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Community Banking | 2021 in the 21st Century

Research and Policy Conference

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Community Banking in the 21st Century

Ninth 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. 28-29, 2021



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About the 2021 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. Similar to last year, the 2021 conference will be held virtually on the Webex meeting platform because of the COVID-19 pandemic. The conference also will be livestreamed on communitybanking.org.

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

Acknowledgment of 2021 Emerging Scholar

Jon Taylor, Florida Atlantic University,
Boca Raton, Florida

Presentation of Findings from the 2021 CSBS National Survey of Community Banks

Presenters: Meredith Covington, Community Bank Research and Outreach, Federal Reserve Bank of St. Louis; Alisha Sears, senior policy analyst, CSBS; and Thomas Siems, senior economist, 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: Paycheck Protection Program Lending

Moderator: Greg Udell, Chase Chair of Banking and Finance at the Kelley School of Business, Indiana University

Community Bank Discussant: David Krause, president and CEO, Pioneer Bank of Mankato, Mankato, Minnesota

Papers and Presenting Authors:

Government Loan Guarantees in a Crisis: Bank Protections from Firm Safety Nets
—Padma Sharma, Federal Reserve Bank of Kansas City

The Effect of the PPPLF on PPP Lending by Commercial Banks
—Sriya Anbil, Board of Governors of the Federal Reserve System

Concurrent Research Paper Session 2: Credit Provision to Marginalized Borrowers

Moderator: Taylor Begley, assistant professor of finance, Washington University in St. Louis

Community Bank Discussant: Dominik Mjartan, president and CEO, Optus Bank, Columbia, South Carolina

Papers and Presenting Authors:

Do Minority Banks Matter?
—Prithu Vatsa, University of Miami

Do Mortgage Lenders Compete Locally? Implications for Credit Access
—Adam Jørring, Boston College

Keynote Conversation

Jelena McWilliams, chairman, FDIC

Day 1 Conference Wrap-Up

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

Optional Virtual Reception for Day 1 Sessions

DAY 2

Community Banker Keynote

Darrin Williams, CEO, Southern Bancorp Inc.,
Arkadelphia, Arkansas

Introduction by **Susannah Marshall**, bank commissioner,
Arkansas State Bank Department

2021 CSBS Case Study Winning Presentation: University of Tennessee at Martin

Introduction: Tom Fite, CSBS 2021 vice chair and
director, Indiana Department of Financial Institutions

Student Team Members: Benjamin Beard, Seth Bishop,
Refugio Palacios, Savannah Pham and McKenzie Reagor

Faculty Advisor: John Clark, interim director,
the Horace and Sara Dunagan Chair of Excellence
in Banking at the University of Tennessee at Martin

Community Bank Partner: TriStar Bank, Dickson, Tennessee

Concurrent Research Paper Session 3: Unintended Effects of Oversight

Moderator: Christa Bouwman, interim head of the
Department of Finance, associate professor of finance
and Patricia & Bookman Peters Professor of Finance,
Texas A&M University

Community Bank Discussant: James Nicholson,
president and CEO, North Valley Bank, Zanesville, Ohio

Papers and Presenting Authors:

*Strategically Staying Small: Regulatory Avoidance
and the Community Reinvestment Act*
—Carlos Parra, Pontifical Catholic University of Chile

*Small Bank Financing and Funding Hesitancy in a Crisis:
Evidence from the Paycheck Protection Program*
—Tetyana Balyuk, Emory University

Concurrent Research Paper Session 4: The Effect of Bank Supervision on Credit Allocation

Moderator: João Santos, senior vice president,
Federal Reserve Bank of New York

Community Bank Discussant: C.K. Lee, president and chief
operating officer, InterBank, Oklahoma City, Oklahoma

Papers and Presenting Authors:

*The Real Effects of Bank Supervision: Evidence from
On-Site Inspections*

—Andrea Passalacqua, Board of Governors of the
Federal Reserve System

*The Life Cycle of a Bank Enforcement Action and Its
Impact on Minority Lending*

—Rimmy Tomy, the University of Chicago

Panel Discussion: The Future of Commercial Real Estate

Moderator: Brian Sullivan, Office of Communications, FDIC

Panelists: John Buran, president and CEO, Flushing Bank,
Uniondale, New York; Robert DiChiara, regional manager,
Division of Insurance and Research, FDIC; Jim Edwards,
CEO, United Bank, Griffin, Georgia; and Joanne Kim,
president and CEO, Commonwealth Business Bank,
Los Angeles

Conference Wrap-Up

John Ryan, president and CEO, CSBS

Optional Virtual Reception for Day 2 Sessions

Recorded Research Paper Presentations

Due to the significant number of submissions and the virtual format of this year's conference, three high-caliber papers were not able to be integrated into this year's scheduled proceedings. Instead, these presentations were recorded and are available for viewing on the conference website: **communitybanking.org**.

*Determinants of Losses on Construction Loans:
Bad Loans, Bad Banks, or Bad Markets?*
—Lynn Shibus, FDIC

*Mandatory Disclosure and Takeovers: Evidence from
Private Banks*
—Jing Wen, Columbia University

*Fighting Failure: The Persistent Real Effects of Resolving
Distressed Banks*

—Ivan Ivanov, Board of Governors of the Federal
Reserve System

Letter from Michelle W. Bowman

The Federal Reserve is pleased, once again, to sponsor this annual research conference with the Conference of State Bank Supervisors and the Federal Deposit Insurance Corp. The conference was launched in 2011, in the wake of a global financial crisis, and has continued for nine years into what is now our second year of a global health crisis. Throughout, it has showcased high quality academic research on the community banking industry. While the research occasionally has looked to the distant past in investigating current conditions facing community banks, it also has been incredibly responsive to recent and ongoing changes in the U.S. economy and the banking landscape.

For example, this year's conference features three papers that provide insight into the Small Business Administration's Paycheck Protection Program (PPP) and the Federal Reserve's Paycheck Protection Program Liquidity Facility (PPPLF). These programs officially ended in the spring and summer, respectively, of 2021, but this conference already finds itself able to present meaningful research that helps us understand the effects of these programs on the distribution of small business credit by community banks. Other selected papers consider topics ranging from the role of minority-owned banks on minority homeownership to how bank supervision impacts credit allocation.

Supplementing these academic presentations are results of a survey of nearly 500 community bankers, conducted by the Conference of State Bank Supervisors, that offer a comprehensive overview of the opportunities and challenges they are now facing. These perspectives don't always appear in economic and banking data. But they are valuable and have supported the development of new research that might not otherwise have been possible.

This year, we learned community banks were able to quickly pivot in the face of changing and uncertain business conditions, offer new technologies to meet customer demand and find new ways to adapt their relationship lending model by accommodating direct customer engagement even when face-to-face communication was not always possible. We also learned, on the other hand, about their concerns with compressed interest margins and slack loan demand.

This conference's melding of strong academic research with the deep insights and perspectives of banking industry practitioners very much reflects the Federal Reserve's time-tested approach to acquiring deeper economic insights using both quantitative and qualitative information. Data matters, research matters, experience matters—I commend the conference organizers for continuing to seek and incorporate expertise from across research and banking to present attendees with a comprehensive view of the opportunities and challenges facing our nation's community banks.

This conference has become a focal point each year for how regulators, researchers, policymakers and community bankers think about our unique and multi-faceted network of community banks. As our financial system continues to evolve, the resiliency our banks displayed in the face of this past year's challenges gives me confidence that our community banking system is fundamentally strong and able to meet, head on, whatever lies ahead.

Michelle W. Bowman

*Governor
Board of Governors of the Federal Reserve System*

Letter from Jelena McWilliams

The value of the annual Community Banking in the 21st Century Conference has never been more apparent. It will take all of us—bankers, researchers, supervisors, and community members—working together to understand, and respond to, the challenges faced by community banks, including the adoption of new technologies and the return to the “new normal.”

It is with this in mind that the Federal Deposit Insurance Corp. (FDIC) proudly joins with the Federal Reserve System and the Conference of State Bank Supervisors as cosponsors of this conference. In the nine years since its founding, the conference has grown into an important platform for developing a deeper understanding of community banks and identifying the challenges and opportunities they face in serving their local economies.

The research featured in this year’s conference highlights the important role of community banks in providing access to credit, especially to traditionally marginalized populations. The research suggests that the relationships community banks forge with their local communities are the likely force behind their significant success in extending credit. At the same time, the research suggests that supervisors, such as the FDIC, also play a critical role in supporting community banks and in turn financial inclusion.

The speed of change required in our lives in the past year has underscored how critical innovation is to ensuring that community banks remain competitive in a rapidly changing world. Moreover, financial innovation can serve as a bridge to financial inclusion and assist community banks in their existing and critical efforts in this space. The FDIC is taking a multi-pronged, novel approach to support community banks and their role in pushing forward financial inclusion. Among other things, we are: seeking to better understand technological advancements occurring in the market; hosting tech sprints through our Office of Innovation (FDITECH) to identify data, tools, and technology to help community banks meet the needs of the unbanked; and collaborating with Minority Depository Institutions and Community Development Financial Institutions to better allow them to compete in the modern era, including through the creation of a Mission-Driven Bank Fund to provide capital investment and technological tools. Still more is yet to come.

Thank you for participating in the 2021 Community Banking in the 21st Century Conference and joining this important conversation. As the research to be discussed at this conference shows, we each have a critical role to play in supporting the vibrancy of the community bank sector.

Jelena McWilliams

*Chairman
Federal Deposit Insurance Corp.*

Letter from John W. Ryan

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

We began this conference nine years ago after the financial crisis to put facts and figures to community banking. This research is always important, as it drives more sound and appropriate regulatory policy and supervision. Twenty months into a global pandemic that has resulted in economic uncertainty in many sectors across the nation, this year's research has particular significance. We have heard anecdotal information about how community banks responded to their communities. Now we are seeing the evidence.

This year's conference presents findings on how community banks pivoted when small business employers in their communities needed help during the pandemic's economic crisis. We have a number of research papers that look at the role of community banks with the U.S. Small Businesses Administration's Paycheck Protection Program. The research at this conference also sheds light on credit and banking for minority and low-income citizens and looks at the future of commercial real estate.

Meanwhile, this year's CSBS National Survey of Community Banks shows us how community banks have evolved due to the pandemic by committing to new techniques to meet customer needs.

Like last year, we are meeting virtually instead of in St. Louis. But as we know by now, like community banks, we have learned how to embrace change and continue to do our jobs.

I look forward to joining you—online—as we learn more about the latest findings of community banks and the important role they serve.

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 "2021 Key Research Findings" is overlaid in white, centered on the image.

2021 Key Research Findings

Concurrent Research Paper Session 1

Paycheck Protection Program Lending

Government Loan Guarantees in a Crisis: Bank Protections from Firm Safety Nets

Authors: W. Blake Marsh and Padma Sharma, Federal Reserve Bank of Kansas City

The authors provide empirical evidence that community bank participation in the Paycheck Protection Program (PPP) was driven by risk aversion rather than profitability; was concentrated among banks with ample funding; and was used to mitigate potential declines in business lending and net interest income. They conclude the PPP not only fulfilled small businesses' funding needs during the pandemic but also indirectly supported the margins of banks that made these loans.

The Effect of the PPPLF on PPP Lending by Commercial Banks

Authors: Sriya Anbil, Mark Carlson and Mary-Frances Styczynski, Board of Governors of the Federal Reserve System

The authors analyze the role of the Federal Reserve's Paycheck Protection Program Liquidity Facility (PPPLF) in providing credit to small businesses under the Paycheck Protection Program. They found that commercial banks using the PPPLF extended more than twice as many loans, relative to their total assets, as banks that did not use the PPPLF. They also found banks' familiarity with the operation of the Federal Reserve's discount window is strongly correlated with the propensity to register with and use the PPPLF.

Concurrent Research Paper Session 2

Credit Provision to Marginalized Borrowers

Do Minority Banks Matter?

Author: Prithu Vatsa, University of Miami

This paper empirically examines the elasticity of minority credit supply to deposit shares of minority depository institutions (MDIs). The author found that a significant and persistent minority credit supply gap results when a neighborhood loses the presence of a local minority-owned bank. MDIs also significantly reduce the minority homeownership gap. The author's findings reveal minority credit declined by 37.3% for up to six years in census tracts that lose their MDIs.

Do Mortgage Lenders Compete Locally? Implications for Credit Access

Authors: Greg Buchak, Stanford University, and Adam Jørring, Boston College

The authors' analysis of household credit access shows that local market concentration strongly affected lending standards and upfront fees on mortgages. It also resulted in higher application rejection rates and reduced the risk of originated mortgages. These findings suggest that, contrary to current policy, regulators concerned with credit access should regard mortgage markets as local when making policy decisions such as bank merger approvals.

Concurrent Research Paper Session 3

Unintended Effects of Oversight

Strategically Staying Small: Regulatory Avoidance and the Community Reinvestment Act

Authors: Jacelly Cespedes, University of Minnesota; Jordan Nickerson, MIT; and Carlos Parra, Pontifical Catholic University of Chile

A 1995 revision to the Community Reinvestment Act (CRA) led to a two-tiered evaluation scheme determined by the size of a bank's assets. While the intention of the 1995 reform was to "replace paperwork and uncertainty with greater performance, clarity, and objectivity," the revisions also included the creation of two bank classifications: small banks and large banks. Determined by year-end assets being greater or less than \$250 million, banks in each group faced significantly different regulatory requirements, creating an incentive to strategically manage assets to stay below the small bank threshold of \$250 million. By bunching banks below the small bank threshold, the authors found that banks exploited the 1995 revision of the CRA by strategically slowing growth. They also found regulatory avoidance increased rejection rates of low- and moderate-income loans and decreased the county-level share of small establishments. Taken together, the authors' findings reveal an unintended consequence of the CRA, whereby strategic avoidance of the regulation reduces credit access.

Small Bank Financing and Funding Hesitancy in a Crisis: Evidence from the Paycheck Protection Program

Authors: Tetyana Balyuk, Emory University; Nagpurnanand Prabhala, Johns Hopkins University; and Manju Puri, Duke University

The authors studied the delivery of subsidized financing to small businesses in the Paycheck Protection Program (PPP). Empirical findings revealed larger firms gained earlier PPP access, which reduced PPP loans made by small banks to small business customers. However, the authors found this was not always the case, particularly for small banks that had established prior relationships with their respective small business customers. The findings reinforce the existing banking literature in suggesting small businesses benefit from pairing up with small banks. In addition, the authors found hesitancy in PPP participation reflected recipients' wariness of government investigative power over recipients.

Concurrent Research Paper Session 4

The Effect of Bank Supervision on Credit Allocation

The Real Effects of Bank Supervision: Evidence from On-Site Inspections

Authors: Andrea Passalacqua, Board of Governors of the Federal Reserve System; and Paolo Angelini, Francesca Lotti and Giovanni Soggia, Bank of Italy

The authors show bank supervision reduced distortions in Italian credit markets and generated positive spillovers for the real economy. After an audit, financial intermediaries were more likely to reclassify loans as nonperforming and make loans to more productive firms. As a result, productive firms invested more in labor and capital, revealing bank supervision is an important complement to regulation in improving credit allocation.

The Life Cycle of a Bank Enforcement Action and Its Impact on Minority Lending

Authors: Byeongchan An and Rimmy E. Tomy, University of Chicago; Robert Bushman, University of North Carolina; and Anya Kleymenova, Board of Governors of the Federal Reserve System

This paper studied the role bank supervision played in improving access to credit for minorities by investigating how enforcement decisions and orders (EDOs) affect bank borrowers. The authors found banks significantly increased residential mortgage lending to minorities after the termination of an EDO and were less likely to deny loans to minority borrowers. Using several measures based on banks' incentives to influence regulators' perceptions, the authors found strong evidence in support of a catering mechanism to gain future leniency from regulators. In particular, the authors found that banks with stricter regulators, more severe enforcement actions and low CRA ratings were more likely to expand lending to minorities after EDO terminations.

Recorded Research Papers

Determinants of Losses on Construction Loans: Bad Loans, Bad Banks, or Bad Markets?

Authors: Emily Johnston Ross and Lynn Shibut, FDIC; and Joseph B. Nichols, Board of Governors of the Federal Reserve System

In this study, the authors explored the extent to which observed losses on construction loans were driven by characteristics of the loans, originating banks and local markets. They found that risk exposure on construction loan portfolios was influenced not only by the originating bank's behavior but also by the behavior of other local lenders in the market at the time of origination. The authors' findings support existing regulatory guidance regarding higher capital requirements for construction loans.

Mandatory Disclosure and Takeovers: Evidence from Private Banks

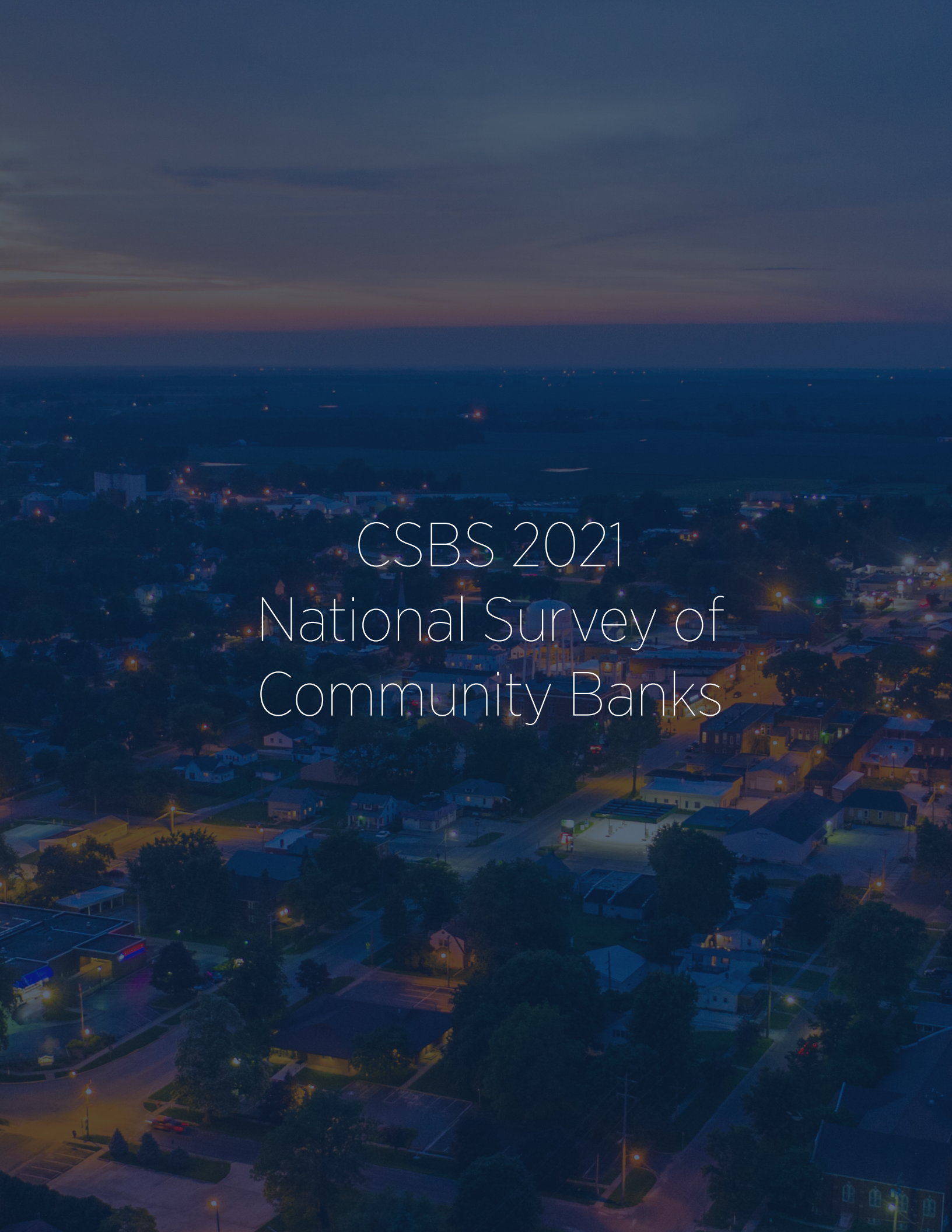
Authors: Urooj Khan, University of Texas; and Doron Nissim and Jing Wen, Columbia University

The authors investigated the role of mandatory financial disclosure in the takeover market for privately held U.S. banks. They found that the time taken to complete acquisitions does not differ for banks with reduced frequency and granularity of regulatory reporting. This is consistent with acquirers having access to private information about targets following the signing of confidentiality agreements and/or letters of intent, which reduces their reliance on public financial information.

Fighting Failure: The Persistent Real Effects of Resolving Distressed Banks

Authors: Ivan T. Ivanov, Board of Governors of the Federal Reserve System, and Stephen A. Karolyi, Office of the Comptroller of the Currency

In this study, the authors provide empirical evidence that resolutions of distressed banks led to reductions in employment and establishment growth of up to 6 percentage points. These effects were concentrated in small, less urban counties, and translated to large declines in business lending and increases in corporate bankruptcies. These effects imply that acquiring banks restricts lending to the small business borrowers of distressed target banks.

An aerial night photograph of a town, likely a coastal or lakeside community, with numerous lights from buildings and streets. The background shows a large body of water under a dark, twilight sky. The text is centered over the middle of the image.

CSBS 2021
National Survey of
Community Banks

Foreword from Melanie G. Hall

Community bankers' concerns have shifted as the COVID-19 pandemic continues to impact the economy. As the nation emerges from the depths of the economic fallout following the start of the pandemic, bankers' top concern has shifted from business conditions to current loan demand.

Some new issues have emerged for community bankers, primarily abundant liquidity and a decline in lending, particularly in the business, agricultural and commercial real estate categories. Community banks nationwide have historic levels of deposits and narrow interest margins as competition for available credits has increased. That means they have a lot of money but not a lot of lending activity—for now.

These are some of the key findings from the 2021 CSBS National Survey of Community Banks. Having this information from nearly 500 community banks nationwide is especially important as policymakers navigate the economy and we hopefully move towards the end of a very long pandemic.

We have conducted this survey for eight years. It does not just reveal new concerns for community banks; it also shows annual trends. Consider cybersecurity breaches. This has been a high concern for community bankers for a number of years, but they are even more concerned today about malware, social engineering and data manipulation. More than 80% of bankers called cybersecurity risk “very important”—ranking it more than double any other type of operational risk.

Reading this survey provides an important reminder of the critical role of community banks in the communities they serve. That is why I look forward to its arrival every year. I invite you to read the full report.

Melanie G. Hall

*Chair, Conference of State Bank Supervisors
Commissioner, Montana Division of Banking and Financial Institutions*

2021 CSBS National Survey

Introduction

This year's National Survey of Community Banks, developed by the Conference of State Bank Supervisors (CSBS) and state regulatory authorities, was conducted in an environment very different from last year, in the immediate aftermath of the COVID-19 crisis. Community bankers then faced dire business conditions. The very nature of what they do was brought into question.

What a difference the ebbing of a pandemic makes. Former operational problems have created newfound efficiencies. Bankers are now worried about insufficient, rather than excessive, loan demand but are more optimistic about long-term prospects for small business lending. And they embraced technologies that they formerly avoided.

"Community bank reputations will be enhanced due to their commitment to serving customers throughout the pandemic by remaining open, by taking aggressive action to protect staff and customers and by issuing loans," one banker said. "However, how the industry operates may be permanently changed as we've figured out how to have non-customer facing work done at home, as well as non-transactional work done more electronically via email, online, and other ways."

Along with new opportunities came new challenges. Bankers warily eyed shrinking net interest margins, which they listed as a top external challenge in this year's survey. They sought new sources of noninterest income, cut expenses, and looked for ways to reduce the costs of and better utilize bloated deposits. One banker summarized the problem as being "flush with cash and no loan demand."

Background

To develop the 2021 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 2021. 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 number of respondents was 470, which exceeds last year's total. The characteristics of participating banks were stable across the two years. (See the accompanying figures.)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: 24% of them were members of the Federal Reserve, and 65% were not. (Other entities included thrift institutions.) 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, and some states (e.g., North Carolina) are overrepresented. (See Figure 1.)
- Respondents participated on a self-selected basis.
- Some banks submitted partial responses.
- 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.
- Quotes used were taken from open-ended questions in the survey and should be treated as individual perspectives, rather than as themes.

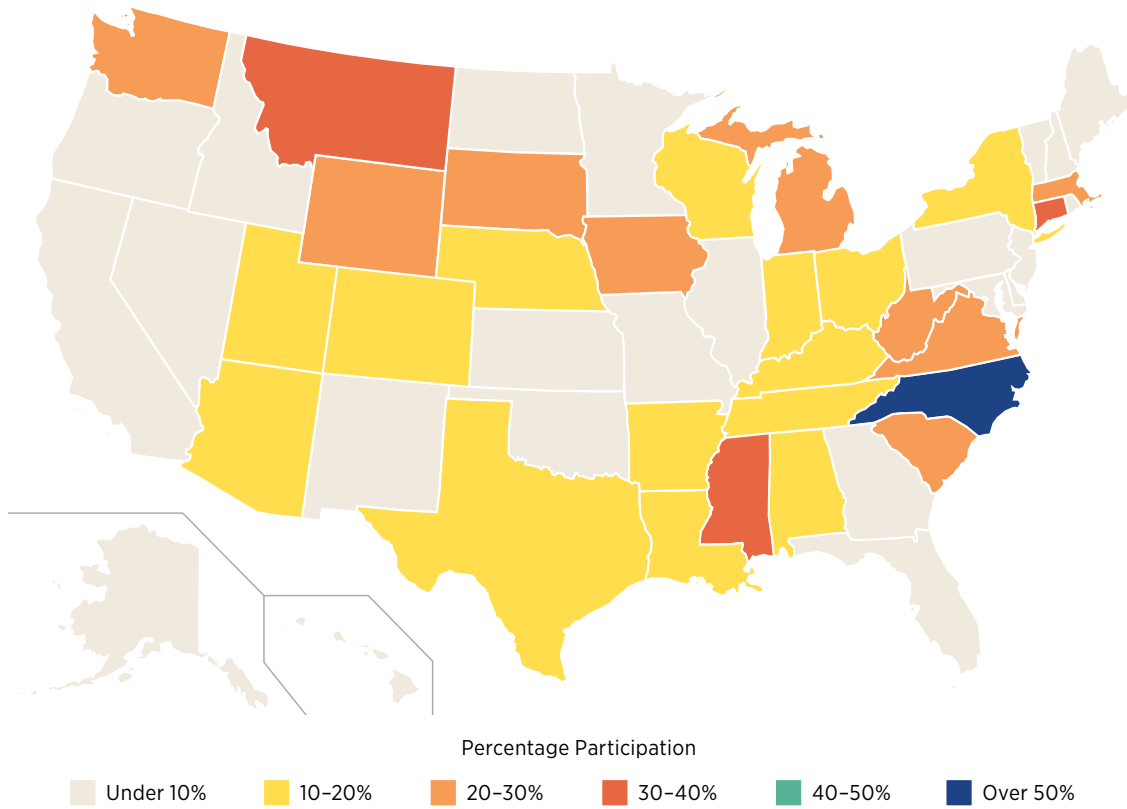
Conclusions must be qualified accordingly.

Key Findings

- Net interest margins were named by community bankers as their most important external challenge.
- Cybersecurity was the top internal risk.
- Loan demand supplanted business conditions in the forefront of banker concerns.
- Credit risk is a lesser concern than it was at the height of the pandemic.
- Operational changes imposed during the pandemic created long-term benefits in bank efficiency and customer engagement.
- Bankers are optimistic about existing technologies but eye the future more guardedly.
- Relative compliance costs declined.

FIGURE 1

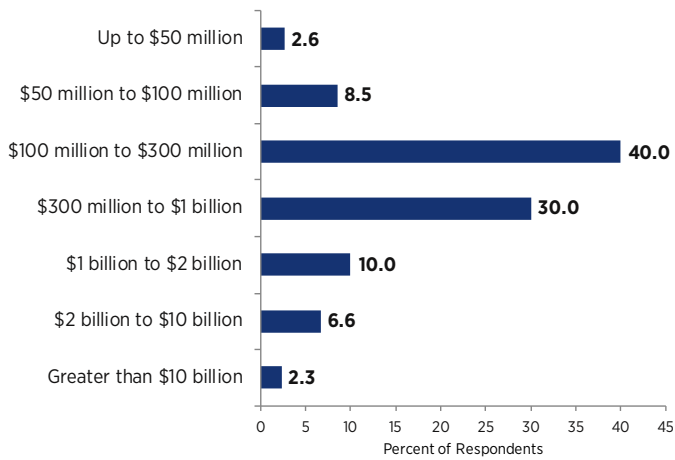
Survey participants by state



BANK SIZE AND BRANCH NUMBERS

FIGURE 2

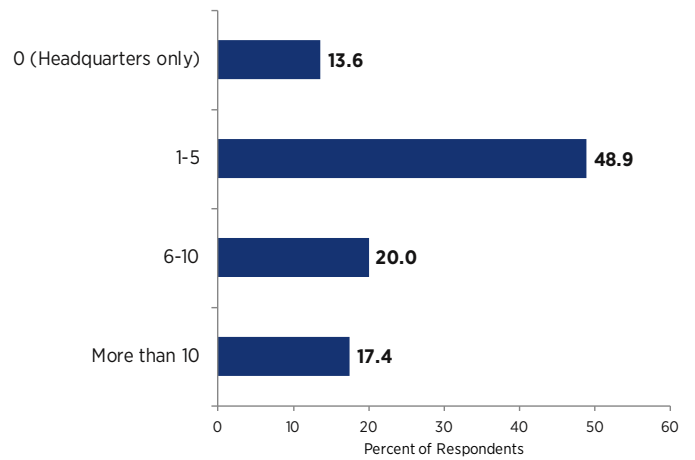
Asset size of surveyed banks



Of the banks surveyed, 70% had assets between \$100 million and \$1 billion, which reflects the composition of banks observed in previous surveys. The numbers of banks in the larger size categories increased slightly compared to previous years.

FIGURE 3

Number of branches of surveyed banks



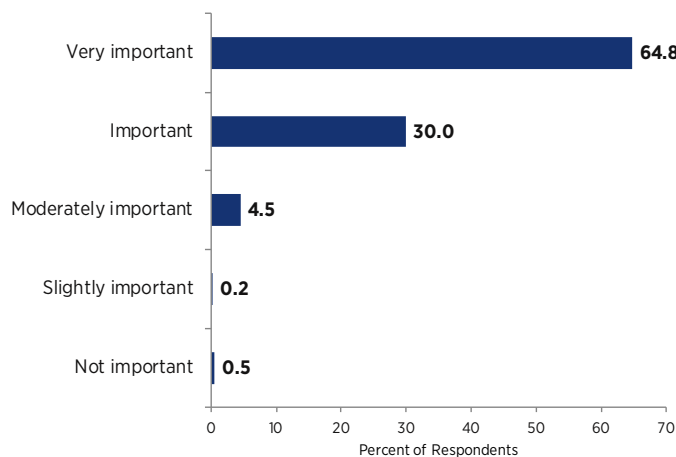
Nearly half of respondent banks operated between one and five branches. Compared to 2020, the percentage of banks operating more than 10 branches declined to 17% from 23%, which may reflect a consolidation of branches among bigger banks.

A Year of Challenges and Opportunities

Having endured the potentially existential threat initially posed by COVID-19, community banks are now confronting new challenges that have emerged in its wake. But they also are finding new opportunities.

CHALLENGES

FIGURE 4
How important are net interest margins?



Net interest margins were named by 65% of bankers as a “very important” external challenge, the highest of any category. This presumably reflects a drop in margins for the banking industry to 2.65% in the first quarter of the year, a record low, as yields on assets declined more than rates on liabilities.² Some, but not all, bankers expect low rates to persist for the foreseeable future.

FIGURE 5
How important are business conditions?

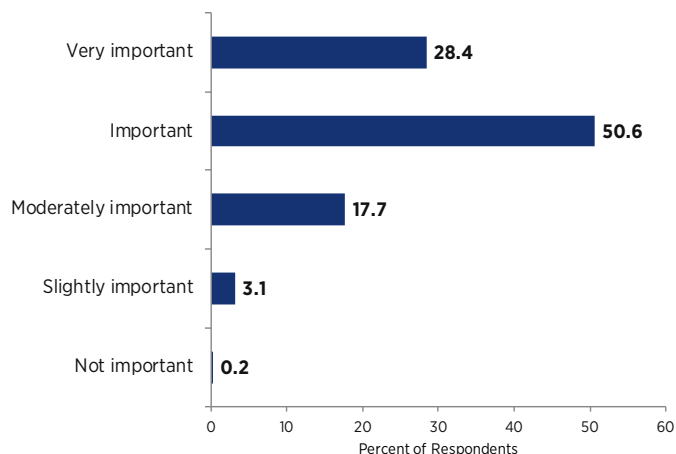
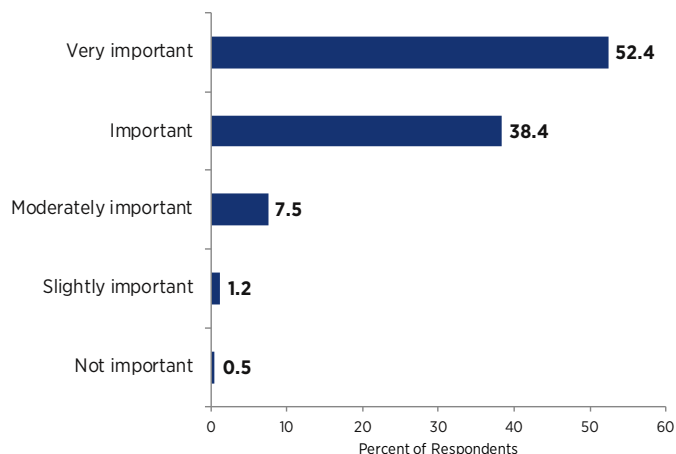


FIGURE 6
How important is loan demand?



Last year, at the height of the pandemic, business conditions were named by 34% of surveyed bankers as their single greatest challenge—quadruple the level recorded by loan demand. This year, the situation reversed. Only 28% of bankers described business conditions as a “very important” challenge, while 52% cited loan demand.

OPPORTUNITIES

The coronavirus crisis changed the nature of working arrangements in the community banking industry. Some of these changes, bankers said, were temporary. Others were described as permanent.

FIGURE 7
How did the COVID-19 pandemic affect bank efficiency?

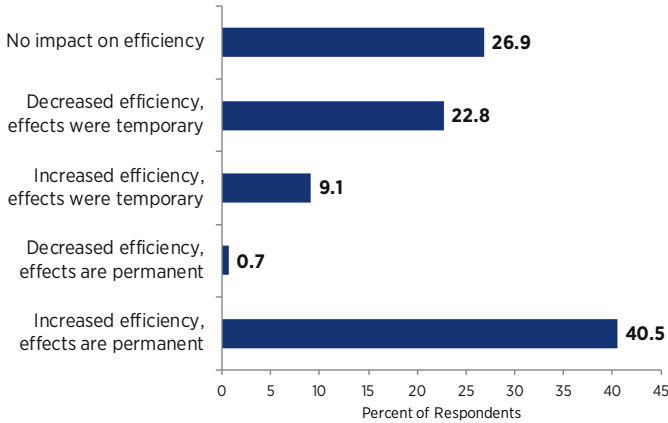
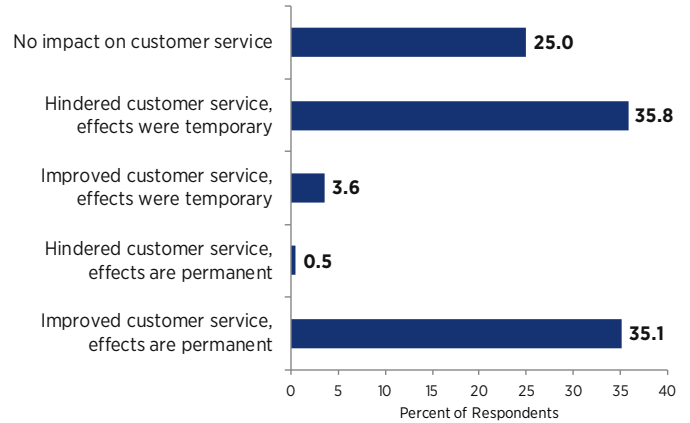
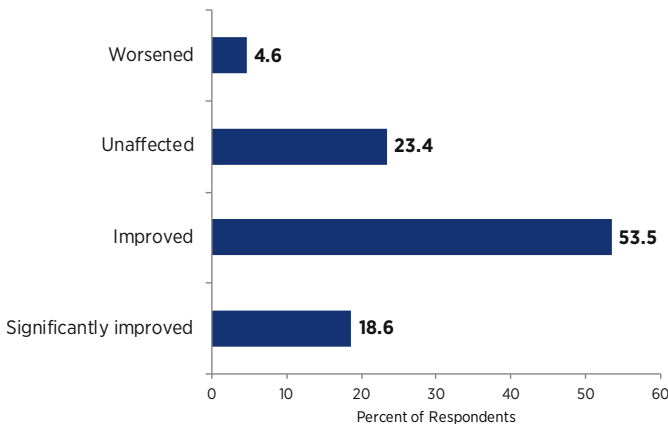


FIGURE 8
How did the COVID-19 pandemic affect customer service?



Operational changes imposed during the pandemic created long-term benefits in bank efficiency and customer service. More than 40% of bankers said the changes permanently increased efficiency. Decreases in efficiency, on the other hand, were more likely to be temporary. For customer service, similar relationships were evident.

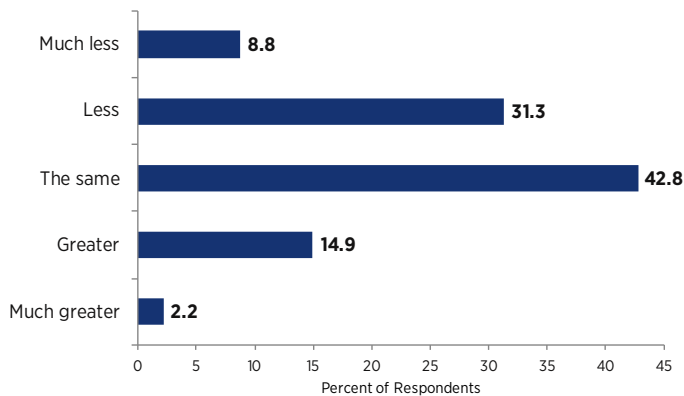
FIGURE 9
What were the effects of COVID-19 on bank prospects for long-term small business lending?



Despite the concern expressed by bankers with current loan demand, they are optimistic about the future of small business lending. More than 70% said long-term lending prospects were improved, to varying extents, by new or closer relationships fostered with customers. One banker said that “the level of customized service we provide has allowed us to maintain relationships.”

FIGURE 10

In the future, compared to relationship lending, the amount of transactional small business lending will be:



In recent years, community bankers have expressed increasing concern about their ability to compete with larger institutions that are better able to offer standardized lending practices based on quantitative criteria such as credit scores. But this year’s survey provides evidence supporting the durability of relationships in small business lending: More than 40% of bankers expect the dollar volume of small business loans that are transactional in nature to decline relative to those that are relationship based.

Section Summary

Community bankers today face a very different array of challenges and opportunities than they did prior to, and at the height of, the pandemic. They are less concerned with business conditions and more concerned with current loan demand. They are optimistic about enhanced operational efficiencies, improved customer service and prospects for small business lending.

Looming over all else, however, are low net interest margins that strain traditional community banks and will force them to adapt in order to survive. In this regard, bankers anticipate expansions in all sources of noninterest revenue, including higher fees. They also plan to cut expenses: The number of physical branch locations will continue to decline, one banker said, and staff levels will get lower as banks work to be more efficient.

But these solutions are not easily achievable. One banker said that “competition will be very stiff” for new sources of noninterest revenue. Another worried that “most cost-cutting measures will reduce customer service and give customers fewer compelling reasons to bank with a community bank.”

Lending

Last year, lending by community banks was dominated by the Paycheck Protection Program (PPP). The PPP was signed into law in March 2020, under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). It provided forgivable loans that were backed by the federal government to small businesses. It was extended and augmented multiple times, distributing eight million loans totaling more than \$700 billion, before closing earlier this year.

The PPP initially bloated bank balance sheets, adding about \$145 billion in loans at the end of 2020. (See the table.) The volume of these loans declined to \$111 billion by June of this year.

Lending outside the PPP, particularly in the commercial and industrial sector, was less robust. Non-PPP commercial and industrial lending declined by \$30 billion, or 10%, from December 2019 to June 2021. This presumably reflects a preference of business borrowers for the PPP. But it also may reflect banker preferences; when it comes to extending traditional loans in this sector, where banks must assume the risk of non-payment, many bankers said they have “lost their appetite.”³

Low rates propelled a bonanza in the mortgage market during the pandemic, but community banks were largely bypassed, as growing non-bank mortgage firms picked up market share when banks tightened lending.⁴ Residential lending declined from \$537 billion to \$495 billion, from December 2019 to June 2021—a drop of 8%.

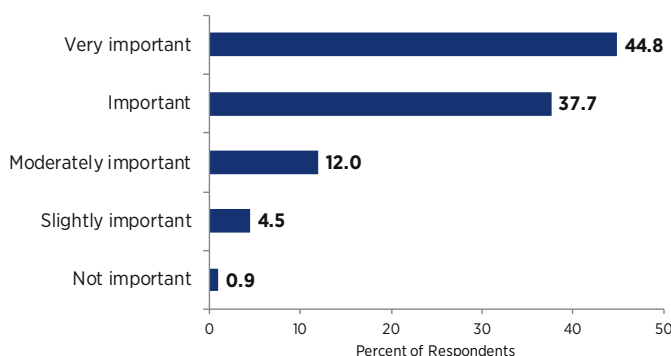
TABLE 1
Loans by community banks (in \$billions)

	Dec. 31, 2019	Dec. 31, 2020	June 30, 2021
Paycheck Protection Program	0	144.6	111.3
Commercial and industrial	290.7	266.4	261.8
Consumer	86.0	85.6	91.8
Agricultural	142.8	136.8	135.7
Residential real estate	537.6	511.6	495.7
Commercial real estate	640.9	639.6	648.4
Total	1,698.0	1,784.6	1,744.7

Notes: Data are obtained on community banks from Call Reports published by the Federal Financial Institutions Examination Council. Commercial and industrial loans exclude PPP lending.

PERCEPTIONS OF CREDIT RISK DECLINE

FIGURE 11
How important is credit risk?

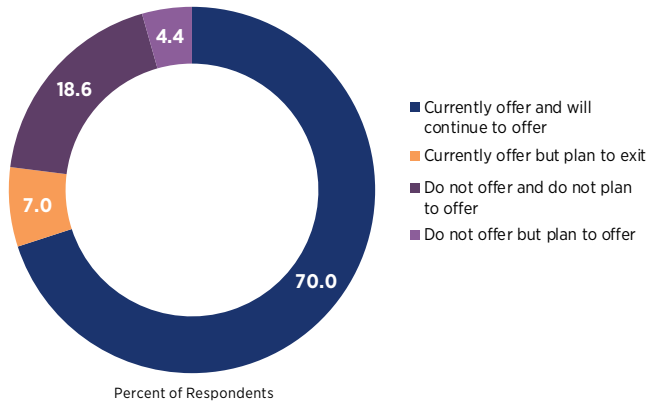


About 45% of bankers considered credit risk to be “very important,” which is considerably lower than the 57% recorded in last year’s report. This may reflect a rebound from what, in retrospect, may have been an unduly pessimistic outlook, as higher provisions for loan losses in 2020 were unaccompanied by increases in loan loss charge-offs. It may also be related to the introduction of vaccines, the opening of state economies, and the issuance, late last year, of interim final rules that clarified the process for loan forgiveness under the PPP.⁵

REACHING BORROWERS

FIGURE 12

What are your intentions regarding SBA loans?



The Small Business Administration (SBA) was a popular vehicle for lending under the PPP. Its prominence was underscored by last year's survey finding: 77% of banks offered loans through the SBA and planned to continue offering them in the future. This dropped to 70% this year.

FIGURE 13

Did your bank partner with a fintech firm to originate PPP loans?

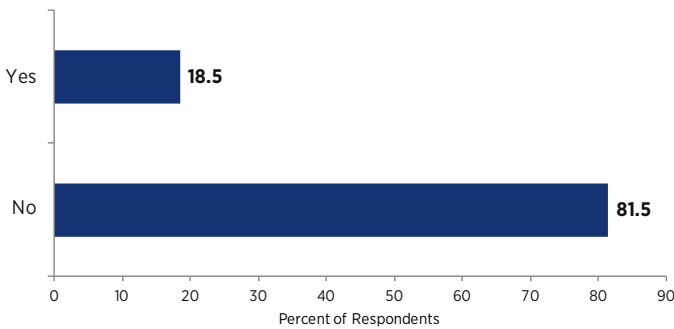
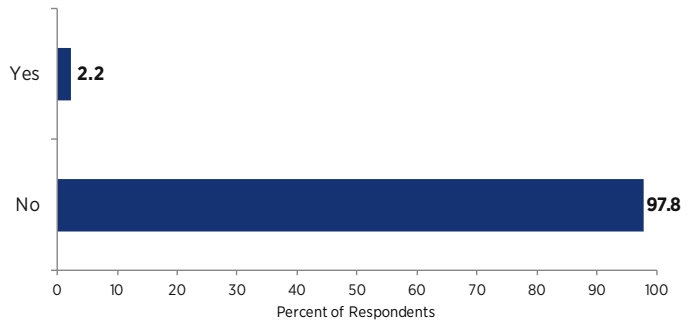


FIGURE 14

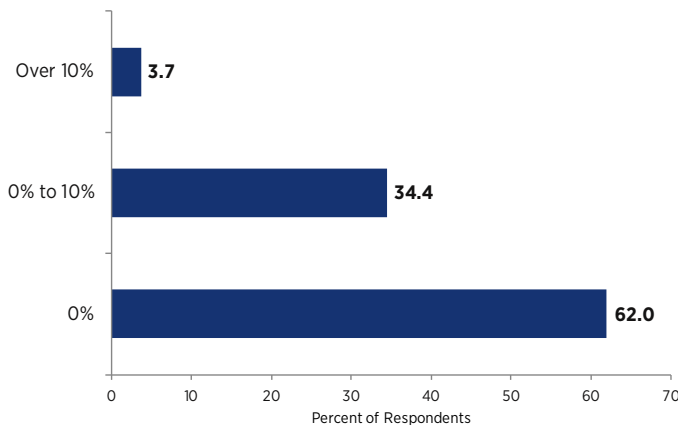
Did your bank partner with a fintech firm to purchase PPP Loans?



Some fintech companies benefit from the small business lending ability of a traditional bank lender, while others develop specialized lending programs for borrowers that traditional lenders are unable to reach.⁶ Survey responses support the former but not the latter: While more than 18% of banks reported partnering with fintech firms to originate PPP loans, only 2% reported partnering to purchase PPP loans.

FIGURE 15

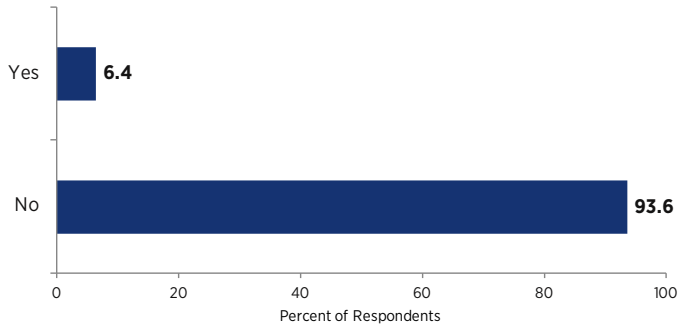
What percentage of loans to small businesses were due to business credit cards?



About 38% of bankers said they relied on credit cards to extend small business credit to some extent. This offers an interesting contrast with the finding of an earlier survey by the FDIC that large banks are more than three times as likely to offer credit cards.⁷

FIGURE 16

Outside of the PPP, did your bank partner with a fintech firm to purchase or sell loans?



In areas outside the PPP, lending partnerships with fintech firms are less common; only 6% of banks reported having them. Supplemental questions indicated that, among these partnerships, nearly 90% involved the purchase of loans originated on fintech lending platforms. This may increase efforts to use fintech firms as a way to increase noninterest income, as described by one banker.

FIGURE 17

Of originated loans, what was the level of loan participation purchases?

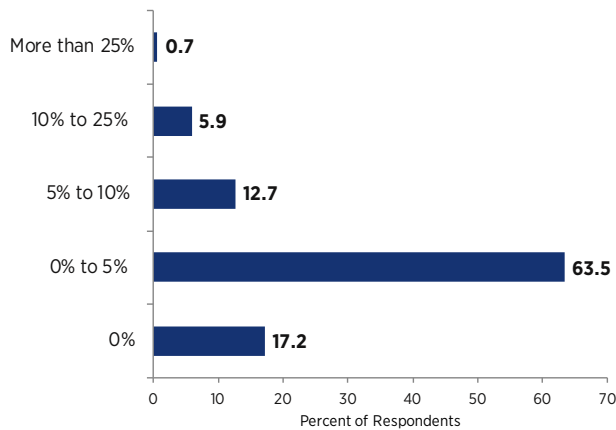
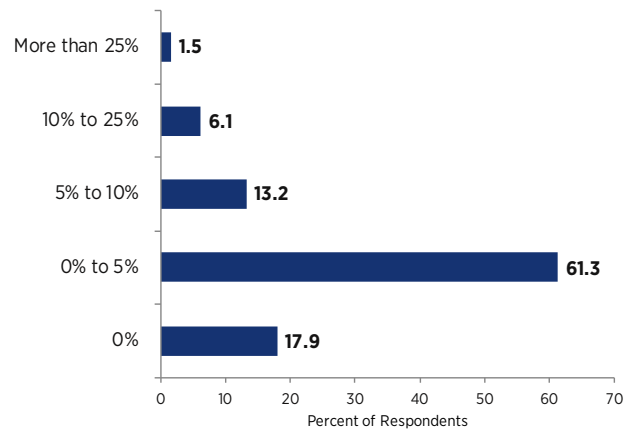


FIGURE 18

Of originated loans, what was the level of loan participation sales?



Most banks were modestly, and relatively equally, involved in the purchase and sale of loan participations. More than 60% of banks reported purchases and sales at levels up to 5% of total loans. Legal lending limits were cited as the most prominent reason for sales. Several community bankers said they expect more purchases of loan participations in order to increase loan volume.

Section Summary

The winding down of the PPP this year focused attention on lackluster lending in other areas, as the banking industry was left out of a nationwide borrowing binge.⁸ For community banks, the volume of loans declined last year in the business, agricultural and mortgage categories.

“Our loan-to-deposit ratio is already historically low, and when all of the PPP and SBA loans are paid back, it will be in uncharted territory,” one banker said. Another said, “We will suffer until loan demand returns.”

A bright spot this year was the decline in banker perceptions of credit risk, underscored for some banks by a release of reserves built up in 2020. Potential increases in reserves later this year would be expected to serve as only a modest headwind to earnings.⁹

Bankers are also seeing demand for small business and commercial real estate loans pick up, creating some optimism—but perhaps more temptation to loosen standards to land borrowers, particularly given low net interest margins. “This will likely make banks take more credit risk and more interest rate risk,” one banker said.

Funding

Efforts to soften the economic blow of COVID-19 have had significant consequences for community bank funding. The volume of deposits was greatly enlarged by government stimulus, while funding costs dropped to unprecedented levels, reaching 0.2%, following reductions in rates engineered by the Federal Reserve.¹⁰ This has coincided with slack loan demand, creating problems in managing excess liquidity.¹¹ Deposit levels increased particularly in transaction accounts. (See the table.)

TABLE 2
Total deposits (in \$billions)

	Dec. 31, 2019	Dec. 31, 2020	June 30, 2021
Transaction	515.3	747.7	896.5
Nontransaction	1,816.5	1,880.4	1,851.5

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

RISKS

FIGURE 19
How important are cost of fund challenges at your bank?

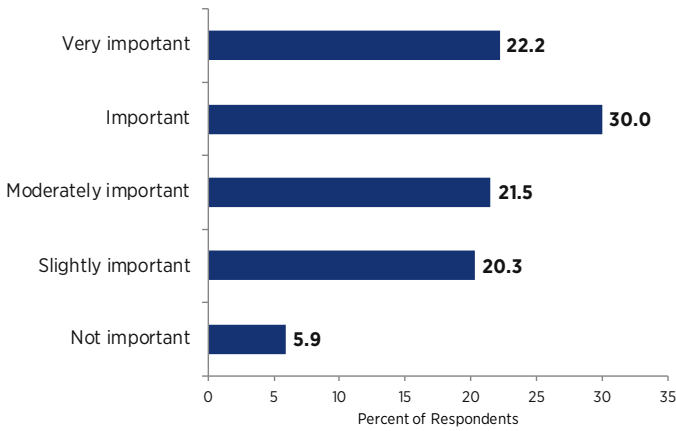


FIGURE 20
How important is the challenge of core deposit growth?

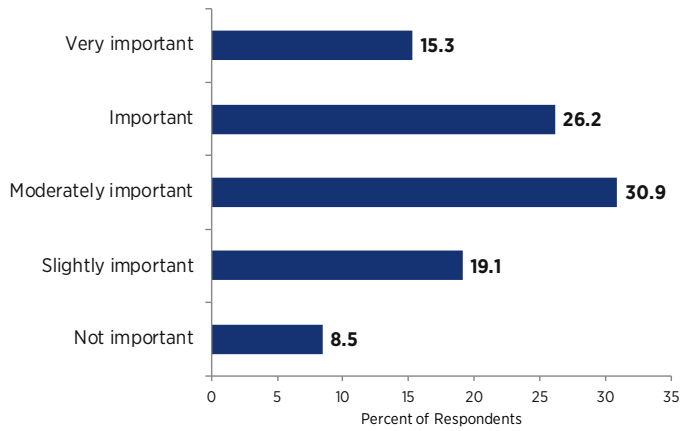
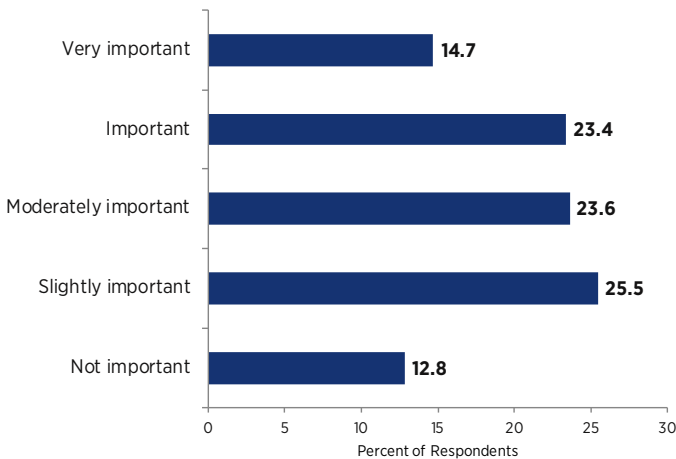


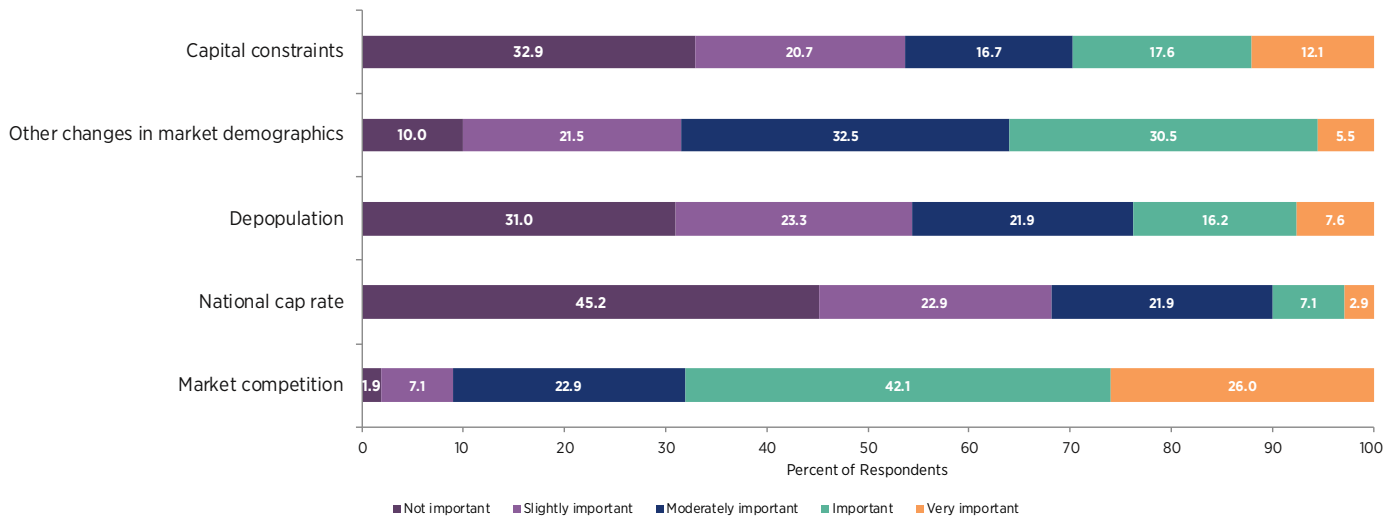
FIGURE 21
How important is liquidity risk?



Bankers are concerned with the costs of funds. This factor, which barely registered as a challenge in last year’s survey, was named this year as a “very important” risk by 22% of bankers. About 15% of bankers described core deposit growth as a “very important” risk, which perhaps suggests a shift in risk perceptions from having too little to having too much. Two years ago, prior to the pandemic, core deposit growth was named as the greatest challenge by 23% of bankers, the highest of any single category.

FIGURE 22

How important are key impediments to retaining core deposits?



Market competition was named by bankers as the most formidable impediment to retaining core deposits, as 26% of them named it as a “very important” factor. Capital constraints, national rate caps, depopulation and other changes in market demographics were considered less important.

TRENDS IN WHOLESALE FUNDS

In contrast to the jump in transaction deposits—or perhaps because of it—wholesale funds declined in most categories in 2021. (See the table.) The exception was public deposits.

TABLE 3

Wholesale funds (in \$billions)

	Dec. 31, 2019	Dec. 31, 2020	June 30, 2021
Brokered deposits	95.5	97.0	82.0
Federal Home Loan Bank advances	109.2	85.1	67.6
Public deposits	209.1	221.2	237.1
Other borrowed money	7.2	31.8	20.8
Fed funds purchased and repurchase agreements	5.1	4.0	3.5
Listing service deposits	23.0	22.8	19.1

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

FIGURE 23

What are your intentions regarding discount window borrowing?

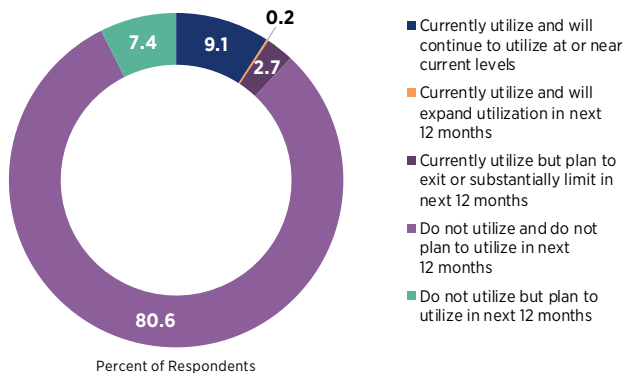


FIGURE 24

How important is discount window access?

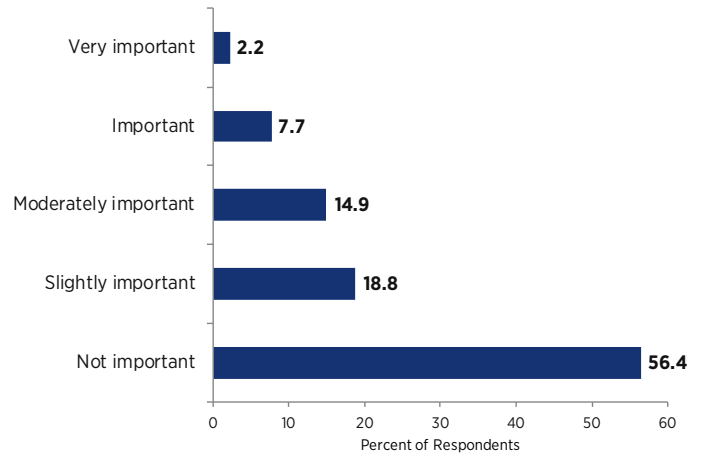
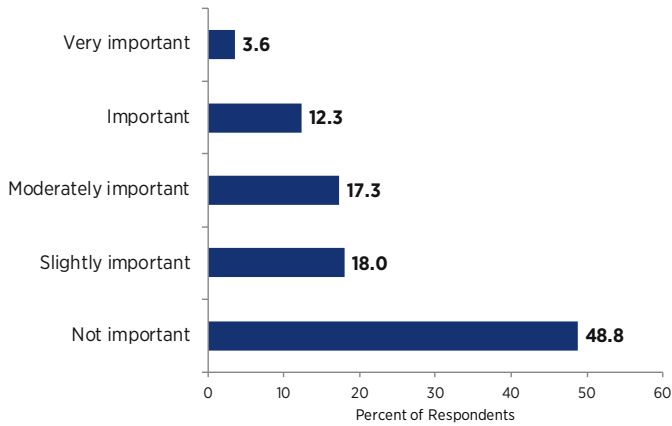


FIGURE 25

How important is access to other liquidity facilities?



About 12% of banks said they currently utilize discount window lending, which is lower than what was reported in 2020 and 2019. More than 43% of bankers, on the other hand, said greater access to the discount window was important to some degree in helping them cope with the pandemic. More than half of all respondents similarly said that other liquidity facilities were, at least to some extent, important to them during the pandemic.

OTHER WHOLESALE FUNDING SOURCES

FIGURE 26

What are banker intentions for sources of funding?



The percentages of banks using wholesale funding sources, with plans for continuation, dropped in every category this year compared to last year. Public funds were used, with expectations of continuation, by more than 70% of banks, the highest reported percentage. Few banks used listing service deposits.

Section Summary

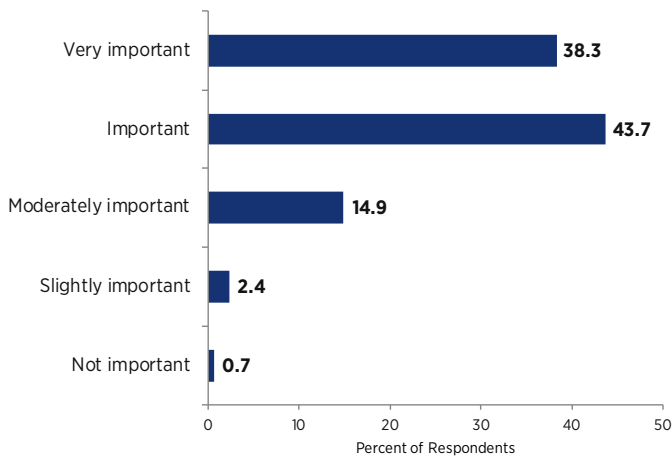
Banker opinions on funding were in some ways predictable but in some ways surprising. A slowdown in the use of wholesale funds as banks emerged from the pandemic is understandable, but greater concerns with costs of funds are less obvious in an era of record low interest rates. The latter may reflect, as one banker said, a continuing effort “to look for low-cost deposits to get [the] cost of funds as low as possible.” It may also reflect concerns with the potential vulnerabilities from competition, which bankers named as their biggest impediment to attracting and maintaining core deposits. One banker said that “we will continue to pay the lower rates until forced by competitors to increase the rates.”

Competition

Competition has always been a commonly expressed concern of community bankers. This year, it has been exacerbated by low net interest margins that push bankers to seek new sources of revenue. But they are hamstrung, as one banker said, by “issues with regard to competition.”

RISKS AND MARKET REACTIONS

FIGURE 27
How important is competition?



Although, as previously indicated, bankers view market competition as an impediment to raising core deposits, they are less concerned with competition generally than they have been in the past. About 40% of them named it as a “very important” challenge, which ranked in the bottom half of all categories. Last year, as well as the year before, competition ranked in the top half.

FIGURE 28
How do community banks influence market loan and deposit rates?

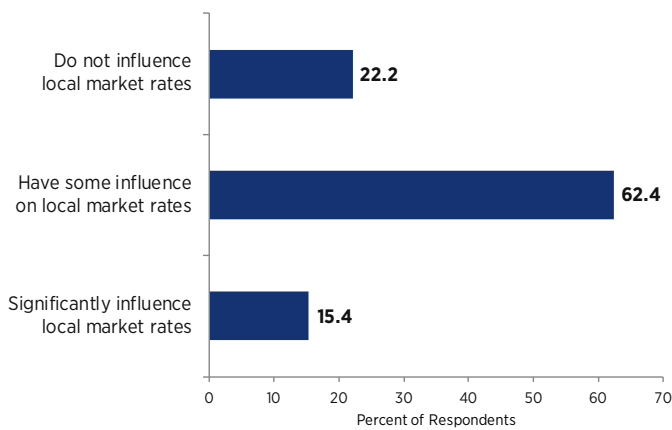
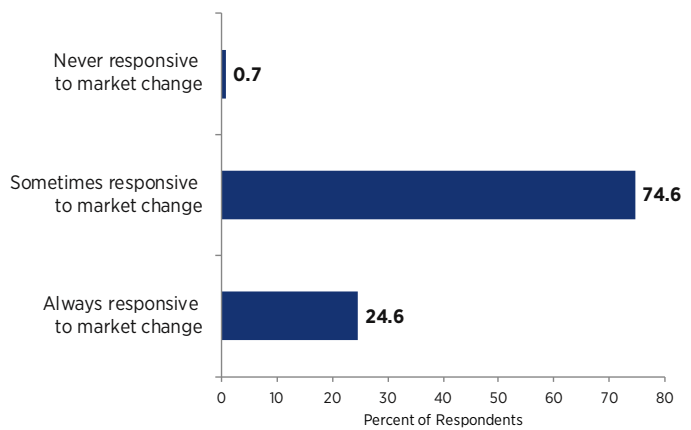


FIGURE 29
How do markets influence community bank loan and deposit rates?

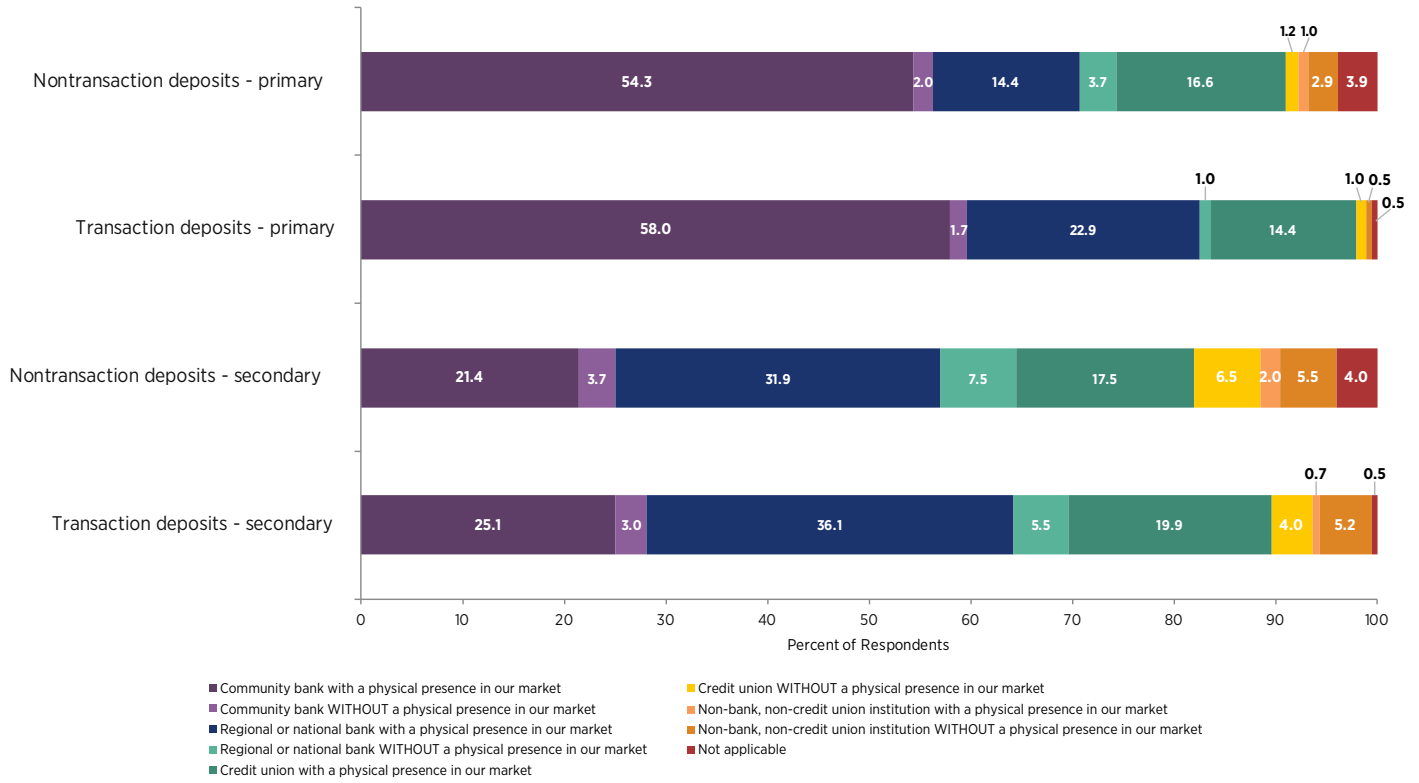


The structure of community banks’ competitive markets can be inferred from the extent to which pricing decisions influence, or are influenced by, changes in market rates on deposits and loans. About 15% of bankers said their pricing decisions significantly influence market rates. Less than 1% of bankers said their pricing decisions were invariant to market changes, while 25% of them said they are always responsive.

COMPETITION FOR DEPOSITS

FIGURE 30

What are the primary and secondary sources of competition for transaction and nontransaction deposits?

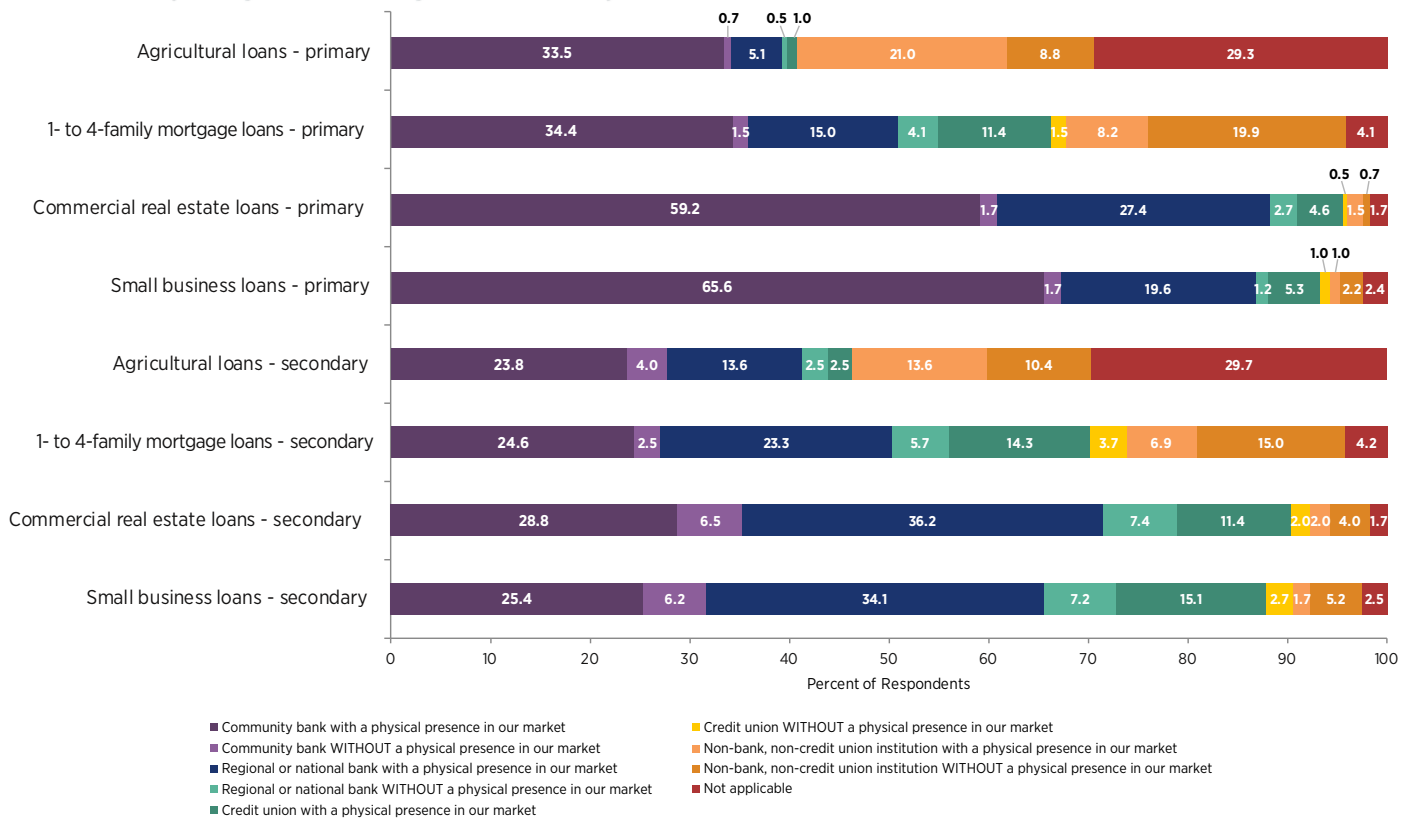


Competition for deposits is fiercest among peer community banks. Nearly 60% of bankers named community banks with a presence in the market as their primary source of competition for transaction deposits, and 25% named them as a dominant secondary source. Regional banks were named as the dominant secondary competitor for nontransaction deposits. Credit unions were named by between 14% and 20% of bankers as a dominant primary or secondary source of competition for both types of deposits.

COMPETITION FOR LOANS

FIGURE 31

What are the primary and secondary sources of competition for loans?



Competition in lending varied by loan type. In mortgage lending, primary competitors were diverse, with 34% of bankers naming community banks with a physical presence in the market, 20% of bankers naming non-bank, non-credit union institutions without a physical presence in the market, and 15% of bankers naming regional banks with a physical presence in the market. Competition for small business lending was exerted primarily by other community banks; competition from non-bank, non-credit union institutions without a physical presence—which presumably includes online fintech lenders—was minuscule.

Section Summary

Community bankers describe themselves as under siege from a proliferation of diverse competitive threats. These include fintech companies, the Farm Credit Administration and Rocket Mortgage, which vie for, respectively, consumer loans, agricultural loans and mortgage loans. Regional banks are also worrisome; surveyed bankers noted the difficulty in competing with banks that offer below 3.5% for 10-year terms.

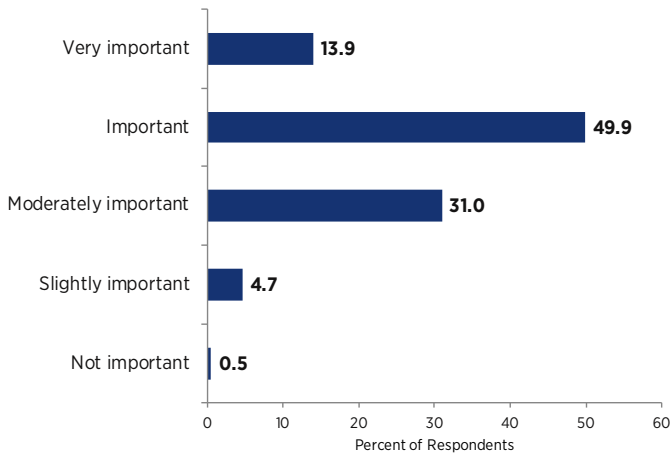
But competition remains dominated by traditional adversaries—other community banks. The fear of one banker is that the industry will “cannibalize itself.”

Operational Risks

Bankers responded to questions on operational risks that varied from those that were relatively focused, such as legal risks, to those that were broader, such as risks of climate change (both of which were considered trivial). Comparisons with last year's findings offer insight into the role played by the pandemic.

OVERALL ASSESSMENT

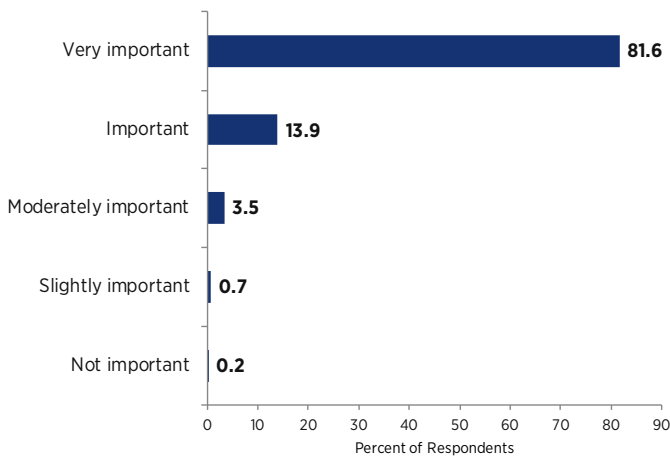
FIGURE 32
How important is overall operational risk?



About 14% of bankers consider operational risk to be “very important,” which is higher, but only slightly, than what was reported in the two previous years. This relative stability suggests that the pandemic may have influenced components of operational risk but not risk levels overall.

CYBERSECURITY RISK

FIGURE 33
How important is cybersecurity risk?



Cybersecurity risks are worrisome to bankers. More than 80% of bankers ranked them as “very important,” which was more than double the rate for any other type of operational risk, and more than the 60% reported last year.

STAFFING RISKS

FIGURE 34

How important is employee retention?

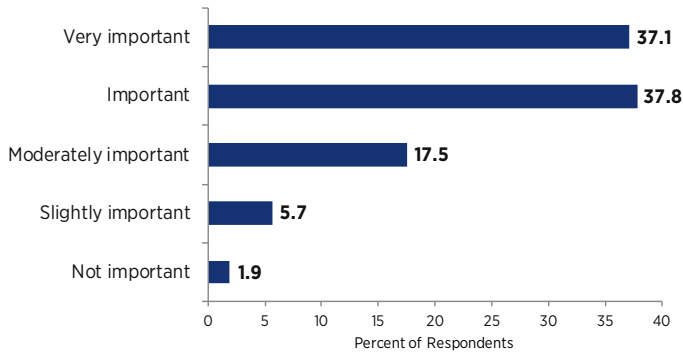
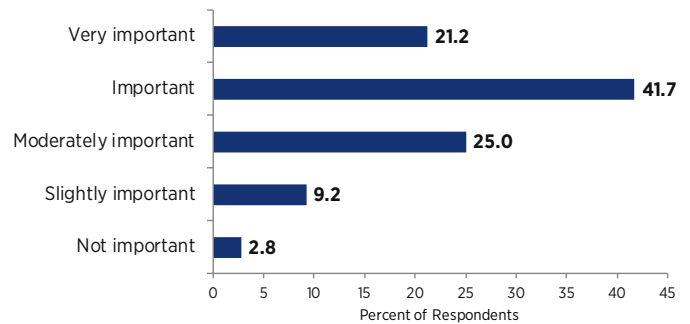


FIGURE 35

How important is management succession to your bank?



More than 37% of bankers said worker retention was a “very important” challenge. Management succession was named as “very important” by 21% of respondents. Board succession was also cited as a challenge facing community banks. Compared to last year’s survey, this year’s survey results reflect increasing concern with succession. “Many CEOs are tired,” one banker said.

THE BANK SECRECY ACT (BSA)

FIGURE 36

How important is BSA risk?

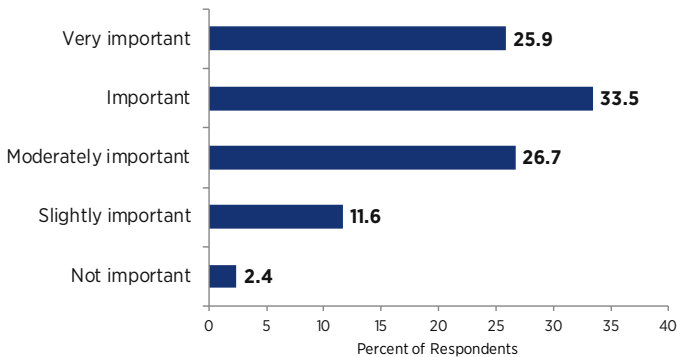
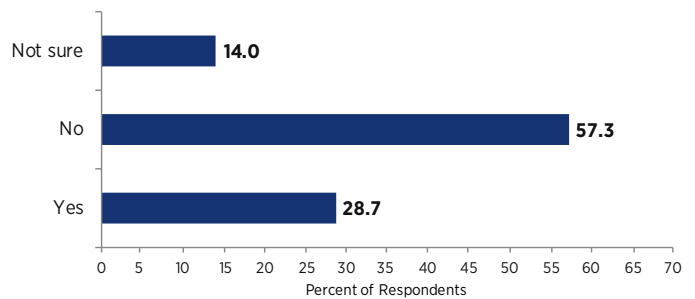


FIGURE 37

Have you been contacted by law enforcement as the result of a suspicious activity report or currency transaction report filing?



The Bank Secrecy Act is an increasing concern to community bankers, as 26% of them rated it as “very important,” compared to 20% last year. Almost 29% of bankers said they were contacted by law enforcement regarding suspicious activities.

Section Summary

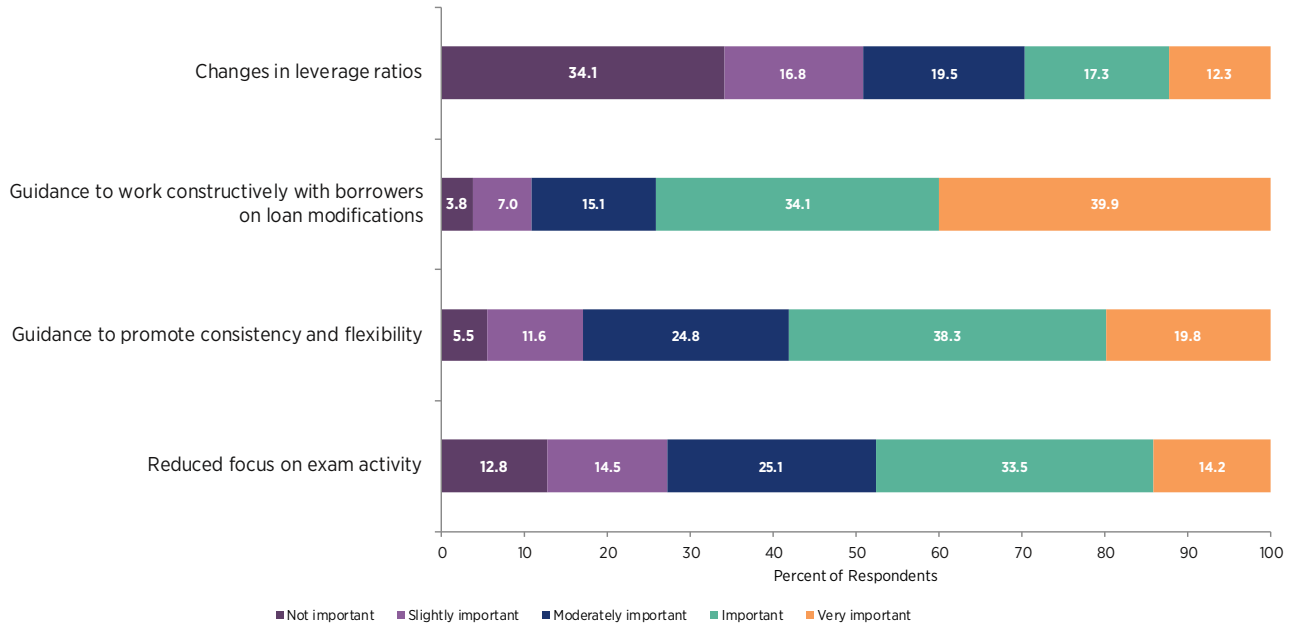
Cybersecurity is, by far, the biggest operational risk facing the community banking industry. But staffing is an emerging concern, driven, perhaps, by dislocations in the labor force due to the pandemic and subsequent recovery. Competitive pressures may also play an indirect role. “Banks will look to cut expenses as margins shrink,” one banker said. “Staff levels will get lower as banks work to be more efficient.”

Regulatory Compliance

Regulatory compliance continues to present persistent challenges to community bankers. This year, however, bankers faced unique problems presented by the pandemic. New questions in this year's survey focus on regulatory efforts to mitigate those problems.

REGULATORY RESPONSES TO COVID-19

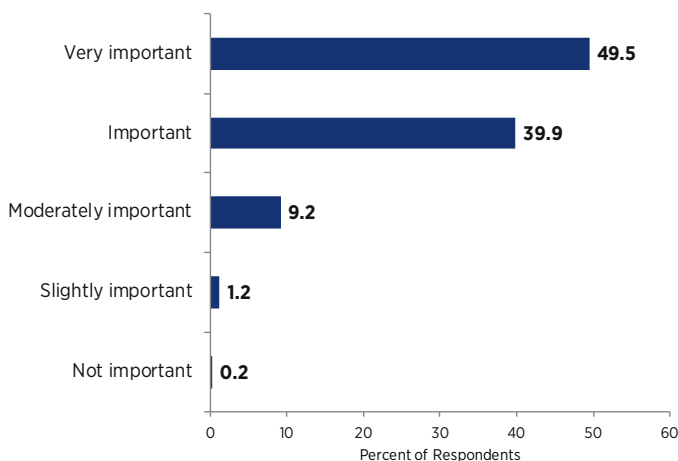
FIGURE 38
How important are certain regulatory responses to the COVID-19 pandemic?



Regulators enacted a series of measures to help banks support the economy in the wake of the pandemic. Among these was guidance to “work constructively” with borrowers on loan modifications, which was named by 40% of bankers as a “very important” regulatory response to the pandemic. Guidance to promote “consistency and flexibility” in supervision was named by 20% of them. Of lesser importance were a reduced focus on examination activity during the pandemic and changes in leverage ratios.

PERCEPTIONS OF RISK

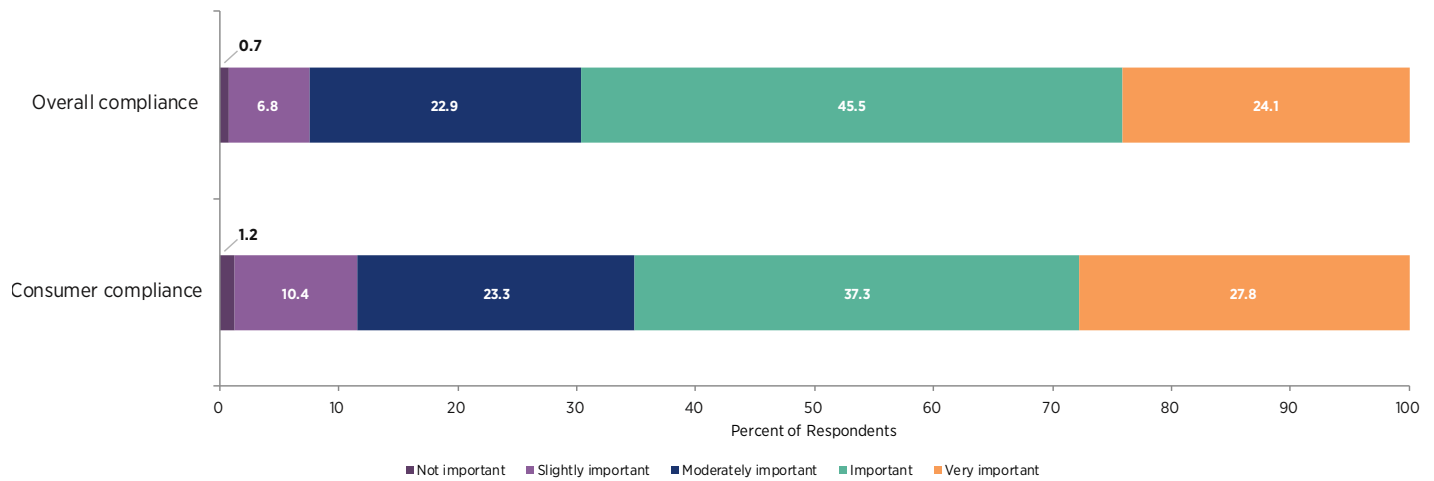
FIGURE 39
How important is regulatory risk?



Some things change, but others remain the same: Regulatory risk remains in the upper tier of banker risk perceptions, as nearly 90% of them consider regulatory risk as “important” or “very important.” A similar percentage was reported last year.

FIGURE 40

How important is compliance risk?



About 25% of bankers consider both consumer compliance and compliance generally to be “very important.” Both ranked higher than they did last year.

COSTS OF COMPLIANCE

As in previous surveys, bankers were asked to identify the compliance portion of the costs they incurred in personnel, data processing, legal services, accounting and auditing, and consulting services. In all categories, compliance costs as a percentage of overall noninterest expenses were similar, and in some cases nearly identical, to what was reported last year. The exception was for personnel expenses: The mean percentage attributable to compliance declined from 10.3% to 9.8%, continuing declines in the medians in each of the previous three years. Because compliance expenses in personnel dominate all other categories, constituting more than 80% of overall compliance expenses, overall relative costs of compliance declined.

TABLE 4

Compliance costs as a percentage of total expenses by category

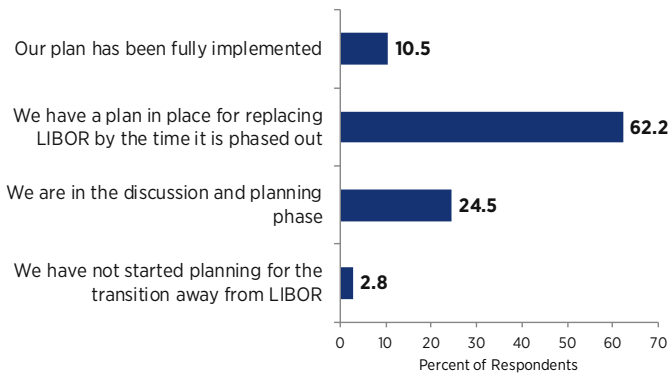
	2016	2017	2018	2019	2020
Personnel (salary and benefits)	12.3 (7.7)	10.4 (7.1)	11.3 (6.4)	10.3 (5.8)	9.8 (5.2)
Data processing	17.8 (11.4)	17.1 (12.4)	18.0 (12.6)	17.1 (11.0)	17.1 (12.1)
Legal	23.0 (14.4)	20.9 (12.5)	22.8 (14.5)	22.6 (14.3)	22.6 (15.4)
Accounting and auditing	41.7 (35.7)	39.4 (32.3)	42.4 (35.3)	42.3 (36.5)	42.8 (37.2)
Consulting and advisory	44.5 (39.4)	45.9 (41.7)	40.5 (34.4)	38.2 (28.2)	41.8 (33.3)

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

LIBOR

The London Interbank Offered Rate (LIBOR) was scheduled to be phased out this year as a benchmark for pricing short-term loans and other securities. It will be replaced by the Secured Overnight Financing Rate (SOFR), which represents the cost of borrowing cash overnight that is collateralized by U.S. Treasury securities.

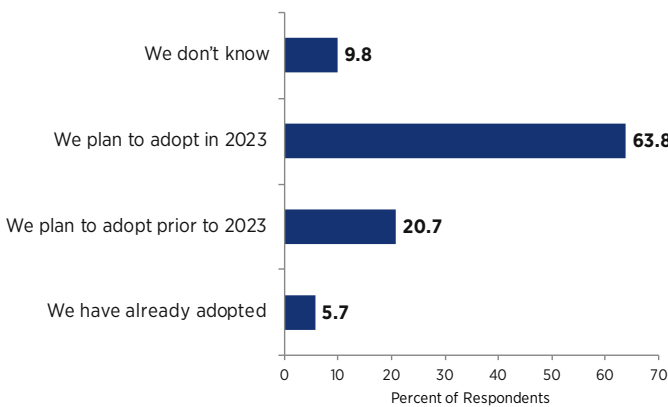
FIGURE 41
Transitioning from LIBOR: What stage of planning is your bank in?



Among banks with exposure to LIBOR, 62% have a plan in place for replacing LIBOR, while more than 10% said they have already made the transition. Last year, the same percentages, respectively, were 9% and 36%. Supplemental questions indicated that only 7% of banks had more than a limited exposure to LIBOR.

CURRENT EXPECTED CREDIT LOSS (CECL) MODEL

FIGURE 42
What is your planned transition date to CECL?



Community bankers are not rushing to convert to the CECL model. Nearly two-thirds are planning to defer implementation to 2023. Of those that have already implemented CECL, 60% said provisions for loan losses increased as a result.

Section Summary

The comments of community bankers that have been reported in surveys over the years seldom acknowledge much progress in their struggle against what they perceive to be excessive regulatory burdens. In some ways, this was true again this year. Although the overall costs of compliance declined, respondents continue to report being “crushed” by “stifling,” and increasing, regulations.

But a slightly different attitude also emerged. Almost all bankers, for instance, said regulatory guidance on loan modifications was important, at least to some extent, in helping their banks respond to the pandemic. A majority of respondents cited similar benefits for a reduced focus on examination activities and more flexible supervision.

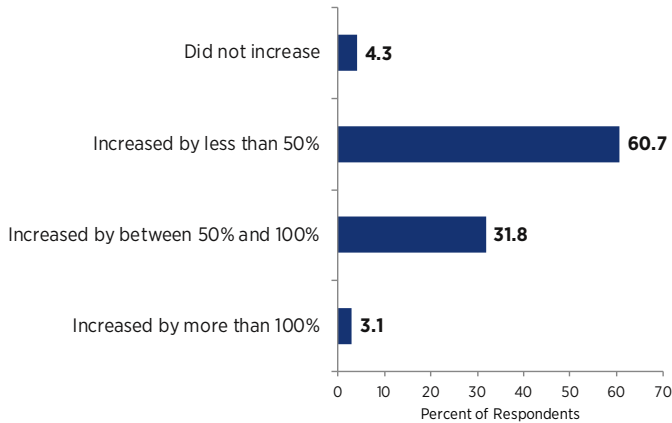
There also appears to be a change in bankers’ overall perspective: Many of them are more concerned about what might happen in the future compared to what is currently happening or what has happened in the past. “Additional regulations that will drive up fixed costs” will hurt profitability, one banker said. Another worried that there will be “hurdles to overcome that come in the form of increased regulation.”

Technology

In earlier surveys, community bankers have described growing challenges and opportunities in adopting new technologies. The COVID-19 pandemic fundamentally changed the nature of technological evolution. A common theme in this year's survey is that the COVID-19 pandemic created strong incentives for banks to adopt new technologies that meet the needs of their customers. The responses in the following section support the idea that the pandemic fundamentally changed the nature of technological evolution at community banks.

THE USE OF TECHNOLOGY EXPANDS

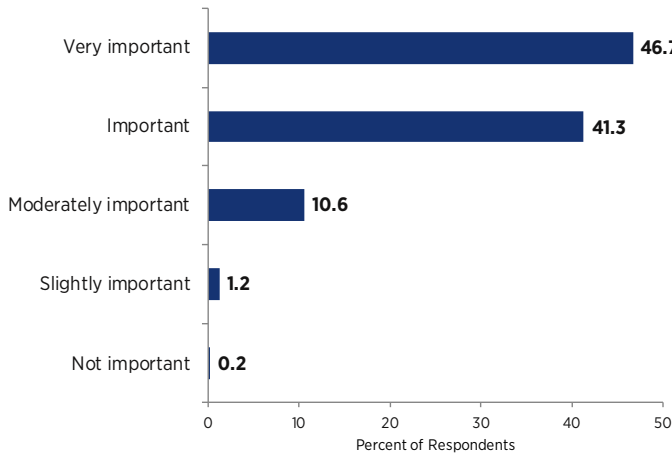
FIGURE 43
How did online services change as a result of COVID-19?



The pandemic quickened the pace with which banks, as well as customers, adopted and embraced new or previously underutilized technological products. Approximately one-third of respondents increased their online services by more than 50%.

THE ROLE OF TECHNOLOGY

FIGURE 44
How important are technology cost challenges?



The cost of technology was named by nearly 47% of bankers as a “very important” challenge, which ranked it among the most important issues facing bankers. As recently as two years ago, it ranked among the least important.

FIGURE 45

How important is adopting new technology?

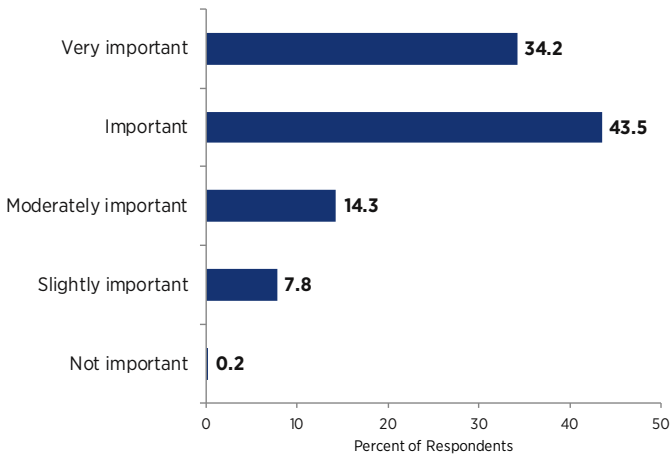


FIGURE 46

What are your views of existing technology?

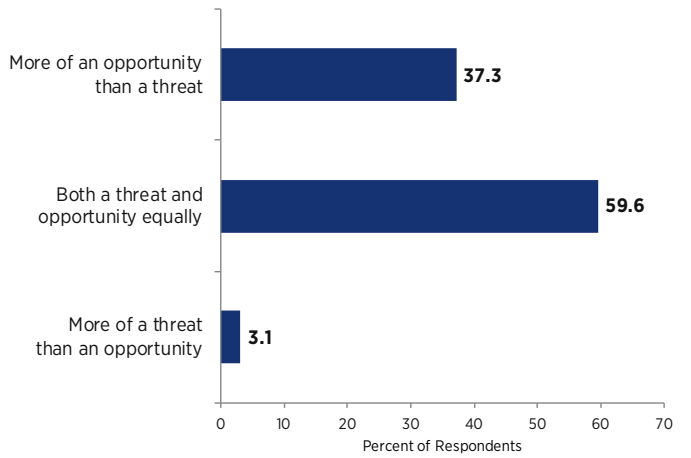
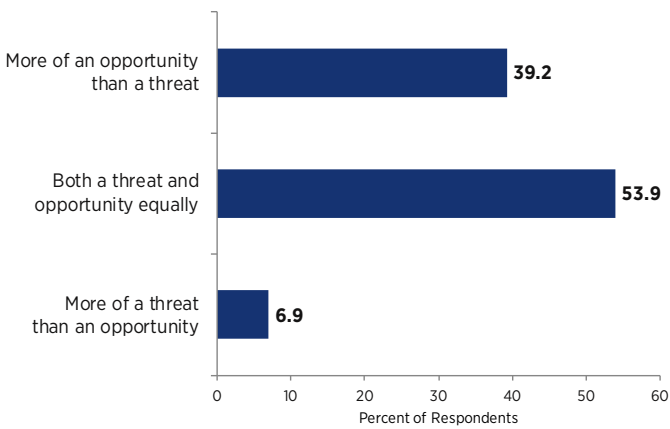


FIGURE 47

What are your views of future technology?

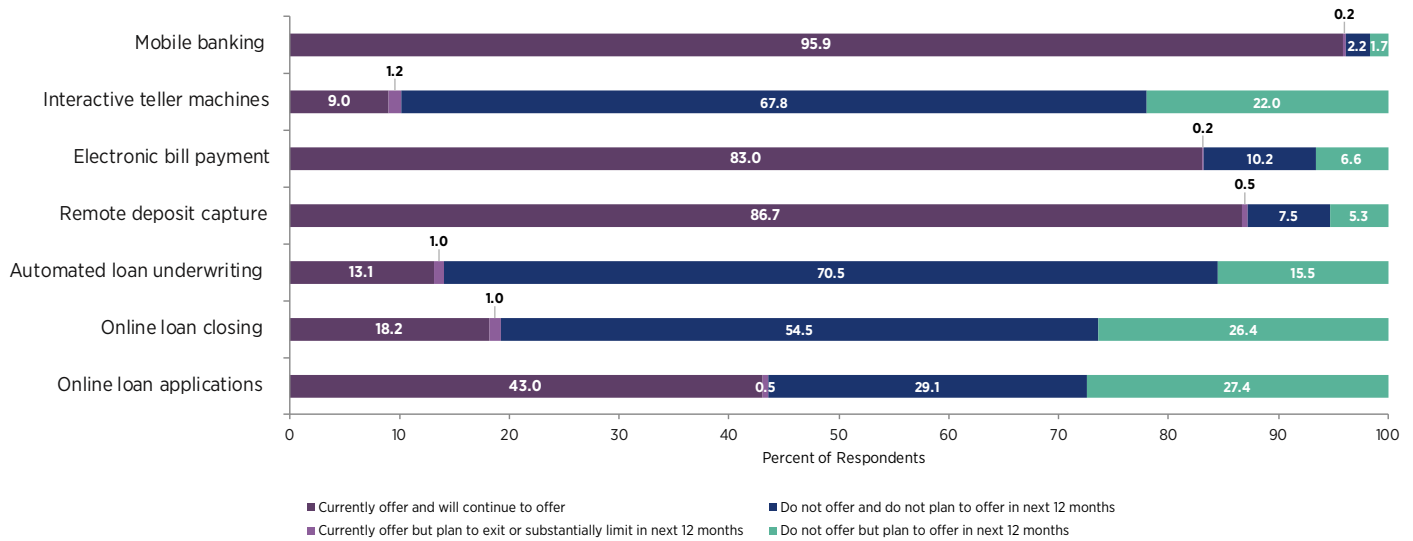


More than 34% said the adoption of new technologies is “very important,” compared to 23% last year and 8% the year before. Only 3% of bankers said they consider existing technology to be more of a threat than an opportunity, while nearly 38% think of it, conversely, as more of an opportunity than a threat. Responses for future technology are similar.

TECHNOLOGICAL INTENTIONS

FIGURE 48

What are your intentions regarding certain bank technologies?

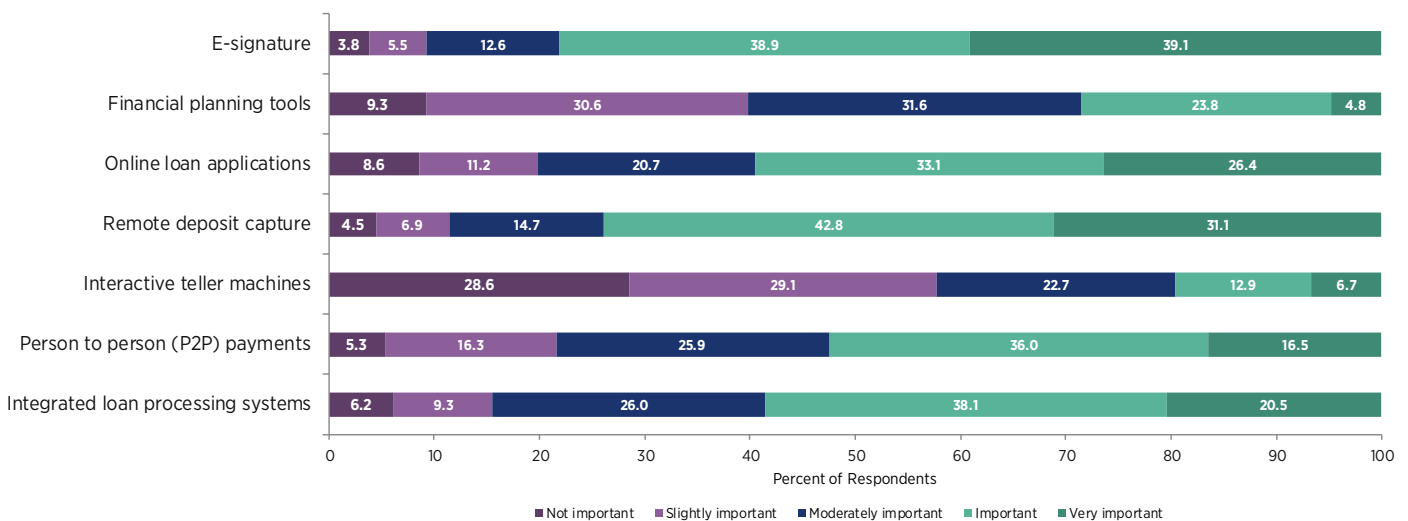


Bankers' intentions varied by product. Mobile banking, for instance, was universally offered, but relatively few banks offered interactive teller machines (ITMs). Differences by product, however, did not translate into differences across time, as these usage percentages were very similar to those reported last year. For instance, online loan applications were offered by 43% of banks, about the same as in previous years, while 27% planned to do so in the future—also the same as in previous years, which suggests a disconnect between planning and implementation.

TECHNOLOGICAL IMPORTANCE

FIGURE 49

How important are certain technological products?

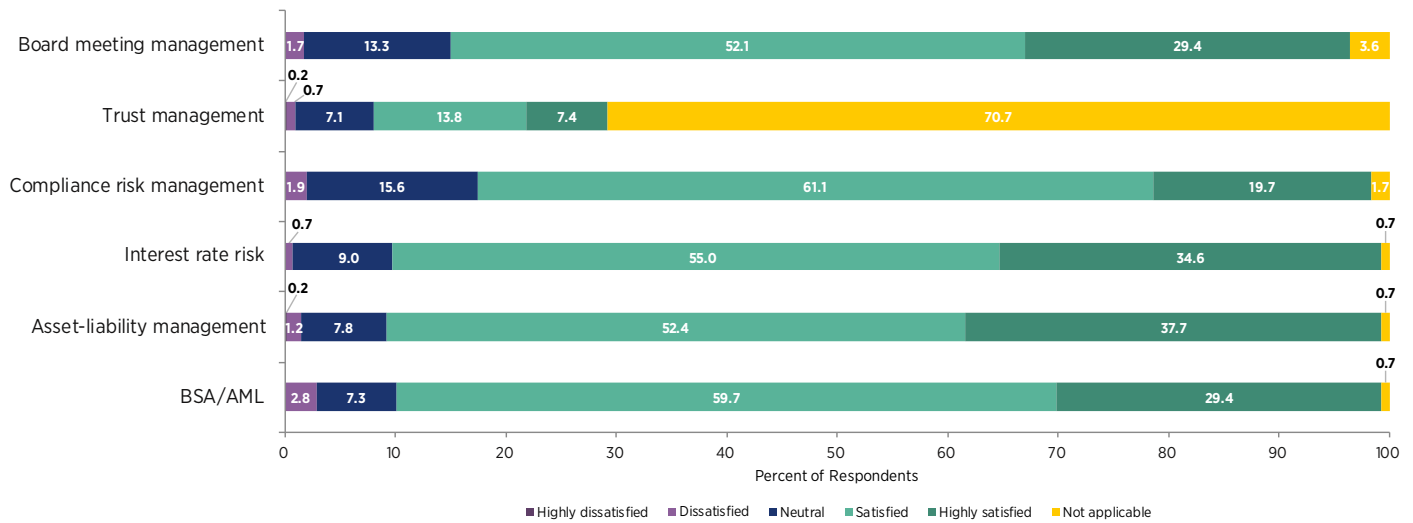


Bankers consider e-signatures to be a promising technological opportunity. They are not as enthusiastic, however, about ITMs or financial planning tools.

SATISFACTION WITH TECHNOLOGY

FIGURE 50

How satisfied are you with the technology for various bank activities?



Overall, community bankers only rarely were dissatisfied with the use of technology in supporting bank activities. More than 29% of bankers said they were very satisfied with the use of technology for asset-liability management, BSA/AML compliance, interest rate risk and board meeting management—which is higher than last year’s results. Satisfaction in compliance and in trust management was lower.

Section Summary

Community bankers, by and large, are satisfied with their use of technology. More of them view technology as an opportunity rather than as a threat. Some banks are rapidly expanding their technological capability, boosted by necessities imposed by the pandemic. “The community banking industry will remain strong and viable as the country emerges from the COVID-19 pandemic,” one banker said. “There will be more customer reliance on technology, such as online account opening, internet banking, mobile banking, and mobile deposits.”

But bankers still worry about the future and “a reckoning with reality” as rapid advances in customer-facing technology abruptly change their business model. Some services, such as cryptocurrency, geotargeting and machine learning, are largely unused. “Those that adopt and embrace the correct technologies will do fine,” one banker said. “The rest will be left behind.”

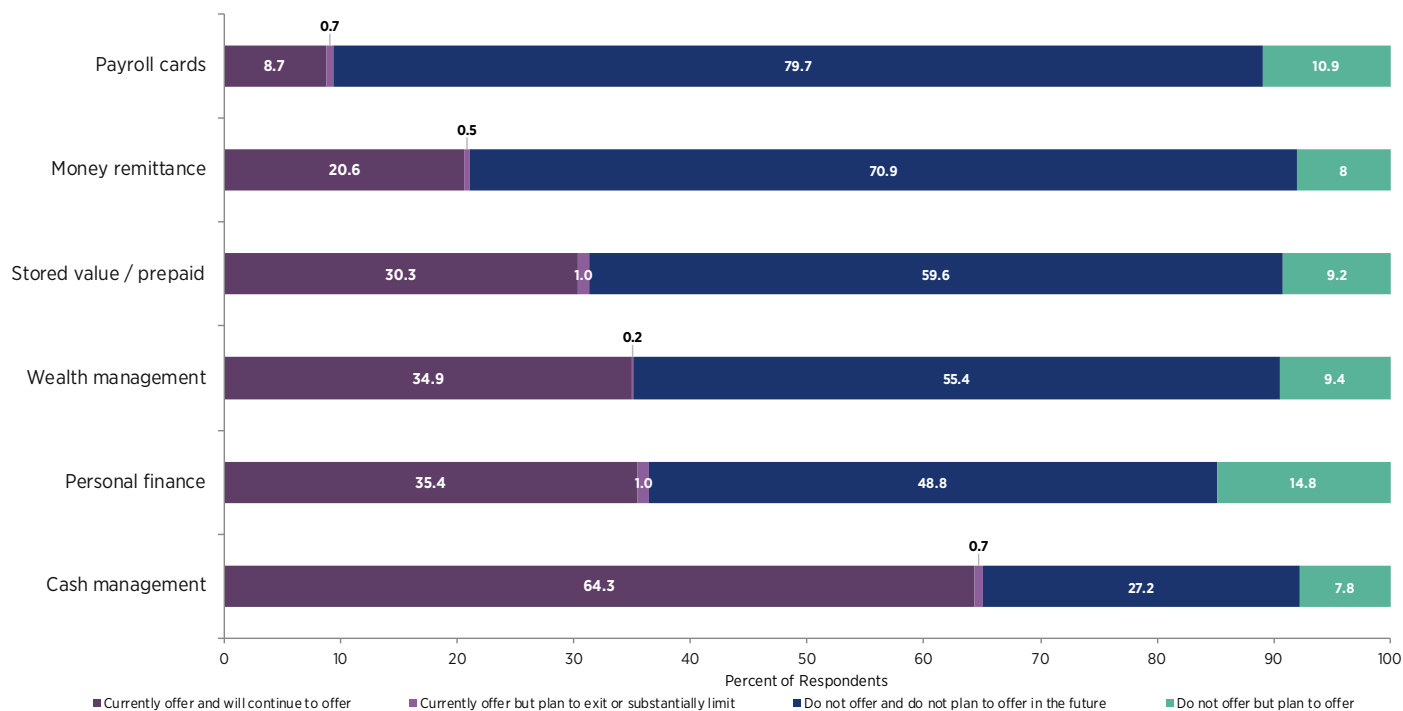
“If a community bank is to remain independent, it must grasp technology,” another banker said. The pandemic “proved that customers want other ways than face-to-face contact to interact with their money and their bank. We must be able to provide a quality mobile experience, as well, meeting the customer’s needs in new and more proactive, not just reactive, ways.”

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 51

What are your intentions for transactional and advisory activities?



Intentions regarding transactional services varied by product, with 64% of banks offering cash management services, but only 8% offering payroll cards. Across all categories, intentions varied little from last year or the year before.

Section Summary

Banker intentions regarding transactional services have been unchanged in recent years. This is perhaps surprising given recent efforts to expand profitable activities in a low-interest rate environment. As one banker said, “We are also looking at different lines of business that may be able to bring more noninterest income to the bottom line.”

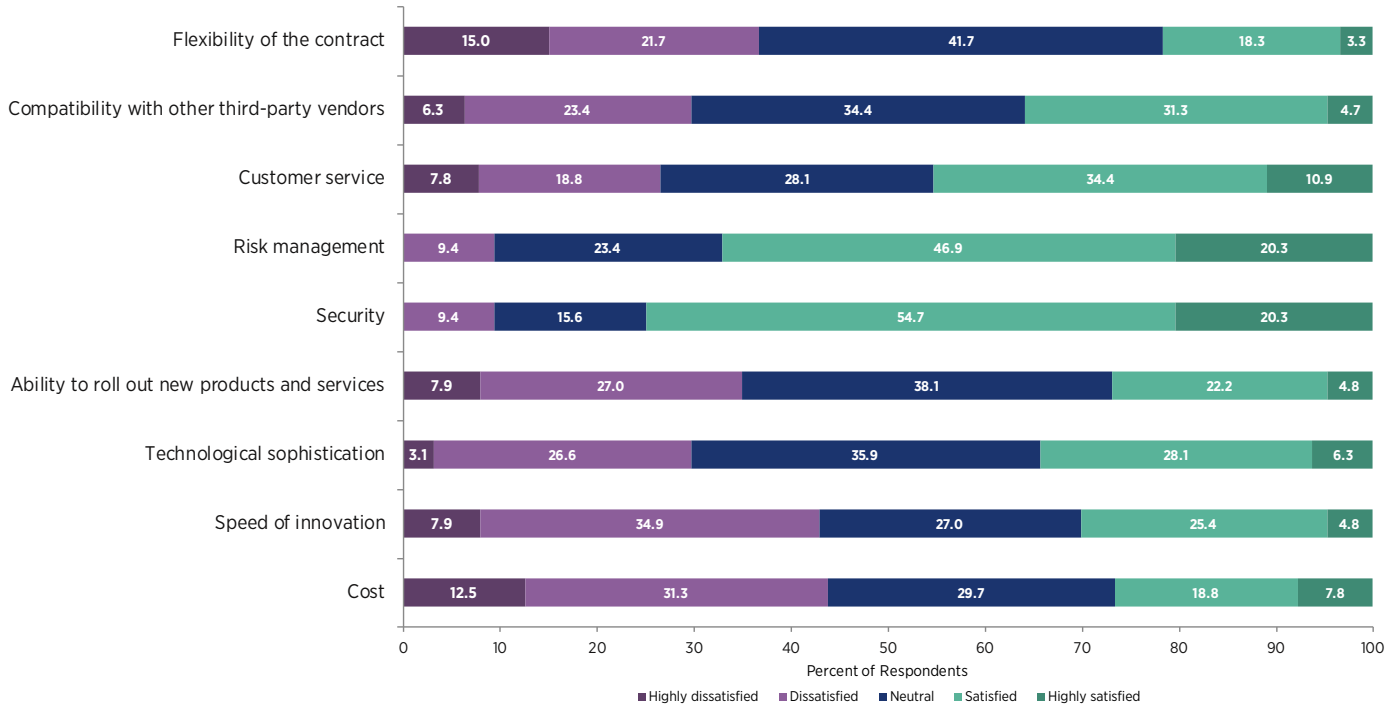
Core Processing

Core processing systems allow banks to provide services including opening new accounts with loan origination software, processing deposits and withdrawals, maintaining general ledgers and accommodating automated clearing house (ACH) transfers, while also enabling banks to provide mobile banking applications and online banking.

SATISFACTION WITH CORE PROCESSING: IN-HOUSE

FIGURE 52

How satisfactory are the internal core processing services at your bank?

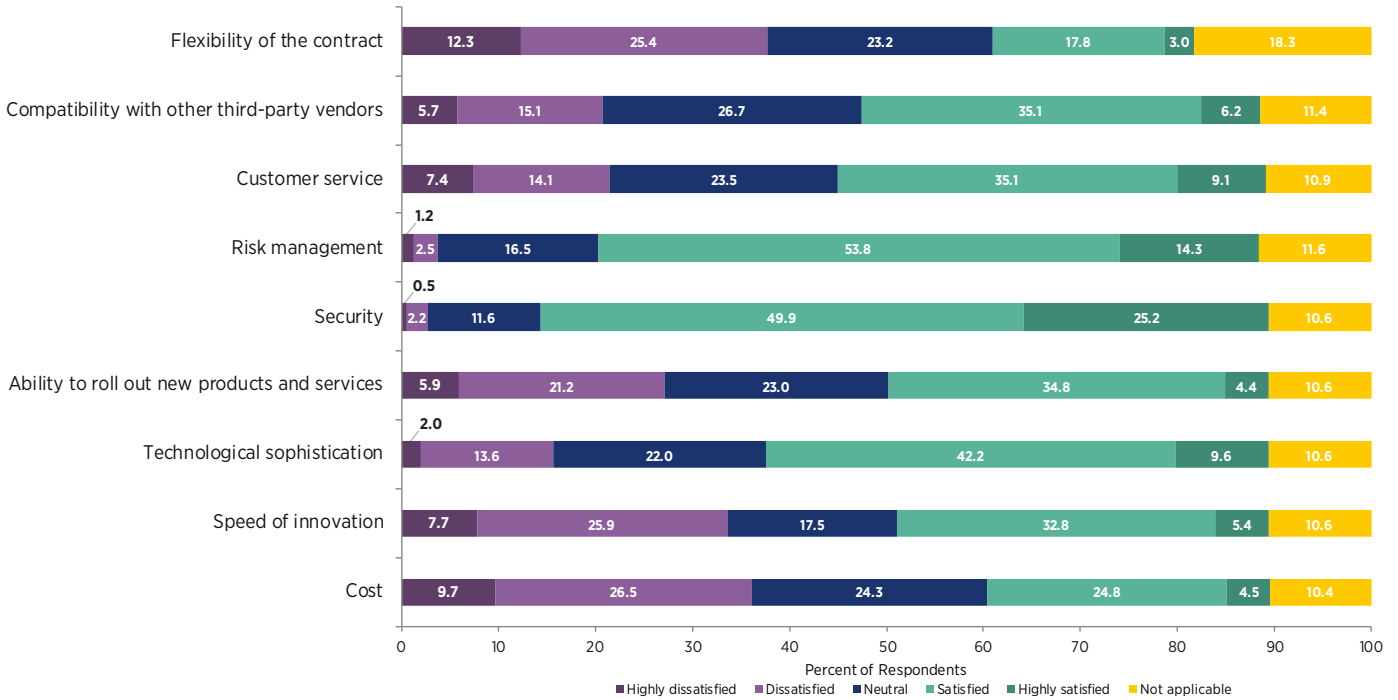


Bankers were relatively satisfied with the security and risk management applications of core processing that was handled internally. They were less satisfied, on the other hand, with costs and flexibility.

SATISFACTION WITH CORE PROCESSING: EXTERNAL

FIGURE 53

How satisfactory are the external core processing services at your bank?



As with core processing done internally, bankers were relatively satisfied with the security provided by their core processing that was done by external providers. They also were less satisfied with costs and flexibility.

Section Summary

Bankers expressed greatest concerns for speed of innovation, cost and flexibility in assessing core processing services. Their opinions did not vary systematically, however, depending on whether they were provided internally or by external providers. In some cases, such as speed of innovation, external providers rank higher on satisfaction, while for other services, such as cost, they rank higher on dissatisfaction.

Acquisition Activity

Acquisitions slowed during the pandemic but rebounded in mid-2021, with more acquisitions occurring this July than in all of 2020.¹²

FIGURE 54
Has your bank considered an acquisition offer?

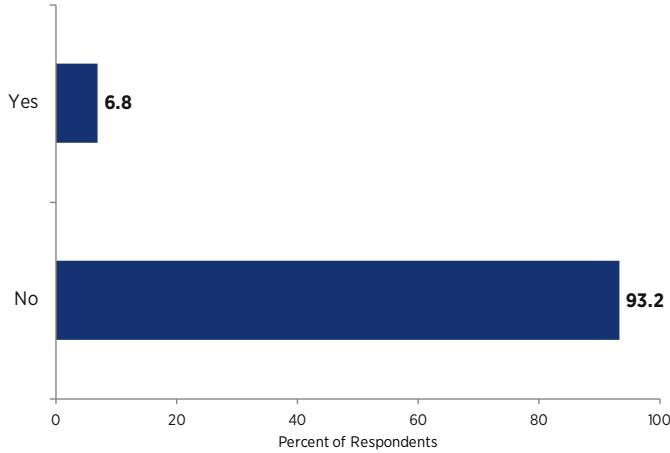
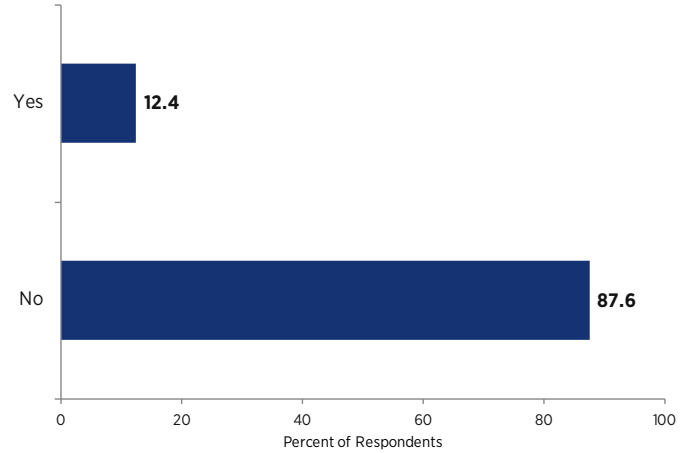


FIGURE 55
Has your bank made an acquisition bid?



Less than 7% of bankers said they had received an acquisition offer this year, and 12% said they had made a bid. Last year, by comparison, the percentages were 14% and 25%, respectively.

THE EFFECTS OF THE PANDEMIC

FIGURE 56
In 2020, what was the effect of COVID-19 on interest in making an acquisition or in being acquired?

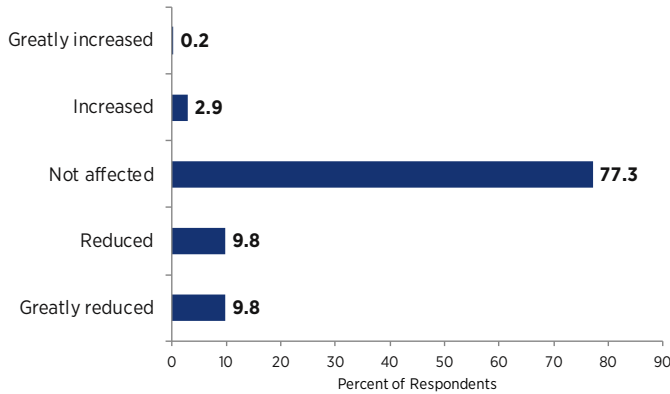
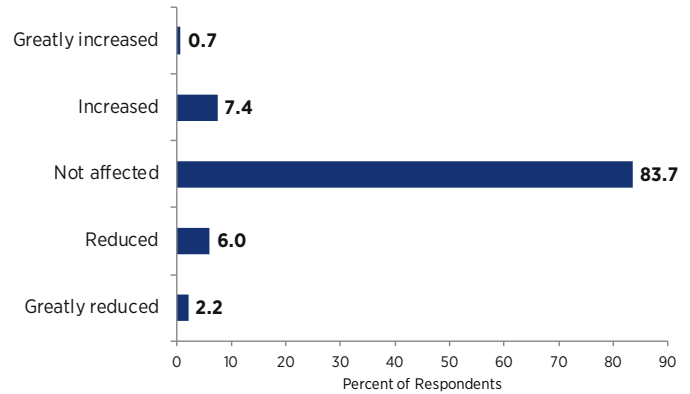


FIGURE 57
In 2021, what was the effect of COVID-19 on interest in making an acquisition or in being acquired?

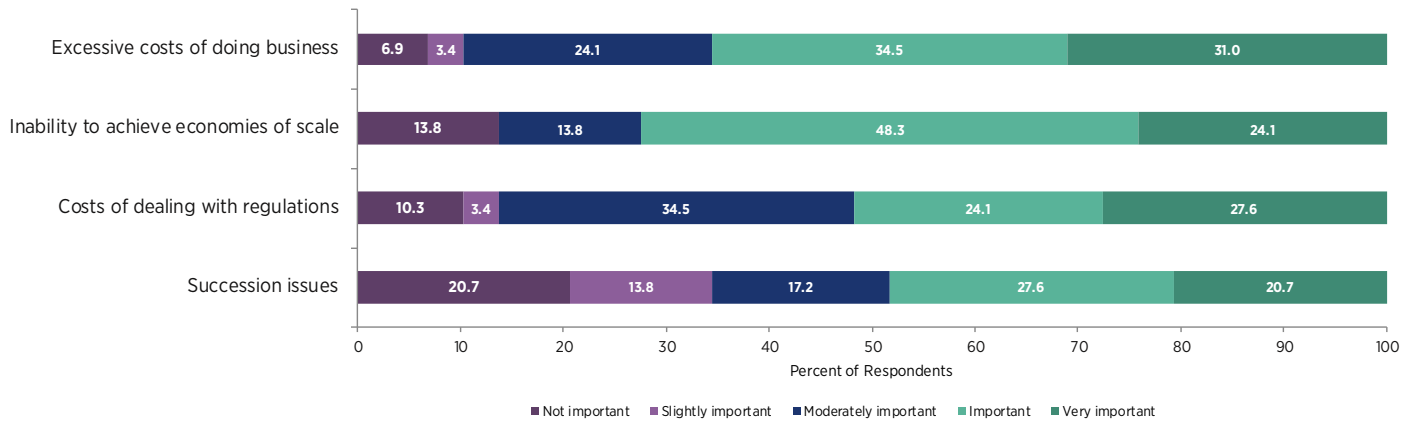


Nearly 20% of bankers said that their interest in making an acquisition or in being acquired was reduced or greatly reduced by the pandemic in 2020. Such disincentives lessened this year.

RATIONALES FOR ACQUISITIONS

FIGURE 58

How important were certain rationales for considering acquisition offers?

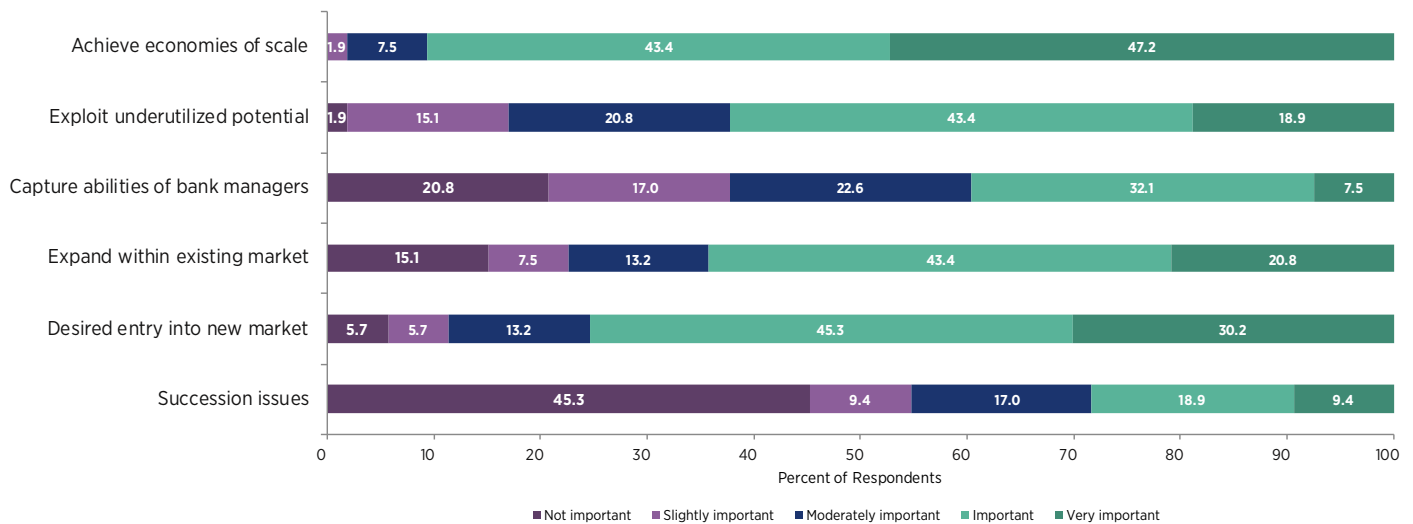


Economies of scale are not as important as they once were in considering acquisition offers. Only 24% of surveyed bankers said they were “very important” in their consideration of offers, down from 40% last year, while 14% said they were “not important,” up from 2% last year. Despite the lesser importance of economies of scale in motivating acquisitions, bankers are more ambivalent concerning costs generally.

RATIONALES FOR BIDS

FIGURE 59

How important were certain rationales for making an acquisition bid?



As in previous surveys, bankers said they were more motivated in their acquisition bids by exploiting underutilized potential rather than capturing the abilities of managers. About 21% and 30% of bankers, respectively, said in-market and new-market expansions were “very important” motivations for their acquisition bids. Last year, the comparable percentages were 19% and 21%.

Section Summary

Bankers expect continuing pressure for consolidation due to low interest rates, inability to achieve economies of scale, regulatory burden, and needed investments in technology and human capital. These are challenging, one banker said, because “most community banks lack the earnings diversification, expertise in staffing, and flexibility with their core providers and other third parties to compete.” Another banker expects some banks to “just throw in the towel and sell.”

But one bank’s challenge is another bank’s opportunity: “Banks with the ability to make acquisitions will likely benefit from this environment,” one banker said. “We will seek out opportunities for mergers and acquisitions. We will cut cost and look to add products and services where and when it makes sense.”

Conclusions

Community banks entered the pandemic on a high note, with annualized returns on assets and equity of 1.2% and 10%, respectively, for 2019. In 2020, returns dropped, but only modestly, as higher provisions for loan losses were offset by increases in income from loan sales. Annualized returns on assets and equity rebounded to 1.3% and 12%, respectively, for the first three months of 2021 as provisions declined.

Bankers’ responses to the questions in this year’s National Survey of Community Banks in some ways reflect this resiliency in profitability. Bankers said the pandemic created an environment of fostering benefits in cost containment, expansions in technological services and advances in small business lending. Relative compliance costs are declining. Credit risk is less of a worry than it was a year ago.

But the survey also reveals concerns with compressed net interest margins that will make “strong earnings hard to achieve,” as one banker noted. Loan demand is weak. Both “will add fuel to the fire of small bank consolidations where gains in efficiencies and fee-based income will rule the day,” as another banker noted.

Bankers expressed mixed feelings on technology. They view it as more of an opportunity than a threat and appear to be generally satisfied with its current use in support of bank activities. But costs present an increasing challenge. And adoption of new technologies was identified as being more important than ever.

“The majority of community banks will discover that consumer financial services have greatly transitioned to non-banks and fintechs who offer more convenient and reliable services for basic financial needs,” one banker said. “Few community banks have kept up with necessary innovation and rollout of products and services that meet customer needs and expectations.”

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. FDIC. (2021, March 31). *Quarterly Banking Profile*.
3. Marks, G. (2020, Dec. 14). America’s traditional bank loans dry up for small businesses—what can they do? *The Guardian*.
4. Eisen, B. (2021, Feb. 10). America went on a borrowing binge, but banks were left out. *The Wall Street Journal*.
5. Scauzillo, A. (2021, May 13). Complying with PPP loan forgiveness requirements. *ABA Risk and Compliance*.
6. Raspa, S. (2020, Sept. 14). How bank and fintech partnerships are redefining the future of banking. *Finextra*.
7. FDIC. (2018). *Small Business Lending Survey*.
8. Dobbs, J. (2021, May 13). As loan demand goes up, banks at risk of letting guard down. *American Banker*.
9. S&P Global. (2021, May 3). *Market Intelligence*.
10. FDIC. (2021, March 31). *Quarterly Banking Profile*.
11. Kline, A. (2021, Jan. 29). Managing excess liquidity getting tougher for banks. *American Banker*.
12. S&P Global. (2021, Aug. 9). Bank M&A deal tracker: 19 deals announced in July. *Market Intelligence*.

Acknowledgments

The 2021 CSBS National Survey of Community Banks was administered by state bank commissioners in 34 states. A total of 470 community bankers participated.

To request a print copy of this publication, email the conference committee at info@communitybanking.org.

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Alabama State Banking Department

Arizona

Evan G. Daniels, Superintendent
Arizona Department of Financial Institutions

Arkansas

Susannah Marshall, Bank Commissioner
Arkansas State Bank Department

Colorado

Ken Boldt, State Bank Commissioner
Colorado Division of Banking

Connecticut

Jorge Perez, Banking Commissioner
Connecticut Department of Banking

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