Closing Panel: Improving Rural Capital Markets

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Last but hopefully not least, I am pleased to be part of such a distinguished list of speakers. I admit to feeling in the minority in as much as I am the only participant who truly lives, eats, and breathes in the rural areas which are the focus of this conference. I think it would be beneficial to hear from other lenders and rural development practitioners who reside in small communities. The balance of the speakers are from university communities, government, cities, or larger metropolitan areas whose business and economic growth are strong and resilient. We envy that, but are appreciative of your commitment and concern for rural development issues. Hats off to the Kansas City Federal Reserve Bank for hosting this important discussion.

As an overview of some of the major issues or themes from today’s presentation, I would first emphasize one of the points Marv Duncan made last evening regarding the heterogeneity of the “nonmetropolitan” areas. Obviously there is a full spectrum of economic activity evident in rural communities, but I think it’s helpful to at least identify two types of communities within the “nonmetropolitan” areas in Marv’s database. For simplicity, I’d call the first group “growth communities” where there is strategic location, unique attributes, or previous successful strategic planning that has spurred economic growth. These communities are on an upward growth spiral, although somewhat slower in general than metropolitan areas. They are communities where a bank branch or a charter will remain or be established and they may need sources of funding to augment local deposit gathering. The second group of communities are experiencing stagnant or negative population and economic growth. They are distanced from the metropolitan areas which tend to be the engines of economic growth. These communities are in a downward economic spiral and there is a real challenge to reverse this direction. It seems that negative growth/low income begets negative growth/low income and I have a concern about how some of these areas can keep from becoming “welfare towns.” These communities will lose the branch of the bank if they had one—new business is not moving in. Addressing rural development issues in these two types of communities requires different tools and approaches. As Marv clearly points out, non-metropolitan growth lags growth in metropolitan areas and with many nonmetropolitan areas doing well, the conclusion has to be that this second group of rural areas is truly being left behind. It did not seem that the conference adequately focused on the problems of this second group of communities.

Another recognized and consensus trend discussed throughout the day is that of the consolidation of the commercial banking industry. Ken Guenther pointed out there’s likely to become a barbell-shaped banking structure with 20 or so nationwide banks and thousands of community banks. Besides the impact this emerging structure has on bank delivery points in rural areas, there is the question of leadership. In my judgment, loss of local ownership will have a negative impact on leadership for the local economy and community growth. The local banker is usually involved in economic leadership while other
investment and loan intermediaries with a presence in the community are not. You don’t normally find the manager of the Edward D. Jones office or the New York Life office or the Farm Credit office manager heading up the Economic Development groups. What about the branch manager of a large regional or national bank?

The ability of community banks to respond to area lending is dependent on funding sources. Traditional sources for commercial banks have been local deposits. Both the Marv Duncan and Peter Barry papers suggested that deposits may be a less reliable future source. My analysis of our deposit structure in our banks concurs with this concern. A stratification of deposits shows that the old 80/20 rule is alive and well in rural banking. In fact, approximately 18 percent of our households supply 80 percent of our bank deposits. Further analysis reveals that of the 80 percent of the deposits, 80 percent are provided by individuals 60 or more years of age. As these deposits go through estates, will they come back to the local area? If so, will they come to the bank? Many younger generation investors are tuned into non-bank products and investment vehicles, most notably mutual funds. Therefore, if we are to keep the surviving community banks viable, I agree there will be an increasing future need for access to wholesale funds to augment deposits.

A current source of funding used increasingly by rural banks is the Federal Home Loan Bank. Existing programs work well. There are proposals to expand the authority of the Federal Home Loan Bank function which have been met with mixed reviews. I believe there will be a need to liberalize the collateralization and purpose for Federal Home Loan Bank advances. At the same time I have great respect for my Congressman and Chairman of the House Banking Committee, Jim Leach, and others who have questions about this proposal. Their concerns for expanded Federal Home Loan Bank powers need to be heard and addressed.

There is no concern for credit availability for strongly capitalized and profitable firms in rural areas. There currently exists a plethora of options, all of which are seeking out sound lending opportunities. Rather, the real challenge in rural development is financing undercapitalized and start-up businesses, small marginal businesses, part-time agriculture, rural housing, senior housing, etc. The challenge is to become knowledgeable and proficient in using the development lending options that are already available. Government offices need to continue to work on ways to make these programs more accessible. Education on what’s available and how to make use of the programs is still needed.

Professor Brophy’s presentation raised an important question regarding directing equity capital to rural areas; that is, are the projects capable of producing adequately attractive returns to attract venture capital or support high levels of debt? This is a critical question as many firms in smaller communities produce generally lower rates of return. When this is the case, and yet the business or industry is vital to the community, then public policy programs need to come into play. I was intrigued by Professor Brophy’s presentation on the use of venture and IPO capital. Can this type of capital be brought to bear into small projects with low returns? More knowledge and education on the part of rural development leaders and community bankers would be helpful in how to access and utilize this specialized equity capital.

The Farm Credit System is to be complimented on the tremendous gains or improvements made in the last decade in the soundness and profitability of their organization. This is largely reflective of their focus on quality of credits over quantity. Most community bankers
see Farm Credit’s current objective as attracting large low-risk borrowers. If that perception is correct, it is unlikely that Farm Credit, if given broader authority, would be helpful in supporting low/moderate income individuals, small firms, low equity operations, or start-up businesses that are so vital to growth of rural communities. Farm Credit has no mandate for this type of lending and is not subject to Community Reinvestment Act regulations. It is likely their new target of expanded authority would be larger established profitable business, where currently significant competition exists. It would seem that synergies do exist for cooperation between commercial banks and the Farm Credit System, whereby the banking industry has an extensive retail outlet system and community lending expertise while Farm Credit has efficient funding access. Much has been discussed about this possibility and from an economic perspective it would seem beneficial. However, historical competitive intensity and even current retail competition create internal political pressures which may preclude the potential synergies to be realized. Cooperation remains worth further exploration.

Like farms, there are many small town elderly business owners ready to turn over ownership. New owners with heavy debt burdens will likely experience financial difficulty whereas the previous owners were actually living on their return on equity. Paid-out equity leaves intergenerationally to distant heirs and estate taxes. Capital gains tax reductions and estate tax relief for family owned businesses would be of major assistance in maintaining equity capital in small communities.

While much of our discussion from several of the presenters focused on the changing structure of the banking industry as a result of interstate banking and branching, it is my contention that the technology and electronic financial delivery revolution may be even more important in the long run in the way financial services reach consumers. All communities, large and small, will have wide access to a vast array of financial services. Many kinds of loans can be standardized adequately to be “put in the box” and delivered electronically. This will make it possible to both invest and borrow money from the smallest of communities without going to the bank. Depending on the response to this competition by the local bank, new electronic impersonal banking delivery systems could bring capital to or take capital away from small communities. The ultimate impact is uncertain, but the Internet and the electronic financial services revolution will be significant in communities of all sizes.

Another theme voiced in several presentations was the need of rural banks to have access to a source of fixed-rate farm real estate financing options. This was mentioned as important from a competitive perspective, as well as necessary for balancing the asset-liability mix. Farmer Mac was conceived and structured to fill this need. For several reasons, most notably a flawed charter which received a legislative fix early in 1996, Farmer Mac has not found adequate volume to achieve profitability. Other reasons for lack of success include timing. By the time Farmer Mac was operational, agriculture had gone through major debt restructuring and commercial banks’ loan to deposit ratios were at all-time lows. Secondly, Iowa banks who were the largest group of shareholders of Farmer Mac stock were prohibited from using the program for Iowa farmers due to prohibitions on the use of prepayment provisions. As Professor Vandell pointed out in his paper, there remains a question whether there is adequate volume available to produce success. Whether this is correct remains in question and Farmer Mac must be given time under the new charter to find out. Whatever the outcome, from today’s discussion and injecting my own thoughts, it is desirable that the Farmer Mac
functions remain intact: primarily the functions of providing fixed-rate alternatives for the farm real estate market and providing a secondary market for guaranteed portions of government-backed loans.

Finally, from the perspective of one who lives and works in rural communities, I express appreciation for the time devoted to this important subject by all of the participants and by the Federal Reserve Bank of Kansas City. Continued discussion will be needed, but the real proof is bringing the subjects of today’s discussions to bear in a positive manner in support of business activity, growth, and incomes in areas most distant from metropolitan America.