DALLASFED

2012 Annual Report

Financial Stability: Traditional Banks Pave the Way

A Lender for Tough Times

By Jeffery W. Gunther and Kelly Klemme

Community banks are not only a major source of credit, but also a stable one for businesses. During the recent financial crisis and its aftermath, these smaller, traditional lenders provided credit to many firms, especially small businesses, when they needed it most.

Financial stability is key to economic performance—a proposition made starkly clear when banks became a source of trouble during the recession. Before the downturn's start in December 2007, U.S. banks stoked an epic real estate boom with lax lending, setting the stage for a severe financial crisis. Once the worst was over, these institutions inhibited a recovery by tightening credit standards and limiting loans. Like a broken thermostat, banks and the financial system helped overheat the economy and then helped overcool it.

Some types of banks destabilized the credit cycle and economy more than others. The biggest banks, their focus diverted from traditional balance-sheet activities and toward capital markets and short-term gains, incurred spikes in loan defaults and exhibited significant cyclical declines in business loan volume.

Meanwhile, community banks concentrated on traditional banking, taking deposits and extending loans, relying on long-term relationships and time-tested judgment. These smaller banks not only demonstrated relative strength in business loan quality, but also maintained business loan volume to a much greater degree, providing credit to many small businesses when they needed it most. Such lending is vital to the economy.

Community banks are organizations with assets of $10 billion or less. The smallest community banks are those with assets below $1 billion.

Their activities are compared with the actions of two classes of larger financial institutions—those in the over $10 billion to $250 billion range and others with assets over $250 billion.

Business Lending Focus

Community banks tend to focus on business lending. Just before the 2007–09 recession, they held overall business loans equal to 30 percent of assets, compared with only 14 percent for the largest banks. This remained true even after the financial crisis. As of June 2012, the subset of smallest community banks held business loans equal to 28 percent of assets, and the group of community banks with assets from $1 billion to $10 billion held business loans equal to 31 percent of assets (*Chart 1*). The largest banks were down to about 12 percent.

Just as important, a significant share of this lending goes to small businesses. Community banks as a group have about 13 percent of assets in small business loans, far above the 2 percent for the largest banks. Among the smallest community banks, small business loans command almost 15 percent of assets.

Community banks held 17 percent of industrywide banking assets as of June 2012—but they accounted for more than half of the amount lent to small businesses (*Chart 2*). This importance to the small-business loan market testifies to community banks' competitive edge based on superior firsthand knowledge of borrowers and their credit needs.

(Continued from Financial Stability: Traditional Banks Pave the Way - A Lender for Tough Times)

Business Lending Durability

Serving the credit needs of small business borrowers in today's challenging times is one thing. But, what happens when the operating environment really turns sour? Who lends to small businesses then?

The housing crisis and recession knocked the financial system off kilter. Small businesses are particularly vulnerable to banking crises because their limited access to broader capital markets increases their dependency on banks. Tightening bank credit will likely curtail small enterprises' activities, jeopardizing the growth and vitality these businesses provide to local communities.

Compared with the big financial institutions, community banks have been more successful in avoiding asset impairment, allowing them to sustain lending activity. At mid-2008, well into the recession, total business lending remained above year-earlier levels for all four bank asset-size categories (*Chart 3*). Over the next two years, however, community bank loan volume held up relative to 2007 levels, while the biggest banks significantly reduced business lending. In 2011 and 2012, business lending tended to recover—but the biggest banks still had not returned to 2008 levels.

A notable pattern also occurred for small business lending: Community banks with assets of less than $1 billion maintained a relatively steady loan volume (*Chart 4*). For other types of banks, small business activity dipped well below precrisis levels. The smallest community banks offer small businesses a relatively stable source of credit—a critical element of the financial landscape worth nurturing.

Stabilizing Force

Community banks are not only a major source of credit for job-creating businesses but also a stable one. By extending new loans to business customers, renewing existing loans and minimizing loan losses, community banks better maintained loan volume during the downturn. Less-crisis-prone banks help promote a less-crisis-prone economy.

About the Authors

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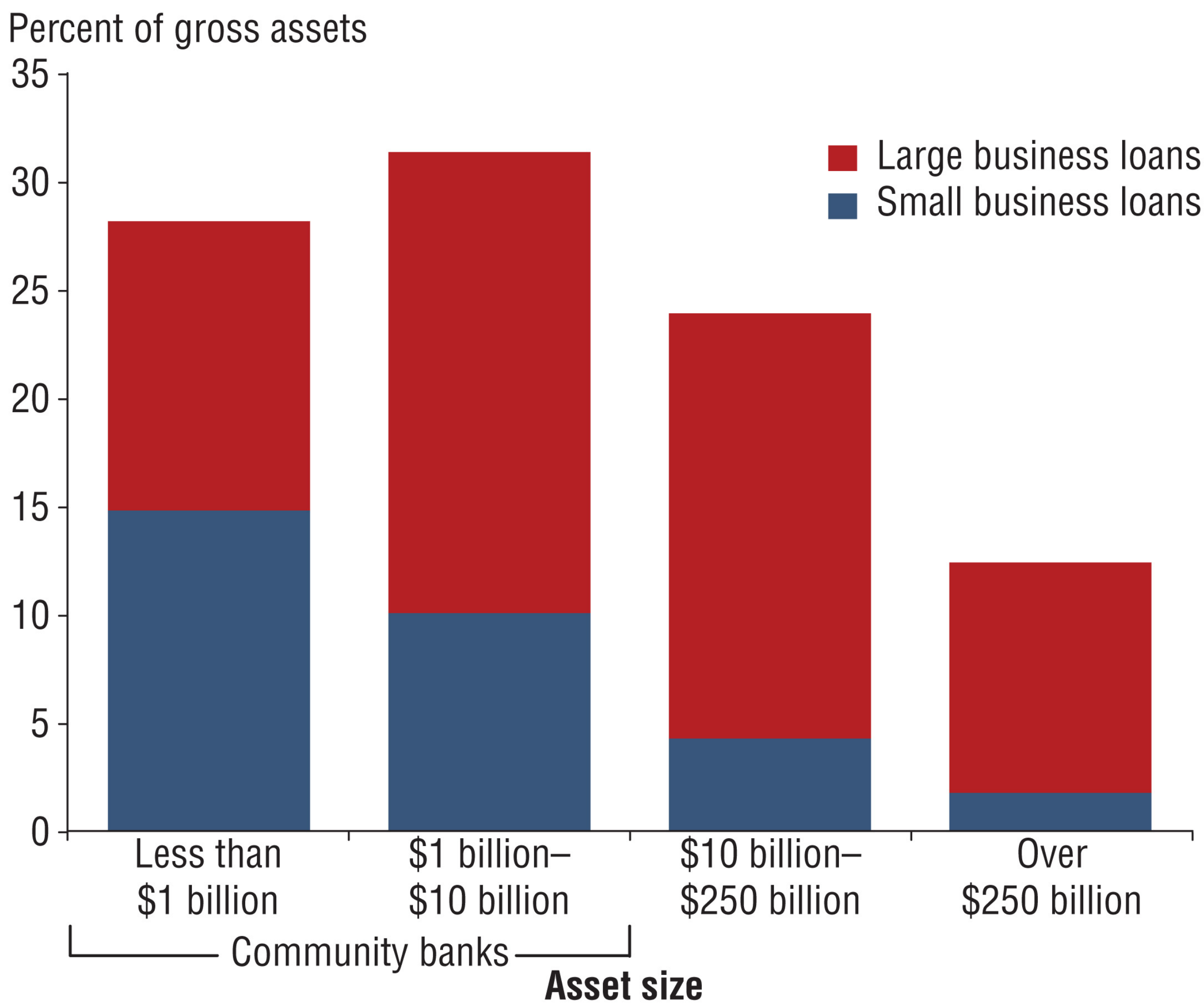
Chart 1
Community Banks Focus on Small Business Loans



NOTES: Data for commercial banks as of June 30, 2012. Asset size is based on the total assets of a U.S. banking organization (holding company, when applicable). Business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans; small business loans are those with original amounts of $1 million or less.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

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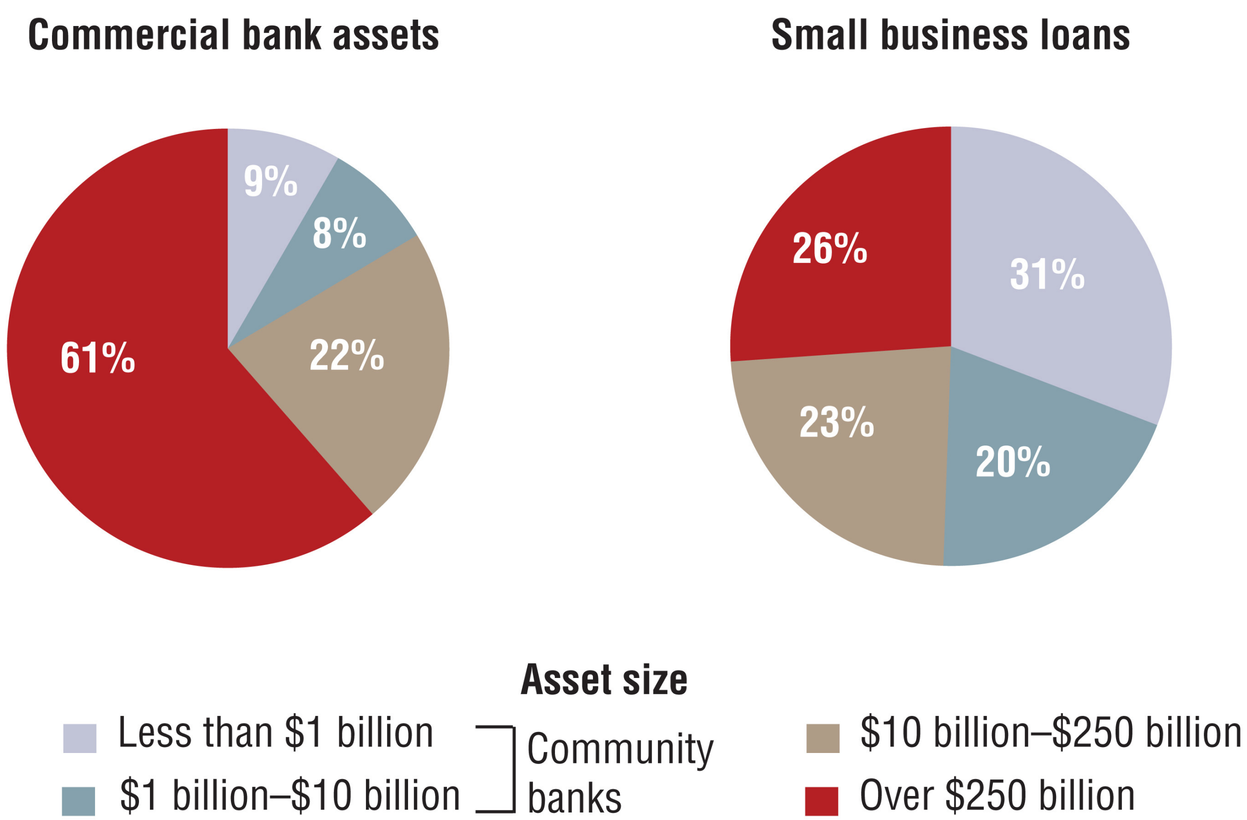
Chart 2
Community Banks Hold Less Than One-Fifth of Industrywide Banking Assets but More than Half of Industrywide Small Business Loans



NOTES: Data for commercial banks as of June 30, 2012. Asset size is based on the total assets of a U.S. banking organization (holding company, when applicable). In the assets pie chart, shown are the size groups' shares of industrywide commercial banking operations, excluding nonbank activities. Small business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans, with original amounts of $1 million or less.

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Chart 3
Business Loan Volume

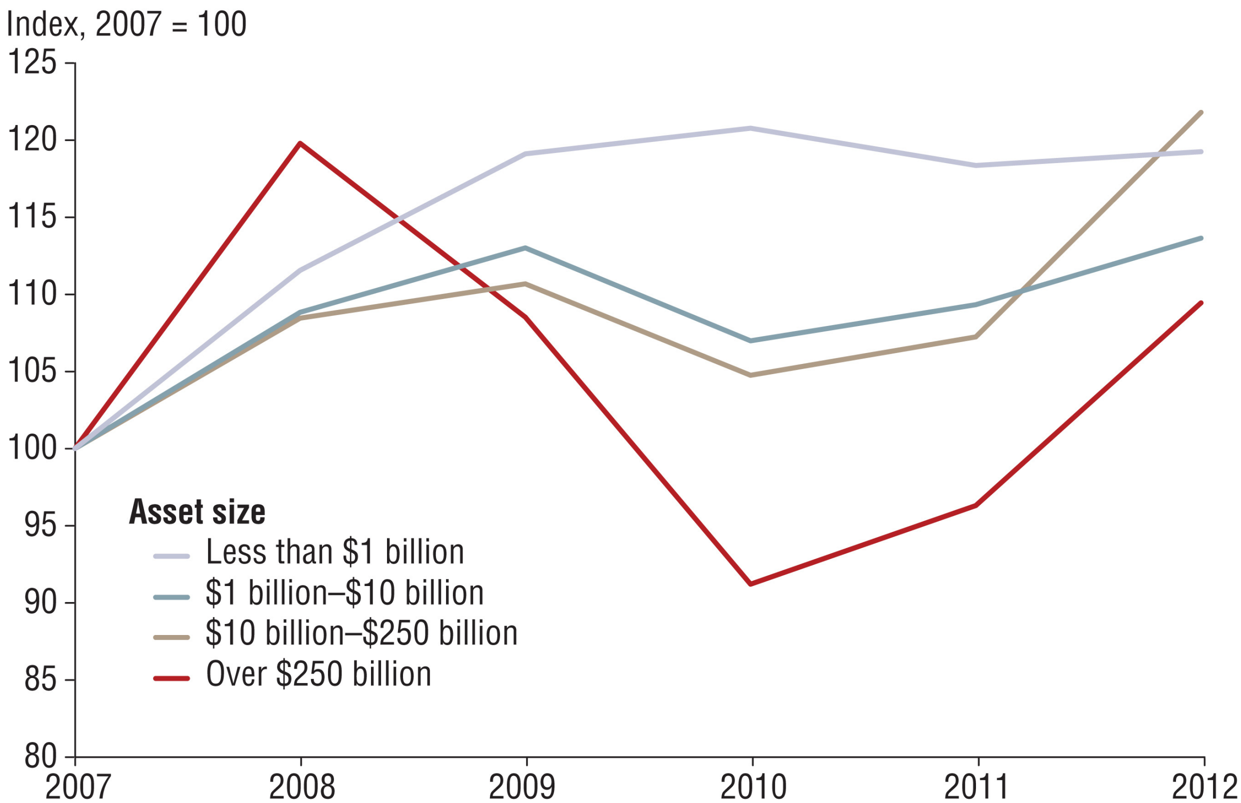

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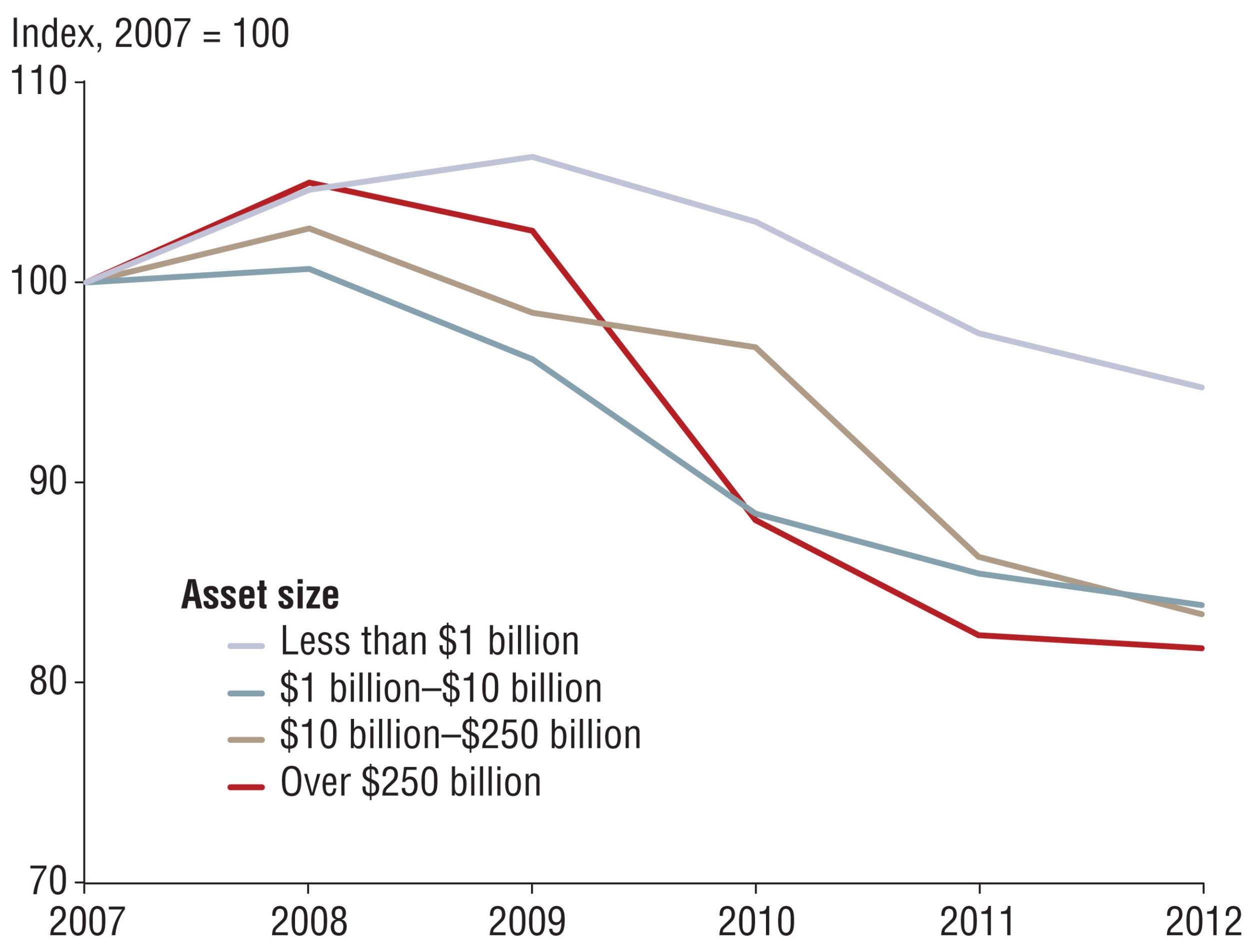
Chart 4
Small Business Loan Volume



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