Financing Rural America: A Conference Summary

By Mark Drabenstott and Larry Meeker

After a steep recession in the 1980s, many rural places are mounting a strong economic comeback in the 1990s. Rural counties, for instance, have added jobs in the 1990s at about 1.8 percent annually, compared with meager gains in the 1980s. And some counties, especially trade centers or those with scenic amenities that have attracted retirees and tourists, are posting stronger growth than metropolitan areas. Reflecting the economic turnaround, more people are moving to rural areas. For example, 1,818 of the nation's 2,359 rural counties had population gains in 1995 compared with half that number in 1990.

Notwithstanding the improved rural economic picture, rural leaders remain concerned about rural America's economic future. Chief among these concerns is gaining access to capital to fuel continued growth. Many rural communities, especially those traditionally tied to agriculture, are trying to diversify their economic base, and capital is needed to finance new businesses. Housing is in short supply, and many communities are seeking to finance affordable housing. And public infrastructure, such as water and sewer systems, is in need of refurbishment in some communities and expansion in others, pointing to additional capital demands.

While capital demands mount, questions linger about the adequacy of rural capital markets to meet those demands. Rural capital markets have not been widely studied, but many analysts believe that rural borrowers face less competitive markets, with fewer capital suppliers and fewer financial products and services. Rural businesses tend to rely heavily on community banks for debt financing and often have few if any sources of equity financing. A fresh wave of consolidation among the nation's banks has only heightened concern about access to credit.

What might be done to improve the operation of rural financial markets? To address this question, the Federal Reserve Bank of Kansas City sponsored a conference entitled *Financing Rural America*, held in Omaha on December 4-5, 1996. The conference brought together 125 of the nation's economic experts, rural business and financial leaders, and public officials to assess current trends in rural financial markets and consider options for improving their operation. This article reviews the importance of capital to the rural economy, discusses some apparent

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shortcomings in the markets, and summarizes the options for improving them presented at the Omaha conference. Conference participants generally agreed there are several viable options to improve access to capital for rural borrowers. These options will be of great interest to the seven states of the Tenth Federal Reserve District, where rural counties account for 40 percent of the district's population, 70 percent of its commercial banks, and nearly 90 percent of its land base.

I. WHAT ROLE DOES CAPITAL PLAY IN THE RURAL ECONOMY?

Charged by Congress to conduct monetary policy and regulate banking institutions, the Federal Reserve has always had a keen interest in capital access issues. In the Heartland, that interest often centers on rural communities and rural capital. Rural America depends on both the private and public sectors for capital. Amid a recent tide of bank mergers and consolidations and new restraints on government spending, there has been growing concern about how rural America's increasingly diverse capital needs will be met. Such concern provided the background for the Federal Reserve Bank of Kansas City's conference on *Financing Rural America*.

In the 19th century, the nation created a decentralized banking structure composed of many locally and independently owned banks to respond to local credit needs. In the early years of this century, legislators established the 12 regional reserve banks of the Federal Reserve System in part to maintain responsiveness to regional economic conditions. These same concerns about being responsive to local credit needs are still being played out today as we approach the 21st century.

One clear signal of those concerns today is the Community Reinvestment Act, or CRA, which requires banks to demonstrate how they meet the credit needs of economically disadvantaged individuals and geographies, small businesses, and small farms. In addition, as new banks are chartered and existing institutions are merged and acquired, regulators evaluate how the proposed changes will affect the ability of local citizens to access banking services.

Historically, the government has played many roles as a source of capital for rural America. The federal government has lent directly or acted as guarantor for bank loans. It has facilitated the development of secondary markets. And it has provided credit subsidies for affordable housing, small business, and infrastructure development. In carrying out these roles, government has been both a competitor and a partner with private sector lenders. For example, government and commercial banks have competed in servicing agricultural borrowers but have been partners in addressing projects such as affordable housing, where access to the government's subsidy programs requires bank participation.

As legislators now attempt to balance the budget, however, the federal government has decreased support for many of its housing, small business, and infrastructure assistance programs. Such shifts in public resources are increasing the importance of private-sector capital sources in rural America, both as a substitute for a decreased government role in providing capital and as a partner with government in leveraging limited funds.

Amid these changes in the availability and structure of capital resources, rural America's capital needs are changing as its economic base broadens. Capital has always helped to develop natural resources and create rural infrastructure. Yet, many rural communities still remain tied to

economic cycles driven by swings in farm and energy prices. Today, new hopes for rural America are seen on the information highway. High technology can help overcome the disadvantages of remoteness and produce new business opportunities. Capital needs in rural communities may expand to encompass newer and more diverse businesses, as well as finance housing for labor force expansions and upgrade aging infrastructure.

Innovations in capital sources may help rural America meet its expanding capital needs. Rural capital issues have been a focus of private sector and foundation initiatives. For example, several principals of the internationally known development bank, Shorebank Corporation in Chicago, collaborated to form a development banking organization in Arkadelphia, Arkansas. The goal was to test their successful approach to urban redevelopment in a rural setting, and they have since undertaken other such ventures. In another private-sector initiative, rural utilities have sponsored or participated in rural development efforts to address both housing and business expansion issues. The rural communities benefit as the utilities preserve and expand their markets.

These changes in banking, government, technology, and economic structure of rural communities raise important questions about the future needs for, and sources of, capital in rural America. The Omaha conference posed two key questions: *Are there shortcomings in rural capital markets today? And, what can be done to improve rural capital markets?* The latter issue was explored on three fronts: expanding community bank access to loanable funds, improving rural secondary markets, and developing rural venture capital markets. Both the questions raised and the options discussed at the conference suggest the debate about the role of capital in rural communities will continue into the 21st century.

II. ARE THERE SHORTCOMINGS IN RURAL CAPITAL MARKETS?

Economists and market participants do not fully agree on how well rural capital markets operate. There is a consensus, however, that rural businesses and consumers have a smaller menu of financial products and often pay more to access capital. This consensus view was referenced by a number of conference participants and provided the starting point for the conference. The shortcomings, or gaps, in rural financial markets generally fall into three categories: liquidity for commercial banks, access to secondary markets, and access to equity capital markets.

Historically, community banks have been the major source of capital for most rural businesses. Despite the steady pace of innovation in financial markets and telecommunications, community banks seem likely to remain a mainstay source of financing in rural America. The problem that many rural community banks now face is a limited or declining supply of loanable funds. Banks face much more competition for deposits than in the past, and the competition comes from a variety of competitors, including mutual funds. Moreover, deposits often leave the local community when heirs, many of whom live in metropolitan areas, settle the estates of rural residents. Finally, in the 1990s the demand for loans has generally grown faster than the supply of loanable funds, driving up loan-deposit ratios at rural banks and reducing their capacity to make additional loans.

Peter Barry and Paul Ellinger noted that liquidity has long been a perplexing problem for rural community banks. Numerous initiatives have been aimed at improving bank access to capital markets, but few have had much success. In particular, "innovations generally seem to come too late, with their effectiveness blunted by new emerging problems and developments."

Another rural financial market concern is that the ranks of community lenders are shrinking due to bank consolidation, thereby reducing the availability of credit to some rural borrowers. When rural banks are acquired by metropolitan banks, some customers find the acquired bank is no longer interested in serving small local businesses. Research in the Tenth District, for instance, has shown that large banks are less likely than small banks to lend to the small businesses that dominate rural areas (Keeton). In his keynote address, Marvin Duncan suggested that bank consolidation seems likely to hurt rural borrowers more than those in metropolitan areas simply because there is less competition for the rural borrower's business.

Secondary markets offer another way for rural community banks to address their liquidity needs; yet the evidence suggests these markets are little used. Duncan pointed out how slowly rural secondary markets have developed. Nevertheless, their importance to rural businesses and consumers will likely grow in the future. Farmer Mac, a secondary market dedicated to farm and rural loans, has had great difficulty developing a viable threshold of business since its creation in 1987. No secondary markets for rural business loans are in operation. And while rural homeowners have access to mortgage secondary markets, including Fannie Mae and Freddie Mac, it appears that relatively few rural home buyers use the markets to finance the purchase of homes. The reasons for this limited use have not been studied by economists.

While rural capital concerns are often voiced in terms of credit, conference participants agreed that the lack of equity capital is an overlooked and often more important issue. The economic challenge facing a great many rural communities is diversifying their economic base. Such diversification often comes with new start-up firms whose success rests on a sturdy capital foundation. Few economic studies have empirically evaluated the supply of rural equity capital, but numerous studies suggest the supply is meager. Duncan concluded that "access to equity capital is both unorganized and very difficult to accomplish in nonmetropolitan areas." A recently released report by a panel of rural financial experts concluded that rural businesses experience more difficulty obtaining equity capital than their urban counterparts (RUPRI). And the conference paper presented by David Brophy provided data which suggest that urban areas dominate rural areas with respect to flows of venture capital and initial public offerings, or IPOs.

Insufficient liquidity, a shrinking number of rural community banks, limited secondary markets, and undeveloped equity markets all suggest that rural financial markets do have gaps. How serious are the gaps? Duncan concluded his keynote address by suggesting that rural financial markets are currently "reasonably efficient," but that, given the diverse nature of rural America, rural financial markets must provide a wider range of services at lower cost if further economic progress is to be achieved in the nation's rural communities. That view was echoed by many conference participants.

III. WHAT CAN BE DONE TO IMPROVE RURAL CAPITAL MARKETS?

With a general consensus on the shortcomings of rural capital markets, the balance of the conference turned to a discussion of options to remedy those shortcomings. Three options were explored in depth: giving community banks new access to loanable funds, improving secondary markets, and developing rural equity capital markets. More generally, the conference considered the implications of continued bank consolidation and the federal role in rural capital markets.

Expanding community bank access to loanable funds

Conference participants agreed that improving liquidity for community banks was a useful starting point for improving rural capital markets. Barry and Ellinger presented evidence showing that rural credit markets are less competitive than urban credit markets, a problem made worse by the fact that most rural borrowers depend on small banks with more limited access to capital markets. Accordingly, they concluded there is justification for expanding rural bank access to loanable funds through government-sponsored enterprises, or GSEs. Expanding this authority, they suggested, would be consistent with the GSE concept of filling gaps in credit markets without subsidizing investors or borrowers.

A more complicated issue is *how* to expand rural access to GSEs. Three options might be explored. First, authority to fund other rural loans might be given to Farmer Mac, a GSE chartered to increase the supply of funds for farm mortgages. Barry and Ellinger noted that while Farmer Mac has had only marginal success, recent legislative changes may make it more viable. Still, whether Farmer Mac can fully address the broader rural liquidity problem is doubtful.

Second, banks might be given greater access to Farm Credit System funds to provide greater liquidity for rural business loans. The Farm Credit System is a GSE that raises capital through issuing bonds in national and international money markets. FCS access is an option favored by many rural banks, but Barry and Ellinger raised doubts that this option would be successful. They noted that channeling FCS funds to commercial banks for farm loans, an avenue that has been available for some years, has not worked well. Moreover, they suggested that this approach would be hampered by conflicts of interest. The regional Farm Credit Banks would essentially be providing funds to both local FCS lending outlets and commercial banks—and these two lending institutions are in direct competition for agricultural customers.

Third, rural community banks could be granted greater access to funds through the Federal Home Loan Bank System. Congressman Richard Baker has proposed that the FHLB system be rechartered to provide funds for community and economic development lending. The renamed "Enterprise Resource Banks" would thus be a source for addressing the rural liquidity problem. Barry and Ellinger concluded that a refocusing of the FHLB as a source of funds for rural banks has considerable merit. A point in favor of overhauling the FHLB system, they suggested, is that it would not require creation of an entirely new institution. Overall, Barry and Ellinger believed the best solution would be to keep the FCS and Farmer Mac focused on agriculture while using a rechartered FHLB system to provide funds for a broader range of rural community lending. They cautioned, however, that such an approach would need to be revisited in the future if continued rural bank consolidation opens new financial market gaps or widens existing ones.

James Hansen underscored the need to address the rural liquidity problem, calling the supply of credit "the lifeblood" of rural economic growth in the future. The outlook for deposit growth in rural communities is not promising, he noted, and the consolidation of banking could destabilize the availability of credit in many rural communities. Hansen expressed optimism over the proposal to overhaul the FHLB system, noting that it would provide a new source of loanable funds to rural America while breathing new life into the FHLB system. He concluded, however, that such an overhaul would require the cooperative effort of bankers, regulators, and legislators.

Thomas Stanton argued that using the FHLB system to channel GSE funds to rural community banks is ill-advised. First, he noted that using the FHLB, or any GSE, to provide collateralized loans is an outmoded and cumbersome lending tool, a point underscored by the fact that half the members of the current FHLB system do not actively use it as a source of funds. Second, access to more funds does not remove the reluctance rural lenders may have in making longer term rural business loans, the very loans many rural observers would like to see increased. Most funds disbursed by the FHLB, Stanton noted, are for a maturity of one year or less. A more effective means of encouraging more business lending in rural America, he suggested, would be to provide credit enhancements on individual loans through such agencies as the Small Business Administration. A third drawback to the FHLB proposal is that it requires capital to be held at both the FHLB and at the community bank. Holding capital at both institutions drives up the cost of making the loans and thus makes them less competitive in the marketplace. This problem could be overcome if legislators trimmed the capital requirements of the rechartered FHLB system, but this would raise the specter of bigger contingent liabilities for taxpayers.

In a related session, Alton Gilbert examined the implications of bank consolidation for regulatory policy. Gilbert began his analysis by considering whether continued bank consolidation and the move to interstate banking would make large banks a more important source of credit to rural America. Evidence from states that have long permitted branch banking suggests that large banks will likely dominate rural banking in the future. The evidence is much more mixed, however, on whether large banks will be as willing to lend to rural businesses as small banks have been in the past. Current studies point to less lending by large banks in rural areas, but the studies have limitations that have not yet been addressed.

Regardless of the outcome, Gilbert concluded that rural community banks will become more important sources of credit to segments of rural communities not served by large banking organizations. Thus, he suggested that "relief from regulatory burden that does not undermine safety and soundness may be appropriate." Recent revisions in the standards for small banks in complying with the Community Reinvestment Act are an example of such relief.

In commenting on Gilbert's paper, Kenneth Guenther began by stating that consolidation will only make the rural liquidity problem worse. Consolidation often results in a loss of deposits to the local community since the out-of-state bank often removes deposits for use in other lending opportunities, often nonrural in nature. Agreeing that large banks will become a bigger presence in rural banking overall, Guenther argued that the role of community banks as source of credit to rural business will become even more important. The rural liquidity problem should be solved, he concluded, either through expanding rural bank access to FCS funds or by re-chartering the FHLB system.

Guenther maintained that rural America is "marching swiftly into the world of full interstate banking and branching" due to an ongoing, historic wave of consolidation in the banking industry. In his opinion, the impact on rural America will "not be totally benevolent." To avoid adverse outcomes for the rural economy, Guenther concluded that community banks will need better access to loanable funds—either through the FCS or the FHLB—and they will need relief from regulations that create an unfair burden on small banks.

Improving rural secondary markets

The conference next turned to an in-depth examination of secondary markets as a potential source of liquidity for rural community banks. In theory, secondary markets would be an attractive tool in providing banks more loanable funds since rural lenders could simply make loans and then sell them to investors elsewhere in the nation. Historically, however, there have been almost no secondary markets for rural loans. Kerry Vandell argued that rural capital markets often have not met the conditions necessary for a secondary market to function. Namely, he showed that, beginning with the borrower and ending with the investor, each participant must find an acceptable price for the transaction to be completed. The borrower, for instance, must be willing to borrow at the given rate, while the originating bank must be willing to sell the loan instead of keep it. If any of the intervening parties does not find a satisfactory price, the secondary market will not develop even though a primary market for loans might still exist. Vandell suggested that the small scale of the rural loan market and lack of complete information on loan performance may have prevented the establishment of satisfactory transaction prices, thus explaining the general lack of rural secondary markets.

Vandell proposed a five-point plan for making secondary markets more viable in rural America. First, he argued that the rural housing mission of Farmer Mac be transferred to Freddie Mac, Fannie Mae, and perhaps Ginnie Mae. These GSEs are the dominant lenders for residential mortgages; they already operate to some extent in rural areas; and there is no reason they could not increase their presence. Second, the federal government should encourage the development of private conduits for rural housing by encouraging standardization of underwriting and documents and possibly by providing tax incentives for venturing into new markets (rural, in this case). Third, Vandell suggested that Farmer Mac could be privatized, since there is no clear rationale for continued government sponsorship of agricultural debt—the liquidity problem in rural America lies beyond agriculture. Fourth, he encouraged the development of private conduits for rural commercial mortgages. The private market for commercial-backed mortgages is in its infancy, and there may be justification for a new GSE to promote its further development. Finally, he encouraged the development of a secondary market for business loans. Such a market is not yet formed for either rural or urban business loans. A new GSE might be required to launch such a market, while it might stand on its own in the long run. Vandell concluded that there is great potential for secondary markets for rural debt, but that the government's role should be limited, mainly to providing temporary sponsorship during start-up of new capital market institutions.

Frank Altman endorsed the view that secondary markets represent a "value chain," in which pricing of each link in the chain is critical to a functioning market. He went on to say that all links in the chain must be in place for the market to function. His experience in rural credit markets suggested that critical components of a secondary market are either missing or underdeveloped. Few rural communities have loan poolers, servicing companies, or other key segments of the secondary market. Moreover, transaction costs and information costs are often high in rural areas, impeding the sale of securitized loans. Notwithstanding these obstacles, Altman was optimistic about further development of secondary markets. Pointing out that the Community Reinvestment Fund has successfully securitized small rural business loans and community development loans from selected rural communities, he concluded that develop-

ing rural secondary markets is a challenge that can be met, even with dwindling federal resources.

Developing rural equity capital markets

The final option for improving rural capital markets considered at the conference was developing rural equity capital markets. Rural firms do have access to national equity markets, but few are taking advantage of those markets. David Brophy presented evidence that rural firms have accounted for less than 10 percent of the nation's initial public offerings over the past decade. While this is a meager portion, the encouraging feature is that when rural firms do go to national equity markets, they are able to do so on very competitive terms. Brophy found little variation in the pricing terms or investment performance of IPOs for rural firms versus urban firms.

Looking ahead, what can be done to improve rural access to venture capital? Brophy laid out four possible remedies. First, states in the Heartland could cooperate to make securities laws and regulations uniform across the region. Currently, state securities laws differ so substantially that it is difficult to pool small-venture- capital deals on an interstate basis. Second, rural businesses and state governments in the region could form stronger partnerships with the federal government. Brophy pointed out that both the SBA and the SEC are relaxing regulations to help nurture small businesses, and that these efforts at the federal level might be matched by complementary efforts in the region to take full advantage of programs such as Small Business Investment Corporations. Third, the region's educational system could be harnessed more effectively to provide technical and managerial assistance to entrepreneurs. For example, business incubators, a business extension of universities, help provide a focal point for potential investors.

Finally, public initiatives could be pursued that would promote and encourage private placement investments in the region's rural businesses by regional institutional investors, such as pension funds. Many such funds would be willing to invest more in the region but lack a convenient means of identifying local opportunities. More generally, there appears to be a need for more brokers or intermediaries who could bring the Heartland's entrepreneurs together with investors. A new licensing program for "business investment finders" may be one answer.

Dennis Roedemeier generally agreed with Brophy's steps for improving access to venture capital, but reminded the conference that the responsibility for obtaining capital begins with the entrepreneur. The ability to locate and raise capital must be viewed as fundamental business skill. Roedemeier also stressed the need for cooperation between government and businesses, and better technology transfer from universities to business owners. Finally, he argued that Heartland firms must improve their ability to market their business plans to investors, noting that venture capital firms from beyond the region often overlook outstanding investment opportunities.

A general theme flowing throughout all the financial market options discussed at the conference was the role of government in improving financial markets. In his luncheon address, Dayton Watkins stressed the role that government has traditionally played in helping rural financial markets. Pointing to the nearly $1 billion in USDA loans to rural businesses, cooperatives, and utilities overseen by the Rural Business-Cooperative Service, he indicated that government would remain a major player in meeting the credit needs of rural America. With government funds becoming more scarce, however, Watkins suggested that partnership between government

and private capital providers would be more essential in the future.

IV. CONCLUSIONS

The conference concluded with comments from an overview panel. In responding to the options for improving rural financial markets, the panelists stressed the need for more cooperation among community leaders, lenders, and government to brighten rural economic prospects.

In his comments as chair of the panel, Emery Castle suggested that three characteristics of rural America are relevant to its financing needs: the diversity of rural places; rural-urban interdependence, especially where capital is concerned; and the fact that "rural" and "agriculture" are not synonymous. These characteristics imply, in Castle's view, a rural America that needs a "pluralistic financial industry with numerous access points and channels into urban capital markets."

The challenge, according to Castle, is the enormous uncertainty facing rural development, where there are more communities wanting to expand and grow than there are firms and people to accommodate them. He cautioned against making specialized investments and improving infrastructure on the hope that someone will come. Rather, he suggested communities identify the deterrents to new economic activity and determine how to overcome them.

Reemphasizing the diversity of rural America, Alan Tubbs suggested the most important distinction among rural communities is whether they are "growth communities" or communities with declining population and economic growth. The latter, in his view, require different tools and approaches and attention, beyond the scope of the conference. Tubbs argued that deposits may be a less reliable source of funds for local banks in the future. Furthermore, he was concerned that banking consolidation would leave local communities with fewer community leaders, since many community bank presidents have played important leadership roles in community development.

Looking ahead, Tubbs believes there are opportunities for commercial banks to cooperate with the Farm Credit System, since commercial banks have extensive retail outlets while the FCS has an efficient funding mechanism. He also viewed the FHLB as an attractive alternative and regarded Farmer Mac as a necessary conduit for fixed-rate financing for farm real estate loans and the guaranteed portions of federal farm loans.

Doug Sims suggested that while both community banks and the FCS have important roles to play in rural America, other parties such as agricultural cooperatives and utilities also have a stake and can increase their roles. He was concerned that too much attention has been given to "how we survive as lenders in a changing economy instead of how we can help our customers become more successful." With successful businesses, survival of the lenders is not an issue.

Sims expressed the view that existing gaps in rural financial markets are "more a gap of capacity and skill than . . . of access to capital." Overcoming such gaps in capacity and skill will require partnerships among lenders for "participations, syndications, and the purchase of whole loans." Similarly, community banks and the FCS need to find ways to work together, such as using the Small Business Investment Corporation model to raise equity capital.

Kathleen Beery emphasized the importance of using local resources to solve problems, including

lenders who are needed for both their financial assets and their leadership. Even when local lenders do not invest their own resources, she said, "they are providing valuable advice on the financial aspects of business ventures." Beery also emphasized the importance of rural housing, which can impede other development if it is not available. Where developers and banks once could construct infrastructure and housing, "it now takes a 'partnership'—banks, economic development groups, cities, counties, not-for-profit housing organizations, utilities, hospitals, nursing homes, telecommunications companies, to name a few." Successful partnerships will be innovative and not ignore local resources. In today's environment, "single players cannot accomplish the larger goals," according to Beery. "Partners need to pool their resources."

Gary Warren stressed that technology and globalization are diminishing the influence of geography on the rural economy. The Internet makes competition global for deposits as well as for loans. Furthermore, as traditional bank products—CDs, home mortgages, auto loans, etc.—become commodities, the banking business is being transformed into a numbers game. The result is a business tied to high volume, low margins, and increased competition, with success based on what one does best, not on geography.

Warren was optimistic that the Information Age will bring with it rural businesses based on information and services. Thus, lenders will be challenged to lend on intellectual property, servicing agreements, and the savvy of individuals, rather than on physical assets like real estate, machinery, and crops. Warren believes technology and telecommunications provide rural America with some advantages "unlike any it has seen in many decades." He also reminded the conference that technology can be a two-edged sword, making rural America a small part of the global marketplace that can easily be bypassed. To enjoy the rewards of the Information Age, Warren said, rural America must have financial institutions that can service new businesses.

ENDNOTES

[1] The seven states in the Tenth Federal Reserve District are: Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming.

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