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The University of Southern Mississippi

The Future of Community Banks and Their Role in the Changing Economy

by

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Abstract

This paper is a survey of the current literature concerning community banks, the current challenges faced by community banks, and the role community banks play in the economy. Currently technological and regulatory changes are creating challenges for community banks. To combat these issues many community banks are increasing their merger and acquisition activity to avoid closing. This objective of this paper is to discuss the reasons community banks are so important to our economy and to define the hardships they are currently facing. It is also important to identify the next steps we should take to ensure the stability of community banks and how they will continue to play a role in the future. This paper will also give suggestions for future research in the community banking industry.

Key Words: Community banking, agency costs, cybersecurity, small business relationships, banking regulation

Table of Contents

List of Tables vi

Chapter 1: Introduction 1

Definition of a Community Bank..2

Chapter 2: The Current State of Community Banking 4

Community Bank Impact on Small Business and the Economy 4

Compliance and Regulation...6

Principal-Agent Problems in Community Banks 7

Community Banking Competition 8

Cybersecurity 11

Chapter 3: Conclusion...12

Suggestions for Future Research 12

References 14

List of Tables

Table 1: Summary of FDIC Research Definition of Community Banking Organizations 4

1. Introduction

Community banks are currently the most prevalent type of bank in the United States. According to a 2012 FDIC Community Baking study, in 2010, 94 percent of the 6,914 banking organizations were classified as community banks. Community banks are not as large as many non-community banks and often do not compete on the same scale as these banks because of their small size. In fact, community banks only account for 10 percent of total bank deposits in the United States (FDIC 2012). This is a staggering distribution of deposits between the smallest and largest banks in the United States. Because community banks hold such a small percentage of total banking deposits there is significantly less research conducted on community banking studies relative to non-community banking studies.

This objective of this paper is to give a comprehensive overview of community banking literature since the financial crisis of 2007-2008, and to suggest topics for future research. Currently community banks make up a very unique part of the banking industry and our economy. In many areas community banks are the only financial institution residents may have access to. The reason for this is that most non-community banks choose to operate in metro areas as opposed to rural areas. The absence of non-community banks in rural areas can lead to negative effects, which are accurately presented in a story about small, rural town in New Mexico. In March of 2014 the last bank in Harding county, New Mexico closed its doors (Domrzalski 2014). The closure of this community bank left the residents of this town 11 hours away from the location of where their deposits were being held in Las Vegas, Nevada. The residents were left to do their banking through automated teller machines (ATMs) left behind in Harding county. They no longer had the ability to

visit a physical branch to handle their personal finances. The difficulties that the residents of this town had to face demonstrates a need for community bank branches in communities lacking a non-community bank presence.

Lux and Greene (2015) estimated that if community banks were to disappear more than 16.3 million people would have limited physical access to mainstream banking services. While community banks may not always have a place in certain areas of the financial markets there will continue to be a need for relationship bankers. Beccalli and Frantz (2013) found that community banks have an advantage in that they can monitor their customers through personal relationships. They noted that larger banks, or community banks that have merged to become larger banks may lose that personal relationship with their customers, which is needed to make sound lending decisions.

1.1. Definition of a Community Bank

Community banks are commonly centered around communities, and a large percentage of community banks have all of their branches located within one to three counties. In 2011, 46 percent of 6,356 community banks had all of their offices located in one county, and another 36 percent had all of their offices located within two to three counties (FDIC 2012). Despite recent increases in the number of community bank branches, they still have fewer offices and a smaller footprint than most larger banks. Although, while they may have fewer branches, many community banks hold a dominant share of total deposits in the areas in which they operate.

The FDIC recognized that community banks are difficult to identify, so they provided some specific criteria a financial institution must meet to be considered a

community bank. Frequently community banks are simply defined as banks with total assets that are less than $1 billion. This can cause issues, however, because there are many smaller banks that do not operate as community banks. In turn, there are also larger banks that operate more like a community bank. Different organizations also classify community banks in different ways. For example, in some instances all banks under $10 billion in assets are considered community banks.

Community banks generally focus on what most people would call "normal" banking activities. They are known for their relationships with their customers and the surrounding community. As shown in table 1.1 there are a few different variables that the FDIC uses to define community banks. First, they exclude organizations with no core deposits, institutions with foreign assets greater than 10%, and institutions with more than 50% of assets tied up in specialty banks. Once all of those institutions are removed they then will look at the asset size of a bank and certain thresholds to determine if the bank is considered a community bank. If total assets are less than $1 billion, the bank is defined as a community bank. See Table 1.1 for more details on how to correctly identify community banks.

According to the 2012 FDIC Community Banking Study, the community banking industry has gone through many changes in the years since the financial crisis of 2007–2008 (FDIC 2012). Although the common opinion is that community banks have suffered since the financial crisis, the FDIC study found that they have been surprisingly resilient. The rate of mergers, acquisitions and failures among community banks has been far lower than non-community banks.

Table 1.1

Summary of FDIC Research Definition of Community Banking Organizations

Designate community banks at the level of the banking organization. All charters under designated holding companies are considered community banking charters.

Exclude:	Include:
Any organization with: - No loans or no core deposits - Foreign Assets ≥ 10% of total assets - More than 50% of assets in certain specialty banks, including: • credit card specialists • consumer nonbank banks[1] • industrial loan companies • trust companies • bankers' banks [1] Consumer nonbank banks are financial institutions with limited charters that can make commercial loans or take deposits, but not both.	All remaining banking organizations with: - Total assets < indexed size threshold[2] - Total assets ≥ indexed size threshold, where: • Loan to assets > 33% • Core deposits to assets > 50% • More than 1 office but no more than the indexed maximum number of offices.[3] • Number of large MSAs with offices ≤ 2 • Number of states with offices ≤ 3 • No single office with deposits > indexed maximum branch deposit size.[4] [2] Asset size threshold indexed to equal $250 million in 1985 and $1 billion in 2010. [3] Maximum number of offices indexed to equal 40 in 1985 and 75 in 2010. [4] Maximum branch deposit size indexed to equal $1.25 billion in 1985 and $5 billion in 2010.

Source: FDIC.

Source: FDIC Community Banking Study 2012

2. The Current State of Community Banking

2.1. Community Bank Impact on Small Business and the Economy

In the 2012 FDIC community banking study, it was noted that "[community bankers] have specialized knowledge of their local community and their customers." This gives them a unique advantage with local small business owners and the communities in which they operate. Often it is assumed that community banks are the only banks that can work with small businesses as opposed to non-community banks (Berger et. al. 2011). Another common assumption is that the disappearance of community banks would cause a severe negative effect on small businesses. In the recent past this may have been the case, however in recent years there has been a shift in small businesses looking to larger banks for banking needs as well (Berger et. al. 2014). According to the 2012 FDIC community banking study, "as of 2011, community banks held 14 percent of banking industry assets, but 46 percent of the industry's small loans to farms and businesses."

Some studies recently found that more small businesses are beginning to use larger banks for their general banking needs as opposed to community banks. Due to updated technologies such as small business credit scoring it is easier for small businesses to work with these larger banks, negating the need for a community banker (Berger et. al. 2009). Small business credit scoring allows for large banks to use statistical methods to predict future credit performance of small firms. The use of small business credit scoring has led many small businesses to utilize larger banks for their credit needs. This has made the existence of community banks less vital to the needs of small, local business owners. There is still a need for community banks in the agricultural, residential, and small business markets, but community banks are no longer the only type of bank that can service these types of loans (Lux and Greene 2015). These markets are still heavily influenced by community bank lending because the firms in these markets still have difficulties obtaining loans from non-community banks, despite the recent update in technologies.

In 2014 Berger et. al. conducted a study to see how the presence of smaller banks affects start-up firms during normal times as compared to times of crisis such as during the recent financial crisis. This study was completed using data for small, start-up firms for the years 2004-2009. They found that while small banks have an advantage in serving these small types of firms, that may not be the case during times of financial crisis. The results indicated that while the presence of small banks attributed to lower failure rates during normal times, these effects were not apparent during times of crisis. It was also found that small banks lend more to small firms than large banks, and this was especially true for information-intensive loan products, such as term loans and business lines of credit. Small

banks are more likely to fail during times of financial crisis than larger banks, and thus are more cautious of their lending activities during those times.

Rodriguez and Goodwin (2015) reaffirmed that there is still a place for community banks in small business lending. They defined the role of relationship banking in servicing small business loans and confirmed that it is still an advantage for community banks to have that ability when making lending decisions. Many small companies have inadequate financial information, leaving larger banks unable to use financial and credit analysis systems to reach a sound lending decision. The lack of adequate information leads to many small businesses being denied for loans. Community banks are able to use their relationship skills and their intimate knowledge of the local community to make these types of lending decisions.

2.2. Compliance and Regulation

Regulators should be aware of the adverse effects that increased regulation has on the community banking sector and their ability to do business. Increased regulation raises costs and can lead to merger activity. Merging is a way for community banks to cut costs because it decreases overhead and allows them to operate on a larger scale, but it can also harm them in the long run. As community banks grow larger they lose their ability to successfully conduct relationship banking, which is what gives many community banks their advantage over non-community banks.

Regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act have had some negative impacts on community banks. These regulations are causing community banks to spend a disproportionate amount of money hiring additional

compliance personnel to keep up with changes in regulation. Lux and Greene (2015) noted that this was causing many banks to become unprofitable as the fixed costs were too high. If these types of regulations continue to affect community banks they could result in an even greater drop in market share.

In 2012 the FDIC interviewed a sample of community bankers on the effects of regulatory compliance costs (FDIC 2012). They discovered in the interviews that it is not one specific regulation that the bankers felt had the greatest impact, but rather the accumulation of all regulations. Most of the interview participants expressed a need for the help of regulatory agencies to provide assistance when new regulatory changes come in to effect. The help of regulatory agencies could eliminate some of the need for costly outside assistance, and could potentially allow these banks to spend less on hiring new compliance personnel.

2.3. Principal-Agent Problems in Community Banks

In 2014 Amel and Prager determined that bank profitability was strongly correlated with the quality of management in community banks. The quality of management is influenced by many different factors. One of those factors is the level of control that management should have in a firm. Much research has been completed to try to determine the optimal level of control managers should hold in a firm. When managers gain too much control they often begin to maximize their own utility rather than the utility of the firm. This distinction leads to the commonly known principle-agent problem. Berle and Means (1932) were the first to introduce the principle-agent problem when they distinguished the separation between ownership and control of the firm. Often times the interests of the

manager and those of the firm do not align. Fama (1980) explained that when the goals of the manager (principle) are not in alignment with that of the firm (agent), agency costs begin to occur. Agency costs are a threat to small community banks and can lead them to failure if they are not properly monitored and managed.

Non-community banks that are actively traded are monitored by capital markets, which mitigate most agency costs created from managers. Many community banks are not actively traded and monitored, introducing the possibility for individuals to take advantage of the firm. It is not financially feasible for shareholders in community banks to actively monitor management of the firm, so it is often not done. This allows management to act more freely within these banks. In situations where there is little outside monitoring it is not uncommon for an owner-manager to become the majority shareholder of a community bank and install himself as CEO or President. When this happens in small community banks a complex principle-agent problem is created among the various shareholders (DeYoung et. al. 2001). Wheelock explained that banks that are poorly managed are prone to acquisition by a larger, more successful bank (2000). As explained by Schulze et al. (2001) private ownership and owner management reduce the effectiveness of external control mechanisms and can lead owners to make poor decisions. When a community bank fails the individuals that are harmed the most are the minority shareholders and taxpayers of the local community.

2.4. Community Banking Competition

The Uniform Financial Institutions Rating System is used by many bank regulatory agencies and is known to be an effective tool for evaluating commercial bank performance.

It is used by bank regulators in order to determine the likelihood a bank will fail and is based on the following five criteria: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk[1]. This system is commonly called the CAMELS rating system. Observing these five criteria allows for bank regulators to get a good overview of bank performance and presents the opportunity to spot the areas where a bank may be struggling. Each criterion is graded on a scale of 1 to 5, and are then compiled to give the bank a composite score on a scale of 1 to 5.

Amel and Prager (2014) study bank characteristics that mimic the variables studied in the CAMELS rating system to explain performance in community banks. The data is taken from 1992 to 2011 and is used to determine the relationship between community bank performance and certain selected characteristics of those banks. It was found that bank profitability is positively related to bank size. They also found that local economic conditions have significant effects on bank profitability and that the quality of bank management has a significant impact on profitability. This data was found to especially hold true during times of financial crisis.

Hays et. al. (2009) developed a model to differentiate between low efficiency and high efficiency community banks. To do this they developed proxies for the commonly used CAMELS rating system and tested data from 2006 to 2008. They used the efficiency ratio as a measure of bank performance. They then lay out a few important variables that community banks should pay attention to in order to stay competitive in the market and avoid failure. These main variables include return on assets, salaries to average assets, the

[1] Sensitivity to market risk is not always included in the CAMELS rating, and the inclusion of it has been controversial since it did not give an accurate measure of risk during the recent financial crisis. When this variable is omitted it is referred to as the CAMEL rating system.

liquidity ratio, the equity capital to asset ratio, loan charge-offs to loans, and a one-year GAP measure[2]. All of these variables line up closely with the variables applied in the CAMELS ratings used by regulators to determine the soundness of banks. This is significant information as community banks emerge from the recent financial crisis, and begin to make decisions about the future. As the competition with non-community banks becomes greater it is important for community banks to be aware of these important variables in order to avoid failure.

Technology has recently entered the banking industry and is affecting banks of all sizes, including community banks. The introduction of technology has made it easier for customers to conduct their business remotely. They are able to do this with new technologies such as automated teller machines (ATMs), online banking, mobile banking apps, etc. Although many researchers view improvements in technology a positive step for the community banking industry many are still not as advanced as non-community banks. Many customers have been leaving community banks and going to larger banks that can offer more personalized features. Customers are expecting services to be inexpensive and to be available to them at all times (Marinč 2015).

These new changes in technology are negating the need for branch banking, which in turn could potentially hurt relationship bankers at community banks who need that face-to-face interaction with their customers. In recent years, new technologies have been developed that are allowing larger banks to do business with smaller companies, similar to small business credit scoring. In the past this opportunity was not available to non-

[2] The one-year GAP measure is defined by the FDIC as a way to estimate how changes in rates will affect future income. GAP analysis helps to identify maturity and repricing mismatches between assets, liabilities, and off-balance sheet instruments.

community banks because they did not have the relationship skills needed to make sound lending decisions. Berger and Black (2011) found that "large banks have comparative advantages in using lending technologies based on 'hard' quantitative information." This advantage in using "hard" information allows these larger banks to have an advantage when lending to large firms. These larger firms are generally very transparent, meaning they have abundant financial information available to view and it is easy to determine their financial standing. On the other hand, these findings also depicted that small banks have an advantage when utilizing "soft" information, meaning their personal knowledge of the firm that cannot be found in financial statements. The "soft" skills that community bankers develop give them an advantage when lending to the smallest and least transparent firms.

2.5. Cybersecurity

Servidio and Taylor (2015) explored the issue of cybersecurity within community banks and discussed how important it has recently become for these banks to be actively aware of cyber threats. They noted that cyber threats may possibly be more of a threat to community banks than to larger banks because community banks are so intertwined with the community in which they operate. If there were to be a data breach at a community banks, this incident could harm an entire community and the safety of the bank. They went on to explain that community banks may have a more difficult time covering the costs of cyber crimes much more so than larger banks; for example, having to replace debit or credit cards can be costly if they are needing to be replaced for all customers. These costs could add up quickly for a community bank. The close relationships community banks hold with

their customers and the possible inability to cover costs in large cyber breaches makes it vital for community banks to have sound cyber security measures in place.

3. Conclusion

The current research on the Community Banking industry suggests that community banks play a unique and important role in our economy. That role is constantly evolving as new technologies and regulations come along, but currently there is still a great need for community banks. If community banks were to be removed or if they continue to have abundant merger activity a large group of individuals could be left without the necessary financial services to conduct small business and personal finance. In the years since the financial crisis of 2007-2008 until now there seemed to be a trend covering five main topics in community banking literature. Those five topics are as follows: the recent changes in small business lending, compliance and regulatory costs, the importance of upper management control, competition among community banks, and the impact of advancing technologies and cyber threats.

3.1. Suggestions for future research

Based on this survey of community banking literature it is clear to see that there are many areas of community banking research that are largely not studied. As found in the literature, community banks are a unique and important part of the banking industry and if they were to disappear it could have harmful effects on the economy. It will be important in the future to find more efficient ways for community bankers to handle the threat of new regulations and compliance costs. Many community banks do not have the funds to be able

to accommodate the amount of new regulations that have currently been affecting all banks. It would be helpful to see the specific ways that new regulations are helping and harming community banks. This could be done by comparing the relative costs of hiring new compliance personnel in community banks to non-community banks, and comparing this cost to total expenses in these banks. This would help to guide new regulations going forward, and to see the impact these regulations are actually making in community banks. The impact of cyber threats in community banks is also a topic that is not heavily studied, but will be affecting community banks significantly in the near future. This type of threat is relatively new to banking, but if we do not prepare community banks on how to handle these threats the effects could be very harmful. One suggestion is to observe the relative costs of a data breach to banks with a cyber security plan in place and banks without a plan for a cyber security breach. This would be helpful to see if current cyber security measures are adequately protecting community banks from these types of threats. Another possibility is to study the historical number of security breaches in community banks and to observe any types of cyber security measures that may have been in place during the breach.

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