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Gregory Gajewski

## Rural Bank Failures Not a Big Problem—So Far

*There were more bank failures in 1985 than in any year since the Great Depression. About two-thirds of them were in rural areas, especially farm areas. Most of the failed banks were purchased and re-opened almost immediately without the severe disruptions that accompanied Depression-era bank failures. Two areas arouse concern: banks that took over failed banks are somewhat more conservative than average and may make small proportions of their funds available for loans; and the Federal Deposit Insurance Corporation (FDIC) is having increasing difficulty finding suitable banks willing to take over failed rural banks.*

**T**he 118 commercial bank failures in 1985 represent a twelvefold increase since 1981 and set a post-Depression record for bank failures in 1 year. An increasing proportion of the failed banks are rural or agricultural banks. Almost 70 percent of the failed banks in 1985 were rural banks, up from 34 percent in 1983; and more than 55 percent were agricultural banks, up from 16 percent in 1983.

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This article highlights recent trends in commercial bank failures to see how the failures are affecting rural communities and if rural growth is threatened by too few banks serving local rural markets.

Bank failures have not, so far, hurt a large segment of the rural population. Most failed banks are replaced by healthy ones within a few days. This may be changing, however. The FDIC is beginning to have difficulty finding banks willing to acquire failed institutions. Moreover, individuals suffering debt repayment problems and marginally qualified borrowers find it more difficult to obtain credit as a result of these failures, hindering local economic growth and development. The continuing financial problems of farmers and problems developing in the energy sector will likely cause additional rural banks to fail over the next several years. While these failures will hurt local and regional credit markets, recent experience suggests that the national effects will be relatively mild.

### A Look at Banks that Fail

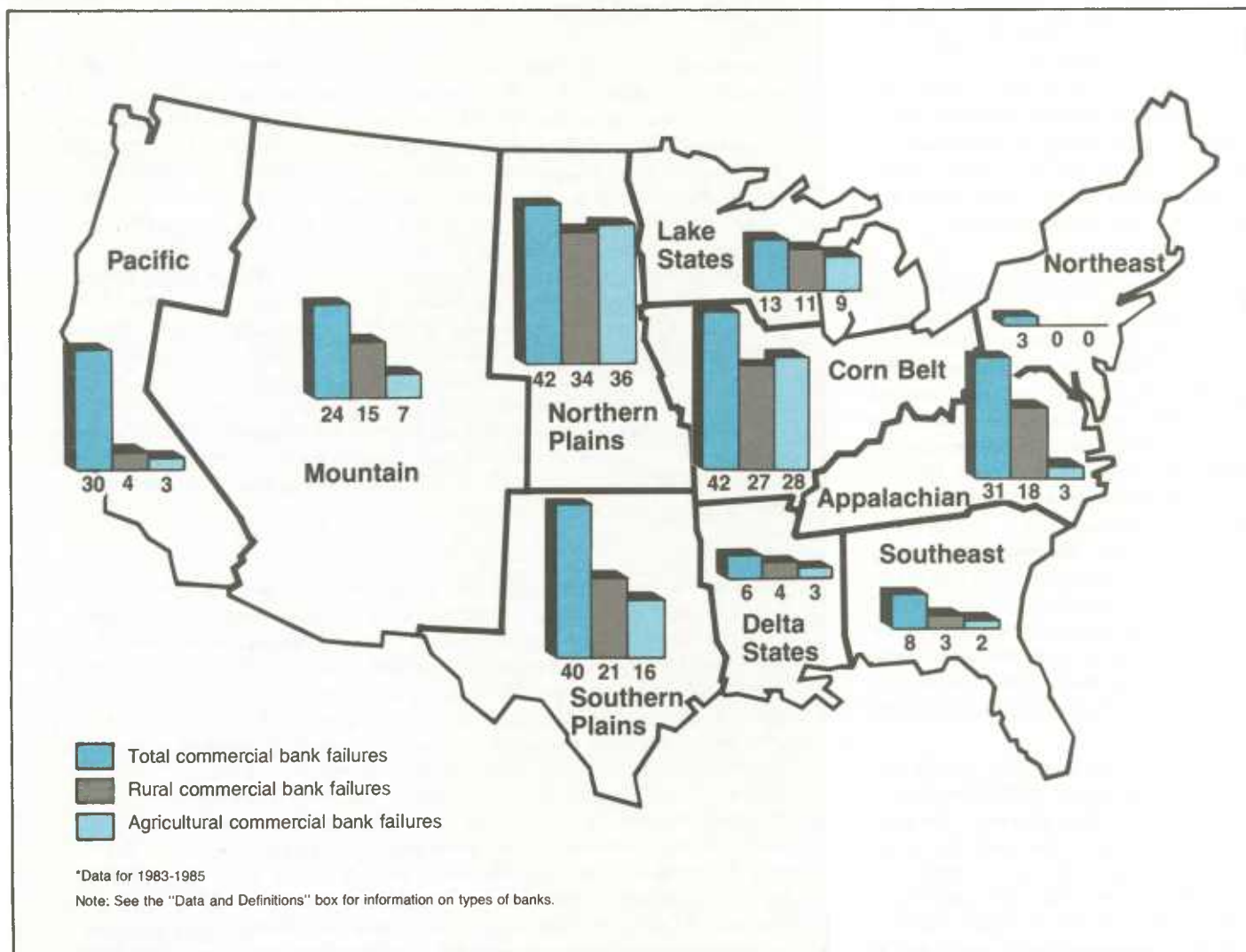
Over the 1983-85 period, 239 commercial banks failed; 137 were rural and 107 specialized in financing agricultural activity (fig. 1). Bank failures in the Corn Belt and Plains States accounted for over half of all failures, about three-fifths of rural bank failures, and almost three-quarters of agricultural bank failures. No rural or agricultural banks failed in the Northeast.

Photo by A. Craig Benson

When Strong's Bank in Dodgeville, WI, closed, no long lines of depositors formed, unlike the situation in the 1920's and 1930's. Deposits are now insured by a Government agency and most banks reopen soon under new management.

Figure 1.

Most rural bank failures are in the nation's heartland



### Rural Bank Failures a Reminder of the Twenties

Problems faced by rural banks in the 1921-29 era and the current period show striking similarities. The roaring twenties were characterized by sustained economic growth on a national level combined with deteriorating conditions (sharp declines in agricultural land values and incomes) in the agricultural sector. These factors, together with excessive debt incurred immediately after the first World War, produced many symptoms of depression in rural America.

An average of 600 banks per year failed between 1921 and 1929. Reflecting the problems of many rural areas, a large proportion of these were rural, and over half were in seven northern grain-producing States. Then, as now, little concern was expressed over these failures precisely because most were small, rural, and isolated. The failures were even touted as a positive force in promoting market discipline.

Despite the strong parallels between the two periods, important differences exist. Relative to the total number of banks, the annual

proportion of bank failures was roughly three times greater during the twenties. Moreover, important institutional changes largely insulate today's rural economy from the devastating effects of commercial bank failures then. A failed bank no longer means the financial ruin of thousands of depositors and subsequent declines in economic activity. Rather, the main issues now focus on the degree of local control in the bank acquiring the failed bank, banking service availability in rural areas, and credit availability for marginally qualified rural borrowers.

The geographic distributions of failed agricultural and rural banks are similar, with the exception of the Appalachian States. The disproportionately high number of rural, nonfarm bank failures there is due in part to the collapse of the Butcher brothers' chain banking organization in Tennessee. In all, 10 banks in this chain failed through 1984; some were rural but none were agricultural banks.

State laws that restrict bank branching have been blamed as major contributors to bank instability and failure, yet the distribution of failures over this period among unit banking, limited branching, and statewide branching States provides inconclusive evidence. While the proportion of bank failures to all banks is somewhat higher in unit-banking States than in limited branching and statewide branching States, many unit-banking States are in regions hit hardest by agricultural problems. As a result, the role of State branching laws in contributing to bank failures is unclear. (See "Definitions and Data" for types of bank structure.)

Only nine banks owned by multibank holding companies (MBHC's) failed from 1983 to 1985. However, the proportion of failures that were one-bank holding companies rose markedly, from 14 percent of all bank failures in 1983 to 54 percent in 1985. MBHC's that acquire failed banks also have a history of making relatively more loans than other types of acquiring banks. The relationships between competition, corporate structure, and safety of the banking system should be considered in State policy debates regarding MBHC's.

The small size of most failed banks since 1982 is one reassuring datum on the stability of the national banking system. About 80 percent of the failed banks had less than \$50 million in assets, and fewer than 5 percent had over \$300 million in assets at the time of failure. Since 83 percent of all banks have assets below \$100 million, size alone does not seem to contribute to bank failure.

Several characteristics set failed commercial banks apart. Data for the year

## Definitions and Data

Commercial bank failures and their acquisitions from January 1, 1983, through December 31, 1985, are included in this article. Excluded are failures of mutual savings banks, savings and loan associations, commercial banks not insured by the FDIC, banks headquartered in U.S. territories and possessions, and two acquisitions of failed banks made by foreign banks. Noninsured commercial banks account for less than 1 percent of commercial bank offices in the United States and less than 3 percent of commercial bank failures over the last 10 years. Although seldom done, regulatory authorities may inject capital and force a change in bank control to prevent an ailing bank from failing. This procedure was followed with Continental Illinois National Bank in 1984, for example. Because such institutions do not technically fail, they are also excluded.

A commercial bank is classified as rural if its headquarters is located in a nonmetropolitan county. Agricultural banks are those with 17 percent (the average for all banks) or more of their loan portfolios in agricultural loans. In December 1984, there were 7,900 rural banks, and 5,157 agricultural banks, of which 4,523 were also rural.

Because much of this article deals with the effects of the bank failure-acquisition process on the structure of local banking markets, a brief review of some important aspects of the U.S. banking industry is presented here. State law determines the allowable numbers and locations of branch offices that banks may operate. No branching activity is permitted by banks located in unit-banking States. In limited-branching States, however, branch offices are restricted to one county or contiguous counties. Statewide branching States place little or no restrictions on bank branching activity. Many States that restrict bank branching allow multibank holding companies (MBHC's) to compete throughout the State via their subsidiary banks. These firms own two or more legally separate banks, each of which may have its own branch offices, if permitted by State law. One-bank holding companies, however, subject to the same branching laws as independent banks, are allowed to offer banking-related services not permitted their independent counterparts. A more informal grouping of banking firms, often referred to as a chain banking organization, represents another way bank owners attempt to get around local branching laws. A chain banking organization is composed of two or more "independent" banks whose controlling interests are owned by the same individual or group of individuals.

Data for individual banks, from quarterly Reports of Condition and Reports of Income, were provided by the Federal Reserve Board of Governors. Failure and acquisition data were provided by the FDIC. Whenever possible, financial information from the December Reports was used in order to avoid comparability problems induced by systematic seasonal variations in the data.

preceding failure show that the typical failed bank was undercapitalized and attracted a high-cost, unstable deposit base to support large, risky loan portfolios. What is unclear is whether the banks adopted those strategies in response to earlier problems and the

threat of failure, or as their long-term corporate plans.

The FDIC usually diagnoses the causes of bank failure as a combination of bad management and poor loan quality. But classifying a primarily agricultural



## When the FDIC Steps In

The decision to close a bank rests not with the bank officers, but with its chartering authority: the Comptroller of the Currency for national banks and the State banking authority for State banks. When the regulator determines that a bank faces imminent failure because its net worth is zero or is irreversibly approaching that level, the FDIC, as receiver, is notified. The FDIC evaluates the bank's condition and selects from among three methods available to close a bank. If the FDIC believes that it can arrange a takeover, it solicits "purchase and assumption" or "deposit transfer" bids from other banks and qualified individuals to assume the failing bank's operations or buy the insured portions of its deposits. Much of this activity takes place behind the scenes so that a bank often reopens under new ownership on the first business day following failure. If no acceptable bid is received, perhaps due to the failed bank's financial condition or because State law prohibits branching activity or MBHC acquisitions, the FDIC is compelled to use the payoff method.

**Payoff.** Under the payoff method, depositors receive all their funds up to the maximum insured deposit of \$100,000; the FDIC assumes ownership of the failed bank's assets, and the bank is closed without being replaced. Depending on the amount the FDIC recovers from disposing of the bank's assets, depositors may later receive some reimbursement for deposits in excess of \$100,000, but the final disbursement may take a year or more.

**Purchase and Assumption.** In a purchase and assumption transaction, the failed bank becomes either a branch of an existing bank, an affiliate of an MBHC, or opens as an entirely new bank or one-bank holding company. All deposit funds, including uninsured balances, become immediately available to the depositors. The acquiring party assumes the failed bank's deposits and other liabilities, and purchases its sound loans and other quality assets. The FDIC holds the remaining assets, which are eventually sold, collected, or written off. This procedure enables the failed bank to reopen under new ownership and in a strong position. It was used in 185 of the 239 cases covered in this article.

**Deposit Transfer.** The FDIC adopted the deposit transfer method in 1983. Used relatively infrequently (21 cases) so far, this method costs the FDIC less than a payoff but may prove more disruptive to customers of the failed bank than a purchase and assumption. A healthy bank buys the right to act as the FDIC's agent in handling the payoff of the failed bank's insured deposits and may also purchase its offices and other selected assets. The major differences from a purchase and assumption are that the acquiring bank need not honor promised interest rates on deposits transferred from the failed bank, and uninsured deposit balances are handled in the same manner as in a payoff.

loan portfolio as a poor management decision seems unreasonable when such portfolios had been highly profitable for decades preceding 1982. The FDIC has recently begun to recognize that a depressed local farm economy

has contributed to a number of failures.

Portfolio choices made by failed rural banks do raise questions about how rural banks can best serve rural com-

munities. Loan portfolios heavily tilted to agriculture and related rural activities are practically predetermined for many small rural banks wishing to serve local loan needs. The review here of failed bank characteristics suggests that such a strategy, if coupled with the practice of holding a high percentage of bank assets as loans, may be unsafe and linked to a higher probability of failure. Thus, the long-term interests of rural communities might be served better if rural banks that adopted such a high-risk strategy adjusted their portfolios to include fewer local loans and more low-risk nonloan assets. Many sound rural banks are now doing just that.

## How the Community Can Be Affected

The effects of a bank failure are intensified for rural communities with relatively few banks. If large local depositors, including the area's major businesses, lose uninsured deposits, economic conditions in the community may worsen. Insurance coverage for large depositors depends on the liquidation method applied to the failed bank by the FDIC (see box, "When the FDIC Steps In"), but deposits up to \$100,000 are available almost immediately in all cases.

Rural communities lose the most banking services when a failed bank is closed and its insured deposits paid off by the FDIC (the payoff method). Although only 33 out of the 239 failed banks were liquidated in this manner in 1983-85, 24 of those 33 were rural. In 1985 alone, 17 rural banks in Kansas, Nebraska, Oklahoma, and Texas were lost through payoffs.

The number of banks remaining in the community after these payoffs is the best gauge of the damage inflicted on availability of local banking services. A rural Nebraska county, after losing two one-office banks, had only three banks left, and a rural county in Kansas was left with only two banks. Most affected counties had four to nine surviving banks operating within their borders, but some rural towns lost their only bank when the FDIC used the payoff method. Because the FDIC has had difficulty recently securing acceptable ac-

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## ***“Risky banks that fail should be replaced with sound banks, but not with banks that are overly conservative.”***

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quisition bids for failing rural and agricultural banks, the number of rural counties and communities that lose banking services is expected to increase.

Regardless of the liquidation technique employed, credit availability in rural communities affected by bank failures is the major long-term issue. Debtors with loans outstanding at failed institutions usually find that their loans have been sold to the acquiring bank, or neighboring banks in the case of pay-offs or deposit-transfers. Even debtors with good loan records will have to establish a new relationship with a loan officer.

Debtors with troubled loans are probably hurt the most. An assuming bank does not purchase such loans; the FDIC is left to administer them. The FDIC tends to be strict with problem debtors since its legal responsibilities are to the failed bank's insured depositors, depositors with uninsured balances, and the bank's bondholders and shareholders. The FDIC liquidators do work with borrowers to try to devise an acceptable plan to retire their debt in an orderly fashion. But many problem debtors, who may have been able to renegotiate their loans with the now-defunct bank, face FDIC-ordered foreclosure. Marginally qualified borrowers in a community where a bank has just failed may find it difficult to secure credit if the community has few other lending institutions.

### **What the New Owners Are Like**

The FDIC ensures that an assuming bank is financially healthy and well capitalized through a cash injection that equals the difference between the acquired liabilities and assets (less the price paid to the FDIC for the bank). The acquiring bank must provide suffi-

cient capital in the form of owners' equity.

The issue of control, however, dominates the disposition of failed rural commercial banks. Communities are concerned that big “outsider” bank organizations may drain local funds for use elsewhere in spite of the large FDIC cash injection. If the new bankers do not understand local market conditions, they may offer insufficient credit or unfavorable loan terms. Reduced competition in local markets is also possible if a former competitor takes over the failed bank.

Whether or not the failure-acquisition process lessens “local” control of a bank's lending decisions is difficult to determine on the basis of public data. Control may or may not be affected if a larger bank organization acquires a failed institution, but the fear of “outsider” control is likely if the failed institution (a) becomes a branch of a larger urban-based bank, (b) is acquired as an affiliate (or the branch of an affiliate) of a large MBHC, or (c) is taken over by individuals who control a chain of other independent banks.

Fears of big bank empire-building through failed bank acquisitions appear unfounded, but cannot be dismissed. Of the 196 commercial banks that acquired failed banks since 1983, 105 were rural and 52 were agricultural banks (fig. 2). On average, assuming banks were slightly larger than the failed banks they purchased. More than 25 percent of assuming banks had total assets under \$25 million, while 85 percent of assuming rural banks had total assets below \$100 million prior to acquisition. For assuming agricultural banks, about half had total assets under \$25 million and 96 percent had assets of less than \$100 million. Only one failed bank had assets in excess of \$1 billion, yet 10 acquiring banks'

assets exceeded \$1 billion. None of these large banks was located in a rural area or specialized in agricultural finance (fig. 3).

More than two-thirds of the acquiring banks were associated with holding companies, with MBHC affiliates accounting for a significant portion of the total (fig. 3). That proportion is similar to the national average. The average acquiring MBHC owned 12 commercial banks after acquisition. Holding companies are not using acquisitions of failed banks to expand their national banking market share. Moreover, unless expressly permitted by State law, holding companies cannot expand across State lines.

Since 1983, 44 independent banks and 66 one-bank holding companies have acquired failed banks, over half of which were rural (fig. 3). While specific data are lacking, chain banking organizations are believed responsible for most of those acquisitions. Most chains are small, but some control over 30 banks.

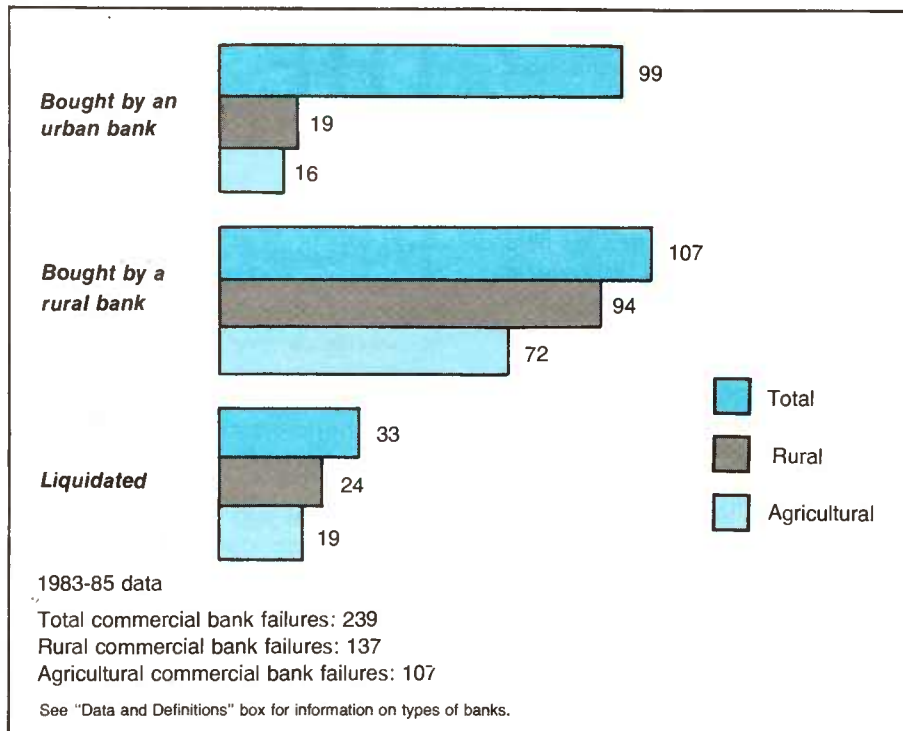
The location of the acquiring bank is also important in measuring the quality of service provided to local banking markets. State law often requires that acquiring banks be located in the same State as the failed institution. In fact, of the 206 failed banks purchased by another bank during 1983-85, 130 were acquired by a bank headquartered in the same county as the failed bank they replaced (fig. 3). Only one rural bank, in Oregon, was acquired by an out-of-State bank.

Another important determinant of the purchasing bank's location is its age. All but 5 of the 89 banks created for the sole purpose of acquiring a failed bank were headquartered in the same county as the failed bank they replaced. Failed bank purchases by previously existing banks, on the other hand, were more likely to be in a different county; 61 percent of these banks were headquartered outside the failed bank's home county.

Fewer than 20 percent of the failed rural banks were acquired by urban-based banks. Moreover, urban money center banks did not acquire any small rural banks that failed. Only one urban

Figure 2

## What happened to failed banks? (1983-85)



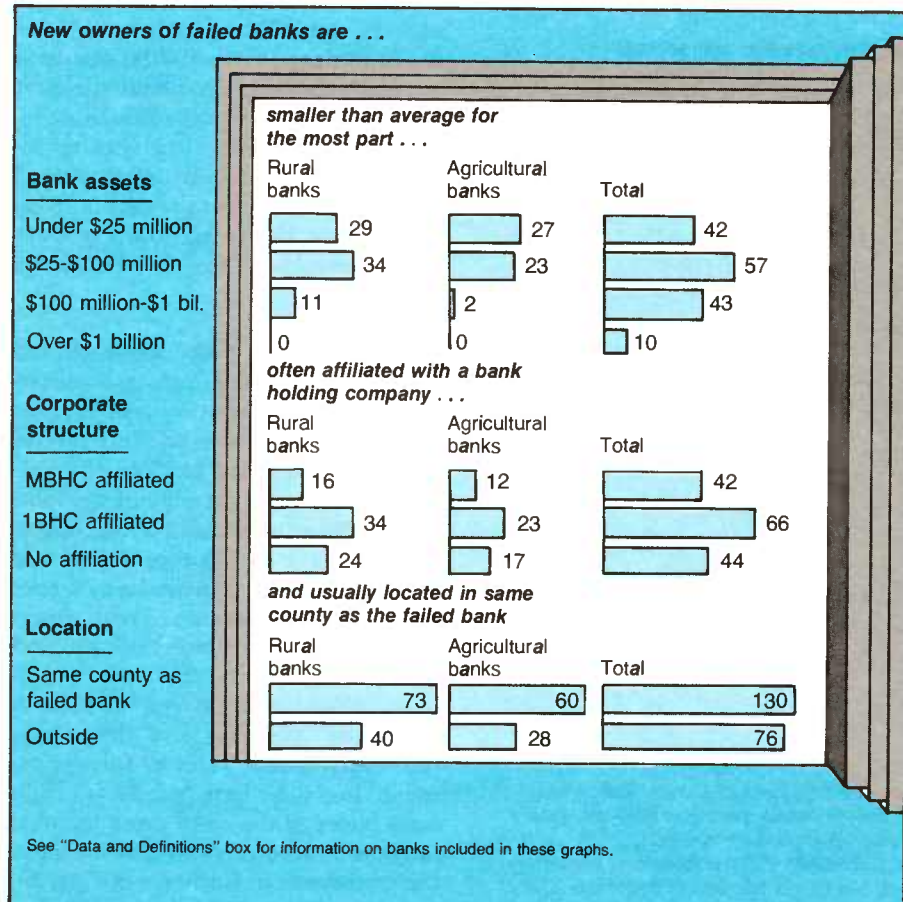
bank with assets over \$1 billion acquired failed rural banks. Headquartered in Portland, Oregon, it purchased two failed small rural Oregon banks. With roughly \$5.6 billion in assets, it is not considered one of the Nation's money center banks. Almost all of the remaining 14 urban banks that acquired failed rural banks over this time period were somewhat larger than the average commercial bank, but all were considerably smaller than money center banks. The average bank has about \$117.5 million in assets, while assets of the acquiring urban banks (excluding the Oregon bank) ranged from \$15 million to \$655 million and averaged \$247 million.

A basic community issue for rural areas regarding the acquiring banks is their viability in the local market. The new banks appear to be well-run, solid institutions, as illustrated by below-average ratios of loan losses (net loan charge-offs) to total loans and adequate to above-average capitalization rates (table 1).<sup>1</sup> Their relatively high ratios of net income to equity capital illustrate the profitability of their operations. Below average loan-to-asset ratios may indicate a conservative approach to making loans. This tendency is even more pronounced for independent acquiring banks, which have loan-to-asset ratios 6.0 to 10.1 percentage points below the average of comparable banks. The FDIC, with the involvement of the Board of Governors of the Federal Reserve System in appropriate cases, apparently selects acquiring banks that are sound and have a high probability of safe future operation.

The conservative behavior of rural banks was sometimes thought to restrict rural development. If so, the conservative nature of acquiring banks, especially those not affiliated with a holding company, may herald tighter credit conditions in affected communities, constraining business starts and expansions. Risky banks that fail should be replaced with sound banks, but not with banks that are

Figure 3

## What kind of banks acquire failed banks?




<sup>1</sup>Equity capital and provisions for loan losses both provide cushions for the bank against future setbacks. Higher ratios of equity capital to assets and provision for loan losses to total loans generally implies improved bank safety.

overly conservative. Selecting "safe" acquiring banks that avoid borrowers whose loan applications would normally have been accepted by other banks can impede a community's long-term growth. While analysis of acquiring banks' behavior raises the suspicion that this is occurring, lack of detailed data prevents a definite conclusion.

The rise in rural bank failures is a regional phenomenon, linked to the agricultural crisis and increased stress in some rural areas due to the uneven nature of the economic recovery from the 1979-82 recession. Over 97 percent of failed banks since 1975 have been members of the FDIC, so depositors' funds were protected for the most part. Furthermore, relatively few bank failures caused the bank offices to close permanently, though this situation may soon change if the FDIC continues to have difficulty finding suitable buyers of failed rural banks. Banks acquiring failed rural banks have tended so far to be small, rural, and headquartered within the same county as the failed institution. Thus, bank

failures have not caused a wholesale shift of local credit market shares to large "outsider" bank institutions, although activity by chain bank organizations somewhat weakens this conclusion.

Despite these reassuring findings, a commercial bank failure does hurt some rural borrowers and depositors. The FDIC has no obligation to help troubled borrowers find alternative sources of credit. Rather, the FDIC is responsible for liquidating failed banks' assets for the benefit of depositors, creditors, and shareholders. As a result, debtors having trouble meeting their loan payments often face FDIC-ordered legal action. Furthermore, the conservative behavior of acquiring banks, especially those not affiliated with a holding company, may mean that marginally qualified borrowers are denied credit once a failed bank reopens. Depending on the behavior of other nearby lenders, communities experiencing a bank failure may face reduced growth potential even if the bank reopens under new ownership and management. 

# THE FARM

The Department of Agriculture estimates that nearly a fifth of the Nation's commercial farms, those with annual sales of over \$40,000, had both excessive debt and negative cash flow as of December 31, 1984. Many of those who operate these farms may have to leave farming.

The three articles that follow focus on several important aspects of the current farm crisis. They are based on presentations made at USDA's Agricultural Outlook Conference last December.

Farmers are under financial stress because economic conditions in agriculture shifted abruptly from being extremely favorable throughout most of the 1970's to being extremely unfavorable in the 1980's. High farm commodity prices in the 1970's, resulting largely from rapidly expanding export markets, combined with low to negative real interest rates (the nominal interest rate corrected for inflation) and rising farmland prices to make farming in the early 1970's and owning farmland throughout the 1970's highly profitable.

These conditions both permitted and encouraged farmers to go into debt to buy rapidly appreciating farmland, to buy more expensive and productive farm machinery, and to increase greatly the production capacity of the farm sector. More important, those conditions led to a strong expectation that returns to owning farmland would continue to be high because of both strong markets for farm commodities and continued inflation. But farm conditions deteriorated in the 1980's. A worldwide recession and the strong U.S. dollar greatly reduced foreign demand for U.S. farm products. High farm prices of the 1970's also induced farmers in other countries to increase their production, further reducing demand for American farm products. The

**Table 1—Acquiring banks look solid, safe, and somewhat conservative**

Item	All banks		Rural banks		Agricultural banks	
	Total	Acquiring	Total	Acquiring	Total	Acquiring
<i>Number</i>						
Number of banks <sup>1</sup>	14,088	115	7,749	52	4,873	33
<i>Percent</i>						
Loans/assets	52.2	50.8	50.8	47.0	50.0	44.5
Total agricultural loans/total loans	17.5	15.2	27.3	31.1	42.4	46.6
Net income/equity capital	10.3	12.7	10.6	12.4	10.7	12.0
Net loan charge-offs/total loans	.8	.7	.8	.7	.9	.9
Effective interest rate	12.6	12.8	13.1	13.1	13.4	13.4
Provision for loan losses/total loans	.8	.8	.9	.7	1.0	.8
Equity capital/total assets	9.1	8.6	9.2	9.4	9.4	10.4

Note: See "Data and Definitions" box for information on types of banks. Ratios represent unweighted averages reported at the end of the previous year and exclude newly chartered banks. Banks reporting extreme values were excluded from totals.

<sup>1</sup>The total number of banks in each category as of December 1984; numbers of acquiring banks are the sum for 1983 through 1985. Acquiring banks are subsets of the totals. Only acquisitions by previously existing banks are included.



# CRISIS OF THE 1980's

reduced foreign demand and the global buildup in the supply of farm

commodities combined to force U.S. farm prices down to price-support

levels and led to the expectation that prices would drop even lower in the future.

Figure 1

**Major economic indicators in the U.S. economy**

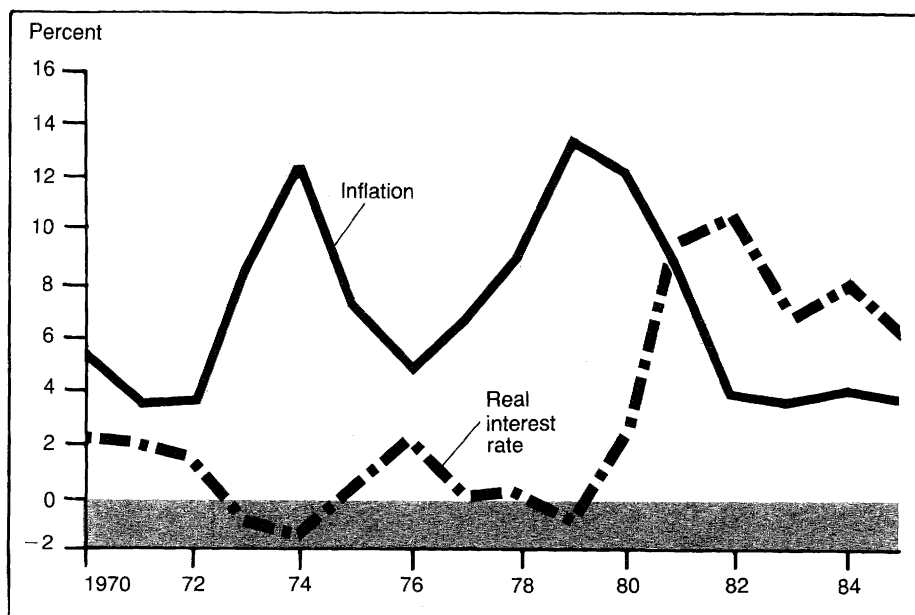
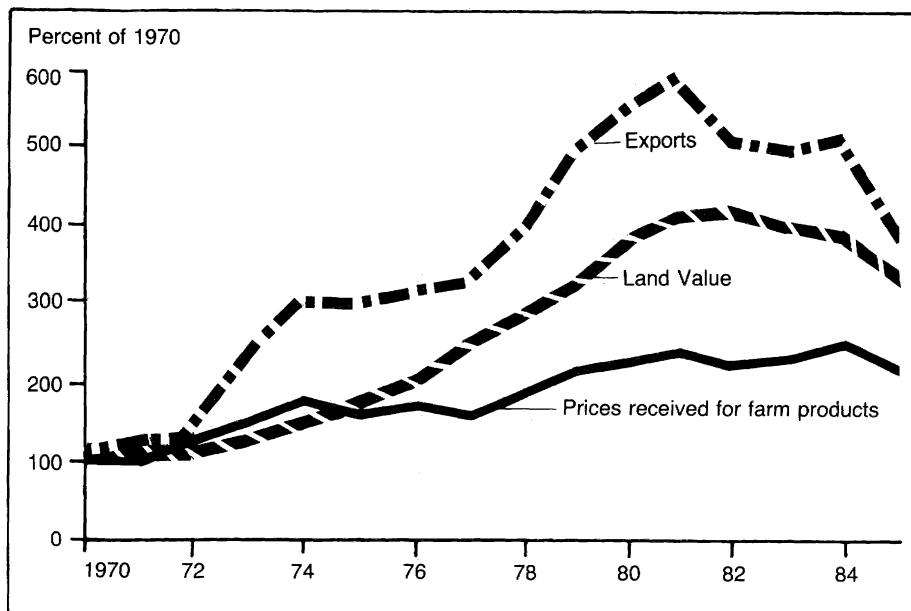


Figure 2

**Major economic indicators in U.S. agriculture**



On the cost side, as inflation was rapidly brought under control in the 1980's, real interest rates rose to unprecedented heights of 8-10 percent. Interest expenses more than doubled from the late 1970's to the early 1980's which reduced the profitability of farm production, and reinforced the expectation that returns to farmland would remain below real interest rates. As a result, investors felt farmland had become overpriced; hence the demand for farmland declined and prices began a steep decline. Since farmland makes up most of the value of farm assets (over 75 percent in 1981), the drop in farmland prices reduced the equity of many farmers, impairing their ability to renew existing loans or to borrow additional funds. The decline in farmland value combined with negative net cash flows to result in increasing numbers of farm foreclosures and forced sales, which in turn, have brought further downward pressures on farmland prices.

In the first article that follows, Fred Hines, Bernal Green, and Mindy Petrulis examine the geography of the farm problem and its effect on total economic activity in different areas and regions of the country. They discuss some of the most important factors influencing a rural area's vulnerability to stress in the farm sector. In the second, Larry Leistritz and others, using newly available data from North Dakota and Texas, look at the characteristics of the farmers in financial distress and the difficult adjustments they and their communities are likely to face. In the third, Daniel Milkove, Patrick Sullivan, and James Mikesell analyze how the farm crisis is affecting rural banks and their ability to serve the needs of the rural economy.