Chapter 1: Community Bank Financial Performance

Between year-end 2012 and year-end 2019, community banks continued to report positive financial performance, including steady improvement in pretax return on assets (ROA) ratios, a wide net interest margin, and strong asset quality indicators. While not the only way of measuring community bank performance, this analysis will address the comparison between these banks and noncommunity banks. Community banks had long underperformed noncommunity banks, particularly in pretax ROA. Although this trend continued during the years between the previous study and this one, community banks' wider net interest margin and strong credit quality caused this gap to narrow.[1] The most important factor contributing to the earnings gap had historically been the ability of noncommunity banks to generate noninterest income—primarily from investment activities that are still not associated with the traditional community-banking business model. Additionally, in the years preceding 2019 noncommunity banks' noninterest expenses relative to assets had fallen below the comparable ratios of community banks. Nevertheless, by providing traditional banking products and services to local communities, community banks remained profitable and were able to compete with their typically larger noncommunity bank competitors.

Community Bank Pretax Earnings Increased Between Year-End 2012 and Year-End 2019

Coming off the recession that ended in 2009, community bank pretax ROA ratios steadily improved, increasing from 1.05 percent in 2012 to 1.44 percent in 2019 (Table 1.1). The improvement in earnings was widespread, with more than 60 percent of community banks reporting increases throughout this study's period. Larger community banks (those with over $1 billion in assets) ended 2019 with the highest pretax ROA (1.48 percent), followed by community banks with assets between $500 million and $1 billion (1.44 percent). Smaller community banks (those with assets between $100 million and $500 million) reported a pretax ROA of 1.41 percent while the smallest community banks (those with assets below $100 million) reported a pretax ROA of 0.94 in 2019, which represents a 24 basis point increase from year-end 2012.

Despite community banks' positive earnings performance between 2012 and 2019, their earnings were lower than the levels reported by noncommunity banks—but the difference narrowed: at year-end 2012 the gap was 43 basis points, and by 2019, it had dropped to 22 basis points. During the entire period, the average earnings gap between community and noncommunity banks in reported pretax ROA was 31 basis points. The trend in reported pretax ROA suggests that community banks were able to manage profitability and could still effectively compete with their noncommunity bank counterparts.

Community Banks' Net Interest Margins Exceeded Those of Noncommunity Banks for Several Years

Net interest margins (NIM) measure the spread between asset yields and funding costs for deposits and other borrowings. Wider NIMs result in higher levels of net interest income. In 2019 net interest income accounted for over 78 percent of community bank net operating revenue. Community banks ended 2019 with a quarterly NIM of 3.62 percent, exceeding the margin of 3.24 percent reported by noncommunity banks. Starting in 2012, community banks were reporting yields that were, on average, 53 basis points higher than yields reported by noncommunity banks (Chart 1.1). The primary way they maintained their margin advantage was by earning higher yields on earning assets.

Table 1.1 Full-Year Pretax ROA (Percent)

	2012	2013	2014	2015	2016	2017	2018	2019
All Banks	**1.42**	**1.55**	**1.46**	**1.49**	**1.50**	**1.54**	**1.69**	**1.63**
Community Banks	1.05	1.12	1.19	1.26	1.30	1.35	1.42	1.44
Noncommunity Banks	1.48	1.62	1.50	1.53	1.53	1.57	1.73	1.66

Source: FDIC.

[1] A focus on pretax ROA, as opposed to return on assets after tax, facilitates comparisons between banks organized as C corporations, which are taxed at the bank level, and S corporations, in which tax obligations pass through to shareholders.

Chart 1.1

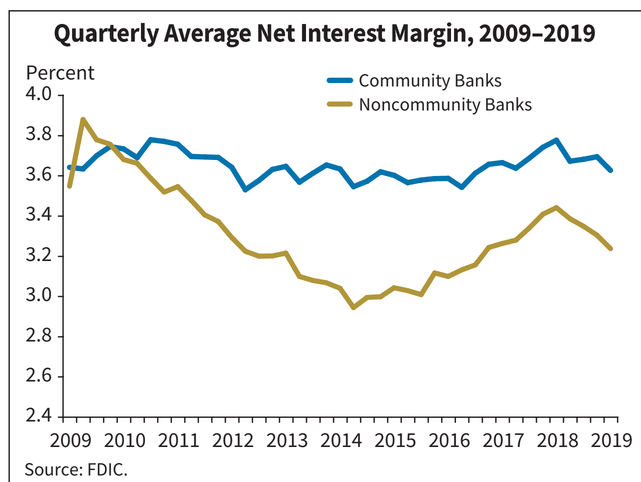


Chart 1.2

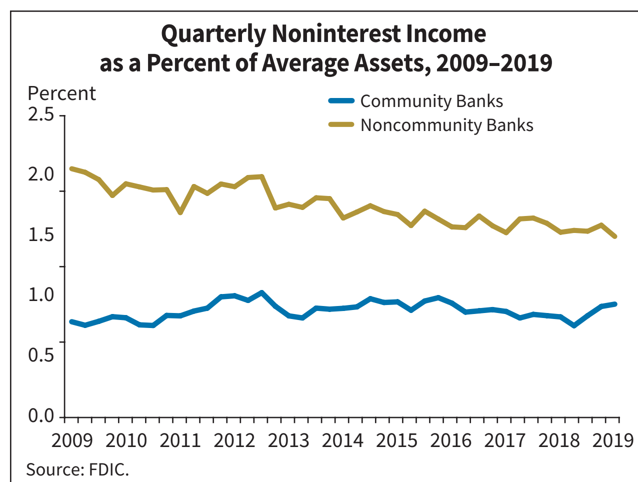


Table 1.2 Assets With Maturities Greater Than 3 Years to Total Assets (Percent)

	2012	2013	2014	2015	2016	2017	2018	2019
All Banks	**28.8**	**29.5**	**30.2**	**31.6**	**32.4**	**32.6**	**32.4**	**33.3**
Community Banks	42.9	47.3	47.9	47.4	47.2	46.8	45.8	44.8
Noncommunity Banks	26.5	26.7	27.5	29.2	30.2	30.5	30.4	31.8

Source: FDIC.

The higher yields reported by community banks were partly attributable to the fact that community banks held a higher share of longer-term assets, which typically have higher returns than assets maturing in the short term. As of year-end 2019, assets that matured or repriced in more than three years accounted for over 44 percent of community banks' total assets (Table 1.2). The comparable figure for noncommunity banks was just 31.8 percent. Between 2012 and 2019 both community and noncommunity banks increased their exposures to long-term assets because the historically low interest rate environment had several effects including causing many banks to lengthen their balance sheets to help maintain their margins as well as meeting credit needs of borrowers looking to lock in at low rates for longer periods.

Compared with Noncommunity Banks, Community Banks Generated Less Noninterest Income

Despite their net interest margin advantage, community banks trailed noncommunity banks in overall earnings because of noncommunity banks' ability to generate higher volumes of noninterest income due to their business model (Chart 1.2).

In 2019, noninterest income represented 0.9 percent of average assets at community banks, driving 20.2 percent of their net operating revenue (Table 1.3). For noncommunity banks, noninterest income represented 1.5 percent of average assets and drove 34.2 percent of their net operating revenue. In 2019 noncommunity banks derived close to 18 percent of their noninterest income from market-sensitive revenue streams, including trading and investment activities, which had not traditionally been part of the community-banking business model. Instead, for additional income, community banks relied more heavily on asset sales and service charges, whether these activities were part of the bank's strategy or not.

Table 1.3 lists the categories of noninterest income reported by banks throughout the period of this study. Despite the granularity of these categories, many of the services offered by both community and noncommunity banks are accounted for in the "all other" category—making it the largest component of noninterest income for both types of institutions. Banks are required to itemize amounts within the "all other" category only if the amounts exceed minimum levels. Thus, it is hard to compare with certainty the relative importance of various components within the "all other" noninterest income category.

Table 1.3 Noninterest Income at Community and Noncommunity Banks (Percent)

Category of Noninterest Income as a Percent of Total Noninterest Income	Full-Year 2012		Full-Year 2019	
	Community Banks	Noncommunity Banks	Community Banks	Noncommunity Banks
Service Charges on Deposit Accounts	24.3	12.7	18.8	13.1
Fiduciary Income	6.9	11.9	8.0	14.3
Gains on Asset Sales	21.7	3.9	22.0	4.0
Market Sensitive Income[1]	2.6	11.8	3.0	17.6
Securitization Income	0.5	0.6	0.1	0.1
Servicing Income	3.1	4.7	3.7	1.2
Insurance Income	3.3	1.4	3.1	1.7
All Other Noninterest Income[2]	37.5	53.0	41.4	47.9
Total Noninterest Income	**100.0**	**100.0**	**100.0**	**100.0**
Noninterest Income as a Percent of Net Operating Revenue	22.0	39.4	20.2	34.2
Noninterest Income as a Percent of Average Assets	0.95	1.9	0.87	1.5

Source: FDIC.

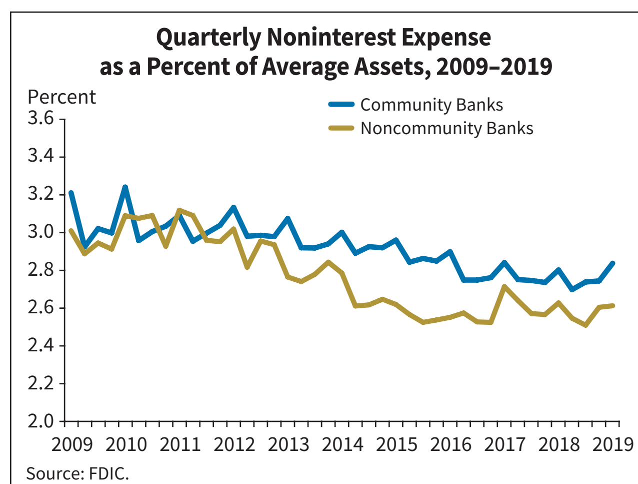
[1] Includes trading, venture capital, and investment banking income.

[2] Other noninterest income includes service charges, commissions, and fees (such as safe deposit box rentals, money orders and cashiers checks, notarizing of documents, ATM fees, wire transfers), check sales, rental income from other real estate owned, bank-owned life insurance income, annual credit card fees and interchange fees.

Community Banks Reported Lower Levels of Noninterest Expense Relative to Average Assets

At year-end 2019, noninterest expenses at community banks were 2.83 percent of average assets, down from 3.13 at year-end 2012 (Chart 1.3). The decline was due primarily to reductions of premises and fixed asset expenses as well as their "all other" noninterest expenses (a category that includes items such as data processing expenses, legal fees, and telecommunication expenses). These reductions could be a combination of items including reducing branches, streamlining computer expenses, and lowering legal expenses. These declines almost completely offset increases in salary and employee benefit expenses (Table 1.4).

Chart 1.3



Source: FDIC.

Historically (1987–2007) community banks reported lower noninterest expenses as a percentage of average assets than noncommunity banks. Between 2012 and 2019, however, community banks reported a noninterest expense ratio that was on average 18 basis points higher

Table 1.4 Compound Annual Growth Rate of Noninterest Expense Categories (Percent)

	Full-Year 2012		Full-Year 2019	
	Community Banks	Noncommunity Banks	Community Banks	Noncommunity Banks
Salary and Employee Benefit Expenses	4.6	7.0	1.4	3.0
Premises and Fixed Asset Expenses	3.2	5.2	-0.8	0.7
Salary + Fixed Asset Expenses	**4.3**	**6.6**	**1.0**	**2.6**
All Other Noninterest Expenses	2.4	4.7	-1.6	0.8
Total Noninterest Expenses	**3.8**	**7.4**	**0.1**	**1.9**
Average Assets	**4.0**	**9.3**	**1.5**	**4.0**

Source: FDIC.

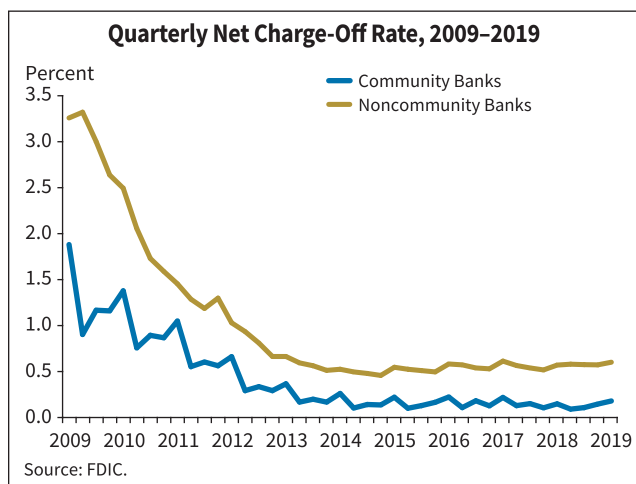
than that of noncommunity banks. In the years leading up to the financial crisis, noncommunity banks had grown their assets at a much faster rate than they had grown their noninterest expenses, which led to the convergence of the noninterest expense ratios of noncommunity and community banks. After the financial crisis, noncommunity banks continued to grow their assets at a faster rate than their noninterest expenses, with the result that in 2019 they reported noninterest expenses relative to average assets that were below community bank levels.[2]

Community Banks Continued to Report Low Levels of Credit Losses

In 2019 the full-year net charge-off rate reported by community banks reached a post-crisis low of 0.13 percent.

Community banks had generally reported lower loan-loss rates than noncommunity banks (Chart 1.4). This was especially true in the period 2008–2011, the years during and immediately after the financial crisis. From 2012 through 2019 community banks' average loss rates in commercial loan categories were comparable to the rates for noncommunity banks (these categories include nonfarm, nonresidential CRE, and C&I loans), but community banks continued to report lower loss rates than noncommunity banks in the two retail loan categories (residential real estate loans and consumer loans) as well as in agricultural loans (Table 1.5).

Chart 1.4



Source: FDIC.

In general, between 2012 and 2019 loan portfolios of community and noncommunity banks did not shift significantly. Community bank loan portfolios continued to remain heavily weighted toward nonfarm, nonresidential CRE loans and 1–4 family residential mortgages. At year-end 2019, these two loan categories together represented 55 percent of community banks' total loans, a share that had been relatively unchanged since 2012. Meanwhile, noncommunity bank loan portfolios continued to consist mostly of C&I loans, consumer loans, and 1–4 family mortgages—categories that, together, represented over 62 percent of noncommunity banks' total loans.

Table 1.5 Average Net Charge-Off Rate by Loan Type (Percent)

Loan Type	Bank Type	2000–2007	2008–2011	2012–2019
1–4 Family	Community Banks	0.06	0.53	0.15
	Noncommunity Banks	0.13	1.64	0.26
Construction & Development	Community Banks	0.13	3.68	0.37
	Noncommunity Banks	0.12	4.81	0.23
Nonfarm Nonresidential	Community Banks	0.08	0.55	0.15
	Noncommunity Banks	0.10	0.94	0.13
Commercial & Industrial	Community Banks	0.63	1.41	0.43
	Noncommunity Banks	0.92	1.56	0.34
Consumer	Community Banks	0.87	1.18	0.85
	Noncommunity Banks	2.88	4.81	2.24
Agricultural	Community Banks	0.12	0.20	0.08
	Noncommunity Banks	0.27	0.65	0.20
Total Loans	Community Banks	0.22	1.02	0.23
	Noncommunity Banks	0.76	2.24	0.65

Source: FDIC.

[2] Chapter 5 includes a more detailed analysis of community bank and noncommunity bank noninterest expenses.

Summary

Community bank performance between 2012 and 2019 showed that despite lower earnings, community banks were profitable and could successfully compete against their typically larger noncommunity bank competitors. Community banks continued to benefit from higher margins due, in part, to their holding a higher share of long-term assets. Community banks also continued their long-run trend of strong asset quality metrics and lower loan-loss rates. However, community banks continued to lag their larger competitors in the ability to generate noninterest income, which appeared to be the biggest driver of the earnings difference between the two groups. Additionally, despite lowering their noninterest expenses, community banks were not able to match the strong asset growth that noncommunity banks had—growth that led to lower noninterest expense ratios for those banks in an area where community banks historically had had an advantage.

Overall, the performance of community banks continued to demonstrate that there is a role for these institutions in the banking landscape. Although they faced different challenges than noncommunity banks, community banks' proven advantages in the areas of net interest income and credit losses put these institutions in a good position to compete with noncommunity banks going forward.

Box 1.1 Financial Performance and the COVID-19 Pandemic

Community banks faced significant challenges in 2020 amid the onset of the COVID-19 pandemic. Through the first half of 2020, community banks reported a decline in earnings primarily driven by significant increases in provisions for credit losses, as temporary shutdowns resulted in reduced business and consumer spending and uncertainty surrounding large parts of the economy continued (Chart 1.1.1). Community bank pretax ROA through the first two quarters of 2020 fell by 25 basis points to 1.19 percent from year-end 2019 as a result of the earnings decline. Comparatively, pretax ROA among noncommunity banks fell by over a full percentage point to 0.35 percent through the first half of 2020.

The NIM for community banks fell in the first half of 2020 as asset yields declined more rapidly than funding costs due to the low interest-rate environment and an increase in the volume of lower-yielding assets, including balances due from depository institutions and Paycheck Protection Program (PPP) loans. The NIM for community banks fell 11 basis points from year-end 2019 to 3.51 percent in the second quarter of 2020. Comparatively, the NIM for noncommunity banks declined 52 basis points from year-end 2019 to 2.72 percent, representing the lowest NIM for noncommunity banks on record.

Loan loss rates for community banks remained low and stable since the start of 2020. The net charge-off rate for community banks through the first half of the year stood at 0.12 percent, just 2 basis points above the rate recorded through the same point in 2019 and still well below the rate recorded by noncommunity banks. Minor credit deterioration among community banks has primarily been concentrated in the C&I, farmland, and agricultural production loan categories. However, community banks may report higher credit losses across other loan categories in the coming quarters as businesses and consumers continue to experience adverse effects as a result of government-mandated business and travel restrictions in response to the pandemic.

Loan growth served as a bright spot for community banks as loan volumes expanded at a rate that exceeded noncommunity banks in the first half of 2020. Community banks reported an annual loan growth rate of 13.5 percent in second quarter 2020. Comparatively, loan balances among noncommunity banks expanded by just 5.6 percent annually. The increase among community banks was driven by large increases in C&I loans and community bank's participation in the PPP. As of second quarter 2020, community banks held 31 percent of PPP loans, with more than four out of five community banks (82 percent) participating in the program.

continued on page 1-6

Box 1.1, continued from page 1-5

Chart 1.1.1