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**COMMUNITY BANKING AND ITS IMPACT ON AMERICA:
UPDATED ANALYSIS FOR THE COVID ECONOMY**

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Community Banking and Its Impact on America: Updated Analysis for the COVID Economy

February 2021

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Abstract

This working paper focuses on the US community banking industry, trends in its development over the past five years, and the impact of the COVID-19 crisis. It begins with a discussion of the American community banking industry from both historical and present-day perspectives with the goal of understanding who community banks serve, what they do, and what their role is within the broader economy. The paper then turns to quantitative and qualitative analyses of community banks from 2015 to 2019. We detail the ways in which the industry has shifted over that five-year period and highlight the continued tribulations of community banks attempting to compete in the modern financial system. In particular, we examine continued consolidation and the impact of changes to the Dodd-Frank regulations that went into effect in 2018. We then examine the performance and resilience of community banks in the COVID-19 pandemic, and we highlight their critical role in the Paycheck Protection Program (PPP). We also examine the disadvantages faced by minority-owned businesses in accessing PPP funding. The paper concludes with our policy proposals, broken down into the categories of smart regulation, support for community banks, and support for community bank-related industries, to put the community banking industry onto solid footing to continue supporting the American economy.

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Introduction

Community banks play a vital role in the American economy in a manner unlike most other developed nations. Of the 4,882 community banks active in the US as of Q3 2020, about half are based in rural counties with populations of less than 50,000, providing a lifeline of financial services in parts of the country where larger financial institutions have less of a presence.¹ Some community banks are classified as community development financial institutions (CDFIs), which are specifically chartered to operate in low-income areas where people have historically lacked access to traditional financial services, or minority depository institutions (MDIs), which predominantly serve communities of color and form a critical part of the financial infrastructure of these communities.^{2,3} Community banks specialize in incorporating on-the-ground knowledge into lending decisions, epitomizing the term “relationship banking”, which allows community banks to power small businesses and local economies in a unique way that is not solely reliant on impersonal credit modeling.

Yet, community banks have been under pressure for decades. Consolidation within the banking system has driven the number of community banks down by almost 50% in the past two decades.⁴ Some of the consolidation has been driven by big banks achieving market expansion through the acquisition of community banks, while other consolidation events have been between community banks trying to grow in order to compete in a banking system increasingly dependent on scale.

Scale is vital for the long-term survival of banks in the modern era. Despite community banks outnumbering big banks by a 32:1 ratio, these 151 big banks have almost six times the assets of all community banks combined.⁵ As the importance of technology in the provision of banking services grows, the relevance of scale will only increase. Unfortunately, community banks have found themselves outcompeted on technology thus far. This has contributed to the declining share of deposits that community banks represent in both urban and rural areas by approximately 15 percentage points and 3 percentage points, respectively, from 1997-2017.⁶

The concerns of rampant consolidation and scale have been structural impediments for the community banking industry for many years, but 2020 and the COVID-19 pandemic threw the industry for another loop. The pandemic tested the balance sheets of even the sturdiest financial institutions due to the prolonged shuttering of the economy and increased the possibility of delinquency on loans, and community banks were no exception. Community banks were particularly vulnerable due to the nature of their lending. A larger proportion of community bank balance sheets are dedicated to local small business lending as compared to those of big banks, meaning that the assets of community banks were in greater danger of taking a significant hit, on average, when Main Street was shuttered due to the pandemic.

¹ Banking Strategist, “Community Banks: Number By State and Asset Size,” n.d., <https://www.bankingstrategist.com/community-banks-number-by-state-and-asset-size>.

² Amber Murakami-Fester, “What Are Community Development Financial Institutions?,” Nerdwallet, August 13, 2020, <https://www.nerdwallet.com/article/banking/what-is-community-development-financial-institution-cdfi>.

³ “Minority Depository Institutions Program” (Federal Deposit Insurance Corporation, 2019), <https://www.fdic.gov/regulations/resources/minority/mdi.html>.

⁴ Randal K. Quarles, “Trends in Urban and Rural Community Banks,” <https://www.federalreserve.gov/newsevents/speech/quarles20181004a.htm>.

⁵ Banking Strategist, “Community Banks: Number By State and Asset Size.”

⁶ Quarles, “Trends in Urban and Rural Community Banks.”

In many ways, small business lending continues to represent a competitive edge for community banks. Despite much public discussion of the revolutionary potential of big data and artificial intelligence in the lending space, the local network and knowledge possessed by community banks provides a unique input for lending decisions that has yet to be replicated effectively. However, this does mean that community bank balance sheets are disproportionately exposed to borrowers that are less resilient than large corporations to unexpected shocks, and the COVID-19 pandemic and the ensuing shutdown of large portions of the economy represents the largest shock in a generation. Yet, community banks were also the best positioned financial entities to implement emergency relief programs, such as the Paycheck Protection Program and Economic Injury Disaster Loans, that the government was trying to use to support shuttered or hampered small businesses. Approximately 60% of the first wave of PPP loans were structured and distributed by community banks, proving that these institutions punch well above their weight in the small business lending market, particularly in critical situations where speed and specific knowledge of the businesses in question were paramount.⁷ During the pandemic, community banks were the first line of defense for the engine of the American economy, showcasing their vital role.

In this paper, we will dive into the world of community banks, discussing what they are, what makes them important, and what structural trends are driving the industry. We'll turn to data from government regulators and industry bodies to understand how community banks have performed since 2015 up until the start of the pandemic in early 2020. The paper will provide an in-depth look at the impact that the COVID-19 pandemic had on community banks, from their balance sheets to pre-existing industry trends, and how these banks performed in providing their vital services to businesses, families, and the nation more broadly. Finally, we'll close with a brief look into the future to see what comes next for the community banking industry and what regulatory and public policy changes are best suited to support these valuable institutions.

We're grateful in this paper to be building off work done five years ago by Marshall Lux, one of the co-authors of this paper, and Robert Greene, who was a student at the Harvard Kennedy School of Government at the time of writing. Their work is titled *The State and Fate of Community Banking*, and it discussed community banking trends up until 2015.⁸ For that reason, this paper will focus almost exclusively on the community banking industry after 2015. We encourage readers to view these papers as companions telling a cohesive story through time as community banks face some of the toughest challenges they've ever had.

⁷ Tom Groenfeldt, "Community Banks Met The Challenge Of The SBA's PPP Funding," *Forbes*, June 17, 2020, <https://www.forbes.com/sites/tomgroenfeldt/2020/06/17/community-banks-met-the-challenge-of-the-sbas-ppp-funding/?sh=152afb6544e3>.

⁸ Marshall Lux and Robert Greene, "The State and Fate of Community Banking" (Harvard Kennedy School Mossavar-Rahmani Center for Business & Government, February 2015), https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf.

The Community Bank Landscape

To begin our analysis, we must lay a foundation regarding the community banking industry upon which we will later build our arguments. To that end, this section will discuss the nature of community banks, providing basic definitions as well as important trends in who community banks serve, how they serve them, and what drives the industry's returns. After this discussion, we will transition to identifying key trends that have continued, ended, or developed over the past five years.

What Defines A Community Bank?

The phrase “community bank” often evokes images of a well-apportioned stone building on Main Street USA or the visage of George Bailey, the erstwhile banker in the classic “It’s a Wonderful Life”. American culture has a tendency to romanticize community banks due to their association with having local roots in small towns across the nation. Most of us, when thinking of community banks, picture something that looks an awful lot like a bygone era.

The reality, however, is that community banks come in all shapes and sizes in the modern era. Some fulfill this image of the picturesque Main Street bank, while others resemble big banks much more closely with a network of branches, diversified funding sources, and a strong digital presence. Clearly, the stereotypical idea of what a community bank is will be insufficient to appropriately define the industry.

There are several qualitative characteristics that tend to be associated with community banks. First, they tend to take deposits and lend money back out into a particular community or set of communities, and these communities are those where the bank and its branches are actually based.⁹ In other words, community banks are broadly defined by their orientation towards the local provision of financial services, and they tend not to have national networks of locations.

Second, because of their focus on local communities, community banks generally focus on bread-and-butter financial services like checking and savings accounts, personal and small business lending, and safety deposit services.¹⁰ While some banks will offer specialized services if there is a need within their customer base, most community banks stick to providing these time-honored services.

Finally, the ownership structure of community banks tends to differ significantly from that of big banks. While big banks tend to be publicly traded institutions with diverse shareholders, community banks are more often privately owned by a small set of local individuals or cooperatives. This structure increases the involvement of ownership with the operations of the bank on a regular basis and ensures that the bank's financial returns are tied more closely into the community. In addition, community banks are generally viewed as more trustworthy by consumers because of their local ties and ownership, with American consumers preferring them for their customer service and personalization.¹¹

⁹ “2012 Community Banking Study” (Federal Deposit Insurance Corporation, December 2012), 1–1, <https://www.fdic.gov/regulations/resources/cbi/report/cbsi-1.pdf>.

¹⁰ “2012 Community Banking Study,” 1–1.

¹¹ Bill Streeter, “People Prefer Small Banks and Credit Unions, But The Clock Is Ticking,” The Financial Brand, November 13, 2018, <https://thefinancialbrand.com/76884/digital-community-banking-credit-unions/>.

However, these qualitative characteristics can be difficult to assess for every bank across the country, despite the importance of many of these characteristics to the operations and structure of community banks. For those reasons, there is some disagreement among financial regulators and industry groups about how to properly define a community bank and differentiate it from a big bank.

Despite the difficulty, the FDIC strives to leverage many metrics and exclusions, in line with some of the qualitative indicators outlined above, to define a community bank.¹² However, the OCC and the Federal Reserve take a more simplistic approach by relying purely on asset size delineations to split community banks from larger banks, though even these two institutions don't agree on what the proper line is. The OCC defines a community bank as any institution with less than \$8 billion in assets, and the OCC adds a middle tier of banks, called midsize banks, with between \$8 billion and \$60 billion in assets prior to the big bank classification above \$60 billion.¹³ The Fed, for its part, categorizes all banks with less than \$10 billion in assets as community banks, with an additional tier, dubbed regional banks, for those with between \$10 and \$100 billion in assets.

Given the disparities between the definitions used by these institutions, we are going to err on the side of simplicity in this paper with the goal of enabling better and more plentiful apples-to-apples comparisons across data sets of varying levels of detail. Thus, our definition of community banks will be those with total assets less than \$10 billion, in line with the standard utilized by the Fed. In the instances where we are performing analysis or leveraging data that does not conform to this definition, we will state whatever alterations are necessary.

Why Are Community Banks Important?

The relevance of community banks in the American economy can sometimes present a puzzle to those who compare the American financial system to those around the world. After all, many developed nations do not have nearly the same rate of small bank existence that the US does through its community banking industry. In this section, we will discuss how the current framework of community banks developed and what makes community banks important to the American economy.

A Brief History Lesson

The origin of the American community bank lies in the state chartering system for banks. The first recorded state-chartered bank was the Bank of North America, chartered by the state in Pennsylvania in 1782.¹⁴ In the ensuing 80 years up to the beginning of the Civil War, the growth in state-chartered banks accelerated, reaching a total of 1,358 banks in 1861. During this era, these banks served their localities and largely remained within the boundaries of the state that chartered them, with some states like New York and Massachusetts having hundreds of banks and others like Alabama and Michigan having only a handful.

¹² "2012 Community Banking Study," 1–2.

¹³ Office of the Comptroller of the Currency, "Midsize and Community Bank Supervision," n.d., <https://www.occ.treas.gov/about/who-we-are/organizations/midsize-and-community-bank-supervision/index-midsize-and-community-bank-supervision.html>.

¹⁴ Warren Weber, "Early State Banks in the United States: How Many Were There and When Did They Exist?" (Federal Reserve Bank of Minneapolis, December 2005), 6, <https://www.minneapolisfed.org/research/wp/wp634.pdf>.

But, during the Civil War, many state-chartered banks converted to national banks, that is, those chartered by the federal government, after the passage of the National Banking Acts of 1863 and 1864 due to the nationalization of currency issuance.¹⁵ It wasn't until the late 1800's, when large regulatory discrepancies emerged between state and federal regulators concerning capital requirements, that state-chartered banks made a significant comeback, reaching over 15,000 in number by 1913.

The Federal Reserve Act of 1913 standardized much of the distinctions between being a state-chartered bank and being a national bank. From that point, the relative number of national and state-chartered banks fluctuated, but the community banking industry held strong, regardless of which government entity chartered them. It wasn't until a slew of deregulation in the financial industry in the 1980s that national charters started to lose favor against state charters and the community banking industry began its long period of consolidation. While the total number of charters outstanding has been decreasing significantly over time, national charters have decreased more quickly, with hundreds of banks switching from national to state charters.¹⁶

As of the end of 2019, there are slightly over 800 banks with national charters and approximately 4,200 banks with state charters. Almost all of the state-chartered banks are correctly classified as community banks, with community banks also representing a significant portion of the national banks.

The state chartering system fueled the proliferation of community banks through the US starting from the earliest days of the republic. Though the balance between national and state charters has fluctuated throughout history, the relevance of community banks focused on local financial services has remained critical for the American economy. Now, we will pivot towards understanding the particulars of how community banks fulfill their role in the economy.

Who They Serve

While community banks are large in number, they are relatively small in overall assets and loans compared to the big banks, holding only 12% of banking industry assets and supplying only 15% of banking industry loans in 2019.¹⁷ Despite their size disadvantage, however, community banks have carved out lending niches where they punch well above their weight, with the most notable being small business lending in a variety of forms.

In particular, community banks play outsized roles in the commercial real estate (CRE), business operational, and agricultural lending spaces.¹⁸ CRE lending is vital for small businesses who need to purchase property assets for their operations, and community banks, with their local knowledge advantage, own 30% of the banking industry's CRE portfolio. Business operational loans are general purpose small business loans for upgrades, inventory investments, and similar activities. Community banks hold 36% of this market, well above their 15% total of all lending. Finally, agricultural lending is critical to the empowerment of America's farmers to make investments and produce efficiently, and community banks are responsible for 31% of these

¹⁵ Richard Grossman, "US Banking History, Civil War to World War II," EH.net, March 16, 2008, <https://eh.net/encyclopedia/us-banking-history-civil-war-to-world-war-ii/>.

¹⁶ Barbara Rehm, "Two Decade Trend Squeezes Choice from Dual Banking System," American Banker, October 26, 2011, <https://www.americanbanker.com/news/two-decade-trend-squeezes-choice-from-dual-banking-system>.

¹⁷ "2020 Community Banking Study" (Federal Deposit Insurance Corporation, December 2020), VI, <https://www.fdic.gov/resources/community-banking/report/2020/2020-cbi-study-full.pdf>.

¹⁸ "2020 Community Banking Study," VI-VII.

loans. In this vertical, there are some community banks that focus specifically on making agricultural loans given the complexities involved.

In addition, it's clear that community banks play a particularly important role in funding small business growth through these three types of loans in rural and exurban areas. In the CRE lending market, community banks play roles in the primary and secondary real estate markets but really thrive in the tertiary markets, representing over 60% of the banking industry's CRE loans in these areas.¹⁹

On the consumer side, mortgage and generic consumer lending are declining in importance for community banks when viewed as a percentage of the bank's total assets. While community banks still have a higher percentage of their balance sheets tied up in mortgages than big banks,²⁰ largely due to the dynamics of the mortgage securitization market, community banks are significantly less involved in the generic consumer lending market than big banks.²¹

Community banks primarily rely on deposits from local consumers in order to fund their operations and lending, with deposits funding 84% of community bank assets in 2019.²² Despite varying total balance sheet sizes and levels of technology adoption among different community banks, these variables did not have significant impacts on the centrality of deposits to the bank's funding sources. This highlights that the underlying premise of community banks, namely, that they primarily serve their local communities with basic financial services like deposit-taking and lending, remains true despite the changes roiling the industry over the past several decades.

Where They Make An Impact

Community banks operate in communities large and small across the country, but they make the biggest impact in rural communities. The average urban area has approximately 200 bank locations scattered throughout its geography, but only about one-third of them are related to community banks. In contrast, the representative rural area has nine bank locations, of which community banks are seven, or over three-quarters of the total.

Community banks serve as a financial lifeline for rural communities that don't offer similar levels of scale and returns as urban markets. Despite other declines in rural economies, access to basic financial services has remained steady for these communities, in large part due to the continued presence and investment of community banks in these areas.

In addition, community bank lending, particularly for small businesses, is more prevalent in the eastern half of the US than in the western half. This is partly due to the historical role that state-chartered banks played in the development of the country, which began in the east and moved westward over time as larger, more consolidated banks gained predominance.

Finally, as with all federally regulated banks, community banks are subject to the provisions of the Community Reinvestment Act of 1977, which set out requirements for banks to ensure a significant portion of their credit provision is directed towards low- and moderate-income communities.²³ By meeting these standards, community banks ensure that they are making an impact across income levels within the localities they serve.

¹⁹ "2020 Community Banking Study," 4–3.

²⁰ "2020 Community Banking Study," 5–12.

²¹ "2020 Community Banking Study," 5–17.

²² "2020 Community Banking Study," 6–12.

²³ Board of Governors of the Federal Reserve System, "Community Reinvestment Act (CRA)," n.d., https://www.federalreserve.gov/consumerscommunities/cra_about.htm.

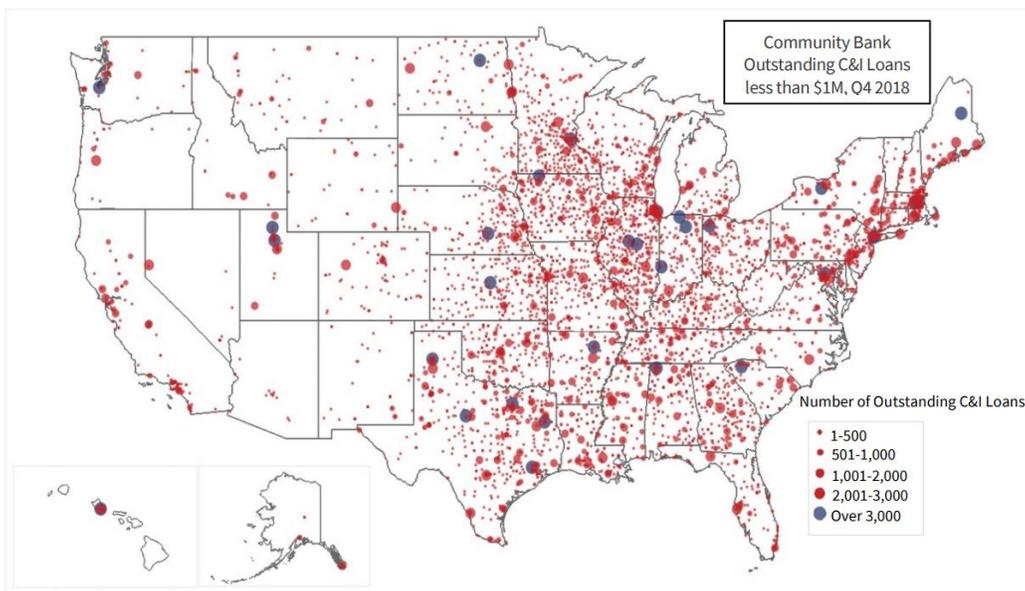


Figure 1: Geographic Breakdown of Community Bank Small Business Lending²⁴

The Unique Role of CDFIs and MDIs

Community development financial institutions (CDFIs) are government-designated financial institutions that serve low-income communities around the country and are eligible for training and financial awards from the government for committing to operate in this manner.²⁵ These institutions can take many forms from credit unions to venture capital funds.²⁶ However, the CDFIs with which we are primarily concerned in this paper are banks, which account for 252 of the 1163 CDFIs active as of the end of 2020.²⁷

By statute, CDFIs must make at least 60% of their loans and investments into economically distressed areas or to underserved populations. CDFI banks tend to exceed this threshold significantly, averaging about 80% of loans being made to distressed geographies.²⁸ With each CDFI bank making \$200mm in loans on average, these institutions account for approximately \$40bn of lending and debt investment activity in distressed communities where that capital is needed most.²⁹

In addition to impact geographies that are economically disadvantaged, CDFIs also disproportionately aid minority communities and entrepreneurs. CDFI banks are particularly

²⁴ Daniel Brown, “Spotlight on Community Bank Lending,” Small Business Facts (U.S. Small Business Administration, September 2019), <https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/25164013/Fact-Sheet-Community-Bank-Lending.pdf>.

²⁵ Murakami-Fester, “What Are Community Development Financial Institutions?”

²⁶ “CDFI Certification,” U.S. Department of the Treasury Community Development Financial Institutions Fund, n.d., <https://www.cdfifund.gov/programs-training/certification/cdfi>.

²⁷ “CDFI Certification.”

²⁸ “CDFI Program and NACA Program Awardees: A Snapshot in 2017” (U.S. Department of the Treasury Community Development Financial Institutions Fund, May 2019), 15, https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi-performance-2017-approval-06-14-2019_508-compliance.pdf.

²⁹ “CDFI Program and NACA Program Awardees: A Snapshot in 2017,” 15.

important for Black-owned small businesses in accessing credit. 17% of Black-owned businesses that applied for a small business loan did so at a CDFI in 2019, far outpacing the rates for businesses owned by other demographics.³⁰ Thus, while most CDFI banks don't possess the massive balance sheets of larger banks, their lending activity makes significant contributions to the livelihoods of Americans, particularly those who are non-white, who are in desperate need of financial lifelines and opportunities.

Minority depository institutions (MDIs) ultimately serve a similar role in the American economy but are characterized differently from CDFIs. MDIs are either owned by minority shareholders or have a board comprised mostly of minority individuals and serve minority geographies.³¹ While not necessarily definitionally required to invest in minority areas, the 145 active MDIs across the country have disproportionate positive impacts in minority communities.³² MDIs are critical players in the mortgage market for minority borrowers and low- and moderate-income (LMI) census tracts, enabling the generation of home wealth in minority communities.³³ In addition, MDIs are a significant part of SBA 7(a) lending to small businesses for LMI and minority communities, empowering commerce in these communities.

As subcategories of community banks, CDFI banks and MDIs are key to serving areas of the country and parts of the population with less access to financial services, particularly those from larger institutions. CDFI banks and MDIs give economic opportunities where few other options might exist. By doing so, they epitomize the critical role that community banks play in distributing capital to disadvantaged populations or less financially integrated parts of America.

How They Make Money

Like all banks, community banks have two primary revenues: interest income and non-interest income. Interest income is generally measured with the metric of net interest margin (NIM), which represents the average spread between what a bank is paying on deposits and what the same bank is receiving on its loans. The average NIM for community banks has remained stable between 360 and 380 basis points since the end of the financial crisis, allowing them to significantly outperform big banks since 2011 on this component of revenue.³⁴ Big banks experienced a significant decrease in NIM between 2010 and 2014, bottoming at ~300 basis points before recovering slightly to 320 basis points in 2019. This indicates that community banks have resisted broader industry trends toward paying higher interest on deposits or lowering loan interest rates, and they have partly achieved this by seeking long-term liabilities like CDs.

³⁰ “Small Business Credit Survey: Report on Minority-Owned Firms” (Federal Reserve Bank of Atlanta, December 2019), 13, <https://www.fedsmbusiness.org/medialibrary/fedsmbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf>.

³¹ “Minority Depository Institutions: Structure, Performance, and Social Impact” (Federal Deposit Insurance Corporation, 2019), 1, <https://www.fdic.gov/regulations/resources/minority/2019-mdi-study/full.pdf>.

³² “Minority Depository Institutions Program.”

³³ “Minority Depository Institutions: Structure, Performance, and Social Impact,” 5.

³⁴ “2020 Community Banking Study,” 1–2.

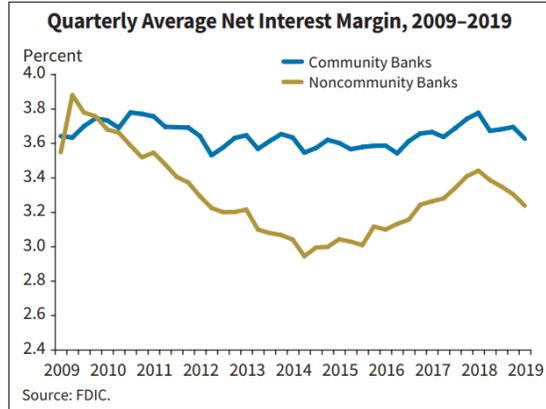


Figure 2: NIM for Community and Big Banks³⁵

However, the overperformance of community banks with interest income does not carry over to non-interest income. Examples of non-interest income include fees charged on accounts, asset sale gains, market income like trading and investment banking revenue, and insurance income. Community banks make larger portions of their non-interest income on fees and asset sale gains than big banks, but the larger institutions have a decisive edge on market income given the expansiveness of their operations. In addition, non-interest income plays a bigger role in the revenue picture for big banks, with these institutions earning 34.2% of their revenue from non-interest sources as compared to 20.2% for community banks.³⁶ The dependence of community banks on interest income showcases their vulnerability to changes in the interest rate environment and highlights the lack of diversification that community banks have in business lines that generate substantial revenue.

From a lending perspective, it should be noted that the local knowledge advantage employed by community banks in their lending businesses is real. Historically, community banks have experienced much lower net charge-off rates, that is, the rate at which banks have to take losses on their loans, than big banks. In 2019, community banks averaged a charge-off rate of 13 basis points, as compared to a rate of greater than 75 basis points for big banks.³⁷

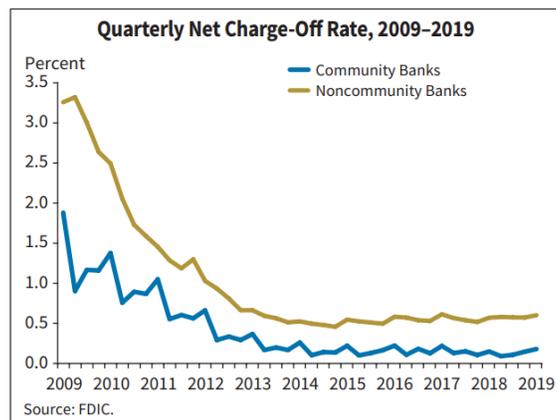


Figure 3: Historical Charge-Off Rates for Community and Big Banks

³⁵ “2020 Community Banking Study,” 1–2.

³⁶ “2020 Community Banking Study,” 1–3.

³⁷ “2020 Community Banking Study,” 1–4.

Ultimately, however, total asset size is positively correlated with the most relevant final metric, which is pre-tax return on assets (ROA). Big banks have consistently outperformed community banks in ROA since 2012 by 20 to 40 basis points.³⁸ Community banks generated a 144 basis point ROA in 2019, compared to an ROA of 166 basis points for big banks. Furthermore, when breaking down community banks into more granular buckets by asset size, the larger institutions tended to outperform the smaller banks, with the smallest bracket of those institutions with assets below \$100 million having the smallest ROA of 94 basis points.

To compete more effectively moving forward, community banks need to determine the optimal strategies to move closer to the big bank model of higher returns that are simultaneously more diversified and, thus, less risky. Without such a change in market dynamics, the consolidation trends are going to continue as it will be a value-creating move for large financial institutions to snap up small community banks at a fast pace. We will explore this trend and others in more detail in the next section.

The State of the Industry in 2015

As previously discussed, this paper is the continuation of prior work by Marshall Lux and Robert Greene published in 2015.³⁹ Moving forward, we will focus almost exclusively on the community banking industry after 2015, but, prior to proceeding, we want to provide a summary of the 2015 work for the reader's sake.

From the early 1990s through 2015, community banks had suffered from declining market share in assets and lending as compared to the largest banks, with both asset and loan share decreasing by approximately 50% over 20 years. This decline was despite the increasing strengths of community banks in the areas of lending we've previously discussed, including agricultural and small business loans, indicating that the decline in market share for community banks in consumer lending was even more stark than the 50% overall drop.

A key finding of the Lux & Greene analysis was the change in market dynamics that occurred with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.⁴⁰ Their analysis discovered that the negative trends impacting community banks in terms of market share and lending activity actually accelerated after the passage of Dodd-Frank in 2010 as compared to the prior four-year period. While the market had not been kind to community banks leading up to and during the Great Recession, the events of 2006-2010 did not impact the relative position of community banks as significantly as the consequential regulatory changes included in Dodd-Frank.

Furthermore, the paper drew a direct link between the passage of Dodd-Frank and accelerated consolidation activity in the community banking sector. M&A activity involving community banks was already a major trend in the industry, but the regulatory burden associated with Dodd-Frank and the regulatory economies of scale achieved by ever-larger financial institutions increased the incentives pushing for the roll-up of smaller community banks.

Overall, the outlook for the community banking industry in 2015 was not strong. While community banks continued to play significant roles in urban and rural communities and areas with disproportionately less access to basic financial services as well as in the small business

³⁸ "2020 Community Banking Study," 1-1.

³⁹ Lux and Greene, "The State and Fate of Community Banking."

⁴⁰ Lux and Greene, 19.

lending market, as we've discussed, the trends were not positive, particularly after the passage and implementation of Dodd-Frank. Lux & Greene made several policy recommendations to alleviate these trends, and some of them, such as the increase in regulatory exemptions and simplifications for community banks below certain size thresholds, have come to pass in the interim, as we will examine later in this paper.⁴¹

But, suffice it to say, that the starting point for community banks in 2015 had few bright spots. Our work over the coming chapters will be to illuminate if and how those trends have continued or reversed and analyze the severe but potentially industry-redefining shock of the COVID-19 pandemic for community banks.

⁴¹ Lux and Greene, 30.

Community Banking Trends (2015-2019)

As in other areas of the financial services industry, community banks have not remained static in the past five years. Even setting aside the COVID-19 pandemic, the impact of which we will discuss in the next section, systemic trends have been battering the community banking sector, from the continued consolidation of banking overall to the declining role that community banks play in servicing the needs of ordinary retail consumers.

In this section, we will look at the changes in community banking from 2015-2019 across areas critical to understanding the current state of community banks and their role in the economy. We will examine their overall size relative to larger financial institutions, their returns, and trends in customer servicing and lending. After a thorough analysis of these areas, this paper will then examine the trend of banking industry consolidation in detail to understand its persistence and causes.

Trends in Performance and Lending

Between 2015 and 2019, the role that community banks play in the American economy has shrunk, particularly regarding retail consumer activities like deposit taking and retail lending. In addition, some of the markets where community banks have historically shown strength, like small business and CRE lending, have shifted somewhat in favor of larger financial institutions.

However, community banks continue to compete with big banks from a quarterly returns perspective, and they enjoy better profitability and risk management metrics on traditional lending products on average.

As we will show in detail, the community banking industry was beleaguered between 2015 and 2019, but it managed to defend several of its core strengths well.

Representation in Banking Ecosystem

Over the past five years, the decline in the overall number of community banks has continued in line with the trend leading up to 2015. While there has been a slight uptick in the number of large community banks with assets between \$1bn and \$10bn, largely due to rampant M&A activity, the total community bank population dropped by over 20% from Q4 2014 to Q4 2019, leaving only a little over 5,000 community banks standing.⁴² In a sign of the long-term trend at play for community banks, for every 4 community banks that existed in 1986, there is only about 1 in 2019, which represents a 4% annual shrinkage in the number of American community banks for almost the past quarter century. Unfortunately, this trend has been even more stark for Black-owned banks, which have declined in number by almost half from 2008 to the end of 2019, outpacing the overall decline in the number of community banks.⁴³

⁴² “FDIC Statistics on Depository Institutions Report” (Federal Deposit Insurance Corporation, 2020 1984), <https://www7.fdic.gov/sdi/index.asp>.

⁴³ Michael Neal, “To Significantly Increase Access to Capital for Communities of Color, We Need to Support Black Banks and All CDFIs,” July 31, 2020, <https://www.urban.org/urban-wire/significantly-increase-access-capital-communities-color-we-need-support-black-banks-and-all-cdfis>.

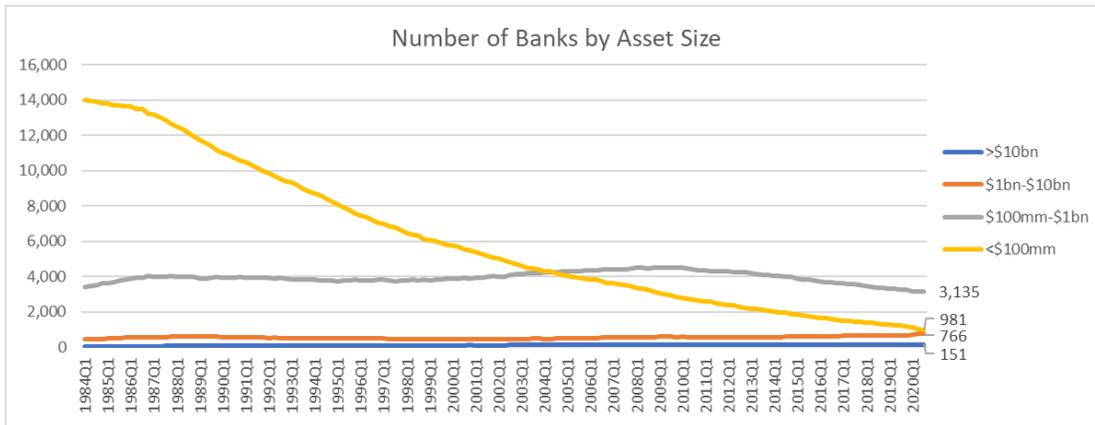


Figure 4: Number of Banking Institutions by Total Institution Asset Size⁴⁴

Furthermore, this consolidation of the overall number of community banks has also translated into the decreasing representation of community banks in banking assets more generally. Community banks held only 16% of US bank assets at the end of 2019, down from 19% at the beginning of 2015 and a whopping 56 percentage points lower than the 72% of assets that they represented in 1984.⁴⁵ While there haven't been sharp discontinuities in the total assets held by community banks in the past five years, community banks have been unable to reverse the downward trend afflicting them in the prior three decades.

Part of this difference between community and big banks derives from the complex lines of business in which big banks engage but community banks generally do not. For example, sales and trading businesses can absorb a large amount of a big bank's balance sheet, but community banks do not have such businesses and do not rely on them to generate revenue. Thus, at least partially, the comparison between community banks and big banks on an asset basis is not necessarily an apples-to-apples comparison. However, looking at asset size does give us insight into where the wind is blowing in financial services, and it, unfortunately, is not in the direction of community banks on this measure.

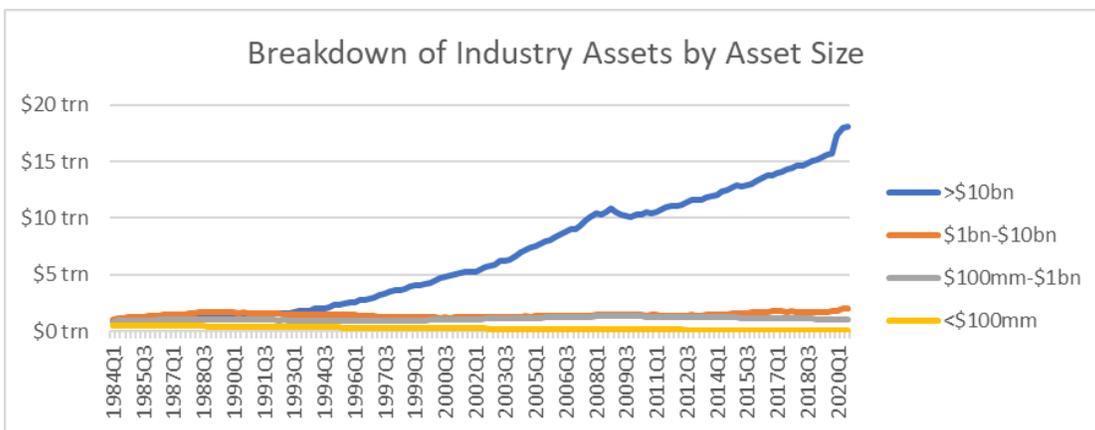


Figure 5: Banking Industry Assets by Total Institution Asset Size⁴⁶

⁴⁴ "FDIC Statistics on Depository Institutions Report."

⁴⁵ "FDIC Statistics on Depository Institutions Report."

⁴⁶ "FDIC Statistics on Depository Institutions Report."

Relative Performance of Community Banks

Despite the decreasing share of assets held by community banks, the industry has not experienced significant detrimental effects on profitability and risk management metrics. Medium and large community banks (those between \$100mm and \$10bn in assets) compete well with big banks from a pre-tax return on assets (ROA) perspective. Since the end of 2014, there have been some quarters when these community banks beat the returns of big banks and others when the big banks won the fight. That being said, the ROA of big banks has proven to be significantly more volatile than that of medium and larger community banks, with significant swings occurring in periods of high systemic stress. Medium and large community banks have provided more consistent returns than big banks over the past five years. In addition, MDIs have, on average, exceeded other banks in ROA performance over time despite facing challenging economic conditions and structural inequities in the communities that they tend to serve.⁴⁷

An important note, however, concerns the performance of the smallest community banks (those with less than \$100mm in assets). These banks have consistently underperformed larger institutions in quarterly ROA by an average of 26 basis points since 2015, representing 22% lower returns.⁴⁸ This trend is a continuation of a deviation for small community banks that materialized in the late 1990s to be interrupted only briefly during the 2008 financial crisis when larger institutions took huge profitability hits. The consistent underperformance for small community banks is one of the key drivers of their declining numbers and importance over time, both through dissolution and mergers. It's only been through growth and consolidation that these banks have been able to achieve key economies of scale to sustainably match the returns of larger institutions.

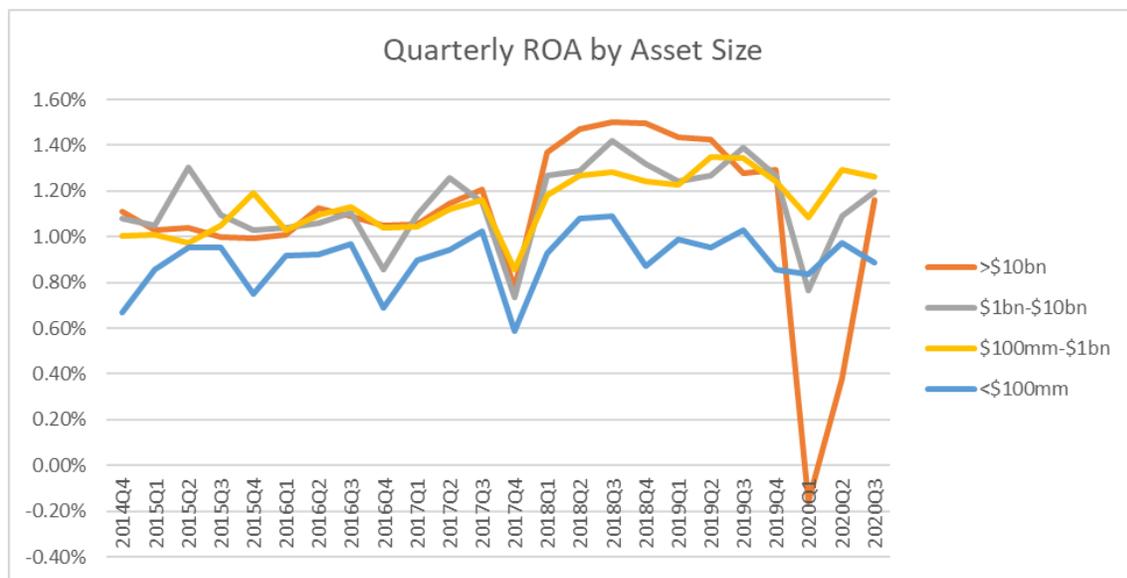


Figure 6: Quarterly ROA by Total Institution Asset Size⁴⁹

⁴⁷ Gregory Fairchild et al., “Good Money After Bad? The Comparative Efficiency of Minority Depository Institutions,” *Journal of Developmental Entrepreneurship* 25 (March 2020): 20, <https://www.worldscientific.com/doi/epdf/10.1142/S1084946720500028>.

⁴⁸ “FDIC Statistics on Depository Institutions Report.”

⁴⁹ “FDIC Statistics on Depository Institutions Report.”

While community banks generally don't engage in certain business lines like sales & trading and investment banking activities, they achieve comparable ROAs primarily by realizing a higher net interest margin (NIM) on their standard deposit-taking and lending activities than big banks. NIM represents the spread between a bank's average interest rate charged on a loan and the same bank's average interest rate paid on deposits, thus, understanding a bank's NIM is a good proxy for approximating the profitability of its traditional banking business.

This competitive edge for community banks is material in size, averaging 52 basis points across the last five years, is similar for community banks of all sizes when compared to big banks.⁵⁰ It has not been shown to be volatile during periods of stress, though it is partially correlated with interest rates. When the Fed began to raise rates in 2015, the NIM of big banks started to close the gap with community banks, shrinking to 37 basis points in early 2019 before widening again.⁵¹

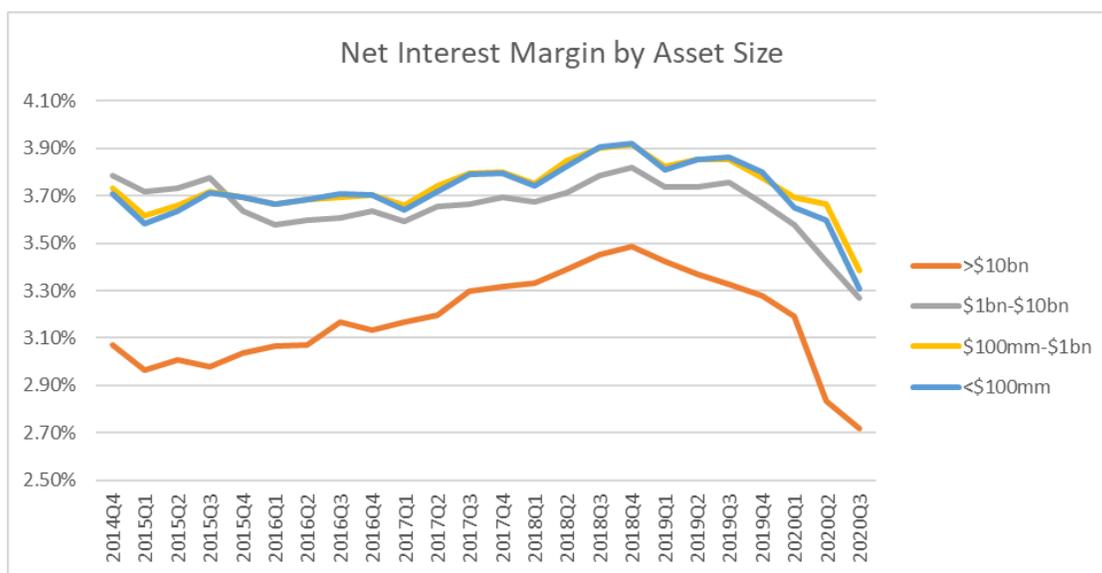


Figure 7: NIM by Total Institution Asset Size⁵²

Finally, community banks perform differently on key risk management metrics than big banks. Regarding credit risk, community banks have lower loan charge-off rates, meaning that a smaller percentage of their lending dollars end up defaulting during the course of the loan. This is a strong indicator that a primary competitive advantage of community banks, that they have local knowledge and expertise that allows them to make more appropriate lending decisions, actually exists and affects the quality of a community bank's business. Lower charge-offs leads to higher returns for community banks and the ability to funnel more capital into the local economy given a lower risk of default. The consistency of maintain lower charge-off rates over the past two decades showcases the stability achieved by community banks even in times of crisis.

⁵⁰ "FDIC Statistics on Depository Institutions Report."

⁵¹ "Federal Funds Rate - 62 Year Historical Chart," MacroTrends, 2020, <https://www.macrotrends.net/2015/fed-funds-rate-historical-chart>.

⁵² "FDIC Statistics on Depository Institutions Report."

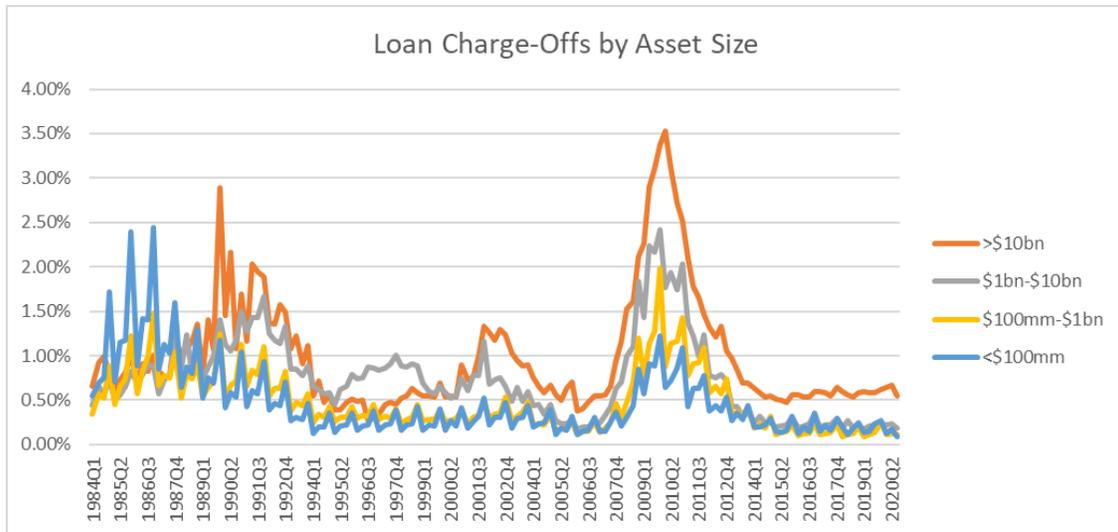


Figure 8: Loan Charge-Off Rates by Total Institution Asset Size⁵³

The second risk management metric on which community banks differ from big banks is the ratio of equity capital to assets that the banks maintain. Community banks have consistently held a higher proportion of their liabilities as equity capital than big banks, which makes the community banks safer and more secure under either systemic or idiosyncratic duress. However, holding a higher ratio of equity capital hurts returns measured on an equity basis because there’s simply more equity at play. For that reason, while community banks are more stable from a systemic perspective and are less likely to collapse given their increased equity buffers, the higher equity capital ratio at community banks likely disadvantages them when competing against big banks from a return on equity perspective.

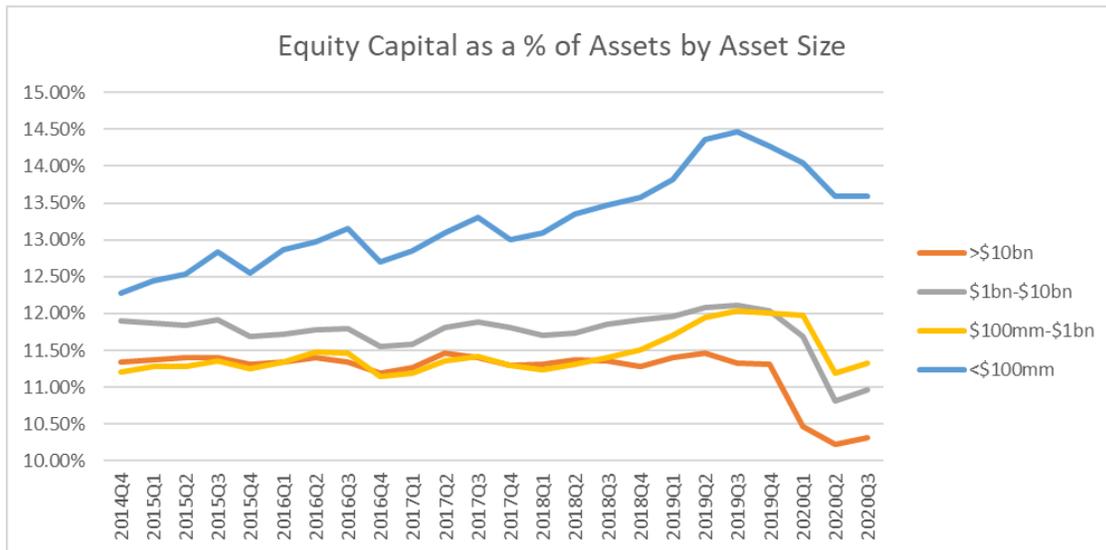


Figure 9: Equity Capital Ratios by Total Institution Asset Size⁵⁴

⁵³ “FDIC Statistics on Depository Institutions Report.”

⁵⁴ “FDIC Statistics on Depository Institutions Report.”

Trends in the Retail Business

When examining the traditional banking business lines of deposit-taking and lending, it’s useful to differentiate by the customer base that the bank is serving. In deposit-taking and retail lending, the bank is servicing ordinary consumers, while small business, CRE, and farm lending are aimed at local businesses. Given the distinction in serving these two types of customers, we will take each in turn, starting with the retail business.

Community bank deposit-taking has suffered for several decades, and the five years since 2015 proved no different. Deposits continued to shift towards big banks with national branch networks, resulting in the deposit market share for community banks falling from 20% to 16% from the beginning of 2015 to the end of 2019.⁵⁵ Unfortunately for community banks, some aspects of customer service that have come to be viewed as essential for deposit-taking, like universal ATM access, experience significant economies of scale, which favor the big banks. Community banks are able to compete on some elements of personalized service, but not with sufficient perks to attract the majority of Americans and their funds.

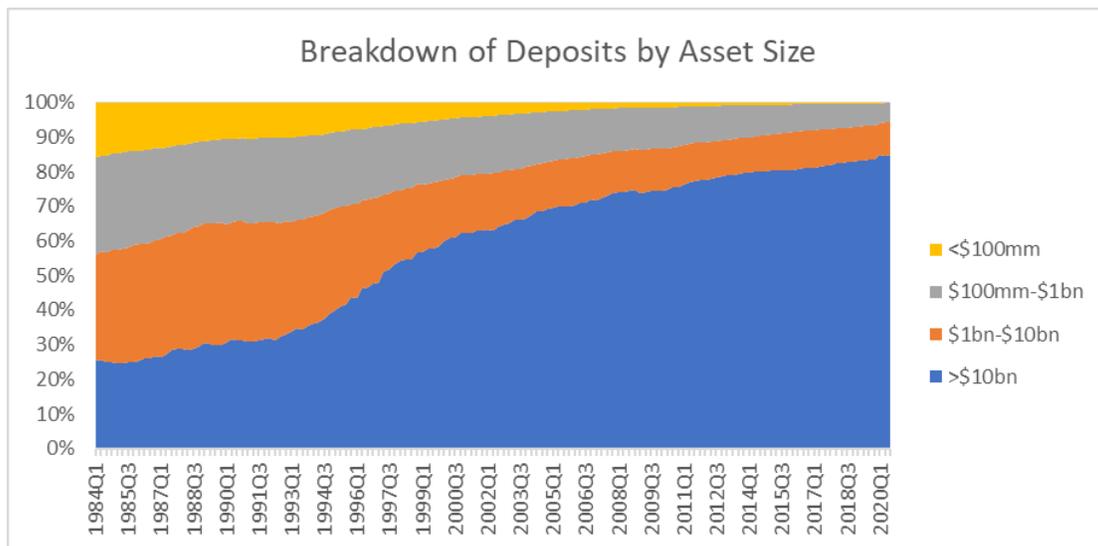


Figure 10: Deposits by Total Institution Asset Size⁵⁶

A similar story has played out in retail lending, which is mostly comprised of loans to individuals and households for personal purposes. The share of the retail lending market that community banks hold has fallen from 19% to 16% from 2015 to 2019, almost exactly in line with the commensurate fall in deposits.⁵⁷ Interestingly, the share of community banks’ total lending that is retail lending has remained largely constant for small and medium community banks over the past five years, while the percentage of the loan books of big banks and large community banks (those with assets over \$1bn) dedicated to retail lending has fallen by four and six percentage points, respectively. This indicates that, while community banks may be less important for consumers desiring loans, consumers desiring loans are not less important for community banks, at least those of a small and medium variety.

⁵⁵ “FDIC Statistics on Depository Institutions Report.”

⁵⁶ “FDIC Statistics on Depository Institutions Report.”

⁵⁷ “FDIC Statistics on Depository Institutions Report.”

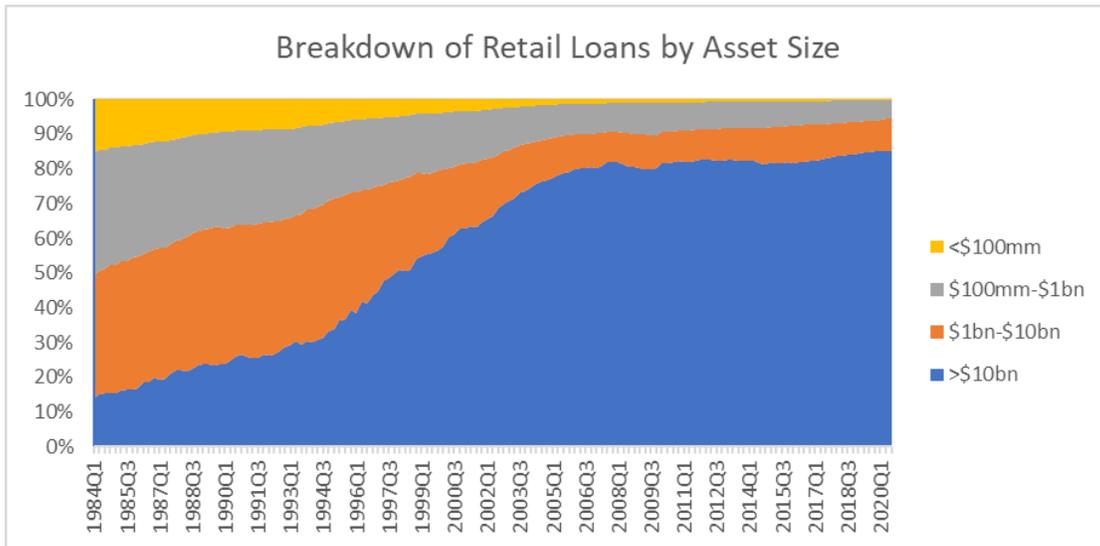


Figure 11: Retail Lending by Total Institution Asset Size⁵⁸

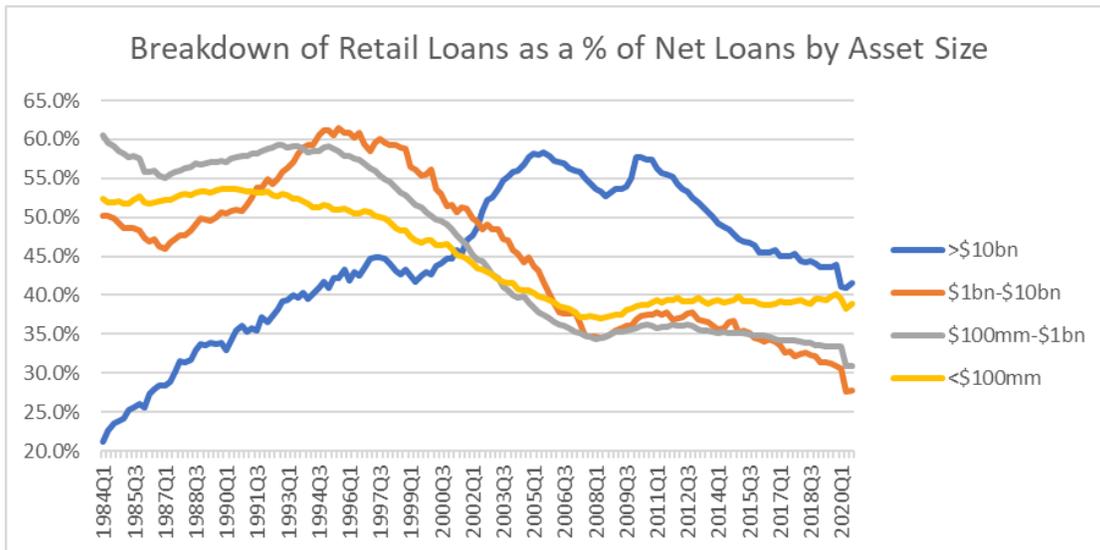


Figure 12: Retail Loans as a Percentage of Net Loans by Total Institution Asset Size⁵⁹

Relationship with Local Small Business & Farms

Lastly, we turn our attention to the non-retail side of the lending businesses for community banks. As previously discussed, there are three primary components where these institutions have held particular advantages, including small business lending, commercial real estate (CRE) lending, and farm lending. Historically, community banks excelled in these areas due to their competitive edge of local expertise, relationships, and knowledge to establish the creditworthiness (or lack thereof) for potential borrowers in these arenas. Unfortunately for the

⁵⁸ “FDIC Statistics on Depository Institutions Report.”

⁵⁹ “FDIC Statistics on Depository Institutions Report.”

community banks, the data over the past 5 years does not show positive trends or progress in several of these areas.

Regarding small business lending, community banks have gone from holding the majority to the minority of the market share from the end of 2014 to the end of 2019, ending at 48% of loans by dollar amount.⁶⁰ The decline was particularly felt among small and medium community banks (those with less than \$1bn in assets), while large community banks remained stagnant and big banks increased their share. In particular, it is notable how big banks dominate the relatively small dollar loans for small businesses, issuing 79% of all small business loans that are less than \$100k, while big banks and community banks approximately evenly split medium and large loans. Community banks must work to defend their market share in the small business lending space given its relevance to the economy and to their remaining business models.

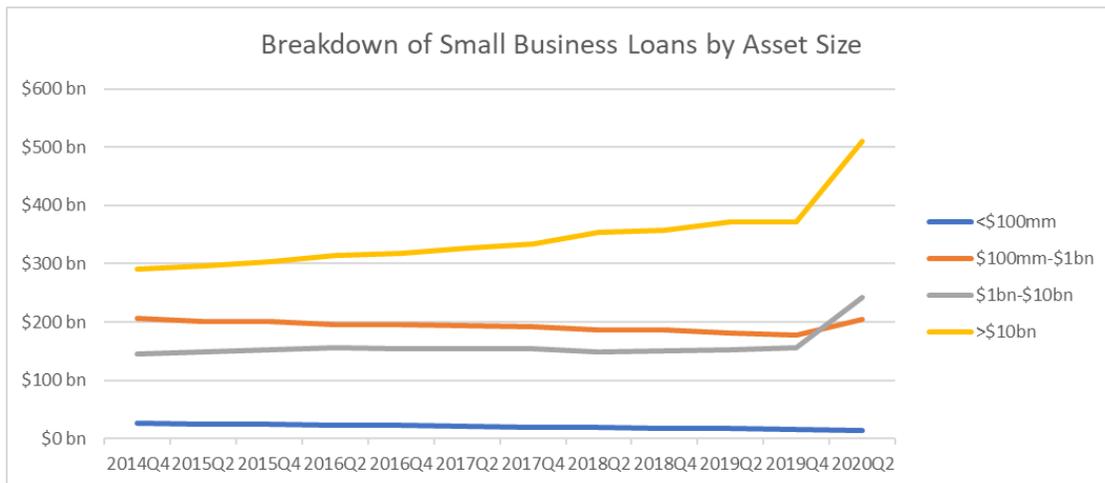


Figure 13: Small Business Lending by Total Institution Asset Size⁶¹

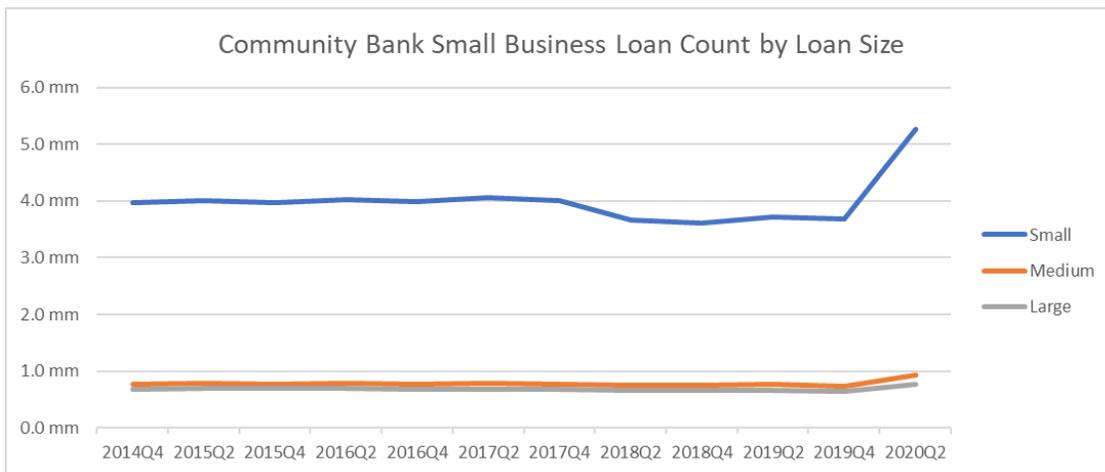


Figure 14: Small Business Lending by Loan Size for Community Banks⁶²

⁶⁰ “FDIC Statistics on Depository Institutions Report.”

⁶¹ “FDIC Statistics on Depository Institutions Report.”

⁶² “FDIC Statistics on Depository Institutions Report.”

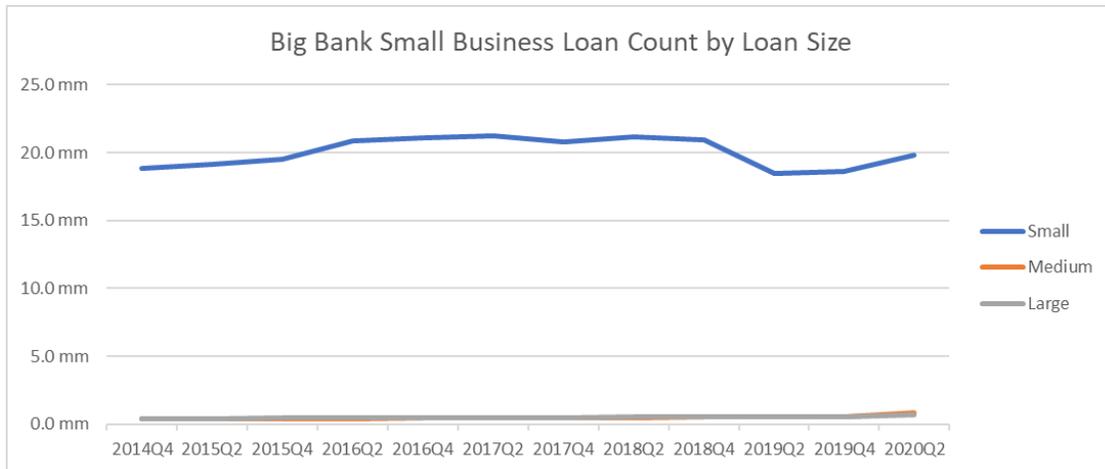


Figure 15: Small Business Lending by Loan Size for Big Banks⁶³

In the CRE loan market, the damage has been even more severe. Community banks have dropped from 44% of total CRE loan dollars to 36% from the end of 2014 to the end of 2019. While large community banks have seen some growth in terms of total dollars loaned, community banks of all sizes have dropped as a proportion of the total market. This trend is likely spawned by an increase in real estate expertise and focus within big banks as they search for new revenue streams in the wake of the financial crisis as well as the inherent linkage between CRE loans and small business loans. A small business tends to go to the same bank for all of the types of loans that it needs to fund its business operations and purchases.

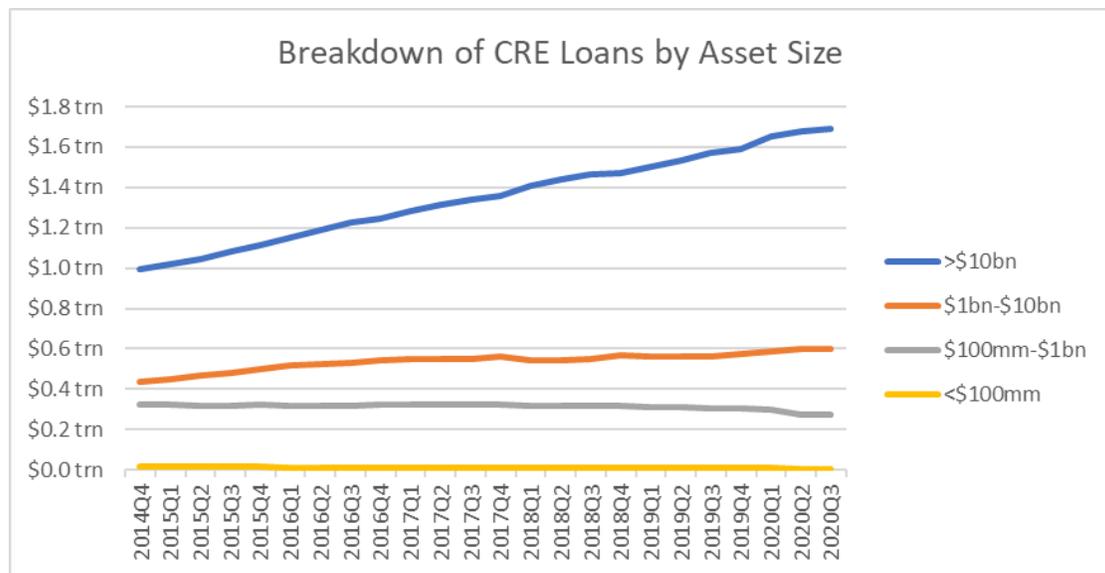


Figure 16: CRE Lending by Total Institution Asset Size⁶⁴

Finally, there is one bright spot for community banks: farm loans. While farm loans are a relatively small market, representing only 11% of the small business loan market and only 3% of

⁶³ “FDIC Statistics on Depository Institutions Report.”

⁶⁴ “FDIC Statistics on Depository Institutions Report.”

the CRE loan market, community banks have increased their market share in this area since 2015 despite already having a strong position. As of the end of 2019, community banks loaned 74% of the dollars in the farm loan market. Much of this trend is driven by the outsized importance of community banks in rural communities that also tend to have significant agricultural businesses that require loans. The continued dominance of community banks in the farm loan market in line with the overall trend of community banks performing better in rural markets and experiencing significant declines in urban markets, as previously discussed.

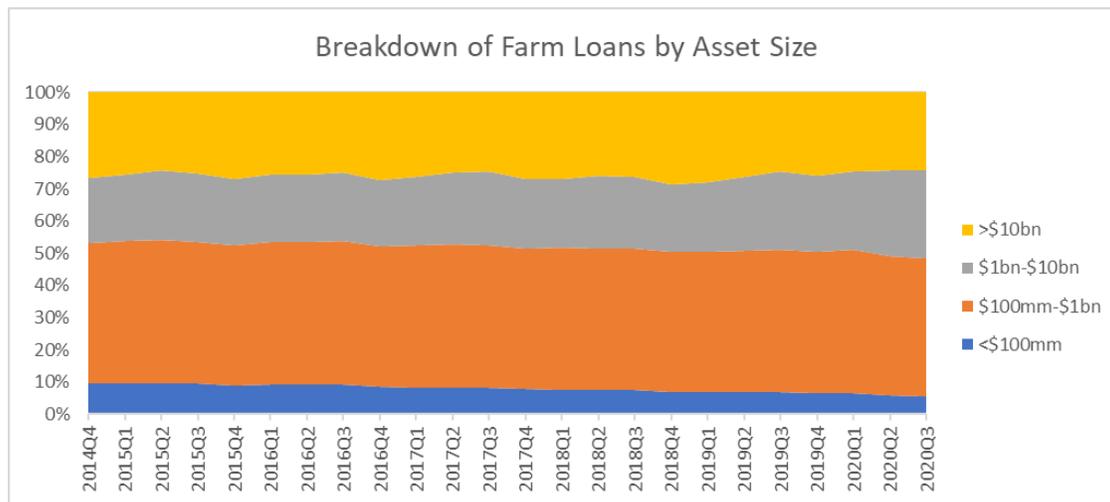


Figure 17: Farm Lending by Total Institution Asset Size⁶⁵

Banking Industry Consolidation

In this section, we’re diving deep into the most consequential trend afflicting the community banking industry: rapid and seemingly unstoppable consolidation. This trend has been apparent for the past three decades in the industry as the number of community banks has shrunk at a 4% annual pace.⁶⁶ The consolidation has at least partially been driven by the broader financial and technology economies of scale that have become increasingly important in the banking industry. Yet, some of the underlying reasons have also shifted over the past decades. We will examine these drivers as well as the impact that public policy and demographic trends have on the ability of community banks to compete in the modern era.

At the outset, it’s important to recognize that there are multiple ways that a community bank can be consolidated. Perhaps the most obvious is that a community bank can be bought by another bank, referred to as an Inter-Company Merger, and it’s also possible for a bank to be subsumed by another bank under the same pre-existing holding company, called an Intra-Company Merger where one bank’s charter is forsaken. Finally, there are banks that truly fail and are liquidated.

However, this one-directional understanding of consolidation is incomplete because it is also possible to start a new bank by receiving a national or state bank charter. For that reason, we will analyze net consolidation in the community banking industry to account for new bank starts that occur at the same time that other banks are merging or failing.

⁶⁵ “FDIC Statistics on Depository Institutions Report.”

⁶⁶ “FDIC Statistics on Depository Institutions Report.”

After accelerating after the 2008 Financial Crisis into 2015, the rate at which community banks are consolidating through voluntary methods like Inter-Company and Intra-Company Mergers has remained relatively consistent.⁶⁷ While the average rate over the past five years is slightly higher than the run rate over the past three decades, it's critical to note that the long-term average rate of 3.9% per annum has remained relatively static when viewed across periods of multiple years, including in the period after the crisis.⁶⁸ Thus, community banks between 2015 and 2019 were largely consolidating at the same historical rate through voluntary mergers as they have been in the past.

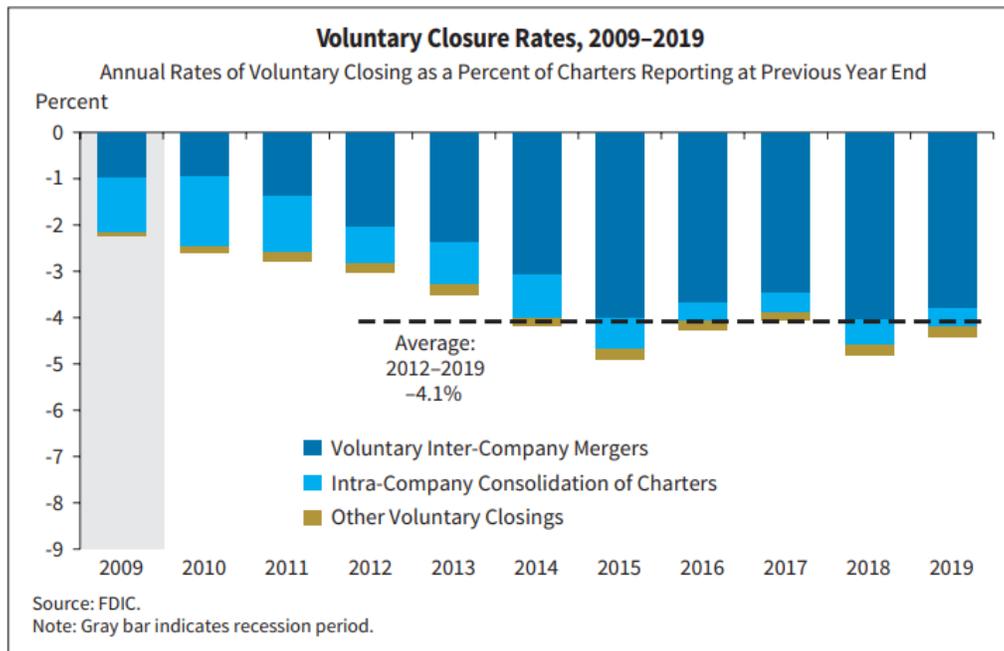


Figure 18: Voluntary Bank Closures⁶⁹

As the financial and economic environment stabilized after the 2008 Financial Crisis, the rate of community bank failures declined to a vanishingly small percentage, particularly after 2015. Only a handful of banks failed during this period, which represents a deviation from the industry's normal behavior prior to this period. Before 2012, banks failed at a rate of 0.7% per annum, whereas, after 2012, that rate dropped to 0.2%, with the rate dropping even lower for the period after 2015. In addition to the macroeconomic environment, this trend is also due to higher risk management standards applied by regulators to banks of all sizes, which prevented failures that would have otherwise occurred during the period.

⁶⁷ "2020 Community Banking Study," 2-2. Please note that this study leverages the FDIC's definition of community banks, which is more complex than the simple \$10bn asset threshold used by this paper. For all statistics involving this study, please be aware that the FDIC's definition excludes approximately 300 of the largest community banks from being classified as community banks. However, this distinction does not materially affect our findings.

⁶⁸ "2020 Community Banking Study," 2-5. Please note that the statistics on consolidation include all bank charters, not just those assigned to community banks. However, given that community banks represent by far the majority of bank charters, we leverage this data in our analysis without adjustment.

⁶⁹ "2020 Community Banking Study," 2-2.

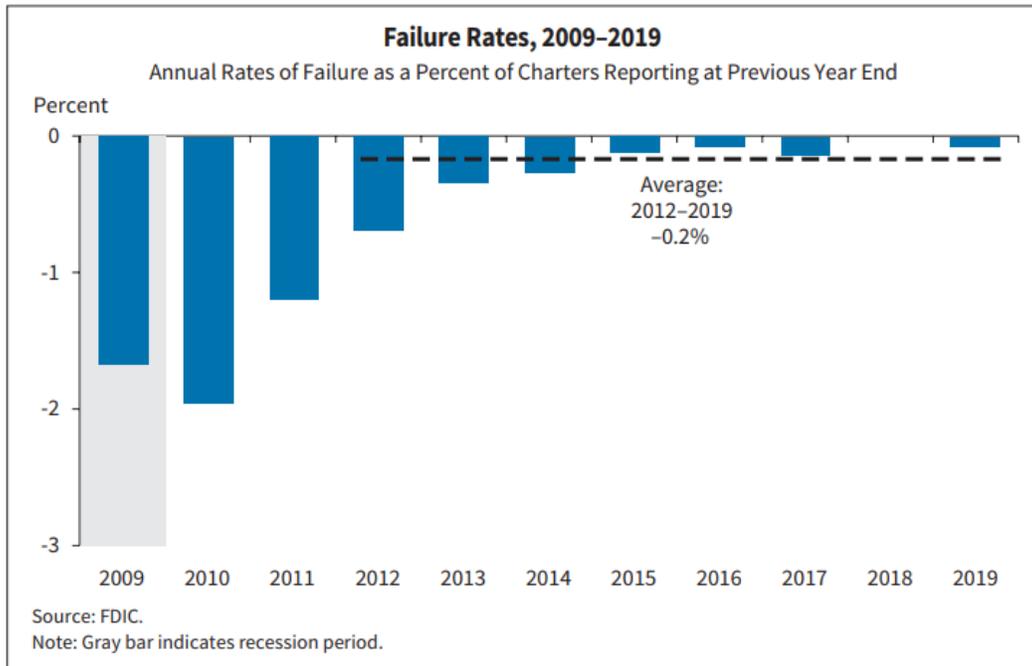


Figure 19: Bank Failures⁷⁰

If one only considered the consistent rate of voluntary closures over time and the declining rate of bank failures in the period after 2015, one would expect that the rate of consolidation in the community banking industry would have been lower between 2015 and 2019 than in historical periods. However, the final factor, new bank charters, experienced a massive deviation from the historical norm ever since the 2008 Financial Crisis. New chartering stalled out completely in the years immediately after the crisis largely due to the imposition of new regulations and near-zero interest rates that made it unattractive to start new banking ventures. In 2012, 2014, and 2016, there were literally no new banking charters issued in the United States. It was only after interest rates started to sustainably climb again in 2017 that a handful of new charters began to be issued. However, the rate of issuance has lagged the historical norm massively. Prior to 2012, new charters were issued at a rate of 1.4% per annum, whereas, after 2012, the rate was 0.1%, meaning that the community banking industry no longer had new banks coming to fill voids left by failed or merged institutions.

⁷⁰ “2020 Community Banking Study,” 2–2.

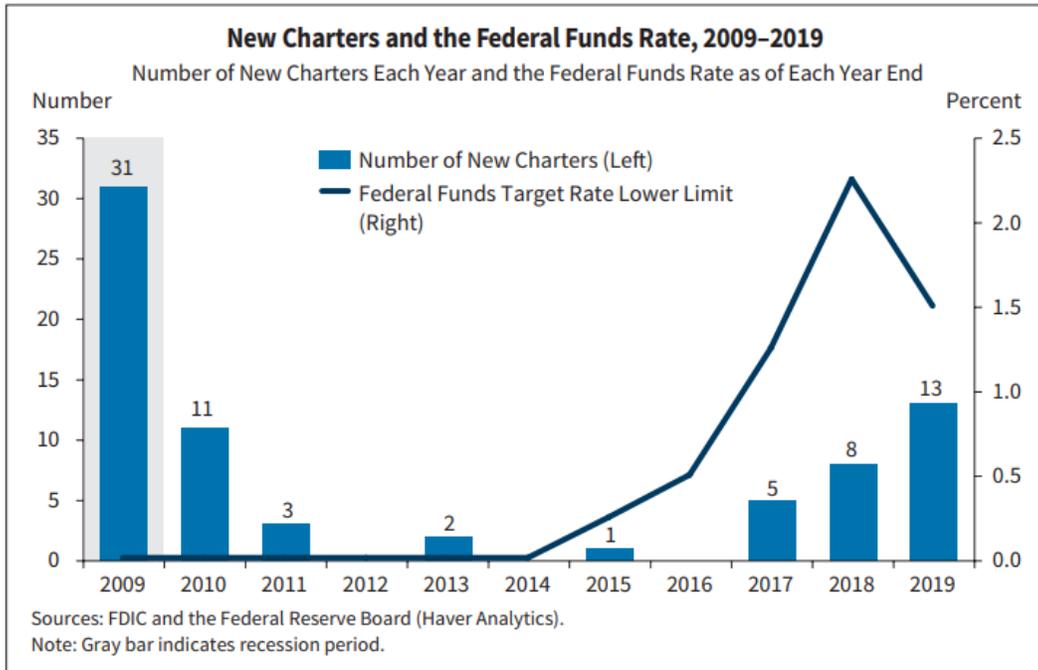


Figure 20: New Bank Chartering Activity⁷¹

With no replacement community banks being started, there was nowhere for the number of community banks to go but down, and that’s what the data show for the period after 2015. Consolidation accelerated, exceeding the historical downward trend that was already not a good sign for the industry. Next, we will turn to a discussion of some of the underlying drivers of the consolidation trend.

Effects of Public Policy

It is undeniable that the burden of regulations has increased on the banking industry since the 2008 Financial Crisis, and community banks are no exception. Numerous restrictions, requirements, and reporting mandates have been applied to banks for the purposes of safety and soundness, and they have played a role in the consolidation of the community banking industry that has been seen since 2015.

Two items are particularly important to note, one relating to the ongoing profitability of community banks and one pertaining to new bank chartering. A key metric to observe for banks regarding ongoing profitability is their noninterest expense level. Prior to the crisis, big banks had higher noninterest expenses as a percentage of assets than community banks, however, during and after the crisis, the relationship flipped with community banks paying higher noninterest expenses. While some of this change is related to the long-term economies of scale that big banks have been able to realize more successfully over time, it is also related to the disproportionate burden of regulation on community banks given their smaller size. The higher relative noninterest expenses experienced by community banks make them less profitable than their big bank peers, damaging their long-term viability.

⁷¹ “2020 Community Banking Study,” 2–4.

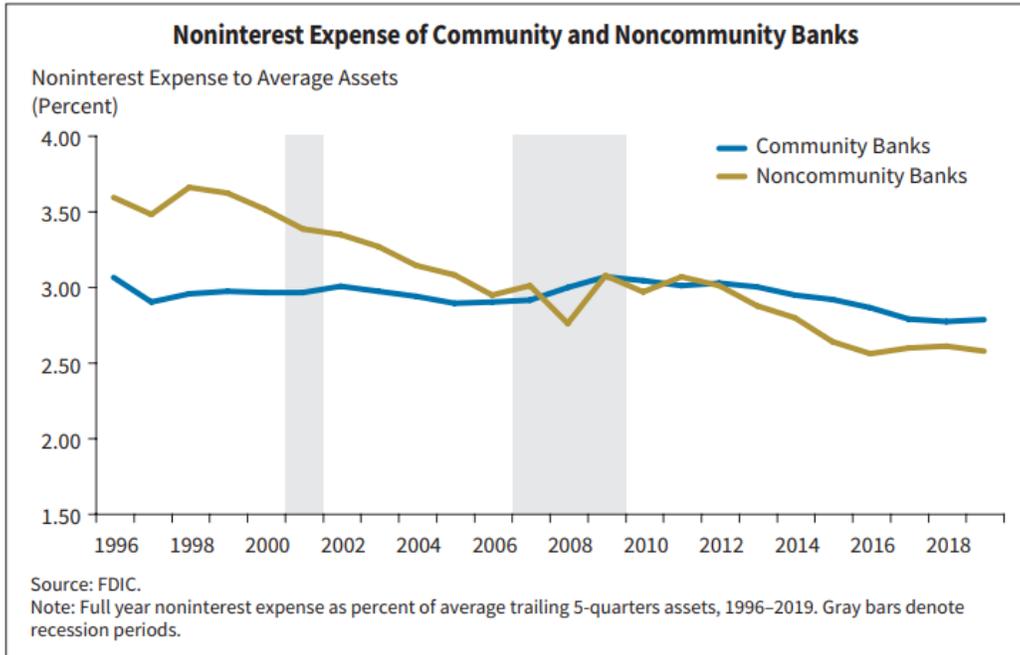


Figure 21: Noninterest Expenses as a Percentage of Assets by Bank Type⁷²

The other area relating to new bank chartering where regulation has played a role in consolidation is capital requirements. After the crisis, capital requirements were increased on banks across the board in order to make them more secure when the next downturn hit. While these requirements may be the correct decision from a systemic risk perspective, they also increase the capital that potential investors must have on hand in order to start a new bank, which raises their costs and decreases the likelihood that they will pursue the venture. We have already seen how new bank chartering has fallen significantly since the crisis, and, indeed, for those few banks that have been chartered, the data show that the initial capital raised is higher than before, indicating that investors are seriously considering capital requirements before launching a new bank. Thus, regulatory changes since the 2008 Financial Crisis have contributed to lower new bank chartering activity and the accelerated consolidation of the community banking industry.

⁷² “2020 Community Banking Study,” 5–3.

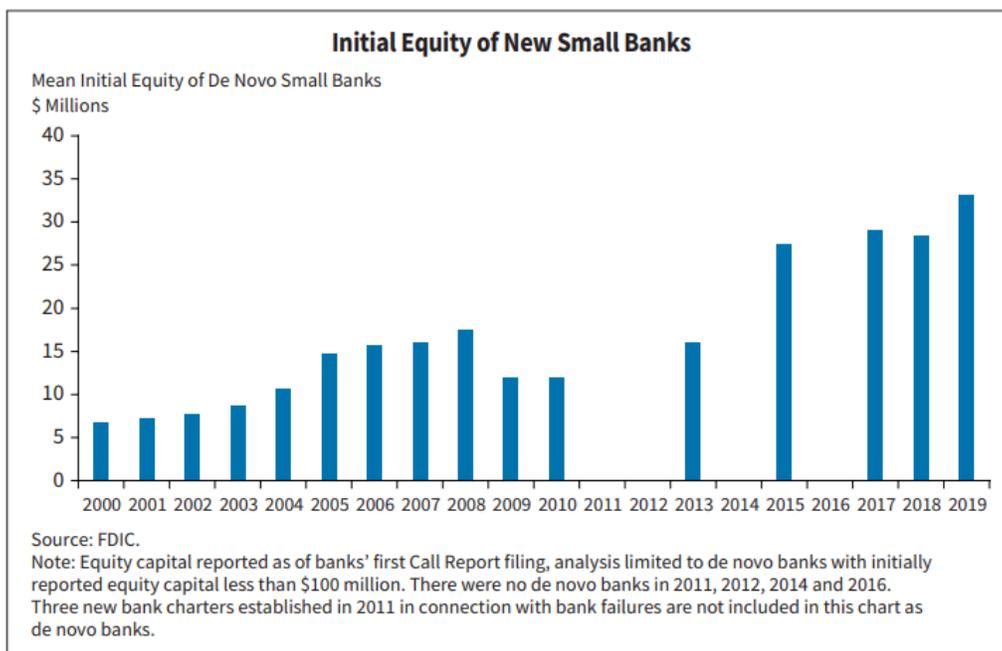


Figure 22: Initial Equity for New Community Bank Charters⁷³

Effects of Demographic Change

When looking at community banks across the country, two key demographic factors of a given county stand out as relevant to the consolidation activity of community banks in that county: the average age of the population, and the net migration of people into or out of the county. Counties that have a positive net migration, that is, more people are moving into the area than moving out of it, tend to have higher rates of community bank consolidation than the national average.⁷⁴ At first, this might seem strange, given that counties with net migration inflows are generally experiencing strong economic growth, but community banks have a tendency to combine through merger activity during periods of growth. Thus, counties with net migration inflows have higher rates of community bank consolidation because the banks are combining to try to compete more effectively in the market.

In a similar fashion, counties with younger population tend to have higher rates of consolidation, though the correlation between youth and positive economic growth is less strong than it is for net migration.⁷⁵ Counties that are young but have net migration outflows tend to track the national average for consolidation rates. Those with old populations and net migration outflows have the lowest rates of consolidation, largely because there is less immediate market pressure and ability to grow to compete as well as because of the strong position that community banks have in the agricultural loan market.

Age and net migration are factors that affect the rate of community bank consolidation in areas that are at the poles of these metrics. Community banks have the opportunity to be healthy in both types of areas, but the dynamics play out very differently for consolidation incentives.

⁷³ “2020 Community Banking Study,” 5–23.

⁷⁴ “2020 Community Banking Study,” 3–6.

⁷⁵ “2020 Community Banking Study,” 3–6.

Impact of Dodd-Frank Scope Narrowing

In May 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) was signed into law.⁷⁶ It was a package of rollbacks to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that passed Congress with bipartisan support, and its primary goal was to reduce the regulatory burden placed by Dodd-Frank on community banks. Furthermore, it contained several of the recommendations made by Lux & Greene in their 2015 paper examining the tribulations of the community banking industry.⁷⁷ We will briefly discuss some of these items and their potential impacts.

The reforms included in the EGRRCPA that are relevant to community banks fall into four main buckets: capital requirements, the Volcker Rule, reporting mandates, and oversight requirements. Regarding capital, the legislation established a simplified version of the Basel III capital rules called the community bank leverage ratio after complaints from community banks that the current ratios were too cumbersome to calculate and track, and any community bank is able to switch to this new framework if they desire.⁷⁸ In addition, the EGRRCPA exempted all community banks from the Volcker Rule, which, among other things, forbids banking institutions from engaging in proprietary trading.⁷⁹ These changes allow community banks to generally hold less equity capital if they desire and engage in business lines like proprietary trading that might give them an advantage from a profitability perspective over big banks in addition to easing the burden of regulatory compliance at these institutions.

Pertaining to reporting and oversight requirements, the EGRRCPA allows community banks with under \$5bn in assets to reduce their call reporting requirements in an effort to lessen regulatory burdens.⁸⁰ Furthermore, the legislation expanded the scope of community banks that have an extended window for regulatory examinations from those with less than \$1bn in assets to those with less than \$3bn in assets.⁸¹ These institutions are only examined on an 18-month cycle, as opposed to the previous annual cycle, which reduces the resources that small and medium community banks need to devote to compliance.

Because the legislation was only signed in mid-2018, it's difficult to ascertain what, if any, effect it has had on community banks so far. The expectation from policymakers is that the loosening of these regulatory restrictions will increase the competitiveness of community banks relative to their larger peers and reinvigorate their standing within the American financial system. Time will tell whether the EGRRCPA has its intended impact and slows the drifting of the banking industry towards large, consolidated institutions with national reach.

⁷⁶ Garrett Fischer and Sarah Wade, "Dodd Frank Rollback Law Provides Regulatory Relief for Community Banks – Part 1," May 30, 2018, <https://www.thompsoncoburn.com/insights/blogs/bank-check/post/2018-05-30/dodd-frank-rollback-law-provides-regulatory-relief-for-community-banks>.

⁷⁷ Lux and Greene, "The State and Fate of Community Banking," 30.

⁷⁸ Fischer and Wade, "Dodd Frank Rollback Law Provides Regulatory Relief for Community Banks – Part 1."

⁷⁹ Fischer and Wade.

⁸⁰ Fischer and Wade.

⁸¹ Garrett Fischer and Sarah Wade, "Dodd Frank Rollback Law Provides Regulatory Relief for Community Banks – Part 3," July 3, 2018, <https://www.thompsoncoburn.com/insights/blogs/bank-check/post/2018-05-30/dodd-frank-rollback-law-provides-regulatory-relief-for-community-banks>.

The Impact of COVID-19

2020 was an extraordinary year for nearly every industry on the planet, and the American community banking sector was no exception. As economies across the country went into lockdown to prevent the spread of COVID-19, banks were called upon to maintain the stability of the financial system and the free flow of credit to individuals and businesses who needed it. Coupled with government sponsorship in the form of policies like the Paycheck Protection Program (PPP), banks of all sizes, but particularly community banks, rushed to provide critical lifelines to American small businesses that were suffering from their worst crisis since at least the Great Depression. Without community banks, the country would undoubtedly have lost even more small businesses than it did, which is already catastrophic at an estimated 3 in 10 small business.⁸²

In this section, we will examine both the impact of COVID-19 on the community banking industry and the role that community banks played in the response to the pandemic and its ensuing lockdowns. We want to understand how community banks weathered the storm and whether the pandemic altered any of the industry trends existing prior to 2020. In addition, we aim to analyze, both quantitatively and qualitatively, the positive impact of the community banking industry on the resilience of the American economy during the pandemic.

Community Bank Health

We'll start by examining how community banks performed during 2020 to understand how their risk management held up under severe strain. We can then examine the performance of community banks under the post-2008 regulatory regime previously discussed.

Risk Management and Loan Losses

Community banks, in line with the banking industry more broadly, have weathered the COVID-19 pandemic well from a risk management perspective. Community banks went into the crisis with an average equity capital to assets ratio of 12%, which exceeded that for big banks by 69 basis points.⁸³

The average community bank took a hit to equity capital when the crisis hit largely due to increased provisions for loan losses, an expected accounting designation when significant troubles are spotted ahead by bank management, which resulted in the average equity capital to assets ratio dropping to approximately 11%.⁸⁴ It's important to note that big banks experienced a similarly sized decrease. In addition, while this move was larger in magnitude than that seen in the 2008 Financial Crisis, this is driven more by proactive recognition of the situation by bank management and regulators than by a decline in the quality of the risk position of banks going into 2020.

The publicly disclosed provisions taken by the US banking industry totaled \$115bn in the first half of 2020, representing an increase in the provisioning rate from 1.3% to 2.7% of total

⁸² Kelly Hannon, "It's a Terrible Time for Small Businesses. Except When It's Not.," *New York Times*, December 14, 2020, <https://www.nytimes.com/2020/12/14/business/smallbusiness/small-business-start-ups-entrepreneurs.html>.

⁸³ "FDIC Statistics on Depository Institutions Report."

⁸⁴ "FDIC Statistics on Depository Institutions Report."

loan value.⁸⁵ Broadly speaking, the data shows that smaller banks increased their provisions by less on proportional basis, as delineated by a 1.5 percentage point rise for banks subject to the Dodd-Frank Annual Stress Test (DFAST) process, which are bigger, more systemically important banks. and only a 1.0 percentage point increase for those that are not. However, this difference is driven largely by provisioning for credit card and other consumer debt losses. Credit card debt was assigned an average loss rate of 9.2% with generic consumer debt averaging 2.9%, as compared to an average rate of 1.7% across all types of debt.⁸⁶ Community banks tend to have smaller credit card business lines, if they offer credit cards at all, and, as previously highlighted, community banks have relatively large exposures to CRE and other commercial loans, which have 1.5% and 1.6% provisions, respectively. Thus, community banks were able to take lower provisions for loan losses when the crisis struck due to the relative quality and distribution of their loan portfolios.

It should be highlighted that realized loan losses have yet to spike across the industry due to significant government support for the economy and moratoriums on certain types of debt and bankruptcy proceedings. In fact, actual loan charge-offs, regardless of the size of bank, have not risen at all since the end of 2019.⁸⁷ It's possible that the credit situation starts to look much worse over time and that loan loss provisions must be increased down the line. But, for now, community banks have weathered the pandemic well from a risk management perspective, with their capital positions and loan portfolios remaining relatively strong.

Bank Failures and Consolidation

There were only four US bank failures in 2020, no more than in 2019 and further demonstrating the resilience of the community bank sector to exogenous shocks.⁸⁸ The bank failures were all small and medium community banks with <\$150mm in assets. However, that doesn't mean that the pandemic did not have an impact on the banking consolidation trends that the industry was experiencing prior to 2020.

At first glance, the data on banking consolidation looks like a contradiction. On one hand, bank M&A activity slowed dramatically in 2020, with only ~100 deals consummated after 258 done in 2019.⁸⁹ But, on the other hand, we saw a dramatic uptick in the number of large community banks offset by similar decrease in the number of small community banks. In Q3 2020, community banks with \$1bn-\$10bn grew at a rate of 16% YoY, far exceeding the average 3% rate of the prior five years.⁹⁰ Similarly, small community banks with assets of less than \$100mm shrank by -19%, well in excess of the average -9% historical rate.

However, this contradiction is explained by the significant explosion in banking industry assets broadly in the first half of 2020 due to increased individual saving layered with direct

⁸⁵ Brendan Browne and Stuart Plesser, "What Lies Ahead For U.S. Bank Provisions For Loan Losses," S&P Global, August 12, 2020, <https://www.spglobal.com/ratings/en/research/articles/200812-what-lies-ahead-for-u-s-bank-provisions-for-loan-losses-11606876>.

⁸⁶ Browne and Plesser.

⁸⁷ "FDIC Statistics on Depository Institutions Report."

⁸⁸ "Bank Failures in Brief – Summary 2001 through 2020" (Federal Deposit Insurance Corporation, 2020 2001), <https://www.fdic.gov/bank/historical/bank/>.

⁸⁹ Zuhaib Gull and Fatima Aitizaz, "Bank M&A 2020 Deal Tracker: Only 4 Deals Announced in November," S&P Global, December 10, 2020, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/bank-m-a-2020-deal-tracker-only-4-deals-announced-in-november-57037182>.

⁹⁰ "FDIC Statistics on Depository Institutions Report."

government support to families. Bank assets grew 13% from Q4 2019 to Q2 2020, increasing from \$18.6trn to \$21.1trn., and deposits grew even faster at a rate of 18%.⁹¹ This increase was driven by consumer saving at the outset of the crisis and the distribution of stimulus checks by the government, many of which were simply added to individuals’ checking and savings accounts.

The result of the increase in deposits was that some banks jumped asset size buckets, with medium community banks moving into the large category and small community banks moving into the medium category. Thus, while merger activity slowed in 2020, the size of the average community bank increased 12% in the six months between the end of 2019 and the middle of 2020, causing the significant redistribution between asset size buckets within the community bank industry.

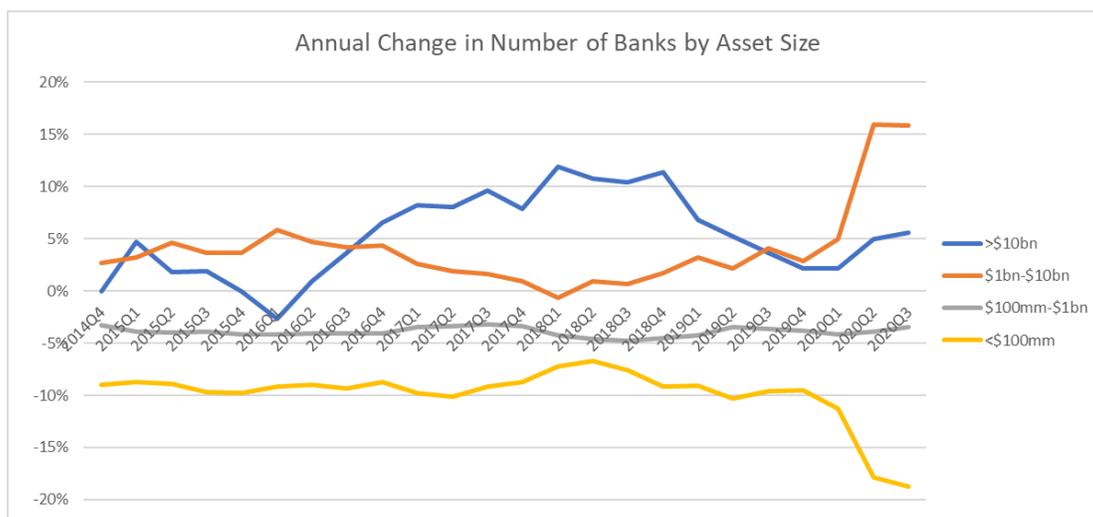


Figure 23: YoY Change in Number of Banks by Total Institution Asset Size⁹²

Activity in the Crisis

With the community banking industry having successfully sustained through the crisis brought on by the pandemic, we now turn our attention to understanding how community banks contributed back into the economy during 2020. To note, some of these elements have already been mentioned as part of the discussion of community bank health, and we will discuss PPP distinctly in the next section.

Deposit-Taking

As previously discussed, community banks saw a significant increase in total deposits in the first half of 2020 representing a 12% increase.⁹³ Even in the midst of the crisis, community banks continued to provide a safe haven for individuals’ assets amidst the turmoil with no increase in failures and by clearly maintaining the trust that they have built with their communities despite the instability.

⁹¹ “FDIC Statistics on Depository Institutions Report.”

⁹² “FDIC Statistics on Depository Institutions Report.”

⁹³ “FDIC Statistics on Depository Institutions Report.”

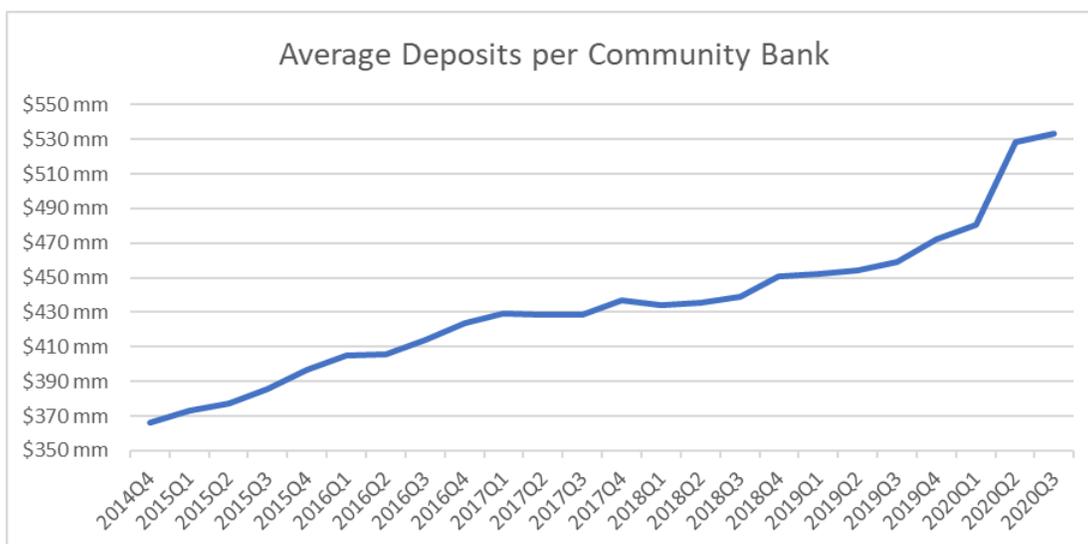


Figure 24: Average Deposits per Community Bank⁹⁴

Part of the ability for the deposit businesses of community banks to withstand and thrive in the COVID crisis comes from the widespread adoption of mobile banking technology, like remote deposit capture and electronic bill payment, prior to the pandemic. Fully 95% of community banks offer mobile banking platforms, which became essential amidst lockdowns and social distancing requirements.⁹⁵ Community banks express a desire to continue building out new technology offerings at a frenetic pace, both to handle the remainder of the pandemic era and to enhance their competitiveness in the long-term.

Lending

On the lending side, community banks did not experience significant setbacks because of the pandemic and, in some cases, thrived. The retail lending businesses of community banks more or less maintained their positions within a market that shrunk slightly from the end of 2019. Similarly, in the areas of CRE lending and farm lending where they have had historical strengths, community banks did not experience significant changes, playing defense in markets that were not undergoing major growth or shrinkage despite the economic turmoil.

However, in the small business lending market, community banks were critical to the timely and rapid explosion of loans to struggling small businesses, leveraging their traditional expertise in credit evaluation as well as their vital local networks. As previously noted, we will discuss the specific impacts of PPP in the next section, thus, this discussion and data solely concern small business lending outside of these programs.

Between the end of 2019 and the midpoint of 2020, small business lending grew by 35%, with community banks maintaining their share of the market.⁹⁶ These loans were essential lifelines to small businesses during the pandemic, allowing them to ride out lockdowns without

⁹⁴ “FDIC Statistics on Depository Institutions Report.”

⁹⁵ Evan Sparks, “For Community Banks, COVID-19 Brings Existential Concerns to Fore,” *ABA Banking Journal*, October 1, 2020, <https://bankingjournal.aba.com/2020/10/for-community-banks-covid-19-brings-existential-concerns-to-fore/>.

⁹⁶ “FDIC Statistics on Depository Institutions Report.”

permanent closure or significant layoffs, make investments to operate safely in a socially distanced era, and grow into new business lines opened up by the crisis. Furthermore, the positive impact of community banks was widespread, with 79% of them expanding their small business lending portfolio in 2020.⁹⁷

While community banks did not grow their market share in small business lending as part of this surge, maintaining market share during this period was a significant improvement from the market share decline experienced over the past five years in this area. By preserving the solvency of small businesses in the crisis, community banks have solidified and expanded their future customer base, which will continue to pay dividends for years to come. We should expect community banks to remain integral to small business lending for the foreseeable future because of the combination of their local expertise, long-standing relationships, and robust balance sheets from which to lend.

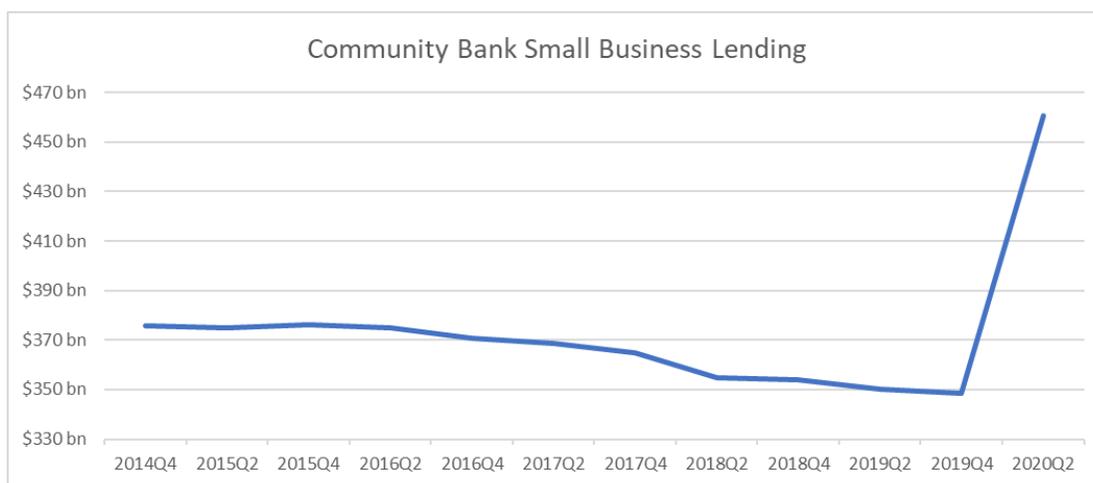


Figure 25: Community Bank Small Business Lending⁹⁸

Impact of Paycheck Protection Program

One of the most impactful government programs of the COVID-19 crisis is the Paycheck Protection Program (PPP), and it is relevant to small businesses and the community banks who serve them. PPP was an invention of the crisis, passed as part of the CARES Act to provide low-interest, forgivable loans to small businesses who maintained a material portion of their payrolls during lockdowns.⁹⁹ The program is run by the U.S. Small Business Administration (SBA), but, critically, the SBA does not deal directly with small businesses. Instead, the SBA works with banks, particularly community banks, to funnel money to small businesses while leveraging the loan evaluation and approval processes of those institutions. Many community banks already had an established relationship with the SBA prior to pandemic, which positioned them to jump into action quickly once the government began the funding of PPP loans. Also, community banks were poised to leverage their relationships with small businesses in distributing loans.

⁹⁷ Sparks, “For Community Banks, COVID-19 Brings Existential Concerns to Fore.”

⁹⁸ “FDIC Statistics on Depository Institutions Report.”

⁹⁹ “Paycheck Protection Program,” U.S. Small Business Administration, n.d., <https://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program>.

Community banks did not disappoint. By the end of June 2020, community banks had issued almost 2mm PPP loans worth almost \$200bn, representing 45% of the total number of loans and 41% of the dollar value.¹⁰⁰ Medium community banks (those with \$100mm to \$1bn in assets) in particular punched well above their weight on a per institution basis, averaging 937 PPP loans issued within the first three months of the program. This compares to 2,392 issued per big bank, meaning that big banks only issued 2.6x more PPP loans than medium community banks despite controlling 16.6x the assets. While the role that big banks played in the distribution of PPP loans was critical, community banks punched above their weight.

In addition, community banks fulfilled their role of reaching areas of the economy to which big banks paid less attention through PPP. The average PPP loan amount increased dramatically with the size of the bank. Big banks issued PPP loans averaging \$119k in size, while medium community banks averaged \$90k, demonstrating that community banks were, on average, reaching smaller businesses than big banks given their local relationships.¹⁰¹ In particular, small community banks (those with less than \$100mm in assets) positively impacted the smallest of businesses, averaging a PPP loan size of \$45k. The ability for the government to inject capital into truly small businesses as enabled by the community banking industry represented a powerful balm for the American economy as COVID-19 lockdowns took their toll in 2020.

PPP was a victory for small businesses, community banks, and the government alike. Small businesses received much needed access to capital in the middle of a catastrophe, and the loans are forgivable under reasonable criteria. Community banks were able to fulfill their role in powering the American small business ecosystem, and PPP provided the opportunity for community banks to strength their ties with existing customers and expand their customer base in ways that will be beneficial in the future. In addition, there is little indication that the growing ubiquity of tools like videoconferencing in business will damage the competitive advantage that community banks currently enjoy in local knowledge and relationships. Lastly, the government, through PPP, stymied the worst of employee layoffs that would have otherwise resulted, and the SBA was able to leverage the network of community banks to efficiently achieve this goal in a matter of weeks.

Without community banks, PPP is significantly less effective at achieving the government's policy aims, and potentially millions more American would have been laid off at the outset of the pandemic. Community banks, in short, are essential to the function of the American economy and vastly increase its resilience. In the final section, we will address specific regulatory and policy changes that can be implemented to bolster and preserve this critical industry for the nation.

Disparate Impacts on Minority-Owned Businesses

It must be noted, however, that the distribution of PPP funding by both community banks and large banks was not perfect, most importantly in the disparate impact felt by minority-owned small businesses in several ways. First, minority-owned businesses were less likely to have access to PPP funding at all primarily due to the lower levels of pre-existing relationships between them and banks of all sizes prior to the COVID-19 crisis. Black-owned businesses in particular are much more likely to apply to online lenders, credit unions, and CDFIs for loans

¹⁰⁰ "FDIC Statistics on Depository Institutions Report."

¹⁰¹ "FDIC Statistics on Depository Institutions Report."

compared to traditional banks, meaning that, when the crisis hit and PPP was rolled out, they were less likely to have an established banking relationship that facilitated good access to PPP funding.¹⁰² The end result was loans being approved and issued at twice the rate for areas with the lowest minority populations as a proportion of the total as compared to areas with the highest minority populations as a proportion of the total.¹⁰³

Second, minority-owned businesses, consistent with lending trends prior to the crisis, were far less likely to get their PPP loan from a traditional bank. White-owned employer businesses received approximately 85% of their PPP loans from traditional banks, while, for Black-owned employer businesses, the figure was only 75%, meaning that 1 in 4 PPP loans for this population was facilitated by an online lender or a CDFI. The statistics were even starker for non-employer businesses like independent contractors. Traditional banks issued approximately 55% of PPP loans for white-owned non-employer businesses, while almost 85% of them for Black-owned non-employer businesses were issued by online fintechs or CDFIs. The racial disparities in the recipients of PPP loans from traditional banks, both big banks and community banks, was stark and portends the importance of online lenders for minority communities.

Finally, even if a business was able to apply for a PPP loan, it took longer for minority-owned businesses to receive approval than white-owned businesses. Banks needed an average of 31 days to approve a loan application from a Black-owned business, similar to the wait times for other minority groups, as compared to 24 days for white-owned businesses.¹⁰⁴ This phenomenon is likely driven by multiple factors relating to systemic racism, including access to lower quality banking institutions and disadvantaged economic assessments for minority-owned businesses. During these disproportionate delays, more harm was most certainly visited on these businesses, and they undoubtedly had negative knock-on effects for layoffs in largely minority communities.

It is clear that the PPP loan distribution process disproportionately disadvantaged minority-owned businesses. While the reasons for this disadvantage mostly existed prior to the crisis from underlying factors related to systemic racism, the PPP process serves as a stark reminder that banks and the government must do more to rectify these historically based problems. It is important for future rounds of small business aid related to the COVID-19 crisis that steps be taken to ensure that minority-owned businesses are not left behind, and it is heartening to see the SBA explicitly issuing guidance to do so for the third round of PPP lending that is opening in early 2021.¹⁰⁵

¹⁰² “Small Business Credit Survey: Report on Minority-Owned Firms,” 13.

¹⁰³ “Minority-Owned Businesses Were Last in Line to Receive Loans, Latest PPP Data Show,” CBS News, January 4, 2021, <https://www.cbsnews.com/news/minority-owned-businesses-were-last-to-receive-ppp-loans-adding-to-their-despair/>.

¹⁰⁴ Sifan Liu and Joseph Parilla, “New Data Shows Small Businesses in Communities of Color Had Unequal Access to Federal COVID-19 Relief” (Brookings, September 17, 2020), <https://www.brookings.edu/research/new-data-shows-small-businesses-in-communities-of-color-had-unequal-access-to-federal-covid-19-relief/>.

¹⁰⁵ Laura Davison and Amanda Iacone, “Minority, Women-Owned Businesses Get First Bid on New PPP Loans,” Bloomberg, January 7, 2021, <https://www.bloomberg.com/news/articles/2021-01-07/minority-women-owned-businesses-get-first-bid-on-new-ppp-loans>.

What Should Change About Community Banking Regulation and Public Policy?

Our work thus far has shown that community banks form an essential part of the American economic and financial ecosystems. Particularly in times of crisis like the COVID-19 pandemic, community banks facilitate the flow of capital to individuals and businesses across the nation, especially to regions and sectors that are underserved by larger financial institutions.

Yet, community banks are being buffeted by a suite of changing market forces that prioritize consolidation, make technology adoption critical to survival, and have disadvantaged sectors of the economy that community banks have traditionally served admirably. If community banks are to be sustained for the long-term health of the economy, policymakers must act to allow community banks to achieve safety and soundness with the lowest possible costs and to make investments that support the health of the community banking sector.

In this final section, we catalog three categories of policy changes that we recommend relating to community banks. We advocate for the optimization of community bank regulation, the support of community banks directly, and the bolstering of industries that are disproportionately served by community banks. Through these actions, policymakers and regulators can give community banks a fighting chance while increasing the power and resilience of the American economy.

Smart Regulation of Community Banks

The first category of critical interventions to bolster community banks concerns their regulatory requirements. We strongly support the regulation of the banking sector for the safety and soundness of the American economy, however, there are several areas where regulatory oversight and requirements can be enhanced to lessen the burden on community banks without sacrificing regulatory goals. These inefficiencies should be on the top of policymakers' priority lists given the opportunity to prove that government regulation can be both effective and efficient.

Mandatory Direct Regulatory Engagement

In the current regulatory paradigm, Congress passes legislation, regulatory agencies write the corresponding rules, and financial institutions are expected to comply with them as written. While this system makes sense in theory, it results in a great deal of confusion and gray areas in practice. Regulators strive to make rules as precise and thorough as possible, but there are inevitably areas where the correct interpretations or applications of those rules to a particular bank's situation are unclear. Despite regulators' best efforts, regulatory rulemaking, in effect, adds uncertainty to the banking system that must then be resolved for banks to continue to operate without significant threat of regulatory action.

In the current system, this lack of clarity is generally not resolved directly between regulators and banks due to the perceived (or actual) threat of regulatory action against a bank if it turns out to be incorrect in its interpretation of the rules. Instead, a plethora of consulting and advisory firms have arisen as middlemen to provide instruction to banks on compliance and inform banks if they are outside the industry norm in their regulatory practices.

These advisory services don't exist at the margins of a bank's compliance strategy. Community banks spend an average of 7% of their compliance costs on consulting and legal

services, much of which is tied to regulatory interpretation.¹⁰⁶ Eliminating the need for these expenditures would lower non-interest expenses by half a percentage point, which is material considering the slim profit margins currently attained by community banks, and this isn't even considering the potential reduction in personnel costs, which are 71% of compliance costs, that could be added to these savings if regulatory clarification is simplified.¹⁰⁷

To achieve the goal of streamlining regulatory interpretation for community banks, policymakers should immediately move to flip the consultative status quo between regulators and community banks. Financial regulators should be mandated to proactively engage with community banks when new regulatory rules are issued to answer whatever questions arise during the implementation and compliance process. In addition, safe harbor rules should be established to allow community banks to ask regulators for rule clarifications without the threat of significant regulatory actions being undertaken against them over the discussion. In short, the burden should be shifted to the regulatory agency to support these critical American institutions, as opposed to the status quo where community banks undertake significant expenditures to clarify regulatory rules.

This paradigm shift does not need to compromise the strength of regulatory rulemaking, but it does ensure that government regulators are supporting community banks in their efforts to comply rather than leaving them out in the cold. Such a shift would be a clear win for those interested in more efficient yet equally prudent government regulation of the financial sector.

Disclosure Requirement Streamlining

In a similar vein to regulatory engagement, disclosure requirements for community banks can be streamlined to improve efficiency and reduce the costs associated with their production without compromising the oversight capabilities of regulators. The EGRRCPA already took a few steps in this direction when it reduced the frequency of call report submission for some banks and introduced the community bank leverage ratio, which was a simplified calculation framework.¹⁰⁸ But, more opportunities for improvement exist.

Currently, accounting and auditing costs represent 8% of compliance costs for community banks, and some portion of personnel costs are also attributable to disclosure requirements.¹⁰⁹ Reducing these costs significantly would contribute to the bottom lines of community banks, allowing them to achieve higher returns to attract more investors and to invest more in bettering their product offerings and technology solutions.

Regulatory agencies should be instructed to do a wholesale reexamination of community bank disclosures to determine where there are extraneous, duplicative, or overly-taxing requirements exist. The goal should be to produce a disclosure framework that does not materially reduce safety, soundness, or transparency while imposing the minimal possible cost on community banks so that they have a fighting chance in the market. Moving to this reality

¹⁰⁶ Drew Dahl et al., "Compliance Costs, Economies of Scale and Compliance Performance: Evidence from a Survey of Community Banks" (Federal Reserve Bank of St. Louis, April 2018), 9, <https://www.communitybanking.org/~media/files/compliance%20costs%20economies%20of%20scale%20and%20compliance%20performance.pdf>.

¹⁰⁷ Dahl et al., 9.

¹⁰⁸ Fischer and Wade, "Dodd Frank Rollback Law Provides Regulatory Relief for Community Banks – Part 1."

¹⁰⁹ Dahl et al., "Compliance Costs, Economies of Scale and Compliance Performance: Evidence from a Survey of Community Banks," 9.

would be another victory for efficient government oversight without endangering consumers or the system.

The Volcker Rule, Simplified

After the EGRRCPA reduced the scope of banks to which the Volcker Rule applies, there has been much discussion within the financial regulatory community about whether it went too far. The EGRRCPA allowed banks with less than \$10bn in assets and less than 5% of their total assets in trading assets/liabilities to be exempt from the Volcker Rule and its associated reporting requirements. However, some advocates believe that this exemption is too broad and are pushing to tighten the parameters to bring more banks in scope.

It should first be noted that most community banks don't have material proprietary trading business lines that were shut down when the Volcker Rule was enacted. Instead, the primary impact that the Volcker Rule had on many of these banks was to increase compliance costs through mandatory monitoring and reporting. In other words, the Volcker Rule didn't change the risk profile of these banks; it merely added incremental costs for them.

Thus, we propose that any tightening of the Volcker Rule exemption should focus on the trading asset/liability metric rather than the asset size metric. Limiting the size of allowable proprietary trading within a bank is the true risk management question addressed by the Volcker Rule, not the total size of the bank's assets. Reducing the limit for trading assets/liabilities would not add incremental costs to most community banks who are engaged in traditional business lines while tightening restrictions on the type of risk about which critics of the EGRRCPA are most concerned.

Changing the Volcker Rule in this way will maintain the simplification achieved by the EGRRCPA for banks that are not involved in the relevant business lines while simultaneously raising safety and soundness for the banking system. Policymakers should take care to ensure that needless burdens are not added to already-struggling community banks by any tightening of the Volcker Rule.

Support for Community Banks

Now, we turn our attention to steps that policymakers can take to actively and directly support the community banking industry given its importance to the American economy. Some of our proposals are more straightforward to implement than others, but all focus on solving key problems that community banks face in the modern economy. Policymakers should pursue these actions to leverage the unique positioning of the government to bolster this vital industry.

Tax Preferences for Community Bank Lending

A powerful but simple way for the government to support community banks would be to implement a tax credit for individuals and businesses who take loans from community banks. For businesses, interest paid on loans is currently tax deductible, and this credit would be added on top of that benefit to the tune of 1-2% of the loan's principal, so long as the loan is made and held by a community bank. For individuals, the credit would operate similarly through an income tax credit.

This preference would have the effect of lowering the interest rate paid on community bank loans by the amount of the credit and, thus, advantaging the lending businesses of community banks compared to those of larger banks. This would drive more volume to the industry, improving its long-term outlook, and the policy also inherently guards against banks taking advantage of it as the benefit would phase out if the bank grew too large.

Introducing a tax credit for community bank lending is a powerful way for the government to support the industry in a straightforward manner that also aids individuals and small businesses, particularly those in rural or disadvantaged areas, who tend to turn to community banks for their lending needs.

Flexible SBA 7(a) Loan Terms for Community Banks

The Small Business Administration (SBA) represents a key facilitator in the small business lending market through its provision of guarantees for small business loans in the 7(a) lending program. In basic terms, the SBA provides guarantees up to 75% for certain small business loans with interest, maturity, and other terms that align with SBA standards.¹¹⁰ Ultimately, this process facilitates approximately a third of small business lending activity in the US.^{111,112}

Currently, the SBA offers the same terms on small business loans regardless of the issuing bank and underlying small business, and banks of all sizes, from the largest to the smallest, participate as SBA lenders. However, the SBA could allow community banks to offer more flexible terms for 7(a) loans issued through them, which would have the effect of shifting small business lending towards community banks. It could be different interest rates, maturities, or guarantee percentages, but the impact would be to allow community banks to offer better and more flexible small business loan terms than the competition.

Given that the dominance of community banks in the small business lending market has been slipping over the years, this change in government policy would go a long way towards shoring up the industry and tying small businesses and community banks together in a mutually beneficial relationship.

Investments in Government Technology and Fundamental Financial Research

The final method for the government to support the community banking industry involves two changes to the government itself. First, the experience of PPP showed that government technology systems on which community banks rely, such as lending systems at the SBA, are in dire need of upgrades. These systems were overloaded at the precise moment that banks of all sizes were trying to funnel PPP money to the small businesses who needed it. The government should comprehensively assess and overhaul these technology systems to ensure that community banks encounter the least resistance possible from interacting with critical government functions.

¹¹⁰ “7(a) Lending Program Terms, Conditions, and Eligibility,” U.S. Small Business Administration, n.d., <https://www.sba.gov/partners/lenders/7a-loan-program/terms-conditions-eligibility>.

¹¹¹ Brown, “Spotlight on Community Bank Lending.”

¹¹² “FY18 Lending Numbers,” U.S. Small Business Administration, October 25, 2018, <https://www.sba.gov/about-sba/sba-newsroom/press-releases-media-advisories/sba-fy18-total-loan-volume-reaches-more-30-billion-more-72000-approved-loans>.

Second, we propose that the government increase funding for fundamental financial research and development, particularly that focused on financial infrastructure and payment systems. It may take several years at a minimum for some of these efforts to start having a positive impact, but the returns to taking a fresh look at the foundation of the financial system is likely to find critical concerns that hamper banks in their operations. These problems could then be tackled as appropriate by some combination of the public and private sectors. A prime example of this effort is the FedNow instantaneous payments system currently under development by the Federal Reserve.¹¹³ Slated to be completed in 2023, it ensures that community banks will not be solely reliant on large financial institutions for cutting-edge payments infrastructure.

The federal government has a long history of investing in open-source research and development to form the foundations of critical industries for the American economy, and this effort represents the next iteration of that tradition. By sponsoring fundamental research in the banking sector, the government can serve as a catalyst to clear hurdles that plague community banks as they seek to compete in the modern financial system, supporting their long-term viability.

Support for Community Bank-Related Industries

The final category of policies that should be pursued to bolster the community banking industry are not actually directly targeted at community banks at all. Instead, we propose several policies that adopt a “two birds with one stone” approach to solving problems with community banks and with industries that tend to heavily rely on them. In essence, these policies neither impact community banks directly nor change their fundamental relationship with their customers. Instead, they seek to provide societally valuable support to industries like farming and small businesses that are experiencing problems in their own right and, by doing so, provide elevated levels of business to community banks.

Expansion of Farm Subsidies

Annually, the US provides billions of dollars in subsidies to farmers across the nation to encourage production and offset the impact of trade disputes. In fact, 2020 proved to be the year with the highest subsidies on record, totaling \$47bn and 39% of net farm income.¹¹⁴

Our proposal is to increase subsidies for farm expansion and development for small and medium farmers with the goal of encouraging them to grow their businesses. As we’ve highlighted, the agricultural lending market is almost wholly supplied by the community banking industry, thus, increased incentives for farms to grow should result in more agricultural loan applications for community banks, particularly those in rural areas that are struggling the most.

It’s critical to note that this policy must be tailored so as not to subsidize the large agricultural companies and not to cause distortions in agricultural production that could have wild consequences in the nation’s agricultural supply chain. However, we believe that increased

¹¹³ “About the FedNow Service,” The Federal Reserve, n.d., <https://www.frbservices.org/financial-services/fednow/about.html>.

¹¹⁴ Chuck Abbott, “Record-High Ag Subsidies to Supply 39% of Farm Income,” *Successful Farming*, December 13, 2020, <https://www.agriculture.com/news/business/record-high-ag-subsidies-to-supply-39-of-farm-income>.

farm subsidies would support struggling small and medium farmers and community banks along with them.

Expansion of SBA 7(a) Lending

As previously discussed, SBA 7(a) lending is a critical component of the small business lending market, expanding the scope of small businesses who are able to access necessary capital through the partial guarantee of loans. Ultimately, the SBA is involved in about a third of all small business loans by dollar amount.^{115,116}

However, there is room for further growth. The SBA could increase its guarantee rate from 75% to a higher percentage to increase small business access, or it could loosen the terms available on loans to allow for more flexibility for small businesses. Both of these changes would result in increased small business lending activity, which in turn aids community banks in raising loan volumes and profitability.

This proposal differs from our previous SBA preferencing suggestion because it is a broad-based expansion of small business capital that may be more politically palatable than an effort by the SBA to preference some banks, in this case community banks, over others, in this case big banks. Regardless of the path that the SBA decides to pursue, it's critical to highlight the linkages between the destinies of American small businesses and community banks. By expanding 7(a) lending, the SBA can support two significantly important segments of the economy simultaneously.

Securitization of the Small Business Lending Market

Today's small business lending market suffers from many of the same problems of the 1930s mortgage market: lack of standardization, no significant secondary market, and insufficient loan availability. Small business loans come with no standard format or template terms. Without a centralizing force, there's been no market incentive to standardize like the mortgage market did under Fannie Mae's influence.¹¹⁷ This increases friction for small businesses in assessing financing options and prevents secondary market development.

The lack of a secondary market has far-reaching impacts on small business lending. Far less capital is brought to bear, raising financing costs. The lending market has a dearth of transparency, making it difficult to assess the health of small businesses, particularly in times of crisis like the COVID-19 pandemic. Furthermore, the risk of these loans remains elevated for lenders because there's no opportunity to securitize small business loans through the equivalent of a mortgage-backed security.

We believe that more inquiry is needed to fix these problems in the small business lending market and that a potentially promising solution is a dedicated GSE for small business lending. This GSE would leverage the government's market-making and standardization powers in a full reimagination of the balance between the government, lenders, and borrowers in the way that Fannie Mae did for mortgages. Congress should examine creating the National Corporation

¹¹⁵ Brown, "Spotlight on Community Bank Lending."

¹¹⁶ "FY18 Lending Numbers."

¹¹⁷ "Selling and Servicing Guide Communications and Forms," Fannie Mae, n.d., <https://singlefamily.fanniemae.com/selling-and-servicing-guide-forms-and-communications>.

for Small Business Lending, a GSE modeled after Fannie Mae (nicknamed Nickie Bill) that would bring the scale and standardization necessary to resolve the market's issues.

By buying small business loans from originating banks, Nickie Bill could enforce a standard set of loan evaluation criteria and terms that will permeate the national market and become the new norm. This standardization, along with the sheer purchasing power of the GSE, would enable secondary trading of small business loans at scale, which, in turn, will free up new sources of capital to participate in the market and lower costs and barriers for small businesses in acquiring funding. In addition, the increased origination volume would aid community banks, who, as we've discussed, hold a disproportionate share of the small business lending market.

To note, there are legitimate concerns that should be examined regarding the structure and potential downsides of GSEs. Fannie Mae and Freddie Mac came under significant scrutiny during and after the 2008 Financial Crisis, and any attempt to launch a new GSE for small business lending should carefully examine these occurrences so that it doesn't create more problems than it solves. In addition, there are questions around how standardized small business loans can actually become without excluding a significant portion of small businesses from accessing capital. However, we believe that the legitimacy of these challenges do not preclude the wisdom of examining how to solve them as part of a broader interest in exploring the Nickie Bill proposal.

The securitization of the small business lending market would have far-reaching, positive impacts on the American economy, one of which will be the support of community banks throughout the nation who will have entirely new markets for their small business loans. While this proposal would certainly take longer to get off the ground, it may be the next step in the evolution of American small business lending and would bolster the community banking industry as it continues to play its important role in the American economy.

Conclusion

Community banks have been an essential part of the American economy since its earliest days. These institutions serve an important role in the fabric of communities across the nation, both in good times and especially in bad, as we saw with the COVID-19 pandemic. The free flow of capital to individuals and businesses, particularly in rural areas and small towns, depends on community banks, even those of the smallest size. Community banks increase the resilience of the country, its businesses, and its citizens, and they continue to do so.

That being said, community banks face significant headwinds. Consolidation is a powerful force in the banking industry, and it's only getting stronger as the role of technology in banking increases. In addition, some community banks suffer from depopulation in their communities, as urban areas become more concentrated and rural areas become sparser. It's difficult to remain profitable as deposits move away and valuable lending opportunities dry up.

For those reasons, policymakers in the federal government must pay attention to the plight of community banks before it is too late. There are clear policy changes and programs that could bolster the industry and cause positive externalities for communities and businesses in need of support, but only if the government plays its vital role. We urge policymakers to take action to aid the vital community banking industry, and we look forward to all of the good that community banks will continue to do across America in the years to come.

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