Financial Performance and Management Structure of Small, Closely Held Banks

Introduction

It is widely recognized that community banks embody unique characteristics that distinguish them from other banks.[1] Community banks are generally smaller in asset size than other banks. They tend to focus on traditional banking activities, making and holding loans, and funding themselves with core deposits. They hold relatively large amounts of equity capital relative to assets. Because they do business in a relatively limited geographic area, community banks are able to make operational decisions locally, frequently based on tacit, personal knowledge of their customers and market area, as opposed to relying primarily on models and standardized data. As a result, a defining characteristic commonly attributed to community banks is that of relationship lending, as opposed to a more impersonal, transactional banking model. A recent study has incorporated a number of these attributes into a community bank definition that can be applied consistently over the past 31 years.[2]

Less extensively studied are the organizational characteristics of community banks, including management and ownership structure. As of December 2014, 93.2 percent of FDIC-insured community banks were organized as stock charters, and the remaining 6.8 percent were organized as mutuals, where depositors own the bank.[3] As of year-end 2014, 35 percent of community banks as defined by the FDIC were organized under Subchapter S, which allows banks with limited ownership to decrease taxes on earnings.[4] Only 7 percent of banks that did not meet the FDIC community bank definition were organized under Subchapter S.[5] This broad measure confirms the general understanding that community banks are much more likely than noncommunity banks to be "closely held," or controlled by an ownership group with relatively few, closely allied members who effectively exercise strategic control over the bank. Subchapter S status, however, is only a rough proxy for being closely held.

Additional information on organizational form is available in confidential supervisory data. A 1995 study by researchers at the Federal Reserve Bank of Kansas City and the Office of the Comptroller of the Currency used supervisory data to identify closely held banks as those where supervisory reports indicated that there was a "principal shareholder" who owned more than 10 percent of voting shares.[6] The study found evidence that efficient banks tend to have a principal shareholder, managers who hold an ownership stake in the bank, or owners who were actively involved in the day-to-day management of the bank. The 10 percent ownership stake, however, is a blunt measure of the ownership structure of a bank. The limited availability of more nuanced data on ownership and related agency issues has impeded research in this area.

This paper revisits the issue of organizational structure using new data from an April 2015 survey of FDIC examiners in three supervisory Regions. The examiners answered questions about ownership structure, overlap of ownership and management, and management succession at FDIC-supervised banks that were examined in 2014 and first quarter 2015. The survey was designed to limit the demands on participating examiners and eliminate any reporting burden for bankers. Although it did not employ a random sample of all FDIC-insured banks, the survey provides a fairly detailed look at the organizational attributes of more than 1,350 FDIC-supervised, state-chartered community banks that operate in the FDIC Kansas City, Dallas, or Chicago Regions.

The survey allows us to identify closely held banks among these community banks. Additionally, it provides information on the overlap of ownership and management, and preparedness for management succession, at these banks. By merging the survey results with Call Report data, we find that closely held banks have not underperformed widely held banks over the past six years. In fact, closely held banks in which the manager is a member of the ownership group, or is another insider, outperform both closely held banks with no overlap between ownership and management and widely held banks.

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[1] For example, see Hein, Koch, and MacDonald (2005).
[2] FDIC (2012).
[3] Approximately 2 percent of stock banks are owned by mutual bank holding companies, so that they are, in effect, mutually owned banks.
[4] Under Subchapter C status, earnings are taxed at the corporate level and again at the shareholder level. Subchapter S eliminates the corporate taxation of earnings, reducing the tax burden to shareholders. There are several conditions—including having 100 or fewer owners—that a firm must meet to receive Subchapter S status. See 26 U.S.C. § 1361 for the restrictions on Subchapter S firms.
[5] See FDIC (2012) for the FDIC definition of community bank, which presents a functional definition, rather than a fixed-asset-size definition.
[6] Spong, Sullivan, and DeYoung (1995).

In the next section, we briefly discuss what economic theory has to say about how ownership structure and the overlap between ownership and management might affect financial performance. Then we describe the survey of FDIC examiners, and compare closely and widely held banks as identified in the survey. The final section summarizes our findings and suggests areas for future research.

Economic Theory: Ownership, Management, and Bank Efficiency

Closely held banks frequently differ from widely held banks in two important dimensions. The first is the degree of concentration of ownership. By definition, ownership is more concentrated in a closely held bank than in a widely held bank. One individual may own the majority of the closely held bank, or ownership may be shared among a group affiliated by family or community ties.

Second, concentrated ownership may have implications for the management structure of the bank. In a closely held bank, day-to-day operational control of the bank may reside with a manager who is either a member of the ownership group or can otherwise be considered an ownership insider.[7] In other cases, the bank may be run by a hired manager who otherwise has no affiliation with the ownership group. Both the concentration of ownership and the degree of overlap between ownership and control present potential advantages and disadvantages in terms of efficiency (Table 1).

Table 1

How Might Closely Held Ownership Influence Operational Efficiency?

Pros	Cons
Closely held banks may be less beholden to short-term earnings pressures.	Closely held banks may have more trouble raising external capital to make investments.
Closely held banks invest more in monitoring managers because they capture most of the returns to monitoring.	Closely held banks may pursue goals other than profit maximization.

Source: Review of literature on pages 39 and 40.

Concentrated Ownership. One reason a closely held ownership structure may be an operational advantage is that insider shareholders are likely to view their stake as a major, long-term investment rather than as one stock in a portfolio. As a result, the owners of a closely held bank can be expected to take a longer, more strategic perspective than the owners of a bank that must meet an earnings target every quarter. To the extent that this strategic focus translates into more profitable operational decisions, it could enhance the financial performance of the institution over time. This effect might be especially pronounced in the case of family-owned banks, for which the planning horizon could span more than one generation.[8]

A second potential advantage of closely held ownership is the ability of the bank to address the *principal-agent problem* that can arise between owners and managers. A principal-agent problem occurs when the owner (principal) of a firm delegates responsibility to the manager (agent), but the two do not share the same goals.[9] Divergence between the goals of owners and managers may cause firms to underperform if the manager's choices do not maximize the value of the firm.

Bank owners can solve this problem by monitoring and supervising the manager, but these actions are costly in both time and money. In the case of a closely held bank, however, owners may have a greater incentive to invest in monitoring managers because more of the benefits of monitoring accrue to insider owners, rather than to external shareholders. Owners of the closely held bank are then better equipped to address principal-agent problems that may arise from the separation of ownership and control.

On the other hand, a bank with a closely held ownership structure may pursue goals other than strict profit maximization, so it may be less efficient than a widely held bank. In some cases, these goals may reflect a decision to incur noninterest expenses for the benefit of the owners, managers, or other affiliated stakeholders to the detriment of current earnings (generally referred to as *expense preference behavior*).[10] This is not to say that the owners' goals are inconsistent with the long-term interests of the bank, or the mission of a community bank.

[7] Although it is possible that the manager of a widely held bank can also hold an ownership stake or be considered an ownership insider, the fact that ownership is not concentrated in a single group limits the degree to which ownership and control can overlap at widely held banks.

[8] Anderson and Reeb (2003) show that family-owned nonfinancial businesses outperform non-family-owned businesses among a sample of S&P 500 companies.

[9] For a theoretical discussion of agency problems, see Jensen and Meckling (1976).

[10] See Edwards (1977).

For example, bank owners may choose to support the credit needs of local businesses during difficult times, or to invest in the local community through sponsorships or community events. In either case, closely held ownership may allow owners to achieve some of their financial and strategic goals through means other than maximizing profits in the short run.

A second potential disadvantage to closely held ownership is that it may be more difficult for the bank to raise capital to make investments that improve the profitability of the bank. Banks raise capital using retained earnings or by issuing new ownership shares. Issuing shares to new shareholders will dilute the stake of the current owners in the bank, so closely held banks may be less willing to do this. Closely held banks may instead raise new capital from existing owners as "external capital," and so the amount of capital they can raise may be limited. This could prevent the bank from making a profitable investment, such as expanding or making an acquisition.

Overlap of Ownership and Control. The degree of overlap between ownership and managerial control can also be an operational advantage or disadvantage for a bank (Table 2). Widely held banks, by definition, have a substantial separation between ownership and control, so they are inherently subject to inefficiencies arising from principal-agent problems and must implement potentially costly measures to overcome them. In contrast, when the principal owner or an ownership group insider exerts day-to-day managerial control over a bank, the agency problem is minimized. The manager can be expected to act in the interests of the owners because the manager *is* an owner.

The potential downside of significant overlap between ownership and control is the limited size of the talent pool from which to recruit qualified managers. When the ownership group comprises individuals with close family or community ties, those ties may also limit the pool of managerial candidates. Even if the owners of the closely held bank solve the principal-agent problem by finding a qualified manager in the ownership group, the bank may face the problem once again when that manager retires and the owners must find a qualified successor. Additionally, if the retiring manager wants to sell a substantial stake in the bank, the bank must also find a new owner as well as a new manager.

Table 2

How Might Overlap of Ownership and Control Influence Efficiency?

Pros	Cons
The incentives of owners and managers are well-aligned and geared toward maximizing the long-term value of the bank.	Succession planning may be more difficult because the bank faces a limited talent pool. Succession can involve transferring both ownership and control, often at the same time.

Source: Review of literature on pages 39 and 40.

Results of the FDIC Examiner Survey

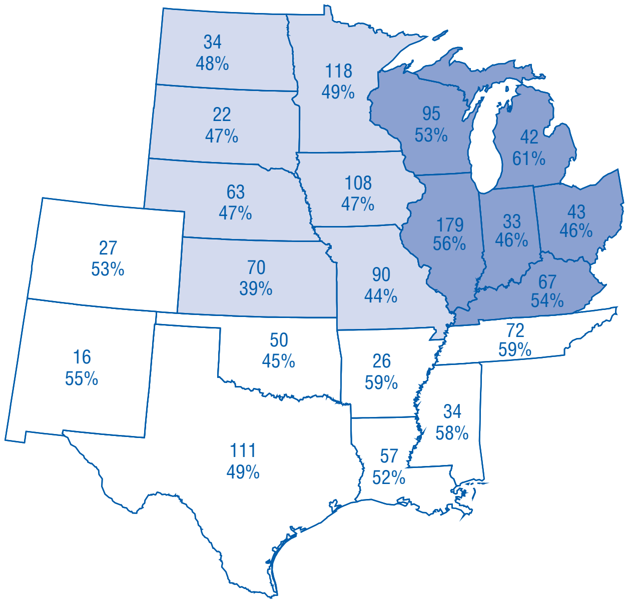
A lack of publicly available data has limited the ability to study how ownership structure and managerial control affect efficiency and profitability at community banks. Most research on bank ownership focuses on large banks that are required to file public disclosures. For smaller banks without these disclosure requirements, researchers have used confidential supervisory data. These supervisory data provide some information on the ownership structure of community banks, but only about the existence of a "principal shareholder." These data do not address the overlap of ownership and management.

This study avoids some of these limitations by using the results of a survey of FDIC bank examiners in the Chicago, Dallas, and Kansas City supervisory Regions, which encompass 21 states (Figure 1). Responses were obtained for every bank that had been examined in 2014 and first quarter 2015. For each bank, the examiners answered a series of simple questions about the structure of bank ownership, the overlap between ownership and management, and how the bank was positioned for management succession. The survey responses include more than 1,400 FDIC-supervised banks, which represent about 50 percent of all FDIC-supervised banks in these Regions. We limit our analysis to the 97 percent of banks covered by the survey that meet the FDIC definition of a community bank, which leaves us with 1,357 community banks.

The survey is a snapshot of bank ownership of a subset of community banks at the end of 2014. The responses are not a random sample of community banks nationwide, nor in these three Regions. The survey responses cover half of the FDIC-supervised community banks in the three Regions, and 33 percent of all FDIC-insured community banks. However, the strengths of the survey approach include the large number of community banks within these Regions, the ability to directly access the

Figure 1

Surveyed Banks Represent About Half of all FDIC-Supervised Community Banks in the Chicago, Dallas, and Kansas City FDIC Regions



FDIC Region	Number of Community Banks Surveyed	Share of FDIC-Supervised Community Banks
Chicago	459	54%
Dallas	393	52%
Kansas City	505	46%
Total	1,357	50%

Source: April 2015 FDIC Examiner Survey. Community banks are as defined by the FDIC Community Banking Study (2012).
Note: Data are as of December 2014.

Table 3

Closely Held Banks Make Up Three-Quarters of FDIC-Supervised Community Banks in Three Regions

Region	Survey Responses	Identifiable Primary Owner	Closely Held
Chicago	459	288	63%
Kansas City	505	424	84%
Dallas	393	301	77%
Total	1,357	1,013	75%

Source: April 2015 FDIC Examiner Survey.
Survey Question 1: In your judgment, is there an identifiable primary owner or ownership group for this bank? The primary owner or ownership group of the bank is a person or group with a substantial ownership stake that individually or collectively exerts a deciding influence over the governance of the institution.

recent experience of FDIC examiners, and the fact that bank owners or managers are not required to respond to survey questions.

The survey results show that among FDIC-supervised community banks in the three Regions, closely held banks are the norm rather than the exception. Examiners characterized 75 percent of community banks in the survey as having an identifiable primary owner, defined as "a person or group with a substantial ownership stake that individually or collectively exerts a deciding influence over the governance of the institution" (Table 3). The vast majority of these closely held banks are controlled by groups with family or community ties (Table 4). In almost all of the closely held community banks, members of the primary ownership group are directors of the banks.

In a majority of closely held community banks, there is also significant overlap between the primary ownership group and the *key officer*, defined by the survey as the person "who effectively runs the bank on a day-to-day basis, regardless of his/her title." In 48 percent of closely held community banks, the key officer can be considered a member of the primary ownership group (Table 5). In an additional 10 percent of closely held banks, the key officer can be considered an ownership group insider, even though he or she is not a primary owner. Taken together, these results imply that in just under 60 percent of closely held, FDIC-supervised community banks covered by the survey, overlap between ownership and management helped to limit the potential for principal-agent problems that could impair operational efficiency.

The survey also included questions on succession planning, as this is widely regarded as an important

Table 4

Most Closely Held Community Banks Are Built Around Family or Community Ties				
Region	Survey Responses Indicating Closely Held Bank	Ownership Group Has Family Ties	Ownership Group Has Ties to Community	Members of Ownership Group Sit on Board
Chicago	288	84%	84%	94%
Kansas City	424	90%	83%	96%
Dallas	301	77%	89%	94%
Total	1,013	85%	85%	95%

Source: April 2015 FDIC Examiner Survey.

Table 5

Ownership and Control Overlap at Most Closely Held Community Banks				
Region	Survey Responses Indicating Closely Held Bank	Key Officer Is Also a Member of the Primary Ownership Group	Key Officer Is Not a Member of Primary Ownership Group, but Can Be Considered an Insider	Total: Key Officer Closely Affiliated With Ownership Group
Chicago	288	44%	7%	51%
Kansas City	424	51%	6%	58%
Dallas	301	45%	17%	62%
Total	1,013	48%	10%	57%

Source: April 2015 FDIC Examiner Survey.

Table 6

Management Succession Is an Issue for Many Closely Held and Widely Held Community Banks			
Region	Survey Responses	Bank Has Identified a Viable Successor	Bank Is Well-Positioned to Recruit Qualified Management From Outside
Chicago	288	41%	56%
Kansas City	424	57%	67%
Dallas	301	50%	62%
Total Closely Held	1,013	50%	62%
Total Widely Held	344	46%	69%

Source: April 2015 FDIC Examiner Survey.

operational concern for community banks.[11] Among the closely held banks, 50 percent have not identified a potential successor for the key officer, compared with 54 percent of widely held banks (Table 6). In addition, 38 percent of the closely held banks were not deemed to be "well-positioned to recruit qualified management talent from outside the bank," compared with 31 percent of widely held banks. Overall, the survey results indicate that succession planning remains a significant challenge for both closely and widely held community banks.

Characteristics, Financial Performance, and Capital Formation

Merging the survey data with financial data from bank Call Reports permits further analysis of closely and widely held community banks. In this section we assess the effects of ownership structure and managerial control of surveyed banks on their size and geographic characteristics, financial performance, and ability to raise capital.

Characteristics: Among community banks in our survey, closely held banks tend to be smaller and more rural and agricultural, and have older charters than widely held banks. As discussed at the outset, we hold certain expectations on how closely held banks might compare to widely held banks in our survey, and these expectations are generally met (Table 7). For example, closely held banks are generally smaller than widely held banks; closely held banks had average total assets of $264 million at year-end 2014, compared with $334 million for widely held banks.

Closely held community banks are also more concentrated in rural areas than widely held banks and are more likely to be headquartered in depopulating

[11] Stewart (2013) discusses the importance of succession planning, especially following the financial crisis.

Table 7

Closely Held and Widely Held Community Banks Differ on Many Characteristics		
Characteristic	**Closely Held Banks**	**Widely Held Banks**
Assets		
Average Asset Size	$264 million	$334 million
Average Equity Capital as Percentage of Assets	10.7%	11.0%
Geography		
Headquartered in Metropolitan County[a]	46%	57%
Headquartered in Micropolitan County	18%	22%
Headquartered in Rural County	36%	21%
Headquartered in Depopulating Rural County[b]	24%	10%
Lending Specialty		
Agricultural Lending Specialty[c]	25%	13%
Commercial and Industrial Lending Specialty	2%	1%
Commercial Real Estate Lending Specialty	20%	23%
Mortgage Lending Specialty	7%	18%
Multiple Lending Specialties	12%	19%
No Lending Specialty (Diversified)	32%	24%
Other Consumer Lending Specialty	1%	1%
Age		
Charter 15 Years Old or Younger	7%	24%
Charter Older Than 100 Years	43%	38%

Source: FDIC Data and April 2015 Examiner Survey.

Notes: All figures are as of December 2014.

a. This study follows the designations established by the U.S. Office of Management and Budget for each of the 3,221 U.S. counties and county equivalents as either metropolitan (1,236 counties that are economically linked to 1 of the 388 U.S. Metropolitan Statistical Areas), micropolitan (646 counties centered on an urban core with a population of between 10,000 and 50,000 people), or rural (counties not located in metropolitan or micropolitan areas).

b. "Depopulating Rural County" refers to a county that lost population between the 1980 census and 2010 census. See Anderlik and Cofer (2014).

c. Community bank lending specialty groups as defined by Chapter 5 of the FDIC Community Banking Study (2012).

counties. Thirty-six percent of closely held community banks were headquartered in rural counties, compared with 21 percent of widely held institutions. Twenty-four percent of the surveyed closely held community banks were headquartered in depopulating rural counties, compared with only 10 percent of widely held banks. Banks headquartered in depopulating areas face challenges of declining customer bases and, in some instances, difficulty in attracting qualified management.[12]

Closely held community banks in the survey were also nearly twice as likely as widely held banks to specialize in agricultural lending.[13] These characteristics are consistent with the higher propensity of closely held banks to be headquartered in rural counties. By contrast, the widely held community banks in the survey, which were more heavily concentrated in metropolitan or micropolitan counties, were more likely to specialize in mortgage lending or multiple lending areas.

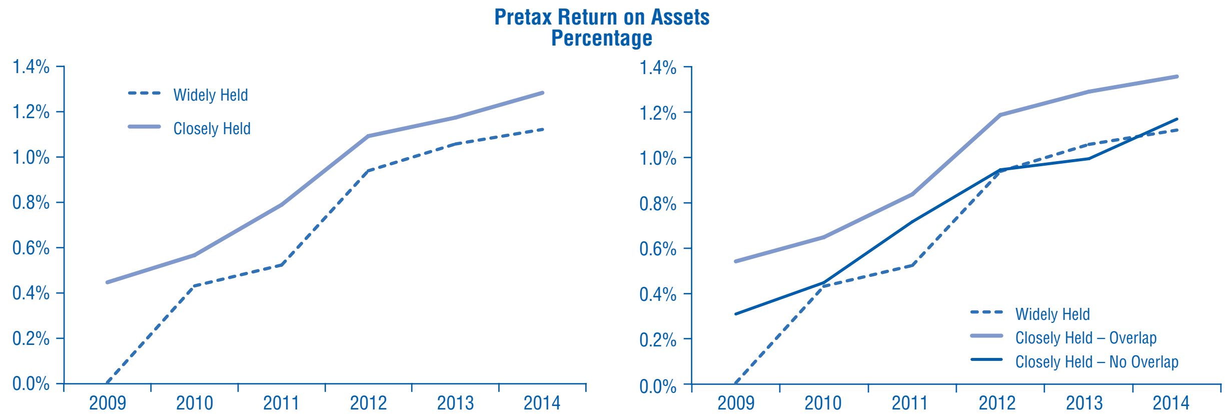
Finally, closely held community banks in the survey tended to have older charters than did widely held banks. Both types of institutions have a substantial proportion of charters that are more than 100 years old—43 percent for closely held community banks and 38 percent for widely held community banks. Widely held banks, however, are more than three times more likely (24 percent) than closely held banks (7 percent) to have a charter 15 years old or younger.

Financial performance: Among community banks in our survey, closely held banks generally outperformed widely held banks in recent years when they had an overlap with management. Based on our prior discussion of the economic theory on ownership, management, and bank efficiency, we wanted to understand how ownership structure and the overlap of ownership and control affect financial performance. To capture these differences, we segmented the banks into three groups: closely held banks where the key officer is also a member of the primary ownership group (denoted as "Overlap" in Charts 1 and 2, Tables 2 and 5, and in Table A1 in the Appendix); closely held banks where

[12] Anderlik and Cofer (2014).

[13] Lending specialty definitions are from Chapter 5 of FDIC (2012).

Chart 1



Closely Held Community Banks Where Ownership and Managerial Control Overlap Have Consistently Reported Higher Profitability

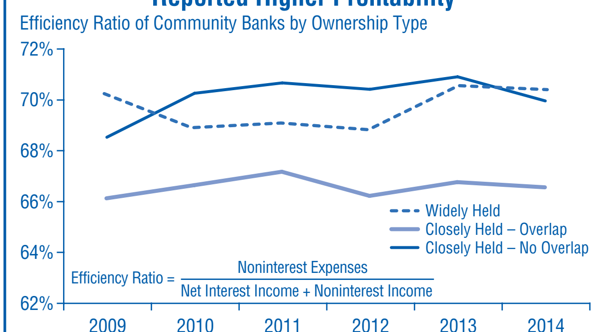
Source: FDIC Analysis of Call Report data on 1,357 FDIC-supervised community banks headquartered in the FDIC Kansas City, Dallas, and Chicago Regions that were identified in the April 2015 FDIC Examiner Survey as closely held or widely held.

the manager is an outsider ("No Overlap"); and widely held banks, where by definition there is no primary ownership group.

The first comparison we made is of the pretax return on assets. The left side of Chart 1 compares pretax return on assets for closely held and widely held community banks in our survey from 2009 to 2014 and shows that the closely held banks consistently outperformed widely held banks over this period. When we split closely held banks into those that have ownership–management overlap and those that do not (right side of Chart 1), however, we found that the closely held banks where ownership and management overlap clearly outperformed both widely held banks and the closely held banks where ownership and management did not overlap. The average annual performance advantage for closely held community banks with management overlap was 21 basis points higher compared with closely held banks with no overlap, and 30 basis points higher compared with widely held community banks. Although these gaps appear to have narrowed over the past three years, they were still more than 20 basis points in 2014.

Another comparison that focuses more squarely on operational efficiency involves the *efficiency ratio*, or the ratio of noninterest expenses to net operating revenue. This measure represents the expense incurred by the bank to generate $1 of revenue. Similar to the profitability comparisons, over the most recent six-year period, closely held community banks in our survey that have overlap between ownership and management consistently reported efficiency ratios better than those

Chart 2



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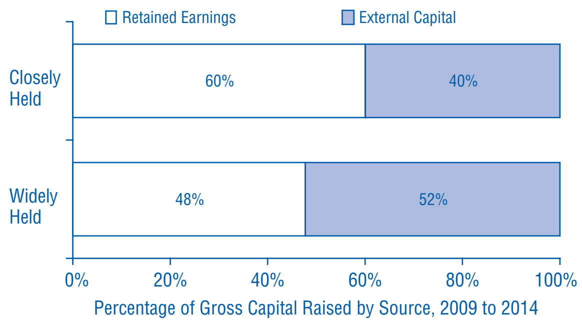
of closely held banks that have no overlap, as well as those of widely held banks (Chart 2).

Looking at the components of the efficiency ratio, closely held banks with overlap of management and ownership reported higher salary expense as a percentage of average assets in each of the past six years. Higher levels of noninterest income and much higher loan yields, however, more than made up for the salary expense disadvantage.

Because closely held banks and widely held banks differ in many characteristics, it is important to attempt to hold these other characteristics constant when comparing performance across these groups. Accordingly, we

Chart 3

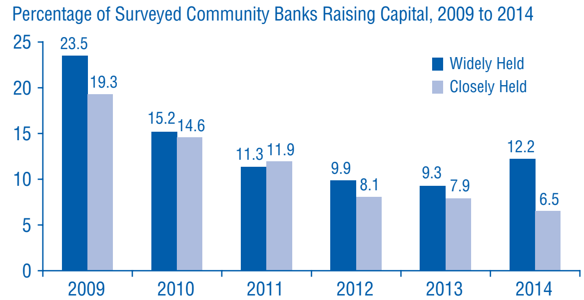
Closely Held Community Banks Rely More on Retained Earnings as a Source of Capital



Source: FDIC Analysis of Call Report data on 1,357 FDIC-supervised community banks headquartered in the FDIC Kansas City, Dallas, and Chicago Regions that were identified in the April 2015 FDIC Examiner Survey as closely held or widely held.
Note: Excludes institutions in first year of existence.

Chart 4

There Is Little Evidence That Closely Held Community Banks Were at a Decided Disadvantage in Access to Capital



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Note: Excludes institutions in first year of existence.

performed multiple regression analysis of the performance of the surveyed banks during the five years from 2010 to 2014 to determine the relative contribution of the different characteristics to financial performance. The appendix presents the results of the analysis. After controlling for the other differences between the banks, we find that being closely held has not had a statistically significant effect on financial performance. Having overlap between owner and management, however, has had a significant, positive effect on financial performance. This effect provides evidence that some of the benefit of a closely held organizational structure is the opportunity to resolve principal-agent problems by aligning the interests of managers with the interests of owners.

Capital formation: Among community banks in our survey, closely held banks raise external capital less often than their widely held peers, but they do not appear to be disadvantaged in their access to capital sources. One potential concern about the closely held organizational structure is whether it limits the bank's access to external sources of capital, thereby limiting the ability to respond to adverse shocks or to pursue strategic opportunities. As expected, the closely held banks surveyed have tended to rely more heavily on retained earnings to increase equity capital and to raise less capital from external sources than do widely held banks (Chart 3). Between 2009 and 2014, the closely held banks obtained 60 percent of gross additions to capital via retained earnings, compared with just 48 percent for the widely held community banks.

Moreover, we find that the widely held community banks surveyed raised capital from external sources somewhat more often than closely held banks over the study period.[14] In all but one of the six years studied, widely held community banks raised external capital more frequently than closely held banks, and the gap was widest in 2014 (Chart 4). It is important to note here that external capital may also include capital from existing owners or insiders and, for community banks, is more likely to take place through a private placement than through a market offering. On balance, although the closely held banks in our sample relied more heavily on retained earnings to increase their capital, and also raised external capital less frequently than widely held banks, there is little evidence that closely held community banks were at a decided disadvantage in terms of access to external capital.

Summary and Conclusions

Community banks have been defined in a number of studies as being generally small institutions that rely on core deposit funding and operate as relationship lenders within a limited geographic area. Less attention has been paid in the literature to the ownership structure of community banks and how it relates to day-to-day operational control and to long-term management succession.

[14] Our time period includes three years in which the federal government recapitalized banks through the Troubled Asset Relief Program (TARP) and the Small Business Lending Fund (SBLF). These programs were more heavily used by widely held banks than by closely held banks. TARP was used in 2009 and 2010, and in those years, 36 percent of widely held banks surveyed that raised capital and 21 percent of closely held banks surveyed that raised capital received TARP funds. In 2011, the year the SBLF disbursed funds, 31 percent of widely held banks surveyed that raised capital received SBLF funds, compared to 24 percent for closely held banks surveyed that raised capital.

This paper addresses the relative lack of data describing these attributes by introducing new survey data collected from FDIC examiners of community banks headquartered in 21 states in the central FDIC supervisory Regions of the United States. We find that three-quarters of FDIC-supervised community banks in these Regions are defined by a closely held organizational form, where a primary ownership group exerts a deciding influence over the governance of the institution. The vast majority of these closely held institutions are owned by groups that share family or community ties, and a majority of them also exhibit a substantial overlap between the ownership group and the key officer who effectively runs the bank. Both closely held and widely held community banks in the survey appear to face significant challenges when it comes to management succession, with only half of closely held banks reportedly having identified a successor to the key officer at the time of the survey.

Economic theory suggests that the closely held organizational form and overlap between ownership and management may each offer potential advantages and disadvantages for community bank performance. Managers of closely held banks may benefit from the ability to make decisions according to a longer time horizon than widely held banks, and their owners may be able to capture more of the returns than can be earned by monitoring the performance of bank managers. Closely held community banks may choose to pursue goals other than strict profit maximization, however, and may have limited access to external capital. Although closely held banks may be able to resolve agency conflicts with managers by recruiting those managers from within the ranks of ownership, this solution constrains the size of the talent pool. Even when a closely held bank successfully aligns the long-term interests of owners and managers, it must do so all over again when it searches for qualified successors to its current management team.

Comparisons of financial performance and efficiency indicate that the closely held community banks surveyed consistently outperformed widely held community banks in recent years. The highest performance has been found among closely held community banks where there is substantial overlap between ownership and management, and therefore the potential for agency conflicts is minimized. Although closely held banks surveyed relied more on retained earnings to raise capital than did widely held banks, and raised external capital less frequently, there is little evidence that closely held community banks were at a decided disadvantage to widely held banks in terms of access to external capital. These favorable comparisons between closely held and widely held community banks suggest that the closely held organizational form is by no means an impediment to performance, and may well be one of the keys to the success of closely held banks. Closely held community banks in which ownership and management largely overlap appear to exhibit advantages over other community banks even after accounting for other factors that affect performance. Nonetheless, this recipe for success—relying on managers who are insiders to the ownership group—may prove difficult for these institutions to replicate going forward as they address the issue of management succession. Additional research would be useful to better understand how community banks address management succession, and how their approach to this issue can affect their financial performance and their ability to remain independent.

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We thank Richard Cofer, Martin Cooper, Chasity Dschaak, Jessica Kaemingk, James LaPierre, and Rich Speigle for their valuable contributions in helping to design and execute the examiner survey. We thank Clayton Boyce and Eric Breitenstein for a wide range of analytical and editorial assistance. Any remaining errors are the responsibility of the authors.

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Appendix:
Regression Analysis of Pretax Return on Assets

Closely and widely held community banks differ in several characteristics that affect financial performance. To ensure that our comparisons are not simply based on these other characteristics, we perform multiple regression analysis of pretax return on assets comparing whether a bank is closely held, whether it has overlap of ownership and control, and a number of control characteristics. Regression analysis allows us to compare the performance of closely and widely held banks that are otherwise similar.

Our regression takes the form of

$$ROA_{it} = \beta_0 + \beta_1 CloselyHeld_i + \beta_2 Overlap_i + \beta_3 Age_{it} + \beta_4 Assets_{it} + \beta_5 Metro_i + \beta_6 BusinessLine_{it} + \beta_7 MarketPower + \gamma State + \delta Year + \varepsilon_{it},$$

where ROA_{it} is pretax return on assets; *Closely Held* is an indicator variable equal to one if the bank is closely held and zero otherwise; *Overlap* is an indicator variable equal to one if there is overlap between ownership and management; *Age* is the age of the bank; *Assets* is the size of the bank measured in total assets; *Metro* is a set of indicator variables for whether the bank is headquartered in a county in a metropolitan statistical area, micropolitan statistical area, or rural area; and *BusinessLine* is a set of indicator variables for the bank's business line. The panel regressions also include state and year fixed effects. Standard errors are clustered at the state level.

The results of the regressions are presented in Table A1. The data are from the December Call Report for each surveyed community bank for the years 2010 through 2014. The data show that closely held banks, on average, have not underperformed widely held banks, even when controlling for other bank characteristics that affect profitability. The coefficient on being closely held is small and statistically insignificant. Once we control for the other differences between closely and widely held banks, there does not appear to be a difference in their financial performance. The coefficient on the overlap between ownership and management, however, is positive and statistically significant, which suggests that having an owner serve as day-to-day manager of the bank is an effective way to mitigate the principal-agent problem in closely held banks.

Table A1

Regression Analysis Shows Closely Held Community Banks With Overlap of Managers and Owners Outperform Other Community Banks

	Pretax Return on Assets
Mean Pretax Return on Assets	0.083
Closely Held = 1	–0.0234 (0.0690)
Overlap = 1	0.117** (0.0427)
Age	0.000125 (0.0011)
Total Assets ($ million)	0.314*** (0.0401)
Headquarters in Metropolitan Area	–0.260*** (0.0518)
Headquarters in Micropolitan Area	0.00821 (0.0767)
Market Power	0.0000516** (0.0000)
Agricultural Specialization	0.409*** (0.1190)
Commercial and Industrial Specialization	0.172 (0.1970)
Commercial Real Estate Specialization	–0.046 (0.1030)
Mortgage Specialization	0.200* (0.1110)
Multispecialty	0.082 (0.0917)
No Specialty	1.039*** (0.3270)
State Fixed Effects	Yes
Year Fixed Effects	Yes
Observations	6,784
Adjusted R-Squared	0.131

Source: FDIC Data and April 2015 Examiner Survey.

Notes: This table presents regression results for pretax return on assets on whether the bank is closely held, whether there is overlap in management and ownership, and a set of controls. Standard errors, clustered at the state level, are in parentheses below the coefficients.

* $p < 0.10$

** $p < 0.05$

*** $p < 0.01$.