Executive Summary

The *2020 Community Banking Study* is an update to the Federal Deposit Insurance Corporation's (FDIC) first community banking study, published in 2012, and covers the period from year-end 2011 through year-end 2019. The earlier work made several important contributions to our understanding of the performance of community banks and the significant role they play in the banking system and the nation's economy. It also established a definition of a "community bank" that was not solely driven by asset size but also incorporated a bank's business plan, geographic footprint, and number of branches (Appendix A). This study retains the definition established in the earlier edition and updates several areas of analysis including community bank financial performance, trends in community bank consolidation, and community bank lending focus. The current study also extends the conversation about community banks in several directions: it broadens the analysis of demographic changes affecting community banks and the products and services they offer, and it provides both an analysis of the effect of regulatory changes on community banks and an account of community banks' adoption of new technologies. Finally, each chapter in this study concludes by suggesting—from the perspective of the subject of the particular chapter—possible effects the COVID-19 pandemic could have on community banks.

Community Bank Financial Performance

Community banks continued to report positive financial performance, including improving pretax return on assets (ROA) ratios, a wide net interest margin, and strong asset quality indicators. Coming off the recession that ended in 2009, community bank pretax ROA ratios steadily improved, increasing from 1.05 percent in 2012 to 1.44 percent in 2019. The improvement in earnings was widespread with over 60 percent of community banks reporting increases from 2009 through 2019. Community banks' earnings performance, moreover, improved relative to noncommunity banks. By certain measures, particularly pretax ROA, community banks have long underperformed noncommunity banks. The most important factor contributing to the earnings gap between community and noncommunity banks had been the ability of noncommunity banks to generate noninterest income—primarily from investment activities that typically are not part of the traditional community banking business model.

During the period 2012–2019, community banks narrowed the earnings gap with noncommunity banks because of factors such as a wider net interest margin and stronger credit quality. Community banks ended 2019 with a quarterly pretax ROA ratio of 1.44 percent, only 22 basis points below the pretax ROA ratio of noncommunity banks, a significant improvement from the 43 basis point gap at year-end 2012. Community banks maintained their margin advantage by earning higher yields on earning assets, which was partly attributable to their holding a higher share of longer-term assets than noncommunity banks. Community banks also maintained their asset quality advantage over noncommunity banks as measured by credit losses. The full-year net charge-off rate reported by community banks reached a post-crisis low of 0.13 percent in 2019, which was 45 basis points below the rate reported by noncommunity banks.

One area that noncommunity banks outperformed community banks was noninterest expenses. Noncommunity banks were able to reduce overhead expenses from 3.01 percent of average assets as of year-end 2012 to 2.61 percent of average assets as of year-end 2019. Community banks saw their overhead ratio decline from 3.13 percent to 2.83 percent during the same time period.

Structural Change Among Community and Noncommunity Banks

After the 2012 study the banking industry continued to consolidate, but existing community banks were less likely to close than noncommunity banks. Of the 6,802 institutions identified as community banks at year-end 2011, just under 30 percent had closed by year-end 2019.[1] In comparison, over the same period, more than 36 percent of the 555 institutions that identified as noncommunity banks had closed. Including institutions that were community banks at year-end 2011 but noncommunity banks at year-end 2019 and vice versa, as well as banks newly chartered between 2012 and 2019, there were 4,750 community banks and 427 noncommunity banks at year-end 2019.

[1] The 2012 Community Banking Study reported 6,799 community banks and 558 noncommunity banks. These numbers have changed slightly reflecting new and revised Call Report filings that caused designation changes.

The drivers of banking consolidation shifted after the 2012 study. In that study, we showed how consolidation between 1984 and 2011 for both community and noncommunity banks was driven by failures and charter consolidation. Between 2011 and 2019, a period of economic recovery, failures declined substantially, voluntary mergers between unaffiliated institutions increased and became the predominant cause of the decline in the number of insured depository institutions, and mergers between institutions that were part of the same holding company fell. The major contributor to the overall decline, however, was the historically low number of newly chartered institutions: between 1985 and 2011, 183 new institutions were chartered per year on average, compared with four per year between 2012 and 2019. This combination of factors pushed up the rate of net consolidation for the banking industry between 2012 and 2019 to 4.3 percent, compared with its average of 3.2 percent during the years 1985 to 2011.

The Effects of Demographic Changes on Community Banks

The changing demographic makeup of the United States affects demand for community bank services: as demographics change, banks see changes in their client bases and in the demand for loans. Two major demographic factors considered in this study are median age and net migration flows. A comparison with the community-bank industry as a whole shows that between 2011 and 2019, community banks that were headquartered in counties at one demographic extreme—counties with lower median ages and the highest levels of net migration inflows—experienced faster asset and loan growth rates, were more profitable, and had larger shares of business loans. Such counties tended to be in metropolitan areas. At the same time, community banks that were serving areas of the country at another demographic extreme—counties with higher median ages and the highest levels of net migration outflows—experienced fewer opportunities for growth. Such counties tended to be in rural areas.

Community banks headquartered in areas simultaneously experiencing two distinct demographic trends nonetheless saw consolidation trends that were similar to trends in the industry as a whole. As a result, these counties' share of the total banking industry headquarters remained stable.

In areas of the United States that were arguably most thriving—those with a younger population and net population inflows—community banks grew quickly and profitably and supported communities with commercial and industrial (C&I) and commercial real estate (CRE) loans to help areas continue to grow. Areas with net outflows, on the other hand, appear to experience demographic and economic headwinds, causing banks in those counties to grow more slowly and have lower commercial lending portfolios—conditions that could weigh on community banks in those areas. These demographic trends could also result in greater consolidation in the future.

Notable Lending Strengths of Community Banks

Community banks by count represent the vast majority of banks in the United States. By other size measures, however, community banks represent a considerably smaller share: in 2019, they had only 12 percent of total industry assets and 15 percent of total industry loans. Despite holding a small share of total loans, community banks are a key provider of funding for many local businesses, most importantly by making CRE loans, small business loans, and agricultural loans.

CRE Lending

CRE loans provide opportunities for businesses to own commercial property, for housing within communities, and for the provision of retail and other services to metropolitan, micropolitan, and rural areas. Community banks are an important source of financing for CRE as evidenced by these banks' loan portfolios, the types of properties they finance, and the myriad locations of the properties financed. The share of CRE loans community banks hold (30 percent of the banking industry's CRE loans) is large relative to the banks' representation in the banking industry. CRE lending also is widely distributed, with almost all community banks holding at least some amount of CRE loans, and many holding substantial portfolios. Community banks originate various types of CRE loans: multifamily lending grew in the years between 2011 and 2019, and community banks are active lenders to a wide range of industries, including industrial, retail, and hotel industries.

In addition to lending across industry types, community banks have been active CRE lenders across all sizes of markets. In 2019, community banks headquartered in rural and small metropolitan areas held more than two-thirds of CRE loans held by all banks headquartered in those smaller geographic areas. In larger metropolitan areas, community banks' share of loans was smaller, but still material. Although community banks of all lending specialties provide CRE financing, the share of community banks that are CRE specialists increased during the period between 2012 and 2019.[2] These CRE specialists are important providers of CRE loans in small communities.

As important providers of CRE financing, community banks are among those lenders interested in CRE market dynamics in the years ahead. As of the beginning of 2020, the long economic expansion had been a positive backdrop to CRE. Delinquency rates among community banks' CRE loan portfolios had declined for much of the previous decade, and at the end of 2019, the average delinquency rate had settled at a very low level.

Small Business Lending

Small businesses are key to the U.S. economy, representing the vast majority of all businesses by count and employing almost half of the private sector workforce. These businesses often need funding, for example for inventory, working capital, or accounts receivable financing. Despite holding only 15 percent of total industry loans in 2019, community banks held 36 percent of the banking industry's small business loans.[3] Community banks focus on building relationships with small business owners and tend to make loans that require more interaction with the borrower. By contrast, noncommunity banks, which dominate the smallest category of business loan originations—loans below $100,000 that are typically business credit card lines—tend to use a scoring model that requires little interaction with customers.[4] During the period covered by this study, community banks' share of small business loans per Call Report data has declined. Small Business Administration 7(a) program loan originations increased from 38 percent of total originations in 2012 to 46 percent in 2019 with many loans greater than $1 million originated. Finally, in response to the 2018 FDIC Small Business Lending Survey, many bankers said their C&I loans were extended predominantly to small businesses, supporting the widely held belief that many loans to small businesses are above the Call Report's $1 million reporting limit.

Agriculture Lending

Community banks are an important source of financing for U.S. agriculture, funding roughly 31 percent of farm sector debt in 2019, with half of that total financed by community-bank agricultural specialists. The lending emphasis of community-bank agricultural specialists largely played in their favor from 2004 through 2013. Community-bank agriculture specialists' exposure to the negative credit effects of the housing crisis and recession that followed was minimized, and instead they benefited from a strong, decade-long farming boom. Beginning in 2014, the agriculture sector struggled in terms of profitability, but erosion in farm financial conditions was gradual and generally modest. Credit quality at community-bank agricultural specialists weakened but still remained favorable by long-term historical comparison, and earnings and capital were strong.

Community-bank agricultural specialists tend to be small; in 2019, more than 75 percent had total assets under $250 million, and just 19 out of 928 community-bank agricultural specialists had total assets in excess of $1 billion. Geographically, community-bank agricultural specialists were heavily concentrated in the center of the country. Agriculture in this area is dominated by cattle, corn, hogs, and soybeans and to a lesser extent cotton, dairy, poultry, and wheat.

Community-bank agricultural specialists have shown a strong commitment to lending to farmers through the peaks and valleys of cycles in the agricultural sector. From first quarter 2000 through fourth quarter 2019, in only two quarters did community-bank agricultural specialists see an annual decline in aggregate agricultural production loan volume, and never in aggregate farmland-secured loans.

Regulatory Change and Community Banks

The period 2008–2019 was one of intense regulatory activity, much but not all of it in response to the 2008–2013 financial and banking crises. So numerous were the regulatory changes that keeping current with them would have challenged any bank, but especially a small bank with modest staff resources. While many factors affect banks and it is difficult to be definitive, the pace of regulatory change may have been one factor that contributed to three post-crisis developments: a high proportion (compared with other time periods and other banks) of small community bank mortgage lenders that reduced their

[2] Refer to Appendix A for specialty bank determination criteria.
[3] This percentage is based on commercial and industrial and nonfarm, nonresidential loans below $1 million.
[4] Federal Reserve Banks.

residential mortgage holdings, the record rates at which community banks exited the banking industry in the years leading up to 2019, and an apparent increase in the target asset size of new small banks as reflected in their initial equity capital.

Based on their sheer number and scope, changes to rules regarding 1–4 family residential mortgage lending and servicing have a strong claim to being the most important rules of the post-crisis period. Between July 2008 and November 2019, largely in response to laws enacted to address abuses in subprime and alternative residential mortgage lending and mortgage servicing, federal agencies issued 36 distinct substantive final rules governing various aspects of 1–4 family residential mortgage lending and mortgage servicing. Even so, community banks *in the aggregate* continued to grow their residential mortgage portfolios. At the same time, noninterest expense ratios for community bank residential-mortgage lending specialists increased relative to those ratios for other community banks, and the proportion of community banks with small mortgage programs that materially reduced their mortgage holdings continued to increase. Both trends are optically consistent with the hypothesis that regulatory changes affected the costs and level of participation in residential mortgage lending of some community banks. Developments in financial and information technology also are likely creating a tendency towards commoditization of residential mortgage lending, with effects on the distribution of mortgage lending across banks of different sizes. Accordingly, it is not possible to be definitive about the relative importance of regulatory changes in driving mortgage lending trends.

The most important change to capital adequacy regulation during the 2008–2019 period was U.S. implementation of a version of the Basel III capital framework. Leverage ratios of community banks increased faster and to higher levels than did those ratios for noncommunity banks, and their loan growth exceeded that of noncommunity banks as well. A detailed look at how community banks brought about the increase in their capital ratios shows that the extent of asset quality problems played an important role in influencing how banks responded. Specifically, healthy community banks with low levels of nonperforming loans increased their capital ratios but do not appear to have curtailed loan growth to do this, while community banks with higher levels of nonperforming assets were more likely to increase their capital ratios in part by curtailing loan growth.

Finally, it is important to emphasize that this study views regulations only through the lens of their effects on community banks; a discussion of the policy goals Congress has sought to achieve with its statutes, or how well the regulations have achieved those goals, is beyond the scope of the analysis. Observations in this study about the effects of rules on community banks should thus not be taken as criticisms of those rules. The overall thrust of the analysis, however, does support the idea that if the societal benefits of a thriving community banking sector are to be preserved, it is important that regulations achieve their public policy goals in ways that accommodate, to the extent appropriate, the business models and learning curves of smaller institutions with limited compliance resources.

The chapter covers several types of rules beyond those mentioned here. Appendix B provides a chronology and a brief description of selected federal rules and programs—157 of them—that applied to community banks and were put in place from late December 2007 to year-end 2019 (an average of 1 every 28 days during the 2008–2019 period).

Technology in Community Banks

Community banks have adopted different technologies at different rates, with newer technologies such as mobile banking, automated loan underwriting, and online loan applications being no exception. According to research and community banks' own descriptions of the opportunities and challenges, several factors may play an important role in community banks' adoption of new technologies. These factors include a bank's characteristics, the economic and competitive environment, and the attitudes and expectations of bank leadership.

Data from the 2019 survey conducted by the Conference of State Bank Supervisors (CSBS) indicate that "low adopters" of several recent technologies were distinguished mostly by their smaller asset size and lower revenues. For at least some of the banks participating in the CSBS survey, those same characteristics predated technology adoption, suggesting that bank size and resources may indeed have influenced community banks' decisions to adopt technology. Although it is also plausible that the use of technology may have increased asset and revenue growth after adoption, additional data and research are needed to determine whether that was the case.

Community banks that had higher ratios of loans to assets, higher growth, and better performance also were more likely to have adopted the technologies covered by the survey, even after differences in size were accounted for. Similarly, banks that faced greater competition, had more optimistic expectations, and had more positive attitudes toward technology were more likely to be "high adopters." Certain factors were not associated with the adoption of technology or else made no difference that could not be explained by asset size. Among these factors were loan specialization, deposits, location of main office, and local population. Future research into these relationships, as well as the methods community banks use to obtain technology, will broaden our understanding of the key drivers, barriers, and risks associated with financial technology and its likely effect on the continuing success of community banking.

Future Challenges and Opportunities for Community Banks

Although our data for this study end with 2019, the significant uncertainty that the COVID-19 pandemic has presented to the economy, the banking industry, and society at large cannot be overlooked. This uncertainty will present community banks with both challenges and possibilities. As earnings decline and credit losses materialize, community bank performance is likely to deteriorate. The rate of community bank mergers may initially slow but then rise as institutions reconsider branching and location strategies. Changes in demographic trends such as population migration away from urban areas could benefit community banks located in more rural areas by providing them with new opportunities for growth. At the same time, community banks that specialize in certain types of lending that are centered in metropolitan areas, such as C&I, could suffer with increased loan losses or lower growth rates. Finally, the increase in demand for contactless ways of doing business may encourage community banks' adoption of new technology or partnerships with financial technology providers. Overall, community banks have a strong history of recognizing and meeting the needs of their customers, and community banks will continue this tradition in years to come.