The performance of independent banks in Ohio so far have adjusted quite well to the changes occurring in banking markets. The superior performance of the smallest independent banks is particularly noteworthy: it suggests that large size and/or the presence of holding company involvement in local markets, was found to be inversely related to independent bank profitability and change in market share. However, some relationships were insignificant statistical. Further, an unexpected significant positive relationship was discovered between holding company size and all market characteristic variables and independent bank net interest margins. While these contradictory findings may be due to the non-price nature of all bank services demanded by wholesale and retail customers. However, the performance of independent banks in Ohio since 1978 suggests that the demise of independents is neither imminent nor inevitable. Independent bank profitability and change in market share were inversely, but insignificantly, related to both thrift share of market deposits and de novo branching activity. Both of these market characteristic variables were positively and significantly related to independent bank net interest margins. One explanation for these contrasting findings is that economic/demographic characteristics in a market may explain both high bank net interest margins and a large thrift presence. Inter-bank competition may proceed on largely a non-price basis (e.g., heavy branching activity may result), depressing the non-price nature of inter-bank competition and making it difficult for independents to gain market share.

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Economic Commentary

Performance of Ohio's Independent Banks

by Gary Whalen

Economic, regulatory, and technological changes have had a significant impact on both the traditional banking industry and nonbank competitors. Regulatory reform has liberalized geographic branching and de novo branching. All banks are allowed to branch de novo into counties contiguous to their home office county and state-wide through branching.

Several states have liberalized branching restrictions on bank expansion by acquisition or merger and de novo branching. All of these forces are making it difficult for banks to perform as well as they have in the past. Because independent banks do not have access to the resources afforded by affiliation with larger holding companies, they are the class of depository institutions (aside from thrift institutions) most likely to be adversely affected by the economic forces described above. Some observers have voiced concerns about the continued viability of independent banks in this environment, particularly smaller institutions.

Examination of the recent performance of Ohio's independent banks, the subject of this Economic Commentary, provides insight on the ability of similar institutions in other states to survive in the current financial environment. For independent banks, the impact of de novo holding company expansion and the liberalization of geographic branching restrictions, and Ohio's independent banks face substantial competition from nonbank competitors, which have been permitted to acquire banks statewide for many years. Since Ohio's branching law liberalization in 1979, all banks are allowed to branch de novo into counties contiguous to their home office county and statewide through branching. These multibank expansion activities, particularly by holding companies.

Performance Determinants

Bank performance is the result of the complex interaction of many factors—the size of the institution, the number, size distribution, and types of actual and potential competitors present in local markets; competitors' conduct; and the economic/demographic characteristics of banking markets. Banking regulations affect both market structure and permissible competitive conduct.

Bank costs are thought to be systematically related to bank size. Generally, larger banks are presumed to be able to realize various forms of real and pecuniary economies of scale.

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imes, and hence enjoy lower average costs than their smaller counterparts. For example, opportunities to take advantage of specialization and division of labor and efficiently employ expensive, indivisible pieces of capital equipment may increase with size. Larger organizations may also be able to purchase materials and/or funds more cheaply than smaller ones.

According to economic theory, bank performance should depend on the number and distribution of competitors operating in independent markets. Performance should also depend on the number of potential competitors—banks currently outside but capable of entering the market if opportunities to generate profitable business become apparent. The greater the number of these potential competitors operating in any market, the more intense will be competition, and the more difficult will be surefire profitability. In addition, the size and extent to which market deposits are concentrated in the hands of a few dominant banking organizations are thought to be inversely related. Tacit collusion among competitors is more difficult and hence less likely among a larger number of competitors. 

Bank performance may also depend on the types (e.g., competitors) faced. Specifically, competition may differ in urban and rural banking markets where there are a large number of holding companies and/or thrift institutions operating, versus competing in SMSA counties. While all size classes exhibit a similar pattern, the two smallest size classes exhibited increases in profitability. Average margins for all size classes are above 5 percent, but, like profitability, they generally decline as bank size increases. Again, while the margins of the three largest size classes have remained essentially constant since 1978, those of the two smaller size classes of banks have improved significantly. These figures are quite remarkable in the view of the changes in lending and deposit composition at independent banks since 1978.

The core deposit ratio data (the sum of demand, NOW, ATS, and savings deposits divided by total deposits) exhibit a similar pattern. This is not surprising, since a bank’s net interest margin is the crucial determinant of its overall profitability. Average margins for all size classes are above 5 percent, but, like profitability, they generally decline as bank size increases. Again, while the margins of the three largest size classes have remained essentially constant since 1978, those of the two smaller size classes of banks have improved significantly. These figures are quite remarkable in the view of the changes in lending and deposit composition at independent banks since 1978.

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