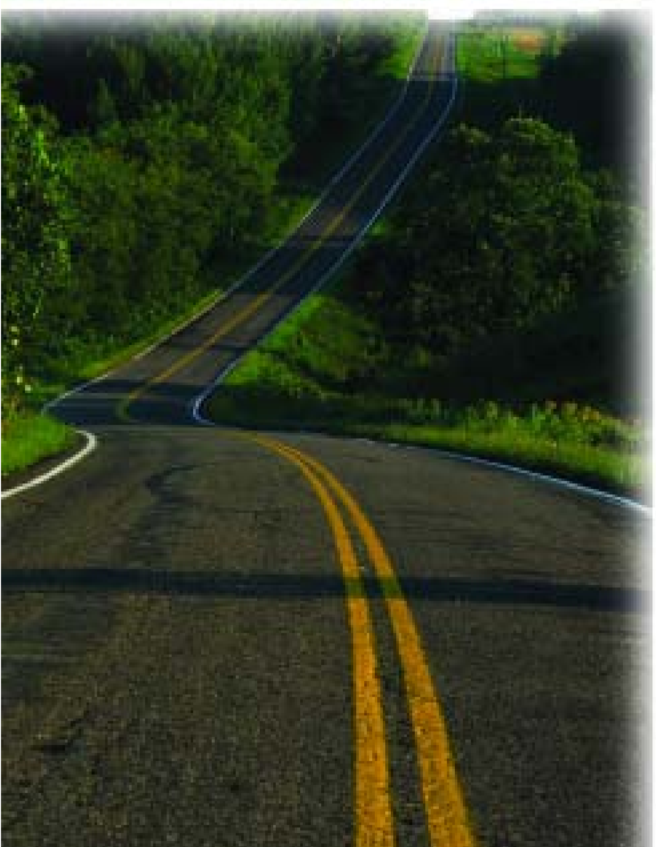
CENTER FOR THE STUDY OF RURAL AMERICA
Federal Reserve Bank of Kansas City

November 2001

The Main Street Economist

Commentary on the rural economy



The Transformation of Banking: What Does It Mean for Rural Economies?

William R. Keeton
Senior Economist
Federal Reserve Bank of Kansas City

The banking industry has undergone profound changes during the last decade. The most obvious change has been the large number of bank mergers, which have increased both the average size of banks and their territories. Other changes just getting under way may also prove dramatic—the growth of Internet banking and the combination of banking with other financial services, such as insurance and securities underwriting.

What do these changes mean for rural economies? To help answer this question, this article focuses on the two groups that are most likely to be affected by the transformation of banking—consumers and small businesses, both of which have always relied heavily on local banks for their credit and payments needs. After weighing the evidence, the article concludes that the recent changes in banking are likely to benefit both groups, as long as they remain free to choose between small and large banks for their banking services.

Major changes in the banking system

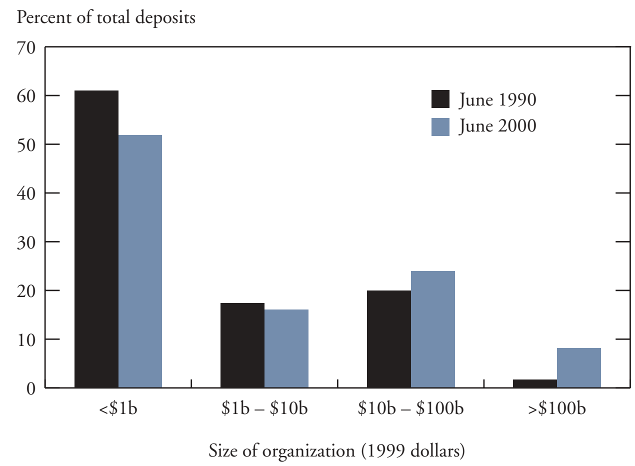
One of the biggest changes in the nation's banking system has been *consolidation*. While mergers have been going on for a long time, the pace accelerated in the 1990s. Some of these mergers took advantage of new laws allowing banks to expand within and across state lines. Other mergers were undertaken to cut costs, although the evidence more often than not suggests they failed to achieve that goal. Merger activity has subsided more recently, and some experts believe the decline is more than just a temporary pause. Even if merger activity does not return to previous levels, however, mergers have already changed banking in important ways.

One important effect of the recent merger wave has been an increase in the role of large banking organizations (Chart 1). The biggest change here has involved the so-called megabanks—banks with more than $100 billion of assets. Such banks are much less important in rural markets than urban markets, but their share of rural deposits still increased considerably during the 1990s—from only 1.7% in mid-1990 to 8.2% in mid-2000. The rural deposit share of regional and super-regional banks ($10 to $100 billion range) also rose over the period, though not quite as much. These gains came mostly at the expense of community banks (less than $1 billion in assets). By mid-2000, these smaller banks still controlled 51.7% of rural deposits, but that share was down from 61.0% ten years earlier.

Another effect of mergers has been a sharp rise in multistate banking. Many of the mergers in the 1990s were between banking organizations from different states. As a result, there was a big shift in ownership of deposits from organizations based in the same market or the same state to organizations based in another state. This shift in ownership has been important in rural markets as well as urban markets (Chart 2). By mid-2000, 28.8% of rural deposits were in banks or branches or out-of-state banking companies, compared with only 12.5% in mid-1990. Some of this increase in out-of-state ownership came at the expense of banking companies located elsewhere in the same state—for example, companies headquartered in nearby cities—but most was at the expense of strictly local banks.

Chart 1

Distribution of Rural Deposits by Size of Banking Organization



Source: Reports of Condition and Income, National Information Center Database

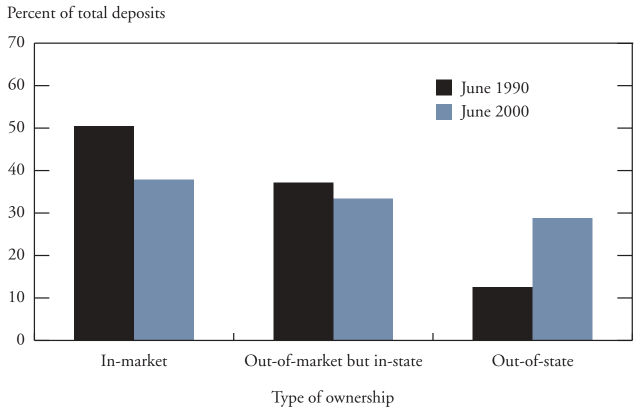
The second way banking is being transformed is through *Internet banking*. The most comprehensive data on Internet banking are collected by the Office of the Comptroller of the Currency for nationally chartered banks. By the fourth quarter of 2000, 37% of national banks allowed their customers to conduct online business, such as verifying account information, transferring funds, paying bills, or applying for loans. That figure was up from only 6% in the second quarter of 1998.

Large banks have made the biggest commitment to Internet banking, but after getting off to a slow start, small banks have begun to catch up. As late as the third quarter of 1999, Internet banking was offered by all national banks over $10 billion in size, but by only 27% of banks between $100 million and $1 billion, and by only 7% of banks under $100 million. By the fourth quarter of 2000, a little more than a year later, the proportion of banks in the two smaller size groups with Internet banking had jumped to 51% and 20%, respectively.

The final often-cited change in the banking system is *financial integration*—the spread of diversified financial firms offering a wide array of financial services in addition to traditional banking. Some movement in this direction occurred in the 1990s, as banks took advantage of loopholes in the laws restricting what they could do. But the trend toward financial integration could well accelerate due to passage of the Gramm-Leach-Bliley Act (GLBA) in late 1999. This law made two major changes. First, it allowed bank holding companies to merge with insurance and securities companies and cross-sell their products. Second, it allowed bank holding companies that did not merge with other firms to offer new financial services on their own—for example, underwriting securities, selling or underwriting insurance, and making equity investments in business firms.

While GLBA has been widely expected to spur more mergers between large banking organizations and other financial companies, the new law could also end up broadening the array of financial services offered by smaller banks. Although too small to underwrite securities and insurance, many small banks might take advantage of the new authority to sell insurance or engage in merchant banking through the purchase of equity in small businesses. Indeed, hundreds of banking organizations under $1 billion in size have already converted to Financial Holding Companies

Chart 2
Distribution of Rural Deposits by Geographic Ownership



Source: Summary of Deposits, National Information Center Database

(FHCs), as required to offer the new financial services. These organizations represent only a small fraction of all banking organizations under $1 billion in size but are more numerous than most analysts expected when the law was passed.

Impact on consumers

How have these changes touched consumers in rural communities? One way mergers could harm consumers is by reducing competition in local banking markets. Some economists argue that banks in highly concentrated markets are less likely to compete with each other for customers by offering superior service or better rates.

As it happens, however, the merger wave of the 1990s has increased the concentration of urban banking markets only slightly and rural banking markets not at all. One reason is that most mergers have been between banks in different markets. The other reason is that when banks in the same market have merged, regulators have often required them to divest some of their branches.

While local market concentration overall has increased only slightly, it does not necessarily follow that consumers will feel no adverse effect from mergers. The last few years, annual surveys by the Federal Reserve have consistently found that large multistate banks charge higher fees for many retail banking services than smaller single-state banks. Some analysts suggest that consumers may not mind higher fees because they view large multistate banks as offering higher quality service and greater convenience—for example, the ability to conduct business at a wide range of locations. Others suggest the higher retail fees may reflect the fact that large multistate organizations depend less on retail customers for their funds and therefore feel less need to hold down fees for those customers.

Whatever the explanation, the difference in fees suggests that most communities will be best served if their small banks remain viable, so that consumers have an alternative to paying the higher fees charged by large multistate banks.

Internet banking would seem to hold clearer benefits for consumers, although different than originally anticipated. It was once thought that the cost to banks of online transactions would be much lower than the cost of traditional transactions through a normal branch, allowing consumers lower fees or higher deposit rates. This hope has not been realized for customers, mainly because banks themselves have not reaped significant cost savings. One reason is that online banking has not enabled banks to cut back on their traditional delivery channels as much as initially hoped. Specifically, consumers have demonstrated that they strongly prefer the "click and bricks" approach to pure online banking, forcing banks to maintain their costly branch networks.

Rather than lower fees, the main benefit of online banking to consumers is likely to be greater convenience. Through online accounts, for example, consumers can now pay their bills by creating a list of regular payees and then instructing the bank to make payments as they receive the bills, either by electronic funds transfer or paper check.

In very small communities, online banking may have the additional benefit of improving access to financial services. In particular, when such communities prove to be too small to support a brick-and-mortar branch, the Internet may provide another way for people to invest their money and take out loans. To be sure, many rural communities currently lack high-speed Internet access because their low population density has discouraged private investment in broadband infrastructure. However, people in these communities can still access the Internet through dial-up services, which are sufficient to take advantage of the online banking services now offered.

Finally, financial integration could turn out to be a nonevent for most consumers. GLBA should make it easier for consumers to purchase a wide variety of financial services from a single organization. It is unclear, however, how much consumers value such one-stop shopping. Empirical studies have found no evidence that customers are willing to pay more when banking services such as lending and deposit-taking are provided by the same bank than when they are provided by separate banks. Furthermore, companies such as Sears have offered consumers one-stop shopping for financial services in the past and met with little success. Finally, the growth of the Internet has made possible an alternative to one-stop shopping, known as the portal model. Under this approach, consumers use a single website to access a wide array of services offered by unrelated companies.

Impact on small businesses

One effect of mergers has been to increase the importance of large, widely dispersed banking organizations. Some people worry this change will end up reducing credit to small businesses. Large widely dispersed banks often end up giving their local lending officers less autonomy in making loans because it is difficult for the head office to monitor and review thousands of credit decisions. These organizations often prefer to base their credit decisions on credit scoring models—statistical models that predict a borrower's probability of repayment based on such characteristics as personal wealth and past credit history. Some people argue that this more rigid approach to small business lending results in many good borrowers being turned down. Not everyone agrees with this view, however. Some people even argue that mergers could increase small business lending because large multistate banking organizations are less vulnerable to regional economic shocks and have greater access to nondeposit funds, allowing them to make more loans.

Empirical studies disagree on whether small business lending declines more when banks are acquired by in-state or out-of-state organizations. For the most part, however, the studies agree that small business lending declines when the acquiring organization is large. Since most out-of-state acquisitions have been by large organizations, the studies tend to support the view that the emergence of large multistate banking organizations has reduced small business lending at the offices making up these organizations.

At first glance, such evidence would appear to be bad news for the many rural communities that depend on their small businesses for job and income creation. Two factors, however, have helped offset this adverse effect of mergers on small business lending.

First, a number of large multistate banking organizations have made a conscious effort to increase their small business lending—for example, by giving local lending officers more discretion in granting loans and trying hard to provide personal service.

Second, in those cases in which mergers have reduced small business lending, smaller banks have often stepped in to fill the gap. This response by small banks has occurred partly through existing banks making more loans and partly through new banks entering the industry.

One indication that such factors have been enough to maintain the supply of small business credit comes from surveys of small businesses taken in the second half of the 1990s, when the merger wave was at its height. These surveys consistently found that credit availability was not an important concern of small businesses, ranking well behind other issues such as labor shortages, taxes, and health care costs.

As in the case of consumers, the main benefit of online banking to small businesses is likely to be greater convenience. For several years, large businesses have enjoyed electronic access to their banks through private computer networks. Internet banking is now extending that access to smaller businesses. Some bank websites allow small business customers to view their balances in real time, transfer money between accounts, and originate wire transfers. A smaller number of bank websites also offer cash management services and payroll services.

Industry observers predict that more banks will offer such services over time because small businesses are among their most profitable customers. Some experts also believe major innovations in payments practices such as business-to-business commerce and electronic billing will make online banking even more useful to small businesses in the future.

Finally, financial integration is likely to prove more beneficial to small businesses than to consumers because of the greater potential for cost savings from information sharing. Among the new financial services authorized by GLBA, the most relevant to small businesses are property and casualty insurance and private equity investment, services that until now have been provided largely by firms outside the banking industry. To maintain a long-term credit relationship with a small firm, a bank must become familiar with the firm's business and keep track of its financial condition. An insurance company or merchant banker may need to acquire similar information about the firm to provide it with property and casualty insurance or private equity financing. Having one financial company provide all these services could reduce the total cost of investigating and monitoring the firm, allowing the firm to be charged a lower price for the services and helping relieve the critical shortage of equity capital in rural communities.

Conclusions

The banking industry is undergoing three major changes—the consolidation of the industry, the spread of Internet banking, and the increased freedom to combine banking with other financial services. On balance, these changes will probably benefit most consumers and small businesses in rural communities. Such an outcome will be more likely, however, if small banks can continue providing a low-cost alternative for retail banking services and continue filling gaps in small business credit created by mergers.

Small banks face many challenges in filling this role, not the least of which is continuing to attract an adequate supply of funds from rural investors. How well small banks meet these challenges will ultimately determine how rural economies fare in the nation's new banking system.

Suggested Readings

Barth, James R., R. Dan Brumbaugh Jr., and James A. Wilcox. 2000. "Policy Watch: The Repeal of Glass Steagall and the Advent of Broad Banking," *Journal of Economic Perspectives*, Spring.

Berger, Allen N., Rebecca S. Demsetz, and Philip E. Strahan. 1999. "The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future." *Journal of Banking and Finance*, February.

DeYoung, Robert. 1999. "Mergers and the Changing Landscape of Commercial Banking (Part I)," Federal Reserve Bank of Chicago, *Chicago Fed Letter*, September.

Furst, Karen, William W. Lang, and Daniel E. Nolle. 2001. "Internet Banking in the U.S.: Landscape, Prospects, Industry Implications," *Capco Journal of Financial Transformation*, September (available at www.occ.treas.gov/netbank/netbank.htm).

Keeton, William R. 2001. "The Transformation of Banking and Its Impact on Consumers and Small Businesses," Federal Reserve Bank of Kansas City *Economic Review*, First Quarter.