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The Special Characteristics of American Community Banking

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Abstract

The banking system in the United States has always been unique in the sense of containing large numbers of small banks closely tied to their local communities. But the banking system in this country has also undergone tremendous change during the last 20 years due to deregulation and mergers. While community banks still comprise the vast majority of banks and maintain strong earning ability, the question arises what are those small banks' special characters which make community banks success in providing credit to certain business sectors? This paper explores some of the more significant characteristics of community banking, examining the importance of community banks in small-business lending in terms of their ability to handle "soft" data, their tendency to rely on retail deposits for funding, and their emphasis on personal service.

Keywords: Community Bank, Characteristics, American Community, Banking, Performance

The Definition of American Community Banks

First of all, the exact definition of American community banks should be given as the foundation of this paper to analyze the characteristic and performance of community banks.

For supervisory purposes, the OCC designates each national bank as a large, mid-size, or community bank. This designation is based on the bank's asset size and whether other special factors that affect its risk profile and complexity are present or absent, such as: The bank and its affiliate national charters are part of a much larger banking organization (company) and proper supervision requires extensive coordination with other regulators; The company is a dominant player within its market; The company has large asset management operations; The company performs significant international activities; The company owns unique operating subsidiaries; The company offers high-risk products and services; The company conducts sophisticated capital markets activities. The community bank is the banking institution which asset is not more than \$1billion¹.

In Sep. 2005, The CRA (Community Reinvestment Act) has raised the small banks asset size threshold from \$250 million to \$1 billion and proposed to reduce undue regulatory burden by

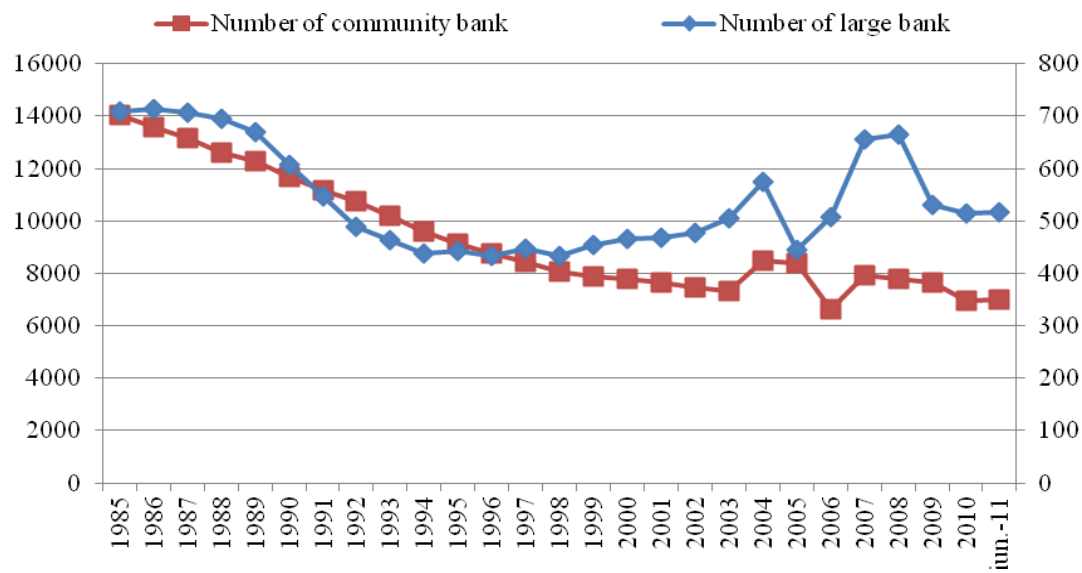
¹ Bank Supervision Process, OCC Comptroller's Handbook, September 2007.

extending eligibility for streamlined lending evaluations and the exemption from data reporting to banks under \$1 billion without regard to holding company affiliation. In addition, the agencies proposed to define small banks with assets between \$250 million and \$1 billion as “intermediate small banks.” The proposal also would annually adjust the asset size for small and intermediate small banks based on changes to the Consumer Price Index. The CRA regulations, effective January 1, 2011, provide that banks and savings associations that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.122 billion are “small banks” or “small savings associations.” Small banks and small savings associations with assets of at least \$280million as of December 31 of both of the prior two calendar years and less than \$1.122 billion as of December 31 of either of the prior two calendar years are “intermediate small banks” or “intermediate small savings associations.”²

The Performance of American Community Banks

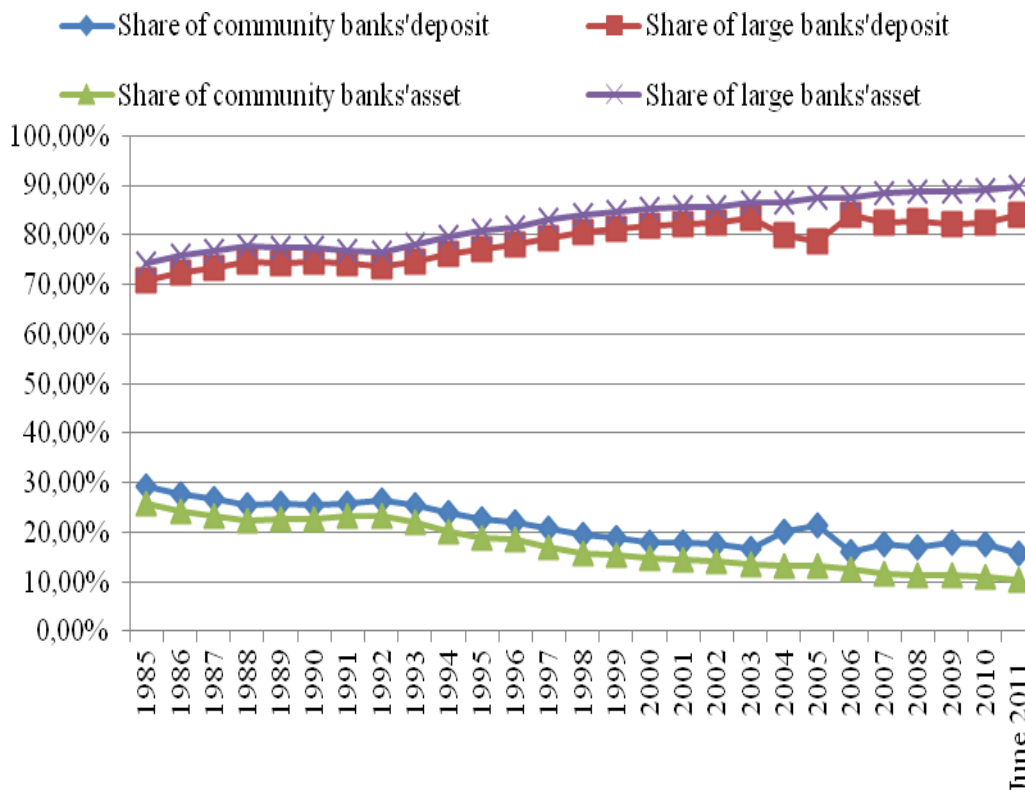
The U.S. banking system has long had a multitude of small institutions. This characteristic of the industry has been shaped by a number of factors. The dual banking system—that is, the coexistence (since the end of the Civil War) of both federal and state chartering—has fostered the creation of small banks, and this effect was reinforced by chartering regulations at both the national and state levels that were frequently permissive. In addition, the fear of concentration, as well as efforts to keep local markets free of outside competition, led many states to impose longstanding limits on branching, and this legacy of unit banking helped swell the numbers of small banks, particularly in the Midwest. The lack, until fairly recently, of the technology necessary for creating very large banking organizations was another factor contributing to the multiplicity of small banks. Of course, during the last quarter of the twentieth century the requisite technological advances occurred at the same time that legal impediments to branching were being gradually removed. Thus, for the last two decades in particular, the industry saw a great deal of consolidation, much of it involving community banks, whose numbers fell significantly (See figure 1.) Moreover, community banks’ shares of deposits, assets have fallen steadily and significantly since 1985 (See figure 2.)

² 12 CFR 228 BB.



Source: FDIC

Figure 1. The number of community banks and large banks³ in USA

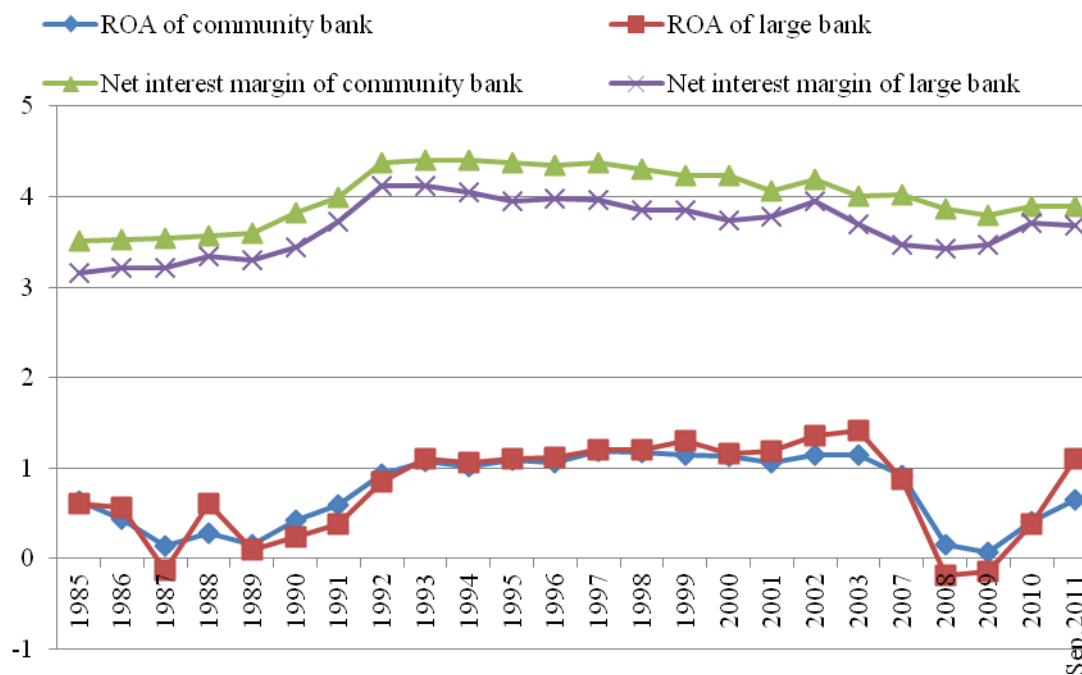


Source: FDIC

Figure 2: The share of community banks and large banks' deposit and asset

³ The large bank is the bank with asset more than 1 billion, and the below is the same.

Although the number of community banks has declined over the past more than 20 years, the performance of these banks and the fact that their numbers remain high confound predictions of their virtual demise—predictions made just a few years ago. For example, in 1997 one bank analyst predicted that the industry would consolidate at a rate of 300 banks per quarter, with a total of less than 1,000 banks remaining. A 1996 prediction held that consolidation would mean the United States would have “well under 5,000” banks just four years later; much of this decline would obviously have involved community banks⁴. Such prognostications are, of course, often inaccurate. It should be noted that this view was not universally shared. As early as 1991 former FDIC Chairman William Isaac believed that consolidation did not pose a danger to well-run community banks; in 1996 Alan Greenspan was quoted as stating that those who were predicting the end of the community bank were “just plain wrong”; and by 1997, others were predicting (rightly) that the decline in small-bank numbers was slowing dramatically⁵. Moreover, we could see that though the number of community bank declined, the community banks’ ability of earning is not less than the larger one. Figure 3 shows that the community banks’ net interest margin is higher than the large banks, and the both ROA is similar.



Source: FDIC

Figure 3: The ROA and Net interest margin of community banks and large banks

Since community banks have not vanished and still have strong earning ability, it appears that many of them must be doing something right; moreover, the formation of significant numbers of new community banks since 1992 demonstrates that these banks are perceived to be viable. Researchers have therefore sought to determine just what the “something right” is and whether it will continue

⁴ Spiegel, Gart, and Gart (1996), 18–19; Kline (1997).

⁵ Isaac (1991); De Senerpont Domis (1996); Kline (1997).

to be important. That “something” is strongly related to community banks’ economic role, and three areas of that role will be discussed here: community banks’ success in providing credit to certain business sectors, their ability to attract retail deposits, and their capacity to build on the provision of personal services to their customers. This following explores some of the more significant characteristics of community banking, examining the importance of community banks in small-business lending in terms of their ability to handle “soft” data, their tendency to rely on retail deposits for funding, and their emphasis on personal service.

The significant characteristics of community banks

The ability to handle “soft” data

One of the more significant elements of community banks’ economic role is their function as providers of credit: they serve important segments of the business loan and farm-loan markets. Although overall their share of small-business loans (loans of less than \$1 million at origination) has declined during the past decade, they still provide almost a third of all small commercial and industrial loans and more than 40 percent of small commercial real estate loans. They are even more important as farm lenders, providing 65 percent of all farm real estate loans, 61 percent of all farm operating loans, and roughly 75 percent of small farm loans (loans of less than \$500,000 at origination) reported on bank balance sheets.

Much recent literature has identified the strength of community banks in these areas as stemming from their ability either to successfully lend to what have been variously described as “informational opaque” borrowers—borrowers without long credit histories suitable for credit-scoring or other model-based lending practiced by large banks—or to engage in relation— or reputation based lending or lending in low-volume markets. Soft data include a borrower’s character or ability to manage, and this information is generally gleaned through a local presence and personal interactions with borrowers; also thought to be helpful is a favorable organizational structure (close proximity of lending officers to management)⁶. In contrast, large banks prefer hard data (e.g., credit history, income, debts, and other data available from financial statements and credit reports) and are less willing to lend to “informational difficult credits.” With the ability to process the soft data, community banks are thought to have certain comparative advantages in lending to informational opaque borrowers, and these advantages are helpful in underwriting and monitoring loans to small businesses and farmers. Empirical support for this view is provided by a recent study that found that small banks earn higher risk-adjusted returns on business loans than large banks; the study concluded that small banks make “better choices” in lending to businesses⁷.

The Tendency to Rely on Retail Deposits for Funding

Community banks have also been defined by their tendency to rely more on retail and insured deposits for their funding than large banks have done. A recent study notes that at year-end 2002, community banks “held 24 percent of deposits (as a percentage of deposits at all banks) in accounts of \$100,000 or less, but only 15 percent of deposits in accounts over that amount”⁸. Given this emphasis, it is not surprising that community banks usually charge lower fees for deposit services. In

⁶ See, for example, Nakamura (1994); Berger and Udell (2002); DeYoung, Hunter, and Udell (2003); Brickley, Smith, and Linck (2001); and Berger and Udell (2003).

⁷ Carter, McNulty, and Verbrugge (2004).

⁸ Keeton, Harvey, and Willis (2003), 28.

2010, the Federal Reserve Board found that, on average, small institutions charged lower fees than large banks. For example, the average annual fees charged by large banks for simple passbook accounts were 72 percent higher than those charged by the smallest banks, and the average stop-payment fee was 38 percent higher at large banks than at the smallest banks.⁹ It should be noted, however, that the fee advantage held by smaller institutions, though still present, has been declining; the decline may indicate that small banks are seeking to exploit fee income somewhat more than they have in the past. Community banks, because they rely on retail deposits and need to attract them, also appear to pay higher rates on retail deposits than large banks competing in multiple markets. Paying the higher rates has been feasible because surviving small banks have been able (until very recently) to earn a higher rate of return on their assets, maintaining profitability even while growing more rapidly than large banks during nearly the past two decades.

Their Emphasis on Personal Service

Another significant element in community banks' economic role is the manner in which they interact with customers. Although advances in information technology, such as the Internet, have enabled many customers to transact banking business without having recourse to a bank's premises, there apparently remain customers who prefer face-to-face contact. Community banks have typically seen personal service as their most important competitive advantage, and they market personal service and local connections to prospective customers. Many community banks seek to demonstrate this service by being active in their communities. For example, a significant percentage of community bankers responding to a recent survey noted that they participated in civic groups, worked with local chambers of commerce, supported local schools, assisted local relief efforts, and offered special help to low-income segments of the community.¹⁰

Recent research has shown that the formation of new banks is strongly correlated with mergers that shift "ownership away from small organizations or toward distant organizations"; one explanation for this correlation is that large organizations tend not to adequately serve "small, relationship-based" customers. The new institutions may be finding a market in providing for the needs of customers to whom the business methods of larger banks are unsatisfactory.¹¹

Anecdotal evidence supports the view that small banks can attract such customers. In a recent Federal Reserve System survey of community bankers, respondents commonly noted that because of their local knowledge and personal service, they were able to draw business away from larger institutions. They also reported that some community banks experienced significant asset growth in the wake of recent acquisitions of other community banks by large institutions. Another indication of the "personal-service" phenomenon is large banks' efforts to emphasize personal service even though their comparative advantage would seem to be in mass market lending based on hard data (credit history and other objective indicators of risk).¹²

⁹ For simple passbook accounts, the dollar amounts were \$36.96 versus \$21.48; for stop-payment orders, \$23.54 versus \$17.00. The Federal Reserve Board defines small banks as institutions with less than \$100 million in assets; medium-size banks, assets between \$100 million and \$1 billion; and large banks, more than \$1 billion in assets. In 2002 medium-size banks' fees were usually somewhere between the fees of small and large banks.

¹⁰ Grant Thornton (2002). Grant Thornton mailed surveys to the chief executives of 5,393 community banks and savings institutions in November 2001. The response rate was 8 percent.

¹¹ Keeton (2000). See also Berger et al. (1999); Seelig and Critchfield (2003).

¹² For example, it is not unusual for large banks to advertise "relationship banking accounts," and many large banks seek to be customer-friendly by turning their branches into "stores."

Prospects for Community Banks and Conclusions

American community banks' future must take into account what may happen to their numbers. Merger activity has slowed in recent years, coupled with the continued creation of new banks; this has meant a significant reduction in the consolidation of community banks. Furthermore, the pattern of community banks' numerical decline does not suggest that any one type of area or market is particularly likely to face accelerated consolidation in the near future. Additional declines may nevertheless be expected. Low returns on equity (resulting partly from higher capital ratios) may lead to consolidation of some institutions, as stockholders seek higher returns through increased leverage at merged institutions. This presumed causal relationship is less relevant, however, to owner-operated banks that do not rely on uninsured or unprotected sources of funds. These owners' returns may be increased by compensation received as bank officers, and there may be non-pecuniary benefits to playing a leading role in the local community. In addition, there may be no outside shareholders to challenge the owners' decisions to remain independent. But financial considerations may not be the only reason for consolidation among community banks. Indeed, in view of apparent lags in the response of individual community banks to market developments, the depth and timing of future consolidation among community banks remain uncertain. These lags may reflect not only a lack of interest on the part of outside banks in acquiring banks located in slow-growth markets but also, as just mentioned, the ability of banks in these markets to perform at levels satisfactory to their owners.

The U.S. banking system is unusual in consisting not only of some very large banks but also a large number of relatively small community banks. This bifurcated banking structure resulted largely from a legal framework that, in the past, restricted banks' abilities to diversify geographically. This institutional structure, in turn, reflected a long-standing concern in the United States about the concentration of banking power in a few very large institutions located far away from many of the customers they serve.

The bifurcated banking system in the United States has served the economy well. Over time, with regulatory change and financial innovation, large banks have become complex organizations engaged in a wide range of activities. They provide a variety of services to their customers, but often rely on hard financial information, computer models, and centralized decision-making as the basis for conducting business. In contrast, small banks have focused more on "relationship banking," basing decisions on personal knowledge of customers' creditworthiness and a keen understanding of business conditions in the communities they serve. In this way, the bifurcated banking system has served the needs of a diverse U.S. economy composed of businesses of all shapes and sizes and consumers with diverse needs and preferences. In a word, the more significant characteristics of community banking, is the importance of community banks in small-business lending, controlling and solve the special customers' information in terms of their ability to handle "soft" data, their tendency to rely on retail deposits for funding, and their emphasis on personal service.

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