

Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

Community banks, which rely on strong customer relationships and disciplined lending practices, weathered the financial crisis better than large, nontraditional banks. This superior performance suggests that a back-to-basics approach to banking could help the nation realize financial stability that lasts.

Community banks began this century lost in the shadow of the big Wall Street financial institutions. During the 2007–09 recession, however, the merits of the community bank model reemerged. With relatively high loan quality, U.S. community banks weathered the severe operating environment—the worst financial crisis since the Great Depression—better than their largest competitors, many of which required special government support. Community banks' failure rate remained far below the rate at which the government propped up the country's biggest banks.



Community banks are organizations with assets of \$10 billion or less. This characterization, although sometimes imperfect, serves as a proxy for institutions following the community bank model, which relies on a strong working knowledge of the local market. A subgroup of smaller community banks—those with assets less than \$1 billion—is analyzed here along with the institutions holding \$1 billion to \$10 billion in assets.

Their performance is compared with two classes of larger banks—those in the over \$10 billion to \$250 billion range and those with assets exceeding \$250 billion.

Loan Quality

The severity of the 2007–09 downturn—with its extensive real estate component—made business difficult for any bank. Even so, community banks displayed relative stability in key measures of loan quality:

- Noncurrent loans
- Net charge-offs (the loan-loss rate)

Looking at business loans backed by nonfarm, nonresidential real estate as well as commercial and industrial loans, community banks experienced fewer problems (*Chart 1*). They mostly avoided the extreme noncurrent and charge-off rates incurred by other types of banks, especially the largest institutions.

The recent recession's significant real estate component played itself out in historically high noncurrent rates for residential mortgage loans. Closed-end, first-lien, one- to four-family loans, traditionally a low-risk lending category, were hit hard. Some banks had to rebook noncurrent loans that had been securitized—that is, bundled with other, similar obligations and sold to investors as mortgage-backed securities. Even within the beleaguered residential real estate category, however, community banks exhibited performance far superior to the nation's largest financial institutions (*Chart 2*).

The superior loan quality among community banks didn't just emerge during the recent financial crisis. The 2001 economic downturn strained banks' loan portfolios but lacked the outsized real estate-based pressures of the 2007–09 recession. Even so, community banks in this earlier period also avoided severe loan quality problems, while noncurrent and charge-off rates among other types of banks, especially the largest ones, rose to high levels (*Chart 3*).

Community Bank Model

The community bank model lies behind this consistently higher loan quality. Locally owned banks establish long-term ties with businesses in their communities. When making lending decisions, community banks tap direct knowledge of customers, going beyond the credit scores, financial statements or other quantitative assessments on which their larger competitors depend. Such lender–borrower relationships become especially important when vital information about borrower creditworthiness is only effectively acquired firsthand.

Of course, we can't expect banks with assets of \$10 billion or less to handle by themselves all the credit and financing needs of a sophisticated, globally competitive economy churning out \$16 trillion a year in output. However, the community bank model serves a useful purpose by illustrating the financial institution attributes that contribute to economic stability. The country needs a diverse financial system, with bigger institutions alongside the community banks, but these larger banks should deliver the same quality performance as community banks and need not be nearly as large as they are today.

In recent decades—especially in the years leading up to the financial crisis—the community bank model became marginalized. To a limited degree, this was to be expected as an increasingly competitive environment, coupled with the removal of restrictions against geographic expansion, led some small banks to seek greater efficiencies by operating on a somewhat larger scale. However, the perceived advantages of larger scale sometimes proved illusory. Big institutions, amid a wave of banking industry consolidation, began dominating credit markets by using transactional, automated approaches to loan underwriting. In many cases, the new credit-market mechanisms inadequately measured lending risk, proving a poor substitute for the community bank model's firsthand knowledge.

Financial conservatism is also a hallmark of successful community banking. It is grounded in the everyday awareness of the chance of failure and government-mandated closure if too much credit is extended to borrowers with insufficient repayment capacity. It is buttressed by the ownership structure of community banks, where much of managers' or directors' wealth is often on the line.

By comparison, some larger banks' lending became overly aggressive at times, perhaps emboldened by a belief that the likelihood of regulator-ordered shutdown was minimal, even if big segments of their loan portfolios soured. The rising volumes of problem loans and the sometimes fragile means used to fund them—for example, off-balance-sheet vehicles and short-term, volatile wholesale monies—brought credit markets to a virtual collapse in 2007–09. The big banks' size and interconnectedness led to “too big to fail” interventions, which shielded troubled big banks from the full consequences of their decisions.

Failures and Special Assistance

Community banks as a group exhibited greater financial stability with relatively strong loan quality, while avoiding the hyper-cyclicality of large, nontraditional institutions. In the recent crisis and its aftermath, only about 5 percent of community banks failed. Within the largest group of banks, controlled by only nine organizations in 2007, two required special open-bank assistance, a “prop-up rate” of about 20 percent. Potential failure of these institutions was deemed a risk to the financial system and the economy—so they received guarantees, liquidity access and capital from the U.S. government.

Recent experience suggests that reestablishing a more prominent role for traditional banking, as exemplified by community banks, could help the nation achieve greater financial stability. Policymakers should take note.

About the Authors

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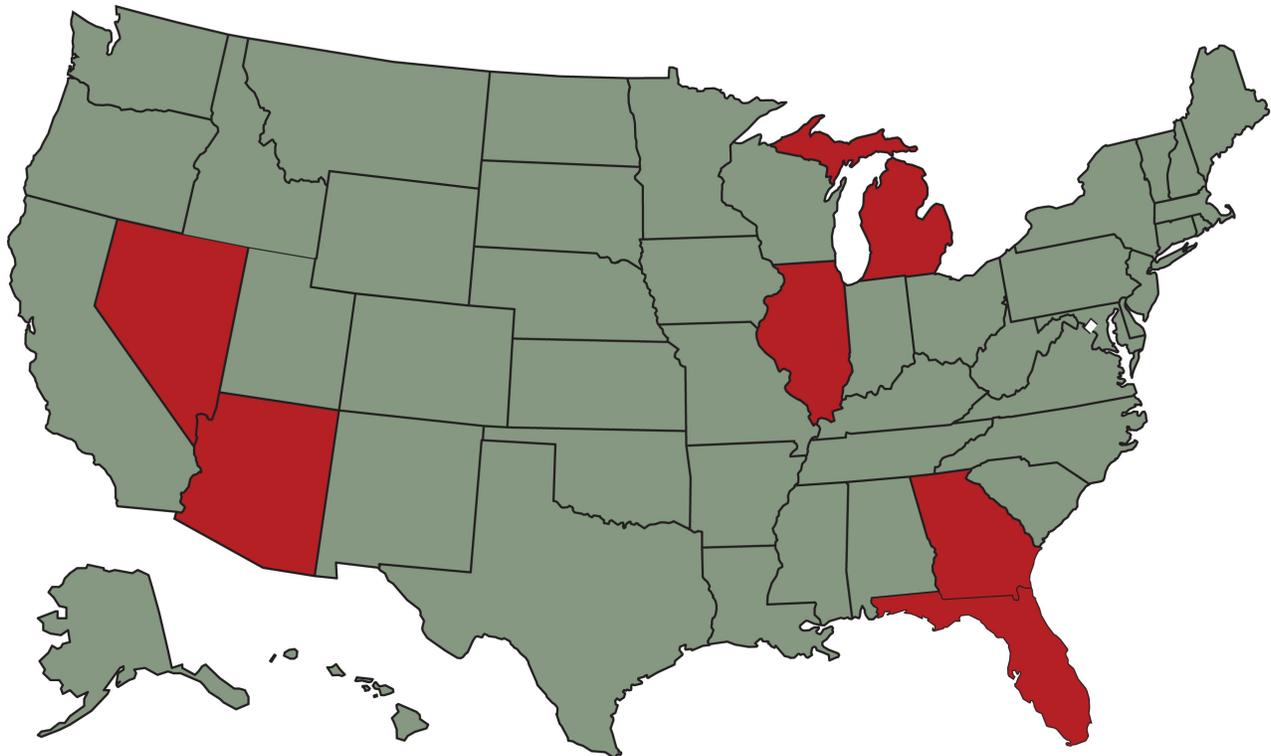
Community Banks Largely Overcome Regional Differences

What if successful community banks were clustered in just a few states with relatively strong regional economies and healthy housing markets? In that case, the group's superior loan quality might merely reflect a relatively favorable operating environment.

Examining the recent financial crisis and recession at the state level provides insight into whether community banks consistently performed well across regions. The aggregate noncurrent rate relative to total business loans is calculated quarterly for community banks in each state from first quarter 2009 to fourth quarter 2011. Quarterly results are averaged for the three years, then compared with the largest banks' nationwide performance.

By this measure, community banks in 44 states performed better than the large banks in terms of holding down loan problems. The six states in which community banks underperformed faced devastated economies. It took this kind of extreme circumstance to render loan quality problems at community banks as severe as those sustained by the largest banks.

Community Banks Have Fewer Loan Woes than Big Banks in All but Six States



NOTES: Data for commercial banks. Community banks have assets of \$10 billion or less. Big banks have assets of \$250 billion or more. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). In states shaded red, community banks had an average aggregate noncurrent business loan rate above that of big banks nationwide for 2009:Q1 through 2011:Q4.

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.

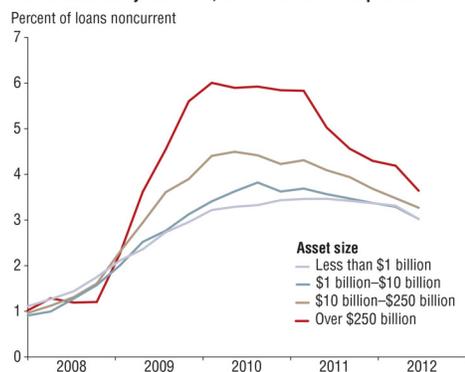
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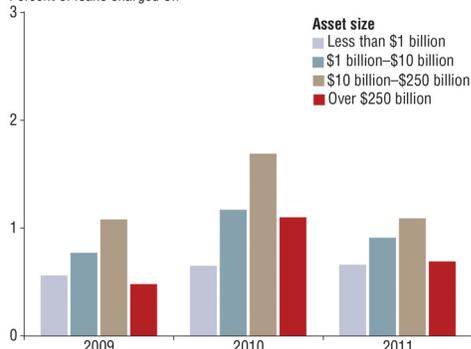
Chart 1

Great Recession: Community Banks Had Fewer Loan Problems than Big Banks

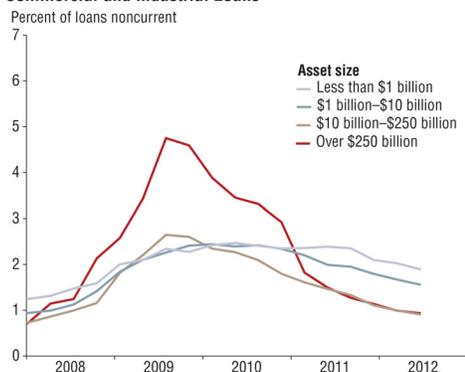
Loans Secured by Nonfarm, Nonresidential Properties



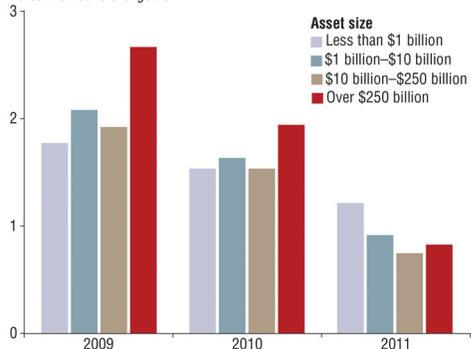
Percent of loans charged off



Commercial and Industrial Loans

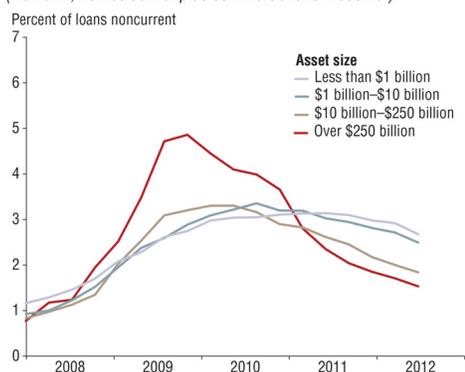


Percent of loans charged off

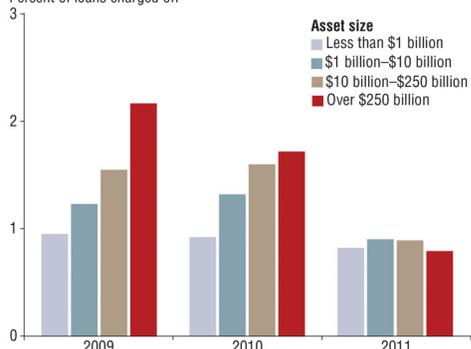


Total Business Loans

(Nonfarm, nonresidential plus commercial and industrial)



Percent of loans charged off



NOTES: Data for commercial banks. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Loans charged off are net of recoveries. (Data revised February 2013.)

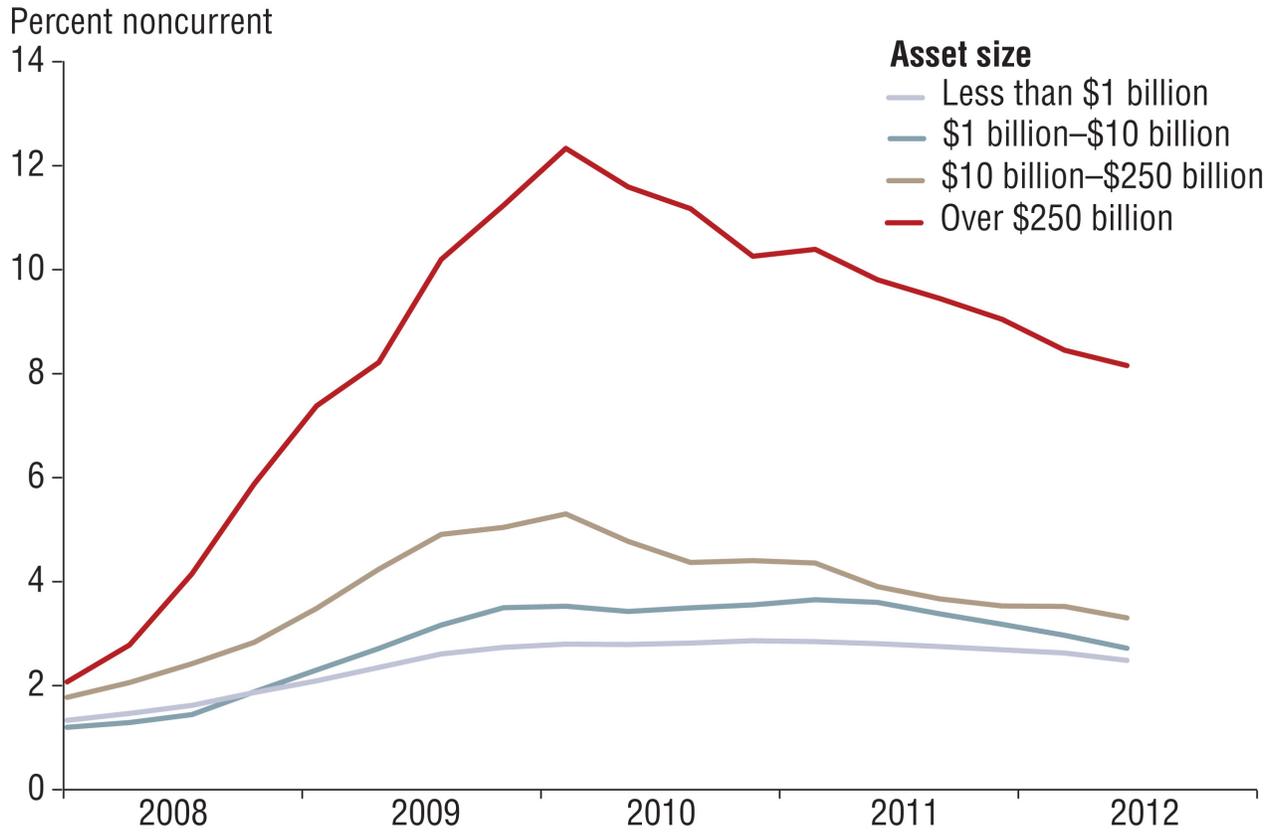
DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

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Chart 2

Community Banks Maintain Residential Real Estate Loan Quality in Great Recession



NOTES: Data for commercial banks. Residential real estate loans are closed-end, first-lien, one- to four-family mortgages. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Noncurrent loan rates have been adjusted to exclude loans rebooked from Government National Mortgage Association securitizations.

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.

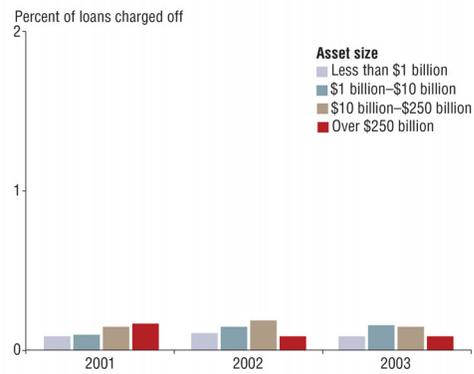
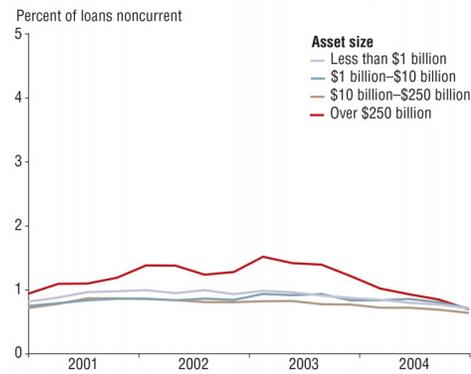
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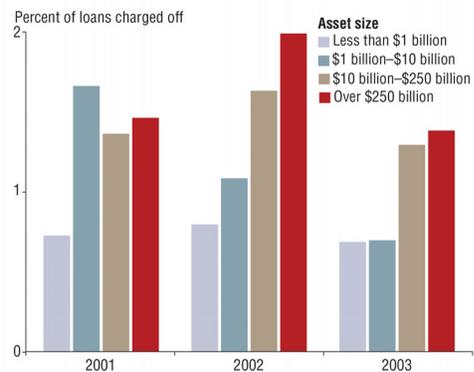
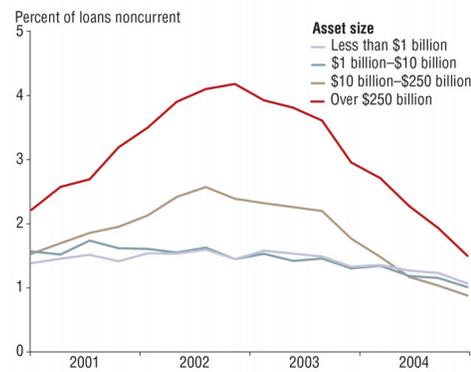
Chart 3

2001 Recession: Community Banks Had Fewer Loan Problems than Big Banks

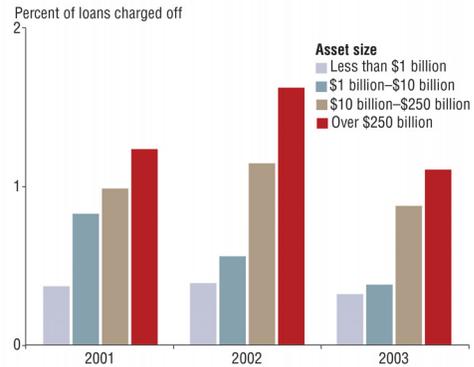
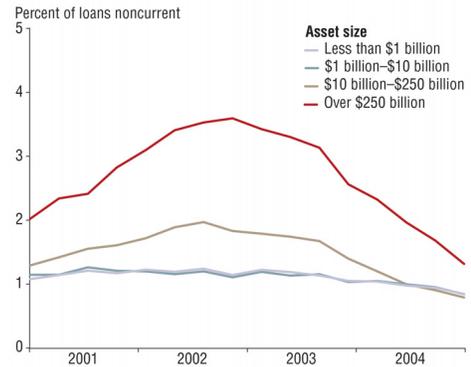
Loans Secured by Nonfarm, Nonresidential Properties



Commercial and Industrial Loans



Total Business Loans
(Nonfarm, nonresidential plus commercial and industrial)



NOTES: Data for commercial banks. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Loans charged off are net of recoveries. (Data revised February 2013.)

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