



## In the Tenth Federal Reserve District September 2011

- Surveys were emailed to community depository institutions (including banks, credit unions, and thrifts) with assets less than \$1 billion (December 31, 2010) located in the Tenth District.
- Previous surveys (2001, 2004 and 2008) conducted by the Tenth District only incorporated banks.
- Of the 1,380 potential respondents, 322 institutions completed the survey, resulting in a response rate of 23.3 percent. This includes 225 bank respondents (out of 888), with a response rate of 25.3 percent.
- The characteristics of survey respondents are closely aligned with the characteristics of institutions located in the Tenth District, although the survey does not represent a random sample.

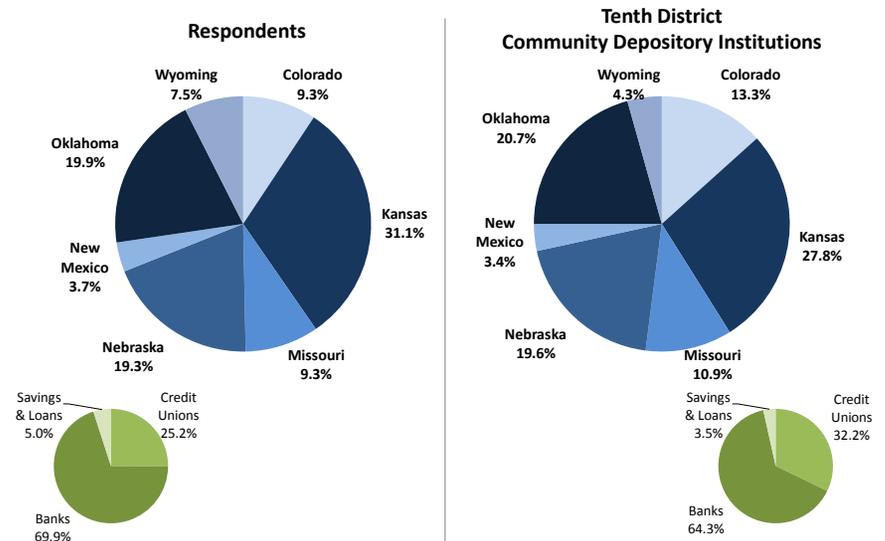
### Respondent Statistics

#### Asset Size:

< \$100 Million: 60%  
 \$100 - \$500 Million: 36%  
 \$500 Million - \$1 Billion: 4%

Median Asset Size: \$77.5 Million  
 Institutions with a net loss (2010): 19%

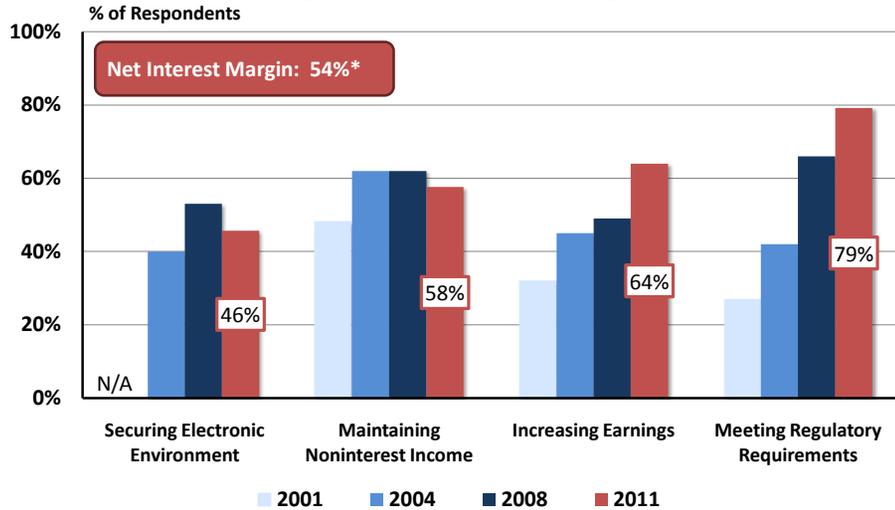
### Survey Respondents



# COMMUNITY BANKING CHALLENGES

## Community Banking Challenges

### “Significant” Challenges



\* Net Interest Margin was introduced in the 2011 survey, so no historical information is available  
 Note: 2001, 2004 and 2008 only included banks as respondents

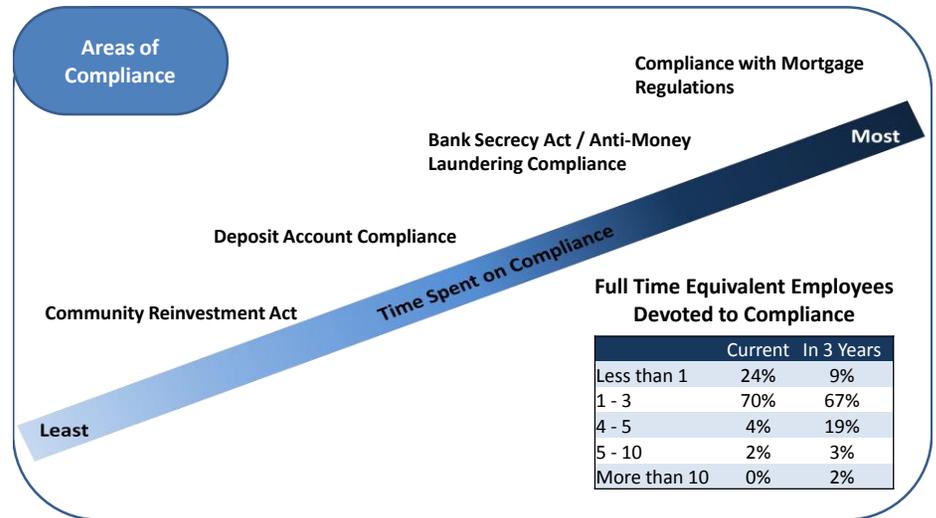
- Regulatory compliance is a significant challenge for 79% of respondents, while 10 years ago was only a significant challenge for 27% of banks, continuing to grow over the past 10 years.
- Earnings are also a significant challenge for 64% of respondents, up from 49% in 2008. This is driven by challenges in noninterest income (significant challenge for 58%) and net interest margins (significant challenge for 54%).
- A significant challenge for credit unions in particular is achieving satisfactory consumer loan volume (68% of credit unions).

## COMPLIANCE

- Respondents indicated that they spend the most time on compliance with mortgage regulations, as indicated by 54% of respondents. This is particularly true for community banks, as only 25% of credit unions indicated mortgage compliance was the most time consuming.
- For community banks, while mortgage regulation compliance is already rated the most time consuming, they expect further increases over the next three years (indicated by 85% of community banks).

- 43% of respondents ranked the Bank Secrecy Act as second most time consuming, while 40% of credit unions rated this as most time consuming. The Bank Secrecy Act was rated most time consuming by community banks in the 2008 and 2004 surveys.
- While deposit account compliance does not require a significant amount of time currently, 75% expect that time to increase over the next three years.
- Senior management and board of directors’ attention to compliance is also expected to increase, as reported by almost 92% of respondents.
- Most respondents are expecting the need to devote more full time equivalent (FTE) employees in the future to compliance activities.
- Not only are more staffing resources expected, 91% of respondents also expect an increase in training expenses and technology software upgrades due to regulatory requirements.

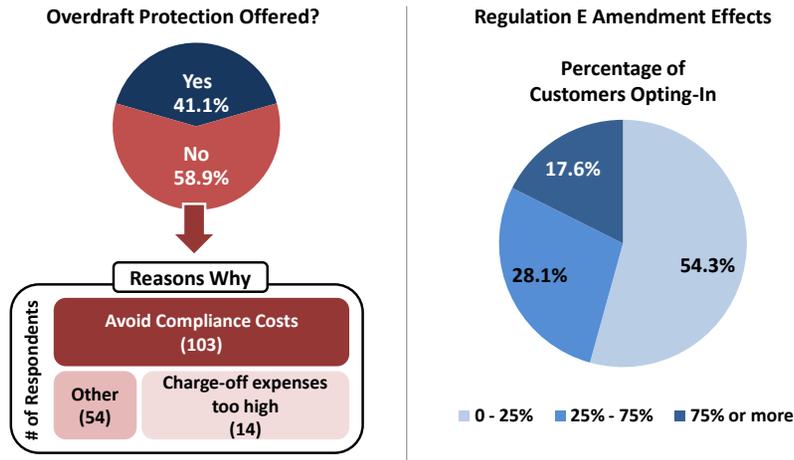
## Regulatory Compliance



# COMMUNITY BANKING CHALLENGES (Continued)

## Overdraft Protection & Regulation E

(Prohibition of Charging Fees for Paying Overdrafts Unless Customers Opt-In)



- Additionally, compliance is the primary reason 59% of the respondents have chosen not to offer overdraft protection.

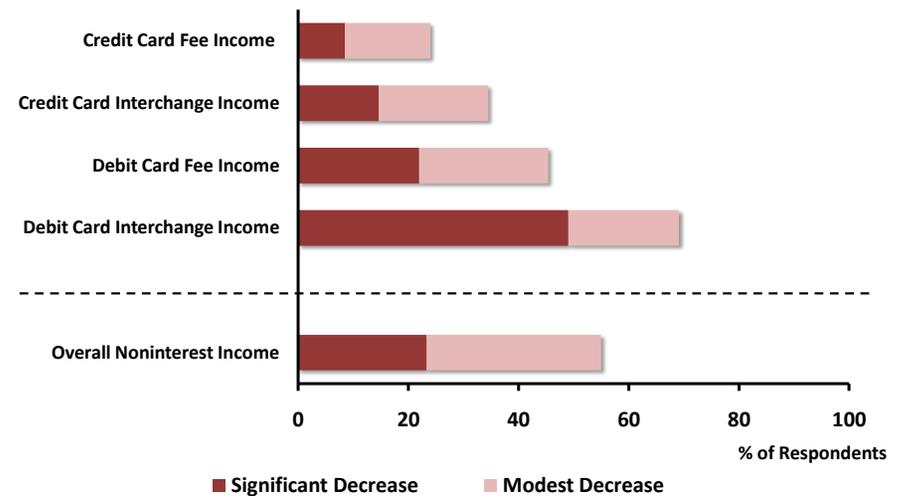
## EARNINGS

- With the amendment to Regulation E, 54% of respondents have experienced an overdraft protection opt-in percentage of less than 25%, resulting in an expected decrease in overall noninterest income specifically due to this amendment (indicated by 58% of respondents).
- 55% of respondents expect overall noninterest income to decline over the next three years. This decline is being driven primarily by a fall in debit card interchange income (69% expect a decrease) and debit card fee income (45% expect a decrease).
- Over half of all respondents, however, foresee no significant change in credit card income over the next three years.
- In order to offset declining debit card income, changes to fee structures will be made, where 61% expect checking account maintenance, overdraft, and per item fees to increase. 44% also anticipate a decline in the proportion of accounts qualifying for free checking.

- Additionally, 41% of respondents believe ATM surcharges will also rise over the next three years.
- 85% of respondents feel that the cost of deposit funding will increase in the next three years, negatively affecting net interest margins.

## Expected Changes in Noninterest Revenue

Over Next Three Years



## Affects of the Repeal of the Prohibition on the Payment of Interest on Commercial Demand Accounts

### Community Banks

- 75% expect businesses to shift deposits to interest bearing demand deposit accounts
- 78% anticipate an increase in interest expenses

### Credit Unions

- 77% feel there will be no significant impact to business demand deposit accounts
- 75% expect little change to overall interest expenses

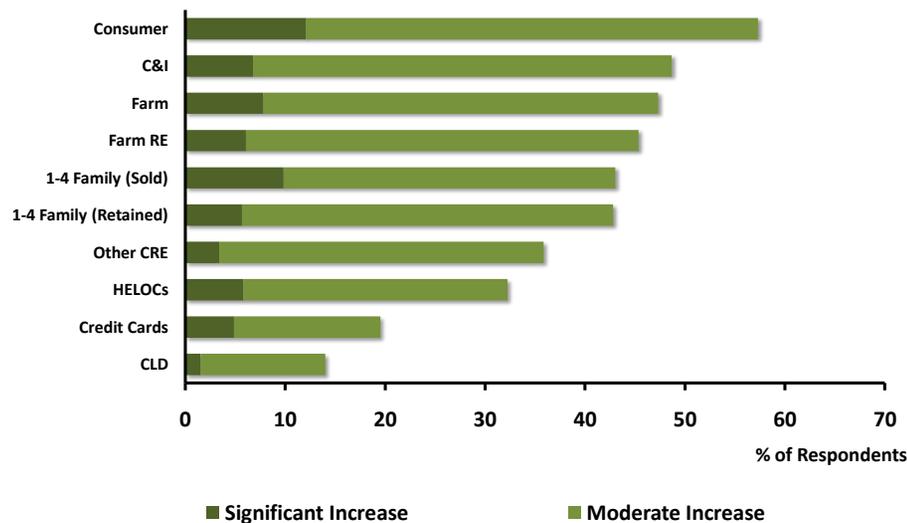
# THE FUTURE OF COMMUNITY DEPOSITORY INSTITUTIONS' BALANCE SHEETS

## ASSETS

- Increasing loans is the main driver for respondents that are seeking to expand operations over the next three years (240 respondents). Increasing deposits followed a distant second, with only about half as many respondents indicating it as a primary driver.
- 42% of respondents anticipate the level of investments (relative to total assets) to increase over the next three years. For community banks, this is driven by growth in agency securities and municipal securities; whereas credit union portfolio growth is expected in agency securities and mortgage-backed securities.

- For community banks that indicated a strategy to increase business lending over the next three years, higher business loan demand in their geographic area is the main driver. This is followed by available deposit funding and expected low demand for other loan types.
- Weak business loan demand in their geographic area is the driving factor for those community banks that do not anticipate increasing business lending (41% indicated this as a highly significant factor). Limited commercial loan expertise and resources is another item impacting their decision to not increase business lending.

**Expected Loan Type Emphasis**  
Over Next Three Years



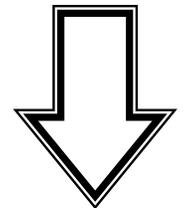
- Over the next three years, there is expected to be an increased emphasis on consumer installment loans for credit unions, and business loans and farm loans for banks.
- Although mortgage compliance is challenging and requires many resources, over 40% of respondents indicated no expected change in emphasis in 1-4 family real estate loans, while another 40% anticipate a significant or moderate increase.

## LIABILITIES



- 53% of community banks expect business demand deposit balances to increase over the next three years, likely driven by the ability to pay interest on commercial demand deposits.
- Over the next three years, 30% of community banks believe retail customers' average demand deposit and average CD balances will increase. This is even greater at credit unions, where about 40% expect retail customers' average demand deposit and average CD balances to increase.

- In contrast, 23% actually feel CD balances are likely to decline over the next three years. This is driven primarily by community banks, as only 16% of credit unions expect a decline in average CD balances.



- Very little change is expected in brokered deposit levels and internet deposits, as reported by 78% and 74% of the respondents, respectively.

# COMMUNITY DEPOSITORY INSTITUTION COMPETITION

- The majority of respondents (75%) indicated more aggressive pricing by existing competitors as a critical factor impacting future competition.

## DEPOSITS

- Over half of the respondents expect deposit competition to increase from larger regional financial institutions, credit unions, community banks, and larger nationwide financial institutions.
- Little change is expected from thrifts.
- 55% of community banks expect deposit competition to increase from community banks, compared to 34% of credit unions.
- For each competitor type, a greater percentage of community banks view deposit competition as increasing when compared to credit union expectations.

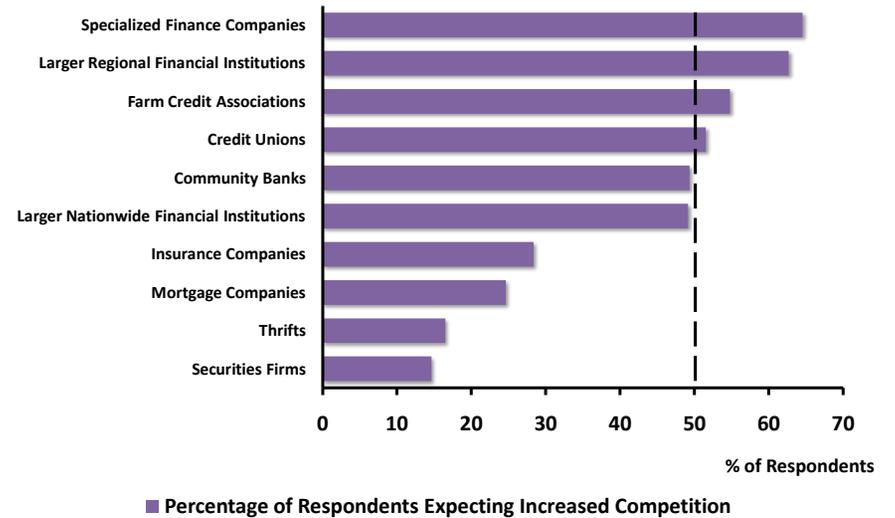
### Deposit Competition Expected to Increase From:

Competitor	Total Respondents		Credit Unions
		Banks	
Larger Regional Financial Institutions	55.3%	59.2%	41.7%
Credit Unions	51.6%	54.2%	43.5%
Larger Nationwide Financial Institutions	50.5%	53.7%	40.8%
Community Banks	50.5%	54.6%	33.8%
Financial Institutions (Online Presence Only)	44.7%	44.9%	40.6%
Insurance Companies	31.0%	33.7%	20.0%
Thrifts	22.1%	24.6%	10.4%

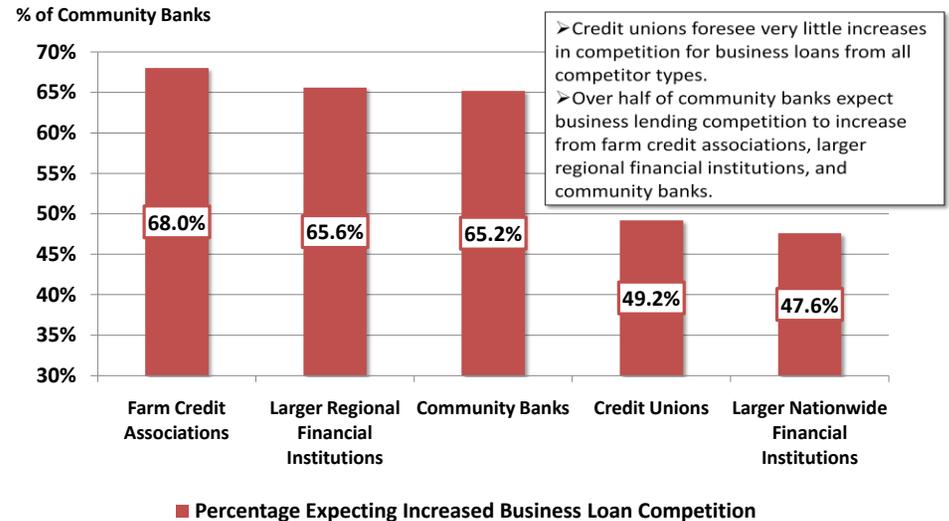
## LOANS

- Over half of the respondents expect loan competition to increase from finance companies specializing in machinery/cars, larger regional financial institutions, farm credit associations, and credit unions
- Little change is expected from securities firms, thrifts, and mortgage companies.
- 71% of community banks anticipate an increase in loan competition from farm credit associations (ranking highest for community banks), compared to only 7% of credit unions. In the 2008 survey, farm credit associations also ranked the highest for community banks.

### Expected Loan Competition Over Next Three Years

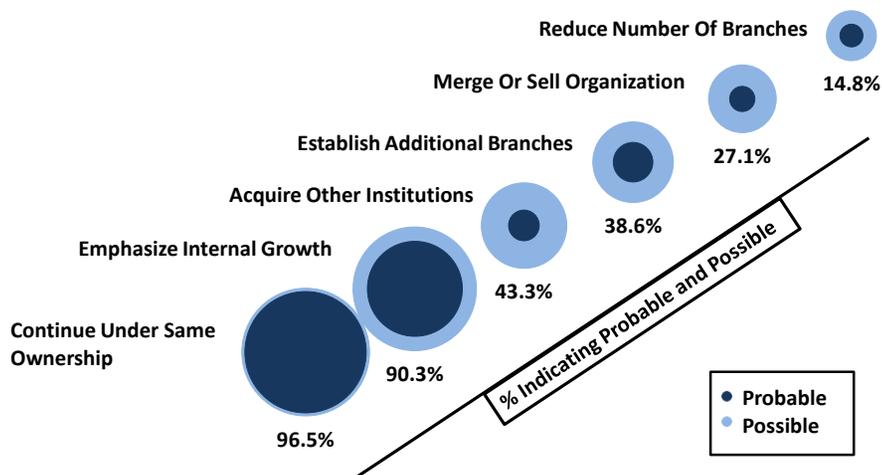


### Expected Business Lending Competition Over Next Three Years (Community Banks Only)



# FUTURE OF COMMUNITY DEPOSITORY INSTITUTIONS

## Strategic Direction Over Next Three Years



- In spite of the challenges, 87% stated that it is probable they will remain under the same ownership and structure during the next three years (with an additional 9% stating that it is at least a possibility).
- 27% of institutions believe it is either possible or probable that they will merge or sell to another organization or ownership group. Of this group, only 4% indicated this is actually probable.

Any questions regarding the survey can be directed to:

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### New products being explored:

- ✓ Mobile banking and mobile payments
- ✓ Email/wireless banking alerts
- ✓ Online loan applications
- ✓ Check deposit by phone
- ✓ Identity theft protection
- ✓ Electronic bill presentment
- ✓ Stored value and/or prepaid cards
- ✓ Person-to-person payments

### Reasons For Optimism As Indicated By Community Banking Institutions

- Advantage in relationship banking
  - Possess a great understanding of their customers and communities
  - Success is tied to their communities, which helps produce loyalty and support
- Superior customer service
  - Capacity to provide personalized services to their customers
  - Ability to service small businesses in their communities
- Business model has been resilient in overcoming past challenges

For the full survey results, please visit the following link on our website: [www.kansascityfed.org/research/bankingandpayments/survey-community-banks.cfm](http://www.kansascityfed.org/research/bankingandpayments/survey-community-banks.cfm)