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Changes in the World of Small Community Banks

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Market Report	Year Ago	4 Wks Ago	1-27-17
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	132.00	NA	NA
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	198.24	NA	159.85
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	165.76	NA	134.77
Choice Boxed Beef, 600-750 lb. Carcass.	226.24	NA	192.09
Western Corn Belt Base Hog Price Carcass, Negotiated	51.55	NA	65.14
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	69.65	NA	82.06
Slaughter Lambs, wooled and shorn, 135-165 lb. National.	143.71	NA	NA
National Carcass Lamb Cutout FOB.	359.79	NA	345.37
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	3.93	NA	2.88
Corn, No. 2, Yellow **Columbus**, bu.	3.33	NA	3.14
Soybeans, No. 1, Yellow **Columbus,** bu.	8.21	NA	9.23
Grain Sorghum, No.2, Yellow Dorchester, cwt.	5.48	NA	4.87
Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.66	NA	2.96
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	250.00	NA	145.00
Alfalfa, Large Rounds, Good Platte Valley, ton.	82.50	NA	70.00
Grass Hay, Large Rounds, Good Nebraska, ton.	85.00	NA	67.50
Dried Distillers Grains, 10% Moisture Nebraska Average.	134.50	NA	67.50
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	51.50	NA	42.00

*** No Market**

Community banks hold a traditional position in financial intermediation. These provide banking services to customers, consumers and small businesses, all within "local" proximity to the bank. They're also more likely to be privately owned than much larger banks. Local ownership provides a strong incentive to management to balance stakeholder concerns relative to the demands of capital markets. Community banks are categorized, based on asset size, by the Federal Deposit Insurance Corporation as having $10 billion, or less, in assets.

Small community banks, those with $1 billion or less in assets, are most likely to retain the original community bank conceptual rationale of relationship banking. Larger pools of depositors or greater numbers of branch locations tend to dissipate the informational advantages of the local geography served by the community bank. Community banks are often found in areas that are underserved by traditional financial service organizations. The realization of this rationale in the banking market makes small community banks the most common size of bank within the industry; approximately 90 percent of U.S. community banks fit this description today.

Despite their popularity, national banking data from 1992 forward shows a consistent decline in the number of banks in general and community banks in particular. A maximum of approximately 14,000 community bank entities existed nationally in 1992; 6,100 community banks were operating on December 31, 2015, with 5,400 of these institutions being categorized as small. There were 164 community banks operating in Nebraska as of the end of 2015; 158 of which were small banks. Since 1992, an average of 344 small community banks ceased to exist.

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each year across the country; approximately 4.0 percent of the small community bank population is removed annually. Given the original rationale for community bank formation as a source, and sometimes the only source, of credit to consumers and small business customers within a specific location or area, it is important to examine the causes for this change.

Responses of small community banks to technological innovation, new regulation, and macroeconomic changes explain the trend in bank numbers. Innovations in credit scoring and leasing affect the ability of large banks to attract new customers. One way to observe this is the change in mean distance between borrower and lender. There was almost no change in this distance in the 1990s but a substantial increase in mean distance has begun to appear more recently. Policy innovations, such as the Community Reinvestment Act (1995) and Gramm-Leach-Bliley Act (1999), facilitated bank consolidation and accelerated the displacement of small community lenders, at least in the home mortgage market. Finally, changes in the economic diversification of local economies over time, and changes in population and income, affect the credit risk associated with the geographic concentration of small business lending.

Small community banks have modified their depository and lending activities in response to these. The most recent year for which financial data are available for many of the banking and macroeconomic variables needed for analysis of this trend is 2014, a period of recovery after the Great Recession. The number of small community banks continued to shrink, declining 26 percent between 2010 and 2014. An average small community bank had asset decreases(-12.9%), deposits declined (4.1%), while net income (-42.5%) and loans (-17.9%) declined respectively when compared with 2010. On average, loans comprised 65.8 percent of total assets for small community banks as compared with 89.2 percent for all large banks, a steadily widening gap between the small community banks and larger institutions. The prominence of real estate liabilities in loan portfolios for community banks in 2014 remained steady (76.2%), and the volume of first mortgages as a fraction of loans changed only slightly (30.9%). Credit card loans remained steady at 0.25 percent, and business loans declined to 12.8 percent of loans.

The changes in the distribution of loan products are related to how well a small community bank can use its inputs (buildings, employees, etc.) to create outputs (loans, etc.). We say that a bank X is more efficient than bank Y if the total size of the "pie" enjoyed by the users and owners of these banks is larger under X than it is under Y. Using the banking and macroeconomic data described previously, one can measure how asset size affects small community bank efficiency and how changes in efficiency are related to the types of products they offer. Data from the 2009-2014 period show the average efficiency of small community banks declines as its asset size increases. In other words, as small banks approach $1 billion dollars, they generate fewer outputs, for the same amount of inputs, as much smaller banks. This finding indicates that as community banks increase their asset base they become less able to convert deposits into loan products. The macroeconomic variables that affect this the most are population, per capita income, and unemployment rates within the local trade area. Conditions internal to the bank also affect this, including loan portfolio quality, the fraction of assets held as loans, quantity of capital reserves, and the fraction of deposits currently loaned.

Analysis of these variables indicates that the changing demographic landscape where many community banks operate affects the growth of the small bank. There may be limited growth opportunities unless there is a merger or acquisition strategy that can further alter the community bank model. These local markets are more subject to limited expansion opportunities and more dependent upon stable employment within the trade area. The consequences for small community banks are that they tend to lag behind larger community banks, and other large banks, when considering residential loans, individual consumer loans, commercial business loans and agricultural lending. As a result, smaller community banks have typically lost market share faster than larger community banks due to their inability to convert assets into effective loan products.

The implications of these results strengthen the importance of community bank managers being aware of customer needs and requirements so they can design product offerings that take advantage of the local information asymmetries. This in effect will extend the concept of relationship banking within the market that exhibits change and market shifts. Bank managers should strategically present products that will allow the customer relationship model to be enhanced and sustained. This approach can be implemented while larger competitors may not adopt the customer affiliation role formed by long standing community awareness.

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