BETTER MARKETS

BANKING

FACT SHEET

Community Bank Funding Challenges and Opportunities

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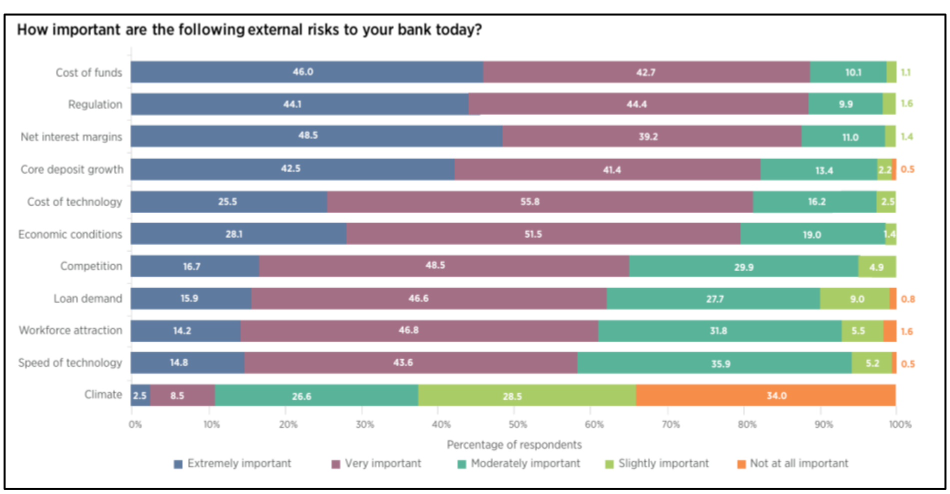
Community banks are vital to Main Street America, providing a safe place for families and small businesses to safeguard and grow their wealth, and reinvesting local dollars to help communities thrive. Community banks have proven to be resilient in the face of an array of challenges, including merger pressures, economic downturns, and financial crises. Through it all, they remain steadfast in their commitment to serve America's families and small businesses.

Community banks rely on deposits from their customers ("core deposits") as a primary funding source for activities such as making loans. These core deposits from customers are typically low-cost and stable. However, community banks also face significant funding challenges.

The 2024 Conference of State Bank Supervisors' ("CSBS") Annual Survey of Community Banks showed that ***cost of funds*** topped the list of community banks' concerns (Chart 1), closely followed by net interest margin ("NIM"), which is the profit that banks make by lending out deposits at a higher interest rate than the rate paid to depositors. This margin has been pressured by the cost of deposit funding increasing faster than the interest income on lending. This fact sheet details three specific funding challenges for community banks—increasing cost of funds, competition with too-big-to-fail banks and crypto firms, and the growth of fintechs. It then provides several actions that policymakers and regulators should take to help ease community banks' funding challenges and better protect consumers who entrust their savings to community banks.

Chart 1

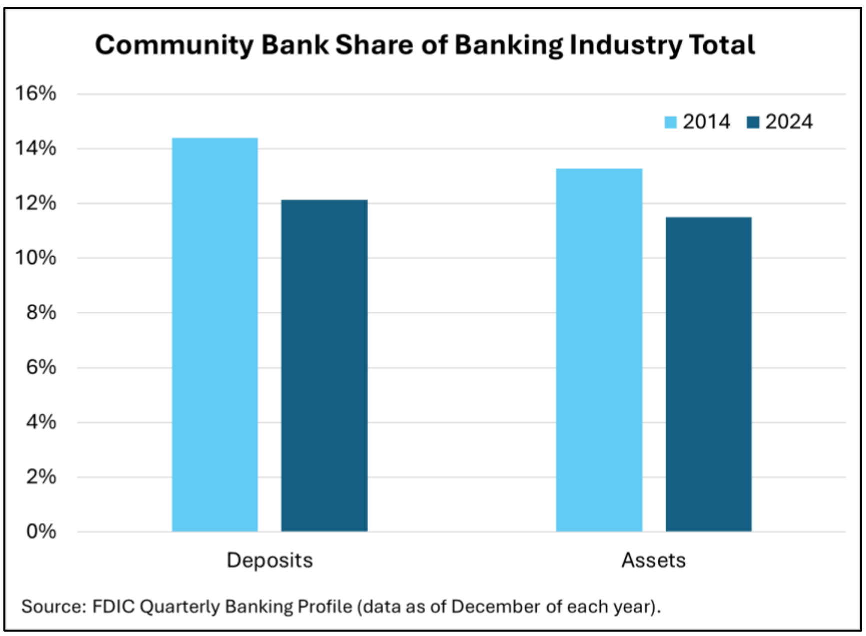


Community Banks' Deposit Function Is Vital to Main Street Families

In the 10 years between 2014 and 2024, nearly 2,000 community banks were lost to mergers or other forms of consolidation. At the end of 2014, there were about 6,000 community banks, and at the end of 2024, that total fell to about 4,000.

Despite the consolidation that has occurred in the last decade, community banks remain the cornerstone and engine of growth in local economies. More than 9 out of every 10 banks in the U.S. are community banks, serving Main Street families and small businesses at more than 26,000 branch locations across the country. Community banks have also remained a key place for consumers to safeguard their money. At year-end 2024, community banks held more than $2 trillion in total deposits at year-end 2024. To put this amount in perspective, community banks hold 12% of the banking industry's total deposits, slightly more than their share of the banking industry's total assets—such as loans and securities (Chart 2). Although community banks' share of total deposits has fallen, the decline has been relatively minor considering the number of community banks that have closed. This proves that Americans continue to trust and rely on community banks.

Chart 2



Moreover, research proves that community banks continue to serve Main Street, even after mergers occur. Most community banks that close or are the target in a merger or acquisition transaction are ***acquired by another community bank. This outcome is vitally important because it keeps the acquired bank's deposits in the local community***. Moreover, community bank acquirers are more likely to keep acquired branch offices ***open after acquisition*** compared to noncommunity bank acquirers. To illustrate, more than 90% of closed community bank branch offices that were acquired by community banks were still open one year after the acquisition, higher than the retention rate for noncommunity bank acquirers. Research also shows that community investment ***increases*** in areas where acquired community bank branches remain open, and that increase is stronger when a community bank is acquired by another community bank. In other words, community bank consolidation often creates larger and stronger institutions that remain committed to and actually ***contribute more*** to community development.

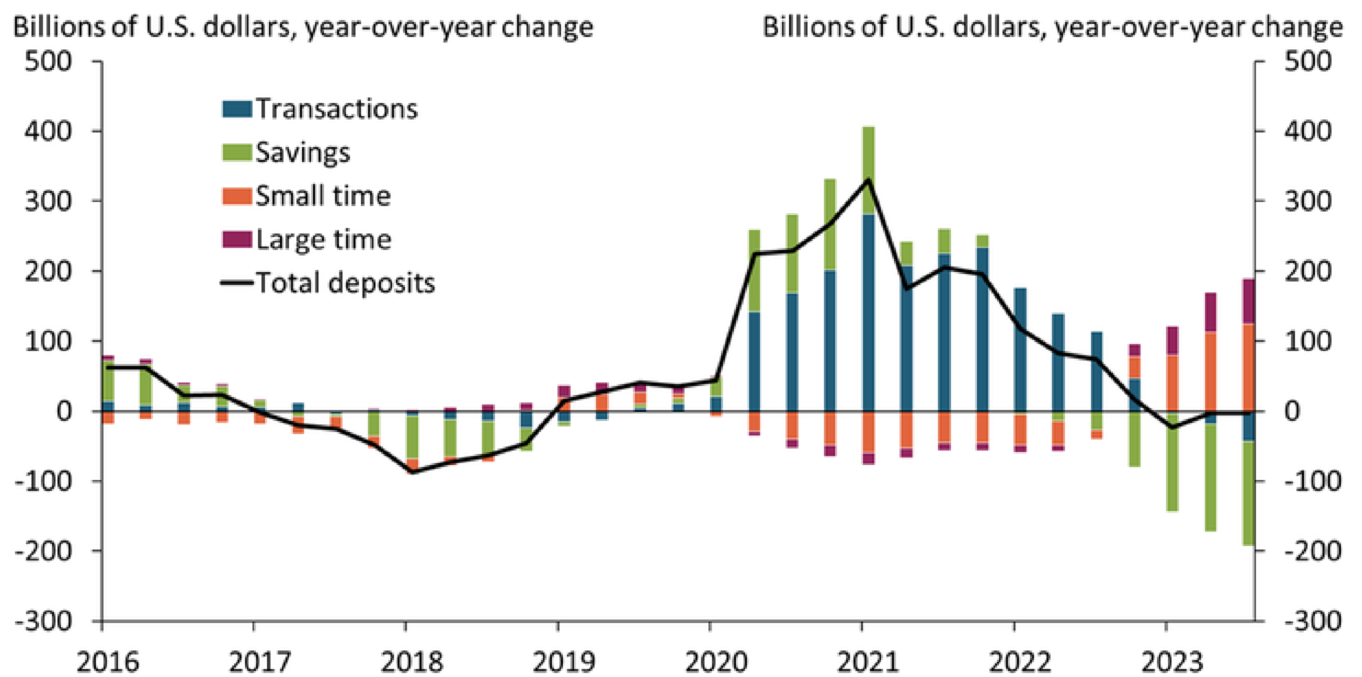
Community Banks' Funding Profile Has Changed, Becoming More Expensive

Although community bank funding is generally stable and low-cost, market forces in recent years have resulted in significant shifts and pressure for these banks. The Federal Reserve ("Fed") increased interest rates 11 times in 2022 and 2023 to combat inflation and protect the economy from a recession. These moves increased interest rates that consumers could earn on bank deposits; consequently, community banks had to raise the interest rates paid to depositors to keep pace with their competitors throughout the financial industry and not lose deposit funding.

As shown in Chart 3, community banks got a boost from large inflows of transactional deposits and savings during and directly after the pandemic. But, as interest rates rose in subsequent years, community banks' customers demanded higher interest rates on their savings, which manifested as outflows of deposits from account types that offered lower rates and inflows to types that offered higher rates.

Chart 3

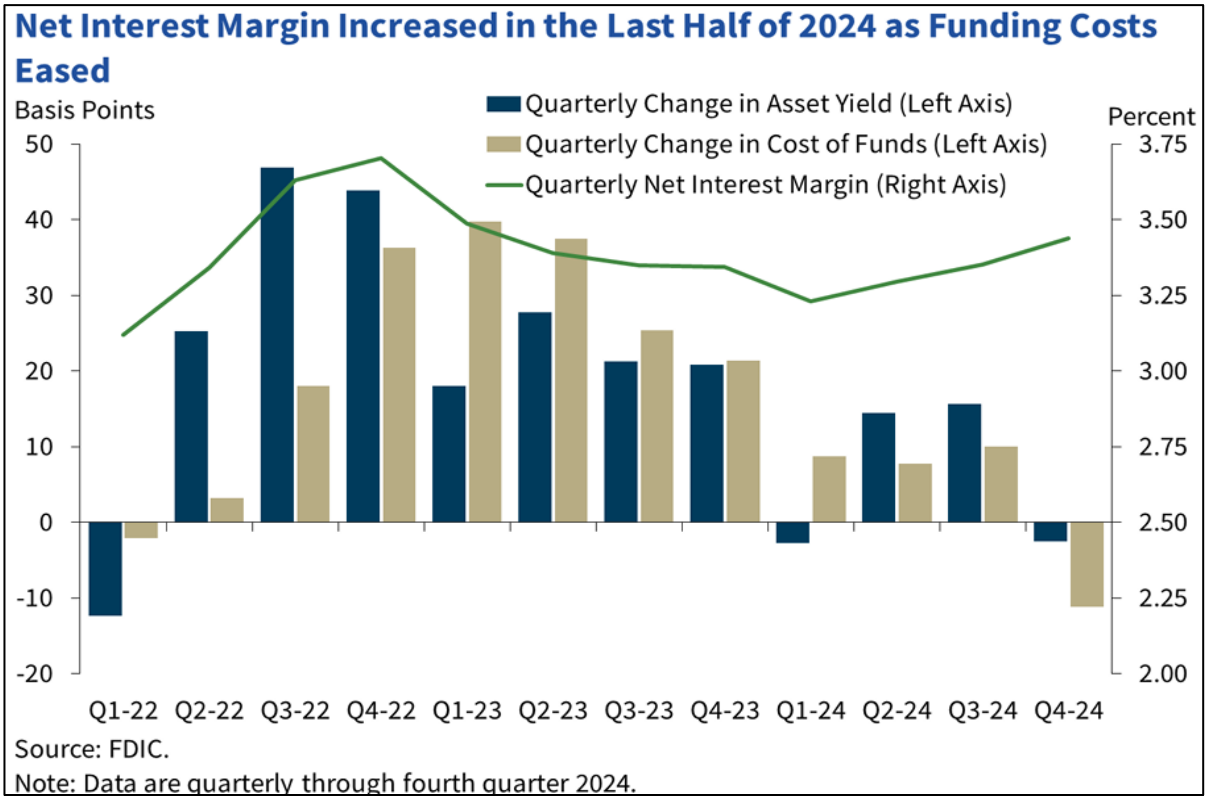
The Composition of Community Banks' Deposits Has Changed Markedly



Source: Federal Reserve Bank of Kansas City, with data from the Federal Financial Institutions Examination Council.

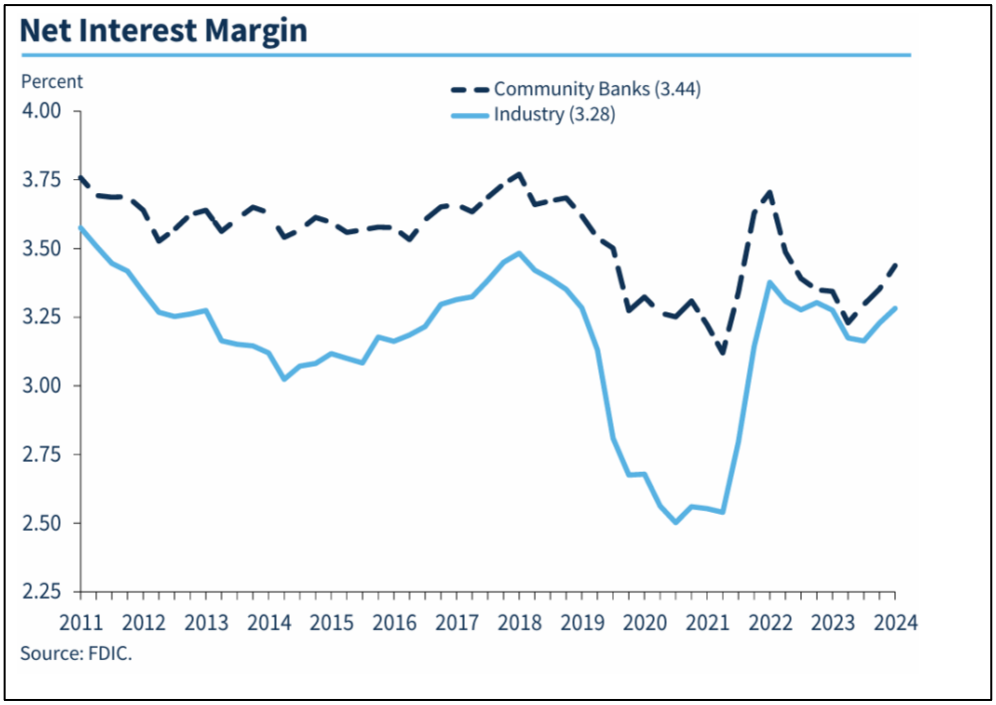
With more deposits in higher-rate accounts, banks' cost of funds rose. However, the increase in interest paid to depositors was not offset by equal increases in interest earned on lending those deposits, causing banks to experience declines in NIM during late 2022 and through 2023 (Chart 4).

Chart 4



Community banks' NIM has historically been well above NIM for the banking industry overall. In 2022 and 2023, however, community banks' NIM fell more sharply than the banking industry's NIM (Chart 5), reflecting the fact that community banks had to pay higher interest rates to keep depositors, and make more of a change than larger banks. Although community banks' NIM recovered somewhat in 2024, it remains below the long-run pre-pandemic average level. This trend could remain a headwind for community banks in the future. As researchers from the Federal Reserve Bank of Kansas City state, "banks with weak deposit franchises are more vulnerable to depositor flight when interest rates rise." In other words, along with being responsive to broader changes in interest rates, community banks can remain resilient to interest rate fluctuations by focusing on broadly serving their customers and providing value with the entire suite of products and services they offer.

Chart 5



Community Banks Were Less Negatively Affected by the 2023 Banking Crisis Than Larger Banks

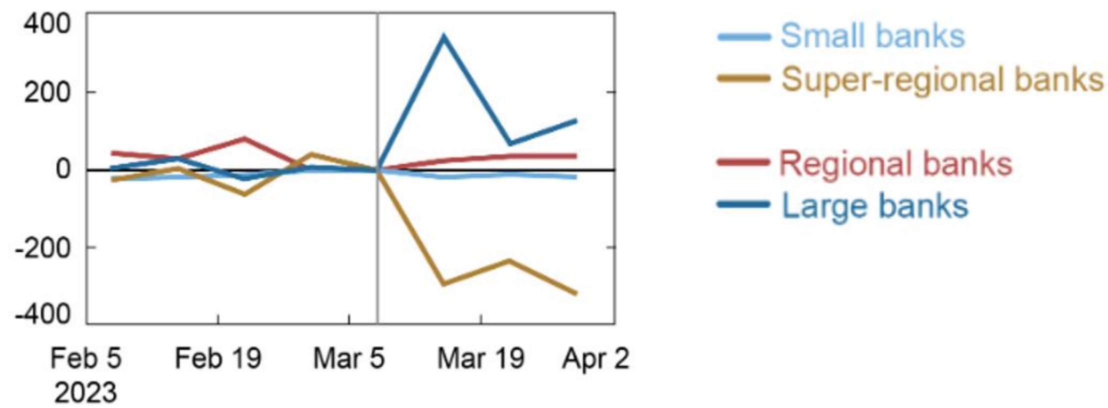
The 2023 banking crisis was, among other things, a crisis of depositor confidence. It was also evidence that too-big-to-fail is alive and well. This remains a key concern for community banks and a deterrent, especially for large depositors, to choose a community bank over a larger bank for their financial services needs.

In March 2023 and through that spring, deposits flowed out of banks that were seen as risky and into banks that were thought to be safer, or at least too big to fail. Most of the deposit outflows were from super-regional banks (those with between $50 billion and $250 billion in total assets). Large banks (those with more than $250 billion in total assets) were the primary source of most of those deposit flows (Chart 6). Small banks also saw deposit outflows in spring 2023, but in much smaller amounts. Nevertheless, this is more evidence that the too-big-to-fail problem hurts community banks.

Chart 6

Change in Deposits

Relative to March 8, 2023, billions of U.S. dollars



Source: Federal Reserve Bank of New York, LIBERTY STREET ECONOMICS, May 11, 2023.

Bank-Fintech Deposit Partnerships Expose Community Banks and Consumers to Serious Risks

Innovation—such as financial technology ("fintech") companies partnering with banks, or any other genuine technological advances—is the fuel that drives our economy, wealth creation, and rising living standards. However, bad actors, short-term thinking, or just development gone out of control can set that all back as the trust and confidence of the public, investors, markets, and governments is undermined, if not destroyed.

Many banks and millions of Americans use fintech companies for deposit placement services, as a conduit to connect depositors and banks. Approximately 68 million U.S. customers have opened a fintech account to work together with their traditional bank account for specific services, such as sending and receiving small-dollar peer-to-peer payments like Venmo. While bank-fintech partnerships can provide convenience, open up additional products and services, and reduce costs, most users are unaware that fintechs are almost entirely unregulated. Consequently, customer funds can be at great risk if the fintech gets into trouble. For example, the possibility that a company whose business is pooling customers' funds as deposits in banks would fail and would not have records of where customers' funds were placed was clearly never considered in the current set of bank rules and regulations.

The most recent example of these risks is the bankruptcy of Synapse Financial Technologies, Inc. Synapse collected customer funds and deposited them in banks such as Evolve Bank and Trust. However, the current rules do not require banks to have records of the deposits of the individual customers whose funds are pooled by a fintech and deposited with them. This is exactly what happened in the case of Synapse and Evolve Bank. Synapse's records showed more customer funds being deposited in partner banks than the banks' records showed—the latest reported shortfall is enormous, between $65 million and $95 million.

The many victims of the Synapse debacle had placed funds in fintech partners of Synapse—funds that they were led to believe would be held in safe, secure bank accounts. Instead, these victims have heard the worst sentence a banker can utter to a depositor: "I am sorry, but we have no record of your deposit." Victims include people who used their Synapse-placed accounts for day-to-day living expenses. Others used their accounts to save for important life events: for example, a former Texas schoolteacher, who had placed over $280,000 with Synapse partners that she was saving towards the purchase of a house, was informed by Evolve Bank and Trust that she would receive only $500 of her funds.

Pending Stablecoin Legislation Threatens the Future Vitality of Community Banks

Stablecoins are crypto assets that purport to be pegged to real-world assets, most commonly U.S. dollars. Stablecoin issuers promise customers that they can trade a U.S. dollar for a crypto dollar on demand, and vice versa. Legislation currently being considered in the U.S. House of Representatives and the Senate (titled the "STABLE Act" and the "GENIUS Act," respectively) creates a bespoke regulatory framework for stablecoin issuers that troublingly lets them engage in deposit-taking activity that looks a lot like banking, but without the attendant regulations.

For example, the legislation allows stablecoin issuers to have affiliate arrangements that permit customers to earn yield on their crypto dollars in exchange for locking those crypto dollars in deposit accounts. Coinbase, in a profit-sharing arrangement with stablecoin issuer Circle, allows users to earn up to 4.1% returns on Circle's USDC stablecoin when those stablecoins are deposited at Coinbase. Coinbase, according to financial disclosures, also lends USDC to institutional crypto borrowers. This deposit-taking and lending activity done through affiliate arrangements looks a lot like traditional banking.

The legislation likewise opens the door to stablecoin issuers being eligible to Federal Reserve Master Accounts, or the payment system used by the Fed to settle transactions in central bank money. Master Accounts also have been the conduit for banks to receive emergency lending from the Fed via the discount window. Because master account access confers so many privileges, the Fed system has historically reserved membership for well-regulated insured depository institutions, which are subject to the robust regulation and supervision of banking agencies.

Finally, stablecoin legislation would allow non-financial companies like Big Tech firms to issue stablecoins, further undercutting the role that community banks play in neighborhoods by providing reliable deposit account access and lending. Big Tech firms may also be able to use the cheap financing provided by deposits to fund their non-financial activities and likewise might allow non-financial activities to create risk that spreads to the payment system.

As Better Markets has advocated, policymakers should ensure that if stablecoin companies are permitted to engage in bank-like activities, they be subject to the full set of bank regulations, including comprehensive regulation and supervision by banking agencies and limitations on interconnections with non-financial companies like those in Big Tech.

Policymakers and Regulators Should Protect Consumers and Help Community Banks Maintain Stable Funding

Expand FDIC Deposit Insurance to Include Certain Transactional Accounts

In the aftermath of the 2023 banking crisis, the FDIC conducted a detailed study of ways that it could reform deposit insurance. Options that were developed in the study would benefit community banks, small businesses, and local municipalities that rely on transaction accounts.

Under the current deposit insurance framework, many transaction accounts exceed the deposit insurance limit and are, therefore, uninsured. These accounts are essentially unprotected and could be wiped out in a bank failure. They could also be moved to a megabank that is perceived to be too big to fail during an unstable period.

However, accounts like these are often vital to a small business or a local municipality that relies on the funds for activities such as payroll or purchasing supplies from other small businesses. For this reason, policymakers should explore ways to bring them under the deposit insurance umbrella. While any changes need to be made carefully and thoughtfully, and a broadening of the account types or balances that are protected by deposit insurance could bring additional cost to banks, community banks would be well served by continuing to support changes to the deposit insurance system, as this would incentivize deposits to remain with community banks rather than flowing to too-big-to-fail banks, thereby lowering competition for community banks' deposit funding and their cost of that deposit funding.

Strengthen Rules Related to Deposits from Bank-Fintech Partnerships

Financial regulators should take concrete steps to protect customers whose funds are bundled by third parties, such as fintechs, and deposited in custodial accounts at banks. No depositor wants to hear their banker utter the sentence, "I am sorry, but we have no record of your deposit." Yet that was precisely what tens of thousands of Synapse customers heard following the company's bankruptcy.

Accordingly, banking regulators should develop and implement stronger recordkeeping requirements for custody deposits that are gathered by fintechs or other nonbanks and kept at banks. These rules should include transaction and nontransaction deposits. While such a requirement would apply a higher standard, and potentially higher costs, for community banks than currently exist, customers whose funds are placed in bank deposits deserve the security of knowing that the banks have adequate records of their deposits.

Increase Enforcement of False Claims of FDIC Insurance

Increasingly, advertising and other statements by fintechs state or imply that they are FDIC insured, that cryptocurrencies are FDIC insured, or that the FDIC protects fintech customers if the fintech fails. These claims are not true; however, they can severely damage confidence in the safety of banks, including community banks, that are FDIC-insured and work every day to faithfully protect customers' deposits.

We have found no instances where the FDIC exercised its legal authority to punish a fintech for violations of laws against such misrepresentations. Instead, the FDIC has issued only warning letters advising fintechs that if such statements do not stop, formal action could follow. The FDIC should use its enforcement authority to take formal cease and desist actions, levy civil money penalties, and, where appropriate, make criminal referrals to deter and punish entities that make false or misleading representations about federal deposit insurance. Appropriate and timely public punishment is essential for both informing the industry and the public while also deterring future misconduct.

Better Banks | Better Businesses
Better Jobs | Better Economic Growth
Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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