



CHANGING TIMES

Community bank mergers increase since the recession

A number of small and medium-size banks have voluntarily merged or consolidated operations since the Great Recession due to shrinking profit margins, tepid loan demand, low interest rates and the demand and cost of staying current with banking technology and regulations. These voluntary mergers have significantly reduced the number of community banks.

The decline, however, isn't necessarily a recent event; rather it is part of a 30-year trend. The number of U.S. banks has dropped from about 14,500 in the mid-1980s to 5,600 today. Recent research by Kansas City Fed economists indicates the decline happened for many reasons, "such as failures during periods of crisis, consolidation spurred by the relaxation of state-branching and national interstate banking restrictions, and voluntary mergers between unaffiliated banks."

Voluntary mergers

An analysis by Kansas City Fed economists found that since the end of the Great Recession voluntary mergers have been the primary reason for the decline in community banks. Even in the crisis periods of the late 1980s, early 1990s, and 2007-09, the number of mergers exceeded the number of failures every year.

Troy Davig, senior vice president and director of research, Charles S. Morris, vice president and economist, and Kristen Regehr, assistant economist, at the Federal Reserve Bank of Kansas City, and Michal Kowalik, a financial economist at the Federal Reserve Bank of Boston, studied bank mergers from 2011-14. They analyzed the financial characteristics of banks with assets of \$1 billion or less that were acquired by an unaffiliated bank. They focused on community banks because mergers

involving larger banks are rare, particularly banks with assets of more than \$10 billion.

“For example, about 90 percent of the 1,500 mergers since 2007 involved a bank with less than \$1 billion in assets,” the economists explained.

The economists say the owners of acquired banks may have sought to exit the industry by selling their businesses, while acquiring banks may have looked for opportunities to expand. The acquired banks were generally smaller, less profitable, less efficient and in weaker condition—more susceptible to future financial problems—than nonacquired banks.

Acquiring banks can gain several benefits from mergers. Banks can expand their business and revenue quickly and reduce risk by diversifying asset portfolios, funding sources and fee-generating activities. Acquiring a bank that operates in different markets or business lines will often increase diversification. To reduce risk, however, the acquiring bank

must have a strong understanding of the new market’s characteristics and risks, along with expertise in new business lines. Otherwise, the risk of the combined institution could increase.

A stronger future

President and CEO Tom McGavran had put the State Bank of Delphos, Kan., up for sale last year.

“He felt the best option for the continuing of his bank was to sell it to another community bank, to merge with another bank that would have the same values and relationship-style banking that he has done,” said, David Brownback, president and CEO of Citizens State Bank, which acquired State Bank of Delphos and merged operations in March.

“We are very similar banks,” Brownback said. “We’re relationship bankers. We’re conservative, we’re rural. We know rural county-seat banking; we’re also ag banks.”



DAVID BROWNBAC, president and CEO of Citizens State Bank of Ellsworth, Kan. His bank recently merged with State Bank of Delphos in Delphos, Kan.

The operational size of Citizens doubled when it acquired State Bank of Delphos' locations in Delphos, Minneapolis and Glasco. Citizens, based in Ellsworth, Kan., now has six offices in five communities. Its total assets grew from \$120 million to more than \$160 million.

Unlike many bank mergers, McGavran and his employees stayed on to manage and operate the former State Bank of Delphos locations.

"He's an outstanding banker and I've known him for many years," Brownback said of McGavran. "We will certainly use the expertise of his staff. They're very good bankers."

Brownback said it was an "ideal acquisition" for Citizens—helping grow its customer base and strengthening its future. The bank now has a presence in a four-county area in north central Kansas. The merger also is ideal for former State Bank of Delphos customers. Because of Citizens' size, it's able to offer its new acquired customers more services, such as fixed-rate residential real estate loans and trust services.

"They weren't able to offer that before the acquisition," Brownback said.

Overhead costs for community banks have increased in recent years due to technological advancements and new regulations.

"By growing we can spread that cost over a bigger base, so we can become more efficient as we grow," Brownback said. "I think there is a limit, but I think we haven't reached it."

Because there are fewer community banks, Brownback said, it may appear that banks are struggling, or worse, failing. When he was a bank examiner in the 1970s, there were more than 600 banks in Kansas. Today, there are more than 200.

"We are becoming more efficient, not weaker" he said. "We certainly have more locations than in 1977, and offer more services, especially with the improvements in technology, than ever before."

Changing times

Steven Burrus, senior vice president at American Heritage Bank, headquartered in Sapulpa, Okla., thinks the mergers represent a change in the community banking system, and more broadly, changes in rural Middle America.

"Many community banks had three generations of family who ran them, but now they don't have anyone who wants to take over," Burrus said. "It's just me talking, but the next generation doesn't always want to continue in the banking business. That fourth generation wants to be an architect in Minneapolis or a doctor in Chicago."

He says community bank mergers and consolidations reflect what's happening in many rural communities.

"I recently read about how small cities in western Kansas are considering consolidation because of the loss of population," he said.

The loss of population and businesses in rural communities makes it difficult for small community banks to provide services because the community can't generate the business necessary to stay viable.

"We see it as banks have to get to a certain size to remain viable, at least in my opinion, given the regulatory environment we're in," Burrus said.

Many small community banks can't afford full-time compliance officers and the staff needed to implement and comply with today's banking regulations, especially with the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Burrus said.

The current low-rate interest environment also has made it difficult for smaller community banks, Burrus said. Although low interest rates can encourage consumer spending, such as purchases of automobiles and homes, it can discourage people from saving and investing long term. For community banks that rely on long- and short-term maturity, low interest rates shrink profit margins.

“There is so much more we have to do as bankers,” Burrus said. “We had to get to a certain size to make it all work. Many smaller banks don’t have the capital or the community to make it work.”

American Heritage, headquartered southwest of Tulsa, merged with two banks in 2012—Osage Federal Bank and Cleveland Bank, both of Oklahoma—and acquired First National Bank in Pawhuska, Okla., in March.

By acquiring more banks, American Heritage can share expenses among the locations by consolidating certain operations, such as compliance, auditing and accounting. They also have strengthened other operational areas of the bank with the acquisitions, such as the formation of loan and data centers.

The mergers also helped American Heritage grow its services. For example, Osage Federal’s niche was single-family residential home loans that it sold directly to Freddie Mac.

“It really gave us some skill sets and products we haven’t offered before,” Burrus said.

The mergers are central to American Heritage’s business model, which is to provide

community banking services to smaller communities.

“We believe in that banking model,” Burrus said. “We’re a \$1 billion balance sheet, but we’re not the large complex big bank in the big city making complex things happen.”

But to make it work, American Heritage has to continue to grow. And for Burrus, if community banks don’t remain strong, who will provide services to communities with smaller populations?

“What large bank is going to care about a small town’s needs?” Burrus said. “Who’s going to buy that bond for the public school?”

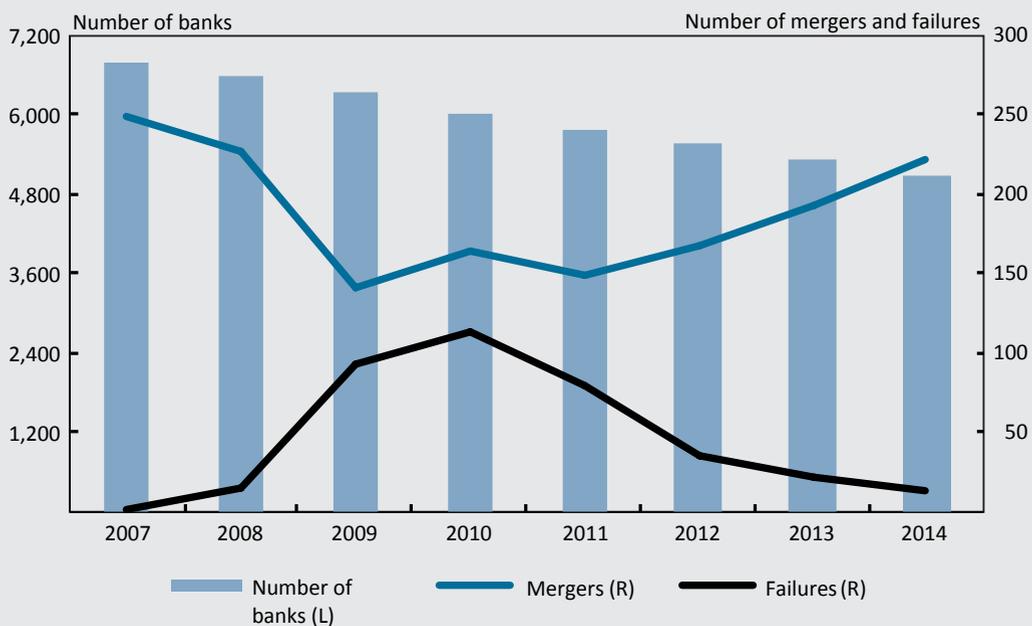
The consumer, the small businessman will find it difficult to live and prosper in rural communities, Burrus said.

“What’s going to happen to small town America?” he added.

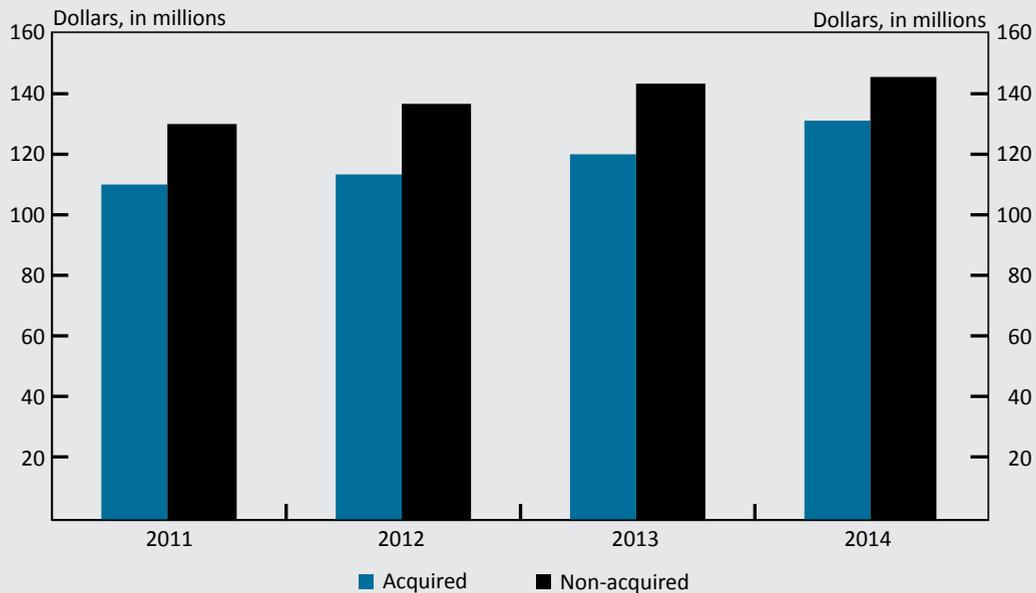
Improving economic conditions help spur mergers

Economists say from 2011 through 2014, voluntary mergers increased each year. Mergers increased from 73 in 2011 to 162 in 2014. Improvement in overall economic and banking

Change in the number of community banks since 2008



Median total assets of acquired and nonacquired banks



conditions since the recession may partially explain the increase in mergers.

The economists say, “Improved economic conditions make potential targets more attractive due to their healthier portfolios and the stronger markets in which they operate. Furthermore, improved economic conditions strengthen potential acquirers, giving them greater ability to acquire new banks.”

Generally, a median acquired bank is about 15 percent smaller than its peers. A bank’s condition can be measured in many ways, but capital tends to be the first measure analysts examine. In many of the mergers economists examined, losses resulting from the crisis left banks with less capital available to cover unexpected losses, making it more difficult for these banks to make new loans.

“The results suggest that mergers on average result in more efficient banks and a sounder banking system, which should lead to greater access to credit at lower cost, and thus, be beneficial for local communities,” the economists explained.

The benefits of mergers, however, can be offset if mergers make local banking markets less competitive and reduce the communities’ access to banking services and credit. Although

federal banking regulatory agencies monitor mergers and balk on mergers that could result in uncompetitive markets, the economists say more research is needed to determine the entire effect of bank mergers on local communities.



KEVIN WRIGHT, EDITOR

FURTHER RESOURCES

“Bank Consolidation and Merger Activity Following the Crisis”

By Michal Kowalik, Troy Davig, Charles S. Morris, and Kristen Regehr

www.KansasCityFed.org/publications/research/er

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.