Executive Summary

Introduction

This report assesses the availability of credit in rural areas for agriculture, housing, and rural development as mandated by Section 650 of the Federal Agriculture Improvement and Reform Act of 1996. Its purpose is to provide Congress with the most recent and comprehensive information available on the performance of rural financial markets as it deliberates on the credit needs of rural America, the availability of credit for meeting these needs, and the effects changes in Federal rural credit policy might have.

The analysis underlying the report was shaped to a large extent by data availability. Little industry-wide reporting on a consistent and comparable basis is undertaken that supports empirical analysis of rural financial market operations. Data limitations are particularly severe in relation to credit demand. Rural credit demand information is generally limited to opinion questions in surveys focused on other issues; responses generally indicate that rural borrowers are satisfied with their credit arrangements or that credit problems are not high on their list of concerns. A significant investment in surveying both successful borrowers and borrowers denied credit would be necessary to develop more robust measures of rural credit demand and how well it is satisfied. Consequently, while the Section 650 mandate emphasizes credit needs and credit demand, information is derived largely from "supply-side" information reported by lending institutions.

While more available than demand data, "supply-side" information on credit markets is also too limited to support rigorous statistical analysis or credit market modeling. Individual market transactions are confidential and institutions are reluctant to release loan approval criteria or records of loan denials. Moreover, much of the reported data are highly aggregated and of limited value given such unreported characteristics as servicing terms, maturities, and collateral arrangements associated with loan amounts and interest rates. Hence, this report relies on a mix of qualitative and quantitative analyses, anecdotal information, and institutional knowledge of rural credit markets to provide a general assessment of rural financial market performance. Definitive answers to the specific questions raised by Congress are often insupportable with the information available.

General Conclusions

In the most general of terms, this report concludes that rural financial markets work reasonably well in assembling capital and servicing the financial needs of the major groups of borrowers in rural communities. However, the range of institutions involved is likely to be different, often narrower, than that serving urban communities, and competition for rural loans is often not as keen as it is for urban loans. The small size of rural communities and the small size of rural borrowers limit the number of lenders that can profitably compete for rural loans.

As a result, not all rural markets and market segments are equally well served. In some rural communities, and for some borrowers, the range of available financial services and institutions is too small to ensure an efficient allocation of financial resources. This report concludes, however, that these limitations do not constitute widespread market failure and are not a serious or insurmountable barrier to economic growth for the rural economy as a whole. Moreover, many existing financial institutions and new actors emerge to fill profitable credit market niches as they evolve.

This report also notes differences in credit market operations across the major sectors of the rural economy. The farm sector, for example, appears to be well served by a combination of private institutions, government-sponsored enterprises (GSE's) such as the Farm Credit System, and public agencies such as USDA. The rural housing market also appears to be well served by a combination of national housing GSE's, direct government programs, and private institutions. Conversely, small municipalities interested in investing in rural development projects and rural entrepreneurs interested in starting new nonfarm businesses may be less well served, although a lack of data seriously hampers comparisons.

This report also concludes that proposals, such as those noted in the Section 650 mandate to expand or modernize Farm Credit System lending authorities and to expand commercial bank access to wholesale funds through the Farm Credit System, would do little to address the rural credit market imperfections identified. While the proposals reviewed here would benefit their sponsors and some rural communities, at the national level, their associated costs would outweigh their benefits.

The report also recognizes that intervention in rural financial markets can have both economic efficiency and social policy goals. The distinction is critical in that public policy initiatives designed to strengthen credit market efficiency can increase the resources available to society and, therefore, are potentially self-financing. However, programs designed to advance social goals through credit markets create economic inefficiencies and require ongoing Government expenditures. Nonetheless, credit programs can be made more effective and less costly in pursuing social goals when combined with other initiatives promoting education and training to improve credit use.

Specific Findings

The Section 650 mandate lists 10 topics for consideration in the study. These topics and the corresponding conclusions of this report are summarized as follows.

Topics 1-4: ...(assess) rural demand for credit from the Farm Credit System, the United States banking system, the Secretary of Agriculture, and other Federal agencies; their abilities to meet the demand; and the extent to which they provide loans to satisfy the demand.

Rural financial markets generally work well.

Credit problems are neither endemic to nor epidemic in rural America. While rural financial markets (including government credit programs and government-sponsored lenders) are diverse and differ from urban markets, they appear to work reasonably well at supplying credit to local users. Rates on home mortgages that conform to secondary market requirements are comparable in rural and urban areas as are rates on small business loans guaranteed by the Small Business Administration. Survey responses of rural borrowers also support this conclusion.

The nature of rural economies (small communities and borrowers, undiversified economies, etc.) can lead to financial market imperfections in individual local areas or in particular segments of the credit market. But these imperfections have not detracted substantially from overall rural growth. Many rural economies have experienced economic and population growth thus far in the 1990’s. While rural America continues to lack the same opportunities for economic growth that exist in urban areas, financial market operations are only one potential barrier. Many other factors, including work force quality, transportation costs, various regulations, and availability of other business services, appear to have as much effect (or more) on rural competitiveness.

Problems exist for some rural borrowers in some markets:

- risk financing (equity for new businesses, long-term operating loans for businesses and community organizations, etc.) is difficult to find;
- transaction costs are often higher for rural borrowers whose financial needs are unusually large or complex (by local standards) as they have to shop over a wider geographic area and deal with a broader range of institutions than is typically true in urban settings; and
- access to credit and other financial services remains a problem for those who fail to qualify for commercial loans because of low incomes, low skills, and lack of collateral.

A precise measure of unmet, commercially viable rural credit demand is not available. Both rural and urban institutions typically do not report information on credit denials or approval criteria.

Credit for rural sectors is generally priced comparably to urban credit, but some submarkets are inefficiently segmented.

In general, evidence is limited and precludes strong conclusions about market performance. All data sources omit some information relevant to loan pricing decisions and no data source available for rural sectors includes data on denied loan applications.

Given these information limitations, rural home buyers generally appear to pay slightly higher rates than urban home buyers, but rural nonfarm businesses pay rates that are comparable to those paid by urban firms. The small disparity for home mortgages could well be due to the greater cost of doing business in sparsely populated areas and managing a portfolio made up of many small transactions dependent on income from a few industries.

Financial markets serving agricultural, rural housing, business, and development needs are segmented by geographic location, loan riskiness, and loan terms including size, term to maturity, collateral, and purpose. This segmentation can reduce competitive pressures; efforts to increase lender competition could benefit some rural borrowers and rural communities.

Institutional design and regulation create barriers to market entry that sustain segmentation. While these barriers are not unique to rural areas, their impact is potentially greater in rural markets, with their smaller numbers of local competing lenders.

Rural commercial banks and the Farm Credit System have the ability to respond to changes in economic demand for loans, but a lack of competition in some markets may dampen this response.

Rural banks are adequately capitalized to provide commercial credit to rural sectors including rural development, and rural bank markets have access to loanable funds from a number of sources. However, rural bank markets are far less competitive than urban markets, raising concerns that some rural borrowers may be at a disadvantage in acquiring credit. Nonetheless, no evidence was found that rural borrowers as a group pay inordinately high interest rates or face tighter loan qualification standards.

The Farm Credit System, through its network of banks and associations, serves as a major source of agricultural credit and is a strong competitor for creditworthy farm borrowers. Its status as a government-sponsored enterprise gives the FCS access to an ample supply of low-cost loanable funds for eligible borrowers.

Federal programs serve targeted rural populations.

A wide range of Federal grant and loan programs provide expanded financing for agriculture and rural housing, businesses, and communities that have difficulty securing capital on a commercial basis.

Most Federal grant and direct loan programs subsidize favored borrowers and/or activities; they do not improve financial market efficiency.

Topic 5: ...(what) measure or measures exist to gauge the overall demand for rural credit, the extent to which rural demand for credit is satisfied, and what they demonstrate.

Data constraints and market complexities make the measurement of credit demand and its satisfaction difficult.

- Borrowers and lenders can disagree about what constitutes economically viable demand.
- Observed prices and quantities tell us only about the demand for and supply of credit under prevailing conditions (prices, incomes, lender practices, laws, and regulations).
- Survey data are sparse, often unscientific, and of limited use.

Primary concerns with respect to market performance are whether lenders have the ability to respond to changes in economic demand for credit and whether rural financial markets are competitive enough to encourage an efficient allocation of capital resources.

Despite reassuring results where data are available, the general sparseness of data and the diversity of financial market conditions among rural communities leave open the possibility that some rural communities or classes of borrowers may be underserved.

Various measures exist for gauging market efficiency. These include general measures of market structure and competitive performance as well as specific measures often applied to credit markets. These measures suggest that although rural credit markets generally lack a competitive structure, widespread market failures do not exist. However, market imperfections, including imperfections associated with risk management, appear to exist.

- Measures of market structure focus on the number of competitors in a market and their market shares. These measures indicate few rural financial markets have enough competitors and enough equality of market shares so that they can be assumed to function competitively.

- Measures of market performance focus on variations in performance (including pricing, service quality, and other factors) across geographic and other markets. For submarkets where data are available, rural credit market performance, on average, is comparable to urban credit market performance.

- Credit market performance is often measured by loan-to-deposit ratios for depository institutions and capital-to-asset ratios for all lenders. These ratios indicate some inefficiencies among rural lenders could well exist. In general, rural loan-to-deposit ratios are lower and rural capital-to-asset ratios are higher than they are in urban areas, indicating that available resources support relatively less credit market activity in rural areas than in urban areas.

Topic 6: comparison of the interest rates and terms charged by the Farm Credit System Farm Credit Banks, production credit associations, and banks for cooperatives with the rates and terms charged by the banks of the United States for credit of comparable risk and maturity.

Available data are inadequate to address this topic definitively. Differences in rates and other terms result from differences in the riskiness of the borrower/applicant and from the other factors that influence the cost of serving particular borrowers or making particular types of loans. Farm Credit System institutions and commercial banks tend to specialize in different types of loans, and no data are available linking borrower characteristics to loan interest rates, noninterest fees, and other terms for either set of institutions.

Despite these caveats, a few general conclusions emerge from the data.

- The difference in interest rates charged by commercial banks and Farm Credit System institutions has changed considerably over time; observations at one time may not apply as market conditions change;

- Using loan-level data covering both commercial banks and Farm Credit System associations for 1995, we were able to make rough comparisons only for non-real-estate loans (adequate data for other comparisons being unavailable). These data proved insufficient to conclude that the cost of borrowing from the Farm Credit System and the banking industry systematically differs; rather, as competitors, these two groups of lenders offered roughly equivalent rates and terms in 1995.

Topics 7 and 8: the nature and extent of the unsatisfied rural credit need that the Farm Credit System proposals are supposed to address and what aspects of the present Farm Credit System prevent the Farm Credit System from meeting the need; the advantages and disadvantages of the modernization and expansion proposals of the Farm Credit System on the Farm Credit System, the United States banking system, rural users of credit, local rural communities, and the Federal Government, including:

—any added risk to the safety and soundness of the Farm Credit System that may result from approval of a proposal; and

—any positive or adverse impacts on competition between the Farm Credit System and the banks of the United States in providing credit to rural users.

Recent proposals to modernize and expand the Farm Credit System similar to ones in H.R. 4129, “The Rural Credit and Development Act of 1994,” are examined. In general, these proposals are:

- advantageous for Farm Credit System institutions in that they would expand business and profit opportunities without imposing additional obligations or fixed costs;

- potentially costly for competing lenders in that they would face increased competition for some newly eligible activities in some areas by a competitor that enjoys intermediate- and longer-term funding advantages and more favorable tax treatment;

- likely to have mixed effects on rural communities. While some rural markets would enjoy slightly improved competition and integration with national money markets, Farm Credit System lending also has the potential to exacerbate boom/bust cycles and increase operating costs for businesses affected by higher asset values related to artificially low borrowing costs; and

- not likely to be cost effective for the Federal Government. All new activity would create implicit subsidies, contingent liabilities, and tax expenditures, while only a small fraction of this activity is likely to involve loans that would not be made otherwise. Furthermore, the addition of competition from the Farm Credit System is unlikely to substantially change the competitive performance of most rural submarkets.

Although the initial justification for the Farm Credit System was in terms of alleviating market imperfections, recent proposals tend to focus on perceived market opportunities. The linkages among rural credit market imperfections, rural development, and proposals to expand Farm Credit System authority are tenuous. The one proposed change we examined that may address a widespread problem would allow the system to support development finance institutions.

Capitalization practices and limits on intrasystem competition reduce the ability of the Farm Credit System to address existing market inefficiencies.

While any change raises potential safety and soundness risks, steps to strengthen safeguards since the farm financial crisis of the 1980's indicate the System can maintain high levels of safety and soundness if the Farm Credit Administration and Congress continue to stress their importance.

Topic 9: the advantages and disadvantages of the proposal by commercial bankers to allow banks access to the Farm Credit System as a funding source on the Farm Credit System, the United States banking system, rural users of credit, local rural communities, and the Federal Government, including:

—any added risk to the safety and soundness of the Farm Credit System that may result from approval of the proposal; and

—any positive or adverse impacts on competition between the Farm Credit System and the banks of the United States in providing credit to rural users.

We assess the advantages and disadvantages of two basic options for broadening commercial bank access to Farm Credit System funds: (1) by reorganizing the Farm Credit System along the lines of the Federal Home Loan Bank System (FHLBS), and (2) by expanding Farm Credit System authority to buy whole rural loans.

Neither option significantly addresses known market imperfections in rural areas or sectors.

The first option is advantageous to bankers while its impact on Farm Credit System associations and the Federal Government would be negative, and its impact on Farm Credit System banks and rural communities would be ambiguous.

The FHLBS-like option creates several safety and soundness concerns for the Farm Credit System:

- Converting the Farm Credit System to an FHLBS structure raises questions about Farm Credit Insurance Fund (FCIF) coverage and premiums. Since the FCIF is close to fully funded, any increase in insured Farm Credit System liabilities to fund advances to commercial banks could force Farm Credit System institutions to pay to insure liabilities incurred for their competitors.

- Competitive pressures could also cause financial distress for some Farm Credit System associations, while stronger associations might seek to end their GSE status. Charter conversions similar to those envisioned by some could, in times of widespread distress, allow healthy institutions to remove capital and assets from the Farm Credit System, slowing replenishment of the FCIF, weakening joint and several liability, and increasing the contingent liability of the Federal Government.

- The voluntary status of commercial bank membership would exacerbate this problem.

- The Farm Credit System would have to take precautions similar to those taken by the FHLBS to avoid safety and soundness problems when providing advances to other financial institutions.

The second option is likely to have more modest effects. The authorized transactions would require willing participation of both the buyer and the seller and would probably not introduce new competition or competitive advantages to rural credit markets.

The option to allow the Farm Credit System to buy whole loans presents no substantial safety and soundness concerns for the Farm Credit System.

Topic 10: problems that commercial banks have in obtaining capital for lending in rural areas, how access to Farm Credit System funds would improve the availability of capital in rural areas in ways that cannot be achieved in the system in existence on the date of enactment of this Act, and the possible effects on the viability of the Farm Credit System of granting banks access to Farm Credit System funds.

Current concerns about expanding rural access to nonlocal funds seem to arise from competitive and demographic changes in rural credit markets that threaten to disrupt existing flows of funds to some rural banks.

Commercial banks have repeatedly sought and currently have access to many nondeposit sources of funds. However, commercial banks make only limited use of these funds except in cyclical upturns. Rural banks make considerably less use of nondeposit funds than do banks headquartered in urban areas, but most rural banking markets are served by banks that do use nonlocal sources of funds to some extent.

It is unlikely that commercial bank access to Farm Credit System funds would substantially affect rural areas. Commercial banks have had access to Farm Credit System funds for certain short- and intermediate-term lending since 1923, but have rarely taken advantage of it. Bankers have expressed concerns about doing business with a direct competitor. It is also unlikely that Farm Credit System institutions would aggressively market services to commercial banks, in contrast to the Federal Home Loan Banks. The current structure of the Farm Credit System inhibits an active marketing program since Farm Credit System associations—direct competitors of commercial banks—own Farm Credit System banks.