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BANK PERFORMANCE IN MEETING LOCAL COMMUNITY NEEDS: A COMPARATIVE STUDY OF INDEPENDENT AND CHAIN BANKING IN RURAL NEBRASKA

by

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L. A. N.

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CHAPTER I

INTRODUCTION

The banking industry in the United States is unique among industries not only because of its product, but also because of its organizational structure. No other industry has the quantity or variety of state and federal restrictions governing its organizational structure. That the banking industry is heavily regulated indicates the importance which the public attaches to a well-functioning financial system. That such a variety of organizational structures exists across the various states is in part due to historical accident and the response of state legislatures to unique sociopolitical settings.

Because of this diversity it was natural that questions concerning the performance of alternative structures would arise. Over the years numerous studies on the performance of alternative organizational structures have been made. These studies have looked at the effects of organizational structure on such items as the degree of competition, the concentration of financial resources, the availability and provision of financial services, the level of interest rates paid and charged, operating efficiencies and economies of scale, and the mobility of funds, among others. Normally, these studies have taken the approach that organizational structure may have important economic impacts via its effect on market structure, although in some cases the effects on performance are seen to be more direct. Regardless of the approach taken, market criteria (efficiency concepts) have been paramount in evaluating bank performance.

This is a comparative study of chain and independent banks in rural Nebraska, and their performance in meeting rural community needs. In this case

performance criteria are also included which are judged to be related to the continued viability of rural communities. It will be argued that structural changes in agriculture are key factors in the continued viability of rural communities, as well as the nature of economic and social development which takes place in them. Because of this, in addition to the more traditional performance measures (price and output), performance measures related to the structure of farming will be included in the analysis.

Organizational Structure Definitions

The organizational structure of banking refers to the legal ownership pattern among banks which in turn has implications for the geographic expansion of banking institutions that are under similar control and management. Because major decisions concerning legal structures are left to the states, there are several different organizational structures across the various states. The major types of organizational structures will be described here briefly. It is important to point out, however, that these types are not mutually exclusive and may be legalized in various combinations from one state to another.

Unit banking. Unit banking is an organizational form of banking where the bank may only conduct business from one physical location, that being the place cited in the bank's charter. In some unit banking states, however, banks are allowed to have a certain number of remote site limited service facilities. These facilities are quite often limited to the home office city, and while they may provide certain basic banking services (accepting deposits and making withdrawals), they are normally precluded from granting loans. In addition to the geographic restrictions, unit banking in its strictest sense is characterized by the

private ownership of bank stock, although in common parlance states which allow one bank holding companies are often classified as unit banking states.

Branch banking. Branch banking refers to the situation where a bank may provide its full range of banking services from more than one office. While some states prohibit branch banking altogether, the geographic scope of branching in those states which allow it varies considerably form one state to another. Branching restrictions vary from those which allow statewide branching to those which restrict branching to within the home office county or home office city.

In addition to these restrictions, branching may also be limited by method, i.e., branching by acquisition of an existing bank or de novo entry (establishing a new branch). Some states allow branching only by acquisition, whereas others allow both acquisition and de novo entry. In other cases, where de novo entry is allowed, home office protection laws may limit banks from establishing a new branch within a certain distance of another home office bank. In any case, just as in the creation of a new bank, a branch charter must be approved by the appropriate financial regulatory authority once state criteria have been met.

Bank holding companies. A bank holding company refers to the situation where a corporation, rather than individuals, owns a bank's stock. If a corporation controls more than one bank it is called a multibank holding company (MBHC), otherwise it is referred to as a one-bank holding company (OBHC). Bank holding companies may also engage in other business activities, but they must be closely related to the business of banking. The decision to legalize the operation of MBHCs or OBHCs is left to the respective states. Both the establishment of a bank holding company and the bank related activities of the holding company must be approved by the Federal Reserve. Because a MBHC may be operated much as a branch bank, the holding company arrangement largely developed as a method of

circumventing state branching restrictions. MBHCs are therefore most prevalent in states which allow MBHCs but prohibit branch banking.

Chain banking. Chain banking refers to the situation where an individual or group of individuals through stock ownership exercises common control of two or more banks. Thus, rather than a corporation exercising control as is the case for MBHCs, in the case of chain banking it is individuals who exercise control. There are few restrictions on chain banking. Because of this chain banking is existent in all states, although for obvious reasons it is most prevalent in states which prohibit branch banking or MBHCs. Thus, states classified as unit banking states are often characterized by many chain banking organizations.

Multibank and multioffice organizations. Multibank organizations refer to organizational structures where two or more banks are in some way under common control. Both MBHCs and chain banks fall under this category. Multioffice organizations on the other hand refer to branch bank organizations.

Methodology

In a recent article in the Journal of Economic Issues Charles Wilber states that, "The principle task of modern scientists has been to understand, interpret, and explain the reality which surrounds them. However unified this purpose may appear, the question of how to go about this process of explanation has been the source of great controversy."[1] Of course Wilber's main concern was the controversy concerning the methodological approaches taken in economic inquiry. The purpose here is not to engage in an exposition of this controversy but rather to make explicit the methodological approach taken in this study.

In a general sense, the investigatory mode taken in this study will be a holistic one. Wilber states that holistic theories are,

> . . . couched in the belief that the whole is not only greater than the sum of its parts, "but that the parts are so related that their functioning is conditioned by their interrelations."[2]

Further describing the holistic approach Wilber states that,

> The implication is that the characteristics of a part are largely determined by the whole to which it belongs and by its particular location in the whole system. Thus, if two superficially similar parts of different systems, let us say markets, are compared closely, they will be found to vary in characteristic ways.[3]

In essence, a holistic approach takes the view that economic or other social phenomena cannot be properly understood unless they are observed in terms of the larger social context in which they exists. Thus, from a holist's perspective, atomistic theories or analyses based on inherent attributes of individual agents will often lead to results which are inappropriate in a specific social setting.

> . . . Robert Heilbroner has given the example of markets in underdeveloped countries. Some economic development experts observed that people spent a large amount of time haggling over prices in local output markets in a particular peasant society. They set up a pilot project wherein a fixed price supermarket replaced the old peasant market. It was a failure because the new market did not satisfy the social intercourse provided by the old market system. Thus superficially similar parts, markets, provided different functions in different systems.[4]

This of course does not mean that atomistic models based on "economic rational man" may not yield useful predictions at times. For it is recognized that institutional arrangements may be such that this particular type of rationality may be characteristic of the parts. But even here, an understanding of the system

requires reference to the other social institutions (legal, political, etc.) as well as the values and norms required to form and support such behavior. It should be pointed out, however, that it is rare when institutional arrangements of the market totally subordinate all other institutions. Most industrialized countries are a mix of market, as well as other economic and social institutions which interact to form economic behavior.

A modeling methodology which is consistent with holistic thought is what is referred to as "pattern modeling."[5] The pattern model utilizes the participant-observer method of investigation. By participant it is meant that the observer must come as close as possible to the system or subject matter which is being observed. This does not mean that the observer must necessarily live and work within the system being observed, for the researcher may become familiar with with the actual operation of the system by reference to other studies, trade journals, surveys, secondary data, etc.

The reason for remaining close to the system being studied is best stated by Wilber.

> In remaining close to the concrete reality of the system being studied, the theorist is in a unique position to perceive a wide variety of recurrent themes (importance of ceremony, target profits/markup pricing) that appear in a variety of contexts. A theme is more important the more links it has with other themes, because the holist wants to construct a model which emphasizes the interconnectedness or unity of the system. These recurrent themes may take the form of an accepted practice (ceremonies), a cultural norm (conspicuous consumption), or a particular mode of production (competitive capitalism) which more or less conditions everything else, or some recognized social objective (social status). As an observer, the researcher looks for themes which illuminate the system's wholeness, that is, which contribute to its individuality or oneness.[6]

Once these recurrent themes have been observed, the researcher may construct more general interpretations or hypotheses concerning the parts of the system. Validation of these hypotheses may be made by utilizing a wide variety of information sources and/or statistical techniques. Eventually, these validated themes or hypotheses fit together into our overall "pattern model" of the system. The important point is that the recurrent themes fit together so as to make a "unified whole." The model is further verified when information continues to fit the existing pattern.[7]

This will be the basic mode of inquiry utilized in this study. First, balance sheet and income statement data will be scrutinized over several years to determine if any recurring differences between chain and independent banks exist. If such recurring themes do exist, they will attempt to be fitted into more general patterns of behavior which may characterize the grouped banks. Of course, behavior patterns which are considered to be more important to rural areas will receive greater attention. Second, patterns of behavior which other studies have suggested may be characteristic of multibank or multioffice organizations will also be tested. This will be done using survey data, along with balance sheet and income statement data previously utilized. The findings here will hopefully reinforce any previous patterns which may have been discovered.

Underlying Value Premises

From the discussion on methodology one may have been left with the impression that what was being engaged upon is a purely empirical study, devoid of any value judgements. This, of course, would be a mistake. Such an attempt would be, as Gunner Myrdal puts it, "naive empiricism." Regarding all inquiry Myrdal says,

> Fac.s do not organize themselves into concepts and theories just by being looked at; indeed, except within the framework of concepts and theories, there are no scientific facts but only chaos. There is an inescapable a priori element in all scientific work. Questions must be asked before answers can be given. The questions are all expressions of our interest in the world; they are at the bottom valuations. Valuations are thus necessarily involved already at the stage when we observe facts and carry on theoretical analysis, and not only at the stage when we draw political inferences from facts and valuations.[8]

Of course, Myrdal was not only cautioning us concerning the use of inductive processes, but was also concerned about the use of economic models with little or no reference to their underlying value premises. His solution was not to purge economics of value judgements for he recognized that this was impossible. Rather, Myrdal argued that in order to avoid bias, underlying value premises should be made explicit.

> As we shall find, the logical means available for protecting ourselves from biases are broadly these: to raise the valuations actually determining our theoretical as well as our practical research to full awareness, to scrutinize them from the point of view of relevance, significance and feasibility in the society under study, to transform them into specific value premises for research, and to determine approach and define concepts in terms of a set of value premises which have been explicitly stated.[9]

Myrdal's advice will be followed here by stating the value premises underlying this study. As in the case for all inquiry, they form the basis for the choice of performance criteria and the type of information which will be scrutinized. Because this is a comparative study of the performance of banks in rural areas, it is natural that value premises concerning what constitutes a healthy rural society

together with a healthy financial system will guide the choice of performance variables and their evaluation.

First, it is maintained that a farm structure characterized by a less concentrated pattern of owner-operated farms is preferable to a system characterized by increasingly concentrated, absentee ownership patterns. This is not to suggest that all farm consolidation that has taken place over the past 50 or so years has necessarily been bad, but that the effects of farm consolidation on the economic and social viability of rural communities must be weighed heavily against any supposed gains. It is also to argue that the inordinate consolidation of farms has resulted in the degradation of rural institutions with little or no benefits to the public at large. This will be more fully argued in Chapter 3. It should also be pointed out that the ethos of a diffused land ownership is a deeply embedded value in American culture.

Second, local control of financial institutions has been a traditional concern of rural communities for numerous reasons. It is generally believed that banks which are controlled locally have a greater interest in the long-term development of the community and are more sensitive to the special needs of the community. This does not mean that branch bank organizations, MBHCs, or chain organizations cannot be operated in a similar manner, for they too have an interest in the long-term viability of the communities in which they operate. It does mean, however, that such organizations may be more susceptible to centralized decision-making based on narrow criteria. This value premise is one of the reasons for comparing the performance of chain and independent banking in rural areas.

Finally, the market concept of an efficient allocation of funds will not be utilized as an ultimate criterion in evaluating bank performance. In effect, this is suggesting that economic and social welfare cannot and should not be viewed in such narrow terms as utility maximization or other derived concepts. It also

suggests that aggregate price and output indicators are only two of several indicators which should be used in evaluating bank performance.

Organization of Study

In the chapter immediately following, the historical development of multibank and multioffice institutions will be reviewed, along with the legal status of multibank and multioffice institutions in Nebraska, and various studies concerning the organizational structure of banks and their performance in rural areas. In Chapter 3 the relationship between farm structure and the nature of economic and social development which takes place in rural communities will be explored. This will be done by reviewing the theoretical relationships between rural spatial settlement patterns and rural trade centers, along with empirical evidence, as expressed in central place theory. More general studies, concerning farm structure and its relationship to the economic and social welfare of rural communities will also be examined. The purpose of this review is to point out the importance of including indicators in rural bank performance studies which attempt to measure the possible impact of financial institutions on farm structure.

In Chapter 4 a general comparison of the performance of chain and independent banks in rural Nebraska will be accomplished using balance sheet and income statement data from the various banks. Several performance variables (ratios computed from balance sheet and income statement data) will be used to compare the grouped banks on both a univariate and multivariate basis. In addition to discovering differences in individual performance variables, the analysis should also help to discover more general patterns of behavior which may be characteristic of the different grouped banks. The major emphasis here, as well as throughout,

will be on those performance variables and behavior patterns which have implications for structural changes in agriculture.

Using the results of a survey of rural Nebraska banks along with data previously utlized, some common contentions regarding multibank and multioffice organizations will be examined in Chapter 5. Specifically, the contentions that multibank and multioffice institutions siphon funds from rural areas, allocate funds towards larger borrowers, and use impersonal credit standards will be explored in the context of their implications for rural communities.

Finally, in addition to conclusions and their policy implications for changes in the organizational structure of banking, Chapter 6 will also include a review of the Community Reinvestment Act and its implementation in rural areas. Suggestions concerning how it might be better implemented, in keeping with its legislative intent, to insure that the credit needs of rural communities are being met will be made.

CHAPTER 2

THE ORGANIZATIONAL STRUCTURE OF BANKING AND PERFORMANCE IN RURAL AREAS

History of Organizational Restrictions in Banking

The United States is one of the few countries where the organizational structure of banking is still a hotly debated issue. In most other industrialized countries of the world the geographic restrictions on banks are few, and banking organizations which are national in scope are quite common. In order to understand why the United States is peculiar in this respect, it is necessary to take a short look at the historical development of banking in the U.S.

Developments Before 1900.

The issue of multioffice or multibank organizations has not always been a controversial issue. In fact, the period prior to 1900 can be characterized as one during which very little concern over this issue was shown. Nevertheless, several events occurred which affected the organizational structure of banking, and ultimately would set the stage for subsequent battles.

Prior to the National Banking Act of 1864, all banks were state chartered with the exception of two banks. The First Bank of the U.S. (1791-1811) and the Second Bank of the U.S. (1816-1836) were both given exclusive 20 year federal charters. The First and Second U.S. Banks were quasi-public institutions in the sense that some stock was held by the government and some of the directors were appointed by the president. Nevertheless, the banks were operated much as any