**Growth and Competition Outlook for Community Banks**

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**Introduction**

The role of community banks in funding small and medium enterprise growth is well known. Whether in large markets with many competitors or small markets with few, community banks play a unique role that is unmatched in any other developed economy. Unfortunately, since the financial crisis, community bank numbers have shrunk dramatically because of both the slower than normal recovery and the impact of increased regulatory and compliance burdens resulting from Dodd-Frank. For example, between 2010 and 2017, only 12 new charters were approved compared to 254 new charters between 2002 and 2009. Since 2008, the number of banks shrunk from slightly over 7,000 in 2008 to about 5,000 by the end of 2017 ([FDIC Historical Statistics on Banking](https://www5.fdic.gov/hsob/HSOBRpt.asp)). Most of this shrinkage occurred with community banks where the number of banks with assets below $1 billion declined by almost one-third from 6,315 as of Dec. 31, 2009 to 4,300 as of Dec. 31, 2017.

A number of recent articles addressed this competitive dynamic. Lux and Greene (2015) discuss the plight of community banks noting the declining market share in key markets, a decrease in small business lending, and incurrence of disproportionate losses.[[2]](#footnote-2) These outcomes are partially attributed to technology and regulation, where they not the complex and uncoordinated actions of regulators have created an uneven playing field for small banks. An article in the *Economist* (2017) provides examples of several community banks responding to these forces.[[3]](#footnote-3) Although decreasing market share through mergers and acquisitions is generally viewed as bad for small banks, Kravitz and Pogash (2018) look at the competitive effects of megabanks on community banks and find that entrance of large banks has a positive effect on small banks.[[4]](#footnote-4)

The National Survey of Community Banks can provide insight into how this change in market structure has affected competition and growth opportunities for community banks. The survey asks banks to identify current primary competitors across product lines as well as expected future primary competitors. Recent income and balance sheet growth rates are calculated and related to market structure. Also included in the survey are questions on planned exit and merger activity that are related to the economic health of local markets, trend in local market deposit share, bank profitability, regulatory cost burden, and future competitive threats across all product lines.

**Who is the Competition?**

Chart 1 provides a current competitive profile for different loan products while Chart 2 shows where community banks foresee future competition. Only for small business loans are other small banks more frequently reported by over half the respondents as the primary competitor. Community banks face a range of competitors for mortgages, especially residential. Other small banks and mid-size banks are the most frequently reported competitor for commercial real estate, while competition for residential mortgages comes from other small banks mid-size banks, credit unions and other non-depository institutions (most likely mortgage banks such as Quicken). The Farm Credit Banks are the predominant competitor for agriculture loans and credit unions for consumer loans.

Chart 2 illustrates some notable changes across product lines for expected future competition. Looking ahead, other small banks become a less important competitor across all loan product lines. The biggest change was in the category of small business loans, the product where they historically have had a strong comparative advantage. Looking ahead, 38 percent consider other small banks as the primary future competitor versus 54 percent today. Perhaps the most important change is the emergence of fintech firms as a competitor for small business loans (0 percent to 7 percent), residential mortgages (4 percent to 13 percent) and consumer loans (2 percent to 14 percent).



**Uneven Growth Across the Country**

Loan growth, core deposit growth and net income growth are critical metrics for the health of commercial banks. Table 1 (Core deposit growth), Table 2 (Loan growth), and Table 3 (Net interest income growth) show the differences across regional economies and the impact of population growth. In Table 1 core deposit growth in the Districts 4 and 5 is more frequently reported in excess of 5 percent, while District 2 banks more frequently report core growth below 2%.

**Table 1: CORE DEPOSIT GROWTH by CENSUS REGION**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Core Deposit Growth | District 1 (Northeast) | District 2 (Midwest) | District 3 (South) | District 4 (Plains) | District 5 (West) | All Banks |
| <-1.5% | 11% | 33% | 27% | 22% | 8% | 20% |
| -1.5% -2% | 13 | 42 | 17 | 23 | 5 | 22% |
| 2% - 5% | 18 | 42 | 19 | 17 | 13 | 19% |
| 5% - 10% | 15 | 24 | 17 | 32 | 12 | 17% |
| 10% + | 8 | 19 | 22 | 35 | 15 | 22% |
| All Banks | 13% | 32% | 21% | 26% | 9% | 100% |

In Table 2, loan growth below 1 percent is more frequently reported by banks in District 2 but more frequently reported in excess of 15 percent in Districts 3 and 5. Banks in District 5 also more frequently reported net interest income growth greater than 15 percent. Slower net interest income growth is more frequently reported by banks in District 2 and 4 (Table 3, see Table A for more detail). No association was found between any of the growth measures and rural versus urban location.

**Table 2: LOAN GROWTH by CENSUS REGION**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Loan Growth | District 1 (Northeast) | District 2 (Midwest) | District 3 (South) | District 4 (Plains) | District 5 (West) | All Banks |
| < 1% | 5% | 41% | 12% | 32% | 11% | 19% |
| 1 - 5% | 14 | 40 | 18 | 21 | 7 | 7% |
| 5 - 10% | 19 | 27 | 25 | 25 | 4 | 18% |
| 10 - 15% | 14 | 36 | 19 | 24 | 7 | 33% |
| 15% + | 9 | 15 | 29 | 29 | 17 | 32% |
| All Banks | 13% | 32% | 21% | 26% | 9% | 100% |

**Table 3: NET INTEREST INCOME GROWTH BY CENSUS REGION**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| NII Growth | District 1 (Northeast) | District 2 (Midwest) | District 3 (South) | District 4 (Plains) | District 5 (West) | All Banks |
| < 2.5% | 5% | 45% | 20% | 28% | 2% | 19% |
| 2.5- 5% | 10 | 52 | 20 | 16 | 1 | 15% |
| 5 - 10% | 16 | 32 | 19 | 26 | 7 | 31% |
| 10 - 15% | 19 | 23 | 19 | 28 | 11 | 18% |
| 15% + | 9 | 14 | 25 | 29 | 23 | 17% |
| All Banks | 13% | 32% | 21% | 26% | 9% | 100% |

Balance sheet and income growth show a strong association with bank size (Tables 4 and 5). The smallest banks (under $200 million) show slower growth in core deposits, loans and net interest income while the larger banks (over $800 million) more frequently report higher growth rates. More sophisticated analysis reveals that the regional effects documented above are really bank size effects dominated by small banks in District 2 states and larger banks in District 1 and 5 states.

**Table 4: LOAN GROWTH by ASSET SIZE**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Loan Growth | < $100 million | $100-200 million | $200-400 million | $400–800 million | Over $800 million | All Banks |
| < 1% | **36%** | **28%** | 22% | 7% | 7% | 19% |
| 1 - 5% | 15 | 24 | 22 | 18 | 21 | 7% |
| 5 - 10% | 13 | 23 | 17 | 26 | 20 | 18% |
| 10 - 15% | 17 | 14 | 30 | 16 | **23** | 33% |
| 15% + | 17 | 17 | 28 | 17 | **23** | 23% |
| All Banks | 20% | 22% | 23% | 17% | 18% | 100% |

**Table 5: NET INTEREST INCOME GROWTH by BANK ASSET SIZE**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| NII Growth | < $100 million | $100-200 million | $200-400 million | $400-800 million | Over $800 million | All Banks |
| < 2.5% | **30%** | **28** | 24% | 9% | 9% | 19% |
| 2.5- 5% | 25 | 25 | 19 | 19 | 13 | 15% |
| 5 - 10% | 17 | 23 | 21 | 21 | 18 | 31% |
| 10 - 15% | 16 | 14 | 26 | 20 | 23 | 18% |
| 15% + | 11 | 22 | 24 | 15 | **28** | **17%** |
| All Banks | 20% | 22% | 23% | 17% | 18% | 100% |

**Merger and Acquisition Activity Related to Financial Health**

Banks with limited organic growth opportunities or those with loan growth exceeding core deposit growth may look for opportunities to buy another franchise. Conversely banks with limited opportunity for loan growth and/or high operating expenses attributable to increased regulatory costs since the Great Recession may be looking to sell.

Twelve percent of the banks reported considering an offer to sell while 18 percent made an offer for another bank in the past 12 months. Motivations varied for banks to consider such a significant action as shown below in Charts 3 and 4. For potential acquisitions, achieving economies of scale was reported as important or most important by 81 percent of the acquiring banks. For potential sales, overall cost of doing business and the costs of dealing with regulations were the most important reasons with over 70 percent reporting important or very important for each.

Tables 6a, 6b and 6c show that reported offers to buy occur more frequently among banks above $400 million, core deposit growth above 5 percent and loan growth above 5 percent. Offers to sell tend to be reported more frequently among smaller banks (although the effect is not as strong as with offers to sell) but not related to relatively poorer loan and core deposit growth.

**Table 6a: OFFER TO SELL/BUY by ASSET SIZE**

|  |  |  |  |
| --- | --- | --- | --- |
| Assets | Offer to Sell | Offer to Buy | All Banks |
| < $100 million | 16% | 0% | 20% |
| $100-$200 million | 15 | 17 | 22% |
| $200-$400 million | 15 | 17 | 23% |
| $400-$800 million | 6 | 26 | 17% |
| $800 million + | 7 | 33 | 18% |
| All Banks | 12% | 18% | 100% |

**Table 6b: OFFER TO SELL/BUY by CORE DEPOSIT GROWTH**

|  |  |  |  |
| --- | --- | --- | --- |
| Core Deposit Growth | Offer to Sell | Offer to Buy | All Banks |
| <-1.5% | 11% | 11% | 20% |
| -1.50%-2.0% | 9 | 8 | 22% |
| 2% - 5% | 10 | 19 | 19% |
| 5% - 10% | 15 | 26 | 17% |
| 10% + | 18 | 28 | 22% |
| All Banks | 12% | 18% | 100% |

**Table 6c: OFFER TO SELL/BUY by LOAN GROWTH**

|  |  |  |  |
| --- | --- | --- | --- |
| Loan Growth | Offer to Sell | Offer to Buy | All Banks |
| < 1% | 12% | 10% | 19% |
| 1 - 5% | 12 | 14 | 7% |
| 5 - 10% | 11 | 18 | 18% |
| 10 - 15% | 9 | 23 | 33% |
| 15% + | 13 | 32 | 23% |
| All Banks | 12% | 18% | 100% |

The effect of profitability on plans to buy and sell are shown in Tables 7a and 7b. Current profitability as measured by ROA shows a positive association for offers to buy with more frequent reports of offers to buy from banks with a six-month ROA above 0.6%. Offers to sell however, show no strong association with ROA. However, offers to sell do show a stronger association with reports of higher ratios of regulatory expenses to total non-interest expense for 2017, especially in the 12.5%-20% category.

**Table 7a: OFFER TO SELL/BUY by CURRENT ROA**

|  |  |  |  |
| --- | --- | --- | --- |
| ROA | Offer to Sell | Offer to Buy | All Banks |
| <.30% | 11% | 11% | 15% |
| .30% - .45% | 9 | 8 | 22% |
| .45% - .60% | 10 | 19 | 24% |
| .60% - .75% | 15 | 26 | 18% |
| .75% + | 18 | 28 | 21% |
| All Banks | 12% | 18% | 100% |

**Table 7b: OFFER TO SELL/BUY by REGULATORY EXPENSE**

|  |  |  |  |
| --- | --- | --- | --- |
| Regulatory Expense/Total | Offer to Sell | Offer to Buy | All Banks (25% missing) |
| < 5% | 9% | 19% | 21% |
| 5 – 7.5% | 13 | 20 | 18% |
| 7.5 – 12.5% | 10 | 20 | 23% |
| 12.5 - 20% | 22 | 17 | 21% |
| 20% + | 16 | 14 | 17% |
| All Banks | 12% | 18% | 100% |

And finally, the emergence of fintech as a competitor across lending products might be a reason to sell is shown in Table 7c. However, both the banks considering an offer to sell and those considering an acquisition more frequently reported fintech as a future competitor across lending product lines.

**Table 7c: OFFERS TO SELL/BUY by THREAT OF FINTECH COMPETITION**

|  |  |  |  |
| --- | --- | --- | --- |
| Report Fintech as Future Competitor | Offer to Sell | Offer to Buy | All Banks |
| No | 11% | 16% | 76% |
| Yes | 17 | 23 | 24% |
| All Banks | 12% | 18% | 100% |

Fintech will undoubtedly continue to increase its market share of the financial services industry as technology improves the safety and performance of online activities and as the quality and depth of information about consumers and firms improves. It will increase the competitiveness in the financial sector, to the benefit of customers and is available to existing financial institutions as well as new institutions.

**Conclusion**

The source of competition reported by community banks in the 2018 survey varies by product line. Other small banks are most frequently reported as the current competition for small business loans, while farm credit is the most frequently reported competitor for agricultural loans and credit unions for consumer (non-mortgage) loans. Looking ahead, fintech’s importance as a competitor increases for small business lending, residential mortgage and consumer loans.

Growth in core deposits, loans and net interest income showed an uneven patter across the country but surprisingly was not related to MSA, a significant factor for explaining economic growth, especially since the great recession. The smallest banks appear to be most associated with slowest growth whether in MSA or non-MSA locations.

Merger and acquisition activity is reported by a small number of the respondents: 12 percent reported seriously considering an offer to sell while 18 percent made an offer for another bank in the last 12 months. The buyers tended be larger banks and the sellers smaller banks. The incidence of reporting was independent of growth or profitability but more closely related to regulatory expense and the emergence of fintech as a competitor across product lines.

1. This work was supported by the Conference of State Bank Supervisors. We are grateful for expert research assistance from Kyle Zhong and for helpful conversations with Michael Stevens and James Cooper at the CSBS. [↑](#footnote-ref-1)
2. The State and Fate of Community Banking, 2015. Marshall Lux and Robert Greene. M-RCBG Associate Working Paper Series (No. 37). [↑](#footnote-ref-2)
3. American’s Community Banks Hope for Lighter Regulation. (June 1, 2017). [↑](#footnote-ref-3)
4. The Competitive Effects of Megabanks on Community Banks, 2018. Troy Kravitz and Jonathan Pogash. Working paper. [↑](#footnote-ref-4)