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Commentary on the rural economy



Small Bank Lending: Tapping Opportunities for Rural Growth

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Banks play a key role in helping rural regions transform their economies by funding new business ventures. In rural America, community bankers often have a unique perspective on their local economy and local business prospects, thanks to their heavy personal involvement and face-to-face contact with customers.

But community banks must now face a challenging new lending landscape. Rural banks have always had fewer opportunities than urban banks for diversifying their loan portfolios, given the narrower range of industries in rural America. And because rural areas lack the thick networks of businesses and innovators that urban areas have, rural bankers are often armed with less first-hand information than urban bankers on dynamic new projects in emerging industries.

Liz Lebioda, a member of the Federal Reserve Bank of Kansas City's Banking Studies and Structure group, provided county-level loan and deposit data.

Still, rural bankers must evaluate frontier projects that are vital to the growth of their communities. Rural bankers can meet these challenges by leveraging the experiences of entrepreneurs and economic development specialists and exploiting continued innovations in information technology.

Community bank lending is vital to rural growth

To survive in today's economy many new and existing businesses must explore the promising frontiers of emerging markets. Lending is a critical fuel for such exploration. A region with strong bank lending is likely to spawn more businesses to explore new markets, increasing the likelihood that new market niches will bear fruit for the region's economy. As this happens, stronger economic growth creates more business activity, more business activity creates new lending opportunity, and more lending opportunity leads to still more growth. This self-reinforcing cycle creates prosperity for banks and local communities alike.

In rural areas, community banks are especially important elements in this lending-growth cycle, for several reasons. First, banks with assets of less than \$300 million hold roughly 30 percent of all rural deposits but less than 7 percent of all metro deposits. Second, local information is especially critical in rural settings. Small banks may have unique information about rural markets and the resulting opportunities that can fuel growth. Third, emerging industries are often explored by entrepreneurs. Financing entrepreneurs often requires an unusual degree of knowledge of the entrepreneur's character and abilities. Such personal traits of the borrower are difficult to quantify in traditional big-bank "credit scoring" models and are more easily considered in the relationship lending employed by community banks.

Measuring lending activity

In this article, bank lending is measured by the loan-deposit ratio, the total value of loans as a percent of deposits. The loan-deposit ratio is a rough indicator of the willingness of a bank to put its deposits at risk in

the form of loans. Those banks with a larger ratio are holding a smaller share of deposits in the form of safe and highly liquid assets such as Treasury securities as they pursue a greater degree of lending. To be sure, small banks today rely much more heavily than in the past on nondeposit funding (for example, Federal Home Loan Bank borrowing). However, the results in this article are similar when lending is measured by loan-asset ratios, which are not affected by the mix of deposit and non-deposit funding.

This analysis focuses on loans used to finance nonfarm business activities. These business loans include loans financing construction and real estate (CRE) and commercial and industrial projects (C&I). A loan taken out by an entrepreneur to fund the expansion of a manufacturing plant would fall into this category. Loans secured by farmland are not included in the CRE or C&I categories. In this sense, the focus on CRE and C&I lending reflects bankers' willingness and ability to engage in broader nonfarm business activity.

To focus on the relationship between lenders and their communities, community banks are specified as a bank with less than

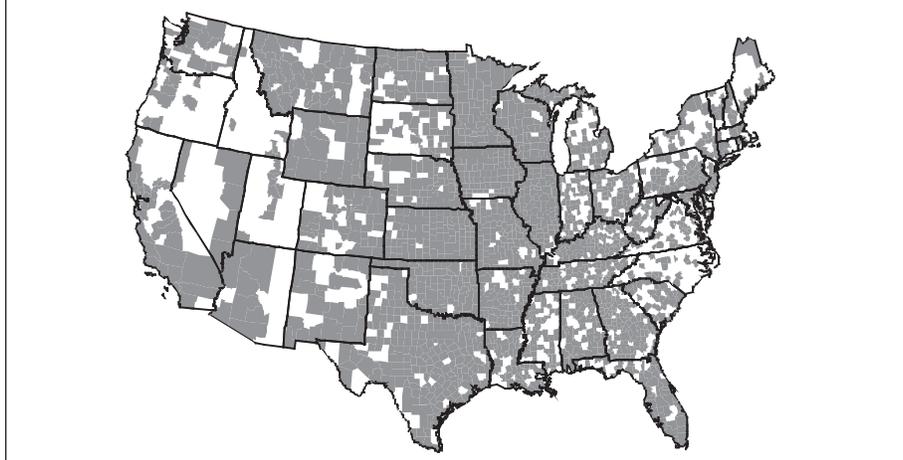
of their resources, loan activities, and loan decisions based in the local area rather than through extended national branch networks. Branches are close to the bank's headquarters. Moreover, as explained above, smaller banks are likely to play especially important roles in shaping economic prospects in rural regions.

To provide a long-run picture, the analysis uses loan and deposit data at the county level for 1984, 1994, and 2004. The decade-long intervals recognize that the subtle impacts of lending activity on regional economic performance might not appear within shorter time frames. In 2004, roughly 70 percent of all rural and metro counties contained headquarters for banks with assets of less than \$250 million [Figure 1]. These counties comprise 85 percent of the U.S. population. Sixty-one percent of community banks are headquartered in rural counties compared to 39 percent in metro counties.

Lending activity varies in metro and rural regions

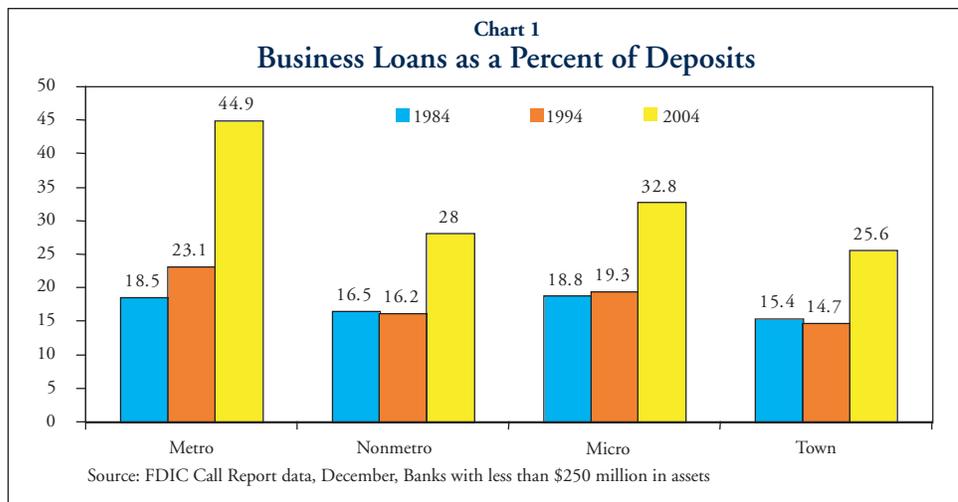
Small metro banks consistently lend a greater share of deposits to nonfarm businesses than their rural counterparts (Chart 1). For all time periods, the business loan-deposit

Figure 1
Counties containing headquarters of small banks, 2004
(Banks with less than \$250,000,000 in assets)



\$250 million in assets. Rural community banks are defined as those with headquarters in a nonmetro county, and metro community banks as those with headquarters in a metro county. Smaller banks are likely to have most

ratios for small banks were significantly higher in metro areas than in rural areas. The loan-deposit ratios remain larger at metro banks even when the analysis is extended to all loans, including farm loans.



Moreover, the gap between metro and rural loan-deposit ratios has widened over the years. In 1984, the business loan-deposit ratio for small metro banks was 18.5 percent, compared to 16.5 percent at rural banks. In 2004, that two-point gap widened to 17 points despite a steady rise in rural loan-deposit ratios. Some of this widening in the gap between rural and metro loan-deposit ratios was probably due to stronger commercial real estate activity in metro areas.

Business loan-deposit ratios also varied among rural counties. Nonmetro counties can be further divided into micropolitan counties, those with core cities of between 10,000 and 50,000 residents, and town counties, those with towns no larger than 10,000. In each of the three decades, banks in micropolitan counties had higher business loan-deposit ratios than banks in town counties (Chart 1). Furthermore, the ratios increased in both micropolitan and town counties—but again expanded faster in the larger, more urbanized micropolitan areas, resulting in a widening of the ratio gap from 1984 to 2004.

Lending ratios are related to economic growth

A comparison of the loan-deposit ratios and job growth suggests that stronger business lending activity goes hand-in-hand with higher economic growth. In particular, for the decades beginning in 1984 and 1994, employment growth was positively

linked to both the beginning-of-period and end-of-period loan-deposit ratios (Table 1). This positive relationship between job growth and loan activity is consistent with the self-reinforcing cycle described earlier—stronger economic activity leads to more lending, and more lending leads to still more economic growth.

The positive relationship between business loan-deposit ratios and job growth held for both metro and rural counties. More important, the correlation was stronger in rural counties than in metro counties, lending support to the idea that small rural banks are more strongly tied to their area's local economic prosperity than small urban banks. One reason that rural community banks might be more closely linked to local economic performance is because they play

a larger local lending role than metro community banks. Though not shown in the table, a similar pattern holds even within rural counties. Specifically, the correlations between loan activity and job growth are consistently higher for the smaller town counties than for the more urbanized micropolitan counties.

Interestingly, business loan-deposit ratios are somewhat more related to past job growth than to future job growth. In rural counties, for example, job growth during the period 1994-2003 had a correlation coefficient of 0.183 with the beginning of period loan-deposit ratio but 0.243 with the end-of-period loan-deposit ratio. Strong economic growth may lead to higher lending activity by increasing loan demand and boosting the returns banks could earn on their loans. Strong economic growth may also stimulate lending activity by increasing the repayment rate on loans and lowering banks' perception of the risk of local loans.

Small banks lend less

Geography may not always shape destiny—but it certainly can influence how bankers see, feel, and understand a local economy when considering a loan. The type of existing businesses, the workforce, the entrepreneurs, and the regional infrastructure—all of these factors play key roles in shaping the perceptions of bankers who must decide on the worthiness of a loan.

Table 1
Correlation between employment growth and loan-deposit ratio

		Business loan-deposit ratio			
		Employment growth*	1984	1994	2004
Metro counties	1984 to 1994	.027	.188	.342	
	1994 to 2003	.086	.123	.230	
	1984 to 2003	.062	.178	.325	
Nonmetro counties	1984 to 1994	.156	.319	.330	
	1994 to 2003	.167	.183	.243	
	1984 to 2003	.195	.315	.351	

Sources: Calculations based on Bureau of Economic Analysis REIS data and FDIC Call Report data. All correlations are statistically significant

First, in rural areas heavily dependent on agriculture, rural banks may have fewer opportunities to make business loans than farm loans. In such areas, a lower proportion of the loan applications banks receive are likely to come from nonfarm businesses and commercial property owners than from farm operators and property owners.

Furthermore, rural bankers may be more cautious about lending than similar-size metro banks because of the lack of economic diversity in many rural areas. This lack of economic diversity makes it more difficult for rural banks to diversify their loan portfolios, increasing the overall risk of lending.

Limited economic diversity can also create informational hurdles for rural bankers in evaluating loan applicants. The small size and isolation of many rural places make it harder for bankers in those areas to acquire first-hand knowledge of developing new market opportunities. In contrast, small metro banks have the advantage of having first-hand connections with a much wider set of business and lending experiences. The information provided by this thicker network reflects the more general economic advantages of urban areas with their greater concentrations and broader diversity of people and firms.

Information of several types is crucial to bankers in considering loans, as they assess business prospects along with the financial background and plans of the applicant. Advances in information technology and access to resources provided by banking associations can assist rural bankers in the credit decision-making process. However, a banker's first-hand knowledge of similar loans still plays a big part in the credit decision. As a result, rural bankers may be at a disadvantage relative to their urban peers in evaluating loan applications in some newly emerging industries—industries where no comparable benchmarks exist to evaluate a local business plan. A smaller base of first-hand experience naturally limits information and lender perspectives on business potential, translating into greater perceived risk and less lending activity.

In sum, economic diversity and information matter when it comes to new business

ventures. Rural areas are often small, remote places that lack economic diversity. These traits limit the pool of loan applicants available to rural bankers and reduce the opportunities for diversifying loan portfolios. The small size and remoteness of some rural areas may also make it harder for bankers in those areas to acquire first-hand lending experience in dynamic frontier industries. Such information barriers can restrain local lending—lending that could spark new waves of job growth in a region.

Can small banks overcome information barriers?

Rural regions face a wide range of obstacles as they seek to reinvent their economies. Small size, remoteness, and lack of economic diversity create “thin” markets of information for everyone from entrepreneurs to economic development officials. Thin markets make it especially hard for rural bankers to evaluate a new business's potential, dampening lending activity, and creating critical shortages of fuel for regional economic growth.

The economic future of rural places thus depends in part on improving information flows. Better information will allow bankers to better assess the riskiness of new business enterprises.

While small banks are well-tuned to evaluate local prospects that fall within their natural local focus, they could improve the value and the stock of their information. To do so, they must reach across typical market boundaries to draw lessons and tap opportunities from a wider set of bank business loan experiences. For example, a rural bank in western Nebraska is connecting to the broader loan potential of nearby metro areas in Cheyenne, Wyoming, and Boulder, Colorado. By incorporating the rapid advances in telecommunications and information technology (IT), the banking sector can open up both information-sharing and market opportunities.

Technology is often considered a substitute for traditional lender-borrower relationships. Yet cutting-edge IT applications may be even more effective as productive complements to these information-enhancing relationships. For example, customer relation-

ship management (CRM) techniques may offer an avenue for bankers to capitalize on marketplace opportunities. In general, CRM strategies focus on using information and communications technology to tailor specific financial and nonfinancial products to individual customers. According to a 2004 Independent Community Bankers technology survey, 14 percent of community bankers currently use CRM technologies, with another 38 percent planning to evaluate CRM technologies. Still, research suggests that financial service firms need to take a broader view of CRM techniques as a strategy to capitalize on marketplace opportunities.¹

Gaining knowledge of other experiences with emerging opportunities in today's rapidly changing global economy may also help banks overcome information barriers. Groups such as the American Bankers Association and the Independent Community Bankers of America may provide forums for the sharing of such knowledge. For example, the ABA is forging new informational resources for community development through their Small Business Development & Lending working group.

The same information barriers that heighten the perceived risks associated with new economic opportunities also keep entrepreneurs and economic developers from recognizing such opportunities in the first place. As a result, entrepreneurs and economic developers may also benefit from technology and information sharing.

Banks are vital to the economic health of regional economies. In rural areas, small lenders play an even more critical role, but also face a tough challenge: When towns are small and remote, information barriers and lack of economic diversity can make it harder for small banks to lend. But by working together, bankers, entrepreneurs, and economic development specialists may use information technology and knowledge sharing to overcome information barriers—and boost the prospects for regional prosperity in the 21st century.

¹ Peppard, Joe. 2000 “Customer Relationship Management (CRM) in Financial Services” *European Management Journal*. 18(3), pp. 312-327.