2024 CSBS Annual Survey of Community Banks

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CONFERENCE OF STATE BANK SUPERVISORS

Findings from the 2024 CSBS Annual Survey of Community Banks Presented at the 12th Annual Community Banking Research Conference

Oct. 2-3, 2024

Foreword from Brandon Milhorn

In the 2024 Conference of State Bank Supervisors' (CSBS) Annual Survey of Community Banks, bankers shared that their top concerns are cybersecurity, regulatory burden, high technology costs, and the costs of funds.

Drawn from nearly 370 respondents across 38 states, the survey results offer valuable insights for CSBS and our members, adding critical perspectives on the economic, regulatory, competitive, and operational challenges faced by the institutions our members charter and supervise.

CSBS has conducted our survey of the nation's community banks for 11 years. Adding this year's responses to over a decade of data helps us understand how risks have changed over time and how the evolving environment affects community banks and their customers. For example, nearly all survey respondents have said over the past several years that the adoption of new and emerging technologies is important. But this year, the cost to implement these new technologies ranked as the second-highest concern.

Meanwhile, the cost of funds continues to be a top external concern—just like last year. But this year, community bankers also ranked burdensome regulations almost equally. While the regulatory burden threat has always been high, it had fallen since 2018. However, with the banking challenges from March 2023 as a backdrop, federal regulators have increased the pace of regulatory and supervisory activity—and our survey responses indicate regulatory burden is creeping up again as a concern.

I hope you read and enjoy the full annual survey results.

Brandon Milhorn

President and CEO, Conference of State Bank Supervisors

2024 CSBS Annual Survey

Introduction

The 2024 Annual Survey of Community Banks, conducted by the Conference of State Bank Supervisors (CSBS) and state banking supervisors, was administered from April 15, 2024, to July 15, 2024. The survey period was a full 13 months after the failure of the first two of three large regional banks in 2023, which triggered, among other things, an intense focus—by bankers, regulators and policymakers—on bank liquidity, uninsured deposits and unrealized losses on available-for-sale and held-to-maturity securities. That focus continues today. Although the most prominent program launched in the wake of the regional banking turmoil, the Bank Term Funding Program (BTFP), sunsetted on March 11, 2024, many banks continue to hold BTFP advances on their balance sheets. These advances were important sources of liquidity valued at the par value of their securities' collateral (versus the market value of the securities). Since BTFP loans were for terms of up to one year, this liquidity will remain on many bank balance sheets through early 2025. This program and other actions by state and federal regulators appear to have had the desired effect. The percentage of respondents citing liquidity as either an "extremely important" or "very important" risk declined by nearly 6 percentage points: from approximately 84% in 2023 to 78% of respondents in 2024.

Unsurprisingly, given the events of last year, bankers in the 2023 survey cited net interest margins and cost of funds as the most significant external risks facing their institutions. These concerns continue today but are joined in importance by a risk that has largely persisted since the annual survey was first launched in 2014: regulation.

Respondents to the 2023 CSBS Annual Survey of Community Banks flagged regulation as an external risk on the minds of community bankers, but anecdotal evidence suggested that some were in more of a "wait and see" posture regarding the risks posed by regulation. Specifically, some noted that in the wake of any negative event in the banking industry, changes in regulation were an inevitability, but some optimistically noted that since the significant issues in early 2023 were isolated among a few banks with unique business models, perhaps the regulatory response would be muted.

That optimism, however, appeared to change throughout the remainder of 2023 and into early 2024. Results from the CSBS quarterly Community Bank Sentiment Index (CBSI) indicated that banker concerns around regulation had moved away from "wait and see" and were once again amplifying. At the time of the 2024 CSBS Annual Survey of Community Banks, banker sentiment toward regulation, as expressed through the CBSI, was around its lowest levels. This negative sentiment is reflected in the annual survey as well, as regulation is essentially tied with cost of funds as the top external risk facing community banks.

While these risks will continue to be areas of focus for community bankers, the 2024 survey also highlighted ongoing concern regarding credit quality in commercial real estate portfolios, particularly for loans on certain property types. The 2024 survey shows that while bankers are managing these risks, they anticipate headwinds throughout the remainder of the year, while continuing to innovate around their product and service offerings and their technology infrastructure. Cybersecurity is top of mind for all bankers and shows no sign of abating.

CSBS launched its annual survey of community banks in 2014, the second year of the Community Banking Research Conference. Each year, some questions are added to the survey; some reflect emerging issues, while others address issues that are more temporary in nature. Most questions, however, are asked every year and have shown how the opportunities and challenges facing community banks have evolved over a decade. The survey report also incorporates comments from interviews that were conducted with five community bankers from across the United States. The interviews, commonly referred to as "Five Questions for Five Bankers," provide important context around the survey findings, while offering a unique window into the thinking of five active industry practitioners. Transcripts of the complete interviews can be found in the last section of this survey report. CSBS is grateful to these bankers for sharing their candid perspectives in support of the 2024 Annual Survey of Community Banks.

Key Findings

- Funding costs and regulation were nearly tied in this year's rankings for the most important external risk. Net interest margins and core deposit growth also ranked highly among surveyed banks, a theme also present in the 2023 survey and consistent with the high interest rate environment. The jump in regulation to a near tie for the top spot reflected a growing proportion of bankers citing this as an important external risk over the last few years.
- Community bankers continued to rank cybersecurity as the highest internal risk to their banks. Technology implementation and costs ranked second, up from a tie for third in the 2023 survey and replacing liquidity, which held the second spot in last year's survey.
- Respondents indicated that inflation-created challenges are likely to persist but are manageable, similar to last year's survey. Bankers shared that the effects of inflation are most impactful on costs of deposits, followed by personnel expenses, the value of securities investments and operating expenses.

Key Findings, cont.

- In terms of wholesale funding sources, the biggest shift this year was in brokered deposits; roughly 56% of bankers indicated that they are using or planned to use brokered deposits at or near current levels, up 5 percentage points from last year's survey.
- Roughly 24% of respondents reported currently receiving instant payments via the FedNow Service, and an additional 44% reported planning to add this service in the next 12 months. Fewer bankers reported sending instant payments via the FedNow Service, with 9% of respondents currently offering this service. However, an additional 39% of respondents have plans to add this service in the next 12 months. Indeed, of those services that bankers did not currently offer but planned to in the next year, FedNow Service instant payments receive and send services ranked the highest, respectively.
- A large share of respondents anticipated credit quality to worsen for loans to individuals, as well as commercial real estate (CRE) and commercial and industrial loans. Bankers had a more neutral outlook for one- to four-family residential and agricultural loan types.
- When asked about certain CRE property types, most respondents indicated that they expected no difference in the credit quality associated with lodging, multifamily, and industrial and warehouse loans. Contrarily, most respondents expected credit quality to be at least somewhat worse across retail and office CRE property types.
- Nearly 40% of respondents applied a high level of stigma to emergency facilities, while roughly a quarter applied this level of stigma to discount window advances and brokered deposits. The lowest levels of stigma were associated with Federal Home Loan Bank advances and public funds.

Background

To develop the 2024 Annual Survey of Community Banks, CSBS staff met with key stakeholders to identify current issues of relevance to community banks. The survey was distributed by the state banking regulatory authorities from April to July 2024. The number of respondents was 367.

All responses captured in this report are from institutions with less than $10 billion in total assets—a benchmark for community banks established under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The majority of responses were from state-chartered banks.

The survey does have several limitations, however, as outlined below:

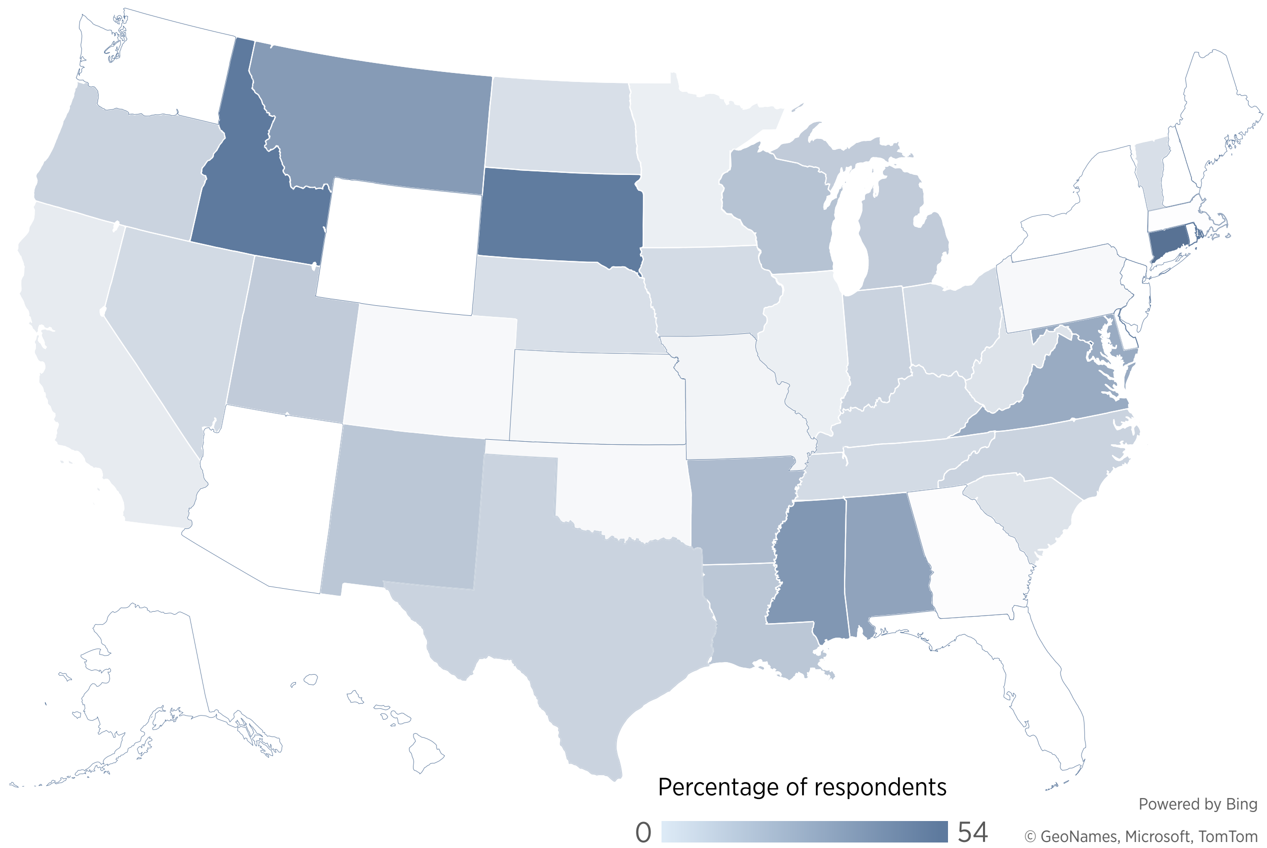
- It was not completed by community banks in every U.S. state and territory. (See map in Figure 1.)
- Respondents participated on a self-selected basis (a "convenience sample").
- Respondents did not necessarily respond to every question in the survey.
- Detailed statistical testing, which would be required to definitively quantify the extent to which the surveyed banks were representative of the overall industry, was not conducted.

Given these limitations, the conclusions in this year's survey report should be quantified accordingly. Because each respondent did not answer every question, responses are expressed as percentages of respondents to specific questions. Because of rounding, not all percentages will sum to exactly 100.

Nevertheless, the responses from the 2024 CSBS Annual Survey provide valuable insights into how the nation's community banks experience key internal and external risks, the marketplace for banking products and services, technology, competition, liquidity and funding, loan participations, compliance costs, and merger and acquisition activity. The findings have implications for researchers, regulators, bankers, and policymakers.

FIGURE 1

Survey participation rate by state



Participants were from 38 states. The participation rate was highest in Connecticut. Texas had the largest number of respondents, with 41 banks responding.

FIGURE 2

Asset size of surveyed banks

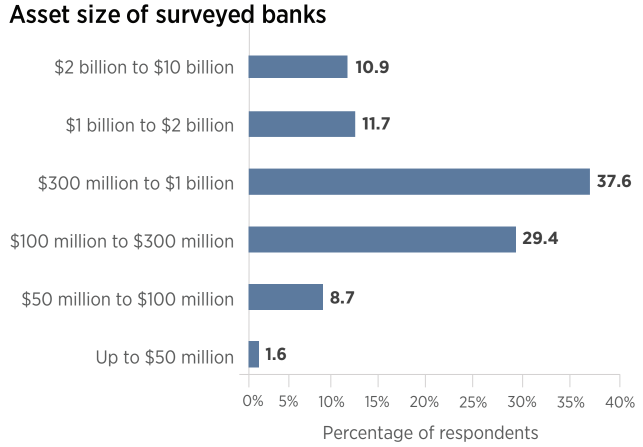
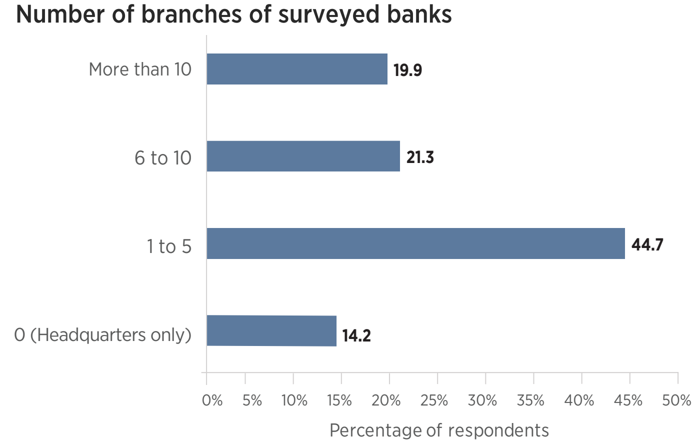


FIGURE 3

Number of branches of surveyed banks



Of the banks surveyed, roughly 67% had assets between $100 million and $1 billion. Nearly 23% of surveyed banks fell within an asset-size range of $1 billion to $10 billion, while roughly 10% had assets of less than $100 million.

Although close to half of all banks had between one and five branches, significant dispersion was evident with 14% of banks having no branches and approximately 20% having more than 10 branches.

At the time of the 2024 survey, the U.S. economy continued to grow at a solid pace and the unemployment rate remained low. Inflation had moderated from highs reached in 2022, though remained elevated relative to the Federal Reserve's inflation target. Monetary policy remained restrictive with the federal funds rate at a range of 5¼% to 5½%, where it had been since July 2023. Within this landscape, community bankers reported that cost of funds, regulation, and net interest margins were the most important external risks facing their institutions.

FIGURE 4

How important are the following external risks to your bank today?

Cost of funds was identified as the most important external risk in the 2024 survey, with nearly 89% of respondents selecting it as either "extremely important" or "very important." This percentage is similar to the result from the 2023 CSBS Annual Survey and likely reflects the higher interest rate environment in which banks continue to operate. For comparison, only 48% of community bankers listed cost of funds as either "extremely important" or "very important" in the 2022 CSBS Annual Survey, which was near the start of the Federal Reserve's most recent tightening cycle.

Banker Perspectives

The inverted yield curve environment has been difficult for many banks, community banks especially, that weren't positioned the right way. We were operating in a rate environment that was very static for a long time and then moved suddenly. Consequently, it narrowed the net interest margin and impacted earnings for a number of banks. When interest rates rose sharply in a short period of time, the cost of retaining deposits changed very suddenly, while the loans weren't repricing as quickly. While things have stabilized more recently, there has certainly been a chilling effect on loan demand and stress on the consumer with higher debit servicing costs.

We were able to somewhat soften the blow because we have a large percentage of our deposits that are not interest bearing. We also service some niche industries that are not as competitive since the accounts require more compliance work. This provides a bit of a moat where there is not as much pricing pressure for lower-priced loans and higher-priced deposits.

—Michael Busch, Burling Bank
Chicago, Illinois

Regulation jumped in this year's ranking of external risks, with nearly 89% of respondents naming it as an "extremely important" or "very important" external risk, essentially tying for the top spot. The percentage of community bankers listing regulation as "extremely important" or "very important" has risen consistently over the last few years, up from 81% in the 2023 CSBS Annual Survey and from 77% in the 2022 survey.

Net interest margins ranked third in importance among surveyed banks, with nearly 88% of respondents naming them as either "extremely important" or "very important." Net interest margins had previously ranked first in both the 2023 and 2022 CSBS Annual Surveys. However, the overall percentage of respondents classifying net interest margins as either "extremely important" or "very important" changed little from the previous two years.

Core deposit growth was viewed as the fourth most important external risk, with nearly 84% of respondents naming it as either "extremely important" or "very important." This percentage was essentially unchanged from last year's survey but materially higher than the 2022 survey, consistent with the change in the interest rate environment over the previous two years.

Additional External Risks

- Cost of technology rose in importance among external risks in this year's survey, with 81% naming these costs as either "extremely important" or "very important." This proportion was up from 74% in 2023 and 77% in 2022.
- Bankers continued to express less concern around economic conditions relative to the 2022 CSBS Annual Survey, when this external risk placed second in overall importance. Roughly 80% of the 2024 respondents listed economic conditions as either "extremely important" or "very important," matching the 2023 result but down from 84% in 2022.
- Respondents had the opportunity to write in any additional external risks. Fraud was the most common external risk cited in these narrative responses.

Banker Perspectives

Rising interest rates and the corresponding sustained inverted yield curve have been some of the biggest challenges of my banking career, aside from the Great Recession. This current yield curve inversion, which has been going on since 2022, is the longest in history, surpassing the previous record set in 1978. The Fed managed to contain last year's banking turmoil, which was a result of changes in the shape of the yield curve, by offering emergency liquidity measures. But the inverted curve has played havoc with the bank's ability to grow our core deposits to keep pace with our loan portfolio. Since the cost of alternative funding rose, the competition for core deposits has sharply increased. So, the inverted yield curve introduced an extra element of uncertainty into our risk and business models. We have widened our search for deposits to new areas, exploring municipal and school district accounts, and are applying to become a Pennsylvania depository for state funds. This challenge has encouraged closer cooperation with our lenders, as well as our business development teams. New business loan customers often want to move their deposits to the bank, and our business development team has been exceptional in working with them to make sure their questions are answered and their needs are met. Margin pressures are real, and they have continued to be an issue resulting in reduced bank earnings. As a result, the hiring of new employees has been muted as a means of expense control, and this has also disrupted the expansion of brick-and-mortar branches into new areas. This has been halted until there is more sustainability and stability in the financial markets. Right now, our motto is "Survive until 2025."

—Lori Maley, Bank of Bird-in-Hand
Bird-in-Hand, Pennsylvania

RISK OF INFLATION

With inflation still above the Federal Reserve's 2% target rate in the first half of 2024, bankers ranked the effects of inflation to their banks. A majority (59%) reported costs of deposits as the most impactful effect of inflation. Personnel expenses were the second most impactful effect of inflation, according to 22% of respondents. Roughly 72% of respondents viewed the challenges created by inflation as likely to persist. Nearly 17% viewed these challenges as likely to persist and difficult to manage, up slightly from 15% in last year's survey. Only 4% of community bankers expect core inflation to return to the Federal Reserve's target by the end of 2024, with most respondents (43%) anticipating this to occur in 2025. Roughly 37% expect a return to target by 2026 or later.

FIGURE 5

How would you rank the following effects of inflation on your bank in terms of level of impact?

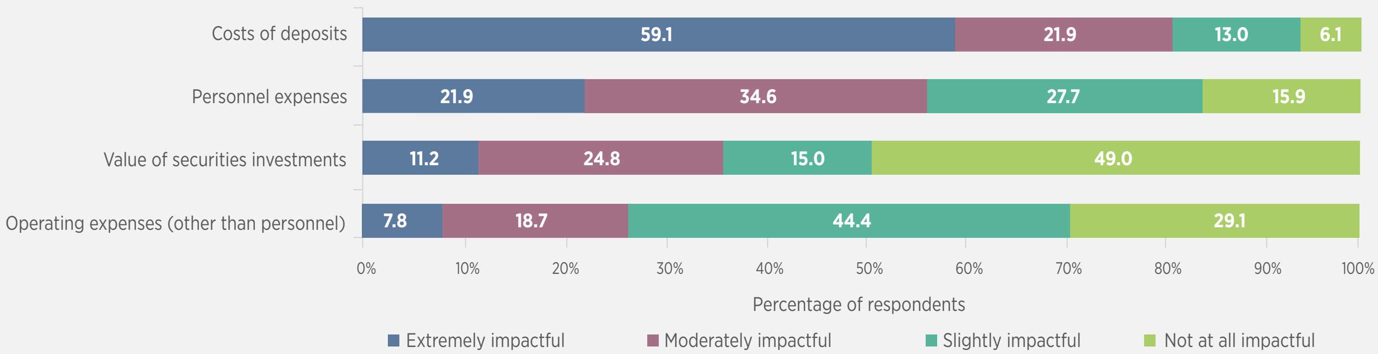


FIGURE 6

How does your bank view inflation challenges?

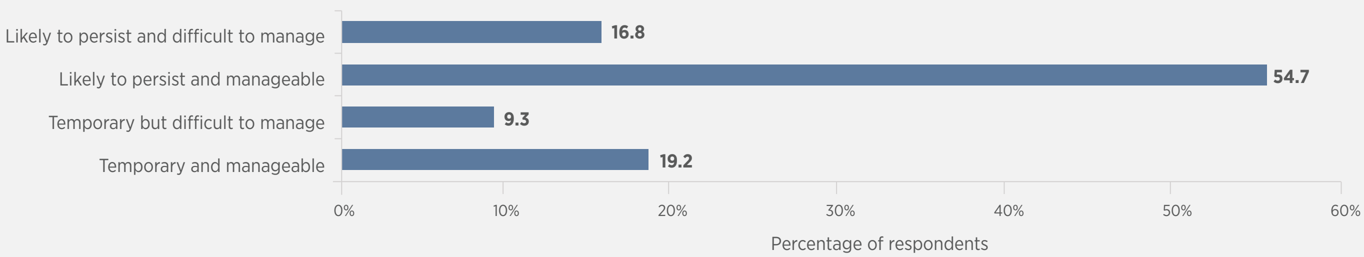
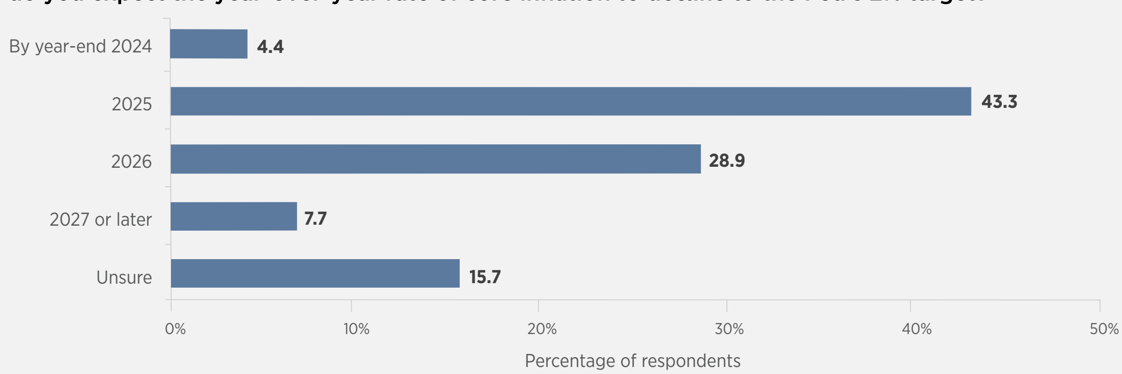


FIGURE 7

When do you expect the year-over-year rate of core inflation to decline to the Fed's 2% target?

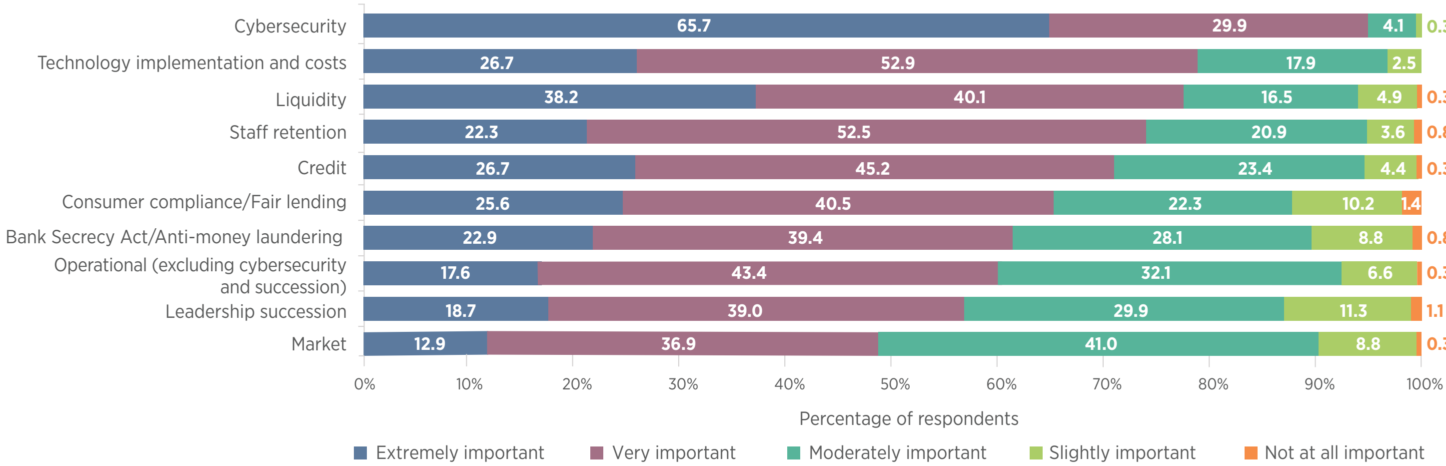


INTERNAL RISKS

While every community bank faces risks that are unique to its operations, some themes carry across the industry. Figure 8 represents the views of survey respondents who were asked to indicate the internal risks they viewed as important. Cybersecurity once again received the largest share of bankers identifying this risk as "extremely important" or "very important." Technology implementation and costs rose to the second most important internal risk, while liquidity ranked third.

FIGURE 8

How important are the following internal risks facing your bank today?



Cybersecurity was identified as the top internal risk in this year's survey. Nearly 96% of surveyed community bankers cited it as an either "extremely important" or "very important" internal risk. This share is up from 93% in last year's survey but matches the 2022 result.

Technology implementation and costs came in as the second most important internal risk in this year's survey. Nearly 80% of respondents viewed this internal risk as either "extremely important" or "very important." This share has steadily increased over the past few years.

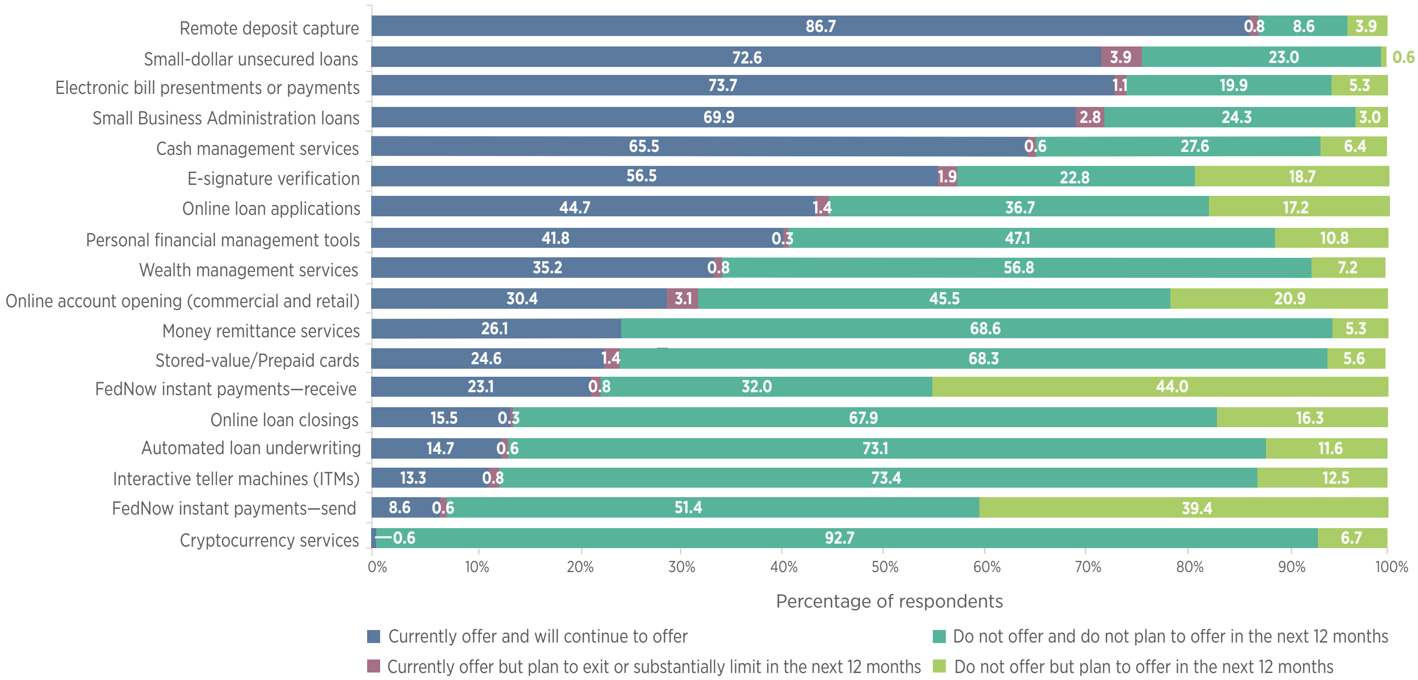
Liquidity slipped to third in this year's ranking of internal risks by community bankers, with 78% of respondents indicating that it was either an "extremely important" or "very important" risk. This percentage is down from 84% in last year's survey but still up sharply from the 2022 survey, when only 35% viewed it as either "extremely important" or "very important."

Additional Internal Risks

- Staff retention continued to rank high in importance, though the share of respondents naming it as an "extremely important" or "very important" risk fell to 75% in this year's survey, down from 77% in last year's survey and 85% in the 2022 survey.
- Survey respondents placed slightly more importance on credit risk this year, with 72% regarding it as either "extremely important" or "very important," up from 69% in 2023 and 71% in 2022.
- Leadership succession risk and market risk ranked the lowest among internal risks, unchanged from the previous two years.
- Bankers cited several other internal risks in some of their narrative responses to the survey, including internal fraud, interest rate risk, and reputational risk.

FIGURE 9

What are your bank's intentions regarding the following financial products or services?



Online banking remained a focal point for survey respondents, with 88% offering remote deposit capture and 75% providing online bill pay (i.e., electronic bill presentments or payments). The share of banks providing e-signature verification increased from 56% in last year's survey to 58% this year. Online loan applications were more common in this year's survey, with 46% of banks offering these services, up from 40% in 2023. However, only 16% of banks reported offering online loan closings, similar to last year.

Approximately 77% of banks offered small-dollar unsecured loans, down slightly from 78% last year.

Roughly 24% of respondents reported currently receiving instant payments via the FedNow Service, and an additional 44% reported planning to add this service in the next 12 months. Fewer bankers reported sending instant payments via the FedNow Service, with 9% of respondents currently offering this service. However, an additional 39% of respondents have plans to add this service in the next 12 months. Indeed, of those services that bankers do not currently offer but plan to in the next year, FedNow Service instant payments receive and send services ranked the highest, respectively.

The share of banks offering Small Business Administration (SBA) loans rose from 66% in 2023 to 73% this year. This share remains below the peak reached in 2020, when the Paycheck Protection Program provided a boost to SBA lending.

The share of banks offering wealth management services rose to 36% in this year's survey, up from 35% in 2023 and 33% in 2022. In addition, 42% of banks reported providing personal financial management tools, up from 38% in last year's survey.

Surveyed banks continued to report little interest in offering cryptocurrency services, with roughly 99% of respondents reporting they are not currently offering these services, and 93% not planning to offer them in the next 12 months.

TECHNOLOGY AND TECHNOLOGY SERVICES

Bankers were asked for their views on both existing and future technologies. Essentially half (50%) of respondents viewed existing banking technology as more of an opportunity than a liability, up from 47% in last year's survey. Roughly 45% saw it as both an opportunity and liability equally, matching last year's result. Only a small share of bankers viewed existing technologies as more of a liability than an opportunity (3%) or as neither an opportunity nor a liability (2%).

On future banking technologies, 49% of respondents saw future banking technologies as both a threat and an opportunity equally, while 46% of respondents viewed these technologies as more of an opportunity than a threat. Only 4% of banks viewed future banking technologies as more of a threat than an opportunity, and just 2% viewed them as neither.

FIGURE 10

How does your bank view existing banking technology?

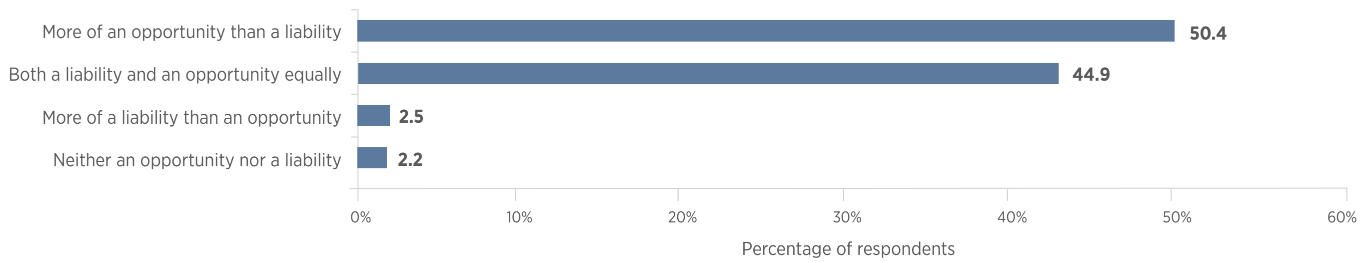


FIGURE 11

How does your bank view future technological innovation in banking?

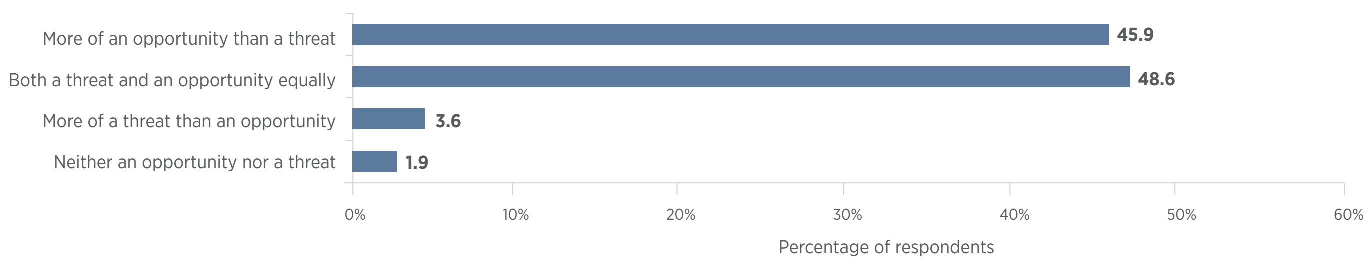
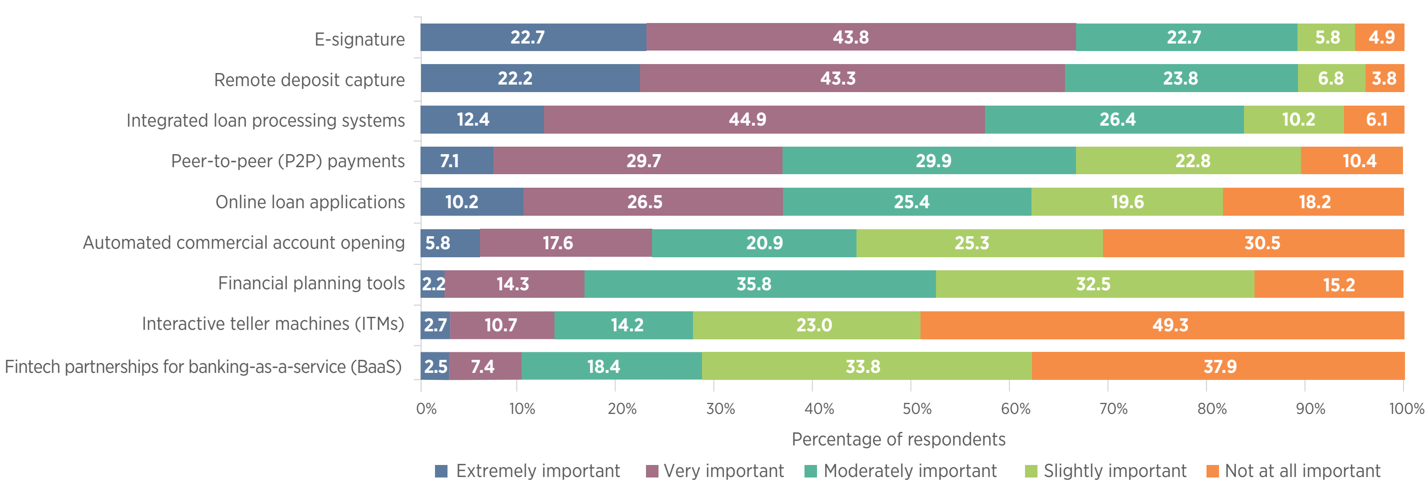


FIGURE 12

How important are the following technologies for your bank?



Community bankers once again viewed e-signature and remote deposit capture as the most important banking technologies for their banks, with these technologies receiving the largest share (more than 65%) of "extremely important" and "very important" responses.

Integrated loan processing systems also ranked highly among surveyed bankers, with roughly 57% of respondents classifying this technology as "extremely important" or "very important."

Bankers placed the least importance on technologies related to financial planning tools, interactive teller machines and fintech partnerships for banking-as-a-service (BaaS).

New and emerging technologies are important tools for banks to meet customer demand. Nearly all bankers surveyed identified the adoption of new or emerging technologies as important, with 12% viewing them as "extremely important" and 45% as "very important." Less than 1% of respondents viewed the adoption of new or emerging technologies as "not at all important."

Costs and implementation remained the largest impediment to adoption, with 46% of respondents citing this barrier, up from 44% in 2023. Roughly 18% of respondents cited cybersecurity risks as the second largest impediment to adoption, up 4 percentage points relative to last year's survey. Limitations of core service providers were the third most cited significant impediment, though the share of bankers reporting this cause fell from 20% last year to 14% this year.

In their narrative responses, several bankers cited internal resource availability, including time and staffing, as an additional impediment to technology adoption.

FIGURE 13

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

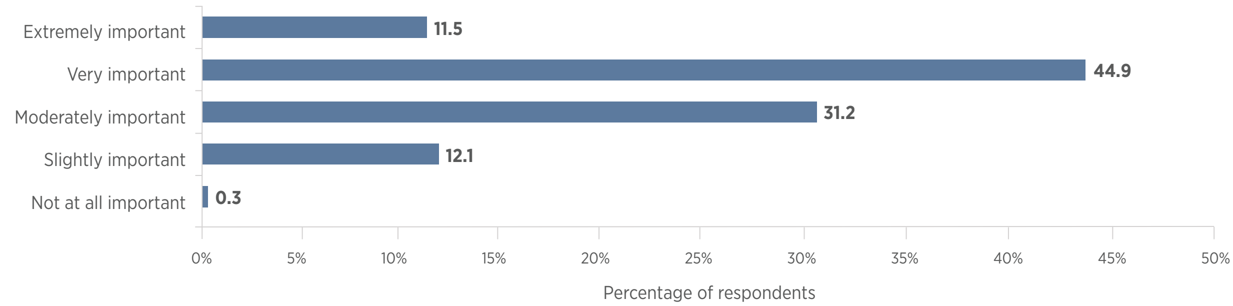


FIGURE 14

What is the most significant impediment to adopting new technologies?

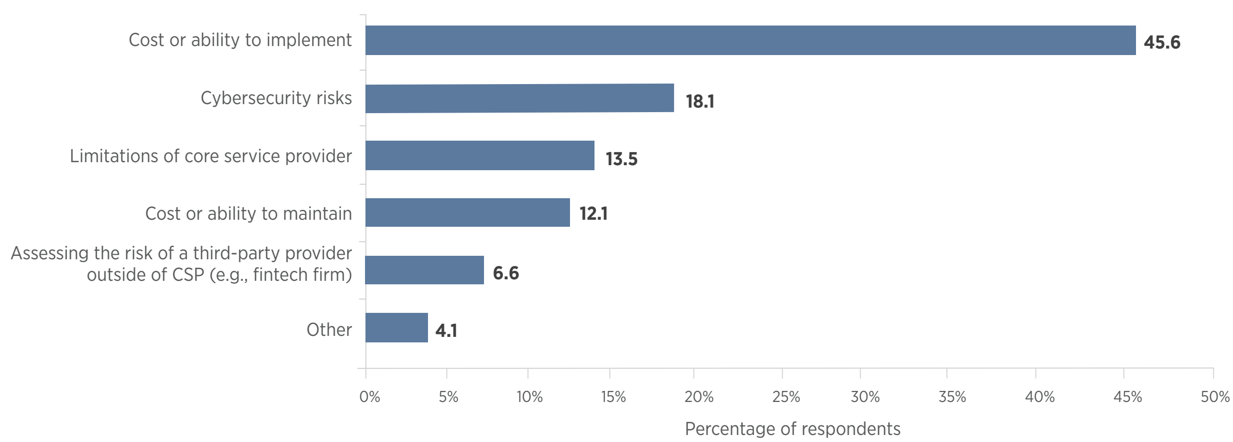
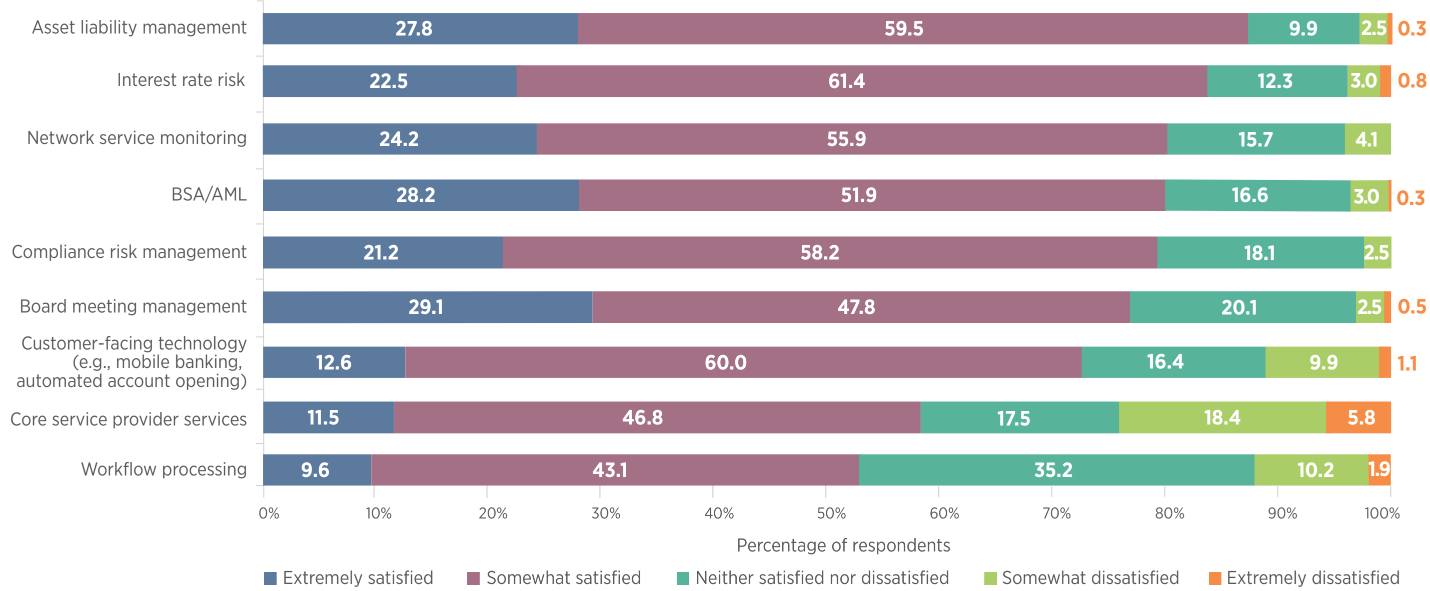


FIGURE 15

How satisfied are you with the effectiveness of your bank's technology in the following areas?



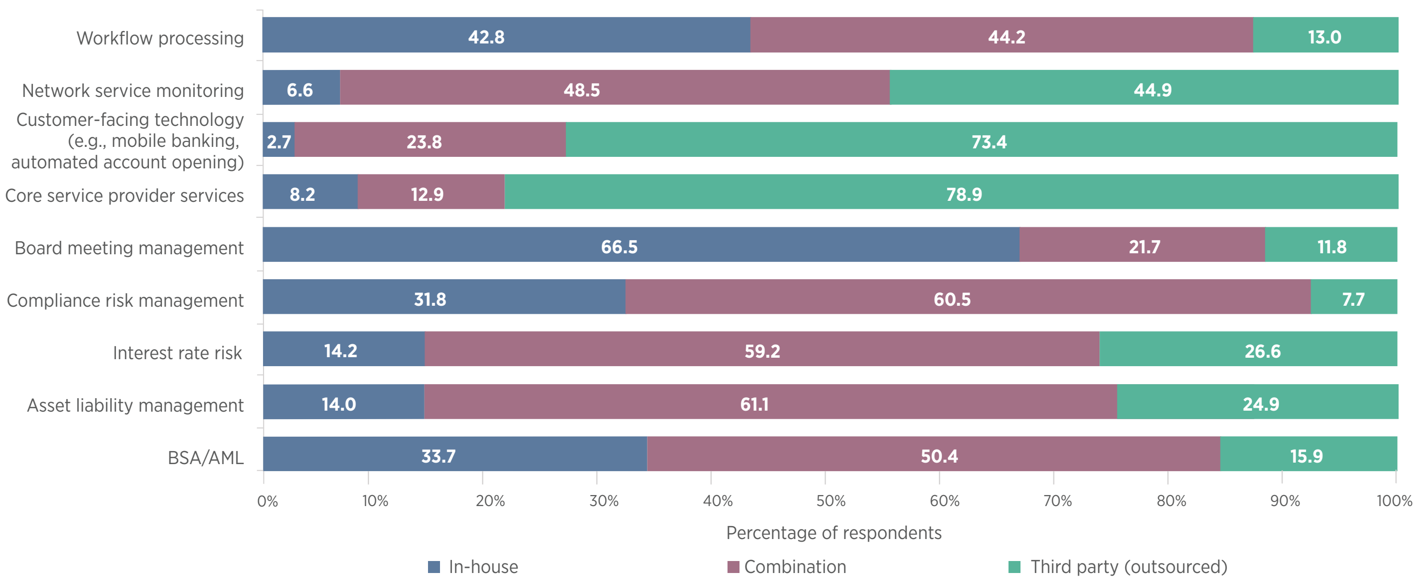
Bankers expressed the highest level of satisfaction when it came to the effectiveness of technology related to asset liability management and interest rate risk, with 87% and 84%, respectively, noting they were either "extremely satisfied" or "somewhat satisfied."

Technologies related to network service monitoring, the Bank Secrecy Act/anti-money laundering and compliance risk management also ranked highly, with roughly 80% of community bankers reporting they were at least "somewhat satisfied" with the effectiveness of these technologies at their banks.

Meanwhile, community bankers expressed the lowest level of satisfaction in technologies related to core service provider services and workflow processing. These were the only two services with less than 70% of banks expressing they were at least "somewhat satisfied."

FIGURE 16

How are your technology needs for the following services being met?

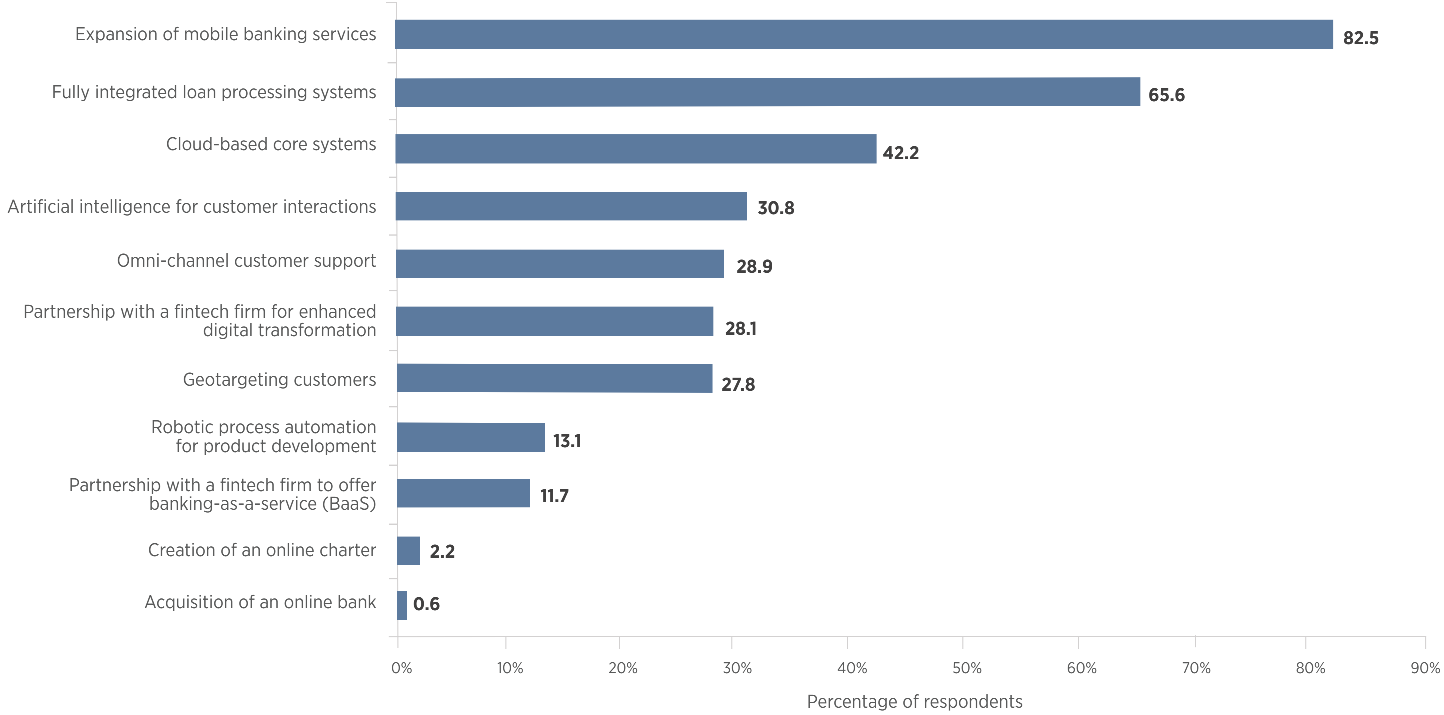


Core service provider services and customer-facing technology were the most common technologies being outsourced to third-party vendors, according to survey respondents. Surveyed bankers identified board meeting management and workflow processing as the most likely to be done in-house.

Other services such as asset liability management, interest rate risk, and compliance risk management were commonly handled by a combination of third-party vendors and in-house staff.

FIGURE 17

What technological developments will be promising opportunities for your bank over the next five years?



NOTE: Participants were asked to select all that apply.

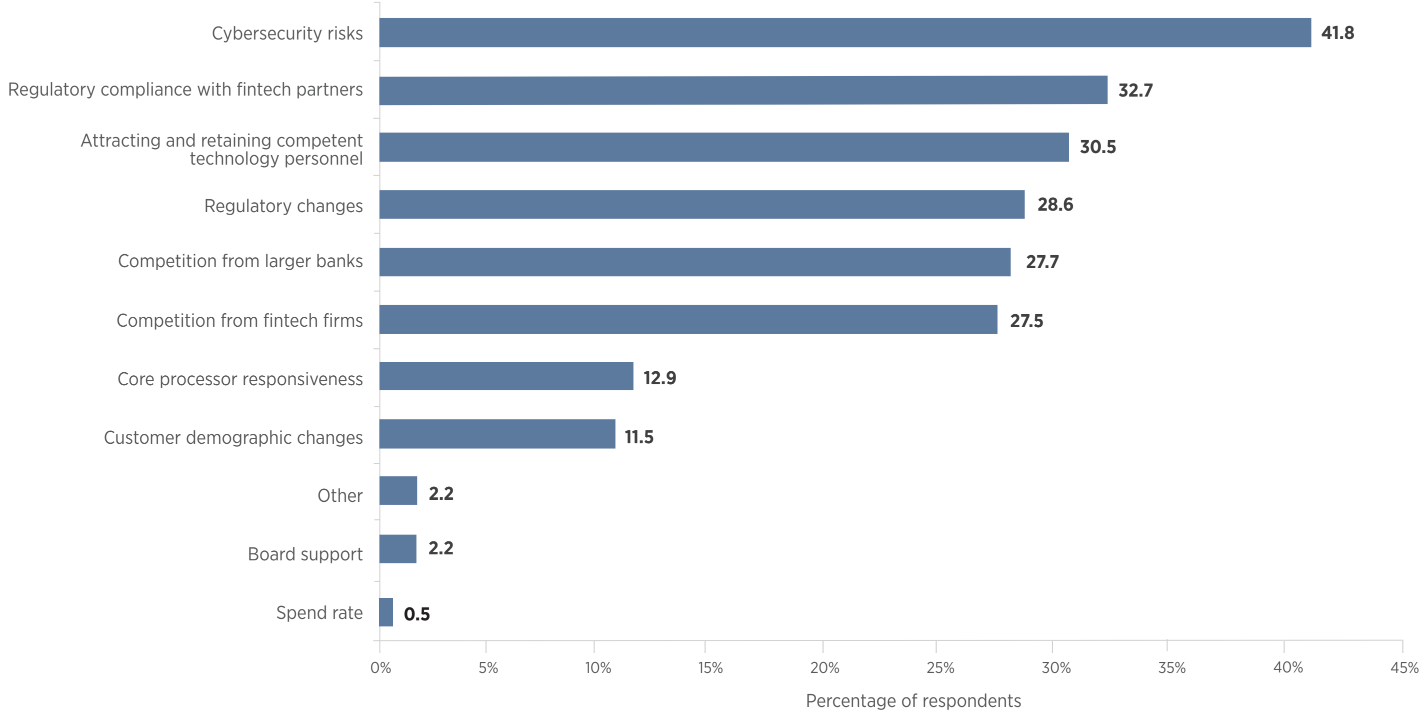
Looking ahead over the next five years, bankers showed the most optimism for technological developments related to expanding mobile banking services, with roughly 83% of bankers identifying it as a promising opportunity for their banks. Nearly 66% of respondents viewed fully integrated loan processing systems as a promising opportunity, while 42% saw an opportunity in cloud-based core systems. In contrast, respondents saw little opportunity in areas related to the creation of an online charter or acquisition of an online bank.

In their narrative responses, community bankers cited several other promising technological opportunities over the next five years, including:

- Acquiring a financial services-related technology company.
- Offering open banking application programming interfaces.
- Adopting artificial intelligence.

FIGURE 18

What do you see as the most difficult challenges to implementing new technology over the next five years?



NOTE: Participants were asked to select all that apply.

Roughly 42% of bankers expect cybersecurity risks to pose the most difficult challenge to implementing new technologies over the next five years.

Regulatory compliance with fintech partners and attracting and retaining competent technology personnel were additional challenges cited by about 33% and 30% of survey respondents, respectively. Other commonly identified challenges included regulatory changes (29%), competition from larger banks (28%), and competition from fintech firms (28%).

In their narrative responses, community bankers highlighted additional impediments to technology implementation, including vendor risk management and challenges surrounding internal implementation, including training staff.

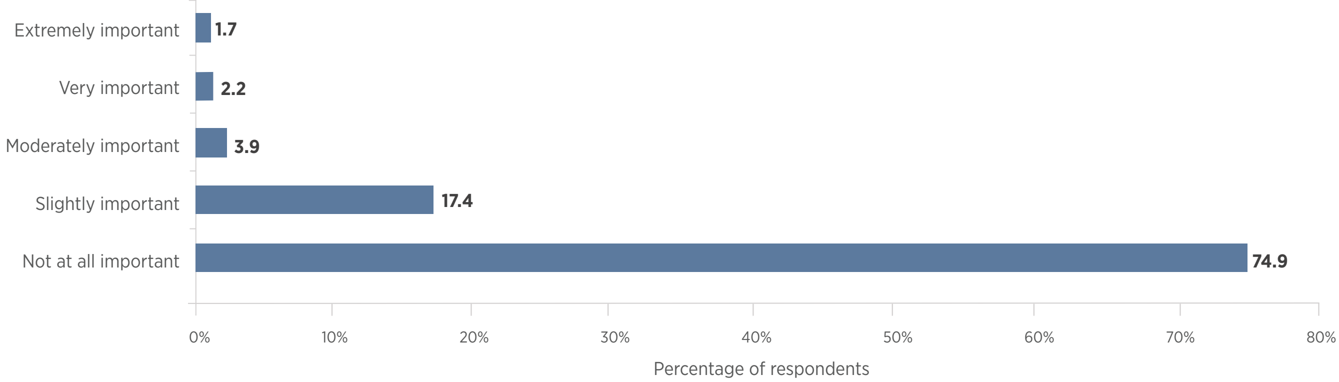
Banker Perspectives

Banking is a complicated, expensive business that is actually two businesses at once—a deposit business and a lending business. These fintechs, in some cases, have been able to pick a piece of the business and deliver more value to consumers, especially in an app-based world. There is certainly an expectation that your banking should be as easy as your other digital activities, like splitting a bill with friends through Venmo. At Seattle Bank, we have picked areas to operate in that are a little more niche or high value, so I don't feel like we have been impacted much by fintechs. If you are a traditional consumer bank, I think you are at very high risk. Some of the typical areas of banking are not very profitable, so you have even more pressure by these fintechs coming in. The biggest opportunity is for community banks to innovate from within the industry. Others have done it successfully and have driven value to customers at scale and in a way that has made them money. It's hard to do but it's also rewarding. If you scan all community banks out there, you will find a lot of interesting things they are doing, and some of those things probably just need a little more investment to blossom.

—John Blizzard, Seattle Bank
Seattle, Washington

FIGURE 19

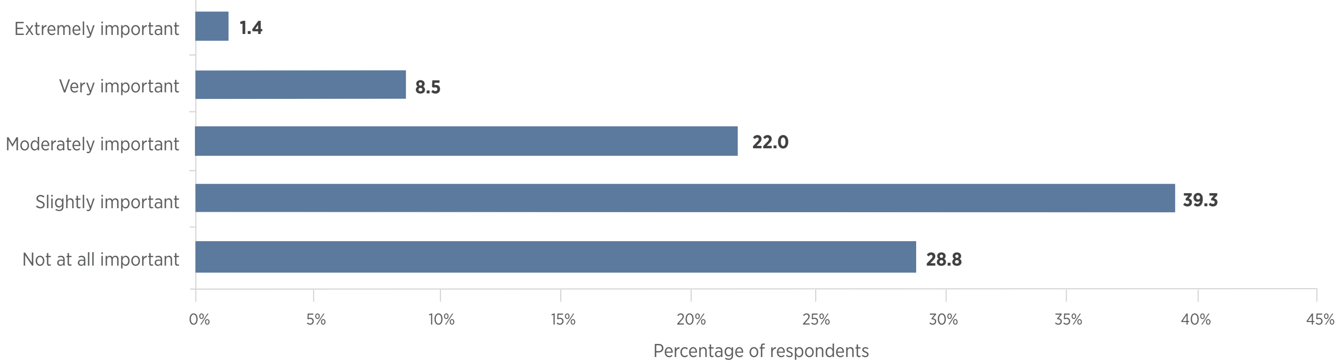
How important is meeting customer cryptocurrency needs at your bank?



The majority of survey respondents (75%) reported that addressing the cryptocurrency needs of bank customers is not an important aspect of bank business. The percentage of community banks reporting addressing the cryptocurrency needs of customers as "not at all important" is up from 73% in last year's survey and 51% in 2022.

FIGURE 20

How important is the use of machine learning, natural language processing or other related technologies at your bank?



Meanwhile, the share of bankers viewing technologies such as machine learning and natural language processing as at least "slightly important" rose from 64% last year to 71% this year.

Bankers' Perspectives

We are in the early phases right now. There are a couple of projects that we are working on. Obviously, there are a lot of things to consider around risk management within a financial institution as you adopt any new technologies, and AI is no different.

—David Ehlis, Bravera Holdings Corp.
Bismarck, North Dakota

It is easy to get caught up in all the hype about AI's potential. However, we've not yet adopted generative AI. We believe we are currently better off exercising a dose of caution and skepticism when it comes to generative AI. As a community bank, we believe it's in our best interest to let others take the lead in working out how to best filter the information and layer in some security practices to verify the content's factuality. We've all seen some questions asked of generative AI and some horrible answers that have come back, but at the same time, as we look at systems that are not part of our core services or not customer-facing, we want to look at their AI potential.

—Cathy Owen, Eagle Bank and Trust Co.
Little Rock, Arkansas

DIGITAL PLATFORMS, CORE SERVICE PROVIDERS AND FINTECH PARTNERS

Core service providers remain the primary source of digital banking products and services. Almost two-thirds of respondents reported relying on core service providers for digital banking products and services and are not seeking any partnerships with other digital providers such as fintech firms. Meanwhile, 20% of bankers identified using core service providers while also seeking partnerships with other financial digital providers. A smaller share, 15%, relied on both core service providers and fintech firms for their digital product and service offerings.

FIGURE 21

On whom does your bank rely for digital banking products and services?

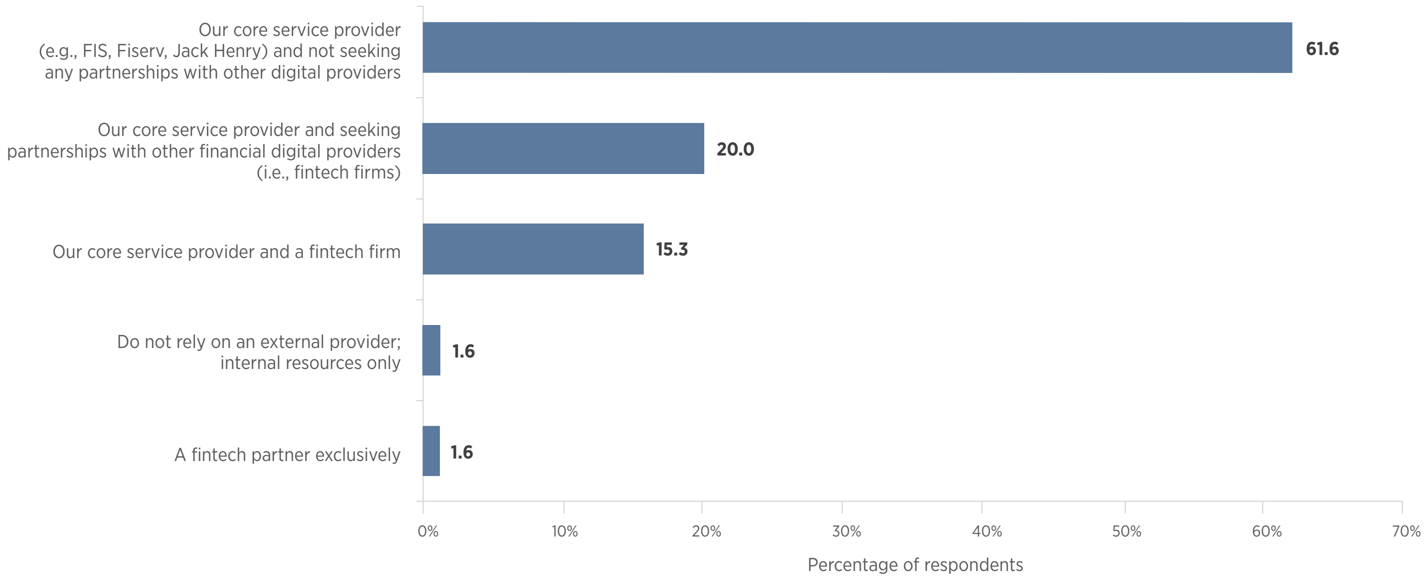


FIGURE 22

How satisfied is your bank with the following in-house enterprise banking services?

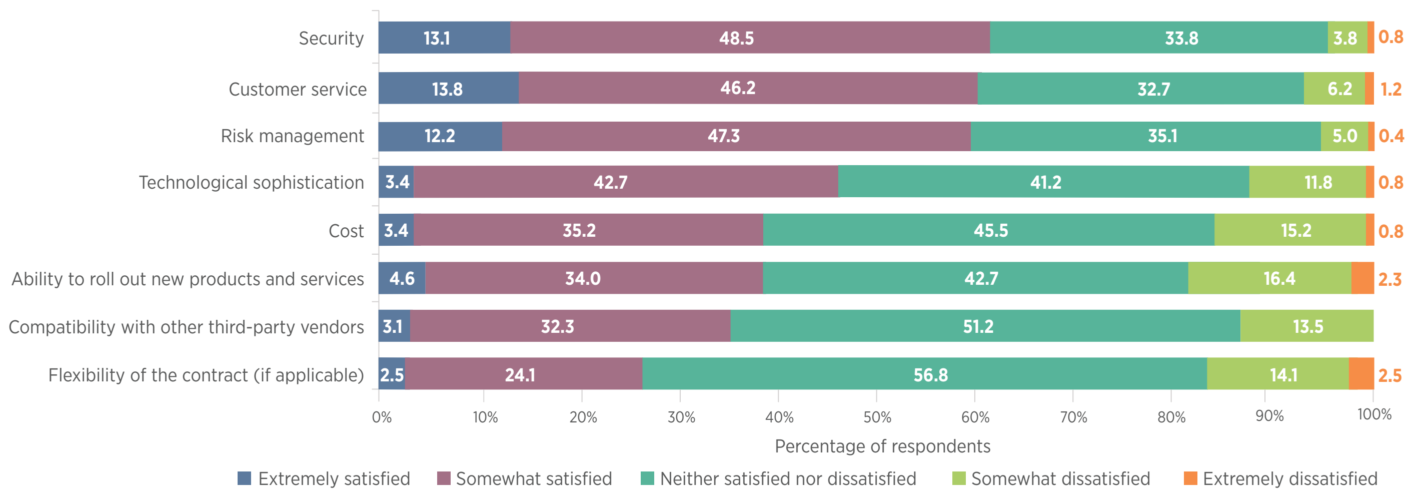


FIGURE 23

How satisfied is your bank with the following enterprise banking services provided by an external company?

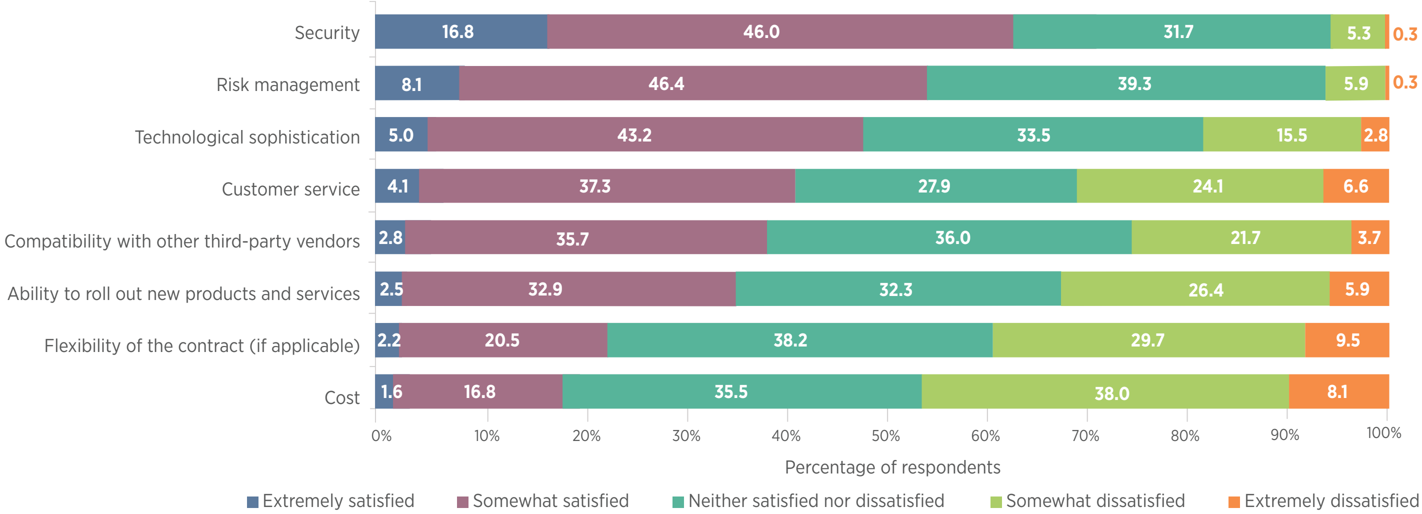
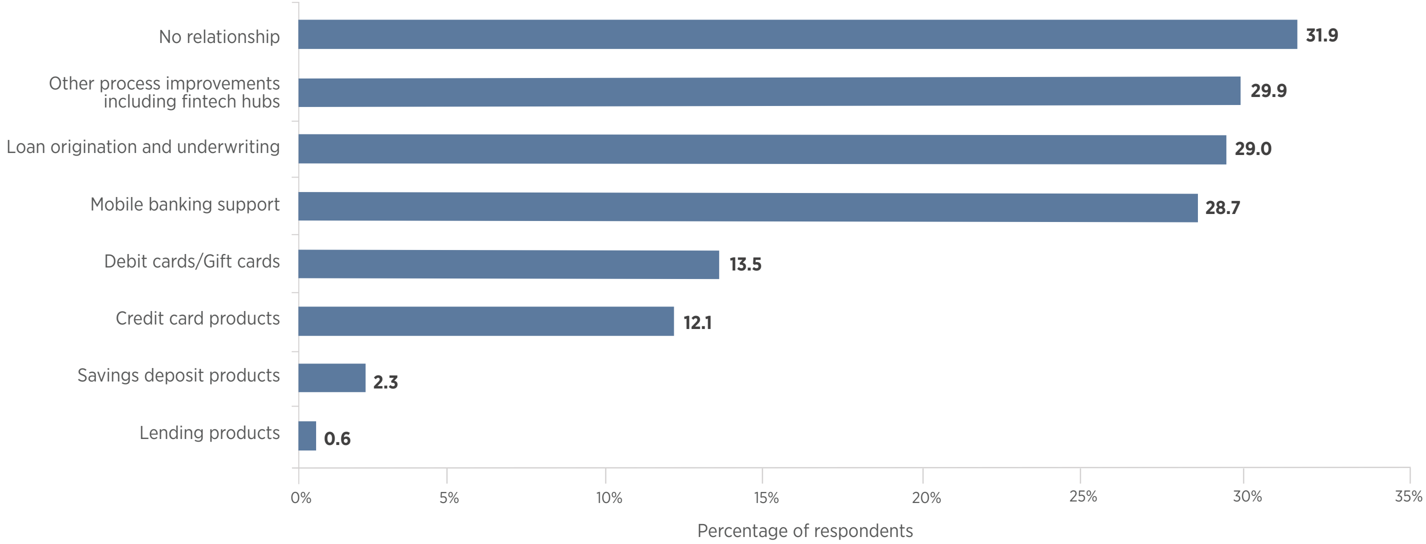


FIGURE 24

If you have a relationship with a fintech firm, what is the nature of the relationship?



NOTE: Participants were asked to select all that apply.

The share of bankers working with a fintech firm rose in this year's survey. Roughly 32% of respondents reported no relationship with a fintech firm, down from 59% in last year's survey. Banking relationships with fintech firms were most common for services such as mobile banking support (29%), loan origination and underwriting (29%), and other process improvements including fintech hubs (30%).

Bankers' Perspectives

As far as partnering with fintechs, the most important thing is being on the same page right upfront. We are going to follow all the rules, we are going to be a pain in the butt to make sure all the rules are followed, we are going to make sure all client funds are tracked, we are going to make sure advertising is done correctly, and we are going to make sure consumers are made whole if they are harmed. We make sure there is the utmost respect in how we operate—especially in any kind of consumer banking operation and especially in these partnerships when we have somebody else display our banking products to an end consumer. What's key is to be upfront and make sure we are on the same page and that they know we are going to be overseeing the process like a hawk. We have passed on a whole bunch of partner opportunities, because either we didn't like the risk/economics, or the management team didn't have the right kind of respect for compliance. We are seeing oodles of opportunity and are very dedicated to the business line, as we see great growth opportunities that we build on a foundation of strong compliance.

—John Blizzard, Seattle Bank
Seattle, Washington

At the end of the day, especially from what we've come to see with the recent enforcement actions, the bank is eventually on the hook for everyone's performance. Four or five years ago, banks didn't quite understand that. In fairness to them, it might not have been clearly articulated in the regulatory guidance offered at the time.

If a bank is going to enter this space, they need to go into it with their eyes wide open and have discussions very early on with their regulators about their plans. While there are certainly some banks that have done this very well, not every bank is well situated to tackle the BaaS sphere.

—Michael Busch, Burling Bank
Chicago, Illinois

We do not have any fintech partnerships at this time. Our bank's risk tolerance is low, and we thoroughly evaluate all of our products and services. ... I would say the bank keeps an open mind, and we will evaluate all opportunities with fintech partners in the future if it makes good sense for our bank and it enhances the value of the bank.

—Lori Maley, Bank of Bird-in-Hand
Bird-in-Hand, Pennsylvania

COMPETITION

Competition for banking products and services remained high, with continued consolidation in the number of community bank charters over the last year. Similar to prior years' results, community banks continue to be the primary competitor across the main products and services identified in this year's survey. Regional or national banks with local market presence were also named as top competitors in three of the nine categories of products and services on the survey.

A listing of the top community bank competitors across the nine product and service lines is shown in Table 1. A complete breakdown of how community banks experience competition from community banks, regional and national banks, credit unions and nonbanks in 2024 can be found in Figures 25 and 26.

TABLE 1

Primary competition for community banks

Product or Service Line	Top Competitor 2024		Top Competitor 2023	
Small business loans	Community bank	62.5%	Community bank	62.4%
Commercial real estate loans	Community bank	51.1%	Community bank	52.0%
Agricultural loans	Community bank	45.4%	Community bank	47.6%
Transaction deposits	Community bank	41.2%	Community bank	47.5%
Payment services	Regional or national bank (in-market)	39.6%	Regional or national bank (in-market)	37.7%
Small-dollar unsecured loans	Community bank	36.3%	Community bank	40.3%
Wealth management and retirement services	Regional or national bank (in-market)	34.6%	Nonbank (in-market)	40.5%
Nontransaction deposits	Community bank	32.6%	Community bank	33.2%
1- to 4-family mortgage loans	Regional or national bank (in-market)	25.9%	Community bank	30.4%

Community banks increasingly compete primarily with other community banks for most product and service lines, but particularly for small business and commercial real estate loans.

Relative to other competitors, community banks continue to compete with one another for small business and commercial real estate loans. Regional or national banks with a physical presence in the market make up the secondary competitor for this type of lending, according to results from this year's survey. Community banks reported that credit unions are competing less in this space, with only 6% of respondents naming credit unions as their primary competitor for small business loans and 5% naming credit unions as their primary competitor for commercial real estate loans.

Community banks maintained their deposit bases in 2024, but fierce competition led to greater diversification across competitors.

Deposits largely stabilized in 2024 following a year of turbulence in which three prominent banks failed. While community bankers were largely able to maintain their deposit balances, it came at a cost. Deposit rates across both transaction and nontransaction accounts increased dramatically this year, raising the competition for such deposits to a level not seen in many years. Respondents to this year's survey continued to record community banks as their top competitor for transaction and nontransaction accounts, but fewer than last year named community banks as their primary competitor for transaction accounts. Instead, other competitors, including regional and national banks and credit unions, were named as primary competitors this year.

Regional or national banks were named the top competitor in wealth management and payment services, along with the one- to four-family mortgage loans.

Competition for wealth management shifted from in-market nonbanks to in-market regional and national banks in 2024. In 2023, nearly 41% of community bankers named nonbank, non-credit union institutions with a physical presence in-market as their primary competitor for wealth management/retirement services. This number fell to 34%, just below the level of banks that reported in-market regional and national banks as their primary competitor this year. Similarly, regional and national banks gained momentum as community banks' primary competitor in the payment services space.

Somewhat more surprising was the increased competition from regional or national banks in the one- to four-family mortgage loan market. Nearly 26% of community bankers named locally operating regional or national banks as their top competitor in the home mortgage market, an increase from 22% in 2023. Credit unions and regional or national banks without a local presence in the markets that community banks serve also gained market share this year.

FIGURE 25

Who is your primary competitor for the following products and services?

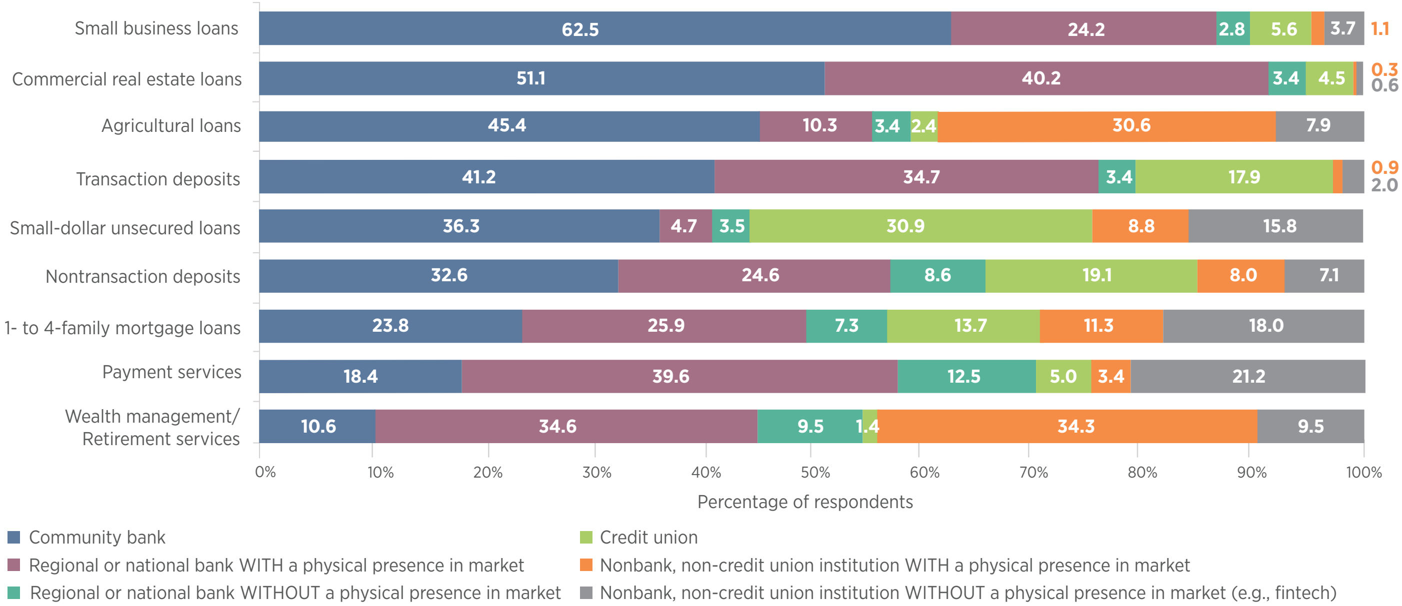
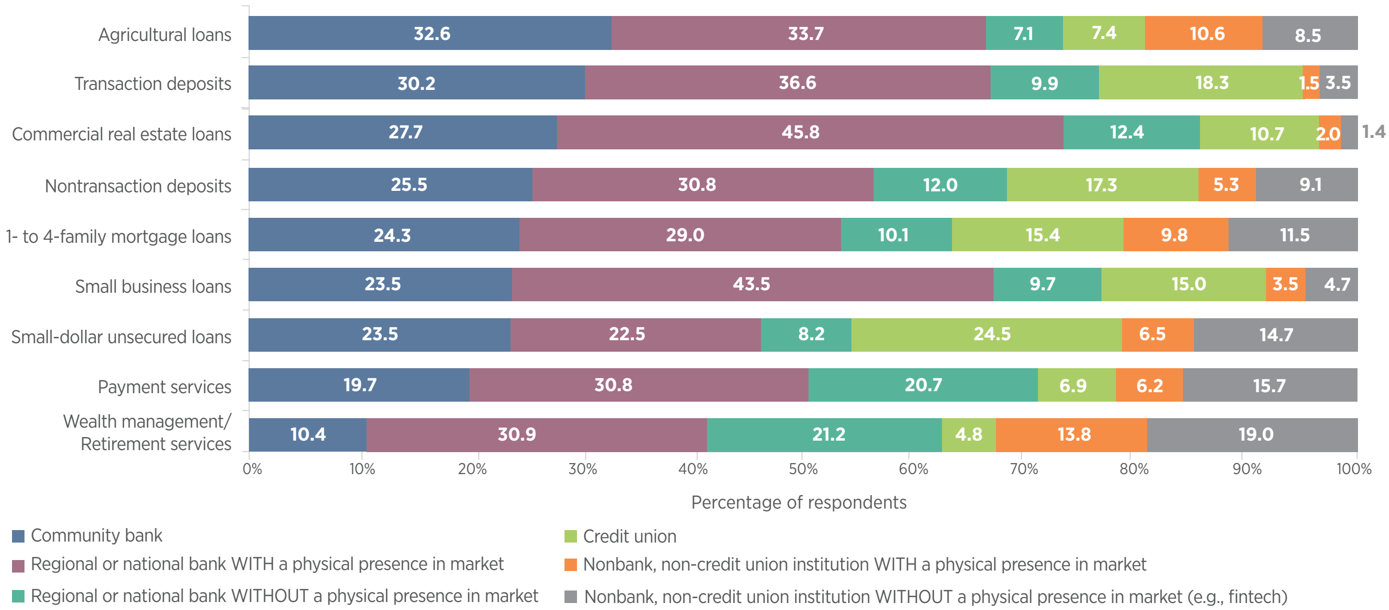


FIGURE 26

Who is your secondary competitor for the following products and services?



Community bankers also answered questions on how competition for deposits and loans impacts their pricing decisions. Compared to last year's survey, fewer bankers indicated that they "always" respond to changes in local market rates on deposits; however, overall, approximately 1 in 4 community banks "always" respond to changes in local market rates on deposits, while nearly 3 in 4 respond "sometimes."

FIGURE 27

How often does your bank respond to changes in local market rates on deposits?

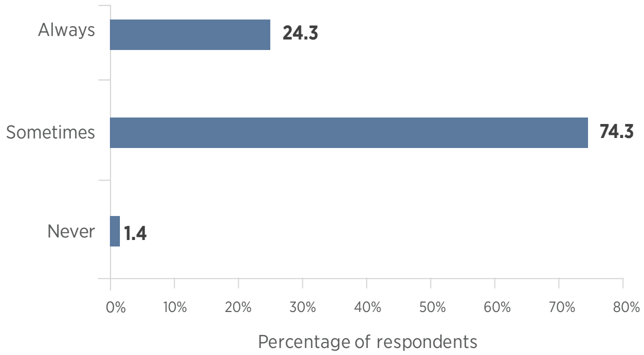


FIGURE 28

How often does your bank respond to changes in local market rates on loans?

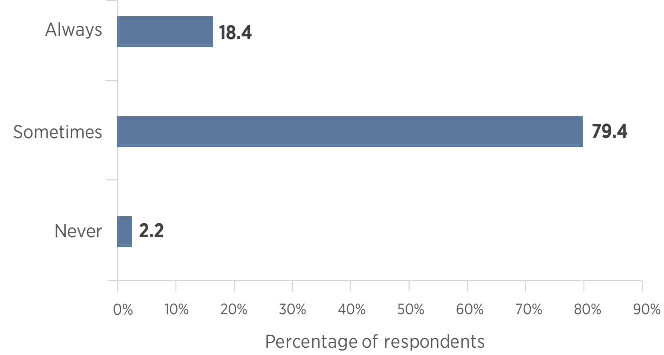
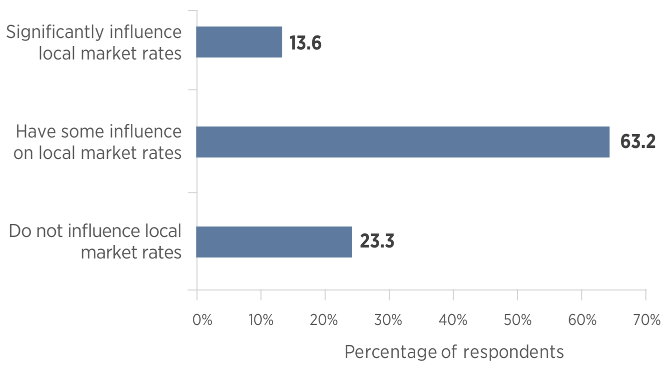


FIGURE 29

How do your bank's pricing decisions on loans and deposits influence local market rates?



Regarding how often their banks respond to changes in local market rates on loans, 18% of bankers responded "always," while 79% responded "sometimes." This was a slight shift from 2023, when 25% of respondents indicated that they "always" respond to changes in local market rates on loans, and 74% responded "sometimes."

In terms of whether their pricing decisions influence local market rates, almost 14% of bankers reported they "significantly influence local market rates," and 63% reported they "have some influence on local market rates." This compared with 21% and 60%, respectively, in 2023.

Banker Perspectives

What we really see in the competing areas are on the loan side—not only with the likes of Lending Club, Rocket Mortgage and others from the home mortgage side, but also on the business loan side. We've run into this when customers come to us to apply for a loan, and as we look up their cash flow, we realize that they already have debt from an unregulated nonbank that they got easily while they were sitting at home but not realizing the consequences. We have had a couple of occasions where we were prevented from being able to make loans to customers because they were not able to pay off the loan debt due to how the contracts were written in the fine print. So, we couldn't help them, and they were drowning in the loans they already had.

There is no doubt the nonbanks are growing and continue to invest a lot of money into technology and other services that are difficult for us to compete with. But I think that as a community bank, we also have a huge advantage in that we have the ability to utilize our customer relationships, our local knowledge and our engagement within our communities, as well as our ability to meet in person with our customers to help them. This is especially true in our rural markets. There is no doubt that we need to do a better job of marketing ourselves and reiterating these strong points about being able to help our communities and our customers.

—Cathy Owen, Eagle Bank and Trust Co.
Little Rock, Arkansas

SMALL BUSINESS LENDING

Small business lending remains a critical area for community banks, as shown in Table 2. The data show small business loans composed of nonfarm, nonresidential, and commercial and industrial loans of $1 million or less by banks with assets less than $10 billion (community banks), compared to banks with total assets greater than $10 billion (noncommunity banks). As of Dec. 31, 2023, small business loans comprised 8% of total assets at community banks, compared to only 2% at the larger banks. Even though this share of assets has trended down in recent years, it remains significant. The table shows that the average loan size at community banks significantly varies year to year, from $85,300 in 2020 to $68,300 in 2021, before shooting up to $106,300 in 2023. Nevertheless, the average small business loan size remains notably larger than that of noncommunity banks. For example, the average loan size as of Dec. 31, 2023, for community banks was $106,300, compared with $17,300 at larger banks. One likely reason for this disparity is larger banks tend to make more high-volume, low-value business credit card loans compared to community banks. This is supported by Figures 30 and 31, where respondents noted that they were more likely to have smaller transactional loans compared to relational small business loans in the future; the vast majority of respondents noted that these loans do not include any business credit card-related debt.

TABLE 2

Loans to small businesses

	Community Banks				Noncommunity Banks			
	Dec. 31, 2020	Dec. 31, 2021	Dec. 31, 2022	Dec. 31, 2023	Dec. 31, 2020	Dec. 31, 2021	Dec. 31, 2022	Dec. 31, 2023
Dollar amount	$318.6	$270.3	$265.5	$272.4	$428.3	$343.9	$357.8	$381.8
% of assets	11.0%	8.6%	8.1%	8.0%	2.5%	1.8%	1.9%	1.9%
Number of loans	3,737	3,956	3,167	2,563	18,880	18,545	21,505	22,083
Average loan size	$85.3	$68.3	$83.8	$106.3	$22.7	$18.5	$16.6	$17.3

NOTES: Dollar amounts are in billions of dollars. Numbers of loans are in thousands. Average loan sizes are in thousands of dollars. Data are obtained from *Call Reports* published by the Federal Financial Institutions Examination Council.

FIGURE 30

In the future, what do you expect your bank's dollar volume to be on transactional small business loans compared to relational small business loans?

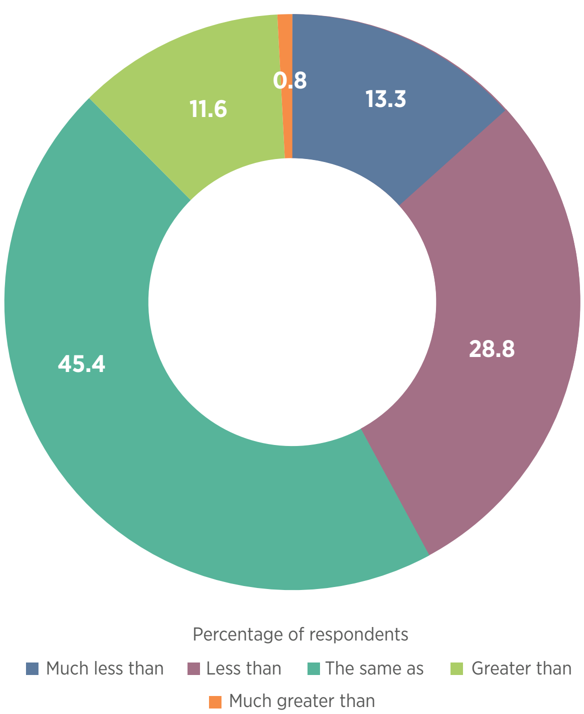
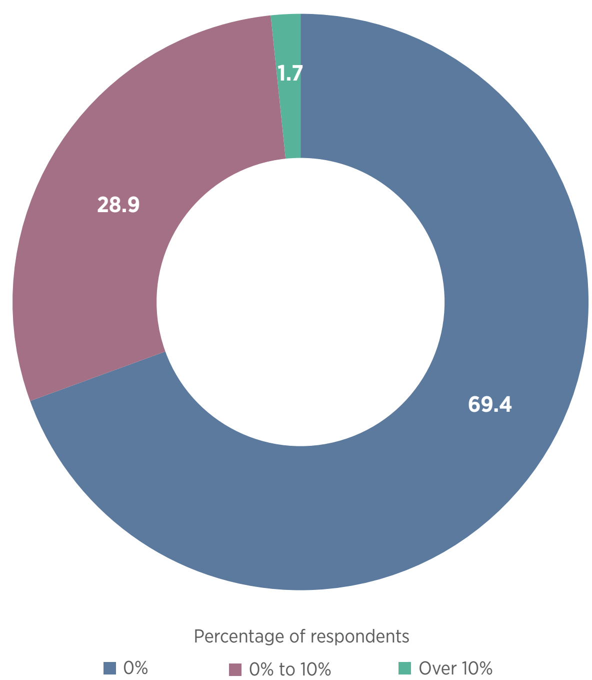


FIGURE 31

At your bank, what is the percentage of small loans to businesses (as defined in the *Call Report*) that are accounted for by business credit cards?



FUNDING

Attracting and retaining core funding has become increasingly difficult for community banks in the current interest rate environment. As such, community banks are increasing their reliance on wholesale funding sources such as brokered deposits, Federal Home Loan Bank (FHLBank) advances, other borrowings and reciprocal deposit networks. Utilization of these funding sources has more than doubled since the end of 2021, when bank balance sheets were flush with COVID-19 stimulus-related deposits. As a result, noncore funding dependency ratios are more in line with historical figures.

One exception is the "other borrowed money" category, which includes loans from the Federal Reserve's Bank Term Funding Program.[1] The program was established in March 2023 to support U.S. businesses and households by making additional funding available to eligible depository institutions to help ensure banks have the ability to meet the needs of all of their depositors. The Bank Term Funding Program ceased extending new loans on March 11, 2024, and with loan durations of no more than one year, many are expected to mature at the end of this year or early in 2025. Community banks that utilized the program will need to procure alternative forms of funding as the notes mature.

TABLE 3

Wholesale funds

	Dec. 31, 2020	Dec. 31, 2021	Dec. 31, 2022	Dec. 31, 2023	March 31, 2024
Brokered deposits	**$85.6**	**$68.9**	**$122.7**	**$163.4**	**$172.3**
Federal Home Loan Bank advances	**$78.4**	**$59.2**	**$118.8**	**$134.6**	**$126.9**
Other borrowed money (total)	**$109.0**	**$76.0**	**$133.3**	**$181.2**	**$175.6**
Fed funds purchased and repurchase agreements	**$25.5**	**$23.8**	**$27.9**	**$25.3**	**$23.9**
Listing service deposits	**$20.3**	**$16.4**	**$16.3**	**$16.6**	**$17.1**
Reciprocal deposits	**$67.2**	**$78.0**	**$86.6**	**$165.4**	**$173.9**

NOTES: Dollar amounts are in billions and collected quarterly for community banks.
Data are obtained from *Call Reports* published by the Federal Financial Institutions Examination Council.

TABLE 4

Cost of deposits and funds

	Dec. 31, 2020	Dec. 31, 2021	Dec. 31, 2022	Dec. 31, 2023	March 31, 2024
Cost of deposits	**0.71%**	**0.37%**	**0.56%**	**2.33%**	**2.73%**
Cost of funds	**0.74%**	**0.40%**	**0.62%**	**2.24%**	**2.85%**

NOTES: Cost of funds refers to the costs associated with both deposits and other forms of bank funding. Percents are collected quarterly for community banks.
Data are obtained from the *Uniform Bank Performance Report.*

FIGURE 32

How important are each of the following potential challenges to attracting and retaining core deposits?

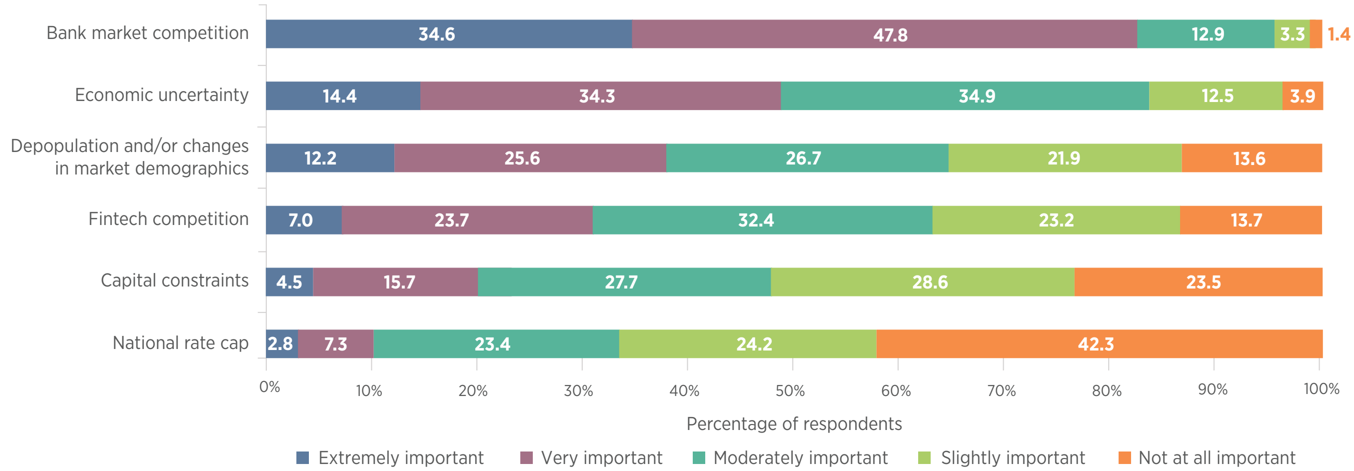
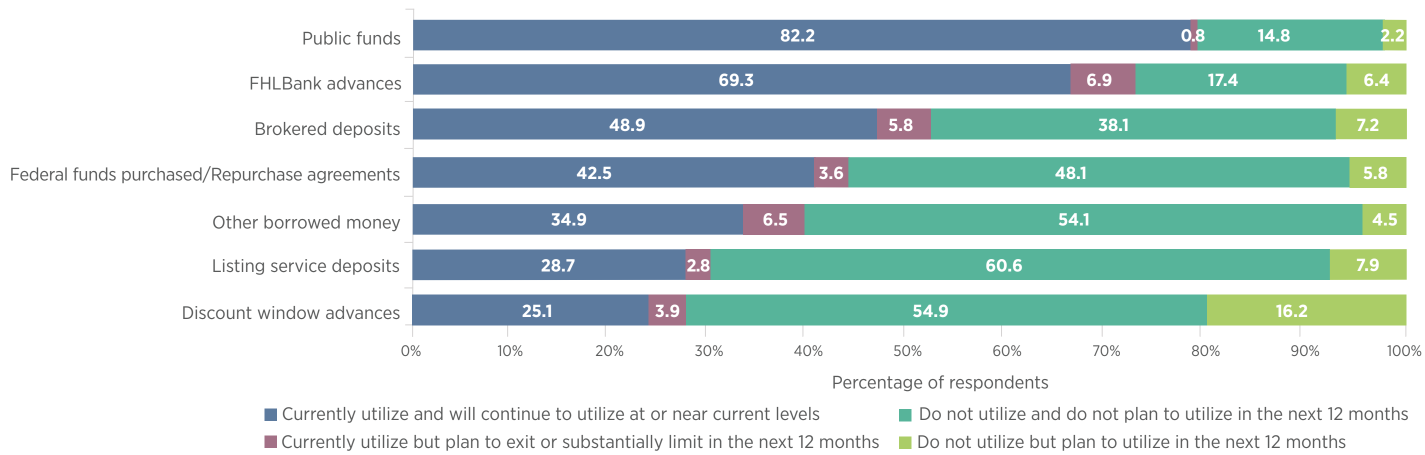


FIGURE 33

What are your bank's intentions regarding the following wholesale funding sources?



Figures 32 and 33 describe the challenges community banks face in attracting and retaining core deposits, as well as intentions regarding maintaining or pursuing various wholesale funding sources.

Similar to last year's results, competition and economic uncertainty remain the most significant challenges that community banks face in attracting and retaining core deposits. Meanwhile, demographic changes and fintech competition remain moderately important challenges for core deposit retention, and the national rate cap and capital constraints remain less important.

Community bankers continue to rely on public funds and FHLBank advances, similar to what was reported in last year's survey. This year, however, a larger percentage of respondents indicated that they currently utilize and will continue to utilize brokered deposits, which increased from 39% in 2023 to nearly 49% in 2024. This may be a sign of greater comfort with brokered deposit networks,[2] but also a growing demand to provide more deposit insurance to customers.

As seen in Table 3, reciprocal deposits at community banks have increased from $67.2 billion as of Dec. 31, 2020, to $173.9 billion in the first quarter of 2024. The two banks that failed in March of 2023 had large uninsured deposit balances. These balances drew scrutiny from regulators, the press and bank customers. As such, many bankers decided to enter into reciprocal deposit arrangements over the last year to provide increased levels of deposit insurance to their customers.

LOAN PARTICIPATIONS

Loan participations can serve as an important mechanism for banks that are near their legal lending limit to continue supporting the lending needs of larger businesses. Participations can also serve as a source of loan diversification and risk mitigation for banks. In 2024, a majority of respondents reported that fewer than 5% of all loans bought and sold were participations.

This lack of loan participation activity could reflect that loan demand has been manageable for banks, with most loans falling within banks' legal lending limits. It could also reflect the historical perspectives of community bankers going back to the 2008-09 Great Recession in which loan participations, particularly in real estate loans, led to significant loan losses for some participants. For those banks involved in loan participations in 2024, 68% of respondents noted they primarily sell participations because of legal lending limit issues, while they primarily purchase participations to earn additional interest income. Only 3% reported that they purchase participations to earn credit under the Community Reinvestment Act (CRA).

FIGURE 34

What percentage of loans sold at your bank are loan participations?

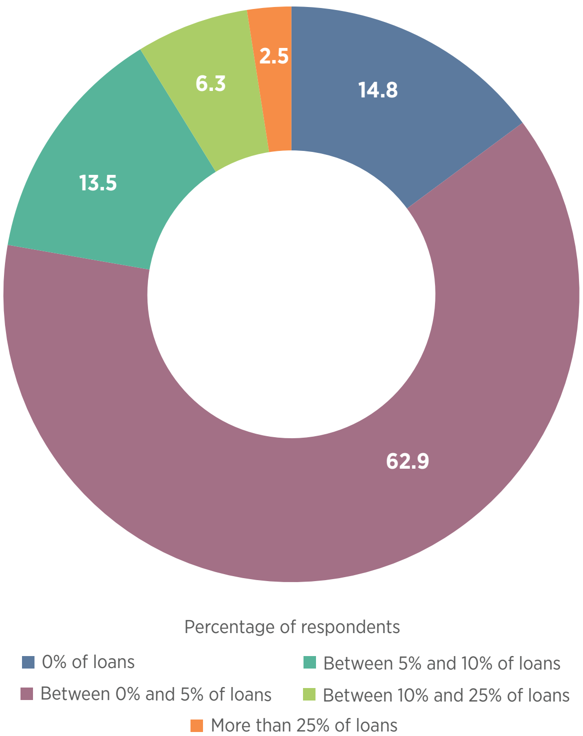


FIGURE 35

What is the primary reason loan participations are sold at your bank?

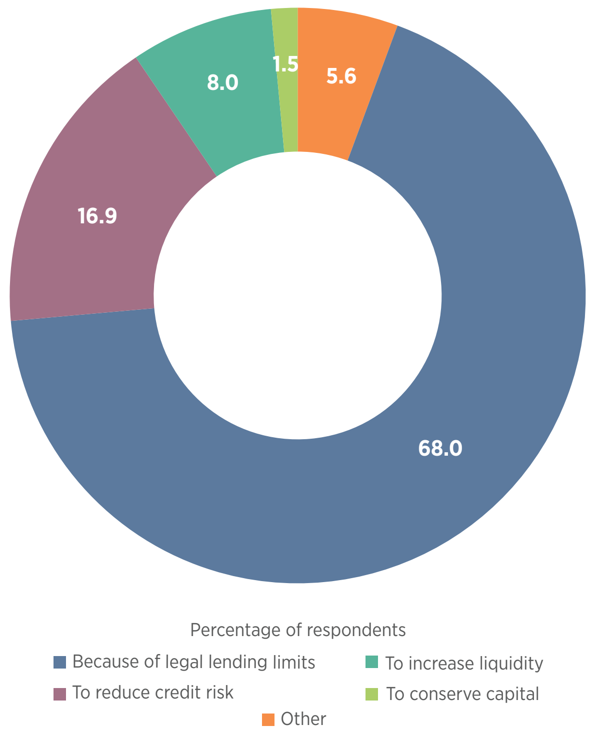


FIGURE 36

What percentage of loans purchased at your bank are loan participations?

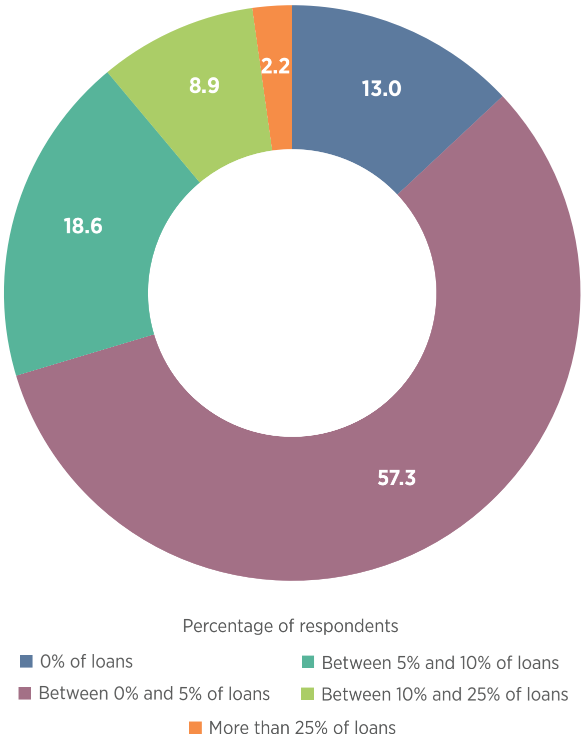
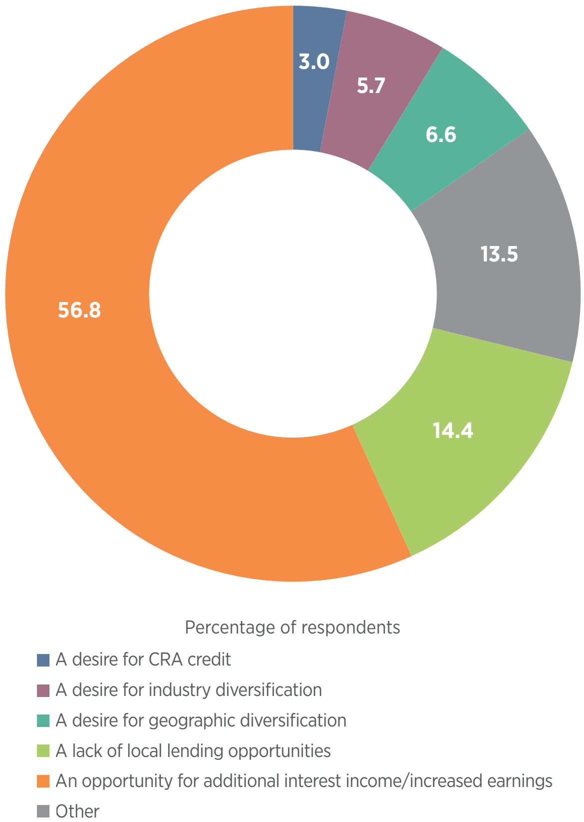


FIGURE 37

What is the primary reason loan participations are purchased at your bank?



Surveyed bankers were asked to report the portion of costs stemming from regulatory compliance (i.e., compliance costs) as a share of their total expenses by resource. In 2023, compliance costs as a percentage of overhead for personnel (i.e., salary and benefits), data processing, and consulting and advisory expenses were consistent with 2022 values. Compliance costs related to legal, as well as accounting and auditing, meanwhile, experienced a more significant change, with shares of total expenses rising nearly 4 percentage points each. The increase in accounting and auditing could be partly attributed to the implementation of the current expected credit loss accounting standard, which requires lenders to estimate losses for the lifetime of a loan instead of on an incurred-loss basis.

TABLE 5

Compliance costs as a percentage of total expenses by category

	Dec. 31, 2022	Dec. 31, 2023
Personnel (salary and benefits)	**12.2**	**12.1**
	(10.0)	*(10.0)*
Data processing	**14.2**	**14.6**
	(10.0)	*(10.0)*
Legal	**12.1**	**15.7**
	(1.0)	*(2.0)*
Accounting and auditing	**30.9**	**34.6**
	(25.0)	*(25.0)*
Consulting and advisory	**22.5**	**22.5**
	(5.0)	*(5.0)*

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

Bankers' Perspectives

In the big picture, we are concerned about "one-size-fits-all" rulemaking. There are important distinctions to make between small community banks that know and have to face their clients, as opposed to what are often called the "too-big-to-fail" banks. I obviously have a bias, but regardless, it gets a bit tiresome reading in The Wall Street Journal that bank "X" gets fined $100 million, writes a large check and then life goes on. As a community bank, our reputation is everything, and I'd like to think that we are viewed as responsible actors by our clients and the regulators. There's a high degree of trust between the public and their community banks, and we certainly want to preserve that. ...

At times it does feel that when there is a particular issue that someone in Congress feels strongly about, everyone rushes to fix it "whack-a-mole" style, as opposed to looking at it holistically. We don't feel that the community banks are the bad guys, so to speak. The success of our businesses requires that we be customer-centric and customer friendly. Given our focus on the relationship rather than the transaction, we want our clients to always feel that they are treated fairly. At the same time, we don't run a risk-free business. We have to take that into account for all of our fee and pricing structures.

—Michael Busch, Burling Bank
Chicago, Illinois

Obviously, there's a purpose for regulation. There's a purpose in protecting the soundness and safety of our institutions. Where we get concerned is when some of these regulations don't appear to enhance that, yet they add to our compliance costs without any direct apparent relationship to overall safety and soundness.

—David Ehlis, Bravera Holdings Corp.
Bismarck, North Dakota

Our regulatory environment has been referred to as a "regulatory tsunami." I have no doubt the implementation of any or all of these [potential new regulations] places a huge burden on banks, especially community banks. I believe the burden will be realized and increase the need for staffing, training and additional technology—all of which come with increased risk and additional costs—which will result in shrinking margins.

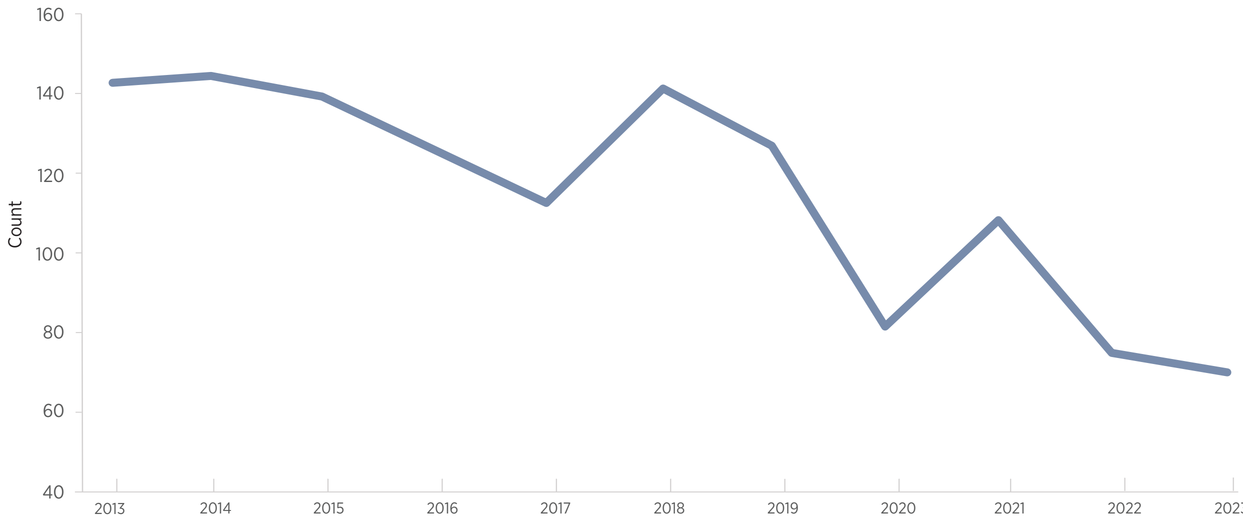
—Cathy Owen, Eagle Bank and Trust Co.
Little Rock, Arkansas

ACQUISITION ACTIVITY

Consolidation activity continued to decline in 2023, according to the *FDIC Merger Decisions* report (see Figure 38).[3] There were 61 approved mergers in 2023, down from 68 in 2022 and a significant decrease from 142 in 2013. The drop in mergers last year potentially reflects ongoing pressure from higher interest rates and uncertainty caused by the regional bank failures in early 2023.

FIGURE 38

Annual number of bank mergers



SOURCE: FDIC Merger Decisions 2013-2023

In the 2024 survey, 6% of respondents reported that they had received and seriously considered accepting an acquisition offer in the last 12 months, which was the same share reported in 2023. This was a slight decrease from 8% in 2022 and 7% in 2021.

Inability to achieve economies of scale was the top reason for consideration, with roughly 64% of respondents selecting it as "extremely important" or "very important," up 14 percentage points from last year when it tied for second at 50%. In 2023, excessive costs of doing business were considered of most importance, with 58% of respondents ranking it as "extremely important" or "very important." This factor fell to third in this year's survey, with 52% of respondents deeming it as "very important" or higher.

The share of respondents who have made an offer to acquire or merge with a target institution in the last 12 months was 12%, the same as in 2023 and close to an 11% share in 2022.

Achieving economies of scale continues to be the primary rationale for making offers, as it has been for the last four years. In the 2024 CSBS Annual Survey, 80% of respondents ranked this reason as "extremely important" or "very important"—an increase of 18 percentage points compared to 2023.

FIGURE 39

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

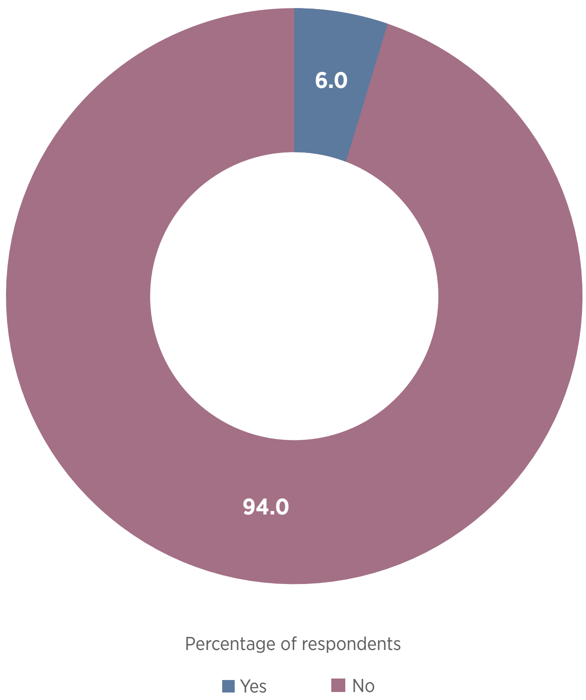


FIGURE 40

How important were the following factors in your decision to seriously consider accepting the acquisition or merger offer?

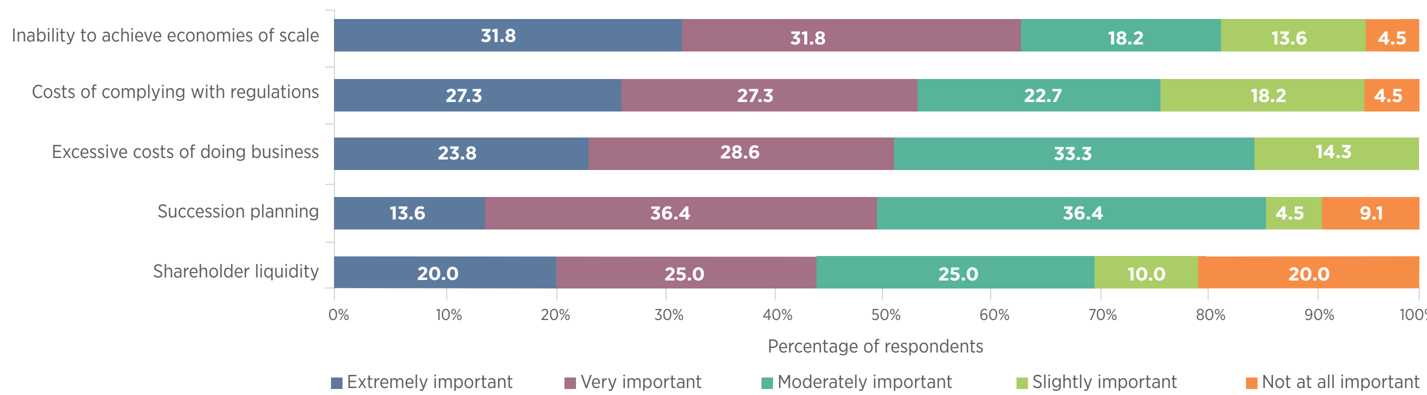


FIGURE 41

Have you made an offer to acquire or merge with a target institution in the last 12 months?

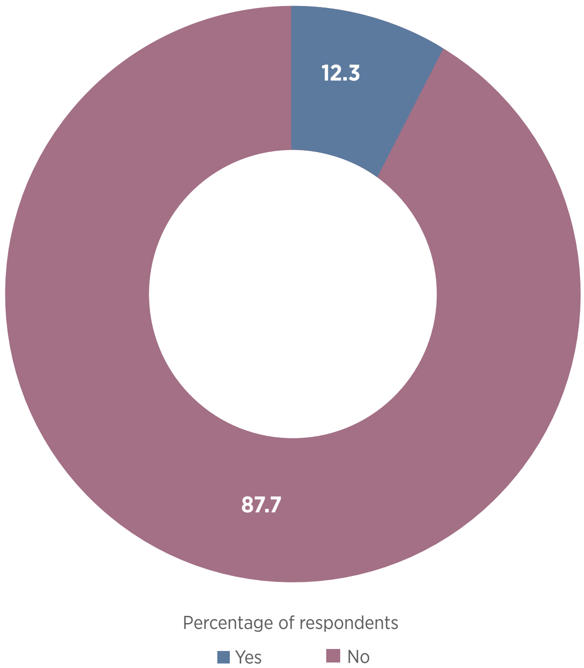


FIGURE 42

How important were the following motivations to make the offer?

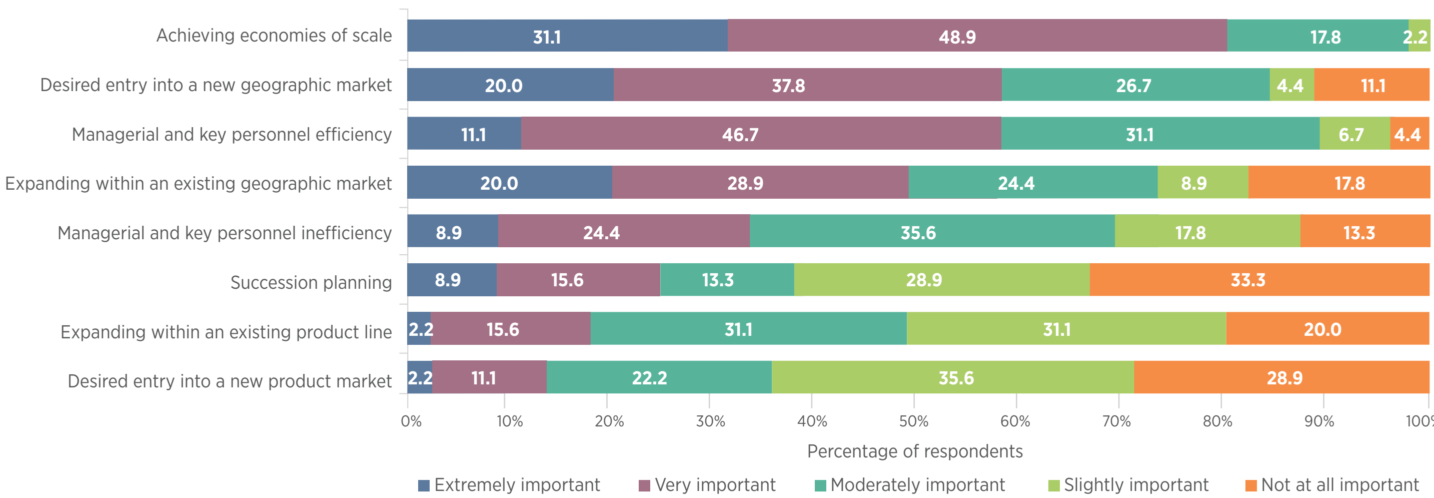
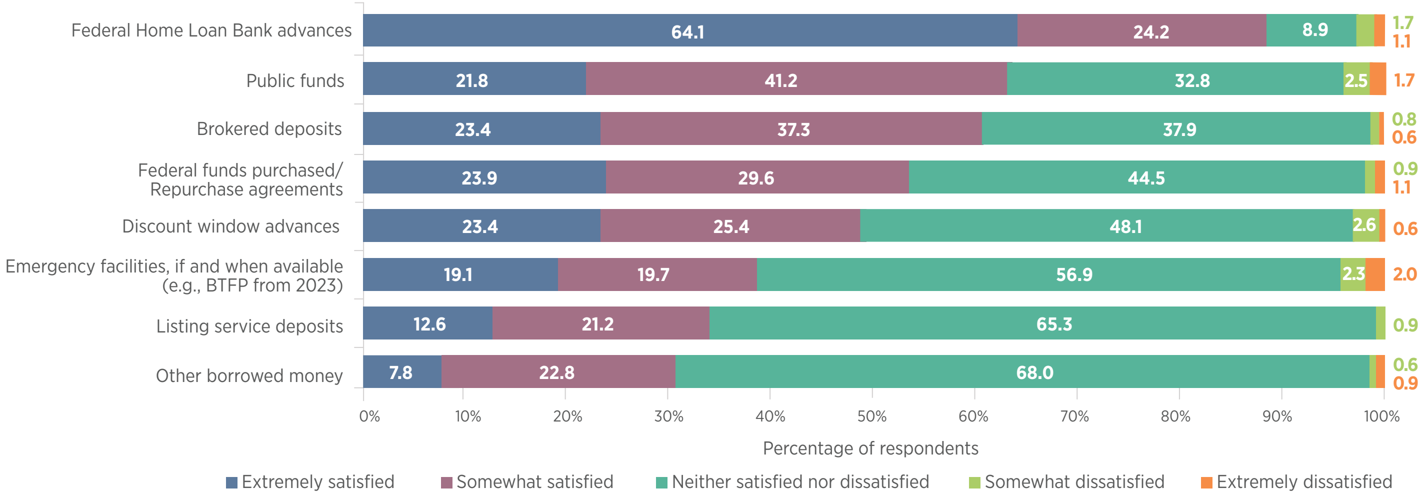


FIGURE 43

In your experience, how satisfied are you with the accessibility of the following funding sources?

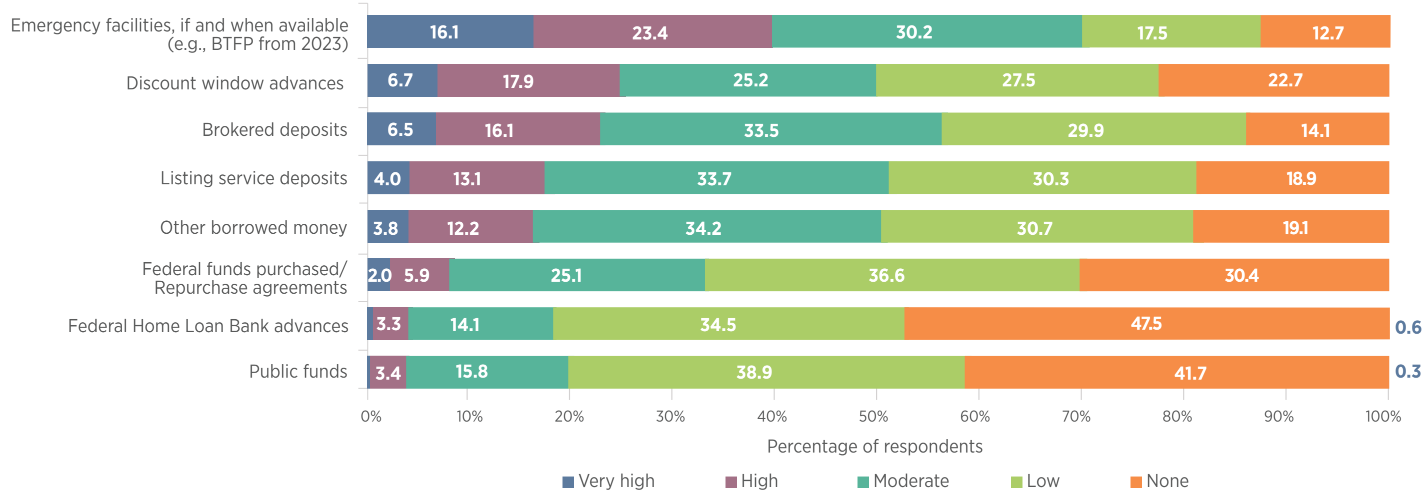


NOTE: BTFP is the Bank Term Funding Program.

The majority (64%) of survey respondents reported being "extremely satisfied" with the accessibility of FHLBank advances, with an additional 24% being "somewhat satisfied." Survey respondents expressed relatively less satisfaction with the accessibility of other funding sources, as a smaller portion (22% to 24%) reported being "extremely satisfied" with federal funds purchased/repurchase agreements, brokered deposits, discount window advances and public funds. Survey respondents appeared more neutral on funding sources such as emergency facilities, listing service deposits, and other borrowed money, with roughly two-thirds of respondents reporting being "neither satisfied nor dissatisfied" with the accessibility of these funding sources.

FIGURE 44

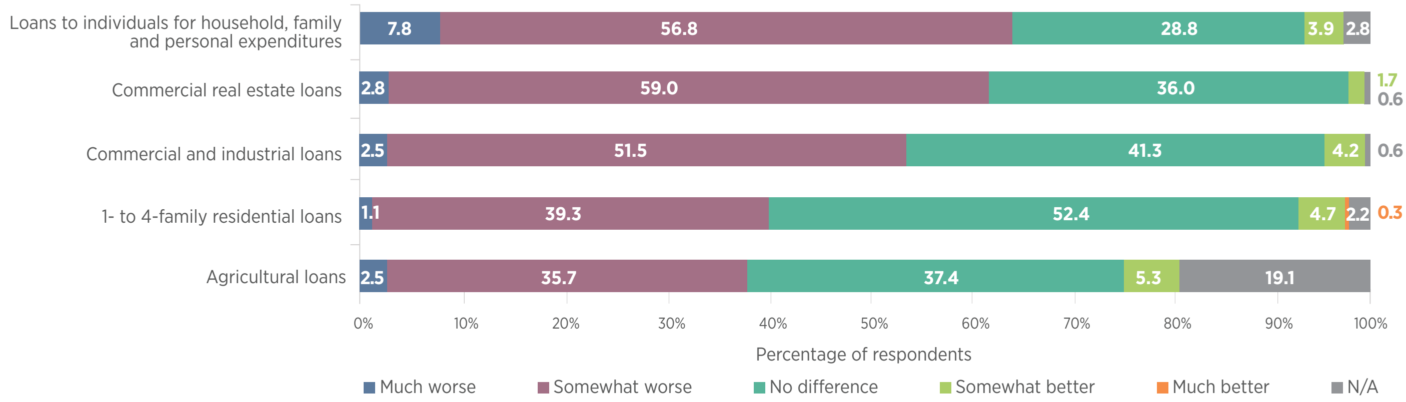
What level of stigma, if any, do you feel is associated with the following funding sources?



Using emergency facilities was considered to carry the highest amount of stigma, followed by discount window advances and brokered deposits. Nearly 40% of survey respondents associated emergency facilities with a "very high" or "high" level of stigma while 25% associated these levels with discount window advances and 23% with brokered deposits. Survey respondents viewed public funds and FHLBank advances as carrying the lowest level of stigma, with more than 80% of respondents reporting either "none" or a "low" level of stigma associated with these funding sources.

FIGURE 45

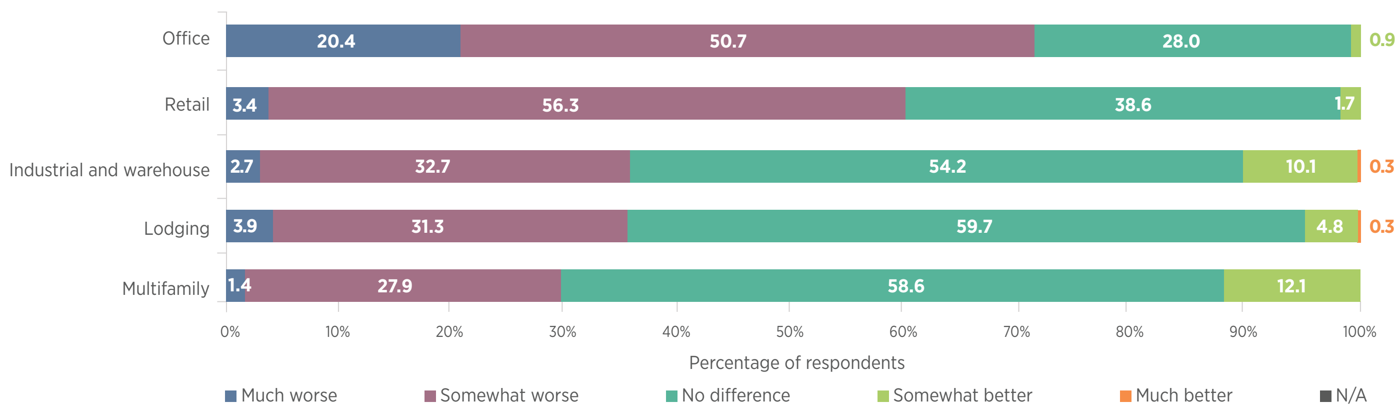
Over the next 12 months, where do you expect credit quality to be across the following loan types in your market?



Nearly 65% of respondents expected credit quality of loans to individuals for household, family and personal expenditures to be at least "somewhat worse" over the next 12 months. Surveyed community bankers expressed similar views on commercial real estate loans, with roughly 62% anticipating credit quality to be at least "somewhat worse." In addition, more than half (54%) of bankers anticipated credit quality on commercial and industrial loans to be at least "somewhat worse." Meanwhile, roughly half of bankers anticipated no difference in loans related to one- to four-family residential loans. Views on credit quality for agricultural loans were generally divided between "somewhat worse" and "no difference."

FIGURE 46

Over the next 12 months, where do you expect credit quality to be across the following commercial real estate property types in your market?



Regarding credit quality of commercial real estate (CRE) loans, bankers expressed the most concern for office property loans, with 20% expecting credit quality to be "much worse," and nearly 51% anticipating credit quality to be "somewhat worse" on these loans over the next 12 months. Bankers also expressed generally pessimistic views on retail CRE loans, with 56% anticipating credit quality to be "somewhat worse" and an additional 3% expecting "much worse" conditions. Views were more neutral on other CRE loan types, with roughly 54% to 60% of bankers anticipating no difference in credit quality on loans for lodging, industrial and warehouse, and multifamily.

CONCLUSION

This 11th Annual Survey of Community Banks provided an opportunity to share the most pressing hopes and challenges facing community bankers. While the banking turmoil seen in early 2023 subsided, bankers shared that cybersecurity, regulatory burden, and all aspects of liquidity risk management remained key risks this year. Specifically, cost of funds and regulation were nearly tied as the most important external risks to respondents. Additionally, many respondents identified fraud as a key external risk in the narrative portion of the survey.

Cybersecurity, technology implementation and costs, and liquidity were all identified as top internal risks this year. Given the focus on competition, the importance of technological implementation remains critical for community banks. Online banking remained a focal point for survey respondents, with nearly all offering remote deposit capture and most providing online bill pay. Nearly 1 in 4 respondents reported that they are currently receiving instant payments via the FedNow Service, the real-time payment settlement service introduced in 2023. Many more are planning to add this service in the next 12 months. Conversely, bankers continue to report little interest in offering cryptocurrency services, with the vast majority uninterested in offering such services in the near future.

Survey results and *Call Report* data indicate that community banks increased reliance on wholesale funds in response to the increasing difficulty in attracting and retaining core funding. This reflects a multiyear trend of bank balance sheets normalizing as the COVID-19 pandemic and related stimulus funding dissipates.

These findings provide insight into the opportunities and threats faced by the community bank business model today. Historical survey results can be viewed at communitybanking.org. These results continue to demonstrate that community bankers remain resilient despite the myriad challenges they have faced over the years. Through financial crises, changing regulatory landscapes and even a global pandemic, community bankers have endured to serve their customer bases and remain relevant in times of rapid change.

ENDNOTES

1. "Bank Term Funding Program." *Financial Stability*, Board of Governors of the Federal Reserve System, last updated Aug. 13, 2024. See federalreserve.gov/financial-stability/bank-term-funding-program.htm.

2. Ryfe, Dylan; and Saretto, Alessio. "Reciprocal Deposit Networks Provide Means to Exceed FDIC's $250,000 Account Cap." *Dallas Fed Economics*, Federal Reserve Bank of Dallas, Nov. 28, 2023. See dallasfed.org/research/economics/2023/1128.

3. *Merger Decisions, Annual Report to Congress, 2023*. Federal Deposit Insurance Corporation (FDIC). See fdic.gov/bank/individual/merger/2023/2023.pdf.

2024
Five Questions for Five Bankers

1. ARTIFICIAL INTELLIGENCE
Have you been adopting, or planning to adopt, generative artificial intelligence (AI) technologies for use in the operations of your bank and/or the services it provides? If so, how?

2. THIRD-PARTY RISK
With many banks considering fintech partnerships and banking-as-a-service (BaaS), third-party risk management is a critical component of modern banking. What steps does your institution take before moving forward with a partner? Can you provide a specific example of how a fintech partnership developed?

3. REGULATIONS
There have been several proposals from the federal regulatory banking agencies in the previous year [e.g., Basel III capital rule, debit interchange fees, junk fees, Community Reinvestment Act (CRA) revamp, small business lending data]. If implemented, how will these efforts impose regulatory burden on your institution, if at all? Which rulemaking(s) are you more concerned with than others?

4. COMPETITION
To what extent is your institution experiencing competition from nonbank entities? How have you had to change as a result?

5. YIELD CURVE
In March 2022, the Fed began raising its target for the overnight federal funds rate. By December 2022, the yield curve had inverted for the 10-year Treasury note minus the federal funds rate and has stayed inverted throughout 2023 and into 2024. What impact does a sustained inverted yield curve environment have on running a community bank? How has it changed the way you manage your bank?

John W. Blizzard

President and CEO, Seattle Bank, Seattle, Washington

John Blizzard is the president and CEO of Seattle Bank, Seattle, Washington. Blizzard first joined Seattle Bank in January 2014 and was appointed president and CEO in April 2014. He is responsible for developing and leading the organization's vision and operating strategies. Blizzard has more than 30 years of banking and financial services experience, including eight years with the Federal Home Loan Bank of Seattle. Prior to joining Seattle Bank, he served as the president and CEO of Northwest Bank, Boise, Idaho. He earned his Bachelor of Science from Oklahoma State University and his MBA from Seattle University. He is also a graduate of the Pacific Coast Banking School at the University of Washington.

ARTIFICIAL INTELLIGENCE

Have you been adopting, or planning to adopt, generative artificial intelligence (AI) technologies for use in the operations of your bank and/or the services it provides? If so, how?

We have an entity called Seattle Bank, and we have a fintech called CD Valet. At Seattle Bank, we are not currently adopting generative AI technologies. We don't see a use case for it in back-office operations and certainly not on the front end with consumers. There are obviously tons of compliance issues when using it for any kind of decision-making, so not a lot happening at the bank level.

At the CD Valet level, we have the best data in the industry on CDs across the industry. That's a data set that's ripe to use with AI—not to be actionable but to be informational and answer questions. That's something we are looking at and applying our unique data set to. CD Valet includes over 31,000 CD offerings that we update regularly, but we're looking at low-risk ways for consumers to quickly get answers to their questions by incorporating AI.

THIRD-PARTY RISK

With many banks considering fintech partnerships and banking-as-a-service (BaaS), third-party risk management is a critical component of modern banking. What steps does your institution take before moving forward with a partner? Can you provide a specific example of how a fintech partnership developed?

Historically, banking is a business that has lots of technology partners, even in the most basic ways that banks operate. If you offer a digital banking solution, you are going to have at least seven technology partners to make the single solution the customer uses work. So, you are already dealing with lots of third parties, whether you are offering standard digital banking products or doing something more modern and complex like BaaS.

Understanding your vendors is critical and needs to be taken seriously. There are multiple levels to it. We do what we call "partner banking"; some people call it "embedded banking." What we do at Seattle Bank is a much more controlled version of BaaS, where we are the lender or the provider of deposit solutions, but we also control all our technology, funds flows and key decision-making. In partner banking, we are working through a third party who has a large customer base. They have this large consumer base, and we are able to offer them something supplemental to what they are already doing. But in our model, we control the banking pieces and don't have to go through one of the third-party BaaS providers. We have great technology that we control and that has made a big difference in building a strong and sustainable partner banking business line.

As far as partnering with fintechs, the most important thing is being on the same page right upfront. We are going to follow all the rules, we are going to be a pain in the butt to make sure all the rules are followed, we are going to make sure all client funds are tracked, we are going to make sure advertising is done correctly, and we are going to make sure consumers are made whole if they are harmed. We make sure there is the utmost respect in how we operate—especially in any kind of consumer banking operation and especially in these partnerships when we have somebody else display our banking products to an end consumer. What's key is to be upfront and make sure we are on the same page and that they know we are going to be overseeing the process like a hawk. We have passed on a whole bunch of partner opportunities, because either we didn't like the risk/economics, or the management team didn't have the right kind of respect for compliance. We are seeing oodles of opportunity and are very dedicated to the business line, as we see great growth opportunities that we build on a foundation of strong compliance.

As far as examples, we are working with a fintech startup that front-ends with consumers. It is composed of people we already know and with a good banking background. We helped them build something super unique from the ground up that is going to enable homeowners to get a quick loan to fix up their home before they sell it. This will enable the homeowner, for example, to put $30,000 of improvements into their house when they and their realtor believe this will increase the value of the home by, say, $50,000. As a lender, we are going to enable them to do that and make it all mobile-native with the end consumer, as opposed to using HELOCs [home equity lines of credit], where they have to go into the bank and wait for an appraisal for two weeks. We are doing some business with them now, but it will broaden in the coming months. They've been great to work with by taking our direction on how the lending must work and making necessary enhancements along the way. A great partnership includes the fintech doing what they are great at and the bank doing the same. We implement super-strong monitoring and management reporting of all our partnership activities, and this gives us the real-time information we need to ensure strong long-term programs for end consumers, our partners and the bank.

REGULATIONS

There have been several proposals from the federal regulatory banking agencies in the previous year [e.g., Basel III capital rule, debit interchange fees, junk fees, Community Reinvestment Act (CRA) revamp, small business lending data]. If implemented, how will these efforts impose regulatory burden on your institution, if at all? Which rulemaking(s) are you more concerned with than others?

The small business lending data rule is problematic. It is already difficult for small businesses to get loans. Small businesses as a group are very high risk, and we see this with the amount of failed small businesses every year, so it can be a difficult area for banks to lend into. Of course, there are tons of great small businesses, but by definition they don't have the back-office finance/administrative support that larger businesses have. So, to add a new regulatory burden that says these business owners/banks have to collect an additional 40-plus elements and track them is the total wrong direction and is harmful to small business lending.

The other one is CRA because it is super complicated. The original rule never envisioned the digital world we have today that has banks with a local presence and banks like us that have a local presence but with national business lines. The new CRA rule was an attempt to tackle that in some regard, but it is also around 1,400 pages long. We can't have regulations that are 1,400 pages long. We need to simplify that. Another frustration I have with the CRA rules is that you historically don't get credit for great stuff you do for your community, like donating down payment funds to firefighters, police officers and teachers in your area to help them buy homes. Under the current rules, these and other examples don't qualify for CRA credit even though they do a great deal of good.

COMPETITION

To what extent is your institution experiencing competition from nonbank entities? How have you had to change as a result?

Banking is a complicated, expensive business that is actually two businesses at once—a deposit business and a lending business. These fintechs, in some cases, have been able to pick a piece of the business and deliver more value to consumers, especially in an app-based world. There is certainly an expectation that your banking should be as easy as your other digital activities, like splitting a bill with friends through Venmo. At Seattle Bank, we have picked areas to operate in that are a little more niche or high value, so I don't feel like we have been impacted much by fintechs. If you are a traditional consumer bank, I think you are at very high risk. Some of the typical areas of banking are not very profitable, so you have even more pressure by these fintechs coming in. The biggest opportunity is for community banks to innovate from within the industry. Others have done it successfully and have driven value to customers at scale and in a way that has made them money. It's hard to do but it's also rewarding. If you scan all community banks out there, you will find a lot of interesting things they are doing, and some of those things probably just need a little more investment to blossom.

YIELD CURVE

In March 2022, the Fed began raising its target for the overnight federal funds rate. By December 2022, the yield curve had inverted for the 10-year Treasury note minus the federal funds rate and has stayed inverted throughout 2023 and into 2024. What impact does a sustained inverted yield curve environment have on running a community bank? How has it changed the way you manage your bank?

Fortunately for us, we were well positioned for rates going up. Importantly, we built our business on paying our depositors well on their deposits. We tend to have larger depositors and a more sophisticated client base. We started building the bedrock of what our bank is today in its current form about 10 years ago.

We are going to provide great service and great technology, but you are also going to get very fair rates on your deposits. If you think about it, banking is really built on the opposite: Banks work really hard to pay you nothing or very little. So, it was obvious to me 10 years ago that technology would have a major impact on the industry. We got out of all our branches, and we decided we were going to pay our depositors fairly because that was the only way we were going to grow over the next decade. That mindset forces us to make sure we make loans that can make a margin and not just take low-cost deposits and make good credit-quality loans but at super thin margins that make no sense. So, the amount of loans done in the three- and four-handle kind of rates during COVID-19 made no sense, and we just didn't participate in that. We didn't do a lot of multifamily lending during that period for example. We passed on other areas and found our niches.

Banking is fundamentally broken from a depositor standpoint, and that ties back to why we created CD Valet. We work really hard to help savers, and we've gotten a huge response with almost two million people on CD Valet because of that. But we also set up the bank that way. For us, rates moved up and benefited us, so we are very fortunate there, but we also positioned the bank for that. A vast majority of the industry took their depositors for granted. Even when they ran their models for when rates go up, they predicted that their depositors would stay with them because of the relationships they had. For the depositors with the $2,500 checking accounts, that's true because they probably don't care what you pay them, but for the depositors with the $45,000 they have sitting in extra savings, there's a good portion of those people that care and will quickly move that money out somewhere else. Rates haven't been this high since before the iPhone. Information is just so plentiful, and the ability to move money is so much easier. I do think banking is kind of broken in that regard. If you are fortunate enough to have tons of small checking accounts or business operating lines with related deposit accounts, you're probably OK on low-cost deposits, but otherwise, you've got to remake your business. Fortunately, we did that over the years, but a lot of banks have not. Because of that, I think you are going to see a lot of mergers and acquisitions.

Michael Busch

President and CEO, Burling Bank, Chicago, Illinois

Michael Busch is the president and CEO of Chicago-based Burling Bank and Burling Ventures, wholly owned subsidiaries of Burling Bancorp Inc. Busch has more than 30 years of banking experience focused in the areas of regulatory compliance, risk management, operations, marketing, client service and business development. As president of Burling Bank, he is responsible for managing relationships with governmental agencies, business partners, civic organizations and financial technology vendors. Previously, he was an independent commodity futures trader and member of the Chicago Board of Trade. He also served as assistant White House press secretary to President George H.W. Bush. He received his MBA from the University of Chicago's Booth School of Business and his Bachelor of Science from Pepperdine University. He is currently a member of the CSBS Bankers Advisory Board.

ARTIFICIAL INTELLIGENCE

Have you been adopting, or planning to adopt, generative artificial intelligence (AI) technologies for use in the operations of your bank and/or the services it provides? If so, how?

We do not have any plans to incorporate generative AI at this point. We are certainly watching this topic and monitoring the discussion from the sidelines. However, I do think that there's a role for automation, and we'll certainly be looking at automation before starting down an AI path. While I don't know if a lot of small community banks will adopt AI, some of their core service providers and vendors might utilize it. In that case, it is important that banks have discussions with their vendors about AI use and be up to speed especially when there is regulatory guidance around its use.

THIRD-PARTY RISK

With many banks considering fintech partnerships and banking-as-a-service (BaaS), third-party risk management is a critical component of modern banking. What steps does your institution take before moving forward with a partner? Can you provide a specific example of how a fintech partnership developed?

Five years ago, BaaS was a hotter discussion. It was discussed almost like how AI is discussed now; you heard it at every conference you attended. One of the primary concerns banks have in utilizing BaaS is how much control they have over it. We engaged in one BaaS opportunity about four years ago. We incubated a payments technology out of the bank, which allowed us to have better control of compliance and managing risk exposure. We not only had the comfort that we were co-founders of the company, but we were also able to have our attorneys review all the documents and draft the agreements so that everybody's roles and responsibilities were carefully defined and understood.

At the end of the day, especially from what we've come to see with the recent enforcement actions, the bank is eventually on the hook for everyone's performance. Four or five years ago, banks didn't quite understand that. In fairness to them, it might not have been clearly articulated in the regulatory guidance offered at the time.

If a bank is going to enter this space, they need to go into it with their eyes wide open and have discussions very early on with their regulators about their plans. While there are certainly some banks that have done this very well, not every bank is well situated to tackle the BaaS sphere.

REGULATIONS

There have been several proposals from the federal regulatory banking agencies in the previous year [e.g., Basel III capital rule, debit interchange fees, junk fees, Community Reinvestment Act (CRA) revamp, small business lending data]. If implemented, how will these efforts impose regulatory burden on your institution, if at all? Which rulemaking(s) are you more concerned with than others?

In the big picture, we are concerned about "one-size-fits-all" rulemaking. There are important distinctions to make between small community banks that know and have to face their clients, as opposed to what are often called the "too-big-to-fail" banks. I obviously have a bias, but regardless, it gets a bit tiresome reading in The Wall Street Journal that bank "X" gets fined $100 million, writes a large check and then life goes on. As a community bank, our reputation is everything, and I'd like to think that we are viewed as responsible actors by our clients and the regulators. There's a high degree of trust between the public and their community banks, and we certainly want to preserve that.

Regarding what are called "junk fees," we can have an honest discussion on what fees are appropriate or not and have a dialogue with our regulators. I think community banks can get incorrectly lumped in with some of the big banks frequently on the naughty list. There's been a chilling effect caused by recent proposed rulemakings on overdraft and other fees regarding when they apply or not. It is a topic we are paying close attention to. We conducted a review of our fees prior to a recent compliance exam to assess the consistency and impact to our clients and the bank. I imagine most banks are conducting similar reviews to make sure that their fee programs are complying with the rules and not susceptible to incurring an unwanted UDAAP [unfair, deceptive, or abusive acts or practices] violation.

At times it does feel that when there is a particular issue that someone in Congress feels strongly about, everyone rushes to fix it "whack-a-mole" style, as opposed to looking at it holistically. We don't feel that the community banks are the bad guys, so to speak. The success of our businesses requires that we be customer-centric and customer friendly. Given our focus on the relationship rather than the transaction, we want our clients to always feel that they are treated fairly. At the same time, we don't run a risk-free business. We have to take that into account for all of our fee and pricing structures.

COMPETITION

To what extent is your institution experiencing competition from nonbank entities? How have you had to change as a result?

Most of our nonbank competition comes from bank-like capabilities that people have in an app on their phones. Perhaps even more importantly, they expect their bank app to have the same level of functionality as the best-in-class fintech apps. Let's call it the "Venmoification" of finance. I'm the CEO of a bank and I'd like to think my kids know the distinction between a bank and an app like Venmo, but it's becoming increasingly difficult. They just care that they can instantly send and receive money from their friends, yet we all know there are sponsor banks that transfer the money around in the system on behalf of the fintechs. The blurred lines between fintech and banking present a challenge.

I wish the word "bank" was not used so loosely in the general finance ecosystem because we have to go through a lot of hoops to be a bank. It is frustrating when companies that are not banks call themselves banks. However, regulators have been doing a good job of making sure that these nonbanks are more clearly communicating to their clients that they are not banks, including the availability of FDIC insurance.

In a sense, our competition is the speed of innovation, and the products and services that are delivered to the public by nonbanks. We have heard many times that the speed of innovation is far outpacing the speed of regulation. I appreciate that faster is not always better and there should be a responsible cadence to the output of regulations. However, therein lies the difficulty of being a bank—you are stuck in the middle where you need to be the responsible party from the regulatory side and accommodate that pace, while also trying to innovate and keep up with the Joneses, so to speak.

Younger people probably don't appreciate all the technology and regulatory compliance steps we have to take behind the scenes—they just want the technology to work. As soon as it doesn't work, or it is too difficult to use, they will be done with it and move on to another technology. We are currently refreshing our website, and I'm intentionally having one of our 24-year-old analysts manage the project so we can benefit from a young person's perspective and see what he feels is archaic or lacking—what might be deemed sufficient to middle-aged senior management may not be to a new generation of bank consumers.

YIELD CURVE

In March 2022, the Fed began raising its target for the overnight federal funds rate. By December 2022, the yield curve had inverted for the 10-year Treasury note minus the federal funds rate and has stayed inverted throughout 2023 and into 2024. What impact does a sustained inverted yield curve environment have on running a community bank? How has it changed the way you manage your bank?

The inverted yield curve environment has been difficult for many banks, community banks especially, that weren't positioned the right way. We were operating in a rate environment that was very static for a long time and then moved suddenly. Consequently, it narrowed the net interest margin and impacted earnings for a number of banks. When interest rates rose sharply in a short period of time, the cost of retaining deposits changed very suddenly, while the loans weren't repricing as quickly. While things have stabilized more recently, there has certainly been a chilling effect on loan demand and stress on the consumer with higher debit servicing costs.

We were able to somewhat soften the blow because we have a large percentage of our deposits that are not interest bearing. We also service some niche industries that are not as competitive since the accounts require more compliance work. This provides a bit of a moat where there is not as much pricing pressure for lower-priced loans and higher-priced deposits.

A lot of community banks were negatively impacted with the exodus of client deposits chasing higher rates and/or safety after the recent bank failures (Silicon Valley Bank, etc.). To add insult to injury, many of those deposits moved to too-big-to-fail banks because of the implicit guarantee by the federal government, which has a little extra sting since those banks are typically the ones that have more consumer protection violations. Yet, the low-cost deposits flowed into those big banks and they did incredibly well during the last couple of years.

One lesson learned from the banks that cratered in the spring of 2023: In this world of social media and the speed of communication, most people won't take the time to assess the true strength of their bank and delve into the financials. Even if they did, I'm not sure that they would know how to digest the information. If your client hears that bank "X" is having a problem, they might infer the same about your bank and get nervous. The speed at which information (or misinformation) can travel presents an accelerant for failures that didn't previously exist. It is concerning how fast those deposits can leave. Your bank could be doing perfectly well, but because something happened at another bank, it may cause customers to get nervous about your bank even when you don't think they should be. We will see what happens in the near future with interest rates, but there is strong signaling that cuts are forthcoming. You certainly want to keep your liquidity ratios in check and be mindful to plan for what's around the corner.

Lastly, banks are always in the position where the customer can ask to refinance their loan in a decreasing rate environment. While the customer may incur some refinancing costs, there is a long-standing relationship at the community bank level, and the community banks are always going to do right by their clients. When rates go up, we are not asking customers to refinance their loan at a higher rate, but when rates go down, and they ask to refinance, we are going to say, "Yes."

David Ehlis

President and CEO, Bravera Holdings Corp., Bismarck, North Dakota

David Ehlis is the president and CEO of Bravera Holdings Corp., Bismarck, North Dakota. Ehlis joined Bravera in July 2014 after holding various management and leadership positions with the U.S. Army, John Deere and CNH Industrial. Ehlis is a native North Dakotan and serves in various roles within his community, including as a member of Humanities North Dakota and the Bismarck Rotary Club. He is also a member of the board of directors of the Bismarck Mandan Chamber EDC and is a trustee at the University of Mary in Bismarck. Ehlis earned his undergraduate degree at the United States Military Academy at West Point and his MBA from the Harvard Business School. He is currently a member of the CSBS Bankers Advisory Board.

ARTIFICIAL INTELLIGENCE

Have you been adopting, or planning to adopt, generative artificial intelligence (AI) technologies for use in the operations of your bank and/or the services it provides? If so, how?

We are in the early phases right now. There are a couple of projects that we are working on. Obviously, there are a lot of things to consider around risk management within a financial institution as you adopt any new technologies, and AI is no different. One area we are working on now is our insurance agency. We have an insurance agency that is owned by our bank, and we are looking at technology from a generative AI perspective that would essentially gather information when we have conversations with customers, and input that information into a decision regarding what types of policies are appropriate for them. This would be more for our commercial customers, as it's a more complex transaction. There is a technology that essentially will take those conversations and put them into a summary, turning them into insurance policies. That's just one area that we're specifically working on, and we're evaluating a number of others.

I think what we're seeing is that many of the vendors we work with already are starting to work with AI to embed in their own technology. As an example, we use a software called UKG for our human resources management. UKG will be deploying an AI-enabled technology where if you're creating a job description, you can put in the job title and some basic information, and the software will write a job description for you. So, I think we'll see that with some of our other existing vendor partners as well, where they are starting to develop or embed AI within their own technology. Those features will be as much of a factor as going out and forming new partnerships.

I think AI is a very broad topic, and it will continue to evolve. While our use of generative AI is more limited at the current time, I do see it increasingly embedded in our core systems to assist with decision-making and productivity.

THIRD-PARTY RISK

With many banks considering fintech partnerships and banking-as-a-service (BaaS), third-party risk management is a critical component of modern banking. What steps does your institution take before moving forward with a partner? Can you provide a specific example of how a fintech partnership developed?

First of all, you need a robust vendor management process. Whenever we're looking at new technology or technology partnerships—whether it's a fintech or a non-fintech partnership—we have a robust vendor management process, which we've had in place for several years. We make sure that we are assessing not just the opportunity, but the risk. The other important thing is making sure that we have our compliance staff fully integrated into the vendor management process, so that we're evaluating that partnership from a compliance standpoint to make sure we don't miss something. I think what everyone realizes, from a regulatory standpoint, is that our vendor risk is ultimately our risk, our partner risk is our risk, and we can't really separate that. We can't just blindly rely on technology partners to manage compliance for us. I would say that having a robust vendor management process is key—using that process rigorously, not deviating from it and making sure that compliance and risk are a key part of it is the key to success.

We're not doing BaaS, but one particular technology that we brought on that would be considered a fintech partner is called Atomic [Financial] Deposit Switch. We've tied it to our online account opening, which we run through Jack Henry's Banno app. What we found was that we weren't getting accounts opened online and utilized to the degree that we desired. A key piece of knowing that you are the primary account for a customer is that their pay is direct-deposited into that account. It's often a roadblock for customers because they have to go to their HR and switch payroll, and therefore it's an impediment for someone to switch their primary banking relationship. Atomic essentially works with the HR system providers to automatically switch their payroll into their new deposit account. So that is one specific fintech partnership that we have worked with to make sure that as we drive more online accounts, we become that primary bank for that client.

REGULATIONS

There have been several proposals from the federal regulatory banking agencies in the previous year [e.g., Basel III capital rule, debit interchange fees, junk fees, Community Reinvestment Act (CRA) revamp, small business lending data]. If implemented, how will these efforts impose regulatory burden on your institution, if at all? Which rulemaking(s) are you more concerned with than others?

All these regulations mean additional cost, right? To comply with these regulations, we must invest in either staff or technology. If we're looking at section 1071 [small business lending rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act], it's additional process work on our side as well, which means more cost. That's probably the biggest concern, especially if we're dealing with a tightened margin environment because of the inverted yield curve.

Obviously, there's a purpose for regulation. There's a purpose in protecting the soundness and safety of our institutions. Where we get concerned is when some of these regulations don't appear to enhance that, yet they add to our compliance costs without any direct apparent relationship to overall safety and soundness. One of the regulations that you listed that has us somewhat concerned would be the CRA revamp. We are concerned with how expansive and broad that could be and how it might put undue burden on us and our clients. We are also concerned about the implementation of section 1071, and how intrusive that might be to our small business and agricultural clients. As we think about competing with fintech companies and nonbanks, it makes it more difficult for us when we have these additional costs that we have to manage, which might not apply to our nonbank competitors.

COMPETITION

To what extent is your institution experiencing competition from nonbank entities? How have you had to change as a result?

Where we have seen the most intense competition is not in the financing, deposit gathering or lending space as much as in the payment space. Look at companies like Square that start with the payments platform, but then, as they continue to grow, they move into services that are more bank-like, such as the Cash App.

Another company that is maybe closer to our core business is a company called Bushel. It was originally a payments platform to connect purchasers of grain to growers by automating some of the payments process between farmers and grain merchandisers. However, they are also now starting to expand some of their services with what they call a "Bushel Wallet," which is essentially a deposit account. That is getting more into our core business.

We understand these competitors are here, and they are here to stay. We need to figure out how we provide value to our customers. Capitalism is competitive, right? You have to earn your right to exist every day. What we have found is that from a technology standpoint, we often have technology offerings that are as good as many of these competitors like Square. With some of the companies that we partner with on payments, our technology offerings could do everything that Square's could do, but we didn't have the sales and support structure around our technology offerings. In the past year and a half, we have created a new position within our company called a "digital success manager." This position is focused on proactive sales to our clients to make sure that they are adopting and using our payment systems that we feel are every bit as good as our competitors'.

We are showing our clients that we can offer them a great technology solution and that they also have the local support that a community bank brings. To me, it's making sure that when these nonbank competitors are moving into our space, we don't just have the technology but also the infrastructure around it. This includes sales support and client management. We found we were not originally delivering on those items, so we put a lot more effort into that and have had success because of it.

As for the Bushel application, we are in the process of evaluating it. They may be a partner for us, so this may be a case where the best way to protect our core franchises is to partner with them. If it's a technology we can partner with, and it improves our customer experience, then we need to do this.

YIELD CURVE

In March 2022, the Fed began raising its target for the overnight federal funds rate. By December 2022, the yield curve had inverted for the 10-year Treasury note minus the federal funds rate and has stayed inverted throughout 2023 and into 2024. What impact does a sustained inverted yield curve environment have on running a community bank? How has it changed the way you manage your bank?

It makes things tough. We saw it last March, in particular, when some of the bank failures happened. It certainly has impacted margins. It has compressed our margins, and I think you've seen that across the banking industry. We are fortunate that we have a diverse loan portfolio. We have ag operating loans that renew every year, as opposed to every three or five years. So, an inverted yield curve doesn't really impact those. We have a good-size consumer portfolio, which is also a shorter-duration portfolio.

Our bank has really worked on increasing our spreads. If we have tighter liquidity and our competitors all have tighter liquidity, that gives a little bit more pricing power to increase margins to spreads out on the yield curve. Even though the yield curve is inverted or would indicate we should be pricing a little bit lower, we work to manage or increase those to protect our margin.

The other thing is making sure we're pricing the risk properly. We have worked a lot with our lending team.

Back in late 2022, we had a generation of loan officers who had never been through a zero-rate environment. So, we clearly published our rate floors and were very specific on our pricing guidance to our officers. We made sure we were pricing to risk, so that if we took on more risk, we got paid for that.

We don't do it anymore, but we would publish all the loans that were booked every week across the bank, so that there would be a little bit of peer pressure to make sure we are pricing where we needed to. As bankers, we saw a zero cost of money for so long that we might have forgotten some of the fundamental skills of banking—how we manage our pricing and pricing to risk. The inverted yield curve has not made it easy, and I think it won't be easy until we get out of it. I'm hopeful that sometime later this year, or early next year, we at least get to a flat yield curve and move to a more normal environment.

Lori Maley

President and CEO, Bank of Bird-in-Hand, Bird-in-Hand, Pennsylvania

Lori Maley is the president and CEO of the Bank of Bird-in-Hand, Bird-in-Hand, Pennsylvania. From the bank's inception in 2013 until 2017, Maley served as the bank's chief financial officer and executive officer, as well as the assistant treasurer and assistant secretary. Prior to joining the Bank of Bird-in-Hand, Maley was the acting chief accounting officer, controller and senior vice president of Customers Bank in Phoenixville, Pennsylvania. She had previously served as the chief financial officer, executive vice president and treasurer of Berkshire Bank of Wyomissing, Pennsylvania and as the comptroller of Pennsylvania National Bank. Maley holds a Bachelor of Science in business administration with a concentration in accounting from Bloomsburg University, Bloomsburg, Pennsylvania, and a master's degree in finance from St. Joseph's University in Philadelphia. She is a certified public accountant. In 2018, she received the Pennsylvania Bankers Association's Patricia A. Husic Woman of Influence Award and was selected as a finalist for EY's Entrepreneur Of The Year Award in the greater Philadelphia region. In May 2024, Maley was elected to serve on American Bankers Association's Community Bankers Council. She is currently a member of the CSBS Bankers Advisory Board.

ARTIFICIAL INTELLIGENCE

Have you been adopting, or planning to adopt, generative artificial intelligence (AI) technologies for use in the operations of your bank and/or the services it provides? If so, how?

The short answer is no, other than in our Bank Secrecy Act and fraud detection software. Generative AI offers enormous productivity benefits for individuals and organizations. It also represents very real challenges and risks. The bank is exploring how technology can improve internal workflows and enrich products and services. The bank also has future plans to implement workflows in our operational areas to create greater efficiencies, specifically when it comes to the core processing software.

THIRD-PARTY RISK

With many banks considering fintech partnerships and banking-as-a-service (BaaS), third-party risk management is a critical component of modern banking. What steps does your institution take before moving forward with a partner? Can you provide a specific example of how a fintech partnership developed?

We do not have any fintech partnerships at this time. Our bank's risk tolerance is low, and we thoroughly evaluate all of our products and services. The bank has a practice where we use requests for proposals for multiple vendors before accepting a bid. The board of directors will get more involved if it's a high-risk vendor and will look into more of the details. Anytime a vendor touches any of our critical information, be it customer or employee information, we raise that to a higher level, and our chief information, security and technology officer will often report to the board. But we also rely on our risk-reward balance prior to developing any of these external vendor relationships. I would say the bank keeps an open mind, and we will evaluate all opportunities with fintech partners in the future if it makes good sense for our bank and it enhances the value of the bank.

REGULATIONS

There have been several proposals from the federal regulatory banking agencies in the previous year [e.g., Basel III capital rule, debit interchange fees, junk fees, Community Reinvestment Act (CRA) revamp, small business lending data]. If implemented, how will these efforts impose regulatory burden on your institution, if at all? Which rulemaking(s) are you more concerned with than others?

Several of those proposals will impose a regulatory burden on our institution. In particular, some of the proposed changes, such as to the Community Reinvestment Act, create uncertainty, and that poses a risk to our bank. We understand that this rule is being challenged in the courts, and the overturn of the Chevron doctrine in the Loper Bright case generates further uncertainty about the future of this rule. In our efforts to remain compliant with all laws and regulations, we continue to stay up to date on developments through the various seminars and training sessions that are made available to us.

There is concern regarding the interchange fees rule because this creates uncertainty for fee income. Merchants pay a small transaction cost to a cardholder's bank any time a cardholder makes a purchase using a debit card, and our bank uses debit cards—we do not use credit cards. This interchange fee reimbursement reverses the cost to the financial institution for the investment in helping create debit payment systems, including offering debit cards, managing the technology, providing customer support and implementing fraud prevention measures. These are really hard-dollar costs. The statute requires interchange fees to be reasonable, as well as proportional, to cover an issuer's costs, not equal to those costs. We understand the courts have gotten involved in this. We are hoping that consideration is given to this so that banks can make reasonable fee income, because in this environment, with all the strain on interest income, the fee income is vital to some banks.

According to the Bank Policy Institute and the American Bankers Association [ABA], exempt financial institutions could reduce services to consumers due to reduced interchange revenue. So, the availability of free non-interest-bearing checking accounts offered by exempt financial institutions is expected to decline by 15.5% following the imposition of the interchange fee cap. If you look back at 2014, 73.3% of those exempt banks surveyed indicated that the debit card interchange cap policy had a negative impact on them, as well as on their earnings.

One other item is the small business lending data gathering requirement. That rule could prove to be a huge challenge for our bank since we are in the heart of the Amish community and some of our customers may not appreciate some of the questions we would have to ask in the demographic and financial data collection. The data produced may put small business privacy at risk and could provide an incomplete and potentially misleading picture of small business lending to these underserved groups. The data gathering remains unnecessary and far-reaching and may harm the relationship banking model, at least in our market. The implementation will cost our bank, and many other banks, time and money to comply, and from what I've read, the proposed cost of implementation is highly underestimated. For example, the CFPB [Consumer Financial Protection Bureau] said it would cost entities only between $44,800 and $77,800 to build the systems and implement processes necessary for compliance with this rule. Respondents to an ABA survey said that one-time costs could range from $112,000 all the way up to $7 million. So not only do you have the implementation cost, but you have the ongoing compliance cost, which I believe the CFPB estimated between $8,300 and almost $300,000 a year, based on the complexity of the institution. But survey results from the ABA found that it could be between $71,000 and $2 million on an ongoing basis.

In April of this year, I participated in the "Future of Banking" workshop at the Federal Reserve Bank of Kansas City. The panel I was on was about how to start more new banks. The panel concluded that it is almost impossible to start a new bank today with all the regulatory burden and costs. So, the barriers for entrance are too high, and it's creating a deficit of new banks. I think we will not see many new banks coming out of the gate to replace the banks being merged out of existence. This is going to lead to the creation of more unbanked and underbanked communities in the United States.

COMPETITION

To what extent is your institution experiencing competition from nonbank entities? How have you had to change as a result?

Our bank is in the heart of the Old Order Amish community in Lancaster, Pennsylvania. As such, the bank competes with Amish and Mennonite private investment entities that raise deposits at higher rates and loan them in the market to first-time farmers with smaller spreads. So, they almost have their own fund for both deposits and loans. The bank also competes with Farm Credit [federal system] for many of our agricultural loans. We have not experienced significant competition with fintechs—because we don't do online account opening right now—other than their online presence that may take customers without our knowledge. We have been able to compete effectively by building a strong relationship with the community we serve, hiring people with really strong skills that fit our corporate culture and maintaining disciplined expense control. However, in this current environment, we have seen increased competition from online banks in the industry, as well as credit card companies and investment brokerage companies. One of my biggest concerns in this environment of high interest rates is wondering if the deposits that left the banking system to alternative products will ever return when rates go down. That is a huge question for community banks. The majority of our customers like to know the people they do business with. During the Silicon Valley Bank crisis in March of 2023, we had very few questions from our customers, because they were content with the knowledge that our bank has roots in what we call "bread and butter" banking. We accept deposits from the community, and we put those deposits back out in loans into the same community. Those roots have anchored us to a community that embraces this bank, because the bank keeps them at the forefront of all that we do.

YIELD CURVE

In March 2022, the Fed began raising its target for the overnight federal funds rate. By December 2022, the yield curve had inverted for the 10-year Treasury note minus the federal funds rate and has stayed inverted throughout 2023 and into 2024. What impact does a sustained inverted yield curve environment have on running a community bank? How has it changed the way you manage your bank?

Rising interest rates and the corresponding sustained inverted yield curve have been some of the biggest challenges of my banking career, aside from the Great Recession. This current yield curve inversion, which has been going on since 2022, is the longest in history, surpassing the previous record set in 1978. The Fed managed to contain last year's banking turmoil, which was a result of changes in the shape of the yield curve, by offering emergency liquidity measures. But the inverted curve has played havoc with the bank's ability to grow our core deposits to keep pace with our loan portfolio. Since the cost of alternative funding rose, the competition for core deposits has sharply increased. So, the inverted yield curve introduced an extra element of uncertainty into our risk and business models. We have widened our search for deposits to new areas, exploring municipal and school district accounts, and are applying to become a Pennsylvania depository for state funds. This challenge has encouraged closer cooperation with our lenders, as well as our business development teams. New business loan customers often want to move their deposits to the bank, and our business development team has been exceptional in working with them to make sure their questions are answered and their needs are met. Margin pressures are real, and they have continued to be an issue resulting in reduced bank earnings. As a result, the hiring of new employees has been muted as a means of expense control, and this has also disrupted the expansion of brick-and-mortar branches into new areas. This has been halted until there is more sustainability and stability in the financial markets. Right now, our motto is "Survive until 2025."

Cathy Owen

Executive Chairman, Eagle Bank and Trust Co.,
Little Rock, Arkansas

Cathy Owen is the executive chairman of Eagle Bank and Trust Co., Little Rock, Arkansas, as well as the chairman, president and CEO of the State Holding Co. in Little Rock. With more than 50 years of banking experience, Owen has served on the board of directors and the executive committee of the American Bankers Association; in 2022 and 2023, she served as chair of its government relations committee. From 2018 to 2019, she was the chairman of the Arkansas Bankers Association, the first and only female banker to serve in this role in the organization's 134-year history. Owen has also chaired numerous local civic and charitable organizations. She earned her undergraduate degree in finance and banking from the University of Arkansas at Fayetteville and her graduate banking degree from the SW Graduate School of Banking at Southern Methodist University. She is currently a member of the CSBS Bankers Advisory Board.

ARTIFICIAL INTELLIGENCE

Have you been adopting, or planning to adopt, generative artificial intelligence (AI) technologies for use in the operations of your bank and/or the services it provides? If so, how?

It is easy to get caught up in all the hype about AI's potential. However, we've not yet adopted generative AI. We believe we are currently better off exercising a dose of caution and skepticism when it comes to generative AI. As a community bank, we believe it's in our best interest to let others take the lead in working out how to best filter the information and layer in some security practices to verify the content's factuality. We've all seen some questions asked of generative AI and some horrible answers that have come back, but at the same time, as we look at systems that are not part of our core services or not customer-facing, we want to look at their AI potential.

For instance, with security systems, we had two ATMs that got compromised via hook-and-chain attacks. Wouldn't it be great if we had AI that could, in real time, send us notifications that a truck is backing up to our ATM and provide us with live footage and information about the license plate prior to the compromise occurring? Or when an unauthorized individual enters a secure area, to be notified right away with a film clip or a text message? We think there is great potential there, but we just haven't made that leap yet.

THIRD-PARTY RISK

With many banks considering fintech partnerships and banking-as-a-service (BaaS), third-party risk management is a critical component of modern banking. What steps does your institution take before moving forward with a partner? Can you provide a specific example of how a fintech partnership developed?

Although we have looked at a few fintech partnerships, at this point we have not made the leap. We've not felt that we really have the expertise to properly evaluate, implement and monitor a fintech partnership. We've not had the need for BaaS, and we are certainly not willing to accept the associated risk that we've seen other banks run into with that.

REGULATIONS

There have been several proposals from the federal regulatory banking agencies in the previous year [e.g., Basel III capital rule, debit interchange fees, junk fees, Community Reinvestment Act (CRA) revamp, small business lending data]. If implemented, how will these efforts impose regulatory burden on your institution, if at all? Which rulemaking(s) are you more concerned with than others?

I would say I'm most concerned with the [Dodd-Frank Wall Street Reform and Consumer Protection Act, section] 1071 small business lending data rulemaking. Every small business loan is different. These differences can't be properly understood or interpreted in data collection. Therefore, I have huge concerns as to how the comparative results may end up being used and believe they may ultimately result in banks' being forced to decline small business loans because they don't fit into a box into which we are being forced to compare loans and analyze them based on those specifics. I have real concerns with 1071.

To be honest, all of these proposals concern me. Our regulatory environment has been referred to as a "regulatory tsunami." I have no doubt the implementation of any or all of these [potential new regulations] places a huge burden on banks, especially community banks. I believe the burden will be realized and increase the need for staffing, training and additional technology—all of which come with increased risk and additional costs—which will result in shrinking margins. Since none of the proposals that I'm aware of have any possibility of adding anything to our bottom line, they therefore hurt our ability to serve our customers, as well as our communities. Bankers are already having to find a real balance between the demands of staffing and technology and the current regulatory challenges. When you add the increased burdens, it will result in more long-time employee retirements, which creates greater staffing issues and more banks choosing to sell or merge as they grow tired of fighting the regulatory burdens and seeing their earnings shrink.

COMPETITION

To what extent is your institution experiencing competition from nonbank entities? How have you had to change as a result?

As a community bank, we aren't necessarily thinking about this every day, but no doubt we are competing with the nonbanks 24/7. This is especially true when it comes to the younger generation, who are used to doing everything at their fingertips. It would be rare to find anyone under 50 years old who hasn't used PayPal, Venmo, Cash App or another type of nonbank product.

What we really see in the competing areas are on the loan side—not only with the likes of Lending Club, Rocket Mortgage and others from the home mortgage side, but also on the business loan side. We've run into this when customers come to us to apply for a loan, and as we look up their cash flow, we realize that they already have debt from an unregulated nonbank that they got easily while they were sitting at home but not realizing the consequences. We have had a couple of occasions where we were prevented from being able to make loans to customers because they were not able to pay off the loan debt due to how the contracts were written in the fine print. So, we couldn't help them, and they were drowning in the loans they already had.

There is no doubt the nonbanks are growing and continue to invest a lot of money into technology and other services that are difficult for us to compete with. But I think that as a community bank, we also have a huge advantage in that we have the ability to utilize our customer relationships, our local knowledge and our engagement within our communities, as well as our ability to meet in person with our customers to help them. This is especially true in our rural markets. There is no doubt that we need to do a better job of marketing ourselves and reiterating these strong points about being able to help our communities and our customers.

YIELD CURVE

In March 2022, the Fed began raising its target for the overnight federal funds rate. By December 2022, the yield curve had inverted for the 10-year Treasury note minus the federal funds rate and has stayed inverted throughout 2023 and into 2024. What impact does a sustained inverted yield curve environment have on running a community bank? How has it changed the way you manage your bank?

There's not much it doesn't impact. An inverted yield curve often signals economic uncertainty, which impacts many areas of community banks. With regard to profitability, net interest margins get compressed. This reduces our profitability, since our short-term borrowing comes at a higher cost relative to the interest we are able to earn on long-term loans. This is because we have to take into consideration our depositor behavior as well as depositor retention. When customers see their ability to earn higher interest rates, they are going to shift their deposits from the low-interest-earning accounts to higher yielding accounts or to other competition if we are not willing to meet those higher rates.

Then, liquidity comes into play with higher short-term rates. We become more focused on paying higher rates on deposits in order to retain the customers. It's so important to retain those customers to avoid the liquidity shortfalls that can come into play. This also leads to the potential for asset liability mismatch, because we've got different durations with our assets and our liabilities.

I would also like to address loan demand. Higher interest rates can reduce the demand for new loans, particularly long-term fixed-rate loans, such as mortgages. Potential borrowers might hesitate to take on new debt because of expectations of economic downturns, which leads to lower loan origination volumes. This means less income for the banks. We also have to consider credit quality. Economic uncertainty can increase the risk of loan defaults, requiring tighter credit underwriting and increased provisions in loan losses, once again affecting profitability.

Our investment portfolio is also greatly impacted. An inverted yield curve results in unrealized losses in investment portfolios due to the long-term securities that were purchased when rates were lower, thus forcing us to mark-to-market losses. Banks also have to be careful with yield chasing. Pressure to maintain yields may lead some banks to take on riskier investments, which can then have adverse consequences if those investments do not perform as expected.

We have several multifaceted strategies when working in an inverted yield curve environment:

1. **Balance Sheet Management:** This comes back to durations matching. It's important to be able to adjust the duration of our assets and liabilities to minimize the impact on rate changes. This may include shortening the duration of the loan portfolio or lengthening the duration of our liabilities. It's also important to be diversified. We have tried to maintain a very diverse loan portfolio to help spread those risks across the various sectors and geographies in which we operate.
2. **Pricing:** We are constantly monitoring our pricing strategies so that we can respond quickly to the changing rate environments. There's also fee income. Between the yield curve and the CFPB [Consumer Financial Protection Bureau], there is now a much greater importance on closely monitoring our noninterest income. That has become so important in being able to offset some of our net interest margin compression.
3. **Credit Risk Management:** This comes back to enhanced underwriting. We have strengthened our credit underwriting processes to ensure our loan quality remains high.
4. **Cost Control/Operational Efficiency:** We are constantly evaluating ways to streamline operations to reduce costs, while improving efficiencies in customer service. Operational efficiency applies to expense management, so we constantly monitor and manage to make sure we are making the right decisions there.
5. **Liquidity Planning:** This is about having a contingency funding plan. We have to have a strong and well-developed contingency funding plan, which includes multiple sources that we test and monitor regularly to ensure we have adequate access to liquidity, should the need arise. We also work very hard to maintain our core deposits, so that we are not forced into volatile funding sources.
6. **Communication:** Through the years, we have worked hard to build an open and clear communication strategy not only with our customers and staff, but also with our regulators, to build that trust and to manage expectations. If something comes up, we are the first to call our regulators to report and let them know. We have always viewed it as a partnership rather than an adversarial relationship, and it has paid huge dividends through the years.

Overall, I believe that community banks have the real advantage of being able to react quicker to changes in unexpected and unfavorable economic conditions affecting a bank's health.

ACKNOWLEDGMENTS

The 2024 CSBS Annual Survey of Community Banks was administered by state bank commissioners in 38 states. A total of 367 community bankers participated. To request a print copy of this publication, email the conference committee at info@communitybanking.org. Participation in the 2024 survey would not have been possible without the efforts of the following state bank commissioners and their staffs.

Alabama
Mike Hill, Superintendent of Banks
Alabama State Banking Department

Arkansas
Susannah Marshall, Bank Commissioner
Arkansas State Bank Department

California
Clothilde "Cloey" Hewlett, Commissioner
California Department of Financial Protection & Innovation

Colorado
Ken Boldt, State Bank Commissioner
Colorado Division of Banking

Connecticut
Jorge Perez, Banking Commissioner
Connecticut Department of Banking

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

Idaho
Patricia "Patti" Perkins, Director
Idaho Department of Finance

Illinois
Mario Treto Jr., Secretary
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