

# Community Banks: What is Their Future and Why Does it Matter?

By Robin Newberger and Robert DeYoung



The U.S. banking system has undergone a dramatic restructuring since the 1970s. One of the biggest changes is the reduced number and market share of community banks. The number of banks with less than \$1 billion in assets – a common definition of community bank – has declined from approximately 14,000 in 1980 to about 7,000 today. Concurrently, the proportion of assets held by the ten largest bank holding companies increased from less than 25 percent to more than 75 percent, while community banks' share fell from about one third of the market to well under one fifth.

This article reports on recent research by economists at the Federal Reserve Bank of Chicago that examines the long-term viability of the community bank business model.<sup>1</sup> This line of research originates with a strategic map, Figure 1, of changes to the banking industry over the past two decades and their effects on commercial bank behavior.

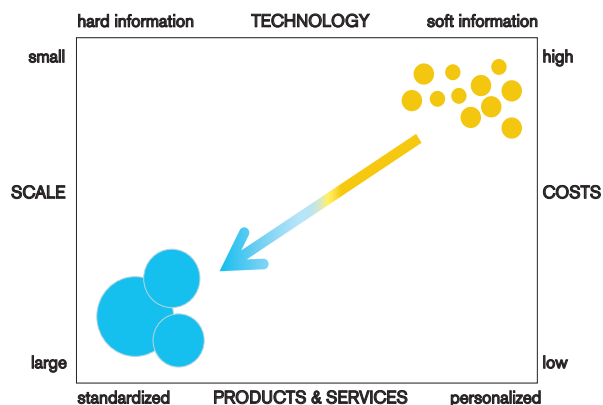
The map indicates that community banks continue to pursue a traditional strategy that provides differentiated banking products and services, but requires high per-unit production costs. In contrast, the map indicates that large banks have moved away from traditional approaches and increasingly pursue a low-cost, high-volume retail strategy. Because it is logical to assume that the new larger bank business model is more profitable than the old one, a natural question arises: if the driving forces behind this bifurcation are permanent, is the traditional community banking model still a viable business strategy?

This question has important implications for local economic development. Small, locally-focused banks channel a larger proportion of their loanable funds to small businesses than large banks. In many small towns, these loans can represent a substantial portion of total available business credit, which in turn may affect job creation and the overall economic health of an area. A reduced community bank presence in a particular region may also impact the Community Reinvestment Act (CRA)

related activities that take place in those areas, even if the community banks are replaced by branch offices of large banking companies. Large banks must pass CRA lending, investment, and service tests, but each branch is not required to pass the tests individually. In addition, recent reductions in the number of community banks may impact growth in community development financial institutions (CDFIs); community banks sometimes seek and receive CDFI certification and support from the federal government to provide financial services in markets with few mainstream financial institutions.

The analysis begins in the 1970s and 1980s, when a set of strict federal and state banking regulations largely shielded community banks from outside competition. There were extensive geographic limitations on branch banking, and non-bank financial institutions were prohibited from offering many traditional banking products. Small investors had few liquid alternatives to bank deposits before the advent of money market mutual funds and other new retail investment products. The combination of these restrictions allowed community banks to act as significant players in the investment, residential mortgage, consumer finance, and payments markets. In this environment, most banking

**Figure 1: Strategic Map of U.S. Banking Industry**



and payments markets. In this environment, most banking institutions followed the traditional small-scale, high-cost strategy of offering personalized products and services.

Deregulation and technology transformed the banking industry in the 1980s and 1990s. Barriers to interstate banking were gradually eroded in the 1980s, and were eliminated by the Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994. In 1999 the Gramm-Leach-Bliley Act effectively repealed the Glass-Steagall Act, which had largely prevented commercial banks, investment banks, brokerage houses and insurance companies from competing with each other. These regulatory changes exposed both large banks and community banks to increased competition from each other as well as from non-bank financial institutions.

This competition was further fueled by new information and communications technologies, financial markets, and production techniques that dramatically altered the cost structures and optimal operating scale of many banking services. Among other advances, internet banking and electronic-based payments diminished the importance of bank location; credit scoring significantly reduced the marginal cost of underwriting a consumer loan; and asset securitization facilitated the large-scale “commoditization” of auto loans, mortgage loans, and student loans. These developments have eroded community banks’ traditional comparative advantages – which are based on small scale, local focus, and relationship-building – over large banking organizations.

These regulatory and technological changes created incentives for banks to grow larger – and acquiring other banks was the fastest way to grow. At first, banks from adjoining markets participated in modest mergers; mega-mergers between increasingly large banking companies followed. As bank size increased, the largest banks gained access to the lowest unit cost structures (many banking services exhibit scale economies). The size of operations allowed large banks to apply the new production technologies more efficiently, such as automated underwriting, securitization, widespread ATM networks, and electronic payments, which reduced unit costs even further. At the end of this process, retail banking at large banks was ultimately transformed into a high-volume, low-cost ‘financial commodity’ strategy, which offered few personalized services and relied on automated production techniques.

Although many community banks have also grown larger via mergers, they have continued to occupy the same strategic ground as in the past. Their relatively small size elevates their costs, but their local economic focus and person-to-person ethos give them a competitive advantage at relationship lending. Relationship lenders rely less on ‘hard,’ quantitative financial information

about their borrowers that can be fed into an automated credit scoring model, and rely more on ‘soft,’ qualitative information about their borrowers that they have accumulated over time through the breadth and depth of their customer relationships. This approach allows them to: assess the creditworthiness of unique small business customers; better understand the needs of their local deposit customers; and deliver high-quality, personalized banking services to both.

Call report data<sup>2</sup> from the Federal Deposit Insurance Corporation (FDIC) in 2003 indicates clear differences between large banks and community banks in terms of their size, production methods, output mix, and financial structure, consistent with the strategic map analysis.

- At \$60 billion, the average large bank is around 100 times larger than the average large community bank.
- On average, credit card loans (a classic financial-commodity product) comprise nearly 10 percent of the loans held by large banks, but less than 1 percent of the loans held by community banks.
- On average, small business loans (a classic relationship product) comprise less than 5 percent of the loans held by large banks, but between 10 and 15 percent of the loans held by community banks.
- On average, community banks finance between 40 and 65 percent of their assets using local household and business deposits, compared to only about 30 percent for large banks.
- Community banks operate considerably more physical office locations per customer, and employ more bank workers per customer, than do large banks – suggesting both higher costs per unit as well as higher levels of convenience and personal service.

But the bottom line for bank survival is profits. In terms of the strategic map analysis, the community bank strategy is profitable only if community bank customers are willing to pay high prices for personalized service, offsetting their high unit costs. In contrast, the large retail bank strategy is profitable only if their costs are low and financial services volumes large, because of their commodity products that generate very slim profit margins.

Can community banks compete in terms of profitability? Recent data on return on equity (ROE), a standard measure of profitability, gives a qualified indication that well-managed community banks can indeed be competitive against larger banking companies. The analysis defines a ‘best practices’ community bank as one that earned a ROE above the median for its peer group. On average, large and medium-sized best-practices community banks earned ROEs of 17.8 percent and 16.9

percent, respectively, in 2003.<sup>3</sup> This is quite comparable to the average ROE of 16.0 percent earned by all large and midsized banks in 2003. (Analysis using data from other years, and other groups of years, produces similar results.) Moreover, the profits earned by community banks also tend to be stable over time, likely because of the relationship nature of their business model. The Sharpe Ratio, a measure of profitability that adjusts for earnings volatility, shows that risk-adjusted profitability at large and medium-sized community banks tended to equal or exceed levels generated by large banks and mid-sized banks between 1995 and 2001.<sup>4</sup>

While community banks cannot compete in every segment of the financial services market, these comparisons suggest that the traditional community bank business strategy can earn satisfactory rates of return – but there are two crucial caveats. First, the best-practices analysis indicates the importance of being well-managed; for example, worst-practices large community banks earned only a 9.3 percent ROE on average in 2003. Well-managed banks do a superior job of controlling costs, screening for creditworthiness, minimizing interest rate risk, servicing depositors, applying new processes and techniques, cross-selling financial products, and many other tasks that enhance profits.

Second, although community banks are very small relative to large banking companies, they can benefit from substantial scale economies by getting larger; for example, ROE at best-practices small community banks in 2003 was only 14.4 percent on average. Small community banks are penalized by their lower scale of operations. By growing larger, these banks could potentially spread their fixed overhead expenses over more customers, better diversify their portfolios, and use greater financial leverage, all of which enhance profitability. The smallest community banks have to be especially well run to overcome these size disadvantages.

Although further reductions are expected in the population of community banks in the coming years, this trend should moderate, and the outlook appears to be positive for well-managed community banks. Their local geographic focus makes them natural clearing houses for information that is valuable for underwriting loans to small local businesses – products that are unlikely to become “commoditized” like residential mortgage and consumer lending – and the profitability of this core line of business will ensure that these banks remain active in local markets from which they draw the majority of their deposits.

This ‘localness’ also makes community banks well suited to provide CRA-qualified loans, investments and access to other financial services for low- and moderate-income households. Going forward, it will be interesting to see how community banks respond to recent regulatory

decisions to streamline CRA exams for institutions between \$250 million and \$1 billion in assets.<sup>5</sup> Under the streamlined rules, CRA exams do not consider an institution's community development lending, investments and services, and do not require small institutions to report small business lending data. These changes could influence the way in which mid-sized and large community banks allocate their resources in increasingly competitive business environments.

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## Notes

1 For example, see Robert DeYoung, William C. Hunter, and Gregory Udell, 2004, “The Past, Present and Probable Future for Community Banks,” *Journal of Financial Services Research* 25(2/3), and Robert DeYoung, 2002, “Whither the Community Bank? Relationship Finance in the Information Age,” *Chicago Fed Letter*, No. 178.

2 Every national bank, state member bank, and insured nonmember bank is required by the Federal Financial Institution Examination Council to file consolidated Reports of Condition and Income (Call Report) as of the close of business on the last day of each calendar quarter (FDIC Web site 12/15/04).

3 The analysis groups banks into size categories as follows: large banks have more than \$10 billion in assets; midsized banks have between \$1 billion and \$10 billion in assets; large community banks have between \$500 million and \$1 billion in assets; midsized community banks have between \$100 million and \$500 million in assets; and small community banks have less than \$100 million in assets.

4 The Sharpe Ratio = (average ROE – average 90-day T-bill rate) / standard deviation of ROE.

5 Streamlined CRA evaluations already apply to banks with assets less than \$250 million. The Office of Thrift Supervision has already increased this threshold, and the FDIC has proposed to do the same.

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