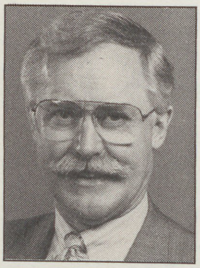
Rural Economic Development:

The Role of Commercial Banking in Rural America

by Marvin Duncan, William Fischer and Richard Taylor

This article is the second in a series about the role commercial bankers play in rural economic development.



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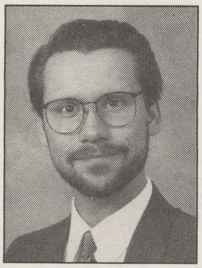

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Commercial bankers can make the difference between success and failure in their communities. Whenever successful innovation or progress occurs in a community – a new sewer, an ambulance service, or a business expansion – chances are high that the local bank had a leadership role. Leadership encompasses a range of activities, of course. Commitment of time, provider of debt capital, orchestrating development of a financial package for a business or public infrastructure project, and community cheerleader are all roles a community banker plays.

Commercial banks have been the nation's primary source of credit for operating small businesses. In the most recent published survey by the National Federation of Independent Business Research and Education Foundation in 1985, commercial banks were found to provide at least 84% of all credit and 89% of short-term credit used by small businesses (1).

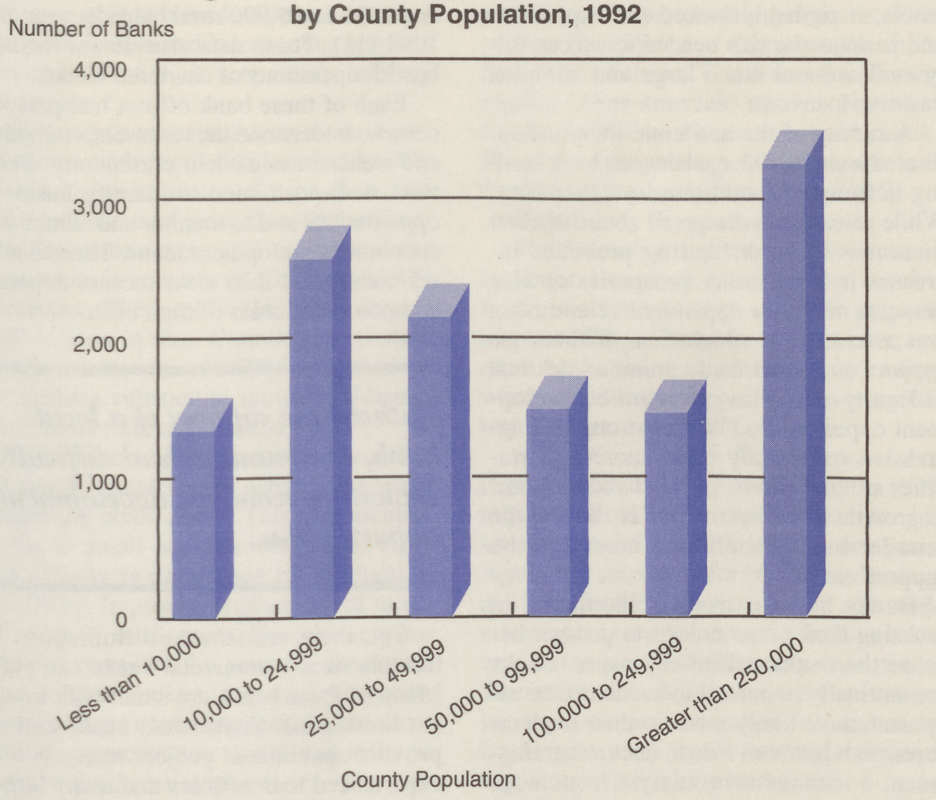
This article reviews linkages between community growth and banks in rural communities. It also discusses the rural bank delivery system and identifies economic development programs available to community banks. Finally, it discusses the experience of one community and its comprehensive approach to rural economic development.

Review of Research

Researchers have attempted to understand the role of banks in the economic health of their rural communities. This section reviews conclusions reached in several studies. Lown noted that changes in bank asset holdings tend to precede changes in economic activity (2). That means bank lending activity stimulated economic activity. The same study found evidence that restrictions on bank lending adversely affected the community's economy.

Dreese concluded that bank lending activity was a necessary condition for regional growth, but that bank lending alone was not sufficient to spur growth when other factors did not support growth (3). Gustafson and Beauclair concluded there was a mutual dependence between bank prof-

Figure 1. Total Number of Commercial Banks by County Population, 1992



Source: FDIC Call Reports, Washington, D.C., 1992.

itability and community prosperity (4). Bank lending policies influenced economic activity, and growth in community prosperity added to the financial health of the bank. Barkley and Helander in a study of bank branches confirmed that community economic activity and bank lending are related, though bank lending could not be concluded to lead to growth in retail sales in a nonmetropolitan branch bank setting (5).

Other researchers compared rural and urban banks. Milkove concluded that rural independent banks and rural branch banks bring strengths to customers; but one structure was not superior to the other in serving the economic development needs of a community (6).

McGlone analyzed the results of a small business survey and concluded rural borrowers pay somewhat higher interest rates than do urban customers, because of more concentrated risk in rural bank loan portfolios (7). Yet rural bank customers were more satisfied with their bank than were urban bank customers. The study indicated rural capital markets appeared to serve their customers as well as did urban capital markets.

Milkove also assessed bank performance across rural/urban location and bank size. He concluded bank size may be more important in determining bank response to risk than was a rural or urban location (8). Small banks were more similar to each other in their response to risk than they were to large banks, irrespective of urban or rural location.

Taff, et. al concluded that small banks in Wisconsin had little experience in making complex business loans (9). The key to quickly assessing a bank's preparedness to make complex business loans was its size. If it had less than about $30 million in total assets, it probably lacked the experience and perhaps the size needed to successfully evaluate and make large and complex business loans.

A survey of the academic literature indicated a strong linkage between bank lending activity and community prosperity. While researchers disagreed about whether increases in bank lending precedes increases in community prosperity or vice versa, a mutually dependent relationship was a reasonable conclusion. Without the support of a local bank, communities had difficulty exploiting economic development opportunities. With a strong and aggressive community bank, more opportunities are likely to be pursued and economic growth will be stronger. However, the broader business climate must also be supportive.

Banks have a strong self-interest in assisting their communities to prosper because the banks will also prosper. Banks are unusually important to economic development, most likely more so than academic research has been able to document. Hagaman, a management analyst, concludes banks are probably the most effective means by which small and moderate-sized businesses gain access to capital (10).

The Rural Bank Delivery System

The commercial bank delivery system is a vital resource in the rural economic development challenge. Nearly every community either has a bank or is near a community with a bank. Over 6,000 commercial banks were located in counties of less than 50,000 in population (Figure 1). That only includes separately chartered banks. It does not take into account the large number of branch offices operated by these banks. Altogether, the total number of community bank facilities, fully staffed each business day, far exceeds the number of chartered banks in counties of under 50,000 population. Veintemillas in a recent analysis prepared for the American Banker's Association using rural and urban designations, identified 6,146 rural banks at year end 1992 and 5,990 rural banks at year end 1993 (11). These data also do not include branch operations of chartered banks.

Each of these bank offices had personnel who understood the resources, strengths, and weaknesses of their community. They were well-positioned to identify business opportunities and to monitor and administer economic development loans. These bankers understood their own success depended upon the success of their customers.

Without the support of a local bank, communities had difficulty exploiting economic development opportunities.

Yet, there are structural limitations to the role rural commercial banks can play. Many of these banks are small with inherent limitations. First, small banks cannot provide specialized project analysis and experienced loan officers that many larger rural economic development projects may require. Second, these banks may have difficulty either funding large project loans out of their own deposit base or carrying many of those inherently more risky development loans in their bank's loan portfolio. Third, many of these banks may not offer their customers the financial services larger business firms require.

Rural commercial banks maintain correspondent relationships with larger commercial banks, typically located in urban areas. The correspondent relationship provides a range of services to rural community banks. These include operational services such as check processing and wire transfer of funds, for example. Additionally, correspondent banks may participate in loans made by the community bank when those loans exceed the smaller banks' loan limits or when the smaller banks find themselves relatively illiquid because of high loan-to-deposit ratios. Loan pooling opportunities also enable a community bank to participate in loans made by the correspondent bank. Multi-bank holding companies are able to provide some of the same loan participation and loan pooling services to members of their respective holding companies.

Bank size constraints were most severe in counties with population less that 10,000. Within these counties, fewer than 187 banks had assets of more than $50 million. Size limitations were still substantial for those banks in counties of 10,000 to 24,999 population. There, only 168 banks topped $100 million in size. Counties larger than 25,000, but less than 50,000 in population, contained a substantial number of banks above $100 million in assets.

For many small rural counties, smaller community banks very effectively serve community credit needs. This is particularly true in small communities where business activity is dominated by production agriculture. Improved profitability of farming, and of businesses directly serving farmers, provides the primary economic base. In that setting, meeting the credit needs of those customers may be the most important contribution a bank can make to rural economic development.

However, more rural banks are asked to provide debt capital and other financial services to larger scale and more complex economic development projects. These range from large-scale livestock production facilities, to expansion of small factories or machine shops, to commercial business expansion, to infrastructure improvements. Rural economic development projects often require lendable funds in larger amounts and with longer loan repayment terms than rural banks can comfortably provide from their local deposit base. Moreover, those loans also entail risk concentrations that cause concern for both bankers and their regulators.

Economic Development Programs

To help bankers overcome institutional limitations, many programs to support economic development have been created over the past two decades. These include federal, state, and local government and private/public partnership programs. This section identifies and discusses the more important of these. The discussion draws, among other sources, upon a National Center for Policy Alternatives publication, *Financial Deregulation: New Opportunities For Rural Economic Development* (12).

Regulatory Programs

The following regulatory tools imposed by federal or state governments require banks to achieve a range of public purpose responsibilities. They do not, however, require banks to engage in unsound lending when sound loan proposals, from a regulatory perspective, are not available.

• The *Community Reinvestment Act* (CRA) enacted at the federal level in 1977 requires all federally chartered and/or insured financial institutions to meet certain regulatory standards for providing lending and other banking services to low and moderate income customers of a bank's trade area and to meet its legitimate service needs. The intent of the legislation and implementing regulations is to assure full access to banking services by all income and racial segments of a banking trade area.

• Some states have enacted and others have considered *net new funds requirements* for nonstate banking institutions wishing to acquire an instate bank. The intent of such legislation is to assure states and communities the same access to lendable funds after bank consolidation as before.

• *Lending disclosure laws* at the federal and state levels are intended to bring lending activities of a bank to public attention in the local community. They require at least an annual disclosure of a bank's activity in the specified lending categories.

Initiatives To Strengthen Bank Performance

• *Bankers' Banks* may be developed and owned by consortia of independent banks to provide specialized banking services for their owners. These banks may be chartered under either federal or state authority and are regulated by the chartering authority.

• *Pension Fund Targeted Certificates of Deposit* have become a means of providing commercial banks with deposits, the maturities of which are compatible with financing the longer-term debt capital needs of start-up and growth businesses. State and local government pension funds are a typical source of targeted certificate of deposit funding.

• *Linked Deposits* are used by governmental units of a number of states and cities to direct debt capital toward enterprises deemed to be in the public interest, often small businesses and start-up firms. These deposits may enable a bank to lend at lower interest rates or for longer terms.

• *Loan Guarantee* programs are widely used by both the federal and state governments. The programs enable banks to lend to firms and individuals not credit worthy by usual bank underwriting standards. Both the USDA's Rural Development Administration (RDA) and the Farmers Home Administration (FmHA) make guarantees available for business and industrial lending in rural communities.

Public Policy Initiatives

The following programs represent public policy initiatives focused on enabling banks to create and/or work with special purpose entities that provide financing and technical support to economic development efforts.

• *Capital Resource Corporations* are privately managed and capitalized corporations formed by consortia of banks or other institutional lenders. They are chartered under state legislative authority and provide long-term debt and equity capital for higher risk rural firms.

• *Business Development Corporations* are privately capitalized and managed lending institutions created to provide intermediate-term and subordinated lending for small- and medium-sized businesses. These firms are state chartered, regulated as nondepository lending institutions, and owned by financial institutions.

• *Business and Industrial Development Corporations*, similar in concept to business development corporations, are more specialized financial institutions chartered by a state to serve defined small business financing needs. They can be owned by individuals and financial institutions or by a government entity.

• *Rural Venture Capital Corporations* usually are privately capitalized, but often enjoy some government support such as tax relief. They focus on purchase of equity or quasi equity in small rural businesses.

• *Rural Community Development Corporations* are community-based organizations focused on spurring housing development and other economic development within a specified geographic area. Most were initially capitalized with federal funds. State governments, private firms, and foundations are now more common sources of capitalization and operating funds.

Banks are unusually important to economic development, most likely more so than research has been able to document.

• *State Rural Development Finance Corporations* work closely with community development corporations to support housing and economic development efforts in local communities. With federal funding no longer readily available, state or local finance corporations have become critically important as capital sources for community development corporations.

• A *Bank Development Corporation* is formed as a wholly owned entity of a commercial bank. Capitalized by the bank, the corporation may provide debt and equity capital, specialized training, and residential/commercial project development.

• *Rural Financial Technical Assistance Organizations* are organized as community assistance groups. These organizations may operate technical support and education programs assisting banks in using various public sector financing tools, such as guaranteed loan programs and secondary market opportunities.

• *Revolving Loan Funds* are locally administered funds often used by nonmetropolitan communities to support rural economic development. Many such funds received their initial capital as pass throughs of state or federal economic development loans directed toward local firms.

State Assistance Programs

In addition to financial assistance, states provide a varied menu of support programs for economic development. These reflect a recognition that financial assistance is seldom sufficient to assure successful economic development projects. Most start-up ventures require feasibility studies. Many require special tax relief. In the case of large projects, special legislative initiatives often are used. Once in operation, start-up and expansion businesses often require specialized training and technical support along with business management assistance to assure their success.

A Comprehensive Approach

Communities across the nonmetropolitan United States are rethinking how they can accomplish rural economic development. Successful communities increasingly think in terms of rural economic development strategies, rather than simply of isolated projects, and about cooperative efforts to support economic development.

Minot, N.D., and its trade area provide an example of such cooperation. Minot has a population of 34,544 and its trade area of 5,040 square miles has a total population of 65,728. The Minot Chamber of Commerce, Minot Area Development Corporation, Souris Basin Planning Council, the local Small Business Development Center, and Minot State University's Business and Community Assistance Center all work together with the Minot Magic Fund to retain, expand, and attract business activity to the Minot trade area. The Minot Magic Fund is built around a 1% sales tax in the city of which 40% of the proceeds are ear-marked for economic development. The Magic Fund assists in financing development projects and is administered by the city council.

The service area for economic development entities in Minot stretches well beyond the city limits. The Magic Fund has supported projects in outlying communities near the Montana border; north to the Canadian border; in north central North Dakota; and in the southwest quadrant of the state. Initiatives outside the city are a part of an economic development approach that holds, "what is good for the trade area is good for Minot." This spirit of cooperation is further manifested in the local policy toward new business recruitment. Marketing of the city and trade area to businesses interested in relocation only occurs outside North Dakota. Minot economic developers do not perceive benefit in relocating businesses from within their trade area to the city. This broad view of community and a spirit of service for the good of the whole has worked well for Minot.

Conclusions

Experience suggests that successful rural economic development results from successful process and teamwork. All the essential components must be available. Three predictors of success stand out. These are **leadership, cooperation,** and **commitment** of key people (13).

Whether development is pursued on an individual community basis or on a more regional basis, rural community banks are essential to the process and to its success. They are catalysts within their communities in stimulating economic development planning. Their participation in providing financing to public and private projects is becoming more important as public sector funding, especially federal government assistance, becomes less available. ▲

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