Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1998

FDIC
MEMPHIS
REGION

DIVISION OF
INSURANCE

GARY L. BEASLEY,
REGIONAL MANAGER

DAVID T. GRIFFITHS,
REGIONAL ECONOMIST

ROBERT L. BURNS,
FINANCIAL ANALYST

F. MIGUEL HASTY,
FINANCIAL ANALYST

In Focus This Quarter

◆ ***Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale***—**The size and value of recent mergers and acquisitions (M&A) in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers. For banks, deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among important drivers of the trend. By identifying the rationale and incentives for bank M&A activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.** ***See page 5.***

By Steven E. Cunningham, John F. Sherman

◆ ***Risks and Challenges for Consolidating Institutions***—**M&A activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies. As premiums paid in bank M&A deals have escalated, some industry observers have questioned whether the promised benefits of the transactions can be realized. Institutions in the process of integrating an acquired entity may be especially vulnerable to a downturn in the economy.** ***See page 11.***

By John F. Sherman

◆ ***Industry Consolidation Presents Unique Risks and Challenges for Community Banks***—**Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope. Aside from merging with or selling to competitors, some small banks are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets. While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate these institutions' operations and risk profiles.** ***See page 14.***

By Steven E. Cunningham

Regional Perspectives

◆ ***Region's Economic and Banking Conditions***—**The Region's economy continued to expand at a moderate pace in the second quarter. Although international concerns have lead to declines in important commodity prices, the Region appears to be less vulnerable than the nation to weakening global trade. Banks and thrifts reported solid results for the first half of 1998, but average net interest margins remained below 1997 levels.** ***See page 19.***

◆ ***Bank Merger Trends***—**The pace of merger activity in the Region is following national trends and is concentrated in areas that have experienced faster economic growth in the current expansion. Potential economies of scale also appear to be influencing merger activity in the Region.** ***See page 20.***

◆ ***Effects of Mergers on Community Banks***—**Banks and thrifts operating in markets where mergers occur are affected by the change in their competitive environment. These effects can include changes in market share, earnings performance, and loan underwriting standards.** ***See page 23.***

By Robert L. Burns, David T. Griffiths

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, FJ, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov/publish/regout. For more information or to provide comments or suggestions about the Memphis Region's ***Regional Outlook,*** please call Gary Beasley at (901) 821-5234 or send an e-mail to *gbeasley@fdic.gov.*

To the Reader:

The *Regional Outlook* is intended to enhance readers' understanding of risks and trends affecting FDIC-insured institutions. The editorial staff welcomes the comments of any reader who is willing to take a few minutes to complete the attached survey. Return the survey in the enclosed envelope or fax to (202) 898-8636.

You may also access the survey through the FDIC Internet site at *www.fdic.gov*. FDIC employees may take the survey via the DOI homepage on the FDICnet.

All feedback is confidential. Thank you for your time and thought.

Sincerely,

George French
Executive Editor

The *Regional Outlook* has three *In Focus* articles that address national issues and a *Regional Perspectives* article that analyzes the economic and banking conditions in each of the eight FDIC supervisory regions.

	0 No Opinion	**1 Strongly Disagree**	**2 Disagree**	**3 Agree**	**4 Strongly Agree**
1 The *In Focus* articles **improve my understanding** of risks affecting the financial institutions of interest to me.					
2 The *Regional Perspectives* article **improves my understanding** of risks affecting the financial institutions of interest to me.					
3 The *Regional Perspectives* article is **relevant** to my geographic area of interest.					

4 How would you prefer the **geographic boundaries** be delineated?
- ☐ by the FDIC's eight supervisory regions—Atlanta, Boston, Chicago, Dallas, Kansas City, Memphis, New York, and San Francisco (current format)
- ☐ by a smaller geographic location, such as ____________________
- ☐ by a larger geographic boundary, such as ____________________

5 The **length** of the *In Focus* section is
☐ just right ☐ too long ☐ too short

6 The **length** of the *Regional Perspectives* article is
☐ just right ☐ too long ☐ too short

7 What **other topics** would you like to see in future editions?

8 Additional **comments and suggestions**

9 I am **affiliated** with:
- ☐ FDIC
- ☐ Federal regulatory agency (non-FDIC)
- ☐ Other ____________________
- ☐ Financial institution
- ☐ State banking department

Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale

- **The size and value of recent mergers and acquisitions in the banking industry have received much attention, yet the activity is a continuation of a longer-term trend and is one aspect of a broader national and global wave of business mergers.**

- **Deregulation, competitive pressures, market valuations, synergistic opportunities, technology, globalization, and managerial incentives are among the important drivers of bank merger and acquisition activity.**

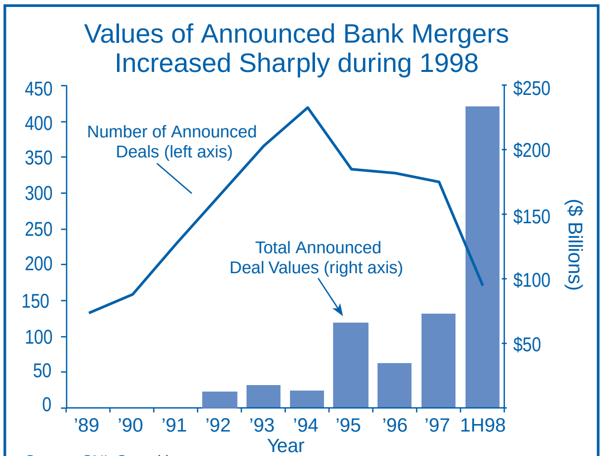
- **By identifying the rationale and incentives for bank merger and acquisition activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.**

Merger and acquisition (M&A) activity among banking companies is changing the industry's structure. The number of insured commercial banks in the United States, which held relatively steady during the FDIC's first 51 years of existence, has declined by one-third since year-end 1984, resulting in just under 9,000 commercial banks at the end of the second quarter of 1998. The number of banking organizations (bank holding companies, independent banks, and thrifts) also has declined precipitously since the mid-1980s.

The recent flurry in M&A activity by banking companies has attracted significant attention as the magnitude of transactions has escalated. As shown in Chart 1, the announced values of bank mergers have increased sharply in recent years. However, increased consolidation activity is not unique to the banking industry: The United States is now experiencing the fifth major wave of business M&A in this century, which is in turn part of an unprecedented level of worldwide M&A activity. According to data from ***Mergerstat***, the value of M&A deals announced for all U.S. industries during the first half of 1998, measured both absolutely and as a percentage of nominal gross domestic product, exceeded the value of announced transactions for any full calendar year on record.

The factors that have contributed to this activity, including the availability of capital, technological change, and

CHART 1



Source: SNL Securities

globalization, are particularly important to the banking industry. Indeed, according to data from ***SNL Securities***, the announced values of banking M&A have accounted for roughly one-third of all U.S. merger activity for the first half of 1998, exceeding any full calendar year percentage since the data have been collected (1989). This article will briefly describe the factors that are driving M&A activity in banking.

Why Are Banks Merging?

Deregulation

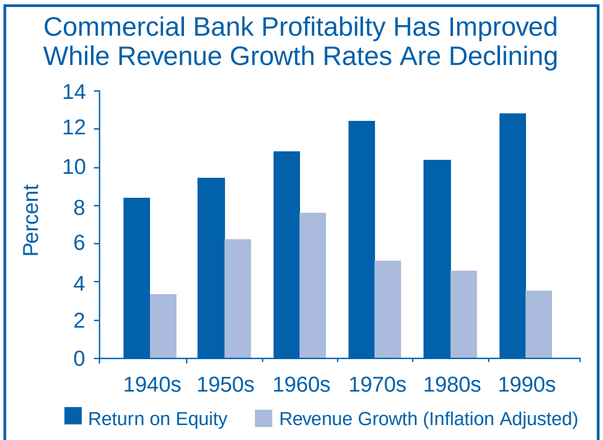
Historically, state regulations and boundaries dictated the structure of commercial banking in the United States. Not until the 1980s did most states remove or substantially relax intrastate branching restrictions. Subsequently, the Riegle-Neal Interstate Banking and Branching Act removed most remaining restrictions to interstate expansion—restrictions that had been significantly liberalized by a 1985 U.S. Supreme Court decision (*Northeast Bancorp* v. *The Board of Governors of the Federal Reserve System*) that upheld the ability of states to reduce restrictions on entry by out-of-state holding companies.[1] As recently as January 1994 only 10 commercial banks owning 30 branches operated across state lines. By early 1998, 165 institutions owned 12,694 interstate branches.[2]

[1] "Interstate Banking—The Past, Present and Future," *FDIC Banking Review,* Fall 1996.

[2] Figures provided by the FDIC's Division of Research and Statistics.

There is some evidence that the recent increase in expansion and branching opportunities arising from deregulation has led to improved efficiencies and profitability, both from M&A activity and from intra-company consolidation of bank subsidiaries by multibank holding companies. In addition, the recent easing of Federal Reserve Board restrictions governing Section 20 securities underwriting subsidiaries of bank holding companies and favorable bank operating subsidiary rule interpretations by the Office of the Comptroller of the Currency have made expansions into new lines of business and mergers across financial sectors more feasible. For example, according to data provided by ***SNL Securities***, since the beginning of 1997, 47 banking companies have purchased investment banking units, investment advisors, or broker-dealers.

CHART 2



Source: FDIC Historical Statistics on Banking

Increasing Competition

Significant changes in the competitive environment also have contributed to the trend in bank M&A activity. One way to consider competition in an industry is through the "industry life cycle" framework. In this framework, an industry is generally categorized into one of four stages—start-up, rapid growth, mature, or decline. In each stage, firms are likely to take certain actions in response to the competitive environment. As discussed below, banking best fits the criteria for an industry in the mature stage. These criteria include declining revenue growth, improving profitability, increasing competition, and a shortage of investment opportunities relative to the amount of capital being generated.

As shown in Chart 2, over the long term, commercial banks have experienced the declining trend in revenue growth and the improving trend in profitability that characterize a mature industry. The average annual revenue growth rate by decade, adjusted for inflation, has declined since the 1960s. Profitability, as measured by the average annual return on equity by decade, has steadily improved since the 1940s, with the exception of the crisis period of the 1980s.

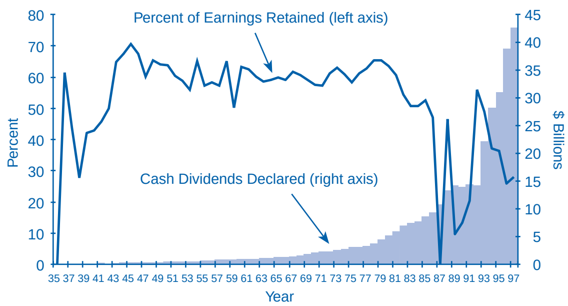
Competition in a mature industry often intensifies as competitors focus on sustaining market share as revenue growth rates slow. In banking, recent changes in the operating environment have stimulated a dramatic increase in competition. Specifically, barriers to entry into the industry have fallen: Capital is plentiful, experienced managerial talent is available (as a result of the many mergers), and regulatory restrictions have been relaxed. Technological and financial innovations also are influencing how banks compete by enabling them to manage disparate operations with broader product arrays more efficiently. Moreover, as a result of intensifying nonbank competition and continuing evolution in distribution systems, some banking services have come to resemble commodities. Consequently, brand loyalty appears to be declining and banks are experiencing reduced influence over pricing.

The final criterion for a mature industry, a shortage of investment opportunities relative to the level of capital being generated ("excess capital"), as discussed below, has become an obstacle for banks. Although generating and retaining capital increase the level of protection from insolvency risk for depositors and the FDIC, rising capital levels without a corresponding increase in profitability reduce returns on equity and, thus, returns to shareholders. Attempts to increase assets relative to equity capital in an industry with excess capital also can be undesirable because competition drives the yield on available investments to levels that either dilute current earnings or fail to compensate adequately for the amount of risk taken. (See ***"Bank Earnings: Competitive Pressures and Risks," Regional Outlook,*** Fourth Quarter 1997.) Alternatives for managing capital in such an environment include dividends, share repurchases, and M&A transactions; banks have pursued all three.

Commercial bank cash dividend payments have reached record levels in the 1990s. In fact, the level of earnings retained over the past two years (26 percent in 1996 and 28 percent in 1997) was the lowest during a noncrisis period since the FDIC's inception (see Chart 3). A large percentage of these dividend payments is made to bank

Chart 3

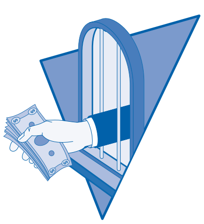
Commercial Banks Are Retaining a Smaller Share of Earnings than during Any Other Profitable Period



Note: Negative 285 percent rate in 1987 shown as zero.
Source: FDIC Historical Statistics on Banking

holding companies, which, in turn, use the funds to repurchase common stock—another means of reducing book capital, increasing financial leverage, and improving return on equity. According to data compiled by ***Keefe, Bruyette & Woods, Inc.***, share repurchases by the top 25 banking organizations increased in each quarter during 1995 and 1996 and reached an all-time high of $11.5 billion in the first quarter of 1997, but have declined steadily since then. There are at least two likely reasons for this trend. First, the continued escalation in share prices through the first half of 1998 made repurchases more expensive. Second, as share prices increase, the "pooling of interests" method of accounting for a merger becomes more attractive; however, it carries certain Securities and Exchange Commission restrictions on share repurchases both before and after the transaction. Therefore, as values rise, institutions considering future mergers are less likely to initiate repurchase programs.

The third capital management alternative, M&A, offers potential benefits to both parties to the transaction. M&A may permit acquirers to deploy excess capital while improving earnings through operating and financial economies, diversification of revenues and geographic exposures, and greater management expertise. M&A also can provide access to new products—a common objective of competitors in mature industries. For institutions acquired through a purchase transaction in which ownership rights are relinquished, mergers provide a means of returning capital to shareholders rather than attempting to remain independent in an increasingly competitive environment.



Market Valuations

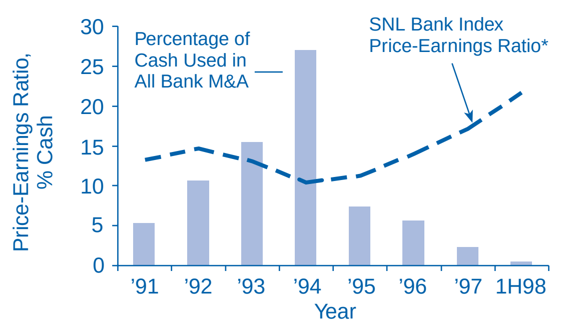
The increased market values commercial banking companies have experienced through the first half of 1998 played a major role in recent M&A activity, as common stock increasingly has been used as "currency" in transactions, especially the largest mergers. More valuable stock allows banks to issue fewer shares to execute mergers, which reduces the potential dilutive effects to shareholders. Through mid-April 1998, the amount of cash used to fund all U.S. business mergers (13.4 percent) had reached the lowest point in ten years.[3] Similarly, the aggregate cash amount of announced bank deal values through the first half of 1998 was less than 1 percent and reflects a steady decline since 1994. There appears to be a strong relationship between bank stock valuations and the level of cash committed in bank M&A activity since 1991 (see Chart 4), although this relationship is obviously influenced by large, stock-based mergers.

Record earnings, positive market assessments of earnings quality and stability, and continued consolidation expectations sparked the upward trend in bank stocks through June 1998. The value of the ***SNL Bank Index***, which is composed of publicly traded banking companies, quadrupled between January 1990 and June 1998 and far outstripped gains in the broader S&P 500 over the same period. The result was a rise in bank stock prices as a multiple of earnings per share (the price-

[3] As reported by the *Wall Street Journal,* April 16, 1998, p. C1.

Chart 4

As Market Valuations Have Increased, Cash Usage in Bank Mergers Has Declined



* Price-Earnings Ratio = stock price of index members to previous 12 months' earnings weighted by market capitalization.
Source: SNL Securities

earnings ratio) both absolutely and relative to the S&P 500. For example, according to the price-earnings ratio for the ***SNL Bank Index***, at year-end 1994, investors paid $9.76 per dollar of bank earnings; on June 30, 1998, investors paid $22.88 per dollar of earnings. Over the same period, the price-earnings ratio of the ***SNL Bank Index*** relative to the S&P 500 increased from 65 percent to 79 percent.

From a corporate finance perspective, firms create wealth for shareholders by generating returns on invested long-term debt and equity capital that exceed their combined cost. Since long-term debt is used less in banking than in other industries, ***Credit Suisse/First Boston*** uses return on equity less the cost of equity capital as a proxy for measuring wealth generation by banks.[4] As shown in Chart 5, over the long term, increases in the price-earnings ratio for banks relative to that for the S&P 500 tends to track with the banking industry's ability to generate returns on equity in excess of the cost of equity capital. Through 1997, high levels of industry profitability, low market interest rates, and market expectations of more stable long-term industry earnings had driven the spread between the return on and cost of equity capital to unprecedented levels.

Following the strong performance through the first half of 1998, the ***SNL Bank Index*** lost 21 percent of its value during the third quarter of 1998 (all during the month of August) because of concerns about corporate earnings, international exposures, the flat yield curve, and the ability of banking companies to expand market-sensitive revenues. Over the same period, the S&P 500 declined only 10 percent. Likely in response to relatively poor stock market conditions, only 75 bank mergers were announced during the third quarter of 1998— a 30 percent decline from the second quarter—with over half announced during July. According to ***SNL Securities***, only 32 bank mergers were announced in August and September 1998, the lowest number for any two-month period since March and April 1997, when 31 mergers were announced. The August 1998 decline in the ***SNL Bank Index*** was the largest monthly decline since a 7 percent drop in March 1997. In addition, the average price-earnings ratio for the index relative to the S&P 500 during third-quarter 1998 was the lowest in eight quarters. Consistent with the aforementioned relationship between bank stock valuations and the level of cash committed to bank M&A activity, the amount of cash committed to mergers in September increased significantly.

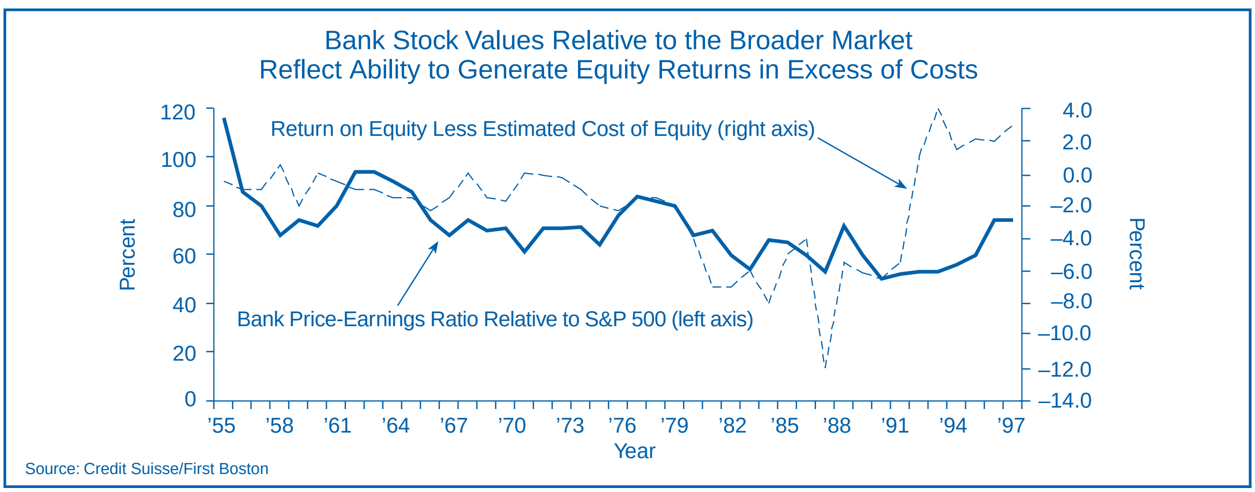
Synergistic Opportunities

A primary motive for M&A activity is to increase the value of the combined company by creating synergies. In other words, through some combination of cost cutting and revenue growth, M&A can produce additional wealth for shareholders of the combined company beyond what the companies operating independently could generate. Although each transaction has unique characteristics, most bank M&A generate additional value from some combination of operating economies, diversification of revenues and geographic exposures, financial economies, and transfer of management expertise.

Operating economies are achieved by eliminating overlapping administrative functions and infrastructure as

[4] "Value-Based Analysis of Banks," Credit Suisse/First Boston, *Equity Research—Americas,* June 4, 1998.

CHART 5

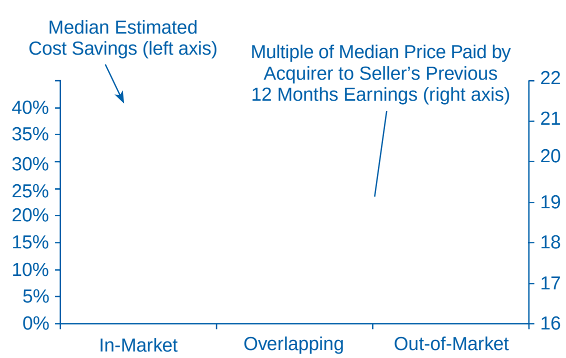


well as by using existing distribution networks to cross-sell products and services to generate revenue gains. However, the degree to which these benefits materialize will depend on the specific characteristics of the merger partners and their markets. For example, a review of 48 banking company mergers from 1995 through the first half of 1998, where the seller held more than $1 billion in assets, revealed estimated cost savings that increased with the degree of market overlap (see Chart 6). Expected cost savings should translate into an increase in a firm's value. This appears to be the case in this sample, as the median price paid by acquirers as a multiple of the target's previous 12 months' earnings increased with the level of expected cost savings. Although perceived cost savings have contributed to bank M&A activity, whether the gains actually materialize hinges on execution, as discussed in ***"Risks and Challenges for Consolidating Institutions"*** in this issue.

Whereas mergers in overlapping markets provide opportunities for cost cutting, value creation from revenue enhancements is more likely to materialize in M&A transactions across markets and industries. Such mergers can be expected to lead to increased diversification of revenues and geographic exposures. These expectations may be driving the recent trend in acquisitions of investment banking units and brokerage houses by banking companies. As traditional interest-spread income has stagnated, many institutions have focused on expanding noninterest sources of revenue. At June 30, 1998, noninterest income made up 40 percent of net operating revenue (net interest income plus noninterest income) for all commercial banks, compared with only 25 percent in 1984. Similarly, geographic expansion can reduce a firm's dependency on local, undiversified economies. Supporting this notion, a May 1998 working paper by the ***Federal Reserve Bank of Philadelphia*** found that economic benefits are strongest for banks engaged in interstate expansion, especially for mergers that diversify macroeconomic exposures.[5]

Chart 6

Estimated Cost Savings and Pricing for Bank Mergers Are Tied to the Degree of Market Overlap



Source: SNL Securities

As an institution's size increases through M&A activity, financial economies may result from greater access to nondeposit funding alternatives as well as traded and over-the-counter off-balance-sheet financial instruments. As of June 30, 1998, commercial banks with assets less than $1 billion funded approximately 80 percent of assets with domestic deposits, compared with roughly 50 percent for commercial banks with assets greater than $1 billion—reflecting how funding flexibility and accessibility increase with scale. Access to money and capital markets is enhanced for larger institutions through potentially lower transaction costs and increased coverage by securities analysts and rating agencies. For the same reasons, large banks are also the primary users of off-balance-sheet financial derivatives.

Differences in the ability of managers to operate institutions efficiently may also provide impetus for acquisitions. As Federal Reserve Board Chairman Alan Greenspan noted in recent testimony, "there are considerable differences in the cost efficiencies of banks within all bank classes, implying that there is substantial potential for many banks to improve efficiency of their operations, perhaps through mergers."[6] Thus, managers of more efficient banks may acquire less efficient competitors in an attempt to increase the latters' value through improved management. As shown in Chart 7 (next page), the efficiency ratios[7] of bank holding companies improved significantly from 1987 to 1997. However, continued disparities in efficiency among companies, as reflected by the upward slope of the lines in Chart 7, may offer additional opportunities for M&A activity.

Technology and Globalization

The application of technology to nearly every aspect of banking offers the potential for more streamlined oversight, management, and evaluation of far-flung

[5] *The Dollars and Sense of Bank Consolidation,* Working Paper No. 98-10,The Federal Reserve Bank of Philadelphia.

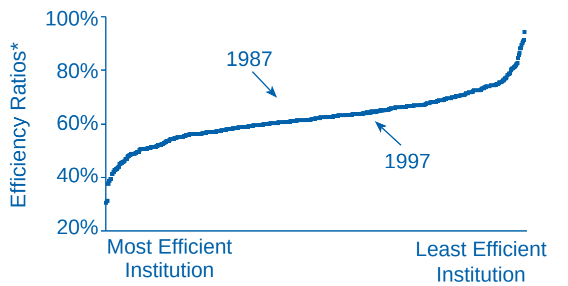
[6] Testimony before the Committee on the Judiciary, U.S. Senate, June 16, 1998.

[7] The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.

Chart 7

Bank Efficiency Has Improved, but Differences among Institutions May Provide Merger Incentives

Bank Holding Companies Continuously Operating from 1987 to 1997



* The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

Source: Federal Reserve Board Y-9 Reports, adapted from an analysis by McKinsey & Company.

operations both domestically and internationally. Consequently, technology can facilitate merger activity. Moreover, some insured institutions may turn to mergers with compliant partners as a solution to Year 2000 computer problems.

In a June 1997 speech to the Institute for International Economics, Deputy Treasury Secretary Lawrence Summers credited information and communication technologies as a contributing factor to the trillion-dollar-a-day volume of cross-border capital flows.[8] Although the number of insured branches of foreign banks and the number of foreign offices of insured domestic banks have both declined in recent years, increasingly interconnected financial markets, firms, and customers have heightened the potential for competition across borders and continents.

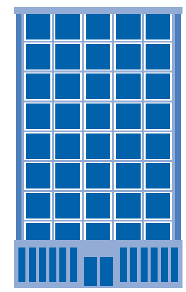
The scale, scope, and structure of many foreign competitors may promote combinations by U.S. institutions looking to enhance competitiveness in the global arena. Approval of proposed large mergers announced in early 1998 will elevate several U.S. banking companies to banking's global elite in terms of assets and market capitalization. Mergers among large European financial institutions in anticipation of the European economic and monetary union may spur U.S. multinational banks to consider strategic mergers across financial sectors.

[8] "Promoting Global Financial Stability: The G-7 Agenda," delivered to the Institute for International Economics, June 12, 1997.

Management Incentives

Other factors that may drive M&A activity are related to managers' compensation, special reward structures, and job security. Industry observers have noted that executive salaries are highly correlated with company size and revenues. Some analysts have noted that compensation of bank executives rises as assets expand, regardless of the source of the expansion. ***Bear, Stearns & Company*** opined in June 1998 that bank mergers would continue partly because "executive compensation in banking is correlating more with asset size than with any other financial performance measure."

Special reward structures also may influence acquisition programs. Large salary increases and special merger bonuses have been observed recently for executives of large acquiring banking companies. Amassed stock holdings and options may offer significant wealth for managers who decide to sell. Additionally, managers may take actions to lessen the likelihood of takeover and the corresponding probability of job loss. Such defensive managers may undertake acquisitions to avoid having their own banks targeted for purchase.



Summary and Conclusions

By identifying the rationale and incentives for bank M&A activity, regulators and industry participants can better understand and evaluate the risks and challenges facing merged institutions. The recent wave of banking industry M&A activity has been stimulated by a number of factors, including deregulation, increasing competition, market valuations, synergistic opportunities, technology and globalization, and management incentives. Although the pace of M&A activity may slow in the short term due to such factors as a stock market downturn or concern about Year 2000 implementation issues, the presence of multiple drivers will likely extend the consolidation trend well into the future.

Steven E. Cunningham, CFA, Senior Financial Analyst
scunningham@fdic.gov
John F. Sherman, CFA, Senior Financial Analyst
jsherman@fdic.gov

Risks and Challenges for Consolidating Institutions

- **Bank merger and acquisition (M&A) activity creates significant challenges for bank managers, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies.**

- **As premiums paid in M&A transactions have escalated, some industry observers have raised concerns over whether the assumptions concerning potential earnings and strategic benefits can be realized.**

- **Institutions in the process of integrating an acquired entity are likely to be especially vulnerable to a downturn in the economy.**

Merging institutions are under great pressure to execute the combination smoothly and realize its anticipated benefits. On the basis of anticipated earnings improvement and other strategic benefits, M&A deals are often executed at premiums substantially above recent market prices. As a result, financial market participants closely scrutinize post-merger results. Senior management of the merged entities, who typically are instrumental in convincing shareholders to agree to the transaction, are responsible for ensuring that expectations are realized. Entities that have demonstrated a proficiency at executing mergers have been regarded favorably by the capital markets. For some organizations, merging has effectively become a line of business. Alternatively, those that struggle after a merger may experience poor financial performance and could potentially become targets for acquisition themselves.

Execution Risk

The term "execution risk" often is applied to potential obstacles to integrating merging institutions. According to some analysts, execution risks are the primary risk in these combinations. These risks stem from a variety of uncertainties that arise following a merger: Can the new institution combine its management teams, integrate technological systems, realize the benefits of diversification, and maximize operating economies, all without interrupting services? Each of these uncertainties, summarized below, presents significant challenges to bank managers.

Management

Combining the management teams of consolidating companies is a critical first step in the transition process. Lines of reporting and authority must be delineated, and compensation arrangements coordinated and aligned with corporate goals. All of this must be accomplished without alienating critical personnel. The most difficult aspect may involve intangible cultural differences. A recent poll by ***Hewitt Associates***[1] of human resource managers of 218 large U.S. companies identified integrating organizational cultures as the "top challenge" in mergers. While some level of turnover must be expected, losses of key personnel and interruptions in service can result in dissatisfied customers, which in turn can lead to poor financial performance.

Technology

Technological advances often are identified as the single greatest enabler of the wave of bank consolidation; however, smoothly integrating existing systems and maximizing potential benefits of technology can be difficult. A ***Federal Reserve Board***[2] study of nine recent mergers concluded that the most frequent and serious problem merging institutions encountered was unexpected difficulty in integrating data processing systems and operations. The faster systems can be consolidated, the sooner cost savings can be realized; however, disruptions in service or breakdowns in control mechanisms may be less likely with a more measured integration timetable. Rather than attempting to integrate existing, sometimes incompatible systems, many merger partners have chosen to maintain parallel operations while integrating data processing systems over time. Year 2000 compliance efforts add yet another layer of complexity to these endeavors.

Diversification

M&A transactions provide an opportunity to diversify risk exposures, thereby potentially decreasing earnings volatility and moderating the effect of economic down-

[1] "Career Tracks: Personnel Execs: Toughest Job in Mergers Is Blending." *American Banker,* August 10, 1998, p. 6.

[2] "The Efficiency Effects of Bank Mergers: An Overview of Case Studies of Nine Mergers." *Journal of Banking & Finance,* March 1998, vol. 22, no. 3, pp. 273–291.

turns on an institution's performance. However, diversification creates added complexity for bank managers. They may have little practical experience with new product lines or new geographic markets and as a result they may not fully understand the risks involved in these new areas.

Operating Economies

The degree to which anticipated operating economies are realized hinges on management's ability to carry out multiple objectives. To achieve anticipated revenue enhancements, managers of consolidating institutions have attempted to promote a culture of cross-selling new and existing products to a broader customer base in new markets, often through new distribution networks. At the same time, they have sought to reduce expenses by eliminating redundant administrative functions. Underlying these efforts is the need to establish strong internal controls and develop appropriate risk management systems.

Are Expectations Unreasonable?

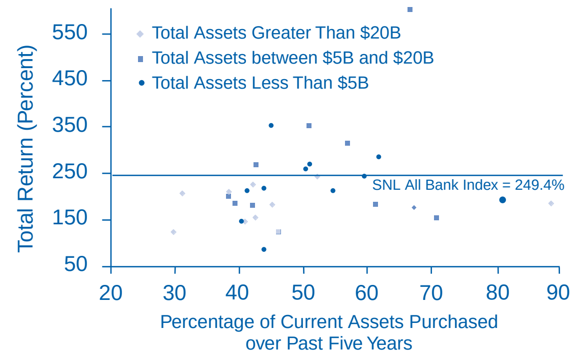
As premiums paid to carry out M&A transactions have escalated, some industry analysts have viewed the assumptions regarding the expected earnings and strategic benefits as aggressive, raising uncertainty as to whether these benefits can be realized. Shares of banking organizations that have been active acquirers have not necessarily outperformed the universe of bank stocks, even before the recent market volatility. According to ***BankINVESTOR***, for the five-year period ending March 31, 1998, most of the returns of the most acquisitive banking organizations across three separate size categories lagged the ***SNL Bank Index*** (Chart 1). This lag may be due to investor concerns about whether and to what extent the anticipated benefits of merger activity will be realized. For example, the assumed benefits related to economies of scale and diversification may be overoptimistic.

Benefits of Scale

Economies of scale associated with greater size and capacity are commonly identified as a potential benefit of consolidation. Large banks make substantial capital investment in areas such as technology and delivery-system infrastructures; spreading these costs across a larger customer base may lead to greater efficiency. However, some observers question whether there is a limit to benefits of scale. Federal Reserve Board Chairman Alan Greenspan testified before the Senate Judiciary Committee in June 1998 that "there are no clear-cut findings that suggest bank mergers uniformly lead to efficiency gains. Returns could be muted by large company inefficiencies, and their customers may face bureaucratic inflexibility." Perhaps the increased complexity of larger institutions combined with their involvement in more nontraditional activities offset the advantages of larger scale.

CHART 1

Many of the Most Acquisitive Banking Companies Have Underperformed the Universe of Bank Stocks
(March 31, 1993–March 31, 1998)



Source: *BankINVESTOR*

Benefits of Diversification

Another common goal of M&A activity is to promote diversification of revenue streams. The relaxation of regulatory restrictions on geographic expansion and permissible activities has made possible new combinations of revenue sources. However, the extent to which combining traditional banking with a broader range of activities will yield a diversified income stream is not yet clear. Industry analysts often point to the declining share of total revenues from net interest income as an example of improved diversification and potentially less volatile earnings. However, others argue that, like margin-related income, fee income from activities such as mutual fund sales, investment management, and brokerage operations is sensitive to both increasing interest rates and deteriorating economic conditions.

Cost of Capital

Failure to meet performance expectations following a merger can lead to negative market assessments of earnings quality and stability. As creditors and investors view an institution's performance less favorably, they require a higher rate of return on capital markets instruments. While cost of capital always has been important for institutions that rely significantly on capital markets as a funding source, changes in the competitive environment have made it a critical issue for all banking organizations. Technological advances and deregulation now permit low-cost competitors to enter previously insulated markets. (See ***"Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale"*** for a discussion of changes in the competitive environment.) Competitors with a lower cost of capital often can provide services at a lower price, or they can accept similar risks in exchange for a lower expected return. Such competition may lead higher-cost competitors to pursue higher-yielding but riskier investment alternatives.

Economic Conditions

The M&A activity of the past few years has occurred in an environment of nearly ideal economic conditions. As a result, many of the new business combinations have yet to be tested by a downturn in the economy. Until these new entities experience a full business (and credit) cycle, the results of the M&A activity cannot be fully assessed.

Regardless of whether the long-term objectives of M&A activity are achievable, institutions that are transitioning to a new structure following a merger are likely to be especially vulnerable to deteriorating economic conditions. The experience of newly chartered institutions during the 1980s banking crisis is an example of deteriorating economic conditions interrupting this transition period. According to the FDIC's recent study, ***History of the Eighties—Lessons for the Future***, more than 16 percent of institutions chartered during the 1980s failed by 1994, compared with just 7.6 percent of preexisting institutions. The study attributed the high failure rate to a combination of "powerful competitive pressures to assume greater risk with relative inexperience in a demanding new environment." The competitive pressures included incentives to "leverage high initial capital positions, increase earnings per share, and meet stockholder expectations." Although recently merged institutions and newly chartered institutions are not identical, today's merger participants face many of the same pressures.

The percentage of institutions that have recently experienced a structural change is higher today than at any other time since the consolidation trend began. Institutions that were chartered or involved in a merger over the past three years represent nearly 13 percent of all commercial banks and 65 percent of commercial bank assets. (See ***"Industry Consolidation Presents Unique Risks and Challenges for Community Banks"*** for a discussion of the trend in newly chartered institutions.) As shown in Chart 2, these percentages have increased substantially in recent years. Much of the consolidation activity is occurring between institutions that have been part of the same holding company for extended periods; however, even these transactions present integration challenges that would be complicated by an economic downturn.

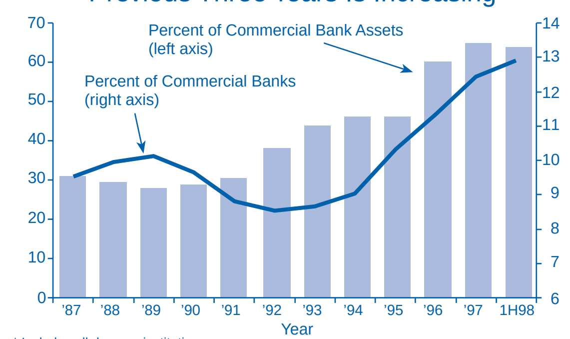
Summary and Conclusions

While substantial benefits may be derived from bank M&A activity, mergers impose heavy demands on bank managers and present potential risks to banking organizations, bank investors, and the insurance funds. Bank managers face significant challenges associated with executing the merger, including combining management teams, integrating technology, realizing the benefits of diversification, and maximizing operating economies. Additionally, uncertainty remains as to whether merger-related expectations can be fully realized. Finally, the process of integrating two institutions is complex and time-consuming. Should this process be interrupted by an economic downturn, these institutions may be especially vulnerable.

John F. Sherman, CFA, Senior Financial Analyst
jsherman@fdic.gov

CHART 2

The Share of Institutions That Were Newly Chartered* or Involved in a Merger within the Previous Three Years Is Increasing



* Includes all de novo institutions
Source: Bank Call Reports

Industry Consolidation Presents Unique Risks and Challenges for Community Banks

- **Industry consolidation has created competitive challenges for small banks and highlights traditional obstacles related to operating scale and scope.**

- **Some small banks that are not merging with or selling to competitors are addressing consolidation challenges by outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, capitalizing on personalized service, and focusing on niche markets.**

- **While these adaptive strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.**

Historically, commercial banking has been characterized by a large number of small institutions operating at the community level. Although the number of small, or community, banks (defined as those with total assets of $500 million or less) has declined significantly since consolidation began in the 1980s, they continue to dominate the industry's demographics. At June 30, 1998, 92 percent (8,306) of FDIC-insured commercial banks held assets of $500 million or less. Approximately 73 percent of these banks had no holding company or were subsidiaries of one-bank holding companies, and more than one-third operated only one office. The June 30, 1997, ***Summary of Deposits*** data present more evidence of the extent of community banking. On that date, two-thirds of all commercial banks operated offices exclusively within a one-county area.

In terms of demographics, the structure of commercial banking continues to reflect the time when state and interstate banking and branching restrictions tended to limit rivalry in many local markets. However, recent changes in the structure, regulation, and operating environment of the financial services sector have affected commercial banks, especially smaller community banks. Specifically, industry consolidation has created new challenges for small banks arising from heightened competition and accentuates traditional small bank obstacles related to size and scope of operations.

Competitive Pressures

In addition to intensifying competitive pressures from nonbanks, industry consolidation has heightened competition among commercial banks. According to the ***Federal Reserve Board's Flow of Funds*** data, for the seven-year period ending on March 31, 1998, commercial banks' share of total financial assets in the U.S. economy declined nearly 6 percentage points to just over 20 percent. At the same time that banks are capturing a smaller slice of the financial services pie, mergers, acquisitions, and consolidation have set the stage for increased competition within the industry. Larger banks operating across state lines and in multiple markets via branches, mailings, or technology now vie for community bank customers. Moreover, the rebound in new bank charters over the past four years, an outgrowth of the consolidation trend, has increased the number of small bank competitors in many markets. The inaugural ***ABA Community Bank Competitiveness Survey***[1] in 1997 reported that small bankers considered other community banks their chief competitors for deposit gathering and all types of lending, and considered large banks formidable competitors in commercial and consumer lending and deposit gathering. While competition among small banks in common markets has existed for some time, the emergence of larger institutions as challengers results largely from many of the merger motivators and drivers discussed in ***"Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale"*** in this issue.

New Chartering Activity

A secondary effect of industry consolidation, and a potential source of increased competition for preexisting community banks, is the recent trend in new bank charters. From June 1994 to June 1998, more than 500 commercial banks were established in 48 states. Although rebounding, the annual level of new chartering activity remains well below the peaks of the previous three decades. Industry observers attribute the recent increase in new charters to many factors, including the availability of displaced banking talent, strong economic growth, potential niche opportunities in mar-

[1] As presented in the *ABA Banking Journal,* April 1997, p. 55.

ket segments underserved by larger banks, and the loss of local decision making and perceived service gaps as local banks are acquired by larger banks or are consolidated into far-flung multibank companies.

New bank activity is not concentrated in one region of the country. However, at the state level there appears to be a relationship between new chartering activity and the number of institutions sold or consolidated in merger and acquisition transactions (see Chart 1). Forty percent of all banks sold or consolidated and 27 percent of new charters from June 1994 to June 1998 were in Texas, California, Florida, Illinois, and Georgia.

As shown in Map 1, ten states currently host a high percentage of recently established community banks. Many of these states have experienced strong economic growth during this expansion and have a large number of banking offices owned by out-of-state institutions. These concentrations are especially noteworthy since newly chartered institutions often pursue aggressive growth to improve profitability, which may influence pricing and terms for competitors within their markets. Reflecting the recent surge in new banks, 57 percent of the 402 unprofitable commercial banks through the first half of 1998 had been in business less than four years, up from 17 percent at year-end 1994 (see Chart 2). As would be expected, the ten states highlighted in Map 1 rank among the top in terms of the percentage of small banks that were unprofitable during the first half of 1998.

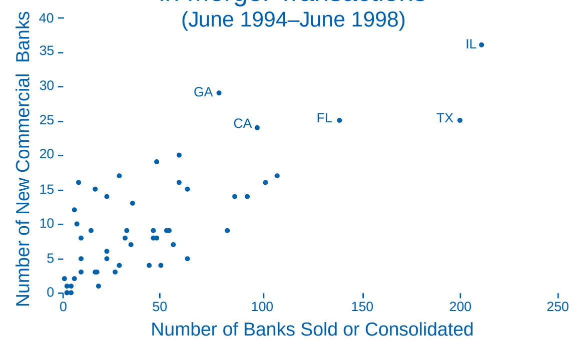
Challenges of Scale and Scope

A by-product of industry consolidation is the emergence of larger institutions. By definition, community banks operate with relatively less scale than their regional, super-regional, and money-center counterparts. As a result, small banks have limited ability to spread the costs of new investments or operating expenses across a broad asset base. This characteristic has traditionally forced community banks to spend more to generate each dollar of revenue than the rest of the industry, as measured by efficiency ratios.[2] The inability of many community banks to fund large expenditures, such as investments in technology, alternative delivery systems, or new business lines, may cause

[2] The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income. The ratio can be interpreted as the cost to generate each dollar of revenue.

Chart 1

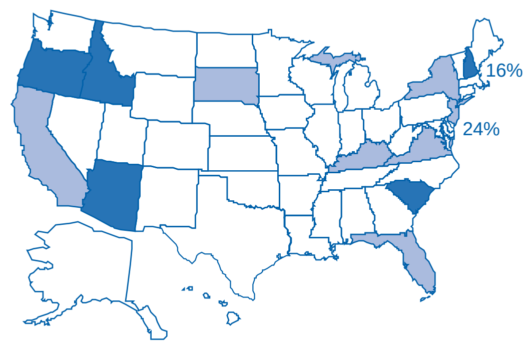
New Chartering Activity Appears to Be Related to the Number of Banks Sold or Consolidated in Merger Transactions
(June 1994–June 1998)



Sources: Bank Call Reports, FDIC Division of Research and Statistics

Map 1

Some States Host a High Percentage of Banks Established in the Past Four Years

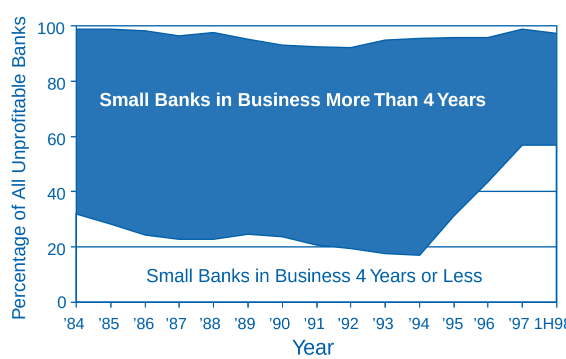


New Banks as a Percentage of Total
June 30, 1998

- Greater than 15% (10)
- 5% to 15% (19)
- Less than 5% (22)

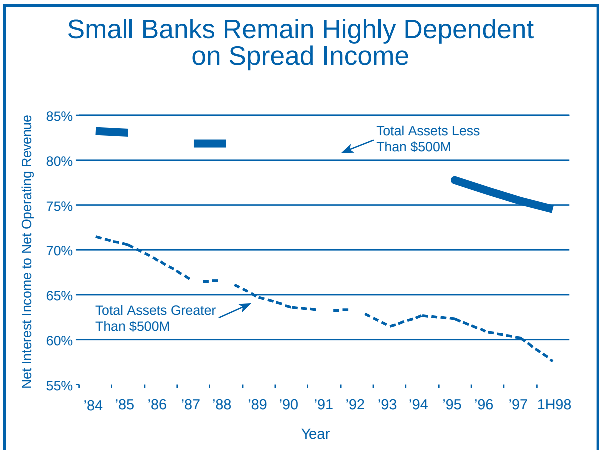
Chart 2

Recently Chartered Small Banks Comprise a Higher Proportion of Unprofitable Institutions



Source: Bank Call Reports

Chart 3



Source: Bank Call Reports

long-term competitive disadvantages. For example, ***The Tower Group*** estimates that 70 percent of 1997 information technology (IT) spending by banks was by the top 15 institutions.[3] Smaller institutions competing with larger banks that are investing in technology to improve operational efficiency, increase customer convenience, or to better identify customer profitability, pricing strategies, or cross-selling opportunities may find a diminished presence in the marketplace. Consequently, small banks may face increasing competition for customers who are attracted to sophisticated pricing, wider product arrays, and multiple delivery channels offered by competitors.

Closely related to scale is the issue of scope of operations, both business line and geographic. Community banks' scale may limit their ability to expand into new business lines or activities, thereby reducing the degree of revenue diversification and resulting in dependence on spread income. Since many noninterest sources of revenue require scale to economically justify investment, small banks tend to derive a greater percentage of net operating revenue from spread income, as shown in Chart 3. Also, the limited geographic scope of many community banks may result in less loan portfolio diversification and greater exposures to local economic downturns. From a portfolio management perspective, lenders with more diverse loan portfolios that can spread risks over a broader customer and economic base may gain pricing advantages over less diversified competitors.

[3] "How Much Do US Banks Spend On Information Technology?," The Tower Group Research Notes, www.towergroup.com.

How Are Community Banks Addressing Consolidation Challenges?

In response to competitive pressures arising from industry consolidation, community banks, new and old, appear to be adapting to meet strategic challenges to their long-term viability. Indeed, this summer, Federal Reserve Board Chairman Alan Greenspan told the Charlotte, North Carolina, Chamber of Commerce that "well-managed smaller banks have little to fear from technology, deregulation, or consolidation." Recent surveys and anecdotes reveal that small banks that are not selling to or merging with competitors are adjusting business practices to cope with the aforementioned pressures and challenges. Their strategies include outsourcing business functions, expanding the use of nondeposit funding sources, partnering with other banks and nonbanks, emphasizing personalized service, and developing niches or specialties. However, as described below, while these approaches may help small banks meet the challenges of consolidation, they potentially complicate the operations and risk profiles of these institutions.

Outsourcing

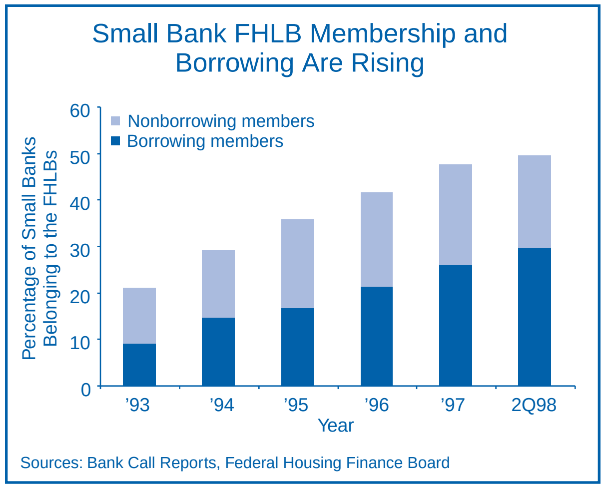
A recent survey by ***Electronic Data Systems Corporation*** and ***Bank Earnings International LLP***[4] found that community bankers are more concerned with controlling operating expenses than any other issue. This finding is not surprising given the cost savings expected from many recent mergers. The study also revealed that banks view IT as the most valuable tool for improving day-to-day performance—from controlling expenses to increasing fee income. Yet, according to ***The Tower Group***, IT budgets as a percentage of total noninterest expenses for small banks are typically half of those for larger banks.[5] As a result, some small banks are turning to outside parties to maximize the utility of expenditures, IT and others.

American Banker recently reported on a trend among small banks to outsource the origination of consumer loans. ***The Tower Group*** noted that third parties handled 2.7 million noncard, nonmortgage loan applications (mostly from small institutions) in 1997, and annual outsourced volume growth is projected to average 40 percent through 2002.[6] Vendor networks designed to

[4] *American Banker,* July 22, 1998, p. 16.
[5] *Computerworld,* May 25, 1998, p. 20.
[6] "More Banks Handing Off Nitty-Gritty of Consumer Lending," *American Banker,* June 12, 1998, p. 1.

enable small banks to reduce hardware and personnel needs also have emerged and allow for more cost-efficient processing and cheaper access to customer information. Many small banks planning Internet-based or home banking also are turning to outside experts. Outsourcing certain business functions may allow for greater focus on profitable business lines, less risky access to state-of-the-art technology, cost savings, and more options for customers. However, these arrangements are not without risk. Indeed, FDIC-insured institutions have experienced difficulties in the past with indirect consumer lending, such as auto lending. Moreover, banks that outsource business functions may have less control over those functions and may become over-reliant on third-party providers.

CHART 4



Nondeposit Funding Sources

As noted above, increasing competition for deposits has left some small banks searching for alternative funding sources to meet loan demand. On average each year from 1993 to 1997, 64 percent of small commercial banks experienced loan growth in excess of deposit growth. Similarly, six in ten banks responding to the ***1998 ABA Community Bank Competitiveness Survey***[7] reported that deposit levels were not keeping pace with loan demand. In response, small banks are increasingly turning to nondeposit funding sources. From 1993 through the second quarter of 1998, the percentage of small banks using borrowings of any type increased from 48 to 56 percent. Over the same period, the percentage of small banks funding with borrowings other than overnight funds (Federal funds and repurchase agreements) increased from 20 percent to 35 percent, and the percentage reporting brokered deposits rose from 7 percent to 12 percent.

The rising number of commercial banks joining the Federal Home Loan Bank (FHLB) System in recent years, as reflected in Chart 4, is likely a symptom of the aforementioned funding trend. At June 30, 1998, nearly half of all small banks were FHLB members, compared with 21 percent at year-end 1993. On the same date, 90 percent of FHLB commercial bank members and 87 percent of FHLB commercial bank borrowers were small banks. In addition to providing a backup source of liquidity, the FHLB is essentially acting as an intermediary to the capital markets for banks with limited access. The relatively limited nondeposit funding options available to many small banks may explain their increasing reliance on FHLB advances. At June 30, 1998, approximately 80 percent of small banks' nonovernight borrowings were FHLB advances.

The increasing liquidity of loan portfolios is becoming another funding alternative. Many small banks have used participation arrangements to sell off portions of loans to correspondent banks or have turned to Fannie Mae or Freddie Mac to sell mortgages. The securitization of other loan types also may become increasingly appealing as funding shortages persist and market opportunities for small banks increase. For example, in July 1998, ***American Banker*** highlighted the creation of a new commercial mortgage conduit established specifically to buy loans originated by community banks.[8] The secondary market for the guaranteed portion of Small Business Administration loans also has been cited as a potential source of liquidity.

Although identifying and expanding the use of nondeposit funds may increase the flexibility of small banks, their use complicates asset-liability management. While net interest margins for small banks have yet to reveal significant compression, recent evidence suggests future declines. For example, a recent survey conducted by the ***Federal Reserve Bank of Minneapolis*** found that 57 percent of small bankers in the upper Midwest expect a shift away from deposit funding to decrease profitability.[9]

[7] *ABA Banking Journal,* February 1998, p. 47.

[8] "Commercial Real Estate: New Conduit Plans to Help Small Banks Enter," *American Banker,* July 21, 1998, p. 29.

[9] "Location Influences Community Bank Challenges," Fedgazzette, Federal Reserve Bank of Minneapolis, July 1998, p. 2.

Partnering

In an effort to expand revenue sources and attract and retain customers, smaller banks are expanding their spectrum of products and services through partnerships with other entities. The ***1998 ABA Community Bank Competitiveness Survey*** found that 10 percent of community banks partnered with other banks in 1997, while nearly twice as many have teamed up with nonbanks. Over two-thirds of the survey's respondents considered their partnering approach profitable. The leading types of arrangements with other banks include loan participations, title insurance, data processing, credit card programs, and mortgage lending. Nonbank partnering has been used to expand offerings to customers such as brokerage, insurance, and travel agency services. However, like outsourcing, partnering could result in less control and overreliance on third parties.

Service Orientation

Small banks have long touted personalized service and local decision making as a competitive advantage. Influenced by the recent wave of merger and acquisition activity in the industry, community bankers cited service as an area with great opportunity in the ***1998 ABA Community Bank Competitiveness Survey***. Indeed, many community bankers have publicly welcomed consolidation as a chance to establish new relationships and attract customers affected by integration problems and personnel shifting at larger acquiring or merging banks.

Establishing prudent relationships with smaller, underserved customers may present opportunities and profits for small banks. This may be especially true for small business customers, which may not fit more standardized lending models of larger banks yet remain acceptable credit risks. According to the Federal Reserve Board's second-quarter 1998 ***Survey of Terms of Business Lending***, rates on small commercial and industrial loans earn the greatest spread of any size business loans. Further, a recent survey by ***PSI Global*** of small business owners in south Florida, which has seen a great deal of merger and acquisition activity in recent years, found that nearly one-quarter of respondents would move their business if their bank was purchased, exemplifying the extent to which small banks may be able to use service to capitalize on consolidation activity.[10]

Developing Niches or Specialties

Anecdotal evidence suggests that some small banks are specializing in narrow markets and niches. Some analysts and consultants have emphasized that community banks should not try to be what they are not, but should instead focus on a particular market segment or niche. By default, many small banks depend on their customers' local businesses and, through local expertise, may be better at serving specific industries than their larger competitors. However, a narrow focus may reduce portfolio diversification and could lead to greater exposures during an economic downturn.

Summary and Conclusions

Small banks are facing heightened competitive pressures from larger, merged institutions and from new banks. Their ability to respond to these pressures is restricted by traditional scale and scope limitations. Community banks are addressing these challenges by outsourcing business functions, utilizing nondeposit funding sources, partnering with other banks and nonbanks to diversify revenues and widen customer options, capitalizing on personalized service, and developing niches or specialties. While these strategies may help community banks meet the challenges of industry consolidation, they potentially complicate the operations and risk profiles of these institutions.

Steven E. Cunningham, CFA, Senior Financial Analyst
scunningham@fdic.gov

[10] *South Florida Business Journal,* May 22, 1998, p. 6.

Regional Perspectives

- **The Region's economy continues recent moderate growth trends. The Region is less vulnerable than the nation to global trade and international financial difficulties in the short term. A slowing of the national economy, however, could result in a disproportionately greater effect on the Region. Banks are continuing to report solid performance in the second quarter, but net interest margins remain below year-ago levels.**

- **The Memphis Region is experiencing the same fast-paced trend in banking consolidation as the nation. The merger trend is concentrated in metropolitan areas.**

- **Mergers alter the competitive environment for other banks operating in areas where acquisitions and consolidations occur. These effects include changes in market share and loan pricing as well as possibly creating niche markets for smaller banks.**

Region's Economic and Banking Conditions

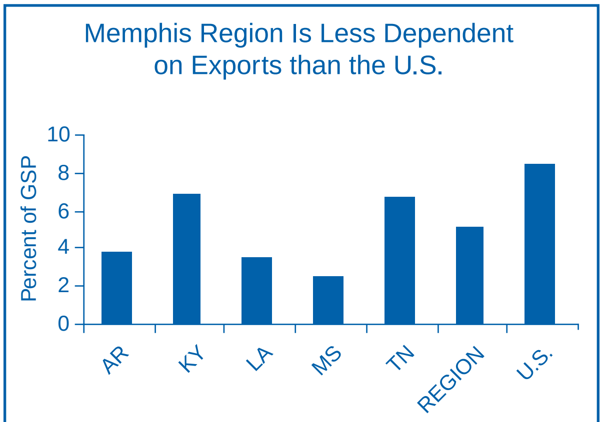
Regional Economy Continues to Expand

The Memphis Region's economy continues to expand at a moderate pace. In the second quarter, 71,500 new jobs were added to the Region's workforce, an annual increase of 1.7 percent. Growth varied considerably among the Region's states. **Arkansas** and **Kentucky** exceeded the nation's 2.3 percent pace, but **Louisiana**, **Mississippi**, and particularly **Tennessee** were well below this figure. Tennessee growth, hampered by declines in manufacturing jobs, was just 0.3 percent. In the Region, 230 counties showed increasing employment growth and 206 showed declining growth. Consistent with longer-term trends, unemployment rates remained significantly higher than the national rate in Arkansas, Louisiana, and Mississippi, while in Kentucky and Tennessee they were slightly below the nation. In the first quarter of 1998, personal income in the Region increased at an annual rate of 7.3 percent compared with 5.9 percent for the nation.

Despite the Region's overall economic growth, some sectors were weak. Summer drought conditions in Arkansas, Louisiana, and Mississippi during the critical growing period of 1998 may worsen already hard-hit farm income. Declining oil prices have resulted in a reduction in the rig count in Louisiana. The number of rigs was down nearly 38 percent in August from its November 1997 peak. Both onshore drilling activity weakness and reductions in exploration in the Gulf of Mexico have resulted in oil-related layoffs.

Because the Region is less dependent than the nation on exports as a proportion of total output (as shown in Chart 1), it appears to be less vulnerable to direct trade effects than the nation. In addition, the Region's proportion of exports to Asia is slightly lower than the nation's, although production of export commodities is concentrated in some areas. Nevertheless, if the international difficulties persist and the U.S. economy continues to weaken as a result, the effects could eventually be disproportionately high in the Region as it has a high manufacturing presence. Expenditures on "big ticket" manufactured products may be delayed and transportation and trucking activity may decline with any slowing of the national economy.

Chart 1



GSP = gross state product
Source: Office of Trade and Economic Analysis

Second Quarter Banking Performance Is Solid

On an aggregate basis, the Region's banks and thrifts continue to report relatively strong financial conditions. During the second quarter of 1998, financial institutions in the Region

- increased leverage capital ratios slightly to 8.91 percent of average assets;
- experienced a decline in return on assets (ROA) of 11 basis points to 1.24 percent; and
- reported low levels of nonperforming assets.

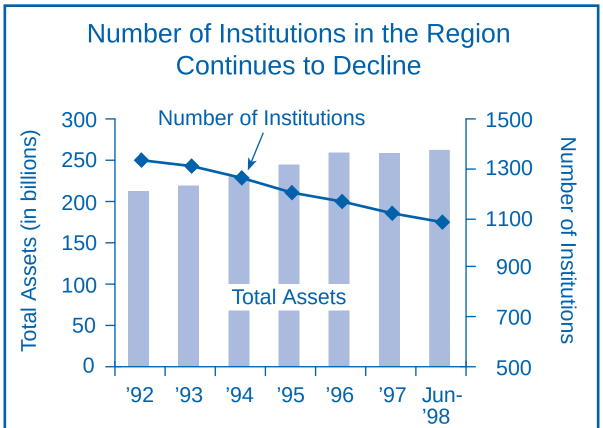
Although the Region's aggregate ROA declined appreciably from first quarter results, an ROA of 1.30 percent for the first six months of 1998 was consistent with 1997 results. The decline in quarterly earnings performance was caused by higher reported noninterest expense in the second quarter, as has been the case in previous years. Also, provisions for loan and lease losses were somewhat higher than in the first quarter. One positive aspect of earnings performance in the second quarter was a slight increase in the average net interest margin (NIM).

Even with this slight improvement from the first quarter, however, the average NIM was 4.40 percent compared with 4.49 percent at the end of the second quarter of 1997, continuing a recent trend of lower NIMs compared with year-ago levels. The reasons for lower NIMs include the flattening of the yield curve since mid-1997 (discussed in the Memphis ***Regional Outlook***, Second Quarter 1998), and increased competition. Recent merger trends in the Memphis Region are one likely cause for increased competition; they are discussed below with particular emphasis on the potential impact of acquisitions on the performance of community banks operating in areas where mergers take place.

Bank Merger Trends

The national trends described in ***"Mergers and Acquisitions Activity in the U.S. Banking Industry: Trends and Rationale"*** (fourth quarter 1998 ***Regional Outlook***) are also occurring in the Memphis Region. As shown in Chart 2, the number of banks and thrifts headquartered in the Region has declined by almost 20 percent since 1992. With only one bank failure in the Region during this time, the decline is almost exclusively attributable to industry consolidation. As the number of institutions shown in Chart 2 includes significant additions of newly chartered banks and thrifts, the actual volume of mergers is higher than otherwise indicated by the chart.

CHART 2



Source: Bank and Thrift Call Reports

The decline in institutions has primarily been concentrated in those with total assets of less than $100 million, as shown in Table 1. These smaller institutions experienced a 32 percent reduction in their numbers from December 31, 1992, to June 30, 1998. With the decline in the number of smaller institutions, the percentage of the Region's total assets held by these institutions has also fallen. Conversely, banks and thrifts with total assets of $1 billion or more are holding an increasingly larger share of total assets.

Merger Activity Varies by Geographic Location

Within the Region, **Louisiana** has experienced the greatest reduction in insured financial institutions, with a 28 percent decline in the number of banks headquartered in the state since December 31, 1992. **Louisiana** was highlighted in a June 1998 article by ***SNL Securities*** published in ***BankInvestor*** as being among the top five states in the nation in terms of banking industry consolidation in recent years. As shown in Table 2, the majority of merger activity in the state has resulted from acquisitions rather than consolidations within organizations, leading to significant declines in the number of

Table 1

Mergers Have Resulted in a Concentration of Assets in Larger Banks and Thrifts				
	Less than $100 Million	$100 Million to $250 Million	$250 Million to $1 Billion	Greater than $1 Billion
	Number of Banks and Thrifts			
Dec '92	949	278	80	30
Dec '97	681	308	99	33
Jun '98	648	306	96	31
	Percentage of Region's Total Assets			
Dec '92	21.8	20.4	16.8	41.0
Dec '97	14.2	18.6	17.0	50.2
Jun '98	13.1	17.7	15.2	54.0

Source: Bank and Thrift Call Reports

top-tier banking organizations and in the number of individual banks.

In contrast, much of the reduction in individual banks over the previous five years in **Tennessee** and **Kentucky** has resulted from consolidations within organizations. In many cases, individual banks within larger organizations may follow the direction of top-tiered company management; therefore, consolidation of these institutions may represent a change in form but not in substance. As a result, consolidations within organizations are likely to have a more limited effect than acquisitions on the merged institution and on competition in the market area. For this reason, the remainder of the article focuses on mergers through acquisitions.

Map 1 reflects the geographic location of banks merged by acquisition in the Region between December 31, 1992, and March 31, 1998. *As indicated, acquisitions occurred throughout the Region but have been more pronounced in or adjacent to metropolitan areas.* Among transactions in the Merger Group (see box defining Merger Group, next page), 43 percent of the acquired banks were headquartered in metropolitan areas,[1] although only 32 percent of the Region's institutions were headquartered in metropolitan areas on December 31, 1992. This tendency for acquisitions to occur in metropolitan areas is particularly evident in Louisiana and

[1] If the review is expanded to cover metropolitan areas and immediately adjacent counties that likely benefit from nearby metropolitan economies, three-fourths of the transactions in the Merger Group are captured.

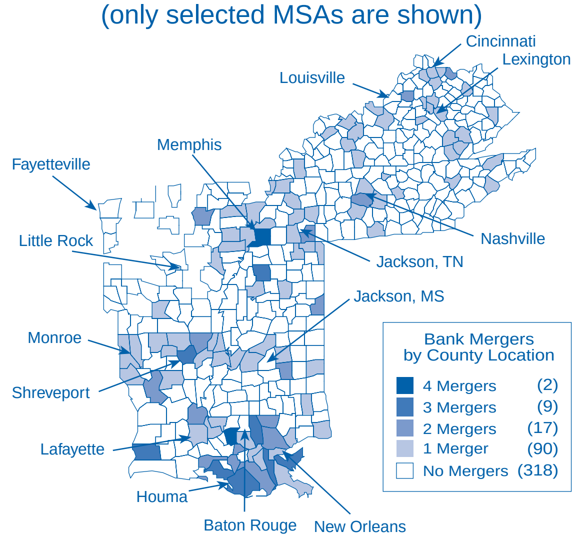
Table 2

Merger Activity Varies by State Acquisitions and Consolidations since 1992			
	Banks in 1992	Acq.	Con.
Arkansas	259	26	21
Kentucky	311	27	41
Louisiana	221	62	9
Mississippi	121	20	7
Tennessee	251	25	40

Sources: FDIC Merger History Database, Bank Call Reports

Map 1

Merger Activity (by Acquisition) in the Region Is Concentrated around Metropolitan Areas (only selected MSAs are shown)



MSA = metropolitan statistical area
Source: FDIC Merger History Database

Merger Group Analysis Background: The reduction in the number of banks and thrifts has resulted from both acquisitions and consolidations within organizations. For the purpose of this article, "acquisition" is defined to include the merger of institutions that were not previously part of the same organization or where one institution had been a part of the organization for less than one year. The phrase "consolidation within organizations" is used to denote the merger of one institution within an organization or top-tier holding company into another institution in the same organization if both institutions had been part of the same organization for one year or longer. This is sometimes referred to as "rolling-up." These definitions and the FDIC's Merger History database were used to create a list of mergers in the Memphis Region from December 31, 1992, to March 31, 1998. This "Merger Group" includes 160 banks merged through acquisition and 118 banks merged through consolidation within an organization. Although the information is considered accurate, some mergers that occurred during the period may not be reflected in the database.

Market Share Analysis: Market share analysis was performed for 40 transactions in the Merger Group that occurred from June 30, 1994, to July 1, 1995. This group was selected because a summary of deposit information collected annually in June was readily available for the year before and two complete years after the date of the acquisition. A "market area" was defined as the county in which the bank was headquartered.

Loan and Deposit Pricing Analysis: Loan and deposit pricing analysis was performed for 104 banks operating in markets where acquisitions by larger banks occurred from January 1, 1994, to December 31, 1995. In each market included in the analysis, the acquiring bank had total assets of $500 million or more. The banks included in the analysis were limited to banks in the market that had total assets of less than $500 million and were in operation for three full years before and two full years after the date of acquisition.

Tennessee, where a majority of Merger Group acquisitions in each state took place in metropolitan areas.

One possible reason for the emphasis on metropolitan areas is the higher concentration of both economic activity and deposits. As shown in Table 3, metropolitan areas represent a dominant share of the Region's total personal income and deposits.

In addition, economic growth during the current expansion has been modestly stronger in metropolitan areas. As shown in Chart 3, total personal income growth in metropolitan areas averaged 6.4 percent from 1992 to 1996, compared with 5.9 percent in nonmetropolitan areas. Also shown in Chart 3, average employment growth has been faster in metropolitan areas, although population growth has been the same for both segments over this period. Per capita income growth for metropolitan areas accelerated to 5.1 percent during the current expansion while nonmetropolitan per capita income growth remained consistent with longer-term growth patterns at 4.7 percent.

Another possible reason for the emphasis in acquisition activity in metropolitan areas is the economies of scale in operations that may be associated with the purchase of larger banks. The median size for metropolitan banks in the Merger Group was $137.7 million, with a median of $70.4 million for nonmetropolitan banks. The same economies of scale may also be evident in pre-acquisition due diligence costs, which could be spread over a larger volume of assets acquired. Also, acquisitions in

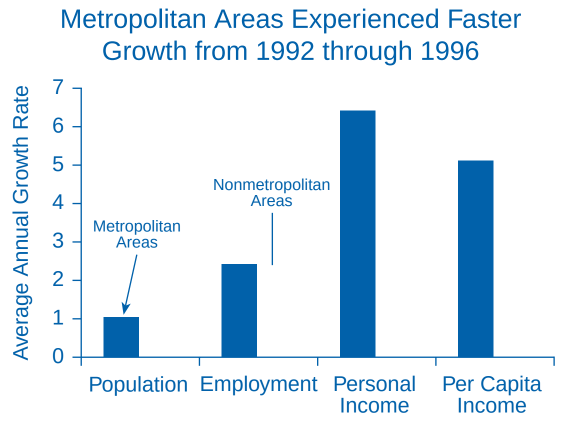
Table 3

The Majority of the Region's Total Personal Income and Total Deposits Are in Metropolitan Areas

	Metropolitan Areas		Nonmetropolitan Areas	
Comparable Period Information	Billions of Dollars	Percentage of Total	Billions of Dollars	Percentage of Total
1996 Personal Income	$229.6	61.3%	$144.7	38.7%
June 1996 Total Deposits	$118.2	61.0%	$75.7	39.0%

Sources: Bureau of Economic Analysis, Bank and Thrift Call Reports

CHART 3



Source: Bureau of Economic Analysis

metropolitan areas often involve the opportunity for the acquiring institution to reduce redundant costs; for example, duplicative branches could be eliminated.

Larger Banks Are More Active Acquirers

While the asset size of the acquired institution in the Merger Group was below $500 million in all but six transactions, the asset size of the acquiring institution tended to be much larger. In the Merger Group, the acquiring bank's total assets exceeded $1 billion in 53 percent of transactions. Not surprisingly, smaller banks have been less active in acquisitions. The acquiring bank had total assets of less than $250 million in only 21 percent of Merger Group transactions.

Effects of Mergers on Community Banks[2]

Concerns for acquiring institutions are discussed in ***"Risks and Challenges for Consolidating Institutions"*** (this issue). Some challenges facing these institutions include successful management integration, the achievement of operating economies, management of unfamiliar product lines or geographic markets, and technology considerations. Acquiring institutions are not the only ones affected by mergers, however. Mergers may also directly affect the performance of other banks operating in the markets where they occur. Effects include gain or loss of market share, changes in loan pricing and deposit funding costs, and the development of niche markets.

Market Share Is Affected When Acquisitions Occur

Community banks tend to gain market share in the year following the acquisition of other community banks in their markets, but the gains may be temporary, according to a review of 40 transactions in the Merger Group that occurred from June 30, 1994, to July 1, 1995. Community banks gained market share in 70 percent of transactions in the first full year of operation following the acquisition of another community bank in their market. Although this trend was consistent regardless of the asset size of the acquirer and the location of the acquired bank, transactions in nonmetropolitan areas in which the acquiring bank had total assets in excess of $500 million resulted in increased market share for community banks on a more frequent basis.

The gains in market share for community banks operating in areas where acquisitions occur were often short-lived. In a majority of transactions reviewed, the merged bank regained market share in the second complete year of operation following the acquisition.[3] *In half of the transactions reviewed, the merged bank reported market share equal to or greater than the original market share of the acquired institution by the end of the second complete year of operations, despite any initial loss of market share.*

Acquisitions by Large Banks Drive Down Loan Pricing

Considerable attention has been focused recently on the ability of large banks to use operating efficiencies to lower loan prices. A mid-1998 survey by ***Electronic Data Systems Corporation*** stated that in some cases

[2] Community banks are defined in this article as those with less than $500 million in total assets.

[3] This analysis was adjusted for any subsequent mergers involving these institutions.

larger banks were driving down loan prices by as much as 150 basis points following mergers.

Analysis of 104 community banks in the Memphis Region operating in markets where acquisitions were made by larger banks in 1994 and 1995 indicates that loan yields tend to decline following such acquisitions. In the first complete year of operation, community banks operating in these markets experienced an average decline in loan yield of 18 basis points relative to other similarly sized banks in the Region. In the second year of operation, as additional loans repriced, community banks in these markets experienced another 15 basis point relative decline in loan yields. With declining loan yields relative to other banks, NIMs at these banks also tended to underperform other similarly sized banks in the Region.

Apparently, there has been no decline in line of business risk to compensate for reduced loan yields. In fact, the 104 banks operating in markets where mergers occurred during 1994 and 1995 reported an increase in portfolio weighting of traditionally higher-risk loans in the two-year period following acquisitions in their markets. While other similarly sized banks in the Region reported growth in all types of real estate lending, these banks experienced a shift from residential real estate loans to commercial real estate loans.

Small Business Lending Niche for Community Banks May Be Eroding

Small business lending has long been considered a niche market for community banks. Such lending has historically been relationship-driven and a relatively cost-intensive lending segment. Many industry observers maintain that mergers creating larger institutions allow smaller community banks to gain small business lending market share.

This traditional niche held by community banks is being pressured, however, by the increased use of credit scoring in small business lending. Banks of all asset sizes have been able to reduce costs and processing time on small business loans through credit scoring. As large banks have increased their efforts in this market, competitive pressure has grown. This national trend and potential risks associated with credit scoring for small business lending were discussed in the Second Quarter 1997 ***Regional Outlook***.

Within the Memphis Region, larger banks hold a growing share of the small business loan market (commercial and industrial loans with original amounts of less than $1 million). From June 30, 1994, to June 30, 1998, the share of the Region's small business loans held by banks with total assets in excess of $500 million increased from 47.5 to 54.8 percent. Larger banks may not have been entirely successful in this market, however, as their growth in small business lending is lagging their overall loan growth.

Conclusions and Implications

Consolidations often significantly alter the competitive environment in which banks and thrifts operate. Small institutions operating in markets where mergers occur may feel pressure to alter pricing strategies or loosen loan-underwriting practices to maintain customer relationships and compete for growth. Also, competition could lead institutions into product lines with which management is unfamiliar. These changes in pricing and strategy may have direct implications for earning performance and asset quality of community banks.

Consolidation may also affect competition in another way. In many markets in the Region where acquisitions have taken place, former officers, directors, and stock-

Arkansas Spotlight: Banks in Arkansas could face additional competitive pressure from acquisitions by out-of-state organizations because of recent legal interpretation and the state's usury law. FDIC General Counsel Opinion Number 11, issued in mid-1998, provides guidance on interest rates charged by state banks operating interstate branches. If certain criteria are met, banks may charge interest rates based on the usury laws of their home state, even if branches are maintained in the state where the borrower resides. As a result, out-of-state banks operating branches in Arkansas may be able to use their own states' usury limitations rather than the Arkansas usury law, which generally limits interest rates charged by banks to 5 percent above the Federal Reserve discount rate. Out-of-state banks may be able to offer traditionally higher-risk products, such as subprime home equity loans, while banks headquartered in the state may not be able to offer these products and to adequately price for risk.

holders of acquired banks and thrifts have formed new institutions. The need for these new institutions to grow in an already highly competitive environment may place additional pressure on underwriting standards and loan and deposit pricing. As with consolidations, new bank formation in the Region has been predominantly in or adjacent to metropolitan areas, as was discussed in the Fourth Quarter 1997 ***Regional Outlook***.

Community banks and thrifts may no longer be able to rely on attracting deposits from acquired institutions and retaining certain market segments where larger banks may not previously have competed. Failure to adjust strategies to address new competition can result in a loss of market share, a decline in earnings, or both. Regardless of asset size, bank and thrift management operating in markets where mergers occur must now take a more proactive approach to identify and address risks arising from the changes in their marketplace.

Robert L. Burns, Financial Analyst
David T. Griffiths, Regional Economist

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________________

Contact Person ______________________________

Telephone ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta	________	Boston	________	Chicago	________
Dallas	________	Kansas City	________	Memphis	________
New York	________	San Francisco	________	All	________

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE
MAIL
Postage &
Fees Paid
FDIC
Permit No. G-36