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PROBLEMS, POLICY ISSUES AND RESEARCH NEEDS IN RURAL FINANCIAL MARKETS: THE VIEW OF SMALL BUSINESS

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Rural financial markets are often characterized as "unsophisticated" and "small in scale," unable to take advantage of the lower cost associated with larger scale, and failing to offer the greater variety of services that scale economies might provide. It is alleged that prices are higher than necessary because rural financial markets are "lacking in competition," with relatively few institutions serving any given geographic market. The accuracy of such characterizations has not been systematically assessed. It is also true that "one man's loss is another man's gain." Some sectors of the economy may have benefited from the "lack of sophistication" that may be present in rural financial markets.

A priori, rural financial markets could potentially benefit from increased competition. With little or no apparent competition, banks in rural financial markets, it is argued, have little incentive to control costs and to price competitively. Furthermore, because they are small, they cannot realize certain scale economies that would lower costs and/or expand services to the benefit of the bank customer.

As a practical matter, a reasonable degree of competition likely prevails in most financial markets, including rural financial markets.[1] Even in "one bank towns," there is the threat of new form entries (particularly in today's electronic environment), and other banks exist in nearby towns. This suggests that the total magnitude of economic rents to be gained from increased competition may be quite small (as may those scale economies that liberal holding company laws are supposed to exploit). Thus, gains due to improved competition may be difficult to measure, especially when the gains may be passed on to customers in many forms.[2]

As a case in point, based on quarterly studies of random samples of the membership of the National Federation of Independent Business (NFIB --over 500,000 member firms), it appears that rural firms have systematically borrowed needed capital at substantially lower rates than their counterparts in metropolitan areas. This could result from lower non-money costs of funds in rural areas (lower overhead and wage costs), a higher proportion of agricultural (subsidized) loans in the banks' portfolios, less reliance on federal funds due to higher levels of excess reserves, lower proportions of deposits in interest-sensitive forms, or a reflection of management preferences and philosophy.

Whatever the reasons, interest rates charged on short-term loans remained substantially lower in rural areas throughout the recent period of high-interest rates (Table 1, Chart 1). The percentage of firms in the metropolitan areas with loan rates in excess of 18 percent was consistently higher than in rural areas, by as much as 26 percentage points in the fourth quarter of 1980 when 23 percent of the rural firms reported interest rates above 18 percent, compared to 49 percent of the

Table 1

Short-Term[a] Interest Rates by Market Size

Date	Under 16%			16% - 18%			19% or More			Prime Plus			Average Prime Rate
	Rural	Sub	Metro	Rural	Sub	Metro	Rural	Sub	Metro	Rural	Sub	Metor	
1982:2	7%	2%	3%	70%	68%	62%	19%	27%	24%	4%	3%	11%	16.5%
1	8	6	1	71	60	57	18	29	30	3	5	12	16.3
1981:4	8	3	3	64	56	49	25	37	31	2	4	17	17.0
3	6	4	*	38	19	14	54	70	75	2	7	11	20.3
2	7	6	5	49	32	17	41	57	67	3	5	11	18.9
1	16	12	10	57	45	33	24	36	43	3	7	14	19.2
1980:4	30	24	17	42	37	20	23	31	49	6	7	14	16.7

*less than .5%

[a] 12 month maturity or less

metropolitan firms.[3] At the other extreme, 30 percent of the rural firms reported interest rates on short-term loans below 16 percent in 1980:4, compared to 17 percent of the borrowers in metropolitan areas. Far fewer rural firms reported loans that were tied to the prime rate of interest. Since information about loans tied to the prime rate was volunteered prior to 1982, these figures underestimate the actual number of short-term loans tied to the prime rate.[4] Rural-urban differences are better illustrated by the data in Table 2 that specifically identify loans tied to the prime rate based on new interest rate questions added to the NFIB survey in 1982:1. First, many more loans were tied to the prime rate than the old data indicated, 38 percent in the third quarter of 1982. Second, 58 percent of the loans in metropolitan areas were tied to the prime, compared to 22 percent in rural areas. Finally, when the prime rate loans are reassigned based on an average prime rate of 14.7 percent for the third quarter, there appears to be little difference in the rate distributions by degree of urbanization. These differences were substantial at the beginning of 1980, but eroded over time (interest rates stayed too high for too long to be ignored by depositors and lenders alike).

Overall, rural borrowers apparently received short-term loans at interest rates substantially lower than their urban counterparts in the 1980-82 period. Most of these gains may have been at the expense of rural depositors who may have earned, on average, lower returns on their savings deposits (e.g., fewer moved their money into higher yielding deposits or money market funds, keeping the cost of funds lower for rural banks). Whatever the source of the "rural differential," it does appear to have been mostly eliminated by the end of 1982.

Table 2

Interest Rates Reported by Market Size

1982, Third Quarter

	As Reported:							
	Under 13%	13-15%	16%-18%	19%-20%	21% or More	Prime Plus 0,1	2	3+
Metropolitan	3%	13%	20%	5%	1%	23%	27%	8%
Suburban	1	16	38	4	2	22	13	4
Rural	*	27	47	3	1	9	9	4
	Prime Loans Assigned at the Average Prime Rate[a]							
Metropolitan	3%	36%	55%	5%	1%	-	-	-
Suburban	1	38	55	4	2	-	-	-
Rural	*	36	59	3	1	-	-	-

*less than .5%

[a]14.7 in the third quarter. Monthly averages were 16.3%, 14.4% and 13.5%

Table 3

Performance Measures

	Rural	Non-Rural
Received Full Amount Requested	80%	79%
Received Requested Terms	69%	67%
Loan Terms and Transaction Satisfactory	72%	69%
Last Application Turned Down	8%	8%
Bank Actively Recruited Firm's Business	30%	46%
More Bank Competition	21%	31%

Interest rates, however, do not tell the whole story. If higher rates are associated with superior service or better credit availability (more risk in the bank's business loan portfolio), it may still be true that firms in metropolitan areas are better served by their banks and other financial institutions. This possibility can be examined in more detail using a special survey conducted in April 1982 of the members of the National Federation of Independent Business.[5] The survey contains 2349 responding firms nationwide, 971 of which identify themselves as operating in a rural area (see Footnote 1). A brief description of these firms is presented in Appendix Table A-1.

Overall, there were very few significant differences between the experience of firms in rural markets and that of those in larger metropolitan areas (Table 3). Eighty percent of the rural firms reported getting the full amount of the loan requested, compared to 79 percent of all other firms. Desired terms were received by 69 percent of the rural firms, 67 percent of all other firms. Seventy-two percent of the rural firms reported that, overall, the loan terms and the transaction were satisfactory, above the 69 percent figure for nonrural firms. Identical percentages (8 percent) reported being turned down on their most recent attempt to get a loan. On three of the four measures, rural firms reported higher "favorable" percentages, although the differences were not statistically significant.[6]

Measures of competitive activity present a different picture. Forty-six percent of the nonrural firms reported an active solicitation for their banking business compared to only 30 percent of the rural firms (Table 3). Similarly, 31 percent of the nonrural firms reported noticing more bank competition in their markets, compared to only 21 percent of the rural borrowers. There are fewer banks in rural markets (Table 4). Sixty-six percent of the rural firms reported three or fewer banks in their financial community, compared to 11 percent for nonrural firms. In the larger markets, 31 percent of the firms reported 11 or more banks, compared to only one percent of the rural firms. Most firms confined their banking activity to only one bank, while about a third used two or three banks.

In spite of more frequent observations of competitive activity and larger numbers of banks, interest rates charged to nonrural firms were higher (Table 1). In addition, more nonrural firms were required to pledge personal collateral (identical proportions pledged business collateral) to keep compensating balances and to pay additional fees (Table 5). And, fewer nonrural firms reported that their borrowing was from a pre-established line of credit. Thus, although there are strong indications that the degree of competition may be stronger in urban markets, the impact of that competition on the relative level of interest rates charged to small firms and on other contract terms was not apparent. This does not prove that the markets are not competitive. Urban banks may be operating on smaller differentials over their costs than rural banks, as well as facing higher operating costs and fund costs.

Another possible explanation of higher rates and less favorable terms is that the average risk of the urban bank portfolio is higher than that of the rural bank. Receiving applications from an (assumed) identical risk distribution of firms, if urban banks accept riskier customers (due to competition), they will be charging higher rates on

Table 4

Number of Banks In The Market

Number of Banks	In Community Rural	In Community Non-Rural	Generally Used Rural	Generally Used Non-Rural
1	17%	1%	60%	55%
2-3	49	10	35	38
4-5	24	26	2	2
6-10	8	28	1	1
11 or more	1	31	*	2
No answer	1	4	2	2
	100%	100%	100%	100%

Table 5
Other Loan Terms

	Rural	Non-Rural
Collateral		
Business	46%	46%
Personal	22%	29%
Compensating balance	9%	10%
Other Fees	9%	11%
Line of Credit	34%	32%

average. However, identical turn-down rates (Table 3) and the distribution of rates charged suggest that this is not likely the case.

It is also possible that urban firms provide more and better services to their customers. The provision of these services generates costs that historically, due to Regulation Q, have been recovered in the contract rate of interest rather than through separate charges as is now being encouraged by deregulation. In the absence of efficient contracting (or with high transactions costs or "free rider" problems associated with separate charges), the provision of superior service could be expected to be associated with higher interest rate charges.

Firms were asked to rate ten factors in terms of importance to their desired banking relationship. They were then asked to rate how well their banks provided the services. The results are shown in Tables 6 and 7. Not surprisingly, there were few significant differences in the ratings of the desired factors between rural and other firms. "One Person Handling All Credit Needs" was very important for 42 percent of the nonrural firms, compared to 37 percent for rural borrowers. "Easy Access to the Loan Officer" was also more frequently rated as very important to nonrural firms. Of the ten factors, rural and nonrural firms each ranked four items as very important to the banking relationship more frequently than the other. In two instances, the percentages were the same. The largest difference in the percentages reporting a characteristic as very important was five percentage points. Overall, there were no significant differences in "desired" bank performance.

Ratings of actual performance were more clearly separated. For all ten factors, rural firms gave their banks better marks more often than

Table 6

Important Characteristics in Banking Relationship

	Very Important	Important	Not Very Important	Not Important	No Answer
Knows you and your business					
Rural	69%	22%	2	1	6
Non-rural	67	22	3	2	6
Provides helpful business suggestions					
Rural	22	33	23	12	10
Non-rural	19	33	25	14	9
Offers the cheapest money available					
Rural	51	27	9	4	9
Non-rural	49	31	8	3	9
One person always handles your credit needs					
Rural	37	37	13	5	8
Non-rural	42	36	10	4	8
Convenient location					
Rural	30	40	18	5	7
Non-rural	30	37	21	5	7
Reliable source of credit					
Rural	54	34	3	2	7
Non-rural	56	29	4	2	9
Knows your industry					
Rural	30	32	20	8	10
Non-rural	25	32	24	9	10
Comes to you with ideas for improving bank service to your firm					
Rural	17	34	25	13	11
Non-rural	17	35	27	11	10
Easy access to loan officer					
Rural	39	44	6	2	9
Non-rural	44	40	5	3	8
Offers a wide range of banking services					
Rural	31	43	14	4	8
Non-rural	32	40	16	3	9

Table 7

Evaluation of Bank Performance

	Good	Better Than Average	Below Average	Not Good	No Answer
Knows you and your business					
Rural	52%	27%	11%	4%	6%
Non-rural	42	30	15	6	7
Provides helpful business suggestions					
Rural	20	26	27	16	11
Non-rural	16	27	28	18	11
Offers the cheapest money available					
Rural	23	32	22	12	11
Non-rural	21	36	19	12	12
One person always handles your credit needs					
Rural	46	33	7	4	10
Non-rural	43	31	9	6	11
Convenient location					
Rural	59	27	4	2	8
Non-rural	52	28	8	3	9
Reliable source of credit					
Rural	53	25	7	5	10
Non-rural	45	29	10	6	10
Knows your industry					
Rural	24	29	22	13	12
Non-rural	19	29	24	16	12
Comes to you with ideas for improving bank service to your firm					
Rural	16	21	26	24	13
Non-rural	14	24	27	23	12
Easy access to loan officer					
Rural	52	31	4	3	10
Non-rural	48	33	5	4	10
Offers a wide range of banking services					
Rural	50	30	8	3	9
Non-rural	45%	34%	7%	3%	10%

did their nonrural counterparts, by as much as ten percentage points. For about half of the factors, the differences in the percentages giving "good" ratings were significant. And, a directional test indicates that the systematic pattern of rural responses in excess of nonrural percentages is not likely a random result of sampling error as was the case for the ratings of importance in the "desired" banking relationship.

Thus, it would appear that rural borrowers not only received more favorable terms on their loans, but also got more satisfactory service from their banks as well. Although others (savers in particular) may have "paid" for these apparent benefits to rural firms, they were real to the firms and certainly made survival through the period of record high interest rates somewhat easier, helping to preserve the jobs and income generated by these firms, some of which might otherwise have been lost.

Footnotes

[1]One deficiency common to most studies of the impact of financial regulation is the arbitrary definition of market size in geographic terms and the use of aggregate data to characterize that geographic market--usually an SMSA which is arguably too large an area to study. In this study, firms define their actual geographic market and report data on that market. Most financial services are obtained in a "local" market of small geographic size. This minimizes transactions costs for the borrower and the cost of collecting information by the lender. Lenders may collect "structured" information (that typically contained on loan applications) but also have "unstructured" information from years of experience with the firm and from a knowledge of the owners or managers. This information has only "local" value and is not easily transmitted to a lender outside of the local market.

[2]Banks offer many services, and loan contracts involve many terms, including loan size, maturity, the contractual rate and other loan fees. The gains from competition will likely be passed along to customers on many of these margins, making it difficult to measure the net impact of regulatory change.

[3]Firms responding to the survey classify themselves as being in a metropolitan/urban area (population over 100,000), a suburban or medium sized city (population between 15,000 and 100,000) or a rural area (population of 15,000 or less). Each quarter, there are approximately 2,300 responses from a sample of about 6,500 firms. Between 40 percent and 50 percent of the firms report a short-term loan in the prior quarter.

[4]These figures underestimate the percentage of loans tied to the prime rate. In 1982, a specific question was added to identify loans tied to a prime rate. Prior to that time, firms either noted that the loan was tied to prime, or used the prime rate to compute a loan rate at the time of the survey. The revised results are shown below:

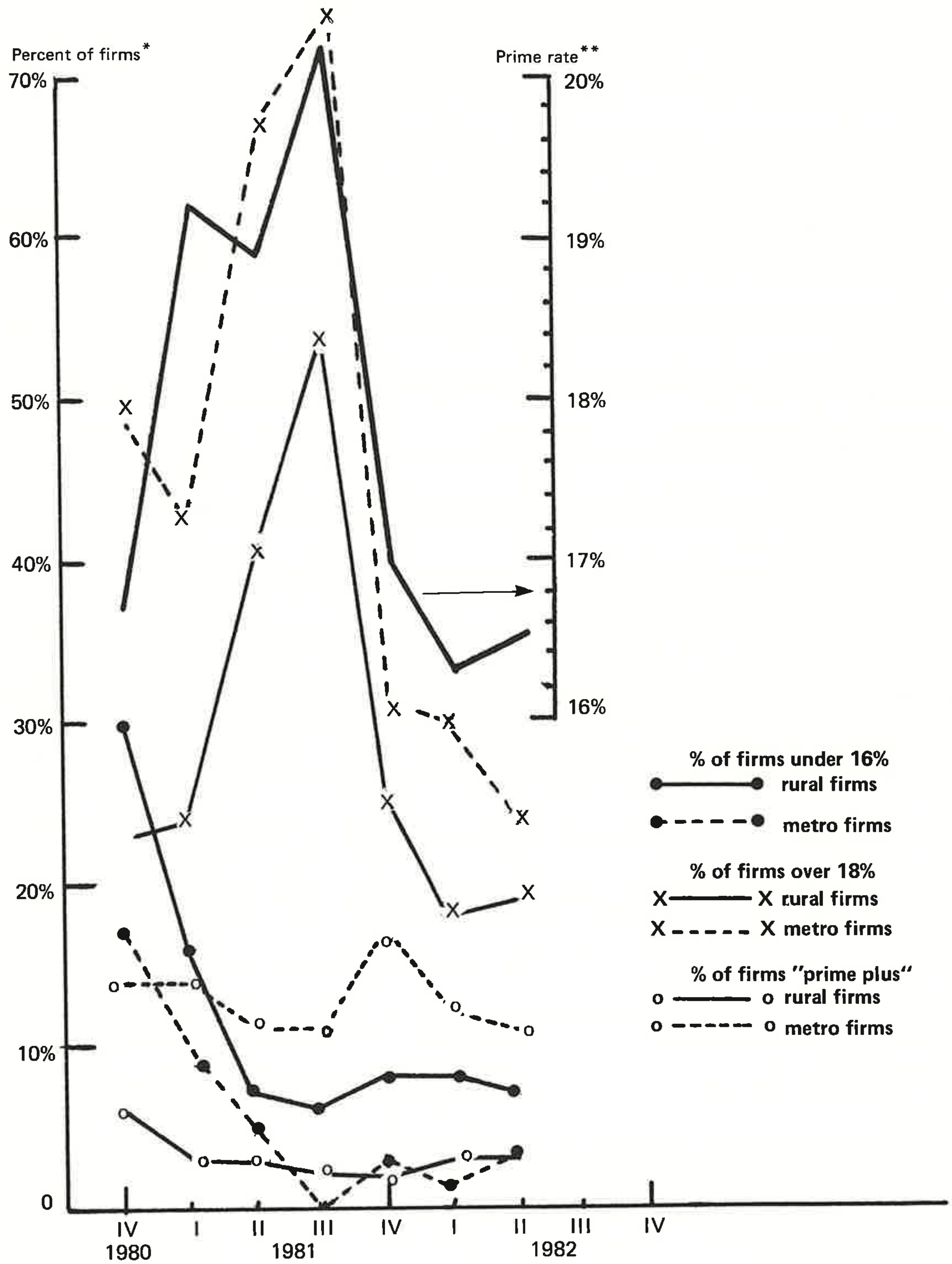
					New Series		
Rate Paid	81:1	81:2	81:3	81:4	82:1	82:2	82:3
Under 13%	3	1	2	2	1	1	1
13%-15%	15	5	3	7	5	4	19
16%-18%	46	34	30	57	50	52	37
19%-22%	27	48	56	25	11	11	5
23% or more	1	5	3	2	1	*	*
Prime, prime + 1	4	4	4	4	17	18	23
Prime + 2	3	2	2	2	13	12	12
Prime + 3 or more	1	1	*	1	2	2	3
	100%	100%	100%	100%	100%	100%	100%

Footnotes (continued)

[5]A nearly identical survey was conducted in April 1980. See Dunklberg and Scott, Credit, Banks and Small Business, National Federation of Independent Business, 1982, for a discussion of the results.

[6]A 95 percent confidence, two tail test would require differences in the percentages in excess of four percentage points.

Chart 1



*Precent of firms taking a loan with a maturity of 12 months or less.
**Average prime rate for the quarter as published in Business Conditions Digest.

Table A-1

Sample Characteristics

Characteristic	Rural	Non-Rural	All
Form of business			
Proprietorship	41%	26%	32%
Partnership	9	7	7
Corporation	49	67	60
No answer	1	*	1
	100%	100%	100%
Industry			
Construction	11%	17%	15%
Manufacturing	10	14	12
Transportation	3	3	3
Wholesale	5	10	8
Retail	38	29	33
Agriculture	10	2	5
Finance	7	7	7
Non-professional services	11	11	11
Professional services	5	7	6
No answer	*	*	*
Sales			
Under $100,000	22%	16%	18%
$100,000-199,999	19	12	15
$200,000-349,999	16	14	15
$350,000-499,999	10	10	10
$500,000-799,999	9	11	10
$800,000-1,499,999	10	13	12
$1,500,000 or more	11	22	18
No answer	3	2	2