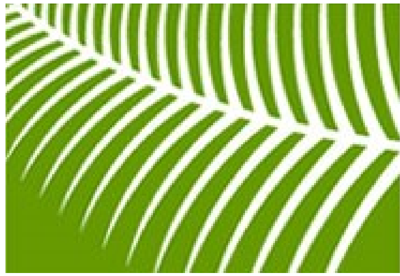

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Rural Conditions and Trends, V

Rural Conditions and Trends

Economic Research Service • United States Department of Agriculture • Fall 1995 • Vol. 6, No. 2

Financial Institutions

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Editor's Note

This special Fall issue is devoted to analysis of rural financial institutions. We decided to make this a special issue for several reasons. We received very positive response to our special Fall 1993 issue on Census data, making us recognize readers' interest in indepth coverage of issues. Had we issued this as a supplement, subscribers would not have received it as part of their regular subscriptions. And, this special issue marks the end of our twice-a-year publication schedule.

In 1996, we will begin publishing *Rural Conditions and Trends* three times a year. One issue will be devoted to analysis of rural industries and will contain much more detailed information than we have been publishing in the Fall issues. Another issue will be devoted to analysis of rural socioeconomic conditions and will cover many of the same topics as the Spring 1995 issue did. The third issue will be devoted to analysis of the effects of Federal policies and programs on rural America. We hope that this new coverage of Federal policies and programs and expanded coverage of industries will provide readers with broader understanding of the conditions and trends shaping rural economies and family life.

Authors

This special Fall issue of *Rural Conditions and Trends* was planned and written almost exclusively by Daniel L. Milkove, 202-219-0318.

James McGlone wrote the article on rural businesses' satisfaction with their banks, and Cliff Rossi contributed to the savings and loan article. Jim and Cliff left ERS before this issue went to press. If you have question concerning anything in this issue, please contact Dan.

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Rural Financial Institutions Are in Good Shape But Must Stay Alert

Rural financial institutions did well in 1994 and are likely to remain successful in the coming years. But they will increasingly face competition from branches of large urban banks.

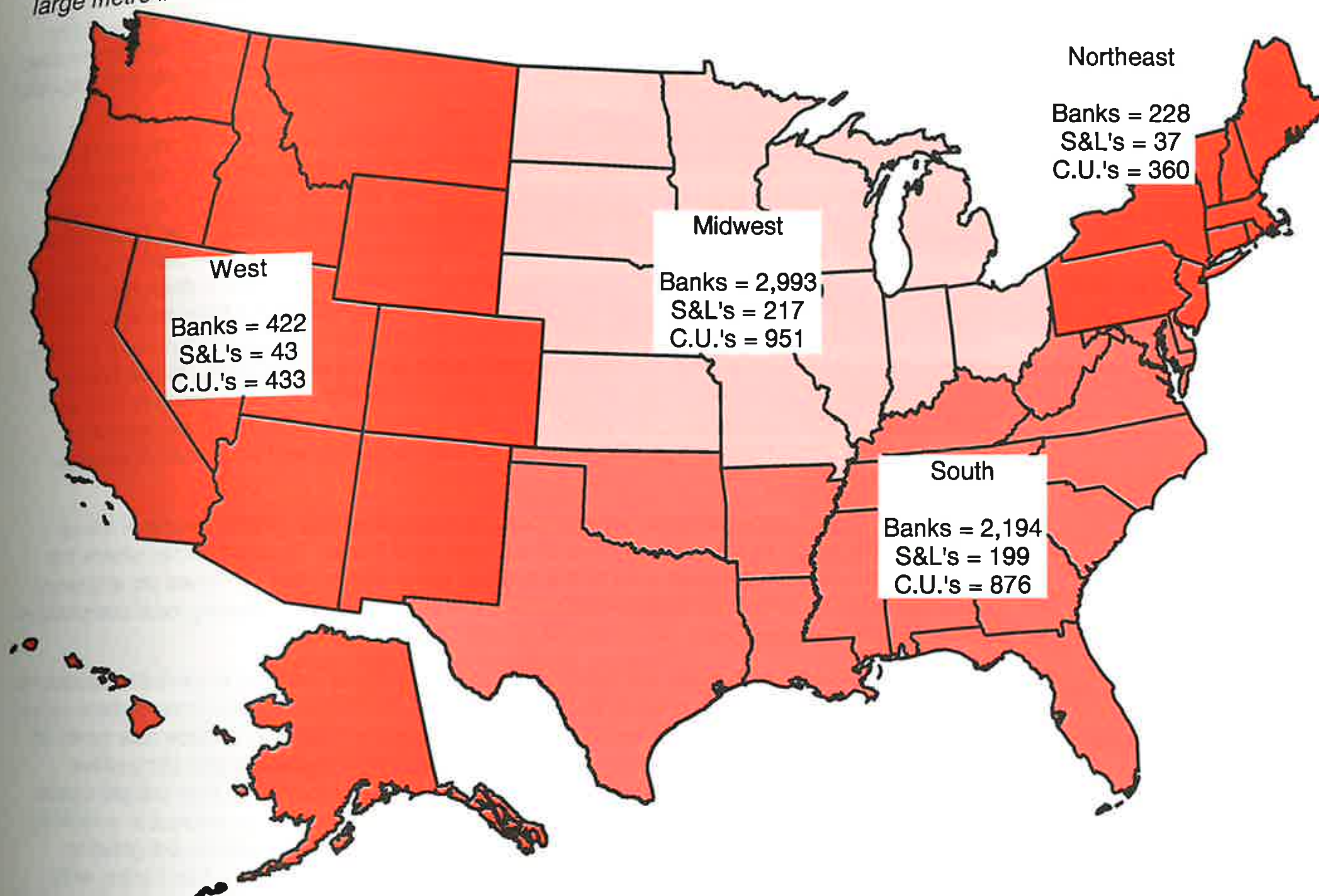
This report tracks the performance of the major depository financial institutions that serve rural America. The 1990-91 recession was not easy for banks, credit unions, and savings and loan associations (S&L's), but rural segments of the financial services industry fared relatively well. As the country recovered from the recession, the financial sector as a whole regained its health faster than the rest of the economy. By type of institution, banks have been reporting record profits since 1993, credit unions escaped the major problems faced by their competitors, and Federal regulators have cleaned up the savings and loan industry by selling or closing those institutions that cannot make it on their own.

When failed banks became a daily media item during the 1980's, rural banks were a major part of the story as a direct result of problems with their agricultural loans. Rural banks, particularly in Texas and Oklahoma, were also hurt by the energy crisis. More recently the major weakness in banking was commercial real estate, with banks in the Northeast and California experiencing pronounced stress. Commercial real estate is more of an urban problem, and relatively few rural banks are found in the Northeast. Thus, while rural banks by no means escaped the effects of a weak national economy during the early 1990's, as a group they have enjoyed an amazing rebound over the last 10 years.

The near future looks generally bright for rural financial institutions. Profits should remain solid at least until the next recession, and most firms should be able to survive then as well. Capital reserves are generally high, and so far most financial institutions seem to be avoiding the sort of major miscalculations that destroyed many firms in the 1980's and early 1990's.

Nonmetro financial institutions by type and region, 1994

The Northeast and West have fewer financial institutions in nonmetro areas because their populations are more concentrated in metro areas and their nonmetro areas are more likely to be served by branches of large metro institutions



Note: C.U.'s stands for credit unions.
Source: See appendix tables 1-3, pp. 34-35, for data sources.

Banks Dominate Rural Financial Institutions

Rural banks remain the key financial institution in rural America. While the banking industry has been consolidating for many years, the mergers, acquisitions, and failures have not necessarily reduced competition at the local level.

By any measure, commercial banks dominate most rural financial markets. At the end of 1994, almost two-thirds of the depository institutions headquartered in rural communities were banks, and they controlled over 80 percent of the total assets, deposits, and loans held by rural depository institutions. Credit unions represent more than a quarter of rural-based depository institutions but due to their small size they controlled market shares below 6 percent for assets, deposits, and loans. Rural S&L headquarters are by far the fewest in number, just 5.5 percent of the rural depository institutions, but their shares of total assets and deposits are almost double this proportion.

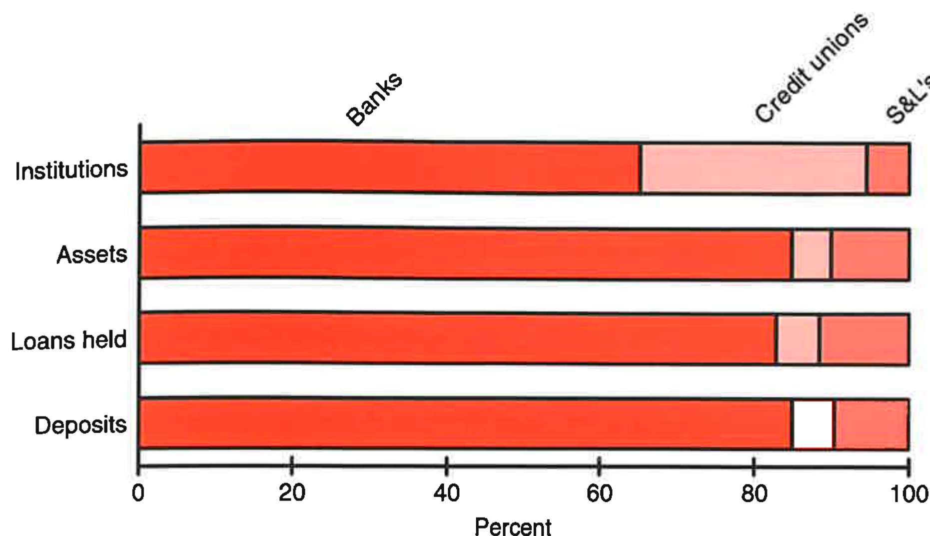
The number of rural-headquartered banks continues to decline during the 1990's, but due primarily to mergers and corporate restructuring rather than to bank failures. Similar statements can be made for S&L's and credit unions, but with heavier stress on failure in the S&L case. However, this does not necessarily imply that rural residents and businesses as a rule have fewer financial institutions to choose from. Banks that lose their legal independence often become branch offices of the acquiring bank. While the number of banks is declining, the number of bank branches is increasing. Plus alternative methods of providing banking services are spreading rapidly. For example, Automated Teller Machines (ATM's) make it unnecessary to go to a full-service bank office to obtain cash or to make deposits. Some banks market credit cards nationally through the mail, and more banks are experimenting with service based on the telephone or computer. Perhaps most important is how many banks or other financial institutions are serving a particular town or county and what level of service they provide.

Several very large bank mergers were announced during the early 1990's. Some of these banks control many rural bank branches or affiliated rural banks. In communities where the merger partners both operated prior to the merger, some offices may be closed on efficiency grounds, and the number of distinct competitors will decline by one, reducing local competition among financial institutions.

In contrast, though such cases are relatively rare, if an "outside" banking organization acquires a locally owned and managed bank, the issue becomes the degree of local commitment rather than reduced competition. In some communities, the outside bank may provide new types of financial services and perhaps even prove itself to be a more aggressive and competitive lender. In others, local borrowers may find the new bank unresponsive to their unique needs and circumstances. Several bank holding companies have expressed an interest in acquiring community banks, provided the banks are profitable and the local economies are growing. Some acquisitions might be rural, but merger targets are typically larger, urban banks, with rural banks or bank branches caught up in the process only because they were already owned by the primary target.

Distributions of nonmetro financial institutions, assets, loans held, and deposits by type of institution, 1994

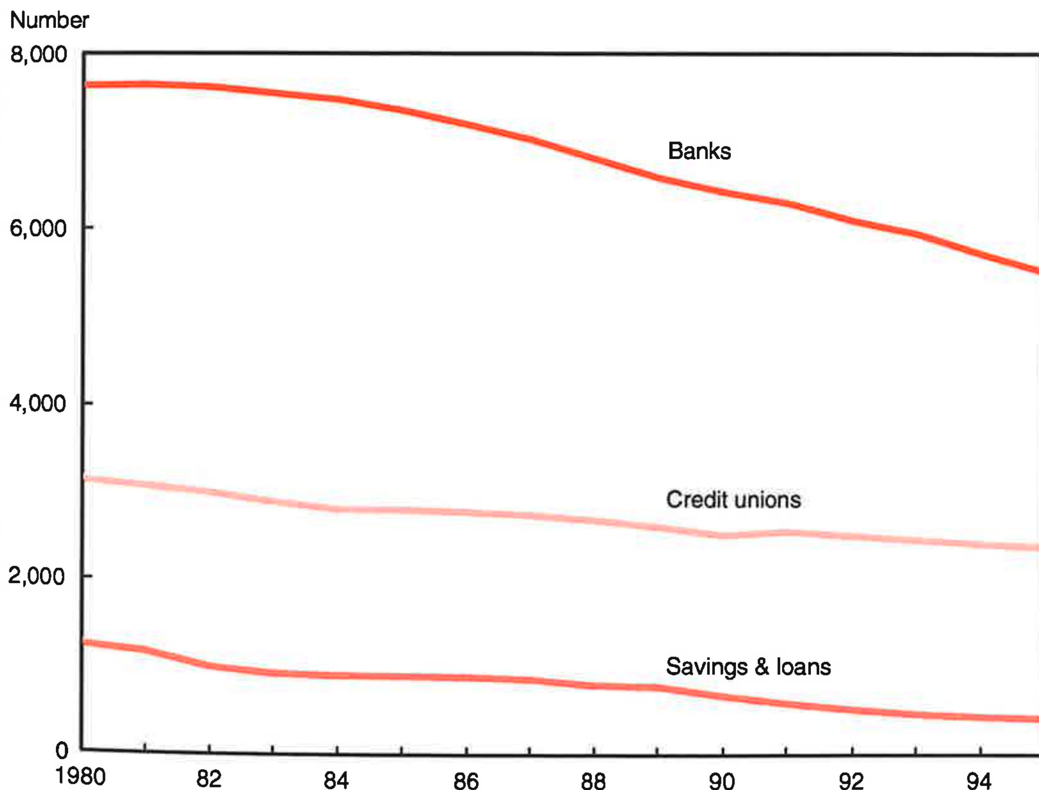
Banks account for 65 percent of nonmetro institutions and even higher percentages of assets, loans, and deposits; credit unions account for nearly 30 percent of institutions, but lag S&L's in the volume of their business



Source: Calculated by ERS using data from Call Reports for December, 1994.

Number of insured rural financial institutions by type, 1980-95

Though starting from a smaller base, the number of S&L's has declined at a faster pace than banks and credit unions



Note: End of year data, except for October 31, 1995. S&L's include Federal savings banks.
Source: Calculated by ERS from the Federal Reserve Board's NIC database.

Rural Banks Are Healthy

Rural banks have regained their financial health and should be able to fill creditworthy loan requests as rural economies continue to recover from the last economic recession.

After declining substantially between 1987 and 1989, the number of rural bank failures increased slightly to 47 in 1990 but again declined rapidly to 26 failures in 1991. With urban failures also slowing in 1991, some analysts attributed that year's drop to a lack of funds in the Federal Deposit Insurance Corporation's (FDIC's) Bank Insurance Fund (BIF). Since the BIF was replenished by 1991 legislation, analysts expected a large increase in 1992 failures. Instead, as the economy turned around and interest rates dropped, many troubled banks were able to regain their health and rural bank failures declined further to 24 in 1992 and 6 in 1993. No rural bank failed during 1994 and only one did so through August of 1995.

Loan Portfolios

Rural banks continue to adjust their loan portfolios towards home mortgages, which represented almost a third of their total loans in 1994. It stands to reason that banks may be picking up some of the pieces left behind by the decimated thrift industry. Loan portfolio data do not tell the whole story, especially in the case of mortgage loans where there are well-developed secondary markets. That is, the loan data show loans held by banks, not loans made by banks in any particular time period. After earning fee income by originating mortgage loans, banks can choose to hold the loans and earn interest income, or to sell those loans that meet the requirements of the secondary market. Selling loans provides funds to make additional loans or other investments, and also lessens credit risk (borrowers may not repay their loans) and interest rate risk (interest paid to depositors might become larger than the rates earned from fixed-rate mortgages) associated with holding loans in portfolio. Banks also purchase securities backed by mortgage loans, which gives them better geographic diversification. Since these securities represent small pieces of many different mortgages, banks gain safety by not facing large losses if one or two of the underlying mortgages default.

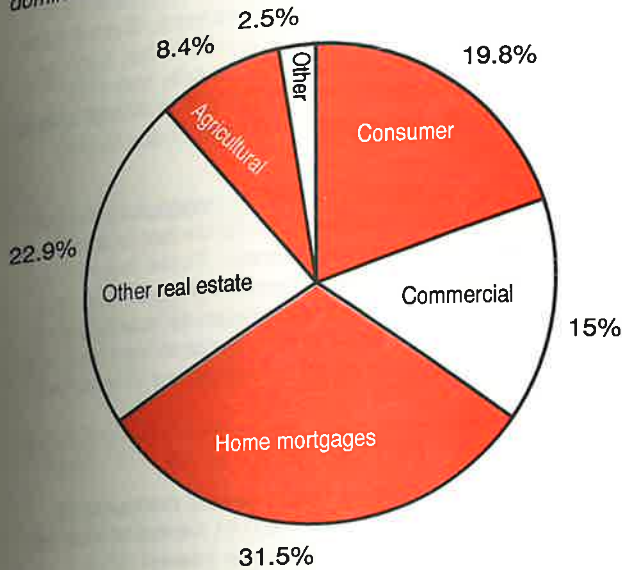
Some banks may have problems using secondary markets because their loan portfolios differ substantially from the national average. Representatives of community development organizations argue that mortgage applications from residents of small rural communities often fail to meet national underwriting standards for secondary markets. Banks in those communities may then make fewer loans or, if they do make nonstandard loans, have less access to the benefits provided by selling loans on the secondary market.

The process of securitization has been spreading to other types of loans due to its perceived benefits for both lenders and borrowers. Borrowers are thought to benefit through lower interest rates made possible by spreading risk over much larger pools of investors. Securities backed by credit card receivables and automobile loans have appeared in recent years, but they were based on loans held by a single large financial institution and thus would not be feasible outlets for rural banks. Farmer Mac was organized more in the spirit of the mortgage secondary market and is meant to be a vehicle for rural banks to sell their agricultural loans. However, Farmer Mac has been slow to get off the ground and is not designed to eliminate risk. Loans purchased for this market will have to meet underwriting standards sufficiently strict to induce investors to purchase securities backed by those loans. Banks will still have to hold in their portfolios loans deemed overly risky. But the program should ultimately increase bank liquidity and credit availability during periods when funds otherwise become scarce. And rural banks in heavily agricultural areas could lessen their sensitivity to conditions in the farm sector by selling some farm loans.

The creation of a secondary market for commercial loans is also under consideration. Because business loans are inherently not standardized, devising underwriting criteria poses significant problems. But if this can be accomplished in a way that permits active loan selling by rural banks, this would further reduce the risk many rural banks bear because their loans are concentrated in a few key industries and over a small geographic area.

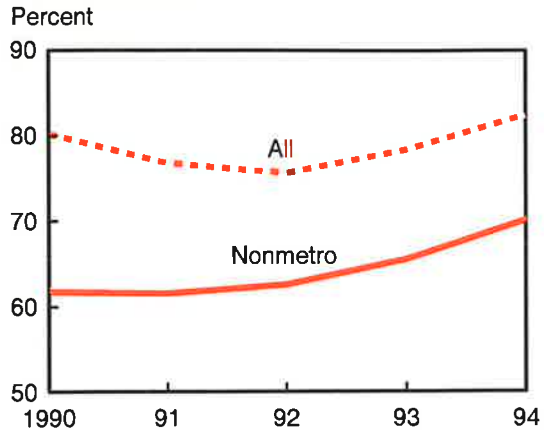
Distribution of nonmetro bank loans by type, 1994

For rural banks as a whole, agricultural loans no longer dominate loan portfolios



Bank loan/deposit ratios

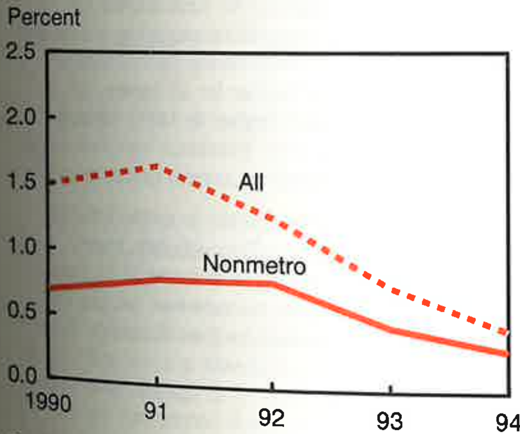
Nonmetro banks lend less than other banks on loans as a proportion of their deposits



Note: See the appendix for definitions of loan/deposit ratios and other performance measures used in the figures and tables.

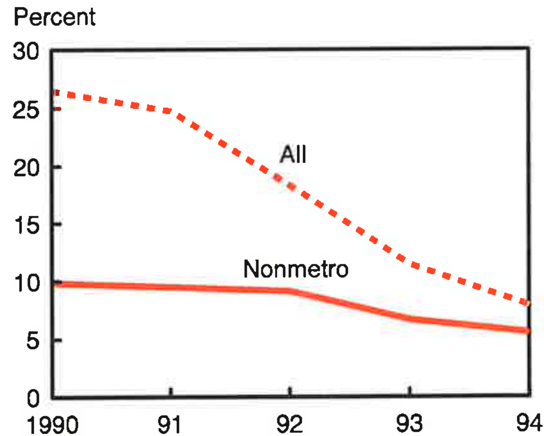
Bank loan loss provisions

A healthy economy allowed banks to set aside fewer funds to cover their bad loans



Problem loans as a share of bank capital

Bad loans continued to decline relative to nonmetro bank capital



Source: All graphs were calculated by ERS using data from the *Report of Condition* and *Report of Income.*

In response to an expanding economy, average loan-to-deposit ratios at rural banks have grown steadily since 1991 and reached 70.1 percent by the end of 1994. Some years ago, loan ratios of this magnitude might have produced concern that rural banks could not continue to handle all of their creditworthy loan requests. However, surveys of bank officers have not detected widespread signs that bankers feel a need to slow down any time soon. Even if bank deposits do not grow fast enough, the banks can raise loanable funds in other ways, such as by selling government securities. Loan ratios of rural banks remain substantially lower on average than those of all banks, though by a narrower margin than in 1990. The overall ratio is heavily influenced by the largest banks, whose ratios often exceed 100 percent due to their use of nondeposit sources of funds to make loans.

At the same time that banks were making more loans, declining loan loss provisions reflected the improving quality of their outstanding loan portfolios. Provisions are funds that financial institutions subtract from current income to add to their loan loss reserves. These reserves in turn are used to balance out bad loans that are written off. Some banks tend to set loan loss provisions just equal to actual loan write-offs, while others add to their reserves in anticipation of future write-offs. In recent years, some banks have managed to take negative loan loss provisions — reserves were higher than necessary so a portion could be transferred to reported profits for that period.

Profitability

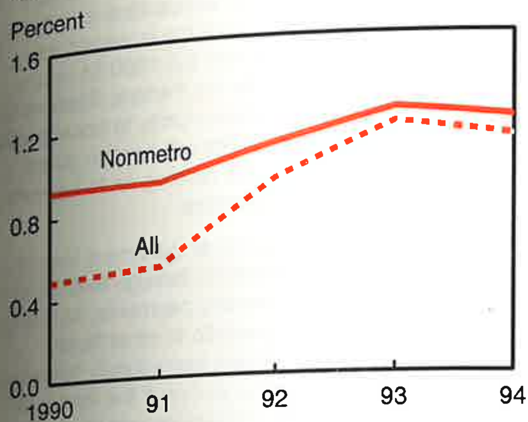
Rural bank performance was solid during 1990 and 1991 according to several measures of profitability, especially relative to the overall banking industry. The 1990-91 recession was certainly not a positive development, as it depressed loan demand. But lower interest rates induced by a weak economy and by Federal Reserve Board efforts to fight the recession increased bank profits since deposit rates fell quicker than loan rates. And rural banks, in general, do not make the sort of commercial real estate loans that haunted Northeast banks during the recession. Thus rural banks came out of the recession in good shape, in line for increasing profitability during 1992-94. And banks continued to get their problem loans under control, suggesting good prospects for 1995 and beyond in the absence of major surprises.

Return on assets, return on equity, net interest margin, and capital-to-asset ratios all improved between 1990 and 1993. Each declined a bit in 1994, but values remaining above those prevailing in 1990 leave no reason to anticipate serious problems similar to those encountered by rural banks during the agricultural crisis of the middle 1980's. The drop in problem loans as a proportion of total capital lends credence to this belief. The average for all rural banks fell below 6 percent in 1994, though this may be attributed in part to regulators requiring increased capital reserves as well as to fewer problem loans. Still, only four rural banks had problem loans exceeding their total capital. Problem loans were somewhat higher for all banks, at close to 8 percent of capital at the end of 1994. This gap was much higher in 1990, heavily influenced by problems experienced by some large urban banks. The difference has narrowed considerably in recent years as the large banks were able to get their problems under control.

Distributions of these measures reveal that a minority of rural banks remain in some trouble. About 7 percent have problem loans exceeding 15 percent of capital. Theoretically, many could survive even after writing off as total losses loans of this amount or somewhat higher. But experience with handling failed financial institutions over the past decade has taught us to anticipate greater losses for seriously troubled firms than are reflected on their financial statements. The 5 percent of rural banks with profits below 0.4 percent of assets are not earning at rates sufficient to survive in the long run. Banks that eat into their capital to absorb loan losses must either replace the capital or shrink their assets to a level at which remaining capital again becomes sufficient to protect against any future losses. Low profits do not support the use of retained profits as a painless method of adding to capital reserves. However, the virtual absence of bank failures suggests that regulators believe most of these banks are handling their problems satisfactorily.

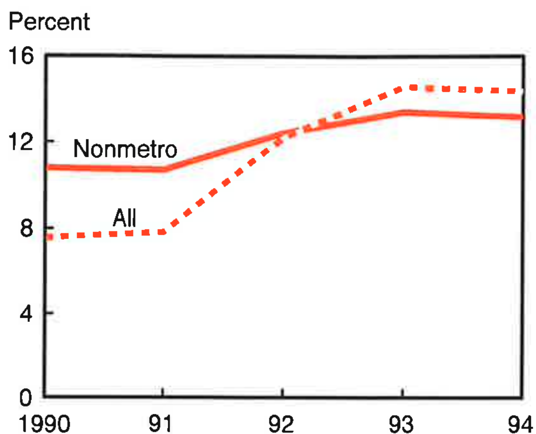
Return on bank assets

Bank profits retreated slightly from their record relative to assets but remained quite high in 1994



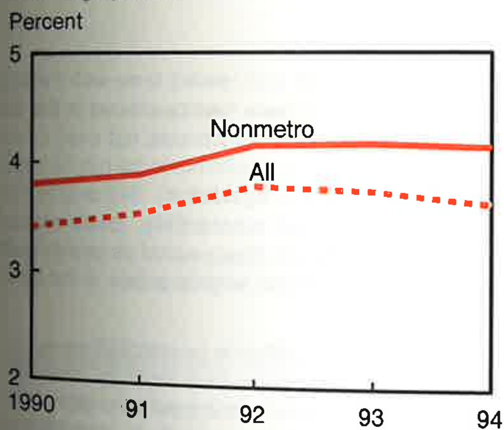
Return on bank equity

Profits as a percentage of equity capital also were solid in spite of a slight drop



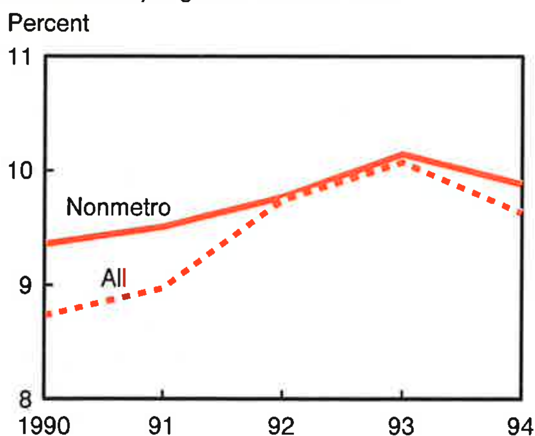
Banks' net interest margins

High net interest margins allowed banks to earn large profits in recent years



Banks' capital ratios

Capital fell as a proportion of assets in 1994 due to the rapid growth of bank loans



Source: All graphs were calculated by ERS using data from the *Report of Condition* and *Report of Income.*

Savings and Loans on the Way Back

While rural savings and loan institutions are moving in the right direction toward regaining financial health, they still have some work to do and must guard against repeating past mistakes.

The fallout of the savings and loan debacle continues to haunt the thrift industry as seen by a continued shrinkage in both the asset base and the number of firms. The thrift industry has regained its health, but at a tremendous cost for which the final tally remains uncertain. By selling assets, thrifts substantially raised their capital/asset ratios in anticipation of more stringent capital requirements. Rural thrifts followed a similar course and the survivors managed to improve their financial position. As the economy recovered from the 1990-91 recession, rural thrifts remained cautious with respect to lending. Moves by the Federal Reserve to stimulate the economy with lower interest rates gave rural thrifts an opportunity to boost profits further due to a lower cost of funds. To maintain this profit margin, thrifts will have to guard against increasing mortgage refinancings at lower rates of interest and holding on to low-rate, fixed-rate mortgages in case of future increases in rates paid to depositors.

Mortgage lenders earn income in several ways: as up-front fee income at the time a loan is made; from monthly interest payments received on loans held in portfolio; through fees for servicing mortgages held by them or by other institutions (collecting monthly payments, handling escrow accounts); and by selling servicing rights on loans in their portfolio to other firms. Lenders typically sell many of their loans through the secondary market immediately following settlement of those loans. Changes in market interest rates enter the picture if the lender initially holds a loan in portfolio but decides to sell it at a future date. Adjustable-rate mortgages (ARM's) protect against interest rate changes since their rates also change. But fixed-rate mortgages (FRM's) maintain the same interest rate over the life of the loan. As with bonds, the value of an FRM moves inversely with prevailing interest rates. S&L's first got into big trouble in the 1980's when dramatic interest rate increases and deposit deregulation resulted in more interest being paid on deposits than was earned from old FRM's still held in portfolio. An attempt to help S&L's survive this period by authorizing new investment powers backfired in many cases due to flawed or fraudulent use of the new lending authority. By selling FRM's and holding ARM's in portfolio, thrifts can earn both fee and interest income without subjecting themselves to interest rate risk.

Structural Change

At the end of 1994, 1,522 savings and loan associations (S&L's) and related firms with Federal insurance from the Savings Association Insurance Fund (SAIF) were headquartered in the 50 States and DC. As recently as the end of 1991, 2,083 S&L's were in business, not even counting firms placed in conservatorship status due to severe financial problems, to be run by regulators while awaiting their final fate (merger, sale to other firms, or liquidation). Not only is the trend toward fewer firms; aggregate industry assets have declined substantially. Some assets were transferred to the banking industry, but billions of dollars just disappeared as assets such as office buildings were given current market values rather than the original prices at the time loans were made.

The 496 S&L's with rural headquarters in 1994 averaged $113 million in assets; 338 were below the $100-million asset level and only 28 exceeded $300 million (app. table 2). This still leaves rural S&L's larger on average than their banking counterparts, but banks are so much more numerous that they dominate most local financial markets. However, savings and loans generally have broader branching authority than has historically been available to banks in many States, and this increases their acquisition value in the minds of large banking firms.

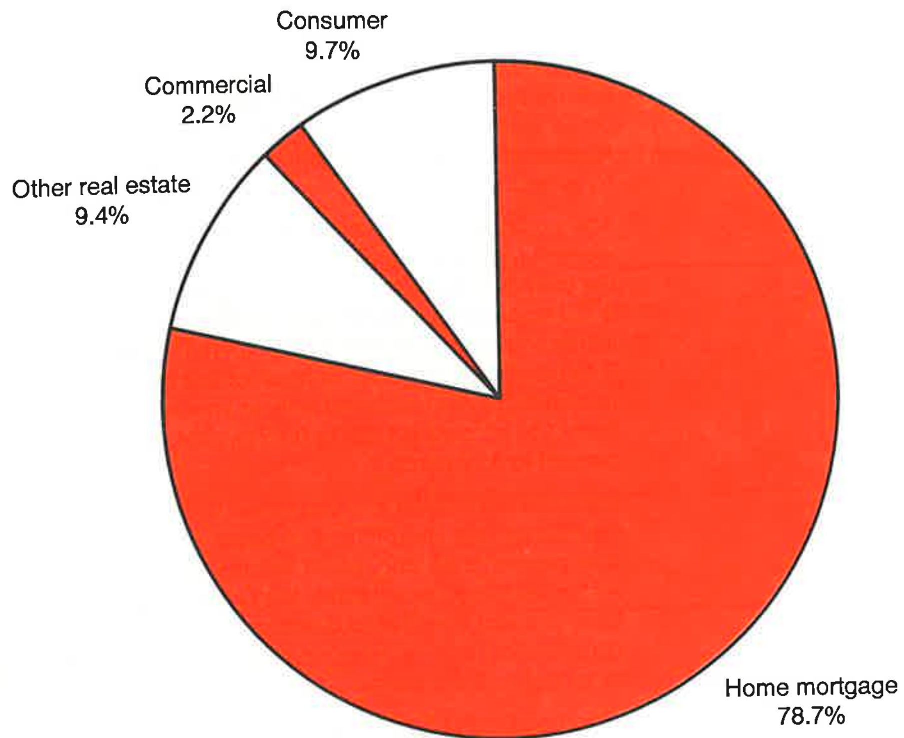
Loan Portfolios

The 1994 distribution of loan portfolios at rural S&L's gives no hint of the risky investments, such as an excess of commercial real estate loans, that destroyed many thrifts. Over three-fourths of their outstanding loans were in the traditional home mortgage category. Remaining loans held in portfolio were split mainly between consumer and other real estate loans. Only about 2 percent of the loans were for commercial purposes, suggesting that surviving members of the rural thrift community make relatively little use of their expanded lending powers to compete directly with banks on a wider front. Instead, these S&L's either returned to, or never left, their primary business of making residential mortgage loans.

Thrifts are extending less credit to the construction sector now than in the mid-1980's with much of that reduction coming in nonresidential construction. However, nonresidential construction lending by thrifts was abnormally high in the mid-1980's so current lending patterns appear to be a return to a more "normal" level, a desired result of regulatory reform.

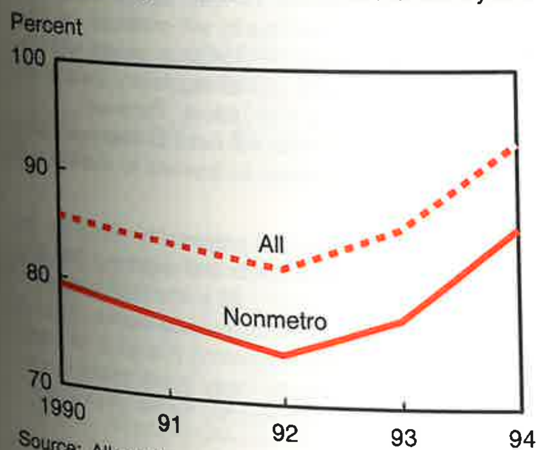
Distribution of nonmetro S&L's loans, 1994

Consumer and business loans are just a sideline to mortgage loans at most S&L's



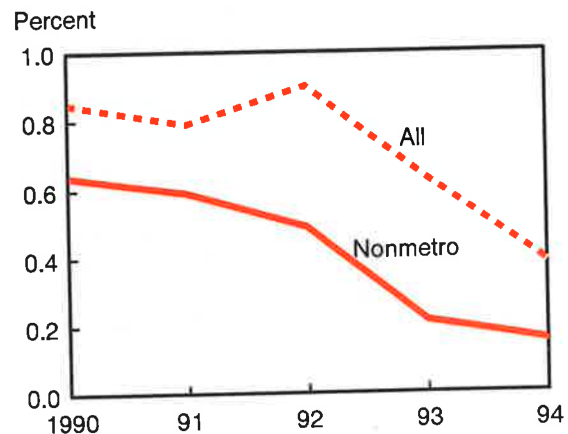
S&L's loan/deposit ratios

S&L loans declined relative to deposits due to a weak economy but have rebounded the last 2 years



S&L's loan loss provisions

Low loan loss provisions suggest that nonmetro S&L's feel their major problems are behind them



Source: All graphs calculated by ERS using data from *Thrift Financial Reports.*

Partly reflecting a return to quality, recent rural thrift mortgage lending grew as a percentage of total loans at the expense of other real estate, commercial, and consumer loans, areas wherein much of the asset deterioration in thrift portfolios occurred during the 1980's. All rural thrifts should now comply with the Qualified Thrift Lender (QTL) test, a rule that requires 65 percent of thrift assets to be mortgage-related.

Loans outstanding grew substantially in 1994 as a percentage of total deposits. But that is to be expected in a strong economy. The value of this ratio for rural S&L's, slightly over 86 percent, far exceeded the corresponding figure for rural banks.

Profitability

Private sector S&L's (those not in conservatorship) were profitable in each size category and region during 1994 (app. table 2). While their profitability still fell below that of banks and credit unions, the gap was much narrower than in 1990. Of course, much of the improvement in these sort of comparisons arises from the elimination of weak S&Ls during those years. Nevertheless, their overall profitability suggests that the remaining segment of the S&L industry is healthy.

The weak average rate of return on assets of 0.14 percent in 1990 cannot be blamed on the recession since this measure was negative in the prior 4 years, reflecting the near collapse of the thrift industry. Return on assets grew to a solid 0.93 percent by 1993, and then fell back to a still respectable 0.86 percent in 1994. Return on equity followed a comparable pattern, increasing each year from 2.34 percent in 1990 to 11.01 percent in 1993 before dropping to 9.49 percent in 1994. While much of this improvement arises from eliminating weak firms, related items are consistent with an improving profit outlook. Loan loss provisions declined from 0.64 percent in 1990 to 0.15 in 1994, and the net interest margin increased from 2.40 percent to 3.17 percent.

Improved net interest margins reflect both an improving economy and the benefits of a declining interest rate environment. A better economy means that more borrowers are able to make their payments on time, which increases the amount of mortgage interest taken in by S&L's. As for declining interest rates, long-term mortgage rates (the primary source of income for a thrift) are less sensitive to downturns than are the shorter term deposits used to fund mortgage lending activity. So while rates on new deposits fell, rates on loans did not fall as much or as fast as firms attempted to boost profit margins.

The capital/asset ratio for rural thrifts increased from 6.04 percent at the end of 1990 to 9.01 percent by December 1994. For about half of all rural thrifts unable to issue stock, their ability to improve the rate spread was critical to meeting higher capital standards by giving them the option of using retained earnings.

With average capital/asset ratios now at 9 percent, rural thrifts on balance should be able to comply with basic capital requirements. Still, some thrifts may have difficulty complying with the risk-based capital standards, which increased to 8 percent of risk-weighted assets in January 1992. Since mortgage loans and securities backed by home mortgages carry lower risk weights, thrifts have an incentive in addition to the QTL test to hold more mortgage assets in portfolio.

The financial prospects for thrifts are not likely to change much in the near future. More consolidation of firms together with marginal improvements in asset quality will continue, making for a healthier but smaller group of rural thrifts. Thrift emphasis on mortgage assets will continue as firms move closer toward compliance with portfolio and capital regulatory standards. At the same time, thrifts will lend less to nonresidential sectors than before. Because Congress enacted legislation permitting interstate abanking, thrifts will need to become more cost-efficient to counter increased competition that is likely to occur as barriers to market entry are reduced.

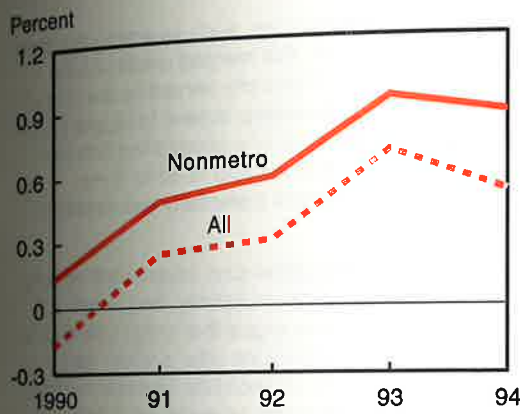
In September 1995, Congress was giving serious consideration to a proposal to eliminate the thrift industry by combining the bank and S&L deposit insurance funds and requiring S&L's to switch to bank charters. By then, the bank fund (BIF) had reached 1.25 percent of insured deposits, thus triggering a large reduction in insurance premium rates paid by banks. The corresponding S&L insurance fund (SAIF) was still years away from achieving this goal, in part because a portion of the annual premium is dedicated to helping to repay government funds used to rescue the industry. Higher costs arising from paying significantly higher premiums

would presumably make it more difficult for S&L's to compete successfully with banks. Combining the two industries is one way of leveling the playing field, but is a somewhat ironic solution. Prior to deregulation of interest rates in the 1980's, banks complained that S&L's had an advantage because S&L's were allowed to pay higher interest rates on savings accounts.

Many commercial banks have been joining the Federal Home Loan Bank (FHLB) system, originally open only to S&L's. FHLB membership provides small banks a source of low-cost, long-term loanable funds for making mortgage loans to supplement their deposit funds. This, plus the memory of what happened to thousands of failed thrift institutions that drifted too far from the home mortgage business, support the notion that thrifts transformed into banks would not radically change their behavior.

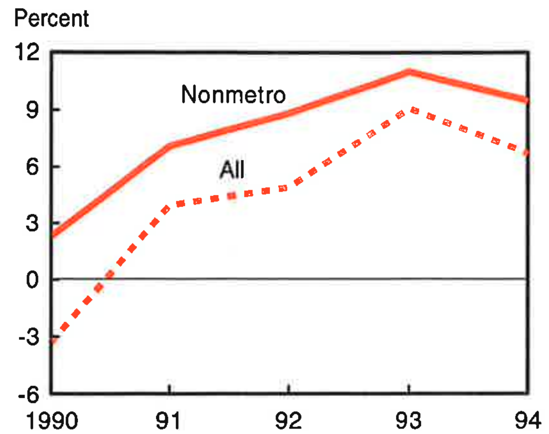
Return on S&L's assets

Nonmetro S&L's as a group are now earning a profit



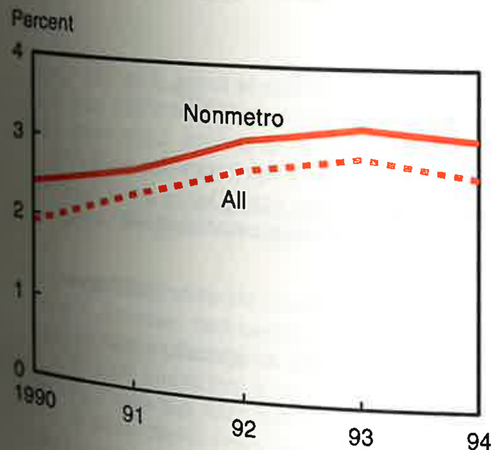
Return on S&L's equity

Those S&L's that survived have regained their financial health



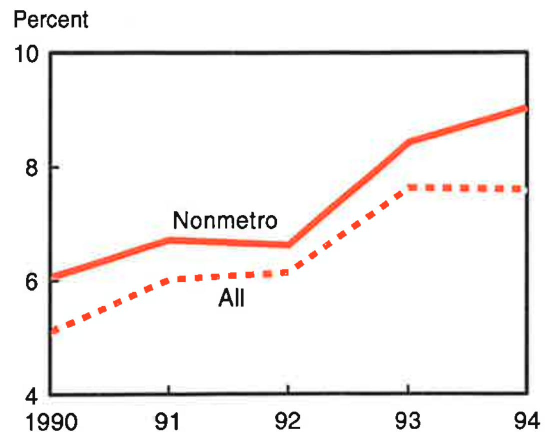
S&L's net interest margins

Net interest margins of nonmetro S&L's improved as interest rates declined



S&L's capital ratios

Nonmetro S&L's are building their capital base to meet regulator rquirements



Source: All graphs calculated by ERS using data from *Thrift Financial Reports.*

Credit Unions Maintain Solid Performance

The market share of credit unions is below 6 percent of deposits and loans held by all rural depository institutions, but they have the potential to play a more important role in rural financial markets.

The credit union industry came through the recession in fairly solid shape. This good fortune followed in part because the traditional role of credit unions, serving deposit and consumer loan needs of their members, kept them away from investments such as commercial real estate that weakened many banks and S&L's. But not all credit unions are the same and the industry is changing. Credit unions now have powers very similar to banks in that they can provide products, such as the equivalent of checking accounts (share drafts), credit cards, ATM's, first mortgage loans, and commercial loans, that range far beyond their original market of auto loans.

Structural Change

Credit unions declined much more rapidly in number over the last 10 or 15 years than did commercial banks. In percentage terms, the drop was comparable to what happened to S&L's though not as drastic. Yet the industry seems to have faced less adversity than did banks and savings and loans, with credit union assets and deposits increasing at a much faster rate than their competitors'.

Credit unions are usually associated with restrictive membership rules, such as employment at a particular firm or local government or membership in a church. But merged credit unions can define their potential membership base as the sum of those formerly served by the component credit unions. This should strengthen credit unions by providing access to bigger pools of prospective customers. Economic problems in one industry or at one sponsoring firm can be better overcome by credit unions with members in other industries and at other firms. Other credit unions have a geographic membership definition, which potentially represents a much larger pool of customers.

Combining less restrictive membership requirements with credit union cost advantages arising from volunteer labor, free office space from employers, absence of tax liability, and direct deposits and loan payments from paychecks leads some banks to argue that credit unions are potentially formidable, unfair competitors. Many expanding credit unions offer a wider range of services than was previously the case. Thus, their members can consolidate financial relationships in the credit union if they wish rather than using banks for some products (checking accounts, first mortgages) and credit unions for others (savings accounts, auto loans). An example that caught the attention of community bankers was the attempt a few years ago by the American Association of Retired People to operate a national credit union for its members. This credit union was soon closed, and bankers prefer not to see similar attempts in the future.

While some credit unions have grown into large financial institutions, most rural credit unions remain quite small, and the industry does not appear to be a major force in rural America. Far fewer credit unions than banks are found in rural counties. Of the 11,958 federally insured credit unions at the end of 1994, only 2,620 were rural (app. table 3). Credit unions also tend to be much smaller. Most rural credit unions have assets well below $50 million, with only 35 exceeding $100 million.

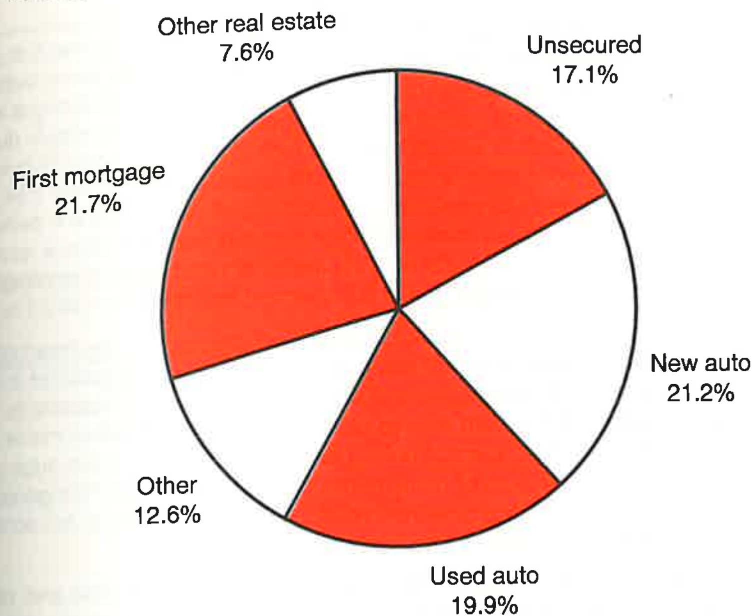
Loan Portfolios

Credit union loan portfolios are dominated by consumer and real estate loans. First mortgage loans held by rural credit unions represent the largest category in 1994, with a slight lead over loans for new autos. Used auto and unsecured loan types are not far behind. Combining used cars with new cars, and first mortgage with other real estate loans, reinforces the traditional stereotype of credit unions as a place to go for car loans. But real estate loans place a strong second, with the majority being first mortgages that were not always associated with credit unions.

Agricultural and business loans made to members are recorded on a separate Call Report schedule filed only by those credit unions for which these loans exceed their reserves. These loans are distributed among several loan categories. For example, an agriculture-related loan might show up on the main loan schedule as an unsecured loan, as a real estate loan, or under other loans. While reported agricultural and business loans are each just over 1 percent of total loans at rural credit unions in aggregate, that does not mean every credit union is immune from possible problems in specific industrial sectors. A few years ago, the largest sin-

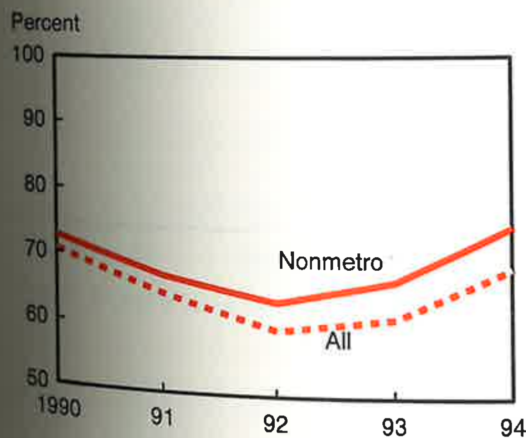
Distribution of nonmetro credit union loans, 1994

First mortgage loans are now the largest single loan category for credit unions, but auto loans combined exceed total real estate loans



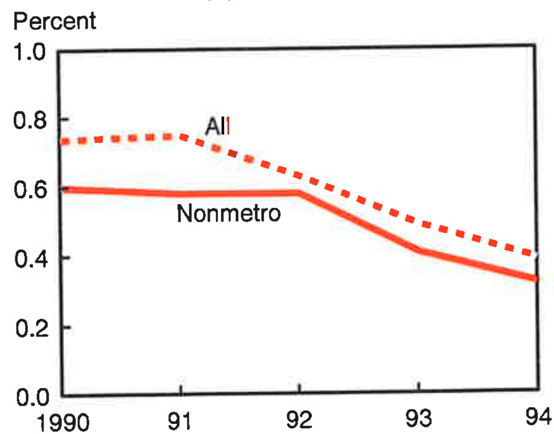
Credit unions' loan/deposit ratios

Nonmetro loan/deposit ratio declined during the recession but now exceeds the 1990 value



Credit unions' loan loss provisions

Provisions for loan losses at nonmetro credit unions held steady during the recession and then declined sharply



Source: All graphs calculated by ERS using data from *Financial and Statistical Reports of Credit Unions*.

gle loss to the credit union insurance fund arose from a credit union with many delinquent business loans. So, while rural areas may benefit if credit unions pursue a wider variety of financial services, recent years have provided abundant anecdotes of problems that can arise when firms try to expand too far or too fast.

Profitability

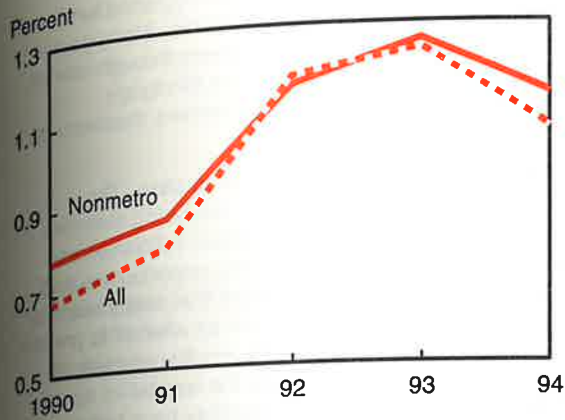
Loan loss provisions changed very little for rural credit unions during the first part of the decade, almost as if they were immune to the recession. However, loans outstanding declined to 64 percent of deposits by the end of 1992, as might be expected during a weakening economy. Because profitability and capital measurements improved moderately during those years, one interpretation is that credit unions tightened their operations, avoiding overly risky loans that plagued other financial institutions. Did credit unions do this on their own, or were they prodded to do so by prescient regulators and examiners? Was it more a demand phenomenon, with credit union members increasing their loan requests at a slower rate than they were adding to their deposit accounts? Or was it a matter of rejecting loan applications that may have been accepted in prior years due to a judgement that the loans would now be too risky?

These questions cannot be answered definitively here but were at the heart of discussions during 1992 and 1993 on whether or not banks and other lenders had created a credit crunch by refusing to make loans. One hypothesis is that people transferred deposits to credit unions because they read about frequent failures of banks and S&L's. Product mix is an alternative explanation. For the most part, credit unions do not participate in areas such as commercial real estate that led to the failure of many banks and S&L's. Avoiding "dangerous" products would explain why credit unions remained relatively healthy, but would not account for their declining loan-to-deposit ratios.

Rural credit unions clearly shared in the economy's growth during 1993 and 1994. Loans grew to 75.1 percent of deposits and loan loss provisions fell to 0.3 percent of outstanding loans. Return on assets increased to 1.26 percent for rural credit unions by the end of 1993 but dropped back to 1.13 percent in 1994. This remains above the 1-percent benchmark generally mentioned as desirable for banks and should probably be considered a healthy result. However, comparing credit union results to those of banks is difficult because credit unions aim to satisfy member-customers rather than stockholders as is the case for banks. Credit unions want to show solid financial results so that they can maintain high service levels for their members and meet regulatory requirements. But rather than trying to maximize performance measures such as return on assets, credit unions "give back" some of their potential profits by paying higher deposit rates or by charging less on loans.

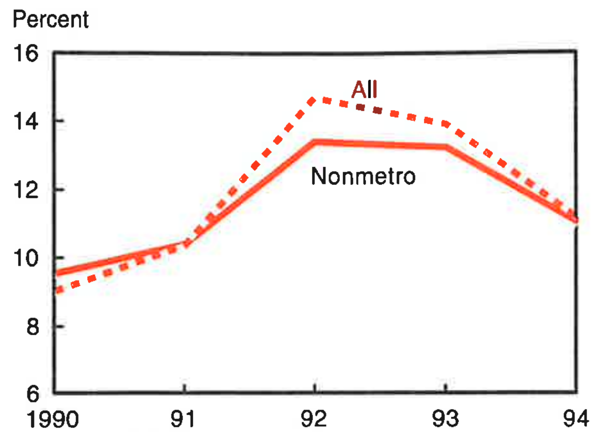
Return on credit union assets

Return on assets improved moderately during the recession and then exploded afterwards



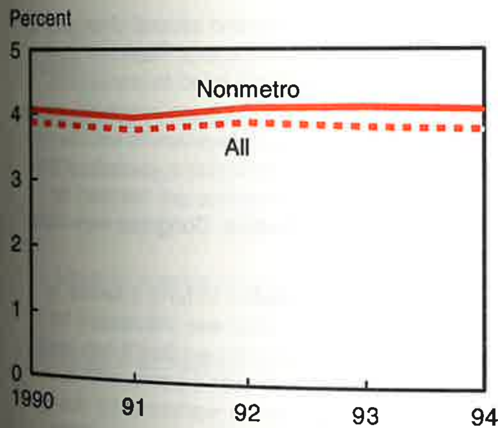
Return on credit union equity

Nonmetro credit unions averaged about the same return on equity as credit unions nationwide



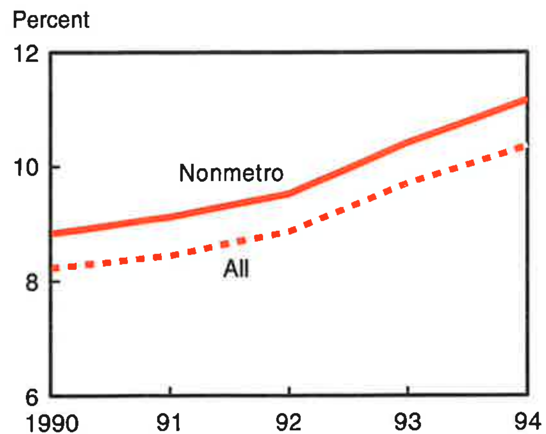
Credit unions' net interest margins

The net interest margins remained high enough to support profitable operations



Credit unions' capital ratios

Credit unions have been strengthening their capital ratios



Source: All graphs calculated by ERS from *Financial and Statistical Reports of Credit Unions.*

Financial Markets Are Rapidly Evolving, but the Rural Effects Are Unclear

A variety of laws and regulations from the Administration, Congress, and regulators of financial institutions were enacted or proposed during 1994 and 1995. Among them are interstate banking, new regulations for the Community Reinvestment Act, and legislation promoting community development institutions.

While the banking industry is reporting record profits and has rebuilt its insurance fund years ahead of schedule, the industry is being criticized on several fronts. Many people argue that banks deepened the last recession and slowed economic recovery through unwise rationing of business credit. Mortgage loan data collected under the Home Mortgage Disclosure Act (HMDA) strongly suggest that banks and other mortgage lenders discriminate against minority applicants.

Drawing rural implications is not easy in either the rationing or discrimination case. The absence of data on individual business loan applications makes formally analyzing business lending decisions by banks difficult. Financial industry representatives reject criticisms concerning credit rationing, arguing that banks do not turn down good lending opportunities and implying that the loan applicants were not good credit risks. Or they claim that overly zealous bank examiners have discouraged banks from taking on additional risk in an attempt to prevent another round of bank failures. While no reliable evidence exists on the creditworthiness of rejected loan applicants, the latter argument may have some validity as the regulatory agencies have admitted that bank examiners may have been too zealous, but they have been instructed to avoid such behavior in the future.

As for mortgage lending, the HMDA data are primarily collected from urban lenders. To the extent that rural credit markets and rural lenders behave the same as their urban counterparts, we would also expect minorities to face higher rejection rates on their mortgage applications in rural communities. But direct rural evidence is lacking. Some bankers and other mortgage industry representatives agree that HMDA evidence of discrimination, whether intentional or not, is too strong to ignore, and their institutions are taking steps to address the problem. For example, applications rejected by using standard rules of thumb are now routinely reevaluated to see if a closer examination of the applicant's finances indicates that he or she can afford mortgage payments exceeding the usual proportion of income. If these sorts of procedures become widespread, they could benefit rural residents in the coming years.

In response to these perceived problems, the Administration has proposed several changes to the Nation's banking laws. At President Clinton's request, in 1995 the Federal Reserve Board and the other bank and S&L regulatory agencies revised the regulations used to implement the Community Reinvestment Act (CRA). The goal is to increase lending in underserved areas while reducing regulatory costs for affected financial institutions. These regulations will eventually produce data on rural business loans made by large banking organizations in each of the markets they serve. This should help to evaluate whether rural communities are harmed by interstate banking. But even before the new regulations become effective, Congress was considering legislation to exempt small banks from the CRA.

Congress enacted a modified version of a Clinton Administration initiative to fund a series of community development financial institutions (CDFI). The CDFI proposal was influenced by the experience of the South Shore Bank of Chicago, which has demonstrated that it can profitably lend in low-income areas. CDFI funding was set at $382 million over 4 years, with a third of the funds going to existing banks as rebates of deposit insurance premiums for doing a good job of servicing low-income areas. This level of funding is not sufficient to measurably improve the national economy, and Congress has not agreed to appropriate the full amount. But it will help those rural communities that get some of the CDFI funds.

Surprisingly, interstate banking legislation was resurrected in early 1994 and passed that fall. Starting in September 1995, the law let bank holding companies expand to any State by acquiring existing banks. Some bank holding companies had already acquired bank affiliates in other States through a loophole allowing States to authorize such purchases. In June 1997, a holding company can convert its affiliates to bank branches unless individual States enact legislation to forbid this part of the process. Large banks favor interstate banking because they can operate branches at less cost than it takes to operate a full-scale bank affiliate. Spreading their business over more States makes banks less vulnerable to weak economic conditions in particular regions or industries, which could help rural communities that depend on agriculture or another industry. But some rural advocates fear that interstate banking might harm rural

America if banking resources are taken over by giant banks who only see small rural communities as a source of deposits.

The Administration has also worked on banking reform. The CDFI legislation includes provisions to lessen the regulatory burden of banks and to facilitate secondary markets for small business loans. The regulatory changes will promote a modest increase in rural lending by lowering bank costs and by giving bankers more time to make loans. If an active secondary market develops for small business loans, rural business lending will increase as banks lower their loan interest rates and sell loans to other investors. A congressional proposal to combine the various Federal regulators of commercial banks (Federal Reserve Board, Comptroller of the Currency, and Federal Deposit Insurance Corporation) and S&L's (Office of Thrift Supervision) into a single agency failed to pass in 1994. The Federal Reserve Board (Fed) would handle monetary policy, and the FDIC would concentrate on its deposit insurance role. The Fed's claim that a supervisory role complements its monetary policy work led to a possible compromise in which the Fed would supervise the largest banking organizations and a sample of other banks. The current session of Congress may instead merge OTS with the Comptroller and have thrifts convert to banks. In addition to reducing the number of regulators, this approach is driven by a desire to address the competitive disadvantage of S&L's resulting from lower deposit insurance premiums for banks.

Congressional attempts to repeal or modify the Glass-Steagall Act took something of a roller coaster ride throughout 1995, and the final outcome remains very much in doubt. Glass-Steagall generally prevents banks from combining with brokerage firms and insurance companies. Agreement that the act is outmoded is widespread, but opposition to parts of the proposal is strong. Insurance agents do not want competition from banks. Small banks would like to sell insurance policies, but many fear the concentration of economic power if large banks merge with large securities and insurance firms. Previous attempts to create financial supermarkets have had limited success. But repealing Glass-Steagall potentially would lead to more competition in these financial services for rural residents.

Recent Factors Affecting Financial Markets

Factor:	*Possible Rural Effects:*
• Revision of Community Reinvestment Act regulations—	
- Reduce regulatory costs	Encourage lending in underserved areas; should make data on rural business loans available from large banks
- Move to exempt small banks	If enacted, will reduce the number of small banks required to report
• Enacted interstate banking effective September 1997	May allow some larger rural banks to diversify their portfolios by lending to a wider array of customers; may reduce banking services in some rural areas if large banks move in or take over existing banks and are interested only in rural deposits
• Reduce regulatory burden on banks	Allow rural bankers more time to make loans
• Facilitate secondary market for small business loans	Allow rural banks to reduce risk of carrying many small business loans
• Move to combine bank and S&L industries or their regulatory agencies	May assist S&L's to remain healthy competitors to banks; may promote consistency in regulating different types of financial firms
• Efforts to repeal or modify Glass-Steagall Act	May give rural residents more choices for obtaining financial services; may hasten consolidation of of financial firms

Rural Banks Should Be Able To Keep Pace With Changes In Rural Credit Markets

Rural banks are likely to continue to do well financially in the coming years. Those that choose to remain independent should be able to use technology to provide a wide range of financial services to their customers.

Ongoing and anticipated changes should make the remainder of the 20th century exciting, or at the very least quite interesting, for the financial industry and for those who analyze its performance and structure. This includes rural financial institutions, although they may experience a less rapid pace of change than is in store for many of their urban counterparts.

The commercial banking industry reported record profits in 1993, due primarily to low interest rates, which facilitated widening interest rate margins, and an improving economy that sharply lowered loan losses. The $43.1 billion in net income represents a return on assets (ROA) of 1.2 percent; ROA had never before achieved the 1-percent level for a whole year. Years of interest rates paid on deposits falling faster than those charged on loans resulted in high net interest margins. A stronger economy meant that loans were more often repaid on time, so that banks could safely set aside fewer funds to cover future loan losses. These same trends also helped credit unions and S&L's. Rural institutions, as a group, shared the good fortune of their industry. That was definitely the case for bank failures, as no rural banks failed during 1994.

Bank performance remained solid in 1994, and was expected to stay strong in 1995 and 1996. However, profit growth slowed down as the Federal Reserve boosted short-term interest rates. Industry profits grew a bit to $44.7 billion in 1994, but this represented a decline in ROA to 1.15 percent as industry assets grew faster than profits. Evidently the Fed is concerned that rapid growth in the U.S. economy could ignite a new round of inflation, though that has not yet shown up in data on wage and price changes. The Fed's stated goal is to achieve conditions of neutrality in its monetary policy, allowing the economy to grow at a normal long-term rate without dependence on artificial factors such as the Federal Reserve's effort to deliberately lower interest rates earlier in the decade. Initially, long-term rates increased faster than short-term rates. But once the financial markets were convinced that the Fed would not be swayed from doing what it thinks is best, long-term rates moderated somewhat in the first part of 1995. By midyear, signs of slower economic growth led the Fed to reverse course and begin to lower short-term rates.

Technological advances that threaten the health of small banks, a category that includes most banks headquartered in rural communities, also provide opportunities for these same banks not only to remain independent but to thrive. Large regional banks have been talking (and acting) for more than a decade about the need to grow through mergers and acquisitions if they wish to compete in global financial markets. Yet small banks can provide their customers with innovative services by working together or with other firms. A small bank does not need to start a proprietary mutual fund — it can simply provide space in its offices for employees of brokerage firms.

Remaining S&L's are doing much better for the same reasons as commercial banks. But the exceptionally good bank results pose a potential future problem for thrifts. The insurance fund for banks is being replenished much faster than that of S&L's. Current legislation permits regulators of banks and S&L's to lower insurance premiums only after their respective insurance funds reach 1.25 percent of insured deposits. The bank fund achieved this goal around May 1995, but the S&L industry needs another 7 years at the present rate. Thus, banks will pay less for deposit insurance, which will make it more difficult for S&L's to compete. Proposals have been made to merge the bank and S&L insurance funds, but bank officials oppose this idea.

The outlook for rural financial institutions can perhaps best be expressed as cautiously optimistic. With all of the changes and problems that occurred in financial markets during the past 15 years and those that are likely to take place over the next few years, outright optimism is probably not very practical. But rural banks and other financial institutions have shown an ability to survive by adapting to a changing financial environment.

The statistics on banks, S&L's, and credit unions cited previously in this issue may somewhat oversimplify the structure of rural financial markets, both by missing other participating institutions and by incompletely portraying those institutions that are covered. A variety of other institutions are active in rural credit markets. The Farm Credit System—a collection of cooperative lending institutions—is a key player in agricultural lending. It is lobbying to have its Federal charter amended to allow it to serve the credit needs of the nonfarm rural community as well, but it now has only a minor role in nonfarm lending. Other Federal and State agencies operate credit programs that serve rural communities, and a number of small private and quasi-public lenders also provide financial support to segments of the rural community. However, their scope of operations is generally much narrower than that of depository institutions, and they quite often operate in conjunction with the commercial banks and other depository institutions which are the focus of this report.

Having to limit the discussion to available data on the headquarters of bank, S&L's, and credit union headquarters may also simplify the situation by not revealing the effects of branch offices in rural areas. The only data available on branch offices is for banks and indicates the branches' locations and amounts of deposits. Those data show that only 536 urban banks had rural branches, but their total of 4,568 rural branches is by no means insignificant next to the 14,643 rural offices (including 6,056 bank headquarters) controlled by rural-based banks. The share of deposits coming from branches in areas other than where the headquarters is located may indicate why some oppose more liberal branching within and across States. Rural-based banks have most (93.3 percent) of their offices (headquaters and branches) in rural areas and collect most (95 percent) of their deposits from rural offices, and the bulk of their lending is probably also with rural customers. But urban-based banks have nearly 18 percent of their offices in rural areas but gather only 10 percent of their deposits through them, which in the minds of some calls into question the importance urban-based banks place on their rural activities.

A related but more ambiguous problem comes about as a result of multibank holding company activity. As a means of surmounting State restrictions on bank branching, holding companies own separately chartered banks in many locations. Affiliates with rural headquarters appear as rural-based banks in the tables, but if the parent holding companies impose centralized control, the affiliates may behave very differently than locally owned banks in terms of the types of loans they offer and the standards that borrowers must meet. These comments on bank branching apply even more so to S&L's. Credit union data are probably the closest to being single-unit operations; some branches exist but not many, and the markets of most credit unions can safely be assumed to lie within the rural county or metro area containing the credit union office.

Bank headquarters and branches by location, 1993

Metro banks control, but do not heavily depend on, thousands of nonmetro offices

Type of bank	Headquarters	Branch offices: Nonmetro	Branch offices: Metro	Total deposits	Nonmetro share of deposits
		Number		Billion dollars	Percent
All banks	11,190	13,155	37,998	2,318.3	18.6
All banks with one or more nonmetro offices	6,592	13,155	21,604	1,397.3	30.8
Nonmetro-based	6,056	8,587	1,057	338.9	95.0
Metro-based with one or more nonmetro offices	536	4,568	20,547	1,058.5	10.3
Metro-based with no nonmetro offices	4,598	0	16,394	920.9	0.0

Source: FDIC Summary of Deposits, June 1993.

New Community Reinvestment Act Regulations May Spur Rural Lending

New Community Reinvestment Act regulations will hold large urban banks accountable for their rural lending and simplify exam procedures for small rural banks.

As one of his 1993 domestic economic initiatives, President Clinton asked the Federal regulators of banks and savings and loan associations (S&L's) to revise the regulations that govern the Community Reinvestment Act (CRA). The President wanted modified procedures that will encourage more creditworthy lending by financial institutions and meet concerns that the current approach wastes resources and does not produce the intended results. The Federal Reserve and other agencies circulated drafts of revised regulations for public comment in December 1993 and in October 1994. Thousands of comments were received each time. The final regulations were released in April 1995, to take effect January 1996 for small financial institutions and July 1997 for larger lenders.

The CRA itself is not being amended because its goal remains intact: prevent redlining (taking deposits from inner cities and lending them elsewhere) by making sure that creditworthy borrowers in all communities are treated fairly. Interest in the CRA has heightened in recent years. Community interest groups use CRA objections in cases of proposed bank mergers to extract community lending promises from banks. Banks were accused of slowing recovery from the last recession through unwarranted credit rationing. And extensive data on mortgage applications made available under the Home Mortgage Disclosure Act (HMDA) strongly suggest that current practices discriminate against minority mortgage applicants.

Broad agreement exists that past methods of implementing the Community Reinvestment Act were not effective, but various parties disagree over how to improve administration of the act. Critics claim that prior regulations stressed style over substance. In preparation for their periodic CRA examinations, banks spend large amounts of time and resources to document how they promote community lending, whereas actual lending is, or should be, the underlying issue.

The new regulations walk a tightrope between goals that may be impossible to meet simultaneously. Regulators wish to induce greater lending in low- and moderate-income areas with regulations that make compliance easier to measure and less costly to follow. Lenders are encouraged to apply innovative programs to increase lending in low- and moderate-income areas, yet the loans must be consistent with traditional standards of default risk. The difficulty of achieving this task may explain why even before the new regulations became effective, Congress was considering legislation to exempt small banks from the CRA.

Summary of New Regulations

CRA examinations are based on 12 performance factors. For large banks, the new regulations replace these factors with three tests: lending, investment, and service. These tests stress outcomes, not the methods or effort behind the outcomes. Small banks, meaning those under $250 million in assets, are eligible for streamlined exams. All banks may select the alternative approach of developing a strategic plan. As before, CRA performance comes into play as a factor when regulators make decisions concerning applications for bank mergers or establishing new branches. Earlier drafts of the regulations strengthened CRA by authorizing enforcement actions against banks not involved in expansion applications, but regulators withdrew this proposal from the final regulations due to a lack of legal authority.

Each bank must define a geographic assessment area that covers most of its loans. The assessment area cannot arbitrarily exclude low- or moderate-income areas. If the bank has more than one office, a single assessment area may incorporate many or all of the bank's offices. However, rural and urban offices cannot be placed in the same assessment area, nor can an assessment area hold offices from two consolidated metropolitan statistical areas (CMSA's). Hence, banks with geographically dispersed branch offices must specify a series of assessment areas. The regulations do not specify how examiners will aggregate CRA performance across multiple assessment areas. However, since large banks must compile loan data for each assessment area, performance by rural offices of large banks should influence their overall CRA ratings.

The three tests have five possible levels: outstanding, high satisfactory, low satisfactory, needs to improve, or substantial noncompliance. Because the CRA Act dictates four rating levels, the final composite rating is based on four levels obtained by combining high satisfactory and low satisfactory categories. Using five levels at earlier stages of the process addresses concerns that the current system is less effective due to the satisfactory rating achieved by most banks. The lending test receives greater emphasis — an overall rating of satisfactory requires at least a low satisfactory rating on the lending test.

Banks subject to the lending test must compile data for loans to small businesses and to small farms originated by or purchased by the banks. They must summarize these data for their regulators based on loan location, loan size, and annual revenue of the borrowing firms. Banks may optionally provide similar data for consumer loans. They must report the total number and amount of community development loans. Banks subject to HMDA must provide more geographic detail on their rural mortgage loans and loan applications than was previously the case. HMDA generally applies to urban lenders, but any rural activity also shows up in their annual reports.

Regulators have the task of compiling the loan data and preparing disclosure statements. The statement for an individual bank will show distributions of loans to small businesses and farms by county, income level of census tracts within the county, and firm revenue. Regulators will also provide aggregate disclosure statements for the rural and urban portions of each State.

The investment test examines the effect of a bank's qualified investments that help low- and moderate-income portions of the assessment area. Examples include investments in affordable housing, community development projects, and small business development corporations. Thus, banks with weak direct lending in low- and moderate-income areas may improve their CRA ratings by investing in these areas.

The service test examines whether reasonable proportions of a bank's branch offices are in low- and moderate-income areas or can be easily reached by many of those residents. This test can also take into account community development financial services, such as technical assistance to groups that provide low- and moderate-income housing, credit counseling, and low-cost government-check cashing.

Streamlined CRA examinations are specified for banks with assets below $250 million and that are not part of a bank holding company with aggregate assets above $1 billion. CRA performance is evaluated on the basis of factors such as the loan-to-deposit ratio, proportion of loans made in the assessment area, and the distribution of loans by income level, size of business or farm, and location. Examiners will take into account other factors such as loan sales (which can make loan-to-deposit ratios look artificially low), local economic conditions, and bank size.

Small Banks and Loan-to-Deposit Ratios

Small banks below $250 million in assets naturally applaud the proposal for streamlined CRA examinations. Bankers argue that besides making their lives easier, the proposal to streamline might benefit rural and other small communities. Since small banks cannot afford to hire full-time CRA compliance officers, lessening the amount of time required by top managers to monitor the bank's CRA performance could allow these managers to put more effort into making loans.

Bankers sometimes claim that rural community banks by definition should achieve satisfactory ratings on CRA examinations and therefore should escape the high regulatory costs associated with documenting their CRA performance. That is, banks in small towns must and do serve their local customers. However, community interest groups (such as ACORN, the Association of Community Organizations for Reform Now) reject the concept outright, arguing that lending practices of small banks should be scrutinized just like those of large banks.

The table shows the size distribution of rural-headquartered banks, along with the distribution of loan/deposit ratios for each bank size category. Most rural banks hold less than $250 million in assets, but many do not reach the 60 percent loan/deposit ratio that was mentioned in an earlier draft of the new regulations. The proposal estimated that less than 10 percent of total assets are held by banks that satisfy both the asset and loan ratio conditions, but that proportion is much higher in rural communities.

The proportion of banks satisfying the 60-percent cutoff will vary year to year with the business cycle and seasonally within the year, particularly for banks that make many agricultural loans. The proposal indicates an intention to take seasonality factors into account, though the details are not spelled out. But the 60-percent figure may prove obsolete in a few years if banks continue the trend of holding securities rather than loans. That is, suppose banks make as many loans in future years, but sell more loans on the secondary market and purchase securities backed by similar loans from many different banks as is done with mortgage loans. Banks might be safer by depending less strongly on local prosperity, which in turn might allow them to better serve the local economy. Yet banks would be penalized if following such a strategy resulted in loan/deposit ratios that fell below levels considered appropriate by regulators.

Further, the majority of banks have less than $250 million in assets and will not be required to provide loan data for the lending test. While large banks dominate national banking industry assets, bank offices in many rural communities represent a mixture of local and nonlocal banks. How are lending test results interpreted if they ignore lending by banks that are important locally yet too small to participate in these tests? CRA examiners have access to bank loan files and in theory could compute much of the loan data to be supplied by larger banks. But it is not likely that this information will be widely available for analysis by community interest groups or other interested observers.

Prospects for Rural Communities

While large banks with rural and urban offices must define and provide loan data for separate rural and urban assessment areas, missing details in the new regulations leave unclear the extent to which poor CRA performance in small rural offices may affect a large firm's overall CRA rating. This approach may help address fears concerning interstate banking and intrastate branching if banks that use rural offices as a source of funds to be loaned elsewhere face the prospect of lower CRA ratings due to poor performance in their rural assessment areas. Analysis of HMDA mortgage data has influenced leading mortgage companies to devise programs for giving a second look at rejected applications from minority applicants. CRA loan data for other types of loans from banks with more than $250 million in assets is potentially just as important. But if banks can escape close scrutiny by doing well just in their main markets, while ignoring the credit needs of the rural communities they serve, then CRA could be largely ineffective in rural areas served by urban-based banks.

Consolidation within the banking industry increases the importance of regional and money-center banks in rural communities, and this process may accelerate in response to the 1994 interstate banking legislation. Even if the CRA rating primarily reflects a bank's urban performance, community groups can monitor the local performance of outside banks serving their communities if they have easy access to the CRA loan data. If data are quickly and inexpensively made available to the public, CRA will have a much greater effect on lender performance, particularly in rural communities served by banks with large branching networks.

Rural-headquartered banks by asset level and loan ratio

Most rural banks hold less than $250 million in assets, but many have loan/deposit ratios below the 60-percent cutoff

Assets	All banks	By loans as a percentage of deposits: 0-20	20-40	40-60	60-80	80-100	Above 100[1]
	Number of banks						
All asset levels	5,837	60	554	1,693	2,691	787	52
Below $50 million	3,228	44	353	1,031	1,455	334	11
$50 to less than $100 million	1,535	14	143	436	717	213	12
$100 to less than $250 million	892	2	55	208	435	177	15
$250 to less than $500 million	135	0	3	16	69	43	4
$500 million to $1 billion	29	0	0	1	10	11	7
Above $1 billion	18	0	0	1	5	9	3

[1]Deposits are not the sole source of funds loaned by banks, which allows the loan/deposit ratio to exceed 100 percent.
Source: Federal Reserve Board of Governors, *Report of Condition and Report of Income*, December 31, 1994.

Rural Businesses Felt Well Served by Banks in the 1980's

Rural businesses generally rated their banks higher than did urban businesses.

Rural businesses were more satisfied with their banking experiences than urban businesses in 1983, 1985, and 1987. During that period, the small business credit market went from conditions of weakness to rapid expansion to solid growth as the national economy went from recession to recovery to boom. Surveys of small businesses conducted by the National Federation of Independent Business (NFIB) in 1983, 1985, and 1987 provide the basis for these findings. The surveys, focused on the relationship between small businesses and their banks, showed that rural businesses were happier with their loan terms even though they faced higher interest rates than urban businesses in the 1983 survey.

Rural and Urban Interest Rates

The interest rate is the most direct measure of the cost of credit. Do changes in the prime rate of interest at giant New York City banks affect loan rates paid by small rural Midwest businesses? At one time, the answer may have been no. But deregulation of interest rates and technological advances make it possible for rural residents to easily move their funds around the world if local banks fail to pay the going rate on deposits. If national economic conditions affect rural bank costs, one could reasonably expect rural loan rates to be similarly affected. This article presents evidence that rural business people are now subject to the same forces as their urban colleagues.

If rural credit markets were not integrated with the national market, then one might expect rural interest rates to be more stable over the business cycle than are urban interest rates. But if the general economy affects rural and urban lenders in a similar fashion, these lenders should respond similarly in terms of changing their willingness to approve loan applications and the rates they charge on loans. Average loan rates charged by rural and urban lenders might differ if they tend to serve different mixes of firms in terms of size or industry. Rural survey respondents did average lower loan sizes. But if credit gets tight and the cost of funds increases in national money markets, loan rates will increase for both groups if rural credit markets are integrated with the rest of the national economy.

The NFIB survey obtained interest rates for loans and lines of credit as either a flat percentage rate for fixed-rate instruments or as a difference from the prime rate for variable-rate instruments. Average rural interest rates were slightly higher than large city and urban interest rates in the majority of comparisons covered by table 1, but the differences were not statistically significant. These interest rates strongly support the hypothesis that the rural and urban credit markets are integrated, at least in the pricing of credit.

Behavior of the Markets Over the Business Cycle

The picture of credit markets that emerges over the business cycle also supports the hypothesis that rural and urban credit markets are well integrated. Prime plus interest rate distributions were fairly stable during the 3 years and rural rate distributions were similar to those reported by the urban and central city firms. The only statistically significant differences in distributions were greater variations in 1985 credit line rates for urban businesses than for rural firms, and for the 1985 large city rates compared with those prevailing in 1987.

Level loan and credit line interest rates fell by statistically significant amounts between 1983 and 1985 and again between 1985 and 1987. In 1983, large city and urban credit loan rates ranged more widely about their average values than did those of the rural firms.

One interesting distinction between the rural and urban and the rural and large city markets emerges. Rural firms in each year tended to stay closer to their average loan sizes, level loan rates, and prime plus loan rates than was the case for the urban and large city firms. The smaller ranges suggest that rural lending is more homogeneous than is urban lending. The greater homogeneity of rural lending may reflect a greater homogeneity of rural borrowers or rural banking practices or both.

Other characteristics of rural business loans also show that the borrowing experience of rural businesses was similar to, and possibly better than, that of urban and large city businesses over the business cycle. Turn-down rates on loan applications were similar for all three groups in 1983 and 1985 and lower for rural firms than for either urban or large city firms in 1987. Rural businesses were also more often satisfied with their loans, though they were slightly more likely to receive less than the amount wanted, particularly in 1987.

Average interest rates and loan sizes, 1983-87

Rural firms obtained smaller loans but were charged competitive interest rates

Location/year	Credit line rates		Loan rates		Loan size
	Level	Prime plus	Level	Prime plus	
	Percent				*Thousand dollars*
Rural:					
1983	17.08	1.75	16.62	1.76	58.19
1985	13.15	1.76	13.36	1.48	75.22
1987	11.48	1.76	11.72	1.63	77.24
Urban:					
1983	16.91	1.53	16.75	1.65	128.35
1985	13.33	1.68	12.74	1.66	325.40
1987	11.75	1.67	11.63	1.68	116.15
Large city:					
1983	16.68	1.55	16.92	1.57	170.42
1985	12.93	1.61	11.80	1.55	325.82
1987	11.49	1.56	11.67	1.61	123.59
All locales:					
1983	17.00	1.57	16.69	1.67	98.31
1985	13.24	1.69	13.13	1.61	211.43
1987	11.62	1.70	11.67	1.67	101.19

Source: Calculated by ERS from Surveys of Small Businesses conducted by the National Federation of Independent Business.

Results of loan applications

Rural firms were more likely to have their loan applications accepted, but not always for the full amount they requested

Location/year	Loan application rejected	Loan terms not satisfactory[1]	Less than amount wanted
		Percent	
Rural:			
1983	11.0	23.4	8.9
1985	21.9	NA	5.3
1987	14.8	18.5	13.1
Urban:			
1983	12.0	27.2	8.5
1985	23.3	NA	7.2
1987	17.0	21.6	11.7
Large city:			
1983	10.3	30.4	8.9
1985	21.8	NA	8.0
1987	19.5	23.9	11.7
All locales:			
1983	11.5	25.2	8.7
1985	22.7	NA	6.3
1987	16.1	20.4	12.2

NA=not available.

[1]Data reported as not available in 1985 because 97.8 percent of the respondents did not answer this question.

Source: Calculated by ERS from Surveys of Small Businesses conducted by the National Federation of Independent Business.

How Businesses Felt About Banking

Business owners were also asked how they felt about banking and their banks. Nine characteristics of the business-bank relationship were specified and businesses were asked to rate the importance of these characteristics in conducting banking transactions. The left column of the table on perceptions lists the characteristics in the order of importance determined by averaging over all responses to all three surveys. This order was more or less maintained in each year and within each geographic group. The one notable exception was that the characteristic "provides helpful business suggestions" was ranked last overall but first in the 1985 survey. The importance of business advice in 1985 is explained by the large majority of businesses in the survey that year that said their primary use of credit was to establish a new business.

How Businesses Felt About Their Banks

The most interesting results from the surveys were those dealing with how businesses rated the actual performance of their own banks on these same characteristics of the business-bank relationship. Businesses rated their banks' performance on the nine characteristics in a different order than they rated the importance of the characteristics. The right panel of the table on perceptions shows the order, based on an average of all three surveys. The only deviation from this order was that rural businesses placed "offers a wide range of banking services" fifth, just below "reliable source of credit," instead of first.

Ranking by performance — not importance — shows how successful the banks were. If a characteristic is not considered particularly important by many businesses, how well banks performed that characteristic does not matter that much. But performance is relevant for those characteristics that were more often cited as important by firms responding to the surveys. The results suggest room for improvement by banks in the areas deemed most critical by small businesses.

On average, rural businesses gave their banks better ratings than the ratings urban and large city businesses gave to their banks. This was true both in the average of all 3 years and in the individual years. The exception is that urban and large city businesses generally gave their banks better ratings on providing a wide range of services. This result is not very surprising. Larger cities tend to be served by larger banks that are able to provide a more complete set of financial services.

The two most important characteristics for economic growth and development are the cost and availability of credit. Businesses in all three areas gave their banks similar ratings on providing the "cheapest money" available. But, rural businesses gave their banks significantly better ratings on being a reliable source of credit in all 3 years. *[James McGlone, formerly an economist with the Economic Research Service. Contact Dan Milkove, the author of all other articles in this issue, at 202-219-0318, if you have questions concerning this article.]*

How businesses felt about banking and their banks

A low interest rate on bank loans is welcome, but businesses place greater value on being confident of obtaining a loan and in dealing with someone familiar with their business

Ranked by importance in conducting banking transactions	Ranked by businesses' perceptions of bank performance
Knows you and your business	Offers a wide range of banking services
Reliable source of credit	Convenient location
Offers the "cheapest money" available	Easy access to loan officer
Easy access to loan officer	One person always handles your credit needs
One person always handles your credit needs	Reliable source of credit
Convenient location	Knows you and your business
Offers a wide range of banking services	Offers the "cheapest money" available
Knows your industry	Knows your industry
Provides helpful business suggestions	Provides helpful business suggestions

About the NFIB and the Surveys

The National Federation of Independent Business (NFIB) is an association of businesses that are closely held and managed by their owners. In 1983, 1985, and 1987, NFIB surveyed its membership about the state of the businesses' finances and the relationship between the business and its bank. The surveys requested factual information on the size, location, and nature of the business, interest rates paid on loans, types of loans held, and purpose of the loans, and elicited opinions on the importance of various aspects of the business-bank relationship and on how well their bank performed in those aspects of the relationship.

This report is based on those surveys, which are interesting to analyze because they cover the end of the 1982 recession, the recovery period, and the period of prosperity that the overall economy achieved in the latter part of the 1980's. These three distinct periods reveal differences in the gap between rural and urban economies at different phases of the business cycle. They also reveal differences in the relationship between banks and businesses at different parts of the business cycle.

Governed by population, businesses responding to the survey were asked to report their location as a rural area (less than 15,000 population), a small city (15,000 to 100,000), a city (100,000 to 1,000,000), or a metropolis (more than 1,000,000). These definitions correspond to none of the usual definitions of rural or nonmetro in the rural development literature. In this article, "urban" refers to all businesses placing themselves in areas other than rural, and "large city" combines the city and metropolis businesses (but not small cities).

Banks typically price their business loans in one of two ways. Either the loan interest rate is fixed (level), or it can vary over time by adding a fixed amount to the prime rate (prime plus). The NFIB surveys also distinguish between rates on loans in which the funds are disbursed at the time the loan application is accepted (loan rates in this report), and cases in which a firm is given a line of credit that can be accessed when needed (credit line rates).

While the tables report averages for interest rates and other aspects of the credit process, I also studied the distributions of rural and urban responses. Distributions of interest rates that banks charge customers in rural and urban areas should be similar if rural credit markets operate efficiently and are well integrated with the national market. If rural and urban patterns are similar, this similarity increases confidence that comparisons of the average interest rates are meaningful.

Data Sources

Several data sources were used for this report. Commercial banks, savings and loan associations, and credit unions are all required to file periodic reports regarding their financial health to their respective regulatory agencies. The reports generally contain balance sheet and income statement information, although the types of reports filed by depository institutions differ between, and sometimes even among, lender categories.

Commercial Banks

We used data on all commercial banks located in the 50 States that are insured by the Federal Deposit Insurance Corporation (FDIC) and that report nonzero assets and deposits. Bank level income and balance sheet information for these firms comes from the *Report of Condition and Report of Income* database maintained by the Board of Governors of the Federal Reserve System. Data on deposits held by individual bank branches as of June 30, 1993, were derived from the FDIC's Summary of Deposits database.

Savings and Loan Associations

We used data on all U.S. savings and loans that reported nonzero assets and deposits and were not part of the managed consignment group of thrifts operated by the Federal Government until they could be sold or closed, as reported to the Office of Thrift Supervision. The data were taken from the Thrift Financial Reports.

Credit Unions

We took credit union data from the Year-end Financial and Statistical Reports of Credit Unions, as reported by the National Credit Union Administration.

Definitions

This report provides data for several measures commonly used to analyze the performance and health of financial institutions. Those measures are described briefly below.

Abbreviations and agency acronyms

ARM = Adjustable-rate mortgage
BIF = Bank Insurance Fund
FDIC = Federal Deposit Insurance Corporation
Fed = Board of Governors of the Federal Reserve System
FHLB = Federal Home Loan Bank System
FRM = Fixed-rate mortgage
OTS = Office of Thrift Supervision
S&L = Savings and loan association
SAIF = Savings Association Insurance Fund

Capital ratios: Equity capital as a percentage of total assets.

Loan/deposit ratio: Total loans as a percentage of total deposits.

Loan loss provisions: Funds set aside out of current income and added to reserves used to cover possible current or future write-offs of bad loans. Measured as a percentage of outstanding loans.

Metro areas: Metropolitan Statistical Areas (MSA's), as defined by the Office of Management and Budget, include core counties containing a city of 50,000 or more people or have an urbanized area of 50,000 or more and a total population of at least 100,000. Additional contiguous counties are included in the MSA if they are economically integrated with the core county or counties. For most data sources, these designations are based on population and commuting data from the 1990 Census of Population. Throughout this publication, "urban" and "metro" have been used interchangeably to refer to people and places within MSA's.

Net interest margins: The difference between interest income and interest expense as a percentage of total assets.

Nonmetro areas: Counties outside metro area boundaries. Throughout this publication, "rural" and "nonmetro" are used interchangeably to refer to people and places outside of MSA's.

Problem loans: Outstanding loans that have been delinquent for at least 30 days as a percentage of equity capital.

Return on assets: Profit as a percentage of total assets.

Return on equity: Profit as a percentage of total equity.

Appendix table 1—Nonmetro banks: Average operating characteristics , 1994

Item	All firms	Assets: Under $100 million	$100-$300 million	$300-$500 million	$500 million to $1 billion	Over $1 billion	Regions: Northeast	Midwest	South	West
					Number					
Banks	5,837	4,763	945	82	29	18	228	2,993	2,194	422
					Thousand dollars per bank					
Net income	965	475	1,898	4,731	8,891	51,634	3,718	642	1,147	823
Assets	80,672	41,057	154,643	385,223	686,172	4,316,925	349,663	56,252	89,482	62,738
					Average percentage[1]					
Loan/deposit ratio	70.11	62.37	68.31	74.52	86.27	91.76	79.01	68.02	69.41	64.25
Loan/asset ratio	58.60	54.50	58.91	62.44	68.57	64.20	61.45	58.55	57.84	55.89
Net interest margin	4.16	4.14	4.12	4.03	4.74	4.15	4.20	3.98	4.22	4.69
Return on assets	1.20	1.16	1.23	1.23	1.30	1.20	1.06	1.14	1.28	1.31
Return on equity	13.16	11.67	13.42	14.54	15.99	16.14	13.38	12.03	13.88	14.69
Capital/asset ratio	9.89	10.72	9.86	9.07	9.22	8.38	9.05	10.23	9.96	9.77
Loan loss provisions/ total loans	0.31	0.23	0.25	0.22	0.79	0.47	0.39	0.22	0.37	0.19

[1] These items were computed by summing the numerator across all firms, summing the denominator across all firms, and then dividing the numerator by the denominator and multiplying by 100 to convert the result to a percentage.

Source: Calculated by ERS using data from the *Report of Condition and Report of Income* database maintained by the Board of Governors of the Federal Reserve System.

Appendix table 2—Nonmetro savings and loans: Average operating characteristics, 1994

Item	All firms	Assets: Under $50 million	$50-$100 million	$100-$300 million	Over $300 million	Regions: Northeast	Midwest	South	West
					Number				
S&L's	496	187	151	130	28	37	217	199	43
					Thousand dollars per S&L				
Net income	968	233	640	1,418	5,552	676	1,025	937	1,069
Assets	113,069	28,445	70,401	171,033	639,220	82,503	120,927	108,806	119,442
					Average percentage[1]				
Loan/deposit ratio	86.07	78.25	82.18	86.85	90.25	86.39	86.22	86.70	82.41
Loan/asset ratio	68.82	66.71	69.83	68.98	68.65	68.82	68.36	70.23	65.26
Net interest margin	3.17	3.33	3.29	3.11	3.13	3.27	3.02	3.33	3.26
Return on assets	0.86	0.82	0.91	0.83	0.87	0.82	0.85	0.86	0.89
Return on equity	9.49	7.85	9.53	8.79	11.19	8.68	9.61	9.53	9.28
Capital/asset ratio	9.01	10.42	9.54	9.43	7.76	9.45	8.83	9.03	9.64
Loan loss provisions/ total loans	0.15	0.13	0.08	0.11	0.25	0.21	0.18	0.14	0.03

[1] These items were computed by summing the numerator across all firms, summing the denominator across all firms, and then dividing the numerator by the denominator and multiplying by 100 to convert the result to a percentage.

Source: Calculated by ERS using data from the *Thrift Financial Reports* maintained by the Office of Thrift Supervision.

Appendix table 3—Nonmetro credit unions: Average operating characteristics, 1994

Item	All firms	Assets: Under $50 million	Assets: $50-$100 million	Assets: $100-$300 million	Assets: Over $300 million	Regions: Northeast	Regions: Midwest	Regions: South	Regions: West
	Number								
Credit unions	2,620	2,507	78	33	2	360	951	876	433
	Thousand dollars per credit union								
Net income	136	83	827	2,135	7,743	141	107	143	184
Assets	10,773	6,696	68,023	159,227	439,783	11,534	9,299	10,095	14,750
	Average percentage[1]								
Loan/deposit ratio	75.12	75.41	71.56	75.11	91.65	73.29	76.34	76.31	73.00
Loan/asset ratio	66.21	66.29	63.83	66.06	79.73	64.96	67.40	66.77	64.58
Net interest margin	4.10	4.27	3.86	3.79	3.98	4.25	4.08	4.05	4.09
Return on assets	1.13	1.10	1.05	1.23	1.48	1.09	1.02	1.27	1.11
Return on equity	10.91	10.35	11.21	12.21	12.27	11.43	10.18	11.18	11.16
Capital/asset ratio	11.17	11.48	10.18	10.96	12.68	10.45	10.79	12.19	10.77
Loan loss provisions/ total loans	0.32	0.33	0.27	0.30	0.51	0.34	0.23	0.37	0.37

[1] These items were computed by summing the numerator across all firms, summing the denominator across all firms, and then dividing the numerator by the denominator and multiplying by 100 to convert the result to a percentage.

Source: Calculated by ERS using data from the *Year-end Financial and Statistical Reports of Credit Unions* from the National Credit Union Administration.