Commentary: Implications of Banking Consolidation for the Financing of Rural America

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Good morning, everyone. Let me begin by congratulating Thomas Hoenig, Mark Drabenstott, and everyone at the Kansas City Federal Reserve Bank for their hard work in putting this conference together and making it a success. The issue of “Financing Rural America” continues to be one of the most important issues many of our banks face.

And the new horizons of the agricultural credit landscape are challenging us to seize the opportunities of the day and move ahead while being mindful of the lessons we’ve learned from the past. Agriculture is consolidating and changing, and rural agricultural banks are facing new challenges.

So I am pleased to have the opportunity to respond to Vice President Gilbert’s paper and share a few thoughts as a representative of the Independent Bankers Association of America, the only national trade association that exclusively represents community banks.

But since my field of academic specialty was the Japanese occupation of Southeast Asia—focusing on Burma—rather than domestic economics of finance, my focus may stray and wander somewhat.

Mr. Gilbert asks the right questions. For those in daily combat in Washington, one can ask why these questions weren’t asked and fully explored before the principal deed was done—the deed being the passage in September 1994 of the Interstate Banking and Branching Bill, which mandated full interstate banking immediately, and almost full national branching on June 1, 1997.

AN EMERGING LIQUIDITY PROBLEM

We in the banking industry often ask ourselves, “What’s ahead on the horizon?” For many small rural and agricultural banks, we are witnessing an emerging liquidity problem caused by a declining deposit base in rural America. There are many reasons for this loss of deposits from rural areas. Some of these include the flight of traditional deposits to mutual funds, which do not supply liquidity for lending purposes, even if the bank is the one selling the mutual funds. Many rural communities are also faced with an aging population, and as individuals pass away, their estates are often divided up between their children living in distant cities. And we would suggest that with consolidation, rural communities often face a loss of deposits since the out-of-state bank often removes deposits from local communities to use them for other economic opportunities, often nonrural in nature. There are a number of other factors as well that contribute to the declining deposit base and result in an emerging liquidity problem. Many rural banks are already beginning to feel a liquidity squeeze, and this topic will become an even more important issue if we are to adequately finance rural America in the years ahead.
Mr. Gilbert’s paper explains that one line of thought (with which IBAA would tend to agree) is that banking consolidation will have “adverse effects on the access to bank credit for rural residents” (p. 8). His paper also suggests that “small banks headquartered in rural areas would become important sources of credit to sectors of rural communities not served by the large organizations” (p. 13).

He goes on to further state, “Existing studies present some evidence that this change in banking structure would restrict the availability of bank lending to small businesses in rural areas” (p. 14). And in the concluding paragraph of his paper we read, “These (small) banks may become more important as sources of credit for rural residents not served by large banking organizations, which will account for larger shares of the banking business in rural communities.” And Mr. Gilbert’s paper suggests the need for more regulatory relief for small banks, a cause that IBAA has strongly supported and fought hard for.

Community banks play a key role in providing credit to the rural communities they serve. This role will become increasingly important as the banking industry consolidates. However, community banks are facing a serious challenge in fulfilling this growing role. As mentioned earlier, a major problem has already poked its head around the corner. Community banks are losing their core deposits to mutual funds and other financial instruments. This continued competition with money market mutual funds for deposit dollars is driving community banks’ liquidity problems.

We must clearly become problem solvers if we are to address the new challenges faced by an emerging liquidity problem for small banks in rural areas and the need to finance many of the small businesses and farmers who could face restricted credit access under a consolidated banking structure. And the banking industry has offered a workable solution. To better finance rural America we need to expand small bank access to the broader capital markets, either through the Federal Home Loan Bank (FHLB) or the Farm Credit System (FCS).

The IBAA supported the legislation introduced last session by Congressman Baker (R-Louisiana) to expand the eligibility criteria of banks seeking to qualify for membership in the FHLB system. And we supported allowing rural banks to be able to pledge their farm real estate loans as collateral for advances, which the Farm Credit System lobbied Congressman Baker to take out of the legislation, and which he did. Obviously, reasonably expanding the FHLB as a source of funding for rural banks to provide lending in rural communities would be a major, major step toward achieving our goal—ensuring that creditworthy citizens have adequate access to credit in rural areas.

The IBAA also joined with the ABA a little over a year ago in proposing that rural banks be allowed to access the broader capital markets through the advance window of the FCS. We believe this could be a “win-win” situation for both sides in the age-old debate of who should serve rural customers. This approach would utilize some of the strengths of both community banks and the FCS, namely, the delivery system of community banks and the access window of the FCS, to ensure rural credit markets have the necessary tools to remain viable in a consolidating and rapidly changing financial marketplace. Offering rural banks access to the capital markets will grow the economic pie in rural America. Unfortunately, the FCS has opposed the legislation.

If the banking industry and the FCS cannot get together to open the FCS’s funding arm to community banks, the advance window of the
FHLB system looms as an increasingly important alternative. Unfortunately, many community banks can’t qualify for membership due to their relatively low level of residential mortgage assets. Others can join but their low levels of qualifying collateral limit their ability to borrow. Liberalizing membership and collateral requirements for FHLB advances will require legislation. Both the Federal Reserve and the Treasury presently oppose such liberalization. Those who take such positions should be prepared to offer viable alternatives—particularly since further consolidation of the banking industry and opening the door to a large bank purchase of Edward D. Jones could aggravate already existing liquidity problems.

We need to keep in mind that Congress created the government-sponsored enterprises (GSEs) to help meet credit needs and this should continue to be their function. If the financial landscape of rural credit markets are changing, then the GSEs need to accommodate change by working with private sector lenders, and not trying to capture market share from commercial lenders who lack the tax and funding advantages that GSEs have. The banking industry and GSEs that desire to serve or continue serving rural markets should seek to creatively address future liquidity issues with a “win-win” approach. In addition, Congress, government regulators, farm organizations, and others interested in rural policies, may need to have a paradigm shift away from a “business as usual” approach, as we all seek to formulate solutions that will aid the rural customer.

Having presented to you our solution to one of the central question marks in the financing of rural America, which again is to ensure that rural community banks have access to the broader capital markets, let me comment briefly on the other side of the coin and discuss the consolidation and merger issue in greater depth.

**CONSOLIDATION AND THE NEW CHARTER ISSUE**

Clearly, we are still in the midst of a historic merger and acquisition wave that can be directly tied to the passage of the Interstate Banking and Branching Bill. When the bill was pending, you were told by most sources—including the Fed—that it was no big deal. The verdict of history will be—a very big deal indeed.

Writing in the fall 1995 issue of the *Stanford Journal of Law, Business and Finance*, George Washington University Law professor Arthur Wilmarth Jr. noted that during 1995, “agreements were announced for the acquisition of more than 400 banks with total assets of $500 billion.” To put this into context, from 1980 through 1989, the yearly average of assets acquired was about $65 billion. Wilmarth also noted that “transactions announced during 1995 included nine of the 14 biggest bank mergers in U.S. history.”

More immediately, the brilliant Arnold Danielson of Danielson Associates just published one of his periodic regional reports on October 21. The title is *Midwest Banking Report 1996—The Battle for the Heartland*. Let me quote from this report:

The 1995 phenomenon, however, was largely coastal and the nation’s Heartland was left relatively untouched by this merger explosion. The First Chicago merger with NBD would have been the headline banking story at any other time, but it was almost lost in a year when Chemical bought Chase to create the nation’s largest bank, Wells Fargo won a protracted battle to acquire the West Coast’s third largest bank, First Union created a banking empire that stretched from Florida to New England, and Fleet made not one, but two, acquisitions with price tags in excess of $3 billion.

With all of this happening, it was almost more interesting just what did not happen—i.e., NationsBank and BankAmerica staying on the sidelines and the country’s least concentrated banking
market, the Midwest, as noted above, being left almost untouched. In buying Boatmen’s, NationsBank has taken care of both of these omissions, and BankAmerica cannot be expected to stay on the sidelines for long.

What happens next in the Midwest is difficult to predict from a timing perspective, but by having so many strong, midsized banks, the region will be the focus of considerable merger speculation. The big question is—will the mergers be intra-regional or will they turn the Midwest into branches of banks based in Charlotte, San Francisco, Amsterdam, and other non-Heartland cities.

Will this have an impact on the financing of rural America? Of course, but we won’t know its full magnitude for some years. The available tea leaves of economic analysis, including Mr. Gilbert’s paper, already indicate that the impact on rural America—and on small business and the consumer—generally will not be totally benevolent.

Mr. Gilbert’s paper usefully builds on a Federal Reserve staff study of July 1994 by Stephen Rhoades, titled “A Summary of Merger Performance Studies in Banking, 1980-93,” which concluded that “bank mergers do not generally yield performance improvements in terms of profitability or cost efficiency.” An outside observer would add that this conclusion calls into serious question the economic benefits of job loss and branch closings that accompany many mergers.

But unfortunately the deed is done—regardless of the consequences, we are marching swiftly into the world of full interstate banking and branching. And it is irreversible. And more and more analysts see a vision of a brave new world that will include very few regional banks—rather, a barbell world of some 20 very large banks on one end with thousands of community banks on the other. I don’t think most of these community banks will be in urban or suburban America.

Is there a lesson to be learned from this? Yes. Legislation can and does have a significant impact on your lives and businesses. In the next Congress, the virtual repeal of both the Glass-Steagall and Bank Holding Company Acts will be considered. At the same time, they will be rewriting the bank charter in the context of doing away with the federal thrift charter, with the exception of federal mutuals.

If these laws are repealed, the common ownership of commercial banks, securities firms, and insurance underwriters will become routine. And apparently Senate Banking Committee Chairman D’Amato and Treasury Under-Secretary Hawke have no problems adding commercial firms to the common ownership mix.

Chairman D’Amato apparently also would open the Fed’s payments system to all comers. Why shouldn’t all firms have the right to clear through the Fed directly, he asks, striking at a key remaining component of the franchise value of all banks.

Please accept my assurances that almost all of those working overtime on this massive rewrite of the legal underpinnings of the financial services industry have never worked in a bank. To assume they fully understand what they are doing and the ultimate consequences of their actions defies recorded history. Make sure you give them your input—early and often.

REGULATORY IMPLICATIONS

Mr. Gilbert’s paper recommends that, given the “important role for small banks in rural communities, relief for these banks from the regulatory burden that does not undermine safety and soundness may be appropriate.” We agree—strongly. But there is a catch. President Clinton doesn’t agree—particularly regarding CRA. I will veto any legislation containing CRA
relief for small community banks was the President’s loud and clear message throughout the last Congress. And his message is not expected to change.

So community banks serving agriculture will continue to confront hands-on CRA examinations, while the newly minted branches of, for example, NationsBank/Boatmen’s may never see a hands-on CRA examiner. This is neither right nor fair. It is an unfair situation that must be remedied, particularly as regards the out-of-state branches of banks operating in many states. In fact, it is absurd—a community bank in Missouri being examined for CRA while a NationsBank branch isn’t.

A FINAL WORD

This important conference is about financing rural America.

If we cannot meet the fundamental needs of community banks, such as access to the capital markets for alternative funding purposes, then our concerns over regulatory burden may become irrelevant. The first goal of community banks will be survival for the bank, their customers, and their community. A logical way to achieve this would be opening up the FHLB advance window to community banks, particularly agricultural banks, or alternatively opening the FCS window.

Ag bankers face a new era with new challenges. The challenge, for example of a new farm bill that will increase volatility in market prices and risk for farmers and therefore ag bankers. Ag bankers may need to ensure their farm customers utilize proper risk management tools and enhance their efforts to educate their borrowers on how to protect against risk, how to better market their products, and how to maximize both profits and yields.

And as we look ahead, we have an ongoing, historic consolidation wave in the banking industry for which there are only recent facts and figures and not yet a firm enough basis to draw adequate conclusions because the major legislation Congress passed only occurred two years ago and doesn’t become fully effective until June of next year.

Adding fuel to the fire, policymakers are looking at legislation that will force the further consolidation of the financial services industry and perhaps other economic sectors. Like full interstate banking and branching, this could have adverse consequences for financing rural America—particularly the remaining small businesses and family farms. May the Federal Reserve Bank of Kansas City and other institutions continue to shine some light on inconvenient dark corners. And may all community bankers get actively involved in the upcoming high stakes legislative game.

The major question, again, is Will community banks have the tools to finance Rural America in light of the changes we could be experiencing? Thank you.