



United States
Department of
Agriculture

Economic
Research
Service

Agriculture
Information
Bulletin
Number 664-11

April 1993

Issues for the 1990's: RURAL ECONOMY

Effect of Bank Consolidation on Rural Credit Availability

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Issue. Bank restructuring affects the local financial markets that rural borrowers rely on for credit and other financial services. While control of rural financial institutions is slowly being transferred to urban-based conglomerates, most banks serving rural areas are still rural headquartered. A reduction in the number of financial institutions serving rural communities might lessen competition and therefore increase the cost of credit or reduce its availability. Proposals to allow interstate banking and branching would accelerate the trend toward fewer but larger banking organizations. Rural business and community leaders worry about how the trend will affect rural economic growth.

Context. The number of commercial banks has declined since the mid-1980's. Part of this reduction is due to bank failures, which initially included many rural-headquartered banks affected by financial problems in the farming and energy sectors. But rural bank failures are now relatively rare. Instead, changes in the size and composition of rural bank markets are due to expansions and mergers of both in-State and out-of-State banking firms. Each State determines the forms of branching and holding company expansion permitted by banking firms already operating in the State, and whether out-of-State bank-holding companies can enter the State by purchasing existing or starting new banks. Most States allow at least some branching by banks chartered within the State, and a large majority permit bank-holding companies based in other States to acquire banks within their jurisdictions. Nonetheless, rural bank offices are not the primary target in most bank acquisitions. And rural banks involved in mergers of bank-holding companies are likely just exchanging one outside owner for another. However, focusing on specific local markets, some mergers do reduce the number of banking firms with a local presence or ownership, and therefore may reduce availability of rural credit. The United States continues to have thousands more banks than other countries, but rural businesses typically have access to just the handful that maintain offices nearby and so can be greatly affected by any change in their local financial markets.

Consolidation of the banking industry can have both negative and positive consequences for rural communities. Some business people and community leaders fear that outside control of rural banks will limit credit availability as local bank deposits are transferred to more profitable outside investment opportunities. Outside banks may also pass up profitable local loans if they fail to accurately evaluate rural loan applications. This may occur because new managers are continually rotated to small rural branches to gain experience before moving on to larger urban offices, or because loan decisions are made by centralized loan committees with limited input from local branches. Those favoring bank consolidation argue that large, geographically diverse banks are less vulnerable to weak economic conditions in a particular region or economic sector. Large banks also provide a wider range of services and products, can handle larger loans, and are less likely to reject loan applications for new types of businesses.

Surveys of small businesses conducted in the 1980's have consistently shown that owners of rural businesses are generally satisfied with their bankers and the availability of bank credit. The data also provide evidence that urban and rural credit markets are well integrated in a national credit market. However, these surveys do not reflect the current regulatory environment that some argue has created a credit crunch. Nor do they provide information on firms that failed or never started due to an inability to obtain credit. Outstanding commercial loans at banks declined during the recession, and the media

provided anecdotal evidence of firms that lost access to credit. Nonetheless, it is difficult to determine whether or not credit is harder to find in rural areas compared to urban areas, or compared to conditions that existed in the 1970's and 1980's. Ratios of loans to deposits at rural banks are well below their historical highs. But is this due to a lack of demand as consumers and firms try to reduce debt levels, or does this reflect a widespread refusal by banks to make loans?

At Stake. Banks represent the primary source of credit in most rural communities and therefore directly influence the pace and direction of economic growth. Banks and other lenders were accused of exacerbating the recent recession by being overly conservative in their loan decisions in response to pressure from regulators not to repeat the errors that caused so many financial institutions to fail during the 1980's. Rural consumers and businesses are likely to find themselves operating in financial markets that are becoming more national and global in nature. Rural banking offices will not disappear, but over time more of them will belong to large banking organizations based in distant cities and States. Whether this change has a positive or negative effect on local credit availability depends, in part, on how competitive rural financial markets remain. If local competition is heightened, rural communities stand to benefit from the banking industry's consolidation.

Alternatives. Federal legislation could open the entire country to interstate banking and branching. Variants of this proposal give each State an opportunity to opt out of interstate banking by passing appropriate legislation within a specified timeframe, or require States to pass enabling legislation to participate in interstate banking. Large bank-holding companies argue that they could operate more efficiently, with benefits passed on to all of their customers, if they were able to convert bank affiliates to bank branches and to enter any market rather than those dictated by individual States.

Experience in States that have permitted widespread branching for many years suggests competition within local markets need not suffer when large urban-based banks move into rural markets. A significant proportion of community banks endure and prosper in statewide branching environments by identifying and serving markets and customers ignored by large banking organizations. This is likely to be the case whether or not interstate banking legislation is passed, as long as the current Federal Deposit Insurance System remains unchanged.

Some proposals for changing the current bank deposit insurance system could penalize rural banks. The system was designed to protect both individual depositors and the broader financial system by assuring that failure of one bank does not scare people into removing deposits from other banks. However, deposit insurance removes the incentive for depositors to closely monitor lending and investing activities of their financial institutions, adding to the cost of the financial system. To reduce this distorting effect, some have proposed lowering the effective ceiling on insured deposits held by individuals and their families. But community bankers and their supporters argue that this would unfairly penalize small banks. Because of concern about possibly jarring the Nation's economy, regulators tend to repay both the insured and uninsured portions of deposits at large failed banks, but not at small banks. If insured deposits are reduced and people expect regulators to continue to protect large banks, depositors might switch from small rural banks to offices of large urban banks, making it difficult for rural banks to compete.

Agenda. Comprehensive banking legislation was proposed in the last session of Congress, but a coalition representing groups such as community banks, insurance agents, and retired people was able to delete those sections addressing interstate banking and additional bank powers.

Information Sources. Two U.S. Dept. of Agriculture, Economic Research Service, reports: J. M. McGlone, "Rural Businesses Voice Few Complaints About Their Bankers," *Rural Development Perspectives*, Vol. 7, Issue 2. D. L. Milkove and P. J. Sullivan, *Deregulation and the Structure of Rural Financial Markets*, RDRR-75, Feb. 1990.