



Would More Rural Bank Access to Nonlocal Funds Provide Public Benefits?

Restructuring of U.S. banking markets has raised concerns that insufficient access to loanable funds will limit economic growth in some rural areas. Access to nonlocal funds can provide public benefits through enhanced competition and efficiency, but subsidized access to nonlocal funds can create economic distortions. Because most rural areas are served by few lenders, public benefits may be limited if additional access does not encourage new competition. Unsubsidized market mechanisms could address the liquidity, risk management, and competitive challenges that some small rural banks may face. At the same time, market mechanisms can promote efficiency-enhancing use of nonlocal funding and limit distortions.

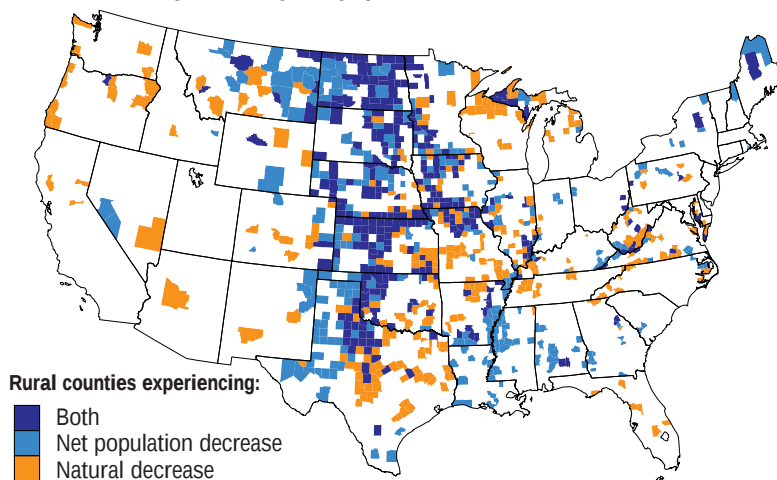
Rural banks rely primarily on local deposits for loanable funds, but because reliance on local funds alone can sometimes limit community growth, some rural-headquartered banks are seeking greater access to nonlocal funds. These banks fear the flow of deposits may be disrupted by ongoing competitive and demographic changes, such as easier entry into banking markets (following, for example, the lifting of restrictions on bank branching), increased acceptance of mutual funds and other uninsured vehicles for household savings, reduced consumer commitment to local financial institutions, and improved information processing and telecommunications. This report examines the degree to which nonlocal funds are available to rural banks and the con-

ditions under which increased access is most likely to provide public benefits.

Since 1978 the share of household financial assets held in depository institutions (banks, thrifts, and credit unions) has declined from 39 to 17 percent. Factors affecting both the supply of and demand for deposits have contributed to this decline. The supply of deposits from households has shifted because of changes in the population's age structure, changes in risk-return preferences, and changes in the costs of financial transactions. In addition, banks in rural counties that are losing total population or experiencing death rates that exceed birth rates may face a greater shift in the supply of local deposits than banks elsewhere (fig. 1). In these

Figure 1

Banks are most likely to have trouble retaining or replacing local deposits in rural counties experiencing net population losses or natural decreases



Source: Economic Research Service compiled from U.S. Department of Commerce, Bureau of the Census data.

counties, past or continuing outmigration has left bank depositors with few local heirs who might maintain banking relationships. Improved computer technology and telecommunications have contributed to a decline in the relative costs of nondeposit investments through discount brokerage firms and mutual funds and, thereby, to a decline in the share of household assets held as bank deposits. On the demand side, banks increasingly sell whole loans to other financial intermediaries and use nondeposit funds to finance their activities. Both strategies reduce demand for deposits.

Nonlocal Funds Can Benefit Rural Banks...

Historically, rural banks have sought access to nonlocal, nondeposit funds to cope with:

- seasonal mismatches in loan demand and deposit levels;
- patterns of loan and deposit growth related to economic cycles;
- an inability to compete for deposits because of regulatory interest-rate ceilings;
- interest rate risk, portfolio risk, and other risks.

Nonlocal funds can be an alternative source of liquidity, profitability, and risk management. Liquidity is increased when commercial banks sell qualifying loans into secondary markets or pledge them as collateral for loans (or advances). Profitability is improved because advances often cost less than new retail deposits when interest and other costs are considered. Sales of loans for securitization also allow a bank to make more loans without raising expensive equity capital, improving the rate of return on equity capital. Making and selling loans can also be profitable because banks earn income from originating loans and from either servicing loans that they no longer own or selling servicing rights. In addition, nonlocal funds channeled through government-sponsored enterprises (GSE's) tend to be readily available under well-

Sources of Nonlocal Funds

Commercial banks have access to numerous alternatives for improving liquidity and risk management, including access to funds channeled through or markets brokered by GSE's (USDA, 1997). Since 1916, Congress has created GSE's to improve credit availability and financial market competition to specific sectors of the economy including agriculture and rural areas, housing, and education. Each GSE is privately owned and operated, limited to a specified economic sector, and receives direct and indirect Government benefits. Most GSE's have some impact on rural areas. The Farm Credit System (FCS) and Farmer Mac specifically serve agriculture and rural residents, while Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLBS) all support some rural housing. Alternative sources of liquidity and loanable funds include:

- direct lending (advances) from GSE's, such as the FCS and the FHLBS,
- sales of whole loans (securitization) through GSE's, such as Fannie Mae, Freddie Mac, Farmer Mac, or through non-GSE loan poolers,
- emergency, adjustment, and seasonal lending from Federal Reserve Banks,
- direct lending from other banks or financial institutions including bankers' banks and other correspondent banks, and
- nonlocal (brokered) deposits.

Of course, a given bank may be unable to use a particular alternative depending on the requirements, and many banks do not use any of these alternatives—their deposits suffice.

specified conditions (see box). This availability allows banks to take advantage of lending opportunities as they arise.

Advances from GSE's like the Federal Home Loan Banks or the Farm Credit System can help control risks associated with lending. They allow banks to reduce interest rate risk by matching their funding to the maturity, payment structure, prepayment options, or other loan features. Selling loans rather than pledging them as collateral eliminates the bank's exposure to credit risk. Similar benefits can be obtained through private market securitization. However, private securitization may be less profitable because extra collateral or other enhancements are usually required to make the securities attractive to investors because of the lack of the implicit or explicit government backing that GSE's provide.

Access to nonlocal funds can also allow small banks to originate and service larger loans that would be too risky otherwise. For safety and soundness reasons, commercial banks

are not allowed to make loans exceeding 10 to 20 percent of their capital (depending on State laws) to any one borrower. To make larger loans, rural banks may rely on overlines with correspondent banks or other financial institutions. An overline is a loan participation by a correspondent in the amount by which a loan exceeds this limit. In contrast to securitization, overlines allow small banks to earn revenue by retaining part of these large loans in their own portfolios.

...and Rural Areas

Reliance on local funds can limit growth in rural areas where local savings are insufficient to meet economically viable credit demand or where seasonal increases in credit demand coincide with seasonal withdrawals of savings deposits. Access to nonlocal funds can also encourage greater lending by providing more and better risk management options. However, if local bank credit markets are not competitive, providing access to nonlocal funds may benefit banks more than borrowers. In addition,

publicly subsidized access to nonlocal funds shifts demand for local deposits, depressing returns to savers.

The Federal Reserve's Seasonal Borrowing Program (SBP) was initiated in response to seasonal shortages of local loanable funds in some rural areas. Lack of access to nonlocal funds, coupled with a relatively unresponsive supply of local deposits and regular deposit outflows during periods of seasonal loan demand (by farmers or the tourism industry), was thought to force small rural banks to keep a high proportion of assets in low-yield, highly liquid securities during other seasons, reducing total lending and constraining local economic growth.

Access to nonlocal funds also improves the ability of a small bank to respond to increases in local loan demand and may allow new competitors to profitably enter small isolated credit markets, enhancing competition. Markets for nonlocal funds can help integrate local and national markets, improving the overall efficiency of capital allocation and benefiting both savers and borrowers.

The less diversified nature of rural economies and their greater dependence on small businesses mean that the typical rural-headquartered bank is itself relatively small and has trouble diversifying its loan portfolio, leading to fewer loans per dollar of deposits and more capital per dollar of assets. Using nonlocal funds can help rural banks and communities by shifting risks to more diversified portfolios, which allows rural banks to safely decrease their risk-bearing capital and increase their lending activity.

Use of Nonlocal Funds Is Limited...

Rural banks make considerably less use of nondeposit funds than do banks headquartered in metropolitan areas, but in most rural banking markets, some banks do use nonlocal funds to some extent (USDA, 1997). Reasons for the relatively low use of nonlocal funds at rural banks include a lack of

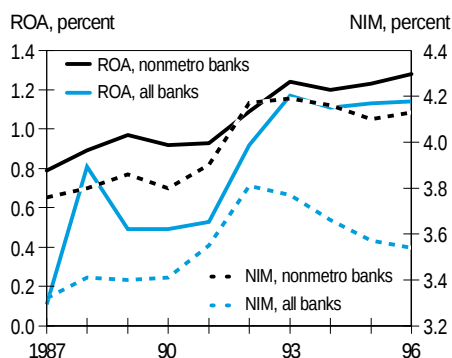
profitable opportunities, lack of necessary managerial knowledge, safety and soundness concerns, and burdensome procedures and regulations.

On average, rural banks have maintained higher returns on assets and net interest margins than nonrural banks (fig. 2), and the percentage reporting low or negative returns to assets has not risen much since its recent low in 1992. By historical standards, net interest margins at rural banks have remained high throughout the 1990's. Such statistics indicate that, despite currently high loan-to-deposit ratios, rural banks have not needed to aggressively raise new deposits to maintain their profitability or soundness.

If attractive profit opportunities were available, banks could pay more for deposits or use nonlocal funds more aggressively. Surveys of small businesses indicate that rural firms are generally satisfied with their lenders and face rates and terms comparable to those offered to urban firms. In addition, demand (especially in rural areas) appears limited for longer term, fixed-rate funding sources. Farmer Mac has had little success with fixed-rate products priced for periods longer than 5 years, and more than 85 percent of Federal Home Loan Bank (FHLB) advances are for periods shorter than 5 years.

Figure 2

Returns on assets and net interest margins at rural-based banks are high by industry standards



ROA=Return on assets. NIM=Net interest margin.

Source: Economic Research Service compiled from Federal Deposit Insurance Corporation data.

List of Acronyms and Abbreviations

- Fannie Mae**—Federal National Mortgage Association
- Farmer Mac**—Federal Agriculture Mortgage Corporation
- FCS**—Farm Credit System
- FDIC**—Federal Deposit Insurance Corporation
- FHLB**—Federal Home Loan Bank
- Freddie Mac**—Federal Home Loan Mortgage Corporation
- GSE**—Government-sponsored enterprise
- SBP**—Seasonal Borrowing Program

Many rural banks are small and may lack specialized personnel who feel comfortable using nontraditional sources of funds. Banks with less than \$100 million in assets are often economically inefficient, yet many rural banks fall in this size class. Such banks are thought to be unable to afford specialized personnel or cutting edge technology necessary to attain operating efficiency.

The Federal Deposit Insurance Corporation (FDIC) has expressed concern about the effect of nonlocal funds on bank safety and soundness. Knowing of FDIC's concerns may discourage bankers from using such funds. Brokered deposits, Farm Credit System (FCS) advances, or FHLB advances allow institutions to increase leverage, which increases risk to deposit insurance funds. Brokered deposits tend to be unreliable sources of funds when yields fall or when risk increases. FCS and FHLB advances can also enable rapid, unsafe growth in securities portfolios or loans without the constraints imposed on brokered deposits, can prolong the life of a failing bank, and can impose other costs on the FDIC as insurer, supervisor, and liquidator of failed federally insured financial institutions. Since information about small banks is not readily available, loans to them are considered higher risk investments for other financial institutions. That perception too may limit small banks' access to Federal

funds and markets for brokered certificates of deposit.

Finally, regulations and other impediments exist to small banks' use of nonlocal funds. To qualify for the Federal Reserve's SBP, for example, commercial banks must establish a pattern of seasonal loan demand countercyclical to deposit availability. Restrictions on seasonal borrowings include their short maturities (up to 30 days), capped renewability (up to 9 months), collateral requirements, and limits on positions in Federal funds, liquid investments, out-of-territory loans, and transfers to parent holding companies or other affiliates. Advances from the FCS and FHLB's are also limited by qualifying procedures and collateral requirements, but those imposed by the FHLB's are the least restrictive.

... and Subsidies Create Economic Distortions

Providing implicitly or explicitly subsidized funds to established lenders in markets with few competitors may limit the benefits to local borrowers and economic growth. If competitive pressures are weak, benefits are more likely to be retained by lenders than in a competitive market. Even if subsidies are passed on to borrowers, they can distort the overall allocation of capital between sectors of the economy. If attractive local investment opportunities are not available, the sub-

sided funds may be used to finance nonlocal investments, increasing public costs and risks but limiting the impact on local economic activity.

Conclusions

Rural banks have many options to control risk and to access nonlocal funds. They have sought repeatedly to expand their access to GSE funds, but have made only limited use of such funds except in cyclical upturns. The current level of interest coincides with concerns about deposit outflows and the competitiveness of rural banks as barriers to interstate branching are removed.

Despite previous success at winning access to nonlocal funds, rural banks make considerably less use of such funds than do banks headquartered in metropolitan areas. Explanations for this relatively low use include a lack of profitable opportunities, lack of necessary managerial knowledge, safety and soundness concerns, and burdensome procedures and regulations. The latter two factors could be addressed by providing access to unsubsidized funds through private markets, since subsidies cause economic distortions. Such markets are more likely than subsidies to promote efficiency-enhancing use of nonlocal funding for rural credit, especially if access encourages new entry into small and remote credit markets.

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Further Readings

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