

## Community Bank Developments in 2012

---

### Introduction

In December 2012, the FDIC published the *FDIC Community Banking Study*, a comprehensive report on trends in U.S. community banking over the 27-year period from year-end 1984 through 2011.<sup>1</sup> Developing a new research definition of community banks, and addressing topics such as structural change, geography, financial performance, lending specialties, and capital formation, the Study showed that community banks continue to play a central role in the U.S. economy and in local communities across the country. At the same time, the Study highlighted a number of important long-term trends that have dramatically reshaped the community banking sector over time.

One such trend is consolidation: The total number of federally insured bank and thrift charters declined by 59 percent between 1984 and 2011 to 7,357. This decline was driven not only by the failures that occurred in two major banking crises, but also by the voluntary mergers and intra-company consolidations that followed the dismantling of geographic restrictions in banking some two decades ago. All of the net consolidation that took place during this period was accounted for by the disappearance of the smallest banks—those with assets less than \$100 million. The number of FDIC-insured institutions with assets between \$100 million and \$1 billion—almost all of which met the FDIC’s research definition of a community bank—actually increased over this period.

This consolidation had little net effect on the relative number of community bank organizations and charters, both of which continued to exceed 90 percent of the total in 2011. Nevertheless, it led to a two-thirds decline in the share of industry assets held by community banks, which was just 14 percent by year-end 2011. Even so, at the end of the period, community banks continued to hold 46 percent of the industry’s small loans to U.S. farms and businesses as well as the majority of banking deposits at bank branches located in rural and micropolitan counties.<sup>2</sup> The Study identified 627

U.S. counties—almost 20 percent of the total—in 2011 where the only FDIC-insured banking facilities in operation were those run by community banks.

The analysis of comparative financial performance in the Study also highlighted a combination of challenges and success stories for community banks. As measured by pretax return on assets (ROA), noncommunity banks outperformed community banks by an average of 38 basis points per year in the 15 years leading up to the financial crisis that began in 2007. While community banks generally held the advantage in terms of provisions for loan losses, overhead expenses, and net interest income, noncommunity banks were much more successful at deriving noninterest income from off-balance-sheet activities. Moreover, the advantage that community banks have traditionally enjoyed in generating net interest income, which accounted for 81 percent of their total revenue stream in 2005, has waned over time. The Study showed that more than 70 percent of the deterioration in the community bank efficiency ratio between 1998 and 2011 could be attributed to a squeeze on net interest income, which has intensified during the zero-interest-rate period that began in 2008.<sup>3</sup>

The Study failed to find systematic evidence that community banks are predisposed to be less profitable than larger, noncommunity institutions. Among charters that operated continuously between 1984 and 2011, community banks were actually a bit more profitable on average than were noncommunity banks. Analysis of average costs showed that economies of scale among community banks—where they existed at all—were mostly realized at a relatively modest asset size of \$100 million to \$300 million.<sup>4</sup> More than 60 percent of community banks in 2011 operated in one of three lending specialty groups—agricultural lending, mortgage lending, or diversified nonspecialty lending—

---

<sup>1</sup> *FDIC Community Banking Study*, 2012, <http://www.fdic.gov/regulations/resources/cbi/study.html>.

<sup>2</sup> Micropolitan counties are those centered on an urban core with a population between 10,000 and 50,000 people. There were 694 micropolitan counties in the United States in 2010, out of a total of 3,238.

<sup>3</sup> The efficiency ratio compares the level of overhead costs (total noninterest expense) to net operating revenues (the sum of net interest income and total noninterest income). A higher efficiency ratio actually suggests inefficiency, because it indicates that the bank is less productive in converting expenditures into revenue.

<sup>4</sup> Stefan Jacewitz and Paul Kupiec, “Community Bank Efficiency and Economies of Scale” (Federal Deposit Insurance Corporation, December 2012), <http://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf>.

---

that generally enjoyed high and stable earnings and low rates of failure during the study period. It was this type of steady earnings performance that enabled community banks to generate almost half of all the new equity capital they added during the study period through retained earnings.

As instructive as these long-term results are, they merely set the stage for a more pressing question: How will community banks fare in the post-crisis environment?

This paper seeks to answer this question by extending the results of the Study. It applies the community bank definition from the Study to year-end 2012 data, and recapitulates key elements of the analysis for 2012. Consistent with the previous Study, it focuses on recent trends in industry structure, balance sheet composition, geography, earnings, and capital formation.

Trends observed in 2012 suggest a positive outlook for the community banking sector. Overall, FDIC-insured institutions have seen problem loans decline from the peak levels of 2009. Net income has recently exceeded pre-crisis levels even if profitability—as measured by ROA—has not.<sup>5</sup> The Study and other FDIC analyses show that smaller institutions have tended to lag larger ones in this respect, owing in part to their greater dependence on loans secured by real estate. Community banks continue to hold a majority of deposits in rural and micropolitan areas, and remain an important source of credit in many sectors. Community bank earnings improved substantially in 2012 primarily because of lower loss provisions and higher noninterest income. Higher earnings, in turn, led to greater capital formation through retained earnings, which has traditionally been the most consistent source of new capital for community banks. While the recovery of the community banking sector remains incomplete, and in some respects continues to lag that of noncommunity banks, 2012 represented the best year for community banks since the onset of the financial crisis in 2007.

### Defining the Community Bank

The *FDIC Community Banking Study* was conducted using a definition of a community bank that emphasized both traditional banking activities and a limited geographic scope of operations. This definition has been

---

<sup>5</sup> Industry net income peaked at \$215 billion in 2006. Industry net income was \$201 billion in 2012, the second-highest level on record.

updated for this report using year-end 2012 data. Designating at the level of the bank holding company, the definition is applied in two steps: (1) excluding banks that do not engage in certain basic banking activities, and (2) including banks that meet minimum requirements for lending and core deposit funding and that conform to limits on the number and size of their banking offices and the number of states and large metropolitan areas in which they operate.<sup>6</sup> The requirements and limits of item (2) are waived for those institutions with assets below a certain time-indexed size threshold (\$1.12 billion in 2012), which are automatically considered to be community banks.<sup>7</sup>

Although size remains one factor in our definition of a community bank, it is not the only factor, as has been the case in much of the previous research on this topic. Moreover, where size-based metrics are employed in the FDIC definition, they have been indexed over time to adjust for increases in banking industry assets as well as increases in the nominal level of economic activity.<sup>8</sup> Establishing the definition in this way allows for meaningful distinctions between community and noncommunity banks across a 28-year period. It is also worth noting that the FDIC's community bank designations for previous years have been updated to reflect annual revisions to historical data; however, the changes to historical designations as a result of data revisions were relatively inconsequential. For example, of the 6,721 banking organizations reporting at year-end 2011, only one had its community bank designation changed as a result of revisions to historical data during 2012.

Table 1 depicts changes in the designations of community and noncommunity institutions between 2011 and 2012. The number of community bank charters fell by 255 (3.8 percent) during the year, while the number of noncommunity bank charters fell by 19 (3.4 percent). The following section explores structural change during 2012 in more detail.

---

<sup>6</sup> For a complete description of the community bank definition developed for the *FDIC Community Banking Study*, see Appendix A of the Study: <http://www.fdic.gov/regulations/resources/cbi/report/CBSI-A.pdf>.

<sup>7</sup> Analysis of these institutions shows that 92 percent of them would have conformed to all of the requirements for inclusion as a community bank at year-end 2012 even if they had not been automatically designated as community banks because of their size.

<sup>8</sup> Between 1984 and 2012, both total assets of FDIC-insured institutions and nominal U.S. GDP rose by an approximate factor of four.

Table 1

Designation of Community Banking Organizations Using FDIC Research Criteria					
		2011		2012	
		6,357 organizations designated as "community institutions" out of 6,721 banking organizations		6,141 organizations designated as "community institutions" out of 6,501 banking organizations	
2011 Asset Size Threshold: \$1.06 billion	32 large organizations excluded	249 organizations \$7.7 trillion in assets	314 organizations \$630 billion in assets	27 large organizations excluded	250 organizations \$8.1 trillion in assets
	\$4.2 trillion in assets			\$4.3 trillion in assets	297 organizations \$655 billion in assets
2012 Asset Size Threshold: \$1.12 billion	83 small organizations excluded	6,043 organizations \$1.3 trillion in assets		83 small organizations excluded	5,844 organizations \$1.4 trillion in assets
	\$18.9 billion in assets			\$20.1 billion in assets	
		6,799 community bank charters out of 7,357 total FDIC-insured banking charters		6,544 community bank charters out of 7,083 total FDIC-insured banking charters	

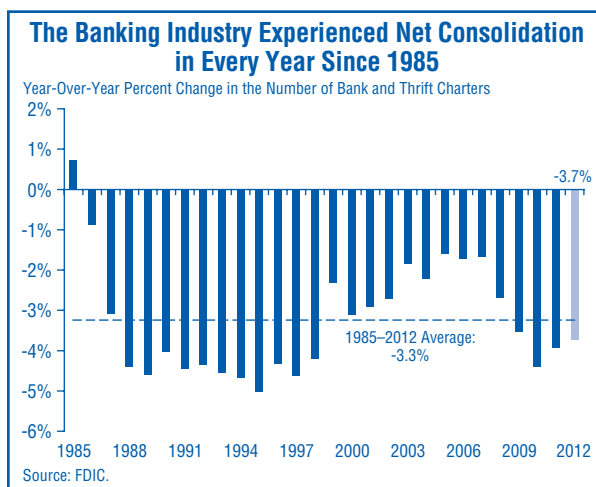
Source: FDIC.

## Structural Change

The banking industry continued to experience a net consolidation of charters during 2012, but at a slower pace than that experienced in 2010 or 2011. The total number of federally insured banks and thrifts fell by 274 (3.7 percent) during the year (see Chart 1), compared with a 4.4 percent decline in 2010 and a 3.9 percent decline in 2011. Meanwhile, the number of community bank charters fell by 255 (3.8 percent) in 2012, compared with 3.2 percent in 2010 and 3.1 percent in 2011.

Although the pace of industry consolidation has slowed for two consecutive years, it continues at a rate that is slightly higher than the historical average. Between 1984 and 2012, the number of insured institutions fell at an average annual rate of 3.3 percent (Chart 1), while the number of community bank charters fell at an average rate of 3.1 percent. Net consolidation of banking charters has taken place in every year since 1985, but slowed somewhat around 2000 before increasing again during the recent financial crisis. As the effects of the crisis recede, it remains to be seen whether charter consolidation will continue at an above-average pace or slow to the historically low rates experienced in the pre-crisis years. The answer depends on future trends in the various components of charter consolidation, namely

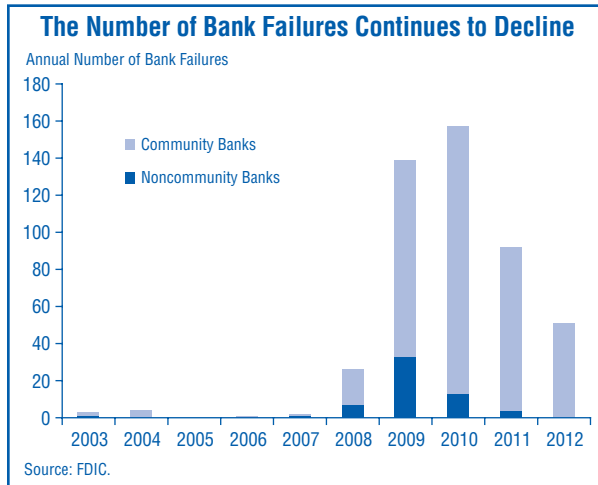
Chart 1



failures, intercompany mergers, intracompany consolidations, voluntary liquidations, and new charters.

The number of bank failures continued to fall in 2012, but was still elevated compared with pre-crisis levels (see Chart 2). A total of 51 institutions, all of which were community banks, failed in 2012. This is down from 88 community bank failures in 2011, and down from a cyclical peak of 144 failures in 2010. The community bank failure rate, defined as the number of community

Chart 2



bank failures as a percent of all community banks at the end of the previous year, fell to 0.75 percent in 2012 from 1.25 percent in 2011 (see Chart 3).

As has been the case throughout much of the post-crisis period, most of the community banks that failed in 2012 were commercial real estate (CRE) lending specialists.<sup>9</sup> A total of 33 CRE specialist community banks failed during the year, representing 64 percent of all community bank failures (see Chart 4). This is down from 79 CRE specialist community bank failures, 90 percent of total community bank failures, in 2011. The high rate of failure among community bank CRE specialists since 2008 illustrates both the shift of community banks toward CRE lending after 2000 and the vulnerability of this line of business to the downturn in U.S. real estate prices associated with the crisis. CRE prices as measured by the Moody's/Real Capital Analytics Commercial Property Price Index bottomed out in 2009, while residential home prices, as measured by the Standard and Poor's/Case-Shiller U.S. National Home Price Index, hit a cyclical low in 2012. Through the end of 2012, FDIC-insured institutions had charged off \$33 billion in CRE loans, and failures had begun to moderate. These trends suggest that bank failures will contribute less to the pace of industry consolidation in the near future.

<sup>9</sup> CRE loans are composed of loans secured by multifamily residential properties, construction and development loans, and loans secured by nonfarm nonresidential properties. CRE lending specialists are institutions that either hold construction and development loans greater than 10 percent of assets or hold total CRE loans greater than 30 percent of assets, and that do not meet any of the other single-specialty lender criteria. Detailed community bank lending specialty group definitions are available on page 5-3 of the *FDIC Community Banking Study*.

Chart 3

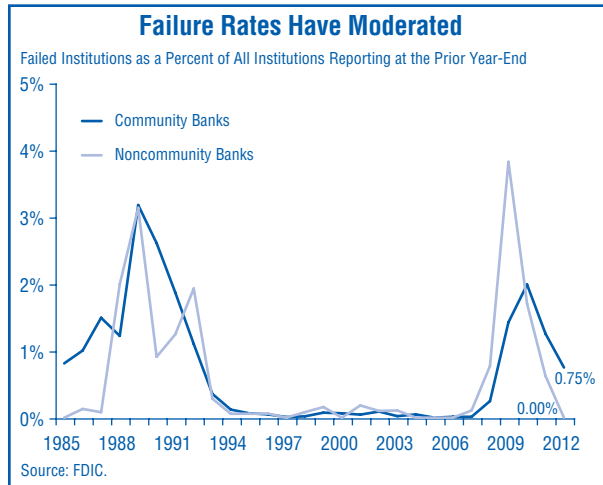
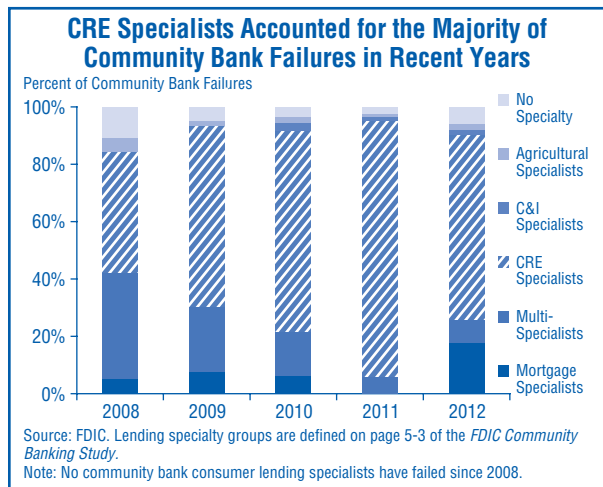


Chart 4



After slowing in the post-crisis years, voluntary closings picked up again in 2011 and 2012.<sup>10</sup> Chart 5 and Chart 6 show that the number of voluntary charter closings among community banks, which averaged 243 per year between 2003 and 2008, reached a low of 102 in 2010. A total of 188 community bank charters closed through voluntary deals in 2012, up from 148 in 2011. Of these 188 closings, 142 were intercompany mergers, 35 were intracompany consolidations, and 11 were voluntary liquidations.

<sup>10</sup> Transactions in which a charter exits the industry without failing are referred to as voluntary charter consolidations. Voluntary charter consolidations comprise intercompany mergers, intracompany charter consolidations, and voluntary liquidations. The number of voluntary liquidations is typically small, averaging seven per year since 1985.

Chart 5

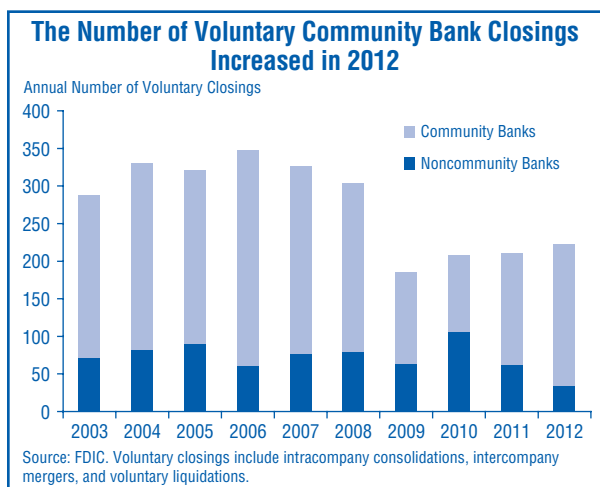


Chart 7

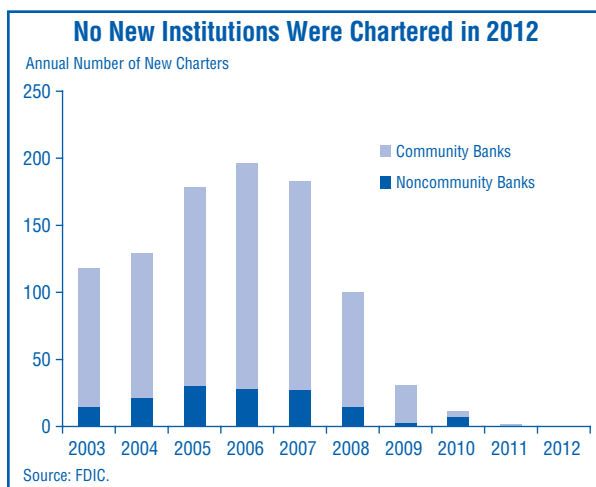


Chart 6

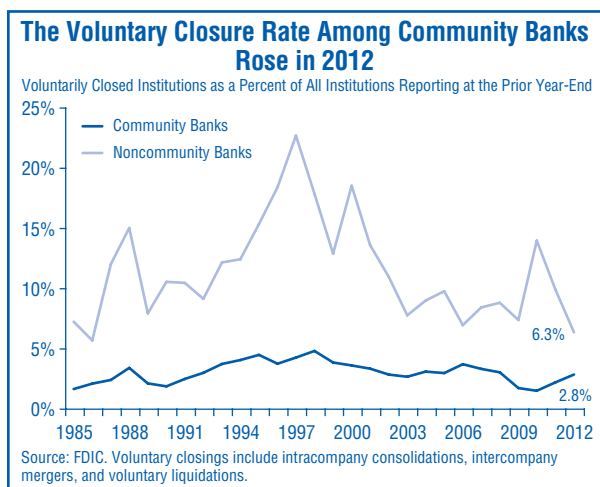


Chart 5 shows that the number of voluntary deals among community banks in 2012 was lower than in any of the pre-crisis years between 2003 and 2008. During those years, a vibrant market for voluntary mergers—many transacted at a premium to book value—was viewed by many as a sign of the high value of the community bank franchise. Chart 6 shows that the rate of voluntary closure among community banks has always been lower than that among noncommunity banks, and this trend continued in 2012. Community banks exited through this route at less than half the rate of noncommunity banks in 2012. Chart 6 also shows that the share of community banks exiting through voluntary closure recovered in 2010 and 2011 to a level more consistent with pre-crisis norms.

Perhaps the most important factor contributing to the net consolidation of the industry in 2012 was the

absence of any new banking charters. Chart 7 shows how chartering activity—always cyclical in nature—declined markedly after the onset of the crisis, and ceased altogether in 2012.<sup>11</sup> A number of factors may have contributed to the steep drop-off in new charters in this cycle, including the availability to investors of hundreds of failed bank charters and the ongoing low interest rate environment that has squeezed net interest margins and profitability at many community banks (see *Comparative Financial Performance: Community Versus Noncommunity Banks* below).

To the extent that temporary factors have been important in the cyclical decline in new chartering, it seems likely that chartering activity will pick back up once these factors begin to abate. As of November 2013, there were two pending applications for deposit insurance by new community banks. In addition, the credit quality of bank balance sheets continued to improve, as evidenced by the decline in noncurrent loan rates for virtually every loan type in 2012. As the number of community bank failures has fallen by 65 percent from its peak in 2010, the availability of charters through failed bank acquisitions has been reduced.

For now, signs point to slowing in the pace of consolidation among community banks and the banking industry as a whole. Table 2 provides a summary of the factors contributing to net consolidation during 2012. As described above, failures are on the way down, voluntary deals are on the way up, and there appears to be greater interest in new banking charters. While gradual charter

<sup>11</sup> Two of the new charters issued in 2011 were “shelf charters,” used at their inception to acquire failed banks.

Table 2

Change in the Number of Community and Noncommunity Banks Charters in 2012			
	Community Banks	Noncommunity Banks	All Institutions
<b>Number of Institutions at Year-End 2011</b>	<b>6,799</b>	<b>558</b>	<b>7,357</b>
Failures	-51	0	-51
Intercompany Mergers	-142	-10	-152
Intracompany Consolidations	-35	-21	-56
Other Closings	-11	-4	-15
All Closings	-239	-35	-274
New Charters	0	0	0
Net Reclassifications to/from Community Bank Status	-16	16	0
<b>Number of Institutions at Year-End 2012</b>	<b>6,544</b>	<b>539</b>	<b>7,083</b>

Source: FDIC.

consolidation has been prevalent among community banks since the mid-1980s, the direction and pace of future industry consolidation are far from clear.

### Community Bank Balance Sheet

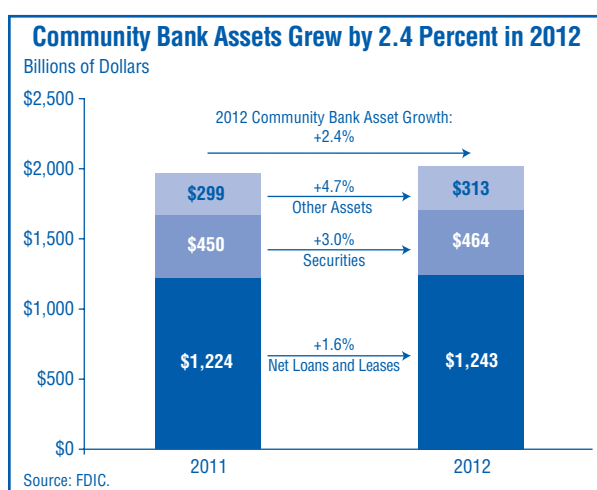
Even as the number of FDIC-insured institutions declined in 2012, the total assets of both community and noncommunity banks increased during the year. Community bank assets grew by \$47 billion (2.4 percent) to \$2 trillion in 2012 (see Chart 8), while noncommunity bank assets grew by \$512 billion (4.3 percent) to \$12.4 trillion.

Net loans and leases held by community banks grew by 1.6 percent in 2012. While this reversed the net decline in community bank lending observed in 2011, it remained below the 3.8 percent loan growth seen at noncommunity banks in 2012. Community banks saw expansion in agricultural, commercial and industrial (C&I), and consumer lending in 2012, and they continued to play a disproportionate role in providing credit to local farms and businesses. Community banks held 14 percent of industry assets at year-end 2012, but held 46 percent of small loans to businesses, shares that are unchanged from 2011.<sup>12</sup>

Meanwhile, community banks saw another substantial decline in their holdings of commercial real estate loans, especially construction and development (C&D) loans. It is in these portfolios that community banks have experienced the highest levels of noncurrent loans and the highest volumes of net loan charge-offs in the years following the financial crisis. Not only do charge-

<sup>12</sup> Small loans to businesses include loans secured by nonfarm nonresidential properties and C&I loans in amounts under \$1 million, and farmland and agricultural production loans in amounts under \$500,000.

Chart 8



offs tend to reduce outstanding loan balances, but high volumes of noncurrent loans tend to discourage banks from extending new credit while they are busy remediating problem loans.

The magnitude of the boom and subsequent bust in community bank CRE balances can be seen by comparing their total CRE loan growth between 2002 and 2008 (+72 percent) and the rate of growth between 2008 and 2012 (-14 percent). The relationship between high levels of problem loans and slow or negative growth in community bank loan balances is best illustrated by C&D loans. As has been the case in recent years, C&D loan balances showed the highest percentage decline of any community bank loan category in 2012 (-9.5 percent, see Table 3), while they continued to show the highest rate of remaining noncurrent loans at year-end 2012 (7.8 percent, see Table 4). The progress that has been made to date in addressing these credit problems can be seen in the volume of total

Table 3

Changes in the Community Bank Balance Sheet, 2011–2012						
Loan or Asset Category	Year-End 2011		Year-End 2012		Change 2011–2012	
	Dollars in Billions	Percent of Total Assets	Dollars in Billions	Percent of Total Assets	Dollars in Billions	Percent Change
Mortgage Loans*	\$400.3	20.3%	\$404.6	20.0%	\$4.4	1.1%
Consumer Loans	\$53.0	2.7%	\$54.4	2.7%	\$1.3	2.5%
Commercial Real Estate (CRE) Loans**	\$523.8	26.6%	\$517.2	25.6%	-\$6.5	-1.2%
Construction and Development (C&D) Loans	\$83.8	4.2%	\$75.9	3.8%	-\$8.0	-9.5%
Commercial and Industrial (C&I) Loans	\$163.5	8.3%	\$171.0	8.5%	\$7.5	4.6%
Agricultural Loans***	\$85.5	4.3%	\$92.5	4.6%	\$7.0	8.2%
Other Loans and Leases	\$21.4	1.1%	\$25.7	1.3%	\$4.3	19.9%
Less: Loan Loss Provisions and Unearned Income	\$23.5	1.2%	\$22.3	1.1%	-\$1.2	-5.2%
Net Loans and Leases	\$1,223.9	62.0%	\$1,243.1	61.6%	\$19.2	1.6%
Securities	\$450.2	22.8%	\$463.5	23.0%	\$13.4	3.0%
Other Assets	\$298.5	15.1%	\$312.5	15.5%	\$14.0	4.7%
<b>Total Assets</b>	<b>\$1,972.6</b>	<b>100.0%</b>	<b>\$2,019.1</b>	<b>100.0%</b>	<b>\$46.5</b>	<b>2.4%</b>

Source: FDIC.

\* Mortgage loans include home equity lines of credit, junior liens, and other loans secured by residential real estate.

\*\* CRE loans include construction and development loans, loans secured by multifamily properties, and loans secured by nonfarm, nonresidential real estate.

\*\*\* Agricultural loans include production loans and loans secured by farm real estate.

Table 4

Community Bank Noncurrent Rates, 2011–2012			
Loan Category	2011 Noncurrent Rate	2012 Noncurrent Rate	Change in Noncurrent Rate 2011–2012
Mortgage Loans*	2.5%	2.3%	-0.2%
Consumer Loans	0.9%	0.9%	0.0%
Commercial Real Estate (CRE) Loans**	4.4%	3.3%	-1.1%
Construction and Development (C&D) Loans	11.2%	7.8%	-3.4%
Commercial and Industrial (C&I) Loans	2.1%	1.7%	-0.4%
Agricultural Loans***	1.0%	0.8%	-0.2%
<b>All Loans and Leases</b>	<b>3.0%</b>	<b>2.4%</b>	<b>-0.6%</b>

Source: FDIC.

\* Mortgage loans include home equity lines of credit, junior liens, and other loans secured by residential real estate.

\*\* CRE loans include construction and development loans, loans secured by multifamily properties, and loans secured by nonfarm, nonresidential real estate.

\*\*\* Agricultural loans include production loans and loans secured by farm real estate.

C&D loan charge-offs that community banks have made since 2007 (\$21 billion) and the fact that their noncurrent loan rate for C&D loans has declined by more than 40 percent from its peak in the first quarter of 2010.

Other community bank loan categories also continue to display elevated levels of problem loans, even as noncurrent rates continue to recede. Some 2.3 percent of 1-to-4 family residential mortgage loans held by community banks were noncurrent at year-end 2012. Although this represents a decline from 2.5 percent in 2011, the noncurrent rate for community bank 1-to-4 family residential mortgage loans never exceeded 1.6 percent between 1990 and 2008. While noncurrent rates for many loan categories are high relative to

historical levels, 1-to-4 family residential loan performance at community banks was better than that at noncommunity banks. The 1-to-4 family noncurrent rate at noncommunity banks actually rose to 8.9 percent in 2012 from 8.7 percent in 2011.

The condition of balance sheets is not the only factor that influences loan volumes at community banks. Loan demand also declined sharply during and after the recession of 2007–2009, and has been slow to recover since the recession ended. The Federal Reserve *Senior Loan Officer Opinion Survey* showed that the net percent of banks reporting stronger demand for commercial loans on the part of small firms was consistently negative during a 13-quarter period that extended from the end of 2006 through the end of

Table 5

Community Bank Share of Banking Offices and Total Deposits Located in Metro, Micro, and Rural Counties								
Year	Community Bank Share of Banking Offices, by County Type (Percent)				Community Bank Share of Total Deposits, by County Type (Percent)			
	Metro	Micro	Rural	Total Share	Metro	Micro	Rural	Total Share
1992	39%	65%	78%	46%	31%	62%	75%	36%
2002	33%	59%	72%	40%	21%	53%	71%	26%
2012	29%	57%	71%	36%	14%	56%	71%	18%

Source: FDIC.  
Note: Based on 2010 county designations made by the U.S. Office of Management and Budget. Deposit and office data are merger-adjusted to year-end.

2010. Since then, however, the net percent reporting stronger demand has been positive in all but one quarter. These trends point to a gradual improvement in loan demand, which should contribute to loan growth at community banks beyond 2012.

### The Geography of Community Banks

As expected, the geographic characteristics of community banking changed little during 2012. While community banks held just 14 percent of industry assets at year-end, they continued to hold the majority of bank deposits in rural and micropolitan counties (see Table 5). Community banks were three times more likely than noncommunity banks to locate offices in a nonmetro area in 2012, and were four times more likely to operate offices in rural counties, as was the case in 2011.

In 2012, 615 U.S. counties (627 in 2011) would not have had any physical banking offices operated by FDIC-insured institutions if not for those operated by community banks. Another 642 counties where community banks operated had fewer than three noncommunity banking offices present. This means that more than 1,200 U.S. counties (of 3,238 total), encompassing more than 16 million in population, would have very limited physical access to mainstream banking services without the presence of community banks. Although the office and deposit shares of community banks continue to decline, they still play a leading role in providing financial services in many parts of the country.

Noncommunity banks continued to hold a dominant market share in the nation's 1,169 metropolitan counties in 2012. Noncommunity banks operated 71 percent of all banking offices and held 86 percent of total deposits in metropolitan counties at year-end, with both figures up slightly from 2011. As described in the Study, these counties not only account for the vast majority of U.S. population and gross domestic product (GDP), but also have grown faster than rural and micropolitan

counties by both measures since 1984. The relative concentration of noncommunity banks in metropolitan statistical areas (MSAs) is one of the factors that have allowed these institutions to grow their assets ten times faster than community banks since 1984.

### Comparative Financial Performance: Community Versus Noncommunity Banks

Community banks continued to improve their earnings in 2012 following the severe downturn in profitability and earnings that they experienced during and after the financial crisis. Their aggregate pretax ROA rose to 1.06 percent in 2012 from 0.74 percent in 2011 (see Chart 9). Moreover, the gap between community and noncommunity bank profitability narrowed to 0.42 percent from 0.59 percent. Although the pretax ROA of community banks has increased in each of the past three years from a low of -0.13 percent in 2009, it remains well below the average of 1.5 percent observed in the period 1992 through 2006. Likewise, although the disparity between community and noncommunity bank earnings has narrowed, it is still comparable to the gap that existed in 2005. It remains to be seen whether this disparity is a persistent trend or simply the result of a slower recovery on the part of community banks.

Low interest rates continued to squeeze net interest income in 2012 (see Chart 10). Community bank net interest income fell to 3.37 percent of average assets in 2012 from 3.43 percent in 2011. Community banks still generated higher net interest income than did noncommunity banks, which saw their net interest income fall to 2.94 percent of average assets in 2012. As long as short-term interest rates remain at zero, net interest margins are likely to remain under pressure as higher-yielding loans and securities come to maturity. Because community banks earned 78 percent of their net operating revenue from net interest income in 2012, versus 61 percent for noncommunity banks, the squeeze on net



Chart 9

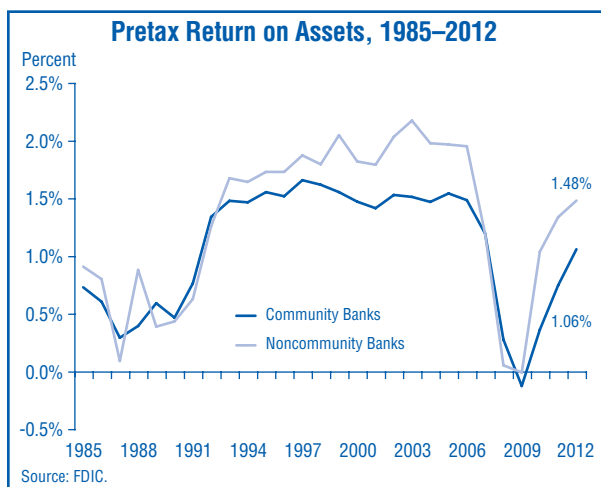


Chart 11

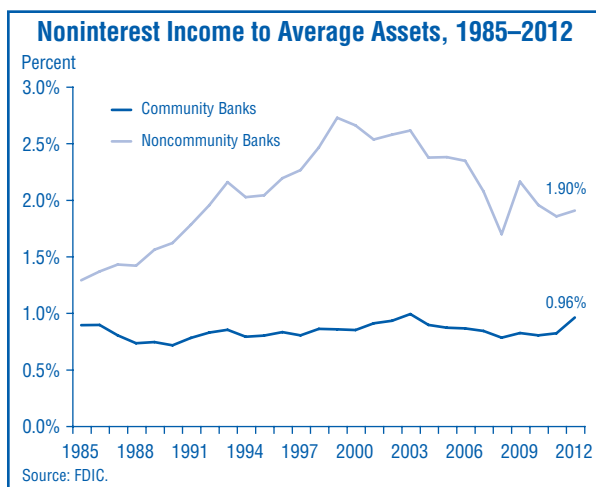


Chart 10

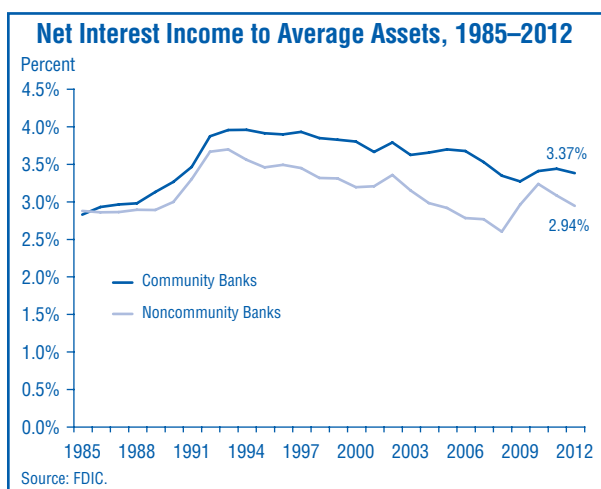
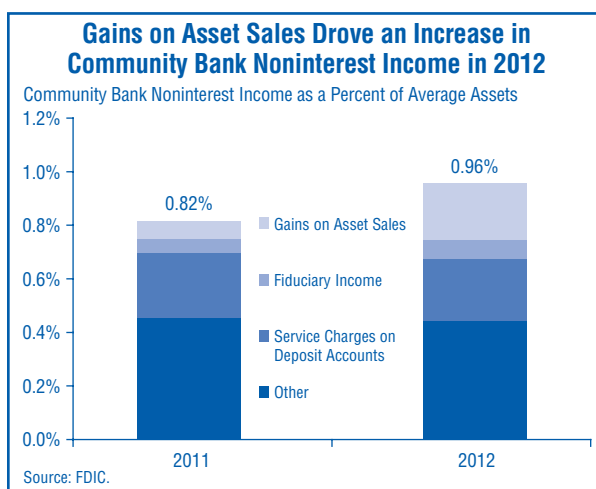


Chart 12



interest income has had a disproportionate impact on overall community bank earnings.

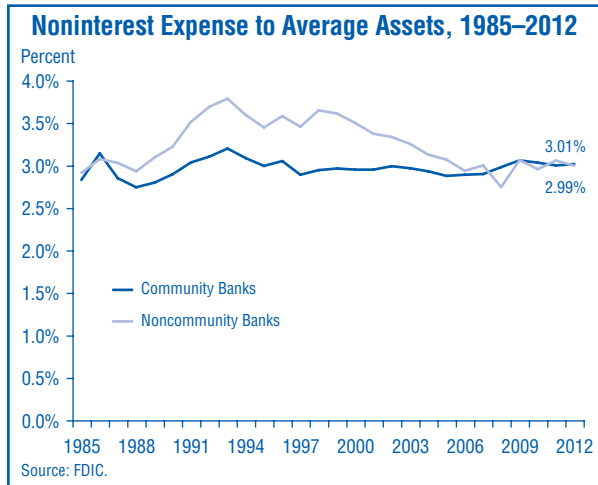
Both community and noncommunity banks earned higher levels of noninterest income in 2012. Community banks saw their ratio of noninterest income to average assets rise from 0.82 percent in 2011 to 0.96 percent in 2012, while noncommunity banks saw their ratio rise from 1.85 percent to 1.9 percent (see Chart 11). Also, as depicted in Chart 12, virtually all of the increase in community bank noninterest income can be attributed to gains on asset sales, which were to some extent facilitated by the decline in long-term interest rates that occurred during the year. The ten-year Treasury yield fell from 2.8 percent in 2011 to 1.8 percent in 2012, before rising again to an average of 2.2

percent in the first nine months of 2013.<sup>13</sup> The higher long-term interest rates observed through September 2013 will make it difficult for banks to replicate their 2012 gains in noninterest income.

Community and noncommunity banks maintained similar levels of noninterest expenses in 2012. Community banks reported noninterest expenses equal to 3.01 percent of average assets in 2012, versus 3 percent in 2011 (see Chart 13). Noncommunity banks reported noninterest expenses of 2.99 percent of average assets in 2012, down from 3.05 percent in 2011. As described in the Study, bank Call Report data do not facilitate the breakdown of noninterest expenses into regulatory and

<sup>13</sup> Source: Federal Reserve Board (Haver Analytics).

Chart 13



nonregulatory expenses. Appendix B of the Study discusses the results of interviews with bankers related to regulatory costs and overhead expenses.<sup>14</sup> Although the stability of overhead expenses is a positive trend for the community banking sector, it does not preclude the possibility that the regulatory component of these costs could be rising.

A useful metric that relates the various elements of income and expense is the *efficiency ratio*, or the ratio of overhead expenses to net operating revenue.<sup>15</sup> As described in the Study, a sizable gap has emerged since the late 1990s between the efficiency ratios of community and noncommunity banks. During that period, community banks experienced a marked increase (deterioration) in their efficiency ratio, most of which was attributable to the gradual decline of their net interest income.

The efficiency ratio of community banks improved in 2012, declining to 69.8 percent from 70.6 percent in 2011, while the efficiency ratio for noncommunity banks improved to a smaller extent, declining to 61.9 percent from 62 percent (see Chart 14). These changes reduced the efficiency gap between community and noncommunity banks to 7.8 percentage points, or less than one-half the size of this gap as recently as 2010. While community banks on average remained less efficient than noncommunity banks in generating

<sup>14</sup> For a discussion of regulatory costs at community banks, see: <http://www.fdic.gov/regulations/resources/cbi/report/CBSI-B.pdf>.

<sup>15</sup> Formally, the efficiency ratio is expressed as:

$$\text{Efficiency Ratio} = \frac{\text{Noninterest Expense}}{\text{Net Interest Income} + \text{Noninterest Income}}$$

Chart 14

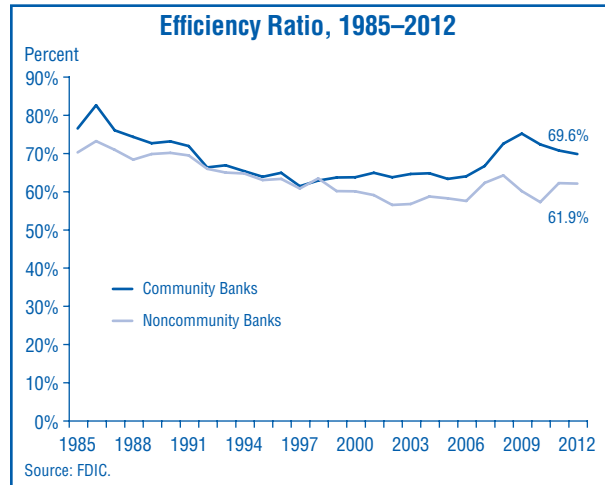
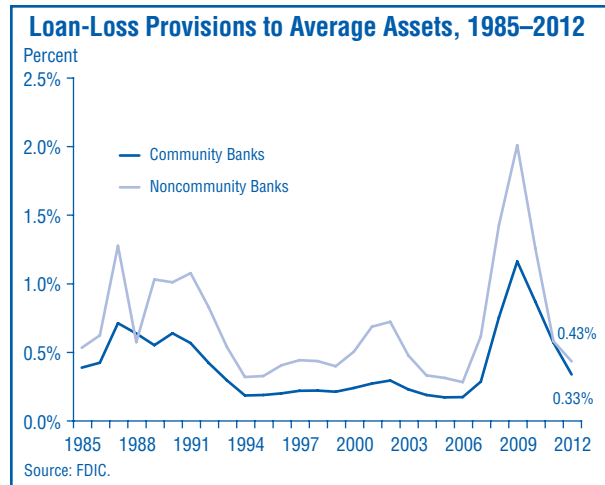


Chart 15



revenue—as has been the case in every year since 2010—the post-crisis trend continues to be a narrowing of this efficiency gap. Despite this narrowing, declining net interest income continued to put upward pressure on the community bank efficiency ratio in 2012 (see Table 6). It may prove difficult for community banks to generate further improvements in this ratio until interest rates rise to levels more in line with historical norms.

For both community and noncommunity banks, a key element of improved profitability in 2012 was the continued rapid decline in loan-loss provisions. Community bank loss provisions fell to \$6.5 billion (0.33 percent of average assets) in 2012 from \$10.9 billion (0.56 percent) in 2011 and a peak of \$22.5 billion (1.16 percent) in 2009 (see Chart 15). Noncommunity banks recorded loss provisions of \$51.7 billion

Table 6

Sources of Change in the Community Bank Efficiency Ratio, 2011–2012				
Ratio	2011	2012	Change in Income or Expense Ratio, Percentage Points 2011–2012	Contribution to Change in Efficiency Ratio, Percentage Points 2011–2012
Net Interest Income Assets	3.43%	3.37%	-0.06	0.97
Noninterest Income Assets	0.82%	0.96%	0.14	-2.30
Noninterest Expense Assets	3.00%	3.01%	0.02	0.40
Efficiency Ratio	70.6%	69.6%		-0.93

Source: FDIC.

Table 7

Community Bank Pretax Return on Assets (ROA) by Lending Specialty Group				
Lending Specialty Group	Year			All Years: 1985–2012
	2006–2010	2011	2012	
Agricultural Specialists	1.25%	1.38%	1.51%	1.41%
Consumer Specialists	0.89%	2.22%	1.53%	1.27%
C&I Specialists	1.04%	0.89%	1.30%	1.04%
Mortgage Specialists	0.64%	0.69%	0.93%	1.00%
CRE Specialists	0.26%	0.36%	0.82%	0.66%
No Specialty	1.05%	1.08%	1.18%	1.27%
Multi-Specialists	0.69%	0.72%	1.17%	0.99%
Total	0.61%	0.74%	1.06%	1.03%

Source: FDIC. Lending specialty groups are defined on page 5-3 of the *FDIC Community Banking Study*.  
 Note: Figures represent weighted average pretax return on assets for federally insured community banks reporting in each group during the period.

(0.43 percent of average assets) in 2012, down from \$66.6 billion (0.57 percent) in 2011 and a peak of \$141.4 billion (1.25 percent) in 2009.

Chart 15 shows that provision expenses of noncommunity banks far exceeded those of community banks at their 2009 peak, and have declined faster since then. As year-over-year reductions in provision expenses at FDIC-insured institutions become progressively smaller over time, growth in community bank earnings will increasingly depend on their ability to increase revenues.

Community banks are not a uniform group of institutions, and there has always been significant variation in performance among community bank lending specialty groups. The Study identified three lending specialty groups (agricultural specialists, diversified nonspecialty lenders, and consumer specialists) as consistently outperforming other groups in terms of pretax ROA during the 1984–2011 study period, while CRE specialists underperformed for the study period as a whole. During 2011, CRE and mortgage specialists

underperformed other community bank lending specialty groups, reflecting the ongoing effects of the real estate downturn. These two specialty groups did show a marked improvement in their profitability in 2012, mostly due to lower loan-loss provisions (see Table 7). Nonetheless, consumer and agricultural specialists continued to outperform other types of community banks in 2012.

### Capital Formation at Community Banks<sup>16</sup>

Improved profitability at community banks in 2012 was driven by higher levels of net income. Community banks as a group generated \$16.4 billion in net income in 2012, up from \$10.6 billion in 2011 and a crisis low of -\$2.8 billion in 2009. The sustained improvement in community bank earnings since 2009 has once again afforded these institutions the opportunity to generate new capital through retained earnings. Community

<sup>16</sup> Although the term “capital formation” is frequently used in national income accounting to describe increases in the stock of physical capital, it is used here to represent additions to equity capital by individual financial institutions.

Table 8

Total Additions to Equity Capital Through Retained Earnings and New Capital Raised From External Sources, 2012					
Bank Type	Additions to Capital Through:				Total
	Retained Earnings		New Capital Raised From External Sources		
	\$ Billions	% of Total	\$ Billions	% of Total	\$ Billions
Community Banks	\$7.5	69%	\$3.4	31%	\$10.9
Noncommunity Banks	\$37.3	84%	\$7.0	16%	\$44.3
Total	\$44.8	81%	\$10.4	19%	\$55.2

Source: FDIC.  
Note: Figures are not adjusted to reflect merger activity.

banks generated \$7.5 billion in capital through retained earnings in 2012 (see Table 8), up from \$4.2 billion in 2011. Some 69 percent of the total increase in community bank capital in 2012 was generated through retained earnings, while the remaining \$3.4 billion (31 percent of the total increase) was raised from external sources.

Although earnings were an important source of capital formation during 2012, community banks devoted a smaller share of net income to retained earnings during the year. Among community banks that earned a profit for the year, the earnings retention ratio fell to 51 percent in 2012 from 58 percent in 2011, with the remaining income being paid out in dividends. Although the community bank earnings retention ratio remained near its ten-year average in 2012, it is well below the average level of 62 percent reported between 1984 and 2002. Meanwhile, noncommunity banks continued to pay dividends at a much higher rate than did community banks, retaining only 31 percent of 2012 earnings and paying out the remaining 69 percent in dividends.

Community banks historically have been more reliant than noncommunity banks on capital raised through retained earnings, but the opposite was true in 2012.<sup>17</sup> Noncommunity banks generated \$37.3 billion in retained earnings during the year, accounting for 84 percent of their total additions to equity capital. Part of the success by noncommunity banks in generating retained earnings is attributable to a more rapid recovery in their net income following the crisis, from a low of -\$7.1 billion in 2009 to \$124.7 billion in 2012. In addition, some of the nation's largest banks either remain unable to pay dividends under the Federal

<sup>17</sup> For a historical comparison of capital raised from retained earnings by community and noncommunity banks, see Table 6.1 of the *FDIC Community Banking Study*.

Reserve's Comprehensive Capital Analysis and Review (CCAR) process or have moved cautiously in restoring their dividends in the wake of the crisis.<sup>18</sup>

Despite the importance of retained earnings to capital formation at both community and noncommunity banks, capital raising from external sources continues to be important to both groups. During 2012, 549 community banks raised \$3.4 billion in new capital from external sources. This capped a five-year period in which community banks as a group raised a total of nearly \$40 billion from the capital markets, and reflects continued investor confidence in the community banking model. Altogether, this new capital represented 18 percent of the total equity capital held by community banks at the end of 2012. In addition, none of the \$3.4 billion in external capital raised by community banks during 2012 was obtained through participation in either the government-sponsored Capital Purchase Program, which stopped disbursing in 2009, or the Small Business Lending Fund, which stopped disbursing in 2011.

With the capital obtained during 2012 through retained earnings and from external sources, community banks were able to increase their capitalization levels as measured by both the leverage and total risk-based capital ratios (see Table 9).<sup>19</sup> Community banks have historically held higher levels of capital than have noncommunity banks, and this pattern continued in 2012. At the end of the year, community banks held equity capital equal to 10.20 percent of total assets, compared with 8.97 percent for noncommunity banks.

<sup>18</sup> For details on the CCAR process and the Federal Reserve's dividend guidance to participating large banking organizations, see: <http://www.federalreserve.gov/newsevents/press/bcreg/20130314a.htm>.

<sup>19</sup> It should be noted that banks report other changes to equity capital, some of which are relatively large, but these changes do not represent net capital formation and are not part of the analysis in this chapter.

Table 9

Capital Ratios at Community and Noncommunity Banks, 2011–2012			
	Bank Type	Year-End 2011	Year-End 2012
Leverage Ratio	Community Banks	10.02%	10.20%
	Noncommunity Banks	8.91%	8.97%
Total RBC Ratio	Community Banks	16.27%	16.47%
	Noncommunity Banks	15.16%	14.89%

Source: FDIC. The leverage ratio measures common equity, certain types of preferred equity, and retained earnings as a percentage of total assets. The total risk-based capital ratio uses a broader regulatory definition of capital and adjusts total assets to reflect a range of on- and off-balance-sheet exposures.  
 Note: Capital ratios for 2011 are adjusted to account for acquisitions that occurred in 2012.

The community bank total risk-based capital ratio at year-end 2012 was 16.47 percent, compared with 14.89 percent at noncommunity banks.

**Conclusion**

By many measures, 2012 was the best year for community banks since the beginning of the financial crisis. The number and rate of community bank failures declined, even as voluntary community bank closures increased. Although there were no new institutions chartered in 2012, recent signs point to renewed interest in new bank charters. Community banks continued to strengthen their balance sheets in 2012 by reducing problem assets and increasing capital levels. Although community bank assets grew at a slower rate than did those of noncommunity banks, the improvement in credit performance at community banks made it possible for them to achieve a net growth rate of 2.4 percent of total assets for the year.

Community bank earnings continued to recover in 2012, with net income totaling \$16.4 billion—the second-highest annual figure on record. Pretax ROA exceeded 1 percent for the first time since 2007, and the profitability gap between community and noncommunity banks narrowed by 17 basis points from 2011. The improvement in community bank profitability was driven by higher noninterest income and lower loss provisions, which more than offset a decline in net interest income. The factors that drove increased profitability in 2012 may prove to be short-lived,

however, and future earnings growth will eventually need to be based on increases in net interest income. Even so, community banks were able to augment their equity capital by \$10.9 billion during 2012, of which \$7.5 billion was derived from retained earnings.

Despite their relatively low 14 percent share of banking industry assets, community banks continue to play an important role in the U.S. financial system. At year-end 2012, community banks represented 92 percent of FDIC-insured banking charters and 95 percent of U.S. banking organizations, and held 46 percent of the industry’s small loans to farms and businesses—all percentages that were unchanged from 2011. Additionally, they continue to hold the majority of deposits in offices located in rural and micropolitan areas, and there were 615 U.S. counties in 2012 where the only physical banking offices were those operated by community banks.

The ability to generate capital and support balanced growth through retained earnings has traditionally been a recipe for long-term success for many community banks. Although operating conditions remain challenging on a number of fronts, these developments mark continued progress in the community banking sector’s recovery from the effects of the financial crisis.

*Author: Benjamin R. Backup  
 Economic Analyst  
 Division of Insurance and Research*