
FRBSF WEEKLY LETTER

January 26, 1990

Small California Banks Hold Their Own

The 1980s were a tumultuous decade for the nation's small banks. They faced increased competition from larger banks, thrifts, and money market funds. Deregulation unleashed new forms of competition, including both intrastate and interstate interest rate competition in markets that formerly had been protected by regulatory barriers. Many small banks also were unable to diversify regional market risks. As a result of these difficulties, there has been considerable consolidation within the banking system. Over the decade, the number of banks nationwide has fallen from about 15,000 to below 13,000. Most of this decline took place after 1986.

In contrast, the number of banks in California rose dramatically over the decade, increasing from under 250 in 1980 to 435 in 1989. New bank formations early in the decade accounted for the increase. Since 1986, net new bank formation in the state has dropped off, but mergers have reduced the number of banks only slightly.

This *Letter* examines some of the factors that influence the competitiveness of small banks in California. The ways in which small banks have been able to compete in a state dominated by large branch banks may have implications for the competitiveness of small banks nationwide.

The California market

California has a large banking market, accounting for about ten percent of U.S. deposits. State-wide branching has allowed several banks in the state to build large branch networks that cover the state. The top ten banks in the state control more than 75 percent of the state's deposits.

At the beginning of 1989 California had 290 "small" banks, defined as banks with less than \$100 million in assets. These banks accounted for

two-thirds of the state's banks and five percent of the state's \$276 billion in domestic banking assets.

Holding their own

Over the decade of the eighties, small banks in California appear to have held their own in a number of ways. First, although the top ten banks in the state suffered a ten percentage point decline in market share during the decade, the state's smallest banks suffered no such decline. In fact, when we take into account growth in the assets of the many banks that outgrew the "\$100 million and under" category during the decade, we find that the state's smaller banks actually increased their market share over the period.

Small California banks also seem to be holding their own with respect to profitability. After suffering sagging fortunes through the middle of the decade, small banks now are enjoying returns on assets (ROAs) roughly comparable to those of their larger rivals. As 1989 data come in, we are likely to find that as a group, small banks' ROA will be above one percent. Improved asset quality and wider net interest margins, compared with earlier in the decade, have led to this improvement in earnings.

Competitive strategies

To a large extent, small banks in California have fared well because the state's economy has enjoyed considerable prosperity throughout the eighties. In contrast, smaller banks in some parts of the country have had to cope with stagnant local economies during portions of the decade.

Nonetheless, small California banks still must compete against some of the largest retail banks in the country. To do so, they have adopted a variety of apparently successful competitive

WESTERN BANKING

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strategies. For example, many small banks have taken advantage of their size to focus on specialized banking services or limited geographic markets. These "boutique" banks may focus on a variety of banking activities, such as local retail banking, small business-oriented financing, real estate lending, automobile financing, or consumer lending. A few specialize in agricultural lending and quite a few more serve the banking needs of a particular ethnic community.

In this way, the state's small banks have been able to differentiate their products from the products offered on a statewide basis by the larger institutions. Customers often prefer the specialized service, local convenience, and/or rapid turnaround on loan approvals and funding that small local banks can offer. And unlike the large banks, which tend to set interest rates and price most services on a statewide basis, small banks tend to be more responsive to local market conditions when setting rates and fees.

The ability of small California banks to differentiate their products is reflected in wider net interest margins (NIM), the difference between their average yield on assets and their cost of funds. Small banks in the state reported much wider NIMs than their larger competitors. As a group, banks under \$100 million in assets reported a NIM of 600 basis points over the first three quarters of 1989, versus only 435 for all banks in the state. And as noted earlier, increasing margins since 1987 have been a factor in the improved fortunes of these small banks.

Small California banks also have taken advantage of the growth of shared automated teller machine networks (ATMs) to compete with their larger rivals. Shared ATM networks enable the state's small banks to provide services on a local, statewide, and even national basis.

Small banks have taken advantage of other financial market innovations to overcome some of the limitations of their size. Many of the state's small banks are active participants in the secondary mortgage market. By selling some of their mortgage loans and taking advantage of government credit enhancement, small banks can reduce the risks associated with lending in only one local market. Also, many small banks purchase mortgage-backed securities to make their

portfolios more liquid and more geographically-diversified. These strategies are important since small banks in California currently hold more than a third of their assets in mortgage loans.

Their size also has allowed small banks to avoid some of the pitfalls faced by their larger competitors. For example, they have not been exposed to the problems associated with troubled lesser developed country loans that have plagued the nation's major banks.

Disadvantages

Of course, small California banks also face disadvantages on account of their size. Limited geographic markets still constrain their ability to diversify asset quality risks, making them more dependent than larger banks on the health of local markets. For many small banks this was a serious problem in the middle of the decade, when many were hit with problems in their commercial and credit card loan portfolios.

Moreover, a marketing strategy of providing "boutique" services often is labor intensive, and may drive up costs. In 1989, small banks in the state had an average of 0.73 employees per million dollars of assets, while banks with over \$15 billion in assets had only 0.46 employees per million dollars. These more labor-intensive operations translate into higher costs, on a per dollar of assets basis, for salaries and benefits and for net overhead expenses (defined as non-interest income less non-interest expenses).

In the future

Small California banks have taken advantage of local market niches to prosper in markets dominated by much larger banks. Moreover, innovations such as ATMs and mortgage-backed securities have enabled them to overcome many of the disadvantages associated with small size. Thus, the lesson of California's small banks may be that while consolidation of the banking system through inter- and intrastate mergers and acquisitions will continue and could significantly further reduce the number of banks, small banks will continue to remain competitive providers of banking services.

Gary C. Zimmerman
Economist

REGIONAL BANKING DATA

SEPTEMBER 30, 1989

(Not Seasonally Adjusted, Preliminary Data)

DISTRICT		ALASKA	ARIZONA	CALIF.	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH.	
ASSETS AND LIABILITIES -- \$ MILLION (ALL COMMERCIAL BANKS)											
ASSETS	TOTAL	452,404	4,427	26,524	315,688	14,431	7,772	14,982	21,419	10,823	36,340
	FOREIGN	41,668	2	N/A	39,257	1,713	N/A	N/A	20	98	578
	DOMESTIC	410,737	4,425	26,524	276,431	12,717	7,772	14,982	21,399	10,725	35,762
LOANS	TOTAL	319,295	1,800	19,075	224,521	8,599	5,186	11,740	14,226	7,117	27,033
	FOREIGN	31,814	0	N/A	30,680	916	N/A	N/A	N/A	N/A	218
	DOMESTIC	287,481	1,799	19,075	193,842	7,683	5,186	11,740	14,226	7,117	26,814
	REAL ESTATE	128,580	667	8,084	94,634	3,586	1,348	2,004	4,573	2,896	10,788
	COMMERCIAL	75,521	695	4,411	51,375	2,259	1,363	1,549	5,044	1,764	7,060
	CONSUMER	57,284	234	4,644	30,927	1,252	1,422	7,865	3,243	1,724	5,973
	AGRICULTURE	5,263	7	487	2,531	30	684	21	351	130	1,023
	INTERNATIONAL	117	N/A	10	105	0	N/A	N/A	N/A	2	0
SECURITIES	TOTAL	43,402	1,744	3,313	23,066	2,780	1,641	1,885	3,639	1,945	3,390
	U.S.T.S.	12,752	1,226	1,207	6,006	832	429	570	980	350	1,152
	SECONDARY MARKET	17,777	186	672	11,553	952	710	475	1,185	993	1,051
	OTHER SEC.	12,873	332	1,433	5,507	996	501	840	1,474	602	1,188
LIABILITIES	TOTAL	424,824	4,001	25,133	297,008	13,541	7,219	13,977	19,970	10,096	33,878
	DOMESTIC	383,157	4,000	25,133	257,751	11,828	7,219	13,977	19,950	9,999	33,300
DEPOSITS	TOTAL	353,300	3,492	22,431	246,890	12,808	6,256	7,049	16,140	8,701	29,533
	FOREIGN	33,554	1	N/A	31,389	1,519	N/A	N/A	20	98	526
	DOMESTIC	319,746	3,491	22,431	215,501	11,289	6,256	7,049	16,120	8,604	29,007
	DEMAND	79,460	1,032	4,359	57,532	2,090	1,021	1,921	3,287	1,648	6,569
	TIME AND SAVINGS	240,286	2,459	18,072	157,969	9,198	5,235	5,129	12,832	6,955	22,437
OTHER BORROWINGS	47,413	459	2,272	29,873	246	878	6,314	3,037	1,182	3,152	
EQUITY CAPITAL	27,579	425	1,391	18,679	890	553	1,004	1,448	727	2,462	
LOAN LOSS RESERVE	8,218	46	689	6,335	136	91	188	196	137	399	
STANDBY LETTERS OF CREDIT	33,316	23	629	29,343	438	124	168	576	286	1,728	
LOAN COMMITMENTS	140,857	272	4,616	113,302	3,819	1,090	1,583	4,788	1,682	9,705	
LOANS SOLD	114,882	14	524	113,701	100	61	74	171	19	218	
ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)											
LOAN LOSS RESERVE (ALL BANKS)	2.57	2.54	3.61	2.82	1.58	1.76	1.61	1.38	1.93	1.48	
NET CHARGE-OFFS, TOTAL	0.97	0.87	4.74	0.73	0.06	0.30	2.15	0.56	0.88	0.44	
REAL ESTATE	0.61	1.11	7.54	0.06	0.01	0.04	0.78	0.45	0.55	0.40	
COMMERCIAL	0.46	0.87	4.56	0.26	-1.10	0.17	0.61	0.46	1.31	0.00	
CONSUMER	1.82	0.36	1.84	1.93	0.35	0.75	2.81	1.03	1.29	1.15	
AGRICULTURE	0.16	N/A	1.58	-0.36	-0.45	0.27	-0.01	0.41	0.10	0.70	
PAST DUE & NON-ACCURAL, TOTAL	5.02	8.95	10.50	5.12	1.10	2.06	5.42	2.46	3.45	3.28	
REAL ESTATE	4.90	13.60	17.60	4.01	0.62	2.77	4.15	4.13	5.02	4.62	
COMMERCIAL	5.73	8.10	8.00	6.56	1.35	2.33	2.89	1.56	2.62	2.53	
CONSUMER	3.02	1.90	2.35	2.66	2.23	1.78	6.35	1.88	2.97	1.98	
AGRICULTURE	8.17	N/A	11.90	11.00	8.88	1.97	0.50	1.99	2.80	4.51	
EARNINGS AND RETURNS -- \$ MILLION (ALL COMMERCIAL BANKS)											
INCOME	TOTAL	38,495	318	2,225	27,090	1,070	630	1,636	1,652	878	2,995
	INTEREST	32,342	269	1,928	22,451	940	567	1,440	1,433	775	2,540
	FEES & CHARGES	1,541	13	112	1,033	26	30	37	89	45	155
EXPENSES	TOTAL	33,528	278	2,999	22,832	880	536	1,263	1,388	806	2,546
	INTEREST	17,656	150	1,123	12,346	533	325	637	772	449	1,321
	SALARIES	6,067	55	421	4,285	173	85	136	273	118	523
	LOAN LOSS PROVISION	2,639	19	939	1,225	24	16	149	83	58	126
	OTHER	7,166	54	516	4,976	151	110	341	260	182	576
INCOME BEFORE TAXES	4,930	40	-774	4,226	189	93	373	263	71	449	
TAXES	1,780	6	-311	1,609	68	30	142	80	19	137	
NET INCOME	3,397	35	-463	2,813	122	64	256	183	54	332	
ROA (%)	1.02	1.06	-2.30	1.21	1.17	1.10	2.37	1.18	0.68	1.25	
ROE (%)	16.40	10.90	-44.00	20.10	18.20	15.40	34.00	16.90	9.99	18.00	
NET INTEREST MARGIN (%)	4.41	3.59	3.97	4.35	3.91	4.18	7.41	4.25	4.10	4.60	

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MARKET SHARE STATISTICS

PERCENT OF TOTAL DEPOSITS, FOR NOVEMBER 1989, BY REGION

DEPOSIT TYPE	DISTRICT			ALASKA			ARIZONA			CALIF			HAWAII			IDAHO			NEVADA			OREGON			UTAH			WASH		
	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU
TOTAL DEPOSITS	47	48	4	70	9	21	55	41	4	43	54	4	65	30	5	86	10	3	67	30	3	66	28	5	67	22	10	57	35	7
DEMAND	93	4	3	98	1	1	93	3	3	93	4	3	93	4	3	93	1	6	99	1	0	95	2	3	92	5	4	94	4	1
NOW	62	31	7	51	14	35	71	20	9	57	36	6	71	26	3	88	8	4	78	16	7	76	17	6	74	15	11	66	22	12
SAVINGS & MMDA	59	33	8	51	8	42	71	20	9	56	37	7	62	28	11	88	8	4	76	19	5	67	23	10	68	11	21	59	26	15
SMALL TIME	28	69	3	65	21	15	43	54	3	21	76	3	40	57	3	83	15	2	41	57	2	52	44	4	55	38	7	45	51	5
LARGE TIME	37	62	1	92	5	2	32	66	2	33	66	1	78	20	2	86	10	3	63	37	0	70	28	2	74	22	4	49	50	1

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND SAVINGS BANKS; CU = CREDIT UNIONS; MAY NOT SUM TO 100% DUE TO ROUNDING

INTEREST RATES ON DEPOSITS AND LOANS (%)

TYPE OF ACCOUNT OR LOAN	DATE	US	DISTRICT	ARIZ	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
MONEY MARKET DEPOSIT ACCOUNTS (PERSONAL)	SEP89	6.55	6.28	5.95	6.58	6.33	6.12	5.85	6.46	5.67
	OCT89	6.48	6.30	5.98	6.49	6.34	6.12	6.00	6.43	5.77
	NOV89	6.47	6.28	6.08	6.51	6.16	6.09	6.09	6.45	5.78
92 TO 182 DAYS CERTIFICATES	SEP89	8.09	7.73	7.58	8.09	7.15	8.05	8.04	7.82	7.17
	OCT89	8.01	7.66	7.58	8.07	7.15	7.80	7.87	7.82	7.27
	NOV89	7.89	7.56	7.45	7.94	7.15	7.70	7.87	7.77	7.06
2-1/2 YEARS AND OVER CERTIFICATES	SEP89	8.10	7.95	7.83	8.22	8.07	8.09	7.73	7.98	7.80
	OCT89	8.03	7.95	7.83	8.21	8.08	8.01	7.68	7.80	7.83
	NOV89	7.91	7.81	7.74	8.00	7.95	7.82	7.73	7.82	7.80
COMMERCIAL, SHORT-TERM*	AVE. RATE	10.50	10.43	10.29	10.20	10.70	12.66	10.63	12.08	11.09
	AVE. MAT. (DAYS)	53	78	110	41	96	160	233	109	179
COMMERCIAL, LONG-TERM*	AVE. RATE	11.36	11.42	11.74	11.54	11.25	N/A	10.51	11.41	10.87
	AVE. MAT. (MONTHS)	43	30	34	22	26	N/A	77	24	60
LOANS TO FARMERS*	AVE. RATE	12.16	10.97	11.36	10.68	10.25	11.51	11.77	12.84	11.87
	AVE. MAT. (MONTHS)	8	6	6	5	N/A	4	9	25	10
CONSUMER, AUTOMOBILE	AVE. RATE	11.94	12.31	N/A	12.50	N/A	13.50	11.40	11.95	11.71
CONSUMER, PERSONAL	AVE. RATE	15.42	16.19	N/A	19.73	N/A	13.50	14.37	16.96	14.86
CONSUMER, CREDIT CARDS	AVE. RATE	18.07	18.25	N/A	19.48	N/A	N/A	19.24	20.27	15.75

SOURCES: SURVEY OF TERMS OF BANK LENDING AND TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS
 * U.S. DATA ARE COMPOUNDED ANNUAL RATES, DISTRICT AND STATE DATA ARE SIMPLE ANNUAL RATES.
 NOTE: CONSTRUCTION LOAN DATA ARE NO LONGER COLLECTED.