
Remarks by Governor Mark W. Olson

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Community Bank Performance in the Twenty-first Century

A natural place to begin these remarks about the future of community banking is in the present, with a snapshot of where we are now. The year that just ended was one of record profits for the industry as a whole, and for community banks in particular. Community banks-- that is, those with assets of less than \$1 billion--earned \$12.5 billion, or 11.7 percent, on equity, an increase of 80 basis points over 2001. This past year was one in which commercial loan demand was very weak, and some of our largest banks stumbled. Community banks were able to adapt successfully to these conditions and made significant changes, in particular to their balance sheets. Low interest rates, strong home values and weak equity markets all had important roles to play.

Total assets of community banks grew 3.7 percent, about the same as 2001, after several years of declines or minor increases. Nearly all of this year's loan growth came in lending secured by real estate. Construction and other commercial real estate lending represented about two-thirds of that growth and rose more than 10 percent during the year. Loans drawn under home equity lines of credit grew nearly 25 percent.

Outside of the loan portfolio, real estate was an important story as well. Holdings of residential mortgage pass-through securities grew 20 percent in 2002, part of an interesting reversal in community bank balance sheet trends. Securities holdings increased in 2002 after eight consecutive years of decline, while total loans have declined only once over the same period (in 1998). Over the past two years, community bank holdings of mortgage pass-through securities have risen some 50 percent.

By and large, lending that is not secured in some fashion by real estate declined last year. Consumer loans declined nearly 9 percent, a bit faster than in 2001, while commercial and industrial loans were off very slightly.

Net interest margins rose slightly, to 4.29 percent, but remain about 25 basis points below levels that prevailed in the first half of the 1990s. Partly as a result of low interest rates and uncertainty in the stock market, Money Market Deposit Account (MMDA) and savings deposits grew 10 percent in both 2001 and 2002 and, at this point, fund nearly 25 percent of community bank assets. For the first time on record, these balances exceeded the volume of small-denomination certificates of deposit (that is, those under \$100,000), although some of the CD balances may have been transferred to money market or savings accounts.

Noninterest income overall remained at about 1.4 percent of assets, although up slightly (about 4 basis points) from 2001. Deposit growth overall also brought higher deposit account fees. Mortgage origination revenues were aided by the refinancing boom, although their beneficial effects were moderated by write-downs of servicing rights at those institutions with mortgage-servicing portfolios. Income from fiduciary activities--trust fees--

-also declined, attributable in large part to weakness in equity markets.

Problem credits remain elevated but, on the whole, manageable. Nonperforming assets continued to rise moderately, reaching 0.95 percent of loans at year's end. While significant, this figure is less than half the 2.46 percent ratio seen in 1992. Loan losses amounted to 40 basis points of loans, about the same as 2001. Provisions once again exceeded charge-offs, at 0.57 percent of loans, allowing loan-loss reserves to remain at about 1.45 percent of loans and about 2.0 times nonaccrual loans.

Although total assets rose during the year, 2002 also brought further consolidation in the number of community banks. At year's end, there were just under 7,500 community banks, down 200 from 2001 and some 3,600 from ten years earlier. There are indications that some mergers took place within banking groups with multiple bank subsidiaries in the wake of the Riegle-Neal Act as a step toward improved operating efficiency.

Vitality of the community bank franchise

As the financial results suggest, the community banking franchise remains vital and vibrant. It's worth talking about that for a minute. Consolidation is not the right or only measure of value in a community bank franchise. This value is better measured in economic terms, that is, by the flows of start-up capital and long-term financial returns on capital invested.

Over the past five years, for every three bank charters that have disappeared through consolidation, one new charter has been approved. These new charters require very tangible investment of investor capital. Since January 2000, some \$2 billion to \$2.5 billion has been invested in new bank charters.

As an important aside to the number of new banks, for some time 75 percent of all new charters issued have been state bank charters. In 2002, the ratio was still high, although closer to two-thirds. The dual banking system, which is such an important part of our financial heritage, continues to function well. Our nation's state banking commissioners can claim much of the credit for this result, having facilitated banks' interest in branching across state lines by developing home/host state bank supervision accords.

This influx of start-up capital reflects the longer-term financial success of community banking as a business model. Over time, return on equity for the bulk of community banks has been consistently high: Returns for the top 60 percent of community banks have exceeded 11 percent to 12 percent annually. As noted earlier, aggregate assets have been on the rise since 1998, and are now 5 percent higher than in 1992 even though there are significantly fewer institutions.

Strategic sources of this vitality

The basic business story behind this vitality is familiar. It is keyed to community banks' ability to attract deposits, draw upon natural lending opportunities, and leverage their connections with the community.

Community banks continue to thrive by providing retail-banking customers with the convenient locations, high-quality service, and attractive prices that they desire. Surveys conducted by the Federal Reserve Board indicate that the single most important factor

influencing a customer's choice of banks is the location of the institution's branches. In the 2001 Survey of Consumer Finances, approximately 43 percent of households report that the primary reason for choosing the institution where they have their main checking account is the location of the institution's offices. Likewise, data collected in the 1998 Survey of Small Business Finances indicate that, for approximately 30 percent of small businesses in the United States, the most important reason for selecting their primary financial institution is "location of offices" or "convenience." Consistent with these findings, responses to questions included in the Michigan Surveys of Consumers in June, July and August 1999 indicate that the most important reason households change banks is a household relocation.

Other important factors underlying household choice of banks include low fees or minimum balance requirements and the ability to obtain many services at one place. For small businesses, the existence of a prior business or personal relationship with the institution or someone affiliated with the institution is a frequently cited reason for choosing a particular provider.

Once a household has chosen a particular depository institution as the location for its main checking account, there is a strong tendency to stick with that institution. According to the Michigan Survey, the median tenure at a depository institution is ten years. The most frequently reported reasons for remaining with a bank are customer service and location. Among those households that changed banks for reasons other than household relocation, the most frequently cited factors are better customer service and more attractive prices.

These patterns of behavior among households and small businesses bode well for the future of community banking. They do not suggest that community banks face any inherent disadvantage relative to larger institutions when it comes to attracting and retaining retail customers.

Common sense, as well as the data, suggests that there isn't a single blueprint for a successful community bank. One idea that is commonly cited is that community banks are at a disadvantage in terms of operating efficiency and the ability to generate fee income.

Let's look first at operating efficiency and then define some terms. One measure of efficiency commonly used in the industry is the efficiency ratio, which compares the level of non-interest expense needed to support one dollar of operating revenue. A lower ratio thus indicates a more efficient bank. In comparing these efficiency ratios for all insured commercial banks in the United States between 1997 and 2001, some interesting results emerge.

One way of comparing these ratios across size categories is to look at the median bank in each category--that is, if you lined up all the banks in a size grouping from highest to lowest in terms of their efficiency ratios, the one that ends up in the middle of the list is the median. For our purposes, we can treat the middle bank as the typical bank in that group. The median efficiency ratio for larger banks--that is, those with more than \$5 billion in assets--ranged between 57 percent and 62 percent between 1997 and 2001. The median ratio for community banks indeed comes out higher, at between 60 percent and 67 percent. In

other words, by this measure, a typical community bank needs to spend 3 to 5 cents more than its large-bank counterpart to generate one dollar of operating revenue. That difference is material, but not overwhelming.

But that median is not the whole story. There is a wide range of efficiency ratios across the population of community banks, and many community banks are indeed not at a disadvantage at all. As a general proposition, some 40 percent of community banks have efficiency ratios that match or fall below that of the typical large bank. The top 10 percent of community banks are extremely efficient, with efficiency ratios generally well below 50 percent, and the best one-third of community banks are well below 60 percent.

All of this suggests that many community banks are as efficient as a typical large bank, and that any efficiency advantage that large banks may have over others may not be that large. Efficiency measures like this do not take account of other key elements of a business strategy, including service quality and the level of customer attention, which have proved to be key advantages for community bankers.

Efficiency measures across the industry improved significantly in the year just ended, because of a change in accounting practice that ended amortization of goodwill. Interestingly, efficiency ratios did not improve nearly as much for community banks as they did for large banks.

One also hears the claim that large banks are better able to generate fee income than community banks and that this ability puts smaller banks at a competitive disadvantage. There is some evidence that bolstering fee income is related to profitability. The top 20 percent of community banks in terms of profitability generate nearly 40 percent of their revenues from fee income, twice the level of other community banks. Nonetheless, based on the profitability figures cited earlier, it is not at all clear that a community bank needs to dramatically build noninterest revenue to be quite successful. Fee income at the remaining 80 percent of community banks consistently represents about one-fifth of total revenue within all but the top profitability stratum, and that includes a very large number of quite profitable institutions.

Protecting the community banking franchise

A healthy business franchise does not guarantee financial success, nor does it ensure a safe and sound banking system. From either perspective, it is important that community bankers continue to protect the value of their franchise by avoiding key missteps we have seen in the past. Let me offer you a bit of a bank supervisor's perspective in that regard.

With market yields at long-term lows and with a relatively steep yield curve, community banks need to keep a watchful eye on interest rate risk issues. Long-term residential mortgage lending comes immediately to mind. I noted earlier the remarkable recent growth in community bank holdings of mortgage pass-through securities. Direct one- to four-family and indirect holdings of one- to four-family mortgage loans as a share of the community bank balance sheet has remained fairly stable for a decade at around 20 percent of assets, but there is evidence that some institutions have sought to extend maturities to take

advantage of the steep yield curve. Those institutions active in mortgage servicing have found their servicing rights have lost significant value with the surge in refinancings.

Most of the loan growth at community banks over the past two years has been in the form of commercial real estate lending--that is, lending secured by nonfarm nonresidential properties, construction projects, and multifamily units. Commercial real estate lending at year-end 2002 reached almost 22 percent of aggregate community bank assets. That's 6 percent higher than five years ago and the highest degree of concentration on record--yes, even higher than in the early 1990s. This increase appears to be fairly widespread across the population of community banks, both at highly profitable and at less-profitable institutions. There are anecdotal indications that some portion of that growth may reflect conversion of unsecured C&I loans to secured loans in response to deterioration in the borrowers' condition, although it is not likely that this effect is very large.

Commercial real estate lending is a normal and natural part of the community banking business, and underwriting practices are much better than in the 1980s. For both reasons, there is no indication at this time that the overall credit quality of community bank commercial real estate exposures has deteriorated. That said, there are a number of markets nationwide that have experienced weakness in recent years, and many of these markets will take some time to recover. Management and supervisors will need to monitor further developments in this area closely.

More generally, a critical "franchise" issue for community bankers has been recognizing and managing credit risk concentrations that also tend to be a natural part of the community banking business. When credit quality problems emerge at an institution, they of course bring lower returns and more attention from your friendly bank supervisors. The presence of lending concentrations means that such problems can develop both more quickly and more broadly across a pool of borrowers.

Successful management of concentrations requires adherence to good credit fundamentals. There have been important advances in the measurement and management of credit risk that community bankers should probably take a good look at in the coming years. There are no magic bullets here, of course, but community bankers may find that these advances provide useful tools and concepts that reinforce systematic and objective risk assessment in the credit management process.

Strong capital ratios, well in excess of regulatory minimums, have also been a key to managing credit concentrations and, indeed, a striking attribute of the most profitable community banks. The top one-fifth of community banks, in terms of profitability, typically holds 1.6 percentage points more capital relative to assets than other community banks.

With the growth in assets and lending opportunities come potential complications with liquidity management. Assets have grown more rapidly than lower-cost nonmaturity deposits over time among community banks and across the industry, a trend that was only modestly reversed in 2002 by the balloon in MMDA and savings deposits. Among other factors, this trend has contributed to narrowing margins over the past few years. The relative

stability of these nonmaturity deposits has been an important strength to community banks. Conversely, there have been too many instances where rapidly growing banks face unexpected liquidity pressures as they come to rely more heavily on noncore funding sources. Careful planning of growth and funding needs is a key aspect of sound management and requires the appropriate degree of management attention.

Let me also make a brief cautionary note about the importance of good internal controls and the need for management attention to their upkeep. This is simply good business practice, of course, but it's more than that. You may recall that a provision of the FDIC Improvement Act of 1991 required that the management of banks--including many community banks--report on the quality and integrity of internal controls and that auditors attest to this. Unfortunately, in several recent examinations, bank examiners were able to identify clear internal control weaknesses that neither the banks' own processes nor outside auditors had noted. Some of these weaknesses raised safety and soundness concerns. Much more progress needs to be made in this area, and we will be following this matter closely in the coming months.

Conclusion

Community banking has a long history of strength and success and a bright future. The past year was a good one for community banks. Once again the vitality and adaptability of the community banking franchise were amply demonstrated. It is important that community bankers stay closely attuned to current and emerging risk issues, and that they explore further advances in risk-management practice in ways that are consistent with their basic business practices and the core