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Personal Attention Sets Small Banks Apart

ST. LOUIS, Mo. -- Small banks (those with assets less than $100 million) have been less successful than midsized banks in reducing overhead and generating non-traditional sources of revenue in the 1990s. Nevertheless, consumer demand for personal attention should allow small banks to remain competitive in the next century.

That';s the perspective of research assistant Boyd D. Anderson and economist Timothy Y. Yeager, both with the Supervision and Regulation Division of the Federal Reserve Bank of St. Louis. Their comments appear in the latest issue of *The Regional Economist*, a quarterly journal of business and economic issues produced by the St. Louis Fed.

Anderson and Yeager found that return on average assets (ROA) the most common tool to assess bank profitability measured 1.11 percent for small banks at the end of 1998, which was 19 basis points below the average midsized bank's ROA.

They also found that banks in the Fed's Eighth District succeeded in trimming their net non-interest margins (non-interest expense less non-interest income, divided by average assets) in the last five years. A lower net non-interest margin implies that a bank has either lower overhead, higher non-interest income (fees), or both. Between 1994 and 1998, for example, the net non-interest margin for District banks with less than $1 billion in assets declined from 2.19 percent to 1.99 percent.

Despite the increased importance of fee income at U.S. banks overall, however, non-interest income has been relatively unimportant in reducing the District's average net non-interest margin. "What has been separating the District from all U.S. banks," said Yeager, "is the lack of fees from sources such as mortgage servicing, credit cards, early withdrawal penalties, safe deposit box rentals, and loan commitments."

Anderson and Yeager said that credit card fees are directly related to the level of credit card loans in bank portfolios. "Credit card lending is becoming increasingly consolidated in major financial centers," explained Anderson, "and banks in those centers are purchasing Eighth District credit card portfolios."

Between 1994 and 1998, midsized banks increased their fee income just 3 basis points to 0.95 percent of average assets. During the same period, however, small bank's non-interest income remained unchanged at 0.63 percent.

"Flat fee income," said Anderson, "reflects small bank's practice of underpricing services relative to their administrative costs. Small bankers fear that high fees will offend their customers. Plus, they usually don't offer the range of products like trust and brokerage services that generate fee income for larger banks."

They also noted that despite overall gains in reducing the net non-interest margin, the District's small banks have not enjoyed equivalent cost savings. For example, the net non-interest margin at the smallest District banks was 2.21 percent considerably above the 1.89 percent for the District's midsized banks at year-end 1998.

For example, an inability to invest in new technology has prevented small banks from reducing labor costs. "Small banks are often unable to invest the large amounts of capital needed to implement the latest innovations," said Yeager. "Consequently, they're less able to reap the related financial benefits."

Nevertheless, the higher staffing levels can pay off in more personalized service for customers and set small banks apart. "Consumer demand for personal attention should help to ensure a place in the future for community-focused banks," they concluded. "And small banks with sound loan portfolios will begin the 21st century in excellent shape."

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