

# **Matters of Size**

**Small banks face unique business circumstances and policy needs**

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January 23, 2011

## EXECUTIVE SUMMARY

The Dodd-Frank Act includes a variety of provisions that, in both purpose and effect, create special benefits for community banks. None of those provisions, though, address community banks' core structural challenge: they are increasingly confined to the most volatile corners of the credit markets.

- **The crisis magnified -- it did not create -- the challenges facing community banks.** Although the variety of bank rescue programs disproportionately benefited the largest "too big to fail" institutions, small banks' woes did not begin, nor have they ended, with the financial crisis. This is because small banks and their larger competitors are fundamentally different from one another. They do not face the same structural challenges, for they differ in personnel, history, and business strategy.

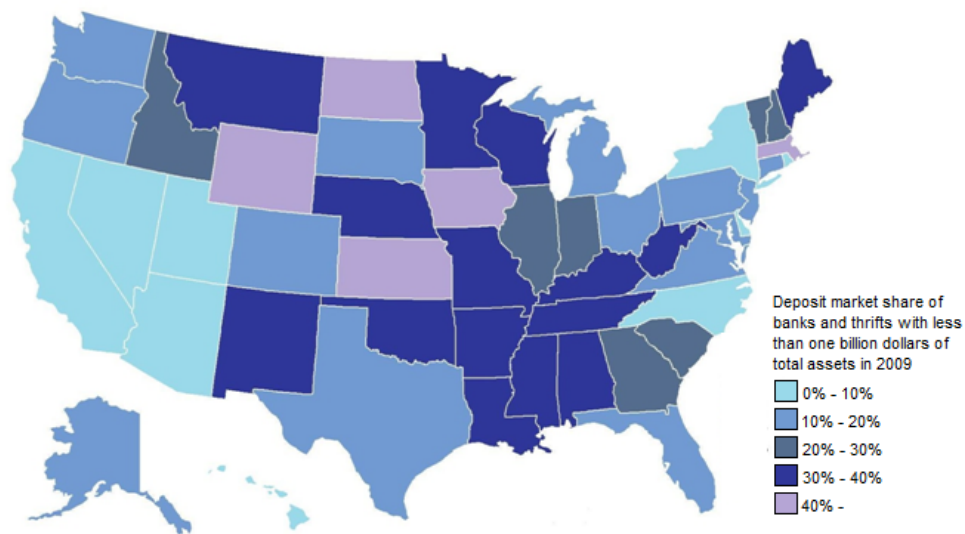
- **Legislation should view small and large institutions through distinct lenses.** The late 1990's reforms, culminating in the 1999 Gramm Leach Bliley Act, have not enabled small banks to enter scale-intensive (but capital-efficient) fee businesses -- those benefits have accrued almost entirely to large banks. At the same time, small banks have found it difficult to efficiently originate credit risk for their traditional balance sheet lending.

- **When making policy, it is essential to understand that small banks and large banks need to be viewed as separate industries that face largely disparate challenges.** A combination of market and regulatory forces has increasingly confined small banks to commercial real estate and construction lending. These particularly volatile asset classes make it difficult for geographically constrained firms to safely hold these assets through the cycle. The plight of small banks is different from the immediate challenges facing the largest financial institutions. Policy makers should not expect the same protocol to equally impact these dissimilar entities.

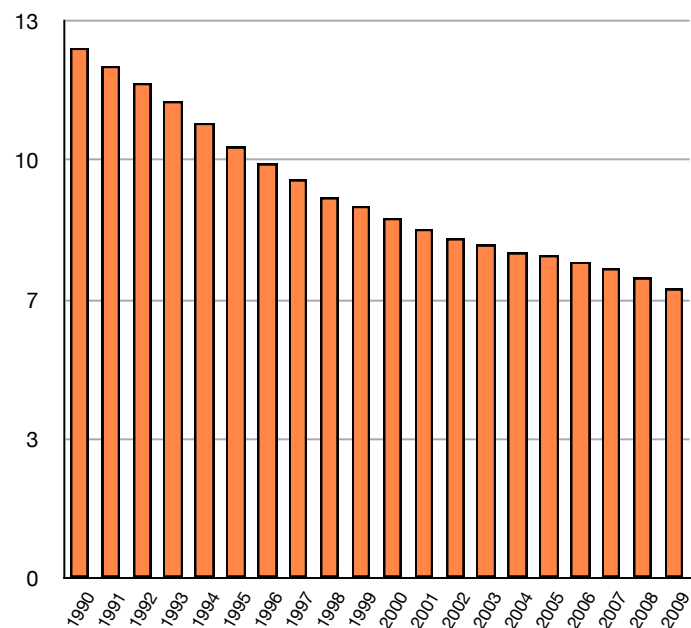
Community banks won a number of special benefits in the Dodd-Frank Act -- like exclusion from primary CFPB supervision, grandfathered tier-I treatment for hybrid securities, and exemption from resolution fund or OFR assessments. Those political gains are not especially surprising; community banks are, quite literally, everywhere, in every congressional district. Despite that continued ubiquity, though, they have a faced a decades-long decline.

## THE PERSISTENT DECLINE IN COMMUNITY BANKS SUGGESTS THAT THEY FACE CIRCUMSTANCES DIFFERENT FROM THOSE OF THE LARGEST BANKS

**Community Banks' Deposit Market Share, 2009**  
Percent



**Community Banks, 1990-2009**  
Number of firms, thousands



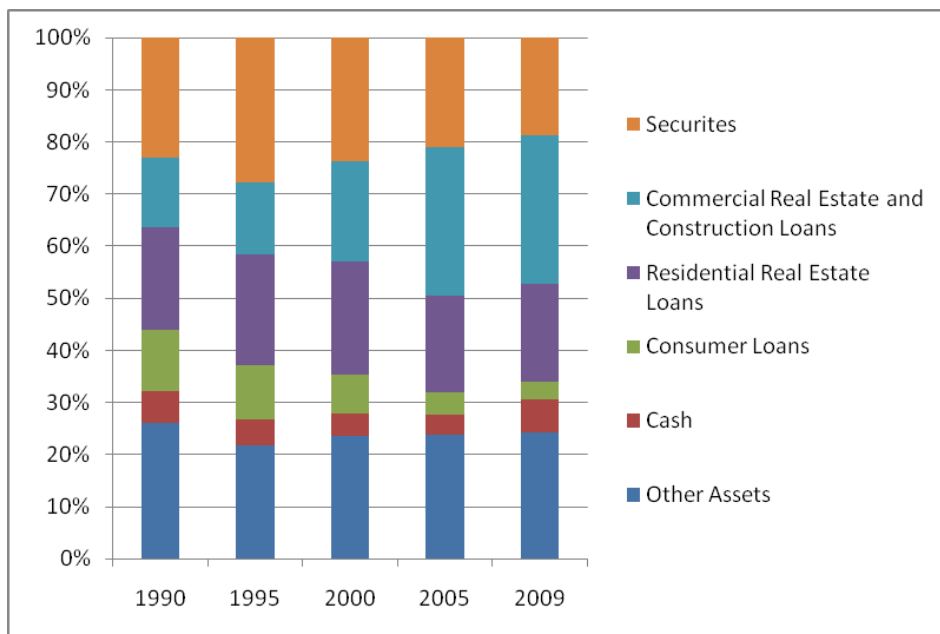
Note: "Community banks" defined as those with under \$1 billion in assets -- including "micro banks" under \$100 million in assets, and "small banks" between \$100 million and \$1 billion in assets. "Large banks" defined as those with \$50 billion or more in assets.

Source: SNL; Cambridge Winter Center

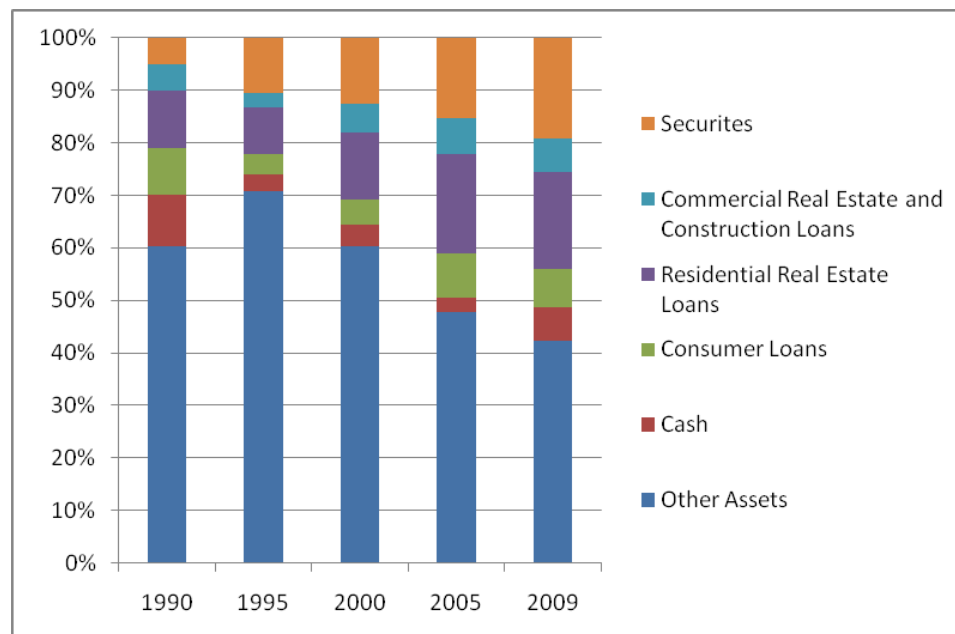
For the past two decades, small banks have become increasingly confined to the most volatile loan classes, namely commercial real estate and construction loans. These high-yield asset classes help support margins but leave small banks exposed to significant credit risk. Large security portfolios help counter-balance this risk and provide critical liquidity but leave smaller banks with few options to generate yield.

## SMALL BANKS AND BIG BANKS HAVE DRAMATICALLY DIFFERENT PORTFOLIOS

**Small Banks' Asset Mix**  
Percent of Total Assets



**Large Banks' Asset Mix**  
Percent of Total Assets



Note: "Small banks" defined as having between \$100 million and \$1 billion in assets. "Large banks" defined as those with \$50 billion or more in assets.

Source: SNL; Cambridge Winter Center

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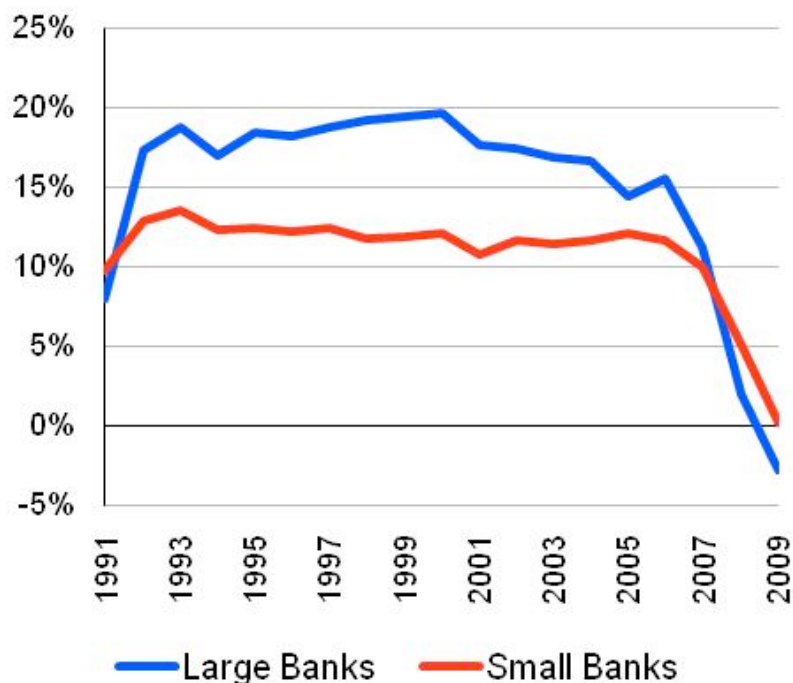
With their advantaged balance sheets, diversified business lines, and structural efficiencies, larger banks generated consistently higher returns up through the crisis. Small banks fared better in the depth of the crisis, but how long before large-bank performance rebounds to a higher level?

We should note that lower ROE does not necessarily mean lower shareholder value: small-bank return expectations and investment priorities might differ from those of larger banks. Community banks, for example, might be as concerned with preserving legacies and ensuring a consistent flow of funds to local enterprises as they are with economic returns. But these differences belie a fundamental difference in business model and perspective.

## SMALL-BANK RETURNS LAG THOSE OF LARGER BANKS OVER THE CYCLE

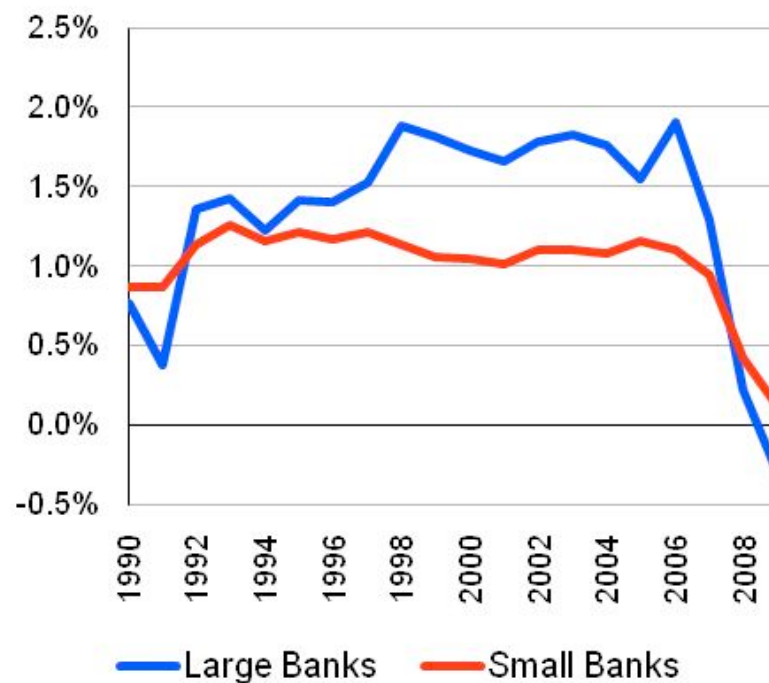
**Return on Equity, 1991-2009**

Percent



**Return on Assets, 1990-2009**

Percent



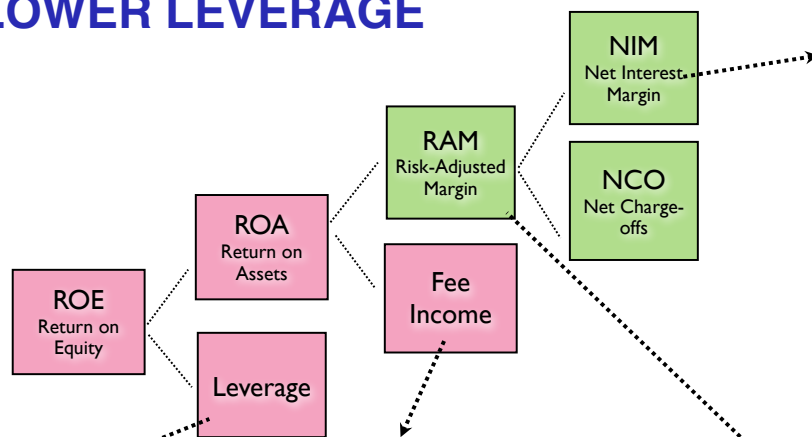
Note: "Small banks" defined as having between \$100 million and \$1 billion in assets. "Large banks" defined as those with \$50 billion or more in assets.

Source: SNL; Cambridge Winter Center

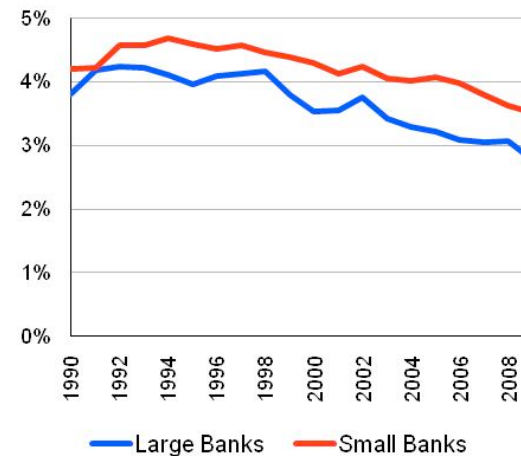
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Small banks have perfectly healthy net interest margins (NIM), net charge-offs (NCO), and risk-adjusted margins (RAM, the combination of NIM and NCO). These are precisely the metrics that most people think of when they imagine the traditional bank lending business. Instead, small bank performance lags that of larger banks because of relatively weak non-interest revenue streams and lower leverage than their larger competitors. The first of these issues -- weak non-interest revenues -- is perhaps inevitable: many fee businesses are scale-intensive, by definition precluding most small banks from participating.

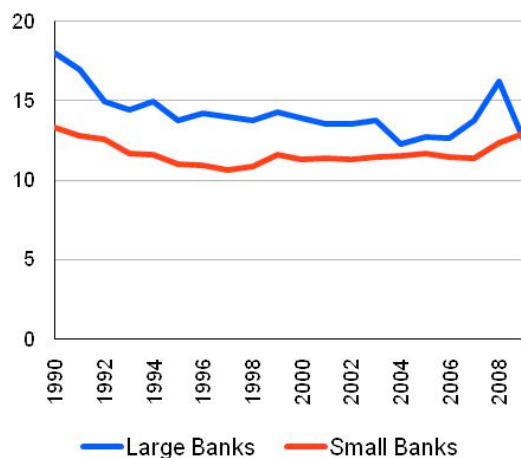
## WEAK SMALL-BANK RETURNS ARE DRIVEN BY LIMITED FEE BUSINESS AND LOWER LEVERAGE



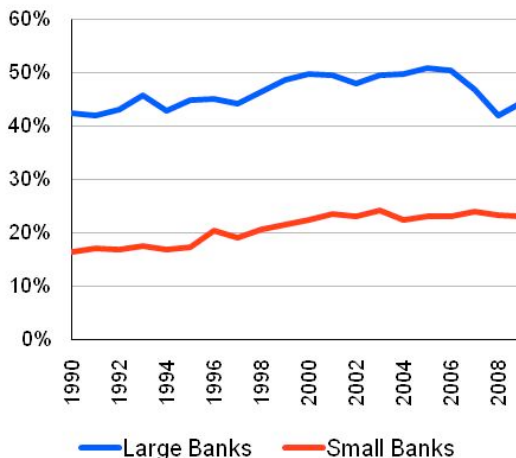
**NIM, 1991-2009**  
Percent



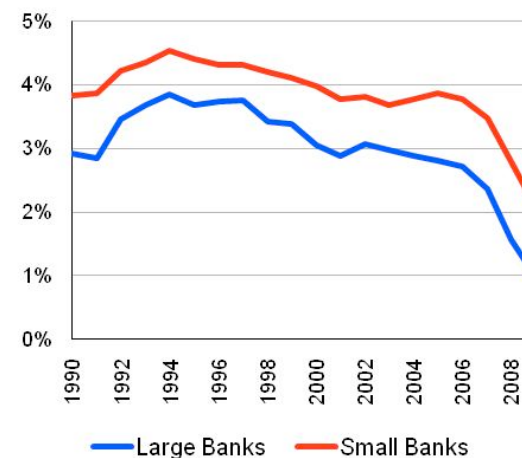
**Accounting Leverage, 1990-2009**  
Ratio (Assets/ Common Equity)



**Fee Income, 1990-2009**  
Percent (Non-Interest Revenue/ Total Revenue)



**RAM, 1990-2009**  
Percent



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Source: SNL; Cambridge Winter Center

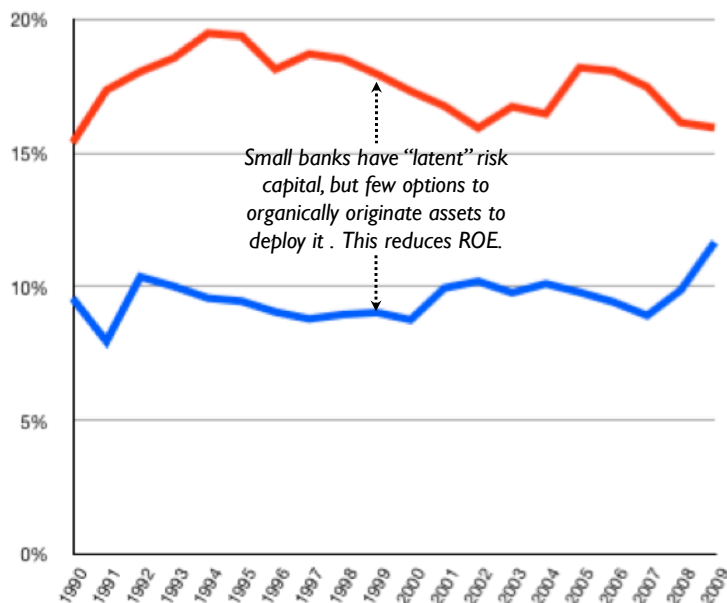
Basel III – and, ironically, small bank challenges in raising capital -- will help narrow but not completely eliminate the leverage gap. Consider that, today, both large banks and small banks carry roughly the same level of accounting capital (as measured by the “leverage ratio”). Unlike larger banks, though, small banks have difficulty organically acquiring sufficient assets to “soak up” capital -- they are effectively shut out of many higher risk-return portfolio businesses like credit card (they lack sufficient scale) and residential mortgage (they cannot compete with GSE subsidies). As a result, small banks carry “latent” risk capital that depresses ROE.

## SMALL BANKS HOLD UNPRODUCTIVE “LATENT CAPITAL” THROUGH THE CREDIT CYCLE

— Large banks  
— Small banks

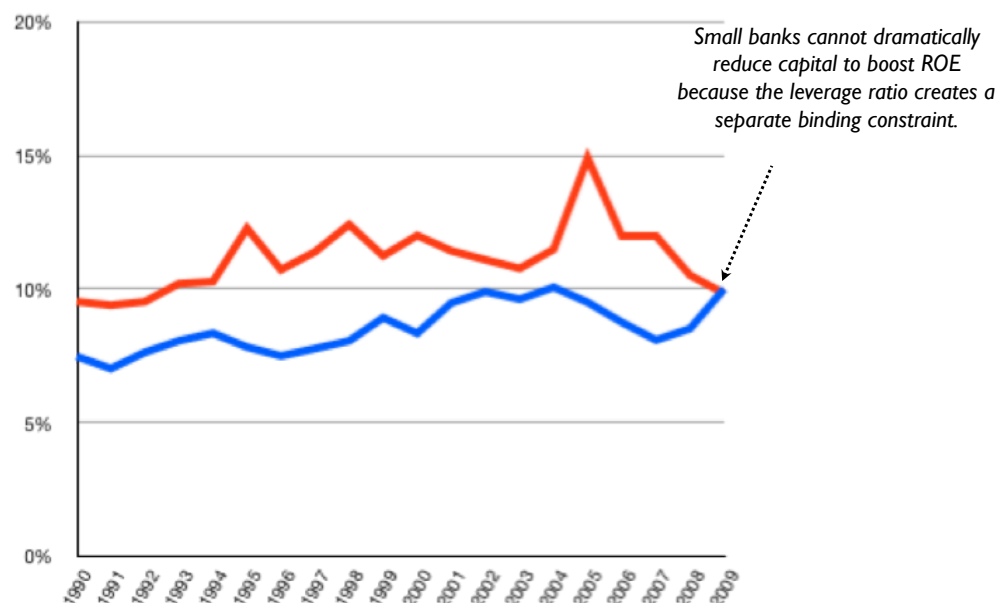
**Tier-1 Risk Based Ratio, 1990-2009**

Percent



**Leverage Ratio, 1990-2009**

Percent



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Source: SNL; Cambridge Winter Center

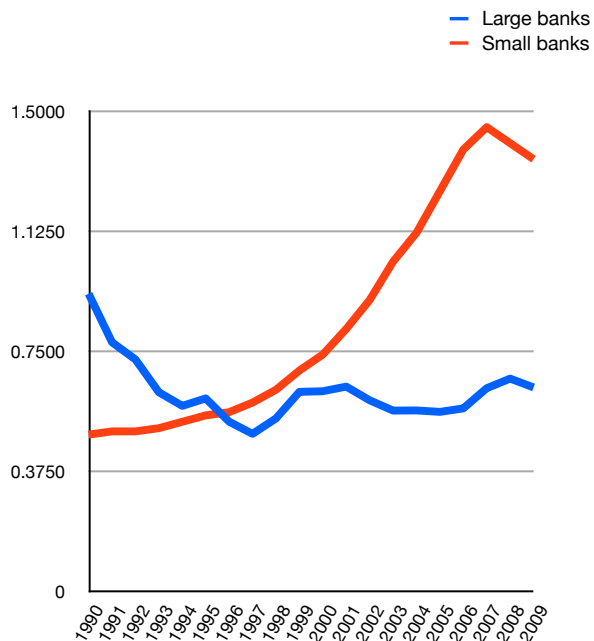
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In an effort to “risk up”, and thereby deploy otherwise latent capital, small banks are largely limited to local, scale-free lending markets. The result has been a steady and disproportionate concentration in real estate lending, and in acquisition, development, and construction lending in particular. Unfortunately, those loans have the highest loss volatility (illustrated by their higher peak to trough loss ratios) and have led to waves of small bank failures.

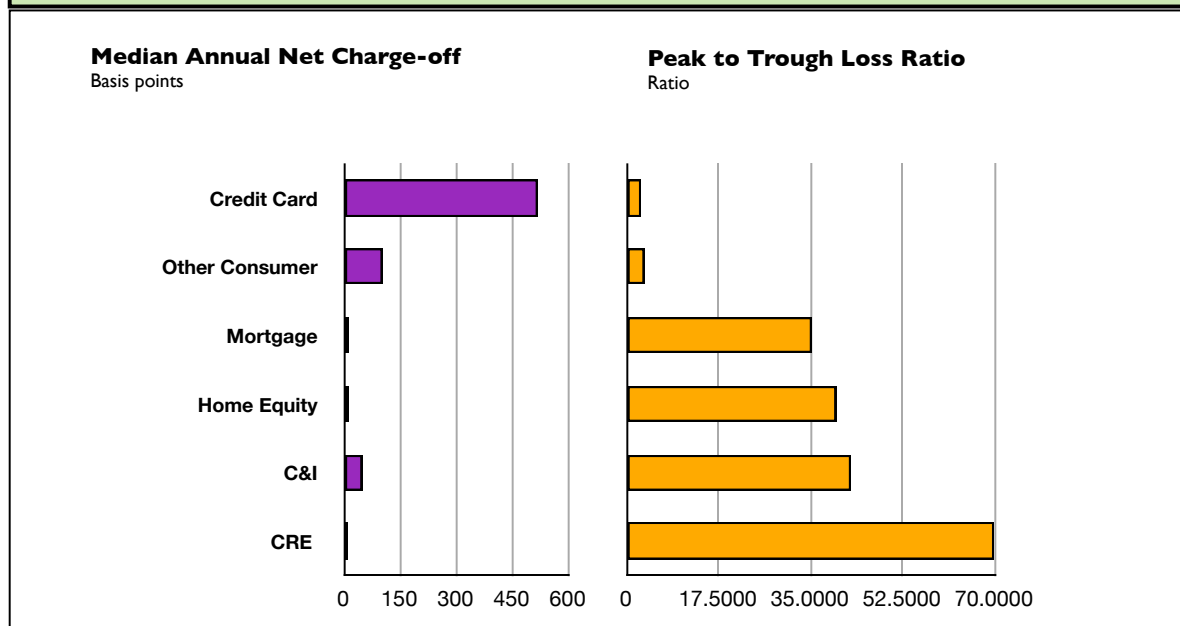
## SMALL BANKS HAVE LIMITED OPTIONS TO “RISK UP”

### Commercial versus Residential Real Estate Lending, 1990-2009

Ratio (CRE and C&D / Residential loans)



### Estimated Credit Loss History by Asset Class, 1991-2009\*



\*For credit card, data is for 2001-2009

Note: “Small banks” defined as having between \$100 million and \$1 billion in assets. “Large banks” defined as those with \$50 billion or more in assets.

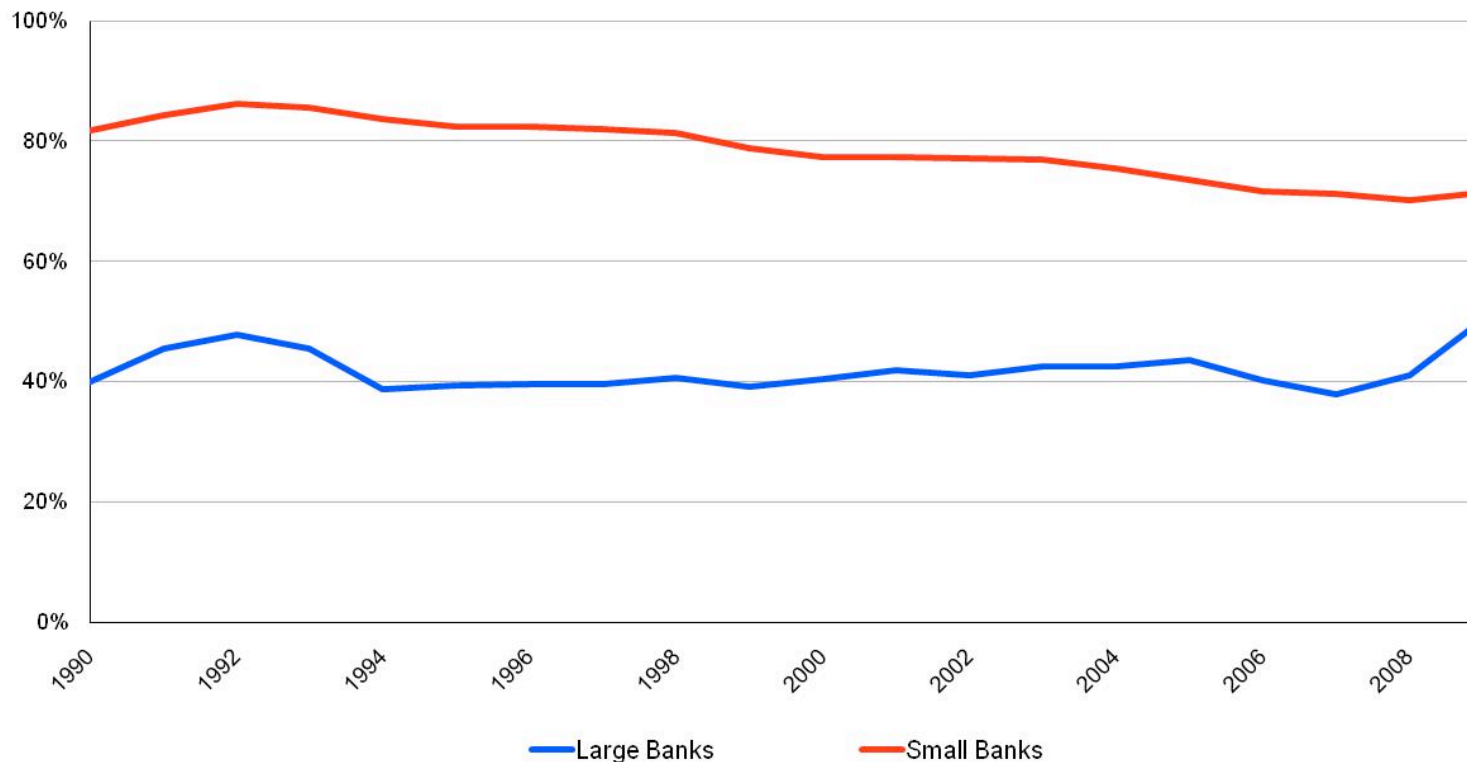
Source: SNL; Barclays Capital; Cambridge Winter Center

Even the community bank golden ticket -- core deposit generation -- is under threat as big banks encroach on this turf. This is further evidence that the community bank business model requires policy consideration distinct from that of the largest banks.

## COMMUNITY BANKS ARE ADVANTAGED COLLECTORS OF CORE DEPOSITS - BUT FOR HOW MUCH LONGER?

**Core Deposits as Fraction of Total Liabilities, 1990-2009**

Percent



Note: "Small banks" defined as having between \$100 million and \$1 billion in assets. "Large banks" defined as those with \$50 billion or more in assets.

Source: SNL; Cambridge Winter Center

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