Chapter 2: Structural Change Among Community and Noncommunity Banks

The decline in the number of banks that began in 1986 continued through 2019. Between year-end 2011 and year-end 2019, the number of banks dropped from 7,357 to 5,177, representing a decline of 30 percent. Among community banks, the number fell from 6,802 to 4,750; among noncommunity banks, the number fell from 555 to 427.

The drivers of net consolidation, however, shifted after 2011. As described in the 2012 FDIC Community Banking Study, a major cause of consolidation in the preceding two decades was bank failures, due mainly to the banking and thrift crises of the late 1980s and early 1990s and then to the financial crisis of 2007–2008 and the ensuing Great Recession. But as the effects of the Great Recession subsided and the economy transitioned into a slow recovery followed by expansion, the number of failures declined.

Nevertheless, the average rate of net consolidation continued to rise (Chart 2.1). The largest component of consolidation identified in the 2012 Study—voluntary mergers between unaffiliated institutions—increased as the economy recovered and expanded. At the same time, the rate of mergers between institutions within a holding company declined. Finally, new bank charters became less common, meaning there were few new institutions replacing those that merged, consolidated, or failed.

At the time the current study was being prepared, the COVID-19 pandemic had not significantly affected the rate of consolidation, although it ultimately may. Box 2.3 at the end of this chapter contains an overview of the pandemic's potential effects on consolidation.

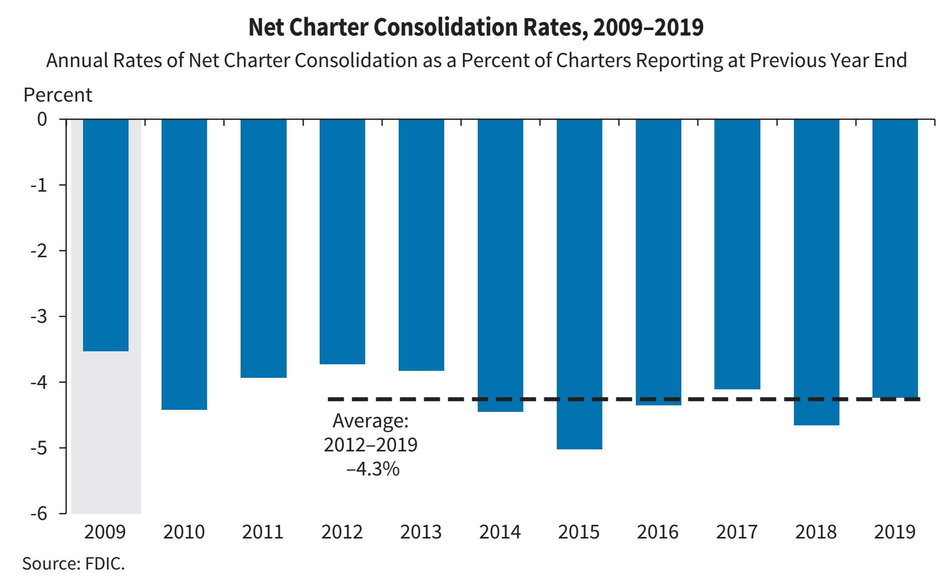
The Largest Components of Charter Consolidation Between 2011 and 2019 Were Failures, Voluntary Mergers, and New Charters

Charter consolidation is the sum total of failures, voluntary mergers, new charters, and other voluntary closings.

Rates of Failure Declined

The merger booms of both the 1990s and the years following the Great Recession came close on the heels of periods of economic and financial disruption, particularly the disruption constituted by the banking crisis from approximately 2008 through 2013. The financial crisis had begun late in 2007, was quickly followed by the Great Recession, and roughly a year after the onset of the financial crisis the number of bank failures began increasing (Chart 2.2). But in 2011 the failure rate started declining, and by 2012 most of the failures associated with the financial crisis and Great Recession had occurred.

Chart 2.1



Source: FDIC.
Note: Gray bar indicates recession period.

Chart 2.2

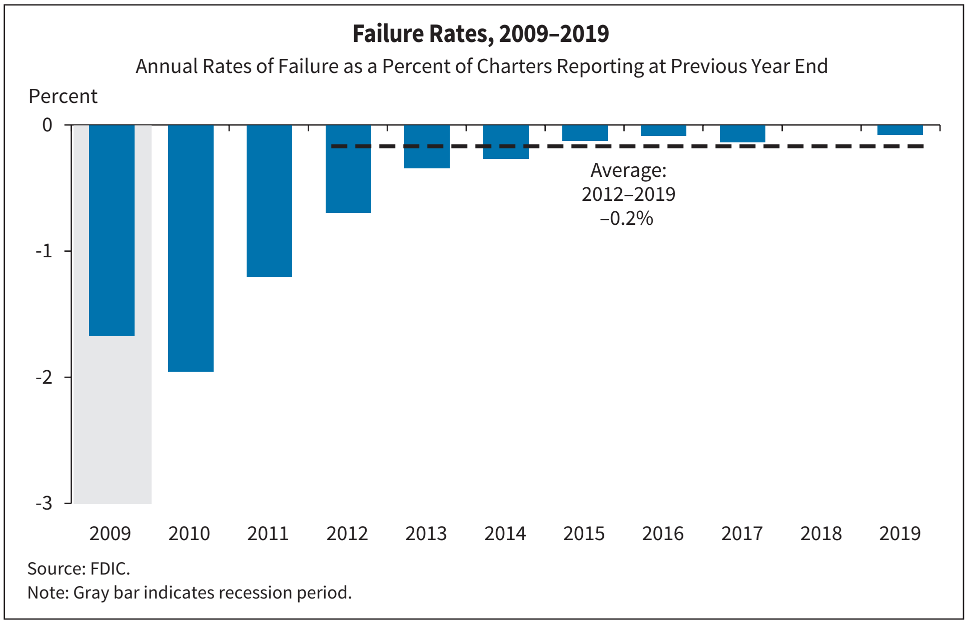
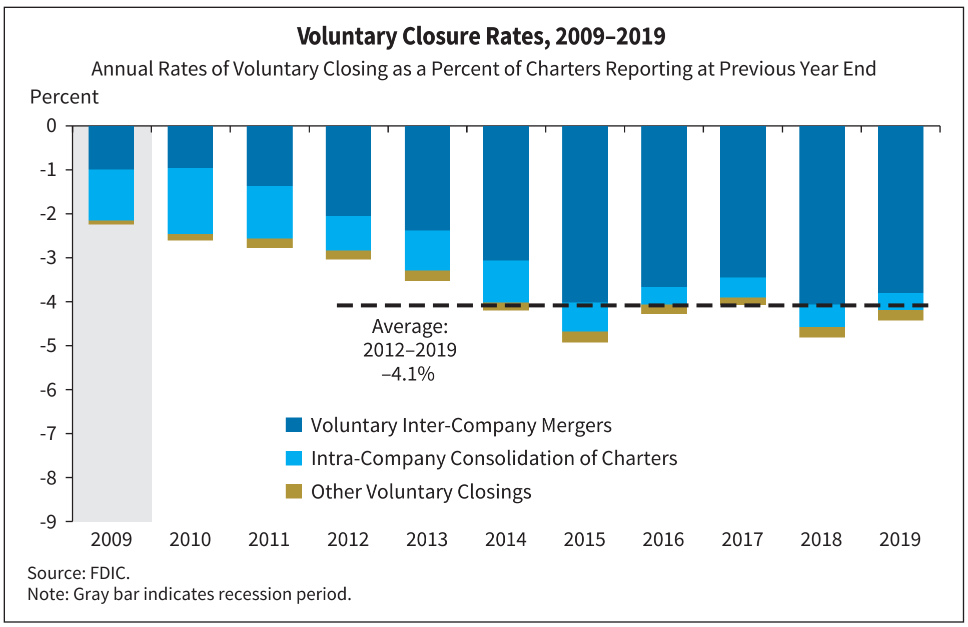


Chart 2.3



As the lingering effects of the recession wore off and economic expansion took hold, the failure rate continued to decline as failures became a much less important factor in charter consolidation. Between 2015 and 2019, only 25 institutions failed. In 2010, at the peak of the banking crisis, 157 banks failed.

Voluntary Merger Rates Increased

Starting in 2011, rates of voluntary mergers rose to levels not seen since the previous merger boom, in the 1990s (Chart 2.3). Many of the earlier mergers, however, particularly those occurring through 2000, were between separately chartered institutions that were owned by the same holding company—that is, they were *intra*-company mergers.[1] Starting in 2011, mergers were more likely to

[1] The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 removed many of the restrictions banks faced if they wished to open a branch in a different state than the one in which they were headquartered. To the extent holding companies maintained separately chartered banks to comply with interstate banking restrictions, the Act rendered the separate charters unnecessary and facilitated their combination.

occur between unaffiliated institutions—that is, they were *inter*-company mergers.

Inter-company mergers reduce the number of genuinely independent institutions. Although intra-company mergers reduce the number of chartered banks, because the merging banks are owned by the same holding company, such mergers can be thought of as combining separate divisions of a single company rather than mergers of distinct companies.

Although between 2011 and 2019 unaffiliated (inter-company) mergers constituted most merger activity among insured institutions, the rate of such mergers did not reach or exceed its previous peak. Between 1994 and 1999 the annual average rate for inter-company mergers was 3.6 percent, with a peak of 4.4 percent in 1998, but in the period after 2011, the annual merger rate for unaffiliated institutions did not again reach 4.0 percent until 2014, and it did not reach 4.1 percent until 2018.

In the meantime, mergers between charters within the same holding company dwindled as most had already consolidated their banks. A comparison of average merger rates for the two types of mergers shows that between 1985 and 2011, the unaffiliated merger rate averaged 2.3 percent of institutions per year, but 3.3 percent per year in the period since 2011. In contrast, the intra-company merger rate averaged 1.5 percent per year between 1985 and 2011, but only 0.6 percent per year between 2012 and 2019.

A new type of voluntary merger occurred in 2012, when for the first time a bank was acquired by a credit union. Between 2012 and 2019, 39 community banks were either acquired or were pending acquisition by 34 unique credit unions, compared with approximately 1,750 community banks that were acquired during this period by other banks. For more information on the acquisition of community banks by credit unions, see Box 2.1.

Box 2.1 The Acquisition of Community Banks by Credit Unions

Historically, credit unions and banks coexisted, offering similar services but with distinct business purposes. Although credit unions may have been viewed as competitors, they focused on a specific field of membership.[a] Mergers and acquisitions did not occur until 2012, when the first "purchase and assumption" of a bank by a federal credit union was completed.[b]

Credit unions continued to acquire banks after 2012, but the number of banks acquired by credit unions pales in comparison with the number of banks acquired by other banks over the same period. In the years since that first acquisition in 2012 through 2019, a total of 39 acquisitions of community banks by credit unions were completed or were pending.

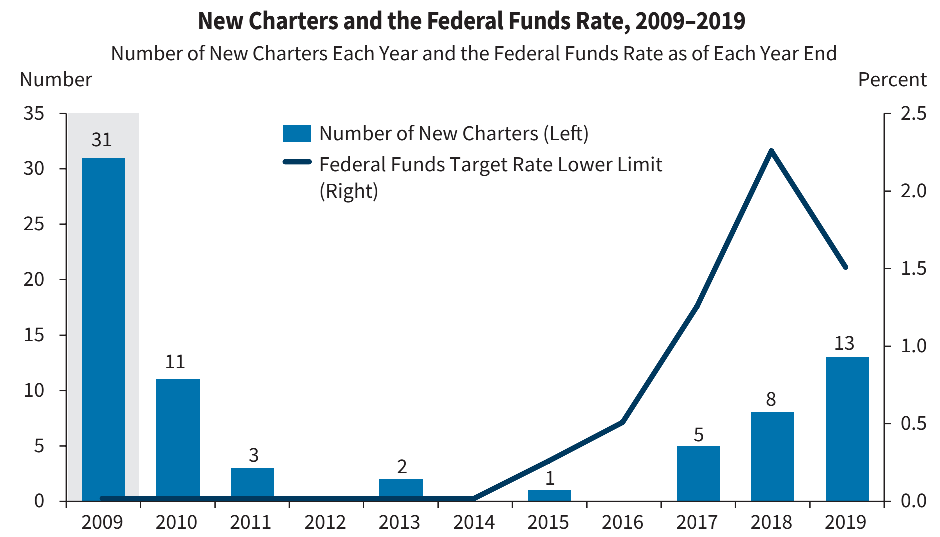
Banks that were acquired by a credit union have some important characteristics that provide insight into possible reasons for their attractiveness to the credit union. Relative to otherwise similar non-acquired banks, acquired banks tended to be smaller in terms of asset size, have larger concentrations of single-family mortgage loans, and have smaller concentrations of C&I loans. These acquired banks also tended to have higher efficiency ratios and less profitability overall. Taken together, these characteristics suggest that the acquired banks were small enough that credit unions could incorporate the bank portfolio into existing operations. The banks also had loan portfolios that complemented the credit unions' business models.

As of year-end 2019, the trend among some credit unions to acquire banks made up a very small portion of the overall number of banks acquired in mergers.

[a] Potential members must belong to a credit union's field of membership in order to join. For example, membership in a credit union with a "community charter" is limited to people who live, work, worship, or attend school within a well-defined geographic area, such as a neighborhood, city, or rural district. Legislative and regulatory changes during the last 20 years, such as the Credit Union Membership Access Act of 1998, have increased the number of people eligible to join credit unions.

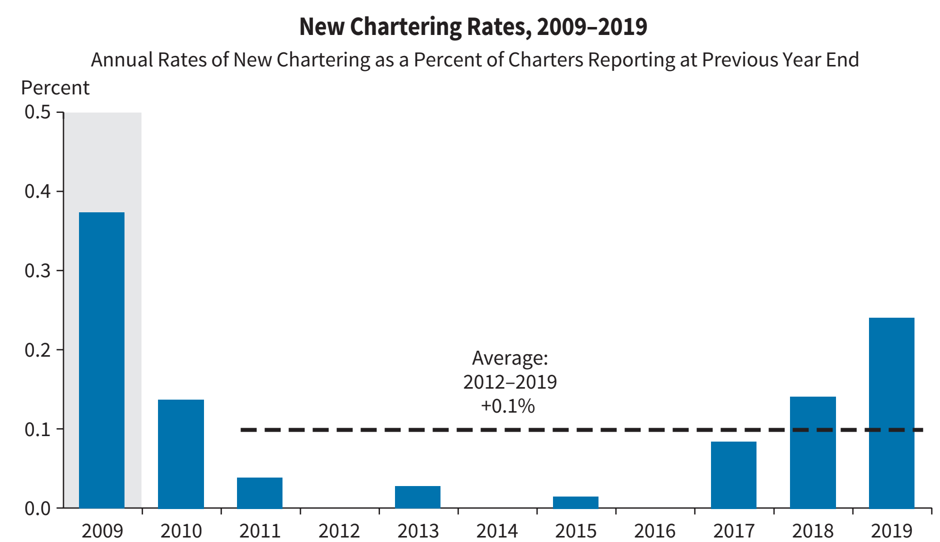
[b] A purchase and assumption transaction involves the transfer of assets and deposit liabilities from one institution to another without the two institutions legally combining into a single entity. When a credit union "acquires" a bank, it purchases all, or substantially all, of the bank's assets and assumes its liabilities. The legacy bank liquidates any remaining assets and relinquishes its charter. While credit unions had acquired assets from banks prior to 2012, there had not been a purchase and assumption of an entire bank by a federal credit union until then.

Chart 2.4



Sources: FDIC and the Federal Reserve Board (Haver Analytics).
Note: Gray bar indicates recession period.

Chart 2.5



Source: FDIC.
Note: Gray bar indicates recession period.

The New Chartering Rate Remains Low

The rate of new charter formation fell to zero in the aftermath of the financial crisis and Great Recession, and as of 2019 had only barely begun to recover. The last year of substantial new chartering activity was 2008; in 2009, the rate of new charter formation set what was at the time a post-1985 record low, and the rate continued to decline until it reached zero in 2012. Almost no new charter formation occurred between 2011 and 2016: no new institutions opened in 2012, 2014, or 2016, and during the entire six-year period, only six institutions opened. Late in the economic expansion new charter formation began to pick up, with 5 new institutions opening in 2017, 8 in 2018, and 13 in 2019 (Chart 2.4). However, the number of new charters in 2019 represented a new chartering rate of only 0.2 percent, far below the historical average rate of 1.4 percent, which prevailed between 1985 and 2011 (Chart 2.5).

Table 2.1 Average Annual Rates of Structural Change

Average Annual Rates of Percentage Change in the Number of Charters Between 1985–2011 and Between 2012–2019								
Average Rates of Change Because of:		**Inter-Company Merger**	**Intra-Company Merger**	**Inter-Company and Intra-Company Merger**	**Other Voluntary Closing**	**Failure**	**New Chartering**	**Net Charter Consolidation**
During the Period:	1985–2011	–2.3	–1.5	–3.9	–0.1	–0.7	1.4	–3.2
	2012–2019	–3.3	–0.6	–3.9	–0.2	–0.2	0.1	–4.3

Source: FDIC.
Note: Mergers are voluntary. Other Voluntary Closings include institutions that, for example, choose to liquidate without being acquired, or choose to relinquish FDIC insurance. The rates of Net Charter Consolidation, and "Inter-Company and Intra-Company Mergers," do not equal the sums of their component rates due to rounding.

The Net Consolidation Rate Increased

An important fact about consolidation within the banking industry is that the average annual rate of voluntary mergers between 2012 and 2019—combining both mergers between unaffiliated institutions and those between institutions within the same holding company—was the same as the average annual rate of voluntary mergers between 1985 and 2011: 3.9 percent (Table 2.1). Moreover, during the period 2012–2019 the average annual rate of failure declined by 0.5 percentage points, while the rate of other voluntary closings increased only slightly. Yet the average annual rate of net charter consolidation during the period 1985–2011 was 3.2 percent, compared with a rate of 4.3 percent during the period 2012–2019. The increase in net charter consolidation was due to the slow rate of new charters in the latter period.

Although a decline in new charter formation following the financial crisis and Great Recession is not entirely surprising given the severity of the crisis and recession, the slow rebound of new charters as the economy recovered is unusual. There are several possible explanations for it. Macroeconomic factors—such as output, interest rates, and unemployment—appear to be primarily responsible.[2] The possible role of regulatory compliance costs in affecting the cost of chartering a new small bank is discussed in Chapter 5.

The primary explanation focuses on bank profitability. This explanation maintains that new chartering declined because of the extraordinary decline and weak subsequent recovery in bank profitability associated with the financial crisis and Great Recession. Put simply, this explanation holds that banking became less profitable after the financial crisis and, therefore, fewer investors were interested in starting banks. It is true that banking became less profitable after the financial crisis, but an important question is how much of bank profitability post-crisis can be attributed to macroeconomic factors and how much to other factors, such as regulation.

FDIC research indicates that "[m]ore than 80 percent of the post-crisis decline in [community bank] profitability can be explained by negative macroeconomic shocks" and that the net effects of regulation, business practices, and other "structural" factors explain less than 20 percent of the post-crisis decline in profitability.[3]

It is important to note that while macroeconomic factors appear to explain most of the decline in community-bank profitability since the Great Recession and that these factors provide a plausible explanation for the low rate of new charter formation, the regulatory environment in which banks operate changed considerably at the same time. For detail on how the changed regulatory environment may have affected community banks, see Chapter 5 of this study.

Community Banks Are More Prevalent Than Noncommunity Banks, Although Both Groups Continue to Consolidate

Among FDIC-insured institutions, community banks are by far the most numerous, and noncommunity banks are the largest by asset size. Also, noncommunity banks have continued to grow their assets at a greater rate than community banks on average. Both bank types have been consolidating since 1986, although community banks were less likely to close than noncommunity banks between 2012 and 2019. This section compares consolidation among community banks with consolidation among noncommunity banks by comparing number of institutions, rates of attrition, and average asset growth.

[2] Adams and Gramlich; GAO.

[3] Fronk.

Chart 2.6

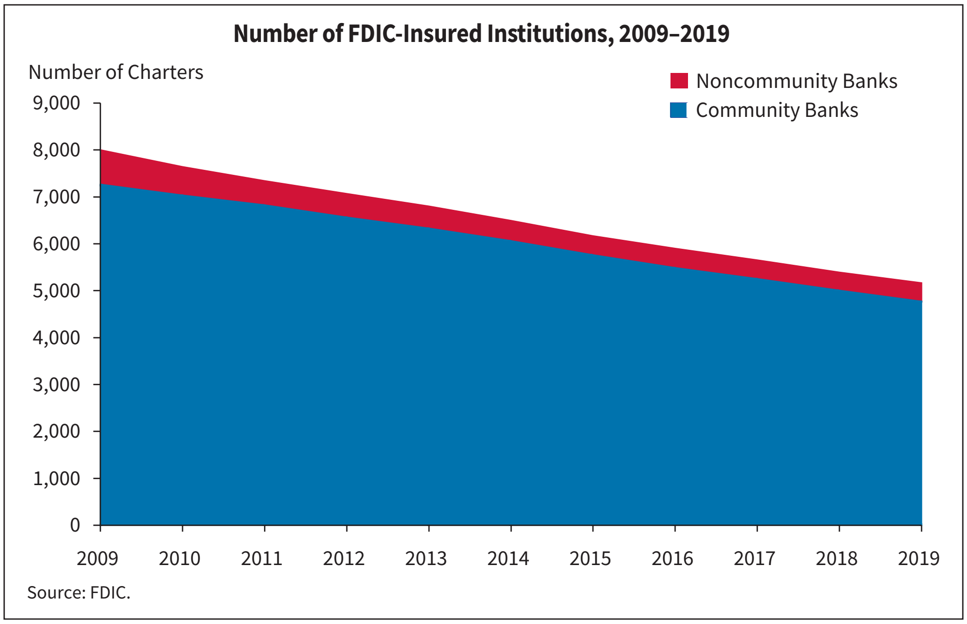
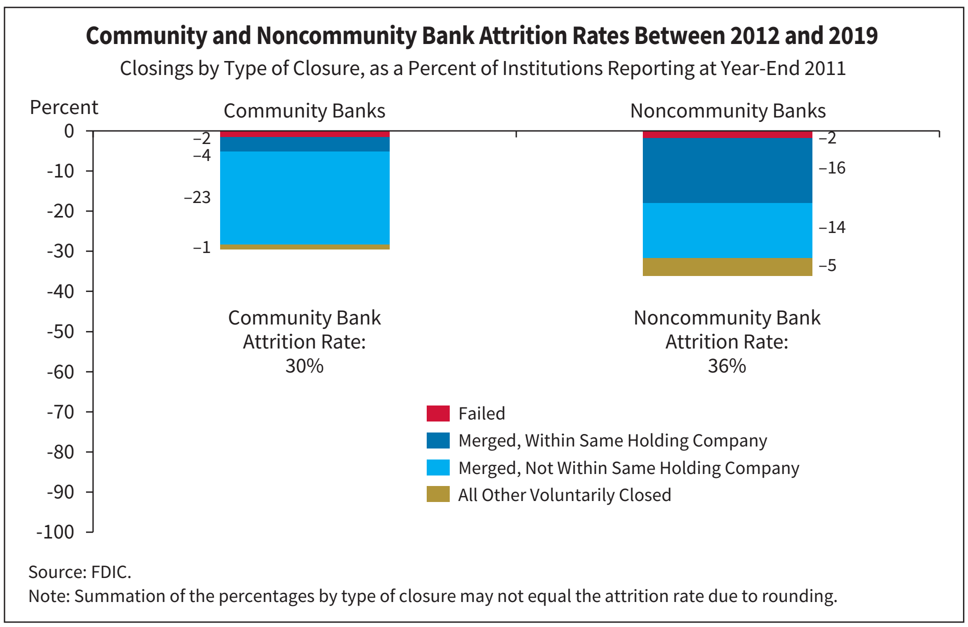


Chart 2.7



The Number of Community and Noncommunity Banks Continues to Decline

Between 1985 and 2019 the numbers of both community and noncommunity banks generally declined, after increases among both groups between 1984 and 1985. For each group the decline was substantial, especially between 2012 and 2019 when the number of community banks dropped by 30 percent and the number of noncommunity banks by 23 percent.

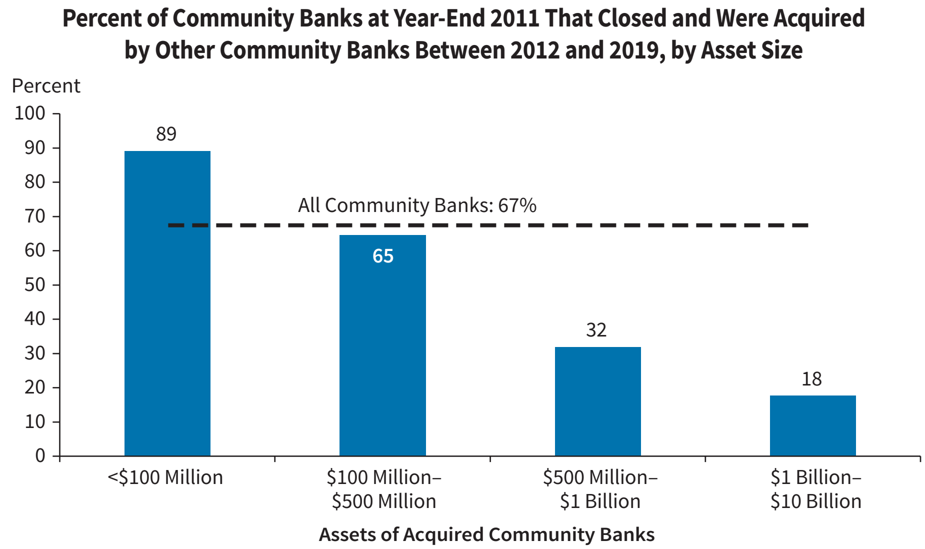
Although the number of community banks continued to decline, as of 2019 they were still the most prevalent type of FDIC-insured institution (Chart 2.6). In 2019, 92 percent of all bank charters were held by community banks, unchanged from 2011 and up from 87 percent in 1984.

Although the number of banks continued to decline, between 2012 and 2019 community banks were actually less likely to leave the industry than were noncommunity banks. Of the 6,802 institutions that reported as community banks at year-end 2011, just under 30 percent had closed by year-end 2019. In comparison, over the same

Box 2.2 Acquirers of Community Banks

Most often, community banks that close do so because they have been acquired by other community banks. Among community banks that ceased operating between 2012 and 2019, just over two-thirds were acquired by other community banks. Even among larger community banks, or those with an asset size between $1 billion and $10 billion, nearly one out of every five that ceased operating was acquired by another community bank (Chart 2.2.1).

Chart 2.2.1



Source: FDIC.
Note: Closed community banks failed, voluntarily merged, or voluntarily liquidated.

While most community banks that close do so because they have been acquired by other community banks, more than half of the offices operated by those acquired community banks are acquired by noncommunity banks (Table 2.2.1). This is because banks with larger asset sizes tend to operate more offices compared with smaller banks, and noncommunity banks acquire larger proportions of closed community banks as the asset size of those community banks rises. As shown in Chart 2.2.1, 89 percent of community banks that closed between 2012 and 2019 and had less than $100 million in total assets were acquired by other community banks. However, these relatively small community banks operated two offices each on average, according to data from the FDIC's Summary of Deposits surveys. Community banks that ceased operating and had between $1 billion and $10 billion in assets, on the other hand, operated 24 offices each on average and were much more likely to be acquired by noncommunity banks.

Table 2.2.1

Offices Acquired and Retained by the Acquirers of Community Banks Between 2012 and 2019

Type of Acquirer	Number of Acquirers	Offices Initially Acquired	Offices Retained by Acquirer	Retention Rate (Percent)	Offices Closed by Acquirer	Offices Sold to Other Institutions
Noncommunity Bank	166	5,874	5,086	86.6	710	78
Community Bank	902	4,727	4,270	90.3	412	45

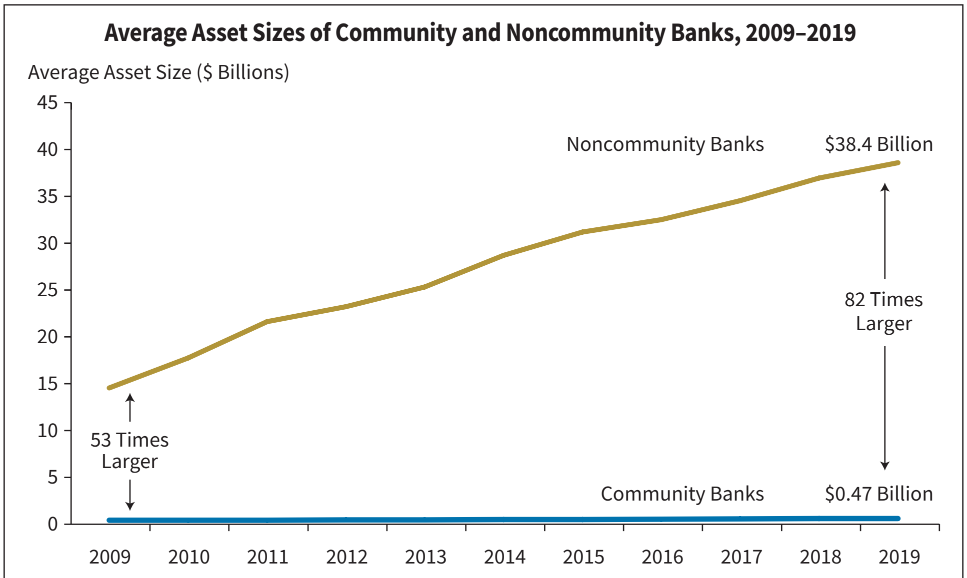
Source: FDIC Summary of Deposits data.
Notes: The offices initially acquired are those listed as belonging to acquired banks according to their last Summary of Deposits filings. The Summary of Deposits filings of acquiring institutions immediately following mergers are used to determine what happened to the acquired offices. Thus, the Table displays outcomes for acquired offices within the first year or less following an acquisition. These outcomes may be different over a time period longer than one year.

period more than 36 percent of the 555 institutions that reported as noncommunity banks had closed (Chart 2.7).

In addition to being more likely to close than community banks, noncommunity banks were also more likely to merge with other noncommunity banks within a shared holding company, as shown in Chart 2.7.[4] For details on who acquires community banks when they merge, see Box 2.2.

[4] The FDIC defines "community bank" at the holding company level, so separately chartered institutions belonging to the same holding company are either all community banks or all noncommunity banks.

Chart 2.8



Source: FDIC.

Average Asset Growth at Noncommunity Banks Outpaces Growth at Community Banks

Between 1984 and 2019, noncommunity banks grew substantially compared with community banks, and as of year-end 2019 the average asset size of noncommunity banks was 82 times larger than the average asset size of community banks (Chart 2.8). Given the FDIC's definition of community bank, however, the growing divergence in average size between the two groups should not be entirely surprising. After all, although the FDIC does not impose an asset size threshold below which all institutions are considered community banks, the FDIC does impose limits on a community bank's geographic scope, among other things, once the bank reaches a certain asset size, which the FDIC adjusts upward over time. As an institution grows its balance sheet, it may grow its geographic footprint. Therefore, community banks that grow their balance sheets and expand into new markets may at some point in their growth become noncommunity banks. This implicitly slows down the rate at which the average asset size across all community banks can grow, since fast-growing community banks are more likely to become noncommunity banks.

On the other hand, noncommunity banks may grow their assets and footprint very rapidly, raising the average asset size growth rate for all noncommunity banks. The removal of restrictions on both intra- and inter-state branching in the 1980s and 1990s, followed by rapid growth in online and mobile banking, has allowed for the growth of noncommunity banks with very large balance sheets. U.S. Gross Domestic Product (GDP) in 2019 was approximately 5.3 times larger than GDP had been in 1984. Similarly, the average asset size of community banks in 2019 was about $470 million, about 5.3 times their average size of $88 million in 1984. Thus, from 1984 to 2019 community banks grew roughly in line with the U.S. economy. The average asset size of noncommunity banks in 2019, however, was more than 38 times their average size in 1984, since their growth during that 35-year period far outpaced that of the broader economy. The implicit growth "restriction" on community banks, described above, may be a key factor as to why their share of banking industry assets declined slowly after 2011. Between 2012 and 2019, the share of banking industry assets held at community banks declined from 14 percent to 12 percent of the total, down from a high of 38 percent in 1984.

Summary

The long-term consolidation of the banking industry that began in 1986 continued between 2012 and 2019. Bank failures contributed less to consolidation as the economy recovered from the financial crisis and Great Recession. Mergers made up a greater share of consolidation as failures receded. However, intra-company mergers became less common while inter-company mergers approached rates last seen in the 1990s. Because new chartering fell to post-1985 record low rates between 2012 and 2019, the average annual rate of net consolidation increased to 4.3 percent from the rate of 3.2 percent, which prevailed between 1985 and 2011.

Both community banks and noncommunity banks consolidated between 2012 and 2019, although community banks that existed at year-end 2011 were less likely to stop operating between 2012 and 2019 compared with noncommunity banks. When community banks did cease operating, more than two-thirds of the time it was because of their acquisition by other community banks.

Average asset growth at noncommunity banks outpaced that at community banks between 2012 and 2019. However, community banks that expand their geographic footprints and their balance sheets may become noncommunity banks because of their growth, while noncommunity banks may grow without limit and remain noncommunity banks. Therefore, noncommunity banks are likely to report greater rates of average asset growth over time when compared with community banks.

Box 2.3 Structural Change and the COVID-19 Pandemic

The COVID-19 pandemic could affect the rate of consolidation in important ways. The number of mergers announced publicly fell in early 2020, suggesting that the rate of net consolidation will decline as planned mergers are postponed or canceled. Offsetting this factor, however, is the potential for a rise in bank failures as a result of the pandemic-related economic downturn, particularly if economic recovery is slow. Finally, while the rate of mergers may fall temporarily because of the effects of the pandemic, once the pandemic subsides, mergers could increase, as deals that were postponed are completed.

The rate of net consolidation in the first nine months of 2020 was nearly the same as the rate in the first nine months of 2019. The number of charters declined by 148 during the first nine months of 2019, representing a net consolidation rate of -2.7 percent, and during the first nine months of 2020, the number of charters declined by 144, which equates to a net consolidation rate of -2.8 percent. The number of mergers was 12 fewer during the first nine months of 2020, but there were also five fewer new charters, one more failure, and two more other voluntary closings than there had been in the first nine months of 2019.

More important, the number of merger announcements during the first nine months of 2020 was down 59 percent compared with the number during the first nine months of 2019, suggesting that merger activity would decline later in 2020 and potentially on into 2021. In terms of actual numbers, financial institutions announced 200 mergers during the first nine months of 2019, compared with 82 during the first nine months of 2020, according to data compiled by S&P Global.

Aside from leading to decreases in merger announcements in 2020, the COVID-19 pandemic also led to the termination and postponement of previously announced mergers. In 2019, 11 planned mergers were terminated, compared with 13 terminated mergers in the first nine months of 2020, according to S&P Global data.[a] In addition, seven planned mergers were postponed or had terms renegotiated and the parties cited the pandemic as one of the factors affecting the decision (Sullivan and Tor).[b]

[a] Terminated mergers are not included in the counts of merger announcements.
[b] As of September 30, 2020, five of the seven postponed or renegotiated mergers had been completed.