Appendix A - Details of the Research Definition of the Community Bank

To capture the essential qualities of community banks in a workable definition, the study reviewed and compared several alternative methods of employing the available bank financial reporting data. The following series of five steps demonstrate how to assemble and filter the available data in order to arrive at the research definition of community bank. This definition was developed during 2011 using year-end 2010 financial and demographic data but can be replicated using future data by following the five steps.

Step 1: Aggregate bank-level data reported under each holding company into a single banking organization.

Although community banks are designated at the level of the banking organization, most of the data used to make that designation are reported at the bank level.[1] Therefore, the first step in applying the definition is to aggregate the bank-level data to the level of the organization. For some very small banks and banks not in a holding company, the bank itself represents the organization. For banks in a bank holding company, all banks under the holding company are combined into one organization. This applies both to balance-sheet measures and the branch structure describing the number and location of banking offices.

Banks are grouped at the organization level in order to take into account the activity of the entire banking organization, not just an individual subsidiary. Considering the entire organization is particularly important when evaluating data from the time before states eased or eliminated restrictions on intrastate branching and before the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994, the federal law that eliminated restrictions on interstate banking. Before laws allowed for inter- or intrastate branching, individual banks in a holding company often functioned as substitutes for branches.

At year-end 2010, 7,658 FDIC-insured banking charters operated within 6,914 separate banking organizations.

Under the designation process, if a banking organization is designated as a community bank, every bank reporting under that organization is also considered a community bank.

Step 2: Exclude specialty banks.

Five categories of specialty banks are excluded from the definition of community banks: credit card specialists, consumer nonbank banks, industrial loan companies, trust companies, bankers' banks, and banking organizations holding 10 percent or more of total assets in foreign offices.[2]

For purposes of the study, holding companies in which more than 50 percent of total bank assets reside within a specialty bank qualify at the organizational level as a specialty bank. In that event, the banking organization as a whole is designated as a noncommunity bank, as are all of the individual banks that operate within that organization. In addition, banking organizations with either no loans or no core deposits are also excluded.

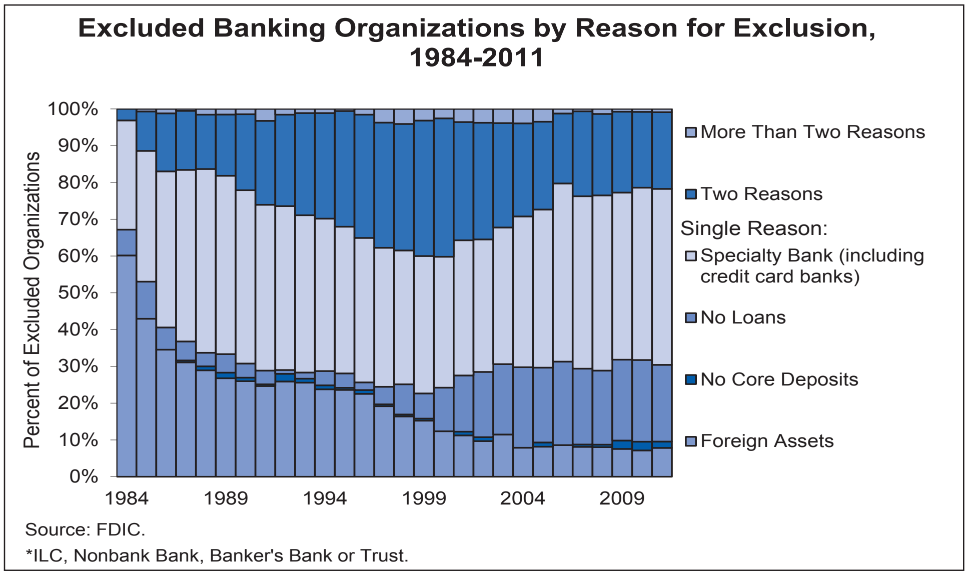
When applying these exclusions to banking organizations operating at year-end 2010, 126 organizations are excluded from the community bank definition. Chart A.1 depicts how the reasons for excluding specialty banks have evolved over time. Most of the exclusions were made due to a single reason. In the earliest years of the sample period, the most prevalent reason was holding foreign assets greater than 10 percent of total assets. Over the past 20 years, specialty banks have represented the most prevalent case of excluded banks. Since 2001, having no loans has been the second most prevalent single reason for exclusion, explaining 22 percent of all excluded banking organizations in 2010 (see Chart A.1).

---

[1] At year-end 2011, 1,039 institutions (14 percent of all FDIC-insured charters) reported under multi-bank holding companies, while another 4,319 institutions (59 percent) reported under single-bank holding companies and 1,999 (27 percent) operated independently of any holding company.

[2] 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.

Chart A.1



Step 3: Include organizations that engage in basic banking activities.

Because the conceptual definition of the community bank begins with the essential functions of lending and deposit gathering, minimum levels for the ratio of loans-to-assets (33 percent) and core-deposits-to-assets (50 percent) are imposed on each banking organization.[3] The thresholds are applied uniformly for each year-end data period. The thresholds are waived for small institutions as described in Step 5 below. Charts A.2 and A.3 depict the share of all banking organizations that fall short of these thresholds in any given year.

[3] Core deposits are defined as domestic deposits less brokered deposits. Historically, core deposits have been defined for analytical and examination purposes as the sum of demand deposits, all NOW and automatic transfer service accounts, money market deposit accounts, other savings deposits, and time deposits under $100,000. On March 31, 2011, this definition was revised to reflect the permanent increase in FDIC deposit insurance coverage from $100,000 to $250,000 and to exclude insured brokered deposits from core deposits. The definition used in the study provides consistency over time, since core deposits as defined before March 31, 2011, included some brokered deposits.

Chart A.2

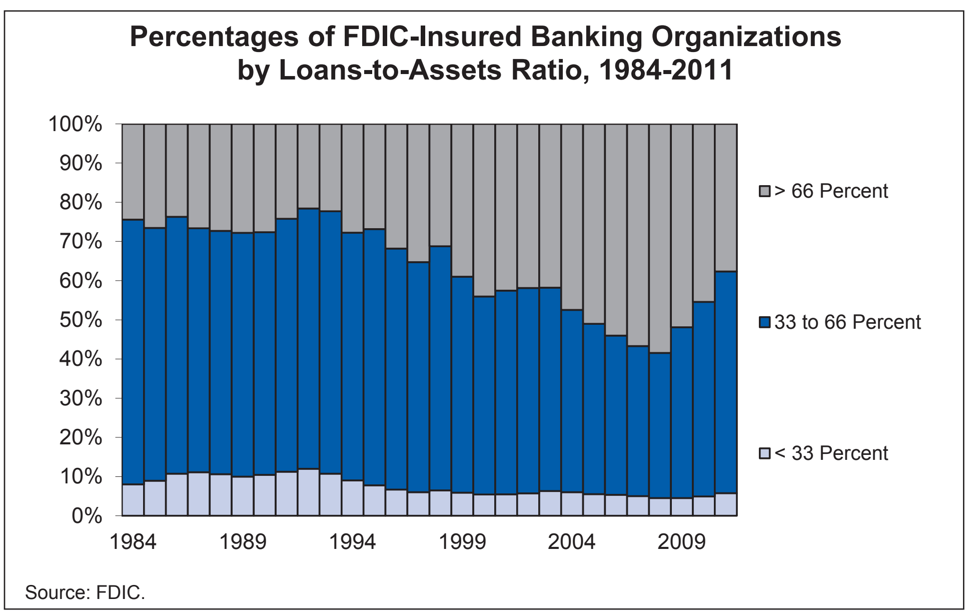
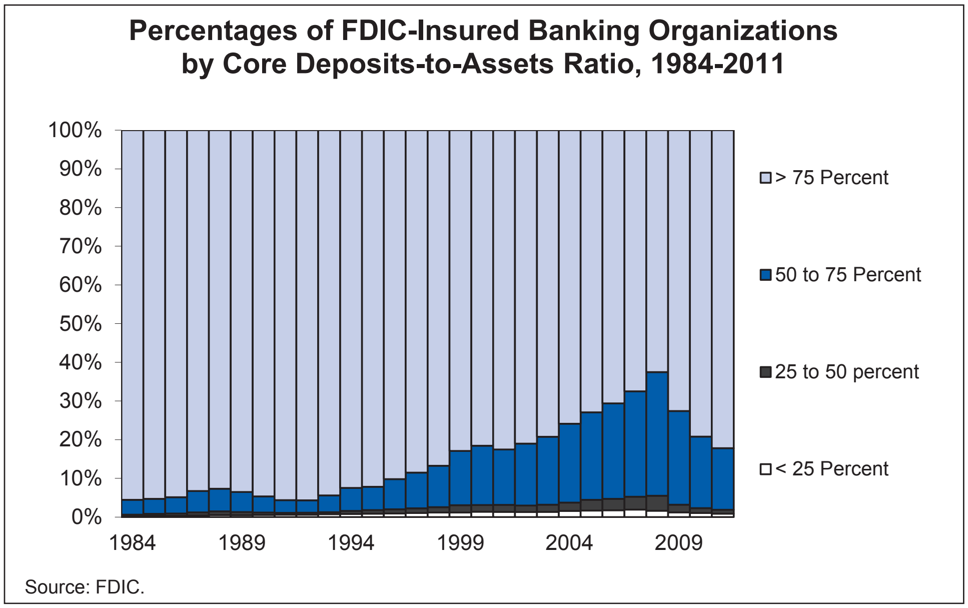


Chart A.3



The charts show that the vast majority of banking organizations meet both of these thresholds for basic banking activities. More banks, however, are excluded under the 33 percent loans-to-assets requirement than under the 50 percent core-deposits-to-assets requirement. FDIC analysis of the historical data shows that community banks typically raise core deposits in their local markets, but some institutions with an apparent community focus hold low levels of loans on their balance sheets, particularly during times of economic distress. Therefore, the 33 percent loans-to-assets threshold is chosen in lieu of a higher value in order to avoid making this requirement too restrictive.

Step 4: Include organizations with a limited geographic scope of operations.

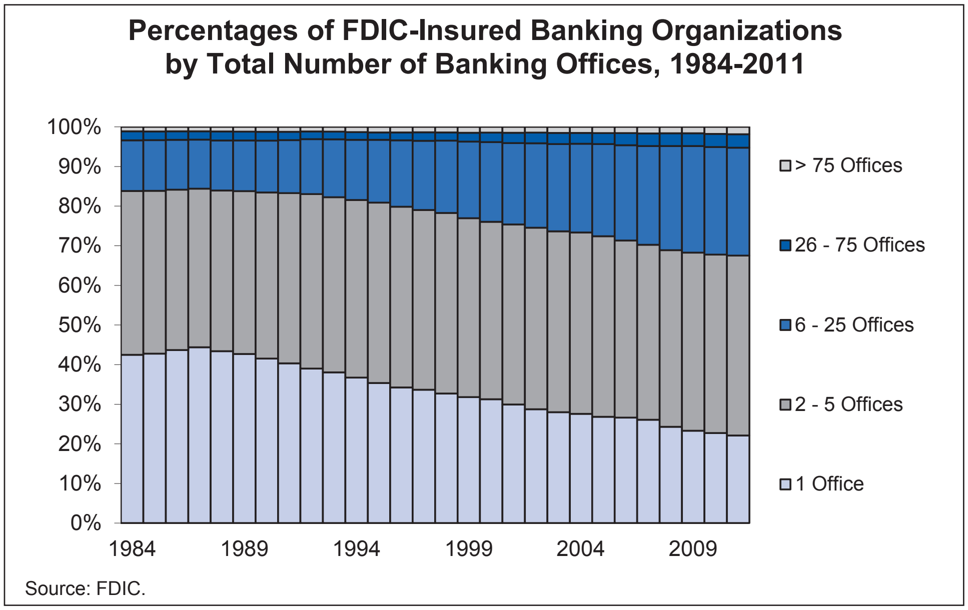
A combination of thresholds was imposed to establish that the institution operates within a limited market area and is therefore in a better position to operate under a relationship lending approach than an institution with more widespread operations. A number of these thresholds are indexed over time to reflect how technological advances have enabled the average institution to gradually increase its geographic reach. As was the case with the thresholds imposed in Step 3, these geographic limits are waived for small institutions as described in Step 5 below.

Number of Banking Offices. The organization must have more than one office but not more than a maximum number of banking offices that varies over time, from 40 in 1985 to 75 in the baseline year of 2010. The maximum number of banking offices slowly increases based on a compound annual growth rate of 2.55 percent and is rounded to the nearest whole number. These thresholds are designed to allow for the fact that some institutions with fairly extensive branch networks can still operate under a community banking model. Beyond these thresholds, it would be difficult for an institution to operate with the degree of local autonomy typical of a community bank. The maximum office threshold encompasses approximately 98 percent of all banking organizations during the time period from 1985 to 2010 (see Chart A.4).[4]

While the minimum office requirement appears to exclude organizations with only one office from the community bank definition, Step 5 below describes how balance sheet and geographic requirements are waived for small institutions. As a result, small institutions with only one office

[4] Office data are obtained from the FDIC Summary of Deposits (SOD) and have been collected annually each June since 1987. These data are merger-adjusted to the end of the year for purposes of defining a community bank. In some cases, a bank with year-end data may have come into existence or obtained deposit insurance after SOD data were collected for that year. If no SOD data are available, data are used from the following year when possible. For banks in years prior to 1987, SOD data and thresholds for 1987 are used to determine whether banks are community banks. If 1987 SOD data are not available, as in the case of a bank failing or being acquired by another bank before 1987, office totals as reported in Call Reports and TFRs filed by banks are used to verify the minimum and maximum office criteria. The definition of an office as reported in the Call Reports and TFRs is slightly more expansive than the definition in SOD; so, for Call Report and TFR data, office thresholds are adjusted upward to 45. Banks in years prior to 1987 for which 1987 SOD data are not available are evaluated based on the loan-to-asset ratio, core-deposit-to-asset ratio, and minimum and maximum office criteria, since data are not available to evaluate the number of states, large metropolitan area, or the deposits in a single office criteria.

Chart A.4



are still defined as community banks. Institutions too large for the waiver described in Step 5 must meet the minimum office requirement, which helps to ensure that the institution primarily gathers deposits locally and does not rely excessively on the internet or other automated means to obtain funding.

Number of States and Large Metro Areas. The institution must maintain offices in no more than three states and no more than two large metropolitan areas.[5] These criteria further help to ensure that the bank headquarters and its branch offices are not located so far apart as to interfere with the bank's ability to make credit and other management decisions as a relationship lender. At the same time, allowing for offices in up to three states helps to ensure that community banks located near state lines are not unnecessarily excluded from the definition. Chart A.5 and Chart A.6 show that relatively few institutions exceed these maximums for offices in multiple states and large metro areas, respectively.

Deposits in a Single Office. To further ensure that the institution primarily gathers deposits locally and does not rely excessively on the internet or other automated means to obtain funding, a limit is placed on the dollar volume of deposits the organization can hold in any one banking office.[6] This threshold varies over time, from $1.25 billion in 1985 to $5 billion in 2010. The maximum slowly increases based on an annual compound growth rate of 5.7 percent.

Step 5: Establish an asset size threshold below which the limits on banking activities and geographic scope are waived.

The preceding steps (Steps 3 and 4) go beyond asset size alone as a criteria for designating community banks and impose limits on banking activities and geographic scope. After imposing these conditions, 94 percent of banking organizations with total assets less than $1 billion in 2010 (and that had not been excluded as specialty banks) meet these criteria.[7] Accordingly, our definition is liberalized somewhat to exempt in 2010 all banking organizations with total assets less than $1 billion from the thresholds imposed on banking activities and geography in Steps 3 and 4 above. Moreover, since the median and average bank size changes over time with inflation, economic

[5] 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.

[6] When filing the SOD, FDIC-insured institutions may follow different procedures when assigning deposits to branches, such as the proximity to the account holder's address, the office where the deposit account is most active, the office where the account originated, or the office assignment used when determining employee compensation. Conceivably, the methodology used by an institution could affect whether it exceeds this threshold.

[7] The minimum office requirement is effectively waived for institutions that fall under the asset size threshold. As described in Step 4, this requirement is intended to ensure that large institutions primarily gather deposits locally and do not rely excessively on the Internet or other automated means to obtain funding.

Chart A.5

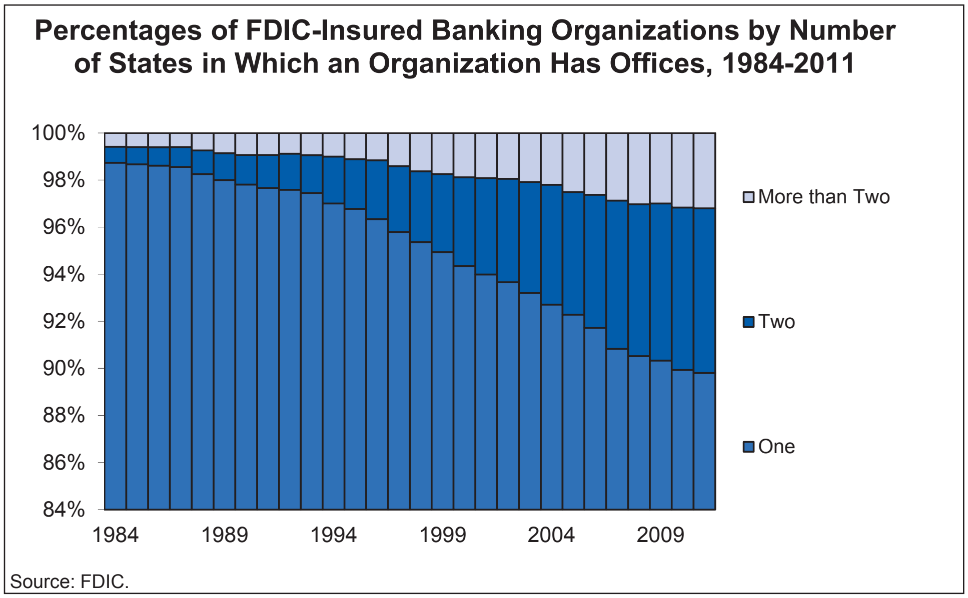
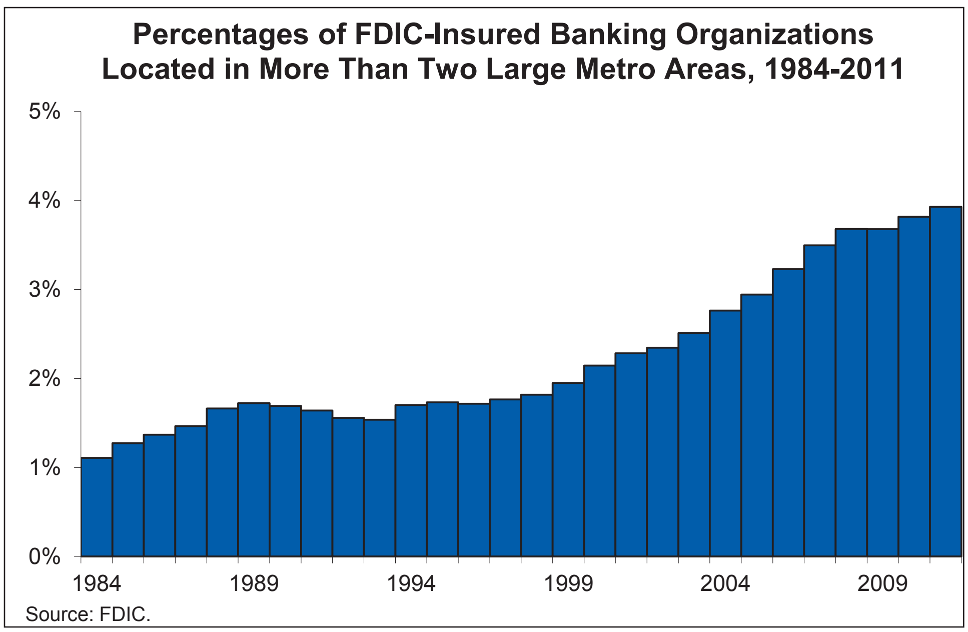


Chart A.6



growth, and the size of the banking industry, the asset-size threshold for this exemption is indexed back over time to a level that equaled $250 million as of year-end 1985.[8] Similarly, as is the case in the 2010 data, more than 90 percent of banking organizations with total assets below the 1985 asset-size threshold (and that had not been excluded as specialty banks) meet the criteria in Steps 3 and 4.

[8] A compound annual growth rate of 5.7 percent is applied to the asset size threshold in every year, making the size threshold $250 million in 1985, $1 billion in 2010. Approximately 90 percent of all banking organizations fall within these asset-size thresholds in both 1985 and 2010, our base years for arriving at this calculation.

Conclusion

The net effect of allowing this asset-size exemption is to make the research definition similar in some respects to previous studies that have imposed a size threshold of $1 billion. By comparison, however, the research definition is more restrictive in that it indexes that size threshold backward over time, and it is more permissive in that it includes any banking organization with assets greater than $1 billion that also meets the definitional requirements for banking activities and geographic scope of operations.