

The Future of Community Banking



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This issue highlights two recent examples of the wave of consolidations sweeping the banking industry. In light of the numerous mergers involving larger institutions, one might wonder about the future of community banking. Some observers predict a significant weakening of community banking. I disagree. There are key reasons to believe that community banking will prosper. The first is that the future of small business itself — the bread and butter of community bank lending — is bright. And second, community banks hold significant advantages in lending to small businesses.

Small business lending is the traditional specialty of community banks. Is the small business sector diminishing in importance? We are all familiar with the demise of the corner grocery. Earlier in this century the grocery business was dominated by locally-owned stores; today it is dominated in many markets by national or regional chains such as Food Lion and Safeway. More recently, entry by Kmart, Wal-Mart and similar nationwide discount department stores is blamed for the decline of the smaller, locally-owned general purpose department store.

Consolidation has taken place in these and other industries because the demand for standardized products allows large firms to enjoy economies of large-scale production, marketing and distribution. But consolidation can proceed only so far in many business sectors. There are many businesses where there is enough variation in customer tastes that knowledge of local demand conditions and the ability to tailor products to meet those conditions is important. Here local specialization is more important than the cost savings that standardization makes possible. Locally-owned businesses catering to these markets cannot be replaced by "big box" discounters.

So the small business sector will survive and prosper. But community banks face competition for the favor of small businesses. For example, a number of interstate banks offer loan programs geared toward small businesses.

Still, community banks have a significant

comparative advantage in lending to small businesses. The detailed, robust, company-specific knowledge that results from close ties to small business borrowers and their communities is fundamental in some kinds of small business lending. Successful small businesses often lack elaborate financial records, their lines of business may be nontraditional or their credit requests unusual. As a result, there is great value in the ability to gather thorough background information through informal means. Community bankers have inexpensive access to just this type of information.

Large banks can also gather idiosyncratic information. But the senior management of all banks, large and small, must monitor loan officers. Monitoring means verifying the information used by loan officers in making their lending decisions. Community bank managers can inexpensively verify much of the information the loan officers gather because they are likely to be in close touch with many of the same sources. For example, the president of a small bank will know personally many local small business owners.

Managers in larger banks are often centrally located in major cities and consequently can verify local information only at considerable cost. Therefore, large banks tend to require loan officers to justify loans with standardized, objective criteria readily verifiable at a distance.

The standardized loan product, with its lower costs, will be appropriate for some small business borrowers. But the community bank approach will better suit others: specifically, borrowers with unusual loan requests or for whom standard creditworthiness information is difficult to obtain. For a significant share of small businesses there will always be a need for the type of lending at which community banks excel. And that makes me optimistic about the future of community banking.



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