

The Evolution of Community Banking

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Since the onset of the global financial crisis, commercial banks have been widely criticized for their role in helping cause the meltdown. They operated with too much leverage. They pushed subprime mortgages on unwary consumers. They speculated with derivatives. Executive compensation and poor governance practices encouraged excessive risk-taking. To a degree, all of this is true. Of course, all banks are not the same and not all banks followed these practices.

In the U.S., the financial crisis has demonstrated the dramatically different roles played by various financial institutions. At one extreme we have firms that regulators and politicians designate as “Too Big to Fail” because they are deemed too interconnected. The failure of one will presumably lead to the failure of others and eventually to economic chaos. Most bankers, bank regulators and analysts attribute the above risky behaviors largely to these giant institutions. At the other extreme are community banks. At the start of the crisis, most community banks were highly capitalized and flush with liquidity. While many had concentrated loan portfolios, agriculture and commodity prices, oil and gas prices, and the values of commercial real estate and land were relatively high such that community banks experienced few problem loans. Banks heavily exposed to agriculture and commodity prices have fared relatively well as these values have either risen or stabilized. However, with the ensuing economic collapse and subsequent decline in real estate values, concentrated commercial real estate loan portfolios now exhibit considerable risk. The change in profiles reflects the important role that community banks play.

Traditional Community Banking

Prior to the advent of option ARMs, credit default swaps, collateralized debt obligations, hedge funds and the push toward credit-scored loans and securitization, banking was a relatively simple business. A bank accepted deposits from individuals and businesses, made loans to these same customers and provided related financial services. In order to better match the interest rate risk characteristics of certain loans, they might borrow from the Federal Home Loan Bank and pledge the loans as collateral. The primary sources of revenue were net interest income and deposit service charges. These revenues, in turn, had to be sufficient to cover overhead costs and taxes to generate a profit. Bankers managed credit risk by knowing their borrowers. They managed liquidity risk by relying on stable deposit funding and holding a reasonable amount of unpledged securities. They were less concerned about maximizing profitability via leverage, so they maintained high capital ratios. While aggregate profits rose and fell with growth and the business cycle, most community banks did not place the institution at risk of failure.

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The next few years will see a return to traditional community banking practices. The emphasis will be on sound and comprehensive risk management practices. With anticipated legislative and regulatory changes, operating and compliance costs will rise such that the returns to traditional banking will fall. Hopefully, this will be temporary as managers restructure their portfolios and the institution's product/service offerings as well as determine the appropriate pricing.

Attributes of Community Banks

Importance of Relationships: Community banking is relationship banking. Specifically, community banks focus on high-touch customer relationships. They know their customers personally. Core deposits are obtained primarily from individuals and businesses within the institution's trade area. Managers know how loan proceeds will be used and how borrowers expect to repay them. Community bankers know their communities because they live in them and serve as community leaders. Community bank customers, in turn, know their bankers. They prefer to conduct business with the same individuals over time. They like not having to explain the financial performance of their business to a new loan officer every time they want to renew a loan or request a new loan. They deal with local people who make the ultimate decisions. They can get quick responses and have a local bank employee answer questions as necessary. High-touch relationship banking involves regular customer contact at a personal level.

Business Focus and Pricing: For this personal service, community banks charge a premium. Customers who view loans or CDs as commodities will typically deal with the largest institutions or anonymously with any firm over the internet. These customers are rate shoppers who have the resources and time to search for the lowest prices. Community banks do not have the pricing power that large financial firms have so they compete by offering high quality personal service to small businesses and individuals. Their investment niche is typically agriculture lending, small business lending and commercial real estate. They fund the majority of their investments with federally-insured deposits. Institutions that stayed close to these core business strategies have generally performed well before, during and after the onset of the crisis. Most community banks do not make large amounts of subprime loans, do not deal in off-balance sheet derivatives and do not have compensation programs that encourage risk-taking. They operate with relatively high amounts of capital. Still, many community banks over-invested in construction, land and development loans. With the collapse in real estate prices and related activity, these banks have suffered.

Size: Community banks can be any size. They can operate with a large branch network and offer services in different geographic markets. The critical question is whether they emphasize relationships over transactions. As banks grow and expand their products and services, they often attempt to reduce costs by centralizing operations and decision-making. More credit decisions are made via credit scoring. They originate more loans with the intent of securitizing or selling them. They acquire businesses that generate fees and focus on cross-selling non-credit or deposit services. Once management emphasizes

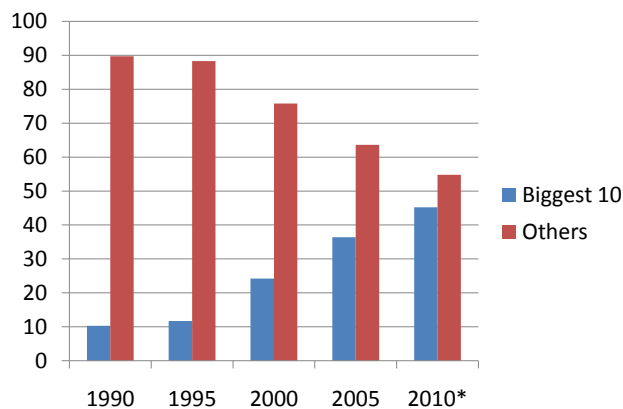
the volume of transactions over personal relationships, the bank loses much of the personal touch which distinguishes a community bank. The ultimate test of whether a bank is truly a community bank is whether management focuses on personal relationships and the type of decision-making associated with knowing your customer personally.

Impact of the Financial Crisis

The financial crisis has had and will have many unfortunate consequences for community banks and the macroeconomy including:

- The largest financial firms are getting larger. Under the original Supervisory Capital Assessment Program (SCAP) in March 2009, 10 of the 19 subject institutions were told to raise \$185 billion in common equity, which they successfully did.² The government guarantee under ‘Too Big to Fail’ combined with the good news following SCAP allowed these large institutions to promptly raise capital and quickly return to profitability with their diversified loan portfolios and heavy reliance on fee income. Exhibit 1 demonstrates that the 10 largest institutions controlled 42% of all deposits in the U.S. at the end of September 2010, which is up from just 24% in 2000 and 10% in 1990. What a perverse result! The largest institutions which contributed more to causing the crisis are benefitting from the crisis at the expense of smaller institutions.

Deposit Market Share of the 10 Largest U.S. Commercial Banks



*Through Sept. 2010

² Federal regulators recently announced that the same 19 large institutions must go through a similar assessment toward the end of 2010.

- The crisis brought about the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. While generally directed at larger institutions, many of the provisions and subsequent regulatory actions will increase compliance costs significantly. Dodd-Frank stipulates that regulators will conduct 67 formal studies and create almost 250 new regulations. The net effect will be to raise compliance costs.
- 140 banks failed in 2009 with another 149 having failed through November 30, 2010. Most failed banks are community banks. To pay insured depositors, the Federal Deposit Insurance Fund (FDIC) increased deposit insurance premiums that banks pay thereby sharply reducing the profits at many community banks. The number of problems institutions further increased from 829 to 860 at the end of September 2010. When regulators lower an individual bank's CAMELS rating and puts the institution under a formal enforcement action, the bank pays a much higher insurance premium. These increased regulatory sanctions on individual banks helps to self-fund the Deposit Insurance Fund. Premiums will likely remain high for several years until the fund is replenished.
- In response to the crisis, bank regulators have taken a harder line when examining banks for safety and soundness and compliance. Along with accountants, regulators are requiring banks, particularly those with large amounts of construction, land and development loans, to sharply increase their allowance for loan losses. Many community banks operate under formal or informal enforcement actions which typically require more capital, increased on-balance sheet liquidity, a lesser reliance on wholesale funding, a resolution program for problem assets and an independent assessment of management, among other items.
- In July 2011, banks can pay interest on commercial checking.

All of these actions will reduce credit availability in the near-term and lower the expected profitability from the traditional business of community banking. We will not know the full impact until we get clarity on the nature of new regulations and how they are enforced.

What Will the Future Look Like?

As Yogi Berra once said, "This is like déjà vu all over again." Community banking in the future will look fundamentally like traditional community banking in the past. In essence, it will represent a return to core values with some new bells and whistles. Given the regulatory and economic environment and emphasis on risk management, community banks will need to emphasize traditional on-balance sheet products and services. Think of building a Fortress Balance Sheet.

What will the fortress balance sheet look like?

- High amounts of capital with a large portion comprised of common equity
- High amounts of core deposit funding
- Reduced reliance on wholesale borrowings
- Large amounts of unpledged securities
- A diversified loan portfolio with reduced loan concentrations
- Make loans retaining some “skin in the game”

The bells and whistles will reflect the non-traditional activities that community banks choose to offer. Importantly, technology is the great equalizer. Community banks can afford and must invest in new technologies as they arise. The next generation of bankers will rely more on the internet and mobile banking as delivery mechanisms. To prevent wealth from leaving local communities as it's transferred among generations, banks will have to offer some form of trust and wealth management services that hopefully will help tie even those customers that leave the community to the local bank. Banks will have to invest in their employees to ensure that they hire and retain the best talent. Finally, community banks will likely enter into partnerships with other community banks to gain access to new products and services. This type of reverse holding company form will reduce costs while it ensures access to the best technology and services.

Community banking offers extraordinary opportunities to those individuals and firms that choose to work through the current difficulties. Community bankers play an important role with their local knowledge and the trust of their customers. Individuals and small businesses depend on these relationships and benefit from them. The future growth and viability of many local businesses and small communities depends on the actions of community banks and bankers. While the number of banks will likely fall, those that emphasize the basics of banking will grow and generate reasonable returns to all stakeholders.