Federal Reserve Bank of Philadelphia

1968

Business Review

February

Trends over the past decade-and-a-half in the Third Federal Reserve District raise some important questions about the relationship between . . .

Mergers and the Small Unit Bank

by Warren J. Gustus

Fifteen years ago the absorbing bank in a typical Third District merger would have been located in a large city. Chances were about four in ten that both the absorbing and absorbed banks would be located in the same city. The absorbing bank would have been one of the larger banks in the District and the absorbed bank would have been small, with roughly $5 million resources.

Today the chances are considerably greater that the absorbing bank will be located in a smaller city. Chances are also less — only about one in ten — that the parties to the merger will be located in the same city. And now the size of the acquiring bank is smaller. But one thing that has not changed is the typical size of the absorbed bank—still about $5 million in resources.

Since World War II unit banks have been steadily disappearing. Probabilities are that they will continue to disappear. While at the end of 1950 there were 722 unit banks in the District, by 1967 their number had dwindled to 264 with over 80 per cent of the disappearances a result of merger. At the same time, regional rivals to the Philadelphia banks have begun to appear. Chances are good that these banks will continue to grow and will become more like the Philadelphia banks in terms of their products and services. In any case, there are as yet no signs that the merger movement has run its course.

BEHIND THE MERGERS

Merging banks, small and large, obviously believe mergers are mutually profitable. However, what are the economic forces which convince so many banks that there are these profit opportunities? In particular, why have these forces had such an impact on small banks?

After World War II many thought commercial banking a mature industry with slowly growing markets and little innovation in products or services. They expected that commercial banks would decline in relative importance among financial institutions. Certainly, almost two decades of experience seemed to support these beliefs. During the Great Depression demand for commercial loans had dried up, but commercial banks were either unwilling or unable to search

CHART 1

NUMBER OF MERGERS IN THIRD FEDERAL RESERVE DISTRICT*

*Includes mergers when either acquiring or acquired bank is in Third District.

BUSINESS REVIEW is produced in the Department of Research. Evan B. Alderfer is Editorial Consultant; Donald R. Hulmes prepared the layout and artwork. The authors will be glad to receive comments on their articles.
Requests for additional copies should be addressed to Bank and Public Relations, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.

out new outlets for their excess reserves. Then, World War II had turned the banks largely into repositories for U.S. Government securities. Immediately after the war specialized financial institutions, such as small loan companies and savings and loan associations, seemed to have preempted markets that commercial banks might have serviced. Even into the early 1950's banks held more securities in their portfolios than loans.

Since then, however, commercial banks have proved that they are far from moribund. They no longer invest primarily in federal debt. Instead they actively seek outlets for their funds in the municipals market, and by developing new ways of serving business and consumers — including leasing and credit-card facilities. Banks, large as well as small, are importantly involved in extension of credit and services to consumers. They have become more aggressive in raising funds, developing such instruments as certificates of deposit and making use of debenture financing. At the same time, the rapid development of computers and expanding use of such bank services as checking accounts have forced banks to take a fresh look at their own structure of operations. The move to the suburbs and changing patterns of economic growth have also had their impact on banking as new markets for bank services have sprung up and old markets have declined or ceased to grow.

In short, the 1950's and 1960's have been years of great change for commercial banking. Mergers are one way banks can respond quickly to changes like these.

Mergers and small banks

With 838 commercial banks in existence in the Third District at the end of 1950 and only 503 at the end of 1967, it is clear that mergers have been an important source of change in number of banks operating in the Third District. The totals, however, hide the impact of the merger movement on the banking structure and particularly on small unit banks. Between 1950 and 1967 about 50 per cent of the banks acquired had total resources of less than $5 million. Over 70 per cent had total resources of less than $10 million.

Most of the acquired banks were unit banks. Many were located in one-bank communities. They relied almost solely on local sources of funds for their resources. Except for funds committed to U.S. Governments and municipals, they lent almost solely in local markets.

Why do small banks make such prime targets for acquisition? The most common reasons given are problems of personnel and management succession. The banks, it is said, are not large enough to support on-the-job training for successors, and costs of going out and hiring experienced personnel as existing management retires have skyrocketed.

Also, the market for small bank equities is either very thin or nonexistent. Sometimes when a swap of stock is used the merger is a way for present owners to acquire a more marketable security. Or, a merger may be attractive to the owners of the acquired bank because they can liquidate their investment at capital gains rates.

In addition, there probably are more basic economic forces motivating the merger sweep. After all, the acquiring bank must staff the acquired bank and compete in the same labor market for personnel. For all but the largest banks the market for equities is thin.

One of these basic economic forces seems to be the difficulty of many smaller banks to achieve economies that come with size. Although the evidence is not conclusive, a number of empirical studies during the past several years indicate that the smallest banks are relatively high-cost operations for many of the products and services they sell. In these cases a small bank may be operated more economically as part of a branch system of a larger bank than as a unit bank.

NEW DEVELOPMENTS

Acquired banks are almost invariably smaller than the acquiring banks, which is what most people would guess. Thus in only 16 per cent of the mergers did the acquiring bank have resources of $10 million or less compared to 70 per cent for the acquired bank. Thirty per cent of the time the acquiring bank had resources of $100 million or more. But what is, perhaps, more surprising is the decreasing importance of mergers by banks located in the larger cities and metropolitan areas of the District, as Table 1 and Chart 2 indicate.

From 1951-1955 both acquiring and acquired banks were located in metropolitan areas 76 per cent of the time. But from 1961-1967 these percentages declined to 65 and 57 per cent, respectively. The same pattern emerges when banks are classified by city size. Merger activity has been increasingly dominated by banks located outside the largest cities of the District. Again this is true for acquiring as well as acquired banks.

The changing geography of mergers also provides further evidence that pervasive economic forces are at work. Between 1948 and mid-1954 there was no merger activity in 28 of the District's 60 counties, but by 1967 there had been mergers in 58 of the 60 counties.

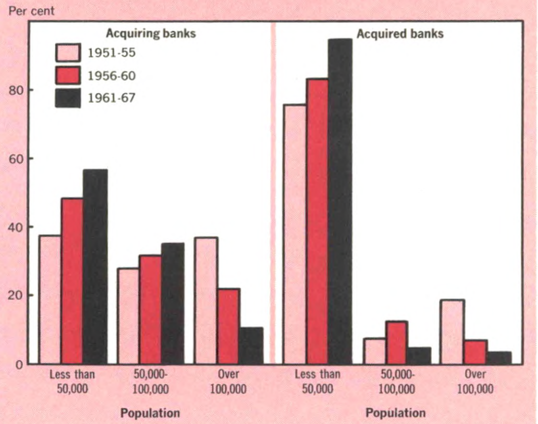
Table 1

PERCENTAGE OF MERGING BANKS IN METROPOLITAN AND NON-METROPOLITAN AREAS

Period	Metropolitan Acquiring	Metropolitan Acquired	Non-Metropolitan Acquiring	Non-Metropolitan Acquired
1951-1955 . .	76%	76%	24%	24%
1956-1960 . .	69	65	31	35
1961-1967 . .	65	57	35	43

CHART 2

PERCENTAGE OF ACQUIRING AND ACQUIRED BANKS, BY CITY POPULATION



As the merger movement has spread among counties, banks also have tended to look more outside their home cities. Between 1951 and 1955 about 37 per cent of the mergers were between banks located in the same city. Between 1961 and 1967 this percentage had declined to ten.

Banks seeking merger partners are increasingly going outside their home city or town. Even so, the geographic reach of mergers has been limited, partly because of legal restrictions on branching. Banks may not operate branches across state lines. With the exception of banks located in Delaware, Third District banks have additional restrictions on geographic mobility. In New Jersey, branches are limited to the home-office county. In Pennsylvania, banks may operate branches only in the home-office and contiguous counties. Even, however, within the framework of these legislative restrictions, the majority of acquiring banks still did not seek partners far from the home town. Only about 25 per cent of the mergers involved a cross-over of county lines.

There is one notable exception to this reluctance to roam very far afield. From 1951 to 1967 banks based in Philadelphia County acquired 21 banks within the county and 31 outside. These acquisitions were in Montgomery, Delaware, and Bucks counties — all areas of rapid economic growth. Once we leave Philadelphia County, however, the number of inter-county mergers decreases sharply. In Montgomery County, acquiring banks reached outside the county only five times and there were 14 mergers within the county. Acquiring banks in Luzerne County had only four acquisitions outside the county compared with 16 inside. Banks in Schuylkill, Lancaster, York, and Berks counties, where mergers also have been frequent, behaved similarly.

ECONOMIC PROFILES

Mergers are bringing about dramatic changes in the banking structure; these changes are being felt throughout the District. As mergers have continued and spread, however, many people have become concerned about the implications for users of banking services. One fear, not new but increasing, is that as smaller banks are absorbed into branch networks they will become less effective suppliers of banking services to their communities.

Without pretending to solve this issue, which would require an analysis of post- as well as pre-merger performance, we have looked at the acquired and acquiring banks in terms of several commonly used economic measures of bank performance. These are the ratios of loans to securities held, the ratios of risk assets (total assets minus cash and Government securities) to capital, and growth rates of deposits and capital.

It turns out that acquiring banks tend to have a somewhat higher ratio of loans to securities than acquired banks, a higher ratio of risk assets to capital, and more rapid rates of growth.

In about 65 per cent of the cases the acquiring banks have had a higher ratio of loans to securities than acquired banks. The loan-security ratio of the acquiring banks has usually been higher than the District average, while the reverse is true for the acquired banks. Most, but not all, of these differences can be explained by size of bank. Larger banks tend to commit a higher proportion of their resources to loans than do smaller banks. Acquiring banks are almost invariably bigger than the acquired banks and bigger than the average for the District. Acquired banks are smaller than the average for the District.

In about 70 percent of the cases, the acquiring bank has had a higher ratio of risk assets to capital than the acquired bank. This reflects both the greater loan commitment of larger banks and also the fact that smaller banks tend to have a lower deposit-capital ratio.

Growth rates measured either by change in deposits or capital five years prior to the merger have been a bit higher for acquiring banks. But growth rates for most merger partners have been above the average for all banks in the District. Not surprisingly, growth-minded banks seek out partners with growth prospects.

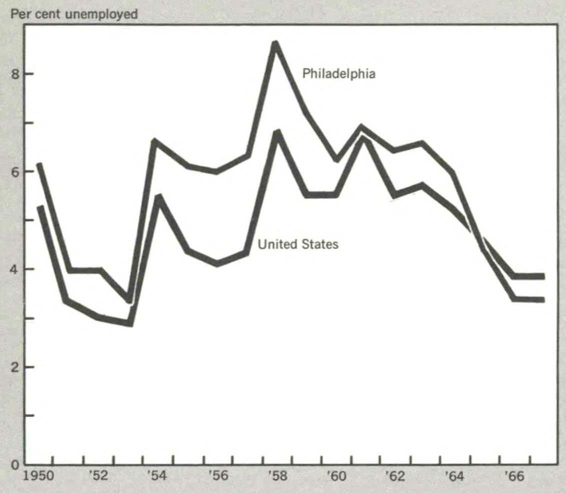
These gross measures of performance do not suggest that acquired banks, i.e., smaller banks, are performing unique functions of lending or risk bearing. Acquired banks have held a larger portion of their earning assets in securities than have the acquiring banks. Then too banks are only one outlet for the bulk of these securities, many of which can be traded in regional or national markets. Whatever the reasons, acquiring banks seem to have had less risk aversion. To the extent that growth rates are an indicator of successful performance, acquiring banks also have shown up well. *(Continued on Page 8)*

Unemployment in Philadelphia

by Shirly A. Goetz

Unemployment is at its lowest level since the end of the Korean War. Moreover, after a decade and a half of higher-than-national unemployment, the Philadelphia[1] rate dropped below that of the United States in 1965 and has remained lower ever since.

UNEMPLOYMENT RATES

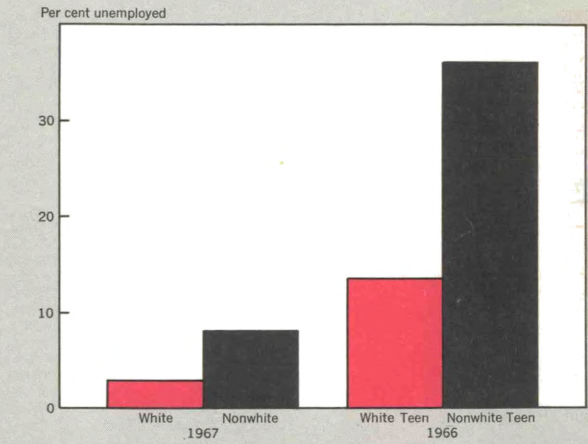


As total joblessness has declined, so has the duration of unemployment.

DURATION OF UNEMPLOYMENT IN PHILADELPHIA (5 PA. COUNTIES)

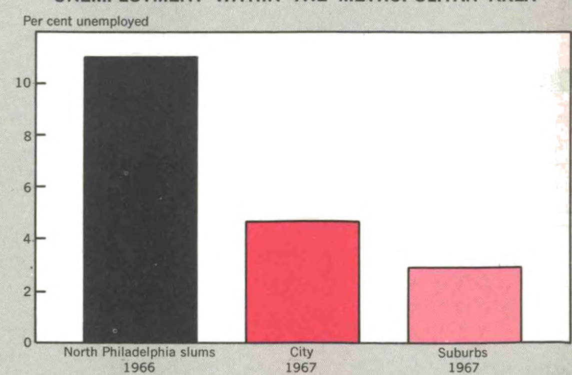
While total joblessness is low, nonwhites and teenagers still have difficulty in obtaining work,

TWO TROUBLE GROUPS: NONWHITES AND TEENAGERS IN PHILADELPHIA



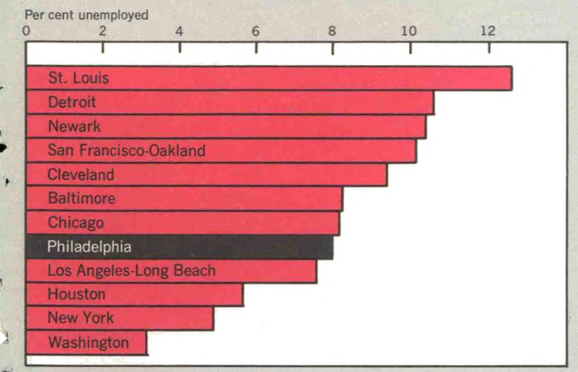
as do slum residents and city dwellers compared to their suburban neighbors.

UNEMPLOYMENT WITHIN THE METROPOLITAN AREA



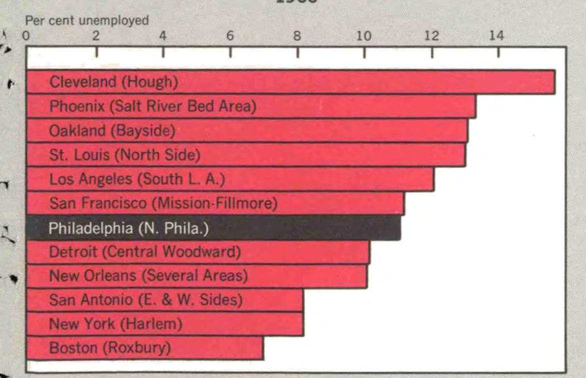
Most large metropolitan areas share Philadelphia's experience of high nonwhite unemployment

NONWHITE UNEMPLOYMENT AROUND THE NATION, 1967



and high slum unemployment.

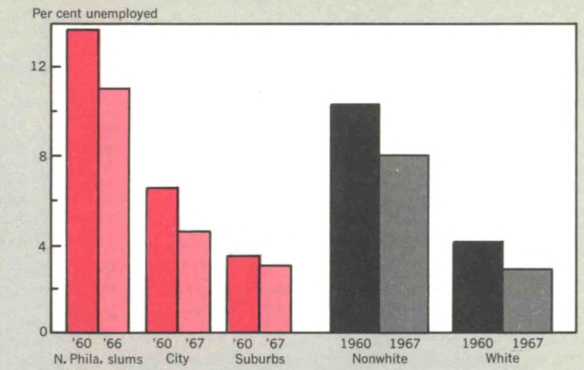
SLUM UNEMPLOYMENT AROUND THE NATION, 1966



Sources: U.S. Department of Labor, U.S. Department of Commerce, Pa. Bureau of Employment Security.

[1]Except where otherwise noted, Philadelphia means the Philadelphia Metropolitan Area: Bucks, Chester, Delaware, Montgomery and Philadelphia counties in Pennsylvania; Burlington, Camden and Gloucester counties in New Jersey.

UNEMPLOYMENT IN PHILADELPHIA, TODAY VS. 1960

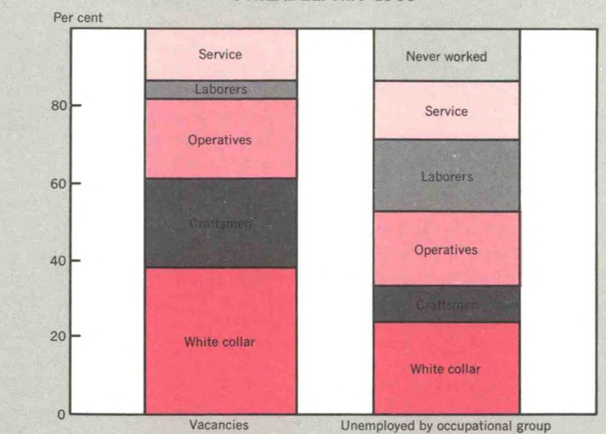


Although joblessness is still higher in the slums and the city, it has declined more there since 1960 than in the suburbs.

Unfortunately, while the rate of nonwhite unemployment has decreased, it has not improved relative to the white rate.

To combat continued joblessness, the unemployed need training to fill existing vacancies. Most jobs exist in skilled areas, while the majority of unemployed are unskilled.

ARE JOBS AVAILABLE FOR THE UNEMPLOYED? PHILADELPHIA 1966



(Continued from Page 5)

Ratio analysis is helpful in arriving at conclusions on individual bank performance, but unfortunately, there are no very good measures to determine such things as the minimum number of banking alternatives necessary to insure effective competition and to meet the convenience and needs of the community. Nevertheless, powerful economic forces are working for mergers. Even without all the knowledge they require, the various regulatory agencies and the courts must make judgments that will importantly affect the banking structure in the future.

FUTURE MERGERS

Without in any way predicting what supervisory or judicial policies may be, let us assume the merger trend continues on its recent course. What are the implications for the banking structure?

Mergers between big banks in big cities have almost disappeared. There are several reasons for this. Good economic fits between large city banks are harder to come by just because of the mergers that have already taken place. However, even when two large banks think that a merger will make them a more effective competitor, regulatory and judicial hurdles are now more difficult to surmount. Several judicial landmarks in the early 1960's established beyond question that the antitrust laws applied to combinations in the banking industry, the Bank Merger Act of 1960 notwithstanding. Further, although the Act was amended in 1966, it appears probable at the time of this writing that two large banks attempting to merge will be faced with long and costly regulatory or judicial proceedings.[1] Where the proposed merger is between a big city bank and a smaller bank based outside the home-office city, the chances of success may be better. However, problems still may be encountered.

The largest banks in the District have developed extensive branch networks during the past two decades, both by merging and by new branching. Hence, the chances are increased that any proposed merger will involve the elimination of existing competition because the acquiring bank is already operating a branch in the market.

Even if the acquiring bank can show that it does not now compete in the market of the bank to be acquired, the hurdle of the potential competition issue may still have to be surmounted. Would the acquiring bank in the absence of the merger set up a new branch in the market of the bank to be acquired? Even if it did not consider establishment of a new branch a realistic immediate alternative, might it not change its mind at some time in the future? Finally, are there enough potential entrants remaining to police competition?

Regional rivals

But one step below the largest banks, regional rivals have begun to appear. Just as many Philadelphia-based banks have relied heavily on mergers to promote rapid growth, others are taking the merger route.

Banking assets in the Third District have been, and still are, heavily concentrated in Philadelphia-based banks. In 1950, the reserve city banks owned 24 per cent of all commercial bank assets in the Third District and by 1966 their share had increased to about 35 per cent. These banks grew by 186 per cent between 1951 and 1966—much of this by mergers. If assets of merged banks are included in the base year, growth rate declines to 76 per cent.

By 1967, however, there were 22 banks outside the Philadelphia Metropolitan Area with assets in excess of $100 million. These banks are still rela-

[1] *As this issue goes to press, a ruling in the U.S. District Court in Philadelphia has turned down the proposed merger of the fifth and seventh largest banks in the Philadelphia metropolitan area.*

Table 2

DISTRIBUTION OF THIRD DISTRICT BANKS
(By number of branches)

Number of branches	December 1950	December 1967
None	772	264
1-3	56	159
4-6	8	36
7-9	—	11
10 and over	2	33
Total	838	503

tively small by Philadelphia standards; nevertheless, they are a growing competitive force. In 1950 they owned about 13 per cent of bank resources in the Third District; by mid-1966 their percentage share had increased to over 21 per cent. Since 1950 the resources of these banks have grown by 215 per cent, with much of this growth as a result of merger.

Over-all, these banks have grown at a more rapid rate than the Philadelphia banks — 215 vs. 186 per cent. Even now, many of them have extensive branch networks, at least by 1950 standards. While in 1950 there were only two banks in the District with ten or more branches, by 1967 there were thirty-three. Of these, all but six had their home office outside Philadelphia.

As these banks grow by merger they will be able to offer a wider variety of services and to act more like reserve city banks. For example, they will be dealers in federal funds for other banks, more important as holders of correspondent balances, and with expanded trust departments. Not only will they offer increasing competition to the Philadelphia banks but also interregional competition among themselves is likely to be increased. Insofar as big banks are able to offer certain unique banking services, consumer alternatives will be improved.

The small unit bank

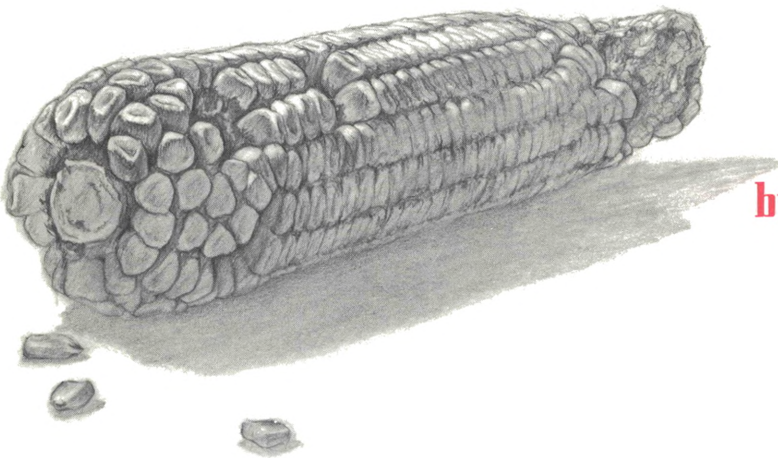
Prime candidates for acquisition will be the 264 unit banks still remaining in the District. Most of them were founded at the turn of the century and are seasoned financial institutions, and about half of them are the only banks in their communities. But over 30 per cent of them have total resources of less than $5 million, and 85 per cent have total resources of less than $10 million. Problems of management succession, diseconomies of size, and increasing competition from branch networks of regional banks will be among the economic forces bringing about the disappearance of some of them.

Even in the absence of anti-trust statutes, many of the banks would not be available for acquisition by the largest banks in the District because of state banking laws. For example, 128 of these banks are located roughly in the eastern portion of the Third District section of Pennsylvania, but not in counties contiguous to Philadelphia. These are likely candidates for the branch networks of the developing regional banks.

If the merger movement continues as it has been going, there will be considerably fewer unit banks a decade hence. The large banks outside the Philadelphia Metropolitan Area will have further narrowed the size gap between their Philadelphia rivals and themselves, both through merger and new branches. Large Philadelphia banks, finding the acquisition route to growth increasingly difficult, may step up *de novo* branching activities. Alternatively, the more rapid development of devices which will allow them to expand their competitive area without branching, of which the credit card is one forerunner, may be in the offing.

As branch networks grow, competition will be more inter-regional in character. More banks will be performing the services heretofore believed to be the unique province of reserve city banks.

Cashing In On Corn



by Evan B. Alderfer

Last year the country's corn crop went over the top. The 4,700 million-bushel harvest was 14 per cent over the year before and 25 per cent above the 1961-1965 average.

Inasmuch as most of the corn is fed to livestock, last year's bumper corn crop is likely to appear this year in the form of heavy shipments of animals to the livestock markets. Overloaded markets spell falling prices and reduced farm income.

Hoping to avoid such a turn of events, the Secretary of Agriculture met with leaders of livestock, poultry, and general farm organizations early last December. He stressed the need for livestock and poultry producers to show restraint and keep their 1968 production in line with demand.

While Secretary Freeman's admonition may seem to have been directed primarily to farmers in the Corn Belt, cash farm income in Pennsylvania, New Jersey, and Delaware is also derived chiefly from livestock and livestock products. For years the three-state region has been a feed deficit area — home-grown corn has had to be supplemented with grain purchases from other states to meet the requirements of local poultrymen and cattle feeders. Cheap corn, whether local or out of state, is an inducement to overfeed.

Local poultrymen with memories of broiler prices degenerating to 10 cents a pound as recently as December 1966 are not likely to be tempted to repeat overproduction, at least not so soon. The chicken cycle is short — from egg to chick to marketable broiler is only a matter of weeks, so there is yet time to limit production and hold the price line.

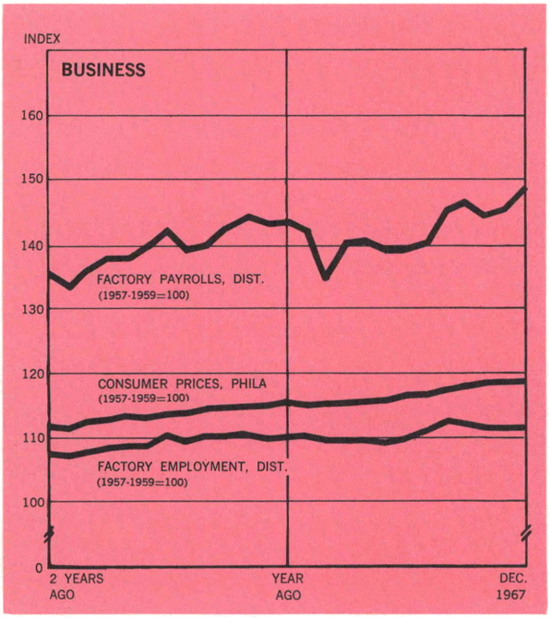
And what of the local cattle feeder? To begin with, some of the Pennsylvania corn, especially the late harvested, was soft and therefore had to be fed immediately. Abundance of local corn is a powerful stimulus to feeding. In early January, cattle feeding was believed to be running somewhat higher than usual. "Better to feed steers than sell corn at present prices," was the comment of one farmer.

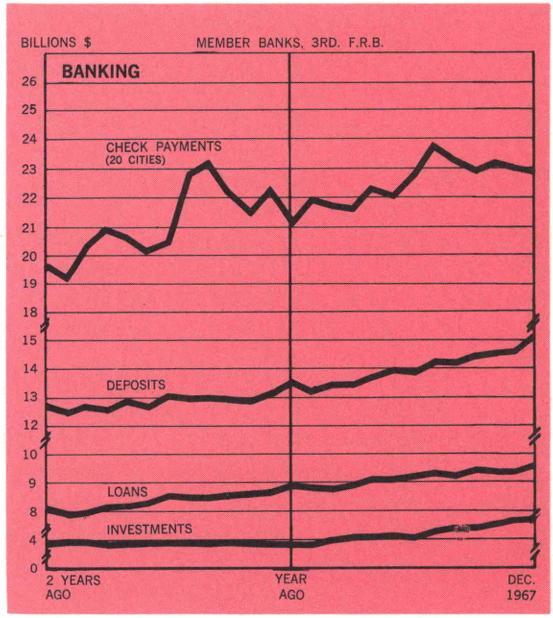
Feeding cattle, however, affords some discretion in how a farmer "sells his corn." He may go in for "short feed" of 90 to 100 days or, in any event, feed to choice grade of about 1,000 pounds. At that weight it is generally considered best policy to sell, for several reasons. First, demand is more and more for lean meat. Second, feeding efficiency drops rapidly as cattle pass 1,000 pounds. An Iowa State University study reveals that with No. 3 corn at a dollar a bushel the cost of putting on a pound of gain on cattle weighing 1,200 pounds is 66 per cent more than what it is at 1,000 pounds. Third, feeding to heavier weights exerts price-depressing effects on the market.

Country bankers who advance funds to cattle feeders, as many of them do, are well aware of the risks. Cattle feeding, according to a circular issued by the Pennsylvania State University College of Agriculture, "has poor years, good years, and average years. The good years seem to come just often enough to encourage many feeders to stay in business after a couple of bad years." That is, if he has the money to buy cattle, or if he can persuade his banker to lend him the capital.

And what kind of year will 1968 be? In the opinion of a knowledgeable Lancaster County cattle feeder with years of experience "the abundance of corn will have some effect by way of ultimate over-feeding and falling prices. For a time, cattle will be marketed light. Later, feeders with still a lot of corn left will feed to heavier weights. Thereupon the added tonnage of beef coming on the market will depress prices." Falling prices, of course, would please consumers—especially in a period of accelerating inflation. But lower retail prices of red meat are not necessarily in the offing. So much depends upon the feeding practices of thousands of cattle feeders and their decisions about cattle shipments to market.

FOR THE RECORD . . .





SUMMARY	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	Dec. 1967 from		12 mos. 1967 from year ago	Dec. 1967 from		12 mos. 1967 from year ago
	mo. ago	year ago		mo. ago	year ago	
MANUFACTURING						
Production	....	....	....	− 1	+ 2	+ 1
Electric power consumed	− 2	+ 5	+ 3	....	....	....
Man-hours, total*	+ 1	0	− 2	....	....	....
Employment, total	0	+ 2	+ 1	....	....	....
Wage income*	+ 2	+ 4	+ 2	....	....	....
CONSTRUCTION**	+38	+75	+11	− 6	+25	+ 5
COAL PRODUCTION	− 1	− 6	− 3	− 5	− 7	+ 2
BANKING						
(All member banks)						
Deposits	+ 4	+12	+ 9	+ 5	+12	+ 8
Loans	+ 2	+ 9	+ 9	+ 3	+ 8	+ 6
Investments	+ 1	+23	+10	0	+19	+12
U.S. Govt. securities	+ 1	+17	+ 3	− 1	+13	+ 7
Other	+ 2	+30	+18	+ 1	+25	+17
Check payments***	− 1†	+ 6†	+ 6†	+ 1	+10	+12
PRICES						
Wholesale	....	....	....	+ 1	+ 1	0
Consumer	0‡	+ 3‡	+ 3‡	0	+ 3	+ 3

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES	Manufacturing				Banking			
Standard Metropolitan Statistical Areas*	Employment		Payrolls		Check Payments**		Total Deposits***	
	Per cent change Dec. 1967 from		Per cent change Dec. 1967 from		Per cent change Dec. 1967 from		Per cent change Dec. 1967 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Wilmington	0	− 1	+23	+ 2	+ 4	− 2	+16	+ 6
Atlantic City	....	....	....	....	+ 1	+ 9	+ 1	+ 2
Trenton	− 1	− 5	0	− 3	+ 1	− 4	+ 5	+17
Altoona	− 1	0	− 2	+ 1	− 3	+ 1	+ 2	+ 8
Harrisburg	0	+ 2	+ 1	+11	− 4	+ 4	+ 4	+14
Johnstown	0	− 4	+ 1	− 1	+ 1	+ 8	+ 1	+ 9
Lancaster	0	− 1	0	0	0	+ 4	+ 2	+ 6
Lehigh Valley	0	− 2	0	− 1	− 1	+ 6	+ 2	+10
Philadelphia	0	− 1	+ 2	+ 2	− 3	+ 9	+ 4	+15
Reading	0	0	+ 1	+ 5	+ 1	+15	0	− 6
Scranton	− 1	0	− 2	+ 4	− 3	+ 9	+ 4	+14
Wilkes-Barre	− 1	− 4	− 4	+ 2	− 2	+ 5	+ 2	+13
York	− 1	0	− 1	+ 5	+ 7	+11	+ 1	+ 8

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.