



Changing Banking Structure

As community banks evolve, their emphasis on customer service remains

Businessman Thomas Hartline (above left) was looking for just the right sized bank—one big enough to fund his loan, but small enough to know its customers by name.

For Hartline, who is based in California and recently started Navitas Utility Corporation in Eakly, just outside Oklahoma City, it also was important his bank have a strong local presence.

He chose Bank2, which met all his criteria with one other selling point: It's owned by the Chickasaw Nation. He has heritage with the tribe.

"We wanted a bank that understands the people and that is close to the people," Hartline says.

With more than \$85 million in assets, Bank2 has grown since moving to the capital city, but to customers, it may still feel like the \$7.5 million asset bank that was located in rural Davidson, Okla.

Such transitions—and subsequent growth—are not unusual. During the past few decades, tremendous changes have occurred in the U.S. banking industry and among community banks in rural areas, particularly as

they move into metropolitan markets, expand further in rural markets or add branch offices, say Jim Harvey and Ken Spong, both policy economists at the Federal Reserve Bank of Kansas City.

"As an outgrowth of changes in the industry, banking has been greatly transformed within just a few decades," Spong says.

To determine strategies that community banks are adopting, Harvey and Spong examined consolidation, merger and expansion trends in the Tenth Federal Reserve District states, which include Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and New Mexico.

A commonly perceived role of community banks is to maintain relationships with customers while bringing banking services to those who might not have their financial needs met by larger institutions.

Says Hartline, "That's how I ended up picking Bank2."

Bank expansion: Metro vs. rural

Community bank expansion has occurred in a number of ways, including acquiring or

opening offices in similar markets, opening branch offices in fast-growing areas, or moving the headquarters into another market.

“It didn’t make a lot of sense to stay there,” says Ross A. Hill, Bank2 president and CEO. “Geographic changes are prompted by business opportunities.

“I think it’s an emerging trend (to move to a metro area) because, especially in Oklahoma, that’s where the people are, that’s where the market is and that’s where the opportunity is.”

While expansion by rural community banks into metro markets is a growing trend, the number of rural banks that have done so is still relatively small. There are six times as many institutions in the District operating solely within rural markets compared to the number of rural banks that have established a

and a broader customer base.”

Harvey and Spong looked at banks and banking organizations operating in the District’s states that had less than \$500 million in assets at the end of 2006. This size of bank typically is focused on providing community banking services.

Some of their findings include:

Location and structure: The vast majority of these community banks have the same rural or metro market focus, including 421 banks that now operate solely within rural markets. However, 102 rural banks were operating branches in metro markets in 2006, and 10 others moved their main office into a metro area between 2000 and 2006.

Rural banks that switched their head office to a metro area or have metro branches reached

“ Geographic changes are prompted by business opportunities. ”

significant metro presence.

One such institution is the family-owned Security State Bank in Basin, Wyo., which has expanded since 2000. Relaxed interstate banking laws made branching possible; population growth presented the opportunity, says President Ron Boyd.

“We’re in a booming little economy here,” Boyd says. “Everywhere (in Wyoming) has more banks.”

Security State has opened branches in nearby towns with significant growth, such as Gillette, where coal mining and other industries have boosted the population. The owners want to open another branch in a similar-sized area in the next few years, Boyd says.

Harvey and Spong examined how banks, like Security State, have performed in different types of rural markets and whether some markets are more attractive than others.

“We found community banks have had some success in achieving greater growth,” Spong says. “This expansion may have also led to other benefits, such as better risk diversification

a greater average asset size in 2006 than other community banks. These banks also have grown rapidly during the past five years (more than 100 percent growth in assets for those that moved headquarters or established branches after 2000), while banks that remained in rural areas grew slower at an average rate of 23.5 percent.

Earnings: Rural banks that have expanded into metro markets overcame the initial adjustment costs and brought their operating incomes close to those of other community banks. Banks in rural markets with the most rapid population growth, though, still have the highest operating incomes.

Capital: Banks that moved headquarters or established branches in metro markets were able to fund this expansion with little, if any, decline in capital ratios.

Loans: Rural banks that have expanded into metro areas also have done well finding new lending business. One measure of their lending efforts—total loans as a portion of all their assets—is well above what other rural and metro community banks have achieved. Among the

banks operating entirely in rural markets, those in multiple rural markets and in faster growing markets also have more of their assets devoted to lending.

Liquidity and core deposits: Compared to other community banks, those that have moved headquarters or established metro branches initially appear to have been less successful in maintaining their liquidity and attracting core deposits. This outcome indicates it may be hard to quickly establish a local base of depositors in a new market, in turn forcing new entrants to make greater use of alternative funding sources that may be more expensive and not as stable.

Efficient operations: As startup costs decrease, rural banks expanding into metro areas are approaching or exceeding the efficiency of other metro banks.

Banking consolidation

This community bank expansion is occurring during a time of rapid consolidation within the banking industry.

By 2006, the number of banks operating nationwide had dropped to about half of those operating in 1980. However, the number of banking offices, which includes main offices and branches, had jumped by about two-thirds, leaving customers with more convenient access, although via fewer banks.

Another major change is the significant rise in the share of all U.S. banking deposits held by the largest organizations—jumping from 17 percent in 1985 to 44 percent in 2006 for the 10 largest banking organizations, according to Harvey and Spang's research.

The dramatic increase in interstate banking is also significant. In 2006, banking organizations surprisingly held roughly the same amount of deposits in other states as they held within their home state.

Although merger activity by large banks has drawn most of the attention, the vast majority of mergers have involved community banks either as a target or as an acquirer.

A number of factors are behind these trends.

Technological change has improved communication, allowing banking organizations to



market to a broader range of customers.

Financial innovations, such as automated underwriting systems, credit scoring and securitization, allow banks to reach and fund a broader range of customers.

Banking regulations have changed to authorize unlimited statewide branching in almost all states and interstate banking on a nationwide basis.

Much of the decline in the number of banks can be attributed to separately chartered banks being converted to branches of other banks. In some cases, these conversions involved multibank organizations using liberalized branching laws to convert their banks into a single branching network. Others were from acquisitions of existing or failing banks (nearly 1,600 banks failed since 1980). These consolidation trends are even more remarkable given that nearly 5,000 new banks opened since 1980, Spang says.

Banking consolidation and the decline of banks in the District are similar to nationwide changes—a sign that banking organizations in the District are also responding to the adoption of more liberal branching laws and other expansion incentives, Harvey says.

One notable difference in the District: The number of banking offices jumped 126 percent from 1980 to 2006. This increase greatly exceeded the pace nationwide and generally can be attributed to the easing of restrictive



branching laws in many District states.

“A significant part of the banking population in the District appears to be operating under a much different structure now than several decades ago,” Harvey says.

Others, though, have continued under their traditional framework and still grow, such as Thunder Bank. Located in Sylvan Grove with a branch in nearby Hunter, it serves an 80-mile vicinity in north central Kansas.

“We’ve been very successful,” says Mark Obermueller, president and CEO. “We’re able to grow without being located in a metropolitan area.”

It would take too much capital to move into a larger market, he says, adding that Thunder Bank’s profits are agriculture-driven. It is also able to make significant home and commercial loans.

“The bank has grown a lot in the last few years,” Obermueller says. “It’s working for us.”

Future movement

“Overall, our analysis suggests that rural banks moving into metropolitan markets are now matching, or close to matching, the performance of other metropolitan and rural banks while generating higher loan and asset growth,” Spong says.

Harvey and Spong’s research suggests banks with multimarket operations are likely to achieve greater size, higher growth rates and

expanded lending opportunities.

They caution that banks expanding into multiple markets may have begun with more financial resources on average than banks that didn’t expand. Expanding banks may have had more previous success as well. Both would provide the incentive and ability to expand while other banks may not be in a position to move into new markets.

“Consolidation and rural bank expansion seem certain to continue,” Spong says. “Expansion will clearly depend on both the opportunities that arise and the growth of individual markets.”

Many small rural banks operate in slower growing markets, and a number of these banks may seek to expand or merge with other banks to take advantage of opportunities in faster growing markets. The amount of future consolidation thus will depend on the continued growth of metro markets, the emergence of other areas of growth and other factors as well.

Harvey and Spong acknowledge it will be important for community bankers to construct sound growth strategies and provide the appropriate financial and managerial resources.

“This will help ensure community bankers direct resources to where they are most needed,” Harvey says, “while bringing financial services to customers seeking that community banking relationship.”

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FURTHER RESOURCES

“THE CHANGING BANKING STRUCTURE: WHAT EXPANSION STRATEGIES ARE COMMUNITY BANKS ADOPTING?”

By James Harvey and Kenneth Spong
www.KansasCityFed.org/TEN

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