain re-discounts to

<sup>1</sup> See Larmer, *Financing the Live Stock Industry*, Ch. X, for reasons why full advantage has not been taken of the system.

<sup>2</sup> See also *Report for 1926*, p. 15, and 1927, pp. 19-20.

<sup>3</sup> See Larmer, *op. cit.*, p. 247.

<sup>4</sup> *Ibid.*, p. 252.

the extent of ten times their capital and surplus, they permit of a considerable expansion of credit to agriculture. They offer some advantages in taking over the long-dated loans from banks and co-operative associations. On the other hand, there are serious dangers of unwise credit expansion, especially where corporations are organized by farmers themselves, for they need provide only one-tenth of the total capital they require by way of loan, and may borrow even this. Where they are established by banks, there is a possible danger that the poorer "risks" may be transferred to them, the best loans being retained by the banks. Larger corporations may be of great assistance in supplementing the work of other credit institutions. They may be of value in taking over the finance of long-dated intermediate loans required by the cattle industry, by co-operative associations, or by banks in capital-deficit areas. They thus provide a useful additional link between the money market and the farmer.<sup>1</sup> But the difficulties of supervising effectively a large number of corporations, particularly if they be of small size, are very real and lend dangers which it is not easy to ensure against; for there is a direct incentive to over-finance, particularly in the case of corporations with small capital organized by farmers themselves.

9. All things considered, the achievement of the Federal Intermediate Credit System during the few years of its existence is highly creditable. A large proportion of the intermediate credit for agriculture is still provided from other sources. The system cannot hope to save the farmer

<sup>1</sup> "The farmer applies for a loan at the agricultural credit corporation; this corporation re-discounts his note with an Intermediate Credit Bank; and the Intermediate Credit Bank secures the funds by selling its debentures on the money markets of the large industrial centres. An agricultural credit corporation will experience no difficulty in providing loanable funds so long as it has eligible paper to send to an Intermediate Credit Bank; and so long as there are loanable funds on the money market of the country to buy the debentures of the Intermediate Credit Banks, these institutions will be able to discount the farmer's notes for the credit corporations. Thus the connection is made between the individual farmer seeking credit, and the capitalist in the large city who desires to invest his money. Country bankers organizing one of these corporations can secure for their communities all the outside funds for which they have any legitimate need." (Benner, *op. cit.*, pp. 227-8).

entirely from the results of depression and strained credit in the future. Nevertheless, it has helped to equalize the terms on which agriculture and industry are financed, by providing an efficient intermediary between the private investor in the city and the farmer on the land. It has helped also in equalizing the flow of resources geographically, and has been especially useful to capital-deficit areas. It has facilitated the renewal of loans and helped towards the ideal of orderly marketing. Many of its effects have been indirect and therefore less capable of assessment. As with most systems of credit provision, the danger of over-expansion of credit is not entirely removed. There is also some danger that in helping the farmer it may reduce somewhat the liquidity of resources of the banking system as a whole. But the system appears to be efficiently and conservatively managed. It is already well established and the extension of its services to agriculture in the future appears likely.<sup>1</sup>

<sup>1</sup> Since this chapter was written, important developments have taken place under the Agricultural Marketing Act (1929) which is described as "one of the most radical laws ever enacted in the United States, because it provides Government aid and subsidy in the form of hundreds of millions of dollars for the re-organization of the machinery of marketing all kinds of agricultural products." (Memorandum by the Standard Statistics Company of New York, published in the *Economic Journal*, March, 1930.) The Act declares it "to be the policy of Congress to promote the effective merchandising of agricultural commodities so that the industry of agriculture will be placed on a basis of economic equality with other industries, and to that end to protect, control and stabilize the currents of inter-state and foreign commerce in the marketing of agricultural commodities and their food products by minimizing speculation, by preventing inefficient and wasteful methods of distribution, by encouraging producers to organize into effective associations or corporations, and by aiding in preventing and controlling surpluses in any agricultural commodity through orderly production and distribution so as to maintain advantageous domestic markets, and prevent such surpluses from causing undue and excessive fluctuations or depressions in price for the commodity." (Quoted—*Acceptance Bulletin*, June, 1930.) In short, the purposes of the Act are to prevent speculation, to prevent inefficiency and waste in distribution, to encourage the organization of co-operative marketing by producers, and to prevent and control surpluses.

(See "Activities of the Federal Farm Board," *Economic Journal*, March, 1930; "The Federal Farm Board and the Cotton Situation," by Carl Williams, *Acceptance Bulletin*, June, 1930; "The Federal Farm Board," *Economist*, 2nd August, 1930; and "The American Farm Board Storm," by G. W. Foaah, *Manchester Guardian Commercial*, 20th March, 1930.)

## CHAPTER V

# SHORT TERM AND INTERMEDIATE CREDIT IN NEW ZEALAND

### I. PRIVATE SOURCES

1. The main private sources of short term and intermediate credit in New Zealand are dealers of various kinds, and commercial banks. Finance and loan companies also operate in some localities.

#### 1. DEALER'S CREDIT

2. Country storekeepers, city merchants, implement dealers, stock and station agents, auctioneers and other business firms provide an uncertain, but very considerable, volume of credit for production and marketing.

3. The discussion of dealer's credit in a previous chapter<sup>1</sup> may be applied in greater or less degree to New Zealand. Such concerns possess the advantage of close personal contact with the farmer and intimate knowledge of his business. They are well able to assess his personal security and the value of the assets over which they may hold a lien. Loans are advanced with little formality and at small initial cost, often in the form of book credit. Dealers have been prepared to tide the farmer over temporary difficulties, and show leniency in bad times. It cannot be doubted that they have performed a service of great value to the Dominion, and are likely to continue to do so. Nevertheless their disadvantages and weaknesses should be fully recognized. Often they have so extended their advances to agriculture as to be seriously embarrassed by a bad season,

<sup>1</sup> Part IV, Ch. I.

and in consequence have been unable to show leniency even if they desired to do so. In this respect they are inferior to the banks whose more adequate resources enable them to take a longer view. Since their financial operations are closely involved with their ordinary business operations, they often expect the farmer to deal largely, if not entirely, through them. This limits his freedom and may lead to vexatious oversight and the imposition of unreasonable terms. Frequently the rates of interest charged are very high. The remedy, however, is not to curtail their credit operations, but to extend competitive facilities such as are provided under the Rural Intermediate Credit Act of 1927.<sup>1</sup>

## 2. COMMERCIAL BANKS

4. It is probably true that, in the aggregate, dealers provide the greater part of the short term and intermediate credit taken together, but commercial banks are the most important single source of short term credit. One writer estimates that more than half of this type of credit is provided directly to farmers by banks,<sup>2</sup> and that indirectly through stock and station agents, finance and lending companies and other lending institutions they provide "more than 90 per cent. of the short term capital necessary for the working expenses of the farmers."

5. As a source of short term credit, commercial banks in New Zealand may be regarded as very satisfactory. The Royal Commission on Rural Credit, already referred to, reported that: "So far as short term credit is concerned, the Commission failed to discover anything better than the facilities already afforded in New Zealand under ordinary banking conditions, and the State Advances Office short term system, which latter, however, does not appear to have been used to any great extent."<sup>3</sup> The weaknesses of commercial banks as a source of agricultural credit, discussed in an earlier chapter,<sup>4</sup> apply to some extent in New Zealand.

<sup>1</sup> See below, p. 265 *et seq.*

<sup>2</sup> Werry, *Rural Credit in New Zealand* (Unpublished Thesis).

<sup>3</sup> *Report of Royal Commission on Rural Credits* (1926), p. 6.

<sup>4</sup> See Part IV, Ch. II.

In particular the small farmer in a remote district will be faced with difficulties, especially as he frequently does not keep proper books and so cannot present a clear statement of his position. Nevertheless, farming industries are of such predominant importance in the economic life of the country that the banks are very familiar with the problems attendant on short term rural finance, and are well qualified to engage in rural business. Branches and agencies are wide-spread, and are to be found in almost every township.<sup>1</sup>

6. Loans are usually advanced on fluctuating overdraft within agreed limits payable on demand. Interest is paid on the day to day balance, the rate of interest varying according to the nature of the security. A wide variety of securities is in use, including collateral, chattel mortgages, warehouse receipts, bills of sale and insurance policies. In the case of dairy farmers, the security frequently takes the form of a lien on the monthly butter-fat cheque to an agreed amount or proportion. In some cases the co-operative dairy company may act as guarantor and bind the farmer to supply milk or cream to it. In others a document is drawn up and signed by the bank manager, the farmer, and the company, covering an agreement to pay moneys into the bank. A portion of these is used to repay the loan, and the remainder goes into the account of the farmer and can be drawn upon by cheque. By this means the bank is amply secured and the farmer liquidates his indebtedness by instalments.

7. A considerable volume of credit is also advanced to dairy companies for the marketing of their products. Pending shipment the company usually obtains an overdraft, which may be up to 80 per cent. of the f.o.b. value of the product, with which it is able to pay its suppliers. Some factories, instead of operating on overdraft, obtain an advance from the purchaser or his agent, in which case a great deal of the finance will be obtained from London on a letter of credit.

<sup>1</sup> The Bank of New Zealand alone has about 240 branches and agencies.



## 3. FINANCE AND LOAN COMPANIES

8. Finance and loan companies provide a useful volume of short term and intermediate credit. In Part III, Chapter V, mention was made of the activities of certain finance and loan companies dealing in long-dated agricultural securities. Many of these concerns "burnt their fingers" during the post-war depression and appear to have largely transferred their activities to short-dated loans. In addition, other companies have sprung up, making direct loans and engaging in the discounting of, or making loans against, hire-purchase agreements. These latter activities do not concern the farmer directly.

9. The bulk of the direct business to farmers consists in small accommodation loans during the off season to provide working expenses until factory receipts or proceeds from the sale of other crops begin to come in. Since such loans can usually be obtained without undue formality and delay, they are a useful though subsidiary form of credit.

## II. PUBLIC SOURCES

## 1. THE NEED FOR AN INTERMEDIATE CREDIT SYSTEM

1. Supplies of short term credit in New Zealand are as adequate and satisfactory as in most other countries.<sup>1</sup> Certain weaknesses undoubtedly exist. In particular, it has been suggested that the small farmer may have difficulty in obtaining adequate supplies on reasonable terms from commercial banks, and may be forced to rely on credit from dealers or others under disadvantageous terms. Nevertheless, the main deficiency of private sources of credit is in respect of intermediate credit. For this, commercial banks are unsuited, and the only remaining resort of any importance was, until recently, the stock and station agent or other dealer. The objections to this source of credit are such that alternative methods are desirable. Recognizing the inadequacy of private enterprise, the Government has attempted to meet the need. In 1922 the Government passed a

<sup>1</sup> See *Report of Royal Commission on Rural Credit*, p. 13.

Rural Credit Associations Act, which empowered the setting-up of co-operative rural credit associations. This act proved abortive and has since been repealed. Two other provisions have since been placed on the Statute Book: (a) The State Advances Amendment Act of 1923 gives the State Advances Office authority to advance money to farmers on chattel security for a period up to five years; and (b) The Rural Intermediate Credit Act of 1927 establishes a Board for the provision of rural intermediate credit.

## 2. THE STATE ADVANCES OFFICE

2. Under the State Advances Amendment Act of 1923, the State Advances Office may make advances on the security of stock and of farm implements or of land, either with or without collateral security. Not more than £500 may be advanced to any one borrower, and the period of loan is not to exceed five years. Loans are repayable by instalments as follows:

(a)	10	per cent.	at the end of the	first year.
(b)	15	"	"	second year.
(c)	20	"	"	third year.
(d)	25	"	"	fourth year.
(e)	30	"	"	fifth year.

Interest on the loan outstanding is payable at the rate of 7 per cent. per annum, reducible to 6½ per cent. per annum, provided that the half-yearly instalments of principal and interest are paid within fourteen days of due date.<sup>1</sup>

3. Small advantage has been taken of these provisions, since for the six years ended 31st March, 1929, only £97,525 had been advanced. This was due largely to lack of knowledge on the part of farmers and to the undue delay occasioned in the granting of loans.

## 3. THE RURAL INTERMEDIATE CREDIT SYSTEM

### A. Organization

4. The Report of the Royal Commission on Rural Credit, presented in 1926, recommended a scheme for the provision

<sup>1</sup> *New Zealand Official Year Book*, 1930, p. 658.

of intermediate credit very much on the lines of the Federal Intermediate Credit System of the United States. Its recommendations were given substantial effect to in the Rural Intermediate Credit Act of 1927.

5. The Act of 1927 established a Board to be known as the Rural Intermediate Credit Board, which was to consist of seven members, including the Public Trustee, who was to be the chief executive officer of the Board. The remaining members were to be appointed by the Governor-General and were to hold office during his pleasure. At least one member of the Board must have had farming experience, and at the present time two members are farmers.

6. For the purpose of enabling the Board to carry out its functions, New Zealand is divided into 16 districts, for each of which a district board has been established. Each district board consists of five members, the chairman of which is an officer of the Public Trust, who is also the "District Intermediate Credit Supervisor." In smaller centres the District Managers of the Public Trust Office act as representatives of the Board, under the designation of "District Officers."

7. The Act provides for the setting up of Co-operative Rural Intermediate Credit Associations, in order to "meet the demand which (had) existed for some time past for the provision of machinery to enable farmers to combine for the purpose of financing themselves as individuals on their collective financial strength as a group."<sup>1</sup> A group of farmers not less than 20 in number may form a co-operative rural credit association, to which the Board may make advances to be re-lent to its members on securities approved by the Board. Each member of the association must subscribe for at least 25 shares of the association, to the value of £1 per share.

8. An association is required to elect four of its members as directors, of whom one shall be chairman, together with a Secretary and Treasurer. No director is entitled to receive payment, other than travelling expenses. Only one salaried officer may be appointed.

<sup>1</sup> *Report of Rural Intermediate Credit Board, 1928, p. 13.*

*B. Finance*

9. The principal business of the Board is to make advances to individuals, associations as established under the Act, and to co-operative societies, and to discount promissory notes and other bills of exchange.

10. (a) *State Assistance.* To provide the necessary funds, the Minister of Finance may make advances, not to exceed an aggregate of £400,000, such advances to be for a period of not less than 20 years. These are to be free of interest for the period of ten years succeeding the date on which the first advance is made. Thereafter, interest is to be paid half-yearly at such a rate as the Minister of Finance determines. One-third of every advance is to be credited to the "Rural Intermediate Credit Redemption Fund," and applied to the redemption of debentures issued by the Boards. The remainder is to be used by the Board in carrying on its business. In addition the Minister of Finance may advance such sums as he thinks fit, not exceeding in the aggregate the sum of £5,000 to be made by way of loan to associations towards their preliminary expenses. Advances to any one association are not to exceed £25 and are free of interest provided that they are repaid within ten years after the registration of the association.

11. (b) *Debentures.* For the purpose of providing such additional funds as may be required, the Board, with the consent of the Minister of Finance, may issue debentures, the total amount of which is not to exceed the balance of advances outstanding from the Consolidated Fund, together with the amount secured by all mortgages, bills of sale, bills of exchange, and other securities held by the Board; or the sum of £5,000,000, whichever is the lesser. All debentures are to constitute a floating charge on all the assets of the Board, and are to have priority over the claims by the Crown in respect of advances made by the Minister of Finance from the Consolidated Fund. Debentures are to be redeemed at par at not less than six months nor more than five years from the date of issue. Pending the raising of funds by the issue of debentures, the Board

may borrow an amount not exceeding in the aggregate the full amount authorized to be borrowed by way of debentures. No debenture shall provide for payment of interest at a rate exceeding six per cent. per annum. At any time the Board may purchase its debentures, at or below par, and these are to be cancelled and discharged. Debentures are eligible for the investment of trustee funds or of any public monies. Surplus funds in the hands of the Board may be temporarily invested in Government securities or deposited with any bank carrying on business in New Zealand.

### *C. Loans*

12. (a) *Advances through Associations.* Each member of a Rural Intermediate Credit Association may receive loans to the extent of £1,000, or ten times the nominal value of his shares, whichever is the lesser. Under the Amending Act of 1929, the maximum amount is increased to £2,000. This provision is designed largely to assist sheep farmers and grain growers for whom the maximum limit of £1,000 was found to be inadequate. Where the demand for an advance by a member of an association is for a term not exceeding six months, the association may, with the approval of the Board, arrange for a loan from any bank carrying on business in New Zealand or from any other approved financial institution.

13. The principal purpose of an association incorporated under the Act is to borrow from the Board or from Banks or other financial institutions, and to lend the funds thus obtained to members on the security of "mortgages, or other charges on land or chattels, or on approved personal security," for the following purposes:—

- (i) The clearing, fencing, and general improvement of land in the occupation of the applicant;
- (ii) The erection of buildings on any such land;
- (iii) The purchase of implements, stock, seeds, plants, trees, and other things required in respect of the occupation and use of any land;

- (iv) The payment of any mortgage, debt or other liability of the applicant incurred in relation to farming operations;
- (v) Any other purpose in relation to farming operations that may be approved by the Board.

14. The interest payable on any loan granted by an association to a shareholder must not exceed seven per cent. per annum. All securities given to an association by a shareholder against any loan must be delivered to the District Intermediate Credit Supervisor and forwarded by him to the Public Trustee for safe custody. The maximum period of loans is fixed at five years, and loans may be repaid by instalments at such times and in such manner as is mutually agreed upon, subject to the approval of the Board. All monies received by an association in repayment of any loan must be applied in reduction of the indebtedness of the association.

15. The paid-up capital of an association must be invested in approved securities, and the income used to meet the current expenses of the association. Any profits derived by an association may be applied in accumulating a reserve of such an amount as the Board may approve or require, to be invested in the same manner as the paid-up capital, or in the payment of dividends to shareholders not exceeding seven per cent. No such dividends may be paid until any loan made by the Board towards the preliminary expenses of the association has been repaid.

16. When any shareholder has repaid his loan, he may surrender his shares and cease to be a member of the association, provided that the number of shareholders remaining is not less than 20. Any transfer of shares must receive the prior approval of the Board.

17. (b) *Direct Loans to Farmers.* Under Part III of the Act provision is made for the granting of direct loans to farmers without the intervention of a rural credit association, under conditions similar to those which are advanced to members of an association, except that such loans must be

collaterally secured by an instrument of guarantee signed by one or more sureties approved by the District Board. Sureties must be not less than 20 per cent. of the amount of the loan originally granted.

18. (c) *Loans to Co-operative Societies.* Part IV of the Act is designed to assist farmers' co-operative societies to obtain finance upon the security of live stock or produce. A co-operative society is defined by the Act as a "Co-operative Company (not being an association established primarily for the purpose of this Act) incorporated under the Companies Act, 1908, and having for its principal object the production or sale of staple agricultural or pastoral products, including live stock, and including also goods manufactured from any such products."

19. A society must have a subscribed capital of not less than £2,500 to be eligible to receive a loan, and must be composed of not less than 30 members. Loans may be authorized by the Board up to 80 per cent. of the live stock or produce belonging to the society upon which the loan is secured. Loans must be for a term of not less than six months nor more than three years. The maximum rate of interest is fixed at seven per cent.

20. (d) *Discount Facilities.* Under Part III, Paragraph 46, of the *Regulations under the Rural Intermediate Credit Act, 1927*, provision is made to enable banks and approved financial institutions to afford financial assistance to farmers by discounting promissory notes and bills of exchange with the Board, under the following conditions:—

- (i) The rate of discount chargeable is to be determined by the Board.
- (ii) The holder of the promissory note or bill of exchange is to be a bank or financial institution, company, firm, or person approved by the Board.
- (iii) The maker of the promissory note or bill of exchange must be a farmer engaged in farming operations on his own account.
- (iv) The promissory note is to be endorsed to the satisfaction of the Board.

(v) The amount of accommodation to any one farmer is fixed at £1,000.

21. Evidence of the financial position of the concern holding the promissory note must be afforded, and the Board fixes the limit up to which notes or bills will be discounted for it.<sup>1</sup>

#### 4. ESTIMATE OF RURAL INTERMEDIATE CREDIT SYSTEM

##### A. *Extent of Operations*

22. The Rural Intermediate Credit Board has only just completed its second year of operation, so that it is scarcely possible to make an estimate of its value to the rural community on the basis of its achievements. The Board appears to have adopted a policy of cautious and steady development, rather than aim at spectacular expansion, so that as yet it has done little more than touch the fringe of the volume of business which it can be expected to undertake when once the scope and nature of its operations are fully understood. The Board has conducted active publicity by means of lectures, the issue of booklets and circular letters, the publication of articles, and the distribution of reports; but the farmer is conservative and there is much inertia to overcome, while large numbers do not fully understand how they may take advantage of the facilities offered. Still, the Board has made a very auspicious beginning and the scheme is now well established.

23. The following figures show the nature and extent of the transactions of the Board as on 31st August, 1929:—

	£
Investments (including loans made and face value of bills discounted) .. .. .	215,176
Loans granted but not completed .. .. .	42,874
Applications entertained and in course of consideration .. .. .	10,260
<b>Total .. .. .</b>	<b>£268,310</b>

<sup>1</sup> Report of the Rural Intermediate Credit Board, 1929, p. 24.



The investments referred to above were made up as follows:—

	£
Advances to associations for preliminary expenses	394
Advances to associations .. .. .	89,530
Advances to farmers under Part III of the Act ..	117,987
Bills and notes discounted (face value) .. ..	7,265
	<hr/>
Total .. .. .	£215,176
	<hr/>

Between the date of inception of the scheme and the 31st August, 1929, loans made and bills discounted totalled £264,496. Advances totalling £197,100 have been received from the Consolidated Fund under Part I, Section 16 of the Act, and £70,700 has been raised by the issue of debentures.

### *B. Direct Loans*

24. It is interesting to note that the volume of advances made to farmers without the interposition of credit associations exceeds that made through credit associations. In the initial stages this is only to be expected, since there is likely to be some inertia to be overcome in the setting up of associations. It has been objected, however, that the terms of the Act are such as to prove an obstacle to the co-operative method by providing the alternative of direct loans. On the face of it this seems a legitimate criticism, since direct borrowers avoid the necessity of subscribing to the shares of a credit association and incurring liability to the extent of their share capital. It would appear also that there is a differentiation as to the terms on which loans are granted. On the other hand loans advanced without the intervention of an association must be supported by one or more sureties. The principle of direct loans would appear to remove some incentive to the formation of associations, but it is important to note that most of the loans granted under the direct provisions of the Act are made through co-operative dairy companies which act as guarantors, so that the co-operative principle is in fact made use of. The practice has much to commend it, since it avoids the duplication of administrative machinery. It seems clear

also that some provision should be made for direct advances to farmers in districts where no association or co-operative societies are in operation; but it is at least arguable that such loans should only be made where the above alternatives are not available, and that the encouragement to co-operation which seems implicit in the Act as an important objective of its framers, would be more readily achieved in this way, or if such benefits as accrue from the collective security of co-operative societies or credit associations were realized in slightly more advantageous terms.

### C. *Co-operative Methods*

25. (a) *Rural Intermediate Credit Associations.* The provision under the Act for the establishment of rural intermediate credit associations provides a useful basis on which to establish a co-operative credit system. By June, 1930, 30 associations had been formed, of which the majority were in the North Island. The associations have been formed mainly in dairying districts. This is largely attributable to the fact that the maximum limit of £1,000 for each loan was too small for sheep farmers and mixed farmers operating on a larger scale. During the 1929 session of Parliament this was increased to £2,000, so that an impediment to the setting up of associations among sheep and mixed farmers is thereby removed. The greater development in dairying districts is no doubt influenced also by the fact that dairy farmers are more accustomed to co-operative methods and that dairying districts are usually more closely settled.

26. It will be noted that the liability of members of associations is limited by the amount of their share capital, and is not unlimited as in the case of Raiffeisen societies. The purpose of unlimited liability is to improve the basis of security against which loans are granted, both by the collective guarantee of members and by the greater scrutiny of loans which this entails. Under the method which has been adopted in New Zealand, the security depends essentially upon the scrutiny which is exercised over the conditions

of loans by the District Boards and supervisors and by the Central Board, and very little upon the method of organization of the credit associations.<sup>1</sup> Unlimited joint and several liability is therefore unnecessary. In any case it may be regarded as certain that New Zealand farmers would not have regarded the principle of unlimited liability with favour and that few, if any, associations would have been formed. There is still sufficient scope under the present form of organization of credit associations to promote the spirit of co-operation. Such associations as have been formed recognize the value of the machinery which has been devised, and it is encouraging to note that many substantial farmers "who are not likely to require loans themselves, have nevertheless joined the associations in order to ensure their formation and to see that they receive a good start. By doing so they are playing their part in fostering the co-operative spirit among the farming community along the lines provided for."<sup>2</sup>

27. In addition to their value as co-operative nuclei, the associations perform a useful service in establishing a close contact with borrowers and undertaking much of the detailed administration involved in the provision of loans, and in the supervision of securities.<sup>3</sup>

28. (b) *Use of Co-operative Societies.* In addition to the encouragement of the application of co-operative principles through the establishment of co-operative credit associations, much importance should be attached to the extent to which co-operative societies, more particularly co-operative dairy companies, have taken advantage of the provisions of the

<sup>1</sup> It should be noted, however, that some economies may be expected through the supervision of securities by the credit associations.

<sup>2</sup> Communication from the Rural Intermediate Credit Commissioner, June, 1930.

<sup>3</sup> "Largely, the principles of co-operation as applied to rural intermediate credit associations will be demonstrated by the economies which may be effected in costs of administration through the co-operation of members, and it is particularly in regard to the costs of supervision of securities, which normally entail a considerable amount of expense, that savings can be effected through the mutual efforts of the members." *Report of Rural Intermediate Credit Board, June, 1929.*

Act to finance the operations of their members. Co-operative societies are eligible to receive direct advances on the security of live stock or produce to the extent of 80 per cent. of its value for periods of from six months to three years. The main financial needs of such concerns are to make payments to suppliers pending sale. Since finance for this purpose is readily obtainable from commercial banks and other sources, little advantage has so far been taken of the provision. By 30th June, 1930, only one application had been received by the Board.

29. The main benefits of the Act to co-operative societies are to be found in other directions. As indicated above,<sup>1</sup> the Board may advance loans to individuals when they are backed by one or more sureties. Dairy companies have availed themselves largely of this provision, particularly in the Waikato District. Dairy companies taking advantage of this means of financing their members must undertake to guarantee 20 per cent. of each loan. Since loans are made by the Board only on sound lending margins on valuations made by capable and experienced valuers, the risk to the company is small. Loans granted in this way are reduced by a charge on the monthly milk cheque, so that the borrower may reduce his loan by regular instalments during the milking season. By conferring benefits on members, this provision indirectly assists the co-operative dairy company as such, both by improving the position of its members and emphasizing in a new way the advantages accruing from membership.

30. (c) *Discount Facilities.* In addition, provision is made under the Act to discount promissory notes and bills of exchange given by farmers.<sup>2</sup> "This system is well suited to the requirements of dairy-factory suppliers needing temporary financial assistance during the winter months, when the milk cheques have practically ceased, to enable urgent outgoings to be met, such as payment of interest on mortgages, living expenses, cost of purchase of fertilizers,

<sup>1</sup>, <sup>2</sup> *Supra*, pp. 268 et seq.

and similar expenses, and it is in active operation amongst dairy companies in various parts of the Dominion. It is the custom of these companies, towards the close of the productive season, to invite applications from their suppliers for loans of amounts required to tide them over the winter months. These applications are scrutinized by the directors of the company, who select those cases which they are prepared to assist. Promissory notes for the individual amounts are taken from the suppliers and endorsed by the dairy companies to the Board and the total discounted value of the notes so endorsed is immediately made available to the companies for distribution to their suppliers.<sup>1</sup> The maximum amount for each loan is £200, and companies as a rule provide for the notes to be liquidated by deduction from milk cheques in the next farming season. Such payments may be used to reduce the indebtedness of companies to the Board, and a rebate of interest is then made. Borrowers therefore pay on the amounts outstanding from month to month. Banks and other financial institutions are also eligible to take advantage of the discounting facilities, but so far do not appear to have done so to any great extent.

31. In addition, co-operative dairy companies have assisted in the extension of the work of the Board by organizing co-operative rural intermediate credit associations among their suppliers. In many cases directors of dairy companies have served also as directors of the newly established associations.

32. In these ways considerable use has been made of dairy companies. Indeed, the bulk of the advances to date appear to have been made with their co-operation, and it seems likely that this will be the case for some time to come. On the whole, this appears to be the most commendable aspect of the Board's activities up to the present. It is quite possible that, in consequence of the facilities offered through co-operative dairy companies, the development of associations will be somewhat retarded, but as long as the

<sup>1</sup> *Report of Rural Intermediate Credit Board, June, 1929.*

results in other respects are satisfactory this is scarcely a cause for concern.

#### *D. Advantages to Dairy Farmers*

33. The above methods of providing financial assistance to the farmer are a marked improvement on the methods previously existing. While commercial banks provided some intermediate credit, they are not suited to this class of business and the main source of intermediate credit was stock and station agents and other dealers. As has been shown, these possess serious disadvantages. With the establishment of the Rural Intermediate Credit Board an important step was taken to close a gap in the credit organization. The discounting facilities, although less important, have proved a boon to those dairy companies which have taken advantage of them, and are well appreciated.<sup>1</sup> The rate charged on loans and discounts compares favourably with that from other sources. Advances to credit associations are made at 6 per cent., and these re-lend at 6½ per cent. The rate on direct loans and discounts is 6½ per cent. Loans made by other institutions would normally cost at least 7-7½ per cent., and in many cases would be higher.

34. Up to the present, the great majority of advances of all kinds have been to dairy farmers. As has been pointed out, it is likely to be easier to form credit associations in the more closely settled dairying districts in which co-operative dairy factories are already well established, while until recently the maximum loan of £1,000 was too small for sheep and mixed farming operations. In respect of discounts and loans made without the intervention of credit associations, dairy farmers are also at an advantage, since co-operative companies are able to act as guarantors who are acceptable to the Board. Another factor of some importance is the greater financial activity of stock and station agents in sheep and mixed farming districts because of the greater volume of commercial business, particularly in the disposal of produce, which normally may be expected to result.

<sup>1</sup> See Report, 1929, p. 26.

*E. Facilities to Sheep Farmers and Grain Growers*

35. With the increase in the limit for loans to £2,000 the system became more suited to the requirements of sheep farmers and grain growers than under the lower limit of £1,000, though it is still to be expected that developments among these classes of farmers will proceed more slowly. With a view to encouraging such an extension, the Board decided to introduce a special system of finance. "The essential feature of this special system is the provision of accommodation during the portion of the year in which no income is received, and during which considerable expenditure has to be incurred for living expenses, the purchase of stock, planting of crops, and farming purposes generally, only monies actually required being available from time to time. The system will enable farmers to arrange for accommodation from their associations, or direct from the Board, to meet outgoings during the "dead" season, to be discharged either wholly or in part according to the circumstances out of the proceeds of the wool, surplus stock, grain or other revenue."

36. The following conditions apply as between the borrower and the association or the Board:—

- "(a) The 'Limit' fixed in each case will not exceed the amount which the Board would be prepared to lend on the usual margins on the preferred security, due regard being paid to the value of collateral security offered.
- "(b) All existing encumbrances on the stock and chattels proffered as security will require to be discharged from the amount made available.
- "(c) The charge on stock, chattels, crops and/or land will be registered to secure present and future advances.
- "(d) Reasonable notice must be given by the borrower of additional advances required from time to time up to the 'limit' approved in each case.
- "(e) Interest is charged only on the amount owing by the borrower from time to time.
- "(f) The position of each borrower is reviewed annually when any variation of the 'limit' is considered."<sup>1</sup>

<sup>1</sup> Communication from the Commissioner, June, 1930.

37. During the "dead" season the outgoings of the sheep farmer or grain grower are very heavy. The above provisions enable the farmer to meet such requirements by means of a fluctuating advance which rises during the period of heavy outgoings, and falls as receipts enable it to be repaid. It therefore possesses much the same advantage as a fluctuating overdraft, and is an elastic form of credit which should commend itself to those for whom it was devised.

#### *F. State Assistance*

38. The success of the Rural Intermediate Credit System will be measured by the extent to which it directs the flow of investment to agriculture at reasonable rates. As has been indicated, funds may be obtained by a grant from the Consolidated Fund of up to £400,000 and by the issue of debentures up to a maximum of £5,000,000. Advances from the Consolidated Fund are to be free of interest for the period of ten years following the date of the first advance, and thereafter to bear interest at a rate determined by the Minister of Finance. By 30th June, 1929, advances totalling £197,100 had been made from the Consolidated Fund, and £70,700 had been raised by the issue of bonds and debentures.

39. While State assistance in the form of a tax-free loan in the early years of operation is desirable in order to facilitate the establishment of the system, yet it should rely on its own resources when once established. Until the volume of business has increased considerably, it is unlikely that the expenditure necessary for efficient management can be met without utilizing some monies advanced free of interest from the Consolidated Fund. Such assistance may be justified on the grounds that the net increase in economic welfare resulting from a successful system will more than outweigh the cost; but it should be relied on no longer than is necessary. The State grant should be kept at such a limit as will enable the Board to meet its expenses and make advances at a fair rate. Since each advance from the Consolidated Fund is for a period of not less than 20



years, there is no provision for gradual extinction before the period of 20 years has elapsed; but as soon as possible the rates charged on monies borrowed from the Consolidated Fund should bear at least the current rate on loans floated by the Government. Otherwise some incentive to efficiency will be removed or funds will be diverted to agriculture at a rate which is lower than is economically justifiable under normal circumstances.

#### *G. Assessment and Oversight of Security*

40. The important provision is that empowering the Board to issue debentures, and thereby enable it to utilize to the full the collective security represented by the assets which it holds. In actual fact the security will be somewhat greater than its reserves, mortgages, and other securities, by the amount which is received from the Consolidated Fund. Apart from this amount, the value of the security will depend upon the care exercised in valuing securities and on the margin which is allowed.

41. The usual practice is for securities to be valued by private valuers, appointed as the need arises. In some cases valuers have been nominated by associations or dairy companies; but in all cases their qualifications have first been considered by district boards and favourably reported on by them. While there is a possible danger that individual valuations may be made too high, as an incentive to future nomination by associations or companies, this is not likely to proceed very far. Loss on an advance due to over-valuation of the security would destroy future chances of a valuer's being accepted by the district boards. Supervision of securities is equally as important as proper valuation. It is expected that the formation of credit associations and insistence on guarantees in respect of direct loans will provide a strong incentive to independent and gratuitous supervision. Members of credit associations will endeavour to safeguard their shareholdings. "In an association well administered, with members properly cognizant of the ultimate benefit to themselves of keeping a reasonable watch

over the operations of other members indebted to the association, adequate supervision should be possible at a minimum of expense."<sup>1</sup> Similarly, the guarantors of independent loans will endeavour to safeguard their guarantees. "It is anticipated that particularly valuable services will be rendered where the guarantors are dairy companies, or stock and station companies and similar concerns, the existing organization of which will enable them to exercise a proper degree of supervision. In the case of private guarantors it will not, of course, be possible to rely to an equal degree upon the supervision exercised by them."<sup>2</sup>

42. There are obvious dangers in relying entirely on the above methods of supervision. These appear to be recognized by the Board, and the adequacy and reliability of the inspection will be tested by independent inspections, mainly by the farm inspecting staff of the Public Trust Office.<sup>3</sup> This method will also enable some check to be made on valuations. It will not be necessary to exercise direct oversight over all securities, since occasional "sample" inspections should enable the Board to form a reliable opinion as to the thoroughness and reliability of the supervision exercised by associations and companies. Where loans are guaranteed by individuals more complete inspection appears to be necessary. Apart from the above methods of supervision, a useful check is provided by the nature and extent of progress payments. Where payments are made by means of an order on butter-fat cheques, these furnish a guide to the productivity of the farm, while in the case of sheep and grain securities, proceeds must be paid in to the Board or association and serve as a useful index of the borrower's position. Where loans are granted through associations, periodical inspections of their books are a useful guide to any unsatisfactory features. In addition, adequate control over stock changes is provided in all cases by the registration of the chattels security taken by the Board or association, and the safeguard that proceeds from the

<sup>1</sup> *Report of Rural Intermediate Credit Board, 1928, p. 22.*

<sup>2</sup> *Op. cit., loc. cit.*

<sup>3</sup> *Report, 1929, p. 32.*

partial realization of the stock must be paid in to the Board or association.<sup>1</sup>

43. It is clear from the general policy of the Board that it endeavours to safeguard as carefully as possible the value of the securities accepted against loans. While the Board takes into account the personal element in security, as well as other factors, it is no part of its intention to provide facilities for those whose security is such that they are unable to obtain finance from other sources. Nor are refusals confined to cases where the security offered is inadequate. "In some cases it has been apparent that the farming proposition is, in view of liabilities attaching to it, economically so unsound that the applicants will not be in a position to continue for long with their operations. Where this is the position, it is felt that no relief would be afforded by the granting of a loan out of the Board's funds, while there would be grave risk of loss of the Board's funds, which it would be improper for the Board to incur in view of its responsibility to debenture holders."<sup>2</sup> Further, the Board regards with disfavour the granting of loans against the security of land, except where a good margin of equity in the land would still remain.

#### H. Organization and Administration

44. There remains to consider briefly the general organization and administration of the system. It will be clear from the analysis of the Act which has been made in the preceding pages, that the system is one of organization from above. The first step was the creation of a central *ad hoc* body which proceeded to facilitate the organization of district boards and credit associations, and which enabled existing institutions to act as guarantors against direct loans. In this respect it follows the plan of the Federal Intermediate Credit System rather than that of the Raiffeisen system.

<sup>1</sup> Report, 1929, p. 32.

<sup>2</sup> Report, 1929, p. 13. In many instances, where security has been inadequate, but where the personal risk has been a good one, the district boards have suggested better financial arrangements in regard to leases, mortgages or other liabilities, or improved methods of farming with a view to improve this security.

Enthusiastic supporters of the co-operative principle might have preferred a system based on local co-operative societies, and building up towards a central co-operative association or bank. It is certain, however, that such a system would not have been brought into being. Some central organization was necessary, both to initiate the system and develop its framework. Local associations would not have arisen spontaneously and the central organization would therefore never have existed. In any case, local associations would have had great difficulty in obtaining finance without the existence of such a body, and if instituted, would in most cases have died in infancy. A body, such as the Farmers Union or the National Dairy Association, might conceivably have taken the initial step, but it is doubtful whether it would have been successful in raising the necessary funds. There was little to stop private enterprise from obtaining the necessary statutory powers to establish intermediate credit machinery had it chosen to do so; but it did not choose so to do. All things considered, the setting up of an *ad hoc* body by the State was the most satisfactory method of approach to the intermediate credit problem.

45. The important question is not whether the system conforms to the principle of this organization or that, but whether it fulfils its objective of directing resources to agriculture expeditiously and on reasonable terms. This depends on: (a) The extent to which confidence is engendered in the minds of investors as to the reliability of the security. (b) The cheapness of administration. (c) The extent to which the machinery set up provides for the consideration and granting of loans without unnecessary delay. In the opinion of the present writer the system is well suited to achieve these ends. The nature of the security against debentures and the methods of valuation and supervision of securities adopted are such as to safeguard the interests of debenture holders, so that there are reasonable hopes that adequate funds will be forthcoming. The administrative machinery should ensure that the system will be operated at a reasonable cost and loans granted with reasonable

expedition. On the Central Board and the District Boards, full use is made of the services of amateur administrators; that is, amateur in the sense that members are not engaged wholly in the work of the Board. These, however, have been appointed by virtue of special qualifications for their task. Although the work of the Rural Intermediate Credit Board does not form part of the business of the Public Trust Office, yet the method of organization permits the use of its officers, and places an efficient and widespread organization at the service of the Board. The cost of setting up a separate organization has thereby been avoided.

46. The establishment of district boards places a fund of local knowledge and practical experience at the disposal of the central board. Power has been given to the district boards to advance loans up to £250, and to furnish recommendations for the guidance of the central board in respect of larger amounts. This ensures a large measure of decentralized administration and avoids unnecessary delay.<sup>1</sup> In addition, the boards have been requested from time to time to deal with matters requiring local knowledge, such as the nomination of valuers, the adoption of standard values for stock, the question of keeping current accounts for farmers, and other matters.<sup>2</sup> Finally, credit associations, dairy companies, and other institutions, provide the necessary machinery to enable intending borrowers to establish contacts with the Board and render available an important fund of gratuitous service for the use of the Board in the granting of loans, the collection and transmission of interest and principal, and the supervision of securities. There is no

<sup>1</sup> Some criticism has been made that undue delays have occurred on the part of the central office. In the early stages some such delay might be expected, but the Board is fully alive to the need for prompt action, and there seems little ground for general complaint. In the *Report* for June, 1929, the Commissioner reviews complaints on the part of a director of an association which were given wide publicity. It then appeared that the majority of the applications had been granted within one, two, or three days after their arrival at the office, and that "as regards five-sixths of the applications received from the association, the average time taken in reaching a decision was four days." (P. 14.) The remaining applications necessitated further information before they could be granted.

<sup>2</sup> *Report*, 1928, pp. 7 and 8.

doubt that, as experience accumulates, the Board will be able to improve its organization, administration, and methods; but the framework is excellently devised and the Board may claim to have laid the foundations of a system which will promote increased productive efficiency and improve materially the economic welfare of the rural community.

## CHAPTER VI

# SHORT TERM AGRICULTURAL CREDIT IN GREAT BRITAIN

1. The nature of the short term agricultural credit system in Great Britain has depended more on the character of the country's banking system than on the character of its agriculture. Unlike many European countries, Great Britain has not developed specialized machinery for the provision of short term loans to farmers, but has relied mainly on the ordinary facilities provided by the commercial banks and upon credit granted by tradespeople. A certain amount of short term credit has also been, and still is, extended by landlords to tenants where rent, nominally payable at certain dates, is actually paid some months later.

### 1. COMMERCIAL BANKS

2. During the latter part of the nineteenth century, rural banking was largely developed by means of privately owned country banks which had on their books a large number of farmer customers. Credit was extended to these customers to a considerable extent upon the personal knowledge which the bank possessed of the farmers. But with the rapid development of the modern joint stock banking system, which took place during the late years of the past and early years of the present century, the private banks were absorbed by the great joint stock banks, and at the same time a considerable extension occurred in the number of branches of these banks. So widely has this movement spread that to-day a branch of one of the great banks is to be found in most substantial villages, while the majority of these branches belong to one or another of the six great joint stock banks which now cover a greater part of the entire field of commercial banking. These banks, therefore, have

become the main credit institutions from which the farmer obtains short term loans.

3. The banks lend to farmers mainly by way of overdraft upon their current account, such overdraft being granted on their personal knowledge of their customers, on the security of a personal guarantor, or on some definite collateral security. A farmer of good standing, who has been a customer for many years and with whose business the bank is fairly familiar, has little difficulty in normal times in obtaining accommodation on his personal reputation alone. In the case of small farmers, or where special circumstances require it, some other security is often used. Not infrequently the farmer deposits with the bank some collateral security against which he will be allowed an overdraft up to a certain limit. Such security may be the title deeds of the farm, if the borrower owns the freehold; it may be industrial stocks or shares, or it may be a life insurance policy, the bank then lending against the surrender value of such a policy.

4. The system is well adapted to the taste and general disposition of British farmers; it is secret, simple, and elastic. It has however not infrequently been subjected to the general and somewhat vague criticism that the banks have been "unsympathetic" in their dealings with farmer customers. Those who recollected the more intimate relationships with the old private banks asserted that local managers have less discretion with regard to loans than the former type of country banker, that the system is too rigid, and that the obligation upon managers to refer exceptional cases to the head office of the Bank in London, increased the difficulty of obtaining adequate accommodation.

5. This criticism was examined by a Committee, appointed by the Minister of Agriculture in 1922, to investigate the question of agriculture credit. On the point just referred to, the Committee reported as follows:—

"On behalf of the banks, it has been pointed out that relatively more agricultural loans are, in fact, outstanding to-day than in



the days of the small private banks. The fact that all applications for overdrafts are referred to the Head Office for approval no doubt accounts for some of the criticism to which the banks have been subjected, though, in actual practice, the older and more experienced managers are allowed considerable latitude. Moreover, where applications are refused, it is possible that the local managers seek refuge from the unpopularity of adverse decisions by throwing the onus on to the Head Office. The banks have always regarded the farmer as a good customer and they are anxious to maintain and, where possible, to develop their agricultural connexion, there being very keen competition between them for that purpose. They claim to appreciate fully the farmer's difficulties at the present time, and their policy is to be as helpful as possible, consistent with their responsibility to their depositors. With the great majority of farmers an overdraft is a routine arrangement for a part of the year. The farmer who is enterprising, keeps books and knows his way about the world, has little difficulty in obtaining credit, and even the less enterprising type of farmer is more afraid of the bank than the bank is shy of him. In some cases of complaint, it transpires that the farmer is carrying on some other business, doing badly at it, and trying to play off one bank against another. To any ordinary farmer, of whom the banks have personal knowledge, they would, if necessary, give credit on his crops alone, although they can take no legal charge. In the fruit-growing districts of Evesham and Pershore, for instance, growers obtain credit from the banks on what the manager can see for himself on the trees. The banks realise that the liquidation of agricultural loans is a longer process, as a rule, than the repayment of purely commercial advances, but there is a constant ebb and flow of money from and into the farmer's account, which means good business, although the loan account may not be cleared rapidly. In the country districts, an overdraft, unspecified as regards purpose, is more common than definite loans for particular requirements. The overdraft is reduced or extended according to the daily or weekly alternations of receipts and expenditure of the farmer concerned."<sup>1</sup>

## 2. CREDIT FROM TRADESPEOPLE

6. (a) *Auctioneers*.—It has been a common practice in many counties for farmers to obtain credit from auctioneers, the latter allowing credit on purchases of live stock, provided the farmer agrees to sell the cattle, sheep or lambs born

<sup>1</sup> *Report of the Committee on Agricultural Credit, 1923.* Cmd. 1810, pp. 20—21.

from the latter through their markets. Undoubtedly the auctioneer in such case is well placed to estimate the value of the security upon which the credit is granted. The chief disadvantage from the farmer's point of view is that it restricts his freedom in marketing and may therefore result in his failing to obtain the best price for his produce.

7. (b) *Merchants and Dealers.*—Credit from merchants is almost universal. A farmer may buy seeds from a merchant on credit, leaving the repayment of the debt until after harvest. Very long credit is sometimes given and, although no statistics are available, there is little doubt that a large sum in the aggregate is lent to farmers in this way.

8. In a similar way dealers often supply cattle to farmers on credit. In both cases the granting of credit may be accompanied by an arrangement by which the farmer agrees to sell the crops when harvested, or the live stock when fattened, through the merchant or dealer who allowed the credit. Merchants and dealers have undoubtedly rendered an important service to farmers in this way. The system has, however, always been open to the objection that the farmer does not know what he is paying for the credit thus provided, and, where it involves some kind of reciprocal agreement in regard to the sale of his produce, the farmer's freedom in marketing is restricted. Both these objections, in so far as they are true, are fundamental.

9. The first attempt to establish by legislation a specialized system of short term agricultural credit in Great Britain was under the Agricultural Credits Act, 1923. It was the outcome of the investigation by the Committee on agricultural credit, appointed in 1922, to which reference has been made above. After a general consideration of the problem, the committee came to the conclusion that "the most effective way of increasing the farmer's credit status is by inducing him to link up his credit with that of his fellows. This is the principle of co-operative credit which has been successfully applied to the case of farmers in other countries, and we are convinced that it is in this direction that a

solution of the short term credit problems of agriculture in this country should be sought."<sup>1</sup>

10. The actual form of organization recommended by the committee differed widely from the European models; indeed, the committee came to the conclusion that any attempt to form credit societies in Great Britain without direct State aid would be futile, and that it would be impossible to adopt the "Raiffeisen principle of unlimited liability."<sup>2</sup>

### 3. THE AGRICULTURAL CREDITS ACT, 1923

11. Under Section 2 of the Agricultural Credits Act, 1923, powers were given to the Minister of Agriculture to promote the formation of credit societies for which the loanable funds were mainly provided by the State.

12. The general principles governing the formation and establishment of these societies were as follows. Each society covered a certain district which had to be defined in its rules. It was intended that in most cases the district should be a small one, including a few contiguous parishes, within which the members would be fairly well known to each other. The membership was to be unlimited and to consist of persons holding at least one share of £1 upon which 5s. had been paid up. The Minister of Agriculture was empowered to make advances to each society at the rate of £1 for each £ share so held. The total loanable funds of the society consisted, therefore, of 5s. per share paid by members, and £1 per share loaned to the society by the State. The State loan was secured by a floating debenture on the whole of the society's assets, including its uncalled share capital.

13. Each society was in turn empowered to make loans to its members, provided that any loan so made would not raise the member's indebtedness to the society to a sum exceeding £5 for each share held by him; that such loans

<sup>1</sup> *Report of the Committee on Agricultural Credit.* Cmd. 1810, p. 27.

<sup>2</sup> *Ibid.*, p. 28.

were limited to a period of five years and that they were limited also to an amount not exceeding a tenth part of the share capital of the society for the time being issued.

14. Model rules for the operation and management of Agricultural Credit Societies under the above Act were issued by the Ministry of Agriculture, and every set of rules actually adopted by a society on formation was based on this model, subject only to the necessary modifications to meet special conditions. Under Section 2 of the Act the powers of the Minister to make advances to Credit Societies were limited in the first instance to three years, and continuation after that period was made subject to Treasury sanction.

15. It will be clear from the above description that the structure of these societies differed very widely from the Continental models. The English societies did not, in fact, carry on a banking business at all, as was the case with the Raiffeisen and other co-operative credit societies on the Continent. While the Act did not expressly exclude the taking of deposits by credit societies, its intention was that the loanable funds should be supplied by the State, and, in fact, this method was exclusively adopted.

16. Immediately on the passing of the Act, steps were taken by the Agricultural Organization Society to promote the formation of credit societies, but from the outset they found a very meagre response by farmers. The scheme, in fact, proved ultimately to be a failure, and, on the expiration of the three years referred to above, it was decided that further advances to existing societies should be discontinued after a short interval. In actual fact, a total of nine societies was registered under the Act of 1923, of which three never started operations. The others continued to operate on a small scale but never showed any signs of developing in the manner which had been expected.

#### 4. THE AGRICULTURAL CREDITS ACT, 1928.

17. The next step in the development of short term credit was the passing of the Agricultural Credits Act in 1928.

It followed upon the publication by the Ministry of Agriculture, two years earlier, of the *Report on Agricultural Credit*, to which reference has already been made in previous chapters. As it was based on very different considerations from those underlying the Act of 1923, it is necessary for a proper appreciation of its provisions to describe some of the ideas which led up to it.

18. Put in a nutshell, the Act was based on the idea that difficulties in the way of developing a more satisfactory short term credit system lay not so much in a paucity or inadequacy of lending institutions (as in some foreign countries), but rather in the fact that agriculture suffered from its own inherent disabilities as a borrower, disabilities which did not arise through any fault of the farmers themselves, but out of the structure of modern agriculture and the law which governed its credit transactions.

19. It has already been pointed out that branches of the great joint stock banks are now widely scattered in rural areas, and physical access to a bank is usually not a matter of difficulty. But physical access is not the only requisite. Equally important is the nature and legal status of the security which the farmer can offer. For on the amount and value of such security must depend the amount of the accommodation which the bank can give. The farmer borrows from the bank largely on his personal reputation; where a definite security is deposited with the bank, the tenant farmer has hitherto been limited to securities of a *non-agricultural* character, such as industrial stocks and shares, life insurance policies, etc. Now the chief asset of the tenant farmer is the agricultural wealth which his own industry creates, the stock and crops upon the farm, and under the existing system these were at least not fully available as a direct security for bank advances. The banks, in lending by way of uncovered overdraft, have usually made it a practice to obtain from the farmer a rough statement of his position, including a statement of his ordinary farm assets, and upon the position thus disclosed the amount of the accommodation has been determined. The

banks have therefore taken the value of these assets into account, but the farmer was still without a satisfactory legal means of charging them in favour of the bank in cases where such a course would have been advantageous. In principle it seemed right that the farmer, like any other producer or trader, should be able, if he wished, to borrow by means of a charge upon his stock-in-trade.

20. Now, certain other factors came under consideration in this connexion. Firstly, the credit furnished to farmers through tradespeople was to a very large extent derived from the banks. The merchant who had a large number of debts on his books owing to him from his farmer customers had in turn borrowed from his bank in order to lend to the farmer. The merchant acting thus as an intermediary, assumed a certain risk which in one way or another had to be paid for. It was thought desirable, therefore, that the farmer should at least be given facilities whereby he could, if he so desired, substitute direct for indirect bank credit, taking advantage of the "discount for cash" terms often allowed by agricultural merchants.

21. At the same time an entirely different suggestion was put forward in certain quarters. Why did not the Government establish an "agricultural bank," that is to say, a bank which would be principally engaged in financing the short term operations of agriculture? Such an institution it was claimed would have the advantage of being able to study and understand the credit needs of farmers much more thoroughly than was possible in the case of the ordinary joint stock banks.

22. The proposal was, however, open to a serious if not fatal objection. Even if such a bank could have been established with a sufficient number of rural branches to give to farmers reasonable access to it—and that alone would have involved heavy expense—there still remained a much more serious obstacle. In order to function as a bank the institution would have had not merely to make loans, but to receive deposits. To obtain deposits it would have had to have

faced the formidable competition of the joint stock banks. By some means or other it would have had to attract the flow of rural savings to itself, and away from the banks. The impregnable financial strength of the great banks, however, which command the confidence of every individual depositor, would have given them a decisive advantage in competition with a new and untried institution, an advantage which might alone have proved fatal to the efficient development of an agricultural bank.

23. All these considerations pointed to the conclusion that, having regard to the nature and extent of the existing banking facilities, the problem of short term agricultural credit was not so much a question of establishing new lending institutions, as of equipping agriculture as completely as possible as a borrower from the existing banks; to enable it fully to utilize the security of its primary asset, the wealth which the industry itself creates.

24. This was the purpose of the part of the Act dealing with short term credit.

#### **5. THE SHORT TERM PROVISIONS OF THE AGRICULTURAL CREDITS ACT, 1928**

25. The Act (which applies only to England and Wales) enables a farmer to create in favour of a bank a charge, called an "agricultural charge," on his farming stock and other agricultural assets as security for an overdraft or for any sum to be paid to him under a guarantee by the bank.

26. A farmer is defined as a person who, as tenant or owner of an agricultural holding, cultivates the holding for profit, but the definition does not include an incorporated company or society. Farming stock is defined as meaning crops or horticultural produce, whether growing or severed from the land, and after severance, whether subjected to any treatment or process of manufacture or not; live stock, including poultry and bees and the produce and progeny thereof; any other agricultural or horticultural produce, whether subject to any treatment or process of manufacture or not; seeds

and manures; agricultural vehicles, machinery, and other plant; agricultural tenants' fixtures and other agricultural fixtures which a tenant is by law authorized to remove. The phrase "other agricultural assets" means a tenant's right to compensation under the Agricultural Holdings Act, 1923, for improvements, damage by game, disturbance or otherwise and any other tenant right.

27. An agricultural charge may be either a fixed charge or a floating charge or both. A fixed charge is a charge on such property forming part of the farming stock and other agricultural assets of the farmer at the date of the charge as may be specified in the charge, but may include, in the case of live stock, any progeny thereof born after the date of the charge, and in the case of agricultural plant any plant which may, whilst the charge is in force, be substituted for the plant specified in the charge.

28. An agricultural charge applies only to farming stock and other agricultural assets belonging to the farmer who creates the charge and therefore would not apply to "agisted" stock upon the farm or to any stock vested in some other owner.

#### 6. FORM OF A FIXED CHARGE

29. The Act states that an agricultural charge may be in such form and upon such conditions as the parties thereto may agree. It was clearly left as elastic as possible in order that its form might be designed to meet the convenience both of the borrower and the bank. There is thus no statutory form, but certain sections of the Act indicate what the form should contain. The following points must be stated in a fixed charge:—

- (a) The event or events which would authorize the bank to seize the property which is subject to the charge (see below);
- (b) The interval which is to elapse between the seizure of the property and its sale.



## 7. EFFECT OF A FIXED CHARGE

30. A fixed charge, so long as it remains in force, confers on the bank certain rights and imposes on them certain obligations:—

- (a) The right, upon the happening of any event specified in the charge as being an event authorizing the seizure of the property subject to the charge, to take possession of the property, and after an interval of five clear days or such less time as may be allowed by the charge, to sell it;
- (b) An obligation to apply the proceeds of the sale in the discharge of the liability secured by the charge.

31. As regards the farmer, a fixed charge imposes upon him the obligation, whenever he sells any of the scheduled property or receives any money in respect of the other agricultural assets comprised in the charge, to pay the money to the bank, except to such extent as the charge otherwise provides or the bank otherwise allows. The sum so paid must be applied by the bank (except so far as otherwise agreed) towards the discharge of liabilities secured by the charge. The Act also provides that in the event of the farmer receiving any money under any policy of insurance on any of the property comprised in the charge, or any money paid by way of compensation under the Diseases of Animals Acts, 1894 to 1927, in respect of the destruction of any live stock comprised in the charge, or by way of compensation under the Destructive Insects and Pests Acts, 1877 to 1927, in respect of the destruction of any crops comprised in the charge, he shall forthwith pay the amount of the sums so received to the bank, except to such extent as the charge otherwise provides or the bank otherwise allows.

32. The general effect of these provisions leaves the farmer complete freedom to market the produce of the farm when and where he pleases, without prior consultation with the bank, provided only that he pays the proceeds of such sale forthwith to the bank.

## 8. THE EFFECT OF A FLOATING CHARGE

33. A floating charge means a charge upon the farm stock or other agricultural assets from time to time belonging to the farmer, or such part thereof as is mentioned in the charge. The position of the parties under a floating charge is much the same as that under a fixed charge, the only important difference being a provision which exempts the farmer from the need to pay the proceeds of sale of farm stock or monies received in respect of other agricultural assets or insurance or compensation, to the bank, if, and so far as, such money is expended by him in the purchase of farming stock which on purchase becomes the subject of the floating charge. If, for example, a farmer sells a number of bullocks at an auction which at the time are the subject of a floating charge on the whole of his live stock, he is entitled to spend the money received in purchasing new stock, which becomes subject to the charge, without paying the proceeds of the sale into the bank.

## 9. PRIORITY OF AN AGRICULTURAL CHARGE

34. Agricultural charges have, in relation to one another, priority in accordance with the times at which they are respectively registered under the Act. When a floating charge has been created, then a subsequent fixed charge or a bill of sale on the same property or any part of it is "void so long as the floating charge remains in force." A further provision states that an agricultural charge shall be no protection in respect of property included in the charge which, but for the charge, would have been liable to distress for rent, taxes or rates. Subject to this last provision, the bank holding an agricultural charge ranks as a secured creditor.

## 10. THE POSITION IN THE CASE OF BANKRUPTCY OF A BORROWER

35. The Act provides that if a farmer becomes a bankrupt within three months of the date when the charge was created, the amount secured to the bank by the charge shall be

reduced by the amount due immediately before the execution of the charge, unless it is proved that the farmer was solvent when he gave a charge. In other words, where a farmer who owes money to his bankers is insolvent, the bank cannot improve their position at the expense of other unsecured creditors by taking an agricultural charge, if the farmer then becomes a bankrupt within three months of the date of the charge.

### 11. REGISTRATION

36. When a charge has been agreed upon between the borrower and the bank it must be registered. Registration is effected by the bank sending by post to the Agricultural Credits Superintendent, H.M. Land Registry, Lincoln's Inn Fields, London, W.C.2, a memorandum in a prescribed form, which contains certain particulars of the charge. These memoranda are filed by the Registry and are open to public inspection. The legal effect of registration is to give actual notice of the charge to all the world, but a provision of the Act states that where an agricultural charge created in favour of a bank is expressly made for securing a current account or other further advances, the bank, in relation to the making of further advances under the charge, shall not be deemed to have notice of any agricultural charge, by reason of the fact that it is so registered, if it was not so registered at the time when the first-mentioned charge was created, or when the last search, if any, by or on behalf of the bank was made, whichever last happened. This provision gives protection to the bank where it allows a farmer to increase his overdraft against the security of an agricultural charge, even though a subsequent charge were created by the farmer for a different purpose.

### 12. RESTRICTION ON PUBLICITY

37. The Act provides that it shall not be lawful to print for publication, or publish, any list of agricultural charges or the names of farmers who have created them. It, however, expressly allows an association representative of a particular trade to notify confidentially the fact of the creation of a

charge to its members trading or carrying on business in the district in which the property subject to an agricultural charge is situate. The primary purpose of this provision is (while giving facilities to other creditors of the farmer whose interests might be vitally affected) to ascertain whether or not an agricultural charge had been created, and at the same time to prevent damage to the farmer's credit which, it was feared, might occur by the publication of his name in newspapers whenever he secured an advance from the bank by means of an agricultural charge.

### 13. CO-OPERATIVE SOCIETIES

38. A registered co-operative society is empowered under the Act to issue a debenture in favour of a bank creating a floating charge on property vested in the society, which is "farming stock" within the meaning of the Act.

39. Such are the main features of the short term agricultural credit system embodied in the Act of 1928. Power to create some form of legal charge over farming stock is not an uncommon feature of legislation in a number of countries dealing with credit. But it will be easily seen that the special feature of the Act of 1928 is that an agricultural charge can be created only in favour of a bank. In effect, it places in the hands of farmers the means by which they can, if they so desire, substitute direct bank credit for other forms of short term credit, a means by which they will know exactly the cost of credit and by which they can avoid the credit entanglements which sometimes are involved in borrowing from auctioneers or other tradespeople.

40. The Agricultural Credits Act, 1928, only applies to England and Wales, but it was followed in 1929 by the Agricultural Credits (Scotland) Act, which made certain provisions in regard to short term loans. Although this Act follows the general principles of the former Act, it differs materially in its method of application of these principles. In the first place the powers to create an agricultural charge may be exercised only by a society registered in Scotland

under the Industrial and Provident Societies Acts, 1893 to 1928, and "having for its principal object, the provision and sale of agricultural requisites to its members, or the sale, either after a process of manufacture or otherwise, of agricultural produce purchased from its members." In the second place the property which may be affected by such a charge is defined as "the stocks of merchandise from time to time belonging to the society in pursuance of the objects which it has been formed to carry out." An agricultural charge may be created only in favour of a bank, and gives to the banks similar rights to those under the English Act in respect of the seizure and disposal of property which is the subject of the charge.

41. The procedure as to registration of agricultural charges in Scotland is similar to that in England, the Register being kept by the Assistant Registrar of Friendly Societies for Scotland. It will be seen therefore that the Scottish Act is much smaller in scope than is the case with the English measure.

42. As to the ultimate consequence of this legislation, it is too early to make any forecast. It will depend partly on the attitude of farmers, partly on that of merchants and tradespeople, whose interests are undoubtedly affected, and to some extent on that of the banks. The habits of farmers in such matters are deeply rooted; their prejudices perhaps no less deeply rooted. The lack of a clear understanding, particularly amongst small farmers, on the efficient use of credit, or its cost, and on the correct way of applying it in a farming enterprise are things which have in the past retarded the development of a more efficient system of agricultural finance. The Act of 1928 at least gives the farmer a means of obtaining short term accommodation from the source which, in the long run, is not only the most important but probably also the cheapest; it also gives him the means of securing such accommodation upon what is by far the greatest asset of the tenant-farming industry, the wealth which is actually created on the farm.



## **APPENDICES**

## APPENDIX I

### A NOTE ON AMORTIZATION

1. Amortization may be defined as the extinction of a debt by means of a sinking fund.

2. The purpose of amortization is to enable a loan to be repaid out of income during the period for which it is current. The method therefore provides normally for the principal to be liquidated by means of small periodic payments. Herrick<sup>1</sup> distinguishes four methods by means of which amortization may be applied:

3. The first method consists in repaying the loan by equal instalments. The borrower agrees to repay a given amount at annual, semi-annual or quarterly intervals, as well as interest on the balance outstanding. Under this method the borrower makes a uniform amortization payment from time to time and a diminishing interest payment. In some cases provision may be made to enable the borrower to increase the amount of his instalments towards the end of the period, as his ability to do so increases through the decline in his interest payments.

4. Under the second method, which is adopted by the German *Landschaften*, the borrower pays interest on the loan, together with an additional amount of, say, one-half per cent. of the loan during the whole period for which it is outstanding. The extra payment is then put into a sinking fund and invested. When the amount thus accumulated, together with the amount it earns at compound interest is sufficient, the proceeds are used to redeem the debentures outstanding against the loan.

5. The third method is very similar. A fund to redeem the loan is accumulated in the same way, but is deposited with the lending institution at compound interest until the total amount accumulated equals the amount of the loan, which is then extinguished. This method is adopted by Austrian and German savings banks. The second and third methods possess the disadvantage that the date of extinction of the debt cannot be determined in advance, since the rate of accumulation of the fund depends on the rate of interest it earns, and this fluctuates from time to time.

<sup>1</sup> *Rural Credits*, Ch. III.



6. Finally, is the so-called French method of amortization, which is perhaps most commonly used, and to which the term amortization most properly applies. Under this system the borrower pays a fixed annual or semi-annual sum during the currency of the loan. This sum depends on the length of the loan and the rate of interest charged. In addition to the ordinary interest rate, is paid a certain percentage of the principal. The shorter the period over which the loan is to be amortized, the greater will this amount be. The difference between the total annuity and the interest on the amount of the loan outstanding from time to time, is applied to reduce the principal. Hence, as time goes on, the principal is diminished at an increasing rate, the interest charge is steadily reduced, and an increasing proportion of the annuity is utilized to amortize the debt. It should be noted that this method amortizes a loan more rapidly than either of the two preceding methods, since the interest *saved* is likely to be greater than the interest *earned*. This arises because borrowers will usually pay a higher rate of interest on their advances than the *net* earnings of the lending institutions on the funds which they accumulate by means of the instalment payments.

7. The following table, prepared by the Federal Farm Loan Board of the United States, serves to illustrate the manner in which amortization operates. The loan is one of \$100 at six per cent. and is amortized in 33 years by means of a semi-annual payment of \$3.50. The table is self-explanatory and scarcely calls for special comment.

8. The method of amortization undoubtedly possesses some advantages over the "straight" mortgage system of making advances. Normally, an amortizable loan is for a longer period and therefore avoids the necessity for renewals which may require to be negotiated in times of stringency and which are frequently costly. It enables the farmer to pay off his advance by means of small instalments which he is likely to look upon as a normal expense to be covered, and which would probably not be accumulated to the same extent if such provision were not made. Amortization is therefore an encouragement to thrift and enables the loan to be repaid out of income without undue strain.

9. The actual amount which must be paid in interest and principal is also much less than in the case of a "straight" mortgage for the same period. Thus, the total payment made on a loan for \$100 at 6 per cent. amortized in 33 years is \$230.34, of which \$100 represents actual repayment of principal and \$130.34 represents interest. A loan which remained at its full

## THE PROVISION OF CREDIT

LOAN OF \$100 AT 6 PER CENT. INTEREST REPAYABLE IN 33 YEARS BY  
 MEANS OF A SEMI-ANNUAL INSTALMENT OF \$3.50, WHICH INCLUDES  
 INTEREST AND PART OF THE PRINCIPAL.

Pay- ment No.	Instal- ment.	Inter- est.	App- lied on prin- cipal	Prin- cipal still un- paid.	Pay- ment No.	Instal- ment.	Inter- est.	App- lied on prin- cipal	Prin- cipal still un- paid.
	\$	\$	\$	\$		\$	\$	\$	\$
1	3-50	3-00	.50	99-50	35	3-50	2-13	1-37	69-75
2	3-50	2-98	.52	98-98	36	3-50	2-09	1-41	68-34
3	3-50	2-97	.53	98-45	37	3-50	2-05	1-45	66-89
4	3-50	2-95	.55	97-90	38	3-50	2-01	1-49	65-40
5	3-50	2-94	.56	97-34	39	3-50	1-96	1-54	63-86
6	3-50	2-92	.58	96-76	40	3-50	1-92	1-58	62-28
7	3-50	2-90	.60	96-16	41	3-50	1-87	1-63	60-65
8	3-50	2-88	.62	95-54	42	3-50	1-82	1-68	58-97
9	3-50	2-87	.63	94-91	43	3-50	1-77	1-73	57-24
10	3-50	2-85	.65	94-26	44	3-50	1-72	1-78	55-46
11	3-50	2-83	.67	93-59	45	3-50	1-66	1-84	53-62
12	3-50	2-81	.69	92-90	46	3-50	1-61	1-89	51-73
13	3-50	2-79	.71	92-19	47	3-50	1-55	1-95	49-78
14	3-50	2-77	.73	91-46	48	3-50	1-49	2-01	47-77
15	3-50	2-74	.76	90-70	49	3-50	1-43	2-07	45-70
16	3-50	2-72	.78	89-92	50	3-50	1-37	2-13	43-57
17	3-50	2-70	.80	89-12	51	3-50	1-31	2-19	41-38
18	3-50	2-67	.83	88-29	52	3-50	1-24	2-26	39-12
19	3-50	2-65	.85	87-44	53	3-50	1-17	2-33	36-79
20	3-50	2-62	.88	86-56	54	3-50	1-10	2-40	34-39
21	3-50	2-60	.90	85-66	55	3-50	1-03	2-47	31-92
22	3-50	2-57	.93	84-73	56	3-50	.96	2-54	29-38
23	3-50	2-54	.96	83-77	57	3-50	.88	2-62	26-76
24	3-50	2-51	.99	82-78	58	3-50	.80	2-70	24-06
25	3-50	2-48	1-02	81-76	59	3-50	.72	2-78	21-28
26	3-50	2-45	1-05	80-71	60	3-50	.64	2-86	18-42
27	3-50	2-42	1-08	79-63	61	3-50	.55	2-95	15-47
28	3-50	2-39	1-11	78-52	62	3-50	.46	3-04	12-43
29	3-50	2-36	1-14	77-38	63	3-50	.37	3-13	9-30
30	3-50	2-32	1-18	76-20	64	3-50	.28	3-22	6-08
31	3-50	2-29	1-21	74-99	65	3-50	.18	3-32	2-76
32	3-50	2-25	1-25	73-74	66	2-84	.08	2-76	—
33	3-50	2-21	1-29	72-45					
34	3-50	2-17	1-33	71-12		230-34	130-34	100-00	—

(Treasury Department, Federal Farm Loan Bureau, Circular No. 18, 1924.)

amount until maturity would necessitate a total payment of \$298, of which amount \$100 would represent principal and \$198 would represent interest. The total saving is therefore \$67-66. This comparison is, of course, unduly simplified. Most loans would require to be renewed several times during the period, and in many cases some reduction of principal would be made on renewal. Hence, the total interest payment would probably be somewhat less than \$198. This saving would be partially

offset by the expense of renewal as the loan fell due from time to time. Allowing for both these factors, there still remains a substantial advantage in favour of amortization.

10. This advantage is strengthened when the mortgagor is enabled to make instalment payments in advance. Such a provision is made by the State Advances Department of New Zealand which permits the mortgagor to pay, at any time, the whole balance of principal owing and obtain a discharge of his mortgage. The mortgagor may also make payments in sums of £5 or multiples thereof, which, at the next instalment due date may be applied:—

- (a) "In payment of the half-yearly instalments (consisting partly of interest and partly of principal) as they fall due, until the deposit is exhausted, or,
- (b) "In payment of as many future half-yearly instalments of principal (but not of interest) as it will cover, and, as far as such instalments are concerned, the corresponding interest will not be charged. On the next half-yearly date, however, the mortgagor will be required to continue his payments as before, the advance payment having the effect of reducing the period during which he would have to pay such instalments. For instance, a mortgagor has a loan of £100 at 6½ per cent. for a term of 36½ years. On the due date of his eighth half-yearly instalment he pays, in addition to the amount due, a sum of £5. This is applied in payment of his ninth, tenth, eleventh, twelfth, thirteenth, fourteenth, fifteenth, sixteenth, and seventeenth instalments of principal—9s. 5d., 9s. 9d., 10s. 1d., 10s. 4d., 10s. 8d., 11s. 0d., 11s. 5d., 11s. 9d., 12s. 1d., making a total of £4 18s. 6d., and the corresponding interest—£3 0s. 6d., £3 0s. 2d., £2 19s. 10d., £2 19s. 7d., £2 19s. 3d., £2 18s. 11d., £2 18s. 6d., £2 18s. 2d., £2 17s. 10d. (which has not begun to accrue) is not charged. A balance of 3s. 6d. remains in his favour. Then on the next due date he has to make the half-yearly payment as usual (less 3s. 6d.), but, instead of being the ninth, it counts as the eighteenth instalment, and by this means the whole loan is repaid four years and a half earlier (nine half-yearly payments) than it otherwise would be."

11. Provision is also made for the readjustment of loans:—

"On the due date of any instalment, after at least one-tenth of the loan has been repaid by means of the half-yearly instalments or of monies repaid in advance, or both, the mortgagor (provided he is not in arrear with any instalment or other payment due under the mortgage) may, with the consent of the Superintendent, readjust the loan by treating the balance of principal then unpaid as a fresh loan duly granted on that date for a fresh term. But no readjustment is allowed to an amount less than £100. Under this arrangement the mortgagor will be relieved of paying interest on the original amount of the loan, and will pay only on the balance of principal owing."<sup>1</sup>

<sup>1</sup> Bulletin, State Advances Offices, 1st April, 1927.

12. The provision that additional instalment payments may be made at any time possesses the advantage that farmers may utilize small surpluses to amortize their loans at an earlier date, or to tide them over lean years by making advance payments. The provision for the readjustment of loans enables the farmer who is hard pressed to obtain some relief by reducing his instalment payments, while still reserving to him the opportunity of making additional payments should his financial position improve.

13. A further advantage arising from amortization consists in the fact that amortization payments may be used as a sinking fund by the credit institution granting the loans. Where the necessary funds are raised by the issue of bonds this increases the security against them and ensures their final repayment.<sup>1</sup>

14. On the other hand, the method of amortization possesses some limitations and disadvantages. It can only be applied conveniently by large concerns. The private investor or small lending institution would have difficulty in investing the small instalments which would periodically accrue. The large concern, on the other hand, would receive a sufficiently large volume of payments to enable it to invest them with profit. In many cases, also, private investors and financial institutions do not care to make advances for periods longer than four or five years. To amortize loans of any size would necessitate large annuities which the majority of farmers would find too burdensome.

15. While the method of amortization systematically reduces the debt outstanding, this necessitates a larger annual payment than if the debt is not repaid. Unless provision is made for relief in lean years this may prove embarrassing to the farmer.

16. There is the final consideration that the mortgage rate of interest may change during the currency of a loan. If interest rates are falling, the terms under which a long loan has been granted will compare less favourably with the terms of new loans. In such circumstances it is conceivable that it would pay the farmer better to obtain loans for a shorter period, provided that the costs of renewal were not too high. Conversely, a long period loan possesses advantages if interest rates are rising.

17. Despite these considerations, the balance of advantage is, in general, in favour of long term amortizable loans. Such loans do not remove the danger that the farmer may be overburdened with mortgage charges, but they do, at least, enable him, in most cases, to reduce his indebtedness by easy instalments.

<sup>1</sup> Cf. Herrick, *Rural Credits*, p. 20.

APPENDIX II  
THE CRÉDIT FONCIER DE FRANCE

1. In the early part of the nineteenth century, land credit facilities were regarded as unsatisfactory in France. In 1826, Casimir Perier offered a prize for the best answers to the questions:

“What are the defects and deficiencies in the French Laws relating to mortgage loans?

“What are the obstacles which deter capital from seeking such investments?

“What would be the best plan to adopt for the purpose of framing a complete project for settling these problems in a way which would be most in harmony with the needs of the public treasury and building contractors and with the security required by lenders?”<sup>1</sup>

2. This offer was followed by a movement towards the reform of land credit institutions which culminated in the Act of 1852. A number of land credit companies came into existence shortly after the passing of the Act. It was then decided that the purposes of the Act could be best satisfied by a centralized institution with a uniform policy. Accordingly, a decree of 10th December extended the powers of the Land Bank of Paris, which had been the first formed, to cover departments in which no companies yet existed, and to absorb existing companies. The new company was given a monopoly for 25 years, and the substantial appropriation set aside to be allotted to the companies which had been authorized was turned over to it. The monopoly was not renewed but it retains its dominant position by virtue of the free subsidy from the State and certain special privileges. These include the right to award prizes by lot upon its debentures when recalled. The State has also transferred to the *Crédit Foncier* the business of financing drainage operations, debentures against which are guaranteed by the State.

3. The capital of the bank is raised by shares, and is designed mainly as a guarantee against the debentures. It must therefore be kept in a liquid form and invested in a prescribed manner. The control of the bank is in the hands of the shareholders, but some directors, the vice-presidents, and the president, are appointed by the State from among shareholders.

4. Loans are granted against mortgages on land and to departments, municipalities, syndical associations, hospitals, public establishments, and on drainage projects. Funds are provided mainly by the issue of debentures, and by the acceptance of deposits, up to a prescribed amount. One-fourth of the deposits

<sup>1</sup> Herrick, *Rural Credits*, pp. 111-112.

must be kept with the treasury department, the remainder in specified securities, but deposits may be loaned on the security of the bank's debentures. The capital stock, reserves and deposits are used mainly to carry on a purely banking business; the proceeds of debentures to finance long term loans.

5. Loans may run from ten to seventy-five years, all above ten years being repaid by annuities. Loans made to individuals must be on first mortgage and may not exceed one-half of the assessed value of the mortgaged property; or one-third in the case of properties liable to easy depreciation such as forests, orchards and vineyards.

6. The rate of interest on money loaned must not exceed the rate on the debentures by which it is provided by more than six-tenths of one per cent., except in Algeria and Tunis. Loans may not be recalled as long as commitments are met. Since 1870, loans have been made in cash. Prior to that date the plan of the German *Landschaften* was followed, and loans were made in the form of debentures on which the borrower had to realize by sale. The total of all classes of debentures must not be more than twenty times the capital stock of the company.

7. Although loans on urban properties<sup>1</sup> and to public authorities comprise the larger part of its operations, the *Crédit Foncier* is still an important source of long term credit to landowners.

<sup>1</sup> Largely through a subsidiary building and loan company, the *Sous-Comptoir des Entrepreneurs de Bâtiment*.

## APPENDIX III

## I. THE LAND AND AGRICULTURAL BANK OF SOUTH AFRICA

1. The Land Bank Act of 1912 provided for the establishment in the Union of South Africa of a "Land and Agricultural Bank of South Africa," which was to supersede the Land and Agricultural Loan Fund of the Province of Natal, the Transvaal Land and Agricultural Bank, and the Land and Agricultural Loan Fund of the Province of the Orange Free State. The Act has been amended from time to time, and the following summary gives the main provisions as set out in an official pamphlet published in 1926.<sup>1</sup>

2. The operations of the bank are controlled by a central board, consisting of a managing director and five other members nominated by the Governor-General. Members of the Board, other than the managing director, retire annually in rotation. The chief executive officer is a general manager appointed by the Governor-General. The Governor-General may from time to time establish a local board for any area of the Union and appoint its members, who shall be three in number and shall hold office for two years. Local boards have no executive functions, but act as agents for the central board. They consider and transmit all applications submitted to them, make recommendations upon them and advise the central board on matters requiring local knowledge.

3. The business of the bank is as follows:—

- (a) "to advance money to farmers on mortgage of land within the Union;
- (b) "to advance money to, and to guarantee the performance of contracts by, co-operative societies or companies;
- (c) "to advance money to farmers holding land under agreement of purchase from the Crown, or holding land from the Crown under a lease the unexpired period whereof is ten years or more; and generally to make all such advances and do all such acts as the bank may, by this Act or any other law, be authorized to make or do."<sup>2</sup>

4. Advances may be made by the bank for the following purposes:—

- (a) "improvements, in which term shall be included farm buildings, fences, tanks, and other structures for the dipping or

<sup>1</sup> Act, *The Land Bank Act, 1912 (No. 18 of 1912) to Establish and to Regulate the Management and Control of a Land and Agricultural Bank for the Union.* (Cape Town, Cape Times, Limited, Government Printers, 1926.)

<sup>2</sup> *The Land Bank Act, 1912, pp. 20-22.*

spraying of stock, the clearing of land for cultivation, the blocking of sluits, dongas, and watercourses to prevent denudation of soil, and the planting of trees, vineyards, sugar-cane, and tea;

- (b) "the purchase of stock or plant of all kinds and of agricultural requirements generally;
- (c) "the discharge of existing liabilities on land or, in special circumstances, any other existing liabilities;
- (d) the payment of costs, incidental to the sub-division of land held in undivided shares;
- (e) "the establishment and promotion of agricultural and rural industries including, in addition to other such industries, tobacco, dairy, and like industries, and the cultivation, sale, and exportation of fruit;
- (f) "the purchase of land for any of the purposes described in paragraphs (a), (b), and (c) of this section, by a person or group of persons whose financial resources are deemed adequate to carry on a purpose described in any of those paragraphs; but no advance exceeding one hundred and fifty pounds shall be made by the bank for the purpose of any such irrigation, water storage, or boring work as may be made the subject of a loan under any law relating to irrigation or conservation of water."<sup>1</sup>

5. The funds of the bank consist of the capital of the provincial banks, whose assets and liabilities were transferred on the establishment of the Land Bank, together with such funds as may be advanced from time to time by Parliament. On such advances interest is payable at 3½ per cent., or at such a rate as is determined by resolution of both houses of Parliament. The board has power to raise additional funds by (a) the discounting of bills of co-operative societies or companies; (b) raising overdrafts with other banks; (c) issuing debentures or "Land Bank Bills" and (d) receiving deposits withdrawable at not less than one month's notice.

6. The additional funds so raised must be employed solely for the purpose of "financing co-operative societies or companies in the form of cash credit accounts in the manner provided in the principal Act, or any amendment thereof; and the amount so raised shall not exceed, during any one year, an amount equal to the cost of grain bags and other farming requisites purchased, or to be purchased, by co-operative societies or companies, and 60 per cent. of the value (as determined by the board) of the live stock, dairy, agricultural, and other farm produce to be financed by the bank through co-operative societies or companies."

<sup>1</sup> *Ibid.*, p. 22.



7. Advances may be made up to 60 per cent. of the value of freehold land and improvements on the security of a first mortgage. No advance upon the security of Crown land may be made to an amount exceeding 50 per cent. of the purchase price already paid, plus 50 per cent. of the value of improvements made since the agreement of purchase. Advances may be made to 50 per cent. of the lessee's interest in leasehold land. Advances on Crown land and land held on lease must be repaid within a period not exceeding ten years. The bank may recover from the Crown so much of an advance to a holder of land under a lease or agreement of purchase from the Crown, or to a co-operative society or company composed mainly of such holders of land, as it is unable to recover from the holder, society or company.

8. Provision is made for the amortization of loans by half-yearly instalments. The rate of interest on new loans is prescribed by the board from time to time.

9. Advances are made to co-operative societies for a period of not more than ten years, on the joint and several liability of the members of the society and on such additional security as the board may require.<sup>1</sup> The board may extend the period of repayment, and under certain specified conditions, may call in the advance before the due date.<sup>2</sup> A loan may take the form of an advance of a given amount for a stated period, or of a cash credit account, which is defined as "an account through which a co-operative society or company may, from time to time during its currency as fixed by the Board, draw monies from the bank and repay monies to the bank, so that the total amount owing to the bank under the cash credit account shall not at any time exceed a maximum to be fixed by the board."<sup>3</sup> Interest is charged on the day to day balance outstanding in the account. The board may at any time close the cash credit account or reduce the maximum. Hence it is virtually an overdraft at call, up to an agreed limit.

10. The central board may act as guarantor to a co-operative society or company in respect of contracts entered into relating to such operations as the supply of produce, payment for grain bags, or general farm requisites, or the repayment of loans. One fifth of the amount of the guarantee must be paid into the bank, but no other charge or fee is made.

<sup>1</sup> Such as subscribed but unpaid capital, and contingent liability attached to shares, debts owing to the company, or agricultural produce.

<sup>2</sup> I.e. as laid down under Section 37 of the Act.

<sup>3</sup> *Ibid.*, p. 4.

## II. AGRICULTURAL LOAN COMPANIES AND RURAL CREDIT SOCIETIES

1. Under an Act passed in 1926, provision is made for the establishment of agricultural loan companies and rural credit societies and to extend the powers of the Land and Agricultural Bank of South Africa.<sup>1</sup>

### *A. Agricultural Loan Companies*

2. The Act of 1926 authorizes the Central Board to divide the Union into areas, called agricultural loan circles, in each of which an agricultural loan company may be established.

3. The Act empowers loan companies to transact the following business:

- (a) "to grant, on such conditions as the regulations of the company may prescribe, accommodation to credit societies in the loan circle in which the company carries on business, by discounting bills endorsed by such credit societies;
- (b) "to grant, on such conditions as the regulations of the company may prescribe, loans to individual farmers (including members of credit societies) against the security of grain or other agricultural produce when represented in the form of an elevator or warehouse receipt: Provided such produce is to be sold through some co-operative agricultural organization approved by the central board: Provided further that the charges (excluding charges for storage) of such co-operative agricultural organization for such sale shall not exceed the amount charged by it for selling the produce of its members;
- (c) "to receive, on such conditions as the regulations of the company may prescribe, monies on deposit from shareholders and non-shareholders;
- (d) "to re-discount with the bank bills endorsed by credit societies or bills drawn by individual farmers in respect of which accommodation or loans have been granted by the company;
- (e) "to acquire by lease, purchase or donation, and to hold, any movable or immovable property to enable the company to carry on its business;
- (f) "to transact such other business as will, in the opinion of the central board, increase or assist agricultural or pastoral production."

4. If any credit society fails to pay any debt on its due date, the loan company may appropriate any amount subscribed by the society to the capital of the loan company. The balance of

<sup>1</sup> Act to provide for the formation, registration, management and control of agricultural loan companies and rural credit societies, and to extend the powers of the Land and Agricultural Bank of South Africa. No. 40, 1926.

liability not thus liquidated may be apportioned equally among all members of the society at the time when the liability is incurred and in addition among all members who join the society thereafter, including those who may have withdrawn from the society in the meantime.

5. The initial capital of a loan company is to be not less than £5,000 subscribed in shares of one pound each. Dividends are to be paid only out of profits and are not to exceed 8 per cent. Dividends on shares registered in the name of the (Land and Agricultural) Bank are not to exceed an average of 5 per cent. Shares may be subscribed by any person, or by agricultural credit societies. At the end of sixty days after books of subscription have been opened by the central board, the central board may subscribe the balance which remains unsubscribed. Thereafter shares are to be issued to credit societies only. After credit societies have subscribed such an amount as is determined in each case by the central board, 25 per cent. of any further subscriptions from societies is to be devoted to the payment and retirement at par of shares issued to private individuals or to the bank.

6. Every loan company is required to establish and maintain a reserve fund to at least 25 per cent. of its paid-up capital.

#### *B. Rural Credit Societies*

7. The Act also provides that not less than seven nor more than fifteen persons engaged in farming may establish a rural credit society. Members are to be jointly and severally liable for the debts and obligations of the society.

8. The business of rural credit societies is laid down in the Act as follows:

- (a) "to grant, on such conditions as such society's regulations may prescribe, accommodation to its members against their bills having a currency of a period so calculated as to allow the investment of the amount advanced by way of accommodation to return the capital thereof and interest thereon within such period, which shall not, subject to the provisions of section *thirty-nine*, in any case exceed two years;
- (b) "to discount the bills of its members, endorsed by it, with the loan company carrying on business in the loan circle in which the society is established: Provided that the discount of such bills shall be so regulated that the total liability of the society in respect of bills so discounted shall not at any one time exceed an amount equivalent to two hundred pounds multiplied by the number of the society's members: Provided further that the amount owing by any one member to the society in respect of bills so discounted shall not at any one time exceed three hundred pounds;

- (c) "to acquire shares in the loan company carrying on business in the loan circle in which such society is established; and
- (d) "to transact such other business as the central board may from time to time permit."

9. Loans may be granted for the following purposes:

- (a) "to enable a member to sow, reap or dispose of a crop;
- (b) "to purchase agricultural implements and machinery, live stock, feeding stuffs, seeds, fertilizers, and other farming requisites;
- (c) "to erect buildings (including the purchase of the necessary material) for treating and handling farm produce, and for housing live stock;
- (d) "to pay wages for and costs to be incurred in reaping, threshing or disposing of crops; and
- (e) "for such other purposes incidental to farming as the central board may from time to time permit."

10. Share capital is not required under the Act, but each credit society is required to take up shares in the loan company in its district up to one per cent. of any bill discounted for its members. The funds necessary to enable a credit society to carry on its business are to be obtained from:

- (a) "the proceeds of bills of its members, endorsed by it, and discounted with a loan company;
- (b) "the dividends received on shares held by it in a loan company; and
- (c) "other revenue funds, including the reserve fund."

11. In addition to providing finance through credit societies, loan companies are empowered to grant loans directly to individuals.

# INDEX

## *Abbreviations used in Index*

A.M.C.	=	Agricultural Mortgage Corporations.
F.F.L.	=	Federal Farm Loan.
F.I.C.	=	Federal Intermediate Credit.
F.L.B.	=	Federal Land Bank.
G.B.	=	Great Britain.
I.C.	=	Intermediate Credit.
J.S.L.B.	=	Joint Stock Land Banks.
l.t.	=	Long term.
N.F.L.A.	=	National Farm Loan Association.
N.Z.	=	New Zealand.
P.T.O.	=	Public Trust Office.
R.I.C.	=	Rural Intermediate Credit.
S.A.	=	South Africa.
S.A. Dept.	=	State Advances Department.
s.t.	=	Short term.
s.t. and i.	=	Short term and intermediate.
U.S.	=	United States of America.

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