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# Rural Banks and Their Communities: A Matter of Survival

By Deborah M. Markley and Ron Shaffer

**A**s rural community banks chart their futures, they are challenged by economic and financial change. Today's rural communities are no longer isolated from global and national economic trends. Competition from abroad has hurt profit margins for rural businesses. Technical innovation, while boosting productivity, has softened the demand for rural labor. Many of the most educated rural workers have migrated to more urbanized areas in search of higher returns on their educational investment. And, many rural businesses are being drawn to urban centers where they can be closer to suppliers and customers.

Just as the economic landscape is changing, so is the financial environment in which rural community bankers must operate. Deregulation and new technology have brought larger financial institutions into the rural marketplace. And, as the regulatory burden on banks continues to change, rural bankers are finding it harder to compete on their home turf.

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This article explores the challenges that face rural communities and their community banks. The article also discusses strategies bankers might use to help themselves in the changing environment. The article concludes that to survive and prosper, rural community bankers need to play a more active role in fostering economic growth in their communities. Fundamentally, the success of rural community bankers is closely tied to the economic health of their rural communities.

## *CHANGING RURAL AND FINANCIAL ENVIRONMENTS*

Just as the national economy is being shaped by changes in the global marketplace, the economies of rural communities are being shaped by national and global economic trends. As a result, a rural location no longer provides a buffer against the ebb and flow of distant markets. Indeed, many rural communities find themselves disadvantaged by recent economic and financial change. Bankers in rural communities are also finding themselves buffeted by change. Deregulation and the changing regulatory burden continue to redefine the competitive environment for banks, while advances in technology, products, and services are creating

new opportunities and new challenges.

### *Globalization of the U.S. economy*

Advances in technology, travel, communications, and financial markets have created a global marketplace for most goods and services—a marketplace that offers both incentives and challenges to rural economies. Low-wage, low-skill rural manufacturers face stiffer competition from developing or emerging economies in the rest of the world. As rural communities adapt to the competitive pressure, those with a diversified economic base are likely to prosper. In contrast, the loss of a plant to an offshore location, for example, could cripple a rural community that lacks other employment opportunities.

Trade agreements may have a disproportionate impact on rural communities. While the effects of the North American Free Trade Agreement (NAFTA) cannot yet be adequately measured, some researchers suggest that the plants most likely to move as a result of NAFTA are concentrated in rural communities (Conroy and Glasmeier). At the same time, NAFTA may give a boost to communities in the heartland that depend on agricultural production.

### *Industrial restructuring within the United States*

Several key changes in the world's industrial sector are reshaping the way that rural businesses must operate to remain competitive. As the industrial structure of rural communities evolves, rural community bankers must develop new tools to meet increased credit needs. And bankers must make difficult decisions about whether to lend to nontraditional businesses.

One key change occurring in the national

economy is the shift away from goods-producing industries toward service-producing industries. In rural areas, goods producers and low-skill service sector activities still tend to predominate (Deavers; McGranahan and Ghelfi). Attracting higher wage, higher skill producer services to rural communities will depend on a community's location, its quality of educational and job training resources, and its infrastructure investments, particularly in telecommunications.

To remain competitive, U.S. firms are being forced to rethink almost every aspect of the manufacturing process. Flexible manufacturing has become the objective for many firms. This change entails reorganizing the production process so that the firm can respond quickly to changes in final demand. The emphasis is on smaller, more adaptable production facilities, lower levels of inventory, higher skill levels for workers, and the latest technological innovations.

With the trend toward smaller and more flexible operations, outsourcing has become a more dominant practice. The emphasis now is on external economies of scale, that is, on developing relationships with other enterprises to permit flexibility in manufacturing and to take advantage of specialized production facilities in other firms. This change suggests that proximity to other potential suppliers is becoming increasingly important for many manufacturing firms.

Changes have also occurred in the traditional basic industries of rural America—agriculture, forestry, and mining. Consolidation in agriculture has resulted in fewer farms, fewer suppliers, and fewer processors of farm products. The search for increased productivity in forestry and mining has led to technological innovation and less demand for labor. Moreover, in all three of these traditional industries, expanded environmental regulations have made it difficult to match concerns for productivity and profitability with the need to protect the

environment.

Another key feature of industrial restructuring is the rising importance of the small business sector. Small businesses are producing more jobs and greater economic diversity, particularly in rural economies. Recognizing the key role of smaller enterprises has helped refocus economic development activities. Emphasis has shifted away from attracting large manufacturing firms toward assisting the creation and expansion of home-grown businesses.

### *Increased importance of agglomeration economies*

In an era of globalization and industrial restructuring, agglomeration economies take on heightened importance. Agglomeration economies refer to a concentration of related business activities in one place. Concentration allows companies to benefit from networking and pools of resources, such as labor. Agglomeration economies may be particularly important for high-skilled producer-service industries. The lack of agglomeration economies may limit the ability of rural communities to attract these service firms, continuing their dependence on low-wage, low-skilled manufacturing and service sector jobs.

In the 1970s, industry tended to decentralize from cities to more rural areas. More recently, the value of agglomeration economies has increased, shifting the competitive advantage back to urban areas for some types of enterprises. Whether a rural community can cope with such a trend may depend on its particular characteristics. For example, a rural community may be better able to attract new firms if its industrial base is diversified. One research study found that rural areas with highly skilled labor, amenities, and proximity to urban areas will be able to compete for modernizing firms, while rural communities without such a base are at a

competitive disadvantage (Barkley and Hinschberger).

The challenge for community bankers will be to help create mechanisms that enable rural businesses, nonbank and bank alike, to capture the benefits of agglomeration. In addition, recognizing the importance of agglomeration economies to particular local industries may help community bankers assess the potential viability of a business and the economic development consequences of such lending.

### *Changes in the financial services industry*

As rural economies undergo fundamental change, so does the financial services landscape. Several factors have dramatically altered the face of banking over the past ten years.

Banking deregulation has prompted much of the evolution in financial services. Mergers have decreased the number of lending institutions while increasing their size. Statewide branching and interstate banking have redefined the competitive environment, particularly for isolated rural community bankers.

Community bankers must now compete for increasingly sophisticated customers with other local and nonlocal lenders. To stay competitive, community bankers must consider offering the same mix of services as their larger competitors—for example, credit cards and leasing. And they must focus on meeting credit needs in a particular market niche.

Advances in technology, products, and services have created new opportunities and sources of competition for rural community bankers. Increasingly, rural residents have access to the same type of financial innovations available to urban residents. Credit card customers are solicited by mail, and money market funds can be established and accessed by phone. Close proximity to customers no longer guarantees rural community banks their traditional deposit base.

As a result, local deposits may prove insufficient, and gaining access to external funds may soon become critical to rural community banks.

As local bankers attempt to plot strategy for the next decade, questions arise about expanded regulation, particularly as it applies to banks reinvesting in the community. Because most rural community banks lend almost exclusively in the local community, they are less likely than urban banks to face official challenges through the federal Community Reinvestment Act. But the reporting requirements in the act still increase costs for community banks. Moreover, some states have begun to review and enact new legislation on community reinvestment and interstate banking—laws that will apply to rural community banks operating within their borders.

The increased reporting requirements resulting from the changing regulatory burden could require local bank staff to spend more time on paperwork and less time on assisting potential borrowers. For small community banks with limited specialized staff, the added costs of meeting regulatory requirements may make it even more difficult to compete with large regional and money center institutions that open branches in rural communities.

### ***RESPONDING TO CHANGE: ROLE FOR COMMUNITY BANKERS***

Rural community banks are in a unique position to respond to the economic and financial changes sweeping rural America and the financial services industry. No one knows the local rural economy better than the community banker. And, while deregulation has raised the specter of large banks entering rural markets, the reality is that most communities remain dependent on the community bank to finance their futures. Thus, rural community bankers and

businesses must work together to respond to a rapidly changing economic and financial environment. In many cases, the future of both the bank and the community is on the line.

Community bankers can use several strategies to improve growth prospects for themselves and their communities.<sup>1</sup> Rural community banks should, of course, continue their traditional role of lending to local businesses. But equally important, community bankers have special knowledge and skills that can be deployed more broadly to foster economic development. Banks can help find the capital—both debt and equity capital—that businesses need to modernize and remain competitive. Banks can also offer financial expertise to rural entrepreneurs who need help in starting small businesses. They can serve as an information link about credit and other programs available to encourage business development and economic growth. And, rural community bankers can provide leadership to help the community develop a vision for adapting to economic change.

### ***Accessing new sources of capital***

To meet the challenges ahead, rural communities and businesses must have access to capital. Rural communities need capital to support new business startup and expansion, and rural businesses need capital to modernize and remain competitive. While community bankers are the primary source of debt capital for local businesses, the ability of banks to meet new demands for capital may be limited for two reasons. One, traditional financial institutions continue to be constrained from providing equity capital. For startup enterprises and expanding industries, future capital needs may be for equity-like capital rather than debt. Two, regulated community bankers must always be sensitive to the risk involved in lending activities. As such, lending to support community economic growth may

involve loans with limited or nontraditional collateral, loans to new enterprises with limited business experience, or loans to existing firms that want to expand into new markets. This type of lending requires increased innovation by community bankers.

To meet the capital needs of local entrepreneurs, community bankers can form partnerships with other private and public entities. These partnerships can be forged with public sector institutions, such as state development finance programs, with private sector community development institutions, or with alternative financial institutions. These partnerships are necessary to pool limited resources and leverage funds to support economic growth. These relationships are also helpful in allowing banks to become more involved in financing local economic activities without incurring unacceptable levels of risk. Not only are funds pooled through these partnerships, but risk is shared as well.

Two prime examples show how partnerships can help banks provide access to new sources of debt capital to support community economic activities. Community bankers in Michigan are able to make moderately risky business loans through their participation in the Capital Access Program, an insurance pool funded by state programs, private lenders, and borrowers. Most of these bankers are making business loans that would not be made without the program. And in Illinois, community bankers can make loans to small businesses, including women-owned and minority-owned businesses, in partnership with a state lending program. Banks can also make loans to individuals, with state funds serving as a second mortgage for the borrower (Markley and McKee).

Access to equity-like capital is considerably more limited in rural communities. Community bankers, however, can develop partnerships with alternative financial institutions. For example, banks in North Carolina purchased stock to capitalize an alternative financial institution that

provides debt and equity-like financing to businesses.

### *Assisting new business formation*

Community bankers have more than capital to offer a potential business borrower. The banker's financial expertise is an additional important resource to rural entrepreneurs since access to business assistance services in rural communities can be difficult. Yet, several surveys suggest that many smaller firms feel they are not being served by their local bank or are unaware of services offered (Steinbrink). Community bankers must be more focused on reaching out to the small business community and playing an active role in local economic development.

Small businesses represent a continuing experiment by individuals who think they have an idea the market will support. Often these ideas require serious revisions. While experienced business managers can anticipate potential financial pitfalls, new business managers or owners may not. The community bank can play a crucial role during the business formation process, therefore, by increasing access to management counseling and support.

Banks could pursue several options for providing this support. The bank could support business management education programs for new and current small business customers. Community banks can create separate affiliations, such as community development corporations and small business advisory committees, that enable the bank to actively support small business development while maintaining an "arm's length" relationship with potential borrowers.

Many private, nonprofit community development corporations also provide business assistance. Local bankers can work with these technical assistance providers, outlining the bank's lending criteria, discussing necessary financial

documentation, and referring potential borrowers to other professional advisers, such as marketing consultants. Having a local economic development organization share in these costs reduces the costs of making small business loans.

### *Providing community leadership*

New economic realities are signaling that the days of passive community banking are over. Bankers must aggressively identify entrepreneurs, encourage and prod community leadership in the pursuit of economic growth, and support economic development activities (Taft, Pulver, and Staniforth). In other words, community bankers need to provide leadership to the community and help develop a vision for how the community can adapt to economic change.

Successful communities develop comprehensive strategies for guiding economic changes. Community bankers have an important role to play in formulating and implementing these strategies. Bankers can engage community groups in determining how the bank can respond to emerging community needs. Bankers can lend needed financial expertise in support of economic development endeavors and make prudent lending decisions in support of community economic change. Communities need to identify the internal investment opportunities that are necessary for successfully adapting to economic change. In turn, community bankers must weigh the potential returns from making short-term investments outside the community against the need for supporting the long-term investments identified as being necessary for growth within the community.

Community bankers in Wisconsin are active participants in the University of Wisconsin-Extension's Community Economic Analysis program, which seeks to help communities build economic development strategies. Their participation involves contributing to the discussion of

major issues facing the community, building strategies to address priority issues, and supporting implementation efforts that often require bank personnel and expertise rather than bank financing.

One particularly important way rural banks can demonstrate leadership in their communities is by relaying information. In most cases, the local bank is the first stop for a business needing capital for startup, expansion, or modernization. Bankers can serve as an information link for these enterprises by maintaining information about state development finance programs, equity investors in the state or region, technical assistance providers, university or state industry modernization programs, and other relevant business assistance providers.

In the early stages of business development, the banker may be able to assist a business most by providing information rather than capital. For example, bankers in Texas actively refer small businesses to business assistance resources available through the Business School at Pan American University. The small businesses can receive assistance in preparing business plans, evaluating financing needs, and preparing the financial documents necessary to apply for a bank loan.

### *CONCLUSION*

The pace of change in the national and global economies demands that rural communities and rural community bankers find new ways of doing business in order to survive. Unfortunately, there is no single model for banks and communities to follow.

This article explores several strategies rural community bankers might embrace to become more active participants in their communities' economic development. Each community banker can customize these strategies to the unique set of circumstances under which the

bank operates. The strategies provide a way to meet both fiduciary and community economic development objectives by accessing new

sources of capital for rural businesses, assisting new business formation, and providing leadership to the community.

### ENDNOTES

<sup>1</sup> Several publications review in greater depth potential strategies for community bankers and development finance

programs operated at the state or community level (Administrator; Hogwood and Shabecoff; Markley and McKee).

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