Community Banking: Past and Future Prospects

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Introduction

As all of you are aware, now is a particularly apt time to look at what has been happening in the banking industry and what the future may hold for you as bankers.

The banking outlook for those of you that are community bankers is a particularly important topic, given the changes that are taking place in banking today. Over the past two decades, we have seen about half of the community banks in the United States disappear. Yet, at the same time, significant numbers of new banks are being chartered and many community banks are expanding their operations, thus indicating that community banks continue to fulfill an important role.

Before examining the community bank outlook in Nebraska, I first want to go back in time and talk about a long, warm, and mutually beneficial relationship between the Nebraska Bankers Association and the Federal Reserve Bank of Kansas City.

And then, I will turn to the banking outlook, discussing the changing banking landscape over the last twenty years and the accompanying challenges you face as Nebraska bankers. Lastly, I'll outline key strategies bankers appear to be implementing to meet these challenges.

The Nebraska Bankers Association and the Federal Reserve Bank of Kansas City

The opportunity to speak here today encouraged me to go back and review the history of Nebraska banking and the Nebraska Bankers Association, as well as the relationships that have existed between the NBA and the Federal Reserve Bank of Kansas City. In my research, I found a wealth of interesting, and sometimes surprising, facts and events.

Both the NBA and the Federal Reserve from their beginning have had a strong interest in serving their membership and the general public.

I was pleasantly surprised to find that the NBA is one of the oldest state banking associations in the US, first organized in 1889 by 45 Nebraska bankers attending an American Bankers Association convention in Kansas City. Was it just a coincidence that the Nebraska Legislature established a state banking department that same year and began providing for the supervision of a rapidly expanding population of state banks? Perhaps not, for like legislation today, I imagine it gave Nebraska bankers much to talk about at this initial gathering, as well as a common cause for joining together.

However, I'm certain there were other important factors. The early days of Nebraska were far from routine, and many stories have been written about drought, blizzards, grasshopper invasions, and financial panics. Banking, in fact, got off to an especially rough start in Nebraska. The first Nebraska territorial legislature voted to prohibit banking. One of these early legislators even said that he would like to look down from heaven someday and see the following inscription on his monument: "Here lies an honest man – He voted against 'wildcat banks' in Nebraska!" In fact, of the first eight banks chartered by the territorial legislature, all failed within two years.

The next few years weren't noticeably better for Nebraska banking. But once through the initial rough spot, many of the larger banks now operating in Nebraska got their start and have managed to survive a variety of challenges since then. This background, I think, provides a good perspective on why Nebraska banks were interested in organizing the NBA and why the NBA has had an important role to perform since then.

The opening of the Federal Reserve Bank of Kansas City dates back only to November 1914. Like national banks at that time, Federal Reserve Banks began with a 20-year charter, which put much pressure on these untested and somewhat controversial institutions to quickly prove their worth to member banks and the public.

These concerns about membership were reflected in this quote from the Kansas City Reserve Bank's first annual report in 1915:

> It seems that the State banks and trust companies have not been sufficiently impressed with the benefits of membership in the Federal Reserve System to make any concerted move toward joining, and it is doubtful if they will do so until circumstances bring forcibly to their notice the decided advantages membership conveys, especially in times of financial uncertainty and distress…
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> It is believed that sooner of later a majority of the better State institutions will seek membership…

I should note that Nebraska banks certainly were part of this initial reluctance to join the Federal Reserve Bank of Kansas City. In the first five years of the Federal Reserve System, only 9 out of more than 950 state banks in Nebraska became members. Moreover, shortly after the Federal Reserve Bank of Kansas City opened, bankers in Nebraska and Wyoming petitioned to be moved into the Chicago District. However, once we established our first branch in Omaha, Nebraska bankers became more supportive.

Thanks to your support and that of the general public, the Federal Reserve survived this shaky start.

Nebraska bankers have since played a particularly important role in the history of the Federal Reserve Bank of Kansas City. A total of 36 Nebraska bankers have served on our Boards of Directors -- 30 on our Omaha Board and six on the Kansas City Board. Moreover, of these 36 directors, ten have also served as Presidents of the NBA, thus serving to illustrate the close ties between the NBA and the Federal Reserve. Four Nebraska bankers have further served as members of our Federal Advisory Council, providing insights to the Federal Reserve on a variety of banking and regulatory topics.

In addition, Nebraska bankers have participated at many of our conferences, economic forums, and regulatory updates. The staff at our Bank has further benefited from valuable comments and a positive relationship with many of you, and we have found participation in your meetings to be quite helpful.

A final area where the contributions of Nebraska bankers and the NBA have been especially noteworthy is in the area of legislation. Nebraska bankers have not only taken an active role in state legislative issues, but have been influential at the national level and in many key pieces of legislation affecting the Federal Reserve. In this regard, I would note that Nebraska Senators and Representatives have often assumed important positions on House and Senate Banking Committees, which certainly reflects the strong interest of Nebraska bankers and the NBA in legislative issues.

One obvious example of this interest is the original Federal Reserve Act. Two key players in the debate leading up to this legislation were from Nebraska and both entered the debate on the side of public rather than private control of the Federal Reserve. One was William Jennings Bryan, who served as Secretary of State and played an instrumental role in the final version of this legislation. The other individual, Senator Gilbert Hitchcock, who founded the Omaha World-Herald, promoted an alternative bill that would have created a more traditional central bank. Hitchcock later played a critical part in the confirmation of the first Governors of the Federal Reserve Board.

I should also note that the person that was responsible for writing much of the Federal Reserve Act and getting it through Congress was Robert Owen of Oklahoma, Chairman of the Senate Banking Committee. Other notable Senate Banking Committee participants from the Midwest included James Reed from Kansas City, who had the deciding vote moving the legislation along, and Joseph Bristow of Kansas, who held many of the same views as Hitchcock. Without this Nebraska and Midwest influence, it is unlikely that the Federal Reserve Act would have been passed in 1913 or that we would have the type of system we have today.

I can also personally attest to the strong policy role that all of you have played. You have made your views very clear to me on such topics as one bank holding company debt, bank expansion laws, regulatory burden, Federal Reserve services, and interest rates and monetary policy. Nebraska bankers have also been supportive of our seasonal borrowing program and have used this program as much as anyone. We have also seen a very positive response to our stationing of examiners in the Omaha Branch. Overall, I have greatly valued your input and insights into Federal Reserve policies and banking issues and will certainly continue to do so.

The Changing Banking Landscape over the Last Twenty Years

Much of the dramatic change we have seen in the banking industry has taken place in just the last 20 years, and most of us have had front row seats throughout this period.

To refresh my memory about where we stood in banking 20 years ago, I went back and looked at our Federal Reserve publications from that period. One article entitled “Bank Profits in a Changing Environment” particularly caught my attention. This article contained such statements as “banking is an industry in transition” and “the last six years have encompassed a period of unprecedented innovation and change in banking.”

These statements could aptly be described as an echo from the past, since we are still using the same words to describe where we are today.

Looking back over the last two decades, we can see a host of significant changes in the banking and financial industry. These changes have included rapid technological innovation, deregulation of what banks can do and what they can charge for their products, the emergence of many nonbank competitors, a growth in consumer protection laws, major changes in banking structure, and banking conditions that went from some of the worst we have experienced to perhaps the best.

I think it is worth noting that many banking analysts predicted that virtually all of these changes would greatly favor large banks and place community banks at a severe disadvantage. Clearly, while large banks have significant influence, community banks remain strong and competitive, which is a real testament to the innovative nature of community bankers and the important role that each of you fulfill.

I would like to touch briefly on some of these changes and then spend a little more time looking at the changing Nebraska banking structure and industry performance, with a particular emphasis on community banks.

Although many realized in the early 1980s that technology would become a major force changing our industry, few knew much in advance how things would play out or where best to invest resources. Among the more prominent technological changes in the last 20 years are the growth of ATMs – beginning at a Hinky Dinky supermarket in Lincoln, the use of debit cards, credit scoring, and the automation of many banking functions – such as back-room operations, data entry, and loan documentation and compliance. Technology has also led to new products and ways of doing business – examples of this include derivatives and securitization. One other very noteworthy change that few could have anticipated in the 1980s is the Internet and its use for communications, transmitting and receiving data, and conducting banking transactions electronically without geographic barriers.

As a result of technology, deregulation, and nonbank entry, the competitive landscape in banking also has changed dramatically over the last 20 years. Changing law has given banks substantial freedom in selecting the financial products they will offer and in expanding their network of offices. At the same time, though, banks must now compete for deposit and loan business with money market mutual funds, the securities and commercial paper markets, captive finance companies, and a rapidly expanding credit union industry.

Structural Changes

With this overview as background, let me focus on the structural changes in Nebraska banking, many of which have been driven by legislative changes at the state and national levels during the last 20 years. For example, until 1983, Nebraska was strictly a unit-banking state. However, that began to change rapidly with the authorization of multi-bank holding companies and limited branching within a city in 1983, followed in 1985 by statewide branching by merger and a gradual liberalization of other branching laws thereafter, and then by regional reciprocal interstate entry in 1990 and nationwide reciprocal entry in 1991.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 took the next step by allowing interstate acquisitions on a nationwide basis in 1995, along with interstate branching through merger transactions in 1997.

These laws have had a profound impact on the ownership structure of Nebraska banks, although I believe that they have not changed the fundamental nature of Nebraska banking. Nebraska continues to be dominated by small to mid-size community banks, serving primarily consumers, small businesses, and farmers.

From 1984 to 2004, the number of commercial banks in Nebraska fell from 468 to 252 – a decline of nearly 46 percent, although similar to what occurred nationwide.

Even though the number of banks has shrunk, it does not appear that the availability of banking services has suffered, as the number of banking offices has increased substantially. As of June 1984, there were 535 deposit-taking banking offices (including head offices) in Nebraska, a little over one office per bank charter, but by June 2004, the number of offices had jumped to 781, more than three offices per Nebraska charter.

With the changes in banking laws, there has also been some interstate activity in Nebraska banking markets. Still, only two of the top 10 banking competitors in the state (as ranked by their Nebraska deposits) are owned by out-of-state banking organizations, compared to one (Norwest) in 1984. Also, one-fifth of the deposits in Nebraska are controlled by out-of-state organizations.

While these changes have certainly been significant, the typical Nebraska bank's structure has not changed dramatically. Most Nebraska banks remain small in asset size and rooted in relatively small geographic areas.

- As of 2004, over 56 percent of Nebraska banking organizations had just a single, deposit-taking office. And 74 percent had assets of under $100 million (compared to 48 percent of all US banks).
- Sixty-seven percent of Nebraska banks are predominantly agricultural lenders.
- Even the largest organizations in the state are not in a dominant position. Lauritzen Corp. (First National of Nebraska), the organization with the largest level of deposits in the state, has just 21 percent of the deposits and 5 percent of the banking offices, located in just 21 percent of the Nebraska counties with banking offices.
- In comparison, the largest organization in the state in 1984 was FirsTier, with 10 percent of bank deposits.

Earnings Performance

In looking at the performance of Nebraska banks over the last twenty years, we could almost summarize it as the “worst of times” followed by the “best of times.” We followed this theme closely in 1988 when we devoted an entire issue of our *Banking Studies* publication to problem banks - with titles such as “Problem Banks: Their Causes and Possible Causes of Deterioration” and “The Death of a Bank: Assuring an Orderly Transition.” By 1988, supervisors had become experts at problem banks, and bank closures had become, sad to say, a routine part of the job. In the 1980s, there were 33 bank failures in Nebraska, with most of these heavily tied to the farming crisis.

For Nebraska farm banks, nonperforming assets peaked in 1986 at 6.7 percent of loans, and the average return on assets plummeted to just 0.32 percent in 1985. Moreover, if not for securities gains and tax credits, the average Nebraska farm bank would have lost money in

1985. And these numbers were just for the surviving banks – 19 Nebraska banks had already failed.

However, a sharp turnaround began to occur in the late 1980s, and since 1989, not a single Nebraska bank has failed. Average farm bank earnings, in fact, were back to 1.18 percent of assets by 1988.

If we jump ahead to the early 2000s, bank financial performance has clearly improved, but there are still a few weaknesses and areas requiring caution.

Earnings, of course, are much improved. Nebraska banks had an average annual return on assets of 1.28 percent over the five year period ending in 2004.

There are other indications of improved conditions, too. Noncurrent assets are at just 1.0 percent of loans.

Nonetheless, there are some trends that are worth watching. Nonperforming assets rose in 2003, although they remain very low. Net interest margin compression has been substantial for all banks, and Nebraska banks have not been immune. Since 2002, Nebraska banks' net interest income as a percentage of average assets has fallen over 55 basis points, although this has been somewhat alleviated by higher fee income and lower loan loss provisions.

But more than the overall pressures on earnings, we have taken note of the earnings discrepancy between large and small banks. Over the last four years, Nebraska banks with under $100 million in assets have had ROAs that have averaged 22 basis points lower than larger banks. While both large and small banks have been hurt by declining interest margins, the smaller banks have not been able to reduce overhead and raise noninterest income. Larger banks have been able to accomplish both of these objectives.

Finally, we are still watching the asset quality of farm banks carefully. Although noncurrent loans as a percent of all loans fell by over 30 basis points at Nebraska farm banks in 2004, they remain at levels well above that of other Nebraska banks (50 percent higher than real estate lenders, for instance).

The Challenges Nebraska Bankers Face

Turning from the topic of earnings, let me take a moment and talk about some other challenges Nebraska bankers face. Since community banks represent a very important part of the Nebraska banking environment, most of my remarks will be directed toward community bankers. In many ways, though, I would consider all Nebraska banks to be community banks, given the significant role that each of you play in your own communities.

If we define community banks as banking organizations with total assets of less than $1 billion, two-thirds of the bank offices in Nebraska and 46 percent of bank deposits are in community banks. In comparison, community banks account for just 18 percent of all banking deposits nationwide. In Nebraska, community banks are of particular importance in agricultural and small business lending.

Last year, we sent a survey to all community banks in our District. The survey questions focused on changes confronting community banks, including legal and regulatory questions, demographic changes and competitive challenges, and operational and technological issues. We published the survey results in our 2004 *Financial Industry Perspectives* publication, but today I will summarize the responses that we received from 74 community bankers in Nebraska.

Nearly 72 percent of these responses come from those of you in towns with populations of under 2,500, and over 70 percent are from communities that either lost population in the 1990s or had growth of under two percent. So, most of you responding to our survey are from small, slower growing communities, and the vast majority list agriculture as the area of primary economic support for their communities.

When asked to identify the significant challenges they would face over the next five years, Nebraska bankers listed developing new sources of noninterest income as their first concern, with nearly 60 percent of the bankers seeing this as a "significant challenge."

Other significant challenges mentioned by more than 40 percent of the bankers included: (1) achieving satisfactory loan growth, (2) coping with slow community growth, (3) meeting regulatory compliance requirements, (4) maintaining a secure electronic environment, (5) achieving satisfactory net interest margins and return on assets, (6) maintaining and attracting retail deposits, (7) achieving adequate diversification, (8) dealing with technological change, and (9) competing with nonbank financial service providers.

In terms of competing with other institutions, Nebraska community bankers rated competition from nonbank financial institutions as the biggest challenge, followed by competition from other community banks. Competition from larger banking organizations and from credit unions followed in that order.

While Nebraska banks in areas with declining population have many of the same concerns as other banks, they are also apprehensive about the demographic changes they are facing. Slow growth or long-term loss of population are listed as "significant challenges" by 73 percent of these banks. Lack of opportunity for diversification is also a concern. About

56 percent of the bankers in areas losing population see this as a problem, compared to 32 percent of bankers in other parts of Nebraska.

Although the Nebraska bankers in our survey identify many areas of concern, they still display great optimism about their prospects. Few expect to be acquired and most expect to expand their operations. Over 94 percent of the Nebraska respondents see their ownership and structure remaining the same over the next five years. In fact, nearly 32 percent say that it is likely that they will acquire another bank, while just 3 percent expect to be acquired.

Forty-four percent of the Nebraska bankers plan to establish more branches, mostly commonly within the same or adjacent counties. Very view see themselves expanding interstate.

Overall, these survey results indicate optimism on the part of Nebraska bankers over the next five years. Community bankers in our survey see themselves facing a myriad of challenges but still surviving and, in many cases, expanding. Their concerns are both short-run and long-term. While those of you responding to our survey are worried about earnings and interest income, you are most concerned with developing new sources of noninterest income. This suggests a changing emphasis in community bank business models. Most of you expect to maintain the same ownership and structure, and expand through branch growth or, in some cases, through acquisitions.

Meeting the Challenges

When we look back just over 20 years ago, Nebraska banks had little opportunity to expand other than through facilities or chain banking. The personal computer was in its infancy and the Internet did not exist in its current form. Reg Q interest rate ceilings were still being phased out, and if you made a home loan, it was probably on your books until it was paid off. Nebraska, moreover, had experienced just two bank failures in the 1970s. All that was about to change in a tumultuous two decades.

So, what will the next 20 years hold? To provide some perspective on this question, I looked back to some comments I made in a speech 20 years ago. Were any of the prognostications I offered then bold enough to foreshadow the momentous changes we have seen over the last two decades? It is with great humility that I choose not to disclose my batting average in this area, and admit that I must be careful in any claims I make about the future. However, I am fairly certain that many significant and dramatic changes will occur over the next 20 years.

We can be reasonably sure about a number of things. Financial competition is much more likely to increase than to decrease, as technology brings new opportunities and products within the reach of financial customers. At the same time, there will still be a need for many of the services that community banks can offer. I also am dead certain that over the next 20 years more regulations will be written. Yogi Berra might say “the future ain’t what it used to be,” but in the case of regulation, I am afraid it just might be.

Given that it is hard, if not impossible, to see where we will be heading several decades down the road, I would like to offer you some “Sound Strategies for Success,” which we garnered from looking at the characteristics of successful community banks.

At our bank, we recently analyzed the performance of Tenth District community banks in slower growing markets, and a number of these banks were from Nebraska. We found that the typical community bank in such circumstances still performed at an acceptable level. However, when compared to banks in faster growing markets, banks from the slow-growth areas tended to have somewhat lower earnings, higher funding costs, somewhat less efficient operations, less noninterest income, and lower asset quality. In essence, these shortcomings mirror many of the challenges Nebraska community bankers emphasized in our recent survey.

A number of the banks operating in these slower growing markets, though, achieved a performance level near the top of all banks in this region. To find out how these banks could be so successful under less favorable conditions, we interviewed a senior officer at ten of these banks, several of which were in Nebraska.

Although their general recipe for success shouldn't surprise anyone in this room, their commitment to making this plan work and their ideas for serving their communities were keys to their performance. Here is what we found:

- The success of these ten banks began with a positive, but realistic attitude toward what they could accomplish.
- They concentrated on getting the basic business of banking down right, including exceptional customer service, highly efficient operations, and unquestionable credit quality. Several comments from these high-performing bankers illustrate this attitude: "We 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." "We go the extra mile to take care of our customers – we do what other banks say they will." "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." "We were a very small, 1-rated bank back in the 1980s – all these other banks began having problems and we just started

acquiring them – that set us on our way and we just stayed with that sound credit philosophy." In case you are wondering about this last bank's strategy, it was a $10 million bank in 1980 in a town with 300 people, and now it operates in ten rural communities and has nearly $150 million in assets.

- These successful bankers were also very active and innovative in looking for new business lines, but they entered such activities carefully and slowly and then expanded as their customers proved themselves and began growing their businesses. In the words of one banker, "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."
- Virtually all of the bankers mentioned a hard-working staff and dedicated board of directors as critical elements in their bank's success. One banker told us, "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."
- These bankers almost uniformly agreed that keeping up with banking regulation was a major challenge for their banks. One banker's most colorful description of this challenge was: "The regulation of small banks is like killing a gnat with a sledgehammer." These bankers, though, used a variety of methods for achieving regulatory compliance, including spreading the responsibility around amongst several staff people, subscribing to regulatory software, designating a compliance person, outsourcing part of their loan compliance, and attending regulatory update seminars given by supervisors and state banking associations.

- The bankers also attributed much of their success to assisting the local community and the bank's next generation of customers. In a number of cases, this meant using FSA guarantees and SBA loans to meet the needs of young farmers and small businesses. As one banker stated, "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." Also, several of these bankers were trying to find ways to use Internet banking and other means to maintain the banking business of younger people, including those that were moving away.

In short, these bankers demonstrated a thoroughly professional attitude, coupled with a strong commitment to their customers and communities. So, if I have one prediction for the next 20 years, it's that bankers who follow these same guidelines are the most likely to be successful.

Finally, I would like to leave you with one last number to ponder. Of the 252 banks in Nebraska today, the median charter date is August 1910. So nearly half of all Nebraska banks are more than 100 years old or will soon be. Over that time, Nebraska banks have experienced many changes, challenges, and opportunities. This historical success is certainly no reason to become complacent now in addressing new challenges. However, your long record of viability and success does suggest a good track record in finding the answers to a changing banking environment, and I trust that all of you will continue on this path.