

Financial Industry

ISSUES

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Financial Shakeouts Slow Erosion of Small Bank Market Share

Recent consolidation has begun to alter significantly the structure of the U.S. banking industry. Large numbers of relatively small, local banking organizations have long distinguished the U.S. financial system from the financial systems in most other countries. This distinction, however, is beginning to fade. From 1980 to the end of 1994, the number of U.S. banking organizations fell from 12,385 to 7,998. This decline was concentrated at the nation's smaller banking organizations. In 1980, 12,212 banking organizations had assets under \$1.3 billion, and as a group, these institutions controlled one-third of the nation's bank assets. In contrast, by the end of 1994, only 7,853 banking organizations existed with assets

under \$1.3 billion (measured in 1980 dollars). The share of total bank assets held by these relatively small banks fell from 33 percent in 1980 to 22 percent at the end of 1994.

But the loss in small bank market share has varied across the country. For example, in the Eleventh Federal Reserve District—which comprises Texas, southern New Mexico and northern Louisiana—close to one-third of regional bank assets was controlled by banking organizations with under \$220 million in total assets (in 1980 dollars) in both 1980 and 1994. A broader examination of trends in market share for different regions indicates that small banks more successfully maintained market share in regions struck by severe banking sector difficulties, primarily because small banks are better able to weather financial shakeouts than their larger competitors.

National Versus Regional Trends In Small Bank Market Share

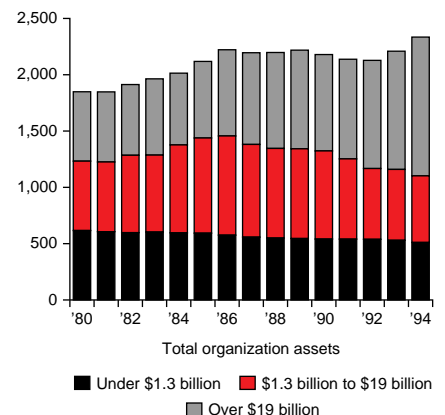
At the national level, small banks have lost substantial ground in the struggle for market share. Chart 1 shows inflation-adjusted total assets for all U.S. insured commercial banks. The annual totals are broken down by the banking organization's size; banking organization refers to a group of banks under a common

holding company or to an individual bank not belonging to a holding company. Each of the three size classes of U.S. banking organizations held approximately one-third of total banking industry assets in 1980. As the chart shows, the inflation-adjusted assets held by the group of small banking organizations declined slightly from 1980 to 1994, while total industry assets increased. These opposing trends reduced the market share of small banking organizations 11.5 percentage points.

A much different picture can emerge, however, at the regional

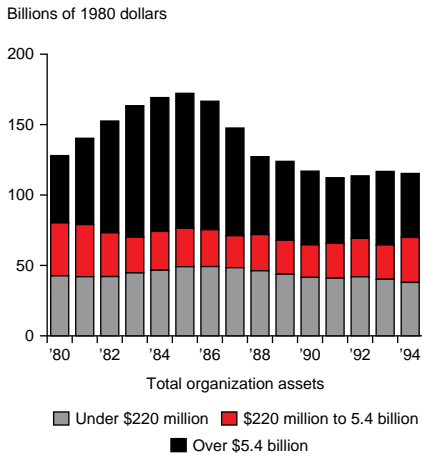
Chart 1
Total Assets of U.S. Insured Commercial Banks

Billions of 1980 dollars



DATA SOURCE: Report of Condition and Income.

Chart 2
Total Assets of Eleventh District Insured Commercial Banks



DATA SOURCE: Report of Condition and Income.

level. Chart 2 shows inflation-adjusted total assets for Eleventh District banking organizations. Small banks controlled about one-third of regional bank assets in 1980. Small Eleventh District banks fared much better at maintaining their market share than their counterparts elsewhere in the United States. Large District banks gained market share rapidly during the early 1980s, only to give up those gains during the last half of the decade when declining energy and real estate prices precipitated a severe regional economic and financial downturn. This observation leads to the notion that, by affecting large banking organizations relatively severely, banking downturns tend to boost the measured market share of smaller banks.

Differential Impact of Banking Cycles on Large Banks

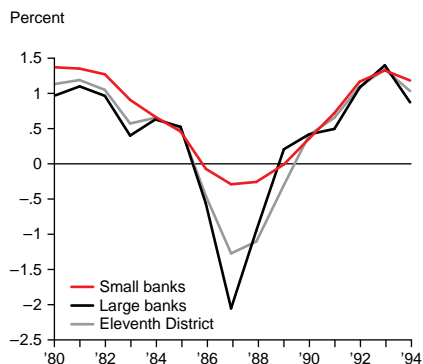
Current banking conditions are favorable in most areas of the country. Eleventh District banks achieved an annualized return on assets of 1.07 percent in the first quarter of 1995. In the rest of the United States, banks generated a 1.11-percent annualized return on assets in the first quarter. The ratio of nonperforming loans and other real estate owned to total assets

was 0.62 percent for Eleventh District banks in the first quarter of this year. Banks located elsewhere in the nation reported a troubled asset ratio of 1.01 percent.

However, the current pervasiveness of high banking performance provides little hint of the severe regional banking downturns that occurred in recent years, and a look back at the effects of these downturns may help explain the differences observed between market share trends at the regional and national levels. When financial conditions are good, most banks tend to look similar in terms of their performance characteristics. However, during bad times, substantial differences in financial performance typically emerge. It turns out that the banking cycles of the recent past reveal dramatic differences in the vulnerability of banks of different sizes to financial difficulties, with larger banking organizations experiencing relatively severe cyclical declines.

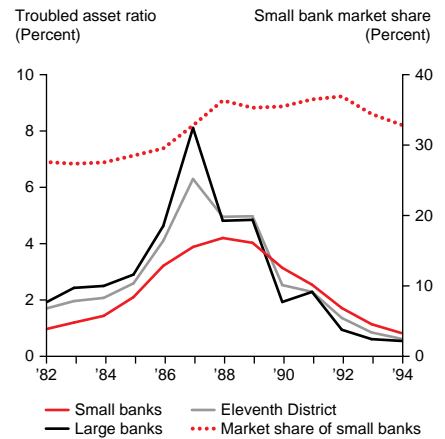
An examination of U.S. bank profitability since 1980 helps assess the differences between the capacity of small and large banks to weather financial downturns. Small banks' return on assets tended to remain above that for large banks during the 1980-94 period, with the exceptions of 1986, 1988, 1993 and 1994. In addition, the return on assets for large banks fluctuates more over time than it does for small banks.

Chart 3
Return on Average Assets for Eleventh District Insured Commercial Banks



DATA SOURCE: Report of Condition and Income.

Chart 4
Troubled Asset Ratio and Small Bank Market Share at Eleventh District Insured Commercial Banks



NOTE: The data for the troubled asset ratio are unavailable prior to 1982.

DATA SOURCE: Report of Condition and Income.

These observations are consistent with the view that large banks generally are more sensitive to changes in banking industry conditions than small banks, so that when banking industry conditions worsen, the impact on large banks is relatively severe.

Even more dramatic differences between small and large bank profitability emerge at the regional level. In the Eleventh District, large banks experienced a relatively severe drop in profitability during the energy and real estate related regional downturn of the late 1980s. As Chart 3 shows, the District's banking industry had negative returns on average assets from 1986 through 1989, and the losses at large banks were much more severe than those at small banks. In addition, profitability was slightly higher for small banks than for large banks during the years immediately preceding the downturn.

A somewhat similar experience recently occurred in the First Federal Reserve District, which comprises Massachusetts, Maine, New Hampshire, Vermont, Connecticut and Rhode Island. The First District also experienced a severe regional banking downturn following the collapse of its real estate market at

the end of the 1980s. While the return on assets for both small and large banks reached a similar low point in 1990, large banks' steep decline in return on assets in 1989 was not matched by small banks, whose return on assets remained positive in that year. In this respect, the large First District banks experienced a more severe drop in return on assets than their smaller counterparts.

Large Bank Difficulties and Regional Trends in Market Share

Can the tendency for banking downturns to affect large banks relatively severely explain the differences between trends in small bank market share at the regional and national levels? A more detailed analysis of the relationship between banking sector difficulties and movements in small bank market share may help answer this question.

Recent cycles in bank profitability have tended to mirror cycles in asset quality, as measured by the troubled asset ratio, or ratio of past-due loans, nonaccrual loans and other real estate owned to gross assets. At the national level, from 1982 through 1994 the troubled

asset ratio for small banks tended to remain below the troubled asset ratio for large banks. Moreover, the troubled asset ratio for large banks exhibits relatively wide fluctuations. These features support the impression that banking downturns have tended to take a relatively severe toll on large banking organizations. And, more importantly, during periods of banking difficulties—when the troubled asset ratio for large banks rose relative to the ratio for small banks—the decline in small bank market share slowed or stabilized. It appears that large banks' relatively severe financial struggles mitigated the downward trend in small bank market share.

The relationship between banking difficulties and small bank market share observed at the national level is even more pronounced at the regional level. Trends in the Eleventh District suggest strongly that banking sector difficulties tend to help small banks gain market share. As shown in Chart 4, when the District's troubled asset ratio rose between 1982 and 1987, the troubled asset ratio for large banks climbed faster and higher than the ratio for small banks. Also, small banks' share of District bank assets increased near

the peak period in the region's troubled asset ratio. In contrast, the District's troubled asset ratio has remained under two percent since 1992, and the market share of small banks has been slipping since that time.

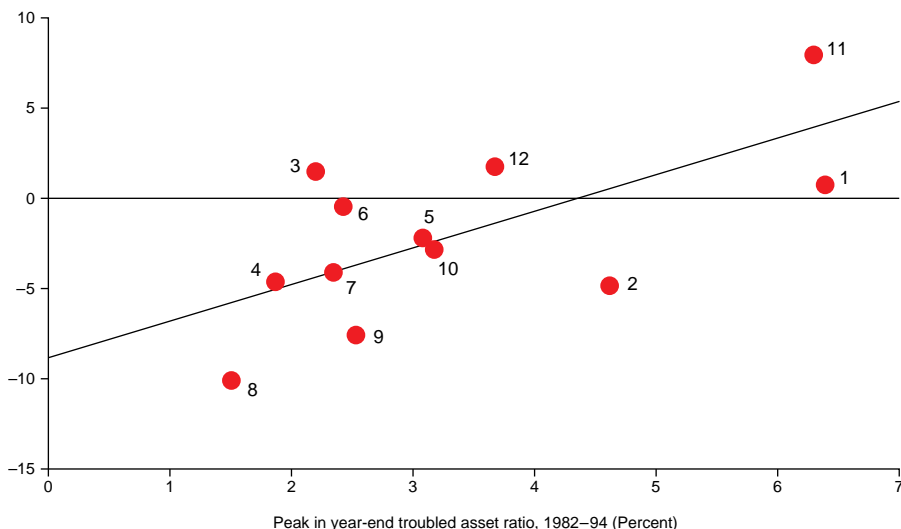
The relationship between banking sector difficulties and small bank market share also is evident in the First District. Between 1982 and 1988, the troubled asset ratio

Federal Reserve Bank Districts

- 1 — Federal Reserve Bank of Boston (includes Maine, New Hampshire, Vermont and Rhode Island and parts of Connecticut and Massachusetts).
- 2 — Federal Reserve Bank of New York (includes New York and parts of Connecticut and New Jersey).
- 3 — Federal Reserve Bank of Philadelphia (includes Delaware and parts of Pennsylvania and New Jersey).
- 4 — Federal Reserve Bank of Cleveland (includes Ohio and parts of Kentucky, Pennsylvania and West Virginia).
- 5 — Federal Reserve Bank of Richmond (includes Maryland, North Carolina, South Carolina and Virginia and parts of West Virginia).
- 6 — Federal Reserve Bank of Atlanta (includes Alabama, Florida and Georgia and parts of Louisiana, Mississippi and Tennessee).
- 7 — Federal Reserve Bank of Chicago (includes Iowa and parts of Illinois, Indiana, Michigan and Wisconsin).
- 8 — Federal Reserve Bank of St. Louis (includes Arkansas and parts of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee).
- 9 — Federal Reserve Bank of Minneapolis (includes Minnesota, Montana, North Dakota and South Dakota and parts of Michigan and Wisconsin).
- 10 — Federal Reserve Bank of Kansas City (includes Colorado, Kansas, Nebraska, Oklahoma and Wyoming and parts of Missouri and New Mexico).
- 11 — Federal Reserve Bank of Dallas (includes Texas and parts of Louisiana and New Mexico).
- 12 — Federal Reserve Bank of San Francisco (includes Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington).

Chart 5
Troubled Assets and Small Bank Market Share at the 12 Federal Reserve Districts

Change in small bank market share
(Percent)



DATA SOURCE: Report of Condition and Income.

for small First District banking organizations was only slightly lower than the ratio for large banks, and the small banks suffered a significant decline in market share. In contrast, small banks' market share stabilized during the period surrounding the sharp increase in the region's troubled asset ratio during 1989-91. During that period of severe regional banking difficulties, the troubled asset ratio for large banks rose much higher than it did for small banks, and the small banks were much more successful in maintaining market share than they had been previously.

To incorporate all the available regional data into this analysis, Chart 5 plots the relationship between banking sector difficulties and changes in small bank market share for all 12 Federal Reserve Districts. The horizontal axis measures the peak in the troubled asset ratio at year-end for each District from 1982 to 1994. The vertical axis measures the change in small bank market share during a six-year window covering three years before the peak in the troubled asset ratio and three years following it. The troubled asset ratio for the Twelfth District peaked in 1992, and the change in market share from 1989 through 1994 is used because year-end 1995 data are not available.

If the view that banking sector difficulties help small banks maintain their market share is correct, then we would expect the points plotted in Chart 5 to slope upward from the lower left to the upper right. Points farther to the right on the chart represent Districts with relatively high peak troubled asset ratios. Points closer to the top of the chart represent Districts where small banks were relatively successful in their struggle for market share. The trend line shown in the chart has a positive slope, which implies a positive relationship between the severity of regional banking sector difficulties and regional changes in small bank market share. The troubled asset ratio

reached its highest peak in the First District and its second-highest peak in the Eleventh District, and small banks in both Districts gained market share. In the First District, the troubled asset ratio peaked at 6.4 percent in 1990, and small banks there gained 0.7 percentage points of market share from 1987 through 1993. In the Eleventh District, the troubled asset ratio peaked at 6.3 percent in 1987, and small banks gained 7.9 percentage points of market share from 1984 through 1990. At the other end of the banking difficulties spectrum, the troubled asset ratio in the Eighth District peaked at 1.51 percent in 1985, and small banks lost 10.1 percentage points of market share from 1982 through 1988. The second-lowest peak of the troubled asset ratio occurred in the Fourth District, with small banks there losing 4.6 percentage points of market share.

Conclusion

Small banks' market share of the banking industry slipped considerably from 1980 through 1994, but the evidence examined here indicates that they tend to be less vulnerable to severe financial distress than large banks. And because small banks as a group are better able to weather banking sector difficulties, their market share performance tends to improve when industry conditions worsen. If large banks continue to be characterized by relatively volatile earnings and their growing trend in market share continues, then the financial condition of the banking industry as a whole might become more variable than in the past. In addition, although past trends suggest that the market share of small banks might continue to decline, the relative stability of small banks' financial performance indicates that the banking industry should continue to be dynamic, with opportunities for banking organizations of all sizes to grow and prosper.

—Robert R. Moore

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