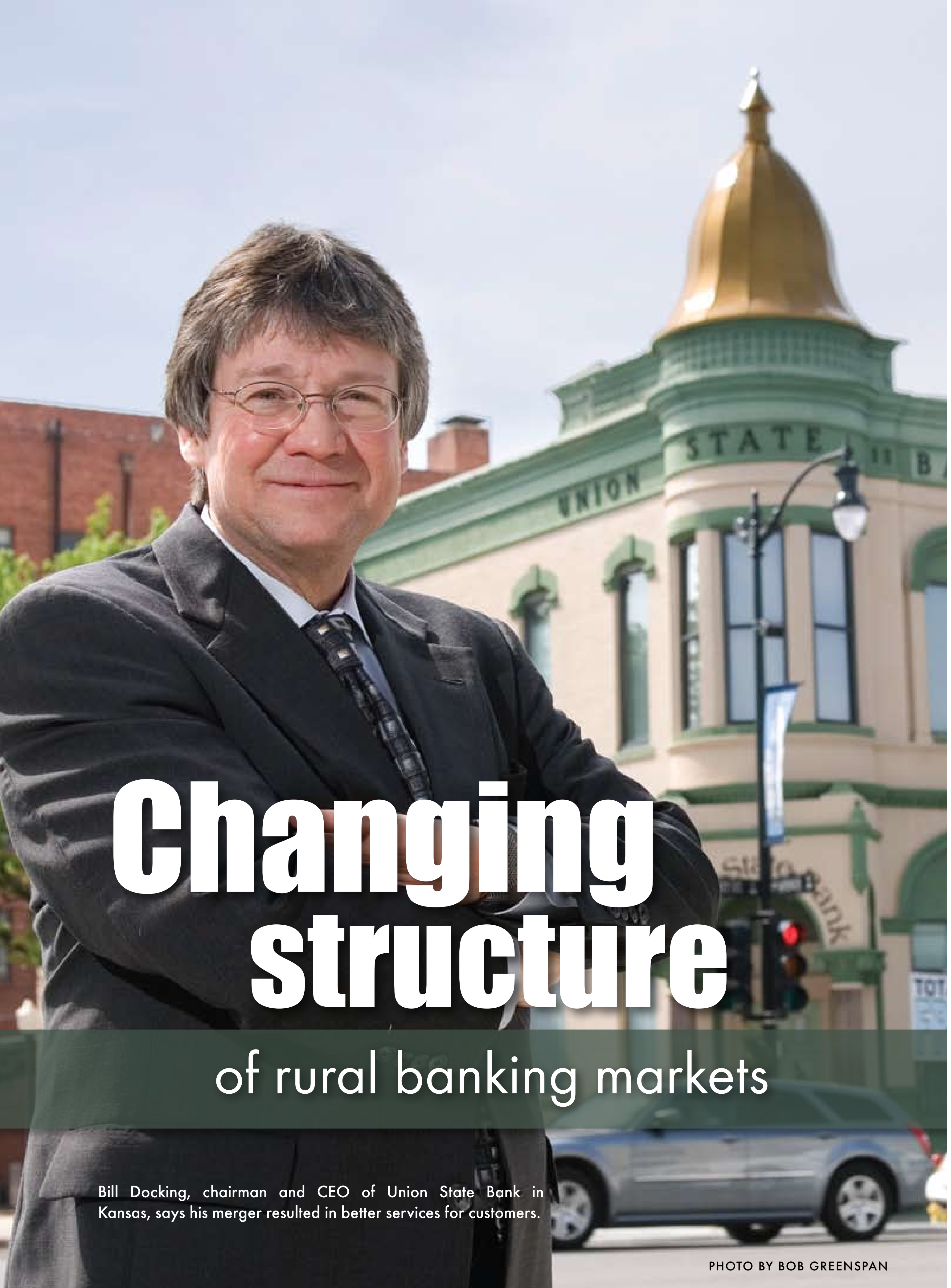

Changing structure

of rural banking markets

Bill Docking, chairman and CEO of Union State Bank in Kansas, says his merger resulted in better services for customers.

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Two small towns in south central Kansas, equal in size and just 12 miles apart, are connected by a four-lane highway that's well-traveled by those who live in one and work in the other—and want to be able to do their banking in both. That's where Docking Bancshares Inc. built its bridge.

In 2006, the Docking company acquired a bank in Winfield to merge with its longtime family-owned bank in Arkansas City. The merged bank—called Union State Bank—now has six locations in Cowley County. It is the county's largest bank corporation in terms of deposits and market share.

"We have added value … because of the merger," says Bill Docking, chairman and CEO of Union State Bank. "We were able to reinvent the combined bank. It allowed us to make systemic improvements across the board."

More locations, expanded services and new amenities, such as drive-up windows and ATMs, mean convenience and ease for customers, Docking says, not to mention the operational and other business benefits for the bank itself. New technology means banking has a higher cost than in the past.

"I think it (bank acquisition) is a clear trend, especially in areas with a declining population," says Docking, adding that Cowley County's population has not decreased, but because of the county's characteristics, consolidation "made good business sense."

Docking Bancshares also recently acquired another bank to merge with one it owned, both just across the border in Guymon, Okla. The Federal Reserve reviewed the Cowley County and Guymon acquisitions in Kansas and Oklahoma to ensure the Docking company wasn't violating antitrust laws in place to prevent monopolies.

Acquisitions, as well as technological advances, financial innovations, deregulation and demographic changes, have led to fewer banking organizations in the United States—a decline of nearly 50 percent in the past 20 years, although the number of actual bank offices has increased.

While banking organizations are evolving, they still face the same antitrust restrictions from decades ago, say Jim Harvey and Forest Myers of the Federal Reserve Bank of Kansas City. The two policy economists recently

PHOTO BY BOB GREENSPAN

UNION STATE BANK IN ARKANSAS CITY, KAN., recently acquired a bank in the nearby town of Winfield. It can be difficult for banks to expand in small rural communities; restrictions may prevent local growth.

researched changing market structure and bank performance in rural banking markets. They compared the relationship between market concentration and bank performance; looked at changes in that relationship during a 20-year period (1985-2005); and determined possible implications for the evaluation of mergers in small communities, as well as for broader antitrust policy.

Traditional antitrust analysis that focuses on the concentration in narrowly defined markets may no longer reflect marketplace realities. This is particularly important for banks wanting to merge in rural markets that, by their nature, tend to be highly concentrated, Harvey and Myers say.

"The traditional concept of a local banking market may have eroded and our antitrust methodology may need to be revisited," Harvey says. "Many of the local markets that are most constrained by antitrust concerns are small rural areas, where in-market mergers may be the most practical strategy for growth, and even survival."

The evolution

"Banking has changed," Myers says.

Legal and regulatory changes have allowed large banks to enter local communities across the country. Technology has reduced the cost of managing operations from a distance for banks, and reduced the cost of serving customers outside of their communities.

Still, it can be difficult for banks to expand in small rural communities where restrictions may prevent local growth. Mergers raise the question of banking monopolies, which are prevented by the nation's antitrust laws—in place to ensure customers receive the best

What characteristics define rural banking?

In general, rural markets have a small number of deposits and are slow-growing. They are served by both large and small banks, and are highly concentrated. They have shown little structural change through time and their market concentration and the number of competitors are not significantly different from those 20 years ago.

When analyzing the impact mergers might have on banks with offices in the same marketplace, the banking agencies look for a geographic area where the effect of a merger will be direct and immediate, say Jim Harvey and Forest Myers, policy economists with the Federal Reserve Bank of Kansas City. In rural areas, the banking agencies often start with the county as an approximation of the banking market.

Harvey and Myers focused their research on rural counties because these areas tend to be highly concentrated and merger transactions within them are more likely to present antitrust issues. They identified a group of rural counties somewhat isolated from a large population, finding 885 non-metro counties (28 percent of all counties nationwide as of 2003), as well as competitors in the markets and their shares of market activity.

There are several notable characteristics during the 1985-2005 period:

- The structural characteristics of the markets remained constant—the average number of banking organizations grew very little and the total number of competitors fell slightly.
- Market concentration remained steady.
- Few rural markets are true monopolies—about 12 percent have only one competitor.
- More than 62 percent of the markets contain at least one large banking organization (assets of more than $1 billion), which was not the case 20 years ago. Now, large out-of-market organizations have branch offices in these markets.
- The population of these markets has grown slowly, if at all—just 1.7 percent on average, compared to 24 percent nationwide. For many of these markets, the population has declined during the last 20 years.
- Bank deposits also have grown slowly, with a compound annual growth rate of 2.7 percent. The entire banking system grew 75 percent faster.

"The structural characteristics of these markets coupled with the population and deposit sizes have several implications," Harvey says. "They represent constraints on the possible increase of banks in the market, and show there is little opportunity for growth."

The stable structural characteristics have implications as well. High concentration of traditional measures suggests banks in these markets should be able to use their market power to generate better performance. This would mean competitors would view the markets favorably and outside entry would occur.

"However, the average number of competitors and the level of market concentration have remained constant during the past 20 years," Myers says. "This suggests these markets are not particularly attractive to outside entrants and may not be generating excessive profits."

Antitrust review: Protecting against monopolies

The nation's antitrust laws, as incorporated into banking laws, make it illegal for transactions that would create a banking monopoly. As a result, federal banking agencies review bank mergers and changes of ownership for possible antitrust issues. The Federal Reserve reviews transactions involving bank holding companies as well.

In their reviews, agencies use Department of Justice merger guidelines. Banking transactions that meet the criteria receive little review, while those that don't will receive more analysis. This may require Federal Reserve staff to conduct interviews or make on-site visits, says Forest Myers, a policy economist with the Federal Reserve Bank of Kansas City, who often works with bankers on their acquisition applications. This process can include:

- determining a bank's competitors;
- noting customers' commuting patterns and economic interaction with local employers, retailers, chambers of commerce, bankers and others;
- surveying households and small businesses to determine where they bank and what alternative banking services are available;
- and considering any special factors or circumstances.

The review process determines what area and who in that area are affected by the transaction.

"The willingness of people to travel, geographic impediments, employment opportunities, shopping alternatives, historic rivalries among towns and aggressiveness of competitors may all influence a market's geographic dimensions," Myers says. "All of these elements must be considered in determining if a transaction raises competitive concerns. If it does, the transaction may not be permitted."

For more information, see Banking Structure Resources at www.KansasCityFed.org/TEN.

services at the lowest cost. As a regulator, the Federal Reserve protects consumers by maintaining competitive banking markets, Myers says.

However, changes in bank branching laws, and the business of banking since the early 1980s may have eroded the traditional geographic market. Even in somewhat isolated, rural markets, customers have a plethora of choices. The possibility of entry by out-of-market firms is significantly higher now. But, the makeup of these particular markets has remained almost unchanged, suggesting they aren't particularly attractive to newcomers, Myers says.

"The very smallness of the banks and the markets where they operate is an impediment to in-market expansion by these banks," he says.

As a result, the market power that typically goes along with market concentration likely has dissipated. This could prompt the rethinking of criteria used to judge the impact of market concentration, Harvey and Myers say. It would open doors that allow banks to seek in-market mergers and increase their ability to compete effectively with larger out-of-market firms.

Effects on geographic markets

Banking laws require the review of banks' ownership and changes of control. The goal of the review is to assess the effects on banking market concentration, and whether the transaction is consistent with merger guidelines established by the Department of Justice, Harvey says.

"This is predicated on the belief that market structure, which is the number and size distribution of competitors in a market, affects competitor behavior, and ultimately competitor performance," he says. "Fewer competitors mean fewer options for customers."

Defining a market's geographic boundaries is necessary to determine the number of sellers in the market and the customers they serve. In the past, both the high cost of conducting banking over long distances and the restrictions on branching resulted in primarily local banking services. However, these barriers were broken down by personal computers and high-speed, low-cost communications, which now let customers access banking services beyond their immediate location and allow financial institutions to serve more distant customers. Remote deposits, online banking and ATMs also made this feasible. Finally, changes in branching laws have opened markets to large numbers of potential competitors.

"All of these factors force more vigorous local competition for customers' business," Harvey says. "The walls that once afforded banks a measure of protection from competition have become more porous. Even remotely located banks in rural areas may feel increased competitive pressure."

In their research, Harvey and Myers focused on banks that operate in a single county to attribute differences in performances to differences in market structure. They used five-year averages, beginning in 1981-1985 through 2001-2005, in their analysis to help reduce the effects of events not representative of bank performance, such as a drought.

Their findings show:

- The number of banks operating in rural markets declined significantly—nearly 65 percent from 1985 to 2005.
- There were few changes in the performance of these banks. Earnings and other financial variables were roughly the same as those of small banks during the same period. Growth was quite slow and barely kept pace with inflation—average asset size went from \$26.9 million in 1985 to \$55.8 million in 2005.
- Banks in more concentrated markets were capable of increasing interest rates on loans and/or decreasing interest rates paid on liabilities relative to banks in less-concentrated markets, especially in the earliest periods.
- The relationship between market concentration and performance weakened substantially in later periods and virtually disappeared from 2000-2005.

These findings suggest that even in isolated banking markets, concentration may be less important than it once was.

"There may be a need to stretch limits set in the Department of Justice guidelines, knowing that concentration measures may no longer capture the full extent of market competition," Myers says.

> "Fewer competitors mean fewer options for customers."

Bill Docking, of Docking Bancshares, agrees. In some cases, market designations can be overly restrictive or "out of touch" with marketplace realities, he says. Re-evaluating the way concentration is measured is beneficial to banks and their customers.

"I've never heard anyone in Guymon, Arkansas City or Winfield express concern about lack of competition among financial service providers," Docking says.

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"THE CHANGING INFLUENCE OF MARKET STRUCTURE ON PERFORMANCE IN RURAL BANKING MARKETS 1985 THROUGH 2005"
By James Harvey and Forest Myers
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.