Small Banks Squeezed

By Jeffery W. Gunther and Kelly Klemme

With consistent loan quality and resilient lending activity, community banks—and the traditional banking model they represent—can be a much-needed force for financial stability. Unfortunately, they've struggled to maintain market share, partly as a result of unintended consequences of public policy.

The community bank model has a lot going for it—superior loan quality, lower rates of severe difficulty and greater credit stability through which to finance small businesses. With these advantages, community banks can be a much-needed force for financial stability. Unfortunately, their prominence isn't increasing; at best, they've struggled to maintain market presence amid industry consolidation in recent decades.

Community banks are organizations with assets of $10 billion or less. In 2004, such banks accounted for about 21 percent of industrywide banking assets. But as the 2007–09 recession began, community banks' market share had dropped to about 19 percent. Over the next five years, their piece of the marketplace fell further—to under 17 percent. Their market share appeared to slip even after accounting for those community banks that grew and moved into a larger size classification (*Chart 1*).

Market Share Impediments

What stands in the way of gains for this high-performing class of banks? Historically, a variety of economic factors have contributed to community banks' stagnating market share. For some financial products and services, larger scale might be needed to achieve fully efficient operations. Also at work recently is a more-troubling force: public policies that keep community banks from reaping the rewards of a business model that works for the financial system and the economy. Two examples are particularly striking.

Too Big to Fail

Especially noteworthy have been financial crisis policies that aided too-big-to-fail (TBTF) banks and resulted in massive public interventions to support and sustain some of the largest institutions. They are the very same banking operations that produced some of the severest losses. Intended or not, these policies worked against community banking and longer-term financial stability.

TBTF policies kept large, deeply troubled banks open, their creditors protected, their shareholders possibly diluted but not wiped out. Propping up large, troubled institutions tended to impede redistribution of market share to smaller, less-trouble-prone banks. The rewards for excessive risk were enhanced; those for prudence were diminished.

A massive rewriting of regulations failed to resolve the TBTF problem. Concentration of deposits among TBTF institutions has increased, not diminished. Funding costs for these institutions have remained less than funding costs for smaller institutions, reflecting persistent TBTF protection of creditors. The regulatory regime still seeks to manage the risk to the financial system that the biggest banking organizations pose. Yet these institutions remain so large and complex—and intertwined with the financial system and economy—that it's doubtful whether regulators would or, indeed, could take decisive action to resolve giant banks if they again encountered serious trouble.

(Continued from Financial Stability: Traditional Banks Pave the Way - Small Banks Squeezed)

Overregulation

Second, a regulatory backlash resulting from the financial crisis presents the risk of an increasingly one-size-fits-all, heavy-handed oversight regime. For some problems, policymakers are continuing to rely on regulatory and supervisory toolkits similar to those used before the crisis but are adding complexity and expanded documentation requirements.

In other areas, they are implementing new and fairly explicit directives that do not credit community banks for their more-intimate customer relationships. Regulators have taken some steps to avoid penalizing community banks with rules aimed at curbing TBTF excess. Still, the cumulative effect of recent policy proposals could ultimately apply regulatory and supervisory approaches befitting large, transaction-oriented banks to small, relationship-oriented ones. The mismatch would unnecessarily boost regulatory costs for community banks.

Right Course

A more promising alternative exists—using proper incentives to bring discipline to financial markets. If all banking organizations were of manageable size and complexity, with diverse strategies, they could be allowed to stand or fall on their own merits. Prudently managed banks, including the vast majority of community banks, could then reap the rewards of their traditional financial conservatism.

By finding a genuine remedy to TBTF, undue risk taking would be penalized through bank failures, with no banking organization exempt from the threat of aggressive resolution, should it become insolvent. A host of new regulations does not ultimately hold the key to a safe and sound financial system. Rather, there is promise in the basic force behind free markets—the discipline that results from combining the freedom to succeed with the responsibility for losses. If we want the financial system to evolve toward greater stability, we must rely less on boundless regulation and end TBTF by ensuring that no bank is too large, complex or intertwined with the financial system for regulators to close.

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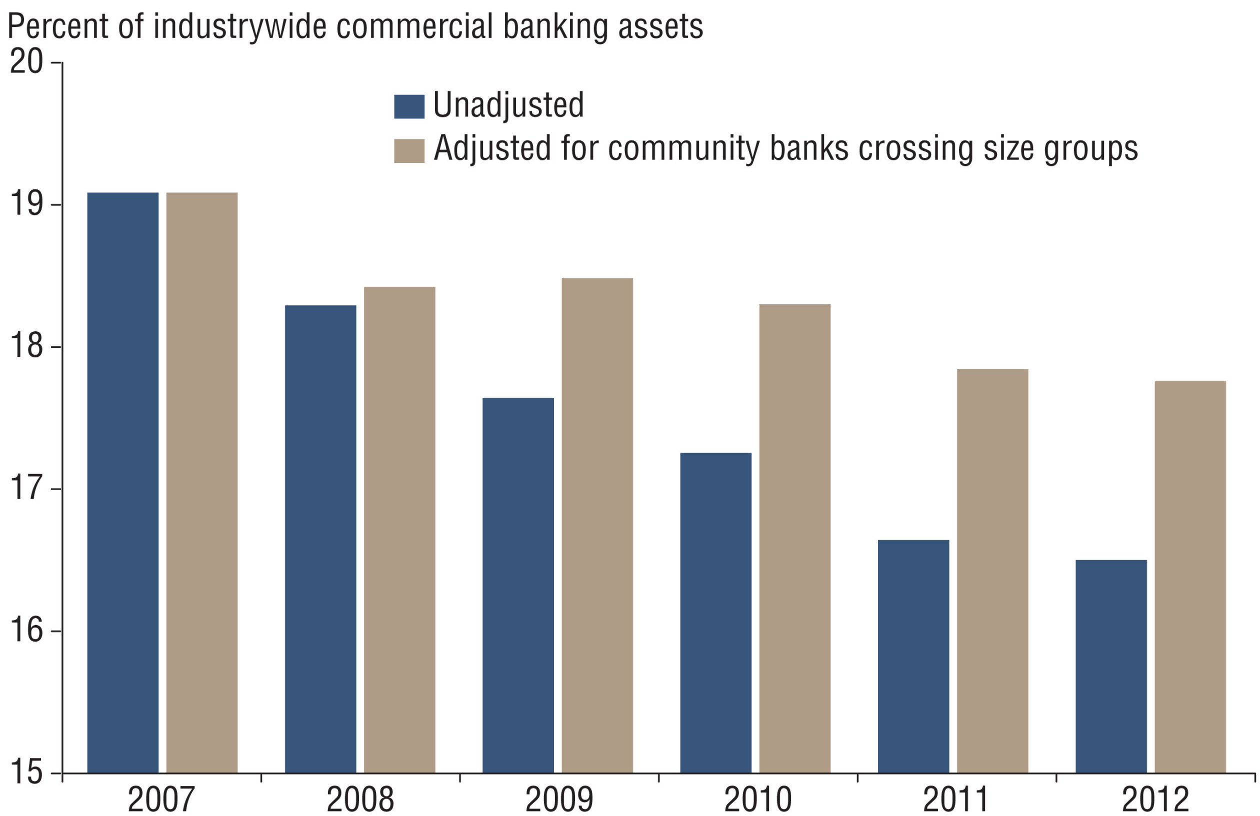
Chart 1
Community Banks Struggle to Maintain Market Share



NOTES: Data for commercial banks as of June 30. Community banks have assets of $10 billion or less. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable).

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.