

Appendix A

Sources of Rural Financial Capital

Congress requested information specifically on the commercial banking system, the Farm Credit System, credit programs operated by USDA, and credit programs administered by other Federal agencies. While each of these lender types is an important source of capital for rural borrowers, they are not the only financial service providers active in rural America. Rural communities, and the business firms, households, governments, and nonprofit organizations that comprise them, are served by a wide variety of financial service providers. Financial capital, in the form of credit or equity investments, is provided or supported by federally insured depository institutions, government-sponsored enterprises, public financial assistance programs, private firms, and individuals. The type, size, and location of financial support provided by these organizations and individuals vary widely. This appendix provides a broad overview of the major sources of financial capital in rural America and discusses some of the trends and policy developments affecting their performance.

Federally Insured Depository Institutions

The most visible components of the financial market faced by rural borrowers are the commercial banks and thrifts located within their communities. Not only are bank and thrift offices prominent community landmarks, but these financial institutions supply most of the credit used by rural borrowers. As the name implies, depository institutions rely heavily on deposits to fund their lending activities. To protect the insurance fund and taxpayers, Federally insured depository institutions face tight regulations on permissible activities. While they dominate many credit markets, depository institutions do not provide equity capital nor do they serve all types of borrowers. Other types of lenders are important sources of credit for specific purposes and supplement the funds available from local banks and thrifts. Nonetheless, the rural credit delivery system in the United States consists largely of privately owned banks, providing financial services with the intent of earning profits.

If agriculture and rural development face inadequate access to credit, the problem and its solution will likely involve depository institutions.

Bank and thrift financial data are widely relied upon for insight into rural financial market developments since they are routinely collected and readily available. Nonetheless, available data can mislead regarding the lending activity of depository institutions within specific locales. Since information on the location of borrowers is not reported, rural lending cannot be measured precisely.¹ The data reflect all of the firm's lending activity, not just loans made to local borrowers. Even for types of loans that are likely to be made only locally, variations in lender organizational structure can affect geographic precision. Lenders with extensive branching networks can and do make loans over wide geographic areas, all of which are attributed to the lender's headquarters. Banks and other depositories that are affiliated with multibank holding companies (MBHC's are bank holding companies that own more than one bank subsidiary) often participate in each others' loans, obscuring the location of each affiliate's lending activity.² These problems cannot be overcome with currently available secondary data. However, since rural and national financial indicators for the various depositories examined here appear to be following similar trends, existing data shortcomings may not distort our view of recent rural banking and thrift developments.

¹ In 1995, Community Reinvestment Act regulations were changed for banks and savings and loan associations. One change requires large banks (those with assets above \$250 million and those part of a bank holding company with aggregate bank assets exceeding \$1 billion) to start reporting on the geographic distribution of their lending to small businesses.

² A similar problem arises for groups of banks that share common ownership without adopting a holding company structure. Known as "chain banks," these nominally independent banks can behave much like MBHC or branch banking networks. Furthermore, independent banks often participate in loans made by other banks, particularly those with which they have a correspondent relationship.

Commercial Banks. By any measure, commercial banks dominate most rural financial markets. Almost two-thirds of the depository institutions headquartered in rural communities are commercial banks, and they control over 80 percent of the total assets, deposits, and loans held by rural depositories. In December 1995, 56 percent of the 9,825 U.S. commercial banks insured by the Federal Deposit Insurance Corporation (FDIC) were headquartered in nonmetro counties and many others served rural areas through their branch networks and other activities. But the large number of rural banks does not necessarily imply competitive rural banking markets since rural banks tend to be small and serve limited geographic markets. On the other hand, many rural communities are served by urban-based banks, so rural bank characteristics alone may not accurately portray rural bank markets.

Rural-headquartered banks operated 74 percent of the commercial bank offices located in rural America, and held 74 percent of the deposits collected by rural commercial bank offices as of June 1994. They provide credit for a wide range of uses, including home mortgages, consumer loans, agricultural loans, and commercial/industrial loans. In addition to lending, rural banks hold tax-exempt securities used to finance State and local government activities.

Relative to the banking industry as a whole, rural banks hold fewer loans as a percentage of deposits (table A-1). Given the smaller average size of rural banks, this pattern is expected since it is harder for small lenders to diversify their loan portfolios and to quickly access nondeposit sources of funds when unexpected deposit withdrawals occur. The distribution of loans reflects the local economies served by rural banks and the comparative advantages that smaller financial institutions exhibit. Agricultural loans are a higher share of total loans than commercial and industrial loans, and both are far less prevalent than home mortgages.

Commercial banks have historically provided short- and medium-term credit for agriculture and the non-farm rural business sector and have been a growing source of real estate credit since the early 1980's. Banks have preferred short-term loans and relatively liquid investments historically, since they rely on short-term deposits for most of their loanable funds.

Nonetheless, banks have a smaller but growing presence in the real estate debt market.

In recent years, home mortgages have become increasingly prominent within rural bank loan portfolios. This undoubtedly results in part from banks moving into a market partially vacated by the thrift industry. Home mortgages accounted for almost 31 percent of the total loan portfolio of rural banks at the end of 1995, compared with 27 percent in 1990. Furthermore, since a well-developed secondary market exists for home mortgages, loans held in portfolio do not represent all of the banking sector's home mortgage lending activity. After earning fee income by originating home mortgages, banks can sell loans that meet secondary market loan underwriting standards.

The rural banking system, like the U.S. banking system as a whole, is well positioned to provide financial support to the agricultural and rural sectors of the economy. Since 1991, loan loss provisions and problem loans have declined for commercial banks nationwide. Bank profitability is high, as are interest rate margins and capital levels (table A-1). In response to an expanding economy, average loan-to-deposit ratios at rural banks have grown steadily since 1991. In the past, a ratio this high might have caused many banks to reduce their lending efforts, because they like to retain liquidity through holdings of cash and securities. Despite this high ratio, surveys indicate that rural bankers are not reluctant to make additional loans to creditworthy borrowers.³

Also of concern is the slow growth in the banking industry's deposit base over the last several years. Between 1990 and 1995, total deposits at rural-headquartered commercial banks increased only 6 percent, compared with 14 percent industrywide.⁴ Both growth figures are less than robust, particularly so given the transfer of deposits from thrifts to commercial banks in recent years. Slow deposit growth is

³ Rural bankers may not be worried about liquidity since their average loan-to-deposit ratio remains well under the national average and nondeposit sources of funds exist if liquidity problems arise.

⁴ Total deposits at rural-headquartered banks reflect changes in bank structure as well as changes in depositor behavior. In particular, bank mergers and the conversion of MBHC affiliates into bank branches artificially inflates urban bank deposits and deflates rural bank deposits. More troubling is the sluggish growth in the industry's total deposits.

Table A-1—Financial trends of rural and U.S. commercial banks, 1990-95

While small by industry standards, rural-headquartered banks are well capitalized, profitable, and have relatively few problem loans.

	1990		1991		1992		1993		1994		1995	
	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural
Number of banks	12,257	6,469	11,825	6,323	11,364	6,129	10,886	5,976	10,366	5,745	9,825	5,493
	<i>Million dollars</i>											
Average assets	274.6	57.2	288.1	61.1	306.3	64.7	337.4	67.6	383.1	71.5	434.7	73.9
Average deposits	214.6	50.6	225.7	53.8	235.7	56.6	250.8	58.5	274.4	61.1	305.0	63.4
Average loans	172.1	31.0	173.4	32.7	178.4	34.3	196.4	37.1	225.9	41.5	262.9	43.4
	<i>Percent</i>											
Composition of loan portfolio												
Home mortgage	20.9	27.1	23.2	29.1	25.2	30.5	26.4	31.0	26.6	31.2	26.7	30.9
Other real estate	21.1	20.7	21.2	21.6	20.8	22.6	19.8	23.5	18.9	23.8	18.2	24.0
Consumer	20.1	20.9	20.0	20.0	19.8	19.1	20.6	18.6	21.7	18.7	21.5	18.9
Commercial	26.9	18.5	24.9	16.7	24.1	15.6	23.0	14.7	22.8	14.6	23.0	14.7
Other	9.3	2.9	8.8	2.6	8.2	2.3	8.4	2.1	8.2	2.0	9.0	1.8
Agricultural	1.7	9.9	1.9	10.1	1.9	10.0	1.9	10.0	1.8	9.7	1.7	9.7
Loans/deposits	80.2	61.2	76.8	60.6	75.7	60.6	78.3	63.4	82.3	67.9	86.2	68.4
Net interest margin	3.4	3.8	3.6	3.9	3.8	4.2	3.8	4.2	3.7	4.2	3.6	4.1
Return on assets	0.5	0.9	0.5	1.0	0.9	1.2	1.2	1.3	1.1	1.2	1.1	1.2
Equity capital/assets	6.4	8.6	6.7	8.7	7.5	9.1	8.0	9.5	7.8	9.3	8.1	10.0
Problem loans/equity capital	35.7	10.6	32.9	10.1	23.7	7.6	14.4	6.1	9.8	5.3	8.6	5.2
Loan loss provision	1.5	0.7	1.6	0.7	1.3	0.6	0.8	0.4	0.5	0.3	0.5	0.3
Quarterly average holdings of tax-exempts/assets	2.5	5.0	2.2	4.8	2.1	4.9	2.1	5.5	2.0	5.5	1.7	5.3
Quarterly average Federal funds sold, securities purchased/assets	4.8	5.4	4.8	4.8	4.5	4.2	4.3	3.6	3.9	2.5	4.2	3.9
Quarterly average Federal funds purchased, securities sold/assets	8.4	1.4	7.2	1.6	7.5	2.0	8.0	2.2	7.8	2.8	7.9	1.9

Source: Calculated by ERS from the Federal Reserve Board's Report of Condition and Report of Income files, December 31, 1990-95.

consistent with the growth of mutual funds and money market funds, which bankers claim are siphoning funds away from communities nationwide. However, rural banks have alternatives to local deposits to fund new loans (see "Commercial Bank Liquidity," in appendix C). They can sell securities from their portfolios or use them as collateral for short-term loans.⁵ Many rural banks are now mem-

⁵ The outright sale of government securities is less likely these days due to accounting regulations governing the valuation of security holdings. Banks must designate securities in their portfolios that might be sold prior to their maturity dates. Those securities must then be valued at their current market values on quarterly financial reports, which makes bank balance sheets subject to greater interest rate risk.

bers of the Federal Home Loan Bank System, which allows them to tap national money markets.

While reassuring, the generally healthy financial condition of the rural banking industry may not translate into readily accessible, affordable financing for all creditworthy rural borrowers. Rural bank performance is often a function of the degree of competition within the local financial markets in which loan decisions are made. Competition varies with the size and type of the loan; the size, type, and creditworthiness of the borrower; and the statutory, regulatory, and technological barriers hindering market entry. Competitive markets are more likely to allocate loan-

Table A-2—Distribution of urban and rural counties by bank market structure, 1994*Rural bank markets have far fewer competing lenders.*

	U.S.	Urban	Rural	Persistent poverty
	<i>Percent</i>			
Counties with an office of:				
No banking firm ¹	0.6	0.0	0.9	0.9
1-2 banking firms	20.6	4.2	26.4	43.0
3-5 banking firms	41.3	21.9	48.2	47.1
6-9 banking firms	24.5	34.4	21.0	8.4
10 or more banking firms	13.0	39.5	3.5	0.6
Counties served by:				
Only local banking firms ²	6.9	1.1	8.9	16.1
Only "nonlocal" banking firms	29.2	21.3	32.0	31.4
Both local and nonlocal firms	63.9	77.6	59.0	52.5
Only small banking firms ³	24.6	4.2	31.9	48.2
At least one large banking firm	67.4	93.6	58.0	41.7
Only small banks	37.3	8.1	47.7	60.4
At least one large bank	50.7	84.4	38.7	28.6
	<i>Number</i>			
Total number of counties	3,089	813	2,276	535

¹ A banking firm is an independent bank or a bank holding company. All of the bank offices and affiliates of a bank or holding company constitute one banking firm. Thus, a banking firm may own many banks in a county, but we treat those banks as a single competitor.

² A local banking firm has all of its offices and affiliates in one county; all others are considered nonlocal, even if the banking firm includes a locally headquartered affiliate.

³ A small bank or banking firm has assets of under \$250 million; a large bank or banking firm has assets over \$1 billion.

Source: Calculated by ERS from the June 30, 1994, Summary of Deposits file of the Federal Deposit Insurance Corporation, and from the June 30, 1994, Report of Condition and Report of Income of the Board of Governors of the Federal Reserve System.

able funds efficiently and offer credit at interest rates that reflect anticipated risks. One simple indicator of bank market competition is the number of bank organizations operating within rural markets. Because of the presence of branch bank offices and multibank holding company (MBHC) affiliates, measuring bank market competition requires information on the number of independent banking organizations operating within a market rather than the number of legally distinct banks headquartered there.⁶ Despite rapid consolidation within the banking industry nationwide, the number of competing banks within rural counties has remained remarkably stable over the past 15

years, perhaps because of potential antitrust enforcement by the Department of Justice and bank regulator concerns over the community impacts of mergers.⁷ Still, in 1994, 27 percent of rural counties were served by 2 or fewer banks (including the branches of banks headquartered elsewhere). In contrast, 40 percent of urban counties were served by 10 or more banks. The poorest counties tend to have the least competitive banking markets (table A-2).

Bank ownership is also viewed as an important determinant of performance by some. Some rural advo-

⁶ Since MBHC affiliates and chain banks located within the same market can operate like branching networks, they should not be viewed as independent competitors. While little public information exists on chain banks, almost 31 percent of insured commercial banks belonged to MBHC's at the end of 1995.

⁷ Proposed bank mergers are rarely rejected outright, but it is not unusual for a merged banking firm to spin off certain bank affiliates or bank branches to gain approval for the merger. Also, banks are aware of Justice Department guidelines concerning acceptable changes in local banking market concentration measures. Mergers between two local banks in the same rural county would rarely meet these guidelines.

cates feel that outside ownership of rural bank offices might prove detrimental to local development prospects. Large banks may transfer funds from rural offices for lending elsewhere, and nonlocal managers may lack information needed to evaluate loan applications fairly. Other arguments favor outside ownership because large banks provide more kinds of financial services, can handle larger loan requests, and are less affected by downturns in the local economy. Nationwide banking industry consolidation trends have made a difference in the ownership of rural banking markets. A third of rural counties are served solely by local banking organizations (banks with no offices outside that county), which is down significantly from 1980. Slightly more than half of rural counties have offices of both local and nonlocal banking organizations (table A-2).

In sum, the rural banking sector appears well positioned to remain the dominant source of credit for creditworthy borrowers. The financial health of the banking sector as a whole, including rural-headquartered banks, should support continued lending activity. However, the lack of bank competition in many rural communities could foster uneven performance by the banking system, with remote rural areas at a potential disadvantage in acquiring equal access to competitively priced credit.

Savings and Loan Associations. Rural savings and loans (S&L's) continue to be haunted by the financial debacle the thrift industry went through in the 1980's. Mergers and acquisitions have dramatically reduced the number of S&L's serving rural communities. And as S&L's revalued their asset holdings and sold assets to other financial institutions in order to meet tough new capital requirements, the S&L industry's assets dropped considerably. Over the last several years, the financial performance of surviving S&L's has shown marked improvement, but the industry continues to face an uncertain future because of increasing competition from commercial banks, the growing securitization of home mortgage loans, and the potential that the Federal thrift charter may be abolished.

At the end of 1994, 496 S&L's were headquartered in rural America, accounting for roughly one-third of the Federally insured S&L's operating nationwide. While reliable information on the location of S&L

branches is not available, S&L's have had interstate branching authority for some time. As a result, many urban-based S&L's serve rural communities as well, meaning that industrywide trends may be as important to understanding rural housing finance conditions as rural S&L trends. Financial trends of rural S&L's have generally mirrored banking trends, in that rural-headquartered S&L's, on average, have outperformed the S&L industry, and conditions for both have generally been improving throughout the 1990's. While not as high as for the banking industry, the average return on assets among rural S&L's has risen, capital levels are high relative to the risk of rural S&L portfolios, and loan-to-deposit ratios have begun to rise, although the rural average still lags behind the industrywide average (table A-3).

Rural S&L's tend to be smaller than urban S&L's, but they still average more assets than the typical rural bank. In 1994, S&L's headquartered in rural areas averaged \$113 million in assets. The 1994 distribution of loan portfolios at rural S&L's gives no hint of the risky investments that destroyed so many thrifts a decade ago. Over three-fourths of their outstanding loans were in the traditional home mortgage category. Remaining loans held in portfolio were split mainly between consumer and real estate loans. Only about 2 percent of their loans were for commercial purposes, suggesting that surviving rural S&L's make relatively little use of their authority to compete with banks for nonhousing development loans.⁸

As with other home mortgage lenders, S&L's make full use of today's burgeoning secondary markets. Over the past 7 years, S&L's have increasingly sloughed off fixed-rate mortgage portfolios and behaved more like the mortgage banking industry—originating loans and immediately selling them off to secondary markets. While rural S&L's are less likely to emphasize this strategy, perhaps due to the lack of scale or a shortage of technical resources, they too are selling more loans than they used to.

⁸ Regulations require S&L's to invest at least 65 percent of their assets in mortgage-type activities. This still leaves a lot of leeway for S&L's to compete with commercial banks for business and other types of loans. In the 1980's, many S&L's aggressively expanded beyond traditional home mortgages and competed for commercial and industrial customers.

Table A-3—Financial trends of rural and U.S. savings and loan associations, 1990-94*Rural-headquartered S&L's are in sound financial shape by industry standards.*

	1990		1991		1992		1993		1994	
	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural
Number of S&L's	2,330	663	2,095	606	1,940	551	1,659	493	1,539	458
	<i>Million dollars</i>									
Average assets	441.0	108.2	427.7	107.4	437.8	114.7	466.1	109.2	503.7	111.4
Average deposits	337.2	93.8	334.0	94.1	343.0	97.6	348.1	92.3	354.8	88.9
Average loans	289.3	73.7	285.6	72.0	281.5	71.8	301.9	71.3	330.0	76.2
	<i>Percent</i>									
Composition of loan portfolio:										
Home mortgage	78.1	77.1	80.2	77.9	81.7	78.5	83.5	78.5	84.2	79.1
Other real estate	12.2	10.9	10.5	10.0	10.1	9.2	8.6	8.5	7.7	8.3
Commercial	3.3	2.3	2.7	2.2	1.5	2.4	1.0	2.2	1.0	1.8
Consumer	6.5	9.7	6.6	10.0	6.6	9.9	6.9	10.8	7.1	10.8
Loans/deposits	85.8	78.6	84.1	76.5	82.1	73.5	86.7	77.3	93.0	85.7
Net interest margin	1.9	2.3	2.4	2.7	2.8	3.1	2.9	3.3	2.7	3.2
Return on assets	-0.2	0.1	0.2	0.5	0.3	0.6	0.6	0.9	0.5	0.9
Equity capital/assets	5.0	6.0	5.9	6.7	6.1	6.6	7.5	8.5	7.5	9.0
Problem loans/equity capital	32.0	23.8	31.4	19.1	29.6	15.2	16.9	7.4	12.2	5.5
Loan loss provision	0.9	0.6	0.9	0.6	0.9	0.5	0.7	0.2	0.4	0.2
Holdings of tax-exempts/assets	0.1	0.2	0.1	0.2	0.1	0.2	0.1	0.3	0.1	0.4
FHLB advances/assets	9.1	4.0	7.4	3.3	7.7	4.3	9.8	4.7	11.4	8.6
Other borrowings/assets	7.6	2.0	5.4	1.1	5.9	2.7	6.0	1.0	9.0	1.0

Source: Calculated by ERS from the Thrift Financial Report of the Office of Thrift Supervision, December 31, 1990-95.

Rural S&L's are likely to play a diminishing role in rural development finance for a number of reasons. More consolidation of firms, together with marginal improvements in asset quality, will continue, making for a healthier but smaller group of rural S&L's. Rural S&L emphasis on home mortgages over business and nonhousing development finance is likely to continue as firms comply with portfolio and capital regulatory standards. With interstate banking being phased in, rural S&L's will face increased competition from, and acquisition by, the banking industry as barriers to market entry are reduced.

State-Chartered Savings Banks and Credit Unions. In some respects, State-chartered savings banks and credit unions have, over time, come to resemble commercial banks. Nonetheless, they are relatively minor players in most rural financial markets. In 1995, 509 State-chartered savings banks were represented in 26 States, with aggregate industry deposits exceeding \$247 billion. While 26 percent of State-chartered savings banks were headquartered in rural

communities, only about 11 percent of all State-chartered savings bank offices were in rural locations. State-chartered savings banks have a strong presence in the Northeast but have small market shares relative to commercial banks almost everywhere.

The number of State-chartered savings banks is substantially higher than it was in 1987, as many surviving S&L's found it convenient to convert to other types of financial institutions to distance themselves from the S&L industry's financial problems. Despite the increasing numbers of State-chartered savings banks, over the 1987-95 period, the industry's deposits increased by only 24 percent, largely because several large savings banks failed or voluntarily converted to commercial banks.

Rural-headquartered State-chartered savings banks tend to be small, averaging \$154 million in assets at the end of 1995, and concentrate most of their lending in home mortgages (table A-4). Unlike the pattern for rural banks and S&L's, rural State-chartered

Table A-4—Financial condition of rural and U.S. State-chartered savings banks, 1995

While few in number, State-chartered savings banks specialize in housing credit.

Item	U.S.	Rural
	<i>Number</i>	
State-chartered savings banks	509	132
	<i>Million dollars</i>	
Average assets	485.4	153.9
Average deposits	382.9	127.7
Average loans	293.2	105.9
	<i>Percent</i>	
Composition of loan portfolio:		
Home mortgage	68.5	72.2
Other real estate	21.1	15.0
Consumer	6.0	7.9
Commercial	3.5	3.8
Other	0.8	0.9
Agricultural	0.0	0.2
Loans/deposits	76.6	82.9
Net interest margin	3.3	3.6
Return on assets	0.9	1.0
Equity capital/assets	9.5	11.4
Problem loans/equity capital	10.3	7.2
Loan loss provision	0.3	0.2
Quarterly average holdings of tax-exempts/assets	0.4	0.6
Quarterly average Federal funds sold, securities purchased/assets	2.4	1.2
Quarterly average Federal funds purchased, securities sold/assets	4.8	0.5

Source: Calculated by ERS from the Report of Condition and Report of Income of the Board of Governors of the Federal Reserve System, December 31, 1995.

savings banks actually have a higher loan/deposit ratio than the industry as a whole. But as with other rural-headquartered depository institutions, rural State-chartered savings banks have larger net interest margins, higher profits, and higher capital ratios than the industry as a whole. While, on average, they are financially sound, State-chartered savings banks are expected to remain a minor source of credit in rural areas.

Credit unions are organized by particular groups, such as labor unions, churches, universities, or business firms. They are “mutuals” in the sense that they are owned and run by depositors. Advantages accrue from certain tax provisions and from low overhead expenses. Credit unions are numerous but generally

very small, even compared with rural-headquartered banks. At the end of 1995, 11,958 Federally insured credit unions held close to \$289 billion in assets. Of these, 22 percent were headquartered in rural areas, controlling less than 10 percent of the industry’s assets. Most rural credit unions have assets well below \$50 million, with only 35 exceeding \$100 million. As a result, credit unions, like State-chartered savings banks, are not a major force in most rural credit markets.

Credit unions are usually associated with restrictive membership rules, such as employment at a particular firm or membership in a particular organization. But merged credit unions can define their potential membership base as the sum of those formerly served by the component credit unions. The combination of less restrictive membership requirements with credit union cost advantages has led some banks to argue that credit unions are formidable, unfair competitors.

Credit unions now have powers very similar to banks in that they can provide products, such as the equivalent of checking accounts (share drafts), credit cards, first mortgage loans, and commercial loans. Credit union loan portfolios are dominated by consumer and real estate loans (table A-5). They are not a major source of business or nonhousing development loans, in either rural or urban markets.⁹

The low labor and facilities requirements of many credit unions, together with tax and regulatory advantages they enjoy over other depository institutions, has helped them aggressively pursue depositors. This has raised the ire of the commercial banking industry, which considers credit unions to be potentially strong, unfair competitors. In an attempt to level the playing field, bank trade organizations are pushing for legislation to apply the same taxation and Community Reinvestment Act enforcement rules to credit unions that currently apply to banks. Bankers are also using the courts to try to roll back an expanded interpretation of the common bond requirement for credit unions. The National Credit Union Administration, the Federal regulator and insurer of

⁹ Credit unions face tight limits on the size of business loans to nonmember borrowers and strict collateral requirements for business loans to members. Their industry organizations are lobbying to have these limits liberalized.

Table A-5—Financial condition of rural and U.S. credit unions, 1995

Rural-headquartered credit unions specialize in consumer lending.

Item	U.S.	Rural
	<i>Number</i>	
Credit unions	11,958	2,436
	<i>Million dollars</i>	
Average assets	24.2	10.7
Average deposits	21.3	9.4
Average loans	14.7	7.1
	<i>Percent</i>	
Composition of loan portfolio:		
Unsecured credit card	7.4	4.4
All other unsecured	12.9	12.6
New auto	23.5	21.0
Used auto	15.1	20.1
First mortgage	21.2	21.8
Other real estate	11.6	7.5
Other loans to members	8.0	12.3
Other loans	0.2	0.3
Agricultural member business loans ¹	0.2	1.2
Other member business loans ¹	1.1	1.1
Loans/deposits	68.9	75.2
Net interest margin	3.8	4.1
Return on assets	1.0	1.1
Equity capital/assets	10.4	11.2
Problem loans/equity capital	5.2	6.2
Loan loss provision	0.4	0.3
Total borrowings/assets	1.47	0.9

¹ Outstanding agricultural and other member business loans must be reported only if their sum exceeds reserves less the allowance for loan losses. These loans also appear in the above loan composition.

Source: Calculated by ERS from the Financial and Statistical Report of the National Credit Union Administration, December 31, 1995.

credit unions, has allowed mergers of credit unions with different common bonds. Other credit unions have used wider geographic definitions to define their membership base. The result is that some credit unions can compete with neighboring banks for essentially all of the banks' customers. Whether the banking industry will succeed in curbing the growth of credit unions is uncertain.

Government-Sponsored Enterprises

The Federal Government uses a number of different approaches to influence the allocation of credit in the U.S. economy. As implied above, Federal regulation of financial institutions affects credit decisions, but so do tax policies, bankruptcy laws, financial assistance programs, and support for secondary markets. Secondary markets encourage lending for desired purposes by increasing the liquidity of qualifying loans. The Federal Government, through the activities of a number of government-sponsored enterprises (GSE's), currently sponsors secondary markets for home mortgages, farm loans, student loans, and various types of federally guaranteed loans. With one notable exception, federally chartered GSE's concentrate on secondary loan markets and do not make loans directly to borrowers in primary loan markets. Rather, they buy or "securitize" qualifying loans made by private sector lenders, or they take such loans as collateral for cash advances to lenders. The one exception is the Farm Credit System, which includes a network of retail lenders that compete directly with other providers of farm and rural housing credit.

GSE's were created to address perceived problems in the availability or cost of certain types of credit, particularly long-term fixed-rate loans for housing, farming, and, more recently, higher education. Most depository institutions were historically reluctant to offer long-term fixed-rate financing because their primary source of funding is short-term deposits. By providing such financing directly, facilitating the sale of such loans, or accepting such loans as collateral for cash advances, GSE's inject liquidity into the markets they are chartered to serve.

Depending upon their authorities and operating characteristics, GSE's can increase retail-level competition by encouraging new lenders to enter the market. They integrate local credit markets with national money markets by facilitating the flow of funds and reducing interest rate variability among markets. By standardizing contractual arrangements for eligible loans and providing a history of loan performance, GSE's also attract additional capital to the sectors they serve.

When a GSE supports a secondary market, benefits can accrue to lenders, security owners, borrowers,

and GSE stockholders and employees. Lenders can earn fee income by originating and servicing loans, while eliminating interest rate risk (deposit rates might rise faster than loan rates) and credit risk (the borrower might default) by selling the loans. Loan sales also release funds for additional lending. Investors in secondary market securities benefit by acquiring a small piece of a large diversified portfolio comprised of loans meeting specific underwriting standards. Some portion of these benefits is also passed back to borrowers in the form of lower interest rates or easier access to credit. Finally, GSE stockholders and employees benefit from the Federal subsidies embodied in GSE status.¹⁰

To assist GSE's to spur competition and increase the supply of credit for purposes judged to be publicly desirable, the Federal Government confers substantial benefits to these entities. The primary benefit GSE's enjoy is the ability to borrow at interest rates similar to those paid by the U.S. Treasury. As federally chartered agencies, investors view GSE securities as having the implicit backing of the Federal Government, making them nearly risk-free. Other benefits GSE's typically enjoy include an emergency line of credit with the U.S. Treasury, exemption from paying certain State and local taxes, and exemption from Securities and Exchange Commission registration requirements and fees. These benefits are worth billions of dollars annually to GSE's as a group.

Farm Credit System. The Farm Credit System (FCS) is a network of federally chartered, borrower-owned cooperatives specializing in agricultural loans. Created in 1916 to provide long-term fixed-rate mortgage loans to farmers (because rural banks were unable or unwilling to take the risk of doing so), the FCS has grown into a major source of agricultural credit and a major competitor in agricultural credit markets. At the end of 1995, the FCS included 8 banks and 228 associations serving every region of the country and providing long- and short-term credit

for farmers, farm cooperatives, farm-related businesses, fisheries, rural housing, rural utilities, and agricultural exports. While its lending authorities have been broadened over the years, most FCS loans are for agriculture. At the end of 1995, the FCS' loan portfolio amounted to \$59 billion, with roughly half being long-term real estate loans (table A-6).

FCS originates and services the vast majority of the loans it holds. Most of its loans are made directly to individual farmers for farm production and real estate purchases or to farmer cooperatives providing inputs, marketing, and processing services to farmers. Each FCS bank and association has specific lending authorities and chartered territories. As a result, FCS institutions compete directly with commercial banks and other farm lenders within their service areas (and within the scope of their charters), but they generally do not compete with other FCS institutions.¹¹ Most FCS banks also have authority to loan funds to qualifying commercial banks and other financial institutions for short- and intermediate-term farm loans, but few financial institutions use the FCS for this purpose.

Eligible borrowers must purchase FCS stock to obtain loans from FCS lenders. FCS associations in turn purchase stock in the FCS bank with which they are affiliated. The banks act as conduits for the lending associations, providing them with funds raised from the sale of notes and bonds on the national money markets. These securities are backed by "joint and several" liability of each FCS bank for each bond. Thus, if any one FCS bank is unable to meet its obligation to bondholders, the other banks are liable to make the required payments. The securities are also commonly viewed by investors as being implicitly guaranteed by the Federal Government, despite the absence of any explicit guarantee. As a result, the FCS enjoys a ready sup-

¹⁰ Privatization studies of Fannie Mae and Freddie Mac indicate that much of the benefits associated with GSE status are retained by these two corporations (Congressional Budget Office, 1996; U.S. Department of Housing and Urban Development, 1996; and U.S. Department of the Treasury, 1996). The CBO estimates that nearly \$1 in benefits goes to stockholders and management for every \$2 that Fannie Mae and Freddie Mac pass on to market participants.

¹¹ The FCS was structured, in part, to offer farmers a competitive alternative to rural banks. Reducing market power of middlemen was a long-standing concern of the populist farmer-cooperative movement when the FCS was created. As cooperatives, with each bank responsible for the obligations of the entire System through its "joint and several" liability, competition within the System generally has been avoided.

Table A-6—Financial trends of the Farm Credit System, 1990-95

After experiencing financial problems in the 1980's, the FCS has greatly improved its finances and has been growing for the past several years.

Item	1990	1991	1992	1993	1994	1995
	<i>Number</i>					
FCS banks	16	15	14	12	9	8
FCS associations	304	250	243	238	232	228
Federal Land Bank Associations	121	85	77	73	71	70
Production Credit Associations	121	72	70	69	69	66
Agricultural Credit Associations	44	70	69	66	60	60
Federal Land Credit Associations	18	23	27	30	32	32
	<i>Billion dollars</i>					
Total assets	63.5	59.7	63.2	64.8	66.4	71.4
Total loans outstanding	45.7	51.5	52.4	53.9	54.7	58.6
	<i>Percent</i>					
Composition of loan portfolio:						
Long-term real estate	29.4	28.8	28.7	28.5	28.4	28.4
Short and intermediate term	10.7	11.2	11.1	11.6	12.4	13.8
Loans to cooperatives	5.6	6.2	6.1	7.3	7.4	10.1
Rural utilities	2.3	2.3	2.6	2.8	3.3	3.5
International trade	3.2	2.9	3.9	3.7	3.2	2.8
Net interest margin	2.0	2.6	2.9	3.2	2.9	3.0
Return on assets	1.0	1.3	1.6	1.9	1.5	1.7
Risk capital/assets	11.6	13.3	13.8	15.2	16.0	16.2
Problem loans/risk capital	37.5	30.5	23.0	15.1	10.1	7.2
Loan loss provision/risk capital	-0.6	0.7	0.2	0.4	0.5	0.3

Source: Calculated by ERS from the Federal Farm Credit Banks Funding Corporation, *Annual Information Statements*, Dec. 31, 1990-95.

ply of relatively inexpensive funds, borrowed at rates approaching those paid on U.S. Treasury securities.¹²

FCS institutions are specialized lenders with a Federal mandate to serve as a reliable source of competitively priced funds for agricultural and other rural borrowers. This mandate, in conjunction with the FCS cooperative nature and some questionable lending practices, resulted in phenomenal growth in the 1970's. But when the farm sector experienced severe financial stress in the early to mid-1980's, the FCS experienced a rapid contraction as creditworthy bor-

rowers found cheaper sources of credit and stressed borrowers defaulted on their loans.¹³

To help the System recover, the Agricultural Credit Act of 1987 (P.L. 100-233) provided a \$4 billion line of federally guaranteed assistance, of which \$1.261 billion was used. The System's finances have since recovered, but as a result of its earlier difficulties, the FCS has become far more selective in its lending.¹⁴ Individual banks and associations retain a great deal

¹² Even when the FCS was having financial difficulty in 1985, the spread between FCS agency securities and comparable U.S. Treasuries was only 50 to 60 basis points (0.5 to 0.6 percentage points), indicating widespread confidence that the FCS was basically sound and that the Federal Government would not let a GSE fail to make timely payments on its debt (Duncan and Singer, 1992). Currently, the spread between FCS and Treasury securities is 7-15 basis points for 1 to 5 year maturities.

¹³ The System's practice of charging interest rates for its loans based on the average cost of its operations, combined with a large stock of fixed-rate, noncallable bonds sold at high interest rates, meant that as interest rates declined in the 1980's, the FCS ceased being a low-cost source of farm credit.

¹⁴ Based on USDA research, farm operators borrowing from the FCS tend to be more financially secure and FCS debt is concentrated among more established and larger operators. Those operators whose primary lender is the FCS own more land, are more likely to be in higher income brackets, and are older than farmers who borrow from commercial banks or from USDA (Koenig and Dodson, 1995).

of discretion with regard to pricing, loan approval, stock purchase requirements, dividend policies, and the like. However, to ensure the safety and soundness of FCS institutions, the Farm Credit Administration and the Farm Credit System Insurance Corporation act as regulator and insurer of FCS obligations, respectively. In addition, FCS banks have voluntarily entered into several agreements with each other that provide further incentive for each bank to maintain a strong financial position. In 1995, the System's total loan volume grew by 4.5 percent, its income exceeded \$1 billion for the third year in a row, and it experienced declines in provisions for loan losses and noninterest expenses (table A-6). Its net interest margin, at approximately 3 percent, remains high enough to support sustained system earnings (USDA, 1996).

In addition to providing credit to farmers and farm cooperatives, the FCS has authority to finance other activities in rural America:

- *Housing.* Specific FCS institutions are currently authorized to finance moderately priced, single-family housing in rural areas having a population of 2,500 or less. Rural housing loans may not exceed 15 percent of the bank's or association's portfolio of outstanding loans.
- *Rural utilities.* The FCS Banks for Cooperatives can finance rural electric and telephone cooperatives and other eligible rural electric and telephone utilities in addition to the construction and operation of water and waste disposal systems in rural areas.
- *Farm-related business.* Currently, the FCS can provide financing for farm-related businesses that serve the on-farm operating needs of farmers and ranchers. However, only activities that primarily benefit a member-borrower's farming operations or a cooperative are eligible.
- *Other financial institutions.* The FCS also has authority to loan funds for short- and intermediate-term farm loans to qualifying commercial banks and other financial institutions that specialize in agricultural lending.

Despite the fact that the FCS is smaller than it was in the early 1980's, it retains advantages that should

allow it to remain a major source of farm credit. It has lending offices and experienced farm lending officers throughout the country. Consolidation has allowed many FCS associations to offer a full range of credit products in one place, relieving farmers of the need to deal with separate FCS institutions for their production and real estate credit needs. Its status as a GSE continues to provide (off-budget) Federal subsidies to the System and access to an ample supply of loanable funds. As cooperatives, even taxable FCS institutions receive tax advantages. For activities that the System's various—largely autonomous—institutions are willing and able to finance, credit should be available to those who meet the loan qualifications.

Federal Agricultural Credit Corporation (Farmer Mac). Farmer Mac was created in 1987 to develop and operate secondary mortgage markets for high-quality agricultural real estate and rural home mortgages (Farmer Mac I). In 1990, Farmer Mac was authorized to serve as the pooler for secondary sales of farm and rural development loans guaranteed by the U.S. Department of Agriculture (Farmer Mac II). While meant to benefit very different clientele, both Farmer Mac I and II are designed to increase access to agricultural and rural housing credit by reducing liquidity constraints among primary lenders.¹⁵ Supervised and regulated by the Office of Secondary Market Oversight in the Farm Credit Administration, Farmer Mac operates as an independent entity within the Farm Credit System.

Farmer Mac's charter has been revised twice since its creation in an attempt to make it financially viable. It now has authority to purchase loans directly from stockholder-originators and issue its own securities (which have agency status) to investors to fund these purchases. Farmer Mac can either create and market loan pools or hold loans in its own portfolio. In addition, Farmer Mac can guarantee the timely repayment of principal and interest on loan pools assembled by private sector poolers. Farmer Mac has the ability to access a \$1.5-billion direct line of

¹⁵ The underwriting standards associated with Farmer Mac I limit participation to financially healthy farmers. Farmer Mac II, on the other hand, benefits borrowers eligible for FSA guarantees—those unable to get commercial credit at affordable rates because of financial problems.

credit to the U.S. Treasury if certain conditions are met.

Farmer Mac has had no perceivable effect on farm loan rates and loan terms to date.¹⁶ The reasons for its slow start include a restrictive charter (until passage of the Farm Credit System Reform Act of 1996) and unfavorable primary credit market conditions. The latter include a weak demand for fixed-rate loans, declining farm real estate mortgage volume, stringent loan capitalization requirements, high bank lending capacity, and slow investor acceptance. Whether its new charter will allow it to play a larger role in agricultural and rural housing finance depends in part upon market conditions during the coming years. Farmer Mac has been unprofitable since its creation and was down to \$12 million in capital (from \$22 million in 1988) before recapitalizing following the 1996 legislation. New stock issuances in 1996 raised over \$37 million in new capital for the GSE.

In the Farmer Mac II market, Farmer Mac purchases from lenders the USDA-guaranteed portions of farm and rural development loans and finances the purchases by issuing securities. This market has grown steadily since 1991, with cumulative volume topping \$250 million by the end of 1996. Because the loan portions sold are Federally guaranteed, Farmer Mac's charter provides less value to this secondary market. There are several privately operated secondary markets for USDA-guaranteed loans that have a combined volume greater than Farmer Mac II.

Housing-Related GSE's. The home mortgage market benefits from a number of GSE's and GSE-like Federal agencies that complement and sometimes compete with each other. While the Government National Mortgage Association (Ginnie Mae) operates as a Federal corporation within the Department of Housing and Urban Development (HUD), and is therefore not a GSE, it operates very much like the housing GSE's. Ginnie Mae operates a secondary mortgage market where, through its mortgage-backed securities program, private lenders issue securities

¹⁶ It was not until 4 years after enactment that Farmer Mac I guaranteed its first loan pool. Through 1996, just under \$1 billion in loans were guaranteed under Farmer Mac I. No rural housing mortgages have been pooled. Much of the Farmer Mac I volume came from the packaging of existing loans, primarily from life insurance companies.

Table A-7—Mortgage market activity of housing GSE's and related agencies, 1993-95

Secondary markets for home mortgages continue to grow.

	1993	1994	1995
<i>Billion dollars</i>			
Ginnie Mae:			
Securities issued	118	141	85
Securities outstanding	416	446	487
<i>Million dollars</i>			
Fannie Mae:			
Mortgage purchases	313,481	193,011	167,054
Mortgage portfolio	661,200	706,500	765,800
Net income	1,873	2,132	2,144
Freddie Mac:			
Mortgage purchases	229,706	124,246	98,386
Mortgage portfolio	494,727	533,484	566,469
Net income	786	983	1,091
FHLBS:			
Advances outstanding	103,027	125,767	132,150

Source: Calculated by ERS from Fannie Mae's and Freddie Mac's 1995 Annual Reports, from HUD's Notes to Consolidated Financial Statements and Budget Summary-FY 1997, and from data provided by the Federal Housing Finance Board.

backed by pools of mortgages insured or guaranteed by the Federal Government (i.e., mortgages insured by the Federal Housing Administration (FHA) and the Department of Veterans Affairs or guaranteed by USDA's Rural Housing Service). The issuer administers and services the pooled mortgages, with Ginnie Mae assuring timely payment of scheduled monthly payments and any prepayments and early recoveries of mortgage principal. Roughly 95 percent of the FHA- and VA-insured mortgages made each year are subsequently sold through Ginnie Mae. In 1995, Ginnie Mae handled \$85 billion in new loans. At the end of 1995, \$487 billion in outstanding home mortgages were securitized with Ginnie Mae's backing (table A-7). Roughly 10 percent of these are rural home mortgages, representing over 860,000 loans.

The Federal National Mortgage Association (Fannie Mae) was originally created in 1938, but it was not until 1968 that it was rechartered as a GSE with private ownership. Fannie Mae's principal activity is the purchase of mortgage loans from local lenders, financed by the sale of securities backed by these loans. Fannie Mae can purchase both conventional

mortgages and those insured or guaranteed by Federal agencies. However, only average- or below-average-size mortgages (i.e., “conforming loans” which in 1997 is \$214,600 or less for single-family structures) which meet Fannie Mae’s underwriting standards qualify. Timely payment of principal and interest to holders of mortgage-backed securities is guaranteed by Fannie Mae. In 1995, Fannie Mae purchased \$167.1 billion in residential mortgages, of which approximately 9.4 percent were rural. Over three-quarters of the loans Fannie Mae purchased in 1995 were conventional long-term fixed-rate mortgages, with most of the balance being intermediate fixed-rate mortgages and government-insured/guaranteed loans. Less than 1 percent were adjustable-rate mortgages.

The Federal Home Loan Mortgage Corporation (Freddie Mac) is another stockholder-owned corporation, having started in 1970 as a government activity to provide liquidity and secondary market access to the thrift industry. As with Fannie Mae, only conforming loans are purchased. In 1995, Freddie Mac purchased 933,559 mortgages valued at \$98.4 billion. Approximately 12 percent of the housing units financed were in rural America. Freddie Mac’s Federal charter is very similar to Fannie Mae’s, making them competitors that share similar constraints and advantages. Like Fannie Mae, Freddie Mac purchases mostly long-term fixed-rate mortgages, but the two GSE’s appear to have different strategies when it comes to adjustable rate mortgages (ARM’s). While Fannie Mae purchased very few, over 20 percent of Freddie Mac’s purchases in 1995 were ARM’s.

Both Fannie Mae and Freddie Mac are privately owned, and both have experienced impressive growth in both portfolio size and profitability. Fannie Mae earned net income of over \$2 billion in 1995, and its profits for the first half of 1996 were 16 percent above last year’s level. On its smaller portfolio, Freddie Mac earned net income of over \$1 billion in 1995, and its profits were up 19 percent during the first half of 1996. These profits, and the potential budgetary exposure represented by \$1.4 trillion in housing GSE obligations, have led to suggestions that Fannie Mae and Freddie Mac be stripped of their agency status and completely privatized. While such a step does not seem likely in the near future, Federal

oversight of their activities has increased in recent years. Fannie Mae and Freddie Mac are regulated by the Department of Housing and Urban Development (HUD) with responsibility split between the Secretary of HUD and the largely independent Office of Federal Housing Enterprise Oversight (OFHEO).¹⁷ The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 required Fannie Mae and Freddie Mac to target more of their activities toward underserved areas, including rural communities and urban centers. As the housing GSE’s move to satisfy their targeting requirements, currently underserved rural communities may find home mortgage loans more accessible.¹⁸

The Federal Home Loan Bank System (FHLBS) provides advances and related products and services to financial institutions in support of their residential mortgage and community development lending. Originally created to serve the savings and loan industry, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 expanded membership to commercial banks and credit unions and mandated that the FHLBS develop programs to promote the financing of housing for low- and moderate-income families. Through 12 regional Federal Home Loan Banks, advances (loans secured by residential mortgages and other eligible collateral) are made to member institutions and eligible nonmember mortgagees. Outstanding advances at the end of 1995 totaled \$132 billion to 5,775 thrifts, commercial banks, credit unions, and other eligible institutions. Of this amount, \$9.7 billion went to rural-headquartered institutions.

The FHLBS raises funds by issuing securities through national and international money markets. The Federal Housing Finance Board, an independent Federal agency, serves as both the safety and soundness and program regulator of the FHLBS. Several eligibility rules restrict FHLBS membership and advances. Prospective members must be financially

¹⁷ In general, the HUD Secretary provides oversight on the public purpose obligations stemming from each GSE’s Federal charter, while the OFHEO provides oversight on financial safety and soundness.

¹⁸ Based on HUD regulations, two-thirds of rural counties qualify as being “underserved.” However, since the GSE targets do not distinguish between urban and rural areas, it seems likely that the GSE’s will concentrate most of their outreach efforts on the more populous urban centers.

sound and have a minimum of 10 percent of their assets invested in residential-mortgage-related loans or investments. A minimum stock purchase is required for both membership and for advances. Advances to non-qualified thrift lenders (some commercial banks and credit unions) are limited to 30 percent of aggregate advances.¹⁹

While it remains an important source of liquidity for residential lenders, the FHLBS faces increased competition from other GSE's. In addition, proposals have been made to broaden its role. For example, the Enterprise Resource Bank Act of 1996, if enacted, would have transformed the FHLBS into a system of Enterprise Resource Banks and expanded its mission to include economic and rural development lending.

Other Government-Sponsored Secondary Markets.

The Federal Government also supports secondary markets for other types of loans. The Student Loan Marketing Association (Sallie Mae) supports a secondary market in federally guaranteed student loans. The College Construction Loan Insurance Program (Connie Lee) supports debt issued to finance the construction of higher education facilities. Both Sallie Mae and Connie Lee will lose their GSE status under recently enacted legislation.

No market has yet developed for resales of unguaranteed business loans, although there have been proposals for Federal activity in this area. Earlier proposals in Congress would have created the Venture Enhancement and Loan Development Administration for Small Undercapitalized Enterprises to support a secondary market in small business loans.

Other Financial Institutions

Information on financial institutions that are not chartered or regulated by the Federal Government is harder to find. If these data are collected at all, they tend to be unstructured and not centrally maintained and distributed. But the presence or absence of non-depository financial institutions in rural communities can have a significant impact on the type of financing

available within those communities. With a couple of exceptions, these lending institutions are not dominant players in rural retail loan markets; rather, they tend to provide specialized financing not provided by heavily regulated institutions.

Pension Funds and Insurance Companies. Pension funds and insurance companies have huge reserves of funds that are invested on behalf of members and policy holders. These institutions are large holders of corporate stocks and bonds, and they also invest directly in real estate ventures, through both equity investments and loans. Proposals are periodically made to place pension and insurance money in "socially responsible" investments, such as low-income housing and new businesses. However, the fiduciary responsibilities of these organizations precludes heavy involvement in investments that do not meet the normal criteria for safety and expected profitability. But since pension and life insurance companies have fairly predictable payouts, they are less concerned with the short-term liquidity of their investments and can afford to hold illiquid long-term assets, unlike most depository institutions.

At the end of 1995, life insurance companies held \$2.1 trillion in financial assets, with mortgage loans accounting for roughly 10 percent of these holdings (Board of Governors of the Federal Reserve System, 1996). Over the past 15 years, the life insurance industry has gradually reduced the share of assets held as mortgage loans, favoring government securities and corporate stocks and bonds (American Council of Life Insurance, 1995). Roughly 4 percent of the industry's mortgage holdings were farm loans. Other private pension funds controlled \$2.6 trillion in financial assets, with mortgage loans accounting for less than 7 percent of these holdings. The magnitude of their importance within rural financial markets is unknown, but based on insurance company lending to agriculture, it is probably limited to large projects.²⁰

¹⁹ Nationwide, rural-headquartered commercial banks are as likely to be members of the FHLBS as are other banks. But rural access is of some concern in the Des Moines (322 ineligible rural banks), Dallas (175 ineligible rural banks), and Topeka (403 ineligible rural banks) FHLBS districts. Rural member banks were larger and held a greater ratio of mortgage-related assets than other rural banks.

²⁰ Data on the activities of all domestic insurance companies are maintained by the National Association of Insurance Commissioners. While the level of detail is sufficient to estimate the rural-urban distribution of many of the industry's assets, no attempt was made to do so for this report since our primary focus is on federally chartered financial intermediaries. But based on the insurance industry's farm real estate lending, as reported by Stam, Koenig, and Wallace (1995), average loan sizes exceed \$500,000. It seems likely, therefore, that the industry's assets are predominantly urban.

Finance Companies. Personal finance companies are like credit unions in the types of loans they make, but they obtain loanable funds by borrowing rather than through deposits. Finance companies tend to target the higher risk segment of the consumer loan market; they charge higher interest rates in return for accepting loan applicants who may not satisfy the credit-worthiness criteria applied by banks and other regulated lenders.

The finance company category also includes the “captive” finance subsidiaries of the auto manufacturers, farm machinery firms, and some other large corporations. When interest rates rose to record highs in the early 1980’s, automobile companies found that offering low interest rates on car loans was an effective marketing tool. Thus, their finance companies greatly increased market shares for auto loans. Using captive finance companies, farm machinery firms have become an important source of credit for the purchase of farm machinery and equipment. Among commercial-sized crop farms, these captive finance companies supplied nearly a fourth of all non-real-estate credit during the 1990’s. Some captive finance companies, notably the General Electric Credit Corporation, have branched into business lending and investment that do not involve the sale of the parent firm’s products.

Revolving Loan Funds (RLF’s)—RLF’s are public or private nonprofit lending institutions designed to further local economic development goals by loaning their initial capital and then reloaning funds as payments are made on the initial loans. The concept is certainly not unique to RLF’s, and other types of financial institutions, such as Community Development Corporations (CDC’s), often operate RLF’s. However, largely because of their unique funding sources, RLF’s are recognized as a type of institution.²¹ While they are most often locally operated institutions that lend to businesses, some RLF’s are Statewide and some are used to fund public infra-

structure investments. Most RLF’s receive a significant portion of their capital from grants or low-cost, long-term loans from a Federal agency, but they also rely on State grants and private donations.

The exact way that RLF’s operate depends on requirements tied to their funding. Income from payments on outstanding loans and loan fees are returned to the fund and used for additional lending. Loans are often made at below-market interest rates and targeted at businesses that cannot qualify for conventional loans without financial assistance. RLF’s also participate with conventional lenders, providing needy borrowers with additional funds without diluting the value of collateral pledged on their bank loans. This “leverages” the RLF’s funds but also increases its exposure to losses. The combination of low interest rates and high-risk loans has prevented most RLF’s from growing rapidly enough to be a major force in local financial markets. Their primary role in financial markets is delivering public and private subsidies to the business community or as public infrastructure “banks.”

Venture Capital and Business Investment

Companies—The early-stage financing needed to get a new business started is generally the most difficult to find. Because of their very high risk of failure, few lenders can afford to provide business financing to budding entrepreneurs or new businesses wishing to expand rapidly. Venture capitalists, through equity investments, are the primary external source of early-stage financing. Venture capital is provided by hundreds of professional venture capital firms, most of which are private, for-profit enterprises, and by an informal network of individual investors (Wetzel, 1995). This section is concerned with public and private venture capital firms, which supply a small but highly visible portion of the venture capital invested each year.²² (Individual investors are discussed under “Other Sources of Capital,” on page 61.)

Private venture capital firms are located in major metropolitan centers across the country, but are heavily concentrated in San Francisco, New York City,

²¹ For our purposes, RLF’s are a group of loosely regulated nonprofit lenders initially capitalized with public funds or private donations. These include institutions capitalized with funds from the Economic Development Administration, USDA’s Intermediary Relending Program, and various community development grant programs (e.g., Community Development Block Grants, Urban Development Action Grants, and Empowerment Zone/Enterprise Community Grants).

²² Professional venture capital funds supply an estimated 10-20 percent of the \$20-25 billion invested annually by venture capitalists (Wetzel, 1995). However, only about 10 percent of venture capital firms’ investments are for start-ups; most prefer later-stage investments and leveraged buyouts (Alleva, 1996).

and Boston.²³ Given the high risks involved in financing new businesses, venture capital firms invest exclusively in businesses with high growth potential, with their potentially large pay-offs. As a result, most of the venture capital invested by professional firms goes to places with vibrant high-technology industries—Silicon Valley, Route 128 around Boston, and, to a lesser extent, regional high-technology growth centers.

By investing equity capital, arranging for operating credit, and providing management assistance, a venture capital fund attempts to fuel rapid growth by the firms it supports, allowing the fund to sell its stock at a high profit after 5 to 10 years. The management and monitoring efforts needed to make high-risk investments pay off discourage small investments in favor of large investments (\$500,000 to several million) in a limited number of firms. For the same reason, private venture capitalists avoid firms with limited growth potential and firms located outside industry centers. Private venture capital firms obtain most of their investment funds as investments by others—pension funds, insurance companies, foundations, bank holding companies, and wealthy individuals looking for high yields. While relatively rare, public venture capital organizations have been established where private firms were slow to evolve. They are often more willing to make smaller investments and accept lower rates of return. Public agencies rely on appropriations, tax-exempt bond sales, and public employee pension funds for the initial funds needed to capitalize venture capital investments.

In addition to purely private or public firms, there are a number of private venture capital firms that operate with public assistance. Small Business Investment Companies (SBIC's) are privately owned and managed investment firms (corporations or partnerships) licensed by the Small Business Administration (SBA) to provide equity and long-term subordinated-debt financing to small businesses. SBA supplements an SBIC's private capital by guaranteeing its securities. Some SBIC's specialize in one particular type of manufacturing or service firm to take advantage of their in-house technical knowledge. Most, however,

consider a wide variety of investment opportunities. Virtually all SBIC's are for-profit firms whose incentive is to share in the success of the assisted business. Some States provide financial support to similar entities, known as Business and Industrial Development Companies, as part of their industrial recruitment efforts.

Community Development Institutions—In addition to SBIC's and other publicly supported institutions that provide financial assistance to the business sector, there exist a range of similar institutions that have a broader charter of fostering community development. These institutions often have active business assistance programs, but they also provide financing for housing, nonprofit organizations, and community projects.

Certified Community Development Corporations (CDC's) are nonprofit corporations that provide growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings as part of a community's or region's economic development efforts. There are about 290 SBA-Certified CDC's nationwide, each serving a specific area. In fiscal 1995, 4,509 loans were approved totaling \$1.6 billion for small businesses. Only for-profit businesses that do not exceed size limits established by the SBA are eligible for SBA-supported funding from CDC's.

Typically, a project includes a loan secured with a senior lien from a private-sector lender covering up to 50 percent of the project cost, a loan secured with a junior lien from the CDC (a 100-percent SBA-guaranteed debenture) covering up to 40 percent of the cost, and a contribution of at least 10 percent equity from the small business being helped. Loan proceeds must be used for fixed-asset projects, such as purchasing land and improvements, rather than as working capital for the purchase of inventory, or for refinancing of existing debt.

Bank Community Development Corporations are similar to CDC's, and may be SBA-certified, but they most often exist without public subsidies. Instead, they are established as a subsidiary of a bank, a bank holding company, or a group of institutions to provide risk capital to underserved communities in their service area. Federal banking regulations allow national banks and bank holding companies to invest

²³ Florida and Smith (1990) report that these 3 cities account for 60 percent of the Nation's supply of venture capital; the Northeast and the Pacific region supply 78 percent.

up to 5 percent of their capital in a bank CDC. This for-profit subsidiary can then make investments not permitted to the bank itself, such as equity investments in real estate and small businesses, as long as community development is furthered.²⁴ Since 1965, the Office of the Comptroller of the Currency has approved 1,177 national bank investments in almost 700 CDC's. In 1995, 178 national banks and their community partners invested \$1.6 billion in 130 community development projects.

Community Development Financial Institutions (CDFI's), like revolving loan funds, are not unique intermediaries, but rather are a set of community lenders that meet the requirements for Federal assistance as specified in the "Community Development and Regulatory Improvement Act of 1994."

Nonprofit financial institutions that target all their funds on economically distressed urban and rural communities can be designated as CDFI's and receive up to \$1 in Federal support for each \$1 in other funding. CDFI's provide a wide range of financial products and services—such as mortgage financing for first-time home buyers, commercial loans and investments to start or expand small businesses, loans to rehabilitate rental housing, and basic retail/consumer financial services needed by low-income households. CDFI's comprise a broad range of institution types, such as community development banks, community development credit unions, community development loan funds, community development venture capital funds, and microenterprise loan funds. The CDFI fund was \$50 million in fiscal 1995, and \$45 million in fiscal 1996, with loans, grants, and technical assistance being eligible uses of Federal funds.

Private Secondary Market Poolers—Federally chartered GSE's support most of the secondary market activity in housing and federally guaranteed loans, but their success has spawned private sector secondary markets as well. Housing loans that are too large to qualify for sale to Freddie Mac and Fannie Mae (commonly referred to as "jumbo" or "nonconforming" loans) are routinely sold to private sector poolers. In addition, the vast majority of federally

insured/guaranteed housing loans are purchased by private poolers, with the backing of Ginnie Mae. In recent years, securities backed by credit card receivables and automobile loans have appeared, but they have been based on loans held by a single large financial institution and thus have not been feasible outlets for rural-headquartered lenders.

Private sector poolers also compete actively for federally guaranteed farm and small business loans. Farmer Mac is the official pooler of USDA guaranteed farm loans, but informal secondary markets for these loans existed prior to Farmer Mac's creation, and continue to capture a significant share of the market. The combined purchases of three companies active in this market exceeded that of Farmer Mac last year (Koenig and Ryan, 1996). Colson Management Group is the "official" pooler for SBA-guaranteed loans. Banks sell the guaranteed portion of SBA-guaranteed loans to Colson, which then puts together loan pools that are sold to investors in the securities market. Should a loan not perform, SBA purchases the loan and ensures that investors' returns are maintained. But in this market too, unofficial poolers actively compete with Colson for SBA-guaranteed loans.

Loan Brokers—Loan brokers, in the form of mortgage companies, are extremely active in the home mortgage markets, acting as intermediaries between borrowers and lenders. Brokers usually have access to funds from a number of sources and with various loan configurations. Mortgage brokers add to the geographic mobility of financial capital by bringing together borrowers and lenders from different locations. The presence of an active mortgage broker in a rural area may bring access to additional mortgage funds and mortgage products that are not offered by other lenders, as well as promote competition by adding another market participant. However, the broker does not necessarily bring financing priced at national levels. Instead, as do other lenders, loan brokers can price their products according to the local market. As with all brokers, compensation comes mainly from the spread between their cost of funding and the price at which it is sold. While important sources of mortgage financing nationwide, mortgage companies are less prominent in rural areas.

²⁴ In the process, the bank can earn profits on its CDC investment, satisfy Community Reinvestment Act requirements, and build ties with potential future users of its traditional banking services (Lenzi).

Government Programs

A basic function of government is to help provide a stable environment in which economic growth can occur. The government agencies charged with regulating financial institutions fulfill this function by concentrating primarily on the safety and soundness of the institutions they oversee. But layered on top of this regulatory framework, a wide range of other government programs have been created to increase the flow of financial resources to favored activities. We have already discussed how GSE's are used to increase the supply of loanable funds for agriculture, housing, and education. This section describes the general approaches governments use to more directly influence the supply and allocation of financial resources for agricultural and rural development.

From a belief that private financial markets do not always allocate resources efficiently or fairly, programs have evolved which either operate outside these markets or attempt to alter the decisions of financial market participants. Grant and direct loan programs are administered by government agencies; while program allocations may partially depend on financial market decisions, they are made by a set of players operating outside the market. Such programs address concerns over the fairness of financial market outcomes by subsidizing activities that have nonmarket benefits from society's point of view. They make no attempt to "fix" the market's operations. On the other hand, guaranteed/insured loan programs and technical assistance programs can be used to address the efficiency of market decisions. While these programs often deliver subsidies, they try to change market outcomes by altering the risks and payoffs faced by lenders and borrowers. For example, loan guarantee programs can reduce inefficiencies associated with credit rationing by lowering the information and transaction costs associated with small loans, and increasing the willingness of lenders to make those loans. This can increase market efficiency and spur economic growth.

Government programs often serve a range of purposes and have both economic efficiency and allocational fairness goals. One result is difficulty in judging whether programs achieve their goals, and no attempt is made to do so here. But in describing the various approaches adopted by government agencies to

improve rural credit conditions, it helps to keep these two goals distinct. Programs dealing with financial market efficiency concerns can, at least conceptually, be structured to be self-financing once they are up and running. On the other hand, allocational fairness requires program subsidies to overcome market decisions. Without subsidies—from the government, lenders, or other borrowers—resource allocations will not change. By definition, grant programs deliver subsidies and are ideal for handling fairness concerns. Most of the other credit-related programs discussed here—direct loans, guaranteed/insured loans, and technical assistance—can treat fairness concerns with varying degrees of success.

As a source of credit, all government programs are constrained by their eligibility requirements and their budgets. Programs that deliver subsidies tend to be fully subscribed, often exhausting their budget allocations early in the year. On the other hand, programs that provide unsubsidized assistance for a risk-based fee are often not fully utilized. As budgets at the Federal and State levels continue to tighten, governments at all levels are reducing explicit credit subsidies in favor of approaches that limit initial budget outlays and, at the State level, limit the government's exposure to risk. Doing so reduces the supply of credit available for investments that cannot demonstrate economic viability, but need not reduce the government sector's ability to meet economic demand for credit.

Grant programs—While not credit per se, grants are an obvious substitute for credit in delivering financial resources to spur rural development. Indeed, from an economic efficiency perspective, grants are often superior to credit for dealing with fairness issues. They can provide the subsidies needed to arrive at a "fair" allocation of resources with the least distortion in the economic behavior of program participants. Grant programs are most prevalent for providing low-income housing, community development and public infrastructure projects, and technical assistance.

USDA's housing assistance is delivered predominantly through loan programs, but the Department operates grant programs for rural housing repair and preservation as well as for the construction of housing for farm laborers. These programs are dwarfed

Federal Program Spending Data

The Federal program spending data reported here is from the Consolidated Federal Funds Reports (CFFR) assembled by the U.S. Department of Commerce, Bureau of the Census. Census collects these data annually from each Federal department or agency. ERS aggregated the data to the county, State, region, and national level for each program for fiscal year 1994. (Unless otherwise specified, references to years are fiscal years.) The Census data for 1994 covered 1,206 individual programs, of which 76 grant or direct payment programs, 24 direct loan programs, and 31 guaranteed/insured loan programs were judged to be significant credit or credit-related assistance programs for agriculture, housing, and community development. The CFFR often consolidates smaller programs, so the data represent more than the 131 program titles listed.

Program data cannot be reliably allocated to the county level if funds go directly to State capitals or regional centers that redistribute the money or program benefits to surrounding areas. Examples include block grant programs and procurement programs that involve a substantial degree of subcontracting. Census screens the data to identify such programs, and ERS further screened out those programs that allocate 25 percent or more of their funds to State capitals. The resulting database includes 122 credit-related programs allocated to the county level for 1994.

No urban/rural statistics are cited for the screened-out programs.

Not all benefits of Federal programs go to the places that receive funds. For example, money spent on national parks benefits all who visit the parks and not just those who live near the parks. Such spillover benefits present in most Federal programs are not reflected in the Federal spending data reported here. In addition, different programs affect communities in different ways and have different multiplier effects on local income, employment, and community well-being. Thus, even if the reported funding dispersion is considered accurate, care is required when interpreting the data as program effects.

Federal spending data may represent either actual program expenditures or obligations, depending on the form of the data provided to the Census Bureau. Direct loans and loan guarantees are reported according to the volume of loans obligated, and do not take into account interest receipts or principal payments. Consequently, these data do not always correspond to program totals reported in government budget documents, such as budget authority, outlays, or obligations.

For a more thorough examination of the geographic impacts of recent Federal spending and policy changes, see *Rural Conditions and Trends: Federal Programs* (USDA, 1996).

by the housing grant programs administered by HUD, which provide funds for rural as well as for urban public and other low-income housing. In fiscal 1994, HUD disbursed over \$900 million for rural housing through its grant programs (table A-8).²⁵

Rural areas received roughly \$6 billion in Federal grants for infrastructure and community development—far more than for any other purpose. Most of this assistance came from the Department of Transportation (for highway planning and construction), HUD (through the Community Development Block Grant programs), and the Economic Development Administration (EDA) for public

works, but USDA's Rural Utilities Service was a major source of grant funds for water and waste water disposal facilities.

In addition to substituting for credit, grant funds also support access to financial markets. USDA, EDA, the Environmental Protection Agency (EPA), and the SBA all operate technical assistance grant programs to improve the technical and managerial skills of a wide range of borrowers. While many of these programs are national in scope, rural areas tend to benefit disproportionately from their use. Rural areas received approximately \$32 million in grant funds awarded for technical assistance and financial market support in fiscal 1994.

Direct loan programs—Direct loans are those originated and often serviced by a Federal agency. For

²⁵ Both HUD and USDA also operate sizeable low-income housing assistance programs (\$4.8 and \$0.5 billion, respectively) which provide subsidies to the owners of low-income housing.

Table A-8—Federal grant programs for economic development

Most Federal grants going to rural areas are for community development projects.

Department/ Agency	Program name	FY-94 rural funding:		FY-96
		Total	Share of U.S. total	U.S. total
		\$ million	Percent	\$ million
AGRICULTURE		127.4	25.7	1,094.8
USDA/CCC	LOAN DEFICIENCY PAYMENTS	4.6	79.1	
USDA/CCC	COMMODITY LOANS AND PURCHASES	19.2	7.1	835.5
USDA/FSA	AGRICULTURAL LOAN MEDIATION PROGRAM	2.4	82.5	2.0
USDA	RESOURCE CONSERVATION AND DEVELOPMENT	1.3	63.8	0
USDA	WATERSHED PROTECTION AND FLOOD PREVENTION	78.0	79.3	34.0
USDA	MARKET PROTECTION AND PROMOTION	0	0.0	15.3
USDA	AGRICULTURAL CONSERVATION PROGRAM ¹	0.0	1.3	105.9
USDA	COOPERATIVE FORESTRY ASSISTANCE	2.0	5.7	86.5
DOI	FISH AND WILDLIFE PROGRAM	16.4	60.2	2.2
USDC	ANADROMOUS AND GREAT LAKES FISHERIES CONSERVATION	0.4	18.6	2.0
USDC	COLUMBIA RIVER FISHERIES DEVELOPMENT PROGRAM	0	0.0	11.4
DOI	OUTDOOR RECREATION—ACQUISITION, DEVELOPMENT, ETC.	3.0	12.3	0
HOUSING		955.7	16.4	6,939.7
USDA/RUS	FARM LABOR HOUSING GRANTS	5.1	50.4	10.0
USDA/RUS	VERY LOW-INCOME HOUSING REPAIR GRANTS	22.5	77.1	25.0
USDA/RUS	RURAL SELF-HELP HOUSING TECHNICAL ASSISTANCE	4.0	33.3	12.8
USDA/RUS	RURAL HOUSING PRESERVATION GRANTS	13.8	64.0	11.0
HUD/H	HOUSING FOR THE ELDERLY OR HANDICAPPED	19.0	14.3	780.2
HUD/H	SUPPORTIVE HOUSING FOR PERSONS WITH DISABILITIES	4.4	16.7	233.2
HUD/H	PRESERVATION OF AFFORDABLE HOUSING	1.9	73.5	624.0
HUD/CPD	RENTAL HOUSING REHABILITATION	1.6	4.2	
HUD/CPD	HOPE FOR HOME OWNERSHIP OF SINGLE FAMILY HOMES	0.5	4.2	0
HUD/PIH	PUBLIC AND INDIAN HOUSING	666.0	17.1	3,139.7
HUD/PIH	HOMEOWNERSHIP OPPORTUNITIES FOR LOW INCOME FAMILIES	12.7	65.6	
HUD/PIH	PUBLIC AND INDIAN HOUSING—COMPREHENSIVE IMPROVEMENT	67.6	20.6	278.0
HUD/PIH	HOPE FOR PUBLIC AND INDIAN HOUSING HOMEOWNERSHIP	0.4	15.2	0
HUD/PIH	PUBLIC AND INDIAN HOUSING—COMPREHENSIVE GRANTS	49.2	14.4	223.8
HUD/H	HOUSING DEVELOPMENT GRANTS	0	0.0	
HUD/H	HOMEOWNERSHIP AND OPPORTUNITY (HOPE 2) ¹	0.0	0.4	31.0
HUD/CPD	SUPPORTIVE HOUSING DEMONSTRATION PROGRAM	6.0	5.9	
HUD/CPD	HOME INVESTMENT IN AFFORDABLE HOUSING	80.4	10.2	1,400.0
HUD/CPD	HOUSING OPPORTUNITIES FOR PERSONS WITH AIDS (HOPWA)	0.7	1.8	171.0
BUSINESS		44.4	11.2	633.9
USDA	RURAL BUSINESS ENTERPRISE (RBEG) DEVELOPMENT GRANTS	31.7	72.2	45.0
USDC/EDA	TRADE ADJUSTMENT TECHNICAL ASSISTANCE	0	0.0	8.5
USDC	ADVANCED TECHNOLOGY PROGRAM	3.3	5.0	352.3
USDC/MBDA	MINORITY BUSINESS DEVELOPMENT ASSISTANCE CENTERS	0.3	2.2	16.9
DOD	DEFENSE TECHNOLOGY CONVERSION, REINVESTMENT, ETC.	4.8	2.1	195.0
SBA	MGMT & TECH ASSISTANCE FOR DISADVANTAGED	0.6	8.1	2.6
USDC	AMERICAN INDIAN BUSINESS DEVELOPMENT PROGRAM	0.6	30.0	1.6
DOD	PROCUREMENT TECHNICAL ASSISTANCE FOR BUSINESS FIRMS	3.2	18.8	12.0
COMMUNITY DEVELOPMENT		5,920.6	16.3	34,890.2
USDA/RUS	WATER AND WASTE DISPOSAL SYSTEMS FOR RURAL COMMUNITIES	324.8	76.3	400.1
USDA/RUS	TECHNICAL ASSISTANCE AND TRAINING GRANTS	5.9	65.2	9.0
USDA/RUS	SOLID WASTE MANAGEMENT GRANTS	1.3	44.0	2.3

--continued

Table A-8—Federal grant programs for economic development--continued

Department/ Agency	Program name	FY-94 rural funding:		FY-96
		Total	Share of U.S. total	U.S. total
		<i>\$ million</i>	<i>Percent</i>	<i>\$ million</i>
COMMUNITY DEVELOPMENT--continued				
USDA/RUS	EMERGENCY COMMUNITY WATER ASSISTANCE GRANTS	14.9	73.5	
USDA/RUS	WATER AND WASTE DISPOSAL GRANTS (SECTION 306C)	5.0	17.7	18.7
USDA/FS	SCHOOLS AND ROADS—GRANTS TO STATES	23.9	8.1	295.7
USDC/EDA	ECONOMIC DEVELOPMENT—GRANTS FOR PUBLIC WORKS, ETC.	85.7	49.2	165.2
USDC/EDA	ECONOMIC DEVELOPMENT—SUPPORT FOR PLANNING ORGANIZATIONS	13.1	61.1	19.1
USDC/EDA	ECONOMIC DEVELOPMENT—TECHNICAL ASSISTANCE	4.8	32.6	9.9
USDC/EDA	ECON DEV & ADJ ASST PRG—SUDDEN ECON DISLOCATION, ETC.	86.4	35.7	120.0
USDC/NTIA	PUBLIC TELECOMMUNICATIONS—CONSTRUCTION AND PLANNING	0.7	36.2	13.3
DOD	COMMUNITY PLANNING ASSISTANCE FOR DEFENSE ADJUSTMENTS	0.7	6.7	1.6
HUD/CPD	COMMUNITY DEVELOPMENT BLOCK GRANTS/ENTITLEMENT GRANTS	4.2	0.2	3,959.0
HUD/CPD	COMMUNITY DEVELOPMENT BLOCK GRANTS/SMALL CITIES	20.9	52.9	61.4
HUD/CPD	INDIAN COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM	18.1	81.4	
HUD/CPD	CDBG/SECRETARY'S DISCRETIONARY FUND/TECHNICAL ASSISTANCE	0.3	2.2	9.0
HUD/CPD	CDBG/SECRETARY'S FUND—SPECIAL PROJECTS ¹	0.0	0.5	
HUD/PIH	INDIAN COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM	6.8	73.3	50.0
DOT/FAA	AIRPORT IMPROVEMENT PROGRAM	192.0	11.6	1,450.0
DOT/FHA	HIGHWAY PLANNING AND CONSTRUCTION	4,470.6	22.1	20,830.0
DOT/FTA	URBAN MASS TRANSPORTATION CAPITAL IMPROVEMENT GRANTS	36.2	1.8	2,018.3
DOT/FTA	URBAN MASS TRANSPORTATION CAPITAL AND OPERATING FORMULA	3.4	0.1	2052
EPA	CONSTRUCTION GRANTS FOR WASTEWATER TREATMENT WORKS	11.4	74.5	
USDC	ECONOMIC DEVELOPMENT—STATE AND LOCAL ECONOMIC PLANNING	0.2	8.7	5.3
USDC/NTIA	TELECOMMUNICATIONS AND INFORMATION INFRASTRUCTURE	1.4	14.2	18.5
DOD	MILITARY BASE REUSE STUDIES AND COMMUNITY PLANNING	4.5	11.2	26.6
HUD/CPD	COMMUNITY DEVELOPMENT BLOCK GRANTS/STATE'S PROGRAM	111.6	11.4	1,249.6
DOT/FRA	LOCAL RAIL SERVICE ASSISTANCE	15.9	46.6	0
DOT/FTA	PUBLIC TRANSPORTATION FOR NONURBANIZED AREAS	18.7	13.4	121.0
EPA	STATE PUBLIC WATER SYSTEM SUPERVISION & TECHNICAL ASSISTANCE	7.5	12.5	90.0
EPA	STATE UNDERGROUND WATER SOURCE PROTECTION	0.5	6.8	10.5
EPA	CAPITALIZATION GRANTS FOR STATE REVOLVING FUNDS	148.1	12.4	1,587.0
FEMA	DISASTER ASSISTANCE	252.1	6.8	2.9
FEMA	CONSOLIDATION OF MANY FEMA STATE PROGRAMS	29.0	18.6	
ARC	APPLACHIAN SUPPLEMENTS TO-FEED-GRAINS-IN-AID	N/A	N/A	196.9
ARC	APPLACHIAN DEVELOPMENT HIGHWAY SYSTEM	N/A	N/A	92.3
ARC	APPLACHIAN LOCAL DEVELOPMENT DISTRICTS	N/A	N/A	5.0

¹ Rural funding in fiscal 1994 was less than \$500,000.

N/A Indicates that county-level data were not available, so rural funding could not be estimated.

Source: Calculated by ERS from the Bureau of the Census, Consolidated Federal Funds Report, 1994, the Catalogue of Federal Domestic Assistance, 1996, and other miscellaneous agency budget sources.

the past two decades, the government has been reducing its direct lending activities in favor of programs, such as loan guarantees, that encourage greater private sector lending. However, many agencies continue to operate direct loan programs for specific borrowers qualifying for subsidized credit, such as victims of natural disasters and limited resource borrowers. In addition, direct loan programs are sometimes used to help capitalize financial institutions, such as USDA's Intermediary Relending Program which finances nonprofit revolving loan funds. While direct loan programs can require large administrative staffs and are a drain on the Federal budget, they are appropriate for delivering highly subsidized credit since, like grant programs, they maximize the Government's control over allocation decisions.

Through a network of thousands of county, district, and State offices, the USDA administers a wide range of direct loan programs for farmers and rural businesses, housing, and utilities. As the size of many of these programs has shrunk, direct loans have increasingly been reserved for those unable to pay market rates of interest.²⁶ The Farm Service Agency (FSA) provides direct loans to farm operators unable to obtain credit elsewhere at reasonable rates and terms. These loan programs go back to the Resettlement Administration of the Great Depression and have served as the Federal Government's primary credit safety net for agricultural producers over much of this period. Today, FSA direct loan funds are largely reserved for beginning and limited-resource farmers. The Department's direct electric and telecommunications loans are made primarily to rural cooperatives and companies that serve sparsely populated, high-cost areas. Direct loans still play a sizeable role in the Department's rural housing and public infrastructure programs, but here too guaranteed loan programs are growing more important (table A-9).

²⁶ Nearly half of direct farm loan debt originated in fiscal 1995 was made at the limited-resource (subsidized) rate of interest. Limited-resource rates are set at half the government's cost of borrowing, but not less than 5 percent. The interest rate on emergency disaster loans is only 3.75 percent, while the rate for the beginning farmer down payment and joint financing programs is 4 percent. Even the "unsubsidized" rate on direct farm loans is below the market rate on loans of similar risk since it cannot exceed the government's cost of borrowing, plus 1 percentage point.

Direct loan programs are less prevalent in other Federal agencies. HUD operates a direct loan program to provide housing finance for the elderly and handicapped, and the Department of Veterans Affairs operates a similar program for disabled veterans. The SBA's disaster loan program also provides direct loans with below-market interest rates for businesses and homeowners who have suffered losses due to physical disasters (floods, earthquakes, hurricanes, etc.). But these and most other Federal agencies rely heavily on insured or guaranteed loans to disburse their credit assistance, and use direct loans for special cases. In fiscal 1994, of the direct loan funds received by rural borrowers, over 95 percent came from USDA.

One major exception to the trend of reserving direct loans for those in the greatest financial need is the direct loan program operated by USDA's Commodity Credit Corporation (CCC). The CCC is a wholly owned Government corporation that provides credit to farm producers and processors. CCC nonrecourse commodity loans are available for a number of agricultural commodities. The primary objective of these loans is to provide producers with a minimum price for their commodities rather than providing credit per se. Because significant subsidies can be involved, the use of direct loans and support payments allows the CCC to control and target program outlays; the fact that most program participants qualify for commercial credit is immaterial.

Under the nonrecourse loan program, farmers or processors who comply with program provisions can pledge a portion of their crop as collateral and obtain a loan from the CCC based on the established price of the pledged commodity. If market prices are above the loan rate when the loan expires or is repaid, the farmers' crops are sold on the market and the loan principal plus interest is repaid to the CCC. If market prices are below the loan rate, loans are repaid at less than face value.²⁷ CCC loan activity

²⁷ Marketing loan provisions were first authorized by the Food Security Act of 1985 allowing producers to repay nonrecourse loans at less than the announced loan rates whenever the world price or loan repayment rate for the commodity is less than the loan rate. Marketing loan provisions became mandatory for soybeans and other oilseeds, upland cotton, and rice and were permitted for wheat, feed grains, and honey under amendments made by the Food, Agriculture, Conservation, and Trade Act of 1990. The 1996 Act retains the marketing loan provisions for feed grains, wheat, rice, upland cotton, and oilseeds.

Table A-9—Federal direct loan programs for economic development*Agriculture is the primary beneficiary of Federal direct loan programs.*

Department/ Agency	Program name	FY-94 rural funding:		FY-96
		Total	Share of U.S. total	U.S. total
		<i>\$ million</i>	<i>Percent</i>	<i>\$ million</i>
AGRICULTURE				
		4,047.0	56.4	6,459.0
USDA/CCC	COMMODITY LOANS	3,345.9	53.1	5,699.8
USDA/FSA	EMERGENCY LOANS	119.5	83.1	109.0
USDA/FSA	FARM OPERATING LOANS	515.1	79.5	579.2
USDA/FSA	FARM OWNERSHIP LOANS	63.0	78.1	70.0
USDA/FSA	SOIL AND WATER LOANS	2.6	91.6	0.0
USDA/FSA	INDIAN TRIBES AND TRIBAL CORPORATION LOANS	0.7	100.0	0.9
HOUSING				
		1,507.9	53.0	1,222.9
USDA/RUS	FARM LABOR HOUSING LOANS	6.6	41.9	15.2
USDA/RUS	VERY LOW AND LOW INCOME HOUSING LOANS	1,126.8	48.7	1,016.2
USDA/RUS	RURAL HOUSING SITE LOANS	0.1	100.0	1.2
USDA/RUS	RURAL RENTAL AND COOPERATIVE HOUSING LOANS	357.3	72.9	152.5
USDA/RUS	VERY LOW-INCOME HOUSING REPAIR LOANS	17.0	79.3	37.8
VA/VBA	VETERANS HOUSING—DIRECT LOANS FOR DISABLED VETERANS	N/A	N/A	0.0
BUSINESS				
		343.8	7.8	181.5
USDA/RBS	INTERMEDIARY RELENDING PROGRAM	43.4	57.7	37.6
SBA	ECONOMIC INJURY DISASTER LOANS	117.7	39.2	143.0
SBA	LOANS FOR SMALL BUSINESSES	1.4	26.1	0.0
SBA	PHYSICAL DISASTER LOANS	174.1	4.3	0.9
SBA	HANDICAPPED ASSISTANCE LOANS	3.6	37.1	0.0
SBA	VETERANS LOAN PROGRAM	3.4	27.2	0.0
COMMUNITY DEVELOPMENT				
		1,541.7	69.7	2,367.4
USDA/RUS	WATER AND WASTE DISPOSAL SYSTEMS FOR RURAL COMMUNITIES	486.3	71.5	546.5
USDA/RBS	COMMUNITY FACILITIES LOANS	106.4	70.0	207.6
USDA/RUS	RURAL ELECTRIFICATION LOANS	504.4	60.3	935.2
USDA/RUS	RURAL TELEPHONE BANK LOANS	N/A	N/A	175.0
USDA/RUS	RURAL TELEPHONE LOANS	433.0	82.0	490.0
USDA/RUS	RURAL ECONOMIC DEVELOPMENT LOANS	11.6	85.9	13.1

¹ The Consolidated Federal Funds Report combined USDA's direct and guaranteed rural housing loans and reported the total as direct loans in 1994.

N/A Indicates that county level data were not available, so rural funding could not be estimated.

Source: Calculated by ERS from the Bureau of the Census, Consolidated Federal Funds Report, 1994, the Catalogue of Federal Domestic Assistance, 1996, and other miscellaneous agency budget sources.

has declined for most supported commodities since passage of the Food Security Act of 1985. Still, annual CCC lending has averaged \$7.6 billion over the last 5 years.

Guaranteed/Insured Loan Programs—Loan guarantees and insurance now dominate Federal agency lending activities. With a loan guarantee or insurance program, the Government leaves the origination and servicing aspects to private lenders, which many believe have comparative advantages over Government agencies in these activities. The guarantee/insurance lowers or completely removes the risk of default losses on loans to qualified borrowers, increasing lenders' willingness to supply them with credit. The fact that the loans are backed by the Federal Government also reduces the amount of capital lenders are required to hold on outstanding loans and increases their liquidity. The increased liquidity resulting from Federal loan guarantees/insurance may allow participating lenders to make more loans—of all types—than they would otherwise.

Loan guarantee/insurance programs without explicit interest rate subsidies need not require large administrative staffs or annual appropriations if they are designed to be self-financing. If the basis of the program is that the private sector is not properly evaluating creditworthy loans, then subsidized interest rates should not be necessary; fees and coinsurance can reduce or eliminate taxpayer support. If, however, the basis of the program is that a class of borrowers cannot afford commercial rates of interest, then subsidized interest rates are required, as is an administrative staff to insure that program beneficiaries meet eligibility criteria. Both self-financing loan programs and guaranteed/insured loans with explicit interest rate subsidies are relatively rare; most guaranteed and insured loan programs fall in the middle, providing implicit subsidies to program participants by shouldering a portion of the program's operating costs.

The major Federal guaranteed/insured loan programs of importance to rural communities are loan guarantees offered by the Farm Service Agency, the Rural Housing Service, the Rural Business-Cooperative Service, SBA's small business loan guarantees, and mortgage insurance programs operated by the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) (table A-10). FSA's farm

loan guarantees typically cover 90 percent of loan losses, although for beginning farmers and "graduating" direct loan program borrowers, up to 95 percent of losses can be covered. Loan terms are negotiated between the borrower and the lender, with FSA limiting the interest rate to that which applies to similar unguaranteed loans made by the lender. The SBA primarily guarantees small business loans made by commercial banks and other private originators. SBA's guarantees vary from program to program and with the size of the loan, but most are in the 75 to 80 percent range. As with the FSA guarantee programs, loan terms are negotiated between the borrower and the lender, with SBA specifying maximum interest rates and fees. But the largest such programs are for moderately priced housing. The Federal Housing Administration's Section 203(b) program provides mortgage insurance to qualified borrowers for loans up to \$155,250. The Department of Veterans Affairs provides insurance on privately originated home mortgages for qualified veterans. FHA covers 100 percent of the housing loans it insures while VA provides a dollar limit, ranging from \$36,000 to \$50,750 depending on the loan size, and on the amount of losses it will cover. All of the major loan guarantee/insurance programs require the borrower or lender to pay a fee for the guarantee, although these vary widely from program to program. Fees collected on the main insured housing loan programs operated by FHA and VA appear to be sufficient to cover loan losses. Those collected from farmers and small business borrowers appear to be too low to cover program losses in the long run.

Housing accounted for two-thirds of the federally guaranteed/insured loans received by rural borrowers in 1994, with the remainder going mostly to farms and to other rural businesses. Only about 15 percent of the guaranteed/insured loan funds going to rural borrowers was from USDA programs.

Technical Assistance—Various Federal agencies provide technical assistance directly to farmers, businesses, and communities. Technical assistance helps to plan and implement credit-financed development. For example, the USDA's Extension Service provides technical assistance to rural farmers, businesses, and communities throughout the Nation, through university extension staff and county extension agents. The Economic Development Administration provides

Table A-10—Federal guaranteed/insured loan programs for economic development*Most federally guaranteed/insured loan funds are for housing.*

Department/ Agency	Program name	FY-94 rural funding:		FY-96
		Total	Share of U.S. total	U.S. total
		<i>\$ million</i>	<i>Percent</i>	<i>\$ million</i>
AGRICULTURE				
		1,490.5	81.0	2,385.1
USDA/FSA	FARM OPERATING LOANS	1,052.4	81.0	1,654.1
USDA/FSA	FARM OWNERSHIP LOANS	437.4	81.0	535.0
USDA/FSA	INTEREST ASSISTANCE PROGRAM			196.0
USDA/FSA	SOIL AND WATER LOANS	0.8	91.6	0.0
HOUSING				
		7,027.4	5.9	82,751.4
USDA/RHS	VERY LOW AND LOW INCOME HOUSING LOANS ¹	N/A	N/A	1,700.0
HUD	REHABILITATION MORTGAGE INSURANCE	12.0	4.6	533.9
HUD	MANUFACTURED HOME LOAN MORTGAGE INSURANCE	32.2	44.2	162.0
HUD	MORTGAGE INSURANCE—HOMES	4,848.0	5.3	50,144.6
HUD	—LOW AND MODERATE INCOME FAMILIES	17.8	12.6	99.2
HUD	—PURCHASE OF UNITS IN CONDOMINIUMS	125.5	1.6	2,700.6
HUD	—RENTAL HOUSING FOR MODERATE INCOME	15.4	3.9	782.3
HUD	—RENTAL HOUSING FOR THE ELDERLY	1.4	35.1	0.0
HUD	—RENTAL HOUSING IN URBAN RENEWAL AREAS	0.0	0.0	38.1
HUD	PROPERTY IMPROVEMENT LOAN INS—NONRESIDENTIAL STRUCTURES	73.3	17.7	1,595.0
HUD	SUPPLEMENTAL LOAN INSURANCE—MULTIFAMILY RENTAL HOUSING	3.8	4.4	145.3
HUD	MORTGAGE INSURANCE—EXISTING MULTIFAMILY HOUSING	52.1	7.2	804.3
HUD	SINGLE-FAMILY HOME MORTGAGE COINSURANCE	0.1	0.1	
HUD	MORTGAGE INSURANCE—2 YEAR OPERATING LOSS/ SECTION 223(D)	37.3	7.3	10.5
HUD	MORTGAGE INSURANCE—MEMBERS OF THE ARMED SERVICES	0.8	26.9	2.5
VA	VETERANS HOUSING—GUARANTEED AND INSURED LOANS	1,807.8	9.9	24,032.3
VA	VETERANS HOUSING—MANUFACTURED HOME LOANS	0.1	35.5	0.9
BUSINESS				
		1,893.3	21.9	13,343.4
USDA/RBS	BUSINESS AND INDUSTRIAL LOANS	153.0	61.6	699.7
SBA	SMALL BUSINESS INVESTMENT COMPANY LOANS	N/A	N/A	347.7
SBA	SMALL BUSINESS LOANS, SECTION 7(a)	1,333.4	21.6	7,323.0
SBA	STATE AND LOCAL DEVELOPMENT COMPANY LOANS	19.2	54.3	0.0
SBA	BOND GUARANTEES FOR SURETY COMPANIES (Insurance)	161.3	18.0	2,530.0
SBA	CERTIFIED DEVELOPMENT COMPANY LOANS (504 LOANS)	226.5	17.5	2,443.0
COMMUNITY DEVELOPMENT				
		24.2	6.1	1,253.4
USDA/RUS	WATER AND WASTE DISPOSAL SYSTEMS FOR RURAL COMMUNITIES	4.6	88.4	50.0
USDA/RBS	COMMUNITY FACILITIES LOANS	10.2	39.2	74.7
HUD	MORTGAGE INSURANCE—HOSPITALS	0.0	0.0	350.0
HUD	MORTGAGE INSURANCE—NURSING HOMES, ETC.	9.4	2.9	778.7

¹ The Consolidated Federal Funds Report combined USDA's direct and guaranteed rural housing loans and reported the total as direct loans in 1994.

N/A Indicates that county level data were not available, so rural funding could not be estimated.

Source: Calculated by ERS from the Bureau of the Census, Consolidated Federal Funds Report, 1994, the Catalogue of Federal Domestic Assistance, 1996, and other miscellaneous agency budget sources.

technical and business assistance to small- and medium-size manufacturers (plants with fewer than 500 employees) through its Manufacturing Extension Partnership program, which operates in over 300 locations nationwide. The Small Business Administration helps small businesses put together business plans and provides other such assistance to small businesses through its Small Business Development Centers.

Technical assistance is unique as a credit-enhancement technique since it fundamentally improves the quality of credit demand rather than its supply. Credit (unless it is merely a disguised income transfer) requires repayment. In order to qualify for commercial credit, households, businesses, and governments must demonstrate the potential to satisfactorily make loan payments on a timely basis. Through its technical assistance programs, the Federal Government improves the ability of recipients to carefully manage their household, business, or public budgets, thereby improving their qualifications for commercial loans. The supply of credit is not altered *per se*, but its availability to underserved populations may be.

State and Local Government Programs—In addition to the Federal Government, State and local governments often have active financial assistance programs for farmers, businesses, housing, and community development. Through loans, loan guarantees, grants, and technical assistance, State and local governments supplement the efforts of the private sector and the Federal Government to spur development, improve living conditions, and provide public services within their jurisdictions. State intergovernmental assistance is a major source of funding for many public infrastructure projects undertaken by rural communities. And economic development agencies at the State and local level rely on a wide range of financial incentives to spur local economic development. However, with the exception of intergovernmental assistance programs, State financial assistance programs tend to be small compared with Federal programs. For example, in 1993-94, the total outstanding loan balance for all known State-sponsored agricultural credit programs was approximately \$1.8 billion. By comparison, USDA's direct loan programs for farmers had an outstanding balance of

\$14 billion at the end of fiscal year 1993 (Wallace, Erickson, and Mikesell, 1994).

Like the Federal Government, State and local governments have been reducing direct on-budget financial assistance in favor of programs that limit the State's exposure to financial losses while influencing the financing decisions of private financial institutions. Seeding revolving loan funds and venture capital funds or supplementing Federal assistance to these types of entities is a common approach. Two popular techniques for providing financial assistance not used by Federal agencies include tax-exempt bond programs and linked-deposit programs.

State and local governments have long used tax-exempt bonds to provide loanable funds to financial institutions or directly to borrowers. Examples include mortgage loans for first-time home buyers, real estate loans for beginning farmers, and industrial development bonds for new business firms. Because holders of tax-exempt securities do not pay Federal income tax on their interest earnings, State and local governments can sell bonds at rates much lower than those paid on taxable securities. In the case of mortgages, funds are passed through to banks and other lenders who identify applicants and originate loans carrying below-market interest rates. These programs are popular because they allow State and local governments to assist favored projects without incurring any costs themselves.

Nevertheless, tax-exempt financing imposes hidden costs on the public, and the practice of assisting privately owned firms has raised concerns about efficiency and fairness. Tax-exempt securities mean lost tax revenue at the Federal level, revenue that must be made up by borrowing or raising taxes. In addition, a sizeable portion of the Federal subsidy goes to investors rather than to the issuer of tax-exempt securities.²⁸ The Tax Reform Act of 1986 addressed these issues by limiting the use of tax-exempt bonds for nongovernmental purposes. The legislation also reduced demand for tax-exempt bonds by reducing marginal tax rates, imposing a minimum tax covering interest earned on tax-exempt bonds, and eliminating

²⁸ There are also economic costs due to a misallocation of resources if funds borrowed for such programs "crowd out" other, more productive borrowers.

a tax deduction given to commercial banks for interest expenses incurred in purchasing tax-exempt bonds.

Linked-deposit programs represent a similar approach used by many States to influence the cost and availability of credit. State revenues are deposited in participating commercial banks (or other depository institutions). In return for earning below-market rates of interest on its deposits, the State requires the bank to make loans to borrowers deemed underserved by commercial credit providers. Interest rates charged on these loans are typically tied to the rate paid on State deposits; for example, deposit rate plus 3 percentage points. The benefit is that a targeted group of borrowers—beginning farmers, new home buyers, small business owners—have greater access to credit at lower rates than they might otherwise receive. The cost of the program is the forgone interest the State could have earned on its deposits at market rates of interest. But all loan obligation and servicing costs remain with the lender, as do any future loan losses, so linked-deposit programs stay off-budget and impose no contingent liabilities on the State.

Other Sources of Capital

In addition to the various public and private financial institutions and programs that exist to collect and reallocate financial capital, either for profit or in pursuit of the social good, capital is also supplied by a number of nonfinancial entities. While these entities exist primarily for nonfinancial pursuits, some are regular and highly proficient financial service providers.

Nonfinancial entities fill important niches in the rural financial market, providing financing unavailable from financial institutions, or available only at higher costs. Even so, relatively few financial institutions provide equity capital to small rural businesses. Thus, by default, nonfinancial entities are the dominant source of equity financing in most rural communities. In addition, the fixed cost of originating a secured loan can make it difficult for commercial lenders to make much of a profit on smaller loans (under \$50,000). Yet, it is quite common for machinery, equipment, and even smaller parcels of land to cost less than \$50,000. Nonfinancial entities have proven adept at holding down the transaction costs

on many types of smaller loans, offering a cheaper source of credit to eligible borrowers.

Since these “financiers” are unregulated and generally fall outside traditional credit delivery channels, the main source of information on their importance comes from borrower surveys. As a result, little is known about their motivations, lending capacities, or earnings.

Individuals—Family, friends, acquaintances, and personal savings are important sources of financial capital for many prospective entrepreneurs and home buyers. Most of the equity capital (downpayment) needed for home purchases comes from personal savings or as gifts from family members. Likewise, entrepreneurs rely almost exclusively on personal savings, supplemented with personal credit and funds from family, friends, and acquaintances to finance new business startups. Individual property owners often provide financing as part of a property sale. For example, individuals held nearly 23 percent of the outstanding farm real estate debt in 1995 as mortgages or installment land contracts.

As lenders, individuals may fill gaps left by commercial sources of credit. Credit gaps are more likely to affect borrowers who have limited credit histories, are less wealthy, and are attempting to borrow when lending costs are high. Based on the experience of farm borrowers, USDA studies have shown that younger operators are more likely to utilize individual financing for real estate purchases. Individuals are also more important sources of credit in States with restrictive foreclosure laws, in regions with volatile farmland markets, and during periods of tight credit.

An important component of the “individuals” category for new rural businesses consists of informal investors, sometimes referred to as “angels.” Informal investors provide most of the external risk capital used by small firms. While this is perhaps the least documented segment of financial markets, surveys suggest that about 750,000 individual investors are active in the venture capital market, providing \$20 billion in equity capital each year.²⁹ Informal

²⁹ Estimates of the annual supply of equity capital from informal investors vary considerably, from as low as \$10 billion (Freear, Sohl, and Wetzel) to as high as \$33 billion (Gaston).

investors tend to be wealthy and are often former business owners themselves. They make smaller investments than professional venture capital firms, but are more likely to supply the early-stage financing needed to get a business started, take greater risks, and invest for longer periods (Gaston). Angels invest their own funds, but quite often coinvest with friends, associates and, occasionally, professional venture capital funds. Because these networks are informal, and because angels often prefer to be involved in managing the firms they invest in, the market they typically operate within is very localized.

Merchants and Dealers—Merchants and dealers offer credit to their customers for a variety of reasons, including the desire to: (1) promote sales, (2) improve the seasonal distribution of sales, (3) generate a profit on credit operations, and (4) provide convenience to, and foster greater loyalty by, their customer. Trade credit has become an increasingly important source of capital to farms, rural businesses, and public agencies. Annual surveys of farm operators have clearly demonstrated this trend. From 1988 until 1993, there was rapid growth in the number of farm input suppliers offering credit and the volume of supplier credit extended. By 1993, manufacturers and dealers held 25 percent of the debt secured by non-real-estate assets owed by commercial-sized crop farms.³⁰

As with individual seller financing in real estate transactions, trade credit appears to fill credit gaps in the non-real-estate farm debt market. While merchants and dealers serve all farm sizes and operators of all ages, they are relied upon most heavily by younger, financially stressed farm operators and smaller farms. Also, the use of trade credit was more common in regions characterized by recent land value instability and in regions adjacent to metropolitan areas where farm credit would likely represent a small share of the total business loan market.

Philanthropic Foundations—Finally, charitable foundations, such as the Ford Foundation, the Kellogg

Foundation, and the Rockefeller Foundation finance many early-stage community development projects. For example, Ford Foundations recently provided funding to help 6-10 high-poverty rural communities participate in a test of an experimental model of citizen team self-evaluation of community revitalization efforts as part of the “EZ/EC Learning Initiative” associated with the new Federal Empowerment Zone/Enterprise Community program. In some cases, foundations provide low-cost loans to finance development. For example, the Housing Assistance Council’s loan fund relies on loans from private foundations and religious institutions to provide 3-year predevelopment loans to various groups, such as local developers, nonprofits, and local housing authorities. Their aim is generally to demonstrate the impact of a new development technique; they do not fund projects on an ongoing basis, nor are they a source of assistance for routine activities. The goal of many philanthropic foundations is to help underserved populations develop the human capital and social infrastructure needed to support economic development. As a result, community leadership training, public policy network development, and pilot projects for innovative solutions to a community’s problems have received foundation grants in the past. In a sense, philanthropic foundations provide start-up financing for risky but promising community projects, much like venture capitalists provide risk capital to the business sector. The pay-offs each receives are very different, and the amount of financial support foundations provide is minuscule compared with that of venture capitalists, but the goal is the same—to pick winning strategies and help them succeed.

Conclusion

Credit markets are segmented along several dimensions. This appendix describes many capital sources that are at least potentially available to rural governments, individuals, and businesses. But for a specific person or business, purpose, and location, the number of different types of capital sources and the number of firms of a given type can both vary substantially. This observation has implications for the availability of rural credit and the cost at which it can be obtained.

³⁰ Through leasing arrangements, individual landlords, manufacturers, and dealers provide physical capital to rural businesses, households, and development organizations. Leases substitute for financial capital since they effectively transfer control of assets without requiring the financing that would be involved in transferring ownership of those same assets.

Commercial banks serve a diverse group of credit needs, but they do not make equity investments. Also, large banks tend to deal with large businesses, and there are concerns about whether rural offices of large urban banks effectively serve their rural customers. Savings and loans and credit unions have financial products similar to those of banks, but they concentrate on mortgages and consumer loans, respectively, and their rural presence does not compare to that of banks. The Farm Credit System is a strong competitor in the agricultural sector but is currently precluded from serving the broader credit needs of rural America. Rather than making loans themselves, the housing GSE's facilitate mortgage lending by banks, thrifts, and mortgage brokers who may not be equally active in all types of rural communities. Government programs try to fill in some of the holes, but loan guarantee programs operate through private financial institutions and therefore may not help much if the underlying problem is a lack of financial institutions.

The diversity of financial market conditions in rural America makes blanket statements about rural credit cost and availability meaningless to specific borrowers. Aggregate data suggest that the rural banking sector is an active lender for a wide range of borrowers and that other lending institutions fill important niches in the rural credit market. Yet knowledgeable practitioners from community organizations and other rural observers often assert that many rural communities lack adequate credit access. For example, they state that banks do not make mortgage loans in some communities because secondary markets do not operate in those areas, yet we know that mortgage holdings are important for rural banks as a group. This apparent contradiction may be explained by differences across rural communities related to factors such as their population and proximity to metro areas. Small, isolated rural communities often have a thin financial market infrastructure in the sense that they are served by relatively few, small local financial institutions, giving rise to credit conditions that differ substantially from those found in the overall rural economy.

Financial institutions and other financial market participants are extremely adept at taking advantage of profitable opportunities by filling niche markets, adopting new technological and market innovations,

and refining their business plans. Large financial institutions already blanket the country with credit card solicitations by mail, and credit-scoring models automate the application process. In time, the Internet will be widely used in a similar fashion for mortgage products. However, not all rural communities will benefit equally. Credit-scoring models that do not incorporate rural features such as the prevalence of manufactured housing or work histories that involve multiple jobs can be a disadvantage for many rural borrowers. And the potential for business credit is more problematical, since standardized business loans suitable for a secondary market do not yet exist.

Competition among financial service providers ensures that, in time, financial market innovations will benefit borrowers by making financing more readily available or lowering its cost. In our economy, more competitors generally results in more products sold, lower prices, and higher quality. For the current context, that means more loans approved, lower interest rates, and a wider variety of innovative loan contracts. Isolated rural communities, with their limited profit potential, find it difficult to support competitive financial markets. As a result, the benefits of a competitive financial market system may be slow in coming to some borrowers.

References

- Alleva, L.M., "Is There a Capital Gap in the South? Price Waterhouse Venture Capital Survey Observations," Southern Growth Policies Board Conference on Financing High-Growth Entrepreneurialism, Charlotte, NC, June 1996.
- American Council of Life Insurance, *1995 Life Insurance Fact Book Update*, Washington, DC, 1995.
- Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, Federal Reserve Statistical Release, Washington, DC, Sept. 1996.
- Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*. Washington, DC: The Congress of the United States, May 1996.
- Dodson, C.B., and Koenig, S.R., "Niche Lending in Agriculture," *Journal of Agricultural Lending*, Vol. 8, Issue 4, Summer 1995, pp. 14-20.

Florida, R., and Smith, D.F., Jr., "Venture Capital, Innovation, and Economic Development," *Economic Development Quarterly*, Vol. 4, No. 4, Nov. 1990, pp. 345-360.

Freear, J., Sohl, J.E., and Wetzel, W.E., Jr., "The Private Investor Market for Venture Capital," *The Financier*, Vol. 1, No. 2, May 1994, pp. 7-15.

Gaston, R. J., "Financing Entrepreneurs: The Anatomy of a Hidden Market," in Bingham, R.D., Hill, E.W., and White, S.B. (eds.), *Financing Economic Development: An Institutional Response*. Newbury Park, CA: Sage Publications, 1990, pp. 266-284.

Koenig, S.R., and Ryan, J.T., "Farm Loan Volume Prospects for the New Farmer Mac," Regional Research Committee NC-207: *Regulatory, Efficiency, and Management Issues Affecting Rural Financial Markets*, New York, Sept. 1996.

Koenig, S.R., and Dodson, C.B., "Comparing Bank and FCS Farm Customers," *Journal of Agricultural Lending*, Vol. 2, Issue 2, Winter 1995, pp. 24-29.

Lenzi, R.C., "Rural Development Finance Gaps: Bank CDCs as an Alternative," *Journal of the Community Development Society*, Vol. 23, No. 2, 1992, pp. 22-38.

Stam, J.M., Koenig, S.R., and Wallace, G.B., *Life Insurance Company Mortgage Lending to U.S. Agriculture: Challenges and Opportunities*, AER-725. Washington, DC: Economic Research Service, U.S. Department of Agriculture, 1995.

U.S. Department of Agriculture, *Rural Conditions and Trends: Federal Policy*, Vol. 7, No. 2, Dec. 1996.

U.S. Department of Housing and Urban Development, *Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility*. Washington, DC: Office of Policy Development and Research, July 1996.

U.S. Department of the Treasury. *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*, Washington, DC, July 1996.

Wallace, G.B., Erickson, A., and Mikesell, J.J., *Handbook of State-Sponsored Agricultural Credit Programs*, Staff Report No. 9426. Washington, DC: Economic Research Service, U.S. Department of Agriculture, 1994.

Wetzel, W.E., Jr., "Economic Policy in an Entrepreneurial World: Seven Treacherous Misconceptions and Half-Truths," *Venture Capital Journal*, Aug. 1995, pp. 52-54.