Community Bank Performance in Slower Growing Markets: Finding Sound Strategies for Success

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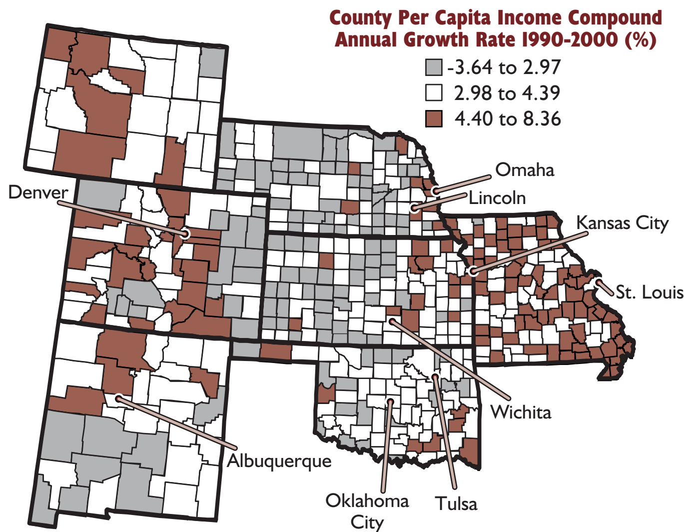
Community banks operate in a variety of different markets in the seven Tenth Federal Reserve District states.[1] These markets include larger metropolitan areas, smaller urban areas, and a wide range of rural communities. This variety of markets further encompasses a range of economic conditions and challenges. For community banks, in particular, local economic conditions are of special importance, because of the close tie between these banks and their communities. A substantial number of community banks are located in parts of the District—predominantly rural areas—that are experiencing slower economic growth, a less vibrant business environment, and little or no population increase. As a consequence, a key set of concerns for these community bankers is how to maintain prosperous banking operations and contribute to the financial health of their communities.

In particular, banks in slower growing areas may struggle to find good lending opportunities. These banks may also face a significant challenge in maintaining a stable deposit base as some bank customers pursue opportunities in faster growing areas. Banks could face other difficulties as well. For example, slower growing markets could present more of a problem in attracting new staff or in finding capable and experienced managers and directors.[2] In addition, banks may not be able to achieve sufficient growth and diversification in markets that do not offer an expanding range of business prospects. At the same time, however, good bank managers are expected to make the best of the opportunities they do have and adopt strategies appropriate to the market conditions they face.

Map 1

Change in County Per Capita Personal Income 1990-2000



Source: Bureau Of Economic Analysis Regional Economic Analysis System 1969 - 2000, May 2002

These challenges thus raise a number of questions regarding the overall performance of banks in slower growing communities and their ability to control risk exposures, attract deposits, find sound lending opportunities, and operate efficiently. In this paper, we attempt to address many of these questions for a subset of banks headquartered in Tenth District states.[3] The first section of the paper uses county economic and demographic variables to identify slower growing counties within Tenth District states. To examine whether slower growing markets pose a serious challenge for local banks, the next section compares the performance of community banks in such markets to that of their counterparts in faster growing counties. The final section looks at banks that have performed well in slower growing counties in order to gain insights into their success and identify sound strategies that other banks might follow.

ECONOMICS AND DEMOGRAPHICS OF SLOWER GROWING COUNTIES

Intuitively, market economic conditions should influence bank performance. These conditions set the stage for performance by determining many of the business opportunities a bank will have, the financial health of bank customers, and the overall vibrancy of a bank's market area. Economic conditions further provide a meaningful test of a bank's management and staff and their ability to adapt and perform under circumstances that may not always be ideal.

To provide a measure of local economic conditions, we first examined a variety of economic and demographic variables measures for all 509 counties in the seven Tenth District states. Our period of analysis is 1990 to 2000, which allows this study to focus on the longer-term trends and not be driven by short-term economic fluctuations in individual markets. The 1990 to 2000 period also allows the most recent Census data to be used in constructing county economic and demographic variables.

There are many measures that could be used to categorize market vibrancy, and after some testing, we found that per capita personal income growth in a county appears to provide a fairly comprehensive measure of county economic conditions.[4] Thus, for purposes of this study, counties are categorized as low-growth counties if they rank in the bottom quartile of all the counties in Tenth District states on the basis of their per capita personal income growth. Counties in the middle two quartiles are referred to as medium-growth counties, and those in the top quartile are high-growth counties. The map on this page shows that most of the low-growth counties (those in gray) are located in the western two-thirds of Kansas and Nebraska, part of eastern Colorado, western Oklahoma and southwestern New Mexico. High-growth counties (those in maroon) are typically located in or near metropolitan areas (a dot on the map represents the center of a designated metropolitan area) or in places that offer geographic or climatic amenities (e.g., the south central part of Missouri around the lakes and rivers and along the mountain ranges in Colorado, New Mexico, and Wyoming).

Consequently, most of the slower growth counties appear to be located in rural areas, especially those areas far from larger cities or more scenic amenities. A primary factor in the slower growth of these rural counties and their communities is likely

to be their dependence on the agricultural sector. At the start of the twentieth century, rural communities commonly thrived as trade centers for the surrounding farming areas. However, in the intervening years, technological improvements in agriculture have increased farm productivity and the amount of land one farmer can efficiently manage, thus leading to significant increases in the average size of farms and a related decline in agricultural employment opportunities.[5] An outgrowth of such trends is long-term population exodus and fewer business opportunities in many rural communities.[6]

Other factors have also played a role in changing rural America. Improvements in transportation and telecommunications have served to shift business away from smaller communities and into larger regional trade centers. The movement of major discount retailers and nationwide franchises into larger rural communities is a prime example of this, but a growing demand for more advanced services has also contributed to rural consolidation in health care, schools, and other important areas.[7]

These trends help provide an insight into the underlying economy of many of the low-growth counties in this study. A more detailed picture of these counties can be derived from looking at other county economic and demographic measures. These measures are summarized in Table 1. In general, counties with low per capita income growth also experience lower population and employment growth, have a greater portion of the population 65 years or older, and have more people employed in the agricultural sector.[8] Additionally, Table 1 shows that low-growth counties are losing retail sales to faster growing counties and, according to several demographic measures, are generally located in rural areas with fewer scenic amenities.

Low-growth counties also differ from other counties with respect to a number of countywide banking structure measures. As shown in Table 2, low-growth counties, as a group, experienced very modest growth in the total number of banking offices between 1990 and 2000 compared to other counties with faster per capita income growth. The faster growing counties, in fact, appear to have benefited most from the significant liberalization of branching and other bank expansion laws that occurred in Tenth District states during the 1980s and 1990s.[9]

When deposits are combined for all banking offices in a county—both main offices and

Table 1

County Demographic Factors

	Quartile Range in County Per Capita Income Compound Annual Growth Rate 1990-2000		
	-3.64 to 2.97% (Low-Growth Counties[1])	**2.98 to 4.39% (Medium-Growth Counties[1])**	**4.40 to 8.36% (High-Growth Counties[1])**
Population Change 1990-2000	7.92%	11.22%	18.36%
Population 65 or older 2000[2]	16.44%	13.01%	11.13%
Employment Change 1990-2000[2]	10.94%	20.06%	32.39%
Farm Employment to Total Employment 2000[2]	14.75%	3.84%	1.98%
Regional Retail Pull Factor 2000[2,3]	.88	1.03	.98
1993 Urbanization Measure[4]	3.39	2.67	2.39
2001 ERS Amenities Measure[5]	3.38	3.71	3.83

Table notes:

1 There are 127 counties in each of the low- and high-growth county quartiles and 255 counties in the medium-growth or middle two quartiles.

2 The value is a weighted average, meaning that the numerator and denominator are summed over all observations in the county quartile before the ratio is calculated.

3 The regional retail pull factor measures the relative ability of a county to capture retail sales from the income earned by county residents. A value less than 1.00 indicates a county is capturing less than its share of retail sales and is presumably losing these sales to other counties. A value above 1.00 signifies that a county is above average in attracting retail sales and is likely capturing sales from other counties. Often retail pull factors compare a county's performance against a state average. In the case of this study, county retail sales and income data are compared against an average for the seven states in the Tenth District.

4 The 1993 urbanization measure can take a value between 0 and 4, where the value 0 represents a very urbanized area and a score of 4 means a completely rural area.

5 The Economic Research Service county amenities measure takes into account a variety of factors — temperature, humidity, daylight hours, land surface (plains, tablelands, open hills and mountains, and hills and mountains), and water area — that may affect the attractiveness of an area's living environment. The measure can take a value between 1 (low amenities) and 7 (high amenities).

Sources: Bureau of Economic Analysis - Regional Economic Information System 1969-2000, U.S. Bureau of Census - 2000 Census, FDIC Summary of Deposits, Department of Agriculture Economic Research Service, Sales & Marketing Management 1991 and 2000 Survey of Buying Power.

Table 2
County Banking Measures

	Type of County by Per Capita Income Growth Between 1990 and 2000		
	Low-Growth Counties	**Medium-Growth Counties**	**High-Growth Counties**
Number of Banking Offices 1990	512	2,230	1,516
Number of Banking Offices 2000	597	3,212	2,551
Compound Annual Deposit Growth 1990 – 2000	2.96%	4.21%	5.27%
Deposits per Banking Office - 1990 (weighted average)	$20.1 million	$34.8 million	$40.3 million
Deposits per Banking Office - 2000 (weighted average)	$23.1 million	$36.6 million	$40.0 million
Population per Banking Office - 1990 (weighted average)	1,984	4,101	4,921
Population per Banking Office - 2000 (weighted average)	1,837	3,167	3,461

Source: FDIC Summary of Deposits.

branches, Table 2 also shows that counties with low per capita income growth have had the slowest compound annual deposit growth between 1990 and 2000. Low-growth counties further show fewer deposits per banking office and substantially less population per banking office compared to counties with faster per capita income growth. These differences have declined somewhat with the more rapid office expansion in faster growing counties during the 1990s. However, banks with offices in low-growth counties still face the challenge of operating with a much lower deposit and customer base and would have to undertake considerable office consolidation to approach the levels of other banks.

BANK PERFORMANCE IN LOW-GROWTH MARKETS

Long-term economic trends and the overall level of market growth are key elements of the environment in which a bank operates. The preceding section indicates that banks in markets with low per capita income growth may also face such challenges as little population and employment growth in their communities, an aging population, heavy dependence on the farm sector, and a loss of retail sales to other markets. In addition, fewer people may be around to support each banking office, thus leaving banks with a smaller market for their services and possibly a greater need to combine offices.

To judge how these market or county conditions might influence individual bank performance, we compare the performance of banks on the basis of whether their main office is located in a low-, medium-, or high-growth county. Since banks in the low-growth counties are virtually all smaller institutions, these performance comparisons are limited to banks with total assets of less than $300 million.[10] This group of banks is further separated into two categories based on a bank's tax filing status—either "C-corp" banks that pay taxes at the corporate level or "S-corp" banks whose earnings are attributed to the individual stockholders for tax purposes.[11]

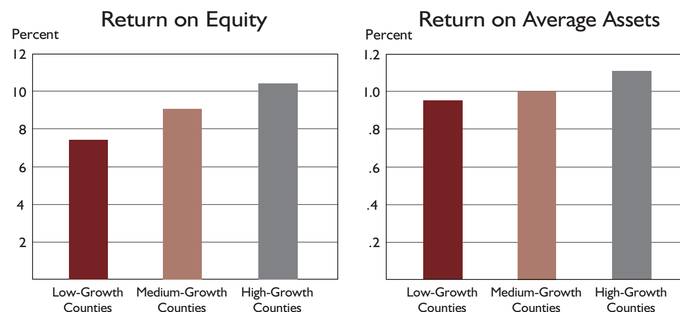
Data from the Reports of Condition and Income provide the primary source of information for measuring and comparing banking performance, and these numbers were used to construct standard bank performance ratios for each bank. Each of these ratios is averaged over a three-year period, 1999 to 2001, to help smooth out any one-time events or unusual circumstances and thus give a more stable, longer-term view of a bank's performance. In addition, the 1999-2001 period was selected because it brackets the end of the decade used for monitoring county economic conditions, thereby tying a bank's performance to the longer-term economic conditions that have prevailed within its market.[12]

The sample of banks that meet all of the study criteria consists of 1,050 banks, made up of 777 C-corp banks and 273 S-corp banks, distributed across the low-, medium-, and high-growth counties. Since many of the observations pertaining to the perfor-

mance of S-corp banks are similar to that for C-corp banks, the following discussion and tables will focus entirely on C-corp banks. Comparable data for S-corp banks are provided in the Appendix. Also, in order to isolate the effects of local market conditions on bank performance, the analysis first looks at banks operating from a single office. The single-office criteria further limits problems in trying to track banks that operate in a number of different markets and under a variety of economic conditions. The performance of banks with multiple offices will then be compared to that of banks operating from a single office.

Graph 1

Panel A - Earnings



Panel B - Interest Margins

Relative performance of banks with a single office

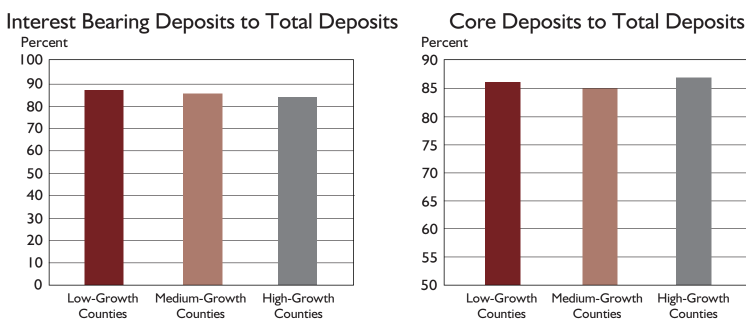
A substantial number of banks—nearly two-thirds of all C-corp banks in the sample—continue to operate from a single office during the time of this study. From an asset size standpoint, banks in low-growth counties are somewhat smaller on average ($30 million) than their counterparts in medium- ($37 million) and fast- ($52 million) growing counties, but the typical bank in any of these county categories would still be regarded as a small community bank.

Graph 1 shows that bank performance tends to mirror market economic conditions. Although banks in low-growth counties are generally performing at a satisfactory level, their performance does not match that of comparable banks in medium- or high-growth counties. For instance, their average return on equity is nearly three percentage points below that of their counterparts in high-growth counties and 1.6 percentage points below banks in medium-growth counties (Panel A). Banks in low-growth counties also show a somewhat lower return on average assets compared to other banks (Panel A). Thus, long-term economic trends in a county appear to play an important role in the overall profitability of local banks.

These performance differences could result from a variety of banking factors. For instance, banks in low-growth counties might have more difficulty in maintaining interest margins, finding lending and income-generating opportunities, or funding their activities. They might also struggle to achieve efficient operations and to limit their risk exposure. Any or all of these factors could be important in explaining the lower earnings of banks in low-growth counties.

Interest margins – Since the underlying economic conditions may influence the "markups" or margins a bank can achieve, interest margins—the difference between interest income and interest expense—provide a starting point for examining bank performance in slower growing markets. Banks in low-growth counties are somewhat behind other

Panel D - Funding



banks in the net interest margins they achieve (Panel B). However, in terms of interest income, banks in low-growth markets actually did better than banks in high-growth markets (Panel B). This advantage, though, was more than offset by the higher interest expenses at banks in the low-growth counties, thus suggesting that funding may be more of a problem in slower growing markets than finding earning assets (Panel B).

Lending and other income-generating opportunities – Compared to banks in high-growth areas, banks in low-growth counties are managing to maintain higher loan-to-asset ratios, but these ratios are below that of banks in the middle group of counties (Panel C). The most obvious difference in lending is that banks in low-growth counties generate most of their lending business from the farm sector and do less business, consumer, and real estate lending as a group (Panel C). Banks in slower growing markets trail other banks in generating noninterest income with less than 11 percent of their income coming from this source, compared to nearly 20 percent for banks in high-growth counties (Panel C). All of these numbers thus suggest that banks in low-growth markets are typically able to find adequate lending opportunities, mostly related to the agricultural economy, and are keeping pace with most other banks in generating revenue, except with regard to noninterest income sources.

Funding – The higher interest expenses incurred by banks in slower growing counties suggest that a key challenge for them may be in obtaining lower cost funding. Graph 1 shows that part of the added cost of funding for banks in low-growth counties could be due to the slightly higher proportion of interest-bearing deposits they hold (Panel D). These banks also have fewer core deposits than banks in high-growth counties, but these differences are very small, and banks in medium-growth counties would appear to have even more of a core deposit disadvantage (Panel D).

Efficiency – Another concern or challenge for banks in slower growing markets is trying to operate at an efficient level, given the possible difficulties in attracting top level employees to small rural markets

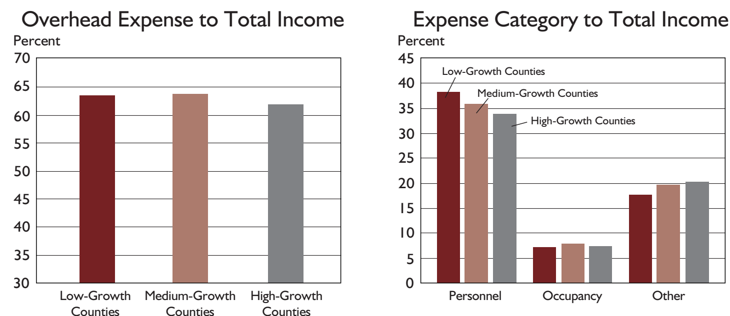
and the fewer opportunities to grow and reach a larger scale of operations. Graph 1 shows that banks in low-growth markets incur somewhat greater overhead expenses relative to the revenue they generate when compared to banks in high-growth counties (Panel E). However, no disadvantage in efficiency can be found when the comparison is with banks in the medium-growth counties. Banks in low-growth counties have the best control over occupancy expenses and other expenses but have higher personnel costs in comparison to the revenue being generated (Panel E). Thus, even though rural banks in low-growth areas are commonly thought to benefit from lower wage rates, this alleged advantage is more than offset by their inability to make effective and efficient use of personnel to generate income for the bank.

Risk and Asset Quality – A common perception of banks in less vibrant markets is that they will have more credit quality problems, particularly with less income growth in the market and fewer sound lending opportunities to pursue. Although some of the differences are slight, this perception generally appears to hold up for the banks in this study. The banks in low-growth counties, for instance, have higher levels of nonperforming loans than banks in faster growing counties (Panel F).[13] Also, banks in slower growing counties appear slightly more risky in terms of their predicted examination ratings under the Federal Reserve System's SEER rating system (Panel F). While these banks have a low probability of failure on average, as measured by the SEER risk rank, this probability is still more than twice as high as that of banks in other counties (Panel F).[14]

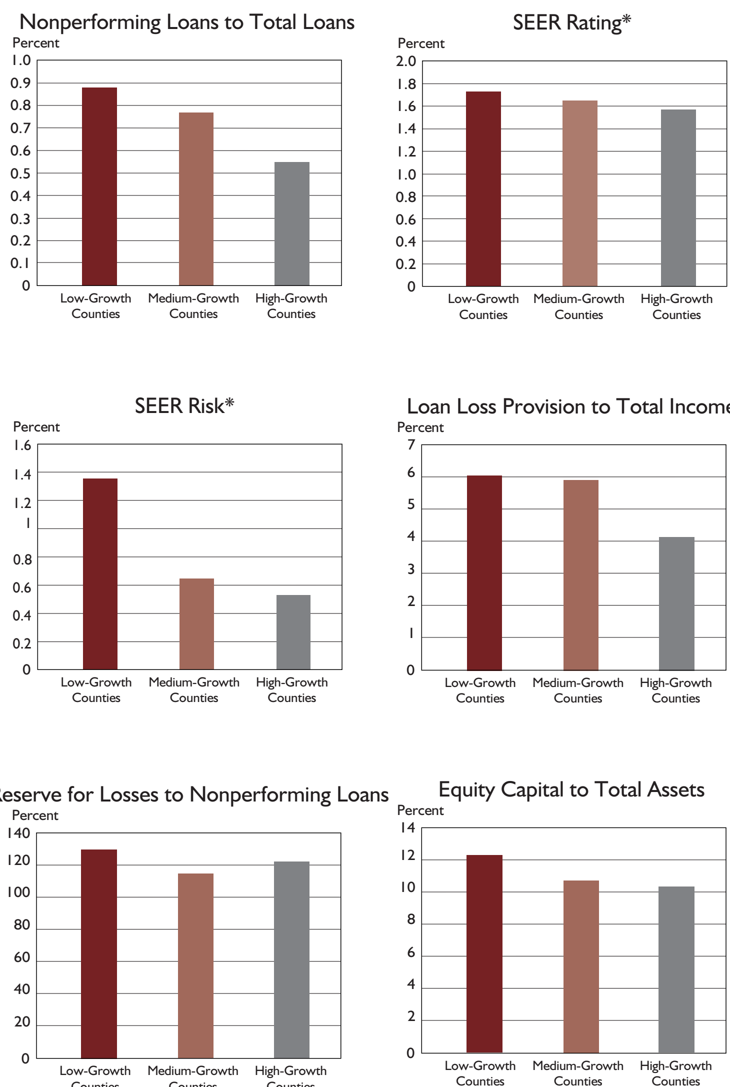
At the same time, banks in slower growing markets provide more out of their revenue for loan losses (Panel F) and maintain higher coverage ratios (Panel F).[15] In addition, these banks have more equity capital, which would help to offset any greater risk in their operations (Panel F). As a result, the average bank in a slower growing market is taking steps to address economic uncertainties and diversification concerns, albeit at some cost to its revenues and overall return on equity.

Graph 1 (continued)

Panel E - Efficiency



Panel F - Risk and Asset Quality



* System to Estimate Examination Ratings, see endnote 14 for a more details on SEER.

Source: Reports of Condition and Income

Table 3

Bank Performance in Low-Growth Counties

(C-corp Banks; Average Performance: 1999-2001)

	Single Office Banks	Multi-Office, Single-County Banks	Multi-Office, Multi-County Banks
Number of Banks	128	6	20
Average Assets (In Millions of $)	30.128	69.985	80.737
Return on Equity	7.48	10.01	8.75
Return on Average Assets	.96	1.16	.87
Net Interest Margin	3.84	4.24	4.14
Interest Income to Average Assets	7.36	7.72	7.78
Interest Expense to Average Assets	3.51	3.47	3.64
Loans to Total Assets	56.26	59.52	66.39
Farm Loans to Total Loans	59.06	31.00	42.86
Business Loans to Total Loans	12.65	20.85	15.69
Consumer Loans to Total Loans	6.08	10.23	6.44
Real Estate Loans to Total Loans	22.21	37.92	35.01
Noninterest Income to Total Income	10.98	14.44	24.10
Interest Bearing Deposits to Total Deposits	87.38	87.38	88.62
Core Deposits to Total Deposits	86.31	84.75	86.02
Overhead Ratio	63.55	63.36	66.90
Occupancy Expense to Total Income	7.25	9.04	8.34
Personnel Expense to Total Income	38.40	34.31	37.97
Other Expenses to Total Income	17.70	19.92	20.15
Nonperforming Loans to Total Loans	.88	1.05	.91
SEER Rating	1.73	1.70	1.86
SEER Risk Rank	1.36	1.76	3.22
Provision to Total Income	5.99	5.12	6.54
Coverage Ratio	129.61	56.88	92.20
Equity Capital to Total Assets	12.37	11.03	9.62

Source: Reports of Condition and Income

Summary – As a group, single-office banks in slower growing Tenth District markets do not appear to be performing as well as their counterparts in other markets when measured by returns on equity and on average assets. While this performance lags other banks, it is still at a satisfactory level, which suggests that these banks are not having serious problems but could face some challenges and adjustments in the future. Among the most likely factors behind this lower performance are higher funding costs, less noninterest income, greater personnel expenses in relation to the revenue being generated, and somewhat lower asset quality.

Performance of banks with multiple offices

A number of banks that are headquartered in low-growth counties have more than one office either within the same county or in other counties. This multi-office structure could affect a bank's performance in several ways. For example, additional offices could provide banks in low-growth markets with an opportunity to diversify their lending activities and customer base, enter faster growing and more prosperous markets, or achieve a larger and more efficient scale of operations. Multi-office expansion may also be a sign of success—banks that perform well are more likely to have the financial and managerial resources to expand their banking office network. On the other hand, multiple offices could be more of a strain on managerial resources or more costly to staff and operate if the offices fail to generate enough business.

Table 3 shows that of the 154 C-corp banks in this study that are headquartered in low-growth counties, 26 have multiple offices and 20 of these operate in more than one county. These multi-office banks are several times larger on average compared to single-office banks in low-growth counties. From an earnings standpoint, this group of multi-office banks achieves a higher return on equity than their single-office counterparts, but banks with offices in more than one county have the lowest return on average assets. When compared to banks headquartered in high-growth counties, multi-office banks in

slower growing counties have lower returns on equity, particularly in relation to multi-office banks in faster growing areas.[16]

Several other performance differences are apparent. As shown in Table 3, banks with multiple offices tend to have higher net interest margins compared to banks with a single office, and much of this advantage reflects such related factors as higher interest income, greater loan-to-asset ratios, and increased real estate lending. Fewer differences exist with regard to interest expenses and core and interest-bearing deposits. Multi-office banks are much more successful in generating noninterest income.

Having more than one office does not appear to contribute to any notable improvement in efficiency. Although multi-office banks show lower personnel costs relative to total income, their occupancy expenses, other expenses, and total overhead are higher in most cases. Multi-office banks on average also do not appear to be achieving any notable risk diversification benefits from their office expansion. Their nonperforming loans are slightly higher than single-office banks, most have slightly higher SEER ratings, and SEER risk ranks are higher. Equity capital levels are lower for multi-office banks, which suggests that their management and stockholders, at least, perceive that greater size and office diversification should have a favorable effect in controlling risk.

Overall, these results suggest that banks headquartered in low-growth counties have found increased lending and income-generating opportunities by expanding through additional offices, but these multi-office banks still lag behind their counterparts in faster growing counties. Becoming more efficient and achieving better risk diversification are proving to be even more of a challenge for multi-office banks in low-growth counties.

STRATEGIES FOR SUCCESS

While banks in low-growth counties generally have not achieved the same level of performance as their counterparts in faster growing areas, a number of these banks have found ways to perform at a remarkably high level. These high performers are clearly of interest because their success has been achieved in a challenging environment, and their particular strategies should therefore prove very useful to other banks operating in similar circumstances.

To identify a group of banks that have done well in low-growth counties, we selected all the banks from low-growth counties that met our previous study criteria and also have an average return on equity from 1999 to 2001 that is in the top quartile of all banks in Tenth District states. A separate comparison was made for C-corp and S-corp banks because of the differences in their after-tax returns. The numerical analysis presented below is based on the 17 C-corp banks in low-growth counties that meet this high-performance test.

We also picked a smaller group of ten banks from both the C-corp and S-corp high performance groups and took a more in-depth look at their performance, operating characteristics, and strategies. This group includes eight of the seventeen C-corp banks that meet the high-performance test and two of the six S-corp banks that also qualify as high performers. These banks were selected on the basis of their strong performance over a period of time and favorable supervisory ratings. An additional objective was to achieve some diversity in the size of banks selected, type of office structure, and business focus and strategies.[17] We conducted telephone interviews with a senior officer at each of these banks—generally the president, focusing on the challenges each bank faces and what strategies and factors have been the keys to success. To supplement these interviews, we further reviewed various financial performance measures for the ten banks and any supervisory and examination information that provided insights into their strategies and success.

High performing C-corp banks

As shown in Table 4, the 17 "high-performing" C-corp banks achieve much higher returns on equity and on average assets than the typical bank in a low-growth county, thus indicating that some banks can find ways to do well in this environment (lines 3 and 4). While the numbers in Table 4 do not provide specific information on the strategies each of these banks use to achieve success, these

Table 4
High-Performing Banks in Low-Growth Counties
(C-corp Banks; Average Performance: 1999-2001)

	High Performing Banks	All C-corp Banks in Low-Growth Counties
1. Number of Banks	17	154
2. Average Assets (In Millions of $)	58.9	38.3
3. Return on Equity	14.68	7.94
4. Return on Average Assets	1.32	.95
5. Net Interest Margin	4.29	3.95
6. Interest Income to Average Assets	8.00	7.50
7. Interest Expense to Average Assets	3.70	3.54
8. Loans to Total Assets	67.74	59.27
9. Farm Loans to Total Loans	35.77	52.13
10. Business Loans to Total Loans	18.49	14.16
11. Consumer Loans to Total Loans	7.33	6.48
12. Real Estate Loans to Total Loans	38.41	27.23
13. Noninterest Income to Total Income	13.31	11.96
14. Interest Bearing Deposits to Total Deposits	88.16	87.73
15. Core Deposits to Total Deposits	85.33	86.12
16. Overhead Ratio	57.25	64.51
17. Occupancy Expense to Total Income	7.47	7.71
18. Personnel Expense to Total Income	32.67	37.96
19. Other Expenses to Total Income	17.07	18.58
20. Nonperforming Loans to Total Loans	.33	1.61
21. SEER Rating	1.44	1.74
22. SEER Risk Rank	.33	1.61
23. Provision to Total Income	3.88	6.08
24. Coverage Ratio	164.76	110.76
25. Equity Capital to Total Assets	8.46	11.52

Source: Reports of Condition and Income

financial ratios do provide a quick overview of key performance differences. First, the high performers are able to maintain greater net interest margins through their ability to generate much higher interest income (lines 5 and 6). This higher interest income is a direct result of these banks finding more lending opportunities, particularly with regard to real estate and business borrowers (lines 8-12). These banks also have a slight edge in generating noninterest income (line 13). As a group, high-performing banks appear to have no funding advantage over the average bank and, in fact, have somewhat higher interest expenses, more interest-bearing deposits, and less core funding (lines 7, 14, and 15).

Another significant factor separating high-performing banks from other banks in low- growth counties is their ability to operate more efficiently. Most notably, the high performers have much lower overhead ratios, largely reflecting their control of other expenses and ability to use personnel effectively in generating income (lines 16-19). A final and very important factor favoring high-performing banks is success in maintaining asset quality and controlling overall risk exposure. High performers, for example, benefit from much lower levels of nonperforming loans, better SEER ratings, less need for loan loss provisions, and more success in building up coverage ratios (lines 20-24). These results further indicate that high performers have not sacrificed asset quality while increasing their lending. Better risk control also helps to explain why high performers may not feel the need to maintain as much capital as other banks (line 25).

Senior officer interviews

While the above numbers help to give an overall picture of high-performing banks, the interviews we conducted with ten senior officers provide much more detailed insights into the factors behind the success of their banks. In addition, the interviews reflect the philosophy and strategies these bankers employ to counter a low-growth environment. The ten banks vary from fairly small banks, as low as $15 million in total assets, to banks that have established a network of branches in surrounding areas and now have $100 to $200 million in assets. Consequently, these ten banks cover nearly the full range of conditions, opportunities, and concerns that banks in low-growth markets are likely to face.

The ten bankers we interviewed also rely on a variety of strategies. A number of the bankers focus entirely on their own small community and achieve their success largely by being outstanding both in serving their communities and in the way they operate their banks. As one banker said, "We are very happy being a small community bank." While these banks all focus on traditional community banking needs, most are also creative in finding business opportunities in their own counties and nearby markets.

Bankers at these smaller community banks specifically mentioned such things as loan participations with other community banks; innovative support for new farmers and local businesses through government guaranteed loans and other means; and efforts to make real estate, business, and consumer loans in neighboring communities experiencing more growth. Although such strategies are unique to each bank and its market, the bankers had a number of common attitudes and objectives. "As a small town bank, if you are going to grow, you need to be a little bit creative and find a market."…"Participations have worked well for me—if all we did was make farm loans, we would be a $10 million bank."…"We've found that we need to expand our horizons in order to grow—you don't stay right within ten miles of town and get a lot of growth."

Other bankers we interviewed look beyond their local market or markets for the chance to grow and are achieving some success in these new ventures, including some bankers that have established branches in faster growing areas. Several comments from the bankers illustrate this philosophy: "We are always looking to expand and I think if we don't, we won't be around."…"We made a decision to not just be agricultural banks, but to get into some other areas and diversify our portfolio and to try and get into some communities that have more substantial growth."

Even with this diversity in size and strategy, the ten banks had many things in common. All of the bankers, for instance, rated the long-term prospects in their communities as holding their own or, at best, growing at a slow pace. These prospects, however, did not deter them. Instead, the bankers had a positive, but realistic attitude toward what they could accomplish with their available resources. As one banker stated: "We aren't looking for the home run, we're going to look for singles and bunts all the time—our population base has remained the same since the Oklahoma land run." Consequently, there often wasn't anything very startling behind the success of these banks other than getting the basic business of banking down right—excellent customer service, sound credit quality, and very efficient operations.

Customer service was an important point of emphasis by the bankers. One banker's philosophy is "to provide customers with everything a big bank can do, but at a better rate, quicker service, and more personal service—customers can call me at home on Saturday and Sunday." Another banker stated: "My philosophy and that of our staff is that we go the extra mile to take care of our customers—we do what other banks say they will." Other comments included: "We bought this bank to keep it in the community."…"Our customers have been with us forever—we keep fees low and don't want to push fees—attracting deposits hasn't been a problem because of our history with customers."…"I keep a good local deposit rate mainly for my seniors."

Without exception, bankers in our survey stressed asset quality as a key and, in many cases, the most important factor in their success. In the words of one banker, "We feel credit quality is the Number 1 issue we have to deal with—we feel strongly we don't want to have any questionable loans—in generating earnings, make sure it is real." Other bankers said: "We will not downgrade our underwriting to make a loan."…"You don't want to grow with bad loans."…"Banking is getting and keeping a good portfolio of loans."

Efforts to achieve high credit quality were specifically mentioned by several bankers as the defining factor in the success of their banks. "We took a very strong stand on diversifying—thinking that would help us in tough times—and it was the smartest thing we ever did."…"We feel comfortable and we like it being more conservative, remembering what we went through [during the 1980s]."…"We were a very small, 1-rated bank

back in the 1980s—all these other banks started having problems and we just started acquiring banks—that set us on our way and we just stayed with that [sound credit] philosophy."

A third factor in the basics of banking—efficient operations—was also cited by many of the bankers as central to their success. In one banker's words: "One of the main budgetary constraints that we work on each year is what our expenses are—we control our expenses from employee costs to paper and everything on down to justify the bottom line." Several bankers stated that: "We have always had low overhead." In addition, many of the bankers are making effective use of technology in increasing the efficiency of their operations. According to one banker: "Technology has allowed us to do some things—particularly in the lending area—loan documentation and analysis, preparation of loan documents, etc.—much, much more efficiently than we used to. We can handle quite a bit bigger volume without increased staff."

In addition, there were many other common elements in the success of these ten banks. Among the most important of these were a 'go slow' attitude toward new activities, a hardworking staff and board of directors, continuous efforts to keep up with banking regulation, and a profound concern for helping the community and the next generation of customers.

While most of these banks were not afraid to venture into new areas, they all entered new business lines slowly and cautiously, starting small and then growing with their customers. A number of the bankers' comments summarize this careful approach: "We started out very slowly and carefully into other types of lending—we are a conservatively aggressive group—we want to do things, but we want to do it slowly enough so we don't risk what we have."…"We try to enter new markets through word of mouth, individual connections, etc.—it is slow growth, but that is exactly the way we have it planned with our Board."…"If you outgrow your infrastructure, you are going to have problems."… "I could grow if I wanted to, but I don't because we are staffed for about as much as we can handle right now."…"We may buy another bank, but are already efficient so added size won't help."

Virtually all the bankers mentioned a hardworking staff of long-term, local employees and a dedicated board of directors as critical elements in the success of their banks. "Part of our success I might say is willingness to work. I credit the staff with a lot of it, because everyone down to the last person is willing to take care of the people they deal with, and they are willing to work the hours it takes to make it work." Another banker stated: "We feel we are very fortunate to have a great group of employees—as we have grown, we haven't had to hire that many more—everyone has just rolled up their sleeves." Other staffing aspects our high-performing bankers stressed were local ties to the area, training, and competitive compensation and benefits. "We want our employees to live here in this community and be involved."…"Hard to attract qualified people to small communities—you have to grow your own."…"We pay them well for this area and send them to all the schools."

The bankers had similar comments and expectations regarding their boards of directors. A few bankers were struggling to find new, younger directors with ties to the community and bank, but most bankers were pleased with the overall makeup of their boards and the role the boards were playing. The bankers also took a number of steps to ensure their boards had the appropriate incentives for corporate governance. As one banker stated, "Our directors have to buy significant amounts of stock so they will look carefully at the bank."

The bankers we interviewed agreed almost uniformly that keeping up with bank regulation was a major challenge for their banks. Perhaps the most colorful description of this challenge we heard was: "The regulation of small banks is like killing a gnat with a sledgehammer." These bankers achieve regulatory compliance through several different, but very effective and efficient, means. "We spread the responsibility around amongst several staff members and reduce it down to what we need to do." Other bankers mentioned subscribing to regulatory software, designating a compliance person, outsourcing part of their loan compliance, and

attending regulatory update seminars given by regulators and state banking associations.

A final, but central factor in their success that these high-performing bankers emphasized was concern for the community and surrounding areas and for passing the torch along to the next generation. Several comments reflected these thoughts: "All the communities in small rural areas have to work together for any of them to survive—we work fine with all the other banks."…"We feel we want to take very good care of the businesses that are here and allow them to expand and utilize the talent and resources they have. If you have an individual that wants to be in business here, we definitely can provide the support."

A notable portion of the bankers specifically mentioned younger customers and the next generation as keys to continued growth and prosperity in their communities and banks. "Our main street is full and every so often the businesses have to take a turn to the younger generation—when the youth come in, they do more and it rejuvenates the community."…"We do many FSA guaranteed loans and a lot of these are for first time borrowers—new, younger farmers—if a guy makes it, he will be with you forever."[18] Several bankers are even extending these efforts beyond their communities: "I'm in the process of having each branch contact kids that have moved out of here to see, if we offer Internet banking, would they bank with us."…"Technology may be one way to keep some of the younger people banking with us through debit cards, credit cards, and Internet banking."

Overall, these interviews with bankers reveal a number of strategies and attitudes that could be of use to other banks operating under the same type of circumstances. While a few of the high-performing banks may benefit, in part, from a unique market or set of opportunities, there appears to be little that separates the challenges these banks face from that of other banks in slowly growing areas. What does appear important, though, is the attitude within these ten banks and their concerted efforts to serve local customers and the local community, find innovative and productive outlets for bank capital and funding, maintain high credit quality, and more than satisfy all the other pieces of the banking equation.

SUMMARY

States and communities in the Tenth Federal Reserve District encompass a variety of economic conditions and challenges. Of particular concern are many rural areas where the local economy, technological change in agriculture, and consolidation in retail and other services often contribute to slow income growth and little or no population growth. The results of this study indicate that banks in these low-growth areas typically struggle to match the performance of banks in faster growing areas. While these rural banks, as a group, still perform at a satisfactory level, they generally suffer from higher funding costs, less noninterest income, greater personnel expenses in relation to the revenue they generate, and somewhat lower asset quality.

A number of banks in these low-growth areas, however, have done much better and more than matched the performance of most banks in faster growing areas. Thus, achieving good or, in some cases, outstanding performance in these slower growing markets is not impossible—just more difficult.

Our analysis of these high-performing banks in low-growth areas and our interviews with their senior officers reveal several factors that help to explain their success. This success, for instance, begins with a positive, but realistic attitude toward what these bankers could accomplish with the available resources. It also includes getting the basic business of banking down right—from exceptional customer service to highly efficient operations and unquestionable credit quality. These bankers and their banks also demonstrate much skill in entering new business lines carefully and slowly, putting together a hard-working staff and board of directors, and assisting the local community and the bank's next generation of customers. The high-performing banks thus set a good example for other banks in low-growth markets—good managers can succeed in almost any environment by making the best of the opportunities they do have and by adopting strategies appropriate to the conditions they face.

Appendix Table 1

Bank Performance by County Growth Categories

(Single Office, S-corp Banks; Average Performance: 1999-2001)

	County Growth Category		
	Low-Growth Counties	Medium-Growth Counties	High-Growth Counties
Number of Banks	39	96	37
Average Assets (In Millions of $)	38.575	43.654	51.075
Return on Equity	13.72	16.58	20.81
Return on Average Assets	1.60	1.74	2.20
Net Interest Margin	3.93	4.15	4.37
Interest Income to Average Assets	7.45	7.54	7.58
Interest Expense to Average Assets	3.53	3.39	3.21
Loans to Total Assets	59.07	59.48	60.72
Farm Loans to Total Loans	54.20	30.11	18.21
Business Loans to Total Loans	16.93	17.86	18.79
Consumer Loans to Total Loans	5.23	11.29	8.74
Real Estate Loans to Total Loans	23.65	40.75	54.26
Noninterest Income to Total Income	10.62	15.39	14.93
Interest Bearing Deposits to Total Deposits	86.83	85.26	82.96
Core Deposits to Total Deposits	85.47	83.92	86.61
Overhead Ratio	57.99	59.68	53.07
Occupancy Expense to Total Income	7.00	7.85	7.56
Personnel Expense to Total Income	34.43	33.60	29.85
Other Expenses to Total Income	16.51	18.10	15.63
Nonperforming Loans to Total Loans	1.30	1.25	.94
SEER Rating	1.54	1.44	1.35
SEER Risk Rank	.95	.50	.33
Provision to Total Income	4.54	3.93	3.38
Coverage Ratio	121.39	107.84	139.85
Equity Capital to Total Assets	11.30	10.10	10.32

Source: Reports of Condition and Income

ENDNOTES

[1] The seven Tenth Federal Reserve District states include Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming. Community banks are commonly defined by their size—typically smaller banks (banks under $1 billion in assets for example)—and/or by their focus—personalized service to customers in the local community. As will be shown later, this study looks at a particular segment of the community bank population.

[2] Forest Myers, "Management and Staffing Challenges," *Financial Industry Perspectives,* December 2001, Federal Reserve Bank of Kansas City, pp.15-16.

[3] A number of other studies have also looked at the relationship between the local economy and bank performance. These include: Robert N. Collender and Sherrill L. Shaffer, "Local Bank Office Ownership, Deposit Control, Market Structure, and Economic Growth," *Technical Bulletin No. 1886*, Economic Research Service, U.S. Department of Agriculture, May 2000; Andy P. Meyer and Timothy J. Yeager, "Are Small Rural Banks Vulnerable to Local Economic Downturns?" Federal Reserve Bank of St. Louis *Review*, March/April 2001, pp. 25-38; and John M. Anderlik, Jeffrey W. Walser, Christopher J. Sesler, and Troy D. Osborne, "Overview of Economic and Banking Conditions," *Regional Outlook*, Federal Deposit Insurance Corporation, Kansas City Region, First Quarter 2000, pp. 19-28.

[4] Any number of measures could be used to categorize the economic conditions in counties, e.g., various income measures, population change, changes in employment, retail sales growth, etc. To select a measure, we constructed maps like Map 1 for each of the economic or demographic measures and compared these maps for similarities and differences. In addition, we did preliminary statistical analysis of the relationship between these economic measures and bank performance levels. All of the different market condition variables we tried were significant factors in the bottom-line performance of banks. The change in county per capita personal income, though, seemed to provide the most general and clearcut measure of county economic performance. From an intuitive standpoint, it appears to be a good, direct measure of economic stress, and from a practical standpoint, it appeared to classify the counties best according to general perceptions of economic growth and underlying banking performance.

[5] The annual average increase in agricultural productivity from 1948 to 1994 was 1.94 percent. This reflects an annual growth in output of 1.88 percent per year and an actual decline in agricultural inputs of 0.06 percent per year. Mary Ahearn, Jet Yee, Eldon Ball, and Rich Nehring; "Agricultural Productivity in the United States", *Agriculture Information Bulletin No. 740,* U.S. Department of Agriculture, January 1998, p.iii.

[6] Richard Rathge and Paula Highman, "Population Change in the Great Plains: A History of Prolonged Decline," *Rural Development Perspectives,* Vol. 13, no.1, U.S. Department of Agriculture, Economic Research Service, pp. 19-21.

Appendix Table 2

Bank Performance in Low-Growth Counties

(Single Office, S-corp Banks; Average Performance: 1999-2001)

	County Growth Category		
	Single Office Banks	Multi-Office Single-County Banks	Multi-Office Multi-County Banks
Number of Banks	39	1	8
Average Assets (In Millions of $)	38.575	110.032	98.912
Return on Equity	13.72	21.82	18.84
Return on Average Assets	1.60	2.50	1.66
Net Interest Margin	3.93	4.78	4.50
Interest Income to Average Assets	7.45	7.72	8.10
Interest Expense to Average Assets	3.53	2.95	3.60
Loans to Total Assets	59.07	61.14	71.51
Farm Loans to Total Loans	54.20	9.09	33.43
Business Loans to Total Loans	16.93	13.82	20.83
Consumer Loans to Total Loans	5.23	7.52	8.74
Real Estate Loans to Total Loans	23.65	69.56	37.00
Noninterest Income to Total Income	10.62	16.98	15.06
Interest Bearing Deposits to Total Deposits	86.83	84.15	87.67
Core Deposits to Total Deposits	85.47	88.39	89.92
Overhead Ratio	57.99	55.25	59.87
Occupancy Expense to Total Income	7.00	6.29	8.47
Personnel Expense to Total Income	34.43	31.82	33.21
Other Expenses to Total Income	16.51	17.14	18.08
Nonperforming Loans to Total Loans	1.30	1.00	1.38
SEER Rating	1.54	*	1.63
SEER Risk Rank	.95	*	.33
Provision to Total Income	4.54	1.23	7.91
Coverage Ratio	121.39	112.58	89.56
Equity Capital to Total Assets	11.30	11.42	8.42

*Because there is only one bank in this category, this item is omitted for confidentiality reasons.

Source: Reports of Condition and Income

[7] Mark Drabenstott and Tim R. Smith, "The Changing Economy of the Heartland," *Economic Forces Shaping the Rural Heartland,* Federal Reserve Bank of Kansas City, April 1996, pp.1-11.

[8] To provide some perspective on Table 1 data, nationwide compound annual per capita income growth was 4.14 percent over the decade of the 1990s and population increased by 13.2 percent. For 2000, 12.4 percent of the population was 65 years old or older, and 1.85 percent of workers were in agriculture.

[9] For a summary of this liberalization in bank expansion laws, see Kenneth Spong and Jim Harvey, "The Changing Structure of Banking: A Look at Traditional and New Ways of Delivering Banking Services," *Financial Industry Perspectives,* May 1998, Federal Reserve Bank of Kansas City, pp. 1-16.

[10] This size restriction thus helps to ensure that banks in low-growth countries are compared with their "true" counterparts in faster growing markets, thereby minimizing any performance or operational differences that could be attributed solely to differences in the size of banks. We also tried alternative size cutoffs of $500 million and $1 billion, and while they didn't markedly change our results, they led to a much greater size disparity among banks in low- and high-growth counties.

[11] This study looks at these two categories of banks separately, due to the different tax treatment they receive and the consequent differences in their reported after-tax income. Since 1997, banks have been able to choose sub-chapter S federal tax filing status like any other corporation, provided they have 75 or fewer shareholders and one class of voting stock. With sub-chapter S status, a bank avoids paying corporate income taxes by instead allocating all of its earnings for tax purposes to the shareholders, who are then taxed on the earnings at their individual tax rates. Because S-corps pay no federal income taxes, their bottom line performance is thus substantially higher than what a comparable C-corp bank would report on an after-tax basis.

[12] Because of this three-year performance analysis, the study only includes banks that remained in operation over the entire three years. To provide a comparable group of banks and filter out the unique characteristics of de novo banks, we further limited this analysis to banks that had been in business for at least five years prior to 1999.

[13] Nonperforming loans are defined as the loans and leases that bankers report as past due for 90 days or more plus nonaccruals.

[14] The Federal Reserve's SEER ("System to Estimate Examination Ratings") is an off-site, early-warning system for monitoring the financial condition of banks during periods between on-site examinations. A bank's SEER rating is a current estimate of its composite CAMELS examination rating, as based upon the bank's most recent Report of Condition and Income and prior examination ratings. Like the CAMELS rating system, a bank's SEER rating will take on a value between "1" (strongest) and "5" (weakest), and due to the statistical estimation procedures, a bank's estimated rating need not be a whole number. The SEER risk rank estimates the probability, from 0 to 100 percent, that a bank will become insolvent and fail within the next two years. So, for example, a bank with a SEER risk rank of 1.0 would be estimated to have a one percent chance of failure within two years.

[15] The coverage ratio is the allowance for loan and lease losses divided by total nonperforming loans and leases.

[16] We haven't included comparable performance measures (1999-2001 averages) in this paper for the multi-office, C-corp banks in high-growth counties. These banks, though, achieved an average return on equity and on average assets of 13.35 percent and 1.35 percent, respectively, when operating from multiple offices in a single county and 14.23 percent and 1.23 percent when they had offices in more than one county. All of these returns thus exceed those reported in Table 3 for multi-office banks in low-growth counties.

[17] Geographically, the banks are also fairly well dispersed across the low-growth counties in Tenth District states with Kansas and Nebraska each having three banks in the sample, Oklahoma with two banks, and Colorado and Wyoming each having one bank.

[18] The FSA (Farm Service Agency—part of the U.S. Department of Agriculture) has programs for both direct and guaranteed loans for beginning or disadvantaged farmers, particularly those that might not qualify for conventional loans due to insufficient resources or setbacks from natural disasters. Under the guaranteed loan program, the FSA guarantees loans made by bankers and other conventional agricultural lenders for up to 95 percent of the principal amount, provided the loans meet certain qualifying criteria.