Commentary: Liquidity and Competition in Rural Credit Markets

James A. Hansen

Good morning and thank you for inviting me to join you. I appreciate the opportunity to visit with you about this very thoughtful paper.

First of all, I want to congratulate the authors for their work on such a timely issue. Today I am here to bring you some comments on this paper from my perspective as an ex-community banker, and now as a bank regulator.

I feel that the situation in Nebraska is fairly representative of what is happening throughout the Tenth Federal Reserve District. Much of the information reflected in this paper is quite accurate as it is representative of the credit markets in this part of the country.

LIQUIDITY AND LOAN DEMAND

The loan to deposit ratios have been increasing from the mid-1980s until now. Also liquidity ratios have been tightening over the last few years. Immediately following the years of the agricultural crisis (mid-to-late 80s) agricultural borrowers were very cautious about incurring additional debt. However, the last few years we have seen much more debt being willingly added to the balance sheets of the rural borrower. In fact, as I researched some data prior to this presentation, I found that in Nebraska, loan to deposit ratios have increased 45 percent since 1987.

One of the highest increases of loans is the loans secured by farm real estate. I remember several years ago, if a bank customer needed a real estate loan, the banker would help coordinate a loan from an insurance company, a savings and loan, or the Federal Land Bank. Generally, banks were not interested in long-term real estate loans. Also, there was a significant amount of seller financing that was available and popular at that time. Seller financing is much less available currently, and there is a very competitive environment now among the Farm Credit System, savings and loan institutions, and the commercial banking system, as banks are actively soliciting farm real estate loans for their own portfolios.

The result has been additional pressure on liquidity and also an increase in dependency ratios. What we mean by dependency ratio is the dependency on short-term liabilities to fund longer term assets. This dependency has resulted in other short-term deposits, borrowings, and other short-term sources of funds such as fed funds and brokered deposits being used to fund these loans. With this in mind, most banks are structuring their term loans as a 3, 5, or 7 year term with a 15 to 20 year amortization and a balloon due at maturity. In a stable interest rate environment this seems to work, but both the bank and the borrower are incurring some significant interest rate risk. Therefore, financial institutions have been searching for an appropriate and stable source of long-term funds with which to match maturities.

DEPOSIT GROWTH

Deposit growth prospects in rural communities
do not look very promising. There are many alternatives for today’s investors. The CD market is very competitive and the CD investor has been willing to shop rates and terms over wider areas. Also, the consumer or investor has become more sophisticated and has been willing to consider and use other investment vehicles. For many years, the common saver had the lion’s share of his savings in passbook savings or CDs. Now, most savers are using mutual funds and other investment alternatives. The current history of the stock market and the extraordinary gains that have been posted have drawn significant funds to that sector. In fact, many 25-40 year olds have never seen the effects of a stock market correction, let alone a down market.

I feel that in the next few years, we will see a tremendous sum of money moving from our rural communities as estates of the older rural residents are settled. Many of the heirs of these estates no longer live in these communities, but live in more populous communities; therefore, the funds of their inheritance will leave our rural communities and will not be available to help finance the development and businesses in the rural areas. These funds will not be easily replaced.

CONSOLIDATION OF COMMERCIAL BANKING

Over the last few years we have experienced a dramatic consolidation of the number of banks in all areas of this country. Most feel that this trend will continue. In most cases, banks have been acquired by other banks and merged leaving a branch office at the location of the acquired bank. In these circumstances, the banking locations are remaining to serve their respective communities. However, the decisions relative to loans, investments, and community involvement are all made at the headquarter bank. Recent studies have revealed that as ownership has changed and moved from our rural communities, the decision making responsibility has also moved. This has created a tendency to destabilize the availability of credit into many rural communities. Again, this points out the need to increase the accessibility of alternative sources of funds for use in our rural communities. Funds that can be used by the financial institutions that continue to supply credit to these communities.

UTILIZATION OF GOVERNMENT-SPONSORED ENTITIES

The GSE access to the capital markets has been a very effective source of longer term funds, which has been beneficial to the rural borrower and to some financial institutions serving rural communities. Wider availability of GSE funding to lenders that serve rural America is currently being considered by legislators and industry leaders.

FARMER MAC

Farmer Mac was developed in order to provide a secondary market for farm real estate loans. Farmer Mac has not been widely utilized and was in need of some fine-tuning by Congress. It is my understanding that the amendments made to the Farmer Mac program early in 1996 have fixed many of these problems. However, banks still have not used Farmer Mac to the extent that the originators had anticipated. It remains to be seen how popular this program will become.

FARM CREDIT SYSTEM

During the last few years, the FCS has proposed to expand their authority to purchase loans from other lenders, as long as the loans are eligible under FCS lending authorities. This would create another vehicle for secondary loan sales from banks to help in their funding of
agricultural loans. This loan participation, or whole loan sale program, has not been popular with the bankers to date. The reason for the unpopularity is multifaceted. The FCS has its own retail branch system and the last several years they have become very competitive with banks for the high quality ag borrower. In fact, because of the ability of the FCS to fund itself from the capital markets at significantly lower rates than banks can fund themselves from savings and CD products, the retail branches of the FCS have been able to offer much lower borrowing rates to their retail borrowers than the banks. Therefore, some of the banks’ good customers have migrated to the FCS for their loans. The banks are concerned that if they sell whole loans or participations of loans to the FCS, they will be exposing their good customers to an aggressive competitor. Also, the banks feel that they would rather keep these loans in their own portfolio in order to benefit from the spread.

The American Bankers Association and the Independent Bankers Association of America are both supporting a proposal whereby banks would have access to the funding of the FCS. This proposal would allow banks to fund agricultural loans in the same manner as they currently use the Federal Home Loan Bank for residential real estate loans. However, the FCS and their cooperative organizations are resisting the banker proposal which would open up their funding mechanism to their competitor. This has been a very perplexing issue which may play out in the 1997-98 political scene.

FEDERAL HOME LOAN BANK/ENTERPRISE RESOURCE BANK PROPOSAL

The Federal Home Loan Bank (FHLB) System has provided the thrift industry a funding mechanism for several years. However, with the changes in the thrift industry and the ability for commercial banks to become members of the FHLB, many are looking to restructure the FHLB into an agency that could provide GSE funds to financial institutions to help facilitate community and economic development lending, including rural and agricultural types of lending. Currently, the FHLB system has more bank members than thrift members, and is a funding mechanism being used extensively by the banking industry. This membership has provided financial institutions greater accessibility to longer term funds which are utilized in matching maturities in their asset-liability management scheme. It also provides a funding mechanism whereby the financial institution can keep these loans in their loan portfolio and benefit from the spread. However, some smaller rural banks cannot qualify for membership to the FHLB because of the requirement for a financial institution to maintain a certain percentage of residential real estate loans in its portfolio. Therefore, I feel that the Enterprise Resource Bank idea that is being proposed has very good possibilities and should be explored. It appears that the remake of the FHLB into an ERB that could provide FHLB-type funding to a broader group of lenders would breathe new life into the GSE. It would give a broader range of financial institutions access to funding from the capital markets and longer term funds. But, it will take legislators, the financial institutions, and the GSEs working together in a spirit of cooperation to address these issues to come to any solution.

CONCLUSION

I felt that the authors of this paper were very much on target with their observations relative to the need for a readily available source of funds for the financing of economic development in our rural areas. There needs to be a common realization that everyone benefits from
rural lender’s increased access to long-term funding through capital markets. The increased access reduces risk and improves the stability of both borrower and lender. Our rural communities’ survival depends on an adequate availability of credit. This supply of credit is the lifeblood for economic and community development to continue and for the growth of the rural areas of this country. Any new attempts to increase accessibility to funds should consider the current delivery systems that are in place. This would be the most effective and economical credit delivery system for our rural communities.

It’s going to be a challenge because the current players are competitors, but the continued viability of the rural community is riding on the ability to be adequately financed.

Thank you again for inviting me today, and I appreciate the opportunity to comment on a very thoughtful paper.