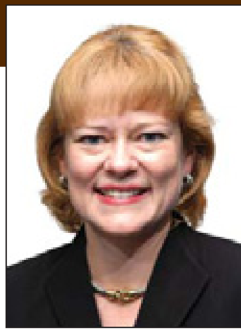

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The State of Banking: It's All in the Branches

Remember in the not so distant past when it seemed as though you spotted a gas station on every street corner? Now, many have observed, there's a bank on every corner. Is this selective perception, or are the number of banking locations increasing at a time when predictions were that brick and mortar bank locations would decrease with the prevalence of a global ATM network and the proliferation of online banking services?

Fewer Trees, More Branches

The number of banking institutions continues to decrease, yet the number of locations is growing. In the competitive banking industry, it appears that face-to-face access to knowledgeable bankers is as important today as it was when the first Texas banks began serving customers.

The Texas Department of Banking's 2005 Annual Report shows that, during the last five years, the number of commercial banks headquartered in Texas has dropped 12 percent, from 711 to 623, while the number of offices has grown 33 percent to 3,129. The Houston PMSA experienced the seventh best employment growth among large metro areas during the period from 1994-2003 and, according to a 2004 FDIC study, was ranked second in the nation for the change in number of bank offices.

States with the largest branch growth rates are those where relaxation of banking laws occurred later. From 1994 to 2003, the greatest increases in branches occurred in former unit banking states of Colorado, Wyoming, Montana and Texas, which had over a 30 percent increase in the number of branches.

In order to understand why this is occurring, let's examine significant events in the past 20 years that have led to the current situation.

Seven Out of Ten Failed

During the 1980's, overextension of bank credit, loose lending to energy related businesses and commercial real estate deals, declining energy prices and over-building of commercial properties contributed to the banking crises in Texas. Between 1987 and 1990, seven of the ten largest commercial banks in Texas failed. During this turbulent time, the Texas commercial banking industry shrank significantly. The number of banking organizations with full-service offices in Texas fell from 1,179 in 1980 to 865 by year-end 1994.

Until the late 1980s, branching was prohibited in

Texas. In a summer 1986 special session, the Texas legislature passed an interstate banking law, which was approved by public referendum in November and took effect on January 1, 1987. This dramatically changed the composition of the banking organizations in Texas. By 1994, only one of the Texas-based banks remained in the top ten banks in the state.

Branches Sprout All Over

Texas allowed countywide branching in 1987 and statewide branching in 1988. Passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 helped large banks spread across state lines and grow. This gave states the option to permit interstate branching as of January 1, 1997. Removing these legal barriers opened the large Texas market to new players. This began a ten-year period that saw a strong upward trend in the number of offices and deposits held in interstate banking organizations.

The FDIC's *Texas State Profile* for summer 2006 shows 109 financial institutions in the Houston market with $99.7 billion in deposits. FDIC data was used to calculate 1,240 bank locations in Harris, Ft. Bend, Galveston, Montgomery and Brazoria counties. The top 10 percent of the institutions operate 58.5 percent of the locations in the Houston market and are estimated to hold 72 percent of the deposit base.

COUNTY	LOCATIONS
Brazoria	63
Ft. Bend	83
Galveston	75
Harris	921
Montgomery	98
Total	**1,240**

According to the March issue of *Texas Banking*, in 2005 Texas enjoyed its biggest year since the late 1980's for mergers and acquisitions, with deal value of $3 billion from 32 transactions. This runs counter to the national trend, with 2005 ending as the second slowest year nationally for mergers and acquisitions in the last decade. Nationally, mergers and acquisitions peaked at 504 transactions in 1988, declining to 231 transactions in 2002.

An FDIC Staff Study revealed that 1,086 Texas banks were acquired from 1980 – 1998. Texas acquisitions comprised 13.6 percent of the total U.S. bank acquisitions (7,985) during this period. Of the Texas acquisitions, 798 of the acquired banks had assets of $100 million or less. Only 26.5 percent of the acquisitions were of banks larger than $100 million in assets.

When examining the asset size of the acquiring banks, the statistics were reversed, with 844 of the acquirers having assets of more than $100 million. Over half (52.5 percent) of the acquiring institutions had assets of $1 billion or greater.

A Time to Sell; a Time to Buy

Some bankers in smaller organizations are weighing increasing compliance costs, the squeeze on net interest margins, the high prices being paid for Texas bank acquisitions and the tax impact of Subchapter S elections to conclude that now is a good time to sell. Publicly traded banks are assessing acquisition opportunities to fuel the growth expected by shareholders. International banks, money center banks, regional banks, publicly traded Texas banks and community banks each have a role in the vibrant Texas banking environment. Healthy community banks serving metro areas will continue to be on the acquisition radar screen of each of the other banking categories, but deals are done only when sellers' and buyers' price expectations are aligned.

Forty-one percent of all Texas-insured institutions have elected the Subchapter S tax structure, eliminating taxes at the corporate level. The impact of the S corporation election begins to yield positive tax benefits to buyers and sellers in 2007. Sellers of S corporations will be able to structure the deal to avoid capital gains tax, and buyers will be able to deduct resulting price premiums paid over the next 15 years.

The effect of mergers and failures was dampened somewhat by the establishment of new banks, mostly in areas of high-density population. According to a 2004 FDIC Banking Review, between 1992 and 2003, 1,250 new community banks were established in the U.S. Only 100 of these were subsequently merged, and just four failed.

Due to the large and growing population, favorable income levels and strong economic outlook, Houston and the other metro areas of Texas remain attractive banking environments. The increasing number of banking offices in the face of a large decrease in the number of banks suggests that local markets continue to demand convenient physical banking locations. The increasing number of ATMs and continued expansion of electronic banking options, once thought to signal a decrease in physical bank buildings, appear instead to complement local banking offices by providing convenient ways to obtain cash or conduct traditional bank transactions. A 2004 American Bankers Association study found that 92 percent of consumers still visit a bank branch at least once per month. Most bank executives agree that, no matter how many branches they add, the most important asset for banks continues to be the skilled bankers who work in the branches.

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Pamela Lovett joined Sterling Bank in 2006 as senior vice president for business development and community affairs. Sterling Bank (Ticker Symbol: SBIB), with total assets of $3.7 billion, operates 40 banking offices in the greater metro areas of Houston, San Antonio and Dallas. Prior to joining Sterling, she served as president of the Greater Houston Partnership's Economic Development Division. She serves on the board of directors of American Leadership Forum and DePelchin Children's Center and on the advisory boards of the Houston Technology Center and Junior League of Houston. Pamela can be reached via email at pamela.lovett@banksterling.com.