



The changing nature of banking

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As trusted financial intermediaries, banks have long served a unique role in the U.S. financial system.

“During the past 25 years, however, deregulation and technological innovation have dramatically changed the banking industry,” says Esther George, senior vice president of the Supervision and Risk Management Division at the Federal Reserve Bank of Kansas City. “Competition is intense, resulting in evolving operations and expanded services and products.”

George recently examined these changes and their effects on banks’ current and future role. She presented her findings to the Federal Reserve Bank of Kansas City’s board and the Bank’s Denver, Omaha and Oklahoma City Branch boards of directors.

Historically, state regulations limited banks’ ability to establish branches, and, in

turn, limited customers geographically—they banked locally or within their state. Other regulations limited the services banks could offer.

As laws changed to accommodate more growth opportunities, the industry experienced heightened acquisition activity as banks merged and consolidated. Banks expanded their geographic footprint by buying other banks or opening new branch offices, and by using technology to reach more customers. As a result of these regulatory changes and technological innovations, banks have merged, consolidated and branched, offering one-stop shopping and an array of customer services.

“I think the big thing is the constancy of change, (and) the magnitude of change,” says Bruce K. Alexander, president and CEO of Vectra Bank, a \$2.4 billion bank in Denver.

Despite significant changes, many in the industry say there is at least one constant:

“Banks remain vital to both the economy and financial intermediation,” George says. “And they will continue to be vital in the future.”

An evolving nature

Size: Mergers and branches

The movement to statewide branching in the mid-1980s caused the number of banks to decline drastically as banks merged and consolidated.

“Although the number of banks in the Tenth District declined by roughly 50 percent in the past 25 years, the loss of a bank doesn’t necessarily mean an area is no longer served by a banking office,” George says. “Often, main offices of banks became branch offices of other banks.”

The decline in the number of banks was offset by an increase in the number of bank branches, which more than doubled between 1980 and 2005.

Nationwide, mergers led to a decline in the total number of banks—from 14,414 in 1985 to 7,457 in 2005. The total number of bank offices, which includes both bank branches and head offices, increased by 60 percent to 78,505.

As new bank offices have flourished in the District, ownership of banking offices also shifted to out-of-state banking organizations. As late as 1990, most bank offices were owned by in-state banking organizations. However,

branching laws were relaxed.

Industry assets are becoming more concentrated among a small number of large banks. In 2005, roughly 80 percent of the industry’s assets were concentrated in just 53 of the largest banks with assets greater than \$20 billion. These banks held \$6.3 trillion of the industry’s \$7.9 trillion in combined industry assets.

Technology

Technological innovations are also changing the nature of banking and how banks serve customers. Similar to the growing number of bank branches, ATM deployment has grown rapidly through the years with nearly 400,000 machines in use in 2005. ATMs, bank branches and online banking not only increased the ways banks could reach customers, but also aided in attracting customers.

“It’s these technological innovations in service delivery that have not only changed banking,” George says, “but also largely shaped it.”

Although relationship banking may still be a part of today’s business model, electronic banking technologies are reducing consumers’ dependence on personal interaction. Today, customers can obtain many services without entering a bank—a growing percentage of households are using electronic banking while banking in person is leveling off.

“This is leading to increasing competition among banks, as both large national and

“ In the face of growing competitive pressures, banks still have a special role to play in the financial services industry. ”

by 2005, out-of-state banking organizations owned one-third of the banking offices in the District, putting District banks face-to-face with national competitors.

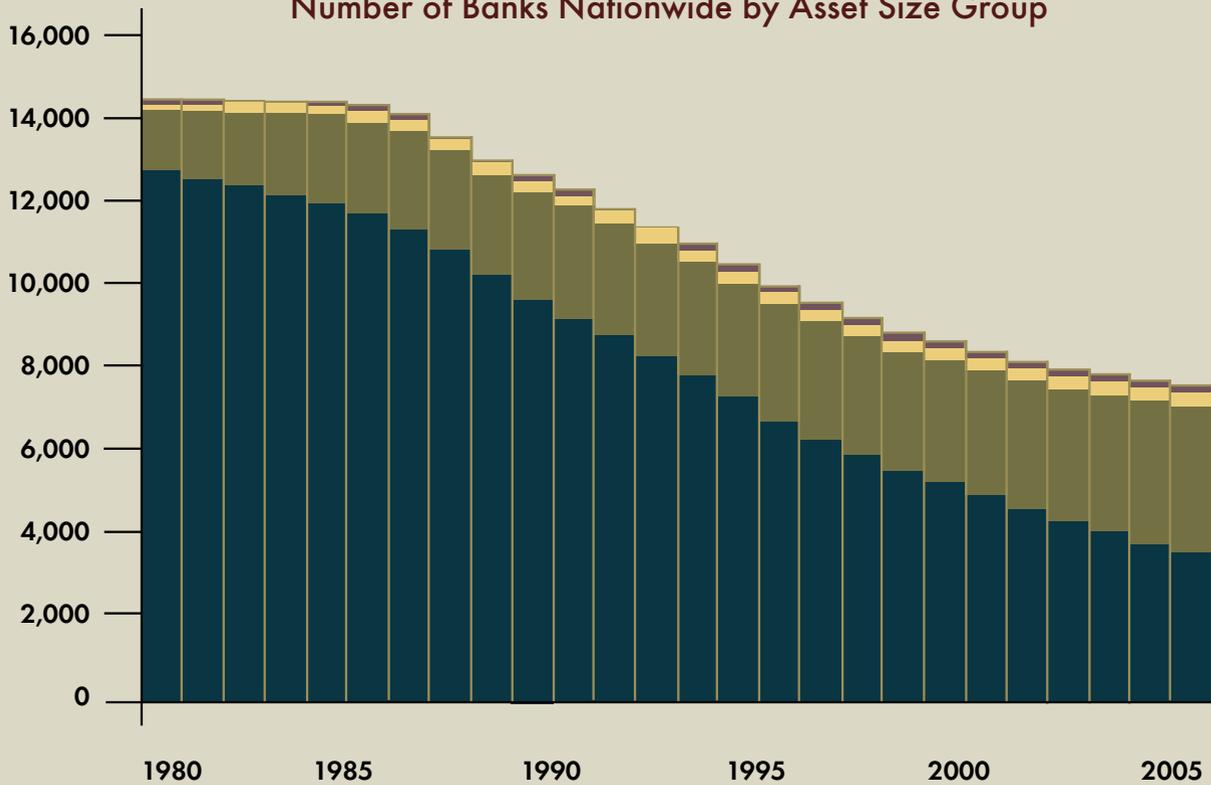
These mergers also resulted in substantially increased asset sizes for banks. By 2005, the average asset size of all U.S. banks was \$1.2 billion, compared to \$191 million in 1985, before

community banks (those with less than \$1 billion in assets) use technology to vie for loan and deposit customers,” George says. “For consumers, this means more loan options and more investment opportunities.”

Presidents of banks of varying sizes throughout the District agree technology has significantly impacted, as well as advanced,

Consolidation is Reducing the Number of Banks

Number of Banks Nationwide by Asset Size Group



< \$100 Million
 \$100 Million to \$1 Billion
 \$1 Billion to \$20 Billion
 > \$20 Billion

Source: Reports of Condition and Income

customers' banking experience.

Dave Brownback, president and CEO of Citizens State Bank & Trust Co., a \$60 million bank in Ellsworth, Kan., has seen the effects of technology, whether it be increased ATM deployment or more online usage.

"People can bank 24/7—that's the biggest change," Brownback says. "We're no longer a 9 (a.m.) to 3 (p.m.) organization. ... Technology has made our world smaller."

Mark A. Sutko, president and CEO of Platte Valley State Bank & Trust Co., a \$390 million bank in Kearney, Neb., agrees technology is certainly advancing the banking

industry, but says at the same time it is also raising costs in product expenses and data protection.

Competition

As financial service providers cross geographic and product boundaries, the competitive environment of banks is changing. Deregulation and technological innovation have allowed customers access to credit from many sources—not just banks—and more competitive rates for their savings.

Prior to these changes, most community banks viewed their strongest competitors as

other community banks. This may no longer be the case as banks feel pressure from other competitors, George says.

Community banks face increasing competition from out-of-market financial service providers. Banks also face increasing competition for consumers' deposits and lending needs from nonbanks. These include brokerage and securities firms, farm credit lenders, and captive finance companies that are owned by automobile manufacturers, such as GMAC, and farm machinery producers, such as John Deere. As a result, consumers and businesses have greater access to new sources of credit and investment options.

Increased technology heightens competition as banks are challenged to attract new customers, Brownback says.

"You don't have to bank with the bank down the street," he says.

Sutko agrees, adding that competition means banks must place a greater emphasis on customer relations.

"There are more players to slice up the pie," says Sutko, who is also a director of the Omaha Branch of the Federal Reserve Bank of Kansas City. "To keep a competitive edge, you're constantly monitoring and updating."

Technological innovations are also affecting competition for loan customers. As banking industry assets have become concentrated in larger banks, these banks have gained an increased share of all consumer loans, while community and midsize banks have seen a decline.

In the past, community banks played a significant part in meeting consumer and home mortgage lending needs. However, technological advances have led to commoditization of consumer credit and provided large banks the ability to become the dominant providers. Large banks utilize more sophisticated modeling techniques to better analyze the risks associated with this type of lending.

Commoditization of consumer and home mortgage lending is changing the dynamics of

customer and bank relationships.

Despite increasing competition, recent bank performance is sound.

"If you look at the last couple (of) years, banks have done well," says Vectra Bank's Alexander, who serves as a director of the Denver Branch of the Federal Reserve Bank of Kansas City. He attributes this to several factors, including a strong economy, managing costs and risks, strong loan growth, and low interest rates.

Constant amid change

"In the face of growing competitive pressures, banks still have a special role to play in the financial services industry," George says, "both as the intermediary to consumers and businesses, and in the regional and national economies."

Banks will continue to face stiff competition, market concentration and technological transformation. And, the regulatory environment will remain challenging.

A greater emphasis on regulations—and the new regulations themselves—requires increased manpower as well as expenses to comply, Sutko says.

As the nature of banking continues to transform, challenges will continue to arise. To meet these challenges, banks will need to be innovative, stay true to their niche and focus on improvements, Alexander says. Many agree banking will always be about developing relationships with customers, and offering good services and fair prices.

"Some things change," Sutko says, "and some don't."



**BY ERIC ROBBINS, POLICY ECONOMIST
& BRYE STEEVES, SENIOR WRITER**

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