Proactive Profits

The Necessity for Revenue Growth Among Community Banks & Credit Unions

STRATEGIC STEPS AND STRATEGIES

By Matt McCall

The Power of Community

Since the late 1700s, American citizens have utilized banks to fund their aspirations – the first of which paid off debts from the revolutionary war. Throughout American history, banks have been the linchpin for economic freedom and freedom in general. It is still true today. The genesis of dreams coming true still starts with financing – whether it be a mortgage, new business, family farm, going to college, etc. Financial availability and funding are vital to a community's economic success. Through lending, community banks and credit unions funnel local deposits into the main streets and neighborhoods they serve. This leads to job creation, innovation, and empowering customers' dreams in communities throughout America. Banking support is essential in today's economic environment. Local communities are best served by a diverse group of lenders of all sizes and specialties, so competition is key. A vibrant community banking sector encourages pricing competition, affordability, more product choices, and better customer service.

There is no time in recent history when customer service was more important to communities than at the onset of the pandemic. With quarantines and the economic slowdown, small businesses and the self-employed needed loans to stay afloat – some to make payroll. The CARES Act initiated the Paycheck Protection Program (PPP) – making hundreds of billions of dollars available to small businesses to fund employee payroll and other qualified expenses, such as mortgage interest, rent, and utilities. The problem: the funds were needed yesterday, and the applications and disbursements had to go through a financial institution. It's no surprise that community banks led the way in supporting local economies considering their specialized local market knowledge and relationships. In the first round of PPP lending, community banks processed approximately 60% of the program's funding, which is a staggering number when one considers that community banks only hold 15% of total industry loans [1]. Banks had to be adaptable and efficient in learning new procedures – with many staff members working into the nights

and throughout weekends to make sure local businesses had funding.

Not necessarily known for their digital efficiency, local community banks embraced the challenge and played a disproportionate role in PPP lending compared to their larger counterparts. Familiar with their economic environment and small business lending, community banks proved to be more effective than any other type of financial institution regarding the efficiency of PPP lending. How did banks with only 12% of total industry assets, and 15% of total industry loans, come to hold 28% of total PPP loans [3]?First, community banks care. One can see how hard community bank FTEsworked to push loans through to local businesses. Second, many of those relationships were already established, with the local bank having previous knowledge of the company and

"Throughout American history, banks have been the linchpin for economic freedom and freedom in general."

Despite support from local community banks and credit unions, several economic headwinds face non urban economies in 2023. Suburban and rural areas are the most likely to be negatively affected if community banks and credit unions are not proactive in ensuring their survivability. These smaller institutions are the only physical banking presence in one out of three US counties [4]. Major banks tend to shy away from rural areas due to lack of volume and the customized relationships required. Luckily, innovation and technology are not just reserved for those with a BoA budget, which are crucial for the success of community banks and credit unions. Utilizing technology and continuous innovation are keys for local banks and credit unions to stay ahead of the curve and be successful.

Headwinds

While the census currently does not capture suburban data, a 2018 Pew Research Center survey polled

its finances.
Americans found that 25% said they lived in an urban area, 43% in a suburban area, and 30% said they lived in a rural area [5]. With the onset of COVID, remote work, and affordability factors, migration to the suburbs has only increased.
As populations migrate, it's essential to understand customer behavior and preferences. In 2019, 83% of banked US households visited a branch (9/10 in rural areas), and the frequency of visits substantialy increased as we moved from urban rural areas.

Unfortunately, as COVID disrupted local economies, banks accelerated branch closures – especially larger institutions within rural and suburban communities. According to S&P Global, 2020 set a record number of branch closures, while 2021 broke the previous record with 2,927 branches being closed. In 2021, Wells Fargo led the way with 267 closures, then US Bank and Truist, with 257 and 234 closures, respectively [7]. And that's not all the bigger banks have done to make their "contribution" to rural and suburban markets.

Community Reinvestment Act and Banking Deserts

Smaller communities and their businesses depend on personalized banking services and the branches that provide such. The Community Reinvestment Act (CRA) requires banks to assist their communities, focusing on low-to-moderate income areas. Formerly, urban areas had most people living below the poverty line. But in 2020, 16.2 million people were living below the federal poverty level in suburban neighborhoods, compared to 15.1 million living below the poverty level in urban communities [8]. Suburban and rural areas are often left unserved by larger FIs, most notably the big four (Chase, BoA, Citi, Wells Fargo). Big bank acquisition and consolidation has decimated the number of branches in smaller communities and negates what the CRA built upon. These big banks are no longer required to assist inferior economic communities in rural and suburban areas if they shutter the branches within those communities. According to NCRC, between 2008-2016, 86 new banking deserts were created in rural areas [9].

"Banking deserts" are service gaps in which no banks were within 10 miles of populated areas. Considering their previously limited market access, rural and suburban areas are especially vulnerable to banking deserts. Unfortunately, the weight of no credit access falls most heavily on the minorities within these areas. Larger banks have acquired and closed many branches formerly owned by smaller banks, removing access to valuable financial services that rural and suburban communities need—depicted below by NCRC.

Several impending effects of branch closures:

- Small business loans decline along with business activity and commercial development
- Less home lending and access to financial services
- Increased number of unbanked individuals and families
- Increase in unregulated financial services such as payday lending
- One less employer and commercial tenant in the community

A common justification for branch closures is the digitization of the industry which can be refuted by shared knowledge and the data mentioned above. An applicable 2022 survey by Raddon Research states the following: "The percentage of accountholders visiting a branch at least once in the past year has increased from 81 percent to 90 percent, with the greatest increase coming among millennials (76 percent to 92 percent)."
Even if we disregard branch closures, we still have a problem. Consolidating the industry to larger banks takes away a valuable, personalized, and relationship-driven approach many communities have relied upon and become accustomed to. Large banks' cookie-cutter approach may only suit some of the loans discussed in the following section. Custom options, trusting relationships, and thinking outside of the box are all attributes unique to the community banking sector. Empowering such institutions with intelligence and technology allow for a growing and profitable community bank, which in turn allows for a stronger and more prosperous community.

Irreplaceable Support

As noted in the introduction, community banks and credit unions are critical in funding various areas of rural and suburban economies. Underserved by large banks, these communities and businesses rely upon the lending relationships they have developed with smaller institutions. Most notably, the following sectors rely heavily on community banks and credit unions:

- Small Businesses
- Commercial Real Estate (CRE)
- Agriculture
- Mortgage Lending

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Small Businesses

Local communities and their respective banks and credit unions have a symbiotic relationship, making mutual success essential. Bankers need to make successful loans, and businesses must make themselves profitable for such loans to be successful. In turn, banks and credit unions leverage profitability to make more loans. Despite headwinds (pandemic, interest rates, supply chains, the great resignation, etc.), small businesses continue to succeed and were the backbone of the COVID recovery. According to the Small Business Administration, small businesses account for two out of every three jobs added the past 25 years [10]. In 2022 there were 33.2 million small businesses (99.9% of all companies), and 61.7 million small business employees (46.4% of all US employees) [11]. The significance of small businesses and those who support them is evident.

Small businesses need funding for many reasons – many are new and need startup capital, some are innovating and pursuing new avenues, and others are simply bridging financial gaps. Cash flow is the number one reason startups fail, and 82% of failed businesses cited cash flow problems as a factor in their failure [12]. The Small Business Credit Survey of 2022[13] shows that more firms seek funding to cover operating expenses versus expansion. "The share of applicants that sought funds for operating expenses grew from 43% in 2019 to 62% in 2021, while the share that sought to fund business expansion fell from 56% in 2019 to 41% in 2021."

Not only so, but fewer applicants are receiving the financing they need. The percentage of small businesses receiving all the funding they sought decreased as follows:

- 2019: 51%
- 2020: 36%
- 2021: 31%

Community banks are attentive to these small businesses, making 36% of small business loans and 46% of SBA 7(a) loans in 2019. These loans are not typically made through scoring models but instead the dedication of a business banker who focuses on building relationships and customizing solutions for small businesses. These numbers do not include any additional credit card offerings for smaller dollar amounts, which are also prevalent. Lastly and most importantly, customers are satisfied: "Satisfaction rates were highest among small-bank applicants.

Among firms that were approved for at least some loan, line of credit, or cash advance financing, 76% of small-bank applicants were satisfied with their experiences, compared to 62% of large-bank applicants and 34% of online-lender applicants."

Commercial Real Estate

CRE lending produces opportunities for local economies to expand. Businesses can own cash flow producing properties, while smaller businesses are able to rent a physical location. Housing markets are expanded, while retail and other service industries now have a place to call home. As suburban areas continue to increase in population, it is important for the development of the community and economy that these areas become funded. In 2019, despite community banks only holding 15% of total industry loans, they funded 30% of the industry's CRE loans... and to take it a step further, community banks headquartered in rural and suburban markets held more than two-thirds of all CRE loans within those respective markets [14]. Community banking clearly drives economic development outside of metro areas through CRE lending.
According to the National Association of Realtors 2019 Commercial Lending Report, 65% of respondents reported commercial clients used debt financing, with an even higher reliance from suburban offices / retail markets. 54% of respondents cited local/community banks and regional banks as the most active sources for financing commercial deals [15]. This makes sense, as community banks make up the largest percentage of commercial real estate financing in most areas as depicted below.

Business owners, property developers, investors, and the like rely on regional and community banks across the country as their main source of financing. These banks fund a wide variety of properties, and as demands change, they are adaptable to meet the needs of their communities. Regional and community banks are active in the CRE space across multiple industries to include industrial, retail, hotel, senior housing, office, and apartment lending. Their activity also scales in volume as one migrates away from the metro areas.

A well-diversified bank is better insulated against market downturns. The understanding and production of CRE loans supports diversification and the local economy. The knowledge of these tertiary markets is often unique to regional and local banks who support said markets. Without physical branches present and relationship development, both the lender and local economy suffers.

Agriculture

Often overlooked in the digital age, agriculture has been (and continues to be) a significant factor in the US economy. According to the 2022 edition of Feeding the Economy, food and agriculture account for one-fifth of the country's economic activity with nearly 21.5 million jobs (14% of US employment). There are more than 2 million farms and ranches in the US which cover two out of every five American acres [16]. Agriculture is an economic driver that doesn't stop at the farm. Broader markets are directly and indirectly impacted throughout industries such as:

- Food sales
- Nutrition research
- Horticulture and engineering
- Trucking and logistics
- Restaurants
- Grocery stores
- Processing plants
- Storage facilities
- Equipment manufacturers

One can note the overarching importance of agriculture throughout numerous industries. Many everyday items are byproducts of food produced by American farmers – from biofuels to building materials, to cosmetics and pharmaceuticals.

Agriculture is a linchpin to the American economy, and community banks are the cornerstone to their funding. The cyclical nature of agriculture lending requires community banks to have specific lending knowledge, and to be adept enough to create customizable solutions that work for both parties. According to ICBA, community banks under $10 billion in assets provided 80% of all financing to agriculture from the banking sector in 2022 [17]. This has increased from 70% since 2019. Many of these rural lenders are

ag-lending specialists. See the 2019 breakdown below.

Local banks rely on and earn this type of business due to their ability to make big decisions quickly and without much friction, stemming from their local knowledge and personalized approach. These close ties are reflected in the fact that despite only holding 12% of industry assets, they hold $155 billion, or 80% of agricultural banking loans [17]. That said, these banks are small – especially agriculture specialist in rural areas. Two imminent threats to these rural farmlands include increasing interest rates, and the consolidation of the banking industry. Rising rates equate to the cost of borrowing going up, with the prime rate reaching levels it hasn't since 2007. Lastly, small banks suffer the greatest decline when it comes to acquisitions and consolidations. In the mid-90s, 84% of FIs held less than $330 million in deposits. Today, nearly half the banks that remain hold $1.3 billion or more [18]. The survivability of these smaller banks is crucial to agriculture's lending landscape and success.

Mortgage Lending

Throughout the past few years, not many divisions within banking have been busier than that of a mortgage department. After years of underbuilding homes following the 2008 financial crisis, coupled with numerous restraints from the pandemic, supply was ultimately limited. Lower rates encouraged refinancing volumes (which has clearly diminished), but on the demand side one area is often overlooked. The nation's population increased more in the 1990s than any previous decade, and the 2010 Census showed populations sprawling from metro areas and spilling into more rural communities. These 1990s babies are now reaching first-time home-buying age. See the graphic from the FRB of St. Louis below:

There is pent up demand from millennial household formation and years of underbuilding. Regardless of demand, the future of the mortgage industry faces its share of challenges. Refinancing volume has essentially dried up thanks to rates that essentially doubled during 2022. The lack of volume will have to be made up somewhere, and thankfully millennials (and many others) still need housing. However, it cost more to originate a purchase versus refinancing due to several factors such as:

- Longer gestation period
- Little to no flexibility with closing date requires more "hands on deck"
- More movement with purchase contract
- More third parties and communication required
- More thorough appraisals needed

As if it weren't challenging enough replacing refinance volume with purchase volume, the latter is set to decrease in 2023 as well. The Mortgage Banker's Association (MBA) forecasts originations to decrease by 3% for 2023 [19]. Pair this with declining revenue per origination, overstaffing from record years, and higher expenses, and many FIs will need to make changes. Larger banks and digital lenders have already begun to make the changes we'd expect of them, with Chase and Wells Fargo both laying off hundreds

of employees throughout 2022. Worse than that, digital lenders such as Better and LoanDepot cut their workforce by more than 50%, laying off thousands. See National Mortgage News for more.

Thankfully, local community banks and credit unions do not typically upsize or downsize with market trends. Due to their smaller asset size, these types of FIs are more cautious and risk-averse when it comes to market opportunities, which makes them steady and reliable – for customers and employees. Increased volumes may simply mean employees working harder, longer hours, and being assisted by other divisions.

The "steady as we go" approach has proven fruitful for community banks within the mortgage sector. In 2020, Banks and Credit Unions with less than $10B in assets provided nearly 1 out of every 3 US mortgages. Furthermore, these banks and credit unions are the only physical banking presence in one out of five US counties [20].

Ensuring Success

Despite challenging headwinds, there are numerous ways in which community bank and credit union leaders can help ensure their financial institutions' success. We've clearly defined the importance and impact of these institutions on a macroeconomic level. As 2023 begins, so does a great deal of uncertainty, with rumblings of an imminent recession. The mortgage industry tends to be a driver and/or depiction of the broader market, and the challenges discussed within mortgages will likely bleed into additional areas. A proactive approach on all fronts is crucial. Many might remember the original "Iron Man," also known as Cal Ripken Junior, who was an MLB All-Star 19 times and still holds the record for consecutive games played. His sustainability was generated through his proactive nature – he would have a better plan for himself than his coaches did for spring training, while most established players coast through spring training. Before analytics, he would scout opposing hitters to position himself in the best possible way to make a play. His proactive planning supported his vision for the future, and his ability to recognize patterns put him in the best possible position to be successful. There is much to learn from the baseball veteran.

Have a plan – and not just for the good days. Forward-thinking banks and credit unions not only envision the future but every scenario of the future. Nobody knows where the Fed Funds rate will be in 2024, but financial leaders must have a plan for every variation of rate hikes - or the opposite. Three strategies are outlined below.

1. Reduce Excessive Costs and Spending

And not in the same style Wells Fargo did throughout 2022. Labor costs include your most valuable asset, which is your people. Retaining quality employees can actually reduce costs when we consider the arduous process of hiring and training. Smaller banks tend to have tenured employees, which is great, but can, unfortunately, create a "we've always done it this way" atmosphere and approach. Technology advance-

ments will not allow for these types of environments to survive for much longer. Workflows need to be efficient and even automated where applicable. Vendor contracts need to be actively managed and negotiated. Many times, an outside expert or firm can help, as you don't know what you don't know. These types of consultants bring pain points to the surface for evaluation, almost like a therapist. The solution may be to exercise more, or there may be a medicine you didn't know existed. Outside perspectives bring great value to tenured teams who have been in the trenches, bringing a helicopter view and unique ammunition to an FI's specific situation.

2. Understand Your Competition

Speaking of perspective, knowing and understanding the competition fosters better outcomes. In a world where data is ultimately valuable, competitive data goes one step further. By obtaining price points, rates, service fees, etc., one can gain an understanding of the competition's strategy to better design their own. Discreet research into relevant FIs can expose wildly valuable information. Based on volumes, incremental adjustments to pricing can greatly affect the bottom line. Attempts can be made in-house, or there are firms that specialize in obtaining confidential pricing information and making valuable, client-specific recommendations. Furthermore, these firms can expose gaps in products, pricing, and fees that a financial institution did not know existed.

3. Utilize Data to Increase Revenue

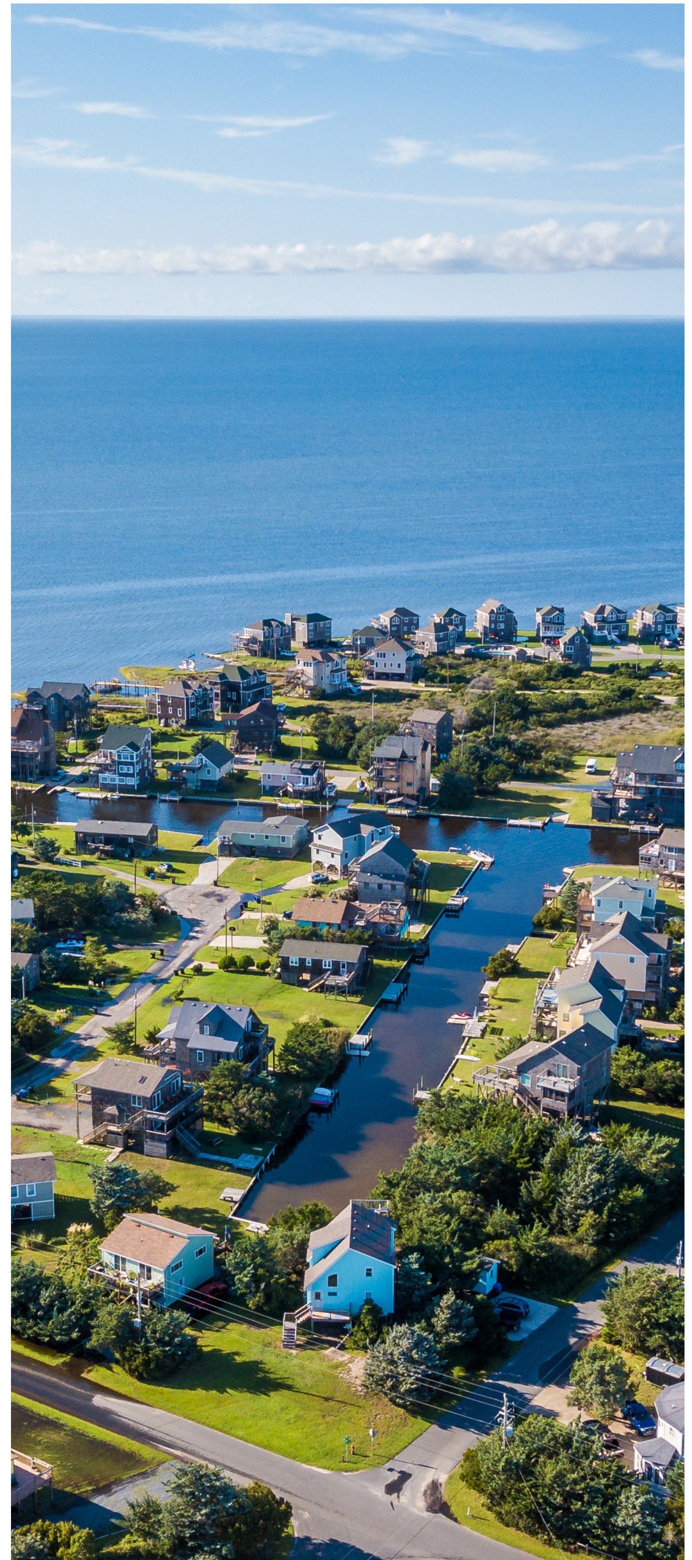
Considering the volatility in rates, there are numerous opportunities within interest income as well as noninterest income to increase revenue. Deciding which opportunities to pursue should be weighed based on strategy, culture, and the potential financial benefit (hence, data). Determining which opportunities are available also starts with the data. By defining a competitive landscape, one can research products/rates/fees and determine where each currently offered product lies in the market. It can also encourage new product offerings. If an FI wants to start with

the heavy hitters, think volume. Where can we make incremental adjustments that will impact the bottom line most significantly? Where are we out of line with the market, and which adjustments would be the most fruitful? Maybe lending rates are slightly below the market, and it has nothing to do with strategy. Or, maybe business processing fees are higher than expected within the market. The examples are plentiful. Once again, this can be done in-house in a variety of fashions, or an FI can hire an experienced firm to perform the evaluation more effectively and efficiently.

In closing, it is clear that non-urban communities and their respective FIs face major headwinds in 2023/2024 to be sustainable and successful. The three strategies above can help local banks and credit unions stay ahead of uncertainty and ensure stability. Their success is ultimately important, as these institutions provide irreplaceable support to local communities through small businesses, CRE, agriculture, and mortgage lending. And as we mentioned, the availability of bank branches is still important to these communities, especially the aging population. Local banks have long served communities by financing main street and helping families and businesses build dreams. FI leaders are encouraged to be great and constantly seek improvement, so their respective communities can follow suit. Based on Malcolm Gladwell's atypical take on David and Goliath, I will close with a not-so-obvious advantage and call to action.

Gladwell claims that it is because of, not despite, David's size and unorthodox choice of weapon which leads to the "underdog" victory over the giant. He also asserts that Goliath could suffer from acromegaly, which causes one to grow in size but leads to poor vision. He is a giant weighed down by heavy armor who can barely see. David has tons of advantages. They are just not obvious. The importance of speed, agility, and accuracy becomes more evident as we see the whole picture. We need to do a better job of recognizing advantages.

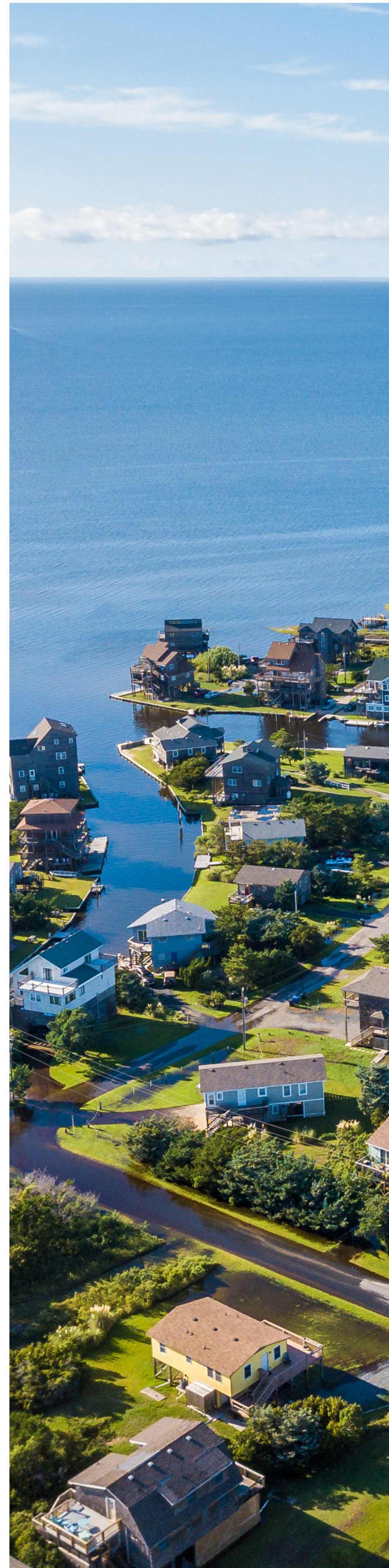
I want to encourage the Davids of the banking industry to recognize and be confident in their strengths. While the large, wealthy Goliaths can be less adept and handcuffed by their size, community banks and credit unions can use their agility and adaptability to outperform larger competitors. A proactive approach will lead to ongoing profits to be recognized by the FI, and, more importantly, continued prosperity for their respective community.



About the Author

Matt McCall currently serves as VP / Market Research & Insights.

Matt has always had a passion for athletics, small business, sales and research. He graduated from Georgia Southern as a student athlete (baseball) with a degree in Finance with an emphasis in banking. In 2012, Matt began his first small business (Mprints South) which sold imprented apparel and promotional products). When he graduated from Georgia Southern, he went on to train under Ty Young and moved over $4 million in retirment funds within a year. He joined the Ceto family in 2016, working in sales at LogicPath. He sold Deposit Reclassification under Ceto's founder, Nicholas Ceto and C3 Financial under Ceto's current President and CEO, Douglas Ceto for almost two years. In 2017, he transferred to consulting and specialized in data quality and harvesting. Because of his knowledge in that role, Matt was offered a position to build out and manage the Market Research team in 2021. He was promoted to VP in 2022 and currently manages MRI, which consists of Market Research, Development and IT.



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