# Commentary: Liquidity and Competition in Rural Credit Markets

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Good morning. It is a pleasure to be here today and to comment on the thoughtful paper by Peter Barry and Paul Ellinger. This paper has two parts, and both make important contributions to the search for new sources of credit for rural America.

The first part of the paper uses bank call report data and other information to generate measures of bank profitability, liquidity, asset-liability structures, and—-perhaps of most value—-levels of economic concentration. These measures are broken down by bank location and characteristics of the relevant county. Perhaps the most interesting finding relates to the high degree of bank concentration, especially in rural counties compared to metro counties.

This part of the paper concludes that fund availability at rural banks is a long-standing and perplexing issue. Numerous initiatives have responded to this issue, but few have had much success. Innovations generally seem to come too late, with their effectiveness blunted by new emerging problems and developments (p. 5).

The second part of this paper provides a useful summary of two recent proposals to address the same issue. This time, the idea would be to give rural banks access to funding from government sponsored enterprises (GSEs), either from the Farm Credit System or from the Federal Home Loan Bank System, with expanded asset powers (the Enterprise Resource Bank concept).

The authors conclude that it would be unwise to try to provide rural commercial banks with access to the Farm Credit Banks for funds, because of the conflicts of perceived interest and disincentives that would be involved. They do suggest that it may be worth trying to provide access to the Federal Home Loan Banks.

I respectfully disagree with respect to this last suggestion, for a number of reasons. First, the use of either GSE to provide collateralized loans (known as "advances") involves an outmoded and cumbersome lending tool. Just look at the figures in this paper: almost half of the members of the Federal Home Loan Bank System don't take advances. They belong to the system in large part just to receive dividends.

Second, only about 10 percent of current advances average six or more years in maturity; over half of all advances average only one year in maturity. In other words, access to advances is a passive and inefficient tool. If rural banks have concerns about credit risk or some of the longer term factors suggested by Marvin Duncan last night, then they will continue to be reluctant to make longer term loans. The availability of longer term advances is likely to alter such decisions only at the margin.

It is much more effective simply to provide credit enhancements for particular types of assets. A good model is the way that loan guarantees from the Small Business Administration (SBA) permit banks to extend the maturity of loans that they are willing to make and to make loans to borrowers that otherwise might not have access to credit.

The third drawback to collateralized advances relates to the issue of bank capital. For a collateralized advance, capital is required at two levels: both for the Federal Home Loan Bank that makes the advance and for the commercial bank that uses the borrowed funds to make additional loans. Capital is needed for both institutions because they each have their own set of financial risks: credit risk, interest rate risk, and management and operations risk.

Fannie Mae and Freddie Mac have been able to push portfolio lenders to the periphery of the residential mortgage market. This has occurred in good part because the capital standards for Fannie Mae and Freddie Mac are markedly lower than the requirements imposed upon other financial institutions by the Basle Accords and federal regulators.

The need for capital at two levels helps to explain why access to advances from the Federal Home Loan Banks was not sufficient to permit portfolio lenders to respond to Fannie Mae and Freddie Mac. When a Federal Home Loan Bank makes an advance to a thrift institution or other portfolio lender, capital is needed both in the Home Loan Bank and in the portfolio lender. By contrast, when Fannie Mae or Freddie Mac fund a mortgage, either in their own portfolios or through securitization, capital is required only for the GSE, and not for the mortgage banker that originated and sold the loan to the secondary market.

The requirement of capital at two levels means that access to collateralized advances is unlikely to enable rural commercial banks to compete effectively with many other types of lenders, except at the margins. Thus, Fannie Mae, Freddie Mac, Farm Credit institutions, Farmer Mac, and large out-of-state banks, for example, can fund loans directly and therefore require proper capitalization only for the lender that actually holds or securitizes the loan.

Of course, policymakers do have a choice: they could ignore the lessons of the Farm Credit System in the 1980s and the savings and loan debacle and permit access to GSEs without imposing prudent capital requirements. We have before us the recent example of forbearance on capital requirements that will permit Farmer Mac—if it succeeds—to operate at potentially exorbitant leverage.

This possibility raises the specter of Stanton's Law: *risk will migrate to the place where the government is least equipped to deal with it.* The hidden issue of GSEs is the way that they provide a public subsidy in the form of preferential capital requirements and unquantifiable risks.

Such an option would fail to bring rural markets forward into the world of enhanced competition and new technologies and new ways to provide credit more effectively. Instead, it would take us back to the mercantilist model when entrepreneurs with the most favorable charters captured the relevant markets and made the most money.

And that is my final comment on this fine paper: the real question for rural America is not whether a particular type of institution—-here the commercial bank—-has all of the access to funds that it would like. The real question is whether rural borrowers will gain necessary access. By starting with commercial banks, this paper provides a solid basis for exploring that larger issue.