

Community Banks' Ongoing Role in the U.S. Economy

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Ongoing consolidation in the banking industry has raised questions about the future of community banks. Over the past several decades, the number of community banks in the United States has steadily declined. At the same time, community banks' share of U.S. banking assets has fallen considerably as the country's largest banks have increased their dominance, aided by wide geographic coverage and economies of scale. In addition to competitive pressures from larger banking organizations, community banks face growing challenges from broader economic consolidation, changing demographics, and rapidly advancing financial technologies.

Despite their declining market share, community banks remain crucial providers of credit and financial services in the United States. Community banks are the predominant providers of banking services in rural communities across the country and play a vital role in sustaining their local economies. In particular, community banks are outsized providers of credit to agricultural and commercial borrowers, including during periods of economic stress—as demonstrated by the relative stability of small banks' business lending during the global financial crisis (GFC), and the significant role they played in intermediating emergency relief funds during the COVID-19 pandemic.

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In this article, we explore the role of community banks in our nation's economy and the challenges they face. We argue that community banks remain critical providers of financial services despite industry consolidation, and that they will continue to play an important role in their local communities and the broader economy in the future.

Section I provides a historical overview of structural changes in the banking industry and describes the factors that have driven community bank consolidation. Section II describes the markets and sectors in which community banks play the most critical role. Section III explores challenges to the community banking model and opportunities presented by technological changes.

I. Banking Industry Overview

Although community banks have no universal definition, they are often described by two characteristics: their small size and their focus on the communities in which they are located (see the box for a more detailed description of the community bank business model). Because these two characteristics tend to go together—and because size is easy to measure—community banks are commonly defined as those with assets below a certain threshold. Consistent with this approach, we define a community bank as a commercial bank with less than \$10 billion in total assets. Conversely, we define a noncommunity bank as a commercial bank with \$10 billion or more in total assets.¹

Consolidation of community banks

The U.S. banking landscape has changed significantly over the past four decades. From 1984 to 2020, the total number of commercial banks declined by almost 70 percent—from 14,376 to 4,404. Much of this decline occurred over the past 20 years (2000–20), when the total number of commercial banks declined by almost 50 percent. Table 1 shows that over this 20-year time frame, the total number of community banks decreased from just over 8,300 to 4,277. As of June 2020, 4,277 community banks and 127 noncommunity banks were operating in the United States.

This decline in the overall number of banks has coincided with an increased concentration of banking assets among the largest banking organizations. Although community banks still account for

Box

Community Bank Business Model

The community bank business model is generally based on taking deposits from the community in which the bank is located and lending those funds to support the bank's local economy. Although these core activities may describe commercial banking more broadly, larger banks typically serve broader regions and generate a greater portion of their income from noninterest sources. Because community banks generally rely more heavily on interest income as their primary source of revenue, they are more susceptible to earnings pressure during periods of low interest rates. Community banks have generally earned lower rates of return than larger banks over the past 20 years; however, their greater reliance on more traditional banking services and local focus have also contributed to lower earnings volatility. (See the appendix for additional detail on community bank and noncommunity bank financial performance.)

Community banks have traditionally been known as "relationship bankers." By establishing longer-term relationships with customers, community banks can obtain information not readily available through more standardized means, providing them advantages in lending to small or newly formed businesses that may lack extensive credit history. Community banks have also proven to be reliable providers of credit during times of economic stress, as evidenced by the relative stability of small bank business lending during the GFC and the key role that community banks played in providing emergency relief funds during the COVID-19 pandemic under the Small Business Administration's Paycheck Protection Program.

Table 1

Share of Community Banks and Noncommunity Banks
in Total U.S. Banking Activity

Category	Characteristic	Community bank share			Noncommunity bank share		
		2000	2010	2020	2000	2010	2020
Banks	Number of banks	8,315	6,530	4,277	99	94	127
	Percent of total banks	98.8	98.6	97.1	1.2	1.4	2.9
Assets	Amount (in trillions)	\$2.391	\$2.475	\$2.656	\$6.051	\$11.236	\$17.015
	Percent of total assets	28.3	18.1	13.5	71.7	81.9	86.5
Deposits	Amount (in trillions)	\$1.848	\$1.996	\$2.194	\$3.762	\$7.468	\$13.580
	Percent of total deposits	32.9	21.1	13.9	67.1	78.9	86.1
Loans	Amount (in trillions)	\$1.517	\$1.629	\$1.817	\$3.700	\$5.959	\$8.401
	Percent of total loans	29.1	21.5	17.8	70.9	78.5	82.2
Total offices	Number of offices	39,011	39,435	31,352	32,119	48,228	47,974
	Percent of total offices	54.8	45.0	39.5	45.2	55.0	60.5
Rural offices	Number of offices	14,158	14,164	12,062	3,549	4,825	4,728
	Percent of rural offices	80.0	74.6	71.8	20.0	25.4	28.2
	Percent of rural deposits	75.4	71.9	65.9	24.6	28.1	34.1
Urban offices	Number of offices	24,853	25,271	19,290	28,570	43,403	43,246
	Percent of urban offices	46.5	36.8	30.8	53.5	63.2	69.2
	Percent of urban deposits	33.3	20.4	11.6	66.7	79.6	88.4

Note: "Rural" is defined as all areas not within a metropolitan statistical area (MSA), as established by the U.S. Office of Management and Budget. "Urban" is defined as all areas within an MSA.
Sources: Federal Financial Institutions Examination Council (FFIEC) and FDIC.

a large share of the overall bank population, they account for a much smaller and declining share of total banking activity. Since 2000, community banks' share of branches, deposits, and assets have fallen considerably. Today, community banks represent 97 percent of all bank charters but account for only 40 percent of bank branches, 14 percent of bank deposits, 18 percent of bank loans, and just over 13 percent of bank assets.

Community banks themselves have also changed due to consolidation, as shown in Table 2. In 2000, almost half of all community banks had assets under \$100 million; today, that share has fallen to around 21 percent. Although just 12 percent of community banks have assets between \$1 billion and \$5 billion, these banks account for 35 percent of all community bank branches and 40 percent of community bank assets.

Table 2
Distribution of Community Banks by Size of Organization

Size group	Number of banks	Percent of all community banks	Number of branches	Percent of all community bank branches	Assets (in billions)	Percent of all community bank assets
2000						
< \$100 million	3,950	47.5	6,659	17.1	\$210	8.8
\$100 million to \$500 million	3,528	42.4	15,383	39.4	\$754	31.5
\$500 million to \$1 billion	450	5.4	4,848	12.4	\$316	13.2
\$1 billion to \$5 billion	325	3.9	8,369	21.5	\$661	27.7
\$5 billion to \$10 billion	62	0.7	3,752	9.6	\$450	18.8
All community banks	8,315	100.0	39,011	100.0	\$2,391	100.0
2021						
< \$100 million	886	20.7	1,491	4.8	\$53	2.0
\$100 million to \$500 million	2,171	50.8	9,051	28.9	\$532	20.0
\$500 million to \$1 billion	605	14.1	5,203	16.6	\$419	15.8
\$1 billion to \$5 billion	532	12.4	10,973	35.0	\$1,061	39.9
\$5 billion to \$10 billion	83	1.9	4,634	14.8	\$591	22.3
All community banks	4,277	100.0	31,352	100.0	\$2,656	100.0

Sources: FFIEC and FDIC.

Reasons for community bank consolidation

Multiple factors have driven the decline in the number of community banks, including intracompany charter consolidation due to geographic deregulation, mergers and acquisitions to achieve economies of scale, bank failures, a decline in new bank entrants (de novo banks), and asset growth to a noncommunity bank size.

Geographic deregulation. Historically, bank expansion activities were limited by federal and state laws that placed geographic restrictions on intrastate (within state) branching and interstate (between states) banking and branching.² In the early 1980s, states began to relax intrastate branching and interstate banking laws; however, most states maintained restrictions on *interstate* branching. In addition, most states initially maintained restrictions on intrastate de novo branching, so banks seeking to expand within the same state were limited to purchasing existing banks or their branches. Only toward the latter part of the 1980s did states begin to permit de novo branching statewide.

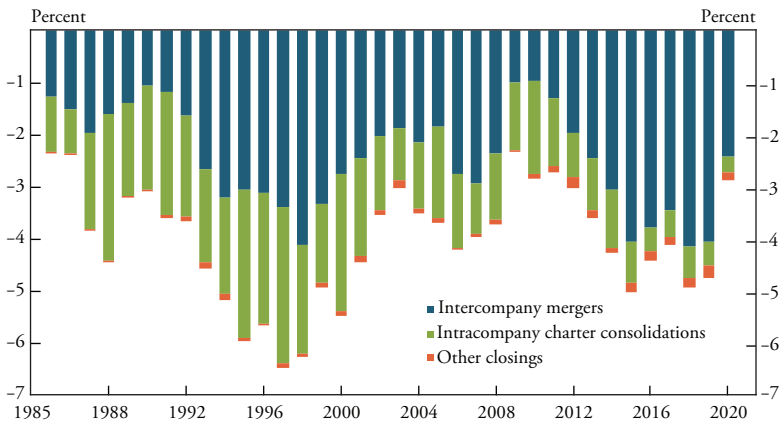
The liberalization of state laws contributed significantly to consolidation in the industry.³ Chart 1 shows that slightly over half of unassisted community bank mergers from 1985 to 1993 involved intracompany consolidation of charters, attributable to the relaxation of intrastate branching laws. One-state holding companies that previously had to maintain separate charters for acquired banks or branches—termed “multibank” holding companies (MBHCs)—consolidated operations, converting separate charters into branches under a one-bank holding company structure.

However, state deregulation of interstate banking encouraged the MBHC structure for out-of-state bank companies. Because interstate branching was still restricted during this period, bank companies formed MBHCs to expand across state lines. Increased competition from nonbanks and a depressed economy in the early 1980s and early 1990s drove weaker institutions to exit the industry, while the loosening of geographic restrictions provided stronger institutions the opportunity to expand their future earnings stream through acquisitions. The share of total U.S. banking assets held by interstate bank holding companies increased from 56.8 percent in 1988 to 88.5 percent in 1993 (McLaughlin 1995).⁴

A significant period of industry consolidation followed the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act (IBBEA) of 1994, which eliminated federal restrictions on interstate banking and branching.⁵ The IBBEA gave multistate MBHCs the ability to consolidate operations, leading to a second wave of restructuring in which separate charters were converted to a branch network under one bank holding company.

This attrition largely reflects the unwinding of an artificially high number of charters. Many of the mergers that occurred after the IBBEA were simply corporate reorganizations to create a more efficient and cost-effective structure once state and federal geographic restrictions on expansion were removed (Backup and Brown 2014). Although the number of charters declined, the number of branches accelerated as separate bank charters were converted to branches and *de novo* branches were established. From 1994 to 2005, the number of out-of-state branches grew from 62 to nearly 25,000. *De novo* out-of-state branches accounted for 39 percent of all new commercial bank branches during this same period (Johnson and Rice 2007).

Chart 1
Annual Rate of Unassisted Community Bank Attrition: 1985–2020



Notes: The attrition rate is calculated using prior year-end charters. Intracompany charter consolidations are institutions that were of common ownership four quarters prior to the date the institution ceased filing Call Reports. Other closings include institutions involved in other liquidations or closings or institutions that stopped reporting for any unexplained reason. Unassisted attrition includes mergers between unaffiliated institutions (intercompany mergers), consolidation of charters within the same holding company (intracompany mergers), liquidations not involving an acquisition, and institutions relinquishing FDIC insurance.
Sources: FDIC and authors' calculations.

Achieving economies of scale. The restructuring and consolidation that occurred during the 1980s and 1990s resulted in a more efficient banking system and encouraged the growth of larger, more geographically diversified banking companies. A large volume of research has been dedicated to assessing the economies of scale that can be recognized through mergers, particularly for the smallest banks. Acquisitions allow organizations to spread costs across a larger asset base, recognize synergies within business lines, reduce staff, and consolidate branches in overlapping markets. Banking organizations may also find that acquiring banks is more cost-effective than de novo branching to expand their geographic footprint in a new market. This geographic diversification may reduce risk by limiting an organization's exposure to downturns in local markets or specific sectors (Emmons, Gilbert, and Yeager 2001).

Anecdotal evidence supports the notion of cost savings as a key driver of acquisitions, as acquiring banks often cite cost savings in deal announcements. More recently, smaller banks have cited the costs of implementing complex regulations following the GFC as a motive for mergers. Thus, while deregulation was central to significant merger activity in the 1980s and 1990s, regulatory burden has been influential

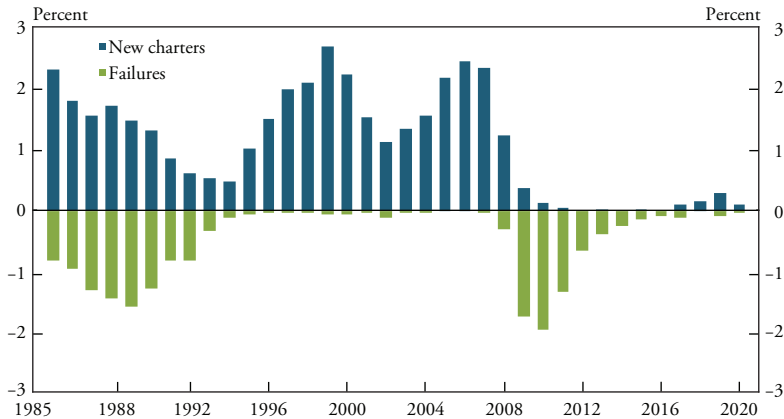
in banks' decisions to exit the industry or acquire other institutions since the GFC. Research has generally found that the smallest institutions can exploit scale economies, with cost benefits declining with size. Several studies have suggested scale economies can be achieved for banks with as little as \$100 million in assets, with most efficiency gains exploited by banks with \$500 million in assets, though this range can vary depending on lending specialization (Jacewitz and Kupiec 2012; Regehr and Sengupta 2016).

Mergers to achieve economies of scale may also benefit bank revenue through more diverse product offerings or a broader client base that provide additional cross-selling opportunities. For example, acquiring competitors within the same geographic area allows banks to increase market power and enhance revenue.⁶ Another more recent trend has been to acquire institutions with a stable, low-cost deposit base to fund asset growth. Empirical evidence from recent merger activity supports this motivation. Acquirers have paid a higher premium for banks with a higher ratio of core deposits to assets, and acquired banks tend to report higher deposit shares than nonacquired banks (Cyree 2010; Kowalik and others 2015). Since the GFC, banks acquired in mergers have been generally less profitable and less efficient than nonacquired banks. Thus, mergers may facilitate a transfer of assets from less efficient institutions to more efficient institutions that can realize the benefits of scale.

Bank failures. In addition to mergers and growth, bank failures have also decreased the number of community banks. Indeed, failures have accounted for nearly 20 percent of net community bank charter attrition since 1985. The green bars in Chart 2 show that the vast majority of these failures occurred during the 1980s and early 1990s, with a second spike during the GFC. Banks failed at an average rate of 1.1 percent from 1985 to 1993 and 1.2 percent from 2008 to 2013.⁷ However, bank failures have contributed less to the decline in community banks than voluntary consolidations. Moreover, many of the reforms introduced after the GFC were designed to improve the resiliency of banks and reduce the likelihood of failure. As a result, we expect bank failures to play a diminishing role in bank consolidation going forward.

Lack of new entry since the GFC. Much discussion so far has been dedicated to the underlying circumstances driving community bank exits, whether through mergers or failures; however, the lack of new

Chart 2

Annual Rate of Community Bank Failures and New Charters:
1985–2020

Note: New charter formation and bank failures are shown as a percent of prior year-end charters.
Sources: FDIC and authors' calculations.

entrants to the community banking sector has played a growing role in consolidation in the last decade. New entrants may be the result of charter conversion (such as a credit union or savings bank converting to a commercial bank) or charter formation (that is, *de novo* entry). Thus far, charter conversions have had a minimal effect on the number of institutions. However, a decline in new charters, or *de novo* banks, has had a greater effect on the structure of the commercial banking industry. The blue bars in Chart 2 show the annual rate of new charters since 1985. According to statistics from the Federal Deposit Insurance Corporation (FDIC), the average rate of new entry was 1.6 percent from 1985 to 2007. Following the GFC, the average rate of new entry dropped to 0.1 percent from 2010 through 2020. With fewer new charters to offset bank mergers and failures, consolidation trends accelerated following the GFC. New charter formation tends to be cyclical, accelerating during periods of economic expansion and slowing during recessions. However, fewer new charters have formed since the GFC than during prior expansionary periods.

Research has suggested regulatory burden has inhibited new bank formation since the GFC, as new bank entry was more prevalent during periods with fewer regulatory restrictions (Ash, Koch, and Siems

2015; Sablik 2016). One way regulations can deter de novo entry is by increasing the requirements or lengthening the process for establishing a bank. The FDIC imposes certain conditions for an institution to be granted deposit insurance, which include minimum initial and ongoing capital requirements for a certain period of time. The FDIC sets a minimum capital requirement after considering each applicant's unique business model, among other factors. At a minimum, the FDIC expects applicants to have sufficient initial capital to achieve a Tier 1 leverage ratio of not less than 8 percent during the first three years of operation. However, the initial dollar amount of capital required to form a bank has increased significantly since the GFC, a trend that may be due to new banks targeting a larger asset size to achieve economies of scale (FDIC 2020a). Furthermore, in 2009, the FDIC extended the period during which a new bank was subject to higher capital requirements and more frequent examinations from three years to seven.

While these changes may have deterred new bank formation, the FDIC's actions may have also prevented bank failures and helped stabilize the banking system. The FDIC indicated de novo bank failures during 2008 and 2009 often occurred during the fourth through seventh years of operation, and Lee and Yom (2016) find that de novo banks formed prior to the GFC were twice as likely to fail.⁸ Under the auspices of an improving economy and more stable banking industry due to post-crisis reforms, the FDIC subsequently rescinded its heightened 2009 requirements in 2016. As a result, new banks are once again subject to heightened requirements only during the first three years of operation.

The FDIC also published a handbook in 2017 to aid applicants in applying for deposit insurance and established a draft proposal review process in 2018 enabling prospective organizers to obtain preliminary feedback prior to filing a formal application. While the industry has welcomed these changes, the initial and ongoing capital requirements may still present a hurdle to significant new charter activity. Likewise, other regulations enacted following the crisis may be burdensome for newly established banks. The volume and complexity of regulations require specialized expertise that can be costly and challenging to find for those seeking to form a new bank. Recent de novo banks, however, have generally outsourced compliance functions to limit costs.

Although regulatory burden has likely played a role in declining de novo formation, recent research has pointed to the weak economy following the GFC and low profitability as overriding factors. For example, Adams and Gramlich (2014) have attributed as much as 80 percent of the decline in new bank entry to the low interest rate environment, coupled with weak demand for banking services. Low interest rates have compressed bank margins with an outsized effect on small banks, as net interest income is typically their main source of revenue. Most new entrants are smaller, with an average asset size under \$100 million. Nearly half of the de novo banks formed since 2010 were opened in 2018–19. This rapid increase in 2018–19 appears consistent with the theory that profitability is a factor in the decision to open a bank, as a stronger economy, increasing interest rates, and corporate tax cuts may have increased investor interest in establishing de novo institutions.

However, other recent evidence suggests a favorable rate environment is becoming less important to the short-term profitability of a de novo bank. Recently established de novo banks have achieved profitability more quickly than previous de novo classes despite a low interest rate environment during the last decade.⁹ Technological advancements have enabled de novo banks to reach customers with a smaller physical footprint and lower headcount, enabling them to use the operational savings to invest in digital offerings and growth.

Growing out of the community banking asset size. A decline in the number of community banking organizations can occur when community banks outgrow their community bank status (as defined by asset size), either organically or through acquisitions. However, very few community banks have grown into a noncommunity bank size, suggesting this has been only a minor factor in the sector's consolidation over the past four decades. Most community banks are acquired by other community banks, resulting in fewer—but larger—community banks. The percentage of all mergers that occur between community banks has risen over time, accounting for more than two-thirds of all mergers since the GFC (FDIC 2020a). For banks in the smallest asset class (under \$100 million), growth into a larger community bank asset class has accounted for 20 percent of the attrition in this size category. According to the FDIC, over 2,700 institutions with less than \$100 million in assets in 1985 had grown into a larger size category by 2013, but only 12 had grown into the asset class of \$10 billion or more (Backup and Brown

2014). Accordingly, many small banks that have grown into larger asset classes remain community banks. Furthermore, the percentage of institutions with less than \$100 million in assets in 1985 that were still operating in 2013 was greater than that of any other size group, indicative of the overall stability of the community banking sector.

II. Importance of Community Banks

Despite industry consolidation and declining market share, community banks remain important providers of financial services in the United States. Community banks play a particularly significant role in providing banking services to rural communities across the country. They are also a major supplier of credit to agricultural producers and businesses, including during times of economic stress when the need for credit is most acute.

Geographic significance of community banks

Community banks have historically been the predominant providers of banking services in rural communities in the United States, and this remains true today. Table 3 shows that community bank branches represented over 71 percent of all bank branches in rural areas and held nearly two-thirds of rural deposits as of June 30, 2020. In addition, in one-quarter of counties across the United States, community banks represent the only commercial bank presence.¹⁰

Community banks account for more than half of bank branches in 22 U.S. states. Table 4 shows the prevalence of community banks by state as of June 30, 2020. Community banks are particularly significant financial service providers in states where a greater percentage of the population lives outside metropolitan areas: in the 25 states with the largest rural population shares, community bank branches average 56 percent of total commercial bank branches, compared with an average of 28 percent in the 25 states with the lowest rural population shares.

While internet and mobile banking allow banks of all sizes to reach customers across the country, they have not rendered geography totally irrelevant or eliminated the need for brick-and-mortar locations. Table 5 reports selected findings from the FDIC 2019 Survey of Household Use of Banking and Financial Services. Almost one-third of rural households reported that they lacked home internet access, and

Table 3
Importance of Community Banks by Community Type (June 2020)

Type of community	Number of community bank branches	Percent of all branches in community type	Deposits at community bank branches (in billions)	Percent of deposits in community type
Rural	12,062	71.8	\$628.5	65.9
Urban	19,290	30.8	\$1,561.0	11.6

Note: "Rural communities" are defined as all areas not within a metropolitan statistical area (MSA), as established by the U.S. Office of Management and Budget. "Urban communities" are defined as all areas within an MSA. Minor discrepancy in total community bank deposits between this table and Table 1 is due to exclusion of foreign deposits in FDIC data.

Source: FDIC.

Table 4
Prevalence of Community Banks by State (June 2020)

State	Share of population in rural areas (percent)	Number of community bank branches	Percent of all bank branches	Deposits at community bank branches (in billions)	Percent of deposits at all bank branches
Maine	61.3	131	53.3	\$9.3	43.5
Vermont	61.1	54	30.2	\$2.6	18.0
West Virginia	51.3	370	63.1	\$18.2	47.7
Mississippi	50.6	636	57.5	\$28.9	45.0
Montana	44.1	207	55.2	\$12.1	42.3
Arkansas	43.8	778	58.6	\$34.9	42.3
South Dakota	43.3	313	70.3	\$28.0	3.5
Kentucky	41.6	1,054	68.0	\$55.5	56.9
Alabama	41.0	681	47.3	\$33.7	26.1
North Dakota	40.1	317	83.0	\$25.4	78.8
New Hampshire	39.7	74	28.5	\$4.5	13.7
Iowa	36.0	1,242	84.1	\$75.7	78.6
Wyoming	35.2	119	56.7	\$9.7	53.5
Alaska	34.0	57	50.4	\$5.6	40.3
North Carolina	33.9	554	25.6	\$30.5	6.2
Oklahoma	33.8	1,016	79.4	\$63.4	61.7
South Carolina	33.7	373	31.9	\$18.3	17.7
Tennessee	33.6	1,053	53.7	\$64.8	34.2
Wisconsin	29.8	1,028	60.0	\$66.7	39.1
Missouri	29.6	1,524	69.2	\$91.9	45.7
Idaho	29.4	112	25.0	\$6.5	20.0
Indiana	27.6	932	52.6	\$61.9	39.6
Nebraska	26.9	813	77.1	\$43.3	60.6
Louisiana	26.8	803	60.3	\$41.3	34.3
Minnesota	26.7	1,032	65.9	\$67.3	25.6

Table 4 (continued)

State	Share of population in rural areas (percent)	Number of community bank branches	Percent of all bank branches	Deposits at community bank branches (in billions)	Percent of deposits at all bank branches
Kansas	25.8	1,148	85.7	\$60.0	73.5
Michigan	25.4	701	31.4	\$41.5	15.6
Georgia	24.9	644	29.0	\$47.3	16.6
Virginia	24.5	841	38.3	\$45.4	13.6
New Mexico	22.6	212	50.2	\$14.1	37.7
Ohio	22.1	1,156	36.5	\$62.7	14.5
Pennsylvania	21.3	1,261	36.9	\$87.7	18.8
Oregon	19.0	101	11.3	\$6.8	7.0
Delaware	16.7	39	18.9	\$12.4	2.7
Washington	15.9	323	21.1	\$29.0	15.4
Texas	15.3	3,003	48.2	\$217.3	22.5
Colorado	13.8	492	35.7	\$32.5	19.5
Maryland	12.8	276	20.1	\$22.2	12.4
New York	12.1	810	20.2	\$92.5	4.5
Connecticut	12.0	49	6.2	\$5.0	3.6
Illinois	11.5	2,130	54.5	\$153.7	26.1
Arizona	10.2	126	11.7	\$7.9	4.7
Utah	9.4	133	27.0	\$14.7	2.8
Rhode Island	9.3	46	22.9	\$6.6	19.6
Florida	8.8	701	15.2	\$70.9	10.6
Hawaii	8.1	57	32.8	\$7.5	17.9
Massachusetts	8.0	143	11.1	\$24.8	6.0
Nevada	5.8	36	7.8	\$3.2	3.4
New Jersey	5.3	395	17.4	\$44.0	12.1
California	5.0	1,120	17.2	\$156.4	8.8

Note: For purposes of the 2010 census, the U.S. Census Bureau defined an "urban area" as comprising a densely settled core of census tracts or census blocks that meet minimum population density requirements, along with adjacent territory containing nonresidential urban land uses and territory with low population density included to link outlying densely settled territory with the densely settled core. "Rural" encompasses all population, housing, and territory not included within an urban area.

Sources: U.S. Census Bureau and FDIC.

Table 5
2019 Household Use of Banking and Financial Services (Percent)

Metropolitan status	Households with smartphone access	Households with home internet access	Banked households using tellers as primary banking method	Banked households having visited a branch within 12 months	Banked households having visited a branch 10 or more times within 12 months
Urban	86.2	79.5	16.9	79.2	22.6
Suburban	88.4	84.5	18.7	83.0	26.2
Rural	75.6	68.0	33.4	87.7	41.6

Note: The FDIC survey classifies those households in a principal city of a metropolitan area as urban, those in a metropolitan area but not in a principal city as suburban, and those not in a metropolitan area as rural.
 Source: FDIC.

one-quarter reported that they lacked smartphone access. In addition, 83 percent of banked households surveyed responded that they had visited a bank branch within the past 12 months, with 21 percent responding that bank tellers were their primary banking method. Rural households reported an even greater reliance on physical bank locations, with 88 percent stating they had visited a branch within the past 12 months, and over one-third reporting bank branches as their primary method for account access. Responses to the FDIC survey suggest branch visits are common even among households that use online or mobile banking as their primary method of account access. In 2019, 80 percent of banked households that used mobile banking as their primary method for account access responded that they had visited a branch in the past 12 months (FDIC 2020b).

The Federal Reserve's 2019 Survey of Consumer Finances confirms these trends. A similar share of families that use online banking reported that they had visited a bank branch in the past year. Unsurprisingly, the share was higher for families that do not use online banking, with 85 percent reporting that they had visited their main checking account branch within the past 12 months (Bhutta and others 2020). Although online and mobile banking are growing in use, they appear to be incomplete substitutes for some physical banking services—particularly in rural areas, where internet and mobile banking access are more limited.

Sectoral significance of community banks

Community banks play a particularly important role providing credit to agricultural and commercial borrowers. Community banks generally collect local deposits and lend them to borrowers within their local markets. They are less likely to rely on out-of-market brokered deposits or be involved in trading, market-making, or other investment banking activities associated with larger banks. This more limited and local scope of activities may contribute to local economic stability by insulating against external credit shocks.

Agricultural lending. Given their extensive rural presence, it is unsurprising that community banks are a major source of credit for the agricultural industry. Overall, commercial banks are the second largest provider of credit to the farm sector in the United States; commercial bank credit accounts for 37 percent of farm real estate debt in the United States and 46 percent of farm non-real-estate debt.¹¹ Community banks provide the majority of bank farm credit, representing 81 percent of farm real estate debt held by commercial banks and 74 percent of operating debt. Community banks have an even greater role in smaller-dollar farmland loans: Table 6 shows that community banks account for close to 90 percent of commercial bank farmland loans with original amounts of \$500,000 or less.

Business lending. Community banks also play an outsized role in financing businesses in the United States. Although community banks hold less than 14 percent of commercial bank deposits, they account for 32 percent of commercial real estate loans. The ability of small banks to lend to borrowers that are relatively informationally opaque by acting on more qualitative, “soft” information has been well-documented (DeYoung and others 2012; Berger and others 2005; Cole, Goldberg, and White 2004). This ability has been hypothesized as an advantage for community banks in lending to small or newly formed businesses, which often lack the financial records and credit history upon which more standardized underwriting models are based. Data on small-dollar business lending supports this view. Community banks hold a disproportionate share of small-dollar commercial real estate and non-real-estate commercial and industrial (C&I) loans. Table 7 shows that community banks hold 78 percent of bank-held commercial real estate loans with original amounts of \$100,000 or less, 64 percent of those with original amounts

Table 6

Importance of Community Banks in Farm Lending (June 2020)

Type of loan	Loans by community banks (in billions)	Community bank share (percent)
Farm real estate		
≤ \$100,000	\$5.2	90.3
\$100,000–\$250,000	\$12.5	88.5
\$250,000–\$500,000	\$16.9	88.7
Farm production		
≤ \$100,000	\$9.5	83.8
\$100,000–\$250,000	\$8.3	86.3
\$250,000–\$500,000	\$9.7	86.2

Note: Loan amounts are rounded to the nearest thousand.

Source: FFIEC.

Table 7

Importance of Community Banks in Business Lending (June 2020)

Type of loan	Loans by community banks (in billions)	Community bank share (percent)
Commercial real estate		
≤ \$100,000	\$8.4	77.5
\$100,000–\$250,000	\$23.9	63.9
\$250,000–\$1 million	\$109.6	54.8
Commercial and industrial		
≤ \$100,000	\$57.2	24.8
\$100,000–\$250,000	\$48.9	39.7
\$250,000–\$1 million	\$99.5	41.6

Note: Loan amounts are rounded to the nearest thousand.

Source: FFIEC.

of more than \$100,000 to \$250,000, and 55 percent of those with original amounts of more than \$250,000 to \$1 million.

Relationship banking allows community banks greater flexibility to adjust credit terms for less conventional borrowers as well as to react to varying economic conditions. Research has shown that business lending at small U.S. banks declined less severely than it did at large banks during the GFC (Cole 2012, 2018).¹² Similarly, research has shown that a greater presence of relationship lenders is associated with fewer nearby firms being credit constrained during cyclical downturns in other countries (Barboni and Rossi 2019; Beck and others 2018). In these studies, the loosening of credit constraints did not reflect the “evergreening” of loans to underperforming firms (that is, the continued extension of credit to support interest payments). Instead, lending during these

downturns was concentrated among relatively safe firms and positively linked to firm investment and growth after the turn of the credit cycle.

Community banks' ability to quickly adapt to changing conditions was apparent in the leading role they played in the Paycheck Protection Program (PPP) from April to August 2020. The PPP was established by the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act to provide economic relief to small businesses and certain other entities adversely affected by the COVID-19 pandemic. The program was implemented by the U.S. Small Business Administration (SBA), which relied on private lenders—including federally insured banks and credit unions, Farm Credit System institutions, and other SBA-approved lenders—to distribute funds. Overall, commercial banks originated 88 percent of the \$525 billion in total loans funded through the program. Community banks played an outsized role in issuing PPP loans, particularly during the first round of funding when the need for support was most urgent. Community banks not only served more than half of all PPP recipients, they also had faster turnaround times than other program lenders (Independent Community Bankers of America 2020). As a result, some community banks were able to form new business relationships, earning goodwill with borrowers who experienced issues obtaining financing from larger banks. Although the average PPP loan size was smaller for community banks than for larger lenders, community banks held 38 percent of all PPP loan balances at commercial banks as of June 30, 2020.

III. Challenges and Opportunities for Community Banks

Community banks face many challenges going forward. The banking industry as a whole is experiencing numerous changes, particularly in the needs and preferences of customers. However, community banks have demonstrated adaptability in the past, and while economic, demographic, and technological changes pose challenges for the traditional banking model, they also present opportunities.

Economic changes

Consolidation in the community banking industry is part of a broader trend of business consolidation in the economy, with implications for small business and agricultural loan demand. Consolidation

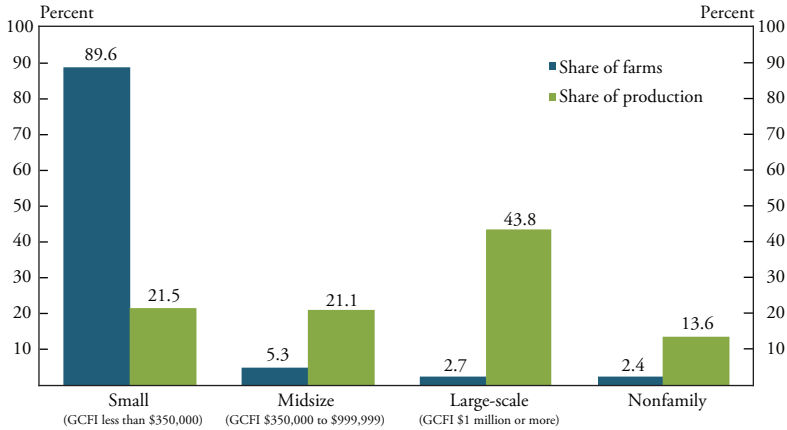
in the agricultural industry has been analogous to that of the banking industry; the number of farms has slowly declined while the average farm size has increased. Chart 3 shows that small farms still make up 90 percent of the agricultural industry, but production is becoming increasingly concentrated among a small number of larger farms. Scale economies have cost advantages in farming; financial performance tends to be higher for larger farms, a trend augmented by the increasing adoption of new technologies (Boehlje and Langemeier 2017).

Competition in the broader economy has also changed, with an increasing share of economic activity shifting from small businesses to larger firms (Kobe and Schwinn 2018). The green bars in Chart 4 show that the number of small establishments in particular has declined in counties that are not part of a metropolitan statistical area. Contributing to this trend is the decline in new business formation over much of the period since the GFC. The blue line in Chart 4 shows that new business growth has been primarily confined to metropolitan counties. New businesses are critical to supporting the small business share of the economy, as they help offset closures and small businesses that grow into large businesses.

The decline in new business formation, combined with the increasing size of farms and small businesses, affects community banks by reducing demand for lending or increasing businesses' financing needs to a size that community banks cannot accommodate. Policy concerns have generally focused on how bank consolidation affects the availability of credit for small businesses. However, recent research indicates banking consolidation is partially a consequence of consolidation in other parts of the economy. Changes in employment at small firms were found to have a statistically significant relationship with changes in small bank deposits, and declines in employment at small firms are correlated with slower growth of small loans to businesses (Brennecke, Jacewitz, and Pogach 2020). The economic disruption caused by the COVID-19 pandemic has had an outsized effect on small businesses and raised concerns about the longer-term effects on certain industries as well as the community banks that serve those customers. Although the full extent of the pandemic's effects on small businesses is still unknown, government relief programs are targeted at reducing the economic effects of the virus and supporting the continuing role of small businesses in the economy.

Chart 3

Farms and Their Value of Production by Farm Type: 2019

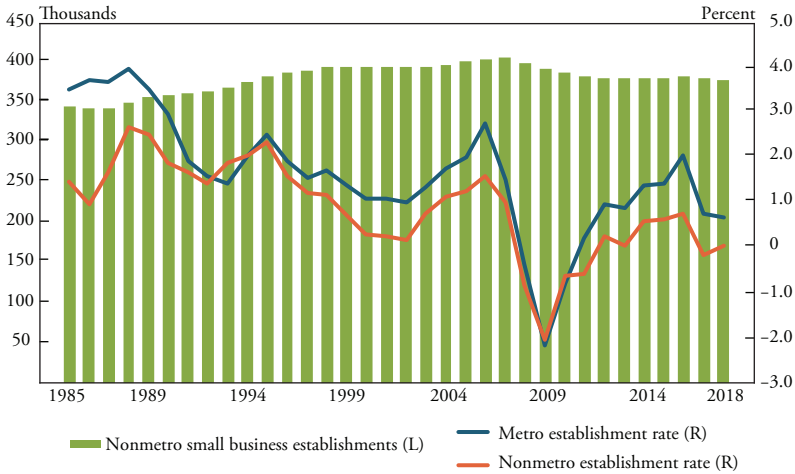


Notes: GCFI is the annual gross cash farm income before expenses. Nonfamily farms are those where the principal operator and their relatives do not own a majority of the business. Data as of December 2, 2020.

Sources: U.S. Department of Agriculture Economic Research Service and National Agricultural Statistics Service.

Chart 4

Nonmetro Small Business Establishments and Net Establishment Rate



Notes: Small business establishments are defined as those with fewer than 500 employees. Net establishment rate is the rate of establishments born less the rate of establishments exited during the last 12 months. A county is designated as metro if it is a component of a metropolitan statistical area (MSA) defined by the U.S. Office of Management and Budget, and nonmetro otherwise. Micropolitan areas are also classified as part of an MSA.

Source: U.S. Census Bureau.

Demographic changes

Both an aging customer base and aging bank management may continue to present strategic challenges for community banks going forward. Banks of all sizes have an increasing need for specialized talent in areas such as regulatory compliance and technology. Community banks, however, face challenges in attracting and retaining that talent. In urban areas, community banks may find it difficult to compete with the compensation packages offered by larger banks and nonbank financial technology (“fintech”) companies. Community banks in rural areas face their own challenges—in particular, a smaller local talent pool compared with metropolitan areas. Difficulties attracting and retaining talent can complicate banks’ succession planning. Management succession is increasingly a key challenge for community banks, where the average age of CEOs is between 60 and 70 (Bonham and others 2019). Consequently, succession issues have driven some acquisition activity over the last decade. The inability to find suitable replacements for aging leadership may drive some banks to sell; other banks may be motivated to acquire other institutions to obtain the necessary talent. Indeed, CEO succession was considered a primary strategic reason to sell for nearly one-third of community bank respondents to *Bank Director’s* 2021 Bank M&A Survey. In addition, a majority of respondents to the Conference of State Bank Supervisors’ 2020 National Survey of Community Banks cited succession issues as an important motivation for making an acquisition offer.

Community banks also face challenges due to aging customer bases and declining populations, particularly in rural areas. The median age in rural towns and communities is 41.3 years and rising, compared with 38.2 nationally (George 2020). Compared with urban areas, rural communities have a greater share of people over the age of 65, with baby boomers—born from 1946 to 1964—accounting for the largest age group. An aging population has implications for community banks, given that over half of their customers are over the age of 51 (FIS 2017). Baby boomers account for 53.5 percent of U.S. household wealth as of June 2020, and baby boomers are expected to transfer an estimated \$30 trillion in assets to their heirs in the coming decades. Most of this wealth will transfer to a younger generation with different financial needs. Younger consumers have different preferences regarding how they interact with financial

institutions and tend to embrace the convenience of digital solutions. Identifying and responding to the unique needs of these customers will be an added challenge for community banks as they attempt to keep pace with the speed of digital transformation in the banking industry.

In addition to the aging of rural populations, migration patterns have also influenced demographic trends. Rural areas have seen their population decline for decades, and this trend has recently accelerated: over half of rural counties lost population from 1980 to 2010, while over 70 percent of rural counties lost population from 2010 to 2018 (Anderlik and Cofer 2014; FDIC 2020a). Depopulation has also contributed to the increase in the average age of rural counties, as young adults account for an outsized portion of out-migration. A declining share of young adults can in turn hinder economic development through a detrimental feedback loop: for example, those who leave rural areas to pursue a college education may lack post-graduation job opportunities in rural areas and thus remain in urban areas, limiting the human capital needed to promote economic development in rural communities. Indeed, the percentage of college-educated young adults is much higher in urban areas, and the college completion gap between rural and urban areas has been widening in recent decades.

This feedback loop presents challenges for community banks to the extent that it weakens small business development and growth. Close to one-quarter of community banks are headquartered in depopulating rural markets. According to the FDIC, loan and deposit growth from 2014 to 2019 was weaker at community banks in rural regions with declining populations than at other community banks. Furthermore, while community banks headquartered in rural depopulating regions have historically outperformed other community banks, stress in the agricultural industry has eroded some of that advantage in the last five years (FDIC 2020a).

Technological opportunities and challenges

Technological changes in the banking industry have allowed for better product delivery, data analysis, and back-office efficiency. Much of this change has been driven by consumer expectations, as financial transactions have increasingly shifted from in-person to virtual, driving banks to provide services such as online banking and remote

deposit capture that are fast, convenient, and easy to understand. Other customer-facing innovations, such as chatbots and automated financial management tools, have the potential to enhance bank revenue by proactively identifying cross-selling opportunities (such as through data-driven recommendations for other bank products and services), while at the same time improving customer retention by assisting customers with routine transactions. Newer data analytic and modeling techniques help support some of these innovations by improving risk identification. Other developments, such as robotic process automation, can streamline back-office operations and lower costs by automating routine, manual processes. Similarly, regulatory technology (“RegTech”) solutions can reduce compliance costs and enhance risk management functions by monitoring transaction data in real time. Most of these digital innovations do not replace personal relationships with bank staff, but rather allow banks to allocate staff where it is most beneficial.

Although these technological changes provide banks with opportunities to increase revenue and reduce costs, community banks, in particular, may struggle to keep up with the pace of innovation. Smaller banks face greater constraints on technology spending than their larger counterparts, placing them at a competitive disadvantage. In 2019, the technology spending budget for the four largest financial institutions totaled over \$38 billion (Shevlin 2019). Recent mergers among large regional banks have cited cost synergies and scale to increase technology spending as key drivers for the consolidation.¹³ Furthermore, banks also face competition from nonbank fintech companies, which are not subject to the same regulatory framework as banks and do not carry the costs of legacy technology systems or branch networks.¹⁴ Lower operating costs allow fintech companies to spend more on innovation to build products and services that enhance the customer experience, often at competitive rates.

Challenges for relationship banking. New, largely digital credit-scoring methods may challenge the community bank business model. Community banks have historically served as a primary source of credit for small businesses, with a business model built around relationship lending and factoring more qualitative, “soft” information into their lending decisions. In recent years, however, community banks have experienced increased competition for small business loans from fintech lenders.

Technological advancement has helped bridge the gap between hard and soft information and reduced the cost and time of underwriting small dollar loans. Fintech lenders have developed interfaces to quickly receive and analyze borrowers' financial data from numerous sources. In addition, some fintech lenders may also use less traditional data in underwriting, such as bank account transactions, sales data from marketplace platforms, utility and rent payment histories, and even social media. Using proprietary algorithms, these lenders often provide lending decisions much more quickly than traditional banks. The speed of lending decisions is likely to attract small business owners, who often point to the application process and decision time as challenges in obtaining credit from banks (Federal Reserve System 2020).

Larger banks also compete with community banks for small business loans, albeit to a lesser degree since the GFC. Large banks have invested heavily in digital strategies to enhance convenience and features as more consumers shift to online and mobile banking. As a result, large banks have been able to capture an increasing share of deposits in the banking industry. Their increased deposit share may, in turn, drive growth in small business lending, as small business owners cite an existing relationship with the lender as the leading factor influencing their decision to apply for credit with a large bank (Federal Reserve System 2020). Small business owners often anticipate they will receive a better rate or have a better chance of loan approval at their existing bank than at another institution. Moreover, large banks can more readily provide ancillary services such as budgeting tools or wealth management that small businesses find beneficial. Nevertheless, the average size of small business loans provided by large banks tends to be larger than those provided by community banks.¹⁵ The fixed costs associated with originating small business loans still deter large banks from originating many of the smallest loans, leaving community banks or fintech companies to primarily meet this credit need.

Research has suggested that the growth in fintech lenders may be more complementary than competitive by filling a credit gap for small businesses underserved by traditional banks (Chen, Hanson, and Stein 2017; Jagtiani and Lemieux 2018). However, growth in small business lending by large banks and fintech companies has led some industry observers to assert that technology may threaten the viability of the community banking business model. That concern has been

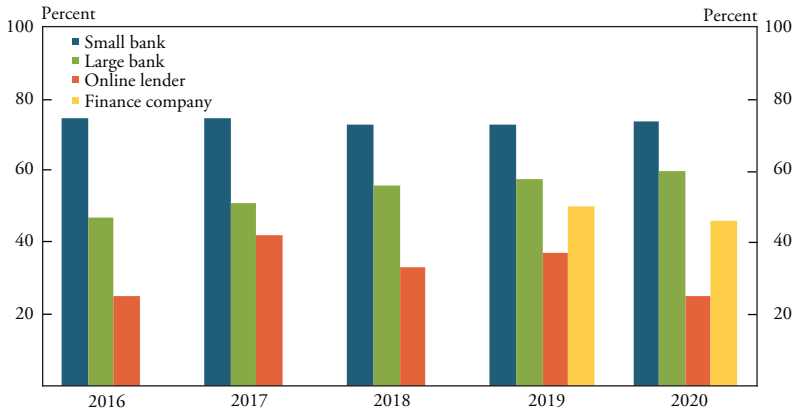
heightened by the accelerated pace of digital adoption during the pandemic, with the crisis serving as a “litmus test for banks’ digital infrastructure” (Shilling and Celner 2020). Larger banks and fintech companies may be gaining ground. However, Chart 5 shows that small business applicant satisfaction is consistently highest at small bank lenders.

Accelerated technology adoption during the pandemic. The COVID-19 pandemic has highlighted digital shortcomings for some community banks but has also provided them an opportunity to evaluate how to improve their services by investing in technology going forward. Community banks’ performance during the pandemic illustrated their continued importance in serving small businesses and supporting local economies. According to the SBA and Department of Treasury, community banks with assets below \$10 billion approved 60 percent of initial PPP funding. The community bank response to the SBA program was particularly remarkable given the common assumption that small banks lag the industry in technology. In general, large banks were initially slower than community banks to accept PPP applications, as they worked to develop and implement their own systems to process applications (Merle and Whalen 2020). Small banks, on the other hand, moved quickly to accept applications, sometimes manually entering information and working extended hours to manage the volume. In many cases, processing PPP applications required community banks to pull staff from other areas. Although larger banks became more active in the second round of the PPP, community banks still accounted for a disproportionately large share of the \$525 billion in total PPP funds approved (Hanrahan and Hinton 2020).

In addition to strengthening relationships between community banks and customers, the PPP also strengthened some relationships between community banks and fintech companies. Several of the most active community banks in PPP lending partnered with fintech firms.¹⁶ Many online lenders that had positioned themselves in recent years to provide alternatives for small businesses were uniquely prepared to partner with banks to originate PPP loans. Fintech companies not only provided banks with more efficient ways of processing applications but also offered streamlined platforms to simplify the forgiveness process. These partnerships demonstrate how banking services are evolving and how fintech solutions can help community banks. Although many community banks have struggled in the past to integrate legacy

Chart 5

Net Small Business Applicant Satisfaction over Time



Notes: Net satisfaction is the share of firms satisfied minus the share of firms dissatisfied as a percent of approved loan or line of credit and cash advance applicants at source. Percentage points may not sum to 100 due to rounding. Data for prior years are not available because “finance company” was not included as a discrete answer choice. Source: Federal Reserve System.

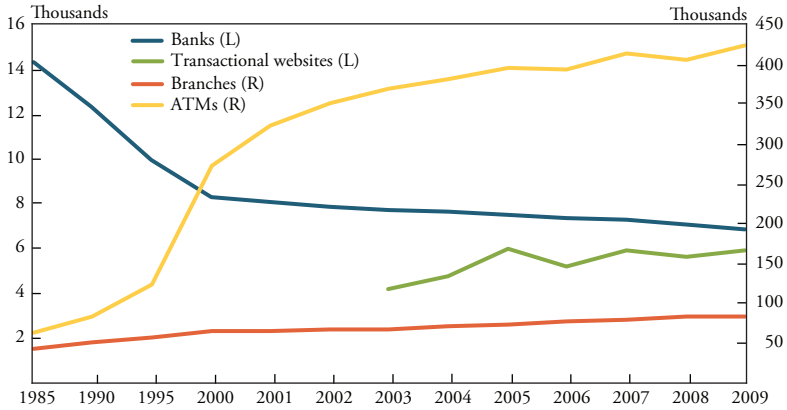
technology with new technology and services, many fintech companies have services and platforms that are flexible enough to provide scalable, customized solutions. The pace of innovation will likely continue to demand that small banks deploy technology rapidly to meet customer needs. However, based on their response to the pandemic, many appear to have passed the litmus test.

Technology’s historical role and future implications. Community banks have faced large technological changes in the past and thrived. From the introduction of ATMs to internet banking, community banks have been able to adopt technology to enhance convenience for their customers while still retaining the relationship model that sets them apart from their competitors. Many observers speculated that the introduction of ATMs (in the late 1960s) or online banking (in the 1990s) would eliminate the need for branches. However, consumers have continued to rely on physical bank locations long after both of these technologies were adopted. Chart 6 shows that the number of branches continued to grow until the GFC.

Community banks have repeatedly demonstrated agility by adapting to new technologies while retaining personal relationships with customers. Technology has allowed community banks to enhance product and service offerings, as well as automate back-office

Chart 6

Distribution Channels for U.S. Commercial Banks Prior to GFC



Sources: FDIC, FFIEC, EFT Network, and International Monetary Fund (FRED).

functions to allow more time for personalized service. Although consumers continue to embrace and expect digital banking services, the results of the FDIC Survey of Household Use of Banking and Financial Services show that many consumers still value personal interactions with their financial institutions. Through various forms of third-party engagement, such as outsourcing, referral arrangements, partnerships, and use of vendor products, community banks may be able to increase efficiency and enhance their digital offerings while adhering to their core strategies.

Regulators also play a role in ensuring community banks can continue to innovate. Initiatives are underway at the bank regulatory agencies to support innovation in a safe and sound manner. For example, the newly established FDiTech initiative at the FDIC aims to foster innovation and has sought public input on a voluntary certification program to remove uncertainty for banks when considering whether to adopt new technologies or partner with fintech firms. Similarly, the Office of the Comptroller of the Currency and the Federal Reserve have launched innovation offices that provide outreach and assistance to support responsible innovation as banks deploy new technologies or collaborate with fintech companies. As movement toward real-time payment systems has progressed, some community banks have expressed concerns about equal access to such systems. So far, much of the advancement in faster payments has taken place

among larger bank consortiums and fintech companies, which may place community banks at a competitive disadvantage. Understanding the need for a solution that ensures universal access to real-time payment capabilities, the Federal Reserve announced the creation of the FedNow Service in 2019 to provide a real-time payment system alongside private-sector services. The federal bank regulatory agencies recognize the unique challenges community banks face in adopting new technologies and continue efforts to ensure a regulatory environment that supports innovation among financial institutions of all sizes and geographies.

Conclusion

Although community banks face challenges due to economic consolidation, demographic changes, and evolving technology, they continue to play a vital role in local economies across the United States. Community banks play a particularly significant role in providing financial services to rural communities and credit to agricultural and commercial borrowers. The strength and adaptability of the community banking model were evident during the GFC, when small banks remained relatively stable providers of business credit, and during the COVID-19 pandemic, when community banks played a vital role administering emergency relief funds under the PPP. Regulatory changes and technological advancements have reduced the importance of geographic proximity to banks, but they have not eliminated the need for physical bank locations or personal interaction in banking. Consolidation in the banking industry will likely continue as organizations look to grow and increase economies of scale; however, community banks will continue to play an important role in their local communities and the broader economy.

Appendix

Community Bank Financial Performance

Although low interest rates, increased regulation, and technological advancements have posed challenges for community banks, these banks have remained competitive with their larger, more diversified peers. Community bank financial performance over the past 20 years has generally reflected the economic environment of the period. Capital ratios have been relatively stable, while earnings and credit portfolio performance have closely tracked economic conditions, with the mid-2000s reflecting the stress of the GFC. Improving credit conditions over the last decade have boosted bank profitability and provided banks the ability to build capital, while post-GFC reforms resulted in a stronger and more resilient banking industry entering the COVID-19 pandemic. Although the full magnitude of credit deterioration as a result of the pandemic remains uncertain, the current crisis has elevated the role of community banks in ensuring continued access to credit for struggling businesses.

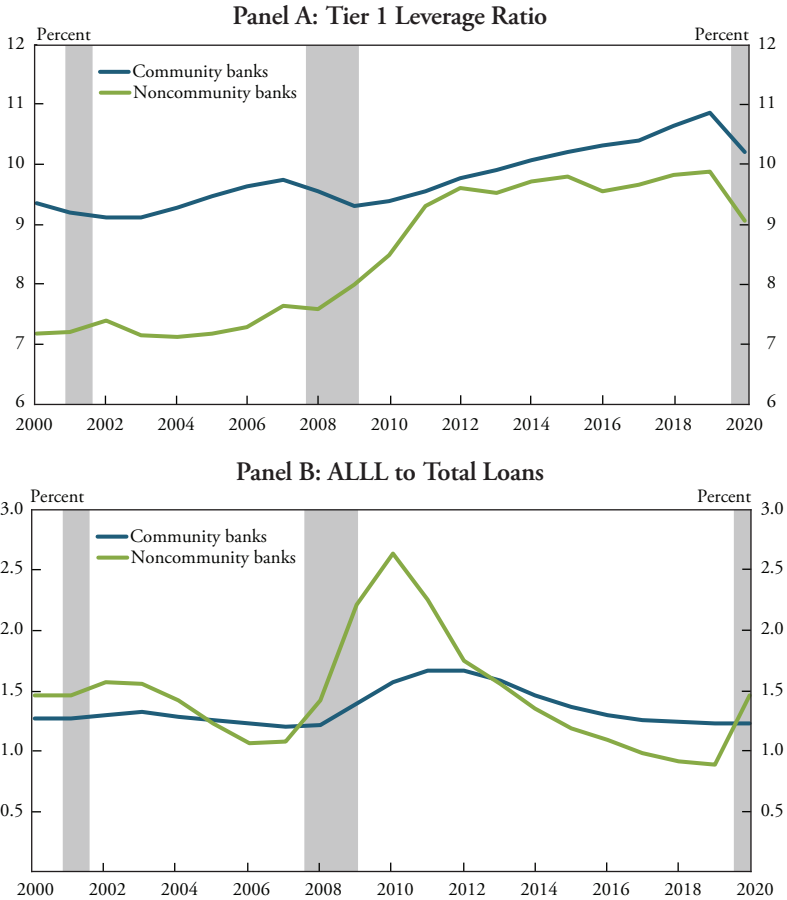
Capital and credit conditions

Community banks have historically held relatively more capital than larger banks. Prior to the GFC, median capital ratios (as measured by the Tier 1 leverage ratio) for community banks were significantly higher than those of noncommunity banks.¹⁷ From 2000 to 2008, the average difference between median Tier 1 leverage ratios of the two groups was 210 basis points (Panel A of Chart A-1). Since the GFC, the difference in capital positions has narrowed. From 2009 to June 30, 2020, the average difference between median Tier 1 leverage ratios was approximately 70 basis points. Post-GFC reforms have placed an emphasis on higher requirements for both the quantity and quality of capital held at banks, especially for the largest organizations. Nevertheless, community banks continue to hold greater amounts of capital relative to assets—as of June 30, 2020, the median Tier 1 leverage ratio for community banks was 10.2 percent, while the median for noncommunity banks was 9.1 percent.

A comparison of the Allowance for Loan and Lease Losses (ALLL), which is considered a form of regulatory capital, shows mixed results

Chart A-1

Capital and Reserves (Median Values)



Notes: Gray bars denote National Bureau of Economic Research (NBER)-defined recessions. Tier 1 leverage ratio is calculated as Tier 1 capital divided by adjusted average assets. Adjusted average assets reflect deductions for goodwill and certain intangible assets.

Sources: FFIEC, NBER, and authors' calculations.

over the last 20 years.¹⁸ Panel B of Chart A-1 shows that in the early 2000s, the median ratio of ALLL to total loans and leases for noncommunity banks was slightly higher than that of community banks. For a brief period prior to the GFC, community banks held slightly higher relative ALLL levels, but noncommunity banks surpassed them as they ramped up ALLL balances in response to stress induced by the GFC. From 2012 through 2019, community banks again held higher ALLL balances than noncommunity banks. That trend has once again reversed as of June 30, 2020, with ALLL balances at noncommunity banks exceeding community banks. Although economic uncertainty resulting from the COVID-19 pandemic has caused banks of all sizes to increase allowance provisioning, noncommunity banks have done so at a faster pace than community banks. This faster pace is largely attributable to the adoption of new accounting standards at publicly traded banks (which includes a relatively small percentage of community banks but almost all large banks) that requires earlier recognition of expected future losses.

Credit performance for banks is also highly reliant on economic conditions, and though the GFC stressed loan portfolios at both community banks and noncommunity banks, community banks were generally less affected than noncommunity banks. Panels A and B of Chart A-2 show that during the GFC, the median noncurrent rate and ratio of problem assets to capital (called the Texas ratio) for community banks were considerably lower than for noncommunity banks. Panel C of Chart A-2 shows that the rates of net loan losses were much higher for noncommunity banks than community banks. However, the weighted average noncurrent rate and weighted average Texas ratio of community banks are significantly higher than median ratios and the Texas ratio exceeds that of noncommunity banks. This difference in median and average statistics is due to the significant problems that some community banks experienced during the GFC, particularly community banks with assets between \$100 million and \$10 billion. Many of these banks had significant concentrations in commercial real estate and construction and land development lending, and subsequently failed as a result of overexposure to the industry.

Chart A-2

Credit Performance (Median Values)

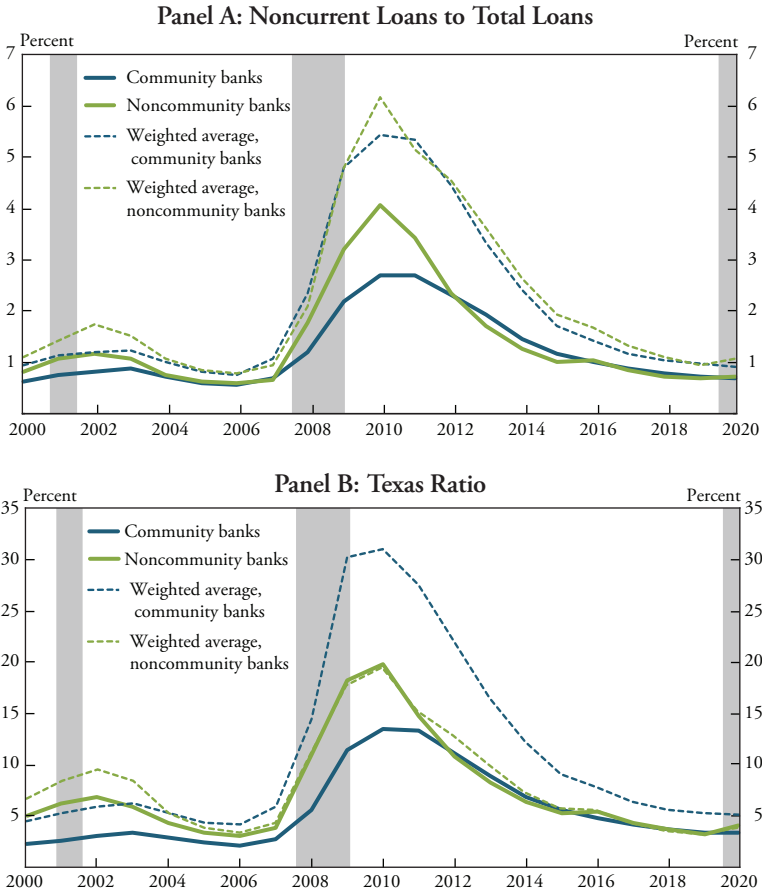
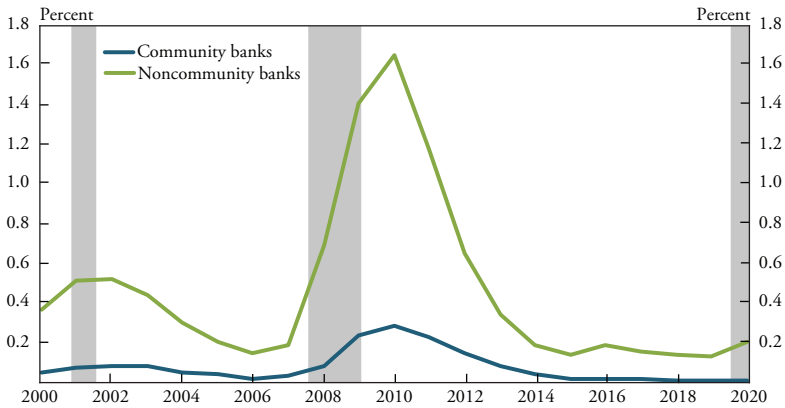


Chart A-2 (continued)

Panel C: Net Charge-offs to Average Total Loans



Notes: Loans 90 days past due and accruing and nonaccrual loans are considered noncurrent. The Texas ratio is calculated as nonaccrual loans and bank-owned real estate to Tier 1 capital plus the ALLL. Net charge-offs are gross loan losses net of any subsequent recoveries. Gray bars denote NBER-defined recessions.

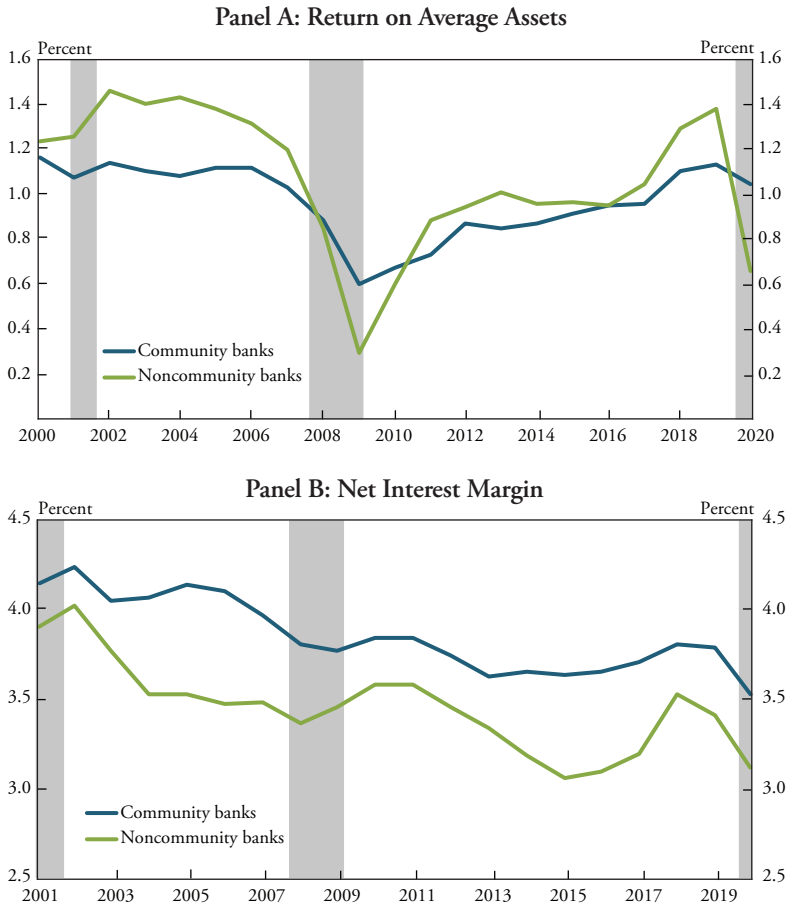
Sources: FFIEC and authors' calculations.

Earnings performance

Over the past 20 years, community banks have generally earned a lower rate of return than larger banks (Panel A of Chart A-3). From 2000 to 2007, the median return on average assets (ROAA) of noncommunity banks tracked between 1.25 percent and 1.43 percent; over that same period, community banks earned consistently less, with median ROAAs tracking between 1.03 percent and 1.17 percent. However, community banks' earnings performance was more resilient and consistent throughout the GFC. The low point for bank earnings during the financial crisis occurred in 2009. During this year, the median ROAA for noncommunity banks was 0.29 percent; community banks performed much better, with a median ROAA of 0.60 percent. As financial conditions stabilized in the mid- to late-2010s, community bank earnings dropped below those of noncommunity banks. However, the turmoil caused by the COVID-19 pandemic has resulted in community banks once again having more stable earnings than noncommunity banks. Despite historically lower profits, earnings are less volatile at community banks that generate most of their income from traditional banking activities.

Chart A-3

Profitability Measures (Median Values)



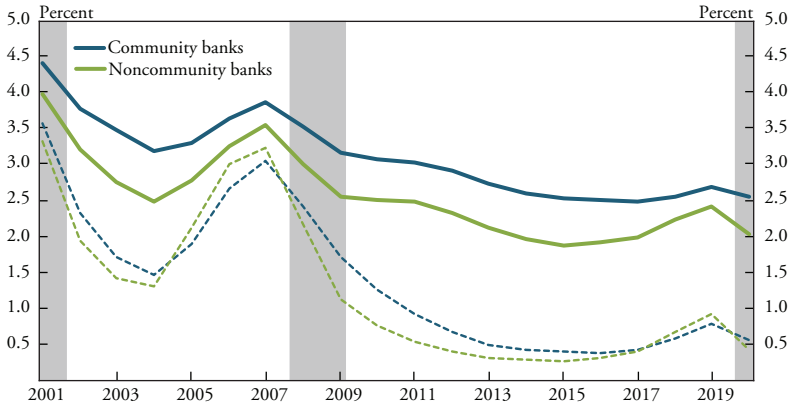
Note: Gray bars denote NBER-defined recessions.
 Sources: FFIEC, NBER, and authors' calculations.

Although community banks have historically earned less than noncommunity banks, net interest margins (NIMs) of community banks have consistently exceeded those of noncommunity banks.¹⁹ Panel B of Chart A-3 shows that while the gap between community bank and noncommunity bank NIMs has widened and narrowed at various points over the past 20 years, the median NIM for community banks has stayed above that of noncommunity banks for the entire period. The primary factor that contributes to NIM outperformance in community banks is consistently higher yields on loans and leases, as shown in Chart A-4. Loan yields are heavily reliant on the interest rate environment, and loan interest rates have steadily declined for all banks over the past 20 years; however, median loan yields at community banks have been at least 25 basis points and as many as 74 basis points above those of noncommunity banks during this timeframe. Chart A-4 shows that the widening and narrowing of the NIM difference between community banks and noncommunity banks is correlated with fluctuations in funding costs. At various points over the past 20 years, community bank and noncommunity bank funding costs have trended above or below one another. Differences in funding costs are most evident at interest rate inflection points (when rates change from falling to rising or from rising to falling). Noncommunity banks are generally more responsive to changes in market interest rates and will more quickly raise deposit rates when market rates increase (leading to higher cost of funds) and lower deposit rates when market rates fall (leading to lower cost of funds). During the periods in which interest rates steadily declined (2000–04 and 2009–18), funding costs at community banks and noncommunity banks tracked one another closely.

Although community banks generally have margins above those of noncommunity banks, their lower levels of noninterest income contribute to overall lower earnings. Community banks have less diversified income streams and lower relative levels of noninterest income, whereas noncommunity banks are less reliant on loan interest income. Chart A-5 shows noninterest income and noninterest expense as a percentage of average assets for community and noncommunity banks. In 2000, median noninterest income was 0.32 percent of average community bank assets compared with 0.81 percent of average noncommunity bank assets. Although noninterest income for noncommunity banks

Chart A-4

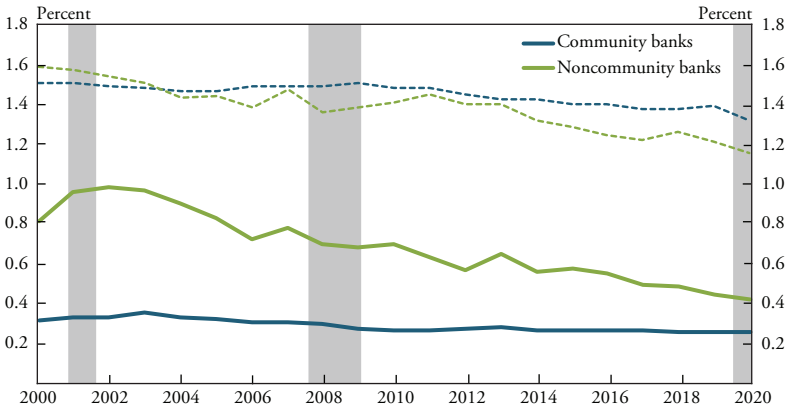
Yields and Costs (Median Values)



Notes: Solid lines denote yield on loans, and dashed lines denote cost of funds. Yield on loans is equal to interest and fees on loans (annualized) to average loans. Cost of funds is equal to total interest expense (annualized) to average earning assets. Gray bars denote NBER-defined recessions.
Sources: FFIEC, NBER, and authors' calculations.

Chart A-5

Noninterest Income and Expense to Average Assets (Median Values)



Notes: Solid lines denote noninterest income, and dashed lines denote noninterest expense. Gray bars denote NBER-defined recessions.
Sources: FFIEC, NBER, and authors' calculations.

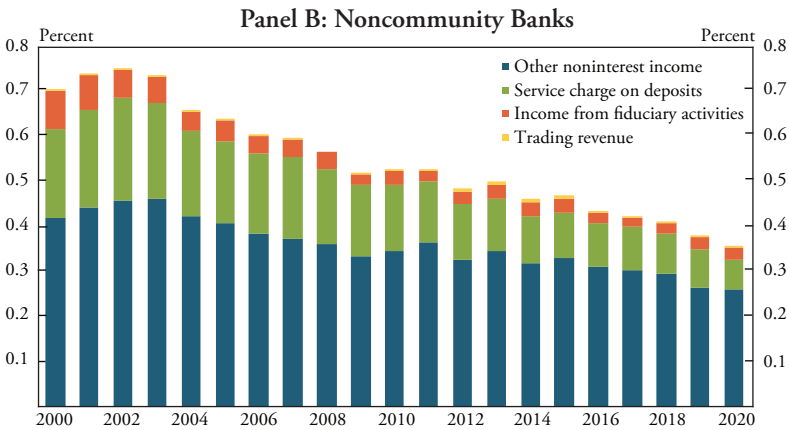
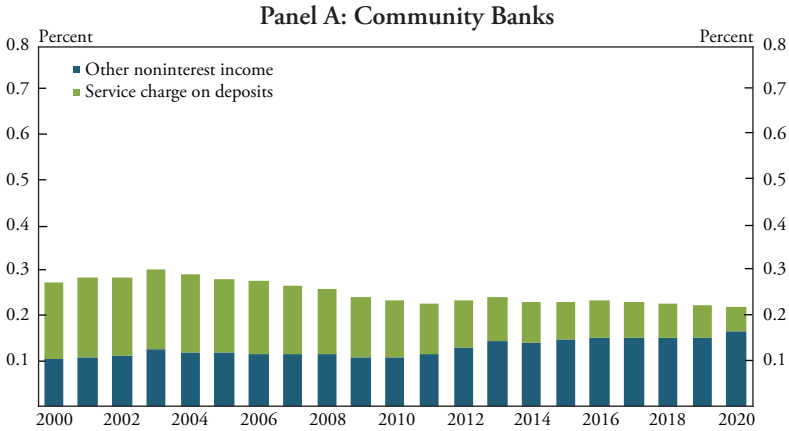
has declined steadily over the last 20 years, it remains well above that of community banks (the median is 0.42 percent of average assets for noncommunity banks as of June 30, 2020, compared with 0.26 percent of average assets for community banks). Noncommunity banks benefit from greater fee-generating activities such as securities trading/underwriting/brokerage and fiduciary services, along with various types of service charges. Although all banks have seen declining deposit service charge income and other noninterest income, noncommunity banks continue to earn significantly more from these sources, as shown in Chart A-6.²⁰ An analysis from the Federal Reserve Bank of Cleveland found that NIMs were negatively correlated with the level of noninterest income, further supporting the notion that community banks, which historically have higher NIMs, are more reliant on margin income and earn less from noninterest income sources.

Finally, noninterest expense has contributed further to the underperformance of community bank earnings relative to that of noncommunity banks. Chart A-5 shows that the median noninterest expense as a percentage of average assets has been higher at community banks for much of the past 20 years. As of June 30, 2020, the median noninterest expense for community banks was 1.32 percent of average assets, 16 basis points higher than the median for noncommunity banks. Although noninterest expense ratios have declined for both community banks and noncommunity banks, noncommunity banks have grown average assets at a faster rate relative to noninterest expense (FDIC 2020a). As previously discussed, economies of scale recognized by larger organizations contribute to lower noninterest expense ratios in noncommunity banks. Larger organizations are able to spread costs across a larger asset base and recognize synergies within business lines. The growing prevalence of digital banking threatens to further increase the gap between community and noncommunity bank earnings, as larger banks have invested heavily in new technologies that can deliver banking services more efficiently.

In contrast, the role of community banks in facilitating loans to small businesses through the SBA's PPP has highlighted the symbiotic relationship of community banks and small businesses, likely strengthening the viability of an essential community bank revenue stream for years to come. Participating lenders received origination fees ranging

Chart A-6

Components of Noninterest Income to Average Assets
(Median Values)



Sources: FFIEC and authors' calculations.

from 1 percent to 5 percent, according to the size of the loan, to compensate for the low interest rate associated with these loans. The program has provided banks with a stable earnings stream during a time when other lending opportunities were limited (Marsh and Sharma 2020). The fees may not have fully offset the operational burden of participating; however, for community banks, participating in the PPP had longer-term benefits, as providing a lifeline to small businesses both strengthened relationships and helped support local economic health.

Endnotes

¹Because this paper considers a 20-year time span, we use the GDP implicit price deflator to adjust the total assets of banks into real 2020 dollars to account for inflation. An important caveat is that definitions based on asset size can lead to anomalies. Some highly specialized banks may do business over a broad geographic area but still be classified as community banks because of their small size, whereas some banks that focus heavily on their local community may not be classified as community banks because they exceed the asset size threshold (Kahn and others 2003). However, these anomalies account for only a small population of banks and do not influence the aggregate trends.

²Branch banking refers to the establishment of branch locations outside of a bank's headquarters, while interstate banking refers to the establishment of subsidiary banks in separate states.

³To a lesser degree, changes to federal laws may have also played a role in consolidation trends. The Garn-St. Germain Act of 1982 included provisions that allowed out-of-state holding companies to acquire failing banks under limited circumstances to address an increasing number of troubled institutions.

⁴The substantial share of assets acquired and held by interstate bank holding companies was, to a great extent, due to the merger of several large banking organizations during the period. Several regional banking organizations were also active acquirers.

⁵The IBBEA provided states with discretion in implementation by allowing states to "opt out" of interstate banking prior to its enactment in June 1997. Two states (Texas and Montana) opted out initially but later opted in. Colorado, Kansas, Missouri, Nebraska, New Mexico, and Oklahoma debated opting out initially but ultimately opted in (American Banker 1995).

⁶Antitrust laws limit the benefits of increased market power. The appropriate regulatory agency and the Department of Justice analyze how a proposed merger would influence competition to ensure the combination would not have adverse effects.

⁷Many community banks failed in the 1980s due to overexposure to real estate and sectoral recessions in the agriculture and energy industries. During the GFC, many community banks that failed had heavy concentrations in commercial real estate, particularly acquisition and development loans.

⁸De novo banks that failed during the GFC tended to be overly concentrated in acquisition and development lending and relied on noncore funding. However, de novo banks are particularly vulnerable to economic shocks due to their financial fragility (Lee and Yom 2016).

⁹The 1,046 de novos established from 2000 through 2009 took an average of 8.6 quarters to turn a profit, compared with 6.8 quarters for the 30 de novos launched since 2010 (S&P Global 2020).

¹⁰“Rural areas” are defined as all areas not within a metropolitan statistical area, as established by the U.S. Office of Management and Budget.

¹¹At year-end 2019, the Farm Credit System was the largest holder of U.S. farm sector debt (43 percent), followed by commercial banks (40 percent), individuals and others (8 percent), life insurance companies (4 percent), the Farm Service Agency (3 percent), Farmer Mac (2 percent), and storage facility loans (less than 1 percent).

¹²Cole defines “small banks” as those with assets of \$1 billion or less in 2000 dollars.

¹³The ability to accelerate digital investments was a key driver in recent mergers-of-equals between SunTrust Banks Inc. and BB&T Corporation; First Citizens BancShares Inc. and CIT Group Inc.; and Huntington Bancshares Inc. and TCF Financial Corporation. Additionally, PNC Financial Services Group Inc. noted in their acquisition of BBVA USA Bancshares Inc. that they would be better positioned to optimize the significant investments made by BBVA in technology.

¹⁴Fintech companies operate under a fragmented regulatory framework that varies according to the firm’s business model. Fintech companies do not have one singular oversight body; their activities may be subject to certain federal or state regulations and licensing requirements depending on the type of services offered. However, the regulatory perimeter surrounding fintech companies continues to evolve in response to significant growth in the industry and increasing interconnectedness with the banking industry. Although fintech companies do not fall under the same supervisory framework as financial institutions, relying on a fintech company or third-party service provider does not negate a bank’s responsibility to ensure the products or services provided through that partnership comply with applicable laws and regulations.

¹⁵According to a 2017 Federal Reserve survey, the average size of business loans originated by large domestic banks was \$593,000 compared with \$146,000 for small domestic banks (Board of Governors of the Federal Reserve System 2017).

¹⁶Cross River Bank of New Jersey, a one-branch community bank with just over \$2 billion in assets at year-end 2019, was one of the top PPP lenders in 2020. Cross River Bank ranked 12th in net dollars approved and third in loan count. The bank, which had actively partnered on several ventures with fintech companies previously, engaged over 30 fintech companies to originate PPP loans.

¹⁷A bank’s capital is the difference in value between its assets and its liabilities. Bank capital is segmented into tiers based on the inclusion of various items, with Tier 1 capital representing a core measure available to absorb losses.

¹⁸The ALLL is a contra-asset account established to absorb estimated credit losses associated with the loan portfolio. Institutions subject to the general regulatory capital rule may include the ALLL in Tier 2 capital, limited to 1.25 percent of the institutions’ risk-weighted assets.

¹⁹NIM is a key ratio in assessing bank earnings performance; it reflects the profitability of core operations by expressing net interest income (interest income

less interest expense) as a percentage of average earning assets. This indicates how much income the earning assets are producing.

²⁰Other noninterest income contains service charge items such as fees from check sales, safe deposit boxes, ATM fees, and debit and credit card interchange fees.

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