The Role of Community Banks in the U.S. Economy

The U.S. banking system is unusual in consisting not only of some very large banks but also a large number of relatively small community banks. This bifurcated banking structure resulted largely from a legal framework that, in the past, restricted banks' abilities to diversify geographically. This institutional structure, in turn, reflected a long-standing concern in the United States about the concentration of banking power in a few very large institutions located far away from many of the customers they serve.

The bifurcated banking system in the United States has served the economy well. Over time, with regulatory change and financial innovation, large banks have become complex organizations engaged in a wide range of activities. They provide a variety of services to their customers, but often rely on hard financial information, computer models, and centralized decision-making as the basis for conducting business. In contrast, small banks have focused more on "relationship banking,"

This article was prepared under the direction of a bankwide work group headed by George A. Kahn, vice president and associate director of research in the Economic Research Department; Linda Schroeder, vice president in the Supervision and Risk Management Division; and Stuart Weiner, vice president and economist in the Payments System Research Department. William Keeton, senior economist in the Economic Research Department, was the principal author. Jim Harvey and Paul Willis, policy economists in the Banking Studies and Structure Department, also contributed to the article. This article is on the bank's website at ***www.kc.frb.org.***

basing decisions on personal knowledge of customers' creditworthiness and a keen understanding of business conditions in the communities they serve. In this way, the bifurcated banking system has served the needs of a diverse U.S. economy composed of businesses of all shapes and sizes and consumers with diverse needs and preferences.

While community banks have a clear place in the U.S. banking system, some analysts have questioned whether they play a sufficiently important role in the economy to warrant public interest and oversight. With increased merger activity over the last 20 years, the number of community banks—while still quite large—has declined. In addition, small banks pose little systemic risk to the nation's financial system. And, if community banks were not there, other financial services providers might readily step in to take their place.

This article examines the role of community banks in the U.S. economy. The first section of the article argues that, while community banks hold only a small share of the nation's banking assets, they provide important financial services—for which there are few, if any, substitutes—to some key sectors of the economy. The second section argues that community banks will continue to play an important role in the banking industry, even as technology and market conditions change. The paper concludes that the Federal Reserve therefore has a strong interest in understanding issues facing community banks.

I. THE CURRENT ROLE OF COMMUNITY BANKS

The banking system in the United States has always been unique in the sense of containing large numbers of small banks closely tied to their local communities. But the banking system in this country has also undergone tremendous change during the last 20 years due to deregulation and mergers. While community banks still comprise the vast majority of banks, the question arises whether their role in the banking system has declined to the point of insignificance. This section shows that community banks account for a much smaller share of total banking activity than they did 20 years ago, but that they still play a key role serving certain types of communities and providing certain types of banking services.

Definition of a community bank

There is no single definition of a community bank. However, most people think of community banks as having two key characteristics—they are small in size, and they do most of their business in the community in which they are located. Because these two characteristics tend to go together and because size is easy to measure, common practice is to define community banks as those below a certain size threshold.

This article also adopts this approach, defining community banks solely in terms of their size. It is important to note, however, that such a definition can lead to anomalies. Some highly specialized banks may be classified as community banks because of their small size but still do business over a broad geographic area. Conversely, some banks that focus heavily on the local community may not qualify as community banks because they exceed the size threshold. Among the large banking organizations falling in the latter group are two kinds—those that conduct most of their business within a single state (for example, Commerce and UMB in Missouri), and those that conduct business in multiple states but grant their banks considerable autonomy in dealing with local customers (for example, Community First Bankshares).

For purposes of this report, a community bank is defined as a bank owned by an organization with less than $1 billion in total banking assets.[1] This size threshold is the one most often used by banking analysts. However, some studies apply the $1 billion threshold at the bank level rather than the organization level, including all banks with less than $1 billion in assets even if they are owned by organizations with more than $1 billion in total assets. The main argument for applying the threshold to the whole organization is that important decisions in a multibank holding company tend to be made by holding company management. This approach is also consistent with the way regulators measure market concentration in deciding whether proposed bank mergers raise antitrust concerns. As noted above, however, there may be some instances in which the subsidiaries of a large holding company behave more like community banks because holding company management has made a conscious decision to cater to local communities.

Table 1

DISTRIBUTION OF COMMUNITY BANKS BY SIZE OF ORGANIZATION

(December 2002)

Size of community banking organization	*Number of banks*	*Percent of all community banks*	*Assets (billions of $)*	*Percent of all community bank assets*
< $100M	3,429	49.4	170.4	18.5
$100M to $500M	2,946	42.5	521.1	56.4
$500M to $1B	561	8.1	231.8	25.1
All	6,936	100.0	923.3	100.0

Source: Reports of Condition and Income

Applying the above definition to the data, there were over 6,900 community banks at the end of 2002.[2] Almost half of all community banks belong to organizations under $100 million in size (Table 1). Because they are so small, however, these banks account for less than a fifth of total community bank assets. In terms of assets, the most important group of community banks are those in the middle size category—those belonging to organizations between $100 million and $500 million in size. These banks represent two-fifths of all community banks and account for well over half of all community bank assets.

Share of community banks in total banking activity over time

Community banks account for a very large share of all banks but a much smaller share of total banking activity. As shown in Table 2, community banks represented 89 percent of all banks at the end of 2002. In sharp contrast, they accounted for only 34 percent of banking offices, 19 percent of bank deposits, 16 percent of bank loans, and 15 percent of bank assets. The reason community banks hold a smaller share of bank assets and loans than of bank deposits is that they have less access than larger banks to nondeposit sources of funds such as federal funds, repurchase agreements, and subordinated debt.

Table 2

SHARE OF COMMUNITY BANKS IN TOTAL U.S. BANKING ACTIVITY

(End of year)

	1980	1990	2002
Banks			
Number	12,366	10,180	6,936
Percent of total	85.7	83.3	88.5
Banking offices			
Number	23,947	22,171	23,565
Percent of total	51.6	39.3	34.1
Assets			
Amount (billions of 2002 $)	1,024	907	923
Percent of total	30.6	21.7	14.8
Deposits			
Amount (billions of 2002 $)	895	798	762
Percent of total	34.5	24.7	19.3
Loans			
Amount (billions of 2002 $)	535	502	591
Percent of total	30.0	19.3	15.5

Note: Data are for end of year except banking offices, which are for middle of year. Assets, loans, and deposits are for domestic offices only.

Source: Reports of Condition and Income and Summary of Deposits

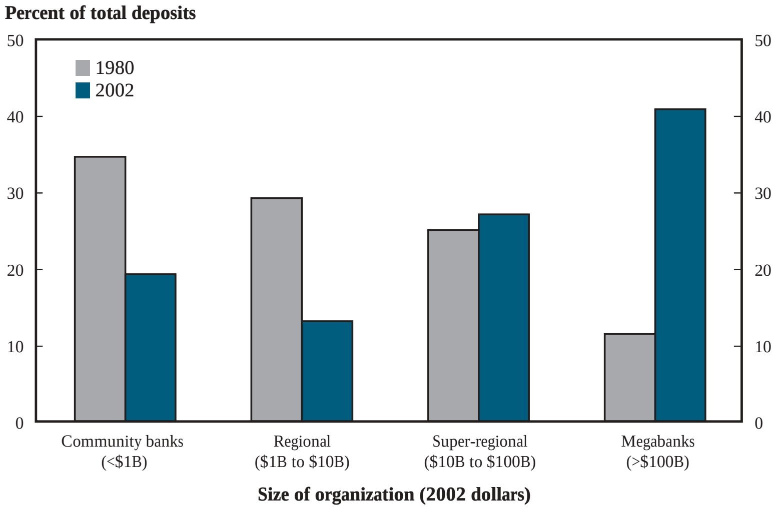
These measures of community banks' importance are down considerably from 1980. Since that time, community banks' share of banking offices has fallen by 18 percentage points and their share of bank deposits, loans, and assets by about 15 percentage points. The decline in community banks' market share has been continuous. However, the pace of decline moderated somewhat in the 1990s, with community banks losing only half as much market share in that period as in the previous decade.

Community banks have not been the only group of banks to lose market share over the last 20 years. As shown in Chart 1, the deposit share of organizations between $1 billion and $10 billion in size, often referred to as "regional" banking organizations, has declined by roughly the same amount. The big gainers during this period have been the "megabanks," those over $100 billion in size. These organizations held only a tenth of total deposits in 1980 but now account for two-fifths.

Chart 1

DEPOSIT DISTRIBUTION BY SIZE OF BANKING ORGANIZATION

(End of year)



Source: Reports of Condition and Income

The reduction in community banks' role in the banking system has been due mainly to absorption by larger banking organizations, and not to below-average growth at those community banks that remained independent. As discussed in more detail in the next section, deposits and assets have actually tended to grow somewhat faster at community banks than at larger banks after adjusting for mergers, suggesting that the community banks that have survived consolidation have had little difficulty competing for customers.

Importance of community banks in key sectors

While community banks account for a relatively small share of total banking activity in the United States as a whole, they remain highly important in some types of communities and in some parts of the country. Community banks are especially important in rural communities, accounting for 58 percent of all banking offices in such communities and 49 percent of all deposits (Table 3). While community

Table 3

IMPORTANCE OF COMMUNITY BANKS BY TYPE OF MARKET

(June 2002)

Type of community	Number of community bank branches	Percent of all bank branches	Deposits at community bank branches (billions of $)	Percent of deposits at all bank branches
Rural	11,787	57.8	325.9	49.3
Urban	11,778	24.2	412.1	13.5
< 1M	5,222	30.9	159.7	23.2
1M to 5M	3,887	23.2	136.2	13.9
> 5M	2,669	17.8	116.1	8.4
All U.S.	23,565	34.1	737.9	19.8

Source: Summary of Deposits

Table 4

IMPORTANCE OF COMMUNITY BANKS BY FEDERAL RESERVE DISTRICT

(June 2002)

District	Number of community bank branches	Percent of all bank branches	Deposits at community bank branches (billions of $)	Percent of deposits at all bank branches
Boston	451	22.5	14.5	9.3
New York	744	13.1	29.0	5.0
Philadelphia	848	26.4	26.9	14.1
Cleveland	1,254	26.8	34.8	15.4
Richmond	1,923	25.4	55.0	16.4
Atlanta	3,357	32.4	106.6	23.1
Chicago	3,642	39.3	126.4	26.2
St. Louis	2,493	50.0	76.6	41.2
Minneapolis	1,951	65.3	54.8	44.7
Kansas City	2,968	58.3	84.0	45.2
Dallas	2,049	46.5	64.9	28.1
San Francisco	1,885	21.3	64.4	11.5
All U.S.	23,565	34.1	737.9	19.8

Source: Summary of Deposits

Table 5

IMPORTANCE OF COMMUNITY BANKS BY STATE

(June 2002)

State	Number of community bank branches	Percent of all bank branches	Deposits at community bank branches (billions of $)	Percent of deposits at all bank branches
Kansas	**904**	**75.3**	**22.3**	**64.4**
Iowa	922	75.4	27.2	64.3
North Dakota	275	77.7	6.5	59.4
Arkansas	646	59.9	18.4	55.1
Oklahoma	**637**	**65.3**	**20.6**	**54.6**
South Dakota	254	68.1	7.4	53.4
Montana	191	60.3	5.3	52.1
Nebraska	**495**	**66.3**	**12.5**	**47.7**
Wyoming	**85**	**47.8**	**3.4**	**44.1**
Kentucky	709	46.6	20.9	41.6
New Mexico	**164**	**41.1**	**5.6**	**40.2**
Wisconsin	854	52.2	26.1	38.2
Missouri	**971**	**51.0**	**29.5**	**38.0**
Minnesota	923	62.7	27.9	36.9
Tennessee	768	41.9	24.2	32.9
Mississippi	374	37.1	9.8	32.0
Louisiana	604	46.3	13.9	30.1
West Virginia	213	37.8	6.4	30.0
Vermont	86	39.4	2.1	28.8
Illinois	1543	45.7	63.7	27.7
Georgia	773	35.5	28.5	27.4
Texas	1793	45.3	58.7	27.0
Alabama	489	36.1	14.5	26.9
Maine	93	32.9	2.3	26.9
Colorado	**402**	**37.0**	**12.5**	**26.5**
Indiana	553	30.0	15.4	23.2
Idaho	88	24.1	2.2	22.8
Virginia	655	29.4	19.8	21.1
Alaska	24	20.0	1.0	21.0
Pennsylvania	916	29.1	28.6	20.9
Washington	369	29.3	9.8	20.3
Utah	121	24.5	3.5	20.0
South Carolina	264	25.1	7.4	19.8
Oregon	176	23.5	4.8	18.4
Florida	899	23.1	30.9	15.6
Michigan	568	22.0	17.3	14.4
Maryland	264	19.6	7.6	13.2
Ohio	738	23.0	20.0	12.6
Nevada	61	16.1	3.0	11.9
North Carolina	521	23.0	13.4	11.6
California	871	19.9	36.2	9.9
New Jersey	318	14.8	11.6	8.7
Connecticut	71	16.5	2.3	8.7
New Hampshire	61	28.6	1.7	8.2
Rhode Island	16	10.3	0.8	6.6
Massachusetts	147	16.8	5.9	6.5
Dist. of Columbia	22	13.9	0.7	6.3
Hawaii	29	14.1	0.8	5.3
Arizona	111	13.1	2.3	5.2
New York	446	13.0	17.8	4.1
Delaware	28	14.7	0.8	1.2
All U.S.	23,565	34.1	737.9	19.8

Source: Summary of Deposits

Table 6
DEPOSIT SHARE OF COMMUNITY BANKS, TENTH DISTRICT VS. U.S.
(June 2002)

Type of community	Tenth District	United States
Rural	72.7	49.3
Urban	28.9	13.5
<500K	41.7	26.5
500K to 1M	28.4	17.3
1M to 5M	25.2	13.9
> 5M	N/A	8.4
All	45.2	19.8

Source: Summary of Deposits

banks account for a much smaller percent of urban banking activity, they do play an important role in smaller metro areas. In metro areas with less than one million people, for example, community banks operate 31 percent of all banking offices and control 23 percent of all deposits.

Community banks are also much more important in some Federal Reserve districts than others. While community banks account for about a third of all banking offices in the nation as a whole, they account for half or more of all banking offices in three Federal Reserve districts—St. Louis, Minneapolis, and Kansas City (Table 4). In each of these districts, community banks also control more than 40 percent of deposits. Another indication of the importance of community banks in the Kansas City district is that four of its seven states are among the top ten in the nation when ranked by community bank deposit share (Table 5). These include top-ranked Kansas (64 percent), fifth-ranked Oklahoma (55 percent), eighth-ranked Nebraska (48 percent), and ninth-ranked Wyoming (44 percent).

One reason community banks are more important in the St. Louis, Minneapolis, and Kansas City Federal Reserve districts is that a higher percent of the population in these districts live in rural areas and small urban areas than in the nation as a whole. In the Kansas City district, for example, 33 percent of the population live in rural areas and another 32 percent in metro areas with less than a million people. In the entire United States, by contrast, only 19 percent of the population live in rural areas and only 23 percent live in metro areas under one million.

Demographics are not the whole explanation for the greater importance of community banks in the St. Louis, Minneapolis, and Kansas City Federal Reserve districts. Compared to the nation, for example, Table 6 shows that community banks in the Kansas City district account for a much higher share of deposits both in rural areas (23 percentage points) and each size category of urban area (11 to 15 percentage points). The fact that such differences in the importance of community banks remain even after controlling for demographics may reflect that intrastate branching was severely restricted in the Midwest until relatively recently, artificially limiting the size of banks in that part of the country.

Importance of community banks as financial service providers

Besides providing a substantial share of banking services in rural areas, smaller cities, and the middle of the country, community banks perform highly important roles as providers of relationship-based and information-intensive banking services. These services are consumed mainly by smaller customers such as small businesses, family farmers, and depositors of low to moderate wealth.

Small business lending. Community banks' role as small business lenders is important because small businesses account for a significant share of total output and employment growth. While there is no single definition of a small business, the most common one is a firm with fewer than 500 employees. According to this definition, small businesses account for just over half of private sector output and employment and provide two-thirds to three-quarters of net job growth. In fact, half of net job growth in the country is provided by even smaller businesses—those with less than 20 employees (U.S. Small Business Administration 1998, 2002).

Community banks have some important advantages over larger banks in making small business loans. Loan officers at small banks can take into account a wide variety of factors in reviewing applications for small business loans, including the character of the borrower and special features of the local market. Loan officers at large, geographically dispersed banking organizations are usually not given so much autonomy in making small business loans because it is not feasible for the top managers of such organizations to review every small loan decision.

Table 7

SHARE OF COMMUNITY BANKS IN BUSINESS LENDING
(June 2002)

Type of loan	Loans by community banks (billions of $)	Loans by community banks as percent of loans by all banks
Commercial and industrial	99.3	12.8
≤ $1M	78.5	32.5
≤ $100K	32.4	35.9
$100K to $1M	46.0	30.5
> $1M	20.8	3.9
Nonresidential real estate	145.6	27.7
≤ $1M	98.1	41.9
≤ $ 100K	19.1	61.4
$100K to $1M	79.0	38.9
> $1M	47.5	16.3

Source: Reports of Condition and Income

Instead, these organizations often prefer to rely on credit scoring models—statistical models that predict a borrower's probability of repayment based on such objective characteristics as personal wealth and past credit history (Cole and others, Berger and others 2002). While such a "cookie-cutter" approach to lending may improve the flow of credit to some small businesses—those whose owners have substantial personal assets and long credit histories—it may also result in other creditworthy small businesses being turned down for credit.

Another reason community banks may be better suited to making small business loans is that such loans often require a close, long-term relationship with the borrower. Lending to a small business with little credit history or collateral may require the bank to carefully monitor the borrower over the course of the loan. To cover the fixed cost of investigating a loan applicant and learning his business, the bank may also need to maintain a long-term relationship with the firm. Large banking organizations may be reluctant to engage in such relationship-based lending because they have a comparative advantage in more impersonal, transactions-based services and because it is inefficient to provide both kinds of services (Berger and Udell). Consistent with this view, researchers have found that large banks are more likely than small banks to deal with small business customers over a long distance, more likely to communicate with customers by mail or phone rather than face-to-face meetings, and less likely to maintain an exclusive, long-term relationship with the borrower (Berger and others 2002).

Data on small business finances confirm the special role played by community banks in lending to small businesses. According to one recent estimate, commercial banks of all sizes supplied 37 percent of small business debt in 1993, where small businesses are defined as non-financial, non-real estate firms with fewer than 500 employees (Berger and Udell). This estimate did not break down small business lending by size of bank. However, other data on bank lending by size of loan make clear that community banks account for a disproportionate share of total lending by banks to small businesses (Table 7). Researchers typically treat commercial and industrial (C&I) loans over $1 million in size as loans to large businesses and loans of $1 million or less as loans to small businesses. According to this definition, community banks accounted for only 4 percent of large business loans in June 2002 but 33 percent of small business loans—much larger than their share of deposits (19 percent) or their share of assets (15 percent). Furthermore, for *very small* business loans, those of $100,000 or less, the share of community banks was even higher, 36 percent.

Community banks are also important providers of another form of small business credit—bank loans backed by nonresidential real estate. In June 2002, community banks accounted for 42 percent of all non-residential real estate loans of $1 million or less held by banks and 61 percent of all loans of $100,000 or less held by banks.

Two other forms of evidence support the view that community banks have an inherent advantage over larger banks in making small business loans. First, some researchers have found that small banks earn higher rates of return on their small business loans than large banks, even after adjusting for loss rates (Carter and others). Second, although far from unanimous, studies of the impact of banks mergers on small business lending have generally found that small business lending declines when the acquiring banking organization is large (Berger and Udell).[3]

Farm lending. Given the importance of community banks in rural areas, it comes as no surprise that these banks are also important farm lenders. While farming is a much less important component of the

Table 8
SHARE OF COMMUNITY BANKS IN FARM LENDING
(June 2002)

Type of loan	***Loans by community banks (billions of $)***	***Loans by community banks as percent of loans by all banks***
Farm real estate	23.9	64.6
≤ $100K	11.0	82.6
$100M to $500K	9.6	64.9
> $500K	3.3	37.2
Farm operating	28.4	60.6
≤ $100K	16.0	82.2
$100K to $500K	8.7	64.4
> $500K	3.7	26.4

Source: Reports of Condition and Income

national economy than small business activity, many rural communities are still heavily dependent on farming. Indeed, the Department of Agriculture still classifies one in four rural counties as farming-dependent, defining such counties as those in which farming contributes 20 percent or more of labor and proprietor income (Cook and Mizer).[4]

Commercial banks as a group held 39 percent of all farm business debt at the end of 2002—a third of all farm real estate loans and a half of all farm operating loans (U.S. Department of Agriculture). As shown in Table 8, community banks provided the majority of such bank loans—65 percent of all farm real estate loans held by banks and 61 percent of all farm operating loans held by banks. The share of community banks is especially high for small farm loans, exceeding 80 percent for farm real estate loans and farm operating loans of $100,000 or less. Like small business loans, small farm loans require substantial information gathering and monitoring by the lender, helping explain why community banks account for an even larger portion of these loans than of all farm loans.

Retail deposit services. Relationship-based services are not only important to small businesses but also to many depositors. Some analysts argue that community banks are more interested than large banking organizations in providing personal service to depositors of low to moderate wealth. One possible reason for this difference in focus is that community banks depend more heavily on retail deposits for their

Table 9

DEPOSIT SHARE OF COMMUNITY BANKS BY SIZE OF ACCOUNT

(December 2002)

Size of deposit account	*Deposits at community banks (billions of $)*	*Deposits at community banks as percent of deposits at all banks*
All domestic deposits	762	19.3
Accounts ≤ $100K	477	23.5
Accounts > $100K	285	14.8

Source: Reports of Condition and Income

funds than large banks. Another reason is that large banks often prefer specializing in impersonal, transactions-based deposit services, where they tend to enjoy a comparative advantage over community banks due to their size and access to technology.

The limited data available suggest that community banks do focus more on small depositors than larger banks, although the difference is not as great as for small business and farm borrowers. At the end of 2002, community banks held 24 percent of deposits in accounts of $100,000 or less, but only 15 percent of deposits in accounts over that amount (Table 9). Community banks also tend to charge lower fees for retail banking services than larger banks, which some analysts interpret as a sign that community banks are more interested in attracting and retaining small depositors (Hannan). In 2001, for example, the average monthly low balance fee on NOW accounts was two to three dollars lower at depository institutions under $1 billion in size than at institutions over $1 billion in size, and the fee for stop-payments orders was two to five dollars lower (Table 10). Consistent with the view that large banks do not have as great a need to attract retail deposits, recent studies have found that large banks serving multiple markets tend to pay lower deposit rates than single-market banks serving the same markets (Hannan and Prager).

Table 10
AVERAGE RETAIL BANKING FEES BY SIZE OF INSTITUTION
(2001, in dollars)

	Size of institution		
Type of fee	*< $100 M*	*$100M to $1B*	*> $1B*
Monthly low balance fee on NOW account	7.61	8.52	10.71
Stop-payment order	16.69	19.46	21.53
Bounced check	19.33	22.05	24.70
Deposit items returned	6.82	7.60	5.90

Note: Includes both commercial banks and savings institutions.

Source: Board of Governors, *Annual Report to Congress on Retail Fees and Services of Depository Institutions*, June 2002

Summary

Community banks have declined in importance over the last 20 years but continue to play a key role in the banking system. There are still over 6,900 community banks, defined as those belonging to organizations under $1 billion in size, but they account for only a fifth of total deposits and an even smaller fraction of total assets and loans. Furthermore, these shares are down significantly from 20 years ago, as mergers have reduced the importance of community banks and increased the importance of super-regional banks and megabanks. Despite these declines, though, community banks still provide a significant share of banking services in smaller communities and in the middle of the country, where branching restrictions have limited the size of banks. Furthermore, in both rural and urban areas across the country, community banks continue to be important providers of relationship-based banking services, especially to small businesses and farmers but also to small depositors who place a premium on personal service.

II. THE OUTLOOK FOR COMMUNITY BANKS

Community banks still play an important role in the banking system. But can they continue to do so as technology and market conditions change? This section begins by pointing out that banking industry observers expect the number of community banks to decline further but remain in the thousands. The section then points out that community banks *as a group* have performed well relative to large banks over the last decade, but that very small community banks—especially those in declining areas—have not fared as well and face a more uncertain future. Finally, the section argues that contrary to the popular view, advances in information technology and the spread of online banking are unlikely to eliminate the demand for relationship-based services from community banks.

Future structure of the community banking sector

Some analysts have used complicated statistical techniques and data on past changes in banking structure to predict how many community banks will remain in operation over the long run. These studies generally conclude that the number of community banks will shrink further but that thousands of banks will survive as independent organizations.

One study in the mid-1990s examined how the size distribution of banks had responded to past episodes of geographic deregulation, such as the elimination of intrastate branching restrictions and actions by individual states to allow acquisitions by out-of-state holding companies (Berger and others 1995). The study then used this information to predict how the size distribution of banks would respond to a recent episode of deregulation—the elimination of virtually all restrictions on interstate banking in the Reigle-Neal Act of 1994. The study concluded that the number of banking organizations with less than $1 billion in assets (1994 dollars) would eventually decline by half, from 7,700 in 1994 to 3,900 in 2019.

A more recent study examined rates of entry and exit for different size categories of banking organizations over the period 1960 to 2000 and used that information to identify nine distinct episodes of consolidation (Robertson). The study then extrapolated the experience of the most recent episode, from 1994 to 2000, to predict how many banking organizations would remain in each size category in the year 2007. Small banking organizations were found to have exited the industry at a considerably slower rate in the 1990s than the first half of the 1980s.

However, the number of organizations with less than $900 million in assets was still projected to fall about 30 percent over the forecast horizon, from 6,100 in 2000 to 4,300 in 2007.

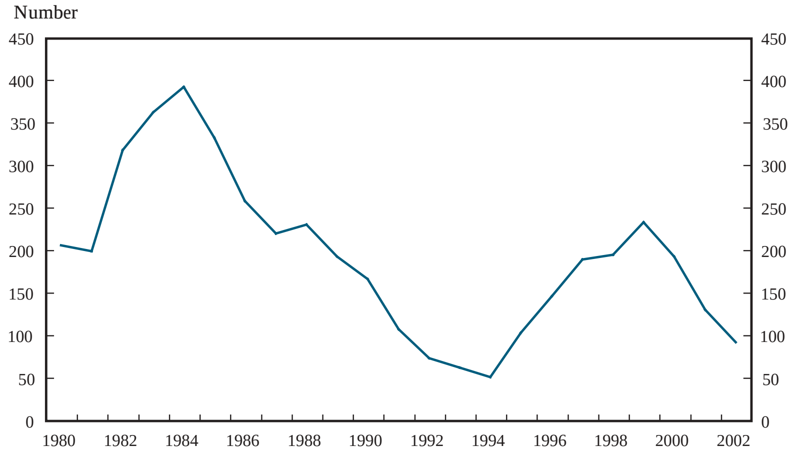
Performance of community banks relative to larger banks

While informative, predictions based on past trends can be criticized for failing to take into account current and future changes in the viability of community banks due to new technology or market conditions. One indication that community banks are still viable is that they continue to perform well by standard measures such as rate of growth, rate of entry, and profitability. To be sure, profitability has declined in recent years at very small banks. However, at least some of that decline appears to be due to the concentration of these banks in declining rural areas. Thus, while the number of very small community banks may dwindle, the recent record suggests that community banks located in more prosperous areas should continue to thrive.

Deposit and asset growth and new entry. One indication that community banks as a group performed relatively well during the 1990s is that they enjoyed faster growth in deposits and assets than large banks. The share of large banks in total deposits and assets did increase over the period, but only as a result of mergers. In a recent study by Board of Governors staff on the performance of small banks during the 1990s, large banks were defined as those ranked from 1 to 100 in assets, medium-size banks as those ranked from 100 to 1000, and small banks as those ranked below 1000 (Basset and Brady). For the fourth quarter of 2000, this definition implied that small banks had assets under $331 million, while large banks had assets over $6.94 billion. The study showed that excluding the effects of mergers, both assets and deposits grew several percentage points faster at small banks than large banks during most of the 1990s. Other studies that adjust for mergers but use different definitions of small banks have reached similar conclusions (Genay; Piloff and Rhoades; Stiroh and Poole).

Small banks appear to have achieved this faster growth in deposits at least partly by offering higher deposit rates than large banks. The Board study cited above found that the average rate paid by small banks on interest-bearing deposits exceeded the average rate paid by large banks by

Chart 2
NEW BANK CHARTERS

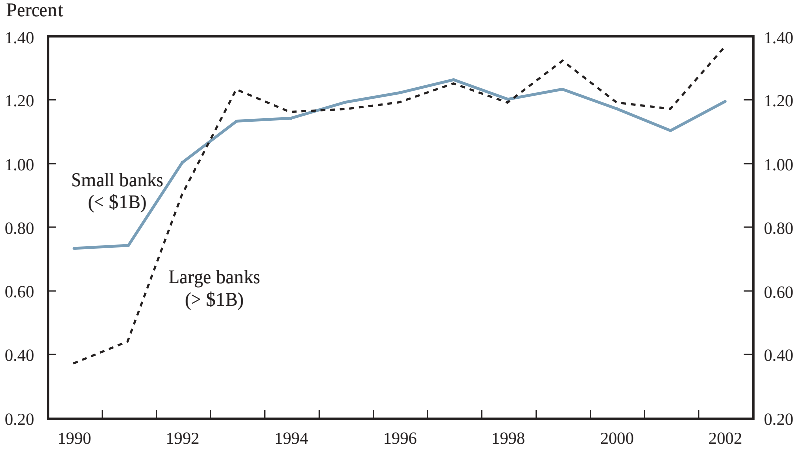


Source: FDIC

60 to 80 basis points during the 1990s (Basset and Brady). The reason small banks were able to pay these higher deposit rates was that they also earned from 75 to 150 basis points more than large banks on their loans. The high loan returns not only enabled banks to pay higher deposit rates than large banks, but also allowed them to maintain higher net interest margins. Indeed, during most of the 1990s, the net interest margin of small banks held steady at over 4.5 percent, while the net interest margin of large banks trended down from 4.0 percent to 3.7 percent.

A related piece of evidence that small banks are still viable is that many new banks continue to be chartered (Chart 2). After declining steadily since the mid-1980s, the number of new bank charters in the United States increased sharply during the second half of the 1990s, surpassing 200 at the end of the decade before falling back to 91 last year. Many of these new banks were started in markets in which large banks had been actively acquiring smaller banks, suggesting that a substantial number of depositors and borrowers still prefer the personal service that community banks tend to provide.

Chart 3
RETURN ON ASSETS

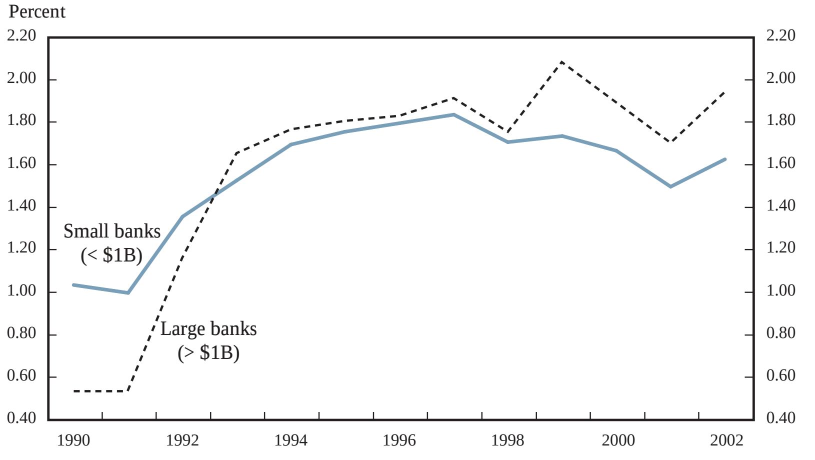


Source: Reports of Condition and Income

Profitability. Community banks as a group have maintained their profitability relative to that of larger banks during most of the last decade, although they have shown some signs of slipping behind the last three years. Chart 3 compares average return on assets (ROA) at two size categories of banks—those under $1 billion in size and those over $1 billion in size.[5] The small size group was significantly more profitable than the large size group at the beginning of the 1990s, when large banks were still recovering from heavy losses on commercial real estate and business loans. The gap in profitability soon disappeared, however, and for the rest of the decade, the two size groups earned approximately the same average ROA.[6] Some analysts have expressed concern that community banks as a group have earned a lower average ROA than large banks during each of the last four years. However, the difference in ROA between the two size groups has remained small, less than ten basis points in three out of the four years. Also, indicators of loan quality suggest that the relative positions of the two groups could easily be reversed if the economy faltered and loan defaults climbed. At the end of 2002, for example, 1.5 percent of loans were noncurrent in the large size group, but only 1.0 percent in the small size group.[7]

Chart 4

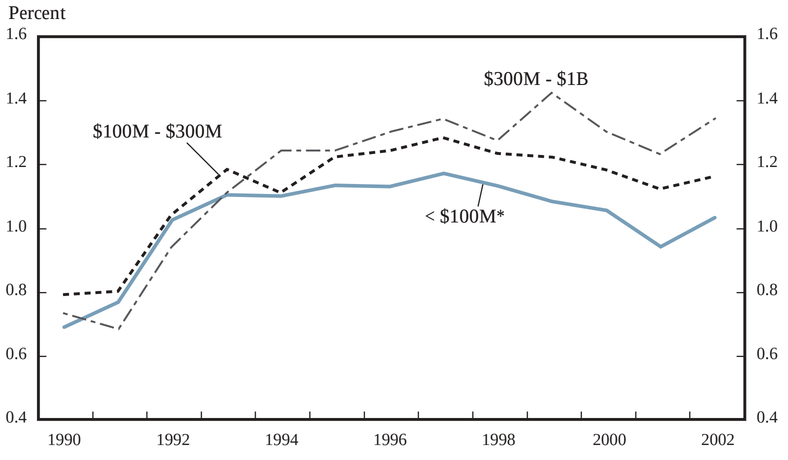
RATIO OF PRE-TAX OPERATING INCOME TO ASSETS



Source: Reports of Condition and Income

Some analysts argue that after-tax measures of profitability such as ROA overstate the relative performance of community banks due to the conversion of many of these banks to Subchapter S corporations, which are generally exempt from federal income tax. About 1,800 community banks have taken advantage of this option since it became available in 1997. One way analysts and bank supervisors have tried to avoid the distortion introduced by Subchapter S is to measure profitability by the ratio of *pre-tax* operating income to assets, as in Chart 4. By this measure, the decline in small bank profitability since 1997 appears slightly steeper and the gap between small and large banks slightly larger. However, using pre-tax earnings as a measure of profits has its own problems, because small banks tend to hold a higher percentage of their assets in the form of low-yield, tax-exempt securities. Also, some analysts have pointed out that the high rate of new bank formation during the 1990s has worked in the opposite direction from Subchapter S conversions. In particular, new bank formation has tended to reduce the average profitability of community banks somewhat because new banks tend to be both small and initially unprofitable (Laderman).

Chart 5
RETURN ON ASSETS AT SMALL BANKS



* Excludes de novo banks under $50 million.

Source: Reports of Condition and Income

Although the profitability of community banks has compared favorably to that of large banks, at least until very recently, such a comparison masks important differences among different sizes of community banks. Specifically, from the mid-1990s through 2001, profitability trended downward at small community banks while remaining high at large community banks. Chart 5 compares average ROA at three sizes of community banks—under $100 million, $100 million to $300 million, and $300 million to $1 billion.[8] From a high of almost 1.2 percent in 1997, the average ROA of banks under $100 million slipped more than 20 basis points, dropping under 1.0 percent in 2001. In contrast, the average ROA of banks between $300 million and $1 billion in size continued rising through 1999 and, despite slipping somewhat the next two years, remained above 1.2 percent. In 2002, average ROA rebounded in all three size groups, but banks under $100 million in size remained the least profitable.

What accounts for the poorer performance of small community banks? One possibility is that these banks are below the minimum efficient scale. Statistical studies have found some evidence that very small banks are cost-inefficient but little indication that banks above some minimum size are less cost-efficient than larger banks (Berger, Demsetz, and Strahan, pp. 157-58). Another possible explanation is that the smallest community banks tend to be located in areas that have experienced below-average economic growth, such as rural counties dependent on traditional agriculture.

The second explanation of the poor performance of the smallest size group has both positive and negative implications for the future of community banks. On the negative side, a substantial number of very small banks may be forced to close in the next decade as the communities in which they operate continue to decline. If so, the total number of community banks may decline even more than predicted by the statistical models reviewed earlier. On the positive side, however, the fact that community bank performance has been held down by the concentration of very small banks in economically declining areas means there is less reason to worry about the viability of community banks in more prosperous areas—cities, suburbs, and rural counties with a diversified economic base. Put another way, the decline in profitability at very small banks since the mid-1990s says more about the local economies in which they operate than the viability of community banking as a business model.

Implications of advances in information-gathering technology for community banks

While community banks continued to perform well through the end of the 1990s, some analysts argue they will not fare so well in the future because advances in information and communication technology are reducing their comparative advantage in relationship-based lending, especially small business lending (Petersen and Rajan). Rating agencies and credit bureaus have become adept at collecting massive amounts of information about firms' financial condition and distributing that information quickly and efficiently to lenders. In addition, the gradual accumulation of data on the ex-post performance of credit scoring models should lead to steady improvements in those models over time. The increased availability of financial information on small businesses and improvements in credit-scoring techniques may reduce the need for loan officers to collect subjective information on a loan applicant's prospects and to monitor loans through personal contact and on-site visits. If so, community banks' comparative advantage in relationship lending may become less important and their share of small business lending may decline.

While advances in information and communications technology are likely to continue, a good case can be made that community banks will still retain important advantages in small business lending. Given the high rate of turnover among small businesses, there will always be some small businesses that have worthwhile investment projects but cannot pass a credit-scoring test because they are too new to have established credit histories or because their owners have too few personal assets to offer as collateral. Community banks should continue to have an inherent advantage in identifying and lending to such businesses because of the banks' familiarity with local markets, their ability to collect and process subjective information, and their willingness to monitor small business loans through personal contact and on-site visits (Mester).

Implications of the spread of online banking for community banks

Another technological change that is widely viewed as a threat to community banks is the spread of online banking. The last several years have witnessed a sharp increase in the number of banks that allow customers to conduct business online—for example, verify account information, transfer funds, pay bills, or apply for loans. So far, however, large banks have made a much bigger commitment to online banking than community banks. Among national banks, for example, only 20 percent of banks under $100 million in size had transactional websites at the end of 2000, while all banks over $10 billion had them. Large banks also tend to offer a much wider array of services on their websites than small banks (Furst and others; Sullivan). Moreover, banks have not been the only financial companies to offer their services over the Internet. In recent years, some online brokerage companies have enjoyed rapid growth by allowing investors to buy and sell individual stocks on the Internet. Most of these companies also allow their online customers to shift funds among a wide variety of investment vehicles, including stock funds, bond funds, and money market mutual funds.

Some analysts argue that the growth of online finance will hurt community banks by making it easier for large banks, mutual funds, and brokerage companies to seek deposits. Thanks to the Internet, these institutions can now seek deposits in smaller communities without having a physical branch or office there. In such communities, community banks may lose some deposit customers because the lower costs of online companies allow them to offer more favorable rates. Community banks could lose other customers who prefer the convenience of online banking. The convenience factor could become even more of an issue as online companies broaden the array of products they offer online, making available such services as insurance and brokerage that they either produce themselves or market on behalf of other companies. Any loss of deposit customers as a result of greater online competition would be especially harmful to community banks because they have less access than large banks to alternative sources of funds such as borrowing on the federal funds market or from investors and securities dealers.

While community banks have been slower than large banks to embrace online banking, a good case can be made that they will be able to catch up over time and compete effectively for online customers. By starting late, community banks may be able to learn from the mistakes of larger banks, some of which have had to write off costly experiments in online banking. Community banks may also be able to compensate for their inability to make large-scale technology investments by outsourcing their data processing. Finally, while unable to spend as much on advertising their websites as larger companies, small banks may be able to draw on their reputations in the community to assuage local depositors' concerns about the security and privacy of online banking.

Some analysts argue that online banking could even help community banks in their basic strategy of focusing on high-value-added, relationship-based services (DeYoung and Hunter). According to this view, community banks can use the Internet to offer greater convenience and choice of financial service to their customers, while continuing to provide person-to-person contact through brick-and-mortar offices. As use of the Internet spreads and customers conduct more of their banking transactions online, community banks may be able to cut back somewhat on their branches and reduce their costs without abandoning their emphasis on personalized service.

Summary

While it is difficult to predict how many will remain in 10 or 20 years, community banks should continue to play an important role in the banking system by serving smaller markets in which large banks have little interest and by specializing in relationship-based services. Except for very small institutions, community banks have continued to hold their own against larger banks, earning comparable profits, enjoying faster growth, and attracting substantial numbers of new entrants. The smallest community banks are likely to face continued difficulties, either because they are below the minimum efficient scale or because they are located in economically declining communities. Also, advances in information technology and the spread of online banking may lead to some reduction in the demand for relationship-based banking services, making it harder for community banks to keep up with larger banks. Even with such advances, however, there will still be some customers who put a premium on face-to-face contact, personal service, and long-term relationships. This fact should preserve an important role for those community banks that are well-managed and sufficiently large to reap the modest economies of scale that currently appear to exist in banking.

III. CONCLUSIONS

Community banks play an important role in the financial system of the U.S. economy. They complement the role of large banks by specializing in relationship banking and providing credit to small businesses—a sector that is arguably underserved by large banks. In addition, community banks serve customers in rural areas and small metropolitan areas that are not served by large banks. Community banks are important lenders in the farm economy, and they serve the retail deposit needs of many depositors. Although the number of community banks will continue to decline because of merger activity, they will continue to play an important role for the foreseeable future.

Given their importance in the economy, the Federal Reserve has a strong interest in understanding issues facing community banks. The Federal Reserve's monetary policy responsibilities require it to understand how its policy actions affect community banks and their customers. In the area of supervision and regulation, the Federal Reserve has a legal mandate to supervise state member banks and bank holding companies. This supervision ensures the safety and soundness of the banking sector, but also provides a "window" through which the Federal Reserve can monitor economic conditions more generally. Finally, in the payments area, community banks provide access to payments services for a large percentage of the population. While community banks pose little systemic risk to the nation's financial and payments systems, their importance to some key sectors and areas of the economy warrant Federal Reserve interest and oversight.

ENDNOTES

[1]In making comparisons across time, this paper also adjusts the size threshold for inflation, using the Consumer Price Index. An alternative approach followed by some studies is to define community banks as those in a specified lower percentile of the size distribution (e.g. those in the bottom third).

[2]The number of community banking organizations was a little smaller, reflecting the fact that some of these organizations owned more than one bank.

[3]Determining the effect of bank mergers has been complicated by the fact that loans are reported at the bank rather than branch level. When a small bank is acquired by a much larger bank and converted to a branch, any change in small business lending due to the merger is likely to be swamped by unrelated changes in lending in the rest of the bank. Studies that disagree with the majority view that the absorption of small banks by large banks reduces small business lending include Berger and others 2001, Jayaratne and Wolken, and Strahan and Weston.

[4]This classification was made in 1994 based on income data for 1987-89. USDA has said it will re-classify counties in the near future using more recent data.

[5]In Charts 3-5, the size categories are not adjusted for inflation and are based on the size of the bank rather than the size of the banking organization.

[6]An alternative measure of profitability is return on equity (ROE). By this measure, small banks were somewhat less profitable after 1992. As in the case of ROA, however, small banks showed no sign of falling further behind large banks until the end of the decade. Small banks have always tended to compare less favorably to large banks in terms of ROE than ROA because of their higher capital-asset ratios.

[7]Further support for the view that community banks as a group have not fallen behind large banks in profitability comes from the Board of Governors study cited above (Basset and Brady). This study found the ROA of small banks equaled or exceeded that of large banks every year except 1999.

[8]New banks under $50 million in size are excluded from the smallest size category to account for the fact that new banks tend to incur losses in their first years.

REFERENCES

Bassett, William F. and Thomas F. Brady. 2001. "The Economic Performance of Small Banks, 1985-2000," *Federal Reserve Bulletin*, November.

Berger, Allen N., Rebecca S. Demsetz, and Philip E. Strahan. 1999. "The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future." *Journal of Banking and Finance*, February.

Berger, Allen N, Anil K. Kashyap, and Joseph M. Scalise. 1995. "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," *Brookings Papers on Economic Activity* 2, pp. 155-218.

Berger, Allen, Nathan Miller, Mitchell Petersen, Raghuram Rajan, and Jeremy Stein. 2002. "Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks," NBER working paper no. 8752, February.

Berger, Allen N., Richard J. Rosen, and Gregory F. Udell. 2001. "The Effect of Market Size Structure on Competition: The Case of Small Business Lending," Board of Governors, Finance and Economics Discussion Series, working paper 2001-63, December.

Berger, Allen N., and Gregory F. Udell. 1998. "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle," *Journal of Banking and Finance*, August, pp. 657-59.

Carter, David A., James E. McNulty, and James A. Verbrugge. 2002. "Do Small Banks Have an Advantage in Lending? An Examination of Risk-Adjusted Yields in Small Business Lending at Large and Small Banks," unpublished working paper, January.

Cole, Robert A., Lawrence G. Goldberg, and Lawrence J. White. 1999. "Cookie-Cutter versus Character: The Micro Structure of Small Business Lending by Large and Small Banks," in Federal Reserve System, *Business Access to Credit*.

Cook, Peggy, and Karen Mizer. 1994. "The Revised ERS County Typology: An Overview," U.S. Department of Agriculture, Economic Research Service, Rural Development Research Report no. 89, *www.ers.usda.gov*.

DeYoung, Robert, and William C. Hunter. 2001. "Deregulation, the Internet, and the Competitive Viability of Large Banks and Community Banks," Federal Reserve Bank of Chicago, working paper no. 2001-11.

Furst, Karen, William W. Lang, and Daniel E. Nolle. 2001. "Internet Banking in the U.S.: Landscape, Prospects, Industry Implications," *Capco Journal of Financial Transformation*, September.

Genay, Hesna. 2000. "Recent Trends in Deposit and Loan Growth: Implications for Small and Large Banks," Federal Reserve Bank of Chicago, *Chicago Federal Reserve Letter*, September.

Hannan, Timothy. 2001. "Retail Fees of Depository Institutions, 1994-99." Board of Governors, *Federal Reserve Bulletin*, January.

Hannan, Timothy, and Robin A. Prager. 2001. "The Competitive Implications of Multimarket Bank Branching," Board of Governors, Finance and Economics Discussion Series, working paper 2001-43, October.

Jayaratne, Jith, and John Wolken. 1999. "How Important Are Small Banks to Small Business Lending? New Evidence from a Survey of Small Businesses," *Journal of Banking and Finance*, February.

Laderman, Elizabeth. 2000. "Small California Banks Holding On," Federal Reserve Bank of San Francisco, *Economic Letter,* May 5.

Mester, Loretta. 1999. "Credit Scoring and Securitization of Small Business Loans: Discussion Comments," in Federal Reserve System, *Business Access to Credit.*

Petersen, Mitchell A., and Raghuram G. Rajan. 2000. "Does Distance Still Matter? The Information Revolution in Small Business Lending," NBER working paper no. 7685, May.

Piloff, Steven, and Stephen Rhoades. 2000. "Do Large, Diversified Banking Organizations Have Competitive Advantages?" *Review of Industrial Organization.*

Robertson, Douglas. 2001. "A Markov View of Bank Consolidation: 1960 to 2000," Office of the Comptroller of the Currency, Economic and Policy Analysis working paper 2001-4, September.

Stiroh, Kevin, and Jennifer Poole. 2000. "Explaining the Rising Concentration of Banking Assets in the 1990s," Federal Reserve Bank of New York, *Current Issues in Economics and Finance,* August.

Strahan, Philip, and James Weston. 1998. "Small Business Lending and the Changing Structure of the Banking Industry," *Journal of Banking and Finance,* August.

Sullivan, Richard J. 2000. "How Has the Adoption of Internet Banking Affected Performance and Risk in Banks? A Look at Internet Banking in the Tenth Federal Reserve District," Federal Reserve Bank of Kansas City, *Financial Industry Perspectives,* December.

U.S. Department of Agriculture, Economic Research Service. 2003. "Agricultural Income and Finance, Annual Lender Issue," www.ers.usda.gov, p. 11, March 11.

U.S. Small Business Administration, Office of Advocacy. 2002. "Small Business by the Numbers," www.sba.gov.advo, May.

________________. 1998. "Small Business Growth by Major Industry, 1988-1995," p. 1, *www.sba.gov.advo*.