SECTION 7

FINANCING NON-METROPOLITAN AMERICA

Non-metropolitan America, including rural areas, and smaller cities and towns, presents a special set of challenges to the financial industry. Its demographic characteristics and property markets are markedly different from those of metropolitan areas. Key attributes include remoteness, lower population density, high poverty rates, lack of housing opportunities and limited economic diversity. Historically, these factors have combined in different non-metropolitan areas to result in generally thin markets for financial products and services whose providers are subject to uneven levels of regulatory oversight. However, non-metropolitan areas have begun to experience the national trend towards consolidation. The decline in community-based small banks and the increasing presence of larger regional and national players herald change in the provision of financial services to rural communities, and suggest the need to rethink the role of CRA regulations in non-metropolitan America.

BACKGROUND

Non-metropolitan areas are those lying outside of federally-defined Metropolitan Statistical Areas. In 1993 the U.S. had 2,276 non-metropolitan counties, accounting for 83 percent of the nation's land area and 21 percent of its population (USDA, 1997). Households and housing stock in these counties are different than those in MSAs. Though home prices are often low, affordability can be a problem because incomes are also low, and poverty rates are high (45 percent of rural households are low-income, 19 percent are below the poverty level). Even though rural areas contain 22 percent of all occupied housing units in the U.S. and tend to have higher homeownership rates (at 75 percent) than urban areas, more than one in five rural households are cost-burdened (Housing Assistance Council, 2000). This translates into 5 million households spending more than 30 percent of their monthly income on housing (National Rural Housing Coalition, 2000). Poor quality housing is also more common in non-metropolitan areas where eight percent of units are moderately or severely inadequate (Housing Assistance Council, 2000). Meanwhile, rural households tend to be older and less racially diverse than in the rest of the country. The nature of rural property also differentiates rural from urban markets. Site-built housing units often do not meet standard mortgage underwriting criteria due to their tendency to be larger and built on non-conforming sites, located in sparsely developed areas, contain numerous out-buildings, combine business and residential uses, include sub-standard buildings, and be served by under-developed infrastructure (Strauss, 1999).

Manufactured housing constitutes a significant share of the overall housing inventory in non-metropolitan areas. In fact, half of the 6.8 million occupied manufactured housing units in the U.S. are located outside MSAs, where they comprise 15 percent of occupied housing units, up from 13 percent in 1993. The prevalence of manufactured housing reflects not only the challenges of site-built construction in rural areas and rural residents' lower incomes, but also the relative difficulty of finding financing for conventional homes. Part of manufactured housing's appeal lies in the ease of placing a unit on a lot, which can be important in areas lacking well-developed construction and trade sectors. There is also limited scope for multi-family rental development, the tenure alternative for lower-income clientele. These factors combine with the relatively low cost of land to make manufactured housing an attractive option for lower-income rural residents.

Special rural population groups, such as migrant and seasonal farmworkers, marginal farm owners, and Native Americans, also present challenges to conventional lending in rural markets. A variety of conditions, including high mobility, extreme poverty, seasonal employment, land trust issues, title problems, and limited downpayment availability, serve as barriers to these prospective borrowers' qualification for conventional mortgages/financing. Migrant and seasonal farmworkers do not fit conventional mortgage markets due to their mobility and seasonal employment patterns. The Housing Assistance Council (1997) found that there are an estimated 670,000 such workers in the U.S., most subsisting below the poverty line. These workers suffer from the paucity of private rental housing in rural communities, compounded by the lack of rural access to housing subsidy programs. Non-profits are constrained in developing farmworker housing given the difficulty of packaging financially viable deals given the low incomes and short occupancy periods of workers. There are some subsidy programs that operate in rural areas, including those housing subsidy programs operated by USDA's Rural Housing Service (RHS), but at current funding levels, available housing assistance falls far short of addressing rural housing needs.

Despite sharing many characteristics, rural areas are heterogeneous. This is illustrated by the county typology of the USDA's Economic Research Service, which differentiates between eleven types of non-metropolitan counties according to their primary economic activity and other policy-relevant characteristics. Counties are classified into one of six distinct economic types – those that are dependent on: farming; mining; manufacturing; government; or services; and a final category of 'non-specialized counties' with economies that do not fit into one of the economic specializations. Counties are also classified into five overlapping policy types: retirement destinations; federal lands; commuting counties; persistent poverty counties; and transfers-dependent counties.

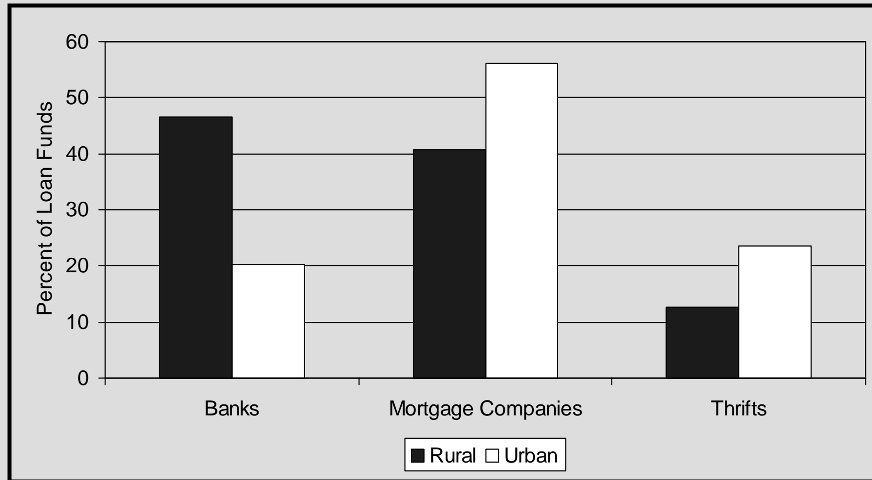
An analysis of population growth using this typology by McArdle (1999) illustrates the differing fortunes of non-metropolitan areas. All economic types experienced faster population growth over the 1990s than the 1980s, illustrating the national trend of population decentralization. Even so, the growth rates of farming and mining-dependent counties lagged considerably behind those of counties that are services- or government-dependent. Similarly, within the policy typology, retirement destination counties had the strongest growth, followed by counties in which federally-owned lands make up more then 30 percent of the land area. However, those counties classified as 'persistent poverty' or 'transfers-dependent' had dramatically slower growth rates than other types, illustrating the varying growth trajectories of differentially-endowed rural areas.

In combination, the characteristics of rural areas make designing suitable financial products and services a challenge. Non-conforming properties can make product development difficult. Cash-strapped workers with variable employment records present higher risks to lenders that can close off access to secondary markets. Serving such markets can pressure lenders toward uneconomic product proliferation or costly manual underwriting and case-by-case analysis.

INDUSTRY STRUCTURE AND MARKET CHARACTERISTICS

In non-metropolitan areas commercial banks are a much more important source of mortgage credit than in metropolitan areas (Exhibit 45). In 1995, banks originated over 46 percent of rural housing loans, greatly in excess of their 20 percent share of urban mortgage originations.

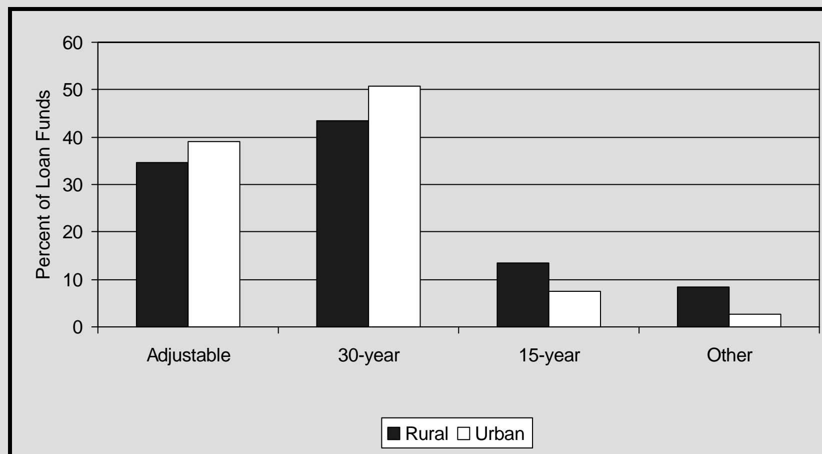
Exhibit 45: Banks Are Stronger in Rural Markets



Source: USDA Economic Research Service, *Credit in Rural America*. 1997

The terms on rural and urban mortgage products differ, with rural mortgages more likely to have shorter maturities. Thirty-year fixed and adjustable-rate mortgages constituted 80 percent of all rural mortgage lending, compared to 90 percent of the urban total (Exhibit 46). Other mortgage loans had fixed rates and a term usually less than 30 years.

Exhibit 46: Short Duration Mortgages More Common in Rural Areas



Rural interest rates are also on average higher than those in urban areas (Exhibit 47). Overall, fixed interest rate home mortgage loans were 17 basis points higher in rural than in urban areas in 1995. That same year mortgage company 30-year loans were 9 basis points higher in rural areas, and the rate on commercial bank 15-year loans was 27 basis points higher (USDA, 1997).

Less favorable loan terms for rural than urban borrowers, as reflected in higher credit costs and loans of shorter duration, have been linked to the lack of effective competition in rural financial markets because of small market sizes, barriers to entry and market segmentation. An assessment of rural financial markets found that the range of institutions involved is likely to be narrower than that serving urban communities, and competition for rural loans less keen, with the small size of rural communities and rural borrowers limiting the number of lenders that can profitably compete for rural loans (USDA, 1997).

Exhibit 47: Mortgage Interest Rates Higher in Non-Metropolitan Areas

	Loan Term					
	15 Year		30 Year		All Loans	
Lender Type	Urban	Rural	Urban	Rural	Urban	Rural
Thrifts	7.90	8.02	8.14	8.28	8.10	8.23
Mortgage companies	7.82	7.82	8.19	8.28	8.13	8.17
Commercial banks	8.06	8.33	8.26	8.20	8.24	8.50
All Lenders	7.89	8.08	8.19	8.25	8.15	8.32

Source: USDA Economic Research Service, *Credit in Rural America*, 1997

Most non-metropolitan areas do indeed have a limited range of financial institutions relative to metropolitan areas. Exhibit 48 presents data on the number of banking institutions in each of the nation's 813 urban counties and 2,276 rural counties. In 2000 some 533 (23 percent) non-metropolitan counties were served by 2 or fewer banks, compared to 25 (3 percent) metropolitan counties.

Exhibit 48: Rural Banking Markets Becoming More Competitive

	Urban			Rural		
	Number of counties			Number of counties		
Number of Banking Firms	1994	2000	Change	1994	2000	Change
None	0	0	0	20	23	2
1-2	34	25	-9	601	510	-91
3-5	178	108	-70	1,097	1,022	-75
6-9	280	254	-26	478	599	121
10 or more	321	426	105	80	123	43
Total counties	813	813		2,276	2,276	

Note: 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, which are treated as a single competitor.

Source: USDA Economic Research Service tabulations of June 30, 2000 Summary of Deposits file of the FDIC, and June 30, 2000 Report of Condition and Report of Income of the Board of Governors of the Federal Reserve System

It is important to note, however, that the banking industry is in a state of flux in non-metropolitan areas. Exhibit 48 shows an increase in the number of rural counties with three or more banking firms between 1994 and 2000, with over three-quarters of rural counties now in this category.

Exhibit 49 offers further evidence of the impact on rural counties of the national trends of consolidation in the banking industry detailed previously. The 1994-2000 period saw the decline of small, local banks in rural areas. Only 73 (3 percent) of rural counties are now served exclusively by local banking organizations (down from 204 or 9 percent in 1994), and 394 (or 17 percent) are served solely by small banking firms (compared to 726 or 32 percent in 1994). This decline was accompanied by a dramatic increase in the presence of large, out of area lenders. The share of counties served solely by non-local banking organizations is now approaching 50 percent, up from 32 percent just six years ago. Now 1,580 (or 69 percent) of non-metropolitan counties have at least one large banking firm compared to 1,320 (or 58 percent) in 1994.

Exhibit 49: Large Banks Are Expanding Into Rural Markets

	Urban			Rural		
	Number of counties			Number of counties		
Counties served by:	**1994**	**2000**	**Change**	**1994**	**2000**	**Change**
Only local banking firms	9	1	-8	204	73	-131
Only 'non-local' banking firms	173	264	91	729	1,057	328
Both local and non-local firms	631	548	-83	1,343	1,146	-197
Only small banking firms	34	7	-27	726	394	-332
At least one large banking firm	761	791	30	1,320	1,580	260
Total counties	813			2,276		

Notes: A local banking firm has all of its offices and affiliates in one county; all others are considered non-local, even if the banking firm includes a locally headquartered affiliate. A small bank or banking firm has assets of under $250 million; a large bank or banking firm has assets over $1 billion.

Source: USDA Economic Research Service tabulations of June 30, 2000 Summary of Deposits file of the FDIC, and June 30, 2000 Report of Condition and Report of Income of the Board of Governors of the Federal Reserve System

In summary, the structure of non-metropolitan financial markets is changing. Larger players are developing strategies to penetrate rural markets given the opportunities provided by the diversity of rural areas. Some are developing agricultural lending strategies, some are targeting smaller-tier but growing markets, and others are focusing on resort/retirement communities.

Though there are still some counties with limited competition, together these changes in the number and type of players in rural financial markets signal increased competition. There may be some concern regarding the diminished presence of local banks in rural markets, given the perceived greater responsiveness of community banks to local needs. However, the increase in the average number of banking firms per rural county bodes well. Larger lenders may benefit rural consumers via reduced prices as a result of enhanced technical capacity, greater access to

capital markets, greater economies of scale, access to secondary markets, and ability to diversify risk geographically.

REGULATORY CHALLENGES

It remains to be seen if some rural markets are too idiosyncratic and relationship-oriented to make larger networks successful. Characteristics of existing rural lenders such as conservatism with respect to (lower) loan-to-deposit ratios and (higher) capital-asset ratios relative to metropolitan lenders may in part be reactions to the riskier rural lending environment rather than a failure to employ the latest risk management techniques. Similarly, limited use of secondary markets by rural lenders may reflect the fact that a higher proportion of rural properties do not conform to secondary market criteria, making it difficult for lenders operating in these areas to reach the minimum scale to deal with Fannie Mae and Freddie Mac, rather than lenders' unwillingness to engage in these more 'sophisticated' financing arrangements.

Although much FHA lending is accomplished by mortgage lenders, rural banks' less frequent use of FHA programs can be seen to be a function of the fact that many rural banks have too little capital to be approved as FHA lenders, and the low volume of mortgage loans in some rural areas combined with the low FHA loan fees make the program unfeasible for some banks (Strauss, 1999). Indeed, rural households access government insurance programs at half the rates of their counterparts inside MSAs (National Rural Housing Coalition, 2000).

Government assistance specifically targeted to improve rural housing opportunities is provided by the Rural Housing Service (RHS), an agency of the USDA. The RHS provides a range of assistance, and is intended as a lender of last resort. Programs encompass multi-family funds, including farm labor and rural rental housing loans, and single-family funds such as direct rural housing loans. The RHS' emphasis has more recently shifted to guaranteeing mortgage loans made by private lenders. CRA requirements can be said to be helping to expand use of such programs because these loans help banks meet CRA requirements (Wilson and Carr, 1999). However, the share of rural home mortgages guaranteed by the RHS is still smaller than the rural market share insured by the FHA or the VA (USDA, 1997).

A further challenge is the lessened regulatory reach in non-metropolitan areas. This relates to the huge geographical scale and diversity of the areas under assessment, and the lessened scrutiny of lending patterns as CRA and HMDA are less potent in these areas. In an assessment of HMDA coverage of the mortgage market, Scheessele (1998) found that HMDA does not adequately measure mortgage market activity in non-metropolitan areas. Small lenders that do not originate loans in metropolitan areas are not even required to report to HMDA. Loans for properties located outside MSAs are reported if originated by a lender with substantial metropolitan activity, however, reporting outside of MSAs is subject to limits on the geographic detail of the information that is reported.

CRA's provision for less frequent performance evaluations for small banks means that regulatory pressure to meet borrowers' needs is less rigorous in rural areas. Case study interviews indicated that rural counties are also less likely to be included in a full scope CRA exam. This sampling bias is attributed to the need to assess large multi-state MSAs and other more populous areas where lending activity is greater. In addition, CRA allows small banks to be evaluated under less strenuous performance standards than large banks. Small banks are only evaluated on the proportion of loans within their assessment area, borrowers' profile and loan-to-deposit ratio. This makes the Act's impact weaker in those rural areas served disproportionately by small

institutions, and constrains rural community groups' ability to analyze lending in these areas, hampering the leveraging of banks through advocacy. Overall, the CRA-related challenge in markets attracting attention from larger lenders is how to encourage banks to serve the entire rural population as they capitalize on growth opportunities in specific areas.

RURAL ISSUES IN COLORADO

Colorado illustrates many of the issues related to non-metropolitan areas. The case study focused on two areas: the San Luis Valley in the south (Alamosa, Conejos, Costilla, Mineral, Rio Grande and Saguache counties); and the central part of the Western Slope (Eagle, Garfield, Mesa, Pitkin and Rio Blanco counties). The San Luis Valley is an agriculturally-based area characterized by persistent poverty. In contrast, the Western Slope has tight property and second home markets, and the lack of affordable rental housing for seasonal and low-wage workers is a key local problem that is most extreme in Eagle and Pitkin counties (home to the resorts of Vail and Aspen). Indeed, Lipman and colleagues (2001) talk of an 'Aspen effect' that includes high property values, lack of affordable housing, a population influx, and the creation of primarily low-wage jobs. Colorado contains several other types of rural areas including developing regional economic centers (such as Grand Junction), and depopulating Eastern Plains communities with a waning agricultural base.

This cross-rural area diversity and attendant variability in market opportunities is reflected in the strategies of Colorado's rural financial industry operators. Some banks are building strategies around penetrating rural markets and bringing new products and services to these areas. Bank of the Rockies and Alpine Bank have established themselves in resort counties, in direct competition with larger national lenders for the business generated by strong housing markets and a wealthy customer base. Vectra Bank is taking a different route, covering the state from the high-growth Front Range communities to the remote towns in the San Luis Valley, and has expanded its rural reach by purchasing sound community banks. Because it serves metropolitan markets in Colorado and because it is owned by Zions Bancorporation, a large regional lender, it can bring resources and deploy products in rural areas that its community lending predecessors could not.

However, small, local community banks remain important in Colorado's agricultural areas given the value of relationship banking in this sector. This is due to the variability associated with the cyclical nature of agricultural prices. To a farmer who may lose money on each harvest for several years running before making enough back to pay back loans in one banner year, relationship banking is paramount. Several lenders in the San Luis Valley mentioned the impact on their balance sheets of a potato blight and several consecutive years of low international prices. It is difficult for out of area lenders to develop the kind of relationships, trust, and expertise to operate in such markets. They may not be inclined to do so because the agricultural environment is inherently risky. These factors in combination tend to act as a barrier to banking consolidation in such areas. The continued presence of small, community banks also highlights the fact that larger players tend not to expand outward from bases in growth markets to serve lower-income rural areas.

CRA is not on the radar screens of many rural Colorado banks. One lender pointed out that pressure to perform in many rural areas is limited by the fact that all activity in many areas is CRA-eligible because it is entirely classified as 'low-income.' Further, its rural operations are less likely to be evaluated. Thus the bank focused its CRA efforts within its MSA assessment areas. Confusion about CRA was also evident, with one lender for example pointing out the struggle to obtain CRA credit for doing the construction loan for a manufactured housing

development under the affordable housing component of the community development lending test. Such uncertainty acts as a disincentive for emphasis on CRA and the development of innovative products and services.

Comparison of the main home purchase lenders operating in the two case study regions (Exhibit 50) also illustrates the varying regulatory reach of CRA. The top ten home purchase lenders in the counties of the San Luis Valley include out of area lenders and independent mortgage companies. In contrast, recognition of the market opportunities presented by the Western Slope counties is evidenced by the presence of major national banks, such as Wells Fargo and Bank of America, and sophisticated smaller players, such as Alpine Bank, which are operating branches within the counties and are subject to CRA regulation.

Exhibit 50: Top 10 Home Purchase Lenders in Rural Case Study Counties, 1999

San Luis Valley (6 counties)	Loans	Western Slope (5 counties)	Loans
Mountain West Financial Inc.	51	Wells Fargo and Co.	1,213
Conseco Finance Servicing Corp.	38	Countrywide Home Loans	531
Dime Savings Bank of NY, FSB	36	Unifirst Mortgage Corp.	426
Associates Financial Services	18	Bank of America Corp.	405
Countrywide Home Loans	17	Fidelity Mortgage Co.	340
Cendant Mortgage	13	Alpine Banks of Colorado	328
Firstmerit Corp.	12	Chase Manhattan Corp.	276
Irwin Financial Corp.	7	Universal Lending Corp.	274
Oakwood Acceptance Corp.	3	Mortgage Portfolio Service Inc.	266
Old Kent Financial Corp.	6	Conseco Finance Servicing Corp.	243
Total for Top 10 lenders	201	Total for Top 10 lenders	4,302
Total for Other lenders	120	Total for Other lenders	2,147
TOTAL	321	**TOTAL**	6,449

Source: Joint Center Enhanced HMDA database

Just as there is diversity among communities and in financial markets in non-metropolitan areas, there is also diversity in the range and quality of advocacy networks. Advocacy may be focused on such issues as protecting agricultural or recreational lands, promoting economic development in declining areas, or enhancing housing opportunity for farmworkers.

Especially impressive in Colorado were the activities and advocacy related to housing provision for farmworkers and their families. An example is provided by the development at Center in the San Luis Valley of a 216-bed dormitory for single male workers that is managed by the Tierra Nueva Farmworker Housing Corporation. This project was supported by the Colorado Rural Housing Development Agency, which provides technical assistance to local governments and non-profits seeking RHS funds to construct farmworker housing. However, the realm of farmworker housing provision illustrates that while Colorado has many excellent non-profit organizations serving rural communities, many unmet needs remain. There is a strong need for sources of development finance other than limited RHS funds for farmworker housing in the state. While banks do enter partnerships for such developments, the limited range of banking organizations operating in the area, makes it difficult to use CRA to leverage funding for a large number of rural projects.

SUMMARY

Rural markets present special challenges to the financial industry due to their demographic characteristics, property markets and heterogeneity. Rural areas are more remote, have lower population densities, higher poverty rates and limited economic diversity. Further, housing alternatives for those with lower incomes are typically limited. These factors have historically limited the opportunities and raised the risks of providing financial products and services in these places. Recently, however, the national trend toward consolidation in the financial services industry has begun to penetrate non-metropolitan America. The decline of community-based banks and the increasing presence of larger regional and national players will offer new opportunities to customers in rural communities. At the same time, these changes suggest the need to rethink the role of CRA outside MSAs, with the key challenge being to encourage larger lenders to serve the entire rural population as they capitalize on growth opportunities in specific areas.