Community Banks and the Federal Reserve

By Thomas M. Hoenig

Thank you for inviting me to participate in this conference on "Whither the Community Bank?" I applaud the Federal Reserve Bank of Chicago for sponsoring a conference on this important topic. Coming from a Federal Reserve District that is well-served by scores of community banks, I appreciate the opportunity to give my perspective on the role these banks play in key sectors of the economy and in the Federal Reserve's mission. While I was unable to be here for the discussion yesterday, I was pleased to see from the program that you are tackling some critical issues with respect to community banking, and I look forward to an informative discussion today.

My plan this morning is to talk first about the role community banks play in the U.S. economy. Then, I will turn to a more detailed discussion of how they relate to each of the Federal Reserve's three missions—monetary policy, banking supervision and regulation, and the payments system. My central theme is that while community banks hold only a small share of the nation's banking assets, they provide important financial services to some key sectors of the economy. Their importance in the economy, in turn, supports the Federal Reserve's

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interest in and oversight of community banks. In fact, community banks play significant, though perhaps not equal, roles in each of the Federal Reserve's three missions. Thus, the Federal Reserve has a strong interest in understanding issues facing community banks and in helping to make possible their continued participation in the nation's financial and payments systems.

Role of community banks in the U.S. economy

Let me begin with a discussion of the current role of and future prospects for community banks in the U.S. economy. My discussion is based, in part, on a study prepared by staff at the Federal Reserve Bank of Kansas City. This study contains the details and the data that support much of what I plan to say. But rather than repeat that for you now, I will instead refer you to the study itself, which also appears in this issue of *Economic Review.*

Current role of community banks. Looking at how community banks contribute to the economy today, I would say they provide important financial services to some key sectors of the economy—services for which there are few, if any, substitutes. While they account for a relatively small share of total banking activity in the United States, they remain highly important in some types of communities and in some parts of the country. Community banks are especially important in rural communities, accounting for 58 percent of all banking offices in rural locations and 49 percent of deposits. Although they account for a much smaller share of urban banking activity, community banks also play an important role in smaller metro areas. In metro areas with less than 1 million people, for example, community banks operate 31 percent of all banking offices and control 23 percent of all deposits.

Community banks also are more important in some Federal Reserve Districts than others. While community banks account for about a third of all banking offices in the nation as a whole, they account for half or more of all banking offices in three Federal Reserve Districts—St. Louis, Minneapolis, and Kansas City. In each of these districts, community banks also control more than 40 percent of deposits. One reason community banks are more important in these districts is that a higher percent of their population live in rural areas and small urban areas than

in the nation as a whole. But demographics are not the only reason. Another factor contributing to the proliferation of community banks in these districts was the regulatory environment that, until relatively recently, restricted interstate banking in the Midwest and thereby limited the size of banks in that part of the country.

Besides providing banking services in rural areas, smaller cities, and in the middle of the country, community banks also specialize in "relationship banking." They base decisions on personal knowledge of customers' creditworthiness and a keen understanding of business conditions in the communities they serve. This market niche is arguably not a focal point for large banking organizations that have come to rely heavily on hard financial information, computer models, and centralized decision-making as the basis of conducting business. Three types of customers depend heavily on the "relationship-banking" model that community banks provide—small businesses, farmers, and depositors with low to moderate wealth.

Community banks' role as small business lenders is important because small businesses account for a significant share of national output and employment. In addition, many small businesses are young and tend to grow rapidly, creating scores of net new jobs in the process. For these businesses, community banks have worked to create a comparative advantage for themselves as a source of credit. Their loan officers can take into account a variety of factors in reviewing loan applications, including the character of the borrower and special features of the local market. And because community bankers maintain close, long-term relationships with their borrowers, they can carefully monitor the borrower throughout the term of the loan.

With this approach as their operating model, it is not surprising that community banks make more than their share of small business loans. By one measure, community banks accounted for 33 percent of small business loans—much larger than their share of deposits (19 percent) or their share of assets (15 percent). Furthermore, for very small business loans (those under $100,000), the share of community banks was even higher, 36 percent.

Community banks also provide more than their share of credit to farmers. This is not surprising given the importance of community banks in rural areas and the fact that one in four rural communities depends heavily on farming for employment and income. Of the total

amount of bank loans to farmers in June 2002, community banks provided 65 percent of farm real estate loans and 61 percent of all farm operating loans. The share of community banks is especially high for small farm loans, exceeding 80 percent for farm loans under $100,000.

The relationship-based services that community banks provide are not only important to small borrowers but also to many depositors. In particular, depositors of low to moderate wealth are perhaps more likely to receive personal service from a community bank than they are from a large banking organization. One possible reason for this is that small banks are more heavily dependent on retail deposits for their funds than large banks. Another reason is that large banks tend to specialize in less personal, transactions-based deposit services where they have a comparative advantage over community banks because of their size and access to technology.

In short, community banks are an important provider of services in those areas where relationship-based banking is important—whether it's small business lending, farm lending, or holding retail deposits for customers who place a premium on personal service.

Outlook for community banks. What about the future though? Will community banks continue to play an important role in the banking system as technology and market conditions change? My view is that they will. Although the number of community banks will continue to decline, they will remain an important provider of financial services for the foreseeable future. They will continue to number in the thousands.

One reason to believe that community banks will remain viable is that, as a group, they continue to perform well by standard performance measures such as rate of growth, rate of entry, and profitability. To be sure, profitability has declined in recent years at very small banks, but at least some of that decline appears due to the concentration of these banks in declining rural areas. Put another way, the decline in profitability at very small banks since the mid-1990s may say more about the local economies in which they operate than the viability of community banking as a business model. Thus, while the number of very small community banks may dwindle, the recent record suggests that community banks located in more prosperous areas should thrive.

What about the challenge from advances in information and communications technology? Is technological change reducing the comparative advantage of community banks in providing relationship-

based services? Can the increased availability of financial data, the growing use of credit-scoring models, the securitization of small business loans, and the proliferation of online banking threaten the future of community banks?

My view is that even in the face of advancing technology, community banks will retain important advantages. For example, given the high rate of new business formation, there will always be some businesses that have worthwhile investment projects but cannot pass a credit-scoring test. Many businesses are simply too new to have established credit histories, and many new business owners have too few personal assets to offer as collateral.

In other areas, such as online banking, technological advances require substantial investments, and small banks have tended to lag behind their larger counterparts. Nevertheless, a good case can be made that community banks will be able to catch up over time and compete effectively for online customers. Community banks may be able to learn from the mistakes of larger banks. They may be able to compensate for their inability to make large-scale technology investments by partially outsourcing their data processing. They may be able to provide a greater choice of financial services online while continuing to provide person-to-person service through brick-and-mortar offices. And, they may be able to find innovative ways to work together to achieve greater economies of scale.

Looking to the future, then, my view is that community banks will continue to have an important role to play in providing relationship-oriented services. Community banks that are well-managed, equipped with appropriate technologies, and located in viable communities should be able to hold their own against other financial services providers.

Role of community banks in the Federal Reserve's mission

Let me turn now to the second part of my presentation—the role of community banks in the Federal Reserve's mission. When Congress designed the Federal Reserve as a decentralized system, the intention was to give it a broad perspective on economic activity in all parts of the nation. Today, as in the past, this regional perspective helps the Federal Reserve carry out its mission. Because community banks play key roles in some regions and in some sectors of the economy, they are a part of

the Federal Reserve's broad perspective. Their activities provide insight regarding the state of the economy and this insight contributes to the Federal Reserve's overarching mission of maintaining macroeconomic and financial stability.

To be more concrete, I would suggest that community banks play a role in each of the Federal Reserve's three missions—monetary policy, banking supervision and regulation, and the payments system. The importance of community banks varies across these missions, as does the nature of community banks' interaction with the Federal Reserve in these areas. But in all cases, community banks play a role.

Monetary policy. In the area of monetary policy, community banks—like all banks—help transmit policy actions to the economy. One channel through which monetary policy works is the capital markets—tighter monetary policy raises interest rates, making it more expensive for businesses to finance new spending by selling bonds or issuing commercial paper. But monetary policy also can affect spending through the banking system. When the Federal Reserve boosts short-term interest rates by raising the federal funds rate, banks find it harder to attract deposits, their main source of funds for making loans. Moreover, when market interest rates go up, banks find it more expensive to borrow nondeposit funds on the capital markets, thereby reducing their incentive to make loans. Banks typically respond by tightening their credit standards or raising their loan rates, causing many businesses to scale back operations.

Community banks potentially play a special role in this process because of their importance as a source of credit to small businesses. Because small firms have less direct access than large firms to capital markets, they are more likely to cut spending when bank loans become more difficult or expensive to obtain. Consistent with this view, some empirical evidence suggests that small businesses bear the brunt of monetary policy, accounting for a disproportionate share of the decline in economic activity following a tightening of policy.

A second reason community banks play a special role in the transmission of monetary policy is that changes in monetary policy tend to have a much bigger impact on their lending than on the lending of large banks. This tendency has been confirmed by careful empirical studies of the response of bank lending to changes in monetary policy.

The most likely explanation is that small banks are more dependent than large banks on deposits as their source of funds for making loans. When tighter monetary policy raises market rates and makes it harder for banks to attract deposits, small banks cannot so easily make up the shortfall of funds by borrowing on the capital markets—either they cannot borrow at all, or they must borrow at high rates because investors lack information about small banks' financial condition.

It is important to emphasize that community banks would play a special role in the transmission process even if they found new ways to access nondeposit funds. Moreover, I support community banks' efforts to address their funding problems, assuming they remain mindful of possible "moral hazard" issues and they manage any related increase in risk. But even if community banks do become less dependent on deposits, monetary policy will still influence their lending to small businesses through changes in the cost of funds and the supply of deposits. As a result, it is essential for the Federal Reserve to continue monitoring the health of community banks and their lending and funding practices.

Banking supervision and regulation. In the area of banking supervision and regulation, the Federal Reserve is charged by Congress with the responsibility of supervising state chartered banks that have joined the Federal Reserve System and bank holding companies that control banks, regardless of charter type. Nationwide, the Federal Reserve directly supervises about 800 community banks that are state members. This is a relatively modest proportion of the nation's community banks (about 11 percent), and these banks control a relatively modest proportion of community bank assets (about 14 percent). In contrast, the Federal Reserve's role in supervising bank holding companies that control community banks is far more extensive. Currently, for example, the Federal Reserve Bank of Kansas City supervises approximately 870 bank holding companies controlling almost 1,000 community banks.

The purpose of the Federal Reserve's supervision of banks is to ensure safety and soundness of the nation's banking and financial system, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions. With respect to community banks, effective supervision helps ensure a reliable source of credit and other financial services to the regions and sectors of the economy that rely heavily on community banks. This is important because the failure

of such banks can have a highly adverse impact on economic activity in rural areas or smaller towns and, to a lesser extent, in urban areas dependent on them for credit and other financial services. In addition, reliable supervision of community banks enhances public confidence in the safety and soundness of the entire banking system.

But along with this mission, supervision and regulation also provides a "window" into the functioning of the banking sector—including community banks. Direct supervision and on-site inspections provide insight not only on emerging trends in community bank performance—often long before they appear in aggregate statistics—but also on challenges facing community bankers, such as declining markets, shifting demographics, technological change, and competitive pressures from other financial institutions. Moreover, by understanding the health and viability of community banks and their prospects for the future, the Federal Reserve gains insight regarding key sectors of the economy that are financed by community banks. Discussions with bankers and the review of specific loans to businesses and consumers provide valuable information about changing business and economic conditions.

Payments system. In addition to their importance in the Federal Reserve's monetary policy and banking supervision functions, community banks also play a critical role in the U.S. payments system. They are the principal means through which many consumers and businesses access the payments system and, in some parts of the country, the only financial institution providing direct access. Three overriding public policy objectives guide the Federal Reserve's involvement in the payments system—accessibility, efficiency, and safety.

For community banks and their customers, access is a particularly important issue. Community banks hold 21 percent of the nation's deposit accounts. These accounts are accessed through checks, ATM machines owned or operated by community banks, and ACH and Fedwire transactions. In addition, many community banks offer credit and debit cards as additional payments products.

To provide these payments services, community banks must have access to the various payments networks and mechanisms that constitute the nation's "payments system." Some community bankers are concerned that accessing these networks and mechanisms is becoming more difficult. While it's hard to document that community banks are being denied

access to the payments system, there may be some basis for the view that access is becoming relatively more expensive for some smaller banks. EFT network switch fees, for example, are often based on volume.

The Federal Reserve's second public policy objective in the payments area is efficiency. Through their presence in smaller communities and remote areas, community banks are instrumental in helping provide near-universal access to the payments system. But their small size and remoteness might make the overall payments system less efficient. Community banks, at least in some instances, would appear to point up a potential tradeoff between accessibility and efficiency.

In evaluating efficiency, though, it is important to distinguish between efficiency at the individual bank level and at the industry level. Individual community banks can be efficient, providing payments services at the lowest possible cost given technological and distance constraints. But the payments system as a whole could potentially be more efficient—that is, the overall cost of making payments could be lower—if there were fewer banks operating on a larger scale in less remote locations.

Whether community banks as a group are less efficient than large banks in providing payments services is unclear. Generally speaking, community banks are unable to take advantage of large economies of scale in processing, and they often face high transportation costs because of their remoteness. But outsourcing of backroom processing and the ongoing shift from paper to electronics are presumably mitigating factors. In addition, there may be other aspects of a community bank's business environment—for example, tight budgets forcing "better" technology choices—that boost community banks' payments efficiency.

The third public policy objective of the Federal Reserve in the payments system is safety. Because community banks are not major participants in large-dollar wholesale payments systems (Fedwire and CHIPS), they pose little or no systemic risk to the overall financial system. Nevertheless, community banks are subject to a number of risks at the firm level, including fraud risk and operational risk. Indeed, as they increasingly outsource to third-party vendors, including offering new Internet-related options to their customers, community banks' exposure to such risks may become greater than in the past. The Federal Reserve, in its supervisory role, can assist community banks in assessing

such risks. New payments vehicles and channels, and the often complex relationships among the parties involved in transactions processing, are among the areas Federal Reserve examiners consider when evaluating community banks.

Conclusions

It is clear that community banks play an important role in the financial system of the U.S. economy and in the Federal Reserve's mission. In the financial system, they complement the role of large banks by specializing in relationship banking and providing credit to small businesses—a sector that receives less focus from large banks. In addition, community banks serve customers in rural areas and small metropolitan and some urban areas that are not as readily served by large banks. Although the number of community banks will continue to decline because of merger activity, they will continue to play an important role for the foreseeable future.

Community banks also play important—though perhaps not equal—roles in each of the Federal Reserve's three missions. They are one of the channels through which monetary policy actions influence the economy. Many of them are supervised by the Federal Reserve, and through that supervision, they provide a window on economic activity in important sectors and areas of the economy. Finally, in the payments area, they provide access to payments services for a large percentage of the population. While community banks pose little systemic risk to the nation's financial system or payments networks, they do face firm-level risk that impacts local communities and that warrants Federal Reserve oversight. For these reasons, the Federal Reserve has a strong interest in understanding issues facing community banks and ensuring their continued participation in the nation's financial and payments systems.