Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Value of Smaller Community Banks[*]

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It is unlikely that smaller community banks can provide the services that their larger community bank cousins can provide, and they certainly cannot provide the full range of services that the regionals and very large banks provide. Arguments that they should be perpetuated because they are friendlier, provide more hands on service, charge lower fees, and can make loans that larger institutions would find difficult to make because of the risk the larger banks see (but the smaller community banks believe are not real) are regularly suggested as the reasons they will continue to have an imprint on the banking landscape. Those arguments are questionable in 2015, although they may have had some validity a decade or two ago. Still, if relatively easy access to the banking industry by new owners and borrowers is important, smaller community banks are very important.

Continuing strengths of smaller banks

Smaller community banks are generally located in smaller communities, although many have been successful in suburban areas of larger cities. In that environment, the managers and owners of the bank have a good understanding of the community. They know in what ways it will develop and in what ways it will not. They have a firm understanding of the businesses, which are doing well and which are not. They understand the consumer population — who pays their bills in a timely fashion and who does not. If in a rural area, they understand the agri-business, and know seasonal lending.

In other words, they're in and around the community personally, attend Rotary and VFW luncheons, play golf at the club, have kids in the various leagues, etc. They probably have developed their branches to provide a welcoming environment, and the tellers probably know customers by name. They may go to the same churches, and certainly all follow the local sports teams. They have an intuitive feel when it comes to underwriting a consumer loan, and probably a decent "going-in" feel as they begin to underwrite a small commercial loan.

That gives them a very good feel for the community, and probably permits them to acquire and hold a strong amount of core deposits. Funding, therefore, is less costly than it would be if they had to enter the wholesale market. They can monitor small business loans more closely than larger community banks and regionals since the borrower often has the bulk of his financial business with the bank and the bank can

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see movements in his financial profile quickly. While that doesn't stop a loan from going bad, it can make the ultimate loss smaller.

Access to the banker who can make decisions is easier there since there is no layering of organizational components whose approval is needed. That permits faster, less painful decisions for the potential customer, and increases the chances for reasonable exceptions to the general lending rules.

Smaller community banks have the reputation of imposing fewer fees upon their customers, and that is always a good selling point for them.

Weaknesses

The obvious weakness is the very limited scope of products and services that can be offered by the smaller community banks. Large community banks and regionals dwarf them in capacity to make major credit available, and they have substantially greater technical skills and many more personnel trained and experienced in innovative ways to extend credit. Smaller community banks cannot absorb the expenses necessary to run a complex securities operation, to engage in rational swaps transactions for major end users (even for major agri-businesses that might be headquartered in the same state), to fully fund a major shopping center development, or to underwrite the dormitory bonds of the local college or the bonds of the new civic center. While they have made efforts to operate cooperatively on many of these products and services, those efforts have not been highly successful.

While many smaller community banks have become part of networks that permit their customers to use their ATM cards beyond the geography of the bank, those are not without cost to the bank. They also do not generally have the technical staff that can create for their consumers and small business customers the ecommerce innovations that have become so popular with a growing number of consumers. Many of those consumers expect to do all of their banking online and cannot imagine any reason to visit the bank offices, no matter how friendly the tellers are or how many cups of good coffee are offered there. This is true regardless of where they live. In addition, there is a growing number that firmly believe that using banks to intermediate is very old-fashioned and they would prefer to do peer to peer lending. Bitcoin is not a passing fancy, as curious minds try to figure out how to operate a payment system with the most modest of rules. Creations such as Apple wallet are changing the landscape, and the stirrings have begun again for the large box stores to enter into the consumer financial business.

Their lending business is often very localized, and in good times in the industry, that dominates their lending region; it is difficult not to fill up on loans to companies in that business. Unfortunately, as all economics masters have said, businesses always have cycles. What seemed like a great book of loans to the farmers in the California fruit and vegetable fields may not prove to be very good as the Colorado and other feeder rivers dry up and water becomes scarce. The larger community banks, regionals, and very large banks have not had to plunge so deeply into that one concentrated market as would the smaller community banks. That's their strength, however — supporting the local economy.

That also becomes a risky business model when the bank stretches to give a loan to develop a new shopping center to good guy Joe whom it has had as a customer for years but who has never developed a shopping center before. That stretch has probably increased the risk of a write-off, and the fact that Joe was well known may or may not make the write-off less painful. Most bank failures, of course, come from the smallest community banks simply because it doesn't take too many bad loans or other bad decisions to run through the limited capital available. The theory that they don't need guidance from regulations because they know their customers is often true, but, unfortunately, too frequently only a reason to make a loan they probably shouldn't make.

It certainly is true that the smaller community banks do not have the resources to deal with the regulatory attitude and burdens that have come from regulators who have vowed that never again will something like the housing bubble sneak up on them. Reams of articles have been written about the negative effect this has on the economy, but the regulators are the ones that had to absorb the media attacks and the difficult questions of Members of Congress in front of crowded hearing rooms with TV cameras focused directly upon their faces. Most commentators have never been in that situation, so are unable to understand this "never-again" attitude that leads to strict supervision and tight regulations. In addition, examiners and regulators are affected by the media characterizations of banks as predatory and greedy and out of control, particularly when it is fueled by the heads of their agencies in speeches and interviews. So, in that environment, smaller community banks will have to continue to utilize a large percentage of their expense accounts simply to comply with laws and regulations.

Most of all, however, they do not offer career advancement opportunities that can rival those of the regionals and large community banks. Smaller banks have very few senior management slots to fill, and many of the better new staff are either not interested in the job of CEO or do not want to wait for the passing of the guard to take place. Everyone has now ready access to communication devices that expose the world's possibilities, no matter how truly unrealistic many of those are, so it's hard to keep them in Goodtown, Anystate. At one time, the prospects of buying ownership of the bank, serving as CEO, and then selling it at a profit after using inside information to buy up all the good farms and the lumberyard and real estate and insurance agencies seemed like a pretty good deal. But those times are long gone.

Importance of access to banking system

Whatever their strengths and weaknesses, smaller community banks, and certainly larger community banks, provide access to the banking system in situations in which a reasonable creditor cannot otherwise get credit. That is essential, since innovative ideas often come with the small innovator, and often that kind of individual or business cannot get in the door of the loan officer of a regional or a very large bank. By itself, this is a sufficient reason to support the continuation of an atmosphere in which smaller community banks can survive.

Similarly, it is important that those who want to charter a bank and begin offering banking services can do so without being required to raise sums for start-up that are "too great," whatever that level might be. The FDIC recently noticed that it is getting very few applications for deposit insurance during the past few years, and has changed its required projected number of years of adherence to start up plans from 7 years to 3. That should provide some encouragement for new applicants, but there are other purely economic reasons why the past few years have been bad years for new charter formation. Still, capitalizing a smaller community bank is easier than a larger community bank and should be perpetuated as an option.

The long-term future of banking is murky, particularly because the full impact of non-bank banks in the space, technological changes, and changing habits and intermediation needs of the population are still unclear. Whether any part of banking should be subsidized with a different set of regulations or different regulators is worth consideration. Current thinking that some regulations and supervision should be reduced for a certain population of banks, however, shortchanges the kind of review that should be made.

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