

Community Banking:  
Is the Playing Field Changing for Bankers and Supervisors?

Thomas M. Hoenig  
President  
Federal Reserve Bank of Kansas City

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## **I. Introduction**

Community banks play a particularly important role within in the Kansas City Federal Reserve District, and the performance and health of community banks is a key focal point of our supervisory efforts. As all of you are aware, now is a particularly apt time to think about what the future might hold for community banks and what we as community bank supervisors should be doing.

Many revolutionary changes have occurred in our financial system over the past several decades, including the disappearance of about half the community banks in the United States. At the same, significant numbers of new banks are being chartered by investors seeking to fulfill perceived needs in their communities. For some, this recent past implies a limited and declining role for community banks, while others believe there is still a wealth of opportunities available for smaller institutions.

My remarks will first address the question of why community banks are important. Next, I will discuss the serious challenges that community banks will face, and then we will explore what these challenges mean for community bankers and what the future holds for us as community bank supervisors.

## **II. Why are community banks important?**

With banking consolidation and the growth of very large organizations, the Federal Reserve and other regulators recently have accorded much attention to systemically important institutions and the large complex banking organizations (LCBO) population. Sometimes lost in this large bank focus is the very important role played by community banks.

The critical role that smaller banks play in their communities was something that became very apparent to me as a bank supervisor in the 1980s. In our District, this period provided firsthand experience with what happens in communities when banks encounter problems and no longer have the financial resources to adequately serve their customers. While none of us want to repeat that experience, it provided detailed insights regarding the many different and crucial roles bankers play in their communities and what can happen when these links are disrupted.

In today's environment, we can cite a variety of financial needs that community banks serve, including lending to such groups as small businesses, home buyers and real estate developers, consumers, and farmers. In addition, community bankers meet their customers' needs for transaction and savings services and provide much in the way of leadership and financial advice in their communities.

Larger banks and other financial institutions provide many similar, competing services. However, community banks have traditionally found a unique and essential role in picking up business that doesn't quite fit the parameters under which other institutions operate. This business, for instance, often includes small companies and individuals without extensive track records and detailed financial statements, customers seeking more personalized services and treatment, and communities or markets with smaller volumes of financial activity.

I think the type of small business lending community banks do is a perfect example of the flexible and innovative nature of these institutions. Such lending also fulfills a need that might not otherwise be met so effectively in our financial markets. In fact, the role and importance of community banks is linked hand in hand with that of many small businesses.

In a study our Bank completed two years ago, we found that community banks – those with less than \$1 billion in assets – accounted for one-third of the small business lending done by banks. This lending role is much larger than the share of all bank deposits held by community banks – 19 percent – or bank assets – 15 percent. Community banks even provide additional support to small businesses through nonresidential real estate lending and individual lending to the owners of small business.

Small business lending by community banks also is important because of the unique form it often takes. In contrast to the “credit scored” and credit card loans that large banks typically offer to small businesses, community banks have made a market for themselves in relationship lending. Such lending involves taking time to thoroughly investigate and understand a small business, especially in cases where there may be little credit history or collateral to support a loan. Good relationship lending also entails closely monitoring a borrower after a loan is made and then being in a position to continue meeting the needs of a small business as its operations prove successful. The strength of community banks in relationship lending makes them particularly adept at meeting the needs of start-up businesses and businesses serving unique and innovative markets.

How important is this small business lending role to the overall economy? A few statistics on small businesses provide a good indication of their importance. According to the U.S. Small Business Administration, small businesses – those with fewer than 500 employees – represent 99.7 percent of all employers and employ one-half of all private sector employees – including much of the high-tech workforce. In addition, small businesses generated 60 to 80 percent of net new jobs annually during the 1990s, created

more than 50 percent of nonfarm private GDP, and produced many of the most commonly cited patents in the United States.

The role of small businesses was perhaps even more critical in the recent recession. While large businesses experienced a net decrease in employment in 2000 and 2001, small businesses hired more than 1.1 million new employees, thus creating all of the net gain in jobs for the U.S. economy.

In many ways, the importance of community banks parallels that of small businesses. While a community bank might not appear to be too important in the overall context of U.S. banking, community banks are important individually to their communities and, in the aggregate, to the national economy. Equally significant, they have served as a testing point or incubator for many start-up businesses and concepts that later assume a much larger role in the economy.

### **III. What are the challenges community banks face?**

A key set of questions for community bankers is: What challenges will they have to address, and what will the future hold for them? In other words, is the playing field changing for community bankers? I think that these are interesting and important questions for us to explore today – in part because we all play a role in the future of community banks, but also because the outcome is by no means clear.

Community bankers typically express a positive, optimistic outlook while mentioning a host of things that must be done to improve their situation. According to a survey we conducted last year of the community bankers in our District, we found that virtually all of the respondents had a positive outlook – 94 percent of those responding to our survey, for example, believed that it was “likely” or “very likely” that they would operate under

the same ownership and operating structure for the next five years. In addition, more than half of the bankers anticipated opening or acquiring additional branch offices during this period, thus indicating that many plan to expand their operations soon.

Undoubtedly, a key factor in the optimism of community bankers is the record levels of profitability they are achieving – a performance that comes just after banks went through some of the most challenging times in the industry. For instance, today's community bankers have successfully dealt with such challenges as the banking crisis of the 1980s and early 1990s, when more than 1,600 banks failed. They also have survived interest rate deregulation, the relaxation of geographic constraints on bank expansion, and rapid technological innovation in banking, including Internet banking. At the time, most thought that each of these events would greatly favor large banks and place community banks at a severe disadvantage.

Although community banks may play a somewhat smaller role than they once did, their record demonstrates that they have been remarkably innovative and flexible during periods of considerable stress. This record also shows that they fill an important need in our financial system.

However, it would be a mistake for community bankers to become complacent and think that they will not face strong challenges going forward. In many ways, I think community bankers may face comparable, if not stronger, challenges than in the recent past. Consequently, while it is difficult to see how everything will play out for community banks, I would like to spend some time looking at the possible challenges for community banks.

One indication of the challenges community banks will face comes from our survey of community bankers in the Tenth District. When we asked them about the challenges

they expect over the next five years, the most common responses were developing new sources of noninterest income, maintaining and attracting retail deposits, and achieving satisfactory loan growth. Other popular responses were achieving satisfactory net interest margin and return on average assets, meeting competition from other community banks, dealing with technological change, and meeting regulatory compliance requirements. Banks in slow-growing markets also mentioned the challenge of dealing with this slow growth and finding opportunities for diversification.

These responses all seem to reflect concerns about the competitive environment community banks will face and whether they can generate the business and revenue streams to be competitive players. As a result, we should take a step back and have a broader look at the competitive framework in our financial markets and the underlying factors that will test community banks.

First, we all think that we have seen a lot of consolidation in banking, and a recent FDIC study predicts that the pace of consolidation is likely to slow down now that the industry has largely adjusted to the relaxation of bank expansion laws. While this might be of some comfort to community bankers, there also are strong reasons for believing that consolidation will continue – including much at the community bank level.

In fact, if we look at other industries, they seem to be experiencing continued pressure for consolidation and in the context of an evermore competitive environment. This is particularly true for telecommunications, transportation, retail trade, and a number of other service sectors. Wal-Mart, for example, still continues a strategy of rapid expansion. While Wal-Mart first focused on rural markets where it faced weaker competition, it has continued to work on improving its distribution system and is now assuming an important and growing role in many metropolitan markets. Similar patterns

can be seen in other retailers, grocery stores, and restaurants, and franchising is leading to other forms of consolidation.

A number of lessons for banking can be drawn from these trends in other industries. One key lesson is that those best able to master their product distribution channels will find further opportunities for expansion. In this regard, larger banking organizations appear to have become better in handling their acquisitions, and there are signs that community banks are no longer benefiting much from customer fallout after big mergers. Also, many larger banks are now paying more attention to their retail business in an effort to lower their funding costs and make up for recent declines in large corporate lending. In fact, many large banks are expanding their branching networks in metropolitan markets, thereby bringing community banks and their larger counterparts into more direct competition. An additional lesson is that consolidation in other industries will continue to reduce the traditional customer base of community banks as more “ma and pa” businesses are replaced by “big box” retailers and franchises.

Another factor in the competitive framework that is likely to become more of a test for community banks is funding costs. Banks, particularly community banks, have benefited over the past few years from increased liquidity and low rates on deposits. Declining returns in the stock market and in other markets also have made deposits more attractive. Rising interest rates, better stock returns, and the increased attention large banks are giving to retail banking all suggest that community bank funding will again become more challenging. In addition, credit unions continue to expand rapidly and are attracting funds from many customers that would otherwise turn to community banks.

A third factor to consider as we look forward is technology. Community banks have been remarkably successful in finding third-party vendors to meet their growing needs in



technology. These vendors have allowed community banks to match many of the services offered by larger banks and in a reasonably efficient manner. However, technological innovation raises a number of competitive issues for community banks. Some of the more important include: Can community banks continue to be efficient and innovative as they rely on others to provide their technology? Will scale economies and the cost of technology give large banks a clear advantage at some point in the future, and will community banks have greater problems gaining access to payments and clearing networks? Will declining information costs allow big banks to reach more of the traditional customer base of community banks?

One other consideration is that many rural community banks are located in small communities with limited growth prospects and declining populations. Such markets pose another set of challenges for these banks. An important question for such banks is: Can they continue to generate enough business from their own community to operate efficiently or should they look for expansion and consolidation opportunities in other markets?

A final factor is regulation. The fixed cost of regulation has a particularly high impact on community banks since they have to become familiar with and comply with many of the same regulations as large banks, while having much less of a customer base over which to spread these compliance costs. An even better explanation of this was provided by a banker in our District who stated, “The regulation of small banks is like killing a gnat with a sledgehammer.”

All of these challenges thus suggest that the playing field and the competitive environment facing community banks will continue to increase in its intensity.

#### **IV. What will these challenges mean for community bankers?**

As we turn to the question of what community bankers will have to do to address these challenges, I think we all realize that it is hard, if not impossible, to anticipate how things will play out for community banks. As Yogi Berra once said, “the future ain’t what it used to be.”

We just discussed a number of reasons why the traditional customer base for community banks could be declining, while the competitive framework they face becomes more intense. However, we also have learned not to sell community bankers short when it comes to developing innovative and successful banking strategies.

Given the difficulties in forecasting trends, I would like to turn instead to what we learned from a study of successful community banks in the Tenth District. While many of the specific strategies these banks have used may have to be adapted to fit tomorrow’s conditions, I think their basic approach to banking provides a clear picture of what community banks must do to be successful in any environment.

We recently analyzed the performance of Tenth District community banks in slower-growing markets. We found that the typical community bank in these slow-growth areas did not perform as well as community banks in faster-growing markets when we looked at earnings, funding costs, efficiency, noninterest income, and asset quality. However, we did find a number of banks that did remarkably well in these more challenging markets, achieving a performance level near the top of all banks in the District. To find out how these banks could be so successful under less favorable conditions, we interviewed the presidents at 10 of these banks.

Although the general recipe for success at these banks shouldn’t surprise any of you as community bank examiners, the real keys to their performance were the strong

commitment to making their plans and strategies work, along with the ideas they had for serving their communities.

These bankers began with a positive but realistic attitude toward what they could accomplish. They concentrated on getting the basic business of banking down right, including exceptional customer service, highly efficient operations, and unquestionable credit quality. Several comments from these high-performing bankers illustrate this attitude: “We provide customers with everything a big bank can do, but at a better rate, quicker service, and more personal service. Customers can call me at home on Saturday and Sunday.” Another banker said, “We go the extra mile to take care of our customers. We do what other banks say they will.” Here is a quote that should please examiners: “We feel credit quality is the number 1 issue we have to deal with. We feel strongly we don’t want to have any questionable loans – in generating earnings make sure it is real.”

Perhaps the best story from one of these bankers was: “We were a very small, 1-rated bank back in the 1980s. All these other banks began having problems and we just started acquiring them. That set us on our way and we just stayed with that sound credit philosophy.” In case you are wondering about this bank – in 1980, it operated from a single office in a town of about 300 people and had about \$10 million in assets. Now, it has about \$135 million in assets and has offices in 10 different rural communities (five of which have populations less than 250 each). Moreover, this bank still provides strong support to its communities, while encountering virtually no credit quality problems.

Another important key to success for these bankers is that they are very active and innovative in looking for new business lines, but they enter new activities carefully and slowly and then expand as their customers prove themselves and begin to grow their own businesses. In the words of one banker, “We started out very slowly and carefully into

other types of lending. We are a conservatively aggressive group. We want to do things, but we want to do it slowly enough so we don't risk what we have.”

Nearly all of the bankers mentioned a hard-working staff and dedicated board of directors as critical elements in their bank's success. One banker told us, “Part of our success I might say is willingness to work. I credit the staff with a lot of it, because everyone down to the last person is willing to take care of the people they deal with, and they are willing to work the hours it takes to make it work.”

These bankers almost uniformly agreed that keeping up with banking regulation was a major challenge for their banks. These bankers, consequently, used a variety of methods for achieving regulatory compliance, including spreading the responsibility around amongst several staff people, subscribing to regulatory software, designating a compliance person, outsourcing part of their loan compliance, and attending regulatory update seminars given by supervisors and state banking associations.

The bankers also attributed much of their success to assisting the local community and the bank's next generation of customers. In a number of cases, this meant using FSA guarantees and SBA loans to meet the needs of young farmers and small businesses. As one banker stated, “We do many FSA guaranteed loans and a lot of these are for first-time borrowers – new, younger farmers. If a guy makes it, he will be with you forever.” Also, several of these bankers were trying to find ways to use Internet banking and other means to maintain the banking business of younger people, including those that were moving away.

In short, these bankers dealt with some very challenging conditions by demonstrating a thoroughly professional attitude, coupled with a strong commitment to their customers

and communities. So, if I have one prediction for the future of community banks, it's that bankers who follow these same guidelines are the most likely to be successful.

## **V. What does the future hold for us as community bank supervisors?**

As examiners and supervisors, we have an important role to play in the future of community banks. First, as the playing field changes, we, as regulators, must make certain that the new playing field ensures a sound and stable financial system. We have a duty to be sure that a community bank -- no less than an LCBO -- is operated safely and soundly. Weak and failing banks, while sometimes unavoidable in a market economy, are highly disruptive to their customers and communities. Consequently, as examiners and supervisors, your first and foremost duty is to apply the same prudential concerns and standards to community banks that would be applied to LCBOs and other banks.

In this prudential role, I would like to emphasize that you, as examiners, are extremely important to the future of community banks. Each of you has taken an in-depth look at dozens of different community banks and is in a good position to assess the comparative strengths and weaknesses of these banks. Thus, you are in a position to let bankers know where they are successfully following best practices, where they have shortcomings that they should correct, and what they can do to manage the risks they face.

This traditional examiner's role is particularly important at community banks, since many smaller banks have no one else making an independent assessment of their operations and overall condition. Consequently, I would encourage each of you to make full use of your experience and insights as you play an active and helpful role in the community banks you examine.

A second role that we play as examiners and part of the Federal Reserve is in creating a supervisory and regulatory framework that is effective in meeting our goals, is equitable for all financial institutions, and keeps compliance costs to a minimum. Maintaining a supervisory framework that meets all of these objectives, though, is becoming more complicated. Large banks continue to expand and take on broader and more complex activities, while most community banks remain focused on traditional banking services. As a result, there are growing differences across the banking industry and an increasing concern over what is appropriate in regulating both small and large banks. The regulatory review mandated by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) is focusing further attention on these regulatory issues.

This issue of an appropriate supervisory framework is a vital topic in the future of community banks and one that will be receiving much emphasis over the next few years. I believe that examiners can be an important part of this process. Indeed, many of our best regulatory comments and suggestions have come from field examiners, such as yourselves, who see the effect of particular regulations on daily basis, as well as the compliance issues they raise. Consequently, I would encourage each of you to continue to look for ways to improve our regulatory framework and to voice your opinions to your Bank's management and throughout the Federal Reserve System.

In looking forward, there are a number of community bank regulatory issues that the Federal Reserve and other banking agencies will have to resolve. I would like to take a few minutes to present some of these.

One current topic is CRA, especially with the actions being taken by the Federal Reserve, OTS, OCC, and FDIC to raise the small institution threshold. However, a

broader issue we must address is to determine the best way to evaluate the contributions smaller banks make to their communities. Does lending in the community provide most of this picture? Or is there something more that should be expected of community banks, and what size of bank should trigger different expectations and concerns?

Another community bank regulatory issue is capital standards. Basel II will allow large banks to link their regulatory capital closer to their own measures of risk. In some areas, such as residential mortgage lending and perhaps small business lending, Basel II might encourage major banks to make more loans or to hold more on their balance sheets. Although most community banks typically hold capital in excess of regulatory requirements, any advantages that Basel II might give to major banks could worsen the competitive position of smaller banks. Also, investors and large depositors could take the view that Basel II banks are developing more effective and transparent risk management systems.

The banking agencies are now discussing how the original Capital Accord could be changed to better measure risk exposures at banks not adopting the Basel II framework. Feedback from examiners would be particularly helpful in constructing new risk weights appropriate for community banks. Also, supervisors have been working on a new loan classification framework that will go beyond the current emphasis on borrower weaknesses and will attempt to focus more on the expected losses from a loan. This change will bring community bank loan assessments more in line with how Basel II banks will be assessing their loans. Community bankers also are likely to require added help from examiners as a new classification framework is implemented.

In all the surveys I have seen, community bankers invariably list the USA PATRIOT Act and the Bank Secrecy Act (BSA) as the two most burdensome laws they face – even

more so than Regulation Z and CRA. I know many of you have heard complaints from community bankers about BSA and the USA PATRIOT Act, and a variety of things have been discussed, ranging from changing the enforcement procedures for small banks to regulatory relief in other areas to compensate for the time bankers spend on these two acts.

Another important regulatory question we should be asking ourselves is: To the extent that community banks have a need to consolidate with one another, do our policies needlessly hinder such actions? More specifically, should we further relax antitrust policies to facilitate more community bank mergers in declining or slow-growing markets? Also, where should the Federal Reserve set the size limit for the small bank holding company debt policy?

One other area where we must be careful to implement policies that reflect the unique nature of community banks is corporate governance. Family ownership at many community banks coupled with much of the family's wealth tied up in the bank suggests a strong inherent interest in controlling risk and addressing stockholder concerns. As a result, some corporate governance problems and recommendations are less likely to apply to closely held community banks. Other problems we may face include the cost of imposing Sarbanes-Oxley on the larger community banks that are publicly traded. In this regard, the SEC has shown some interest in reviewing what should be expected of smaller, publicly traded companies.

A final regulatory issue for the Federal Reserve to consider is how to make financial disclosures easier for consumers to understand and less of a burden on banks. This is obviously a concern for all banks and their customers, but it is of particular interest at community banks.



These are all topics for which you have a great deal of expertise and I hope you will make your views known throughout the Federal Reserve.

## **VI. Concluding comments**

In summary, I would like to raise the question again of what is the outlook for community banks. I believe that community banks have an important role to play in our economy – a role that other financial market participants would have trouble filling as well as community banks have.

This need for community banks, though, is no guarantee of success. Community banks will face a number of significant challenges in the future and will face greater competition for their customer base, which are trends that could lead to a gradually declining role for these banks. Such trends also may mean more mergers among community banks as the more successful community bankers are called upon to spread their strategies to more markets and reach more efficient scales of operation.

I also would note that it would be wrong to sell community banks short. As previously mentioned, we have seen community banks in the Tenth District performing at exceptional levels – even under very challenging circumstances. I’m sure many of you have seen such banks in your own Districts. These banks – by getting the basic business of banking down right and by meeting the needs of their communities in an innovative and prudential manner – provide an indication of what community banks must do to survive and prosper.

Finally, I cannot stress enough the role that you, as examiners, and we, as the Federal Reserve, have to play in the future of community banks. You are in the best position of anyone to judge how well the regulation of community banks is working – which

regulations are effective, which impose too much of a burden, and what should be done in reforming community bank regulation. In addition, community bankers value your advice, especially given your experience and training and the wealth of information you have acquired on community banks. I can assure you that the Federal Reserve System also values all the contributions you are making to community bank supervision.