Commentary: Improving Secondary Markets in Rural America

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This document discusses the Community Reinvestment Fund (CRF), a unique secondary market operating in rural America. The discussion is structured as a commentary on a paper presented by Dr. Kerry D. Vandell, Tiefenthaler Professor and Director of the Center for Urban Land Economics Research at the University of Wisconsin-Madison. While Professor Vandell’s paper examines key requirements for a successful secondary market from a macro perspective, notably the functions of “Farmer Mac,” the discussion in this paper examines secondary market transactions in rural America from a decidedly micro perspective. The paper examines the fundamental bases for a secondary market, it then addresses several key factors raised by Dr. Vandell’s paper including: 1) the role of the primary market in driving the secondary market; 2) the “chain of transactions” necessary for a secondary market to function; 3) specific technical barriers and market imperfections which currently impede the growth of secondary markets in rural America; and 4) the impact of the economic transformation that is occurring in the rural economy.

We are examining the role of secondary markets in rural America at this meeting today because we want to see if their development and use can increase the supply of capital for rural development. I have been asked both to discuss the role of secondary markets in rural America from the viewpoint of a practitioner and to respond to Professor Vandell’s paper with a somewhat different perspective than that offered by Dr. Vandell. I believe that Dr. Vandell has written an excellent paper identifying ways to improve the operation of secondary markets in rural America, particularly the programs operated by Farmer Mac, a government-sponsored enterprise (GSE) created specifically to provide liquidity for farm loans and certain rural housing loans. While Professor Vandell examines the functionings of a large national secondary market, I will focus at the other end of the spectrum on the operation of CRF, a private, nonprofit corporation that is building a national secondary market for economic development loans “from the ground up.”

ABOUT CRF

Before I turn to a specific discussion of Dr. Vandell’s paper, let me take a few moments to acquaint you with CRF and its experience in bringing capital to rural America. CRF began in the late 1980s as an experiment to determine whether or not a secondary market could be created to provide liquidity to various governmental and private, nonprofit lending organizations known collectively as Revolving Loan Funds or RLFs. During the 1980s and into the 1990s, hundreds of rural communities established RLFs to finance economic development projects in their communities. Coming out of the farm crisis of the 1980s, many rural leaders saw the need to diversify their local economies away from heavy dependence on farming and resource-based industries. A number of communities established RLFs in order to help retain existing manufacturing and service jobs to assist in the expansion
of key businesses in the community or to provide incentives for new businesses to locate in their communities. Revolving loan funds were necessary to fill a capital gap in many communities between the need for equity and the ability of local banks to provide debt financing.

Capital for revolving loan funds was generally provided through grants from the federal or state governments. Key sources of capital for rural RLFs have come from Small Cities Development Grants funded by the U.S. Department of Housing and Urban Development, the USDA’s Intermediary Relending Program and the U.S. Department of Commerce’s Economic Development Administration, among others. Nationally, more than $4 billion is held by local RLFs, with perhaps $1 billion held by rural revolving loan funds.

Because RLFs raise capital primarily by obtaining government grants, rather than deposits, they can often face liquidity problems once their capital is fully committed to loans. In theory, RLFs are structured so that the repayments they receive from initial loans will be relent to new borrowers when sufficient cash is available. Organizations that seek to make new development loans must either wait for repayments to accumulate or they must obtain additional government grants in order to recapitalize their funds. In this era of federal budget reductions, the latter method of recapitalization is becoming increasingly difficult.

CRF was thus created to meet the need of local RLFs for cash to relend. CRF purchases existing, seasoned development loans from local RLFs, assembles them into pools, enhances the credit of the pools of loans it purchases, and ultimately securitizes these development loans.

CRF securities are privately placed with accredited institutional investors including banks, insurance companies, and pension funds. To date, CRF has purchased more than 600 loans totaling nearly $30 million. These loans were originated by 46 RLFs in nine states and the District of Columbia. Figure 1 shows the locations where CRF has purchased loans.

At this point in time, CRF has proven the viability of its specialized secondary market. It has issued nine series of asset-backed securities and has attracted more than two dozen institutional investors. Since inception, all of its securities have paid as and when due, and CRF has never had to dip into reserves to meet scheduled debt service payments. Given its success, CRF is now on a major growth trajectory. In the coming year, CRF plans to purchase $20 million in additional loans—with a particular emphasis on loans from rural communities.

ASSUMPTIONS

Now that you are familiar with CRF, let me review a few assumptions with you that influence my perspective.

Assumption 1: The federal government will continue to reduce discretionary domestic spending. Because economic and community development programs fall within the area of the federal budget that is most likely to see further spending cuts, new dollars to capitalize RLFs will be very limited. As confirmation of this assumption, funding for the USDA’s Intermediary Relending Program was cut in half by the last Congress, and funding for the EDA has been slashed as well. If RLFs are going to continue to function they must diversify their funding sources. Use of a secondary market is one way to diversify.

Assumption 2: There will be no more new GSEs. The same factors that are reducing expenditures for economic development will constrict the formation of new GSEs. For example, efforts
to create a GSE for business loans have languished in Congress for nearly a decade. Although some might argue that in an era of budget restrictions, Congress might seek to get around budget constraints by creating GSEs that are outside of the federal budget, I believe that the inherent advantage that GSEs have over purely private-sector liquidity providers is access to the “moral obligation” of the United States. Congress may be loathe to create additional moral obligations.

Assumption 3: Capital formation in rural America is dependent on the creation of new institutions and the realignment of existing ones. I view the RLFs that I described earlier as emerging, alternative financial institutions. Some of them may be defined as Community Development Financial Institutions, while others function as sources of patient capital or surrogate equity for small businesses. They support and supplement lending by rural banks, and they may be the only source of local capital in some rural communities as banking consolidations eliminate many rural banks.

START WITH THE FUNDAMENTALS: WHAT IS THE PURPOSE OF A SECONDARY MARKET?

Having disclosed my assumptions or biases, let me now examine the functions of secondary markets. Why create secondary markets at all? What are their purposes?

Secondary markets exist to correct imbalances between the supply of capital and the demand for capital among geographic regions, among different types of financial institutions, and among

Figure 1
LOCATIONS WHERE CRF HAS PURCHASED DEVELOPMENT LOANS
classes of assets or financial products. For example, one region of the country may be experiencing a housing boom while another is in a recession. Institutions in the region experiencing an economic slowdown may be unable to make as many mortgage loans in their region as they have the capacity to make. By investing in secondary market instruments, these institutions can channel capital into the area of the country where the demand for housing is high. A functioning secondary market thus helps to balance areas of capital surplus with areas of excess demand. Capital can thus move efficiently across a wide geographic area.

Similarly, secondary markets help to balance the supply of and demand for capital among different financial intermediaries or institutions. For example, pension funds must invest huge amounts of capital on a daily basis. While they have substantial capital to invest, they are not equipped to originate loans. Retail lending would simply be too expensive for pension funds to undertake. Conversely, banks, mortgage bankers, and other institutions have particular expertise in originating loans efficiently at the retail level. However, specific institutions may not have sufficient capital from depositors to meet demands. By selling loans on a secondary market, retail institutions can thus access much larger amounts of capital from pension funds and other similar, wholesale financial institutions. The market mechanism enables different types of institutions to come together synergistically to finance home mortgages or other instruments.

Finally, secondary markets help to balance supply and demand among different classes of credit products. Institutions may sell loans or other instruments in order to balance their portfolios, to match assets and liabilities, or to reduce credit concentrations. The availability of a secondary market thus enables institutions to more carefully manage the allocation of assets within their portfolios.

Incidentally, secondary markets may also improve the quality of loan underwriting. Credit decisions become “transparent” when they are subject to review by potential secondary market investors. Over time, credit decisions and loan documentation may improve as a result of the trading of financial instruments in secondary markets. While secondary markets do not exist solely for the purpose of improving credit quality, the securitization process may produce better credits, or lower interest rates, as by-products.

Given this short digression into the fundamental purposes of secondary markets, we must ask: “Is there an imbalance in any one of the aforementioned areas, which is significantly impeding the health of the rural economy?”

My answer is “Yes!” Let me now turn to a discussion of the factors which impede capital formation in rural areas. Many of these factors were examined by Professor Vandell in his paper.

FACTORS THAT IMPEDE CAPITAL AVAILABILITY IN RURAL AREAS

Dr. Vandell ably highlights many of the factors that may impede the availability of credit, especially for rural development. Some of the factors he identifies apply particularly to emerging markets, such as the market being organized by Farmer Mac. Other factors apply specifically in a rural context. Let me review a few of these factors and conditions in light of Community Reinvestment Fund’s experience.

Factor 1: The primary market drives the secondary market

In his paper, Dr. Vandell has created a simple but elegant econometric model to describe the
conditions that must be satisfied among all players in a secondary market in order for a secondary market transaction to be completed. He has identified a “value chain,” that is, he shows how at each step in a chain of secondary market transactions, beginning with the borrower and ending with the investor, a set of suitable prices must prevail in order for the transaction to progress.\footnote{Initial transaction costs are often negotiated between the originator of a loan and the borrower. If these initial prices are not sufficient to allow the originator to recoup costs and make a target rate of return once the loan is sold, the originator is unlikely to sell a loan. Dr. Vandell shows similar requisite conditions for loan servicing, pooling, credit enhancement, securitization, and other components in the secondary market “value chain.”} Initial transaction costs are often negotiated between the originator of a loan and the borrower. If these initial prices are not sufficient to allow the originator to recoup costs and make a target rate of return once the loan is sold, the originator is unlikely to sell a loan. Dr. Vandell shows similar requisite conditions for loan servicing, pooling, credit enhancement, securitization, and other components in the secondary market “value chain.”\footnote{While Dr. Vandell’s construct is somewhat theoretical, I would argue that the pricing of each component in the “value chain” is critical to the functioning of a secondary market. Without proper prices, the whole process is hampered. This has certainly been CRF’s experience. Because CRF buys loans from nontraditional lenders, whose loans often bear below-market interest rates, CRF has found that lenders often do not want to recognize the market value of their loans if that market value is determined to be less than the face value of the loan. The fact that prices set between borrower and lender are below market levels, thus ripples through to the loan sale transaction and oftentimes prevents an RLF from selling the loan at all. To the extent that the purchaser of the loan desires to increase the price offered for a loan above the market price, the purchaser must secure a subsidy in order to reduce its cost of capital. Thus, decisions made in the primary market, i.e., the structure of a loan, its interest rate and term, directly affect the suitability of that loan for trading in a secondary market. In an emerging market, whether it is the market being organized by Farmer Mac or CRF’s secondary market for economic development loans, the demand for debt capital in the primary market, together with the way the debt is structured, can have profound implications for the functioning of the secondary market.\footnote{Factor 2: The entire chain of value must be in place for the secondary market to function As important as the primary market is in determining the success of the secondary market, properly priced primary market transactions are necessary but not sufficient to enable the secondary market to flourish. Rather, the entire chain of participants must be in place for a mature secondary market to operate.\footnote{Unfortunately, in my experience, in many rural areas critical components of the value chain are either missing or underdeveloped. As Professor Marvin Duncan noted in his earlier remarks, banking consolidations are reducing the number of rural banks.\footnote{Moreover, banks are often the most advanced financial institutions operating in rural areas. Unlike metropolitan areas, which may be replete with organized venture capital institutions, factoring companies, commercial credit companies, merchant banks, investment banks, and other specialized sources of both equity and debt, most rural areas are home only to community banks or branches of larger national institutions. I would argue that revolving loan funds have emerged in hundreds of rural communities to compensate for the lack of other, private sector financing entities. RLFs often provide subordinated capital, which looks like equity to a bank. They are flexible institutions that can structure debt to fill a financing gap, or to act as “quasi-equity” in an economic development financing. As banks consolidate and recede from rural areas, RLFs may take on even more prominent roles as surrogates for both equity and bank debt. I believe they are emerg-}}}}
ing in rural areas as a vital part of the value chain. They may have the capacity to originate debt instruments that, once securitized, are proper and profitable investments for banks, insurance companies, and pensions funds.

However, with respect to secondary markets in rural America, the entire value chain is not in place. Few rural communities are home to loan poolers, guarantors, insurers, servicing companies, or the other components of the secondary market value chain identified by Dr. Vandell. Formal capital structures are weaker and more likely to be supplanted by informal structures, surrogate structures (RLFs), or no structures at all.

Factor 3. Certain inherent aspects of rural areas impede efficient secondary markets

In addition to the value chain discussed above, there are some features of rural areas that inherently impede the efficient functioning of secondary markets, indeed other markets as well. Rural areas are characterized by vast distances and remoteness from cities. They are also characterized by dispersed institutions whose trade areas must cover large territories. As a result, transaction costs and information costs are generally higher in rural areas than in urban areas. For example, it can sometimes take days to drive to remote rural communities in order to perform due diligence on a loan. Often these transaction costs are unacceptable to institutions that can choose to invest elsewhere in lower cost transactions. Rural areas often do not generate sufficient volumes of financial activity to support one or more components of the value chain. Smaller volumes lead to specialization by lenders in the narrow range of financial transactions that can generate sustainable levels of activity. For example, most rural banks are active farm lenders, while a relatively smaller number originate business loans. The lack of volume in business lending simply may not support a specialist in that area. These factors, among others, conspire to impede the growth of the secondary market in rural communities. At the same time, they may give rise to a high demand for liquidity among rural lenders, both banks and RLFs.

Factor 4. Lack of standardization and expertise slows use of secondary markets

Another set of issues affects the development of secondary markets. While the mortgage lending market is characterized by a high degree of uniformity among lending documents and underwriting standards, most emerging secondary markets are not sufficiently large to dictate loan structures or lending practices. The RLFs that CRF serves are perhaps the least standardized of any financial institution. But, as Dr. Vandell shows in his paper, lack of standardization is a problem for a much larger segment of the rural credit system than that which CRF serves. Lack of uniform documents, wide variation of credit standards, and loan structures raises transaction costs and increases the price that must be charged at various stages of the secondary market value chain. To the extent that documentation and underwriting can be standardized among classes of debt instruments, secondary markets for both rural and urban business and commercial loans will advance, together with the market for farm loans already in place under the auspices of Farmer Mac. As important as standardization may be to the improvement of rural secondary markets, even more important is the expertise of the lenders who originate loans. As I noted earlier, many rural areas are characterized by low volumes of financial transactions. Lenders simply do not get enough “hands-on” experience in writing a wide variety of loans. Document standardization is important, but unless a lender understands which documents are appropriate for various types of loans, the quality of loans submitted for sale on a secondary market may still suffer. One
way to compensate for the lack of lending experience may be to accredit lenders and/or financial institutions. CRF has taken a first step in this area by launching a series of training seminars that culminates in certification as a Microcapital Lender under a unique arrangement with the US WEST Foundation. Rural lenders that have been certified may be eligible to obtain matching grants from US WEST to capitalize microloan programs. This is one small step in the process of secondary market improvement. Other steps that should be pursued include the application of new information and communications technologies, such as credit scoring models, distributed underwriting, and other methodologies that may result in higher quality loan originations.

Factor 5. The transformation of the rural economy is creating niches for new institutions

Finally, Dr. V andell hits on another critical factor in his paper, which I believe deserves more exploration. That is the transformation of the rural economy. For decades, farms have been capitalized primarily with debt. In fact, over-reliance on debt was a major factor contributing to the farm crisis of the 1980s. Reliance on debt may have resulted, in part, because credit institutions are more prevalent in rural America than are organized sources of equity. Nonetheless, equity (positive net worth) is a critical component for the long-term success of both farm and nonfarm enterprises. Moreover, the need for equity will grow dramatically if the kind of rural transformation and economic integration that Dr. V andell predicts in his paper actually occurs. While technological advances in telecommunications and transportation infrastructure may blur the distinction between the rural and urban economies, at present, rural areas are generally devoid of organized equity investors. And, as Professor Duncan noted in his keynote address, what informal equity there is in many rural communities is rapidly being transferred through inheritance to sons and daughters now living in the suburbs.

Why am I talking about equity in a discussion of rural secondary markets? Because without adequate equity, business borrowers are generally not able to access debt capital. Without the origination of adequate volumes of new loans, there is little need for a secondary market. Equity is thus a key part of the value chain I discussed earlier, and without it there simply will not be enough “good deals” to drive the secondary market.

Clearly, as Dr. Vandell shows in his model, if the fundamental economics of the farming or manufacturing sectors are weak, or if borrowers are overleveraged, fewer borrowers will borrow, fewer loans will be originated, and overall loan volume will fall short of the economies of scale necessary to attain a viable secondary market. My point is that rural secondary markets cannot improve by themselves; their development depends, in part, on how the rural economic transformation unfolds. On the positive side, Dr. Vandell implies that as the rural economy diversifies and manufacturing and professional employment increases, new sources of rural equity may emerge. Similarly, as banks consolidate, new opportunities for nontraditional lenders may emerge. Revolving loan funds already exist in many rural communities, state-wide community loan funds, bank lending consortia, and other novel structures are emerging throughout the countryside. In rural northeastern Minnesota, a targeted venture capital firm is thriving and a national association of community development venture funds has recently been formed. The growth and development of these and other new institutions will undoubtedly increase demand for secondary markets. Moreover, the U. S. Treasury is currently spearheading an effort within the federal government to facilitate the securitization
of economic and community development loans, originated primarily in rural areas. All of these efforts will both contribute to a transformed rural economy and increase the supply of capital for rural development.

CONCLUSION

As I have attempted to point out in my remarks, there are a variety of issues that constrain the growth of secondary markets in rural areas. Some of these issues are related directly to “ruralness” while others are inherent to emerging markets. Dr. Vandell has ably critiqued a large national secondary market operated by Farmer Mac. In assessing its strengths and weaknesses, he has created a useful economic model, which I have dubbed a “value chain.” This model can help explain the factors that may lead to success or failure with respect to each component of a fully functioning secondary market. I have attempted to highlight and amplify some of the factors identified by Dr. Vandell from a completely different frame of reference—that of a private, nongovernmental institution that is organizing a specialized secondary market for economic development loans. CRF’s “grass-roots” perspective is nonetheless salient, because CRF has shown that it is possible to create a secondary market for some of the most difficult assets to securitize, small-business loans and other, nonstandard community development loans. As a result, CRF has brought capital to some very remote rural communities who would never have been able to tap pension fund or insurance company investors. The rough work is behind us. What is necessary now is to get about the business of completing the value chain, building new institutions in rural America that can respond to the economic transformation that is taking place there, and doing so without relying on dwindling federal resources. This is a tough challenge, but I believe it can be met.
ENDNOTES

1 For a thorough discussion of the value chain concept, see Botkin, James W., and Jana B. Matthews, Winning Combinations: The Coming Wave of Entrepreneurial Partnerships between Large and Small Companies, John Wiley & Sons, Inc. New York, 1992. While the value chain concept discussed by Botkin and Matthews focuses mainly upon entrepreneurial partnerships, the lessons they present bear directly on the chain of transactions inherent in a secondary market.


3 See remarks by Professor Marvin Duncan, North Dakota State University, in his Keynote Address to this conference.

4 See Vandell, pp.24-26.