

PERSPECTIVES

FINANCIAL INDUSTRY

Perspectives

AUGUST 2007

FEDERAL RESERVE BANK *of* KANSAS CITY

The Changing Banking Structure: What Expansion Strategies are Community Banks Adopting?

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The last few decades have been a period of tremendous change in the U.S. banking industry. One of the most notable changes in this period has been a rapid consolidation among banks and banking organizations. Technological change, financial innovation, and the liberalization of bank expansion powers have all contributed to this consolidation trend. By 2006, the number of banks and banking organizations operating in this country had fallen to just over one-half the 1980 levels. This decline in the banking population is even more noteworthy given that the total number of banks in operation had remained virtually constant from 1934 to the mid-1980s. Another major change in the banking landscape is a significant jump in the share of all U.S. banking deposits held by the largest organizations. The share held by the 10 largest organizations rose from 17 percent in 1985 to more than 44 percent in 2006.

While merger activity by large banks has drawn a great deal of attention, the majority of mergers have involved smaller banking organizations. One study, for example, found that 91.5 percent of all bank and thrift acquisitions between 1994 and 2003 involved a target organization with less than \$1 billion in assets.¹ In addition, 45 percent of the mergers during this period were completed by acquiring organizations that had less than

\$1 billion in assets. These numbers thus imply that community banking organizations have played a very active—although often less noticed—part in the banking consolidation movement.

This notable volume of merger activity among community banks raises a variety of questions about their expansion strategies and objectives as well as their subsequent performance. For instance, what are the factors driving all these mergers? Do mergers provide a way for community banks to reach a more efficient scale of operation and to achieve greater diversification in their activities and geographic structure? Are technology needs, staffing issues, and regulatory compliance problems forcing community banks to merge and become larger in order to spread such costs over a larger base? Moreover, can community banks in slow growing markets use branching and bank acquisitions as a means to enter more promising markets and take advantage of new opportunities?

Another important question is whether acquisition and expansion strategies will provide a better means for community banks to serve their customers and to survive in a banking industry where more and more of the deposit base is shifting to larger banking organizations. A commonly perceived role of community banks is to maintain close relationships with their customers and bring banking services to those that might not have their financial needs met as well by larger institutions. Consequently, expansion by community banks may serve as a sign that they are still filling a void left by other banks and finding new avenues to reach customers whose banking needs might otherwise be underserved.

The first part of this article will provide an overview of banking consolidation across the United States as well as within the Tenth Federal Reserve District states.² Next, we will look at the community banks in Tenth District states and divide them into a number of different categories based on office structure and whether they have recently entered new markets in a significant manner. These categories will then be used to examine how banks

have performed according to their particular expansion strategies. This analysis will first look at rural banks that have started significant operations in metropolitan markets and will then turn to banks that have expanded into multiple rural markets.

BANKING CONSOLIDATION TRENDS

The rapid and nearly unprecedented consolidation of the banking industry over the past few decades has been driven by a number of factors.³ Most noteworthy are technological change, financial innovation, and the liberalization of bank branching, holding company acquisition, and interstate entry laws. Technological change has influenced many aspects of banking, ranging from expanded access to financial information, automation of various backroom activities, and improved and much less costly means of communication. Overall, these developments have made it much easier for banking organizations to operate and coordinate activities across greater distances and to consolidate processing and decision-making functions. As a result, technological change has removed many of the constraints and costs that had previously limited the ability of banking organizations to expand into new areas and market their services to a broader range of customers.

In much the same manner, financial innovation is also providing opportunities for banks to consolidate and expand their operations. Such innovations as automated underwriting systems, credit scoring, and securitization allow banks to reach and to fund a broader range of customers. More elaborate risk management systems and tools are further helping banks to track and control their risk exposures as they enter new markets and activities. The development of new financial instruments has also been important in giving banks the means to hedge the risks they take and providing the product base to attract a wider group of customers.

The ability of banking organizations to act on all of these incentives and opportunities, though, would not have been possible without the relaxation of many

laws limiting bank expansion. In the early 1980s, for instance, more than half of all 50 states either limited or prohibited bank branching within their borders. A number of these states also limited holding companies to owning a single bank, and interstate banking was only possible under a very limited set of circumstances. Since then, all but a few states have authorized unlimited statewide branching, and all states now allow multibank holding companies. During the 1980s and early 1990s, nearly every state enacted some form of law allowing entry on an interstate level—either on a nationwide or regional basis. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 further liberalized interstate banking by allowing bank holding companies to acquire banks in any state after September 29, 1995, and by opening the door for interstate branching on June 1, 1997.

These developments have paved the way for substantial consolidation in the U.S. banking industry. As shown in Table 1, nearly half of all banking organizations and banks have disappeared since 1980. The number of banks, in fact, has declined from 14,351 in 1980 to just 7,364 in 2006.⁴

This decline in the number of banks can be largely traced to separately chartered banks being converted into branches either on an intrastate or interstate level. In some instances, these conversions involved multibank organizations converting their existing banks into

branches after state branching laws were liberalized. Other conversions were the result of bank acquisition activity. Bank failures also explain some of the decline in banks, given that nearly 1,600 banks have failed since 1980. However, because the Federal Deposit Insurance Corporation arranged purchase and assumption transactions, deposit transfers, or financial or bridge bank assistance for the vast majority of these failed banks, nearly all were either reopened with new charters or as branches of an acquiring bank. As a result, many of their banking offices were left intact and have continued to be counted as banks or banking offices in Table 1. The decline in the number of banks is even more noteworthy, given that nearly 5,000 new banks have been opened since 1980.

U.S. banking organizations have experienced a similar decline in numbers as shown in Table 1. This large decrease is reflective of the vast amount of bank acquisition activity that has occurred since 1980.

In sharp contrast to the decline in banks, the number of banking offices, which includes both main offices and branches, grew by about two-thirds over this period. This substantial increase in banking offices provides a clear sign that banking organizations have responded to the adoption of more liberal branching laws and to the other incentives for expansion. These office numbers further indicate that many of the “disappearing” banks may still be around, but they are operating as branches of another bank. As a result of

Table 1
Number of Banking Organizations, Banks, and Banking Offices
(As of June 30 for Each Year)

	1980	1985	1990	1995	2000	2005	2006	Percentage change from 1980 to 2006
United States								
Banking organizations	12,336	11,240	9,350	7,730	6,711	6,320	6,275	-49.13
Banks	14,351	14,364	12,342	10,073	8,372	7,448	7,364	-48.69
Total banking offices	46,139	51,012	56,517	60,379	67,120	74,395	76,861	66.59
Tenth District states								
Banking organizations	2,385	2,328	1,924	1,532	1,321	1,279	1,262	-47.09
Banks	2,780	2,960	2,505	1,962	1,601	1,462	1,443	-48.09
Total banking offices	3,247	3,882	4,231	4,937	6,149	6,981	7,339	126.02

this growth in offices, banking customers typically have more convenient access to banking services now, albeit through fewer banking organizations.⁵

Table 1 also shows similar levels of banking consolidation in Tenth Federal Reserve District states. The decline in the number of banks and banking organizations in District states has occurred at virtually the same pace as nationwide.⁶ Much of this change in banks and banking organizations, moreover, took place between 1985 and 2000 when District states were taking major steps to liberalize what had been some of the most restrictive bank expansion laws in the nation.⁷

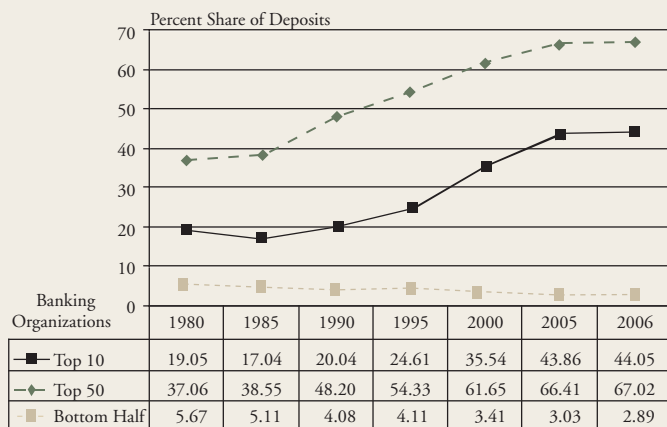
As shown in Table 1, the number of banking offices in District states experienced a 126.02 percent increase from 1980 to 2006, which was a much more rapid pace than nationwide. The most plausible explanation for this office expansion is the removal of restrictive branching laws in most District states and efforts by bankers to “catch up” in establishing branching networks. One other way of looking at this growth in banking offices and decline in banks is that the average number of offices per bank in 1980 was less than 1.2, whereas by 2006, this average had jumped to more than five offices per bank. Consequently, a significant part of the banking population in the District would appear to be operating under a much different structure now than it was several decades ago.

The nearly 50 percent decline nationwide in the number of banks and banking organizations since 1980 would suggest that the typical bank or organization should be noticeably larger now and serve many more customers. However, these numbers by themselves do not indicate which part of the banking industry—large, regional, or smaller banking organizations—has seen the greatest growth and consolidation. As shown in Chart 1, the largest banking organizations in the United States appear to have experienced the most significant gains in relative size, and a gradual decline has occurred in the share of deposits held by smaller organizations. The 10 largest banking organizations, for example, held just over 19 percent of the deposits in all U.S. banking offices in 1980. By 2006, their deposit share had risen to more than 44 percent. Other large banking organizations have also experienced a rising deposit share as shown by the trend line in Chart 1 for the top 50 banking organizations.

These substantial increases in deposit shares for the largest banking organizations would imply that the remainder of the banking population must be experiencing a declining share. This generally holds true across the remaining size categories of banks. Chart 1 shows that the half of the banking population that is made up of smaller organizations experienced a decline in its share of deposits from 5.7 percent in 1980 to 2.9 percent in 2006. While the number of banks in this group is also declining, the small banks that are left now hold a fairly minor portion of all banking industry deposits. The greatest decline in deposit share has occurred among regional organizations and the middle-tier of banks, particularly since many of these institutions became the acquisition targets of the largest banking organizations. The share of deposits held by banking organizations in the top half but not in the top 50 fell from 57 percent in 1980 to just 30 percent in 2006.

Chart 2 indicates that similar consolidation trends have occurred across Tenth District states, although

Chart 1
Shares of Domestic Banking Deposits Nationwide



Source: *Reports of Condition and Income*

most of the deposit gain by the District's top 10 and top 50 banking organizations took place before 1995.⁸ The half of the banking population that consists of smaller banking organizations has experienced a continuous decline in its share of deposits in District states, dropping from about 10 percent in 1980 to about 6.5 percent in 2006. These trends thus indicate that consolidation has helped larger organizations gain a greater share of deposits in District states, with smaller organizations losing part of their share of District deposits.

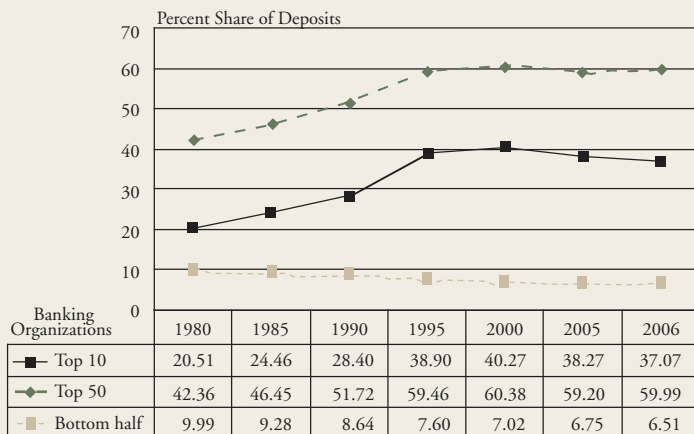
One other change that has occurred in the structure of the U.S. banking industry is a dramatic increase in

most states in which an organization had banking offices in 2006 was 32 (Bank of America Corporation), and no other organization was in more than 24 states.

In Tenth District states, 2.6 percent of all deposits were held outside of the home state in 1980. By 2006, these interstate deposit holdings had increased to 38.3 percent. The District and nationwide trends thus show that a substantial part of the banking business is now conducted on an interstate level. In establishing and expanding interstate operations, organizations are showing that they can find numerous ways to take advantage of technological change, financial innovation, and liberalized expansion laws.

As an outgrowth of all these industry changes, the U.S. and Tenth District banking structure has been greatly transformed within just a few decades. According to the numbers shown in this section, approximately half as many banks and banking organizations now exist as in 1980, but far more banking offices are now in place and many of these are part of interstate banking networks. It seems likely that some organizations may have been quicker to take advantage of this changing banking structure, and the gains in the deposit shares of large bank organizations would imply that they have played an active role in banking acquisitions and consolidation. For other organizations, consolidation has also been a common event but with a more diverse effect, enabling some organizations to expand beyond their existing markets and communities while leaving others to continue under their traditional framework or be acquired by surviving institutions.

Chart 2
Shares of Domestic Banking Deposits
(Tenth District States)



Source: *Reports of Condition and Income*

interstate banking. In 1980, only 2.4 percent of all banking deposits were held in offices outside of the "home state" where the parent banking organization had its main banking office. However, interstate banking has grown substantially since then. By 2006, banking organizations, as a group, surprisingly held roughly the same amount of deposits in other states as they held within their home state. Moreover, for the 10 largest banking organizations taken together, interstate deposit taking has become much more significant than their home state activities. These organizations, though, have a ways to go before any of them becomes a true nationwide bank. The

TENTH DISTRICT COMMUNITY BANKS AND THEIR EXPANSION STRATEGIES

With the removal of legal and technological barriers to geographical expansion, community banks in Tenth District states have explored a number of different branching and merger strategies. While some have chosen to be acquired by larger organizations, others have sought to expand on their own, and many have chosen to continue to operate under their existing office structure.

Community banks expanding beyond their traditional markets have done so in a variety of ways. These include acquiring or opening offices in markets similar to those where they already have offices, and opening offices in faster growing areas, such as rural banks branching or moving their headquarters into metropolitan markets.

All these community bank expansion strategies are being pursued for a wide range of reasons. Some community banks may be looking to become larger in order to spread operating, data processing, and regulatory compliance costs over a larger base of business, thereby becoming more efficient and competitive with larger institutions. Community banks may also expand in hope of achieving greater product and geographic diversification, thus lowering their exposure to a particular group of customers. Banks in small or slower growing markets may be interested in expanding into larger, faster growing markets to generate greater growth and a more secure future. Other reasons for expanding could include bringing in more skilled personnel, taking better advantage of the expertise a bank's staff may already have, capitalizing on special opportunities or further expanding a successful operation, and increasing the bank's capacity for developing new products and services. While it is difficult to determine the specific factors and reasons behind a bank's acquisition and expansion strategies, it is possible to follow the performance of different types of banks and the results they are able to achieve after a change in their structure.

To examine community bank strategies and performance, we looked at all banks operating in Tenth District states that had less than \$500 million in total assets at year-end 2006 and were not under the control of a banking organization with more than \$500 million in assets. These size limits help to provide a generally comparable group of banks which are focused on providing community banking services. We further separated these community banks into different categories based on their location and office structure on June 30, 2000, and how this office structure might have changed by 2006.

As shown in Table 2, the vast majority of community banks have maintained the same rural or metropolitan market focus from 2000 to 2006. A total of 421 banks, for instance, operated entirely within one or more rural markets, while 599 banks largely operated within metropolitan markets.⁹

A notable number of banks, though, have expanded into new types of markets and have made substantial changes in their office structure. Ten banks moved their main office from a rural market to a metropolitan market between 2000 and 2006. Another 102 banks headquartered in rural areas operated branches in metropolitan markets during 2006. Table 2 divides these rural banks according to whether their metropolitan branches are small or are significant, with significant branches holding deposits that make up more than 25 percent of their bank's total deposits. Of these rural banks, 46 had small metropolitan branches in 2006, and 34 had metropolitan

Table 2
Community Banks in Tenth District States
Banks with Assets <\$500 Million, 2006

Banks by office structure	Number of Banks	Average Asset Size (\$000)	Asset Growth One Year	Asset growth Five Years
Moved head office to metro area	10	137,924	22.0	131.3
Rural with significant new metro branch	22	165,373	14.7	103.6
Rural with significant established metro branch	34	140,477	7.8	47.0
Rural with small metro branch	46	147,633	7.6	72.6
De novo banks—metro	50	101,770	na	na
De novo banks—rural	7	68,537	na	na
Rural—no metro branch	421	59,812	6.0	23.5
Other metro banks	599	117,182	7.0	37.1

branches that were significant in both 2000 and 2006 (“significant established metro branch”). The remaining 22 banks had metropolitan branches that reached the significant size category somewhere between 2000 and 2006 (“significant new metro branch”). These branches included both new branches opened after 2000 and existing branches that achieved significant deposit growth by 2006. An additional 50 banks were opened in metropolitan markets after 2000 (“de novo banks—metro”), and seven others were opened in rural markets (“de novo banks—rural”).

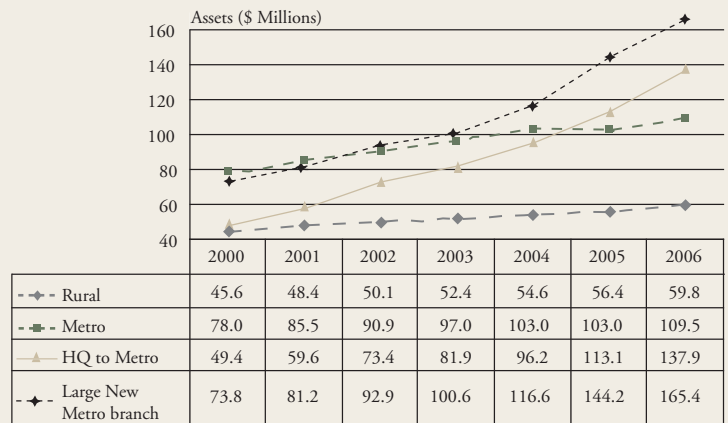
An initial question to ask about these different categories of banks is what are their general characteristics with regard to size and growth trends. As shown in Table 2, rural banks that switched their head office to a metropolitan area or that have metropolitan branches (either significant new, significant established, or small branches) reached a greater average asset size in 2006 than other rural or metropolitan community banks. The average asset sizes for these groups of banks ranged from \$137.9 million for banks that moved their head office to a metropolitan area to \$165.4 million for banks with a significant new metropolitan branch. These 2006 average asset figures all exceed that of traditional metropolitan banks—\$117.2 million in average assets—and of rural banks without metropolitan branches—\$59.8 million in average assets.

A key factor behind this higher asset size would appear to be the rapid growth rates these banks have attained for both one year and five years prior to 2006. Table 2 indicates that rural banks moving their head offices to metropolitan markets grew by more than 131 percent over the five-year period running through year-end 2006. This means that they would have started this five-year period only slightly larger than the typical rural bank, which they now greatly exceed in asset size (see Chart 3). Banks with significant new metropolitan branches have also grown rapidly during the past five years—more than 103 per-

cent. In contrast, banks that remained in rural areas only achieved a five-year growth rate of 23.5 percent. Consequently, to the extent that rural banks were using expansion into metropolitan areas as a means to improve their growth prospects and achieve a more efficient or competitive size level, they would appear to have been successful in many cases.

The financial performance of banks that have started or expanded operations in metropolitan areas can be judged in a number of ways, including their success in generating income, maintaining adequate capital, finding lending opportunities, and controlling asset quality. Other performance measures could encompass managing liquidity, achieving more efficient operations, and gaining favorable supervisory ratings. All of these performance categories should help provide a picture of whether the expansion strategies of community banks will enable them to meet the significant chal-

Chart 3
Average Asset Size By Office Location



Source: *Reports of Condition and Income*

lenges they face in a changing banking environment.

To simplify the following analysis, we have chosen to look at two rural bank expansion strategies: moving the head office to a metropolitan market or establishing a significant metropolitan branch. The other expansion strategies pictured in Table 2 are also important, but

they involve less significant expansion or expansion strategies that have been in place for some time. As a result, they may not provide the same insights into recent adjustment processes. In addition, de novo banks opened between 2000 and 2006 are not used in this analysis because many of them are still too new to have established a clear performance record. To assess the expansion strategies of these rural banks, we will compare them to the metropolitan and rural banks in Table 2 that have largely remained within their traditional markets.

In terms of generating earnings, rural banks that have expanded their presence in metropolitan markets since 2000 have substantially increased their operating incomes, as shown in Chart 4. Those banks that moved their headquarters into a metropolitan market after 2000 have seen their net operating income to average assets rise from 0.77 in 2000 to 1.42 in 2006.

Rural banks with new significant metropolitan branches during this period also saw their net operating income increase rapidly from 0.72 in 2000 to 1.26 in 2006. The lower income levels in the early part of this period might reflect start-up or adjustment costs on the part of those that entered metropolitan markets then. The lower earnings could also be a sign that some banks had been struggling in their rural markets and

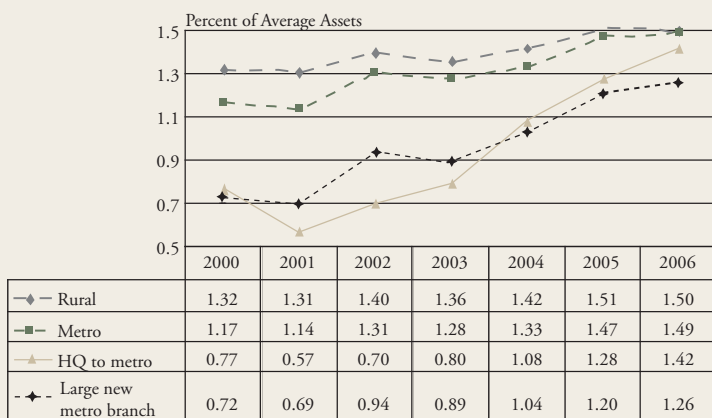
were seeking more promising opportunities. The rapid growth in earnings since 2000 shows that these rural banks generally have been able to overcome their adjustment problems and bring operating income much closer to that of other banks.

The ability of these banks to maintain their capital is also of interest, given the rapid growth they experienced after entering metropolitan markets and the start-up and adjustment costs they incurred. As Chart 5 shows, both the banks that moved their headquarters and those that had significant branch expansion were able to take these steps and grow quickly without suffering much, if any, decline in their capital levels. The capital levels they maintained, though, were more in keeping with that of other metropolitan banks than with the higher capital levels at rural banks. The fact that these banks did not suffer any obvious decline in capital suggests that they had the necessary resources to undertake their expansion strategies.

With regard to loan business, Chart 6 indicates that the banks expanding into metropolitan markets appear to have had little trouble in finding new credit customers. Both the banks moving their headquarters and those branching into metropolitan markets have increased their average loans-to-assets ratios by more than 6 percentage points between 2000 and 2006. These ratios have remained well above those of other rural banks, as well as other metropolitan banks, thus indicating that rural banks moving into metropolitan markets were active lenders to begin with and have become even more so with their metropolitan offices.

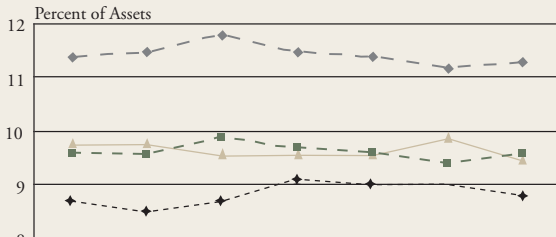
As shown in Chart 7, this increased lending has yet to lead to any notable lending problems for the banks moving into metropolitan markets. For much of the period, these banks have maintained lower levels of nonperforming assets, although some of this might be expected from the high volume of new loans they made and, consequently, little time for credit problems to emerge from the newest, less-seasoned loans on a bank's books.¹⁰ However, by 2006, the rural banks that

Chart 4
Net Operating Income to Average Assets
by Office Location



Source: Reports of Condition and Income

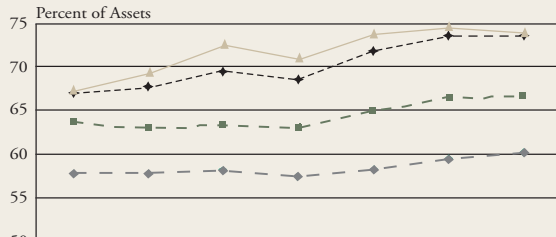
Chart 5
Equity Capital to Assets by Office Location



	2000	2001	2002	2003	2004	2005	2006
-◆- Rural	11.4	11.5	11.8	11.5	11.4	11.2	11.3
-■- Metro	9.6	9.6	9.9	9.7	9.6	9.4	9.6
-▲- HQ to metro	9.8	9.8	9.6	9.6	9.6	9.9	9.5
-✕- Large new metro branch	8.7	8.5	8.7	9.1	9.0	9.0	8.8

Source: Reports of Condition and Income

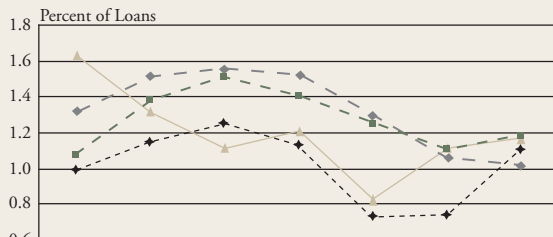
Chart 6
Loans to Assets by Office Location



	2000	2001	2002	2003	2004	2005	2006
-◆- Rural	57.77	57.70	58.19	57.34	58.29	59.49	60.09
-■- Metro	63.65	62.97	63.40	62.99	64.93	66.32	66.68
-▲- HQ to metro	67.42	69.44	72.65	70.97	73.74	74.65	73.94
-✕- Large new metro branch	67.21	67.71	69.30	68.60	71.75	73.75	73.59

Source: Reports of Condition and Income

Chart 7
Nonperforming Assets to Loans by Office Location



	2000	2001	2002	2003	2004	2005	2006
-◆- Rural	1.32	1.52	1.55	1.53	1.30	1.07	1.02
-■- Metro	1.08	1.38	1.51	1.41	1.25	1.10	1.19
-▲- HQ to metro	1.64	1.32	1.12	1.21	0.83	1.12	1.17
-✕- Large new metro branch	0.99	1.15	1.25	1.13	0.73	0.74	1.10

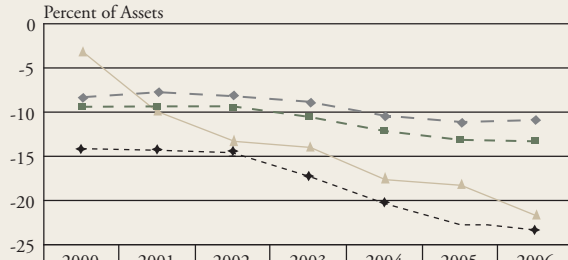
Source: Reports of Condition and Income

entered metropolitan markets through significant branches or main offices were back to having nonperforming asset ratios that were fairly similar to other banks. According to Chart 7, this increase in nonperforming assets took place in the last year or two—which was a time when nonperforming assets were generally declining or stable at other rural banks or established metropolitan area banks. As a result, it is uncertain whether this growth in nonperforming assets will continue for these metropolitan entrants or whether they will be able to keep them in line with other banks.

At the same time that lending increased, Chart 8 suggests that the rural banks expanding into metropolitan areas have been less successful in terms of maintaining liquidity and attracting core deposits. The ratio of net liquid assets to total assets has fallen substantially for these banks, which would imply a decline in liquid assets coupled with an increased use of noncore or less stable liabilities, such as large deposits and Federal Home Loan Bank advances.¹¹ This decline in liquidity is consistent with the need to find funding for the rapid loan and asset growth at these banks.

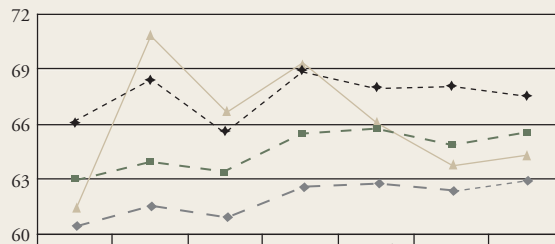
Another performance aspect of banks expanding into metropolitan markets is their ability to achieve efficient operations. In this regard, Chart 9 compares banks' efficiency ratios, which measure the cost that a bank incurs to generate a dollar's worth of earnings.¹² As shown in this chart, rural banks that have either moved their headquarters to metropolitan markets or now have significant metropolitan branches generally have had higher efficiency ratios (in other words, are less efficient) than traditional metropolitan and rural banks. However, these ratios have been declining, presumably as start-up costs decrease. In fact, rural banks that have moved their headquarters to metropolitan markets have become even more efficient than other metropolitan banks over the past few years.

For a final measure of performance, we looked at the examination ratings that bank supervisors have

Chart 8**Net Liquid Assets to Assets by Office Location**

	2000	2001	2002	2003	2004	2005	2006
◆ Rural	-8.27	-7.68	-8	-8.74	-10.31	-11.03	-10.79
■ Metro	-9.41	-9.24	-9.54	-10.52	-12.13	-13.1	-13.21
▲ HQ to metro	-2.95	-9.77	-13.05	-13.85	-17.27	-18.03	-21.36
⊠ Large new metro branch	-14.15	-14.34	-14.51	-17.35	-20.35	-22.6	-23.15

Source: Reports of Condition and Income

Chart 9**Efficiency Ratio by Office Location**

	2000	2001	2002	2003	2004	2005	2006
◆ Rural	60.51	61.54	60.93	62.57	62.82	62.41	62.99
■ Metro	62.98	64.06	63.39	65.46	65.79	64.91	65.55
▲ HQ to metro	61.56	70.93	66.78	69.31	66.20	63.89	64.41
⊠ Large new metro branch	66.09	68.41	65.59	68.93	68.03	68.10	67.55

Source: Reports of Condition and Income

assigned to the banks expanding into metropolitan areas. We found that in their most recent examinations, as of year-end 2006, banks with new metropolitan headquarters or significant branches had slightly weaker composite, asset quality, and management ratings than the typical metropolitan or rural bank. The average ratings, though, were still good and were not at levels raising supervisory concern.

Overall, our analysis suggests that rural banks moving into metropolitan markets are now matching or are close to matching the performance of other metropolitan and rural banks in most categories. Based on their income and

efficiency measures, these banks appear to have incurred some start-up and adjustment costs—much like any other bank opening new offices—and many of them may now be getting past this period. The new or expanded metropolitan offices have also provided these banks with an additional and significant source of growth, as well as added lending opportunities. As a result, expansion appears to have offered these banks a good means for diversifying their business and reaching a new customer base. These banks further seem to have had the financial and managerial resources to pursue their expansion strategies without noticeably increasing their risk exposure or reducing their capital levels. We would note, though, that these banks expanded during a period of very good banking conditions, and more difficult times might lead to greater adjustment problems.

EXPANSION INCENTIVES AND STRATEGIES FOR OTHER RURAL BANKS

The previous section looked at rural banks that had moved part of their operations into metropolitan markets. However, there are limits to how many rural banks can follow this strategy. In addition, many traditional rural banks may not have the financial resources and organizational capacity to pursue such expansion. Moreover, rural bankers may already be pursuing a successful strategy within their current market areas, and they may not want to move these banking operations away from their rural roots. In this regard, Table 2 on page 6 shows that 66 rural banks have been able to establish a significant metropolitan presence, while 421 banks—or more than six times as many institutions—continue to operate solely within rural markets.¹³ Consequently, a key question for these 421 rural banks is what, if anything, they should do to expand their existing office structure and market coverage.

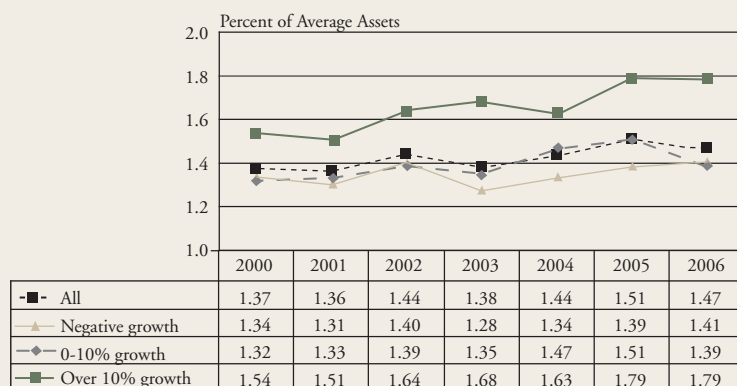
To examine this question, we first looked at how banks have performed in different types of rural markets and whether some of these markets would be more attractive for entry than others. We divided the rural

counties in Tenth District states into three categories based on their population growth between 1990 and 2000: those markets with negative population growth, those with 0 to 10 percent population growth, and those with more than 10 percent population growth. Table 3 looks at the 333 rural banks that have all their offices in a single county and divides them according to their county's population growth. As shown in this table, just over half of these single-county banks operate in markets that have had negative population growth. As might be expected, these banks are smaller—average assets of \$41.5 million—than the rural banks in faster growing markets, and they have also had lower asset growth rates over the last one- and five-year periods.

In terms of performance, banks in rural markets with the most rapid population growth have achieved the highest operating incomes, while banks in counties with negative or 0-10 percent population growth have had lower earnings levels (see Chart 10). As shown in Chart 11, banks in faster growing counties have also maintained higher loans-to-assets ratios than other rural banks, especially when compared to banks in counties with negative population growth. This result suggests that loan demand and lending opportunities have been greater in fast-growth counties. A number of other performance measures that we examined, such as net interest margins, favor banks in faster growing markets, as well.

Given these performance differences, expansion-minded banks in slower growing rural markets would appear to have an incentive to look first at fast-growth markets—either rural or metropolitan—for new office

Chart 10
Net Operating Income to Average Assets by Population Growth, 1990-2000
Single-Market Rural Banks Only



Source: Reports of Condition and Income

locations. As shown in the previous table and charts, such markets would seem to offer opportunities for better growth, improved earnings, and increased lending. Moreover, expansion into growing markets could provide ways to reach a more efficient scale of operations and to achieve better diversification and spreading of risk across markets. However, rural banks also have many other factors to consider in possible expansion strategies. These factors could include their own financial and managerial resources, specific areas of expertise, availability of desirable office locations or acquisition targets, and the relative convenience and synergies associated with any particular choice of markets.

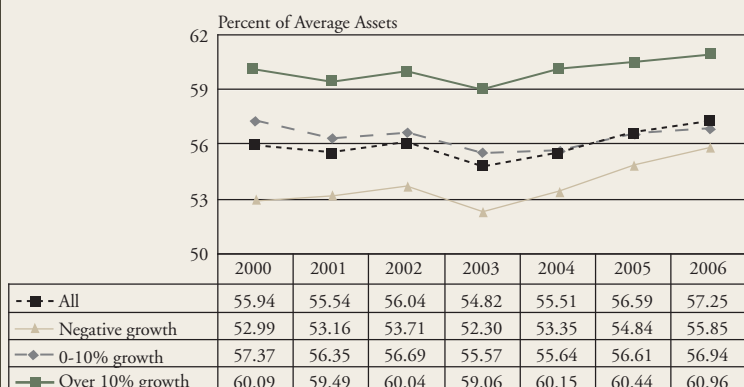
A simple way to test rural expansion strategies is to compare the performance of banks that now operate in a single rural county to that of banks that operate in multiple rural counties. This comparison should pro-

Table 3
Rural Banks in Slower and Faster Growing Counties—Tenth District States
Banks with Assets <\$500 Million

	Number of Banks	Average Asset Size (\$000s)	Asset growth one year	Asset growth five years
Rural—single county	333	51,395	5.50	20
Negative Growth	172	41,537	4.66	14.18
0-10% Growth	117	57,357	6.37	26.67
Over 10% Growth	44	74,080	5.40	20.69

Chart 11

Total Loans to Assets by Population Growth, 1990-2000 Single-Market Rural Banks Only



Source: *Reports of Condition and Income*

vide some indication of how successful rural banks have been in capturing the potential benefits from expanding into other markets. It also provides a test of whether rural bank managers can avoid any major problems that might arise in controlling and coordinating activities across different offices.

Table 4 provides an overview of the community banks in Tenth District states that operate solely within rural markets, and it shows that 88 of these banks operated in more than one county in 2006, while 333 banks were just in a single county.¹⁴ The banks with operations in multiple counties had average assets of more than \$91 million, while those banks in single markets were typically smaller with average assets of \$51.4 million. Table 4 further shows that banks in multiple counties have achieved higher asset growth rates over the past one- and five-year periods. Thus, expansion into multiple markets seems to have given these banks the opportunity to grow and reach a higher size level.

With regard to generating income, rural banks in multiple markets have only recently exceeded the performance of single-market banks (see Chart 12). Some of these banks may have expanded into their new markets during the past few years and had their earnings held down by start-up or merger costs. At the same time, there could be added costs in maintaining offices and conducting business in multiple counties. Still, the growth in earnings for banks in multiple counties has clearly outpaced that of single-county banks.

Chart 13 shows that banks in multiple rural markets have succeeded in finding lending opportunities. Throughout the 2000-2006 period, these banks have maintained loans-to-assets ratios well above those of banks operating within a single county. However, on a number of other performance measures, multiple-market and single-market rural banks have achieved fairly similar results. In 2006, for example, multiple-market banks were slightly better with regard to net interest margins, noncurrent assets, and efficiency, but they operated with a little less liquidity.

These results thus imply that multimarket operations may help in reaching greater size, increasing growth rates, and finding lending opportunities. Other benefits have been less apparent, but these banks may gain in the long run from having a more diversified base of customers and activities.

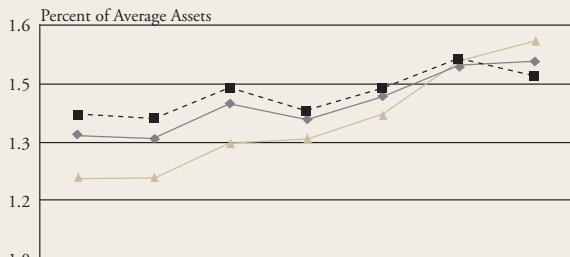
We should add one note of caution in interpreting the above results. Banks that expanded into multiple markets may have begun with more financial resources, on average, than banks that didn't expand,

Table 4

Banks Operating in Single and Multiple Rural Counties—Tenth District States

	Number of Banks	Average Asset Size (\$000s)	Asset Growth One Year	Asset Growth Five Years
Rural—no metro branch	421	59,812	6.0	23.5
Rural—single county	333	51,395	5.5	20.0
Rural—multiple county	88	91,659	7.2	31.4

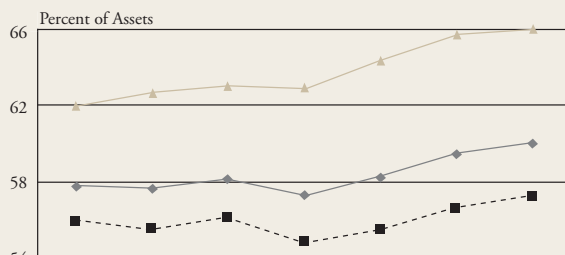
Chart 12
Net Operating Income to Average Assets by Office Location—Rural Banks Only



	2000	2001	2002	2003	2004	2005	2006
Rural	1.32	1.31	1.40	1.36	1.42	1.50	1.51
Single market	1.37	1.36	1.44	1.38	1.44	1.51	1.47
Multimarket	1.21	1.21	1.30	1.31	1.37	1.51	1.56

Source: Reports of Condition and Income

Chart 13
Loans to Assets by Office Location—Rural Banks Only



	2000	2001	2002	2003	2004	2005	2006
Rural	57.77	57.70	58.19	57.34	58.29	59.49	60.09
Single market	55.94	55.54	56.04	54.82	55.51	56.59	57.25
Multimarket	62.03	62.72	63.09	62.96	64.40	65.74	66.12

Source: Reports of Condition and Income

and they may have had more previous success, as well. Such resources and success would provide the incentive and the ability to undertake an expansion strategy, while banks without these attributes might not be in a position to make an investment in new markets. Consequently, the above results may reflect a blend of the characteristics these banks had before their expansion and any qualities that were derived from the expansion process.

SUMMARY

Consolidation has dramatically changed the structure of the banking industry over the past few decades.

There are approximately half as many banking organizations and banks as there were in 1980, and the largest banking organizations now have a much greater share of the industry's deposit base than ever before. At the same time, the total number of banking offices, which includes both main offices and branches, has increased by about two-thirds nationwide, thus giving customers more convenient access to financial services. These trends are being driven by technological change and innovation and by the liberalization of bank branching, acquisition, and interstate entry laws. Similar consolidation trends have occurred across Tenth District states. The growth in banking offices, though, has been even more rapid than nationwide, reflecting the removal of very restrictive branching laws that once existed in most District states.

While most of the attention in banking consolidation has been directed at mergers among large organizations and their rising share of the banking business, the vast majority of mergers have involved community banks either as a target or as an acquirer. For community banks, mergers and branch expansion offer a range of potential benefits, including growth opportunities, geographic and product diversification, and a larger base over which to spread their fixed costs.

In this article, we looked at two aspects of community bank expansion: rural banks moving into metropolitan markets and rural banks operating in multiple rural markets. In both cases, we found that community banks have had some success in achieving greater growth, expanding the size of their operations, and finding new lending opportunities. This expansion may have also led to other benefits, such as better risk diversification and a broader customer base. Rural banks pursuing these expansion strategies appear to have incurred some start-up and adjustment costs, thus raising the importance of having the financial and managerial resources to get through such periods. Such resources would be of even greater importance for banks that encounter banking conditions less favorable than those during our 2000-2006 study period.

Consolidation and rural bank expansion seem certain to continue. Many small rural banks operate in slower growing markets, and a number of these banks may seek to expand or merge with other banks to create a larger base of operations and to take advantage of opportunities in faster growing markets. A portion of rural bankers are also likely to have skills and expertise that could translate into successful operations on a larger scale.

How much consolidation will occur, though, is likely to depend on other factors, as well. While there are still many strong incentives for rural bank consolidation and market expansion, the initial spurt of consolidation that came from liberalizing bank expansion laws is largely over. Also, as shown by our numbers, rural banks have already expanded into many of the metropolitan markets in Tenth District states, and further expansion opportunities will depend on the continued growth of these markets or the emergence of other growth areas. An additional factor is that many rural banks are closely held and under family ownership. As a result, many of these banks, by themselves, may not have the added financial or managerial resources needed for significant expansion, and they may not be interested in being acquired until a turnover in ownership is imminent.

These factors thus suggest that rural bank consolidation will be driven by a variety of considerations. While there will continue to be significant incentives for community banks to expand into new markets and reach a broader customer base, this expansion will clearly depend on both the opportunities that arise and the growth of individual banking markets. In this environment, it will be important for bankers to construct a sound expansion strategy and be sure that they have the financial and managerial resources to support this strategy. As in the past, these strategies will be important in helping to ensure that community banks play an important role in directing banking resources to where they are most needed and bringing financial services to customers seeking a community banking relationship.

ENDNOTES

¹Steven J. Pilloff, "Bank Merger Activity in the United States, 1994-2003," Staff Study no. 176 (May 2004), Board of Governors of the Federal Reserve System.

²The seven states in the Tenth Federal Reserve District are Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming.

³The only other period in U.S. banking history when the number of banks declined by a similar proportion was from the early 1920s—when more than 29,000 banks were in operation—to 1934—when only about 14,000 banks were left. This drop in banks was largely a function of the Depression and a declining rural population.

⁴These numbers and other banking office statistics are taken from the Federal Deposit Insurance Corporation *Summary of Deposits* report, which collects deposit data for each commercial banking office in the United States, as of June 30 for each year. The bank performance numbers in this article are taken from the *Reports of Condition and Income* that banks file with their federal supervisors.

⁵Another aspect of this growth of banking offices is the rising number of branches that banks are placing in locations where their customers frequently conduct other business. Such locations include supermarkets, large retail and discount stores, and shopping centers. Under this branching option, banks typically rent a small area within a store or shopping center and bring in several employees to offer a limited range of services, most commonly deposit and transaction services and limited lending activities. These branches have contributed to the increase in banking offices by giving banks an opportunity to locate in a high-traffic area, but with a fairly low initial outlay. Approximately nine percent of the bank branches in Tenth District states in 2005 were located in retail stores.

⁶In Table 1, the number of banking organizations operating in the Tenth District includes any organization that has at least one banking office in those states. Some of these organizations will have their headquarters and their main banking operations in other states. The District banks listed in Table 1 are those that have their main office (that is, are chartered) within one of the Tenth District states.

⁷For a discussion of the changes in bank structure laws in Tenth District states, see Kenneth Spong and James 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.

⁸These organizations are ranked by the amount of deposits they have in their banking offices within Tenth District states. Some of these organizations have their headquarters, as well as substantial deposits, outside of the District states and are large organizations at the national level, while others have most of their banking operations within District states.

⁹In this analysis, we define a metropolitan market as either a metropolitan statistical area or a micropolitan area, as defined by the Office of Management and Budget. We combined these two areas to limit the number of bank categories to be examined and

to recognize the regional importance and growth trends of many micropolitan areas in District states.

¹⁰Nonperforming assets include loans past due 90 days or more, loans placed on nonaccrual status, and other real estate owned.

¹¹Net liquid assets are measured by the difference between liquid or temporary investments and noncore or less stable liabilities. Liquid investments include securities with floating rates or maturing within one year, fed funds sold and securities purchased under agreements to resell, and interest bearing bank balances. Noncore liabilities include fed funds purchased and securities sold under agreements to repurchase, large deposits, all foreign deposits, and other borrowings, which include Federal Home Loan Bank advances.

¹²The efficiency ratio is calculated by dividing a bank's noninterest expense by the sum of its noninterest income and interest income net of interest expense.

¹³As shown in Table 2, the 66 rural banks that have established a significant metropolitan presence include 10 banks that have moved their headquarters into a metropolitan area, 22 banks which have opened or expanded metropolitan branches to a significant level after 2000, and 34 banks that established significant metropolitan branches prior to 2000. Another 46 rural banks have small metropolitan branches.

¹⁴A number of the banks that operated in a single county may have had more than one banking office in that county.