THE ENVIRONMENT FOR CONSOLIDATION OF COMMERCIAL BANKS IN RURAL MARKETS

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The structure of rural financial markets is undergoing transformation. A major part of that transformation results from the consolidation of commercial banks. As the geographic limitations on branching and holding company ownership have been relaxed, increasing numbers of banks have chosen to merge. Although this process has been ongoing for decades, there has been a resurgence in the pace of merger during the early 1990's. Further, recent legislative changes imply that the pace of amalgamation will likely continue and may even increase.

This consolidation engenders a very basic question about its effect on the institutions and people involved. Considerable research has been conducted on the effects of merger on bank efficiency and stockholder wealth. Much less focus has been placed on the end user of financial services, the customer. A major customer of rural financial markets is agricultural producers.

This paper provides a brief review of the current agricultural banking environment, examines some of the legislative changes that are allowing and encouraging rural financial market consolidation and then discusses some of the issues surrounding the benefits and costs of fewer and larger rural banking entities.

The current agricultural lending environment

The agricultural lending environment in which banks must operate is undergoing rapid change. The size distribution of agricultural units is becoming increasingly bimodal with large farms and small part-time units predominating. The part time units fit into a consumer credit mode, but owners of such businesses will prefer loan officers with some understanding of their business. The credit needs of the large farms now frequently exceed the sole funding capacity of many small community banks. These larger farm units also use a much more complex combination of financial services. To better serve this customer base, many smaller community banks will find consolidation into multibank holding companies, being merged into a larger bank as branches or establishment of strategic alliances with larger banks will improve their competitive position.

The Farm Credit System (FCS) is consolidating its geographical structure and, at least in some areas, it is modifying its operating procedures to make it a stronger competi-

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tor in the agricultural credit and financial services market. District banks are merging to reduce the cost of lendable funds to their association owners. Associations are also merging to reduce costs and to achieve sufficient size to serve the needs of their best customers. The merger of the CoBank and the Farm Credit Banks of Springfield to form an Agricultural Credit Bank represents a consolidation of functional areas with opportunities for further efficiencies.

The change in the FCS that may have the largest affect on the competitive environment in agricultural lending is the combination of operating credit (Production Credit Associations) and real estate credit (Federal Land Banks) functions in one lending entity, either as a merged association or as jointly managed associations. This combination provides opportunities for improved lending efficiency and better loan packaging.

Budget limitations and concern with the high loss levels, particularly with emergency loans, are reducing the role of the Farm Service Agency (FSA) in agriculture credit markets. Direct lending is being drastically reduced and lending authority is focusing on guaranteed loans. However, only part of the former direct lending clientele base can be served by guaranteed loans. Commercial lenders will have the job of identifying and refusing loans to the remaining high risk, low income borrowers. A curtailing of FSA efforts will also slightly increase the credit risk of commercial lenders. The FSA safety net for borrowers allowed farmers with financial problems to shift part of all of their borrowing to FSA, thus, shifting credit risk from commercial lenders to FSA. With the guarantee program, lenders will need to identify problems early enough to obtain a guarantee and will sustain at least ten percent of any loss.

The establishment of the Federal Agricultural Mortgage Corporation (Farmer Mac) as a secondary market for agricultural and rural real estate loans augments the product line that banks can offer while minimizing interest rate risk. The expanded product line could reduce the incentives for small banks to merge. It also provides an easily packaged product with fee income which is attractive to banks of all sizes.

Agriculture is experiencing a proliferation of new entrants into the credit market. Non-bank entities such as implement manufacturers and other input suppliers as well as some product processors are getting more active in credit as a profit center rather than as the unintended result of normal business activities. Foreign entities such as Rabobank and Credit Agrico are focusing on certain niches in agribusiness, such as large scale livestock production and agricultural processing/food manufacturing. These entities are direct competitors with large regional and money center banks, as well as with the FCS.

Legislative changes

The past 39 years have resulted in a full circle of legislative changes at the federal level regarding interstate banking. These changes have involved both ownership of banks by out-of-state bank holding companies and branches of banks in states other than the bank's home state. During that same period, there has been a gradual reduction in the intrastate branching and holding company restrictions that have allowed considerable consolidation of banking institutions in much of the U.S.

Intrastate Legislation

Relaxation of branching and holding company restrictions has been a gradual process that has been on-going for decades. Between 1959 and 1986, the number of unit banking states declined from 15 to 6. Many states that allowed limited branching, reduced their restrictions. The number of states that allowed statewide branching increased from 13 to 19 (Milkove and Sullivan).

The pressures to change state restrictions and the apparent desire of institutions to merge surged in the late 1980's and early 1990's. By mid 1994 a total of 47 states had passed statewide branch banking statutes. Some states had a variety of conditions and others had future effective dates, but, clearly, statewide branching had been accepted throughout most of the U.S. The number of bank acquisitions increased by nine fold between 1988 and 1994 (Stieven and Maples).

Out of state bank ownership

Prior to 1956, federal laws and regulations did not prevent bank holding companies from owning banks in more than one state (Savage). None the less, only nineteen multi-state bank holding companies were in existence in that year. The Bank Holding Company Act, passed by the Congress in 1956, prevented a holding company from acquiring banks outside its home state unless state law in the holding company's home state specifically permitted it. No states' laws did so. As a result, no new multi-state organizations could be formed, although those in existence were grandfathered in. Over time smaller bank holding companies gave up their grandfathered rights and the number of multi-state bank holding companies declined to seven.

In 1975, Maine enacted legislation permitting out-of-state bank holding companies to acquire Maine Banks beginning in 1978. Maine's desire for interstate banking was focussed on attracting outside investment capital into the state. The home state of a bank holding company acquiring a bank in Maine had to permit a Maine bank holding company to acquire banks in its state.

Within a decade of Maine's action, 25 states had passed interstate acquisition statutes. Motivation for statutory change derived from many sources. Increasing access to investment capital was a strong motivation. The banking industry recognized interstate banking activity was increasing through credit cards, loan production offices, nonbanks, nonbank subsidiaries of bank holding companies, interstate thrift institutions and financial services extended by nonfinancial firms (Savage). Banks, themselves, had various competitive reasons for wanting interstate banking.

Where states enacted interstate banking laws, they typically retained certain restrictions. In addition to reciprocity, some states restricted entrance of out-of-state bank holding companies to a limited number of states within their region. Many states put a cap on the share of state deposits controlled by a single bank organization; caps ranged from a low of 10 percent in Iowa to as high as 30 percent in Minnesota. Some states promoted certain kinds of banking activity; such as credit card processing. In addition, some states differentiated between out-of-state banking organizations and foreign owned organizations. Still others permitted individual banks to opt out of interstate banking provisions.

Financial stress in the U.S. banking and thrift systems during the 1980s resulted in a number of states relaxing barriers to interstate bank holding company ownership of failing institutions. Bank holding companies were permitted to acquire failed thrift institutions nationwide. The Federal Deposit Insurance Corporation (FDIC) also favored making it easier for bank holding companies to bid on the assets of failed banks and thrifts nationwide, in a effort to limit the cost of bank failures to its insurance fund.

Over time state laws have become more permissive toward interstate banking via bank holding company acquisitions of banks in other states, with the decade of the 1980s experiencing major changes in state statutes. By mid 1994, twelve states had national non-reciprocal statutes (American Bankers Association, July 1, 1994). Twenty five states had national reciprocal statutes in place. Thirteen states had regional reciprocal statutes, three of which had a national trigger. One state had an international reciprocal statute.

Bank response to changes in state statutes has been measured. As of June 30, 1993, only 170 U.S. Bank holding companies owned banks in more than one state. Eight foreign bank holding companies did so, as well. Fully 111 of the companies had banks in only two states and 45 more had banks in only three or four states. The share of domestic bank deposits held by insured commercial banks owned by out-of-state bank holding companies on that date ranged from a low of 0.25 percent in North Carolina to a high of 89.69 percent in Arizona. The national average was 22.81 percent.

Interstate branching by banks

By the early 1990s, it was clear that interstate bank holding company activity was becoming ever more common. What remained to be decided was whether interstate branching would be permitted. While states could control the introduction of interstate bank holding company activity they had limited authority to change bank branching restrictions. States could permit interstate branching only by state chartered banks that were not members of the Federal Reserve System. The McFadden Act of 1927 prohibited national banks and state chartered member banks from branching beyond their home state.

Interstate branching was very limited in the early 1990s. By June 30, 1992, 146 bank branches were being operated across state, territory or possessions borders. Only 43 of those branches were operating across state lines (Savage). This compared with more than 56,000 branch offices operated by FDIC insured commercial and savings banks.

Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 setting the stage for more uniform application of interstate branching across the nation (Interstate Banking Efficiency Act). The Act provided that interstate branching was to become effective on June 1, 1997. States could pass legislation that permitted banks to branch into or out of their state before that date. States could also enact legislation before that date to prevent banks from branching into or out of their state. A state opting out of interstate branching must do so by June 1, 1997; but it could later opt back in should it decide to do so. The legislation applied to nationally chartered banks. State restrictions on branching for state chartered banks were continued in effect, until changed b state legislation.

States would be required to be even handed in treating in-state and out-of-state banks on branching issues (The Conference of State Bank Supervisors). They would no longer be permitted to maintain statutes that discriminate against out-of-state banks. Moreover, only those states that elect to opt in early to interstate branching may impose conditions on the operation of an interstate bank branch. States may require reciprocity as a condition for entry of non-home state banks, providing conditions are non-discriminatory and do not pre-empt federal law.

States would be able to decide whether an out-of-state bank could enter the state by acquiring a bank and converting it to a branch or whether a bank could establish a new (de novo) branch in the state. Additionally, states could decide whether out-of-state banks could acquire a branch of an insured bank without buying the bank, itself. States can also require minimum age-of-existence of up to five years for acquired banks within their boundaries. Finally, states may impose certain constraints on concentration of total state deposits held by an out-of-state bank, requirements for servicing credit needs of communities where banks are acquired by out-of-state banks and non-discriminatory Community Reinvestment Compliance laws.

According to American Bankers Association data, as of September 18, 1995, eleven states had decided to opt in early to the Interstate Banking Efficiency Act. Another eleven states had chosen to opt out in a timely manner or to have legislation in conformance with the Act. Only Texas had chosen to opt out at that time.

While it is too soon to determine the full impact of the new branch banking authority for bank holding companies, it seems likely that there will be considerable interest in interstate branching. The law is also likely to result in a reduction of intrastate consolidation restrictions as states pass laws to opt in or be in conformance with interstate branching. The Act appears to strike a reasonable balance between state authority over banking and federal banking authority (The California Bankers Association). The dual banking system is preserved. States have an opportunity to make major decisions, within the Act's framework, regarding their banking systems and their supervisory authority.

Benefit and cost issues

A considerable body of research indicates that scale economies are likely all achieved for banks in the range of $75 to $500 million in assets (Berger et al). Research on agricultural banks, which tend to be small in size, also finds little evidence of economies of scale for average size ($60 million of assets) agricultural banks (Featherstone and Moss). This result is supported by studies indicating that acquiring bank stockholders do not gain from mergers (Rose). However, the continued merger of large institutions suggests that good reasons for merger may exist. One possibility is that the clear gains by the acquired bank stockholders and acquiring bank management, with few strong negative results for acquiring stockholder, may be sufficient motivation. A second possibility is that noncost factors such as market power or market position may be important. Finally, it may be that the research is incomplete. Research assessments (Berger, Collender) that call for profit function and other improvements lend credence to this possibility.

Research on the effect of bank consolidation on bank customers, and particularly agricultural customers, is sparse. A study of New York commercial bank mergers in the 1950's (Kohn) found that some fees were lowered, namely checking account fees, rates on auto loans and compensating balance requirements on small businesses.

A major issue for rural and agricultural banks is whether consolidation process, which frequently involves combining rural banks with more urban banks, results in a net flow of funds into or out of rural areas. Clearly, systems that branch over a wide area allow more fluid movement of funds in either direction. Krone's assessment of the performance of banks that became rural branches of major branch banks was that, "The available evidence does not support the view that there was any systematic policy on the part of these banks to slight rural communities." In a 1973 study of Virginia banks, Snider found no evidence that independent banks that became branches of urban banks reduced their ratio of agricultural loans to total loans compared to the performance of banks that remained independent. More recently, in a study of a small sample of midwest banks purchased by out-of-state banks, Lawrence and Klugman found "...little evidence to support the contention that the interstate organizations are abandoning agricultural lending or competing unfairly to monopolize the market."

One factor that these studies may not be allowing for is the normal "treatment-cycle" to which acquired banks are usually subjected, which may make long run effects of merger different than short run effects. To insure that the merger is "friendly" the acquiring bank frequently promises to do little or nothing to the acquired bank. After the merger there is a "honeymoon" during which these promises are fulfilled. As soon as profits cycle down or key people leave, the acquiring bank exerts more control. Over time, sometimes several years, policies change considerably. For example, in a 1987 study LaDue found that merged banks did not reduce their proportion of agricultural loans for up to six years after merger. However, in the early 1990's two of the banks that did the most merging and ended up with $100 and $60 million agricultural loan portfolios have instituted policies that are resulting in precipitous declines in agricultural loans. This is contributing to a declining market share for New York banks during a period when national market share is rising.

Agricultural lending cycles also have an impact on agricultural lending policies. Banks that reduced their exposure to agriculture during the financially troubled 1980's are, in many cases, now selectively rebuilding their agricultural portfolio. However, where a shift in emphasis during the 1980's resulted in a loss of specialized lending skills and industry knowledge, it is much less likely that agricultural lending will be re-emphasized.

The expectation that urban or out-of-state banks would siphon funds out of the rural areas and leave agriculture and other rural businesses without needed credit has been and continues to lead rural representatives to resist unlimited branching and, particularly, out of state branching and holding company ownership.

Perceived optimal product mix at commercial banks currently de-emphasizes loan products in favor of fee income products. This makes agricultural loans a less desirable product, but not necessarily less desirable than other types of business loans. Such a shift could cause total bank lending to agriculture to decline even if agricultural loans maintain their historical proportion in the optimal portfolio mix.

The large farm segment of agriculture is becoming more like small and midsize nonfarm businesses. Business size and complexity should provide a market for a number of financial services besides loans. Thus, many agricultural producers are becoming better potential bank customers.

Not all mergers need be a large bank from an urban area gobbling up a small rural bank. Many mergers or holding company acquisitions can result from relatively small rural banks joining forces to achieve scale economies and sufficient size to serve the expanding agricultural and rural businesses in their market area.

Summary

The consolidation of rural banks is occurring in an environment of rapid change in both agriculture and rural credit markets. Although consolidation has been occurring for decades, recent changes in statewide and interstate branching laws have expanded consolidation opportunities and resulted sharp increases in the rate of amalgamation. Recent federal interstate branching laws may even increase the pace of consolidation. Whether mergers result in increased or more limited flows of funds into rural financial markets is an important question which could have an important effect on the viability and vitality of agriculture and rural communities. Ongoing research to evaluate the impact of current and prospective changes in rural financial markets will provide important insights for business persons, banks and public policy makers.

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