Interstate Banking and Rural America

Rural communities currently served by offices of large banks are more likely to participate in interstate banking. Through loopholes in current laws, nine States already have interstate branches. Antitrust regulations should limit reductions in the numbers of banks serving particular rural communities.

National trends toward increased bank consolidation and interstate banking will affect rural communities in the coming years, but probably less than urban communities. Relatively fewer independent rural banks will disappear since most large banks will concentrate their expansion efforts in urban financial markets. Today only about 150 rural bank branches belong to banks headquartered in other States, and most of these branches are in Maryland, South Carolina, and Virginia. Many more rural communities participate in interstate banking as a result of bank holding companies that own banks in two or more States. While bank mergers and failures have steadily reduced the number of legally separate banks over the past decade both nationally and in rural America, the average number of banking firms and offices per rural county grew slightly between 1980 and 1993. However, rural residents generally have few lenders to choose from. Over a quarter of rural counties have offices of just one or two banks, and another half have only three to five banking firms.

Interstate banking and other forms of bank consolidation may bring both gains and losses to rural communities. Fewer rural banks would mean less choice in obtaining financial services, and perhaps higher prices due to lessened local competition. While Federal antitrust guidelines for banking mitigate the likelihood in most rural markets that the number of independent banking organizations will drop, rural people often believe that outside ownership of a bank is as bad as losing the bank outright. Outsiders may not care about local businesses, or they may lack the necessary local knowledge to accurately evaluate loan requests and to identify profitable investments.

On the other hand, large outside banks may provide a wider range of financial services. They have geographically diversified loan portfolios that are less sensitive to local economic downturns. Outside banks may be more inclined to accept loan applications from types of businesses not previously found in that area. Loan size is less likely to be an issue because outside banks generally have large capital stocks to support larger loans. Large banks may be more familiar with government loan programs that can be used by people who do not qualify for conventional credit. And some outside owners maintain local managers because they value their knowledge of local markets.

Bank consolidation is a response to various forces that are buffeting financial markets. Large banks believe they must grow even larger to better compete in what has become a global financial market. Size brings the promise of cost efficiencies, the ability to serve larger customers and to provide a wider range of services, protection from local economic problems through geographic diversification, and less chance of being taken over by another bank. Rural banks will not be in the forefront of this process, but no longer can they or their customers afford to ignore the broader financial markets. Many rural financial markets will at least see indirect effects as the existing outside bank is taken over by an even larger outsider. Employment in banking will also decline as a result of consolidation.

Interstate Banking Will Spread Under 1994 Act

Interstate banking has received substantial media attention over the past year, stemming from the Interstate Banking and Branching Efficiency Act of 1994 and from announcements of mergers between large banks. The legislation extends interstate banking in two steps. As of September 1995, bank holding companies could acquire banks in any State. In June 1997, holding companies will be able to convert their out-of-State bank affiliates to branches of the lead bank provided the affected State does not pass legislation to prevent this.

A loophole in Federal legislation made interstate banking a reality even before the 1994 legislation was passed. A State may permit banks headquartered in that State to be acquired by bank holding companies based in other States as long as they do not become branches of holding company affiliates in different States. That is, an acquired bank might have branches in its State, but those branches could not legally be transferred to affiliates controlled in other States. Most States permitted such acquisitions by the time the 1994 law was signed, some with restrictions which the new act repeals. State rules still hold with respect to limits such as the proportion of total State banking deposits that may be controlled by a single banking organization.

Intrastate holding company acquisitions and branching are equally important. Many rural communities will participate in interstate banking only because they already have local banking offices that are controlled by outside banking firms headquartered elsewhere in the State. Rural areas may not be targeted directly by large banking firms that are expanding in their own State or into other States. But rural offices will be part of the package when out-of-State banks acquire major banking firms within the States that already control rural bank affiliates or own rural branches. In some cases, the large bank may try to spin off rural offices that do not fit its strategic plan, by selling them to other banks or to local investors. Regulators often require this sale if the acquiring bank

Complex Organization Characterizes American Banking System

In addition to commercial banks, the U.S. has a variety of financial institutions, such as savings and loan associations, credit unions, and Federal and State savings banks. Many nondepository institutions also provide financial services, including finance companies, the Farm Credit System, brokerage firms, and insurance companies. This article is limited to commercial banks with Federal insurance.

The American dual banking system is a complex one. A bank may obtain a national or State charter. Both Federal and State regulators and laws play roles in determining permissible behavior by a particular bank. Most banks receive deposit insurance through the Federal Deposit Insurance Corporation (FDIC). National banks typically are authorized to do whatever a State allows its State-chartered banks to do in terms of branching and providing certain financial services. Dual banking is given credit for many financial innovations over the past 20 years, such as interest-paying checking accounts, as State or Federal regulators test new products or extend regulations in new areas.

A bank holding company (HC) owns one or more commercial bank affiliates. These affiliates are legally separate banks; each has its own charter and board of directors, and must file quarterly financial reports to its regulator. HC's are regulated by the Federal Reserve Board (Fed). A multibank holding company (MBHC) owns at least two bank affiliates. Initially, this was a method of surmounting branching restrictions within a State, and more recently permitted HC's to extend their operations to other States. A second advantage to forming a holding company explains why many HC's control a single bank. A variety of financial services may be provided through HC subsidiaries but not directly by a bank.

Chain banks, in which the same investors own two or more banks without forming an HC around them, represent an alternative method of getting around branching restrictions within or across State boundaries. Chains avoided Fed regulation over HC's. But the Fed is now involved anyway whenever ownership of a bank changes. With the trend toward liberalized State branching laws, many chains have reorganized as HC's.

At one time, many States prohibited bank branching entirely, or severely limited the number of branches and their locations. This reflects the traditional American fear of concentration of economic power. Some States placed similar restrictions on MBHC expansion, not allowing MBHC's to circumvent branching constraints. By today, however, most States have much more liberal branching regulations. When an MBHC purchases a bank in another State, prior to 1997 that bank cannot be converted to a branch of the lead bank. But the acquired bank may have branches in its State, and the HC may merge banks if it owns more than one in the same State (depending on State regulations). Hence thousands of branch offices are controlled by out-of-State holding companies, but they are not (yet) interstate branches in the formal sense of being directly owned by a bank in another State.

already has its own offices in the rural market. Otherwise, the parent banking organizations will likely reorganize in 1997 and convert their affiliated banks and branches to interstate branches. Some of these banks are already touting the ease with which customers will be able to deal with branches throughout the region or country.

Currently independent rural community banks will not necessarily remain immune to the new wave of consolidation. Some regional and super-community banks have expansion strategies based on acquiring well-run community banks in growing communities. And many community banks may choose to join larger firms, to provide a wider range of services to their customers or perhaps to reward their shareholders if a prospective partner offers a premium over the current market value of the bank's stock.

Some Cases Exist Now, but Interstate Branching Will Really Take Off in 1997

Interstate branching does not become legal under the 1994 legislation until June 1997, but banking regulations are occasionally stretched to create interstate bank branches. This has happened during the past year or so through a loophole in legislation that allows national banks to move their headquarters up to 30 miles at a time. The loophole involved the recognition that the legislation neglected to address the technical issue of crossing State boundaries. Moving its headquarters into a neighboring State transforms those branches left behind in the original home State into interstate branches. Exceptions made while cleaning up the remains of the S&L disaster represent a second possible source of interstate branches. On the grounds of disposing of failed financial institutions at the lowest cost, regulators were granted legislative authority to permit combinations of financial institutions that otherwise would not have been allowed. States may also pass legislation permitting interstate branching prior to 1997.

At one time, some aggressive banks evidently intended to leapfrog their way across the country in 30-mile jumps to create interstate branching empires. Several banks may continue to use this process in selected markets to get a head start, but the 1994 legislation makes this unnecessary provided that few States take the opportunity to opt out of the interstate branching portion of the 1994 legislation. Texas is the first State to block the interstate branch option. Numerous large Texas banking firms failed in the 1980's and were taken over by out-of-State banks. Whether valid or not, many Texans believe that the new owners have refused to make loans in Texas, and therefore do not want to encourage additional outside bank entry into their State.

The Federal Reserve Board database as of November 15, 1995, contained 2,129 interstate branches, including 150 in rural counties. These branches were controlled by only 35 banking organizations. Two banks owned two-thirds of all interstate branches. The rural interstate offices were primarily in Maryland, South Carolina, and Virginia. The number of interstate branches would be considerably larger if savings and loans and other depository financial institutions were counted.

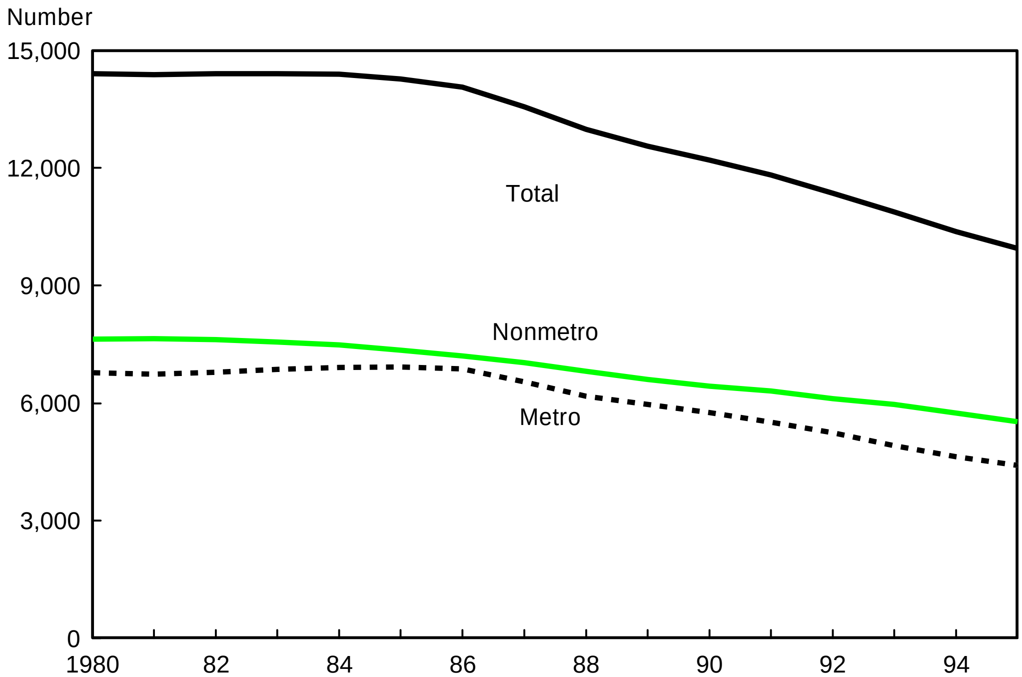
Rural Financial Markets: Past, Present, and Future

The number of U.S. banks has declined since 1980, especially over the past decade. This decline has been more gradual in rural counties and has been partly offset by a rise in bank offices per county. Local economic conditions and bank laws have also been important influences on the numbers of banks in individual States, as can be seen in Texas. Since banks could not branch in Texas until the late 1980's, a strong economy led to many new banks being chartered in the first part of the 1980's. Later, in response to severe problems in the energy and agricultural sectors, Texas banks declined more rapidly in number than in the country overall. This was facilitated when Texas began to permit holding companies to merge their bank affiliates at the local level.

The numbers of different banking firms and bank offices available to residents of the average rural county are well below those available to residents of the average urban county. Nevertheless, the average numbers of banking firms and offices serving rural counties

Number of insured commercial banks by location, 1980-95

The number of banks has been dropping since 1986

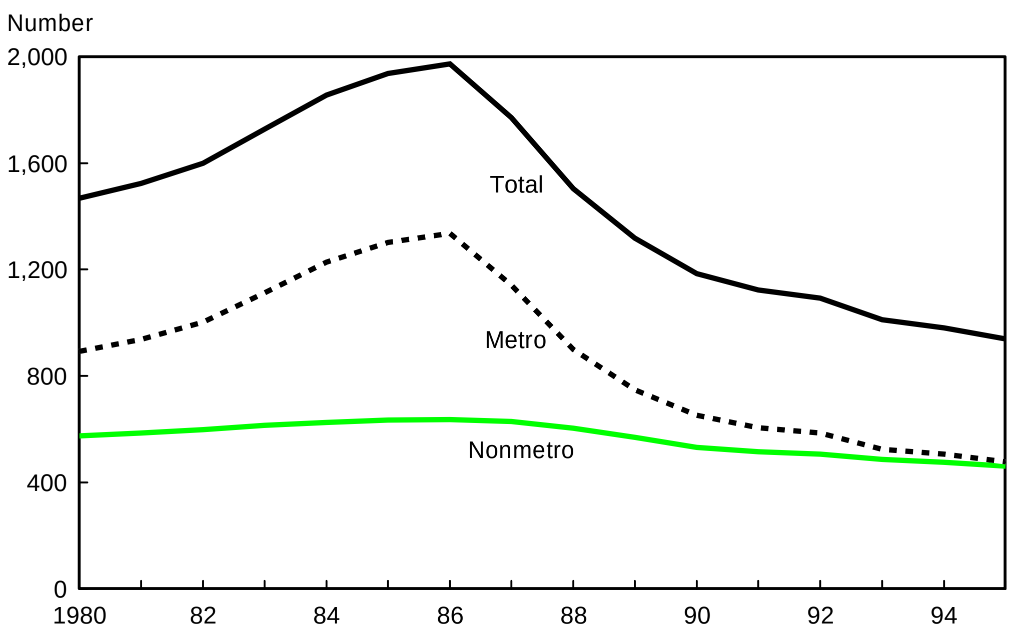


Note: End of year data, except for October 31, 1995.

Source: Calculated by ERS from the Federal Reserve Board's NIC database.

Number of insured Texas commercial banks by location, 1980-95

The number of banks grew until 1986 and then declined rapidly due to failures and changes in Texas bank branching laws



Note: End of year data, except for October 31, 1995.

Source: Calculated by ERS from the Federal Reserve Board's NIC database.

actually increased slightly between 1980 and 1993. While nationally the number of banks has declined, this has not reduced the number of different banks in rural counties.

The number of banks will continue to drop in the coming years. However, as in the past much of that will be due to holding companies converting bank affiliates to branches as laws permit and as they decide cost savings from branches outweigh the benefits of maintaining a local identity for their affiliated banks. Perhaps as many as a dozen banks will extend their operations to large parts of the country, but that does not mean they will have an extensive network of rural offices. Thousands of community banks will continue to compete in rural areas. *[Daniel Milkove, 202-219-0318; dmilkove@econ.ag.gov]*

Interstate branches of insured commercial banks in selected States by branch location, November 15, 1995
Interstate branching exists, but only in a few nonmetro areas so far

State	Nonmetro	Metro	Total
		Number	
Connecticut	0	76	76
District of Columbia	0	47	47
Illinois	0	20	20
Kansas	0	20	20
Kentucky	3	39	42
Maryland	30	361	391
New Jersey	0	542	542
New York	9	195	204
Pennsylvania	6	263	269
Rhode Island	0	13	13
South Carolina	55	172	227
Tennessee	1	1	2
Virginia	42	204	246
West Virginia	2	2	4
Wisconsin	2	1	3
Other States[1]	0	23	23
Total	150	1979	2129

Note: Both the branch and its head office are in the 50 States or D.C.; banks or branches in Puerto Rico, Guam, etc., are excluded. The table only includes those States with at least 1 nonmetro branch belonging to an out-of-State bank, or with at least 10 metro interstate branches.

[1]These States, with metro interstate branches in parentheses, are Arkansas (3), Colorado (1), Georgia (1), Iowa (6), Missouri (7), Oregon (1), Texas (1), and Washington (3).

Source: Calculated by ERS from the Federal Reserve Board's NIC database.

Metro and nonmetro county banking markets
Nonmetro counties average fewer banks than metro counties

Bank market characteristics	Metro		Nonmetro	
	1980	1993	1980	1993
		Number		
Counties with one or more bank offices	713	835	2,356	2,278
Banking firms per county	10.6	10.7	4.1	4.2
Bank offices per county	45.6	52.7	7.3	8.3
		Percent		
Counties served by:				
1-2 banking firms	5.6	4.2	31.1	27.4
3-5 banking firms	24.0	22.0	45.8	48.3
6-9 banking firms	31.4	33.9	18.9	20.9
10 or more banking firms	39.0	39.9	4.1	3.4

Source: Calculated by ERS from the Federal Deposit Insurance Corporation's Summary of Deposits database for June 30, 1980 and 1993.