

Where Have All the Community Banks Gone?

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The number of community banks in the U.S. has been declining over the last decade. This represents a huge economic loss to local areas, impeding the recovery of many parts of the U.S. Further, community banks are an important source of funding for consumers and businesses, whose access to credit is necessary for a sustainable economic recovery.

The Federal Reserve defines a community banking organization as one with assets of \$10 billion or less. Although this size-based definition correlates well with the other characteristics of community banks, such a quantitative measure does not capture the full meaning of the term “community bank” or illuminate the business model behind the term. Community banks are locally owned and focus their attention on the needs of the community and its businesses. Because they are grounded in their communities, these banks are able to provide services that are personalized and tailored to meet local preferences and needs. Community banks transform local deposits into loans to the community where their depositors live and work. By doing this, they help to keep their local economies vital and growing.¹ According to Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair, “Community banks are essential to the economy, but many of them are experiencing acute credit distress; community banks are doing more than their share under difficult circumstances to provide the credit that will be needed to create jobs in the recovery.”²

Community banks were not responsible for the worst excesses that led to the credit crisis. However, many of these banks are highly dependent on commercial real estate and construction loans. And these concentrations did create a vulnerability to the credit crisis that impacted mortgage and real estate markets during the past three years. Institutions that did not manage these risks are now experiencing high credit losses and, in many cases, lower supervisory ratings. Supervisory ratings refer to the amount of capital relative to a financial institution’s loans and other assets. Banks must hold a minimum amount of equity capital against their risk weighted assets. While most of the risky subprime and nontraditional mortgages that fueled the housing bubble were the work of a highly complex, disjointed and

¹ “Past Present and Future of Community Banking,” by Governor Daniel Tarullo, Speech at Federal Reserve Bank of N.Y. Community Bankers’ Conference (4/8/2010).

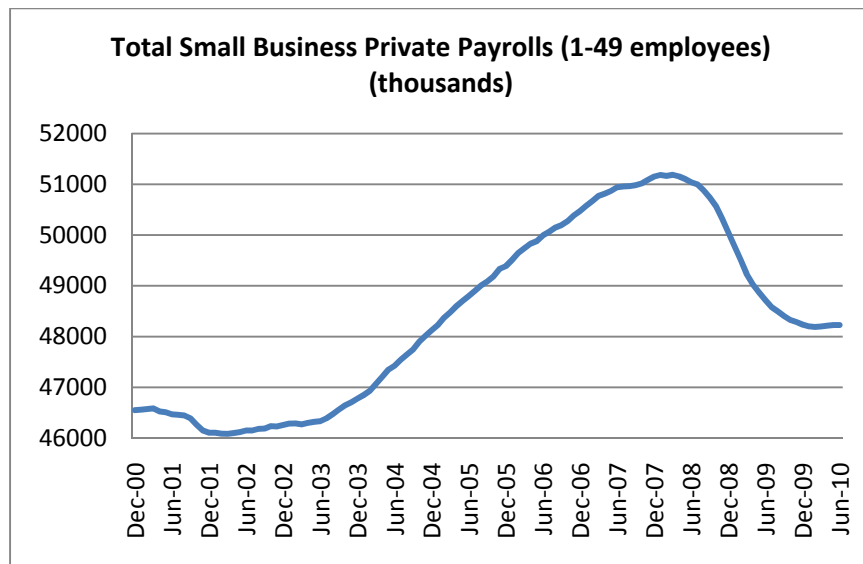
² Remarks by FDIC Chairman Sheila Bair to the Independent Community Bankers of America’s 2010 National Convention and Techworld; Orlando, Florida (3/19/2010).

depersonalized securitization process undertaken by large financial institutions, the losses from these securities have been felt by the banking sector as a whole.³

Importance of Relationship Banking

Community banks epitomize the notion of relationship banking. They are better positioned than their national competitors to go beyond models and consider other factors when making credit decisions. They can often respond more quickly to lending requests than their national competitors because of their direct knowledge of their customers' financing needs and debt servicing capacities. While many of the large U.S. financial institutions try to promote relationship banking, they may not have the direct knowledge of the communities they are claiming to serve that community banks have.

Community banks are crucial to promoting small business development. Other than personal borrowing or credit card use by proprietors, community banks are often the only source of credit potentially available to small businesses. Knowledge of local borrowers' characteristics and local economic conditions are some of the most significant factors in making decisions on creditworthiness of individuals and businesses. These decisions are critical for the economic recovery to be sustainable because small businesses create at least two thirds of all net new jobs.⁴ Since the recession began, small businesses, which range from 1 to 49 employees, have shed close to 3 million workers of the total 8 million private sector jobs lost.⁵



Source: ADP/Macroeconomic Advisors

With the decline in community banks and the unwillingness of large banks to lend, total loans and leases held by FDIC-insured institutions fell by 7.5% in 2009, the steepest decline since 1942. Several factors

³ Ibid.

⁴ "Past Present and Future of Community Banking," by Governor Daniel Tarullo, speech at Federal Reserve Bank of N.Y. Community Bankers' Conference (4/8/2010).

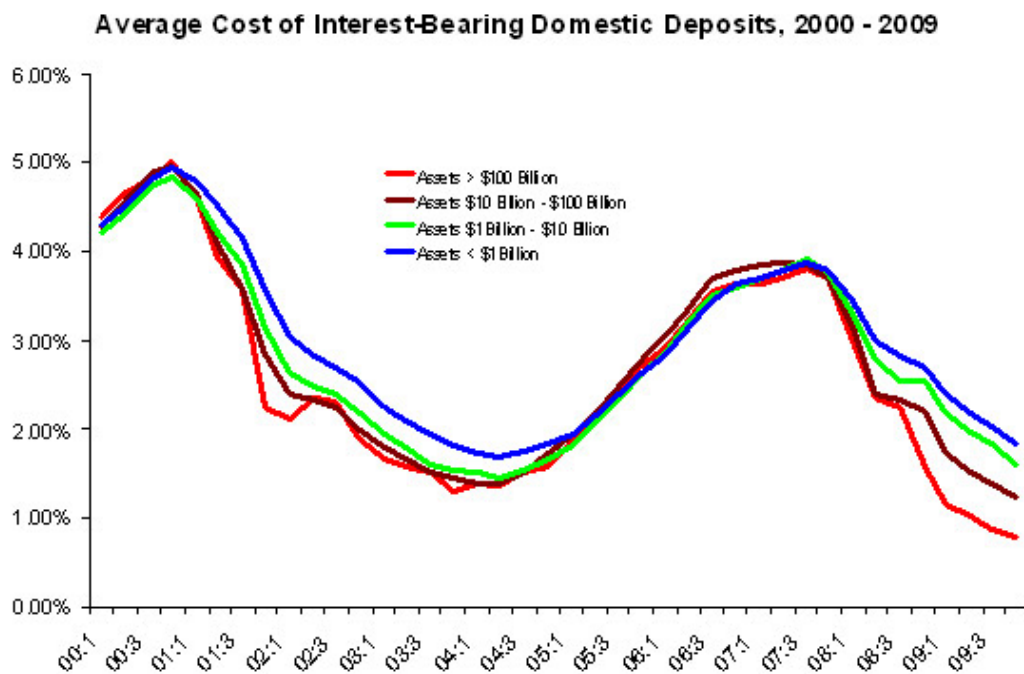
⁵ The ADP/Macroeconomic Advisors June 2010.

are responsible for this large decline besides the drop in the number of community banks, including weak demand from household and business borrowers, a decline in the credit standing of many borrowers, and tighter standards on the part of many banks.⁶

During the final quarter of 2009, loans and leases at the largest banks, those with over \$100 billion in assets, fell by 2.8%. That was about seven times greater in percentage terms than the decline at community banks. The largest banks accounted for more than 90% of the total drop in bank lending for the quarter. The smallest banks, banks with assets of less than \$100 million, actually increased their loans by more than one-half of one percent. While so many big banks contracted their lending, small community banks continued to lend, offering small local businesses a needed source of capital.⁷

Community Banks Are at a Disadvantage Relative to Large Banks

Large banks have received implicit government support to the distinct disadvantage of community banks. This is most evident when looking at the disparity in funding costs, or interest rates that banks have to pay. The average cost of interest-bearing domestic deposits for the largest banks was more than 100 basis points less than the average deposit costs at community banks in the fourth quarter of 2009.⁸



Source: Federal Reserve

⁶ Remarks by FDIC Chairman Sheila Bair to the Independent Community Bankers of America’s 2010 National Convention and Techworld; Orlando, Florida (3/19/2010).

⁷ Ibid.

⁸ Ibid

The Challenges for Community Banks

The number of community banks has consistently declined over the last few decades. During the current economic downturn, community banks have been particularly hard hit. During 2009, banks with assets of \$10 billion or less recorded an aggregate net loss of more than \$4 billion. This weak performance stemmed primarily from sustained deterioration in residential mortgages and commercial real estate loans. Loan loss provisions, a non-cash expense for banks to account for future losses on loan defaults, reached \$33.0 billion, seven times the 2006 pre-crisis level of \$4.5 billion. Net interest margins also narrowed, squeezed by a substantial rise in nonaccruing assets, and the nonperforming assets ratio reached nearly 5%.⁹

Almost one in every three community banks recorded a net loss in 2009. Moreover, only a little more than one quarter of these institutions reported a return on assets of 1% or more (a typical measure of sound earnings performance), down from 56% of institutions in the pre-crisis year 2006. And the FDIC problem list recently reached 775 banks and thrifts, its highest level since 1993.¹⁰

A major challenge for many community banks stems from the weakness in commercial real estate lending activities. A large volume of commercial properties is expected to come onto the market as a result of failures of other banks that concentrated their lending in the commercial real estate sector, and this will further weaken that sector.¹¹ Commercial real estate has caused large losses for community banks and helped to bring the number of overall bank failures so far in 2010 to 86, compared to 140 for all of 2009 and 35 for 2008.¹²

Another long-term challenge facing community banks is the secular compression in the net interest margin. Despite an emphasis on noninterest revenues in recent years, community banks have had difficulty diversifying their revenue streams and continued to rely heavily on spread income. The aggregate net interest margin for banks with assets of \$10 billion or less has tightened considerably as competition in the debt and lending markets has intensified, compressing by more than 70 basis points over the last 10 years to 3.63%. As a result, it becomes more difficult for community banks to cover their overhead, pressuring their earnings and their ability to support capital needs from internal sources.¹³

Possible Impacts of Financial Reform Bill on Community Banks

According to many people in the banking community, the proposed financial reform legislation will not impose any lending regulations that community banks do not already comply with on their own. Kevin Smith, vice president of First Citizens National Bank, commented, "I think for most of the community

⁹ "Past Present and Future of Community Banking," by Governor Daniel Tarullo, speech at Federal Reserve Bank of N.Y. Community Bankers' Conference (4/8/2010).

¹⁰ Ibid.

¹¹ Ibid.

¹² <http://www.fdic.gov/bank/individual/failed/banklist.html>.

¹³ "Past Present and Future of Community Banking," by Governor Daniel Tarullo, speech at Federal Reserve Bank of N.Y. Community Bankers' Conference (4/8/2010).

banks that the impact of most of this legislation will be pretty negligible.” Smith further said, “A lot of the legislation is geared at protecting consumers from aggressive lending practices and overly aggressive fee structures. Most of your community banks have not done those things to begin with. Nothing’s going to change for them except it’s going to be law.”¹⁴

Sarah Wallace, board chairwoman of First Federal Savings and Loan Association, disagreed with Kevin Smith’s argument. She wrote recently that financial reform legislation being considered by Congress, combined with other legislation enacted in the past year, could bring an end to community banking. Wallace stated that the reform bill would rewrite financial regulations by putting new limits on bank activities, creating an independent consumer protection bureau, and adding new rules for largely unregulated financial instruments. A major concern for Wallace is that banks will make decisions based on compliance with federal regulations and fear of penalties rather than the best interest of potential borrowers. She said, “This is really going to hurt the middle class, the low- and moderate-income folks.” According to Wallace, the bill would add about 30 major new regulations to the 50 previously created in the past year, making compliance a burden on smaller institutions.¹⁵

Large banks, community banks, and credit unions have all recently lobbied for U.S. lawmakers to drop a piece of the financial reform legislation that would allow the Federal Reserve to limit fees charged to retailers on debit card transactions. While government officials say the intent of the amendment is to protect consumers and merchants from big banks, the financial institutions say the fee limits would end up damaging consumers. These “interchange fees” are charged to merchants every time someone swipes a card and enters a PIN number to make a purchase. Lawmakers attempted to support community banks when they decided not to limit fees charged by institutions with less than \$10 billion in assets. But those smaller banks are still worried about the legislation, saying merchants could choose to disallow the use of their cards if they continued to charge the current interchange fees. Institutions claim that they use the extra money gained from interchange fees to fund rewards and travel mileage programs. Banks also warn that lower interchange fees could lead to the disappearance of such rewards programs or even an industry-wide shift away from free checking accounts.¹⁶

Small Businesses Need Community Banks

In contrast to large businesses, which can turn to capital markets for funding, many small businesses are dependent on banks for financing. Although the worst of the recent credit crunch is probably over, many small businesses still find it difficult to obtain bank loans. Community banks, a key source of small business financing, have limited their lending because of losses in commercial real estate. In addition, many small business owners who historically would have used real estate assets as collateral for expansion loans can no longer do so because of declines in real estate values. Also, small businesses that traditionally used credit cards to purchase equipment and supplies have been hindered by reductions in credit limits.¹⁷

¹⁴ “Local Banks: Reforms Could Cost Customers,” by John Jarvis, The Marion Star (7/6/2010).

¹⁵ Ibid.

¹⁶ <http://www.mybanktracker.com/bank-news/2010/06/08/banks-interchange-fee-limits-bad-for-banks-consumers/>.

¹⁷ http://www.brookings.edu/~media/Files/rc/papers/2010/0604_innovation_small_business/pb_175.pdf.

The number of small community banks has been declining for years, as they labor to master expensive new technologies and regulatory changes. At the same time giant banks have undertaken a rash of megamergers and have expanded their reach into many areas of the U.S., while reducing the overall amount of credit available in the economy. The consolidation trend is expected to continue through this year. “A lot of the regional and community banks are going to struggle to remain independent,” said Terry Moore, a managing director at Accenture. “We're going to see those numbers shrinking.”

Considerable shrinkage has already occurred. Since 1994, the number of commercial banks with assets of \$50 million or less has dropped by more than 3,600 to 1,198, according to FDIC data. At the same time, the deposits held by the biggest banks have soared, following years of megamergers punctuated by bank bailouts in 2008. The five biggest banks – Bank of America, Wells Fargo, JPMorgan Chase, Citi and PNC – held 37% of all deposits as of June 30, 2009. That is triple the top five’s share 15 years ago, according to the FDIC.¹⁸

With the loss of so many community banks, many parts of the U.S. have lost critical financing for small businesses and community development projects, and this is contributing to the overall weakness in the economy. The relationship between community banks and small business development is important at the microeconomic level because it impacts individual borrowers and communities, but it also has a macroeconomic impact by increasing overall economic demand in the economy through business growth and job creation.

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¹⁸ “Small Banks Big Problems,” by Colin Barr, cnmone.com (12/23/2009).