FYI: An Update on Emerging Issues in Banking

Trends in Community Banking

May 18, 2004

Print Version - PDF 85k (PDF Help)
Request Hard Copy

Overview

Note: These papers are the second installment of a series of papers comprising the FDIC's Future of Banking Study.

This issue of *FYI* summarizes three reports released today under the FDIC's Future of Banking Study. While the reports were written by different authors who draw their own conclusions, the FDIC has released them as a group because they are all focused on aspects of community banking in the United States. The full reports can be found at http://www.fdic.gov/bank/analytical/future/index.html.

The first report addresses the broad trends leading to the significant decline in the number of bank and thrift organizations in the U.S.—almost 50 percent in the past 15 years—and presents some evidence suggesting an eventual balance developing between the number of new bank start-ups and charter losses that may result in a stabilization of the number of banking organizations nationwide. The second report notes that while community bank charters have been halved in the consolidation wave, they still comprise the vast majority of banks in the United States and provide vital services to the small business and agricultural sectors. The final paper discusses a specific segment of community banks, namely the over 1,400 rural banks located in depopulating counties, and the reasons behind these demographic trends. This paper concludes that depopulation will likely continue in certain areas of the country and outlines strategies that some community banks have used to help them rise above the realities of their marketplace.[1]

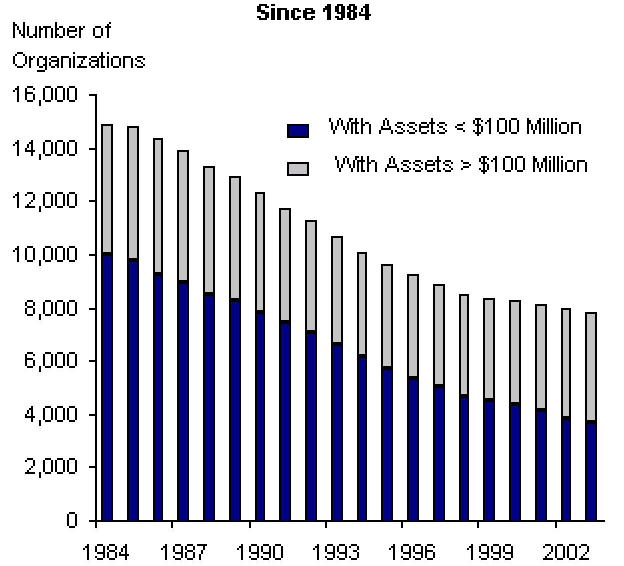
The Declining Number of U.S. Banking Organizations: Will the Trend Continue?

Over the last quarter of a century, the structure of the U.S. banking industry has undergone an almost unprecedented transformation—one marked by a substantial decline in the number of commercial banks and savings institutions and a growing concentration of industry assets among a much smaller number of extremely large financial institutions.

After remaining fairly stable since the 1930s, the number of federally-insured banks and savings institutions began to decline rapidly in the mid-1980s. At the beginning of 1984, there were 15,101 banking and thrift organizations (defined as commercial banks, thrifts, and bank and thrift holding companies). By year-end 2003, that number had fallen to 7,842—a decline of almost 50 percent (Chart 1). Distributed by size, nearly all the decline occurred in the community-bank sector (organizations with less than $1 billion in assets), and especially among the smallest size group (less than $100 million in assets).

Chart 1

Number of Commercial Bank and Thrift Organizations Has Declined by Almost Fifty Percent Since 1984



Source: Call and Thrift Financial Reports

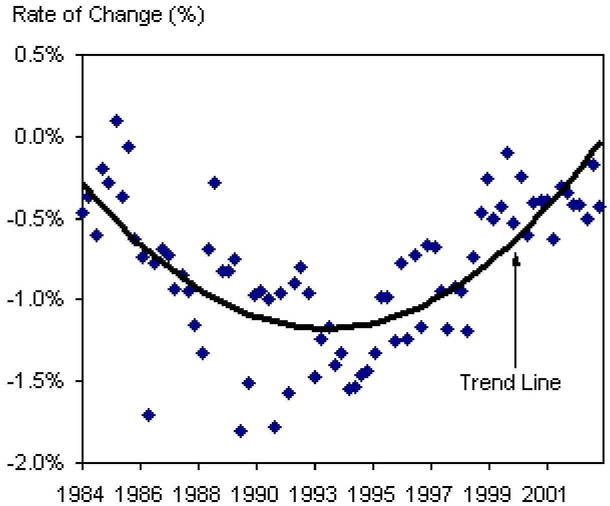
The bulk of the decline in the number of organizations from 1984 through 2003 was due to unassisted mergers and acquisitions. During that period, 8,122 individual bank and thrift organizations disappeared through unassisted mergers and acquisitions and 2,262 were eliminated through failure. About 75 percent of the failures occurred in the five year period between 1987 and 1991, when failures averaged 388 per year. In contrast, from 1994 to 2003 only 66 institutions failed (fewer than 7 per year), which reflected the greatly improved condition of the banking industry in a generally favorable economic climate.

Amid the two-decade wave of consolidation, significant entry into banking was also taking place. Some 3,097 new banking organizations entered the industry from 1984 to 2003—an average of 163 per year. The presence of significant entry into banking during an era of large-scale consolidation suggests a somewhat more complex picture of structural change than the overall figures would suggest.

Moreover, the evolution of industry structure has not been uniform over time. The rate of decline in the number of banking institutions reveals a very strong cyclical pattern, occurring at an increasing rate in the 1980s only to slow in the 1990s (Chart 2). Since 1992, the rate of decline in the number of banking organizations has trended consistently lower than the rate during the previous eight-year period. The slowing rate of decline in the number of banking organizations since the early 1990s suggests the influence of economic, regulatory, and technological changes that have taken place since then. In particular, the turning point roughly coincides with both the end of the 1990-1991 recession and a sharp decline in the number of bank and thrift failures.

Chart 2

Rate of Change in the Number of Banking Organizations Has Been Slowing



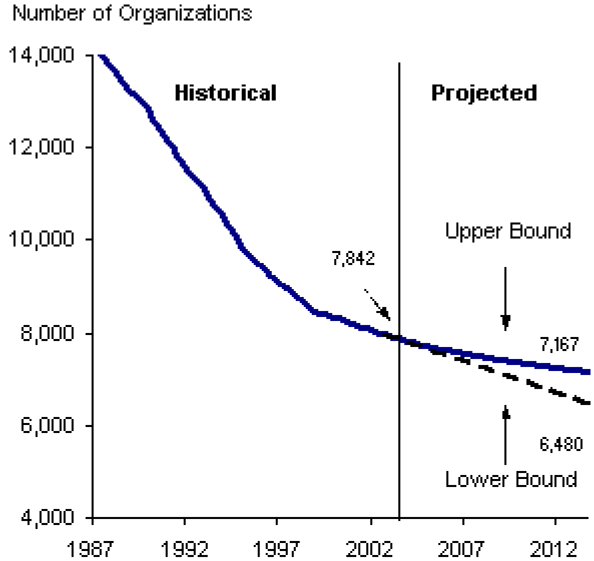
Source: FDIC

This report constructs scenarios for the future population of U.S. banking organizations based on analysis of the historical data. As a starting point, a simple linear method is used to project the number of banking organizations in each of five size classes through the year 2013. These projections, which are based on the average quarterly net change over the five-year period 1999-2003, suggest a continuing decline of 136 organizations per year. This pattern would reduce the total number of bank and thrift organizations from 7,842 at year-end 2003 to 7,161 at year-end 2008 and 6,480 at the end of 2013—declines of 8.7 percent and 17.4 percent, respectively, over those intervals.

However, due to the presence of a nonlinear trend in the data pointing to a slowing of the rate of decline, it would appear that the linear projections represent a lower-bound estimate of the future population of banking organizations. Projections based on the rate of change indicate that the number of organizations comprising the banking industry is likely to decline more slowly over the next five to ten years. Under this nonlinear projection (shown as the upper bound in Chart 3), the number of banking organizations will decline from 7,842 at the end of 2003 to 7,435 by 2008. From there, the pace slows further, resulting in 7,167 organizations by 2013. However, because this result is somewhat sensitive to the selection of the base period used to form the projection, it should be viewed as an upper-bound estimate of the future population of the banking industry.

Chart 3

Projected Number of Banking Organizations Indicates a Slower Rate of Decline Through 2013



Source: FDIC

Regardless of the exact numbers of institutions going forward, these projections indicate that in the absence of a new shock to the industry, the U.S. is likely to retain a structure characterized by several thousand very small- to medium-sized community bank organizations, a less-numerous group of midsized regional organizations, and a handful of extremely large multinational banking organizations. It does not appear that the future U.S. banking industry structure will resemble the banking structures seen in some countries (Germany, for example), where only a handful of universal banks are present. Instead, this report envisions an eventual balance developing between the number of new bank start-ups and charter losses due to mergers and acquisitions—with little net change in the number of banking organizations nationwide.

Community Banks: Their Recent Past, Current Performance, and Future Prospects

Although the number of community banks (community banks are defined as independent banks and savings institutions and bank and savings institution holding companies with aggregate assets less than $1 billion) has declined significantly, they still comprise 94 percent of the banking industry, a figure essentially unchanged from 1985. [2]

Moreover, detailed analysis of the changes in the number of community banks revealed that community banks in 2003 had maintained a proportionally similar presence in all types of markets—urban, suburban and rural—and this remained true for markets that experienced both population growth and decline; in addition, there was only a slightly greater decline in community banks in formerly unit-bank states in comparison to non-unit-bank states.[3]

Community banks' deposit share declined significantly since 1985, during a time when large banks greatly extended their reach throughout the country (See Table 1). Community banks' ability to provide personal service to depositors continues to be one of their strengths, allowing them to continue to play an important role in local deposit markets, albeit a smaller one than before.

Table 1

Community Banks' Share of Local Banking Markets Has Declined as Large Banks Have Expanded Their Geographic Reach				
	Rural Areas	**Small Metro**	**Large Metro Suburban Areas**	**Urban Areas**
Community Banks				
Share of deposits				
1985 deposit share	72.1	48.4	38.1	19.2
2003 deposit share	53.0	27.8	21.9	9.0
Number of markets with offices				
Operated offices in 1985	2,207	215	77	104
Operated offices in 2003	2,149	215	78	104
Total number of market segments	2,253	215	78	104
Midsize/Regional				
Share of deposits				
1985 deposit share	24.0	41.3	53.3	54.5
2003 deposit share	28.5	38.8	37.2	29.4
Number of markets with offices				
Operated offices in 1985	1,210	207	75	104
Operated offices in 2003	1,413	214	78	104
Total number of market segments	2,253	215	78	104
Top 25 Banks				
Share of deposits				
1985 deposit share	3.9	10.3	8.6	26.3
2003 deposit share	18.5	33.4	40.9	61.6
Number of markets with offices				
Operated offices in 1985	249	86	30	58
Operated offices in 2003	1,033	211	75	103
Total number of market segments	2,253	215	78	104

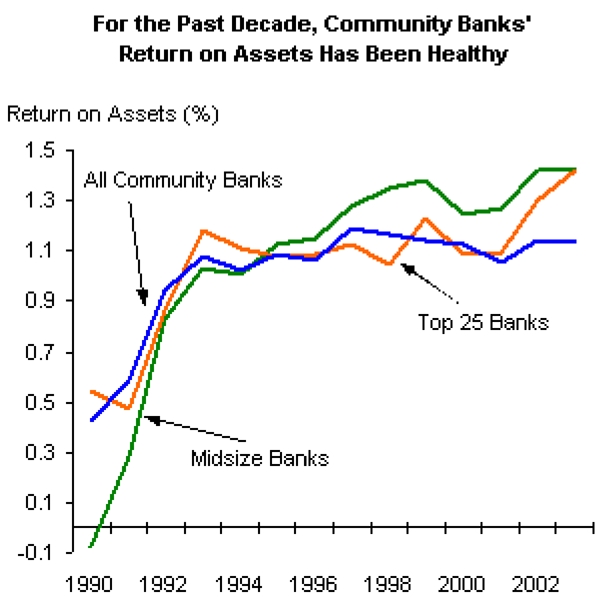
Notes: Deposit market shares are measured as the share of all deposits reported by FDIC-insured institutions in a given market segment that are held by each size class of banking organizations. Large MSAs are those with populations over 500,000. In large MSAs where the population density was less than 1,000 per square mile, any county that exceeded the median population density of that MSA's central counties (as defined by the U.S. Census Bureau) was classified as urban; those below the median were classified as a suburban county.

Source: FDIC

Although the asset share of community banks also dropped, an examination of community bank lending demonstrates that they continue to have a stable share of real estate lending to businesses, and continue to provide a disproportionate amount of credit to the small business and agricultural sectors. Success in these sectors is due to the ability and willingness of community banks to assess the creditworthiness of borrowers who may have been traditionally ignored by larger banks or who have been dissatisfied with the services provided by larger banks. Typically, these borrowers do not have the types of credit histories or financial reporting mechanisms that fit the model-based lending approaches used by many larger banks. As such, they react positively to the relationship-based lending practiced by community banks.

The earnings performance of community banks since 1985 has until very recently been comparable to that of the very largest banks. Over the past decade, it has been stable, with a return on assets of at least one percent, a level that many industry observers would term "satisfactory" (See Chart 4). Moreover, this is true even in areas that have experienced population declines. Additionally, the market has provided an impressive case for the continued presence of the community bank in today's banking landscape: more than 1,200 new community banks have been established since 1992. New bank owners have therefore been willing to risk their capital in these ventures, and often have done this in areas where existing community banks have been acquired by large and distant banks to take advantage of customers who may find the business practices of large, non-local banks to be unsatisfactory.

Chart 4



Source: FDIC

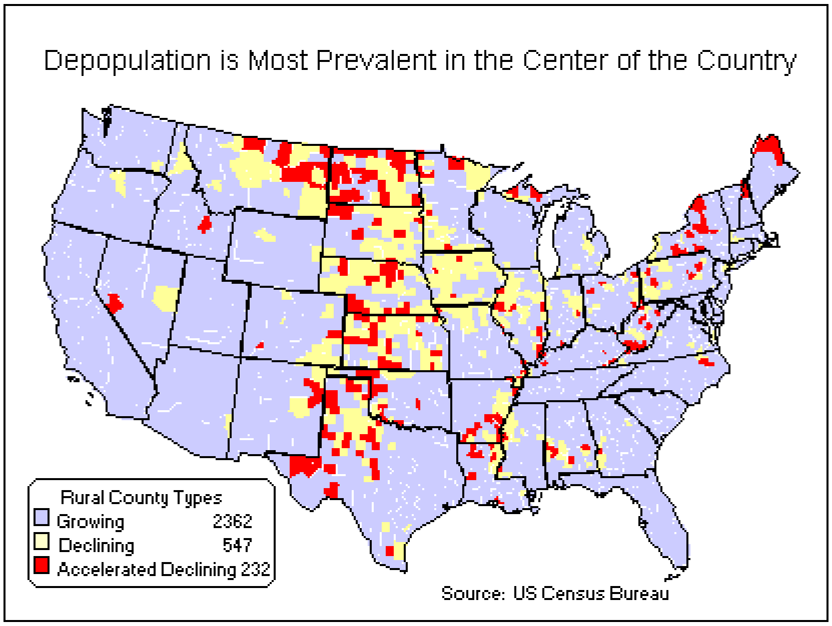
Community banks do face challenges. Many community bankers state that it is difficult to both find and retain qualified employees. Competition with large banks and nonbank competitors, including credit unions, will continue. The fixed costs of regulatory requirements fall more heavily on community banks than on larger ones. Regulatory burdens could, therefore, have a significant negative effect on community banks' future prospects. Nevertheless, the evidence from the recent past about community banks' market presence, industry share, and earnings performance, coupled with the continued creation of new community banks, points strongly to community banks being a viable business model in the future.

Rural Depopulation: What Does it Mean for the Future Economic Health of Rural Areas and the Community Banks that Support Them?

The United States is currently in the midst of a major demographic event: the depopulation of a significant portion of its rural counties. While the U.S. population continues to increase overall, many rural areas are experiencing population outflows. In fact, 662 of the nation's 2,052 rural counties lost population between 1970 and 2000. This issue has significant ramifications for the banking industry and its regulators, as 1,451 banks and thrifts with total assets of $132 billion were headquartered in rural counties with declining populations at year-end 2003.

Rural depopulation is occurring in several areas of the country, as seen in Map 1, which illustrates population trends by county. Blue counties gained populations between 1970 and 2000; yellow counties lost population but at a relatively stable rate; and red counties not only lost population over the three decades, but saw population outflows increase in the 1990s.

Map 1



There are four major areas of the nation that are experiencing rural depopulation – the Great Plains, the Corn Belt, the Delta-South, and Appalachia-East. The first three areas are heavily dependent on agriculture. This dependency has led to population outflows because technological advances throughout the twentieth century made it possible to farm large areas with fewer people. The population decline in the Appalachia-East region is also related to technological advances, but in the coal mining industry.

The report focuses on the Great Plains because it by far has the most advanced population problems of the four regions showing significant rural depopulation trends. The Great Plains region is marked by very low population densities (measured by persons per square mile), widely spaced towns, and sparsely populated counties compared to the other regions. Many rural counties in the Great Plains have lost so many people that they may lack the tax bases to reasonably maintain necessities such as government offices, school and health care systems, and infrastructure.

In the Great Plains, there are over 500 banks and thrifts headquartered in rural counties with declining populations. However, despite the population declines, in aggregate, Great Plains community banks' earnings, net interest margins, asset quality measures, and equity capital levels are all in line with community banks in more vibrant economic environments (See Table 2).[4] Additionally, consolidation trends are consistent with nationwide statistics.

There are several possible reasons for the parity in performance metrics: 1) depopulation is occurring slowly, even though in some areas it is now accelerating; 2) depopulation has been ongoing in many areas for over a century, so bankers have had time to develop and adopt strategies to cope with the challenges that population outflows create; and 3) over the past decade farmers in the Great Plains have received substantial federal farm assistance, enabling them to maintain stable, profitable banking relationships.

Table 2

Great Plains Rural Banks Continue to Perform Similarly to Rural Banks in the Rest of the Nation					
	2003	**2002**	**2001**	**2000**	**1999**
GP - Pretax ROA	1.44	1.49	1.42	1.59	1.55
Nation - Pretax ROA	1.44	1.51	1.39	1.50	1.54
GP - Net Interest Margin	4.12	4.25	4.17	4.34	4.24
Nation - Net Interest Margin	4.05	4.24	4.08	4.24	4.23
GP - Loans-to-Assets Ratio	58.51	59.59	58.92	59.25	57.45
Nation - Loans-to-Assets Ratio	61.94	62.39	63.02	64.52	63.04
GP - Total PD Loan Ratio	2.59	2.89	2.86	2.53	2.50
Nation - Total PD Loan Ratio	2.59	2.82	2.92	2.62	2.29
GP - Net Charged-off Loans	0.31	0.34	0.46	0.30	0.30
Nation - Net Charged-off Loans	0.30	0.33	0.31	0.23	0.22
GP - Equity Capital	10.97	11.19	10.95	10.81	10.16
Nation - Equity Capital	10.52	10.59	10.25	10.34	10.05
GP - Ag Loans/Total Loans	40.33	40.68	40.84	40.35	40.81
Nation - Ag Loans/Total Loans	13.76	13.68	13.27	13.22	13.42
GP - Ag Inst./Total Inst.	79.97	80.08	80.44	81.22	82.21
Nation - Ag Inst./Total Inst.	28.46	28.55	28.07	28.62	29.03

Notes: "GP" refers to banks and thrifts with less than $250 million in assets in rural counties in the Great Plains. "Nation" refers to banks and thrifts with less than $250 million in assets in rural counties in the Nation, excluding the Great Plains.

Source: Bank and Thrift Call Reports

Although overall performance is similar, banks located in Great Plains depopulating counties have relatively low growth rates due to dwindling borrower and depositor bases. For example, in the 10 years between 1994 and 2003, assets and deposits grew 81 percent and 83 percent less, respectively, in rural Great Plains banks versus institutions located in metropolitan areas in the Great Plains.

While many counties in the Great Plains face similar economic issues, individual community banks have responded differently and reported disparate operating results. This report analyzes two community bank metrics – profitability and growth – to determine whether some community banks have identified successful techniques to help overcome their challenging economic environments. The analysis shows that for banks that have reported high profitability and high growth, prudent branching and lending expansion has been the key to their success. For other banks, controlling costs has allowed them to achieve relatively high profitability even without commensurate asset growth.

Unfortunately, the factors behind the demographic trends are not receding, and depopulation is very likely to continue into the future. On the positive side, technology, such as the Internet and the continued spread of broadband access into rural areas, potentially holds some promise for depopulating counties.

Rural businesses, including community banks, hope that such technology will allow them to market their goods and services to customers well beyond their county lines. However, technology can be a double edged sword as urban businesses, including large banks, will have the means to reach into isolated rural communities, providing another source of competition.

Aside from technology improvements, the strategic options available to community banks in depopulating counties are limited. In the short-term, community bank success in rural areas could depend on the willingness and ability of management to take well-conceived risks, such as branching into more economically vibrant areas. Another viable strategy may be to streamline their institutions, cutting costs wherever possible, to remain profitable despite the absence of local growth opportunities.

However, over the very long term, perhaps the next 10 to 20 years, two factors could dramatically alter the rural banking landscape, perhaps leading to fewer rural banks. First, the large pocket of very elderly in rural depopulating counties threatens to significantly weaken community bank funding bases. Also, the lack of succession plans due to the absence of younger, capable bank managers in some areas could leave many retiring bank owners and operators with no option but to sell their institutions.

[1] The FDIC staff wish to thank the many bankers, trade-group representatives, researchers, industry analysts and others who shared their views with us regarding the future of banking. Their insights and perspective were invaluable in developing these papers and the other papers in this series. While their important contributions are acknowledged and much appreciated, these individuals bear no responsibility for the views as expressed in this series of papers which, as noted below, are those of the authors.

[2] Bank size was adjusted for inflation over time for analysis in this paper; a bank with $100 million in assets today is comparable to one with about $66 million in assets in 1985.

[3] Unit bank states were defined in the report as states that had previously prohibited branching for the most part.

[4] For the purpose of this report only, the FDIC uses a $250 million asset cutoff for community banks for two reasons (1) the vast majority of banks in the Great Plains - 89 percent - have less than $250 million in assets; and (2) our analysis shows that for institutions this size, most of the banking activity, in terms of location of banking offices, occur in the same county as the headquarters location.

Comments and Inquiries

Comments or questions on these reports can be directed to:

The Declining Number of U.S. Banking Organizations: Will the Trend Continue?
Kenneth Jones kenjones@fdic.gov

Community Banks: Their Recent Past, Current Performance, and Future Prospects
Lee Davison ldavison@fdic.gov

Rural Depopulation: What Does it Mean for the Future Economic Health of Rural Areas and the Community Banks That Support Them?
John Anderlik Janderlik@fdic.gov

Send feedback and technical questions about the *FYI* series to:
FYI@fdic.gov

All media inquiries should be addressed to: David Barr, FDIC Office of Public Affairs, dbarr@fdic.gov

About *FYI*

FYI is an electronic bulletin summarizing current information about the trends that are driving change in the banking industry, plus links to the wide array of other FDIC publications and data tools.

Disclaimer