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THE NEW ENVIRONMENT IN COMMERCIAL BANKING

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Proceedings of a Seminar sponsored by
North Central Regional Project NC-207
"Regulatory, Efficiency and Management Issues Affecting Rural Financial Markets"
Kansas City, Missouri
October 16-17, 1995

Department of Agricultural Economics And Rural Sociology
221 Agriculture Building
Fayetteville, Arkansas 72701

January 1996

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The New Environment in Commercial Banking

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The new environment in commercial banking can be described as competition, consolidation and geographic expansion. The trends in both the U.S. and 10th District have been fewer banks. The number of banks in the District has declined from 2,532 at year-end 1984 to 1,719 at year-end 1994. Although the number of banks has declined, the number of banking offices has increased from 3,623 at year-end 1984 to 4,442 at year-end 1994.

The Passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 was signed into law on September 29, 1994. Interstate banking started in September 1995. This however, will have little significance on our district because of the modification of the Douglas amendment which occurred through individual state actions. Five of the seven district states currently permit interstate banking on a nationwide basis while the other two, Missouri and Kansas, permit interstate branching regionally. Currently out of state multibank holding companies control 17 percent of district deposits and this is increasing. Looking forward, I have included three state district states as examples. The lowest percentage of out of state ownership is in Missouri. As larger companies continue to expand, Colorado may be more representative of the ownership structure in district states in the future where 60 percent of deposits are controlled out of state.

Percent of deposits by form of ownership (1994 data).

	District	Colorado	Kansas	Missouri
Out of state multibank	17%	60%	14%	1%
In state multibank company	49%	18%	38%	75%
Unit bank ownership	34%	22%	48%	24%

Interstate branching by merger can begin by July 1, 1997 unless the states opt in at an earlier date or opt out. However, as we have experienced in our district and elsewhere the OCC has speeded up this process or circumvented the law, depending on your perspective, by allowing a quirk in the law which allows a bank to move its banking headquarters up to 30 miles including to another state. Banks which relocated across state lines under this provision are permitted to retain offices in the state from which they have relocated, creating interstate branching networks.

Most observers generally believe that the trend will continue and there will be fewer banking organizations and banks. This consolidation will likely quicken with interstate banking. Forecasters see banking in the 21st century populated by a few large nationwide banking organizations, a growing tier of regional firms and a declining number of community banks. Despite this decline in community banks, these banks will continue to remain and thrive in the marketplace serving a particular market niche.

We are also likely to see the continued convergence of bank and non-bank firms in a broad financial services marketplace. Banks are expanding into areas which were previously not allowable. Congress is debating repeal of Glass-Steagall which would tear down the wall between commercial and investment banking. But even without total repeal, the wall is being chipped away by both the OCC and Federal Reserve. The Federal Reserve has a proposal outstanding to boost the 10% limit on bank-ineligible securities that section 20 affiliates are allowed to deal in. The Federal Reserve last year issued several exemptions to the rules permitting banks to provide discount brokerage services to customers. Banks in some rural markets are becoming one stop shopping for banking services, discount brokerage and insurance.

I believe that competition will continue to intensify. As banks expand geographically and competition from other banks and nonbank financial institutions intensify, margins may be squeezed. What are the implications for bank operations, safety and soundness? Geographic expansion through interstate banking can reduce risk by allowing greater diversification of loan portfolios. However, this expansion can increase credit and operational risk if carried out too rapidly and control systems are not adequate. Interstate branching can simplify organizational structure and make it easier to apply and administer risk-control systems. A simplified structure could reduce regulatory compliance and examination costs. However, the increased size of the institutions can increase systemic risk by creating a number of too important to fail institutions.

Bank products will also expand because of deregulation, improved technology, court decisions and competition. Several key areas where we see banking products and services evolving are in the lending function, managing bank and customer risks, investment banking and insurance. Banks will continue to scrutinize more assets, develop new and more automated methods of collecting financial information and evaluating the creditworthiness of borrowers. Efficiencies in these areas could reduce the cost of booking a credit creating an increased competitive environment. As larger banks securitize more loans, banks will hold fewer loans on balance sheets and those credits they retain will be to borrowers with unique characteristics and limited access to other markets. If a bank does not have the technology available to take advantage of credit scoring systems and automated information, they may find themselves taking excessive credit risk or losing business to other market participants.

What does this mean for the future of community banks? We will likely see fewer community banks. Technological advances will make it difficult for smaller banks to compete. But as we see in markets in which the larger banks currently operate, community banks will continue to thrive because they fill a market niche.