

Community Banking in the 21st Century

OPPORTUNITIES,
CHALLENGES AND
PERSPECTIVES



SINCE 1902

CONFERENCE OF STATE BANK SUPERVISORS



CENTRAL TO AMERICA'S ECONOMY
STLOUISFED.ORG

Community Banking in the 21st Century

OPPORTUNITIES,
CHALLENGES AND
PERSPECTIVES



CENTRAL TO AMERICA'S ECONOMY™
STLOUISFED.ORG

Acknowledgements:

This publication was made possible by the collaborative efforts of state banking supervisors, community banks, the Conference of State Bank Supervisors and the Federal Reserve System. Town hall meetings with community bankers were held in 28 states from April to July. These meetings would not have been possible without the efforts of the following state banking commissioners and members of their staff:

Arizona

Lauren Kingry, superintendent,
Arizona Department of Financial
Institutions

Arkansas

Candace A. Franks, commissioner,
Arkansas State Bank Department

California

Jan L. Owen, commissioner,
California Department of Business
Oversight

Connecticut

Howard F. Pitkin, commissioner,
Connecticut Department of Banking

Georgia

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

Idaho

Gavin M. Gee, director, Idaho
Department of Finance

Indiana

David H. Mills, director, Indiana
Department of Financial Institutions

Kentucky

Charles A. Vice, commissioner,
Kentucky Department of Financial
Institutions

Maine

Lloyd P. LaFountain, III,
superintendent, Maine Bureau
of Financial Institutions

Maryland

Mark A. Kaufman, commissioner,
Maryland Office of Financial
Regulation

Massachusetts

David J. Cotney, commissioner,
Massachusetts Division of Banks

Mississippi

Jerry T. Wilson, commissioner,
Mississippi Department of Banking
and Consumer Finance

Missouri

Richard J. Weaver, commissioner,
Missouri Division of Finance

Montana

Melanie G. Hall, commissioner,
Montana Division of Banking and
Financial Institutions

Nebraska

John Munn, director, Nebraska
Department of Banking and Finance

New Hampshire

Glenn A. Perlow, commissioner,
New Hampshire State Banking
Department

North Carolina

Ray Grace, commissioner, North
Carolina Office of Commissioner
of Banks

North Dakota

Robert J. Entringer, commissioner,
North Dakota Department of
Financial Institutions

Ohio

Charles J. Dolezal, superintendent,
Ohio Division of Financial
Institutions

Pennsylvania

Glenn E. Moyer, secretary,
Pennsylvania Department
of Banking and Securities

South Dakota

Bret Afdahl, director, South Dakota
Division of Banking

Tennessee

Greg Gonzales, commissioner,
Tennessee Department of Financial
Institutions

Texas

Charles G. Cooper, commissioner,
Texas Department of Banking

Utah

G. Edward Leary, commissioner,
Utah Department of Financial
Institutions

Virginia

E. Joseph Face, Jr., commissioner,
Virginia Bureau of Financial
Institutions

West Virginia

Sara M. Cline, commissioner,
West Virginia Division of
Financial Institutions

Wisconsin

Peter J. Bildsten, secretary, Wisconsin
Department of Financial Institutions

Wyoming

Albert L. Forkner, commissioner,
Wyoming Division of Banking

CONTENTS

Letter from Jerome H. Powell	5
Letter from John W. Ryan	6
Foreword from Charles A. Vice.....	7
Introduction	9
Part I	12
Part II	15
Appendix A.....	21
Appendix B	25
Arizona	27
Arkansas	28
California	29
Connecticut	31
Georgia	33
Idaho	34
Indiana	36
Kentucky.....	38
Maine	41
Maryland	43
Massachusetts	44
Mississippi	45
Missouri	46
Montana	47
Nebraska.....	48
New Hampshire.....	49
North Carolina.....	50
North Dakota.....	51
Ohio	52
Pennsylvania.....	53
South Dakota	55
Tennessee	56
Texas	57
Utah.....	59
Virginia	60
West Virginia	61
Wisconsin.....	63
Wyoming	64

Letter from Jerome H. Powell

Community banks are a critical component of our country's financial system and economy. They creatively meet a diverse array of consumer and commercial credit needs and are important partners in the economic stability of their communities. Over the years, community banks have successfully adapted to changing consumer and business preferences and challenges in local and national economies.

Despite past successes, community banks face considerable challenges in the years ahead. Technology is changing the way consumers interact with their banks and has reoriented consumer expectations around the types of products and services desired. The regulatory environment is also changing, requiring community banks to adjust to new rules. Moreover, community banks face increasing competition from nonbank financial services providers that move the customer interaction outside of the traditional banking system.

It is important to understand the implications of challenges facing community banks. And it is for that reason that the Federal Reserve and Conference of State Bank Supervisors have co-sponsored the research conference titled "Community Banking in the 21st Century" and this related publication. Our goals are simple: to inform discussions among policymakers, to collect unique and innovative practices of successful community banks and to serve as a reference point for future research conferences on this important topic.

I look forward to working together to help identify those factors that will sustain the success of community banks in the years ahead.

Jerome H. Powell

Governor

Federal Reserve Board of Governors

Letter from John W. Ryan

At the start of this conference on the opportunities and challenges facing community banking, I think it is a good time to reflect on the important role that community banking institutions play not only in the daily lives of their customers, but also on the health and stability of the broader national financial system.

As public officials with a local presence, state financial regulators have the opportunity to see the impact banking institutions have on the communities and towns they serve. We get to see firsthand the unique and positive relationships that local banks can have with their customers.

As state financial regulators, we are also keenly aware of the challenges inherent in reconciling local concerns and state regulations within the context of national and global financial markets and oversight. The recent financial crisis sometimes affirmed and often challenged what we think we know about how our financial system works. It renewed discussions about the importance of a diverse banking environment to provide a more stable and resilient financial system, and it highlighted the system's dynamic nature and the push and pull of local, national and global forces.

The financial crisis also showed us how important it is to have public policy that better reflects how the various components of our financial system contribute to the economic life and financial well-being of individuals, businesses large and small, states and localities, and the national economy. And there is much to understand about how financial policy and regulation shapes and impacts all aspects of the financial system.

By conducting new research, collecting better data and compiling more thorough information, our hope is to provide a better basis for future public policy. As public servants, we must strive for better tools to assess how our banking system is meeting the diverse needs of our economy and whether we are achieving our goals of a more stable and resilient financial system.

To do this, we need robust, honest, disciplined research and a willingness to challenge our assumptions.

I hope this conference, the academic research being presented and the feedback state regulators gathered directly from the banking industry during their town hall meetings give us a better understanding of where we are now and where we are going. Moreover, I hope this is the beginning of a more vigorous discussion among academics, researchers and regulators about how our banking system and its regulation can better serve individuals, our local communities and our national interests.

John Ryan

President and CEO

Conference of State Bank Supervisors

Foreword from Charles A. Vice

This inaugural Community Banking in the 21st Century research conference is an important step toward understanding and quantifying the contributions of community banks to the local and national economy. Earlier this year, state financial regulators held town hall meetings around the country to hear from bankers and to understand the current challenges and opportunities they face. It is vital that state and federal regulators thoroughly explore the issues that will impact the future of the community banking business model. Where appropriate, policymakers must be willing to right-size regulations to foster a U.S. banking system as diverse as the communities financial institutions serve.

I was pleased to see the widespread participation from my fellow state financial regulators as we held town hall meetings with bankers over the spring and summer months. Approximately 1,700 bankers from 28 states attended more than 50 meetings. We were varied in our approach: Some held town halls, some met individually with bankers, and others sought feedback through surveys. But we each collected extensive on-the-ground reports from community bankers that serve as the foundation of this publication.

From Maine to the great commonwealth of Kentucky to Arizona, community bankers expressed concern regarding the future of the community banking business model. But they also recognized that there are opportunities well-suited for community banks. Community bankers continue to be innovative in their approach to banking through technology and niche markets. Their deep knowledge of the local communities they serve allows them to build strong relationships with their customers.

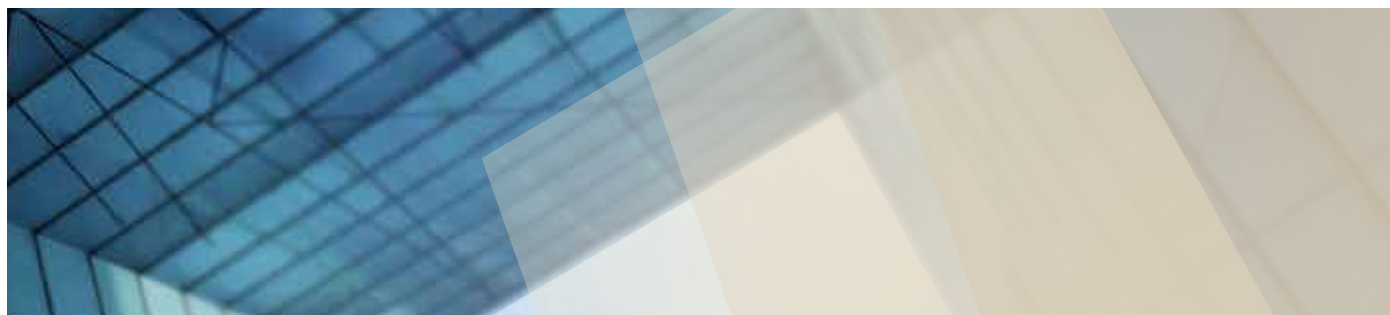
I look forward to the meaningful dialogue and the additional research this report will generate. Through this conference, the participants will seek to better understand the many changes in the economy, markets, demographics and regulatory expectations that will affect the future of community banking in the United States.

Charles A. Vice

Chairman, Conference of State Bank Supervisors

Commissioner, Kentucky Department of Financial Institutions

Introduction



Since the end of financial crisis in 2009 and the subsequent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010, community banks have had to adapt to a new financial and regulatory landscape.

In assessing and understanding the challenges and opportunities this new paradigm presents to community banks, the Federal Reserve, state banking commissioners (working in conjunction with the Conference of State Bank Supervisors) and other federal regulators and academics concluded that research on the community banking industry was relatively thin for an industry so deeply enmeshed in the economies of thousands of communities across the United States. These institutions collectively decided that, given all of the recent changes facing the industry, the time was right both to identify existing academic research on community banking and to motivate future research in that direction.

With more than 6,000 community banks across the country, it is a considerable undertaking to study the industry and understand how it is adapting to changes in technology, regulation, customer preferences and demographic shifts in

the United States. That's why, in addition to organizing a research conference for 2013, it became increasingly important to hear directly from the industry to understand the future viability of the community banking model.

To solicit the views of this diverse industry, state banking commissioners from the majority of states hosted meetings with community bankers in their respective states. While most of the meetings were conducted in a "town hall" format, the approach for engaging community bankers varied from state to state, further underscoring that the community banking regulatory model is as dynamic and varied as the industry itself.

The results of those meetings have been captured and synthesized in this publication. They represent the direct and oftentimes extremely candid views from community bankers in states experiencing different economic and fiscal realities. Some are from states experiencing unprecedented prosperity, while others still continue to feel the aftereffects of the financial crisis.

Part I of this publication presents current and historical community banking data to provide an appropriate context for understanding how the industry has changed over the

past two decades and to help frame discussions on how the industry might be poised to react to future challenges and take advantage of future opportunities.

Part II synthesizes and analyzes, in aggregate, the responses to the questions that community bankers were asked. This section highlights responses common to a majority of community bankers and further highlights unique and innovative responses.

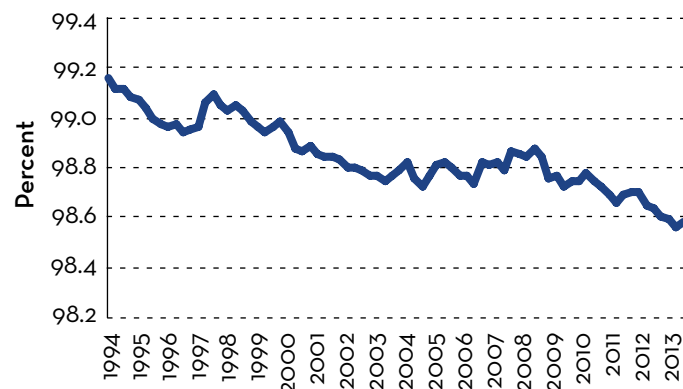
Appendix A lists the town hall meetings and highlights the significant efforts that state commissioners made to ensure they had captured an appropriate range of viewpoints.

Appendix B provides a state-by-state summary of the responses from each town hall meeting. State banking commissioners were asked to synthesize the responses from their meetings and submit a representative summary view.

Part I

FIGURE 1

Percentage of Banks with Assets under \$10 Billion*

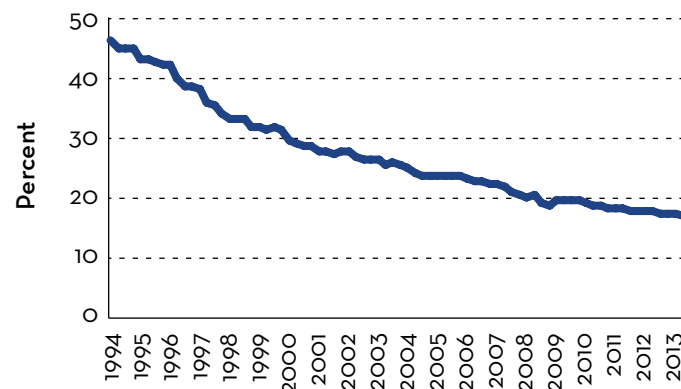


* in 2013 dollars

SOURCE: FFIEC Consolidated Reports of Condition and Income and Federal Reserve Economic Data

FIGURE 2

Percentage of Assets in Banks under \$10 Billion*

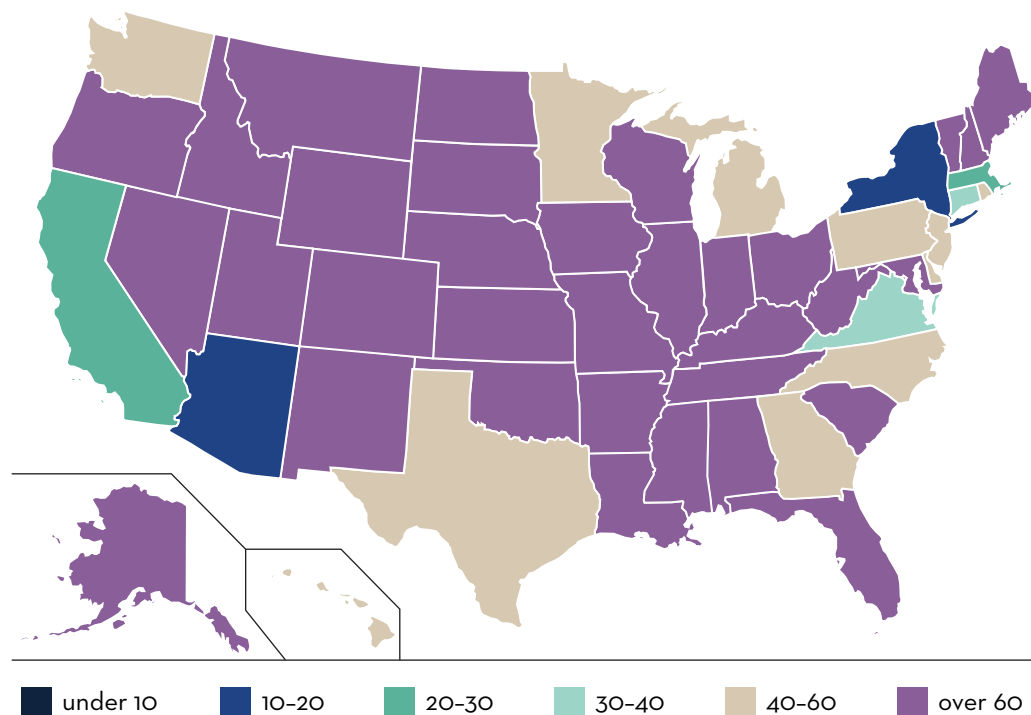


* in 2013 dollars

SOURCE: FFIEC Consolidated Reports of Condition and Income and Federal Reserve Economic Data

FIGURE 3

Percentage of Deposits in Community Bank Branches—June 30, 1994³



SOURCE: FDIC Summary of Deposits

The Demographics of Community Banking¹

The following maps highlight that, since 1994, the share of deposits that have moved outside of community banking institutions has increased steadily. While the shift has been most pronounced in the northeast and western parts of the United States, community banks in the Midwest have not been immune to this trend. These shifts also mirror changes in the number of community banks. Using the Dodd-Frank Act implied definition of community banks—those with less than \$10 billion in total assets—there were more than 10,300 community banks at year-end 1994, but only around 6,000 community banks at year-end 2012.

Figure 1 shows that most banking organizations fall within the size range of community banks and have done so since the early 1990s.² Figure 2 indicates, in contrast, that community banking organizations account for much lower percentages of the assets and deposits of banking organizations in

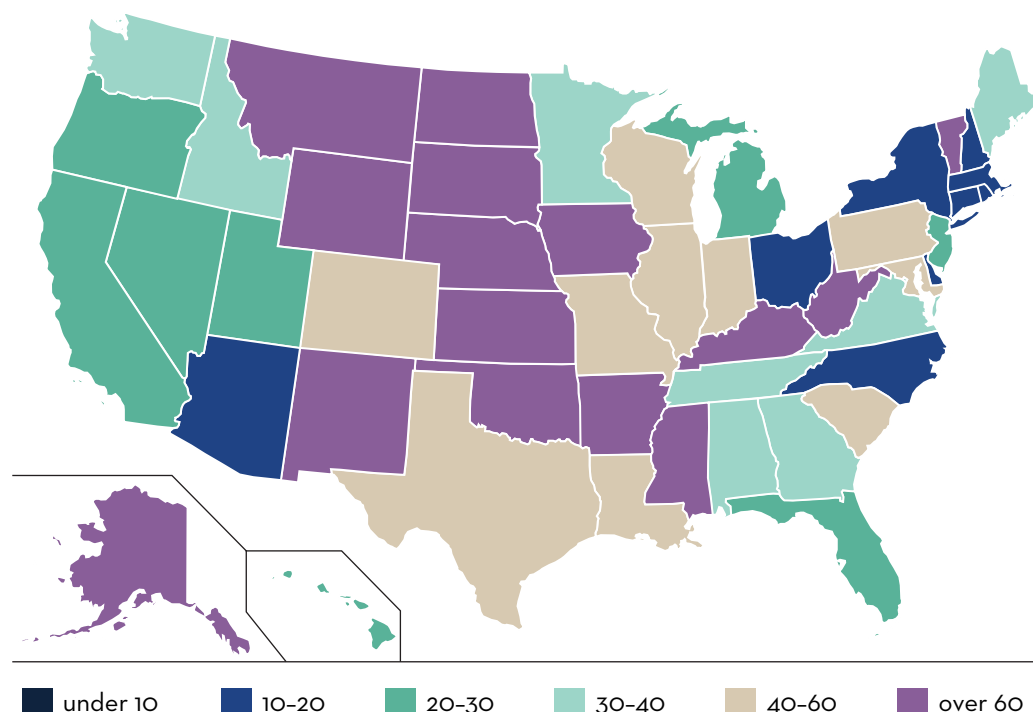
the United States than their share of the number of banking organizations, and that the asset and deposit shares for community banks have been declining since the early 1990s. Figures 3 through 5 present the deposit shares of community banks at the state level in June 1994, June 2003 and June 2012 using the summary of deposits data for deposits by banking office.

Any discussion of the changing demographics of the community bank landscape would be incomplete without also looking at the challenges facing community banks in the wake of the Great Recession. At the end of 2007, there were 7,219 community bank charters in the U.S. By 2009, roughly 12 percent of these institutions were considered “problem banks” as defined by the Federal Deposit Insurance Corp. (Figure 6). Problem assets, largely related to construction and land development lending, overwhelmed many institutions. Figure 7 indicates the distribution by state of the more than 400 bank failures that occurred from 2008 through 2013.

The number of community banks that failed during the financial crisis represents 5.4 percent of the total number of community banks that were in existence prior to the crisis. Since 2007, however, the overall number of community bank charters has declined by 19.2 percent, as community banks that were experiencing a wide range of challenges merged with healthier institutions. As of June 30, there were 5,833 community bank charters remaining in the United States.

FIGURE 4

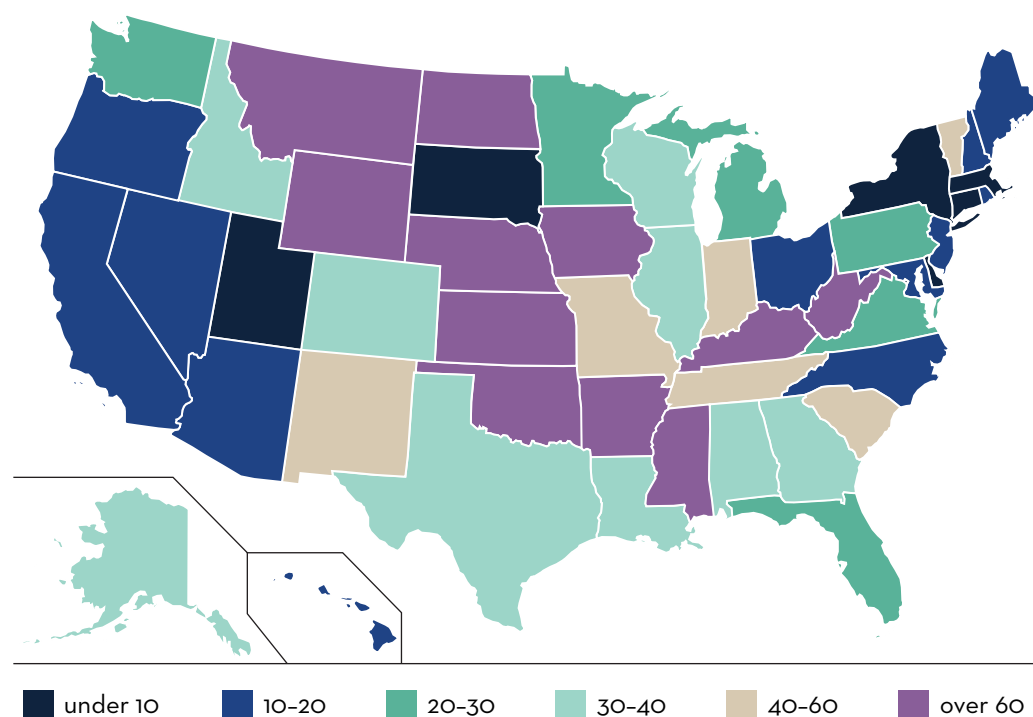
Percentage of Deposits in Community Bank Branches—June 30, 2003



SOURCE: FDIC Summary of Deposits

FIGURE 5

Percentage of Deposits in Community Bank Branches—June 30, 2012



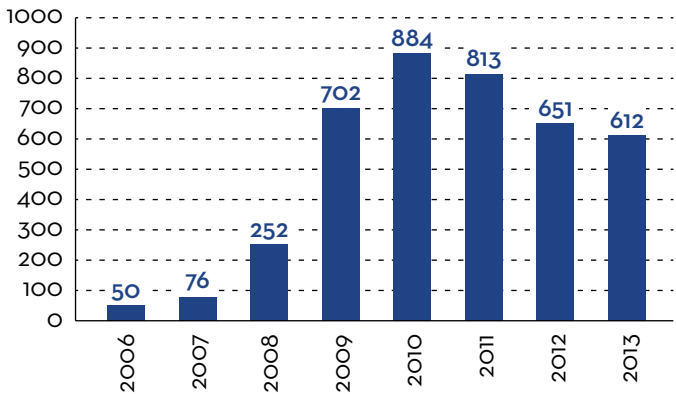
SOURCE: FDIC Summary of Deposits

figures continued on the next page ►

ENDNOTES

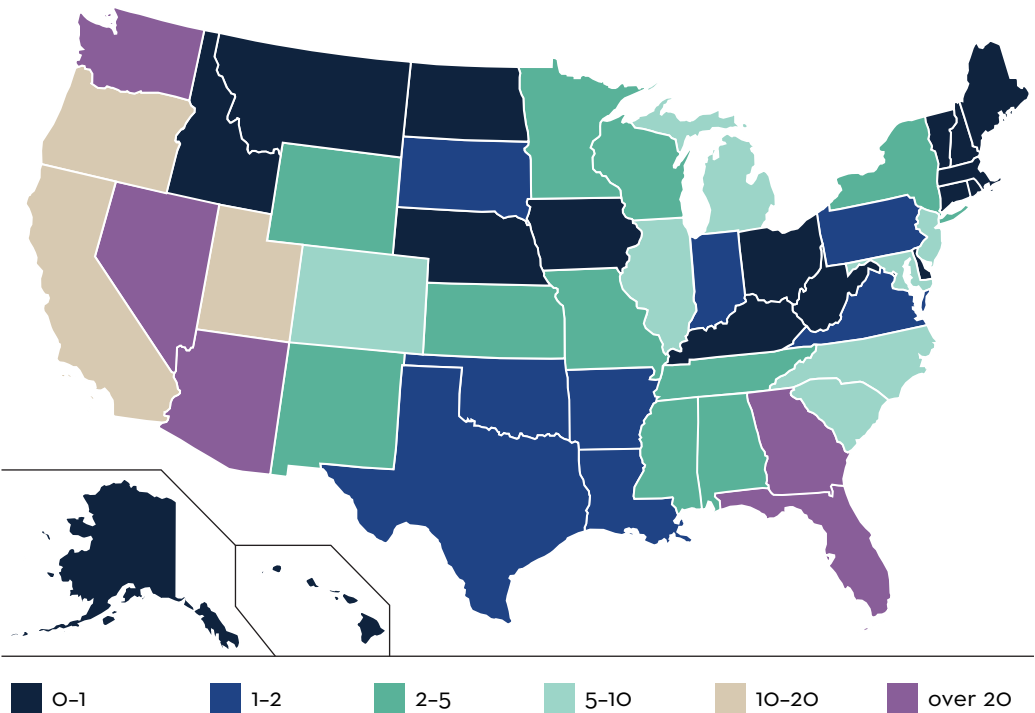
- 1 For purposes of this document, community banks are identified as banking organizations with total assets less than \$10 billion. The FDIC used a different definition of community banks in the *FDIC Community Banking Study* (December 2012).
- 2 The assets and deposits of each bank are consolidated at the level of the parent organization.
- 3 The earliest available year that summary of deposits data is available is 1994. It would have been preferable to have data back to 1992 to capture a full 20-year time horizon.
- 4 Percentages are based on the number of commercial banks in existence as of Dec. 31, 2007.

FIGURE 6
Number of FDIC-Designated Problem Banks
(2006–2013)



SOURCE: FDIC

FIGURE 7
Percentage of Commercial Banks in Each State That Failed (2008–2013)⁴



SOURCE: FDIC Historical Statistics on Banking

Part II

From April through July 2013, bank commissioners from 28 states held town hall meetings with approximately 1,700 community bankers from across the country. The meetings covered a range of issues including: the challenges and opportunities facing community banks at the local and national levels, the changing role of bank management and boards of directors, competition from nonbank financial services providers and the importance of size and scope to the future viability of the community bank model.

The text below summarizes the comments of community bankers at the town hall meetings:

Describe the single greatest opportunity and the single most significant challenge your community bank is experiencing in the markets in which you currently operate.

Describe the single greatest opportunity and the single most significant challenge, at a national level, that could impact the community bank business model.

Opportunities

Some of the most cited opportunities revolved around community banks differentiating themselves from larger banks. Bankers noted several opportunities stemming from individuals and small businesses preferring to work with community banks over larger banks. This includes taking advantage of the deep knowledge community bankers have regarding their service areas, taking advantage of customer frustration over big-bank fees and emphasizing their personalized customer service.

Increased lending opportunities were also mentioned by bankers across the country. Bankers noted that an improving economy provides more lending opportunities, as does capitalizing on the struggles of competitors that gave long-term fixed rate loans once interest rates rise and serving areas where mortgage companies left following the recession and where there is a void of competition in general. Bankers also indicated the need to make more Small Business Administration (SBA) loans and become more aggressive

in making residential and commercial real-estate loans.

Customer service is another potential area of focus for community banks. Specifically, bankers cited the need to respond more aggressively to customer demands and to leverage technology from third-party vendors. The use of technology could also mean attracting and retaining younger customers.

Among states with high failure rates, an opportunity comes from a return to a “normal” banking market with no competitors operating under shared-loss agreements with the FDIC. Another opportunity applicable to specific states is the ability to help local customers manage additional wealth derived from natural gas exploration and development by energy companies.

Challenges

Regulatory issues were frequently cited as posing significant challenges for community banks. Many bankers felt that the move toward standardized products and a “one-size-fits-all” supervisory approach were taking away one of the strongest advantages of community banks:

the ability to tailor products to fit individualized needs.

One example given was the qualified mortgage rule, with bankers concerned about the legal risk posed by mortgages not conforming to the new standards. These regulations are seen by many community bankers as having the potential to hinder their ability to meet the demand for housing in rural areas.

Bankers also noted increased regulatory scrutiny and costs—with one state saying its banks are spending 10 percent to 15 percent of their net income on compliance costs—and a seeming lack of consistency and certainty of regulations.

Many community bankers discussed increased competition being a challenge. There is concern that customers view “too-big-to-fail” banks as being safer. Also, community banks are seeing strong competition from credit unions, the Farm Credit System and nonbank providers of payment services.

Younger customers present both an opportunity and a challenge. In particular, keeping up with technology, especially technology demanded by younger gen-

erations, is proving to be a challenge. Bankers also expressed concern about continuing to access capital and attracting and retaining qualified employees.

How important are “scale,” or size, and “scope,” or product diversification, to the viability of the community bank business model?

Statements from many states focused on a need for community banks to have sufficient scale to cover regulatory costs. As an example of regulatory costs, some community bankers mentioned that a bank with less than \$300 million in assets has a full-time compliance officer. Bankers noted it is not cost effective for a small institution to employ or contract individuals with necessary compliance expertise. Others felt that size is not the answer to survivability, because regulatory burden only grows with the bank, increasing as the bank reaches certain asset-size thresholds. Community bankers generally emphasized that the size of a bank must be related to the community it serves and give it the capacity to serve that community.

Community bankers in the town hall meetings of the various states expressed a wide range of opinions about the importance of scale:

- Some said there are limits to the value of scale. Many banks with assets less than \$500 million are profitable.
- There is a general feeling that any community bank less than \$1 billion in assets will have great difficulty hiring the appropriate staff to keep up with the regulatory environment.
- Some of the most successful and profitable banks are small in asset size. Larger scale, however, makes compliance costs more feasible.
- Many bankers noted that there is the idea that it

will be difficult to survive long term at less than \$500 million.

- Many community bank executives believe that unless they attain at least \$1 billion in asset size, they will be unable to compete with larger banks.

Many bankers suggested that a minimum scale is necessary for a separation of duties of bank staff. Bankers in several states argued that community banks need to find niches and focus on what they do best to survive.

Comments from several states focused on the influence of technology on the scale of community banks. Customers expect online banking, so banks have to be large enough to offer this service. Community bankers, even those whose banks serve primarily rural customers, feel as though they must offer the same bill pay, mobile banking, ATM, online banking and other commodity banking services offered by the larger, regional banks to retain and increase market share among consumers and younger small-business owners. Many community banks have been successful in expanding into the mobile banking world and attracting the “smartphone” consumer while still retaining robust “brick-and-mortar” operations. Bankers in several states reported that vendors play an important role in helping community banks offer their customers the services they want.

Given the costs that come with regulatory changes

and technology demands from their customers, many community bankers discussed the importance of managing investor expectations regarding returns on bank stock. For smaller institutions, there seemed to be a general belief that owners needed to be willing to accept lower returns, at least in the short term, as community banks adapt to the new regulatory and technology landscape.

What characteristics of bank management and bank boards of directors are important to high performance of a community bank?

Characteristics of Management

Some of the comments focused on recruiting staff to join the management team of community banks. Bank managers with local ties were seen as generally having a longer tenure at their institutions than those who come from outside the community. Many community banks have been successful in recruiting management from some of the larger financial institutions that operate in and around their communities. In general, community bankers who are successful at recruiting talent from larger financial firms cite the fact that community banks allow management teams to make decisions and exercise judgment. The management model at many large, regional banks does not allow for much local decision-making, according to many community bankers.

Some community bankers noted that in the past, bank employees could start as tellers and work their way up to management positions. This dynamic appears to have changed for many community banks, as there is not enough money to retain employees long enough for them to become part of the bank's management team. Another challenge facing senior management is generational: Many community banks cited that younger generations of employees view a "normal" career as one in which an individual has multiple jobs rather than staying at one firm for his

or her entire career. Many bankers highlighted the importance of succession planning, especially given the challenges of recruiting and retaining younger staff.

Smaller community banks also cited their inability to hire staff specialists devoted specifically to certain areas due to the costs they would incur. Within a community bank, the management team needs to be willing and able to undertake a number of tasks, perhaps irrespective of the titles they hold. Due to fewer financial resources, management must have a greater knowledge of all aspects of banking, especially compliance. For bank management, increasing specialization leads to more outsourcing of duties, resulting in less overall breadth on the management team.

Characteristics of the Board

A community bank's board of directors must be independent, have the willingness to challenge the direction of the institution and hold management accountable for its decisions. Boards must also resist the temptation to try to micromanage the day-to-day operations of the bank. While it is important for bank board members to be active in the community, many community bankers suggested that the traditional model has changed from attracting local business leaders who could bring business to the bank to focusing on individuals who understand finance and corporate governance. Directors need

to be an integral part of the risk-management process. They must devote the time needed to understand the bank business model. Two things about the role of the bank director have changed: increased personal liability of board members and higher expertise required in banking and finance.

People who have the time to devote to serving as directors of community banks must be ready, willing and able to learn, think creatively and strategically, and embrace technology. Costly training is required for directors because of evolving regulations. They must be willing to participate in continuing education. Board members must be comfortable with technology because of its pervasive use in the banking industry, including its role in the development and delivery of products and services. Bankers in some states said that it is getting more difficult to find directors who possess the necessary financial skills, willingness to take on the potential liability and desire to meet the ever-expanding commitment of time. One of the responsibilities of board members is to attract younger leaders in the community to serve as board members.

Reports from various states mentioned the following characteristics of board members:

- Good communication skills
- Diverse in abilities and backgrounds
- Realistic in expectations
- Understand the balance between growth and safety

- Awareness of issues and challenges facing community banks
 - An understanding and acceptance of the responsibilities and risk of the position
 - Belief that they are part of the bank
 - Adept at strategic planning
- The following characteristics apply to both management and board members:
- Entrepreneurial spirit
 - Disciplined, adhering to sound lending practices throughout economic cycles
 - Sound business acumen
 - Diverse backgrounds
 - Deep understanding of the markets served
 - Nimbleness and teamwork

Describe the financial services model that you believe can best survive in regions that are experiencing declining population growth and economic decline, and what role financial services providers can play in stabilizing or restarting growth in such regions. Are there any supervisory or regulatory impediments to institutions in those roles?

Most community bankers stated that noncommunity banks are generally not interested in offering banking services in offices located in declining rural areas. The employees and board members of community banks live in the markets they serve and have a stake in seeing that the community is well served. Community banks can provide special project financing in areas with declining economic activity. Some bankers mentioned special project financing through capital campaigns for hospitals, recreation centers, libraries and other public services. Community bankers could also focus on cooperation with each other to offset the additional challenges involved in operating in areas of declining growth and population. Some bankers mentioned the support that the contributions made by charitable foundations, which are run by community bank holding companies, provide to economically challenged communities.

The economic impact of closing a banking office in areas with declining economic activity depends on the availability of alternative banking services nearby. Community bankers noted that branches become closure candidates when their assets are around \$10 million or less. Assuming the area is adequately banked with a branch in a nearby town, the closure of a banking office usually has

less impact than one might initially anticipate.

Suggestions by banks in several states for reversing economic decline would involve government action. Bankers in some states said that community banks can help to bring stability to these areas by providing basic credit support and leveraging their support through programs of the SBA, the U.S. Department of Agriculture and the Federal Home Loan Banks.

Some states have programs to promote economic growth in areas with declining economic activity. However, bankers did express concern that state-level economic and community development offices, particularly those that make loans and provide grants to small businesses, compete directly with community lenders. Bankers feel that state agencies should not be underwriting business loans that the community banks could have closed. Most community bankers expressed, however, that there is a role for state-level engagement in areas of economic decline and suggested that these organizations can be a valuable resource for community banks.

Some bankers suggested that a potential solution would be to create tax incentives for those community banks specifically dedicating resources to communities affected by declining population and deteriorating economic conditions. Some

even suggested that credit unions seemed best prepared to serve declining markets because of the government subsidy they receive in the form of not having to pay federal income taxes.

Banks in several states said that regulations are restricting the ability of community banks to offer services tailored to the needs of individual rural areas experiencing economic decline. The example of this effect cited most frequently involved regulation of residential mortgage lending applied to rural areas, specifically the qualified mortgage exemption from litigation. Some bankers went as far as to say that new regulations on rural housing are directly contributing to the decline of rural America.

Bankers suggested that regulators could provide incentives for banks to stay in small communities by providing relief on capital standards and offering some benefits like those provided to low-income designated credit unions. Banks working in these areas are likely to have a higher risk profile and can be subject to harsher regulatory reviews. Regulatory agencies can assist by following an approach that permits safe but unique loan products customized for the community—without any overlay of heavy regulation—if there is no evidence of abusive practices. Such policies would require innovative regulatory thinking and analysis.

What areas of research, if undertaken, could promote a better understanding of the future of the community bank business model?

Some of the comments from community bankers reflect the view that researchers and policymakers do not understand community banks or their customers. Sample comments articulating this view are listed below:

- “[It would be] beneficial for researchers to communicate with banks to see how they actually operate on a daily basis, to conduct surveys for customer feedback and to study how community banks are actually affected by the regulatory environment.”
- “It would be beneficial for researchers to spend time with community bankers to study how they operate both inside the bank and outside in the local community.”
- “Legislators, policymakers and bureaucrats should also get outside of the Washington, D.C., beltway and spend some time in the rural areas of this country to understand the challenges community banks face at ground level. A general feeling is that people inside the beltway are too reliant upon so-called ‘experts’ or general academic types who conduct research in a vacuum and who never spend real face time with the consumers, businesspeople and community leaders impacted by their decisions.”

Many of the ideas by community banks for research are related to the impact of regulatory burden on community banks:

- Quantify the products eliminated as unintended consequence of regulation
 - Study the effects of the qualified mortgage exemption from litigation on mortgage lending by community banks
 - Test whether consumers actually read and/or understand disclosures
 - Study whether increasing regulations are increasing the percentages of people who do not have bank accounts
 - Examine the impact of restrictions on overdraft fees for checking accounts and interchange fees on the revenue of community banks
 - Evaluate the effects of giving examiners incentives to help community banks find real solutions to current problems within the banking industry
 - Assess and quantify the impact credit unions and the Farm Credit System are having on community banks
- Bankers in some states suggested studies of the local economic impact of community banks. These suggestions included a study of the formation and activities of the community bank foundations and the impact these entities have on the local communities. Several states suggested a study of the impact on a community of losing a community bank.

Some of the suggestions for research would be relevant for the operation of community banks:

- The banking needs for younger bank customers, including the significance of technology for serving these customers
- Important factors for the success of high-performing community banks
- Ways to lower costs of capital for community banks
- Ways to successfully execute interest rate swaps for longer-term loans that are not prohibitively expensive
- Alternative banking services that might best serve smaller markets
- The opportunities created by a “shared-services” model for small community banks

Additionally, some community bankers suggested bringing back the Federal Reserve’s Functional Cost Analysis, while others appreciated the focus on the importance of community banks in small business lending highlighted within the FDIC’s Community Bank Study.

How has competition from nonbank financial institutions—on both the lending and funding sides—changed in the post-crisis environment?

Bankers in several states noted less competition from mortgage brokers than before the financial crisis, although some states report a recent increase in competition from mortgage brokers. Comments of the bankers focused a great deal on competition from credit unions, which are posing greater competition in commercial and mortgage lending.

In addition, community bankers see greater competition from the Farm Credit System. Nonbank financial institutions are more aggressive in promoting payments services: In

particular, bankers mentioned Wal-Mart, Yahoo, Google Wallet, Amazon Payments, PayPal and Square. Bankers in some states reported more competition from retail stores, brokerage companies, insurance companies, grain elevators, seed dealers and finance companies. One bank cited Quicken Loans as a competitor. Bankers in some states concluded that the regulation of banks is pushing some customers to payday lenders.

Leaders of community banks reported concerns about competition from large banks that are now

seeking earning assets from community banking markets. Funding side competition has decreased since the financial crisis, but some community bankers mentioned that bank customers are looking for higher yields than they receive on bank deposits. Community bank leaders mentioned more competition from banks without branch networks, such as Ally Bank. Large banks are offering consumers high credit card limits, which are decreasing consumer loan demand at community banks.

Appendix A

From April to July, state banking commissioners from 28 states held 51 meetings and spoke with more than 1,700 community bankers. Some held traditional town hall meetings, some met individually with bankers, and others sought feedback through surveys and followed up with phone calls to individual bankers. Community bankers from across the country were asked the same seven questions. The table below lists the dates and locations for each meeting. Appendix B provides the individual responses from each state as compiled and reported by the banking commissioner from that state.

	TOWN HALL EVENT	PARTICIPATION
Arizona	submitted survey—April 11	11 surveys
Arkansas	submitted survey—May 13	21 surveys
California	submitted survey—May 9	66 surveys
Connecticut	Hartford—June 4	16 attendees
	Hartford—June 7	19 attendees
Georgia	submitted survey—month of June	18 surveys
Idaho	Coeur d'Alene—June 25	5 attendees
	Boise—June 26	6 attendees
	Idaho Falls—June 28	5 attendees
Indiana	Indianapolis—May 30	35 attendees
Kentucky	Frankfort—June 4	16 attendees
	Dawson Springs—June 13	18 attendees
	London—June 25	13 attendees
Maine	multiple bank visits, various locations—May 29 through July 18	17 attendees
Maryland	Maryland Banker Assoc. Meeting—June 4	15 attendees
Massachusetts	Marlborough—May 15	67 attendees
Mississippi	Jackson—May 9	12 attendees
Missouri	Lake Ozark—May 15	120 attendees
	Branson—June 13	130 attendees
Montana	Missoula—April 26	6 attendees
	Glasgow—May 3	5 attendees
	Billings—May 9	5 attendees
	Helena—May 29	12 attendees
	submitted survey—April through May	31 surveys
Nebraska	submitted survey—July 31	13 surveys

continued on the next page ►

	TOWN HALL EVENT	PARTICIPATION
New Hampshire	Concord —June 23	75 attendees
North Carolina	submitted survey—May 9	19 surveys
North Dakota	Williston —May 9	25 attendees
Ohio	Columbus —June 6	99 attendees
	Columbus —June 6	93 attendees
Pennsylvania	multiple bank visits, various locations— March through July	100+ attendees
South Dakota	Aberdeen —May 13	7 attendees
	Sioux Falls —May 14	8 attendees
	Mitchell —May 14	7 attendees
	Pierre —May 15	9 attendees
	Rapid City —May 15	2 attendees
	submitted survey—May 13-15	27 surveys
Tennessee	Washington, D.C. —May 8	60 attendees
Texas	Lubbock —May 29	44 attendees
	Dallas —May 30	39 attendees
	San Antonio —June 11	53 attendees
	Houston —June 12	34 attendees
	submitted survey—April 17	107 surveys
Utah	Salt Lake City —May 29	8 attendees
Virginia	Richmond —April 26	35 attendees
West Virginia	Roanoke —June 6	14 attendees
Wisconsin	Madison —May 1	27 attendees
	Eau Claire —June 25	20 attendees
	Oshkosh —June 4	19 attendees
	Oconomowoc —June 11	27 attendees
Wyoming	Casper —April 11	60 attendees

Arizona

KEY POINTS

Community banks must focus on tailoring their operations to their specific markets.

Size is important, but serving the needs of the community is more important.



Greatest Local Opportunities and Challenges

The greatest opportunity for community banks involves the ability to fund loans in their local communities. Community banks also have the ability to deepen and broaden relationships with personal and business customers because they want something different than the large national banks, which tend to be inefficient.

The greatest challenges of community banks include the inability to find quality, reasonably priced loans and the perceived protection of the “too-big-to-fail” competition, which creates an uneven playing field for community banks.

Greatest National Opportunities and Challenges

There has been very little opportunity for local community banks at the national level. A significant challenge is the increase in federal regulatory burden. The cost of complying with complex, consistently changing regulation is becoming overwhelming.

Importance of Scale and Scope

Scale and scope are becoming increasingly important. Regulatory burdens are diffi-

cult to cover with small scale and work to eliminate many small banks. However, size, while sometimes beneficial, is not the measure of a successful community bank. The ability to serve the needs of the community is key for success.

Important Characteristics of Bank Management and Boards of Directors

Having an entrepreneurial spirit, maintaining discipline, adhering to sound lending practices throughout economic cycles, showing sound business acumen and having diverse backgrounds and experience are key components to success. Bank boards must have independence and the will to challenge the direction of the institution while maintaining awareness and flexibility to change their approaches. They must also be active in the community.

Serving Regions with Declining Populations and Slow Economic Growth

Successful business models focus on the needs of the community and service to their customers. Community banks must adapt and find new products and services that can assist their operating regions. Profitability can still be found when banks are able to operate with an appropriately sized staff and

deliver the goods and services the community desires. One regulatory impediment to institutions is limiting bank loan exposure to 300 percent of capital.

Competition from Nonbank Institutions

Competition from non-bank financial institutions has increased, but is not posing a significant change in competition. Increased regulation on financial institutions allows more prominent migration away from traditional banks. There is a strong feeling that credit unions are maintaining a strong hold on consumer lending and do not play on a level playing field with community banks.

“Size, while sometimes beneficial, is not the measure of a successful community bank. The ability to serve the needs of the community is key for success.”

Arkansas



KEY POINTS

Regulatory burden makes scale and scope more important for community banks.

Banks can find ways to work together to offset the costs and challenges of working in declining areas.

Greatest Local Opportunities and Challenges

The greatest opportunities for community banks include increasing market share and growth in the bank and providing more opportunity for the bank through management's knowledge of the community. The greatest challenges facing community banks include weak loan demand and margin compression due to prolonged periods of low interest rates.

Greatest National Opportunities and Challenges

The greatest opportunity for community banks at the national level involves capitalizing on new markets and expanding into other areas when smaller banks consolidate or larger banks acquire smaller banks and close operations in smaller communities.

The greatest challenges at the national level include regulatory burdens, increased costs and attracting and retaining employees. Smaller banks can be forced out of smaller areas due to increased regulatory burden or compliance violations, which will lead to a new volume of "unbanked people" in rural areas.

Importance of Scale and Scope

Scale and scope are very important to the survival of the community bank business model. Regulatory burden, government involvement and compliance costs contribute to the need for scale and scope.

Important Characteristics of Bank Management and Boards of Directors

Management and board members need to possess strong knowledge of, and be involved with, the community the bank serves. Also, management and board members

must have a high level of commitment, daily involvement and integrity, and be knowledgeable and experienced in management operations.

Serving Regions with Declining Populations and Slow Economic Growth

Regulatory burdens are greatly impacting the traditional banking financial services model, though there is a general belief that the community banking model is the best option for the specific region. Community banks should focus on working together to offset the challenges of operating in areas of declining growth and population and on improving operating efficiencies to thrive and survive. A suggested model would be a "community bank with big-bank services."

Government regulations are impeding operations specific to the communities in which the bank operates, specifically impeding mortgage lending. Regulations are complex, and ones such as the Dodd-Frank Act are particularly challenging for bank employees and management.

Areas of Research Beneficial to Community Banks

Areas of possible research include the impact of regulatory burden and oversight, and the effects of increasing

costs on community banking. It would also be beneficial for researchers to communicate with banks to see how they actually operate on a daily basis, to conduct surveys for customer feedback and to study how community banks are actually affected by the regulatory environment.

Competition from Nonbank Institutions

Generally, credit unions have an unfair advantage over banks, and nonbank providers, such as brokers and insurance companies, are providing pressure as well. Another concern is the potential and long-term impact of financial services offered online from institutions that will not operate in their communities but attract their customers.

There are not as many issues on the funding side from nonbank financial institutions, but definite competition on the lending side. Major auto companies offer very low or even zero percent rates, which take almost all car loans away from local banks. Also, brokers have increased competition for home-equity loans.

"Community banks should focus on working together to offset the challenges of operating in areas of declining growth and population and on improving operating efficiencies to thrive and survive."

California



KEY POINTS

Community banks are best positioned to help their local areas because it's their home.

Regulatory agencies can help by being logical and cooperative in their oversight.

Greatest Local Opportunities and Challenges

The greatest opportunity comes from the improving economy and real estate markets, which create improved business opportunities in the state. A decrease in new entrants in the community banking sector is leading to opportunities for growth for existing institutions. Other opportunities come from a strong agricultural sector and abundance of low-cost deposits.

While recovery in the real-estate markets benefits community banks, it also presents challenges. Large bank pricing power, coupled with an artificially low interest rate environment, compresses net interest margins and stresses profitability. Large banks compete with community banks for the same customers, and the absence of new loan demand causes both sides to refinance loans by competitors on more favorable terms to the borrower. A general lack of demand for loans (outside of commercial real estate) is a challenge as well.

Overall, there is significant concern about the one-size-fits-all approach to supervision. Bankers' concerns about an increasing regulatory compliance burden, along with regulatory guidelines are restricting and/or vague.

There are also hiring challenges, including retaining and attracting qualified staff and the increased costs of additional employees needed to handle compliance and other regulatory requirements.

Lastly, rapidly changing technology within the industry is both an opportunity and a challenge. Some institutions struggle to keep up with the changes, while others are able to take advantage of trends in technology to help create efficiencies.

Greatest National Opportunities and Challenges

The greatest opportunities at a national level include a strong economic recovery and exemptions from regulatory rules. Also, community banks should carve out their own identities and promote the differentiated service that banks give small businesses. Other opportunities include reduced FDIC insurance costs, deposit growth, favorable legislation and stable real estate values.

The single most significant challenge involves strained resources due to regulatory compliance burden. Other significant challenges include competing with too-big-to-fail banks, a double-dip recession, retaining talent, a stalemate in Congress, increased health care cost

“Community banks are best positioned to serve markets experiencing economic/population decline because they are headquartered within local markets. Employees and board members live in these markets and have a stake in seeing that the community is well served.”

and taxation, and the lack of understanding by examiners.

Importance of Scale and Scope

Scale has significant importance. Due to increasing regulatory burdens, small banks must grow to spread the cost of operations across a larger base. One banker notes that his bank has less than \$300 million in assets but requires a full-time compliance officer. It is difficult to cover compliance expenses without a certain level of earning assets.

There is agreement on the existence of thresholds an institution must pass to remain structurally profitable. Currently, these thresholds are high due to low net interest margin. One banker notes healthy community banks are actively pursuing the purchase

or acquisition of other community banks within their markets to gain scale, add product diversification and attract new customers.

Size plays a large role in an institution's ability to attract and retain talented employees. Employees typically would rather work at a larger organization that can provide better compensation, better benefits and more opportunities for career advancement.

Size and scale, however, may be less important than strategy and execution, plus third parties enable many banks to offer a diverse range of products. Multiple banks are profitable with less than \$500 million in assets. Community banks need to diversify their product offerings and use technology to compete with large

continued on the next page ►

California (cont.)

competitors that benefit from economies of scale and are able to diversify more rapidly.

A lack of revenue diversification, which is a problem for many community banks, places greater reliance on an already compressed net interest margin. While diversification is important, it may not always be necessary or prudent to offer the latest or greatest product.

Important Characteristics of Bank Management and Boards of Directors

Important characteristics include trust, humility, compassion, nimbleness, a team-player mindset, focus, discipline and integrity. Additionally and equally important is dedication to the oversight responsibilities of the bank, involvement in the community, a deep understanding of the markets served and the ability to develop and execute viable business strategies.

Serving Regions with Declining Populations and Slow Economic Growth

Community banks are best positioned to serve markets experiencing economic/population decline because they are headquartered within local markets. Employees and board members live in these markets and have a stake in seeing that the community is well served. The health of an individual community bank can be an indicator of the health of the local economy. Banks can help to bring stability to these areas by providing basic credit support, perhaps through government guaranteed loan programs such as

Small Business Administration or U.S. Department of Agriculture loans.

However, banks working in these areas are likely to have a higher risk profile and can be subject to harsher regulatory reviews. Regulatory agencies can assist by recognizing these situations and applying a logical and cooperative approach to supervision of these institutions.

The one-size-fits-all approach hampers a bank's ability to support a troubled community. The high cost of regulation, failure to communicate clear expectations, a lack of understanding of community bank business plans and inconsistent messaging from regulators impedes an institution's ability to survive in these markets. Some argue that regional institutions are best suited to survive given the scale, returns, visibility and flexibility necessary to be profitable, while others argue that credit unions are best prepared to serve declining markets due to the government subsidy they receive in the form of not having to pay taxes.

Additionally, technological innovations could bring cost-effective banking services to areas in decline. Remote deposit capture, virtual ATMs, mobile banking and online banking can increase the reach of an institution and availability for customers in these markets to access banking services.

Lastly, government at all levels could assist by reducing the costs of starting and operating a business in these areas. Banks should be allowed to merge more easily across state lines to allow for

business between banks that generate deposits and loans.

Areas of Research Beneficial to Community Banks

Areas of research include a focus on mergers and acquisition activity, the relationship between capital and earnings assets, community banking services versus the services of global banks, the economic impact of community bank loans, emerging technologies and the financial impact of increased regulation on community banks at each asset size.

Additionally, some suggest research is needed on the evolutionary development timeline on the evolving consumer and business needs, while others note the FDIC has done sufficient research and nothing more is needed.

Competition from Nonbank Institutions

Traditional banking institutions are at a disadvantage because nonbanks and credit unions are subject to less supervision and receive more favorable economic/financial treatment. Credit unions have strayed far from their original purpose to provide consumer-only financing and are now becoming more active in commercial business lending. They also have an unfair tax advantage over community banks, allowing them to underprice on loans and overprice on deposits. These advantages are enhanced in the current low interest rate economy, where loan demand continues to weaken and the importance of keeping costs of funding low is critical to profitability. The operational advantage

gained from not having to pay taxes, coupled with lower capital requirements, make it difficult for banks to compete.

Regulation of nonbank institutions is a positive outcome of the crisis that will lead to more stability in the financial system. Many large nonbank lenders are pulling back from some markets due to increased reputational risks, increased regulatory oversight and exposure. In addition, because there is an influx of deposits, nonbank deposit alternatives have not drawn as much attention as they would if deposit rate sensitivity returns.

One area of concern is that nonbank financial institutions are making a big push into the payments area. This is of concern because there are few places left as new sources of revenue for community banks.

There is a regulatory disconnect between community banks and these competitors. One example of this disconnect is that credit unions do not have to comply with the Community Reinvestment Act (CRA). Additionally, underwriting, pricing and concentration expectations placed on banks by regulators are much more conservative than for credit unions and nonbanks. Community banks are subject to both the regulatory burden and tax burden that these competitors are able to avoid.

One final competition issue is the increased competition from large banks seeking earning assets in traditionally community banking markets.

Connecticut

KEY POINTS

The state's proximity to New York means community banks are competing with the smallest and largest of banks.

Community banks have a large advantage by simply knowing their local markets.



Greatest Local Opportunities and Challenges

The single greatest opportunity for community banks is industry consolidation, which is changing the banking landscape as large banks grow even larger. With interest rates at record lows, community banks are not relying on pricing to gain customers, but on customer service to attract and retain customers. Community banks are well-positioned to benefit from industry consolidation by focusing on local decision making, responsiveness to customers and commitment to and knowledge of the local marketplace.

The single greatest challenge to Connecticut community banks is maintaining pricing discipline within a very competitive market. Connecticut community bankers are competing with banks and nonbank entities that operate within the financial services arena, so differentiating on rates is not an effective strategy. Competitive pricing may give them a short-term boost, but it comes with potential long-term consequences. Community banks are committed to remaining in the market for the long term, so this level of interest rate risk is not amenable to their banking model due to portfolio and geographic concentration.

Greatest National Opportunities and Challenges

At a national level, the single greatest opportunity for community banks is the ability to leverage technology from third-party vendors on a cost-effective basis. This allows community banks to decrease their reliance on extensive branch networks and offer competitive products and services such as mobile banking and remote deposit capture.

The single greatest challenge for community banks is the ability to operate profitably in this protracted low interest rate environment, while being subject to significant regulatory burden and associated costs.

The regulatory impediments and related costs associated with such regulatory proposals as the qualified mortgage rule and Basel III are significant. Community bankers believe the qualified mortgage rule will commoditize them in the one area where community banks have been able to distinguish themselves. The qualified mortgage rule will destroy community banks' ability to provide flexible solutions and work with their customers. Basel III requirements will further constrain banks' lending and growth as it will tie up capital that could be deployed into the market. There are significant unknown

consequences to the banking industry and markets should these rules be implemented as proposed.

Importance of Scale and Scope

The community bank business model is impacted by scale and size. Connecticut's geographic profile, demographic profile and close proximity to New York City has community banks competing against the smallest and the largest banks.

Adding staff in non-revenue-producing positions in response to increased regulatory requirements continues to significantly impact community banks. Increased regulatory and technology costs require banks to reach a certain scale to spread costs. Overall, the community banking industry needs to be large enough to attract capital and maintain vendor interest in developing technology and product solutions that allow community banks to offer a complete array of products and services. Access to capital is critical for the community bank business model.

Additionally, Connecticut has financial institutions that are mutual banks. The boards of these mutual banks are committed to mutuality. They understand the potential growth constraints and limitations on raising capital. Understanding and having

alternative methods for raising capital are especially important for mutual banks. Mutual banks have an access point for capital with trust-preferred instruments. Eliminating this source further limits growth prospects for mutual banks.

Important Characteristics of Bank Management and Boards of Directors

In the current environment, it is difficult to attract and retain bank directors given the increased personal liability assumed with this position. The traditional board of director model has changed from attracting local business leaders who can bring contacts and/or business to the bank to focusing on individuals who understand finance and corporate governance. The board of directors needs to be fully engaged, diversified and composed of financially skilled and/or knowledgeable persons who are committed to the success of the bank and the community.

Board members who have the time to devote to this directorship must be ready, willing and able to learn, think creatively and strategically, and embrace technology. Board members must be comfortable with technology due to its pervasive use in the banking industry, including its role in the development

continued on the next page ►

Connecticut (cont.)

and delivery of products and services. It is important to recruit creative and forward-thinking people who will provide value to the bank. The board of directors should also be periodically evaluated on its effectiveness and have an opportunity to refresh or inject new life into the board as needed.

Bank management needs to be built with a senior team possessing very broad experience. Several community bankers referenced success in recruiting management from some of the larger financial institutions. They are looking for more strategic thinkers and people who can bring new ideas. Smaller community banks cannot afford to devote staff to specific areas. The management team of a community bank needs to be willing and able to undertake a number of tasks, perhaps irrespective of their titles.

Serving Regions with Declining Populations and Slow Economic Growth

Financial service providers play a critical role in stabilizing the economy through the financial crisis and restarting growth. Community banks help Connecticut, which is experiencing economic and population growth decline, weather the crisis through continued lending. While larger institutions retreat from lending, community banks embedded within their respective communities lend to their customers.

Bankers are particularly concerned with competition from the Connecticut Department of Economic and Community Development (DECD), an agency

that makes loans and provides grants to small businesses. Bankers feel that this agency is underwriting business that community banks could have closed. Bankers believe strongly that the DECD should not be making loans or issuing grants, but rather should be issuing some form of guarantee and partnering with the local community banks. Such partnerships would allow the DECD to more effectively leverage its capital and thus provide greater economic stimulus.

Supervisory and regulatory impediments are one of the largest problems facing the community banks as they make loans and stimulate the economy. Rules are inconsistent, and regulators demonstrate a bias toward the largest of institutions. Regulators should be urged to use common sense in their approach to regulations, which is something community bankers are not seeing.

Bankers note an inconsistency between the regulatory agency office staff and their field examiners in the implementation of examination procedures and application of regulations. They believe community banks should be allowed to operate with less capital than the largest, most complex national institutions.

Assuming a fair and level supervisory and regulatory infrastructure, the financial services model that can best survive in the market is the community bank model. Community banks are engaged in the community and serve as an engine for economic growth. They want local businesses to do well and thrive, as they have a clear stake in their

community. It is uncertain if the larger, out-of-territory banks have an interest in the local community.

Areas of Research Beneficial to Community Banks

Areas of research include the implications of not having community banks, common factors of high-performing community banks, state programs and tax incentives that promote community banking, and the impact community bank foundations have on the local communities.

If there was a true understanding of the community bank model, community banks would not be lumped together with the larger complex banks and regulated to the same degree because of the mistakes of large banks. How do community banks get this in front of the legislators, both locally and in Washington? It is critical that the legislators understand what a true community bank is and the significant history and impact they make in the economy, both across the nation and locally here in Connecticut.

Competition from Nonbank Institutions

The competition from nonbank financial institutions has changed significantly within the post-crisis environment. The exodus of a majority of the pre-crisis nonbank entities within the mortgage arena provides an opportunity for banks to re-establish their position within the mortgage market.

While technology benefits community bankers and their ability to compete with national banks, it is also facil-

itating the entry of nonbank institutions into the market, which impacts lending and funding. As an example, Quicken Loans was identified as one of the largest residential mortgage lenders in Hartford County.

The expected introduction of payment system alternatives from companies such as Yahoo, Google and Wal-Mart could result in the disintermediation of banks from the payment system.

Bankers feel they are at a competitive disadvantage by credit unions' tax-exempt status. Credit unions continue to offer higher CD rates and lower loan rates, due in large part to their tax exemption.

While the Consumer Financial Protection Bureau (CFPB) should be leveling the playing field, community banks are not seeing this. The CFPB needs to step up its examinations of larger national and nonbank financial institutions and address entities within the shadow-banking industry. This needs to be done through a balanced approach that does not further restrict community banks from lending and attracting deposits within their respective communities.

For example, there is an opportunity for community banks to undertake expansion within indirect lending with the proper expertise to ensure sound underwriting. However, proposed actions by CFPB in regulating this lending product may cause the exit of sound community banks from offering indirect lending. Again, without a level of common sense, regulators might very well regulate community banks out of business.

Georgia



KEY POINTS

Serving regions in decline means being able to adapt and to serve both commercial and consumer needs.

New regulations have some worried that their banks may be too small to survive.

Greatest Local Opportunities and Challenges

Making agriculture loans is the single greatest opportunity at community banks in Georgia. Other opportunities include maximizing banks' approach to traditional relationship banking, making better use of technology and returning to a "normal" banking market with no competitors operating with shared-loss agreements.

Significant challenges include the time and money required for complying with federal regulations, a decline in rural population, quality loan growth, competition for certain loans and finding new niches diverse enough to replace CRE loans.

Greatest National Opportunities and Challenges

The greatest opportunity lies within the community bank business model itself. The relationship-lending model of community banking institutions fills the void created by larger banks' model-based decision-making. Bankers hope Congress understands that community banks are not like the systemically important financial institutions that caused the financial crisis. Reasonable regulations that are tiered to the size

and complexity of financial institutions will reduce the regulatory burden on community banks and promote stability and growth.

Georgia's community banks face numerous challenges. Georgia bankers worry that their institutions could be too small to survive the costs of implementing new regulations, such as the CFPB's qualified mortgage rule. The high unemployment rate, slow economic recovery and lack of demand for loans are also challenges.

Importance of Scale and Scope

While there is a great importance assigned to scale and scope, the personal service community banks have is where they shine. Scale and size will be relevant to the pace of economic growth and geography.

Important Characteristics of Bank Management and Boards of Directors

It is extremely important for management and board members to be engaged in the communities in which they operate. Management and bank boards need to have a long-term vision that extends beyond the next quarter's call report. Diversification is essential both in board business backgrounds and in portfolio risk manage-

ment. Management and the board must clearly articulate the bank's policies and strategic plan and be fully aware of changing regulatory requirements.

Serving Regions with Declining Populations and Slow Economic Growth

The best model for regions in decline is one that is fluid, far reaching and on the cutting edge of products. It is a one-stop shop for commercial and consumer loans and is adaptable to a changing environment. To stabilize or restart growth in such areas, companies must move there. Regulatory and supervisory mandates are impediments.

Areas of Research Beneficial to Community Banks

Bankers appreciated the focus on the importance of community banks in small-business lending highlighted within the FDIC's Community Bank Study. Future research could seek to quantify the costs of regulatory compliance on both the institutions and consumers.

Competition from Nonbank Institutions

Credit unions and other nonbank institutions are pressing for more freedom to make commercial loans. Other changes include nonbank financial institu-

"The relationship-lending model of community banking institutions fills the void created by larger banks' model-based decision-making."

tions absorbing small-dollar consumer business. Some bankers see the post-crisis environment as more of the same, while others have not seen any affect from non-financial institutions.

Idaho



“Community banks need to find their niche and focus on what they do best.”

KEY POINTS

Regulations are taking away community banks' individual identities.

Community banks need to focus on what they do best and not try to do too many things.

Greatest Local Opportunities and Challenges

The greatest opportunity at the local level is that small businesses prefer doing business with community banks because of their responsiveness and their knowledge of the market and customers. Community banks will be able to gain market share in communities where large banks are closing branches.

With respect to challenges, community banks face competition from irrational competitors offering favorable terms and pricing. Competition from nonbank competitors—particularly credit unions and the Farm Credit System—is increasing. Also, challenges in the payment system—from entities such as PayPal, Bitcoin and third-party card payment processors—impedes a bank's ability to operate effectively. The cost of doing business, in part due to regulation, compliance regulation and technology, is also affecting the community banking model. Other challenges also include attracting and retaining quality personnel, creating a mentor system at the senior-staff level and lacking an adequate political voice.

Greatest National Opportunities and Challenges

The greatest opportunity at the national level will be capitalizing on the struggles of competitors who gave loans at long-term, fixed rates when interest rates eventually rise. This opportunity is limited in the near-term time horizon, given current Federal Reserve policy.

The most significant challenges at the national level include the prolonged flat interest rate environment and impending Basel III requirements. The regulatory environment appears to be commoditizing community banks, “taking away their individual identity and making them look all the same.” Regulators try to eliminate risk rather than allowing bankers to manage risk.

Also, the regulatory environment is becoming “hostile” to community banks, and there is a need to differentiate between big banks and community banks when enacting regulation, as community banks must comply with and pay costs associated with regulation written for big banks. Regulation prevents banks from helping customers, making it almost impossible to make consumer loans. This is driving consumers to predatory lenders, which is an unintended consequence of consumer protection laws.

Community banks can only be profitable if they can control costs, and this is becoming increasingly difficult given current and proposed regulations. Inconsistent interpretation and application of regulation increases cost, and there should be a greater effort toward coordination among federal regulators before rules are issued to allow consistent application of rules. There is also a general feeling that regulation tries to fix things after the market has already solved the problem.

Importance of Scale and Scope

Scale is critical to survival and is required to drive down the cost of regulatory compliance. If regulation applies regardless of size, banks need to be larger. The expectation is that technology needs to be at the same level for small and large banks. This expectation requires community banks to be able to compete and is critical to attracting and retaining qualified staff.

Regulation is driving too much uniformity and prohibiting banks the ability to diversify. There is too much compliance risk on some new products, and community banks' reluctance to innovate with products for fear of unknown regulatory implication or inheriting regulatory risks is impeding operations.

Idaho (cont.)

Product diversification may not be critical, as banks are focusing on their strengths. Community banks need to find their niche and focus on what they do best.

Important Characteristics of Bank Management and Boards of Directors

Strong management characteristics include embracing change, having leadership experience, being proactive and earning and sharing respect and trust with the board. Senior management must also have the ability to develop strong, cohesive, respectful teams, promote integrity and honesty from other team members, have transparency, and be problem solvers. Bank management must also have the ability to make tough decisions that may not be popular.

Board members must challenge management and hold them accountable without micromanaging and also be involved in the community to promote and develop business for the bank. Board members need to be active and engaged with a variety of opinions, have a strategic direction for the institution, be adaptable and embrace change. Board members should also have good communication skills, abilities and backgrounds; have realistic expectations; understand the balance between growth and safety; be aware of issues and challenges facing community banks; understand responsibilities and accept the risk of their position; and believe they are part of the bank.

Serving Regions with Declining Populations and Slow Economic Growth

A financial service provider has to cut and contain costs to do business in an area of economic and population decline. Thus, the community banking model is a difficult business model from a growth and profitability perspective. Community banks are financially limited to control costs, but need to provide local services such as agricultural loans. There is a general feeling that community banks should not “try to be too many things to too few people.”

The best model to serve challenged regions is the traditional community bank model—with local shareholders and board members—of taking in local deposits and making local loans. Regulators could provide incentive for banks to stay in small communities, perhaps providing relief on capital standards and some benefits like those provided to low-income designated credit unions.

Areas of Research Beneficial to Community Banks

One area of research would be the benefits to the community through an increase in loans, charitable contributions and community service by employees. Other areas of research include the cost of regulatory compliance, the models for high-performing banks of different sizes and locations, the effects of tiered regulation, strategic differences between community banks and large banks, an examination of ways to lower costs of capital and

the products eliminated as unintended consequence of regulation.

Competition from Nonbank Institutions

Irrational pricing, not reflective of underwriting by credit unions, is leading greater competition for business loans. Competition has increased from other payment systems—including Google Wallet and Amazon Payments—which rely on technology and are not regulated to the same extent. Also, the Farm Credit System, peer-to-peer lending and individual private lenders are entities increasing competition. Generally, competition from nonbanks has not changed much post-crisis, but regulation has made it more difficult for banking.

Indiana



“Survival of community banks in regions of declining population is dependent on the banks’ ability to service the unique needs of these local markets.”

KEY POINTS

While size indicates viability, the necessary scale of banks depends on the banking needs of the community.

It is crucial for all bank employees to understand the bank’s business model.

Greatest Local Opportunities and Challenges

One of the greatest opportunities for community banks is the competitive advantage of having an exemplary knowledge of the local market. When properly engaged with the community, a local bank can have a substantial impact on the economic development of the community and local infrastructure. Products offered by banks are tailored to the needs of the local community, particularly when it comes to small business and consumer lending. This ability to customize the structure of banking products promotes relationship banking, while many regional/national banking institutions take more of a transaction-based approach. A reduction in technology costs has afforded community banks the ability to meet the growing service expectations of the local customer base.

Net interest margin compression is the most significant challenge for community banks in the current market. It is difficult to compete for business in this sustained period of low interest rates. This problem is further exacerbated by the uneven playing field resulting from the tax and regulatory advantages afforded to credit unions and the Farm Credit System.

Loan demand is weak, and many smaller communities are lacking population growth. The end result is that institutions are tempted to compromise basic lending tenets to take business away from their competition. From a funding standpoint, community banks are seeing erosion within the traditional deposit structure, as customers are migrating toward the incentives offered by larger institutions for credit card and mobile transactions. In response to aforementioned market challenges, institutions have likely increased interest rate risk. Thus, earnings could be further reduced should market rates start to rise.

While shrinking net interest margins is a large concern among community bankers, the increasing burden from the regulatory and accounting industries is also a growing issue. Concern for the potential of regulatory scrutiny is high, particularly when it comes to underwriting decisions. Also, the increasing volume of regulations adds to overhead, placing further pressure on bank earnings. These regulations favor standardized products, which hinder the ability of community bank management to develop products that fit the needs of the local market. The accounting industry poses a similar

threat, as new accounting guidance has been complex and difficult to implement.

Greatest National Opportunities and Challenges

Improvement in the national economy is starting to yield modest opportunity for community banks, particularly increasing loan growth. While the level of growth desired has been hard to achieve, some banks are seeing value in a strategic merger with another financial institution.

On several levels, staffing is a challenge for community banks. Perception of the banking industry is not favorable, and one consequence is difficulty attracting and retaining talented staff members.

Ensuring that all employees understand the bank’s business model is crucial. Regulatory burden has further increased the demand for staff expertise. Regulations at the national level are written in a manner that is not clear or understandable to bank staff.

Importance of Scale and Scope

Asset size is an indicator of viability, but the necessary scale of an institution is relative to the banking needs of the community. A smaller

Indiana (cont.)

institution can survive if it fits in with the local market and offers the right services.

Some minimum scale is necessary for an institution to achieve effective separation of duties and to have the means to comply with regulatory expectations. Consumer compliance regulations are demanding a higher allocation of staff resources, so the minimum staffing expectation is increasing. Community banks will continue to expand their reliance on technology as a means to mitigate scale concerns.

Important Characteristics of Bank Management and Boards of Directors

Community bankers need to be flexible and adaptable, and directors need to be an integral part of the risk-management process. Directors and management need to jointly understand where risks will be assumed. Members of bank management with local ties tend to have longer tenure. However, diversity within the work team creates strength, especially at the board level.

The age of the CEO is likely an indicator of the bank's potential for sell/merger. Thus, succession planning is important. This is especially notable given that it is becoming harder to recruit and retain younger staff.

Serving Regions with Declining Populations and Slow Economic Growth

Survival of community banks in regions of declining population is dependent on the banks' ability to service the unique needs of these local markets. Regulatory

agencies should be careful not to homogenize banks. A "cookie-cutter" regulatory approach effectively eliminates the ability of community banks to cater to the needs of smaller markets. For example, it is becoming increasingly difficult for banks to originate nonconforming loans to meet the funding needs of a small community borrower. It is necessary that banks leverage the programs offered by entities such as the Small Business Administration and the Federal Home Loan Bank.

Community bankers noted branches become closure candidates when they are around \$10 million in size. Assuming the area is adequately banked with a branch in a nearby town, the closure is usually of less impact than one might initially anticipate. Around 75 percent of the accounts are generally retained.

Areas of Research Beneficial to Community Banks

The importance of banks as part of the community's economic cycle needs to be assessed. Banks support local businesses, which then create jobs, the income from which is then reinvested in the local market. Banks also provide funding for infrastructure that would not otherwise exist. Another area of study would be the impact to the health of a community after the local bank charter is lost.

Bank customers should be studied, specifically how they are impacted by regulations. The impact of regulatory burden should be discussed with customers to determine if regulations are providing the desired effect. If not, it should be determined what

customers really want and/or expect from their bank.

Differences between banks and credit unions should be evaluated, including the difference between the foundational structure between a bank and a credit union to justify differences in regulations. Also, it would be beneficial to evaluate the impact the tax-exempt status of credit unions has on the viability of community banks.

Competition from Nonbank Institutions

On the lending side, there is less competition from captive lenders such as residential mortgage originators, auto finance dealers and payday lenders. However, credit unions are undercutting banks' loan rates. Government-sponsored enterprises—including the Farm Credit System and the Federal Land Bank—are showing evidence of mission creep, and they are taking business from community banks through pricing.

A greater emphasis on technology has brought competition from alternate delivery channels. With regard to funding, customers are now more aware of the FDIC's insurance limitations, and this gives a distinct advantage to the banks perceived to be too big to fail. Credit unions have expanded to steal market share as well through their expansive membership definitions and competitive advantages.

Competition from money-market funds and investment houses shows little change. However, other entities (PayPal, Square, etc.) are gaining access to the payment system to steal market share.

Kentucky



KEY POINTS

Community banks' ability to customize products to meet local needs is being hampered by increasing regulation.

Nonbank institutions have significant advantages that should be addressed so everyone is on a level playing field.

Greatest Local Opportunities and Challenges

One local opportunity for community banks is knowledge of their customer base, enabling banks to be flexible and responsive to customers. In addition, expansion in underserved markets is a potential area for growth. Community banks can rebrand or create niche markets because of their knowledge of the local customer base and their flexibility to respond more quickly than a large bank.

Emerging technologies such as mobile banking allow for new product development and cross-selling, which will attract younger clients who avoid brick-and-mortar facilities. Also, remote deposit capture allows banks without a physical presence in the area to offer services. Local ownership allows community banks to build relationships that create new opportunities for economic and community development. Banking consolidations, cooperatives and outsourcing allow for efficiencies in support operations.

With respect to challenges at the local level, competition is increasing from credit unions, nonbank financial institutions, the Farm Credit System and other nonbanking entities. These organizations have a competitively advantaged business model,

with tax-exemptions or less regulation, which is creating a disadvantage for community banks.

Hiring and retaining qualified staff in rural communities is challenging, especially in the areas of compliance, audit and technology. Attracting new board members is also difficult due to the liability, knowledge and time requirements of the position. This problem is especially concerning given that directors are aging, and a lack of new board members will create a leadership void.

The challenges of high unemployment, weak loan demand, customers with marginal credit histories, compressed margins and shareholder expectations are impossible to balance in the current regulatory environment.

Banks are more aggressive in pricing as a result of limited loan demand and competition for those loans. As a result, profit margins are lower, and the pressure to achieve higher levels of non-interest income has increased. Margin compression, along with the expense and potential loss of revenue from compliance overregulation, places community banks at a distinct disadvantage. Access to capital is limited for community banks.

Employee stress is high due to implementing new regulations and a seemingly

low tolerance for error by regulators. Out of fear, loans are now based on a potential reaction of an examiner. Many customers do not meet the criteria, yet have a history of loan repayment.

Greatest National Opportunities and Challenges

As national banks are moving to homogeneous lending products, community banks have a new opportunity for individualized lending, especially for small businesses. State regulators and community banks can be a stabilizing force due to their inherent interest in the local economy.

The greatest threat to community banks is the crippling regulatory burden imposed because of the improper actions of a few large institutions. These regulations are requiring bankers to take on the responsibilities of federal enforcement agencies. In addition, the excessive cost of regulation in terms of personnel and technology expenses further reduces already tight profit margins, as regulations such as the Dodd-Frank Act and the impending Basel III are further impeding community banks' abilities to operate. The high cost and risk in implementing new banking technologies is economically challenging for the com-

munity bank to justify over a smaller customer base. However, the entire banking model is more dependent on technology.

Further, bankers are making decisions from a defensive posture rather than through strategic planning and are hesitant to introduce new products. Consumers are uncertain how actions taken by Washington will affect their future, making them afraid to borrow. Mortgage disclosures required to meet federal regulations are so complex and lengthy that customers read very little of what they are signing, ultimately hurting the customer.

Some bankers experience difficulty working with federal regulators who are not familiar with or sensitive to local issues, but instead are more focused on unrealistic timeframes for problem resolution and protection of the deposit insurance fund. There seems to be a zero tolerance for error, especially in compliance examinations.

Bankers are increasingly concerned about civil money penalties and think the focus on extending credit in this environment is being done out of compliance concerns rather than the needs of the customer or the safety and soundness of the institution.

Reputational risk has also posed a challenge, as banks have been demonized

Kentucky (cont.)

by government to ensure re-election. This creates an environment where it is more difficult and costly for the consumer to borrow.

Also, low interest rates are impeding a bank's ability to maintain profit margin.

Importance of Scale and Scope

Community banks cannot grow or survive without product diversification, which is needed to compete with the offerings of larger banks and to maintain and grow their customer base. Historically, community banks' competitive advantage was achieved through flexibility. Increased regulation and oversight has removed this flexibility to meet the customers' needs and demand.

The demands of customers (technologically advanced products) and regulators (extensive documentation and precision) require an increase in staff, which will in turn require more income at a time when revenues are diminishing. Additional personnel are needed for back-room operations, compliance, security, technology and legal, and these positions come at a high cost after accounting for training and salaries.

There is a general feeling that community banks less than \$1 billion in assets will have great difficulty hiring the appropriate staff to keep up with the regulatory environment. The need to be larger just to cope with the economic issues is growing. Scale is becoming increasingly important as the overhead necessary to meet the new regulatory requirements will just be forgone profit. Forgone profit will result in

less interested shareholders due to lower return on equity, a smaller market for the stock and greater difficulty raising external capital.

The only way for community banks to save money is in sales and customer service, but cutting back on these services limits growth, since much of this growth stems from customer relations.

Rural communities are different from urban communities in many ways, including the products demanded, the stability of the customer in terms of credit and the availability of documentation. Many are doubtful the community bank business model will be viable in 20 years, as maintaining customer loyalty is a growing problem. Banks must offer mobile banking and deposits, while the brick-and-mortar operations are not as important.

Larger banks have advantages in funding and operating costs, operating with more leverage. Small banks have to truly provide exceptional personal service as a defense against these larger banks. The FDIC allowing nontraditional banks to have charters, along with the inevitable growth of virtual banks, will fundamentally change a community bank's effectiveness in maintaining and relying on core deposit funding. The definition of "core" volatility and dependency measures will have to be liberalized over time to avoid regulatory criticism.

Important Characteristics of Bank Management and Boards of Directors

Bank boards of directors and management should be good risk managers, have

good work ethics, be connected with the community and be knowledgeable and experienced. They should also be visionaries when it comes to ways to retain and increase the customer base.

However, these qualities are difficult to find due to the changing dynamics in the banking industry. Replacing the large number of board directors and staff retiring is challenging due to increased knowledge requirements, responsibilities and liabilities. Directors are no longer chosen for the business they can bring the bank, but the knowledge they can provide. Management must have a greater knowledge of all aspects of banking, especially compliance.

Rural communities have difficulty recruiting and retaining directors and management because of location. Individuals with the skill set required often do not want to live in these communities. Recruiting is more difficult overall because of tarnished public images of "Wall Street" banks, which are difficult to separate from community banks in the public's mind.

Due to evolving regulation and compliance changes, costly training is required, and training should be formalized and overseen by the state, not the federal government. However, trained individuals are often recruited to larger banks with higher salaries. Many community banks lack revenue to provide salaries and benefits required by experienced individuals, and the days of keeping employees long enough for them to become managers are in the past.

Serving Regions with Declining Populations and Slow Economic Growth

To remain competitive with larger financial institutions, community banks must continue offering more personalized products and services to their customers, continuing the community banking model of character-based lending. The ability to develop customized solutions for customers, as opposed to only offering homogeneous products, is one of their biggest advantages.

However, burdensome regulation designed to control the excessive risks accepted by larger and more complex institutions is hindering community banks' ability to operate effectively and personalize the products and services offered. There needs to be less regulatory emphasis on repayment capacity for loans held in the banker's portfolio. There are other factors when making credit decisions on both individual loans and small-business loans.

One helpful model would be a system where banks could share services, such as compliance, audit or Bank Secrecy Act employees. Through technology, they would not have to be in the same geographic region, and three or four banks may be able to share the costs.

Banks must also have a higher level of competence in compliance. Characteristics of a competent officer are highly organized, disciplined, specialized and exceptionally talented. However, these individuals are typically expensive as well.

Online banking and information technology platforms

continued on the next page ►

Kentucky (cont.)

are important for banking younger generations, but banks must work out third-party vendor risk management issues when offering these services.

Community banks must diversify and expand branch locations to get into other markets. It will be important to offset declining markets with expansion in other areas. This may be best aided by finding a niche that can be expanded geographically.

Bankers also note difficulty finding talented people and feel there is a need to begin educating and developing the next generation of bankers. Consumers also need education on using money and banking products responsibly, as well as why they must provide certain documentations because of regulatory requirements.

Banks are not able to effectively use the CRA credit as an economic vehicle because of concerns of expensive fines. Community reinvestment is about bringing products and services to the community not as a handout, but rather as a community banking philosophy. Bankers need to have the expertise on staff to bring grant programs and other sources of funding to stabilize the community. The government could offer training for bankers to become experts in CRA.

An advantage for community banks is effective customer service and knowledge of the community. Bank holding companies should be able to open a finance company so they are able to help the individual customer. There needs to be a focus on core deposits and acceptance of a shrinking balance sheet if quality lending

opportunities are not available. The financial services model for community banks should not have to expand into non-traditional banking products to be able to survive.

For communities or regions to grow, they must have banks willing to take a chance on a new small business or an expanding existing business. However, the current regulatory environment prohibits or disincentives banks from accepting this risk. There is a general feeling that most banks are going to survive, but at a cost to consumers.

Areas of Research Beneficial to Community Banks

It would be beneficial to research the necessity, costs and effectiveness of consumer compliance regulations and the associated paperwork requirements. This research should quantify the regulatory cost of enforcement and costs incurred by banks, which are ultimately passed onto the consumer. Research should also include focused studies and testing to determine whether consumers actually read and/or understand the voluminous amount of disclosures required.

Other beneficial research topics include whether the problems that led to the financial crisis were prevalent in small banks and whether the new regulations are effective. Bankers also note it would be important to determine the ability for the community bank to survive given the regulatory environment.

Competition from Nonbank Institutions

There is a general feeling that traditional financial

institutions are at a competitive disadvantage with nonbank financial institutions and government-backed services caused by an unbalanced regulatory burden and unfair advantages. If uncorrected, the regulatory unbalance would incentivize huge multi-national companies to compete with community banks by offering more and more nonbank products and services, like check-cashing, money transmitting and currency exchange.

Credit unions are providing tougher competition due to their easing membership requirements and their tax advantages. Credit unions can price deposits, loans and other products differently, because they do not operate under the same regulatory framework. They are also expanding into commercial lending, further increasing competition.

The Farm Credit System is becoming more difficult to compete with due to lower funding costs and loans being booked for projects other than agriculture or significantly different than the intended purpose of these entities. The rules for loan types and purposes are too loose and allow for other uses, and banks are forced to take on significant interest rate risk exposure, offering low fixed-rate financing over long terms.

Mortgage and finance companies are still originating 100 percent financed mortgage loans, and banks are at competitive disadvantage because of regulatory loan-to-value guidelines/restrictions. New regulations have not fixed the problem that led to the financial

crisis, and bankers also note challenges with regard to different rules for appraisals.

Large banks are offering consumers high credit-card limits, which is decreasing consumer loan demand at community banks. Insurance companies and conduit lenders act almost as a secondary market lending on the commercial side. They have the ability to offer low fixed-rate loans to low credit-risk commercial customers and sell them on the secondary market. Bankers also note prepaid/stored-value cards, such as the Wal-Mart Bluebird® card or even government payments made on preloaded cards, are being increasingly seen as alternative to checking accounts. These retail stores do not have the restrictions with regard to investing funds.

Payday lenders have fewer rules and no paperwork and are allowed to charge triple-digit percentages, while banks cannot even charge overdraft fees. Banks cannot effectively serve those customers because of compliance or Unfair or Deceptive Acts or Practices issues.

Online lenders such as Quicken Loans offer another source of competition and do not seem to have to do the same due diligence. Also, Ally Bank has lower costs and thus can provide better rates. Federal Home Loan Banks are conducting more audits. Other forms of competition are resulting from online payment methods, such as PayPal.

Maine

KEY POINTS

Any business model can work if it is executed well.

Community banks do not need to offer every product, but need to be competitive in their specific markets.



Greatest Local Opportunities and Challenges

Maine bankers find that the greatest opportunities at the local level include attracting new commercial and residential customers from large national banks. The ability to offer local “personalized” service is important to finding and retaining these new customers. Some bankers noted a growing demand for commercial banking products and for trust services. Other opportunities include filling the gaps left when competitors, such as large national banks, leave a market area. This is true for mortgage lending in market areas vacated by nonbank lenders during the recession. Also, a lack of competition in certain rural communities in Maine benefits community banks in those areas. Some Maine bankers strive to differentiate their bank from others and seek opportunities by branching into new markets within the state.

Challenges at the local level include addressing the generational differences within a bank’s customer base. Different age groups use technology and bank branches in different ways. Technology, with its ability to replace traditional modes of banking, is becoming more important to the younger generation of bank customers. Maine bankers

find it challenging to keep up with the technology that consumers want, while continually enhancing technology to provide data security.

The Maine economy creates other challenges for state bankers. Some bankers pointed out the difficulty of doing business with shrinking net interest margins, coping with current market conditions including some depressed market areas within the state and managing a “one-size-fits-all” regulatory approach to supervision.

Bankers find it challenging to stand out from other banks and credit unions. Many bankers feel the state is overbanked and the only way to grow is to steal business away from the other banks. Some bankers are concerned about the long-term viability of their bank and are worried they might not survive if they only offer traditional banking services. Several observed that it is difficult to grow non-interest income. Some feel migration from certain communities will be necessary to achieve growth in commercial and residential lending.

Maine bankers noted that regulations are excessive and burdensome and that the costs of compliance are becoming too expensive. It was noted that banks spend many hours interpreting and implementing new rules and regulations, driving up costs.

Many bankers noted that there are significant differences between banks in terms of ownership, size, geography and product lines, and feel that bank regulations should reflect these differences. Bankers noted increased operating expenses stemming from the Dodd-Frank Act and from Home Mortgage Disclosure Act reporting.

Greatest National Opportunities and Challenges

The greatest opportunities at the national level include attracting customers from the big banks by providing unique services. Some bankers believe opportunities exist to merge with or acquire other banks.

Bankers find that challenges include the stagnant national economy and a shrinking net interest margin. The management of mortgage pricing is also a challenge. Some also find it difficult and expensive to maintain a team of commercial loan officers. Another challenge at the national level includes responding to the negative stigma of larger national banks.

Bankers noted that the regulatory burden is a challenge at the national level, pointing out the requirements of the Dodd-Frank Act. Banks must heavily rely on third-party vendors to guide them through burdensome com-

pliance regulations. Other challenges were similar to those at the local level and include competing against tax-advantaged credit unions, working with mutual firms, addressing generational changes, competing with online banking and managing technology costs.

Importance of Scale and Scope

Any business model can work if it is executed well. Bankers noted that the business of banking is more difficult for smaller banks. Size provides greater opportunity to develop management and to take on risk. Size and scale may depend on geography

continued on the next page ►

“There will always be small ‘niche’ banks. However, community banks always need to be thinking about growth. If a bank is not growing, it becomes an anchor.”

Maine (cont.)

and competition in the market place. The smaller the banks, the more dependent they are on third-party vendors. It was noted that banks can grow their infrastructure and avoid the use of many third-party vendors. Hiring additional compliance staff does not bring income to the bank, but it is less expensive to have in-house expertise than to outsource.

One banker indicated that there will always be small “niche” banks. However, community banks always need to be thinking about growth. If a bank is not growing, it becomes an anchor. Size matters because of the current cost structure, and growth will be needed in the next five to 10 years.

Some bankers feel it is critical for banks to offer a wide range of services. Other bankers believe that community banks do not need to offer every product, but do need to be competitive in their specific markets. Many banks prefer to offer traditional banking products. They believe diversification is not necessary for success and that customers are not asking for diversification. Some banks offer additional services but are reluctant to offer a select group of products. It was noted that community banks need to pay extra attention to risk as they move outside traditional banking.

Maine bankers indicated that technology is becoming more important, as more transactions are now done electronically as opposed to through the traditional teller line. They also stated that fee income is very important, as banks are always searching for other sources of income.

Important Characteristics of Bank Management and Boards of Directors

Bank management should include an experienced team that has worked through several economic cycles. Other qualities of bank management include engagement, education and passion. Management should believe in the mission of the bank and should live in the market area of the institution. Important characteristics include diversity of talent, extensive training and credit experience. Maine bankers also want management to have a global view and to know how to work with younger employees and recognize their talents. They should also have a good understanding of the markets served by the institution and be personally involved in the community.

Boards should not be a “social club,” but should be a diverse group of individuals with various skill sets. Bankers find that it is important that board members be willing to attend training and/or educational programs and that they are influential and diverse with respect to industry, gender, education and geographic location. Board members should also focus on implementing strategic practices with the expectation that they will bring business to the bank. Board members should also be proactive and not afraid to ask questions.

Serving Regions with Declining Populations and Slow Economic Growth

Maine bankers stated that the business of a community bank helps to sustain and revitalize a community.

Maine bankers assert that community banks are often the centers of rural communities. In that position, they are key lenders to small businesses and play a vital role in lending to consumers. Maine bankers do not believe community banks were the cause of the current foreclosure problem.

Senior management and employees of community banks are very active in their communities, and community banks are often the first place that nonprofit organizations solicit for charitable contributions. These banks also help fund many capital campaigns for hospitals, recreation centers, libraries and other public services, and many have their own charitable foundations.

Community banks also provide good paying jobs to local citizens in the community, as individuals who work at the bank tend to be from the community.

Areas of Research Beneficial to Community Banks

Maine bankers offered a variety of ideas for continued research. There is interest in understanding how banks will best interact with and serve future generations. Bankers also want an evaluation of the effects of competition on community banks from mortgage companies and credit unions. This would include an evaluation of the effects of the tax-exempt status of credit unions on the community banking model. Bankers expressed the view that the exemption gives credit unions an unfair competitive advantage. Some bankers stated further that credit unions should be taxed

and examined for compliance with the CRA. One banker hoped that there would be a review and determination as to the continued value of reporting under the Home Mortgage Disclosure Act.

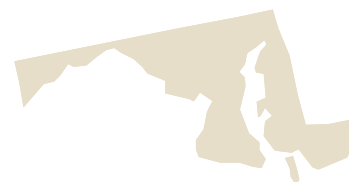
Competition from Nonbank Institutions

Maine bankers noted that they compete with nonbank lenders. Some observed that residential lending competition declined in Maine because the recent recession led to the closure of several mortgage companies. However, it was also noted that such lenders are returning to some, but not all, markets in Maine. Indirect auto lending is an area where banks face strong competition.

Maine bankers observed that there is less competition from nonbank lenders for commercial loans. Large banks remain significant competitors in this area. With respect to competition from credit unions, Maine bankers were divided. Some bankers find that credit unions are significant competitors in their markets, while others do not. Most bankers expressed that credit unions, because they act like banks in areas such as lending, should be held to the same standards as banks. Further, bankers observed that they face major competition from Internet banking.

Finally, some bankers noted that sustained low interest rates are causing bank depositors to slowly migrate back into the stock market.

Maryland



KEY POINTS

Greater size makes compliance costs more feasible, but some of the most profitable banks in the state are small.

Technology is helping some community banks compete with larger institutions.

Greatest Local Opportunities and Challenges

The greatest opportunities at the community level include long-term funding at attractive levels, recovery in the real estate market, leveling the playing field with regulation of nonbank competitors and having a regulator that serves as an advocate.

With respect to the greatest challenges, community bankers are facing weak loan demand and uncertainty around regulations, particularly surrounding Basel III and liability associated with originating non-qualified-mortgage loans.

There are also challenges in managing differences in economic regions, such as the Eastern and Western Shore in Maryland. Banks in struggling economic regions will continue to have difficulty finding business and credit-worthy borrowers. Capital is not flowing to small banks, as investors are hesitant due to uncertainty in the economy.

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is economic recovery. If the recovery were to accelerate, community banks as small-business lenders are well positioned to benefit. The greatest chal-

lenges for community banks are the regulatory uncertainty and rules that allocate capital, and the stretching for yield and excessive rate risk that may increase with the continuation of a sluggish economy.

Importance of Scale and Scope

Size does not determine success, as some of the most successful and profitable banks in the state are small, such as Chesapeake Bank and Bank of Ocean City. Further, larger scale does not necessarily benefit community banks, although this makes compliance costs more feasible.

Technology products are leveling the field, as small banks can leverage large banks ATMs and provide fee rebates. Some community banks have been very successful in accessing the smartphone consumer. Retaining brick-and-mortar operations, while expanding into the mobile banking world, has proven effective for some banks. Size importance is a function of ownership base. Shareholders or owners with patience and conservative practices do not have difficulty maintaining a relatively constant size. If shareholders are invested for growth, they have the ability to encourage acquisition and increased diversification.

Important Characteristics of Bank Management and Boards of Directors

Important characteristics include experience, pragmatism and detailed knowledge and relationships in the markets of their communities. Senior management and board members must also have the ability to adapt, conduct sound planning in the face of uncertainty and embrace new technology to integrate into the bank's business plan.

Serving Regions with Declining Populations and Slow Economic Growth

Community banks find value in places where large banks are not willing or able to capitalize given their size. Restricting products and techniques for finding value and managing risk hinders efforts to provide credits in the corresponding, adversely affected regions. Larger banks will not lend in these regions and community banks will feel pressure to follow as they allocate more resources to compliance. The qualified mortgage rule discourages some of the lending that could be done in these areas. Also, social policy and other government regulations that do not directly involve banking can interfere with economic recovery in these regions.

Areas of Research Beneficial to Community Banks

Areas of research include examining the effects of compliance costs on return on assets and looking at the characteristics of successful, smaller banks.

Competition from Nonbank Institutions

Competition has increased from both direct and branchless banks. Ally Bank, for example, has growth of more than 25 percent a year, which is a big threat to traditional banks relying on core deposits. Person-to-person and bank-to-bank competition has also increased, as these entities have the capacity to drive up the costs of deposits, while their costs will likely always be less expensive than the commercial deposits that community banks rely on for profit. Charles Schwab's branchless bank is an example of this problem. Other threats to community banks also include virtual payments and competition from credit unions.

Massachusetts



KEY POINTS

Technology plays a big role in helping community banks compete.

The one-size-fits-all approach to regulation is a significant burden to community banks.

“One of the greatest opportunities for community banks at a local level is the use of technology as an ‘equalizer,’ including the use of mobile banking and social media.”

Greatest Local Opportunities and Challenges

One of the greatest opportunities for community banks at a local level is the use of technology as an “equalizer,” including the use of mobile banking and social media. Other opportunities include focusing on personal service, commercial lending and real-estate lending.

The greatest challenges for community banks will be legislative and regulatory uncertainty and shrinking margins.

Greatest National Opportunities and Challenges

The greatest opportunities at the national level are recognizing and differentiating community banking, while rebuilding consumer confidence in the banking system. The greatest challenges at the national level are the regulatory burden and its one-size-fits-all approach and the lobbying power of the big banks. Competition from credit unions also threatens the community bank business model.

Importance of Scale and Scope

Scale is important to offset compliance burdens and have access to technology. Scope is less important, though a smaller scope limits

the opportunities for community banks.

Important Characteristics of Bank Management and Boards of Directors

Characteristics of bank management that are important for high performance include bank-wide teamwork, diversity, integrity and accountability. Board members should be engaged, have a unified vision and be mindful of the current environment.

Serving Regions with Declining Populations and Slow Economic Growth

An important aspect within the community banking model is the use of technology to retain customers. Another is identifying and meeting customer needs and the needs of the community. Banks play an important role as they can tailor products to the needs of citizens and businesses within the region. However, impediments to community bank operations include local ordinances (such as mandatory mediation requirements, vacant property bond posting and eminent domain), compliance and qualified mortgage requirements.

Areas of Research Beneficial to Community Banks

One area of research would be the impact of apparent

payments system transformation, including mobile payments and the evolution of the banks’ role. Other areas include the efficient use of derivatives to hedge interest rate risk, the impact of the qualified mortgage rule, and mobile debit-card and credit-card processing.

Competition from Nonbank Institutions

Increased competition for community banks include person-to-person online and payday lending, along with credit unions and their increased commercial lending.

Mississippi



KEY POINTS

Banks should look at sharing arrangements for back-office operations that don't impact service to the customer.

Finding ways to bring in new leaders from other areas is a significant challenge for community banks.

Greatest National Opportunities and Challenges

The greatest opportunities at the national level would be to scale regulation relative to the business model, size and risk of the institution. This allows community banks to differentiate themselves from larger institutions through their strong connections to the community and willingness to customize products and services. There are also opportunities for growth as the economy improves, particularly through strategic consolidation.

At the national level, the greatest challenges include the lack of differentiated regulation of community banks, with resulting associated expenses and the too-big-to-fail problem. Consumer regulations that encourage standardization of products have also been a challenge.

Another challenge is risk associated with the consolidation of charters, as branches may not offer the same support of the community as independent institutions can offer.

Importance of Scale and Scope

Though there is some minimum scale needed, size is important for no other reason than to allow for separation

of duties. However, the cost of regulation could ultimately be a defining factor.

With regards to scope, technology will increase in importance for small community banks as a means of offering an array of products and services.

Important Characteristics of Bank Management and Boards of Directors

Flexibility and adaptability are important characteristics needed in senior management and board members. Managers must have the ability to develop business, monitor and control risks and costs, and focus on asset quality, rather than growth. It is also important to exhibit accountability and have deep connections and understandings of the community. Board members should come from diverse backgrounds and experiences and promote a culture of trust and respect. Further, it is important to have an adequate management succession plan.

Serving Regions with Declining Populations and Slow Economic Growth

It will become necessary for more banks to leverage programs offered by the Small Business Administration, the Federal Home Loan Banks and other organizations. Banks need to investigate cooperative

models that achieve scale in compliance or other back-room operations, but do not impact the service offered to the customer. It will also be important for policymakers to consider a financial services model that permits safe, but unique loan products customized for the community, without any overlay of heavy regulation if there is no evidence of abusive practices.

Areas of Research Beneficial to Community Banks

Areas of research include the costs of compliance, such as direct costs and impact to loan volume, and the impacts of the tax-exempt status of credit unions and the Farm Credit System on the viability of community banks.

Other areas of research include the impact to the health of a community after the area experiences a loss in a bank charter and alternative banking services that might best serve smaller markets.

Competition from Nonbank Institutions

Competition continues to intensify, as government-sponsored enterprises—including the Farm Credit System and the Federal Land Bank—show evidence of mission creep, underpricing community banks. Credit unions remain a serious challenge, and expansive membership

definitions should be culled or the tax-exempt advantage removed. For smaller community banks, competition from mortgage lenders, auto finance dealers and other captive lenders reduces consumer lending opportunities.

“It will also be important for policymakers to consider a financial services model that permits safe, but unique loan products customized for the community, without any overlay of heavy regulation if there is no evidence of abusive practices.”

Missouri



KEY POINTS

Banks need to develop niche markets and move into growing areas.

They should also find ways to share resources and costs that won't hinder competitive operations.

Greatest Local Opportunities and Challenges

The greatest opportunities for community banks include generating relationship banking through long-term associations with local businesses and customers and fostering customer loyalty through active community involvement. Community banks can also establish more divergence in the business model and offer products tailored to customers based on their knowledge of the local market.

The greatest challenges facing community banks include competition from nonbank financial institutions, net interest margin compression, access to capital markets, an increase in the cost burden of compliance regulation, the integration of technology, a declining local population and struggles with meeting the needs of the younger generation.

Greatest National Opportunities and Challenges

The greatest opportunities at the national level include the establishment of a tiered regulatory regime for the banking industry and the expansion of more customer-friendly lending programs through entities such as the Small Business Administration.

With respect to challenges, the increasing cost burden of

compliance regulation, along with the disregard for the needs of community banks and small business, threaten the viability of the community banking industry. The philosophy that large financial institutions carry more importance than community banks is detrimental to the community banking model.

Importance of Scale and Scope

Each individual business model dictates the importance of size, as community banks under \$50 million will struggle given the regulatory burden and cost to operate in the current financial industry environment. The size of the institution is relative to the niche market that can be established, and the viability of smaller banks is a function of the willingness of owners to accept lower returns. Obtaining the same profitability as a large bank is virtually impossible in many markets.

Product diversification plays an important role in the business model, and community banks must be responsive and able to offer all products that the customers or businesses need in their community.

Important Characteristics of Bank Management and Boards of Directors

Bank management must be self-motivated, have strong

character, have knowledge of their customer base and local community and think long term for management solutions. Bank directors should also be involved with the community, devote the time needed to understand the bank business model and show integrity and knowledge of bank operations.

Serving Regions with Declining Populations and Slow Economic Growth

It is important for a community bank to establish a niche market and move into an area with some growth. Banks can also develop shared resources with other banks in the community in a non-competitive way.

The role financial service providers can play is to work with Congress to ease the burden of regulation. There is a concern that if community banks try to think or develop outside-the-box products, they may be in violation of an established regulation.

Areas of Research Beneficial to Community Banks

It would be beneficial for researchers to spend time with community bankers to study how they operate both inside the bank and outside in the local community. Other areas of research include the banking needs of younger generations and how

technology is used now and will be used in the future.

Understanding the advantages community banks provide to small businesses will help in the designing of future regulations in the banking industry. Also, allowing Midwest universities to produce research on local banking systems would be beneficial, given their more profound understanding of how the Midwest operates.

Further, research on the correlation of the economic and population growth in the presence of community banks, along with a cost-benefit analysis before and after regulation is implemented, will help promote the community banking model.

Competition from Nonbank Institutions

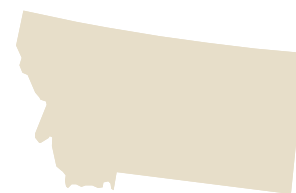
Competition has increased significantly, as community banks are experiencing increased competition from credit unions, the Farm Credit System, retail stores, brokerage companies and financing companies. The lack of regulation on nonbank financial institutions is a competitive threat, and nonbank financial institutions have an advantage with establishing a more available funding source while also requiring less time and effort to generate loans.

Montana

KEY POINTS

Local, flexible lending is key for a successful community bank model.

It's not enough for bank board members to be engaged and active in the community. Now, they have to have detailed knowledge in every area of banking.



Greatest Local Opportunities and Challenges

The greatest opportunities for community banks include the continued emphasis on local decision-making and individualized customer service, Main Street versus Wall Street banking and the expansion of product offerings.

The greatest challenges, however, include the costs of regulatory compliance, such as the high marginal costs associated with residential real estate lending in rural areas, pricing competition from the Farm Credit System and large banks, and the shrinking net interest margin.

Greatest National Opportunities and Challenges

The greatest opportunities at the national level include the frustration of customers with big-bank fees, the ability of community banks to meet individual needs, technology enabling the expansion and retention of the bank's customer base, and the application of regulations based on bank size or product volume helping to lessen regulatory burden and increasing deposits.

However, the greatest challenges include the commoditization of product offerings particularly in real estate, the inability to keep

up with regulatory changes and costs, decreasing exports with the potential of hurting agricultural prices, the speed of technology change and potential fraud, and the possibility of rapid inflation.

Importance of Scale and Scope

Scale and scope among community bankers is very important, especially in metropolitan areas. Larger banks see less impact on their margins due to keeping up with new regulations and also have the ability to keep up with changing technology.

In rural areas, size is perceived to be less important if a bank is well capitalized, as this allows for an increased lending limit. Many rural banks choose not to engage in residential real-estate lending due to high marginal costs of compliance. At some point, significant growth can cause deterioration in customer relationships.

Important Characteristics of Bank Management and Boards of Directors

Traditionally, it was important for boards and management to be conservative, have common sense, stay engaged, understand the dynamics of their community and have a basic knowledge of how banks stay profitable. Today, though, board

members, including external boards, need a complete and detailed understanding of every facet of banking, such as interest rate risk, lending and compliance.

Serving Regions with Declining Populations and Slow Economic Growth

One of the most important aspects of the community bank model is community lending. Community bankers have daily interaction with their customers and a great amount of accountability in the success of the area. It is also becoming increasingly important to use any or all available technology, if economically feasible.

Areas of Research Beneficial to Community Banks

Areas of research include the time necessary to perform a loan given different lending levels or types, along with research methods to further break down regulations based on the size of a bank or the volume of certain products.

Competition from Nonbank Institutions

Community bankers feel competition is not currently a large problem on the funding side, given liquidity levels. On the lending side, the biggest nonbank competition comes from the Farm Credit System, which has become

incredibly aggressive in Montana both on rates and terms. Banks cannot compete with these terms because regulators would criticize them for the interest rate risk inherent in long-term fixed rates, especially on agriculture credits, and the rates would kill earnings as banks do not have the same tax advantages as the Farm Credit System.

“Community bankers have daily interaction with their customers and a great amount of accountability in the success of the area.”

Nebraska



KEY POINTS

The Farm Credit System could be used to enhance the community bank model.

Regulatory oversight should be applied in a risk-based manner.

Greatest Local Opportunities and Challenges

The greatest opportunity at the community level is residential and commercial real-estate lending, including nonconforming loans. The greatest challenge at the community level is competing with the Farm Credit System's ability to offer long-term fixed-rate loans with funding that has the full faith and credit of the U.S. government and a dividend to borrowers based upon its profitability.

"Product diversification is important, but a double-edged sword, as offering a broad range of products invites more regulatory burden."

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is capitalizing on the struggles of the too-big-to-fail banks. The greatest challenge at the national level is the overwhelming regulatory burden. If regulation cannot be applied in a risk-based manner, the community bank model will fail in areas the too-big-to-fail banks do not want to serve.

Importance of Scale and Scope

Product diversification is important, but a double-edged sword, as offering a broad range of products invites more regulatory burden. A community bank's ability to balance personnel and technology costs is also important.

Important Characteristics of Bank Management and Boards of Directors

For bank management, important characteristics include maintaining effective information systems to further the effectiveness of the board, having accountability to the board in addressing issues and following bank policies, and executing plans.

For bank directors, the most important characteristics include having knowl-

edge about banking and the bank's market, knowing what is important strategically, participating actively in the functions of the board, asking questions, thinking independently and always acting in the best interest of the bank.

Serving Regions with Declining Populations and Slow Economic Growth

Banks must be well-capitalized, staffed to serve branch markets effectively with a broad product line leveraged with technology and heavily involved with economic development and the quality-of-life elements necessary for that development. An impediment is the degree of compliance and compliance management, which should be much less than that of banks that market to the masses.

Areas of Research Beneficial to Community Banks

One area of research is the impact of the Farm Credit System's government-subsidized operations on rural economies and community banks. Other areas of research are the role of community banking in regions where locally chartered banks have become branches of other banks and finding ways to leverage the Farm Credit System to enhance the com-

munity banking model. The Farm Credit System could become the farm version of the Federal Home Loan Bank and, together, the Farm Credit System and community banks could provide tremendous products and services to rural America.

Competition from Nonbank Institutions

Having escaped the Dodd-Frank Act, the Farm Credit System is creating greater competition on the lending side, pushing the dividends they offer to borrowers more aggressively. The availability of credit facilities for farm input suppliers and farm equipment dealers to offer financing suffered during the crisis. However, they are now back in full force and covering submarket rates by building it into the cost of their products. Competition, with respect to the funding side, includes more aggressive insurance companies in marketing annuities.

New Hampshire

KEY POINTS

A tiered regulatory approach would be preferable to a one-size-fits-all approach.

Nonbank institutions are becoming more aggressive in seeking business currently done by banks.



Greatest National Opportunities and Challenges

The greatest challenge is regulatory burden, such as qualified mortgage rules not accommodating “jumbo” lending. Fair Lending Act compliance versus qualified mortgage rule compliance creates a dilemma, as 20 percent of loans currently made would fall outside of the qualified limits. Bankers feel increasing regulations are impeding their ability to lend, as community bankers are competing against the “no-money-down” loans.

Overdraft fee restrictions are presenting a challenge, as overdrafts and other fee income are “bread and butter” for community institutions given the reduction in net interest margin. The reduction in net interest margin is another challenge, as is information technology security and short time frames for compliance with new regulations.

The greatest strength of community banks is the ability to provide flexible loan products. As interest rates and the economy improve, displacing the one-size-fits-all regulatory approach with a tiered approach will improve opportunities for providing such loans.

Importance of Scale and Scope

A greater amount of regulations will inevitably lead to fewer community institutions, as regulation such as the Dodd-Frank Act has a disproportionately greater impact on smaller institutions and Consumer Financial Protection Bureau regulations are not sufficiently differentiating or exempting smaller institutions. Further, it is not cost effective for a small institution to employ or contract with individuals with necessary compliance expertise and the time to devote to compliance.

Competition from Nonbank Institutions

Nondepository home loan lenders continue to offer products common before the crisis. Increasing regulatory and supervisory constraints prohibit banks from participating in these activities or services.

Credit unions, leveraging their tax-exemption and other advantages, are pushing aggressively for more market share and are increasingly aggressive in marketing, specifically targeting banks in their advertising. Credit unions are also offering rates that are impossible for community banks to match responsibly, while increasing the number of their loan offices and new branches.

“Fair Lending Act compliance versus qualified mortgage rule compliance creates a dilemma, as 20 percent of loans currently made would fall outside of the qualified limits.”

North Carolina



KEY POINTS

Industry consolidation allows banks to not only increase market share, but retain talent as well.

Smaller banks must find their niche, as they can't offer the same product diversification as larger banks.

Greatest Local Opportunities and Challenges

The greatest opportunity within the community is industry consolidation, allowing for increased market share and the ability to retain talent. The greatest challenge at the community level is the lingering sluggish economic environment, which is resulting in fewer loan opportunities and the inability to increase net interest margin.

“As quoted by one banker, ‘We are not as much worried about [too big to fail] as we are [too small to succeed].’”

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is the rebirth of small-business borrowing, allowing community banks to support small businesses, professionals, consumers and nonprofit agencies in the communities they serve. The greatest challenges threatening the business model are the increased regulatory burdens and cost of compliance with legislation such as the Dodd-Frank Act.

Importance of Scale and Scope

Scale and scope are very important to the viability of the community bank business model. Smaller banks do not enjoy the economies of scale to spread new regulatory costs. Smaller community banks are forced to find their niche to survive, as they cannot effectively provide as much product diversification as a larger bank.

As quoted by one banker, “We are not as much worried about [‘too big to fail’] as we are [‘too small to succeed’].” Banks cannot rely solely on ‘spread lending’ in this prolonged low-rate environment as a pathway to success. Rather, they must diversify their model and have the resources to deal with the

Dodd-Frank Act, Consumer Financial Protection Bureau and potentially Basel III.”

Important Characteristics of Bank Management and Boards of Directors

Bank management must have integrity, be proactive in looking for ways to maintain a competitive edge and be engaged, focused, transparent and knowledgeable of their local communities.

Board members must be engaged and actively involved in their bank's affairs, have the ability to make prudent personnel decisions, have diverse professional experience, be adept at strategic planning, have common sense and have a credible reputation with knowledge of the communities served.

Serving Regions with Declining Populations and Slow Economic Growth

Credit enhancement tools, such as Small Business Administration programs, can be very helpful in allowing businesses access to capital while keeping lending standards intact. Regulatory impediments to these institutions may come in the form of strict capital requirements and concentration limits that are not always one size fits all.

Areas of Research Beneficial to Community Banks

Areas of research include ideal balance sheets or income statement profiles, community bank capital adequacy relative to risk profiles, ways to successfully execute interest-rate swaps for longer-term loans that are not prohibitively expensive, and the unintended consequences of one-size-fits-all or broad-based examination processes.

Other areas of research also include preferences of first-time bank customers (ages 18-25), different regulatory processes for small community banks, and potential new markets and business models.

Competition from Nonbank Institutions

Credit unions have an exceedingly unfair advantage with their tax-exempt status. When paired with a good business model, this will give them a significant advantage in the future.

North Dakota

KEY POINTS

The oil boom has created new opportunities for community banks.
Hiring and retaining qualified staff is a significant challenge.



Greatest Local Opportunities and Challenges

The greatest opportunity to community banks is centered on growth, with increased customers, deposits and loan demand. However, these expanding areas can also be viewed as a challenge, as there is a need to establish relationships with the new customer base and work with new products. Banks also need an understanding of environmental opportunities that have been created as a result of the oil boom.

Other challenges facing community bankers include the inability to hire and retain qualified staff and adapt to increased regulatory burdens and managing interest rate risk. There is also increased competition with tax-exempt entities.

Greatest National Opportunities and Challenges

A significant opportunity at the national level is the ability to use technology to create cost efficiencies. The increasing consolidation of banks can cause challenges in implementing these technologies.

Overly burdensome regulation is a significant national-level challenge. This includes regulation involving various real estate disclosure requirements. Specifically,

uncertainty exists as to other federal laws including the Farm Bill and Basel III capital requirements. The too-big-to-fail idea has a major impact on smaller community institutions, as the media has grouped all banks together, regardless of their responsibility in the crisis.

Importance of Scale and Scope

Scale and scope are very important to the viability of the community bank business model. Community banks have limited resources and are generally not able to take advantage of the economies of scale available for larger banking institutions. Based on limited resources, some products are unattainable for community banks.

Federal regulations are stifling some banks' previous activities, such as producing auto loans. Also, many consumers now expect certain banking services such as online banking, which in the past were an "added bonus."

Important Characteristics of Bank Management and Boards of Directors

An important quality of bank senior management and board members is the need for engagement. Senior management members should have a more active role in responding to risks.

Senior management and board members also need to learn to work with the younger generation of employees. Specifically, it is important to manage the younger generation's idea that it is normal to have multiple jobs throughout one's career.

Serving Regions with Declining Populations and Slow Economic Growth

The idea of the one-size-fits-all regulatory approach does not work. In this current environment, the financial sector must maintain a flexible working model. Specifically noted is the inflexibility of the Financial Services Authority and its resulting decisions that "defy common sense."

The Bank of North Dakota has been a valuable resource for community banks, as it has been actively working with community banks to create mutually beneficial relationships.

Areas of Research Beneficial to Community Banks

One area of research would be to compare the benefit of the increased regulatory environment against the cost of regulatory compliance, specifically at the community banking level. This study should include the impact of regulatory burden on smaller institutions and address how more responsibilities are

being placed on community banks, including flood insurance and dealing with the banking needs of broken families. This will bring awareness to the positive effects of banking.

Competition from Nonbank Institutions

Regarding lending, there is greater focus on non-taxed credit unions expanding into commercial lending. There is increasing displeasure relating to the fact that government-sponsored entities such as the Farm Credit System are able to "cherry pick" loans, due to their significant advantages over tax-paying entities such as banks.

Regarding funding, customers are now looking for better returns.

Ohio



KEY POINTS

Community banks are vital to declining areas, as they can provide special financing for their projects.

Management and board members must be flexible, adaptable, connected and actively involved in the community.

Greatest Local Opportunities and Challenges

The greatest opportunities come from strategic expansion and consolidation opportunities and by capitalizing on excellence in customer service. Community banks can offer reasonable financing to small businesses and consumers, though it is difficult to be competitive.

Other opportunities include supporting economic growth in communities, leveraging the bank's "community mindedness," using technology and customer service to help differentiate community banks from larger ones and seeing increased deposits and future loan opportunities due to the shale boom.

The most significant challenges include the growth of regulation, cost of compliance and pressures from competitors including co-ops, credit unions and payment system providers, given the extended low interest rate environment and relatively weak loan demand. Other challenges include continuing to offer high service levels and navigating economic decline in key markets. Technology can also be a challenge, as younger generations are using more technology and the use of technology can present additional risks. It is important to stay competitive in this area yet difficult to attract new talent. Companies such as Square and PayPal are taking over payments in a powerful way.

Greatest National Opportunities and Challenges

On a national level, opportunities include economic improvement; improved housing markets; growth through consolidation; the ability to differentiate from larger competitors; community focus; the opportunity to scale regulation relative to the business model, size and risk of the bank; and capitalizing on affordable technological advances.

Challenges on a national level include growth of regulation, a lack of differen-

tiation, cost of compliance, resolving too-big-to-fail, competitive pressures and the persistent low interest rate environment. Other challenges include offering high-quality services and maintaining high levels of personal service as a community bank due to increased regulatory burden, weathering economic decline in markets, and managing the impact of Basel III capital rules on community banks. Specifically, a challenge facing the community bank industry is the qualified mortgage rule and the potential for added liability for loans outside the parameters and possible effects on directors and officers liability coverage.

Importance of Scale and Scope

There is probably a minimum scale needed, although the level is uncertain. Technology will increase in importance for small community banks to offer differentiated products. Balance is important, as banks must be big enough to compete but small enough to remain close to their customers.

Important Characteristics of Bank Management and Boards of Directors

It is important for management and boards to be flexible and adaptable and to have

deep connections and active involvement in the community. Management and board members must also have the ability to develop business, monitor and control risks and costs, and focus on asset quality, not asset growth. Boards should be informed and have diverse backgrounds, including ethnicity, race and financial experience within the community they are serving.

Serving Regions with Declining Populations and Slow Economic Growth

The community bank model will continue to work, as many communities are more interested in basic and cost-effective financial services than "bells and whistles." The existence of community banks is necessary to the survival of these communities, as community banks can provide special project financing for businesses in these areas. The community bank must be more than an engine for growth, but also an active participant toward growth in communities experiencing economic declines.

Areas of Research Beneficial to Community Banks

Areas of research include the costs of compliance, including direct costs, and the impact on loan volume and on a community when

"The community bank must be more than an engine for growth, but also an active participant toward growth in communities experiencing economic declines."

Ohio (cont.)

access to banking services is lost or diminished.

Other areas also include the impact of tax-exempt status of credit unions to the viability of community banks, how to identify banking services desired in a particular market, and the opportunities created by a “shared services” model for small community banks.

There is still a need for basic cost-effective bank services, and the symbiotic

relationship between bank and community. A bank must not just be an engine for growth but a vision for growth in communities to rally folks together.

Competition from Nonbank Institutions

Competition is intense, as government-sponsored enterprises—including the Federal Land Bank and the Farm Credit System—are under-

pricing community banks. Credit unions remain the most serious challenge. For smaller community banks, competition from mortgage lenders and auto finance dealers has limited opportunities to lend in these areas.

Pennsylvania

KEY POINTS

Loans to businesses in declining regions are necessary to help reverse those trends.

Community banks must focus on quality, personalized customer service.



Greatest Local Opportunities and Challenges

The greatest opportunity within the community is to increase market share by capitalizing on the consumer and commercial customer base. Generally, small- to mid-sized businesses are not satisfied with the larger regional and money center banks’ ability to provide quality, individualized customer service. These banks’ lack of personalized service has left many consumers disenfranchised.

The greatest challenges, however, stem from increased regulatory burden from implementation, consistency and certainty perspectives. The cost of understanding the evolving landscape and implementing new regulatory mea-

sures in a time of slow quality loan demand, increased capital requirements, low interest rates and compressed margins is very challenging.

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is to focus on quality, personalized customer service. This will help the average consumer prosper and help businesses grow jobs, foster positive economic activity and improve local economic conditions. By improving local economic conditions throughout the country, the aggregate effect on the national economy will be apparent.

The greatest challenge for community banks at the national level includes man-

aging uncertainty in the current business and regulatory climate. The lack of certainty regarding regulatory changes, compliance costs, capital requirements and health-care expenses creates a major challenge to the community bank business model.

Importance of Scale and Scope

Scale and product diversification are very important to the viability of the community bank business model. Many community bank executives within Pennsylvania believe they will be unable to compete with larger banks unless they attain at least \$1 billion in asset size. As examples, a lack of scale hinders a bank’s

continued on the next page ►

Pennsylvania (cont.)

ability to compete with larger competitors with respect to funding alternatives, net interest income, fee income, technology enhancements, marketing/customer acquisition, regulatory compliance and capital procurement.

Product diversification is also important to the community bank business model. Diversifying loan products and various fee income initiatives will allow community banks to enhance earnings, which, in turn, will allow banks to satisfy regulatory requirements, retain capital and provide a return on capital.

Important Characteristics of Bank Management and Boards of Directors

An engaged, knowledgeable, diverse and community-aware management team and board of directors are vital to creating a high-performing

community bank. The board of directors should maintain the proper amount of independence and provide management with clear, measurable, high-level goals to which management is held accountable. Complacency and inaction regarding a consistently underperforming management team should not be tolerated by members of the board.

Bank management needs to clearly understand where the organization should be to place it within its high-performing peer group, effectively and efficiently implementing the actions necessary to attain such a distinction.

Serving Regions with Declining Populations and Slow Economic Growth

Community bankers feel providing capital in the form of small business and commercial loans to regions

experiencing negative population and economic trends is needed to reverse those trends. Having strong, viable community banks operating in such regions is important to multiplying the effect of injected capital in a community. This will ultimately create jobs, economic and population growth, and a higher standard of living for the community.

Supervisory and regulatory bodies need to be cognizant of issues facing organizations and provide support where appropriate to allow these organizations to prosper. Short-term guidance and an understanding of local issues are necessary to achieve longer-term objectives. Inconsistency in regulatory approach is also an impediment to institutional growth.

Areas of Research Beneficial to Community Banks

An area of research would involve analyzing high-performing community banks by region (with the smallest segmentation possible) to determine strategic direction and goal setting. This could include data on net interest income, composition of net interest income, fee income, composition of fee income sources, funding sources, composition and cost of funding sources, loan customer segmentation (consumer, residential mortgage, home equity, small business commercial and industrial (C&I), small-business real estate, commercial C&I, commercial real estate), asset size, regulatory compliance costs, asset-liability risk measurements, regulatory capital requirements, and return on capital requirements.

Another report that would be helpful is a concise quarterly summary report provided by a high-level authority that is analyzed over time to provide community banks with a blueprint on how to become a high-performing institution and how to track the progression of that peer group. It is acknowledged that this information is somewhat available from the Uniform Bank Performance Report and other sources, but a more user-friendly, high-level, independent analysis for high-performing community banks is needed. A study on the impact that a community bank has on a local economy would also be of great benefit to the industry.

Competition from Nonbank Institutions

On the lending side, nonbank financial institutions such as mortgage companies provide less competition for community banks. Nonbank auto lenders and household good lenders have diminished in terms of competition. Credit union competition for consumer and small-business customers has increased substantially on both the lending and funding side. Funding side competition overall has decreased for community banks as evidenced by the high level of liquidity currently in the community bank system. Wholesale funding sources remain a viable funding source for many institutions as needed.

“Community bankers feel providing capital in the form of small business and commercial loans to regions experiencing negative population and economic trends is needed to reverse those trends. Having strong viable community banks operating in such regions is important to multiplying the effect of injected capital in a community. This will ultimately create jobs, economic and population growth, and a higher standard of living for the community.”

South Dakota

KEY POINTS

Strong rural economies provide tremendous opportunities for community banks.

Regulations are hindering housing in rural areas.



Greatest Local Opportunities and Challenges

The greatest opportunity for community banks is to build relationships and capitalize on strong rural economies to create loan growth, while leveraging technology to better serve existing customers. Another opportunity is attracting and retaining future customers.

The greatest challenges at the community level include the less-regulated and/or tax-exempt status of the Farm Credit System and credit unions. Rural housing needs are harder to meet each year because of regulations and appraisals. Agricultural customers are outgrowing community banks, as their lending needs are becoming larger than smaller banks' lending limit.

Greatest National Opportunities and Challenges

The greatest opportunities at the national level include the negative press on the too-big-to-fail banks and the advantageous relationship positions community banks have in their region. However, the greatest challenges at the national level include consumer compliance, the regulatory burdens on rural housing loans and the low interest rate environment,

which is causing margin compression.

An innovative idea would be to allow rural community banks to perform their own appraisals on small 1-4 family loans within the community. These loans are very low risk, and individuals who travel into rural communities to complete these appraisals know little, if anything, about the community.

Importance of Scale and Scope

Size is not the answer to survivability, because the regulatory burden only grows as the bank reaches certain asset-size thresholds. The size of a bank must relate to the community it serves, giving the bank the capacity to serve that community.

Information technology is one area that disproportionately impacts smaller banks. Smaller, rural banks need to offer some or all of the same technology-related options for consumers, but these banks have very few opportunities to transfer these costs to the customers.

Important Characteristics of Bank Management and Boards of Directors

Directors must be aware of daily operations of a bank, while serving local businessmen and farmers that understand the needs

of the community. Officers must be dynamic, educated, disciplined ambassadors for the bank.

Serving Regions with Declining Populations and Slow Economic Growth

Regulations on rural housing are directly contributing to the decline in rural America. If customers cannot obtain financing to build/buy a house from their local bank, it is more likely that they will seek out other opportunities. Rural banks in declining population areas will need to work even harder on developing and maintaining their relationship-driven business model, while also developing a customer-friendly information technology platform. This will allow the next generation of customers to stay with their hometown bank. Many rural banks will have no choice but to branch into larger communities to grow and to follow their customers as they move to the nearest metropolitan center.

Areas of Research Beneficial to Community Banks

Community bankers question the cost of regulatory burden on banks and want to know the cost of the discontinuation of services in rural parts of the state and throughout the country. Most of these regulations

were intended for larger banks. Bankers also question if consumers are protected given dwindling financial services options.

Competition from Nonbank Institutions

Nonbank competitors—including the Farm Credit System, credit unions, grain elevators and seed dealers—are more aggressive on the lending side. Regulations are driving consumers out of banks to less or nonregulated entities to avoid the hassles of increased scrutiny. There is less competition in 1-4 family housing in rural America because the appraisal nightmare applies to everyone except for the Farm Credit System, as the Farm Credit Administration conducts its own appraisals.

Tennessee



KEY POINTS

Community banks need to show that they are the financial institution of choice in their communities.

Regulatory burdens, specifically the Consumer Financial Protection Bureau and the Dodd-Frank Act, pose a significant challenge for community banks.

Greatest Local Opportunities and Challenges

The greatest opportunities include economic growth, increased mortgage business, revival of the construction market, opportunities for acquisition and the ability to demonstrate that community banks are the “financial institution of choice” in local communities.

With respect to challenges, community banks within the state are facing pricing issues and an environment of weak loan demand and competition from credit unions and out-of-state banks. Impending mortgage rules, specifically the qualified mortgage rule and the liability associated with Ability to Repay entails uncertainty. If a bank is not making qualified mortgages, there is a concern of exposure to lawsuits in the future.

Greatest National Opportunities and Challenges

Several opportunities that could impact the community bank business model at the national level include creating a bifurcated regulatory system (regulatory “right-sizing”), addressing consolidation issues and benefiting from credit union taxation. There is also the opportunity to capitalize on the positive perception of “Main Street” banking, given the negative connotation of “Wall Street” banking.

However, there are several challenges at the national level threatening the community bank business model. Regulatory burdens, with regard to the Consumer Financial Protection Bureau, the Dodd-Frank Act and various compliance regulations are not advantageous for small community banks.

The qualified mortgage rule is most frequently cited among the state’s community bankers. Deposit acquisition is also noted, as there are growing concerns that current liquidity could change funding philosophies and pose a problem when funding challenges emerge. Non-taxable and/or less regulated industries encroaching on the banks’ market share also pose a threat to the community bank business model.

Importance of Scale and Scope

Scale and scope are becoming exceedingly important given increasing compliance costs and the fact that relationship banking has limitations in a more globalized economy.

Scale is important to the extent that it allows for regulatory cost covering and for obtaining adequate stockholder return. Given the squeeze on margins, the pressure to find alternative revenue sources and increasing expenses, it has been difficult for banks to determine how big they need to be. Many bankers noted that there is the idea that it will be difficult to survive long term at less than \$500 million. Revising compliance and Bank Secrecy Act requirements would help lessen scale issues directly.

Size also impacts capital, as bankers feel regulators do not consider a given bank’s shareholders, which are a real and practical concern for the banks. Compliance costs have increased dramatically over the past several years, but only a fraction of the Dodd-Frank Act rules have been written, which is a troubling reality for compliance costs. For smaller banks located in larger metro areas, CRA requirements are impeding bank operations. Regulators are telling institutions that they need to start branching into low to moderate income areas, which is not feasible for smaller banks.

Important Characteristics of Bank Management and Boards of Directors

Important qualities for bank management and board members to have include experience, integrity, flexibility, patience, a willingness to participate in continuing education, a proactive mindset, a willingness to challenge management assumptions about future business viability and the ability to facilitate relationships with regulators. It is also important to be able to hire qualified staff and have the experience to function during “tough times.”

“The ‘cradle-to-grave’ model is noted as the most efficient model for community banks, as it would be beneficial to allow community banks to design their own products and tailor regulations to help banks jump-start areas of declining population and slow economic growth.”

Tennessee (cont.)

Serving Regions with Declining Populations and Slow Economic Growth

In general, return on assets, asset quality and CRA pressures make it difficult for community banks to survive. Mergers are needed in some cases. The “cradle-to-grave” model is noted as the most efficient model for community banks, as it would be beneficial to allow community banks to design their own products and tailor regulations to help banks jump-start areas of declining population and slow economic growth. Regulations written

for large banks do not allow community banks to thrive, as federal focus is not on rural economies.

Areas of Research Beneficial to Community Banks

Helpful areas of research include studies of successful banking personnel, credit union tax, the effects of regulatory costs and tighter margins and the characteristics of rural economies.

Other areas of study include the economic impact of Consumer Financial Protection Bureau on community

banks, the true risks associated with commercial and industrial lending versus real estate secured lending and the effects of incentivizing examiners to help community banks find real solutions to current problems within the banking industry.

Competition from Nonbank Institutions

Nonbank competition has not posed a challenge to community banking. However, competition from credit unions and others such as Wal-Mart and

Internet service providers have an impact.

Capital and opportunities will leave the community banking industry for other markets to avoid unequal regulation if the regulatory environment is not tailored for community banks. Nonbanks are also handling many of the smaller loans, creating some competition for community banks within the state.

Texas

KEY POINTS

The one-size-fits-all approach to regulation impedes banking operations.

Community bankers have significant advantages through their personal relationships with local citizens and businesses.



Greatest Local Opportunities and Challenges

The greatest opportunities at the local level are predicated on moderate economic growth, which should enhance lending opportunities, promote loan portfolio growth, reopen the doors for potential mergers and/or acquisitions, and energize new financial services in rural markets. Select segments in the state will see additional benefit from oil exploration and production.

The greatest challenge at the local level is the regulatory environment, as bankers are spending 10 to 15 percent

of net income on compliance. The increase in regulation and overly complex regulatory environment impedes banking operations and contributes to thinner margins. In some areas, banks have ceased offering low-dollar consumer loans and home mortgages due to overly burdensome regulation and the fear of noncompliance.

Greatest National Opportunities and Challenges

Though some bankers believe no opportunity exists at the national level, others noted the possibility to enact changes in the Dodd-Frank

Act. Moderate economic growth and improvement, the use of technology and the capitalization of merger and acquisitions could provide significant opportunities in the future.

Noted challenges at the national level included regulatory “overload and overreach” from new compliance legislation and associated costs. Capital requirements under Basel III, mortgage lending restrictions and perceived anti-bank sentiments are also causing concern for the viability of the community banking model. Other challenges include shrinking

continued on the next page ►

Texas (cont.)

“[At \$500 million], there is a need to consolidate to be able to afford the associated compliance costs. In effect, small banks are experiencing a ‘too-small-to-comply’ problem and are disappearing as an undesired consequence of the one-size-fits-all regulations.”

interest rates and net interest margins, significant disadvantages from tax-exempt entities and compensating for increased burdens on the consumer. There is a general consensus among bankers that banking is no longer a viable career.

Importance of Scale and Scope

Scale and scope are very important for the viability of the community banks. If a bank reaches \$500 million, additional regulations are implemented, and there is a need to consolidate to be able to afford the associated compliance costs. In effect, small banks are experiencing a “too-small-to-comply” problem and are disappearing as an undesired consequence of the one-size-fits-all regulations. These challenges hamper the community banking system, which many community bankers believe is the last line of defense in preventing nationalization of the banking industry.

Important Characteristics of Bank Management and Boards of Directors

Characteristics important to high performance for bank management and board members include experience, commitment, foresight, flexibility, a strong business understanding, integrity, teamwork, discipline, effective communication skills and involvement or ties to the community. It is difficult to attract and retain effective senior management and directors, and unexpected events leading to a need for replacement members can be

detrimental to the viability of a bank.

Serving Regions with Declining Populations and Slow Economic Growth

Community bankers feel the one-size-fits-all regulation is impeding banking operations and the viability of the community banking model. Punitive laws and policies hurt community banks.

Community bankers have the advantage of personal banking relationships with citizens and local businesses. However, this strength may not be valued by the younger generations who are not focused on personalized customer service. It is important for senior management and board members to exhibit leadership and have a vested interest in the community.

Areas of Research Beneficial to Community Banks

One of the major areas of research should be the effects of regulatory costs, both on the bank and consumer. Also beneficial would be a study about the increasing percentage of unbanked people due to regulations and perceived risk.

An additional benefit may be derived from examining the costs for new mortgage loans and perhaps conducting exit polls for consumers/bankers closing a mortgage loan or even a checking account. Additional areas of suggested research include the limitation of credit in mortgage lending and foreclosures by community banks versus “mega” banks or mortgage lenders.

Competition from Nonbank Institutions

Though some bankers within the state feel there is little-to-no change in the competition, some note several changes at the national level. Items leading to an increase in competition include insurance companies, lower interest rates, the tax-exempt status of credit unions and large lenders and nonbank entities. Increased competition from nonbank financial institutions is also partly due to regulations not being as stringent or numerous for these entities.

KEY POINTS

Bank management and boards must have strong knowledge of the community and be heavily involved.

Competition is always increasing and will become even more intense in the future.



Greatest Local Opportunities and Challenges

The greatest opportunity for community banks is the ability to leverage intimate knowledge of local communities in providing loans. The greatest challenge is competition from big banks and credit unions.

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is the ability to change and/or redefine the business model. The greatest challenge for community banks is finding a way to attract and retain the next generation of customers.

Importance of Scale and Scope

Scale and scope are very important due to increasing fixed costs, such as regulatory compliance, technology and security.

Important Characteristics of Bank Management and Boards of Directors

The most important characteristics for management and board members are first-hand knowledge of the local community, the ability to be involved with and connect to local businesses in the community and the ability

to provide key products and services. Management and board members must also have the ability to detect, and willingness to accommodate and adapt to, the changing needs of customers and demographics.

Serving Regions with Declining Populations and Slow Economic Growth

During times of economic decline, mark-to-market accounting in effect suppresses lending.

Areas of Research Beneficial to Community Banks

An area of research that could promote a better understanding of the future of the community bank business model would be on a bifurcated regulatory system with appropriate regulatory expectations for community banks.

Competition from Nonbank Institutions

Competition is consistently increasing, whether it is from credit unions, payday lenders, prepaid debit cards or different and new delivery methods and payment systems, and community banks need to be able to adapt. Competition will become more intense in the future.

“The most important characteristics for management and board members are first-hand knowledge of the local community, the ability to be involved with and connect to local businesses in the community and the ability to provide key products and services.”

Virginia



KEY POINTS

The one-size-fits-all approach doesn't work well with community banking. Increased community involvement has become more important since the Great Recession.

“Regulators need to have an understanding of market-area differences and have the ability to measure and examine banks based on their specific market opportunities and constraints. This will require innovative regulatory thinking and analysis.”

Greatest Local Opportunities and Challenges

The greatest opportunities facing community banks include increasing value to the local community and capitalizing on customers looking for increased community involvement. This is more apparent on this side of the financial crisis.

The greatest challenges facing community banks are insufficient economic and loan activity to sustain the number of banks in the marketplace and the need to regain the community's trust in banks.

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is to demonstrate value to younger generations. The value tailored specifically to the community bank model allows for adaptability, which in turn helps to attract younger generations.

The greatest challenge at the national level is the general political, economic and regulatory environment. There is also the challenge of attracting and retaining talented directors and management.

Importance of Scale and Scope

Scale and scope are becoming increasingly important,

as it is imperative to spread costs and be able to access capital markets.

Important Characteristics of Bank Management and Boards of Directors

The current environment places pressure on community banks to recruit technicians and subject matter experts as directors. There is still a need for directors to serve as community leaders and for employees and senior management to have an understanding of how to work with “Gen Y,” technology, changing societal demographics and other aspects that affect the performance of a community bank. There is also a need for Securities and Exchange Commission experience for publicly held banks and innovative staff with the ability to reinvent banks themselves.

Serving Regions with Declining Populations and Slow Economic Growth

It is important to emphasize that the one-size-fits-all regulatory approach will not work in community banking. Regulators need to have an understanding of market-area differences and have the ability to measure and examine banks based on their specific market opportunities and constraints. This will require innovative regulatory thinking and analysis.

Areas of Research Beneficial to Community Banks

There is a need to examine and quantify the beneficial impact of a bank located in a community. The community bank model's sustainability could be threatened if certain lines of business are lost or changed. This includes mortgage overdraft, debit interchange, the impact of regulatory burden on banks in markets with stable or declining populations and the “de-multiplier” effect of losing a community bank in a market.

Competition from Nonbank Institutions

Credit unions are becoming more aggressive in commercial and mortgage lending. Many nonbank mortgage bankers and brokers are leaving the industry. The post-crisis environment has also led to a change in the payment system.

West Virginia



KEY POINTS

Gas development has created considerable wealth management opportunities for community banks.

Bank management and board members must be visionaries, strategists and problem solvers.

Greatest Local Opportunities and Challenges

The greatest opportunity for community banks in West Virginia is gas development in the Marcellus and Utica shale formation. This will result in benefits from increased demand for wealth management services by both landowners with oil and gas rights and by royalty owners with new income streams. There will also be an increase in the loan demand from individuals directly involved in upstream, midstream and downstream operations.

However, there will be challenges arising from the large inflow of cash/wealth into the local markets. Community bankers from the state anticipate customers who benefit from the gas development will do the following with their influx of wealth: pay off their debt, buy a new home or other large purchase item, and then put the remaining funds in the bank. Though West Virginia's community banks will have the opportunity to expand into wealth management product lines, there will also be an associated liability and reputational risk.

Greatest National Opportunities and Challenges

There are a number of multifaceted, multi-tiered con-

cerns plaguing the community bank business model, but the greatest challenge at the national level is the increasing burden and cost of federal regulation, including the cost of keeping bank directors and management informed. Increasingly, federal laws, regulations and statements of policy are forcing greater uniformity and conformity across bank products and services. This “cookie-cutter” effect has the potential of reducing or eliminating the ability of community banks to customize products and services, which will disadvantage small businesses and consumers in rural areas. Additionally, the current regulatory environment is slowly removing human judgment from the decision-making process. Banking is no longer an art, but a science.

The greatest opportunity for community banks on a national level is the ability to distinguish themselves from the large, regional companies through better customer service, leading to a stronger future.

Importance of Scale and Scope

Scale and product diversification are important, but as long as community banks continue to have a “regulatory box” built around them, scale will become more important and product diversification

“Many of the markets in West Virginia are experiencing declining population growth and economic decline, and larger financial institutions are not interested in serving these areas in a meaningful way. Hence, the community banking model is the only viable option in regions fitting this definition.”

less—to the detriment of the community bank business model. Regulatory compliance comes at a cost, and economies of scale are a proven means of addressing those costs. Similarly, products that do not fit the regulatory mold also come at a cost. Federal policy is pushing community banks away from the ability to establish product diversification and/or differentiation toward greater product standardization, in which case, scale wins and community banks lose.

Important Characteristics of Bank Management and Boards of Directors

Bank management and bank board members must be visionaries, strategists and problem solvers. They also need to be engaged,

continued on the next page ►

West Virginia (cont.)

enthusiastic and focused. Sound judgment is becoming less important as credit decisions are founded more on regulated criteria rather than the borrower's character and historical performance.

Serving Regions with Declining Populations and Slow Economic Growth

Many of the markets in West Virginia are experiencing declining population growth and economic decline, and larger financial institutions are not interested in serving these areas in a meaningful way. Hence, the community banking model is the only viable option in regions fitting this definition. Community banks are often the only provider that will craft unique solutions for borrowers in these areas, because they take the time to understand the customer's situation. To stabilize or restart growth in declining markets, community banks must be able to adjust to meet the needs of its residents. The one-size-fits-all model is a large supervisory or regulatory impediment for community banks to offer customized products and services will shut out many consumers and businesses in declining markets if not addressed.

Community banks are becoming increasingly "boxed in," thereby denying them the ability to craft flexible financing options unique to their markets. Also, the lack of high-speed Internet and good mobile device coverage in rural markets can be a barrier to the delivery of electronic and mobile banking products and services.

Areas of Research Beneficial to Community Banks

Prior to March 2000, the Federal Reserve published a functional cost analysis report that revealed the cost for banks, savings and loans, and credit unions to provide various products and services such as installment loans, mortgage loans, checking accounts and credit cards. Community bankers feel that reviving this report would give them a valuable tool in helping politicians achieve a better understanding of the cost of doing business for a community bank, so they would not be so quick to criticize the fees they charge to offset the cost of doing business.

A study of the overall cost of compliance versus the benefits gained by the consumer by product line would also be useful. Although consumer protections are needed and even necessary in some cases, consumer protections have become consumer entitlements in disguise. The consumer has been absolved of individual financial responsibility because regulators have created policy to ensure his or her protection.

Legislators, policymakers and bureaucrats should also get out of the Washington, D.C., beltway and spend some time in the rural areas of this country to understand the challenges community banks face at ground level. A general feeling is that people inside the beltway are too reliant upon so-called "experts" or general academic types who conduct research in a vacuum and who never spend real face time with the consumers, businesspeople and commu-

nity leaders impacted by their decisions. Policymakers need to realize that rural versus urban definitions do not matter as they are not reflective of the actual needs of the marketplace served. Policymakers should look at the business model, not demographics.

Further research is necessary to provide a greater understanding of the formula for successful banking through economic cycles and environmental changes. Research on trends in customer preferences, such as mobile and online usage, and product offerings would also be helpful.

Competition from Nonbank Institutions

Competition from credit unions has increased, as they have benefited from public backlash toward larger financial institutions post-crisis. The mortgage-broker business has taken a large downturn, but now seems to be increasing again, although it is not operating at past levels. Also, the regulatory environment has a propensity to push consumers of "modest means" out of traditional banking to nonbank lending products.

KEY POINTS

Community banks must be at the forefront of development efforts of declining areas.

Competition is fierce, as nonbank institutions become more aggressive.



Greatest Local Opportunities and Challenges

The greatest opportunity for community banks is the ability to take market share from bigger regional and national banks.

The greatest challenge is the competition from tax-advantaged and price-advantaged institutions such as credit unions and the Farm Credit System. Wisconsin has more state-chartered credit unions (eight) than banks (four) with assets of \$1 billion or more. Wisconsin also has the second highest number of credit unions per capita in the U.S.

Greatest National Opportunities and Challenges

The greatest opportunity at the national level is a tiered regulatory structure that would provide some relief for community banks while keeping regulatory focus on the largest banks.

With respect to the greatest challenge, community banks have similar regulatory responsibilities as large banks, placing them at a distinct disadvantage due to fewer resources.

Importance of Scale and Scope

Scale is extremely important, given that the average asset size of state-chartered banks

in Wisconsin is \$233 million. Size also hinders product diversification and innovation by community banks.

Important Characteristics of Bank Management and Boards of Directors

For bank management, increasing specialization leads to more outsourcing of duties, resulting in less overall breadth on the management team. It is getting more difficult to find directors who possess the necessary financial skills, the willingness to take on the potential liability and the desire to meet the ever-expanding time commitment. Banks must find individuals who have an overriding commitment to their community.

Serving Regions with Declining Populations and Slow Economic Growth

Declining population growth and economic decline affect all sectors of a community, including banks, schools, government and other businesses. Community banks must be at the forefront of re-energizing economic development efforts in these areas. A potential solution would be to create tax incentives for community banks that are dedicating resources to communities affected by declining population and economic conditions.

“It is getting more difficult to find directors who possess the necessary financial skills, the willingness to take on the potential liability and the desire to meet the ever-expanding time commitment. Banks must find individuals who have an overriding commitment to their community.”

Areas of Research Beneficial to Community Banks

Areas of research include the impact of direct government lending programs such as the Farm Credit System on community banks, the impact of taxation of credit unions and the value of community banking in small, rural communities.

Competition from Nonbank Institutions

The Farm Credit System and credit unions are becoming aggressive and creating significantly more competition for community banks. The regulatory pressure of making small, short-term loans has opened the door for profitable, less-regulated nonbank institutions such as payday lenders.

Wyoming



KEY POINTS

- Size is important, as it helps banks offer the features customers have come to expect.
- Community banks must be allowed to continue to provide personalized customer benefits.

Greatest Local Opportunities and Challenges

The greatest opportunities community banks have include the ability to establish favorable relationships with customers and the growing markets due to the energy industry expansion. The possibility that credit unions could lose their tax-free status due to the tightening federal budget could give community banks a more competitive advantage.

However, the low interest rate environment, paired with the increase in regulations, makes it difficult for community banks to compete with larger, national banks. One of the greatest challenges is the too-big-to-fail mindset, which is an impediment to the community banking industry.

Greatest National Opportunities and Challenges

The greatest opportunity would be eliminating the application of all new banking regulations to community banks under \$10 billion in assets. The state’s community bank members feel smaller banks were not the culprits in the recent financial debacle that hit our nation.

The greatest challenges at the national level are new regulations that are making it difficult for community banks to operate profitably. Trying to comply with new regulation reduces time spent helping customers. Most new regulations have little-to-no application on small community banks, yet these banks must spend time and money to ensure they are in compliance.

Importance of Scale and Scope

Size is very important, as community banks must offer the same bill pay, mobile banking, ATM, online banking and other commodity banking services offered by the national banks to retain and increase market share among consumers and younger small-business owners. Providing these products and services is difficult because of limited staff and interest margins,

as it is becoming even more difficult due to the increasing compliance costs.

Community banks need to grow in size to generate enough additional income to cover the costs of staying in compliance with regulations, while offering competitive products and services.

Important Characteristics of Bank Management and Boards of Directors

Bank management and board members must be active and engaged in the community to market the bank effectively. They must have a working knowledge of banking to help oversee operations, lending, compliance, personnel and economic outlooks. Board members need to attract younger directors with the ability to adapt to new and changing environments.

Serving Regions with Declining Populations and Slow Economic Growth

A holding company or regional office that can efficiently take care of such operations including compliance, vendor management, human resources, information technology and electronic banking gives local management and staff the necessary time to meet the needs of individual customers and provide personalized products. A community bank’s

“The greatest opportunity would be eliminating the application of all new banking regulations to community banks under \$10 billion in assets. The state’s community bank members feel smaller banks were not the culprits in the recent financial debacle that hit our nation.”

Wyoming (cont.)

ability to emphasize personalized benefits attracts local customers and enables it to remain competitive. Consumer compliance hinders this ability and forces banks to create “boxed products.”

Areas of Research Beneficial to Community Banks

Community banks could benefit from research that identifies the difference between community and large, national banks. For example, this could include the impact on community banks having a better understanding of how large banks

work and how they manage given policies and procedures. Further research could also examine how federal agencies, such as the Farm Credit System, create unfair competition by obtaining high-quality loans.

Another important area of research would be the impact of federal regulations on small banks, particularly examining the effects of the one-size-fits-all regulations.

Competition from Nonbank Institutions

There has been expansion in the mortgage-lending

industry, and lenders are still able to make riskier loans that banks are unable to make due to increased regulation. The Farm Credit System is exempt from interest rate swaps, but community bankers feel agencies overseeing operations do not seem aware of this issue. Thus, bankers need to be in the forefront of these agency meetings to have their opinions heard.

