



**April 2000**

# *The* Main Street ——— Economist

*Commentary on the rural economy*



## **A New Century for Community Banks**

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**A**ccess to capital through viable rural credit markets will be key to meeting many of the challenges facing Rural America in the years ahead. The menu of capital sources in many rural communities, however, is much shorter than in urban centers. Urban capital sources might include numerous local, regional, and national banks, finance companies, and venture capital firms. In many rural communities, the menu starts and ends with the local community bank.

What is the outlook for Main Street's primary lender in the new century? A recent overhaul of the nation's banking laws promises to give bankers a new array of tools to finance rural businesses. And technology will continue to redefine how banking gets done, even in rural America. Finally, community banks will struggle with several challenges in the farm lending market, traditionally the cornerstone of their loan portfolios. In the end, a close relationship with its community is likely to remain the defining element of the community bank's destiny. Thus, the long-standing relationship holds true: as go rural communities, so will go community banks.



### A banking revolution

Community banks face a veritable revolution in the financial services industry.<sup>1</sup> This revolution is sparked by bold new legislation governing the financial industry and by the march of technology, which in its own way is redefining finance—and the geography of banking.

After years of negotiations and a number of failed attempts, Congress passed and the president signed a comprehensive bill overhauling the nation's core laws governing banking and financial services more generally. The Financial Services Modernization Act of 1999 (FSMA) aimed to provide a new regulatory framework for an industry that had outgrown the confines of banking laws written during the Great Depression.

Extremely comprehensive, the law will have far-reaching implications for community banks. While many aspects of the bill will affect them, three provisions are particularly important: the repeal of the Glass-Steagall Act, the creation of new powers for banks, and new access to loanable funds.

A paramount provision of the FSMA was to repeal and replace Glass-Steagall. Passed during the 1930s, that act created a wall of separation between banking and commerce. Banks were permitted to take deposits and make loans but not to engage in brokering or underwriting securities. Nor could banks engage in insurance agency or underwriting activities.

In one bold stroke, the FSMA tears down these 60-year-old walls separating banks from the securities and insurance businesses. A primary vehicle by which banks can enter the previously forbidden lines of business is the financial holding company. To form a financial holding company, a bank holding company must meet three tests: it must be well managed, well capitalized, and score a satisfactory or better rating on its compliance with the Community Reinvestment Act. Once a financial

holding company is formed, it can engage in a broad menu of financial activities, including securities underwriting, merchant banking, insurance selling and underwriting, and a long list of activities that can be classified as “financial in nature.”

Apart from a financial holding company, commercial banks themselves are given much broader powers. Under the FMSA, all commercial banks can now operate an insurance agency (the power to underwrite insurance was given only to financial holding companies). Previously, only commercial banks in towns with population under 5,000 were allowed to own insurance agencies. Commercial banks were also given the authority to underwrite securities. One important aspect of this new power for rural community banks is that they can now underwrite municipal revenue bonds, an important source of funding for rural infrastructure projects. Finally, the FSMA left open the possibility that com-

with less than \$500 million in assets can now gain access to Federal Home Loan Bank (FHLB) advances without meeting a Qualified Thrift Lender test.

Previously, community banks could access FHLB funds, but the funds essentially had to fund rural housing loans. The FSMA sweeps away that requirement, enabling banks to use FHLB funds for housing, small business, small farm, or agribusiness loans. The broadened access to loanable funds could prove to be the FMSA's most favorable and biggest impact on many community banks.

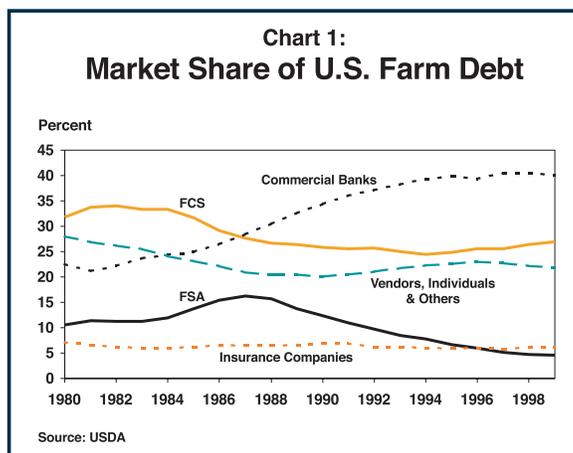
While the new banking legislation obviously will redraw the future for community banks, so will the new digital era. Like all other businesses, community banks are adapting to e-commerce. The transition is especially difficult for community banks, however, because their franchises are especially tied to a particular geographic place.

Internet banking opens banks to a new world of customers, but it also provides new opportunities to their existing customers. Whether the net effect is positive or negative is open to question. At this point, relatively few community banks have aggressively marketed themselves on the Internet, in part because the human resource and other costs of building a Web presence are considerable. According to the FDIC, only 160 banks with assets less than \$100 million offered transactional banking via the Internet as of October 31, 1999. That was less than 3 percent of all banks that size.

In the end, new technologies will no doubt make community banks more efficient overall. Yet most community banks regard relationship lending as a core strength. Whether sturdy lending relationships can be built online remains to be seen. Many community banks may dabble online but continue to direct their core business strategies at local businesses.

munity banks might engage in merchant banking—taking investment positions in local companies. There is a five-year moratorium on merchant banking by banks, after which time financial regulators are to review the matter again.

Finally, the FSMA substantially broadened community banks' access to loanable funds, one of their biggest business concerns. Any commercial bank



### Farm lending challenges

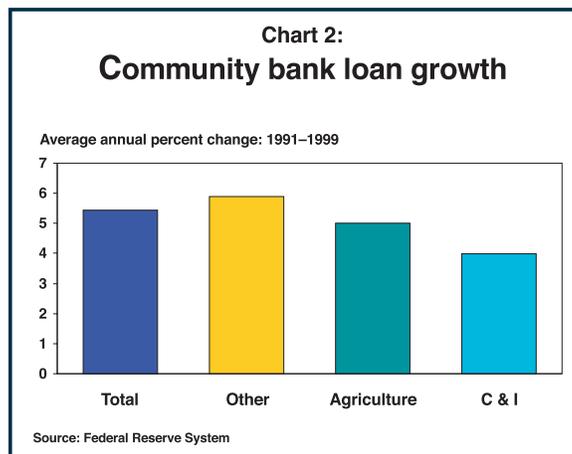
In addition to the twin challenges of new banking laws and technology, community banks must adjust to new challenges in farm lending. Long the cornerstone for many community banks, farm lending has become a slow-growth but highly competitive business. Adjusted for inflation, farm debt fell steadily after the 1980s farm crisis, finally hitting bottom in 1993 and growing only 1½ percent a year on average since then.

The slow growth in farm debt notwithstanding, a crowd of lenders is vigorously competing for market share (Chart 1). Commercial banks hold the lead in farm lending, gaining market share from the Farm Credit System (FCS) after the farm financial bust of the mid 1980s. Nevertheless, the FCS—the nation's specialized, cooperative farm lender—still remains an industry leader and formidable competitor, with prospects brightened by a new streamlined structure and continued access to national money markets. Insurance companies compete vigorously for large, high-quality real-estate transactions. And a growing field of farm input suppliers, such as farm machinery and seed companies, use credit to enhance their product sales while also boosting competition in the already crowded farm-lending market.

Agriculture's changing structure also presents a moving target for farm loan portfolios at community banks. Farm debt is almost evenly split between a large and growing group of small life-style farms and a much smaller and shrinking group of bigger, commercial-size farms. These two shifting groups of farms define the polar extremes of a divided farm lending market for community banks.

The USDA estimates the nation's farms have dwindled from more than 5 million a half century ago to slightly more than 2 million today. The lion's share—about 9 out of 10—are small farms barely achieving a commercial scale of operation

with annual sales of no more than \$250,000. The remaining 1 in 10 farms are the productive core of the industry. These bigger, commercial-size farms account for two-thirds of the industry's sales volume, despite their relatively small number. In addition, commercial-size farms are increasingly the first link in new supply chains, which are carefully orchestrated production, processing, and market-



ing channels stretching from genetics to grocery.

Faced with this divided farm lending market, community bankers must carefully define their farm customers, their credit products, and their strategy for product delivery. At one end of the market is the large group of small farmers that support their families and offset the risks of their farming activities with off-farm income. Individual credit lines are small, and servicing these credit lines is a high-touch business similar to consumer lending. Profits in the small-farm lending market could be steady—but also small and slowly growing. At the other end of the market is the much smaller group of commercial farmers, many of whom are participants in supply chains. Individual credit lines are large and the average cost of credit delivery is low, but servicing these credit lines requires sophisticated financial products and delivery systems. The commercial farm market offers more growth potential

to community banks. But the competition from other lenders is keener, and commercial-farm borrowers are increasingly sophisticated credit shoppers.

### The rural banking outlook

In sum, commercial banks are entering a whole new financial landscape. The FSMA gives bankers a broad new set of financial tools and more funds to tap at the FHLB. But while technology also opens a new world of opportunities, most community banks still consider themselves tied to their communities.

Community bank loan growth in the 1990s probably provides a reasonable window on the future. Total loans grew more than 5 percent a year in the current economic expansion (Chart 2), with consumer and agricultural loans growing faster than commercial loans. That pattern may be reversed in the coming decade. Much of the growth in farm loans came at the expense of the Farm Credit

System; a period with more stable shares may lie ahead in the slow-growth, highly competitive farm lending market. Meanwhile, commercial lending may grow somewhat faster as banks search for new sources of growth—for themselves and their communities.

Community banks will almost certainly remain the dominant rural business lenders in the period ahead, especially given the new tools they received in the FSMA. And while technology will clearly change the banking business, most rural community banks will remain heavily tied to their communities through a legacy of business relationships. Thus, the simple relationship still holds: as go their communities, so will go community banks.

<sup>1</sup> Two criteria define community banks in this article: 1) each is headquartered in a rural area (outside Standard Metropolitan Statistical Areas or SMSAs), and 2) each holds total assets of no more than \$1 billion. Slightly more than half (55 percent or about 4,800) of the nation's commercial banks fit this definition of community bank. Given their relatively small size, community banks together hold a small slice—less than 8 percent—of the nation's total banking assets.

## Survey of Agricultural Credit Conditions

Federal Reserve Bank of Kansas City

December 31, 1999

Highlights from the fourth quarter survey<sup>1</sup>

- Farmland values edged up during the fourth quarter, strengthened by big government payments to farmers and improved profits in the livestock industry. Average values rose 0.6 percent for cropland and 1.6 percent for rangeland. Compared with the year before, irrigated cropland values were up 1.2 percent, nonirrigated cropland values 1.8 percent, and rangeland values 3.3 percent.
- Average interest rates on farm loans increased 13 basis points during the fourth quarter, the third consecutive quarterly increase. At the end of the quarter, interest rates on new loans averaged 9.20 percent on real estate loans, 9.72 percent on intermediate loans, 9.74 percent on feeder cattle loans, and 9.90 percent on operating loans.
- The survey results indicated further improvement in farm loan portfolios. Repayment rates on farm loans climbed for the fourth consecutive quarter, and requests for loan renewals or extensions declined further.
- District bankers expect incomes to diverge in 2000 for crop and livestock producers. More than half the bankers expect incomes for crop producers to be lower in 2000 than in 1999, and 4 in 10 bankers expect the decline to be at least 5 percent. In contrast, about three-fourths of the bankers expect incomes for livestock producers to increase in 2000, and half the bankers expect the increase to be at least 5 percent.

Note: 306 bankers responded to the fourth quarter survey.

<sup>1</sup> Please refer questions to Kendall McDaniel, associate economist, at 816-881-2291 or kendall.l.mcdaniel@kc.frb.org.

### Farm Real Estate Values December 31, 1999 (Average value per acre by reporting banks)

	Nonirrigated	Irrigated	Rangeland
Kansas	\$619	\$984	\$353
Missouri	929	1,177	599
Nebraska	859	1,415	351
Oklahoma	502	733	355
Mountain states*	331	1,104	204
Tenth District	\$671	\$1,148	\$359
Percent change from:			
Last quarter+	0.64	0.65	1.62
Year ago+	1.23	1.82	3.25
Market high	-20.53	-20.28	-11.54
Market low	69.38	68.82	115.07

\* Colorado, New Mexico, and Wyoming combined.

+ Percentage changes are calculated using responses only from those banks reporting in both the past and the current quarter.

Source: Federal Reserve Bank of Kansas City

### Selected Measures of Credit Conditions at Tenth District Agricultural Banks

	Loan demand (index)+	Loan Fund availability (index)+	Loan repayment rates (index)+	Average renewals or extensions (index)+	loan-deposit ratio* (percent)
<b>1998</b>					
Jan.-Mar.	120	108	93	109	65.9
Apr.-June	123	100	78	118	68.0
July-Sept.	112	99	58	136	68.4
Oct.-Dec.	107	108	55	138	66.9
<b>1999</b>					
Jan.-Mar.	105	113	56	143	65.7
Apr.-June	107	107	71	127	66.5
July-Sept.	103	90	74	126	67.7
Oct.-Dec.	100	99	86	115	67.7

\* At end of period.

+ Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than, or the same as in the year-earlier period. The index numbers are computed by subtracting the percent of bankers that responded "lower" from the percent that responded "higher" and adding 100.

Source: Federal Reserve Bank of Kansas City