Small Banks' Strengths and Weaknesses

Julian E. Fant, Jr.

Highly competent management is the key to ensuring independence for community banks.

In addressing the strengths and weaknesses of small banks in competition with larger banks we are really distinguishing between independent community banks and those banks or branches that are part of a system encompassing many communities with control at a headquarters level, either by the lead bank or a holding company. So, to put it in the vernacular, we are focusing on independent community banks as opposed to chain banks.

A distinct disadvantage of a small bank in a metropolitan area is its inability to saturate the market with advertising. Such a community bank may be several times the size of a local branch office of a bank with distant headquarters, but the latter can rely on its parent's resources to produce a sophisticated advertising program. Thus the citizens of that metropolitan area may perceive the small branch as omnipresent with a knowledgeable, professional, dedicated, and reliable staff—which may, in fact, consist of 5 or 6 people who turn over on an average of every 6 to 12 months.

The ultimate success of the saturated advertising approach is limited by the actual performance of the bank or branch. But the value

---

The author is president and chairman of the board of First Guaranty Trust Company and Five Points Guaranty Bank in Jacksonville, Florida.

advertising gives to the bank is effective, particularly on the more transient segment of the population without established roots and knowledge of the community's various institutions. This can be referred to as the "sizzle effect"—all that sweet aroma and delectable smell is the perceived value. But the value is of limited benefit if it does not emanate from real meat.

Another competitive disadvantage of smaller banks is their inability to obtain approval and funds quickly for worthy loan requests that exceed legal lending limits. This problem has been mitigated in the past few years by more liberalized loan limits. Until recently, a state chartered bank in Florida was limited to 10 percent of its capital and surplus when granting loans and 25 percent when these loans were fully and amply secured. Today the percentage is applied to the undivided profits account, in addition to capital and surplus. This change gives our two Guaranty Banks a total legal lending limit of $739,000 per customer; excluding the undivided profits account would reduce the limit to $380,000. Of course, the traditional outlet for loan participation with a correspondent bank is still available, but this adds another level of approval with a concomitant time delay.

Skirting Size Limitations

Nine states have formed "bankers' banks," which are banks owned entirely by other banks for the sole purpose of serving banks. They accept no retail deposits and provide services exclusively for other banks, including but not restricted to stockholder banks of the bankers' bank. Essentially, the role of the bankers' bank is to perform the services traditionally provided by the correspondent bank without the potential conflict of interest of competing for the customers of its client banks. Bob Pope, president of the Independent Bankers of Georgia, and Julian Hester form the nucleus of a group in Georgia that is setting about to form a bankers' bank. The Community Bankers of Florida, called the Independent Bankers until recently, established the Bankers' Bank of Florida in 1983. After 14 months in operation, its revenues exceeded expenses on a current basis, which is satisfactory given the high level of services it renders.

Other programs are available to smaller banks. For example, the Small Business Administration, a U.S. government agency formed for the purpose of assisting small businesses in obtaining financing, guarantees to the participating bank repayment up to 90 percent of a loan up to $500,000. Only the uninsured 10 percent is counted against the bank's legal lending limit. This means that a bank with a lending limit of $200,000 may grant a loan of $500,000 through SBA, with only $50,000 counting against its legal limit. Since that leaves $150,000 available against its limit, the bank's customer may have total loans of $650,000 or, in this example, 3 1/2 times the amount available without the SBA program.

Fortunately, the SBA has reduced the administrative burden of the loan for the participating bank with its certified lenders program. Under this program a certified bank may submit a loan application which will be approved or disapproved in no more than three business days after receipt, quicker than many banks can approve them on their own. Because an active secondary market exists for the insured portion, a bank may increase its liquidity by selling and servicing that portion if it so desires. If the bank retains it, the insured portion may be pledged against the deposit of public funds since its repayment is guaranteed by an agency of the government.

Our bank in Jacksonville uses this SBA program extensively, and is among the certified lenders. Although we have only two or three percent of the Jacksonville market, last year we generated more loans through the Jacksonville District SBA office than any bank in northeast Florida. We find the SBA program advantageous not only for traditional businesses, but for new dentists. Graduates come out of dental school with debts and usually without two pennies to rub together. But they do have promise and need funds for equipment. Through the SBA we have made equipment loans for 10 years, 90 percent guaranteed, and at market rates. This arrangement works well for all parties.

Distributing Versus Manufacturing

The small bank must ask itself if it should deal with customers whose regular needs are greater than what the bank can meet without stretching its limitations. The strength of a small bank is in responding to the needs of small businesses and retail customers, not in providing services to the largest corporations.

Some say the incapacity of a small bank to pioneer new products and services requiring large capital commitments is a competitive disadvantage. However, banks of all sizes may elect to be distributors rather than manufacturers of many products and services, as is well exemplified in the case of automated teller machines. Some larger banks committed themselves to ATMs in their embryonic stage. Today any bank can offer its customers use of ATMs through the evolution of networking, which does not even require that a bank own a single ATM.

The re-regulated—not deregulated—environment is moving toward giving banks the option to form their own insurance subsidiary or simply to rent space to an insurance agent and share in its commissions. The same option will apply to real estate and security brokerage operations. The key competitive issue is how critical the lag is between the time the large bank pioneers a product or service and the small bank also offers that service, whether by manufacturing or distributing.

Neither a community bank, nor any bank, needs to compete by being all things to all people. A small bank may elect to offer the full range of services and products, but it is not necessary to place the same level of competence and emphasis on each one. There is an old saying: "One can recognize the pioneers by the arrows in their backs." Evidence is lacking that being among the avant garde in manufacturing revolutionary financial products and services is critical to the success of a community bank.

A large banking chain's relative ease in raising capital, equity, or debt in the open market may be deemed a competitive advantage by some observers. Certainly a smaller bank does not have reliable access to the open market. Generally, smaller banks appear to be more profitable and better capitalized than larger banks. The 198 banks composing the Community Bankers of Florida, for example, have a capital to asset ratio of 8.4 percent and a net earnings to asset ratio of 1.3 percent, on average. A small bank in a bustling community may experience a rapidly accelerating deposit growth that outstrips its capital growth. In the absence of the owner's ability or desire to supply additional capital, the bank may feel the constraints of the capital marketplace. This contingency argues for a bias toward a more modest dividend payout policy for such banks.

Small Banks and Computers

The rapid transition from the hand-posted ledger to computerized information was thought to be the Achilles' heel of the community bank. But ironically, the velocity of technology seems to have brought about the opposite result. The ability to network and buy or lease technology gives the small bank advantages. At Guaranty Bank, we used to shudder at the thought of controlling our own computer environment, rather than renting from our correspondent bank. But in November 1983 we purchased a computer, a document processer, a printer, and all sorts of related equipment, and now we do our own processing. What caused us finally to get our feet wet was the ability to have a sophisticated, responsive system without doing any programming. In fact, we cannot do any programming because the source key is retained by the software vendor and placed in escrow in a Florida bank. The present cost of this system exceeds what we previously paid our correspondent for computer services. However, additional activity is largely an offset to fixed cost and not a direct variable cost as before. As we gain experience—we now use 12 boxes of paper per month instead of 30—the differential is shrinking. Our ability to massage the data for both analytical and marketing purposes is superior to what was available in our prior arrangement.

Economies of Scale

Economies of scale often are cited by advocates of further consolidation of financial resources. But, the empirical evidence does not seem to support the proposition—nor does the evidence dampen the backing both small and large banks give this idea.

Bob Forrestal, president of the Atlanta Federal Reserve Bank, has said that, "The evidence indicates that banks with $50 million to $100 million in assets produce basic banking services most efficiently."

The strength of a community bank is that it is born of the community to serve the community, instead of being a branch of an out-of-town or an out-of-state institution acting as a conduit of deposits to the home office. The loan policies, investment policies, and personnel policies of a community bank are developed for the sole benefit of the community in which it resides. As one community banker advertised, "Where other banks have their branches, we have our roots." A personal relationship with customers is the characteristic of a community bank that is not much in evidence in the chain bank environment. The authors of *In Search of Excellence* stated that, "probably the most important management fundamental that is being ignored today is staying close to the customer, to satisfy his needs and anticipate his wants." A similar thought is expressed in an entirely different way by the Dale Carnegie course, which teaches that the most important and sweetest sound in any language is the sound of one's own name. The ability to know one's customers, care about them, and respond to their needs is what permits the community bank to thrive in any competitive environment.

Being Close to the Customer Is the Key

Only an enlightened bank management and staff can cause the community bank to thrive. The nurturing of an atmosphere that allows for true personal relationships stems from the much lower turnover rate of a community bank's staff relative to the chain bank's. The chain bank often rotates its branch management personnel as part of its training program. This practice does not favor customer relationships or staff morale, and thus further aggravates turnover. The community bank typically has one or two branches, if any, and does not conduct a revolving training program. Also, the community bank often is managed by those who own the bank, in contrast to an investor owner whose interest in banking may be casual, or with ownership so fragmented that it cannot be identified.

The quick decision-making capability a simplified chain of command allows is another significant strength of the community bank. Added to a personal knowledge of customers, this directness leads to prompt response to loan applications and other customer needs. Compare the loan-making ability of an officer who has served a particular community bank branch over the years with that of a branch manager, only 6 to 18 months at a location, whose limited loan authority derives from a distant headquarters bank.

A large measure of the success of the community bank should owe to its competitive advantage in being able to identify and cultivate its more profitable customers. It may do so by massaging deposit data on its customer base to determine more profitable accounts, by designating particular markets in the community to capture, or by a combination of the two. Our three-year-old preferred customer strategy at Guaranty Bank has convinced us that a larger bank that identifies customers only by computer information will have limited success zeroing-in on preferred customers and implementing meaningful programs to reward them.

We call our preferred customer program the Gold Circle Club. Members average more than $7,500 in checking or savings accounts and $25,000 in CDs or money market accounts. These customers are provided an identification card with an unlisted telephone number that is a direct line to our Gold Circle Counselor, who is located in a private banking room. Members of the club may conduct their banking in this opulently decorated room, which is supplied with beverages and the *Wall Street Journal* and *New York Times*.

Additional benefits include waiving of most service charges, auto rental discounts, loan discounts, automatic $100,000 accidental death coverage, a bimonthly club bulletin, special mailings, Christmas gifts, and birthday cards signed by officers who know the customers personally. Among recent special events have been an exclusive symphony concert, private performance of a play, a wine and cheese party at the restored Florida Theatre in Jacksonville, and an open house at my home. We realize we have barely scratched the surface of using our imagination in directing our resources to those who provide us with profits. It would be difficult if not impossible for a large chain banking system to do more than provide preferred rates and credit lines to identifiable preferred customers.

Incidentally, we recognize that one of the risks inherent in a preferred customer strategy is alienating customers not in the club. But still, the residual fall-out of this program has lifted the morale of our bank, has heightened awareness among our entire staff, and resulted in an upgrading of services at all levels to all our customers.

The board of directors of any bank has the potential to be a competitive force. However, a small bank in a rural community, where the only competition is in the form of branches of out-of-town institutions, has the unique advantage of being the only board in town. If that board is informed and if that board is motivated to use its influence in attracting business for the bank, the potential competitive effect is difficult to overstate.

Conclusion

A number of competitive weaknesses and strengths of smaller banks have been reviewed here. None of the weaknesses appears to be unduly formidable to community banks as a whole; indeed, many are more perceived than real. However, one area that has the potential for being the greatest strength or the greatest weakness of a community bank is its management. The chief executive officer of a large chain bank may come and go and the bank likely will continue in the same general direction because of the organization's various management levels. The CEO of a community bank usually owns a significant portion of the bank, and often the CEO, perhaps with several others, constitutes the management. To compete successfully, particularly in an urban and metropolitan environment, the community bank must have competent management with a passion for excellence. If it does, that same passion will be absorbed by the entire staff and the bank will have a competitive edge, regardless of size. If it lacks that passion, the community bank ultimately will wither and likely be absorbed into a larger banking organization.