Randall S Kroszner: Community banks – the continuing importance of relationship finance

Remarks by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the America's Community Bankers Government Affairs Conference, Washington, DC, 5 March 2007.

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I am delighted to be with you today to share some of my views on the vital role that community banks play in the U.S. economy. I am particularly pleased to be part of this excellent America's Community Bankers conference for a very personal reason: one of my first jobs was with a community bank. My experiences at the teller's window provided a useful, in-the-trenches introduction to some of the issues I now face as a Federal Reserve Governor.

Community banks play an important role in the United States economy, as they have throughout our history. Indeed, the roots of commercial banking in the United States can be traced to the development of community banks soon after the founding of the republic. The U.S. banking industry has, of course, changed dramatically over the past 200 years with the emergence of large, geographically diversified banking organizations that have the ability to exploit economies of scale and scope and to compete in global markets. More recently, this evolutionary process has accelerated, and the past two decades have witnessed dramatic changes in the structure of the banking industry and the business environment in which banks operate. These changes have brought with them new challenges for community bankers. Nonetheless, many community banks continue to thrive by providing traditional relationship banking services to members of their communities. Their local presence and personal interactions give community bankers an advantage in providing financial services to those customers for whom, despite technological advances, information remains difficult and costly to obtain.

These close ties, however, represent a two-edged sword, exposing community banks to risks even as they provide a valuable and profitable market niche. For example, the close ties of community banks to their customers bring not only potential benefits in screening and monitoring borrowers, but also the potential for conflicts of interest. I would like to spend the next few minutes discussing both the benefits of and the challenges facing community banking.

The special role of community banks: relationship finance

The earliest banks in the United States and elsewhere relied on close relationships with their customers to obtain information about creditworthiness and to monitor loan performance. For example, in an analysis of early nineteenth century banking in New England, Naomi Lamoreaux found that many bank directors lent the bulk of the funds under their control to themselves, their relatives, friends, and business partners. At the time, information systems were quite primitive, and it was difficult and costly to obtain data about potential borrowers who were not family members or those with whom they had a close relationship (Lamoreaux, 1994).

Relationship finance continues to be at the heart of community banking. I believe that the most significant characteristics of community banks are: 1) their importance in small-business lending; 2) their tendency to lend to individuals and businesses in their local areas; 3) their tendency to rely on retail deposits for funding; and 4) their emphasis on personal service (Critchfield, et. al., 2004; Petersen and Rajan, 1994). Hence, successful community banking today depends importantly on the same characteristics that formed the foundations of the U.S. banking industry two centuries ago – personal interactions among bankers, their customers, and their communities.

The conventional paradigm of relationship finance is based on the premise that small businesses and households tend to be informationally opaque – an economist's term that may be even more opaque than these small businesses and households. What I mean by this phrase is that "hard" systematic data about the creditworthiness of such potential borrowers tend to be quite difficult to obtain. Thus, the efficient supply of credit to these agents depends on "soft" information that may be generated through close interactions with the borrower and knowledge of the community – that is, classic relationship lending.

In contrast, larger banks tend to have a comparative advantage with larger, more mature firms for whom quantitative, or “hard,” information, such as longer, more-detailed credit histories, is relatively easy to obtain (Petersen and Rajan, 1994). The distinction between community banks and large banks, however, is clearly changing. Technology has lowered the cost of information processing and facilitated the growth of information bureaus, making information about households and small businesses more readily available. This information has allowed some institutions to substitute credit scoring for more costly traditional techniques in the underwriting of some types of consumer and small-business loans, particularly credit card loans. These products are quite different from traditional unsecured personal or business loans, which rely heavily on information obtained from personal interactions and relationships.

Indeed, there can be no doubt that community banks today face considerable challenges. Rapid technological changes in the production of financial services, improved production and dissemination of financial information about consumers and businesses, deregulation, the increasing geographic scope of some banking activities, and the increased importance of nonbank providers of financial services are some of the factors altering the financial marketplace. While many of these changes may have increased financial system efficiency and lowered costs for consumers, they also present new and sometimes difficult challenges for community banks.

These changes have coincided with a significant consolidation of the banking industry and a pronounced decline in the number of community banks. If we define a community bank as any bank or thrift organization that has total real assets of less than $1 billion, in 2002 dollars, the number of community banks has declined about a third over the past decade. Most of this consolidation has been due to mergers. A Federal Reserve Board staff study reports that between 1994 and 2003 there were more than 3,500 bank and thrift mergers (Pilloff, 2004). In more than 90 percent of these mergers, the target institution had less than $1 billion in total assets, and in about half of those cases the acquiring organization also had assets of less than $1 billion. Acquiring organizations were typically larger than their targets; about 50 percent of the transactions involved an acquirer that was at least ten times as large as the target institution. Although merger activity has slowed since the 1990s, there were still at least 200 mergers each year between 2000 and 2006.

Despite these changes, community banks continue to fill an important niche in banking, providing relationship loans in specific business and economic sectors (most notably small-business and agricultural lending), personalized service, and a local presence. Indeed, we have a considerable body of evidence that points to the value and viability of these institutions. For example, despite the decline in numbers that I just mentioned, there are still more than 7,000 community banking organizations, accounting for about 95 percent of all banks and thrifts in the United States today. Furthermore, new community banks continue to be formed. During the period 2000 through 2005, about 120 new community banks were chartered, on average, each year. And during the first three quarters of 2006, 137 new community banks were chartered. These figures suggest that many people continue to believe that community banks have an important niche to fill and, as a result, are willing to invest in the future of community banking.

A variety of indicators suggest that as a whole, today’s community banks are doing well. The average return on equity (ROE) at community banks, for instance, is quite solid and has improved over the past few years. Net interest margins for community banks are, on average, higher than those for larger banks, and recently this difference has been widening. And, as a result of stable interest margins and improved cost controls, the return on assets (ROA) for community banks as a whole has remained well above industry standards for strong performance.

Looking at other performance measures, we see that loan quality and capital ratios remain strong at community banks. On average, their nonperforming-loan-to-asset ratios have been low and comparable to those of the largest banking organizations, and their capital ratios have remained high. In addition, community banks continue to demonstrate a healthy ability to attract deposits, with core deposits funding about 70 percent of assets as of year-end 2005.

Community banks and small businesses

The thesis that I have put forward – namely, that relationship finance is important in sustaining the role that community banks play and in accounting for their strong performance – has a number of implications for small businesses’ use of community banks and the proximity of banks and their customers. The Board’s Survey of Small Business Finances gives us a window on the relationship

between community banks and small businesses and the evolution of the banks’ role. The survey data are also helpful in contrasting the characteristics of small businesses that use community banks with those of small businesses that use larger depository institutions.

By way of background, the Board conducts the small-business survey every five years. Our most recent data are for year-end 2003 and were obtained from interviews conducted during 2004 with more than 4,200 small businesses, a representative sample drawn from more than 6.3 million small enterprises in the United States. The data were made available to the public in June 2006, but to my knowledge no one has yet used them to assess the role that community banks play in small-business finance.

Not surprisingly, the vast majority of small businesses obtained some type of financial service from a bank or thrift in both 1998 and 2003. Over that period, the share of small businesses obtaining services from nondepository institutions increased substantially, from about 40 percent of firms in 1998 to about 54 percent in 2003. Nondepository sources typically supply loans and financial management products, including such services as check clearing, provision of letters of credit, cash management, and credit card processing. Although the fraction of small businesses obtaining these types of services from nondepositories has increased, the proportion obtaining them from banks increased as well. Both of these changes reflect the fact that between 1998 and 2003 small businesses substantially increased their demand for these types of services.

Our survey data provide evidence that community banks continue to play an important role in providing financial services to small businesses, even in an increasingly competitive marketplace. Among the small businesses that reported using a bank or thrift, in both 1998 and 2003 about a third used a community bank.

One of the traditional strengths of community banks – indeed, a practical requirement for successful relationship lending – is local presence. Although our survey results suggest that community banks increasingly face competition from both larger banks and nondepository institutions, they also illustrate the importance of proximity for many small businesses. In 2003, the median distance between a small business’s headquarters and its bank or thrift was three miles, about the same as in 1998. For lending relationships, the median distance was four miles. Clearly, proximity and convenience, two of the characteristics that epitomize relationship finance at community banks, are important factors underlying the choice of financial service providers by small businesses.

Comparisons of the characteristics of the community and larger banks used by small businesses reveal differences that are consistent with the idea that community banks specialize in relationship finance. On average, the distances between small businesses and the banks from which they obtained financial services were smaller for community banks than for larger banks. Small businesses were also more likely: 1) to have longer relationships; 2) to obtain a larger number of services; and 3) to conduct business in person with community banks than with larger banks. And when asked why they used a specific institution, business owners using community banks were substantially more likely to mention the importance of relationships.

Our survey results also allow us to consider whether small businesses that use community banks have different characteristics than those that use large banks. Of the firms that used banks in 2003, one-fifth used community banks exclusively, two-thirds used large banks exclusively, and the remainder (14 percent) used both.

As described above, relationship lending is most important to firms lacking hard information, and those firms, in general, are expected to be the smaller firms. Consistent with this view, our survey indicates that the average firm that used community banks exclusively was smaller in terms of number of employees, sales, and assets than the average firm that used large institutions exclusively or that used both community banks and large banks. In addition, firms that used only community banks used fewer services overall than other types of firms – which is consistent with their smaller size – but at the same time obtained slightly more services from each bank than did firms that used only larger banks. This suggests that community-bank-only firms are more likely to cluster their purchases at a single institution than are other firms, behavior that is consistent with the importance of relationship finance.

Overall, in my judgment, our survey data confirm the view that, despite changes in the competitive environment, community banks continue to play an important role in providing relationship finance to small businesses in their local banking markets.

Potential conflicts of interest

The very relationships that underlie relationship finance, and that constitute the primary source of community bankers' comparative advantage in meeting the financial needs of small businesses and households, also present challenges. As I mentioned earlier, relationship finance dates back to the very earliest banking institutions in our country. Although the extreme form of relationship lending that characterized early nineteenth century New England banking had the potential to undermine the safety and soundness of these early banking institutions, Naomi Lamoreaux's research suggests that market forces acted to minimize the adverse effects. In an environment characterized by easy entry into banking, bank directors apparently had strong incentives to monitor lending and minimize risks because their business success depended crucially on maintaining their unsullied reputations. Of course, this salutary outcome was by no means inevitable, as evidenced by experiences in a number of developing countries where this type of lending behavior has had quite pernicious effects; rather, the outcome was the result of the particular circumstances and competitive environment prevailing in New England at the time (Lamoreaux, 1994).

When it comes to more recent times, evidence on the extent to which conflicts of interest resulting from close ties between banks and their potential borrowers may have adversely affected bank performance is limited to studies of the largest banking organizations. One example is my own research with Phil Strahan that looked at linkages between the boards of directors of banks and nonfinancial firms. Such board linkages can be beneficial because they improve information flow between the linked firms; however, they can also lead to conflicts of interest because the individual who serves as the link has fiduciary responsibilities to both firms, and those firms' interests can sometimes diverge.

In our research, Phil and I focus on board linkages between large U.S. banks and Fortune 500 nonfinancial firms. This focus is driven largely by data availability. I would be very interested in hearing from you about the extent to which community bankers sit on the boards of nonfinancial firms and your views on the benefits and costs that result from these linkages. Our research finds that board linkages are quite prevalent among the largest banking organizations – more prevalent than among large nonfinancial firms – but that these linkages tend to involve firms in which shareholder-creditor conflicts of interest are least likely to arise. We also find that the connected firms are more likely to borrow from their connected bank, and that when they do, the loan terms are similar to the terms on loans to unconnected firms. Thus, contrary to the results of studies of some other countries, where it has been found that connections were misused, our results suggest that the avoidance of conflicts of interest explains both the allocation and behavior of bankers in the U.S. corporate governance system (Kroszner and Strahan, 2001, 2002).

On balance, evidence from both community banks in early nineteenth century New England and larger banks in more recent times suggests that, as a whole, U.S. banks have managed their relationships well and have avoided engaging in systematic conflicts of interest. Nonetheless, the potential for problems is there, and it is important that bankers remain vigilant and regularly review the corporate governance mechanisms they have in place to deal appropriately with challenges that can arise with relationship finance.

Conclusion

In sum, it is clear that community banks face many challenges today, as they have in the past. Technological developments in information production and dissemination, changes in the management strategies of larger banks and other institutions, deregulation, and changes in the delivery of financial services have reduced some of the advantages that community banks could once offer their customers. As a result, community banks have lost market share to larger banks and to nondepository institutions. At the same time, a large portion of small businesses and households continue to value and avail themselves of the relationship lending, personal service, and local proximity that community banks offer their customers. Community banks today are generally healthy and profitable, and new ones are being chartered every year.

Along with the benefits of relationship finance, however, come some risks, including the potential for conflicts of interest. This particular risk appears to have been mitigated significantly in the United States, although it is important for bankers to remain vigilant and to regularly review the corporate governance mechanisms they have in place. I expect that community banks will continue to exploit

their traditional advantages and expertise, to be valuable members of their communities, and to adapt to their changing environment in ways that allow them to remain strong and viable competitors.

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