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This year's ***FDIC Banking Review*** features papers from the FDIC's Future of Banking project. Initiated by Chairman Donald Powell, the study projects likely trends in the structure and performance of the banking industry and anticipates the policy issues that will confront the industry and the regulatory community in the coming years.

The Future of Banking in America

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Community Banks: Their Recent Past, Current Performance, and Future Prospects

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The U.S. banking system has long had a multitude of small institutions. This characteristic of the industry has been shaped by a number of factors. The dual banking system—that is, the coexistence (since the end of the Civil War) of both federal and state chartering—has fostered the creation of small banks, and this effect was reinforced by chartering regulations at both the national and state levels that were frequently permissive. In addition, the fear of concentration, as well as efforts to keep local markets free of outside competition, led many states to impose longstanding limits on branching, and this legacy of unit banking helped swell the numbers of small banks, particularly in the Midwest. The lack, until fairly recently, of the technology necessary for creating very large banking organizations was another factor contributing to the multiplicity of small banks. Of course, during the last quarter of the twentieth century the requisite technological advances occurred at the same time that legal impediments to branching were being gradually removed. Thus, for the last decade of the century in particular, the industry saw a great deal of consolidation, much of it involving community banks, whose numbers fell significantly.[1] (See table 1.) Moreover, community banks' shares of deposits, assets, and offices have fallen steadily and significantly since 1985. (See table 2.) Given these trends and the oft-cited notion that such small banks are destined to disappear, victims of their inability to compete with larger institutions, one might ask why the future of community banks is of interest.

One reason is that although the number of community banks (those with less than $1 billion in assets, a definition explained on the next page) has decreased, thousands of such banks remain: at year-end 2003 community banks constituted 94 percent of all banks in the nation. Thus, by this criterion, what happens to these banks is not insignificant. Another reason is that from an economic viewpoint, these institutions remain very important in specific business and economic sectors, notably small-business and agricultural lending. Small businesses play a critical role in the U.S. economy as a whole and in economic growth in particular, so their ability to find credit—and where they find it—is of consequence. Some observers have expressed concern that a continued banking industry consolidation that significantly diminished the number of

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[1] Consolidation in the 1990s mostly involved mergers between two community banks, and merger targets were usually community banks (DeYoung, Hunter, and Udell [2003], 14; their paper also provides a useful history of the relaxation of legal impediments to branching during the past 30 years).

Table 1

Number of FDIC-Insured Community Banks, 1985–2003

		Additions		Deletions				
Year	Number at Beginning	De Novo Banks	Other Additions[a]	Unassisted Mergers and Acquisitions	Net Decline from Growth out of Size Group	Closings from Failures[b]	Other Deletions[c]	Number at Year-End
1985	14,351	304	162	490	33	144	9	14,141
1986	14,141	214	122	581	43	180	15	13,670
1987	13,670	175	65	510	29	216	95	13,204
1988	13,204	171	66	480	26	339	39	12,613
1989	12,613	138	25	338	1	433	27	12,025
1990	12,025	118	29	345	(2)	325	38	11,538
1991	11,538	62	20	286	1	223	24	11,116
1992	11,116	29	27	351	(9)	133	25	10,692
1993	10,692	37	7	511	18	45	32	10,144
1994	10,144	32	8	515	17	15	1	9,612
1995	9,612	71	2	495	36	8	17	9,143
1996	9,143	109	2	432	25	6	(3)	8,776
1997	8,776	149	4	425	49	1	7	8,443
1998	8,443	166	8	482	42	3	15	8,089
1999	8,089	212	8	349	43	7	6	7,902
2000	7,902	178	10	263	32	5	6	7,782
2001	7,782	113	5	224	31	2	5	7,634
2002	7,634	79	1	198	25	9	25	7,489
2003	7,489	101	1	208	43	1	22	7,337
Total		2,458	572	7,483	483	2,095	405	7,337

Note: Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

[a]Includes (1) new charters issued to absorb another charter and (2) noninsured institutions.

[b]Does not include failures when the institution remained open.

[c]Includes mergers into noninsured charters, transfers to noninsured charters, voluntary liquidations, and any errors that resulted from all changes balancing to the number of community banks at the end of the year.

community banks serving small-business and agricultural lending could leave the credit needs of such businesses unmet (although evidence as to the validity of this concern is mixed).

The future of community banks is worth examining from a third viewpoint as well—that of deposit insurance. Community banks' prospects are of significant interest to the FDIC because small-bank failures have represented a disproportionate share of FDIC losses in recent years; between 1998 and 2002, for example, community banks with 63 percent of failed-bank deposits accounted for approximately 72 percent of the FDIC's failure costs.[2] Many of these failed small banks experienced at least some period of very high growth within five years before failure, and some of the failed community banks, whether through new ownership or a change in business plan, had adopted rapid-growth, high-risk policies, which resulted in high resolution costs when the institutions failed. Such a rapid transformation of a bank's risk profile is rarer in the case of a large bank.

A community bank can be defined in different ways, but size is usually the determining factor. These banks are generally thought of as relatively small institutions that do most of their business within a fairly circumscribed geographic area. For the purposes of this article, community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion; in addition, bank asset-sizes are calculated using

[2] These figures count First National Bank of Keystone as a community bank. Although it had slightly more than $1 billion in assets the year before it failed, it had grown very quickly for the previous five years and so was well below $1 billion in assets during most of the period when it engaged in the high-risk policies that ultimately led to its failure.

Table 2

Shares of Banking Industry Assets, Deposits, and Offices, 1985–2003

	Percentage of Assets			Percentage of Deposits			Percentage of Offices		
Year	Community Banks	Midsize Banks	Top 25 Banks	Community Banks	Midsize Banks	Top 25 Banks	Community Banks	Midsize Banks	Top 25 Banks
1985	25.89	46.06	28.05	29.19	45.73	25.08	47.29	43.67	9.04
1986	24.28	47.84	27.88	27.60	47.37	25.03	45.10	43.81	11.08
1987	23.33	48.56	28.11	26.62	47.77	25.61	43.99	44.11	11.90
1988	22.35	49.77	27.88	25.49	48.74	25.78	42.52	43.98	13.49
1989	22.53	48.12	29.35	25.68	47.40	26.92	42.27	43.87	13.86
1990	22.61	46.02	31.37	25.42	45.38	29.20	41.55	41.71	16.74
1991	23.18	42.55	34.27	25.72	42.34	31.94	41.38	39.70	18.91
1992	23.40	40.58	36.02	26.31	40.39	33.30	41.74	38.32	19.95
1993	22.02	39.23	38.75	25.36	39.10	35.54	40.70	37.95	21.36
1994	20.24	38.20	41.57	23.81	38.25	37.94	39.13	37.12	23.75
1995	18.97	37.37	43.66	22.75	38.09	39.16	38.28	37.89	23.83
1996	18.42	34.50	47.08	22.08	35.22	42.71	37.93	35.39	26.68
1997	17.06	33.04	49.90	20.84	34.30	44.86	36.90	35.49	27.61
1998	15.86	29.61	54.53	19.57	31.18	49.24	35.56	33.89	30.56
1999	15.25	30.10	54.65	18.81	31.05	50.14	35.12	34.03	30.85
2000	14.61	30.41	54.97	18.07	32.12	49.82	35.17	34.24	30.59
2001	14.53	28.77	56.69	17.98	29.59	52.42	35.02	32.32	32.66
2002	14.27	28.29	57.44	17.55	29.23	53.22	34.61	32.80	32.58
2003	13.55	28.78	57.67	16.72	29.75	53.53	33.70	33.50	32.80

Note: Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

assets measured in 2002 dollars.[3] Some studies may not include thrifts, but if thrifts and banks can be viewed as competitors, it is logical to include both kinds of financial organizations. However, it must be noted that some analyses in this article, particularly those examining earnings and performance, require the exclusion of de novo banks (defined here as banks less than five years old) because during the early years of a bank's existence, earnings and growth are atypical. In addition, because of historical differences between banks and savings institutions, certain analyses of performance and balance sheets treat commercial banks separately from savings institutions.

This article first explores some of the more significant characteristics of community banking, examining the importance of community banks in small-business lending in terms of their ability to handle "soft" data, their tendency to rely on retail deposits for funding, and their emphasis on personal service. The tremendous consolidation that community banks have experienced has already been mentioned, and the second section of the paper investigates the decline in community bank numbers from 1985 to 2003, analyzing both the nature (failures, mergers, and new banks) and the geographic distribution of the decline. Was consolidation more pronounced in formerly unit-bank states than in other areas? How did consolidation differ between large metropolitan, small metropolitan, and rural areas and between growing and declining markets? This section also examines changes in the presence and the importance of community banking in different types of local deposit markets. Having examined changes in community bank presence, we turn our focus to these banks' balance sheets, business lines, and performance. Where has community banks' share as lenders suffered, and where have these banks held their own? Have the characteristics of community bank funding changed? How have community banks performed, both compared with larger banks and within their own ranks? How has community bank performance been affected by growth in the markets in which community banks are present? The article ends with some discussion of the prospects for community banks in light of their competitive strengths and the challenges facing them.

[3] Under this definition, a bank or thrift that has less than $1 billion in assets but is within a holding company with more than $1 billion in assets is therefore not a community bank. (In this paper, the terms *thrift* and *savings institution* are synonymous.)

The Economic Role of Community Banks

Although the number of community banks has declined over the past 20 years, the performance of these banks and the fact that their numbers remain high confound predictions of their virtual demise—predictions made just a few years ago. For example, in 1997 one bank analyst predicted that the industry would consolidate at a rate of 300 banks per quarter, with a total of less than 1,000 banks remaining. A 1996 prediction held that consolidation would mean the United States would have "well under 5,000" banks just four years later; much of this decline would obviously have involved community banks.[4] Such prognostications are, of course, often inaccurate. It should be noted that this view was not universally shared. As early as 1991 former FDIC Chairman William Isaac believed that consolidation did not pose a danger to well-run community banks; in 1996 Alan Greenspan was quoted as stating that those who were predicting the end of the community bank were "just plain wrong"; and by 1997, others were predicting (rightly) that the decline in small-bank numbers was slowing dramatically.[5]

Since community banks have not vanished, it appears that many of them must be doing something right; moreover, the formation of significant numbers of new community banks since 1992 (to be discussed in greater detail below) demonstrates that these banks are perceived to be viable. Researchers have therefore sought to determine just what the "something right" is and whether it will continue to be important. That "something" is strongly related to community banks' economic role, and three areas of that role will be discussed here: community banks' success in providing credit to certain business sectors, their ability to attract retail deposits, and their capacity to build on the provision of personal services to their customers.

One of the more significant elements of community banks' economic role is their function as providers of credit: they serve important segments of the business-loan and farm-loan markets. Although overall their share of small-business loans (loans of less than $1 million at origination) has declined during the past decade, they still provide almost a third of all small commercial and industrial loans and more than 40 percent of small commercial real estate loans. They are even more important as farm lenders, providing 65 percent of all farm real estate loans, 61 percent of all farm operating loans, and roughly 75 percent of small farm loans (loans of less than $500,000 at origination) reported on bank balance sheets. A detailed examination of community bank lending is presented below in the section "Community Bank Industry Shares, Portfolios, and Performance."

Much recent literature has identified the strength of community banks in these areas as stemming from their ability either to successfully lend to what have been variously described as "informationally opaque" borrowers—borrowers without long credit histories suitable for credit-scoring or other model-based lending practiced by large banks—or to engage in relation- or reputation-based lending or lending in low-volume markets. As a recent article notes, "large hierarchical firms are at a comparative disadvantage when information about individual investment projects is innately soft."[6] Soft data include a borrower's character or ability to manage, and this information is generally gleaned through a local presence and personal interactions with borrowers; also thought to be helpful is a favorable organizational structure (close proximity of lending officers to management).[7] In contrast, large banks prefer hard data (e.g., credit history, income, debts, and other data available from financial statements and credit reports) and are less willing to lend to "informationally difficult credits."[8] With the ability to process the soft data, community banks are thought to have certain comparative advantages in lending to informationally opaque borrowers, and these advantages are helpful in underwriting and monitoring loans to small businesses and farmers. Empirical support for this view is provided by a recent study that found that small banks earn higher risk-adjusted returns on business loans than large banks; the study concluded that small banks make "better choices" in lending to businesses.[9]

Community banks have also been defined by their tendency to rely more on retail and insured deposits for their funding than large banks have done. A recent study notes that at year-end 2002, community banks "held 24 percent of deposits [as a percentage of deposits at all banks] in accounts of $100,000 or less, but only

[4] Spiegel, Gart, and Gart (1996), 18–19; Kline (1997).
[5] Isaac (1991); De Senerpont Domis (1996); Kline (1997).
[6] Stein (2002), 1912.
[7] See, for example, Nakamura (1994); Berger and Udell (2002); DeYoung, Hunter, and Udell (2003); Brickley, Smith, and Linck (2001); and Berger and Udell (2003).
[8] Berger et al. (2002).
[9] Carter, McNulty, and Verbrugge (2004).

15 percent of deposits in accounts over that amount."[10] Given this emphasis, it is not surprising that community banks usually charge lower fees for deposit services.[11] In 2002, the Federal Reserve Board found that, on average, small institutions charged lower fees than large banks. For example, the average annual fees charged by large banks for simple passbook accounts were 72 percent higher than those charged by the smallest banks, and the average stop-payment fee was 38 percent higher at large banks than at the smallest banks.[12] It should be noted, however, that the fee advantage held by smaller institutions, though still present, has been declining; the decline may indicate that small banks are seeking to exploit fee income somewhat more than they have in the past.[13] Community banks, because they rely on retail deposits and need to attract them, also appear to pay higher rates on retail deposits than large banks competing in multiple markets.[14] Paying the higher rates has been feasible because surviving small banks have been able (until very recently) to earn a higher rate of return on their assets, maintaining profitability even while growing more rapidly than large banks during nearly the past two decades.[15]

A third significant element in community banks' economic role is the manner in which they interact with customers. Although advances in information technology, such as the Internet, have enabled many customers to transact banking business without having recourse to a bank's premises, there apparently remain customers who prefer face-to-face contact. Community banks have typically seen personal service as their most important competitive advantage, and they market personal service and local connections to prospective customers. Many community banks seek to demonstrate this service by being active in their communities. For example, a significant percentage of community bankers responding to a recent survey noted that they participated in civic groups, worked with local chambers of commerce, supported local schools, assisted local relief efforts, and offered special help to low-income segments of the community.[16] Recent research has shown that the formation of new banks is strongly correlated with mergers that shift "ownership away from small organizations or toward distant organizations"; one explanation for this correlation is that large organizations tend not to adequately serve "small, relationship-based" customers. The new institutions may be finding a market in providing for the needs of customers to whom the business methods of larger banks are unsatisfactory.[17]

Anecdotal evidence supports the view that small banks can attract such customers. In a recent Federal Reserve System survey of community bankers, respondents commonly noted that because of their local knowledge and personal service, they were able to draw business away from larger institutions. They also reported that some community banks experienced significant asset growth in the wake of recent acquisitions of other community banks by large institutions.[18] Another indication of the "personal-service" phenomenon is large banks' efforts to emphasize personal service even though their comparative advantage would seem to be in mass-market lending based on hard data (credit history and other objective indicators of risk).[19] Whether face-to-face contact will continue to be as important is a subject dealt with below.

Consolidation and the Geography of Community Banking

There is some concern that the economic role played by community banks has diminished. Their presence has clearly declined as the banking industry has been transformed into one composed of fewer, larger institutions. Changes in community bank presence can be measured in a number of ways. Two approaches are used here. One is to examine the components of change (mergers, failures, and new banks) between 1985 and 2003 in different types of markets (rural, small metropolitan, and large metropolitan [and, within the last,

[10] Keeton, Harvey, and Willis (2003), 28.
[11] Timothy Hannan, cited in Keeton, Harvey, and Willis (2003), 28.
[12] For simple passbook accounts, the dollar amounts were $36.96 versus $21.48; for stop-payment orders, $23.54 versus $17.00 (Federal Reserve Board [2003], appendix B). The Federal Reserve Board defines small banks as institutions with less than $100 million in assets; medium-size banks, assets between $100 million and $1 billion; and large banks, more than $1 billion in assets. In 2002 medium-size banks' fees were usually somewhere between the fees of small and large banks.
[13] Federal Reserve Board (1999); Kimmelman (1999).
[14] Timothy Hannan and Robin A. Prager, cited in Keeton, Harvey, and Willis (2003), 28.
[15] Bassett and Brady (2002).
[16] Grant Thornton (2002). Grant Thornton mailed surveys to the chief executives of 5,393 community banks and savings institutions in November 2001. The response rate was 8 percent.
[17] Keeton (2000). See also Berger et al. (1999); Seelig and Critchfield (2003).
[18] DeYoung and Duffy (2002), 9.
[19] For example, it is not unusual for large banks to advertise "relationship banking accounts," and many large banks seek to be customer-friendly by turning their branches into "stores."

urban and suburban] as well as in markets experiencing population growth and population decline) and under different past restrictions on branching. The other approach used here is to analyze changes in community banks' shares of deposits and deposit-taking offices across the same types of markets also between 1985 and 2003. Both approaches allow us to see if there were kinds of markets or states where, in the face of consolidation and competition, community banks fared better or worse than they did in other markets or states.

Changes in the Number of Community Banks

Between 1985 and 2003, the total number of community banks declined by just under half (table 1). The greatest decrease was among small community banks (those with assets below $100 million in 2002 dollars), but it should be noted that a significant portion of the overall decline came about because small institutions outgrew the community bank size class. The number of community banks having inflation-adjusted assets of less than $100 million declined by 64 percent.[20] These small banks accounted for 92 percent of the decline in the total number of community banks. The decline in the number of larger community banks (those having assets of between $100 million and $1 billion in 2002 dollars) was much smaller—this group experienced only a 13 percent drop in number.

Before exploring the consolidation that led to the decrease in community bank numbers, we examine the positive side of the ledger—the formation of new banks—because trends in their establishment have implications for the future of community banks. New-bank formation fell into three periods: the first, from 1985 to 1990, corresponded with a relatively permissive chartering environment and saw considerable numbers of new banks formed (though formations dwindled as the period drew to an end);[21] the second period, from 1991 to 1995—from the last part of banking crisis through the beginning of the industry's recovery—had few new banks; and the third period, from 1996 to 2003—as the industry thrived and consolidation created new opportunities—once again saw significant numbers of new banks. (See table 1.)

The substantial number of new banks confirms that many investors believe the community bank model remains viable, at least where local economies are growing. Since 1992 there have been approximately 1,250 new community banks, of which about 150 have been merged and about 1,100 still exist as independent organizations.[22] This market test is impressive testimony on behalf of viability, even though some of these de novos developed substantial risk factors as they matured. Young banks, because they have tended to locate in rapidly growing markets and because they have concentrated more heavily on real estate lending, are substantially more vulnerable to serious real estate problems than their established counterparts.[23]

In the 1980s new institutions did not fare well, but institutions formed in the 1990s can be expected to do better. First, newly chartered banks now face more stringent supervision.[24] Second, in 1991 the FDIC obtained separate statutory authority to approve deposit insurance for national banks;[25] previously approval had been automatic. Third, new banks in the 1990s might have been able to tap more experienced management than new banks in the 1980s because in the 1990s many de novo banks were formed in the same geographic areas where there had been merger activity. Thus, the supply of locally available bank management personnel would have increased.[26] Fourth and most important, serious regional recessions comparable to those of the 1980s have been absent.[27] Only 4 of the approximately 1,250 new community banks established between 1992 and 2003 have failed.

Although new-bank formation has been significant, the effect of consolidation on the community bank population far outweighs it. There were essentially two components to the decline: mergers and failures. Throughout the entire period 1985–2003, mergers accounted for most of the decrease in the number of community banks; failures were significant as well, but (not surprisingly) were almost completely confined

[20] Because this comparison has been adjusted for inflation, it compares the number of banks in 2003 that had less than $100 million in assets with the number of banks in 1985 that had less than $66 million in assets. See table A.2.

[21] For a discussion of chartering policies in the 1980s, see FDIC (1997), 106ff.

[22] Twenty-one have disappeared: 17 were voluntarily liquidated, and only 4 failed.

[23] Yom (2003).

[24] DeYoung (2000), 5. DeYoung notes that the payment of dividends by these banks is also restricted.

[25] The Federal Deposit Insurance Corporation Improvement Act of 1991.

[26] Seelig and Critchfield (2003).

[27] DeYoung (2000) notes that in his analysis, banks chartered closest to the peak of the "banking recession" failed at relatively high rates. For a discussion of the effect of the recessions of the 1980s and early 1990s on banking, see FDIC (1997).

to the years of industry problems—the years before 1993.[28] This consolidation, coupled with the lifting of structural restrictions and the frequent expression of belief that community banks were doomed to vanish, might have seemed to augur great geographical disparities in the landscape of community banking (even aside from the sheer decrease in numbers).

As we began our investigation, it seemed likely that further examination of the decrease in community bank numbers might help explain why the number of community banks had been halved. We explored two logical explanations for the decline: (1) that the removal of interstate branching restrictions likely played a significant role, and (2) that community banks located in markets having differing economic prospects would have experienced differential declines in numbers. (We analyzed four market segments: rural markets, small metropolitan markets, and suburban and urban parts of large metropolitan markets.) Both analyses, however, yielded surprising results and demonstrated that neither of these explanations was persuasive; the declines were, in fact, proportionally similar no matter how the pie was sliced. (See figure 1.)

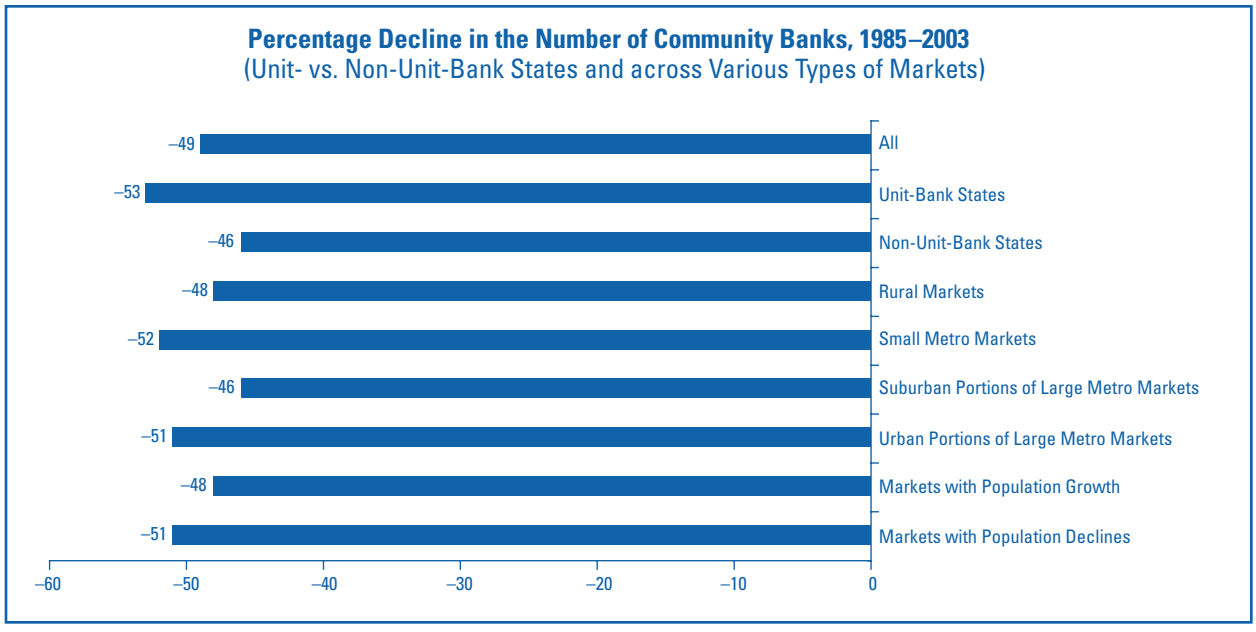
To examine the hypothesis that, with the removal of branching restrictions, formerly unit-bank states would have witnessed a disproportionate decline in community bank numbers, we compared 12 such states with the rest of the country.[29] We found that community bank numbers declined by 53 percent in the unit-bank states and by 46 percent in the non-unit bank states. The unit-bank states contained 42 percent of community banks in 1985 but still had 39 percent of them in 2003. This decline in share stemmed largely from less new-bank activity and proportionally more failures in the unit-bank states.[30] These relatively small differences fail to suggest that unit-banking laws had artificially maintained high numbers of community banks, and it is hard to argue, at least from experience, that by virtue of their previous banking statutes these states will see greater consolidation in the future. However, since many of the unit-bank states are predominantly rural and since banks in rural areas have been comparatively less attractive as merger targets, it may be that not enough time has passed for consolidation to occur.

[28] Interestingly, banks growing large enough to leave the ranks of community banks made up a steady trickle of the decrease during the entire period, except briefly when capital standards were being increased in response to the banking crisis and few or no banks managed to grow out of the community bank classification.

[29] The states described as having "prevalent unit banking" (a categorization determined by the Conference of State Bank Supervisors "based on the type of banking seemingly prevalent in each state") as of year-end 1977 were Colorado, Illinois, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming (Conference of State Bank Supervisors [1978], 95).

[30] See tables A.1 and A.2.

Figure 1



An examination of community bank presence in different types of markets yielded a similar picture—one of proportional stability in the community bank population.[31] There were significant declines of 46 to 52 percent in all types of markets (figure 1), but the differences in the percentage changes of community banks in each type of market between 1985 and 2003 were small. However, there have been significant differences in the dynamics underlying the declines in the number of community banks. Rural areas saw proportionally fewer mergers and very little de novo entry in comparison with both small metro and large metro areas, and the largest amount of merger and de novo activity took place within large metro areas.[32] When we extended our analysis to community banks in both growing and declining markets, we saw similar patterns. Predictably, the overall drop in the number of community banks was less in growing markets than in declining markets. Also predictably, particularly in all three types of metropolitan markets, mergers and new banks were far more numerous in areas of growing population than in areas of declining population.[33]

The other article in this issue of the *Banking Review* notes that many banks are located in rural areas with declining populations, and that long-standing trends in farm depopulation and consolidation have led to economic decline in many of these areas—most notably in the Great Plains states. Despite depopulation and its attendant economic effects, however, reductions in the number of banks even in areas experiencing the most profound depopulation mirrored the reductions in rural areas across the country. The long-term effects of depopulation, coupled with a lack of succession plans at closely held community banks, may eventually lead to problems with the survival of community banks in those states.[34] Thus far, however, these banks have not performed badly, and predicting with confidence how quickly consolidation will occur in these areas as a result of such long-term processes—and how much of it there will be—is difficult.

It is, however, worth noting that community banks in the Great Plains represent only about 13 percent of all U.S. community banks. And not all rural areas are declining; some are growing because of high birth rates and high immigration. During the 1990s, the rural West grew by 20 percent—twice the national average. The overall population in the 343 rural counties in the Western Census Region increased by about 27 percent from 1985 to 2001; only just over a quarter of those counties experienced population decline, whereas the remainder saw their populations expand.[35] Furthermore, many rural areas are no longer dominated by agriculture. Indeed, the U.S. Department of Agriculture finds that in seven out of eight rural counties the economy is now dominated by manufacturing, services, and other employment not related to farming. Even within agricultural areas, future job growth is more likely to come from industries related to farming than from farming itself.[36] The performance of, and prospects for, banks located in rural areas that are not experiencing depopulation are likely to mirror those of similar-size banks in urban areas.

Community Bank Presence in Local Deposit Markets

Although the distribution of community banks across different types of markets has remained remarkably stable, the distribution of community bank deposits across local banking markets has shown more variation. In this section we look at change in the deposit-taking presence of different-size institutions in various types of local banking markets and at the implications of these changes for where community banks tend to operate. We find that changes in the composition of local deposit markets reflect the increasing geographic reach of larger (noncommunity) banks into new

[31] We measured community bank presence by looking at the location of a bank's headquarters. It is important to go beyond simple comparisons between MSAs (metropolitan statistical areas) and non-MSAs and to identify suburban areas. By our definition, only large MSAs (those with populations over 500,000) can have suburbs. Initially, the urban area within the MSA was defined by the Census's central city, so all counties within those central cities were identified as "central counties"—hence, urban counties. However, significant numbers of central cities in large MSAs spanned multiple counties, so the "central-city" measure was less useful. Therefore, in large MSAs that had more than two central (or urban) counties, an adjustment was made: if population density in the MSA exceeded 1,000 per square mile, all counties that exceeded this density were designated as urban; all other counties in those MSAs were designated as suburban. In large MSAs where the population density was less than 1,000 per square mile, any county that exceeded the median population density of that MSA's central counties was classified as urban; those below the median were classified as suburban. It should be noted that we used 2003 census classifications of counties and projected them back to 1985. Therefore, if a county became part of an MSA at any time during the period, that county would always have been classified as part of an MSA.

[32] See table A.3.

[33] See tables A.5 and A.6.

[34] Walser and Anderlik (2004).

[35] This region includes the states of Arizona, California, Colorado, Idaho, Montana, New Mexico, Nevada, Oregon, Utah, Washington, and Wyoming. The 93 counties that experienced decline saw a decrease of about 11 percent from a population of 910,000. The 250 counties that experienced population growth had an increase of 32 percent from a population of 5.8 million.

[36] Whitener and McGranahan (2003). In the Department of Agriculture's study, rural counties were those outside of MSAs.

markets—a spread made possible by branching deregulation and changing banking technologies that have reduced the costs associated with distance. Changes in local deposit markets also reflect a consolidation of community banks themselves into fewer, larger institutions. But, as with trends in the number of community banks, deposit market patterns suggest that community banks have not been left to wither in areas with declining economic prospects. Rather, community banks continue to play an important role, albeit a smaller one than before, in all types of local banking markets.

Community banks' share of the deposits held in all types of local markets certainly declined between 1985 and 2003. The largest decline was in the urban parts of large metro markets, where the community bank share was halved; in other types of markets, decreases in community bank market shares were proportionally smaller (see table 3). Moreover, these changes in community bank market shares understate the extent to which surviving community banks have actually maintained their competitive position in the face of local consolidation activity. In other words, given the shift that has taken place toward fewer, larger banks, one would have expected to see even greater declines in community bank market shares than have actually occurred. Indeed, when we net out changes in deposit share that are due to the reclassification of banks into larger-size categories (because of subsequent mergers, acquisitions, or asset growth), we find that the remaining community banks have been increasing their deposit shares; this is particularly true in small MSAs and suburban areas of large MSAs.

It is also instructive to look at changes in the extent to which the different size categories of banks have any deposit-taking presence (i.e., the extent to which they report any deposit-taking offices) in local banking markets. The 25 largest banking organizations were those best positioned to expand their geographic reach. In 1985 they reported having offices in roughly half of large urban areas, in 40 percent of small MSAs, but in only 11 percent of rural counties. Midsize banks had deposit-taking offices in practically all metropolitan markets but in fewer than half of all rural counties. Hence, as recently as the mid-1980s, a significant number of rural banking markets were served entirely by community banks. By mid-2003, the 25 largest banks had increased their deposit-taking reach to more than 45 percent of rural markets and almost all urban markets. Of course, the widening reach of the very largest banks is not surprising, for they tended to be the banks most constrained by the branching restrictions that were lifted during the period.

Like measures of deposit market share, the relationship between bank consolidation and the geographic scope of banking offices yields information about the nature of consolidation activity at the local-market level. Between 1985 and 2003, the number of rural markets where community banks reported having any deposit-taking offices declined; but given the consolidation that has taken place, one would have expected this decrease to have been much more pronounced. Conversely, the very largest banks have increased the number of rural markets where they have deposit-taking branches; but in many of the rural markets where they acquired a branching presence they have not maintained it. Rather, the data suggest that other community banks entered markets where a community bank presence had been lost because of merger activity.

These patterns in local deposit markets indicate that changes observed in community bank presence understate the extent to which surviving community banks are actually prospering. Adjusting for reclassifications in size category due to acquisition activity or asset growth, we find that despite experiencing market share declines, community banks—here measured in terms of their local deposit taking—were actually growing. In other words, activity by existing (and new) community banks has offset what would have been larger declines in market share due to bank consolidation.

Other studies have found similar patterns for community bank assets, deposits, and small-business lending. A study of the performance of smaller community banks shows that, after adjustments for mergers, the growth of assets has been "significantly faster" at small banks than at large banks in every year from 1985 to 2000.[37] Deposit growth—both total deposits and uninsured deposits—followed the same pattern. Along the same lines, a study of small-business lending by community banks found that, adjusting "for size category reclassifications due to consolidation

[37] Bassett and Brady (2001), 722. It should be noted that these authors' definition of "small" banks does not conform to our definition of community banks. Bassett and Brady defined small banks as insured commercial banks with an asset size below that of the largest 1,000 banks (in other words, with assets below $331 million in 2000). They defined large banks as the 100 largest institutions (assets of at least $6.94 billion in 2000); institutions between these two size groups were defined as medium-size. Medium-size banks experienced greater "merger-adjusted" asset growth than large banks but less than small banks.

Table 3

Changes in the Distribution of Domestic Deposits by Type of Geographic Area, 1985–2003

	Community Banks				Midsize Banks				Top 25 Banks			
			Large Metro				Large Metro				Large Metro	
	Rural	Small Metro	Sub-urban	Urban	Rural	Small Metro	Sub-urban	Urban	Rural	Small Metro	Sub-urban	Urban
Share of deposits												
1985 deposit share	72.1	48.4	38.1	19.2	24.0	41.3	53.3	54.5	3.9	10.3	8.6	26.3
Adjusted for subsequent mergers and asset growth	51.3	19.7	17.3	7.7	23.0	32.5	28.7	24.2	25.7	47.8	54.0	68.1
2003 deposit share	53.0	27.8	21.9	9.0	28.5	38.8	37.2	29.4	18.5	33.4	40.9	61.6
Deposit-share changes												
Change from 1985 to 2003	–19.1	–20.6	–16.3	–10.2	4.6	–2.5	–16.0	–25.1	14.5	23.1	32.3	35.3
Adjusted for subsequent mergers and asset growth	–20.8	–28.7	–20.8	–11.6	–1.0	–8.8	–24.6	–30.2	21.8	37.5	45.4	41.8
Change in deposit share of surviving banks (and new entrants)	1.7	8.1	4.6	1.3	5.6	6.3	8.6	5.2	–7.2	–14.4	–13.1	–6.5
Number of markets												
Operated offices in 1985	2,207	215	77	104	1,210	207	75	104	249	86	30	58
Adjusted for subsequent mergers and asset growth	1,986	205	76	102	1,413	210	73	103	1,345	211	76	104
Operated offices in 2003	2,149	215	78	104	1,413	214	78	104	1,033	211	75	103
Memo items												
Share of size-class deposits												
Distribution in 1985	33.1	19.5	15.1	32.3	7.8	11.8	15.0	65.3	3.4	7.7	6.4	82.5
Adjusted for subsequent mergers and asset growth	49.5	14.8	12.6	23.1	15.8	17.4	14.9	51.9	8.1	11.8	13.0	67.1
Distribution in 2003	38.9	17.3	17.0	26.8	12.9	14.9	18.0	54.2	5.4	8.3	12.8	73.5
Market Concentration												
Mean deposit-market Herfendahl in 1985	3,593	1,345	893	893	3,593	1,345	893	893	3,593	1,345	893	893
Mean Herfendahl adjusted for subsequent mergers	4,052	2,039	1,877	1,877	4,052	2,039	1,877	1,877	4,052	2,039	1,877	1,877
Mean deposit-market Herfendahl in 2003	3,671	1,573	1,387	1,387	3,671	1,573	1,387	1,387	3,671	1,573	1,387	1,387
Mean change in Herfendahl 1985–2003	85	228	493	493	85	228	493	493	85	228	493	493
Total number of markets	**2,253**	**215**	**78**	**104**	**2,253**	**215**	**78**	**104**	**2,253**	**215**	**78**	**104**

Notes: Deposit-market shares are measured as the share of all deposits in a given market segment (as reported by FDIC-insured institutions in the June Summary of Deposits data) that are held by each size class of banking organization. The mean levels of local deposit-market concentration in rural, small metro, and large metro markets, respectively, are measured using Herfendahl indices constructed from these deposit-market shares. Herfendahl indices for suburban and urban parts of large MSAs are calculated for the entire MSA market. Large metropolitan areas are those with populations above 500,000. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

or asset growth and for local market conditions," community bank small-business-loan market shares increased from 1994 to 2000.[38] Together these findings indicate that the relative growth of surviving (and new) community banks (measured in terms of assets, deposits, and small-business lending) has been such that one would have underestimated community banking's continuing presence by looking only at the pace of merger activity.

[38] Avery and Samolyk (2004), 320. This study looks at small-business lending by community banks in local banking markets, and it defines community banks as we do here.

Changes in the presence of larger (noncommunity) banks in local deposit markets have affected where community banks tend to operate. Not surprisingly given the spreading reach of the top 25 banks, the concentration of the largest banks' deposits in large urban centers has declined as they have diversified into smaller markets. Perhaps also not surprisingly, the concentration of community banks' deposits in rural markets has risen, a trend suggesting that community banks' comparative advantage has shifted even more toward serving small, less densely populated markets. However, the declines in deposits held in metro areas are smaller than the declines implied by reclassifications due to acquisition activity or community bank growth during the period; indeed, the share of community banks' deposits located in suburban markets actually increased between 1985 and 2003. This increase is consistent with the notion that there is a niche for service-oriented community banks in suburban markets.

To understand the geographic deposit patterns in relation to longer-term economic prospects in local markets, we conducted a parallel analysis of deposit trends for growing versus declining markets, defined in terms of positive and negative population growth.[39] Community banks do not appear to have been relegated to providing services in markets where the economic base is dwindling. Community banks have seen their deposit market shares decline in all types of markets, but those declines are no more pronounced in growing markets than in declining ones.[40]

Community Bank Industry Shares, Portfolios, and Performance

As noted above, the many observers who argue that the community banking segment of the industry remains viable often base their claims on the importance of community banks in certain types of loan markets—specifically, in lending to small businesses and farms. A significant amount of research holds that community banks' strength as lenders stems from their ability to form the relationships necessary to lend to informationally opaque borrowers (an advantage widely viewed as important in small-business and small-farm lending), and studies have documented the importance of smaller banks in such lending.

This section describes the evolving role of community banks in the banking industry. It examines the ways in which community banks as intermediaries are different from larger banks in terms of their industry shares, portfolio composition, and performance. The analysis of community banks' performance includes a comparison between community banks that remained community banks and surviving community banks that outgrew the community bank size classification or were acquired out of it. We also relate the performance of community banks to the longer-term growth of the local markets where they were located.

Unless otherwise indicated, all analyses of "banks" and "banking" include both commercial banks and savings institutions. Here we do, however, also present some trends for commercial banks and savings institutions separately to highlight relevant differences between these two types of institution. Despite their increasing similarity, these segments of the industry have evolved from very different places and continue to exhibit differences (particularly on the asset side of their balance sheets) that are important to consider when one is assessing community banking's prospects.

Industry Shares of Assets and Liabilities

Between 1985 and 2003 community banks' share of total banking industry assets declined by nearly half, from 27 percent to less than 14 percent. (See table 4.) This overall decline reflects large relative declines in the shares of consumer credit and home mortgages funded by community banks. But despite having lost out in some credit markets, smaller banks appear to be holding their own in others—notably real estate lending to businesses and farms. Although community banks control less than 14 percent of banking-sector assets, they fund almost 29 percent of the industry's commercial real estate lending and more than 65 percent of farm real estate loans. And in terms of small commercial and small farm loans, community banks are even more important: as of mid-2003, community banks held 37 percent of small loans to businesses (real estate and commercial & industrial loans) reported by banks and almost three quarters of outstanding small farm loans (real estate and operating loans).

[39] See table A.7.

[40] It should be noted that in both growing and declining markets, the larger market-share declines associated with bank consolidation activity have been offset by market-share increases for the remaining community bank population. In addition, the share of community banks' deposits held in low-growth markets actually declined during the 1985–2003 period.

Table 4

Share of Banking-Sector Assets and Funding, 1985, 1994, and 2003

	A. Assets, midyear								
	Community			Midsize			Top 25		
	1985	1994	2003	1985	1994	2003	1985	1994	2003
Consumer Credit	28.7	15.5	8.4	47.1	40.1	29.8	24.3	44.5	61.8
Home mortgages	37.1	26.3	13.9	50.1	46.6	28.9	12.8	27.1	57.2
Commercial & industrial loans	16.1	12.7	11.7	35.5	33.8	25.2	48.4	53.5	63.1
Domestic commercial & industrial loans	20.9	15.3	13.6	44.2	40.5	28.5	34.8	44.2	57.8
Small commercial & industrial loans	NA	38.5	31.7	NA	38.5	34.1	NA	23.0	34.2
Commercial real estate	32.9	28.5	28.6	50.3	43.0	40.2	16.8	28.5	31.2
Small commercial real estate	NA	44.5	43.2	NA	37.4	34.7	NA	18.1	22.2
Construction & land development	23.2	31.3	24.7	52.7	41.4	43.7	24.1	27.4	31.6
Multifamily real estate	27.2	20.0	16.5	60.7	57.6	43.9	12.1	22.4	39.6
Farm real estate	71.8	68.7	65.4	20.6	20.5	22.6	7.7	10.7	12.0
Small farm real estate	NA	75.7	74.0	NA	18.4	19.0	NA	5.9	7.1
Farm operating	65.5	65.0	60.9	19.2	18.6	20.2	15.3	16.3	18.9
Small farm operating	NA	76.8	75.7	NA	15.6	15.8	NA	7.6	8.5
Foreign government loans	0.5	0.8	0.2	19.9	7.4	6.3	79.7	91.8	93.4
Total loans and leases	26.2	20.6	14.8	43.7	39.8	29.4	30.1	39.6	55.7
Securities	38.6	28.6	16.6	50.2	43.2	35.8	11.2	28.2	47.6
Mortgage-backed securities	27.6	19.4	10.4	61.8	50.8	38.5	10.6	29.8	51.1
Other Assets	18.8	12.0	8.2	41.6	26.2	18.7	39.7	61.7	73.0
Total Assets	27.0	20.9	13.8	44.5	38.1	28.4	28.6	41.0	57.8
	B. Funding, year-end								
	Community			Midsize			Top 25		
	1985	1994	2003	1985	1994	2003	1985	1994	2003
Total deposits	29.2	23.8	16.7	45.7	38.2	29.8	25.1	37.9	53.5
Domestic deposits	32.5	27.0	19.1	49.0	41.2	32.9	18.5	31.9	48.0
Core deposits	34.1	26.9	18.9	49.4	40.8	31.6	16.5	32.3	49.5
Other borrowing	8.1	6.8	5.6	53.1	45.4	29.7	38.7	47.8	64.6
Subordinated debt	3.7	0.6	0.4	38.3	22.5	16.0	58.0	76.8	83.6
Federal Home Loan Bank advances[a]	NA	22.3	15.6	NA	73.3	49.4	NA	4.4	35.0
Other liabilities	9.7	4.3	2.2	33.5	15.6	12.4	56.9	80.0	85.4
Total liabilities	25.7	19.9	13.4	46.2	38.3	28.6	28.1	41.8	58.0
Equity	29.9	24.1	15.2	42.9	37.1	30.3	27.2	38.8	54.5
Memo items									
Volatile liabilities	11.3	9.1	7.6	41.6	36.8	26.4	47.1	54.2	65.9
Number of banks[b]	15,128	10,736	8,049	2,426	1,505	1,033	479	364	100

Note: The data in these panels are the bank asset-size group's percentage of the total amount reported by commercial banks and savings institutions. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

[a]1994 data for commercial banks taken from Federal Housing Finance Board.

[b]The number of banks refers to the number of commercial banks and savings institutions controlled by organizations classified as either community, midsize, or top 25.

Trends in the shares of industry assets held by community banks are consistent with the view that larger banks have a growing advantage in the increasingly standardized consumer credit and home mortgage markets. Meanwhile, community banks remain important for less-standardized types of lending, such as small-business loans and loans collateralized by business real estate. Moreover, as discussed above, community banks that survived the consolidation trend have actually increased their market

share, offsetting some of the effect of community bank mergers.

Looking only at industry shares of assets held by all community banks, however, does obscure some important differences between commercial banks and saving institutions as separate segments of the industry.[41] In 1994, the largest organizations controlled only 8 percent of savings institution assets but had already come to dominate the commercial banking sector. Although some large organizations (such as Citigroup) have increased their presence, midsize organizations continue to dominate the savings institution industry. Meanwhile, the shares of consumer credit and home mortgages held by community savings institutions have declined less (in relative terms) than the shares held by community commercial banks. However, in both segments of the industry, community banks appear to be holding their own as business lenders, particularly in funding small loans to businesses and farms.

Turning to the liability side of the banking industry's balance sheet, we see in the bottom panel of table 5 the changes in the distribution of bank liabilities and equity across bank size groups between 1985 and 2003. Community banks continue to hold higher shares of deposits (compared with their share of banking sector assets) and rely less on other types of borrowing than larger organizations. However, community banks' shares of the industry's deposits have generally moved lower with their overall share of industry assets. Recently concerns have been expressed about whether Federal Home Loan Bank (FHLB) advances are propping up small institutions, and we note that the share of total FHLB advances owed by community banks appears also to have tracked their declining share of the industry.

There are, however, some differences between commercial banks and savings institutions in how liabilities are distributed across the bank size classes.[42] First, the share of commercial bank equity held by community commercial banks has declined more than these banks' share of commercial banking assets; the opposite has been true for community savings institutions. These contrasting patterns reflect differences in the types of institutions that needed to be recapitalized after the banking sector problems of the 1980s and early 1990s. In the commercial banking industry, it was the larger institutions that needed greater recapitalization, whereas in the savings institution industry, recapitalization was more pronounced among smaller institutions. Second, in the commercial banking sector, community banks account for a disproportionate share of total FHLB advances, but among savings institutions, the opposite is true: community banking's share of total FHLB advances to saving institutions has been declining as borrowing among institutions controlled by the very largest organizations has expanded dramatically.

Portfolio Ratios

To understand what trends in the distribution of banking industry assets and liabilities imply for the portfolio composition of community banks vis-à-vis their larger counterparts, we constructed parallel data that measure portfolio ratios for community banks and for their larger counterparts. Again, we first discuss trends evident for all community banking institutions and then highlight key differences between community commercial banks and community savings institutions. Table 5 reports portfolio ratios for each size class of banks (community banks, midsize banks, and the top 25 banking organizations).[43]

Given trends in industry shares on the asset side of the balance sheet, it is not surprising that community banks have increased their business real estate lending—including commercial real estate loans, farm real estate loans, and construction & land development loans—as a share of their assets. In contrast, the largest banking organizations have not exhibited comparable shifts. Instead, consumer credit and home mortgage lending now account for greater shares of the total assets controlled by the 25 largest banking organizations.

It is important that increases in business real estate lending by community banks are not merely substituting for other types of lending (such as C&I loans or consumer credit). After moving lower during the late 1980s and early 1990s, the loan-to-asset ratio for all community banks rose from 57 percent in 1994 to more than 63 percent in 2003. To some extent this increase undoubtedly reflects lending opportunities associated with the economic expansion of the 1990s. These portfolio trends, however, also reflect community banks' need to generate sufficient earnings to maintain profitability.

[41] See table A.8.

[42] See table A.8, bottom panel.

[43] Comparable data for the two subsets, commercial banks and saving institutions, classified by the size of the banking organizations that control them, are presented in table A.9.

Table 5

Banking-Sector Balance-Sheet Ratios: 1985, 1994, and 2003

	A. Assets, as of June								
	Community			Midsize			Top 25		
	1985	1994	2003	1985	1994	2003	1985	1994	2003
Consumer Credit	9.5	7.2	5.2	9.5	10.2	9.0	7.6	10.5	9.1
Home mortgages	26.2	25.3	21.7	21.4	24.5	21.8	8.5	13.3	21.1
Commercial & Industrial loans	9.4	7.1	8.9	12.6	10.4	9.3	26.6	15.3	11.4
Domestic Commercial & Industrial loans	9.4	7.0	8.9	12.0	10.2	9.0	14.7	10.4	9.0
Small Commercial & Industrial loans	NA	6.1	6.9	NA	3.3	3.6	NA	1.8	1.8
Commercial real estate	5.9	9.2	15.2	5.5	7.6	10.4	2.9	4.7	3.9
Small Commercial real estate	NA	7.3	9.9	NA	3.4	3.8	NA	1.5	1.2
Construction & land development	3.3	2.5	5.2	4.6	1.8	4.4	3.3	1.1	1.6
Multi-Family real estate	2.5	1.9	1.9	3.4	2.9	2.5	1.0	1.1	1.1
Farm real estate	0.8	1.5	2.1	0.1	0.2	0.4	0.1	0.1	0.1
Small farm real estate	NA	1.4	1.8	NA	0.2	0.2	NA	0.1	0.0
Farm operating	2.6	2.5	2.3	0.5	0.4	0.4	0.6	0.3	0.2
Small farm operating	NA	2.4	2.0	NA	0.3	0.2	NA	0.1	0.1
Foreign government loans	0.0	0.0	0.0	0.5	0.1	0.0	3.0	0.7	0.1
Total loans and leases	60.3	57.4	63.4	61.0	60.8	60.9	65.4	56.2	56.7
Securities	26.0	31.9	23.8	20.4	26.4	24.9	7.1	16.0	16.3
Mortgage backed securities	3.7	10.3	8.7	5.0	14.9	15.7	1.4	8.1	10.2
Other Assets	13.8	10.7	12.8	18.5	12.7	14.2	27.5	27.8	27.1
Total Assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	B. Liabilities, as of year-end								
	Community			Midsize			Top 25		
	1985	1994	2003	1985	1994	2003	1985	1994	2003
Total deposits	94.5	93.3	90.2	82.2	78.0	75.0	74.2	70.8	66.6
Domestic deposits	94.4	93.0	90.2	79.1	73.9	72.6	49.1	52.4	52.4
Core deposits	84.2	84.3	74.9	67.6	66.4	58.5	37.2	48.2	45.2
Other borrowing	4.1	5.7	8.9	15.0	19.7	21.9	18.0	19.0	23.5
Subordinated debt	0.1	0.0	0.0	0.4	0.5	0.7	1.0	1.7	1.9
Federal Home Loan Bank advances[a]	NA	3.0	6.8	NA	5.1	10.0	NA	0.3	3.5
Other liabilities	1.3	1.0	0.9	2.5	1.8	2.4	6.9	8.4	8.0
Total liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo items									
Liabilities (% of assets)	93.8	90.7	89.7	95.0	92.4	90.4	94.8	92.7	91.4
Equity (% of assets)	6.2	9.3	10.3	5.0	7.6	9.6	5.2	7.3	8.6
Volatile liabilities	14.4	14.0	20.5	29.4	29.4	33.2	54.8	39.6	40.8
Domestic liabilities	99.9	99.7	99.9	96.7	95.7	97.3	71.1	73.7	80.5

Note: These are aggregate balance sheet ratios for each size class. Asset categories are measures as a percentage of total assets. Liability categories are measured as a percentage of total liabilities, except where noted. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

[a]1994 data for commercial banks taken from Federal Housing Finance Board.

Turning to the composition of community bank liabilities, one finds (as mentioned above) that anecdotes about the reliance of community banks on retail deposit funding are borne out by the data. Although deposits as a share of total liabilities for community banks are lower than a decade ago, this share still exceeds 90 percent, and these deposits are almost all domestic deposits. Portfolio ratios also indicate that FHLB advances have become a more important funding source for community banks; but this is also true for larger banking organizations (table 5, lower panel).

There are significant differences in portfolio composition between community commercial banks and community savings institutions, particularly on the asset side of the balance sheet.[44] As discussed below, these differences have important implications for the relative performance of, and prospects for, these two types of community banks. The increase in community banks' loan-to-asset ratio reflects greater lending (as a share of assets) by commercial community banks, and specifically more real estate lending of all types. In contrast, community savings institutions (which historically have had higher loan-to-asset ratios than community commercial banks) remain primarily home mortgage lenders.[45] In mid-2003, 38 percent of community savings institution assets were home mortgage loans, and another 13 percent were mortgage-backed securities; the next-largest loan component was commercial real estate lending, which accounted for 9 percent of savings institution assets.

Community commercial banks and community savings institutions differ as well in the composition of their liabilities.[46] The former rely more on deposits and less on other borrowing—mainly FHLB advances—than do the latter. And although both community commercial banks and community savings institutions have increased their reliance on FHLB borrowing as a source of funds, large savings institutions rely more on FHLB advances as a source of funding. On the other hand, the recapitalization of savings institutions has reduced this sector's overall riskiness in terms of their leverage measured relative to their buffer stock of capital.

Performance

Despite or perhaps because of their differences from larger banking organizations, community banks have been able to compete with the larger organizations in terms of performance during the past decade. Aggregate performance patterns of institutions in different size classes suggest that community banks have been able to earn more as lenders than larger organizations have, but community banks also face rising relative operating costs. Here we analyze aggregate performance trends for community banks and larger banking organizations, highlighting the differences between community savings institutions and community commercial banks that reflect the composition of their portfolios—particularly on the asset side of the balance sheet.

As we discuss below, these differences suggest that community banks that engage primarily in home mortgage lending (i.e., community savings institutions) do not generally have the same competitive advantages as either their larger counterparts or community banks that are primarily commercial lenders (i.e., community commercial banks).

Table 6 reports aggregate performance ratios for all banking organizations (by size category) from 1985 through 2003. Since 1993, community banks have tended to earn a healthy return on assets (ROA), exceeding 1 percent. And until very recently, the ROA for the community banking sector was very comparable to that earned by the 25 largest banking organizations (although the ROAs measured for midsize banks exceeded those measured for both of these groups). However, because smaller institutions have tended to have higher capital ratios than larger institutions, a given level of earnings has translated into a lower return on equity (ROE) for the smaller institutions.[47] Thus ROE measured for community banks is below that for larger banks, and the ROEs earned by small community banks have tended to be lower than those for larger community banks.

Among commercial banks, earning differentials across the three size groups do not reflect poorer interest margins for community banks.[48] To the contrary: their profitability reflects higher net interest margins earned by these smaller banks. Even among community banks in the commercial banking sector, the smaller ones have tended to have higher net interest margins than the larger ones. However, the size-related differentials in net interest margins among all but the very largest banks have narrowed in recent years. At the same time, smaller banks have increasingly faced higher relative costs, here measured by the ratio of noninterest expenses to the sum of net interest and noninterest income. In terms of this "cost ratio," the gap has been growing between community banks and their larger

[44] See table A.9.
[45] This is true of larger savings institutions as well.
[46] See table A.9.
[47] With respect to earnings performance, pretax ROAs of community banks tend to suggest that profitability has been lower for smaller institutions than for larger banks in recent years (reported on table 6). However, the gap between community-bank ROAs and larger-bank ROAs is narrowed after corporate taxes are taken into account. Community banks hold a larger percentage of their assets in lower-yield, nontaxable municipal bonds. In addition, with the passage of the Small Business Job Protection Act of 1996 (effective January 1, 1997), banks that meet certain conditions have been able to convert to Subchapter S-corporation status. Such corporations are exempt from income taxation at the corporate level. Income is allocated to shareholders on a pro rata basis before taxation and is then taxed at the individual-shareholder level. Currently, approximately 1,800 community banks are S corporations.
[48] See table A.10.

Table 6

Banking-Sector Performance Ratios, 1985–2003

	1985	1986	1987	1988	1989	1990	1991	1992
ROA								
Small Community Banks	0.68	0.49	0.41	0.35	0.44	0.63	0.72	1.02
Medium Community Banks	0.66	0.51	0.09	0.28	0.24	0.48	0.62	0.95
Large Community Banks	0.50	0.22	–0.06	0.18	–0.30	0.09	0.34	0.83
All Community Banks	0.63	0.44	0.14	0.28	0.16	0.43	0.59	0.94
Midsize Banks	0.70	0.57	0.22	0.24	0.11	–0.07	0.28	0.83
Top 25 Banks	0.52	0.56	–0.49	0.97	0.08	0.54	0.47	0.86
Pre-tax ROA								
Small Community Banks	0.88	0.69	0.66	0.63	0.75	0.94	1.06	1.48
Medium Community Banks	0.90	0.81	0.39	0.57	0.55	0.76	0.95	1.43
Large Community Banks	0.72	0.56	0.30	0.48	–0.07	0.29	0.61	1.28
All Community Banks	0.86	0.72	0.44	0.57	0.45	0.69	0.90	1.41
Midsize Banks	0.89	0.76	0.42	0.45	0.29	0.05	0.51	1.23
Top 25 Banks	0.77	0.81	–0.34	1.37	0.36	0.79	0.70	1.26
ROE								
Small Community Banks	8.43	6.10	5.13	4.44	5.52	7.21	8.14	11.11
Medium Community Banks	11.62	8.63	1.47	4.30	3.59	6.23	7.89	11.54
Large Community Banks	10.72	4.10	–1.01	2.97	–5.22	1.39	4.90	11.20
All Community Banks	10.38	6.99	2.14	4.06	2.40	5.51	7.37	11.36
Midsize Banks	14.08	10.84	4.10	4.43	2.02	–1.30	4.52	12.00
Top 25 Banks	10.66	10.91	–9.80	18.65	1.51	9.85	8.01	13.23
Net Interest Margin								
Small Community Banks	4.28	4.12	4.07	4.04	4.05	4.16	4.25	4.58
Medium Community Banks	3.39	3.43	3.45	3.51	3.57	3.80	3.96	4.37
Large Community Banks	2.88	3.04	3.16	3.19	3.13	3.51	3.75	4.22
All Community Banks	3.51	3.52	3.54	3.57	3.59	3.82	3.99	4.38
Midsize Banks	3.01	3.08	3.14	2.96	3.05	3.26	3.60	4.08
Top 25 Banks	3.30	3.36	3.29	3.71	3.55	3.62	3.86	4.17
Cost Ratio								
Small Community Banks	NA	NA	NA	71.9	71.8	70.9	70.7	66.6
Medium Community Banks	NA	NA	NA	71.8	71.8	69.9	69.3	65.5
Large Community Banks	NA	NA	NA	70.9	76.8	71.5	70.3	65.5
All Community Banks	NA	NA	NA	71.6	72.9	70.5	69.8	65.7
Midsize Banks	NA	NA	NA	71.0	70.4	71.1	69.1	64.5
Top 25 Banks	NA	NA	NA	64.2	66.2	66.9	67.4	64.1
Nonperforming Asset Ratio								
Small Community Banks	4.54	5.16	5.01	4.63	4.30	3.43	3.37	2.83
Medium Community Banks	4.23	5.60	5.92	4.44	4.31	3.65	3.85	3.31
Large Community Banks	4.48	5.78	5.91	5.01	5.69	5.07	5.16	4.06
All Community Banks	4.36	5.54	5.72	4.62	4.65	3.96	4.04	3.38
Midsize Banks	3.05	3.90	4.47	4.14	3.82	4.94	5.27	4.13
Top 25 Banks	3.88	3.97	5.63	4.37	4.53	5.30	5.87	5.32

Note: This table presents aggregate performance measures for all commercial banks and savings institutions classified by size group. Performance ratios are expressed in percentage terms. For performance measures, de novo banks (those less than five years old) are excluded. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations. Small community banks are community banks with less than $100 million in total assets, medium community banks are community banks with total assets greater than $100 million but less than $500 million, and large community banks are community banks with total assets greater than $500 million but less than $1 billion.

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.12	1.04	1.07	1.05	1.13	1.10	1.07	1.07	1.01	1.11	1.04
1.08	1.01	1.11	1.08	1.21	1.20	1.13	1.14	1.07	1.14	1.13
1.05	1.03	1.05	1.03	1.19	1.15	1.20	1.14	1.06	1.17	1.21
1.08	1.02	1.09	1.06	1.19	1.17	1.14	1.13	1.06	1.14	1.14
1.03	1.01	1.13	1.15	1.28	1.35	1.38	1.24	1.27	1.42	1.42
1.18	1.11	1.08	1.08	1.12	1.05	1.23	1.09	1.10	1.30	1.42
1.59	1.49	1.55	1.52	1.61	1.50	1.41	1.42	1.33	1.42	1.36
1.58	1.50	1.63	1.60	1.77	1.73	1.60	1.60	1.47	1.55	1.52
1.56	1.53	1.55	1.53	1.80	1.72	1.74	1.64	1.53	1.68	1.70
1.58	1.50	1.59	1.56	1.74	1.68	1.60	1.58	1.46	1.57	1.55
1.49	1.51	1.70	1.71	1.95	2.03	2.10	1.90	1.95	2.10	2.12
1.79	1.70	1.72	1.70	1.77	1.62	1.96	1.71	1.66	1.98	2.14
11.56	10.48	10.33	9.81	10.45	9.95	9.86	9.93	9.14	10.00	9.16
12.18	10.97	11.46	10.92	12.03	11.68	11.35	11.77	10.69	11.21	11.20
12.93	12.16	11.54	11.13	12.49	11.65	12.43	12.23	11.17	11.99	12.33
12.16	11.08	11.19	10.70	11.77	11.31	11.32	11.53	10.54	11.22	11.17
13.88	13.15	14.18	14.13	15.36	15.44	16.15	14.59	13.83	15.08	14.87
16.19	15.11	14.79	14.27	14.44	13.34	15.42	13.75	13.49	14.68	16.33
4.59	4.60	4.56	4.50	4.52	4.41	4.30	4.39	4.14	4.25	4.11
4.37	4.38	4.37	4.36	4.39	4.32	4.26	4.22	4.07	4.22	4.05
4.30	4.30	4.15	4.20	4.24	4.15	4.12	4.14	4.04	4.08	3.87
4.41	4.41	4.37	4.35	4.38	4.30	4.24	4.23	4.07	4.19	4.01
4.09	3.98	3.94	4.02	4.12	4.03	4.05	4.00	3.99	4.04	3.74
4.15	4.12	3.96	3.93	3.81	3.66	3.66	3.49	3.58	3.86	3.65
67.1	66.9	65.9	66.9	65.3	67.4	67.7	66.5	69.2	68.1	70.7
65.6	65.4	63.8	65.0	61.8	62.3	64.4	64.1	65.2	64.9	65.8
64.4	62.6	61.7	63.0	59.6	61.7	61.2	61.0	61.6	61.2	63.4
65.7	65.2	63.9	65.0	62.1	63.2	64.2	63.7	64.9	64.3	65.9
63.0	62.0	59.3	59.3	56.4	56.1	55.4	56.4	56.7	56.0	56.9
63.3	63.3	61.9	61.9	59.9	62.9	58.9	58.5	56.9	54.2	54.4
2.23	1.73	1.58	1.51	1.34	1.35	1.22	1.24	1.47	1.55	1.50
2.63	1.87	1.58	1.45	1.18	1.11	0.97	0.99	1.17	1.21	1.16
2.94	2.03	1.54	1.31	1.25	1.14	0.91	0.91	1.15	1.28	1.09
2.60	1.87	1.57	1.42	1.23	1.16	1.00	1.01	1.21	1.28	1.19
2.72	1.70	1.46	1.36	1.23	1.10	0.98	1.09	1.31	1.27	1.06
3.25	1.94	1.55	1.26	1.11	1.06	1.05	1.24	1.57	1.67	1.35

commercial bank counterparts; the gap has also been growing among community banks in the different size categories. These patterns suggest an "economies-of-scale" interpretation of performance differentials across the bank size groups during the past decade. Although smaller institutions earned more on their assets, these earnings did not translate into higher ROAs because smaller institutions also had higher costs. Moreover (as noted), the need to hold more capital translated into lower equity returns among community banks.

Performance differentials evident among saving institutions in the different size classes appear to reflect the continuing role of these institutions as mortgage lenders.[49] ROA measured for large savings institutions have been rising relative to the ROA measured for community savings institutions. And net interest margins for community savings institutions have moved closer to those earned by their large counterparts, while cost ratios for community saving institutions have been rising. Therefore, the lower profitability evident for community savings institutions appears to reflect the higher costs facing these banks, without the higher net interest margins to cover them. Overall, these patterns suggest that community savings institutions face greater competitive disadvantages than their commercial banking counterparts, which are more focused on business lending. In addition, these patterns are consistent with the evolution in mortgage lending toward standardized transactions in a national market.

Performance and Community Bank Migration

To better understand the declining population of community banks, it is useful to compare the relative performance of institutions that remained community banks with the relative performance of institutions that outgrew the size classification or were acquired by larger banks. In particular, was it the better performers that became part of the population of larger banks? To examine this question, we tracked the performance of all institutions (other than de novos) that had originally been classified as community banks to see if there were differences in performance between those that were still classified as community banks in subsequent years and those that had either grown out of the community bank classification or been acquired out of it. Because industry conditions in the 1980s and early 1990s were starkly different from conditions in the later 1990s, we conducted separate analyses of the two nine-year subsets of the 1985–2003 period. We also analyzed commercial banks and savings institutions separately. For each year (and both segments of the banking industry) we first measured the performance of institutions that had been classified as community banks at the beginning of the eight-year period and were still community banks as of the year in question; we also measured the performance of institutions that had been community banks at the beginning of the period but had outgrown the classification or been acquired by larger banks in a given year.[50]

Certain general patterns emerged from this analysis. Not surprisingly, patterns evident for the banks that outgrew the community bank size classification are consistent with some of the size-related performance differentials discussed above. However, a comparison of community banks that were acquired with those that remained community banks fails to suggest that those continuing as community banks were generally poorer performers.[51] Moreover, differences in performance between banks that remain community banks and those that outgrow the classification are likely to reflect differences in the economic conditions in the markets where they are located.

Performance and Local Market Conditions

Because of community banks' small size, their portfolios and performance have an inherently local dimension. In analyzing their performance, therefore, we examined the extent to which community bank performance has been related to longer-term local-market demographic and economic prospects in the markets where these institutions are located. Some recent studies have

[49] See table A.11.

[50] See table A.12. Here we are able to track only the performance of institutions that were originally classified as community banks and that still file Call Reports. We cannot track the performance of community banks that failed or were absorbed into a noncommunity-bank charter through a merger. Of course, many community banks were merged into institutions that remained community banks.

[51] During the more troubled 1985–1994 period, however, bank health did appear to have been related to whether an institution outgrew the community bank classification, particularly for savings institutions. The relatively small number of savings institutions that moved out of the community bank size class tended to be those that were better capitalized and had fewer asset-quality problems. Among commercial banks, those that outgrew the community bank classification tended to have lower nonperforming asset ratios despite having significantly higher loan-to-asset ratios. During the 1994–2003 period, however, performance differences between banks that remained small and those that became larger were attributable to differences in size.

looked at the prospects for community banks in rural markets where population has been declining.[52] But it is also useful to look at the prospects in high-growth areas, where community banks may play an important role in meeting the strong small-business loan demand attendant on local growth.

In this analysis of the relationship between community bank performance and longer-term conditions in local banking markets, we classified longer-term local market conditions in terms of population growth between 1985 and 2003.[53] Each market (defined in terms of metropolitan statistical areas [MSAs] and non-MSA counties) was placed in one of three population-growth classes: (1) low growth if population growth was negative, (2) moderate growth if average annual population growth was between zero and 2 percent, and (3) high growth if population growth averaged more than 2 percent per year during the 1985–2003 period.

During this period, urban markets had higher growth on average than rural markets, although 12 percent of MSAs had negative population growth.[54] These negative-growth metro markets tended to be in the northeastern United States, whereas high-growth metropolitan areas tended to be in the South and West. Not surprisingly, rural markets tended to have lower population growth (and lower real personal income growth) than urban markets: 40 percent of rural counties experienced negative population growth between 1985 and 2003, 49 percent had moderate population growth, and only 10 percent had high population growth.[55] As in the analysis above of changes in the number of community banks, we examined the link between local population growth and community bank performance in particular market segments: rural markets, small metro markets, and suburban and urban parts of large MSAs.[56]

We calculated five performance measures for community banks headquartered in markets that experienced negative, moderate, or high population growth.[57] The results indicate that community banks located in markets exhibiting higher growth during our study period tended to have greater earnings growth and, for the past decade, somewhat higher ROAs and larger net interest margins. At the same time, cost ratios also exhibited some relation to local market conditions, with community banks in higher-growth markets also tending to have higher expenses relative to their income.[58] In recent years, however, cost ratios have tended to converge across markets. Higher net interest margins suggest that community banks in robust regions have benefited from local lending opportunities to a greater extent than community banks in lower-growth markets.

On the other hand, even community banks in low-growth (by our definition, negative-growth) markets seem to have been buoyed up by the economic expansion of the 1990s. Although community banks in higher-growth markets have higher loan-to-asset ratios, community bank lending (relative to assets) has increased most in low-growth markets. And it is noteworthy that even in regions with low growth, community bank performance has been solid during the past decade, as has the performance of the banking industry generally.

It should also be noted that there are some qualitative differences in the relationship between local growth and bank performance ratios in different types of markets.[59] For example, we find the greatest variation in cost ratios for community banks in urban parts of large metro markets, where local rents and other costs are likely to be more sensitive to local conditions. But the general patterns, particularly for profitability and net interest margins, are evident in the different segments of local markets studied here.

[52] For example, a recent study of small-bank performance in the Kansas City Federal Reserve District assesses bank performance in counties with low per capita income growth. That study, however, focuses on the performance of banks in the 25 percent of counties in the district where per capita income growth was lowest. See Myers and Spong (2003).

[53] We compared levels in 2003 with levels in 1985 in each market. To quantify the changes in terms of annual averages, we divided the net change over the 18-year study period (a growth rate) by 18. We also looked at real personal income growth, which measures the growth of local economic activity and reflects both population growth and the growth of per capita income. The results for both types of growth classifications were similar; thus, only the results for the population-growth classification are discussed here.

[54] For the period 1985–2003, 62 percent of MSA markets had average annual population growth of between 0 and 2 percent, and 26 percent of MSA markets had average annual population growth of more than 2 percent.

[55] This is another way in which our analysis differs from that of Myers and Spong (2003). They look at the distribution of counties (both urban and rural) in the Kansas City Federal Reserve District in terms of growth, and simply classify the bottom quartile as low growth.

[56] See note 31 for an explanation of these market segments.

[57] See figures A.1–A.5.

[58] The cost ratio, also called the efficiency ratio, is generated in the following manner: noninterest expense less amortization of intangible assets as a percent of net interest income plus noninterest income. The ratio measures the proportion of net operating revenues that are absorbed by overhead expenses, so that a lower value indicates greater efficiency.

[59] See table A.13.

To further test the robustness of the relationship between local growth and community bank performance, we constructed comparable sets of performance measures that tracked the performance of institutions that had been community banks in 1985.[60] Specifically, we constructed measures to reflect the performance of all community banks in 1985 that had neither failed nor been merged into a bank not classified as a community bank.[61] These measures were intended to explore the notion that observed community bank performance could understate true community bank performance because top performers outgrow the classification.[62] Somewhat surprisingly, there was very little difference in the cohort-level performance measures for this broader group when compared with the cohort-level performance measures for community banking organizations classified in terms of their current asset size. Hence, at least for this period, banks exiting the community banking population (through internal growth or acquisition activity) do not appear to be markedly better performers than community banks that remained community banks.[63] In sum, although there is a clear link between the local environment and the performance of community banks, community banks seem quite able to survive in a variety of environments.

Competition Faced by Community Banks

Community banks face many competitors. A useful way to assess these is with an examination of just what kinds of financial institutions community bankers themselves have identified in surveys as their most significant competitors. (See tables 7 and 8.) Community bankers view other community banks as their prime competitors, and also see credit unions as significant competitors. When community banks are broken down by asset size, the same pattern emerges, but community bankers running the largest community banks view regional or megabanks as competitors much more than do those running the smallest community banks. The idea that other community banks are prime competitors is borne out when one looks at core business lines: other community banks are regarded as the main competitors in short- and medium-term loans to businesses and farmers, unsecured loans to consumers, and consumer

[60] For brevity, we do not report these results.

[61] Thus we identified all banks that were part of a community banking organization in 1985 and included them in cohort-level performance measures even if they had outgrown the community bank size classification or been acquired out of it. We can include community banks that became affiliates of noncommunity banking organizations, since they still reported separate Call Report data. But we cannot include community banks that were merged into a noncommunity banking organization, since they no longer reported separate Call Report data.

[62] These measures differ from measures reported for existing community banks in that they include institutions that have outgrown the community-bank size classification or institutions that have been acquired by large organizations.

[63] We also examined whether the community bank performance patterns in local market were affected if de novo institutions were included, and, again, we found patterns related to local growth that were similar to those reported here.

Table 7

Perceived Competitors of Community Banks, Survey Results, 1994–2003
(Percentage of Respondents)

Competition	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Other community banks	24	41	60	51	63	66	66	57	70	75
Credit unions	55	66	78	70	67	65	60	63	63	68
Brokerage firms	50	46	63	64	68	66	65	66	56	41
Regional or megabanks	33	39	41	45	49	36	47	45	47	49
Mortgage companies	21	16	N/A	N/A	47	51	45	36	42	48
Mutual-fund companies	N/A	N/A	52	57	55	48	51	49	37	27
Farm credit banks	N/A	N/A	40	32	29	31	22	17	23	22
Insurance companies	N/A	N/A	N/A	N/A	N/A	N/A	N/A	31	21	20
Internet banks (e.g., NetBank)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	30	19	9
Government-sponsored entities	N/A	N/A	N/A	N/A	N/A	N/A	N/A	16	18	10
Finance companies	N/A	N/A	N/A	29	31	34	32	7	8	8
Nonfinancial companies	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	6	26

Note: Percentages do not add to 100 percent because most institutions identified several competitors. The dates in the table's column headings refer to the surveys' publication dates. The surveys' definition of community bank may differ from that used in this article. See the relevant survey for the definition used.
Source: Grant Thornton, *Annual Survey of Community Bank Executives* (1994–2003).

Table 8

Perceived Competitors of Community Banks, by Community Bank Size, 2004
(Percentage of Respondents)

Competition	≤ $100 Million in Assets	$100–500 Million in Assets	$500+ Million in Assets
Brokerage firms	30	35	41
Other community banks	74	79	77
Credit unions	64	65	63
Farm credit banks	35	19	13
Finance companies	12	5	6
Mortgage companies	38	45	33
Insurance companies	22	22	16
Mutual fund companies	18	27	23
Regional or megabanks	34	46	63
GSEs	10	10	13
Nonfinancial companies	39	33	14
Industrial banks	5	7	9

Note: Percentages do not add to 100 percent because most institutions identified several competitors. The date in the table's title refers to the survey's publication date. The survey's definitions of community bank and the size groups may differ from that used in this article. See the survey for the definitions used.
Source: Unpublished data from Grant Thornton, *Eleventh Annual Survey of Community Bank Executives* (2004).

and business deposits. Other types of firms are prime competitors in markets that have a nationwide reach—for example, finance companies for auto loans, and mortgage companies for first mortgages. (See table 9.) Perhaps surprisingly, regional banks and megabanks are not identified as the most important competitors except in a few business lines, such as business and personal trust operations and home equity loans.

The attitude of community bankers (particularly those associated with smaller institutions) to their large-bank competitors may reflect their belief that their business model is effective in its emphasis on reputational lending and personal service and that they have an advantage in their presumed ability to attract customers dissatisfied by the more impersonal approach of large banks. Credit unions would seem to be a natural competitor to community banks and might well have been viewed as even more significant competition in the surveys, were it not for the effects of both their size and their location. Among credit unions, as of year-end 2003, 88 percent held under $100 million in assets, whereas only 50 percent of community banks were in that size category. And credit unions are located mainly in urban areas in the central and eastern states. Eighty

Table 9

Top Two Competitors of Community Banks by Business Lines, 2003

Business Banking	%	Farm Banking	%	Consumer Banking	%
Operating Loans		*Equipment Loans*		*Auto Loans*	
Community banks	61	Community banks	23	Captive finance companies	45
Large banks	32	Farm credit system	18	Credit unions	27
Term Loans		*Farm Mortgages*		*Personal Unsecured Loans*	
Community banks	60	Farm credit system	31	Community banks	43
Large banks	29	Community banks	17	Credit unions	32
Business Deposits		*Farm Operating Loans*		*Home Equity Lines*	
Community banks	55	Community banks	29	Large banks	36
Large banks	40	Farm credit system	25	Community banks	34
Business Cash Management				*First Mortgages*	
Large banks	63			Mortgage companies	34
Community banks	15			Community banks	24
Business Long-Term Investments				*Consumer Deposits*	
Large banks	42			Community banks	49
Broker-dealers	15			Credit unions	25
Business Trust				*Personal Trust*	
Large banks	42			Large banks	41
Community banks	8			Community banks	13
				Personal Financial Planning	
				Broker-dealers	26
				Large banks	19

Note: The date in the table's title refers to the survey's publication date. The survey's definition of community bank may differ from that used in this article. See the survey for the definition used.
Source: Seventh Annual Community Bank Competitiveness Survey, *ABA Banking Journal* (2003).

percent of credit unions are located within MSAs, whereas only 53 percent of community bank offices are (as of midyear 2003). These differences in size and geography suggest that some community banks face formidable credit union competition, while others do not.

For several reasons (credit unions' perceived importance as competition, their tax-exempt status, and their exemption from provisions of the Community Reinvestment Act, as well as legislation that has allowed credit union membership to expand significantly), it is useful to look briefly at the trends in deposit share of credit unions and community banks. Community banks' share of deposits, as noted above, has decreased steadily, from 25.5 percent in 1994 to 17.7 percent in 2003; during the same period, credit unions with over $100 million in assets have seen their deposit share increase, while smaller credit unions have lost deposit share. Deposit share growth was greatest for the largest credit unions (those with more than $1 billion in assets—by our definition larger than a community bank). Overall, credit union deposit share has increased, but not dramatically (from 7.7 percent to about 9.5 percent).[64] By far the largest gains in deposit share have been made by the 25 largest banks, with their share rising from 28.4 percent in 1994 to 44.2 percent in 2003.[65] (See table 10.) An examination of deposit share in rural areas and in large and small metropolitan areas finds similar general patterns: to varying degrees, in each of these areas community banks have lost deposit share, credit unions with more than $100 million in assets have had gains in deposit share (and again, credit unions with more than $1 billion in assets saw the greatest percentage growth in deposit share—particularly in all types of metropolitan areas), and the largest banks have experienced gains (for the largest banks, the gains were especially strong in urban and suburban areas within large MSAs).[66] In terms of credit union deposit share, overall it has been the large credit unions that have experienced the fastest growth; most credit unions, however, remain small in comparison even with small community banks. Whether credit unions will capture a significantly greater share of the market in the future remains an open question.

The extent to which these trends in deposit share are causally related is hard to determine. Because the geographic overlap between community banks and credit unions is limited, changes in the aggregate deposit shares of these groups may not reflect increased competition between them. To address the question of competition, we performed a separate analysis using markets with both a community bank presence and a relatively large and growing credit union presence. In these markets, community banks experienced a decline in deposit share that was not, on average, significantly greater than the decline they experienced in all areas. For example, in the 20 MSAs in which small credit unions both increased their deposit share from 1994 to 2003 and held 8 percent or more of the deposits at the end of this period, community banks experienced a mean loss in deposit share of about 7 percent. In comparison, the mean decline in deposit share of community banks in all MSAs during this period was approximately 6 percent, and the median declines were almost identical. An analysis of rural counties yielded similar results.

It is useful to examine the industry more closely by looking at credit unions according to their membership types.[67] Perhaps most credit unions, especially the smaller ones that make up much of the industry, have a local component and so could be seen as competitors with community banks. Federally chartered community credit unions, which are defined as those whose members are within a well-defined local community, neighborhood, or rural district, might be perceived as particularly competitive with community banks, especially as recent NCUA rules have allowed for broad interpretations of "local."[68] Our analysis will therefore emphasize trends observed in these institutions.

The credit union industry, like banks, has undergone significant consolidation in recent years. When we look at the number of institutions within this context,

[64] For another recent examination of credit unions as competitors to small banks, see Gunther and Moore (2004), 10–11.

[65] It has been argued that a different picture of growth in credit union deposit share would be found if deposits held by the 25 largest banks were excluded. With the use of this (somewhat artificial) method, credit union deposit share has grown substantially, from 10.8 to 15.4 percent, whereas the deposit shares of community and midsize banks have decreased.

[66] See tables A.14 and A.15. As of this writing, branch-level deposit data for credit unions had not been collected by the National Credit Union Administration (NCUA). However, as of year-end 2003, 71 percent of all credit unions had less than $30 million in total assets, and the NCUA noted that most credit unions were small, localized operations. Therefore, our study assumes that the county in which a credit union is headquartered is an adequate proxy for the location of its deposits and is comparable to the Summary of Deposits data collected on banks. This assumption is particularly compelling for credit unions with under $100 million in total assets, which we refer to as "small" credit unions.

[67] The data allow us to break up the industry into four groups: single common bond, multiple common bond, community, and state-chartered credit unions.

[68] U.S. General Accounting Office (2003), 32–33.

Table 10

Share of Deposits and Offices

Community, Midsize, and Top 25 Banks vs. Large and Small Credit Unions, 1994–2003

	Share of Deposits						Share of Offices					
	Banks			Credit Unions			Banks			Credit Unions		
Year	Community	Midsize	Top 25	<$100M	$500M–$1B	> $1B	Community	Midsize	Top 25	<$100M	$500M–$1B	> $1B
1994	25.55	38.33	28.38	3.25	3.62	0.86	34.53	32.49	19.73	12.52	0.71	0.02
1995	24.59	38.50	29.09	3.16	3.66	0.99	33.85	32.91	20.25	12.23	0.73	0.02
1996	23.75	35.16	33.02	3.11	3.88	1.08	33.62	29.90	23.85	11.84	0.77	0.03
1997	22.48	35.34	34.01	3.00	4.01	1.17	32.97	31.57	23.15	11.49	0.80	0.03
1998	21.51	33.04	37.15	2.91	4.13	1.26	32.20	30.35	25.51	11.09	0.83	0.03
1999	20.63	32.34	38.25	2.95	4.32	1.50	31.64	30.43	26.37	10.67	0.85	0.04
2000	19.85	32.79	38.72	2.71	4.31	1.62	31.60	30.33	26.99	10.15	0.89	0.04
2001	19.31	29.82	41.93	2.56	4.43	1.96	31.64	28.74	28.92	9.70	0.95	0.05
2002	18.79	29.06	42.69	2.47	4.68	2.32	31.70	28.39	29.57	9.24	1.03	0.06
2003	17.73	28.59	44.23	2.25	4.53	2.67	31.24	29.55	29.27	8.79	1.07	0.08

Note: Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations. Small credit unions are those with less than $100 million in assets.

Source: Credit Union data from NCUA.

the only type of credit union that has seen significant growth since 1997 is the community credit union, though at about 1,000 institutions these still make up only about 11 percent of the industry. Since 1997, community credit unions' industry asset share has also increased, from just over 3 percent to more than 12 percent (state-chartered credit unions' asset share has also increased, while both single- and multiple-common-bond credit unions' shares have decreased). Community credit unions' average asset size has also seen the fastest growth, more than doubling to over $76 million dollars in 2003, although this size means that they remain small in comparison with all but the smallest community banks.[69]

Some industry observers have asserted that credit unions are acting more like commercial banks, and point to their increasing entry into business loans as evidence for this trend. Although some individual credit unions are engaging more heavily in this activity and the industry ratio of member business loans to assets has nearly doubled since 1997, this measure, until now, has grown only to just under 1.5 percent. Community credit unions' ratio of business loans to assets dropped between 1997 and 2000 but has risen since then, from just over 1 percent to about 1.8 percent. So although business loan activity has been increasing in recent years, on an industry-wide basis it remains a relatively small part of credit union lending. In terms of performance, credit unions overall have done reasonably well since 1997, though not as well as community banks. Community credit unions' ROAs have generally been the lowest of the four types since 1997, dipping as low as 80 basis points in 2001, though in the past two years they have performed more in line with state-chartered and multiple-common-bond institutions, with ROAs above 90 basis points (single-common-bond credit unions have performed best). Credit union ROEs have been lower than those of community banks, and since 1997, community credit unions' ROEs have been either in line with or somewhat lower than other types', starting the period at about 9 percent, dipping to about 7.5 percent in 2001, but recovering to about 8.7 percent in 2003.[70]

Prospects for Community Banks

Our examination of community banks' future must take into account what may happen to their numbers, as well as these banks' competitive strengths and challenges.

Decline in Community Bank Numbers

Merger activity has slowed in recent years; coupled with the continued creation of new banks, this has meant a significant reduction in the consolidation of community banks. Furthermore, the pattern of community banks' numerical decline does not suggest that any

[69] See table A.16.

[70] See table A.16.

one type of area or market is particularly likely to face accelerated consolidation in the near future. Additional declines may nevertheless be expected. Low returns on equity (resulting partly from higher capital ratios) may lead to consolidation of some institutions, as stockholders seek higher returns through increased leverage at merged institutions. This presumed causal relationship is less relevant, however, to owner-operated banks that do not rely on uninsured or unprotected sources of funds. These owners' returns may be increased by compensation received as bank officers, and there may be nonpecuniary benefits to playing a leading role in the local community. In addition, there may be no outside shareholders to challenge the owners' decisions to remain independent. But financial considerations may not be the only reason for consolidation among community banks. Indeed, in view of apparent lags in the response of individual community banks to market developments, the depth and timing of future consolidation among community banks remain uncertain. These lags may reflect not only a lack of interest on the part of outside banks in acquiring banks located in slow-growth markets but also, as just mentioned, the ability of banks in these markets to perform at levels satisfactory to their owners.

Competitive Strength and Challenges

We have seen that community banks that avoided acquisition by larger banks had relatively strong growth rates and sustained profitability. These growth rates and profitability have been partly attributed to the institutions' ability to underwrite and monitor loans to small businesses that might have been ignored by large, distant institutions. Some observers suggest that relationship lending is likely to become less important as more data become available on small businesses' performance and as further technological advances make it possible to disseminate to lenders more hard data on small businesses.[71] Similarly, personal service based on local presence and direct contact with customers may become somewhat less important as younger customers, accustomed to transactions on the Internet, grow older and become financially dominant. Still, it would be a mistake to discount the future importance to many bank customers of direct contact with bank employees—or at least with tangible bank premises. How else to explain that in the face of advancing technology and increasing computer literacy, the number of bank offices has held relatively steady and the number of ATMs has continued to grow beyond earlier expectations? The number of bank offices, despite the tremendous consolidation that has occurred in the industry, has hovered within a fairly narrow range since 1985, and more recently has been increasing (see table 11); the number of ATMs increased 241 percent between 1990 and 2001.[72] It seems that for the foreseeable future, the ability to offer personal service economically will be a competitive advantage for many small banks. Another competitive strength is the strong market position of community banks (including de novos) in economically healthy rural, suburban, and small metropolitan markets. With sizable market shares in such areas come customer recognition and awareness, which are likely to be advantageous in the future.

Community banks' competitive strengths, however, must be matched against the competitive challenges they face in a number of respects. The need to attract

[71] See Petersen and Rajan (2003), 2535; also Berger and Udell (2003), 219ff.

[72] Although some industry observers had predicted that the ATM would be obsolete by 2000, the growth rate of ATMs between 1996 and 2001 was significantly greater than it had been between 1983 and 1996. See Cobas, Mote, and Wilcox (2003), 51ff.

Table 11

Bank Offices by Size Category, 1985–2003

Year	Community Banks' Offices	Midsize Banks' Offices	Top 25 Banks' Offices	Total Offices
1985	38,956	35,973	7,443	82,372
1986	37,733	36,655	9,272	83,660
1987	37,192	37,290	10,061	84,543
1988	36,174	37,414	11,478	85,066
1989	36,560	37,944	11,991	86,495
1990	35,813	35,955	14,433	86,201
1991	35,007	33,585	15,999	84,591
1992	34,292	31,483	16,390	82,165
1993	33,087	30,853	17,364	81,304
1994	31,769	30,138	19,280	81,187
1995	31,129	30,809	19,381	81,319
1996	31,311	29,214	22,027	82,552
1997	30,858	29,675	23,085	83,618
1998	30,074	28,660	25,843	84,577
1999	30,220	29,286	26,551	86,057
2000	30,246	29,446	26,306	85,998
2001	30,317	27,981	28,272	86,570
2002	30,213	28,633	28,441	87,287
2003	29,769	29,588	28,966	88,323

Note: Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

and hold qualified personnel will remain a significant issue. Community banks may face the need to find a more diverse set of both funding options and sources of income. Possibilities for moving beyond reliance on core deposits exist, as does the potential for generating more fee-based income, but difficulties may accompany such courses. Community banks, having at first lagged behind large banks in adopting and using technology, are now rapidly making up their deficit and must navigate the best path for its use. Finally, community banks face the problem of the fixed costs incurred in complying with banking regulations.

Surveys of community bank executives indicate that attracting and retaining qualified personnel is perhaps these executives' most important concern. Retaining key employees was identified as a factor critical to success by 93 percent of respondents in the Grant Thornton survey published in 2003, including those from both large and small community banks.[73] Although only 13 percent of respondents in an American Bankers Association (ABA) survey published in 2003 found retention a significant problem (a situation probably reinforced by a soft economy), the survey nevertheless demonstrated that finding qualified candidates for important positions was often hard (and sometimes very hard). (See tables 12 and 13.) The difficulty filling a particular type of position sometimes depended on the community bank's size or location or both. There was, however, some general concern about the unavailability of qualified employees and a belief that potential employees were moving into nonbanking jobs, as well as concern that large banks were better able to attract personnel.[74] (See table 14.) Overall, community banks located in declining or slow-growth economies are likely to experience the most difficulty with employment.

[73] Grant Thornton, *Tenth Annual Survey of Community Bank Executives* (2003). This survey was sent to 5,014 CEOs and senior officers of community banks and savings institutions and had a response rate of 10.2 percent.

[74] Cocheo (2002, 2003). The survey published in 2003 was sent to 5,474 top management subscribers to the *ABA Banking Journal*, mostly from banks under $1 billion in assets, and had a response rate of 14 percent. The survey published in 2002 was sent to 6,492 subscribers and had a response rate of 14.2 percent.

Table 12

Problems Attracting and Retaining Employees, 2000–2003

(Percentage of Respondents Reporting Significant Problems)

Year	Attraction	Retention
2000	51	32
2001	53	33
2002	45	28
2003	34	13

Note: The dates in the table's title refer to the surveys' publication dates. The surveys' definition of community bank may differ from that used in this article. See the relevant survey for the definition used.

Source: 4th–7th Annual Community Bank Competitiveness Surveys, *ABA Banking Journal* (2000–2003).

Table 13

Level of Difficulty in Finding Qualified Candidates, 2003

(Percentage of Respondents)

Position	Hard	Very Hard	Total
Trust officer	45	46	91
Compliance officer	55	36	90
IT officer	49	37	85
Business lender	55	27	82
Sales mgr./Business development mgr.	61	20	82
Operations officer	57	24	81
Farm lender	53	23	76
Marketing officer	55	16	71
Administrative/support staff	40	6	46
Consumer lender	39	6	45
Teller	33	3	36

Note: The date in the table's title refers to the survey's publication date. The survey's definition of community bank may differ from that used in this article. See the survey for the definition used.

Source: Seventh Annual Community Bank Competitiveness Survey, *ABA Banking Journal* (2003).

Table 14

Reasons for Problems Attracting and Retaining Employees, 2002

(Percentage of Respondents)

Reason	Attraction	Retention
Unemployment very low	53	53
No one is qualified	30	15
They are moving into nonbanking fields	29	52
Large banks offer more than we can	25	28
Young people are leaving the area	24	25
Poor work ethic	24	28
De novo banks snap them up	7	10

Note: The date in the table's title refers to the survey's publication date. The survey's definition of community bank may differ from that used in this article. See the survey for the definition used.

Source: Sixth Annual Community Bank Competitiveness Survey, *ABA Banking Journal* (2002).

Community banks largely depend on core deposits, and for many community banks, this may not pose any concern.[75] In recent years, however, core deposits in many areas have lagged behind total deposits and behind loan demand. Responses to ABA surveys from 1997 to 2001 suggest that deposit growth lagged behind loan demand at a significant number of community banks. More recently, a return flow from the stock market has eased funding problems, but perhaps only temporarily.[76] Raising rates to increase core deposits in the local community may be costly because of cost increases for existing accounts, or because of a limited supply of local funds in slow-growth areas. Funds attracted from the outside through brokers or the Internet may be volatile.

At this point, Federal Home Loan Bank (FHLB) advances are the main supplement to core deposits. There has been some use of other "nontraditional" sources, such as fed funds, sales of participations, and repurchase agreements.[77] (See table 15.) Measured as a percentage of community bank liabilities, FHLB advances clearly have been used increasingly since 1993; these advances moved from just over 2 percent of liabilities in 1993 to almost 6.8 percent in 2003. Not surprisingly, larger community banks have made greater use of advances during the period, but even among the smallest community banks the use of advances has increased substantially. (See figure 2.) Although narrower funding options may be a handicap, community banks have been able to offset higher interest costs with higher loan rates charged to idiosyncratic borrowers who have limited access to large-bank funding.

In principle, small banks have fewer prospects for diversifying their sources of income; mergers may allow them to expand their opportunities to do so. Diversification does not, however, lead only to benefits. A recent study notes that diversification can carry risks because community banks may "move beyond areas of comparative advantage and enter businesses where they lack the necessary expertise, technology, or scale to compete successfully," and concludes that community banks "do better when they stay focused on major activities but gain by diversifying within that area of expertise."[78]

Some observers have suggested that community banks should rely more on fee income. Fee income of small banks is largely from deposit services, and (as noted above) fees on deposit services tend to be lower at small banks than at large banks. Because small banks generally

[75] Core deposits are domestic deposits less time deposits above $100,000.

[76] The percentages of respondents describing deposit growth as lagging behind loan demand from 1997 to 2001 were, respectively, 57, 59, 39, 48, and 66; in 2003, the percentage dropped to 33, with 40 percent of respondents stating that deposit growth exceeded loan demand (Cocheo [2000, 2001, 2003]).

[77] Surveys from 1999 to 2001 show increasing use of nontraditional methods of funding.

[78] Stiroh (2004), 137.

Table 15

Nontraditional Funding Methods of Community Banks

(Percentage of respondents)

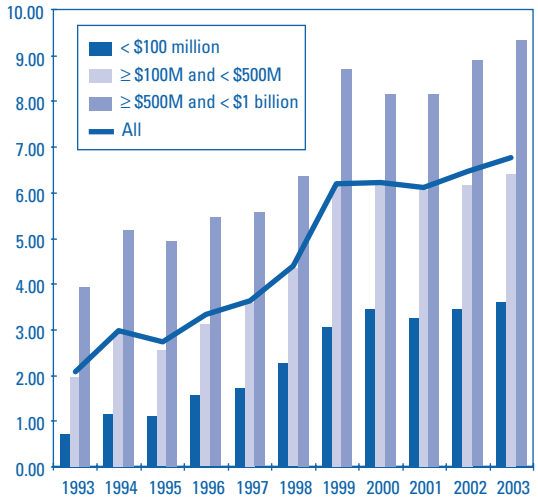
Method	1999	2000	2001
FHLB Advances	72	78	82
Fed funds	48	60	66
Selling participations	33	28	27
Repurchase agreements	20	20	21
Brokered deposits	18	20	18
Loan sales	12	12	13
Banker's banks	3	8	9
Discount window	9	9	8
Internet	N/A	N/A	6
Securitization	4	6	2

Note: The dates in the table's column headings refer to the surveys' dates of publication. The surveys' definition of community bank may differ from that used in this article. See the relevant survey for the definition used.

Source: Third, Fourth, and Fifth Annual Community Bank Competitiveness Surveys, *ABA Banking Journal* (1999, 2000, and 2001).

Figure 2

Community Banks' Use of Federal Home Loan Bank Advances as a Percentage of Liabilities, 1993–2003



offer a narrower service base, their total fee income is proportionally lower than that of large banks. Broadening fee income would make community banks less dependent on core deposits and less vulnerable to reductions in interest margins in periods of rising interest rates. Raising fees associated with deposit services, however, might conflict with community banks' efforts to attract retail deposits and with their personal service image. As noted above, the gap between large- and small-bank fees appears to be closing, so some community banks may be making greater use of fees to generate income.[79] In a survey recently conducted by the Federal Reserve System (admittedly with a very small sample—only ten bankers), half the participants noted that they intended to increase revenues through fee income, and those interviewed realized that "chronically delinquent or overdraft customers are profitable."[80] Broadening fee income from other sources generally entails broadening the service base. However, some of the sources of fee income of large banks, such as investment banking, securitization, and back-up lines of credit, require a large base of transactions and therefore are not feasible for small banks.

Community banks will face a strategic choice between trying to perform relatively narrow functions more efficiently and trying to broaden into new activities that may involve greater risk and greater cost for small-scale operations.[81] It is not clear which course will prevail or whether all banks will make the same choice. The important point seems to be that numerous community banks have found it possible to grow and prosper not by trying to emulate large banks with many business lines but by performing largely traditional functions more efficiently.[82]

[79] Large banks still almost always charge higher retail deposit fees than do smaller banks. In many cases, however, although fees at both large and small banks have generally been increasing, the rate of increase at small banks has been more rapid. For example, between 1999 and 2002 overdraft fees at small banks went up 25.2 percent; at large banks, 16.9 percent; in 1999, large banks charged 43.7 percent more for overdraft fees than did small banks; in 2002, the comparable figure dropped to 34.2 percent. During the same period, fees for stop-payment orders at small banks went up 24 percent; at large banks, 15 percent; in 1999, large banks charged 49.3 percent more for stop-payment orders than did small banks; in 2002, the comparable figure dropped to 38.4 percent. There is a similar pattern for insufficient-funds charges. Between 1999 and 2002, monthly NOW account fees for single-fee accounts with a low balance dropped 3 percent at large banks while rising 3.4 percent at small banks. It should be noted that for some fees, such as monthly passbook account fees, large banks have increased charges more quickly than small banks, and that the dollar amount differences between all fee levels at large and small banks have not changed substantially since 1999 (Federal Reserve Board [2001 and 2003], appendix B).

[80] Federal Reserve System (2002), 3, 15.

[81] See DeYoung and Duffy (2002); DeYoung and Hunter (2003).

[82] See DeYoung, Hunter, and Udell (2003).

Although automation of back-office operations is essentially universal, community banks have lagged behind large banks in adopting other technology—specifically, Internet banking. However, delayed entry after some of the initial problems have been resolved has not necessarily been a major disadvantage.[83] Moreover, community banks are adopting Internet services fairly rapidly. One measure of the Internet presence of community banks is found in their reporting a Web address on their Call Reports. As of September 30, 2003, there were 7,374 community organizations containing 5,663 institutions that reported Web addresses. A survey conducted by the Independent Community Bankers of America indicates that 77 percent of community banks have Internet sites and that 75 percent of these community banks have transactional Web sites;[84] an earlier Grant Thornton survey suggests similar magnitudes.[85] Small banks are less able to make large investments in technology individually but have generally been able to meet their needs by outsourcing or purchasing widely available systems for in-house use. However, when a community bank is just one client of a service provider, the bank may face varying levels of loss of flexibility.[86] The great uncertainty, however, concerns future technological change. De Young and Hunter have laid out two possibilities: First, new technology may enable large banks to personalize their services while maintaining the advantages of large-scale operations. Second, small banks may be able to retain the advantages of their personalized approach while overcoming the disadvantages of small-scale operations.[87] It is difficult to know which of the two is more probable.

It should also be noted that the provision of a bank safety net and the existence of regulatory agencies to enforce compliance have led to substantial reporting and other regulatory burdens. These requirements normally involve fixed costs that tend to be proportionally heavier for small banks; thus, regulatory burden is likely to have some effect on these banks' long-term prosperity.[88] Conceivably such regulatory requirements will contribute to further consolidation.

[83] Keeton, Harvey, and Willis (2003), 38.

[84] See Golter and Solt (2004).

[85] See table A.17.

[86] At least to an extent, these problems can be mitigated through user groups. See Golter and Solt (2004).

[87] De Young and Hunter (2003), 196–97.

[88] For a review of the issue of the cost of bank regulation, see Elliehausen (1998).

Conclusion

Community bank numbers shrank by almost half between 1985 and 2001; during this period their market share dropped considerably, with small community banks affected most. Taken at face value, such observations might suggest that community banks face considerable difficulties. However, more detailed examination presents a rather different picture. Community banks made up 95 percent of the industry in 1985, yet despite the tremendous consolidation that has occurred, they still constituted 94 percent of U.S. banks in 2003. Moreover, closer inspection of the geography of consolidation reveals some surprising results: by many different measures, community bank declines were proportionally similar. The number of community banks decreased only slightly faster in formerly unit-bank states than in non-unit-bank states. Community banks did not disappear more rapidly in declining markets than in growing ones. Declines were similar across rural, small metropolitan, and large metropolitan areas, and within the last category, across both urban and suburban areas, although the factors that contributed to community bank numbers (failures, mergers, and new banks) differed subtly with the type of area. In particular, both mergers and de novos were concentrated in large metropolitan areas. Community banks have been able, however, to maintain their presence in all areas.

Community banks experienced a significant loss of deposit share between 1985 and 2003, a period during which large banks were by far the largest gainers in deposit share, and credit unions saw modest gains. Community banks also had significant losses in asset share; in lending this was most pronounced in sectors (such as consumer credit) that have been commoditized. They are, however, holding their own in real estate lending to businesses. It should be noted that community savings institutions remain primarily mortgage lenders. As regards earnings, community banks are at a minimum performing satisfactorily, and the performance of community commercial banks reflects higher net interest margins sufficient to offset higher costs. Community banks did perform better in high-growth than in low-growth markets, but even in the latter their performance may be regarded as acceptable, with returns on assets of 100 basis points or better for the last decade of the period studied.

Overall it is impressive that community banks, while facing intensified competition due not only to the removal of branch restrictions (which had protected many from competition) but also to the growth of nonbank competitors, have been able to achieve both respectable earnings and growth in recent years. Community banking, therefore, appears to be a viable business model. Research suggests that these banks possess certain advantages as lenders to small businesses, small farmers, and other informationally opaque borrowers through their ability to assess the risks of borrowers who lack long credit histories, to process soft data such as borrower reputations, or to operate effectively in situations where the proximity of decision making to customers is important. The proposition that community banks have informational advantages in lending to small business is supported by research suggesting that small banks have higher risk-adjusted returns on business loans than large banks. The willingness of private investors to risk their own money to create new banks is a powerful market test of the viability of small banks, at least in areas of high population density. Moreover, a concentration of new banks in areas where large and distant banks have taken over local institutions also suggests that many customers may prefer the more personal approach of community banks. Consumer attitudes may change and larger banks may seek to emulate the personal service approach of smaller institutions. However, community banks should continue to occupy an important position in the banking industry for the foreseeable future if policymakers can maintain economic stability and moderate the impact of regulatory burden.

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APPENDIX

Figures A.1–A.5 present aggregate performance measures for community banks classified by the population growth of the MSA or non-MSA county where each bank was headquartered. High-population-growth markets include all MSAs and non-MSA counties that experienced an average annual growth rate of more than 2 percent during the 1985–2003 period. Medium-population-growth markets include all MSAs and non-MSA counties that experienced an average annual growth rate between zero and 2 percent during the 1985–2003 period. Low-population-growth markets include MSAs and non-MSA counties that experienced negative population growth over the 1985–2003 period. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) that controlled bank assets or thrift assets of less than $1 billion (in 2002 dollars).

Figure A.1

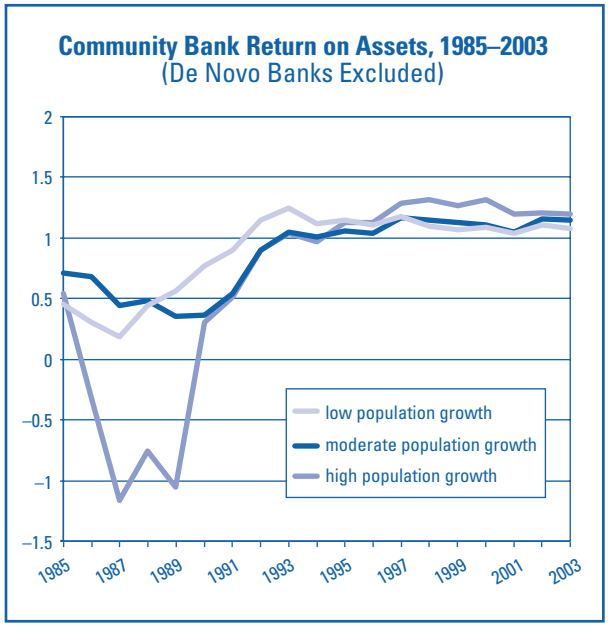


Figure A.2

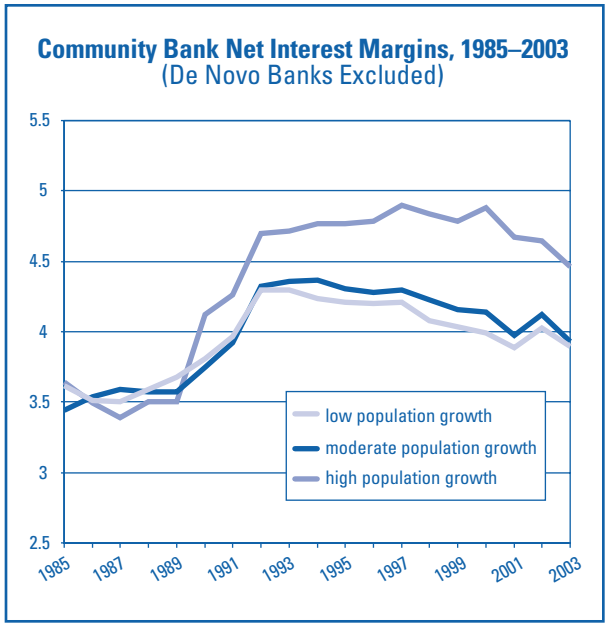
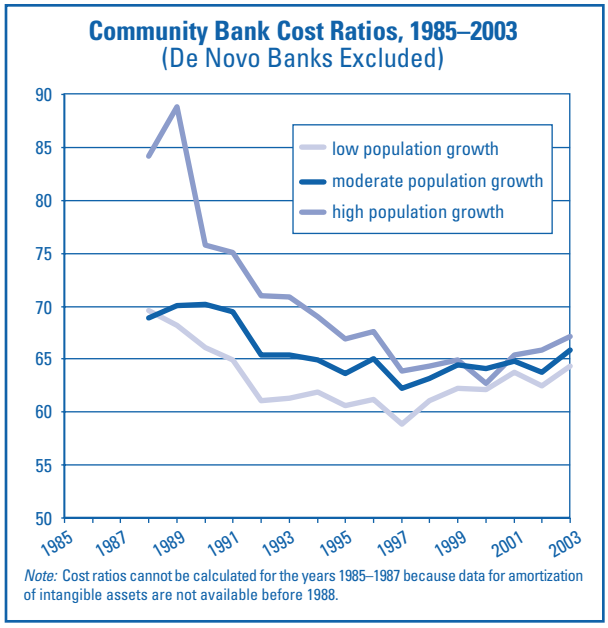


Figure A.3



Note: Cost ratios cannot be calculated for the years 1985–1987 because data for amortization of intangible assets are not available before 1988.

Figure A.4

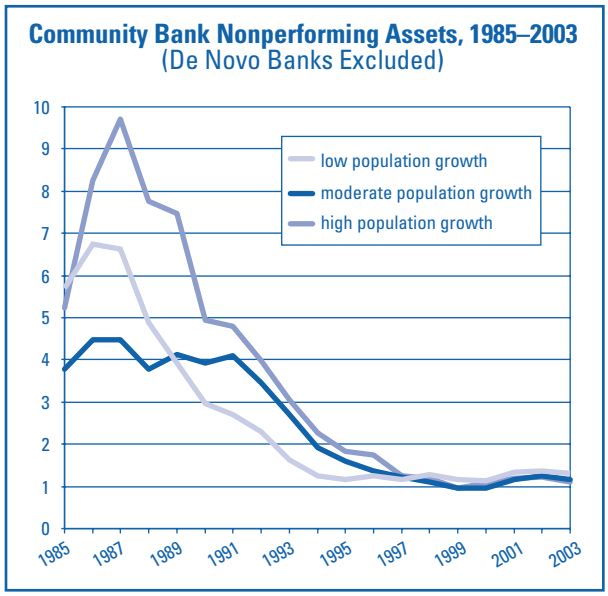


Figure A.5

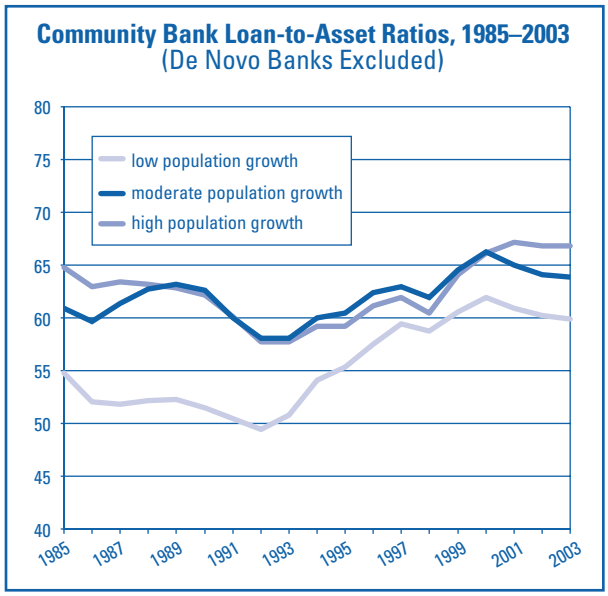


Table A.1

FDIC-Insured Community Banks

Unit-Bank States vs. Non-Unit-Bank States, 1985 and 2003

	Number of Banks			Percentage of Base Year (1985)		
	Total	Unit-Bank States	Non-Unit-Bank States	Total	Unit-Bank States	Non-Unit-Bank States
Beginning 1985	14,349	6,061	8,288	100	42	58
Additions for De Novo Entry	2,458	527	1,931	17	9	23
Other Additions/(Deductions)	68	120	(52)	0	2	1
Deductions for Mergers	(7,483)	(2,800)	(4,683)	52	46	57
Deductions for Failures	(2,055)	(1,043)	(1,012)	14	17	12
Year-end 2003	7,337	2,865	4,472	51	47	54
Total Decline 1985–2003	7,012	3,196	3,816	49	53	46

Note: Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). Banks are classified geographically on the basis of the location of their headquarters.

Table A.2

FDIC-Insured Small Community Banks

Unit-Bank States vs. Non-Unit-Bank States, 1985 and 2003

	Number of Banks			Percentage of Base Year (1985)		
	Total	Unit-Bank States	Non-Unit-Bank States	Total	Unit-Bank States	Non-Unit-Bank States
Beginning 1985	10,146	4,673	5,473	100	46	54
Additions for De Novo Entry	2,403	510	1,893	24	11	35
Other Additions	184	81	103	2	2	2
Deductions for Mergers	(4,467)	(1,934)	(2,533)	44	41	46
Deductions for Failures	(1,364)	(764)	(600)	13	16	11
Net Decline from Growing Out	(3,218)	(793)	(2,425)	32	17	44
Year-end 2003	3,684	1,773	1,911	36	38	35
Total Decline 1985–2003	6,462	2,900	3,562	64	62	65

Note: Small community banks are community banks having less than $100 million (in 2002 dollars) in total assets. Banks are classified geographically on the basis of the location of their headquarters.

Table A.3

Number of FDIC-Insured Community Banks by Type of Geographic Area, 1985 and 2003

	Number of Banks					Percentage of Base Year (1985)				
				Large Metro					Large Metro	
	Total	Rural	Small Metro	Suburban	Urban	Total	Rural	Small Metro	Suburban	Urban
Beginning 1985	14,305	7,216	2,228	1,713	3,148	100	50	16	12	22
Additions for De Novo Entry	2,449	394	424	464	1,167	17	5	19	27	37
Other Additions/(Deductions)	(44)	(240)	49	50	97	0	3	2	3	3
Deductions for Mergers	(7,366)	(2,978)	(1,303)	(1,060)	(2,025)	51	41	58	62	64
Deductions for Failures	(2,049)	(626)	(325)	(249)	(849)	14	9	15	15	27
Year-end 2003	7,295	3,766	1,073	918	1,538	51	52	48	54	49
Total Decline 1985–2003	7,010	3,450	1,155	795	1,610	49	48	52	46	51

Note: Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

Large metropolitan areas are those with populations above 500,000. Banks are classified geographically on the basis of the location of their headquarters.

(For further information, see above, n. 31.).

Table A.4

Number of FDIC-Insured Small Community Banks by Type of Geographic Area, 1985 and 2003

	Number of Banks					Percentage of Base Year (1985)				
				Large Metro					Large Metro	
	Total	Rural	Small Metro	Suburban	Urban	Total	Rural	Small Metro	Suburban	Urban
Beginning 1985	10,126	5,966	1,349	1,080	1,731	100	59	13	11	17
Additions for De Novo Entry	2,357	381	404	452	1,120	23	6	30	42	65
Other Additions/(Deductions)	51	(185)	67	60	109	0	3	5	6	6
Deductions for Mergers	(4,404)	(2,254)	(698)	(555)	(897)	43	38	52	51	52
Deductions for Failures	(1,358)	(499)	(180)	(150)	(529)	13	8	13	14	31
Net Decline from Growing Out	(3,127)	(1,136)	(506)	(529)	(956)	31	19	38	49	55
Year-end 2003	3,645	2,273	436	358	578	36	38	32	33	33
Total Decline 1985–2003	6,481	3,693	913	722	1,153	64	62	68	67	67

Note: Small community banks are community banks with less than $100 million (in 2002 dollars) in total assets. Banks are classified geographically based on the basis of the location of their headquarters.

(For further information, see above, n. 31.)

Table A.5

Number of FDIC-Insured Community Banks in Growing Markets, 1985 and 2003

	Number of Banks					Percentage of Base Year (1985)				
				Large Metro					Large Metro	
	Total	Rural	Small Metro	Suburban	Urban	Total	Rural	Small Metro	Suburban	Urban
Beginning 1985	10,059	3,897	1,806	1,640	2,716	100	39	18	16	27
Additions for De Novo Entry	2,275	324	397	463	1,091	23	8	22	28	40
Other Additions/(Deductions)	93	(133)	50	37	139	1	3	3	2	5
Deductions for Mergers	(5,634)	(1,698)	(1,093)	(1,022)	(1,821)	56	44	61	62	67
Deductions for Failures	(1,569)	(300)	(261)	(228)	(780)	16	8	14	14	29
Year-end 2003	5,224	2,090	899	890	1,345	52	54	50	54	50
Total Decline 1985–2003	4,835	1,807	907	750	1,371	48	46	50	46	50

Note: Growing markets are defined as markets where the population grew from 1985 to 2003. Large metropolitan areas are those with populations above 500,000. (For further information, see above, n. 31.)

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). Banks are classified geographically on the basis of the location of their headquarters.

Table A.6

Number of FDIC-Insured Community Banks in Declining Markets, 1985 and 2003

	Number of Banks					Percentage of Base Year (1985)				
				Large Metro					Large Metro	
	Total	Rural	Small Metro	Suburban	Urban	Total	Rural	Small Metro	Suburban	Urban
Beginning 1985	4,246	3,319	422	73	432	100	78	10	2	10
Additions for De Novo Entry	174	70	27	1	76	4	2	6	1	18
Other Additions/(Deductions)	(137)	(107)	(1)	13	(42)	3	3	0	–18	10
Deductions for Mergers	(1,732)	(1,280)	(210)	(38)	(204)	41	39	50	52	47
Deductions for Failures	(480)	(326)	(64)	(21)	(69)	11	10	15	29	16
Year-end 2003	2,071	1,676	174	28	193	49	50	41	38	45
Total Decline 1985–2003	2,175	1,643	248	45	239	51	50	59	62	55

Note: Declining markets are defined as markets where the population declined from 1985 to 2003. Large metropolitan areas are those with populations above 500,000. (For further information, see above, n. 31.)

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). Banks are classified geographically on the basis of the location of their headquarters.

Table A.7

Changes in the Distribution of Domestic Deposits by Type of Geographic Area, Declining Markets, and Growing Markets, 1985–2003

A. Negative Population Growth Markets

	Community Banks				Midsize Banks				Top 25 Banks			
			Large Metro				Large Metro				Large Metro	
	Rural	Small Metro	Sub-urban	Urban	Rural	Small Metro	Sub-urban	Urban	Rural	Small Metro	Sub-urban	Urban
Share of deposits												
1985 deposit share	80.5	58.5	51.7	24.3	17.3	31.1	38.1	54.4	2.2	10.4	10.2	21.3
Adjusted for subsequent mergers and asset growth	61.4	27.1	24.6	12.6	20.3	36.5	40.4	38.7	18.2	36.3	35.0	48.6
2003 deposit share	66.6	35.4	30.8	12.6	22.5	40.1	37.4	40.1	10.9	24.5	31.8	47.2
Deposit-share changes												
Change from 1985 to 2003	–13.9	–23.1	–21.0	–11.6	5.2	8.9	–0.7	–14.3	8.7	14.2	21.6	25.9
Adjusted for subsequent mergers and asset growth	–19.1	–31.4	–27.1	–11.6	3.0	5.4	2.3	–15.7	16.0	26.0	24.8	27.3
Change in deposit share of surviving banks (and new entrants)	5.2	8.3	6.2	0.0	2.2	3.6	–3.0	1.4	–7.3	–11.8	–3.2	–1.4
Number of markets												
Operated any offices in 1985	893	33	4	5	400	32	4	5	72	13	1	2
Adjusted for subsequent mergers and asset growth	835	33	4	5	501	33	4	5	442	32	4	5
Operated any offices in 2003	876	33	4	5	465	33	4	5	268	32	4	5
Memo items												
Share of size-class deposits												
Distribution in 1985	13.5	3.3	1.0	1.5	2.1	1.3	0.5	2.5	0.7	1.1	0.4	2.5
Adjusted for subsequent mergers and asset growth	22.2	3.0	0.9	1.4	5.2	2.8	1.1	3.1	2.2	1.3	0.4	1.8
Distribution in 2003	13.6	2.4	0.8	1.1	2.9	1.7	0.6	2.2	0.9	0.7	0.3	1.7
Total number of markets	904	33	4	5	904	33	4	5	904	33	4	5

B. Positive Population Growth Markets

	Community Banks				Midsize Banks				Top 25 Banks			
			Large Metro				Large Metro				Large Metro	
	Rural	Small Metro	Sub-urban	Urban	Rural	Small Metro	Sub-urban	Urban	Rural	Small Metro	Sub-urban	Urban
Share of deposits												
1985 deposit share	67.3	46.7	37.4	19.0	27.8	43.0	54.1	54.5	4.9	10.3	8.5	26.5
Adjusted for subsequent mergers and asset growth	45.3	18.5	16.9	7.5	24.6	31.8	28.0	23.7	30.2	49.8	55.0	68.8
2003 deposit share	47.7	26.9	21.6	8.9	30.9	38.6	37.2	29.1	21.4	34.5	41.2	62.0
Deposit share changes												
Change from 1985–2003	–19.5	–19.9	–15.8	–10.1	3.1	–4.3	–16.9	–25.4	16.5	24.2	32.7	35.5
Adjusted for subsequent mergers and asset growth	–22.0	–28.3	–20.5	–11.5	–3.2	–11.2	–26.0	–30.8	25.2	39.5	46.5	42.4
Change in deposit share of surviving banks (and new entrants)	2.5	8.4	4.6	1.4	6.3	6.8	9.2	5.4	–8.8	–15.2	–13.8	–6.8
Number of markets												
Operated any offices in 1985	1311	182	73	99	810	175	71	99	177	73	29	56
Adjusted for subsequent mergers and asset growth	1151	172	72	97	912	177	69	98	900	179	72	99
Operated any offices in 2003	1272	182	74	99	948	181	74	99	764	179	71	98
Memo items												
Distribution of deposits of size class												
Distribution in 1985	19.6	16.1	14.0	30.8	5.8	10.6	14.5	62.8	2.7	6.6	6.0	80.0
Adjusted for subsequent mergers and asset growth	27.3	11.8	11.7	21.6	10.5	14.5	13.9	48.8	6.0	10.5	12.5	65.3
Distribution in 2003	25.2	14.8	16.3	25.7	10.1	13.2	17.4	52.0	4.5	7.6	12.5	71.8
Total number of markets	1346	182	74	99	1346	182	74	99	1346	182	74	99

Notes: Deposit-market shares are measured as a percentage of all deposits in a given market segment (as reported by FDIC-insured institutions in the June Summary of Deposits data) that are held by each size class of banking organizations. The mean levels of local deposit-market concentration in rural, small metro, and large metro markets, respectively, are measured using Herfendahl indices constructed from these deposit-market shares. Herfendahl indices for suburban and urban parts of large MSAs are calculated for the entire MSA market. Large metropolitan areas are those with populations above 500,000.

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

Table A.8

Share of Banking-Sector Assets and Funding, Commercial Banks vs. Savings Institutions

1985, 1994, and 2003

A. Assets, midyear

	Commercial Banks								
	Community			Midsize			Top 25		
	1985	**1994**	**2003**	**1985**	**1994**	**2003**	**1985**	**1994**	**2003**
Consumer credit	27.6	14.5	8.1	44.6	38.0	25.1	27.8	47.5	66.8
Home mortgages	35.3	21.5	12.8	39.9	35.3	24.1	24.8	43.1	63.2
Commercial & industrial loans	15.8	12.3	11.4	34.1	33.4	23.5	50.1	54.3	65.1
Domestic commercial & industrial loans	20.8	14.9	13.3	42.8	40.1	26.8	36.5	45.0	59.9
Small commercial & industrial loans	NA	38.1	31.8	NA	38.1	32.3	NA	23.7	35.9
Commercial real estate	32.1	26.9	28.0	44.2	40.0	38.6	23.7	33.1	33.4
Small commercial real estate	NA	42.5	42.2	NA	36.2	34.0	NA	21.3	23.9
Construction & land development	16.1	24.6	23.7	44.1	39.7	40.7	39.8	35.7	35.6
Multifamily real estate	27.4	23.3	19.1	38.0	40.5	44.7	34.5	36.2	36.2
Farm real estate	71.7	68.7	65.3	20.6	20.6	22.6	7.7	10.7	12.0
Small farm real estate	NA	75.5	73.8	NA	18.5	19.1	NA	6.0	7.1
Farm operating	65.5	65.0	61.3	19.2	18.6	20.3	15.3	16.3	18.4
Small farm operating	NA	76.8	76.1	NA	15.6	15.8	NA	7.7	8.1
Foreign government loans	0.5	0.8	0.2	19.9	7.4	6.3	79.7	91.8	93.4
Total loans and leases	21.4	17.6	14.2	37.4	34.0	26.1	41.3	48.3	59.7
Securities	43.6	28.2	15.3	41.4	36.0	31.6	15.0	35.8	53.1
Mortgage backed securities	39.2	17.4	8.8	44.3	38.3	32.4	16.4	44.2	58.8
Other Assets	17.1	9.9	7.0	36.5	23.1	16.7	46.4	67.1	76.3
Total Assets	23.8	18.3	12.7	37.8	32.1	25.0	38.4	49.6	62.3

B. Funding, year-end

	Commercial Banks								
	Community			Midsize			Top 25		
	1985	**1994**	**2003**	**1985**	**1994**	**2003**	**1985**	**1994**	**2003**
Total deposits	25.3	21.3	15.6	40.4	33.1	26.7	34.2	45.6	57.7
Domestic deposits	29.8	24.9	18.3	44.6	36.0	30.0	25.5	39.1	51.7
Core deposits	31.2	24.8	17.9	45.3	35.5	28.7	23.5	39.7	53.4
Other borrowing	4.2	4.5	4.8	42.4	35.3	24.4	53.3	60.2	70.8
Subordinated debt	3.5	0.6	0.4	26.6	19.9	14.5	69.9	79.5	85.0
Federal Home Loan Bank advances[a]	NA	26.6	18.7	NA	55.6	49.2	NA	17.8	32.2
Other liabilities	7.0	3.4	1.7	27.7	12.6	10.6	65.3	84.1	87.7
Total liabilities	21.8	17.4	12.4	40.1	32.2	25.1	38.1	50.3	62.5
Equity	29.4	21.4	13.9	39.1	31.9	27.2	31.6	46.7	58.9
Memo items									
Volatile liabilities	9.1	7.1	6.7	33.5	29.3	21.4	57.4	63.6	71.9
Number of banks[b]	11,876	8,831	6,810	2,058	1,269	869	473	351	90

Note: These panels are calculated as the bank asset-size group's percentage of the total amount reported by commercial banks or by savings institutions, as indicated. Bank-level data for commercial banks and savings institutions are classified by the size class of their controlling organization

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

[a]1994 data for commercial banks taken from Federal Housing Finance Board.

[b]The number of banks refers to the number of commercial banks and savings institutions (respectively) controlled by organizations classified as either community, midsize, or top 25.

Savings Institutions

Community			Midsize			Top 25		
1985	**1994**	**2003**	**1985**	**1994**	**2003**	**1985**	**1994**	**2003**
34.8	26.8	11.8	60.8	64.0	74.1	4.4	9.1	14.1
37.8	31.9	16.2	53.7	59.7	38.2	8.6	8.4	45.6
24.3	34.7	18.9	75.6	56.3	59.8	0.0	9.0	21.3
24.3	34.7	18.9	75.6	56.3	59.8	0.0	9.0	21.3
NA	49.2	30.6	NA	47.6	56.4	NA	3.2	13.0
33.9	36.3	33.1	58.3	57.7	53.0	7.7	6.0	13.9
NA	54.9	51.1	NA	43.8	40.5	NA	1.3	8.4
32.6	52.0	30.4	64.0	46.6	60.8	3.4	1.4	8.8
27.2	18.4	13.5	63.9	65.7	42.9	8.9	15.9	43.6
96.6	85.7	69.5	3.4	11.1	16.2	NA	3.2	14.3
NA	88.4	79.9	NA	11.5	15.1	NA	0.1	5.0
39.7	67.9	24.5	60.3	28.0	8.7	NA	4.2	66.8
NA	84.0	57.3	NA	15.3	13.2	NA	0.6	29.5
NA	6.1	0.0	NA	34.7	100.0	NA	59.1	0.0
35.8	31.0	17.7	56.4	60.0	44.5	7.8	8.9	37.8
31.5	29.9	22.5	62.7	64.1	55.0	5.7	6.0	22.5
25.0	22.4	16.5	65.7	70.6	61.3	9.3	7.0	22.2
26.7	32.8	21.3	65.9	57.4	40.4	7.4	9.8	38.2
33.8	30.9	19.2	58.9	61.0	46.3	7.2	8.1	34.5

Savings Institutions

Community			Midsize			Top 25		
1985	**1994**	**2003**	**1985**	**1994**	**2003**	**1985**	**1994**	**2003**
37.2	33.6	22.6	56.7	58.4	46.4	6.1	8.0	31.0
37.2	33.6	22.6	56.7	58.4	46.4	6.1	8.0	31.0
38.9	34.1	24.4	56.0	58.3	47.0	5.2	7.6	28.5
15.4	14.5	8.5	73.1	78.5	48.7	11.5	7.0	42.8
4.8	1.7	0.3	90.0	66.6	40.9	5.3	31.7	58.8
20.6	19.3	12.3	71.9	76.7	49.7	7.5	4.0	38.0
24.1	21.4	11.5	64.7	68.9	48.3	11.1	9.7	40.3
33.8	29.7	18.3	59.2	62.4	47.0	7.0	7.9	34.7
32.0	34.8	21.4	57.3	57.3	45.8	10.7	7.9	32.8
18.5	18.5	11.2	69.0	73.0	46.2	12.5	8.5	42.6
3,252	1,905	1,239	368	236	164	6	13	10

Table A.9

Banking-Sector Balance-Sheet Ratios, Assets, and Liabilities, Commercial Banks vs. Savings Institutions

1985, 1994 and 2003

A. Assets as of June

	Commercial Banks								
	Community			Midsize			Top 25		
	1985	1994	2003	1985	1994	2003	1985	1994	2003
Consumer Credit	12.8	8.9	5.8	13.1	13.3	9.3	8.0	10.8	9.9
Home mortgages	10.8	16.0	16.8	7.7	15.0	16.2	4.7	11.8	17.0
Commercial & Industrial loans	14.8	9.7	10.6	20.0	15.1	11.2	28.9	15.9	12.4
Domestic Commercial & Industrial loans	14.7	9.6	10.6	19.1	14.8	10.9	16.0	10.8	9.8
Small Commercial & Industrial loans	NA	8.3	8.3	NA	4.7	4.3	NA	1.9	1.9
Commercial real estate	5.4	10.4	17.0	4.7	8.8	11.9	2.5	4.7	4.1
Small Commercial real estate	NA	8.5	11.1	NA	4.1	4.6	NA	1.6	1.3
Construction & land development	2.2	2.2	5.4	3.8	2.0	4.8	3.3	1.2	1.7
Multi-Family real estate	0.5	1.0	1.5	0.5	1.0	1.8	0.4	0.6	0.6
Farm real estate	1.2	2.1	2.7	0.2	0.4	0.5	0.1	0.1	0.1
Small farm real estate	NA	2.0	2.3	NA	0.3	0.3	NA	0.1	0.0
Farm operating	4.3	3.6	2.9	0.8	0.6	0.5	0.6	0.3	0.2
Small farm operating	NA	3.4	2.5	NA	0.4	0.3	NA	0.1	0.1
Foreign government loans	0.0	0.0	0.0	0.8	0.1	0.0	3.3	0.7	0.1
Total loans and leases	54.2	55.0	64.0	59.7	60.4	59.9	64.9	55.6	54.9
Securities	28.6	33.6	23.1	17.1	24.4	24.5	6.1	15.8	16.4
Mortgage backed securities	1.6	8.2	7.5	1.1	10.3	14.2	0.4	7.7	10.3
Other Assets	17.2	11.4	12.8	23.1	15.2	15.6	29.0	28.6	28.6
Total Assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

B. Liabilities as of year-end

	Commercial Banks								
	Community			Midsize			Top 25		
	1985	1994	2003	1985	1994	2003	1985	1994	2003
Total deposits	96.1	94.8	91.5	83.5	79.8	77.5	74.2	70.5	67.1
Domestic deposits	96.0	94.4	91.4	78.2	73.7	74.2	46.9	51.3	51.3
Core deposits	82.8	85.1	76.8	65.5	66.1	61.2	35.6	47.3	45.6
Other borrowing	2.4	4.1	7.6	13.2	17.5	19.1	17.5	19.1	22.2
Subordinated debt	0.1	0.0	0.0	0.4	0.7	0.9	1.0	1.7	2.0
Federal Home Loan Bank advances[a]	NA	1.1	5.3	NA	1.2	7.0	NA	0.2	1.8
Other liabilities	1.4	1.0	0.8	2.9	2.0	2.6	7.2	8.7	8.7
Total liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo items									
Liabilities (% of assets)	91.8	90.6	89.9	94.0	92.3	90.2	94.8	92.7	91.4
Equity (% of assets)	8.2	9.4	10.1	6.0	7.7	9.8	5.2	7.3	8.6
Volatile liabilities	15.6	13.0	18.4	31.1	28.8	29.1	56.0	40.1	39.3
Domestic liabilities	99.8	99.6	99.9	94.3	93.6	96.3	68.6	72.6	78.4

Note: These are aggregate balance-sheet ratios for each size class. Asset categories are measures as a percentage of total assets. Liability categories are measured as a percentage of total liabilities, except where noted.

Bank-level data for commercial banks and savings institutions are classified into the size categories on the basis of size class of their controlling organization.

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

[a]1994 data for commercial banks taken from Federal Housing Finance Board.

Savings Institutions								
Community			Midsize			Top 25		
1985	1994	2003	1985	1994	2003	1985	1994	2003
4.4	3.3	3.1	4.4	4.0	8.2	2.6	4.3	2.1
49.5	46.4	38.4	40.4	43.9	37.4	52.4	46.4	60.0
1.2	1.1	3.0	2.2	0.9	3.9	0.0	1.1	1.9
1.2	1.1	3.0	2.2	0.9	3.9	0.0	1.1	1.9
NA	0.9	2.3	NA	0.5	1.7	NA	0.2	0.5
6.7	6.4	9.1	6.7	5.2	6.0	7.2	4.1	2.1
NA	4.7	5.7	NA	1.9	1.9	NA	0.4	0.5
5.1	3.3	4.2	5.7	1.5	3.5	2.5	0.3	0.7
5.5	3.8	3.3	7.4	6.9	4.3	8.4	12.4	5.9
0.0	0.0	0.1	0.0	0.0	0.0	NA	0.0	0.0
NA	0.1	0.2	NA	0.0	0.0	NA	0.0	0.0
0.0	0.0	0.0	0.0	0.0	0.0	NA	0.0	0.1
NA	0.0	0.1	NA	0.0	0.0	NA	0.0	0.0
NA	0.0	0.0	NA	0.0	0.0	NA	0.0	0.0
69.5	62.9	61.3	62.8	61.6	63.8	70.3	68.7	72.9
21.9	28.2	25.9	25.0	30.5	26.2	18.6	21.3	14.4
6.9	15.2	13.0	10.4	24.2	20.0	12.1	18.0	9.8
8.6	8.9	12.8	12.2	7.8	10.0	11.1	10.0	12.7
00.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Savings Institutions								
Community			Midsize			Top 25		
1985	1994	2003	1985	1994	2003	1985	1994	2003
92.4	89.8	85.6	80.4	74.2	68.3	74.0	80.4	62.0
92.4	89.8	85.6	80.4	74.2	68.3	74.0	80.4	62.0
86.1	82.3	68.0	70.7	67.0	50.9	55.6	69.0	41.9
6.4	9.4	13.3	17.4	24.2	29.6	23.2	17.1	35.3
0.0	0.0	0.0	0.4	0.3	0.4	0.2	1.0	0.8
4.3	6.2	11.8	8.6	11.7	18.5	7.6	4.9	19.2
1.2	0.9	1.0	1.8	1.3	1.7	2.6	1.5	1.9
00.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
96.6	90.9	89.2	96.6	92.7	90.8	94.7	92.1	91.0
3.3	9.1	10.8	3.4	7.3	9.2	5.3	7.9	9.0
12.7	16.2	27.6	27.0	30.5	44.2	41.5	28.2	55.3
00.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table A.10

Commercial Bank Performance Ratios, 1985–2003

	1985	1986	1987	1988	1989	1990	1991	1992
ROA								
Small Community Banks	0.74	0.55	0.58	0.70	0.77	0.75	0.80	1.05
Medium Community Banks	0.87	0.80	0.84	0.82	0.91	0.77	0.78	1.02
Large Community Banks	0.78	0.68	0.79	0.93	0.82	0.79	0.66	0.90
All Community Banks	0.81	0.70	0.74	0.80	0.85	0.77	0.77	1.01
Midsize Banks	0.83	0.71	0.39	0.68	0.76	0.28	0.51	0.95
Top 25 Banks	0.51	0.53	–0.53	0.99	0.05	0.54	0.46	0.90
Pre-tax ROA								
Small Community Banks	0.93	0.71	0.81	0.97	1.09	1.07	1.15	1.50
Medium Community Banks	1.08	1.01	1.11	1.13	1.28	1.10	1.12	1.48
Large Community Banks	0.95	0.90	1.08	1.28	1.17	1.12	0.96	1.31
All Community Banks	1.01	0.89	1.00	1.10	1.20	1.09	1.10	1.46
Midsize Banks	1.02	0.85	0.57	0.95	1.05	0.44	0.75	1.38
Top 25 Banks	0.74	0.75	–0.39	1.38	0.33	0.79	0.66	1.30
ROE								
Small Community Banks	8.23	6.19	6.51	7.79	8.41	8.20	8.76	11.19
Medium Community Banks	10.91	10.03	10.27	9.99	10.86	9.27	9.33	11.87
Large Community Banks	10.76	9.10	10.46	12.15	11.01	10.10	8.64	11.34
All Community Banks	9.82	8.41	8.87	9.50	10.01	9.04	9.03	11.56
Midsize Banks	13.52	11.52	6.31	11.08	12.00	4.54	7.73	13.47
Top 25 Banks	10.20	10.30	–10.70	19.48	1.02	10.00	7.84	13.88
Net Interest Margin								
Small Community Banks	4.75	4.51	4.44	4.45	4.51	4.47	4.50	4.78
Medium Community Banks	4.63	4.51	4.50	4.50	4.63	4.50	4.50	4.75
Large Community Banks	4.66	4.52	4.46	4.55	4.53	4.53	4.51	4.75
All Community Banks	4.68	4.51	4.47	4.49	4.57	4.49	4.50	4.76
Midsize Banks	4.14	3.95	4.01	3.97	4.08	3.92	4.12	4.43
Top 25 Banks	3.44	3.47	3.41	3.79	3.63	3.68	3.90	4.20
Cost Ratio								
Small Community Banks	NA	NA	NA	69.4	68.6	70.0	70.2	67.0
Medium Community Banks	NA	NA	NA	67.3	66.0	67.6	68.3	66.0
Large Community Banks	NA	NA	NA	64.7	65.8	64.2	67.4	65.4
All Community Banks	NA	NA	NA	67.6	66.8	67.7	68.7	66.2
Midsize Banks	NA	NA	NA	67.7	64.9	67.2	67.3	65.0
Top 25 Banks	NA	NA	NA	64.4	66.6	67.1	67.9	64.0
Nonperforming Asset Ratio								
Small Community Banks	4.43	4.88	4.44	4.02	3.74	3.46	3.37	2.86
Medium Community Banks	3.50	3.66	3.30	3.25	3.26	3.43	3.66	3.30
Large Community Banks	3.51	3.77	3.31	2.77	3.23	3.77	4.46	3.71
All Community Banks	3.82	4.08	3.68	3.40	3.40	3.50	3.72	3.25
Midsize Banks	2.35	2.50	2.78	2.53	2.65	4.37	4.56	3.73
Top 25 Banks	3.65	3.76	5.61	4.55	4.73	5.51	5.98	5.30

Note: This table presents aggregate performance measures for all FDIC-insured commercial banks classified by the size of their controlling organization. Performance ratios are expressed in percentage terms. For performance measures, do novo banks (those less than five years old) are excluded.

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars). The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations. Small community banks are community banks with less than $100 million in total assets, medium community banks are community banks with total assets greater than $100 million but less than $500 million, and large community banks are community banks with total assets greater than $500 million but less than $1 billion.

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.13	1.09	1.16	1.16	1.21	1.16	1.14	1.17	1.06	1.13	1.03
1.11	1.12	1.23	1.26	1.32	1.30	1.24	1.26	1.16	1.25	1.21
1.14	1.19	1.22	1.26	1.33	1.30	1.31	1.28	1.16	1.29	1.33
1.12	1.12	1.21	1.24	1.29	1.27	1.23	1.24	1.14	1.24	1.21
1.22	1.20	1.25	1.30	1.38	1.46	1.49	1.35	1.36	1.48	1.45
1.23	1.13	1.12	1.13	1.15	1.05	1.25	1.09	1.08	1.30	1.42
1.59	1.53	1.65	1.67	1.70	1.56	1.49	1.51	1.35	1.41	1.30
1.60	1.61	1.78	1.84	1.89	1.85	1.72	1.73	1.57	1.65	1.59
1.63	1.71	1.77	1.86	1.98	1.90	1.89	1.83	1.66	1.84	1.86
1.60	1.61	1.74	1.80	1.87	1.80	1.71	1.71	1.55	1.66	1.61
1.72	1.77	1.90	1.98	2.12	2.19	2.25	2.05	2.06	2.20	2.16
1.85	1.73	1.76	1.77	1.80	1.62	2.00	1.72	1.64	1.97	2.13
11.56	10.88	11.12	10.98	11.26	10.62	10.75	11.00	9.72	10.35	9.18
12.34	12.06	12.73	12.87	13.25	13.02	12.72	13.29	11.88	12.57	12.24
13.63	13.99	13.60	14.08	14.49	13.66	14.18	14.25	12.47	13.58	13.78
12.29	11.99	12.40	12.56	12.96	12.56	12.58	13.01	11.58	12.41	12.05
15.96	15.53	15.57	15.62	16.43	16.64	17.38	15.74	14.42	15.42	14.90
16.86	15.37	15.28	14.79	14.68	13.28	15.47	13.58	13.19	14.77	16.39
4.74	4.77	4.78	4.70	4.71	4.59	4.47	4.56	4.30	4.39	4.23
4.69	4.73	4.77	4.71	4.72	4.64	4.55	4.52	4.33	4.44	4.25
4.71	4.82	4.69	4.71	4.63	4.56	4.51	4.60	4.40	4.35	4.17
4.71	4.76	4.76	4.71	4.70	4.61	4.52	4.55	4.34	4.41	4.23
4.49	4.39	4.40	4.48	4.52	4.40	4.40	4.31	4.27	4.27	3.93
4.15	4.15	4.02	3.97	3.87	3.74	3.76	3.61	3.64	3.94	3.69
67.6	66.8	65.2	64.7	64.4	66.9	66.9	64.9	67.6	66.8	69.9
66.6	65.7	63.5	62.6	61.7	61.4	63.5	63.2	64.4	63.7	64.9
64.1	62.8	61.3	60.0	59.8	60.9	61.0	60.6	61.4	60.0	62.8
66.4	65.5	63.6	62.6	61.9	62.5	63.6	62.9	64.1	63.1	65.1
63.5	62.4	60.1	58.5	56.7	55.8	55.7	56.4	56.6	56.1	56.9
63.1	63.4	62.2	61.6	60.1	63.2	59.3	59.0	57.3	54.3	54.7
2.24	1.73	1.58	1.50	1.33	1.37	1.25	1.27	1.50	1.59	1.52
2.67	1.91	1.58	1.34	1.19	1.14	1.02	1.03	1.24	1.29	1.23
2.66	1.84	1.44	1.23	1.09	1.08	0.92	0.95	1.22	1.26	1.09
2.55	1.85	1.55	1.36	1.20	1.17	1.04	1.06	1.28	1.33	1.23
2.23	1.42	1.25	1.16	1.07	1.02	0.94	1.11	1.43	1.35	1.09
3.27	1.92	1.49	1.22	1.10	1.07	1.07	1.30	1.63	1.73	1.42

Table A.11

Savings Institution Performance Ratios, 1985–2003

	1985	1986	1987	1988	1989	1990	1991	1992
ROA								
Small Community Banks	0.43	0.22	–0.32	–1.11	–0.89	0.11	0.34	0.86
Medium Community Banks	0.43	0.18	–0.77	–0.39	–0.63	0.03	0.35	0.83
Large Community Banks	0.33	–0.06	–0.61	–0.33	–1.20	–0.55	0.01	0.76
All Community Banks	0.39	0.11	–0.67	–0.45	–0.84	–0.16	0.24	0.81
Midsize Banks	0.51	0.36	0.00	–0.31	–0.80	–0.70	–0.16	0.56
Top 25 Banks	0.68	0.90	–0.08	0.77	0.47	0.56	0.73	0.38
Pre-tax ROA								
Small Community Banks	0.66	0.58	0.06	–0.81	–0.67	0.32	0.63	1.36
Medium Community Banks	0.69	0.58	–0.43	–0.12	–0.42	0.23	0.65	1.34
Large Community Banks	0.57	0.35	–0.22	–0.07	–1.06	–0.47	0.25	1.24
All Community Banks	0.65	0.51	–0.31	–0.18	–0.66	0.01	0.52	1.31
Midsize Banks	0.70	0.64	0.23	–0.16	–0.78	–0.64	0.05	0.89
Top 25 Banks	1.09	1.42	0.22	1.16	0.82	0.86	1.26	0.62
ROE								
Small Community Banks	10.43	5.26	–8.08	–31.48	–25.62	1.52	4.53	10.68
Medium Community Banks	13.81	5.03	–21.75	–9.07	–13.78	0.37	4.87	10.81
Large Community Banks	10.66	–1.42	–14.29	–6.47	–26.88	–9.57	0.19	11.02
All Community Banks	12.35	2.86	–17.55	–10.09	–19.18	–2.41	3.46	10.85
Midsize Banks	15.61	9.30	–0.10	–7.27	–18.23	–14.30	–2.99	8.48
Top 25 Banks	17.56	18.01	–1.29	10.12	6.33	8.25	9.85	4.96
Net Interest Margin								
Small Community Banks	2.16	2.44	2.54	2.37	2.20	2.82	3.06	3.65
Medium Community Banks	1.96	2.22	2.26	2.30	2.22	2.73	3.03	3.64
Large Community Banks	1.79	2.16	2.30	2.26	2.03	2.58	2.96	3.62
All Community Banks	1.93	2.23	2.31	2.30	2.16	2.69	3.01	3.64
Midsize Banks	1.39	1.83	1.98	1.72	1.64	2.14	2.62	3.30
Top 25 Banks	1.78	2.12	2.04	2.59	2.48	2.84	3.29	3.64
Cost Ratio								
Small Community Banks	NA	NA	NA	91.2	96.8	77.3	74.1	63.8
Medium Community Banks	NA	NA	NA	81.8	87.2	76.1	71.9	64.0
Large Community Banks	NA	NA	NA	78.6	95.6	83.3	75.1	65.6
All Community Banks	NA	NA	NA	81.8	90.9	78.5	73.2	64.5
Midsize Banks	NA	NA	NA	80.3	89.5	85.1	75.8	62.7
Top 25 Banks	NA	NA	NA	58.3	57.7	62.2	56.8	65.3
Nonperforming Asset Ratio								
Small Community Banks	4.91	6.03	6.73	6.51	6.00	3.35	3.37	2.69
Medium Community Banks	4.90	7.34	8.31	5.62	5.47	3.94	4.13	3.34
Large Community Banks	4.99	6.81	7.35	6.33	7.41	6.16	5.80	4.40
All Community Banks	4.93	7.03	7.84	5.96	6.15	4.61	4.55	3.60
Midsize Banks	4.01	5.89	6.78	6.17	5.55	5.92	6.57	4.98
Top 25 Banks	6.28	6.31	5.86	2.12	2.20	2.81	4.56	5.54

Note: This table presents aggregate performance measures for all FDIC-insured savings institutions classified by the size of their controlling organization. Performance ratios are expressed in percentage terms. For performance measures, do novo banks (those less than five years old) are excluded.

Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

The top 25 banks are the 25 largest banking organizations, measured in terms of the banking industry assets they controlled at the indicated time. Midsize banks consist of all remaining banking organizations.

Small community banks are community banks with less than $100 million in total assets, medium community banks are community banks with total assets greater than $100 million but less than $500 million, and large community banks are community banks with total assets greater than $500 million but less than $1 billion.

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.03	0.81	0.65	0.41	0.70	0.74	0.65	0.53	0.72	0.97	1.14
1.00	0.78	0.83	0.63	0.94	0.91	0.84	0.80	0.77	0.83	0.83
0.94	0.83	0.80	0.66	0.92	0.85	0.97	0.83	0.84	0.87	0.95
0.98	0.80	0.80	0.62	0.91	0.87	0.86	0.79	0.79	0.85	0.90
0.67	0.59	0.84	0.84	1.00	1.05	1.10	0.95	1.04	1.23	1.33
0.02	0.64	0.48	0.29	0.74	1.04	0.97	1.03	1.24	1.27	1.44
1.58	1.25	1.04	0.67	1.13	1.13	1.01	0.89	1.17	1.49	1.72
1.54	1.24	1.28	0.98	1.45	1.38	1.27	1.21	1.16	1.24	1.25
1.48	1.30	1.25	1.02	1.43	1.36	1.46	1.23	1.24	1.30	1.35
1.53	1.26	1.24	0.96	1.40	1.34	1.30	1.18	1.18	1.28	1.33
1.01	0.97	1.24	1.15	1.51	1.60	1.69	1.45	1.65	1.82	1.99
0.24	0.93	0.97	0.47	1.25	1.55	1.60	1.60	1.93	2.03	2.29
11.56	8.34	6.27	3.76	6.22	6.35	5.49	4.47	5.98	7.98	9.00
11.82	8.56	8.52	6.19	8.96	8.30	7.75	7.68	7.28	7.47	7.77
11.98	9.79	8.63	6.88	9.06	8.04	9.31	8.35	8.41	8.46	9.23
11.83	8.89	8.23	6.08	8.63	7.99	7.96	7.51	7.50	7.84	8.42
9.40	7.98	10.83	10.77	12.48	12.19	12.98	11.28	12.08	14.01	14.78
0.32	8.39	6.67	3.96	10.09	14.14	14.72	16.10	16.82	13.88	15.79
3.82	3.74	3.50	3.50	3.54	3.42	3.36	3.47	3.21	3.41	3.36
3.74	3.62	3.45	3.50	3.51	3.44	3.46	3.35	3.28	3.58	3.33
3.80	3.64	3.40	3.44	3.51	3.36	3.35	3.20	3.23	3.43	3.20
3.77	3.65	3.44	3.48	3.52	3.42	3.42	3.31	3.26	3.51	3.28
3.31	3.16	2.92	3.08	3.14	3.09	3.16	3.13	3.27	3.40	3.24
4.07	3.43	3.07	3.25	3.00	2.79	2.72	2.41	3.05	3.16	3.31
64.1	67.9	70.5	82.5	72.2	71.3	73.8	77.6	78.3	75.3	75.1
63.0	64.5	64.7	73.6	62.3	65.9	68.1	67.6	68.9	70.1	70.5
64.8	62.3	62.6	69.7	59.3	64.0	61.9	62.8	62.6	65.7	65.8
63.7	64.2	64.8	73.4	62.7	65.9	66.8	67.3	68.1	69.3	69.4
61.4	60.7	56.4	61.8	54.7	57.2	53.9	56.2	57.0	55.4	56.7
69.9	60.5	56.9	72.2	55.7	56.8	50.4	47.2	50.3	52.3	50.4
2.18	1.70	1.60	1.54	1.39	1.25	1.05	1.07	1.31	1.32	1.40
2.55	1.79	1.58	1.68	1.15	1.03	0.84	0.85	0.95	0.95	0.93
3.25	2.26	1.68	1.42	1.52	1.26	0.89	0.83	0.97	1.33	1.11
2.71	1.92	1.61	1.57	1.29	1.12	0.88	0.86	0.99	1.11	1.03
3.65	2.25	1.96	1.77	1.64	1.31	1.09	1.05	1.03	1.05	0.97
2.95	2.56	2.46	1.78	1.24	0.93	0.78	0.69	1.08	1.17	0.90

Table A.12

Performance Measures for Community Banks Based on Their Subsequent Size-Group Classification

A. Commercial Banks

	Classified as Community Banks in 1985									
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Return on Assets										
Still community banks	0.81	0.69	0.75	0.82	0.86	0.77	0.78	1.02	1.14	1.14
Acquired by larger organization	NA	0.88	0.90	0.73	0.82	0.57	0.37	0.78	1.04	1.17
Outgrew size class	NA	0.37	0.40	0.73	1.05	1.10	1.08	1.63	1.89	1.86
Net Interest Margin										
Still community banks	4.68	4.50	4.47	4.49	4.58	4.50	4.51	4.77	4.72	4.76
Acquired by larger organization	NA	4.45	4.44	4.42	4.43	4.32	4.26	4.62	4.64	4.63
Outgrew size class	NA	4.98	6.05	5.63	5.35	5.53	5.83	6.06	5.85	5.73
Loan-to-Asset Ratio										
Still community banks	53.1	52.1	53.6	54.6	55.2	55.3	53.9	52.7	53.5	55.9
Acquired by larger organization	NA	58.0	61.9	63.4	64.3	64.6	62.9	60.6	61.7	64.7
Outgrew size class	NA	62.2	70.8	67.4	66.4	68.1	67.3	62.9	65.7	65.8
Nonperforming Asset Ratio										
Still community banks	3.82	4.09	3.62	3.35	3.38	3.48	3.68	3.20	2.51	1.83
Acquired by larger organization	NA	1.96	1.99	2.37	2.46	3.49	4.30	3.65	2.58	1.49
Outgrew size class	NA	1.92	1.92	1.80	2.01	2.38	3.08	2.97	2.45	1.86
Equity Ratio										
Still community banks	8.07	8.01	8.25	8.30	8.35	8.34	8.44	8.75	9.25	9.25
Acquired by larger organization	NA	7.64	7.39	7.05	7.12	7.35	7.54	8.03	8.38	8.33
Outgrew size class	NA	7.77	7.36	6.92	7.41	7.60	8.29	8.77	8.55	8.44
Cost Ratio										
Still community banks	NA	NA	NA	67.4	66.4	67.8	68.6	66.0	66.1	65.3
Acquired by larger organization	NA	NA	NA	68.1	66.0	67.4	68.0	65.7	63.1	61.9
Outgrew size class	NA	NA	NA	64.8	60.0	50.0	48.0	46.7	50.0	52.2
Average Assets (2002 dollars)										
Still community banks	80	77	78	79	80	83	85	88	90	91
Acquired by larger organization	NA	182	240	289	301	331	363	418	420	475
Outgrew size class	NA	531	710	637	747	868	895	894	931	1,031
Number of Banks										
Still community banks	10,560	10,129	9,842	9,589	9,429	9,281	8,983	8,660	8,253	7,842
Acquired by larger organization	NA	236	381	490	526	551	539	516	556	580
Outgrew size class	NA	45	51	84	89	92	92	91	88	86

Note: Performance ratios are expressed in percentage terms. Average asset size is in millions of 2002 dollars. Performance measures are aggregate ratios for commercial banks and savings institutions, respectively (excluding de novos), that were classified as community banks at the beginning of a given eight-year study period, based on whether they were still classified as community banks in the year identified versus whether they had outgrown the community-bank size classification or had been acquired by a larger banking organization. Banks that were merged into a larger bank ceased to file Call Report data and are therefore not included in performance measures in years subsequent to their absorption. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

Classified as Community Banks in 1994									
1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.12	1.21	1.24	1.29	1.25	1.23	1.24	1.14	1.23	1.21
NA	0.71	0.95	1.12	1.04	1.10	1.01	0.98	1.19	1.29
NA	1.17	1.10	1.45	1.68	1.63	1.55	1.43	1.69	1.65
4.76	4.77	4.72	4.71	4.57	4.52	4.51	4.32	4.38	4.18
NA	3.82	4.26	4.41	4.38	4.18	4.25	4.06	3.90	3.64
NA	5.77	5.97	5.81	5.21	4.96	4.38	4.29	4.28	4.18
56.0	56.8	58.9	60.0	59.3	62.2	64.1	63.7	63.4	63.3
NA	52.6	57.4	61.3	61.0	60.3	59.5	58.6	57.5	56.9
NA	69.8	73.5	69.9	67.7	69.4	62.3	55.7	59.8	63.7
1.85	1.55	1.36	1.20	1.17	1.04	1.05	1.29	1.32	1.25
NA	1.35	1.50	1.13	1.01	0.81	0.95	1.08	1.09	1.00
NA	1.69	1.49	1.31	0.94	0.78	0.99	1.13	1.10	1.21
9.25	9.84	9.79	9.93	9.86	9.42	9.71	9.71	10.01	9.97
NA	10.60	9.49	9.35	9.30	8.80	8.99	9.61	10.06	11.09
NA	8.67	9.01	8.91	8.86	8.54	8.66	8.99	9.18	9.21
65.5	63.7	62.5	61.9	63.0	63.6	62.9	64.0	63.8	65.3
NA	66.0	64.2	60.2	63.2	58.3	58.4	60.4	57.9	56.2
NA	58.1	52.5	49.0	50.3	51.5	52.0	53.7	48.7	50.8
91	93	98	102	107	113	119	126	132	117
NA	231	292	347	453	528	682	754	959	872
NA	332	552	674	717	894	1,102	1,334	1,465	1,223
8,508	8,128	7,828	7,456	6,993	6,665	6,348	6,101	5,926	5,719
NA	109	153	224	289	298	258	252	225	268
NA	74	99	116	152	156	170	177	181	205

continued

Table A.12 continued

Performance Measures for Community Banks Based on Their Subsequent Size-Group Classification

B. Savings Institutions

	Classified as Community Banks in 1985									
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Return on Assets										
Still community banks	0.39	0.22	–0.62	–0.38	–0.63	–0.12	0.28	0.82	0.99	0.82
Acquired by larger organization	NA	–1.59	0.75	0.76	0.21	–0.67	0.22	0.63	1.14	0.94
Outgrew size class	NA	1.31	0.23	–0.59	–0.10	–0.46	0.61	0.67	0.95	0.88
Net Interest Margin										
Still community banks	1.93	2.23	2.33	2.33	2.21	2.72	3.01	3.64	3.76	3.64
Acquired by larger organization	NA	2.04	3.23	3.34	3.44	3.05	3.41	3.62	3.70	3.76
Outgrew size class	NA	2.66	2.29	2.12	2.26	2.43	3.01	3.61	3.71	3.26
Loan-to-Asset Ratio										
Still community banks	70.3	67.5	68.5	69.5	70.2	69.6	66.7	64.0	63.3	65.1
Acquired by larger organization	NA	75.0	76.7	78.9	79.0	73.8	66.6	62.3	62.3	66.0
Outgrew size class	NA	68.7	64.3	66.3	67.0	68.8	63.5	65.8	60.5	59.1
Nonperforming Asset Ratio										
Still community banks	4.93	7.04	7.63	5.78	5.83	4.38	4.46	3.45	2.66	1.89
Acquired by larger organization	NA	9.28	3.19	2.09	3.50	5.52	5.67	3.83	1.90	1.70
Outgrew size class	NA	3.86	6.25	6.04	4.97	5.62	5.09	4.48	2.82	1.79
Equity Ratio										
Still community banks	3.31	3.94	3.58	4.41	4.28	6.61	7.07	7.92	8.82	9.31
Acquired by larger organization	NA	6.98	10.62	10.20	9.48	8.28	7.69	8.25	9.32	9.17
Outgrew size class	NA	9.03	6.91	5.49	6.20	5.22	7.27	8.27	7.10	7.04
Cost Ratio										
Still community banks	NA	NA	NA	80.6	87.4	77.2	72.4	63.4	62.8	63.6
Acquired by larger organization	NA	NA	NA	56.4	56.6	74.1	66.9	59.8	53.6	55.0
Outgrew size class	NA	NA	NA	90.8	74.3	86.4	58.0	60.4	58.1	57.4
Average Assets (2002 dollars)										
Still community banks	203	198	198	201	197	195	189	189	184	182
Acquired by larger organization	NA	342	714	825	894	528	541	507	469	540
Outgrew size class	NA	930	1,124	1,241	1,302	1,546	1,541	1,541	1,485	1,629
Number of Banks										
Still community banks	3,017	2,934	2,834	2,639	2,528	2,221	2,035	1,900	1,784	1,684
Acquired by larger organization	NA	2	4	14	17	43	42	47	55	55
Outgrew size class	NA	26	50	56	52	38	37	35	34	35

Note: Performance ratios are expressed in percentage terms. Average asset size is in millions of 2002 dollars. Performance measures are aggregate ratios for commercial banks and savings institutions, respectively (excluding de novos), that were classified as community banks at the beginning of a given eight-year study period, based on whether they were still classified as community banks in the year identified versus whether they had outgrown the community-bank size classification or had been acquired by a larger banking organization. Banks that were merged into a larger bank ceased to file Call Report data and are therefore not included in performance measures in years subsequent to their absorption. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

Classified as Community Banks in 1994									
1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
0.80	0.81	0.62	0.92	0.91	0.89	0.82	0.77	0.85	0.87
NA	0.63	0.38	1.04	0.95	1.18	1.40	1.65	2.13	2.22
NA	0.78	0.82	1.02	0.97	1.00	0.98	1.25	1.43	1.55
3.65	3.44	3.48	3.52	3.41	3.41	3.32	3.25	3.49	3.30
NA	2.92	2.77	3.61	3.48	3.71	3.73	4.26	4.57	4.17
NA	3.25	3.19	3.03	2.84	2.94	2.76	2.99	3.33	3.28
65.1	65.4	67.5	68.2	66.9	68.3	69.5	66.8	63.9	62.8
NA	67.9	60.3	69.5	73.1	72.5	77.1	77.8	77.2	74.9
NA	60.9	73.7	71.9	66.7	69.0	67.1	70.4	72.0	74.0
1.92	1.58	1.57	1.29	1.08	0.87	0.86	0.99	1.04	1.01
NA	1.21	1.46	1.15	0.74	0.73	0.74	0.92	0.79	0.76
NA	2.72	2.18	1.64	1.38	1.12	1.15	1.24	1.21	1.00
9.20	10.05	10.14	10.68	10.95	10.52	10.59	10.45	10.70	10.75
NA	9.72	8.66	9.57	9.10	7.86	9.05	9.16	7.79	8.79
NA	8.62	7.39	7.66	8.00	7.95	8.08	8.46	8.44	8.60
64.2	64.7	73.3	62.7	64.8	66.0	66.5	68.4	67.5	69.1
NA	65.6	67.0	62.9	67.9	57.2	47.0	52.0	39.7	42.6
NA	58.9	55.5	48.7	53.7	51.9	51.6	51.7	50.2	51.0
181	178	182	180	184	191	200	207	214	188
NA	349	700	654	795	1,024	1,010	1,265	1,848	1,839
NA	1,229	1,660	1,803	2,137	2,159	2,616	3,003	3,159	3,097
1,859	1,748	1,645	1,522	1,423	1,347	1,277	1,217	1,157	1,106
NA	24	32	22	28	28	24	19	17	18
NA	15	22	40	45	55	59	60	65	66

Table A.13

Community Bank Performance and Local Growth by Type of Geographic Area, 1985–2003

A. All Community Banks/All Markets

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Return on Assets									
Negative population growth	0.46	0.31	0.19	0.44	0.56	0.77	0.90	1.14	1.24
Moderate population growth	0.71	0.69	0.45	0.48	0.35	0.37	0.54	0.90	1.04
High population growth	0.55	–0.32	–1.17	–0.76	–1.06	0.30	0.51	0.90	1.04
Net Interest Margin									
Negative population growth	3.62	3.51	3.51	3.59	3.68	3.81	3.97	4.30	4.30
Moderate population growth	3.44	3.54	3.59	3.57	3.58	3.75	3.92	4.33	4.36
High population growth	3.64	3.49	3.39	3.50	3.51	4.13	4.26	4.70	4.71
Cost Ratio									
Negative population growth	NA	NA	NA	69.6	68.2	66.1	64.9	61.0	61.3
Moderate population growth	NA	NA	NA	68.9	70.1	70.2	69.5	65.4	65.4
High population growth	NA	NA	NA	84.2	88.9	75.8	75.1	71.0	70.8

B. All Community Banks by Type of Market

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Rural Counties									
Return on Assets									
Negative population growth	0.52	0.33	0.28	0.53	0.65	0.83	0.94	1.17	1.25
Moderate population growth	0.72	0.61	0.51	0.60	0.60	0.80	0.88	1.17	1.28
High population growth	0.87	0.55	0.33	0.69	0.61	0.72	0.85	1.24	1.30
Net Interest Margin									
Negative population growth	3.80	3.64	3.63	3.70	3.77	3.88	4.02	4.32	4.31
Moderate population growth	3.77	3.72	3.73	3.75	3.77	3.95	4.08	4.44	4.45
High population growth	4.15	4.03	3.94	4.01	4.05	4.30	4.38	4.80	4.78
Cost Ratio									
Negative population growth	NA	NA	NA	68.0	66.3	64.9	64.2	60.6	61.3
Moderate population growth	NA	NA	NA	67.0	67.7	65.2	64.7	60.9	61.0
High population growth	NA	NA	NA	67.7	68.7	68.3	67.8	62.6	63.3
Small MSAs									
Return on Assets									
Negative population growth	0.43	0.19	–0.18	0.46	0.53	0.76	0.80	1.06	1.21
Moderate population growth	0.70	0.41	–0.20	0.03	0.22	0.42	0.64	1.05	1.11
High population growth	0.55	0.00	–0.02	0.05	–0.21	0.53	0.72	1.17	1.25
Net Interest Margin									
Negative population growth	3.43	3.25	3.26	3.58	3.63	3.80	3.90	4.21	4.22
Moderate population growth	3.30	3.26	3.22	3.37	3.46	3.66	3.89	4.34	4.38
High population growth	3.36	3.53	3.67	3.64	3.67	4.05	4.23	4.70	4.74
Cost Ratio									
Negative population growth	NA	NA	NA	70.3	70.7	67.3	67.2	63.1	62.5
Moderate population growth	NA	NA	NA	73.4	72.4	69.4	68.0	63.8	63.7
High population growth	NA	NA	NA	76.6	75.8	69.4	69.7	64.6	65.1

Note: Performance ratios are expressed in percentage terms. Average asset size is in millions of 2002 dollars. Performance measures are aggregate ratios for commercial banks and savings institutions, respectively (excluding de novos), that were classified as community banks at the beginning of a given eight-year study period, based on whether they were still classified as community banks in the year identified versus whether they had outgrown the community-bank size classification or had been acquired by a larger banking organization. Banks that were merged into a larger bank ceased to file Call Report data and are therefore not included in performance measures in years subsequent to their absorption. Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) with aggregate bank or thrift assets of less than $1 billion (in 2002 dollars).

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.11	1.15	1.10	1.18	1.10	1.07	1.08	1.04	1.11	1.08
1.01	1.06	1.04	1.17	1.15	1.13	1.11	1.04	1.16	1.14
0.97	1.13	1.13	1.29	1.32	1.27	1.32	1.20	1.21	1.20
4.24	4.21	4.20	4.21	4.08	4.03	3.99	3.89	4.02	3.89
4.36	4.31	4.28	4.30	4.23	4.16	4.14	3.98	4.12	3.93
4.77	4.77	4.79	4.90	4.83	4.79	4.89	4.67	4.65	4.46
61.9	60.7	61.2	58.9	61.1	62.3	62.1	63.7	62.5	64.3
64.9	63.7	65.0	62.3	63.2	64.4	64.2	64.8	63.8	65.9
69.0	66.9	67.6	63.9	64.3	64.9	62.8	65.4	65.9	67.2

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.14	1.16	1.14	1.20	1.12	1.10	1.12	1.06	1.15	1.13
1.19	1.21	1.18	1.24	1.21	1.19	1.14	1.10	1.20	1.19
1.27	1.35	1.31	1.37	1.33	1.41	1.34	1.28	1.21	1.26
4.27	4.24	4.23	4.25	4.13	4.10	4.08	3.96	4.12	3.99
4.41	4.38	4.35	4.38	4.27	4.21	4.18	4.07	4.24	4.06
4.89	4.95	4.89	4.94	4.83	4.79	4.77	4.55	4.56	4.45
61.6	60.6	60.2	58.8	61.2	62.1	61.7	63.5	62.2	63.7
61.5	60.6	60.7	59.1	60.8	61.6	61.4	62.5	61.3	62.8
62.2	60.6	60.6	60.3	61.3	60.7	61.1	62.4	61.9	63.0
1.01	1.14	1.02	1.17	1.06	0.97	0.99	0.96	0.98	0.88
1.09	1.11	1.07	1.16	1.05	1.10	1.09	1.05	1.12	1.15
1.11	1.06	1.10	1.42	1.29	1.23	1.25	1.26	1.27	1.39
4.18	4.20	4.14	4.17	4.01	3.91	3.79	3.70	3.79	3.65
4.38	4.36	4.28	4.29	4.20	4.20	4.14	4.01	4.17	3.94
4.77	4.59	4.65	4.77	4.87	4.72	5.23	5.11	5.24	4.75
63.6	60.5	63.2	59.3	61.6	63.6	64.1	65.9	64.5	66.7
63.9	62.8	62.4	61.0	63.5	64.3	62.2	63.7	63.1	64.2
66.4	67.1	65.7	59.1	58.7	62.5	61.6	62.8	61.4	62.9

continued

Table A.13 continued

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Large Metro–Suburban									
Return on Assets									
Negative population growth	0.40	–0.52	0.18	–0.50	–0.11	0.35	0.84	1.08	1.21
Moderate population growth	0.84	0.93	0.72	0.74	0.61	0.22	0.42	0.92	1.08
High population growth	0.83	0.45	0.34	0.16	–0.32	0.29	0.34	0.89	1.17
Net Interest Margin									
Negative population growth	3.43	3.38	3.30	3.19	3.51	3.83	4.00	4.44	4.47
Moderate population growth	3.35	3.50	3.56	3.48	3.44	3.56	3.72	4.20	4.29
High population growth	3.52	3.40	3.45	3.42	3.46	3.77	3.87	4.38	4.46
Cost Ratio									
Negative population growth	NA	NA	NA	83.7	77.5	73.2	68.6	62.5	62.9
Moderate population growth	NA	NA	NA	65.9	66.3	72.4	70.6	63.8	63.6
High population growth	NA	NA	NA	73.8	77.5	74.4	75.7	68.8	68.3
Large Metro–Urban									
Return on Assets									
Negative population growth	0.08	0.78	0.22	0.18	0.18	0.48	0.83	1.09	1.27
Moderate population growth	0.64	0.78	0.61	0.52	0.15	0.12	0.30	0.63	0.81
High population growth	0.34	–1.02	–2.65	–1.88	–2.18	0.09	0.40	0.68	0.80
Net Interest Margin									
Negative population growth	2.66	3.08	3.11	2.91	3.04	3.21	3.62	4.17	4.21
Moderate population growth	3.34	3.58	3.69	3.59	3.56	3.73	3.91	4.29	4.31
High population growth	3.68	3.37	3.10	3.33	3.30	4.28	4.42	4.81	4.80
Cost Ratio									
Negative population growth	NA	NA	NA	74.9	74.9	70.3	63.9	58.7	56.7
Moderate population growth	NA	NA	NA	69.3	72.1	72.9	73.1	69.9	70.3
High population growth	NA	NA	NA	97.5	107.2	81.0	79.0	77.1	76.7

Note: This table presents aggregate performance measures for community banks classified by the type of market area where they were headquartered and by the population growth of the MSA or non-MSA county in which they were located. Performance ratios are expressed in percentage terms. For performance measures, do novo banks (those less than five years old), are excluded. (For further information, see above, n.31.) Community banks are defined as banking organizations (bank and thrift holding companies, independent banks, and independent thrifts) that control bank assets or thrift assets of less than $1 billion (in 2002 dollars).

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1.17	1.21	1.11	1.17	1.14	1.08	1.07	1.06	1.06	0.91
1.06	1.07	1.01	1.14	1.10	1.06	1.00	0.94	1.14	1.01
1.08	1.32	1.33	1.48	1.54	1.49	1.69	1.34	1.39	0.91
4.35	4.33	4.27	4.19	3.97	3.90	3.83	3.67	3.68	3.37
4.30	4.18	4.17	4.16	4.04	4.00	4.00	3.82	3.92	3.71
4.59	4.66	4.68	4.78	4.61	4.64	4.52	4.40	4.39	4.04
63.1	61.2	64.5	60.3	60.7	61.6	62.1	62.6	62.8	68.5
62.9	62.7	64.8	60.7	62.2	63.6	62.6	64.5	58.9	65.6
68.1	64.6	66.4	63.7	63.7	64.3	59.5	64.2	65.7	74.2
1.05	1.01	0.92	1.04	1.00	0.96	0.89	0.95	1.02	0.97
0.80	0.90	0.90	1.13	1.18	1.11	1.14	1.04	1.13	1.17
0.75	1.00	0.97	1.08	1.20	1.08	1.13	1.04	1.07	1.21
3.97	3.91	4.03	3.90	3.78	3.69	3.55	3.54	3.66	3.67
4.35	4.28	4.28	4.29	4.31	4.18	4.17	3.95	4.08	3.90
4.82	4.83	4.86	5.02	4.94	4.90	4.96	4.64	4.50	4.53
59.2	61.1	64.5	58.1	59.3	61.5	63.2	63.3	61.6	65.4
69.0	67.1	69.9	66.2	65.6	67.2	68.1	67.6	68.6	69.6
72.7	70.1	71.6	68.0	69.0	68.4	65.9	69.0	71.0	68.4

Table A.14

Mean Share of Deposits and Offices by Type of Geographic Area, Banks vs. Credit Unions by Size Category, June 1994

	Share of Deposits				Share of Offices			
			Large Metro				Large Metro	
	Rural	Small Metro	Suburban	Urban	Rural	Small Metro	Suburban	Urban
Community	57.80	30.61	27.56	14.29	57.64	33.02	31.75	21.01
Small Credit Union	3.22	5.73	2.44	2.84	9.88	15.95	8.88	14.29
$100M–$1B Credit Union	1.09	4.78	2.77	4.30	0.16	0.83	0.49	1.11
Over $1B Credit Union	0.00	0.44	1.34	1.08	0.00	0.01	0.01	0.04
Midsize	26.43	38.05	42.70	40.63	22.79	33.15	38.24	36.17
Top 25	11.46	20.4	23.19	36.85	9.53	17.04	20.63	27.37

Note: Large metropolitan areas are those with populations above 500,000. (For further information, see above, n. 31.)
Source: Credit Union data from NCUA.

Table A.15

Mean Share of Deposits and Offices by Type of Geographic Area, Banks vs. Credit Unions by Size Category, June 2003

	Share of Deposits				Share of Offices			
			Large Metro				Large Metro	
	Rural	Small Metro	Suburban	Urban	Rural	Small Metro	Suburban	Urban
Community	50.00	23.91	19.78	8.19	55.66	30.10	26.30	16.91
Small Credit Union	3.21	4.48	1.85	1.64	7.29	11.16	6.06	10.00
$100M–$1B Credit Union	2.35	7.97	3.31	4.61	0.36	1.43	0.69	1.58
Over $1B Credit Union	0.00	1.70	3.43	3.31	0.00	0.05	0.07	0.16
Midsize	26.97	33.26	33.75	26.61	23.20	32.49	32.99	30.94
Top 25	17.48	28.68	37.88	55.63	13.5	24.77	33.89	40.41

Note: Large metropolitan areas are those with populations above 500,000. (For further information, see above, n. 31.)
Source: Credit Union data from NCUA.

Table A.16

Federally Insured Credit Union Summary Data by Type of Membership: Year-end 1997–2003

(Dollars in Thousands)

	1997	1998	1999	2000	2001	2002	2003
All credit unions							
Number of institutions	11,241	10,995	10,628	10,316	9,984	9,688	9,369
Total assets	352,859,887	388,690,762	411,396,606	438,243,433	501,555,049	557,074,565	610,155,496
Mean asset size	31,390	35,352	38,709	42,482	50,236	57,502	65,125
Member business loans / Assets	0.82%	0.86%	0.95%	1.06%	1.07%	1.19%	1.45%
Return on assets	0.99%	0.90%	0.91%	0.99%	0.90%	1.02%	0.95%
Return on equity	8.90%	8.21%	8.30%	8.65%	8.20%	9.36%	8.82%
Community							
Number of institutions	376	423	469	522	781	855	986
Total assets	11,120,176	16,054,454	21,901,061	27,041,107	40,309,771	50,285,837	75,405,253
Mean asset size	29,575	37,954	46,697	51,803	51,613	58,814	76,476
Member business loans / Assets	1.48%	1.13%	1.13%	1.05%	1.21%	1.35%	1.82%
Return on assets	0.95%	0.86%	0.86%	0.92%	0.80%	0.97%	0.92%
Return on equity	9.01%	8.26%	8.19%	8.29%	7.45%	8.98%	8.68%
Single common bond							
Number of institutions	2,916	2,880	2,665	2,513	2,403	2,256	2,106
Total assets	37,575,603	44,268,969	44,481,965	43,401,240	49,480,305	54,374,597	58,942,310
Mean asset size	12,886	15,371	16,691	17,271	20,591	24,102	27,988
Member business loans / Assets	0.52%	0.53%	0.50%	0.52%	0.50%	0.50%	0.54%
Return on assets	1.05%	0.99%	0.98%	1.14%	0.96%	1.00%	1.11%
Return on equity	8.56%	8.14%	7.88%	8.85%	8.06%	8.66%	9.73%
Multiple common bond							
Number of institutions	3,636	3,463	3,405	3,290	2,933	2,842	2,684
Total assets	164,982,816	170,370,799	171,755,420	172,044,823	180,222,868	196,577,442	202,235,914
Mean asset size	45,375	49,197	50,442	52,293	61,447	69,169	75,349
Member business loans / Assets	0.42%	0.39%	0.45%	0.50%	0.52%	0.59%	0.77%
Return on assets	0.97%	0.88%	0.90%	1.00%	0.91%	1.04%	0.95%
Return on equity	8.99%	8.22%	8.38%	8.83%	8.30%	9.59%	8.86%
State-chartered							
Number of institutions	4,260	4,181	4,062	3,980	3,866	3,735	3,593
Total assets	137,764,676	156,786,492	172,080,805	195,359,951	231,432,401	255,836,688	273,572,020
Mean asset size	32,339	37,500	42,364	49,085	59,864	68,497	76,140
Member business loans / Assets	1.32%	1.43%	1.56%	1.67%	1.61%	1.77%	2.06%
Return on assets	1.00%	0.91%	0.91%	0.95%	0.89%	1.01%	0.92%
Return on equity	8.89%	8.20%	8.34%	8.47%	8.28%	9.42%	8.61%
Other (Unidentifiable)							
Number of institutions	53	48	27	11	1	0	0
Total assets	1,416,616	1,210,048	1,177,355	396,311	109,705	NA	NA
Mean asset size	26,729	25,209	43,606	36,028	109,705	NA	NA
Member business loans / Assets	0.06%	0.07%	0.10%	0.00%	0.00%	NA	NA
Return on assets	1.20%	1.01%	0.98%	1.44%	0.43%	NA	NA
Return on equity	10.00%	8.61%	9.03%	12.81%	3.46%	NA	NA

Note: These membership types are defined by the NCUA as follows: Community credit unions are those whose members are from a well-defined neighborhood, local community, or rural district, and who have common interests and/or interact. Performance ratios are expressed in percentage terms. Single common bond unions are those whose members comprise a single associational or occupational group. Multiple common bond unions are based on multiple groups (associational and occupational) with no single group predominant. These definitions apply only to federally chartered unions; state-chartered unions are treated separately. "Other" consists of federally chartered credit unions whose membership type was not indicated. Performance ratios are expressed in percentage terms. For performance measures, do novo credit unions (those less than five years old) are excluded.

Source: NCUA.

Table A.17

Percentage of Community Banks Offering Various Internet Services in 2002 and Expectations for those Services Three Years Later

Type of Service	2002	Three Years Later	Change
Track account balances	65	91	26
Transfer funds among accounts	63	89	26
Bill payment	49	81	32
Email-based customer service	35	58	23
Cash management and other small business services	32	65	33
Person-to-person electronic payments	26	54	28
Loan applications	21	70	49
New demand-deposit account applications	18	61	43
New CDs, IRAs, etc.	17	59	42
Bill presentment	16	54	38
Business-to-consumer portal for nonbank products	11	39	28
E-mortgages	9	37	28
Brokerage trades	9	33	24
Business-to-business portal for nonbank products	5	28	23
Sell insurance	5	27	22
Aggregation services	4	37	33

Note: The date in the table's title refers to the survey's publication date. The survey's definition of community bank may differ from that used in this article. See the survey for the definition used.

Source: Grant Thornton, *Ninth Annual Survey of Community Bank Executives* (2002).

The Future of Banking in America

Rural Depopulation: What Does It Mean for the Future Economic Health of Rural Areas and the Community Banks That Support Them?

*Jeffrey Walser and John Anderlik**

The United States is in the midst of a major demographic event: the depopulation of a significant portion of the nation's rural counties. Although in many rural counties the population has been growing since World War II, in a large number of others there has been a persistent pattern of population decline. Rural depopulation has ramifications for the future economic viability of the counties involved and for the banks that serve these counties. This three-part article spells out the causes and ramifications of depopulation, explores the effects of depopulation on community banks in the depopulating regions, and discusses possible policies for coping with the phenomenon.

Specifically, in part 1, after locating the major areas of rural depopulation in four regions—the Great Plains, the Corn Belt, the Delta-South, and Appalachia-East—we focus on the relationship between agriculture and population density; the relationship between agriculture and depopulation; the contributing factors of technological change, organizational innovation, and change in fertility patterns; the demographic components of depopulation (the increase in the proportion of elderly people in depopulating counties, and the exodus of the most educated and skilled young people); and the commercial structure of rural counties and how it affects—and is affected by—depopulation. We conclude this part of the article by discussing the vicious circle of decline. Because the Great Plains is undergoing the most serious depopulation and is exposed most deeply to its effects, we examine that region in special detail.

In part 2 we look at community banks in the Great Plains. Across the nation, more than 1,400 insured financial institutions with total assets of more than $131 billion are based in counties with declining populations. Many of these banks will face challenges on both sides of the balance sheet: funding becomes increasingly difficult, and the demand for loans continues to wane. Rural depopulation therefore has significant implications for the U.S. banking industry, especially with regard to the long-term health of rural community banks. The Great Plains is where the problem is most advanced.

Part 3 of the article is a brief look not only at policy approaches to depopulation but also at the prospects for the banking industry in depopulating rural areas.

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Part 1. Rural Depopulation

Here we identify the areas where depopulation is occurring and quantify its extent, discussing the significant differences in population density and depopulation across rural counties. We also explain the causes of depopulation, its demographic components, and the implications of all of this for the economic viability of the communities involved.

Regions Where Depopulation Is Occurring

Although the U.S. population as a whole continues to increase, many rural areas are experiencing continued problems of population outflows. According to Census figures, between 1970 and 2000 the nation's population rose from 203 million people to 282 million, for an average annual increase of 1.1 percent, but this increase was not evenly distributed across the country. Our analysis of Census data at the county level shows that during the 30-year period 1970–2000, 779 of the nation's 3,141 counties (both rural and metropolitan) lost population. It is important that in 232 of the depopulating counties the rate at which the population declined actually accelerated during the 1990s.

For purposes of analysis, we divided the nation's counties into categories depending on each county's rurality and then on its population trend between 1970 and 2000. First we identified metropolitan counties (the overwhelming majority of which added population during our 30-year period) and separated them out.[1] We considered the remaining counties to be rural and classified them into three groups according to the nature and extent of population growth: growing rural counties, declining rural counties, and accelerated-declining rural counties ("depopulating" refers to the second and third groups combined):

- Growing rural counties added population between 1970 and 2000.
- Declining rural counties lost population between 1970 and 2000, but not at a faster rate during the 1990s.
- Accelerated-declining rural counties not only experienced a population decline between 1970 and 2000 but also lost population more rapidly in the 1990s than in the prior two decades.

Figure 1 locates these three types of rural counties on a map of the United States. As the figure indicates, depopulation is taking place mainly in the middle of the country, in the South, and in the Northeast. For purposes of analysis, we have identified four regions where the depopulation of the past 30 years has been significant: the Great Plains, the Corn Belt, the Delta-South, and Appalachia-East (see figure 2). These regions capture just under 66 percent of all rural counties in the nation—but 91 percent of all depopulating rural counties. As we discuss below, although each of these regions has experienced depopulation during the past three decades, the nature, severity, and causes of depopulation vary.

The Great Plains

The Great Plains is defined as the continental slope of the west-central United States, bounded on the north by Canada and on the west by the Rocky Mountains.[2] The Great Plains includes North Dakota, and portions of Montana, Minnesota, South Dakota, Wyoming, Nebraska, Colorado, Kansas, Oklahoma, New Mexico, and Texas. Of the four depopulating regions, this one is the most rural—only 11 percent of the region's counties are metropolitan—and its rural depopulation trends are the most significant. That is, depopulation here has been more prevalent and more severe than in the other three regions. As shown in table 1, the Great Plains is home to 304 of the country's 662 depopulating rural counties. In this region, 72 percent of rural counties have lost population since 1970, and more than one-third of the 72 percent experienced increasing outflows during the 1990s (for a comparison with the numbers in the other three regions discussed here, see table 1). In 2000, 16.1 percent of the region's population lived in depopulating counties. Furthermore, populations in rural counties in the Great Plains are significantly smaller than populations in the three other depopulating regions, and the population density (people per square mile) is substantially less.

The connection between larger sizes of farms and ranches and lower population densities is twofold: obviously the population density of agricultural workers is lower, but in addition the towns that support them are fewer and smaller. Both the smaller size of the population (which means communities are relatively isolated) and the low population density greatly exacerbate the

[1] To identify metropolitan counties, we used the U.S. Department of Agriculture's Rural-Urban Continuum Codes, a typology developed in the 1970s and updated after each decennial census. The most recent version of the codes was released in August 2003.

[2] For the definition of the Great Plains Region, see Rowley (1998), 5.

Figure 1

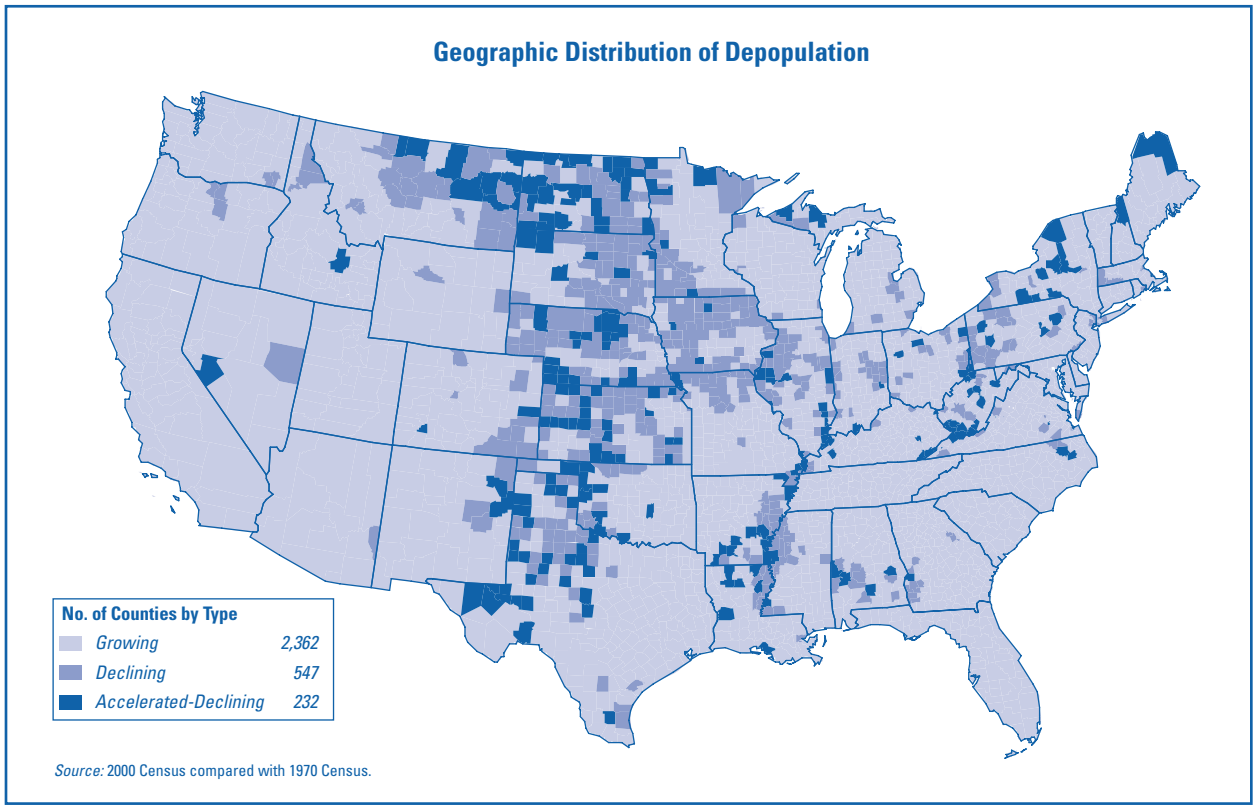


Figure 2

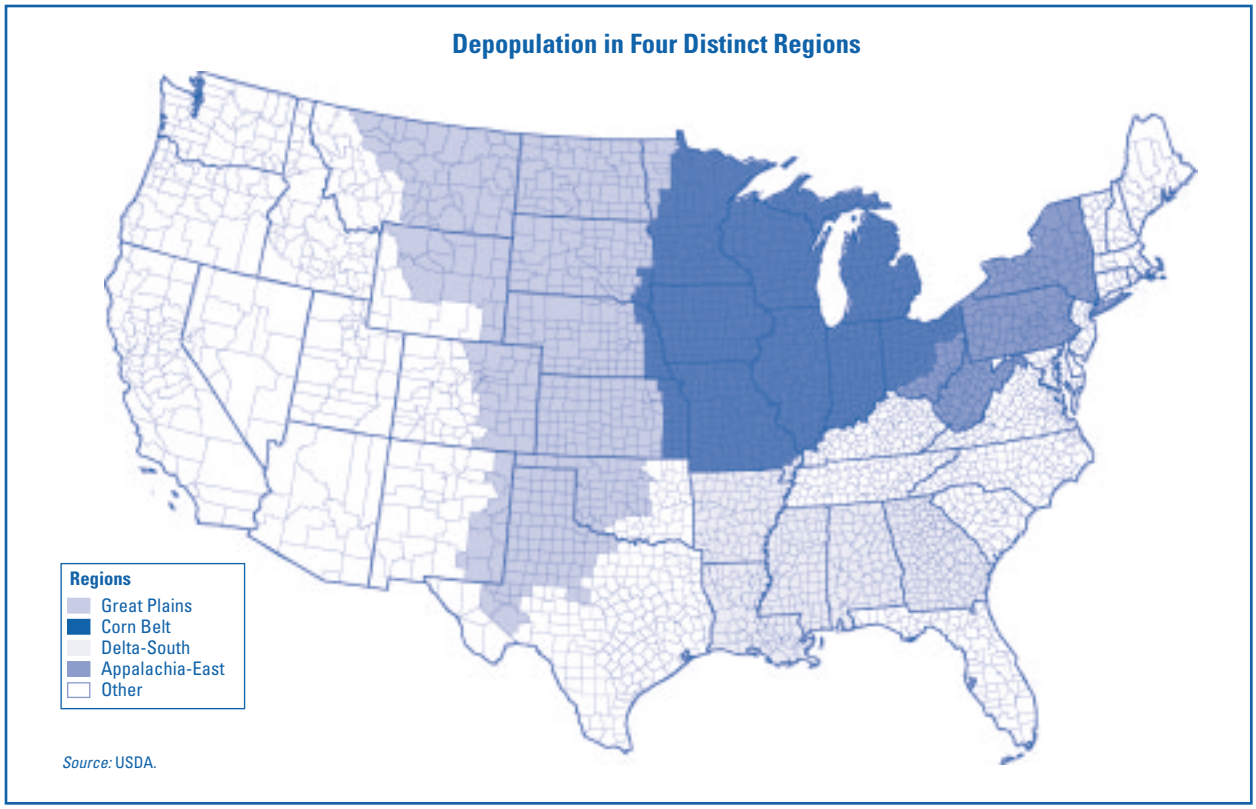


Table 1

Average Population and Density for Each Type of County, by Region

	Rural Counties				
	Growing Counties	Declining Counties	AD[a] Counties	Metro Counties	Total
Great Plains					
Counties	120	189	115	53	477
Average population	19,250	6,093	5,849	135,805	23,756
Density (People per Sq. mile)	11.6	5.2	4.8	97.4	17.8
Corn Belt					
Counties	292	166	28	263	749
Average population	30,343	17,609	17,025	179,700	79,468
Density (People per Sq. mile)	46.7	30.3	26.5	324.3	132.3
Delta-South					
Counties	213	49	25	164	451
Average population	26,185	16,673	24,049	95,801	50,348
Density (People per Sq. mile)	46.6	28.4	33.4	181.1	89.6
Appalachia-East					
Counties	87	12	18	96	213
Average population	44,312	61,470	38,392	304,555	162,071
Density (People per Sq. mile)	65.0	99.5	62.4	556.4	264.8
Other					
Counties	678	36	24	513	1,251
Average population	32,082	9,359	14,466	255,176	122,574
Density (People per Sq. mile)	14.9	8.4	10.6	243.1	74.1
Total					
Counties	1,390	452	210	1,089	3,141
Average population	30,471	13,199	13,280	211,490	89,596
Density (People per Sq. mile)	20.9	15.1	12.7	256.6	79.6

[a] "AD counties" refers to accelerated-declining counties.

Source: U.S. Census.

economically debilitating effects of depopulation (these effects are spelled out below). Businesses require a minimum number of customers to remain viable, so businesses in less densely populated areas must draw customers from a wider area. Thus, low-density counties are most in danger of losing economic viability.[3]

The dominant industry in the Great Plains is agriculture: 85 percent of the region's geographical area is devoted to agriculture (the largest percentage of our four regions). As discussed below, structural changes in agriculture are the root cause of the region's demographic and economic predicament, which has been aptly summarized as a "patterned movement of people" in response to these structural changes.

[3] McGranahan and Beale (2002), 2.

The Corn Belt

The Corn Belt consists of the states identified by the U.S. Department of Agriculture (USDA) as major producers of corn across the central-eastern part of the country.[4] The Corn Belt includes Iowa, Wisconsin, Illinois, Indiana, Michigan, and parts of Ohio, Missouri, Minnesota, South Dakota, Nebraska and Kansas. As table 1 indicates, 40 percent of the Corn Belt's rural counties lost population between 1970 and 2000, but few lost population at an accelerating rate in the 1990s. The average population of the depopulating counties in the Corn Belt is almost three times the average in the Great Plains (17,500 versus just over 6,000); in

[4] This definition of the Corn Belt Region is adapted from the USDA's Cost and Returns Regions for corn production, available at http://www.ers.usda.gov/Data/CostsAndReturns/oldregions.htm#corn.

2000, only 5.7 percent of the Corn Belt's population lived in declining or accelerated-declining counties; and the population density is much higher than in the Great Plains.

In one respect, though, the Corn Belt is similar to the Great Plains: agriculture is an important industry, with farmland accounting for 69 percent of total land area. But because of differences in topography and weather, the types of agriculture practiced in the Corn Belt differ from the types practiced in the Great Plains. Over time, these differences have meant that in the comparatively fertile Corn Belt farmers require smaller acreages to earn a living. Therefore, population densities (as we have seen) are higher, and cities and towns form a more dense and extensive network. As a result, although portions of the Corn Belt are vulnerable to the effects of ongoing rural depopulation, these effects tend to be less severe and more localized than those observed in the Great Plains. In other words, quantitative differences in average population and population density are associated with qualitative differences in economic complexity and future viability.

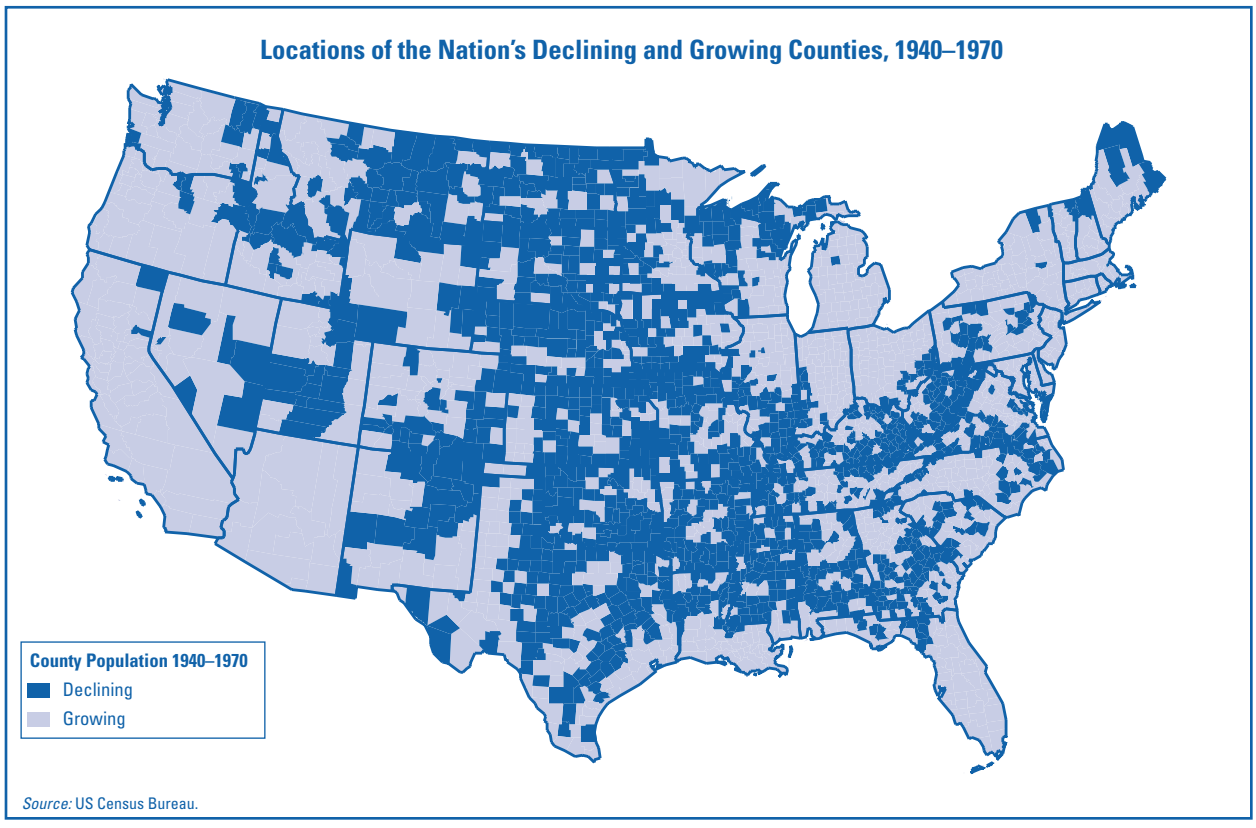
The Delta-South

The Delta-South includes Arkansas, Louisiana, and Mississippi (encompassing the part of the Mississippi Delta that falls in those states), along with Alabama and Georgia.[5] As figure 1 shows, a great deal of depopulation has occurred in the Mississippi Delta area—more than a quarter of the region's rural counties have lost population since 1970—but the depopulating counties are scattered throughout the region. In the region as a whole, population trends have actually improved during the past 30 years. In fact, much more of the Delta-South region was depopulating between 1940 and 1970 than depopulated in the 30 years after 1970 (see figure 3).

In the period 1940–1970, the mechanization of agriculture and the consequent consolidation of farms displaced farm workers, many of whom migrated to the growing urban industrial centers in the Midwest and West.[6] But the industrial resurgence of the South

[5] This definition of the Delta-South Region was constructed from the distribution of declining counties per 1970 and 2000 censuses.
[6] Cosby et al. (1992), 47.

Figure 3



that began in the 1970s led much of the region to experience sustained economic and population growth. Despite the overall improvement in the region, some clusters of counties, including much of the Mississippi Delta, were unable to compete with other southern areas because of extreme poverty and low levels of educational attainment (conditions that still exist), and these counties have continued to depend heavily on the agricultural sector.[7] In the meantime, the growing prosperity of many other areas in the South has attracted workers from the Delta region, contributing to its persistent decline in population.

Appalachia-East

The Appalachia-East region includes part of Ohio and all of West Virginia, Pennsylvania, and the state of New York.[8] Just over a quarter of the rural counties in this region lost population between 1970 and 2000, but unlike the case in the other three regions discussed here, depopulation in this area was not driven primarily by an exodus from farming. Rather, it reflects an ongoing decline in the coal-mining industry, a decline caused by technological advances and the restructuring of the steel industry that occurred in the 1970s.[9] Figure 3 shows that coal-intensive Appalachia (a region that is not coterminous with Appalachia-East and includes Kentucky, West Virginia, southern Ohio, and western Pennsylvania) also experienced widespread out-migration three decades earlier, between 1940 and 1970. The population of West Virginia, for example, peaked in 1950;[10] the number of coal miners employed in the state declined from 150,000 in 1945 to fewer than 19,000 in 2002.[11]

Correlation between Agriculture and Population Density

Low population density puts a region at risk for depopulation, but low population density by itself is not synonymous with depopulation. In this section we examine the high correlation between agriculture and low population density; in the next section we examine the correlation specifically between agriculture and depopulation.

Agriculture tends to be a land-extensive enterprise, requiring substantial tracts of land for field crops and cattle raising. The result is relatively low population density—a characteristic of rural counties. However, rural population densities vary widely, depending largely on topographical conditions, the type of agriculture practiced, and differences in per acre production. For example, wheat is tolerant of a wide variety of natural conditions, including low rainfall and less-than-ideal soil conditions, so it can be grown on land unsuitable for crops such as corn and soybeans. Cattle grazing, requiring little labor or other inputs, represents an ingenious use of extensive areas of short grasslands that are unsuitable for other purposes: the vast grasslands of the Great Plains are converted to meat by the cattle that graze over them extensively. In contrast, the greatest proportion of the cattle in the Corn Belt are in the finishing sector, where they are fed locally grown corn and soybean products in confined feedlots (see table 2). As can be expected, all these differences translate into corresponding differences in the typical size of farms or ranches across the depopulating regions, with farm size—and therefore population density—varying inversely with productivity.

A comparison between Iowa (a Corn Belt state) and North Dakota (a Great Plains state) is illustrative. Both states are highly dependent on agriculture, with 91 and 89 percent of land area, respectively, in farms (see table 3). But agricultural revenue (annual per acre cash receipts) in Iowa is almost five times that of North Dakota. The land in North Dakota is not as fertile as the land in Iowa and rainfall is less plentiful, so the predominant products are wheat and cattle, whereas the commodities produced in Iowa are corn, soybeans, and hogs. Corn, soybeans, and hogs typically generate comparatively high returns per acre; returns per acre for wheat and cattle are much lower. Where productivity per acre is relatively low, farmers and ranchers require larger operations to make a living; consequently, farms in North Dakota are four times the size of those in Iowa, and population density in North Dakota is much lower.

We can also illustrate the relationship between population density and the characteristics of the underlying land (and the resulting commodities produced there) by looking at cattle raising in Nebraska, a Great Plains state (see figure 4). Nebraska has the second-largest

[7] Ibid., 284.
[8] This definition of the Appalachia-East Region was constructed from the definition of Appalachia appearing in Couto (1994), 5.
[9] Global Insight Historical Labor Force Database.
[10] U.S. Bureau of the Census (1996).
[11] Williams (2002), 345; and Global Insight Historical Labor Force Database.

Table 2

Agricultural Output per Acre, by Type of County and Region, 1997

	Agricultural Cash Receipts per Acre ($)				
	Growing	Declining	AD[a]	Metro	Total
Great Plains	**132**	**106**	**105**	**123**	**115**
Crops	120	95	86	126	102
Livestock	134	116	121	120	124
Corn Belt	**299**	**338**	**272**	**332**	**320**
Crops	187	218	219	242	216
Livestock	624	977	500	716	726
Delta-South	**395**	**279**	**312**	**373**	**361**
Crops	210	298	304	216	242
Livestock	599	214	342	571	538
Appalachia-East	**297**	**278**	**197**	**498**	**368**
Crops	116	149	77	309	199
Livestock	545	474	343	888	639
Other	**134**	**71**	**72**	**421**	**226**
Crops	220	138	278	709	425
Livestock	98	40	31	234	135
U.S. Total	**178**	**174**	**124**	**350**	**213**
Crops	183	157	122	399	228
Livestock	171	194	126	293	197

[a] "AD" refers to accelerated-declining counties.

Source: 1997 Census of Agriculture.

Table 3

Population Densities and Type of Agriculture Practiced, Selected States, 2000

	Great Plains			Corn Belt			
Selected states:	**N. Dakota**	**S. Dakota**	**Nebraska**	**Iowa**	**Minnesota**	**Missouri**	**U.S.**
Population/Sq Mile	9.3	9.9	22.3	52.4	61.8	81.2	79.6
Cash Receipts/Acre	76	93	204	353	284	161	215
Farm Size in Acres	1,300	1,354	875	350	361	277	437
% Land in Farms	89%	91%	94%	91%	56%	68%	42%

Source: 2000 Census and USDA.

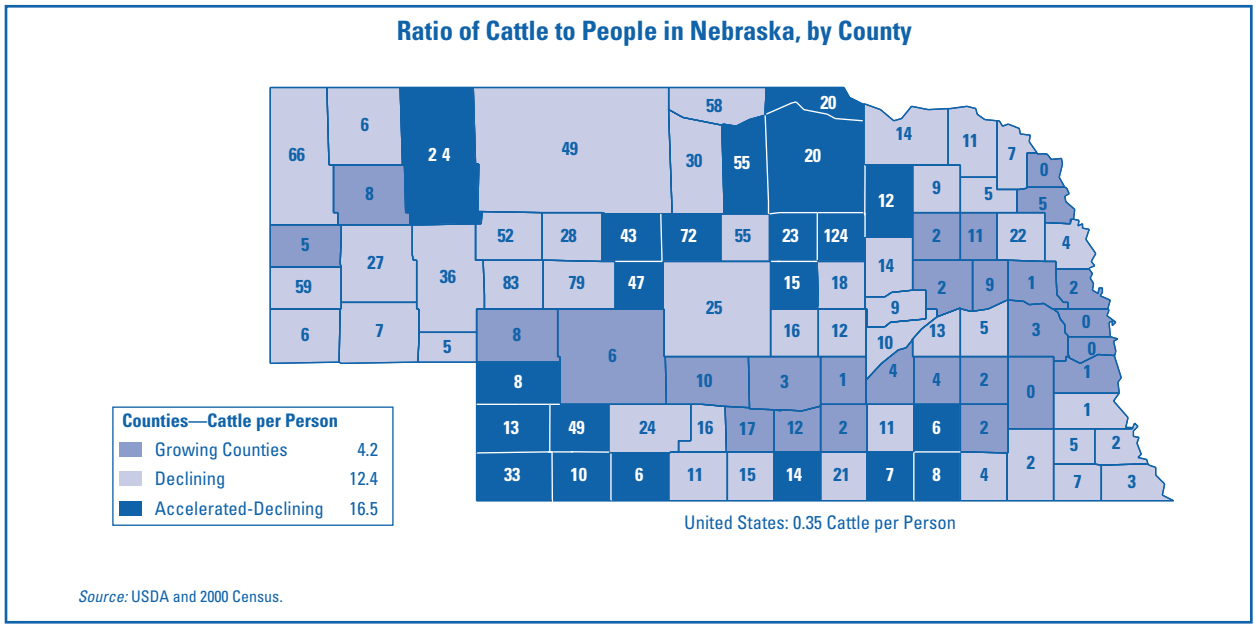
population of cattle among the 50 states, with 6.7 million head of cattle in 2000; in comparison, the state had only 1.7 million people in the same year.[12] As the legend in the figure indicates, the proportion of cattle to people depends on the type of county: in declining rural counties, the ratio is 12.4:1, and in accelerated-declining counties the ratio grows to 16.5:1. This pattern of ratios suggests an association between this land-extensive sector of agriculture and the low population densities that are typical of counties where populations are declining.

[12] USDA (2001), 4.

In the Delta-South, where the crops grown are rice and cotton, the farms are even larger than those in the Plains because of the economies of scale associated with the rice and cotton production practiced there. But the linkage to population density is less direct because the states in the Delta-South are near or below the national average for the relative importance of farmland (figure 5).

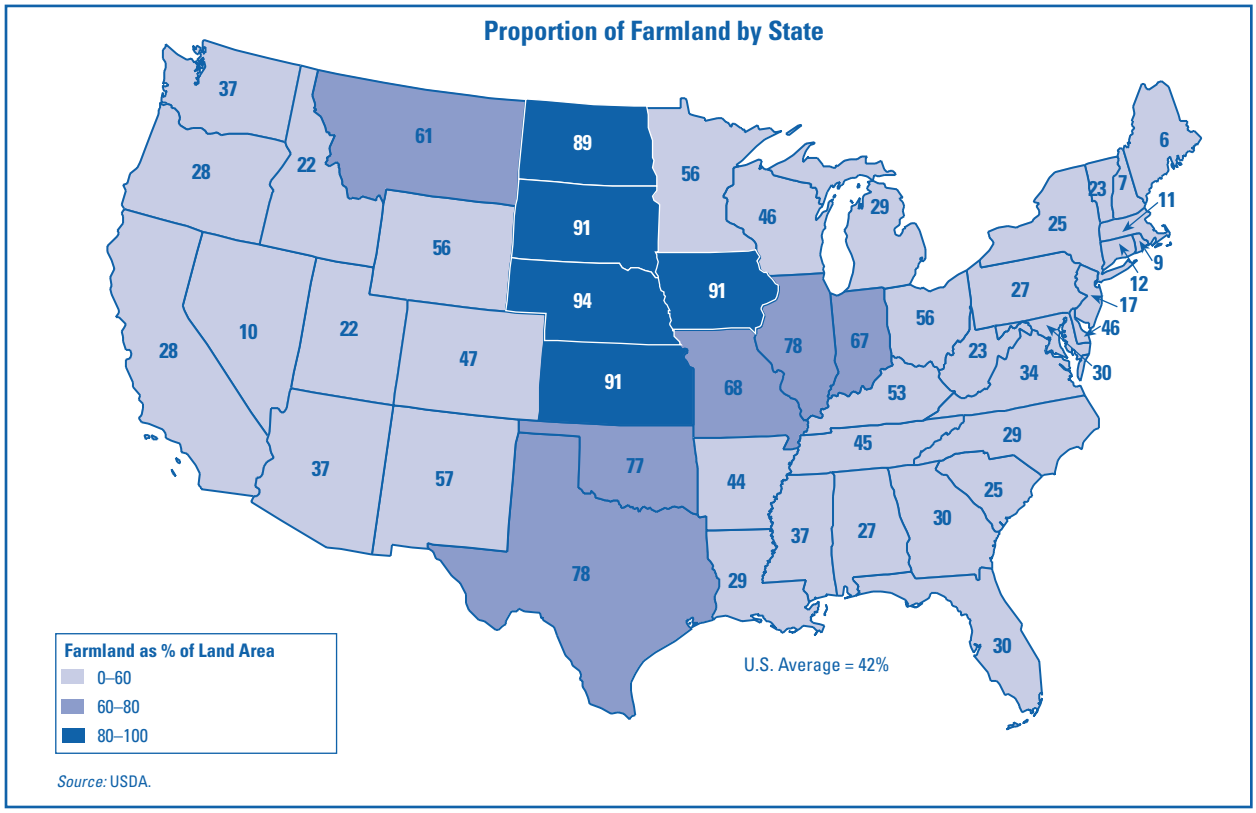
A way of portraying the difference in population density between the Great Plains and the other regions with declining populations is to compare the distribution of county sizes (see table 4). The data indicate that in

Figure 4



Source: USDA and 2000 Census.

Figure 5



Source: USDA.

Table 4

Distribution of Counties by Population Size, by Region, 2000

	County Population						
	<=1,000	1,001–5,000	5,001–10,000	10,001–15,000	15,001–20,000	>20,000	Grand Total
Great Plains							
Growing	0	15	34	19	10	42	120
Declining	12	90	64	14	2	7	189
AD[a]	9	62	24	11	5	4	115
Metro	0	1	6	1	3	42	53
	21	168	128	45	20	95	477
Corn Belt							
Growing	0	4	26	32	43	187	292
Declining	0	9	43	42	29	43	166
AD	0	2	8	7	4	7	28
Metro	0	0	9	15	16	223	263
	0	15	86	96	92	460	749
Delta-South							
Growing	0	4	25	34	34	116	213
Declining	0	3	10	18	3	15	49
AD	0	0	4	3	6	12	25
Metro	0	2	6	18	12	126	164
	0	9	45	73	55	269	451
Appalachia-East							
Growing	0	1	6	9	6	65	87
Declining	0	1	0	1	0	10	12
AD	0	0	4	1	3	10	18
Metro	0	0	2	2	0	92	96
	0	2	12	13	9	177	213
Other							
Growing	6	48	90	100	87	347	678
Declining	3	10	13	2	3	5	36
AD	1	7	6	2	2	6	24
Metro	0	3	23	26	27	434	513
	10	68	132	130	119	792	1,251
Total	31	262	403	357	295	1,793	3,141

[a] "AD" refers to accelerated-declining counties.
Source: 2000 Census.

2000 more than 85 percent of the Great Plains' depopulating counties had populations of 10,000 or fewer, compared with 32 percent in the Corn Belt, 25 percent in the Delta-South, and 17 percent in the Appalachia-East. Many analysts consider a county population of 10,000 the minimum threshold of long-term economic viability.

Correlation between Agriculture and Depopulation

Since the rise of cities and towns, rural-to-urban migration has long been common around the world; and at least since the end of the nineteenth century, farm populations in industrialized nations have declined and become a minority of total populations. Analysis of the geographic importance of agriculture in the United States suggests a clear connection between the prevalence of agriculture and the tendency toward rural depopulation: the distribution of significant concentrations of farmland (figure 5) corresponds with the distribution of rural depopulation. In fact, the states where farmland covers the greatest percentage of land area—North Dakota, South Dakota, Nebraska, Kansas, and Iowa—are the states where depopulation has been most extensive in the past 30 years.

Researchers at the USDA recently identified three factors that characterize rural counties that lost population in the 1990s: (1) a location away from metropolitan areas, (2) a low population density, and (3) a low level of natural amenities (as measured by climate, topography, and the presence of lakes and ponds).[13]

These researchers argue that a meaningful measure of economic activity is a 10.1 person per square mile density cutoff (this cutoff represents the lowest population quartile of nonmetropolitan counties).[14] This measure is superior in most respects to the size of the largest town in the county, for community boundaries have become increasing diffuse as people commonly live in one town, shop in another, and work in yet a third. Furthermore, service providers such as governmental units and retailers tend to locate their branches on the basis of population densities rather than the sizes of specific towns.

The Great Plains, where the average size of farms and ranches is large, meets the first two criteria set forth by the USDA researchers: many counties are characterized not only by low population densities but also by remoteness from urban areas. A look at two road maps, one of Iowa (a typical Corn Belt state) and the other of Kansas (a typical Great Plains state), is suggestive. Iowa comprises seven metropolitan areas and hundreds of small cities and towns spread across its landscape, whereas Kansas comprises only four metropolitan areas, and its smaller communities are spread much more thinly over the landscape.

Counties that depend on agriculture also tend to be the counties that are least endowed with natural amenities. One USDA researcher notes:

> Population change in rural counties since the 1970s has been strongly related to their attractiveness as places to live. Natural aspects of attractiveness can be summarized in three types of amenities: mild climate, varied topography, and proximity to surface water—ponds, lake, and shoreline. Counties scoring high in a scale of these amenities had substantial population growth in the last 25 years. High-scoring counties tended to double their population, while the average gain for the low-scoring counties was only 1 percent, and over half lost population.[15]

Unfortunately, the characteristics that distinguish areas covered by extensive farms are not those that define high-amenity areas. The best cropland tends to be in areas lowest in natural amenities—areas where the land is flattest and least broken up by ponds and lakes, where the winters are the wettest, and where the summers are the hottest and the most humid. In general, the lower a county's score on the scale of natural amenities, the higher the proportion of land that is in crops and the less likely the area is to be classified as a recreationally oriented county.[16] Much of the Great Plains receives very low amenity scores.

Depopulation and the Roles of Technological Change, Organizational Innovation, and Change in Fertility Patterns

As noted above, rural depopulation has been occurring at least since the end of the nineteenth century. During the twentieth century, however, the decline in the U.S. farm population became dramatic. At the beginning of the century, nearly 40 percent of the population lived and worked on farms; by the close of the century, that proportion had declined to just over 1 percent (see figure 6). During this hundred-year period, the population of the United States grew from 76 million people to 281 million, but ongoing improvements in the technology of agriculture enabled the ever-increasing population to be provided with food and fiber by a continually shrinking number of farmers.[17] Contributing to the decline in the farm population have been organizational innovations within agriculture and the trend in fertility rates since World War II.

As noted by one agricultural economist, agricultural technology has changed radically, especially with the changes since 1950 such as mechanization, the developments of herbicides and insecticides, and the availability of genetically improved crops and animals—all of which have made possible production techniques that economize on labor.[18]

Technological progress also had a significant effect on trends in the number and size of farms. The number of farms declined from 5.7 million in 1950 to 2.2 million in 2000, while the average size more than doubled, going from 213 acres to 434 acres

[13] McGranahan and Beale (2002), 2.
[14] Ibid., 4.
[15] McGranahan (1999), iii.
[16] McGranahan and Beale (2002), 6.
[17] U.S. Bureau of the Census (2003), table 1.
[18] Huffman (1999), 1.

(see figure 7).[19] As farmers adopt improved technologies that require greater capital investment, the optimal farm size increases.[20] Farmers who adopt new technologies are able to achieve lower costs of production by applying the new methods to larger land areas. Looking forward, we believe that ongoing research in both the public and private sectors will continue to yield technological improvements in agriculture, perhaps at an even faster rate.

Tractors and other machinery continue to become larger, more complex, and more specialized. Crop yields continue to increase steadily over time, as seed quality improves and fertilizers, insecticides, and herbicides become more effective.[21] If recent advances in the genetic engineering of plants can gain public acceptance, they hold the potential for enormous advances in agricultural productivity in the near future.[22]

Also contributing to continued consolidation are organizational innovations in many agricultural operations, especially innovations affecting the integration of supply chains.[23] Supply chains usually consist of contractual alliances between specialized businesses at successive stages of the production process, a business model that was especially successful in the chicken industry in the 1960s and 1970s. In that industry, chicken processors contract with growers who typically provide the labor and facilities to raise chickens. The processors own the chickens throughout their lifetimes

[19] The aggregate statistics presented in figure 7 actually understate the degree of consolidation in U.S. agriculture, for they are based on the USDA's extremely broad definition of a farm as any operation with more than $1,000 in annual sales. Commercially viable farms are those with more than $100,000 in annual sales, and for them the proportional decline in number has been much greater.
[20] Gardner (2002), 15.

[21] Ibid., 11, 12, 19, 22, 24.
[22] Wordie (2003), 80.
[23] Drabenstott (1999), 66, 68.

Figure 6

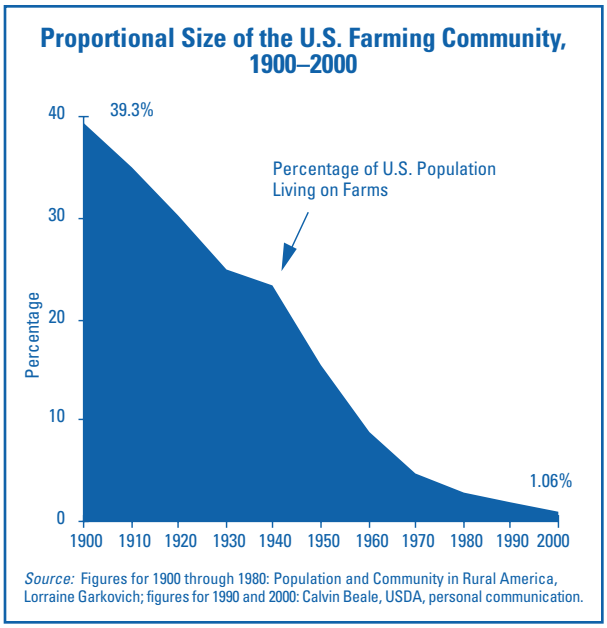
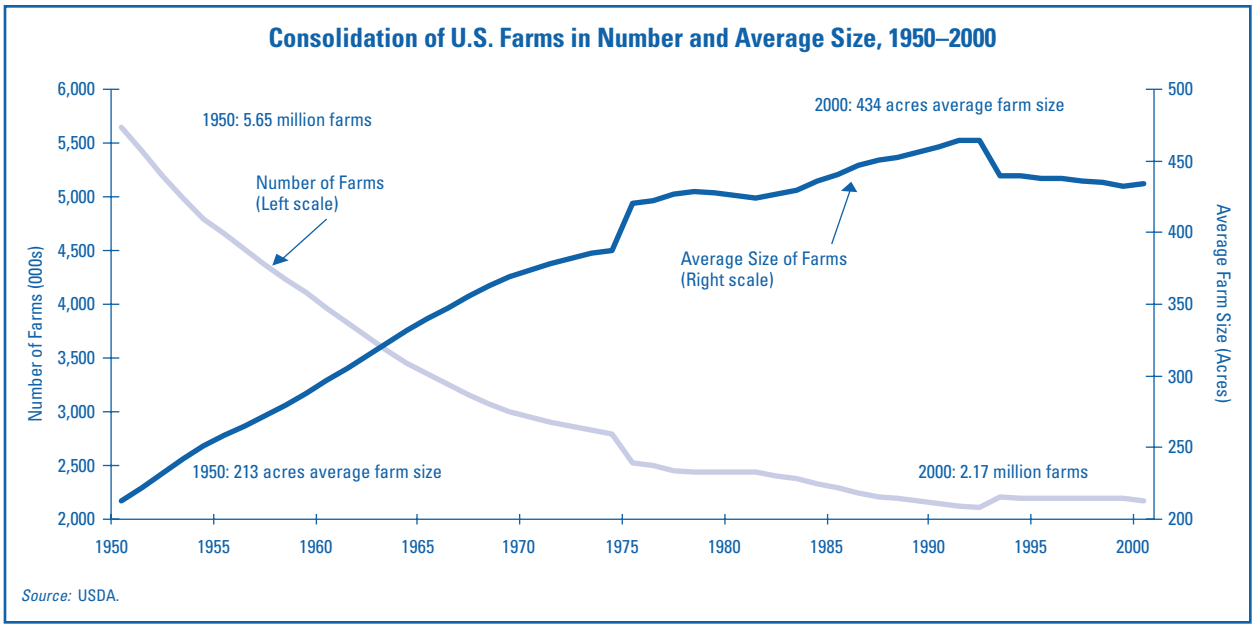


Figure 7



and provide feed, veterinary care, and management to their network of growers. This arrangement, also known as vertical integration, has resulted in rapid and sustained productivity improvements in the industry, resulting in declining costs of production that have allowed chicken to dominate the meat menu of the U.S. consumer.[24] This business model has led to significant consolidation in the particular sector: in 2002, 42 firms accounted for more than 99 percent of the chickens produced in the United States.[25]

As other sectors emulate the poultry industry, organizational innovation, together with the long-term trend of technological innovation, will probably drive the continuing and perhaps accelerating consolidation of agriculture. Consolidation will dramatically reduce the demand for agricultural labor for the foreseeable future, and areas with the largest farm populations stand to lose the most workers. As table 5 shows, the Great Plains, where rural depopulation is already the most severe, nevertheless has the highest proportion of farm workers. Thus, this region's risk from the ongoing technological and organizational change in agriculture continues to increase.

Another reason for the accelerated pace at which population in agriculturally dependent counties has declined in the past generation is fertility rates: especially recently, these rates—and therefore the number of children per family—have declined significantly in agriculturally dependent counties and now are only slightly higher than fertility rates in urban areas.

Traditionally families on farms and in small towns had many more children per family than their urban counterparts. The higher number of children born into rural families served partly to offset the steady departure of working-age migrants to employment opportunities in the cities. After World War II, however, rural women began to bear fewer children, as technology evolved and fewer farm workers were required. In addition, rural women came to be affected by the same trends that reduced fertility among urban women, including rising levels of education, greater participation in the labor force, and delayed marriage.[26] A noted agricultural economist has quantified this effect: "In 1990 there were 2.1 persons per farm household. In 1940 there had been 5.2. The major reduction in household size did not begin until 1940, but after that, change came quickly."[27]

Demographic Components of Depopulation

Technically, changes in population are a function of migration (in or out) and natural increase (or decrease), defined as the difference between births and deaths. Table 6 displays the change in population in the 1990s for the depopulating regions, broken down into changes due to migration and changes due to natural increase.

The first thing to notice in the table is the difference in growth rates between the depopulating rural counties and the growing and metropolitan counties across the board. Much of that difference is due to the fact that people who leave depopulating counties tend to migrate to growing rural counties and metropolitan counties. In addition, metropolitan counties are more likely to attract migrants from outside the state because their larger economies are more completely integrated into regional and national labor markets.

The second thing to notice is that the rates of natural increase are often highly correlated with rates of migration. There are two reasons for the high correlation. One is that out-migrants are usually young people in their prime child-bearing stages of life, and therefore birth rates in counties experiencing out-migration tend to be lower than average. The other reason for the correlation is that counties experiencing out-migration typically have larger proportions of the elderly, so death rates are higher than average. The combination of lower birth rates and higher death rates results in lower rates of natural increase in declining and accelerated-declining counties, except in the Delta-South region.

In other words, depopulating counties—especially those in the Great Plains—are losing an important demographic battle on two fronts.[28] First, they have a disproportionate number of elderly people. Second, they are rapidly losing well-educated people of working age.

[24] Gardner (2002), 70.
[25] William Roenigk, staff economist, National Chicken Council, telephone conversation with Jeffrey Walser, January 15, 2004.
[26] Johnson (1999), 7.
[27] Gardner (2002), 94.
[28] Table 6 shows that, compared with the other regions, the Great Plains exhibits the highest rate of population decrease in both the declining and accelerated-declining categories. When this finding is combined with the finding from table 4 that the counties in the Great Plains are significantly less populated to begin with, the severity of the risk that that region's counties face from depopulation is evident.

Table 5

Proportion of Farm Population by Type of County, by Region, 1990

	Percent of Population Living on Farms				
	Rural Counties				
	Growing	Declining	AD[a]	Metro	Total
Great Plains	5.5	13.8	11.0	1.2	4.3
Corn Belt	7.2	12.6	8.2	1.3	2.9
Delta-South	3.1	3.6	2.4	0.8	1.5
Appalachia-East	3.1	1.6	1.9	0.5	0.8
Other	3.6	4.0	2.3	0.6	1.0
United States Total	4.4	9.8	5.4	0.8	1.6

[a] "AD counties" refers to accelerated-declining counties.
Source: U.S. Census 1990 (the most recent data available, for the Census discontinued county-level enumerations of farm populations after that).

Table 6

Rate of Population Growth Due to Migration and Natural Increase by Type of County, by Region, 1990s

	Rate of Population Growth, 1990s (%)				
	Rural Counties				
	Growing	Declining	AD[a]	Metro	Total
Great Plains					
Migration	–1.3	–3.1	–9.6	6.2	2.4
Natural Increase	5.7	–0.1	1.1	8.2	6.2
Total	4.4	–3.2	–8.5	14.4	8.6
Corn Belt					
Migration	5.1	–1.5	–4.3	–0.4	0.3
Natural Increase	2.7	0.3	0.6	6.3	5.4
Total	7.8	–1.1	–3.7	5.9	5.7
Delta-South					
Migration	5.0	–5.9	–10.2	6.5	5.1
Natural Increase	3.8	3.9	4.1	7.2	6.1
Total	8.8	–1.9	–6.1	13.7	11.2
Appalachia-East					
Migration	2.0	–1.7	–3.7	–3.1	–2.6
Natural Increase	2.4	–0.2	0.7	4.5	4.1
Total	4.3	–1.9	–3.0	1.4	1.5
Other					
Migration	8.5	–0.6	–9.0	5.3	5.7
Natural Increase	3.8	1.2	1.3	8.1	7.4
Total	12.2	0.6	–7.7	13.4	13.1
United States					
Migration	6.1	–2.4	–7.3	3.0	3.2
Natural Increase	3.5	0.7	1.6	7.2	6.4
Total	9.6	–1.7	–5.7	10.2	9.6

[a] "AD counties" refers to accelerated-declining counties.
Source: U.S. Census.

The Age Structure of Depopulating Rural Counties

One of the key predictions of human-capital theory is that young people are more likely to invest in education or migration because present income forgone is less for the young, and they are able to benefit from improved earnings over a longer period.[29] This prediction has been validated many times throughout history, including after World War II in the United States. The rural-to-urban migration observed in this country at that time consisted overwhelmingly of young people seeking either advanced education or improved employment opportunities.[30]

Whereas the young seek more and better employment opportunities, those who have retired are, by definition, no longer part of the workforce and are largely indifferent to the quantity and quality of employment opportunities. Thus, it is reasonable to expect that where there has been significant out-migration of the young, there will tend to be disproportionate numbers of elderly people.[31] In addition, there is evidence that a significant number of the "oldest elderly," or those over age 85, return to their home rural communities to take advantage of support by their families, after spending their early retirement years in high-amenity areas far from home.[32]

Data from the 2000 Census are consistent with this scenario (see table 7). The Great Plains—the depopulating region with the most significant out-migration in the 1990s—shows the greatest proportion of elderly and oldest elderly people in its depopulating counties. Conversely, the relatively low proportions of elderly people in Great Plains metropolitan and growing rural counties at least partly reflect the large inflows of young migrants to those areas.

The most serious outcome when populations are disproportionately older is that the high number of retired elderly people diminishes productive capacity in the communities where the retirees live, relative to counties with fewer elderly people.[33] If historical trends persist, the concentration of elderly in depopulating counties is expected to grow substantially in the next 20 years.

The dramatic difference in age structures among counties can be seen in age pyramids, which are a graphical technique used by demographers to portray the joint distribution of ages and sexes in a given population. Using 2000 Census data, we constructed three such pyramids by dividing the population into five-year intervals and dividing the population in each of these intervals by total population, graphing the male populations on the left and the female populations on the right, consistent with traditional practice (see figure 8).[34] These pyramids contrast the age structures of three counties in Nebraska:

- Douglas County (population 464,000), the metropolitan county where Omaha is located
- Hall County (population 54,000), a growing rural county in south-central Nebraska
- Holt County (population 12,000), an accelerated-declining county in north-central Nebraska.

Visually, the differences in the age structures of the three counties are striking and largely typical of the differences observed across categories of all the counties in the Great Plains region.

The shape of the Douglas County age pyramid is typical of shapes associated with moderately growing metropolitan areas.[35] The proportions of population in the 0–35 range are rather uniform, with differences in birth rates across the cohorts masked by net positive in-migration, both from rural areas in the state and, in this case, from rural areas in neighboring states. A metropolitan area the size of Omaha will have an economy large and complex enough to draw a variety of migrants from relatively great distances.[36] The cohorts in the 35–44 age range are the largest in the population, representing the end of the post–World War II baby boom phenomenon that has been extensively documented.[37] After age 55, the decline in the relative size of the age cohorts results from the deaths and out-migration of retirees. The proportion of the population older than 65 is 11.0 percent, and the proportion of the subset older than 85 is 1.4 percent.

[29] Baines (2003), 116.
[30] Albrecht and Murdock (1990), 153.
[31] Johansen (1993), 59.
[32] Moore and McGuiness (1999), 149.
[33] Hendrik Van den Berg, *Economic Growth and Development* (New York: McGraw-Hill, 2001), 267.
[34] Steve H. Murdock and David R. Ellis, *Applied Demography—An Introduction to Basic Concepts, Methods, and Data* (Boulder, Co.: Westview Press, 1991), 152.
[35] Van den Berg (2001), 263–4.
[36] U.S. Bureau of the Census (2003), table 30.
[37] Becker (1991), 169.

Table 7

Elderly People as a Proportion of Total Population by Type of County, by Region, 2000

	Elderly as Proportion of Total Population (%)				
	Rural Counties				
Age	Growing	Declining	AD[a]	Metro	Total
Great Plains					
>65	13.3	19.0	18.3	10.5	12.4
>85	1.9	3.0	2.8	1.2	1.7
Corn Belt					
>65	14.8	17.8	16.7	11.8	12.7
>85	2.0	2.8	2.3	1.5	1.6
Delta-South					
>65	13.2	13.9	14.0	10.4	11.5
>85	1.6	1.9	1.9	1.2	1.3
Appalachia-East					
>65	14.3	18.0	16.0	13.9	14.0
>85	1.7	2.3	1.9	1.7	1.7
Other					
>65	14.2	15.7	15.7	11.7	12.1
>85	1.6	2.0	1.9	1.4	1.4
United States					
>65	14.5	17.3	16.2	11.9	12.4
>85	1.8	2.6	2.2	1.4	1.5

[a] "AD" refers to accelerated-declining counties.

Source: U.S. Census 2000.

The shape of the age pyramid of Hall County is similar to the shape for Douglas County except that the 20–30 age cohort is noticeably smaller, a difference reflecting a small net out-migration of these groups. Although growing rural counties tend to lose some young people to larger urban areas, they also tend to be destinations for young migrants from more-rural counties. As an agricultural economist has stated, "It is noteworthy that the heaviest off-farm migration is to rural nonfarm or smaller urban areas rather than to large central cities."[38] Hall County, where Grand Island is located, is home to a community college, a satellite campus of the University of Nebraska, several farm equipment manufacturers, and a meat-packing plant. Notably, Interstate 80 passes through Hall County—a defining characteristic of many growing rural counties in Nebraska.

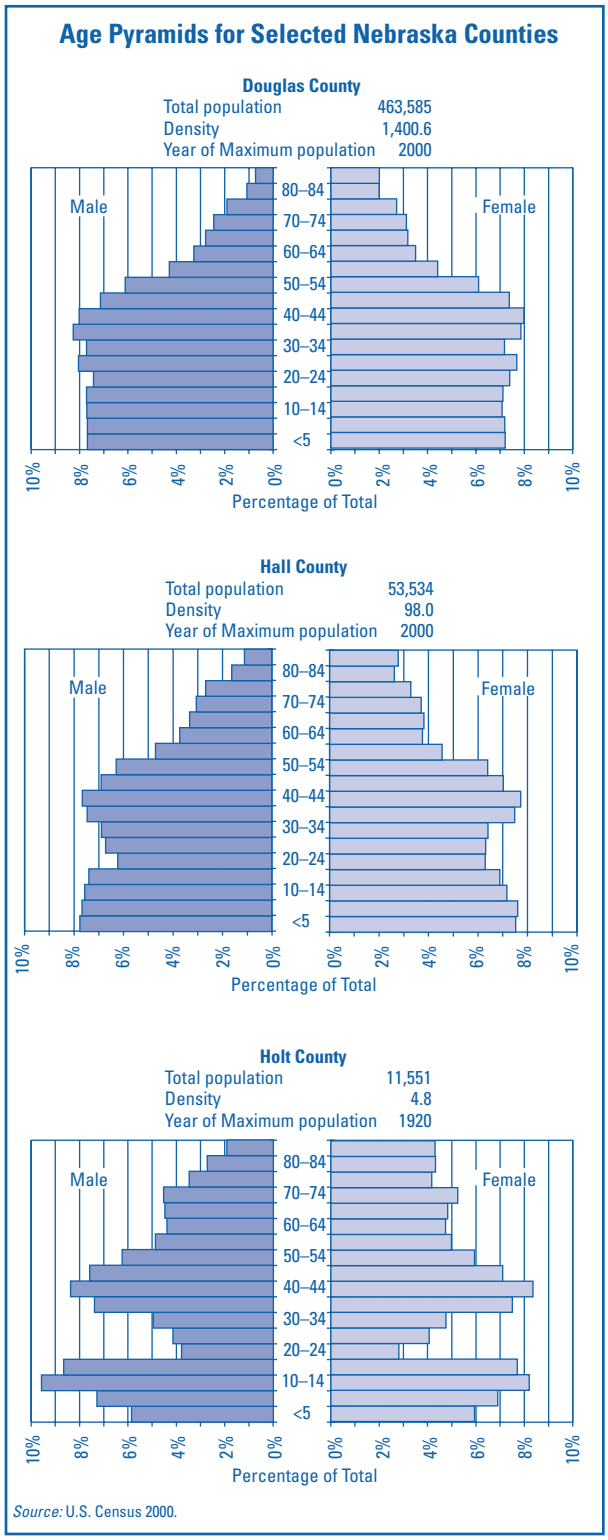
The shape of the age pyramid of Holt County is typical of the shape for many accelerated-declining counties. The most distinctive attribute of this pyramid is its "pinched waist" in the 20–34 age cohorts, representing the significant out-migration of high school graduates presumably seeking higher education or employment opportunities in other counties. In addition, the relatively narrow 0–5 age cohort probably results from the out-migration of fertile young people, illustrating the link between out-migration and natural population increase as discussed above. Also apparent here are the relatively high values in the over-65 cohort (as discussed above). It is noteworthy that Holt County reached its maximum population in 1920, whereas Douglas and Hall counties continue to reach new highs.[39]

The high proportion of retired elderly people in low population counties contributes to the economic disadvantage of their small workforces that limit the scale of businesses that can locate there. Even if labor quality is assumed to be homogenous, the small size of the typical population in a rural county in the Great Plains means that only a short list of industries are able to locate in those markets. In May 2003 we met with bankers from small-population rural counties in western Kansas, and one banker from a county of fewer than 5,000 people discussed his county's experience in trying to persuade a telemarketing operation to relocate

[38] Gardner (2002), 102.

[39] Maximum populations were calculated using the decennial U.S. Censuses.

Figure 8



Source: U.S. Census 2000.

to the county. Technological advances in communications technology are sometimes touted as a way for rural communities to compete and diversify away from dependence on agriculture, and telemarketing is an example of a business that may be able to conduct its operations far from urban centers. The banker told us, however, that the community, despite offering tax incentives and a building appropriate for the telemarketer, was unable to lure the company. The firm opted instead to relocate to a community larger than the banker's county, citing concerns both about housing for the relocated workers and about the small size of the available labor force.

This already unfavorable labor-force situation is exacerbated when a small community has a high proportion of elderly people, who typically lack both the economic motivation and the skills needed to work. In addition, elderly people as a group are characterized by a disproportionate demand for medical services, but specialized care centers tend to concentrate in urban areas that are often distant from small rural communities.[40] This need by elderly people tends to strain local and state taxing jurisdictions—another factor reducing the areas' relative attractiveness as locations for new businesses.

The Phenomenon of "Brain Drain"

A second significant demographic effect of out-migration in depopulating rural counties is a phenomenon that development economists (economists who study differences in economic growth between countries) have long identified as the "brain drain":

> Immigrants are often different from the natural citizens of a country in terms of their skills, motivation, education, and social behavior. It has often been noted that immigration has not been undertaken by the average person. Rather, groups of immigrants tend to be especially ambitious, more willing to take risks, harder working, more open to new ideas, and more willing to innovate. This is so because the act of moving from one country to another generally involves risks, temporary hardship, and a willingness to experience major changes in lifestyle… immigrants are seldom "average" compared to the population they left behind or the one they join…. The emigration of educated people from developing countries…to the most developed economies is often referred to as the **brain drain.** This is not by any means a minor phenomenon: the number of

[40] Rogers (1999), 1.

well-educated emigrants from developing countries to developed economies is large.[41]

With the existence of the brain drain well established at the international level, it is reasonable to suggest that an analogous effect may be associated with rural-to-urban migration within the United States. This effect is hard to quantify at the county level because data are usually unavailable. However, a study conducted by the Federal Reserve Bank of Minneapolis at the state level suggests that the effect is real.[42] The researchers used Census data to estimate the number of people who were older than age 25 and held bachelor's degrees in 1989 and 1999 in each of the states in the Minneapolis Federal Reserve Bank district. They then subtracted the total number of bachelor's degrees granted between 1989 and 1999 by all degree-granting institutions in the particular state, arriving at an estimate for each state of its net brain drain or gain (see table 8).[43] The data suggest that Minnesota, the most urbanized of the states studied, is the destination of many migrants leaving the Dakotas, and northern Wisconsin, although probably many migrants from Wisconsin may also move to the Chicago metropolitan area.

North Dakota in particular has an increasingly critical problem with the out-migrating of educated people. According to Roger Johnson, North Dakota's commissioner of agriculture and the leader of a task force that examined this issue, 60 percent of those earning bachelor's degrees or higher in the state leave North Dakota within one year of graduation. "One thing is clear: A lot of people leave. No other state faces the [brain-drain] problem to the degree that North Dakota does. There's nobody that's worse off than us."[44]

Further research on North Dakota's brain drain suggests that the state's highest achievers are the people most likely to leave. A 1995 survey of the state's graduating high school students who took college entrance examinations found that high scorers were the most likely to leave the state: five years after graduating from high school, only one in four remained in North Dakota.[45]

At the state level, much of the concern with the brain drain is fiscal, as rural states such as North Dakota subsidize the education of their young citizens only to see them leave. Here the correspondence with the international brain drain is nearly exact. Low-population, rural states such as North Dakota already face comparatively high per capita costs for university-level education but are able to capture only a small fraction of the benefits for their local economies.

The outflow of college-educated people also suggests a broader policy issue, for most development experts consider the supply of highly educated workers to be a key contributor to the future prosperity of a state or region. Such workers are necessary to provide leadership in the local economy and to attract outside investment.[46]

[41] Van den Berg (2001), 270, 400.
[42] Wirtz (2003), 1.
[43] Ibid., 4.
[44] Ibid., 2–3.
[45] Wirtz (2003a), 2.
[46] Feser and Sweeney (2003), 39.

Table 8

Migration of College Students in the Upper Great Plains

	Estimated Number of Persons Over 25 Years Old with a Bachelor's Degree		Estimated Change in Bachelor's Degree	Number of Degrees Produced	Estimated Net Brain Drain or Net Gain
State	**1989**	**1999**	**1989–1999**	**1989–1999**	**1989–1999**
Minnesota	577,920	953,920	376,000	234,945	141,055
Montana	106,977	134,160	27,183	42,976	–15,793
North Dakota	89,244	89,200	–44	45,022	–45,066
South Dakota	79,672	110,848	31,176	40,669	–9,493
Wisconsin	571,725	790,600	218,875	269,647	–50,772

Note: Population data were revised by the Federal Reserve Bank of Minneapolis.
Source: Postsecondary Education Opportunity.

The depopulating counties most in need of economic and policy leadership may have populations least likely to supply these skills and least likely to attract outside investment. Like the small size of the labor force in many depopulating counties, the quality of the labor force may raise concerns that shorten the list of companies willing to locate in those communities.

Depopulation and the Commercial Structure of Rural Counties

Above, we discuss how variations in agricultural practices influence differences in population density and how advances in agricultural technology are related to persistent declines in population. We also discuss the effect on a county's prosperity of the size and quality of its labor force. Another relationship that is at least equally important is the one we now discuss: that between trends in commercial activity and population in rural counties.

Economic geographers have developed a model known as "central-place theory" that provides insights into the distribution of commercial activity across a landscape. Central-place theory holds that

- Towns and cities (central places) in a region may be thought of as organized into a hierarchy.
- The greater the number and complexity of goods and services available in a central place, the higher its rank in the hierarchy.
- Lower-order places offer convenience goods, such as groceries or gasoline that are consumed frequently and are provided by small-scale businesses that can be viable with only a small number of customers.
- Higher-order places are fewer and farther apart and are home to larger-scale businesses whose survival requires a greater number of customers.[47]

Central-place theory also holds that businesses require a minimum number of customers to be viable. Over time, as the number of farms has dwindled in many rural areas, fewer customers are available to shop in the grocery stores, hardware stores, and agricultural supply facilities that are common in small rural towns.[48] Thus, businesses in many of these areas have declined. Because the Great Plains has the largest and fewest farms, its commercial decline has been most profound.

When the decline in the number of farm customers leads to a decline in the number and complexity of businesses in lower-order central places, such lower-order central places become less important as destinations for those who live in the surrounding countryside. In many cases these places are able to support only businesses that provide just the most basic needs of the people who live there.

Furthermore, as farms become larger they often outgrow the ability of local small-town businesses to serve their needs. In the Great Plains, where farms are few and far apart, the towns that support them are also fewer and smaller and are able to support only the simplest businesses. Consequently, people who live in rural areas in the Great Plains have access to only a restricted range of goods and services. But according to recent research by the USDA, more than 40 percent of farmers have Internet access, and increasing numbers of them are using it to procure supplies from regional or national providers, bypassing local businesses even where these exist.[49]

In addition to the challenge of declining demand from the countryside, lower-order central places have also faced the challenge of increasing competition from businesses in larger towns. Much of this competition can be ascribed to the increased availability of inexpensive and reliable automobiles and vastly improved networks of roads, both of which allow residents of the countryside and smaller towns alike to visit larger central places to purchase a wider variety of goods and services. In fact, residents of smaller towns are willing to drive great distances to shop in larger market areas. More broadly, the increasing convergence between rural and urban cultures—an effect of education and the mass media—has stimulated the demand for a greater variety and volume of the consumer goods and services that are available in the larger towns.[50]

Retail businesses—even those in larger towns—are affected, in addition, by the consolidation of retail

[47] Berry, Conkling, and Ray (1976), 228.

[48] Gardner (2002), 125.
[49] USDA, Economic Research Service (2001a), 19.
[50] Gardner (2002), 125.

activity, as national retail chain stores present businesses in the rural Great Plains and in smaller towns elsewhere with strong and growing competition. Smaller retail stores have succumbed in great numbers to competitors that offer a larger variety of goods and services at lower prices. Many sources have dubbed this phenomenon the "Wal-Mart effect" because that chain offers the most prominent example.

Professor Ken Stone of Iowa State University, an economist who studies rural retail activity, declares:

> There is strong evidence that rural communities in the United States have been more adversely impacted by the discount mass merchandisers (sometimes referred to as the Wal-Mart phenomenon) than by any other factors of recent times. Studies of Iowa have shown that some small towns lose up to 47 percent of their retail trade after 10 years of Wal-Mart stores nearby.[51]

Professor Stone's findings are summarized in figure 9, which shows that the communities with the smallest populations are the ones most affected when Wal-Mart stores open nearby. Although local businesses have been losing revenue to national chains since early in the last century, when Sears and Montgomery Ward began mailing catalogues, the effect has accelerated since 1970, with the massive proliferation of discount merchandisers.[52] Although Wal-Mart and chains like it have been criticized for generating stiff competition for hundreds of Main Street competitors, comparative surveys have shown that traditional retailers are only 60 percent as productive as mass retailers—of which Wal-Mart is the leading, though not the only, example.[53]

The consolidation of retail activity in larger towns has been accompanied by the consolidation of other businesses in higher-order central places. For example, agricultural suppliers, such as machinery dealers and fertilizer and chemical suppliers have consolidated to achieve economies of scale.

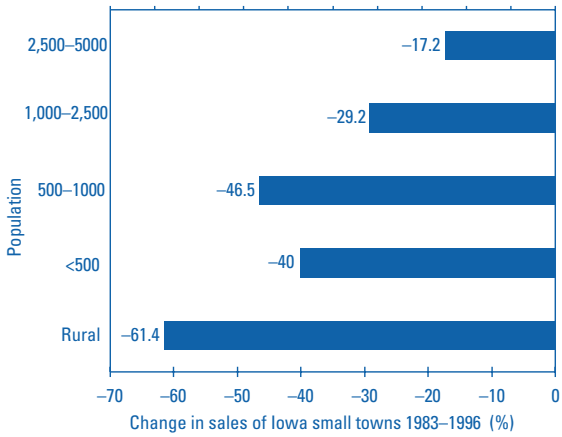
Central-place theory predicts that the increasing importance of multipurpose shopping trips leads to a self-reinforcing trend of the consolidation of commercial activity.[54] The more activities of all kinds that are concentrated in larger towns, the more willing small-town and rural residents are to make the trip to the larger towns. For example, if small-town residents travel to a nearby large town once a week to buy the agricultural goods and services available there, they may begin buying groceries at the large supermarket as well, bypassing the local store. The proliferation of mass discount stores that carry thousands of items increases the opportunity for multipurpose shopping trips, thereby increasing the traffic to larger central places.

This loss of retail activity can be quantified. One measure of the loss of business from rural counties to nearby larger counties is a trade "pull-factor," a statistic that measures the retail activity of a county in relation to the activity in nearby counties.[55] A researcher calculates trade pull-factors by dividing a county's per capita retail sales for a given year by the state average per capita sales. This calculation is then adjusted to take into account differences in per capita income between the counties.[56]

A pull-factor of 1.0 implies that the county's sales tax revenue is proportional to the income of its residents,

[51] Stone (1998), 189.
[52] Ibid., 199.
[53] Basker (2002), 4.
[54] Morrill (1970), 76.
[55] Broomhall and King (n.d.), 2.
[56] Ibid.

Figure 9



Source: Impact of the Wal-Mart Phenomenon on Rural Communities, 1997. Iowa State University, Kenneth E. Stone.

or that its residents are spending their dollars in their home county. A pull-factor greater than 1.0 suggests that a county is drawing business from adjoining counties, for its retail sales figures are higher than its population and per capita income levels would suggest. On the other hand, a pull-factor of less than 1.0 suggests that a county is losing business to neighboring counties.

To illustrate county pull-factors, we chose Nebraska (see figure 10). As expected, metropolitan and growing rural counties have aggregate pull-factors greater than 1.0, a score suggesting that they are attracting business from nearby counties. Conversely, depopulating counties have aggregate pull-factors of less than 1.0, a score suggesting that they lose business to nearby counties. The band of counties with pull-factors greater than 1.0 across the southern third of the state corresponds to the path of Interstate 80; this correlation suggests spending by tourists or travelers on the highway. Like the pull-factors of the counties in the path of the interstate, the unexpectedly high pull-factors of some other depopulating counties tend to reflect special circumstances, such as very small populations on other heavily traveled roads.

Pull-factors are greatly influenced by discounters such as Wal-Mart, especially in rural counties. Figure 11 shows the location (by type of county) of Wal-Mart stores in Nebraska—a distribution that is typical in Midwestern states.[57] A majority of growing rural counties have Wal-Marts, and figure 10 indicated that these counties had the highest aggregate pull-factor, at 1.13. Although Wal-Mart is not the only reason for the favorable pull-factors in those counties where it is located, the Wal-Mart stores are emblematic of concentrations of retail activity.

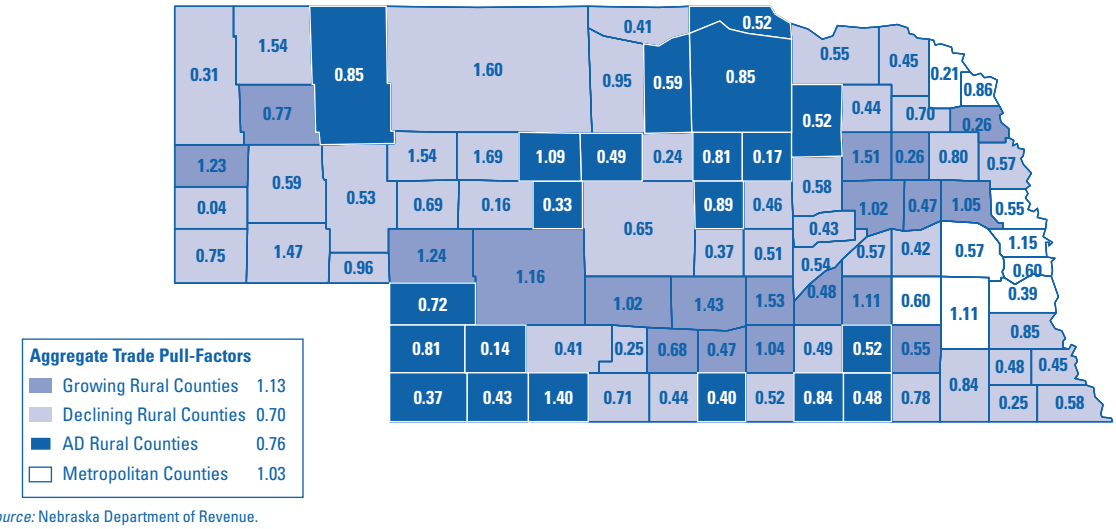
Demographic Conclusion: The Threat to Viability and the Vicious Circle of Decline

Many demographers argue that communities whose populations fall below a critical mass are destined for irreversible decline because they no longer have sufficient resources to maintain economic viability. Given their low populations and low population densities, many rural counties, especially those in the Great Plains, face a number of interrelated difficulties. First,

[57] Wal-Mart stores have tended to be built in larger counties. Our analysis of 13 states shows that the 247 rural counties where Wal-Marts have been built since 1968 had an average population of 30,218 and an average population density of 27.9 as of the 2000 Census. By contrast, the rural counties in the same 13 states that did not have Wal-Marts averaged a population of 8,215 and a density of 6.9 people. (See Rand McNally Road Atlas with Wal-Mart and Sam's Club Store Directory, 2003 Edition. States included are Colorado, Idaho, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, Nebraska, Oklahoma, South Dakota, Wisconsin, and Wyoming.)

Figure 10

Trade Pull-Factor Analysis of Nebraska, by Type of County



Source: Nebraska Department of Revenue.

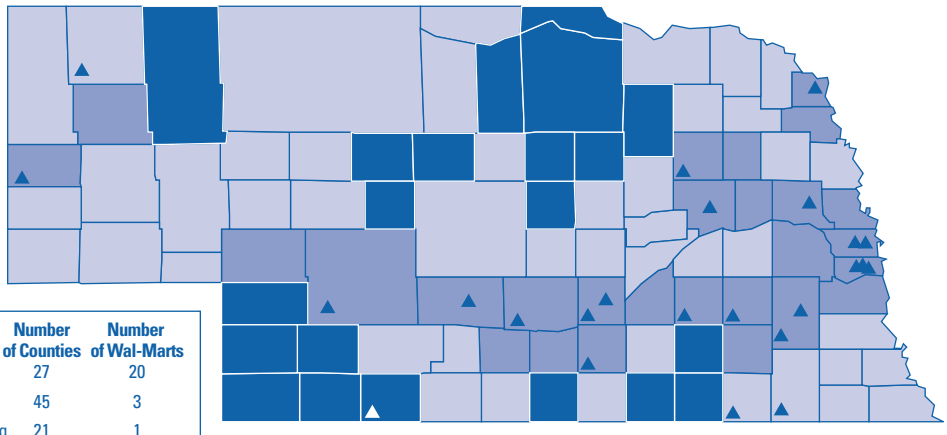
with small workforces and populations that are relatively unskilled and uneducated, they have a hard time appealing to prospective employers to relocate. Second, the shrinking customer base, as well as the Wal-Mart effect, drains scope and vitality from the commercial activity in these counties. Third, the per capita costs of services provided by governments—for example, law enforcement, maintenance of infrastructure (roads, bridges, and so forth), education of a quality comparable to that found in more populated areas, health care of a quality commensurate with the needs of a disproportionately elderly population—are high in areas of low population densities, where relatively few people must share the fixed costs associated with such investments.[58] Consequently, low-population counties not only find it difficult to maintain the existing level of services but also lack the resources to improve their infrastructures to the point at which they can attract new businesses. In addition, small adjoining counties often find that they are maintaining redundant public resources as they struggle to provide a full menu of governmental services.[59] Yet efforts to consolidate or share services (as frequently proposed) typically face strong political opposition, for residents of small-population counties are reluctant to surrender their separate identities.

Thus, many counties may face a self-reinforcing cycle of decline: declining populations lead to decreased economic vitality, and both lead to higher per capita costs; the higher costs provide incentives for continued out-migration—and the downwardly spiraling quality of life and of the supporting infrastructure in these counties makes it increasingly difficult for the counties to attract new businesses to the area.[60] Counties with accelerating population declines may already be experiencing this phenomenon.

[58] On health care, see Rowley (1998), 4.
[59] Drabenstott, Henry, and Gibson (1987), 41.
[60] Ibid., 44.

Figure 11

Distribution of Wal-Mart Stores in Nebraska, by Type of County



County Types	Number of Counties	Number of Wal-Marts
Growing	27	20
Declining	45	3
Accelerated-Declining	21	1

Source: Rand McNally Road Atlas 03, Including Wal-Mart and Sam's Club Store Directory.

Part 2. The Banking Implications of Rural Depopulation

Rural depopulation—which is long-term and continuing and has serious consequences for the communities involved—is also significant for the banking industry. At year-end 2003, there were 1,451 banks and thrifts—16 percent of all insured financial institutions in the nation—headquartered in rural counties with declining populations (see table 9).[61] For financial institutions, declining populations equate to declining customer bases.

[61] To be sure, these institutions represent a very small percentage of total industry assets.

The demographic data discussed above indicate clearly that the Great Plains is far more vulnerable to depopulation trends than other regions, and the banking data reinforce this vulnerability. In terms of number of institutions, most of the institutions that are headquartered in depopulating rural counties are located in the Corn Belt (48 percent) or the Great Plains (35 percent); in the rest of the country, including the two other depopulating areas, there are significantly fewer institutions headquartered in depopulating rural counties. But in proportional terms—the banks located in depopulating counties as a proportion of all banks in the region—the Great Plains stands out: approximately 46 percent of all banks that are headquartered in the Great Plains are in declining or accelerated-declining counties. This percentage is far higher than the percentage for any other depopulating region. Furthermore, 17 percent of

Table 9

Number and Assets of Banks and Thrifts by Type of County, by Region

	Rural Counties				
	Growing Counties	Declining Counties	AD[a] Counties	Metro Counties	Total
Great Plains					
Number of Institutions	306	323	184	286	1,099
Total Assets (in billions)	37.9	20.1	12.1	91.1	161.2
Median Assets (in millions)	70.8	39.3	39.0	106.9	55.6
Corn Belt					
Number of Institutions	862	610	85	1,649	3,206
Total Assets (in billions)	108.0	52.6	7.9	1,843.1	2,011.5
Median Assets (in millions)	84.0	57.3	53.1	118.0	88.5
Delta-South					
Number of Institutions	386	81	58	438	963
Total Assets (in billions)	74.5	10.8	5.9	470.7	561.9
Median Assets (in millions)	106.3	78.4	79.4	128.2	111.1
Appalachia-East					
Number of Institutions	147	18	34	429	628
Total Assets (in billions)	58.4	8.7	8.0	1,998.7	2,073.8
Median Assets (in millions)	150.6	96.1	84.2	246.5	193.4
Other					
Number of Institutions	991	29	29	2,219	3,268
Total Assets (in billions)	212.0	1.7	4.0	3,971.3	4,188.9
Median Assets (in millions)	105.5	53.3	72.2	169.8	139.8
Total					
Number of Institutions	2,692	1,061	390	5,021	9,164
Total Assets (in billions)	490.8	93.9	37.9	8,374.8	8,997.4
Median Assets (in millions)	94.9	52.7	50.6	147.9	105.8

Source: Bank and Thrift Call Reports, December 31, 2003.

[a] "AD counties" refers to accelerated-declining counties. The number of banks and thrifts refers to institutions headquartered in those counties.

all Great Plains institutions are in accelerated-declining counties.

The relative size of institutions is another indication that Great Plains institutions are at a disadvantage compared with banks in more vibrant areas (size correlates with an institution's ability to grow its business). The median asset size of a bank in the Great Plains is only $56 million, and in rural counties with declining populations it is only about $39 million. Institutions in other regions are significantly larger: even the Corn Belt's median bank holds $89 million in assets. Thus, although other areas may also be experiencing depopulation, they begin with much larger customer bases.

Here we analyze patterns of consolidation among Great Plains rural community banks. Then we survey the performance of Great Plains community banks, comparing them first with community banks in the nation as a whole and then among themselves.[62] Next we analyze profitability and asset growth among these banks, which are not homogeneous in either regard; our focus is on asset size, branching, risk taking, and net interest margins. In the final section in this part of the article, we consider how the Internet may affect rural banks' customer base. Overall, we identify strategies that some banks in depopulating areas have used to remain successful.

Community Bank Consolidation in the Great Plains, Past and Future

The number of insured banks and thrifts in the United States has been declining for two decades, primarily because state unit-banking requirements were weakened (and then eliminated), many banks failed and merged during the banking and thrift crises of the 1980s and early 1990s, and many banks wished to grow larger to achieve economies of scale. Between year-end 1984 and year-end 2003, the number of financial institutions in the nation shrank to slightly more than half what it had been. Because of the large number of depopulating rural counties in the Great Plains, one might expect that bank consolidation would have been more robust in that region; after all, wouldn't fewer people require fewer banking institutions? However, the reductions in bank numbers that have occurred in the Great Plains are similar to the reductions in rural areas in the rest of the nation (see figure 12). At year-end 1984, the Great Plains was headquarters to 1,559 rural banks and thrifts (of all sizes); this number declined to 813 by the end of 2003, or 52 percent of the total from 19 years earlier.[63] At year-end 2003, rural areas outside the Great Plains had 54 percent of their earlier total. And the reduction in insured institutions is consistent across all three types of Great Plains rural counties (see figure 13).

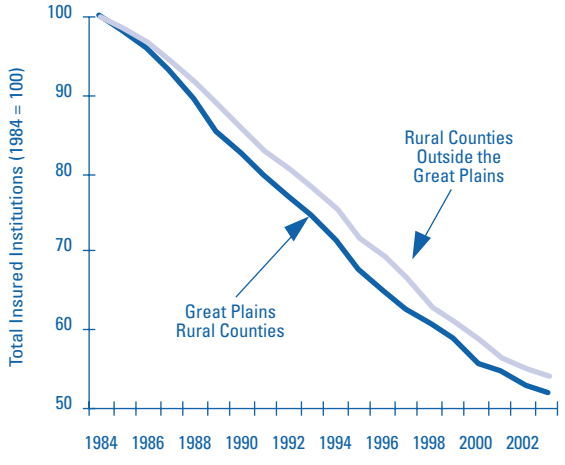
Where we do see differences is in the number of counties that are not home to the headquarters of a bank. Of the 424 rural counties in the Great Plains, 76 of them, or 18 percent of the total, do not have a headquartered

[62] In this article, community banks are defined as banks and thrifts that hold less than $250 million in assets. We chose $250 million for two reasons: (1) The vast majority of institutions in the Great Plains—88 percent—have less than $250 million in assets; and (2) our analysis shows that for institutions under $250 million, most of the banking activity (in terms of location of bank offices) occurs in the same county where the bank is headquartered. In fact, as of June 30, 2003, Great Plains institutions with less than $250 million in assets had 70 percent of their banking offices located within the same county as the headquarters. By contrast, in institutions between $250 million and $1 billion the figure falls to 38 percent of banking offices. When bank performance is analyzed by its headquarters county, it is important for the bank's activity to be concentrated in that county to the greatest extent possible.

[63] Between year-end 1984 and year-end 2003, 766 rural community banks were eliminated in the Great Plains; 720 of them were acquired by other institutions (149 of those acquisitions were failure related), and the other 46 failed or voluntarily liquidated.

Figure 12

Bank Consolidation Trends for Rural Counties, Great Plains and Elsewhere, 1984–2003



Source: Bank and Thrift Call Reports.

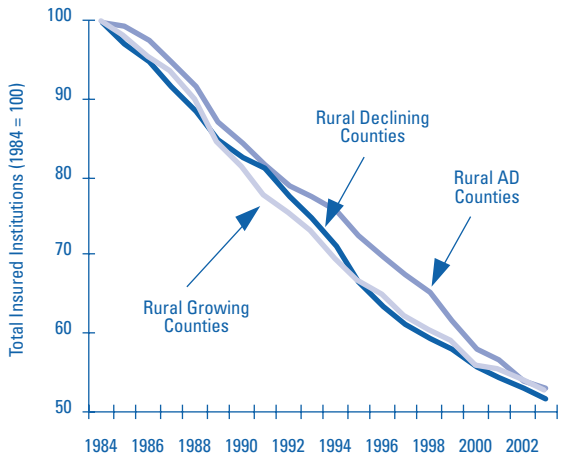
bank or thrift. By contrast, of the 890 rural counties in the other depopulating regions, 13 percent do not have a headquartered institution. Of the 76 rural Great Plains counties that do not have headquartered banks, 18 did not have an institution headquartered there over the entire 19-year period we studied. The other 58 had at least one institution at the beginning of the period, but those institutions either failed or were purchased by other institutions in the succeeding years.

As one would expect, the vast majority of the counties without headquartered banks are experiencing population declines. Only 11 percent of Great Plains rural growing counties have no headquartered institution, but the comparable figure for declining and accelerated-declining counties is more than 20 percent. Of the states in the region, South Dakota has the largest proportion (and greatest number) of counties with no headquartered institution, or 32 percent (21 counties) of its 66 counties. Montana, at 20 percent (or 11 counties), has the second-highest proportion and number.

Even though many Great Plains rural counties lost their only bank headquarters after 1984, few actually lost a bank facility; rather, in most instances what had once been a main office became a branch office of an institution headquartered in another county. In most counties this consolidation activity has had a relatively neutral effect on branch totals, but a qualitative decline in bank service is possible. The conversion of a once-main-office to a branch is sometimes accompanied by reductions in customer services, customer service hours, and managerial authority and decision-making discretion.

Figure 13

Bank Consolidation Trends for Each Rural-County Type, Great Plains, 1984–2003



Note: "AD counties" refers to accelerated-declining counties.
Source: Bank and Thrift Call Reports.

Although consolidation trends in rural community banks in the Great Plans have been stable and representative of national figures, two pieces of evidence suggest that consolidation in the Great Plains may increase more rapidly in the future. One is the significant number of elderly people living in depopulating counties. In Part 1 of this paper, figure 8 depicted the age pyramid of a depopulating Nebraska county. That age pyramid—representative of many Great Plains counties—shows a large pocket of elderly people. At some point in the relatively near future, these people are going to pass away, and as indicated above, their banking business may move outside the area with the heirs. As many elderly customers also carry large deposit balances, their passing may result in a major loss of funding that may be difficult for many small banks to withstand.

The second factor that could increase consolidation is the lack of a succession plan in many community banks in the Great Plains. The typical profile of community banks in the Great Plains is that they are small—as noted above, the average size of a community bank in depopulating counties is only $39 million—and are owned and operated by the same person. In many cases, the owner/operators do not have family members groomed to take their place when they retire because, like other young people, the family members have migrated to counties where economic opportunities are greater. And because of the brain drain in rural areas, there may not even be suitable nonfamily members to assume operations.

During outreach meetings in the Great Plains the problem of succession plans has been a common theme, and bankers do not seem to have identified solutions. The typical short-term plan is for owner/operators to delay retirement, since other suitable options do not exist. The most likely outcome when these bankers do retire is the sale of their institutions, which could dramatically increase the pace of rural bank consolidation.

The Performance of Great Plains Community Banks: External and Internal Comparisons

In this section we examine the performance of rural banks in the Great Plains. Given the relative severity of rural depopulation trends in the region, it would seem reasonable to assume that insured institutions based in the Great Plains would be in a worse condition than banks headquartered in other regions' rural counties. It would also seem reasonable to assume that performance data within the region itself would vary by type of county. Neither of these assumptions is borne out.

Comparison with Community Banks outside the Region

Surprisingly, when the financial ratios of community banks in the Great Plains are compared with the ratios of community banks headquartered outside the Great Plains, evidence of depopulation-induced deterioration does not emerge (see table 10). From 1999 to 2003, the overall earnings, net interest margins, and asset-quality ratios reported by rural community banks in the Great Plains were similar to those reported by rural community banks headquartered outside the Great Plains. A notable difference is the loan-to-asset ratio: community banks based in the Great Plains report lower loan-to-asset ratios than their counterparts across the country. These lower ratios are probably explained by a comparative lack of lending opportunities in the market areas of Great Plains rural community banks.

Thus, despite the lack of strong loan demand and a shrinking customer base in the Great Plains, community banking performance there is similar to what it is across the entire nation. How have community banks in the Great Plains been able to report similar operating results when such a large number of them are located in dwindling markets? One possible answer is that, to date, depopulation has been occurring very slowly, and bankers have been able to adjust capably to their economic environments. Anecdotal evidence from our outreach meetings with rural bankers suggests that this is the case.

Table 10

Financial Ratios, Rural Banks in the Great Plains Compared with Rural Banks in the Rest of the United States, 1999–2003

	2003	2002	2001	2000	1999
GP - Pretax ROA	1.44	1.49	1.42	1.59	1.55
Nation - Pretax ROA	1.44	1.51	1.39	1.50	1.54
GP - Net Interest Margin	4.12	4.25	4.17	4.34	4.24
Nation - Net Interest Margin	4.05	4.24	4.08	4.24	4.23
GP - Loans-to-Assets Ratio	58.51	59.59	58.92	59.25	57.45
Nation - Loans-to-Assets Ratio	61.94	62.39	63.02	64.52	63.04
GP - Total Past Due Loan Ratio	2.59	2.89	2.86	2.53	2.50
Nation - Total Past Due Loan Ratio	2.59	2.82	2.92	2.62	2.29
GP - Net Charged-off Loans	0.31	0.34	0.46	0.30	0.30
Nation - Net Charged-off Loans	0.30	0.33	0.31	0.23	0.22
GP - Equity Capital	10.97	11.19	10.95	10.81	10.16
Nation - Equity Capital	10.52	10.59	10.25	10.34	10.05
GP - Ag Loans/Total Loans	40.33	40.68	40.84	40.35	40.81
Nation - Ag Loans/Total Loans	13.76	13.68	13.27	13.22	13.42
GP - Ag Inst./Total Inst.	79.97	80.08	80.44	81.22	82.21
Nation - Ag Inst./Total Inst.	28.46	28.55	28.07	28.62	29.03

Notes:
"GP" refers to banks and thrifts with less than $250 million in assets in rural counties in the Great Plains.
"Nation" refers to banks and thrifts with less than $250 million in assets in rural counties in the nation, excluding the Great Plains.
Source: Bank and Thrift Call Reports.

An additional, quantitative answer can be found in the final pair of lines in table 10, which indicate that community banks in the Great Plains have nearly three times the exposure to agricultural lending that community banks in the rest of the nation have. In fact, 80 percent of community banks in the Great Plains are considered farm banks, compared with just 28 percent elsewhere.[64] This is a key point, especially when one considers government assistance to farmers and, by extension, to their lending institutions during the past three decades. Farming has been, and continues to be, one of the most heavily subsidized industries in the United States. In fact, government payments nationally averaged $19 billion per year from 1999 through 2003, representing about 40 percent of net farm income over that period. Although not all farm products nationwide are subsidized, the primary crops of the Great Plains—wheat, corn, and soybeans—tend to be supported more generously than products grown outside the region.[65] As a result, farms in the Great Plains have received higher subsidies as a proportion of net farm income than farms elsewhere in the nation (see figure 14). Such support has certainly helped farmers repay their farm loans and has helped offset whatever negative consequences farm banks might have otherwise experienced from adverse demographic trends.

[64] The FDIC defines farm banks as institutions where at least 25 percent of total loans are made for production agriculture or are secured by farm real estate.
[65] While the region's primary crops are heavily subsidized, cattle, another important product in the Great Plains, are not.

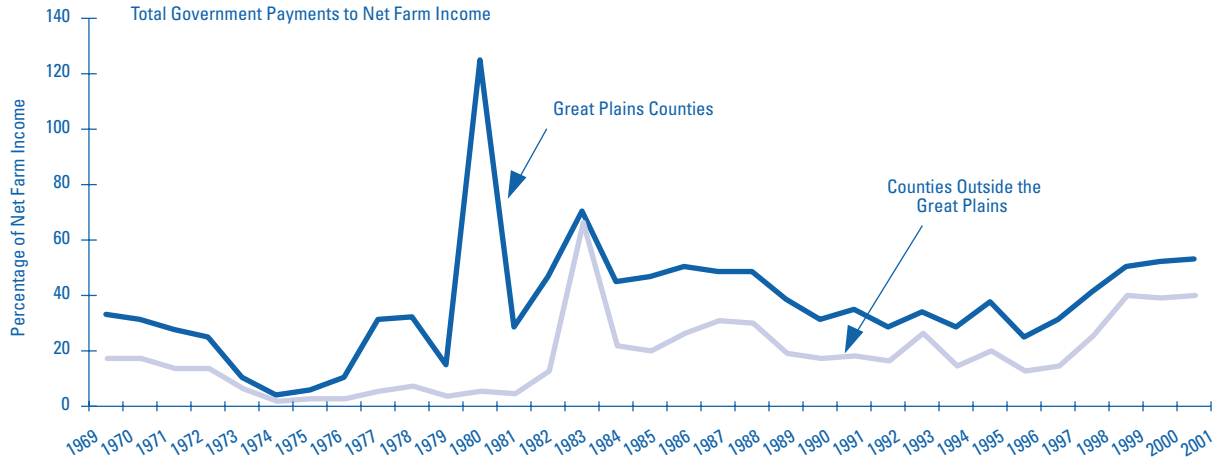
Comparisons within the Region

Just as performance data are similar for rural banks in the Great Plains and rural banks located elsewhere, performance data within the Great Plains itself are also relatively similar across the different types of county. Table 11, which shows community bank performance broken down by growing, declining, and accelerated-declining county types, indicates that banks in depopulating areas continue to perform well. Institutions in growing counties have earned a bit more pretax revenue, largely through higher sources of noninterest income, but institutions in declining and accelerated-declining counties have not fared poorly. Net interest margins are similar in the three types of county, for banks in declining and accelerated-declining counties have offset lower loan yields with lower funding costs. Loan-quality measures tend to modestly favor institutions in growing counties, but the other institutions offset this with higher levels of equity capital.

However, significant disparities in lending activity exist among institutions in the three types of county. Growing counties, which are probably adding to their populations through growth in the number of nonagricultural jobs, tend to offer community banks more diversified opportunities for lending. Although community banks in growing counties continue to hold concentrations in farm lending, they make significantly fewer farm loans than their counterparts in declining or accelerated-declining counties, and

Figure 14

Reliance on Government Payments, Great Plains Counties Compared with Counties Outside the Great Plains, 1969–2001



Source: Bureau of Economic Analysis; 2001 are the latest data available at the county level.

Table 11

Financial Ratios for Community Banks by Type of County, Rural Great Plains, 1999–2003

	2003	2002	2001	2000	1999
Growing - Pretax ROA	1.46	1.57	1.43	1.61	1.60
Declining - Pretax ROA	1.46	1.45	1.41	1.56	1.51
Acc. Declining - Pretax ROA	1.39	1.41	1.42	1.58	1.51
Growing - Net Interest Margin	4.04	4.23	4.19	4.36	4.26
Declining - Net Interest Margin	4.20	4.27	4.17	4.32	4.23
Acc. Declining - Net Interest Margin	4.15	4.27	4.15	4.32	4.22
Growing - Loans-to-Assets Ratio	58.94	60.23	59.93	60.80	59.21
Declining - Loans-to-Assets Ratio	57.30	58.65	57.99	58.14	56.27
Acc. Declining - Loans-to-Assets Ratio	59.75	59.79	58.31	57.64	55.36
Growing - Total Past Due Loan Ratio	2.63	2.76	2.80	2.54	2.41
Declining - Total Past Due Loan Ratio	2.63	2.99	2.79	2.42	2.45
Acc. Declining - Total Past Due Loan Ratio	2.43	3.02	3.13	2.68	2.83
Growing - Net Charged-off Loans	0.29	0.32	0.63	0.36	0.30
Declining - Net Charged-off Loans	0.38	0.38	0.32	0.25	0.29
Acc. Declining - Net Charged-off Loans	0.26	0.34	0.34	0.25	0.32
Growing - Equity Capital	10.51	10.74	10.51	10.32	9.54
Declining - Equity Capital	11.30	11.57	11.36	11.23	10.72
Acc. Declining - Equity Capital	11.37	11.54	11.21	11.17	10.66
Growing - Ag Loans/Total Loans	30.41	30.88	30.54	29.62	30.58
Declining - Ag Loans/Total Loans	48.04	48.08	48.29	49.14	49.95
Acc. Declining - Ag Loans/Total Loans	48.43	50.31	51.42	50.85	50.79
Growing - Ag Inst./Total Inst.	66.54	65.84	64.58	65.20	66.67
Declining - Ag Inst./Total Inst.	86.48	86.81	87.72	89.21	90.78
Acc. Declining - Ag Inst./Total Inst.	88.70	90.06	91.62	91.37	91.04

Note: Only banks and thrifts with less than $250 million in assets in the Great Plains are used.
Source: Bank and Thrift Call Reports.

fewer of the institutions in growing counties have enough farm lending to be labeled farm banks. The ability to diversify out of agriculture offers benefits, such as spreading risk across various industries and reducing dependence on federal farm assistance. Such assistance may not always be as generous as it has been in the recent past.

Beyond issues of performance, however, overall asset growth rates indicate that depopulation in rural counties has adversely affected community banks. Declining populations translate into dwindling borrower and depositor bases; and compared with community banks in growing counties, community banks in declining and accelerated-declining counties have lower growth rates for total assets, loans, and deposits. Table 12 shows annualized growth rates for Great Plains community bank balance-sheet accounts for the ten years ending December 31, 2003. The first thing to note is the tremendous difference between community banks based in metropolitan areas and those based in rural areas. Across the board, the economic vibrancy of metropolitan areas has contributed to higher growth rates in the banks headquartered there, even when these areas are compared with rural counties where populations have been increasing.

When we look only at the rural counties in the Great Plains, the differences among them are evident, although far less striking than the metro-rural disparity. Not surprisingly, community banks in growing counties reported the greatest asset growth during the past decade, commensurate with their expanding communities: annualized asset growth was over two-thirds of a percentage point higher in growing-county community banks than in banks in declining or accelerated-declining counties. Although at first

Table 12

Balance-Sheet Growth Rates by Type of County, Great Plains, Year-end 1993 to Year-end 2003

	Annualized Growth Rate (%) between Year-end 1993 and Year-end 2003			
County Type	Total Assets	Total Loans	Total Deposits	Core Deposits
Metropolitan	8.87	11.16	8.61	7.87
Rural	4.37	6.77	3.84	3.04
Growing	4.78	6.96	4.28	3.47
Declining	4.04	6.32	3.45	2.64
Accelerated Declining	4.10	7.16	3.61	2.84

Note: All growth rates are merger adjusted. Community banks are defined as banks and thrifts with less than $250 million in total assets.
Source: Bank and Thrift Call Reports.

glance this disparity does not appear significant, its cumulative effect is more striking (see figure 15). Growing-county community banks expanded aggregate assets by 60 percent over the past decade, compared with 49 percent for banks in declining and accelerated-declining counties.

The three county types are clearly differentiated in terms of deposit growth. Community banks in growing counties reported growth in deposits of 4.3 percent per year between 1993 and 2003, whereas institutions in declining and accelerated-declining counties posted annual growth rates of 3.5 and 3.6 percent, respectively. Even more important than growth in total deposits is growth in core deposits. These are stable funds that have traditionally provided the backbone of community bank funding sources and consist of noninterest-bearing, savings, and money market deposit accounts, as well as time deposits of less than $100,000.[66]

Core deposits are generally less expensive and less sensitive to interest-rate movements than other funds, such as large time deposits, brokered deposits, and other borrowings such as Federal Home Loan Bank advances. As shown in figure 15, growing-county community banks reported cumulative growth in core deposits of 41 percent, or 3.5 percent annually, from 1993 to 2003; by comparison, community banks in declining counties reported cumulative growth in core deposits of 30 percent (or 2.6 percent annually), and for community banks in accelerated-declining counties the comparable figures were 32 percent (2.8 percent annually).

Although declining population during the past decade tends to be a reason for institutions in depopulating counties to have difficulties raising core deposits, the problem goes even deeper. The massive aging of depopulating areas (as discussed above) has caused significant problems for community banks. Many rural bankers tell the same story: an elderly depositor with large accounts in the bank passes away, and the deposits that the community bank had used to fund loans and other investments are withdrawn quickly by heirs who no longer live in the community but have long since moved to more thriving metropolitan counties. These funds are very hard to replace, and the large population of elderly people in Great Plains rural counties suggests that this problem will only intensify in coming years.

Analyses of Profitability and Asset Growth among Great Plains Community Banks

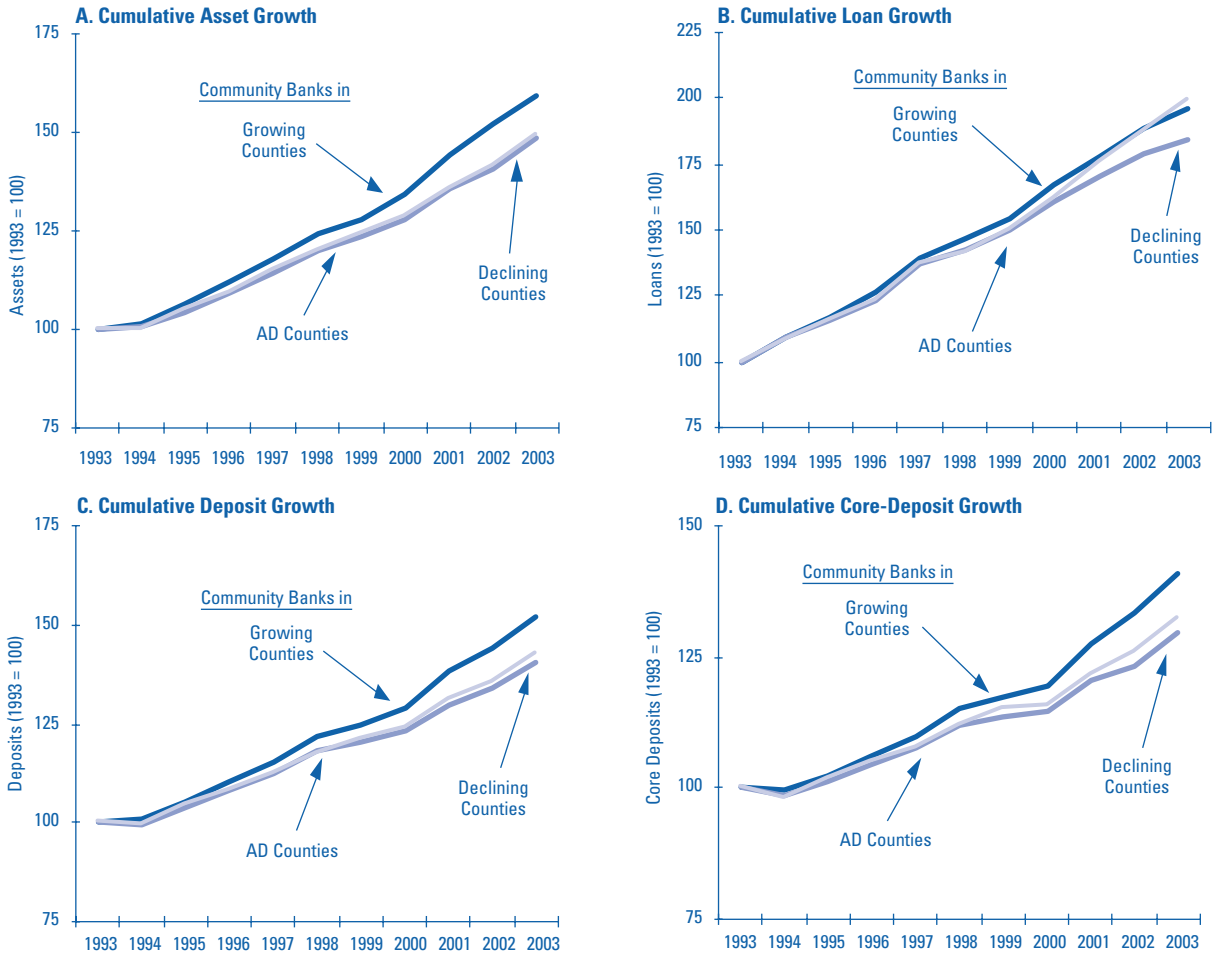
Although, as noted, many counties in the Great Plains face similar economic issues, not all community banks have responded in the same way or have reported the same operating results. Our goal in these analyses was to determine if some banks located in counties with declining populations had identified successful techniques to overcome local economic problems. Defining success is a somewhat subjective exercise, but we chose two community bank metrics that tend to generally indicate banking success: profitability and asset growth.

Most analysts would agree that profitability is an appropriate measure of success, and we measured profitability

[66] As of December 31, 2003, community banks in the nation reported that 69.3 percent of their assets were funded by core deposits. By contrast, larger institutions (those with over $1 billion in total assets) had core deposits totaling just 44.8 percent of total assets. Although both of these ratios have declined over time, the differential has been relatively steady.

Figure 15

Cumulative Balance-Sheet Growth Rates by Type of Rural County, Great Plains, 1993–2003



Notes: All growth rates are merger-adjusted. "AD counties" refers to accelerated-declining counties.
Source: Bank and thrift Call Reports for banks and thrifts with less than $250 million in assets.

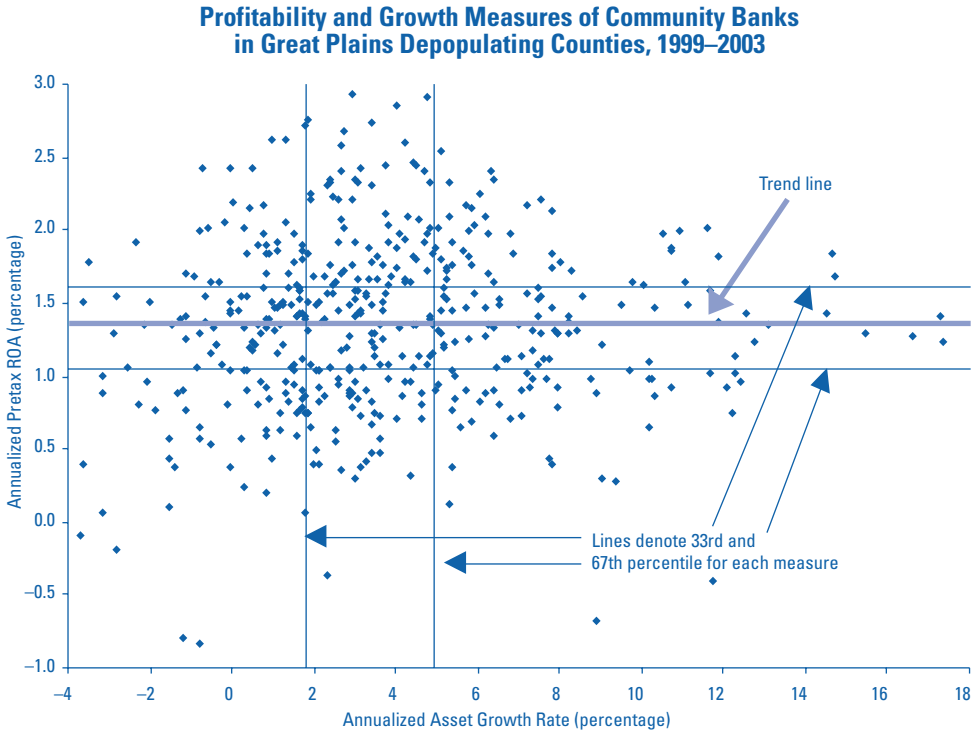
by the five-year (1999–2003) pretax return on assets (ROA) ratio.[67] Asset growth also indicates success, though some banks may experience success in other variables (such as profitability) without achieving growth. We measured growth by the five-year annualized merger-adjusted asset growth rate. To prevent new banks from distorting the results, we looked only at the 483 depopulating-county community banks that had been operating for at least 10 years.

[67] Pretax ROA is used in lieu of after-tax ROA because some institutions have adopted Subchapter S status, in which they do not pay income taxes; these institutions therefore have much higher after-tax ROAs than non-Subchapter S institutions.

The two banking metrics—profitability and growth—are shown in figure 16, with each community bank's performance indicated by a single dot. The figure clearly shows the significant disparity in operating results: annualized profitability ranged from a low of –1.07 percent to a high of 3.53 percent, with the middle 80 percent of banks in the range of 0.62 percent to 2.10 percent. Only nine community banks were unprofitable over the five-year period.

Annualized asset growth ranged from –11.71 percent to 79.65 percent, with the middle 80 percent of banks falling between –0.51 percent and 9.04 percent. Sixty-two institutions, or 12.8 percent, reported

Figure 16



Source: Bank and Thrift Call Reports for institutions in Great Plains rural depopulating counties that reported less than $250 million on December 31, 2003, and were established on or before December 31, 1993.

declining assets over the five-year period. The trend line is interesting: it is nearly flat and slopes slightly downward, indicating a slight negative correlation between earnings and growth. Typically, healthy asset growth would be joined by strong earnings, but in this case the results raise the question of whether some institutions are trading profitability for asset growth.

To analyze the data further, we divided each metric into thirds, creating a nine-cell matrix. For profitability, one-third of institutions reported annualized pretax ROA of less than 1.05 percent; the middle third, between 1.05 percent and 1.57 percent; and the upper third, at least 1.57 percent. For asset growth, the lower third of institutions reported annualized growth of less than 1.91 percent; the middle third, 1.91 percent to 4.88 percent; and the upper third, at least 4.88 percent. The lines on figure 16 indicate these breakdowns and the resulting matrix.

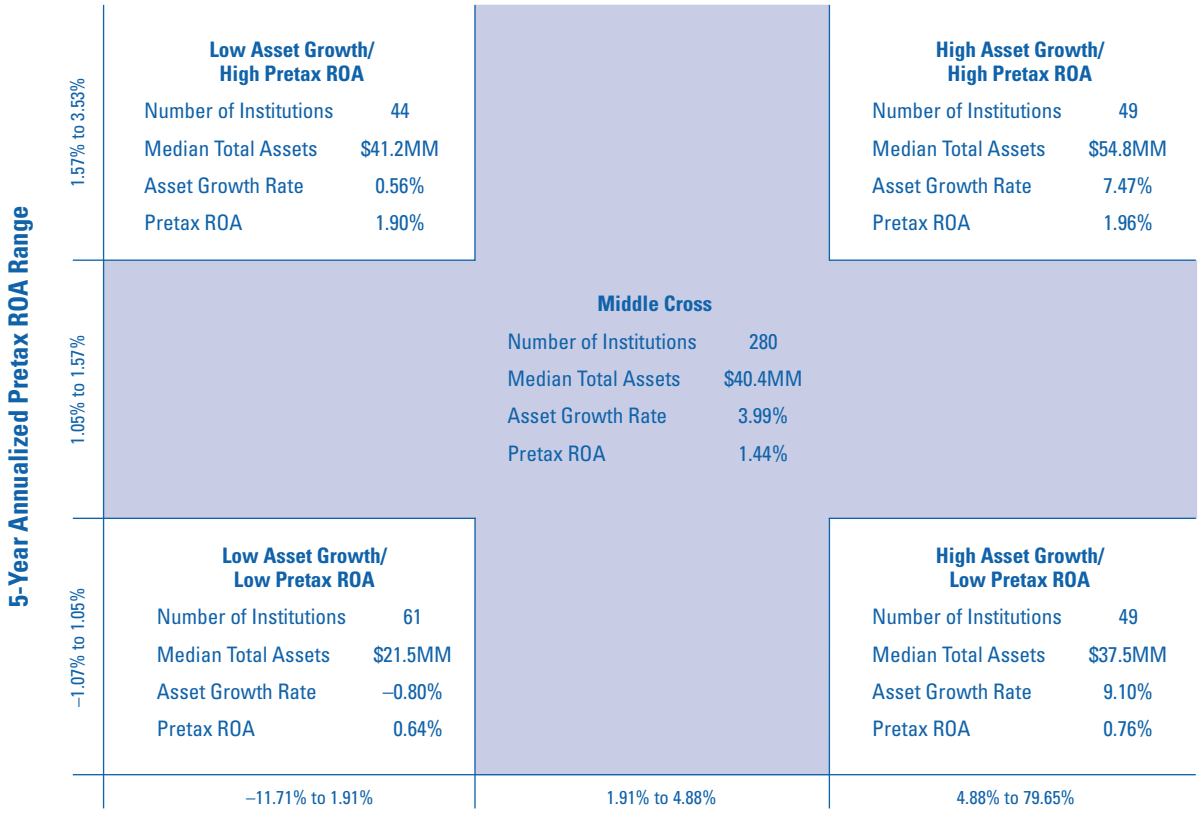
The corners of the matrix are of particular interest. For example, what is the secret of the 49 community banks in the upper right-hand corner (those that reported high asset growth and high profitability)? By contrast, why do the 61 institutions in the lower left-hand corner report both low growth and low profitability? The other corners indicate, respectively, institutions that were able to achieve high profits despite low growth and institutions that reported high growth but low profits. We lump the 280 institutions in the matrix's other five cells into a single unit that we term the "middle cross," to use as a control group for analysis. Figure 17 puts the data from the scatter plot of figure 16 into a simpler format.

Our analysis points to several key factors that indicate why groups of institutions are faring so differently:

- Significantly higher asset size appears to result in lower operating costs through economies of scale.
- Branching into other counties has benefited some banks but possibly hindered others.
- Risk taking differs considerably between the groups of banks.

Figure 17

Profitability, Growth Rates, and Asset Size of Community Banks in Great Plains Depopulating Counties, by Segment, 1999–2003



Notes: 1. Asset growth figures are merger-adjusted, asset-weighted annualized five-year growth rates.
2. Pretax ROA figures are merger-adjusted, asset-weighted annualized five-year pretax return on asset performance
3. Total asset figures are in millions

Source: Bank andThrift Call Reports, institutions meeting all of the following descriptives:
1. December 31, 2003, total assets of $250 million or less,
2. Established December 31, 1993, or earlier,
3. Headquartered in rural counties within the Great Plains Region, with either declining population or accelerated-declined population.

- Net interest margins differ significantly between the groups of banks.

Asset Size

Community banks that have achieved high earnings and high asset growth are the largest community banks, at a median $54.8 million in total assets. Banks that have achieved high earnings without commensurate growth also have relatively high levels of assets, at $41.2 million. By contrast, institutions that have achieved lower profitability are significantly smaller—$37.5 million for those with high asset growth, and just $21.5 million for those with low asset growth. These figures suggest that asset size is a significant determinant of success, and particularly of earnings.

Larger asset sizes can result in certain economies of scale, helping institutions keep operating costs relatively low. Our analysis indicates that larger banks posted significantly lower noninterest expenses (in relation to average assets) than smaller institutions (see table 13). When the earnings of banking groups that are most different—those with high growth/high earnings and those with low growth/low earnings—are compared with each other, operating expense is one factor that stands out. High-growth/high-earning banks reported annual noninterest expenses of 2.67 percent of average

Table 13

Operating Performance Measures of Community Banks in Great Plains Depopulating Counties, by Segment, 1999–2003

	High Growth/ High Earnings Banks	Low Growth/ High Earnings Banks	Middle Cross Banks	High Growth/ Low Earnings Banks	Low Growth/ Low Earnings Banks
Equity Capital Ratio (year-end 2003, %)	11.22	13.07	11.26	9.32	11.38
Growth Rates (1999–2003, annualized %)					
Assets	7.47	0.56	3.99	9.10	–0.80
Loans	9.21	2.30	5.31	9.82	0.55
Deposits	6.64	0.27	3.16	8.63	–1.08
Core Deposits	5.89	0.41	2.60	8.03	–0.80
NonCore Funding	15.43	1.15	11.32	14.78	–1.23
Branching Characteristics (% of institutions)					
Unit Banks	38.78	70.45	53.57	34.69	65.57
Multibranch—all in HQ county	14.29	20.45	13.93	16.33	19.67
Multibranch—some branches in metro counties	6.12	2.27	8.93	16.33	4.92
Multibranch—no metro branches but some in growing counties	18.37	0.00	8.21	10.20	4.92
Multibranch—but only in depopulating counties	22.45	6.82	15.36	22.45	4.92
Earnings Ratios (1999–2003, annualized %)					
Pretax Return on Assets	1.96	1.90	1.44	0.76	0.64
Net Interest Margin	4.49	4.28	4.15	4.07	3.87
Yield on Earning Assets	7.53	7.03	7.13	7.25	6.97
Yield on Total Loans	8.53	8.49	8.42	8.41	8.40
Cost of Funds	3.19	2.94	3.12	3.21	3.22
Noninterest Income/Average Assets	0.68	0.52	0.56	0.65	0.59
Noninterest Expense/Average Assets	2.67	2.48	2.74	3.25	3.18
Salaries and Benefits Expense	1.55	1.48	1.59	1.83	1.84
Premises Expense	0.32	0.29	0.34	0.46	0.41
Other Noninterest Expense	0.79	0.71	0.81	0.96	0.92
Provision for Loan Losses/Average Assets	0.20	0.07	0.20	0.35	0.34
Asset Quality Ratios (1999–2003, annualized %)					
Past-Due and Nonaccrual Loans/Total Loans	2.21	2.47	2.78	3.25	3.75
Charged-Off Loans/Total Loans	0.21	0.13	0.31	0.44	0.55
Asset Composition (1999–2003, annualized %)					
Earning Assets	92.06	92.02	91.84	90.80	91.36
Total Loans	64.68	53.85	56.16	61.19	52.21
Securities	23.87	31.03	31.05	25.06	31.77
Loan Composition (1999–2003, annualized %)					
Agricultural (RE secured and operating)	45.75	59.81	51.54	45.75	47.99
Commercial and Industrial (not RE secured)	16.45	12.06	14.67	16.45	15.12
1–4 Family Residential (all liens)	15.33	10.13	12.72	12.95	14.99
Commercial Real Estate	10.60	7.25	9.72	11.69	9.54
Consumer	10.21	8.61	9.59	11.66	11.01

Notes: Branch data are as of June 30, 2003.

Growth rates are merger-adjusted.

"Commercial Real Estate" loans consist of nonresidential real estate, construction and development, and multifamily housing loans.

Source: Bank and Thrift Call Reports, institutions meeting the following descriptives:

1. December 31, 2003 total assets of $250 million or less;
2. established in 1993 or earlier; and
3. headquartered in rural counties in the Great Plains that have declining populations since 1970.

assets, whereas low-growth/low-earning banks reported expenses of 3.18 percent. The primary difference between these groups is salaries expense, which accounts for more than half the difference in noninterest expenses between the two groups of banks. Apparently, larger institutions are able to spread managerial and other salaries across larger asset bases. A similar but smaller difference can be seen in premises expenses, which again are significantly lower in larger institutions because these banks can spread the expenses further.

Banks reporting low growth but high earnings have the tightest control on operating expenses: these banks reported noninterest expenses of just 2.48 percent of average assets. We noted above that these banks, too, are relatively large in size, with size again making possible some efficiencies of scale. In addition, perhaps the management teams of these institutions, realizing that opportunities for robust asset growth do not exist, have streamlined their organizations to maximize profitability. As we show below, these institutions tend to operate a single branch, albeit a large one, and this allows them to keep costs down. At the opposite end of the spectrum, banks with high growth and low earnings have reported the highest operating expenses, at 3.25 percent of average assets. Salaries, premises costs, and other noninterest expenses are all high in this group of banks compared with other groups.

Branching

Another significant factor in the success of community banks in depopulating areas is the willingness and ability to add branches appropriately. For many banks in the rural Great Plains, branching into areas that are more economically vibrant than the county of the bank's headquarters is a relatively popular strategy. But although such a strategy can certainly be expected to add to a bank's asset base, it may not always prove profitable.

Community bank managers have many branching choices available to them, including operating a single branch. In fact, just over half of Great Plains community banks located in depopulating counties are unit banks. As table 13 shows, the unit-bank option is most popular with low-growth/high-earning banks (70 percent), which appear to achieve high profits by keeping operating costs low. By contrast, far fewer high-growth/low-earning banks (35 percent) operate a single branch, but these banks may have sacrificed profits for growth. Even when we add in multiple branches inside the bank's "home" county, we find these same differences in branching patterns persisting. Low-growth/high-earning banks tend to have all branches within the home county, while high-growth/low-earnings banks tend to operate branches outside their home county.

The question is whether branching outside a bank's home county can be expected to improve a bank's prospects, and the answer is unclear. A case can be made that branching into other counties, especially those with more vibrant economies, was a primary factor in high-growth/high-earning banks' success, for 47 percent of these banks operate branches outside their home counties. These banks have achieved asset growth because of the branch expansion, but they have also been able to report high profitability. By contrast, only 15 percent of low-growth/low-earning banks have branched into other counties, at the cost of both growth and profit potential.

But branching can also be a risky proposition because management's knowledge of new markets, its expertise in new types of lending activities, and its ability to control expenses become more important. It would be reasonable to assume that high-growth/low-earning banks, nearly half of which operate branches outside their home county, might have lacked the management skills necessary to make such bold branching moves successful. Sixteen percent of these banks have branched into metropolitan counties, where the competitive arena—and therefore the required managerial expertise—is much different from what it is in rural areas.

Other balance-sheet components besides total assets are affected by branching decisions. For example, banks with high asset growth have been able to achieve relatively strong loan and core-deposit growth, but they have also significantly increased noncore funding. Low-growth banks have had difficulties retaining core deposits; in fact, from 1999 through 2003 low-growth/low-earning banks lost $22 million in core deposits and posted little loan growth.

Risk Tolerance

Another factor that appears to influence community banks' success is risk taking. Management's tolerance for risk is apparent in branching activities, capital levels, and asset composition, and differs significantly among the groups of banks we studied. Although high-growth banks tend to show increased levels of risk tolerance,

the fact that significant earning disparities exist suggests that risk taking can be a double-edged sword.

Adding branches, especially well outside a bank's headquarters county, is certainly a risky proposition, depending on management's abilities. Still, many institutions have proved successful at such branching moves.

Another area that evidences management's tolerance for risk is capital levels. As table 13 indicates, equity capital levels range from 9.32 percent for high-growth/low-earning institutions to 13.07 percent for low-growth/high-earning banks. Banks with high growth tend to have significantly lower equity capital levels than banks with low growth. As we saw with branching decisions, banks with high growth are willing to take greater risk, and whereas some have been rewarded, others have experienced far fewer benefits.

A significant divergence in risk tolerance is indicated by the share of assets held in loans. High-growth community banks hold substantially more loans (and, conversely, fewer securities) than low-growth banks. Since loans tend to have far greater credit risk than securities, these holdings tend to indicate management's greater tolerance for risk. In fact, researchers have found that in the agricultural crisis of the 1980s, the primary factor influencing whether a bank failed was the loan-to-asset ratio.[68]

Interestingly, despite high-growth banks' willingness to take on additional credit risk, an examination of loan composition within the different groups of banks reveals only relatively minor differences among the groups. The most significant differences are that low-growth/high-earning banks make substantially more agricultural loans and fewer single-family housing loans than the other groups, and that high-growth banks make slightly fewer farm loans but more commercial real estate loans. The fact that loan composition is comparable for all groups indicates that high-growth banks, despite taking on more loans, continue to make particular types of loans in roughly the same proportion as low-growth banks.

Although high-growth banks have made substantially more loans, high growth alone does not appear to indicate how the loans will perform. During the past five years, low-earning banks—whether or not they have been growing assets significantly—have reported elevated levels of past-due loans and significantly higher loan charge-off rates than high-earning institutions. In fact, charge-off levels at low-growth/low-earning institutions were more than four times higher than levels at low-growth/high-earning banks.

Net Interest Margins

When the earnings performance of community banks that are based in depopulating areas is examined, the disparity in net interest margins (NIMs) is particularly striking. The range of NIMs reported for 1999–2003 went from 3.87 percent for low-growth/low-earning institutions to 4.49 percent for high-growth/high-earning institutions. A considerable majority of community bank revenue is generated through the NIM; as a result, this difference is significant.

Differences in the NIM can be attributed to a variety of causes. First, some of the disparity can be linked to the substantial difference in loan-to-asset (LTA) ratios. Typically loans are characterized by far higher yields than securities, federal funds sold, or other "earning" investments; as a result, higher loan volume usually translates into higher levels of net interest income. Thus, high-growth/high-earning banks, with an aggregate LTA ratio of 65 percent, report higher yields on earning assets than low-growth/low-earning banks, with an aggregate LTA of only 52 percent.

However, low-growth/high-earning banks have achieved the second-highest aggregate NIM, despite having a relatively low (54 percent) LTA ratio. These banks appear to have achieved their NIMs through a combination of a very low cost of funds (at 2.94 percent, by far the lowest of the groups) and relatively high loan yields. Low funding costs have been achieved through high levels of core deposits (the second highest of the groups) and low-growth prospects that do not require the raising of higher-cost funds. High loan yields appear to be the product of the group's loan mix, which has more agricultural loans and fewer residential loans than the mixes of the other groups, but could also be the product of stable lending relationships and the fact that these banks are not entering new, highly competitive lending areas.

[68] FDIC (1997), 281–82.

The Effect of the Internet on Customer Base

Beyond these differences in bank performance, does a cure exist for community banks in depopulating rural areas? One common response from rural bankers is that the Internet could be the elixir that helps them to overcome their problems, but this remains to be seen.

Use of the Internet in rural America is widespread and growing.[69] In fact, the adoption of computers by farm households is similar to that by U.S. households in general.[70] Clearly, rural populations can benefit from using the Internet, which expands their choices for goods and services and reduces the burden of being located in geographically remote areas. Although it may be an overstatement to suggest that the Internet could abolish distance entirely, it is certainly true that the Internet can enhance the ability of farmers, rural consumers, and rural businesses to access information, goods, and services from faraway sources and that such access may perhaps increase the economic viability of rural areas. Thus, some economists view the Internet as the possible savior of rural areas, for companies could locate their businesses in rural areas, taking advantage of lower costs for labor and land and less-stringent environmental regulations while still marketing their products to urban end-users.

Although many economists argue that the Internet has the potential to improve the economic prospects of rural communities, the history of earlier technological innovations suggests otherwise. In the early 1900s, for example, it was widely thought that expanding telephone service to rural areas would solve the depopulation problems of that time.[71] As we point out above, similar claims were made when the automobile became available in rural areas in the 1920s and when rural electrification became widely available after World War II, but some believe that these innovations actually increased the pace of rural-to-urban migration rather than decreasing it.

Proponents of the Internet see it as a bridge from rural communities, in that rural populations can reach beyond their local communities to shop and conduct business, but those who are more skeptical about the rural benefits see the potential for the Internet to provide a bridge to rural areas, in which non-local businesses can easily enter rural areas to compete. Rural residents are increasingly able to use the Internet to shop for goods and services anywhere in the country, rather than use the products and services of local businesses that have long served them. For community banks, the spread of the Internet, in the best-case scenario, would allow them to expand their customer bases electronically even while their local populations are declining. However, in that scenario, the banks also would effectively be undoing the geographic ties that bind them to their customers.

Furthermore, the Internet may also allow larger banking companies to market their products in rural areas where locating a physical branch might never have been feasible. Large banks typically have a wider array of products than rural banks, and their size allows large banks some scale benefits in the cost of providing banking services. When use of the Internet is widespread in rural areas, therefore, these larger companies may become very formidable competitors of rural institutions.

[69] Much of this section is drawn from Walser (2002).
[70] Abbott, Yarbrough, and Schmidt (2000), 220.
[71] Kline (2000), 24.

Part 3. Policy Approaches and Prospects

What does the future hold for depopulating rural counties in the Great Plains and for the insured financial institutions that are headquartered there? As we have seen, of the four regions studied, the Great Plains is the one where rural depopulation seems most extensive and severe. The low population densities, the relative isolation of the population, the lack of natural amenities, and the dearth of opportunities for nonagricultural industries all pose significant obstacles to any strategies to reverse the trend. In addition, the very low populations of many Great Plains communities, in tandem with high concentrations in agriculture, make these communities highly vulnerable to slipping below the threshold of continued economic viability.

Policy makers at every level continue to search for solutions to the problem of rural depopulation in the most severely affected counties. The question is what public policies are appropriate responses to the continuing depletion of the populations of many rural areas.

One viewpoint holds that rural depopulation is the result of fundamental economic forces, or the cumulative effect of millions of individuals responding to market forces. The proponents of this view maintain that the role of public policy should be limited to programs that facilitate migration from the rural areas. These programs may include educating and training rural residents to improve their skills, thereby presumably improving their attractiveness to employers. Such programs would typically have a short-term orientation and would work in concert with the underlying market forces.[72] These policies would be expected to adversely affect community banks in depopulating areas, for the banks' customer bases would continue to erode. The programs favored by the advocates of this viewpoint are labeled by some observers as "rural transition programs."

Advocates of the opposing viewpoint favor an "economic development strategy" that would use government funds to reverse market forces and restore viability to declining rural areas. Theirs would be a long-run strategy, addressing the needs of those left behind—those who are unwilling or unable to migrate. Economic development policies are usually justified by arguments that lie beyond economics, such as the social value of the rural lifestyle. Such policies typically include expenditures for the development of infrastructure and the enhancement of business opportunities.[73] These policies could ultimately benefit community banks in counties where such policies were implemented, but the ultimate cost of such programs could be substantial.

On a smaller scale, some communities have implemented economic development policies that have shown some promise. For example, several communities in Kansas—most recently the city of Marquette—have given away land if a new residence or business were erected on it. While these efforts have worked well for these communities, their scale is much too small to be considered as a macro policy to reverse depopulation trends throughout the Great Plains.

Communications technology (e.g., the Internet and the continued spread of broadband access into rural areas) potentially holds some promise for depopulating counties. Rural businesses hope that such technology will allow them to market their goods and services to customers well beyond the businesses' own county lines. However, such technology could become a bridge to these communities as well as the hoped-for bridge from them: urban businesses, including large banks, would have the means to reach into isolated rural communities, thus becoming a powerful new source of competition.

On the bank regulatory side, one effort that may assist rural community banks is the federal agencies' work in reducing federal banking regulations. A law known as the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) requires the federal financial regulatory agencies to identify outdated, unnecessary, or unduly burdensome statutory or regulatory requirements for possible elimination. These efforts could reduce the operating costs of financial institutions, and be of particular importance to small banks, which, because of their size, have disproportionately high legal compliance costs.

Looking ahead, we foresee increasing bank consolidation in depopulating rural areas, potentially altering the number of institutions dramatically over the next

[72] Drabenstott, Henry and Gibson (1987), 47.

[73] Ibid., 51.

20 years. Community bank consolidation in these areas has yet to outpace the consolidation elsewhere in the nation, but two factors are approaching a critical juncture. First, the large pocket of very elderly people in rural depopulating counties points to a future significant weakening of community bank customer bases. Second, in areas where the lack of succession plan is due to the lack of younger, capable bank managers, many retiring bank owners could have no option but to sell their institutions.

In the meantime, the strategic options available to community banks in depopulating counties are limited. Over the short term, community bank success in rural areas could depend on management's willingness to take well-conceived risks, such as branching into more economically vibrant areas. However, many management teams may not have the expertise to do this without heightening their institutions' risk profiles. Another viable strategy may be for management to streamline their institutions, cutting costs wherever possible, to remain profitable despite the absence of local opportunities for growth.

While the current economic prospects of the Great Plains rural counties remain foreboding and bank consolidation may increase considerably over the next 20 years, rural banking is by no means entirely discouraging. As discussed in this paper, many insightful bank managers have already crafted strategies to combat the demographic challenges and have been rewarded with strong profitability, asset growth, or both. Such managers will continue to do so, even if the numbers of rural banks continue to dwindle around them. The result could be that while there may in fact be far fewer rural banks in the future, the rural banking system still may be intact and strong.

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The Future of Banking in America

The Mixing of Banking and Commerce: Current Policy Issues

*Christine E. Blair**

Introduction

The issue of whether, or to what extent, banking and commerce should be allowed to mix is again the focus of a public policy debate. The issue often arises when criteria for permissible activities for a bank and its owners, subsidiaries, and affiliates are being discussed, as they are now. Although there is no hard evidence that combinations of banking and commerce are harmful, there is no evidence that they are beneficial, either. Nevertheless, developments in the foreign and domestic marketplaces suggest that combinations involving banking and commerce are becoming more common. Thus, the debate has been renewed.

The current debate centers on industrial loan companies (ILCs), also known as industrial banks. ILCs are state-chartered institutions that have banking powers, subject to certain restrictions on lending and deposit taking. ILCs are regulated by their state chartering authorities and, at the federal level, by the FDIC. The unique nature of the ILC charter has kept these institutions outside the purview of the Bank Holding Company Act (BHCA). As a result, the parent companies of ILCs include a diverse group of financial and commercial firms.[1]

Two pieces of legislation passed by the U.S. House of Representatives in 2003 have focused attention on whether ILCs should be considered equal to other insured depository institutions with regard to powers such as interstate banking and payment of interest on business checking accounts.[2] Consumer groups and community bankers have responded to the proposed legislation by raising questions about its competitive effects. In particular, concerns focus on the possibility that commercial entities, which in certain states can enter banking by acquiring an ILC charter, could branch nationwide. For example, in 2002, Wal-Mart

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[1] ILCs are discussed more fully in a later section of this paper.

[2] In April 2003, the House passed both H.R. 758 and H.R. 1375. The former is the proposed Business Checking Freedom Act, which would allow banks to pay interest on business demand deposits and would permit ILCs to offer their corporate customers interest-bearing negotiable order of withdrawal (NOW) accounts. The latter is the proposed Financial Services Regulatory Relief Act of 2003, which would remove the remaining regulatory barriers to interstate de novo banking: banks and ILCs would be allowed to use start-up branches to cross state lines. In March 2004, the House amended H.R. 1375 to restrict the ability of certain ILCs to branch interstate: only ILCs that had been established before October 1, 2003, and were owned by companies such that no more than 15 percent of income is derived from nonfinancial sources would be permitted to branch interstate. The amendment effectively prevents commercial firms such as Wal-Mart from using the ILC charter to develop a branch banking business. As of March 2004, none of these issues had been addressed by the Senate.

attempted to acquire an existing ILC in California. In response, the California legislature amended the state's law, thereby prohibiting a commercial entity from making such an acquisition, and Wal-Mart subsequently withdrew its notice. Other concerns focus on whether federally insured depository institutions, including insured ILCs, should be allowed to pay interest on business checking accounts; some people argue that if they were, the ILCs would have a competitive advantage over other insured depository institutions. Finally, fears have been expressed that the failure to prohibit such a mixing of banking and commerce could lead to a situation like that in Japan, where informal links between commercial firms and banks have raised safety-and-soundness concerns.

The Federal Reserve Board has expressed concern that expanding the powers of ILCs would weaken the legal barriers separating banking and commerce. The Board argues that there is a long-standing policy of separating banking and commerce and that the proposed expansion would undermine that policy. Although the FDIC has the authority to examine the parent of any ILC, the Federal Reserve Board argues that the absence of federal oversight of the owners of ILCs threatens the safety and soundness of the banking system.[3]

As the primary federal regulator of ILCs, the FDIC has expressed the view that these institutions pose no greater safety-and-soundness risk than do institutions with any other charter.[4] Rather, the challenge facing bank regulators is to ensure that market innovation can take place while maintaining the public's confidence in the banking system. As FDIC Chairman Donald Powell has noted, regulators must guard "against the possibility that the regulatory system itself does not impair the vital process of innovation and change that is the lifeblood of the American marketplace."[5]

And so the stage is set and the debate over banking and commerce continues.[6] The relevant questions are should banking and commerce should be allowed to mix, and if they mix, should the combination be regulated?

[3] See, for example, Greenspan (2003).
[4] See Powell (2003a).
[5] See Powell (2003b).
[6] On July 16, 2003, the FDIC held a symposium at the National Press Club in Washington, D.C., entitled "The Future of Banking: The Structure and Role of Commercial Affiliations," where the issue of affiliation between banks and commercial firms was discussed. Several of the papers presented there are referenced in this paper. Information on the symposium can be found at http://www.fdic.gov/news/conferences/future.html.

This paper examines the arguments in terms of the public interest; reviews the evidence about an alleged long-standing principle of separation; explores the benefits of, and then the risks posed by, affiliations between banking and commerce; discusses firewalls and prudential supervision; spells out two approaches to regulating affiliations; and concludes with a summary and a discussion of policy implications.

Separation versus Affiliation: The Public Interest

There are generally two views on whether banking and commerce should be separated. The first view argues that a line of separation must be maintained because the risks of allowing banking and commerce to mix outweigh the possible benefits. The failure to maintain a separation of banking and commerce, especially in terms of ownership and control of banking organizations, could have potentially serious consequences, ranging from conflicts of interest and the lack of impartiality in the credit decision-making process to the unintended expansion of the financial safety net. To adequately protect the insured entity from such abuses (it is argued), the insured entities' corporate owners need to be subject to federal supervision and regulation.[7] This viewpoint has been articulated over the years by (among others) the Federal Reserve Board, some members of Congress, and community bankers; many of these advocates of separation claim that their position is based on a long-standing principle of the separation of banking from commerce (this claim is examined in detail below).[8]

The other view argues that mandating a separation of banking and commerce prevents the benefits of affiliation from being realized and can result in an inefficient allocation of resources. Given adequate supervisory oversight of the insured entity, federal regulatory and supervisory authority over the corporate owners of the insured entity represents an unwarranted hampering of the market process that is neither necessary nor desirable. This view has been expressed by (among others) the FDIC, some members of Congress, and public policy groups.[9] The FDIC has long argued that with certain safeguards in place to protect the bank and ensure the safety and soundness of the banking system,

[7] Such oversight of bank holding companies has been the purview of the Federal Reserve Board under the Bank Holding Company Act (BHCA).
[8] See, for example, Corrigan (1987, 1991) and Jorde (2003).
[9] See, for example, FDIC (1987a, 1987b) and Wallison (2003).

affiliations between banking and commerce should be permitted.

Although the current debate centers on the industrial loan charter, the underlying policy issues—which have been debated for many years—come down to whether the public interest is served when affiliations between banks and commercial entities are prohibited.

Testifying before Congress on financial services reform in 1987, the FDIC's then-chairman L. William Seidman argued that the public interest would be best served by a financial services industry that met four objectives: the financial system should be viable and competitive, the banking system should be operated in a safe and sound manner, customers should realize benefits from enhanced competition, and the system should be flexible enough to respond to technological change.[10] Consistent with these objectives, the regulatory and supervisory structure of banking should be the simplest and least costly one available.

The question facing policy makers then was—and continues to be—whether these objectives can be met without restricting the ability of banks to choose the corporate structure that best suits their business needs. As Seidman noted: "The pivotal question . . . is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries?"[11] If so, then the banking and commerce debate should focus on how affiliations should be regulated so that the public interest is met.

A Long-Standing Principle of Separation?

The literature on the issue of a long-standing principle of separating banking and commerce is extensive.[12] This literature shows that the extent to which banking and commerce have mixed or have remained separate has been a function of the demands of the marketplace, the level of technology and the state of development of organizational and business structures. Recently, Haubrich and Santos (2003) dispel any notion that a separation of banking and commerce has been a long-standing principle in American banking history. They conclude that despite the regulations and prohibitions on certain activities and forms of control, extensive links between banking and commerce have existed and continue to exist and have often been facilitated by the use of arrangements very similar to those that have been prohibited by law.

For example, certain charter types—including limited-purpose consumer banks and ILCs—permit a mixing of banking and commerce. These charter types do not fit the definition of a bank under the BHCA and technically are not banks; in certain states, they can be owned by commercial firms. These firms, in turn, are not subject to the BHCA and are not required to become bank holding companies.[13]

And there is other evidence of banks exercising control over commercial firms, and commercial firms exercising control over banks, through various means. Sometimes, as legal restrictions were placed on the mixing of banking and commerce, certain exceptions were made that allowed commercial firms to retain their affiliations with banks. Examples include the limited number of nonbank banks that were grandfathered by the Competitive Equality and Banking Act of 1987 (CEBA), and the unitary thrift holding companies that were grandfathered under the Gramm-Leach-Bliley Act of 1999 (GLB). Sometimes, the mixing has resulted from the equity investments of banks, including investments in small business investment companies, equity acquired in loan workouts and equity kickers, and merchant banking activities. Outside of chartered banking, captive finance companies of large commercial firms (e.g., GE Capital) also approximate a mixing of banking and commerce. Moreover, individuals are permitted to hold a controlling interest in both a bank and a nonbank commercial firm. For example, in the case of chain banking organizations, federal regulatory oversight does not extend to the owner.[14]

[10] See FDIC (1987b), 3.

[11] Ibid.

[12] See Golembe (1997) for an overview of the policy issues. See also Blair (1994, 2004), FDIC (1987a), Halpert (1988), Hammond (1936, 1957), Haubrich and Santos (2003), Redlich (1951a), Shull (1999), and Symons (1983).

[13] Limited-purpose consumer banks, which are national or state-chartered banks and operate under certain restrictions, are discussed in Yom (2004). Industrial loan companies are discussed below under "The Bank-Up Approach to Regulation" and in West (2004).

[14] Because most states in the early part of the twentieth century prohibited branch banking, chain banking provided a way for one or more individuals to hold control in a chain of several banks. When permitted by law, chain banking organizations often were turned into branch banks or evolved into bank holding companies. See Klebaner (1990).

International comparisons of the treatment of banking and commerce are instructive. The U.S. practice of prohibiting affiliations between banking and commerce contrasts with the practice of most other industrialized countries, since in these countries linkages among banking and commercial entities in the form of ownership and control are common. Throughout Europe, where universal banking is common, and in Japan, where the keiretsu is a dominant business form, banking and commerce traditionally have had greater freedom to mix.[15]

U.S. banking is in fact characterized less by a tradition of being separate from commerce than by regulatory attempts to separate it from commerce. Since the banking crisis and economic depression of the 1930s, these attempts have focused on prohibiting affiliations between banking and commercial firms—that is, on separating banking from commerce at the ownership level. In 1933, responding to the general belief that the nation's banking and economic problems had been caused by conflicts of interest between banks and their securities affiliates, Congress passed the Glass-Steagall Act, which prohibited affiliations between commercial and investment banking. Two decades later, in 1956, a general and long-standing distrust of large banking conglomerates combined with the increased merger activity of the 1940s and early 1950s led to the passage of the BHCA, which separated banking from commerce by restricting the activities of owners and affiliates of banks. The BHCA defined bank holding companies and established a framework for their regulation by the Federal Reserve. The restrictions on ownership and affiliation that are currently in effect stem from the BHCA and its subsequent amendments.

Throughout the remainder of the twentieth century, rapidly changing technology and the changing nature of banking led to increasing demands for the banking system to be restructured and given broader powers.[16] At the same time, the regulatory line separating banking from commerce was being weakened as banks increasingly found ways to engage in a range of financial activities.[17] And other financial services providers found ways to offer bank-like products to their customers, one example being the cash management account offered by securities firms. After repeated congressional attempts to address financial modernization, GLB was passed in 1999, effectively acknowledging and extending the degree to which banking organizations were permitted to engage in nonbank financial activities.[18]

[15] The European-style universal bank has greater freedom to be owned by, and to own, nonfinancial firms (Barth, Caprio and Levine [2000]). Barth, Caprio and Nolle (2004) present a relative ranking of countries by permissible banking activities and ownership restrictions, noting that countries generally place greater restrictions on the ability of banks to own nonfinancial firms, than on the ability of nonfinancial firms to own banks. The EU countries are ranked among the least restrictive countries, while the United States ranks as one of the most restrictive, although the data used was compiled before the passage of GLB. Shull and White (1998), 14, note that a pure universal bank requires neither subsidiaries, affiliates, nor holding companies. Traditional banking and nontraditional activities are carried out in an integrated manner; that is, they are not separated by firewalls nor the legal doctrine of corporate separateness. Universal banks typically provide both short-term banking credit and underwriting and equity investments for intermediate and long-term capital formation. They are characterized by close and long-term relationships between the bank and its commercial and industrial customers. The Japanese keiretsus are conglomerate groupings in which banks are linked to their client companies through equity ownership. Concerns that the mixing of banking and commerce would produce a concentration of power have evoked comparisons with these systems. The comparisons, however, are misleading, for the close ties among the government, commercial firms, and banks found in the Japanese keiretsus and between European universal banks and commercial firms are unlikely to be replicated in the United States. U.S. capital markets developed early and have been an important source for corporate funding, especially relative to European markets. And U.S. banking law prohibits banks and commercial firms from being both creditors and shareholders. As an example, if Citigroup were acquired by General Electric (or vice versa), the bank subsidiary (or affiliate) would continue to be prohibited from owning stock in the other.

[16] The FDIC was among those calling for such financial modernization; see FDIC (1987a). See Corrigan (1987) for the perspective of the Federal Reserve. The U.S. Treasury also made recommendations for modernizing the financial system; see U.S. Department of the Treasury (1991).

[17] Before passage of GLB, banking organizations had been permitted to engage in the following: the post–Glass-Steagall securities activities in which bank holding companies were permitted to engage through Section 20 subsidiaries, the securities activities that the states permitted to subsidiaries of state-chartered nonmember banks, and activities that the OCC permitted to operating subsidiaries of national banks under its interpretation of the National Bank Act. Also included were the insurance activities of state-chartered banks and the insurance agency activities permitted to banking organizations and national banks operating in communities with populations under 5,000.

[18] GLB provided for affiliations between qualifying bank holding companies—called financial holding companies—and securities and insurance firms. The Federal Reserve Board was designated the umbrella regulator of the financial holding company, while the bank, securities, and insurance affiliates were to be supervised on a functional basis. The Federal Reserve (in conjunction with the Secretary of the Treasury) was authorized to determine the set of activities—those that are financial in nature, or incidental to such financial activities—that are permitted within the financial holding company. In addition, the Federal Reserve can determine that complementary activities that do not pose a significant risk to the safety and soundness of depository institutions or of the financial system generally are permissible activities. GLB also recognized merchant banking as financial in nature and a permissible activity for financial holding companies.

In summary, banking has never been absolutely separate from commerce. Although the activities permitted to banks have always been subject to prohibition, restrictions on affiliations with nonbank firms are relatively recent. Moreover, despite the regulatory line prohibiting affiliations between banking and commercial firms, it is likely that the market will continue to move toward a greater blending of banking and commerce. The linkages that exist between banking and commerce outside of the current restrictions on ownership or activity can also be expected to continue.[19] Thus, as has recently been noted, "It is perhaps better to replace the claim that banking has been separated from commerce in the United States with the observation that regulations have attempted to separate banking and commerce."[20]

The Potential Benefits of Affiliation

The potential benefits of mixing banking and commerce are well known and have been discussed in the economics literature.[21] Among the potential benefits are operational efficiencies—cost and revenue synergies—including economies of scale, economies of scope, and informational efficiencies. Other potential benefits may result from greater product and geographic diversification, access to new sources of capital, and enhancement of the global competitiveness of U.S. banks.

Cost synergies can result from economies of scale (when increasing the scale of operations lowers the average costs of production) or from economies of scope (when costs of production are lowered by the production of products that share inputs). Finding empirical evidence for the existence of these economies in banking has proven to be difficult.[22] However, the lack of demonstrable economies in banking does not imply a lack of cost complementarities between banking and other commercial activities. For example, the entrance of commercial firms into bank-like activities may be evidence of economies of scope. Technological innovations in recent years have made combinations of banking and commerce in the United States economically feasible and profitable. Changes in the cost structures of banks and commercial firms alike, which are the result of improvements in technology, also leave room for potential economics of scope.

Should economies of scope exist, they would provide one incentive for banks and commercial firms to seek mergers with one another. However, even though GLB has lessened the restrictions on affiliations among banks and securities and insurance firms, the limitations on bank activities and commercial affiliations have largely kept U.S. banks from availing themselves of the possible synergies.

A further incentive for affiliating may come from informational efficiencies.[23] For example, banks could have an incentive to hold equity positions in commercial firms if doing so would make it easier for them to gain the information necessary for their role as intermediary. In addition, holding equity can limit the bank's exposure to moral hazard. Bank financing of start-up ventures, when an equity claim substitutes for collateral, is an example. The equity claim can provide the bank with information about, and the ability to exercise control over, the commercial firm. These informational incentives would probably result in bank ownership of commercial firms, but not commercial ownership of banks.

Other literature has focused on the implications of banks holding equity positions in borrowing firms. For example, Pozdena (1991) cites arguments in favor of lifting existing restrictions on commercial and bank affiliations, noting that the ability simultaneously to hold the equity of commercial firms and lend to them is important to the successful intermediation of risky credits. Santos (1999) examines the implications—given deposit insurance—of equity stakes when funding is provided by a bank rather than a financier: mixed debt and equity are shown to control moral hazard. Haubrich and Santos (1999) argue that there is a liquidity synergy that gives banks an incentive to own a nonfinancial firm: by creating an internal market, merging with a nonfinancial firm increases the bank's efficiency in disposing of assets that back defaulted loans.

Other incentives for affiliations between banking and commercial firms include enhanced product

[19] See, for example, Haubrich and Santos (2003).
[20] Haubrich and Santos (2003), 112.
[21] Halpert (1988), Saunders (1994), Shull and White (1998), and Krainer (2000), among others, discuss the potential benefits and costs of mixing banking and commerce. (Potential risks are discussed in the next section of this paper.)
[22] See Saunders (1994), Shull (1999), and Krainer (2000) for a discussion of the literature.
[23] See Krainer (2000).

and geographic diversification and greater access to capital.[24] Affiliations could lead to the diversification of the combined organization's portfolio risk, although the effect is likely to differ among banks of different size. Large banks with overseas operations that are permitted equity investments would probably see a smaller effect from affiliations at home than would smaller banks with no overseas presence. Although access to new capital was thought to be a compelling argument for affiliation in the early 1990s, when the cost of capital to banks was high, the immediacy of the need disappeared with the decade-long banking recovery and with structural changes (such as interstate branching) that have facilitated mergers.[25]

Affiliations between banking and commercial firms can also enhance the global competitiveness of U.S. banks. As noted, many other countries do not place similar restrictions on the affiliation of banks with commercial entities, with the result that combinations of industrial, commercial and banking firms are common.[26] It can be argued that this potential benefit was tacitly acknowledged by the provisions of GLB that allow financial holding companies to engage in limited merchant banking activities for investment purposes. As such, these provisions result in a mixing of banking and commerce that was heretofore prohibited to U.S. banks.[27]

[24] Shull (1999) and Saunders (1994) discuss these incentives. Shull notes that many of the same issues that arose in the debates over bank expansion into finance (the securities and insurance businesses) are relevant to the debate about banking and commerce.

[25] In 1991, the U.S. Department of the Treasury published an interagency study that made recommendations for modernizing the financial system (see U.S. Department of the Treasury [1991], 54–61). The study recognized the benefits of lowering the barriers between banking and commerce, but it did not recommend lowering them evenly. Affiliations between banking and commercial firms were recommended partly as a way to infuse capital into a then-weak banking system. The study recommended that commercial firms be allowed to own banks indirectly through a financial services holding company, although banks and bank holding companies were not to be permitted to acquire commercial firms as subsidiaries or hold equity claims on commercial firms on their balance sheets. Banks and financial firms would have been able to affiliate with each other.

[26] One example is DaimlerChrysler, which was formed in 1998 from the merger of Germany's biggest industrial group, Daimler-Benz, with Chrysler Corporation. The mixing of banking and commerce in this case arises from the ownership position held by Germany's Deutsche Bank in the former Daimler-Benz. DaimlerChrysler's long-range plans called for the creation of a global entity that would include automobile leasing and finance, information technology, real estate, and telecommunications, into one financial-services provider.

[27] Haubrich and Santos (2003), 159, note that although the merchant-banking provisions do not allow banks to own or operate nonfinancial firms, the possibility of bank control of nonfinancial firms remains.

Questions remain about the extent to which an incentive exists for banks and other firms—financial and nonfinancial alike—to affiliate. For example, large firms such as Sears Roebuck and Ford Motor Company took advantage of the unitary thrift charter during the 1980s, only to sell those thrifts subsequently. Krainer (2000) reports speculation that these firms may have wanted to capture tax losses at troubled thrifts rather than establish a long-term presence in banking. Another possible conclusion is that the combination of banking and commerce may be less attractive to commercial firms than some might expect.[28]

The Potential Risks of Affiliation

The potential risks from allowing banking and commerce to mix that are cited most often are the potential for conflicts of interest and for the misallocation of credit; the fear of, or aversion to, a concentration of power—financial or economic—that could lead to monopolies; and the potential for an expansion of the federal safety net, which could expose the taxpayer to losses. (A discussion of these risks and whether they justify a separation of banking and commerce is presented in this section. The following section expands on the ways of managing the risks.)

Conflicts of Interest

Potential conflicts of interest exist whenever an entity that serves more than one interest is in a position to favor one of those interests over the other(s).[29] In banking, the opportunity for self-dealing at the expense of bank clients, beneficiaries of the bank's trust accounts, or bank creditors may create conflicts of interest. Conflicts of interest may also result from transactions between the bank and its affiliates, and these are the situations focused on by the debate about the separation of banking and commerce. For example, a bank affiliated with a commercial firm may choose to deny loans to the affiliate's competitors, may choose to lend preferentially to its commercial affiliate(s), or may illegally tie loans to purchases of the affiliate's products. Other sources of potential conflict of interest exist as well and are also discussed in this section.[30]

[28] Other literature suggests that there are limits to the synergies between commercial and investment banking. See Craig (2004).

[29] FDIC (1987a), 46. Conflicts of interest are also discussed in Halpert (1988) and Walter (2003).

[30] Craig (2004) notes that the recent expansion of commercial banking into investment banking, as allowed under GLB, has increased the potential for conflicts of interest.

Denying Credit to the Affiliate's Competitors. Does a bank with a commercial affiliate have an incentive to deny credit to its affiliate's competitors? From an economic perspective, given a competitive market for loans, a bank that unreasonably prefers its own affiliates is likely to suffer diminished earnings. When alternative sources of funds are readily available, the competitor will receive its funding elsewhere, but the bank will lose the profit it would have made on the loan. By denying loans to an affiliate's competitors, the profits of the consolidated banking organization will be lower than they would have been otherwise. However, such an incentive could exist if markets were not competitive, or if the affiliation yielded informational synergies so that the bank had a cost advantage over its competitors. In either case, the bank would have an incentive to deny credit to its affiliate's competitors.[31] The question then becomes how to counteract the bank's incentive, which is discussed below.

Preferentially Funding the Affiliate. A situation in which the bank could choose to lend preferentially to its commercial affiliates, whether willingly or under duress, could arise because of the bank's access to lower-cost funds as a by-product of federal deposit insurance. This argument for separation, too, fails to hold in a competitive market for bank loans. Again, the nonaffiliated customer will be able to obtain loans from other providers at a competitive rate, and the bank's decision not to lend to its affiliate's competitors at competitive rates will result in lower profits. Moreover, this potential conflict has been addressed by Sections 23A and 23B of the Federal Reserve Act, which restrict the amount and terms under which banks can lend to their affiliates.[32]

Tying Loans to Purchases of the Affiliate's Products. Tying loans to other business has the potential to harm the corporate customer or the bank. Tie-in arrangements are illegal under antitrust laws for all businesses, but Congress made it much easier to prove a tying arrangement when a bank was involved. The BHCA eliminates the need for the plaintiff to establish the economic power of the bank and the specific anticompetitive effects of the tie-in arrangement, as would be required under the general antitrust laws.[33] Section 106(b) of the BHCA prohibits anticompetitive tying practices: banks are prohibited from requiring customers to obtain nontraditional banking services or products in return for loans or a discounted banking service. This provision also precludes a bank from tying its banking services or products to the requirement that the customer not obtain some product or service from a competitor of the bank or its affiliates. Section 23B of the Federal Reserve Act, which requires transactions between affiliates to be at arm's length and on market terms, also serves to prohibit certain tying arrangements.

Tying is legally permissible in certain circumstances.[34] For example, a bank may restrict the availability or vary the price of a loan on the condition that the customer also obtain a traditional bank product from the bank or an affiliate.[35] Tying violations generally involve the tying of loans with securities or insurance services or products. However, restrictions on tying can be avoided. For example, there is no violation if the loan is booked through a nonbank affiliate or parent holding company. Tying prohibitions do not apply to investment banks or to U.S. banks' business with non-U.S. companies. Moreover, tying is permitted when the transaction is requested by the customer rather than initiated by the bank.[36]

The federal banking regulators have recently addressed the incidence and effect of illegal tying. In August 2003, the Federal Reserve Board issued a proposed regulation that would define the terms under which banks can legally engage in tying. The Office of the Comptroller of the Currency (OCC) also reported on the extent to which illegal tying poses concerns. Both agencies concluded that illegal tying was not a widespread

[31] Halpert (1988), 508–9, notes that concern over this potential conflict of interest was expressed during the congressional debates that preceded the 1970 amendments to the BHCA, which expanded the BHCA's purview to all bank holding companies. At that time, one-bank holding companies were free to engage in commercial activities through nonbank affiliates without being subject to the BHCA. Supporters of the amendments claimed that deposit and asset growth of one-bank holding companies threatened the availability of credit to nonaffiliates, although no evidence of such behavior was presented.

[32] Federal Reserve Act, ch. 6, §§23A and 23B (1913) (codified as amended at 12 U.S.C. §§371c and 371c-1 (2001)).

[33] Bank Holding Co. Act Amendments of 1970, Pub. L. 91-607, Title I, §106(a)–(h), 84 Stat. 1766 (1970) (codified as amended at 12 U.S.C. §§1971–78 (2001)).

[34] Legal tying might be better described as cross-selling.

[35] Craig (2004) notes that the Federal Reserve Board recently clarified the following as traditional bank products: loans, discounts, deposits, trust services, cash management, custodial services, payroll services, settlement and wire transfer services, and discretionary asset management.

[36] Several banks have recently faced losses from lines of credit that were extended to corporate customers in return for receiving that corporation's underwriting business. In this sense, legal tying or cross-selling can lead to losses that could threaten the bank's safety and soundness. See Craig (2004).

problem among U.S. banks and that banks generally had adequate procedures to comply with antitying restrictions. In October 2003, the U.S. General Accounting Office released a study on the incidence of illegal tying and concluded that the extent of such tying is minimal and does not pose significant problems.[37]

Other Potential Conflicts of Interest. Another potential conflict of interest is to use inside information to benefit the bank at the expense of a nonbank affiliate or an investor. The bank has access to private information as part of its commercial lending and trust activities, and typically the privacy of such information is achieved through the use of firewalls between respective departments of the bank. This conflict can also arise between the bank and its investment banking affiliates. For example, if a corporate customer of the bank were in financial distress and, in turn, the bank's loans to that firm were in jeopardy, the bank's parent would have an incentive to underwrite bonds for the firm through its securities affiliate—bonds that could then be used to pay off the troubled bank loans. Or the parent could use the securities affiliate to underwrite high-risk issues and could use the bank to extend loans to preferred customers. (Again, current law addresses these possibilities by establishing firewalls that prohibit the sharing of inside information between a bank and its affiliate.)

Other conflicts can arise from the bank's dual role as marketer of services and impartial investment advisor. Recent studies have found evidence of conflicts between promoting services and giving disinterested financial advice.[38] Most recently, significant conflicts between the bank's role in promoting the securities it underwrites and its role in providing disinterested financial advice have been identified and addressed. In April 2003, the nation's biggest investment firms agreed to pay a record $1.4 billion to settle charges brought by the Securities and Exchange Commission, state prosecutors, and market regulators. The firms were charged with fraud in issuing recommendations for the securities of firms they knew were in trouble, in order to acquire investment banking business. In addition to significant fines, the settlement requires the following: a clear separation of securities research from investment banking; the provision of competing, independent research for investors at no cost; better disclosure of stock rankings; and a ban on the practice of allotting initial public offering shares to favored clients.[39]

* * *

On examination, the principal potential conflicts that are offered as a rationale for separating banking and commerce seem unlikely to pose significant risks to the safety and soundness of the bank or to the federal safety net. Firewalls—including the restrictions on the transactions between a bank and its affiliate imposed by Sections 23A and 23B of the Federal Reserve Act, the BHCA Section 106 restrictions on tying, and Federal Reserve Regulation O (which restricts transactions with insiders)—are in place to mitigate the incentives underlying the potential conflicts.[40] And market-oriented solutions—for example, competition in the markets for banking products—can also play a role in mitigating those incentives. If markets were not competitive, competition could be increased through the elimination of barriers to entry. Or if affiliation provided an informational advantage, banks without affiliates could achieve the same result, as they have done through leasing arrangements with grocery chains and other commercial firms. In short (and the point is elaborated on below), most conflict situations affecting banks can be controlled through the supervisory process and enforcement of the appropriate firewalls and need not pose excessive risk to banks or the banking system.

Concentration of Economic Power within Banking

The second kind of potential risk that is often cited as an argument for restricting the ability of banks to affiliate with nonbank firms has been the need to prevent the development of unacceptable levels of economic aggregation and power within the financial sector. When the BHCA was enacted, the concern was that the growth of unregulated bank holding companies could lead to the "undue concentration of control of banking activities."[41] Since then that phrase has been used to promote two related but different goals: preventing bank monopoly power from proliferating into nonbanking businesses, and discouraging the growth of large entities.

[37] See Board of Governors of the Federal Reserve System (2003), U.S. General Accounting Office (2003), and Office of the Comptroller of the Currency (2003).

[38] Craig (2004) reviews these studies.

[39] Although a settlement was reached, it should be noted that the firms did not concede that they were guilty of the charges. Craig (2004).

[40] The statutory basis for Regulation O (12 CFR 215) is Federal Reserve Act, §§22(g) and 22(h) (1913) (codified as amended at 12 U.S.C. §§375a and 375b).

[41] Halpert (1988), 500ff.

The conventional antitrust argument for separating banking and commerce has been that banks with monopoly power will attempt to expand into nonbanking businesses to extract monopoly profits and engage in price discrimination. In practice, however, it is not likely that conglomerate integration—the combination of banks and nonbanks under a holding company—would result in monopoly rents because when markets for bank loans are competitive, it is difficult for the bank to extend market power from banking to nonbanking lines of business. Refusing to lend to the competitors of its nonbank affiliates or granting credit to its affiliates and their customers on favorable terms (as discussed above under conflicts of interest) serves only to reduce bank income. Attempts by the bank to engage in predatory pricing, by cross-subsidizing the operations of its affiliate, would work only if there were considerable barriers to entry. To the extent that banking markets are competitive, this antitrust argument for separating banking and commerce fails. Banking markets became increasingly competitive during the 1970s and 1980s; thus, the likelihood that banks would be able to extract monopoly rents was reduced. Although consolidation in banking has increased over the past decade, interstate banking and a competitive market for small banks continue to make it unlikely that monopoly power will spread from banking to nonbanking business.

The existence of limited economies of scope in banking makes it unlikely that banks and commercial firms would affiliate to the extent needed to produce an economic concentration.[42] When Congress, in GLB, permitted combinations of large banks with large securities and insurance firms, it seemed to acknowledge that the potential for monopoly power is of less concern today and does not provide a rationale for separating banking and commerce.[43]

The second goal mentioned above—discouraging the growth of large entities—seems equally to be based on a straw man. A fear and distrust of banks—especially large money-center banks—has long been a hallmark of U.S. political history and probably contributed to the idea that the separation of banking and commerce was necessary to prevent the growth of large conglomerates.[44] The net-public-benefits test of the BHCA instructs the Federal Reserve Board to consider, among other criteria, whether an "undue concentration of resources" would result when making its decisions regarding permissible activities for bank holding companies.[45] Over the years, the Federal Reserve Board has relied on this criteria as the basis for denying applications under Section 4(c)(8) of the BHCA when major bank holding companies have applied for approval to undertake a joint venture with a substantial enterprise.[46] Again, in light of GLB provisions mentioned above, this seems unlikely to be a justification for separating banking and commerce today.

And from the viewpoint of many community bankers, maintenance of a diversified economic system with a robust small- and middle-market business sector could be threatened by affiliations between banks and commercial firms.[47] The primary concern of these bankers is that if a large commercial entity with monopoly power, as Wal-Mart is often perceived to be, were allowed to enter banking, it would use its monopoly power to displace its banking competitors. However, the argument could also be made that a large commercial bank—not just a large commercial entity—could similarly displace its banking competitors in any given market. To the extent that there are few barriers to entry in that market, the argument that either a Wal-Mart or a large commercial bank would be able to exert monopoly power is weakened. Saunders ([1994], 239), notes that "there is no reason to expect, a priori, that the competitive behavior of the banking industry would be eroded by eliminating the

[42] Halpert (1988), 507.

[43] Wallison (2000, 2003) argues that GLB, in effect, says that none of the reasons advanced against commercial ownership of banks are valid.

[44] Walter (2003), 13–15, notes that the legislative history of the BHCA indicates that the Congress' intent was to guard against the undue concentration of control in banking activities and that this has been interpreted as a concern over the proliferation of conglomerate monopoly, where both banks and nonbanks are combined under one holding company.

[45] The BHCA establishes a net-public-benefit test under which the Federal Reserve Board must consider "whether the performance of the activity by a bank holding company or a subsidiary of such company can reasonably be expected to produce benefits to the public, such a greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." 12 U.S.C. 1843(j)(2)(A).

[46] For examples of such decisions, see Halpert (1988), 506, and Walter (2004), 14.

[47] See Jorde (2003) on the viewpoint of community bankers. She notes, for example, that permitting banking and commerce to mix would run counter to the U.S. ideals of separation and dispersion of political and economic power and would exacerbate the current trends of consolidation in banking and other industries.

commerce-banking separation. Indeed, it may be that such a policy could have a pro-competitive effect, as the number of potential entrants and potential competitors expands."

Thus, although the fear of monopoly power in banking has deep roots, it is not a sufficient reason to prohibit affiliations between banks and commercial firms.[48] Certainly concentrations of economic and political power, regardless of their source, are likely to continue to raise concerns and warrant the attention of policy makers. These concerns have traditionally been (and are best) addressed by Congress.

Safety-Net Issues

Safety-net issues arise when the bank and its affiliates (including its parent) have an opportunity or incentive to act in ways that threaten the solvency of the bank. Such a situation can exist when an insured bank enters into transactions (e.g., loans, guarantees, or other obligations or transfers) for the benefit of an affiliated person or organization *and* those actions endanger the safety and soundness of the bank.[49] For example, the parent organization could shift bank funds to its nonbank affiliates, or a bank could buy assets from the affiliate at inflated prices or provide a capital infusion to the affiliate through a loan at below-market rates. As a result, the parent could shift potential losses to the bank, ultimately threatening the deposit insurance funds and the taxpayer. In the context of the debate about banking and commerce, if transactions between the bank and its affiliates threaten the solvency of the bank, the fear is that the creditors of the bank's commercial affiliate(s) will be protected as a result of the federal safety net.[50]

Walter (2003) expands on the circumstances under which the shifting of losses among the bank and its affiliates is likely to threaten the solvency of the insured bank and thus potentially threaten the deposit insurance funds and the taxpayer. One set of circumstances involves shifting losses among the parent's affiliates to protect the reputation of the firm; the other involves shifting losses to take advantage of limited liability.[51]

Under the first set of circumstances, the parent company would have an incentive to shift losses from one subsidiary to another to prevent negative information from reaching analysts and the market. For example, when the capital of the bank is greater than that of the nonbank affiliate—so that a loss shift would harm the bank but not cause it to fail—there is an incentive to shift losses to the bank, where they may go undetected and the reputation of the parent would be preserved. The reputation would be spared partly because the balance sheet of the bank might be more opaque than that of the nonbank affiliate.

Under the second set of circumstances, the shifting of losses from a more-capitalized affiliate to a less-capitalized affiliate would allow the parent to minimize its losses by taking advantage of limited liability. For example, if a nonbank affiliate incurred a loss that was larger than the capital or net worth of the bank, shifting that loss to the bank would cause the bank to fail. However, the loss to the parent would be limited to its capital investment in the failing bank. In fact, however, this shift could have a negative effect on the parent's reputation and is therefore less likely to occur than one might expect.

Because the creditors of the nonbank affiliate and the parent are more likely to exert market discipline than are the creditors of the bank, loss shifts either for repu-

[48] U.S. Department of the Treasury (1991), 57, noted that the allocation of credit and the concentration of economic power were best addressed by means other than prohibiting the mixing of banking and commerce.

[49] Transactions with affiliates—commercial or otherwise—need not pose safety-net concerns. For example, upstreaming dividends to the bank's parent organization would be acceptable, provided the dividends were reasonably related to the bank's existing capital and earnings potential. However, when transactions benefit a related party and are detrimental to the viability of the insured bank, the safety net can be threatened. See FDIC (1987a), 87.

[50] Conversely, the parent could engage in activities that benefited the bank at the expense of its affiliates. It is argued generally that this conflict is of less concern because fewer safety-and-soundness issues surround most nonbanking firms. When the bank is allowed to affiliate with other businesses or to own nonbank subsidiaries, that affiliate or subsidiary can be sold to generate a source of added capital for the bank. See, for example, FDIC (1987a), chap. 5, "Conflicts of Interest." See also Jones and Kolatch (1999) for a discussion of the relative benefits of the bank subsidiary model.

[51] Walter (2003) discusses a third circumstance that has been cited as justification for separating banking and commerce: that moral hazard, resulting from mispriced deposit insurance, provides an incentive for the parent company to hold risky assets in the bank rather than in its nonbank subsidiaries. The argument is that because access to insured deposits provides banks with a lower cost of funds than nonbank firms, banks are more willing to hold riskier assets. However, nonbank firms will be able to sell those riskier assets to banks, whether they are affiliated or not. Thus, separating banking from commerce does not prevent risky assets from being shifted to banks. This argument is not unique to banking and commerce, as it applies equally to affiliations between banks and other financial services firms, such as those permitted under GLB. For a discussion of moral hazard as it applies to deposit insurance, see Hanc (1999), 3ff.

tation or for purposes of limited liability are more likely to be directed to the bank—a potential that raises safety-and-soundness concerns. The undesirable effects of shifting losses from nonbank affiliates to the bank can range from causing the bank minimal harm to causing its failure.

If the bank's creditors are aware of the potential for loss shifts, they should demand higher interest rates when they perceive a higher risk of such shifts. However, mispriced deposit insurance makes it less likely that the creditors of the bank will impose discipline by demanding higher interest rates. Thus, it is more likely that losses will be shifted to the bank.[52] And it is precisely because these loss-shifting transactions raise safety-and-soundness concerns and potentially threaten the safety net that they have been made illegal under existing law. In particular, the firewall restrictions contained in Section 23A and Section 23B of the Federal Reserve Act require that transactions between an insured bank and its nonbank affiliates, including its parent, are on market-related, arms-length terms. Applicable to all insured depository institutions, they are intended to ensure that the loss shifting described above does not threaten the solvency of the insured bank.

Summary

The examination of the potential risks of affiliation has shown that potential conflicts of interest and the fear of monopoly power in banking do not provide sufficient justification for separating banking and commerce. Concerns about the safety and soundness of the bank and the potential expansion of the safety net exist when transactions occur in which an affiliate's financial condition is improved at the expense of the bank and those transactions threaten the solvency of the bank. The parent company and its nonbank affiliates have an incentive to shift losses to the insured bank if doing so will protect the reputation of the parent company or allow the parent to take advantage of limited liability. These incentives result when the creditors of the bank do not impose discipline on the bank.

Unchecked, these transactions and the resultant safety-net concerns would raise doubts about permitting banks to affiliate with nonbank entities, whether financial or commercial in nature. However, if regulatory discipline is imposed by the enforcement of firewalls and the prudential supervision of the insured entity, the potential harm to the deposit insurance funds and the safety net can be contained.

Managing the Risks: Firewalls and Prudential Supervision

The primary means of controlling abuse and ensuring the safety and soundness of the banking system is through the supervisory process. The goal is to balance the need for maintaining the safety and soundness of the banking system with banks' need to pursue activities and affiliations by which they can increase their profits, attract capital, and enhance their competitiveness.

The previous section mentioned several firewall restrictions: those contained in Sections 23A and 23B of the Federal Reserve Act, those contained in Section 106 of the BHCA, and the Federal Reserve Board's Regulation O. Sections 23A and 23B ensure that transactions between an insured bank and its nonbank affiliates, including its parent holding company, are on market-related, arm's-length terms. Applicable to all insured depository institutions, these restrictions are intended to ensure that the loss shifting described above does not threaten the solvency of the insured bank. Similarly, Section 106 protects from harm that may result from illegal tying. And Regulation O governs the transactions between insiders and the bank.

Other safeguards that must be in place to adequately protect the insured entity are the requirements that the bank's investment in any operating subsidiary be deducted from regulatory capital, that the bank be well capitalized following that deduction, and that the corporate separateness of the bank be protected. To achieve adequate separation, the insured entity should be financially separate—that is, it must be separately funded and have no commingled assets, and all transactions with affiliates must be at arm's length. The insured entity must also be perceived by the market to be operated separately and to be legally separate—that is, to be not responsible for the liabilities of its affiliates.[53]

[52] Walter (2003) also notes that if creditors recognize the incentive to shift losses and risks to the bank and to the FDIC, they will require lower interest rates from the bank's commercial affiliate. The resulting lower cost of capital will give these firms an incentive to engage in projects that otherwise would be unprofitable.

[53] See FDIC (1987a), 65–69. Carns (1995) discusses corporate separateness—the ability of firewalls and supervision to protect the insured entity—in the context of a "two-window" banking system. The arguments are applicable to the more general case of banking and commerce.

During periodic safety-and-soundness examinations, banks are examined for compliance with regulatory standards, including firewalls. As the primary federal regulator, the FDIC examines state-chartered nonmember banks; the OCC examines national banks; the Office of Thrift Supervision (OTS) examines thrift institutions; and the Federal Reserve examines state-chartered member banks. As noted earlier, the Federal Reserve also has authority to examine bank holding companies and financial holding companies. Off-site monitoring by banking regulators provides a check on the institution between examinations.

In the 1990s, regulators began to develop risk-focused supervision for those banks that are determined to be large and complex. Risk-focused supervision assesses a number of risks in each of the bank's major business lines. Because the risk profiles of large and complex banks may change rapidly, supervisors monitor risks on an ongoing basis so as to be better able to allocate supervisory resources to the areas that pose the greatest risk.[54]

In combination, prudential supervision and the enforcement of regulatory standards and firewalls can provide sufficient protection for the bank and help ensure the safety and soundness of the banking system.[55] That is, these regulatory tools must be effective enough to ensure that the risk to the insurance funds is minimal, and flexible enough to allow institutions to explore the opportunities presented by affiliations with nonbank entities. The intended effect of firewalls is that the soundness of the bank not be jeopardized by an obligation to bail out an affiliate. Restrictions on the quantity and quality of transactions between the bank and its affiliates allow some synergies to be realized while minimizing the possibility that the insured bank will be harmed.[56]

The result is that the existing firewalls may not be fail-safe. Firewalls are acknowledged to work well during normal times, but they are criticized for being less effective in extremis, when they may be needed most.[57] (Moreover, no firewalls have been tested since GLB made expanded affiliation possible.) And although impenetrable firewalls can be constructed, they may not be desirable. For example, as enacted in 1956, Section 6 of the BHCA achieved the complete isolation of banks within a holding company by effectively prohibiting transactions between affiliated banks, but the 1966 amendments to the BHCA repealed the prohibition.[58]

Two Regulatory Models

How then should affiliations be handled? Although separating banking from commerce would prevent the risks described above, it would do so in a heavy-handed way and would prevent the economically preferred market-based outcome from being realized. As Walter (2003) noted, "Maintaining a wall separating banking and commerce at best addresses a symptom of an uncompetitive market rather than the lack of competition itself."[59]

The alternative to prohibiting affiliations between banking and commercial firms is to regulate the affiliations so that potential harm to the safety net is contained. There are two regulatory models or long-term strategies for accomplishing the objective. In this context, the two models are distinguished by the extent to which the entire enterprise, including the parent of the insured entity, is subject to federal oversight. The first model reflects the view that federal oversight of the banking organization from the top down—that is, from the parent down to its subsidiaries, both bank and nonbank—is necessary if the safety net is to be protected. The second model reflects the view that regulatory scrutiny can be accomplished from the bank or insured entity up: adequate safeguards will make it possible to protect the insured entity from the risks and conflicts that arise from affiliations without the need for explicit oversight of the parent.

[54] See, for example, Bennett and Nuxoll (2004). The regulatory and supervisory issues raised by large and complex banks will likely be considered in the context of the New Basel Capital Accord (Basel II).
[55] The enforcement of capital standards, the monitoring of loan quality and the capability of management to run the bank, reporting requirements and disclosure standards, and the use of enforcement tools such as cease-and-desist orders and civil-money penalties, are among the supervisory tools that are used to protect the insured entity from excessive risk.
[56] Carns (1995) and Shull and White (1998), 15, discuss this issue.
[57] Walter (2003), 23, notes two instances when the breaching of firewalls led to the failure of the bank. In 1953, the failure of an Illinois bank (the First State Bank of Elmwood Park) resulted from shifts of bad loans from a nonbank loan company affiliate to the bank. In 1976, the failure of Hamilton National Bank and Trust Co., Atlanta, GA, was also caused by transactions between the bank and its affiliates.
[58] See Shull and White (1998), 9.
[59] Walter (2003), 12.

The Top-Down Approach to Regulating the Banking Organization

The top-down model—advocated by the Federal Reserve Board (among others), codified by the BHCA, and amended most recently by GLB—features federal oversight in the form of consolidated supervision of a bank holding company and umbrella oversight of a financial holding company.[60] As mentioned, the rationale for supervision of financial holding companies is to ensure that the safety net is protected from the risks associated with affiliations outside of banking. The logic of this model suggests that, as the market creates pressure for additional commercial activity to be associated with banking, there is a need to ensure that those activities will be subject to federal oversight.

Proponents of the top-down model argue that it maintains a separation of banking from commerce by limiting the ability of banks and banking organizations to own, or be owned by, nonfinancial or commercial firms. This limitation is achieved in three ways. First, affiliations among financial services providers are permitted only under the organizational structure of the financial holding company, which is subject to federal oversight (including functional regulation of certain nonbank affiliates and umbrella supervision of the entire organization by the Federal Reserve). Second, the Federal Reserve (in conjunction with the Secretary of the Treasury), has effective control over the determination of permissible activities for financial holding companies—thus, over banking and commerce.[61] Finally, by eliminating the unitary thrift holding company charter, GLB precludes further commercial ownership of thrifts. But questions have been raised as to whether GLB maintains or undermines the separation of banking and commerce (see below).

Oversight of the Banking Organization. Traditionally, those who argue that affiliations between banking and commerce should be prohibited believe that the reliance on firewalls and prudential supervision alone is not sufficient to protect the insured entity.[62] These advocates of separation question whether firewalls can be strong enough to prevent unacceptable levels of risk from harming the insured entity, yet flexible enough to permit the economic advantages of affiliation to be realized. They also question the ability of firewalls to ensure the corporate separateness of the insured entity.[63] Accordingly, supervision of the insured entity and enforcement of firewalls to protect it from the risks posed by affiliation must be supplemented by consolidated or umbrella supervision of the entire banking organization.[64]

As noted above, bank holding companies became subject to consolidated supervision by the Federal Reserve under the BHCA. Under consolidated supervision, separate units of a holding company are supervised as one entity. The consolidated supervisor has direct oversight of the parent and its subsidiaries so that the relationship between nonbank affiliates and the insured entity can be controlled. Under GLB, the Federal Reserve received the power to be the umbrella supervisor of the financial holding company and in that capacity has various authorities.[65] But for the purposes of umbrella supervision, functionally regulated nonbank affiliates are not treated as banks, and

[60] Whereas both types of supervision involve a top-down approach, the former applies stricter product, service and capital requirements on the banking organization. See Kushmeider (2004).

[61] GLB defined an initial set of permissible activities considered financial in nature, including securities and insurance activities and merchant banking. Additional activities for financial holding companies and their affiliates are determined by the Federal Reserve in consultation with the Secretary of the Treasury. These include activities that are financial in nature or incidental to such financial activities. In addition, financial holding companies are permitted to engage in activities that the Federal Reserve determines are complementary to financial activities, as long as the complementary activities do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

[62] See, for example, Corrigan (1987, 1991).

[63] Cases exist in which limited-liability law has been shown to be less than perfect. In particular, the courts have occasionally disregarded limited liability—or pierced the corporate veil—when a corporation has been shown to have engaged in conduct such that creditors were led to understand that the shareholder was the true debtor. Certain safeguards can be applied to ensure that the bank and its affiliates are viewed as separate; they include separate management and record keeping for the bank and any affiliates, and boards of directors that are not identical. See, for example, Black, Miller, and Posner (1978), Walter (1996), and FDIC (1998).

[64] For a comparison of powers available to bank regulators versus holding company regulators see West (2004).

[65] Among the powers of the Federal Reserve as the umbrella supervisor of financial holding companies are the following: the power to examine the holding company; to require certain reports; to set consolidated capital standards for the banking organization, except with respect to certain functionally regulated subsidiaries; to take enforcement actions under Section 8 of the Federal Deposit Insurance (FDI) Act (12 U.S.C. §1818)); to limit activities for the holding company; to limit transactions between the insured entity and its affiliates under Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. §§371(c)–371(c-1); to prohibit tying arrangements under Section 106 of the BHCA (12 U.S.C. §1971); to limit the establishment or acquisition of additional depository institutions or other subsidiaries; to disapprove changes in control; to disapprove a merger of two holding companies; to require prompt corrective action under the FDI Act; to impose cross-guarantee liability; and to prohibit golden-parachute payments.

the Federal Reserve is directed to rely primarily on the information provided by the nonbank affiliates' functional regulators.[66]

Consolidated supervision has been criticized on several counts. Some of the critics have noted that it can be viewed as a "vote of no confidence in firewalls."[67] If firewalls can effectively protect the insured entity, consolidated supervision is unnecessary. The argument is also made that consolidated supervision signals the market that regulators expect affiliates to be managed as integrated entities. As a result, ensuring effective separation of the insured entity from the risks posed by its affiliates may become harder as supervisors are more likely to focus on the integrated entity rather than the insured depository institution. Moreover (the argument goes), the requirements of consolidated supervision reduce the flexibility of bank or financial holding companies to adapt to a rapidly changing financial environment and to best meet the needs of their customers.[68] The view that consolidated supervision need not extend to the owners of banks was clearly articulated by the interagency study issued in 1991 by the U.S. Treasury, which made broad recommendations for modernizing the financial services industry.[69] The Treasury study noted that beyond certain necessary safeguards designed to ensure that the safety net was not extended beyond the bank, cumbersome bank-like regulation was not necessary for the financial services holding company that was then being proposed.[70] The study argued that "it is practically infeasible for a bank supervisor to effectively regulate a complex and diverse range of businesses. Bank regulation should be concentrated on the bank, not on protecting a diversified [financial services holding company] that should be subject to normal market discipline."[71] The study noted that consolidated regulation of the holding company ran the risk of being viewed as implicit government backing of holding companies, increasing the taxpayer's exposure and potentially expanding the safety net beyond the insured entity. The study also noted that full holding company regulation would deter nonbanking firms from investing in banks because potential investors would deem too high the price of having bank supervisors regulate all nonbanking activities. Moreover, the study noted that none of the hypothetical problems of combining banking and commerce was evident among commercial companies that owned depository institutions at that time, notably unitary thrifts, nonbank banks, and industrial loan companies.[72]

Similarly, the GLB requirement that financial firms submit to umbrella oversight through the financial holding company structure may deter these firms' entry into banking. Although GLB's functional regulation provisions appear initially to shield nonbank firms, the Federal Reserve's authority and powers remain extensive, and from the viewpoint of these firms, GLB has restricted the incentives of the marketplace.[73] A further deterrent may be the Federal Reserve's source-of-strength doctrine, which requires a holding company to provide financial assistance to its troubled subsidiary banks. Although the doctrine was restricted by the Fifth Circuit Court of Appeals in a case in which the Federal Reserve ordered a holding company to inject capital into a failing bank, under current regulation the source-of-strength doctrine remains the Federal

[66] See Section 111 of GLB. The Federal Reserve has the authority to require the holding company to submit reports, but it must rely on reports made by the holding company to the functional regulator and must request unusual reports through the functional regulator. Similarly, the Federal Reserve has the authority to examine a functionally regulated subsidiary of a financial holding company, but it must first find that there is a reasonable cause to believe either that the subsidiary was engaged in activities that posed a material risk to an affiliated insured depository institution or (on the basis of reports and other available information) that the regulated subsidiary is not in compliance with relevant laws, such as Sections 23A and 23B of the Federal Reserve Act. In addition, only by examining the affiliated depository institution or its holding company can it determine that it cannot either assess that risk or decide whether a law has been violated. In establishing capital requirements, the Federal Reserve is generally precluded from imposing capital requirements on functionally regulated subsidiaries of the holding company.

[67] Edwards (1996), 161.

[68] See Carns (1995), 7–9, and Qua (2003).

[69] See U.S. Department of the Treasury (1991).

[70] Specifically, the ability to engage in expanded activities through financial affiliates would have required that the bank be well capitalized and that nonbank financial affiliates be separately capitalized. Regulation would have been focused on protecting the bank rather than on protecting the holding company or its nonbank affiliates. Nonbank affiliates would have been subject to functional regulation, and funding and disclosure firewalls would have been enforced. Responding to the criticisms that it would be harder to regulate banks if they were owned by commercial companies or that biased allocations of credit and inappropriate concentrations of economic power could result, the study noted that those risks could be addressed without a total prohibition on affiliation, and it cited as evidence the positive experience of commercial companies that own depository institutions such as thrifts, nonbank banks, and industrial loan banks. See, U.S. Department of the Treasury (1991), 54–61.

[71] See ibid., 61.

[72] See ibid., 57.

[73] Board of Governors of the Federal Reserve System and U.S. Department of the Treasury (2003), 10, note that more than 600 bank holding companies have chosen to become financial holding companies, while only "several" firms that were not affiliated with a commercial bank before passage of GLB have chosen to acquire a commercial bank and become a financial holding company; some of the large securities firms that have not become financial holding companies already conduct banking activities through the ownership of bank and bank-like entities that are not subject to the BHCA.

Reserve's policy.[74] By making investments in bank equities less attractive, the policy could have the effect of raising the organization's cost of capital. And because the policy is directed primarily at the corporate owners of banks, it would lead to the differential treatment of individual owners, for presumably they would not be held to the standard.[75]

Determination of Permissible Activities. Under GLB, the Federal Reserve plays the dominant role in determining permissible activities for the financial holding company and its subsidiaries. Beyond an initial set of permissible activities, GLB authorizes the Federal Reserve Board, in conjunction with the Secretary of the Treasury, to determine additional permissible activities—those that are financial in nature or incidental to such financial activities. The Federal Reserve alone is authorized to determine the set of activities that are complementary to financial activities, as long as they do not pose a substantial risk to the safety and soundness of the insured entity or the financial system.

The dynamics of expanding the list of permissible activities are different under GLB than under the BHCA. Under GLB the test is "financial in nature or incidental to," and unlike the "closely related to" standard of the BHCA, there is no net-public-benefits test. Once defined as permissible, an activity is open to financial holding companies and financial subsidiaries with only a post-entry notification to the Federal Reserve required. As a result, subsequent competitive evaluations are not possible. And, as noted earlier, GLB also directs the Federal Reserve to permit an unspecified set of commercial activities defined as complementary, and permits financial holding companies to engage in merchant banking.[76]

Through the provisions for determining what activities are financial, incidental, or complementary—and are thus permissible for financial holding companies—GLB has shifted the line of separation: instead of drawing it between banking and commerce, GLB has drawn it between finance and commerce. On this basis, some argue that GLB effectively undermined the policy rationale for separating banking and commerce.[77] Moreover, the process of defining what is financial yet not commercial considerably weakens the congressional intent to maintain a separation of banking and commerce. The line becomes adjustable in response to changes in markets and technology, as determined primarily by the Federal Reserve. The result is a blurring of the distinctions between banking, finance and commerce, and without operational limits to expansion, GLB suggests a slow but accelerating integration of banking and commerce.[78]

But it is hard to argue that the potential risks posed by affiliations between securities firms and banks are less risky than those posed by affiliations between banks and other nonbank or commercial entities. For example, with regard to the use of credit or the benefits to be gained from affiliation with a bank, the activities of a securities firm do not differ significantly from those of a commercial firm.[79] If it is imperative to keep banking separate from commerce, it should be no less important to separate banking from securities activities. By permitting affiliations among banking, securities, and insurance, GLB tacitly acknowledges that the safety-and-soundness risks posed by these affiliations are manageable. This acknowledgment makes it hard to defend the principle of separation.

Elimination of the Unitary Thrift Holding Company Charter. GLB placed new restrictions on the ability of banking and commerce to mix. Specifically, it ended the ability of commercial firms to own a single thrift

[74] *MCorp Fin., Inc. v. Bd. Of Governors,* 900 F.2d 852 (5th Cir. 1990), *reh'g denied,* 911 F.2d 730, *aff'd in part, rev'd in part on other grounds,* 502 U.S. 32 (1991), *on remand,* 958 F.2d 615 (1992). Section 112 of GLB sets conditions on how the Federal Reserve can impose its source-of-strength doctrine on the functionally regulated nonbank affiliates in the financial holding company. See, also, Qua (2003) and Wallison (2003).

[75] Individuals who own banks are not similarly required to be a "source of strength" for their banks. That is, an individual owner is not obligated to inject capital into the bank when doing so would not prevent the bank's failure.

[76] For example, on October 2, 2003, the Federal Reserve Board approved the notice of Citigroup to engage in physical commodity trading activities on a limited basis as an activity that is complementary to the financial activity of engaging regularly as principal in commodity derivative activities. See http://www.federalreserve.gov/boarddocs/press/orders/2003/20031002/default.htm.

[77] See, for example, Wallison (2000, 2003). Shull (2002) also expresses concern about whether a separation of banking and commerce can be maintained.

[78] The time-consuming regulatory process by which activities are determined to be permissible has become an issue in the debate about banking and commerce. As an example, Shull (2002) discusses the lengthy regulatory process by which the Federal Reserve considered whether real estate brokerage would be determined to be a permissible activity.

[79] Wallison (2001, 2003) is among those making this argument.

in a unitary thrift holding company, although existing holding companies were grandfathered.[80]

Supervised by the OTS, unitary thrift holding companies are subject to prudential supervision and firewall restrictions[81] and have long operated without raising safety-and-soundness concerns. For example, thrifts that were part of diversified holding companies were not significant sources of losses during the savings and loan crisis of the 1980s.[82] Nor have they been recipients of a significant number of enforcement actions.[83] In addition, thrifts in unitary thrift holding companies have tended to outperform other thrifts because of the greater diversification of their revenue streams, loan and asset portfolios, and funding sources. The mixing of banking and commerce conducted in the unitary thrift holding company has not been shown to pose undue risk to the safety net.[84] Despite this, those opposed to the mixing of banking and commerce consider it unsuitable for a diversified holding company to own a single thrift.[85]

The enactment of GLB restrictions on diversified holding company ownership of thrifts closed a long-standing avenue through which banking and commerce have successfully mixed. Like ILCs, unitary thrift holding companies operated outside of the bank holding company structure and outside of supervision by the Federal Reserve. When GLB eliminated this corporate structure, it narrowed the options available for mixing banking and commerce.

[80] Existing thrift holding companies that (a) owned a single savings and loan or other thrift institution, (b) were in existence before May 4, 1999, and (c) continued to meet the qualified-thrift-lender test were grandfathered. However, they may not engage in any new commercial activities or transfer their right to mix banking and commerce.

[81] The Savings and Loan Holding Company Act of 1967 limited ownership by a diversified holding company to one thrift institution and imposed comprehensive supervisory requirements on savings and loan holding companies. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA [Public Law 101–73, 103 Stat. 183]) imposed tougher firewalls on unitary thrift holding companies; prohibited lending between the thrift and any affiliate that engaged in activities not permissible for a bank holding company; and subjected transactions with other affiliates to the same restrictions imposed under Sections 23A and 23B of the Federal Reserve Act. See Doyle, DeSimone and Biddle (1999).

[82] See Shull and White (1998).

[83] OTS (1998), 6.

[84] See Thomson (2001).

[85] See Doyle, DeSimone and Biddle (1999).

The Bank-Up Approach to Regulation: Protection of the Insured Entity

Sometimes referred to as a bank-up or safeguard approach to supervision, the other model for containing potential risks focuses on protecting the insured entity—and, in turn, the insurance funds—at the bank level rather than at the parent's level. Properly enforced, firewalls and regulatory safeguards can serve to ensure legal and financial separation and to promote market separation. These protections can be confined to the insured entity, and regulatory and supervisory oversight of the parent and nonbank affiliates becomes unnecessary. Because the insured entity can be adequately protected by safeguards applied at the bank level, this model will be called the bank-up model.[86]

By focusing on the bank itself rather than attempting to oversee the entire banking organization, bank supervisors should be able to defend adequately against any tendency by the owners of the bank to aid their nonbank affiliates. To do this, the banking supervisor requires certain powers, including the authority to monitor compliance on both sides of all transactions between the insured entity and its affiliates (including its parent), the authority to require that the insured entity and its affiliates report such transactions, and—in the case of nonbank affiliates—the authority to require that financial statements or other relevant information be made available to the primary bank regulator.[87]

As the primary regulator of state-chartered, nonmember banks and as the deposit insurer, the FDIC has various powers that allow it to ensure the safety and soundness of the insured entity and, by extension, to ensure the safety of the deposit insurance funds. When the FDIC is the primary federal regulator—for example, for ILCs—the necessary protections can be provided without consolidated oversight of the insured entity's owners. Among the powers the FDIC has are the authority to examine both sides of transactions between the bank and its affiliates and to examine the bank and any affiliate, including the parent, as may be necessary

[86] Although the Federal Reserve has consolidated supervisory authority over U.S. bank holding companies, this authority does not extend to the parent companies of foreign banks. The home-country regulator is responsible for regulating and examining the consolidated operations of the foreign bank. As a result, it can be argued that the Federal Reserve effectively uses a bank-up approach in its supervision of the operations of foreign banks in the United States. See, *Foreign Banks: Assessing Their Role in the U.S. Banking System,* GAO/GGD-96-26, 48.

[87] See FDIC (1987a), 91.

to determine not only the relationship between the insured entity and the affiliate but also the effect of such relationship on the insured entity. When the parent is subject to the reporting requirements of another regulatory body (e.g., the Securities and Exchange Commission or a state insurance commissioner), the FDIC has agreements in place to share information with that regulator.[88] Moreover, in examining any insured depository institution, the FDIC has the authority to examine any affiliate of the insured entity, including its parent company, as may be necessary to determine the relationship between the insured entity and the affiliate, and the effect of the relationship on both of them.[89]

The regulation and supervision of ILCs illustrate how the bank-up model can effectively protect the insured entity and the insurance funds without subjecting the entire organization to consolidated or umbrella supervision.[90] The state of Utah, as home to approximately one-half of all ILCs and more than 80 percent of industry assets, provides a case in point.

ILCs became eligible for federal deposit insurance under the Garn–St Germain Act of 1982. In 1987, the Competitive Equality Banking Act expressly exempted ILCs from the BHCA and from oversight of the parent organization by the Federal Reserve.[91] GLB did not repeal this exemption. Generally ILCs are authorized to engage in traditional financial activities that are available to all charter types. They may make all kinds of consumer and commercial loans and may accept federally insured deposits, but not demand deposits if total assets exceed $100 million. They may be original issuers of Visa or MasterCard credit and debit cards and may fund their operations with Federal Home Loan Bank borrowings. If an ILC is organized as a limited-purpose or credit-card institution, its products and services are limited to those specified by its charter.

ILCs are subject to the same regulatory and supervisory oversight (including the laws and regulations pertaining to bank safety and soundness and consumer protection) as chartered banks. They are subject to the same or higher capital requirements and the same regulations affecting transactions between the insured entity (the ILC) and its parent and affiliates. However, because of the ILC exemption from the BHCA, the activities and powers permitted under the ILC charter are restricted less than those under other charters. Given its flexibility, the ILC charter has been an attractive choice for companies that are not permitted to, or choose not to, become subject to the restrictions of the BHCA. As a result, it is not surprising that the parent companies of ILCs include a diverse group of financial and, where permitted, commercial firms.

The example of the ILCs offers one answer to the question of whether a bank regulated at the bank level can be insulated and isolated from the parent company's improprieties. G. Edward Leary, commissioner of the Utah Department of Financial Institutions, is among those who have argued that it can, noting that the contrary case has not been made. Leary argues that the collaboration between Utah and the FDIC has resulted in the effective regulation and supervision of the state's ILCs and serves as a working example of how well the bank-up approach can work.[92]

By Leary's admission, the supervision of ILCs is an evolving regulatory dynamic in the sense that the regulations must evolve to meet the changes in the industry. This responsive evolution is most visible in the approval orders for de novo ILCs, which contain many of the prudential safeguards under which the ILC will operate for the life of its charter. Among the safeguards for Utah's ILCs are requirements designed to maintain the autonomy of the board of directors and management and their independence from the parent company. To achieve autonomy and independence, the ILC's management must act in the best interest of the ILC; must maintain accurate and reliable accounting records on-site—records on which to base its decisions; must retain authority to set policy and make decisions for

[88] Moreover, FIRREA provided the FDIC with the ability to recover from solvent affiliated banks the losses the FDIC has incurred from the failure of an insured bank. Two federal circuit courts of appeal have upheld the constitutionality of that cross-guarantee provision (see Walter [1996], 34). In terms of the banking and commerce debate, the cross-guarantee provision should reduce the incentive for bank owners to shift losses to the bank.

[89] 12 U.S.C. §1820(b)(4).

[90] The ILC charter has been in existence since the early 1900s. Referred to as "industrials" or "thrift and loans," ILCs typically provided banking services to industrial workers, and until the 1940s ILCs operated in most states. Today, ILCs are found mainly in Utah and California and also operate in Colorado, Hawaii, Indiana, Minnesota, and Nevada. As of December 2003, there were 56 ILCs; 73 percent of ILCs reported total assets of less the $500 million; approximately 10 percent of ILCs reported total assets greater than $5 billion. See West (2004) for further discussion of ILCs.

[91] ILCs generally maintain this exemption by meeting at least one of the following conditions: (1) control of the ILC has not been acquired by any company since August 10, 1987; or (2) the ILC does not accept demand deposits; or (3) the ILC maintains total assets of less than $100 million. 12 U.S.C. §(c)(2)(H).

[92] Leary (2003).

credit underwriting; must ensure that all transactions with the affiliate or parent corporation are at arm's length; and must have sufficient personnel and resources to carry out its decisions.[93] The state of Utah requires that the parent company register with the Utah Department of Financial Institutions and be subject to the department's jurisdiction and examination authority. As noted above, even though the FDIC is not designated the umbrella supervisor of ILCs, it does have the authority to examine the parent company of the ILC to determine the relationship between the parent and the ILC and the effect of that relationship on the ILC. That is, it has the authority to "supervise the organization" from the bank up.

Because ILCs are ably and effectively regulated and supervised from the bank up—both at state and federal levels—it is argued that they pose no greater safety-and-soundness risk than other charter types. Troubles in ILCs have not stemmed from issues pertaining to permissible activities or commercial affiliations or from the regulatory structure under which they operate, but from faulty strategic or tactical decisions.[94] In short, the ILC charter does not represent an inappropriate mixing of banking and commerce. It is important that the ILC charter should not be seen as a loophole, but as a viable charter type and supervisory option.

The Example of Conseco. The bankruptcy of the corporate owner of an ILC—Conseco Inc.—but not of the ILC itself illustrates how the bank-up approach can effectively protect the insured entity without there being a BHC-like regulation of the parent organization. Conseco Inc. was originally incorporated in 1979 as Security National of Indiana Corp. After several years of raising capital, it began selling insurance in 1982. Security National of Indiana changed its name to Conseco Inc. in 1984, after its 1983 merger with Consolidated National Life Insurance Company. Conseco Inc. expanded its operations throughout the 1980s and 1990s by acquiring other insurance operations in the life, health, and property and casualty areas.[95] Conseco Inc. was primarily an insurance company until its 1998 acquisition of Green Tree Financial Services. A diversified financial company, Green Tree Financial Services was one of the largest manufactured-housing lenders in the United States.[96] Upon acquisition, it was renamed Conseco Finance Corporation. Included in the acquisition were two insured depository charters held by Green Tree Financial Services—a small credit-card bank chartered in South Dakota[97] and an ILC chartered in Utah. Both of these institutions were primarily involved in issuing and servicing private-label credit cards, although the ILC also made some home improvement loans. The ILC—Green Tree Capital Bank—was chartered in 1997 and changed its name to Conseco Bank in 1998 after the acquisition. Conseco Bank was operated profitably in every year except the year of its inception, and grew its equity capital from its initial $10 million in 1997 to just over $300 million in 2003. Over the same period, its assets ballooned from $10 million to $3 billion.

Conseco Bank was supervised by both the Utah Department of Financial Institutions and the FDIC. Despite the financial troubles of its parent and the parent's subsequent bankruptcy (filed on December 18, 2002), Conseco Bank's corporate firewalls and the regulatory supervision provided by Utah and the FDIC proved adequate in ensuring the bank's safety and soundness. In fact, $323 million of the $1.04 billion dollars received in the bankruptcy sale of Conseco Finance was in payment for the insured ILC—Conseco Bank, renamed Mill Creek Bank—which was purchased by GE Capital.[98] As a testament to the Conseco Bank's financial health at the time of sale, the $323 million was equal to the book value of the bank at year-end 2002.[99] Thus, the case of Conseco serves as an example of the ability of the bank-up approach to ensure that the safety and soundness of the bank is preserved.

[93] Many Utah ILC approval orders impose the following key conditions: an independent board with a majority of outside, unaffiliated directors; no change in executive officers for the first three years of the ILC's operation; on-site officers, including (at a minimum) a chief financial officer and a chief credit officer with sufficient staff and the knowledge, ability, and expertise to successfully manage the ILC, maintain direct control of it, and retain its independence from the parent company; and monthly meetings of the board of directors for the first two years of the ILC's operation (Leary [2003]).

[94] Powell (2003a) and West (2004).

[95] Conseco Corporate Website (2003).

[96] Hoovers Online (2003).

[97] Green Tree Retail Services Bank, the South Dakota credit-card bank, voluntarily liquidated in 2003.

[98] Wisniewski (2003).

[99] GE Capital did not purchase the bank in toto but purchased the majority of the bank's assets and assumed all of its liabilities. As of July 26, 2003, the bank forfeited its charter and voluntarily liquidated without cost to the FDIC.

Policy Implications

This section discusses whether umbrella oversight of the parent company is necessary and explores how the debate about banking and commerce is affected by the increased complexity of banking organizations and how important it is for the banking system to have regulatory alternatives.

A Need for Umbrella Oversight of the Parent?

If the risks posed by mixing banking and commerce can be contained through adequate safeguards, affiliations need not be prohibited. But is it possible to permit affiliations between banking and commerce without imposing federal regulation or oversight on the bank's parent company and affiliates? In other words, under what conditions is umbrella oversight of the parent necessary?

The purpose of umbrella oversight is to protect the insured entity from the risks posed by its affiliates. Over the years, varying opinions on the need for umbrella oversight have been expressed. From the perspective of the Federal Reserve, umbrella oversight provides the necessary framework that allows the risks associated with an organization's consolidated activities to be monitored and restrained. Umbrella oversight protects the insured entities in the organization and, in turn, the safety net. It also makes financial crises and risk to the financial system easier to prevent.[100]

Walter (2003) reached the conclusion that mixing banking and commerce need not be prohibited but argues that umbrella oversight of the entire organization is necessary. He notes that umbrella oversight is intended to mimic the types of limitations that private creditors would impose on risky affiliations.[101] When uninsured creditors are aware of increased riskiness on the part of their debtor, they demand compensation for the added risk. In the face of increased risk taking by a nonbank affiliate, supervisors would similarly impose restrictions or other penalties to compensate for the added risk posed by the affiliate. For example, the supervisor could reduce the bank's supervisory rating or impose restrictions on transactions with the bank's affiliates. In doing so, the supervisor would be mimicking the monitoring behavior of the private creditor in the absence of deposit insurance and a federal safety net. In Walter's model, supervision of the entire banking organization is performed by the Federal Reserve in a top-down model.

Others have expressed the view that umbrella supervision of the entire organization is neither necessary nor warranted.[102] If commercial firms that choose to enter the banking business were subjected to umbrella supervision, growing amounts of economic activity would be brought into a regulatory framework that was designed to administer the nation's financial safety net. Instead, federal oversight could be focused on containing the risks posed by such mixing of banking and commerce—the risk that losses would be shifted to the insured entity and, in turn, to the deposit insurer—through the use of firewalls and prudential supervision directed at the insured entity. Confining regulatory oversight to the bank can achieve effective regulation of the insured entity without unwarranted regulatory intrusion into the marketplace.

As noted above, experience has shown that the bank-up model, with proper safeguards, can work. In the bank-up regulatory model, supervision is performed by the primary regulator, which stands in the place or performs the role of the uninsured creditor. Importantly, regulatory discipline can be exerted to protect the safety net without the parent organization and the bank's nonbank affiliates being subjected to federal supervisory oversight. Under these conditions, regardless of holding company affiliation or size, banks should be entitled to choose the corporate structure that best suits their business needs.

Separation and the Increased Complexity of Banking Organizations

A significant change during the past two decades has been an increase in both the size and the degree of complexity of financial organizations. Some observers have noted that on a global scale, in the absence of adequate controls, combinations of banking and finance can produce large losses that must be borne by society at large.[103]

How does the greater complexity of financial organizations affect the debate about banking and commerce? Given the increased complexity, what (if anything) is needed to ensure that the risks posed by the mixing of banking and commerce can be contained within a

[100] See Kushmeider (2004), and Ferguson (2000), 2.
[101] Walter (2003), 24.
[102] Again, see U.S. Treasury (1991), FDIC (1987a) and Leary (2003).
[103] For example, problems in Japan and Korea have led to such losses. See Seidman (2003).

framework of regulatory choice? Are current regulations sufficient? Or can they be improved?

Before GLB was passed, nonbank affiliates were generally quite a bit smaller and less complex than their bank affiliate. As a result, the incentives for the parent to shift losses to the bank affiliate in order to take advantage of limited liability were lessened. Today, under a financial holding company, banks are able to affiliate with securities and insurance firms that are likely to be as large as, if not larger than, the bank itself. The result is often an organization that is both large and complex, and is likely operated as an integrated entity that manages risk across business lines, rather than within legal entities. Thus, the likelihood may be greater that these large and complex financial organizations may attempt to shift losses to the bank and the insurance funds for limited-liability purposes.[104]

As financial organizations increasingly rely on risk-control strategies that view the activities of the organization in toto, it is all the more important that regulators have the ability to assess the risk posed to the insured entity.[105] The framework of umbrella oversight in intended to provide the necessary transparency regarding the activities, practices, and inter-company dealings that affect the distribution of risk across the financial holding company, and to serve as a supplement to supervision by legal entity in that case. However, some have argued that the necessary degree of oversight or monitoring might be better determined by the degree of complexity within the organization, rather than solely on the basis of affiliation.[106] For example, organizations that combine banking and finance, where business lines are managed at the holding company level, might warrant more of such oversight than organizations that combine banking and commerce, where the insured entity is clearly separate.

Outside the financial holding company structure, however, the transparency necessary to properly assess risk and protect the insured entity should be accomplished without requiring the organization (parent and affiliates) to be subject to a top-down form of umbrella supervision. Rather, any monitoring should be the responsibility of the functional regulator, and policy makers should consider whether additional powers may be required to ensure sufficient transparency.[107] A clear benefit of this approach is that the nonbank economic activity associated with the mixing of banking and commerce would continue to be driven by the market rather than by regulation.

The Importance of Regulatory Alternatives

Throughout U.S. banking history, the states have chartered, regulated, and supervised banks. The existence of state-chartered depository institutions, including ILCs, remains integral to the checks and balances of the dual banking system. In meeting the banking needs of their communities, state-chartered institutions have fostered creativity and experimentation. Part of the reason the state charter remains a viable banking option is that it allows for innovation in a locally controlled environment that has traditionally limited systemic risk. This capacity for innovation is particularly true of the ILC charter.

It is important that there be more than one approach to the regulation and supervision of banks. A key attribute of the dual banking system is the insured entity's ability to choose the supervisory structure under which it operates: the ability to choose contributes to a competition in excellence among bank regulators. Through its role as primary regulator

[104] Walter (1996), 34–35, argues that to reduce the likely occurrence of loss shifts, the size of commercial affiliates should be restricted. However, with sufficient firewalls and the regulator's ability to monitor both sides of any transaction and to examine the bank and its affiliates, including the parent, it can be argued that size alone should not be a reason to prohibit affiliations.

[105] During testimony on financial services reform, the FDIC (1997) noted that in light of the increasing complexity of the financial marketplace, some form of added oversight of banks and other providers of financial services could enhance coordination and attention to interstitial concerns, such as maintaining accurate information about all operations in the organization and monitoring compliance with the rules on inter-company dealings. The FDIC further noted that for safety-and-soundness purposes, it would not be necessary "to include investment-by-investment or activity-by-activity regulation as part of the oversight of the consolidated organization, provided that risks to the financial system and to the insurance funds are understood and appropriately limited" (p. 10).

[106] Kushmeider (2004) discusses the use of complexity as the criterion for determining appropriate regulatory oversight.

[107] Policy makers should also consider the need for improved communications between the banking organization and the regulatory authorities, for which both parties must take responsibility. Bankers are responsible for understanding what takes place in their organizations and for communicating this information to their regulators. Their incentive, of course, is that the possible alternative is additional regulation. Similarly, the regulatory authorities must clearly communicate relevant information about the regulations and supervisory procedures; the goal would be better mutual understanding through discussions and communications with the boards of directors and corporate managers. Communication between functional regulators in a complex institution can also contribute to protecting the institution and, more broadly, the safety net. An example of such communication is the cooperation between the FDIC and the Utah Department of Financial Institutions in supervising ILCs.

of state-chartered nonmember banks and ILCs, the FDIC provides the bank-up regulatory alternative for organizations and individuals that choose not to be regulated by the Federal Reserve under a holding company structure. Thus, this model offers greater flexibility for corporate enterprise, while managing the risks posed by a mixing of banking and commerce. Without this alternative regulatory structure, the ability of the market to meet the demands of consumers could be severely restricted.

Conclusions

Does the mixing of banking and commerce constitute good public policy? The evidence suggests that the answer is a qualified yes: with adequate safeguards in place, the careful mixing of banking and commerce can yield benefits without excessive risk. Because the main potential risk of mixing banking and commerce—the shifting of losses that may threaten the insured institution and the safety net—can be contained through the use of adequate safeguards and firewalls, the separation of banking and commerce does not appear to be justified.

Furthermore, there is no evidence of a long-term separation of banking from commerce in U.S. banking history. Certainly the activities permitted to banks have always been subject to prohibition, but affiliations with nonbank firms have not been prohibited until relatively recently. Nevertheless, the current prohibitions on corporate ownership of banks have been justified on the grounds that banking and commerce have always been separate.

Despite the current prohibitions, the current regulatory structure makes it possible for banking and commerce to continue mixing in many ways. In addition, the current trend in the market place is toward more combinations of banking and commerce. As FDIC Chairman Powell recently noted, "This trend is nothing more than the natural outgrowth of dynamics that have been under way in banking and bank regulation over the last two decades."[108] The issue facing policy makers is how these combinations of banking and commerce will be regulated. Specifically, will increasing amounts of commercial activity be subject to umbrella supervision, or will the insured entity be the focus of supervision?

Is umbrella oversight of the entire organization necessary? The evidence suggests that the answer is a qualified no. Given the important role that regulatory choice has played and continues to play in the U.S. banking industry, there should be no need either to reconcile or to choose between the two approaches to regulating banking organizations. Each approach performs its role within the current regulatory system. Given the increased complexity of many banking and financial organizations, it is important that the risks to the insurance funds and the safety net are understood and that firewalls remain effective. In particular, there may be a role for added information sharing and disclosure within the current regulatory structure. Importantly, that added oversight could be performed under either the top-down or the bank-up regulatory model. Regulators and policy makers should consider what additional powers, if any, are needed to be able to effectively ensure corporate separateness of the insured entity, while also ensuring regulatory choice about how the banking enterprise is regulated.

[108] See Powell (2004).

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The Future of Banking in America

The Changing Corporate Governance Environment: Implications for the Banking Industry

*Valentine V. Craig**

Introduction and Legal Underpinnings

Failures of corporate governance can cause enormous financial losses, not only to individual corporations and their stockholders but also to society as a whole. One widely quoted estimate of the cost of U.S. corporate governance failures is $40 billion a year, or the equivalent of a $10 a barrel increase in the price of oil.[1] Enron shareholders alone lost $63 billion in Enron's failure. Other recent scandals of corporate governance have entailed huge losses as well. These events together have resulted in new legislative, regulatory, and judicial initiatives to counteract perceived failings in corporate governance.

This paper identifies the main developments of the changing environment and illuminates issues of corporate governance that U.S. bankers are likely to face. The paper begins by reviewing the so-called Anglo-Saxon model of corporate governance, which is derived from English common law and based upon extensive legal protections and a large, diffuse ownership of companies.[2] The paper then reviews major academic research on the mechanisms and strategies used to promote good governance in the United States. Next, the paper reviews recent efforts to reform U.S. corporate governance and traces dominant trends. These sections are concerned with corporate governance as it applies to all U.S. businesses. The final section (before a summary and conclusion) focuses specifically on banks and their corporate governance within the broader context.

Corporate governance is defined and practiced differently throughout the world, depending upon the relative power of owners, managers, and providers of capital. Basically, different national systems of corporate governance reflect major differences in the ownership structure of firms in different countries, and particularly differences in ownership concentration.[3]

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[1] Robert Litan, remarks delivered at AEI/Brookings consortium on The Future of Corporate Governance, March 5, 2003.

[2] The Anglo-Saxon approach to corporate governance is also known as the shareholder model. When this paper alludes to "U.S. law" or "U.S. corporate governance" standards, it is not referring to federal law or federal standards but (generally) to the Anglo-Saxon approach to corporate governance as practiced in the United States. There is no federal law of corporations per se except the Sarbanes-Oxley Act of 2002; but the combined actions of the SEC, the national stock exchanges, and state courts have resulted in the development of standards of corporate governance that are generally accepted (i.e., accepted to a degree) in the United States.

[3] This discussion draws on Shleifer and Vishny (1997).

In much of the world outside the United States and the United Kingdom, heavily concentrated shareholdings and controlling ownership are the norm. Virtually every country on the European continent has an ownership concentration higher than that in the United States. Single stockholders are not unusual; many European firms, even large ones, are family owned and operated.

Concentration is an outgrowth of the way foreign firms fund their activities. Whereas U.S. firms typically access the capital markets for equity and debt funding, firms in much of the rest of the world (including the advanced economies of Europe and Japan) typically rely much more on bank lending to meet their funding needs. And whether as lenders or as investors, these banks have constituted a controlling presence. For instance, through proxy voting, large banks in Germany typically control more than a quarter of the votes of major companies. In Japan, large cross-holdings and bank ownership result in highly concentrated ownership and control. In the rest of the world, ownership is typically heavily concentrated in families, with a few large outside investors and banks.

Where there is more control, there may be less need for legal protections.[4] In continental Europe and Japan, large investors and the banks rely less on legal protections and more on themselves to protect their interests. Large shareholders, even large minority shareholders, have the financial incentive and power to investigate how their investment is being used and to initiate change if their rights are not respected by the firm's management.

In the United States, in contrast, controlling (or concentrated) ownership is not the typical case.[5] Ownership and control of businesses by banks, mutual funds, insurance companies and other institutions are legally restricted. This has led to U.S. business reliance on the public capital markets for liquidity and on the legal system for monitoring corporate governance. The role of the legal system in U.S. corporate governance is one focus of this paper.

Courts in the United States provide more protections to stockholders than courts anywhere else in the world, yet managers and directors are protected from liability based on mere mistakes in judgment and good faith errors. U.S. courts review the actions of directors according to the "business judgment rule," developed by state common law.[6] The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[7]

Generally, directors of U.S. companies owe shareholders the duty of care and the duty of loyalty. The duty of care requires that they act with the care that a reasonably prudent person in a similar position would exercise under similar circumstances, and that they perform their duties in a manner they reasonably believe to be in the best interests of the corporation. The duty of loyalty requires that they refrain from engaging in personal activities that would injure the corporation and its shareholders. This duty requires their undivided unselfish loyalty to the corporation and its shareholders, and prohibits the use of their personal position of trust and confidence to further their own private interests.

Although the affirmative duty of loyalty by managers and directors to shareholders is accepted throughout the member countries of the Organization for Economic and Cooperative Development, enforcement of this duty differs. In particular, U.S. courts are considered very strict in enforcing the duty of loyalty, whereas courts in much of the world outside the Anglo-Saxon countries review only major violations of investors' rights. U.S. courts have actively pursued cases of corporate theft and the diversion (civil and criminal) of assets, dilution of existing shareholder equity, and other forms of managerial self-dealing. They have enforced legal requirements that managers consult their boards of directors, and have upheld the rights of minority shareholders.

As mentioned, U.S. courts have traditionally respected the discretion and judgment of corporate managers and

[4] In the case of controlling ownership by one or several owners, however, the rights of minority shareholders can be overlooked.
[5] But large minority ownership and even controlling ownership do exist to some degree in the United States. Holderness (2003) reports that 20 percent of exchange-traded stock belongs to insiders. Shleifer and Vishny (1997) find several hundred cases of over 51 percent ownership in the United States. *Business Week* (2003a) reports that in 177 of the S&P 500 companies as of July 2003, founders or their descendants continued to hold positions in senior management, on the board, or among the company's largest shareholders.

[6] The business judgment rule applies to both managers and directors, but the paper will address the protections it offers to directors.
[7] *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984), *rev'd on other grounds, Brehm v. Eisner,* 746 A.2d 244 (Del. 2000).

directors in the performance of their duties. As discussed below, however, there is some indication that courts are beginning to reexamine their position and stance toward the business judgment rule.

Finally, it is very important that the United States allows those who feel they have been wronged to bring class-action suits. Most other countries do not permit class-action suits, and prohibit contingent fees. The legal remedy of a class-action suit is powerful, and it permits U.S. investors to sue corporate managers for violation of the duty of loyalty.

Strategies for Ensuring Sound Corporate Governance: A Review of the Literature

Shleifer and Vishny (1997) provide a comprehensive overview of the literature on corporate governance. Their study portrays corporate governance as a solution to a principal-agency problem: corporate governance mechanisms are necessary because conflicts of interest are inherent between principals (owners) and agents (management) when the ownership and control of a firm are separate. Corporate governance mechanisms are the economic and legal means created by the firm to mitigate this inherent problem of ownership-control, or principal-agency. The corporate governance structure therefore provides a framework within which corporate objectives are set and performance is monitored, and it provides assurance to investors that they will receive a return on their investment.

Demski (2003) is concerned with corporate conflicts of interest and examines how the multiple players in a business' governance—auditors, boards, analysts, regulators, management and others—manage these conflicts. He argues that conflicts are widespread, and if not managed properly, can grow into financial fraud. Society tends to rely on a combination of prohibition, disclosure and legal remedies to manage conflicts and to apply specific controls to specific problems; instead, he argues that we need to recognize the existence of multiple conflicts and multiple players, which requires an "enlarged interactive web of controls."

Other corporate governance research focuses more narrowly on specific strategies used by U.S. firms to ensure sound corporate governance. One major area of study is the role of the board of directors in protecting shareholder interests—a responsibility with which boards of directors are specifically charged. Another subject of research is the efficacy of large stockholders (blockholders) in corporate governance. Researchers have also evaluated the effectiveness of tailored executive compensation schemes to align the interests of managers with the interests of owners so that managers act in the owners' interests. The final major area of corporate governance reviewed by researchers is the value of corporate information provided to owners through third parties—independent auditors and investment analysts—or corporate information supplied directly from the firm to its owners so that the owners are in a position to act in their own best interests.

The Role of the Board of Directors

Boards of directors are responsible for overseeing management activities and protecting stockholders' interests. They are not always successful. Several studies examine this issue and conclude that the major problems with unsuccessful boards are the board's dependence on management and the board's own lethargy. Hermalin and Weisbach (2003) survey the research on boards and report a number of conclusions common to these studies. The board's composition (i.e., insider vs. outsider) does not seem to predict corporate performance, while the board's size appears to be negatively related to performance. Boards with more outside directors, and smaller boards, tend to make arguably better decisions about acquisitions, poison pills,[8] executive compensation, and CEO replacement. There are some problems with these studies, however. Hermalin and Weisbach caution that these studies are hard to perform and hard to interpret, for factors beyond the composition of the board affect independence—factors such as the degree of the interlock among directors, the extent to which CEOs participate in the process of nominating and selecting board members, the CEO's voting stake, and the unique unobservable personal dynamics of each individual board. Furthermore, for the most part these studies define an outsider very narrowly as someone who is not a current high-level executive of the firm or a relative.

Adams and Mehran (2003) examine corporate governance in bank holding companies (BHCs). They find that boards of BHCs are typically much larger (1.5 times on average) than boards of manufacturing firms; the percentage of outside directors is higher (however,

[8] "Poison pill" is the term used to describe tactics adopted by a company to make itself unattractive to potential buyers in order to prevent a hostile takeover. Such tactics are often viewed as protecting management at the expense of shareholders.

as in other studies of independence, inside directors are narrowly defined as those working for the firm, and outsiders are defined as "not a top executive, a retired executive, a former executive, a relative of the CEO or chairperson, or an outsider lawyer employed by the firm" during the sample period); BHC boards have more committees; and the boards meet more frequently. Contrary to the studies of nonbanking businesses, the study by Adams and Mehran finds that large BHC boards on average are not value-decreasing. They also find that board composition (insider or outsider) is unrelated to BHC performance.

The Role of Blockholders

Holderness (2003) surveys the empirical literature on large shareholders, focusing on four areas: the prevalence of blockholders; the motivation for blockownership; its effect on executive compensation, leverage, takeovers and other corporate decisions; and its effect on firm value.[9] The survey finds that insiders (officers and directors) on average own approximately 20 percent of exchange-listed corporations, and that this concentration has increased over time. It also finds wide variation in the degree of blockownership among companies. The motivation for blockownership is to increase returns through the shared benefits (with all stockholders) of control or the private benefits (not shared with small stockholders) of control. The survey finds that few major corporate decisions are different because of the presence of large blockholders except that blockholders do appear to monitor executive compensation better. Holderness does not find that ownership concentration affects firm value. One of his major conclusions is that the existence of blockholders is not a problem, especially when blockholders are active in the management of the firm.

Other sources suggest that ownership concentration is a definite advantage. A recent special report by *Business Week* (2003a, p.100) reports that one-third of S&P firms have significant founding-family representation in management (as senior managers, as directors, or as the largest stockholders), and, in "what may be Corporate America's biggest and best-kept secret, [they are] . . . beating the pants off their nonfamily-run rivals." Interesting in this regard are the views of legendary investor Warren Buffett on this subject. In his most recent annual letter to shareholders of Berkshire Hathaway, he equated true board independence with the board's personal financial stake in the company. Each of Berkshire Hathaway's 11 directors holds more than $4 million in Berkshire Hathaway stock.[10]

The Role of Executive Compensation

Executive compensation is a subject of immense and growing public concern. In 1980, executive compensation was 40 times the compensation of the average employee; in 2000, it was 400 times. William McDonough, chairman of the Public Company Accounting Oversight Board, reported in 2003 that executive compensation was the biggest issue that members of Congress heard about from their constituents—bigger than the war in Iraq and bigger than recent job losses. He believed that extraordinary executive compensation had encouraged companies to "cook the books" to maintain their upward earnings trend, and that although initially this fiddling with the books was perhaps unconscious and minor, over time it became necessary and cumulative.[11]

A number of studies on executive compensation focus on the use of stock and stock options as an incentive tool, and find a large increase in the use of stock options for CEO compensation over the last two decades. Core, Guay, and Larcker (2003) synthesize research of the past decade on stock-based compensation and incentives. Their review finds no theoretical or empirical consensus on the effect of stock options and management ownership on the performance of the firm. In fact, they find that research results are often contradictory and raise more questions than answers. The authors conclude that despite considerable prior research, "the performance consequences of equity ownership remain open to question."[12] A key finding of their survey is that simple normative prescriptions concerning equity based incentive plans are inappropriate, and that one must understand the characteristics of each firm, its shareholders, and its management before drawing conclusions. They caution that activist shareholders can cause damage to the firm by pressuring directors to institute inappropriate executive compensation plans based on normative prescriptions.

[9] While blockholders often serve as directors or officers of the corporations in which they own a major stake, this is not always the case. There are three types of blockholders—individuals who are insiders, individuals who are outsiders, and corporations. Holderness suggests that the incentive structure for all three is different and presents an interesting future area of study.

[10] *Washington Post* (2004b).

[11] Speaking at the U.S. Chamber of Commerce Conference on Strengthening Our Capital Markets, November 12, 2003.

[12] Core, Guay and Larcker (2003), pg. 35.

Another major area of research on executive compensation is on the relationship between compensation and earnings manipulation. Lev (2003) reviews the literature on this aspect of executive compensation. He reports that both aggregate data and cross-sectional research confirm increasing divergence between reported and actual earnings during the 1990s. There has been a dramatic increase in the restatement of earnings by public companies in the last several years, and an increased frequency of firms beating their earnings estimates. (Analysts view restatement of earnings and the beating of earnings estimates as suggestive of earnings manipulation.) The review of the literature shows that manipulation is done for a variety of reasons: for personal gain, to maintain investor or supplier support, or to satisfy contractual agreements.

John and Qian (2003) examine the incentive features of top-management compensation in the banking industry. Their study finds that pay-performance sensitivity is lower for bank CEOs than for CEOs of manufacturing firms and that it declines with bank size. Adams and Mehran (2003) find that compared with other industries, BHC CEOs on average have a smaller percentage of their total compensation in stock, their equity holdings are smaller, and institutional ownership of BHC stock is less.

The Role of Auditors

Demski (2003) argues that conflict of interest is inherent in the auditor's role due to management's hiring of auditors; the typical long-term nature of the auditor/client relationship; the provision of nonaudit services by the auditor; and personnel moves from auditing firms to client firms. There is little evidence on how well these conflicts are managed, for the relationships are not readily observable and there have been few Securities and Exchange Commission (SEC) actions or lawsuits. Bazerman, Loewenstein, and Moore (2002) argue that due to the subjective nature of accounting and the close relationship between auditors and clients true auditor independence is impossible. Unconscious bias, rather than criminal intent, is the major problem with bad audits. They argue that true auditor independence will not occur until companies acknowledge the existence of this unconscious bias and deal with it.

The Role of Investment Analysts

Demski's (2003) review of the research on conflict of interest suggests that similar problems exist with the independence of analysts, brokers, and investment bankers. Studies he reviews find that analysts' forecasts are upwardly biased (though still more accurate than simple time series); recommendations are skewed upward to "strong buy" and "buy"; there is censorship; analysts appear to follow firms with which their own firms have underwriting relationships, and these recommendations tend to be favorable. Other studies he reviews show that firms switch underwriters to acquire access to star analysts and that there is conflict of interest in the advancement of analysts.

The Role of Transparent Disclosure

Bushman and Smith (2003) survey the economics-based research on the role of financial accounting in corporate governance and find a positive relationship between the quality of financial accounting information and economic performance. Studies they review suggest that problems occur when owners lack the necessary power or information to monitor and control management and when the interests of owners and management are out of alignment. They find that financial accounting information is one element of a complex information infrastructure that helps the firm identify investment opportunities and reduces information asymmetries between large and small investors.

Recent Reforms and Trends in Corporate Governance

This section examines recent events and trends in corporate governance and finds a growing movement toward greater independence of boards of directors, greater control by shareholders, and greater accountability of boards, as well as increasing concern over excessive executive compensation. The section begins with summaries of several important provisions of the Sarbanes-Oxley Act of 2002 (SOX) as well as summaries of the new corporate governance rules of the New York Stock Exchange (NYSE) and the NASD. Then the section looks at the recent agreement between the SEC and MCI, recent SEC activities regarding shareholder access, recent court decisions in Delaware on the business judgment rule, and recent efforts by different constituencies to restrict excessive executive compensation.

The Sarbanes-Oxley Act of 2002

Congress passed the Sarbanes-Oxley Act of 2002 (SOX) in response to the very visible and widespread corporate governance failures of the past few years.[13] These failures

[13] Pub. L. No. 107–204. For more information on SOX, see Zinski and Pacioni (2003).

resulted from poor corporate behavior characterized by conflicts of interest, self-dealing, deceptive financial reporting, inadequate disclosure, and weak oversight by boards of directors. A major focus of SOX is to prevent conflicts of interest that might jeopardize the firm. SOX is particularly concerned with ensuring the independence of the audit committee, auditors, and securities analysts so that conflicts of interest do not arise.[14] SOX applies to publicly held businesses.[15]

SOX requires that audit committees of corporations that issue securities registered with the SEC (or with the federal financial regulatory agencies) be composed solely of independent board members.[16] "Independent" means the member is not affiliated with the issuer or with any of its subsidiaries *and* is not receiving consulting, advisory, or other compensatory fees from the issuer.[17] The issuer is to disclose annually whether it has at least one "financial expert" (as defined by SEC regulations) on the audit committee, and if not, why not.[18] The audit committee is required to set up a whistleblower mechanism to protect employees who report accounting, internal control, and auditing problems.[19] SOX also prohibits issuers from extending certain credit in the form of personal loans to or for any director or executive officer.[20] This credit restriction provision does not apply to insured depository institutions that are already subject to the insider lending restrictions of the Federal Reserve Act.[21]

To ensure the independence and objectivity of auditors, auditors are forbidden to provide to the issuer, contemporaneously with the audit, any of the nonaudit services listed in the statute or in the SEC's regulations.[22] The issuer's audit committee must give prior approval for any nonaudit services not expressly forbidden by the Public Company Accounting Oversight Board.[23] Rotation of the audit partners is required, subject to exceptions for firm size.[24] And SOX establishes a one-year cooling-off period before a member of the audit team may accept employment in certain positions with an issuer.[25] To further ensure the independence of the auditor, the audit committee—rather than management—is required to preapprove, hire, and oversee the auditor.[26]

To encourage corporate accountability, SOX requires the issuer's principal executive officer(s) and principal financial officer(s) to certify those items specifically listed in the statute, including the accuracy and materiality of the quarterly and annual reports and the adequacy of internal controls.[27] SOX also mandates additional financial disclosures. All material off-balance-sheet transactions, arrangements, obligations, and relationships must be disclosed in each quarterly and annual report, prepared in accordance with generally accepted accounting principles.[28] The issuer must also disclose whether it has adopted a code of ethics for its senior financial officers, and if not, why not.[29]

New Stock Exchange Regulations

The NYSE submitted its amended recommendations to the SEC on June 20, 2003.[30] The SEC accepted these new rules on November 4, 2003. The standards, which go further than SOX, apply to all companies listed on the NYSE.

The NYSE standards require NYSE-listed companies to have boards composed of a majority of independent

[14] This summary of the law is not meant to be exhaustive. It ignores several aspects of the new law, including provisions on SEC funding and responsibilities.

[15] SOX applies only to institutions that issue securities registered with the SEC or with a federal financial regulatory agency—in other words, publicly held businesses. In regard to financial institutions, there are approximately 700 bank and thrift holding companies registered with the SEC, and approximately 200 banks and thrifts registered with the banking agencies. Additionally, nonpublic banking institutions with more than $500 million in assets are required to comply with the SEC's definition of auditor independence. There are approximately 1,100 banking organizations with more than $500 million in assets. (Many of these are publicly held and are therefore included in the previous figures.)

[16] § 301.

[17] Ibid.

[18] § 407.

[19] § 301.

[20] § 402.

[21] Regulation O, which implements sections 22(g) and 22(h) of the Federal Reserve Act, already restricts loans from banks to their executive officers, directors, and principal shareholders.

[22] § 201.

[23] § 202.

[24] § 203.

[25] § 206.

[26] §§ 202, 204.

[27] § 302.

[28] § 401.

[29] § 406.

[30] The NYSE is the private nonprofit regulator (commonly referred to as an SRO, or self-regulatory organization) for the firms whose securities are listed with it (approximately 2,800 such firms at year-end 2002). The member firms constitute a cross-section of large, midsize, and small-cap U.S. companies and include approximately 470 non-U.S. companies. Although a nonprofit itself, the NYSE is owned by its 1,366 for-profit members, which include traders on the floor as well as large Wall Street brokerage firms, all of whose interests it represents.

directors; and the boards' audit, compensation, and nominating committees are required to be composed solely of independent directors. (These independence requirements are waived for controlled companies—companies in which more than 50 percent of the voting power is held by an individual, a group, or another company. Only the audit committees of controlled companies are required to be wholly independent.)

The criteria for independence are stricter under the NYSE standards than under SOX. Former employees of the company or of the independent auditor of the company, and their family members, are not considered independent until five years after their employment ends. Furthermore, for a director to be deemed independent, the board must affirmatively determine that the director has no material relationship with the listed company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company. Companies must disclose these determinations.

Sitting on a client's or customer's board is discouraged, although not prohibited. The standards state that there is a potential conflict of interest in sitting on a customer's board, particularly if the customer's business is responsible for a significant portion of the income of the director's firm ("significant portion" is defined as the higher of 2 percent of revenues or $1 million). The NYSE standards also require that

- Nonmanagement directors meet regularly without management;
- Directors' fees be the sole compensation for audit committee members;
- The audit committee have sole authority to hire and fire independent auditors and to approve any significant nonaudit relationship with the auditors;
- Shareholders vote on equity compensation plans, including stock option plans (with some exceptions in routine matters);
- Listed companies adopt and disclose corporate governance guidelines and a code of ethics; and
- CEOs certify to the NYSE each year that they are not aware of any violation of NYSE corporate governance standards.

The NASD fashioned similarly focused corporate governance standards, which were also approved by the SEC on November 4, 2003.[31] The NASD, too, is concerned with ensuring the independence of the board, the independence of and a heightened role for the audit committee, and a stronger role for independent directors on compensation and nomination committees. Like the NYSE standards, those of the NASD require listed members to have a majority of independent directors, a code of conduct for all directors and employees, and the approval of stockholders for the adoption of all stock option plans and of any material modification of such plans. Independence is defined in terms of a three-year period rather than the five-year period of the NYSE. As with the NYSE standards, audit committee members may receive no compensation other than their board compensation. Other board members may receive additional compensation of not more than $60,000.

Agreement between the SEC and WorldCom (now MCI)

The August 26, 2003, settlement between the SEC and MCI is a potentially significant development. In particular, the provisions governing board independence and shareholder control have been described as groundbreaking, and the agreement as a whole has been touted as a possible model for evolving U.S. corporate governance standards.[32] Negotiated by former SEC chairman Richard Breeden, MCI agreed to 78 separate corporate governance reforms.

The agreement requires that MCI's board be wholly independent; most particularly, it calls for an independent chairman. It also prohibits the CEO from sitting on other boards. It calls for an increase in board qualifications and commensurate pay; MCI board members will be paid $150,000, rather than the $35,000 that WorldCom paid its directors. The agreement places constraints on both the board and

[31] The NASD is the private nonprofit regulator for the securities industry and virtually all U.S. stockbrokers and brokerage firms. It oversees approximately 5,500 securities firms and more than 650,000 registered securities professionals. It also oversees and regulates all trading on the NASDAQ stock market (which it sold in 2000) and on the over-the-counter market, as well as transactions in securities listed on the NYSE and the American Stock Exchange that are executed and reported to NASDAQ by NASD member firms. It regulates members' market-making activities and trading practices; their municipal securities activities; their underwriting arrangements in connection with the public distribution of securities; and mutual funds. And it monitors all securities firms' advertising.

[32] *The Economist* (2003).

management: it requires an explicit dividend policy (suggesting 25 percent of net profits, to ensure that reported profits are real) and limits the board on how much it may pay the chief executive. Shareholder approval is required to change these conditions.

Recent SEC Actions regarding Shareholder Access

On July 15, 2003, the SEC, against significant opposition, proposed amendments to its proxy rules, which if enacted would make it easier and less expensive for dissident shareholders to be heard. The proposed amendments, known as "shareholder access," contain several triggers that, if reached, would permit dissident shareholders to propose nominees for directors on the company's own proxy. This proposed rule is highly controversial, with consumer groups generally favoring it and groups representing businesses generally opposing it. James Heard, CEO of Institutional Shareholder Services, is encouraged that institutional investors are beginning to assert themselves but believes that the trigger thresholds are hard to achieve.[33] Martin Lipton, a frequent spokesman on corporate governance, believes that the triggers are very easy to attain and will result in the balkanization of boards.[34]

The SEC also recently adopted a rule requiring companies to disclose how they select directors and how shareholders can participate in this process. This rule, the recently adopted NYSE and NASD rules removing the CEO from the formal nomination process, and the proposed shareholder access rule are all important indications of the movement in corporate governance toward greater board independence and greater shareholder control.

Recent Judicial Actions

Courts in the United States have traditionally been reluctant to question management decisions in the absence of evidence showing a lack of good faith. There is some indication, however, that courts may be willing to reexamine the question of whether they have become too lax in applying the business judgment rule.[35] In particular, two recent cases decided in Delaware seem to suggest this willingness to reexamine.

In the *Walt Disney Company Derivative Litigation,* Walt Disney shareholders alleged that the CEO had hired a friend as president without a final employment agreement reviewed by the board and with minimal board input; that the CEO had given the president an accelerated nonfault termination without board approval after he had served less than one year with questionable performance; and that demanding that the board remedy the situation before filing the litigation would be futile.

The Delaware Supreme Court found that shareholders had raised sufficient doubt about whether the employment contract should be protected under the business judgment rule, and the court sent the case forward to trial.[36] The court ruled that if board members had reviewed and approved the employment agreement, the business judgment rule might have protected them.[37] However, the board had refused to evaluate the agreement, "blindly allowing" the CEO to pursue the interests of a friend. "Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not . . . advance the best interests of the company."[38]

Subsequent to the *Disney* case, shareholders in another case asked the Delaware courts to address compensation paid to the president and CEO of Martha Stewart Living Omnimedia. In this case,[39] the court ruled that the shareholders had not pleaded their case with sufficient particularity to continue the litigation. Although the court did not break any new ground, it expressed its concern generally that litigants' ineptitude (and implicitly not the legal standards) had prevented judicial review and allowed directors to escape justice.

These recent cases suggest that Delaware courts are willing to examine corporate decisions, but shareholders must make a case that the board has violated its duties of loyalty and care and is not entitled to the protection of the business judgment rule. With more than half of all corporations in the United States incorporated in Delaware and subject to its law, Delaware is a leading jurisdiction in the development of corporate gover-

[33] Speaking at the U.S. Chamber of Commerce Conference on Strengthening Our Capital Markets, November 12, 2003.

[34] Ibid.

[35] Hamilton (2003) concludes that the recent spate of corporate governance scandals raises "the legitimate question whether the fundamental assumption that shareholder primacy exists in modern publicly held corporations should be routinely accepted."

[36] The court ruled that the case was de novo and plenary (in other words, the court would look at the case afresh, as if it had not been heard before, rather than deferring to the trial court's findings and conclusions, as case precedent required).

[37] *Walt Disney Company Derivative Litigation,* 825 A.2d 275 (Del. Ch. 2003).

[38] *Id.* at 289.

[39] *Martha Stewart Living Omnimedia Derivative Litigation,* 833 A.2d 961 (Del. Ch. 2003).

nance law. As such, the rulings by its courts may signal that broader changes are forthcoming. At a minimum, the *Disney* court's expansion of the standard of review should mean that more derivative actions go to trial, thereby creating opportunities to change corporate governance law.

This changing legal environment has brought an element of uncertainty to boards regarding current and future accountability standards. This changed environment also has time and cost implications. Thirty-seven percent of public-company directors reported spending more than 150 hours on board work in 2003, up from 26 percent the previous year.[40] And, IAG/National Fire Insurance, a provider of directors and officers insurance (d&o), reports that class-action lawsuits against directors and officers of corporations increased 137 percent from 1997 to 2003, necessitating large increases in the price, and limitations in coverage, of d&o insurance.[41]

Executive Compensation Activities

The manner and amount of executive compensation is a growing public concern—as the two aforementioned Delaware cases suggest. The public has expressed dismay at what it considers the outrageous executive salaries of the CEOs of Tyco, the New York Stock Exchange, and other companies. The Corporate Library, an independent research organization concerned with issues of corporate governance, cites CEO compensation as one of the most important indications of board effectiveness and is urging boards to better align management compensation with shareholder returns. Berkshire Hathaway chairman Warren Buffett has publicly asked boards to rethink their compensation policies, concerned that confidence in U.S. business will not be restored until executive compensation is controlled. And, as mentioned above, members of Congress reported that excessive executive compensation was the major subject raised by their constituents in 2003.

Some labor unions and large stockholders have become very active in maintaining public interest in this issue. For instance, the AFL-CIO has created a website that provides the amount of compensation to senior executives, which can be accessed by company name, industry or total compensation level. The California Public Employees' Retirement System (CALPERS), the nation's largest public pension fund, has developed a list of companies in its portfolio with the worst executive compensation packages. CALPERS' goal, like the Corporate Library's, is to better align the interests of management with shareholders.[42]

Of particular significance, a coalition of labor unions was successful in getting a resolution included on the proxies of 40 large companies this year—a resolution that, if adopted, would limit CEO pay to $1 million in salary, $1 million in bonuses, and $1 million in stock and stock options. Attempts by targeted companies to keep the resolution off their proxies were disallowed by the SEC.[43]

Some boards have also shown increased sensitivity to the executive compensation issue. The *New York Times* reports that the CEO of MBNA recently resigned because of irresolvable conflicts with his board over his compensation.[44] The CEO earned more than $50 million a year over the past two years, an amount that made him one of the most highly paid executives in the United States. That fact reportedly discomfited his board.

In March 2004, the Financial Accounting Standards Board (FASB) proposed the mandatory expensing of employee-stock option compensation beginning the first quarter of 2005. The expensing of stock options—which are a major source of senior executive compensation in the technology industry, investment banking industry and others—has been a very contentious issue over the years. Although FASB recently voted to delay the deadline for this change by six months, this action represents a significant development in executive compensation.

Despite the furor over executive compensation, two years (2001 and 2002) of overall decreases in management compensation levels were followed by a year in which total executive compensation rose to record levels. Much of the lower executive compensation reported in 2001 and 2002 reflected the fact that executive stock options lost value in a depressed stock market. With a revived market in 2003, options again regained value, and executive compensation rose

[40] *Washington Post* (2004a).
[41] John Keogh, president and CEO of AIG speaking at the U.S. Chamber of Commerce Conference on Strengthening our Capital Market, November 12, 2003.
[42] Dow Jones Newswires (2004).
[43] *Washington Post* (2004c).
[44] *New York Times* (2004).

overall. Increased corporate earnings in 2003 also explain higher 2003 executive compensation.

Issues of Governance for Banks

Banks are different from other types of businesses due to their public purpose. They are therefore subject to corporate governance rules, regulations, and policies issued by the bank regulatory agencies and subject to regular supervisory review of their corporate governance practices and procedures. In fact, many of the SOX provisions are derived from similar standards for bank corporate governance that were enacted in the 1980s and early 1990s in response to bank insider abuses. Nevertheless, the current climate for corporate governance will affect banks.

Differences between Banks and Other Businesses

There are more stakeholders in the governance of banks than other businesses due to the banks' liquidity function and role in promoting the health and stability of the economy.[45] Accordingly, a loss of confidence in banks has the potential to create severe economic dysfunction, adversely affecting the general welfare. A systemic banking crisis caused by bank malfeasance (or the appearance of it) has the potential to shift bank losses to the deposit insurance funds or to the taxpayer.

The banks' corporate governance focus is also different due to the source of their financing. Banks typically receive approximately 90 percent of their financing through debt, which tends to be in the form of deposits from multiple unsophisticated depositors rather than from the more typically sophisticated debtholders of nonfinancial businesses. Banks are also different due to deposit insurance, which largely removes the incentive for depositors (the debtholders of the bank) to monitor the bank's activities—and which can also lead to risky behavior on the part of bank management, for losses from bank failures flow through to the deposit insurance fund.[46]

For all these reasons, banks are subject to regulatory oversight and bank directors are held to the highest fiduciary standards. They are responsible not only to the stockholders who elected them "but [also for] the safety of depositors' funds and the pervasive influence the bank exercises on the community it serves."[47] The public accountability implicit in the bank director's role distinguishes this position from directorships in most other corporate enterprises.

Current Standards for Bank Governance

In the late 1980s and early 1990s, irresponsible and, in some cases, criminal behavior of a number of banks and savings and loans produced significant losses to the deposit insurance funds. Insider abuse was a particular problem. A study by the Office of the Comptroller of the Currency (OCC) (1988) found that insider abuse contributed to approximately one-third of national bank failures between 1979 and 1987. A U.S. General Accounting Office study (1989) of this same period showed insider abuse present in over 50 percent of the banks that failed.

In response to these problems of corporate governance, Congress enacted standards for heightened oversight of and compliance by the industry. In particular, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) enhanced enforcement and regulatory oversight.[48] These laws, as well as state laws regarding management responsibility, were used by regulators to improve financial industry governance in general and to ensure independent audits, minimize conflicts of interest, and enforce fiduciary responsibilities for boards and management in particular.

FIRREA significantly expanded the enforcement authority of banking regulators. It gave the FDIC the authority to suspend temporarily the deposit insurance of a bank that had no tangible capital, and it extended the cease-and-desist (C&D) authority of regulators to cover specific bank activities. Temporary C&Ds could be issued to restrict an insured bank's growth; they could also be issued if regulators concluded that an activity would result in significant damage to bank assets or earnings, or if bank records were too incomplete for regulators to determine the bank's financial condition. FIRREA also greatly increased the civil money penalties that could be imposed on federally insured banks, and it required banks that could not meet capital adequacy requirements to obtain FDIC approval before accepting brokered deposits.

[45] This argument is developed fully in Macey and O'Hara (2003).
[46] See Hanc (1999) for a discussion of deposit insurance and moral hazard.
[47] FDIC (2002), Section 4.4-1 (Management/Administration), Subsection II (Directors).
[48] FDIC (1997), 101–3.

FDICIA was above all a supervisory law, enacted in response to the belief that regulators had not acted quickly enough during the savings and loan crisis. This statute initiated the system of "prompt corrective action," which required regulators to institute increasingly severe actions—ranging from restricting certain activities to closing institutions—on the basis of an insured institution's capital adequacy. As implemented through Part 364 of FDIC regulations, FDICIA also prohibited, as an unsafe and unsound practice, the payment of excessive compensation as well as compensation that could lead to material financial loss to an institution.

In addition, FDICIA amended the Federal Deposit Insurance Act (FDI Act) to require increased reporting by larger banks. As implemented by Part 363, banks with more than $500 million in assets were required to have annual audits by licensed and registered auditors in good standing who met the independence requirements of the SEC.[49] They are required to submit annual reports that contain a statement of management's responsibility for preparing financial statements, for establishing and maintaining an internal control structure and procedures for financial reporting, and for complying with laws and regulations related to insiders and dividend restrictions. The report also must contain an evaluation of the effectiveness of the internal control structure. For banks of this size, FDIC regulations now require that audit committees be composed entirely of independent directors and that the bank's public accountants meet with the audit committee.

For banks with more than $3 billion in assets, the audit committee must also include at least two directors with banking and related financial expertise and must not include any large customers of the bank.

Institutions with less than $500 million in assets are not subject to Part 363 but are nonetheless encouraged to comply with its provisions. If such an institution's securities are registered with the SEC or with one of the federal banking agencies, the institution is subject to SOX.

[49] From time to time, the FDIC may amend Part 363 to improve the regulation of auditor independence. Any amendments to Part 363 would be developed in consultation with the other federal banking agencies and would generally be published in proposed form for public comment in the *Federal Register.*

Issues Arising from New Initiatives in Governance

As mentioned above, banks and bank holding companies are already accustomed to corporate governance regulation, examination, and enforcement and are therefore in a better position than nonbanks to adjust to the new initiatives that have been instituted. That is not to say that compliance is free of problems.

The SEC reported in early 2003 that approximately a dozen community banks had filed notice of their intention to withdraw the registration of their securities. The main reason given for delisting was the additional cost of registration resulting from the bookkeeping and accounting mandates of SOX.[50] Smaller, less actively traded institutions are balancing the benefits and costs of having publicly traded securities, and some have decided that the benefits do not outweigh the costs.

Some banks have also expressed difficulty in meeting SOX's new definition of independence for audit committee members. Recent corporate governance events presage an even greater move toward board independence as well as a stricter definition of what constitutes it. Many banks may experience some difficulty, at least initially, in complying with these evolving standards. In particular, interlocking directorships may become an issue.

Banking rules and regulations permit interlocking directorships between a bank and its major customers; in fact, interlocking directorships were encouraged by the National Bank Act, which required directors to reside within a 100-mile radius of the bank or within its home state. Directors are also permitted to serve both on the board of the holding company and on the board of its bank. For the most part, the FDIC has not found these interlocking directorships a serious governance problem. When interlocking directorships threaten to compromise or have compromised the safety and soundness of the institution, the FDIC has used its regulatory authority to protect depositors and the deposit insurance funds.[51] Nonetheless, breach of duty by officers and directors—across the corporate spectrum—and issues of board independence are attracting the attention of public interest groups, Congress, and the press. As a recent example, the board of J. P. Morgan Chase was included on the Corporate Library's top ten list of worst boards in

[50] *American Banker* (2003c).
[51] FDIC (2003).

2003 primarily because of the board's large number of interlocking board members.[52] Although regulators have not identified board interlocks as an issue, banks should be aware that the public's views on this issue are evolving and that the status quo could change. This paper contends that banks would be well advised to plan for more change in the standards of board independence.

As also discussed above, the excessive compensation of employees of publicly held companies is an issue of increasing power. FDICIA prohibits excessive employee compensation, which it defines as "amounts [that] are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder."[53] Regulatory standards on executive compensation, however, leave significant discretion to boards (and shareholders) to determine appropriate executive compensation. Publicly held banks are advised to be sensitive to this issue and to recognize that federal regulators are not their only audience. New NYSE and NASD rules on the independence of compensation committee members, a new activism by stockholders, a generally more favorable environment for dissatisfied stockholders, and the public embarrassment of many boards over recent executive compensation decisions have worked to change the environment for this issue.

As mentioned, FASB has announced plans to require companies to treat employee stock-option compensation as an expense against earnings beginning the third quarter of 2005. While this represents significant change for many industries, banks should be relatively less affected by the expensing of options as stock options do not represent a significant portion of compensation for bank executives—even at very large banks—relative to executives of other companies.[54]

Banks are among the many businesses that have also complained of difficulty in recruiting directors. Increased board time commitments, increased issues of liability, increased emphasis on financial expertise, and the movement toward independent boards are likely to exacerbate this problem. In addition, many companies have begun to restrict their CEOs to a maximum of two or three outside boards because of the increased time demanded for board service.

As mentioned above, a strategy that Richard Breeden at MCI used to recruit board members in this challenging environment was to raise board salaries—from the $35,000 that WorldCom had paid its directors to $150,000 to new MCI directors. There are other strategies. As noted by Spencer Stuart, a major recruiting agency for board members and executives, a large untapped pool of potential directors continues to exist. Board recruiters see not a shortage of capable directors, but a mismatch between the types of individuals currently available for board service and the types of directors businesses are still seeking.[55] Board duties still represent status, are intellectually challenging, and provide good opportunities for networking, but the CEOs that companies used to look to for board service are no longer available. The recruiters suggest that companies look to a different type of board member. They advise them to focus on both younger and older members—for example, on more division directors and fewer sitting CEOs, and on more retired persons, who have the time and expertise to put into board service. They suggest that women are another large untapped potential board resource.[56]

In this demanding and changing corporate governance environment, banks, like other businesses, will need to broaden their horizons to find knowledgeable, independent, and committed directors.

Summary and Conclusions

The paper finds that the environment for corporate governance remains fluid, as standards and norms continue to evolve. It would appear, however, that public and private views on corporate governance have changed dramatically. Specifically, the paper finds evidence of a growing movement in corporate gover-

[52] The Corporate Library (2004).

[53] FDIC (2002).

[54] According to a study by Merrill Lynch (as reported in the *American Banker (2004),* the expensing of options should result in a 3 percent reduction in earnings for the typical large bank, compared with an average 7 percent reduction for companies in the S&P 500. The study expects only one large bank, Northern Trust Corp., would be more affected than the average S&P business, with an estimated 10 percent reduction in earnings.

[55] Julie Daum, North American leader of Spencer Stuart, Inc. speaking at the U. S. Chamber of Commerce Conference on Strengthening Our Capital Markets, November 12, 2003.

[56] *Business Week* (2003b) reports that in 2003 women represented only 14 percent of S&P 500 board members, but the new emphasis on board financial expertise makes women executives more attractive as board members, for they are much more represented in CFO ranks than in CEO ranks. In 2003 over 7 percent of CFOs at S&P 500 companies were women, as opposed to less than 2 percent of CEOs.

nance toward greater board independence, greater shareholder control, and greater board accountability, along with increasing attention to excessive executive compensation and other corporate behaviors viewed as nonresponsive to shareholder concerns.

One must not be naïve, however. Corporate governance reforms have often followed in the wake of corporate scandal. This said, the enactment of SOX, the exchange reforms, recent SEC activities, recent court decisions, and new shareholder activism suggest that changes in standards and norms for corporate governance in the United States are not a passing phenomenon.

Specifically, the Sarbanes-Oxley legislation represents real change. This is the first federal statute ever enacted on the corporate governance of nonregulated businesses[57]—an area traditionally reserved to state law. The new NYSE and NASD rules on board independence and the agreement between MCI and the SEC on board independence and shareholder control also represent significant changes in the way things are done. And the SEC proposal to permit dissident directors on company proxies, if adopted, would promote board independence and cede more control to shareholders.

Recent Delaware court decisions, especially the decision in *The Walt Disney Co. Derivative Litigation*, are significant for suggesting that the courts may be more willing than in years past to review shareholder allegations of breach of fiduciary duty. They may portend a more rigorous review by the courts of the business judgment rule as a protection for boards from shareholder suits. Because Delaware is home to more than half of all U.S. corporations, it is a very important jurisdiction for developments in corporate law, and one that has generally been considered friendly to business.

Finally, recent successful efforts by different constituencies to curtail excessive employee compensation suggest that this matter remains an issue of abiding and growing concern.

What is the likely effect on banks of these reforms? Although for most businesses the Sarbanes-Oxley legislation represents significant change, the act should have little effect on most banks that are subject to it because of the strong standards of governance that were adopted by banks in the 1980s and early 1990s, and even earlier.[58] Many of the provisions of SOX, in fact, are derived from bank governance standards. This is not to say that there is no room for improvement in bank governance, nor that banking organizations are not experiencing and will not experience problems in adjusting.

The paper concludes that meeting the evolving norms of board independence is likely to pose more of a challenge to the banks. In particular, interlocking directorships may become a major problem for the banks in the future. Publicly held banks, like other businesses, must also be prepared for changes in standards of board accountability and for increased involvement of shareholders.

Another issue with which some bank boards will have to contend—perhaps the driving focus in corporate governance for publicly held businesses today—is excessive executive compensation. Major constituencies, including labor unions and pension funds, and boards of some of the highest-paid public businesses, including banks, are currently examining this issue. The use of stock options to motivate executives is an area of particular public interest. Although banks, even large ones, for the most part make less use of stock options in compensating their executives than other businesses do, public focus on executive compensation—in all its forms—is likely to continue.

Because of their important role in society, banks need to be especially careful about their governance so as to maintain public confidence. The paper concludes that the most effective way to avoid corporate governance problems is to select a knowledgeable, engaged, and independent board of directors. But like other businesses, banks may have difficulty recruiting board members in the current environment. The increased commitment of time required of board members, increased issues of liability, an emphasis on financial expertise, and the trend toward more independent boards are likely to exacerbate this problem. The paper suggests that banks—and other businesses—may need to expand their vision of what constitutes a qualified board member in this demanding and changing environment for corporate governance.

[57] FIRREA and FDICIA are, of course, federal statutes concerned with the governance of regulated financial institutions.

[58] Publicly-held banks under $500 million in assets are the major exception.

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