Executive Summary

The FDIC Community Banking Study is a data-driven effort to identify and explore issues and questions about community banks. The first chapter develops a research definition for the community bank that is used throughout the study. Subsequent chapters address, in turn, structural change, the geography of community banking, comparative financial performance, community bank balance sheet strategies, and capital formation at community banks. This study is intended to be foundational, providing a platform for future research and analysis by the FDIC and other interested parties.

Defining the Community Bank

To study community banks, it is necessary to define them. In the past, most analysts have used a maximum asset size, often $1 billion. However, using only a size cutoff does not account for industry growth, and the attributes associated with community banks are not exclusively tied to size. To overcome these problems, the study develops a new research definition of a community bank around criteria related to traditional lending and deposit gathering activities and limited geographic scope. Based on this definition, there were 7,658 FDIC-insured community banks operating within 6,914 separate banking organizations (or 94 percent of all banking organizations) as of year-end 2010. Importantly, the new definition captures 330 larger banking organizations that might have been excluded if asset size were the only criterion used.

Community Banks Retain a Unique Identity

Far-reaching changes in the U.S. financial sector in recent decades have made community banks a smaller part of our financial system. Of the U.S. credit market debt held by domestic financial intermediaries, the share held by U.S. chartered banks declined by almost half between 1984 and 2011, from 49 percent to 25 percent.[1] Over the same period, the share of U.S. banking assets held by community banks declined by more than half, from 38 percent to 14 percent.

Despite these changes, this study demonstrates that community banks continue to play a unique and important role in our economy. As of 2011, community banks made up 92 percent of FDIC-insured banks and 95 percent of U.S. banking organizations. The study shows that community banks hold the majority of banking deposits in U.S. rural and micropolitan counties, and that there are more than 600 counties—or almost one out of every five U.S. counties—that have no other physical banking offices except those operated by community banks.

The value of community banks has always been associated with the unique combination of services they provide to their customers, as well as the manner in which they do business. Community banks tend to be relationship lenders, characterized by local ownership, local control, and local decision making. By carrying out the traditional banking functions of lending and deposit gathering on a local scale, community banks foster economic growth and help to ensure that the financial resources of the local community are put to work on its behalf. Community banks have always been inextricably connected to entrepreneurship. As of 2011, they held 14 percent of banking industry assets, but 46 percent of the industry's small loans to farms and businesses.

The Implications of Banking Industry Consolidation

Consolidation in the U.S. banking industry is a multidecade trend that reduced the number of federally insured banks from 17,901 in 1984 to 7,357 in 2011. Over this period, the number of banks with assets less than $25 million declined by 96 percent. The decline in the number of banks with assets less than $100 million was large enough to account for all of the net decline in total banking charters over this period. Meanwhile, the largest banks—those with assets greater than $10 billion—grew elevenfold in size over this period, raising their share of industry assets from 27 percent in 1984 to 80 percent in 2011.

These trends took place in the context of powerful historical forces that were highly conducive to consolidation, particularly in the first half of the study period. One of these forces has been bank failures. Altogether, some 2,555 banks and thrifts failed during the study period, mostly as a result of the banking crisis of the late 1980s and early 1990s and the financial crisis that began in 2007. From this experience, it is clear that the future pace of industry consolidation depends in large part on whether the coming years are marked by a period of financial stability

[1] Source: Federal Reserve, *Flow of Funds*, Table L.1.

or another wave of bank failures. The stronger the risk management practices of community banks, and the more effective the supervisory policies put in place by regulators, the less consolidation will take place as a result of failures.

Most of the consolidation that took place during the study period came about through mergers of banks belonging to different organizations and consolidation of banks within organizations. In all, some 7,583 banks exited the industry through merger during the study period, while another 4,929 exited through consolidation. In order to evaluate the implications of these trends, it is useful to consider why they occurred. One of the most important factors driving voluntary consolidation during this period was the relaxation of restrictions on intrastate branching and interstate banking that took place in the 1980s and early 1990s. Based largely in state law, these long-standing restrictions had the effect of artificially inflating the number of banking charters, and their removal was bound to result in consolidation. In the former unit banking states, for example, banking organizations that were prohibited from operating branches could instead operate separate charters within their organization. The same was true for banking organizations that crossed state lines, where interstate banking and branching were frequently restricted prior to the mid-1980s.

With the relaxation of restrictions on branching and interstate banking in the late 1980s and early 1990s, the pace of mergers and consolidations gathered steam. Between 1995 and 1998, the period immediately following the passage of the Riegle-Neal Act, an average of 5.7 percent of banks merged or consolidated each year. However, a slowing pace of mergers and consolidations suggests that the effects of these regulatory changes are beginning to wane. In the pre-crisis period between 2004 and 2007, this yearly average of mergers and consolidations fell to 3.7 percent.

It is possible that such forces as financial innovation, technology and regulatory developments could lead to additional consolidation. However, it is not clear that these forces would operate on the same scale as the past waves of consolidation that have resulted from the relaxation of branching and geographic restrictions or from failures.

The Implications of Geography

Although most banking offices operated by both community and noncommunity banks are located in metro counties, this study describes how community banks have a particular relevance in nonmetro counties—the small towns and rural areas that make up most of the country by area. Community banks are almost three times more likely than noncommunity banks to operate a banking office outside a metro area, and they hold the majority of banking deposits in both micropolitan and rural counties.

While the prevalence of community banks in nonmetro areas remains part of their unique identity, it may come at the cost of size and growth. Nonmetro areas accounted for just 16 percent of U.S. population in 2011, and just over 12 percent of U.S. economic output. Moreover, they experienced consistently slower rates of growth in population and economic output during the study period. Fifty percent of rural counties lost population between 1980 and 2010, continuing a long-term trend that has accelerated since the 2000 census.

These disparities in population and growth have not necessarily hurt the financial performance of community banks that operate in nonmetro areas. Both community and noncommunity banks headquartered in nonmetro areas outperformed their counterparts headquartered in metro areas on the basis of pretax return on assets (ROA) for the study period as a whole and for each five-year interval for which the comparison was made. Even the 1,091 community banks headquartered in depopulating rural counties in 2011 outperformed their counterparts headquartered in metro areas over the past decade. Instead, the disparities between metro and nonmetro counties are reflected in the growth rates of the institutions headquartered there. Banks headquartered in metro areas in 2011 that also operated in 1984 grew more than twice as fast over that interval as similar banks headquartered in nonmetro areas.

One of the reasons that noncommunity banks were able to accumulate an 86 percent share of industry assets during the study period was their ability to shift their activities to (and accumulate market share in) fast-growing metro areas. In the 21 fastest-growing U.S. metro areas with population of more than one million in 2011, 237 noncommunity banks were able to accumulate a 90 percent deposit share in part by directly or indirectly acquiring nearly 8,700 banks during the study period. Moreover, as described in Chapters 2 and 5, asset growth at noncommunity banks was led by mortgage and consumer lending during a period when these loan types were expanding rapidly. Between 1984 and 2011, total U.S. mortgage debt grew 7.7 times while total consumer debt grew fivefold.[2]

[2] Source: Federal Reserve, *Flow of Funds*, Tables L.218 and L.222.

Most of this growth, however, predated the financial crisis that began in 2007. The crisis marked a sudden interruption of a long-term cycle of rising home prices, rising mortgage and consumer debt, and expanding residential construction activity that not only fueled balance sheet expansion at noncommunity banks, but also provided much of the impetus for economic growth in metro areas and for the U.S. as a whole. Whether metro-area growth continues to fuel the expansion of mortgage and consumer loan portfolios at noncommunity banks in the years ahead depends in no small part on the extent to which the pre-crisis pattern of growth reasserts itself in coming years.

Some signs suggest that the future pattern of U.S. economic growth may not be a replay of the past 25 years. The composition of U.S. economic output has undergone something of a shift away from some of the sectors that boomed before the financial crisis. Between 2006 and 2011, the share of U.S. economic output derived from construction, retail trade, and finance, insurance and real estate declined by 2.3 percentage points, while the share derived from mining, utilities and agriculture, forestry, and fishing expanded by 0.7 percentage points.[3] To the extent that this shift in the pattern of growth persists, it could help to mitigate the disparity in growth rates between metro and nonmetro areas that has limited the growth potential of community banks.

The Implications of Performance Gaps Between Community and Noncommunity Banks

The study identifies some long-term gaps in profitability and efficiency between community and noncommunity banks. Between 1993 and 2006, noncommunity banks reported a pretax ROA that averaged 35 basis points higher than for community banks. This was a period characterized by high consumer spending and borrowing, as well as significant banking industry consolidation through which noncommunity banks increased their market share through acquisitions.

While it is true that community banks have earned a lower average pretax ROA than noncommunity banks over the past 15 years, most community banks in most periods have been profitable. Moreover, there are readily identifiable segments of the community banking sector that have posted earnings that are relatively high and stable. One such group is community banks that operated continuously from 1984 through 2011. Their weighted average pretax ROA over the study period was one basis point higher than that of continuously operating noncommunity banks.

One element of the performance gap has been a narrowing of the traditional advantage that community banks have had in generating net interest income in recent years as the net interest margin (the spread between asset yields and funding costs) has narrowed. Because of their focus on traditional lending and deposit gathering, community banks derive 80 percent of their revenue from net interest income compared with about two-thirds at noncommunity banks. Accordingly, the narrowing of net interest margins places a significant drag on the earnings of community banks.

The historically low level of interest rates in recent years has been an important factor pushing down net interest margins at community banks. The heavy reliance of community banks on deposit funding—typically an advantage during periods of higher interest rates—has been more problematic in recent years as community banks have found it difficult to pass along ultra-low interest rates to their deposit customers.

Another factor contributing to the earnings gap between community and noncommunity banks has been the ability of noncommunity banks to generate noninterest income from a wider variety of sources. These include trading, venture capital and investment banking activities that are not typically part of the community banking model. Noninterest income averaged 2.05 percent of assets at noncommunity banks over the study period compared with only 0.8 percent at community banks.

While the disparity in performance between community banks and noncommunity banks has been driven by revenue, the study also explores community bank credit losses and overhead expenses. Community banks have almost always incurred lower credit losses than noncommunity banks. This difference has been most notable in economic downturns, and is likely a result of the relationship lending approach favored by most community banks. Community banks also have traditionally incurred lower noninterest expenses than noncommunity banks, and their ratio of noninterest expenses to assets remained fairly steady over the study period. Noncommunity banks were able to lower their noninterest expenses as a percent of assets in the pre-crisis years by reducing average expenses associated with employees and premises.

[3] FDIC calculations based on data from the Bureau of Economic Analysis. Each percentage point equals approximately $150 billion in 2011 U.S. economic output.

One question the study tried to address was how regulatory costs have changed for community banks over time. Unfortunately, the data available through Call Reports and other regulatory filings do not provide a breakdown of regulatory versus other types of noninterest expenses. As part of this study, the FDIC conducted interviews with nine community bankers to better understand what drives the cost of regulatory compliance at their bank (see Appendix B). Most interview participants stated that while no one regulation or practice had a significant effect on their institution, the cumulative effects of regulatory requirements led them to increase staff over the past ten years. Moreover, the interviews indicated that it would be costly in itself to collect more detailed information about regulatory costs. As a result, measuring the effect of regulation remains an important question that presents substantial challenges.

The performance gap between community and noncommunity banks can also be expressed in terms of the efficiency ratio (the ratio of noninterest expense to net operating revenue). An "efficiency gap" in favor of noncommunity banks grew from 1.3 percent in 1998 to 9.7 percent in 2011. By 2011, noncommunity banks on average generated a dollar in net operating revenue for every 60 cents in noninterest expenses incurred, while community banks generated a dollar of revenue for every 70 cents in noninterest expenses. While the efficiency ratio of noncommunity banks declined (improved) through much of the study period because of lower noninterest expenses, those gains largely dissipated after the onset of the crisis that began in 2007. Instead, the efficiency gap that emerged between 1998 and 2011 was almost entirely attributable to a cumulative 8 percentage point increase (deterioration) in the efficiency ratio of community banks.

Why did community banks become so much less efficient in generating revenue after 1998? A relatively small portion (20 percent) of the net deterioration in efficiency at community banks was attributable to higher noninterest expenses, all of which came about after 2008. A much larger portion (72 percent) of the net deterioration in efficiency at community banks is attributable to a decline in net interest income (discussed above), most of which occurred in the last five years of the study period.

Whether the performance gaps of recent years might persist into the future appears to depend on three factors. One is the extent to which new community bank charters enter the industry in coming years. *De novo* institutions typically require some time to become profitable, and can also be vulnerable to problems during economic downturns. If the number of new community bank charters in the next decade were to approach the 997 de novo community banks established in the 2000s, the likely result would be to push down the aggregate financial performance of community banks over that period.

The second factor that will determine the existence and size of any performance gaps going forward is the timing, speed and magnitude of the eventual increase in interest rates to levels more in line with historical norms. The longer this normalization in rates is delayed, the longer community banks will experience a squeeze on their net interest margin and the longer the current efficiency gap is likely to persist. At the same time, a large and abrupt increase in interest rates also carries risks to institutions that have increased their holdings of long-term assets in the current low-interest-rate environment.

The third factor that appears likely to shape the competitive playing field in coming years is the ability of large noncommunity banks to generate noninterest income and cut noninterest expenses. In the years immediately preceding the crisis, the largest noncommunity banks were able to generate significant amounts of noninterest income through a variety of sources, including securitization and other capital markets activities, mortgage origination and servicing, and service charges on deposit accounts. There is reason to question whether some elements of this revenue model will regain their former importance in the wake of the financial crisis. For example, the volume of private mortgage securitization remains more than 95 percent below its pre-crisis peak, and the market share of the top five mortgage originators fell by 6 percentage points in the first half of 2012 compared with the prior year.[4]

Similarly, the large reductions in the noninterest expense ratio of noncommunity banks that took place in the pre-crisis years may not be sustainable in the post-crisis period. In the aftermath of the crisis, large noncommunity banks have incurred billions of dollars in expenses associated with problems such as process deficiencies in mortgage underwriting and servicing, insufficient controls on trading activity, and misleading disclosures to investors in capital markets instruments. Through 2011, the ratio of noninterest expenses to average assets at noncommunity banks had already risen by more than 11 percent from its 2008 low for the study period. Deficiencies that have been identified in mortgage servicing, trading, and other income-generating activities may necessitate even higher

[4] Source: *Inside Mortgage Finance*.

expenditures on the part of noncommunity banks in the years ahead. These developments raise the possibility that much of the large decline in noninterest expenses at noncommunity banks that occurred before the crisis will be reversed as these deficiencies are fully addressed.

Finally, the large-scale consolidation that took place during the study period naturally leads to the question of whether it is related to economies of scale among community banks that might put smaller institutions at a competitive disadvantage. As part of this study, the FDIC conducted research designed to detect the presence of economies of scale among community banks that could prompt them to try to lower their average costs through growth.[5] These results show that most of the benefit from economies of scale is realized once community banks reach $100 million to $300 million in total assets, depending on the lending specialty. These results comport well with the experience of consolidation during the study period, during which the number of banks with assets less than $25 million declined by 96 percent, but the number of banks with assets between $100 million and $10 billion increased by 19 percent. This is where 65 percent of community banks operated in 2011. In short, there does not appear to be much evidence to suggest that economies of scale are an important source of competitive disadvantage for most community banks or that they will compel significant additional consolidation in the years ahead.

The Implications of Community Bank Lending Strategies

While many community banks hold relatively diversified asset portfolios, the study categorizes community banks into seven lending specialty groups to further explore the relationship between business model and long-term performance. As of 2011, about 57 percent of community banks were categorized as mortgage specialists, consumer specialists, commercial real estate (CRE) specialists, commercial and industrial (C&I) specialists, and agricultural specialists, while the rest were categorized into a group with multiple lending specialties or a group with no lending specialty. The no specialty group was the largest group in nearly every period, and is made up of banks that are diversified lenders or that tend to have more securities and fewer loans.

Community banks in the mortgage, agricultural and no specialty groups were generally the strongest and steadiest performers over the study period, reporting lower provision expenses to assets and a lower incidence of failure than each of the other four lending specialty groups. In addition, agricultural specialists and the no specialty group reported higher average pretax ROA than any of the other five groups across the study period. At the other end of the spectrum, CRE lending specialists turned out to be the lowest-performing lending specialty group by a variety of measures. They trailed the average ROA of all community banks by one-third, and failed more than twice as often as the average community bank.

While noncommunity banks shifted their loan portfolios away from commercial lending and toward retail lending during the study period, community banks shifted their portfolios toward loans secured by commercial real estate. Among the seven lending specialty groups identified in this study, CRE specialists became the largest specialty group between 2005 and 2009, peaking at just under 30 percent of all community banks. Still, the CRE category includes a variety of loan types that performed differently in the real estate downturn of the late 2000s. More than one-third of all CRE loans held by community banks in 2011 were secured by owner-occupied nonfarm nonresidential properties, meaning that they were essentially collateralized commercial loans. This type of lending increased among community banks in every specialty group over the study period. During the recent crisis, the performance of loans secured by nonfarm nonresidential properties was roughly comparable to that of C&I loans, with both loan types performing much better than the construction and development (C&D) loans that made up 16 percent of community bank CRE portfolios in 2011.

Despite the relatively strong long-term operating results obtained by community banks in the baseline mortgage, agricultural and no specialty groups, hundreds of community banks shifted out of these groups and into other lending specialties between 2000 and 2005, mostly by accumulating larger balances of C&D and other CRE loans. The community banks most likely to undertake such a shift in lending strategy after 2000 were those organized as C corporations, those chartered since 1980, those headquartered in a metro county or in a state where home prices were rising rapidly, and those with trust preferred securities (TruPS) outstanding at the holding company level.

[5] Paul Kupiec and Stefan Jacewitz, Community Bank Efficiency and Economies of Scale, FDIC, December 2012, http://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf. This study of efficiency and economies of scale was limited to the universe of community banks, and does not provide comparisons of cost with noncommunity banks, which are frequently much larger in size.

While these alternative strategies initially provided a small performance advantage for community banks that shifted into them after 2000, they proved to be highly problematic during the crisis period that followed. Community banks that shifted to a C&D strategy failed almost five times more frequently than the average community bank between 2006 and 2011, while more than half of those that survived after 2008 were rated 3, 4 or 5 by bank supervisors. While the results were somewhat better for community banks that shifted to a more diversified CRE strategy, they, too, failed at almost twice the rate of all community banks after 2006, and after 2008 they were rated 3, 4 or 5 more than twice as often as banks that remained in one of the baseline specialty groups.

One of the factors that appears to have contributed to the shift from the baseline groups to the C&D and CRE strategies is the search for growth. Of community banks that belonged to one of the three baseline specialty groups in 2000, those that switched to a C&D strategy grew more than 90 percent faster on average between 2000 and 2005 than those that did not, while those that switched to a CRE strategy grew more than 80 percent faster. Community banks with a growth imperative in the first half of the 2000s were able to grow faster by raising their concentrations in C&D and CRE loans than by maintaining a specialty in mortgage or agricultural loans or by holding a diversified portfolio.

Targeted research further explores the role of bank management decisions in determining the pretax ROA of community banks by estimating a model that accounts for factors such as underwriting standards, loan growth, capital base, funding mix, lending specializations, and staffing in addition to local economic conditions. The results underscore the importance of a management approach that sticks to the basics, avoiding such practices as out-of-area lending and reliance on noncore funding, and emphasizing portfolio diversification and strong practices in loan underwriting and administration. These results also suggest a trade-off between growth and financial performance that appears to define the opportunity set facing many community banks.

The high credit losses and elevated failure rates experienced by CRE and C&D lenders during the two banking crises covered by the study period point to an important policy issue for future research. This study documents the considerable costs associated with credit losses and bank failures among the CRE specialist group. Clearly, concentrations in these loan types—particularly in the C&D category—can represent a significant risk during real estate market downturns. What this study does not document are the social benefits that arise from commercial real estate financing by community banks. In many respects, CRE lending exemplifies the type of local knowledge and local decision-making at which community banks excel. Not only is construction activity essential to economic activity and the quality of life in local communities, but community banks are very important providers of credit to the construction industry. Future research should further explore the appropriate policy balance between the social benefits and social costs of CRE lending by community banks.

The Implications of Community Bank Capital Strategies

The ability of any bank to consistently meet the credit needs of its borrowers over time depends on maintaining a solid base of equity capital. By standard measures, community banks reported higher capital ratios than noncommunity banks across the study period, and they mostly maintained this level of capitalization through internally generated sources of capital. Community banks reporting positive earnings set aside 57 percent of their net income as retained earnings during the study period. Retained earnings accounted for 48 percent of all additions to equity capital from internal and external sources—percentages that were in both cases substantially higher than for noncommunity banks. Retained earnings for community banks were at their highest as a percent of prior-period equity between the early 1990s and the mid-2000s—precisely the periods when their pretax ROA was also at its highest levels. In periods where earnings have faltered, retained earnings have declined sharply or become negative, requiring more community banks to raise capital from external sources.

Relatively few community banks were found to raise capital frequently from external sources during the study period. Of community banks operating in 2011, 42 percent had never raised external capital after their first year of operation, 40 percent had done so occasionally, and 19 percent had done so frequently, or more than once in five years on average.[6] The overall frequency of external capital raising by community banks rose after 2000, as TruPS became, for a time, more common on the balance sheets of bank holding companies. With the financial crisis that began in 2007, both community and noncommunity banks

[6] Based on the lifetime frequency of community banks not in their first year of operation raising capital from external sources between 1984 and 2011. The reported figures add up to 101 percent due to rounding.

initially experienced large financial losses that temporarily reduced their capital ratios and diminished their ability to generate new capital through retained earnings. As a result, both groups of institutions expanded the frequency and volume of their capital raising from external sources. However, in every year of the study period, noncommunity banks raised external capital more frequently than community banks, and also made use of TruPS and the Troubled Asset Relief Program more frequently than community banks. By 2011, however, as earnings and capital ratios recovered from the crisis, both community and noncommunity banks began to return to a more normal mix of additions to capital through internal and external sources.

While community banks were found to rely less on external capital and more on retained earnings than noncommunity banks, the study showed that many community banks were able to access external sources of capital when needed. In many cases, they did so in response to financial difficulties or a desire to grow. One-third of the capital raises carried out by community banks during the study period were undertaken by "troubled" institutions, or those that had been rated 3, 4 or 5 within the past two years. During non-crisis periods, up to half of all capital raises undertaken by community banks were found to immediately precede an acquisition or a period of significant growth.

Taken together, these trends suggest a community banking sector that can generate most of the capital it needs through retained earnings. However, two important caveats to this conclusion are in order. First, the ability to generate capital internally depends on a healthy level of earnings. In periods where earnings have faltered, retained earnings have declined sharply or become negative, requiring more community banks to raise capital from external sources. Second, retained earnings can only be a sufficient source of capital if the asset base of the institution is not growing more rapidly than its earnings. Chapter 5 demonstrates how hundreds of community banks in relatively stable, high-performing lending specialties in 2000 pursued growth-oriented strategies centered on C&D and CRE lending that ultimately underperformed for many of them. Community banks with TruPS at the holding company level were almost twice as likely to undertake such a shift in strategy as those that did not use TruPS. The experience of community banks during the study period appears to indicate that maintaining a stable balance between growth and earnings has been the surest path to long-term viability.

Topics for Future Research

The detailed analysis of banking industry data in this study provides a basis for further research of community banking issues. The study points to the considerable costs associated with credit losses and bank failures among CRE specialists. Clearly, concentrations in CRE, and especially C&D lending, can represent significant risk during real estate market downturns. However, construction activity is essential to the economic activity in local communities. Further research should explore the appropriate policy balance between the social benefits and the social costs of CRE lending by community banks. The study tried to examine how regulatory costs for community banks have changed. Measuring the effect of regulation remains an important question that presents substantial challenges. The competitive effects of chartering policies, and the benefits and risks of chartering activity during boom periods, also warrant further study. Finally, as new technology continues to transform the financial sector, more research will be needed on the future implications for the community banking sector.