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RURAL CREDIT IN A CHANGING FINANCIAL ENVIRONMENT

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Credit availability affects the employment and population changes which we heard about earlier in this session, through its impact on economic activity. Some people suggest that rural areas are treated differently, and are probably disadvantaged in their access to credit. We will look at the evidence of rural/urban credit differences; and at trends in financial markets which may affect rural America in the future.

Special Rural Credit Issues

Less diverse economies:

Rural economies are small relative to urban economies. They have fewer people, fewer jobs, fewer and smaller businesses. These rural economies are more often concentrated in a few activities than are their urban counterparts. This lack of diversity shows up in the loan portfolios of some rural banks, particularly those in heavily agricultural areas. Recently some of these banks have failed, while many others have suffered financial setbacks. Fourteen of the 58 banks which failed in the first 9 months of 1984, had over 1/4 of their loan funds in agriculture. The potential for such problems becomes evident, when one looks at the loan portfolios of all nonmetro banks. As of the end of 1982, nearly 1,300 of the 8,000 nonmetro banks, had over half of their loan funds in agriculture.

Profitable banks:

Despite the problems of some agricultural banks, nonmetro banks are generally both profitable and well capitalized when compared to metro banks (Chart 1). In mid 1984 the annual profit rate was 11.7 percent of equity capital for nonmetro banks and 10.0 percent for metro banks. And their equity position was also better, with equity capital 8.5 percent of assets, versus 5.7 percent for metro banks. In both items the nonmetro advantage was similar to that of earlier years.

Nonmetro banks have maintained their profit advantage despite getting a large part of their deposits in high cost ways. "Interest sensitive" deposits, those not subject to interest rate ceilings, were about 2/3 of both metro and nonmetro bank deposits in mid 1984.

Potential market disadvantages:

There are 3 types of arguments given for a rural disadvantage in credit markets:

1) rural communities have limited competition in financial services,
2) urban based markets discriminate against rural borrowers, and
3) rural banks perform poorly as intermediaries to national financial markets.

There are few local lenders in most rural communities, resulting in a less competitive market structure. This may explain the just mentioned higher profits of rural banks.

Many rural banks are either branches of, or are owned by, urban based organizations. However, we have seen no clear evidence of rural discrimination. Some suggest that urban based organizations use their rural operations to channel money to urban areas. Again there is no evidence of this; and it might be noted that independent rural banks can do the same thing by lending excess funds to urban banks.

A study of business loans, indicates that rural banks may only infrequently act as intermediaries between their communities and external sources of credit assistance. Sixty percent of the study banks had never sold a business loan in whole or part. Forty percent had never sold a loan or made a government guaranteed loan (Taff).

Any of these 3 types of market failure might mean that rural borrowers are not able to obtain credit on the same terms which are generally available for comparable loans nationally. We looked for evidence of such market failure by examining rural/urban differences in 3 types of credit where full access to national credit markets seems most likely to be denied.

Small Business: For small business loans there is no authoritative evidence on rural/urban credit term differences. However, there is evidence that established small rural businesses are generally as well satisfied with their lender relationships as are urban borrowers, but that they have fewer alternative lenders. Small businesses were asked what items were very important in a lender relationship and their current level of satisfaction with each surveyed item (Chart 2). Getting the "cheapest money" was mentioned as very important less often than were several other items. "Knowing you and your business" was important for more businessmen, and was also the one where rural businesses showed the biggest advantage over urban businesses in good lender performance. This speaks well for the ability of local rural banks to compete within their community. Generally rural businesses were as well or better satisfied with their lenders than were urban businesses.

Another study looked at sources of small business credit, as perceived by bank loan officers (Chart 3). Most communities, whether rural or urban had at least 2 banks actively making business loans. But, rural communities were less likely to have an active nonbank lender.

Home mortgages: Whether rural residents have a disadvantage or an advantage in home mortgage borrowing is unclear (Chart 4). Most of the nonmetro interest rate disadvantage which existed in 1971 had disappeared by 1981. Nonmetro homebuyers had an advantage in their downpayment, which was usually a smaller fraction of the purchase price than it was for metro homebuyers. However, the shorter time to maturity of nonmetro mortgages was a disadvantage.

Local government borrowing: Rural governments may pay slightly more for borrowed funds than do urban governments (Chart 5). Interest rate differences are negligible but nonmetro governments pay a larger underwriter's fee per $1,000 of bonds sold. The data does not show that nonmetro governments have trouble borrowing; or that higher fees are caused by anything other than the smaller size of their bond issues.

In summary the evidence just presented shows no persistent disadvantage for rural borrowers. However, this neither disproves nor proves the existence of a "rural credit gap." Despite our inability to resolve this issue, the fact remains that national financial market events affect rural areas.

Recent Events and Trends in Financial Markets

Recently financial markets have experienced considerable change in regulation, structure, innovations in technology and operation, and monetary policy (Chart 6). These events often, but not always, have had similar rural and urban impacts. Since the six-month money market certificate was introduced in 1978, the cost of funds for rural banks has been tied closely to national levels. Today, both rural and urban banks have about 2/3 of their deposits in accounts which are not subject to fixed interest rate ceilings.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) set a framework for major deregulation. It legalized interest bearing checking accounts and by 1986 will have phased out all interest rate ceilings on time and savings deposits.

Intrastate branching has been expanding steadily for many years, both through increased MBHC activity and by more liberal state branching laws. While 25 states now allow statewide branching, only 8 states retain unit banking restrictions and 5 of these allow MBHC's. This is an alternative to branching for accomplishing bank consolidation and expansion. Some 23 percent of nonmetro bank assets were held by MBHC owned banks in mid 1984. This is an increase from the 1982 level of 21 percent, but well below the metro level of 2/3.

Interstate branching is currently proceeding by 3 methods: 1) special purpose banks owned by out-of-state MBHC's handle activities such as credit card operations, avoid home-state restrictions on interest rates and annual fees, 2) nonbank banks look like banks but avoid the legal definition by not making commercial loans, and 3) regional interstate branching is restricted to a multistate region where states have entered reciprocal agreements to allow entry by outside HC's. Such true interstate branching within a region may soon be a reality.

Depending on the outcome of a Supreme Court challenge, the largest banking organization in Massachusetts may soon also rank second in Rhode Island and Maine, and fourth in Connecticut.

New technology is certainly a driving force in current financial markets. For example, at least 55,000 automatic teller machines (ATM's) are now in place. Almost half are in shared networks which allow consumers to withdraw cash from money machines owned by other banks. This is one of numerous innovations in bank operation which small and rural banks can buy into at a reasonable cost. Thus, innovations have generally not placed rural banks at a competitive disadvantage.

As with other industries which have experienced deregulation, change in the financial industry has been less than smooth. Thus, we may see some new regulations to deal with unforeseen market changes. Closing the nonbank bank loophole, revised bank capital requirements and risk-based deposit insurance premiums are all likely candidates.

The Outlook for Rural Credit

For most rural banks the day of low cost deposits is at an end. Rural banks must, and do, provide the higher paying deposits demanded in large numbers by their depositors. Because loan rates often reflect a bank's cost of funds, future rural credit terms will respond to national changes in step with urban credit terms. That financial markets are better integrated may speed rural economies toward their destiny, be it to grow or to decline. This may mean that chronically depressed rural areas will be hurt the most by greater financial market integration; but this is far from certain.

What is the likely future for financial institutions in rural communities? (1) Few existing rural banks will disappear, and in most rural communities the number of financial institutions is unlikely to decline. Some additional failures of banks with high levels of agricultural loans may be forthcoming; but on the whole rural banks are financially sound. And, while the number of banking firms may begin to shrink nationally, that does not translate to local markets. (2) The expanding reach of MBHC's will continue; and they will purchase more rural banks. Whether this is to the rural community's advantage depends on how the bank is operated. MBHC ownership might bring the advantages of new services, higher loan limits, and loan risk spread over the entire organization; or the disadvantage of rural market discrimination.

The growing integration of financial markets is drawing rural and urban economies closer. In aggregate most financial market events have similar rural and urban impacts. However, community differences in economic structure will continue to cause considerable variation in the responses of local rural areas to financial market happenings.

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Sullivan, Patrick J. The Cost of Metro and Nonmetro Government Borrowing. RDRR-35. U.S. Dept. of Agr., Econ. Res. Serv., 1983.

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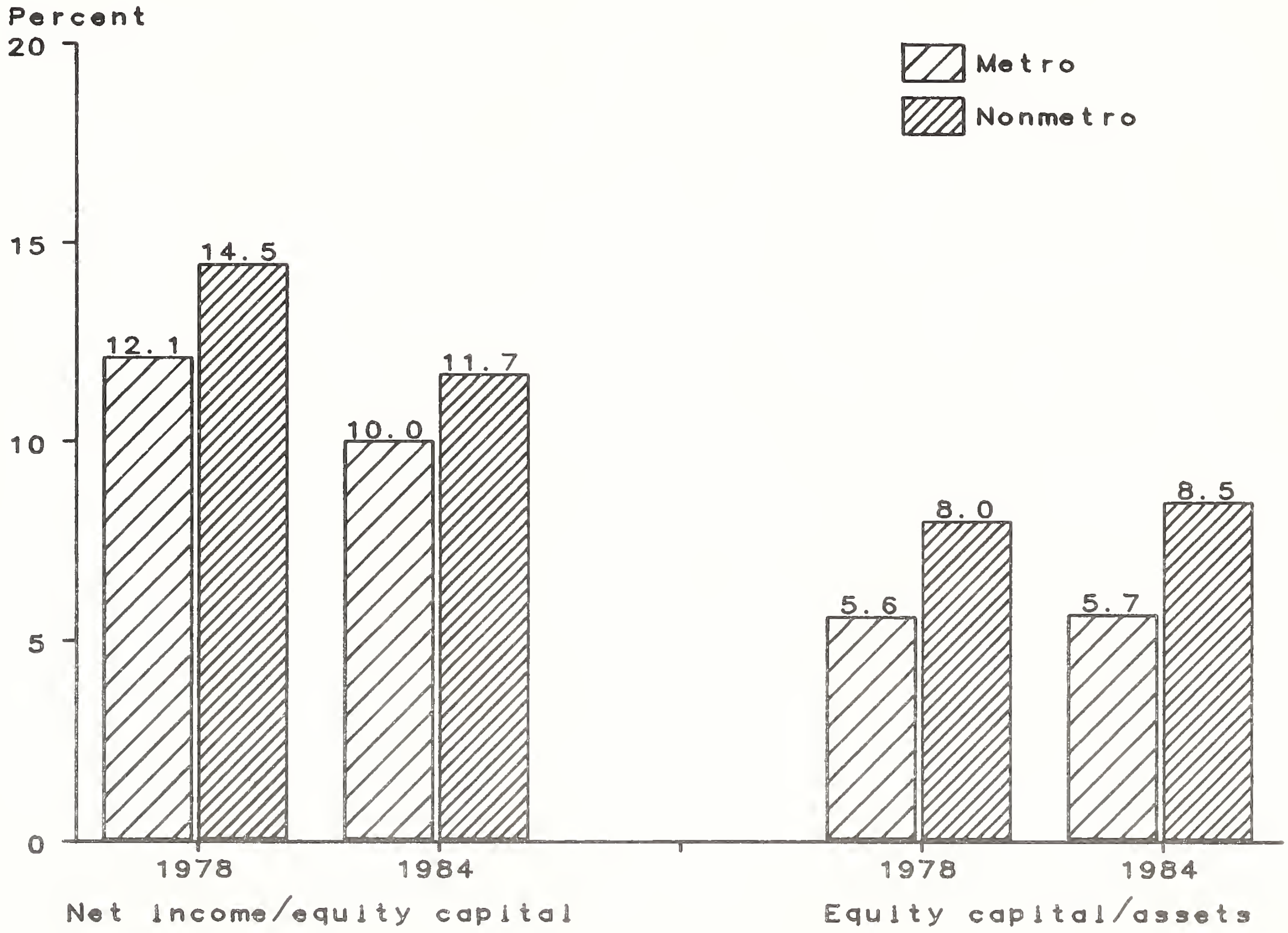
Chart 1

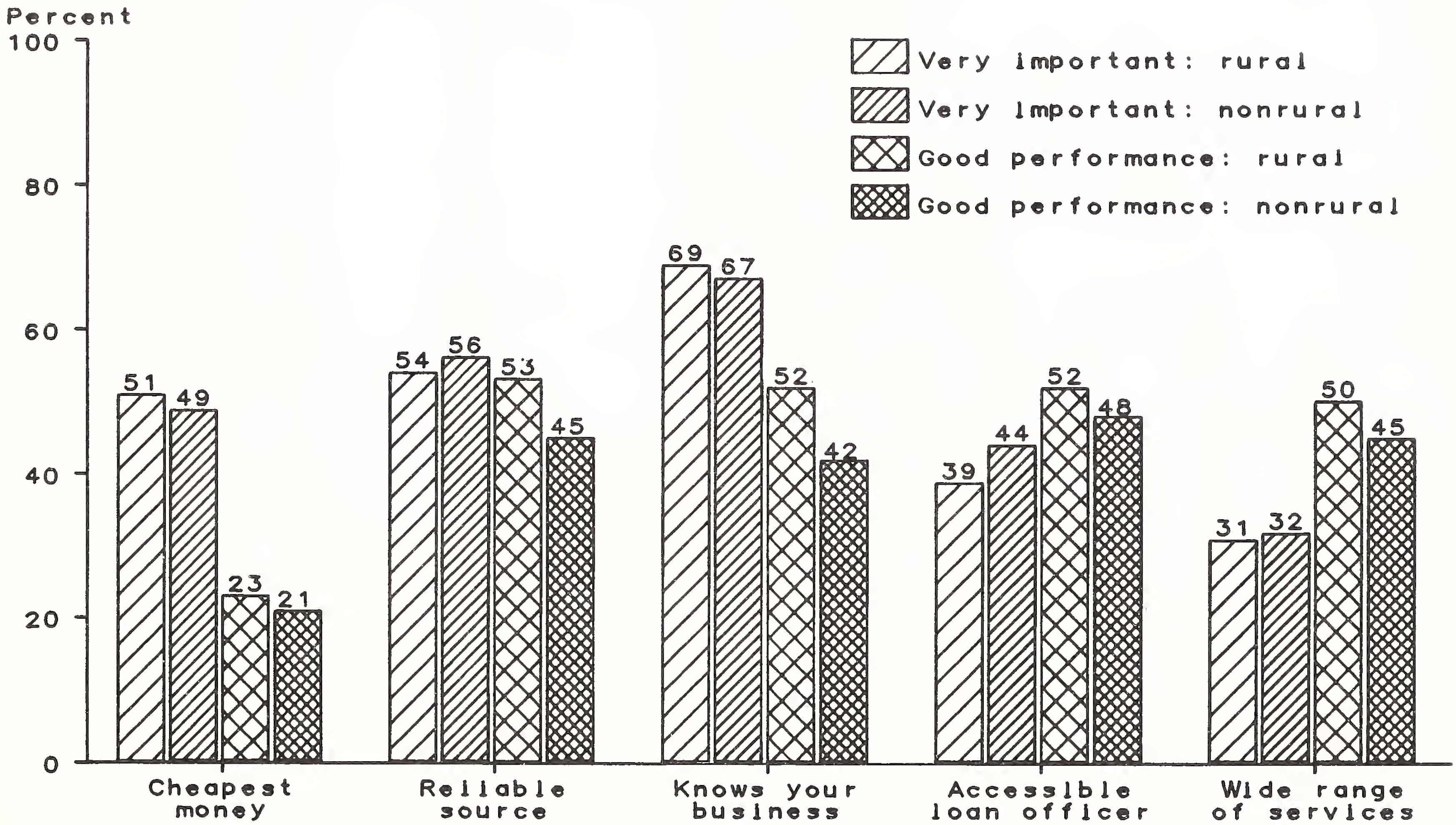
Annual bank profitability, midyear, 1978 and 1984



Source: ERS tabulations from Board of Governors, Federal Reserve Bank database.

Chart 2

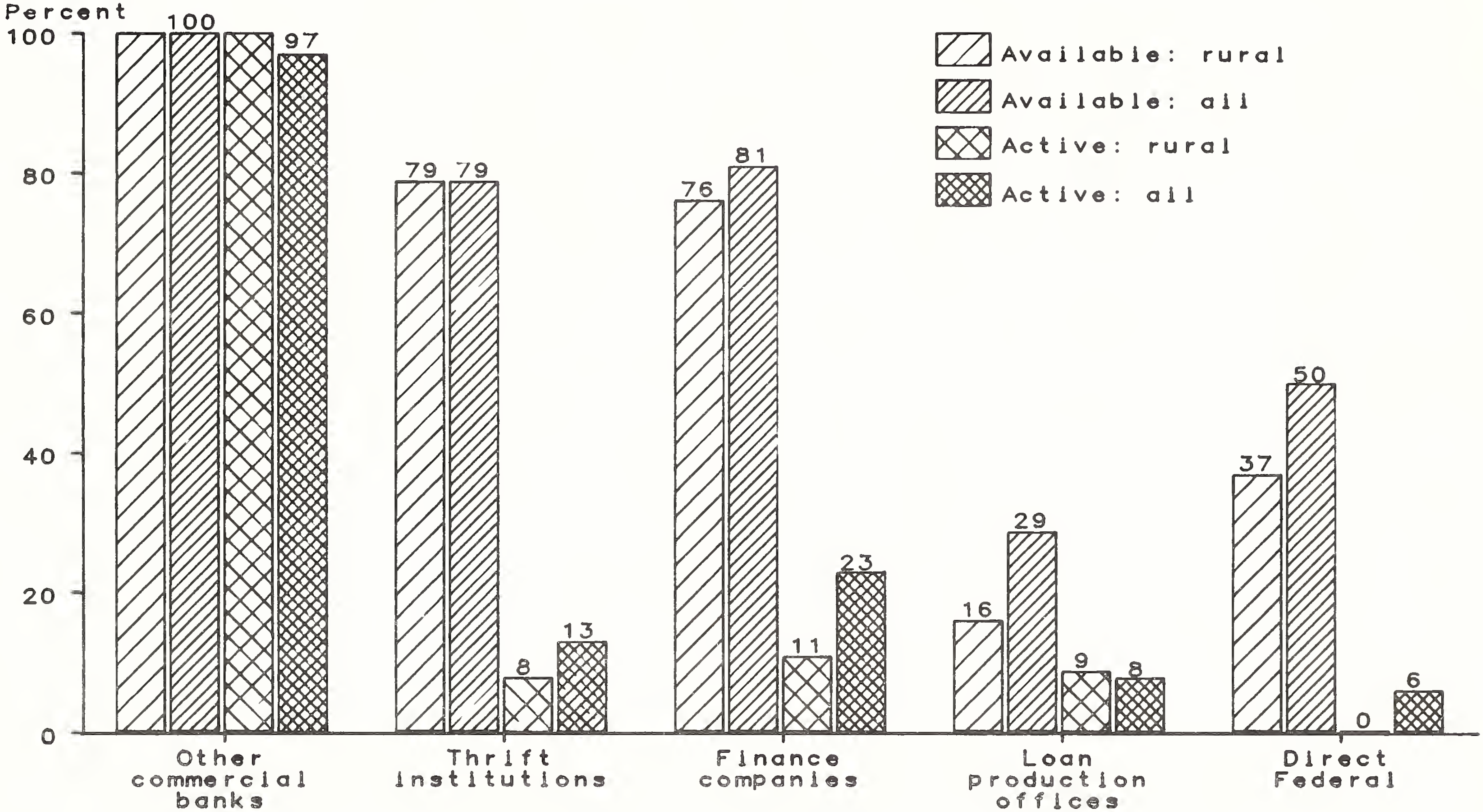
Banking relationships



Source: Adapted from tables 6 and 7 of Dunkelberg and Scott (1982). Based on an April 1982 survey of 2,349 members of the National Federation of Independent Business. 971 firms were rural (proxied by location in an area with a population of 15,000 or less).

Chart 3

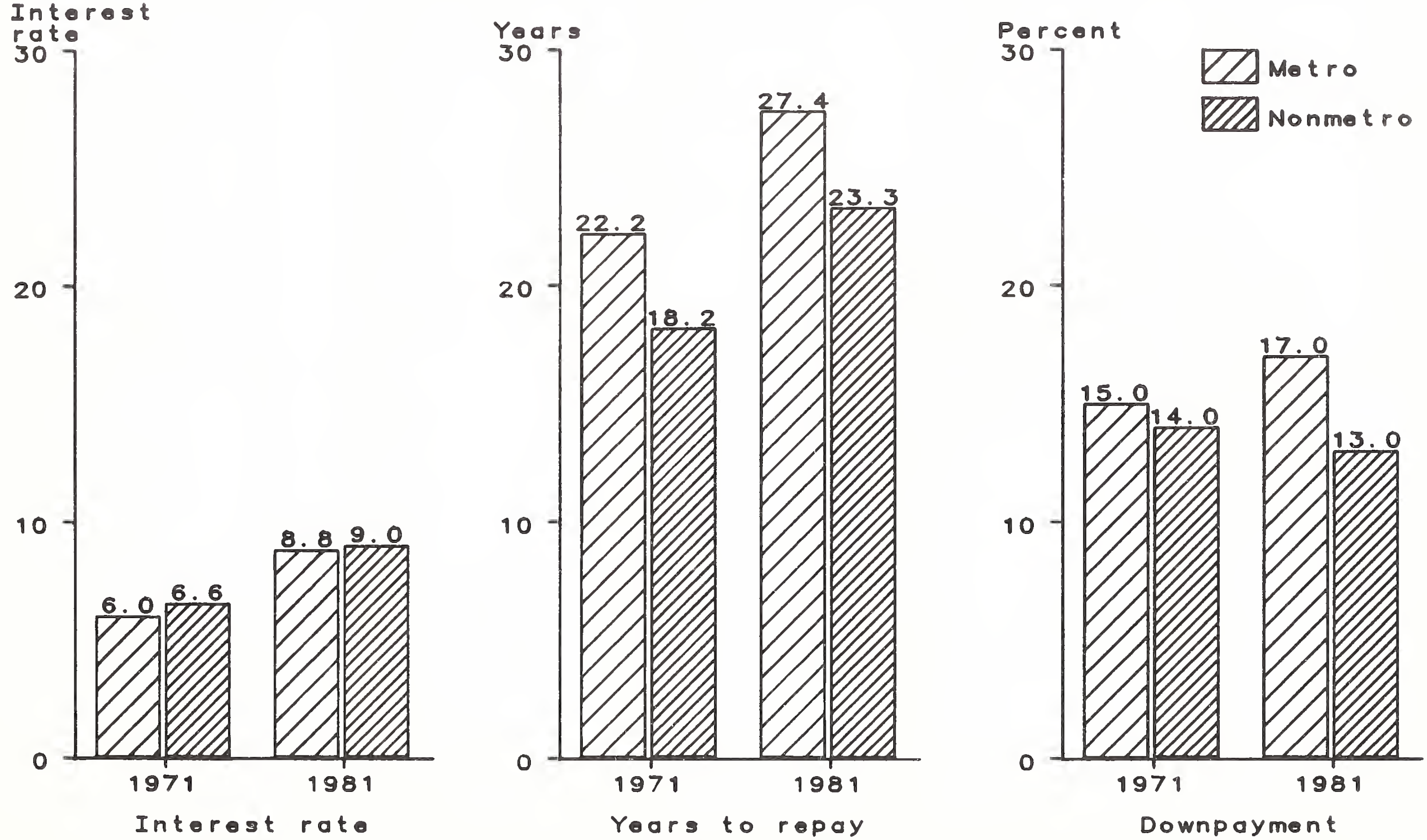
Bankers perceptions of Small Business Credit Availability



Source: Adapted fiom tables 11.1 and 12.1 of Glassman and Struck (1982), reporting on a survey of loan officers at 224 banks, 44 of which were located in rural counties.

Chart 4

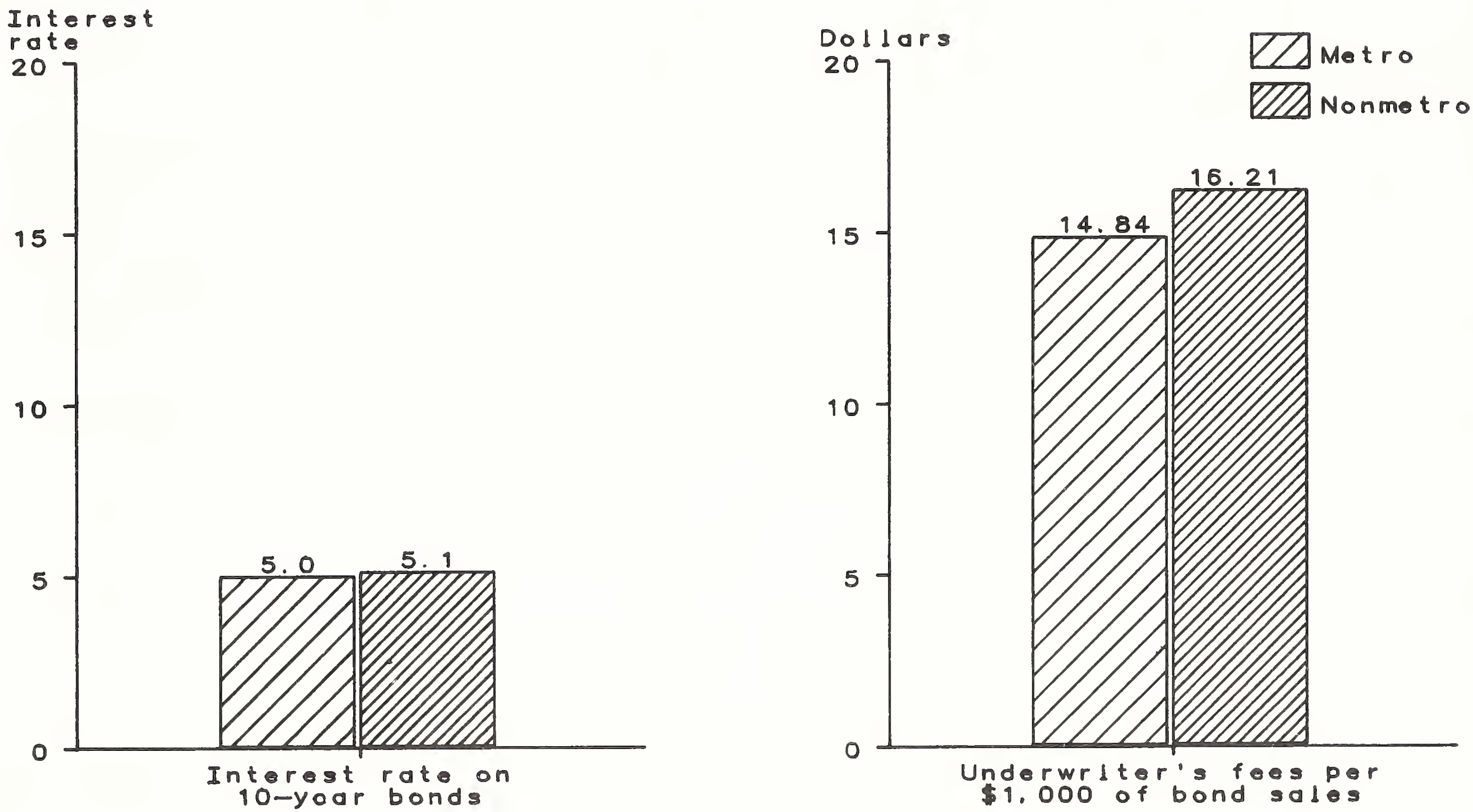
Lending terms on outstanding home mortgage loans



Source: Survey of Residential Finance, Bureau of the Census, 1971 and 1981.

Chart 5

Local government borrowing costs, 1977



Source: Sullivan, Patrick J, The Cost of Metro and Nonmetro Government Borrowing. RDRR 35. Economic Research Service, USDA, Wash., D.C. 1983. Calculated from Public Securities Administration data.

Chart 6

Financial Market Events

- 6-month money market certificates: 1978
  - The first small deposit without interest rate ceilings
- Federal Reserve Board starts targeting the money supply: 1979
  - Fights double digit inflation
  - Precedes record high interest rates and large interest rate fluctuations
- Depository institutions deregulation and monetary control act: 1980
  - Legalizes interest bearing checking accounts
  - Eliminates deposit interest rate ceilings (Reg. Q) by 1986
- Double digit inflation: 1979-1980
- Garn - St. Germain Depository Institutions Act: 1982
  - S and L's can make consumer and business loans
  - Emergency interstate mergers of financial institutions
- Intrastate bank branching expands
- Interstate branching
  - Special purpose banks
  - Nonbank banks
  - Regional reciprocity agreements