Future of Banking Study

Regional and Other Midsize Banks: Recent Trends and Short-Term Prospects

Heather Gratton

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by
Heather Gratton*
Division of Insurance and Research
Federal Deposit Insurance Corporation

*Heather Gratton is a Senior Financial Analyst at the Federal Deposit Insurance Corporation.
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The midsize banking sector is difficult to define. We call “midsize” any banking organization (bank or thrift holding company, independent bank, and independent thrift) that has aggregate assets of more than $1 billion, excluding the 25 largest banking organizations. [1] Although banks of this size are often called regional banks, some are heavily concentrated in one market or one state: in many ways they are more like super-size community banks.[2]

In this paper, regional banks are defined as those institutions that are located in more than one state and have less than 60 percent of their deposits in one market. “Other” midsize banks are defined as institutions that are located in one state, or have more than 60 percent of their deposits in one market, or both.

For purposes of analysis, therefore, we divide midsize institutions into two subsets according to their geographic reach: one subset is midsize banks that are truly regional (covering a region of the country), and the other subset is “other” midsize banks, that are more geographically concentrated.[3] Only one-fourth of midsize banks were found to be truly regional, as defined above, while three-fourths are included in the “other” midsize group. However, it is important to note that the line drawn here is essentially arbitrary. In reality, variations among midsize banks are a continuum that is gradually changing over time.

Some commentators have predicted that midsize banks will disappear because banks need to have either the close community ties associated with a small bank or the extensive geographic scope, marketing power, and product lines of a superregional or a mega bank to

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[1] According to this definition, assets of regional and other midsize banks at the end of 2003 ranged from $1billion, the top of the community bank size group, to $42 billion, the asset size of the smallest of the 25 largest banks. Over time, the minimum asset size of midsize banks has been adjusted for inflation.
[2] For purposes of defining regional and other banks, markets are measured by metropolitan statistical areas (MSAs).
[3] “Other” will be inside quotation marks whenever it refers to the specific subset of midsize banks. An example of a truly regional bank was First Virginia Bank, Inc., recently acquired by BB&T Corp. First Virginia Bank was an $11 billion institution with eight associated institutions that had branches throughout Virginia and portions of Maryland and East Tennessee. An example of an “other” midsize bank is Southern Financial Bancorp, Inc., a $1 billion institution headquartered in Warrenton, Virginia, with 27 branches in Northern Virginia and Washington, D.C.

thrive. For example, in the past decade, most of the country's largest banks were assembled by acquiring mid-tier banks like First Virginia.[4] The result has been a growing disparity in asset size: a group of large national banks and thousands of smaller local banks. The banks in between, not exactly small community banks, but then not nearly as large as their super-regional competitors, are an endangered species.

Wilmarth (2002) made a similar prognosis when he reviewed the changes in the financial services industry from 1975 to 2000. He concluded, "it is increasingly doubtful whether most midsized banks with assets in the $15-$50 billion range can remain viable over the long term….most midsized banks will probably be forced to choose either a growth strategy of acquiring other banks, or an exit strategy of merging with a larger bank." (p.18). According to this viewpoint, the cost structure and organizational complexity of midsize banks prevents them from matching the individualized services of smaller "niche" banks. In addition, a scarcity of resources prevents midsize banks from making large investments in information technology and expert staff, selling mutual funds and consumer loans on a mass-market basis, and offering derivatives and other sophisticated capital market services to compete with larger banks.

Are Wilmarth and others right? Are midsize banks endangered? Here we examine the recent trends in this sector to try to ascertain the sector's likely prospects. Specifically, we ask the following questions:

- How are midsize banks performing?
- Are their numbers increasing or decreasing and are they gaining or losing market share?
- What is their asset composition?
- What are their typical business lines?

[4] Johnston (2001), E10.

- Are their only options to grow or to merge?

Performance Measures

We begin by examining a few basic performance statistics for midsize banks and various subsets of them.[5] To compare the recent profitability of the top 25, midsize, and community bank sectors, we analyzed four common performance measures from 1985 to 1993 (see table 1) and from 1994 to 2003 (see table 2).[6] The measures were return on assets (ROA), return on equity (ROE), the net interest margin (NIM), and the efficiency ratio (ER).[7]

Table 1
Performance Measures of FDIC-Insured Banks, 1985-1993

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Midsize Banks									
No. of Organizations	683	689	682	671	644	582	523	464	439
Return on Assets	.70	.57	.22	.24	.11	–.07	.28	.83	1.03
Return on Equity	14.08	10.84	4.10	4.43	2.02	–1.30	4.52	12.00	13.88
Net Interest Margin	3.01	3.08	3.14	2.96	3.05	3.26	3.60	4.08	4.09
Efficiency Ratio	N/A	N/A	N/A	71.05	70.45	71.13	69.13	64.46	62.99
Community Banks									
No. of Organizations	14,064	13,599	13,164	12,590	12,272	11,690	11,187	10,755	10,196
Return on Assets	.63	.44	.14	.28	.16	.43	.59	.94	1.08
Return on Equity	10.38	6.99	2.14	4.06	2.40	5.51	7.37	11.36	12.16
Net Interest Margin	3.51	3.52	3.54	3.57	3.59	3.82	3.99	4.38	4.41
Efficiency Ratio	N/A	N/A	N/A	71.63	72.85	70.53	69.85	65.75	65.74
Top 25 Banks									
No. of Organizations	25	25	25	25	25	25	25	25	25
Return on Assets	.52	.56	–.49	.97	.08	.54	.47	.86	1.18
Return on Equity	10.66	10.91	–9.80	18.65	1.51	9.85	8.01	13.23	16.19
Net Interest Margin	3.30	3.36	3.29	3.71	3.55	3.62	3.86	4.17	4.15
Efficiency Ratio	N/A	N/A	N/A	64.19	66.22	66.92	67.43	64.09	63.28

Source: FDIC.
Note: All ratios reflect the performance of organizations other than de novos.

[5] Because the earnings of de novo banks (defined as banks less than five years old) are atypical, these institutions are excluded from the analysis of earnings and performance.
[6] Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and thrifts) with aggregate assets of less than $1 billion.
[7] ROA is defined as net income divided by average total assets. ROE is defined as net income divided by average total equity capital. NIM is defined as the difference between interest and dividends earned on interest-bearing assets and interest paid to depositors and other creditors, expressed as a percentage of average earning assets; no adjustments are made for interest income that is tax exempt. ER is defined as noninterest expense divided by the sum of net interest income and noninterest income; banks that are controlling costs best will have the lowest ERs.

Banks of all sizes struggled between 1985 and 1991 because of the economy. As a sector, midsize banks slightly lagged both the community banks and the top 25 banks. On average, return on assets was 9 basis points lower for midsize banks than for community banks and 9 basis points lower than for the top 25. Likewise, on average the return on equity was 2 basis points lower for midsize banks than for community banks and 159 basis points lower than for the top 25 banks. However, between 1992 and 1996, when all banking sectors were recovering, midsize banks started to narrow the performance gap between themselves and the rest of the banking industry.

Table 2
Performance Measures of FDIC Insured Banks, 1994-2003[8]

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Midsize Banks										
No. of Orgs.	412	418	408	423	409	430	441	444	452	480
Return on Assets	1.01	1.13	1.15	1.28	1.35	1.38	1.24	1.27	1.42	1.42
Return on Equity	13.15	14.18	14.13	15.36	15.44	16.15	14.59	13.83	15.08	14.87
Net Interest Margin	3.98	3.94	4.02	4.12	4.03	4.05	4.00	3.99	4.04	3.74
Efficiency Ratio	62.03	59.34	59.26	56.36	56.06	55.36	56.38	56.65	55.98	56.87
Community Banks										
No. of Orgs.	9,611	9,139	8,772	8,442	8,087	7,899	7,781	7,631	7,485	7,335
Return on Assets	1.02	1.09	1.06	1.19	1.17	1.14	1.13	1.06	1.14	1.14
Return on Equity	11.08	11.19	10.70	11.77	11.31	11.32	11.53	10.54	11.22	11.17
Net Interest Margin	4.41	4.37	4.35	4.38	4.30	4.24	4.23	4.07	4.19	4.01
Efficiency Ratio	65.20	63.85	64.96	62.07	63.15	64.19	63.68	64.89	64.31	65.88
Top 25 Banks										
No. of Orgs.	25	25	25	25	25	25	25	25	25	25
Return on Assets	1.11	1.08	1.08	1.12	1.05	1.23	1.09	1.10	1.30	1.42
Return on Equity	15.11	14.79	14.27	14.44	13.34	15.42	13.75	13.49	14.68	16.33
Net Interest Margin	4.12	3.96	3.93	3.81	3.66	3.66	3.49	3.58	3.86	3.65
Efficiency Ratio	63.29	61.94	61.93	59.94	62.91	58.87	58.46	56.91	54.16	54.41

Source: FDIC.

As the economy continued to improve, midsize banks caught up with and then passed the top 25 banks in terms of performance and efficiency (see table 2). From 1997 to 2003, profitability was clearly higher for the midsize banks than for the other sectors (except in 2003, when midsize banks and the top 25 banks both had an average ROA of 1.42). On average, between 1997 and 2003 return on assets was 20 basis points higher for midsize banks than for the community banks, and 15 basis points higher than for the top 25. Likewise, on average, return on equity was 378 basis points higher than for community banks and 55 basis points higher than for the top 25 banks. Midsize banks also had the best efficiency ratios from 1994 to 2001 (the top 25 banks did slightly better in 2002 and 2003). The community banks' net interest margin, however, was always higher than that of both the midsize and the top 25 banks, except in 1988.

Why have midsize banks outperformed the other two sectors for six of the past seven years? There are a number of plausible reasons. Compared with community banks, midsize banks have more diversified fee income and a broader array of product lines; some midsize banks also have wider geographical areas from which to choose investments.[9] Therefore, midsize banks rely less on their net interest margins than community banks and, accordingly, are less susceptible to interest-rate risk. Because of their larger size, midsize banks are often better able to diversify credit risk, make large loans, attract good employees, and obtain and maintain a more diversified group of customers than community banks. They are also able to attract larger, more sophisticated clients. Most midsize banks are the result of the mergers of smaller institutions, so they can use one brand name to enhance their market power. Compared with some community banks, midsize banks have a cost advantage because of economies of scale.[10]

The top 25 banks are considerably larger than the midsize banks; thus, many people expect to see the advantages of midsize banks over community banks magnified when the top 25 banks are compared with the midsize banks. However, during the 1990s many large continental

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[8] "No. of Orgs." stands for number of organizations.
[9] FDIC (2003b), 9. For the first half of 2003, the ratio of noninterest income to assets, by asset distribution, was as follows: banks less than $100 million, 1.41; banks $100 million to $1 billion, 1.32; $1 billion to $10 billion, 2.09; and greater than $10 billion, 2.50.

European banks actually saw their market capitalization shrink, partly because of low profits. Some analysts and portfolio managers believe that performance at large conglomerates may be harmed as unprofitable segments of the conglomerate's business are effectively subsidized by more profitable business lines; thus the necessary restructuring of business lines is postponed.[11] In some U.S. markets, the available evidence suggests that consolidation can cause some customers to migrate from newly merged institutions to smaller (community) banks, thereby helping community banks gain customers at the expense of midsize and top 25 banks.[12] In addition, a few of the top 25 banks have suffered losses on large credits (Argentina, Enron, Sunbeam).

We have seen that recently, midsize banks on average outperformed both the community banks and the top 25 banks. But could it be that a significant number of underperformers are hidden in the sector aggregates? To answer this question, we examined the number of unprofitable organizations and failures from 1994 to 2003. In every year but one, the percentage of unprofitable organizations was lower for midsize banks than for community banks, and sometimes the percentage was lower than for the top 25 banks. In addition, although 63 community banks failed, only 3 midsize banks failed.[13] The data, then, reveal that the number of midsize banks that were unprofitable or failed is small. But midsize banks are quite diverse; perhaps a subclass of midsize banks, though not failing, are lagging?

As mentioned above, some midsize banks are located in only one state or have greater than 60 percent of their deposits in only one market, or both. Although these "other" midsize

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[10] DeYoung, Hunter, and Udell (2003).
[11] Breuer (2001).
[12] Keaton (2000). See also Seelig and Critchfield (2003). Usually the reason the customer gives for migrating to the community bank is poor service at the larger institution.
[13] FDIC (2002). The three failures were First National Bank of Keystone (Keystone) in 1999; Superior Bank, FSB, in 2001; and Hamilton Bank, NA, in 2002. Keystone grew out of the community bank sector only during the last

banks resemble large community banks in many ways, they are, of course, larger than community banks and often have achieved a measure of geographic diversification within the definition used in this paper. As noted earlier. approximately three-fourths of midsize banks fit this description (their deposits are concentrated in only one state, or MSA, or both), while the other one-fourth are more geographically dispersed and in this paper are designated as truly regional.

Table 3 compares the recent performance of the true regional banks with the recent performance of the "other" midsize banks.

Table 3
Performance Measures of Midsize Banks by Geographic Dispersion
1994-2003
($ in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Regional Banks										
No. of Orgs.	104	101	98	100	98	114	109	113	117	126
Total Assets	$964	$955	$902	$961	$940	$1,027	$1,091	$1,061	$1,176	$1,281
Return on Assets	1.00	1.18	1.20	1.26	1.27	1.26	1.11	1.25	1.38	1.28
Return on Equity	13.23	15.03	15.28	15.74	15.20	15.51	13.43	14.32	15.27	13.90
Net Interest Margin	4.11	4.05	4.12	4.09	3.99	3.97	3.93	3.86	4.06	3.70
Efficiency Ratio	63.29	59.15	59.15	56.34	56.93	56.16	57.52	57.02	57.18	58.55
Other Midsize Banks										
No. of Orgs.	308	317	310	323	311	316	332	331	335	354
Total Assets	$954	$1,040	$1,032	$1,036	$994	$1,045	$1,179	$1,204	$1,210	$1,332
Return on Assets	1.02	1.07	1.10	1.29	1.43	1.49	1.37	1.29	1.45	1.55
Return on Equity	13.08	13.39	13.15	15.04	15.66	16.76	15.64	13.42	14.91	15.77
Net Interest Margin	3.85	3.85	3.92	4.14	4.07	4.12	4.07	4.11	4.02	3.79
Efficiency Ratio	60.69	59.51	59.36	56.37	55.32	54.69	55.52	56.41	54.95	55.44

Source: FDIC.

Both groups have done well, usually outperforming the other two sectors (top 25 and community banks) since 1994. In addition, differences between the regional and "other" midsize banks are relatively small. On average, the "other" midsize banks had a return on assets that was 9 points higher, and an efficiency ratio that was 130 basis points lower, than the truly regional

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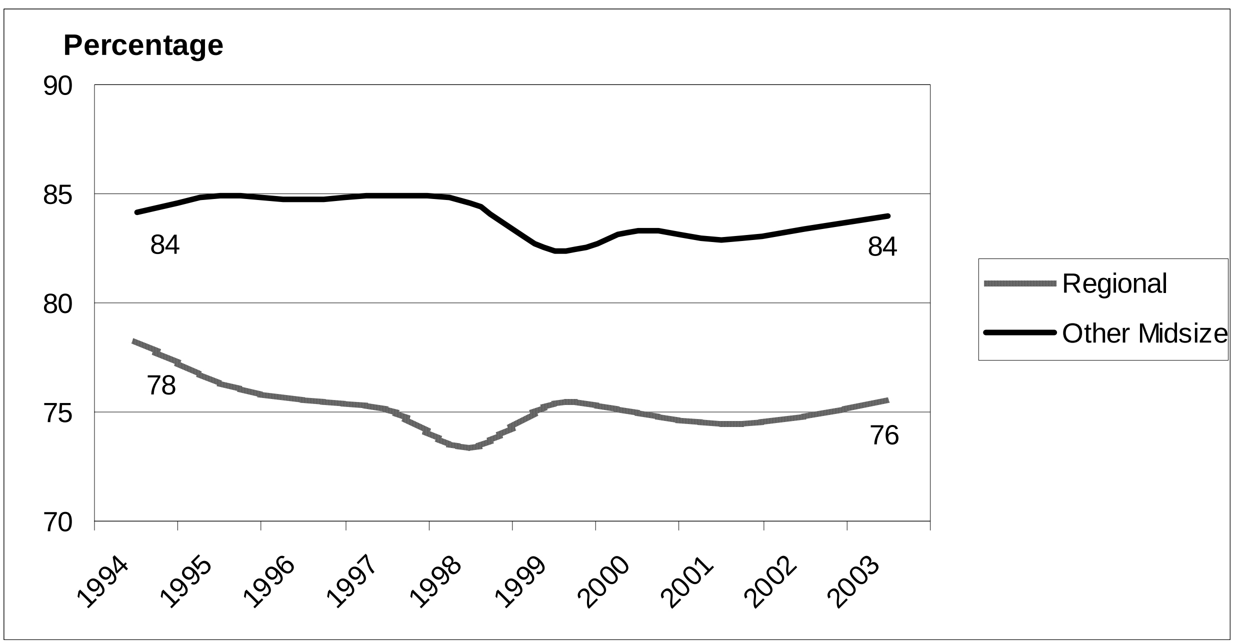
five months of its existence, so perhaps its failure should be viewed more as that of a community bank than as that of a midsize bank.

banks. Each subset had an average NIM of 3.99, and the regional banks' return on equity was only 1 basis point higher than that of the "other" midsize banks. And although the "other" midsize banks are smaller organizations than the regional banks in terms of assets, as a group they hold slightly more assets than the regional banks.

Despite some differences, both types of midsize bank are performing well. By our definitions, we know that the regional banks are located in more than one MSA, but does that mean that regional banks have a greater percentage of their branches in MSAs than "other" midsize banks? Figure 1 presents data about the distribution of branch from 1994 to 2003 (as of June each year).

Figure 1
Distribution of Regional and "Other" Midsize Bank Branches in MSAs
(as of June, 1994–2003)
(Percentage)



Source: FDIC.

Both regional and "other" midsize banks have most of their branches in MSAs, but "other" midsize banks—not regional banks—have consistently had a higher percentage of their branches in metropolitan areas. "Other" midsize banks have maintained a fairly constant percentage of metropolitan branches since 1994 (84 percent), whereas regional banks' percentage of metropolitan branches has slightly declined (from 78 to 76 percent). By internal expansion, mergers, and acquisitions, regional banks appear to have become truly regional banks by spreading throughout many of the nonmetropolitan counties between their various MSAs.

Berger and De Young (2000) studied the effects of geographic expansion on the efficiency of 7,000 U.S. banks from 1993 to 1998. They found that managerial control tended to dissipate as the distance to the affiliate increased. However, they found the effects to be modest, and they surmised that there might not be an optimal geographic scope for banking organizations. Our results support Berger and De Young's suggestion that some banks might operate most efficiently within a single region, while others might be more efficient on a national or international basis. Engler and Essinger (2002) came to a similar conclusion: they believe that in order to be profitable, banks must be comfortable with their size—large enough to optimize business effectiveness, yet small enough to be manageable.

Another aspect to consider is whether the location (region) of a midsize bank influences its performance (see table 4). Regional differences were readily apparent during the downturn (1985 to 1991) and the recovery period (1992 to 1996). From 1985 to 1991, the ROA of midsize banks in the Central United States was significantly above the national average, while the ROA of midsize banks in the Southwest was significantly below the national average. At one point (1988) the spread between the highest and the lowest regions was 393 basis points. During the recovery period, the spread between the highest and lowest regions narrowed substantially. The banks in the Southwest made a strong turnaround and often outperformed those in all the other regions, whereas the banks in the West consistently lagged all the other regions.

Table 4
Return on Assets of FDIC-Insured Midsize Banks by Region
1985-2003

Year	Central		Midwest		Northeast		Southeast		Southwest		West	
	#	ROA	#	ROA	#	ROA	#	ROA	#	ROA	#	ROA
1985	120	.78	51	.53	214	.77	117	.77	71	.55	110	.57
1986	123	.92	49	.67	214	.87	118	.81	71	–1.47	114	.57
1987	122	.60	48	.28	221	.48	112	.68	70	–2.75	109	.31
1988	116	.92	48	.03	220	.58	111	.64	66	–3.01	110	.06
1989	110	.87	45	.24	219	.01	107	.42	58	–1.52	105	–.33
1990	103	.66	40	.50	205	–.53	91	.03	50	–.44	93	–.21
1991	94	.79	37	.75	181	–.05	83	.33	43	.02	85	.18
1992	79	1.08	32	1.13	173	.72	68	.93	38	1.25	74	.50
1993	82	1.24	34	1.29	159	.94	60	1.14	33	1.59	71	.64
1994	77	1.15	31	1.10	145	1.06	57	1.13	32	1.17	70	.56
1995	86	1.18	32	1.35	150	1.16	56	1.19	30	1.16	64	.78
1996	86	1.17	28	1.18	143	1.19	55	1.22	32	1.57	64	.84
1997	87	1.30	25	1.28	148	1.34	62	1.27	32	1.18	69	1.12
1998	85	1.29	25	1.29	143	1.50	58	1.21	32	1.35	66	1.29
1999	91	1.40	26	1.21	148	1.43	58	1.35	35	1.27	72	1.35
2000	92	1.27	30	1.15	144	1.30	60	1.16	34	1.22	81	1.22
2001	88	1.20	31	1.24	144	1.25	61	1.32	41	1.32	79	1.36
2002	84	1.21	30	1.31	147	1.35	64	1.48	41	1.54	86	1.73
2003	92	1.30	31	1.22	152	1.30	70	1.56	44	1.57	91	1.66

Source: FDIC.
Note: **Central:** Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin; **Midwest:** Iowa, Kansas, Minnesota, Nebraska, North Dakota, South Dakota; **Northeast:** Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont and U.S. Virgin Islands; **Southeast:** Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia; **Southwest:** Arkansas, Louisiana, New Mexico, Oklahoma, Texas; and **West:** Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Pacific Islands, Utah, Washington, Wyoming.

Significant differences between the regions largely disappeared when the regional recessions ended and the industry recovered. Recently, midsize banks have consistently performed well across all regions: between 1997 and 2003 the ROA spread between regions ranged from 15 to 52 basis points.

In summary, we found that midsize banks performed well for the past seven years not only in the aggregate but also at a subsector level and across all regions.

Bank Consolidation and Market Share

Even though midsize banks are performing well, has recent bank consolidation reduced their numbers? Do the consolidation data support the contention that "the banks in the middle" will ultimately thin out or disappear? To answer these questions, we divided both community banks and midsize banks into three subsets by asset size and analyzed changes in the number of organizations and market share (measured as the share of industry assets) from 1985 to 2003 (see table 5).

Table 5
Number of FDIC-Insured Banks by Asset Size
1985–2003

Year	Community Banks			Midsize Banks			Top 25	Total
	Small	**Medium**	**Large**	**Small**	**Medium**	**Large**		
1985	9,738	3,845	481	418	246	19	25	14,772
1986	9,272	3,849	478	424	241	24	25	14,313
1987	8,951	3,749	464	411	243	28	25	13,871
1988	8,501	3,606	483	386	252	33	25	13,286
1989	8,232	3,546	494	369	248	27	25	12,941
1990	7,826	3,401	463	330	226	26	25	12,297
1991	7,425	3,342	420	302	198	23	25	11,735
1992	7,035	3,312	408	275	164	25	25	11,244
1993	6,641	3,183	372	266	150	23	25	10,660
1994	6,189	3,054	368	239	149	24	25	10,048
1995	5,740	3,031	368	247	145	26	25	9,582
1996	5,353	3,025	394	240	142	26	25	9,205
1997	5,048	3,025	369	263	131	29	25	8,890
1998	4,695	3,015	377	257	123	29	25	8,521
1999	4,513	2,985	401	270	133	27	25	8,354
2000	4,338	3,027	416	276	135	30	25	8,247
2001	4,105	3,081	445	275	142	27	25	8,100
2002	3,863	3,148	474	271	154	27	25	7,962
2003	3,683	3,172	480	291	155	34	25	7,840
85 to 91 Change	**–24%**	**–13%**	**–13%**	**–28%**	**–20%**	**21%**		**–21%**
92 to 96 Change	**–24%**	**–9%**	**–3%**	**–13%**	**–13%**	**4%**		**–18%**
97 to 03 Change	**–27%**	**5%**	**30%**	**11%**	**18%**	**17%**		**–12%**
1985 Share	**95.2%**			**4.6%**			**0.2%**	
2003 Share	**93.6%**			**6.1%**			**0.3%**	

Source: FDIC.

Like bank performance, the number of banks has changed significantly over time. From 1985 to 1991, the number of midsize banks in the United States decreased 23 percent, while the total number of banks decreased 21 percent and the number of community banks decreased 20 percent.[14] As banking recovered from the crisis of the late 1980s and early 1990s, the declines in number slowed, and from 1992 to 1996 the number of midsize banks decreased 12 percent, while both the total number of banks and the number of community banks decreased 18 percent. But from 1997 to 2003 the number of large community banks *increased* by 30 percent and the number of midsize banks *increased* by 13 percent, while the total number of banks and the total number of community banks continued to decrease. While not comprehensive, the aggregate profitability measures and industry trends support a conclusion that the sector is relatively healthy—not endangered. Perhaps the negative viewpoints arise from shifts in the distribution of total bank assets. Table 6 presents changes in total banks assets and market share.

[14] Small community banks are defined as banks with less than $100 million of assets, medium community banks as banks with assets equal to or greater than $100 million but less than $500 million, and large community banks as banks with assets equal to or greater than $500 million but less than $1 billion. Small midsize banks have assets equal to or greater than $1 billion but less than $3 billion, medium midsize banks have assets equal to or greater than $3 billion but less than $18 billion, and large midsize banks have assets equal to or greater than $18 billion but less than the assets of the smallest of the top 25 banks. Size groups are adjusted for inflation.

Table 6
Total FDIC-Insured Bank Assets by Asset Size
1985–2003
($ in billions)

Year	**Community Banks**			**Midsize Banks**			**Top 25**	**Total**
	Small	**Medium**	**Large**	**Small**	**Medium**	**Large**		
1985	$279	$532	$223	$466	$1,063	$311	$1,120	$3,993
1986	277	547	226	495	1,153	422	1,206	4,328
1987	275	548	227	494	1,187	505	1,265	4,502
1988	271	544	244	473	1,232	653	1,321	4,737
1989	274	552	259	469	1,272	577	1,414	4,819
1990	273	545	251	429	1,167	580	1,483	4,727
1991	270	555	238	412	1,058	483	1,572	4,588
1992	267	564	239	396	906	554	1,647	4,573
1993	263	558	220	386	901	568	1,833	4,729
1994	252	542	222	351	943	624	2,087	5,021
1995	242	547	224	365	939	691	2,331	5,338
1996	230	558	245	357	909	668	2,640	5,607
1997	222	576	234	395	836	767	3,016	6,045
1998	211	585	239	405	773	756	3,561	6,531
1999	206	588	257	429	880	763	3,762	6,884
2000	203	613	275	444	938	888	4,103	7,463
2001	202	643	299	449	1,015	799	4,461	7,869
2002	196	677	330	448	1,121	817	4,846	8,436
2003	192	699	339	481	1,127	1,004	5,235	9,077
85 to 91 Change	**–3%**	**4%**	**7%**	**–12%**	**–1%**	**55%**	**40%**	**15%**
92 to 96 Change	**–14%**	**–1%**	**3%**	**–10%**	**0%**	**21%**	**60%**	**23%**
97 to 03 Change	**–14%**	**21%**	**45%**	**22%**	**35%**	**31%**	**74%**	**50%**
1985 Share	**26%**			**46%**			**28%**	
2003 Share	**14%**			**29%**			**58%**	

Source: FDIC.

Total bank assets have grown 127 percent from 1985 to 2003. The asset size of the average bank increased from roughly $270 million to over $1 billion. The assets held by the top 25 organizations rose 367 percent: these banks' market share increased from 28 percent to 58 percent. Over the same period, assets held by community banks increased only 19 percent; these banks' market share dropped from 26 percent to 14 percent. And the assets held by midsize banks increased only 42 percent; their market share dropped from 46 percent to 29 percent.

The primary phenomenon that caused midsize banks to lose market share between 1985 and 2003 was merger activity by the top 25 organizations. Rhoades (2000) identified 116 large-bank mergers between 1994 and 1998.[15] These mergers effectively shifted substantial assets out of the midsize bank sector and ushered some of the midsize banks into the top 25 sector. The market share of the top 25 banks soared, at the expense of community and midsize banks. Therefore, an argument could be made that the loss in market share indicates that the number of midsize banks could decrease as well. The midsize banking sector is a relatively small sector in the overall banking market: 6 percent of the total number of organizations and 29 percent of the assets. In terms of market share, some further deterioration may well occur.

What about merger activity involving institutions other than large ones? Rhoades (2000) analyzed approximately 8,000 bank mergers from 1980 to 1998. He found that along with the increased frequency of large mergers in recent years, 49 percent of the targets between 1980 and 1998 had assets of less than $50 million and 85 percent had assets of less than $200 million (community banks). In many states, the majority (or almost the majority) of acquiring firms had more than $1 billion in assets.

De Young and Hunter (2003) analyzed commercial bank mergers and acquisitions from 1985 to 1999.[16] They found that:

- 55 percent of the acquirers were community banks targeting other community banks
- 40 percent of the acquirers were large or midsize banks targeting community banks
- 5 percent were large or midsize banks acquiring large or midsize banks.

We reviewed changes in the number of the midsize banks between 1994 and 2003 in terms of the components of the changes: de novo entry, net growth, other additions and

[15] Rhoades defined large mergers as those in which both the acquiring firm and the target bank had more than $1 billion in assets.

[16] DeYoung and Hunter (2003) define large banks as those with more than $10 billion in assets, midsize banks as those with between $1 billion and $10 billion in assets, and community banks as those with less than $1 billion in assets. Assets are in 1999 dollars.

subtractions, subtractions for mergers and acquisitions, and failures.[17] Net growth (dominated by community bank growth) was the predominant cause of additions to the midsize sector between 1994 and 2003, and mergers and acquisitions were the predominant cause of subtractions from the sector. The "other" midsize banks had significantly more activity than the regional banks. "Other" midsize banks had more net growth (a 94 percent increase since 1994, compared with a 12 percent increase since 1994 for regional banks) and more subtractions due to mergers and acquisitions (an 80 percent increase since 1994, compared with a 44 percent for regional banks). And while additions to "other" midsize bank were primarily due to net growth from community bank growth into the sector, additions to regional banks were primarily due to other factors—particularly geographic expansion that shifted "other" midsize banks into regional banks (per our definition).

Although mergers and acquisitions are not evenly spread across the banking industry, all sectors are active merger participants. There seems to be a natural tendency to move from small sectors to large. So while some midsize banks will merge into the top 25 organizations and depart the sector in the years ahead, large community banks will continue to grow (or merge) into the midsize bank sector. In addition, some of the market-share loss due to top 25 and midsize bank mergers is likely to be offset when small regional banks grow and when some midsize banks merge with each other instead of with a top 25 bank.

Will merger activity continue? Some believe that, as some midsize banks have fared better than others, the result may be consolidation between well-off and not so well-off midsize institutions.[18] According to this view, midsize banks are beginning to reposition themselves in

[17] Additions from net growth is the number of community banks that grew into the midsize sector by growing total bank assets minus the number of midsize banks that shrunk out of the midsize sector by shrinking total bank assets.
[18] Dow Jones Newswires (2003).

possible preparation for an increase in mergers and acquisitions.[19] Both recent merger activity and the comments of industry experts point toward continuing activity in this area.

How many midsize banks are there likely to be in the future? Robertson (2001) studied consolidation in banking between 1960 and 2000 and projected the size distribution of banks from 2001 to 2007.[20] While earlier papers had predicted sizable declines for the midsize sector, this study projected that midsize banks would be the most stable sector, with only a 3 percent decrease in the number of institutions, compared with a projected 34 percent decrease for community banks and a 9 percent decrease for top banks. This forecast is largely in line with the recent profitability and growth seen in the midsize bank sector.

Therefore, we conclude that even if the midsize sector loses additional market share as the industry evolves toward larger institutions, the sector is not likely to shrink dramataically in the near future. Barring a prolonged economic downturn, the number of midsize banks is likely to be stable or even to grow slightly. Midsize banks have increased their numbers significantly in the last five years and the sector is outperforming the other sectors. Although the move toward larger institutions has led to midsize banks losing some market share, we see no evidence that this loss has harmed the remaining midsize banks. Furthermore, there are literally thousands of community banks that may yet grow or merge into the midsize bank sector, and there are also a number of midsize banks that may merge with each other rather than with a top 25 bank.

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[19] Elsas (2003) analyzed the consequences of distress mergers in Germany between 1993 and 2001. Preliminary results suggest that while short-term profitability (three years) is negatively affected, the costs are moderate and there is strong evidence of gains from diversification.

[20] Robertson's seven size classes (real assets from implicit GDP deflator, 1996 = 100) are as follows. Class 1 = <$100 million, Class 2 = between $100 million and <$300 million, and Class 3 = between $300 million and $900 million (for discussion purposes, we will call Classes 1–3 community banks) Class 4 = between $900 million and $2.7 billion, Class 5 = between $2.7 billion and $8.1 billion, and Class 6 between $8.1 billion and $24.3 billion (for discussion purposes, we will call Class 4-6 midsize banks) Class 7 = $24.3 billion and over (for discussion purposes,

Asset Composition

So far we have seen that midsize banks—both those that are geographically dispersed (regional banks) and those that are local ("other" midsize banks)—are performing very well and that, not surprisingly, their numbers are growing. But are midsize banks achieving this performance by increasing their risk exposure? We explore this question by first examining the shifts in asset composition for midsize banks between 1985 and 1994 and between 1994 and 2003. Community banks and the top 25 banks are included for reference (see table 7).

Table 7
Asset Composition of FDIC-Insured Banks by Sector
Loans as Percentage of Total Assets
June 1985, 1994, and 2003

	Community Banks			Midsize Banks			Top 25 Banks		
Category	**1985**	**1994**	**2003**	**1985**	**1994**	**2003**	**1985**	**1994**	**2003**
No. of Orgs.	14,064	9,611	7,335	683	412	480	25	25	25
Consumer Credit	9.26	7.50	5.06	9.69	10.53	9.05	8.29	11.86	10.50
Home Mortgages	26.73	26.06	21.29	20.31	24.88	22.12	8.17	14.17	21.34
C&I Loans	8.93	7.19	8.90	12.39	10.26	9.19	25.13	15.77	10.95
Commercial Real Estate	6.23	9.29	15.86	5.67	7.36	10.78	3.07	4.78	3.92
Construction & Development	3.45	2.63	5.60	4.43	1.80	4.61	3.27	1.12	1.58
Multifamily Real Estate	2.62	1.85	2.00	3.34	2.87	2.58	1.10	1.00	1.14
Agricultural	3.01	3.99	4.35	.56	.64	.74	.55	.44	.28
Foreign Loans	.02	.01	.00	.45	.05	.02	2.77	.58	.10
Other & Contra Accounts	.17	.29	.89	3.49	2.50	2.78	12.16	9.52	8.10
Total Loans and Leases	**60.42**	**58.81**	**63.95**	**60.33**	**60.90**	**61.88**	**64.50**	**59.24**	**57.91**
Mortgage-backed Securities	3.32	9.71	8.58	5.29	14.91	15.63	1.19	7.51	8.94
Other Securities	21.89	20.93	15.96	15.63	11.11	9.47	7.08	7.03	6.59
Other Assets	14.38	10.55	11.50	18.75	13.09	13.02	27.24	26.21	26.55
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Memo Items									
Return on Assets	.63	1.02	1.14	.70	1.01	1.42	.52	1.11	1.42
Return on Equity	10.38	11.08	11.17	14.08	13.15	14.87	10.66	15.11	16.33

Source: FDIC.

The changes in the asset composition of the three sectors between 1985 and 2003 show some differences. During this period both community and midsize banks increased their commercial real estate lending, but by varying amounts (community banks 10 percent and

we will call Class 7 the top 25 banks). Robertson's projections are based on a 1994 to 2000 transition matrix with 131 new charters added to Class 1 each year.

midsize banks 5 percent). For the midsize banks, the largest loan change was the 5 percent increase in commercial real estate; all of these banks' other loan classes increased or decreased by 3 percent or less. Loans as a percentage of assets increased 2 percent between 1985 and 2003.

Increases in both commercial real estate portfolios and total loans indicate an increase in potential risk exposure.[21] Taking a closer look at the midsize banks, it appears that their overall risk exposure likely declined between 1985 and 1994, but increased between 1994 and 2003. Between 1985 and 1994, the increased risk from commercial real estate loans was offset by declines in construction and loan development loans and by increases in securities, both the decline in one and the increase in the other are generally considered to improve a bank's risk stance. Between 1994 and 2003, both commercial real estate and construction and development loans increased, while securities slightly decreased, all signs of increased risk. However, is difficult to conclude much with certainty without a more detailed bank-by-bank analysis.

Comparatively, community banks had larger increases in commercial real estate loans and total loans (10 and 4 percent, respectively) but have had fewer offsets to risk exposure: their C&I loans and total securities were about the same in 1985 and 2003. Despite these changes, in general the banking industry has seen a broad-based reduction in noncurrent loans between 1994 and 2003.[22]

Are there differences in asset composition between the two subsets of midsize banks? To answer this question, we broke the "midsize" data from table 7 into two groups, one for regional and one for "other" midsize banks (see table 8).

Table 8
Asset Composition of FDIC-Insured Midsize Banks by Geographic Dispersion

[21] FDIC (1997) found that the total loans to total assets was the best predictor of future failures and that the banks that failed in the 1980s had higher ratios of commercial real estate loan to total assets than surviving banks.
[22] FDIC (2003b), 2-3. The industry's inventory of noncurrent loans declined by 4 percent in the second quarter of 2003, the largest quarterly decline since the fourth quarter of 1994. The second quarter of 2003 is the third in a row when noncurrent loans have fallen.

Loans as Percentage of Total Assets
June 1994 and June 2003

	Regional Banks		"Other" Midsize Banks	
	1994	**2003**	**1994**	**2003**
No. of Orgs.	104	126	308	354
Consumer Credit	10.63	7.16	10.43	10.88
Home Mortgages	25.32	20.34	24.44	23.83
C&I Loans	12.26	11.07	8.24	7.38
Commercial Real Estate	7.64	12.47	7.09	9.17
Construction & Development	1.85	5.57	1.74	3.69
Multifamily Real Estate	2.39	2.18	3.35	2.97
Agricultural	.86	.97	.41	.53
Foreign Loans and Leases	.02	.02	.08	.02
Other & Contra Accounts	3.22	3.74	1.78	1.85
Total Loans and Leases	**64.19**	**63.51**	**57.57**	**60.30**
Mortgage-backed Securities	12.79	14.73	17.05	16.49
Other Securities	10.10	8.66	12.13	10.26
Other Assets	12.92	13.10	13.26	12.95
Total Assets	**100.00**	**100.00**	**100.00**	**100.00**
Memo Items:				
Return on Assets	1.00	1.28	1.02	1.55
Return on Equity	13.23	13.90	13.08	15.77

Source: FDIC.

As seen in table 8, there are some differences between the regional and "other" midsize banks in asset composition. Both groups increased their commercial real estate and construction and development loans from 1994 to 2003. However, the growth rates were somewhat higher for the regional banks than for the "other" midsize banks; accordingly, the regional banks were probably at higher risk. But regional banks somewhat offset this risk by simultaneously decreasing their consumer credit exposure. Moreover, they have better geographic diversification in their portfolios.

Do the data presented in tables 7 and 8 indicate that midsize banks have become more risky? Overall, midsize banks have increased their exposure to riskier types of assets since 1994 by increasing their investment in loans, particularly commercial real estate loans. However, midsize banks as a sector appear to be maintaining a well-diversified asset mix, and noncurrent loans are low. Furthermore, since the downturn of the late 1980s and early 1990s, several positive changes have occurred in the industry: levels of commercial real estate securitization and transparency are higher, regulatory oversight has increased, and lending requirements are stricter.[23] In addition, the midsize banks with the most commercial real estate are those that are more geographically diverse—the regional banks. Thus, it is likely that their commercial real estate portfolios are also geographically diverse, and this diversity somewhat mitigates the inherent risks of these types of loans.[24] Of course, a definitive conclusion about the overall risk presented by midsize banks would require an assessment of other vulnerabilities as well as the effectiveness of risk management techniques.

Business Lines

Do differences between regional and "other" midsize banks in terms of asset composition extend to business lines as well? To answer this question, we aggregated the individual regional and "other" midsize banks (rather than aggregating the independent banks and holding companies) by specialization and compared both their ROAs and their percentages of unprofitable institutions (see tables 9 and 10).[25]

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[23] FDIC (2003a).

[24] Acharya, Hasan, and Saunders (2002) looked at the effects of specialization and diversification on bank risk and return by examining the individual bank loan portfolios of 105 Italian banks from 1993 to 1999. Their results indicated that the diversification of bank assets did not guarantee either superior performance or greater safety. Specifically, they found that the industrial and sectoral diversification of banks that were already highly risky led to reduced bank profitability, a lower-quality loan portfolio, and increased inefficiency. However, the results for geographical diversification were somewhat different. Although risky banks had lower profitability, the overall quality of the loan portfolios improved with geographic diversification. And banks that were originally slightly or moderately risky improved their risk-return tradeoff: they became more profitable, increased the quality of their loan portfolios, and improved their efficiency.

[25] It is exceedingly difficult to determine the business line of a holding company. Therefore, we analyze business lines at the level of the individual bank and thrift. Business-line definitions are as follows: Commercial lenders have commercial and industrial loans, plus real estate construction and development loans, plus loans secured by commercial real estate properties, that exceed 25 percent of total assets. Mortgage lenders have residential mortgage loans, plus mortgage-backed securities, that exceed 50 percent of total assets. Consumer lenders have residential mortgage loans, plus credit card loans, plus other loans to individuals, that exceed 50 percent of total assets. Credit card lenders have credit card loans, plus securitized receivables, that exceed 50 percent of total assets plus securitized receivables. Agricultural banks have agricultural production loans, plus real estate loans secured by farmland, that exceed 25 percent of their total loans and leases. International banks have assets greater than $10 billion, and more than 25 percent of total assets are in foreign countries. Other specialized banks' loans and leases are less than 40 percent of total assets. Nonspecialized banks do not meet any of the definitions above.

Table 9

Aggregate Statistics for Regional Banks by Specialty

Year-End 1994–2003

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Commercial Lending										
Number of Banks	289	296	296	283	307	375	338	270	292	307
Return on Assets	1.21	1.28	1.42	1.35	1.28	1.28	1.17	1.18	1.39	1.29
% Unprofitable	1	1	2	1	2	2	4	4	3	4
Mortgage Lending										
Number of Banks	84	80	69	68	71	57	33	31	33	40
Return on Assets	.35	.90	.65	1.00	1.13	1.12	.97	1.23	1.30	1.16
% Unprofitable	11	3	5	3	6	4	3	4	0	5
Consumer Lending										
Number of Banks	53	52	45	30	22	21	19	8	4	4
Return on Assets	1.34	1.19	1.34	1.31	1.02	1.37	1.25	1.18	1.32	1.57
% Unprofitable	4	2	5	4	9	5	0	0	0	0
Credit Cards										
Number of Banks	18	14	12	9	9	7	7	6	4	4
Return on Assets	2.45	1.68	.78	1.84	1.38	1.51	1.37	1.22	2.62	2.70
% Unprofitable	0	10	25	0	0	0	0	0	0	0
Agriculture										
Number of Banks	59	50	47	37	36	39	15	12	13	12
Return on Assets	1.34	1.28	1.32	1.33	1.33	1.16	1.21	1.03	1.40	1.30
% Unprofitable	2	0	0	0	0	11	7	0	0	0
International										
Number of Banks	0	0	0	0	0	0	0	0	0	1
Return on Assets	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	.91
% Unprofitable	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	0
Other Specialized										
Number of Banks	42	39	27	25	24	17	16	17	20	15
Return on Assets	1.04	1.02	1.17	1.43	2.25	2.02	2.10	3.29	1.92	1.71
% Unprofitable	3	3	0	0	0	0	0	0	6	0
Nonspecialized										
Number of Banks	252	252	177	167	126	88	54	62	57	45
Return on Assets	1.22	1.24	1.23	1.29	1.36	1.39	.76	1.53	1.43	1.43
% Unprofitable	1	1	2	3	2	3	4	2	0	0
Total No. of Banks	**797**	**783**	**673**	**619**	**595**	**604**	**482**	**406**	**423**	**428**
Avg. Midsize ROA	**1.01**	**1.13**	**1.15**	**1.28**	**1.35**	**1.38**	**1.24**	**1.27**	**1.42**	**1.42**

Source: FDIC.
Note: By bank, not summarized at the holding-company level.

Regional banks are becoming increasingly specialized, with commercial lenders leading the way. In 1994, 68 percent of all regional banks were categorized as specialized institutions; by 2003, the comparable figure was 89 percent. However, as with the definitions of regional and other midsize banks, the definitions used to identify specialized institutions are somewhat arbitrary. It does not require a radical change in asset mix to move an institution from nonspecialized to specialized. Therefore, shifts reported here sometimes overstate the underlying industry changes.

Furthermore, this shift to specialization was not uniform across business lines. The percentage of regional banks categorized as commercial lenders rose from 36 percent in 1994 to 72 percent in 2003, whereas all other categories either remained the same or declined. This relative increase in small to medium-size commercial lenders occurred during an extended period of economic expansion (with a brief pause in 2001), bringing a number of banks above the 25 percent threshold to be categorized as commercial lenders. During this same period, however, retail lending—especially credit card lending and residential mortgage lending—became more concentrated. This increased concentration was due to the commoditization and securitization of retail loan products, a trend that made scale a significant competitive factor. Small and medium-size commercial loans, in contrast, are usually more heterogeneous, and they have not been commoditized. Because commercial loans remain labor-intensive, larger competitors' economies of scale are less important; and thus, the motive for concentration is weaker.

Commercial lenders also stood apart from other specialized banks in having lower volatility. Their return on assets from 1994 to 2003 was the most stable, with only a 25 basis point spread between the low and high years. In addition, commercial lenders were the only specialized banks to keep their percentage of unprofitable institutions below 5 every year.

Despite the success of commercial lenders, specialized banks as a whole outperformed the nonspecialized banks in only one of the ten years between 1994 and 2003. Mortgage lender performance was relatively weak, and the number of mortgage lenders has diminished substantially; this diminution probably reflects the sector's response to the commoditization of single-family mortgages. And although the aggregate returns for credit card companies have been very high, they occasionally had years where many companies were unprofitable (25 percent in 1996).[26] In contrast, the nonspecialized banks had only one year where the average ROA was below 1.20, and their percentage of unprofitable institutions never exceeded 5.

[26] Some high-cost failures were credit card lenders (Best Bank and Next Bank).

Table 10
Aggregate Statistics for "Other" Midsize Banks by Specialty
Year-End 1994–2003

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Commercial Lending										
Number of Banks	239	217	211	238	242	253	295	331	292	355
Return on Assets	.91	.99	1.12	1.27	1.30	1.27	1.17	1.04	1.36	1.45
Percent Unprofitable	6	4	4	3	1	3	2	4	1	1
Mortgage Lending										
Number of Banks	160	155	155	152	133	123	116	126	115	121
Return on Assets	.83	.85	.78	1.05	1.02	1.05	.96	.95	1.28	1.27
% Unprofitable	5	4	3	1	2	3	2	3	2	2
Consumer Lending										
Number of Banks	22	30	23	20	13	22	20	21	30	26
Return on Assets	1.15	1.33	1.76	1.08	.88	1.54	.86	2.09	1.01	1.50
% Unprofitable	0	0	0	0	0	10	11	10	7	4
Credit Cards										
Number of Banks	14	22	18	21	13	15	13	16	11	8
Return on Assets	3.50	2.70	2.38	2.44	3.52	4.16	3.71	3.15	3.68	4.67
% Unprofitable	0	6	14	12	0	9	0	21	0	0
Agriculture										
Number of Banks	35	31	14	11	20	12	15	10	6	12
Return on Assets	1.43	1.29	1.16	1.03	.98	1.03	1.27	1.00	1.27	1.10
% Unprofitable	0	0	0	0	0	0	0	0	0	0
International										
Number of Banks	2	1	2	2	1	0	0	1	2	1
Return on Assets	.93	.95	.99	1.09	.75	N/A	N/A	.59	.34	.81
% Unprofitable	0	0	0	0	0	N/A	N/A	0	50	0
Other Specialized										
Number of Banks	33	23	18	26	33	31	41	25	15	17
Return on Assets	.98	1.26	1.39	1.50	3.39	2.90	2.32	2.96	1.24	1.48
% Unprofitable	7	10	7	5	0	0	10	12	0	8
Nonspecialized										
Number of Banks	203	195	164	149	142	116	110	97	80	65
Return on Assets	.99	1.10	1.15	1.29	1.56	1.15	.92	1.00	1.45	1.05
% Unprofitable	1	1	0	0	3	1	3	4	5	0
Total No. of Banks	**708**	**674**	**605**	**619**	**597**	**572**	**610**	**627**	**551**	**605**
Avg. Midsize ROA	**1.01**	**1.13**	**1.15**	**1.28**	**1.35**	**1.38**	**1.24**	**1.27**	**1.42**	**1.42**

Source: FDIC.
Note: By bank, not summarized at the holding-company level.

Like regional banks, "other" midsize banks are becoming increasingly specialized, with commercial lenders again leading the pack. In 1994, 71 percent of all "other" midsize banks were specialized institutions, but by 2003 the comparable figure was 89 percent. This shift was not uniform across business lines. The percentage of "other" midsize banks categorized as commercial lenders rose from 34 percent in 1994 to 59 percent in 2003, whereas most other categories either remained the same or declined.

Specialized banks as a whole outperformed the nonspecialized banks in only three of the ten years between 1994 and 2003. Mortgage lenders had five years where their average ROA dropped below 1 percent. And although the other specialized banks' average ROAs were good, they often had years where their percentage of unprofitable institutions was over 5 (consumer lenders and credit companies also had this same problem).

There are a few differences between the regional and "other" midsize banks in regard to business lines. "Other" midsize banks have a significantly higher percentage of mortgage lenders than regional banks (20 percent and 9 percent, respectively, in 2003) and "other" credit card banks have consistently outperformed the regional credit card banks (by 163 basis points on average).

Prospects and Options

Midsize banks are currently performing very well, but like all banks they will face significant demographic changes and competitive challenges going forward. New financial entrants are poised to enter the market, and potential nonbank competitors are growing in number and diversity. Many of these nonbank competitors have a competitive advantage—less regulation. And although some technological advances are helping midsize banks tremendously, others could help these banks' competitors move more aggressively. In the future, therefore, new entrants could come from a multitude of large organizations. Yet midsize banks are far from defenseless going forward. They have a diverse set of options they can pursue to maintain their strength or improve their long-term prospects.

Some of the larger midsize banks are under pressure from Wall Street analysts to grow like the top 25 banks. One potential growth strategy is to acquire other midsize banks. The resulting entity would have the ability to make larger loans, the chance to offer broader product lines, and the possibility of decreasing its risk by diversifying into new markets. The new entity, however, would have new operational risks to manage, such as handling diverse corporate cultures, integrating systems, and managing far-flung offices.

Another potential growth strategy is to acquire one or several community banks. Then management could leverage the local banks' knowledge of the local economies and their relationships with customers. This has been done successfully in two ways—a complete absorption, or a "federal model" in which the brand and identity of each individual bank is maintained, although support and product activity are centralized.[27] Perhaps a more risky growth strategy would be to acquire a nonbank competitor or enter new lines of business (such as financial advisory services), with the idea of being a one-stop financial supermarket.

If merger candidates are unappealing, some midsize banks may wish to expand internally. One option would be to build new offices. This strategy could work well where there are a significant number of customers wishing to conduct their banking business in person—for example, in communities with a large population of retirees. Another option would be to increase the bank's presence on the Internet. This strategy could work well where there are a significant number of customers wishing to conduct their banking business on the Internet—for example, in academic and high-tech communities.

For midsize banks that want flexibility, strategic alliances provide an alternative to mergers.[28] Midsize banks that wish to remain independent can use strategic alliances to offer more products in order to compete with large banks and competitors. For example, a midsize

[27] Salvatori (2002). See also Anthony (2003). A good example of the absorption model is BB&T. A good example of the federal model is Synovus.
[28] Gup and Marino (2003). Between 1990 and 1999 there were 3,005 joint ventures and strategic alliances involving the financial sector. Of these, 1,640 were in North America.

bank may ally itself with an insurance company or a mutual fund. Strategic alliances can also help midsize banks expand their access to new markets.

Some midsize banks may find it advantageous to develop an expertise or innovation and become a specialist. Wallenberg (2002) believes that technology plays an important role in this option, with the factors necessary for success being "scale, a low cost and fast product development."[29] However, although technology can help specialists undercut their more general competitors in price, the downside of this option is a lack of risk diversification. Therefore, some midsize banks may instead find it more advantageous to become multispecialists.

Midsize banks have many viable options at their disposal. The ideal strategy or mix of strategies for an individual bank will depend on its particular expertise, resources, and market.

Summary

We found that in the last seven years, both regional and "other" midsize banks have consistently outperformed community banks and have usually outperformed the top 25 banks. In addition, we have found that over the same period, the number of regional and "other" midsize banks increased 7 percent. But in terms of assets, the midsize sector lost market share between 1996 and 2003, largely because of the top 25 banks' dramatic growth through mergers and acquisitions. The midsize sector increased its investments in loans, particularly commercial real estate loans, while decreasing its investments in consumer loans and increasing its investments in mortgage-backed securities. Analysis of business lines revealed that an increasing number of midsize banks are shifting their emphasis to commercial lending. The nonspecialized banks, however, are continuing to perform well.

[29] Wallenberg (2002).

In conclusion, we found the midsize banking sector to be very profitable. The sector currently exhibits substantial asset diversity and low levels of noncurrent loans. Considering the existing variety among these banks and the multitude of viable options available to them, we believe that midsize banks are likely to remain both heterogeneous and generally profitable. Some midsize banks are also likely to continue to be acquisition targets of the top 25 banks and "other" midsize banks. At the same time, many community banks will enter the sector through internal growth, mergers, and acquisitions. Therefore, we expect that in the near future the number of midsize banks, although relatively small, will likely remain stable or grow slightly.

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