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Community Banking | 2020 in the 21st Century

Research and Policy Conference

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Community Banking in the 21st Century

Eighth Annual Community Banking Research and Policy Conference

Sponsored by the Federal Reserve System, the Conference of State Bank Supervisors
and the Federal Deposit Insurance Corp.

Sept. 30-Oct. 1, 2020



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About the 2020 Conference

The Community Banking in the 21st Century research and policy conference is sponsored by the Federal Reserve, the Conference of State Bank Supervisors (CSBS) and the Federal Deposit Insurance Corp. (FDIC).

Since 2013, the annual conference has brought together researchers, regulators, policymakers and community bankers to discuss and debate the latest research on community banks. The research has explored the many facets of small-bank financial intermediation in the U.S. and has enhanced the understanding of the importance of relationship lending in the allocation of credit—especially for small businesses. For 2020, the conference is being held virtually on the Webex online meeting platform because of the COVID-19 pandemic.

Research presented at the conference is evaluated and critiqued by an academic moderator and by a community banker. Blending an academic perspective with a practitioner's perspective gives researchers feedback on the academic merits of their papers and provides important insights into the relevance of their work to the day-to-day challenges faced by the more than 5,000 community banks operating in the U.S.

The insights generated by this research each year are further contextualized with the results of the annual CSBS National Survey of Community Banks, which has been conducted by CSBS and the state banking commissioners since 2014. The survey findings are presented as part of the conference proceedings and provide a current snapshot of the opportunities and challenges facing community banks. The survey also gathers data that are not available elsewhere. Data from the survey have been used to support academic research.

The conference also features keynote addresses by senior Federal Reserve, CSBS and FDIC officials, and by a community banker. Since its inception, the conference has evolved in ways that have added additional voices and perspectives to the annual proceedings. For example, in 2015, CSBS launched an annual Community Bank Case Study competition for undergraduate students. The competition requires student teams of no more than five to partner with a community bank to conduct an original case study on an important topic to community banks. The winning case study team is invited to present its findings at the conference.

More information about the conference can be found at communitybanking.org.

Order of Proceedings

DAY 1

Welcome

Presentation of Findings from the 2020 CSBS National Survey of Community Banks

Presenters: Andrew Meyer, senior economist, Federal Reserve Bank of St. Louis; Alisha Sears, senior analyst, CSBS; and Michael Stevens, senior executive vice president, CSBS

Keynote Remarks

Michelle Bowman, governor, Board of Governors of the Federal Reserve System

Introduction by **James Bullard**, president and CEO, Federal Reserve Bank of St. Louis

Concurrent Research Paper Session 1: The Future of Community Banking

Moderator: Elena Loutskina, professor of business administration and Peter M. Grant II Bicentennial Foundation Chair in Business Administration, Darden School of Business, University of Virginia

Community Bank Discussant: Mike Butler, president and CEO, Radius Bank, Boston, Massachusetts

Papers and Presenting Authors:

Shared Destinies? Small Banks and Small Business Consolidation
—Jonathan Pogach, FDIC

Bank Entrepreneurs
—Chiwon Yom, FDIC

Concurrent Research Paper Session 2: Community Development and Support

Moderator: Lamont Black, associate professor of finance, Driehaus College of Business, DePaul University

Community Bank Discussant: Alden McDonald Jr., president and CEO, Liberty Bank and Trust Company, New Orleans, Louisiana

Papers and Presenting Authors:

“Revitalize or Stabilize”: Does Community Development Financing Work?

—Daniel Ringo, Board of Governors of the Federal Reserve System

The Propagation of Local Credit Shocks: Evidence from Hurricane Katrina

—Samir Elsadek Mahmoudi, Georgia State University

Keynote Conversation

Jelena McWilliams, chairman, FDIC

Moderator: Diane Ellis, director, Division of Insurance and Research, FDIC

Day 1 Conference Wrap-Up

Carl White, senior vice president, Federal Reserve Bank of St. Louis

Optional Post-Plenary Meetings for Day 1 Sessions

DAY 2

Community Banker Keynote

Laurie Stewart, president and CEO, Sound Community Bank, Seattle, Washington

Introduction by **Roberta Hollinshead**, director of banks, Washington State Department of Financial Institutions

2020 CSBS Case Study Winning Presentation: Mississippi State University

Introduction: Kevin Hagler, chairman, CSBS; and commissioner, Georgia Department of Banking and Finance

Student Team Members: Juan Benavides, Liam Benson, Byron McClendon, Jake Mlsna and Kirk Wright

Faculty Advisor: Matthew Whitledge, assistant clinical professor of finance, Mississippi State University

Community Bank Partner: Citizens National Bank, Meridian, Mississippi

Concurrent Research Paper Session 3: Local Lending and Credit Access

Moderator: Amiyatosh Purnanandam, Michael Stark Professor of Finance, Ross School of Business, University of Michigan

Community Bank Discussant: Vernon Hirata, vice chairman and co-chief operating officer, Territorial Savings Bank, Honolulu, Hawaii

Papers and Presenting Authors:

Big Banks, Household Credit Access and Intergenerational Economic Mobility
—Erik J. Mayer, Southern Methodist University

Government-Sponsored Wholesale Funding and the Industrial Organization of Bank Lending
—Dayin Zhang, University of Wisconsin–Madison

Concurrent Research Paper Session 4: Moral Hazard Issues in Regulation and Oversight

Moderator: Kathryn Judge, Harvey J. Goldschmid Professor of Law, Columbia Law School

Community Bank Discussant: David Coxon, president and CEO, Georgia Primary Bank, Atlanta, Georgia

Papers and Presenting Authors:

How Important Is Moral Hazard for Distressed Banks?
—Ajay A. Palvia, FDIC

Insurance Pricing, Distortions, and Moral Hazard: Quasi-Experimental Evidence from Deposit Insurance
—George Shoukry, FDIC

Panel Discussion: Community Banking in the Time of COVID-19

Moderator: Rhoshunda Kelly, interim commissioner, Mississippi Department of Banking and Consumer Finance

Panelists: Jill Castilla, president and CEO, Citizens Bank of Edmond, Edmond, Oklahoma; Kenneth Kelly, chairman and CEO, First Independence Bank, Detroit, Michigan; and Frank Scott Jr., Mayor of Little Rock, Arkansas

Conference Wrap-Up

John Ryan, president and CEO, CSBS

Optional Post-Plenary Meetings for Day 2 Sessions

Letter from Michelle W. Bowman

Welcome to the 2020 Community Banking in the 21st Century conference.

This year's conference is being presented virtually, as the COVID-19 pandemic has necessitated sustained social distancing.

The pandemic has created significant changes in how we safely engage one another professionally and personally during this time. It has also given us a view into the strengths, vulnerabilities and resiliencies of our national and local institutions.

As communities across the United States faced a number of significant challenges in the response to the virus, community banks engaged their customers and communities to identify ways to support local businesses and other vital community organizations. They sought innovative solutions to support customers who may have lost jobs, been furloughed or saw declines in income, and they supported emergency lending programs, especially the Small Business Administration's Paycheck Protection Program (PPP), in which the majority of loans were made by community banks.

Throughout the pandemic, I've heard firsthand from community bankers about how they were able to quickly develop and deploy targeted banking products and services that met the unique needs of their communities. The value of relationship banking can sometimes get lost in today's discussions around the increasing role that technology plays in the provisioning of banking and financial services. At the time of this year's conference, we still appear to be a ways away from being able to look back on this pandemic and take stock of what we've learned. However, the CSBS National Survey of Community Banks gives us an early glimpse of community banks' successful navigation of these challenges. Banks that offered consumer-friendly technology while still maintaining close personal ties to their customers and communities were best positioned to thrive during these unprecedented times.

Research presented at this year's conference will also provide a critical foundation for understanding the lessons and implications of the pandemic on community banks. For example, this year's research demonstrates important linkages between small businesses and small banks, provides evidence of the value of "soft information" used by community banks that lend in low- and moderate-income communities, investigates risk-reducing behavior by banks during a financial crisis and assesses the effects of community development lending on economic activity.

The Federal Reserve is proud to join CSBS and the Federal Deposit Insurance Corporation in presenting this research conference during such challenging times. I hope the research and other data and information presented this year spark new lines of thought and research inquiry as we endeavor to deepen our understanding of the community bank business model and the vital role of community banks in our financial system.

Michelle W. Bowman

*Governor
Board of Governors of the Federal Reserve System*

Letter from Jelena McWilliams

The Federal Deposit Insurance Corp. is pleased once again to join with the Federal Reserve System and the Conference of State Bank Supervisors to sponsor the Community Banking in the 21st Century annual conference. Our continued support of this conference reflects our commitment to a deeper understanding of the vital role of community banks in our economy and the forces that create both challenges and opportunities for their ongoing success.

The research included in this eighth year of the conference clearly demonstrates the value of bringing together bankers, researchers, regulators and community members in a dialogue about the future of community banking. The findings show that community banks help fill the gaps in local lending left by multi-market and larger banks, contribute to local employment growth, and enable communities to take advantage of emerging opportunities. The findings also illustrate that regulation affects the incentives for bank risk-taking and that economic shocks experienced by local industries can have lasting effects on the structure of the community banking sector.

Communities across the nation are now facing unprecedented challenges as a result of the COVID-19 pandemic. Notwithstanding these challenges, I am encouraged by news reports describing how community banks have worked day and night to serve their communities as a source of strength—news of how banks quickly developed new loan programs for small businesses and consumers, provided up to three years' worth of loans within weeks, and launched donation campaigns that provided funds for local businesses, hunger relief and front-line workers.

The pandemic has also accelerated demand for digital banking services, which is why the FDIC has advanced its FDiTech initiative. The initiative aims to assist community banks foster technological innovation in order to meet the evolving needs of their customers in a safe and sound manner. We aim to promote the efficient and effective adoption of innovative technologies at community banks, which could enhance their competitiveness, modernize supervision and reduce compliance burden. The FDIC expects to conduct additional research on community banks to better understand how they evolve and respond to the rapidly changing banking environment.

Thank you for your participation in this conference. As the research showcased here demonstrates, we each have a role to play in the health and vibrancy of our economies and our community banks.

Jelena McWilliams

*Chairman
Federal Deposit Insurance Corp.*

Letter from John W. Ryan

I am delighted to join Federal Reserve Board Governor Michelle Bowman and Federal Deposit Insurance Corp. Chairman Jelena McWilliams in sponsoring the eighth annual Community Banking in the 21st Century research and policy conference.

The conference is different this year—at least in format. We are in the midst of a global pandemic that has upturned how we approached just about everything only six months ago. Instead of meeting in the shadow of the Gateway Arch at the Federal Reserve Bank of St. Louis, we are meeting virtually. And it is essential that we do so.

This conference serves an important purpose. It provides a forum for regulators, bankers, policymakers and academics to share research and data about community banks. Year after year, this conference builds more evidence of the importance of community banks, which informs legislation and regulation that impact community banks and the communities they serve.

In this pandemic year, the strength of community banks in meeting local needs is perhaps more apparent than ever before. From adjusting to working remotely to helping the federal government get loans to small businesses quickly, they have been instrumental in keeping money flowing. We are especially grateful to the bankers who participated in this year's CSBS National Survey of Community Banks.

This year, we will focus on the future of community banking, community development, and local lending and credit access. We will also learn about the moral hazard issues in the regulation and oversight of community banks during the pandemic.

It does not matter how we meet. It is the sharing of ideas that is important. I am so eager to learn more.

John W. Ryan

*President and CEO
Conference of State Bank Supervisors*

An aerial night photograph of a town, likely a university campus, with numerous buildings and streets illuminated by warm lights. In the background, a large body of water is visible under a dark, twilight sky. The text "2020 Key Research Findings" is overlaid in white, centered on the image.

2020 Key Research Findings

Concurrent Research Paper Session 1

The Future of Community Banking

Shared Destinies? Small Banks and Small Business Consolidation

Authors: Claire Brennecke, Consumer Financial Protection Bureau; Stefan Jacewitz, FDIC; and Jonathan Pogach, FDIC

Key Findings: The study investigates whether changes in the composition of businesses affect the composition of the banking industry. It finds that small-firm employment is positively associated with small bank deposits, income and small business lending, but not associated with large-bank balance sheets and income. The authors link their results to the propensity of small banks to be acquired. The findings are consistent with a view that, in the absence of small-business financial service demand, a large-bank business model based on economies of scale may be more profitable than a small-bank business model based on comparative advantages in relationship lending. While many existing policies seek to support small businesses through the support of small banks, the authors' results suggest supporting small businesses could be a potential mechanism for supporting small banks.

Bank Entrepreneurs

Authors: Kristoph Kleiner, Indiana University and FDIC; Manju Puri, Duke University and FDIC; and Chiwon Yom, FDIC

Key Findings: The study analyzes the characteristics of entrepreneurs who participated in the opening of 185 de novo banks from 2000 to 2008, and how these characteristics influenced subsequent bank performance. These bank entrepreneurs were driven by local opportunities and also had significant banking and managerial experience—particularly at small banks—unique local knowledge and the networks necessary to raise local funding. Prior employment experiences had a causal effect on bank investment strategies and performance. For instance, prior experience in the real estate industry predicted a higher rate of commercial real estate lending, especially for construction and development loans. These results provide insights that can guide policies that support entrepreneurship and financial stability.

Concurrent Research Paper Session 2

Community Development and Support

“Revitalize or Stabilize”: Does Community Development Financing Work?

Author: Daniel Ringo, Board of Governors of the Federal Reserve System

Key Findings: The study uses data obtained from bank performance evaluations under the Community Reinvestment Act to estimate how increased community development lending and investment affect local economic activity. It finds that lending increases wages and employment (at a rate of one job per \$56,000 in loans), but does not increase the supply of affordable housing or the growth of house prices. Evidence on the effect of investments is inconclusive. These findings are important insofar as banks in the United States originate \$100 billion in community development loans annually and hold similar amounts of community development investments on their balance sheets.

The Propagation of Local Credit Shocks: Evidence from Hurricane Katrina

Author: Samir Elsadek Mahmoudi, Department of Economics, Georgia State University

Key Findings: In the aftermath of Hurricane Katrina in 2005, banks operating in multiple markets diverted financial resources to areas that were damaged—where demand was high for housing and mortgages—from areas that were undamaged. A resulting credit tightening in the undamaged areas reduced housing prices and slowed construction activity. Community banks, being unexposed to damaged areas, partially insulated their local markets from these spillovers.

Concurrent Research Paper Session 3

Local Lending and Credit Access

Big Banks, Household Credit Access and Intergenerational Economic Mobility

Author: Erik J. Mayer, Cox School of Business, Southern Methodist University

Key Findings: The study examines access to credit for low-income borrowers provided by local banks. It finds that small banks approve a higher percentage of mortgage applications than large banks and that mortgage approval rates decrease with increased distances to branch locations. These results indicate that “soft” information is important when lending to low-income households, and that smaller banks incorporate more of this information into their lending decisions. The author also finds that intergenerational economic mobility is lower in areas where banks are larger, raising the question of whether consolidation in the banking industry contributes to economic inequality.

Government-Sponsored Wholesale Funding and the Industrial Organization of Bank Lending

Author: Dayin Zhang, University of Wisconsin–Madison

Key Findings: The study shows that a bank’s access to low-cost funding through the Federal Home Loan Bank (FHLB) is associated with an 18-basis-point reduction in its mortgage rates and a 16% increase in its mortgage lending. This effect, moreover, is 25% stronger for small community banks. The author also finds that intensified local competition pushes other lenders to lower their mortgage rates as well, and overall market lending grows. The author concludes that the FHLB increases annual mortgage lending in the U.S. by \$50 billion and saves borrowers \$4.7 billion in interest payments every year, through changing the competitive landscape of the mortgage market.

Concurrent Research Paper Session 4

Moral Hazard Issues in Regulation and Oversight

How Important Is Moral Hazard for Distressed Banks?

Authors: Itzhak Ben-David, The Ohio State University and the National Bureau of Economic Research (NBER); Ajay A. Palvia, FDIC; and René M. Stulz, The Ohio State University and NBER

Key Findings: This study examines incentives for distressed banks to increase risk-taking as a consequence of deposit insurance and other related elements of the bank safety net. The moral hazard incentives of the bank safety net predict that distressed banks take on more risk and higher leverage. The author investigates two distinct periods, the first being 1985-1994 and the other being 2005-2014. They both encompassed a financial crisis and were subject to different regulatory regimes. The author found that, rather than expand leverage, distressed banks took actions to reduce leverage by shrinking assets, closing branches, cutting employees, reducing deposits, reducing deposit rates, adding equity capital and cutting dividends. They also reduced risk, as evident in lower nonperforming loans and earnings volatility. The author concludes the role of moral hazard is limited and the deleveraging of banks is independent of regulatory regime.

Insurance Pricing, Distortions, and Moral Hazard: Quasi-Experimental Evidence from Deposit Insurance

Author: George Shoukry, FDIC

Key Findings: The author finds evidence that differentials in insurance premiums under risk-based deposit insurance provide banks with incentives to curb excessive risk-taking, which points to the effectiveness of risk-based pricing. However, the evidence also identifies distortionary effects, as institutions paying higher premiums shifted their funding sources away from deposits and engaged in an intricate form of regulatory arbitrage to lower their total burden of deposit insurance premiums. This erodes the effectiveness of risk-based pricing and highlights the importance of strong regulatory controls when risk-based insurance pricing is used.

Additional Papers of Topical Note

Due to the significant number of submissions to the 2020 conference, a number of high-quality papers were not able to be fully integrated into this year's proceedings. The conference's research committee identified two such papers that it wanted to highlight. These "additional papers of topical note" are being featured on the conference website, along with a recorded video presentation by an author of each paper.

Cyberattacks on Small Banks

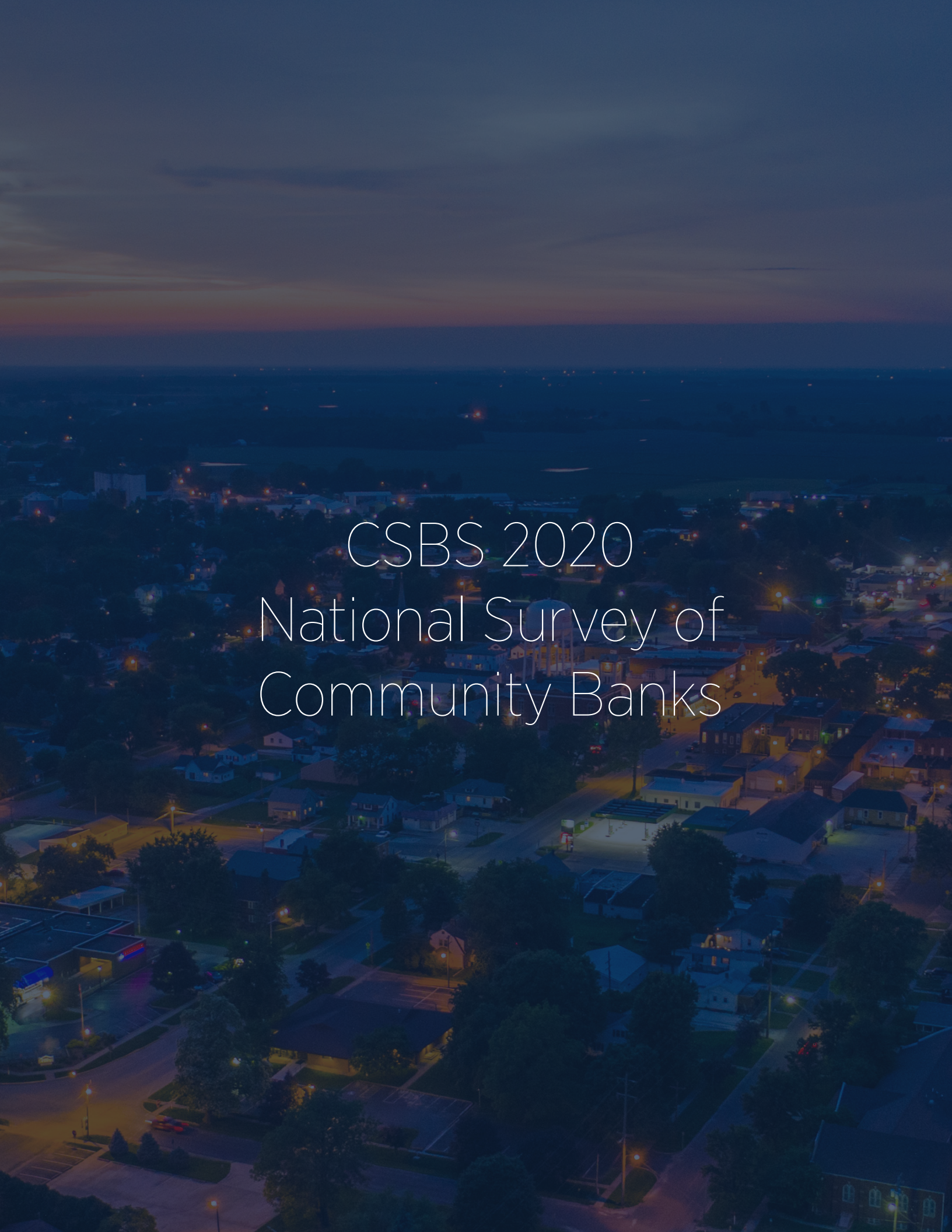
Authors: Fabian Gogolin, University of Leeds, Leeds, England; Ivan Lim, Durham University, Durham, England; and Francesco Vallascas, Durham University

Key Findings: The authors study cyberattacks at small banks with assets under \$10 billion that occurred between 2005 and 2017. The attacks were external data breaches involving losses of personal information by hacking or malware/electronic entry. Cyberattacks led to an outflow of deposits at affected banks. Larger deposit outflows are observed in markets with less digital literacy and markets where large banks dominate. The authors conclude that cyberattacks reduce the trust of bank customers by generating bank-specific reputational damages.

Measurement of Small Business Lending Using Call Reports: Further Insights from the Small Business Lending Survey

Authors: Jacob Goldston, FDIC; and Yan Y. Lee, FDIC

Key Findings: The authors assess the validity of a commonly used proxy for small business lending that is based on commercial and industrial loans with denominations of \$1 million or less. Using data from the Small Business Lending Survey, a nationally representative survey of banks, they find that more than 30% of commercial and industrial lending by banks with \$1 billion to \$10 billion in assets is made either in smaller denominations to large firms or in larger denominations to small firms. Both findings undermine the proxy's core assumption of a high correlation between loan size and firm size. The authors also find that small business lending by banks likely recovered from the 2007–09 recession two to four years earlier than indicated by the proxy.

An aerial night photograph of a town, likely a small city or suburb, with numerous lights from buildings and streets. The town is situated near a large body of water, possibly a lake or bay, which is visible in the background under a dark, twilight sky. The overall scene is dimly lit, with the primary light sources being the artificial lights of the town.

CSBS 2020
National Survey of
Community Banks

Foreword from Kevin B. Hagler

Not surprisingly, community banks reported business conditions as their greatest challenge in the past year.

As the world turned upside down in the spring of 2020 due to the coronavirus, community banks were especially impacted. These banks played a key role in their communities in mitigating the impact of the coronavirus pandemic by helping small businesses and farms access emergency credit.

The seventh annual CSBS survey of community banks found in the wake of the crisis that the hallmark of community banking—relationship lending—had become even more pronounced.

As community banks pivoted quickly to adjust to the COVID-19 pandemic, they not only maintained but, in many cases, strengthened their customer relationships.

When banks and branches had to shut down due to COVID-19, community banks expanded customer access to services through extended use of drive-through facilities and technological interfaces. Their staffs worked additional hours to help customers gain access to emergency credit through the U.S. Small Business Administration. In fact, community banks accounted for 75% of lending under the Paycheck Protection Program.

The pandemic was not the sole focus for community banks this year. They raised other factors to watch, like challenges with core service providers and concerns about updates to the Bank Secrecy Act and Anti-Money Laundering law.

Just how will the pandemic impact the future of community banks? Reaction is mixed. But no matter what the situation, customer relationships matter. This is the strength of community banks across the United States.

I invite you to read the full report to learn more about how community banks have navigated the pandemic and how these turbulent times could impact their futures.

Kevin B. Hagler

*Chairman, CSBS
Commissioner, Georgia Department of Banking and Finance*

2020 CSBS National Survey

Introduction

Since its inception seven years ago, this National Survey of Community Banks, conducted by the Conference of State Bank Supervisors (CSBS) and state regulatory authorities, has encompassed a range of varying, but often recurring, topics. Regulatory burden, small business lending, industry consolidation, competition and technological innovation have been of ongoing interest to community bankers. Last year's survey results revealed that funding, particularly core deposit growth, was a key theme.

This year's survey findings are presented not as an evolving analysis of banking industry trends but rather in the context of a banking world turned upside down by the COVID-19 pandemic. The crisis strained the community bank business model—underscored by one banker's comment that “social distancing and shelter-in-place orders created a significant challenge for our customer-facing representatives”—but also highlighted important aspects of the industry's human touch. It provided a chance, as one banker said, “to help people with whom we have a personal relationship.” And it solidified loyalties: Bankers said customers expressed gratitude to them “for how we responded to their needs” and for “just being able to speak to a human being during this time of crisis.”

The 2020 survey included several questions on how community bankers were responding to the pandemic. The short answers: with resolve, empathy and an acceptance that the community banking industry may never be the same. These questions are covered in the first section of this report. Other questions, more general in nature, are presented in subsequent sections. The responses offer insight into what the community banking industry may look like longer term, after it emerges from the current crisis.

Background

To develop the 2020 national survey, CSBS staff met with key academic, industry and regulatory stakeholders to identify current issues of relevance to community banks. The survey was distributed by the state banking regulatory authorities from April to July 2020. The Survey Research Institute at Cornell University constructed the web interface used by the respondents, handled technical aspects of data collection and transmitted the data for analysis.

The distribution of the survey coincided with the COVID-19 pandemic. This presumably contributed to a decline in the number of respondents to 396 from 579 in 2019. It is worthwhile to note, however, that the characteristics of participating banks were stable (see below). From this perspective, responses given this year may be viewed as equally representative of the community banking industry.¹

Almost all of the participating institutions had less than \$10 billion in assets, a benchmark for community banks established under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). The vast majority were state-chartered banks: 21% of them were members of the Federal Reserve, and 70% were

not. (Last year's percentages were 19% and 70%, respectively.) For ease of exposition, all surveyed entities in the analysis that follows will be referred to as “community banks.”

We acknowledge certain limitations of the survey:

- It was not distributed in every state.
- Respondents participated on a self-selected basis.
- Banks did not necessarily respond to every question.
- Detailed statistical testing, which would be required to definitively quantify the extent to which surveyed banks were representative of the overall industry, was not conducted.

Conclusions must be qualified accordingly.

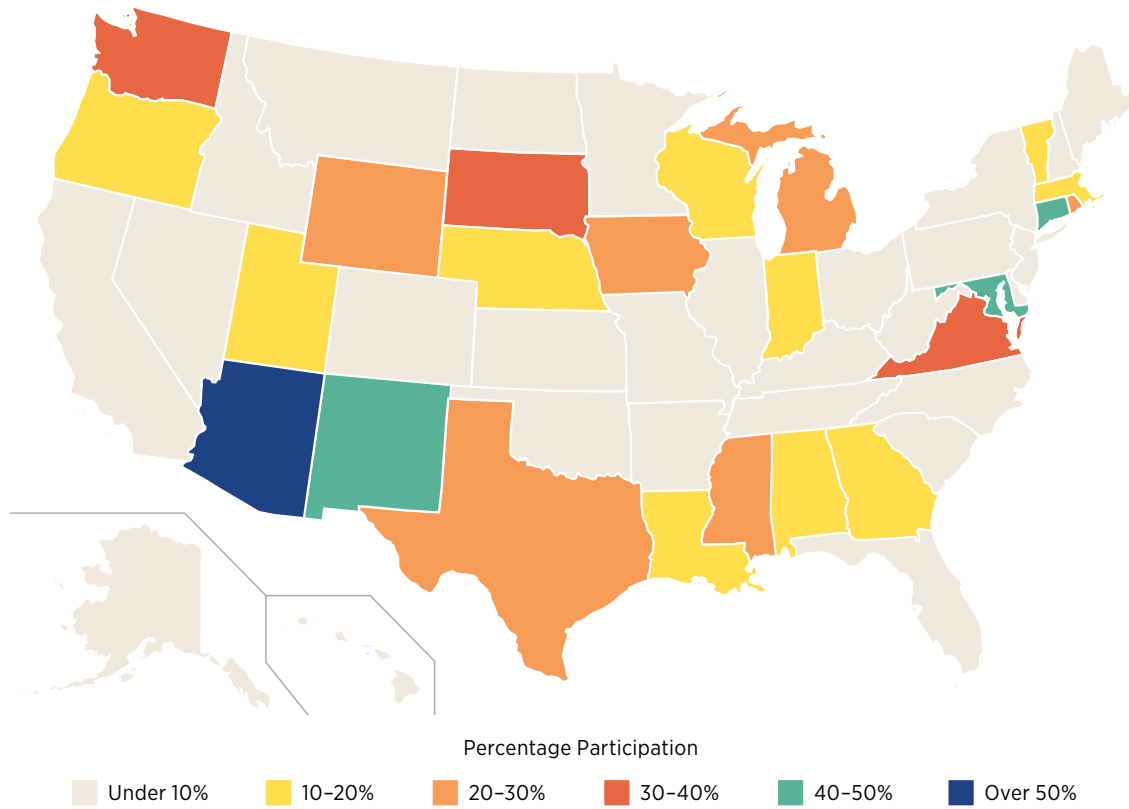
In addition to the survey results, this year's report incorporates interviews with bankers conducted by 15 state banking commissioners. Quotes from these interviews, identified by state, will be interspersed throughout the reports as additional context for evaluating the survey results.

Key Findings

- Community bankers expressed pride in mitigating the impact of the COVID-19 pandemic by increasing their loans to small businesses by 40% for the year ended in June. Their loans under the Paycheck Protection Program (PPP) totaled \$196 billion, an amount representing at least 37% of all funding provided under this program.
- Business conditions supplanted funding as the greatest challenge currently facing community banks.
- Community bankers relied on Small Business Administration (SBA) lending to a greater extent this year than last year. But their views were decidedly mixed, as significant percentages of bankers planned to terminate or initiate relationships with the SBA.
- The COVID-19 pandemic, although daunting, may have sown seeds that could lead to longer-term benefits for some community banks. Bankers cited the benefits of reintroducing customers to available technologies that were previously resisted and a renewed appreciation for relationship banking.
- More than 40% of respondents said supervisory expectations for due diligence of third-party providers were an impediment to establishing new third-party relationships.
- Relative regulatory costs declined year over year. Personnel expenses, for instance, dropped to 10% of noninterest expense from 11% in the previous year.

FIGURE 1

Survey Respondents as a Percentage of State-Chartered Banks and Thrifts by State

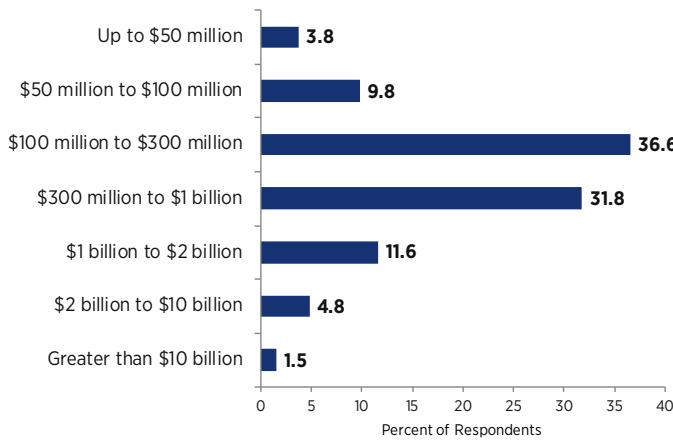


BANK SIZE AND BRANCH NUMBERS

FIGURE 2

Asset Size of Surveyed Banks

(as of Dec. 31, 2019)

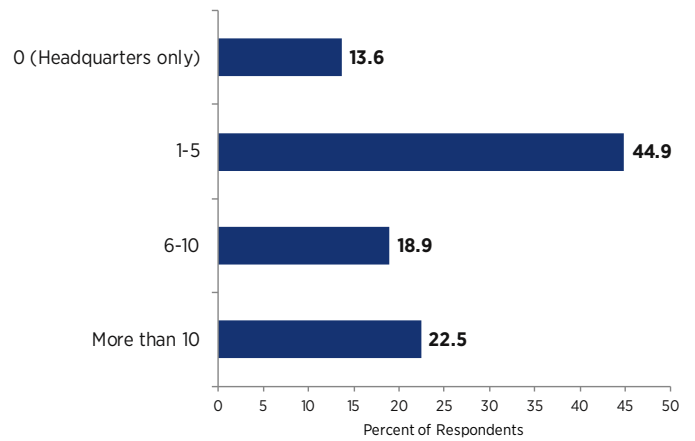


Nearly two-thirds of surveyed banks had assets between \$100 million and \$1 billion. A slight reduction in the number of banks in smaller size categories, noted in previous surveys, continued in the 2020 survey. This may be related to consolidation among the smallest banks.

FIGURE 3

Number of Branches of Surveyed Banks

(as of Dec. 31, 2019)



Nearly 45% of respondent banks operated between one and five branches, while more than 22% operated networks of more than 10 branches. This is similar to the distribution of branches observed last year.

COVID-19 and Community Banking

Community banks participating in the survey acknowledged being dramatically affected by the COVID-19 pandemic. While not alone in their concerns, they were unique in the role they played in mitigating the effects of the pandemic—notably through participation in the Small Business Administration’s Paycheck Protection Program (PPP). (See box.) One banker described community banks as a “conduit for all this money being put into the economy.”

Participation in the PPP presented surveyed bankers with difficult situations. Some reputations were dented, and customers lost, when loan applications stalled.

Many bankers anticipated ongoing problems; for instance, loan repayment was a concern despite government guarantees. One respondent expected parties in the PPP to “inevitably suffer consequences.”

Community Bankers Face COVID-19

As in previous surveys, bankers were asked to identify their greatest challenge. This year, responses must be interpreted in the context of COVID-19.

Paycheck Protection Program

The Paycheck Protection Program was established under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to extend \$669 billion in loan guarantees to small businesses through qualified lenders. The CARES Act also allocated nearly \$500 billion to the Federal Reserve to support lending facilities and provide businesses with direct credit; increased the express loan amount of the SBA from \$350,000 to \$1 million; increased funding for grants through the SBA’s Economic Injury Disaster Loan Program; and funded principal, interest and fees for six months for existing SBA customers. In addition to modifying and funding existing SBA loan programs, the act temporarily permitted the SBA to guarantee 100% of loans under the PPP.

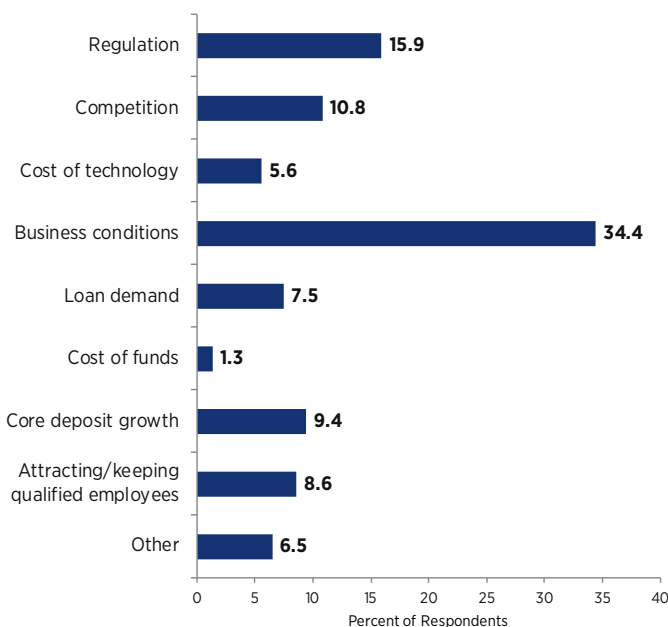
PPP loans were available to small businesses with fewer than 500 employees that were in operation between February 15 and August 8. Forgiveness was provided up to the full principal amount of qualifying loans guaranteed under the PPP. The amount of forgiveness was based, in part, on the percentage of eligible costs attributed to nonpayroll costs, decreases in employee headcount and decreases in salaries or wages per employee.

Through August 8, when the PPP closed, the program had funded 5.2 million loans, made by 5,460 lenders, totaling more than \$525 billion.²

CHALLENGES POSED

FIGURE 4

What is the single greatest challenge facing your bank today?



Business conditions were identified as the greatest challenge for 34% of respondents. Funding, represented by the categories “cost of funds” and “core deposit growth,” fell off dramatically this year, to less than 11% collectively from 33% last year. Regulation was cited as the single greatest challenge by approximately 16% of respondents, which is similar to what was reported in 2019.

PPP lending presumably was reflected in “business conditions.” In this regard, the comments of bankers were vociferous. “The challenges that we experienced [in PPP] are too numerous to list,” one banker said. “It was and continues to be the most frustrating, ill-planned, wrongly directed and misunderstood program that the federal government could have possibly created.” Among the noted challenges: a “horrific” rollout of the PPP program; “ever-changing” rules and procedures for loan processing; a race to satisfy loan requests under “first-come, first-served” approaches; and “nightmares” associated with accessing SBA websites—including lockouts, lost credentials and password access.

Lending under COVID-19

Community banks greatly expanded commercial lending in response to the COVID-19 pandemic. (See Table 1.) They held \$394 billion in loans to small businesses as of June 2020, which was a year-over-year increase of 40%. The increase reversed a steady decline in earlier years.

Loans made by community banks specifically under the PPP totaled \$196 billion, an amount representing at least 37% of all funding provided under this program.³ Bankers were both overwhelmed and proud as a result of their participation. (See box.)

The increase in small-business lending was not matched in other areas. Lending in the consumer, agricultural, residential mortgage and commercial real estate sectors all declined. This is consistent with a tightening of standards and terms for all categories of loans in the second quarter of 2020.⁴

Community Bank Perspectives: PPP

“Despite a rollout that was disjointed and frustrating,” one banker said, “we were able to support our small business customers.” Another noted that, “once we got it rolling, it was smooth sailing and did what it was intended for—putting money in the hands of small businesses to keep people employed.” Bankers in Mississippi, for example, described “lifelines” provided to their customers searching for relief. Another bank saw its role as filling a “huge gap in our community by making these loans not only for our clients but for other institutions’ clients that could not get help from their own bank—usually a large nationwide bank.”

TABLE 1
Total Lending by Community Banks (in \$billions)

	2016	2017	2018	2019	2020
Paycheck Protection Program					196.0
Small Business	308.0	300.8	287.2	282.2	394.0
Commercial	297.9	297.7	289.1	296.3	470.5
Consumer	117.6	112.8	107.5	103.7	98.5
Agricultural	58.8	59.6	59.0	60.0	59.2
Residential real estate	515.3	507.0	502.1	492.5	478.1
Commercial real estate	605.7	636.3	632.4	642.9	642.7

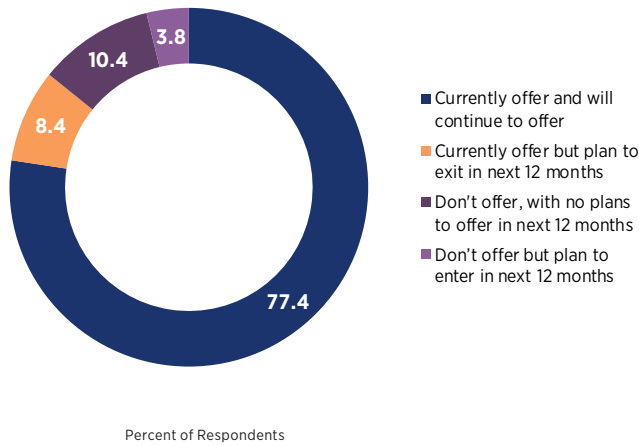
Notes: Amounts are reported each year in June. Data are obtained from Call Reports published by the Federal Financial Institutions Examination Council.

ROLE OF THE SMALL BUSINESS ADMINISTRATION

Bankers, in general, were sympathetic to the difficulties encountered by the SBA in rolling out such a massive program so quickly. But their individual experiences with the SBA were decidedly mixed.

FIGURE 5

What are your intentions regarding SBA loans?



The impact of the PPP was likely reflected in the 77% of banks that offered, and planned to continue offering, SBA loans. Although a sharp increase from the 67% reported last year, this level seems modest in comparison with the larger increase in loans to small businesses previously described. It may suggest that lending was extended more by banks with an existing SBA relationship than by banks newly establishing an SBA relationship.

About 10% of banks stayed on the sidelines. Participation in the program was hindered for some bankers by a lack of staff, while others just gave up entirely. One banker had planned to participate, despite lacking status as an approved lender, but was unable to do so: "We had difficulty getting in touch with the SBA, so we had to refer our clients to a third party in order for them to participate."

Nearly 4% of bankers said they now intend to enter SBA lending, while planned exits doubled to 8% from the level reported in 2019. The latter may be related to frustrations with the PPP; one banker expressed "disappointment" that "we ever agreed to participate in a program where the terms we must live by were changed midstream."

COVID-19 AS A FACTOR IN LENDING

FIGURE 6

Did you increase lending to small businesses and farms in response to the COVID-19 pandemic?

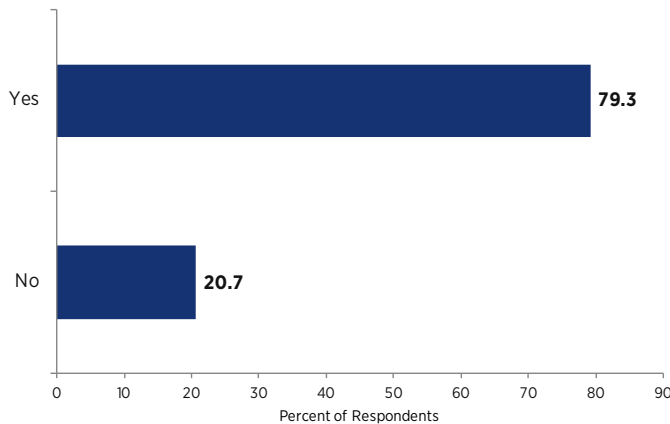
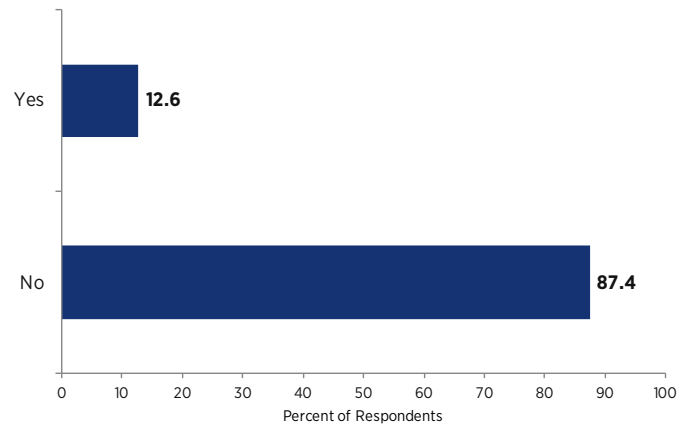


FIGURE 7

Did you increase nonbusiness lending or lines of credit in response to the COVID-19 pandemic?



Nearly 80% of respondent banks increased lending to small businesses and farms in response to COVID-19. However, less than 13% increased nonbusiness lending or lines of credit.

Credit Risk

The COVID-19 pandemic forced community banks to “balance” decisions between helping businesses and “protecting their bottom lines.”⁵ This was particularly relevant to credit risk.

Community banks increased provisions for loan losses, from \$1.4 billion in the last quarter of 2019 to \$3.2 billion in the first quarter and to \$3.4 billion in the second quarter of 2020. By comparison, JPMorgan Chase set aside \$10.5 billion in the second quarter alone.

Quarterly charge-offs decreased from the last quarter of 2019 to the second quarter of 2020, perhaps influenced by relief from accounting rules for troubled debt restructurings. Aggregate capital was largely unchanged, while reserves were bolstered. Supplemental survey questions confirmed the role of COVID-19 in these decisions. The economic impact and credit repayment issues resulting from COVID-19 were named by 76% of bankers as the most important factor in increasing reserves.

TABLE 2

Loan Performance (in \$billions)

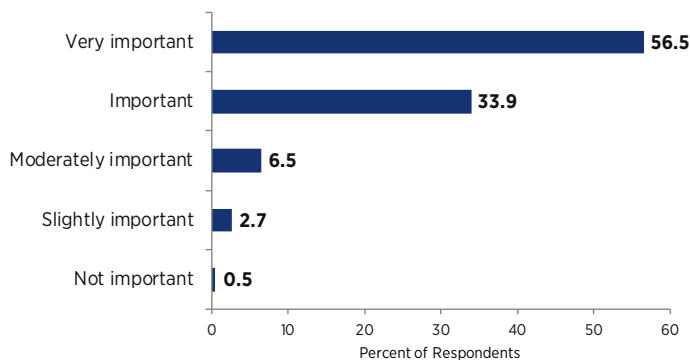
	2019 Q4	2020 Q1	2020 Q2
Provisions	1.4	3.2	3.4
Charge-Offs	1.1	0.9	1.0
Reserves	23.1	26.0	28.0
Equity	359.7	355.7	358.0

Notes: Amounts for provisions and charge-offs represent flows over a given quarter (not year-to-date flows), and amounts for reserves and equity are as of the end of the quarter. Data are obtained from Call Reports published by the Federal Financial Institutions Examination Council.

RISK PERCEPTIONS

FIGURE 8

How important is credit risk to your bank?



Increases in loan loss provisioning coincided with an elevation in perceived risk. Nearly 57% of bankers considered credit risk to be “very important,” which is considerably higher than what was reported in 2019. This may reflect, in part, continuously changing rules under the PPP that one banker said “adds risk to the banks and removes risk from the SBA after the loans have been made.” Uncertainty is further underscored by guidance issued by the SBA in August in the form of 23 “frequently asked questions.”⁶ Several exasperated bankers complained of having to wait on instructions for submitting loan forgiveness forms.

Effects of COVID-19 on Funding

Community banks were flooded with deposits in the wake of the pandemic, as transaction deposits increased 33% to \$659 billion for the year ending in June. (See Table 3.) Deposit growth supported new lending. In this regard, one banker noted that all his bank’s PPP loans were funded by local depositors: “It was truly neighbors helping neighbors.”

TABLE 3

Total Deposits (in \$billions)

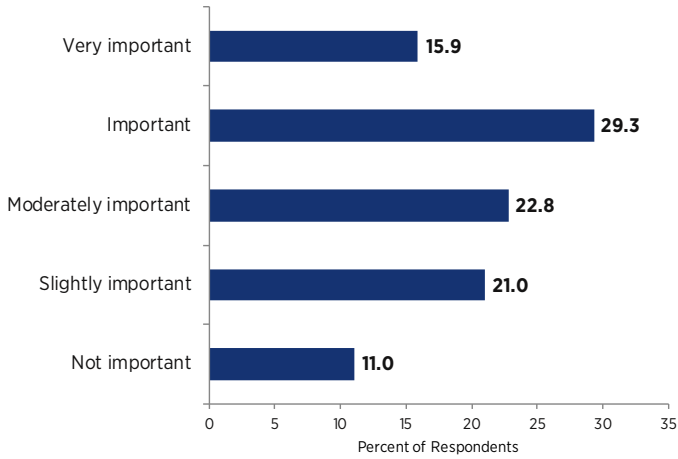
	2018 Q4	2019 Q2	2019 Q4	2020 Q2
Transaction	509.9	495.0	518.9	659.1
Nontransaction	1,862.1	1,846.2	1,856.4	1,935.0

Notes: Dollar amounts are collected quarterly. Data are obtained from Call Reports published by the Federal Financial Institutions Examination Council.

LIQUIDITY AND CORE DEPOSITS

FIGURE 9

How important is liquidity risk to your bank?



The COVID-19 pandemic appears to have changed bankers' perceptions of liquidity risk. The percentage of respondents who considered it "not important" more than doubled from last year, while the percentage of those who considered it "very important" declined substantially.

FIGURE 10

How important is market competition as an impediment to attracting and retaining core deposits?

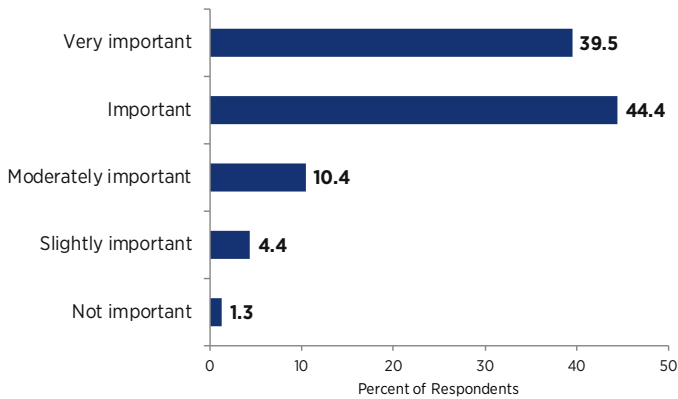
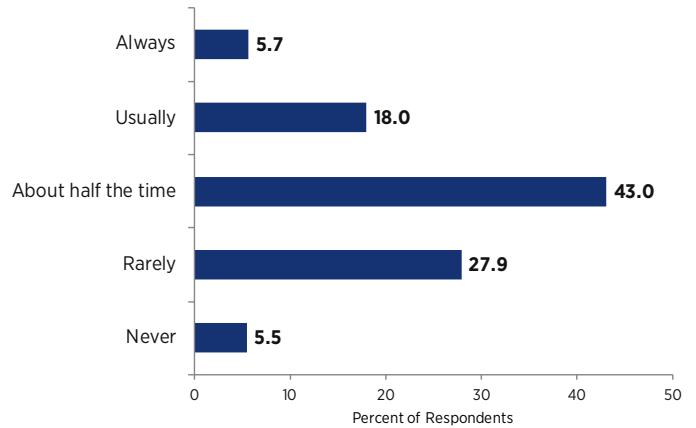


FIGURE 11

How often is core deposit growth prioritized over loan growth?

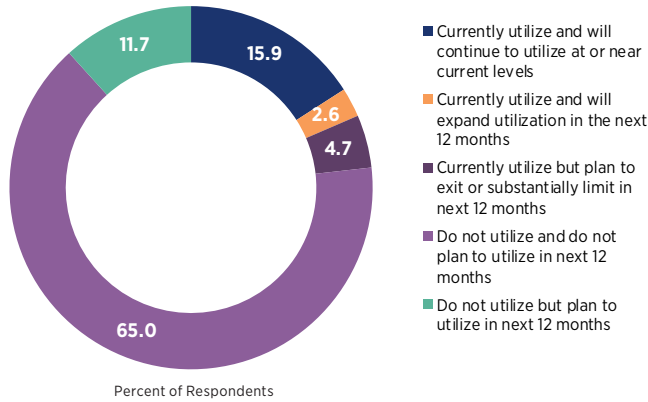


Core deposits were a decreasing concern for community bankers. Although 40% of banks considered market competition to be a very important factor in core deposits, the result was a steep decline from the 54% reported in 2019. Nearly 6% of bankers said they always prioritized deposit growth over loan growth, compared with 9% in 2019, while 6% of them said they never did, compared with 4% in 2019.

USE OF THE DISCOUNT WINDOW

FIGURE 12

What are your intentions regarding discount window borrowing as a wholesale funding source?



About 16% of bankers said they currently utilize discount window lending, which is similar to what was reported in 2019. Intentions of community bankers regarding future use of the discount window, however, changed dramatically. Last year, less than 1% of banks said they planned to exit this source of wholesale funding, and 6% said they planned to enter it. Responses this year indicated more change in both intentions: Nearly 5% said they planned to exit it, while 12% said they planned to enter it.

SOURCES OF COMPETITION

FIGURE 13

What is your greatest source of competition for transaction deposits?

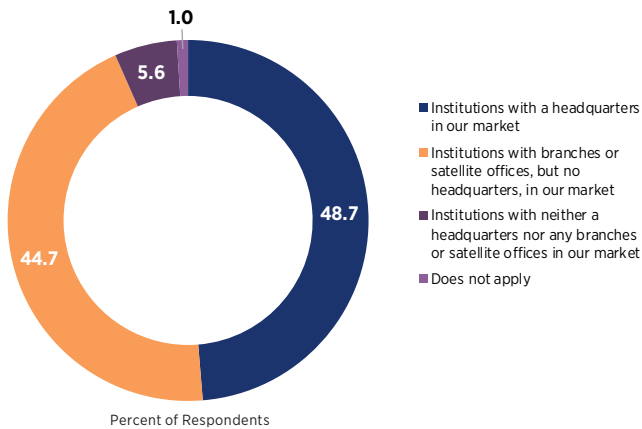
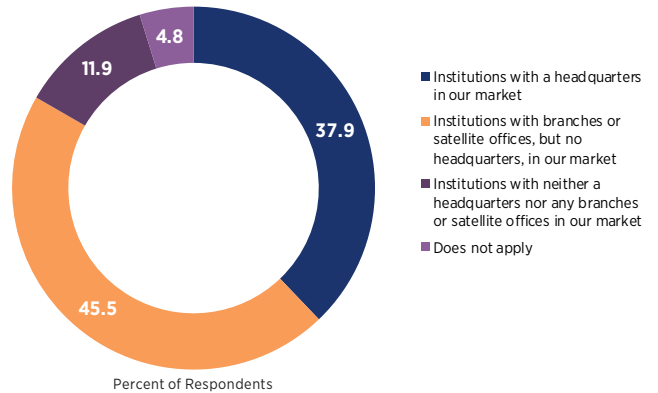


FIGURE 14

What is your greatest source of competition for nontransaction deposits?



Competition for transaction deposits typically came from local banks (49%) and, to a slightly lesser extent, local branches (45%). Last year, the situation was reversed: Competition came more from local branches (53%) than local banks (43%). Competition for nontransaction deposits from local branches declined to 46% from 53% last year.

The coronavirus crisis changed the nature of working arrangements in the community banking industry. Some of these changes, bankers said, were temporary. (See box.) Others were more likely to persist.

Community Bank Perspectives: Impact of COVID-19 on Bank Operations

Bankers described challenges in “all hands on deck” employment strategies required under COVID-19. Staff from one bank, for instance, met clients in parking lots to sign documents. But respondents also talked about a newfound camaraderie. One banker from North Dakota said that employees without small children stepped in to allow those with children to stay at home when schools closed, which created a stronger organization. Multiple bank executives in Oregon reported working long hours alongside their teams late at night. One of them described it as “the most professionally rewarding experience of my career.”

FIGURE 15
Did you implement a work-from-home policy for nonessential staff in response to the COVID-19 pandemic?

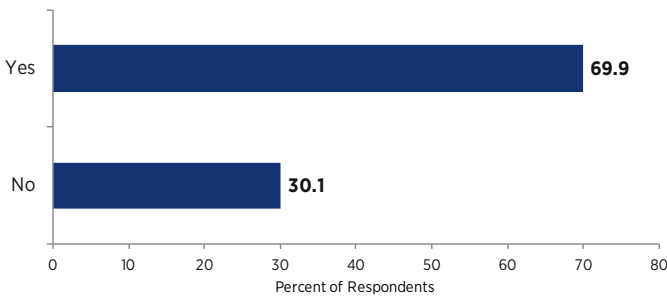
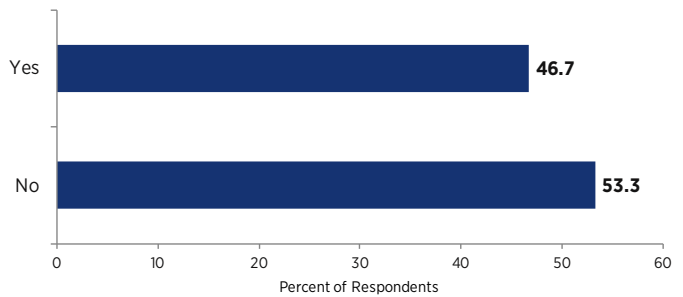


FIGURE 16
Did you increase paid or unpaid sick leave or family leave for your employees in response to the COVID-19 pandemic?



Banks adopted more flexible employment practices in response to COVID-19. About 70% of them implemented a work-from-home policy, while close to half increased allowed absences for health or family considerations. Some bankers said the transition of large numbers of employees to work-from-home status was easier than expected due to technologies that previously had been put in place.

FIGURE 17
Did you expand your full-time equivalent staff in response to the COVID-19 pandemic?

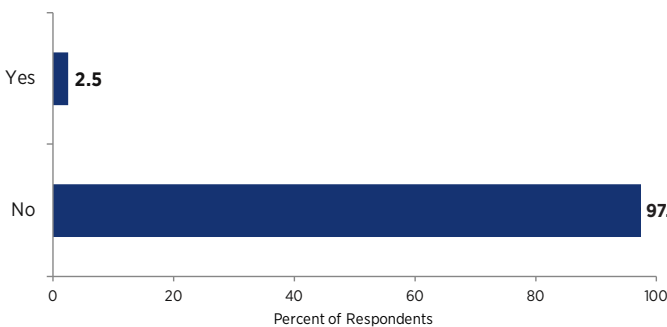
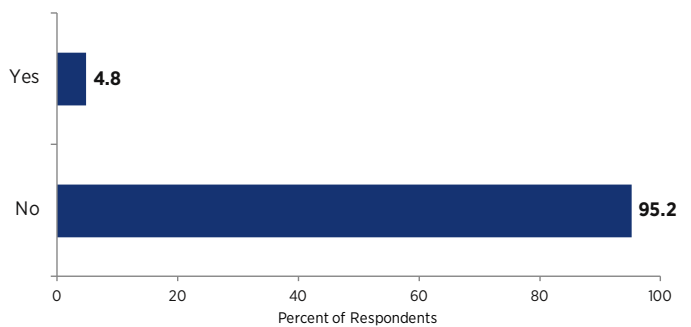


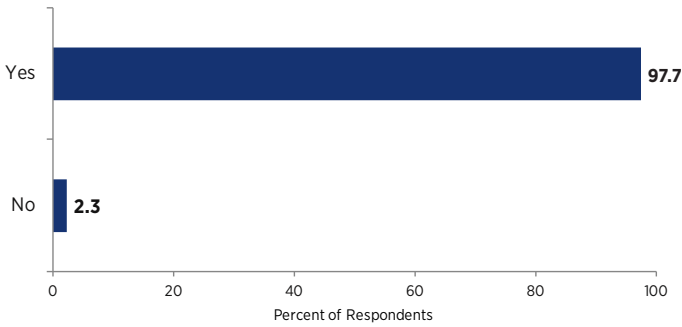
FIGURE 18
Did you reduce your full-time equivalent staff in response to the COVID-19 pandemic?



Changes were made in staffing, as 3% of respondents expanded and 5% reduced headcount. The latter is consistent with operational changes, as illustrated by one banker who slashed staff by half, with two shifts alternating mornings and evenings every other week. The former is consistent with the comment of another banker who said the creation of an online application portal and automated workflow system (for PPP lending) required the “mobilization” of employees.

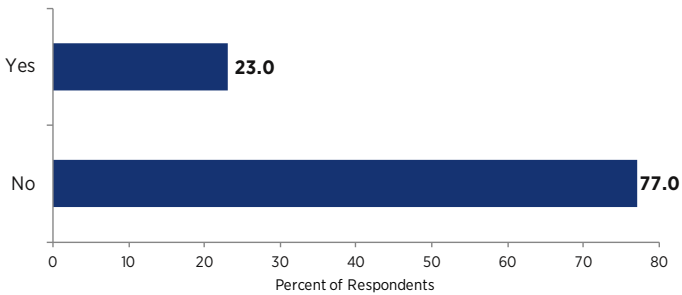
COVID-19 AND BANK OPERATIONS, CONT.

FIGURE 19
Did you restrict your lobby usage in response to the COVID-19 pandemic?



Almost all banks have been restricting lobby usage during the pandemic. Bankers described practices resembling those in other businesses—e.g., protective glass in front of tellers, limitations on the number of people in the bank at any one time, intraday closures for cleaning and requirements for face masks.

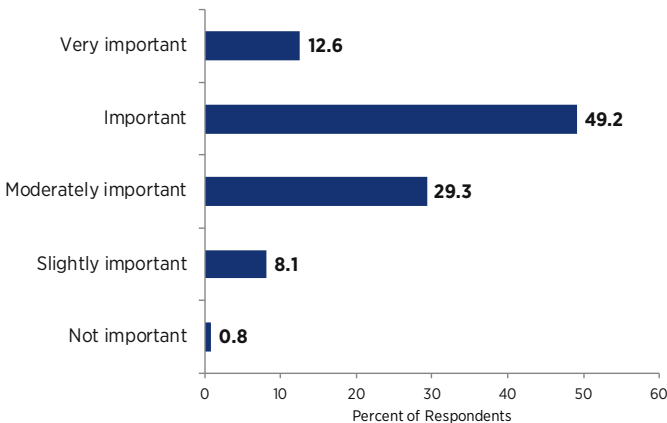
FIGURE 20
Did you close one or more branches (at least temporarily) in response to the COVID-19 pandemic?



About 23% of banks closed branches, at least temporarily. For the entire banking industry, 1,565 branches were closed through August 2020, compared with 1,874 for the same period last year, which was a 16% decline.⁷ In other words, community banks in our survey appeared to close branches to a greater extent than other banks.

OPERATIONAL RISK

FIGURE 21
How important is operational risk (excluding cybersecurity and succession risk) to your bank?



About 62% of bankers considered operational risk to be either “important” or “very important,” which is the same level as reported in 2019. This may suggest that although COVID-19 created many risks for banks, it did not necessarily influence the perceived extent of potential losses stemming from inadequate internal systems due to breaches, fraud, employee error or other external disruptors.

The CARES Act provided credit reporting relief for consumers impacted by COVID-19, forbearance for borrowers with federally-backed mortgage loans and a 120-day moratorium on eviction notices by lessors that are part of covered housing programs or have financing backed by federally-backed mortgages. Many banks also instituted their own policies. (See box.)

FIGURE 22

Did you reduce or eliminate late-payment penalties on credit card or loan payments in response to the COVID-19 pandemic?

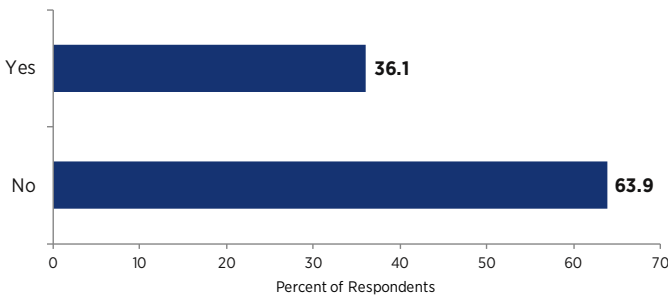
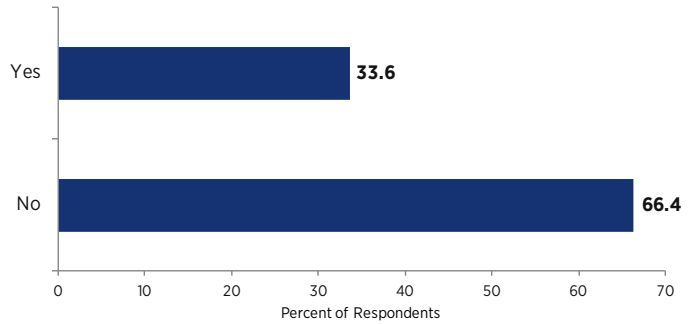


FIGURE 23

Did you reduce or eliminate fees on deposit accounts in response to the COVID-19 pandemic?



More than one-third of the banks reduced or eliminated late-payment penalties on credit card or loan payments, while a similar percentage reduced or eliminated fees on deposit accounts.

Community Bank Perspectives: Supporting Communities During COVID-19

Community bankers supported their communities often and in sometimes very personal ways. One surveyed banker described a “consumer assistance program” that included overdraft protection and deferrals of principal and interest on loan balances. One Kentucky bank gave employees a card explaining the bank’s history with a \$100 bill attached and asked them to send both along to their favorite local businesses. Bank staffs at an Ohio bank educated their customers on mobile banking options. A Massachusetts banker reached out to the unbanked and underbanked populations to foster relationships. A charitable foundation at one bank allowed it “to help first responders very quickly.”

Section Summary

COVID-19 radically changed the operational environment for community banks, as it did for all other businesses, but perhaps more significantly in terms of the role banks played in mitigating impacts of the pandemic by allocating emergency credit throughout the economy. The hallmark of community banking—relationship-based lending—came to the fore.

The response of community banks to COVID-19 created costs for them, however; these ranged from inefficiencies in processing PPP loans of as little as \$400 to perhaps more significant reputational damage arising from some disgruntled customers who, in the words of one banker, felt “left out” of the application process. “While I applaud the speed with which the federal government and the Federal Reserve put together a stimulus package and other funding benefits to help individuals and businesses,” one banker said, “it put banks like ours in a precarious position.”

The people who work at community banks also paid a price: The number of total full-time equivalent employees dropped by 4% from June 2019 to June 2020. Noncommunity banks increased their number of employees by 1% over the same period.⁸

But other bankers raised the possibility that COVID-19 may help reverse, to some extent, the diseconomies of scale that have long plagued the community banking industry. One banker pointed to the advantage smaller banks have in their “nimbleness in adapting.” Another banker noted that loans during the pandemic “were never transactional matters. We were presented with several opportunities by bank customers who simply couldn’t get a loan from their large corporate-style banks. Their loss is our gain.”

Beyond COVID-19: Other Issues Facing Community Banks

In the succeeding sections, we present survey findings that do not necessarily reflect the COVID-19 pandemic as much as underlying factors that may be more likely to persist once it is over.

Regulatory Compliance

Regulations continued to present multifaceted challenges to community bankers. In this section, we examine those tied to explicit costs and risks, with a particular emphasis on the Bank Secrecy Act (BSA).

Bankers were asked to identify the compliance costs they incurred in 2019 in personnel, data processing, legal services, accounting and auditing, and consulting. In all categories, average (mean) costs as a percentage of overall noninterest expenses decreased in 2019. (See Table 4.) The decreases were sometimes modest. They nevertheless suggest at least a plateau of costs at levels observed since 2017.

TABLE 4

Compliance Costs as a Percentage of Total Expenses by Category

	2015	2016	2017	2018	2019
Personnel (Salary and Benefits)	11.4 (7.5)	12.3 (7.7)	10.4 (7.1)	11.3 (6.4)	10.3 (5.8)
Data Processing	17.7 (12.9)	17.8 (11.4)	17.1 (12.4)	18.0 (12.6)	17.1 (11.0)
Legal	20.7 (12.8)	23.0 (14.4)	20.9 (12.5)	22.8 (14.5)	22.6 (14.3)
Accounting and Auditing	41.5 (35.3)	41.7 (35.7)	39.4 (32.3)	42.4 (35.3)	42.3 (36.5)
Consulting and Advisory	42.6 (34.4)	44.5 (39.4)	45.9 (41.7)	40.5 (34.4)	38.2 (28.2)

Note: The percentages are **means** (first row) and **medians** (second row) of ratios of compliance costs to expenses within a given expense category.

A decline in compliance costs is further suggested anecdotally. (See box.)

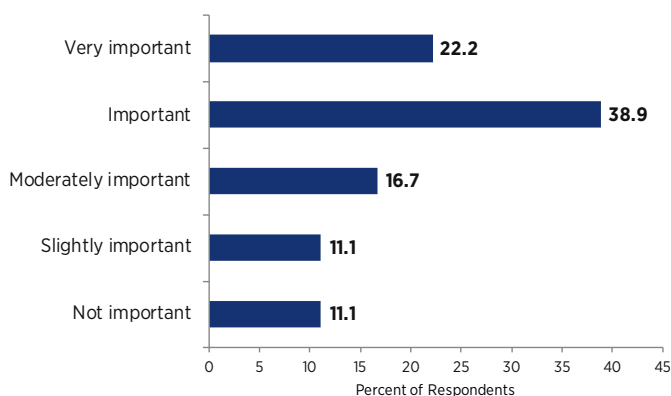
Community Bank Perspectives: Regulatory Burden

Many banks described the benefits of a reduction in regulatory burden, albeit modest in many cases. One bank from South Dakota that adopted the new community bank leverage ratio said it is saving eight hours of staff time per quarter. Several Texas banks reported “significant” benefits from changes to reporting requirements under the Home Mortgage Disclosure Act. Flexibility provided to appraisal requirements was said to have “meaningfully changed” in rural areas. The most recent delay to the implementation of current expected credit loss (CECL) for small banks was seen as a positive.

COMPLIANCE COSTS: IMPACT ON ACQUISITIONS

FIGURE 24

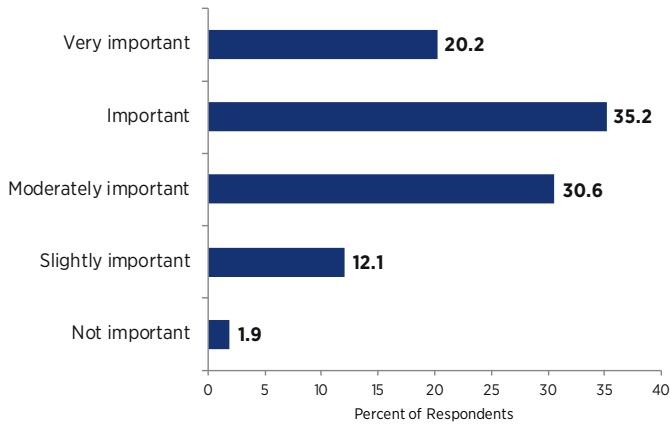
How important were the costs of regulations in your decision to seriously consider accepting an acquisition offer?



A flattening of compliance costs is also reflected in the stable responses to regulatory issues being a motivation for acquisitions: The percentage of respondents who said regulatory issues were a “very important” consideration for selling a bank, at 22%, was the same as in 2019.

FIGURE 25

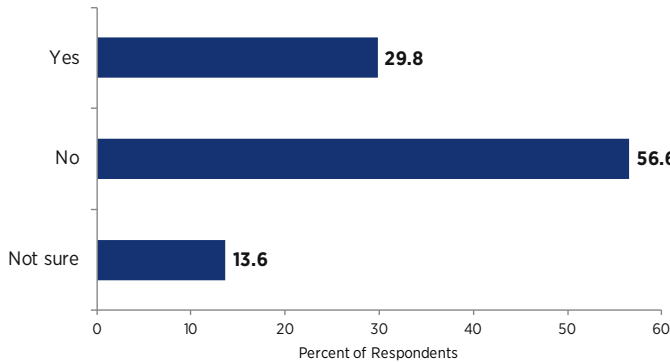
How important is Bank Secrecy Act (BSA) risk to your bank?



Risks tied to BSA may stem from a perceived disconnect between the expectations of examiners and law enforcement, as identified by some bankers. “Law enforcement has told us multiple times that they don’t need a lot of the information we collect that the examiners require of us,” one banker said. Another banker said that examiners are more interested in making sure “all the boxes are checked” and require duplicate narratives on items already documented on the Suspicious Activity Report form. “What seems to get smaller banks in trouble are mundane issues,” the banker said.

FIGURE 26

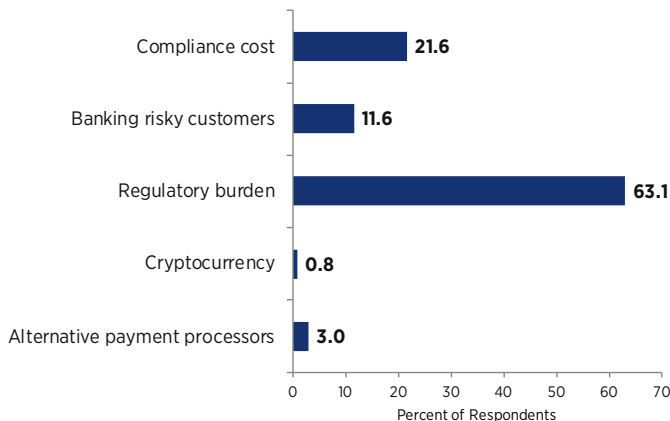
Have you been contacted in the last two years by law enforcement related to a Suspicious Activity Report (SAR) or Currency Transaction Report (CTR) filed by your bank?



Less than 30% of respondents said they had been contacted in the last two years by law enforcement. Among those who weren’t contacted was a banker who asked, “Where do the SARs actually go? It would be nice if there could be some sort of acknowledgment of receipt at least. In the 40-plus years I’ve been in banking, I’ve never had a response.”

FIGURE 27

What Bank Secrecy Act/Anti-Money Laundering (BSA/AML) issue concerns you the most?



Regulatory burden was named as the most important BSA/AML concern of community bankers. “By far the biggest burden and waste of time is having to complete beneficial ownership forms for each transaction,” one banker said. “A simple attestation that nothing has changed should suffice. We are a small community bank and know our customers extremely well, and there are infrequent changes of ownership.”

OTHER COMPLIANCE RISKS

FIGURE 28

How important is consumer compliance risk to your bank?

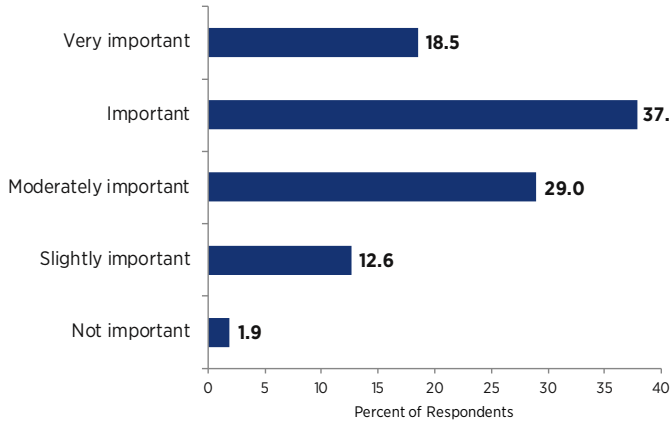


FIGURE 29

How important is compliance risk (excluding BSA and consumer compliance risk) to your bank?

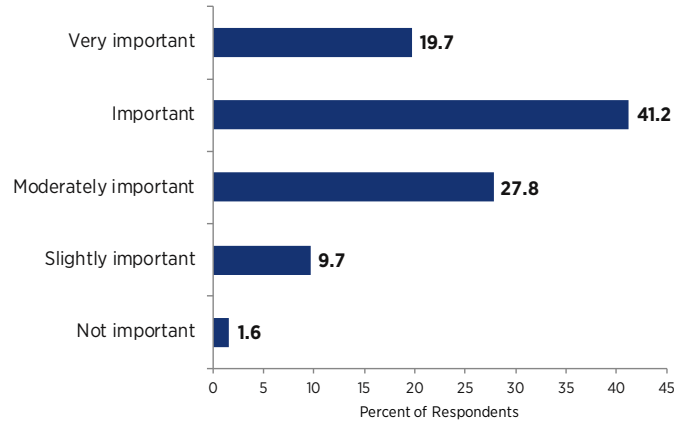
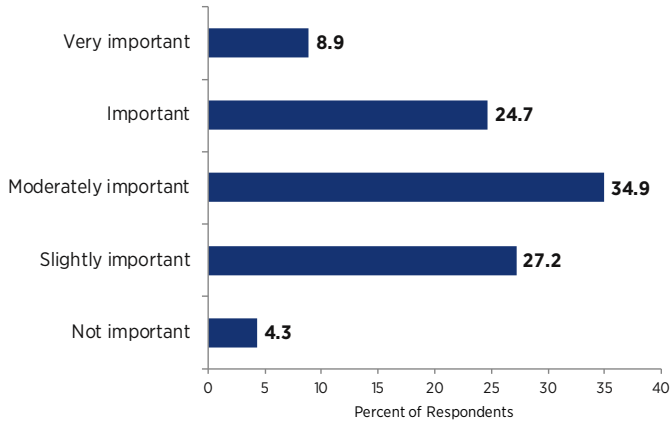


FIGURE 30

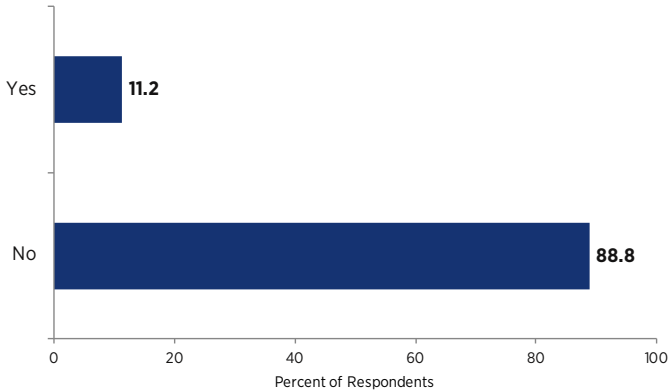
How important is legal risk (excluding consumer compliance risk) to your bank?



The extent of concern with compliance risk expressed by bankers was relatively evenly distributed across consumer and other compliance risk categories. Relatively few bankers considered them to be “not important,” while larger percentages considered them to be “very important.” Less concern was evident in how respondents viewed legal risks to their banks.

FIGURE 31

Did the adoption of CECL or other accounting-related effects cause you to increase your loan loss reserve?



Although regulatory changes as a result of COVID-19 allowed banks to delay implementing the Financial Accounting Standards Board's CECL standards for their reserves, some banks were already adjusting to it. More than 11% of survey respondents said they had increased their reserves in response to CECL.

Section Summary

Information on regulatory costs supplied by survey respondents suggests at least a flattening, if not a decline, in overall compliance costs. Comments from some bankers suggest they are paying less attention to regulatory burden than has been the case in the past. On the other hand, some banks, particularly the smallest, continue to struggle. One banker said, "If we don't get a reduction in regulations, I am not sure we will survive."

Bankers had stronger opinions about BSA and associated anti-money laundering regulations. Many bankers described an environment in which these regulations have become almost hopelessly outdated. They complained about transaction limits that "have not been changed in *forever*," as one banker noted. Another banker commented that changes in BSA enforcement should occur "from time to time, when the world we live in changes. We quit riding horses to get somewhere a long, long time ago."

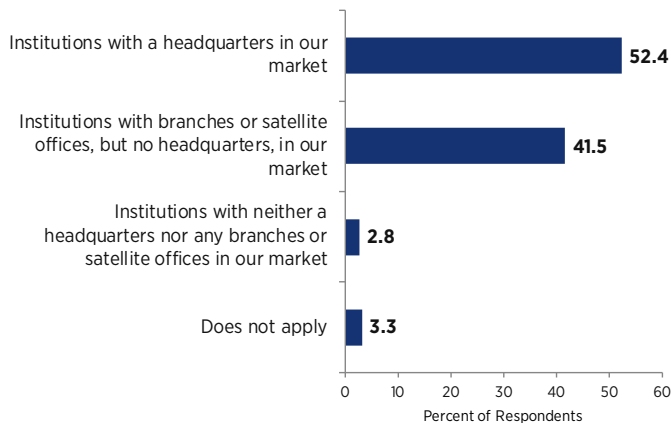
Lending Competition and Libor

The competitive aspect of banking was the focus of several questions in this year's survey, as in previous years.

LENDING COMPETITION

FIGURE 32

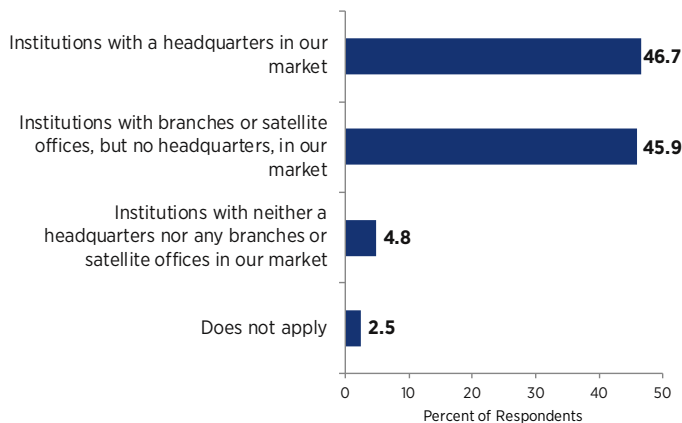
What is your greatest source of competition for small business loans?



Competition for small business loans was dominated by institutions with a local presence, either a headquarters (52%) or branch-only locations (42%).

FIGURE 33

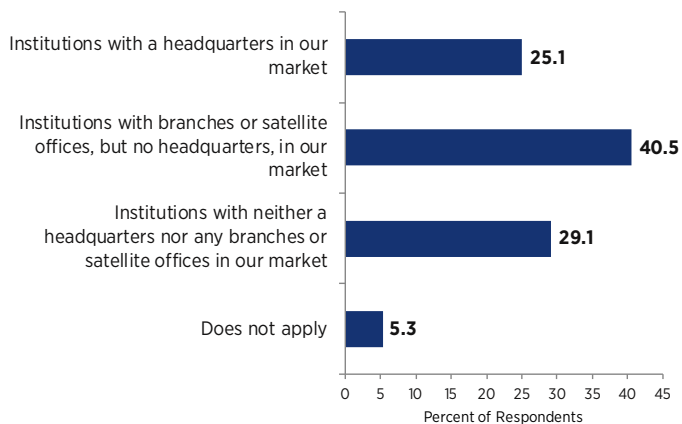
What is your greatest source of competition for commercial real estate loans?



Proximity also was important in competing for commercial real estate loans, as less than 5% of respondents cited competitors with no physical locations in their markets as their primary competition.

FIGURE 34

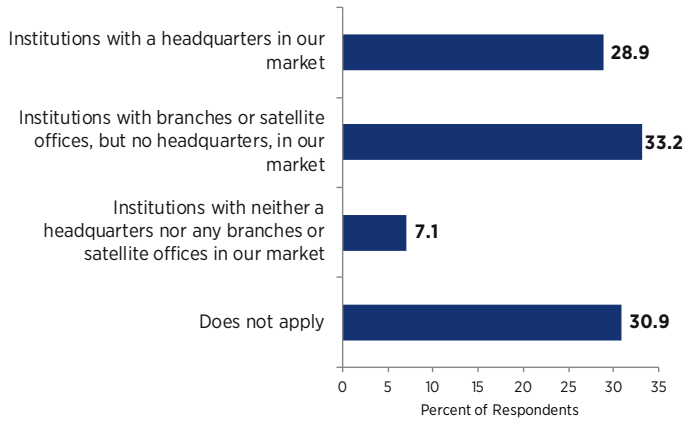
What is your greatest source of competition for 1-4 family mortgages?



Competition for mortgage loans was dispersed, as 25% of bankers named entities with a local headquarters as their greatest source of competition, while more than 40% said their biggest rivals were institutions with local branches or satellite offices. Competitors without a local presence were named by 29% of respondents as their greatest source of competition for 1-4 family mortgages, which was higher than what was reported in 2019.

FIGURE 35

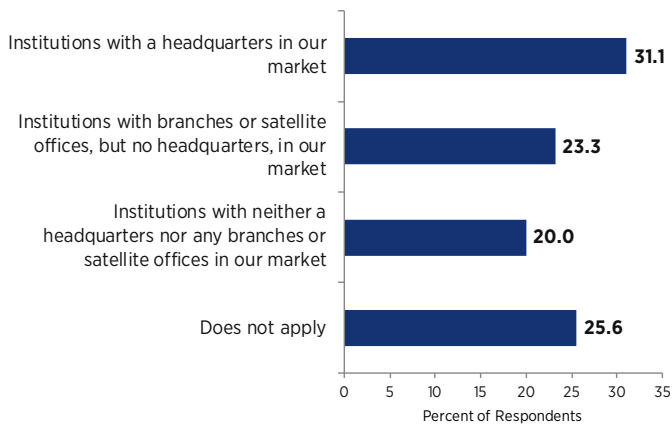
What is your greatest source of competition for agricultural loans?



About 7% of respondents named entities without a local presence as their toughest competitors for agricultural loans. This is a sharp decline from the level reported last year.

FIGURE 36

What is your greatest source of competition for small-dollar unsecured loans?



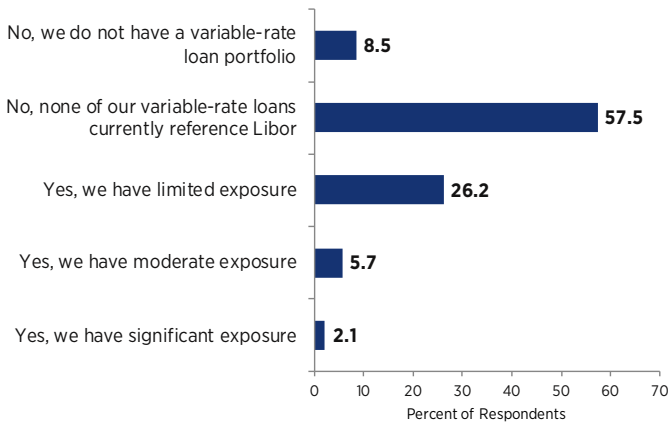
The impact of entities without a local presence was significant in small-dollar unsecured loans, as these institutions were named the greatest competitors by 20% of respondents.

LIBOR

After the financial crisis, it became apparent that the London Interbank Offered Rate (Libor) no longer served as an effective benchmark for pricing short-term loans and other securities worldwide. Libor is scheduled to be phased out by the end of 2021 and replaced by the Secured Overnight Financing Rate (SOFR). SOFR is a cost of borrowing cash overnight that is collateralized by U.S. Treasury securities.

FIGURE 37

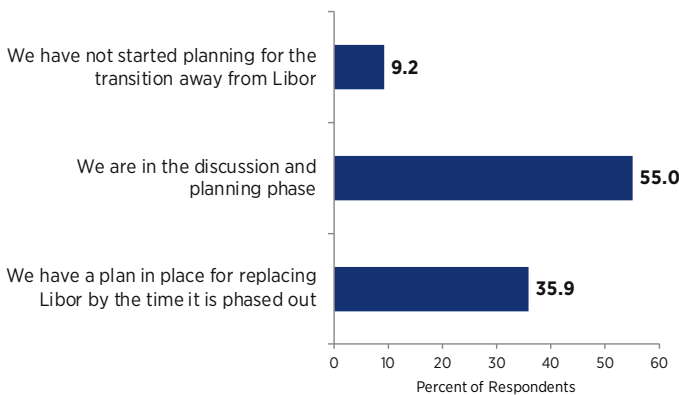
Do you currently have any loans that reference Libor?



About 8% of banks reported at least moderate exposure to Libor, the same as in 2019.

FIGURE 38

Which of the following most closely describes your bank's readiness to transition away from Libor by the time it is phased out in 2021?



Progress has been made in preparation for the transition away from Libor. Less than 10% of banks said they had not yet started making plans for it, while 36% said they had a plan in place. Last year, the same percentages, respectively, were 15% and 27%.

Section Summary

The lending environment faced by community bankers this year, as described in the analysis of the impacts of COVID-19, was radically different from previous years. Changes in the sources of competition were less pronounced but still evident in some areas. For instance, out-of-market competition decreased for agricultural lending but increased for mortgage lending.

Trends in Wholesale Funding

Questions on banker intentions with respect to funding sources were a focal point of last year's survey. Similar questions were asked again this year. Aside from discount window activity, as previously noted, banker responses were very similar to those expressed last year.

FIGURE 39

What are your intentions regarding brokered deposits as a wholesale funding source?

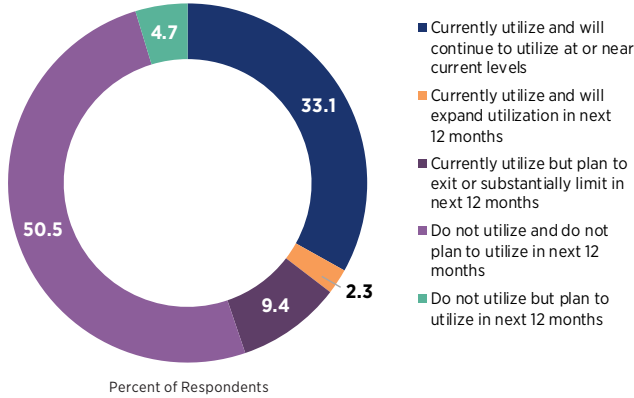


FIGURE 40

What are your intentions regarding Federal Home Loan Bank advances as a wholesale funding source?

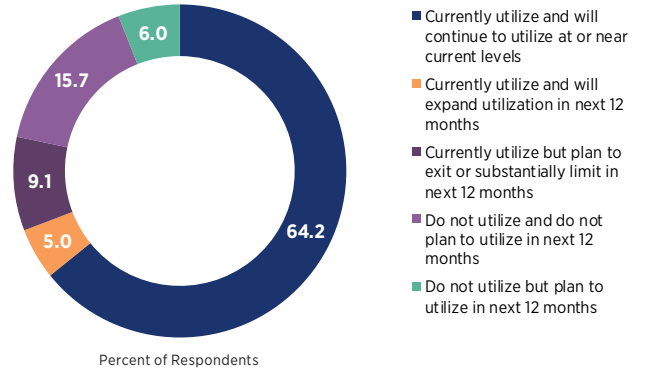


FIGURE 41

What are your intentions regarding public deposits as a wholesale funding source?

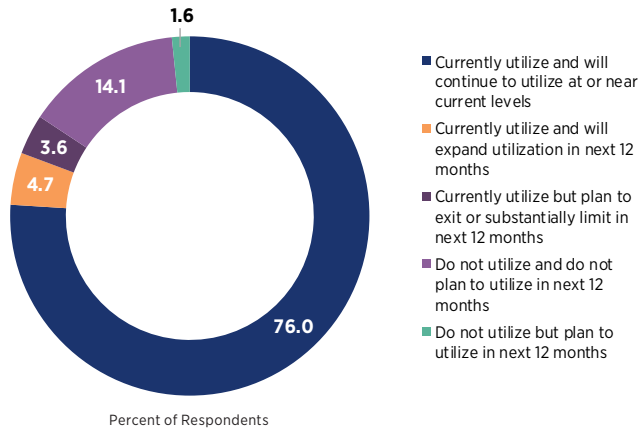


FIGURE 42

What are your intentions regarding other borrowed money as a wholesale funding source?

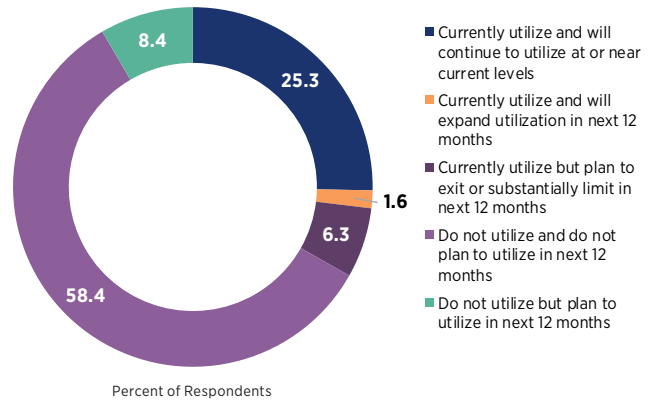


FIGURE 43

What are your intentions regarding fed funds purchased and repurchase agreements as a wholesale funding source?

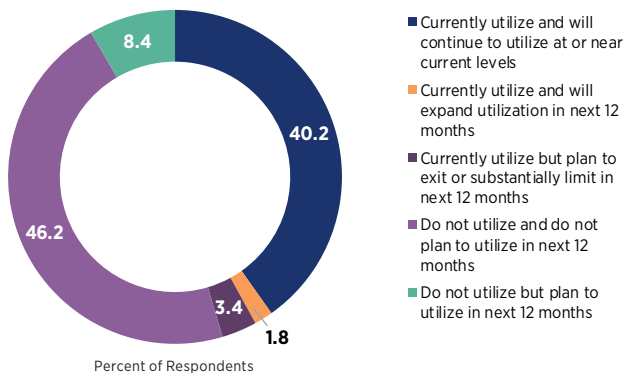
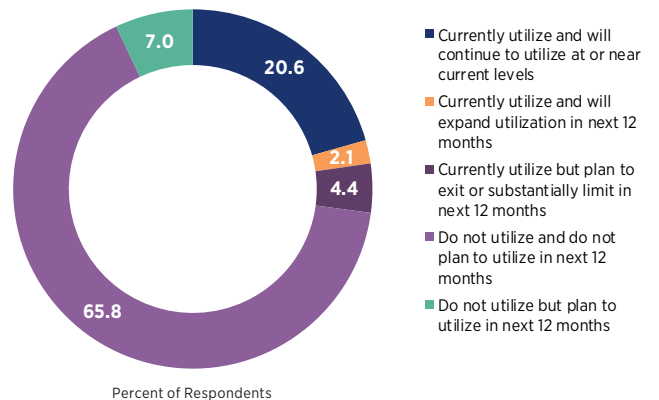


FIGURE 44

What are your intentions regarding listing service deposits as a wholesale funding source?



IMPEDIMENTS TO RETAINING CORE DEPOSITS

FIGURE 45

How important is the national rate cap as an impediment to attracting and retaining core deposits?

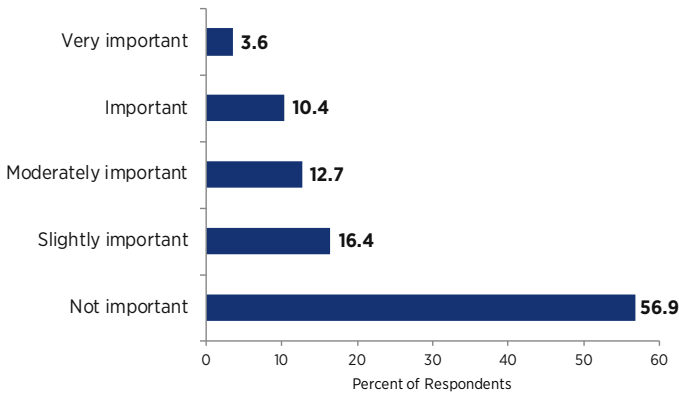


FIGURE 46

How important is depopulation as an impediment to attracting and retaining core deposits?

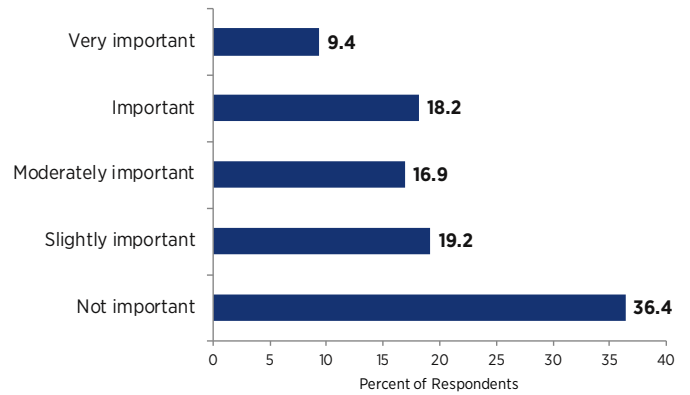
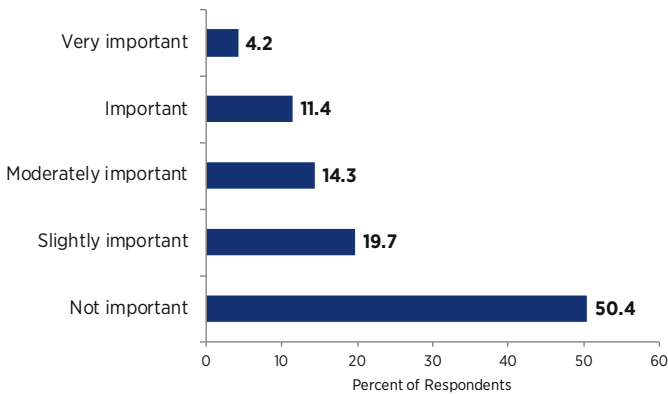


FIGURE 47

How important are capital constraints as an impediment to attracting and retaining core deposits?



Section Summary

Community bankers reported varying levels of involvement across wholesale funding activities. With respect to intentions for future use, more stability was evident in public deposits and less in Federal Home Loan Bank advances. Depopulation was viewed as a more significant impediment to core deposit growth than were capital constraints.

Online Banking and Technology

Community bankers responding to this year's survey considered themselves held back in adapting to technological change. They worried that the delivery of technological products is becoming "too complex for employees," as one banker stated, while innovation is becoming "cost prohibitive due to technology fees and possible staffing increases needed to monitor and manage new technologies." But bankers also acknowledged that technology is increasingly important in delivering products and services. (See box.)

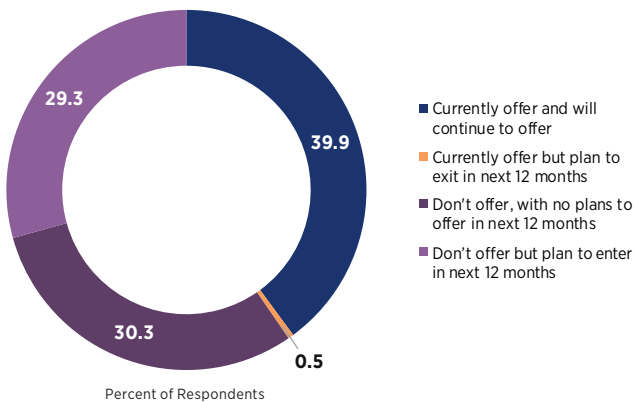
Community Bank Perspectives: Impact of Technology

Several community banks said that their business models will need to be adapted to deliver financial products and services in a "multi-channel environment" that exists outside branches. Bankers in Wisconsin, for example, anticipate significant investments in technology and information security and in the hiring, training and retaining of staff. Idaho banks have pivoted their business models to meet the unique challenges of the pandemic through increased reliance on technology to communicate with customers. A banker from Nebraska said the community banking industry must "envision new-norm opportunities."

ONLINE SERVICES

FIGURE 48

What are your intentions regarding online loan applications?



Online loan applications were offered by 40% of community banks, up slightly from the 39% of banks that offered them last year. This contrasts with the 27% of banks that last year expressed their intentions to offer online loan applications. It also may suggest that plans of the 29% of banks intending to offer online loan applications in the next 12 months may not materialize.

FIGURE 49

What are your intentions regarding online loan closing?

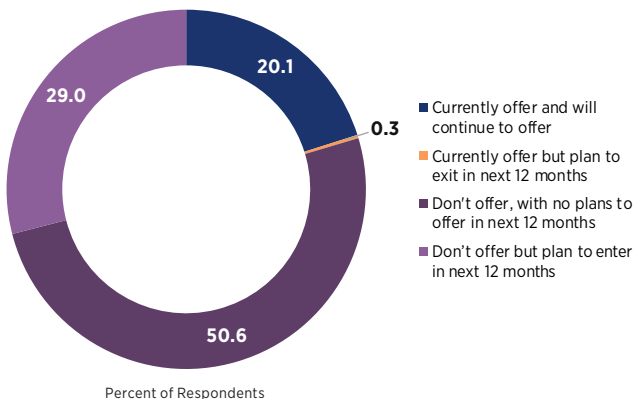


FIGURE 50

What are your intentions regarding automated loan underwriting?

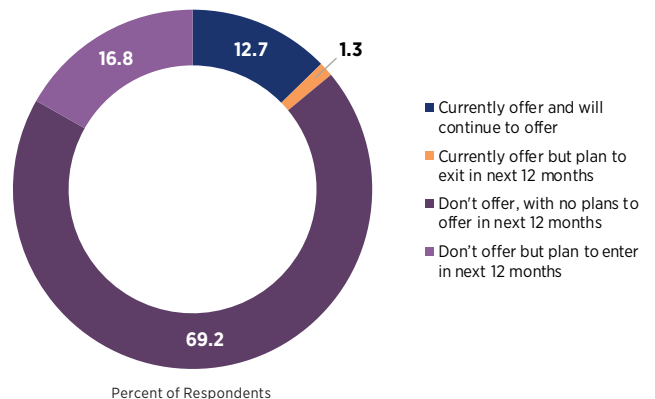


FIGURE 51
Which of the following best describes your views on the creation of a separately branded online-only division (i.e., a microbank) to attract loans and/or deposits?

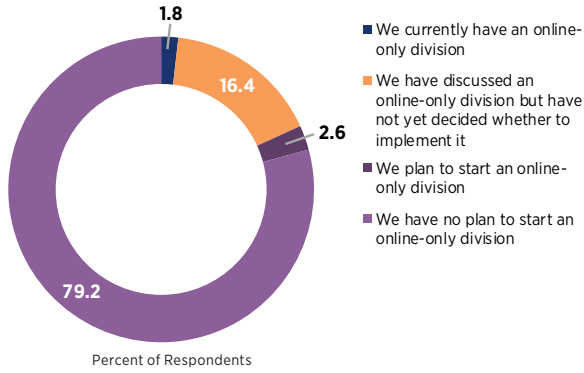


FIGURE 52
What are your intentions regarding remote deposit capture?

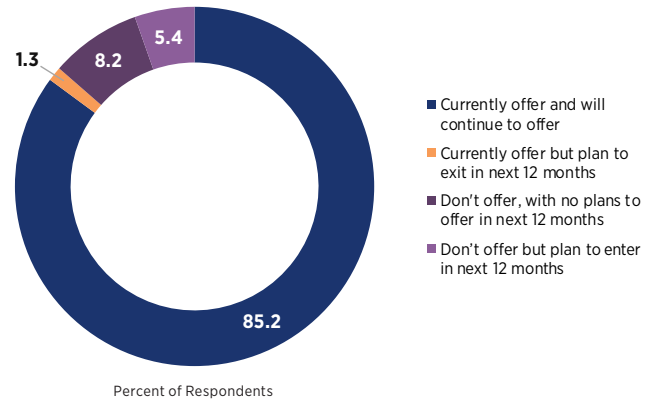


FIGURE 53
What are your intentions regarding electronic bill presentment or payment?

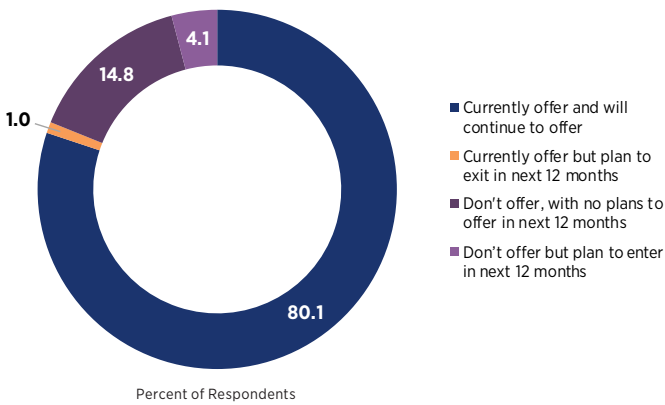


FIGURE 54
What are your intentions regarding interactive teller machines (ITMs)?

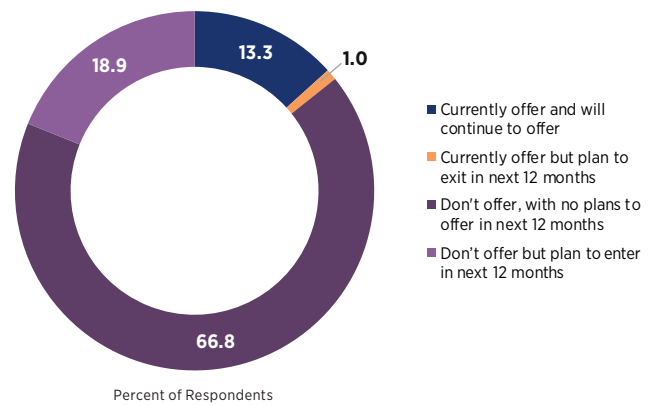
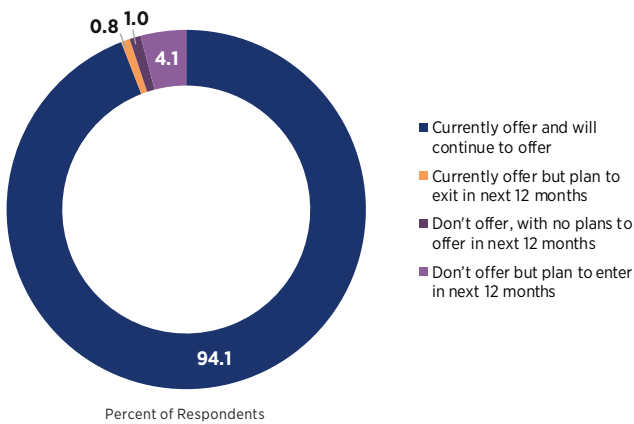


FIGURE 55
What are your intentions regarding mobile banking?



For all of these online services except remote deposit capture, percentages in various categories were very similar to those reported last year. Remote deposit capture was offered by 85% of banks, an increase from the 79% previously reported.

PROVISION OF FINANCIAL TECHNOLOGY

FIGURE 56

To what extent does your bank rely on in-house technology for nonlending digital banking products and services?

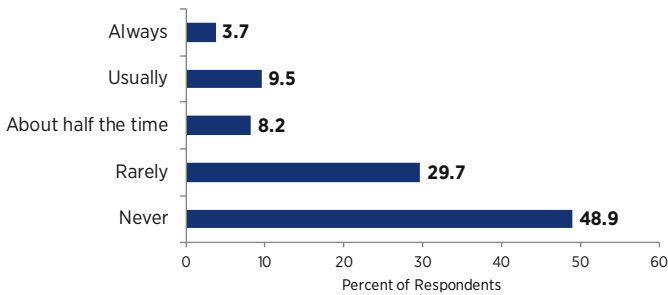
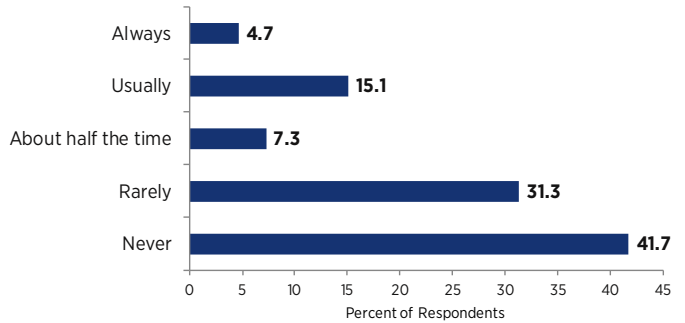


FIGURE 57

To what extent does your bank rely on in-house technology for online loans?



Only a minority of community banks reported relying on in-house technology to provide online loans and nonlending digital products; in both cases, less than 27% of bankers were doing so at least half of the time.

FIGURE 58

How important is the adoption of new or emerging technologies to meet customer demand in your market?

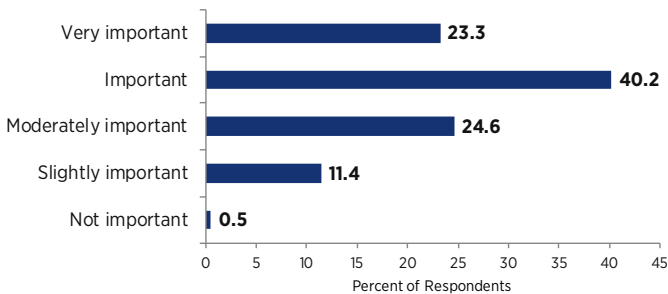
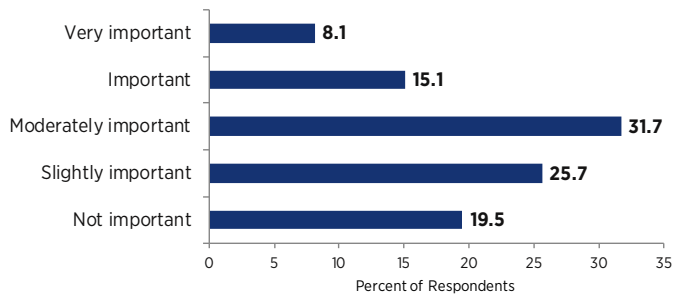


FIGURE 59

How important is it to be a leader in new or emerging technology adoption to meet customer demand in your market?



Although most bankers considered adoption of emerging technologies to be important in meeting customer demand, they assigned a much lower importance to technological leadership. “As a small community bank, it is never a goal to be a market leader in technology,” one banker said. “However, implementing new technology is a necessity to be able to compete for the younger customer.”

SATISFACTION WITH TECHNOLOGY

FIGURE 60

How satisfied are you with the effectiveness of your bank’s technology in the area of BSA compliance?

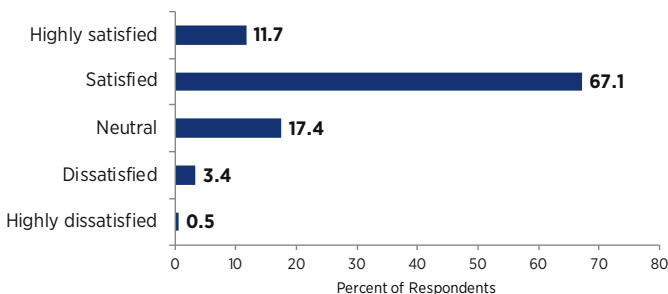
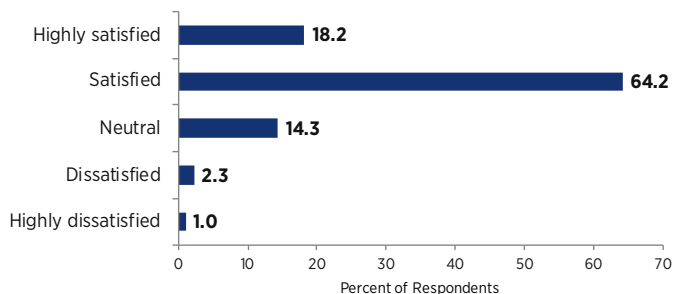


FIGURE 61

How satisfied are you with the effectiveness of your bank’s technology in the area of asset/liability management?



SATISFACTION WITH TECHNOLOGY, CONT.

FIGURE 62

How satisfied are you with the effectiveness of your bank's technology in the area of interest rate risk?

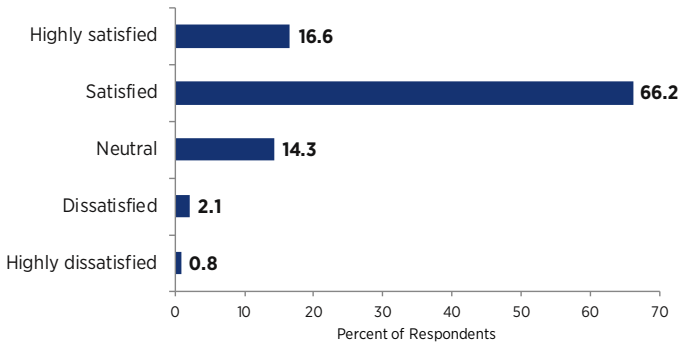


FIGURE 63

How satisfied are you with the effectiveness of your bank's technology in the area of compliance risk management?

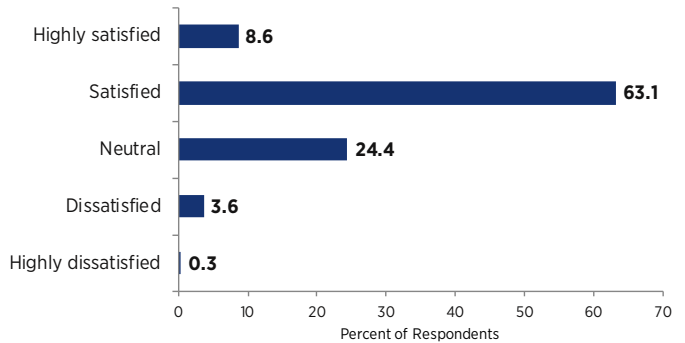


FIGURE 64

How satisfied are you with the effectiveness of your bank's technology in the area of trust management?

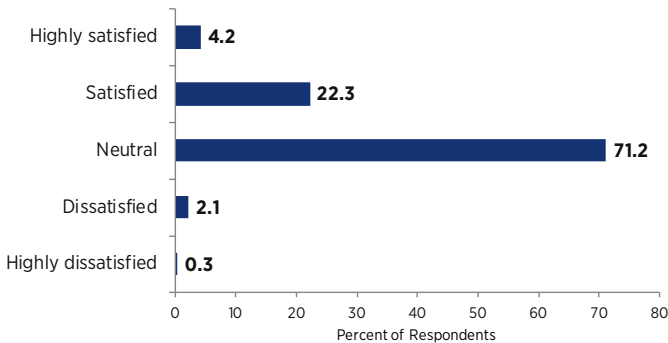
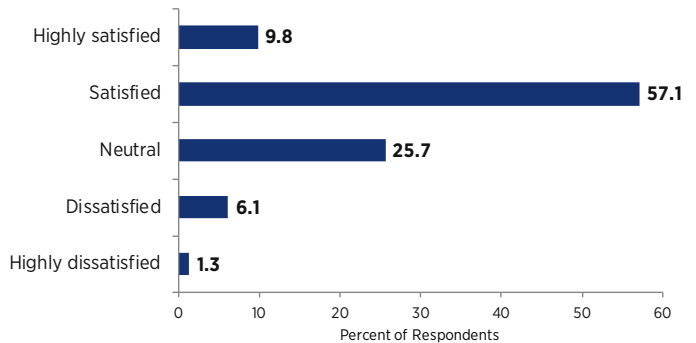


FIGURE 65

How satisfied are you with the effectiveness of your bank's technology in the area of board meeting management?



In each of four specific operational areas—BSA compliance, asset/liability management, interest rate risk and compliance risk management—fewer than 4% said that they were “highly dissatisfied” or “dissatisfied” with the effectiveness of technology, while at least 72% said they were “satisfied” or “highly satisfied.” Less satisfaction was expressed in the technology used for trust management, in which less than 27% of bankers said they were “highly satisfied” or “satisfied,” and for board meeting management, in which more than 7% of bankers said they were “highly dissatisfied” or “dissatisfied.” Cybersecurity risk was still an issue, although to a lesser extent than it was in 2019.

Section Summary

Community bankers appear generally satisfied with the role played by technology in the delivery of products and services. They see opportunities in introducing their customers to technologies that already existed, but were previously resisted, in electronically delivered products—including Interactive Teller Machines, mobile banking, remote deposit capture, automated clearinghouse (ACH) originations, commercial loan systems, online account openings, electronic signatures and secure file sharing.

But many others remain pessimistic: “Technology will rule the industry in both the lending and the deposit side,” one banker said. “In fact, I am not sure that banks as we know them will exist at all.”

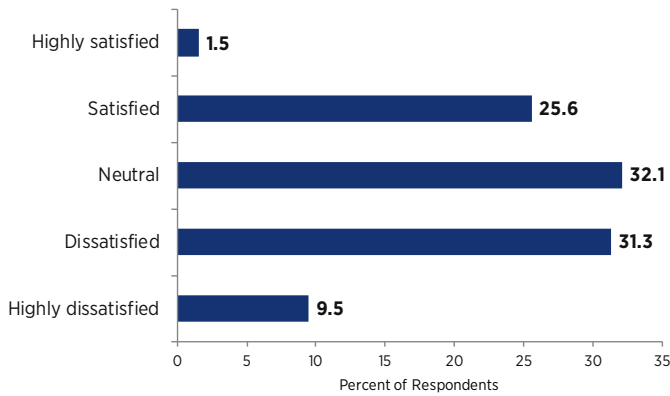
Core Processing

Unlike larger banks that develop technology themselves, community banks rely to a greater extent on a handful of core service providers.⁹ These companies provide core banking systems, which allow a bank to open new accounts with loan origination software, process deposits and withdrawals, maintain its general ledger, accommodate automated clearing house (ACH) transfers and provide mobile banking applications and online banking. This year's survey included a wide variety of questions on bankers' attitudes about their relationships with these core processors.

COSTS AND CONTRACTS

FIGURE 66

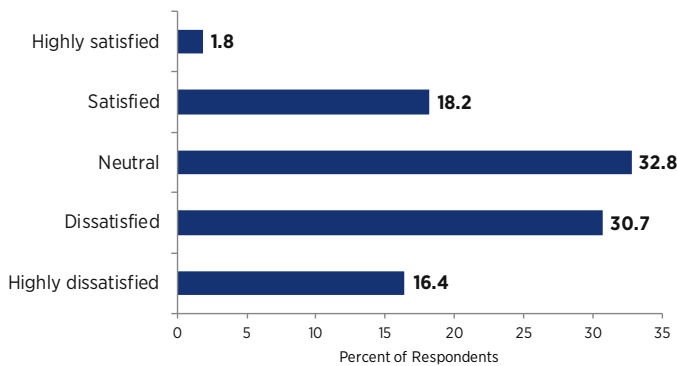
Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with cost?



Nearly 10% of respondents were “highly dissatisfied,” while less than 2% were “highly satisfied,” with costs of core processing services. With regard to external providers, one banker described a “nickel and dime” approach by its core provider “when asking for more extension or depth of use of their technological capabilities.”

FIGURE 67

Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with their flexibility?



Nearly half of respondents were “highly dissatisfied” or “dissatisfied” with flexibility in core processing services. In this regard, costs of migration to a new system can be onerous in terms of the time needed to map data fields, link interdependent software and train staff.

COSTS AND CONTRACTS, CONT.

FIGURE 68
How long have you been with your core service provider?

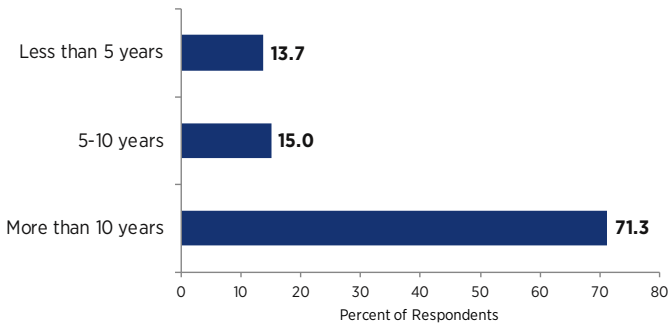
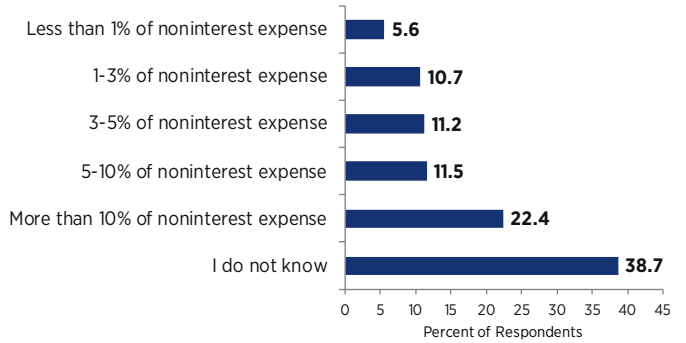


FIGURE 69
How much would it cost to terminate your contract with your core service provider tomorrow?



More than 71% of bankers said they have been with their core providers for more than 10 years. Such enduring relationships may be influenced by the long-term nature of contracting; more than 22% of bankers estimated termination costs to represent more than 10% of total noninterest expenses.

FIGURE 70
Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with speed of innovation?

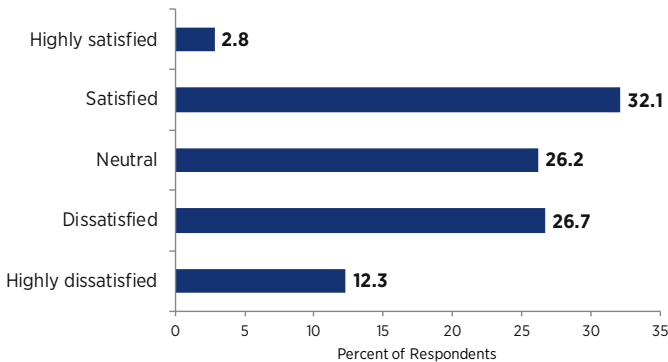
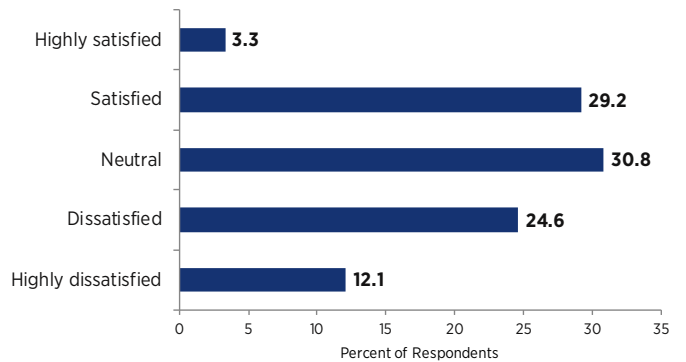


FIGURE 71
Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with the ability to roll out new products and services?



Bankers expressed a relatively negative opinion about the ability of core service providers to operate innovatively: About 12% of them were “highly dissatisfied” with the speed of innovation and the ability of their providers to roll out new products.

FIGURE 72

Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with technological sophistication?

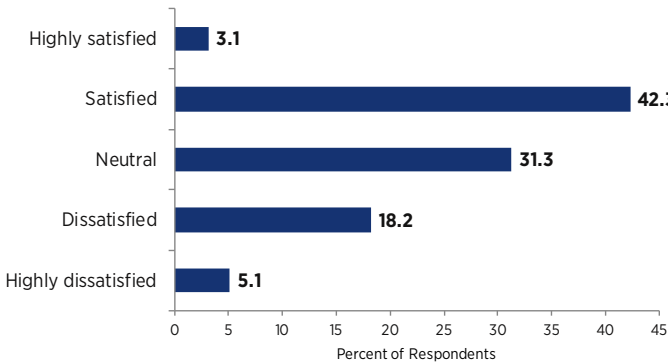


FIGURE 73

Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with security?

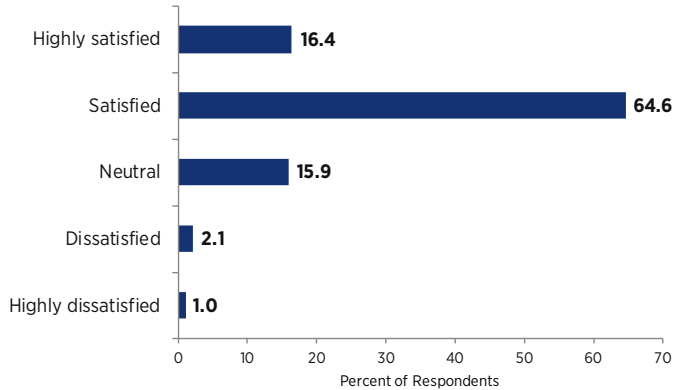


FIGURE 74

Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with risk management?

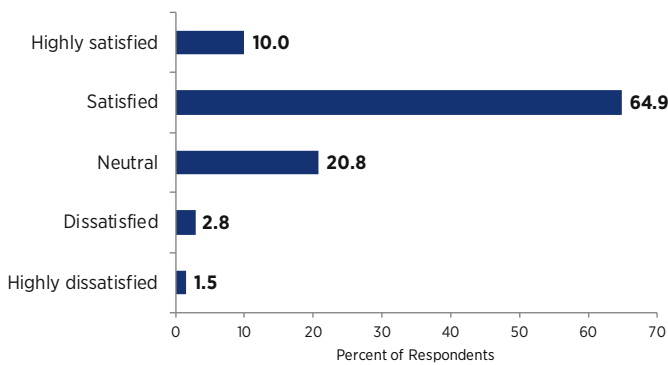
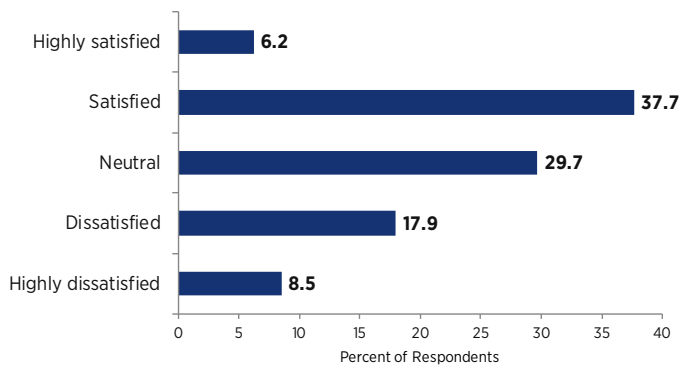


FIGURE 75

Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with customer service?



Bankers were not uniformly critical of their core service providers. More than 16% of bankers were “highly satisfied” with security, the highest ranking of any metric. In the area of risk management, 75% of bankers were “satisfied” or “highly satisfied,” with somewhat lower levels of satisfaction reported in customer service. Sentiment was also generally positive for technological sophistication.

FIGURE 76
With respect to outside providers of digital banking products and services, our bank:

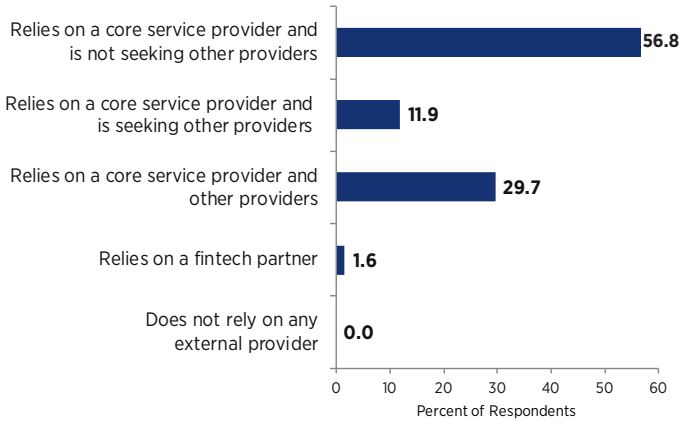


FIGURE 77
Regarding core processing services at your bank, whether in-house or through an external provider, how satisfied are you with third-party compatibility?

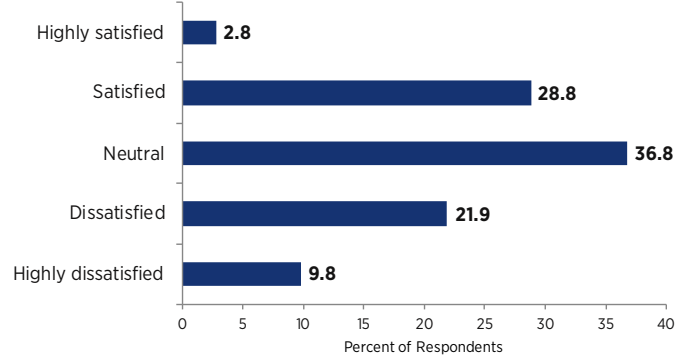
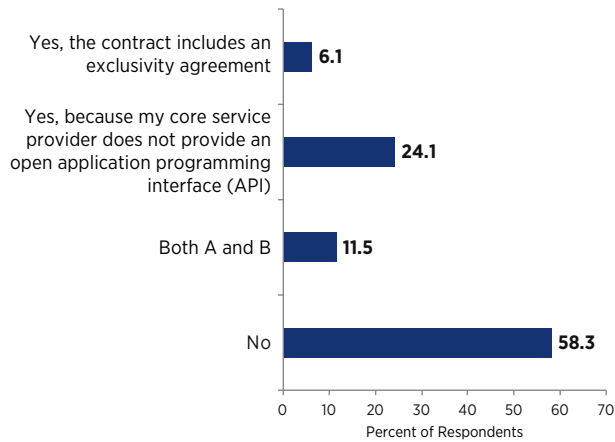


FIGURE 78
Is your relationship with your core service provider an impediment to entering into a partnership with a fintech company?



Less than 2% of respondents relied on a fintech partner to provide digital banking products and services. One-third of bankers were satisfied with the compatibility of their core processing services with other third-party vendors. Most did not consider relationships with core service providers an impediment to partnering with a fintech company.

REGULATORY RELATIONSHIPS

FIGURE 79

How strongly do you agree with this statement?
Supervisory expectations for due diligence of a third-party provider are an impediment to establishing new third-party relationships.

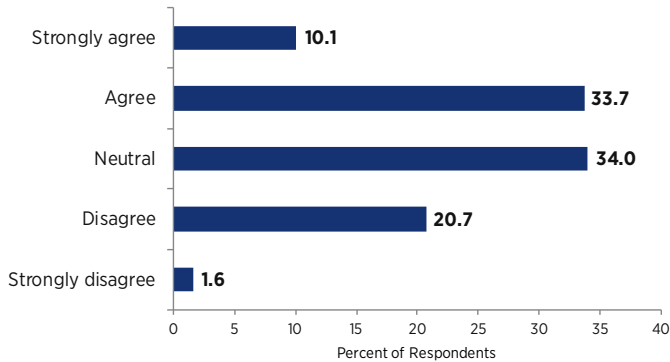
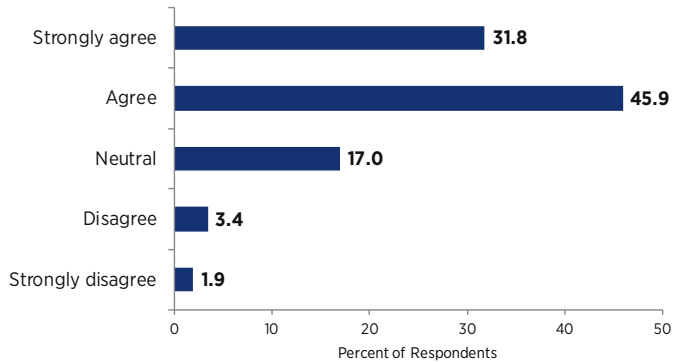


FIGURE 80

How strongly do you agree with this statement?
Having more information about my core service provider from the banking agencies that supervise it would be helpful.



Decisions of community bankers with respect to core service providers appear to have significant regulatory implications. More than 43% of respondents said the expectations of bank supervisors regarding due diligence of a third-party provider to some extent impeded the establishment of new relationships with those providers, while nearly 78% of respondents said more information from supervisors about core service providers would be helpful.

Section Summary

Bankers expressed varying opinions of their relationships with core service providers. But they often complained about diseconomies of scale inherent in contract terms: “Generally, all solutions are based on volume with a minimum monthly cost,” one banker noted. Another banker, referring to community banks with lower volumes, said, “This pricing structure prevents implementation of new technologies, resulting in the inability to compete with larger banks in our market area.” Yet another banker said it limits access to promising opportunities and could “cause failure in the future.”

Transactional and Advisory Activities

Bankers were asked to describe their activities in areas that are transactional and advisory in nature. Similar questions were asked in previous surveys.

FIGURE 81
What are your intentions regarding stored value cards?

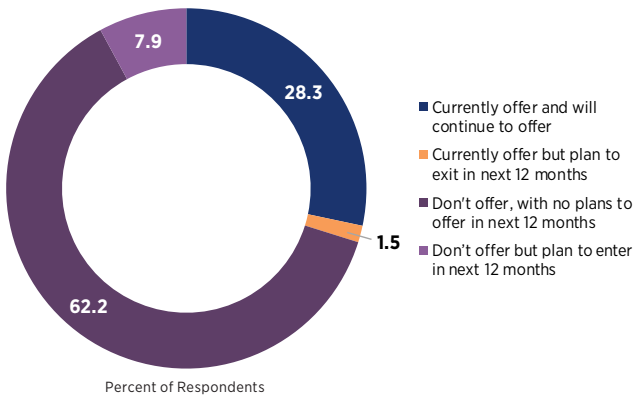


FIGURE 82
What are your intentions regarding cash management services?

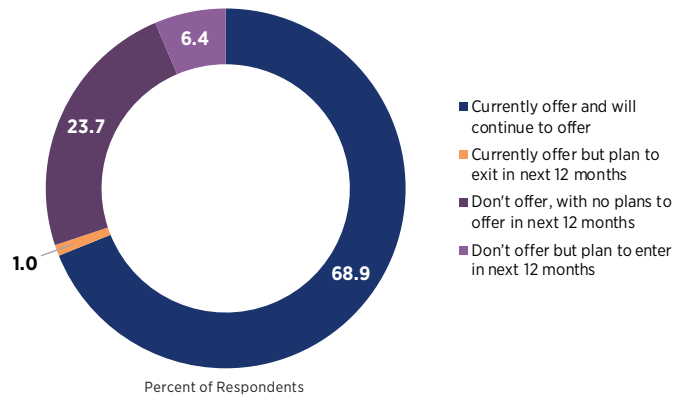


FIGURE 83
What are your intentions regarding payroll cards?

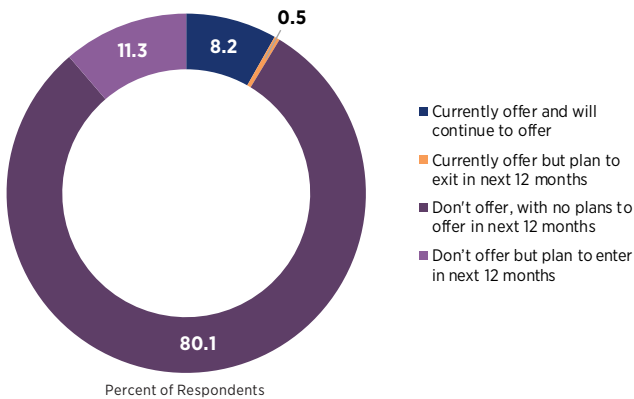


FIGURE 84
What are your intentions regarding money remittance services?

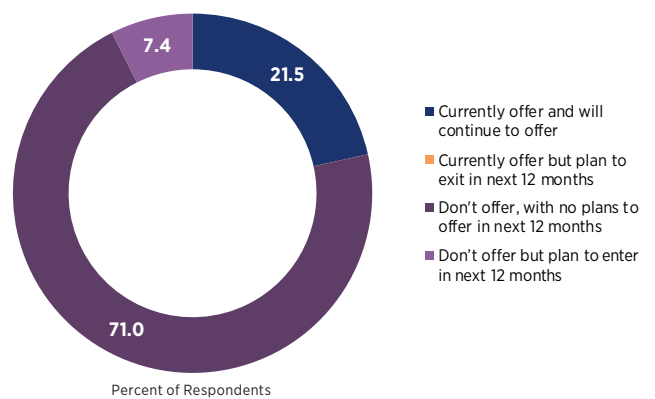


FIGURE 85
What are your intentions regarding wealth management services?

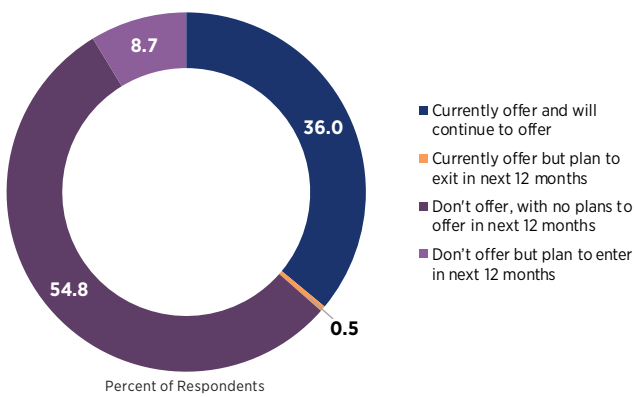
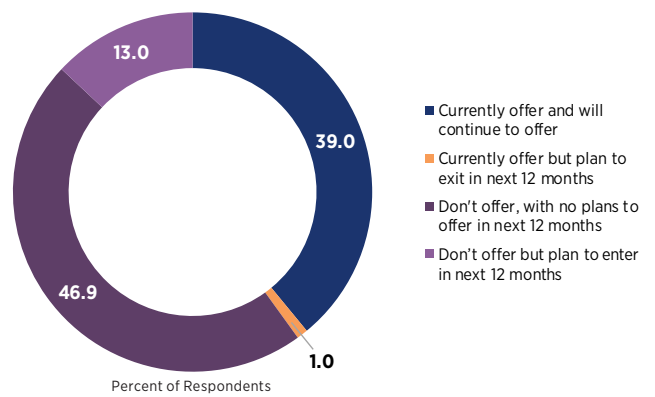


FIGURE 86
What are your intentions regarding personal financial management tools?



Section Summary

Levels of involvement in transactional and advisory activities reported in this year's survey were very similar to those reported in previous years. The COVID-19 pandemic, despite its severity, apparently did not radically impact all community bank operations.

Acquisition Activity

Acquisition activity has slowed in the wake of the pandemic, as business combinations dropped to 109 year to date through August from 122 for the same period last year.¹⁰ But many industry observers expect the consolidation trend to resume, and even accelerate, when economic activity normalizes.¹¹

FIGURE 87

Have you received and seriously considered an acquisition or merger offer in the last 12 months?

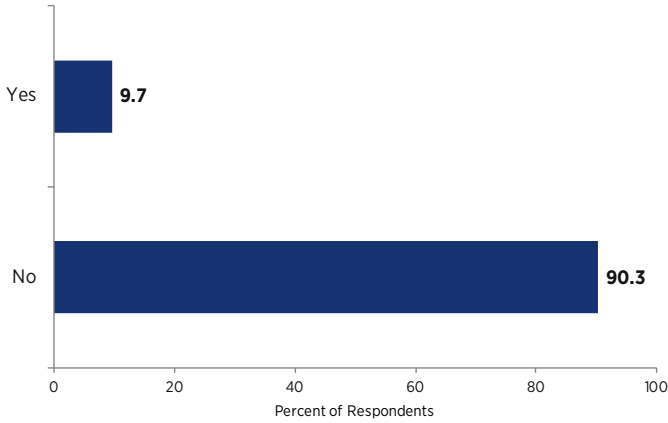
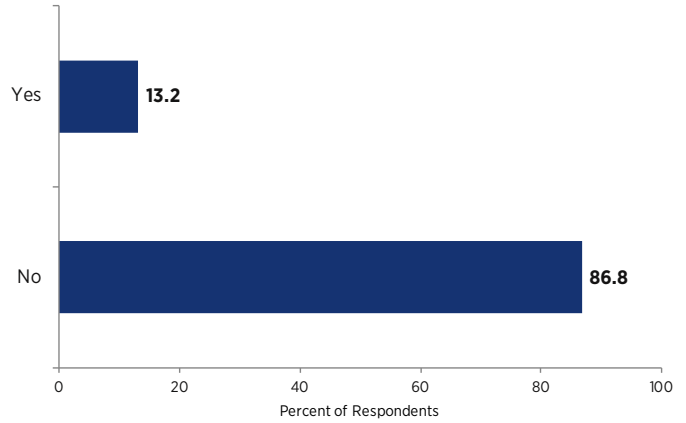


FIGURE 88

Have you made an offer to a target institution in the last 12 months?

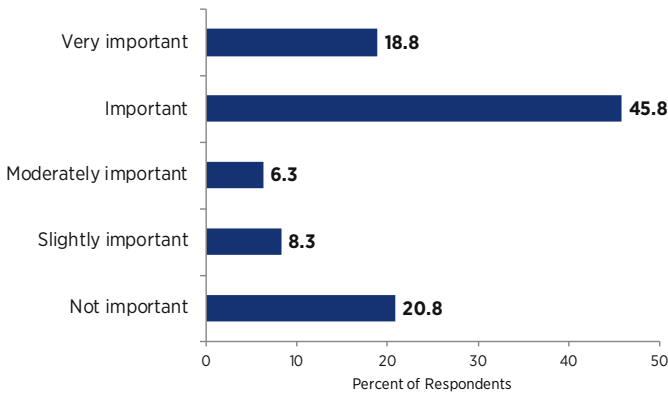


Less than 10% of banks said they received acquisition offers, while 13% said they made acquisition bids. Last year, 14% of banks said they received an acquisition offer, and 25% said they made acquisition bids.

RATIONALES FOR ACQUISITIONS

FIGURE 89

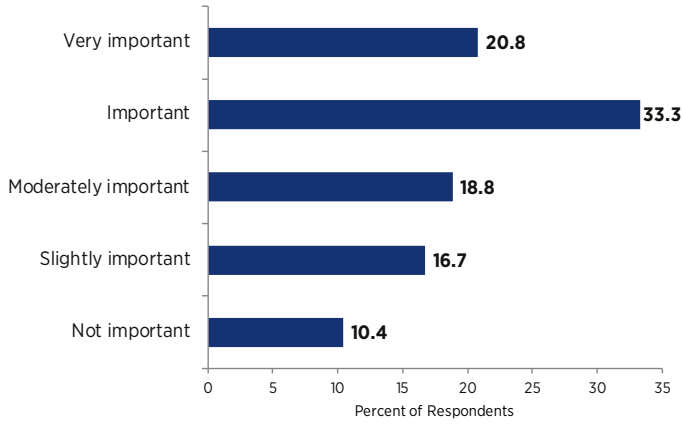
How important was expansion within an existing market in your motivation to make an acquisition offer?



Expanding within existing markets was an important motivation for making acquisition offers.

FIGURE 90

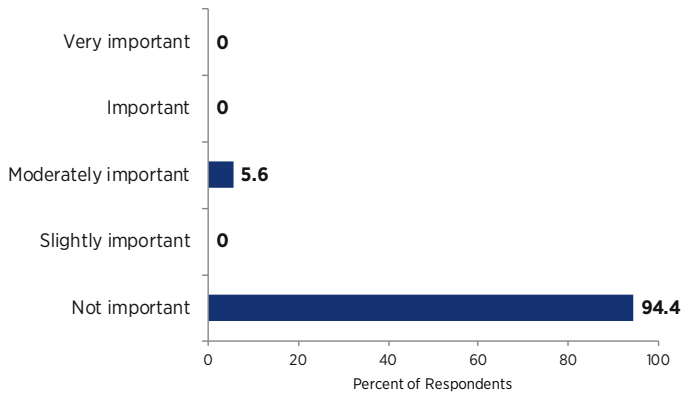
How important was entry into a new market in your motivation to make an acquisition offer?



About 19% and 21% of bankers, respectively, said in-market and new-market expansion was a “very important” motivation for their acquisition bids. In 2019, the comparable percentages were 34% and 30%, respectively.

FIGURE 91

How important was the opportunity to start a de novo bank in your decision to seriously consider accepting an acquisition offer?



Starting a new bank was mentioned by less than 6% of bankers as a factor in considering the sale of their banks, which represented only a slight decline from last year. For this year through August, three new banks were established nationally, compared with nine for the same period last year.¹²

RATIONALES FOR ACQUISITIONS, CONT.

FIGURE 92

How important was an inability to achieve economies of scale in your decision to seriously consider making an acquisition offer?

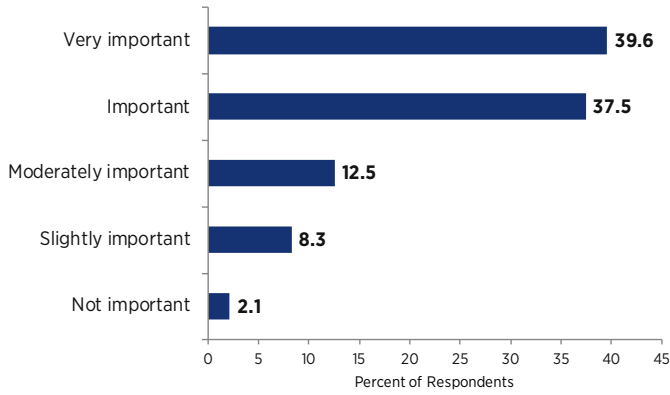


FIGURE 93

How important was the ability to achieve economies of scale in your motivation to seriously consider accepting an acquisition offer?

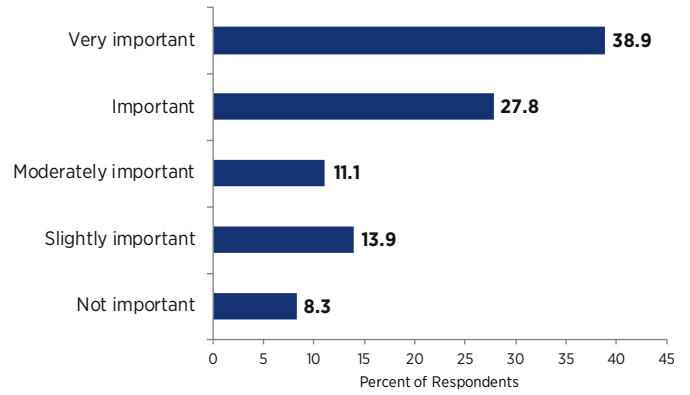
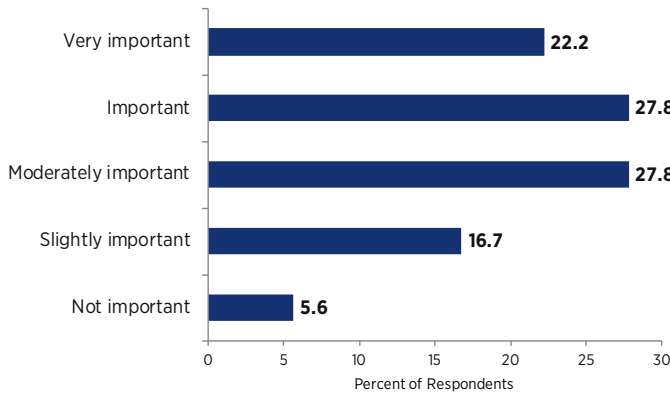


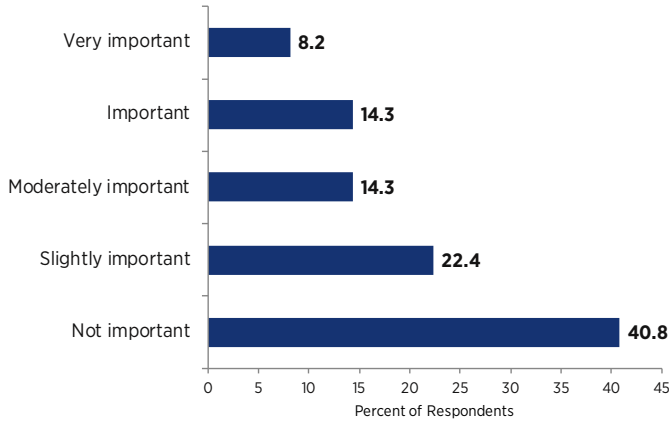
FIGURE 94

How important was an excessive cost of doing business in your motivation to seriously consider accepting an acquisition offer?



Nearly 40% of bankers said economies of scale were “very important” in their respective motivations for considering making or accepting acquisition offers. In addition, the vast majority of bankers said the excessive costs of doing business were at least “moderately important” in their motivations for seriously considering acquisition offers.

FIGURE 95
How important were succession issues in your motivation to make an acquisition offer?



A solid majority of banks bidding to acquire others said that management succession was important, to varying degrees, in their decisions. This is important insofar as the average age of community bank CEOs is between 60 and 70 years old.¹³

FIGURE 96
How important is management succession risk to your bank?

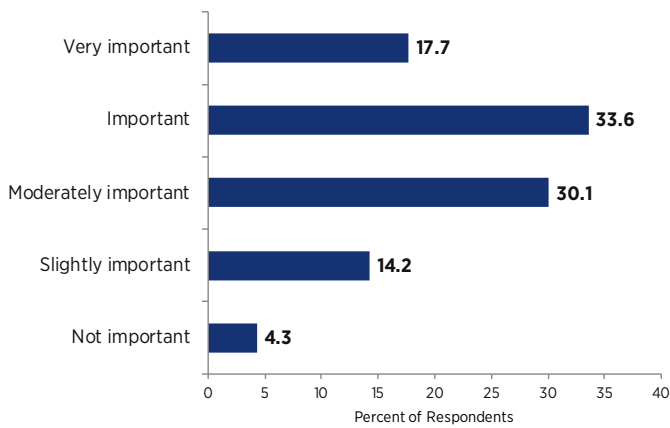
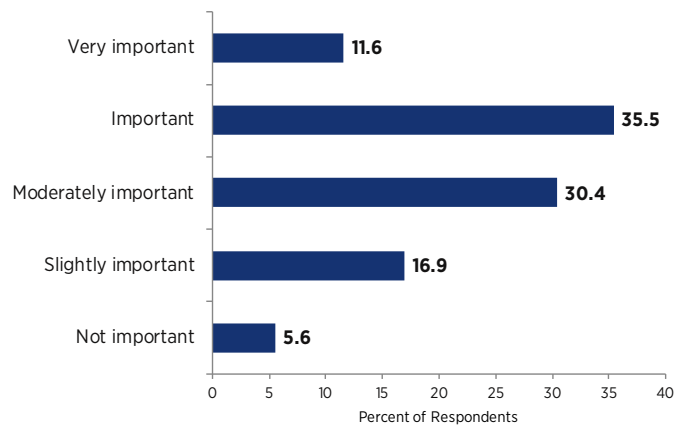


FIGURE 97
How important is board succession risk to your bank?



The risk of management succession was named by 18% of respondents as “very important,” while only 4% considered it “not important,” a dichotomy that underscores difficulties that many banks face in preparing for managerial retirements. The perceived risk of board succession was lower, as 12% of bankers considered it “very important” and 6% considered it “not important.”

FIGURE 98

How important was the ability to exploit underutilized potential in your motivation to make an acquisition offer?

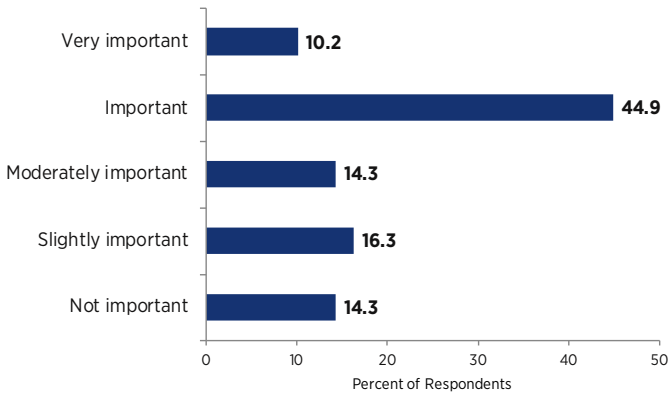
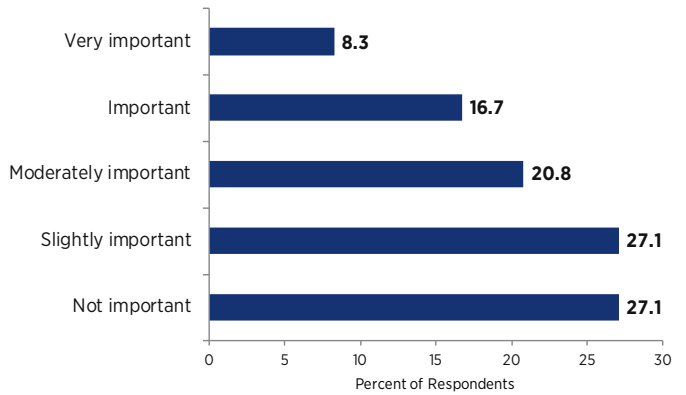


FIGURE 99

How important was the opportunity to capture the abilities of bank managers in your motivation to make an acquisition offer?



Although only 25% of bankers said that capturing the abilities of managers was an “important” or “very important” motivation in extending an acquisition offer, 55% of them rated exploiting underutilized potential in these top categories. In this regard, banks are increasingly finding it difficult to compete for talent, particularly loan officers.¹⁴

Section Summary

Community bankers were less focused on acquisition activity this year. Lower percentages of bankers reported receiving or making acquisition bids. For those who expressed interest in either kind of transaction, economies of scale remained an important consideration.

Conclusions

The responses of community bankers to questions in this survey underscore the challenges they faced, and how they faced them, in the throes of the COVID-19 pandemic. Bankers shut down lobbies and branches, and expanded customer access to services through extended use of drive-through facilities and technological interfaces. They worked overtime in adapting to the ever-changing circumstances under which they offered emergency credit to businesses through the SBA. Through it all, they maintained, and in many cases deepened, customer relationships.

The survey findings also offer insight into what community bankers thought their industry would look like when the pandemic finally ebbs. Some were pessimistic. A continuing shift of consumers to online products and services “will shrink small towns and stifle growth,” one banker noted. Consolidation of smaller banks will likely persist, which suggests bigger banks and fewer employees—in other words, a lesser reliance on the personal touch that has been the hallmark of the community banking industry: “We will have a higher percentage of our staff working remotely, access to all of our products and services will be digital, and there will be less and less traffic in our lobbies,” another banker said. “We will continue to strive to build personal relationships and to be available in person, but that is going to be a real challenge to maintain as a business model.”

Other bankers were optimistic. They saw opportunities in introducing their customers to technologies that already existed but were previously resisted: “With COVID,” one banker said, “more customers are willing to embrace new technology.” Other bankers pointed to a renewed appreciation of the “nimbleness” of community banks, which one banker said “has allowed our customer-centric service model to shine in serving the rural and small-town communities in which we operate.”

The future of community banks will depend, of course, on the futures of the communities they serve. On this, bankers also voiced a wide range of opinions. Some bankers predicted increases in rural populations, driven by a retreat from urban areas as a result of the pandemic and by increased acceptance of the ability of employees to work effectively from remote locations. Others anticipated rural depopulation as “young people flock to metropolitan areas.”

And still others just didn’t know: “I believe the way we deliver our services will look totally different,” one banker said. “But it is yet to be determined.”

Endnotes

1. For all questions, responses are expressed as percentages of respondents to those specific questions. Due to rounding, not all percentages will add up to exactly 100.
2. Small Business Administration, Paycheck Protection Program (PPP) Report, Aug. 8, 2020; see https://www.sba.gov/sites/default/files/2020-08/PPP_Report%20-%202020-08-10-508.pdf.
3. SBA. The dollar amounts reported in Table 1 were obtained from Call Reports published by the Federal Financial Institutions Examination Council on June 30, 2020. The aggregate total across all lenders reported by the SBA runs through Aug. 8, 2020.
4. Senior Loan Officer Opinion Survey, Federal Reserve Board, July 2020.
5. McCaffrey, Orla. “As Coronavirus Spreads, Community Banks Watch for Fallout,” *The Wall Street Journal*, March 30, 2020.
6. Drew, Jeff. “New FAQs Address PPP Loan Forgiveness Issues,” *Journal of Accountancy*, Aug. 4, 2020.
7. Federal Deposit Insurance Corp. (FDIC).
8. FDIC.
9. These include Fiserv, FIS and Jack Henry & Associates.
10. FDIC.
11. English, Carleton. “Bank Mergers Will Resume when the Crisis Passes. Here’s a Look at Potential Buyers and Sellers,” *Barron’s*, May 8, 2020.
12. FDIC.
13. Bonham, Jeff; Curtis-Wittenberg, Paul; Hanson, Whitney; Kennedy, Pamela; Millerick, Robert; and Rensink, Gregory. “Community Banking: A Time of Promise and Challenge,” *Chicago Fed Letter*, No. 412, 2019.
14. FDIC Advisory Committee on Community Banking, July 30, 2019.

Acknowledgments

The 2020 CSBS National Survey of Community Banks was administered by state bank commissioners in 36 states. A total of 396 community bankers participated. New questions were added to the 2020 survey to gauge the impact of the COVID-19 pandemic on community banks and their communities. The survey was conducted between April and July 2020, a time period when the U.S. was experiencing significant volatility in financial and labor markets. To help contextualize the survey responses, 15 banking commissioners volunteered to conduct informal interviews with bankers in their respective states. Where appropriate, some of those interview responses were included in the survey analysis to provide greater context. A summary of each state's interviews has been compiled in a separate publication. To request a print copy of this publication, email the conference committee at info@communitybanking.org.

Participation in the 2020 survey would not have been possible without the efforts of the following state bank commissioners and members of their staffs:

Alabama

Mike Hill, Superintendent
Alabama State Banking Department

Arizona

Evan G. Daniels, Superintendent
Arizona Department of Financial Institutions

Arkansas

Candace Franks, Bank Commissioner
Arkansas State Bank Department

Connecticut

Jorge Perez, Banking Commissioner
Connecticut Department of Banking

Florida

Russell C. Weigel III, Commissioner
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Georgia*

Kevin Hagler, Commissioner
Georgia Department of Banking and Finance

Idaho*

Patricia Perkins, Director of Finance
Idaho Department of Finance

Illinois*

Deborah Hagan, Secretary
Illinois Department of Financial
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Jeff Plagge, Superintendent
Iowa Division of Banking

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Kansas Office of the State Bank Commissioner

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Louisiana

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Office of the Commissioner of Financial Regulation

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Massachusetts Division of Banks

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Anita Fox, Director
Michigan Department of Insurance
and Financial Services

Minnesota

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Minnesota Department of Commerce

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Consumer Finance

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North Dakota*

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Caroline C. Jones, Commissioner
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Vermont Department of Financial Regulation

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Joe Face, Commissioner
Virginia Bureau of Financial Institutions

Washington

Charles Clark, Director
Washington Department of Financial Institutions

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Kathy Blumenfeld, Secretary
Wisconsin Department of Financial Institutions

Wyoming

Albert Forkner, Commissioner
Wyoming Division of Banking

**This state's commissioner conducted informal interviews with community bankers to supplement the 2020 National Survey of Community Banks.*

