FYI: An Update on Emerging Issues in Banking

Bank Branching Trends and Prospects of Key Banking Sectors

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Overview

This issue of FYI summarizes three reports released today that represent the fourth installment of the FDIC's Future of Banking Study. The first report discusses the decade-long trend of bank branch growth, the reasons behind the trend, and the branching outlook going forward. The other two reports are focused on various segments of the banking industry in the United States.

Bank Branch Growth Has Been Steady – Will It Continue?

The number of institution charters has been declining since 1984, and in the decade between 1994 and 2003, dropped almost 29 percent.[1] At the same time, however, the number of physical bank *offices* has been steadily increasing, driven by an increase in branches (see Chart). In the decade between 1994 and 2003, the number of bank branches increased 15 percent.[2]

Chart 1

Over the Long Term, the Number of Banks Has Declined and the Number of Branches Has Increased

Year	Institutions	Branches	Offices
1934	14,146	0	14,146
1935	14,125	3,112	17,237
1936	13,973	3,261	17,234
1937	13,797	3,381	17,178
1938	13,661	3,412	17,073
1939	13,538	3,456	16,994
1940	13,442	3,489	16,931
1941	13,430	3,517	16,947
1942	13,347	3,555	16,902
1943	13,274	3,744	17,018
1944	13,268	3,875	17,143
1945	13,302	3,896	17,198
1946	13,359	3,928	17,287
1947	13,403	4,096	17,499
1948	13,419	4,283	17,702
1949	13,436	4,530	17,966
1950	13,446	4,832	18,278
1951	13,455	5,157	18,612
1952	13,439	5,486	18,925
1953	13,432	5,855	19,287
1954	13,323	6,346	19,669

1955	13,237	6,965	20,202
1956	13,218	7,639	20,857
1957	13,165	8,267	21,432
1958	13,124	8,955	22,079
1959	13,114	9,732	22,846
1960	13,126	10,556	23,682
1961	13,115	11,436	24,551
1962	13,124	12,421	25,545
1963	13,291	13,581	26,872
1964	13,493	14,699	28,192
1965	13,544	15,872	29,416
1966	13,538	17,029	30,567
1967	13,514	18,079	31,593
1968	13,487	19,183	32,670
1969	13,473	20,379	33,852
1970	13,511	21,839	35,350
1971	13,612	23,336	36,948
1972	13,733	24,829	38,562
1973	13,976	26,673	40,649
1974	14,230	28,651	42,881
1975	14,384	30,205	44,589
1976	14,410	31,344	45,754
1977	14,411	33,108	47,519
1978	14,391	34,791	49,182
1979	14,364	36,791	51,155
1980	14,434	38,738	53,172
1981	14,414	40,786	55,200
1982	14,451	39,783	54,234
1983	14,469	40,853	55,322
1984	14,496	41,799	56,295
1985	14,417	43,293	57,710
1986	14,210	44,392	58,602
1987	13,723	45,357	59,080
1988	13,137	46,381	59,518
1989	12,715	48,005	60,720
1990	12,347	50,406	62,753
1991	11,927	51,969	63,896
1992	11,466	51,935	63,401
1993	10,960	52,868	63,828
1994	10,452	55,145	65,597
1995	9,942	56,512	66,454

1996	9,530	57,789	67,319
1997	9,143	60,325	69,468
1998	8,774	61,957	70,731
1999	8,581	63,684	72,265
2000	8,315	64,079	72,394
2001	8,080	65,564	73,644
2002	7,887	66,185	74,072
2003	7,769	66,775	74,544
Source: FDIC Office Structure Information			

The growth in physical branches is all the more striking in that it occurred during a period of rapid technological advances that would appear to have diminished the need to use branches. These advances include a proliferation of automated teller machines, and the rise of the Internet and increasing broadband capacity, which have enabled customers to bank on line. Moreover, legal changes and financial innovations have intensified the competitive landscape by removing many of the traditional barriers between banks and other financial service companies, allowing these companies to offer products and services typically provided through bank offices, again seemingly reducing the need for physical bank branches. However, over time, bank branches have proven to be a highly effective and profitable distribution channel.

The steady increase in branching is due primarily to the following three factors:

Changes in bank branching laws led to structural shifts in branching. – Historically, a number of states had significant restrictions on branching. Gradual easing of these laws occurred on a state-by-state basis from the early 1980's until the 1994 passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal). Riegle-Neal removed many remaining individual state law restrictions on interstate branch banking. As a result, interstate branching increased rapidly as banks sought to simplify their structure by consolidating multi-state and multi-bank operations into branches and then began to expand their branch networks under the new, relaxed rules.

Branching, when well executed, appears to improve performance. - Bank branches are costly, so noninterest costs are higher for banking organizations operating multiple branches versus companies with a single office. However, banking organizations with larger branch networks generally have much higher non-interest revenue, and as a result, have better efficiency ratios. Improved efficiencies are reflected in higher overall profitability for multi-branch banking organizations.

Favorable economic and demographic trends encourage branching in certain markets. – The increase in physical branches during the past decade was not uniform across the country. Not surprisingly, states with the largest branch growth rates are those where relaxation of branching laws occurred later. However, economic vibrancy of a community and demographic patterns also appear to be important drivers of branch formation. In particular, population growth and employment growth are the most highly correlated economic drivers.

To a large extent, the increase in branches has also been driven by demand, as

consumers seem to like the convenience of bank branches. Indeed, surveys conducted by the Federal Reserve Board indicate that the single most important factor influencing a customer's choice of banks is the location of the institution's branches.[3] It would be difficult to predict what consumer preferences for physical branches will be going forward. However, the general trends suggest that branching will continue, at least in some markets, particularly those with strong population and employment growth. Additionally, other trends in the retail banking business will have implications for the future pace of branching, such as deposit growth and the overall attractiveness of the consumer sector.

Prospects for Key Banking Sectors

These remaining papers address two segments of the banking industry: (1) regional and other mid-size banks and (2) limited-purpose banks, which specialize in relatively narrow lines of business. Together with previously-issued papers on community banks, these reports supplement the discussion in the Future of Banking Study of prospects for specific sectors of the industry. Although these groups of banks differ greatly in size and other characteristics, they also face similar challenges—intense competition within and from outside banking, the trend toward fewer charters, and the need for sophisticated risk-management techniques. How they have responded to these challenges provides a basis for assessing their future prospects.

Regional and Other Midsize Banks: Recent Trends and Short-Term Prospects - For purposes of this paper, regional and other midsize banks are defined as banking organizations with aggregate assets of more than $1 billion, excluding the 25 largest banking organizations.[4] The midsize group is very diverse, with some banks operating as regional banking organizations across state lines and in more than one market. Others are concentrated in only one state or market and are closer to large community banks.

During the last seven years, regional and other midsize banks have consistently outperformed community banks in terms of earnings and have often outperformed the top 25 banks. Over the same period, the number of regional and other midsize banks increased by 13 percent as a result of mergers and growth of community banks. However, in terms of market share of assets, this sector lost market share between 1996 and 2003, largely because of the top 25 banks' dramatic growth through mergers and acquisitions. This paper finds that merger activity in this sector will continue, but that there is an abundant supply of community banks that will enter the midsize bank sector via internal growth, mergers, and acquisitions. Therefore, it is likely that in the near future the number of midsize banks, although relatively small, will remain generally stable or grow slightly.

Limited Purpose Banks: Their Specialties, Performance, and Prospects – For the purposes of this paper, limited purpose banks are institutions that specialize in relatively narrow business lines. In particular, credit card banks, sub-prime lenders, and internet primary banks are examined. In number, these institutions make up a small share of the banking industry. Yet, their unique and concentrated functions and product mixes have attracted considerable attention.

As of December 2003, the average ROA for the credit card banks was more than four times the banking industry average. Over time, credit card banks have managed to offset the effects of higher credit risk with higher yields than traditional lenders, by successful utilization of technology, and with the benefits of scale economies. For these reasons, this paper concludes that credit card banks have likely found a permanent place in the banking sector.

In this study, sub-prime lenders refer to insured institutions that extend credit to borrowers who may have had more limited borrowing opportunities due to their poor or weakened credit histories. Although sub-prime lenders earn interest income higher than the industry average, higher non-interest expense and credit losses offset a portion of income. Moreover, increased scrutiny from regulators on issues such as capital adequacy and consumer issues may have effectively eliminated the advantage insured institutions once enjoyed relative to other financial firms operating in the field. In response, sub-prime lending at banks has trailed off recently and some participants have withdrawn from the market. As such, this paper indicates that it is likely that bank participation in sub-prime lending has stabilized and may even decline.

Internet primary banks are institutions that deliver banking services mainly online. By eliminating physical branches and employing fewer employees, they can potentially provide banking services at lower cost. In reality, however, internet banks under-perform “brick-and-mortar” banks. This may reflect limited consumer demand for internet banking services and the lack of barriers of entry for other banks to offer internet banking. They are also at a competitive disadvantage relative to “brick-and-mortar” banks in lending to small businesses because they lack the means of building long-term relationships with borrowers. This paper concludes that, over time, these disadvantages could damage the internet primary business model.

[1] For a more complete discussion of the reasons for charter declines, refer to two papers issued under the FDIC’s Future of Banking series: “The Declining Number of U.S. Banking Organizations: Will the Trend Continue?” and “Community Banks: Their Recent Past, Current Performance, and Future Prospects.”

[2] The net increase in offices (decrease in main offices plus increase in branch offices) was 8 percent over the decade of June 1994 to June 2003.

[3] Olsen, Governor Mark W., “Remarks at the Fortieth Annual Conference on Bank Structure and Competition, Sponsored by the Federal Reserve Bank of Chicago, Chicago, Illinois.” May 6, 2004.

[4] According to this definition, assets of regional and other midsize banks at the end of 2003 ranged from $1 billion, the top of the community bank size group, to $42 billion, the asset size of the smallest of the top 25 banks.

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.

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