AFTER THE RECESSION

THE CONTINUING RECOVERY OF COMMUNITY BANKS

A strong system of community banks is critical for the health of local, regional and national economies. While the health of community banks has recovered significantly since the financial crisis, commentary from bankers and industry analysts suggest they are still struggling due to pressures on core revenue from interest earned on loans and securities investments. Federal Reserve Bank of Kansas City Economist Charles S. Morris and Assistant Economist Kristen Regehr examine the reasons for these pressures in their research, "What Explains Low Net Interest Income at Community Banks?"

OVERALL PERFORMANCE OF COMMUNITY BANKS

Return on Average Assets

Source: Reports of Condition and Income

The overall performance of community banks—defined as banks with total assets up to $1 billion—has improved since the end of the Great Recession. For example, profitability, measured by return on average assets (ROAA), has increased significantly over the past few years, but remains below pre-crisis levels. While the increase in ROAA is encouraging, the concern about the recovery in community bank profits is the absence of any post-recession growth in net interest income.

Notes for both charts: The shaded areas depict recession quarters.

THE IMPORTANCE OF NET INTEREST INCOME

Net interest income is the core source of revenue for banks, particularly community banks. For example, in the third quarter of 2013, net interest income accounted for 62 percent of industry total revenue, but 77 percent of community bank total revenue.

Net interest income rose early in the recovery but has since decreased and is near a 40-year low (see chart on page 19). Low short-term interest rates, a flat yield curve (the relationship between short- and long-term market interest rates) and weak lending activity are cited by many bankers and analysts as important reasons for the current low levels of net interest income.

ECONOMIC CONDITIONS' INFLUENCE ON COMMUNITY BANKS

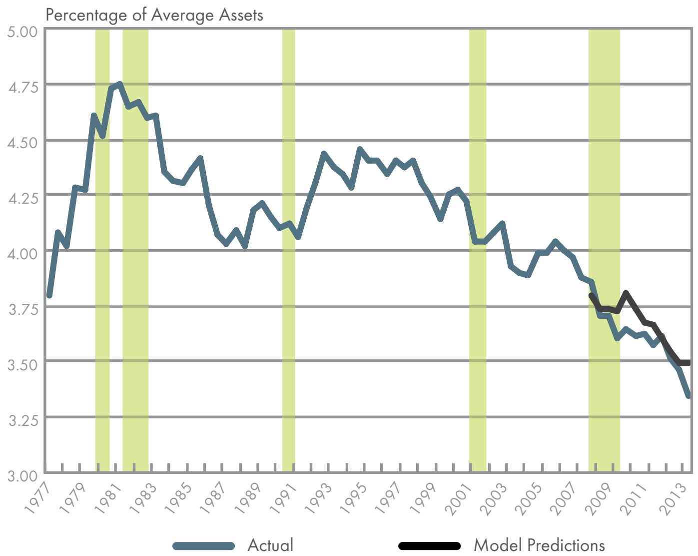
Net interest income depends directly on the interest rates a bank charges on loans, earns on securities and pays on deposits and other debts, and on the composition of its assets and liabilities. These factors, in turn, are affected by broader economic conditions, such as market interest rates and economic growth.

IS THIS THE NEW NORMAL?

Given community banks' importance to local households and businesses, policymakers, bankers and other interested parties would like to know whether low net interest income is the new normal for community banks or if it will recover once the economy improves.

EXAMINING RECESSIONS, RECOVERIES & NET INTEREST INCOME

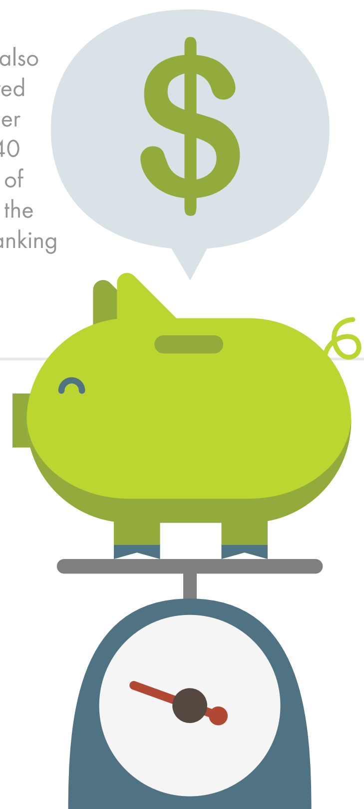
Community Bank Net Interest Income: Actual and Predicted Values



Source: Reports of Condition and Income

Why hasn't community bank net interest income recovered more than four years after the Great Recession? Morris and Regehr construct a model that shows how net interest income is affected over time by differences in economic and banking conditions. The black line shows the predictions of the model are fairly close to actual net interest income (blue line). The results indicate the decline in community bank net interest income in the current recovery is largely consistent with the historical influence of the factors that affect it, such as market interest rates and lending activity.

Morris and Regehr also find that when compared with recoveries from other recessions over the past 40 years, the current levels of net interest income are in the middle of the pack given banking and economic conditions.



THE FUTURE OF COMMUNITY BANKS

The success of community banks ultimately depends on their ability to earn an adequate return on lending. So, given the importance of community banks to local economies, the lack of recovery in community net interest income is a legitimate concern.

Community banks have faced hard times over the years, but they have always found ways to grow their business and thrive. Morris and Regehr's analysis shows that low net interest income can be explained by low short-term interest rates, a flat yield curve and a decline in lending. Thus, they conclude that net interest income should return to pre-crisis levels as the economy improves and monetary policy normalizes.

FURTHER RESOURCES

"What Explains Low Net Interest Income at Community Banks?," by By Charles S. Morris and Kristen Regehr, www.kansascityfed.org/publications/research/er/index.cfm.