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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 continues to expand at a moderate pace, and banks report healthy financial conditions. However, instability in global markets clouds the future as exports fall and the stock market falters.** *See page 19.*

◆ ***Community Banks Hurt by Tighter Margins, Higher Costs*****—The Region's community banks are facing earnings pressure because of tighter interest margins, higher costs, and low levels of noninterest income. These factors render community banks more vulnerable to the flat yield curve and increasing competition.** *See page 21.*

◆ ***Small Businesses Play Large Role in Region's Economy: Competition for Their Business Is Intensifying*****—The growth of small businesses has played a vital part in the Region's economic expansion. Responding to growth in the sector, banks have increasingly been targeting small business customers. Intensifying competition is leading to declining spreads and the possibility of looser underwriting standards, posing risks for the Region's financial institutions.** *See page 23.*

By Norman Gertner, Karen A. Wigder, Kathy Kalser

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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.**

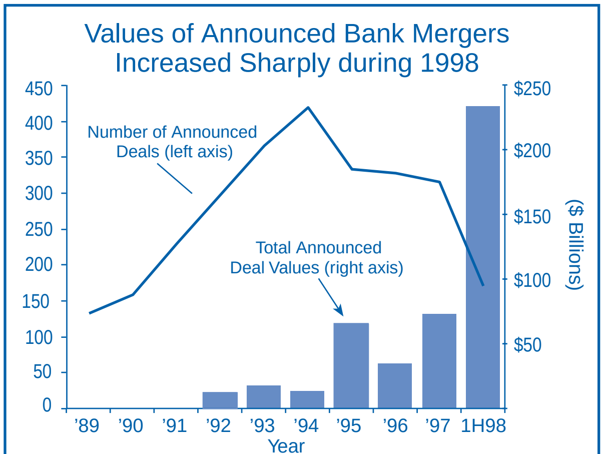
- **By identifying the rationale and incentives for bank merger and acquisition activity, industry participants can better understand and evaluate the risks and challenges facing merged institutions.**

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

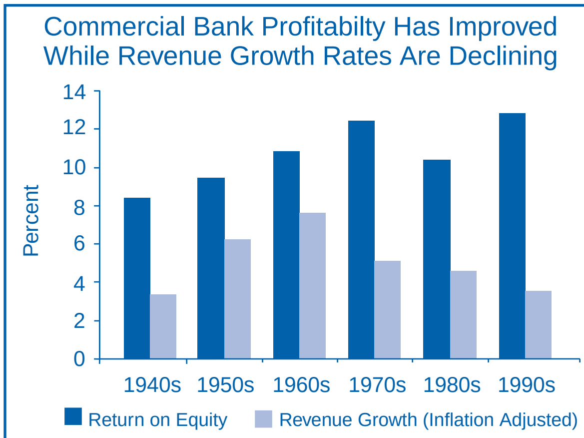
Historically, state regulations and boundaries dictated the structure of commercial banking in the United States. Not until the 1980s did most states remove or substantially relax intrastate branching restrictions. Subsequently, the Riegle-Neal Interstate Banking and Branching Act removed most remaining 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 intracompany 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.

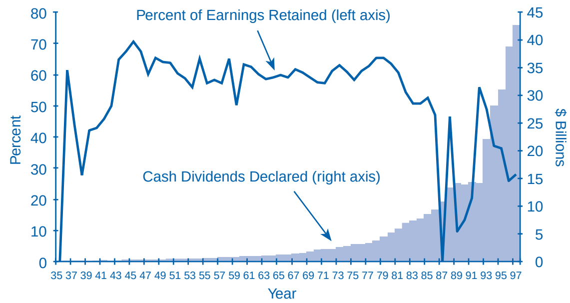
Competition in a mature industry often intensifies as competitors focus on sustaining market share as revenue growth rates slow. In banking, recent changes in the operating environment have stimulated a dramatic increase in competition. Specifically, barriers to entry into the industry have fallen: Capital 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

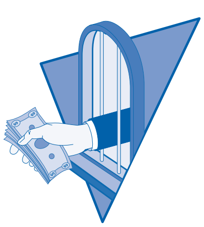
Commercial Banks Are Retaining a Smaller Share of Earnings than during Any Other Profitable Period



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

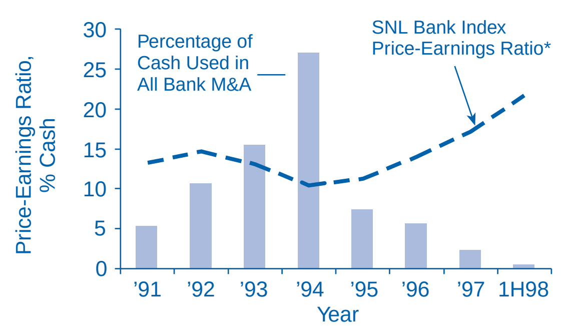
The increased market values commercial banking companies have experienced through the first half of 1998 played a major role in recent M&A activity, as common stock increasingly has been used as "currency" in transactions, especially the largest mergers. More valuable stock allows banks to issue fewer 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.

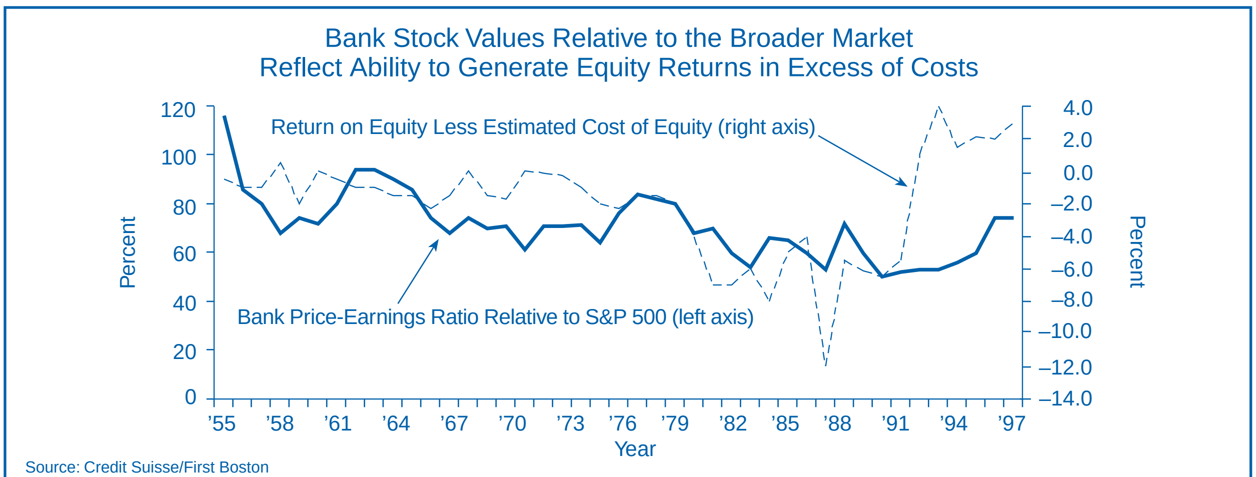
Synergistic Opportunities

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.

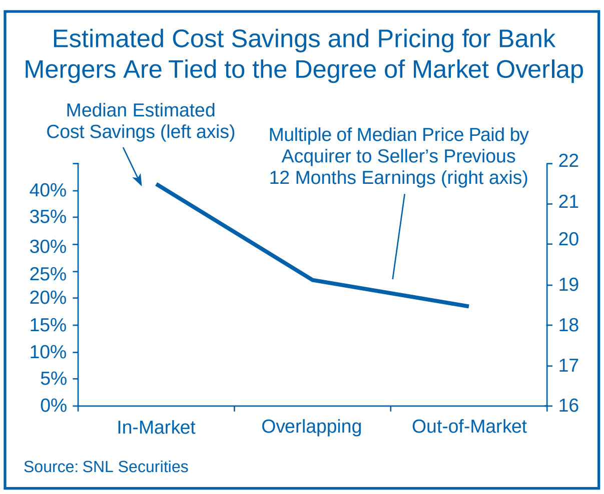
CHART 5



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

CHART 6



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]

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.

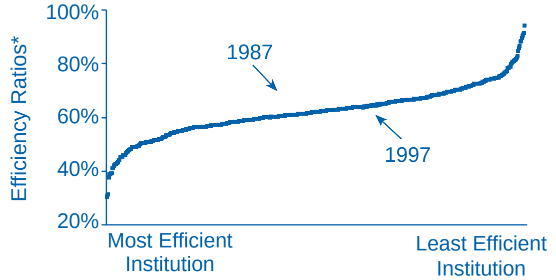
[6] Testimony before the Committee on the Judiciary, U.S. Senate, June 16, 1998.

[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.

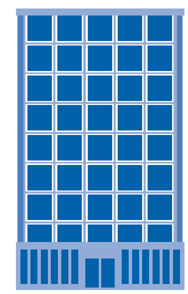
In a June 1997 speech to the Institute for International Economics, Deputy Treasury Secretary Lawrence Summers credited information and communication technologies as a contributing factor to the trillion-dollar-a-day volume of cross-border capital flows.[8] Although the number of insured branches of 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.

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.

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

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.

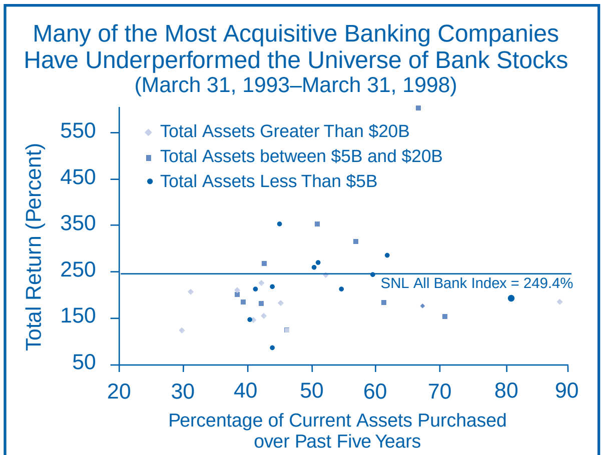
Are Expectations Unreasonable?

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



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.

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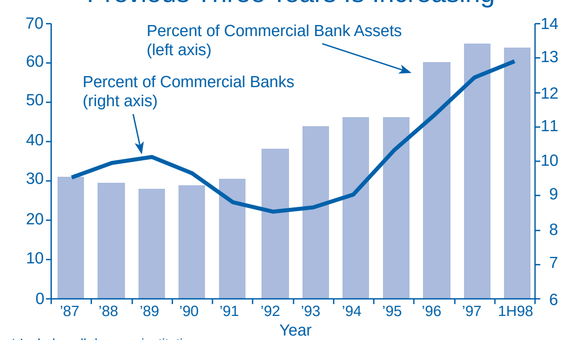
CHART 2

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.

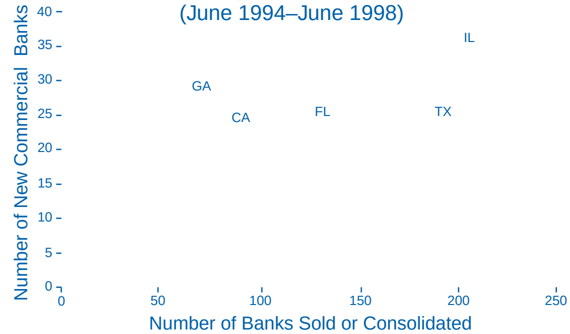
Challenges of Scale and Scope

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

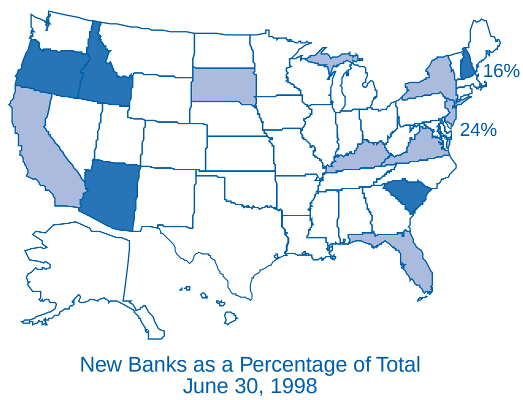
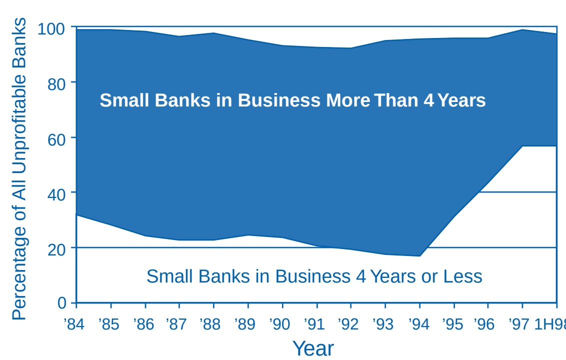


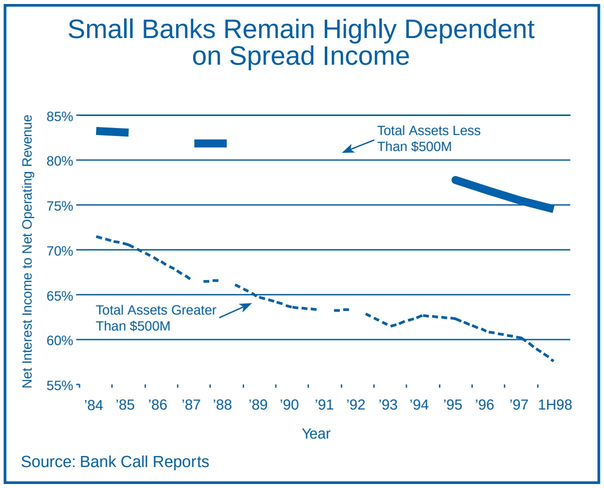
CHART 2

Recently Chartered Small Banks Comprise a Higher Proportion of Unprofitable Institutions



Source: Bank Call Reports

CHART 3



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

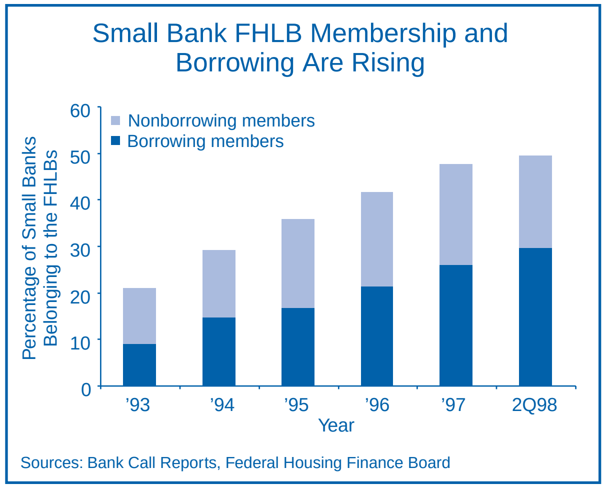
[4] *American Banker,* July 22, 1998, p. 16.
[5] *Computerworld,* May 25, 1998, p. 20.
[6] "More Banks Handing Off Nitty-Gritty of Consumer Lending," *American Banker,* June 12, 1998, p. 1.

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.

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.

CHART 4



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.

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

Regional Perspectives

- **The Region's economy continues to expand and its banks remain healthy. Instability in global markets and U.S. stock market jitters cloud the future, however.**

- **The Region's community banks are being hurt by tighter interest margins and higher costs. Lower noninterest income is weakening profitability. Small banks' earnings are more vulnerable to the flat yield curve and competition.**

- **Small businesses play a large role in the Region's economy, and competition for their business is intensifying. Declining spreads and the possibility of looser underwriting standards pose risks for the Region's financial institutions.**

Region's Economic and Banking Conditions

Region's Economy Continues to Expand

The New York Region's economy continues to grow at a moderately healthy pace. In the quarter ending June 30, 1998, 274,000 new jobs were added to the Region's workforce, an annual increase of almost 1.3 percent. The Region's employment growth rate is about one-half the nation's rate, although unemployment rates in most states are close to the national average of about 4.5 percent. Personal income growth in the Region has been picking up. The gap between growth in the Region and the nation has narrowed considerably (see Chart 1). In the first quarter of 1998, personal income in the Region rose at an annual rate of about 5.7 percent over the first quarter of 1997, compared with a 5.9 percent growth rate in the nation.

Reports from around the Region show a robust demand for housing. In the **Washington, D.C.,** area, residential sales during the first half of 1998 ran 37 percent ahead of the first half of 1997, making this the best year of this decade. Stronger demand also has been noted in the counties surrounding **New York City** and **Philadelphia**, where prices have risen to their highest levels in almost a decade. In the **Baltimore** area, home sales were up almost 27 percent in July 1998 over July 1997, marking the seventh consecutive month of increases.

Region's Banks Remain Healthy

The Region's banks and thrifts reported healthy financial conditions in the second quarter of 1998 (see Chart 2). Insured institutions in the New York Region posted

CHART 1

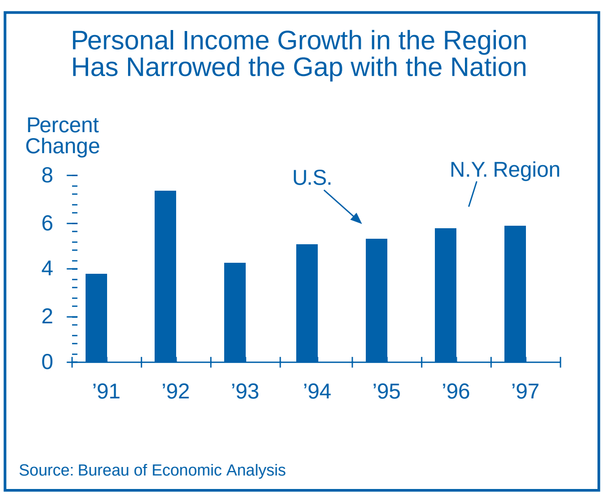
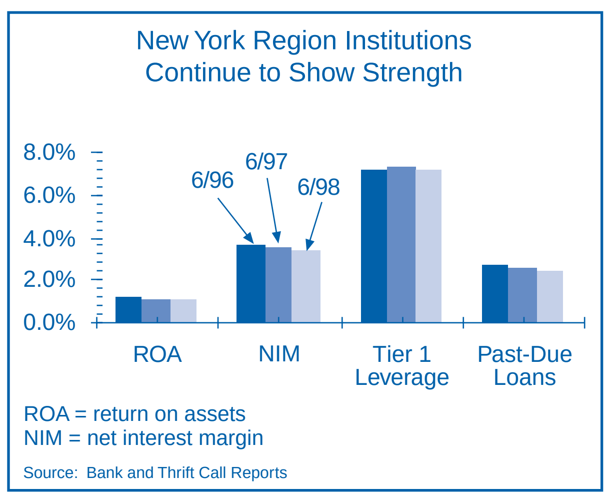


CHART 2



stable income figures. The Region's average return on assets (ROA) ratio was 1.10 percent, almost the same level as a year earlier. Financial institutions continue to bolster earnings by increasing efficiency and emphasizing fee income as a revenue source. However, the continuing trend of lower net interest margins (NIMs), the result of a prolonged flat yield curve environment (see New York's ***Regional Outlook***, Second Quarter 1998) and stiff industry competition, is pressuring the bottom line. Capital ratios remain strong but continue their slightly downward trend of the past several quarters. Reported past-due ratios are declining as well, reflecting improvement in residential and commercial real estate loan portfolios. The primary area of weakness continues to lie in credit card loan portfolios. Nonperforming credit card loans as a percentage of total credit card loans are higher than in 1996 and 1997, despite continuing high charge-off levels. Further, a larger portion of nonperforming credit card loans falls in the more severe "90 days and over past due" category than in previous periods, suggesting a prolonged weakness that will not be quickly corrected.

Instability in Global Markets and U.S. Stock Market Jitters Cloud the Future

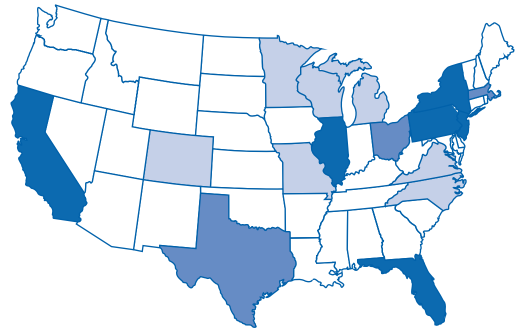
The Asian crisis and its contagion effects continue to ripple through the U.S. and the Region's economies. Currency devaluations are taking a toll on American manufacturers who export to Asia, resulting in lower aggregate production. Economists expect a further slowdown in Asian demand for U.S. goods, leading to a reduction in U.S. corporate profits.

Although the Region appears less vulnerable than the nation in general (see ***Regional Outlook***, Third Quarter 1998), the effect of the Asian crisis on the Region's economy is now more visible and more severe than initially expected. Export statistics released by the ***Department of Commerce*** as of March 31, 1998, show that exports to the Asian 10[1] countries dropped further in the Region than in the rest of the nation. Between the first quarter of 1997 and the first quarter of 1998, exports to Asia from the New York Region fell 17 percent, compared with 10 percent for the rest of the nation.

[1] The Asian 10 countries are China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

MAP 1

New York Region Residents Hold the Largest Share of Equity Mutual Fund Assets



Source: Investment Company Institute

Troubles in Asia also have led to weakened world economies and unstable global markets, including those of Russia and Latin America. The U.S. stock market has reacted negatively to this increasing global uncertainty. Beginning in mid-July 1998, the market has seen wild fluctuations and lost much of the gains it had posted over the previous year.

A stock market downturn of considerable length or breadth may have severe consequences for the securities industry ("Wall Street") and therefore for the Region's economy. Wall Street affects the Region's economy significantly more than it affects the nation's. In 1996, Wall Street activity accounted for 3.8 percent, or $50 billion, of the Region's economic output. Comparatively, it accounted for only 1.0 percent of the nation's gross domestic product. In **New York**, which has the highest concentration of securities industry employees of any state, Wall Street contributed almost 7 percent of the state's aggregate economy. A ***New York State Comptroller*** report found that Wall Street fueled about one-half of New York's real earnings growth between 1995 and 1997. As a result, a downturn on Wall Street poses a potentially greater risk to the economies of New York and New York City than elsewhere.

Another concern is the reliance individual investors place on the stock market for savings and wealth creation. During the last several years, huge numbers of individuals have jumped into the stock market as the value of equities has soared. The ***Federal Reserve Board*** has estimated that the value of stocks owned by U.S. households, either directly or through mutual funds, is now about $11 trillion, double the level of just four years ago. An ***Investment Company Institute*** analysis found that almost one-quarter of all equity mutual funds in the U.S. are owned by residents of the New York Region, the largest share of any region. Because the New York Region has only 17 percent of total households in the U.S., but 25 percent of equity mutual fund holdings, the Region is more vulnerable to market declines (see Map 1).

A sustained Wall Street slump also could have negative consequences for the Region's banks. Lower market valuations could make it more costly for banks to raise new capital. Mergers and acquisitions in the industry may slow because of lower valuations resulting from many acquirers using their high-valued stock to make purchases. In addition, fee income could be reduced for banks that have expanded into financial-market-related services. The derivative securities market also could be negatively affected. Banks in the New York Region reported more than $22 trillion of derivatives, or 78 percent of all derivative contracts held by insured institutions as of June 30, 1998. Although the effect on derivative securities depends on the type and terms of the contract, the large concentration makes the Region especially vulnerable to market volatility.

Community Banks Hurt by Tighter Margins, Higher Costs

Higher Costs and Lower Noninterest Income Weaken Profitability

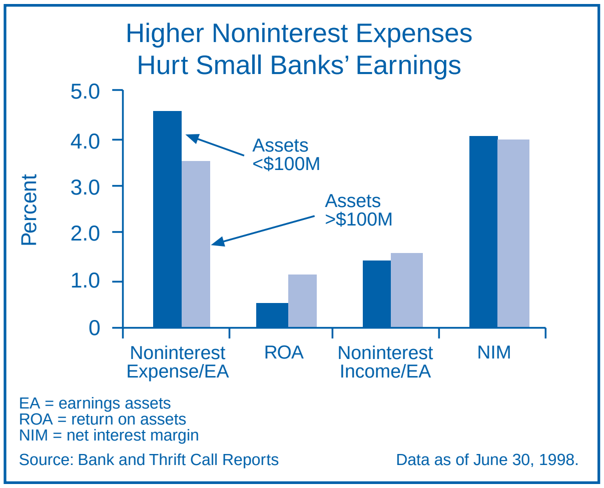
Shrinking margins, higher costs, and lower noninterest revenue are threatening the earnings growth of the Region's 277 community banks (defined as those with total assets of less than $100 million). Although most community banks posted satisfactory second quarter net income levels, analysts expect earnings to slow by year's end. The prolonged flat yield curve environment, caused by declining long-term interest rates, has led to historically low mortgage rates. Because short-term interest rates have not fallen in step with long-term rates, banks have not been able to lower their short-term deposit rates sufficiently to maintain favorable spreads. Low long-term rates also are encouraging more people to prepay mortgages by refinancing into low-interest, fixed-rate mortgages, which places further downward pressure on bank margins.

Competition among financial institutions is affecting small (herein synonymous with "community") banks' bottom lines. Banks are having to pay more and charge less to attract consumers. Mergers between larger banks often lead to increased efficiencies, both through lowering costs and increasing revenue opportunities (see ***"Merger and Acquisition Activity in the U.S. Banking Industry: Trends and Rationale"*** in this issue). Cost savings from those transactions are being used by larger banks to slash loan prices, some say by as much as 150 basis points, according to a recent ***Electronic Data Systems Corporation*** study. Further, large banks have been acquiring brokerage firms and other businesses to increase noninterest income, and are less reliant on interest spreads than smaller institutions.

One difficulty facing smaller institutions is that they generally have higher operating costs and less room to improve earnings through cost reductions. Community banks in the Region have an average ratio of noninterest expenses to earning assets of 4.3 percent, compared with the larger banks' (those with assets over $100 million) average ratio of 3.5 percent (see Chart 3). Furthermore, unlike larger institutions, community banks have not, on average, been able to reduce this ratio over the past five years; it has actually increased. Although the higher average ratio in part reflects the influence of new banks, the result is similar even when outliers are not considered. Efficiency ratios,[2] which measure effectiveness in generating revenue, are equally as telling. Small banks had an average efficiency ratio of almost 80 percent as of June 30, 1998, compared with 61 percent for larger institutions. This means that smaller institutions incur significantly higher costs to earn the same revenue as their larger counterparts. Again, larger institu-

[2] The efficiency ratio is defined as noninterest expense divided by the sum of net interest income and noninterest income.

CHART 3



tions have shown significant improvement in this ratio over the past five years, while community banks have not.

Community banks also have fewer opportunities to raise revenues through fee income. Fee income totaled just 8 percent of total income for the Region's community banks as of June 30, 1998, less than half the figure reported by financial institutions with assets over $1 billion. (Mid-sized banks, those with $100 million to $1 billion in assets, average only slightly higher fee income to total income ratio than community banks.)

When margins become tighter, smaller institutions' net income levels are squeezed more than those of larger banks, which have a more diverse revenue base. Community banks in the Region reported an average NIM of 4.12 percent as of June 30, 1998, compared with 4.29 percent on June 30, 1997. Reflecting this decline, their average ROA fell to 0.55 percent from 0.57 percent over the same period. Almost 60 percent of community banks in the Region reported lower year-over-year ROA and NIM figures. ROA figures for larger institutions reflect the positive effect that noninterest income is having on their bottom lines. Although the larger institutions' lower NIM of 4.04 percent fell 12 basis points from a year ago, their much higher average ROA of 1.19 percent is a 4 basis point improvement. Furthermore, over the past five years, community banks have seen their ROAs fall 24 basis points while larger banks have improved their ratios by 10 basis points, despite similar drops in their NIMs.

Smaller Institutions Face More Potential Risks

Although all banks face pressure on earnings as a result of the flat yield curve and increased industry competition, small banks are particularly vulnerable. Community banks are facing increased reinvestment risk; as assets with higher yields mature or are repaid, funds invested in similar assets earn the current market yield, which is historically low. For example, community banks are heavily invested in residential mortgage loans. These loans made up 59 percent of total loans in community banks in the Region as of June 30, 1998. Because of the low long-term rates over the past year, the majority of refinanced mortgage loans, including adjustable rate mortgages, are being converted into long-term fixed-rate mortgages. As a result, small banks are likely to have significant volumes of low-yielding, long-term, fixed-rate assets on their books for many years. When and if interest rates begin to rise, margins could tighten even further as liabilities, which are generally short-term and have floating rates, rise in cost.

Another risk is that banks may loosen underwriting standards as they try to make up in volume what they lose because of low rates and competition. Analysts and regulators warn that more institutions are lowering underwriting standards and therefore lending to riskier borrowers. In June 1998, the ***Federal Reserve Board***, in response to this apparently growing trend, issued a supervisory letter indicating that this is a "critical time for banks to maintain their lending discipline." The Federal Reserve further warned that "such easing [of lending terms and standards] can undermine a bank's financial health, especially if the economy weakens or the extraordinary recent performance of business profits and cash flows does not persist."

There also is the consideration that banks are venturing into unfamiliar lines of business. For example, to boost interest margins, small banks may feel the need to shift focus from low-earning assets such as mortgages to higher-earning assets such as high loan-to-value or subprime home equity loans. Such strategies will increase interest income but also increase the risk profiles of the banks' balance sheets. Also, new business lines raise the risk that banks do not have the proper expertise to price and structure new types of loans, develop or sell new products in a cost-effective way, or otherwise undertake new ventures in a prudent manner.

Small Businesses Play Large Role in Region's Economy: Competition for Their Business Is Intensifying

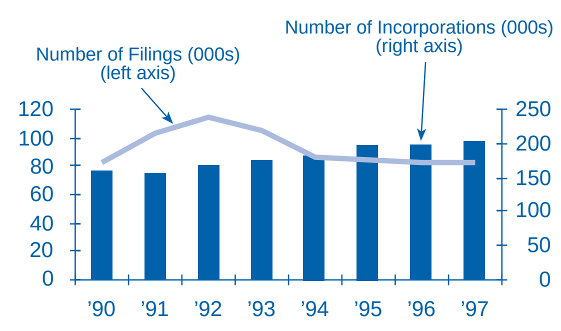
Small Businesses Spur the Economy

A vital part of the Region's economic expansion has been the growth in small businesses (defined as establishments with fewer than 100 employees). A 1995 survey by the ***Small Business Administration (SBA)*** found that almost 98 percent of all establishments in the Region were classified as small businesses. Small businesses contribute more than half of the private-sector workforce and create two out of three new jobs. The SBA estimates that small businesses produce two and one-half times as many innovations per employee as do large firms. The composition of small businesses in the Region is diverse. In **Delaware**, eating and drinking establishments are the largest small business employers. In **New York** and **New Jersey**, the largest small business employers are health care companies. Other significant small business industries throughout the Region include insurance carriers, educational services, business services, and engineering and management consulting.

The climate for small businesses in the Region has been improving. Reflecting the favorable economy, the number of new business incorporations (most of them small businesses) has recovered completely from the recession of the early 1990s (see Chart 4). Over the same time, business bankruptcies in the Region have declined, consistent with the Region's economic expansion. Although the Region's economy continues to grow, a downturn could hurt small businesses disproportionately because they generally have fewer available resources, both financial and otherwise, than larger companies.

Chart 4

New Incorporations Have Grown While Business Bankruptcy Filings Have Declined



Source: Administrative Office of the U.S. Courts, Dun & Bradstreet

Small Business Lending Is Increasingly Competitive

Competition in the banking industry extends to the small business lending sector. Small businesses are being courted by new competitors offering innovative products and approaches to delivery. While some competition is coming from outside the industry, much of the new competition is from banks venturing outside their traditional lending areas or trying to expand their customer base. Product offerings are expanding as business credit cards and lines of credit for small businesses increase in popularity. The use of credit scoring technology has reduced underwriting costs, encouraging more institutions to enter this potentially lucrative lending sector. In addition, the increasing use of the Internet by small businesses makes their banking relationships less tied to geographic location.

Another factor likely to increase competition in the small business lending arena is the SBA. The SBA recently proposed rules outlining new standard requirements for the securitization of the unguaranteed portion of SBA loans. The new proposal is intended to increase the liquidity for SBA loans in the secondary market and could encourage more banks to underwrite and securitize SBA loans. Under its 7(a) General Business Loan program, the SBA guarantees up to 80 percent of the principal loan amount of small business loans. The risk of loss on the remaining balance is borne by the lender. Nonbank lenders have been allowed to securitize the unguaranteed portion of SBA loans since 1992, but banks were prohibited from doing so until April 1997. Since then, approval of the securitization of the unguaranteed portion by banks has been made on an individual basis. The proposed guidelines address these discrepancies and apply to both regulated banks and nonbank lenders.

Commercial bank small business lending exposures in the New York Region are considerable. (For this article, small-business lending is defined as commercial and industrial loans with original amounts of $1 million or less.) As of June 30, 1998, the Region's commercial banks reported $28 billion in small business loans, amounting to 12 percent of all commercial and industrial loans. Banks with total assets under $1 billion have significantly more exposure to small business loans as a percentage of equity capital (see Table 1). Both the dollar volume and the proportional amount of small business loans have declined slightly in the Region in the past year, perhaps because of the increased competition from both within and outside the Region and the industry.

Small Business Lending Poses Potential Risks

Growing competition in the small business lending segment poses several potential risks to banks. The desire for portfolio growth or expansion into new market areas may cause some banks to lower their lending standards to capture a greater share of business. In addition, although margins on these loans traditionally have been relatively high because of inherent risk, margins are tightening as banks vie for customers. The question is raised as to whether banks are being adequately compensated for potential risks in these loans. Also, expansion into new geographic or business areas requires that management has a commensurate level of expertise.

TABLE 1

BANKS UNDER $1 BILLION HAVE GREATER EXPOSURE TO SMALL BUSINESS LENDING

COMMERCIAL BANKS WITH TOTAL ASSETS OF:	AVERAGE SBL* AS % OF EQUITY CAPITAL	
	06/30/98	06/30/97
$100 MILLION OR LESS	70.6%	69.7%
$100 MILLION TO $1 BILLION	71.6%	73.2%
$1 TO $10 BILLION	45.1%	47.7%
OVER $10 BILLION	34.7%	36.4%

* SBL = COMMERCIAL AND INDUSTRIAL LOANS UNDER $1 MILLION
SOURCE: BANK CALL REPORTS.

The heavy reliance of small business on banks for financing could pose a threat if the economy falters and small businesses suffer substantial hardships as a result. Therefore, due diligence and credit review should include taking into consideration the possibility of an economic downturn, especially in light of the length of the current expansion.

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For More Information

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