President's Message: A 40-year perspective on community banking

by:

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In the face of many changes, community banks have remained a vital source of banking services for consumers and small businesses.

President George delivered these remarks in August at the Kansas Bankers Association's annual conference in Colorado Springs, Colorado.

The role of the banking industry in the U.S. economy has been central to my work at the Federal Reserve Bank of Kansas City for more than 40 years. From my first assignment as an examiner in 1982 to my current position as the Bank's president and CEO and member of the Federal Open Market Committee, I have witnessed dramatic changes to the financial system and the broader economic landscape. And despite this tremendous change, it remains as true today as it did in 1982 that access to credit and other reliable financial services is essential to the success of local communities, households and small businesses.

With that overarching theme, my remarks will focus on some key developments that I view as shaping the current and future community bank landscape. For example, my own Federal Reserve district, which covers the heart of the Midwest, parts of the Rocky Mountains, and the Southwest, has over the last few decades, gradually urbanized as people moved from small towns to larger, more urban centers, a trend that parallels much of the rest of the country. This population shift occurred as the District's economy became less concentrated in energy and agriculture and moved toward service sectors and away from manufacturing.

In the face of these changes, community banks have remained a vital source of banking services for consumers and small businesses, including being a key provider of reliable capital. When I talk to business leaders from the region, I often hear stories of how community banks help support local entrepreneurs and small business owners. I also hear stories of the challenges communities face when locally based banks disappear. One business owner in our region noted that after her community's locally owned banks were acquired, she turned to lines of credit from one of the nation's largest banks with favorable terms. In the midst of a product expansion, however, the national economy turned down and the line of credit was quickly withdrawn. The experience stood in sharp contrast to the reliable access to credit and long-term relationships with a community bank that her business had enjoyed across previous business cycles.

A closer look at changes over the decades

By far, the most significant change to the community banking landscape over the past four decades has been the declining number of banks and increased concentration in the banking sector. In 1985, just three years after I began my career with the Kansas City Fed, there were about 15,000 community banks in the United States. Today, that number is less than 5,000. Similarly, the number of banks in my seven-state region has declined by more than 70% over that same period.

Most of the decline in the number of banks has been due to mergers and acquisitions. Although community banks still represent the vast majority of bank charters, they now account for only about 13% of bank assets nationally as the nation's largest banks have significantly expanded their market share of assets and deposits. With a relatively rural geography, the Kansas City Fed's region still features hundreds of community banks, holding more than 60% of total banking assets and representing 99% of banks.

As the banking system has consolidated, its role in the financial system also has shifted. For example, banks have become a less important source of corporate credit. The share of business loans held by banks has declined from nearly 40% in 1985 to less than 25% today, as businesses are now more reliant on publicly issued debt and loans from non-banks. The decline in the number of banks may partly explain their reduced role in business lending, but it is not the whole story. Other factors from outside the financial sector have also contributed to these dynamics, including the country's changing demographics, increasing reliance on technology, and landmark regulatory changes.

Demographic shifts over the last four decades have significantly changed the composition of the U.S. population. Since 1980, the number of Americans 65 and older has more than doubled, and the United States has become more racially and ethnically diverse. The Hispanic population has tripled, and the U.S. population of those of Asian descent has grown five-fold, largely through immigration.

These demographic shifts have changed the communities that small banks serve. Non-metro counties, where large numbers of community banks operate, have seen both slower population growth and an aging customer base. These counties are also more racially and ethnically diverse today than they were decades ago, and community banks have had to adapt and adopt new strategies for attracting customers and employees.

In addition to demographic changes, technological advancements over the last 40 years have been striking. In the financial services sector, these advancements have disaggregated many traditional banking services. Product origination, delivery methods, and customer interactions with financial institutions have all changed dramatically. Banks are also increasingly automating processes that have historically required human interaction. Although these changes have expedited account management and allowed banks to leverage more advanced modeling to manage risks, they may also have contributed to larger banks' economies of scale. Perhaps most significantly, internet and mobile banking has allowed banks to reach customers across the globe, diminishing the necessity of geographic proximity.

Technology has also fostered competition from the broader financial services sector with new entrants promising greater speed, convenience, and flexibility in delivering financial services to households and businesses. More recently, lending and payments platforms have moved outside of the banking industry altogether. Household names in the technology sector such as Amazon, Facebook, Square, and PayPal, along with a wave of fintech startups, continue to pursue cutting-edge financial services.

These technological innovations reflect customers' changing preferences for value and convenience. In particular, the demand for fast and mobile payments continues to grow, and services providing these features are being adopted at a very rapid pace.

Along with payment innovations, non-bank lenders, especially fintechs, have made significant inroads into loan markets. Business lending by fintechs has grown very rapidly in recent years. This shift could reflect changes in customers' expectations or a considered decision by banks to avoid certain risky assets. Nonetheless, the trend does suggest a move toward transactional lending forms and away from relationship-based lending. If these trends accelerate, lenders that rely heavily on technological solutions using "big-data" to reach borrowers could challenge community banks' "soft information" advantage and market share.

Finally, regulation has been an important factor shaping the evolution of banking. Across the spectrum of regulatory changes, three aspects of regulation have factored prominently: geographic deregulation, the deregulation of non-banking activities, and regulation in response to crises.

Geographic deregulation began slowly in the late 1970s before picking up rapidly in the 1980s. Ultimately, what started as localized efforts to remove barriers to entry for banks resulted in federal legislation that allowed banks to operate and branch nationwide. As a result, bank consolidation picked up considerably starting in the 1980s, mostly reflected in mergers of smaller banks as intra- and interstate restrictions were relaxed. However, geographic deregulation also enabled the largest banks to begin operating nationwide and to compete globally. As market share of the largest banks increased in key loan markets, many community banks looked to mergers for scale or saw their balance sheets become more concentrated as some business lines moved to larger competitors.

Through the 1990s, as banking consolidated, the largest banks also began to engage in what were traditionally considered non-banking activities, predominately securities dealing and underwriting. While these activities had been prohibited at banks for close to 70 years under the Glass-Steagall Act, the Gramm-Leach-Bliley Act of 1999 permitted a wider array of activities at bank holding companies. In response, bank holding companies began engaging in investment banking while also maintaining access to important safety net advantages, such as deposit insurance and access to Federal Reserve services.

The deregulation of banks' activities and geographic operation produced two very different commercial banking models. Today, thousands of small community banks continue to operate in traditional business lines. At the same time, a handful of large banking organizations now operate at such scale and are so intertwined with the financial system that their failure poses systemic risks to the global economy. As revealed during the Global Financial Crisis, large banks have enjoyed some benefits from being "too big to fail."

After the financial crisis, however, the regulatory environment changed, as it often has following financial and economic crises. Regulators sought to learn from the earlier agricultural bank and Savings and Loan crises of the 1980s, as well as the Global Financial Crisis of 2007- 2009, and took steps to ensure a safer banking system after each crisis. The Dodd-Frank Act of 2010, for example, made important inroads into addressing "too big to fail" advantages—though how successful it was remains to be seen.

The regulatory responses to these crises have generally taken a one-size-fits-all approach. Regulations can be blunt instruments, failing to effectively account for

the incentives and risk profiles associated with the relationship lending model of many smaller banks. As a result, community banks can bear a disproportionate burden as they implement costly compliance processes without commensurate benefits to safety and soundness or fair access to credit.

The importance of community banks

Even as new nonbank entrants become embedded in the financial services sector, the banking system continues to hold a unique role in our economy. Banks remain the primary financial firms for providing liquidity when needed, ensuring that payments are readily transferable, and facilitating monetary policy implementation.

For their part, community banks continue to leverage relationship lending, with a focus on local lending and deposit-taking. Credit decisions are based on qualitative as well as quantitative aspects of a borrower's credit profile. In particular, smaller banks provide a critical source of financing for small businesses. Despite holding a fraction of the nation's banking assets, community banks underwrite a sizeable 40% of lending to small businesses. The strength of the relationship between community banks and small businesses was highlighted during the implementation of the Paycheck Protection Program. At a time when COVID-19 lockdowns threatened the viability of many small businesses, community banks ensured that pandemic relief funds quickly reached this segment of our economy, ultimately holding 37% of all outstanding PPP loans serviced by banks.

Beyond lending to local businesses and households, smaller banks often serve key leadership roles in their communities. These bankers sit on the boards of local schools, hospitals, and other civic organizations, not only meeting the credit needs of their local communities, but they are also an integral part of them.

Given the importance of these attributes to local economies, the implications of an evolving financial services landscape for access to credit in rural markets, for small business, and for the overall health of Main Street should be carefully considered. Both regulators and banks will be influential in ensuring these critical financial services can continue to meet the needs of thousands of communities, safely and efficiently.

A message to regulators

Having been handed thousands and thousands of pages of legislation intended to secure the financial stability of our nation's financial system, it's a tall order to ask bank regulators to minimize regulatory and supervisory burden while promoting competition and maintaining the safety and soundness of the banking system. It is made more difficult when the business models of banks vary from small, traditional banks to global systemically important banks. Still, in the interest of meeting the range of business needs served by these institutions, I see opportunities for further calibrating the supervisory framework, taking into account the business model of small banks in three key areas: advancing risk-focused approaches to supervision, appropriately tailoring capital requirements, and providing clearer guidance around innovation and alternative business models.

Over the past four decades, the volume and complexity of the data collected from community banks has increased substantially. This data has supported both policy development and supervision. Unfortunately, the time spent on the examination of an individual community bank has not meaningfully declined as a result of this data collection. In fact, according to the Conference of State Bank Supervisors, the most recent Community Bank Sentiment Index showed that community banker sentiment toward regulatory burden is at a multi-year low and more negative than any other component. Moreover, a large majority—81% of respondents—expect regulatory burden will be worse in the future.

Under the Economic Growth and Regulatory Paperwork Reduction Act, regulations can be questioned for their continued effectiveness and burden. This provides an avenue to reshape the supervisory framework in way that preserves its focus on safety and soundness and fair access to credit while recognizing today's banking landscape requires a far more tailored approach.

Among these regulations, capital requirements play a particularly important role in the stability of our financial system. Here, too, ensuring that these requirements are capturing the full range of risks and avoiding unintended advantages will be necessary. The financial crisis of 2007-2008, as well as the market upheavals of March 2020, demonstrated that extreme events can and do happen. Most importantly, bank failures, particularly large bank failures, are costly. Capital requirements should reflect these heavy social costs.

Currently, the nation's largest banks hold less capital than community banks. While small banks in the United States hold a Tier 1 leverage ratio of nearly 10%, global systemically important banks hold just under 7%. Imbalanced capital requirements, combined with perceived market advantages, can result in disproportionate gains for large banks and their shareholders. As a result, large banks may capture market share, thereby encouraging community banks to consolidate to compete. More work is needed in my view to tailor capital requirements across bank size and business models.

Finally, as the financial services landscape continues to evolve, regulators play an important role in providing clear expectations and timely guidance to regulated entities. The ability of smaller banks to compete and innovate as they respond to market dynamics and customer preferences will depend on such guidance, especially to evaluate investments in technology and various fintech and vendor partnerships.

A message to bankers

A more-tailored approach to regulation does not of course solve for every challenge confronting community banks, as bankers well understand. The strategies these banks pursue have long been the key determinant of their success and survival in meeting their communities' needs. Those strategies increasingly hinge on adopting new technology to meet the demands of a mobile and connected customer base and to attract talent. By doing so, bankers can lower costs, reach new customer segments—including underbanked populations—and drive new business growth.

Investments in technology can help banks meet their customers' changing needs, gain operational efficiencies, improve access to an evolving payments system, and better connect local customers to the broader economy. Adoption of instant payments settlement services, for example, offers the ability to provide new services that meet customer preferences for speed. Alongside private sector services, the Federal Reserve's implementation next year of a new retail payment rail known as FedNow will allow banks of all sizes to meet household and business demand for real-time payments. Deploying contemporary technology also can help to attract and retain a workforce with diverse skillsets. This talent can, in turn, help banks identify what is needed to compete in a connected, fast-paced world, and importantly, provide critical leadership succession.

Conclusion

The economic vitality of thousands of communities and rural geographies depends on reliable access to credit and other financial services. Over the past 40 years, much has changed in the delivery of those services, driven by demographics, technological innovation, and regulation. Over this time, community banks have continued to play an instrumental role in meeting the needs of rural places and their communities. With the right mix of strategy and innovation, and a well-calibrated regulatory approach, the community bank model can continue to be a trusted cornerstone of the U.S. financial system for thousands of households and small businesses who look to them for essential credit needs and services.
