Community Banking
in the 21st Century

OPPORTUNITIES, CHALLENGES AND PERSPECTIVES

Federal Reserve and the Conference of State Bank Supervisors
Second Annual Community Bank Research and Policy Conference
Sept. 23-24, 2014
St. Louis

Community Banking
in the 21st Century

OPPORTUNITIES, CHALLENGES AND PERSPECTIVES

Federal Reserve and the Conference of State Bank Supervisors

Second Annual Community Bank Research and Policy Conference

Sept. 23-24, 2014

St. Louis

Acknowledgements:

This publication was made possible by the collaborative efforts of state bank supervisors, community banks, the Conference of State Bank Supervisors and the Federal Reserve System. The *Community Banking in the 21st Century* National Survey was administered by state bank commissioners in 38 states. A total of 1,008 community bankers participated in the survey. Town hall meetings with more than 1,300 community bankers were held in 30 states from April to July. Participation in both the survey and the town hall meetings would not have been possible without the efforts of the following state bank commissioners and members of their staff:

Arizona

Lauren Kingry, Superintendent, Arizona Department of Financial Institutions

Arkansas

Candace A. Franks, Commissioner, Arkansas State Bank Department

California

Jan L. Owen, Commissioner, California Department of Business Oversight

Connecticut

Howard F. Pitkin, Commissioner, Connecticut Department of Banking

Georgia

Kevin B. Hagler, Commissioner, Georgia Department of Banking and Finance

Hawaii

Iris Ikeda Catalani, Commissioner, Hawaii Division of Financial Institutions

Idaho

Gavin M. Gee, Director, Idaho Department of Finance

Illinois

Manuel Flores, Acting Secretary, Illinois Department of Financial and Professional Regulation

Indiana

Dennis L. Bassett, Director, Indiana Department of Financial Institutions

Iowa

James M. Schipper, Superintendent, Iowa Division of Banking

Kansas

Deryl Schuster, Commissioner, Kansas Office of the State Bank Commissioner

Kentucky

Charles A. Vice, Commissioner, Kentucky Department of Financial Institutions

Louisiana

John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions

Maine

Lloyd P. LaFountain, III, Superintendent, Maine Bureau of Financial Institutions

Maryland

Gordon M. Cooley, Acting Commissioner, Maryland Office of Financial Regulation

Massachusetts

David J. Cotney, Commissioner, Massachusetts Division of Banks

Michigan

Karen K. Lawson, Director, Michigan Department of Insurance and Financial Services – Office of Banking

Minnesota

Mike Rothman, Commissioner, Minnesota Department of Commerce

Mississippi

Jerry T. Wilson, Commissioner, Mississippi Department of Banking and Consumer Finance

Missouri

Debra Hardman, Acting Commissioner, Missouri Division of Finance

Montana

Melanie G. Hall, Commissioner, Montana Division of Banking and Financial Institutions

Nebraska

Ray A. Pont, Acting Director, Nebraska Department of Banking and Finance

New Hampshire

Glenn A. Perlow, Commissioner, New Hampshire State Banking Department

New Jersey

Ken Kobylowski, Commissioner, New Jersey Department of Banking and Insurance

New Mexico

Cynthia Richards, Director, New Mexico Financial Institutions Division

North Carolina

Ray Grace, Commissioner, North Carolina Office of Commissioner of Banks

North Dakota

Robert J. Entringer, Commissioner, North Dakota Department of Financial Institutions

Ohio

Charles J. Dolezal, Superintendent, Ohio Division of Financial Institutions

Pennsylvania

Glenn E. Moyer, Secretary, Pennsylvania Department of Banking and Securities

South Dakota

Bret Afdahl, Director, South Dakota Division of Banking

Tennessee

Greg Gonzales, Commissioner, Tennessee Department of Financial Institutions

Texas

Charles G. Cooper, Commissioner, Texas Department of Banking

Utah

G. Edward Leary, Commissioner, Utah Department of Financial Institutions

Vermont

Susan L. Donegan, Commissioner, Vermont Department of Financial Regulation

Virginia

E. Joseph Face, Jr., Commissioner, Virginia Bureau of Financial Institutions

Washington

Scott Jarvis, Director, Washington Department of Financial Institutions

West Virginia

Sally Cline, Commissioner, West Virginia Division of Financial Institutions

Wisconsin

Peter J. Bildsten, Secretary, Wisconsin Department of Financial Institutions

Wyoming

Albert L. Forkner, Commissioner, Wyoming Division of Banking

CONTENTS

Letter from Jerome H. Powell 5

Letter from John W. Ryan 6

Foreword from Candace A. Franks 7

2014 *Community Banking in the 21st Century* National Survey Results 11

2014 Town Hall Responses....................... 25

- Introduction 27
- Arizona 29
- Arkansas 30
- Connecticut 31
- Idaho 33
- Illinois 34
- Indiana 35
- Iowa 36
- Kansas 37
- Kentucky 38
- Massachusetts 40
- Michigan 41
- Minnesota 43
- Mississippi 44
- Missouri 45
- Montana 46
- New Hampshire 47
- New Mexico 49
- North Carolina 50
- North Dakota 51
- Ohio 53
- Pennsylvania 54
- South Dakota 56
- Tennessee 57
- Texas 59
- Utah 61
- Vermont 62
- Virginia 63
- West Virginia 64
- Wisconsin 66
- Wyoming 67

Letter from Jerome H. Powell

For many community banks, the past year has been one of significant improvement. Bank balance sheets have strengthened, with notable reductions in problem assets. Liquidity remains ample, with many banks actively competing for prime lending opportunities. Yet despite this progress, community bank earnings have not returned to precrisis levels, and many banks feel burdened by the challenges of new and changing regulations and developing cybersecurity threats.

As time passes, the challenges facing community banks continue to evolve. This year's research and policy conference, *Community Banking in the 21st Century*, addresses a number of issues important to community banks. For example, we focus on how patterns of community bank formation, behavior and performance have changed since the financial crisis and on the effects of government policy on community bank behavior. In addition, new survey data collected by bank commissioners across the country informs the discussions and furthers the opportunity for academics to examine the issues.

I commend the state bank commissioners who conducted the survey and hosted town hall meetings with community bankers during the spring and summer of 2014. I look forward to continuing to build on our understanding of the industry as we combine the perspectives of researchers, regulators and community bankers.

Jerome H. Powell
Governor
Federal Reserve Board of Governors
Chair, Subcommittee on Smaller Regional and Community Banking

Letter from John W. Ryan

Along with Conference of State Bank Supervisors Chairman Candace Franks and Federal Reserve Gov. Jay Powell, I am pleased to present this second report on the opportunities, challenges and perspectives of community banks. The response following last year's inaugural *Community Banking in the 21st Century* research conference has been very positive, and I am encouraged by the increased interest from researchers and by the increased number of academic papers that were submitted for this year's research conference. Academics and economists are presenting new research on community bank performance, the effects of government policies on these institutions and their impact on the financial system as a whole.

During last year's inaugural conference, the Federal Reserve System and the CSBS issued a first-of-its-kind report that assessed the challenges and opportunities community banks were facing from data gathered through town hall meetings between state regulators and community banks. This year's report builds on that research, including quantifiable data gathered from a survey taken by banks from across the country. This survey complements the qualitative research we received from town hall meetings conducted this year. The survey data clarifies—and for some may challenge—the anecdotal feedback state regulators hear from community bankers every day. Through both the survey and the town hall meetings, we are able to put in perspective the challenges and opportunities community banks are facing today.

Last year's community banking research conference was an important first step in sharing research related to community banking. Through an increased dialogue among the industry, academics and policymakers, we hope to better understand the role of these institutions and the impact they have on the communities they serve.

John W. Ryan
President and CEO, Conference of State Bank Supervisors

Foreword from Candace A. Franks

As we come together for this second annual *Community Banking in the 21st Century* research conference, I am honored to be able to present to you the culmination of the hard work and research of my fellow state and federal financial regulators. Earlier this year, state financial regulators held town hall meetings around the nation to continue the dialogue we started last year and to once again learn from community bankers what new and continuing challenges and opportunities their institutions face. It is critical that state and federal regulators continue to explore these important issues that will impact the future of community banking. By doing so, we become better informed of how the various aspects of our current system of supervision work and more capable of finding right-sized solutions that promote a competitive, diverse and dynamic banking system.

Hearing the views of community bankers over the past several years, trends are beginning to emerge that deserve our attention. First, it is becoming increasingly clear that banks are finding it difficult to customize solutions that meet their customers' needs. Community banks are feeling the need to standardize and streamline their products to meet compliance requirements.

Furthermore, community bankers are finding that compliance itself is becoming more costly. The increase in and complexity of compliance regulations is having a direct impact on bank profitability, forcing banks to focus more of their efforts and time on compliance than on providing services to customers. And as these community banks are struggling but adapting to regulatory expectations, they also face increased competition from bank and nonbank financial service providers.

To meet the challenges of doing business in a 21st century environment, more and more community banks are now turning to Internet and mobile solutions for their customers. While potentially costly, community banks increasingly view technology solutions as an advantage they have over other firms. Technology will continue to change the banking model for a long time to come in still unexpected ways.

It is vital that we invest in new research and continue dialogue on the future of community banking in this country. Conducting this research and continuing the conversation will undoubtedly lead us to a clearer picture of the opportunities and challenges facing community banks and help us develop a future system of supervision that provides for a strong, enduring future for the dual-banking system.

Candace A. Franks
Chairman, Conference of State Bank Supervisors
Commissioner, Arkansas State Bank Department

2014 Community Banking in the 21st Century National Survey Results

Community banks are going through a period of substantial change, and they are responding to pressures to develop business plans that will allow them to thrive. Some of the pressures are coming from new regulations, particularly concerning their activities in offering customers residential mortgages. In addition, pressures for change are coming both from new technology challenges and from increased competition from other financial service industry businesses.

The Conference of State Bank Supervisors (CSBS) and state bank regulators have conducted a survey of community banks on a variety of topics that will shape the future of community banking. The goal of the survey was to provide a national view of how bankers are thinking about key issues facing the industry and how they are responding to changes in the market. The hope is that these data will be used by researchers to support their work in the community banking sector. This document presents the results of the survey. These topics include:

- Lines of business pursued by community banks, including the lines of business they are entering and exiting
- Community bank participation in the market for 1- to 4-family mortgages in light of recent changes in regulation of mortgage lending
- Effects of changes in technology and compliance with regulations on the operating expenses of community banks
- Changes in competition in the markets in which community banks operate
- Consolidation in the banking industry, including receiving or making acquisition offers

To develop the survey, staff members of the CSBS met with representatives of several Federal Reserve banks, the Federal Reserve Board of Governors and academic researchers with an extensive background in community bank research. This committee developed draft questions that were refined by a professional survey firm. The survey firm developed the web interface used by the respondents, handled the technical aspects of the data collection and removed any potential identifying information from the raw responses before forwarding them for analysis. Respondents could also provide contact information to participate in follow-up studies. Subsequent studies will provide a unique opportunity to evaluate changes in these banks over time and match their responses with other publicly available information.

Synopsis of the Results

The survey provided a fascinating look into the community banking sector. The respondents were largely state-chartered banks operating in a single state and engaging in traditional banking activities.

The planning group intentionally focused a significant number of questions on mortgage lending. Bankers have been vocal about the compliance burdens associated with mortgage lending. While the ability-to-repay (ATR) and the qualified mortgage (QM)[1] rules have only recently taken effect, bankers most likely made the initial business decision on how they would respond to the new rules. Understanding the impact of these rules on bank lending and credit availability is important to public policy.

The results of this survey provide an early look into the industry's thinking. Banks continue to see opportunity in residential mortgage lending but have a mixed view of non-QM lending. Assessing the ATR and QM standards against current exposures, bankers generally identified a low level of nonconformance, suggesting the rules may generally be in line with bank practices while still requiring significant changes in operations.

The survey identifies very few banks looking to exit any products or services. Areas where banks are looking to expand are largely centered on technology, including mobile banking, online loan applications and remote deposit capture.

The increasing cost of regulatory compliance has been a concern expressed by the industry but difficult to quantify. To encourage additional data collection and research in this area, the survey sought to identify how increased compliance costs are realized in the bank's operations. Almost all banks realize these costs through increased time allocation of their employees, overall increased personnel costs, and increased costs for third-party vendors.

As banks grapple with a different regulatory environment and assess the opportunities from an improving economy, it is a natural time to evaluate merger opportunities. The survey asked four questions about receiving and making offers. Given the size of the industry, the survey results do not seem to suggest a significant amount of actual or planned activity in this area.

Comparing Survey Respondents to the Community Banking Industry

This report is based on information from 1,008 bankers who completed the survey. It is important to determine how representative the survey respondents are of all community banks. All but 23 of the 1,008 survey respondents identified their institutions as state-chartered banks. For this reason, we compare information from the survey respondents to information about all state-chartered banks. Comparing the survey respondents to community banks in general is especially important for this survey because the percentage of state-chartered banks that completed the survey varies widely among the states (Figure 1). Survey respondents were concentrated in several states; eight states account for 609 of the respondents (60 percent). (These same states account for 38 percent of all banks and thrifts.)

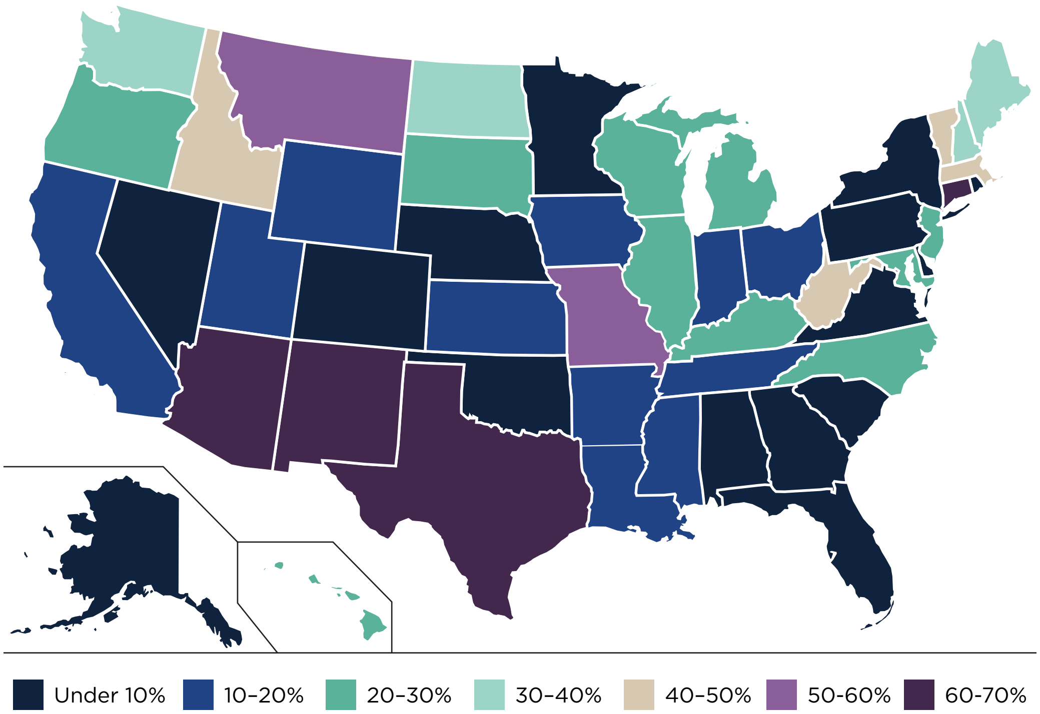
Tables 1-4 compare information about the survey respondents to the same information for all state-chartered community banks.

Table 1 indicates that the banks that participated in the survey tended to be larger than all state-chartered community banks as a group. In particular, the percentage of survey respondents with total assets less than $100 million was less than the comparable percentage for all state-chartered community banks. Tables 2 and 3 indicate that the survey respondents tended to operate in more states and had more branches relative to all state-chartered community banks. These observations are consistent with the pattern in Table 1, which indicates that the survey respondents tended to be larger than the general population of state-chartered community banks.

Table 4 indicates that the ratios of 1- to 4-family mortgage loans to total loans tended to be lower on average among the survey respondents that provided complete information on their 1- to 4-family mortgages than for all state-chartered community banks that had mortgage loans in their portfolios. Differences in the distributions for survey respondents and all state-chartered banks in Table 4, however, are not large.

FIGURE 1

Percentage of All State-Chartered Banks and Thrifts that Participated in the Survey



"The survey provided a fascinating look into the community banking sector. The respondents were largely state-chartered banks operating in a single state and engaging in traditional banking activities."

TABLE 1

What was the asset size of your bank as of December 31, 2013?	Banks in Survey		All State-Chartered Community Banks	
	Number	Percentage	Number	Percentage
1. Up to $50 million	79	7.8	635	12.7
2. $50 million to $100 million	167	16.6	944	18.8
3. $100 million to $300 million	414	41.1	1,961	39.1
4. $300 million to $1 billion	253	25.1	1,089	21.7
5. $1 billion to $2 billion	52	5.2	214	4.3
6. $2 billion to $10 billion	38	3.8	176	3.5
7. Greater than $10 billion	5	0.5	0	0
Total	**1,008**		**5,019**	

TABLE 2

In how many states does your bank operate?	Banks in Survey		All State-Chartered Community Banks
	Number	Percentage	Percentage
1 state	895	88.8	91.8
2 states	76	7.5	5.7
3 states	23	2.3	1.2
4 states	2	0.2	0.5
5 or more states	12	1.2	0.8
Total	**1,008**		

TABLE 3

How many branches does your institution currently have?	Banks in Survey		All State-Chartered Community Banks
	Number	Percentage	Percentage
0-1	246	24.4	38.7
2-5	438	43.4	35.8
6-10	184	18.3	13.1
More than 10	140	13.9	12.4
Total	**1,008**		

TABLE 4

As of Dec. 31, 2013, what share of the dollar value of total loans held in your portfolio was comprised of 1- to 4-family mortgage loans?	Banks in Survey		All State-Chartered Community Banks	
	Number	Percentage	Number	Percentage
0 to 10 percent	176	19.9	875	17.7
11 to 20 percent	236	26.7	1,249	25.2
21 to 30 percent	194	21.9	1,150	23.2
Greater than 30 percent	278	31.4	1,673	33.8
Total	**884**		**4,949**	

Lines of Business of Community Banks

Banks were asked to identify their primary lines of business, with no restrictions on the number of lines of business each bank could select. On average, the respondents identified about four primary lines of business; the largest concentrations of responses (Figure 2) were in the following lines of business:

- 1- to 4-family mortgage lending (755)
- Commercial real estate lending (754)
- Commercial and industrial lending (647)
- Consumer lending (533)
- Agricultural lending (480)

Among the responses that included "other" as a primary line of business, the most frequently mentioned was trust services.

Survey respondents were asked to indicate from a list which products or services they offered. On average, the respondents checked about eight services on the list. Figure 3 shows that the products or services checked most frequently were:

- Automobile loans (932)
- Unsecured consumer credit loans (798)
- Second mortgages other than home equity lines of credit (738)
- Services involving electronic banking (remote deposit capture, mobile banking and electronic bill presentment and/or payment) (717)

Bankers were asked whether they planned to start offering one or more of the products or services on a list in the survey form. About 40 percent of the respondents said that they did not plan to start offering any of the products or services on the list (Figure 4). The bankers that planned to begin offering products or services on the list most frequently checked:

- Mobile banking (230)
- Online loan applications (190)
- Remote deposit capture (133)

Thus, plans by community bankers to offer new products or services reflect, to a large extent, their plans to incorporate new technology into their operations. Survey respondents indicated reasons why they expect to offer additional products or services, including:

- Competitive pressure
- Consumer demand and convenience
- Profitability, including expectation of increased noninterest income
- Technological changes and improved security

A comment from one respondent tied plans to expand product offerings to regulatory burden: "We were forced to sell to a bigger institution because of regulatory costs and couldn't afford to add the services

FIGURE 2

Primary Lines of Business (All that Apply)

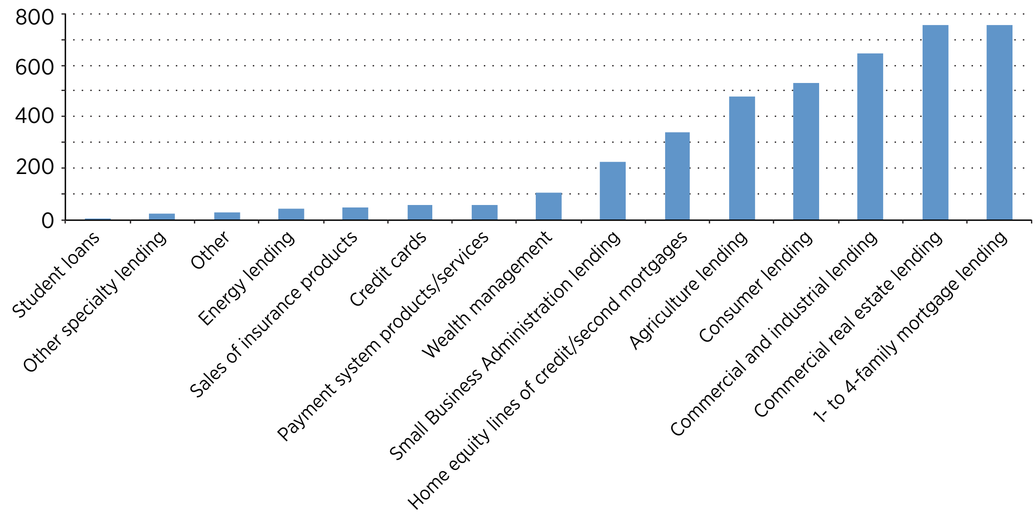


FIGURE 3

Products and Services Currently Offered (All that Apply)

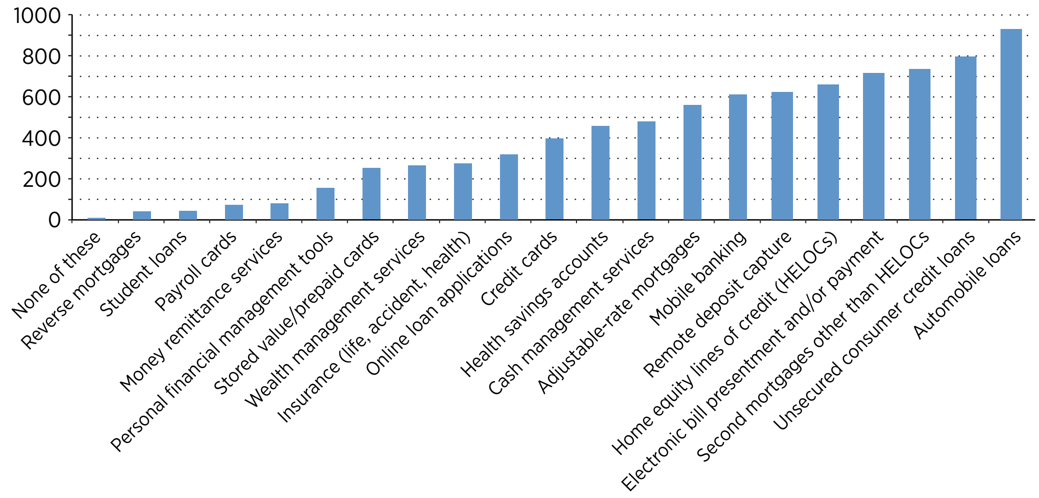


FIGURE 4

New Products Planned to Be Offered in Next Three Years (All that Apply)

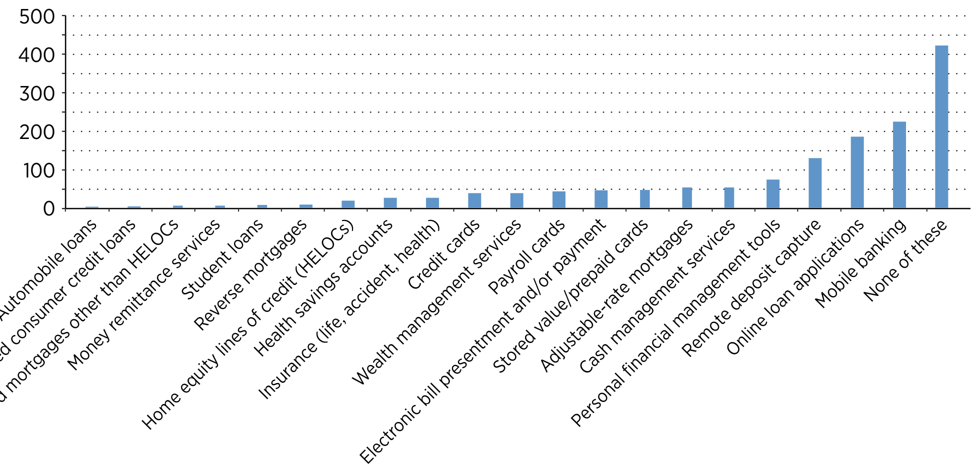


FIGURE 5

Exit or Substantially Limit Any Products or Services in Next Three Years

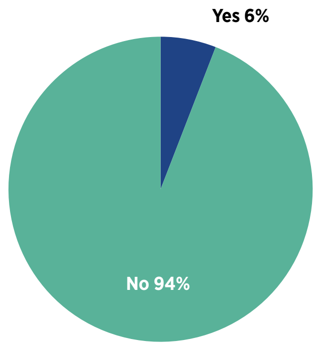
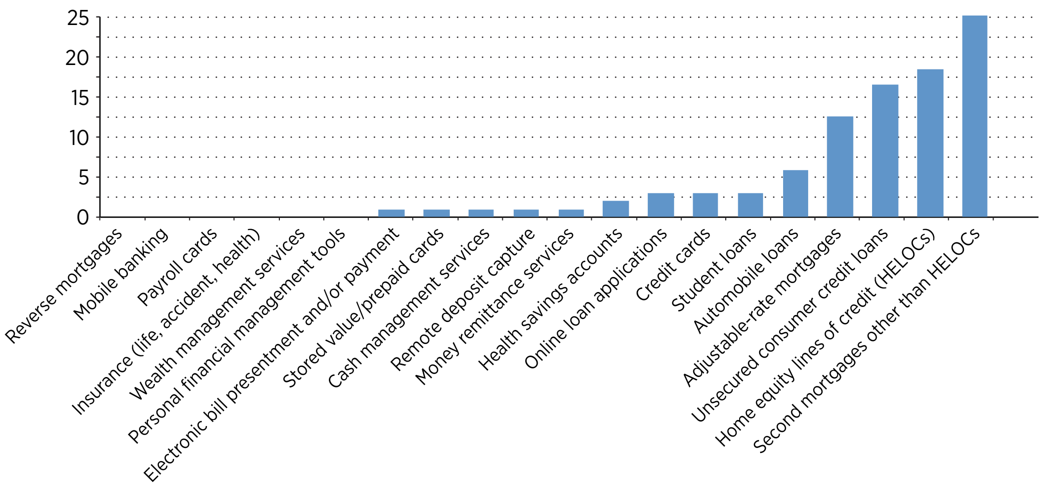


FIGURE 6

Products or Services to Exit or Substantially Limit (All that Apply)



requested by customers as each new service added comes with more regulation."

Figure 5 indicates that only a small minority of community bankers plan to exit or substantially limit products or services during the next three years. Figure 6 indicates the products or services these bankers plan to exit or substantially limit. Bankers who plan to exit or substantially reduce their product offerings cite regulation and compliance costs most often.

1- to 4-Family Mortgage Lending of Community Banks

Figure 7 indicates that many loans in community bank portfolios are 1- to 4-family mortgage loans. The survey focused on the effects of recent changes in government regulations on the 1- to 4-family mortgage lending of community banks.

Roughly 12 percent of survey respondents indicated that they do not make residential mortgages or hold at least a portion of them in their portfolios. Although that number is higher than the 1.5 percent of all banks that reported zero loans secured by 1- to 4-family real estate on their year-end 2013 call reports, the discrepancy is likely due to the fact that loans remaining in portfolios may have been booked prior to a change in business strategies.

Figures 8 through 18 reflect a sample of 884 banks that reported current mortgage activity (active mortgage lenders).

Figure 8 indicates a wide range of opinions by community bankers on making residential mortgages in 2014 that do not meet QM standards (or mortgages with terms that provide some legal protection from claims that they failed to consider the ability of the borrowers to repay their loans). Figure 9 indicates that the share of active mortgage lenders that plan to decrease their holdings of residential mortgages relative to 2013 is about equal to the percentage that plan to increase their holdings of residential mortgages. Bankers who anticipate reductions in the dollar value of the 1- to 4-family mortgages of their banks cited increased regulation and compliance costs as reasons for this change. Bankers who expect the dollar value of the 1- to 4-family mortgage loans of their banks to rise mentioned increased demand for mortgage loans.

Figures 10 through 18 provide information on the effects of changes in regulations on the 1- to 4-family mortgage loans provided by community banks. About half of active mortgage lenders are eligible to make residential mortgage loans with balloon payments (Figure 10). Of these banks, about two-thirds plan to originate such loans with balloon payments (Figure 11). The ability to make balloon loans in rural and underserved markets was an important accommodation made in the Consumer Financial Protection Bureau mortgage rules. Understanding why banks that are eligible to make these loans may not do so and the impact on credit availability in these areas is crucial to future public policy.

Figure 12 provides information on the mortgage loans of respondents that would not have complied with ATR regulations. The percentage of mortgage loans that would not have complied with ATR regulations was 10 percent or less for a large majority of active mortgage lenders. In contrast, some of the respondents reported that 91 percent to 100 percent of their mortgage loans would not have complied with ATR regulations. Thus, some of these banks indicate that they will have to make major changes in their business plans for offering 1- to 4-family mortgages to comply with the ATR regulations.

FIGURE 7

1- to 4-Family Loans as a Percentage of Total Loans by Size Class

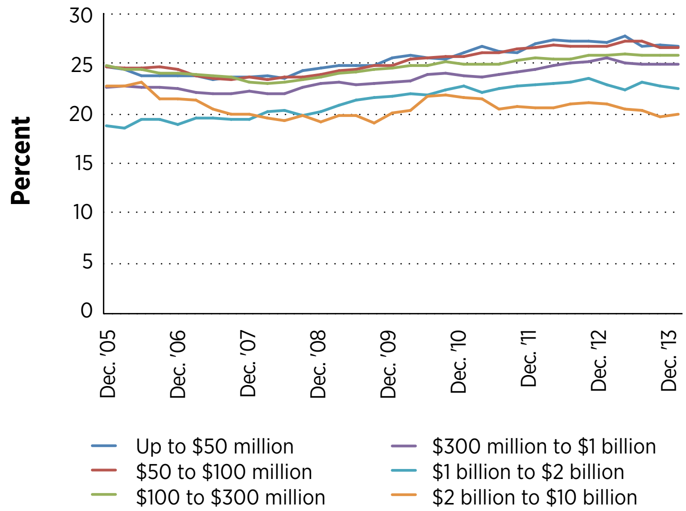


FIGURE 8

Banks Making Non-Qualified Mortgages in 2014

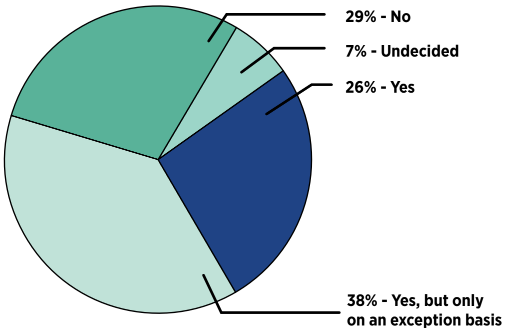


FIGURE 9

Expected Change in Dollar Volume in 1- to 4-Family Mortgages in 2014

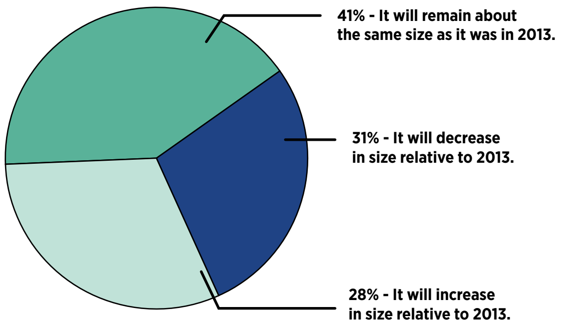


FIGURE 10

Eligible to Make Rural, Balloon-Payment Qualified Mortgages in 2014

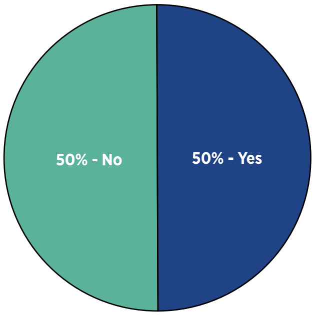


FIGURE 11

If Eligible, Banks that Plan to Originate Rural Balloon-Payment Qualified Mortgages in 2014

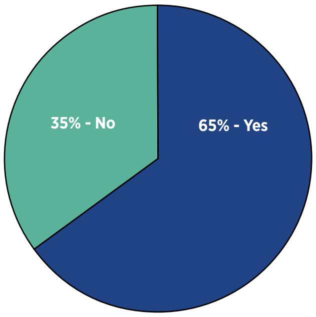


FIGURE 12

Percentage of Mortgage Loans That Would Not Have Qualified under "Ability to Repay"

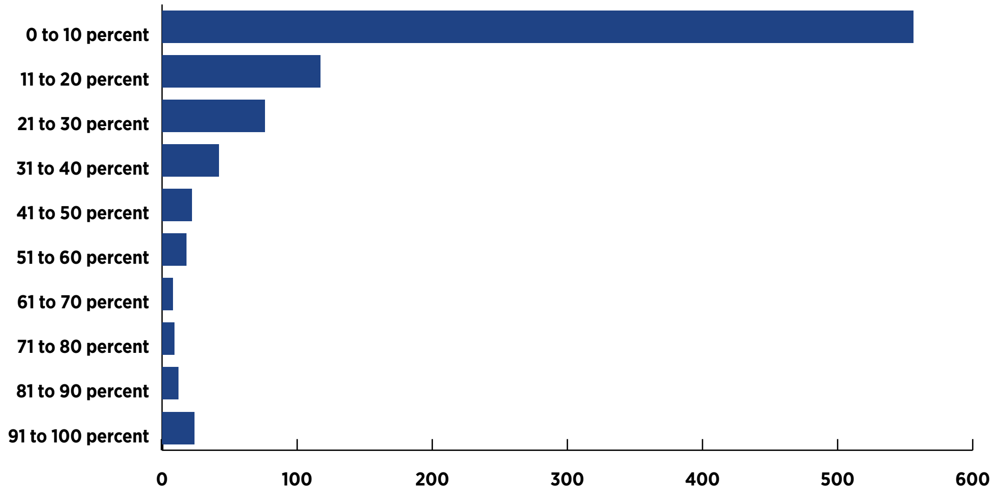


Figure 13 displays survey results on reasons why 1- to 4-family mortgage loans would not comply with the ATR regulations. On average, each respondent checked two reasons. Figure 14, in contrast, displays the primary reason checked by each bank. Results are generally consistent in Figures 13 and 14: The reasons cited most often on why 1- to 4-family mortgages would not comply with ATR regulations were:

- Unaffordable debt-to-income ratio (401)
- Inability to verify income or assets (317)
- Weak or nonexistent credit history (301)

For banks choosing "other" for this question, the explanation given most often was that some borrowers had plenty of asset wealth but a lack of income.

Figure 15 indicates the distribution of active mortgage lenders by percentage of those loans that would not meet QM requirements. For a large majority of these banks, the percentage of 1- to 4-family mortgage loans that would not meet QM requirements was under 10 percent. In contrast, 15 percent of active mortgage lenders noted 80 percent or more of their 1- to 4-family mortgage loans would not meet QM requirements.

FIGURE 13

Reasons for Not Qualifying Under "Ability to Repay" (All that Apply)

FIGURE 14

Primary Reason for Not Qualifying Under "Ability to Repay"

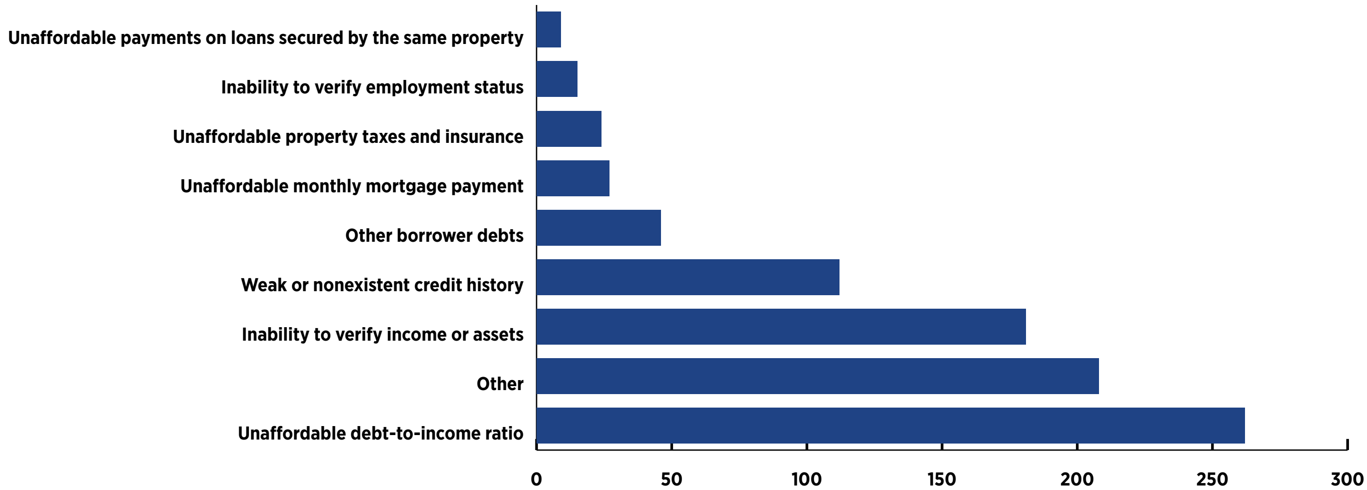


Figure 16 indicates the degree to which the loans that fail to meet QM requirements reflect loans originated prior to 2013. For a large majority of the bankers that provided information on their 1- to 4-family mortgages, the percentage of loans that failed to meet QM requirements made during 2013 was under 10 percent. This observation may indicate that banks are phasing out mortgage loans that fail to meet QM standards, but data from prior years would be necessary to confirm this possible change in lending standards.

> "15 percent of active mortgage lenders noted 80 percent or more of their 1- to 4-family mortgage loans would not meet QM requirements."

FIGURE 15

Percentage of Mortgage Loans that Would Not Have Qualified as a Qualified Mortgage

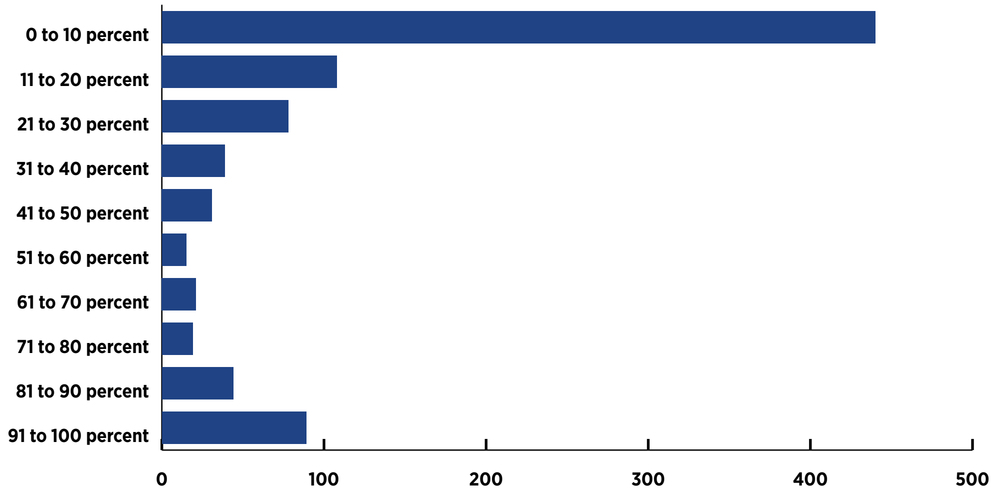


FIGURE 16

Percentage of Mortgage Loans that Would Not Have Qualified as a Qualified Mortgage Originated in 2013

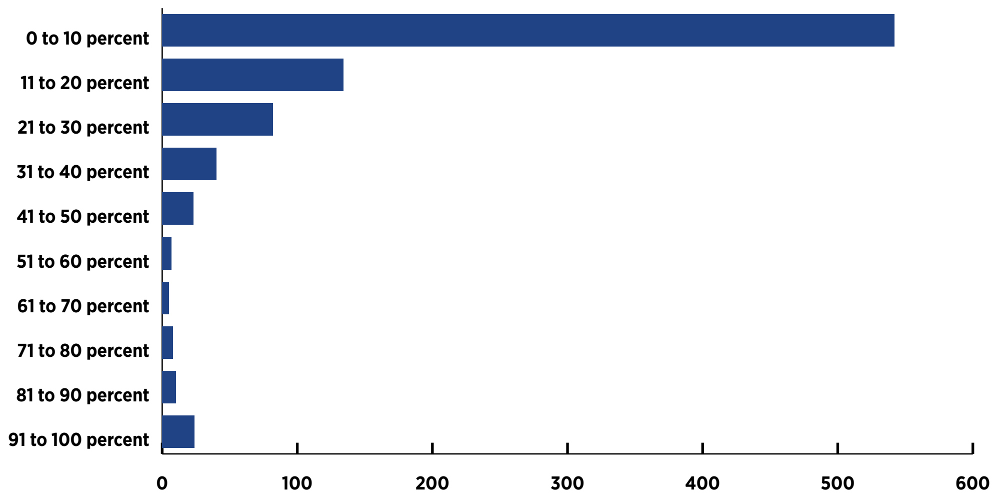


Figure 17 displays survey results on reasons why 1- to 4-family mortgage loans would not comply with QM requirements. The majority of bankers provided one or two reasons. Figure 18 displays the primary reason checked by each banker. Figures 17 and 18 yield consistent results.

The primary reasons 1- to 4-family mortgages would not comply with QM requirements are:

- Loans exceeding the 43 percent debt-to-income ratio threshold (514)
- Loans having a balloon payment within the first 60 months (395)

FIGURE 17

Reasons for Not Qualifying as a Qualified Mortgage (All that Apply)

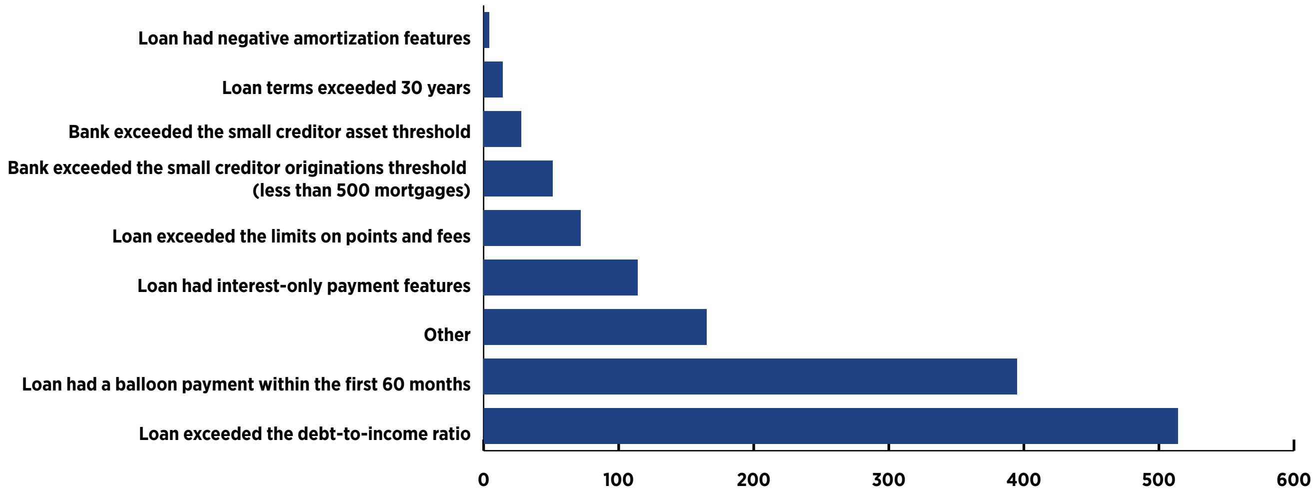
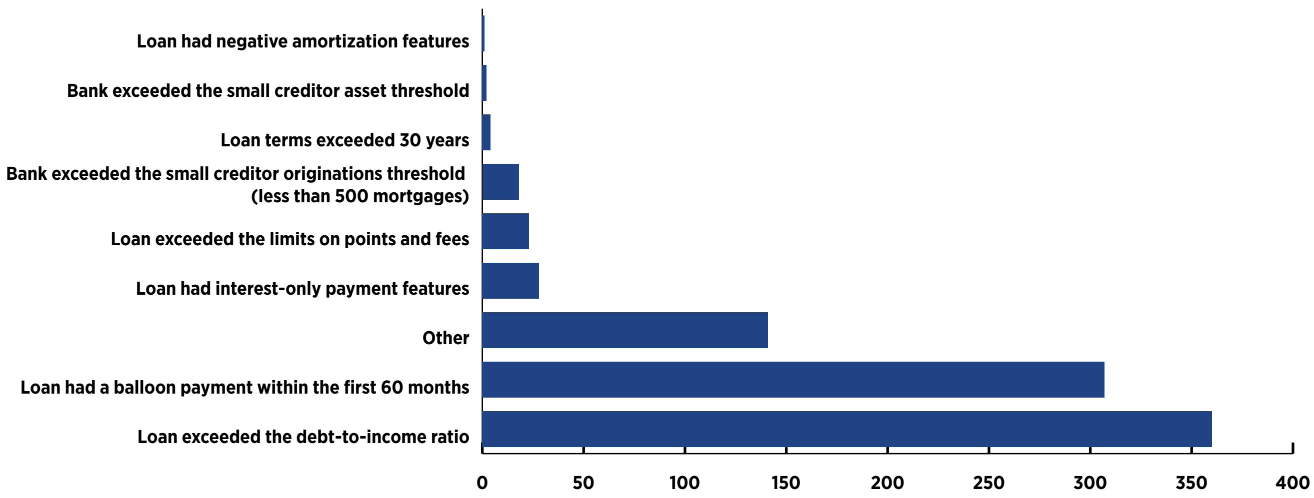


FIGURE 18

Primary Reason for Not Qualifying as a Qualified Mortgage



Impacts of Changes in Technology and Compliance Regulations on the Operating Expenses of Community Banks

Technology Expense

Figure 19 indicates that the technology expenses of community banks as a percentage of their total assets tend to be concentrated at relatively low levels or at relatively high levels: 5 basis points or less at 37 percent of banks, and 16 basis points or more at 29 percent of banks. The pattern in Figure 19 is consistent with the view that community banks are tending to follow very different business plans on adopting new technology. These banks are making either large investments in technology relative to their asset size or relatively low investments in new technology. The pattern in Figure 19 is consistent with the results in Figure 4, in which about 40 percent of respondents do not plan to offer any new products on the list, but the new services that other respondents plan to offer tend to involve incorporating new technology into their operations.

Compliance Costs

Compliance costs increased for 94 percent of the respondents. When respondents are asked to list all the reasons

FIGURE 19

Technology Expenses as a Percentage of Total Assets

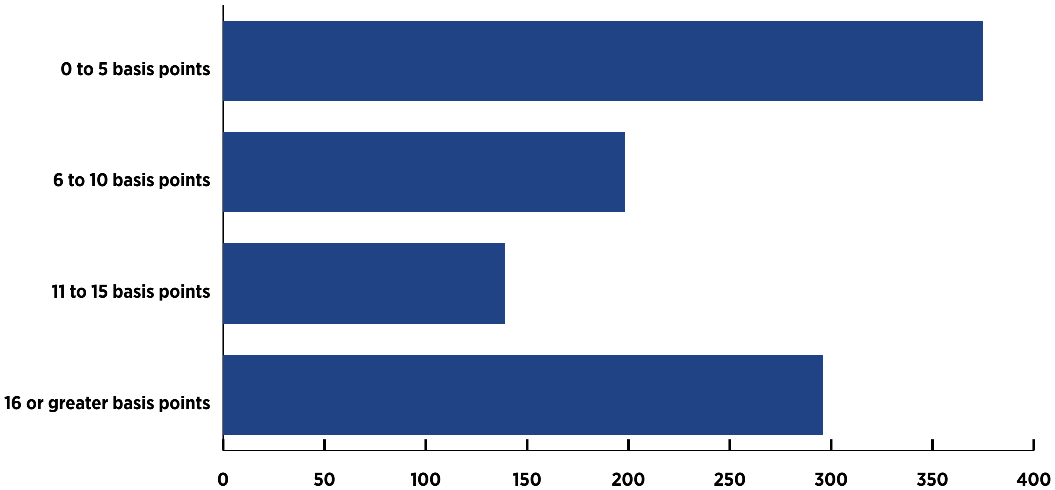
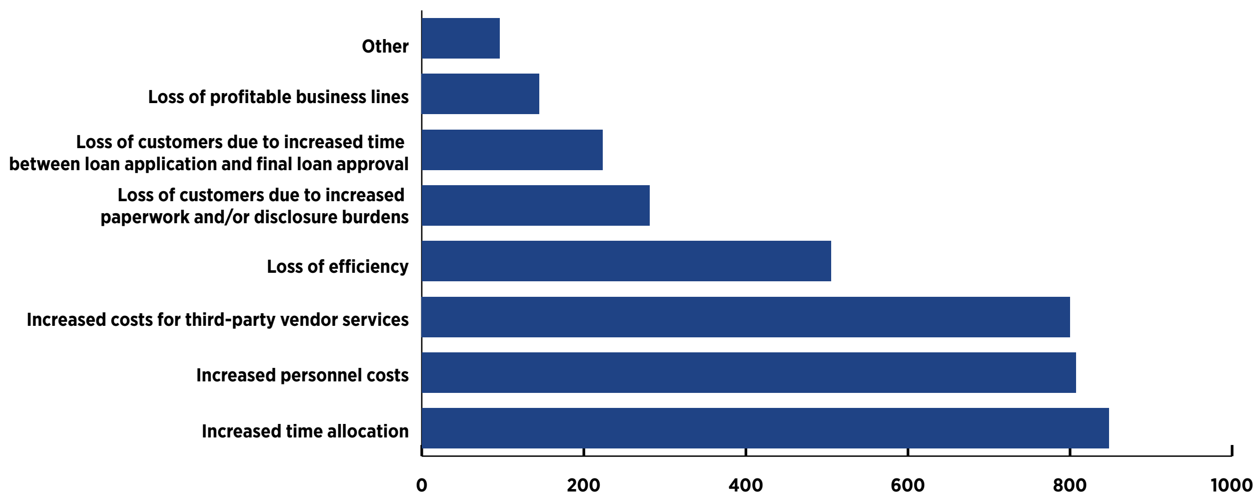


FIGURE 20

Drivers of Increased Compliance Costs (All that Apply)



for increased compliance costs (Figure 20), the following drivers were identified most frequently:

- Increased time allocation (848)
- Increased personnel costs (807)
- Increased costs for third-party vendor services (800)

When asked to identify the single most important reason, the same three drivers dominated the list (Figure 21).

Changes in Competition

The future for community banks will be shaped by the kinds of challenges they face from competitors. Most of the respondents expect competitive pressures on their banks to increase in the future: 45 percent expect somewhat more competition, and 17 percent expect significantly more competition (Figure 22). A small number of respondents indicated that they anticipate less competition in their market areas. One reason respondents cited for this decreased competition was consolidation among community banks.

About 36 percent of respondents indicated that they expect their banks to face about the same level of competition in the next year (Figure 22). Comments by bankers on why they expect competition to remain about the same included:

- The local market is already competitive.
- Their bank is located in a small or rural market that is unlikely to support new entrants.
- Loan demand is weak.

Respondents who anticipate greater competition were asked to indicate the source of greater competition, with an option to select more than one choice. They expect the greatest competitive challenges to come from other community banks, followed by regional banks and credit unions (Figure 23). Just 13 percent of the responses cited competition

FIGURE 21

Biggest Contributor to Increased Compliance Cost

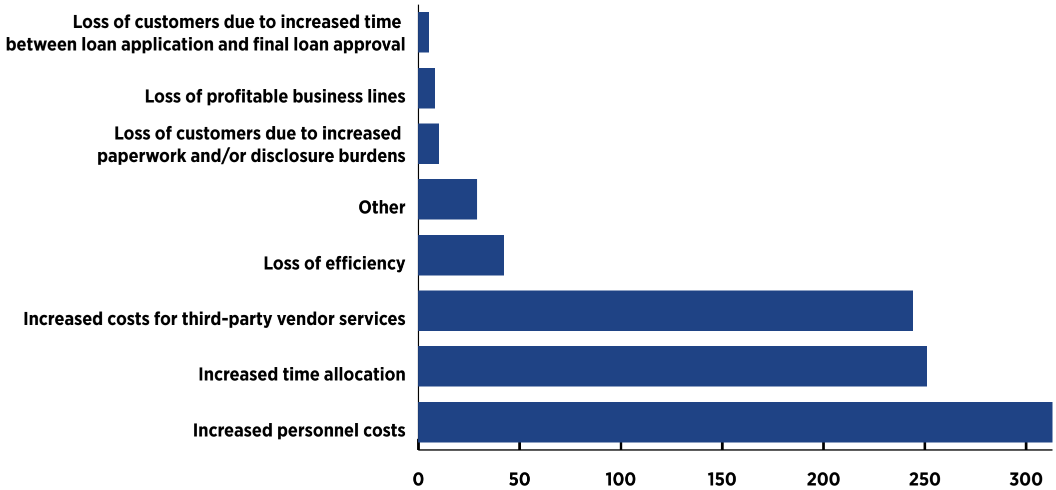
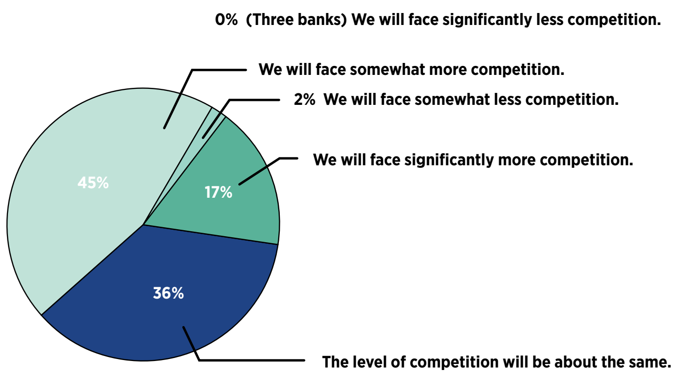


FIGURE 22

Competitive Outlook



from large banks (assets greater than $50 billion). Comments from survey respondents mentioned increased competition from additional sources not listed on the survey. These sources included the Farm Credit System; nonbank service providers such as Wal-Mart, Amazon, Google, PayPal, Green Dot and eBay; and other nontraditional financial service providers.

Consolidation Among Community Banks

The future of community banks will also be shaped by patterns of consolidation among community banks and acquisitions of community banks by larger banking organizations. Survey results indicate that a large majority of community bankers do not expect their banks to be acquired in the near future, and they do not expect to be involved in acquiring other banks. Figures 24-27 show, however, that consolidation plans are on the agenda for many community banks. Figure 24 indicates that 11 percent of respondents have received and seriously considered accepting an acquisition offer in the past 12 months, and Figure 25 shows that 21 percent of respondents expect an offer during the next 12 months.

Comments from survey respondents link reasons for considering acquisition offers to regulatory burden. One banker said, "The appearance [is] that institutions of our size may not be viable in the future." Additional comments communicate personal reflections on the stress of operating community banks under what bankers perceive as excessive regulatory burden. One comment mentioned "management fatigue," and another respondent said, "Banking is not fun anymore."

Figure 26 shows that 20 percent of respondents have made an acquisition offer in the past 12 months, and Figure 27 shows that 20 percent of the

FIGURE 23

Expectations for Change in Competition (All that Apply)

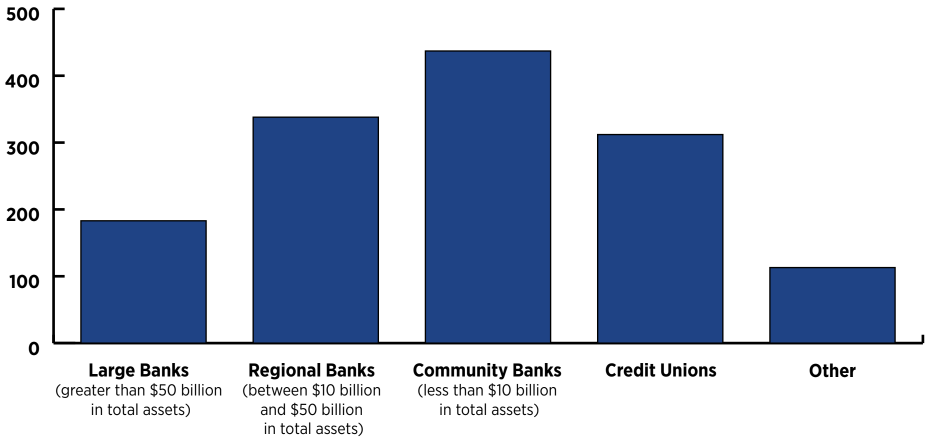


FIGURE 24

Received and Seriously Considered Accepting an Acquisition Offer in the Past 12 Months

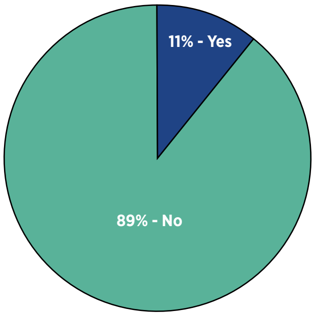


FIGURE 25

Expect to Receive an Offer in the Next 12 Months

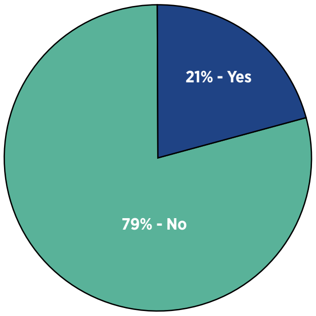


FIGURE 26

Made an Offer in the Past 12 Months

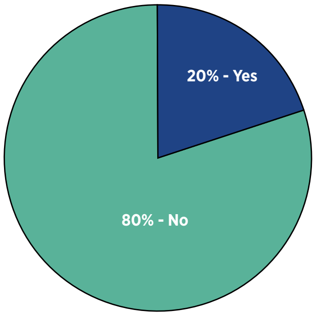
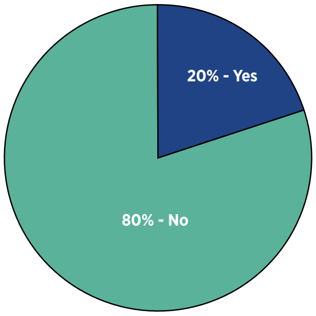


FIGURE 27

Expect to Make an Offer in the Next 12 Months



respondents expect to make acquisition offers during the next 12 months. It is not possible to relate these percentages directly to the record on actual mergers involving community banks, because some mergers may involve offers from more than one potential acquirer and, for some banks, expected acquisition offers may never occur. The actual rate of consolidation among community banks is a fraction of these percentages.

Conclusion

This survey presents an overview of the community banking sector of the banking industry as described by community bankers. The pattern that emerges from the survey is that of community banks pursuing substantially different business plans. About 40 percent of the survey respondents plan no significant changes to their products and services in the near future, whereas many of the other community bankers plan major investments in new services based on the adoption of new technology. Community bankers have different plans for complying with recent changes in regulation of the underwriting of 1- to 4-family mortgages. While plans for consolidation are on the agenda for many community bankers, a large majority do not expect to receive or make acquisition offers during the next year.

From the products and services listed in the survey, community bankers identified their most important products and services as various types of loans. The most frequently identified services included electronic banking, and in their comments some community banks added trust services as important services provided by their banks.

Just as community bankers have a wide range of plans for offering products and services in general, they also have a wide range of plans for offering one of their important services: 1- to 4-family residential mortgages. They expressed many views on offering 1- to 4-family mortgages that do not meet the QM standards for legal protections. In addition, the percentage of community banks that plan to reduce their mortgages during 2014 is about equal to the percentage that plan to increase their mortgages.

More than 60 percent of survey respondents expect to face greater competition in the future, primarily from other community banks, regional banks and credit unions. Survey responses indicate that a large majority of community bankers have not received offers from acquirers or made offers to acquire other banks during the past year. Survey responses indicate, however, that many community bankers expect offers in the next year or expect to make offers to acquire other banks. These observations indicate that consolidation plans are on the agenda for many community bankers.

The mortgage lending questions in this survey are some of the most critical as they reflect significant changes in mortgage finance and the traditional way banks have engaged in this business. The survey data suggest that the majority of banks are engaged in portfolio lending, and that most of these banks have a relatively small portion of loans that would not have qualified under the ATR and QM rules. However, researchers and policymakers will need to evaluate the impact of how these banks respond to the new rules on the local communities in which these banks operate and to overall availability of credit, especially customized credit designed to meet the needs of the borrower. Because this survey is an early look at bankers' thinking as they work to implement the mortgage rules, continued surveys and research in this area will be crucial to fully understand the impact on traditional community banking and access to credit.

Endnote

[1] The rule generally requires creditors to make a reasonable, good faith effort to determine a consumer's ability to repay a consumer credit transaction secured by a dwelling (excluding an open-end credit plan, timeshare plan, reverse mortgage or temporary loan) and establishes certain protections from liability under this requirement for a QM. A loan satisfies the QM requirements if, among other things, it has a term of no more than 30 years and adheres to specific limits on points, fees and risky features such as balloons, interest-only and negative amortizations.

2014 Town Hall Responses

State Commissioners Key to Leading Town Hall Effort

When creating the annual community bank research conference, the planners recognized that industry engagement was vital for a successful outcome. Industry engagement needed to be broad based, cover a range of issues and go well beyond those invited to the conference. The state regulators were well-positioned to lead this effort, given that they operate at the local level and know most, if not all, of the bankers in their states.

Thirty state regulators and more than 1,300 bankers participated in this process in 2014 in events held between April and July. Events ranged from a series of small roundtables to large events with a facilitator.

The states were given seven areas to explore:

1. What do you consider the most promising opportunity for your bank this year, whether it is growth from an existing line of business, new product or service, new market presence or other opportunity? What is the single greatest challenge to your bank, whether it is competition from another bank or nonbank, regulatory burden, weak economic conditions or other challenge?
2. Do you plan to launch any new products or services over the coming year? If so, what major impediments could keep you from capturing new business or market share, and how do you plan to address them?
3. What areas of your business have been most impacted by new or evolving regulations? How is your bank reacting to these regulatory changes? Have they changed your bank's compliance costs, and what have you done to adapt to any changes? What is the most effective way for community banks to handle changing regulatory and compliance costs?
4. Will recent mortgage rules (qualified mortgage, ability-to-repay, etc.) change the types of loans you are willing to make going forward? If so, how, and how will this affect your bank?
5. Which type of financial institution (credit union, large bank, nonbank financial institution, etc.) poses the greatest competition to your institution and to community banks in general? What competitive advantage do community banks have over these other types of financial institutions?
6. What characteristics are most important for community banks' executive management teams and boards of directors in today's banking environment?
7. What key changes in the dialogue or general attitude did you observe since last year's town hall meeting?

The questions were designed to complement the *Community Banking in the 21st Century* national survey also presented in this publication. The results of the town hall meetings provide a unique opportunity to connect the quantitative data in the survey with the stories and experiences of bankers serving their communities.

The following provides an insightful look into these views as summarized by each state.

Community Banking Town Hall Event Summary

State Agency	Attendance Count
Arizona	13
Arkansas	3
Connecticut	36
Idaho	15
Illinois	50
Indiana	21
Iowa	18
Kansas	36
Kentucky	34
Massachusetts	82
Michigan	19
Minnesota	16
Mississippi	34
Missouri	110
Montana	29
New Hampshire	11
New Mexico	7
North Carolina	40
North Dakota	60
Ohio	120
Pennsylvania	76
South Dakota	42
Tennessee	50
Texas	165
Utah	5
Vermont	7
Virginia	81
West Virginia	16
Wisconsin	101
Wyoming	40
Total	**1,337**

Greatest Local Challenges

Arizona community bankers pointed to increasing regulatory burden as the most pressing challenge facing their institutions. At the heart of the issue is a misunderstanding by lawmakers and federal regulators regarding the differences in the business models of community banks and large national banks. Community bankers in the state feel that the federal reaction to the financial crisis has been too focused on banks and not enough on the nondepository financial service providers who caused the most harm to consumers. The level of trust between community banks and their regulators has decreased due to this critical oversight. Arizona community bankers also cited low loan demand and competition from nonbank entities for the few customers who are seeking loans as significant challenges.

Risks associated with working with third parties are another challenge for community banks. Examiners expect community banks to address the systemic risks associated with this work, but community banks are constrained by long-term contract restrictions, and there are few alternatives to relying on these service providers. In addition, information from interagency exams of service providers is not delivered to banks in a timely fashion. Regulators could be significantly more helpful in this area.

Competition from large banks, credit unions and the Farm Credit System is increasing. Large banks are offering attractive "teaser" rates that community banks cannot match. Credit unions are not as big of a threat, but community bankers are concerned with relaxed business loan limits for these institutions. In addition, Farm Credit is increasingly seen as a competitor for agricultural loans.

New Products and Services

Arizona community bankers generally feel unable to offer new products and services to their customers. Compliance and risk assessment hurdles have made it too costly to develop and implement new systems.

Changing Regulatory and Compliance Environment

It is critically important that staff stay informed of ongoing regulatory changes. Community bank management is struggling to train newly hired staff and provide ongoing training to existing staff. Between compliance costs and training costs, community banks have little ability to invest in new services and community engagement.

Community bankers in Arizona feel that the new ability-to-repay and qualified mortgage rules will have a negative socioeconomic impact on lower income families, who will have limited access to mortgage credit. Historic losses do not suggest that there is higher risk in the communities that are served by the state's community banks. In addition, the increased amount of disclosures and paperwork involved in mortgage lending will increase the costs for all consumers. In today's regulatory environment, banks that engage in mortgage lending will be required to have a unique skillset to manage the risk of noncompliance.

"Risks associated with third parties are another challenge for community banks. Examiners expect community banks to address the systemic risks associated with this work, but community banks are constrained by long-term contract restrictions, and there are few alternatives to relying on these service providers."

Arkansas

Greatest Local Opportunities and Challenges

Arkansas community bankers believe that their greatest opportunities over the coming year will come from new or expanded market presences rather than new products or services. Community bankers prefer expanding their banks' footprints, perhaps through acquisitions, to launching new products or services, which can be very costly endeavors. Indeed, none of the Arkansas community bankers indicated specific plans for releasing new products or services over the next year.

Community bankers highlighted their ability to identify and attract qualified employees, and this issue's impact on management succession planning, as one of their chief concerns. Overall, Arkansas bankers believe they face a variety of challenges in today's environment, and they feel strongly that improved economic conditions can help banks to absorb many of these challenges.

As far as competition is concerned, Arkansas community bankers believe other community banks pose the greatest competition in their respective markets. Larger banks are not as significant a competitor as other community banks, because community banks tend to offer better and more competitive rates, products and services than their larger counterparts. Credit unions always pose a competitive threat to community banks, but competition from the Farm Credit System is also increasing. One particular banker noted that a Farm Credit entity is trying to attract the bank's largest and strongest customers. Farm Credit operates with fewer regulations, and its funding source allows for attractive rates and terms.

New Mortgage Rules

Collectively, Arkansas community bankers agree that recent changes in mortgage rules will change the types of loans banks are willing to make going forward, and the new rules have already changed the loan process in some areas. Mortgage rule changes result in a much longer and delayed process for making a mortgage loan. Community bankers indicate that it is now a much more difficult process to originate a loan, unless that loan is to be sold in the secondary market. Arkansas bankers indicate that the rules are too stringent, and prospective borrowers cannot meet all of the new criteria. The specific "check box" criteria keep even strong borrowers from qualifying for some mortgage loans.

Changing Regulatory and Compliance Environment

Arkansas community bankers agree that compliance costs have increased over the past few years. Specifically, one banker noted that compliance costs in his institution have increased approximately 60 percent in the past three years. In some instances, banks are looking to outsource some of the compliance functions and use models or other external sources to appropriately staff and address the increased need for strong compliance programs. However, the need for qualified internal compliance staff continues, and both avenues ultimately result in increased costs to the institution.

Increased compliance costs lead to margin compression and have a direct effect on the bank's earnings and profitability. Arkansas bankers indicate that as costs increase, this translates to increased fees to consumers. Specifically, there are not many opportunities for "free checking" for consumers in the current regulatory environment. Community banks are looking to offset higher compliance costs, which is likely to negatively affect consumers.

In general, Arkansas bankers indicate that the changing regulatory environment has impacted their reinvestment in their communities. Specifically, the increased costs and resources they must allocate to stay on top of regulatory changes result in decreased time and money (contributions) that banks are able to give back to their communities. Because they must devote more resources to regulatory compliance, the bankers commented that their public image has diminished in their communities. Arkansas bankers are concerned that a declining community presence will also negatively impact the loyalty of the next generation of customers. Unfortunately, community contributions, projects and resources are some of the first areas banks are forced to re-evaluate when faced with trimming expenditures and enhancing the bottom line.

Important Characteristics of Bank Management and Boards of Directors

Arkansas community bankers agree that involvement is the most important characteristic of board and bank management in today's environment. Bank management needs a deep knowledge of their customers and should continue to be community-focused. Additionally, community bankers feel that keys to institutional success are ownership involvement and maintaining a vested interest in the institution. Lastly, Arkansas bankers noted that management and the board should always maintain a high level of ethics and integrity.

Greatest Local Opportunities and Challenges

Community bankers in Connecticut agree that the most promising opportunities available to their institutions involve the expansion of activities in which they are already engaged. Opportunities include expanding market area through acquisition or branching, improving processes for greater efficiency and increasing market share from large institutions that are active in the state. Community banks are benefiting from increased demand for commercial real estate lending, commercial and industrial lending and small business lending. In addition to the expansion of existing activities, Connecticut's community banks are seeking to gain new business and retain existing customers through the increased use of mobile and electronic banking channels. Community bankers are also confident that improved relationships and enhanced communication between their institutions and the state legislature will contribute to more effective advocacy efforts.

Community bankers in Connecticut cited competition from other banks and nonbanks, regulatory burden and weak economic conditions as some of the most pressing challenges facing their institutions. Banks in the state see stiff competition for both loans and the payment system from unregulated nonbanks and less-regulated credit unions. Capital flows to the less-regulated entities, and these organizations are able to adapt more quickly to customer trends and to provide pricing advantages due to fewer regulatory requirements. The media tends to paint banks and nonbanks with the same brush, and mistakes made by nonbanks are having a negative impact on the reputation of the banking industry.

On the topic of regulatory burden, community banks in the state remain challenged by the level of resources needed to address continued proliferation of bank regulations. Banks are finding themselves unable to provide a high level of customer service due to the need to shift all available resources to compliance. Limited resources make it difficult for banks to respond to customer demands for new products and services, including mobile banking. Community banks need to provide these services to remain competitive, but many institutions are finding it difficult to absorb the additional expenses associated with development and rollout.

Other challenges exist outside of the control of financial institutions, such as the low interest rate environment and a sluggish economy in Connecticut. Both of these factors are contributing to increasingly thin margins, and banks are struggling to find new sources of fee income to offset reduced profitability.

New Products and Services

When it comes to offering new products and services, Connecticut community banks are focused on pursuing technology-related initiatives such as person-to-person payments and mobile check deposit. These services are considered important in attracting and retaining younger customers who tend to be less price sensitive.

Enthusiasm for new ventures is tempered, however, by the significant cybersecurity risks involved with electronic banking. Some banks in the state have taken a reputational and financial hit stemming from merchant data breaches. Bankers agree that embracing microchip technology could significantly reduce the number of merchant breaches, but disagree on who is responsible for the slow implementation of the technology. More critical impediments to cybersecurity include the costs associated with cybersecurity preparedness and the difficulty of finding and retaining qualified information technology staff. Community bankers in the state have discussed partnering to share information related to electronic transactions and cyberactivity with an emphasis on preventing fraud.

"Limited resources make it difficult for banks to respond to customer demands for new products and services"

Changing Regulatory and Compliance Environment

Community bankers agreed that compliance costs have increased dramatically in recent years. Due to the need to evaluate regulatory impact and compliance associated with any new product or service, banks noted longer product development cycles than nonbank entities. One banker noted that his institution is offsetting the cost of hiring additional compliance staff by curtailing new hiring in the customer service department. Due to increased compliance costs as well as increased regulatory costs associated with examinations, banks are forced to reduce costs through creative and disruptive means. Strategies for cost reduction include outsourcing, and reducing employee expenses such as pensions and healthcare policies.

Connecticut community bankers are wary of the Consumer Financial Protection Bureau's (CFPB's) new mortgage rules, and bankers agree that management strategies for their residential loan portfolios have changed significantly since the rules were finalized. Strategies include:

- Using brokers and reducing the amount of loans originated
- Focusing on loan documentation and exceptions given concerns about perceived disparate treatment for Community Reinvestment Act evaluations
- Keeping only qualified mortgage (QM) loans in portfolio
- Ceasing to originate high-cost or exotic loans

Bankers expressed concern for the lack of oversight in the CFPB's rule-making and agreed that oversight and requirements applied to the other federal agencies should apply to the CFPB. Connecticut community bankers feel strongly that their practices did not contribute to the mortgage crisis. There is consensus among community bankers in the state that all loans held in portfolio should be given qualified mortgage status. Overall, bankers are concerned with the level to which their institutions have to spend time and money to develop new systems and compliance infrastructure for QM lending, despite ongoing uncertainty about the actual legal protections afforded by QM status as well as the application of the new mortgage rules in upcoming examinations.

Critical Characteristics for Bank Management

Bank management and board members need ongoing training to remain cognizant of regulatory developments. Barriers to attracting new board members include the increasing time commitment required and increased liability. Community bankers agree that attracting talented, skilled and dedicated board members is critical to the success of community banks.

Greatest Local Opportunities and Challenges

Despite the challenges posed by increasing regulatory burden and low interest rates, Idaho community bankers believe that there remain some opportunities for growth. Bankers in the state are seeing an increase in demand for custom construction lending and commercial and industrial lending. A rebounding local economy, coupled with improved conditions in nearby states, is fueling new development and increasing loan demand among customers. Although larger institutions are competing for many of the same customers, Idaho community banks are benefiting from increased antipathy towards the biggest banks. Idaho community bankers stated that they still hold an advantage over their competition through their ability to use local decision-making to quickly respond to customer requests. This competitive advantage is especially evident in certain lines of business that competitors are not experienced in, such as agricultural lending.

Idaho community bankers pointed to regulatory burden, especially in the area of consumer compliance, as the single greatest challenge facing their institutions. Consumer regulations, such as the Consumer Financial Protection Bureau's (CFPB's) new mortgage rules, have "driven banks into a box" as they are forced to treat every customer the same. Designed to protect consumers from unscrupulous lenders, these rules have had the unintended consequence of depriving customers of variety.

Staying "relevant" due to outside competition, especially from nonbank financial institutions, is another challenge often cited by Idaho community bankers. Money service businesses and online payment systems are two of many sources of competition. To retain customers and to attract new customers who desire mobile interactions with their financial services providers, community banks need to invest capital in technology. Competition from credit unions is also increasing. Some of Idaho's community bankers noted that they have ceded the consumer loan business to credit unions, who have essentially assumed the traditional community bank role in the state.

Changing Regulatory and Compliance Environment

Community bankers in the state share the perception that the policies pursued by federal regulators are counterintuitive. Regulators want banks to offer more products and meet the specialized needs of consumers; however, the preponderance of new regulations is making this nearly impossible for community banks in the state. Idaho's community banks perceive impediments to offering new products and services. Bankers cited a high cost of entry for new products, especially for technology-based products that are attractive to younger customers. While focused on growing existing lines of business, bank management is now also forced to consider limiting or exiting some of those existing lines, specifically consumer and mortgage lending.

Idaho community bankers stated that consumer and mortgage loans have been the products most impacted by new and evolving regulations. Traditionally, consumers would become customers to get a home loan or other loan and would then use the bank for their other credit needs. This type of relationship lending has been critical to the business model of community banks. Idaho's community banks are no longer able to exercise discretion and rely on independent judgment in their lending decisions. The new mortgage rules, while difficult for banks to understand, are even more difficult to explain to customers. Customers seeking a specific type of mortgage or other consumer credit product are turning to nonbank competitors who can offer better pricing and terms, often at the expense of increased risk for the consumer. Community bankers noted that a carve-out from the CFPB's mortgage rules for all loans held in portfolio would be helpful, but they also stated that their institutions can only portfolio so many mortgages without increasing risk in other areas. Idaho community bankers stressed that rural communities in the state have been hit hardest by the new mortgage rules. Banks operating in these areas are unable to price in the increased risk of lending in rural markets.

Regulations geared toward larger institutions present a compliance burden that is proportionately greater on smaller banks. These institutions have far fewer employees to tackle an increasingly large workload, and the costs of hiring additional compliance staff further squeeze margins and profitability. Margins that have already been compressed by a continued flat yield curve and low interest rates are increasingly stressed by the need to dedicate these additional resources to compliance. One banker noted that only five years ago, his bank had one compliance officer compared to the seven they have today. There is concern that many opportunities have been lost because employees who would be focused on developing business are now working on compliance.

> “The rules have limited the ability of community banks to exercise the discretion that is central to the relationship lending business model.”

Greatest Local Opportunities and Challenges

Illinois community bankers expressed that the multitude of challenges facing their banks outweighed any opportunities that may be available in today’s economic and regulatory environment. However, bankers in the state noted that their experiences interacting with state regulators have been increasingly positive. Bankers are also finding it easier to communicate with federal regulators. These improved relationships are providing institutions with additional flexibility needed to solve problems as they arise. Community bankers in Illinois engage directly with the Federal Deposit Insurance Corp., and many said that they feel more comfortable picking up the phone and engaging in a conversation with agency staff.

Regulatory burden was consistently cited as the most pressing challenge facing community banks in Illinois. Small banks that have operated in their communities for a decade or more are struggling to retain profits while diverting resources to keep up with new regulatory requirements. One small bank with assets fewer than $1 billion has had 18 exams in less than four years from multiple agencies. In addition, bankers are struggling to keep up with and provide necessary training to staff in areas such as the Bank Secrecy Act (BSA) and Office of Foreign Assets Control requirements. Bank employees typically receive training outside of the office, making it even more difficult for banks to continue normal operations with limited staff remaining in the institution. One banker who represented an institution with less than $50 million in assets stated that his bank has had to hire a full-time compliance officer for the first time in more than 50 years.

Community bankers in Illinois expressed concern with an increasing disconnect between the regulatory approach of federal regulators and the needs and circumstances of local communities in Illinois. Too often, federal regulators have cited community banks in rural counties for concentrations in agriculture without recognizing that the areas in which these banks operate specialize in this type of lending due to their location and the needs of their local communities. Small banks pride themselves on providing economic benefits and stability to their local communities. Community bankers in Illinois feel that the onslaught of new regulations and compliance requirements is crippling their institutions to a point where they can no longer effectively serve the communities in which they operate.

New Mortgage Rules

According to Illinois community bankers, new mortgage rules have made the lending process extremely complicated and have failed to improve the process for consumers. Participants noted that community banks in the state have always followed thorough underwriting guidelines. The rules have limited the ability of community banks to exercise the discretion that is central to the relationship lending business model. Even where regulators have attempted to create tiered regulation, such as with the small creditor qualified mortgage exemption, there is evidence that banks are hesitant to take advantage of these carve-outs. Banks operating on the edge of the 500-loan requirement feel constrained by the carve-out, which does not distinguish between loans that are held in portfolio and loans that are sold to the secondary market.

Focus on Management

Bankers in Illinois spoke of difficulty in succession planning and in attracting qualified individuals to serve on banks’ boards of directors. The goal of seeking board members who could attract business to the bank has now shifted to seeking members who have deep experience in areas such as BSA requirements and interest rate risk liability. In today’s regulatory environment, board members must be more willing to focus on paperwork related to regulatory compliance, rather than spending time engaging with stakeholders in their local communities.

Greatest Local Opportunities and Challenges

Community banks in Indiana continue to generate opportunities for themselves by offering responsive and flexible service to their customers. Despite increasing regulatory burden, community banks are able to execute decision-making faster than their big bank counterparts. Knowledge of local economic conditions and circumstances impacting customers allows community banks in the state to cater their services in a way that large institutions cannot. Currently, regional banks operate 780 branches outside of major cities in rural areas of Indiana. The bankers projected that 70 percent of these branches will close in the next five years as these banks decide to pull out of rural areas. Community banks are determined to stay in these communities, and they have the opportunity to gain customers from institutions that are more focused on metropolitan areas. Increased use of technology is seen as another way that community banks can compete on the same level as large banks.

Indiana community bankers agree that the use of technology is important to their customers. However, the costs associated with producing and implementing electronic services present some of the toughest challenges facing banks in the state. One banker noted that it is not bad loans that keep him up at night. Rather, the fears of bankers in the state are centered on cybersecurity and vendor management. Providing the technology that customers demand while ensuring the security of their systems is challenging for small institutions with limited resources already stressed by rising compliance costs. Community banks also need to be certain that vendors are diligently working to safeguard customer information. Bankers would appreciate enhanced information sharing from state and federal regulators concerning reviews of data service providers and other vendors. Often, information known by regulators is not shared with banks until problems occur.

Credit unions continue to compete for the same customers as community banks. An elimination of the advantages and leveling of the playing field between banks and credit unions is near the top of the wish list for Indiana community bankers. Community banks are also feeling the impact of increased competition from the Farm Credit System. Tax advantages and less regulatory oversight allow nonbank entities to operate with significant advantages over community banks.

Changing Regulatory and Compliance Environment

Community banks are a key provider of credit in their local communities. Many bankers have been working with particular families for generations. These institutions take pride in maintaining customer relationships, and their ability to tailor products based on the needs of their community members is what distinguishes them from larger institutions. Unfortunately, new regulations and changes in existing regulations continue to discount the business model of community banks. According to bankers in Indiana, the current regulatory environment has become more product-sensitive and less customer-sensitive.

Specifically, community bankers pointed to the Consumer Financial Protection Bureau's (CFPB's) ability-to-repay and qualified mortgage (QM) regulations as an impediment to their ability to exercise discretion in extending residential loans to borrowers. Just a year ago, community bankers referred to their ability to lend to marginal borrowers as a competitive advantage. Today, this traditional community banking trait is seen as a liability. Given the uncertainty surrounding the treatment by examiners of non-QM loans, many community banks in Indiana will not be making non-QM loans. Many community bank customers would not qualify for a QM loan due to falling under the debt-to-income ratio requirements or having income that is difficult to validate. For these borrowers, access to credit will be restricted. These customers are likely to take their business to entities that are less regulated, but whose products carry more risk and additional costs. Community bankers in Indiana would appreciate if the CFPB tweaked the mortgage rules to clarify that all loans held in portfolio have QM status. Community bankers also recommended that loans sold into the secondary market should not count towards the 500-loan cutoff for the small creditor exemption.

The new mortgage rules and other rules that have come into effect over the past year are contributing to rising compliance costs for the entire

industry. Increased compliance costs have a disproportionate effect on smaller institutions. These entities, already dealing with constricted margins due to a low interest rate environment, must shift all possible resources to compliance. Upcoming changes to Home Mortgage Disclosure Act reporting requirements are also expected to bring additional regulatory costs to community banks.

Staffing Difficulties

Community banks in Indiana are struggling to attract qualified directors, managers and board members. Managers at many institutions will be retiring in the coming years, making management succession a top priority. It is difficult to entice new staff to move to rural areas and even more difficult to ensure that employee bases are diverse. It is critical that management teams develop succession plans for both senior management and the board of directors.

> "It has become increasingly difficult for institutions operating in rural areas to recruit executive level talent."

Greatest Local Opportunities and Challenges

Although the challenges facing their institutions are numerous, Iowa community bankers are confident that their institutions can benefit from a diverse set of opportunities. Smaller banks in the state are seeing strategic opportunities in both commercial and agricultural lending. Community banks are also experiencing increased demand for wealth management services. Given the large number of community banks in the state, banks that are struggling with ownership or management succession have a wide pool of banks willing to acquire their institutions. In addition, bankers are optimistic about their ability to gain new customers and retain existing customers through increased use of technology and mobile banking services.

Regulatory burden was cited as the most pressing challenge facing community banks in Iowa. Bankers feel that the huge increase in employee hours spent on compliance has no benefit to consumers or the economy. To the contrary, rising compliance costs have resulted in more expensive products for customers and less time available to work with members of the community.

The tax advantages enjoyed by nonbank financial institutions such as credit unions and Farm Credit System organizations were noted as another ongoing challenge for community banks. Credit unions are competing for the same customers as urban community banks, while competition in rural areas is coming from Farm Credit. These institutions are able to offer more flexible rates on loans and have been increasingly pushing into lines of business traditionally held by community banks.

Succession planning is another challenge for community banks. It has become increasingly difficult for institutions operating in rural areas to recruit executive level talent.

New Products and Services

Community bankers in Iowa are eager to enhance their offering of technology-related products such as mobile and online banking. While bankers see technology as critical to being able to compete with larger institutions, bankers worry that there is limited opportunity for profit due to the costs associated with implementation. Security is also a concern, and community bankers will need assistance from third-party vendors to help mitigate threats.

Changing Regulatory and Compliance Environment

New and changing federal regulations have failed to take community banks into account. While larger institutions are able to easily absorb rising compliance costs, community banks are forced to move resources from other areas to stay afloat amid an ocean of new regulatory requirements. Community banks are hiring additional staff to meet regulatory requirements, significantly reducing profit margins that are already stressed by technology costs and a low interest rate environment. Compliance costs related to items such as lost time, salaries, auditing and policy work are difficult to determine. One banker said that costs have increased by $100 per loan file over the past three years. Due to the proliferation of regulations, training costs have also increased. New hires are overwhelmed by the magnitude and complexity of regulations, and existing employees struggle to keep up with constantly changing requirements. The vast amount of training options available makes it difficult to determine which courses will be beneficial to employees.

Iowa community bankers agreed that mortgage lending is the area of business that has been most impacted by recent regulatory changes. One banker estimated that new mortgage rules have added four to six hours of work for each mortgage application. In addition, the Consumer Financial Protection Bureau's narrow definition of "rural" has made it difficult or impossible to serve bank customers in certain communities. Nonbanks are increasingly able to compete for residential and consumer loans due to less regulatory oversight.

Despite uncertainty surrounding mortgage lending, Iowa community banks are determined to continue offering residential real estate loans. Approximately half of Iowa community banks have indicated that they will offer nonqualified mortgage loans and hold them in portfolio on a very selective basis.

Management Issues

Bankers noted that federal regulators have unrealistic expectations for bank board members. The responsibilities of board members are numerous; however, many board members have professional responsibilities outside of the institution. Iowa bankers agreed that diversity for both the board and management is very important. Not everyone on a board should have a banking background. Today's board members need to be technologically savvy, committed to ongoing education and not averse to risk analysis. Occasional turnover is to be expected and is necessary for a healthy institution.

Greatest Local Opportunities and Challenges

Kansas community bankers noted their greatest opportunity and advantage has historically been flexibility. However, this flexibility is getting "regulated away" from them by new rules that replace bankers' judgment with box-checking exercises. Community banks must now rely on the loyalty of their customers, which is difficult given that consumers are primarily price-oriented. No amount of personalized service can overcome significantly cheaper loan terms.

With community banks losing their flexibility, neighboring credit unions and the Farm Credit System are able to offer more attractive rates. One banker relayed that a credit union competitor informed him that he looked at the bank's rate sheet, and then simply undercut the community bank. Another Kansas banker said a Farm Credit organization singled out one of his bank's larger agricultural loans and was eventually able to poach the borrower by offering loan terms that the community bank could never match.

Changing Regulatory and Compliance Environment

Kansas bankers have seen their compliance costs increase in the wake of regulatory reforms. These costs are having a negative, material impact on the bottom line of many community banks. One banker shared how his institution was forced to increase spending on compliance staff. In the past, his bank only needed a part-time compliance officer, but he now employed two full-time compliance staff out of 32 total employees. The banker had to dismiss a loan officer to hire a compliance staff member. He estimated that each compliance staff member cost his bank 35 to 40 basis points. Additionally, compliance is no longer strictly confined to compliance staff. All bank employees must now be well-versed in regulatory compliance.

Even though the largest institutions are the regulators' primary targets, community banks experience a host of negative effects from rules intended for their larger counterparts. Regulators might think their new rules only have a marginal impact on community bank activities, but it is precisely these small activities that add up and translate into real economic growth. On a broader level, regulations are hurting Kansas bankers' abilities to fuel economic growth in their communities.

New Mortgage Rules

New mortgage regulations are a serious threat to Kansas community banks. One banker from a town of 800 residents related how new mortgage rules are hurting both his bottom line and the broader community. In this rural community, the price of a home may average only $50,000. Some borrowers may not have pristine credit, but the banker noted his institution's willingness to work with these borrowers to keep them in the community. In fact, the Kansas community bankers noted they were the only ones in their market willing to make such loans. However, rigid new mortgage rules are taking away the flexibility community banks need to serve their consumers, thereby removing a primary source of credit and banking services on which rural communities rely.

A Kansas banker from a $130 million institution said home lending was a cornerstone of his business. He has seen more demand as other banks flee from making mortgage loans, but is hesitant to fill the lending gap due to uncertainty from new mortgage rules. The banker said, "I feel like I'm the rat in the trap who's wondering if he wants more cheese." Another rural banker noted that his institution's focus on character lending would run afoul of regulators' stringent new debt-to-income requirements, even though the bank holds its mortgage loans in portfolio. The banker argued that loans held in portfolio should be exempted from qualified mortgage requirements.

Important Characteristics of Bank Management and Boards of Directors

Kansas community bankers stated that smart, well-connected individuals who are engaged and speak their minds make ideal directors. Such directors reflect well on the institution and provide good guidance. However, community banks face difficulties attracting directors in today's environment. New rules and regulations regarding bank boards of directors have increased their expected workload, increased their liability, exposed them to higher risks and stripped the position of any of its former prestige and reward.

New rules also have an impact on a bank's senior leadership team. Older, more experienced community bankers in leadership roles are frustrated with the new rules. Many of these individuals do not want to put in the time to learn and navigate the changing banking environment and are choosing to leave the industry altogether. New rules could lead to a mass exodus of deep knowledge and experience from community banks. While many senior leaders are leaving, Kansas bankers noted it is difficult to attract talented senior management to rural areas to replace them. Additionally, there are many family-owned community banks that have relied on drawing management from the family, which can be good or bad. Many of the bankers noted the importance of having solid succession plans in place.

Kentucky

"The Consumer Financial Protection Bureau's qualified mortgage (QM) rule is forcing community banks to treat long-time customers like new ones."

Greatest Local Opportunities and Challenges

Community bankers in Kentucky feel that there are opportunities currently available to their institutions. Banks in the state are seeing an increase in loan demand, especially in commercial and consumer lending. Agricultural loan opportunities, as well as loan demand from coal mining operations, are growing, and community banks are increasingly able to reach into other markets through participations. Some banks in the state have expanded into additional counties through the purchase of existing institutions. Despite increased compliance costs, community banks are finding ways to improve staff efficiency. Strategies include taking advantage of automated systems to reduce fixed expenses and working with outside vendors to assist employees with underwriting and other time consuming responsibilities. In addition, increased use of technology has led to less foot traffic in branches and improved operating efficiency.

Community banks in the state have numerous competitors, including credit unions, national banks, regional banks, the Farm Credit System and other nonbank entities. Credit unions pose the most significant competition to community banks, and their presence in the state is growing. Credit unions benefit from a significant tax advantage, and they hold a large percentage of market share in many areas of the state. Large national and regional banks benefit from lower marginal costs and higher lending limits, and they are able to easily reach out to customers given their large marketing budgets. Farm Credit is able to underprice banks and lock in long-term fixed rates. These entities are able to circumvent regulatory requirements by securing commercial loans with farmland, and they are increasingly moving into residential lending. In addition, nonbank entities such as check cashers, insurance companies, lenders and brokerage houses are not subject to the same regulatory framework and have lower compliance costs. Due to increasing regulatory burden, community banks are finding it difficult to offer the same level of customized, customer-focused service that has traditionally distinguished them from these nonbank entities.

New Products and Services

Community banks in the state recognize that to compete with larger banks, they need to offer customers access to mobile and online banking services. Many community banks already offer mobile banking and services such as remote deposit. However, institutions are lagging behind larger banks in developing protocols and training employees for cybersecurity readiness. There are many hidden costs associated with producing and implementing technology-based products and services. Hidden costs include staff training, hiring of information technology staff, equipment costs and third-party contracts for implementation and maintenance. Vendor management is a challenge, partly due to a lack of information sharing between regulators and the industry concerning vendor reviews. The largest cost and concern for community banks looking to increase their use of technology is the responsibility to absorb security and fraud costs. Reputational risk is a serious concern since banks typically bear the brunt of the blame for security breaches, even if the breach resulted from third-party errors.

Changing Regulatory and Compliance Environment

Community banks, already faced with reduced margins stemming from stagnant economic conditions and a low interest rate environment, are struggling to remain sufficiently profitable in a constantly changing regulatory environment. The federal response to the financial crisis has failed to take into account the intricacies of the community bank business model. No longer can community banks exercise discretion and rely on their knowledge of their customers. Current paperwork and documentation requirements have essentially removed the personal relationship from banking. New regulations encourage "plain vanilla" products that need to fit within certain parameters. Any deviation from the standard results in compliance problems for community banks. Banks are ceasing to offer variable-rate loans, balloon loans and other products that consumers actively seek out. Management teams are finding that it is necessary to have specialized personnel in each lending area to properly comply with regulatory requirements for each product. It is no longer possible for a loan officer to originate any product. One banker noted that he used to make twice the number of loans with half of his current staff.

Staffing needs related to compliance costs are overwhelming for community banks, and there is the perception that new rules have led to an asset-size minimum that community banks must achieve to remain viable. As loan demand has decreased, personnel-related overhead expenses have increased. Banks attribute this quandary directly to regulatory burden. Many banks are unable to even consider introducing new products and services due to rising compliance staffing costs. There is no benefit to consumers when bankers are forced to put their brightest employees in backroom compliance positions.

Community bankers expressed concern with the zero tolerance attitudes of regulators when it comes to compliance. These exams have a "gotcha" approach, and examiners fail to consider the difference between unintentional errors and intentional violations. In addition, bankers are frustrated by inconsistent applications of compliance rules between different regulatory agencies.

Effects of New Mortgage Rules

The Consumer Financial Protection Bureau's qualified mortgage (QM) rule is forcing community banks to treat long-time customers like new ones. There is no longer the ability to customize a product to meet a customer's individual needs. The new rule is disproportionately affecting borrowers from rural parts of the state. It is difficult to find qualified appraisers and comparable properties in rural areas. More importantly, banks are experiencing difficulty when trying to consolidate or restructure loans for troubled borrowers. Kentucky's community bankers expect the new rule to lead to increased foreclosure rates due to the inability to work with troubled borrowers. Despite the challenges associated with mortgage lending in today's regulatory environment, some Kentucky bankers will make non-QM loans on an exception basis for existing customers who do not qualify for QM.

Greatest Local Opportunities and Challenges

Community bankers in Massachusetts are optimistic that their institutions can take advantage of multiple opportunities to foster growth and stability. Despite an industry-wide movement toward online banking, branching continues to allow community banks in Massachusetts to serve new markets and bring in new customers. Community banks are also benefiting from significant cost savings and increased flexibility by leasing existing real estate for branches instead of constructing new buildings. Additional opportunities include an increase in construction lending and increased demand for home equity lines of credit.

Challenges facing community banks in Massachusetts are numerous. Community bankers agreed that the greatest challenge is planning for the future in a world of unknowns associated with cybersecurity, regulatory burden and credit risk.

Community banks face an uphill battle when it comes to cybersecurity preparedness. Given the speed and sophistication of cyberattacks, institutions face challenges in protecting their institutions as they attempt to contain the damage under rapidly changing conditions. Small institutions typically do not have the information technology expertise necessary to counteract cyberattacks, which can range from highly complex corporate account takeover attacks to phishing attempts against employee email accounts.

Increasing regulatory burden stemming from a proliferation of new and changing regulatory requirements makes it difficult for community banks to develop strategic plans for the future. More time and money is being spent on compliance-related costs, resulting in less time available to serve bank customers.

Another noted challenge is increasing competition from regional banks and credit unions. Regional banks attract customers with competitive pricing and convenient locations. Large credit unions are expanding into commercial lending and other activities traditionally performed by community banks. Additionally, there is concern about large, out-of-state credit unions that are increasingly opening branches in the state.

New Products and Services

In response to increased demand from consumers for faster and more convenient banking options, community banks in Massachusetts plan to expand or upgrade existing mobile services, including the addition of mobile check deposit, e-checking and peer-to-peer payments. While community banks see technological advancement as an important goal, bankers share concern that increased use of mobile and online banking will make their physical branch locations obsolete. Despite this risk, offering additional mobile services will help to attract new customers and will allow community banks to remain competitive against larger institutions with more robust mobile offerings.

Changing Regulatory and Compliance Environment

Community banks in Massachusetts are doing their best to keep up with a rapidly changing and complex regulatory environment. More so than in previous years, banks are hiring new employees or consultants for quality control and are dedicating additional staff hours to policies, procedures and general compliance. Bankers noted that there are many layers of sometimes duplicative regulations. In certain areas, such as the federal regulations that govern permissible bank activities, rules between agencies are not consistent, leading to confusion and extra work for compliance staff and management. Rules are also inconsistently applied, and enforcement seems arbitrary, especially around compliance with fair-lending regulations and the Community Reinvestment Act. One bank representative noted that bankers are essentially becoming full-time compliance officers who sometimes make loans or offer other banking services to customers.

Community bankers agreed that the area of business most impacted by new or evolving regulations is residential lending. Institutions have seen diminishing residential mortgage portfolios in recent years due to secondary market standards, and the new mortgage rules will further contribute to a decrease in this business line. Massachusetts community banks are still able to offer first-time homebuyer loans through local programs, but overall credit availability is anticipated to decline. Community bankers agree that there is a large percentage of the marketplace that will not be served due to ability-to-repay requirements, including self-employed individuals and younger borrowers with student debt. Due to the severe consequences associated with making non-qualified mortgage (QM) loans, at least one community banker indicated that his institution would not be making them. Bankers suggested that there should be a broadening of alternative means of documentation. Another suggestion was that borrowers should be able to sign a waiver recognizing a non-QM loan, which would shield banks from litigation risk. Despite decreasing loan demand and the challenges associated with mortgage lending under the new Consumer Financial Protection Bureau rules, community banks in Massachusetts are determined to stay active in the residential lending market.

Opportunities and Challenges

Michigan community bankers readily cited challenges for their banks, and potential opportunities were often quickly paired with related impediments. Opportunities are being driven in large part by improving economic conditions, which are benefiting both individual and commercial customers as well as the banks themselves. Home sales have picked up in many markets, and individuals are also considering larger consumer purchases. Businesses are seeking commercial and industrial loans as well as commercial real estate loans, and construction has returned in certain markets. A number of bankers report commercial customers are requesting increases in existing lines of credit. The improving economy has helped alleviate asset quality issues, strengthened institutions and permitted bankers to dedicate more time to what their business is all about: helping the customer.

Technology-related initiatives and wealth management services were viewed as other areas of potential opportunity. Community banks are generally not early adopters of the latest technology, and decisions to move forward with new customer-facing applications are often driven by clients and implemented to complement current product lines and services. Wealth management was highlighted by a number of bankers, particularly in light of the impending generational transfer of wealth.

The most prominent challenges facing Michigan community banks fall into the following broad categories: regulation, competition, staffing and succession, and market issues. A consistent concern is increased operating costs related to regulatory compliance. Competitive pressures have increased with the improving Michigan economy, and competition is posed by a number of different players within and outside the traditional financial services industry. Many bankers noted difficulties attracting and retaining qualified candidates for management and board positions. While the overall state economy has turned around, certain markets continue to experience weakness, and some bankers also noted declining and/or aging populations in their markets, particularly in the more rural communities.

Changing Regulatory and Compliance Environment

Michigan community bankers know their customers and their customers' circumstances and try to do what makes sense for them. Community banking used to be about developing a solution to fit the customer's needs, and many feel it is becoming the opposite. What standard product is closest to fitting? If the best solution falls outside a standard, what are the potential regulatory implications?

Community banks are dedicating significant and increasing resources to consumer compliance and Bank Secrecy Act personnel, third-party reviews, continual staff training and interpreting what at times appears to be conflicting regulations. Where once a single employee could wear several hats, community bankers report adding the equivalent of two to three full-time employees dedicated to compliance due to the complexity of the regulations and the scrutiny applied by regulators.

Bankers expressed frustration over products and services they can no longer offer due to changing regulations or perceived regulatory pressures. Certain mortgage products and balloon mortgages, in particular, were common examples. The concept of "know your customers' customers" was also identified as an impediment, particularly for cash businesses and complex depositor relationships that involve a high number of ACH transactions. Furthermore, bankers fear that increasingly complex demands are causing directors to lose the forest for the trees. At the same time, it seems examiners are continually coming up with even more areas that bank directors should learn about and oversee. One banker noted, "The pendulum of regulatory oversight swung too far in response to the crisis, and I fear a permanent 'us versus them' relationship, specifically on the federal side. The relationship needs to be repaired. Regulators used to provide answers and help with solutions."

New Mortgage Rules

The qualified mortgage (QM) and ability-to-repay (ATR) rules are generally viewed as impediments to individuals and the economy—perhaps well-intentioned, but ineffective. The rules are very prescriptive, and the specific documentation required is burdensome for borrowers and slows down the origination process. The rules have a significant impact on self-employed individuals, in particular.

Michigan bankers were divided on whether the QM and ATR rules have changed the types of mortgages they are willing to make. Many felt more direction is needed on the potential implications of making non-QM loans. Those originating non-QM loans noted that doing so requires a great deal of work and patience.

"At the heart of community banking is a collection of stories about serving customers."

A number of bankers cited the historical delinquency and foreclosure rates of residential mortgages held in their portfolios, which are better than national averages, as evidence of the community banking industry's tradition of prudent and responsible lending. Others noted that QM and ATR, if in place prior to the crisis, wouldn't have made a difference for borrowers in areas hit especially hard economically because their circumstances changed as a result of the recession. There was cautious optimism by a few that the rural petition bill and exemptions for all portfolio residential mortgages, if enacted, could make a meaningful difference.

According to one Michigan community banker, "The new mortgage rules lead to higher costs and longer loan processing times for customers. Customers don't feel protected. They feel inconvenienced, burdened."

Competition and Advantages of Community Banks

There is no single greatest competitor in the financial services industry, but rather key competition is often viewed by product or service type and can differ by market. Recurring examples include credit unions for personal and auto loans; the Farm Credit System for agricultural loans; large, regional banks for commercial loans; nonbank firms for a variety of financial transactions, and emerging payment systems that go around the banking industry.

Michigan community bankers were quick to point out the advantages their institutions hold over competitors, all of which are distinctly rooted in customer service and a dedication to the community as a whole. Bankers often noted that community banks actually answer the phone when customers call. Customers can get the right answer the first time, and can speak with a decision-maker. Members of the community know their bankers as individuals and know where they live. They see them at sports events, church, the grocery store, etc. They trust their local bankers. The core of community banking is building relationships. However, some fear millennials take a more transactional approach to their financial needs and may not value the concept of relationship banking.

"At the heart of community banking is a collection of stories about serving customers," another community banker noted. "When a customer complained, via social media, that the bank's ATM was down, the CEO promptly responded with an apology and said he had $40 in his wallet and that the customer was welcome to have it to tide her over until the bank opened the next day."

Important Characteristics of Bank Management and Boards of Directors

Executive management in community banking requires a broad range of experience, a commitment to continuing education, and dedication to the community. The breadth and depth of knowledge required of a CEO is staggering and seems to be ever-increasing. Many bankers noted difficulty in attracting qualified candidates, especially in rural areas, and that there appears to be little interest in community banking by college students.

Michigan bankers universally identified diverse backgrounds as being a critical component of the most effective community bank boards. Individual board members must be engaged, be able and willing to learn, and be able to make the time commitment. Directors' responsibilities require a huge investment of time, which, combined with the potential individual liabilities, deter some business leaders from serving on bank boards.

Executive management and board members must be willing to ask the tough questions and always be looking for, and be hungry for, new opportunities. The process of continually identifying and evaluating opportunities is crucial, even if the ultimate decision is not to pursue them. A community banker noted, "Bank executive positions require experience, integrity and intelligence. Banking's not for dummies."

Key Changes Since Last Year

Few Michigan bankers noted any key changes in the dialogue or general attitude toward community banks during the past year. Locally based institutions have always had much better reputations in the communities they serve than the big banks. There is mutual respect and trust between community bankers and their customers.

Political and regulatory leaders seem to recognize the value of community banks. They understand the importance of such institutions in serving the needs of individuals and small businesses, as well as their collective significance in the broader economy. However, few bankers felt the positive rhetoric was reflected in the rule-making process or the application of the rules and regulations by examiners. More could be done to "right-size" expectations and "risk-focus" examinations. While politicians appear to understand the plight of community banks, they seem to have little appetite to do anything to remove roadblocks and alleviate the challenges.

Greatest Local Challenges

Minnesota bankers focused their discussion on regulatory, compliance and competitive challenges. Minnesota community bankers feel they are being forced to act more like big banks. Smaller community banks are required to ask more and more information from their customers. The value of the social capital that small banks have earned in the community is being reduced. These requirements are damaging the relationships that community banks have built.

Changing Regulatory and Compliance Environment

Minnesota bankers believe that overreach in Washington has resulted in rules that are too complex and too numerous as applied to the size of their banks. The quantity and complexity of the rules creates uncertainty in the examination process and how different federal regulators interpret the law. Community bankers state that this regulatory uncertainty has turned their focus from serving their customers and from innovating to regulatory compliance.

Minnesota bankers state that the quantity, complexity and uncertainty of new regulations impose costs that are difficult for them to absorb. They feel that they cannot afford all of the staff time required to figure out new regulations. Ultimately, Minnesota community bankers feel that they suffer from regulations that were designed for larger institutions.

Minnesota bankers feel that regulatory relief would help community banks increase capital to help grow the Minnesota economy. Additionally, Minnesota bankers believe federal regulators should take a more progressive stance on community bank innovation. For example, community banks might be able to share noncompetitive overhead costs and collaborate more in rural areas to decrease costs and benefit the bottom line.

New Mortgage Rules

Community bankers feel that new mortgage rules, such as the ability-to-repay and the qualified mortgage (QM) rules, put community banks at risk and restrict credit to consumers. Community bankers believe that the rules do not take the nuances of community banks' business models into account. Minnesota bankers state that they are afraid to make non-QM or balloon mortgage loans for fear of running afoul of new regulations, even when they believe those products have a good track record. New mortgage rules will ultimately restrict credit in Minnesota communities as banks pull back from real estate lending.

> "The value of the social capital that small banks have earned in the community is being reduced."

Minnesota bankers expressed hope their legislative representatives understand the problems that arise in communities when credit is restricted. Minnesota community bankers believe that the core of their business model is their commitment to building a strong community and that they should not be penalized for doing so.

Mississippi

> "Mississippi community banks with more than $500 million in assets are largely looking to expand their footprints by opening new locations and entering into new markets."

Greatest Local Opportunities and Challenges

Bankers from smaller community banks in Mississippi (those with less than $500 million in assets) see growing their existing customer bases as their best opportunity. Mississippi community banks with more than $500 million in assets are largely looking to expand their footprints by opening new locations and entering into new markets.

Most Mississippi bankers project that their earnings will increase approximately 10 percent. They also expect loan growth throughout 2014. Banks that do not project increased earnings for the year are in markets where unemployment still exceeds 10 percent, or that are in agricultural areas in which farm loans comprise a major portion of their portfolios. Loan demand is down in these markets due to a string of excellent crop years.

Mississippi community banks are also increasing their investments in technology. Over the past five years, bankers noted their technology-related investments have risen anywhere from 10 to 25 percent.

A majority of Mississippi bankers, regardless of bank size, identify regulatory burden as their greatest challenge. Local economic conditions present another challenge for a number of community banks, as a number of Mississippi counties still struggle with double-digit unemployment.

Most of the bankers reported other financial institutions to be their main competition. While smaller banks did not think they had a competitive advantage over other banks, most larger banks perceived that they did have a competitive advantage. Only bankers from some of the larger banks reported credit unions as competitors. Many bankers reported that the Mississippi Land Bank, a part of the Farm Credit System, is a major competitor for many of their loans.

New Mortgage Rules

Mississippi bankers report a wide range of effects from the qualified mortgage rule, based mainly on the market areas they serve. Many counties in Mississippi are designated as rural, low-income counties, and institutions located in these communities could benefit from the Consumer Financial Protection Bureau's small creditor exemption.

Changing Regulatory and Compliance Environment

Mississippi community bankers note that regulatory and compliance costs are a tremendous challenge to their institutions. Also, many bankers reported Bank Secrecy Act exams are now a major focus of the examination process.

Overall, most of the bankers report that their regulatory and compliance costs have increased by approximately 25 percent, while some state that their costs have risen by as much as 50 percent over the past few years.

Greatest Local Opportunities and Challenges

Missouri community bankers see commercial, noncredit services to be one of the most promising opportunities for their banks over the coming year. The New Markets Tax Credit program presents their banks with additional business opportunities. At least one-third of bankers believe that they will increase their loan portfolios in the next year.

Regulatory burden is the greatest challenge Missouri community bankers face. Federal regulators fail to differentiate between the community bank relationship lending business model and larger institutions' risks and practices. Nonbank competition is also a major concern for community banks, specifically the Farm Credit System, aggressive credit unions, Internet lenders such as Quicken Loans, and even Wal-Mart. The slow pace of the economic recovery has also taken a toll on community banks in Missouri. A potential challenge looms once interest rates begin to normalize. Agricultural conditions are currently good, due to strong commodity prices and low interest rates, but agricultural banks could suffer when interest rates begin to rise and if commodity prices fall.

New Mortgage Rules

The ability-to-repay and qualified mortgage (QM) rules have negatively impacted community banks' mortgage originations, hurting their bottom lines and ultimately the customers who look to community banks for mortgage loans. Simply put, borrowers are not uniform, and new mortgage rules strip community banks of the flexibility they once had to meet customers' housing finance needs through specially designed mortgage loans.

With new mortgage rules coming out of the federal agencies, one-third of Missouri bankers report that they plan to change how they approach mortgage lending products and services. However, an even larger number of bankers believe they will have to withdraw from mortgage lending if regulators do not expand exceptions for making non-QM loans. This belief is driven by the fear that community bankers might be required to hold more capital against non-QM loans.

Changing Regulatory and Compliance Environment

Missouri community bankers state that regulatory compliance costs have increased over the past few years, and that their resources are stretched thin as they try to keep up with evolving regulations. In their attempts to navigate and manage rising regulatory costs, community bankers have hired more compliance staff, turned to outside consultants and outsourced compliance to third-party providers to leverage their resources.

With rising compliance costs, Missouri community bankers say they lack the resources needed to explore new products or services. Bankers feel that they are being regulated out of business, as they spend hours creating new products only to find that there will be a regulatory or compliance obstacle that quashes the product before it is implemented. Community banks are hesitant to venture outside of regulatory boxes for fear of getting in trouble, and this means more standardized products and mechanical processes that lead to fewer consumer options.

Important Characteristics of Bank Management and Boards of Directors

Community bankers highlighted intelligence, initiative and integrity as essential characteristics for successful senior bank managers and boards of directors. They are looking for well-rounded leaders with a wider range of banking experience, including those with backgrounds in retail, wholesale and operations, and who are also adept at risk management. Community banks need leaders who can effectively communicate up and down the organizational chain and who are also open to change.

"Community banks are hesitant to venture outside of regulatory boxes for fear of getting in trouble, and this means more standardized products and mechanical processes that lead to fewer consumer options."

Montana

"Certain bankers feel that their banks are too small to survive and to be profitable without increasing their respective footprints and obtaining more efficient economies of scale."

Greatest Local Opportunities and Challenges

In today's economic and regulatory environment, community bankers in Montana face challenges that are numerous and complex. Opportunities, where they exist, are often coupled with uncertainty and their own set of difficulties. For example, Montana community banks are seeing renewed growth within the home construction industry—particularly in the eastern parts of the state. Despite this new business, the increased compliance costs associated with residential real estate lending are causing many banks to decide not to engage in this type of lending. In other parts of the state, opportunities in real estate lending are limited due to a large amount of housing still in flux because of the financial crisis. Overall, only a small portion of community banks in the state expect to see an increase in the dollar volume of 1-to-4-family mortgages in 2014.

Community banks in Montana continue to see increasing competition from the Farm Credit System, regional banks and large national banks. Competition from Farm Credit is not limited to agricultural real estate, and it holds significant competitive advantages over Montana community banks in terms of taxes, less regulation and the ability to have appraisers on staff. Large national and regional banks are able to offer lower rates and to handle credits without the same level of scrutiny that community banks would undergo for credits of similar size. As loan growth in the state remains low and liquidity levels remain high, loan competition is fiercest from these larger institutions.

Changing Regulatory and Compliance Environment

Bankers in the state agree that increased compliance costs associated with real estate lending present the biggest challenge facing their institutions. All Montana community bankers indicated that their compliance costs have increased over the past three years. Consistent with the 2014 *Community Banking in the 21st Century* national survey data, the majority of these increases are associated with "people costs," either in the form of hiring additional personnel, third-party vendor costs or increased time allocation among existing staff. In addition, finding qualified compliance staff or attracting qualified board members is difficult given the rural nature of the state. Community bankers are also increasingly concerned by rising information technology (IT) compliance costs and the balance between wanting to stay competitive through the offering of mobile and Internet banking services and the significant costs associated with doing so in a way that is safe for customers and their institutions.

When it comes to mortgage lending, Montana's results from the survey show that there is a hesitancy to take advantage of the small creditor exemption for qualified mortgage (QM) lending, or to offer balloon loans in rural areas. About 70 percent of Montana community bankers indicated that they are eligible to make balloon-payment QM loans in 2014 (significantly more than the national average), but only 50 percent of those banks indicated that they will make these loans (significantly less than the national average).

Regulatory burden is also cited by many Montana community bankers as a factor in their decisions relating to mergers. Certain bankers feel that their banks are too small to survive and to be profitable without increasing their respective footprints and obtaining more efficient economies of scale.

> "Larger community banks in New Hampshire are actively competing with the big national banks, especially through winning business accounts by providing strong customer service."

Greatest Local Opportunities and Challenges

New Hampshire community bankers see growth opportunities in their existing lines of business, particularly on commercial accounts and in terms of volume. There is also opportunity for competition among the banks. As an indicator of competition among fellow community banks, they are moving into each other's geographic markets through branching and expansion, specifically in the southern tier of the state. Larger community banks in New Hampshire are actively competing with the big national banks, especially through winning business accounts by providing strong customer service. New Hampshire banks are also open to merger opportunities that can lead to cost savings and larger market share.

There are more opportunities for growth in the southern tier of New Hampshire than in the northern tier. Bankers located in the northern part of the state indicate that the economy there has still not recovered. There is no new business formation activity, no expansion of business and no consumer lending. Many cash deals are being made on residential real estate. Bankers expressed a sentiment that New Hampshire is really a tale of two states: the northern tier and southern tier.

New Hampshire bankers feel that government regulation poses the greatest challenge to community banks. It seems that even state legislators feel that business is the enemy, with some state legislators recently coming after interchange fees in proposed legislation. Regulatory burden has resulted in significant time and money spent on compliance. In addition, government interference with bank business has gone beyond regulation to imposing government philosophies. For example, "Operation Choke Point" discourages banks from doing business with certain types of entities, despite those entities being legal.

Government regulation and oversight activities appear to be tied to the negative image of banks and antibusiness sentiment in general. Federal Deposit Insurance Corp. examiners have described their purpose as being to "protect the consumer." Community banks are left feeling on the defensive even though they have done nothing wrong. Generally, New Hampshire bankers feel that customers are happy with their community banks, yet the banks are cast as "bad."

Additionally, the most significant short-term problem is lower earnings. Interest earnings remain down while expenses are up, and rules and regulations make it difficult to collect "noninterest" earnings such as overdraft fees and interchange fees. Charitable giving and employment are lower due to higher costs and lower earnings.

New Hampshire community bankers strongly feel that their greatest competition comes from credit unions. There is an unlevel playing field in that credit unions act as banks, with the ability to have an expansive field of membership and a patently unfair tax advantage for doing exactly the same business. Credit unions are no longer small, discreet groups with a common bond. One credit union in New Hampshire advertises that "if you live and work in N.H., you're a member." Credit unions comprise a multi-trillion dollar industry that is tax-exempt. They are using their financial advantage to expand, to take over banks and to move into more profitable markets. Credit union call reports and financial performance reports are sparsely detailed in comparison with the information that banks are required to report.

New Mortgage Rules

Some New Hampshire community banks are not changing the types of loans they will offer but are tightening up the rules regarding income. Others are choosing to do only qualified mortgage (QM) loans. The smallest banks feel they cannot risk making non-QM loans. The QM regulations are slowing down the loan process, requiring approximately two additional hours of work per loan. This makes customers and real estate agents angry and adds to the negative image of banks.

New Hampshire bankers are concerned about their ability to continue securitizing and selling loans on the secondary market. They are also concerned about the lack of regulation around nonbank loan servicers.

Changing Regulatory and Compliance Environment

New Hampshire bankers' compliance costs have increased over the past few years. One community bank determined in 2012 that the cost of compliance at that time accounted for more than 90 percent of its total overhead costs, and that compliance costs have only gone up. To manage compliance costs, banks are using a combination of third-party resources and internal expertise, specifically senior staff. Regardless of the methods used, assessing and implementing rules and regulations in a community bank will always involve senior staff.

Customer service is the area most impacted by new regulations, as the plethora of lending regulations promulgated by the Dodd-Frank Act has moved employees away from helping customers to analyzing and implementing regulations. Even when a regulation ultimately does not apply to the community bank, it still requires employee hours to assess and make this determination.

Bank consolidations will continue unless something changes. One New Hampshire community bank's decision to sell was due, in large part, to regulation. In five years, New Hampshire bankers think they could see approximately half the current number of community banks in the state.

Important Characteristics of Bank Management and Boards of Directors

The most important attributes of today's community bank executive or director are a positive outlook, adaptability and a sense of humor. Banks are looking for board members who are more active and engaged in business and community, and individuals who can be real contributors. Like large banks, community banks are about processes and services. Unlike larger banks, they are also about people and community. Executives and directors need to represent a diverse spectrum and possess an ability to create new business and to get things done.

Greatest Local Opportunities and Challenges

Bankers in New Mexico are optimistic about promising opportunities stemming from customer frustration with larger banks. Attendees noted that big national banks have essentially abandoned New Mexico by reducing their emphasis on serving smaller customers, allowing community banks to gain customers and profit. For example, community banks in the state are seeing increased business from home builders who have become more active after a slow period that spanned the past five years.

Unfortunately, the challenges identified by New Mexico community bankers far outweigh the opportunities available to their institutions. The low interest rate environment continues to trouble banks in the state. The financial crisis of 2007-09 caused New Mexico to lose a significant number of jobs, and the state's economy has been slow in returning to a level where there is a healthy and productive labor force. The costs of compliance with new regulations, when coupled with low interest rates, have taken an especially heavy toll on small banks.

Another challenge facing New Mexico's community banks is competition from credit unions and nonbank financial services providers. Both are engaging in business lending, resulting in community bankers losing a significant portion of commercial loan opportunities.

New Products and Services

Community banks in New Mexico are finding it difficult to keep up with technological advances within the industry (such as mobile banking) due to the high cost of implementing these new technologies. Capital and earnings that were once used to support these new services are now being absorbed by compliance demands. Due to a 91 percent increase in compliance costs over the past three years, New Mexico's community banks are limited in their ability to offer new products and services.

Changing Regulatory and Compliance Environment

Bankers in New Mexico stated that the Dodd-Frank Act has doubled the cost of regulatory compliance and increased the number of days spent preparing for an examination. Community banks have been forced to hire additional compliance personnel, which has put additional stress on profits. New regulations have also made it nearly impossible for community banks to maintain their "relationship lending" business model. Due to fair-lending risk and uncertainty regarding the application of new regulations like the qualified mortgage and ability-to-repay rules, some community bank products that were once offered may no longer be available. Small business owners in the state, due to a lack of documentation surrounding income, are having a difficult time qualifying for loans due to the new mortgage rules. Many small business owners have excellent credit and equity but lack the documented income to show the ability to repay a loan. Prior to the current regulatory environment, community bankers were able to exercise discretion and accommodate these customers based on their long-standing business relationships.

Further research is essential to ensuring the survival of the community bank business model. The application of one-size-fits-all regulations on community banks will continue to suppress the growth of community banks. The current regulatory landscape is limiting the ability of community banks to work with small businesses across the state. The economy of New Mexico will suffer unless regulators craft rules that allow community banks to operate and thrive.

> "...big national banks have essentially abandoned New Mexico by reducing their emphasis on serving smaller customers, allowing community banks to gain customers and profit."

Important Characteristics of Bank Management and Board of Directors

Bank management and board members must keep actively involved in the oversight of today's banking environment. It is critical that they have the skillset to stay focused on the needs of the bank and the flexibility to tackle issues as they arise. Community bankers in New Mexico recognize the importance of bringing in new board members with experience in technology.

The Future of Community Banking

North Carolina bankers have many questions about the future of community banking, given the wide-ranging challenges in everything from regulations to economic developments to new technologies. The future looks uncertain, and the complexity of issues facing community banks seems to be only increasing. For example, community banks feel they could still be suffering the fallout from negative public perceptions of "too big to fail" institutions.

With the long-term decline in net interest margins, community banks are contemplating which products will allow them to remain profitable. Even if small institutions can continue to pull in profits, the industry seems to be facing an employment crisis, and community banks are struggling to attract new talent. The median age of employees at community banks is going up, and training young bankers to handle the complexity of today's banking challenges takes more time. All in all, North Carolina bankers are unsure about what the future holds for their institutions.

Community Banks and New Technology

North Carolina community banks are wrestling with the potential benefits and possible challenges of adopting new technologies. North Carolina bankers are considering how much they should be investing in new technology, especially mobile banking platforms. They also believe that their smaller size might provide them with an edge over larger banks when it comes to adopting new technologies. Mobile technology could allow community banks to "play larger than their footprint" and might be a growth strategy going forward. However, North Carolina bankers also expressed uncertainty about how potential regulations could impact mobile platforms, and when to expect such regulations.

Mortgage Market Concerns and New Mortgage Rules

North Carolina bankers expressed concern that strong potential borrowers are having trouble getting suitable loan products, due in large part to the way the secondary market is viewing community banks' mortgage loans. One banker reported difficulty in financing rural homebuyers due to a lack of interest from the secondary market. This banker's market involves a lot of family land and custom-built properties (outside major homebuilder subdivisions) that the secondary market is unwilling to consider based on variations in borrowing profiles and property types. Another banker reported documentation and secondary market difficulties with balloon loans. Although this institution is in a rural county with a total population of less than 60,000, it also falls in a metropolitan statistical area. Therefore, it will not benefit from the rural designation under the small creditor rule. As a result, documentation for non-QM balloon loans is prohibitively difficult, even though the economic benefit from three- to five-year balloon loans has a positive impact on the local economy.

Rethinking Regulation for Smaller Institutions

North Carolina bankers were vocal about the complexity of the current regulatory environment. They questioned whether there were significant regulations that could be reduced, such as the multiplicity and complexity of regulations on what were formerly simple matters. Community banks report lengthier compliance exams on their small portfolios. As such, the number of bank personnel hours expended on examinations has increased, and bankers question whether the rising regulatory compliance costs add that much value to the overall system.

North Carolina bankers discussed the idea of establishing a multi-agency and industry partnership that would work to identify a certain number of regulations each year for elimination. For example, such a commission could consider Regulation B, which implements the Equal Credit Opportunity Act and privacy notices. Bankers identified a lack of consistency in enforcement and violations in this area. Additionally, North Carolina bankers discussed how assigning values to the cost of regulations versus the economic consequence of such regulations could be helpful.

Community banks are concerned that the impacts of new regulations are not affecting all players in the financial industry equally. Regulators might need to rethink how they deal with smaller institutions, such as amending or considering additional factors beyond the prompt corrective action framework or the cost to the Federal Deposit Insurance Corp.'s deposit insurance fund when closing a small bank. Additionally, federal regulators might expedite application decisions for troubled community banks given that time is very much of the essence in these situations.

Questions still abound regarding fair-lending compliance. North Carolina bankers are unsure how Home Mortgage Deposit Act (HMDA) data is used, and worry about the consequences and costs of unintended fair-lending violations. They discussed whether fair-lending violations should involve an element of intent, and if there should be safe harbor defenses for inadvertent fair-lending violations that are revealed solely on the basis of HMDA data. North Carolina bankers are also worried about the effect of the many unwritten and unimplemented rules of the Dodd-Frank Act, and question whether some banks are simply too small to survive in the current regulatory environment.

Greatest Local Opportunities and Challenges

North Dakota bankers identified a variety of promising opportunities relating to the current banking environment. Specifically, they addressed taking advantage of the state's growing economy by expanding current programs and offering new products and technologies. Community bankers indicated the growing economy has led to increased loan volume and pricing opportunities and has allowed banks to branch into new communities. Enhanced mobile banking products were also seen as a way of reaching the market. Finally, they recognized the ability to use the Bank of North Dakota as a way of accessing the secondary housing market.

North Dakota bankers also identified the possibility of positioning their banks to take advantage of rising interest rates. Additionally, there may be the ability to enhance noninterest income by offering products relating to trust services and third-party processing.

North Dakota bankers face several challenges. One such challenge relates to the perceived regulatory burden, or as one banker called it, "regulatory fatigue." Many bankers indicated that their banks have been forced to hire both internal and external compliance officers, and these requirements have been costly in both time and money. Further, many bankers noted they fear their regulators.

Another challenge noted by bankers relates to competition from other nonbank institutions and specifically the unfair advantage that some of these institutions have over banks. These institutions include the Farm Credit System, credit unions and various other nondepository lenders. As examples of the unfair advantages that these groups have over banks, one banker addressed the "cherry picking" of loans by Farm Credit and the "tax-free" operations of credit unions. The bankers indicated that whether it is the tax advantages of credit unions, the ability of Farm Credit to pick the best loans available, or the lesser regulations enjoyed by nondepository mortgage brokers, banks do not feel that they have any significant advantages over their competition. They also indicated a concern that credit unions would soon be able to secure secondary capital. Community bankers are also concerned about the lines of credit offered by farming industry suppliers (aka suppliers' liens). Bankers indicated that many farmers take advantage of these credits to fund their operations, and the liens secured by the suppliers step into a superior position to the interests of the banks.

Community bankers also indicated that banks are having a difficult time finding experienced bankers. This is especially true for banks located in rural areas and located in the western side of the state. Another area of concern relating to employment had to do with health insurance and the changes occurring at the federal level.

North Dakota bankers expressed an understanding of the challenges surrounding information technology security and enhanced services to customers. Security breaches can seriously damage a bank's reputation, as any breach would be seen as the fault of the bank. The bankers also recognized that the costs of banking security are always on the rise. As a result, it is a challenge balancing the need for security and the costs of maintaining the security. North Dakota bankers added that although customers expect the best security available, they are generally unwilling to pay for it. Therefore, bankers find that they often have to educate customers about the costs of security.

New Mortgage Rules

North Dakota bankers pointed out that the increased mortgage rules have caused many smaller institutions to either quit offering mortgage services or attempt to partner with larger institutions that are better able to deal with regulations. In addition, the bankers stated that instead of referring borrowers to community banks, local real estate agents are increasingly sending borrowers to nonbank mortgage lenders. The bankers partially attribute this behavior to the fact that many nonbank entities are regulated to a lesser extent, or in their view, are completely exempt

from regulations. The group indicated that loan decisions are no longer made on the basis of safety and soundness, but instead are made based on compliance issues.

Changing Regulatory and Compliance Environment

Community bankers indicated that compliance costs have increased substantially due to the need for staff, consultants, attorneys and IT programming services. As a result, some banks have retreated from offering various products, and in some cases have ceased operations entirely or have merged into larger institutions.

While bankers see the need to further train employees in the area of compliance, they have indicated that many of their seasoned employees have left employment with their banks to avoid the stresses of increased compliance. North

The bankers discussed the fact that their IT software vendors struggle to keep up with the increased and evolving compliance burden.

Dakota bankers pointed out that the limited number of staff in community banks, combined with the steep learning curve for new employees, has in some cases resulted in periods where the bank has a lack of informed employees able to comply with bank regulations.

North Dakota bankers reiterated their position that mortgage regulation has substantially impacted North Dakota banks. Multiple bankers stated that their banks have experienced ever-increasing costs related to the need for compliance employees, consultants and attorneys. Additionally, the bankers discussed the fact that their IT software vendors struggle to keep up with the increased and evolving compliance burden.

Another area of evolving regulation that was discussed related to FAS 166 (ASC 860): Accounting for Transfers of Financial Assets. The community bankers noted that the accounting rule has had a negative impact on banks because it restricts their ability to repurchase loans sold to a participating bank, even when circumstances have changed for the bank.

Important Characteristics of Bank Management and Boards of Directors

North Dakota bankers asserted that a community bank's executive management and board must be flexible and willing to change, even when such changes are uncomfortable.

Greatest Local Opportunities and Challenges

Ohio community banks' greatest opportunities are fueled by continued economic growth and lower unemployment. Ohio bankers are expanding in existing markets as well as reaching out to new markets for new customers and offering new products. Ohio community banks have seen some growth in existing markets as larger regional organizations redeploy their resources and products and services. Ohio community banks continue to enjoy an advantage of knowing and understanding their customer base, which allows them a potential advantage over larger banking organizations. Wealth management services are another area of growth, particularly in eastern Ohio, which benefits from shale-based energy production.

Ohio bankers mentioned that finding the right personnel to work with new customers in new markets is a challenge. Additionally, Ohio banks are struggling with board and management succession. It can be difficult to attract good potential directors and younger talent to bank management. Community banks noted that larger regional banks are challenging competitors, especially for commercial real estate loans. One banker expressed a concern regarding pre-paid cards that can function as a demand account for the consumer, potentially capturing what may be viewed as the "underbanked" population.

New Mortgage Rules

Most Ohio bankers felt there would be no significant impact from the new qualified mortgage and ability-to-repay mortgage rules. By and large, Ohio banks are portfolio lenders, and thus the impact may be minimal, especially as it relates to alternative mortgage lending. Most Ohio banks that were originating nonconforming products will likely continue to originate portfolio loans not covered by the new mortgage rules. There is some concern about the potential of future litigation based on these new rules. Bankers expressed a concern regarding the potential for a shockwave in the mortgage lending market when the first lawsuit is eventually filed.

Changing Regulatory and Compliance Environment

Ohio bankers remain concerned with ever-increasing compliance costs, especially as the need for third-party expertise is growing to meet regulatory requirements. This additional cost burden, along with narrowing margins, is putting increased earnings pressure on Ohio banks. Some Ohio bankers feel that concerns about regulatory burden just need to be accepted, and that banks should put forth best efforts to implement changes resulting from new regulatory requirements.

Important Characteristics of Bank Management and Boards of Directors

Successful Ohio banking organizations have boards of directors and management teams that have strong connections and active involvement in their local communities. Board and management teams that can adapt to changes in the marketplace, technology and regulatory requirements will have the best chances of succeeding. Several Ohio banks are working with younger staff members from a training perspective to build the leaders of tomorrow's banking organizations, including implementing a mentoring program that pairs senior executives with more junior staff members. Other Ohio bankers are using more traditional training sessions to facilitate knowledge exchange.

"Several Ohio banks are working with younger staff members from a training perspective to build the leaders of tomorrow's banking organizations, including implementing a mentoring program that pairs senior executives with more junior staff members."

Pennsylvania

Greatest Local Opportunities and Challenges

For Pennsylvania community banks, the most promising opportunity is the return of customers who are looking for better customer service. Consumers are commenting they are tired of "big banks" and their level of customer service and like the face-to-face transactions at local banks. Customer service is a local community bank's competitive edge.

Most Pennsylvania community banks are hesitant to develop new products or services. They prefer to let the larger banks lead with product diversification and new technology opportunities. Once these products and services are proven and the costs are reduced, community banks will then adopt the new products to be competitive without all the overruns from the trial-and-error stage. However, a few of the smaller banks were adding features to electronic banking to keep pace with national trends. In addition, banks are increasing their presence in online banking services to attract the younger generation to community banking.

Pennsylvania bankers expect a moderate improvement in the economy in 2014. Small businesses are expanding operations slowly due to a sluggish economy. Consumer confidence is low, as demonstrated by lower and slower "new money" loan applications.

Most community banks have little resources for new product development. They are stretched thin by the need to cross-train existing personnel to cover all the regulatory and compliance burdens and by the need to bring in their legal teams to address and clarify the regulatory rules regarding mortgages, capital requirements, privacy laws and information technology (IT) threats.

Pennsylvania community bankers see several challenges, including the Federal Reserve's artificially low interest rates, uncertainty over the continued implementation of the Dodd-Frank Act, Consumer Financial Protection Bureau "trickle down" fears, cybersecurity concerns and a sluggish economy.

Community bankers expressed concern with increased competition from new market entrants such as more aggressive credit unions, Wal-Mart and nontraditional lenders.

Cybersecurity issues are also a concern among Pennsylvania bankers. Banks with $300 million to $500 million in total assets stated that a single cyberattack could "shutter the bank." Banks with higher asset levels were adding additional levels of internet security.

New Mortgage Rules

The qualified mortgage (QM) rule and ability-to-repay (ATR) standards have not changed the types of loans Pennsylvania community banks are willing to make. They state these rules make little difference, as they never were involved in originating risky mortgages. Many keep their mortgages in-house and rely on mortgage servicing fee income. Some indicated they will not approve a non-QM loan due to potential litigation and reputational risk. Pennsylvania bankers also commented that, based on their strong relationships with their communities, they will make occasional exceptions to the rules to help those in their communities. However, some customers who need financial assistance will ultimately pay a higher price with another institution.

Changing Regulatory and Compliance Environment

Some Pennsylvania banks are targeting only QM mortgages, while the few that even consider offering non-QM mortgages are maintaining them in-house. Due to the changes in regulations, bankers state they are losing their competitive edge. Pennsylvania community banks are losing distinction from big banks, including the number of days it takes to close a loan and the inability to approve a loan based on a consumer's character. New regulations have increased expenses, and limited staff must be cross-trained on all products.

The overall regulatory burdens being placed on community-focused banks for compliance, and the costs associated with them, along with their already reduced/compressed margins, are an earnings concern. Many community banks are expressing that the regulatory agencies do not want them to succeed and are more concerned with the larger banks. Community banks are stretched with their expanded roles, including spending more time with issues related to the Bank Secrecy Act, the filing of Suspicious Activity Reports and the move toward increased monitoring and reporting of financial elder abuse.The most effective way for community banks to handle changing regulatory and compliance costs is through dedicating more staff and resources. While community banks with less than $2 billion in assets were not specifically tracking the compliance costs, the majority of banks in the survey stated they had increased costs and time delays. Some banks estimated the cost increase to be as much as 30 percent per loan.

Important Characteristics of Bank Management and Boards of Directors

Pennsylvania community bankers almost always turn the discussion to the topic of finding appropriate executive management and directors, since many are getting close to retirement and succession planning is a cause of concern. Executive management is typically replaced from within the institution, but there are limited exceptions. They know the person, and the person is familiar with the bank's policy and community mission. Community bankers are looking for candidates with experience throughout the different economic and regulatory climates over the past 20 years and who are able to use that experience to protect and grow their banks' business models.

Board directors are more difficult to replace. Community banks indicated that they are looking for new directors who are dedicated to the bank, who are involved with the community and who have strong business backgrounds. The challenges of obtaining qualified board members include the prospect of increased board scrutiny and possible legal actions against board members.

Key Changes Since Last Year

Pennsylvania bankers definitely had a more positive attitude since the last meeting. Many are modestly upbeat with the increase in mortgage activity and commercial lending. They are also adapting to the increased regulatory burden and the increased threat from IT issues.

More than half of the community banks in the survey thought merger and acquisition activity would continue to grow. Surprisingly, the smallest banks were not necessarily the ones discussing mergers and acquisitions. Banks located in niche markets were confident about their future in banking, whereas banks located in more competitive areas with lower asset levels thought merger and acquisition activity would continue.

Many of the institutions' boards of directors have become hesitant to expand loan products and services. Board directors are content with their current business models and refuse to explore other opportunities. They are "hunkered down" and watching the slow economic recovery and the lingering regulatory uncertainty.

"Pennsylvania's community-focused bankers are increasingly upbeat about the Commonwealth's steady, albeit slower-than-desired, economic recovery. The impacts, both direct and indirect, derived from the booming Marcellus Shale gas industries and the recent Philadelphia Fed-reported significant increases in manufacturing activity are providing increasing numbers of jobs, boding well for their future banking efforts. Their earnings—affected by tight margins and increased compliance costs—remain a concern, but the boards and management teams are clearly moving from the 'survive' to the 'thrive' stage of this recovery period."

South Dakota

Greatest Local Opportunities and Challenges

Strong economic conditions in South Dakota are contributing to increased loan demand for the state's community banks. Bankers are also seeing growth in their agricultural lending portfolios as a result of a recent moderation in commodity prices. Community bankers are optimistic that their institutions will be able to grow into new markets in the coming year.

The greatest challenge for South Dakota's community banks is competition from nonbanks. Traditional competitors, including Farm Credit and credit unions, benefit from substantial tax advantages. In addition, local agricultural suppliers finance their own products, leading to a further reduction in loan demand for community banks. These suppliers are not required to be licensed as lenders under South Dakota state law. Despite this competition, community bankers still feel that they are able to generate business due to long-term relationships they hold with customers, loyalty to the community and the ability to provide more customized products and services.

Regulatory impediments to residential lending, especially in rural parts of the state, pose significant challenges for banks and the communities in which they operate. The lack of qualified appraisers is a huge roadblock to residential lending in rural South Dakota. The requirements of the Federal Financial Institutions Examination Council's appraisal subcommittee for becoming an appraiser should be reviewed to ensure that they do not discourage potential candidates from joining this line of work. In addition, the costs of complying with new and changing regulations have increased dramatically, resulting in limited options and higher costs for customers.

New Products and Services

Only a limited number of the state's community bankers indicated that they would be offering new products or services in the coming year. Mobile applications are a focus of banks; however, institutions are wary of undertaking technology initiatives for multiple reasons. Given the high costs associated with implementing new electronic products and services, community bankers do not expect to generate significant revenue from mobile and online banking applications. Despite the costs, these initiatives are seen as critical for the purposes of retaining customers and competing with larger institutions. Not only are the costs of production and implementation significant, but community banks must also absorb the regulatory costs associated with appropriate due diligence and cybersecurity. Faced with these compounding costs and risks, many institutions have decided to forego plans for expansion in this area.

Changing Regulatory and Compliance Environment

Residential lending in rural areas has been the area of business most impacted by a changing regulatory environment. The impacting regulations are not limited to the Consumer Financial Protection Bureau's qualified mortgage rule, but also include appraiser requirements and requirements of the secondary market to qualify a loan for sale. Many rural communities have been cut off from the secondary market for years due to a lack of qualifying comparable sales. With regard to the CFPB's mortgage rules, community banks in South Dakota would like to see a carve-out that would grant qualified mortgage status to all loans held in portfolio.

South Dakota's community bankers noted that compliance costs have more than doubled over the past three to five years. Staff members are burning out quickly, and management teams are finding it difficult to recruit new loan officers and other staff, especially in rural areas. Overall, bankers feel that enhanced compliance efforts offer no benefit to the institutions or their customers.

Management Characteristics

Candidates must be willing to take on an extremely high level of risk with little or no reward to serve as a community bank director. These positions used to be a matter of pride and prestige in rural communities, but increasing liability has made these positions difficult to fill. Passion for the community and the community banking business model is necessary to overcome numerous obstacles while maintaining a positive attitude.

Greatest Local Opportunities and Challenges

The greatest opportunity for community banks in Tennessee is very much dependent on the size and location of a given institution. Community banks within metropolitan statistical areas have seen an increase in demand predominantly for residential real estate loans. However, maintaining a balanced loan portfolio while limiting reliance on commercial real estate lending is a challenge that has come with growth in this business line. In addition, growth in real estate lending, coupled with the uniformity of products offered to consumers, poses an increased concentration risk for community banks.

Smaller banks in rural areas of the state have continued to struggle with a lack of loan demand. For these institutions, the only "opportunities" may exist in consolidation. Soaring compliance costs have contributed to an environment where it is almost impossible for small community banks to provide an adequate return to shareholders. Rather than shutting down, merging with other local banks could allow these institutions to reduce compliance costs and continue to serve their communities. Other opportunities are not dependent on size or location. For example, recent changes in state trust laws have opened doors for banks to provide trust services to their customers.

New Mortgage Rules

The consensus among community bankers in Tennessee is that the new rules have made mortgage lending an exceedingly complicated process. Senior employees with years of mortgage experience struggle with the uncertainty surrounding the application and interpretation of these rules by examiners. The lack of clarity presents a difficult environment for banks that pride themselves on doing things the right way. Given the difficulties faced by senior staff, bringing new employees up to speed on the rules can be an insurmountable task. In light of the new rules, bankers will continue to approach every loan with due diligence and customers can expect to see a slower loan environment. For community banks in Tennessee, the mortgage rules exemplify the federal regulator's lack of understanding of the community bank business model. Qualified mortgage (QM) loans are not structured for the average community bank customer. To best meet the needs of their local communities, some banks have made the decision to take on the risk of making non-QM loans on a case-by-case basis.

Community bankers noted that the new mortgage rules and associated fair-lending risk have forced their institutions to reduce or eliminate the offering of certain products, including consumer loans. Community banks have traditionally been able to accommodate a customer based on their individual finances and needs. These institutions would often make the loans that the large banks and the secondary market did not want. Today's community banks are driven to a very narrow product base. Multigenerational relationships between a community bank and its customers can no longer be taken into consideration. Banks can no longer focus on how to help their customers. Instead, the focus is on how to tailor a loan to make it work within the framework of the mortgage rules. Federal regulators fail to understand community banks' use of other loan products such as balloon loans and adjustable-rate mortgages. Given that most QM loans will be 15- or 30-year fixed mortgages, there is concern among community bankers that their institutions and customers will be steered into interest rate risk sensitive instruments.

Tennessee's community banks need guidance from federal regulators that will better prepare them for upcoming examinations that will include compliance with the mortgage rules. If given clear guidance, community bankers in the state would have the ability to confidently vet their product offerings and operations to ensure compliance. Simple questions remain to be answered, such as whether compliance with the mortgage rules will be examined through compliance or safety and soundness examinations. Overall, there is concern about the negative impact on local communities due to these rules. When a bank is unable to finance a home for a deserving customer, there is a trickle-down effect on home builders, truck drivers and suppliers. Employment and investment in the local economy will also suffer when housing credit is constrained. The mortgage rules make sense for loans that are available for sale; however, for banks with skin in the game, these rules should not apply.

Changing Regulatory and Compliance Environment

There is significant concern about the "one-size-fits-all" approach to supervision. This approach runs contrary to the relationship-based business model of community banks and limits the ability of institutions to offer the right product to their customers. Flexibility used to be a key selling point, yet in the current environment, banks no longer have the opportunity to be nimble. Products that can be offered to consumers now look identical to those provided by regional or nationally active banks. To be able to compete, community banks need to be able to differentiate themselves from their large bank counterparts.

Compliance costs have soared for community banks in Tennessee. Some bankers have noted as much as a 500 percent increase in regulatory (compliance) costs over the past five years. The proliferation of new rules has made it impossible for a single person to handle compliance at a given institution. Some institutions have sought to build a comprehensive "team" of employees to handle compliance. Banks across the state are seeking experienced compliance staff who specialize in the Bank Secrecy Act and other compliance areas, and it is very difficult (particularly in rural areas) to find that kind of expertise. There are a handful of private consultants in the state that work with community banks, yet even their resources are limited. Tennessee bankers have discussed the possibility of hiring compliance personnel to serve a group of banks. This appears to be an attractive option for banks struggling to hire experienced compliance personnel; however, there is concern that participating banks could face increased systemic risk due to the possibility of one mistake being shared across institutions.

There is a need for an overarching supervisory approach to the evaluation of new products and services. In addition, there should be a learning period following the release of a new rule. Guidance is still forthcoming on multiple regulations, and community banks fear that examiners will fail to take this lack of clarity into account when examining institutions for compliance with new rules. The primary goal of policymakers should be to "do no harm" when considering new guidance. To limit unintended consequences for community banks, federal regulators need to carefully consider the costs and benefits of proposed guidance and regulations. Community bankers in Tennessee continue to look to federal regulators for guidance that will provide clarity on the application of new rules.

Greatest Local Opportunities and Challenges

Community banks in Texas are embracing technology to compete with larger institutions. For example, Texas bankers have found that remote deposit capture is one way to stay competitive and are generally offering these services to medium-sized businesses. However, technology is also a double-edged sword in that face-to-face customer service is sacrificed. With somewhat diminished personalized service that community banks have historically offered, they must compete more aggressively in pricing. To maintain the personal touch, Texas bankers stated that they are expanding their market through mobile banking, and more than a few bankers plan on opening branches and moving into new markets with traditional physical presence and community involvement. Regarding risk management, community banks are also increasing investments in technology, spending more on fraud detection and data security, and upgrading ATMs and workstations due to the phase out of Windows XP.

While Texas bankers stated that they face challenging competition from a wide variety of financial institutions, they voice a greater concern about competing against the federal regulations coming out of Washington, D.C. Regarding institutional competition, big banks often offer rates and terms that community banks cannot match. Credit unions are now going after larger commercial loans, some as high as $5 million. In rural areas, the Farm Credit System is a very large competitor and takes community banks' high-dollar, high-quality loans at rates and terms that are very competitive. Many consumers are forced to go to payday lenders for small-dollar loans, even though they would prefer to receive a loan from a bank. Community banks would love to make these loans, but the fear of noncompliance and the reality of a prolonged "penalty box" status if compliance issues are alleged, have driven many bankers out of this market or at the least eliminated small-dollar consumer loans as an option.

Many consumers are forced to go to payday lenders for small-dollar loans, even though they would prefer to receive a loan from a bank.

New Mortgage Rules

Only a handful of Texas bankers say that they will continue making non-qualified mortgage (QM) loans, and most of this group say the new rules deter them from making more of these loans. They cite the inordinate amount of time required to document non-QM loans to perceived federal standards. Historically, bankers focused on character and repayment capacity in making mortgage loans, but they have shifted to making sure loans stay within the regulatory box. One banker noted that his community bank made about 900 loans last year, but that he only expects to make about 400 this year.

Texas bankers are more concerned about the negative impacts from the ability-to-repay (ATR) standard. Many good prospective loans are turned down because of ATR's strict documentation requirements. For example, self-employed individuals often lack the requisite documents needed to comply with ATR. Additionally, many rural customers are self-employed or sole proprietors. Texas bankers have been doing business with these types of customers for years on commercial loans, but the new rules keep banks from also extending them mortgages.

Texas community bankers were strongly supportive of measures that would grant QM status to loans held in portfolio.

Changing Regulatory and Compliance Environment

Texas bankers stated that just trying to keep up with the vast number of regulations being issued is a challenge, and once they think they have a working knowledge, new ones are issued. New rules represent a lost opportunity for the banks because they must divert an increasing amount of funds to compliance issues, rather than customer service and helping customers meet their financial needs. Banks would like to grow by increasing services, but the regulatory environment forces everyone in the bank to focus on getting compliance right before expanding services or exploring new opportunities.

Basically, community bankers feel they have been regulated out of consumer lending, which has been especially detrimental to rural community banks and the customers in those markets. Consumers are forced to get the credit they need from alternative lending sources, such as payday lenders.

Generally, community bankers are struggling to attract and retain the necessary staffing to keep up with all of the new rules and regulations. Indeed, half of the bankers stated that they have been forced to hire additional compliance staff, and pay for these compliance officers was roughly 20 percent higher than previous compliance staff. Even with a competent compliance officer, outside consultants are usually required to supplement the compliance program, and costs continue to rise.

Texas community bankers believe the federal philosophy toward compliance examinations has deteriorated over the past few years to a game of "I'm going to get you" rather than a balanced review of the facts and, if inconsistencies are identified, working with the institution to achieve a fair and timely remedial response. Because of federal regulatory pressures, community bankers are now forced to focus much more on compliance. One banker estimated that his institution spends about 70 percent of its time on compliance risk management and only 30 percent addressing general safety and soundness issues. Another banker noted that his bank's compliance exam took nine weeks, while his safety and soundness exam lasted nine days. The banker was questioned about why he had given a $3,000 loan to a 79-year-old widow with poor credit, but had turned down another borrower with a better credit score. The widow had needed the loan to bury her deceased husband, and the banker expressed frustration about having to justify every single one of his bank's actions.

Many of the bankers used "intimidation" to describe their federal compliance examinations. They did not know what they would be asked, and examiners were combative and often had the same questions about the rules and regulations that bankers had.

Texas bankers commented about spending the most money on fair-lending compliance. They feel that they cannot deviate from a scoring matrix because the time and expense is too high if an examiner finds an exception. Community banks feel that examiners unnecessarily probe to find problems with a bank's matrix. Bankers feel this regulatory attitude has stripped them of the discretion they once had and need to make loans to service their community. In the end, the banks and consumers lose.

Ultimately, Texas bankers believe that the federal government does not know the true benefits and services that community banks provide. They feel like politicians and regulators have given them lip service since the crisis started, and that new regulations keep coming and negatively impacting community banks and consumers.

The Future of Texas Community Banks

Texas bankers offered a number of predictions regarding the future of their institutions and the character of community banking in the state. Some were optimistic that there would always be demand for the high levels of customer service that only community banks can offer. Community banks will always exist, even though they might have to change their business models. Other bankers pointed to aging bank management, a lack of succession plans, lucrative merger offers, and regulatory costs and fatigue as reasons for continued consolidation in the Texas banking market.

Greatest Local Opportunities and Challenges

Utah community bankers see the fairly strong economic conditions in Utah as an opportunity. Small business growth will provide opportunities for community banks. Also, smaller community banks seem to have an advantage in customizing products to meet their customers' needs. However, bankers feel that, more and more, the regulatory burden is limiting the ability to customize and therefore taking away this advantage. Bankers mentioned that overregulation ultimately leads to standardization.

In terms of new products and services, Utah bankers mentioned that the two major issues with any new product or service are information security and regulatory compliance. If these two areas are not right, they likely will not be successful. Consumers expect information security issues to be in the background, but when problems surface, this erodes confidence in using electronic means for transactions and becomes a problem and a hindrance to new offerings.

Utah bankers face a number of competitive challenges. Credit unions have cornered the consumer business market and now are getting into small business lending. Large national and regional banks are poaching smaller and smaller business customers, and they are willing to undercut rates to get the business. Competition is also increasing from the nonbank and nontraditional arena. Alternative payment methods and branchless banks are attracting customers. However, community banks feel their advantages over these competitors continue to be strong service and value-added products.

Utah bankers mentioned that customers are used to very low loan rates, and as rates continue to increase, this may affect loan demand in the future. Another major concern is in the area of information security. This is a huge area and a growing concern. With breaches, electronic theft and fraud in the news, coupled with increasing customer demand for online and mobile banking, it is a constant and growing battle for community banks.

New Mortgage Rules

Utah bankers stress that new mortgage rules keep them from helping and serving customers like before. Going forward, there can be no customization of mortgage loans. Banks are being forced to make cookie-cutter loans, which hurts community banks' historic ability to offer flexible mortgage products.

Changing Regulatory and Compliance Environment

Utah bankers cited regulatory burden and costs as the primary challenges to their businesses. Their focus on consumer compliance and new mortgage requirements has dramatically increased. Most banks have seen costs increase because of the need to hire compliance personnel and are spending substantially more time in this area. Hiring additional staff has resulted in huge cost increases, and the only way to sustain regulatory changes seems to be through growth.

Important Characteristics of Bank Management and Boards of Directors

Utah bankers believe senior leadership must be able to adapt to change while remembering their bank's core values and appropriate risk tolerance. This is crucial in being able to understand and operate within the regulatory environment. There are many smart, creative people out there, but it is tricky to be successfully creative within a heavily regulated industry.

Board leadership must possess integrity and have an understanding of banking. Boards should also reflect a healthy cross section of the community. Finally, Utah bankers thought it was important to have the right chairman in place to provide the guiding leadership and vision for the bank.

Banks are being forced to make cookie-cutter loans, which hurts community banks' historic ability to offer flexible mortgage products.

Vermont

Greatest Local Opportunities and Challenges

Vermont bankers see that customer dissatisfaction with large national banks has created opportunities for community banks. Customers appreciate the personal service they receive from community banks.

The recession forced Vermont's community banks to adopt many cost-saving initiatives. Their overhead costs have been reduced and are now set. They are well-positioned for any improvements in the economy. Thus, any increase in the net interest rate margin will flow directly to the bottom line.

The community banks are starting to see some improvement in the economy. This should provide increased loan opportunities.

Improved second-generation technologies, such as 24-hour banking and mobile apps, provide some promising opportunities to attract a younger market. Vermont bankers are not looking to offer new products. Rather, they are looking at new ways to offer their products, particularly to a younger market that increasingly uses mobile and electronic banking.

The greatest challenge to community banks is the prolonged low net interest rate margin. The current net interest rate margin is not sustainable. It negatively affects the banks' earnings and will make it difficult for community banks to survive.

The commoditization of nearly every product and service a bank offers makes it difficult for a community bank to compete and negates one of the biggest advantages a community bank can offer—specifically, the quality and personalization of its products and services. One Vermont banker stated that regulations are so strict that they inhibit operations and make every product and service homogenous. This limits innovation and the ability to adapt loans to the market he serves. The banker argued that if all products and services are homogenous, his community bank has to do everything like a big bank, and he loses his ability to compete.

In terms of local competition, credit unions are a high concern for Vermont bankers. The tax-exempt status of credit unions poses a threat to community banks. Community bankers do not see credit unions using their tax advantage to provide lower interest rates on loans, to provide better rates on savings accounts or to put their tax advantage back into the community. Rather, Vermont bankers see credit unions using their tax advantage to build bigger and flashier buildings and to increase their advertising and marketing activities. Community banks consider this an unfair tax advantage.

Vermont bankers are also concerned about the increasing frequency with which credit unions use the terms "bank," "banking" and similar terms in their marketing efforts. Community banks are concerned that a credit union's ability to use terms such as "bank" and "banking" increases the advantage credit unions already have due to their tax-exempt status. They are also concerned that it desensitizes the public to the differences between banks and credit unions.

Changing Regulatory and Compliance Environment

The cost to comply with regulations and mandates has significantly increased, resulting in costly allocations of personnel and technology. Vermont bankers are increasingly concerned that banks are an easy target to police various activities and federal mandates. Furthermore, these unfunded mandates and increased compliance costs do not add to the bank's profitability; rather, they detract from banks' bottom line and banks' ability to serve their customers.

In addition to hiring personnel and purchasing technology, community banks must also contract with third parties to comply with increasing regulatory burdens. Community banks can no longer meet all of their regulatory requirements with in-house personnel. Contracting with third-party specialists creates additional burdens for community banks, as they must meet the due diligence standards of federal regulations before contracting with third-party specialists.

Vermont community banks are not given sufficient leeway to market their services, and they do not receive adequate credit for the things they do well. If the bank makes a loan that is permitted by a regulation, but is not strictly within a safe harbor, regulators will raise a safety and soundness concern. This disconnect between what federal regulators are saying in examination reports and what a regulation permits creates a significant challenge to the banks' ability to compete in communities that they know very well.

Leadership Challenges Facing Community Banks

Vermont banks are having difficulty finding eligible candidates to fill middle- and senior-level management positions. Community banks are increasingly having to recruit out of state, but are having difficulty filling the positions due to a perceived high cost of living in Vermont. It is also difficult to compete with the higher salaries offered in non-rural areas. Vermont bankers are concerned that this could create a real void of bankers with the education and experience to manage the banks as current management teams move closer to retirement.

Vermont community banks are also having a difficult time finding qualified candidates to fill vacant bank director positions. Increased regulatory requirements, potential personal liability and the increased time commitment all contribute to the difficulty in persuading qualified candidates to be directors.

Greatest Local Opportunities and Challenges

Virginia bankers see opportunities in commercial lending, wealth management and residential mortgage lending. The opportunities in commercial lending and wealth management are consistent with their outlook for the economy, with 66 percent of the bankers at least "somewhat optimistic" on the 12-month economic outlook. Virginia enjoys a highly diverse and balanced economy driven by state and federal government, military, manufacturing, information technology, higher education, agriculture and tourism.

Virginia banks believe they will need to emphasize electronic banking and payments over the next three years. This is an expected reaction to continued improvements to technology, ease of adoption and customer demand. Virginia banks are generally positive on their capabilities in this area, with 71 percent of banks stating they are at least "superior to some" of their top competitors in their technology capabilities.

Virginia banks are facing challenges in the marketplace stemming from irrational pricing and underwriting. This is primarily occurring with commercial loans, as many banks chase the same opportunities in a limited market.

Virginia bankers generally describe a tougher competitive environment, consistent with the concerns expressed with pricing and underwriting. Almost no banker described a less competitive environment. Looking to the future, Virginia bankers are generally open to strategic mergers, but only a minority is aggressively pursuing them. In a rather interesting insight into the future, Virginia bankers were recently asked about the impact of changes in the banking industry. Fifty-four percent responded that the changes would be more than some could handle, with an additional 26 percent stating that the changes would be more than most could handle.

New Mortgage Rules

While opportunities in mortgage lending appear contrary to conventional wisdom, many Virginia banks operate in robust housing markets that benefit from the state's major economic drivers. Bankers expressed concerns about complying with the new mortgage rules, but overall believe they have the ability to comply. Many Virginia bankers continue to see mortgage lending in particular, and retail banking in general, as an important profit center.

"Bankers expressed concerns about complying with the new mortgage rules, but overall believe they have the ability to comply."

Changing Regulatory and Compliance Environment

On the regulatory front, Virginia banks continue to be focused on the ongoing implementation of the Dodd-Frank Act and specifically the start-up of the Consumer Financial Protection Bureau. At this stage of implementation, the concerns appear to be mostly of the "unknown." While concerns about regulatory examinations remain, the broad-scale concern seems to be declining.

West Virginia

Greatest Local Opportunities and Challenges

Community banks across West Virginia are seeking to expand their markets into areas with higher loan demand. With the recent decline in coal mine production, banks in the southern region will explore new markets and find new customers, while banks in the eastern region will take advantage of a slight increase in real estate values and a rebound in the timber industry by increasing land development and residential construction loans.

Personal relationships remain the single greatest competitive advantage of the community banking business model. West Virginia banks will continue to employ the traditional model of building meaningful relationships with borrowers in the communities they serve, while also expanding technology with particular focus on new mobile banking technologies to attract and retain the next generation of customers. West Virginia banks are also prepared to review, revitalize and market existing product lines to generate new sources of revenue.

West Virginia community banks have become increasingly reliant on noninterest income. New products and services are often developed as a means to supplement core profits. Some West Virginia bankers have added, and others are considering adding, the sale of insurance and other financial services to bolster income. Community banks throughout the state have also initiated plans to expand banking services through new technology and mobile banking.

Community banks face a number of hurdles in developing and implementing new product lines and new banking service portals. Costs are a significant factor for community banks. Development and infrastructure costs associated with new lines of business and new technology can be prohibitive, especially when considering size and scale of the communities served in this region. The cost of ensuring regulatory compliance and data security are also increasingly significant.

West Virginia community banks face a unique challenge with regard to mobile banking technology, as the community banking business model has always centered on face-to-face transactional relationships with the customers they serve. As the use of new mobile banking technology becomes more widespread, bank customers become further removed from the bank, and the relationship becomes more remote. West Virginia bankers feel they must find ways to strike a delicate balance between offering their customers the convenience of remote mobile banking while preserving the important personal relationships they have developed with the individuals in the communities they serve.

West Virginia bankers also report a challenge in finding, recruiting and retaining managerial talent. Furthermore, competition from both large regional banks and mega banks remains tough, and tax-exempt credit unions continue to siphon off potential customers. The emerging payment system is a new and burgeoning threat to the current payment system and threatens the way community banks do business.

In other areas, the economic recovery is extremely slow, both nationally and locally, and with an aging and declining population in many communities across the state, West Virginia banks are dealing with a shrinking customer base and diminished loan demand. The next generation of bank customers' increasing demands for new technology, including free mobile and online banking, drives up costs without a corresponding increase in revenue.

West Virginia banks face tough competition on several fronts. Community banks now compete for lending opportunities with out-of-state, Internet-based, nondepository lenders and larger regional banks. Both take advantage of their size and scale in pricing loans to stay competitive in the smaller more remote markets. In the auto lending market, community banks are up against automobile dealers offering their customers highly competitive dealer financing options. These institutions perpetually innovate and modernize their products and services.

In the face of constantly evolving competition from the outside, community banks are steadfast that their business model—centered on knowing the customer, understanding the community and the needs of the local marketplace, and building individual relationships intent on meeting those needs—is the key to maintaining an edge over their competitors.

New Mortgage Rules

New and developing regulations have had a significant impact on the ability of West Virginia bankers to make residential mortgage loans. The highly subjective calculations that must be made to comply with the ability-to-repay (ATR) requirements, particularly with regard to self-employed borrowers, scare many institutions away from lending to those individuals, denying a portion of would-be borrowers the opportunity to buy a home. Many of these institutions serve subprime markets, and new rules and regulations relating to high-cost mortgages and the mandatory escrow accounts make it very difficult for them to price the risk. This is unfortunate as West Virginia bankers see little to no value afforded to the consumer by the recent rules on qualified mortgage and ATR. Both residential mortgage and construction lending have been hindered by uncertainty, fear of non-compliance, risk of litigation and diminished profitability.

Changing Regulatory and Compliance Environment

Ongoing developments at the federal regulatory level continue to be a primary source of concern for community banks throughout the state. New regulations have restricted traditional sources of revenue for some banks, and net interest margins remain very low. As the rule-making and implementation of various provisions of the Dodd-Frank Act advance, and the Consumer Financial Protection Bureau expands its enforcement authority over newly adopted rules and regulations, a sense of uncertainty persists. In addition, West Virginia bankers continue to struggle with a "one-size-fits-all" regulatory structure that fails to account for the community banking business model and the geographic and demographic footprint of its customer base. For example, documentation and reporting requirements under the Community Reinvestment Act continue to place undue burden on institutions that, but for their ongoing commitment to the communities that they serve, would cease to exist. Many bankers believe that increasing costs associated with regulatory compliance have become a prohibitive factor to their success. New regulations—such as rate caps, caps on overdraft fees and reduction in interchange fees—have limited income for community banks.

For West Virginia's community banks, the cost of compliance with new federal regulations has increased significantly in recent years. To keep up with the volume and complexity of legislation at the federal level, many community banks have been forced to reallocate resources away from revenue production to regulatory compliance. Some institutions have added compliance staff. Other banks are compelled to hire external compliance consultants for which they pay hefty monthly premiums. Across the board, community banks report an increase in compliance costs over recent years—anywhere from 20 to 400 percent.

Important Characteristics of Bank Management and Boards of Directors

West Virginia bankers believe bank management members must be strong willed and resilient to adversity in the marketplace. They must be visionary and innovative in meeting the needs of the communities they serve. They must foster meaningful relationships and design products and services that work for their customers and their communities. They should be nimble, adaptive and always prepared to grow and change within a financial services marketplace that is in constant motion.

Wisconsin

Greatest Local Opportunities and Challenges

Mortgage lending represents an important opportunity for Wisconsin's community banks, despite concerns raised about qualified mortgage (QM) rules. The outsourcing of mortgage servicing to nonbank institutions by larger banks is creating an opportunity on the local level. By retaining the mortgage servicing function, community banks believe they can strengthen their relationships with customers and take business away from bigger competitors.

Wisconsin bankers identified other potential opportunities. Some banks are looking at more adjustable rate mortgages (ARMs), including longer terms (seven to 10 years), and 61-month balloon loans. Fee income from investment, insurance and other services are another opportunity for community banks. Also, some bankers mentioned the opportunities of participation loans involving trusted partners that are closer to home.

There is little appetite among Wisconsin community bankers to add new products or services in the coming year, even though they acknowledge their banks are lagging behind larger institutions on this front. Bankers say they are so consumed with the day-to-day demands of keeping up with their regulatory responsibilities that they have few resources—financial and human—to devote to new products or services.

Competition is a major area of concern for Wisconsin community bankers. Competitive pressures are felt on many fronts—from credit unions, the Farm Credit System and large banks. Credit unions, which have a stronger presence in Wisconsin compared with many other states, are viewed as threats for several reasons. Bankers say that credit unions are moving aggressively into business lending, expanding their geographic markets and taking advantage of a perception that credit unions are subject to less regulation than banks. Farm Credit benefits from a pricing advantage on its loan products and continues to reach into nonagricultural lending such as residential lending and small business loans. National and large regional banks have become very aggressive on rates and terms, sometimes stretching amortizations on business loans to 25 and even 30 years.

New Mortgage Rules

New and evolving regulation has had significant impact on most Wisconsin community banks' mortgage origination activity—especially related to disclosures, appraisals, flood insurance and Home Mortgage Disclosure Act reporting. The need for intense attention on compliance (versus safety and soundness) has taken focus away from sales and service.

Many Wisconsin bankers indicated they expect to make more ARMs and 61-month balloon loans, but they expressed concern about the added complexity of making ARMs.

Wisconsin bankers are split roughly 50-50 on the question of non-QM loans. About half said they intend to make non-QM loans, while the other half expressed serious concern about the risks and said they plan on making only QM loans.

Changing Regulatory and Compliance Environment

In addition to competition, compliance is the other major challenge to Wisconsin community banks. Wisconsin bankers express deep concern about the impact of ongoing and increasing regulation. While compliance costs are often difficult to measure, they are going up, especially "soft costs" such as training and loan review. The cost and regulatory burden of technology (especially vendor management) is viewed as very challenging. The concern over the impact of compliance was summed up aptly by one banker, who said, "More of our decisions are being made based on compliance concerns than on safety and soundness concerns."

All Wisconsin community bankers reported significant increases in compliance costs over the past few years. Compliance demands have resulted in some banks resorting to compliance committees instead of a single compliance officer. Qualified compliance officers are difficult for community banks to attract and retain, and they are often lured away by larger banks. As a result, this has contributed to the escalating cost of compliance.

With the growing use of third-party vendors, there is a downside for community banks. As more of these functions are farmed out, the broad-based expertise of community banks' management teams has been weakened. In addition, compliance demands on boards of directors are making directorships less attractive.

Important Characteristics of Bank Management and Boards of Directors

Wisconsin bankers say it is increasingly difficult for community banks to find qualified and willing directors. As a result, some banks have found it necessary to increase board fees to attract and retain directors.

One Wisconsin banker noted that it used to be considered a privilege to serve as a bank director. Today, it is viewed as more of a burden, given the added complexities, the increased time commitment and the potential for personal liability. Another banker said he had recently been turned down by five prospective directors for a position on his board.

Greatest Local Opportunities and Challenges

The greatest opportunity for community bankers in Wyoming, which is also seen as a challenge, is promising loan growth. Another opportunity for Wyoming community bankers is the ability to offer new products not previously offered and to continue to focus on providing small business loans to business owners in local communities to help foster their success and therefore keep local communities alive and thriving.

Wyoming community bankers see regulatory burden as their greatest challenge. To keep up with new regulations, bankers are hiring additional staff and purchasing new loan software specifically designed to help them stay in compliance. These increases in overhead costs— along with loan-to-deposit ratios of around 60 percent, a shrinking number of successful businesses in rural America and the impact of changing technology—have made it tough for Wyoming community bankers to keep making money.

The greatest competition to Wyoming community banks is credit unions. Wyoming bankers said credit unions are their biggest competition because of the tax advantage they receive and because they are not subject to the same underwriting standards as community banks. Large banks were listed as the greatest competitor for consumer auto loans, and the Farm Credit System is stiff competition for land and agriculture loans. The advantages of community banks are their excellent customer service and their ability to offer customized solutions and give quick responses on loans. But Wyoming bankers say regulatory burden is eroding this advantage.

Launch of Mobile Banking Services

Wyoming bankers see cost as an impediment to launching new services, because there is often not enough volume to justify the cost of offering a service for free even as other institutions are doing so. It has, however, become easier to offer services like mobile banking over the past few years due to lower costs and advances in technology. Some Wyoming bankers stated plans to launch mobile banking services in the near future, others had recently launched mobile banking services, and some were tentative on the possibility of offering mobile banking services. The bankers who had previously launched mobile banking services noted that, while this service does not generate income, it is a cost of doing business that banks have to absorb. To justify the expense of mobile banking, some bankers encourage customers to sign up to receive their statements electronically instead of by mail. New products that bankers expect to launch in the next year include adding identity theft protection, home equity lines of credit and personal lines of credit.

New Mortgage Rules

Recent mortgage rules have changed the type of loans Wyoming banks are willing to make. Bankers say that their institutions are now turning down loans that they would have offered three years ago due to new mortgage rules. The new mortgage rules have made it especially hard to do business with self-employed customers. Bankers stated that, in the past, you knew the history of the self-employed through customer relationships, so you granted them the loan. Bankers also expressed concern about a potential shadow mortgage lending industry emerging as a result of the new rules.

In fact, new regulations have had their most negative impact on Wyoming bankers' mortgage businesses, both secondary and in-house. Bankers say because of this, volume in mortgage lending has gone down year by year, and the time it takes to close on a home loan has increased. Other changes due to new mortgage rules include offering more adjustable rate mortgages, not offering balloon loan mortgages and, in some cases, closing mortgage departments altogether.

Changing Regulatory and Compliance Environment

The compliance costs for community bankers in Wyoming have increased. To adapt to these changes, bankers are absorbing the cost of outsourcing as another cost of doing business. They are changing loan software to help remain in compliance with evolving regulations and putting in place mechanisms to verify the software is doing its job. Wyoming bankers also expressed a need for a resource where bankers can go to ask questions and get answers on new regulations and implementation requirements.

Most Important Characteristics of Community Bank Management and Boards

The most important characteristic of a community bank's executive management team and its board of directors is having a leader who engages in the local community. Being generally well-educated is also important, but so is education in the world of compliance and financial regulation. There was recognition that it is, and will continue to be, difficult to add or replace board members who have an understanding of new regulations. Wyoming bankers also expressed a need for senior management and board succession planning. Aging boards are a concern, and some bankers are looking for young individuals who will remain in the workforce longer.