The FDIC Podcast – The State of the Nation's Community Banks

BRIAN SULLIVAN: Welcome back to the FDIC Podcast, a place to talk about banks, banking and your money. I'm Brian Sullivan with the Federal Deposit Insurance Corporation. Today we talk about the state of our nation's community banks.

In this country, there are more than 5,000 banks…some are household names with trillions of dollars in assets. Other *community* banks are smaller by comparison but are nonetheless critical to the financial health in their communities.

Just how important are these community banks? And how are they holding up in this period of economic uncertainty?

The FDIC just published the *2020 Community Banking Study*, a look at the nation's community banks and the role they play in our broader economy.

Joining us is Diane Ellis, director of the FDIC's research division…and Shayna Olesiuk, the FDIC's associate director for national and regional risk analysis. Diane, Shayna, welcome!

DIANE ELLIS: Thanks Brian! Thanks for inviting us!

BRIAN SULLIVAN: Diane, let's begin with you. Set the table for us. What is this study all about?

DIANE ELLIS: Well, first of all, I would like to mention why we did this study. The FDIC insures all banks and most of the banks, by number of banks, are indeed community banks. And we are also the primary federal regulator of most of the nation's community banks. So, the FDIC has a strong interest in this sector and therefore, we regularly conduct research on issues important to community banks.

Well, it was our chairman, Chairman Williams, who asked us earlier in 2020 to prepare a study as a follow up to our 2012 comprehensive community bank study. At the time she had found that study very useful as a policymaker and she wanted us to update it. So, this study is another very comprehensive look at the community banking industry, and I think should be an interest to anyone interested in community banks in the U.S.

BRIAN SULLIVAN: You and your team looked at community banks from a lot of different angles. What did you focus on?

DIANE ELLIS: Well, there are six chapters, so six primary areas of focus, and the first four are similar to the 2012 study and certainly necessary for a comprehensive study of community banks. They include things like community bank performance, structural change, which also includes consolidation, demographic changes, which are particularly important to the community banks in rural areas, of which there are many. And also notable strengths of community banks, including their commercial real estate, small business, agricultural lending.

Two of the chapters are new compared to the 2012 study, they include one chapter on regulatory change and another on technology. Both of these issues have grown importance to community banks since 2012. So, we thought it would be important, it was important to focus on those issues.

BRIAN SULLIVAN: Ok, we'll get to both of those two issues in just a moment. Shayna let's dive into the meat of this study. What are the key findings from where you sit?

SHAYNA OLESIUK: Thank you Brian. I agree. There are several interesting results to talk about and I'm happy to highlight just a few here.

First, I'll talk about structural change. It should come as no surprise that our study observed a continued trend of fewer banks in our country. We call that consolidation. To be more specific, between 2012 and 2019, about 2,000 banks ceased operation for one reason or another. This is a trend among both community banks and non-community banks. So, it's important to talk about and highlight the cause of the consolidation and this cause has changed from the prior study.

As we move away from the financial crisis, bank failures have become less common. Now, voluntary mergers between unaffiliated institutions, in other words, banks that are not a part of the same holding company. These were the primary causes in the decline in the number of banks since 2012.

Also, even though the number of community banks has declined, their presence remains. Two statistics from the study illustrate this point. First, the community banks that closed in recent years, about two-thirds of these were acquired by other community banks. So, community banks presence is remaining in these areas. And importantly, more than 90 percent, or essentially all, community bank branches remained opened within a year after the acquisition. So, community banks as a whole aren't going away.

BRIAN SULLIVAN: That's good. Although there are fewer of them, they don't appear to be failing, rather they're combining.

SHAYNA OLESIUK: Correct

BRIAN SULLIVAN: You mentioned regulations and not to judge whether bank regulations are good or bad…but following the Great Recession in 2008, everybody agrees there was *a lot* of change. What impact did all this change have on community banks and how they operate?

SHAYNA OLESIUK: I agree Brian. During the last decade, the pace and volume of regulatory change affecting community banks, it's been intense.

Our study finds that during this period between 2008 and 2019, there were 157 new rules and programs that applied to community banks. Now, that works out to one every 28 days. So, keeping up with all of these regulations, would've challenged any bank, but especially smaller community banks.

So, our study looks at how all this regulatory change influenced community banks and I would point out two notable observations that boiled to the surface. So first, there was a reduction in residential mortgage lending by smaller mortgage lenders. Now to be clear, in aggregate, community banks are not reducing their mortgage holdings, but the smaller community banks are and it's reasonable to think that regulations focused on mortgage lending are contributing to this trend.

Now secondly, there's been an increase in the amount of initial capital that small banks start out with. This suggests that the groups starting these new banks believe that the amount of capital they'll need to operate a new bank has increased and we believe that this is at least partially attributable to regulatory compliance costs.

DIANE ELLIS: You know Brian, I'd like to add here that it's very difficult to empirically quantify the scale economies that may develop over time and also why banks make certain business decisions that they make. And so there may be a number of factors at work here, but I think our study points to the fact that regulation certainly should be considered one of the important factors driving the change in the composition of mortgage lending, and also the size of the initial capital contributions that new owners are making.

BRIAN SULLIVAN: Diane, in our previous podcast on the role community banks are playing in making loans to small businesses during our pandemic… loans made through the Small Business Administration's *Paycheck Protection Program…* you told me that these generally smaller banks are playing a huge role. 'Punching above their weight' as it were. What does this larger study say about the *kinds* of loans community banks are making?

DIANE ELLIS: Sure, well it confirms that they are indeed sort of punching above their weight in a few areas, not just in PPP loans. Community banks as you mentioned at the outset tend to be relatively small, but their commercial real estate, small business…that's what PPP loans are – small business loans…and agriculture loans. The lending in these three areas far exceed their relative size in the banking industry. So, while community banks account for just 15 percent of the banking industry's total loans, they hold 30 percent of commercial real estate, 36 percent of small business loans and 70 percent of agricultural loans. They're clearly important providers of credit in these areas.

BRIAN SULLIVAN: You brought up technology earlier…with the explosion of digital and online banking, how are community banks adopting technology compared to the non-community banks?

DIANE ELLIS: And that's definitely as I indicated earlier a significant trend that emerged after our 2012 study so it's something we wanted to focus on. It's kind of hard, given the lack of data, but we did rely upon some survey data from the conference of state bank supervisors to do some pretty creative analysis.

And we found that several factors drove community banks adoption of technology, including their characteristics, the economic and competitive environment, and attitudes and expectations of bank leadership. So, for example, we found that larger community banks and community banks with higher loan to asset ratios and higher growth were greater technology adopters. Similarly, community banks face greater competition and those whose leadership had more optimistic expectations about the future also were more likely to adopt technology.

BRIAN SULLIVAN: Are we at a moment where community banks really must adopt technology or else?

DIANE ELLIS: Well, I think so, yes. There are a number of studies showing the growing use of technology. Our own "How America Bank" study, which we released late last year, shows a significant trend in customer use of mobile banking and I think those trends are only going to continue. So yes, I think that community banks are definitely faced with the need to adopt technology and new technology and that is definitely one of their challenges given their smaller size.

BRIAN SULLIVAN: Shayna, now that we've established how important community banks are to the health of our economy, and specifically in certain sectors like small businesses, small business lending, commercial real estate, farm loans…are *they* healthy themselves?

SHAYNA OLESIUK: Absolutely Brian. Community banks have reported positive financial performance during this period of economic recovery that the study covers from 2012 to 2019.

In particular, one measure of earnings that we reference in the study is pre-tax return on assets or the ROA ratio, and this ratio for community banks has steadily improved during the study period of 2012 to 2019. In other words, community banks are narrowing this earnings gap relative to non-community banks.

Community banks have also benefited from wider net interest margins and better asset quality metrics that are superior to those of non-community banks. Now, I think it's important to point out as well, despite these positive trends, community bank earnings do continue to lag non-community banks, and this is primarily result of the fact that community banks are generating lower volumes of non-interest income. This is trading income and other investment income from business lines that are not traditionally a focus of the community banking model.

BRIAN SULLIVAN: Still a gap, but a more narrow gap.

SHAYNA OLESIUK: Definitely

BRIAN SULLIVAN: Diane, you get the last word here…I know this report focused on community banks from 2012 through 2019, but is there anything in this study that tells us how community banks are holding up during our public health crisis and all the economic fallout?

DIANE ELLIS: Well, for each of our six chapters we did have a mention, we tried to acknowledge the role that the pandemic and the economic fallout might have in that area.

You know, despite the fact that this pandemic has been going on for some time now, there's still a great deal of uncertainty of how it's going to affect banks. Thus far, I think it's fair to say that community banks have faced the challenges and uncertainty and are holding up well, and frankly that goes for banks of all sizes.

But we expect that there still are challenges on the horizon that are going to take some time to play out. For example, credit quality, that's probably a more near-term challenge. We would anticipate challenges for certain lending portfolios, such as commercial real estate or small business lending, which is as I mentioned earlier, what community banks specialize in.

Over the longer run, there could be demographic and structural changes. So, if people move away from cities to rural areas, where there are many community banks, some community banks may find new growth opportunities that didn't exist before. Back to technology, community banks that have adopted technology may be better positioned to respond to demand for contactless ways of doing business. So, I would have to say there is still a lot of uncertainty and we are going to be paying close attention as things play out.

BRIAN SULLIVAN: Well, if you want to read more about the state of our nation's community banks, visit, FDIC's website…FDIC.gov…and search 'Community Banking Study.'

Diane Ellis…Shayna Olesiuk…thank you both for joining us!