

THE PERFORMANCE OF COMMUNITY BANKS OVER TIME

Executive Summary

The U.S. banking landscape includes a wide array of lenders and has over 6,000 financial institutions insured by the Federal Deposit Insurance Corporation (FDIC). Community banks, defined generally here as banks with assets less than \$10B,¹ are an important part of this setting, providing access to banking services for millions of Americans and serving as the only local source of brick-and-mortar traditional banking services for many counties, as well as key sources of credit for rural communities and small business loans.

Economic evidence finds that community banks remain strong across a range of measures, from lending growth to geographic reach, including in their performance since financial reform passed in 2010. The findings in this brief, as well as research by other economists, show that access to community banks remains robust and their services have continued to grow in the years since Dodd-Frank has taken effect, though this trend has not been uniform across community banks, with mid-sized and larger community banks seeing stronger growth than the smallest ones. At the same time, though, many community banks—especially the smallest ones—have faced longer-term structural challenges dating back to the decades before the financial crisis. These structural challenges underscore the importance of implementing Dodd-Frank in an equitable way that gives community banks a fair chance to compete, which has been a key priority for the Obama Administration.

Although opponents of financial reform often claim that it has harmed community banks, a closer and more comprehensive review of the economic evidence shows that community banks remain healthy. Critics typically point to declining numbers of community banks as evidence that new regulatory requirements are too restrictive. In reality, due to bank branching patterns, the number of institutions does not provide a comprehensive picture of the health of community banks, and other indicators like lending growth and

geographic reach show that community banks remain quite strong. Many community banks—particularly those with assets between \$100M and \$10B—have continued to grow steadily, as evident by their substantial lending growth, increasing market share in agricultural and mortgage lending, and expansion into new counties. With these trends, access to community banks and the important services that they provide has remained robust across many communities. At the same time, longer-term trends in the banking industry over the past several decades—including bank branching deregulation, merger activity, and other factors—often have created long-term challenges for community banks, particularly for the smallest ones. Macroeconomic conditions in recent years have also contributed to the lower rate of new entry by small banks.

While the evidence presented in this brief makes clear that community banks have remained healthy as the Dodd-Frank financial reform has been implemented, the long-standing challenges facing some smaller financial institutions underscore the importance of implementing Dodd-Frank in a way that allows community banks to compete on a level playing field. The Administration has taken important policy steps to achieve this, including increasing deposit insurance coverage to better protect community banks' core source of funding and shifting the costs of deposit insurance away from small banks toward larger, riskier banks; leveling the playing field with competing nonbank lenders like mortgage brokers; making the biggest banks subject to heightened prudential standards, which both help reduce systemic risks in credit markets that can spill over onto small banks and force large institutions to bear the costs of the risks that they create; and taking steps to streamline regulation of community banks to avoid exams by multiple regulators and to allow fewer exams for the smallest banks as long as they are well capitalized and in good standing.

¹ Asset size is computed in constant 2009 dollars. We sometimes also refer to the group of community banks as

defined by the FDIC using additional conditions, but always explicitly specify these cases.

This issue brief presents five facts relevant to the debate:

- 1. Lending by all but the smallest community banks has increased since 2010.** The annual growth rate of lending by community banks in each asset range (<\$100M, \$100M-\$1B, and \$1B-\$10B)² has increased since the financial crisis and reached levels between 3 and 9 percent in 2015, in line with rates seen prior to the crisis and well above the negative rates seen following the crisis. Community banks also have maintained or increased their industry market share in a number of markets since 2010, the year Dodd-Frank was passed.
- 2. Access to bank offices at the county level remains robust.** There is no evidence that Dodd-Frank has led to a decline in access to banks across counties. Although the number of bank offices per county has declined since its height during the real estate boom and bust in 2006-2011, it is higher than levels prior to that period. Nearly every county has a bank office, something that has not changed since 2010, with community banks playing an important role. About 1 in 4 counties rely exclusively on community banks for brick-and-mortar services within county lines. Almost half of rural³ counties have only community banks located within them under the broad definition (under \$10B in assets) and about 5 percent of rural counties have only a single community bank office.
- 3. The average number of bank branches per community bank has increased.** For community banks with assets \$100M-\$10B, the average number of branch offices per bank has increased since 1994. For the smallest community banks, with assets less than \$100M, the number of branches per bank has remained almost unchanged over this period.
- 4. Over the past two decades, the number and market share of the smallest community banks—those with assets less than \$100 million—has been declining.** The decline is due both to exits as well as to growth, whereby the bank leaves the less than \$100M category and enters the \$100M-\$1B category. The vast majority of the decline occurred before 2008 and well over half of exits by the smallest community

banks have occurred through mergers with FDIC-identified community banks.

- 5. Macroeconomic conditions likely explain a substantial portion of the drop in new bank entry in recent years.** Entry by banks with assets of less than \$100M has dropped considerably since 2008, likely due to a combination of factors. Recent research (Adams and Gramlich 2016) suggests macroeconomic factors contribute substantially to reduced entry as all loans on the balance sheets of new entrants are tied to current macroeconomic conditions, including global cyclical weakness that has generated low interest rates and the persistent global trend in recent decades toward low equilibrium long-term interest rates, discussed in an earlier CEA report (CEA 2015), due to shifts in demographics, productivity growth, global savings behavior, and other factors.

Long-term Trends Affecting Community Banks

The term “community bank” is used generally to describe locally owned, medium and small depository institutions that engage in highly localized traditional banking activities. There is no universal definition of a community bank, although most definitions rely upon an asset threshold set at \$10B or less. This choice is critical as the apparent health of community banks varies across definitions. We define community banks as banking institutions with less than \$10B in assets, which is consistent with the Dodd-Frank Act’s many exemptions for banks with less than \$10B in assets. We also include the FDIC’s multifaceted community bank definition first published in 2012 and revised quarterly; it considers geographic proximity of bank branches and the type of banking activities in which the bank engages. For brevity, we will refer to banks with more than \$10B in assets as big banks and banks with less than \$10B in assets as community banks: very small community banks have less than \$100M in assets, mid-size community banks have \$100M-\$1B in assets, and larger community banks have \$1B-\$10B in assets. All asset classes are expressed in constant 2009 dollars.

² Average taken in each year by asset class.

³ We define “rural” as a county not meeting the Census definition of “metro” or “micro” statistical area.

Long-term Shift in Market Share Away from the Smallest Banks

For much of the twentieth century, community banks were protected by regulation that greatly restricted the legal authority to bank across state and sometimes county lines. The McFadden Act of 1927 gave states greater authority to regulate bank branching. Most states prohibited interstate branching, which is the establishment of a branch by an out-of-state bank, but allowed at least limited branching by banks within the state, called intrastate branching. During the 1980s and 1990s, some states passed interstate banking deregulations, allowing banks in one state to acquire a bank in another state, but most continued to restrict interstate branching. The Riegle-Neal Act of 1994 nationalized interstate banking and branching deregulation. It allowed banks to set up new branches across state borders without the need to acquire a subsidiary bank. Bank consolidation—defined to include bank failures, mergers, or acquisitions—increased as a result of this deregulation (Adams 2012; Berger, Demsetz, and Strahan 1999). Strahan (2003) shows that the market share of small banks dropped following branching deregulation: from 1976 to 1994, the share of assets held by banks with less than \$50M in assets (in 1994 dollars) fell by 1.6 percentage points, the share of assets held by banks with \$50–\$100M in assets fell by 2.0 percentage points, and the share held by banks with \$100–\$500M fell by 2.2 percentage points. The figures discussed below show that the market share of the smallest banks continued to fall after the Riegle-Neal Act of 1994 was passed.

Consolidation on this scale is not unprecedented: Carlson and Mitchener (2009) show a similarly dramatic decrease in the number of unit banks in California following liberalization of intrastate branching within California in 1909. They argue that competition from branch banks induced unit banks to adopt more cost-efficient modes of operation that led to greater efficiency. All else equal, they show that unit banks in jurisdictions with branch bank competitors were better able to survive the Great Depression.

Community Banks Since 2010

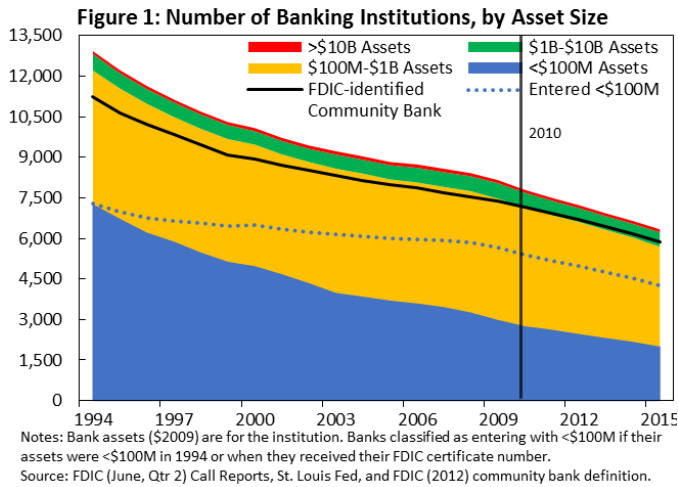
The Dodd-Frank Wall Street Reform and Consumer Protection Act—signed July 21, 2010, but with provisions implemented over time—is the most comprehensive

financial regulatory reform of the twenty-first century. It is designed to prevent excessive risk-taking and protect consumers from exploitative bank lending practices. Dodd-Frank does distinguish between banks on the basis of size – many rules include exemptions for financial institutions with less than \$10B assets. However, some argue that Dodd-Frank nevertheless exacerbates the preexisting trends of small bank consolidation and reduced market share (Greene and Lux 2015; Marsh and Norman 2013). Greene and Lux (2015) find that from 2010:Q2–2014:Q2, market share for small banks with less than \$10B in assets fell in some market segments: 22 percent in the commercial and industrial lending market, 8 percent in the individual lending market, and 2 percent in the small business lending market.

The FDIC (2014) finds that most community banks remain resilient amid long-term industry consolidation. It shows that consolidation has been confined to banks with less than \$100M in assets: from 1985 to 2013, the number of institutions with assets less than \$100M declined by 85 percent, while the number and total asset size of banks with \$100M–\$10B in assets increased. Figure 1 illustrates the long-term decline in the number of community banks—in particular, that it is principally confined to very small banks with less than \$100M in assets. Evidence below shows that this decline appears to be the result of industry consolidation following interstate branching deregulation (FDIC 2012), and has been occurring at least since passage of the Riegle-Neal Act of 1994. This finding is consistent with independent academic studies (e.g., Strahan 2003).

To look in aggregate at what is happening to the smallest bank entrants, Figure 1 includes a blue dashed line representing the number of banks in each year that had less than \$100M in assets in 1994 or when they entered (if they received their FDIC certificate after 1994) regardless of their actual asset size in that year. The actual number of banks with less than \$100M in assets in each year is captured in the blue area and it declines much faster than the blue dashed line. The contrast demonstrates that growth into higher asset classes is an important contributor to the declining number of the very small community banks. Many banks that entered as very small over the last two decades grew into larger asset classes. The fact that their numbers were not fully replenished by new very small banks suggests that under increased competition from large banks, economies of scale and other factors may have taken on a new

importance. Carlson and Mitchener (2009) show a similarly dramatic decrease in the number of unit banks in California following liberalization of intrastate branching there in 1909.



In addition, McCord, Prescott, and Sablik (2015) suggest that a shift has taken place in recent years, where the declining number of banks is now attributable to a sharp decline in the rate of bank entry, not due to a change in exit dynamics. They hypothesize that this is due to new financial regulations aimed at better securing stability in credit markets. However, Adams and Gramlich (2016) present detailed arguments that financial regulation since 2009, including new FDIC guidelines extending the *de novo* period from 3 to 7 years for new bank entries⁴, does not explain declining entry of new small banks, as they observe a similar decline in branch expansion by incumbent banks.⁵ They argue that interest margins on the balance sheets of new entrants, whether *de novo* banks or branch expansion into new markets by existing banks, are more often dampened by the low equilibrium interest rates generated by the current economic environment because their loans are new and thus tied to recent interest rates. Although they argue that regulation has not contributed to the sharp decline in new charters, they do not rule out the possibility that regulation may, in the future, become an independent weight on entry as interest rates begin to rise.⁶

⁴ The FDIC recently rescinded this measure: <https://www.fdic.gov/news/news/press/2016/pr16027.html>.

⁵ Adams and Amel (Forthcoming) also explore determinants of branch expansion by incumbent banks.

Evidence analyzed below shows that the decline in entry is confined principally to the smallest class of community banks and that the profitability of new entrants—which is typically lower on average than an established bank of comparable size—is declining in the current macroeconomic environment

The Changing Role of Small Banks

A classic theme in economics literature on finance is that relationship lending is a way to overcome information asymmetries between borrowers and lenders (Petersen and Rajan 1994). Proponents argue that an existing relationship between the borrower and lender helps to substitute for a prior borrowing history, and helps to align the interests of the two parties such that they will treat each other fairly so as not to damage their future relationship. Many suggest that community banks engage in relationship lending as their lending decisions are made by loan officers on the ground who specialize in gathering and applying “soft” information on the local liquidity needs of families, small businesses, and farmers. The argument moreover suggests that community banks are better able to form strong relationships with small businesses whose finances and business prospects may be relatively more opaque, while large, multimarket, nonlocal institutions tend to serve larger, more transparent firms (Stein 2002; Berger Goulding, and Rice 2014).

In contrast, recent literature suggests that over the past decades new laws and practices have led to substitution away from relationship lending and changes in the overall banking market. For example, Berger, Goulding and Rice (2014) present evidence that credit scoring and bank deregulation such as the Riegle-Neal Act have promoted alternatives to relationship lending and therefore small, informationally opaque firms are neither more nor less likely to bank with community banks.⁷ They support their arguments using cross-sectional data from the 2003 *Survey of Small Business Finance*. Other papers have also pointed to similar patterns (e.g., Canales and Nanda 2012; Frame et al.

⁶ Covas, Rezende, and Vojtech (2015) and Claessens, Coleman, and Donnelly (2016) further analyze the relationship between macroeconomic conditions and banks’ net interest margins.

⁷ Bank branching deregulation allows banks to integrate offices across state lines, presumably reducing levels of hierarchy and making it easier to transmit “soft” information.

2001), some demonstrating an increase in the use of credit scoring techniques by large banks (e.g., Berger, Frame and Miller 2005) and an increase in lending distance over time (e.g., Petersen and Rajan 2002; DeYoung et al. 2011). Brainard (2015) notes that community banks' share of small loans to businesses has eroded only for the smallest denominations, where credit scoring may neutralize community banks' information advantage.⁸

Yet, available data suggest that even as big banks have expanded their reach, community banks' proximity to local borrowers may provide them with an advantage in rural and small business lending, as suggested in earlier literature. The FDIC (2016) reports that in 2015:Q4, FDIC-identified community banks accounted for 44 percent of outstanding small loans to businesses, making them a key provider of credit for small businesses.⁹ Empirical and anecdotal evidence underscore their importance in rural areas, where borrowers may be more informationally opaque but information gathering is not high cost. Gilbert and Wheelock (2013) note that looking at deposits, the market share of community banks in rural markets changed very little between 2001 and 2012, stabilizing after the decline in the 1980s and 1990s. DeYoung, Glennon, Nigro, and Spong (2012) find that loans made by rural banks to local small businesses have lower default rates than those made by urban banks, but that the difference diminishes when borrowers are located outside the geographic market of the bank, even when conditioning on physical distance. "We don't make bad loans," said Albert Christman, a small banker in Louisiana, in an interview published by Bloomberg news agency. He attributes his success to building a different business model than that of large banks, explaining "We don't use [electronic credit scoring] systems. We only make loans in markets we do know" (Greeley 2013). Other observers suggest that small banks may be unique in their commitment to serve communities facing hard times or declining populations (Federal Reserve Bank of

St. Louis and Conference of State Bank Supervisors 2013), suggesting they may be important both to ensure inclusive growth and mitigate downturns.

Below, this report consolidates and expands on some of the key observations in the literature on community banks, examining lending growth, market share, and entry and exit patterns to see where historical trends continue within or diverge from recent activity. It also examines how community banks' profitability has evolved over the last 15 years. To do this, we analyze data from the FDIC, which publicly releases quarterly financial information for all FDIC-insured institutions that file Call Reports and structural information (deposits, county, services offered, and establishment date) for individual bank offices.¹⁰ They also release information from their Deposit Insurance Assessment detailing the reason for bank exit.¹¹ Additionally, we use the FDIC Community Banking Study Reference Data in order to employ the FDIC's multifaceted community bank indicator.¹²

Trends in Lending Activity

Recent Rebound in Lending Growth Since the Financial Crisis

Many community banks have experienced a recent rebound in lending growth, which stalled for several years following the financial crisis.¹³ Figure 2a and Figure 2b show that lending (whether examined by the rate of growth in assets or loans) by community banks with assets over \$1B rebounded as strongly as lending by big banks. Banks in both asset categories are back to asset and lending growth rates seen in the pre-financial crisis era. Mid-size community banks, with \$100M–\$1B in assets, also have increased their lending steadily over the last four years. The smallest banks, those with less than \$100M in assets, have experienced the shallowest

⁸ Brainard (2015) calls these micro loans—those with initial principal amounts less than \$100,000.

⁹ Small loans to businesses outstanding is the amount currently outstanding on loans to commercial borrowers with initial principal amounts less than \$1 million and farm loans with initial principal amounts less than \$500,000.

¹⁰ Available at <https://cdr.ffiec.gov/public/>

¹¹ Available at <https://www.fdic.gov/deposit/insurance/assessments/mergers.html>

¹² Available at

<https://www.fdic.gov/regulations/resources/cbi/data.html>

¹³ We continue defining community bank explicitly either as FDIC-identified community banks, or under the more general definition of banking institutions with assets of less than \$10B (in 2009 constant dollars). We include banks whose headquarters and branches are located in the 50 states + DC and exclude banks that are insured branches of foreign banks.

recovery, but their asset and lending growth rate still has remained positive since 2011.

Figure 2a: Average Asset Growth Rate of Banking Institutions, by Asset Size

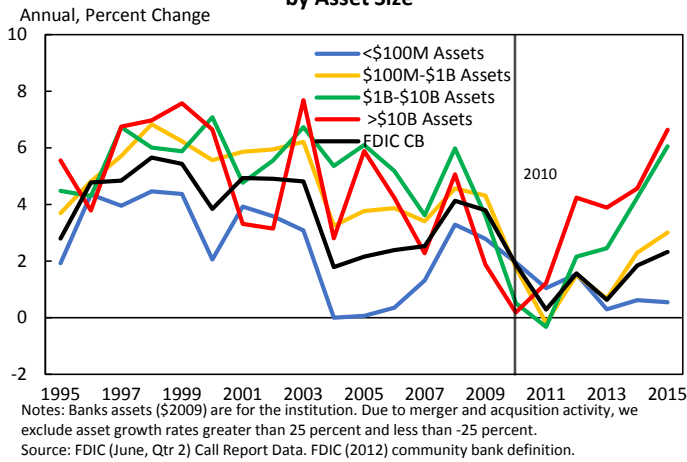
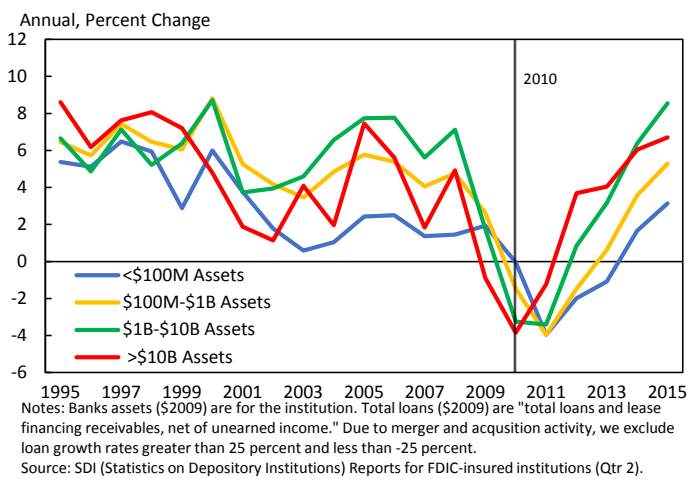


Figure 2b: Average Loan Growth of Banking Institutions, by Asset Size

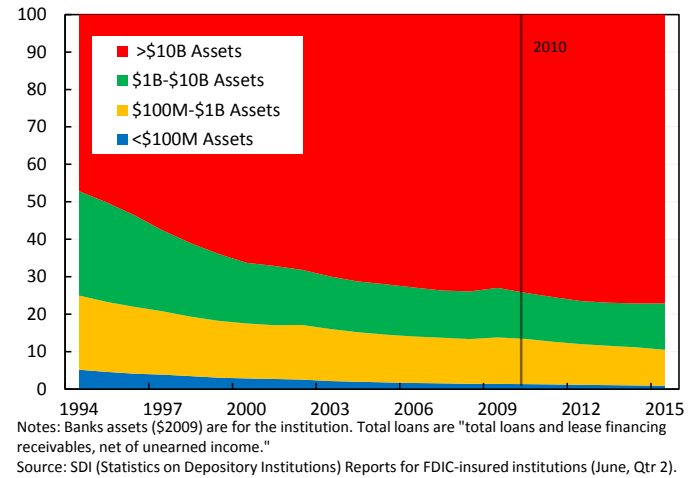


Trends in Share of Loans by Type: Industry Aggregates

Looking across all lending markets in Figure 3, over the past two decades, the share of loans held by big banks (those with assets greater than \$10B) increased continuously from about 50 percent in 1994 to about 80 percent in 2015. While this has resulted in a corresponding decline in total community bank market share, the vast majority of this change occurred before 2008. Since then, the market share of community banks as a group has held steady at around 20 percent, including after the passage of Dodd-Frank in 2010. The smallest community banks (with less than \$100M in assets) experienced the largest losses since 1994, with most of their decline taking place in the decade following 1994. They held a 5 percent market share in 1994, which

fell to 1 percent by 2008 and has stabilized since then. Within the population of community banks, the market share of the smallest members has declined from 10 percent to 4 percent, a sign that growth in other community banks has also contributed to their decreasing market share.

Figure 3: Market Share of Loans for Banking Institutions by Asset Size



In agricultural lending, the market share of community banks as a whole began stabilizing in 2002. Nonetheless, this stability overlays the fact that the market share of the smallest community banks has been overtaken by somewhat larger ones, as the share served by banks with \$100M–\$1B in assets actually has increased. Community banks, especially very small ones serving rural areas, have faced increasing competition from the Farm Credit Associations (FCA) (Hogue, Morris, and Wilkinson 2015; Robbins 2009). FCA farm business debt market share increased from 25 percent in 1994 to 41 percent in 2015.

In the mortgage market, the share of residential mortgage lending by the largest banks has increased dramatically between 1994, when it comprised about 40 percent of the market, and 2007 when it reached 80 percent. Since 2005, the share held by community banks as a group has been relatively flat, though the share held by the subset of community banks with \$100M–\$1B in assets actually has increased, as in agriculture. In a 2015 study, Bassett and Driscoll (2015) argue that smaller banks not only have been undeterred by and actively engaged in the “originate to distribute” business model, but they also have become a more important part of the market and have profited from doing so. In particular, they find that the share of community banks that engage

in mortgage loan selling and securitization has been rising, as have their net returns on assets and equity.

Similarly, in Commercial and Industrial (C&I) lending, the market share of big banks has increased over the past two decades, from 63 percent in 1994 to nearly 85 percent in 2015. The bulk of this incursion by large banks occurred before 2007. The share of lending to individuals conducted by big banks has also increased sharply over the past two decades, more than doubling from about 40 percent of the market in 1994 to more than 90 percent in 2010. Since 2010 the shares have stabilized, with community banks retaining nearly one-tenth of the market.

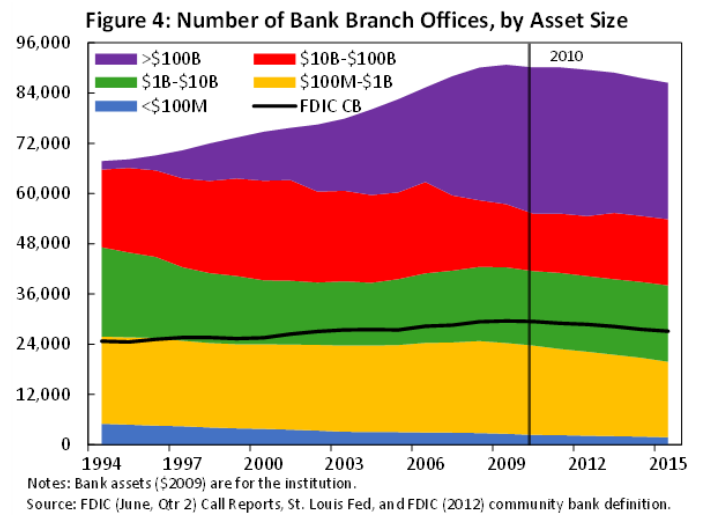
Thus, community banks lost market share to big banks precipitously after 1994; however, in recent years, including since 2010, the trend now is toward stabilization of, or even regaining, community banks' market share. The overall trend across lending market categories does not seem to have been affected by the financial crisis or Dodd-Frank reforms, except possibly to stabilize the market share of mid-size banks with assets of \$100M to \$10B in some slices of the market.

Access to Community Banks

A key question is whether the change in market structure, characterized by industry consolidation, has affected local access to brick-and-mortar banking services.

Community Bank Expansion through Branching and Local Access

Branching is an important but often overlooked measure of access to community bank services. Figure 4 shows that the number of total community bank branch offices was stable from 1998 to 2006 and began increasing prior to the financial crisis before declining slightly with the onset of the financial crisis. This build-up and drop-off is evident using either the FDIC's definition of community bank, or by summing the number of branch offices across all bank categories with assets less than \$10B.



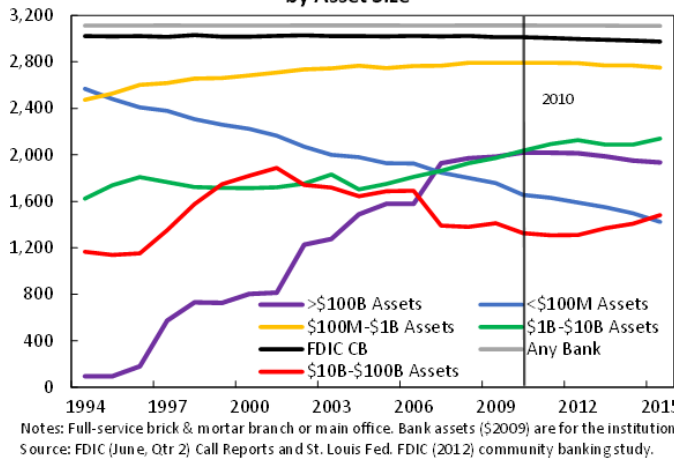
In terms of branches per bank, the average number of full-service brick-and-mortar branch offices per community bank with assets \$100M–\$10B ticked up from 7.4 to 7.6 offices from 1994 to 2015. If we include all full- and limited-service branches, the increase is greater, from 7.6 to 8.6. The average number of branch offices for very small community banks has remained almost unchanged comparing 1994 to 2015 whether considering only brick-and-mortar or all types of branches. For all FDIC-identified community banks as a group, the number of full-service brick-and-mortar branches per bank doubled, from 2.1 to 4.2, and the total number of branches of any kind per bank more than doubled, from 2.2 to 4.6. Overall, the growth in branch offices has largely offset the decline in the number of FDIC-identified community bank institutions over the last two decades, preserving access to community banks across local areas.

County-level Access to Banking Services

Access to traditional bank offices at the county level has remained steady over the last decade with about 99 percent of all counties having at least one brick-and-mortar bank. Figure 5 shows the number of U.S. counties served by banks of various sizes, which has remained roughly constant over the last ten years. Since 2005, the number of counties served by a full-service brick-and-mortar bank office has varied slightly between 3,109 and 3,114, as has the number of counties served by a bank office of some type, between 3,112 and 3,116. The composition of banks serving counties has changed over time. The number of counties served by the largest community banks has trended up, whereas the number

of counties served by the very smallest community banks has trended down. Access to FDIC-identified community banks at the county level has remained roughly steady. These trends appear relatively unchanged since the mid-1990s; there is no evidence that the trends have shifted post-2010, when Dodd-Frank was passed.

Figure 5: Number of Counties with 1+ Brick-and-Mortar Bank Offices by Asset Size



Further, the average number of bank offices per county among banks with assets \$100M-\$10B, with bank offices defined as a main office or branch office, is roughly the same as it was in 2000. This is due to expansion by community banks with assets between \$1B and \$10B. The number of counties hosting one of these larger community banks has increased since 2010 as shown in Figure 5.¹⁴ The fact that this geographic expansion by larger community banks occurred in part between 2010 and 2015, the same time the number of branches and county coverage by the biggest banks (with more than \$100B in assets) edged down, suggests that some of the biggest banks were retrenching while larger (\$1B-\$10B) community banks expanded their reach.

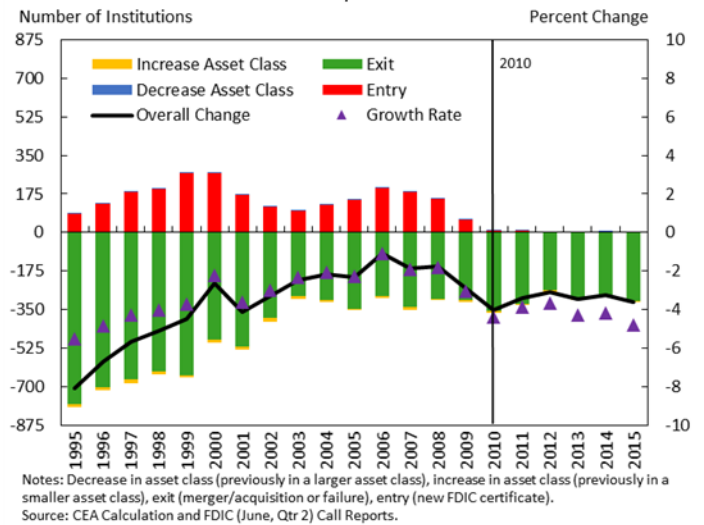
Community banks play a key role in local access to banking services. About 1 in 4 counties rely exclusively on community banks for brick-and-mortar services within county lines. Almost half of rural counties have only community banks under the broad definition (under \$10B in assets), with about 10 percent of these counties having only a single community bank office, or about 5 percent of rural counties overall.

¹⁴ Although not shown here, the average number of bank offices belonging to parent community banks with assets over \$1B per

Breaking Down Growth Within Versus Across Asset Categories

Analysis by economists at the Federal Reserve Bank of Richmond (McCord, Prescott, and Sablik 2015) finds that the decline in the number of community banks in recent years reflects decreased entry rather than increased exit. We see in Figure 6 that, indeed, exit rates for community banks have been roughly steady since 2004. Entry began falling in 2005-2006, with the number of entries dropping to nearly zero by 2010 and remaining there since.

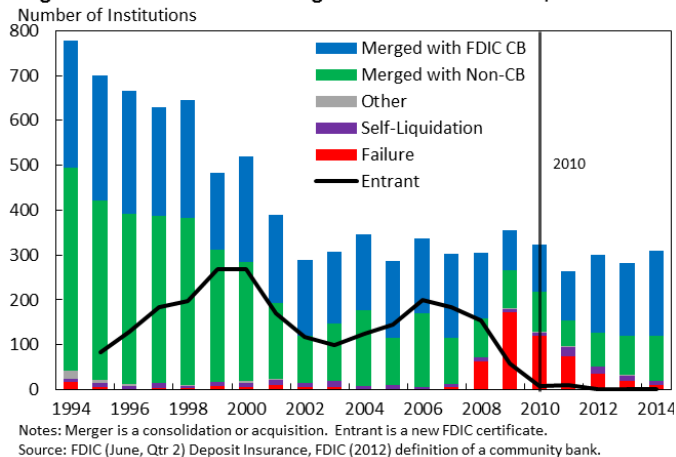
Figure 6: Change in the Number of Banking Institutions: Less than \$10B Assets



The three primary ways a bank exits the market are mergers (through both consolidation and acquisitions), failures, and liquidation. Figure 7 shows that much of the exit has occurred in the form of mergers with other community banks, underscoring that many are thriving. The number of bank failures rose in 2008 and 2009 as the Great Recession took hold before starting to drop off, and the number of failures are now roughly in line with those in the decades prior to the Great Recession. The fraction of mergers between community banks that join them with other community banks has risen from almost 40 percent in 1994 to 65 percent in 2014.

county also increased from 4.7 in 2005 (before the crisis) to 5.3 in 2015, though it has oscillated somewhat in between.

Figure 7: Exit Mode for Banking Institutions: Less than \$10B Assets



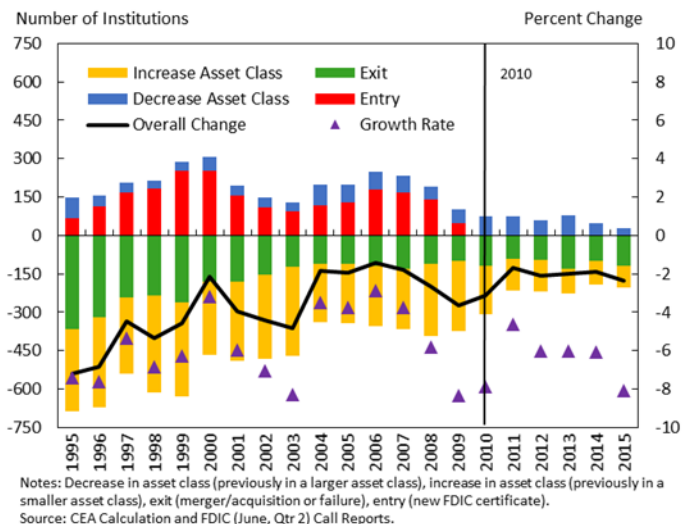
Dropoff in Entry Among the Smallest Asset Class of Community Banks¹⁵

Figure 8 shows that the number of banks in the <\$100M category has been on the decline (averaging 6 percent per year) since at least 1994. Moreover, most new banks start with assets less than \$100M before moving into larger asset categories, as described in more detail below. The contribution of bank entry to growth has declined since 2006: from 2006 to 2010, entry by banks in the smallest size category declined by 98 percent and it has not yet recovered. While many observers have conjectured that the decline in the number of bank institutions since 1994 may be related to economies of scale, scale issues stemming from compliance costs and the new regulatory regime do not appear to be the explanation for the recent decline in entry. As pointed out by Adams and Gramlich (2016), all new entry, including expansion by existing banks into new markets, fell at the same time de novo charters fell. Expansion by existing banks into new markets is a way of exploiting economies of scale and the drop in de novo charters was accompanied by a drop in this expansionary type of charter activity, not offset by it.

¹⁵ Measured by new FDIC certificates of insurance. We count a certificate as new in a particular year if a new certificate identification number appears in Q2. A minority of new issuances are associated with reorganizations by FDIC-insured banks or switching between insurers rather than the addition of a new bank into a market place.

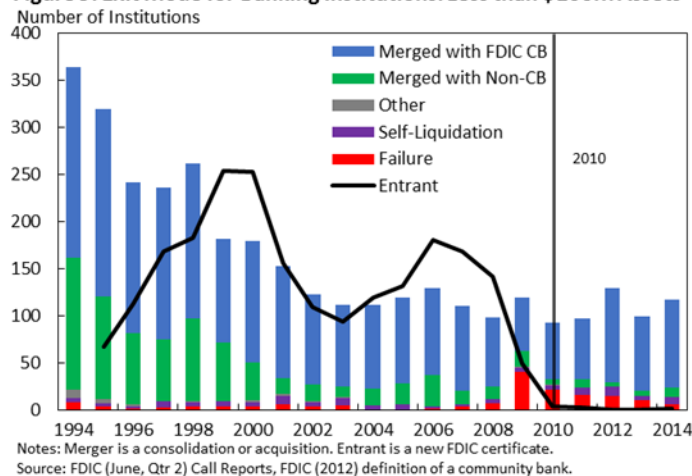
¹⁶ For example, a bank that has \$99M in assets in one year and then \$101M in the following year would be counted as part of

Figure 8: Change in the Number of Banking Institutions: Less than \$100M Assets



From 1996 to 2013, Figure 9 reveals that the largest contributor to negative growth in the number of banks in the smallest size category was increasing asset class—banks moving up to a larger asset class.¹⁶ Since 2013, the largest contributor has been exit, which includes by mergers.

Figure 9: Exit Mode for Banking Institutions: Less than \$100M Assets



Most of these very small banks are merging with other community banks. Figure 9 provides a breakdown of the

the less-than-\$100M category in the first year and then part of the \$100M–\$1B category in the second year. The reverse, if a bank decreases its asset class, is also possible. Thus, what might appear to be “exits” and “entries” in categories instead can reflect the same banks being re-categorized from one year to the next. Our decomposition in Figures 6 and 8 parse out these composition effects to provide greater clarity.

exit modes for banks with assets less than \$100M. The most frequent mode of exit is categorized as a merger with another community bank (according to FDIC’s definition). The figure indicates that the number of these community bank mergers has increased since 2009 and the fraction of mergers with another community bank, as opposed to a non-community bank, has increased from 60 percent in 1994 to 90 percent in 2014. These merged banks are living on as community banks, just part of a larger parent group.

The post-crisis macroeconomic environment has been challenging for both profitability and entry. Adams and Gramlich (2016) argue that the smallest banks are disproportionately the newest banks, with a larger proportion of their loans made in the current global macroeconomic environment that includes low equilibrium interest rates, which depresses profit margins on traditional lending activity. Figure 10 demonstrates that, for the smallest community banks, profitability measured as return on assets (ROA) falls precipitously relative to incumbent banks between 2001 and 2009. Recently, though, the performance of these banks has shifted. All cohorts existing before 2008 have achieved a level of profitability roughly equal to or exceeding what they earned prior to the financial crisis.

Figure 10: Return on Assets of Banking Institutions with Less than \$100M Assets, by Age

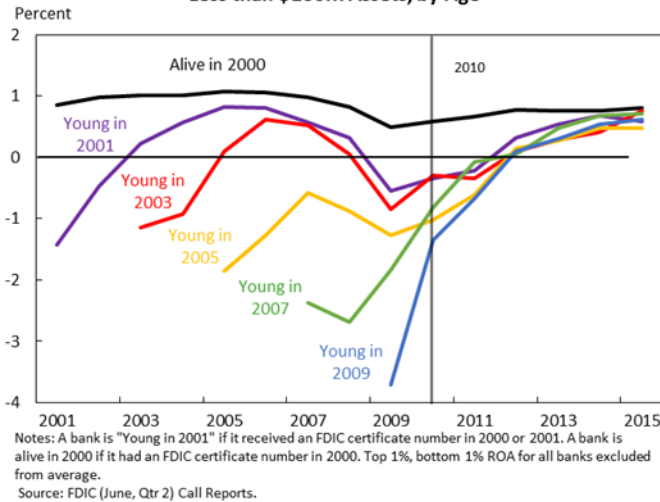


Figure 11 suggests that, while there is a decline in entry into the combined \$100M-\$10B asset category, lower growth in this segment is primarily due to a lack of growth in the assets of the very smallest banks into asset classes over \$100M. There is no dramatic drop in new entry. Because de novo entry as a large bank is relatively

rare, growth in the number of banks in this category is mainly through growth of small banks into a larger asset class, not through newly-certified institutions, so we do not see a drop in new FDIC-insured institutions having a big impact on numbers in this asset class. Although not visible here, a finer breakdown shows that the drop in entry through growth is almost entirely due to a decline in banks growing from below to above \$100M, as opposed to growth from below to above \$10B, potentially reflecting lower levels of profitability and subdued growth among the very smallest banks. In short, new entrants generally enter as very small banks, while banks in larger categories generally enter through asset growth, not as new FDIC-insured institutions. Yet the slowdown in both are rooted in the entry and health of the very smallest community banks.

Figure 11: Change in the Number of Banking Institutions: \$100M-\$10B Assets

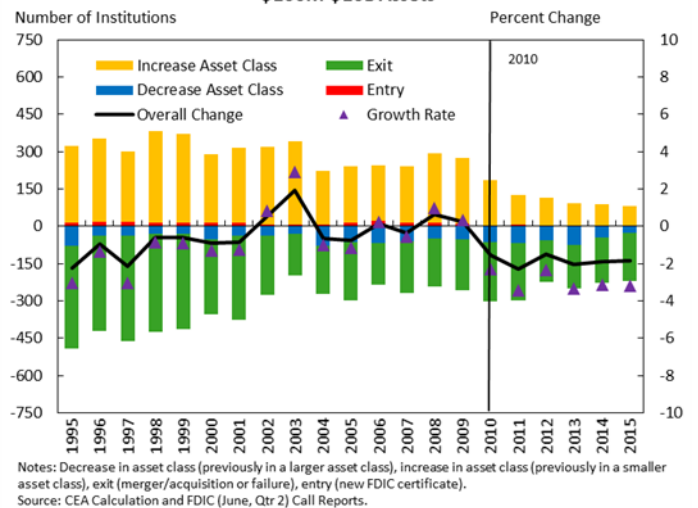
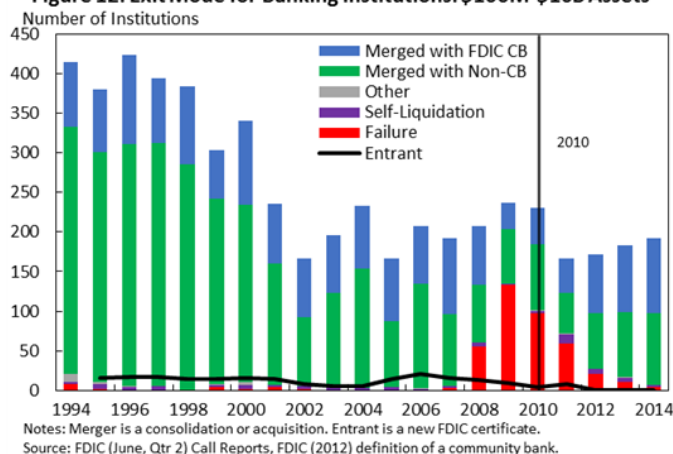


Figure 12 provides a breakdown of the exit modes for banks with \$100M-\$10B in assets. During the financial crisis (2007-2009) and years immediately following (2009-2011), bank failure was the most frequent mode of exit. Since 2011, however, mergers with other community banks (according to FDIC’s definition) have been growing, reflecting a trend similar to that in Figure 7. Although not evident in this figure, the phenomenon mainly occurs among banks with under \$1B in assets and is less obvious in larger community banks.

Figure 12: Exit Mode for Banking Institutions: \$100M-\$10B Assets



The Role of Policy in the Current Environment

Community banks play a key role in the economy, especially in rural and small business lending. As the evidence presented in this issue brief shows, community banks have recovered strongly from the financial crisis and have remained healthy in recent years as Dodd-Frank financial reforms have been implemented. For example, the growth rate of lending by community banks has risen back to pre-recession levels, profits have recovered, mid-sized and larger community banks have increased their market share in agricultural and mortgage lending, and the number of community bank failures has dropped every year since 2009. These trends suggest that the community banking sector has been resilient in the face of a challenging competitive and macroeconomic environment.

At the same time, community banks have faced meaningful long-term challenges over the last several decades. Since at least the mid-1990s, big banks have held an increasing share of assets and accounted for more lending, while the number and share of assets held by all community banks as a group (banks with less than \$10B in assets) has declined. This trend held steady from about 1994 to 2008 but appears to have slowed following the financial crisis. The shift toward big banks since at least 1994, as well as evidence that many community banks grow over time and move into larger asset classes, suggests that economies of scale or scope may be at play in the longer-term trend. Larger scale may be important to pay for fixed costs like IT systems, or to engage in more diversification of product offerings.

While this issue brief shows that community banks have remained strong as Dodd-Frank reforms have been implemented, contrary to the claims of some critics, it also points to places where more work is needed. The Obama Administration has taken several important steps to ensure that community banks can compete on a level playing field and succeed, both through reforms passed in the Dodd-Frank Act and by implementing Dodd-Frank reforms in a manner that recognizes the lower level of risk that community banks pose.

The reforms passed in the Dodd-Frank Act helped neutralize some cost advantages that favored larger banks based on their scale. For example, the Dodd-Frank Act permanently raised FDIC coverage to \$250,000 per account from \$100,000, which protects savers and allows small banks to attract more deposits to expand lending. It redesigned insurance assessments and increased the size of the deposit insurance fund in a way that would protect small banks, while ensuring that big banks bear costs proportional to their larger level of risk. Dodd-Frank levels the playing field for small banks by prohibiting abusive practices among mortgage brokers. It also uses capital and liquidity requirements to ensure that the costs of proprietary trading fall to the larger banks that typically engage in this practice, thus reducing some of the advantage in financing costs that they may have held in the past relative to small banks, who depend on deposits to finance loans and are less likely to engage in risky trades with bank capital.

In implementing the provisions of Dodd-Frank, the Administration has taken important steps to ensure that regulatory requirements are implemented in a fair and equitable manner for community banks. The banking agencies have begun and are continuing to tailor regulatory requirements to reflect the different needs of community bank and the lower level of financial risk that they pose. Some steps include allowing for longer exam cycles for smaller banks that are well capitalized, streamlining the regulatory reports that community banks must file, and continuing to develop a simpler and shorter regulatory reporting procedure for community banks. Furthermore, the banking agencies continue to consider the written and oral comments made by community banks in the banking agencies' nationwide meeting, working to reduce unnecessary regulatory burden under the Economic Growth and Regulatory Paperwork Reduction Act. The Administration strongly supports these ongoing efforts by the banking agencies

to fairly tailor the regulatory requirements for community banks and avoid any undue burdens.

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