



## Is the Playing Field Changing for Bankers and Supervisors?

**This is an excerpt from a speech delivered by Bank President Thomas M. Hoenig at the 2005 forum for community bank examiners. To read the full text of the speech, visit the Bank's website at [www.kansascityfed.org](http://www.kansascityfed.org).**

**T**he 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 striking 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 of 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 small 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 as a single unit 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.

## **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

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 Federal Deposit Insurance Corporation 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

## **Record levels of profitability for community bankers attributes to a positive outlook for the next five years.**

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

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.

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**COMMENTS/QUESTIONS** are welcome and should be sent to [teneditors@kc.frb.org](mailto:teneditors@kc.frb.org).