



**In the Tenth Federal Reserve District
September 2014**

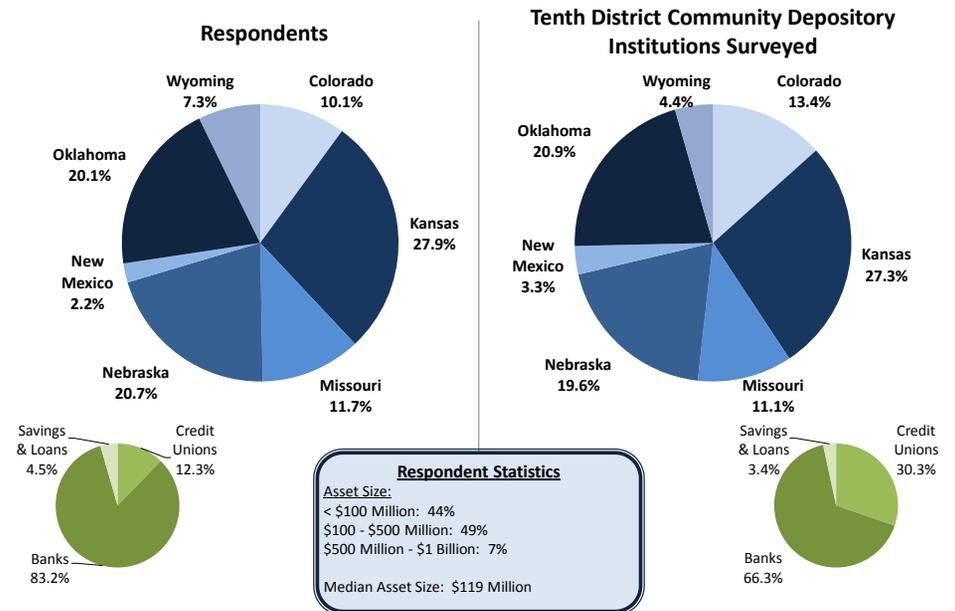
Executive Summary

- Surveys were emailed to community depository institutions (including banks, credit unions, and savings and loans) with assets less than \$1 billion (December 31, 2013) located in the Tenth District.
- Of the 1,071 potential respondents, 179 institutions completed the survey, resulting in a response rate of 16.7 percent.
- Survey respondent characteristics closely align with the characteristics of institutions located in the Tenth District, although the survey does not represent a random sample.

Sections

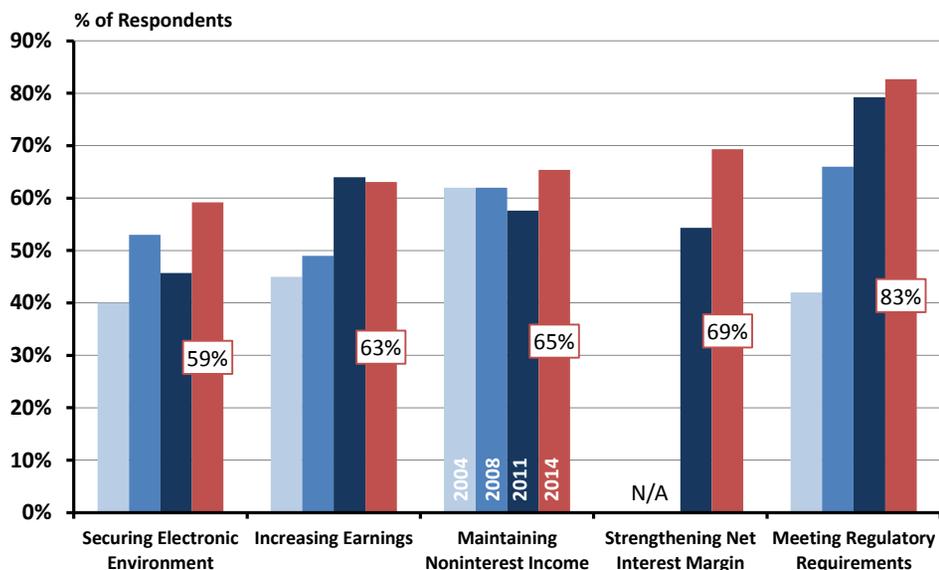
- [I. Community Banking Challenges](#)
- [II. Future of Community Depository Institutions' Balance Sheets](#)
- [III. Competition for Community Depository Institutions](#)
- [IV. Future of Community Depository Institutions](#)

Survey Demographics



COMMUNITY BANKING CHALLENGES

Significant Community Banking Challenges



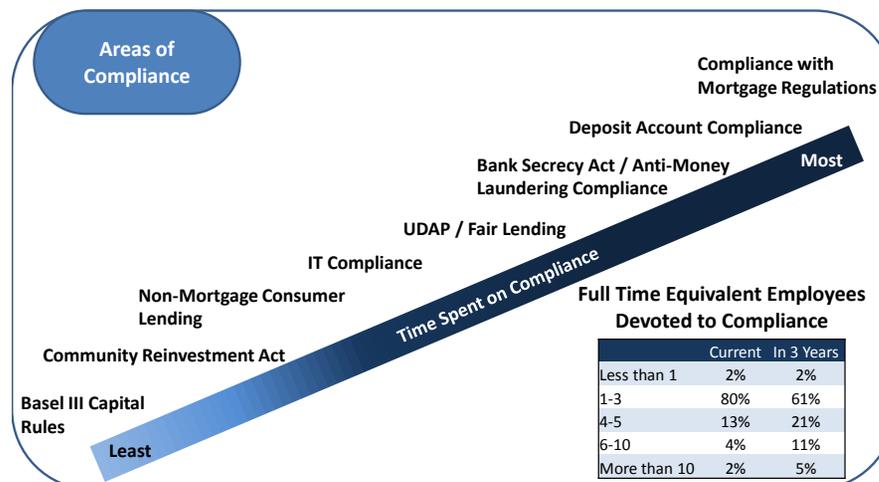
Note: 2004 and 2008 only included banks as respondents

- Meeting regulatory requirements continues to be the most significant challenge as indicated by 83% of respondents, growing over the past decade as only 42% of banks rated it a significant challenge in 2004.
- Regulatory and compliance risk management over the next three years is a significant concern for 77% of respondents.
- Earnings are a significant challenge for 63% of respondents, remaining nearly identical to 2011.
- The challenge in earnings is driven by concerns regarding net interest margins and noninterest income (significant challenge for about two-thirds of respondents). More respondents indicate both net interest margins and noninterest income are a significant challenge when compared to the 2011 survey.
- 59% of respondents indicate securing an electronic environment is a significant challenge, a rise from 46% in 2011.
- Risk management surrounding IT risk over the next three years is the second highest rated risk area (significant concern for 42% of respondents).

COMPLIANCE

- Respondents spend the most time on compliance with mortgage regulations, as indicated by the full time equivalent staff members dedicated to compliance and the overall expenses attributed to compliance activities. This is consistent with the 2011 survey results.
- While mortgage regulation compliance is already rated most expensive and time consuming, the number of full time equivalent staff members dedicated to compliance is expected to increase by 37% over the next three years, while total expenses are expected to rise by 91%.
- Deposit account compliance is the second most time consuming compliance activity and third most expensive. Time spent on deposit account compliance is expected to increase 22% over the next three years.
- Senior management and board of directors' attention to compliance is also expected to increase, as reported by 93% of respondents.
- Not only are more staffing resources expected, almost 90% of respondents also expect an increase in training expenses and technology software upgrades over the next three years.

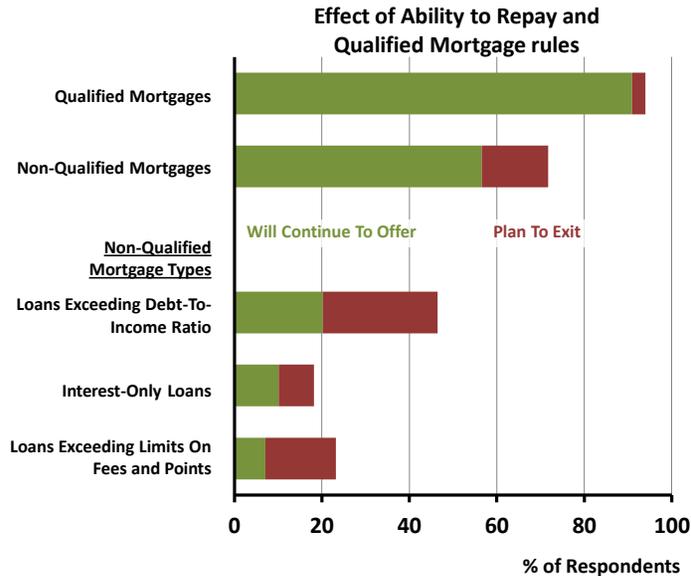
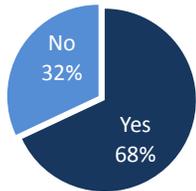
Regulatory Compliance



COMMUNITY BANKING CHALLENGES (Continued)

Impact Of Mortgage Lending Regulations

Is 1-4 Family Mortgage Lending A Significant Business Line?



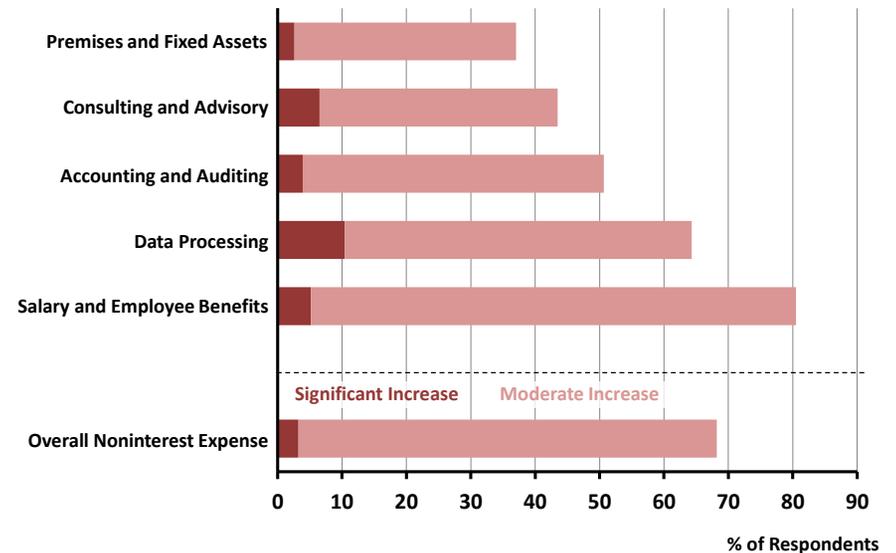
- 68% of respondents indicate 1-4 family mortgage lending is a significant business line for their organization. The Ability to Repay and Qualified Mortgage rules will have little effect on them continuing to offer qualified mortgages over the next three years.
- In contrast, 15% of respondents plan to no longer offer non-qualified mortgages, particularly loans exceeding the debt-to-income ratio (26%) and loans exceeding limits of fees/points (16%), due to the Ability to Repay and Qualified Mortgage rules.

EARNINGS

- Noninterest income is expected to grow over the next three years as indicated by 47% of respondents. The increase in noninterest income is primarily driven by service charges on deposit accounts, debit card fee income, and debit card interchange income.

- Changes to fee structures are also anticipated, where nearly half of all respondents expect checking account maintenance, overdraft, and per item fees to increase over the next three years.
- Over two-thirds of respondents expect overall noninterest expense to increase over the next three years. This increase is being driven primarily by a rise in salaries / employee benefits and data processing (81% and 64% of respondents expect an increase, respectively).

Anticipated Increases To Noninterest Expense Over Next Three Years



- Risk management surrounding interest rate risk is a significant concern for 38% of respondents.
- In order to mitigate the impact of rising interest rates, approximately three-fourths of respondents are currently funding more adjustable rate loans and shortening average lives of new fixed-rate loans / investments.
- 87% of respondents feel that the cost of deposit funding will increase over the next three years, negatively affecting net interest margins.

THE FUTURE OF COMMUNITY DEPOSITORY INSTITUTIONS' BALANCE SHEETS

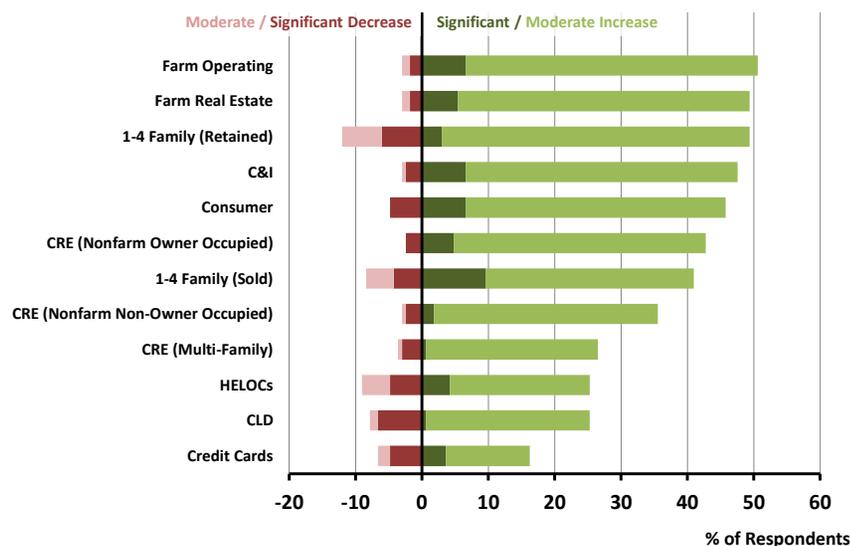
- Overall, increasing loans is the main driver for respondents that are seeking to expand operations over the next three years (132 respondents). Achieving economies of scale followed as a distant second, with 86 respondents indicating it as a primary driver.

INVESTMENTS

- 20% of respondents anticipate the level of investments (relative to total assets) to increase over the next three years, compared to 29% expecting a decrease in the level of investments. The decline in the investment portfolio is expected to be centered in MBS and municipal securities.

LOANS

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



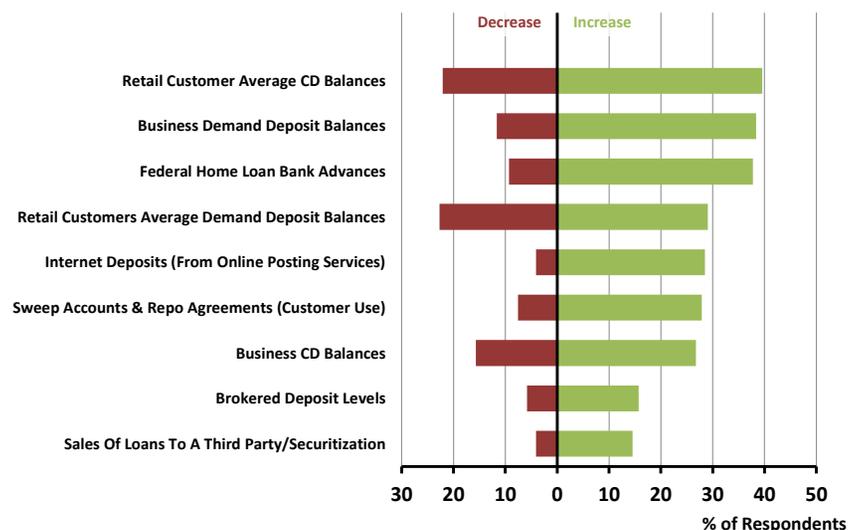
- Over the next three years, about half of all respondents plan on increasing their emphasis in farm loans and 1-4 family residential loans (retained).
- Although mortgage compliance is challenging and requires many resources, only 10% of respondents expect an emphasis decline in their 1-4 family real estate loan portfolio.

- Loan demand in their geographic area is the main driver for respondents planning to either increase or decrease business lending over the next three years.
- The agriculture, professional and business, construction, and retail trade commercial industry sectors make up the top four industry exposures in commercial loan portfolios.

LIABILITIES

- 40% of respondents expect retail customer average CD balances to increase over the next three years. This is followed by expected increases in business demand deposit balances and Federal Home Loan Bank advances.
- Retail customers' average demand deposit balances and CD balances are expected to decline over the next three years, as indicated by over 22% of respondents.
- Very little change in funding is expected in the sales of loans to third parties / securitization and brokered deposit levels.

**Expected Funding Changes
Over Next Three Years**



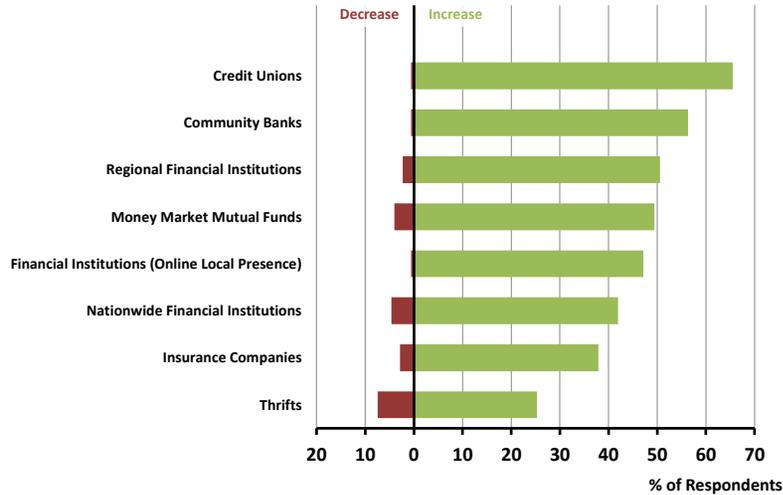
COMPETITION FOR COMMUNITY DEPOSITORY INSTITUTIONS

- More aggressive pricing by existing bank and nonbank competitors is the most critical factor impacting future competition.

DEPOSITS

- Over half of the respondents expect deposit competition to increase from credit unions, community banks, and regional financial institutions over the next three years.

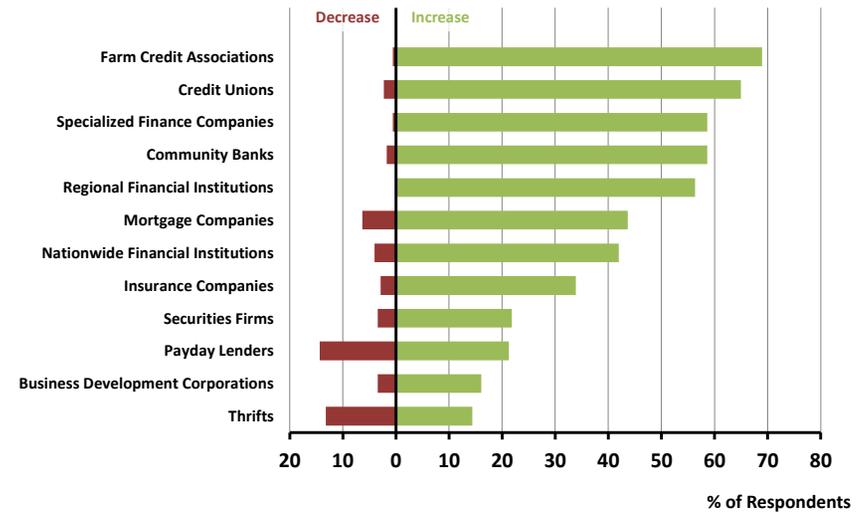
Expected Deposit Competition Over Next Three Years



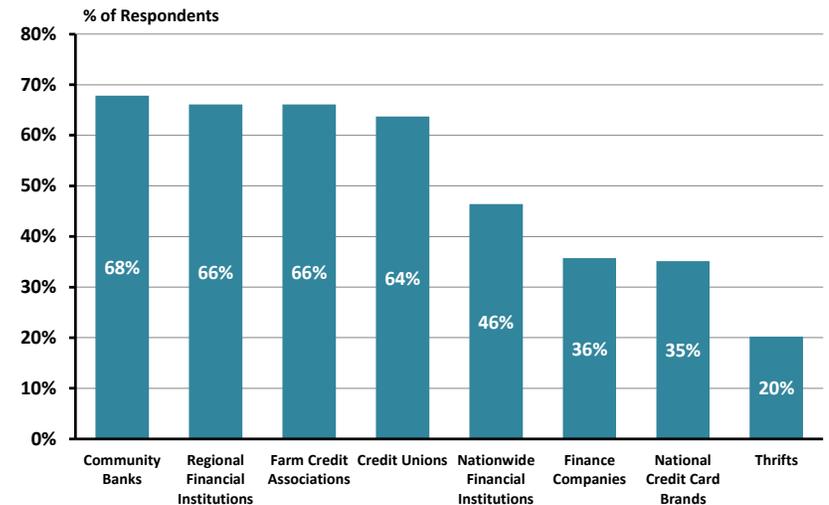
LOANS

- Over half of the respondents expect loan competition to increase from farm credit associations, credit unions, specialized finance companies, community banks, and regional financial institutions.
- Approximately two-thirds of respondents expect business lending competition to increase from community banks, regional financial institutions, farm credit associations, and credit unions.

Expected Loan Competition Over Next Three Years



Expected Business Lending Competition Over Next Three Years

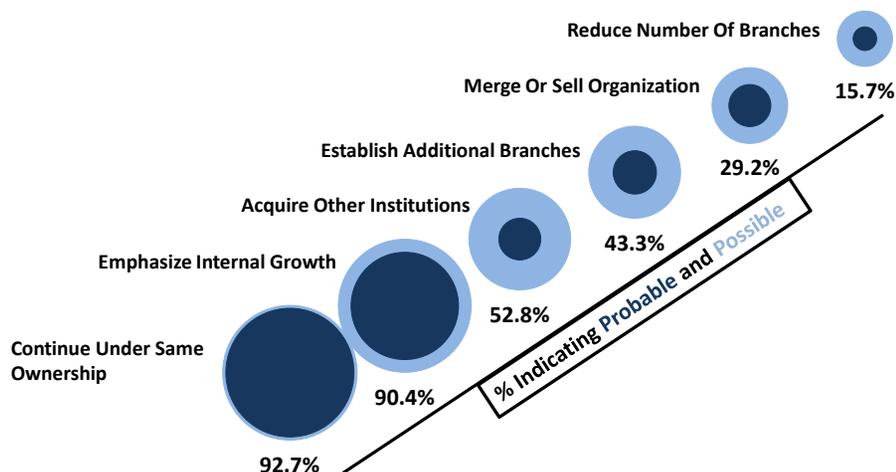


FUTURE OF COMMUNITY DEPOSITORY INSTITUTIONS

Future of Community Banks

Strategic Direction

Over Next Three Years



- In spite of the challenges, 84% of respondents are probable to remain under the same ownership and structure during the next three years (with an additional 8% stating that it is at least a possibility).
- 29% of respondents believe it is either possible or probable that they will merge or sell to another organization or ownership group. Of this group, only 9% indicate this strategy as probable.

Any questions regarding the survey can be directed to:

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New products being explored:

- ✓ Person-to-person payments
- ✓ Identity theft protection
- ✓ Mobile banking
- ✓ Remote deposit capture
- ✓ Mobile payments
- ✓ Email/wireless banking alerts
- ✓ Online loan applications
- ✓ Stored value/prepaid cards

Reasons For Optimism In The Future Of Community Banking

- Relationship banking
 - Understanding of customers and communities
 - Loyalty and support from bank customers
- Superior customer service
 - Can provide personalized service to their customers
 - Provide support for small businesses in their communities
- Resilient business model which has overcome past challenges

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