

# Chapter 1 - Defining the Community Bank

To begin a study of community banking, it is necessary to define what it means to be a community bank.<sup>1</sup> Most people are able to articulate the characteristics of community banks, as the characteristics tend to revolve around how and where a community bank conducts business. For example, community banks focus on providing traditional banking services in their local communities. They obtain most of their core deposits locally and make many of their loans to local businesses. For this reason, they are often considered to be “relationship” bankers as opposed to “transactional” bankers.<sup>2</sup> This means that they have specialized knowledge of their local community and their customers. Because of this expertise, community banks tend to base credit decisions on local knowledge and nonstandard data obtained through long-term relationships and are less likely to rely on the models-based underwriting used by larger banks.

This relationship approach to lending is particularly important to small businesses that rely on community banks for loans and other services. Small businesses, particularly small start-up companies, may be unable to satisfy the requirements of the more structured approach to underwriting that larger banks use. The relationship lending approach used by community banks is often the only avenue small businesses have to obtain loans and access other financial services.

Community banks can develop these close relationships with customers because they tend to be smaller in size and only conduct business locally. The larger the institution, and the more places it does business, the more difficult it is to manage relationships at a personal level.

Community banks are also more likely to be privately owned and locally controlled than larger banks. Even when community banks have public shares, they are usually not traded on the major exchanges. This means that community banks may weigh the competing interests of shareholders, customers, employees, and the local

community differently from a larger institution with stronger ties to the capital markets.<sup>3</sup>

While a rough consensus exists on the attributes that describe a community bank, defining one clearly proves to be more difficult in practice. The standard method used by most bank analysts has been to define community banks according to their size, as measured by their assets. Some studies rely on various asset size limits in their analysis of community banking trends without actually specifying the size that separates community banks from other institutions.<sup>4</sup> Others do impose a specific size limit in their definition of community banks, even while acknowledging that size alone is an imperfect criterion and that fixed size limits can be arbitrary. Many of these studies use \$1 billion in total assets as a limit, which is typically applied to individual banks rather than to all banks in a banking organization; that is, at the charter level rather than the banking organization level. Some studies, however, apply the definition at the level of the banking organization.<sup>5</sup> More recently, a \$10 billion size limit has come to be used more frequently to define community banks.<sup>6</sup>

One problem with defining community banks using a fixed size limit is that any dollar-based yardstick must be adjusted over time to account for factors such as inflation, economic growth, and the size of the banking industry itself. According to any of these measures, \$1 billion is not what it used to be. Between 1984 and 2011, the Consumer Price Index rose 2.1 times, while the size of the U.S. economy, in terms of nominal Gross Domestic Product, rose by 3.8 times. In addition, even as more financial transactions were taking place outside of the formal banking system, the total assets of federally insured banks and savings institutions also rose by 3.8 times.

<sup>1</sup> For purposes of this study, the term bank refers to FDIC-insured banks and thrifts.

<sup>2</sup> Numerous studies refer to and describe the concept of relationship banking. See, for example, Hein, Koch and MacDonald (2005); Critchfield, Davis, Davison, Gratton, Hanc, and Samolyk (2004); Berger and Udell (2001), and DeYoung, Hunter and Udell (2004).

<sup>3</sup> See, for example, Ostergaard, Schindele, and Vale (2009).

<sup>4</sup> An example of this approach is found in Hein, Koch and MacDonald (2005).

<sup>5</sup> DeYoung, Hunter and Udell (2004) apply a \$1 billion limit at the charter level, while Critchfield, Davis, Davison, Gratton, Hanc, and Samolyk (2004) apply the \$1 billion limit at the level of the banking organization. The 2003 study by the Federal Reserve Bank of Kansas City also takes the latter approach.

<sup>6</sup> See, for example, Statement by Maryann F. Hunter, Deputy Director, Division of Banking Supervision and Regulation Community, Federal Reserve Board, Before the Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC, April 6, 2011, <http://www.federalreserve.gov/newsevents/testimony/hunter20110406a.htm>.

The other problem with using a fixed size limit to define community banks is that the attributes associated with community banking are only loosely correlated with size. Some smaller institutions may have business specialties that are far removed from deposit gathering and lending to local customers, while some larger institutions may continue to do just that. Therefore, a closer look at the business and office structure of the institution is necessary to determine the extent to which it is focused on traditional lending and deposit gathering activities, as well as its geographic scope of operations.

This is precisely the approach used by the FDIC to arrive at a new research definition of the community bank. The FDIC research definition makes extensive use of financial reporting data on the balance sheet and number and location of offices for each bank. It uses the data to establish standard requirements for lending and deposit gathering and to set limits on the geographic scope of operations that a banking organization must meet to be designated as a community bank. The definition remains loosely based on size, but goes beyond size alone in separating community banks from noncommunity banks. Finally, the FDIC definition of a community bank offers potential benefits over purely size-based definitions in terms of minimizing the influence of outliers that could interfere with statisti-

cal comparisons between community and noncommunity banks.

The process of designating community banks for this purpose consists of five steps, described below. A summary of the designation process appears in Table 1.1, and details are described in Appendix A.

The first step in defining a community bank is to aggregate all charter-level data reported under each holding company into a single banking organization. This aggregation applies both to balance-sheet measures and the number and location of banking offices. At year-end 2011, there were 7,357 FDIC-insured banking charters operating within 6,720 separate banking organizations. Under the FDIC definition, if the banking organization is designated as a community bank, every charter reporting under that organization is also considered a community bank when working with data at the charter level.

The second step is to exclude any banking organization where more than 50 percent of total assets are held in certain specialty banking charters, including: *credit card specialists, consumer nonbank banks, industrial loan compa-*

**Table 1.1**

<b>Summary of FDIC Research Definition of Community Banking Organizations</b>	
Designate community banks at the level of the banking organization. All charters under designated holding companies are considered community banking charters.	
<p><u>Exclude:</u></p> <p>Any organization with:</p> <ul style="list-style-type: none"> <li>- No loans or no core deposits</li> <li>- Foreign Assets <math>\geq</math> 10% of total assets</li> <li>- More than 50% of assets in certain specialty banks, including:               <ul style="list-style-type: none"> <li>• credit card specialists</li> <li>• consumer nonbank banks<sup>1</sup></li> <li>• industrial loan companies</li> <li>• trust companies</li> <li>• bankers' banks</li> </ul> </li> </ul> <p><sup>1</sup> Consumer nonbank banks are financial institutions with limited charters that can make commercial loans or take deposits, but not both.</p>	<p><u>Include:</u></p> <p>All remaining banking organizations with:</p> <ul style="list-style-type: none"> <li>- Total assets &lt; indexed size threshold<sup>2</sup></li> <li>- Total assets <math>\geq</math> indexed size threshold, where:               <ul style="list-style-type: none"> <li>• Loan to assets &gt; 33%</li> <li>• Core deposits to assets &gt; 50%</li> <li>• More than 1 office but no more than the indexed maximum number of offices.<sup>3</sup></li> <li>• Number of large MSAs with offices <math>\leq</math> 2</li> <li>• Number of states with offices <math>\leq</math> 3</li> <li>• No single office with deposits &gt; indexed maximum branch deposit size.<sup>4</sup></li> </ul> </li> </ul> <p><sup>2</sup> Asset size threshold indexed to equal \$250 million in 1985 and \$1 billion in 2010.  <sup>3</sup> Maximum number of offices indexed to equal 40 in 1985 and 75 in 2010.  <sup>4</sup> Maximum branch deposit size indexed to equal \$1.25 billion in 1985 and \$5 billion in 2010.</p>
Source: FDIC.	

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nies, trust companies, bankers' banks, and banks holding 10 percent or more of total assets in foreign offices.<sup>7</sup>

Once the specialty organizations are removed, the third step involves including organizations that engage in basic banking activities as measured by the total loans-to-assets ratio (greater than 33 percent) and the ratio of core deposits to assets (greater than 50 percent). Analysis of the underlying data shows that these thresholds establish meaningful levels of basic lending and deposit gathering while still allowing for a degree of diversity in how individual banks construct their balance sheets.

The fourth step includes organizations that operate within a limited geographic scope. This limitation of scope is used as a proxy measure for a bank's relationship approach to banking. Banks that operate within a limited market area have more ease in managing relationships at a personal level. Under this step, four criteria are applied to each banking organization. They include both a minimum and maximum number of total banking offices, a maximum level of deposits for any one office, and location-based criteria. The limits on the number of and deposits per office are gradually adjusted upward over time. For banking offices, banks must have more than one office, and the maximum number of offices starts at 40 in 1985 and reaches 75 in 2010. The maximum level of deposits for any one office is \$1.25 billion in deposits in 1985 and \$5 billion in deposits in 2010. The remaining geographic limitations are also based on maximums for the number of states (fixed at 3) and large metropolitan areas (fixed at 2) in which the organization maintains offices.<sup>8</sup>

Finally, the definition establishes an *asset-size limit*, also adjusted upward over time from \$250 million in 1985 to \$1 billion in 2010, below which the limits on banking activities and geographic scope are waived. This final step acknowledges the fact that most of those small banks that

are not excluded as specialty banks meet the requirements for banking activities and geographic limits in any event.<sup>9</sup>

While more detailed than a simple asset-size limit, the FDIC research definition of the community bank is entirely based on standard data reported by the financial institutions themselves or by federal government agencies. This ensures that the definition is as objective and transparent as possible, that it can be applied consistently across the 27-year period of the study, and that it can be replicated and used by other researchers.

Applying this research definition of the community bank shows that most banks are community banks. Of the 6,914 U.S. banking organizations reporting at year-end 2010, 94 percent were designated as community banks (Table 1.2).

Table 1.2 shows that the 390 banking organizations designated as noncommunity banks fell into three groups. The left side of the diagram shows that the 92 organizations with assets less than \$1 billion, plus another 34 with assets greater than or equal to \$1 billion, were excluded at the outset as specialty banks. Another 264 banking organizations (upper right of Table 1.2) failed to meet the requirements for banking activities and limited geography, and exceeded the 2010 asset-size limit of \$1 billion under which those requirements could be waived.

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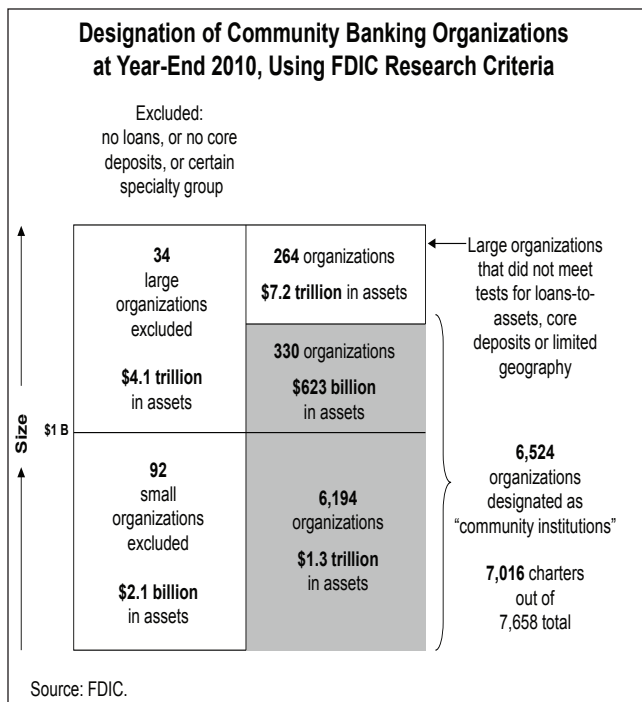
<sup>7</sup> Credit card banks are defined as institutions with credit card loans plus securitized receivables in excess of 50 percent of total assets plus securitized receivables. A consumer nonbank bank is a financial institution with a limited-purpose charter that can make commercial loans or take deposits, but not both. Industrial loan companies can be owned by commercial firms that are not regulated by a federal banking agency. A trust company is a corporation whose function is to act as a trustee, fiduciary, or agent for individuals or firms. A bankers' bank is a financial institution that provides financial services to other banks.

<sup>8</sup> As defined by the Office of Management and Budget, a metropolitan statistical area (MSA) contains a core urban area of 50,000 or more in population. For purposes of the study, a large MSA is defined as one with a population of more than 500,000.

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<sup>9</sup> In 2010, after excluding specialty banks and banks that did not meet the minimum office requirement, 94 percent of banking organizations with assets less than \$1 billion met the requirements for banking activities and limited geographic scope. The minimum office requirement is effectively waived for institutions that fall under the asset size threshold applied during step 5.

Table 1.2



The result was the designation of 6,524 banking organizations (holding 7,016 FDIC-insured charters) as community banks. Of these, 330 exceeded the \$1 billion limit that might have identified them as noncommunity banks if a strict asset-size definition had been applied. The designation of these larger institutions as community banks is important, in that it shows that using asset-size limits alone could unnecessarily exclude relatively large banks that otherwise conduct business very much like other community institutions.

**Who Are the Noncommunity Banks?**

While the FDIC’s research focuses on refining the definition of a community bank and further analysis of that universe, it is important to review those institutions that were not identified as community banks. As of year-end 2010, there were 390 organizations that did not meet the definition of a community bank and were designated as noncommunity banks. Although noncommunity banks represent only 6 percent of all 6,914 banking organizations, they account for 63 percent of total U.S. banking offices and 85 percent of total industry assets.

Total noncommunity banks were separated into the following size groups for further analysis: noncommunity banks under \$1 billion, between \$1 billion and \$10 billion, between \$10 billion and \$100 billion, over \$100 billion, and those institutions that are part of the four largest banking organizations (Bank of America Corporation; Citigroup Inc.; JP Morgan Chase & Company; and Wells Fargo & Company. Table 1.3 compares the number of organizations, total assets, and the number of offices for each of these noncommunity bank size groups against the corresponding totals for community banks and for the industry as of year-end 2010. The four largest banking organizations report the largest share of industry assets, with 45 percent; however, they report only 19 percent of the total number of industry offices. In comparison, community banks report 37 percent of the total number of industry offices, and 15 percent of industry assets.

**Table 1.3 Composition of Noncommunity Banks Compared With Community Banks as of Year-End 2010**

Noncommunity Bank Categories	Number of Organizations	%	Total Assets (in \$ Billions)	%	Number of Offices	%
Four Largest Banking Organizations*	4	0%	5,989	45%	18,937	19%
Noncommunity Banks over \$100 Billion	12	0%	2,172	16%	16,636	17%
Noncommunity Banks between \$10 Billion and \$100 Billion	76	1%	2,430	18%	15,112	15%
Noncommunity Banks between \$1 Billion and \$10 Billion	206	3%	764	6%	11,368	12%
Noncommunity Banks under \$1 Billion	92	1%	21	0%	150	0%
Community Banks	6,524	94%	1,944	15%	36,274	37%
Industry Totals	6,914	100%	13,319	100%	98,477	100%

Source: FDIC.

\* Includes 21 FDIC-insured institutions owned by the nation’s four largest banking organizations by asset size: Bank of America Corporation; Citigroup Inc.; JP Morgan Chase & Company; and Wells Fargo & Company.

Note: Total asset data are based on the amounts reported by the holding company.

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## Summary

Community banks are known for their focus on traditional banking activities. Community banks mainly conduct lending and deposit gathering activities within a fairly limited market area. They are said to be relationship lenders, which rely to a significant degree on specialized knowledge gained through long-term business relationships. They are likely to be owned privately or have public shares that are not widely traded, and therefore tend to place the long-term interest of their local communities high relative to the demands of the capital markets. Since these attributes are generally—but not always—associated with smaller banking organizations, most previous studies have used asset size alone to define community banks.

Using detailed balance sheet and geographic data, this study goes further to define community banks primarily in terms of their traditional relationship banking and limited geographic scope of operations. Based on this definition, 94 percent of all U.S. banking organizations and 92 percent of FDIC-insured banking charters were community banks as of 2010. Importantly, the definition includes 330 institutions at year-end 2010 that met the criteria for community banks, but exceeded the size limit that might ordinarily have excluded them from this group. The remainder of the study employs this definition of the community bank to explore a range of structural, performance, and competitive issues.

