

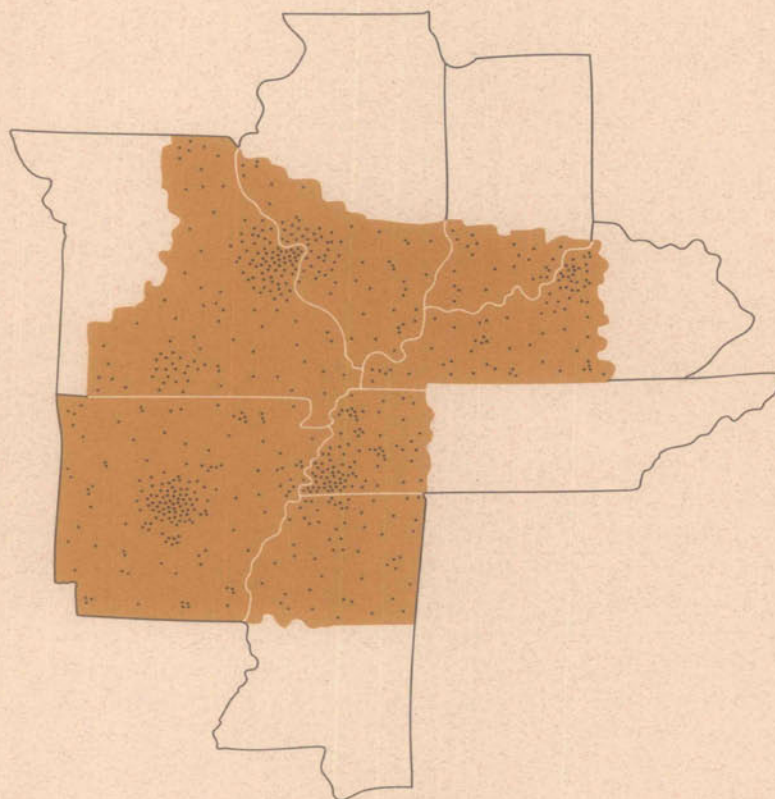
PR 0 1 1992



The Future of Community Banking

1991 Annual Report

WHAT IS A COMMUNITY BANK?



T

here is no consensus about the definition of a community bank. In general, however, a community bank is a fairly small institution that turns locally generated deposits into local investments — mainly loans. Community banks usually prosper because of loyal customer relationships and a keen knowledge of their customers' creditworthiness. In this report, a community bank is defined as a bank that had less than \$200 million in assets in 1990. (This definition is actually a bit more complicated: some community banks are independent, some are affiliates of holding companies. See the back flyleaf for more detail.)

By the end of 1990, community banks numbered 9,075 (3,428 were independent, 5,647 were part of holding companies) and accounted for about three-quarters of the nation's banks. They controlled, however, only about 13 percent of the nation's banking assets, down from about 16 percent at the end of 1980.

In the Eighth Federal Reserve District, about 80 percent of all banks are community banks. At year-end 1990, these 977 banks controlled about \$48.2 billion, or one-third, of the District's total banking assets. Of the 10 new District banks that opened for business in 1991, eight were community banks.



he demise of the community bank has been predicted for some time. Some say that community banks will not be able to compete in an era of deposit rate, product and geographic deregulation and that competitive forces will drive small institutions out of the market. Others argue that community banks will thrive in a more competitive environment because they concentrate on basic banking — that is, they turn low-cost funds into low-risk, but profitable investments, earning rates of return that often exceed those of their more diversified competitors.

Which view is correct? The simple answer is “both.” Most observers agree the number of banks will shrink over the next decade, with the bulk of the reductions occurring among the nation’s smallest banks. Predicting these numbers with any certainty, however, is difficult. If you recall, some analysts predicted in the early 1980s that only 100 U.S. banks would survive the decade. But, as Mark Twain discovered when he picked up an 1897 London newspaper, death notices can sometimes be overstated. Certainly this one was: we have about 12,000 banks in the United States today.

The fact is, though more than 2,000 community banks either failed or merged with other organizations during the 1980s, most community banks survived. And they survived in an era of sweeping regulatory change, including the elimination of interest rate ceilings and the liberalization of state branching and interstate banking laws. Moreover, 3,076 new U.S. banks — most of them community banks — opened their doors for business in the 1980s.

As the numbers on the previous page show, community banks are an integral part of Eighth District banking. In addition to their numbers and the substantial amount of credit they provide, they are often the cornerstone of their communities, growing as the communities grow. Many seem to have been around forever: of the 273 District banks in business since before 1900, almost 70 percent are community banks. These banks are long-term, stable forces in their local economies.

Because of their strong community ties, the continued viability of these banks is an important public policy issue. The challenges community banks face and the strategies they’re employing to thrive in the 1990s are the focus of this report.

Before we begin, I would like to express my appreciation to several retiring directors, who provided us with valuable advice and service over the past few years: Thomas F. McLarty, III, at our head office; Lois H. Gray in Louisville; and Katherine Hinds Smythe in Memphis. I’d also like to convey my sympathy to the families of two directors who died during 1991: William Earle Love at our Little Rock Branch and Wayne G. Overall, Jr., in Louisville. Their participation and guidance at their respective boards will be missed.

Thomas C. Melzer
President and Chief Executive Officer

“Reports of
my death
are greatly
exaggerated.”

— Mark Twain



**H. Edwin Trusheim (left),
chairman of the board,
and Thomas C. Melzer,
president and chief
executive officer**

In small towns, the community bank is often the first place borrowers turn to for credit. At right, State Bank of Waterloo, Illinois, sits in a prominent location — on Main Street in the middle of the town square.



THE CHALLENGE TO COMMUNITY BANKS



Despite the consolidation that has occurred in banking as a result of deregulation and technological innovation, the community bank is often the first place many small businesses and households turn to for credit. Community bankers assert that local banks are better able to judge the creditworthiness of borrowers and are more interested than other lenders in funding projects that will enhance local economic growth. Thus, they say, community banks still play an important role in financing economic activity, especially in rural communities. But it will not be easy for community banks in the 1990s.

The Problems of Being Small

Many of the hurdles community banks face can be traced to their size. Numerous studies have shown that banks with less than \$25 million in deposits have a significant cost disadvantage compared with their larger peers. This is primarily because they lack what economists call economies of scale (when the average cost of producing a firm's output declines as output — or firm size — increases). In an industry with significant economies of scale and few regulatory restrictions — which can keep the number of firms artificially high — a small number of very large firms usually dominates.

What is the evidence on economies of scale in banking? Most economists agree that banks with less than \$25 million in deposits have higher average costs than banks with deposits in the \$25 million to \$100 million range. (There is no consensus about whether scale economies exist above \$100 million.) Because many community banks operate in this mid-range, it would appear that a great number of them have a cost advantage over their smaller and, perhaps, even their larger peers.

The smallest community banks, unable to take advantage of the cost savings that come with increased size, are disappearing, however. Since 1980, according to one study, the annual decline in the number of banks with assets of less than \$25 million has exceeded 300 in all but one year. Until 1984, that decline was matched by an increase in the number of larger banks, indicating that much of the "decline" was actually the smaller banks growing larger. From 1984 through 1988, however, bank failures became the primary factor in the reduction of banks in this category. To remain viable then, many of the smallest banks may have to merge with other institutions.

The Tougher Competition

Another challenge to community banks in the 1990s will be keeping up with the competition. Among small depository institutions, credit unions appear to pose the greatest threat, as they expand in membership and offer more bank-like products and services. Credit unions are attractive to many consumers and small businesses because, as tax-exempt institutions, they are often able to pay more on deposits and charge less on loans than comparably sized banks.

Community banks will also face increased competition from their larger peers, as interstate banking and branching barriers fall by the wayside. Large banks with low-cost branching networks will no doubt gain market share as depositors

District Community Banks Over 125 Years Old

1852

First Columbus National Bank, Columbus, MS

1854

Greene County National Bank, Carrollton, IL

1857

Callaway Bank, Fulton, MO

1859

First Bank and Trust Co., Cairo, IL

1860

First National Bank, Litchfield, IL

1865

First National Bank of Vandalia, IL

First National Bank, Columbia, MO

Paris National Bank, Paris, MO

1866

Anderson National Bank of Lawrenceburg, KY

Bank of Columbia, KY

1867

Bradford National Bank, Greenville, IL

Farmers Deposit Bank, Eminence, KY

First State Bank, St. Charles, MO

Moniteau National Bank of California, MO

First State Bank, Winchester, IL

and borrowers become more comfortable with the technology that makes branching cost-effective: automatic teller machines, electronic funds transfer, and so on.

Large banks also have an edge in competing for the biggest deposit accounts. Despite recent curbs in the way large bank failures are handled (the "too big to fail" principle), uninsured depositors still generally think they are more likely to be compensated when a large bank fails than when a small bank fails. Because of this, large banks are often able to attract deposits away from small banks. In addition, they generally have greater access to purchased funds — federal funds and large CDs — than small banks. As a result, small banks are often limited to the core deposits of their communities. Bank customers, on the other hand, have several options: they can obtain credit from sources other than their local banks, including credit unions, finance companies and out-of-town banks. These factors limit community banks' ability to grow.

CAN COMMUNITY BANKS SURVIVE MORE DEREGULATION?

The Growth of Eighth District Community Banks (by structure)



any community bankers view the dismantling of geographic barriers as the biggest threat to their viability. State branching and banking laws were considerably liberalized in the 1980s, and most analysts believe full geographic deregulation is less than a decade away. Some community bankers fear that a few large organizations — within their state or across the country — will gobble up the nation's small banks. This is unlikely for several reasons.

First, despite what happens with geographic restrictions on banking, capitalization requirements are unlikely to be loosened. Many large banks will continue to be hobbled by their need to increase capital and will be in no position to attempt massive acquisitions. The nation's smallest banks, on the other hand, are generally the best capitalized group of banks.

Second, the nation's anti-trust laws will also be a barrier to large-scale consolidation. Policymakers have an interest in increasing competition, but an equal interest in preventing the development of an industry dominated by just a few.

Third, and most important, there is little evidence to suggest that full geographic deregulation will severely harm the nation's community bankers. The experiences of states with liberal branching laws are especially instructive. North Carolina, for example, has permitted statewide branching since 1921. Between 1980 and 1990, the number of community banks declined by two to 57; nevertheless, they still make up about three-fourths of the state's banks. In California, which has always permitted statewide branching, the number of community banks actually increased during the decade: from 202 in 1980 to 304 in 1990. This growth occurred despite the increased presence of foreign banks in the state and the growth of some of California's (and the nation's) largest banks.

What about the Eighth District? The bar chart at left illustrates the changes in the number and structure of District community banks between 1980 and



Applying for a loan or
conducting any other type
of bank business at a
community bank often
means dealing directly
with the bank president.

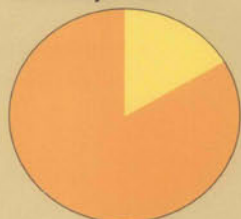
Community banks in urban areas typically conduct their business in the shadow of much larger neighbors. Though faced with more competition than their small-town peers, urban community banks are holding their own.



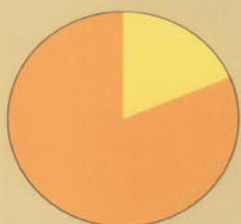
1990. The number of community banks declined about 20 percent during the 1980s, just slightly less than the national decline. Interestingly, the proportion of community banks affiliated with a holding company increased dramatically. In 1980, 12 percent of the District's community banks were part of a bank holding company; by the end of 1990, about 70 percent were affiliated with holding companies. At the national level, about 60 percent of community banks are now affiliated with holding companies, up from about 20 percent in 1980. Much of the shrinkage in the number of community banks is matched by the growth of holding companies. Why this has happened is clear: community banks have formed holding companies to take advantage of tax savings and to circumvent restrictions in state branching laws.

Also of note is the percentage of District community banks located in metropolitan areas. Because they're typically more economically diversified than rural areas and, hence, more attractive investment opportunities, metropolitan areas are thought to be the arena where community banks would face the stiffest competition from deregulation. Although state results vary considerably, the proportion of community banks located in metropolitan statistical areas (MSAs) in the District decreased only slightly from 1980 to 1990 (see pie charts at left). In some states, the proportion of community banks located in MSAs increased, although the absolute number declined. The increased proportion of urban community banks in some states occurred despite the wave of District mergers and acquisitions during the last 10 years.

The Location of Eighth District Community Banks



1980
17.6% in MSAs
82.4% in rural areas



1990
15.9% in MSAs
84.1% in rural areas

SURVIVING YES, BUT THRIVING?



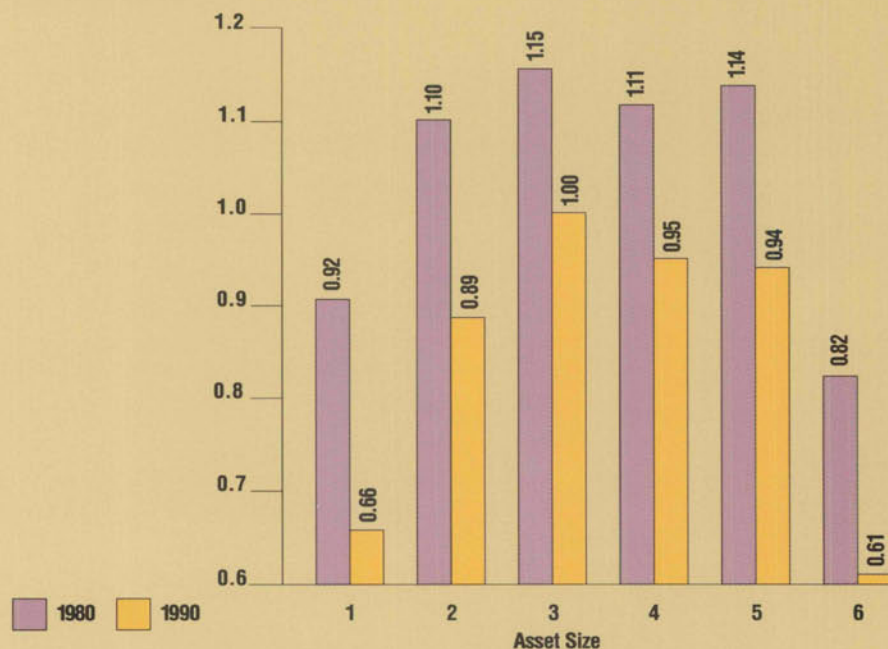
Despite forces that threaten their existence, community banks are surviving. But are they doing well or just hanging on? Until recently, studies comparing the profitability of small and large banks have shown that smaller banks generally outperform their larger peers. Those aggregate results tend to be skewed, however, by the lumping of urban and rural banks together. When the farm economy is healthy, rural banks of all sizes tend to be more profitable than urban banks because of less competition. When one compares the recent performance of small urban banks with that of large urban banks, however, the larger urban banks appear more profitable.

Whether urban or rural, however, the profitability of all small banks is declining quite clearly. The figure on the following page shows return on average assets — net income divided by average assets — for District banks in 1980 and 1990. Keeping in mind that a 1 percent return on average assets is the industry benchmark, two trends become apparent. First, the profitability of *all* banks declined considerably over the 1980s, a decline that can be attributed to an agricultural crisis, bad loans to lesser developed countries and a real estate loan bust, as well as increased competition. The District's smallest and largest banks, however, experienced the largest declines in profitability. Banks in the two smallest asset categories, for example, experienced de-

clines of 26 and 21 basis points, respectively, over the decade. The District's largest banks experienced a 21 basis-point decrease over this period. Second, the most profitable categories of banks continue to be the two mid-sized categories (banks with \$25 million to \$150 million in assets in 1980, and \$50 million to \$300 million in 1990).

These results reinforce the results from most bank cost studies, which show that very small banks and very large banks face higher average costs than banks operating in the middle range. With increased competition forcing banks to charge less on loans and pay more on deposits, the result is declining net interest margins. The tendency for small banks to hold larger ratios of government securities to assets than loans to assets protects them from credit risk (the risk that loans will not be repaid), yet geographic concentration in their loan portfolios makes them more vulnerable to local economic downturns. A number of small banks lost this trade-off and closed their doors during the 1980s, as stable revenue from holdings of securities could not offset loan losses resulting from deteriorating business conditions. Small banks that do not diversify or find ways to reduce their costs are likely to face the same fate.

**Return on Average Assets,
Eighth District Banks**



Category 1 Less than \$12.5m in 1980; Less than \$25m in 1990
 Category 2 \$12.5m-\$25m in 1980; \$25m-\$50m in 1990
 Category 3 \$25m-\$50m in 1980; \$50m-\$100m in 1990
 Category 4 \$50m-\$150m in 1980; \$100m-\$300m in 1990
 Category 5 \$150m-\$500m in 1980; \$300m-\$1b in 1990
 Category 6 \$500m-\$5b in 1980; \$1b-\$10b in 1990

**District Community
Banks Chartered in
1991**

Commonwealth Bank &
Trust Co., Middleton, KY

Omni Bank,
Pontoon Beach, IL

Greers Ferry Lake State
Bank, Heber Springs, AR

First Western Bank &
Trust Co., Rogers, AR

First State Bank,
Huntsville, AR

Citizens Bank of Northwest
Arkansas, Fayetteville, AR

Peoples Bank,
Paragould, AR

First Community Bank,
Conway, AR



One of the community
bank's main strategies
for success, particularly
in rural communities, is
to cater to customers
who prefer personal
contact with their banker.

MAKING IT IN THE 1990S



s we have discussed, the challenges facing the small bank in the 1990s are formidable. Even the pessimistic industry observer, however, now believes that a large number of community banks will not just survive but thrive in the 1990s. How will they do it?

Although the blueprint for success will differ from bank to bank, two major strategies have evolved. The first is a continuation of what community banks have always done best: focus on basic banking products that serve their customers' needs. Community banks can build a solid business by catering to customers who like personal contact with their banker.

The second strategy is diversification. Many successful community banks, like their larger peers, have taken advantage of liberalized state branching laws, expanding their markets considerably and improving their opportunities for success. The nation's small banks already operate about 28,000 branches, more than half the U.S. total. Branching allows community banks to diversify their loan portfolios, making them less susceptible to local economic downturns. Product diversification — or full service banking — is another option for banks large enough to profitably offer services like trust accounts and credit cards.

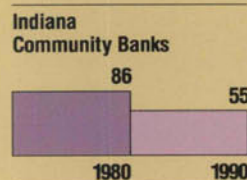
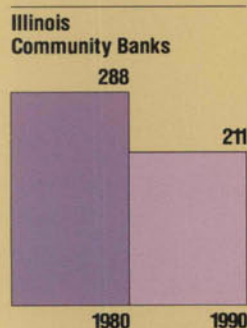
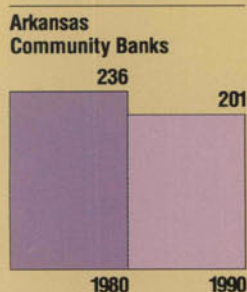
Whichever strategy they employ — basic banking or diversification — increasing numbers of community bankers have decided not to go it alone. By banding together, they are resolving some of the industry's cost problems and expanding their mix of products. The use of computers and other technology-based products in banking has forced many small banks to invest in equipment they can ill afford on their own. Increasingly, they and many of their larger peers are using vendor services for their data processing and other technologically intensive operations. The Independent Bankers Association of America, for example, has more than 1,000 small banks enrolled in its credit card services subsidiary. Other community bankers are using correspondent banking and bankers' banks to manage their operations and product needs.

Correspondent Banking

One of the oldest tools available to community bankers is the correspondent bank network. Correspondent banks are usually mid- to large-size banks with a diversified product mix. Correspondents help their clients with such services as check-clearing, loan sales and participations, data processing, federal funds trading, securities purchases and sales, mortgage servicing and credit card operations. Correspondent banking continues to be popular among community bankers, although the advent of interstate banking and branching is making some community banks nervous about sharing their financial records with potential competitors.

Bankers' Banks

One relatively new way around this problem is a development called the bankers' bank. Bankers' banks are cooperative depository institutions whose customers and stock-

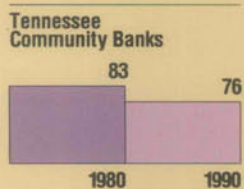
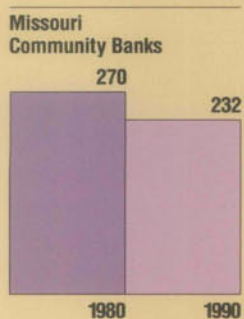


holders are commercial banks. They can be either state- or federally chartered, and all carry FDIC insurance coverage. The earliest bankers' bank, the Independent State Bank of Minnesota, dates back only to 1975.

Bankers' banks carry out many of the services typically provided by correspondent banks. Because of their cooperative nature and the fact that many bank customers are also stockholders, however, banks using bankers' banks generally pay less in fees and earn a return on their investment. Although these banks collectively are small (\$800 million in combined assets as of June 1991), they provide many of the services of the larger banks. Including federal funds trading, these banks manage about \$3.5 billion in assets daily.

Bankers' banks market themselves almost exclusively to independent and community banks. As of mid-June 1991, 16 U.S. bankers' banks (operating in 16 states) had about 3,000 customers and 1,700 shareholders. Four bankers' banks are located in the Eighth District — in Arkansas, Illinois, Kentucky and Missouri. In Arkansas, 56 banks, about 22 percent of the state's total, were using bankers' bank services as of mid-June 1991.

IS AMERICA OVERBANKED?



Community banking is rooted deep in American culture. The nation's demographic and economic diversity, together with the dominance of small business in American economic life, have promoted the growth of banks in small towns and big cities. Although the patchwork of big banks and little banks, urban and rural, has served the country well over much of its history, it is increasingly clear that we have more banks than we need. In fact, we have by far the largest number of banks per capita in the world. This abundance is largely the result of

laws that confine banks geographically. To remain competitive with nonbanking firms and foreign banks operating in this country, the banking industry will have to move to dismantle these laws and reduce the number of banks further.

Industry consolidation will result in the loss of some of the nation's smallest banks. Especially endangered are very small banks with high cost structures; as competition increases, the only way for these banks to remain viable is to slash expenses, a difficult prospect.

There will always be a place, however, for the well-managed community bank. Like Mark Twain, community banks have continued on long past their projected demise. They have shown remarkable resiliency in previous periods of economic stress and regulatory change because they focus on basic banking and personal service. Such banks will likely find a place in a revamped, leaner banking industry.

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STATEMENT OF CONDITION

(thousands of dollars)

	December 31, 1991	December 31, 1990
ASSETS		
Gold certificate account.....	\$ 328,000	\$ 346,000
Special Drawing Rights certificate account.....	307,000	307,000
Coin.....	28,685	35,550
Loans to depository institutions.....	24,725	27,837
Securities:		
Federal agency obligations.....	160,083	183,879
U.S. government securities.....	7,057,649	6,816,617
Total securities.....	\$7,217,732	\$7,000,496
Cash items in process of collection.....	275,264	279,991
Bank premises (net).....	28,576	27,856
Other assets.....	852,436	1,027,092
Interdistrict settlement account.....	(1,609,158)	182,779
TOTAL ASSETS.....	\$7,453,251	\$9,234,601
LIABILITIES		
Federal Reserve notes.....	\$6,034,906	\$7,507,195
Deposits:		
Depository institutions.....	913,513	1,409,917
Foreign.....	3,930	4,050
Other.....	42,048	906
Total deposits.....	\$ 959,491	\$1,414,873
Deferred availability cash items.....	255,223	105,039
Other liabilities.....	72,467	80,374
Interdistrict settlement account.....	0	0
TOTAL LIABILITIES.....	\$7,322,087	\$9,107,481
CAPITAL ACCOUNTS		
Capital paid in.....	\$ 65,582	\$ 63,560
Surplus.....	65,582	63,560
TOTAL CAPITAL ACCOUNTS.....	\$ 131,164	\$ 127,120
TOTAL LIABILITIES AND CAPITAL ACCOUNTS.....	\$7,453,251	\$9,234,601

INCOME AND EXPENSES

(thousands of dollars)

	December 31, 1991	December 31, 1990
CURRENT INCOME		
Interest on loans to depository institutions	\$ 2,525	\$ 5,553
Interest on government securities.....	522,560	586,282
Earnings on foreign currency	65,658	70,467
Revenue from priced services	31,357	30,802
All other income	495	438
Total current income	\$622,595	\$693,542
CURRENT EXPENSES		
Current operating expenses.....	\$ 68,172	\$ 64,916
Less expenses reimbursed.....	(8,686)	(8,149)
Current net operating expenses	\$ 59,486	\$ 56,767
Cost of earnings credits	5,935	5,491
Current net expenses.....	\$ 65,421	\$ 62,258
CURRENT NET INCOME	\$557,174	\$631,284
PROFIT AND LOSS		
Additions to current net income		
Profit on sales of government securities (net)	\$ 4,177	\$ 1,823
Profit on foreign exchange transactions (net).....	10,301	57,764
All other additions.....	0	6
Total additions.....	\$ 14,478	\$ 59,593
Deductions from current net income		
Loss on foreign exchange transactions (net)	\$ 548	\$ 0
All other deductions	4	10
Total deductions	\$ 552	\$ 10
Net additions or deductions	\$ 13,926	\$ 59,583
Cost of unreimbursed Treasury service	(4,274)	(4,675)
Assessment by Board of Governors		
Expenditures	\$ (2,843)	\$ (2,834)
Federal Reserve currency costs.....	(7,330)	(5,924)
NET INCOME AVAILABLE FOR DISTRIBUTION	\$556,653	\$677,433
DISTRIBUTION OF NET INCOME		
Dividends paid	\$ (3,881)	\$ (3,772)
Payments to the U.S. Treasury (interest on Federal Reserve notes) ..	(550,750)	(671,683)
Transferred to surplus	2,022	1,978
Surplus, January 1.....	\$ 63,560	\$ 61,582
Surplus, December 31	\$ 65,582	\$ 63,560

NOTE: Detail figures may not balance to total due to rounding.

OPERATING STATISTICS

Operations	Number of Pieces Handled		Dollar Amount (thousands)	
	1991	1990	1991	1990
Services to Depository Institutions				
Check Services:				
U.S. Government Checks.....	30,369,000	32,568,000	30,029,000	28,500,000
Postal Money Orders	165,332,000	161,877,000	17,716,000	16,485,000
All Other	569,064,000	590,568,000	371,734,000	389,112,000
ACH Services:				
Commercial	79,175,000	64,819,000	359,985,657	317,008,300
U.S. Government	24,399,000	24,490,000	38,345,085	19,385,100
Collection Services:				
U.S. Government Coupons				
Paid.....	36,096	39,250	17,492	20,500
All Other	115,622	141,995	253,715	324,400
Currency Received and Counted:	692,465,000	690,265,000	8,147,804	7,965,000
Wire Transfer of Funds:	3,163,027	3,093,950	3,721,547,000	3,708,876,000
Loans to Depository Institutions:.....	1,545	1,132	1,314,000	1,636,000
Services to U.S. Treasury				
Transfer of Government				
Securities:	154,279	140,798	314,291,000	210,535,000
Food Stamps Redeemed:	222,487,000	186,717,000	1,119,157	895,900

OFFICERS

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Executive Officer

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First Vice President and
Chief Operating Officer

Anatol B. Balbach
Senior Vice President
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Information

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Martha L. Perine
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Support Services

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Harold E. Slingerland

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General Auditor

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Vice President and Manager

Thomas R. Callaway
Assistant Vice President

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Assistant Vice President

Credits

This report was written by Federal Reserve Bank of St. Louis economist Michelle A. Clark and was edited by Daniel P. Brennan. R. Alton Gilbert provided research direction, and Thomas A. Pollmann provided research assistance. Bernard E. Berns of our Customer Support Department and Helge Christensen, president of the Bankers' Bank of Wisconsin, also provided valuable information. For additional copies of this report, please call the Public Information Office, (314) 444-8809.

Definition of Community Bank

In this report, a community bank is defined as follows: an independent bank or a bank holding company whose affiliated banks had combined assets of less than \$100 million in 1980 or \$200 million in 1990. The asset limit for community banks was doubled from 1980 to 1990 to reflect the growth of Eighth District bank assets over the 1980s. About 84 percent of District banks met the community bank definition in 1980 and about 78 percent qualified in 1990.

For Further Reading

For a discussion of economies of scale in banking, please see:

Clark, Jeffrey A. "Economies of Scale and Scope at Depository Financial Institutions: A Review of the Literature," Federal Reserve Bank of Kansas City *Review*, September/October 1988.

Humphrey, David B. "Why Do Estimates of Bank Scale Economies Differ?," Federal Reserve Bank of Richmond *Economic Review*, September/October 1990.

Mester, Loretta. "Efficient Production of Financial Services: Scale and Scope Economies," Federal Reserve Bank of Philadelphia *Business Review*, January/February 1987.

For a discussion of small bank profitability, see:

Fraser, Donald R., and James W. Kolari. *The Future of Small Banks in a Deregulated Environment* (Ballinger Publishing Company), 1985.

Gup, Benton E., and John R. Walter. "Top Performing Small Banks: Making Money the Old-Fashioned Way," Federal Reserve Bank of Richmond *Economic Review*, November/December 1989.

Rhoades, Stephen A., and Donald T. Savage. "Post-Deregulation Performance of Large and Small Banks," *Issues in Bank Regulation*, Winter 1991.

Shaffer, Sherill. "Challenges to Small Banks' Survival," Federal Reserve Bank of Philadelphia *Business Review*, September/October 1989.

Wall, Larry. "Why Are Some Banks More Profitable Than Others?" *Journal of Bank Research*, Winter 1985.

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