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The Structure of Rural Banks

by Carlos Veintemillas

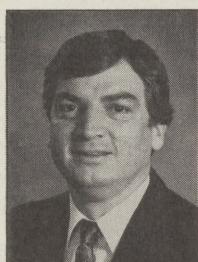
Commercial bank structure is a function of geography and demographics. Banks structure their assets and liabilities to serve unique markets. Commercial banks in rural areas typically cater to small businesses in sparsely populated regions of the country. Banks located in urban areas, on the other hand, cater to a more diversified customer base composed of small, medium and large businesses. Rural and urban banks are the same, however, in being the primary source of financial services in their communities.

This report analyzes the structure of our nation's rural banks and when appropriate compares them to urban banks. Rural banks are defined as any bank that does not lie within the boundaries of a Metropolitan Statistical Area (MSA); urban banks are defined as banks located in an MSA.

*Rural banks on average
are more profitable
than urban banks.*

Bank Performance

Low interest rates, healthy economic growth, and fewer loan losses than expected boosted bank profitability to record levels in 1993. Commercial banks in the U.S. earned a record \$43.4 billion (1.21% return on assets) compared to \$32 billion in 1992 (0.93% return on assets). The largest contribution to commercial bank earnings came from a continued improvement in asset quality which resulted in a significant reduction in provisions set aside for loan losses. In 1993, commercial banks set aside \$16.6 billion in loan loss reserves, the lowest set-aside since 1984, according to the FDIC. Net interest margins also had a significant impact on commercial bank earnings during the year. Thanks to falling interest rates, interest income exceeded in-



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terest expense at commercial banks by approximately \$139 billion in 1993, up from \$133 billion in 1992.

Number of Banks

At year-end 1993, there were 10,955 commercial banks in the United States, 491 less than the previous year and almost 1,000 below the number of banks that were in operation at the beginning of the current decade. Consolidation (reflected by the figures shown in the table below), affected the distribution of banks in rural areas to a greater degree than banks in urban areas. There were 5,990 rural banks at year-end 1993, down 156 (from 6,146) in 1992 and down 340 since 1991. The decline in the number of rural banks primarily occurred in the \$1 million to \$25 million asset class as these banks either closed doors or merged with other banks to make a larger institution. Evidence of this is the growth in the number of banks over \$100 million asset class, which grew by 85 between 1991 and 1993.

Although the number of banks in urban areas did not change significantly in 1993, these institutions did not escape consolidation. There were a total of 4,965 urban banks in the U.S. in 1993, down from 5,300 in 1992 and 5,579 in 1991. Banks with \$1 million to \$25 million in assets experienced the largest change in numbers from 906 in 1991 to 583 in 1993. It should be noted that the data on the number of banks reported by the FDIC includes only banks and **does not** include the number of branches operated by these institutions.

Asset Composition

Commercial banks held \$3.6 trillion in assets in 1993, up 5.6% from the previous year. The vast majority of commercial bank assets are held by institutions located in urban areas with a heavy asset concentration among banks with over \$500 million in assets. Rural banks held roughly 14% of commercial bank assets. Approximately 83% of rural bank assets were held by banks with assets between \$25 million and \$500 million. The unweighted average rural bank size was \$67 million in assets whereas the urban banks average was much larger at \$660 million.

Rural banks hold the majority of loans to agriculture.

Loans and leases comprise the bulk of commercial bank assets. The level of this ratio depends upon the loan demand and general economic conditions in the bank's service area. Total loans and leases outstanding at commercial banks were \$2.1 trillion in 1993, 90% of which were held by banks in urban areas and the remainder by rural banks. There was a strong corre-

Number of Banks

Bank Size	1991		1992		1993	
	Urban	Rural	Urban	Rural	Urban	Rural
\$0-\$25 mil.	906	2,014	738	1,819	583	1,649
\$25-\$100 mil.	2,457	3,417	2,352	3,376	2,204	3,357
\$100-\$500 mil.	1,613	877	1,606	929	1,586	957
\$500 mil. +	603	22	604	22	592	27
Total	5,579	6,330	5,300	6,146	4,965	5,990

Loans and Leases as a Percent of Total Assets

Bank Size	1991		1992		1993	
	Urban	Rural	Urban	Rural	Urban	Rural
\$0-\$25 mil.	51.53	48.14	51.49	48.12	51.51	49.49
\$25-\$100 mil.	55.50	49.75	55.00	49.66	55.67	51.19
\$100-\$500 mil.	58.84	55.05	56.79	54.53	57.09	56.29
\$500 mil. +	61.32	64.48	59.15	63.97	58.82	65.45
Total	60.74	52.81	58.68	52.69	58.50	54.52

Securities as a Percent of Total Assets

Bank Size	1991		1992		1993	
	Urban	Rural	Urban	Rural	Urban	Rural
\$0-\$25 mil.	27.36	35.29	28.45	35.79	29.17	35.73
\$25-\$100 mil.	28.36	37.23	28.92	38.10	29.63	37.71
\$100-\$500 mil.	27.02	34.26	28.90	34.82	30.20	34.84
\$500 mil. +	17.40	26.13	19.21	27.91	19.75	26.46
Total	19.02	35.38	20.73	35.76	21.23	35.33

lation among rural bank loan holdings and bank size. That is, the larger the bank, the more loans it held as a proportion of their assets than smaller institutions. This relationship also held for banks in urban areas.

to the cyclical nature of the agricultural economy and the need to maintain liquidity to counteract its effect on banks' balance sheets and income statements.

Rural banks are more numerous than urban banks.

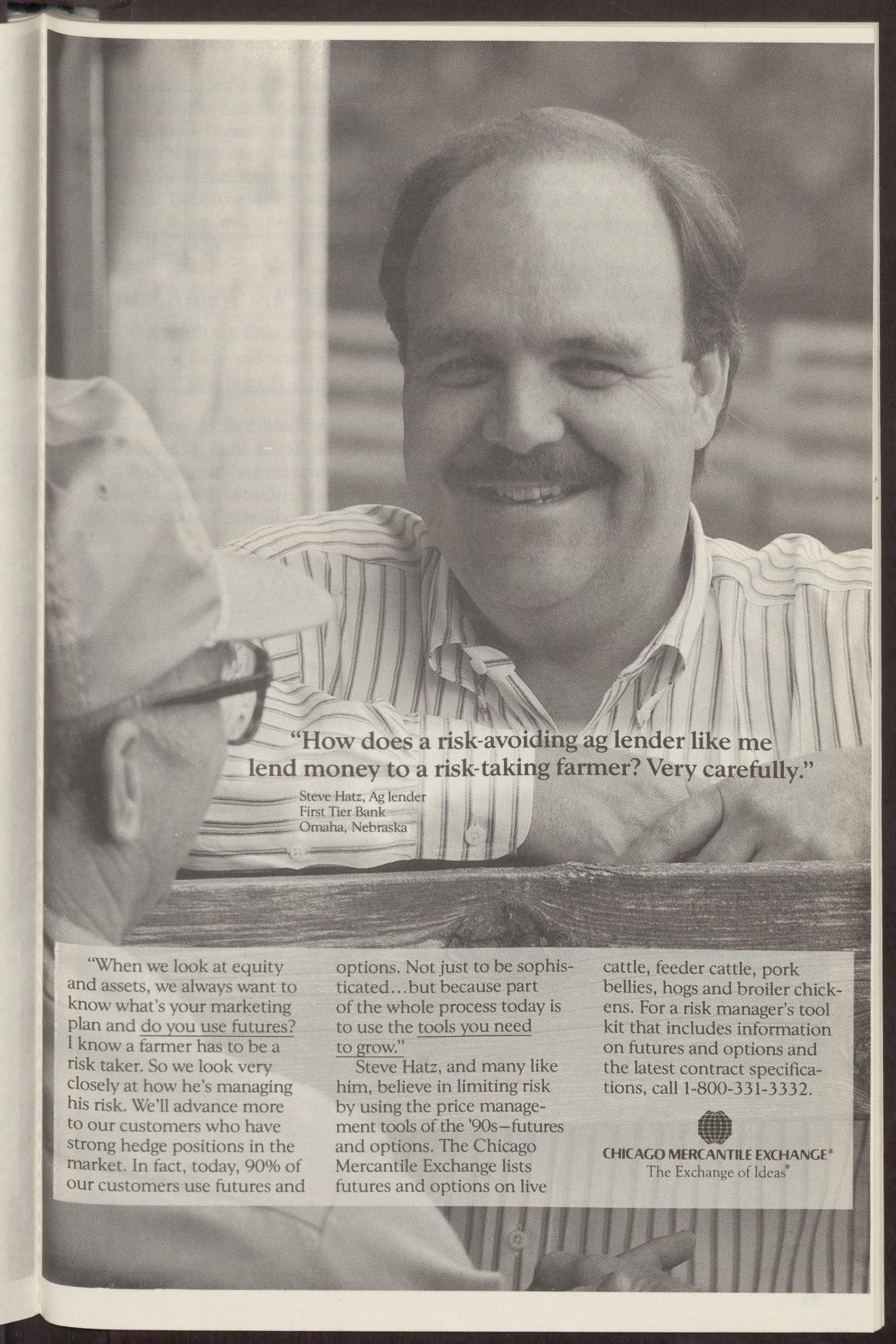
Securities are also an important part of the asset composition of commercial banks. Commercial banks held \$839 billion in securities in 1993, 83% were held by urban banks and the remainder by rural banks. When loan demand is weak, banks will invest unused funds in securities. Small or rural banks have historically held more securities than large and urban banks due

Lending to Small Business

The Federal Deposit Insurance Corporation Improvement Act (FDICIA), requires banking agencies to collect data on commercial bank lending to small businesses. Commercial banks report these data in their June Report of Condition and Income. Banks began to report small business lending data in June 1993. Hence, a historical analysis of bank lending to small businesses is not possible at this time. Also, it should be noted that the data reported does not classify a small business but rather loan size is used as a proxy for business size.

Loans are classified as follows:

- loans with original amounts of \$100,000 or less;



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First Tier Bank
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options. Not just to be sophisticated...but because part of the whole process today is to use the tools you need to grow."

Steve Hatz, and many like him, believe in limiting risk by using the price management tools of the '90s—futures and options. The Chicago Mercantile Exchange lists futures and options on live

cattle, feeder cattle, pork bellies, hogs and broiler chickens. For a risk manager's tool kit that includes information on futures and options and the latest contract specifications, call 1-800-331-3332.



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- loans with original amounts of more than \$100,000 but less than \$250,000; and
- loans with original amounts of more than \$250,000 but less than \$1,000,000.

The type of small business loans reported are:

- loans secured by non-farm non-residential real estate;
- commercial and industrial loans;
- farm production loans; and
- farm real estate loans.

Small Business Lending

According to the latest available data (June 1993), commercial banks held 8.8 million loans to small business totaling \$347 billion. These loans accounted for roughly 9.74% of industry assets and 16.8% of total loans and leases. The location of a bank had a large influence on their small busi-

ness lending activity. Commercial banks located in rural areas tend to have a larger customer base composed of small businesses than banks that operate in urban areas where the size of the business customer mix is more diversified.

Rural banks are significantly smaller than urban banks.

Rural banks held \$90 billion in small business loans. These loans accounted for 22.9% of their assets and over 42% of their loans and leases. Urban banks, by contrast, held \$257 billion in loans, but these

Small Business Loans

June 1993

<u>Bank Size</u>	<u>Total</u>	Urban \$ Mil.	Rural	<u>Total</u>	Urban % Loans	Rural
\$0-\$25 mil.	10,467	2,398	8,068	53.83	45.46	56.95
\$25-\$100 mil.	72,773	29,642	43,131	45.40	41.58	48.46
\$100-\$500 mil.	96,545	63,172	33,373	34.76	33.26	38.01
\$500 mil. +	167,722	161,964	5,758	10.42	10.21	25.27
Total	347,507	257,177	90,330	16.81	13.88	42.46

Small Business Non-farm and Non-residential Loans

June 1993

<u>Bank Size</u>	<u>Total</u>	Urban \$ Mil	Rural	<u>Total</u>	Urban % Loans	Rural
\$0-\$25 mil.	1,750	959	993	9.00	14.35	7.01
\$25-\$100 mil.	24,162	13,083	10,652	15.07	18.95	11.97
\$100-\$500 mil.	43,175	28,725	12,659	15.54	16.07	14.42
\$500 mil. +	70,171	88,446	2,794	4.36	4.25	12.27
Total	139,258	131,214	27,100	6.74	6.05	12.68

accounted for only 8.11% of their assets and about 14% of their loans and leases.

Total small business non-farm and non-residential loans amounted to \$139 billion or 14.53% of total loans to small businesses. Rural banks held approximately \$27 billion of these loans and urban banks the remaining \$112 billion. Proportionally, however, rural banks were more involved in small business non-farm non-residential lending than urban banks. Approximately 12.7% of rural bank loans were in small business non-farm and non-residential loans. The comparable ratio at urban banks was 6.1%.

As of June 1993, commercial banks held approximately \$161 billion in small business commercial and industrial (C&I) loans. Again in terms of volume, urban banks held the bulk of these loans (\$131 billion)

while rural banks held the remainder (\$29.9 billion). Proportionally, rural banks held a larger percentage of small business C&I loans than urban banks. Approximately 14% of rural bank small business loans were C&I loans while urban banks held only 7% of their small business loans in this category.

Small farm loans totalled \$47 billion in June 1993. As expected, rural banks lead in both volume and proportions in this type of lending over urban banks. Rural banks held approximately \$33 billion in loans to agriculture compared to \$14 billion at urban banks. Small farm loans accounted for roughly 16% of rural banks' loan portfolio and less than 1% at urban banks. Of the \$47 billion in small business agricultural loans held by rural banks, \$21 billion were extended for production pur-

Small Business Commercial and Industrial Loans

June 1993

<u>Bank Size</u>	<u>Total</u>	Urban \$ Mil.	Rural	<u>Total</u>	Urban % Loans	Rural
\$0-\$25 mil.	2,840	959	1,880	14.61	18.19	13.27
\$25-\$100 mil.	25,895	13,082	12,812	16.16	18.35	14.40
\$100-\$500 mil.	41,451	28,725	12,726	14.92	15.12	14.49
\$500 mil. +	90,930	88,446	2,484	5.65	5.57	10.90
Total	161,117	131,214	29,903	7.80	7.08	13.99

Small Business Farm Loans

June 1993

<u>Bank Size</u>	<u>Total</u>	Urban \$ Mil.	Rural	<u>Total</u>	Urban % Loans	Rural
\$0-\$25 mil.	5,876	681	5,195	30.22	12.92	26.67
\$25-\$100 mil.	22,715	3,050	19,665	14.17	4.28	22.10
\$100-\$500 mil.	11,919	6,931	7,988	4.29	2.07	9.10
\$500 mil. +	6,619	6,142	478	2.28	0.39	2.10
Total	47,131	13,805	33,327	2.28	0.74	15.59

poses and \$12 billion were backed by real estate.

As stated at the beginning of this report, location appears to be a strong determinant of bank lending to small businesses. Small businesses tend to be the predominant form of business in rural areas. Urban areas on the other hand, have a mix of small, medium, and large businesses. In order to disentangle this location relationship, small business lending by bank asset size and location is analyzed below.

Low interest rates, healthy economic growth, and fewer loan losses boosted bank profitability to record levels in 1993.

Most of the small business lending made by rural banks is concentrated at banks between \$25 and \$500 million. Urban banks have a higher proportion of small business lending in the lower asset class than rural banks. Urban banks with over \$500 million in assets had 9.8% of their loan portfolio in small business loans while the proportion for rural banks of this size was 23%.

The small business lending data, however, is heavily skewed towards rural banks due to their significant involvement in the

agricultural sector. Urban banks in all asset classes, except the over \$500 million asset class lead rural banks in lending to small businesses when loans to the agricultural sector are excluded from the base.

Earnings and Capital

Return on assets (ROA) at our nation's banks reached 1.17% in 1993, up from 0.92% in 1992 and 0.58% in 1991. Healthy net interest margins and lower loan losses continued to play a major role in raising commercial bank profitability across the board. Rural and urban banks took advantage of the steep yield curve by reducing the maturity of their liabilities. Hence, although interest income fell slightly in 1993, interest expense fell faster.

Rural banks have historically outperformed urban banks and 1993 was no exception. ROA at rural banks rose from 0.94% in 1991 to 1.29% in 1993. Similarly, ROA at urban banks jumped from 0.48% in 1991 to 1.16% in 1993.

Bank capital continued to increase in 1993 reaching \$295.2 billion or 8.01% of assets. Rural banks in general continued to augment their capital with retained earnings to a larger degree than urban banks which depend more on additional sales of equity and capital transfers from their parent companies. Rural banks held \$38.3 billion in capital compared to \$257 billion held by urban banks. Capital ratios, however, were higher at rural banks than at urban banks. Capital ratios at rural banks rose from 8.74% in 1991 to 9.49% in 1993.

Return on Assets

<u>Bank Size</u>	<u>1991</u>		<u>1992</u>		<u>1993</u>	
	<u>Urban</u>	<u>Rural</u>	<u>Urban</u>	<u>Rural</u>	<u>Urban</u>	<u>Rural</u>
\$0-\$25 mil.	0.19	0.79	0.69	1.01	1.05	1.04
\$25-\$100 mil.	0.53	0.97	0.84	1.19	0.95	1.27
\$100-\$500 mil.	0.77	0.96	0.94	1.21	1.09	1.31
\$500 mil. +	0.43	0.89	0.88	1.30	1.18	1.45
Total	0.48	0.94	0.88	1.19	1.16	1.29

Equity Capital as a Percentage of Assets

Bank Size	1991		1992		1993	
	Urban	Rural	Urban	Rural	Urban	Rural
\$0-\$25 mil.	11.62	9.61	11.60	9.86	11.77	10.34
\$25-\$100 mil.	8.62	9.18	8.96	9.50	9.32	9.92
\$100-\$500 mil.	7.86	8.34	8.20	8.75	8.79	9.24
\$500 mil. +	6.18	7.27	7.10	7.75	7.64	8.05
Total	6.50	8.74	7.32	9.08	7.83	9.49

The smallest institutions, \$0-\$25 million in assets, had stronger capital ratios than large banks in both rural and urban areas. This is not surprising since small banks in general tend to hold more capital than large banks and many newly chartered banks are concentrated in this size class.

Rural banks are structured differently than urban banks, perhaps as a result of a different customer base and more conservative business practices. The structure of rural banks has worked well for these

institutions which have consistently outperformed urban banks. Rural banks in general, are more numerous, despite having been hit to a greater degree by consolidation and failures than banks in urban areas. Rural banks outperformed urban banks in profitability as well asset quality and continue to be among the better capitalized banks in the nation. Factors that place these institutions in a strong position to compete and thrive well during the remainder of this decade. ■