



WRITTEN STATEMENT FOR THE RECORD

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The RUPRI Center for Regional Competitiveness helps regions craft world-class development strategies for competing in the global economic race. The Center's regional projects give regions the tools and technical assistance they need to strengthen region-wide partnership, identify their competitive advantages, and prioritize investments.

The Rural Policy Research Institute provides objective analysis and facilitates public dialogue concerning the impacts of public policy on rural people and places.

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Chairman Holden, ranking member Goodlatte, and members of the subcommittee, it is an honor to appear before this important hearing. I commend your ongoing leadership in ensuring that rural America has access to the capital it needs to help rural businesses compete in today's economy. As you know, capital is the lifeblood for businesses, not only to survive in today's troubled times but also to create the jobs and wealth that sustain the rural economy in the long run.

I am Mark Drabenstott, Director of the RUPRI Center for Regional Competitiveness. My Center helps rural areas think and act regionally to compete globally. We provide the tools and technical assistance rural regions need to identify their competitive advantage, strengthen regional partnerships, and prioritize investments. RUPRI provides objective analysis and facilitates dialogue on the impacts of public policy on rural people and places.

This committee is rightly concerned about current agricultural credit conditions. Conditions have deteriorated over the past 9 months, reflecting a softening farm economy and turbulent financial markets. The most notable change has been a sharp increase in lender credit standards. Lenders are requiring more collateral to offset rising credit risks. At the same time, farmland values appear to have stalled, after one of the biggest booms on record. Lastly, farm income is projected to tumble more than a fifth this year due to a sharp fall in commodity prices from last year's peaks.

These developments are cause for concern, but they do not yet translate into alarm. Farm borrowers and their lenders are both coming off a period of strong profits, leaving them with solid capital cushions. Nevertheless, in a small number of cases, that cushion may be tested this year.

All of these issues merit monitoring, but this committee must also keep in its sights on a set of longer term rural capital issues. The financial crisis has grabbed headlines and the attention of nearly everyone in Washington. Most of that attention has focused on markets and institutions far-removed from Main Street. How Washington responds to today's financial crisis, however, will have profound implications for future capital availability on Main Street. Indeed, how the nation's financial architecture is re-fashioned in the months and years ahead will likely have a far bigger impact on the rural economy than any current concerns about agricultural credit.

In my testimony today, therefore, I will focus on this question: *What steps should Washington take to assure effective rural financial markets in the future?* To frame this question, I will address four subsidiary questions:

- How has the financial crisis affected rural financial markets?
- How have rural America's capital needs changed over time?
- What principles can guide future federal responses to rural capital markets?
- How can we build a stronger information base for federal decisions in this area?

The first section of my testimony discusses how the financial crisis poses major implications for the future of rural financial markets. The second section reviews how capital needs have changed in rural America. The third section identifies some key principles that can guide federal policy in rural capital markets. The final section describes some recommended steps in improving the knowledge base for federal action.

The financial crisis and rural financial markets

Global financial markets have been rocked the past nine months. A wave of losses triggered by collapsing housing derivatives has brought low some of the world's best known banks. The same wave brought an end to one of the landmarks of U.S. financial prowess—investment banks. The turmoil in financial markets resulted in a nearly total freeze in bank lending. In response, the United States and many other nations launched special measures to lubricate credit channels and shore up bank balance sheets. Lending channels have begun to thaw, but the effects of the financial crisis still linger throughout the nation.

No one is sure what U.S. and global financial markets will look like when all the dust settles from the current crisis. Two observations are warranted, though. First, financial markets will operate differently than they did before the crisis, and in ways that cannot be fully anticipated now. Second, financial market regulations will be dramatically reformed. Policymakers will take a hard look at a wide range of regulations with the goal of avoiding in the future the very problems that brought about the current crisis.

What does all this mean for *rural* financial markets? Rural capital markets have not been the front lines in this financial crisis, but the impacts clearly extend to Main Street. The global economic downturn is dragging down important elements of the rural economy. In particular, manufacturing-dependent rural areas have experienced some of the biggest job losses in the downturn. (Jobs in manufacturing-dependent rural counties have fallen 3.9 percent over the past year, compared with 2.9 percent in all rural counties and 3.5 percent in the nation.) Finally, credit standards have risen for rural borrowers as losses have piled up for lenders.

That said, it should also be noted that while rural financial markets are part of national and international financial markets, they also retain important distinct features. In rural areas, there are generally fewer lenders than in metro areas, raising ongoing questions about whether rural borrowers enjoy the same benefits of competitive markets that urban borrowers enjoy. Lack of access to equity capital is an even greater issue for rural areas, forcing rural businesses to look longer and harder to assemble the equity base that powers new businesses.

A whole new architecture for financial market regulation is likely to emerge in weeks and months to come. The issues in that dialogue obviously have broad implication for the U.S. economy, including its vital rural areas. Nevertheless, for this regulatory and policy debate to be successful, it must take into account the unique needs of rural businesses and the powerful forces that have swept across the rural economic landscape. Put simply, financial policy must aim for a 21st century rural economy instead of the one that is now past.

It is not a simple task to assemble the knowledge base your committee and others in Congress will need to design new rural financial markets. First, rural capital markets have not been studied extensively. To give but one example, the last major study done by the Federal government on rural capital markets is now more than a decade old (ERS, 1997). Second, the databases on which analysis can be performed are comparatively scant. Washington has always viewed rural financial markets mainly through the lens of

agriculture. As a result, much more is known about the finances of farm businesses than non-farm businesses, even though the non-farm businesses now provide the lion's share of rural jobs and income. Finally, no expert panels have been created to frame and evaluate rural financial market policy issues. This is ironic since President Teddy Roosevelt's *Country Life Commission* provided the landmark report in 1908 that ultimately resulted in one of the most significant policy interventions in rural financial markets—the Farm Credit System. A lot has changed in the past century, so the time may be right for a new commission.

The shifting economic & business landscape in rural America

The rural economic landscape has undergone dramatic changes in recent decades—shifts RUPRI has closely watched and chronicled. Three trends are especially notable. Agriculture remains an important sector, but its role has declined sharply. Commodity production continues to consolidate (farms getting fewer and bigger). This shift has not been offset fully by new efforts to add more value to farm production. As one indicator of agriculture's changing role, 82 percent of farm family income now comes from sources *off* the farm. Meanwhile, manufacturing still supplies almost 20 percent of rural income, but global pressures and technological advance are reducing the number of factory jobs. And, as noted above, rural factories are especially hard-hit in the current downturn. Finally, the service sector is taking root in rural areas, although activity appears concentrated in exurban and scenic areas. In addition, rural areas have not participated fully in the growth of many high-earning service industries.

Against the backdrop of these long-term trends, the global economic downturn will lead to some significant short-term economic shifts. Agricultural incomes will drop after a sharp boom. Rural factories will be under enormous cost pressures, especially in the troubled auto industry. Rural service businesses will struggle as corporate customers cut back and tourism declines.

The shifts in the rural business landscape are difficult to pinpoint due to limited data on the businesses in rural America. One rich source of data is the Federal Reserve Board's *Survey of Small Business Finance* (Federal Reserve Board, 2008). This survey is conducted every five years, and captures information from more than 6 million small businesses, defined as firms with fewer than 500 employees. Roughly a quarter of the businesses in the sample are in rural areas. The data is robust, but it becomes available only after a long lag. The 2003 data are the most recent available.

A comparison of data from the 1998 and 2003 surveys points to some important shifts in the rural business landscape (Table 1). First, the typical rural business was getting bigger and generally more profitable. In 2003, the typical rural small business had total sales of \$915,000 and profits of around \$167,000. This sales figure was still smaller than the metro counterpart, but the gap had closed (82 percent of metro, compared with 64 percent five years ago). Rural businesses earned profits roughly on par with metro businesses in 2003; by comparison rural profits were 23 percent below metro five years ago.

The balance sheet reflects more interesting differences. The typical metro small business was far more leveraged in 2003 than its rural counterpart (debt/asset ratio of 1.56 vs. 0.70). Viewed another way, the typical rural small business grew its sales nearly

40 percent in five years, but had to rely almost entirely on retained earnings to do so. As a result, liabilities grew only modestly for the typical rural business. Moreover, a separate question on the Survey suggests that very few rural businesses obtained equity capital from sources other than the owner (Table 2). Both urban and rural businesses raise equity from individuals, but rural businesses rely mostly on their own capital reserves, whereas urban businesses turn to angels, employees, and others with much greater frequency.

The picture that emerges of rural small business finances is sketchy, but poses some big questions in this critical period of decision for rural financial markets. First, rural businesses have grown bigger, but appear to be relying more on retained earnings to fund their growth. This poses fresh questions about whether lending standards are tighter or the supply of credit is less than in urban areas. It also raises questions about whether rural lenders are keeping up with the increasing scale of at least some rural businesses. Second, rural businesses have built more equity in their balance sheets, but they appear to have more limited access to equity capital. The retained earnings approach was possible during a time when the national economy was growing; such an approach will be much more difficult in the economic period through which we are passing today.

Principles for policy intervention in rural financial markets

The principles that can guide public policy for rural financial markets are well-established. These principles still ring true, although the practical implication of them has likely changed as the rural economy and the financial needs of rural businesses have shifted. Looking back over a century of government oversight and policy involvement in rural capital markets, a handful of principles have been present throughout:

- Rural businesses should have comparable access to capital as urban businesses.
- Policy should aim to encourage competitive markets that yield a steady supply of credit at market rates.
- Where credit markets fail, government policy should encourage the creation of new lenders that fill critical market gaps, but limit the role of such institutions to those market segments.
- Government should be a lender of last resort for segments of rural borrowers who cannot obtain any credit in rural financial markets. In the main, this should be a short-term credit facility.
- Government should provide credit and loan guarantees to ensure that rural areas have adequate access to housing, utilities, and basic infrastructure. This should be a long-term commitment given the fundamental nature of these investments.

This list is still relevant in the current period. That said, other considerations may lead to some adjustment in the application of these principles in the future. These include:

- The cost of bailing out housing-related government sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, in the current crisis may bring fresh oversight scrutiny to all such enterprises, including the Farm Credit System. It will be important to weigh each GSE on its own merits.

- Principles in the past have focused almost exclusively on rural *credit* markets, with a heavy emphasis on agriculture. In a more entrepreneurial, innovation-driven economy, *equity* capital has risen in importance relative to debt. There have been several isolated forays by public policy into this arena, but it remains mostly a new frontier in rural areas (Freshwater and others, 2001).

Building a stronger framework for policy decisions

Experts, rural businesses, and policy officials alike would agree that the nation is entering a critical period of decision regarding the financial policies and rules that will govern rural financial markets for the next several years. However, rural America will only benefit from the new financial market architecture if the dramatic shifts in the rural economic landscape and the unique needs of rural businesses are taken into account.

To put *rural* into the policy calculus, policymakers must engage a fresh set of questions most likely to shape rural America's business and economic future. Answering these questions, however, probably demands a better base of information than is currently available.

The questions at the heart of the upcoming dialogue will span many dimensions of rural financial markets:

- In a period when banks are actively rebuilding their capital base, what will be the impact on the credit available to rural businesses?
- In a period of significant consolidation among commercial banks, what will be the impact on the credit available and the interest rates charged to rural borrowers?
- As more rural businesses shift from products to services, what provisions are necessary to help rural lenders underwrite loans increasingly backed by "knowledge assets"?
- How can public policy encourage the emergence of a stronger network of rural equity capital institutions?
- What changes in regulations may be important in helping rural lenders match the growing size and regional scope of larger rural businesses?
- How can rural financial institutions better meet the widening financial service requirements of rural businesses increasingly engaged with customers all around the world?
- What unique role do rural financial institutions play in the emerging framework of regional economic development, and what can be done to encourage their participation and leadership?

These questions cannot be answered with the available base of rural financial information. Filling this information gap will be a difficult challenge. Databases that shed light on rural business conditions are few, and some of them are even being retired. For instance, the Federal Reserve Board has indicated it will no longer conduct the survey on small business finance, even though it is widely regarded as a benchmark set of financial data. Apart from data limitations, much of the research and analysis on rural financial markets is still heavily oriented on agricultural finance, not *rural* finance.

A national panel of experts on rural finance would help in assembling better data and in spurring new research on rural financial markets. This panel might bring together national experts, policy advisors, and capital providers to supply an objective, ongoing source of information, analysis, and policy insight on rural financial market issues. The panel could be modeled after RUPRI's highly successful Rural Health Panel. It could issue policy briefs on rural financial market issues, including recommendations for shoring up the information base for public decision. It could encourage rural finance research and strengthen the network of rural finance researchers. Finally, it could provide a valuable sounding board for regulators and policy officials in current and future policy dialogues.

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Table 1. Financial Characteristics of Metro and Rural Small Businesses.

<u>Income Statement</u>	<u>2003</u>		<u>1998</u>	
	<u>Metro</u>	<u>Rural</u>	<u>Metro</u>	<u>Rural</u>
Total sales	\$ 1,112,514	\$ 915,570	\$ 1,064,664	\$ 664,088
After Tax Profit	\$ 167,117	\$ 167,384	\$ 116,685	\$ 90,235
<u>Balance Sheet</u>	<u>2003</u>		<u>1998</u>	
	<u>Metro</u>	<u>Rural</u>	<u>Metro</u>	<u>Rural</u>
Total Assets	\$ 560,272	\$ 524,426	\$ 426,706	\$ 356,708
Total Liabilities	\$ 341,409	\$ 215,136	\$ 261,455	\$ 194,198
Owners Equity	\$ 218,866	\$ 309,293	\$ 165,253	\$ 162,512
n=	4.6 m	1.7m	4.2m	1.1m

Source: Federal Reserve Board *Survey of Small Business Finance*.

Table 2. Sources of Equity Capital for Incorporated Rural and metro Small Businesses, 2003.

Question: Did the firm obtain any new equity from new or existing shareholders, excluding retained earnings?		
	<u>Metro</u>	<u>Rural</u>
Yes	6.2%	5.1%
No	93.8%	94.9%
Question: Of those answering yes, did the firm raise equity from...		
	<u>Metro</u>	<u>Rural</u>
Individuals investors	94.2%	85.2%
Venture capital firms	0.7%	0.0%
Public equity	0.3%	0%
Other	5.3%	14.7%
Question: Of those obtaining new equity from individual investors, did the firm raise equity from...		
	<u>Metro</u>	<u>Rural</u>
Original founders	78.6%	97.1%
"Angel" capitalists	8.5%	0.6%
Employees	1.9%	0.0%
Someone else	15.7%	2.2%

Source: Federal Reserve Board *Survey of Small Business Finance*.

*BIOGRAPHICAL SKETCH***Mark Drabenstott****Director
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Mark Drabenstott is a seasoned observer of regional development and policy issues whose insights have gained national and international recognition. Mark is a native of Markle, Indiana, where he grew up on his family's farm and learned agriculture and basketball firsthand. Mark earned his bachelor's degree from Earlham College and his M.S. and Ph.D. degrees from Iowa State University.

Mark was named founding director of RUPRI's national Center for Regional Competitiveness in September 2006. The Center helps regions craft world-class development strategies for competing in the global economic race. The Center's regional projects aim to help regions build region-wide partnership, identify their competitive advantages, and prioritize investments.

Mark has engaged leading topics related to regional development, the food and agriculture sector, and related policies throughout his career. He spent 25 years in the Federal Reserve System, and led the creation and development of the Center for the Study of Rural America. He has been a prolific researcher, writing more than 150 articles and editing 10 books. He has shared his economic and policy insights very widely. Throughout his career, Mark has given more than 1,000 presentations to audiences throughout the nation and beyond. He has also been invited to share his policy insights with Congress on numerous occasions.

Mark's provides leadership to global efforts to understand the new frontier of regional competitiveness. He is chairman of the OECD's Territorial Development Policy Committee, the premier global forum on regional development policy. He led the planning for the OECD's first-ever global ministerial meeting on regional policy in March 2009. In 2005 he was selected to chair a U.S. Department of Commerce advisory panel that conducted the first major review of federal economic development in 40 years. He has also advised the World Bank.

RUPRI is a national, interdisciplinary institute that focuses on the rural differential in public policy.