The challenges facing community banks: In their own words

Robert DeYoung and Denise Duffy

Introduction and summary

When economists analyze an industry, they typically do so at arms length, using a combination of theoretical models and large amounts of statistical data. The theoretical models describe the interplay between the structure of the industry and the competitive behavior of the firms that populate the industry. The statistical data—which may include financial ratios, industry trends, and peer group comparisons—serve to personalize the sterile, one-size-fits-all nature of the theoretical models. But most industry studies never get especially close to the people most responsible for the industry data: the managers and owners who make long-run strategic plans that shape the data, who make short-run competitive decisions in response to the data, and whose careers and companies are ultimately defined by the data.

In this article, we analyze the U.S. community banking sector—a sector populated by small firms that hold a shrinking share of an increasingly competitive and technology-based financial services industry—but we rely on an atypical approach to perform the analysis. We use numerous first-hand observations made by individual community bankers, collected during a Federal Reserve survey in August 2001 (Federal Reserve System, 2002), to complement the usual data-intensive industry analysis. Although the survey itself was an effort to learn about the evolving payments services needs of community banks, the surveyed bankers also made wide-ranging observations on a variety of other topics, including the fundamental mission of community banks; the threats and opportunities posed by large banks; perceptions that the playing field is not always level; and the growing tension between traditional high-touch relationship banking and potentially more efficient high-tech banking.

Augmenting systematic industry data with bankers' anecdotal observations humanizes our analysis. The bankers tended to be more optimistic about the future viability of the community banking business model than many industry observers and, not surprisingly, they tended to be less sanguine about the regulatory and technological changes that have increased the competitive pressures on community banks. But aside from these and a few other differences, the assessments of the two groups were quite consistent—despite being stated from different perspectives and arrived at using different (and, in the case of the bankers, implicit) analytic frameworks. The consensus view is that industry consolidation and technological change are providing opportunities as well as posing threats for community banks; that community banks can profitably coexist with large multi-state banks in the future; but, to do so, community banks must be efficiently operated, well-managed, and must continue to innovate.

Forces of change

The past decade has witnessed tremendous changes in how banks are regulated, how they use technology to produce financial services, and how they compete with each other. These transformations have important consequences for the typical community bank, for the community banking sector as a whole, and by extension for the households and small businesses that purchase financial services from community banks.

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Geographic deregulation

The McFadden Act of 1927 restricted U.S. commercial banks from branching across state borders. In addition, most state governments have historically restricted bank branching within state borders. These restrictions reduced the efficiency of the U.S. banking system by artificially limiting the size of commercial banks. But state governments began to gradually relax their geographic branching restrictions beginning in the mid-1970s, and by 1994 the federal government had passed the Riegle–Neal Act which eliminated virtually all prohibitions against interstate banking in the U.S. Both large and small banking companies have taken advantage of geographic deregulation by acquiring banks in other counties, states, or regions. Growth via acquisition is a fast way to expand into a new geographic market, because the expanding bank can begin its operations in the new market with an established physical presence and an established customer base.

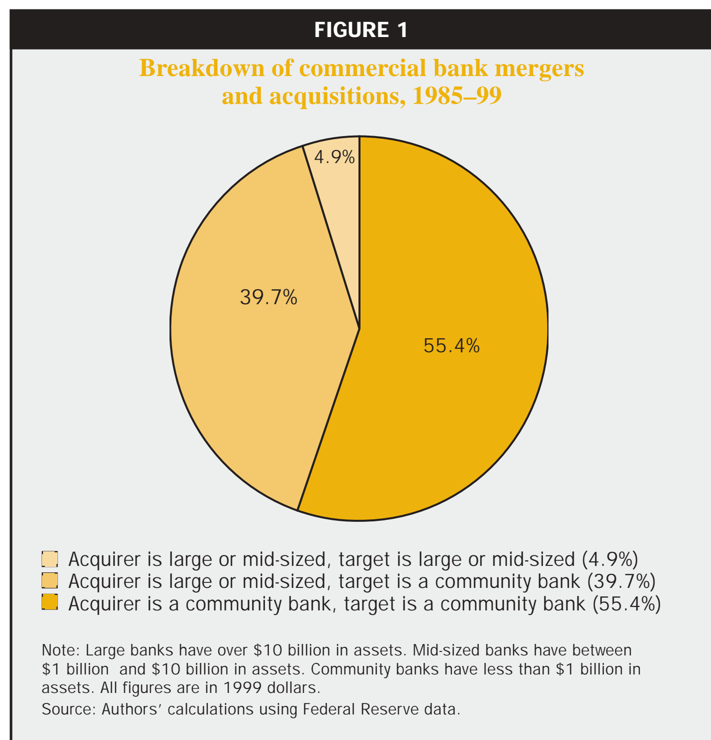
The most visible evidence of these geographic-expansion mergers is the substantial reduction in the number of community banks in the U.S. As shown in figure 1, over half of all U.S. bank mergers since 1985 have combined two community banks (defined here as having less than $1 billion in assets), and in most of the remaining mergers a larger bank has acquired a community bank.[1] Figure 2 illustrates the dramatic change in the size distribution of U.S. commercial banks caused by these mergers. The number of small community banks (less than $500 million in assets) has nearly halved since 1985, while the numbers of large community banks ($500 million to $1 billion), mid-sized banks ($1 billion to $10 billion), and large banks have remained relatively constant.

Perhaps the primary motivation for community banks to merge is to capture scale economies, reductions in per unit costs or increases in per unit revenues that occur as small banks grow larger.[2] By growing larger via merger, a community bank can make loans to bigger firms; offer a broader array of products and services; attract and retain higher quality managers; diversify away some of its riskiness by lending into new geographic markets; generate network benefits from integrating systems of branches and ATMs (automated teller machines) in different geographic areas; gain access to new sources of capital; or operate its branch offices and computer systems closer to full capacity. Another motivation for community banks to merge is to become large relative to the local market: A combination of two community banks that operate in the same small towns may increase their pricing power in those towns. But increased size can also have a downside: A community bank that grows too large, too geographically spread out, or otherwise too complex may become unable to deliver the same level of personalized service that attracted many of its business and retail customers in the first place.

Market-extension mergers have approximately doubled the geographic reach of the typical U.S. bank holding company over the past two decades. The average bank holding company affiliate with more than $100 million in assets was located about 160 miles from its holding company headquarters in 1985; by 1998 this distance had increased to about 300 miles (Berger and DeYoung, 2001). But as banking companies have used mergers to arc across geographic boundaries, the structure of local banking markets has changed very little. Since 1980, the nationwide share of deposits held by the ten largest U.S. banks has doubled from about 20 percent to about 40 percent, but there has been little upward trend in concentration in local banking markets (DeYoung, 1999). As a result, the bank merger wave is unlikely to have resulted in a systematic increase in local market power. On the contrary, recent studies suggest that the merger wave has intensified

FIGURE 1

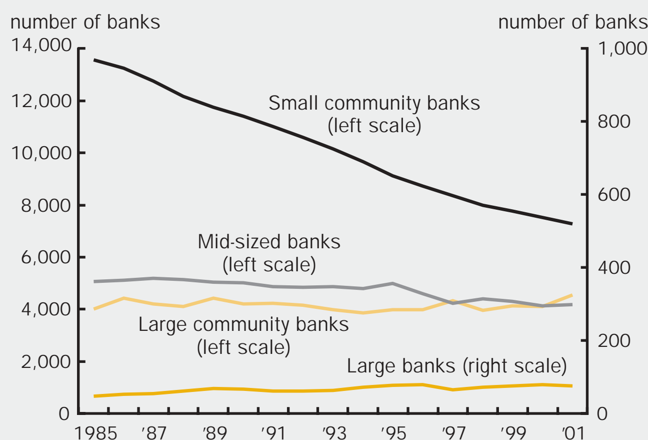
Breakdown of commercial bank mergers and acquisitions, 1985–99



Note: Large banks have over $10 billion in assets. Mid-sized banks have between $1 billion and $10 billion in assets. Community banks have less than $1 billion in assets. All figures are in 1999 dollars.
Source: Authors' calculations using Federal Reserve data.

FIGURE 2

Size distribution of U.S. commercial banks, 1985–2001



Notes: Large banks have over $10 billion in assets. Mid-sized banks have between $1 billion and $10 billion in assets. Large community banks have between $500 million and $1 billion in assets. Small community banks have less than $500 million in assets. Assets are in 1999 dollars.

Source: Authors' calculations using call reports.

competition among banks in local markets: Banks tend to operate at higher levels of efficiency after one of their local competitors is acquired by an out-of-market bank.[3]

Product market deregulation

Deregulation has also broadened the scope of financial services that banks are permitted to offer their customers. The Gramm–Leach–Bliley Act of 2000 ended or greatly relaxed restrictions that for decades had limited the financial activities of commercial banks; the most famous of these restrictions was the Glass–Steagal Act of 1933, which prohibited commercial banks from engaging in investment banking. Commercial banking companies are now permitted to produce, market, and distribute a full range of financial services, enveloping the previously separate areas of commercial banking, merchant banking, securities brokerage and underwriting, and insurance sales and underwriting.[4]

Product market deregulation has had a subtler impact on community banks than geographic deregulation. Community banks have traditionally offered a limited array of banking products, generating interest income from loans and investments and generating a limited amount of noninterest income (service charges) from deposit accounts. Larger commercial banks offer these traditional interest-based banking services as well, but they also sell a variety of additional financial services that generate fees and noninterest income. Large banks are more likely to securitize their loans; they collect little interest income because these loans are not held for long on their books, but collect potentially large amounts of noninterest income from originating and servicing these loans. Large banks often write back-up lines of credit for their large business customers; they receive fees for this service but receive interest income only in the rare case that the client draws on the credit line. Large banks can generate large amounts of noninterest income by charging third-party access fees at their widespread ATM networks. And, compared with community banks, large banks tend to charge high fees to their own depositors.[5]

Figure 3 shows that noninterest income accounts for a relatively small percentage of community bank revenue and has increased slowly over time relative to its growth at larger banks. This suggests a growing differentiation between the business strategies of small community banks and larger commercial banks. Whether community banks can continue to be profitable by offering a relatively narrow range of services, while their largest rivals are becoming "financial supermarkets," is an important question for determining the future size and viability of the community banking sector.

New technologies

Like deregulation, advances in information, communications, and financial technologies over the past two decades have increased the competitive pressures on commercial banks. For example, mutual funds, online brokerage accounts, and money market funds have provided attractive investment options for depositors; as a result, core deposits have become less available for all size classes of banks.[6] Because community banks have fewer non-deposit funding options than large banks (for example, small banks typically do not have access to bond financing), it costs them more to attract and retain core deposits.[7] New financial instruments, combined with improved information about borrower creditworthiness, have intensified competition on the asset side of banks' balance sheets. Commercial paper has become an attractive alternative to short-term bank loans for large, highly rated business borrowers, and junk bond financing has become an alternative to long-term bank loans for riskier business borrowers.

In some cases, banks have been able to fight back by deploying new financial technologies of their own. Virtually all banks are using ATMs—and an increasing number are using transactional Internet websites—to

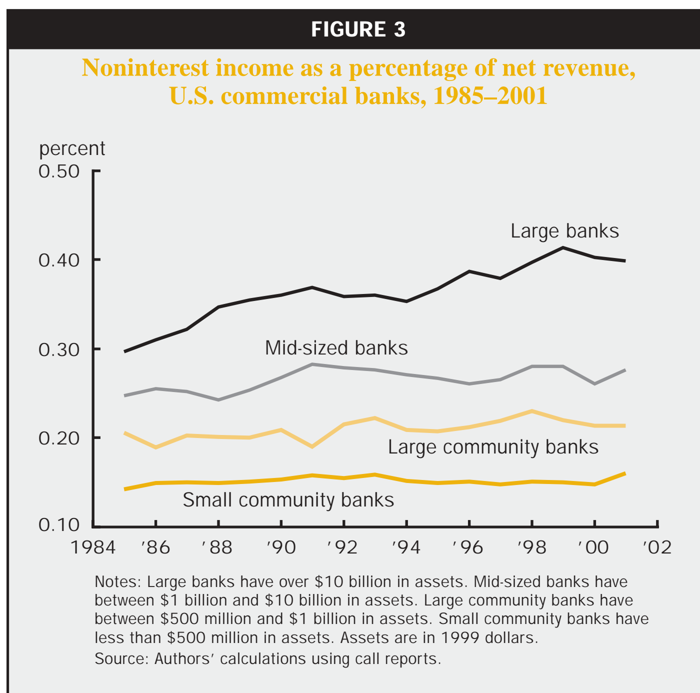


FIGURE 3

Noninterest income as a percentage of net revenue, U.S. commercial banks, 1985–2001

Notes: Large banks have over $10 billion in assets. Mid-sized banks have between $1 billion and $10 billion in assets. Large community banks have between $500 million and $1 billion in assets. Small community banks have less than $500 million in assets. Assets are in 1999 dollars.
Source: Authors' calculations using call reports.

offer increased convenience to their depositors. Many banks offer sweep accounts and proprietary mutual funds to limit the number of small business and retail customer defections to nonbank competitors. And as discussed above, some banks have reoriented their business mix toward off-balance-sheet activities like back-up lines of credit, so they can continue to earn revenues from business customers that switched from loan financing to commercial paper financing.

Technology has also allowed banks to fundamentally change the way they produce financial services. Securitized lending is a prime example. By bundling and selling off their loans rather than holding them on their balance sheets, banks can economize on increasingly scarce deposit funding while simultaneously generating increased fee income. Securitized lending operations exhibit deep economies of scale, so banks that originate and securitize large amounts of loans can operate at low unit costs. As a result, the cost savings and increased revenues generated by securitized lending are generally not available to small banks. However, a securitized lending strategy can limit the strategic options of a large bank. Securitization only works for standardized loans like credit cards, auto loans, or mortgage loans—"transactions" loans that can be underwritten based on a limited amount of "hard" financial information about the borrower that can be fed into an automated credit-scoring program.[8]

Securitized bundles of transactions loans share many of the same characteristics as commodities: They are standardized products, easily replicable by other large banks, and they are bought and sold in competitive markets. As a result, securitized lending is a high-volume, low-cost line of business in which monopoly profits are unlikely. In contrast, "relationship" lending requires banks to collect a large amount of specialized "soft" information about the borrower in order to ascertain her creditworthiness. The classic example of relationship lending is the small business loan made by community banks. The uniqueness of these lending relationships gives banks some bargaining power over borrowers, which supports a relatively high profit margin.

Internet website technology is relatively inexpensive, so both large banks and community banks can theoretically use the Web to do business in local markets anywhere in the nation. But in reality, community banks face a disadvantage at using this new technology. First, small banks often do not have a large enough customer base to efficiently utilize this delivery channel.[9] Moreover, profitable entry into a new market is not just a technological feat, but also a marketing feat. Getting noticed in a new market generally requires expensive advertising; getting noticed on the World Wide Web is even more difficult, and requires substantial advertising expenditures beyond the resources of the typical community bank. One way that banks have attracted customers' attention on the Web is by offering above-market rates on certificates of deposit, so that the bank's name gets posted on financial websites that list high-rate payers. But this strategy is itself a costly substitute for advertising, and usually attracts one-time sources of funds that do not develop into long-lasting relationship clients.[10]

Implications of these changes for community banks

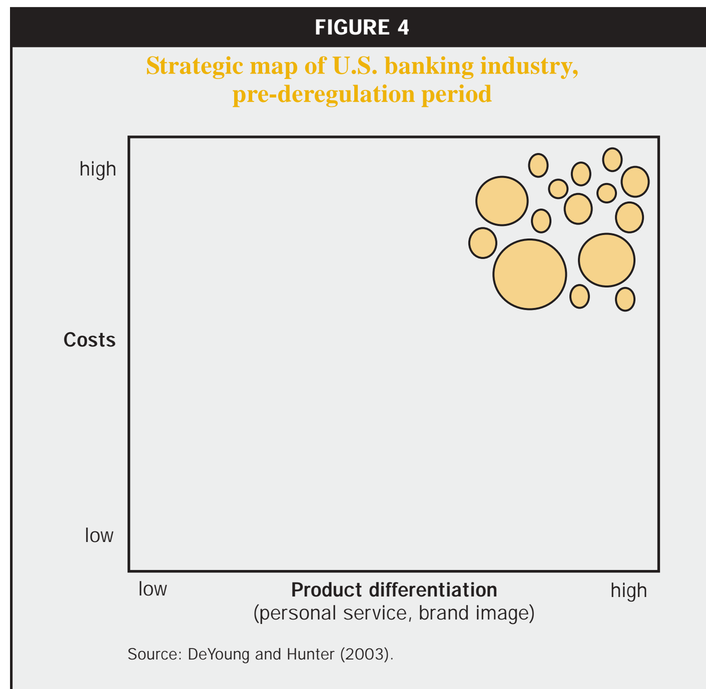
Many of these developments appear to favor large banks at the expense of small local banks. However, some have argued that well-managed community banks may be able to turn these competitive threats into opportunities. One case in point concerns the market for small business loans, a prime product line for small community banks.[11] The idiosyncratic nature of small business relationship lending is in many ways inconsistent with automated lending technology. Thus, when a large bank shifts toward an automated lending culture, traditional community banks may stand to pick

up profitable small business accounts. Similarly, the movement of large banks toward charging explicit (and often higher) fees for separate depositor services may provide an opportunity for community banks to attract relationship-based deposit customers who prefer bundled pricing.

DeYoung and Hunter (2003) argue that the banking industry will continue to feature both large global banks and small local banks. They illustrate this argument using the strategic maps in figures 4 and 5. The maps are highly stylized depictions of three fundamental structural, economic, and strategic variables in the banking industry: bank size, unit costs, and product differentiation. The vertical dimension in these maps measures the unit costs of producing retail and small business banking services. The horizontal dimension measures the degree to which banks differentiate their products and services from those of their closest competitors. This could be either actual product differentiation (for example, customized products or person-to-person service) or perceived differentiation (for example, brand image). For credit-based products, this distinction may correspond to automated lending based on “hard” information (standardization) versus relationship lending based on “soft” information (customization). In this framework, banks select their business strategies by combining a high or low level of unit costs with a high or low degree of product differentiation. The positions of the circles indicate the business strategies selected by banks, and the relative sizes of the circles indicate the relative sizes of the banks.

FIGURE 4

Strategic map of U.S. banking industry, pre-deregulation period

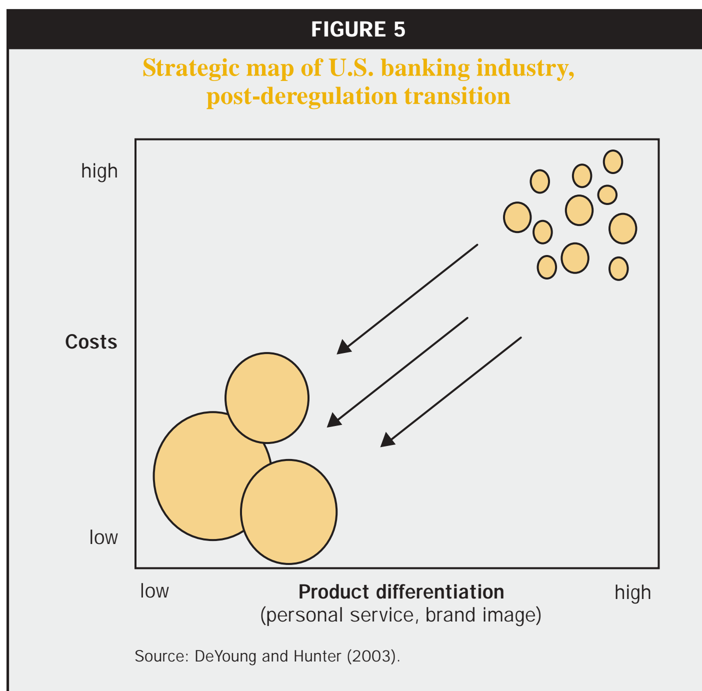


Source: DeYoung and Hunter (2003).

Figure 4 shows the banking industry prior to deregulation and technological change. Banks were clustered near the northeast corner of the strategy space. The production, distribution, and quality of retail and small business banking products were fairly similar across banks of all sizes. Small banks tended to offer a higher degree of person-to-person interaction, but this wasn’t so much a strategic consideration as it was a reflection that delivering high-touch personal service becomes more difficult as an organization grows larger. Large banks tended to service the larger commercial accounts, but bank size often wasn’t a strategic choice; the economic size of the local market and state branching rules often placed limits on bank size.

Deregulation, increased competition, and new financial technologies created incentives for large banks and small banks to become less alike. Large banks began to get larger, at first due to modest within-market mergers, and then more rapidly due to market-extension megamergers. Increases in bank size yielded economies of scale, and unit costs fell.[12] Increased scale also gave these growing banks access to the new production and distribution technologies discussed above, like automated underwriting, securitization of loans, and widespread ATM networks. These technologies reduced unit costs even further at large banks, but in many cases gradually altered the nature of their retail business toward a high-volume, low-cost, and less personal “financial commodity” strategy.

The combined effects of these changes effectively drove a strategic wedge between the rapidly growing large banks on one hand and the smaller community banks on the other hand. The result is shown in figure 5. Large banks have moved toward the southwest corner of the strategy space, sacrificing personalized service for large scale, a more standardized product mix, and lower unit costs. This allows large banks to charge low prices and still earn a satisfactory rate of return. Although many community banks have also grown larger via mergers, they remain relatively small and have continued to occupy the same strategic ground, providing differentiated products and personalized service. This allows small banks to charge a high enough price to earn a satisfactory rate of return, despite low volumes and unexploited scale economies.[13] In the following section, we consider these trends from the



community bankers' point of view, based on the results of the August 2001 Federal Reserve survey.

The survey

In August 2001, the Federal Reserve System's Customer Relations and Support Office (CRSO), located at the Federal Reserve Bank of Chicago, conducted a series of interviews with officers and employees of ten community banks from across the U.S. These interviews covered a wide range of topics, and the interviewers encouraged respondents to include a large amount of detail in their answers. These interviews represent the first stage of an ongoing Federal Reserve effort to better understand the business strategies community banks are implementing to remain viable in a changing banking environment and to determine what community banks require from the payments system in order to survive in this environment. A secondary goal of the study is to stimulate research and public policy interest regarding the community bank sector.

The ten surveyed community banks were not selected using a statistically valid sampling technique, and in any event this sample of banks is too small to use for statistical inference testing. Rather, these banks were selected based on knowledge that Federal Reserve Business Development staff had accumulated about them over time. The ten banks share two important traits. First, each of their business models was based on the concept of community banking. Second, based on previous contact with these firms, Fed Business Development staff had reason to expect that the officers and employees of these organizations would answer the survey questions in an open and forthcoming manner. In addition, these ten banks were selected so that the sample, though small, was heterogeneous in terms of bank size, bank location, and other organizational characteristics.

The banks were selected from across the country, from urban, suburban, and rural areas, and from three *ad hoc* size tiers: less than \$50 million in assets, between \$50 million and \$200 million in assets, and between \$200 million and \$1 billion in assets. Two of the banks are de novo (newly chartered) banks; two are minority-owned banks; one has a primarily commercial customer base (as opposed to the traditional community bank mix of commercial and retail customers); three have a bilingual/ethnic customer base; and three provide services to customers whose banking transactions sometimes involve foreign countries, including Canada, Mexico, and Pacific Rim countries. Table 1 summarizes the characteristics of the surveyed banks.

The major decision makers and policymakers at each bank participated in the interviews. This typically included the bank's chief executive officer (CEO), chief financial officer (CFO), chief operations officer (COO), and cashier, as well as a branch manager and a lending officer. Participants were asked a series of questions regarding their bank's business strategy, product offerings, operations, and purchases of payments and other financial services during the past three years, as well as projections for the next three years. Participants were specifically asked to discuss how their community bank was positioning itself to survive in a rapidly changing financial services environment. A representative list of questions is presented in box 1.

Below, we present a selection of responses from the community bankers that best reflect the challenges and issues facing the community banking sector. A full summary of the results can be read in the Federal Reserve System's (2002) *Community Bank Study*.

Mergers taketh away—but mergers giveth, too

As discussed earlier, the number of community banks in the U.S. has plummeted over the past two decades. This is partly because large banks gobbled up small banks in the process of building regional and national networks—but it is also because large

TABLE 1

Characteristics of community banks in the survey

Asset tier	Market type	Location	No. of branches	Other
3	Urban	Southeast	3	
3	Urban	Northwest	4	Minority owned and operated
3	Rural/small town	Midwest	0	A "bankers' bank"
3	Rural/small town	Mid-South	18	
2	Urban	South	7	Minority owned and operated
2	Suburban	West Coast	3	Recently chartered
2	Rural/small town	Midwest	2	
1	Suburban	East Coast	0	Savings and loan
1	Rural/small town	Midwest	0	Recently chartered
1	Rural/small town	Southwest	0	Serves a bilingual population

Note: Banks in asset tiers 1, 2, and 3, respectively, have less than $50 million in assets, between $50 and $200 million in assets, and between $200 million and $1 billion in assets.

BOX 1

Community bank survey topics

- What current and expected future strategic initiatives will position your institution for profitable growth?
- Does your institution face potential challenges in implementing these strategic initiatives?
- Which customer segments will you target with these initiatives?
- What is your current and expected future product mix?
- Please describe the relationship between strategic importance and ease of offering the various products and services mentioned above.
- Which customer segments are most profitable?
- Which profitable customer segments have you recently lost to competitors?
- Which of your customers' business concerns are not adequately addressed in the financial marketplace?
- What are the competitive factors that affect the community bank sector?
- Please forecast the potential impact of current or impending regulations on your institution.
- Do you use strategic alliances? If so, in what ways?
- Do you use third-party processors? If so, in what ways?
- Which payments system services do you use? Which services do you plan to use in the future?

TABLE 2

Option and swap positions at U.S. commercial banks, year-end 2001

	Banks with positions	% of banks with positions	% total underlying notional value[a]
		Options	
Small community banks	39	0.53	0.01
Large community banks	16	4.92	0.03
Mid-sized banks	42	13.46	0.21
Large banks	54	69.23	99.74
		Swaps	
Small community banks	48	0.65	0.00
Large community banks	19	5.85	0.00
Mid-sized banks	88	28.21	0.12
Large banks	67	85.90	99.87

[a]Percentage of the total notional value underlying the derivatives contracts held by commercial banks.
Source: Call reports.

community banks acquired small community banks, and because small community banks merged with each other. Still, community bankers tend to focus on the competitive threat posed by large, acquisitive, out-of-state banking companies:

- *"Community banks aren't necessarily stealing customers from other community banks; larger banks are stealing customers from community banks."*

There is certainly some truth to this "David versus Goliath" point of view. In some lines of business—like mortgage banking and credit card lending—large banks have increased their market share substantially at the expense of small banks. But community banks sometimes experience increased demand in other lines of business—like household deposits and small business relationships—after large banks enter the local market due to differences in service quality, as the following responses suggest:

- *"With all these mergers, the personal service level isn't what people in small towns are used to. Big banks [from out of state] buy small banks and sell them off, because bankers in Minnesota don't know what the economy is like in Texas."*
- *"Most of our competitors are so big—the First Unions, the Commerce Banks—they're offering services in a different (impersonal) way. They're driving their customers away, and we're more than happy to take care of them."*

There is plenty of anecdotal evidence that supports these statements.[14] The $9.5 billion Roslyn Savings Bank recently reported that 15 percent of its new deposits were coming from former depositors of Dime Savings Bank, who were unhappy about changes made to their passbook savings accounts after Dime was acquired by the $275 billion thrift Washington Mutual. In the 12 months after NationsBank acquired Boatmen's Bancshares in 1997, community bank Allegiant Bancorp of St. Louis grew by $100 million, nearly a 20 percent increase in assets. And in the wake of its merger with First Interstate Corp, Wells Fargo faced a 15.5 percent reduction in deposits. These anecdotes are consistent with recent studies of de novo bank entry, which tend to find that new commercial banks are more likely to start up in local markets that have recently experienced entry (via merger or acquisition) by a large, out-of-state banking company (Berger, Bonime, Goldberg, and White, 1999; Keeton, 2000). The presumption is that new banks are starting up in these markets because they contain a substantial number of disgruntled customers of the acquired bank who are shopping for a new banking relationship.

What is it that attracts these disgruntled customers to community banks? Nearly all of the surveyed bankers identify the local focus of community banks as an important competitive advantage:

- *"We can't out-research and develop them, and we can't out-produce them. But we can have more and better knowledge of the personal situations and financial problems that we're trying to solve."*
- *"We're known and we're local. If you have the local connection, and I think a local bank has that better than anybody, then you have a foot up. You're going to have more credibility with your local people."*

Strategies and production functions

The strategic analysis in figures 4 and 5 juxtaposed community banks and large banks in a number of ways: small versus large, personal versus impersonal, high cost versus low cost. The common thread that connects each of these juxtapositions is the bank production function—that is, the methods and techniques that banks use to produce financial products and services. According to the analysis, if a bank uses a production process that includes automated credit-scoring models, moving loans off its books via asset securitization, and a widespread distribution network (branch offices, ATMs, and Internet kiosks), it will likely become a large bank, operate with relatively low unit costs (due to scale economies), and produce relatively standardized financial products. In contrast, if a bank uses a production process that includes personal contact with customers, portfolio lending, and a local geographic focus, it will likely become a small bank, operate with relatively high unit costs, and produce more customized financial services.

The community bankers that participated in the survey did not make explicit references to production functions or related concepts. But implicit in many of their remarks was the understanding that there are differences between large and small bank production functions, and that these differences cause challenges for community banks. For example, one banker stressed that the size deficit between community banks and their larger competitors has important cost implications for the type of financial services he produces and the prices that he charges for them:

- *"It's a volume-driven business [offering residential loans], and we can't compete with the larger banks and mortgage companies, because volume drives rates down. We offer it as a customer service … but these loans aren't a big part of our portfolio."*

Indeed, economic research confirms that automated mortgage underwriting and servicing procedures have generated huge cost reductions at specialized mortgage banks and have allowed them to quickly become some of the biggest players in home mortgage markets. Rossi (1998) reported that mortgage banks were originating over 50 percent of all one-to-four-family mortgages in the U.S. in 1994, a spectacular increase from the 20 percent market share that they held just five years earlier. Rossi also estimated a series of best-practices production (cost) functions for mortgage banks and used them to illustrate some clear links between bank size and bank costs: Unit costs equaled about 1 percent of assets for the smallest quartile of mortgage banks, but fell to just 0.25 percent of assets for the largest mortgage banks. Cost advantages like these allow large mortgage banks to price below small, full-service community banks, as this comment confirms:

- *"Regional banks came in priced about 150 basis points below our market for a 15-year fixed term loan—we did lose about $10 million for that. Our strategy as a bank is not to fix for 15 years. Five years is our threshold. We still remember the 1970s when the rates went up and banks got in trouble with fixed rates."*

How can large banks offer these loans at terms that community banks find unprofitable? Large banks can write mortgage loans and consumer loans in volumes large enough to exploit the scale economies associated with automated lending processes (that is, credit scoring and securitization). Some of these savings can be passed along to the consumer. Furthermore, large banks are better able to manage the interest rate risk associated with long-term, fixed rate loans by using financial derivatives contracts. For example, banks that issue fixed-rate loans for terms that exceed 15 years can hedge against the risk that rates will rise (squeezing their profit margins by increasing the cost of their short-term deposit funding) by entering into fixed or floating rate swaps. Similarly, to hedge against the risk that borrowers will prepay their fixed-rate mortgages when interest rates fall, banks can purchase interest rate puts or floors where the option pays the difference in yield between the floor rate and a reference rate such as the London Interbank Offered Rate (LIBOR).

Although community banks could theoretically use derivatives positions like these to hedge against interest rate risk, most community banks lack the sophistication to do so. As illustrated in table 2 on the previous page, over 99 percent of interest rate swap and derivative positions are held by banks with more than $10 billion in assets. During 2001, options and swaps positions were held by 69 percent and 86 percent, respectively, of banks with over $10 billion in assets. In comparison, less than 1 percent of small community banks (assets less than $500 million) held options or swaps positions during 2001.

Maximizing the return from customer relationships

While community bankers often speak to the importance of "serving the community," they cannot pursue this "chamber of commerce" motive for long without earning at least competitive returns. Community bankers that sacrifice earnings to pursue other objectives become targets for takeovers. So as competition

in banking markets has grown more intense, community banks have been looking for ways to enhance their earnings. Some community bankers have recognized that basic marketing strategies—like cross-selling products to existing customers and imposing higher switching costs on those customers—can play a key role in their bank's earnings profile:

- *"If I can get your residential loan, that's a very important key element, and your main checking account. Now I'm starting to tie you down because I have two of your most basic needs met."*
- *"When they're tied to us with that many services, it makes it harder to leave us."*

Another banker noted that even though his bank may sell off a customer's loan, it doesn't sell off the all-important customer relationship:

- *"While we sell our loans on the secondary market, we're retaining the servicing. Customers deal with us, not an 800 number for [a credit company] in Colorado or California."*

These observations are consistent with recent research studies. Based on a survey of 500 U.S. households, Kiser (2002) found that switching costs are more severe for households with high income and education, which suggests that banks may be strategically targeting these lucrative customers. Hunter (2001) lays out a competitive strategy—which is based on the existence of switching costs—that a community bank can use to retain these high-value customers while it is converting its high-cost, brick-and-mortar distribution system over to an Internet-based distribution system.

When determining which customers are worth retaining and which are not, community banks have traditionally focused on the following banking truism: "80 percent of our profits are generated from just 20 percent of our customers." As a result, bankers have attempted (if only by benign neglect) to cull the less profitable 80 percent of their customers. But the Fed survey suggests that community bankers have started to look at customer profitability issues a bit differently:

- *"The irony is that 10 to 15 years ago, you wanted to get rid of that [frequent overdraft] account. Now, all of a sudden, everyone woke up and figured out that these are the most profitable accounts."*
- *"Our industry hasn't addressed the blue-collar segment of the market. One of the most profitable segments [due to fee income] is the blue-collar worker who goes from paycheck to paycheck. Those individuals are left behind in the industry. We [have tended] to focus our marketing efforts, our product development, toward the wealthier customer."*
- *"The most lucrative product is the checking account with an NSF [non-sufficient-funds] fee ... we used to close those accounts, but now we're letting those customers stay, and our fee income has doubled since last year."*
- *"A regulator told us, 'You've got a few of these people who pay late, you need some more of them.' You don't want the guy who is 30 days late, but 15 days late is okay. You get a nice return on someone who pays late a few times."*

High tech, low tech, or no tech?

Another issue that community banks are grappling with is whether, how quickly, and to what extent they should compete with the new technologies being rolled out by larger banks. Adding a new technology can range from installing individual applications (like account aggregation, automated credit analysis, or telephone banking) to purchasing entire established firms to provide products for on-line sales (like insurance or brokerage products). In either case, adding a new technology may be prohibitively expensive for a community bank:

- *"When the management of a community bank sits down to plan their budget for the next operating year, or for a horizon of three years, they've got one shot to get it right. They might be investing $300,000 or $500,000, which for a community bank might be an entire year's earnings or more. If they get it wrong, they've wiped out their bank for three years."*
- *"I don't think community banks have a more difficult time or are less flexible in their ability to deploy technology. I think we're more flexible than our larger competitors. We're able to roll out faster and more efficiently in a general sense. However, we don't typically have a large say in the design structure itself of the technology that becomes deployed—it's typically engineered by larger institutions."*

Furthermore, there is no guarantee that installing the new technology will add to the bank's bottom line. However, *not* installing certain applications may have even worse consequences, as these responses suggest:

- *"It would make us vulnerable [against the competition] if we didn't have it."*

- *"You're not going to get us to be the first bank in the country to claim that [Internet banking] is going to be a significant profit generator. It will be a means to protect the Gen Xers and Gen Yers and the Net generation, instead of finding another bank because their father's or grandfather's bank doesn't do anything."*

Given this uncertainty, it is paramount that community banks carefully choose only those applications that match their business strategies and serve the needs of their customers. But this is only half the battle. After the bank has chosen and installed the new applications, it must manage those applications efficiently. In a recent study of the Internet-only business model, DeYoung (2001a, 2001b) finds that the most successful Internet-only banks and thrifts are those that follow fundamental, low-tech management practices like controlling their costs. Here is the experience of one community banker with a new technology:

- *"We used to average 225 transactions per teller per day, and that average is down to 180 [because of telephone banking]."*

Because community banks are often too small to profitably deploy certain applications themselves, they may decide to form alliances with other financial services providers to give their customers access to brokerage services, insurance products, or even credit cards. However, a community bank that strikes up one or more strategic alliances must be careful to maintain its role as the primary customer contact, or risk losing customer relationships to the allied financial service providers. In fact, one community banker worries that her all-important customer relationships may be vulnerable to high-tech intrusions—in this case, account aggregation—even if she doesn't engage in strategic alliances:

- *"The rule is, he who aggregates first, wins. It's going to kill the ... community banks out there, because the large banks are going to cherry-pick the cream of the crop of your customers. They'll see what accounts your customers have, then offer them their teaser rates and the customers will take it. So, who's going to use aggregation services? The wealthier clients who are on the road and want to see all of their accounts in one place."*

Identity crisis: Banker or financial services provider?

Deregulation has removed most of the traditional boundaries that separated commercial banks from other financial services providers like insurance companies, brokerage firms, investment banks, and venture capital firms. Commercial banking companies can now offer virtually any of the financial products and services previously available only from those more specialized firms. Should community banks take advantage of this new freedom and broaden their product offerings? Or should community banks stick to a "pure banking" strategy? Some bankers wish they didn't have to make such choices:

- *"I think if we stuck with what we are best at, we would be a lot better off. If bankers stuck with banking, and let the insurance guys stick with insurance instead of them trying to write car loans, do IRAs, and write residential mortgages that they know squat about, and us trying to write homeowner's and life insurance and write trusts, we'd all live a better life."*

A narrowly focused, pure banking strategy may prove to be profitable for some community banks—but a focused strategy will not shield community banks from competition from nonbank financial firms. A number of the bankers that we surveyed used brokerage firms as examples of the threats, pitfalls, and opportunities facing the community banking sector in the newly deregulated financial services world:

- *"The competition isn't commercial banks anymore, it's brokerage companies. You have [national insurance company] offering car loans. Your broker is giving you investments, selling you credit cards, giving you a second mortgage on your house, giving you a line of credit, giving you interest on your checking account, on your idle funds."*
- *"It's difficult to offer [financial planning] and make money through a third-party. You have to contract because you need brokerage licenses, and most banks don't have staff that are licensed. So, you have to have a partner that can do it, and the margins aren't very good."*
- *"I think that the general public really prefers the stereotype of the financial planners of the [national brokerage firms]. We have a person who is just as capable, but he focuses on things that are more profitable. Most financial planning is not profitable. There are software packages that for $40 can do what 80 percent of the people want."*

The playing field isn't level

Many of surveyed community bankers voiced strong concerns that the rules of competition worked against them—namely, that state and federal regulations

placed them at a disadvantage relative to their large bank and nonbank rivals. All commercial banks must comply with costly regulations, such as the requirements of the Community Reinvestment Act (CRA) and the costs related to periodic safety and soundness examinations. In some cases, the fixed costs of complying with these regulations may fall more heavily on community bankers. The Fed survey uncovered some differing points of view about the impact of these costs on community banks:

- *"We shouldn't minimize the significance of competition from our large bank counterparts, but at least they play by the same rules."*
- *"The new state laws tie our hands because of all the regulations that come with it. Out-of-state banks open branches here but are regulated by their own state's laws, while we are subject to the laws of this state, which mandate a lower loan to value ratio. It hurts us in our ability to do loans that they [the out-of-state competition] might be able to do."*

The surveyed bankers were more uniformly concerned about the regulatory advantages enjoyed by their nonbank competitors. While it is true that these nonbank competitors incur substantially fewer regulatory expenses, limitations, and intrusions, it is also the case that banks enjoy two regulatory advantages that are unavailable to many of their nonbank competitors: access to the payments system and the ability to issue insured deposits. On balance, it is not clear how the various costs and benefits of the financial regulatory environment net out, but community bankers nonetheless feel that they often come out on the short end:

- *"Farm Credit has an advantage in that they have no requirement to live up to CRA rules. They can cherry-pick. They don't have to provide funding to low and moderate groups."*
- *"Payday loan companies are driving bankers crazy because they're totally unregulated."*

The most frequent and vociferous complaints were reserved for credit unions—cooperatively owned depository institutions that are not subject to federal or state income taxes. Credit union members (that is, their owners) can consume the resulting tax savings in the form of lower interest rates on loans and/or higher interest rates on deposits. This tax advantage makes membership in a credit union an attractive alternative to depositing funds in a community bank.

TABLE 3

Trends at U.S. credit unions and community banks, 1997–2001

	Credit unions			
	Number	Membership	Assets	Mean assets
		(millions)	*($ billions)*	*($ millions)*
1997	11,238	71.4	351.2	31.25
1998	10,995	73.5	388.7	35.35
1999	10,628	75.4	411.4	38.71
2000	10,316	77.6	438.2	41.51
2001	9,984	79.4	501.6	50.24
% change	–11.2	+11.2	+42.8	+60.8

	Community banks[a]			
	Number	Deposit accounts < $100,000	Assets	Mean assets
		(millions)	*($ billions)*	*($ millions)*
1997	9,323	108.5	1,103.8	118.40
1998	8,946	106.8	1,132.7	126.62
1999	8,779	104.8	1,202.7	136.88
2000	8,524	103.0	1,247.7	146.38
2001	8,295	101.9	1,326.6	159.93
% change	–11.0	–6.1	+20.2	+35.1

[a]Community banks defined as insured commercial banks with assets less than $1 billion in 1997; after 1997 this threshold was adjusted upward for 12 percent annual industry growth.
Sources: National Credit Union Administration (2001) and Federal Deposit Insurance Corporation (1997–2001).

TABLE 4

Mean averages for selected financial ratios at large banks and community banks, 1996–2000

		Small community banks		Large community banks	
	Large banks	All banks	Best-practices banks	All banks	Best-practices banks
Return on equity	.1653	.1267***	.1748**	.1431***	.1832***
Loans to assets	.6469	.6207***	.6426	.6304*	.6342
Noninterest expense to net revenue	.6013	.6133	.5646***	.6040	.5776***
Core deposits to assets	.4749	.7286***	.7387***	.6785***	.7258***
Noninterest income to net revenue	.3967	.1684***	.1800***	.2192***	.2229***

Notes: Large banks have more than $10 billion in assets. Small community banks have less than $500 million in assets. Large community banks have between $500 billion and $1 billion in assets. Best practices banks are defined as having return on equity higher than the group median. Assets are in 1999 dollars. ***, **, or * indicate that the community bank mean is significantly different from the large bank mean at the 1 percent, 5 percent, or 10 percent level, respectively.
Source: DeYoung and Hunter (2003).

- *"It's not a fair playing field. Credit unions are not subject to taxation, so they can lend their money out at 38 percent less. Second, they don't have to spend their time on CRA and other regulations."*
- *"... Credit Unions ... I won't get started on that! We get hammered on the rates that we're able to pay on our deposits, whereas credit unions can offer lower rates on vehicles and higher rates on deposits, and they're not subject to tax."*

Although membership in a credit union is limited to people who share a "common bond"—such as a common employer or a common geographic neighborhood—recent federal legislation liberalizing the interpretation of "common bond" has allowed credit unions to expand their market share at the expense of community banks.[15] As illustrated in table 3, the numbers of credit unions and community banks in the U.S. have declined about equally over the past five years. But while the number of deposit accounts at community banks has declined over this period, the number of credit union members has increased. Furthermore, the assets of credit unions have grown much faster than the assets of community banks.[16]

Conclusion

The slide in the number of community banks over the past 20 years is undeniable. The implications of this slide for the future of the community banking sector are open to debate. What does the future hold for community banks?

Recent experience indicates that well-run community banks can earn high and sustained profits. Table 4 compares selected financial ratios from large banks, community banks, and "best-practices" community banks, defined here simply as the community banks that generated above median return on equity. The best-practices community banks generated significantly higher returns than the average large commercial bank. Furthermore, the table indicates that these well-run community banks used a business model that was clearly different from the one used by the average large bank. On average, these banks used higher amounts of core deposit funding (evidence of relationship banking), incurred lower levels of noninterest expenses (suggesting that well-managed community banks are more likely to survive the industry consolidation), and generated less noninterest income (indicating that high earnings are available to community banks even if they don't enter nontraditional lines of business).

All else equal, the recent past is generally a good predictor of the near future. But long-run predictions about the future of the community banking sector—like all other long-run economic predictions—are subject to a large degree of uncertainty. Ken Guenther, president of the Independent Community Bankers of America, recently issued a statement on this issue that echoed in many ways the sentiments of the community bankers that we have quoted anonymously above:[17]

- *"Pundits continue to mistakenly announce the demise of the community-based banking sector. Simply stated, increased prosperity for Americans means a greater demand for financial services, and community banks continue to provide the customized personal financial services that can*

compete effectively with other providers. Greater use of technology is in no way limited to the exclusive benefit of large financial conglomerates but is employed successfully by community banks to compete most effectively. Before discounting the future of our nation's community-based banks, one should bear in mind that small banks have always been more nimble and responsive than huge banks and have been able to position themselves much faster than the bureaucratic giants. Given their proven ability to adapt to change and their survival over the past century, we can be confident that community banks will remain a competitive force well into the future."

Despite Guenther's optimistic predictions, some would consider the disappearance of almost half of the nation's community banks over the past 15 years to be *prima facia* evidence that the community bank business model is losing its viability. However, others argue that the healthy competition introduced by the deregulation and consolidation of the U.S. banking sector merely exposed the inefficiently run community banks to the pressures of the marketplace, while at the same time providing increased opportunities for efficiently run, progressive community banks to flourish. Not surprisingly, the community bankers that we surveyed embrace the second of these two visions of the future of community banking.

NOTES

[1]There is no generally accepted definition of "community bank." For convenience, a size-based threshold of less than $1 billion in assets is used.

[2]Although economists continue to debate how large a bank must be before it fully exhausts all potential for scale economies, there is general agreement that small community banks have access to substantial economies of scale. For an in-depth review of scale economies in banking, see Berger, Demsetz, and Strahan (1999).

[3]See DeYoung, Hasan, and Kirchhoff (1998), Evanoff and Örs (2001), and Whalen (2001). One explanation for this phenomenon is that the acquiring bank makes numerous changes that intensify competitive rivalry in the local market—for example, underperforming managers are replaced, assets are reallocated to higher yielding investments, excess expenses are slashed, new products are introduced, fees are reduced, or deposit rates are increased. Local banks either respond in kind or lose market share.

[4]This deregulation does have some technical limits. For example, to engage in certain nonbanking financial activities (for example, insurance underwriting) a bank must adopt a new organizational structure called a financial holding company (FHC), in which commercial banking affiliates are capitalized separately from nonbanking affiliates.

[5]Federal Reserve System (1997, 1998, 1999).

[6]See Genay (2000) for details. Core deposits are typically defined as funds in transactions accounts plus funds in savings accounts under $100,000.

[7]There is evidence consistent with this in the Federal Reserve's *Survey of Retail Pricing and Fees* (1997, 1998, 1999), which reports that small banks tend to charge lower fees on deposit accounts.

[8]"Hard" information (for example, salary, wealth, debts) can be gleaned from a borrower's financial statements and credit reports. In contrast, accumulating "soft" information (for example, the borrower's character or her ability to run a business) requires the lender to have personal interactions with the borrower. See Stein (2002) for a detailed discussion.

[9]A study by Celent Communications found "negative returns" to Internet banking at banks with fewer than 10,000 customers. See article in *American Banker* (Thomson Corporation, 2000a). Consistent with these findings, DeYoung (2001a) finds that newly chartered Internet-only banks tend to exhibit deeper scale economies than newly chartered branching banks.

[10]DeYoung (2001b, p. 65) discusses these issues at greater length and provides some industry evidence.

[11]See Strahan and Weston (1998), Peek and Rosengren (1998), and DeYoung, Goldberg, and White (2000) for details on small business lending and the consolidation of the banking industry.

[12]There is an extensive literature on scale and scope economies in the commercial banking industry. See Hunter, Timme, and Yang (1990), Hunter and Timme (1991), Evanoff and Israilevich (1991), Berger and Mester (1997), and Hughes, Lang, Mester, and Moon (2000) for evidence. This evidence suggests that scale economies are modest for community banks under $1 billion, but that larger banks produce a different output mix using a different production technology that yields more substantial economies of scale.

[13]Note that large banks do personalize some of their financial services—for example, investment banking or merger finance to large wholesale clients—but their retail and small business strategies tend to be commodity-like compared with those delivered by small community banks.

[14]The three anecdotes that follow come from the following sources: Thomson Corporation (1999, 2002b) and Bank Administration Institute (1997).

[15]The Credit Union Membership Access Act of 1998 (P.L. 105-219) allows a federal credit union to accept as members groups of up to 3,000 individuals that are not related by a common bond to the current membership group.

[16]The comparatively low community bank asset growth rates are not due to our working definition of a community bank, which truncates the annual populations at $1 billion. The differences in growth rates were even larger when we used a $10 billion asset threshold. (Note that in both cases, we allowed the asset threshold to increase by 12 percent per year to account for average nominal industry growth rates.)

[17]The quoted material is condensed from Guenther (2002).

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