FEDERAL RESERVE BANK OF DALLAS

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Southwest Economy

Economic Recovery Gains Steam in Texas

During 2003, the Texas economy bottomed out and began to grow again. Most sectors ended the year stronger than they began it, and there is reason to believe 2004 will bring substantial growth to Texas.

Judging only by the current job market, one might think Texas has entered a period of extremely slow growth. But the U.S. economy grew at a torrid pace in the second half of 2003 despite sluggish employment growth, and the same appears true for Texas. As the state economy's composition becomes more like the nation's, Texas and U.S. business cycles should be more closely tied, absent dramatic upheaval in the few sectors where the two economies continue to differ.

We will not have official 2003 output data for Texas until 2005, but strong U.S. growth, coupled with a relatively stable picture in Texas-centric industries such as energy and telecom, suggests the Texas economy is also growing faster than the sluggish employment situation implies. This is consistent with the Dallas Fed's coincident index for Texas, which has now clearly entered expansionary territory (*Chart 1*).

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Small Banks' Competitors Loom Large

Small banks have long played a key role in the U.S. financial system. Sprinkled heavily across the country, they serve virtually all but the most isolated geographic areas. Built on personal contact, community ties and close lender–borrower relationships, these institutions traditionally have met the banking needs of individuals, farms and small businesses.

But small-scale banking has encountered rough going in recent years. Competitive forces, unleashed by technological advancement and financial deregulation, have led many small banks to combine or otherwise grow to achieve a larger scale, suggesting a reduced role for the traditional small bank. In addition, other types of financial institutions, such as credit unions, have made significant inroads into small banks' market segments.

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Small Banks' Competitors Loom Large

(Continued from front page)

These developments call into question the competitive position and future viability of small banks. A close look at financial trends shows small banks meeting with some success as they adjust to the changing environment. Nevertheless, small banks continue to lose ground to competing types and forms of financial institutions. An important goal for public policy is to ensure that the outcome of this competitive struggle reflects the fundamental strengths and weaknesses of the various players involved as opposed to the regulatory environment, which, if misaligned, could favor one set of institutions over another.

Fall from Prominence

The decline of small banks—defined here as banking organizations with assets of less than $1 billion, measured in 2002 dollars—has been dramatic. While there were about 6,000 small banks as of June 2003, that represents a substantial decline from more than 11,000 in 1984. Further, since 1984, small banks' share of commercial banking system assets has fallen by almost half, from 23 percent to 13 percent (*Chart 1*). Midsize banks likewise dropped from 35 percent to 16 percent of the market. Only large banks have gained market share, rising from 42 percent to 71 percent. Moreover, these shares based on asset size actually overstate the relative position of small banks because off-balance-sheet activities, such as securitization and derivatives trading, tend to be concentrated at the largest institutions.

In one sense, small banks' declining market share understates their performance because many of the more successful small banks have grown rapidly, both organically and through mergers and acquisitions, so that they have crossed the $1 billion threshold to become part of the midsize group. If these previously small banks are counted as still belonging to the small size group, then small banks' market share actually has increased slightly since 1984, from 23 percent to 24 percent.

But while small bank growth can account for the shrinkage in small bank market share, small banks nevertheless are becoming a less prominent feature of the financial landscape. Many small banks have merged or otherwise grown out of their previous smallness, fueling a continuing structural shift toward the

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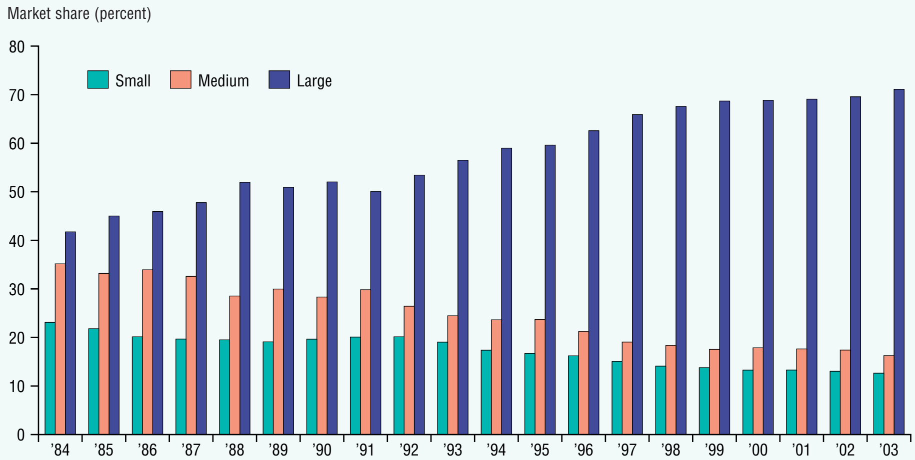
Chart 1

Small Banks Lose Market Share to Large Banks



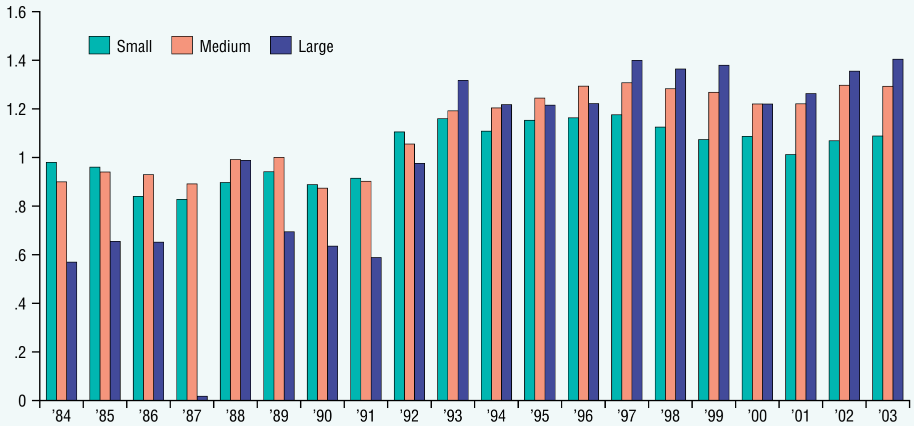
NOTES: Small banks belong to organizations with less than $1 billion in commercial bank assets, medium-sized banks to those with $1 billion to $25 billion in bank assets, and large banks to those with more than $25 billion. Assets are measured in 2002 dollars. All data are year-end except 2003 data, which are as of June 30. The market share for each size group is that group's proportion of total bank assets.

SOURCES: Call Report, FFIEC; Consumer Price Index for All Urban Consumers, Bureau of Labor Statistics.

Chart 2

Small Banks Now Lag Large Banks in Profitability

Return on assets (percent)



NOTES: Small banks belong to organizations with less than $1 billion in commercial bank assets, medium-sized banks to those with $1 billion to $25 billion in bank assets, and large banks to those with more than $25 billion. Assets are measured in 2002 dollars. All data are year-end except 2003 data, which are as of June 30 and annualized. Figures are the median return on assets for each size group.

SOURCES: Call Report, FFIEC; Consumer Price Index for All Urban Consumers, Bureau of Labor Statistics.

largest size class of banks. While substantial numbers of new small banks have been chartered in recent years, the additions to small bank assets have been insufficient to offset the reductions associated with growth into the midsize category. Industry growth has tended to occur through the movement to larger sized banks, as opposed to greater numbers of small institutions. As a result, there has been a dramatic shift in the mix of banking firms toward large-scale banking and a resulting fall from prominence for small banks.

Not only do small banks represent a shrinking component of the banking industry, but their profitability lags as well (*Chart 2*). While the banking industry as a whole has generated record profits in recent years and small bank profits have been substantial, the profitability of small banks nevertheless has fallen behind that of larger institutions.

Several interrelated forces set the stage for small banks' declining position. Until the 1970s, regulation had reduced competition, both among banks and between banks and other types of financial institutions. Technology and innovation, however, eventually enabled the various types of financial services providers to circumvent regulatory restrictions and compete more directly. An increasing number of banks then found that not only did the old regulatory structure no longer protect them from competition, it actually restricted their ability to respond. Regulations that had prevented banks from competing by paying market interest rates on deposits were gradually removed. Laws that had prohibited banks from competing through the establishment of branch networks met a similar fate.

The new, more open and interconnected financial environment has posed some challenges for small banks. Geographic expansion through branching has enabled previously distant banks to reach into local markets, achieve closer contact with potential depositors and borrowers, and thereby compete more directly with small, community-based institutions. Distant banks have also increasingly contacted potential customers through brokers and the Internet, thereby reducing the advantage of a local presence. Similarly, armed with large data warehouses and automated data-mining tools, lenders are relying more and more on computer-aided statistical analyses of historical data to identify creditworthy borrowers, as opposed to the personal contact and informal lender–borrower relationships typically associated with a small bank. And securitization, whereby individual loans are grouped together and sold as a traded security, has added liquidity to the lending market and helped other institutions, such as mortgage companies, compete more effectively with banks, both large and small.

Credit unions, aided by favorable legislation and regulation, have emerged as another particularly severe threat to small banks. Beginning in the early 1980s, rule changes gradually relaxed the "common bond" requirement for credit union membership, leading to legislation in 1998 allowing a federal credit union to serve multiple membership groups. The loosening of membership restrictions enhanced growth opportunities, especially when coupled with policies favoring credit unions over banks, such as credit unions' exemption from both federal taxation and the regulatory requirements of the Community Reinvestment Act.

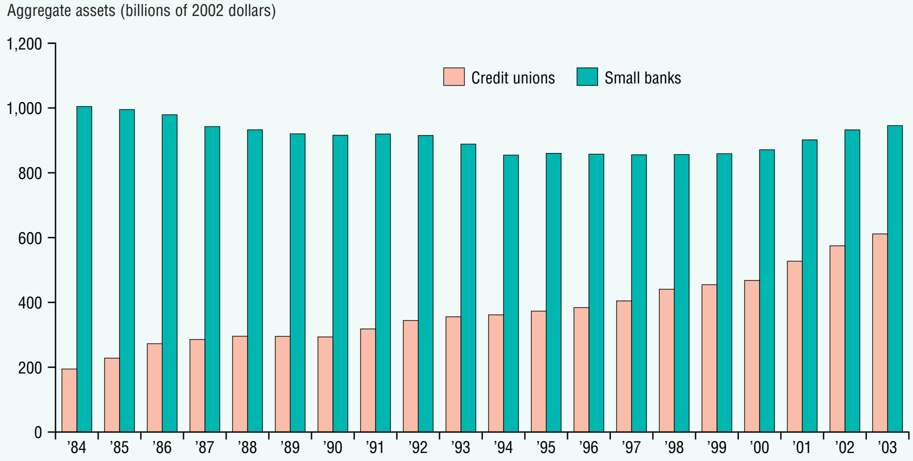
Here, too, small banks have lost significant market share. As shown in Chart 3, credit union assets, adjusted for inflation, have more than tripled since 1984, from $194 billion to $611 billion, whereas small bank assets have actually decreased in value. If small banks that grew into the midsize group are still counted as small, then small bank assets have risen to $1.8 trillion from $1 trillion in 1984. But even this growth of 80 percent pales in comparison with credit unions' 200 percent growth.

Looking to Rebound

Despite their declining prominence, small banks have shown signs of resilience. They have met with some success in their efforts to shore up business with traditional customers. One positive sign is found in regional trends in the presence of small banks. While nationally small banks have lost market share to large banks, the losses have been uneven across states. Since 1991, small banks have tended to lose the most market share in states where their share had been unusually high, perhaps correcting an overabundance of small banks associated with prior regulatory protections. At the same time, small banks have actually gained market share in many states for which the initial small bank share was unusually low (*Chart 4*). The positive adjustment of small bank market share in these states suggests an important role for small banks in a region's banking structure. The trend line fit to the points in Chart 4 crosses the horizontal axis at 12 percent, providing some

Chart 3

Credit Unions Gain on Small Banks



NOTES: Small banks belong to organizations with less than $1 billion (2002 dollars) in commercial bank assets. All data are year-end except 2003 data, which are as of June 30.

SOURCES: Call Report, FFIEC; Consumer Price Index for All Urban Consumers, Bureau of Labor Statistics; Credit Union National Association.

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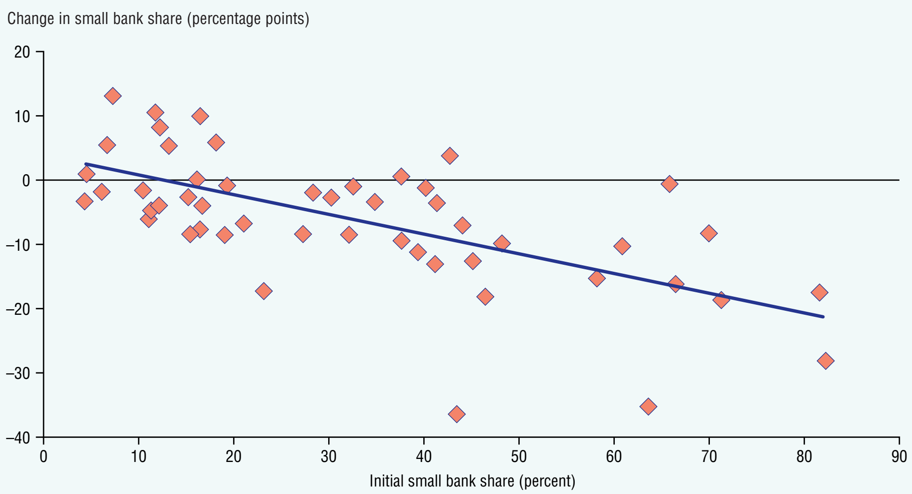
evidence of an equilibrium small bank market share well above zero.

Small Businesses. A substantial part of small banks' activity involves providing financial services to small businesses. While lending decisions have increasingly relied on data-rich statistical analyses, in many cases the most relevant indicators regarding the creditworthiness of individual small businesses still take the form of first-hand information gained through close lender–borrower relationships. And it is here that small, community-based banks may have retained a degree of competitive advantage.

Despite the continuing shift in banking system assets to larger institutions, small banks' share of total bank lending to small businesses (business loans with original amounts of $1 million or less)

Chart 4

Small Banks Gain in Many States Where Market Share Had Been Low

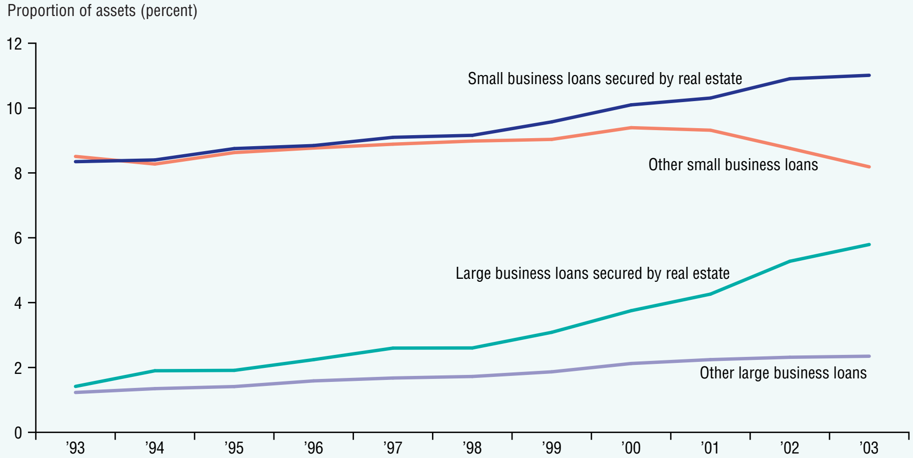


NOTES: Small banks' market share in a state is defined as the share of total bank deposits in the state controlled by organizations with nationwide bank assets less than $1 billion (2002 dollars). The change in small bank market share is the change in small banks' proportion of total bank deposits from 1991 to 2001, by state. The initial small bank share is small banks' proportion of total bank deposits in 1991, by state.

SOURCES: Summary of Deposits, FDIC; Call Report, FFIEC; Consumer Price Index for All Urban Consumers, Bureau of Labor Statistics.

Chart 5

Small Banks Turning to Business Lending Backed by Real Estate



NOTES: Small banks belong to organizations with less than $1 billion (2002 dollars) in commercial bank assets. Business loans are commercial and industrial loans and loans secured by nonresidential, nonfarm real estate. Small business loans have original amounts of $1 million or less. All data are as of June 30.

SOURCES: Call Report, FFIEC; Consumer Price Index for All Urban Consumers, Bureau of Labor Statistics.

has slipped only slightly. Small banks currently account for 37 percent of total bank lending to small businesses, compared with 40 percent in 1993, when data first became available. Small banks' 37 percent share of small business lending is particularly remarkable given that they control only 13 percent of banking system assets. Small banks' greater focus on small business lending explains their disproportionate share of system-wide small business loans. Small banks currently devote more than 19 percent of their assets to small business loans, up from 17 percent in 1993. In contrast, small business loans represent only 3.5 percent of aggregate large bank assets.

The high and increasing share of small bank assets in small business loans reflects an effort to shore up business with this customer group. While business loan demand generally has fallen off in recent years, small banks have achieved growth in a particular subset of this area—business lending backed by nonresidential real estate. As a proportion of total small bank assets, small business loans secured by nonresidential real estate have increased substantially (*Chart 5*). And the trend toward real estate-secured lending is also evident in large business loans.

Farms. While small business lending represents an important niche for small banks, it is not the only one. Just as first-hand borrower information can often still give small banks an advantage in lending to small businesses, community-based banking appears to have the upper hand in farm lending. The advantage associated with close lender–borrower relationships may be especially important in agriculture; farms are typically located a substantial distance from regional banking centers, which would make it difficult for a large bank's central office to evaluate farm borrowers or monitor lending decisions made at rural branches.

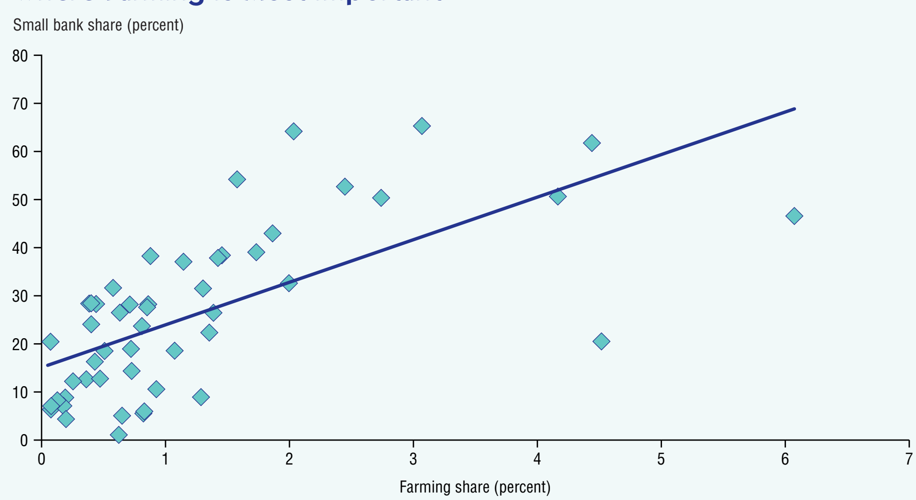
A positive association between small banks and farming is clearly visible in the market share data for 2001, the most recent year for which data on farming's share of state output are available. Small banks tend to account for a large share of total deposits in states where farming accounts for a large share of total gross state product (*Chart 6*). Further reflecting their agricultural niche, almost 59 percent of all small banks are headquartered in rural areas.

The positive association between small banks and farming involves strong financial ties. Small banks currently account for 64 percent of total bank lending to farms, down only slightly from 68 percent in 1993. As a group, small banks devote 5.6 percent of their assets to farm loans, and for many small banks this ratio is much higher. Small banks in rural areas hold 10.3 percent of their assets in farm loans. In contrast, the farm loan ratio for large banks is 0.3 percent.

Individuals. Small banks have also been working to reinforce their position

Chart 6

Small Banks Tend to Have Highest Market Share in States Where Farming Is Most Important



NOTES: Small banks' market share in a state is defined as the share of total bank deposits in the state controlled by organizations with nationwide bank assets less than $1 billion (2002 dollars) in 2001. Farming share is the proportion of total gross state product farming accounted for in 2001.

SOURCES: Summary of Deposits, FDIC; Call Report, FFIEC; Consumer Price Index for All Urban Consumers, Bureau of Labor Statistics; Regional Economic Accounts, Bureau of Economic Analysis.

in even some of the most hotly contested areas of the consumer market. These efforts are perhaps best illustrated by developments in home mortgage lending.

Today's home mortgage market is highly securitized and competitive, bolstered by government-sponsored enterprises like Fannie Mae and Freddie Mac. Large mortgage lenders have adopted high-volume, low-cost strategies based on highly automated systems, resulting in strong price competition. Such a market may appear to leave little role for small banks.

But despite the seemingly long odds, small banks remain active players in the home mortgage market, and recent data indicate small bank mortgage operations have been profitable. Fourteen percent of small banks' total assets currently are in first-lien home mortgage loans, reflecting substantial involvement in this area. In addition, many of the home mortgage loans small banks originate are sold in the secondary market, either directly or more often indirectly through a mortgage broker, and are no longer reflected on the banks' books. Taking the share of assets in home mortgages as a rough indicator for involvement in the home mortgage market, the available data indicate small banks are successful in this line of business. A large portfolio of home mortgage loans has tended to boost small banks' return on assets, while reducing the variability of that return.

The positive relationship between home mortgage lending and profitability at small banks suggests they retain significant capacity in this area. Some small banks have pursued aggressive approaches, including direct connections to the secondary market and web sites that allow geographically distant individuals to apply for home mortgage products. In this sense, technology increasingly is allowing small banks to acquire some large bank attributes. Other small banks have followed a more scaled-back approach, opting to outsource much of the mortgage function. Even here, though, many have found a way to satisfy their customers' mortgage needs.

Churned or Cheated?

An important question for public policy has to do with the reasons behind the dramatic shift in the mix of banking firms toward large-scale banking. Has small banks' decline stemmed only from the technology-induced dismantling of regulations that previously had protected them from competition? If so, the reduced prominence of small banks may simply represent another manifestation of technology's beneficial effect in churning the economy, whereby new, superior modes of business are enabled, which then supplant more traditional, but less effective, business forms.

Another possibility, however, is that the regulatory environment has evolved into one that not only no longer protects small banks but actually works against them. The decline in small banks might then be overdone, to the detriment of their primary customers. Disparities in regulatory treatment involving competitors outside the banking industry, such as credit unions' exemption from both federal taxation and Community Reinvestment Act requirements, represent a potentially important disadvantage for small banks. With regard to competition between banks of different sizes, the burden of regulation often weighs most heavily on small institutions. Because compliance costs contain a substantial fixed component, they can easily eat up a greater share of revenue for small banking operations than for larger ones.

Such considerations, coupled with the pronounced decline in small bank market share over recent years, suggest policymakers may need to assess whether a once protective regulatory environment has evolved into one that now places small banks at an artificial disadvantage.

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