October 30, 1991

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Dear Maureen and Lori:

Enclosed is a copy of the draft report on financial services industries in rural areas. This report will be the basis of a chapter in Marie Howland's and my book on rural services. Because the work was funded by Aspen, I am wondering if you may wish to include the report as a working paper (after completion of necessary editorial changes).

Thanks for all your help.

Yours sincerely,

Amy

Amy Glasmeier

Introduction

Financial service industries in rural areas have undergone radical restructuring over the past 15 years and from all accounts will continue to experience change through the 1990s. Corollarily the provision of financial services to rural areas is also changing. The driving force behind both phenomena is increased market competition which has been engendered by governmental deregulation and technological change, specifically automation and advancements in telecommunications. Deregulation is opening local markets to regional and national competitors. Automation and advanced telecommunications are revolutionizing information handling and thus altering required skill levels and job profiles. The combined effect of deregulation and technological change is restructuring decision making processes and institutional hierarchies at the local level.[1] Nowhere are these phenomena more evident than in the commercial banking industry.

The primary spatial manifestation of deregulation and the technological revolution in banking services is consolidation and concentration at the local and regional levels in nonmetro areas. The small locally-owned bank is either being absorbed into larger bank holding companies or it is going out of business. From 1980 to 1986 in rural areas the number of local banks dropped by 11%

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[1] Barbara Baran, "The Technological Transformation of White Collar Work: A Case Study of the Insurance Industry," (Diss. University of California, Berkeley 1986).

while multicounty banking firms jumped by 52%.[2] More than likely the bank holding company into which the local bank is absorbed has been urban-based. Indeed, the number of rural offices of urban holding companies increased by 1,473 or 38% from 1980 to 1986.[3]

Bankers and industry specialists disagree on the relative efficiency in local service delivery provided by exogenous-based financial institutions. The debate has largely centered on the question as to whether lending practices of small nonmetro banks vary greatly from their new competitors or replacements, and if so, whether this will affect the availability of credit at the local level. While most advocates of deregulation argue that theoretically the availability of services should increase, anecdotal evidence suggests that perhaps due to the overall decline in basic industries, particularly agriculture, in rural areas the impetus to enter these local markets may not be as strong as previously anticipated, hence consolidation could in the end mean contraction of banking services.

To explore these potential impacts, we have both surveyed the literature addressing the evolution of banking and informally interviewed bankers from rural communities across the U.S. While information gathered from these conversations cannot be considered

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[2] Daniel Milkove and Patrick Sullivan, Deregulation and the Structure of Rural Financial Markets (Washington: United States Department of Agriculture, Economic Research Service, 1990), p. 31.

[3] Milkove and Sullivan, p. 31.

definitive, we find some of the anecdotes useful in illustrating our interpretation of the current state and future of banking in rural communities.

Our analysis of these findings begins first with a broad overview of the major institutions providing financial services in nonmetro areas, punctuated by brief explanations of how they operate and the impact of critical major historical trends or events. Next we examine structure and operations of the banking industry in nonmetro areas. Then we turn to the issue of consolidation of the industry, how the process has unfolded and at root what are its causes. Finally, we highlight some of the significant implications of deregulation and consolidation on the nonmetro banking industry, the provision credit, local employment, and the availability and ownership of other financial services.

An Overview of Financial Institutions Serving Rural Credit Markets

Currently rural financial needs are satisfied through both public and private sources. Quasi-public sources include the Farm Credit System(FCS) and government-sponsored enterprises such as Federal National Mortgage Association(Fannie Mae), the Federal Home Loan Mortgage Corporation(Freddie Mac), and the Government National Mortgage Association(Ginnie Mae). Other major public sector institutions serving rural credit needs are the Farmers Home

Farmer MAC

Administration(FmHA), the Small Business Administration(SBA), the Department of Housing and Urban Development, the Veteran's Administration(VA), and the Environmental Protection Agency(EPA). From the private sector depository institutions, insurance companies, and finance companies represent the principal players in rural financial markets.[4]

Public Sector Credit Providers

Quasi-public and public institutions provide long term credit and other significant credit functions to rural areas. Some may interact directly with individual borrowers and some may indirectly effect businesses and individuals through local financial institutions. For instance, government sponsored entities(GSEs), Fannie Mae, Freddie Mac and Fannie Mae, increase the availability of long term capital for mortgage lending. These GSEs furnish the mechanisms and markets by which individual residential mortgages are sold by local mortgage lenders, assembled into standardized portfolios and then resold to investors. Selling mortgages off in this way frees funds to the lender to be reloaned locally.

In contrast to the relative anonymity of the GSEs operating in secondary financial markets, the Farm Credit System more directly supplies credit to farmers and related businesses through a system of member-owned cooperatives. Originally the FCS issued securities

[4] "Special Report on Financial Institutions and Markets," Rural Conditions and Trends, Supplement 1 (Spring 1991), p. 4.

the proceeds of which were downstreamed to the local cooperative in order to lend to its members.[5] Since the borrowers were also the lenders, prudence in making credit decisions was often compromised. However, it was not until the Farm Crisis of the 1980s that this weakness in the system caused much mischief.[6]

In a nutshell the Farm Crisis began in the 1980s after a period of extraordinary growth in the U.S. agricultural exports. At its peak in 1980 the U.S. captured 40% of the world agricultural market, but beginning shortly thereafter, a strengthening dollar and rising foreign production, reversed the American competitive advantage. By 1985 the U.S. share of the world market had fallen to under 20%.[7]

Agricultural export demand fueled an extraordinary rise in domestic agricultural production. To finance this new production, farmers borrowed heavily at high interest rates. When exports dropped, farm income shriveled, and property values plummeted.[8]

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[5] Thomas Frey and Robert Behrens, Lending to Agricultural Enterprises (Boston: Bankers Publishing Company, 1981), pp. 393-397.

[6] Ben Sunbury, The Fall of the Farm Credit Empire (Ames: Iowa State University Press, 1990), pp. x-xv.

[7] Patrick O'Brien, et al., "A Market Context for the 1990 Farm Bill Debates," in Agricultural Policies in a New Decade, ed. Kristen Allen (Washington: Resources for the Future and the National Planning Association, 1990), p. 58.

[8] Farmland values across the United States fell by 35% between 1981 and 1987, and in some parts of the Midwest the drop was even more severe (from Sunbury, p. 233).

The combined effect was the farmer's inability to make loan payments and the evaporation of collateral that covered his/her outstanding credit obligations. Consequently, virtually all agricultural lenders were faced with major losses, especially the FCS.

The FCS was particularly hard hit because its credit policies were more liberal than private sector lenders. Although the FCS has survived as an important supplier of credit to agriculture, the aggregate amount of credit it extends to rural borrowers has dropped precipitously. Total credit outstandings have shrunk from a high of $82 billion in the early 1980s to about $32 billion in 1988, largely due to writing off bad loans.[9]

The enormous losses suffered by the FCS required federal intervention and has prompted Congress to impose institutional changes under the Farm Credit Act of 1987.[10] Under this legislation, a new independent entity is being established, the Federal Agricultural Mortgage Corporation(Farmer Mac), which replaces the FCS agency that issued the bonds by which the agency funded its credit operations. Farmer Mac will operate in the secondary mortgage markets like the other Fannie Mae or Freddie

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[9] From Ben Sunbury's <u>The Fall of the Farm Credit Empire</u> (p. 234), and <u>Rural Conditions and Trends</u> (p. 4).

[10] Kennedy, J. and Visser, J., "An Introduction to U.S. Agricultural Programs," in <u>Agricultural Policies in a New Decade</u>, ed. Allen, K. (Washington: Resources for the Future and the National Planning Association, 1990), p. 58.

Mac. It will set underwriting standards in order to insure conformity with new rigorous credit requirements.[11] In short this new funding mechanism is designed to mandate stricter and more standardized credit procedures than had existed under the old entity.

The other major public sector entity engaged primarily in providing credit and financial services to rural areas is the FmHA, but unlike the FCS and other GSEs, the FmHA is a federal agency. Its function is to provide credit to rural areas for agricultural and nonfarm purposes. The FmHA makes loans to farmers who are unable to obtain credit elsewhere.[12] During the recent farm crises, like the FCS, the agency withstood huge losses on its loan portfolio. As the financial position of farmers deteriorated, the number of applications for FmHA credit has risen. To cope with the flood of requests the FmHA has begun to issue guarantees rather than direct loans, whereby the agency obligates itself to fulfill borrower obligations in the event of default, but the actual loan

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[11] Also to insure the marketability of the pooled agricultural mortgages, a subordination interest participation of 10% of the principal will be required. Also, Farmer Mac will guarantee timely payments of interest and principal, and it cover defaults exceeding the 10% reserve (from Kennedy and Visser, p. 45).

[12] Although the FmHA is known as the farmer's 'lender of last resort,' over half of the $160 billion in credit extended in its lifetime has gone to nonfarm programs. In 1989 a total of $5.1 billion in grants and loans was extended primarily for housing, water supply and waste water disposal projects (from Rural Conditions and Trends, p.4).

is obtained from a private lender.[13] Theoretically this should relieve some of the administrative burdens from the agency, but more importantly it should also leverage the FmHa's limited resources.

Private Sector Credit Providers

Although there are numerous private sector financial institutions serving the needs of rural areas, they fall into two general categories, depository and non-depository institutions. Chief among the nondepository institutions are major insurance companies.

Insurance lenders extend residential, commercial and agricultural mortgage loans. At mid year 1990 domestic insurance mortgage loans totalled $225.6 billion.[14] Providing long term credit is an important function in rural financial markets, for which large insurance companies are well suited. Insurance lenders have pools of funds committed for long periods of time, i.e. insurance premiums. This perspective enables them to make long term investments and loans. As a result, insurance lenders frequently play a key role in the real estate development process. For example, banks often provide the construction loan during the development phase of a real estate project. Upon completion of the

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[13] Kennedy and Visser, p. 45.

[14] Rural Conditions and Trends, p. 4.

project insurers furnish the long term financing or take out loan which is repaid over the operational life of the project.

Insurance companies actively extended credit in the domestic real estate market throughout most of the 1980s, but due to depressed conditions in the residential and commercial markets nationwide, major insurers have altered their aggressive investment strategies.[15] Growth in total mortgage loans due insurers slowed in the late 1980s, and in 1989 total outstandings actually dropped slightly from the preceding year to $225.6 billion.[16] Farm mortgages decreased at a more rapid rate. U.S. life insurance companies, the principal insurance lenders, have disposed farm mortgages faster than they have placed new ones since 1981.[17] While much of this decrease can probably be attributed to the Farm Crisis of the 1980s, for near term, alternative investment opportunities increasingly divert insurance companies' funds from traditional real estate investments, especially in rural areas.

Although major insurers remain important credit providers to rural areas, their activities are confined to specific market niches and functions. The backbone of the private sector credit

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[15] George Anders, "Empire Builders: Insurance Companies, Pension Funds Become Landlords." The Wall Street Journal, April 1, 1986, p. 1.

[16] Rural Conditions and Trends, p. 4.

[17] 1989 Life Insurance Fact Book Update, (Washington: American Council of Life Insurance), p. 46.

industry in rural areas remains the depository institution, and as Table 1 illustrates, commercial banks account for the lion's share of rural loans, deposits and assets.

Table 1
Depository Institution Shares of Rural Assets, Deposits and Loans, (1989)[1]
(in billions)

	Assets		Deposits		Loans	
Banks	$383.6	(69.3%)	$338.6	(70.0%)	$210.2	(65.7%)
S&Ls	111.8	(20.2%)	88.5	(19.3%)	84.8	(26.5%)
Credit	58.2	(10.5%)	51.8	(10.7%)	25.0	(7.8%)
Total	$553.6	(100.0%)	$483.7	(100.0%)	$319.9	(100.0%)

(1) Rural depository institutions are defined here as those firms whose headquarters are located in rural areas. It should be noted that due to the fluidity of credit and depository activities as well as the presence of branch facilities in nonmetro areas, such relative or absolute measurements are imprecise.

Source: Derived from United States Department of Agriculture, Economic Research Service. "Financial Institutions and Markets." Rural Conditions and Trends. Spring 1991, Supplement 1.

Depository institutions(Dis), more than any other type of institution, provide a wide range of financial services. Yet, their essential functions are taking deposits and making loans. The combination of these functions places Dis in a unique position in the economy. This also means that beginning with the regulation of the banking industry in the early 19th century, they have been closely regulated by the federal and state governments.

Historically, banks, thrifts, and credit unions have furnished a relatively safe place for individuals and businesses to store money. Also, either by the physical exchange of currency or via the clearing process of written drafts, these institutions facilitate the transfer of funds. Today, technological advances in communications and information processing have dramatically enhanced their capability to transfer funds electronically and make them readily accessible at remote locations for individuals and businesses alike.

A DI generates revenue by utilizing deposits to invest in government securities or to make loans. Because it can pool funds, the DI can make larger investments that yield higher rates than what it must pay its depositors, but more importantly, deposits are the DI's primary source of funds for loans. As most deposits are on deposit because they are not being used, only a small percentage must be readily accessible at any given time. The remainder is available for lending purposes. For the use of the depositors' money, the DI provides services, e.g., check processing, and/or it pays interest. Conversely, it charges borrowers interest on loans. In addition to opportunity costs, interest rates are determined by inflationary expectations and various evaluations of risk. Thus for example, interest rates the DI charges for long term deposits or to risky borrowers will be higher than those charged for short term deposits or to relatively secure borrowers. The difference between the average of interest rates paid to depositors and that charged to the borrowers is the DI's interest spread.

The combination of depository and lending functions empowers depository institutions with the ability to create money by increasing or decreasing the money supply. For every dollar of deposits made some fraction is in turn loaned, which is then in turn deposited and then reloaned, etc. To more easily conceptualize this phenomenon assume that the entire U.S. banking system is one bank. A customer deposits $100. The bank takes the deposit and then lends $50 to another customer who redeposits the $50 back into the bank. Total deposits have just increased from $100 to $150 as has the overall money supply.[18]

Although in the example just cited, illustrates a 'closed system' where there are theoretically no leaks or lost funds, in reality it is easy enough to recognize that they do occur. A case in point might be using a loan to import goods. Indeed, anytime borrowed funds are not redeposited into a DI the process of monetary expansion stops.

Largely because of regulations prohibiting branch banking, rural financial markets have remained largely self-contained. Consequently, the recycling of deposits by funding reinvestment in communities is a critical function of rural depository institutions and distinguishes it from metropolitan institutions. On the other hand, metropolitan financial markets are quite fluid and intimately

[18] The expansion of the monetary supply is equal to the reciprocal of the required reserve ratio(see Appendix A). Hence, if a bank is required to maintain reserves equal to 6% of total demand deposits, the aggregate expansion caused by a $100 deposit would be 1/.06 x $100 = $1,666.67.

integrated into the national and international monetary systems. The largest metropolitan institutions are known as money center banks. These institutions historically have acted as clearing agents for smaller banks particularly those not members of the Federal Reserve System. Consequently, money center banks are also collectors of excess funds from regional or correspondent banks.[19] Because of their size and market dominance, they are also attractive reservoirs for longer term deposits.

Size affords larger banks unique competitive advantages. Because they have diverse funding sources and enormous deposit bases, only the largest institutions have sufficient reserves to support large loans.[20] Large transactions create economies of scale in extending credit which translates into lower interest rates. The prime lending rate for example is the rate of interest established by major lenders which is offered to their best corporate customers. These major customers are regarded also the least risky of borrowers.

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[19] See Appendix A for fuller explanation of the Federal Reserve System and of correspondent banking.

[20] Although large banks have the capacity to make very large loans, usually bankers attempt to ameliorate risk. Moreover, borrowers attempt to maintain credit arrangements with numerous lenders in order to foster competition amongst them and keep their financing options open. Consequently at least several banks will participate(that is provide a portion of the loan) in larger credit arrangements. Often the lead bank, the one negotiating credit terms with the borrower, will solicit participation in major financings from its correspondent banks.

Larger corporate customers also demand more sophisticated financing arrangements. Generally speaking only major commercial banks have the resources and the technical expertise necessary to create, market, and monitor such credit extensions. Thus larger banks have become the principal bank creditors to major commercial enterprises.[21]

But regardless of their size, all depository institutions are creatures of the states or the federal government. They must abide by the legislated rules of their respective charters, which, among other aspects, regulate what activities Dis may engage in, how many offices(branches) they may operate, and whether they may acquire or merge with a competing entity. Commercial banks historically have dominated rural, and for that matter metropolitan credit markets, mainly because their activities are not nearly as circumscribed as have been those of S&Ls and credit unions. They provide credit for the full range of individual and commercial purposes, while S&Ls' activities were largely limited to residential mortgage lending and credit unions were allowed to provide consumer credit.

A major financial function from which commercial banks are

[21] . It is important to note that today commercial paper markets, insurance companies, and commercial finance companies all also compete with commercial banks for majors corporations credit business. For a full discussion of commercial bank competitors see Catherine Yang's article, "The Future of Banking," in Business Week, April 22, 1991.

prohibited is underwriting.[22] Prior to 1933 banks could both underwrite securities and provide the financing for their purchase. This scenario lead to conflict of interest, unsound banking practices, and spiralling speculation which culminated in the crash of the U.S. stock markets in 1929. When stock prices fell so did collateral values creating panic among depositors and bank runs nationwide. The ensuing collapse of the banking industry caused Congress to pass the Bank Act of 1933(Glass-Steagall) which structurally separated commercial and investment banking activities, as well as limiting the activities of each.[23]

In attempting to revive confidence in the banking industry Glass-Steagall also established the industry's first government sponsored deposit insurance. Under its current provisions depositors accounts are insured up to $100,000 by the federal government via the Federal Insurance Deposit Corporation. The institution became a model for the Federal Savings and Loan Deposit Insurance Corporation and other state chartered deposit insurance corporations. While deposit insurance did stem bank runs, its critics argue that deposit insurance allows managerial incompetence and fosters a false sense of security on the part of depositors.

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[22] Underwriting is to guarantee the sale of a security issue that is to be offered to the public for subscription. Except in a few instances, only investment banks operating largely under the jurisdiction of the Securities and Exchange Commission may carry out this activity.

[23] Stephen Hiemstra, <u>Prospective Rural Effects of Bank Deregulation</u> (Washington: United States Department of Agriculture, Economic Research Service, 1990), p. 5.

Certainly it has been a factor in the S&L crisis and the banking industry's current troubles.[24]

S&Ls were created during the Depression to make mortgage loans to residential home buyers. S&Ls primarily financed these long term loans with demand deposits or savings accounts. To assure stability in the markets interest rates on depository accounts were set and usury limit on loans were imposed. This financing method was functional during the long period of relatively stable economic prosperity that followed WWII, but when inflation rose in the 1970s alternative investment interest rates, such as money market accounts, siphoned funds from S&Ls.

To counteract the increasing illiquidity of S&Ls, Congress deregulated the industry, first removing caps on interest rates for both deposits and lending purposes. Yet as most S&Ls had large portfolios of residential mortgages bearing low interest rates, raising interest rates to attract deposits simply equated to a negative interest spread current cost of funds. They simply lost money, and their capital was eroded.

To reverse this trend Congress then lifted restrictions which formerly prohibited S&Ls to compete in commercial real estate markets. In attempting to counterbalance the negative interest

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[24] Catherine Yang, et al., "The Future of Banking," Business Week, No. 3210 (1991), p. 73.

spreads on much of their existing portfolios, S&L managers rushed to finance high yield, but risky, real estate developments and other speculative investments. When the real estate boom of the early 1980s turned sour, large numbers of S&Ls already weakened by a decade of poor earnings in the 1970s were left with big loans that were backed by devalued collateral, and they simply closed their doors. In 1988 and 1989 alone the rural thrift industry contracted by 10%, and another 13% remain technically insolvent (liabilities exceeding the market value of assets).[25]

Throughout the entire S&L debacle even the large S&L depositor generally turned a blind eye to his/her respective institution's financial performance. Deposit insurance critics maintain that the lack of financial risk to the individual depositor negated his/her incentive to demand accountability from the depository institution's management.

Last year Congress turned to alternative regulatory measures to insure financial responsibility of depository institutions by passing the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ~~1990~~ (FIRREA). Under the new legislation, thrifts must meet stricter capital requirements.[26] While FIRREA's

[25] Rural Conditions and Trends, p. 16.

[26] Under FIRREA thrifts must meet the requirement that common equity capital not exceed 3% of total assets or 8% of risk-related assets. Assets are categorized into several groups according to their degree of risk; for example, cash and U.S. securities bear no risk, while consumer loans are categorized at 100%.

objective is to bolster the financial integrity of S&Ls and to encourage conservatism in lending practices, the immediate effect will probably be a sharp contraction in lending activity. Only about 82% of rural thrifts can meet the new capital standards. Most of these S&Ls will do so by shrinking total assets by reducing loan outstandings. The remaining 18% face an aggregate capital deficit of $4.38 billion most of which is attributable to technically insolvent thrifts. Because of their weak earnings records and the poor quality of their assets, neither are these thrifts capable of raising new capital nor are they attractive for merger or acquisition. In short the contraction in the thrift industry in rural areas is likely to worsen.[27]

Due to the shakedown and radical contraction of the S&L industry, and the consequent stringent regulations placed on the S&Ls, the provision of credit has increasingly fallen to the remaining members, banks and credit unions. While credit unions are relatively numerous, their activities are largely circumscribed to consumer credit, i.e., personal loans, credit cards, auto loans etc. Banks have been called on to pick up the slack, and, indeed, total nonmetro bank loan volume jumped from $23.5 billion to $30.2 billion or 28.5% from 1986 to 1989.[28]

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[27] Clifford Rossi, "Rural Financial Institutions after FIRREA," Rural Conditions and Trends, Supplement 1, Spring 1991, pp. 24-25.

[28] Derived from Mikesell and Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, (Washington: United States Department of Agriculture, Economic Research Service, 1991) and Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics,

The Banking Industry in Rural Areas[29]

Historically, small towns in rural America have centered around a number of core private sector institutions, not the least of which is the locally owned bank. At year end 1989 of all nonmetro based banks 91% were independent banks or one-bank holding companies.[30] As Table 2 indicates, most of these nonmetro based banks were very small or small firms, i.e., banks with total assets of less than $25 million and $100 million, respectively.

Key issue - non-metro-based banks vs urban.

1986, (Washington: United States Department of Agriculture, Economic Research Service, 1989).

[29] In outlining the hierarchical structure and aggregate operations of nonmetro and metro banks for the period between 1986 and 1989, I refer to statistics derived from Mikesell and Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, (Washington: United States Department of Agriculture, Economic Research Service, 1991) and Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, (Washington: United States Department of Agriculture, Economic Research Service, 1989), except where otherwise noted.

[30] It is important to note that branch banking facilities' financial statements are reported on a consolidated basis to the FDIC. Consequently, in this report a bank is designated according to the location of its headquarters.

Table 2
Nonmetro Bank Characteristics:
Geographic Location, Size, Age and Ownership, (1986 and 1989)

	No. of Banks in 1986	No. of Banks in 1989
Bank Size:[1]		
Very small	3,231	2,571
Small	3,675	3,551
SNBs[2]	6,906	6,122
Medium	654	832
Large	9	14
Holding Company Type:[3]		
Non-HC or one bank HC	5,854	5,196
Limited multibank HC	1,002	1,148
Large multibank HC	713	624
Total Rural Banks	7,569	6,968

(1) Very small banks have total assets of $25 million or less; small banks have between $25 and 100 million in total assets; medium banks have between $100 million and $1 billion in total assets; and large banks have more than $1 billion in total assets.
(2) SNBs are smaller nonmetro banks and include: very small and small nonmetro banks.
(3) An HC is a nonbank firm that owns controlling interest in on or more banks. Limited multibank Hcs own between two and nine banks whose total assets do not exceed $1 billion. Large multibank HCs own more than nine banks and have assets in excess of $1 billion.

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

More than any other factor size dictates the operations of smaller nonmetro banks(SNBs). The smaller nonmetro banks' size parallel the smaller scale of rural economies, and differentiate them from the more diverse base of urban areas.[31] Hence, SNBs are small because they serve extremely localized or restricted markets.

[31] James Mikesell, "Rural Banks Reflect the Local Economy," Rural Development Perspectives, 2, No. 2 (1985), p. 16.

From Table 3 we can see that in 1989 of the 6,054 nonmetro banks 6,122 or 88% operated within a market range of five counties. As to be expected, the table also reflects a large difference in mean asset base size between locally restricted banks and rural banks with extensive markets.

Table 3
Nonmetro Bank Characteristics:
Asset Concentration by Market Extension, (1989)[1]
(000's Omitted)

	Number of Banks	Mean Asset Base	Subtotal	Percent of Tot Assets
Nonmetro Banks				
Local	2,571	15,135	38,912,085	10.84%
Restricted	3,551	50,038	177,684,938	49.47%
Extensive	832	171,300	142,521,600	39.69%
Total Nonmetro	6,954		359,118,623	100.00%

(1) The market extension is the number of markets in which a bank operates. A local organization has branches or offices in only one market. A Restricted Organization has branches/offices in two to five markets. An Extensive Organization has branches/offices in six or more markets. A bank organization is an independent entity not owned by a bank holding company. Each nonmetro county and each metro area(MSA) is classified as a separate market.

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

State laws limiting branch banking geographically confine firms to the local community thus linking their ability to grow to that of the local economy. Often these markets are geographically remote and predominantly agricultural as is the case in much of the Midwest and to a lesser extent the South. Moreover, until relatively recently state law also generally prohibited bank holding companies from acquiring substantial numbers of formerly independent banks. Critics of unit banking therefore maintain that neither could economies of scale be achieved nor could diversification of operations occur, the result being that the application of technology in nonmetro banks was slower and the diversity of services was less than in metro banks.[32]

SNBs may comprise nearly three quarters of all nonmetro banks, but they control only 56% of the $383 billion total nonmetro bank assets, as illustrated in Table 4.[33] And, the SNB share is declining. While the mean asset base of small nonmetro banks rose slightly, SNB total assets dropped from $226 billion to $216 billion between 1986 and 1989.

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[32] Milkove and Sullivan, p. 30; and Stephen Hiemstra, Prospective Rural Effects of Bank Deregulation (Washington: U.S. Department of Agriculture, Economic Research Service, 1990), p. 5.

[33] When compared to the aggregate U.S. banking system the concentration in asset base becomes even more marked, as the smaller banks share of total assets drops to 7.16%.

Table 4
Nonmetro Bank Characteristics:
Asset Concentration by Firm Size, (1986 and 1989)
(000's Omitted)

		Asset Concentration, 1986		
Nonmetro Banks	Number of Banks	Mean Asset Base	Subtotal	Percent of Tot Assets
Very small	3,231	14,571	47,078,901	13.53%
Small	3,675	48,703	178,983,525	51.43%
SNBs[1]	6,906	32,734	226,064,996	64.96%
Medium	654	165,845	108,462,630	31.17%
Large	9	1,499,351	13,494,159	3.87%
Total Nonmetro	7,569		348,019,215	100.00%
Total US	14,008		2,902,578,992	

		Asset Concentration, 1989		
Nonmetro Banks	Number of Banks	Mean Asset Base	Subtotal	Percent of Tot Assets
Very small	2,571	15,135	38,912,085	10.15%
Small	3,551	50,038	177,684,938	46.35%
SNBs[1]	6,122	35,380	216,597,023	56.50%
Medium	832	171,300	142,521,600	37.17%
Large	14	1,733,614	24,270,596	6.33%
Total Nonmetro	6,968		383,389,219	100.00%
Total US	12,657		3,282,464,476	

(1) SNBs are smaller nonmetro banks and include the two categories: very small and small nonmetro banks.

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

In addition to the disproportionately lower share of total assets held by SNBs within the industry, the composition of assets varies markedly from larger and metro banks. As Table 5 reflects SNBs hold more government securities and make fewer loans than their commercial bank competitors. In part these differences are due to there being simply more lending opportunities in larger and more economically diverse areas.[34] Over 29% of all rural banks are in agriculturally dependent counties.[35] Being tied to the local

Table 5
Nonmetro and Metro Bank Characteristics:
Asset Breakdown, (1989)
(000,000's Omitted)

	Percent of Assets Held in:					
	Cash	Gov. Secur.	Federal Funds Sales	Federal Funds Purchs.	Total Loans	Total Assets
Nonmetro Banks						
SNBs[1]						
Very small	4.74	30.53	7.10	.25	48.47	15,135
Small	4.34	30.74	6.12	.56	51.11	50,038
Medium	4.49	24.23	5.52	2.22	59.23	171,300
Large	6.25	20.00	1.47	5.95	66.23	1,733,614
Metro Banks						
Very small	5.99	20.15	11.00	.48	53.42	15,821
Small	5.65	20.86	8.37	1.13	57.55	53,774
Medium	6.15	17.89	6.27	4.38	62.38	271,597
Large	6.98	10.43	3.80	11.49	64.67	6,325,123

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

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[34] In our interviews with rural bankers, independent and branch bankers alike, frequently complained of limited lending opportunities. To illustrate his point, one independent banker in Alabama stated that his bank's loan to deposit ratio currently stood at 30%. Ten years ago it was 80%.

[35] Rural Conditions and Trends, p. 6.

economy, particularly in one industry towns or primarily agricultural communities, imposes additional risk factors which must be considered by SNBs when extending credit. SNBs compensate for additional risk by maintaining higher percentages of their assets in secure and liquid assets such as U.S. government securities. Also as shown in Table 6, larger and metropolitan based banks have access to a wider variety of funding sources, hence they are able to support higher levels of credit activity.

Table 6
Nonmetro and Metro Bank Characteristics:
Breakdown of Liabilities, (1989)

	Percent of Deposits				Percent of Total Liabilities
	Deposit. Insts.	Government State	Government Local	Large Time (>$100,000)	
Nonmetro Banks					
SNBs					
Very small	.16	.16	8.29	9.28	98.37
Small	.18	.15	7.63	10.74	97.91
Medium	.47	.17	6.78	12.35	95.71
Large	.68	.19	5.73	17.61	89.74
Metro Banks					
Very small	.79	.27	6.05	13.41	97.56
Small	.89	.27	5.40	14.57	97.28
Medium	1.15	.23	5.39	15.31	92.04
Large	2.20	.30	4.03	20.25	77.08

(1) SNBs are smaller nonmetro banks and include the two categories: very small and small nonmetro banks.

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

One measure that reflects how a bank funds its credit operations is the percent of liabilities that is comprised by deposits. Because SNBs operate for the most part in local or restricted markets, any deposits they hold are probably local funds. In 1989 as Table 6 indicates, deposits represented nearly 98% of total liabilities for SNBs versus about 77% for large metro banks. Of these total liabilities, for metropolitan banks 20.25% are in large time deposits, while for SNBs only 9.28% are in such accounts. The direct relationship between deposits from other depository institutions and bank size and metropolitan location suggests a flow of funds from smaller nonmetro institutions to larger and larger metro banks. This observation is correlated by the Fed Funds sales and purchases statistics from Table 5 which indicate that SNBs are net sellers of Fed Funds while large metro banks are net buyers of funds.

SNBs loan portfolios are substantially weighted to agriculture. In 1989 agricultural loans represented 31.69% for very small nonmetro banks and 19.16% for small nonmetro banks(see Table 7). While they are well capitalized and historically have been run conservatively, SNBs remain heavily reliant on local deposits and vulnerable to the health of the agricultural industry. This notable credit activity for small nonmetro banks, agricultural lending, primarily provides general working capital credit for seasonal operations, and to a lesser degree farm mortgages.

Table 7
Nonmetro and Metro Lending Characteristics:
Loans for Agricultural Purposes, (1989)
(000's Omitted)

	Number of Banks	Mean Business Operations Loan	Mean Real Estate Loan	Subtotal	Percent of Total Agric. Loans
Nonmetro Banks					
Very small	2,571	1,684	640	5,975,004	12.53%
Small	3,551	3,163	1,735	17,392,798	36.48%
SNBs	6,122			23,367,802	49.01%
Medium	832	4,243	3,008	6,032,832	12.65%
Large	14	10,570	11,330	306,600	0.64%
Total Nonmetro	6,968			29,707,234	62.32%
Metro Banks					
Very small	1,137	467	219	779,982	1.64%
Small	2,426	656	449	2,680,730	5.62%
Medium	1,767	1,440	1,100	4,488,180	9.42%
Large	359	19,836	8.061	10,015,023	21.01%
Total Metro	5,689			17,963,915	37.68%
Total US	12,657			47,671,149	100.00%

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

In short, the proportion of agricultural loans to total loans for small and very small nonmetro banks were, respectively, 8 and 13 times the industry average in 1989. Consequently as Figure A illustrates, smaller nonmetro banks supply about half of the total credit that the banking industry provides to agriculture.

[Figure A ....graph of % of total agricultural lending by bank type]

Interestingly enough it is large metro banks that supplies the bulk of the rest of agricultural credit furnished by the banking industry. This reflects the fact that large metro banks make loans to larger enterprises including agricultural ones. Moreover, as most large agribusinesses are located in metropolitan areas, they are likely customers of large metro banks.

Despite the fact that larger nonmetro banks generally target business, real estate and consumer loans, SNBs continue to furnish a significant portion of credit to small businesses in rural areas. Figure B illustrates that SNBs provided 49% of credit extended by nonmetro banks for nonagricultural business operation loans in 1989. This proves to be a critical function as small businesses obtain approximately 90% of their short term financing and 85% of all of their financing from commercial banks.[36]

[Figure B ....graph showing business loan by bank type]

Correlation bet. manuf + branch bank?

Overall, nonmetro banks have not competed effectively against their urban rivals in manufacturing communities. Although nonmetro banks represent about fifty percent of the banks in manufacturing counties at year end 1989, they controlled only 16% of the total banking assets of these counties. It is commonly held that this is due in large part to the fact that larger industries bank with bigger

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[36] Deborah Markley, Small Business Rural Banks, Assessing and Strengthening the Link (Washington: The Ford Foundation and the Rural Economic Policy Program of the Aspen Institute, 1990), p. 8.

metro based institutions.[37] Moreover as the archetypical manufacturing establishment in rural America is a branch plant, its credit needs are frequently supplied through the parent.

Large scale manufacturing establishments are the norm in rural areas. Most of them are branch plants, however a few of these establishments are indigenous or "homegrown" to their locale. Branch plants generally are located in nonmetro areas to achieve economies of scale in production, by exploiting the natural advantages of cheap labor, inexpensive real estate, low taxes, etc. These establishments also tend to be large, at least relative to other local establishments.

Since the typical nonmetro manufacturing enterprise is not indigenous to the area and more than likely most of its financial accounting functions other than basic bookkeeping are performed at the corporate headquarters, the possibility of extensive local banking relationships being established is remote. Most credit functions will be determined at the corporate level. And, most corporate headquarters are in metropolitan areas. Even in the rare instances of firms headquartered in rural areas, it is just as easy for the vice president of corporate finance to talk to New York as it is to call the banker of the local community. Furthermore, larger banks, even those in metropolitan areas, actively solicit their business. But more importantly, SNBs are simply ill-equipped to meet the financing

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[37] Mikesell and Marlor, p. 8.

needs of large scale enterprises.

Small rural banks have relatively small deposit bases thus they are faced with limited lending capacities. Even when the SNB technically has sufficient reserves to extend a large loan to a local manufacturing enterprise, often it is simply imprudent for the bank to undertake a risk exposure to a single customer of such magnitude. Moreover, the SNB probably lacks the capability to negotiate and to monitor, let alone to construct, many types of sophisticated credit arrangements that larger manufacturing firms demand. Hence, by default larger manufacturing facilities are forced to seek credit from larger metro institutions regardless of their geographic location.

Nonmetro banks are also well represented in counties experiencing heavy inmigration of retired persons. It has been suggested that nonmetro banks in retirement communities have surplus deposits relative to local lending opportunities.[38] This implies enhanced credit availability in these communities. And indeed, the mean asset size and ratio of loans to assets are both greater for nonmetro banks in retirement communities.[39] Exactly how much credit is extended locally is undetermined. But in spite of comprising 75% of the banks located in retirement counties, nonmetro banks have captured only a

[38] Mikesell and Marlor, p. 8.

[39] In 1989 nonmetro banks in retirement communities and SNBs had mean total assets of $60,518,000 and $35,380,000, respectively; and total loans to total assets for the two bank types averaged 59.1% and 50.0%, respectively (derived from Mikesell and Marlors' Nonmetro, Metro and U.S Bank-Operating Statistics, 1987-89).

40% share of total banking assets. Anecdotal accounts from some of our interviews suggest that retirees simply do not transfer all of their banking business to their new home towns.

One interview with a small town banker in Montana, revealed that often retirees reside in retirement communities for only part of the year. Consequently, there was far less incentive for these seasonal residents to change their primary banking relationships from their hometown banks. In fact none of the SNB bankers we interviewed indicated that much trust or even standard consumer account business could be attributed to the inflow of retirees. In short the benefits to nonmetro banks from the retirement community may have been overstated.

Industry Concentration

As we noted earlier, due to acquisition, merger and failure, the number of nonmetro banks is dropping. Smaller nonmetro banks experienced most of the decrease, from 1986 to 1989 their number declined by 660 firms or 11%(see Table 4). Failures were a sizable portion of the drop in total SNBs, however, merger and acquisitions accounted for the bulk of the change.

In contrast to the decrease in SNBs, the number of medium sized banks jumped from 654 to 832 from 1986 to 1989, and the number of mutibank holding companies also increased significantly (see Table 2).

While the large bank sector grew only by five institutions, mean asset base swelled by over 15%. As this growth in asset base is substantially faster that the rest of the nonmetro market, much of it may have resulted from acquired institutions. On the other hand medium sized banks mean asset base grew only slightly, suggesting most of the mutibank holding company formation accommodated the consolidation of SNBs into larger entities.

Ownership changes do not simply imply consolidation within the nonmetro markets. Indeed the most notable feature of this process is the growing ownership of nonmetro banks by urban-based firms. In geographic terms, the percent of counties served by urban-based firms increased from 35.4% to 45.1% from 1980 to 1986.[40] In aggregate, 42% of all rural bank offices were controlled by urban-based banks as of June 30, 1986.[41] Of the 377 urban-based banks with nonmetro branches 20% maintained branches in more than five counties, but over half of these urban banks had offices in just one rural county.[42] It may be that much of the urban incursion is being waged by medium-sized urban banks that target nonmetro banks on the periphery of suburban areas. Indeed one Missouri banker whose bank is located in adjacent to metropolitan St. Louis reported that numerous banks in the area had been acquired up by some of the bigger suburban banks.

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[40] Milkove and Sullivan, p. 33.

[41] Milkove and Sullivan, p. 49.

[42] Milkove and Sullivan, p. 28.

Deregulation is without a doubt the single most important factor causing the consolidation within the nonmetro banking industry. However, the move to deregulate the industry has been slow. Federal regulations had sent mixed signals to the industry. Regulation Q of the 1933 Bank Act, for example, prohibited banks from paying interest on demand deposits. Banks were forced to compete for customers by offering better service, namely by establishing numerous convenient banking locations, which reinforced the model of branch banking. However, the McFadden Act of 1927 and the Bank Act of 1933 both delegated regulatory authority over nationally chartered banks to the states where branch banking was generally opposed. So for the most part, deregulation has proceeded cautiously at the state level.

Many state regulators historically have had a strong apprehension over relinquishing control of commercial banks. They geared regulations limiting or prohibiting branch banking to prevent the shift of that control to large holding companies and out of the hands of local investors. But as the traditional rural economy faltered deregulation proponents have touted the ability of larger banks to offer more and diverse credit services as a means of enhancing rural economic development. Larger banks also are more financially stable from the standpoint that they are industrially and geographically diversified; they are in effect not subject to the fortune of a single industry. In any event, such arguments for deregulation have steadily gained acceptance throughout the nation. Since 1960, 22 states have significantly liberalized their branch banking restrictions.[43]

[figure c - US branch banking map, Milkove and Sullivan p. 11]

Those states in the Midwest and the South that historically prohibited branch banking and had densely populated rural areas, also have large numbers of SNBs. These small institutions are particularly vulnerable to consolidation. As state legislatures have removed barriers to branch banking, the rash of merger activity has unfolded. As Table 7 indicates, these regions accounted for nearly 88% of the total decline in nonmetro banking firms between 1986 an 1989.

Table 8
Nonmetro Bank Characteristics:
Changes in Firms by Geographic Location (1986 and 1989)

Region:	Number of Banks in 1986	Number of Banks in 1989	Percent of Total Change
West	628	581	7.82%
Midwest	3,922	3,580	56.91%
South	2,777	2,588	31.45%
Northeast	242	219	3.82%
Total	7,569	6,968	100.00%

Sources: Derived from J. Mikesell and F. Marlor's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1987-89, 1991, United States Department of Agriculture, Economic Research Service, and J. Mikesell's Nonmetro, Metro, and U.S. Bank-Operating Statistics, 1986, 1990, United States Department of Agriculture, Economic Research Service.

[43] Milkove and Sullivan, p. 10.

Figure C also reflects the fact that states allow several variations of branch banking. Some states tolerate unrestricted branching throughout the state, however many limit the number and/or geographic dispersion of branch locations. The remainder allow branch banking through the acquisition or merger. In the early 1980s many states began deregulation of the industry by allowing multi-bank holding companies to pursue this latter option. The impact was quite noteworthy. In Missouri, for example, 130 banks were absorbed as subsidiaries of holding companies between 1984 and 1986, after state bank branch banking restrictions were eased.[44]

Bank expansion has recently proceeded mainly by merger and acquisition. Among the reasons cited for this corporate strategy by banks is that the Monetary Control Act of 1980 phased out Regulation Q interest rate ceilings, thereby reducing a major structural impetus for de novo branch banking.[45] Branch facilities have become marketing arms of the parent as opposed to deposit collectors, and absorbing existing firms provides instant and reasonably assured market share in a community. This tact also has made deregulation more palatable to the small local banks, whose equity value has risen due to the larger market for their stock.[46]

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[44] Milkove and Sullivan, p. 46.

[45] De novo branches are new establishments.

[46] While several independent bankers expressed a strong sense of commitment to the local community, several others stated that they would not mind making a profit on their long term investment in their bank.

The trend in bank consolidation has not been limited by state boundaries. In 1980 ten interstate banking firms operated offices in rural counties, by 1986 the number had increased to 51. At year end 1986 there were 320 nonmetro commercial banks affiliated with interstate banking operations. By 1993, 28 states will allow interstate banking, another 17 will allow interregional banking within their borders and only 5 will continue to restrict the industry to unit banks.[47]

While most of the interstate multibank holding companies have targeted urban-based banks, many smaller nonmetro acquisitions are being made as well. For example, Norwest Bank(Minneapolis) in 1991 acquired the largest bank holding companies in Colorado and Wisconsin, but simultaneously small and medium sized banks in Iowa, Wyoming, and Illinois.[48] In doing so, Norwest is constructing geographic market networks which should prove beneficial in staging future diversification into new financial product areas. Just recently the bank purchased a title company, and plans to aggressively cross-sell this product through its home mortgage loan officers.[49] Norwest's acquisition strategy also secures a sufficient market for financial services where volume is absolutely key to profitable operations such

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[47] Markley, p. 3.

[48] Norwest Corporation (1991 Disclosure Online Database, Disclo Company Number: N917800000), nd, np.

[49] Linda Corman, "Norwest Plans Expansion in Title Insurance,' American Banker, April 16, 1991, p. 8.

as credit card receipt processing.[50]

Industry consolidation as represented by Norwest is accelerating also because of technological advances in communications, information storage and retrieval, and data processing. A notable project that the bank has heavily invested in is Bank One's $100 million software development for an integrated, high volume, high quality retail banking system. Designed with the emerging technology called cooperative processing with which inexpensive personal computers will relieve processing from the bank's main frame. The new system will also speed delivery of new retail banking products to the market by cutting software development time for new products by 75%. Credit applications will be able to be processed during a phone conversation. Organization wide installation of the software will also eliminate high training and retraining costs. And, by improving retail profitability and cutting back office expenses, costs associated with acquisitions are minimized.[51]

In short the complexion of rural, localized banking is undergoing radical transformation. What is suggested here is not simply concentration within the rural nonmetro market, but a dramatic increase in the fluidity of capital and the transfer of economic

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[50] Karen Gullo, "Determined Banks Still Dominate Processing of Card Receipts," American Banker, April 22, 1991, p. 17.

[51] Richard Layne. "Banc One's $100 Million Software for Retail Banking Slated for Test." American Banker, February 27, 1991, p. 1.

control from nonmetro to metro areas.

The Implications of Consolidation

Initially it was simply assumed that rural banks were simply less competitive than metro banks, thus, most analyses to date have focused on operating and profit measures of rural banks versus metro banks. Many of these studies refute the notion of nonmetro banks being disproportionately disadvantaged.[52] They do not take into account, however, macro economic or external factors. For instance, the federal government provides 20% of all farm income in the form of farm subsidies, hence by supporting small scale agriculture it indirectly subsidizes the small nonmetro bank. As such agricultural subsidies are scheduled to be cut by $13 billion over the next 5 years, the impact on banks with large agricultural loan portfolios could be quite adverse.[53]

The rash of rural bank failures that occurred throughout the 1980s was originally diagnosed by the FDIC as a combination of poor loan quality and bad management. One of the leading characteristics of poor loan quality was a primarily agricultural loan portfolio, yet

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[52] Jonathan Scott, "Rural Versus Urban Bank Performance: An Analysis of Market Competition for Small Business Loans." Journal of Bank Research, 15, No. 3 (1984), p. 1.

[53] Rural Conditions and Trends, p. 12.

historically the charge of local banks has been to provide credit to the community. Indeed it was not until the mid 1980s that FDIC began to realize that macro economic forces that were depressing the local farm economy were in many, if not most, cases the primary contributing factor to the bank failures. Ironically a long term survival strategy adopted by many nonmetro banks, including many independent bankers we interviewed, is to adjust their portfolios to include fewer local loans and more low-risk nonloan assets.[54]

The effects of a bank failure on the local community can be devastating. In the case of uninsured deposits the community suffers a severe outflow of local capital. Even when the FDIC pays off its insured deposits of a failed local bank, the wealth of local investors is decreased and occasionally rural communities lose most of their banking services. In 1985 alone 17 rural banks were disposed in this fashion.

While most failed banks have been recapitalized or acquired by other firms, to date metro banks have shown little interest in investing in newly reconstituted nonmetro banks, and those that have are primarily small and medium sized firms. Consequently, the FDIC is experiencing increasingly greater difficulty in securing acceptable acquisition bids for rural bank foreclosures. In addition, political pressures on the FDIC are mounting to dispose bank assets at the least

[54] Gregory Gajewski, "Rural Bank Failures Aren't a Big Problem Yet," American Banker, August 28, 1986, p. 5.

possible cost. Since it is often cheaper to pay off a failed banks obligations and permanently close rather than reorganize the insolvent institution, the number of communities with no banking services is expected to continue to rise.[55]

The failed banks that are reconstituted appear to be well-capitalized and well-run, their below average loan-to-asset ratios indicate conservatism in credit policy. What implications this has on the availability of credit in the local community is as of yet undetermined.

Certainly one consideration in attempting to determine the availability of local credit is regional density or at least the location of the nearest neighboring town with banking institutions. Studies of competitive measures in relatively densely settled areas of the Midwest such as Illinois indicate that there exists considerable customer mobility between rural communities and that smaller rural banks' geographic market extends well beyond the town borders.[56] However, the distance between neighboring towns plays an important part in the coincidence of market areas. For example, in one study a market area is defined by a radius of merely twelve miles.[57] Yet in discussing market areas with bankers in less

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[55] Gajewski, p. 5.

[56] Morgan Lynge and Tai Shin, "Factors Affecting Rural Bank Market Share," Akron Business and Economic Review, 10, No. 3 (1979), p. 38.

[57] Lynge and Shin, p. 35.

populated areas in the upper plains states it was quite clear that since similar geographic proximity between towns generally does not exist, their market areas may two or three times this size. Therefore, even if local populaces in remote areas are substantially mobile, rural banking market areas may simply not overlap, and that markets are truly more self-contained. In such cases, the consequences of bank closure would be obviously more severe.

Most banks failures, however as we know, do not end up as closures. Indeed, merger or acquisition is by far the more common result. It is important whom the local bank merges with or is acquired by. In the case of merger or acquisition by another local small bank, there is an implied decrease in competition and perhaps availability of credit. While the new combined entity may be larger and more financially sound, it may not have the incentive to fulfill all of the local communities credit needs, particularly the riskier ones. Furthermore, it may also be forced to seek geographic and or sectoral diversification of it loan portfolio because it needs to ameliorate the risk of a concentrated portfolio. Finally, although it is implied that the new entity will be more financially viable, in numerous cases mergers between ailing financial institutions have only created larger weak ones.[58]

Most acquisitions of SNBs by larger regional banks have been

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[58] John Meehan, "If Mergers Were Simple, Banking Troubles Might Be Over," Business Week, No. 3210 (1991), p. 77.

selective, and usually SNBs are consolidated first into small holding companies and then acquired by the larger entity. Generally the regionals are interested in financially sound local banks with strong market shares. More than likely, they will be more be interested in institutions in areas where the local economy is growing, as is the often the case in adjacent nonmetro areas.

To reiterate an important point made earlier, the primary strategy of the regional bank is to create market blocks through which it can funnel its various financial services. This often means that financial services are being expanded for the local community. Although often these services are not necessarily new, e.g. brokerage services or title insurance, in very small communities they may not be readily available. In slightly larger communities where such services are already provided, the flip side of this outcome is that a financial giant is muscling in on other independently owned or franchised services in the community. Therefore, acquisition of local banking establishments may not simply consolidate credit services, but it may also impact other locally provided financial services as well.

Still ultimately the critical issue is whether the availability of credit is enhanced or diminished by the ongoing consolidation of the banking industry in nonmetro areas. Implicit in this argument is that local needs are understood and handled in a different and more responsive manner than by outside owned and controlled entities. To date it appears that regionals are interested in the building large nonmetro bank markets for the purpose of creating mass and somewhat captive consumer markets. Little attention if any has been focused on the provision of business, real estate and development, or agricultural credit. Deborah Markley's study of banking practices in New England has shed considerable light on the issue.[59]

In general Markley maintains that there seems to be no substantial difference between branches and independents in terms of providing the same level of banking service. However numerous nuances in her findings, as well as the geographic and temporal context in which the study was done, suggest that perhaps this conclusion loses validity when applied comprehensively or examined closely. For example, one key finding revealed that the probability of obtaining unsecured credit on terms acceptable to the applicant was substantially higher in markets dominated by independent banks than in those dominated by large banks or their affiliates(see Figure D).

Figure D: 2 pie charts showing: local banks- 46% obtain, 2% rejected, 44% never applied. Affiliates- 29% obtain, 6% rejected and 54% never applied. p. 9(Markley)

Other findings also indicate substantial differences in lending practices. Affiliated banks were more likely to lend to larger businesses than they were to small ones. Affiliated banks were also

[59] Markley's study surveyed 114 bankers and 582 business borrowers from rural areas in four states including: Maine, Mystic, Vermont, and New Hampshire. It was concluded in 1990. (from p. 5, Small Business Rural Banks)

more likely to rely on current and projected cash flows in making credit decisions, while independents relied much more heavily on the character of the borrower. More important however is the fact that 36% of the affiliate or branch managers cited limited understanding of the applicant's business as the most important criterion in rejecting loan applications versus 15% by local independents. At least in part it would appear that the affiliate branch tended to make loans to familiar, larger businesses based more on strictly financial criteria than do independent bankers.

These findings go hand in hand with a disturbing loss of autonomy in making credit decisions at the branch level. The survey results from the state with the longest history of interstate banking, Maine, revealed a full 40% of the bankers at affiliate establishments reported that lending decisions had been increasingly removed from the local office. Only 11% of the local bankers surveyed reported loss of credit decision making authority. Our conversations with branch and affiliate bankers confirmed that in some cases local offices lost considerably autonomy. In others while a hierarchy of decision-making existed, the authority at the local office level was about what the establishment's legal lending limit would be if the office had been independent bank.

More affiliated bankers also claim local business conditions constrain lending than do independent bankers. Although Markley maintains that the evidence from her study does not support the notion that branch bank networks deliberately funnel local savings to outside investments, she readily admits that larger branch banking systems are likely to be sensitive to regional conditions and that funds might be easily transferable to more profitable investments elsewhere. They could also be used to bolster the faltering financial resources of a lead bank experiencing deteriorating loan portfolios.

Yet it should also be noted that affiliated banks or branches have far greater lending capacity than independents, hence the availability of funds locally is technically increased. In addition to greater lending capacity, our interviews revealed that an increased number of financial products to local businesses may be made available through local affiliated banks. One Wyoming banker reported that his establishment could now provide hedging services to agriculture and brokerage services. His lead bank also supplies software packages that assist ranchers in determining stocking levels for breakeven operation. He and other bankers reported that affiliation with a large bank also increased their ability to provide asset based loans, but overall the main opportunity that these bankers recognized for developing new commercial business was in providing cash management services to the several large local governmental or private sector employers.

Yet opposed to these significant, but relatively few additional financial products available to commercial borrowers, affiliation with a large regional bank often brings numerous consumer services to the rural community.[60] One reason may be that rural and metro bank customers are relatively similar in terms of their banking needs, on the other hand, the differences between rural and urban economies are substantial. Moreover, some argue that the slow growing rural economy has presented limited opportunities for expanding bank lending.[61] If true, this scenario provides few incentives for the parent organizations to invest heavily in developing or marketing financial products tailored for retail businesses.

The much debated repeal of the Glass-Steagall and lifting of restrictions on activities banks may engage in could certainly increase the number of financial services provided by affiliates to local communities, but it would probably not increase local independents' competitive strengths. Likely targeted activities for affiliates include insurance, brokerage and underwriting. In some cases these services are already provided locally by small independent firms or franchise establishments. In a limited local market, these small firms simply may not be able to survive in the face of a larger competitor. Hence, product deregulation may only further enable large banking institutions to consolidate numerous financial services under a single corporate umbrella, e.g., the Sears-Discover Card-Allstate-Dean Witter conglomerate, and offer them through the affiliate, which

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[60] As many as 30 enhanced or new retail services were made immediately available to one establishment in Montana after it was acquired by a large Midwest regional bank.

[61] Charles Morris and Mark Drabenstott, "Financing Rural Business: What Role for Public Policy?" Federal Reserve of Kansas City Economic Review, September/October (1989), p. 30.

already increasingly resembles a sales office.

For most SNBs, financial product deregulation is irrelevant. They are simply too small to take advantage of the various niches that are already available to them due to specific regulatory exemptions.[62] Furthermore, in our interviews with independent nonmetro bankers most had no intention of diversifying their services. Indeed, one Missouri banker summarized their prevailing sentiments in saying that, "We should stick to doing what we know how to do."

Yet in isolated instances we found local banking firms that pursue currently unique market niches that are open to them. A Montana independent bank, for example, underwrites most of the local municipal borrowings and capital financings. While underwriting had been a profitable business in the past, the Montana bank's president was quite concerned about prospect of financial product deregulation in light of the fact that several large outstate banks had recently acquired nearby competitors in the region. Indeed his fears may be warranted as a large institution has greater technical expertise, has lower funding rates, large pools of long term funds, and access to secondary markets, could certainly undermine the local bank's near monopoly of the local municipal underwriting market.

Finally, much has been touted as to financial services providing tremendous growth employment opportunities for rural communities.

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[62] Hiemstra, p. 31.

Services have been among the leading areas of employment growth in the U.S. The expansion of large metro banks has been seen as an opportunity for rural communities to capture back office export-oriented employment.[cite] Yet, as has been seen in the insurance industry, service employment is being transformed and undergoing contraction due to automation and new optical data entry and information processing capabilities.[63]

In an recent study of rural corporate services, Marie Howland and Amy Glasmeier trace the growth in employment between 1980 and 1986 for branch plants, subsidiaries and independent firms.[cite] Their study the results indicate that nonmetro corporate services generally did not experience extraordinary employment growth. Indeed, banking services grew even slower than other corporate services, and increased employment occurred came at the expense of independent firms. One of the representative states examined, Kansas, actually registered aggregate negative employment growth. In short, the massive decentralization of back office functions by major metropolitan banks has more than likely stopped at the edge of the suburbs, where land is plentiful, and relatively skilled and cheap labor is abundant. Consequently, the major portion of nonmetro bank employment growth has been in market oriented functions. Indeed as one affiliate banker described his bank's new corporate culture, "We are a sales oriented bank." Finally, the easing of geographic restrictions on branch

[63] See Barbara Baran's "The Technological Transformation of White Collar Work: A Case Study of the Insurance Industry," (Diss. University of California, Berkeley 1986).

banking and potential product deregulation may spell consolidation of separate service establishments and further reduce employment prospects, particularly for lower level positions.

Conclusion:

It has been argued that the loss of even as many as half of the nonmetro banking firms in the U.S. would have little appreciable effect upon rural communities, that often this process of consolidation involves nothing more than a change of ownership. We believe that Markley's findings directly contradict these vague reassurances. While for the retail customer, there probably will be a wider offering of financial services, there is less evidence to support the argument that credit will be greatly enhanced to local businesses. True, affiliated entities are probably more financially secure and they may have access to technical and financial resources than independents, but so far urban-based regional banks have merely raced tic douloureux to create regional marketing networks. They have shown little interest in developing financial services applicable to rural businesses, particularly small ones. Frequently they appear to be out to capture specific mass retail markets and not to be full service institutions.

In this context of governmental deregulation, for rural businesses and agricultural concerns little relief appears to be forthcoming from other financial institutions. Credit policies for quasi-public sector entities such as the Farm Credit System are now far more restricted than in earlier periods. Scheduled reductions in federal agricultural subsidies and the corresponding reductions effects on farm income can only tarnish the negative image of agricultural communities to investors and financial institutions.[64]

The decline in mortgage lending by insurance companies also may have grave consequences for some rural communities. For the near term, real estate projects in rural areas increasingly may have to compete for financing with projects in more rapidly growing suburban areas. While rural communities adjacent to growing metropolitan areas may benefit from such suburban sprawl, remoter nonmetro areas that had banked on developing retirement communities or tourism for their economic salvation may find that this scenario combined with the well-publicized savings and loan debacle equates to real estate financing that is more limited and costly.

Some deregulation proponents have claimed that the lending practices and markets served by affiliates and independents are sufficiently different that there are niches that must be filled by local independents. In reality what may be more likely is that the most profitable sectors will be captured up by affiliates, and more marginal business will be left for the independents. The consequence

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[64] Farm subsidies are scheduled to be cut by $13 billion over the next five years. These subsidies constitute of farmers' net cash income (from Rural Conditions and Trends, p. 12).

for independent banks is for business to be further concentrated sectorially, and in those sectors that are the most volatile and marginally profitable such as agriculture. If independents are weakened to the point of failure and if local markets become primarily dominated by large regional banks the niches formerly filled by the independents will become voids. As rural businesses already face obstacles such as labor shortages and limited markets, added uncertainty regarding credit availability can only dampen new firm formation as well as expansion of existing establishments.

So what does this mean for rural communities? As the traditional institutions of rural communities undergo transformation, the most notable consequence is the unraveling of the ties and interdependencies that have bound the community together. No longer is the local bank solely dependent upon local investors to provide equity and depositors to provide deposits to provide credit services. The new affiliate is not bound to the local community as its sole source of income. Yet, consumers will probably have increased access to credit, and business borrowers will be less dependent upon having a long term relationship with the local banker or being an established member of the community. In short the local community will no longer be as self-contained as it was before deregulation.

While for years rural communities have been subject to external forces, however they have had to deal with them in large measure with local means. Now rural communities appear to have little choice.

Improvements in telecommunications, consolidation of regional bank power in urban areas, and globalization of agricultural and industrial markets all mean that their local economies increasingly are being integrated into the regional and national economies.

Appendix A

The Federal Reserve(Fed) is the central bank in the U.S. It is composed of 12 district banks which are headed by a board of governors. The district banks act as bankers' banks by accepting deposits and making loans to the member commercial banks. While all nationally chartered banks must join the Federal Reserve System, most state chartered banks elect not to do so as federal regulations are generally more stringent than are those of the states. However historically Federal Reserve members have held a very high percentage of the nation's demand deposits, hence the Fed has been able to exert its influence.[65]

The chief charge of the Fed is to create monetary conditions that are consistent with the goals of high employment and stable prices. It attempts to achieve this end by regulating the banking industry. There are three main tools by which the Fed implements monetary policy: (1) setting required reserve ratios, (2) controlling the discount rate, and (3) open market operations.

All member commercial banks are required to maintain certain levels of reserves in order to meet the demands of depositors who may wish to withdraw funds. Reserves include cash on hand and any deposits that the commercial bank may have on deposit at Federal Reserve district banks. The reserve requirement is thus the ratio of a bank's reserves to its total deposits. By lowering or raising this ratio the Fed increases or decreases the amount of deposits which may be loaned, hence the capacity to expand or contract the money supply.

Occasionally member banks find themselves in the position of having insufficient reserves. In such instances, they may take out loans from other banks which are called Fed Funds. The Fed closely monitors the prevailing interest rate on Fed Funds as it is an indicator of credit activity. The other option commercial banks exercise to maintain required reserves is to borrow directly from the Fed. Borrowings from the Fed bear interest at what is known as the discount rate. Changing the discount rate effects the cost of maintaining credit outstandings, and it also signals Fed policy to the commercial banking industry.

The most effective tool the Fed has in influencing money supply is open market operations. By buying and selling large amounts of government securities, the Fed immediately injects and withdraws money from the commercial banking system. For example, when the Fed buys securities, the sale proceeds are deposited in commercial banks. However, not only does the money supply immediately rise, but the availability of credit is increased.

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[65] James Cicarelli, Economics: Macroeconomic Principles and Issues (Chicago: Rand McNally College Publishing Company, 1978), pp. 268-276.

Finally, the Fed also issues currency and provides the operational framework through which funds are electronically transferred and checks are cleared. Banks who are not members of the Federal system, generally smaller ones, establish correspondent relationships with large regional and money center banks in order to clear checks and carry out other financial services.[66]

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[66] Paul Wonnacott and Ronald Wonnacott, Economics (New York: McGraw-Hill Book Company, 1979) pp. 215-226.

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