THE FUTURE OF SMALL TOWN BANKING

By Joe Sullivan, CEO of Market Insights

"There is apprehension in some quarters about the survival of the small or moderate-sized community bank. Will it suffer the same eclipse in economic significance as the corner grocery and independent merchant? Or will it somehow struggle through these new challenges and emerge onto the new frontiers of banking, modernized but still preserving the sturdy independent tradition?"

This quote could have been taken from just about any financial services publication these days. Anxiety is running high and questions about the future of smaller banks (and credit unions) come up nearly every day at conferences and in board rooms around the country. The number of small banks and their share of U.S. banking assets and domestic deposits have declined substantially since 2000.

Most recent studies have pointed to historic data as sobering evidence of the future challenges facing small institutions. Others cite the economic and operational impact of the new regulatory environment as the primary cause for concern. But there are forward-looking factors (e.g. demographics, urbanization, consolidation, competition, etc.) that must also be considered if we are to understand the challenges and survive this probable path of decline. In fact, it is the intersection of two of those factors—demographics and urbanization—that will have undeniable impact.

DEMOGRAPHICS & URBANIZATION

Markets large and small are experiencing the effect of changes in *demographics*. Shifts in variables such as age, ethnicity and employment status can drastically alter a market profile and an institution's prospects for ongoing profitability. Small banks should be especially concerned with the aging of the population.

According to a January 2016 report released by the Public Research Bureau (PRB) there are an estimated 46 million Americans 65 years of age or older. By 2060, that number is estimated to reach

over 98 million, representing 24 percent of the total population.

In many parts of the country, especially the Midwest, and notably, Michigan, residents are "Aging in Place"—meaning that the younger people are leaving the area and the older population remains. In a recent article written by Nancy Derringer for Bridge Magazine, entitled "Left Behind, Michigan's Rural Dilemma" it addressed the sobering fact that 11 of Northern Michigan's counties have a median age above 50. This is high, given that the median age of Kent County (Grand Rapids) is 34.6 years old. Why is this important?

On the one hand, this may seem to be an opportunity for small banks. After all, the customer experience delivered by most small institutions is generally aligned with the needs and preferences of the Silent Generation and Baby Boomer segments. On the other hand, it is important to remember that every customer segment has different priorities, expectations and lifetime value. Customers 65 years of age or older have migrated from asset accumulation to asset depletion. While they may hold higher deposit balances, their need for loans, credit cards, etc. diminishes. They become less profitable. Moreover, small institutions are already starting to feel the impact of long-time, loyal older customers dying and their accounts transferring to children and grandchildren in other parts of the country.

According to Matthew Dolan, in an article for the Detroit Free Press summarizing key points from a University of Michigan economic forecast, the state is in its seventh year of economic recovery, and has done well, due in large part to a booming auto industry with strong sales. However, its attempts to diversify beyond the auto industry into technology for example, (i.e.: booming in places like Grand Rapids and Ann Arbor, etc.) will be put to the test, should a slow down in auto sales come to fruition as projected in 2017. While job growth in recent years has been impressive, Michigan still lags the nation in the number of people in their 20's and 30's with a college education and the income level of all residents.

These issues become even more important when you factor in *urbanization*—the increase in population in cities and towns versus rural areas. As younger customers migrate to urban areas for employment or educational opportunities, small town/rural areas end up with a disproportionate percent of the older population. This trend is exacerbated by the migration of older adults to smaller communities where cost of living is less.

There is already a disproportionate percentage of small bank customers concentrated in small town/rural and small metro markets. The net result of these migration patterns is the shrinking base of profitable customers.

EVOLVE OR DIE

So, will small banks survive? Yes. There will be fewer of them as consolidation continues, but they will not disappear. Leaders like you will embrace the well-used phrase: you must evolve or die! Business as usual is not a viable strategy as margin compression erodes your profits and customer churn shrinks your base and causes your assets to dwindle. Survival requires evolution. You must be nimble in your response to these challenges and continually adjust your growth strategy to reflect market realities.

In the short-term, small banks must become hyper-local; leveraging a comprehensive understanding of your local market and your customer to offer the customer experience and suite of products that is aligned with your unique profitable customer segments.

In the long term, keep practicing the Three R's: *Research, Refine and Reposition.*

STEP 1

RESEARCH YOUR MARKETS

We communicate with clients everyday that every decision they make, every dollar they allocate, must be rooted in

the fundamentals of their market, and in many cases, those markets have shifted exponentially since The Great Recession. Consider assessing the following market characteristics:

- Long term demographic trajectory of your markets (2016 to 2021 and beyond).
- The degree to which urbanization may be eroding (or growing) your markets (i.e.: net migration toward Grand Rapids, Ann Arbor and Detroit suburbs with net losses in smaller towns elsewhere).
- Whether and where jobs are being created or lost.
- How age (older or younger) may be changing your channel usage patterns.
- What your competitive climate will look like in five years.

STEP 2 REFINE

After having done the research, ask yourself what needs to be changed (refined). Look at your products, your processes, your branch network and evaluate what must evolve.

- Has your target audience changed given changes in your markets?
- Does your message need to be modified given these changes?

STEP 3 REPOSITION

Bottom line—you need to routinely reposition yourself to ensure that you're playing your best hand. In Michigan, for example, that may mean marketing the products and services that help customers rebuild their financial lives after a painful recession and slow recovery—speaking directly to their unmet emotional needs about how to move forward. If you are in a high tech community like the Silicon Valley, or Raleigh-Durham, or Austin, you may need to speak to more aspirational needs.

The way small banks and credit unions will survive (and perhaps thrive) is to continually deploy the three steps outlined here; recognizing that it is a journey, not a destination. Your ability to move swiftly on these three steps and to be agile in making needed adjustments is key to survival.

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One final note. The quote that opened this article was taken from remarks by George W. Mitchell, member of the Board of Governors of the Federal Reserve System…on March 14, 1966. So as you can see, the question of small bank/credit union survival has been debated for a very long time. The challenges may seem greater, and the stakes may, in fact, be higher; but even the smallest banks in the smallest communities can find ways to move forward.

Joe Sullivan will be presenting at the MBA's Bank Management and Directors Conference in Rochester on December 1. His topic will be The Future of Small Town Banking. Don't miss this opportunity where he will elaborate in detail how small banks can position themselves to compete amidst the challenges outlined in this article.